GENERALI INVESTMENTS

Market Perspectives

September 2017

Internal

Content

Global View

Thomas Hempell

- **Geopolitical tensions around North Korea and political turmoil in Washington weighed on global yields and on overall risk sentiment in August.**
- **These tensions and the risk of a failure by the Congress to raise the US debt ceiling by the end of September are likely to remain a burden to financial markets over the next weeks.**
- **That said, a continued synchronized global upswing and more evidence of a gradual policy normalization by major central banks will help global yields to recover further out in our view, while European credit and equities are set to hold up well.**

The sharp increase in geopolitical tensions between the US and North Korea weighed on financial markets over the course of August. The yields on 10-year Treasuries and Bunds dropped by 16 and 20 bps respectively by Aug. 29. Equities held up relatively well for most of the month but ultimately lost some ground on rising geopolitical tensions. Spreads on European IG corporates widened only moderately. By contrast, the risk premium on Southern European sovereign debt increased by almost 20 bps, burdened by receding risk sentiment and concerns over Italy's Silvio Berlusconi's floating the idea of a parallel currency after next year's election. The EUR/USD temporarily broke the 1.20 mark, extending year-to-date gains to 14%, while the USD/JPY suffered from lower US yields and safe-haven flows.

	Growth			Inflation		
	2016	2017f	2018f	2016	2017f	2018f
US	1.5	2.1	2.2	1.3	2.0	2.0
Euro Area	1.7	2.0	1.6	0.2	1.5	1.3
China	7.1	6.7	6.3	2.0	1.5	2.3
World	3.1	3.4	3.5	2.3	2.4	2.7
f=forecast						

Looking ahead, concerns about the political turmoil in Washington are unlikely to abate soon. President Trump's confrontational stance with the Congress has further dented the odds of any progress towards a meaningful tax reform during the remainder of the year. What is more, the US Congress may fail to lift the Treasury's debt ceiling and to agree on a new budget by end-September, incurring the risk of a government shutdown and – in the worst case – a technical default. We deem a last-minute solution most likely, but brinkmanship in US politics is set to weigh on markets for a while.

Also the conflict with North Korea will remain a source of continued market uncertainty. Tension rebounded sharply on Aug. 29 with North Korea firing a missile over Japan and full-blown escalation of the conflict would not only trigger a human tragedy on the Korean peninsula and widespread economic damage, but would likely also imply more lasting capital flows into safe haven assets, like Bunds and Treasuries.

That said, beyond these risks, the fundamental economic backdrop remains benign. We anticipate a renewed rise in yields and moderate gains on equities when concerns about the US debt celling and the North Korean tensions ease. In Europe, the recovery is broadening and reflation hopes are prevailing over disinflation fears, with core inflation at 1.3%. The US economy is likely to grow at an annualized rate above 2% over the coming quarters, supported by firming capex spending and consumption benefitting from a strong labor market. Data in China are likely to soften, but the leadership will use fiscal and monetary policy tools to prevent a sharper cooling. Meanwhile, a weaker US dollar has helped to cool – and in parts to reverse – capital outflow pressures among EMs, allowing for further rate cuts by several EM central banks, supporting the growth outlook.

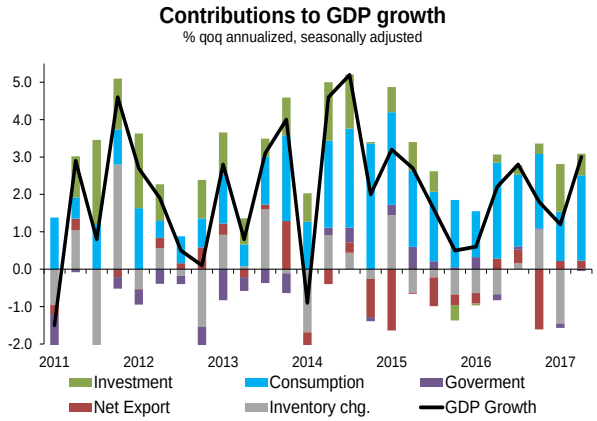
Bonds	**29/08/17***	**3M**	**6M**	**12M**
10-Year Treasuries	2.16	2.25	2.40	2.70
10-Year Bunds	0.36	0.45	0.60	0.85
Corporate Bonds				
IBOXX Corp. Non Fin	126	125	130	135
IBOXX Corp. Sen. Fin	109	110	120	120
Forex				
EUR/USD	1.20	1.18	1.17	1.18
USD/JPY	109	112	115	117
Equities				
S&P500	2445	2430	2425	2415
MSCI EMU	121.5	124.0	125.0	126.0
* avg. of last three trading days				

Amidst the decent economic perspectives in the US and the euro area, the US central bank Fed and the ECB will take further steps towards monetary policy normalization. The Fed will likely announce to start unwinding its balance sheet on Sept. 20, while the ECB will prepare markets for a decision in autumn to taper its asset purchases in 2018.

In this setting, we expect moderate upside pressures on global yields to prevail on a three-month view. Equities especially in the euro area and Japan have some further upside potential, with valuations not yet looking stretched. We prefer European IG corporate bonds over government bonds due to their higher carry and a stable outlook for risk premia. The EUR/USD may still benefit from continued US political uncertainties in the near term. However, after rising 14% ytd and entailing a more than 5% political risk premium on the USD, a moderate correction seems more likely on a three-month view.

USA

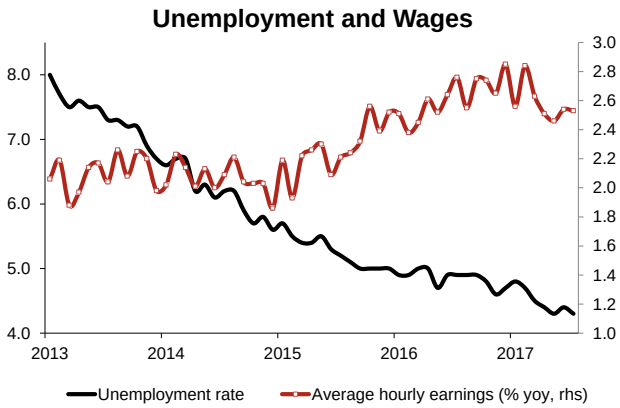
Paolo Zanghieri



- **Q2 data confirm the steady growth of domestic demand, which will drive GDP to increase by 2.1% this year. Activity will expand at roughly the same pace in 2018, under the assumption of a small fiscal stimulus.**
- **The unemployment rate is at a 16-year low, but temporary headwinds to inflation are proving stronger than expected, preventing its quick return to 2%.**
- **Still weak inflation for the rest of the year makes a third rate hike in December a close call, but the start of the Fed's balance sheet reduction should be announced at the September meeting.**

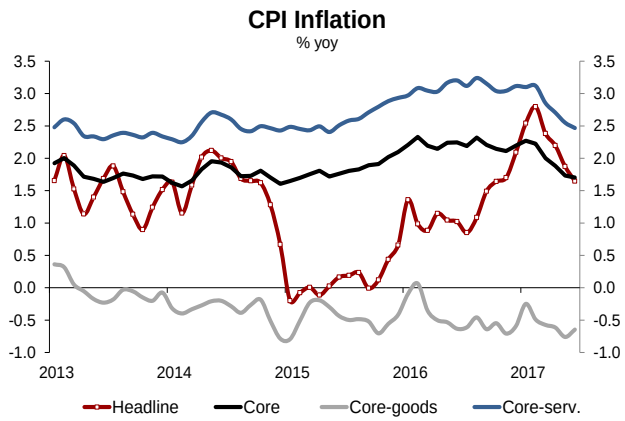
Internal

In the second quarter of the year, GDP grew by 3.0% qoq annualized, accelerating markedly from Q1's 1.2%. Consumption staged a strong pick up (from 1.9% to 3.3% annualized), while investment continued to expand (6.9% annualized, in line with Q1). The strength of the labor market and still favorable financing conditions are consistent with a continuation of the current consumption growth in the following quarters. Also investment is expected to expand, possibly at a slightly slower pace, as capex in the energy industry should weaken in line with the prospects of basically flat oil prices. The unclear political situation will be crucial for growth in 2018, as our forecast of growth just above 2% hinges on the successful implementation of a fiscal stimulus package. While very costly in terms of losses and material damages, hurricane Harvey is not expected to have a long lasting impact on growth. Some weakness in retail sales is to be expected in Q3, to be followed by reconstruction-related investment expenditure later on.



Labor market tightening has yet to trigger inflation

We have revised downward our inflation forecast, and now expect headline CPI to remain at around 1.7% for the rest of the year, leading to a 2% average for 2017 as a whole. A host of temporary and structural factors are dampening and delaying the wage and price impact of the strong tightening the labor market is experiencing. Ongoing steady job creation (payroll went up by 209k in July) has pushed the unemployment rate to 4.3%, the lowest level in 16 year. Yet hourly wage growth remains stuck at 2.4%-2.5% yoy, held back by two key factors in our view. The first is related to the demographic transition in employment, with retiring highly paid workers being replaced by younger, lower paid ones. The second, and more structural headwind is sluggish productivity which is capping real wage growth. On top of that, muted inflation expectations are limiting wage demands by employees. We expect the labor market to tighten further over the coming months (with the unemployment rate heading to 4% by mid 2018), leading to a mild acceleration of wages. This will contribute to an uptick in inflation, accelerated by the unwinding base effect on core inflation, which will



USA

materialize in Q2 2018, when headline inflation will be back to (just) above 2%, due also to firm import prices.

Financial conditions remain favorable

Market financing conditions continue to remain rather loose, thanks to sliding long-term rates and well-performing equity markets, on top of a weaker currency. The outlook for bank credit is more nuanced and generally more favorable for investment than for consumption. Since the start of the year, the rise in delinquencies in auto loans has led to much tighter standards, which were responsible for the slowdown in sales. The recent data on credit card show a marked deterioration in solvency too, matched by tighter supply. If protracted, this could dampen a still solid, and income led, consumption growth. On the contrary, the improvement in profitability and good sales prospects are allowing for looser lending standards for corporations, both large and small ones.

