GENERALI INVESTMENTS

Market Perspectives

Spring fever

March 2019

Content

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Global View

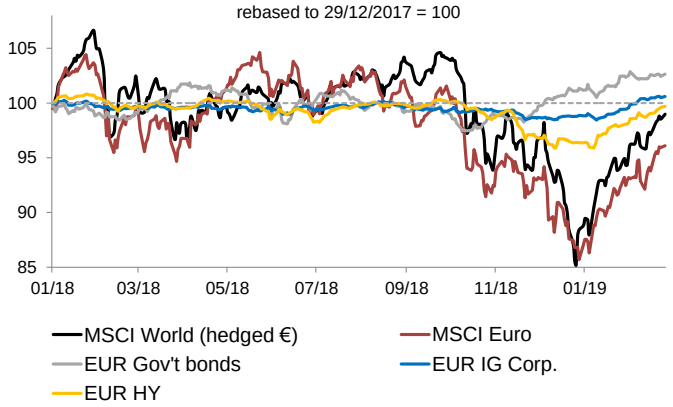
Vincent Chaigneau / Thomas Hempell

- **Spring has come early this year, and risk assets too are flourishing – despite the slump in exports and industrial data. Investor participation has been poor, hence this rally still has legs for now.**
- **Global risks still abound (not least the US/EU trade spat), but the near-term triggers look rather friendly: China's National People's Congress, ECB meeting and Brexit (semi) conclusion. China's policy support is starting to play out, and we remain confident that a sharper global downturn will be avoided. Importantly, low inflation has helped central banks turn more dovish, creating the conditions for a 'mini-Goldilocks'.**
- **We keep a pro-risk bias, with a prudent overweight in equities and an underweight in Govies. We trim our short-duration bias especially in credit, where a steeper credit curve makes longer-dated EUR IG more attractive. We further reduce the cash OW.**

It's winter still, but the weather has been exceptionally warm; markets too have got spring fever. After a dismal last quarter 2018, global equities have recouped most of their losses. And thanks to a dovish U-turn by the Fed and falling core yields, fixed income assets have done rather well, too, despite the sharp rebound in risk sentiment.

Asset class total returns

rebased to 29/12/2017 = 100



We continue to warn against fading this risk rally too quickly. After sticking to its normalization course through most of last year's market wobbles, the Fed is now paying closer attention to global risks and market volatility. Not only the rate hikes have been paused, but the Fed is now questioning the fast reduction of its balance sheet. This new patience is also backed by more muted price pressures: despite a very tight labor market, the risk of an inflation overshoot has subsided.

The Fed is not alone. The ECB will likely deliver a new TLTRO on 7 March. It looks likely to keep rates on hold this year; and if it moves at all, this will be to rebalance its policy in a way that is less penalizing for banks (and positive for growth). The BoE too has signaled a more dovish stance. Some EM central banks, e.g. India's, have surprised with rate cuts, in contrast to last year.

Continued data disappointment has not spoiled the early spring fever. Exports and industrial data have slumped, with the euro area PMI export order component at a 7-year low of 46.5. The resilient activity in services – which still make up for the biggest share oft the advanced economies – as well as the very cautious investor positioning have helped markets climb a wall of worry.

Better news in China is helping, too. Lending data for January soared. News on the trade war has improved. Constructive progress in the talks has led President Trump to postpone the March 1 deadline for even higher tariffs. Given the complexity (US trade deficit, intellectual property rights and market access), a deal may still take time. But the risk of an uncontrolled escalation has diminished.

We are also confident that Brexit is not headed for a disaster. Political brinkmanship persists, but there are mounting signs that British MPs are taking control of the process to avoid a no-deal Brexit on March 29.

Risks of course have not disappeared. US trade pressures may turn from China to the EU, with President Trump due to decide on car tariffs by mid-May. The US debt ceiling may cause ructions. We are not losing much sleep over the EP elections in May, though populism will advance. We expect a more discernible recovery of Germany and the EA by summer, but the US will slow and the headwinds to global trade persist.

Bonds	**25/02/19***	**3M**	**6M**	**12M**
10-Year Treasuries	2.67	2.75	2.85	2.90
10-Year Bunds	0.11	0.20	0.40	0.60
Corporate Bonds				
BofaML Non-Financial	131	130	150	170
BofaML Financial	139	140	160	180
Forex				
EUR/USD	1.13	1.14	1.16	1.20
USD/JPY	111	109	108	105
Equities				
S&P500	2788	2845	2745	2670
MSCI EMU	118.0	118.0	117.0	117.0

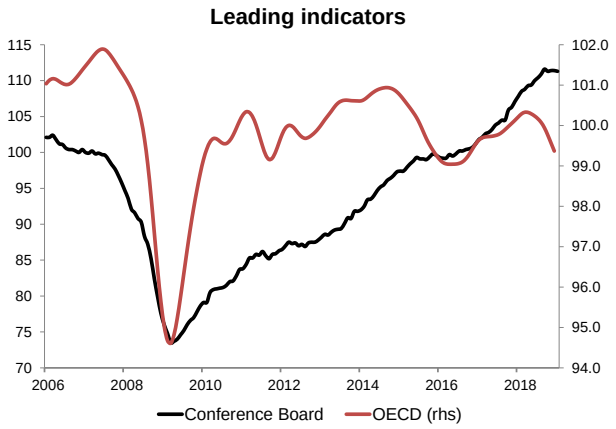
* avg. of last three trading days

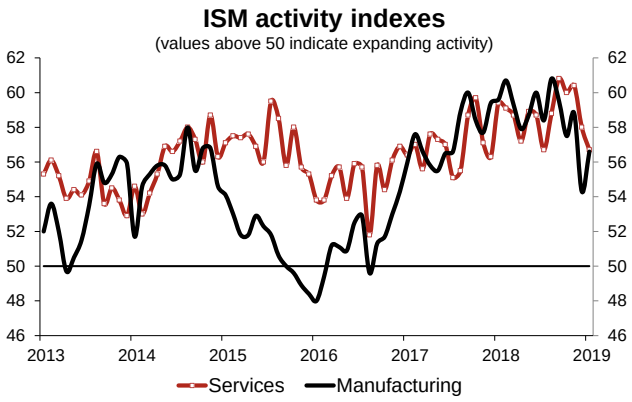
Mini-Goldilocks to prevail for a while

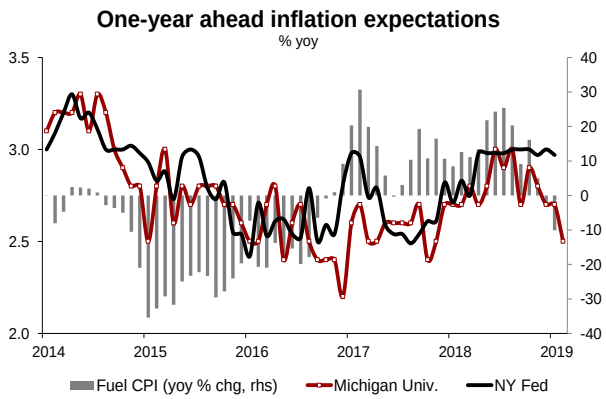
We continue to favor a prudent overweight in equities, credit and EM govies, while we stick to an underweight in core and quasi-government bonds. With the more dovish stance by central banks capping the upside to yields, we trim our overweight in cash. We also reduce the short-duration tilt in EUR IG credit as the steep spread curve makes longer-dated corporates more attractive.

USA

Paolo Zanghieri







- **The first data for 2019 are consistent with less firm growth, but they are still strong enough to dispel fears of an imminent recession.**
- **Manufacturing sentiment rebounded in January, as trade tensions eased. Stable financial conditions and strong labor income growth, amid tame inflation, will lead to above 2% growth in 2019.**
- **The Fed plans to end the unwinding of the balance sheet in the final months of the year. The January meeting minutes show some support for another rate hike, which is also our baseline.**

The picture provided by the first data for 2019 is one of somehow less buoyant, possibly plateauing growth, but leading indicators still show that the economy is still very far from a recession. That said, Q1 GDP data will be held down by the 7 week government shutdown in Dec/Jan.

Domestic demand supports above 2% growth

Manufacturing sentiment rebounded in January helped by signs of improvement in the US-China relationship. The ISM index went back to above 55. The decline in the service sector index continued, but the level is still consistent with a fairly robust pace of expansion. The evolution of the labor market should favor consumption growth; payrolls grew by a very strong 304k in January, with wage growth continuing to exceed 3% yoy. Positive developments in labor income should be more than offset the negative impact of consumption from the increase in interest rates seen over the last months of the year This depressed demand of durable goods and contributed to a marked slowdown in construction, with building permits flat on yoy basis in December after having posted over 5% growth in the first part of the year. The stabilization in financial conditions, in addition to improved sentiment, will support capex. Adding to this a fading fiscal stimulus and weaker net export, we expect growth to moderate to 2.3% this year, form an estimated 2.9% in 2018.

Falling inflation expectations help the Fed be patient

The plunge in expected inflation as measured by forward interest rates is mirrored in the University of Michigan survey. Tame realized and expected inflation was quoted by the Fed as one of the reasons to put rate rises on hold; the latest figures confirm this view, as January core inflation eased to 2.1%. The January meeting minutes showed that many FOMC members still favor tighter rates. We see another, final, rate hike that we now expect in the final months of the year. On the dovish side, the Fed is likely to bring forward the end of the balance sheet unwinding to the final months of the year. This will further reduce the relatively mild upward push the balance sheet reduction has had on US Treasuries yields.

