GENERALI INVESTMENTS

Market Perspectives

Climbing a wall of worry

May 2018

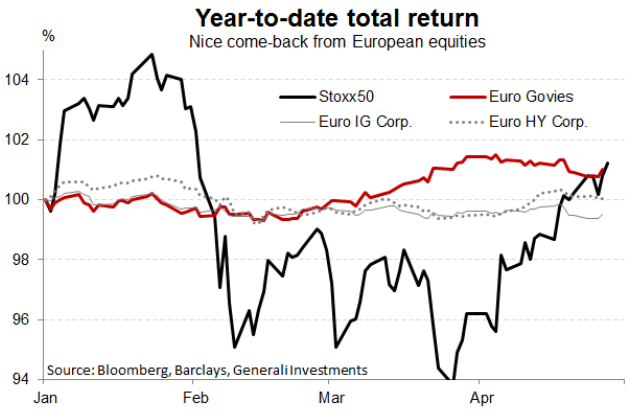
Content

Global View

Vincent Chaigneau / Thomas Hempell

- **Global markets are 'climbing a wall of worry', as softer euro area (EA) growth, trade and geopolitical tensions and concerns about tighter tech regulation seem to have been digested.**
- **Recent data disappointment in the euro area appears overstated by temporary factors; data from the US and China remain overall solid.**
- **Concerns about an overheating US economy, higher oil prices and still underpriced future rate hikes by the Fed will continue to lift global yields, burdening the fixed income space. Remain short duration and overweight cash.**
- **Volatility in equities will remain elevated as the Fed enters more restrictive waters. We are still buyers on dip and overweighted, more so in Europe.**

Euphoria about positive data surprises at the start of the year has given way to a moderate hangover. In the euro area, weak data has defied high expectations, with the Citi economic surprise index hitting the lowest since mid 2012. This added to growing concerns about the global economy, with tariffs announced by US President Trump fueling fears of a spiral of mutual retaliation. A trade war would only know losers, and we still deem the odds of a conciliatory deal reasonably high (watch US and China, where most is at stake). Investors will need to live with occasional trade spats, and more so as the expansive fiscal policy is sure to widen the US trade deficit.



Global economy still strong enough for yields to rise

Despite recent European data disappointment, we deem the glass still half full. To some extent, the softness in European Q1 data results from temporary factors such as the unusual cold weather, strikes in Germany and an epidemic flu. The Chinese economy continues to expand solidly, while in the US the pro-cyclical fiscal policy bears the risk of an overheating rather than of a slowdown.

Even after the remarkable increase in US yields over the course of April (10-year US Treasuries temporarily exceeded 3% for the first time since early 2014), there is room for a further (moderate) rise. Markets have lifted expectations of Fed rate hikes, pushing up yields all along the curve. But the implied peak in the Fed fund cycle, at 2.75%, is still at least 50bp too low in our books. This holds in particular as rising oil prices are adding to inflationary pressures resulting from a tight US labor market. Higher US rates have also helped the US dollar to regain some lost ground.

Bonds	**26/04/18***	**3M**	**6M**	**12M**
10-Year Treasuries	3.00	3.05	3.10	3.25
10-Year Bunds	0.62	0.70	0.85	1.05
Corporate Bonds				
BofaML Non-Financial	88	90	100	110
BofaML Financial	98	100	110	115
Forex				
EUR/USD	1.22	1.22	1.26	1.28
USD/JPY	109	109	110	112
Equities				
S&P500	2647	2650	2690	2700
MSCI EMU	126.6	125.0	128.0	129.5

* avg. of last three trading days

In Europe, yields have been capped by disappointing data (and FX hedging making European bonds attractive relative to Treasuries). But ebbing geopolitical tensions and the rise in US yields have still lifted 10-year Bund yields for from below 0.5% in late March to 0.6%. Drawbacks on higher volatility and trade concerns are likely, but yields remain skewed to the upside.

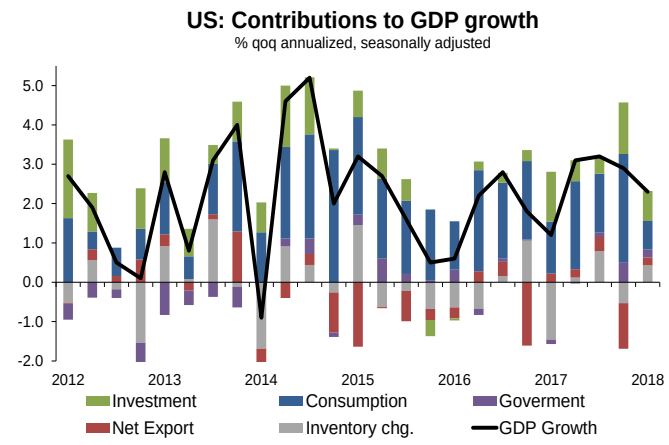
Favor short duration, cash and (prudently) equities

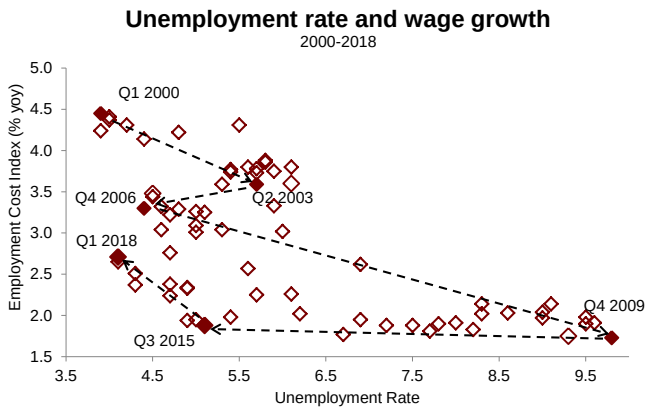
This rise in global yields will be a burden for the fixed income space more generally. The negative correlation between high-rated (IG) EUR corporate spreads and Bund yields offer diversification benefits (and depresses the volatility of the asset class). But this will not protect investors from incurring negative total returns on fixed income products over the coming months. Also our continued preference for shorter durations offers only limited relief. High-yield corporates have outperformed over recent weeks, but we deem the risks skewed to significantly wider spreads in the medium term. The IMF has recently emphasized the risks from the worrying rise in global leverage.

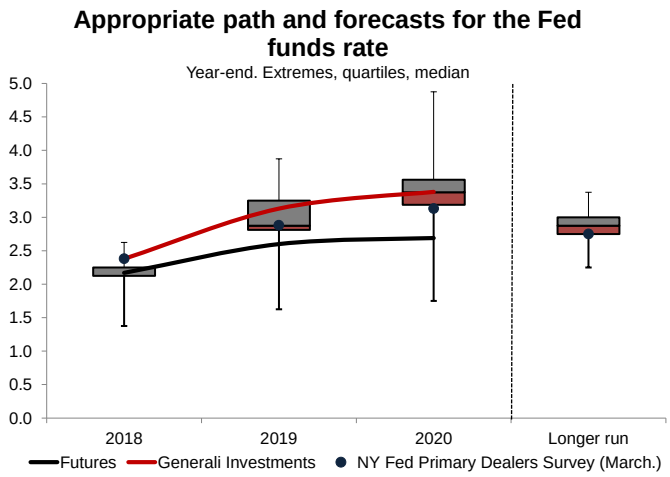
We therefore continue to prefer a prudent overweight in equities, cash and covered bonds (asset class barbell strategy). Higher volatility will trigger repeated setbacks for stocks. But with the equity outlook for the rest of the year still decent, potential corrections are offering buying opportunities. For the first time this year, our overweight is starting to bear fruits (see chart).

USA

Paolo Zanghieri







- **In Q1 GDP grew by 2.3% annualized, beating expectations. The fiscal boost will be largely responsible for the 2.7% growth rate for this year.**
- **Base effect and increasingly strong demand and cost pressures lifted core inflation to 2.1% in March. It will end the year at 2.3%.**
- **The minutes of the March Fed meeting show a higher confidence in reflation. We expect a total of four rate hikes this year.**

According to the first estimate, GDP grew by 2.3% qoq annualized in Q1, above the expected 2%. We expect the impact of the tax cuts to prop up investment while the effect on household consumption will be somehow dampened by higher fuel costs. Growth should peak at 2.7% this year, before reverting quickly to the 1.7% estimated trend growth rate.

At this junction, the strongest downside risk to our growth forecast is an escalation of the trade tensions, after China announced retaliation against the proposed US tariffs. Uncertainty about the viability of the current trade arrangements could lead firms to slowdown investment plans.

Core inflation back to above 2%...

The unwinding of the negative base effect largely contributed to lift core inflation from 1.7% to 2.1% in March. However, cost and demand pressures are creating momentum: the three months annualized rate stands at 2.9%. Evidence from business surveys indicate a gradual build up of inflationary pressures, which, in conjunction with accelerating wages, stronger global prices and the effects of a weaker dollar will contribute to the core rate hitting 2.3% by H2 and stabilize around that value until the end of the year. Looking through the volatile March employment date, labor market continues to tighten very gradually: hourly earnings were up by 2.7% yoy and job openings remained near its all time high in February. In Q1 as a whole employment cost increased by 2.7%, the highest rate since 2008.

