Market Perspectives

November 2016

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Global View

Thomas Hempell

- **Over the course of October, global yields have come off from very depressed levels, while spreads on Southern European debt widened moderately amid political uncertainties ahead of the Italian constitutional referendum in early December.**
- **Economic data in Europe have continued to surprise on the upside, defying fears of a more detrimental fallout from the British decision to leave the EU.**
- **Looking ahead, we do not deem the recent recovery of yields the start of a protracted bear market in bonds yet. While downside risks to growth have subsided, we still anticipate the ECB to extend its asset purchase program in December, defying fears of an early tapering.**
- **Given sizeable political risks ahead of the US presidential elections and the Italian referendum, we still prefer a moderately prudent allocation stance, slightly favoring European credit over equity exposures for the coming weeks.**

Concerns about a tapering of ECB asset purchases and a recovery in inflation expectations helped global yields to recover from their very depressed levels. The yield of 10-year German Bunds turned positive again, rising by more than 20 bps compared to end of September. Spreads on Southern European debt increased due to a rising risk premium on Italian debt amid political uncertainties ahead of the constitutional referendum on December 4th. The MSCI World retreated slightly, while European equities bucked this trend. The US dollar gained traction, rising to levels below 1.09 USD/EUR for the first time since March this year.

	Growth			Inflation		
	2015	2016f	2017f	2015	2016f	2017f
US	2.6	1.6	2.2	0.1	1.2	2.2
Euro area	1.9	1.5	1.2	0.0	0.3	1.3
China	6.9	6.7	6.3	1.4	2.1	2.0
World	3.3	3.0	3.3	2.3	2.4	2.7

f= forecast

Four months after the British ‘Leave’ vote, fears of a sharper deterioration in economic sentiment in Europe have not materialized. On the contrary, key indicators in the euro area like the composite PMI and the German Ifo have recovered strongly in October and now exceed the readings over the months ahead of the British vote. While we anticipate a moderate drag on activity from subdued investment activity, the downside risks to the economic outlook have clearly subsided over the past weeks. In the US, recent data have been more mixed, but the solid labor market and a mild recovery of investment activity are about to take economic expansion back to above 2% average growth over the coming quarters.

In this environment of still subdued growth with easing downside risks, financial markets are closely monitoring the outlook for monetary policy. We continue to see the Fed on course to hike the Fed Funds Rate in December and to envisage further, albeit extremely gradual, two hikes for 2017. This contrasts the outlook for the ECB, which – despite more resilient recent data – is likely to extend its current QE program beyond March 2017, defying recent fears of a looming tapering.

At the same time, political uncertainties are high both in the US and the euro area. While Spain seems finally set for a functioning government after almost a year of political stalemate, the outcome of the constitutional referendum in Italy – a key vote for PM Mateo Renzi – remains highly uncertain. A ‘No’ vote would not necessarily imply a fall in the current government, but has the potential to spark new fears about Italy’s reform capabilities as well as its growth outlook and debt sustainability. In the US, a victory of Donald Trump – even though having become less likely – may still trigger greater global uncertainties. Here, it is in particular emerging markets – and Mexico specifically – which are at risk of suffering from a shift of the US towards more protectionist trade policies.

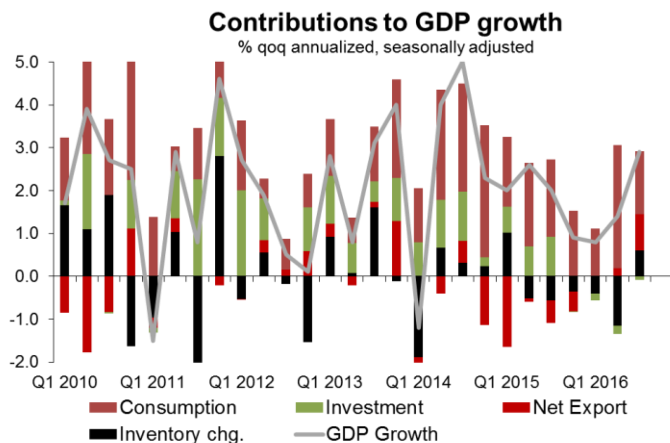
Bonds	**Current**	**3M**	**6M**	**12M**
10-Year Treasuries	1.80	1.85	1.90	2.00
10-Year Bunds	0.10	0.10	0.15	0.20
Corporate Bonds	**Current**	**3M**	**6M**	**12M**
IBOXX Corp. Non Fin	123	120	115	115
IBOXX Corp. Sen. Fin	115	120	120	120
Forex	**Current**	**3M**	**6M**	**12M**
USD/EUR	1.09	1.07	1.08	1.11
JPY/USD	105	106	107	107
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2139	2105	2095	2065
MSCI EMU	108.5	108.0	107.0	106.0

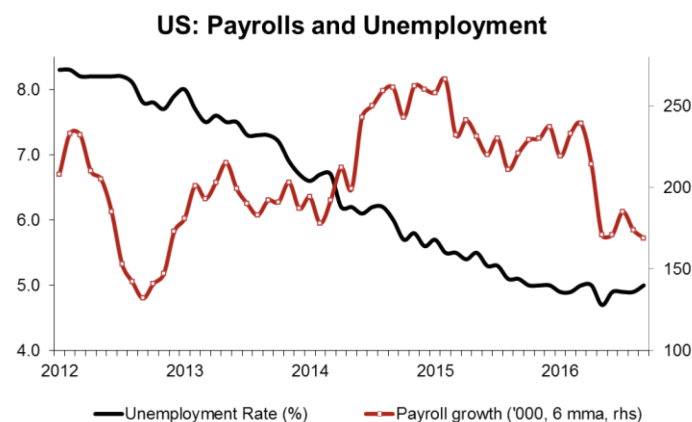
Current Values = average of last three trading days

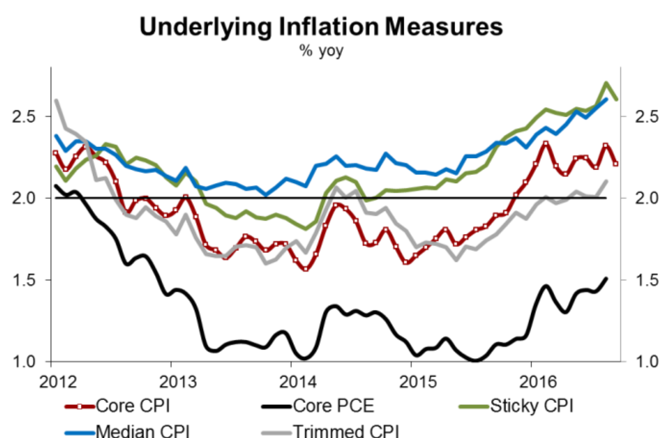
In this setting of easing major economic risks but still high political uncertainties, we still favor a prudent allocation stance, characterized by a small tactical overweight in European credit at the expense of a reduced equity exposure, in particular in the US. Importantly, we do not deem the recent rebound in European yields as the harbinger of a protracted bond sell-off as markets appear currently overly preoccupied by an early withdrawal of the ECB from its asset purchase program, which we deem unlikely. There are somewhat higher risks of rising yields in the US, but also here we anticipate the rise in rates to turn out very gradual, with the Fed eager to avoid a sudden bond sell-off in a repeat of the 2013 ‘taper tantrum’.

USA

Paolo Zanghieri







- **According to the first estimation, GDP grew by 2.9% qoq annualized in Q3. Consumption slowed down, but investment picked up. This pace should be kept in Q4, as lower political uncertainty should help capex.**
- **Services prices continue to support core CPI inflation (2.2% yoy in September); the pick-up in energy prices lifted the headline rate to 1.5% yoy.**
- **The FOMC has stepped up its rhetoric, in order to steer market expectations to an imminent rise.. An increase in December is very likely.**

Preliminary data for Q3 show a better than expected rebound in GDP, which was up by 2.9% annualized thanks to a much lower drag from inventory, offsetting slower consumption growth. Investment went up by 3.1% after three quarters of contraction.

Core inflation remains firm at 2.2% yoy, driven by services, mostly shelter and healthcare. The persistent and strong increase in house prices will contribute to over 3% shelter inflation over the coming months and the upward drift in healthcare prices - especially pharmaceuticals and insurance - will not abate soon. Moreover, the negative effects of the past strong dollar on non-oil import prices are petering out.

Employment continues to grow, wages accelerate

In September, payroll growth was, at 156k, slightly below expectations. However, data on job offers and business surveys point to an ongoing expansion in employment. Moreover, in September, initial jobless claims fell to 258k, the lowest level since 2000. Hourly wages continued to accelerate to 2.7% yoy, the fastest rate in over four years, providing further evidence that the economy is nearing full employment. In the following months, we expect a slowdown in the pace of employment growth due to demographic factors limiting the expansion of labor supply and the increasing difficulty firms report in finding adequately skilled workers. In the end we expect unemployment to fall to below the 4.7% estimated equilibrium rate by Q1 2017. This will provide further support to wage growth. Yet, consumer confidence fell in October, while remaining near post-crisis high and consumption growth moderated to 2.2% qoq ann. in Q3, due to the uptick in inflation.

Demand pressures to support core inflation

House prices continued to edge up with the FHFA index up by 6.4% yoy in August. This should continue to support shelter price inflation, one of the key drivers of core inflation, which should therefore continue trending up, also given the likely acceleration in labor costs. This, and the mild increase in oil prices expected over the next months, lead us to confirm our forecast of the overall CPI

USA

rate to average 1.3% in 2016, before returning to around 2% by the Q1 2017.

Improving manufacturing, export picks up

The outlook for manufacturing continues to brighten, and, despite some volatility, the PMI index points to an expansion in activity, with positive readings for forward-looking indicators like orders. In September, orders (ex. Transportation) were flat year on year after 20 straight months of decline. Moreover, orders from the oil sector seem to have bottomed out. The stabilization of the dollar is also helping export. Goods exports were up by 0.6% yoy, driven by food and industrial goods, while capital goods, down by 3.1% yoy still suffer from the weak global investment cycle. Trade should continue to provide a mildly positive contribution to growth, which, combined with a stronger performance of capex in Q4, would lead GDP growth to 1.6% for 2016.