Euro Area

Martin Wolburg

- **The latest data flow implies that activity will stay muted in Q1. That said, in H2 we see leeway for higher growth as Brexit and trade uncertainties will have dissolved in our base case.**
- **We revised our 2019 growth expectation down to 1.0%.**
- **At the March meeting, the ECB will have to adjust its macro outlook to the downside, open the door for a new TLTRO and adopt a dovish tilt.**

Over the past month the euro area economic news flow surprised less negatively than in the previous month. Following five consecutive months of decline, the composite PMI advanced in February and we see signs of stabilization at the horizon.

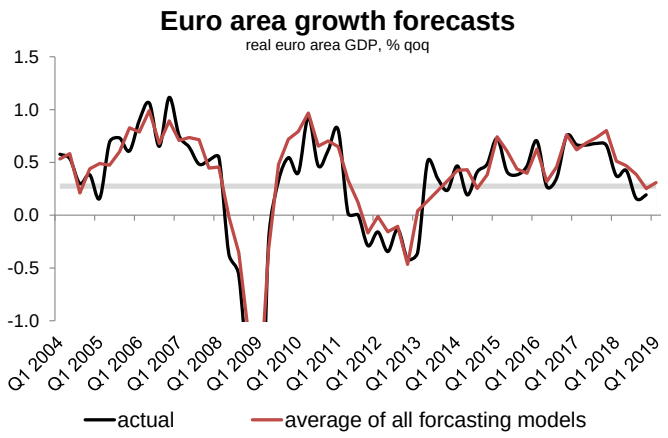
Solid domestic demand vs uncertainty and trade risks

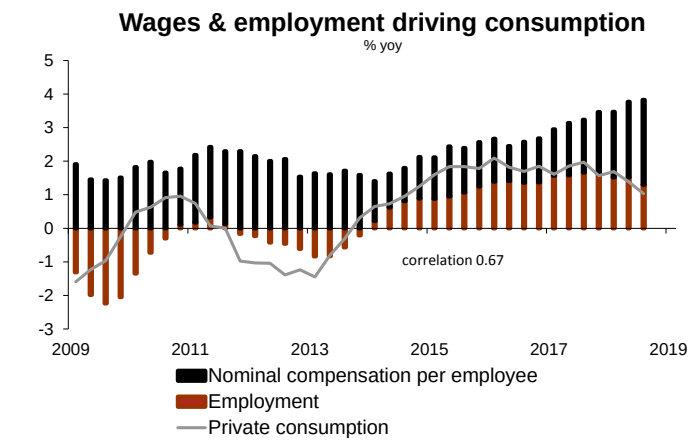
Behind this stands a split development in the euro area: Sentiment in the domestically-oriented parts of the economy like the service sector and construction holds up relatively well. Also, consumer confidence is elevated and recovered in February. With employment creation continuing according to indicators and wage growth improving, we continue to the see the fundamentals for solid domestic activity in place. In contrast, sentiment in the export-oriented manufacturing sector took another hit (Feb. PMI at lowest level since 06/2013) as export orders went further into contractionary territory. Here, trade uncertainties, the looming risk of US car tariffs and the Brexit drama take their toll. As we have discussed elsewhere, this primarily affects Germany for which we now expect a meagre 0.7% annual growth rate for 2019.

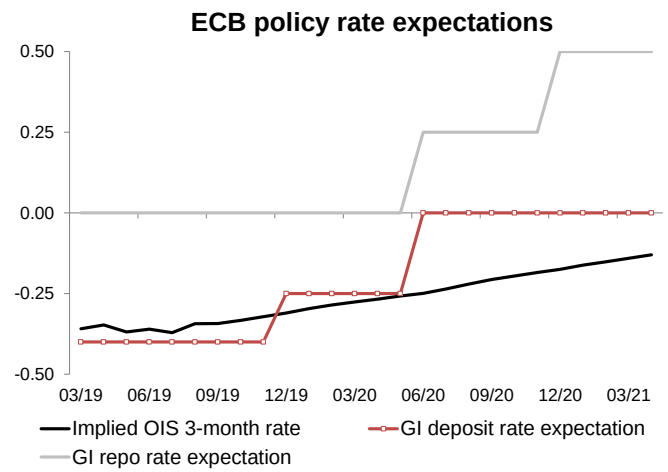
All in all, we do not look for an acceleration of growth from the poor Q4 reading of 0.2% qoq at the outset of 2019. That said, we see sentiment stabilizing and the various uncertainties petering out over the further course of the year. In this environment, domestic activity will set the tone again and lift growth towards potential in the second half of the year. Accounting for the poor start into the year, we nevertheless revised our growth forecasts for 2019 down to 1.0% (from 1.2%).

ECB to adopt a dovish tilt at the March meeting

At its January meeting, the ECB had to acknowledge that the growth risks have shifted to the downside. The assessment of the latest data will induce a further downward adjustment of the macro forecasts at the March 7 meeting. While this clearly argues for a more dovish stance and no (depo) rate hike this year, the decision whether to postpone the first rate hike into 2020 largely depends on the ECB's confidence in the recovery. In any case, comments from officials suggest that the ECB is flirting with a new TLTRO for which the door will likely be widely opened at the March meeting.

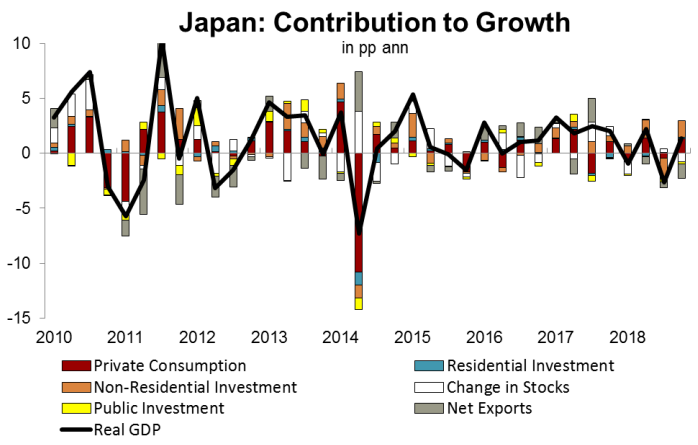


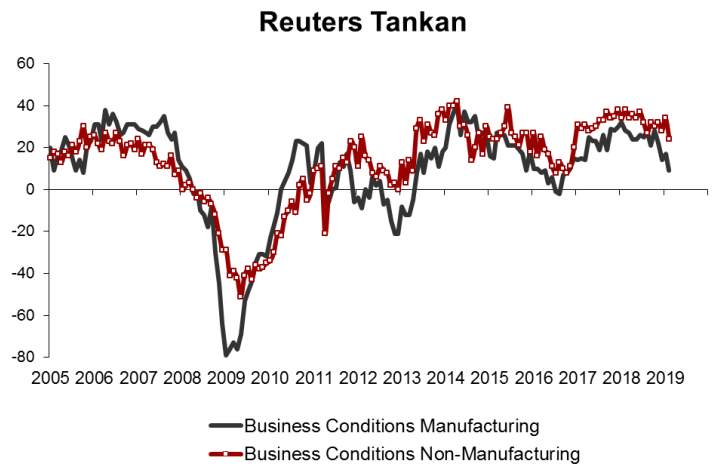




Japan

Christoph Siepmann





Main Forecasts[1)]	2017	2018	2019f	2020f
GDP	1.7	0.8	0.9	0.3
Consumer spending	1.0	0.6	1.2	-0.2
Government consumption	0.1	0.6	1.0	1.1
Investment	2.6	0.9	1.8	0.8
Inventories	-0.1	0.1	-0.1	0.0
Net trade	0.5	0.0	-0.1	0.0
Domestic demand	1.2	0.6	1.2	0.3
Consumer prices	0.5	1.0	0.9	1.4
Unemployment rate[2)]	2.8	2.4	2.2	2.2
Budget balance[3)]	-4.3	-3.7	-2.8	-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

- **Japan's economy had a rather soft start into the year with exports especially suffering.**
- **Looking ahead, we see net exports as a drag to growth while private consumption will benefit ahead of the planned sales tax hike.**
- **Monetary policy is likely to stay constant until uncertainties from the tax hike will have receded.**

According to the first print, Japan's GDP grew by 1.4% qoq annualized (ann) in Q4, rebounding limitedly from the 2.6% qoq ann drop in Q3, which had been caused by natural disasters. The figures also show that the recovery was not strong enough to fully compensate for the previous drop. The main reason was a substantially negative contribution from net exports. January customs data were even worse, witnessing real exports to slump by 5.2% mom. China's new year holidays but also its slowing growth played a major role. On a broader base, headwinds from a generally softer international environment have intensified, so that we expect exports to stay lackluster for the time being. Although the odds of a positive settlement of the US-China trade conflict have risen of late, US-Japan trade talks should resume shortly, possibly creating some uncertainties especially for the car sector. All in, we expect net exports to contribute slightly negatively to GDP growth for most of the year.