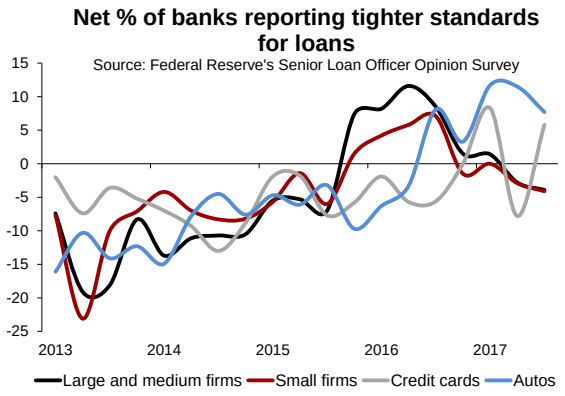
Political gridlock puts fiscal boost at risk

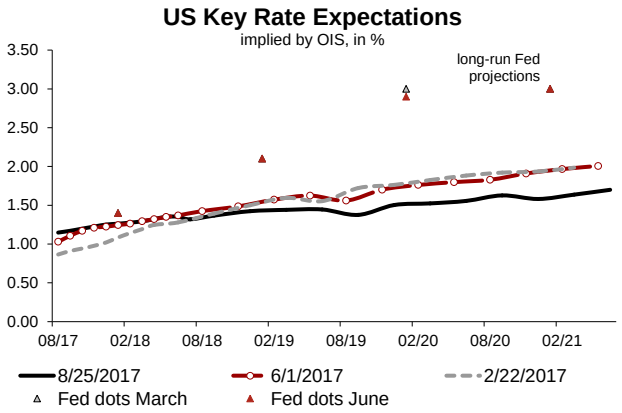
The latest news on the investigation into the alleged links between the Trump staff and the Russian government and the further deterioration of the relationship between the President and the Congress keep markets focused on political risk, as key fiscal deadlines are approaching fast.

The failure to repeal of Obamacare has shown the large divisions within the Republican party which are likely to complicate progress on some of the key items of the fiscal reform promised during the election campaign, such as the border adjustment tax and a substantial reduction in the statutory corporate tax rate. Yet the need to show some results by the November 2018 election will likely take Congressmen to deliver on some modest tax cuts, to come into force in the first months of next year, but risks of failure remain high. Meanwhile, political tensions have increased the perceived risk that no agreement will be found on the needed increase of the debt ceiling and on the 2018 budget. They both have to be agreed on by end of September and we think a crisis will eventually be avoided, as it would be too politically costly for the Republican majority in the Congress.

The Fed: December rise much less certain

In her speech at Jackson Hole, Governor Yellen strongly defended the current regulatory framework for banks, but did not provide any new information on the monetary policy outlook. We still think that the details on the balance sheet reduction plan will be unveiled at the September meeting but the Fed seems now slightly more likely to forego another rate hike not only in September but also at its December meeting. Going into 2018, however, we still see the case for three further rate increases, as inflation should pick up and the uncertainty weighing on fiscal policy should have eased. This contrasts with market expectations of just one further rate hike by the end of next year.



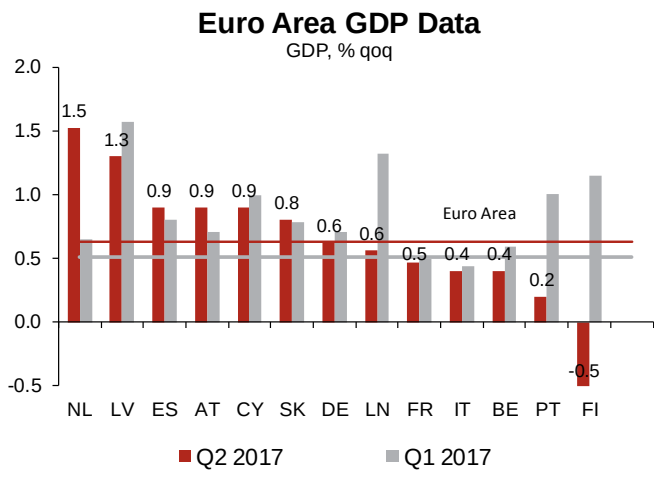


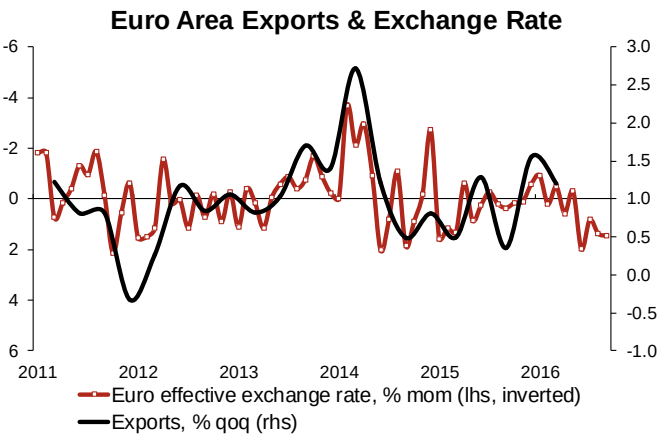
Main Forecasts[1)]	2015	2016	2017f	2018f
GDP	2.9	1.5	2.1	2.2
Consumer spending	3.1	2.8	2.3	2.4
Gov. consumption	0.7	0.9	0.8	0.5
Investment	5.4	1.8	4.9	4.6
- residential inv.	8.9	7.8	5.1	4.2
- structures	-1.5	-2.3	4.2	3.8
- intell. property production	5.7	1.9	4.2	5.4
- equipment/software	3.1	0.4	5.5	4.6
Inventories	0.4	-0.3	-0.2	-0.2
Exports	1.1	2.7	4.1	3.6
Imports	4.9	4.2	5.2	5.4
Net trade	-0.6	-0.3	-0.3	-0.3
Domestic demand	3.2	2.3	2.5	2.4
Consumer prices	0.1	1.3	2.0	2.0
Unemployment rate[2)]	5.3	4.8	4.4	4.1
Budget balance[3)]	-2.5	-2.9	-3.3	-4.4
Fed Funds Rate[4)]	0.38	0.66	1.41	2.16

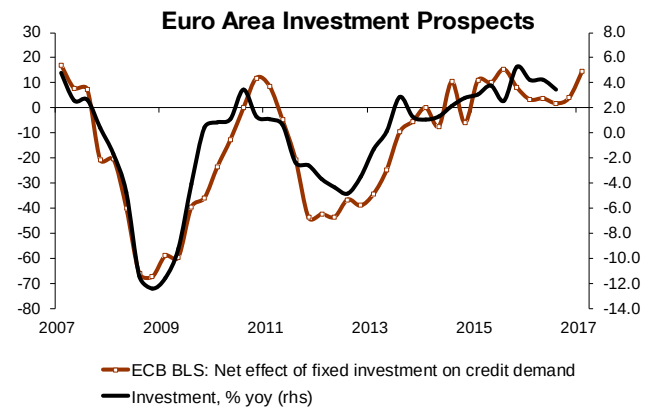
1) Unless noted otherwise, annual % changes, net trade and inventories: growth contribution to GDP 2) yearly average as %, 3) in terms of GDP, federal deficit 4) as %; year-end

Euro Area

Martin Wolburg







- **Q2 GDP growth came in at 0.6% qoq, broad-based among economies and is likely to stay firm also in the quarters to come.**
- **Looking ahead, we expect the pillars of growth to change more towards domestic activity. We even see some upside risks, especially to our 2018 growth forecast of 1.6%.**
- **We still expect the ECB to announce tapering in October and to start in January 2018.**

Q2 GDP flash estimate for the euro area confirmed the acceleration of growth to +0.6% qoq (+2.2% yoy), from a downward revised Q1 figure of 0.5% qoq (1.9% yoy). What is remarkable when looking at the country data is that growth in the major four economies (DE, FR, IT, ES) remained clearly above potential and even accelerated in Spain. The only country with negative growth was Finland (-0.5% qoq), but GDP was still up by 1.6% yoy. However, with Finish economic sentiment still improving and being 1.4 standard deviations above average in July, we view the Q2 data only as some volatility on the recovering path of the Finish economy.

Growth to stay above potential for the time being …

Looking ahead, key sentiment indicators like the PMIs signal that the euro area powers ahead with unabated economic strength. The August euro area flash composite PMI was reported at 55.8, even slightly up from 55.7. While this is almost one index point below the Q2 average (of 56.6), it is clearly consistent with quarterly growth above potential (of about 0.3% qoq).

… and mix to change more towards domestic activity

Within the PMI survey, confidence advanced in the manufacturing sector to the highest level since April 2008 (to 57.4, from 56.6) but receded in the service sector (to 54.9, from 55.4). This development came as a surprise and is unlikely to last. Looking ahead, we see manufacturing sentiment weakening for the following reasons: First, over the past months the EUR appreciated against the currencies of its major trading partners (+5.7% Apr./Aug., monthly averages) which will dampen the export outlook more meaningfully in the months to come. Instead, PMI export orders rose to the highest since May 2010 as of late. Second, German manufacturing sentiment will additionally be burdened by the consequences of the Diesel scandal. So far, such signs are missing.

In contrast, we continue to see domestic demand well underpinned. First of all, employment creation will continue according to surveys. The unemployment rate fell to 9.1% in June, the lowest level since Feb 2009. Second, investment activity has the potential to firm over the coming months. Capacity utilization advanced further

Euro Area

in the third quarter. With a reading of 83.2, it is well above the average of 80 and at the highest since May 2008. Moreover, the latest ECB's Bank Lending Survey shows an increased demand for investment related credits.

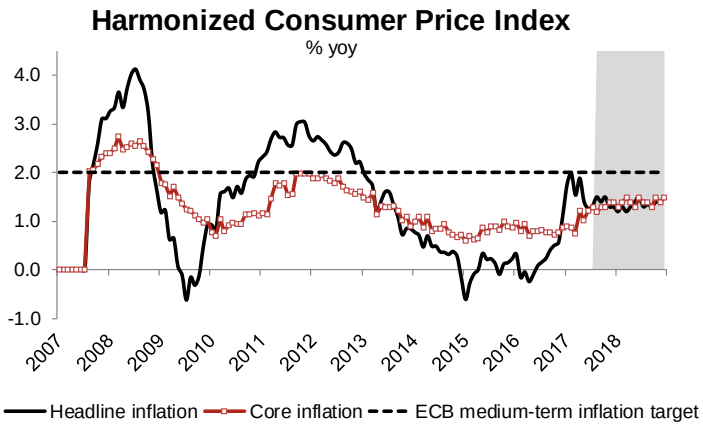
All in all, we expect the dampening effects from less favorable export prospects to be to a high degree compensated by stronger domestic activity, even when accounting for higher import demand. In the second half of 2017, we expect quarterly growth to stay clearly above potential, but deem it unlikely that the Q2 strength can be maintained. We stick to our 2017/18 growth forecast of 2.0% /1.6% but see the risks tilted to the upside, especially for 2018.