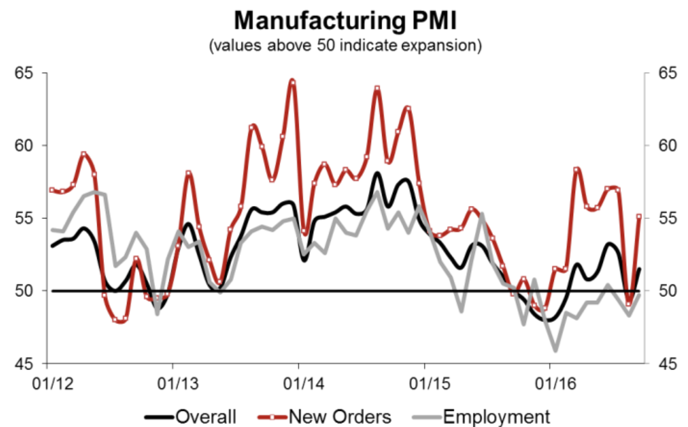
The presidential campaign enters the final stage

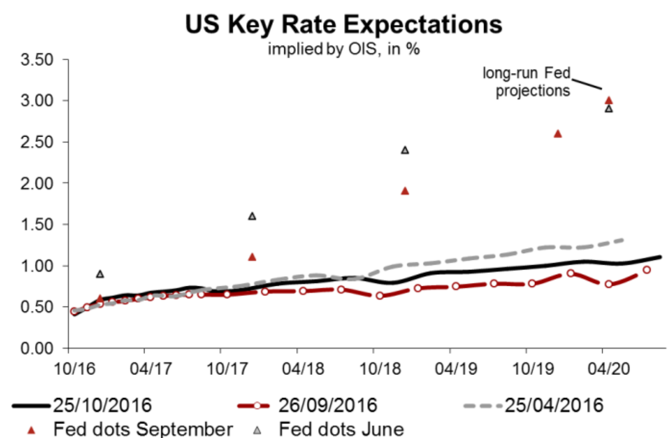
The gap in the pools between the Democratic and the Republican candidate has widened. The most likely outcome of the election is still a Democratic president having to face a Republican-led Congress. This would result in the continuation of the current stance. Fiscal policy will remain moderately expansive, providing a small positive contribution to growth; the bipartisan consensus on stepping up infrastructure expenditure will speed up the increase in public investment, but less strongly than promised by Mrs. Clinton. Yet, a compromise would have to be found on any mayor fiscal policy decision, resulting in a slow and cumbersome legislative process, which will keep political uncertainty high.

The probability of Mr. Trump's victory remains at around 10%, roughly the same percentage as a Democratic president backed by a full majority in the Congress. In such a scenario, a more expansionary fiscal policy is to be expected. Moreover, actions would be taken to curb the increase in drug prices, extend access to healthcare and to step up banks' regulation.

Rates to increase in December

The ongoing increase in employment amid gradually building up wage and inflation pressure fits neatly in the economic outlook painted by the Fed. Its communication has turned to an even more hawkish stance, aimed at preparing markets to a rate increase soon. This, and the fact that in September three FOMC members already favored a hike, further strengthen the odds for a 25 bps rate in December, whose probability is just over 75% according to forward contracts. The FOMC has signaled that a relatively mild path of normalization will suffice to stabilize the economy going forward, implying just two additional interest rate increase in 2017, instead of the four envisaged in June. Yet, despite this abrupt revision, markets are still pricing a much flatter profile for the policy rate.



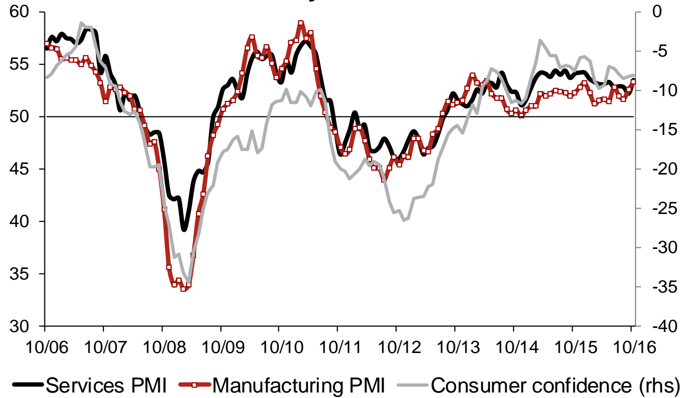


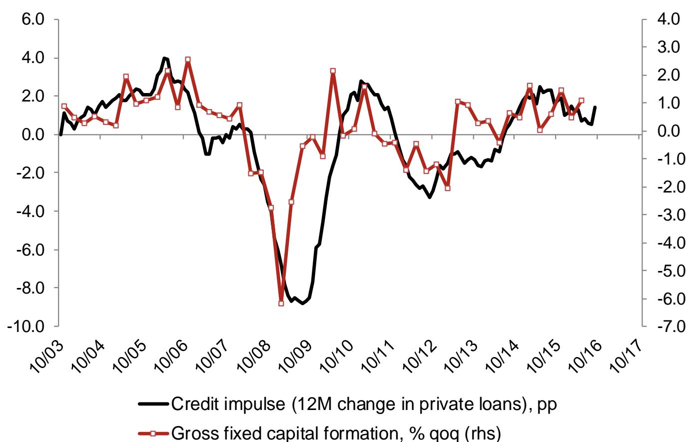
Main Forecasts[1]	2014	2015	2016f	2017f
GDP	2.4	2.6	1.6	2.2
Consumer spending	2.7	3.1	2.6	2.3
Gov. consumption	-0.6	0.7	0.9	0.8
Investment	5.3	5.4	1.8	3.1
- residential inv.	1.8	8.9	7.8	4.6
- structures	8.1	-1.5	-2.3	2.8
- intell. property production	5.2	5.7	1.9	2.2
- equipment/software	5.8	3.1	0.4	3.1
Inventories	-0.0	0.4	-0.3	-0.1
Exports	3.4	1.1	2.7	4.1
Imports	3.8	4.9	4.2	4.7
Net trade	-0.2	-0.6	-0.3	-0.3
Domestic demand	2.5	3.2	2.2	2.2
Consumer prices	1.6	0.1	1.2	2.2
Unemployment rate[2]	6.2	5.3	4.8	4.6
Budget balance[3]	-2.6	-2.7	-2.9	-2.6
Fed Funds Rate[4]	0.13	0.38	0.63	1.13

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





- **Key sentiment indicators hint at unabated growth at the outset of Q4 with forward looking components improving.**
- **We slightly revised up our 2017 outlook. But, looking ahead, we still see headwinds that will prevent growth from accelerating.**
- **Following the message from the October meeting, we expect the ECB to announce an extension of its QE program by six months in December.**

Over the foregone weeks, the euro area macroeconomic news flow surprised on the upside. Most recently, the composite PMI inched up to 53.7 in October, clearly above the pre-Brexit level and to the strongest reading since December last year. It added to other data defying previous concerns about the fallout from the Brexit on activity. Instead, the latest set of macroeconomic indicators implies that the euro area economy powers ahead with unabated speed. What is more, forward looking indicators also advanced on a broad scale, even recovering above their pre-Brexit levels.

Euro area domestic activity remains on track …

Taking a deeper look into the euro area economy, the latest data also confirmed that the domestic pillar of the recovery is still on track. Employment creation (Q1 and Q2/16 +0.4% qoq / +1.4% yoy) has returned to the pre-financial crisis strength with the unemployment rate being stable at 10.1%. Moreover, the weakening of the employment component that occurred in August and September partly reversed in October. Also, consumer confidence rebounded further but has not yet reached the pre-Brexit referendum level.

The extraordinary ECB monetary policy measures continue to be a backbone of the recovery. Financial conditions are extremely supportive and in September, loan growth accelerated to 1.8% yoy (from 1.3% yoy), the strongest pace since five years. An improving credit impulse tends to go hand in hand with higher investment activity (see mid graph). It is also consistent with the latest ECB Bank Lending Survey that shows somewhat higher credit demand for investment spending.

Another supporting factor is fiscal policy. Following some expansion this year, fiscal policy will remain slightly supportive also in 2017.

… but headwinds still ahead

That said, there are still headwinds ahead which are difficult to assess. Policy induced uncertainty receded but was still above the pre-referendum level in September. With a third round of general elections in Spain avoided and Portugal maintaining an investment grade rating by at least one rating agency, two risks

Euro Area

are off the table now. However, a "No" in the Italian constitutional referendum (December 4) still has the potential to increase uncertainty; polls show a neck-and-neck race. Moreover, there is indication that the forthcoming Brexit negotiations will be tough with a non-negligible risk of a hard Brexit. Hence, uncertainty and its negative effects on activity can easily increase again.

Exports advanced by 2.3% mom in August and the trade balance improved to €28 bn (from €24.6 bn). Thereby, the external environment turned out to be more favorable than we had expected. Also, the latest manufacturing PMI new export orders are back to the strength seen at the start of the year. The exports to the UK (about 13% of total exports) are trending down after the Brexit-referendum, reflecting the depreciation of the GBP. However, exports to other countries - and especially to the Asian region - advanced. Looking ahead, we see exports to the UK weakening further and Chinese growth to moderate. All in all, we expect the export environment to deteriorate again.

Growth outlook slightly up

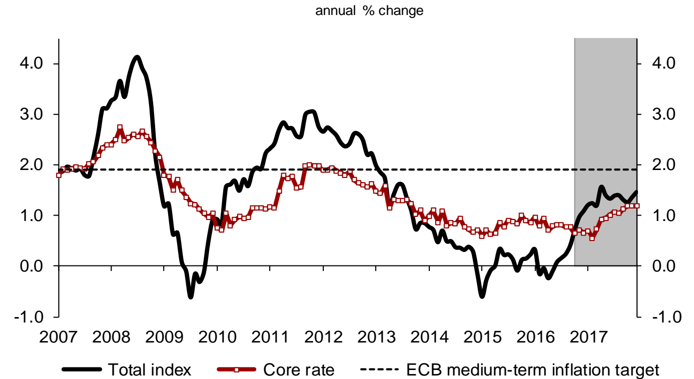
With Q3 2016 GDP growth of 0.3% qoq and survey indication that the pace of growth remains undampened, the growth outlook improved. We revised our 2017 growth expectation slightly up to 1.2% (from 1.1%). The 2016 growth forecast of 1.5% was left unchanged.

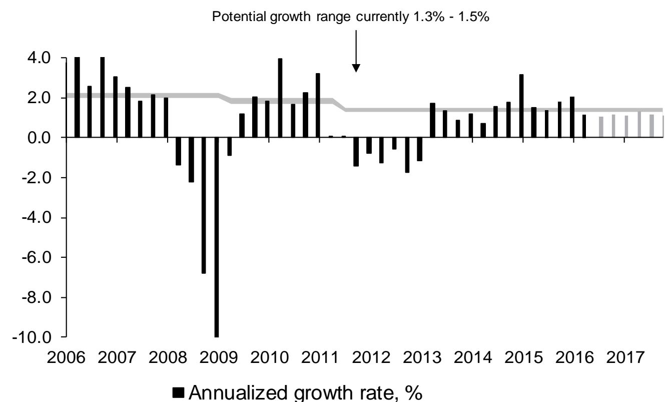
ECB to adjust APP and extend QE in December

At its October monetary policy meeting, the ECB did not act. However, President Draghi made clear that at the next meeting, action will be taken. An overhaul of the asset purchase program will then be inevitable. Without adjustments, the scarcity issue becomes binding towards year-end and the ECB can no longer conduct its asset purchases properly. These adjustments it will come in December, jointly with a new set of macro projections, just three month before the current QE program ends.