Service sectors started to weaken slightly

In contrast to net exports, Q4 domestic demand was strong. However, recently, the composite PMI as well as the Reuters non-manufacturing Tankan signaled that softness in manufacturing has started to spill over to some extent to the service sector. Nevertheless, we expect private consumption to be more and more supported ahead of the sales tax hike from 8% to 10% in October 2019, but to fall markedly thereafter. The government is mulling action to smooth this pattern. Together with the supplementary budgets (set up to mitigate the effects of the Q3 natural disasters), the fiscal impulse could amount to about 0.5 pp of GDP, starting to stabilize growth already in Q1. Spring wage negotiations are likely to result in a similar increase as last year (about 2.2% in 2018 including seniority payments increases). The rising share of pensioners in the population, already exceeding the part benefitting from wage negotiations, will also limit the impact. Thus, underlying inflation pressures will likely remain limited. Regarding business investment, we expect some softening going forward as its growth rate typically follows the export performance with a lag. Slowing growth will make it even more difficult for the BoJ to change its monetary policy ahead of the sales tax hike. Moreover, headline inflation fell in January to 0.2% yoy, even below the core-core inflation rate of 0.4% yoy (inflation ex. fresh food was 0.8% yoy). Given the past oil price development, the energy component is likely to recede further, keeping the inflation outlook subdued.

China

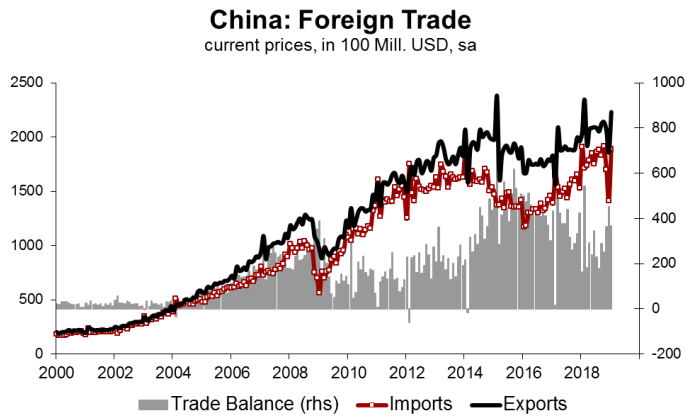
Christoph Siepmann

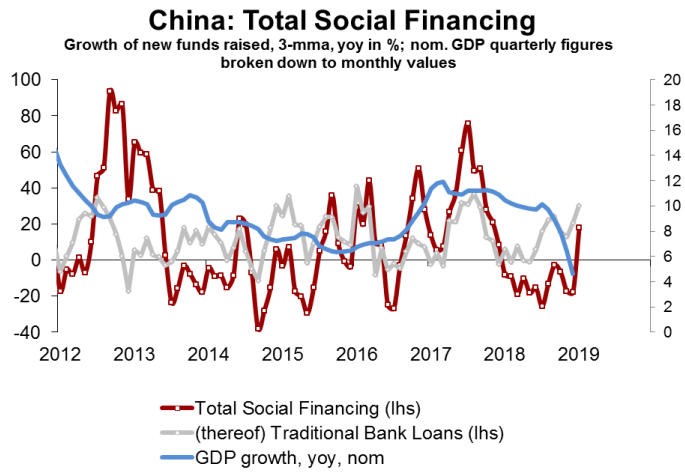
- **US President Trump delayed the tariff hike scheduled for March 1, suggesting progress in the US-China trade negotiations.**
- **In January, credit growth of both banks and shadow banking was strong but will need time to filter through the economy, in our view.**
- **We still consider it most likely that China will stabilize only in H2 2019, but – given the aspects above – risks have recently shifted slightly to the upside.**

Due to the Chinese New Year (Feb. 5) holidays, China's statistical office published (as usual) only a limited data set for January. Moreover, given the variability in timing and length of these holidays, data comparisons are often less reliable. Regarding real activity, the strong drop of the Caixin manuf. PMI was likely a case in point. However, the latest NBS version also receded. With regard to trade figures, exports recovered unexpectedly strongly to 9.1% yoy. By contrast, imports continued to slow, albeit less markedly than in the previous month. Looking ahead, after merchandise exports had increased by almost 10% in 2018, we expect the growth rate this year to more than half, reflecting the softening global activity as well as diminishing effects from the US fiscal impulse. On the import side, yoy growth rates could very well turn negative over summer, given the strong base effects. However, the trade talks with the US will likely set the tone. President Trump delayed the scheduled tariff increase on imports from China on March 1 and acknowledged "productive" talks. The negotiations reportedly covered topics of high conflict like "forced technology transfer" and "intellectual property rights", so that hopes on a positive settlement of the trade conflict have risen. However, we remain somewhat skeptical regarding the quick removal of already existing import tariffs.

Strong credit growth

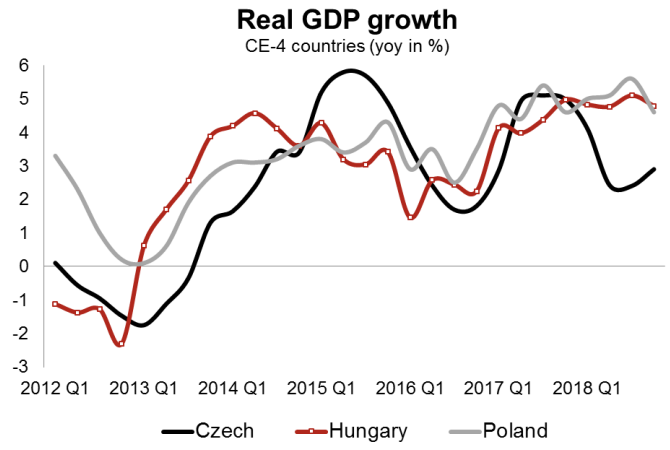
On the monetary side, fresh bank loans rose surprisingly strongly by RMB 3.2 tr. in January. On top, total social financing (TSF) growth increased for the first time in January (by 0.6 pp mom), after the regulatory tightening had led to a significant deceleration last year. Notwithstanding the fact that fresh credit is always strong in January, the higher TSF growth mainly reflects more corporate bond issu-ance, which could be a secondary effect from the fresh quota for local government infrastructure bonds. This will become visible in infrastructure investment over the next months. However, the positive credit impulse will need time to filter through the economy and will be felt in nominal GDP growth only with a significant delay (see graph). As the bulk of fiscal loosening will also come in the form of tax cuts (especially VAT this time), their effects will also need more time than the historically preferred instrument of infrastructure investment. Accordingly, we expect China to stabilize only in H2 and to reduce its growth target at the March NPC meeting to the range of 6%-6.5% in 2019.

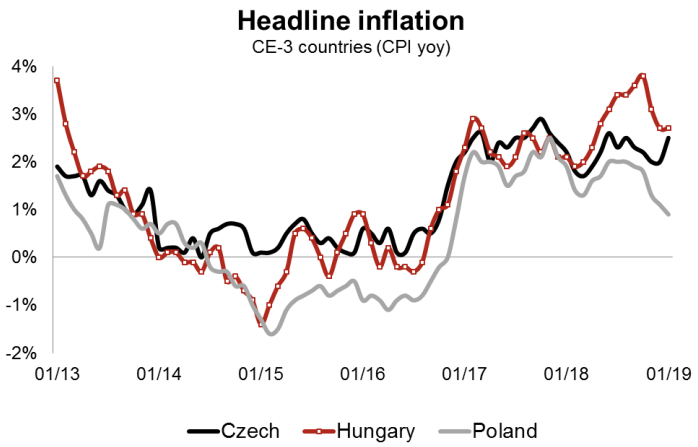




Central and Eastern Europe

Radomír Jáč





Main Forecasts	2017	2018	2019f	2020f
Czech Republic				
GDP	4.5	3.0	2.7	2.7
Consumer prices	2.5	2.1	2.2	2.0
Central bank's key rate	0.50	1.75	2.00	2.50
Hungary				
GDP	4.4	4.9	3.6	3.0
Consumer prices	2.4	2.9	3.1	3.0
Central bank's key rate	0.90	0.90	1.25	1.75
Poland				
GDP	4.8	5.1	3.6	3.0
Consumer prices	2.0	1.7	2.0	2.6
Central bank's key rate	1.50	1.50	1.50	1.75

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

- **The CEE region reported solid GDP growth for Q4 with positive surprises in the Czech Republic and Hungary. However: the manufacturing sector starts to feel the impact of a weaker external environment.**
- **Price pressures remain muted in Poland, while growing core CPI is giving a headache to central bankers in the Czech Republic and Hungary.**
- **Higher core inflation amid no CZK firming put the possibility of a CNB rate hike on the table. In Hungary, changes in non-conventional tools are likely in March.**

Preliminary data for Q4 report a stronger than expected GDP growth for the Czech Republic (1.0% qoq) and Hungary (1.1% qoq), while Poland came in below forecast, as its growth slowed to 0.5% qoq after a very strong increase of 1.7% qoq recorded in Q3. However, Poland was the regional outperformer in 2018 and the recently announced fiscal plans of the Polish government represent upside risk to country's GDP growth for both this year and for 2020. Slower growth in the euro area represents a downside risk for the CEE but the region should be shielded by the strong domestic demand.