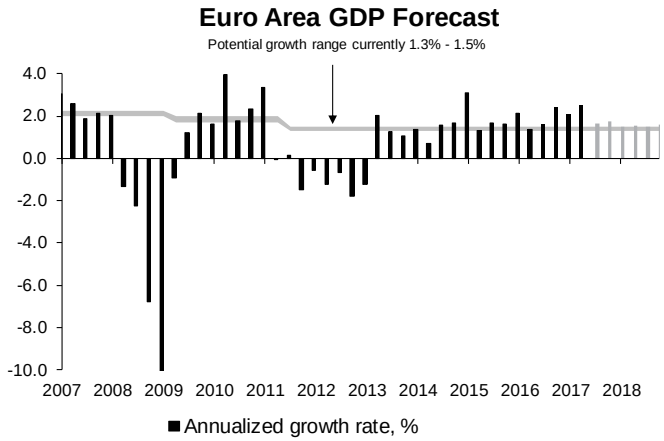
ECB tapering announcement is coming closer

At its July policy meeting, ECB President Draghi stated that the monetary policy roadmap will be discussed in fall. Since then, there was confirmation of the recovery and the ECB's June staff projection with the 2017/18 growth outlook of 1.9%/1.8% will likely be confirmed. Moreover, the corresponding inflation outlook of 1.5%/1.3% looks feasible while core inflation has advanced recently. That said, the effective euro appreciation has accelerated since then and already at the last meeting the exchange rate development received "*some attention*". For the further course of monetary policy, it will be key how the euro appreciation is qualified. Taking past behavior as a blueprint, the use of "*important*" or even "*very important*" would express a higher degree of concern. However, latest comments from ECB officials suggest that the current euro appreciation is viewed as fundamentally justified.

Against this backdrop, we continue to expect communication by the ECB that tapering is about to come. But, at the same time we anticipate a confirmation of the message given in the last press conference that it will be smooth. ECB's Hansson for instance stated that in the post QE period the reinvestment of bonds bought will continue for some time. That said, we think that the Governing Council will only enter into the tapering discussion seriously after the September meeting. At the July meeting Draghi stated that the staff had not been asked to look into the technical options beyond December. In the past, major announcements related to QE came after such internal requests had been made.

We therefore continue to expect the tapering announcement for the October 26 meeting and see the beginning in January 2018. At the forthcoming meeting on September 7, however, Draghi might already comment on the tapering options. Key questions in the Q&A session will likely focus on whether there will be rule-based tapering or a discretionary unwinding of asset purchases, whether there will be continuous monthly QE reduction or quarterly tapering and whether tapering will be proportional across government and corporates bonds or less for the latter one.



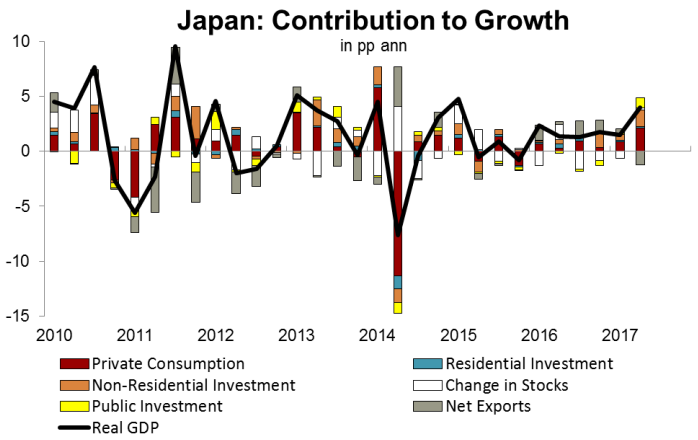


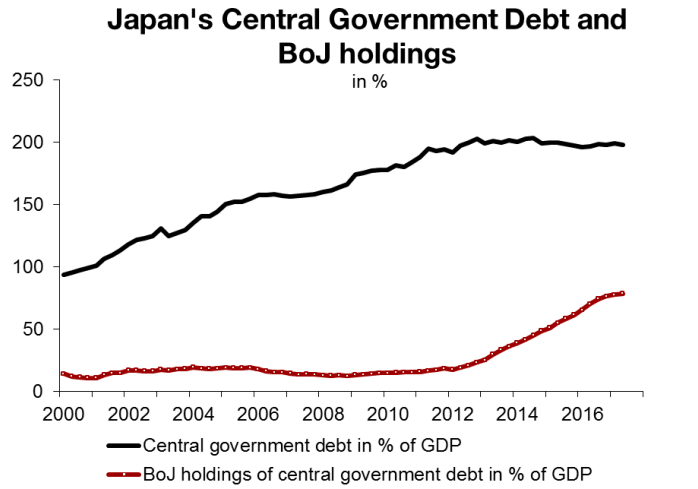
Main Forecasts[1)]	2015	2016	2017f	2018f
GDP	1.9	1.7	2.0	1.6
Consumer spending	1.8	2.0	1.6	1.3
Gov. consumption	1.3	1.8	1.3	1.1
Total fixed investment	2.9	4.1	2.6	3.8
Inventories	-0.1	-0.1	-0.1	-0.1
Net trade	0.1	-0.4	0.4	0.0
Domestic demand	1.8	2.3	1.7	1.7
Consumer prices	0.0	0.2	1.5	1.3
Unemployment rate[2)]	10.9	10.0	9.2	9.0
Budget balance[3)]	-2.1	-1.7	-1.5	-1.4
ECB refi rate[4)]	0.25	0.00	0.00	0.00

1) unless noted otherwise, annual % change, net trade and inventories: growth contribution to GDP, 2) yearly average as %, 3) ratio of budget balance to nominal gdp, 4) as %; year-end

Japan

Christoph Siepmann





Main Forecasts[1)]	2015	2016	2017f	2018f
GDP	1.2	1.0	1.8	1.1
Consumer spending	-0.4	0.4	1.6	1.0
Government consumption	1.6	1.5	0.3	0.8
Investment	0.1	1.0	4.0	1.4
Inventories	0.4	-0.1	-0.3	0.1
Net trade	0.4	0.1	0.2	-0.1
Domestic demand	0.7	1.0	2.0	1.2
Consumer prices	0.8	-0.1	0.3	0.5
Unemployment rate[2)]	3.4	3.1	2.8	2.7
Budget balance[3)]	-3.5	-4.3	-3.9	-3.3

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

- **According to the first print, Japan's Q2 GDP rose surprisingly strongly by 4.0% qoq annualized.**
- **PM Abe reshuffled his Cabinet in early August, but political worries have not disappeared.**
- **The BoJ reduced its de-facto JGB purchases but this will not limit its control over the yield curve.**

Japan's GDP growth surprised very much on the upside in Q2. According to the first print, GDP expanded by 4.0% qoq annualized (ann), up from an also revised 1.5% qoq ann in Q1. The result was mainly driven by domestic factors. Private consumption accelerated to 3.7% qoq ann while private and government investment also increased. With regard to private capex, the GDP figures were at odds with core machinery orders, and only corporate investment statistics early September will bring more clarity. (We expect this to lead to a slight downward revision of the first GDP print). Public sector fixed capital formation surged amid a concentrated implementation of the second complementary budged for FY 2016. Concerning external trade, net exports were a drag on growth as exports receded while imports remained strong. However, we consider the drop in exports to be a temporary factor. In July, real trade improved again, while industrial output saw a payback effect (receded by 0.8% mom), after the strong increase by 2.2% mom in June. Looking into Q3, especially private consumption may undershoot after the strong Q2 result. However, an upturn in inventories is still possible, thus preventing a strong drop in Q3 growth. Consequently, we revised our GDP growth forecast up to 1.8% this year, from 1.4% before.

Political uncertainties have risen

In the wake of a favoritism scandal, low approval ratings and a historic LDP defeat in the Tokyo assembly election, PM Abe reshuffled his Cabinet in early August. Nevertheless, speculations about early national elections resided. Most commentators see the likelihood of PM Abe to step down as limited. We expect the future role of PM Abe to become clearer in LDP leadership elections in late 2018.

BoJ to stick to its policy in the short run

Given this assumption, the next BoJ Governor to be appointed in April 2018, will likely again be the incumbent Mr. Kuroda. Thus, the concept of monetary policy should not move much. However, recently markets focused on the de facto lower JGB buying by the BoJ, despite no change in its official purchases of around JPY 80 tr per year. However, when the BoJ introduced its "QQE with yield curve control" in September 2016, we already commented on the conflict of a simultaneous quantitative and price target. However, in an environment of rising JGB supply scarcity, the BoJ will be able to maintain its price target with even lower purchases. Therefore, we do not expect markets to worry about the yields cap and the recent development supports this view.

China

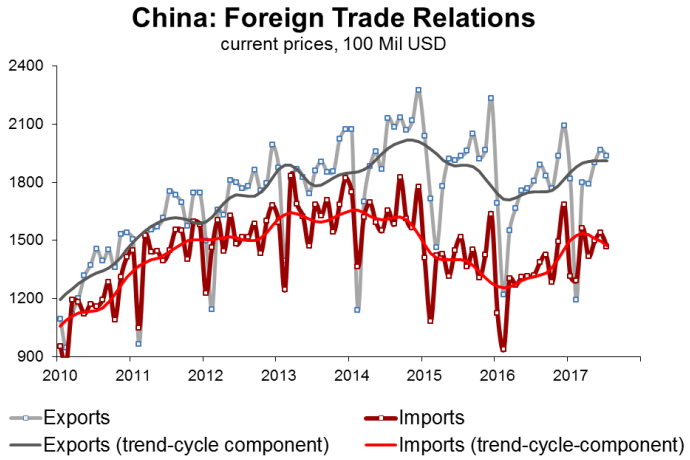
Christoph Siepmann

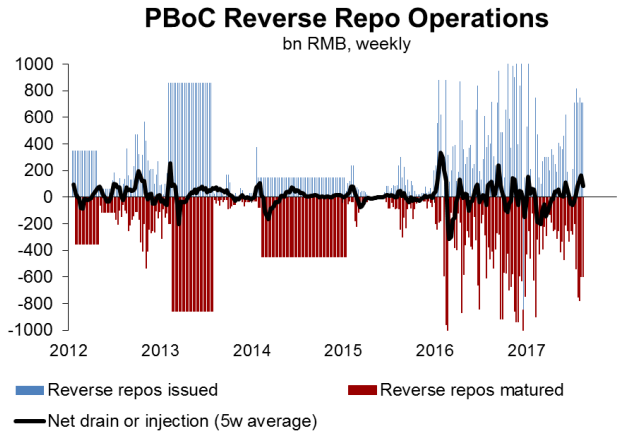
- **After China's real activity indicators finished Q2 on a high note, July data mainly reverted back to previous, more "normal" levels.**
- **However, a strong drop in monthly property sales warrants further attention.**
- **Beijing will probably continue to focus on economic stability ahead of the 19th Party Congress, which will probably take place in early November.**

China's two manufacturing PMIs re-converged in July, mainly due to the rebound of the Caixin manufacturing PMI, which rose 1.5 index points over the last two months. Dominant drivers were a strong recovery in new export orders, but also domestic orders and output contributed positively. The NBS PMI for August improved slightly. Thereby, both PMIs continue to signal solid growth.. However, real activity data came off in July from their very strong note in June to more "normal" levels. Industrial production fell back to 6.4% yoy, after 7.6% yoy in July, but broadly in line with April and May readings of 6.5% yoy. Urban fixed asset investment receded to 8.3% yoy ytd amid less support from the government side. Infrastructure investment receded by about 1 pp, but maintained with 19.2% yoy ytd still a very high level. Central government investment growth already turned negative at the outset of this year. However, due to a less negative base effect, the slowing eased slightly last month. Local as well as SoE investment continued to soften. The latter was also true for the real estate sector (from 8.5% yoy ytd in June to 7.9% in May), while monthly sales indicators saw a surprisingly strong drop both in value as well as in square-meter terms. A plausible explanation is not readily available which warrants further close attention, whether this effect was more than just a monthly fluctuation. Overall, however, investments signal only a mild easing of the domestic economy.