In our view, the ECB is too optimistic on growth and underlying inflation. The current projection sees core inflation averaging 1.5% in 2018. The new projection will cover 2019 for the first time and we think that it will put core inflation on a lower trajectory. Also, we deem the ECB's growth expectation of 1.6% for 2017/18 too optimistic. Moreover, the ECB is aware that the current financing conditions reflect expectations that the extraordinary monetary policy support remains in place. Therefore, it did not come as a surprise that at the last meeting tapering or the expected horizon of QE was not discussed.

We expect the ECB to announce an extension of its QE program by six month at the December 8th meeting. Whether the current volume of € 80 bn/month will be maintained depends on the macro outlook. The better the news flow, the higher the probability that the volume of asset purchases will be reduced.



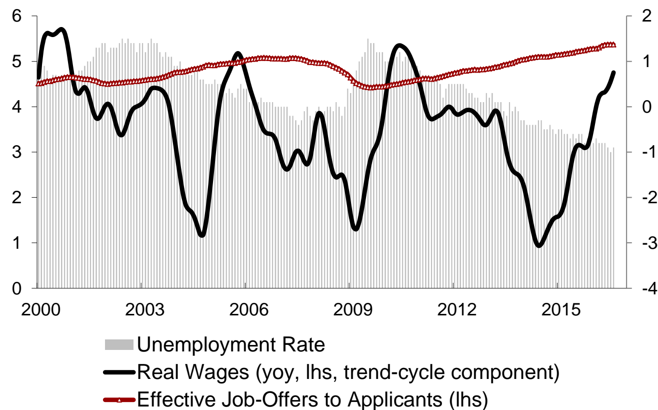


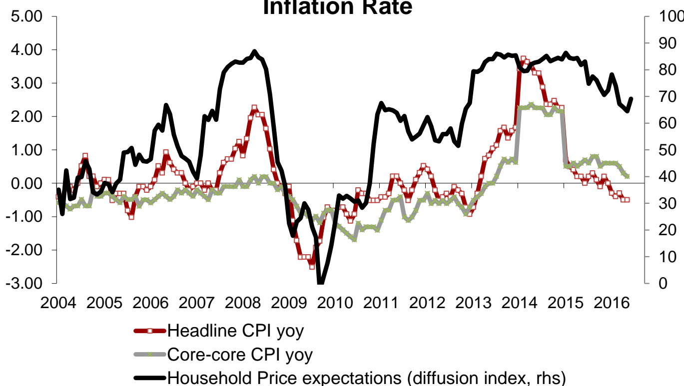
Main Forecasts[1]	2014	2015	2016f	2017f
GDP	1.2	1.9	1.5	1.2
Consumer spending	0.8	1.8	1.6	1.1
Gov. consumption	0.6	1.4	1.6	0.7
Total fixed investment	1.4	2.9	2.9	1.5
Inventories	0.4	-0.2	-0.1	0.0
Net trade	0.0	0.2	-0.1	0.1
Domestic demand	0.9	1.9	1.7	1.0
Consumer prices	0.4	0.0	0.3	1.3
Unemployment rate[2]	12.0	11.6	10.1	10.0
Budget balance[3]	-2.6	-2.1	-1.9	-1.7
ECB refi rate[4]	0.25	0.05	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)]	2014	2015	2016f	2017f
GDP	-0.1	0.6	0.6	0.8
Consumer spending	-1.0	-1.2	0.4	0.7
Government consumption	0.1	1.1	1.9	0.9
Investment	1.1	0.1	1.0	2.1
Inventories	0.1	0.4	-0.1	-0.1
Net trade	0.3	0.4	-0.1	-0.1
Domestic demand	-0.3	-0.5	0.8	0.9
Consumer prices	2.7	0.8	-0.3	0.3
Unemployment rate[2)]	3.6	3.4	3.1	3.0
Budget balance[3)]	-5.2	-5.2	-5.5	-5.5

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 Q3 growth is expected to come in with 0.7% qoq ann only slightly better than in Q2.**
- **The BoJ is likely to leave monetary policy unchanged over the medium term, except for renewed international crises.**

According to Japan's real private consumption index, household demand likely stayed weak in Q3. Due to a marked drop of retail sales in August, Q3 consumer expenditure growth will probably remain even slightly below the already soft Q2 reading of 0.7% qoq ann. This softness occurs despite the ongoing strength in the labor market and real wage growth near past cyclical highs (compare top chart on the left). Looking ahead, this still argues for private consumption to gain some strength over the upcoming quarters. By contrast, capex showed some improvement of late but only within a volatile sideways movement, so that the 0.6% qoq ann drop in Q2 will probably be more than compensated. However, the last Tankan report of the BoJ suggest firms' investment intentions across all sectors to be more subdued in FY 2016 compared to last year, against the backdrop the past strong appreciation of the yen. Thus, support from this demand component is expected to stay muted. The same is true for exports. Net export likely contributed only 0.2 pp to GDP in Q3. In sum, we expect Q3 growth to come in about 1.0% qoq ann, i.e. not much different from the previous quarter of 0.7% qoq annualized.

Monetary policy to remain on hold

On the monetary side of the economy, headline inflation remained in negative territory (with -0.5% yoy in September) for the sixth month in a row. Moreover, the inflation rate excluding food and energy continued to diminish to 0.2% yoy, after still 0.8% at the end of 2015. We attribute the slowing of the core-core rate mainly to the appreciation of the yen, while second round effects of the past drop in oil prices also played a role. The lagged appreciation effects suggest negative inflation readings to last at least until the turn of the year. Moreover, household price expectations continued to weaken. Against this backdrop, the BoJ introduced a new monetary policy concept at its September meeting, combining its previous quantitative and qualitative easing approach with a yield curve control. While these two elements could become conflicting, we overall interpret this move to better position the BoJ for a prolonged battle to reach its inflation goal of 2% (or even overshoot it). This implies that the BoJ will likely hold its powder dry at the current meeting (Oct. 31st to Nov.1st) but also over the medium term. A possible exemption would be a renewed period of a strong yen appreciation or world demand to drop markedly. In sum, aggregate demand management has markedly shifted from monetary to fiscal policy.

China

Christoph Siepmann

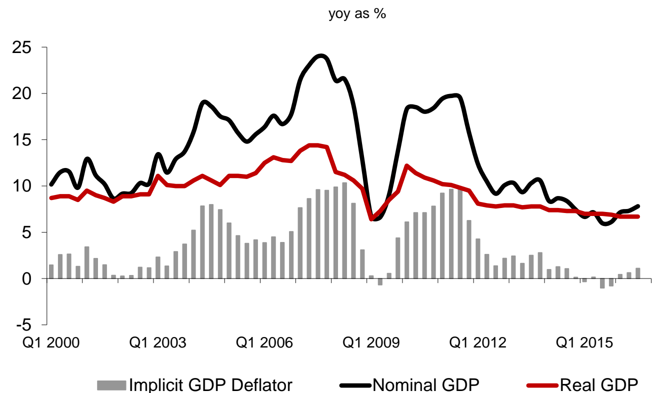
- **China's real GDP growth remained unchanged for the third quarter in a row at 6.7% yoy in Q3.**
- **Monthly data from September broadly confirmed the current sideways movement.**
- **However, against this background of stable growth we expect the government to start withdrawing some of its support over the winter half-year, in order not to aggravate China's structural problems.**

China's real GDP growth came in at 6.7% yoy in Q3 2016, unchanged from the previous two quarters. The same was broadly true for the important manufacturing and service sub-sectors, which grew on a cumulative basis by 6.1% yoy resp. 7.6% yoy. By contrast, nominal GDP growth accelerated to 7.8% yoy ytd, up from 7.3% in Q2, reflecting a still soft but continued uptrend in the implicit deflator. The latter was mainly due to a turn-around in producer price inflation which became positive by 0.1% yoy for the first time since March 2012. Important deflationary sectors like coal and steel – which also suffer from a high debt load and overcapacities – benefitted especially from the ongoing recovery in the real estate sector. After already having improved in spring, the latest reading of property sales accelerated markedly again. Real estate investment also ticked up to 5.8% yoy ytd, supporting overall urban investment which remained broadly unchanged at 8.2% yoy ytd. Industrial production slowed back to 6.1% yoy, but stayed in the range of the previous months. Finally, September PMIs stayed in slightly expansionary territory. On the monetary side, new yuan loans were significantly stronger than in September last year. However, despite the very strong start into the year, loans over the first nine months increased only by 2.7% yoy ytd, much lower than the 17.3 % yoy in 2015. At the same time, Total Social Financing rose by 12.2%, signaling a shift away from bank loans. Inflation rose to 1.9% yoy, after a drop to 1.3% in August. Both moves were largely driven by volatile food inflation.

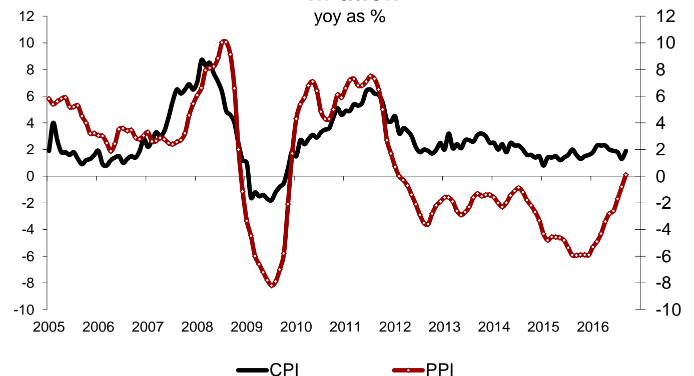
Government support likely to be gradually withdrawn

In sum, at the turn of the quarter, China's growth looked stable and the government will likely consider its growth target to be broadly achieved. Thus, priorities should shift more towards the fundamental problems of the economy again, namely the high debt to GDP ratio (amid still accumulating SoE debt and low profitability), overcapacities in certain sectors and too strong a focus on an investment-led instead of a more consumption-based economy. Help from the real estate sector should also weaken as major local governments re-introduced buying restrictions to dampen the property price hike which already advanced to 11.2% yoy in September. Thus, we expect government support to be gradually withdrawn over the winter half-year, which will result in gradually softer growth as exports are unlikely to fill the gap.