Price pressures remain muted in Poland according to both headline and core CPI data. However, core inflation is growing in the Czech economy and Hungary, to 3.0% yoy in both cases in January, which may lead to a tighter monetary policy stance.

Monetary policy: watch Hungary and the Czech CNB

The CNB left its key interest rate unchanged at 1.75% in February and its updated quarterly forecast shows one rate hike (25 bps) as a maximum for 2019. However, the upside surprise from core inflation and the fact that the Czech crown does not appreciate as the CNB assumed in its forecast implies that the Czech central bank will debate the possibility of a rate hike seriously at its next monetary policy meeting in late March. However, we see the possibility of a rate hike more likely only in May, as the CNB may prefer to assess more data from the global economy.

Growing core inflation is likely to lead to monetary policy response also in Hungary. Steps towards a gradual policy normalization are likely to be announced at the MPC meeting in March via changes in the setting of unconventional instruments. The MNB may limit liquidity supply via swap operations and this could be followed by an increase in O/N deposit rate from its current level of -0.15%.

Poland should keep monetary policy rates on hold in 2019, as inflation remains low. This could change only if the government implements fiscal stimulus, presented in late February, as fiscal relaxation would imply higher price pressures.

Bonds/Fixed Income Strategy

Florian Späte

- **International core government yields moved in a tight trading range in February. While US yields inched up marginally, euro area core yields hardly moved on balance.**
- **A precondition for higher core yields would be a lasting stabilization of the economic data flow. Moreover, as central banks are eager to not trigger a tightening of financial conditions, the potential for a considerable upward movement in core yields appears limited in the short term.**
- **The development of euro area non-core spreads differed in February. Although political headwinds are unlikely to abate, the potential for a significant spread widening appears rather limited, going forward.**

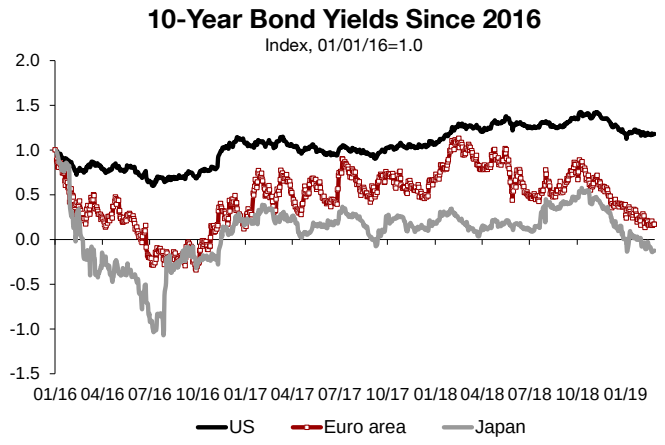
On balance, international government bond yields hardly moved in February. For example, 10-year Bund yields remained between 0.09% and 0.18% and finished the period under review at 0.11% (associated with a somewhat flatter yield curve). US yields showed no clear direction either and finished slightly higher compared to the end of January. Accordingly, the transatlantic yield spread increased marginally.

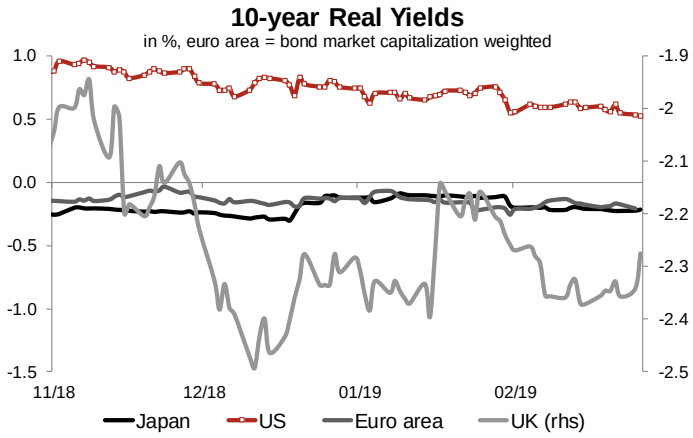
Noteworthy, the increase in oil prices translated into higher US inflation expectations (e.g. 2-year inflation swaps up by 14 bps in February). Hence, despite higher nominal yields US real yields continued their downtrend. Meanwhile, 10-year real yields have fallen by more than 40 bps since the start of November. In contrast, euro area real yields have hardly changed since November – they remain close to historical lows.

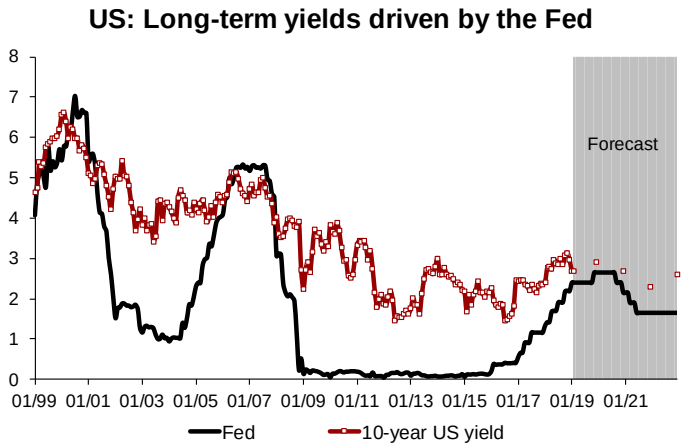
Limited upward pressure for core yields short term

The combination of a strong dovish shift by the Fed and the string of disappointing macroeconomic data releases limit the upside potential for core yields in the near term. Although euro area macroeconomic data showed some signs of stabilization recently, we do not expect a clear turnaround already in the weeks to come. Hence, financial market participants' near-term growth expectations are likely to remain muted.

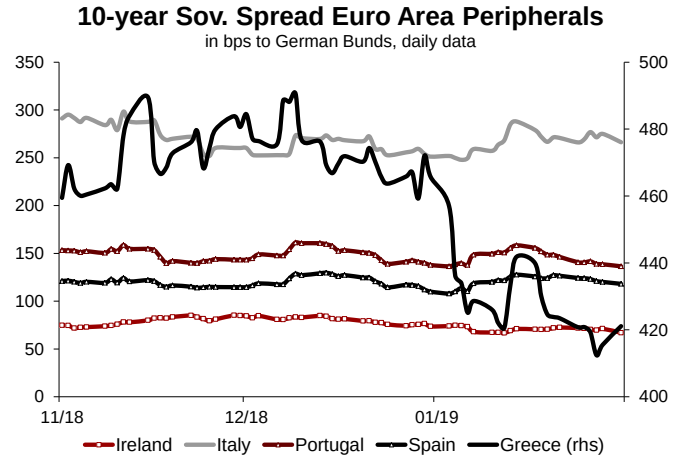
Furthermore, central banks are likely to remain on the sidelines for the time being. Particularly, the Fed shifted to a much more dovish stance and put future key rate hikes on hold. Among other reasons, this modified assessment is due to the strong tightening of financial conditions. Although the recent rally of risky assets undid most of the unwelcome development, we do not expect the Fed to change gears anytime soon again. Accordingly, financial markets have adjusted future US key rate expectations. This implies that the scope for higher core yields on both sides of the Atlantic appears rather limited for the time being. This applies even more as several political event

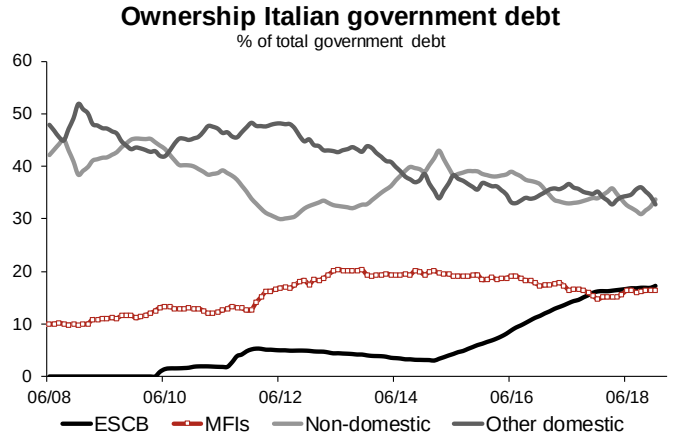


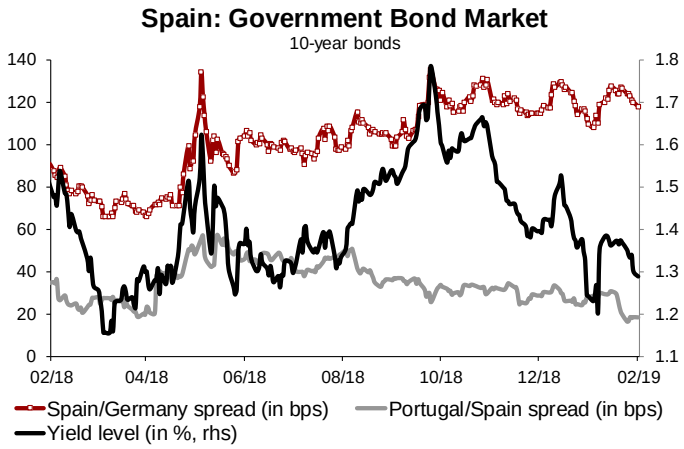




Bonds/Fixed Income Strategy







risks remain on the table and an unwinding of safe haven flows in the near term is not on the cards. On a 3-month horizon, we forecast 10-year Treasury and Bund yields to rise to 2.75% and 0.20%, respectively.