…..appears consistent with four rate hikes this year

The minutes of the March FOMC meeting (where the Fed raised the target on the Fed fund range to 1.5%-1.75%) showed an increased confidence in the recovery of inflation. According to the projections, the unemployment rate should reach 3.8% by the end of this year, markedly below the 4.5% equilibrium rate. Expectations of firmer inflation and the possibility of an overheating in the labor market will eventually lead the Fed to hike rates for three more times this year. We anticipate this policy shift to show up in the "dots" at the June meeting, when the Fed is widely expected to deliver another 25bps hike.

Euro Area

Martin Wolburg

- **While hard data for Q1 continued to come in weaker, key sentiment indicators showed signs of stabilization in April.**
- **Against this backdrop we have adjusted our 2018 growth forecast down to 2.1% (from 2.3%), but continue to expect above potential growth.**
- **The ECB will carefully watch the economic data flow in order to gauge its path towards policy normalization.**

Following two months of decrease euro area sentiment indicators, economic confidence showed signs of stabilization in April. The composite PMI stabilized at 55.2 and consumer confidence rebounded. However, hard data for the first quarter continued to come in on the weak side. Industrial production receded (Jan/Feb -0.6%/-0.8% mom) and also retail sales were weak (Jan/Feb -0.3%/0.1% mom). All in all, we expect that GDP growth receded to the 0.4% to 0.5% qoq range in Q1, from 0.6% qoq before. A preliminary euro area flash GDP will be released on May 2.

Further deceleration of activity ahead

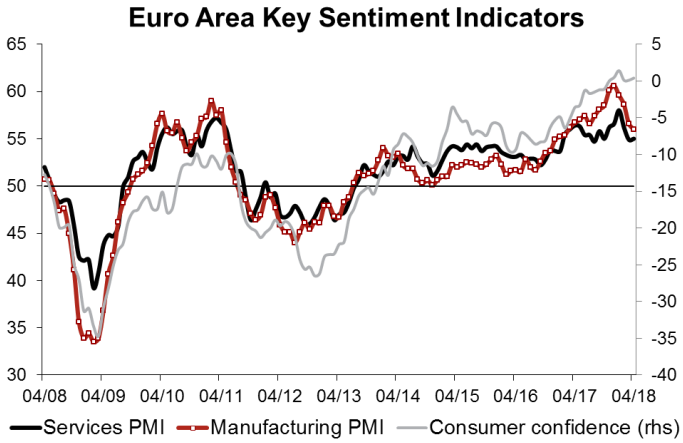
Looking further down the road, forward-looking indicators signal ongoing softening of the growth momentum. While still being clearly above normal, indicators like new orders kept on weakening thereby heralding an ongoing slowing.

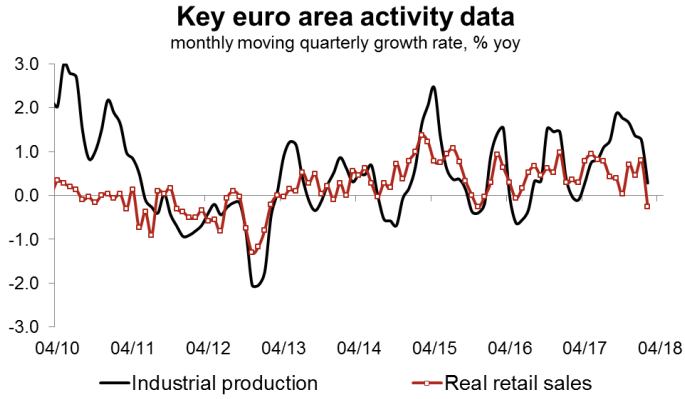
The Q1 weakness is in our view largely due to temporary factors like bad weather, the flu and strikes in Germany (especially in the metal industry which runs at full capacity). This implies potential for rebound. However, we also see more fundamental factors at work. First, the credit impulse has weakened as the stimulus from QE has largely run its course. Second, the output gap will close in 2018. Third, the euro appreciation that started in H2/17 begins to bite. Last, uncertainties related to the risk of a trade war weigh on confidence.

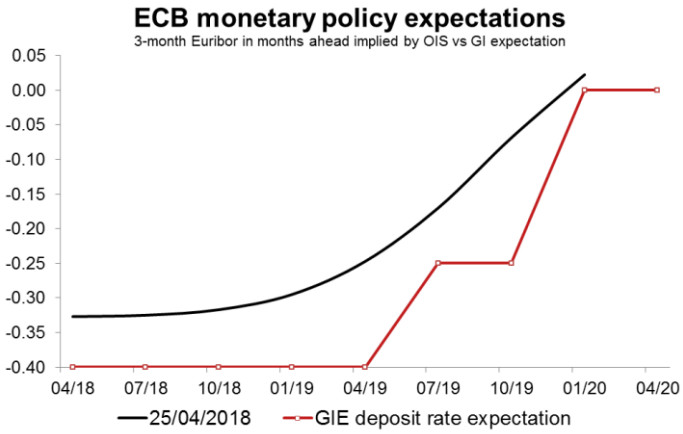
All in all, we adjusted our growth outlook to the downside and see growth at 2.1% in 2018 (from 2.3%) and at 1.7% in 2019 (from 1.8%). Still, we expect quarterly growth to stay at or above potential.

ECB: clues on policy normalization only in June

At its April meeting the ECB Governing Council left its policy stance unchanged and did not discuss monetary policy issues either. However, some concerns about the latest data weakness and the risks from protectionism were expressed. Still, the ECB stated unchanged confidence in reaching the inflation target. All eyes will be on the June meeting when the staff macro forecasts will be updated and the macro data flow will have provided more indication about the extent of the moderation in activity. Given the increased uncertainty on growth, the scenario of another round of tapering before ending QE has gained probability. We envisage a first depo rate hike in Q2/2019.

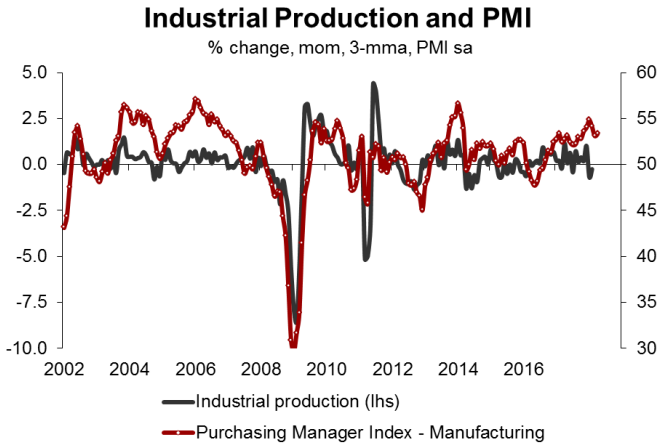


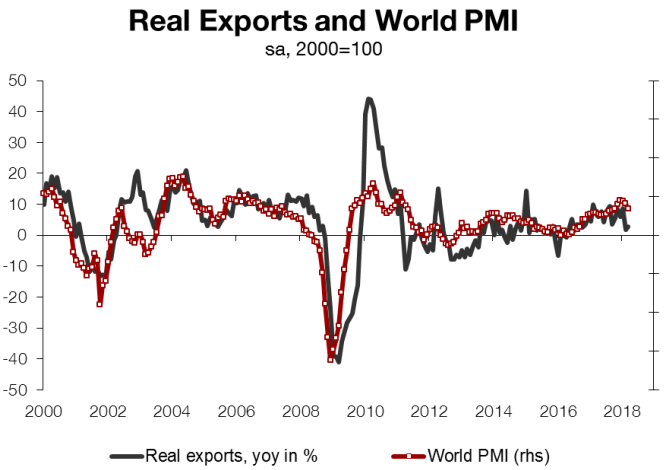




Japan

Christoph Siepmann





Main Forecasts[1)]	2016	2017e	2018f	2019f
GDP	1.0	1.7	1.3	1.1
Consumer spending	0.1	1.0	0.8	1.0
Government consumption	1.3	0.1	0.5	1.1
Investment	1.1	2.6	2.0	1.9
Inventories	-0.2	-0.1	0.2	0.0
Net trade	0.5	0.5	0.2	0.0
Domestic demand	0.6	1.2	1.0	1.3
Consumer prices	-0.1	0.5	1.0	1.0
Unemployment rate[2)]	3.1	2.8	2.4	2.4
Budget balance[3)]	-4.2	-4.1	-3.3	-2.9

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

- **Japan's GDP growth is likely to have about stalled in Q1 amid softer private demand and neutral net exports.**
- **Like in other countries, sentiment indicators have come off but are still at comfortable levels. Therefore, we expect Japan to rebound in Q2.**
- **Headline CPI inflation receded back to 1.1% yoy, and we expect the BoJ to maintain its current policy stance for longer.**

After Japan's Q4 GDP growth had been revised up to 1.6% qoq, the country experienced in 2017 a year with outstanding high growth of 1.7%. However, in Q1 2018 GDP expansion is likely to have about stalled. Real export growth probably dropped from about 10% qoq in Q4 to 2% qoq in Q1. As the development on the import side was similar, the drag of net exports on GDP will nevertheless be limited. By contrast, private consumption is expected to reach only about a quarter of its strength in Q4 while private business investment will likely also have slowed slightly. Industrial output decreased by 1.4% qoq in Q1. However, we currently consider this development overly tilted to the downside, driven by base effects and adverse weather conditions. Although sentiment indicators have a come off a bit, overall PMIs remained on comfortable levels, suggesting that Japan's economy might return to decent growth already in Q2 this year. Although PMI new export orders fell in slightly contractionary territory, this is likely due to the US protectionism on steel and aluminum, from which Japan is not exempted. Realized exports currently look much worse than the world PMI would have suggested. All in, we revised our growth forecast only slightly down to 1.3% this year and 1.1% in the next.