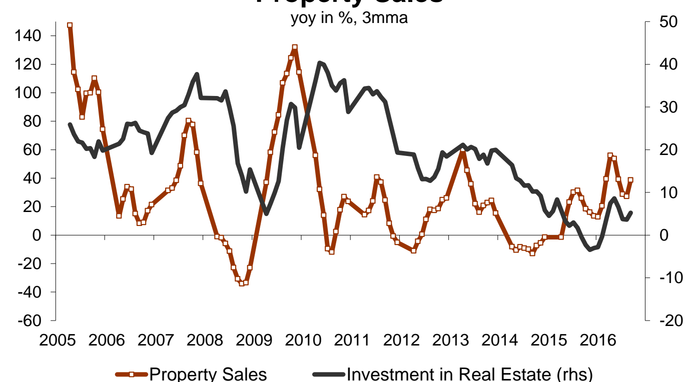
China: Nominal and Real GDP Growth



China: Consumer- and Producer Price Inflation

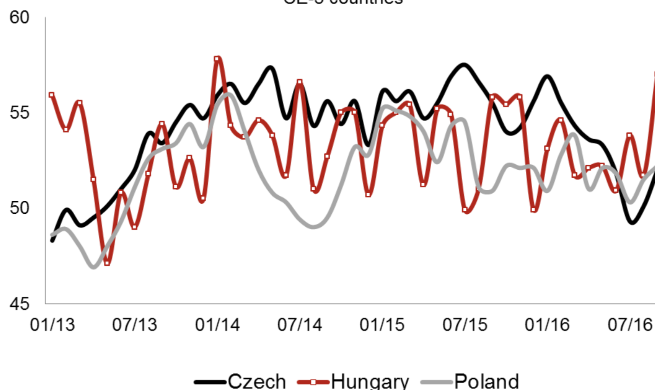


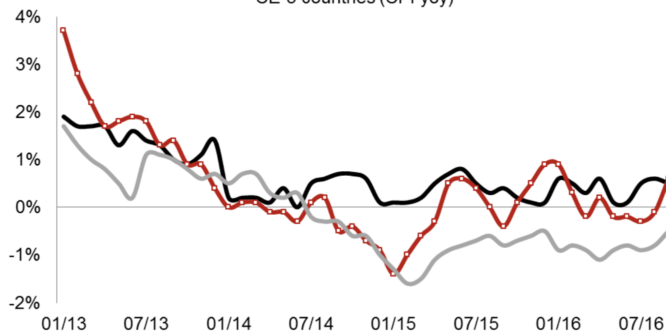
China: Investment in Real Estate and Property Sales



Central and Eastern Europe

Radomír Jáč





Main Forecasts	2014	2015	2016f	2017f
Czech Republic				
GDP	2.7	4.6	2.3	1.9
Consumer prices	0.4	0.3	0.6	1.7
Central bank's key rate	0.05	0.05	0.05	0.05
Hungary				
GDP	3.7	2.9	1.8	2.7
Consumer prices	-0.2	-0.1	0.4	2.1
Central bank's key rate	2.10	1.35	0.90	0.90
Poland				
GDP	3.3	3.6	3.0	3.2
Consumer prices	0.0	-0.9	-0.6	1.3
Central bank's key rate	2.00	1.50	1.50	1.50

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

- **Manufacturing PMI improved across the region, also thanks to positive impulses from abroad.**
- **Inflation starts to reflect pro-inflationary base effect of oil price. However, other important components, like food prices, help keeping headline inflation at bay.**
- **Monetary policy in the region will be affected by the ECB's decision on QE. This can play an important role for the Czech CNB, which may delay the exit from its FX pledge into late 2017.**

Both sentiment surveys and hard data indicate that activity in industry is gaining momentum. This comes after a weak start into Q3, as the performance in July was hit by factory holidays and calendar factors. The improvement in the Manufacturing PMI - reported for September - was in line with similar signals from the global surveys. Worth noting is that the CEE industry was missing a major positive impulse from the external environment so far this year.

Both PPI and CPI start to reflect a pro-inflationary base effect of oil price development. This is visible particularly in Hungary, where inflation jumped from -0.6% to +0.1% yoy in September, which was the first positive reading since April. However, other important factors, in particular food prices and steady core inflation, are keeping headline inflation at low levels. This was the case of Czech inflation, which eased from 0.6% to 0.5% yoy. Polish inflation moved from -0.8% to -0.5% yoy, but core CPI remained at its historical low of -0.4% yoy. While the Czech CNB expects inflation to reach the 2% target in spring 2017 and Hungarian inflation is projected to reach 2.3% yoy in Q1 2017 (vs. the target set at 3%), Polish inflation is likely to move to positive territory in December at the earliest (Polish NBP targets inflation at 2% yoy).

Hungarian monetary policy in easing mode

On the monetary policy side, the Czech CNB prolonged its commitment to keep EUR/CZK above 27 by three months, saying that the pledge will not be removed before Q2 2017. We think that the CNB may delay the exit further, if the ECB extends its QE beyond March 2017. The Hungarian MNB set its limit for its 3-month deposit tender for end-2016 and said that the limit will be evaluated quarterly, i.e. the limit for end of Q1 2017 will be announced in December. The limits in the deposit tender are supportive for the demand for Hungarian government bonds. On top of that, the MNB surprisingly cut its O/N lending rate by 10 bps to 1.05% at its October meeting and said that it stands ready to ease monetary conditions further, if warranted by the achievement of the inflation target. The Polish NBP, which keeps its key rate at 1.50%, is not considering a rate cut, despite low inflation. The Polish MPC indicates that the next step will be an interest rate hike, with a timing mentioned in early 2018. We are of the opinion that Polish monetary policy interest rates are likely to stay on hold even for longer and, if anything, the MPC may turn more dovish in upcoming months due to the low inflation in Poland and the likely steps of the ECB.

Bonds/Fixed Income Strategy

Florian Späte

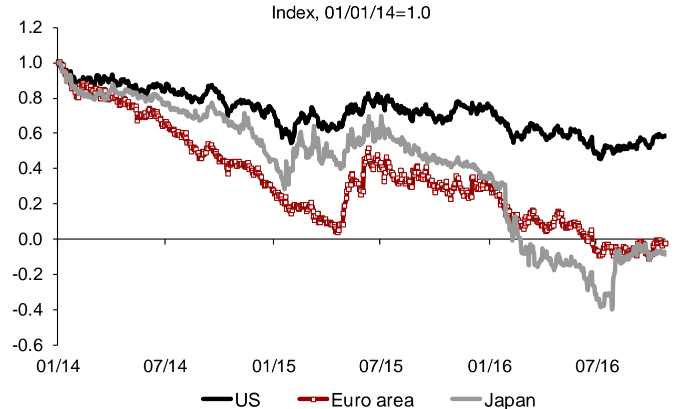
- **Since the end of September, core government bond yields have backed up strongly. Mainly due to higher inflation expectations, 10-year core yields increased by 22 bps and 23 bps in the euro area and in the US, respectively.**
- **Peripheral bonds did not benefit from the improved macroeconomic data flow and the stable sentiment on financial markets. Particularly Italian BTP spreads widened in the course of October.**
- **Looming political risks and still low underlying inflation are expected to prevent a continued upward movement in euro area core yields in the short term. In this environment a lasting spread tightening of Southern European bonds is not on the cards either.**

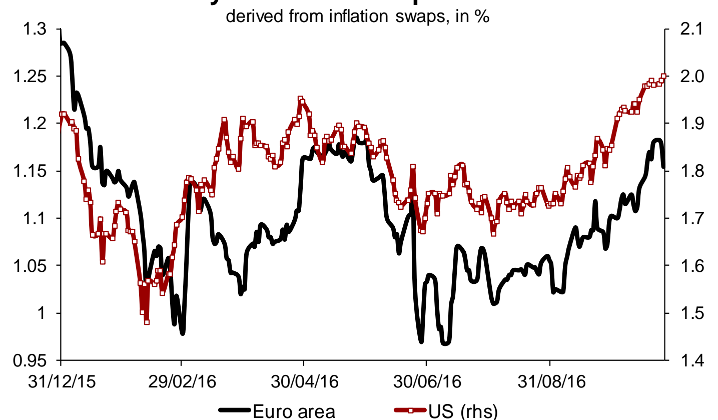
While it was not a strong sell-off, government bond yields still increased considerably in October. The euro area yield curve bear steepened last month, with 30-year yields up by 28 bps (to 0.73% – the highest level since end of June) and 2-year yields up by 6 bps. In the euro area, the increase was driven in equal parts by higher real yields and higher inflation expectations. Given the string of strong euro area macroeconomic data, the increase in real yields is well justified. The fact that the euro area composite PMI has risen to the highest level since the start of the year indicates that the fallout of the Brexit vote will remain more limited than feared in June. Oil prices rose as well in October, thereby extending the increase after the surprise OPEC decision. This bodes well for the future path of inflation rates. Therewith, deflation fears have largely vanished.

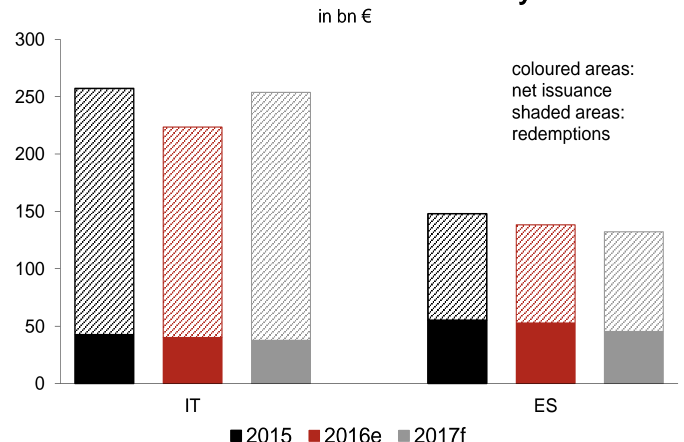
The US yield curve bear steepened as well. While 2-year US yields rose by 12 bps in October, 30-year US yields increased by 25 bps. Speculations about a forthcoming Fed hike in December restricted the steepening of the US curve somewhat. In contrast to the euro area, the increase in yields was to a large extent due to higher inflation expectations. At around 2% 10-year inflation swaps have reached the highest level since summer 2015.