Party Congress to elect New Politburo

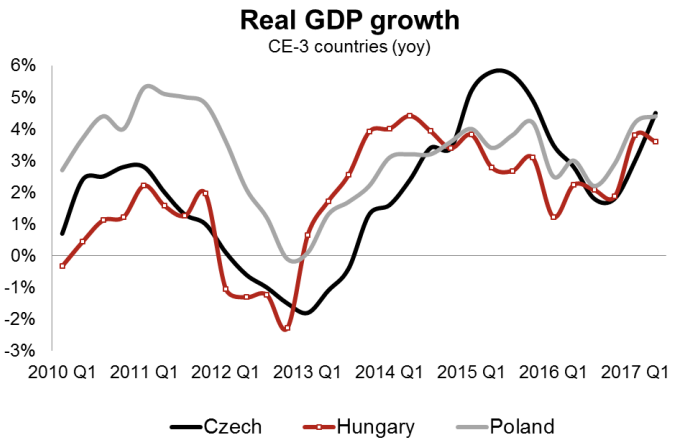
Exports and imports rose by 7.2% yoy resp. 11.2% yoy. However, there are large base effects involved. In contrast, the trend-cycle component suggests that exports – after strongly accelerating in H2 2016 – moved sideways on a higher level, while imports began to soften. However, there is a strong seasonality involved which renders seasonal adjustment less reliable. We expect the government to continue to smooth any larger fluctuation, especially ahead of the leadership reshuffle at the 19th Party Congress, taking probably place in early November. The Congress will end with the election of the new Central Committee, which then will vote on the new Politburo and its Standing Committee. However, changes will likely be limited to the five retiring members. Like already in the Financial Work Conference in July, limiting financial risks will be a topic ranking high among the discussed policy priorities. Therefore, we expect the relatively tighter liquidity management to be kept by the PBoC, while not jeopardizing growth.

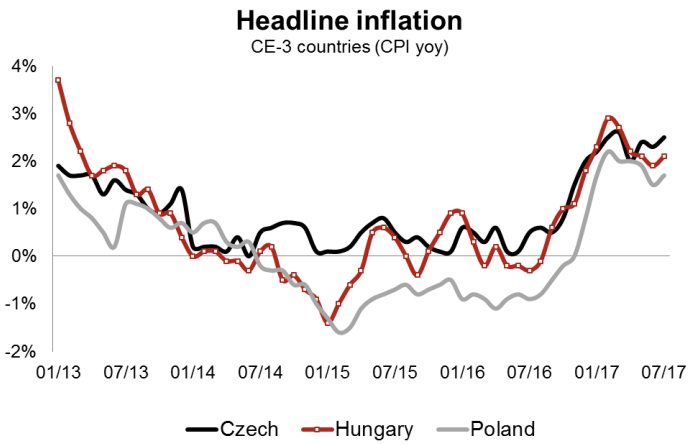




Central and Eastern Europe

Radomír Jáč





Main Forecasts	2015	2016	2017f	2018f
Czech Republic				
GDP	5.4	2.5	3.8	2.9
Consumer prices	0.3	0.7	2.3	2.0
Central bank's key rate	0.05	0.05	0.50	1.00
Hungary				
GDP	3.1	2.0	3.7	3.0
Consumer prices	-0.1	0.5	2.4	2.9
Central bank's key rate	1.35	0.90	0.90	0.90
Poland				
GDP	3.9	2.7	4.0	3.2
Consumer prices	-0.9	-0.6	1.9	2.0
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

- **GDP data for Q2 confirm robust CEE growth, running above its potential. GDP develops in line with the central bank‘s forecast in Hungary and Poland but came in much stronger in case of the Czech Republic.**
- **Core inflation has grown in the Czech Republic and Hungary, while in Poland remains moderate.**
- **Polish central bank keeps neutral stance, while Hungarian MNB sent dovish signals. Czech CNB raised its key rate in August and may do more in the rest of 2017, as the CZK fails to strengthen.**

The CEE economies maintained solid performance in Q2, with GDP growth exceeding expectations in most cases and mainly in the Czech Republic. Czech GDP jumped 2.3% qoq (4.5% yoy), which was a full percentage point above the CNB forecast. This implies that the Czech economy is overheating at a faster pace than thought so far, which may impact CNB‘s view on the needed pace of its interest rate adjustments. Data for both Hungary (0.9% qoq) and Poland (1.1% qoq) are in line with central banks' projections for the full-year GDP growth, so they should not have any significant implication for monetary policy.

Headline CPI is affected by anti-inflationary impact of fuel prices and remains below central banks‘ inflation target in most countries in the region, with Czech CPI (2.5% yoy in July vs. target at 2%) being an exception. That said, core CPI, which excludes impact of commodity prices, stands above headline inflation not only in Czech economy (2.6% yoy) but also in Hungary (2.6% yoy vs. 2.1% yoy), which signals that the strong demand and capacity utilization already creates price pressures in respective economies. Poland at the same time reports headline CPI at 1.7% yoy (vs. target set at 2.5%) and core inflation at 0.8% yoy.

Czech CNB delivered rate hike, more may follow in Q4

Czech central bank raised its repo rate by 20bps to 0.25% in early August. This was the first increase in the CNB interest rates in almost 10 years and the first rate hike in the EU in the current business cycle. The CNB indicated the rate hike in advance and the market reaction was muted, both in case of government bond yields and the currency. The Czech crown did not manage to firm below 26 vs. euro, which is supportive to scenario in which the CNB raises its interest rates further in Q4.

Both GDP and inflation data for Poland would support the NBP's view of keeping interest rates on hold in the foreseeable future. Hungarian MNB sticks to the view that both the base rate and the loose monetary conditions achieved through the change in monetary policy instruments earlier should be maintained steady for an extended period. The fresh comments made by the Hungarian central bank actually indicate that it is closely examining more monetary easing via further non-conventional policy tools.

Bonds/Fixed Income Strategy

Florian Späte

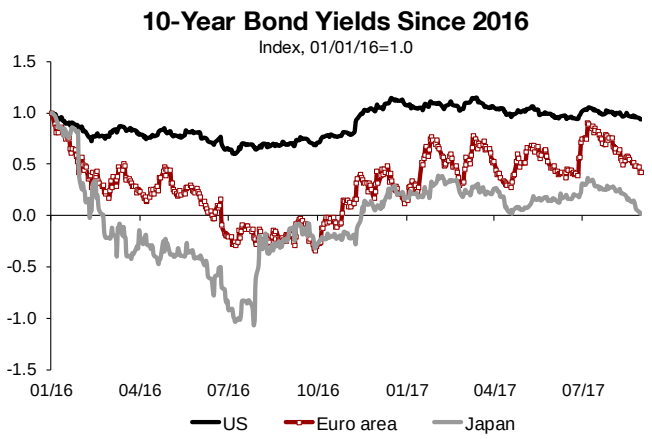
- **Long-dated international core yields changed direction in August and fell on both sides of the Atlantic. Driven by geopolitical concerns and the state of the US government, 10-year yields have approached the lower end of the trading range.**
- **Southern European government bond spreads widened from very low levels despite an overall friendly macroeconomic environment and a supportive issuance activity.**
- **While the scope for higher core yields is limited on a very short term horizon, the preconditions for higher yields further down the road are still fulfilled. Accordingly, we recommend to increase the short duration for both euro area core and peripheral government bonds.**

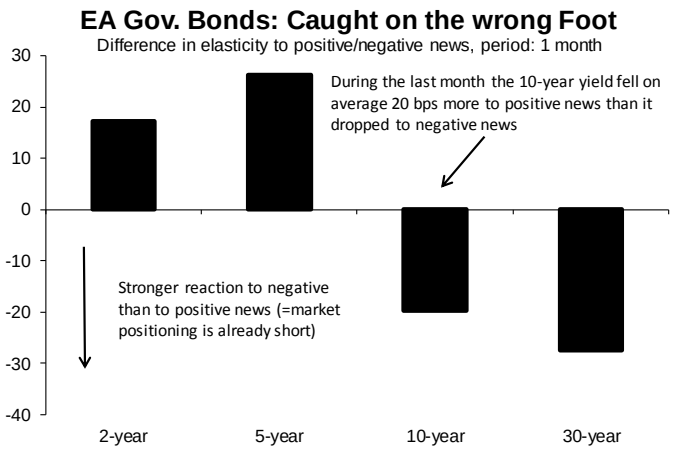
Although economic data held up rather well in August, nominal yields in the euro area and in the US fell across the curve. While 10-year Bund yields dropped by 19 bps to 0.36%, 10-year Treasury yields decreased from 2.31% to 2.16%. Whereas 10-year Bund yields still remain in the middle to the trading range of 0.15% to 0.60%, the 10-year Treasury yield has come close to the lower end of the range – and temporarily even fell below the lower end of 2.10%. As inflation expectations hardly moved, the decline was mainly due to lower real yields. The drop was less pronounced at the short end as 2-year yields fell slightly by up to 3 bps. During the summer break, the news flow was all in all limited. On balance, the lasting tensions on the Korean peninsula and concerns about the inability of the US administration to deliver on the promised reforms supported core government bond markets and contributed to the bull flattening on both sides of the Atlantic.