BoJ removed timeframe for price goal

March nationwide headline CPI inflation receded back to 1.1% yoy, down from 1.5% yoy in February, as the previously important driver "fresh food" started to normalize. CPI excluding this factor came in at 0.9% yoy, while inflation excluding fresh food and energy stayed constant at 0.5% yoy. Looking ahead, we expect core inflation to about maintain this level over the coming months. We see inflation to stay near 1% in this year and the next (incl. the sales tax hike in October 2019). Consequently, the BoJ did not change its monetary policy stance and only marginally altered its economic forecasts. However, it removed the timeframe for achieving the price goal in order to decouple potential further delays from easing expectations on markets. We basically expect the current BoJ policy to stay in place for longer, even if the current political turmoil in Japan would lead to a failure of PM Abe to be re-elected LDP party president in September. A change in monetary policy, in our view, would depend very much on a substantial depreciation of the yen, much more than currently visible.

China

Christoph Siepmann

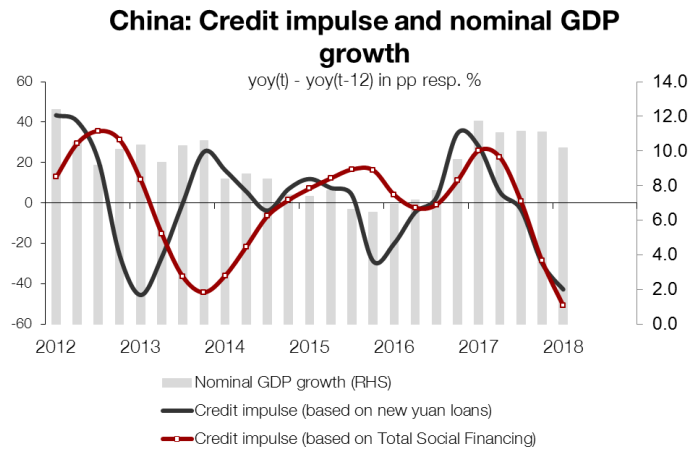
- **In Q1 2018, China's growth reached again 6.8% yoy, unchanged for the third quarter in a row.**
- **The People's Bank of China (PBoC) surprised with a cut of its reserve requirement ratio by 100 bps.**
- **Looking ahead, we expect a mild slowing of China's GDP growth amid less government support and financial regulation to go on. The trade conflict with the US remains a major risk factor.**

China's GDP growth in Q1 reached 6.8% yoy. This was broadly in line with market expectations and the third quarter in a row with an identical real growth number. According to official data, the expansion in Q1 was especially driven by private consumption while net exports constituted a drag. Nevertheless, exports witnessed a strong quarter, rising by 13.6% yoy and accelerating compared to H2 2017, but were even outpaced by imports, which increased by 19.2% yoy.

Monthly activity data from March were a bit more mixed. Both manufacturing PMIs continued to fluctuate but returned to levels above 51 index points, suggesting decent growth to go on. Part of the fluctuations have of course to do with the US-China trade conflict. PMI new export orders fluctuated strongly and its volatility was matched by actual exports. February exports grew by 43.7% yoy, only to drop by 3.2% in March. Repercussions from the "shifting" Chinese New Year as well as base effect played a role. On the domestic side, industrial production fell back to 6.0% yoy, after 7.2% yoy in the January/February period, but returning to the development at the end of last year with numbers around 6.1%/6.2% yoy. Urban investments remained a bit more upbeat. Its growth rate softened to 7.5% yoy in March, after 7.9% yoy before. One reason was real estate investment. However, in the light of tighter credit conditions and the fight of local governments against property speculation, we do not deem real estate investment to be a lasting driver of China's GDP growth, going forward. In fact, we see the administrative credit tightening and less fiscal policy support as reason for China's GDP growth to slightly soften over the course of the year. However, in case of a stronger slowing (trade war), China would surely loosen its purse again.

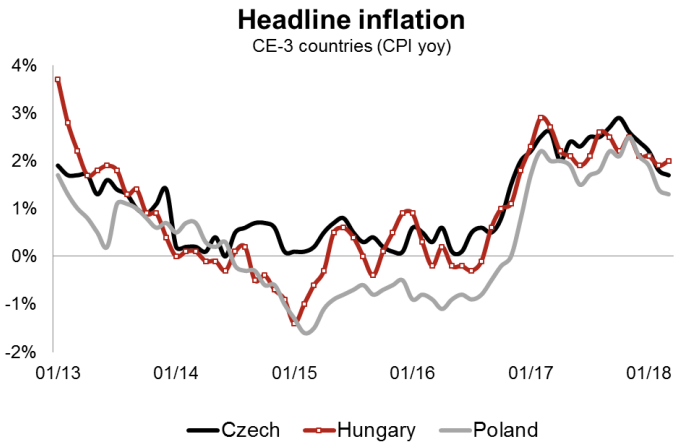
PBoC surprisingly cuts RRR

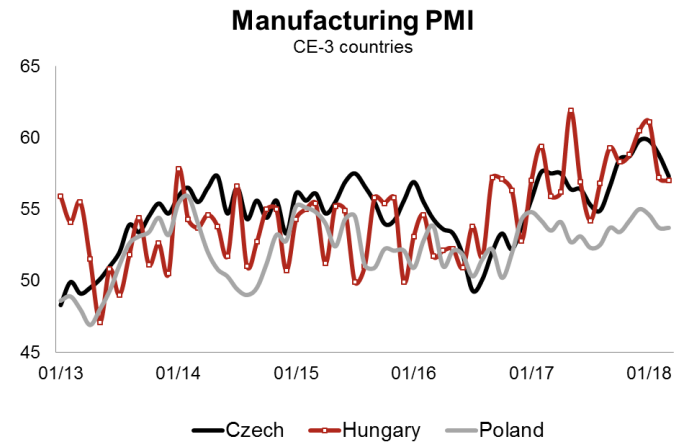
Moreover, the People's Bank of China surprisingly cut its reserve requirement ratio by 100 bps for most banks. While a big part of the free reserves shall be used to repay past lending (MFL loans), the other part is intended to support small firms and to lower their cost of capital. The move may well be intended to mitigate the current regulatory tightening for SMEs, as it seems likely that they will disproportionally suffer in their access to credit. Therefore, more PBoC action of this kind looks likely. The credit impulse has already deteriorated significantly. However, the correlation to growth has not been especially strong in China in the past.



Central and Eastern Europe

Radomír Jáč





Main Forecasts	2016	2017	2018f	2019f
Czech Republic				
GDP	2.5	4.6	3.2	2.9
Consumer prices	0.7	2.5	1.9	1.9
Central bank's key rate	0.05	0.50	1.00	1.50
Hungary				
GDP	2.1	4.2	3.8	3.0
Consumer prices	0.4	2.4	2.6	3.0
Central bank's key rate	0.90	0.90	0.90	1.50
Poland				
GDP	2.9	4.6	3.9	3.2
Consumer prices	-0.6	2.0	2.0	2.5
Central bank's key rate	1.50	1.50	1.50	2.00

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

- **Inflation moderated in Q1 due to food and energy prices but also due to the previous exchange rate appreciation and its impact on core CPI.**
- **While inflation is expected to increase in Q2 in all CE-3 countries, the development seen so far this year points to unchanged monetary policy rates in Hungary and Poland, and no rush into interest rate hikes in the Czech Republic.**
- **Growth dynamics seem to have eased across the region in early 2018 but still remain solid.**

Q1 was characterized by lower inflation in all three CE-3 economies. The decline in the headline inflation rate was driven by commodity prices, but also by core CPI, particularly in the Czech Republic and Poland. Core CPI moderated due to the previous appreciation of the respective national currencies (CZK, PLN).