No sell-off in euro area core yields in the offing

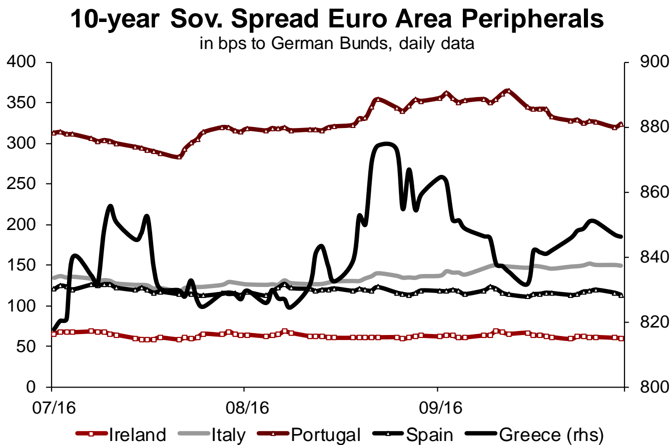
In light of the recent upward movement in euro area core yields and taking into account rumours about a possible tapering of the ECB in March, market participants are concerned about a continuation of the recent euro area yield increase. We doubt that a sell-off (like the one in spring 2015) is in the offing. There are several factors which should keep a lid on euro area core yields. First, while the euro area economy is likely to weather the Brexit vote better than expected, euro area growth is unlikely to accelerate further in the months to come. Moreover, speculations about a hard Brexit can trigger safe haven flows from time to time. Second, although the euro area headline inflation rate will rise going forward due to base

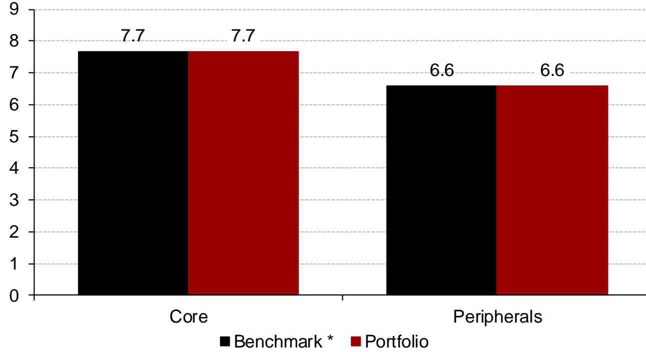




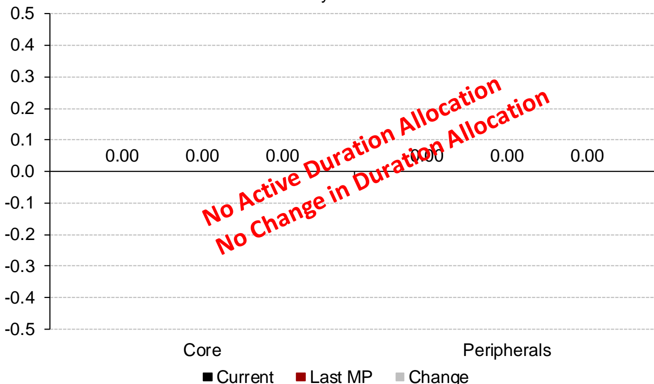


Bonds/Fixed Income Strategy





* JPMorgan EMU Government Bond Index



effects, the underlying inflation pressure remains low. We do not see a significant increase in the core rate and it will remain well below the ECB's medium target of 1.9%. Third, in the weeks to come, several political risks are looming (e.g. US elections, Italian referendum) which will keep euro area core bonds well bid. Finally, the ECB will continue to purchase government bonds on a large scale. This strong demand is seen to prevail in the months to come. Speculations about a forthcoming tapering are premature and are seen to be short-lived. Therefore, we expect euro area core yields to move broadly sideways on a short term horizon. Edging closer to the end of QE, a slight upward drift is expected in the longer term.

In the US, there is some leeway for somewhat higher yields. Although a Fed hike of 25 bps is priced with a probability of nearly three quarters, the actual decision can drive yields slightly higher. Moreover, financial markets remain too complacent in the long term. Only two rate hikes until the end of 2018 are priced. The required adjustment opens leeway for higher US yields. On a 12-month horizon, 10-year Treasury yields are likely to reach the 2% threshold again.

Strong underperformance of BTPs in October

The weighted average of 10-year peripheral bond spreads widened in October. However, this was exclusively due to a higher BTP/Bund spread. While the news flow from Spain (avoidance of a third round of elections) and Portugal was constructive (DBRS confirmed BBB rating), the Italian news flow was less constructive. Not only Fitch cut Italy's rating outlook to negative and concerns about the banking system prevailed (despite some encouraging news regarding the capitalization of Monte dei Paschi), but also the polls regarding the Italian referendum now point to a rejection of the proposal. While this is unlikely to trigger an immediate withdrawal of PM Renzi, it would still be seen as an important setback to the reform process.

In the weeks to come, the uncertainty will persist as the referendum will take place only on December 4th. Consequently, BTPs are likely to remain under pressure going forward. Nevertheless, the achieved spread level (against Bunds, but also against Bonos) make a significant spread widening in November less likely.

Our portfolios

For a while we have not taken an active duration stance. The flat yield curve limits the use of carry trades and the narrow trading range of yields hampers outright duration positions as well. In fact, the total return of short-dated and long-dated Bunds for the last months is almost the same. This is unlikely to change in the weeks to come. Hence, we continue recommending a neutral duration allocation stance for core and peripheral government bonds.

Corporate Bonds (Non-Financials)

Florian Späte

- **Non-financial spreads traded sideways in an extremely tight trading range in October. However, due to an increase in underlying yields, the yield level edged upwards moderately.**
- **For the time being, the market has found a balance and is waiting for a new impetus.**
- **Although the fundamental situation of euro area non-financials has deteriorated somewhat, we expect the overall still positive environment to tip the scales resulting in a further moderate spread tightening.**

The spread of IG non-financials moved in an extremely tight trading range between 122 bps and 124 bps. Eventually, the spread tightened by 1 bp to 123 bps. Due to the increase in underlying yields, the non-financial yield level backed up slightly from 0.75% to 0.83%, thereby moving away from the historical trough of 0.69% reached at the beginning of September.

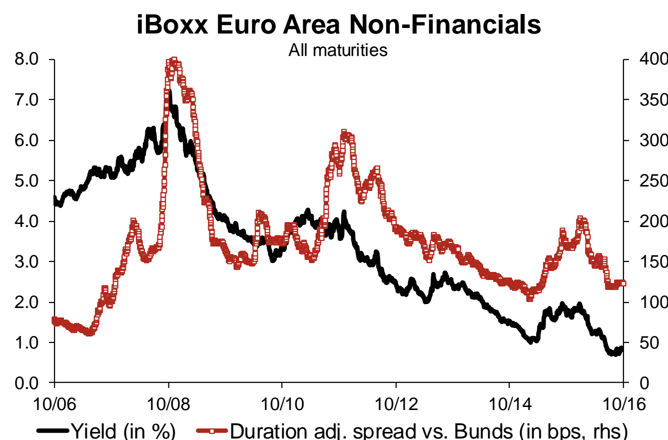
Several factors influenced non-financials in October. On balance, they canceled each others out. To start with, issuance activity was healthy but not overwhelming. While around € 22bn of new non-financials were issued – which is the highest amount on record for October – it was still below the September level. Moreover, it is well below the average of the months March to May when more than €40bn of new bonds were issued. Overall, the supply in October was well absorbed. First, a lot of non-financials were redeemed in October. Second, the inflow of funds remained in positive territory although flows lost some momentum. Third, the ECB remains an important player in the market. After buying nearly €10bn of IG non-bank corporates in September, it is on the way to buy again more than €9bn in October.

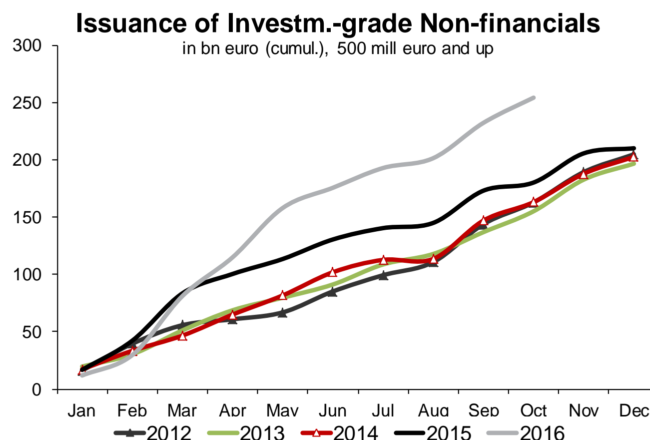
Despite deterioration, fundamentals still solid

Moreover, the latest Moody's report confirmed the low default risk. The trailing 12-month default rate of non-investment grade corporates fell to the lowest level for one year in September. Given the benign funding situation, the accommodative ECB policy and the ongoing economic rebound, we forecast default rates to remain at or even below the current level of 2.2% on a 12-month horizon.

Nevertheless, there are some warning signs on the horizon. The leverage (net debt/Ebitda) of euro area non-financials has increased from 1.9 to 2.4 since 03/2014. Over the same period the interest charge coverage has fallen from 4.3 to 3.9.

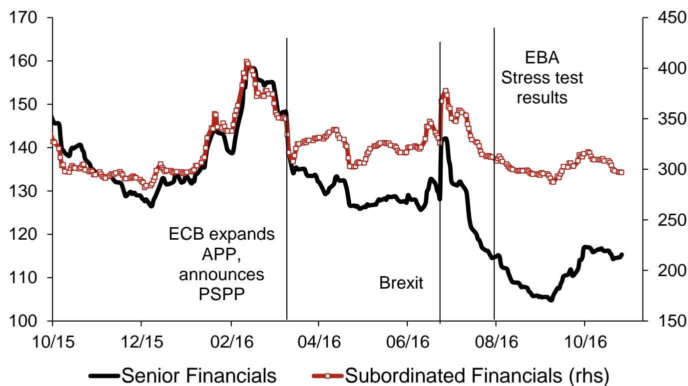
However, we think that the support by the ECB and the benign funding situation will gain the upper hand again in the weeks to come. Notwithstanding political risks and taking into account that the bulk of the spread tightening is already gone, we see leeway for a further moderate spread tightening of around 5 bps on a 3-month horizon.