Looking further down the road, we see upward potential particularly for euro area core yields. Meanwhile, a first depo rate hike (by 15 bps) is only priced by June 2020 and a first repo rate hike (by 25 bps) is not expected before the end of 2022. Assuming no political interference, we regard this as too cautious. Moreover, as euro area growth is seen to return to potential in H2 2019, we forecast yields to move upwards. We expect 10-year Bund yields to rise to 0.60% on a 12-month horizon.

Euro area non-core bonds show a mixed picture

Italian BTPs came under moderate pressure in February. After a strong rally which started at a level of well above 320 bps in November, the 10-year BTP/Bund spread rose from 240 bps at the end of January to well above 260 bps. Beside some disappointing economic releases, we regard the strong issuance activity as one trigger for the setback. In contrast to this, other non-core bonds performed well and spreads tightened across the board in February.

The political environment is unlikely to brighten in the weeks to come. In particular, the looming European elections are seen to bring forward eurosceptical headlines. In addition, the macroeconomic data flow is not expected to turn for good already in the weeks to come. Hence, we forecast non-core spreads to widen moderately going forward. Though, higher coupons are seen to secure an outperformance versus euro area core bonds in the months to come.

This rather constructive stance is triggered by some encouraging signals from non-core markets. First, despite the ongoing concerns about the debt sustainability of Italy, non-domestic investors have not withdrawn funds in Q4. On the contrary, the share of non-domestic investors even increased. The affirmed investment grade rating by Fitch for Italy and the attractive carry of BTPs are likely to support Italian BTPs, going forward.

Second, the resilience of Spanish Bonos in view of snap elections lends support, too. Although the minority government of PM Sanchez was unstable anyway, the spread to German Bunds even tightened in February. Moreover, the Spanish economy has been outperforming for a long time which has eased fundamental concerns. Finally, Spanish banks have reduced their government bond holdings strongly in recent years breaking the vicious circle of sovereign bond holdings by the financial sector that was a major problem during the debt crisis. Meanwhile, Spanish banks could cushion temporary stress and, thereby, limit any potential spread widening.

Corporate Bonds

Florian Späte

- **Corporate bonds continued to rally in February. Mainly due to a further spread tightening, euro area IG corporate bonds have already achieved a total return of 1.8% year to date.**
- **More dovish central banks in combination with a forecast stabilization of the economic data flow can support corporate bonds for the time being. However, the potential for a sustained tightening appears limited.**
- **Looking further down the road, the environment remains challenging. Large funding requirements and a slowdown in growth are expected to trigger a meaningful spread widening in H2.**

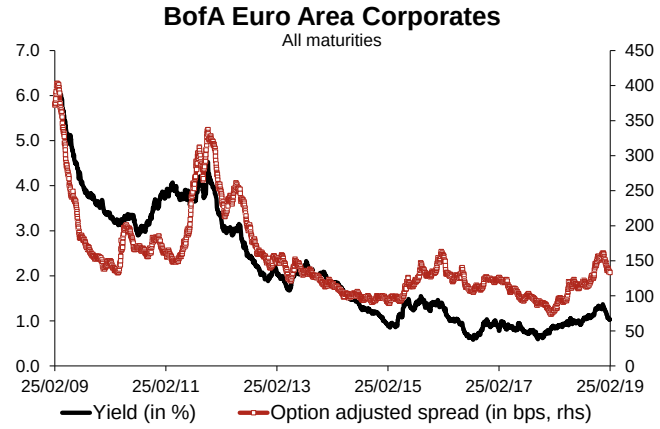
Euro area (EA) corporate bonds performed very well in February. Option-adjusted spreads tightened by 12 bps to 132 bps. The rally was broad-based as non-financials narrowed by 11 bps and financials by 12 bps (EA HY spreads even tightened by 45 bps). As underlying yields decreased only marginally, the spread tightening is reflected in a very solid total return of 0.7% in February. Adding the strong start in January, EA IG corporate bonds have already achieved a total return of 1.8% year to date (non-financials: 1.9%, financials: 1.7%).

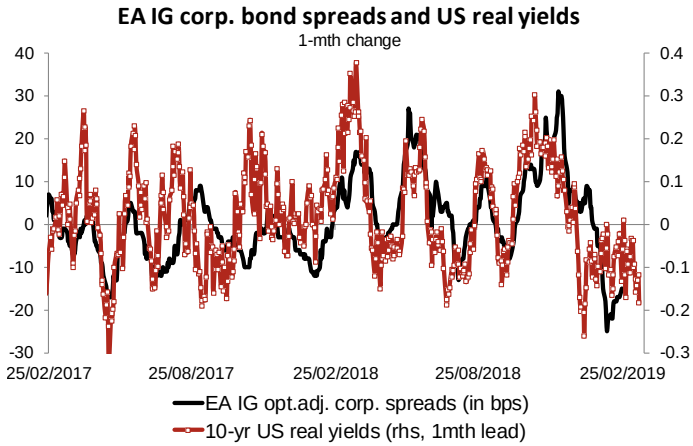
Going forward, there is scope for a continuation of the rally. Particularly the dovish shift by the Fed can support corporates. Decreasing nominal yields lowered real yields as well (see chart) which allowed spreads to tighten over the recent weeks. Although we expect a final hike by the Fed in Q4 2019, this is unlikely to be priced short term as central banks appear very eager to avoid a re-tightening of financial conditions. Accordingly, a significant upward trend for real yields appears unlikely. In addition, the performance of corporate bonds has lagged behind other risky assets (e.g. equities), giving leeway for some catch-up. Finally, we expect the string of weak economic releases to peter out. All in, the leeway for a lasting spread widening appears limited in the near term. Based on our analysis, we slightly favor non-financials versus financials.

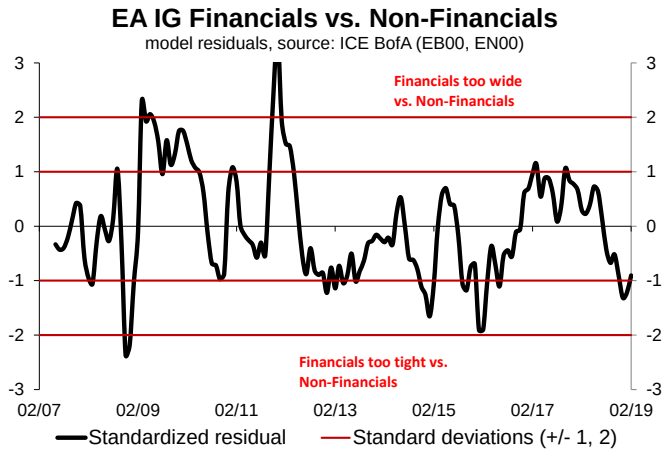
Medium term outlook remains challenging

But, later this year EA IG corporates are likely to widen meaningfully as the more dovish stance by central banks will not be sufficient. On the one hand, markets have priced the dovish stance already and on the margin we think markets are too cautious. On the other hand, if economic data continue to weaken and the Fed will cut soon (not our base case) this tends to trigger a spread widening.

Above all, the strong net supply in 2019 (even assuming a new TLTRO will be launched) and the end of ECB's QE put is a huge burden on the private sector. Even assuming no political risk event to materialize, we forecast EA IG corporate bond spreads to widen by around 40 bps on a 12-month horizon – not least due to a growth slowdown.