Inflation now stands below target in all CE-3 countries. Commodity prices and core CPI pressures related to the strong capacity utilization are likely to drive headline CPI higher in the upcoming months. The fact that the regional currencies do not firm anymore should also lead to higher inflation. Nevertheless, any such recovery in the price growth will come from the low CPI levels recorded in Q1. This means that inflation is likely to stay below the target level also in the rest of 2018 in Hungary (with target at 3%) and Poland (2.5%). Note that Hungarian inflation stood at 2% yoy in March, while Polish inflation reached 1.3% yoy. Czech CPI may exceed the 2% target only temporarily during 2018, as it fell to 1.7% yoy in March.

Regarding economic growth, the surveys indicate that the momentum lost its strength in Q1. This is in line with the expectation of a slower GDP growth vs. 2017. Nevertheless, the growth should remain solid in 2018 and the regional economies will operate above their potential.

Monetary policy: Lower inflation hits policy outlook

The low inflation recorded in Q1 is having an impact not only on the CPI outlook but also on monetary policy, particularly in Poland. We now expect the NBP to keep its key interest rate on hold at 1.50% in 2018 and the first rate hike in Poland looks likely in mid-2019 at the earliest.

The Hungarian MNB keeps its dovish stance, saying that the loose monetary conditions are necessary, in order to achieve the inflation target in a sustainable manner. The base rate should remain stable at 0.90% according to the MNB and a rate hike is unlikely before 2019.

The Czech CNB operated with the assumption of stable rates for the rest of 2018 after the key rate was raised to 0.75% in February. Monetary conditions were expected to tighten via the CZK firming but the Crown has weakened in the past two months. This will, in our opinion, lead to a need for higher interest rates. We expect a 25 bps hike in H2 but no CNB action is in the pipeline for Q2.

Bonds/Fixed Income Strategy

Florian Späte

- **Over the course of April, government bond yields rose again as risk appetite stabilized. Both, real yields and inflation expectations contributed to the increase. Noteworthy, the transatlantic yield spread widened further and marked a new long-term high.**
- **Southern European government bonds overperformed core bonds in April as spreads tightened further. Particularly Italian BTPs performed well although the political gridlock continued and economic indicators softened.**
- **Going forward, the way is paved for higher yields. Hence, we recommend a short duration for core bonds. As the peripheral spread tightening has gone a bit too far, we suggest an even more cautious duration stance for peripheral bonds.**

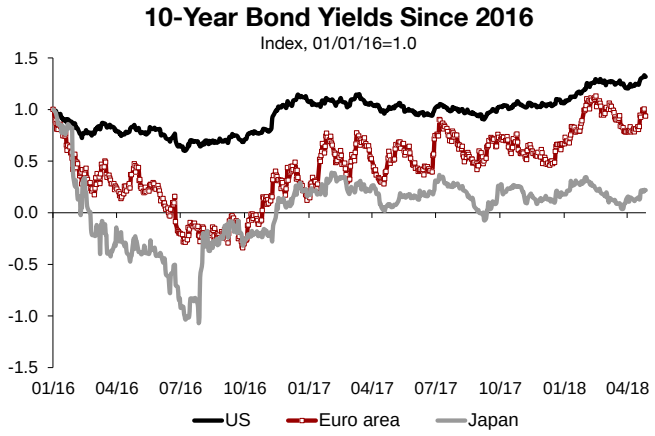
Government bond yields on both sides of the Atlantic rose in April. While the 2-yr/10-yr euro area yield curve steepened by around 4 bps, the US was characterized by a parallel upward shift upwards (the very long end of the US curve slightly flattened). Not least due to a further weakening of the euro area economic data flow, the US yield increase was more pronounced driving the transatlantic yield spread to an even higher level across all maturities. 10-yr US yields increased by more than 20 bps and temporarily even moved above the psychological threshold of 3%.

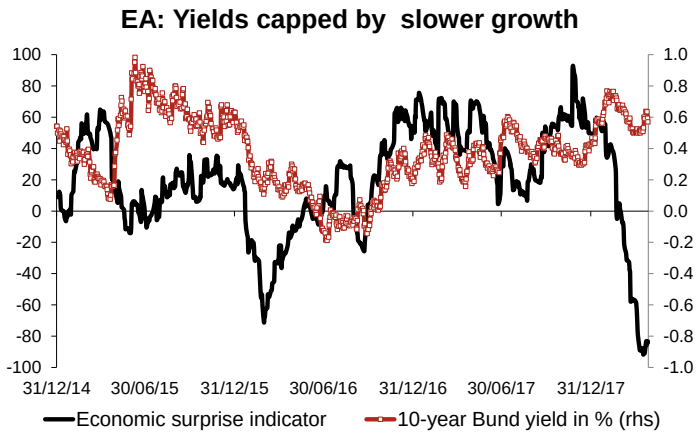
The increase in nominal yields was driven both by higher inflation expectations and higher real yields. In the US, 10-yr inflation swaps rose by 10 bps to the highest level since 2014 (2.38%) and its euro area counterpart increased by 4 bps to 1.55%. The discrepancy in real yields remains noteworthy. While US real 10-yr yields are above 0.6%, real 10-yr Bund yields are still deeply in negative territory – not substantially above the historical trough. Going forward, there is scope for real Bund yields to narrow this gap.

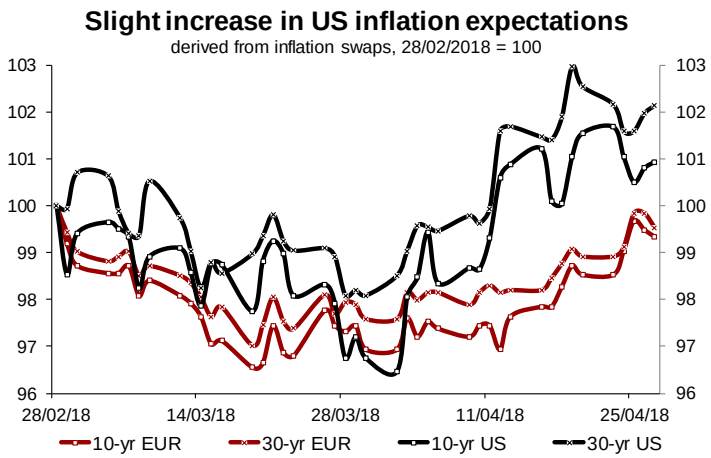
Leeway for higher US yields more limited

In the months to come, government bond yields are forecast to rise further – particularly euro area ones. To start with, financial markets are still too complacent with respect to future central bank actions and have overreacted to their recent rather dovish comments. Currently, they price the peak in the US cycle at around 3.0% and the terminal ECB rate at 0.75%. While this appears a bit too cautious for the Fed, it is much too low for the ECB. Although it could take some time until markets start pricing a more aggressive ECB, the need for an adjustment further down the road appears inevitable.

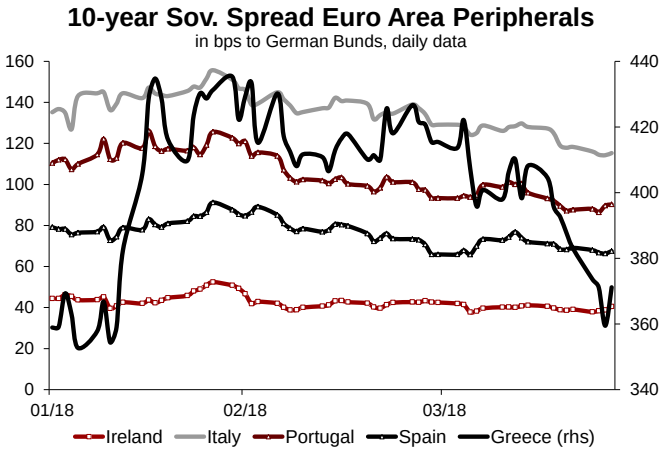
What is more, the increase in oil prices in combination with a tightening labor market is likely to drive inflation expectations further upwards. Again, taking into account current levels, this applies particularly to the euro area.

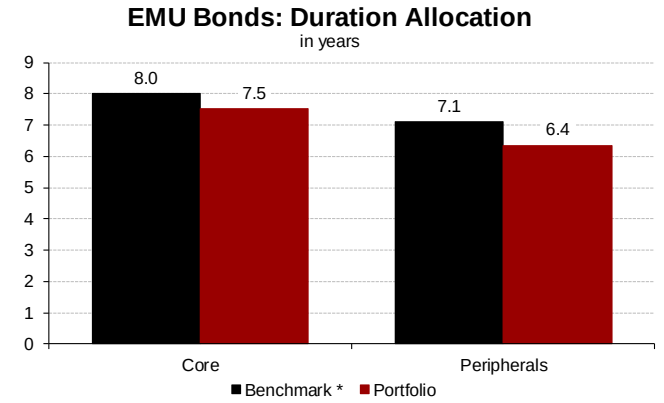




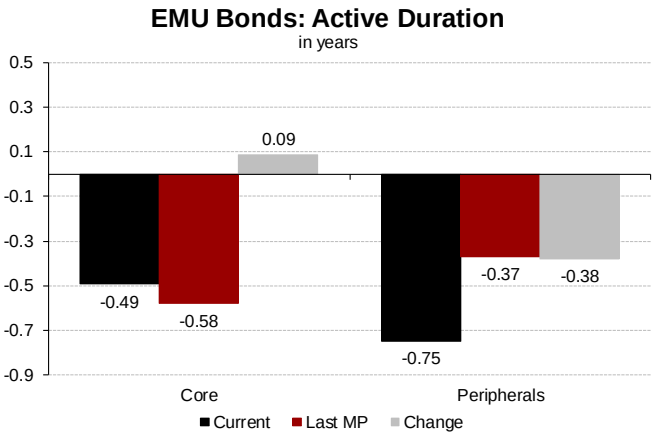


Bonds/Fixed Income Strategy





* JPMorgan EMU Government Bond Index



Although the inflation pressure will increase on both sides of the Atlantic in the months to come, it is more sustainable in the euro area. While US inflation will probably peak this year and will slowly decrease thereafter, euro area inflation rates are expected to rise towards the ECB target of 1.9% over the longer term. This should be reflected in a tightening gap between US and euro area inflation expectations going forward.