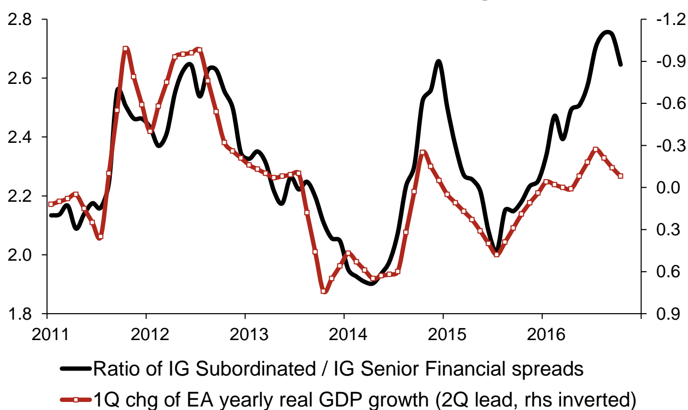


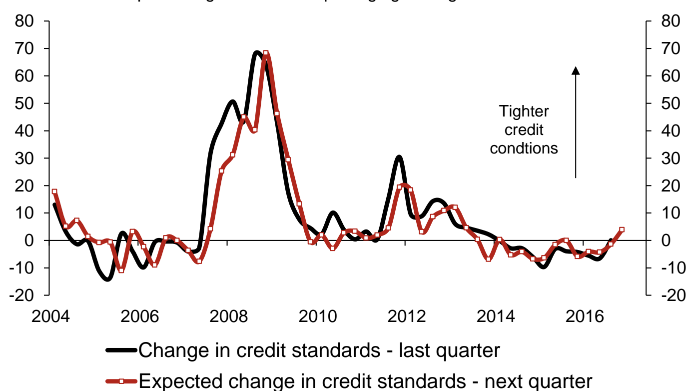


Corporate Bonds (Financials)

Luca Colussa







- **IG Senior Financial spreads were broadly flat in October, but the increase in the underlying yield pushed the total return into negative territory.**
- **On the contrary, Subordinated Financial bonds delivered positive returns as higher yields and recovering inflation expectations contributed to ease the concerns over banks' profitability.**
- **Looking ahead, we expect Senior Financial spreads to remain stable. The likely retracement in core yields after the recent increase should support total return performance in the near term.**

EUR-denominated Investment Grade (IG) Senior Financial spreads were broadly stable (down 1 bp to 116 bps) in October, but the month-to-date total return was negative (-0.70%) due to the increase in the underlying yield (up by almost 20 bps). Better macroeconomic data, rising inflation expectations, a further postponement by the ECB on the changes to eligibility criteria and no reference to an extension of purchases beyond March 2017 – albeit we still expect a 6-month extension to be announced in December – all contributed to higher Bund yields.

Some respite for Subordinated Financials

After the 21 bps widening seen in September, the spread on IG Subordinated Financial bonds reversed the whole movement and fell back to 296 bps. This was enough to offset the increase in the underlying yields. As a result, the total return was positive (+0.38%). Subordinated Financials benefitted from the increase in rates as this helped to ease the concerns over banks' profitability. Rumors over a reduction in the size of the forthcoming capital increase for Monte dei Paschi di Siena and no additional negative news on Deutsche Bank also contributed to a more positive sentiment on banks. Consequently, equity prices recovered and Subordinated Financials outperformed.

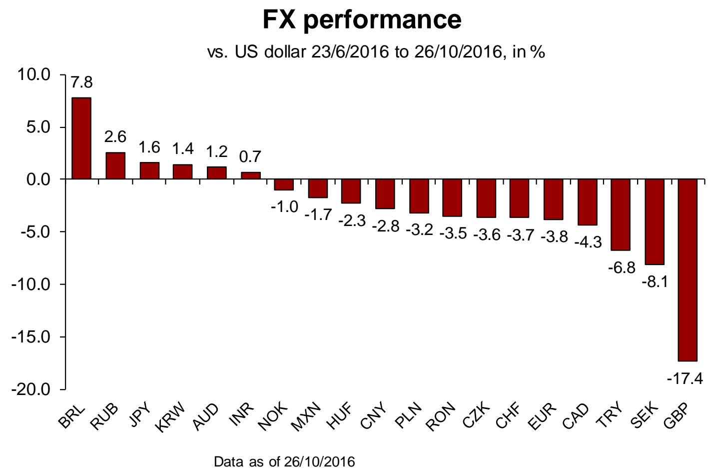
Interest risk a more pressing issue ahead

The recent increase in government bond yields and the subsequent losses in total return terms reveal how exposed corporate bonds are to interest rate risk. Despite the overall decent fundamentals, better than expected macro data and the ongoing ECB's purchases on the non-bank side, low yields and the limited potential for further spread tightening (especially for Senior Financials) expose investors to potential losses in case of higher underlying yields. That said, in the short-term, the likely announcement of an extension of the QE program in December should trigger some retracement in core rates in our view, thus supporting the total return performance also for Financial corporate bonds despite a largely stable level for spreads.

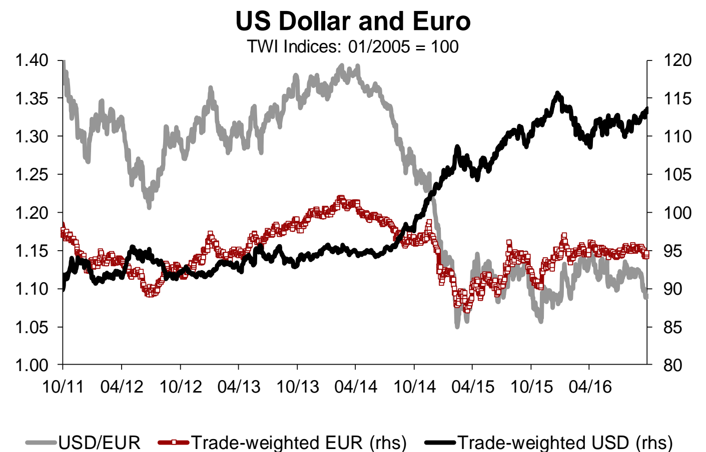
Currencies

Thomas Hempell

- **Fuelled by stronger odds of a December rate hike by the Fed, the US dollar gained markedly against a broad set of currencies, including the euro.**
- **Looking ahead, we anticipate the EUR/USD to ease moderately further on more visible monetary policy divergence between the Fed and the ECB.**
- **Fears about the impact of a 'hard Brexit' will keep the British pound under pressure, despite the 17% fall against the US dollar already seen since the EU referendum.**
- **The depreciation of the Chinese yuan against the US dollar may extend somewhat further, even though the Chinese central bank will continue to stand ready to prevent a stronger sell-off.**

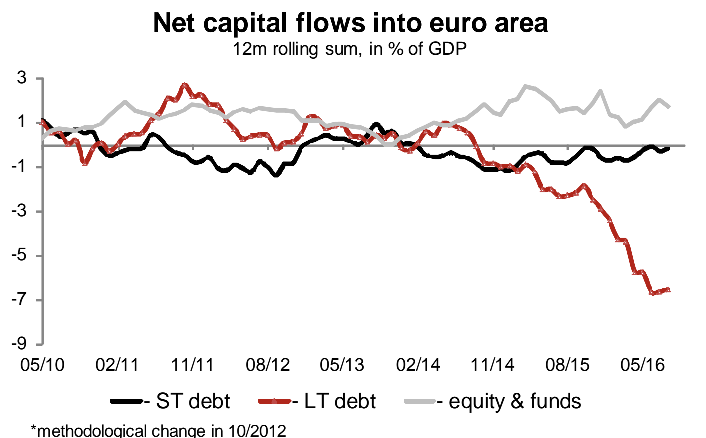


Rising odds of a rate hike by the Fed in December have lent the US dollar stronger support over the past weeks. The Greenback rose by 1.3% since end the of September in trade-weighted terms. The strength was particularly pronounced against the British pound, which came under pressure from mounting concerns about the impact of a looming 'hard Brexit', with the British government striking hardening its rhetoric on immigration policy. Also the EUR/USD weakened by more than 3%, temporarily falling below 1.09 USD/EUR. This contrasted a strong recovery of the Mexican peso, triggered by US polls that showed declining odds of a Trump victory at the upcoming elections. The protectionist trade and migration policies advocated by Trump would impact Mexico particularly hard, making the MXN a seismograph of election polls in the US.



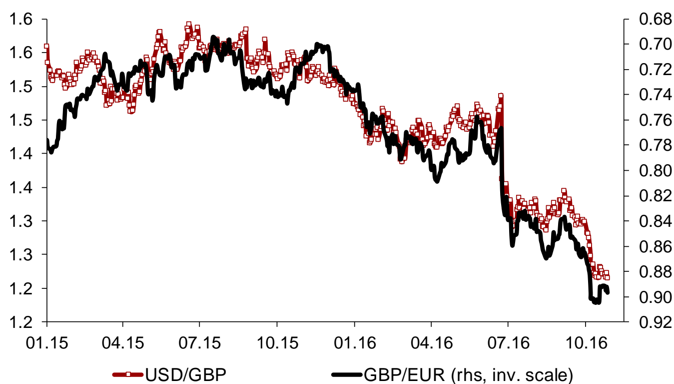
Monetary policy divergence to keep a lid on EUR/USD

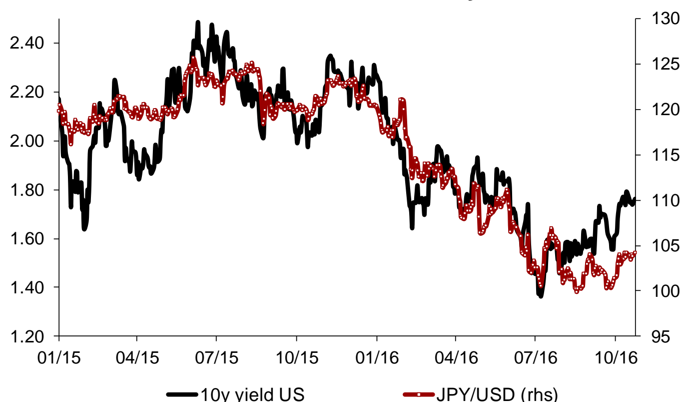
The more than 3% fall in the EUR/USD in September was not outstanding in size in historical terms. But it sent the cross below the lower end of its trading range between 1.095 and 1.14 USD/EUR in which it had been trading for most of this year. Looking ahead, we anticipate some further downside for the euro against the US dollar over the coming weeks, with monetary policy divergence a key driver. While the Fed remains on course to hike the Federal Funds Rate for the second time in December, we anticipate the ECB to extend its asset purchase program (amounting to currently € 80 bn per month) by another six months beyond the currently envisaged March 2017. Both actions are not fully discounted by markets, leaving some further scope for forex markets to react to these divergent actions by central banks.

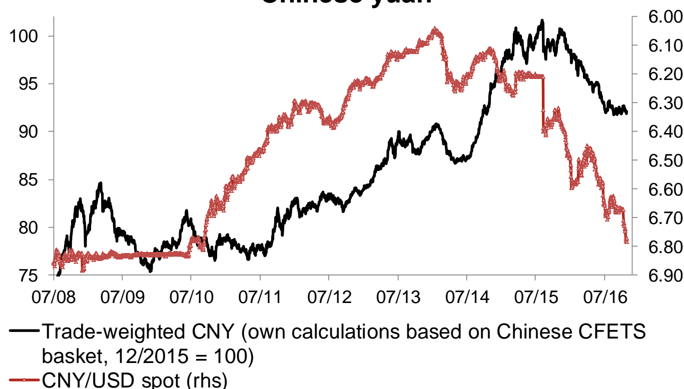


Furthermore, the euro may suffer more visibly from the continued strong portfolio outflows out of the euro area, which are concentrated in long-term debt investments amid the ultra-low euro area yields. The FX impact of these flows have so far been muted, presumably because investors tended to currency-hedge their exposure to

Currencies







bonds outside the euro area. That said, with the Fed still targeting a very gradual normalization of key rates, the short-term hedging costs on USD exposure will continue to rise. The expenses for one-year contracts have already risen by 0.4pp to 1.7% this year, largely wiping out the yield advantage on 10-year Treasuries over Bunds. As a result, we see some moderate further downside to the EUR/USD. It will likely take until much into next year before a looming tapering of the ECB's quantitative easing may help the euro to regain some of its value later in 2017.