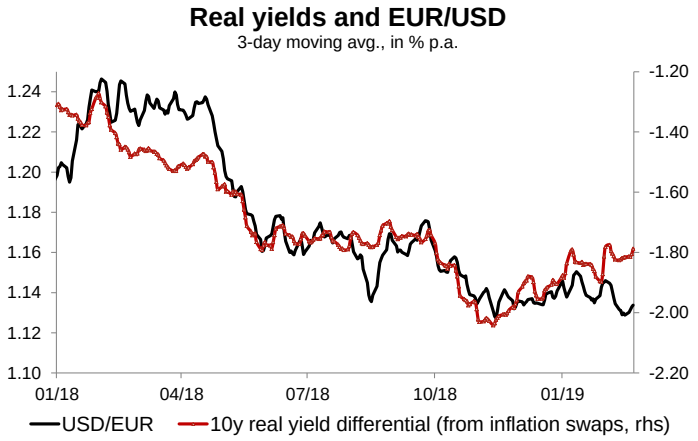


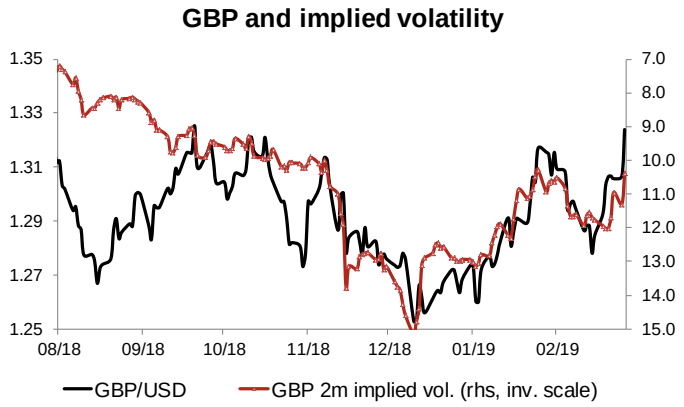


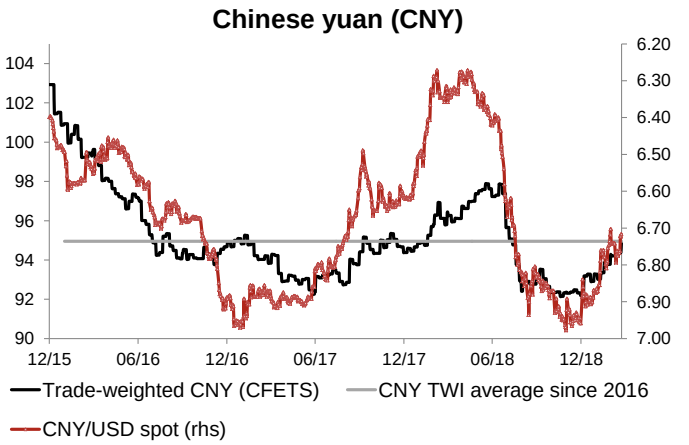


Currencies

Thomas Hempell







- **Weak economic data and political uncertainties are holding back the EUR. However, a slowing US economy, a reluctant Fed and the continued reserve diversification are set to make USD weakness more visible further into the year.**
- **Sterling is already pricing a lot of Brexit optimism. Further strength is feasible, but will require more robust evidence that the UK is indeed headed for a Brexit backed by a deal.**
- **Progress in US/China trade talks may offer further support to CNY/USD, but the CNY's upside is limited by cyclical considerations.**

The Fed's policy U-turn this year has so far inflicted only limited damage upon the Greenback. The USD DXY (vs. major peers) has even gained some modest ground year-to-date, despite a sharp fall in fed funds futures. Weak global industrial data are one reason for the dollar's resilience. But it is also the dovish twist by other major central banks, including the ECB, BoE and PBoC, which have prevented major FX peers from rallying.

Near term, the EUR/USD is still capped by weak euro area data and economic uncertainties (Brexit, populist rise in European elections). On the encouraging side, however, recent gauges of domestic demand (incl. the services PMI for Germany) continue to hold up well. Also, the euro area's external account keeps improving, with investment outflows ebbing. Ultimately, a leg higher in the EUR/USD will require a discernible rise in depressed Bund yields, but a widening gap with the transatlantic real yield differential already points to some upside. Conversely, the USD will remain burdened by a decelerating US economy on a fading fiscal stimulus, a reluctant Fed and a persistent reserves diversification by global reserves managers. We still see upside potential for the EUR/USD to 1.20 by year-end.

Sterling carried by Brexit optimism

GBP/USD has gained more than 4% ytd on rising optimism that a hard Brexit can be avoided. Recent defections among Labor and Tory MPs may indeed help to strengthen the political leverage of those MPs favoring softer Brexit options vs. their party leaders. There are also growing chances that parliamentary amendments will dent the risk of an accidental no-deal Brexit. GBP is already pricing a lot of optimism (see mid chart). A more visible rise of GBP from levels reached would likely require clearer indications that a deal-backed Brexit is indeed on the cards, not just a mere extension fo the March 29 deadline.

The Chinese yuan has recovered further, helped by progress in US/China trade talks and a recovery of risk sentiment. A trade deal could bring USD/CNY even lower. That said, cyclical weakness in China and further accommodative monetary policy measures (RRR cuts) limit the further upside to the yuan.

Equities

Michele Morganti / Vladimir Oleinikov

- **In February, equities extended the rally due to decreasing risks and credit spreads, dovish central banks and signs of a macro stabilization.**
- **While earnings estimates are susceptible to be further reduced, the 2019 forecasts have no huge downside as exogenous risks should remain sufficiently contained, at least for the short term.**
- **Valuations are fair but positioning, Central Banks' stance and reduced risk could prolong the positive momentum: we remain tactically overweight.**
- **We stay defensive inside the equity space: OW the defensive FTSE 100 and SMI plus the undervalued Japan, staying balanced the EA vs the US.**

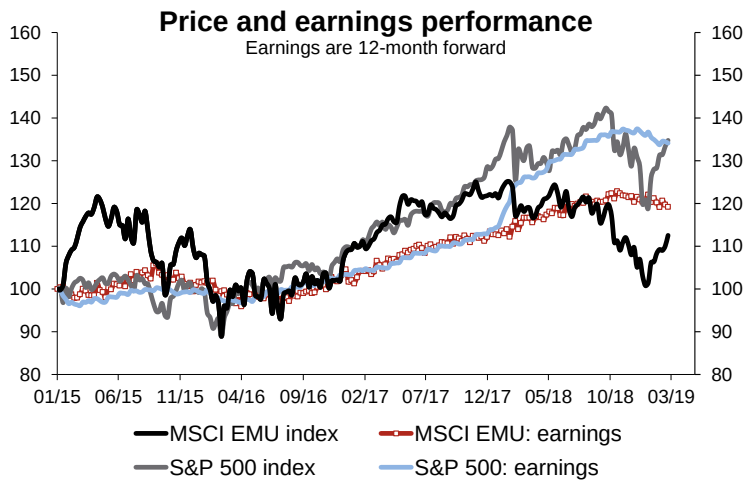
In February, equities extended the rally as macro surprises ex US and Japan stabilized and exogenous risks abated via the probable Brexit delay and the US-China trade agreement. On top of this, global central banks confirmed their dovish stance which is clearly positive for risky assets. Finally, stable bond yields and declining credit spreads helped equity PEs to stabilize, too. The US index posted a +3.5% total return, in line with the EMU, Japanese and UK ones. The Swiss SMI outperformed with a +4.8%. The EM index underperformed (+1.6%) but the MSCI China posted a 4.8% return. EU Growth overperformed the Value (+5% vs +3%) while cyclicals and defensives moved in line (4%). Quality came out particularly strong (+5.7%), whereas Small Cap underperformed visibly (+2.8%).

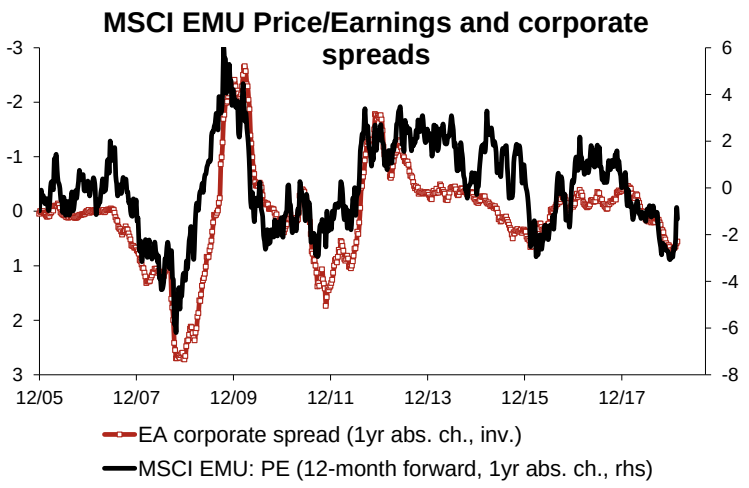
Negative macro surprises with signs of stabilization

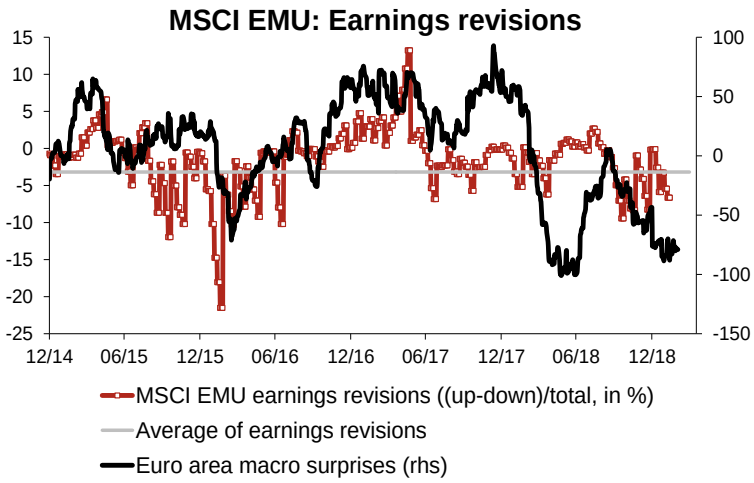
Macro surprises in the EA remain as low as only in 2012 and mid-2018 but there are first signs of stabilization and our base case is for a small rebound of GDP growth in H2. The US ISM new orders component has recently rebounded along with the adjusted German IFO index (expectations component minus composite indicator). Of course, in the short term we could experience a further earnings reduction but, should exogenous risks stay at bay as we think, it should overall turn out contained. In addition to this, the dispersion of analyst earnings forecasts around average (a measure for market risk, i.e. uncertainty) has decreased visibly from the cyclical peak reached at the end of 2018. Indeed, after having cut Q4 earnings estimates aggressively, analysts were reassured by a reporting season which overall didn't surprised further negatively. As a result, the EA equity risk premium (measured by subtracting the 10-year bond yield from the equity earnings yield) declined from 8% at the end of December 2018 to current 7%. The risk premium has been higher than 8% only in 2011-2012 and 2008-2009 (at and above 10%, respectively).