Finally, the increase in bond market volatility in February turned out to be temporary for the time being. But, this should not be misinterpreted as a lasting development. There is still scope for a normalization of bond market volatility. This will – in combination with a less accommodative monetary policy stance and higher inflation rates – eventually increase the term premium.

Overall, we regard the increase in core bond yields in April only as a start of a lasting rise in yields. However, given the levels already reached the scope for US yields to continue at the same rate is unlikely. The 3-month and 12-month forecast for 10-yr US yields is 3.05% and 3.25%, respectively. The corresponding forecasts for 10-yr euro area core yields are 0.70% and 1.05%.

Strong performance of peripheral bonds will not last

Southern European government bonds rallied in April and spreads marked long-term lows. In particular, Italian BTPs did very well and despite the increase in Bund yields even the yield level of medium- and long-dated BTPs decreased. This development is remarkable as the political gridlock is still in place. The formation of a stable government remains a complicated process. At the same time, the economic data flow softened recently, possibly ending the cyclical economic upswing for the time being.

Against this background, the recent spread tightening has gone too far. As a stable government enacting necessary structural reforms is not in sight, the economic cooling is likely to trigger a spread widening. But, the softening of anti-EU rhetoric should limit any rise in risk premiums.

Our portfolios

As outlined above, the way is paved for higher euro area government yields. Hence, a cautious approach appears appropriate and investors are advised to keep the duration structurally short to limit losses.

Hence, we recommend a moderate short duration for euro area core bonds compared to benchmark (-0.49 yr from -0.58 yr before). For peripheral government bonds, we suggest to shorten the duration and propose an even shorter duration (-0.75 yr vs. -0.37 yr before). The current income is not sufficient to balance the forecast spread widening and especially long-dated bonds should be held as underweight positions given their vulnerability to an increase in yields or a spread widening.

Corporate Bonds

Florian Späte

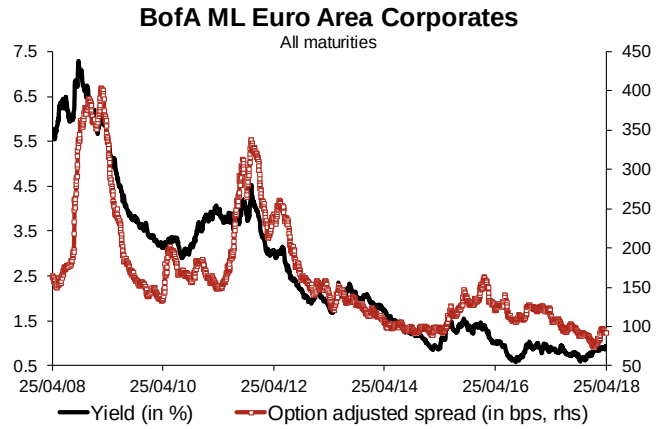
- **Driven by a more benign environment, euro area IG corporate bond spreads recovered in April and tightened by 4 bps to 92 bps.**
- **There are reasons to believe that the positive tone can last a bit longer as issuance is seen to remain manageable and the ECB will continue to support the market.**
- **However, a less risk-prone environment is getting closer. At latest from H2 onwards, investors should position more cautiously as spreads are likely to widen by around 20 bps on a 12-month horizon.**

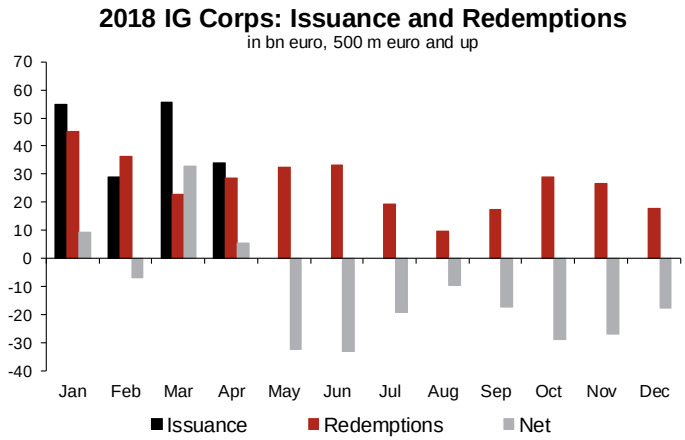
After having been under pressure for two months, euro area IG corporate bonds eventually rallied and spreads tightened. Option-adjusted spreads tightened from 96 bps to 92 bps (from this issue of the Market Perspectives onwards we generally refer to BoA/ML indices). Financial spreads tightened slightly more than non-financial ones (5 bps versus 4 bps). However, due to increasing underlying yields, the corporate yield level rose moderately by 4 bps to 0.92%. Consequently, the current income was not sufficient to balance price losses. The total return was marginally negative in April (-0.1%).

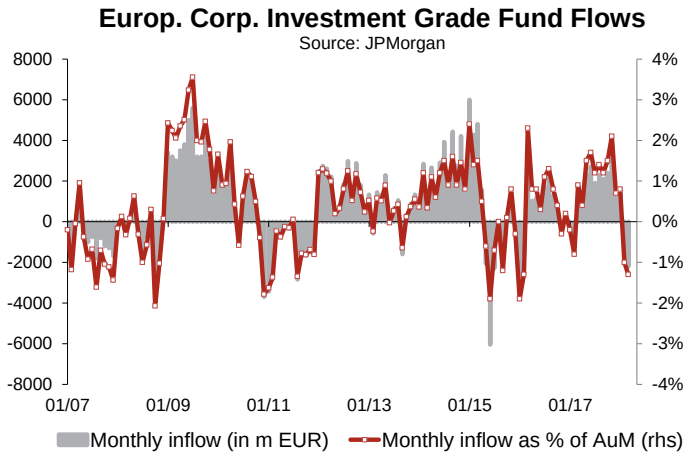
The main factors which triggered the rebound can last a bit longer. Hence, the near-term outlook appears rather benign. To start with, primary market activity was manageable in April (net issuance only slightly positive) and given the combination of high redemptions in May and an ongoing earning season, new issuances are likely to be absorbed well. Moreover, the ECB is seen to continue to support the corporate bond markets. Since the start of the year the ECB has purchased on average €5.8 bn each month. We regard the recent drop (seen from the weekly data) as temporary and forecast the central bank to return to its average monthly volume going forward. Finally, 12-month trailing defaults fell in March from 3.0% to 2.4% and are expected to decrease further in the months to come. In this environment, the near-term outlook is benign and spreads have even leeway to tighten slightly.

More difficult environment ahead

However, the scope for a new lasting spread tightening trend appears limited as darker clouds are gathering. With euro area growth having peaked, the fundamental situation is seen to get more difficult in the months to come. In addition, the way is paved for higher underlying yields which will not only affect the total return outlook but is also likely to trigger higher spreads. The bleak total return outlook has already negatively influenced the flow of funds. Finally, the ECB's QE will eventually come to an end. In this environment investors should act cautiously as there is leeway for corporate bond spreads to widen by around 20 bps on a 12-month horizon.