No change of transatlantic yield spread short term

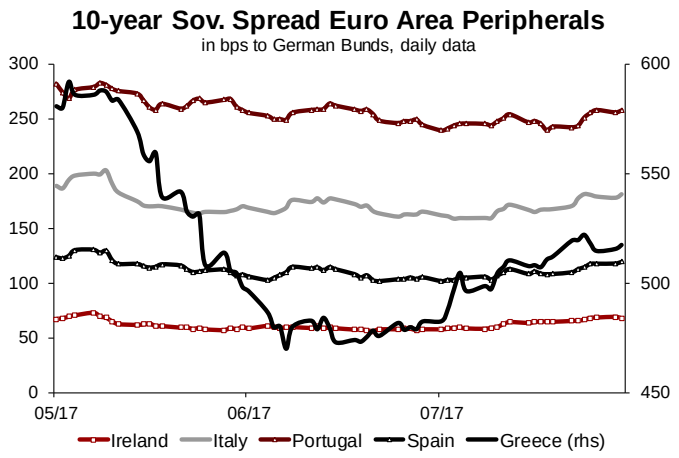
Going forward, we maintain our view of higher yields in the medium term. First, financial markets price in only one further key rate hike by the Fed until the end of 2018. Although a hike in December has become more uncertain in recent weeks given the persistent low inflation, we still expect three hikes in 2018. This forecast is mainly driven by the expectation that the inflation pressure will increase next year. Second, an end to the economic expansion in the US is not in sight. In 2017 and 2018, the US is seen to achieve growth rates above 2%. Third, in light of the poor performance of the new US administration so far, expectations regarding possible reforms have been dented. Hence, any success is likely to surprise financial markets positively. Finally, the net-long position of non-commercial traders in 10-year Treasuries is close to a historical peak. A normalization is generally accompanied by higher yields.

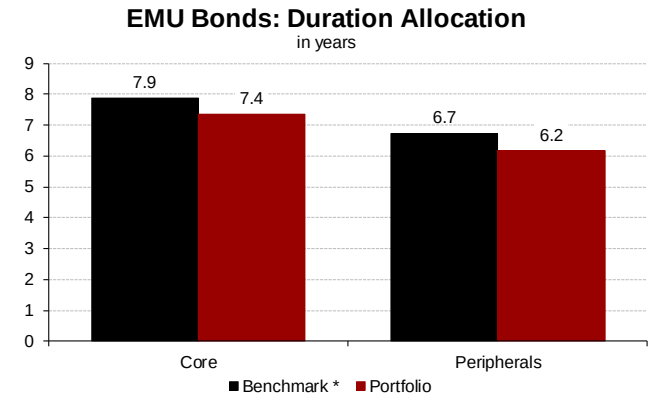
However, in the short term the scope for higher US yields appears limited. Not only because a continuation of the low inflation environment is likely, but mainly due to the



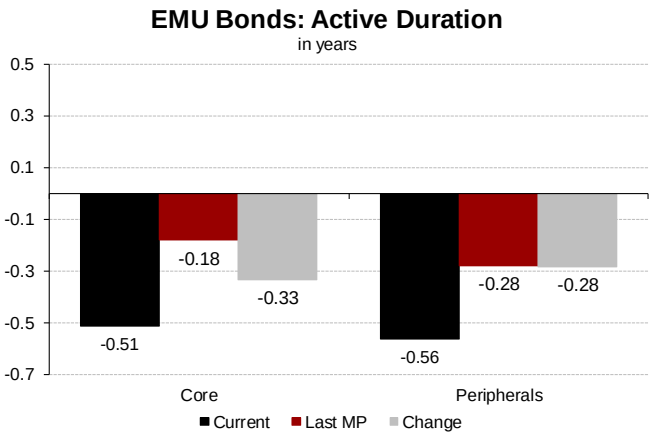


Bonds/Fixed Income Strategy





* JPMorgan EMU Government Bond Index



approaching debt ceiling. Given President Trump's tough approach, dissolving the crisis in the short term appears rather unlikely. If last debt ceiling episodes are any guidance, higher yields in the run-up to a possible shutdown are rather unlikely.

While the development of US yields will impact euro area core yields, the expected ECB announcement to start tapering the QE programme from January onwards, should pave the way to higher long-dated Bund yields as well. Moreover, while the short-term trajectory for the US headline inflation is somewhat down, the euro area headline inflation is forecast to inch further up in the months to come. All in, 10-year Bund yields are seen to increase to 0.45% on a 3-month horizon. This implies that the transatlantic yield spread at the long end of the curve is likely to remain roughly unchanged.

The increase in long-dated yields will only be retraced partially at the short end. Hence, yield curves are expected to steepen on a 3-month horizon. This applies particularly to short-dated Bund yields as the QE programme continues for the time being and a first rate hike is still far away. What is more, the increasing scarcity of German Bunds is likely to anchor the short end of the euro area yield curve. Accordingly, the transatlantic yield spread at the short end of the curve is forecast to widen.

Rally of Southern European bonds stalled in August

After marking the lowest level for one year, peripheral spreads widened considerably in August. In particular Spanish Bonos came under pressure and the 10-year spread versus Bunds widened by 25 bps to 121 bps.

Despite the ongoing economic expansion, the pressure is unlikely to abate lastingly in the weeks to come. To start with, the ECB is forecast to announce QE tapering in autumn. Although it is by and large expected by financial markets, there could be some selling on the news. What is more, after the summer break issuance activity is expected to pick up. The technically less benign environment could become a burden for peripheral government bonds. Finally, the forthcoming Italian elections will increasingly impact BTPs and are expected to contribute to an underperformance of Italian bonds.

Our portfolios

Taking into account the recent drop in long-dated core yields, we recommend reducing the duration of the core bond portfolio. Accordingly, we suggest a duration of -0.51 years (from -0.18 years before). Despite the higher carry, we are even a bit more cautious regarding peripheral bonds and recommend a duration of -0.56 years (from -0.28 years before). Still, both portfolios are not expected to evade the forecast increase in yields. The total return on a 3-month horizon is negative for all European government bonds.

Corporate Bonds (Non-Financials)

Florian Späte

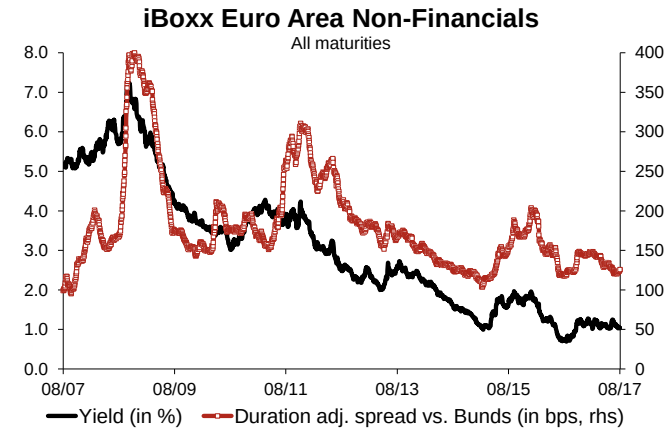
- **Despite a moderate spread widening, non-financial corporate bonds performed well in August. The drop in underlying yields was sufficient to secure a positive total return.**
- **While the fundamental situation of euro area corporates is still solid, the valuation from an absolute point of view but also with respect to other assets appears ambitious.**
- **Accordingly, although there is no reason to be worried in the short term, we regard the scope for a further spread tightening as limited. Investors should be particularly careful with low-rated and long-dated euro area IG non-financial corporates.**

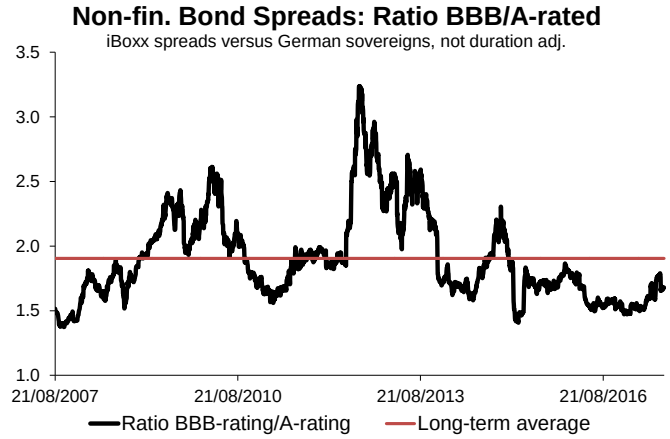
Although non-financial IG corporate bonds performed better than other spread products in August, they could not evade a moderate spread widening. On balance, the (duration adjusted) spread widened by 5 bps to 126 bps. However, as underlying yields fell strongly, the non-financial corporate yield level fell by 12 bps to 1.00% - the lowest level since fall 2016. Accordingly, non-financials yielded a total return of 0.8% in August (thereby outperforming financial bonds). The total return year-to-date is 1.7%.

Although there are some factors which favor a further spread tightening going forward, we send a note of caution as the leeway for a significant spread tightening appears limited. To start with, the current spread level is only partially comparable to the levels at the start of the financial crisis. Adjusted for a higher rating, it is fair to conclude that the current spread is closer to the trough as it appears at first sight (by roughly 10 bps). What is more, after a negative net issuance in August, we expect issuance activity to become positive again in the months to come. In addition, although the ECB acts rather flexibly and is willing to increase purchases in times of market stress (beyond the regular monthly amount of €6 bn), QE tapering is looming. Moreover, the relative attractiveness has come down as well. The yield advantage compared to 5-year euro area sovereign bonds has diminished since the start of 2016 by around 50 bps to less than 100 bps.

Reward for taking risk is becoming unattractive

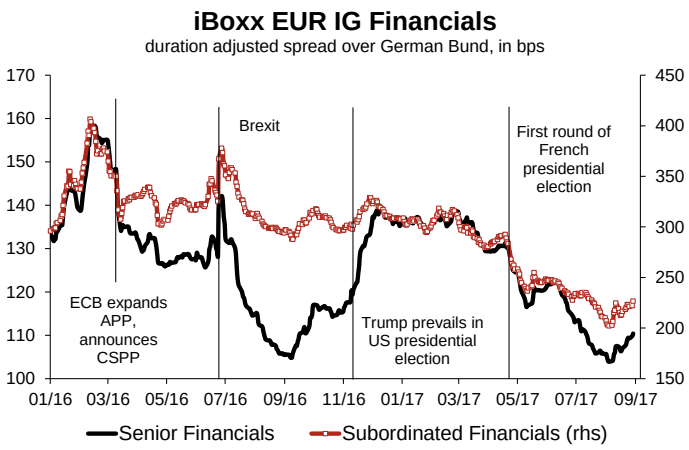
Accordingly, although we remain rather constructive for non-financials in the near term, the reward for taking risks is less attractive than before. While some further spread tightening in the months to come cannot be excluded, the leeway for a significant tightening from current already low levels appears limited. Particularly, low-rated bonds are unattractive as the spread ratio of BBB-rated to A-rated non-financials is below the long-term average – which is unlikely to persist in periods of widening spreads. Furthermore, long-dated corporates are particularly exposed to an expected increase in underlying yields.