Sterling to remain under pressure

Despite its fall by more than 17% in the GBP/USD since the Brexit vote on June 23, sterling is likely to remain under pressure. The UK's large current account deficit of almost 6% of GDP still leaves the pound vulnerable to further skepticism by investors. With British PM Theresa May striking a tough tone on future immigration policy, the risks of a 'hard Brexit' with severely harmed trade ties between the UK and the EU are rising. And while the BoE seems likely to remain on hold in November, there are few signs yet that the Bank of England would reverse its still very accommodative monetary policy stance.

Following its strong rise over the first three quarters of the year by 19% against the US dollar, the Japanese yen weakened in October, trading well above the 100 JPY/USD threshold. Over the coming weeks, we do not anticipate major actions by the Bank of Japan to move the cross, which will leave the currency gradually weaker in line with moderately rising US yields.

Some further weakness in CNY/USD

The Chinese yuan remained under selling pressures amid continued capital outflows, with the exchange rate against the US dollar weakening by 1.5% against the US dollar in October to levels around 6.78 CNY/USD, the weakest level in six years. Strikingly, however, this move was not associated with financial market concerns about a looming sharp devaluation of the Chinese currency, as was the case in August last year and in January this year. Obviously, Chinese authorities have gained credentials that they will not use the exchange rate for short-term stimulus to the economy. In fact, the trade-weighted value of the yuan has barely changed since early July (see chart), implying that the CNY/USD weakness seen over recent weeks is more a reflection of a stronger Greenback than a devaluated yuan. Looking ahead, we anticipate some further controlled weakness in the yuan to levels around 6.85 CNY/USD by the end of the year. However, the Chinese central bank will likely intervene on FX markets if there are stronger headwinds to the yuan, both to ward off self-enforcing depreciation pressures but also to maintain the yuan's credentials as a stable currency also after its inclusion into the IMF's SDR basket on Oct. 1st.

Equities

Michele Morganti

- **The good market tone extended in October as the "reflationary" momentum gained more visibility. It could linger short term .**
- **That said, we remain cautious due to stretched US valuations, the political risk, the next Fed hike and too optimistic 2017 earnings estimates.**
- **Inside equities, we reiterate an overweight position on the euro area and the FTSE 100, a neutral position on Japan and the EMs and an underweight position on the US and Switzerland.**

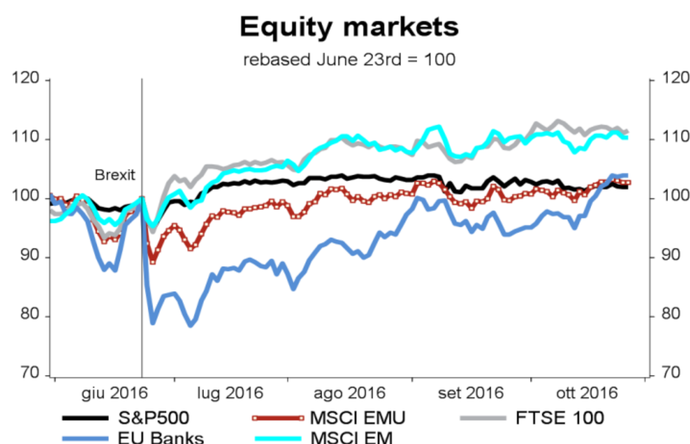
In the last month markets extended their good momentum. Coherently to our proposed allocation inside equities, euro area (EA) indices (+3%) and the Japanese one (+4.5%) outperformed the US equities (-0.5%) and the EM ones (+0.5). We remain cautious for the next quarter, notwithstanding a possible good momentum in the short term; some of the reasons being a too optimistic earnings consensus, expensive US valuations, possible volatility around the next Fed's hike and the political risk (Italian referendum, "hard" Brexit etc.).

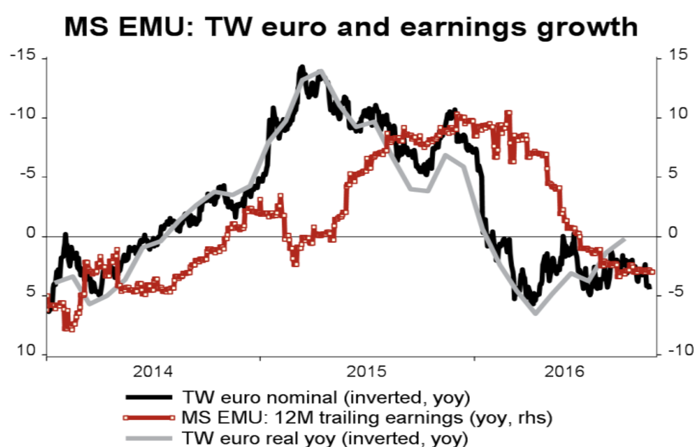
Macro stabilization drives better earnings momentum

The economic momentum continued to show signs of resiliency. This is seen from the nominal yoy change of the global GDP growth which extended its rebound together with the world index sales growth. Confidence indicators surprised on average on the upside and the inflation component of the macro surprise index accelerated visibly, reaching a 6-year high in terms of 3 month variations.

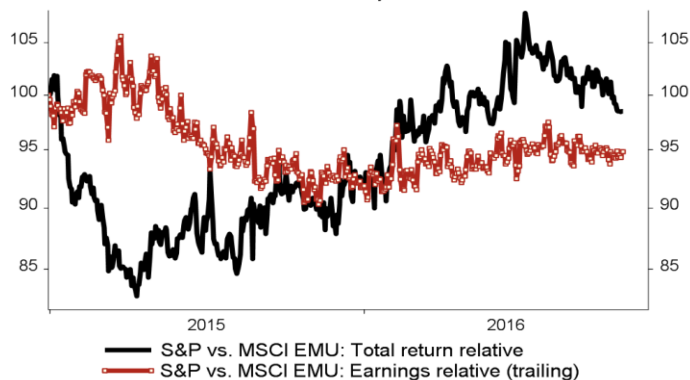
The "reflationary" wave started with a more cautious Fed stance in Q1, which in turn, helped the US dollar and the oil price to stabilize. They contributed to a rebound of the global trade in nominal terms (volumes stayed weak) and the manufacturing sector. As a result, profits of commodity-related and export-oriented companies experienced a trough. In both the EM and the UK the currency depreciation added to the positive effects. After the Brexit, the better profit momentum has extended to the broader indices also thanks to even more dovish global monetary policies. The latter helped to ignite a strong rally of EA corporate bonds and EMBI spreads (in USD) with the consequence of further lowering the cost of debt for corporates, thus helping profit stabilization.

In the last weeks solid earnings revisions lingered (net positive 12-month earnings revisions divided by total revisions). Investors' preference was then ready to rotate into countries and sectors being more cyclical, under-valued and riskier (financials included) once they were reassured by positive macro surprises, marginally steeper yield curves and better inflation data. The sequence was one of a continuing reflation trend which reassures markets about the prospects of corporate pricing momentum and cash flow growth.





Equities



Area	past earnings growth, p.a.	expected yoy growth 2017, GIE	expected yoy growth 2017, Consensus	difference * 2017
US	7.3%	1% - 4%	13.0%	-10.5 pp
Euro Area	4.4%	4% - 6%	13.1%	-8.1 pp
Japan	3.1%	5% - 7%	9.0%	-3.0 pp
EMs	9.6%	6% - 9%	13.2%	-5.7 pp

* Midpoint of GIE forecasts minus consensus

Markets	PE		PB		PCF		DY		Avg.	Avg.
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	Discount	Disc. (-1M)
USA	16.5	9.0	2.6	12.5	10.9	13.5	2.3	3.0	8.0	10.4
JAPAN	13.7	-52.3	1.1	-11.4	7.1	1.6	2.3	21.3	-20.9	-22.5
UK	15.0	8.7	1.7	-6.2	8.6	10.8	4.1	4.9	2.1	5.2
SWITZERLAND	15.8	3.4	2.1	-3.7	12.4	12.1	3.9	18.4	-1.7	2.6
EMU	13.8	-2.8	1.4	-6.4	7.3	16.4	3.6	-7.1	3.6	1.7
FRANCE	14.0	-2.5	1.4	-7.7	7.9	18.7	3.7	-2.8	2.8	0.3
GERMANY	13.0	-14.3	1.5	5.2	7.8	21.8	3.2	-6.0	4.7	2.2
GREECE	12.7	-0.1	1.4	-12.1	6.6	13.8	3.4	-12.6	3.6	3.8
ITALY	12.1	-21.2	0.9	-27.7	4.4	-3.6	5.0	5.8	-14.6	-21.4
PORTUGAL	15.8	27.4	1.8	1.3	6.4	9.9	4.5	0.2	9.6	4.3
SPAIN	13.4	3.8	1.2	-29.1	4.9	-3.2	4.6	-12.3	-4.0	-10.3
EURO STOXX 50	13.5	2.2	1.4	-3.9	7.2	21.9	4.0	-8.1	7.1	4.0
STOXX SMALL	15.6	10.7	1.7	2.3	6.5	-19.3	3.1	-3.1	-0.8	-0.1
EM, $	12.4	-15.6	1.4	-12.3	7.4	-3.6	2.7	-22.1	-2.3	-1.3
BRAZIL	14.1	61.2	1.5	-10.6	7.7	-47.7	3.2	-27.7	7.7	-1.9
RUSSIA	5.6	-22.2	0.6	-35.4	3.6	-22.2	5.3	57.2	-34.2	-32.6
INDIA	17.2	21.5	2.7	1.1	11.7	2.1	1.6	-0.4	6.3	8.7
CHINA	12.0	-8.0	1.4	-19.7	7.6	0.8	2.3	-25.7	-0.3	2.5

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

Source: Thomson Reuters Datastream, IBES estimates.

Earnings assessment: consensus for 2017 still at risk

For the EA in particular, the negative earnings momentum in H1 had to do with lower financial profits (-25%), lower GDP growth (reducing profits by nearly 1.5%) and higher real trade-weighted euro (passing from -6 to +4% yoy). So it comes as no surprise that, faced with a less bad news flow on banks, better confidence indicators and a more stable trade-weighted euro, profits are now stabilizing, too, and the good market tone extends. While the broader EA index's earnings growth in the Q2 reporting season was -5% yoy, for the median sector it was less negative at -2.7%. The median stock and the median sector ex-commodity did even better: +2.4% and +0.9% yoy, respectively. The first data for the Q3 reporting season are confirming an improving earnings momentum after the trough experienced in Q1.