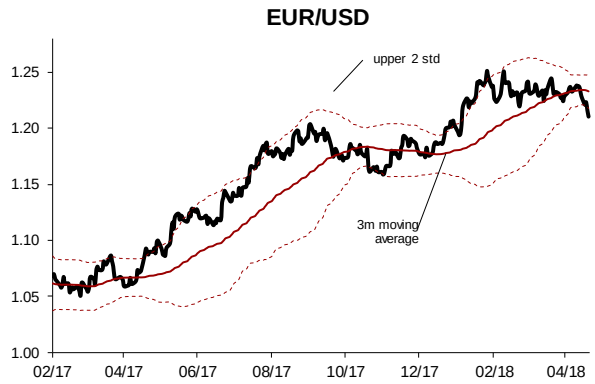


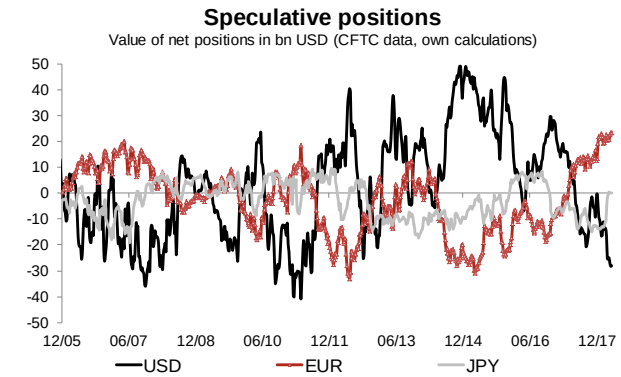


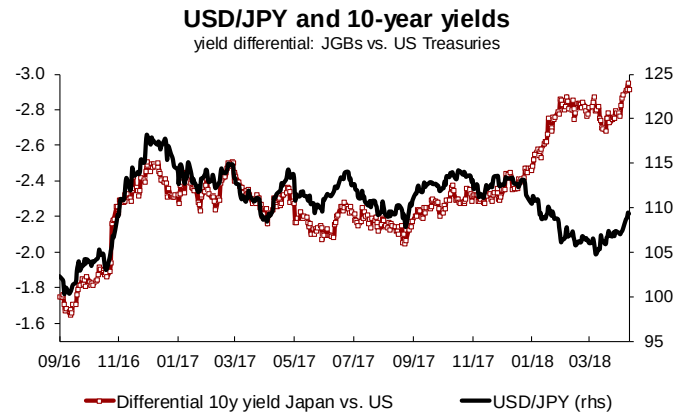


Currencies

Thomas Hempell







- **The EUR/USD has broken out of the lower bound of its tight trading range, helped by rising US yields.**
- **Near-term, further USD strength cannot be ruled out on technical grounds. Medium-term the euro is still set to rise, but we slightly lower our EUR/USD forecasts.**
- **The yen has weakened on resuming correlations with US yields. Japan's strong C/A position and uncertainties about international trade will keep the expected trend rise in USD/JPY limited.**

The EUR/USD has broken out to the downside of its tight trading range of 1.22-1.25 prevailing since late January, helped by the marked increase in US yields as Bund yields were sluggish to follow this move. With speculative short USD positions very stretched (see mid chart), there is a clear risk that unwinding of short positions triggers a further fall, closer to the 200-day average of 1.20, a technically important threshold.

Technical short-term support to the USD

Near term, the widening yield differential may also sustain this move, with US yields likely to rise, while European yields still appear capped by softer economic data and the ECB in wait-and-see mode.

This may change, however, in June, when the ECB is likely to give further guidance on its plans for exiting its ultra-accommodative policy measures. We also believe that over H2, the headwinds to the US dollar from a rising fiscal deficit and a worsening trade balance will prevail. Following the more muted economic backdrop in Europe and the more reluctant ECB, we slightly lower our 12-month EUR/USD target from 1.30 to 1.28.

Tentative resumption of JPY/yield correlations

The Japanese yen retreated partially from the pronounced strength seen over Q1. Easing of geopolitical risks around the Korean peninsula also supported global risk sentiment, which helped to unwind safe haven flows. Importantly, however, there are tentative signs that the long established correlation between US yields and the yen is resuming. In April, the USD/JPY recovered mainly in the wake of the roughly 20 bps increase in 10-year US Treasury yields.

Going forward, this correlation is likely to prove more fragile than in the past. The political and fiscal premium on the USD as well as fundamental considerations (JPY overvalued, JPY backed by a C/A surplus of 4% of GDP) will limit the upside for the USD/JPY amid a further rise in US yields. Also renewed spikes in trade concerns would underpin the yen. That said, we slightly upgrade our USD/JPY forecasts from 110 to 112 on a 12-month view on the tentative resumption in yen/yield correlations.

Equities

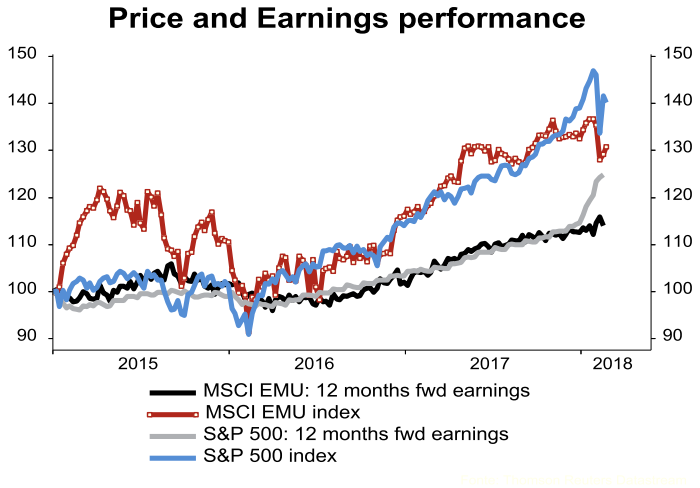
Michele Morganti / Vladimir Oleinikov

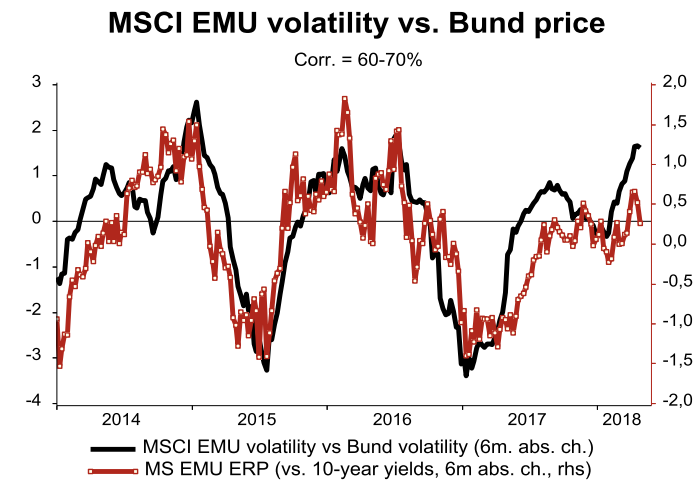
- **Markets rebounded after the spike in volatility experienced in February. EMU and *value* stocks overperformed *growth* ones and the S&P 500.**
- **The reporting season started strongly in the US, less so for Europe. Declining macro surprises will keep the earnings' momentum less upbeat.**
- **Global equity positioning has somewhat decreased in the last weeks. This is less evident in Europe where cyclicals are far from capitulating.**
- **Being lower, equity volatility is higher than last year and increasing versus bonds' one: not good for equities. Short term we remain cautious, not exploiting the full overweight position yet and maintaining a defensive sector tilt.**
- **For the next 12 months, however, we expect total returns of nearly 6% in the EA and Japan due to contained overvaluation, good earnings growth and still limited pressure from higher yields.**

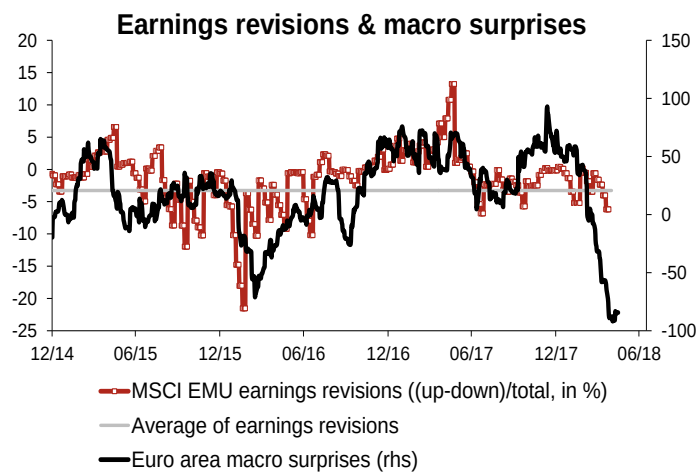
Markets rebounded after the spike in volatility experienced in early February. EMU overperformed the US (+4% total return vs. +1.2%). The Topix posted a return of 3% while emerging markets underperformed with a -2%. The UK (which we hold in overweight) did a respectable 5% after having disappointed for a while. Finally, as yields increased and investors' sentiment improved, the *value* names (an overweight for us) outperformed the *growth* ones (by nearly 3%). The oil price increased by 5%, supporting the earnings estimates of the oil sector and its relative performance (n.1 sector in Europe).

72 US firms reported higher yearly growth in Q1

Positive triggers were the enduring robust macro trend, a weak dollar, and higher oil prices. The first European results are weaker, much probably due to the strong euro and declining macro surprises. As business confidence indicators show signs of deceleration more clearly, we expect the earnings' revision momentum to fade. This does not mean equity returns should suffer for this reason only, (earnings growth in absolute terms should remain healthy this year and the next), rather the support coming from earnings is less strong. In sum, while the picture for earnings will likely remain good, much of this is already discounted in analysts' forecasts, so sentiment on profits should turn less euphoric. EMU's relative performance stabilized in the month after the notable underperformance versus the US. Indeed, the EUR/USD declined a bit, euro area (EA) macro surprises have reached a cyclical trough versus the US, US tax advantages are well discounted by the market, the yield curve flattening (a negative for a cyclical market as the EA) has been discounted too by investors, the mounting regulatory pressure on the US IT sector is good for the EA. Finally, the EA valuation remains at discount vs. the US.