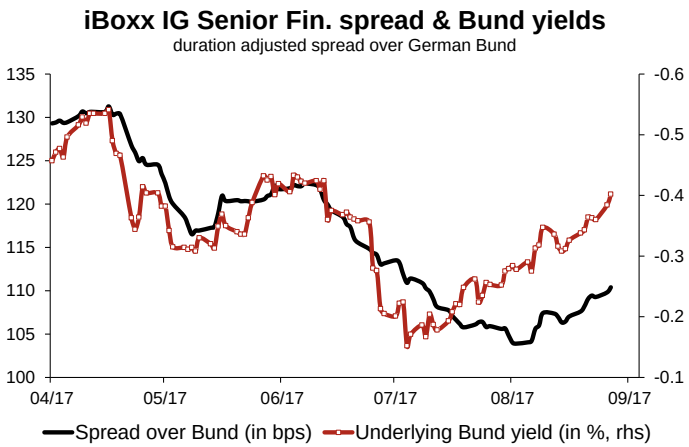


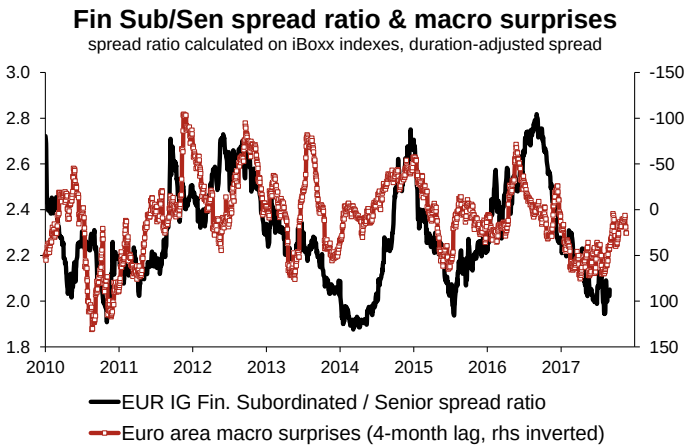


Corporate Bonds (Financials)

Luca Colussa







- **EUR Financial corporate bond spreads widened in August as the risk-off mode prevailed. The total return performance of Investment Grade Senior Financials was anyway positive thanks to the drop in the underlying Bund yields.**
- **Going forward, we expect Senior Financial spreads to trade sideways in the near term, before rising moderately as Italian elections in H1 2018 come closer.**
- **Subordinated Financials underperformed Senior bonds by nearly 50 bps in August. We continue to favor a balanced stance between the two as the higher carry of Sub. notes should be weighed against their relatively more stretched valuation.**

EUR Investment Grade (IG) Senior Financial bonds performed well in August (+0.65% since end July according to the iBoxx index), thus extending the gains seen in July (+0.71%). However, this reflects the drop in the underlying Bund yields (down by 15 bps), which offsets the mild rise in Senior bond spreads (up 4 bps to 110 bps, after hitting a 27-month low at 104 bps in early August). The year-to-date performance climbed to 1.76%.

Bund yields to remain a key driver of performance

As we anticipated last month, the downward trend in Senior Financial bond spreads had gone a bit too far given the renewed decline in Bund yields seen since mid-July. Moreover, as the downward trend in Bund yields continued in August, the mild spread widening in Senior Financials was inevitable, also due to the re-widening in sovereign risk premiums.

Going forward, the expected moderate rise in Bund yields advocates for a slight decline in corporate bond spreads, but this impact should be offset by our expectations of rising sovereign spreads. As a result, we expect Senior Financial spreads to move sideways over 3 months (at around 110 bps), before moving higher to 120 bps as Italian elections approach. As a result, the total return performance will likely be slightly negative.

Sub. bonds' relative valuation looks somewhat dear

IG Subordinated bonds underperformed Senior Financial ones in August (total return: +0.09%) due to their larger spread widening (+16 bps to 226 bps). While a gradual easing of the risk-off mode may favor a short-term outperformance of Subordinated bonds, their relative valuation looks a bit stretched. Indeed, the spread ratio between Subordinated and Senior bonds looks too low given the less upbeat momentum in euro area macro surprises, the recent decline in Bund yields and the still too moderate recovery in banks profitability. We consequently continue to recommend a balanced stance between Subordinated and Senior bonds.

Currencies

Thomas Hempell

- **Amid mounting political uncertainties, the EUR/USD rose further in August, temporarily surpassing 1.20 for the first time since early 2015.**
- **In the very near term, the EUR/USD may still benefit from brinkmanship in the US Congress around the necessary debt ceiling increase.**
- **However, after rising by 14% year-to-date and entailing a more than 5% political risk premium, a moderate correction seems more likely on a three-month view.**

The euro extended its broad-based rally over the course of August. The EUR/USD strengthened another 2%, temporarily surpassing 1.20 and extending its year-to-date gains to 14%. In trade-weighted terms, the single currency has strengthened by 6% over the course of this year so far.

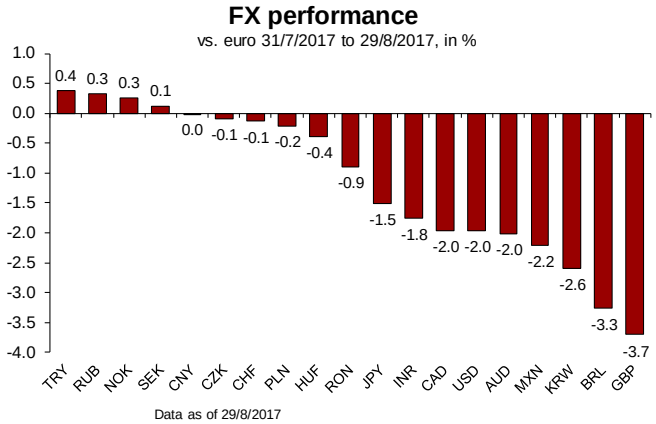
A striking feature of the last leg higher in the EUR/USD is that it is very much decoupled from financial market correlates like yield differentials, Southern European risk, the oil price and the S&P500. In fact, a model based on these factors (which accounts for 74% of the daily EUR/USD variance) points to a gap as high as 6% by which the EUR/USD has overshot. One explanation is mounting concerns about politics in Washington, with the Congress still struggling to raise the debt ceiling by end-September to avoid a government shutdown or, worse, a technical default on Treasury debt.

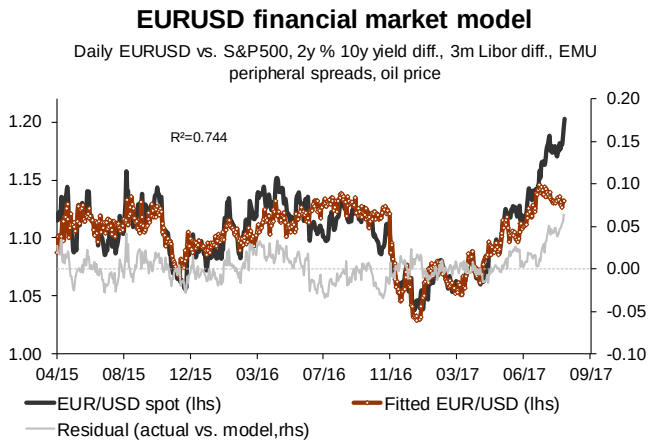
US politics burdening the US dollar

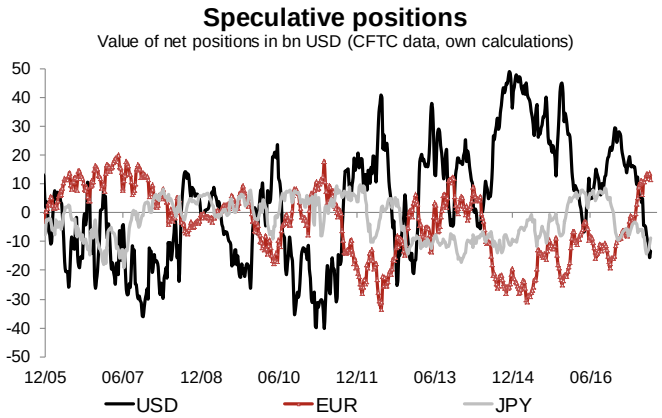
Short term, these tensions may intensify over the course of September, further burdening the USD. The EUR/USD may also benefit from growing reassurance that the ECB will announce a tapering decision in October. The momentum is on the euro's side, too, with wrong-footed investors increasingly hedging their USD exposure. And, as we have argued in the past, the persistently high current account surplus in the euro area (3.4% of GDP) contrasts with a sizeable deficit (2.4% of GDP) in the US.

That said, the higher USD risk premium and the rise in short US dollar positions has raised the risk of a correction. In the medium term, we also expect the US/EA yield differential to widen again. And finally, even though the Fed will likely forego a rate hike in September and "only" announce the start of the balance sheet reduction, markets are much too complacent in anticipating only one further rate hike by the end of next year. Furthermore, in case of continued euro strength, the ECB may intervene verbally.

The British pound in the meanwhile has underperformed sharply, with the EUR/GBP closing hitting almost an 8-year low. In parts this has been due to unwinding rate hike expectations. But the greater burden for sterling currently is the persistently large Brexit uncertainty coupled with a sizeable current account deficit. EUR/GBP is already far detached from levels implied by yields differentials, but any quick recovery of the pound is not on the cards.