Valuation fair in Europe but positioning still contained

We just updated our earnings forecasts and results have not changed appreciably since December.







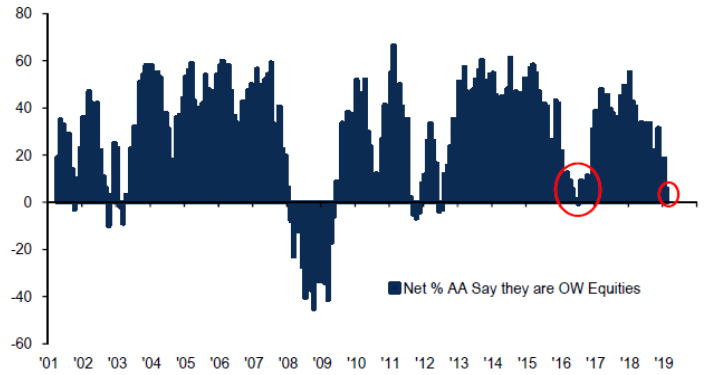
Equities

Markets	PE		PB		PCF		DY		Avg.	Avg.
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	Discount	Disc. (-1M)
WORLD	15.2	-4.8	2.2	12.6	10.1	15.3	2.7	-2.5	6.4	-0.1
USA	16.4	7.2	3.0	28.0	11.5	16.7	2.1	-3.6	13.9	7.0
JAPAN	12.4	-19.9	1.1	-10.8	7.1	-0.6	2.5	30.5	-15.5	-19.7
UK	12.3	-11.1	1.6	-11.1	7.9	0.4	4.8	19.7	-10.4	-14.8
SWITZERLAND	15.6	1.6	2.4	8.2	10.7	-4.3	3.5	6.6	-0.2	-4.7
EMU	12.7	-9.8	1.4	-4.1	7.5	15.8	3.8	-2.0	1.0	-5.3
FRANCE	13.3	-7.3	1.5	-1.1	7.9	13.7	3.7	-2.1	1.9	-5.3
GERMANY	12.0	-20.3	1.4	-6.8	7.6	13.9	3.6	8.2	-5.4	-8.8
GREECE	12.9	0.7	2.0	29.0	6.9	14.0	5.5	37.7	1.5	-4.1
ITALY	10.4	-31.3	1.1	-6.7	5.2	11.9	4.9	4.8	-7.7	-13.0
PORTUGAL	15.0	17.6	1.7	0.1	5.8	-1.5	4.8	6.9	2.3	-2.9
SPAIN	11.2	-13.3	1.2	-27.0	5.1	1.3	4.8	-4.7	-8.6	-10.1
EURO STOXX 50	12.7	-3.9	1.5	1.2	7.6	21.7	4.0	-5.3	6.1	0.3
STOXX SMALL	15.3	5.7	1.8	5.8	9.4	13.3	3.2	0.4	6.1	2.4
EM, $	11.8	-18.1	1.5	-8.7	7.3	-4.6	3.1	0.4	-7.9	-13.3
BRAZIL	11.9	30.8	2.0	18.4	8.0	-41.3	4.0	-7.7	3.9	3.8
RUSSIA	5.1	-27.4	0.6	-28.0	3.2	-28.3	7.7	101.1	-46.2	-46.5
INDIA	17.6	21.4	2.6	-3.5	11.8	2.1	1.7	4.9	3.8	3.5
CHINA	11.6	-10.4	1.5	-12.3	7.5	-0.8	2.5	-17.4	-1.5	-10.2

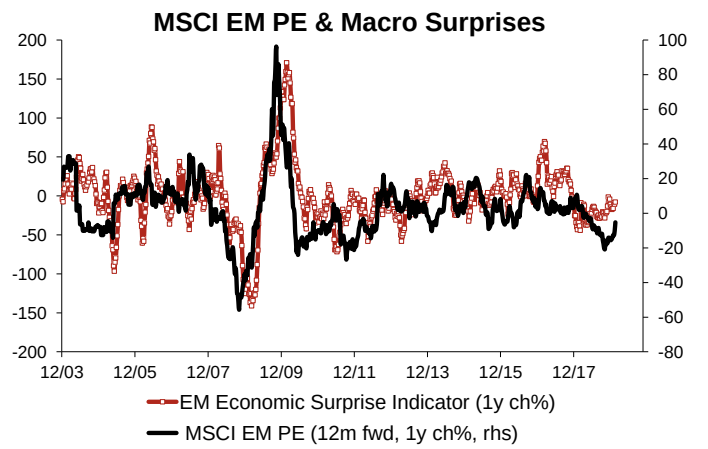
Note: Discount in % to long-run norm; blue and negative numbers = undervaluation. Red and pos. numbers = overvaluation; PEs are since 1987, the rest is since 2003. In case of DY, a discount means the market had a higher DY, meaning the market is at premium for this multiple. 12m f = expected in 12 months

Source: Thomson Reuters Datastream, IBES estimates.

Exhibit 2: Smallest overweight in FMS global equity allocation since Sept'16



Source: BofA Merrill Lynch Global Fund Manager Survey



Indeed, in December we have been conservative enough so that we did not have to cut estimates further down. Overall we see a 2019 earnings growth of 3-4% in the US and EA which is slightly below consensus by nearly 2% (6% in Japan). Such discount increases in 2020 to 7-8% where we see a growth around 4% vs 11% of consensus. In assessing the fair market value we used - compared to December - slightly reduced bond yield forecasts and marginally higher PE target (+0.5), justified by the lower yields and reducing inflation expectations. As a result, in 12 months we expect 3% to 5% total returns in Europe and Japan and a slight negative one in the US (-2%). Current market multiples are overall fair in the EA, at premium in the US and cheap in the EM, Japan and UK. Risks remain tilted on the downside as volatility is high.

Reduced risks and low positioning to help short term

While valuation is no more a valid argument for buying markets, there are other positive triggers at work in the short term: macro stabilization, decreasing exogenous risk plus the dovish stance by central banks and still low investors' positioning in risky assets. We remain tactically overweight equities but with a defensive positioning inside. Namely we are OW the defensive SMI and UK, plus the undervalued Japan, staying balanced the US vs the EA.

Sectors and styles

We reduce the OW of cyclicals vs. defensives, remaining OW Utilities, Industrials, Discretionary and Financials. Pharma are UW with Real Estate, Materials and IT. Staples, Telecom and Energy are neutral. We are UW Small cap Growth vs Large cap Value, neutral on Quality and balanced Value vs Growth (both OW vs EU). Momentum is neutral but looks increasingly attractive.

EM: to benefit from the mitigated risk of a tariff war

Over the last month, EM equities increased by 3% and are now trading at a discount of 8%, when looking at their multiples vs history. Earnings estimates have been lowered over the last month across the board except for CEE region (ex. Turkey) and especially Brazil (+5%). The EMs should benefit from increased investors' sentiment, following the progress in the trade dispute between the US and China. Further positive factors for future EM performance are expected weakening US dollar, the dovish stance by the Fed, and still light equity positioning.

The slowdown in China and political uncertainties will continue to keep a lid on trade growth, burdening the earnings outlook. Nonetheless, we see Chinese A-shares – being already quite undervalued (market multiples' discount is at 18%) – to benefit in the short-term from trade related de-risking and a possible higher inclusion factor in the MSCI EM. Within the EM universe, we also favor Korea, India, along with the CEE markets.

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Asset Allocation

Thorsten Runde

- **February 2019 has so far turned out to be the second month in row with nearly all covered asset classes residing in positive return territory.**
- **Once again, equity markets are holding the top positions in the return ranking by far.**
- **In contrast, Italian BTPs lost value in the course of February throughout all maturity buckets, with the long end clearly suffering the most.**
- **Core government bonds performed positively. Yet, they did not manage to outperform the benchmark.**
- **All corporate bond segments (IG / HY / non-financial / financial) revealed positive performance figures. Apart from the very short maturity buckets they even outperformed the benchmark.**
- **We recommend only small adjustments to the overall allocation stance, maintaining a pro-risk tilt. We halve the underweight in peripheral government bonds by taking money out of cash.**
- **Furthermore, we are halving the duration gap for IG non-financials and IG financials leaving the exposure to these asset classes constant.**

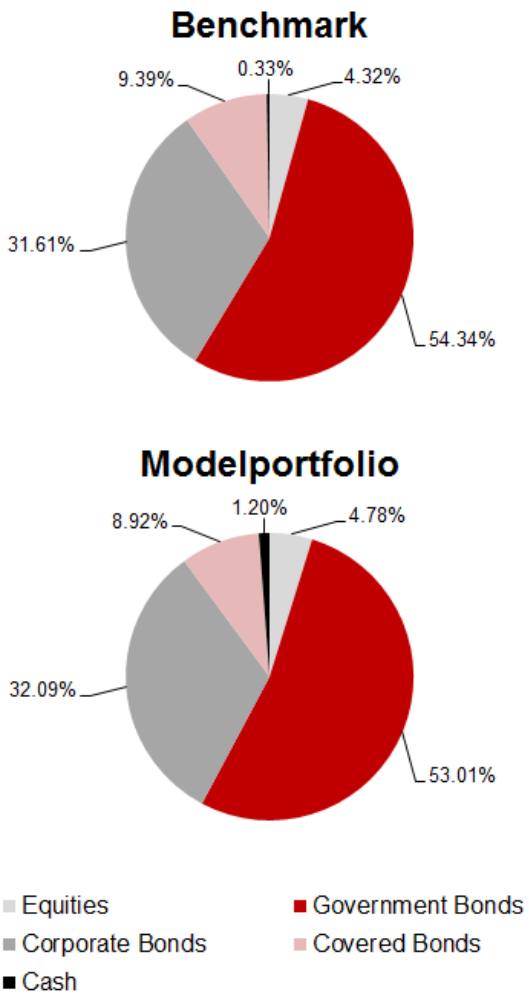
In the course of February 2019 core yields have fallen, with Bund yields now residing close to the 2016 lows. Italian BTP spreads widened against the backdrop of rising doubts with respect to the debt sustainability and Italy having dropped into a technical recession in H2 2018. Equity markets rallied for the second month in a row due to a more optimistic view on the trade tensions between the US and China and central banks adopting a more dovish tone.