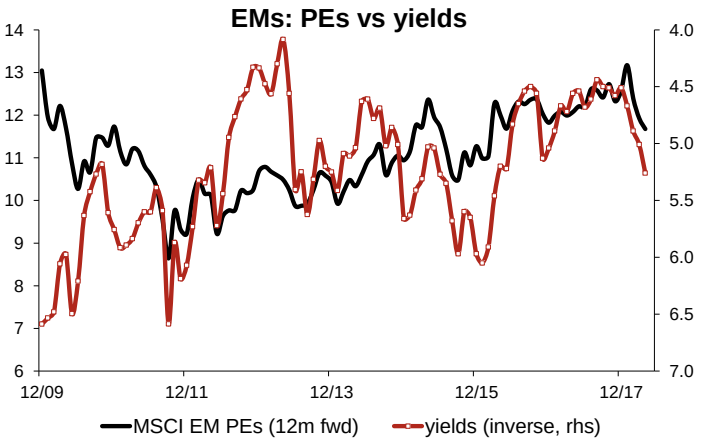


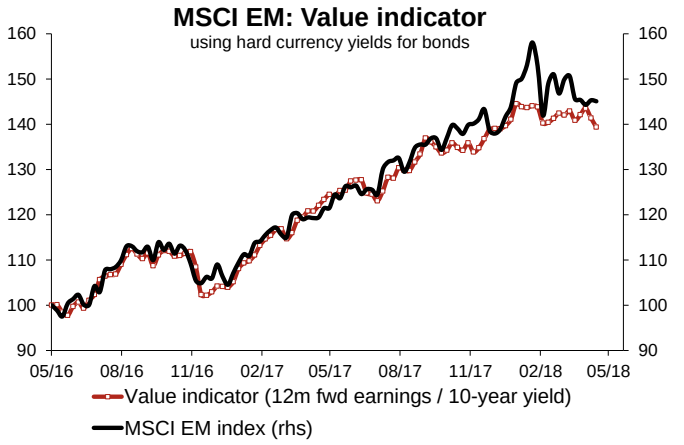


Equities

Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.	Avg.
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %	Disc. (-1M), %
WORLD	15.4	16.0	2.2	1.9	10.4	8.7	2.6	2.7	8.6	7.6
USA	16.5	15.3	2.9	2.3	11.8	9.9	2.1	2.2	14.9	13.9
JAPAN	13.9	15.6	1.3	1.3	8.1	7.1	2.1	1.9	-2.0	-4.9
UK	13.8	13.8	1.8	1.8	8.8	7.9	4.2	4.0	0.6	-4.8
SWITZERLAND	15.3	15.4	2.3	2.2	11.1	11.2	3.7	3.3	-2.9	-4.3
EMU	13.7	14.2	1.6	1.5	7.9	6.4	3.5	3.9	8.2	7.1
FRANCE	14.8	14.4	1.6	1.5	8.9	6.9	3.3	3.8	12.6	7.1
GERMANY	12.8	15.1	1.6	1.5	7.9	6.6	3.2	3.3	3.8	0.9
GREECE	13.6	12.8	1.7	1.6	7.6	6.0	4.2	3.9	8.3	7.8
ITALY	12.9	15.3	1.3	1.2	6.1	4.6	4.1	4.7	9.0	1.1
PORTUGAL	17.3	12.6	1.9	1.7	6.5	5.9	4.4	4.5	14.6	11.5
SPAIN	12.3	13.0	1.3	1.6	5.3	5.1	4.3	5.1	-1.8	-4.8
EURO STOXX 50	13.5	13.3	1.5	1.5	7.8	6.1	3.8	4.2	10.7	5.8
STOXX SMALL	17.0	14.3	1.9	1.7	10.4	8.2	3.0	3.2	16.9	15.1
EM, $	11.7	14.5	1.5	1.6	7.3	7.7	3.0	3.1	-6.5	-3.2
BRAZIL	12.4	9.0	1.8	1.7	7.7	14.0	3.7	4.3	2.9	2.2
RUSSIA	5.8	7.1	0.7	0.9	3.5	4.5	6.9	3.6	-39.8	-35.0
INDIA	18.1	14.4	2.7	2.7	12.0	11.5	1.6	1.6	8.0	4.7
CHINA	12.0	13.0	1.6	1.7	7.9	7.6	2.4	3.0	2.9	7.9

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





Cautious short term, still constructive in 12-months

Global equity positioning has decreased somewhat in the last weeks but less so in Europe. While sector positioning is slightly more defensive than 3 months ago, cyclical are still far from capitulating. Furthermore, macro surprises have declined more visibly but central banks' stance and inflation pressures remain challenging. The market is not discounting four Fed's hikes yet (our estimate for this year). In addition to this, while decreasing, equity volatility remains higher than in the recent history and, most of all, it is increasing if compared to the bonds' ones. This in turn could keep the equity risk premium high for longer.

Overall, we maintain a cautious approach to equities (not full overweight yet), a less cyclical sector tilt and balanced allocation between EMU and the US. OW Japan and UK. We like the most undervalued sectors (insurance, discretionary ex-retail, oils, telecoms, media) plus the domestic recovery baskets. Materials, Industrials, healthcare eq. and IT hardware are under-weight. Banks neutral. Slight overweight bias on Value, neutral on Growth. On a mid-term view, we use weak market phases to re-increase exposure to cyclical and financials. Over 1 year, we overweight the EA and Japan, being cyclical, cheaper and supported by good earnings growth and slightly higher inflation. US is too expensive and remains a short.

EM: higher US yields add to short-term risks

Based on multiples, the EM stocks have become even more cheaper and are now at a discount of 6.5% versus their history. Overall, EM earnings both for 2018 and 2019 have slightly decreased (by 0.3%). The Taiwanese market, having a higher share of IT companies, suffered more (-1% and 1.6%, respectively), while earnings of the Russian market have been significantly revised up (by around 5.5%), in the first place as a result of even higher oil prices (+5.1% over the last month). While resilient oil and commodity prices are supportive for EM equities in general, the higher financing costs represent an appreciable burden. Thus, over the last month yields and EMBI spreads have increased by 12 and 2 bps, respectively, while the trade-weighted dollar has risen by almost 2%. Judging by the "value" indicator (12-month forward earnings / 10-year bond rates), EM equities have become even more expensive than one month ago.

Higher US yields and US dollar are hurting performance, and we remain cautious on EMs in the short-term, as macro surprises are additionally experiencing a down-ward move. Beyond the short-term, the EMs are to bene-fit from supporting macro development, improved global trade momentum, relatively lower valuations, stabilizing oil prices. We favor India along with Korea and CEE countries, while maintaining a prudent stance on China.

Asset Allocation

Thorsten Runde

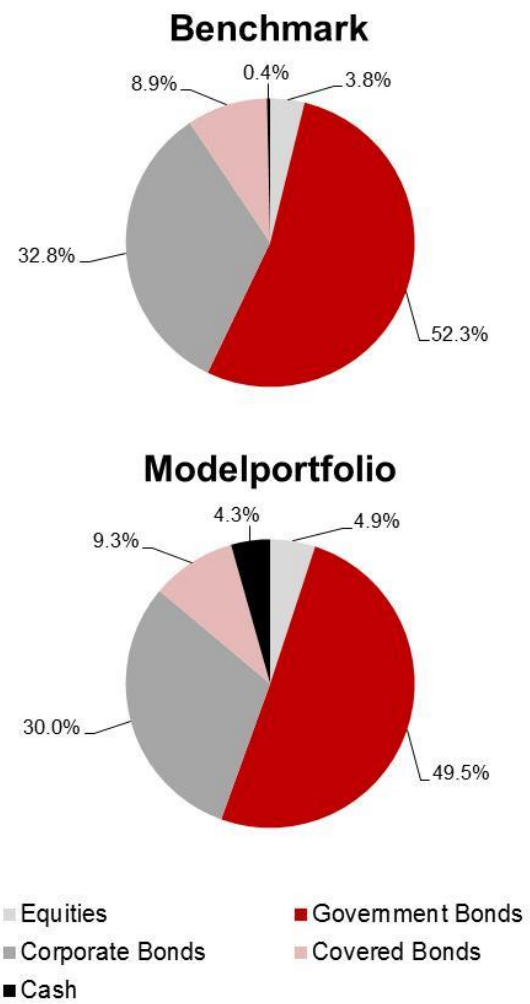
- **Since the end of March the developed equity markets of our investment universe roughly gained 2.5% on average.**
- **Government bond yields have continued to rise markedly on average, keeping the majority of the total return figures for that asset class in negative territory.**
- **Spreads on long-dated BTPs tightened by around 15 bps, relieving the pressure on the overall total return.**
- **Spreads on IG corporate bonds moved rather sideways, whereas those on HY bonds tightened, resulting in positive total returns for the latter.**
- **We still see global yields in an upwards trend, which will burden the whole fixed income space. Equities still have upside medium term, and dips amid higher volatility will offer buying opportunities.**
- **We continue to recommend an overweight in equities (with a defensive tilt) and cash at the expense of government bonds (core and periphery) and credit (IG as well as HY).**