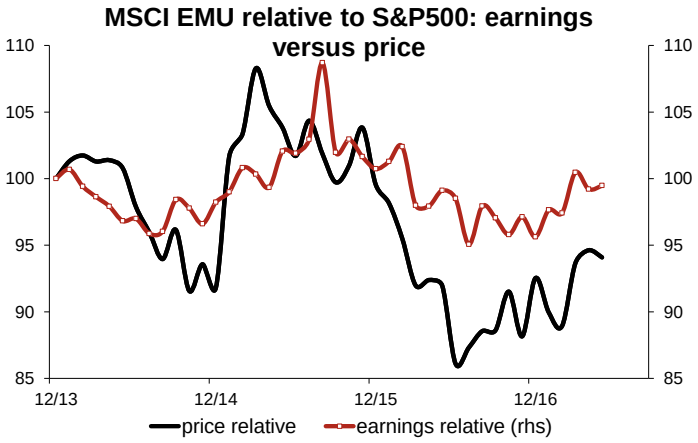




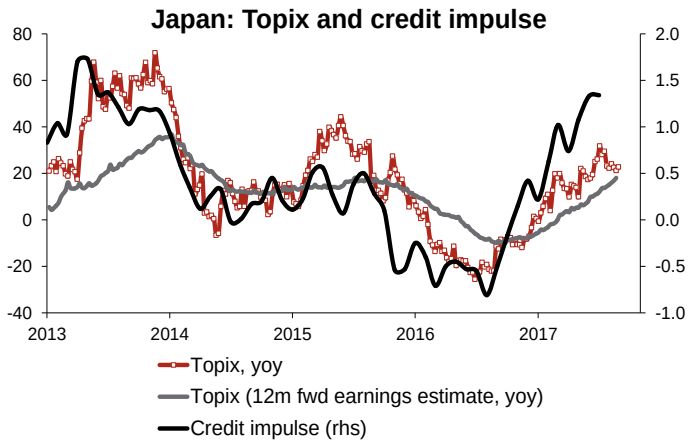


Equities

Vladimir Oleinikov



Sector	S&P earnings growth, yoy: Q2 2017	Euro Stoxx earnings growth, yoy: Q2 2017	Topix earnings growth, yoy: Q2 2017	S&P sales growth, yoy: Q2 2017	Euro Stoxx sales growth, yoy: Q2 2017	Topix sales growth, yoy: Q2 2017
Energy	210.0%	31.9%	7.8%	15.8%	15.6%	17.6%
Materials	5.2%	45.6%	80.7%	7.2%	11.1%	10.2%
Industrials	5.8%	3.6%	45.9%	4.7%	5.7%	4.6%
Cons. Discretionary	1.9%	-7.9%	35.1%	4.2%	6.1%	5.8%
Consumer Staples	3.6%	75.7%	26.4%	2.2%	21.6%	5.7%
Health Care	6.6%	-2.3%	9.6%	4.0%	5.6%	1.6%
Financials	9.5%	25.4%	12.3%	4.5%	2.0%	3.4%
IT	15.3%	26.3%	71.6%	9.0%	8.4%	8.3%
Telecoms	5.0%	8.7%	-26.7%	-1.3%	3.1%	3.8%
Utilities	-4.0%	282.3%	14.2%	6.4%	1.7%	5.0%
Market	9.5%	27.5%	27.0%	5.4%	6.8%	5.9%
Median (all sectors)	5.8%	25.8%	26.4%	4.7%	6.1%	5.7%
Median, ex. Energy & Materials	5.8%	17.0%	26.4%	4.5%	5.7%	5.0%



- **In August Developed Market (DM) equities came under pressure amid US political uncertainty and geopolitical tensions.**
- **Euro area (EA) earnings continued their positive trend, both in relative and positive terms. The Q2 reporting season for the EA was one of the best globally.**
- **Overall, we remain constructive on equities. The lower yield expectations should provide additional support.**
- **We favor the EA and Japan over Switzerland and the US and are neutral on the UK and EMs.**

DM equities came under pressure in August. The S&P 500 and Topix lost around 1.0%. The MSCI EMU decreased by 1.7% (due to euro appreciation), while UK and EMs outperformed (-0.5% and +1.4%, respectively). The SMI dropped the most (-2.7%).

Reporting season: decent to firm earnings growth

As the Q2 reporting season is practically over, we see a confirmation for the upward trend in earnings. Thus, the US earnings growth is revealed at 9.5% to be decent, while EA and Japanese earnings have grown at a reassuring rate of around 30%. Yet Q2 results look a bit worse than those of Q1, due to stronger currencies in the EA and Japan as well as a lower oil price. While the earnings surprises have come down compared to Q1 as well, they are still higher than the average over the last nine quarters. Given supportive macro data and a very moderate cost growth, we expect corporate earnings to improve for the reminder of the year.

We remain constructive on equities

From the valuation point of view, the US market remains the most expensive. Thus, its multiples are priced at a premium of 16% vs history and the current PE of 17.6 lies above the historical average of 15.2. While the market is getting support from a decent earnings growth (we expect 6%-8% for 2017) and lower yield expectations (December rate hike much less certain), some pressure would come from an increasing wage growth, from the current low level. Over the next year, we forecast a total return of around 1% (2% of which is a dividend yield). Apart from geopolitical tensions, which might weigh on all markets, the short-term risk for the US market is represented by the eventual government shutdown in October.

As for the favored EA and Japanese markets, their expected 12-month total return is around 7%. Compared to the US market, they are characterized by stronger earnings trends, improving ROE and are less expensive (both vs the US and their history, the PEs for the EA and Japan being at 14.2 and 13.8, respectively). They are to benefit from expected respective currency depreciations.

Emerging Markets Equities

Vladimir Oleinikov

- **EMs in August have gained due to lower yields, a weaker US dollar and improving macro surprises.**
- **While we still expect a higher earnings growth in 2017 vs DMs, we see a major deceleration until the end of this year.**
- **The EMs are to benefit from lower valuations, stabilizing macro surprises, the continuation of the world trade recovery, and lower spreads. Risks come from geopolitical tensions, a re-appreciation of the US dollar and higher US yields.**
- **We continue to be constructive mid-term on EMs and still favor India along with Korea and CEE countries. China remains, in our view, at risk given the need to reduce the high credit-to-GDP ratio.**

Over the last month, EM equities have gained (+1.7% in US dollar terms), despite increasing geopolitical tensions between the US and North Korea. The top performer was Brazil (+8.2%), followed by Hungary (6.4%) and Poland (+5.4%). The worst performing ones were India (-2.1%), Greece (-1.8%), and Korea (-1.5%). The Brazilian market has kept benefitting from the past drop in local yields. The countries from the CEE regions have, on the other hand, received a boost from recent solid GDP data. The disappointing reporting season in yoy terms (-3.2%) brought the Indian market under pressure.

Overall, EM 2017 earnings have been revised slightly up during the last month (+0.5%). The markets with significant upgrades are: Hungary (+4.5%), Mexico (+3.4%), and China (+3.2%). The earnings downgrades occurred for the Indian (-2.8%), Brazilian and Russian companies (both -1.1%). The Korean earnings have been upgraded by 1.0%.

India: reforms to pay-off beyond short-term

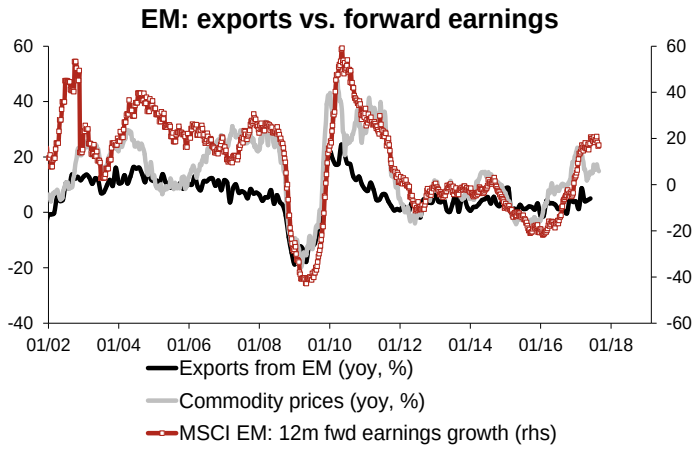
While the Q1 2017 reporting season was disappointing in yoy terms (in qoq terms aggregate earnings growth is positive at 7.6%), key macro variables – inflation, the fiscal side and current account – have been well behaved. The market is characterized by a slowdown in activity, but some initial signs of structural benefits from the implementation of the goods and services tax are visible. So, we remain constructive beyond the short term as reforms should start paying off after the initial disruption.

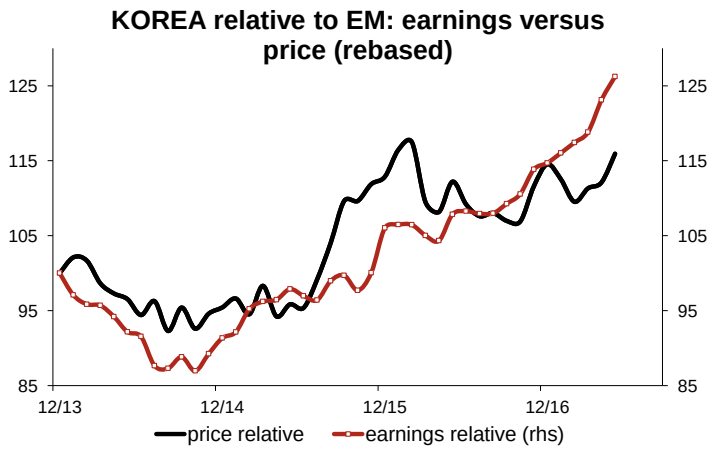
Korea: supporting fundamentals

The market is undervalued compared to its fundaments. Korea's valuations are at a discount of 13.5% versus its history. Apart from a better earnings trend versus price development relative to the EM universe, the market is characterized by increasing margins, a high return on equity, and payouts. While a further escalation of geopolitical tensions cannot be excluded, we do not see tensions with N. Korean crisis escalate to military action. Thus, we consider the temporary setbacks as an opportunity to buy.

Markets	price, %-chg		earnings, %-chg		10y yld	FX (TW), %-chg	
	-1M	YTD	-1M	YTD	chg, YTD	MTD	YTD
WORLD ($)	-0.8	11.1	1.3	10.6			
US	-1.0	9.3	0.9	6.4	-32	-0.9	**-7.8**
EMU	**-2.1**	5.0	1.0	8.6	10	**1.5**	6.5
GREECE	**-1.8**	15.7	-0.2	16.9	**-159**	**1.5**	6.5
CZECH REP.	1.3	10.8	-0.1	**-0.3**	**45**	0.3	6.6
HUNGARY	6.4	17.4	**4.1**	22.2	5	-0.2	3.7
POLAND	5.4	27.6	1.3	20.6	-36	0.2	6.6
EM ($)	1.7	25.4	1.5	17.7	-56		
BRAZIL	**8.2**	16.4	0.4	7.5	-133	**-2.1**	-2.6
CHINA	3.7	**38.6**	**4.3**	17.1	**63**	**1.3**	-1.4
INDIA	**-2.1**	18.3	**-0.9**	3.6	2	-0.7	-0.5
INDONESIA	0.8	13.4	0.6	8.4	-117	-1.0	-5.1
KOREA	**-1.5**	20.6	1.6	**35.4**	17	-1.2	1.0
MALAYSIA	-0.5	7.0	0.2	5.0	-32	-0.5	-1.1
MEXICO	0.4	11.8	1.0	5.9	-64	-0.7	**11.1**
RUSSIA	3.8	**-12.2**	1.5	**-0.2**	-53	0.9	-5.1
TAIWAN	0.1	14.5	-0.2	5.4	-20	-0.6	1.5
THAILAND	3.1	7.9	0.3	8.0	-34	-0.6	1.8
TURKEY	2.7	**41.1**	**4.1**	26.9	-75	**1.2**	**-6.3**
VIETNAM	1.0	11.4	0.0	31.2	-56	-1.1	-5.9
SHANGHAI	3.4	8.5	1.2	4.6	**63**	**1.3**	-1.4

All the markets are represented by MSCI indices, except for US (S&P500) and Shanghai.