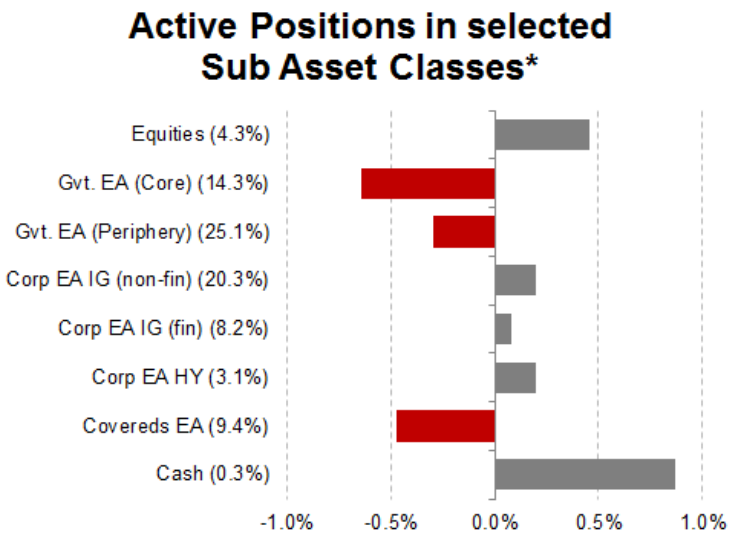
Given these major market movements our small but still positive active position in equities contributed the most to the overall positive TAA result followed by the under-weight in 10Y+ Italian government bonds. On the negative side, the overweight in cash and the underweights in long-dated IG corporates (non-financial and financial) as well as in the 10Y+ Covered bond segment eat up quite a bit of the relative performance.

Moderate pro-risk allocation stance to be maintained

Although weak macro data will limit the upside potential for risky assets over the coming weeks they are still looking attractive. Thus, we basically maintain our overall pro-risk allocation stance. As we deem Italian bonds a potentially rewarding tactical buying opportunity after the recent spread widening, we are reducing our underweight in BTPs at the expense of cash.

With euro area IG spreads to trend sideways and the credit curve already rather steep, we shift some exposure from the shorter corporate maturity buckets to long ones. Simultaneously, we leave the overall overweight position in the corporate bond segment unchanged.





Benchmark weights in parentheses

Forecast Tables

Growth

	2017	2018e	2019f	2020f
US	2.2	2.9	2.3	1.6
Euro area	2.5	1.9	1.0	1.3
Germany	2.2	1.6	0.7	1.2
France	2.3	1.5	1.0	1.2
Italy	1.6	0.9	0.0	0.6
Non-EMU	1.8	1.4	1.5	1.8
UK	1.7	1.3	1.5	1.8
Switzerland	1.6	2.7	1.5	1.6
Japan	1.7	0.8	0.9	0.3
Asia ex Japan	6.1	6.2	5.9	5.9
China	6.9	6.6	6.2	6.2
Central/Eastern Europe	3.9	3.1	1.8	2.5
Latin America	0.6	0.3	0.9	2.0
World	**3.6**	**3.6**	**3.2**	**3.2**

Inflation

	2017	2018e	2019f	2020f
US	2.1	2.4	2.0	2.2
Euro area	1.5	1.8	1.6	1.7
Germany	1.8	1.9	1.7	1.7
France	1.0	2.0	1.7	1.6
Italy	1.2	1.3	1.2	1.4
Non-EMU	2.5	2.3	2.1	2.0
UK	2.7	2.5	2.2	2.0
Switzerland	0.5	1.0	0.7	0.9
Japan	0.5	1.0	0.9	1.4
Asia ex Japan	2.2	2.6	2.9	2.8
China	1.6	2.1	2.3	2.3
Central/Eastern Europe	5.0	6.1	7.3	5.8
Latin America	4.3	4.0	4.0	3.7
World	**2.3**	**2.8**	**2.8**	**2.7**

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

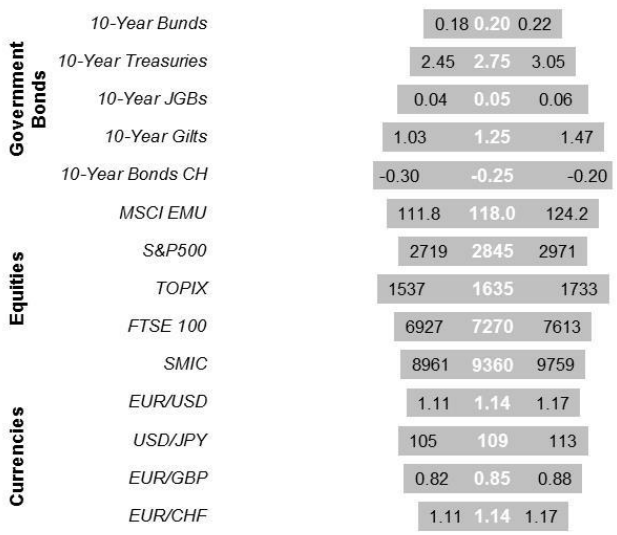
Financial Markets

3-month LIBOR	**25/02/19***	**3M**	**6M**	**12M**
USD	2.65	2.70	2.80	2.90
EUR	-0.34	-0.35	-0.35	-0.20
JPY	-0.08	-0.05	-0.05	-0.05
GBP	0.86	0.85	0.90	1.10
CHF	-0.71	-0.75	-0.75	-0.75
10-Year Bonds	**25/02/19***	**3M**	**6M**	**12M**
Treasuries	2.67	2.75	2.85	2.90
Bunds	0.11	0.20	0.40	0.60
BTPs	2.82	2.95	3.15	3.25
OATs	0.53	0.65	0.85	1.00
JGBs	-0.04	0.05	0.10	0.10
Gilts	1.18	1.25	1.40	1.55
SWI	-0.29	-0.25	-0.05	0.10
Spreads	**25/02/19***	**3M**	**6M**	**12M**
GIIPS	197	200	200	195
BofAML Covered Bonds	60	65	65	70

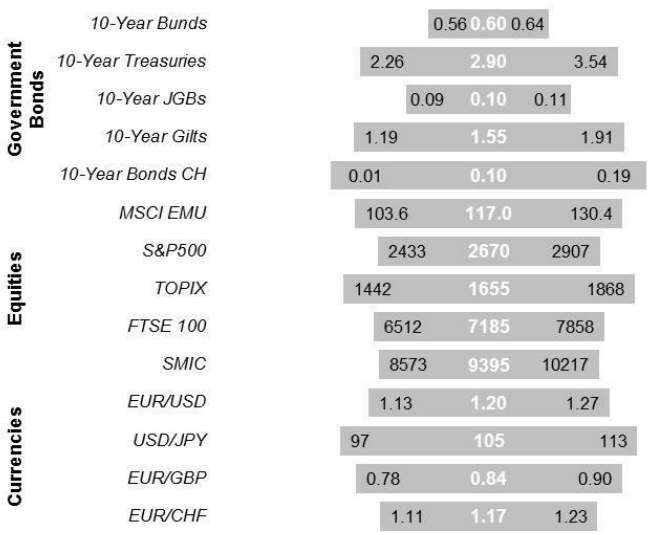
*average of last three trading days

Corporate Bond Spreads	**25/02/19***	**3M**	**6M**	**12M**
BofAML Non-Financial	131	130	150	170
BofAML Financial	139	140	160	180
Forex	**25/02/19***	**3M**	**6M**	**12M**
EUR/USD	1.13	1.14	1.16	1.20
USD/JPY	111	109	108	105
EUR/JPY	126	124	125	126
GBP/USD	1.31	1.34	1.36	1.43
EUR/GBP	0.87	0.85	0.85	0.84
EUR/CHF	1.13	1.14	1.16	1.17
Equities	**25/02/19***	**3M**	**6M**	**12M**
S&P500	2788	2845	2745	2670
MSCI EMU	118.0	118.0	117.0	117.0
TOPIX	1615	1635	1635	1655
FTSE	7177	7270	7195	7185
SMI	9360	9360	9340	9395

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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