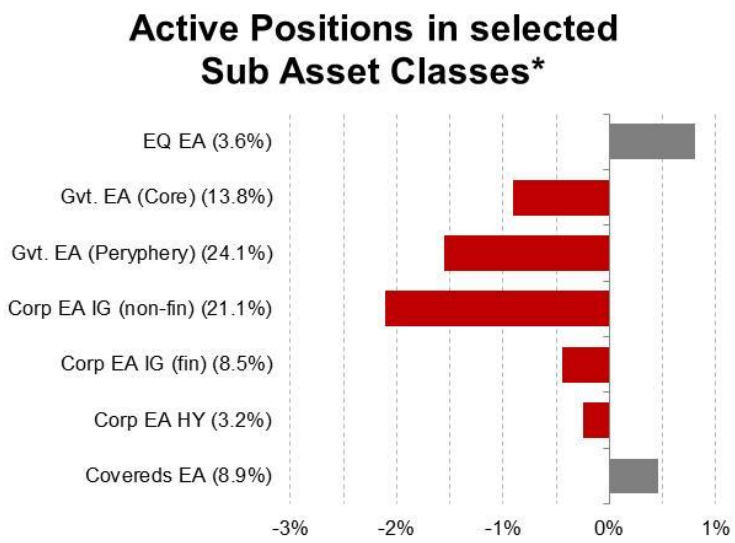
Trade concerns and disappointing data in Europe have clouded the economic outlook, exerting pressure on yields leading to local lows at the beginning of April. However, with those concerns abating, the yield trend has reverted leading to a clear rise in yields towards the end of the months. Equity markets revealed the by far most attractive return figures over the course of the month, led by EA equities with round about 4%. Thus, tactically preferring equities to bonds proofed rewarding in April.

Customized pro-risk stance to be most promising

Overall, however, we still deem the global economy in a solid expansion. In our base case, we do not foresee an outright trade war that would derail the global upswing. The ECB is treading carefully, amid most recently disappointing economic data. Rising price pressures and a boost to activity from fiscal expansion will make the Fed continue to pursue its course of quarterly rate hikes well into next year. We still see global yields in an upwards trend, which will burden the whole fixed income arena. Risks for HY bonds remain heavily skewed to the widening side in the medium term. Equities still have upside medium term, dips amid higher volatility offer buying opportunities.

Against this backdrop we recommend a customized pro-risk stance in a sense that equities should be overweighted in general (but with a defensive bias) whereas credit (IG as well as HY) should be underweighted. Furthermore, we recommend to stay underweighted in government bonds (core and periphery) in favor of cash and covered bonds (short- and medium -term maturity buckets).





Benchmark weights in parentheses

Forecast Tables

Growth

	2016	2017	2018f	2019f
US	1.5	2.3	2.7	2.4
Euro area	1.8	2.5	2.1	1.7
Germany	1.9	2.5	2.2	1.7
France	1.1	1.7	1.9	1.7
Italy	1.0	1.5	1.2	0.9
Non-EMU	2.1	1.9	1.7	1.6
UK	1.9	1.8	1.5	1.5
Switzerland	1.4	1.1	1.9	1.8
Japan	1.0	1.7	1.3	1.1
Asia ex Japan	6.4	6.1	6.0	5.9
China	7.1	6.9	6.5	6.2
Central/Eastern Europe	1.5	3.8	2.9	2.9
Latin America	- 1.3	0.8	1.6	2.2
World	**3.2**	**3.7**	**3.7**	**3.5**

Inflation

	2016	2017	2018f	2019f
US	1.3	2.1	2.2	2.3
Euro area	0.2	1.5	1.5	1.6
Germany	0.4	1.8	1.7	1.9
France	0.3	1.1	1.2	1.5
Italy	- 0.1	1.3	1.1	1.2
Non-EMU	0.7	2.5	2.4	2.2
UK	0.7	2.7	2.6	2.3
Switzerland	- 0.4	0.5	0.8	1.0
Japan	- 0.1	0.5	1.0	1.0
Asia ex Japan	2.6	2.2	3.0	2.9
China	2.0	1.6	2.3	2.1
Central/Eastern Europe	5.2	5.0	4.6	5.0
Latin America	6.3	4.3	3.5	3.7
World	**2.3**	**2.3**	**2.7**	**2.7**

Regional and w orld aggregates revised to 2015 IMF PPP w eights; Latin America Inflation excluding Argentina and Venezuela

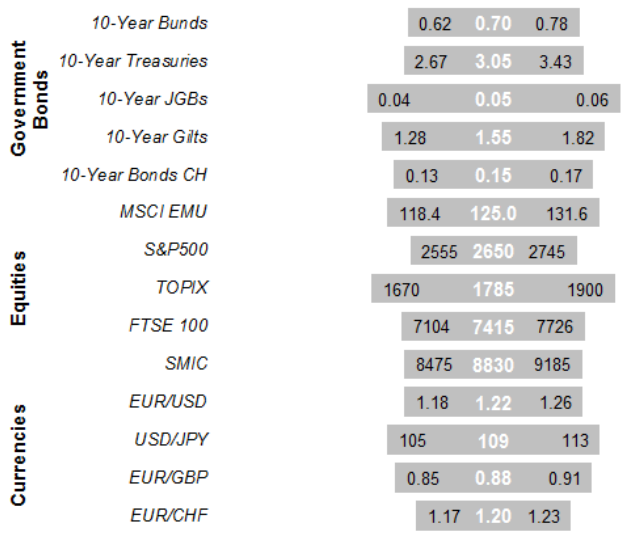
Financial Markets

3-month LIBOR	**26/04/18***	**3M**	**6M**	**12M**
USD	2.36	2.45	2.55	2.70
EUR	-0.36	-0.35	-0.35	-0.30
JPY	-0.03	-0.05	0.00	0.05
GBP	0.76	0.75	0.85	1.05
CHF	-0.73	-0.75	-0.75	-0.75
10-Year Bonds	**26/04/18***	**3M**	**6M**	**12M**
Treasuries	3.00	3.05	3.10	3.25
Bunds	0.62	0.70	0.85	1.05
BTPs	1.77	2.00	2.25	2.50
OATs	0.85	0.95	1.10	1.30
JGBs	0.06	0.05	0.05	0.10
Gilts	1.53	1.55	1.60	1.75
SWI	0.14	0.15	0.20	0.35
Spreads	**26/04/18***	**3M**	**6M**	**12M**
GIIPS	92	105	110	115
Covered Bonds	67	65	65	70

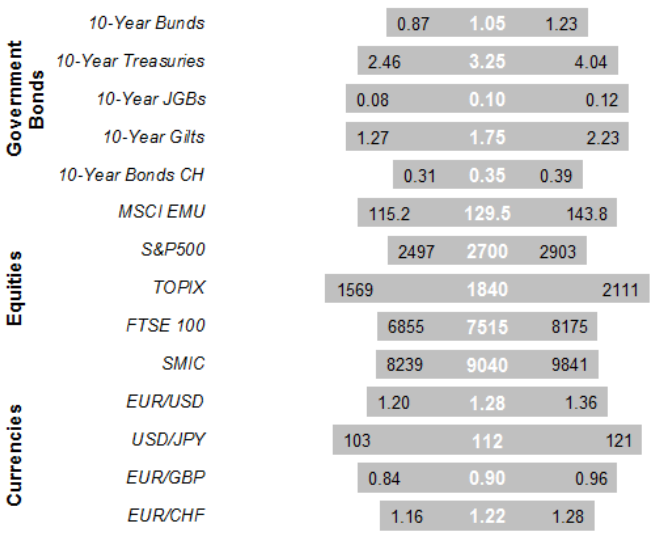
*average of last three trading days

Corporate Bond Spreads	**26/04/18***	**3M**	**6M**	**12M**
BofaML Non-Financial	88	90	100	110
BofaML Financial	98	100	110	115
Forex	**26/04/18***	**3M**	**6M**	**12M**
EUR/USD	1.22	1.22	1.26	1.28
USD/JPY	109	109	110	112
EUR/JPY	133	133	139	143
GBP/USD	1.39	1.39	1.42	1.42
EUR/GBP	0.87	0.88	0.89	0.90
EUR/CHF	1.20	1.20	1.21	1.22
Equities	**26/04/18***	**3M**	**6M**	**12M**
S&P500	2647	2650	2690	2700
MSCI EMU	126.6	125.0	128.0	129.5
TOPIX	1770	1785	1800	1840
FTSE	7409	7415	7400	7515
SMI	8791	8830	9060	9040

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.

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