Asset Allocation

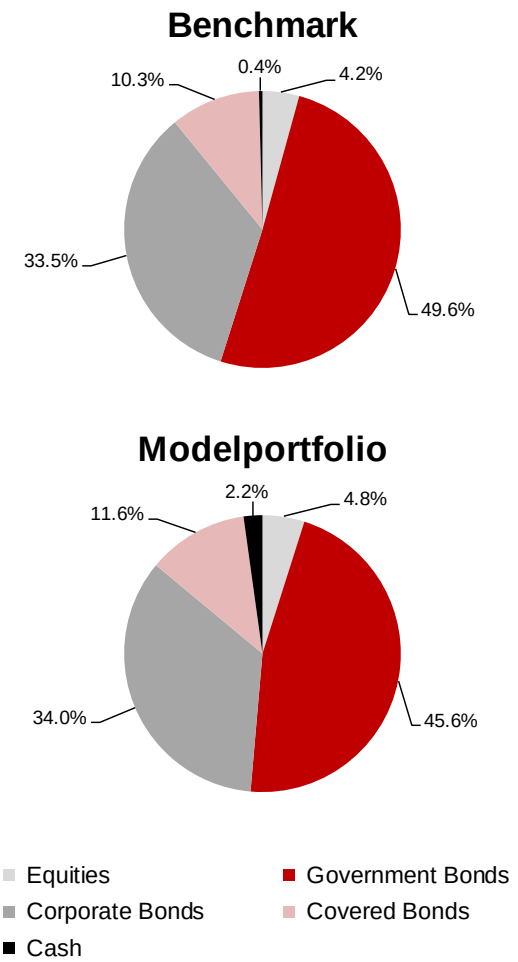
Thorsten Runde

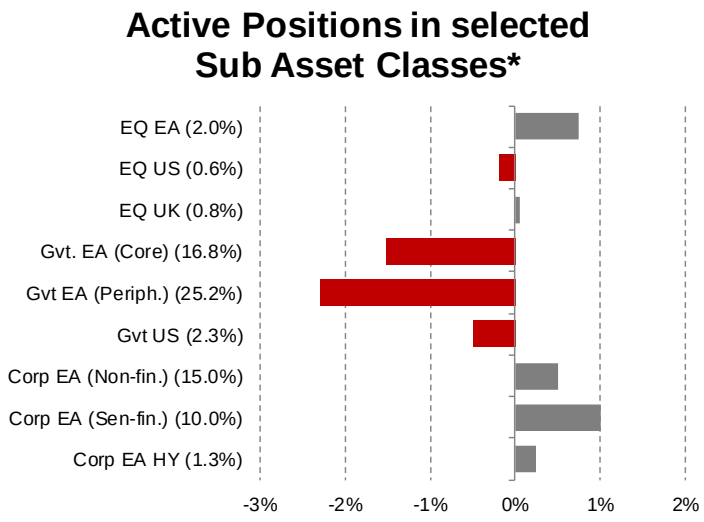
- **Long-dated government bond core yields on both sides of the Atlantic decreased distinctly – particularly in Europe.**
- **Corporate bond spreads rather moved sideways, whereas spreads on Southern European sovereign bonds clearly widened.**
- **The development of international equity markets was again heterogeneous. The developed equity markets, apart from the UK, lost more than 1.5% on average. Having said that, EM equities rose by more than 2.5% on average.**
- **Recently increased geopolitical tensions (North Korea) and political riots in the US are expected to continue to strain financial markets short term.**
- **Nonetheless, with economic perspectives still favorable for the US and euro area, as well as central banks slightly going back to normality, we basically confirm our preference for European risky assets and credit over sovereign debt.**
- **Given the mentioned looming political and geopolitical imponderables, this cautiously constructive view on markets is more likely to materialize on a three-month horizon.**

Over the past weeks, the performance of the equity markets in our investment universe was again quite heterogeneous. While the developed equity markets were residing at the lower end of the return range, the emerging equity markets, at least Latin America and CEE, turned out to be the top performers. Long-dated government bond core yields fell significantly throughout due to the exacerbation of the political conflict between the US and North Korea. Corporate bond spreads rather moved sideways, whereas spreads on Southern European sovereign bonds clearly widened. Against this backdrop, underweighting US equities and euro area peripheral government bonds paid off quite well. The same is true for the active positioning in euro area investment grade corporates. Having said that, the tactical allocation stance for euro area equities and core government bonds did not prove successful. All in, the modelportfolio slightly underperformed its benchmark. In that sense, reducing the aggressiveness of the recommendation turned out to be appropriate.

Cautiously constructive stance on a three-months view

Looking forward, favorable economic perspectives and a further normalization in central bank policy make a moderate upward pressure on government bond yields appear most likely. We still see further upside potential for equities, especially for the euro area and Japan. We thus confirm our last month's recommendation, presumably more likely to pay off on a three-months view than in the very short term.





**Benchmark weights in parentheses.*

Forecast Tables

Growth

	2015	2016	2017f	2018f
US	2.9	1.5	2.1	2.2
Euro area	1.9	1.7	2.0	1.6
Germany	1.5	1.9	1.8	1.6
France	1.0	1.1	1.7	1.6
Italy	0.7	1.0	1.3	0.8
Non-EMU	2.4	2.0	1.7	1.6
UK	2.2	1.8	1.6	1.4
Switzerland	0.8	1.3	1.5	1.6
Japan	1.2	1.0	1.8	1.1
Asia ex Japan	6.2	6.4	6.0	6.0
China	6.9	7.1	6.7	6.3
Central/Eastern Europe	1.3	1.4	2.6	3.0
Latin America	- 0.5	- 1.5	1.0	1.8
World	**3.4**	**3.1**	**3.4**	**3.5**

Inflation

	2015	2016	2017f	2018f
US	0.1	1.3	2.0	2.0
Euro area	0.0	0.2	1.5	1.3
Germany	0.1	0.4	1.7	1.6
France	0.1	0.3	1.1	1.2
Italy	0.1	- 0.1	1.4	1.1
Non-EMU	0.1	0.7	2.4	2.5
UK	0.0	0.7	2.7	2.7
Switzerland	- 1.1	- 0.4	0.5	0.7
Japan	0.8	- 0.1	0.3	0.5
Asia ex Japan	2.4	2.6	2.4	3.2
China	1.4	2.0	1.5	2.3
Central/Eastern Europe	9.2	5.2	5.1	4.7
Latin America	6.2	6.3	4.2	3.7
World	**2.3**	**2.3**	**2.4**	**2.7**

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

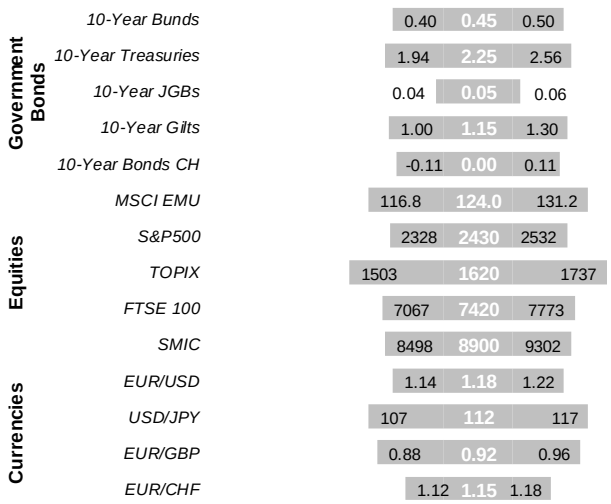
Financial Markets

3-month LIBOR	**29/08/17***	**3M**	**6M**	**12M**
USD	1.32	1.35	1.50	1.90
EUR	-0.37	-0.35	-0.35	-0.30
JPY	-0.03	0.00	0.05	0.05
GBP	0.28	0.30	0.35	0.50
CHF	-0.73	-0.70	-0.70	-0.70
10-Year Bonds	**29/08/17***	**3M**	**6M**	**12M**
Treasuries	2.16	2.25	2.40	2.70
Bunds	0.36	0.45	0.60	0.85
BTPs	2.08	2.30	2.55	2.75
OATs	0.68	0.75	0.90	1.15
JGBs	0.01	0.05	0.10	0.15
Gilts	1.04	1.15	1.20	1.30
SWI	-0.14	0.00	0.10	0.25
Spreads	**29/08/17***	**3M**	**6M**	**12M**
GIIPS	148	160	170	160
Covered Bonds	79	75	75	75

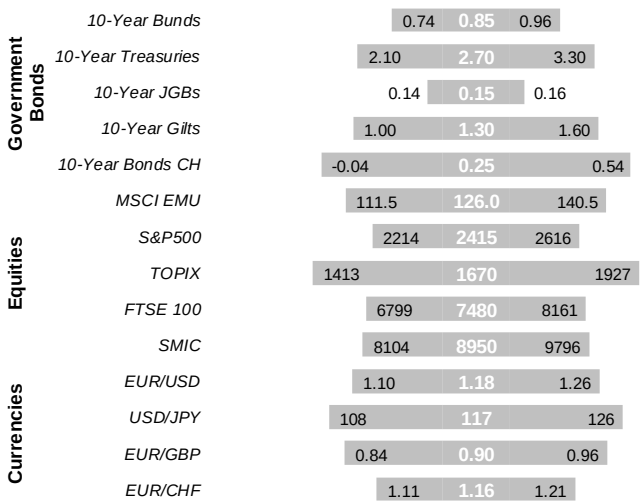
*average of last three trading days

Corporate Bond Spreads	**29/08/17***	**3M**	**6M**	**12M**
IBOXX Non-Financial	126	125	130	135
IBOXX Sen-Financial	109	110	120	120
Forex	**29/08/17***	**3M**	**6M**	**12M**
EUR/USD	1.20	1.18	1.17	1.18
USD/JPY	109	112	115	117
EUR/JPY	130	132	135	138
GBP/USD	1.29	1.28	1.29	1.31
EUR/GBP	0.93	0.92	0.91	0.90
EUR/CHF	1.14	1.15	1.15	1.16
Equities	**29/08/17***	**3M**	**6M**	**12M**
S&P500	2445	2430	2425	2415
MSCI EMU	121.5	124.0	125.0	126.0
TOPIX	1598	1620	1640	1670
FTSE	7380	7420	7475	7480
SMI	8862	8900	8990	8950

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

Head of Research: Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

Deputy Head of Macro & Market Research: Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

Team:
Luca Colussa, CFA (luca.colussa@generali-invest.com)
Radomír Jáč (radomir.jac@generali.com)
Jakub Krátký (jakub.kratky@generali.com)
Michele Morganti (michele.morganti@generali-invest.com)
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)
Dr. Martin Pohl (martin.pohl@generali.com)
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)
Frank Ruppel (frank.ruppel@generali-invest.com)
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)
Paolo Zanghieri (paolo.zanghieri@generali.com)

Issued by:
Generali Investments Europe Research Department
Cologne, Germany · Trieste, Italy
Tunisstraße 19-23, D-50667 Cologne
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In Italy:
Generali Investments Europe
S.p.A Società di gestione del risparmio

Corso Italia, 6
20122 Milano MI, Italy

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

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

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

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-invest.com

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