That said, our profit forecasts remain below consensus for the next year both in the US and in the EA (see table) due to a persisting low sales growth and possible negative spillovers from political uncertainty (Brexit process, Italian referendum and elections in the core EA countries). As a matter of fact, we are still facing a weaker economic growth versus history which is reflected by the percentage of companies characterized by a negative sales growth: 41% globally, 56% in Japan, 37% both in the EA and the US.

In this respect, the consensus estimates for 2017 remain uncomfortably high at around 13% (which makes 2018 earnings estimates unrealistic as well) and analysts are likely to revise downward their forecasts in the next months.

Regional equity markets and sectors

As the mood concerning a more stable economic momentum and yields extends, we continue to favor a more cyclical allocation inside equities. In this respect we keep to the overweight on the EA and UK FTSE 100 at the expense of the Swiss index and the US one (local currency). Mainly as a result of a better profit outlook and lower valuations (13.8X 12-month PE vs. a 16.5X US one), we forecast the total return for the EA equities to be slightly positive over a one-year time versus a negative low-digit one for the US. We remain neutral on Japan and EMs but we remain constructive on both over the mid-term due to contained valuations, supportive monetary policy and higher cyclicality. Inside Europe, we suggest the relative bet by going long in France and Italy (Italy with a lower weight given its high specific risk) and shorting Switzerland. The former are characterized by being more cyclical, cheaper, having higher exposure to banks and much lower to defensive sectors like food or pharma. Turning to European sectors we favor a less balanced portfolio with an overweight on IT, telecoms, financials and capital goods, a neutral position on commodities and now an underweight on pharma and food.

Emerging Markets Equities

Vladimir Oleinikov

- **Looking ahead, we see the EM performance to be muted, even though resilient oil and commodity prices along with a range-bound US dollar should provide further support.**
- **While the expected Fed hike in December could have some impact, we reckon its extent to be rather limited as the current macroeconomic situation is in much better shape now than during the past Fed hikes.**
- **We now favor Taiwan along with India, Korea, and smaller CEE countries.**

Over the last month, EM equities have increased only by 0.6% in US dollar terms. The top performer was Brazil (+9.4%), being followed by Hungary (+8.5%) and the Czech Republic (+5.8%). The Vietnamese market has shown the worst performance (-3.2%). While the Brazilian market has benefitted from the decrease in key rates (-25 bps), the major positive driver for Hungary was the recent sovereign debt rating upgrade to industrial grade by S&P. The market of the Czech Republic was pulled up by Komercni Banka, previously oversold on fears over its dividend outlook.

While the emerging markets are likely to continue to benefit from rising oil (+7%) and commodity prices (+4%), the rally has lost its vigor. The EM stock market has closely followed oil prices, with the gap between the two currently being closed. Looking ahead, we expect only a very moderate increase in oil prices and, as the equity price trend has outpaced that of earnings, we expect the EM performance to be contained. It should be noted that corporate margins have, in general, only slightly increased since their lows at the end of 2014, staying one standard deviation below their historical average. Finally, the macro surprises have recently become weaker.

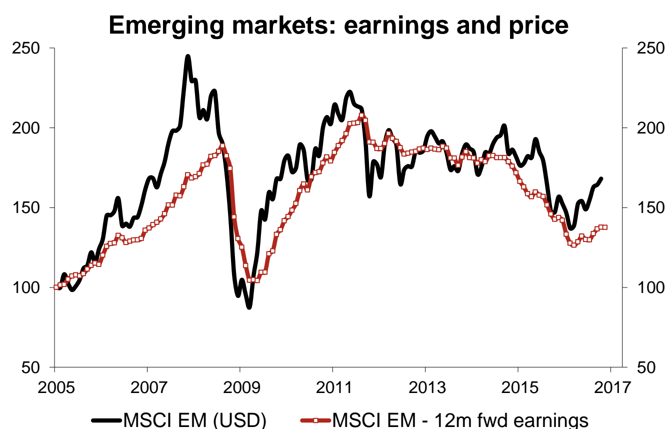
Taiwanese market getting more attractive

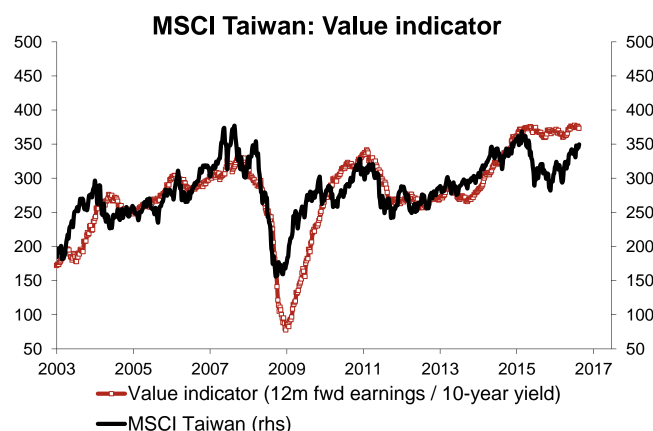
In the Q2 reporting season, the Taiwanese market has disappointed, showing negative yoy growth for earnings and sales (-20% and -2%, respectively). Since then, the outlook has somewhat improved. Earnings in the Q3 reporting season have surprised positively (+27%). The 12% of companies having presented their results show a turnaround of earnings from -20% in Q2 to 54% in Q3 (with yoy sales growth of -1%). The positive outcome is dominated by IT companies (having a weight of 61% in the broader index). Judging by the multiples, the Taiwanese market has a discount of 8% versus its history and is characterized by positive earnings revisions (0.8% for both 2016 and 2017). Relative to EMs, its price trend is fully justified by that of earnings. But in terms of fundamentals, the index looks to be rather undervalued.

Within EM universe we also favor India, Korea and the smaller CEE countries.

Markets	price, %-chg		earnings, %-chg		10y yld	FX (TW), %-chg	
	-1M	YTD	-1M	YTD	chg, YTD	MTD	YTD
WORLD ($)	-0.9	2.2	1.1	1.3			
US	-0.3	4.7	0.9	2.8	-48	1.2	0.0
EMU	2.9	-3.8	0.8	-1.0	-50	-0.3	2.4
GREECE	3.3	-23.6	4.6	-52.8	-6	-0.3	2.4
CZECH REP.	5.8	-3.9	-2.0	-17.6	-8	-0.4	0.7
HUNGARY	8.5	24.3	0.6	20.3	-54	-0.5	2.9
POLAND	2.5	-4.3	0.0	-2.1	13	-1.1	-0.2
EM ($)	0.6	14.7	0.8	3.3	-148		
BRAZIL	9.4	42.9	-1.6	0.2	-518	5.3	28.7
CHINA	-0.7	6.1	1.1	-6.8	-13	0.0	-6.9
INDIA	-1.2	6.1	1.2	5.7	-89	1.4	-1.0
INDONESIA	-0.9	17.2	1.3	5.2	-180	2.0	4.1
KOREA	-0.3	7.5	0.8	7.6	-45	-1.3	3.1
MALAYSIA	0.0	-0.1	0.1	-3.8	-61	1.1	1.9
MEXICO	1.0	10.5	0.3	4.8	-12	5.6	-7.4
RUSSIA	-0.5	13.0	4.7	8.4	-130	3.8	19.0
TAIWAN	2.7	15.4	1.6	-1.4	-5	0.9	3.6
THAILAND	-1.3	19.5	-0.6	0.3	-36	0.7	1.0
TURKEY	3.0	10.5	1.3	6.6	-74	-0.1	-4.9
VIETNAM	-3.2	-1.6	2.6	1.8	-108	1.6	0.0
SHANGHAI	4.6	-11.9	1.1	-10.8	-13	0.0	-6.9

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



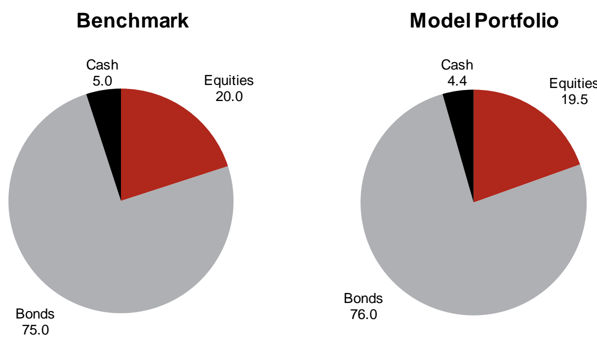


Mark to Market Allocation

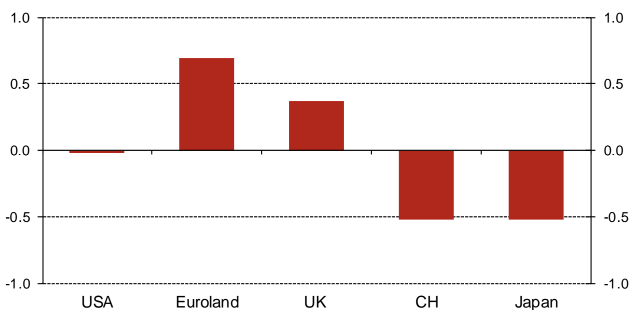
Thorsten Runde

Asset Class	Benchmark	Model Portfolio	Previous Allocation
Equities	***20.0***	***19.5***	***19.5***
Bonds	***75.0***	***76.0***	***76.0***
Cash	***5.0***	***4.4***	***4.4***
Equities, US	3.0	**2.9**	2.9
Equities, EMU	12.0	**11.9**	11.9
Equities, UK	2.0	**2.0**	2.0
Equities, Switzerland	1.0	**0.9**	0.9
Equities, Japan	2.0	**1.9**	1.9
Bonds, Gvt. US	11.3	**11.5**	11.5
Bonds, Gvt. EMU Core	27.0	**27.1**	27.1
Bonds, Gvt. EMU GIIPS	18.0	**18.2**	18.2
Bonds, Gvt. UK	7.5	**7.7**	7.7
Bonds, Gvt. Switzerland	3.8	**3.8**	3.8
Bonds, Gvt. Japan	7.5	**7.7**	7.7
Cash, Euro 3-Mth.	5.0	**4.4**	4.4

Asset Classes



Equities - Regional Structure



Bonds - Regional Structure

- **Apart from the US, all equity markets have revealed positive performance figures during the course of October so far, with Japan clearly leading the return ranking.**
- **All government bond markets in our asset universe performed negatively, driven by generally rising yields.**
- **Thus, as the risk of setbacks on stock markets did not materialize, last time's tactical recommendation could not add value.**
- **Various political imponderables are still virulent, which generally argues for a continued cautious active positioning.**
- **Thus, looking forward, we leave the recommended allocation stance, primarily characterized by a moderate underweight in equities in favor of government bonds, unchanged.**

In the course of October, apart from the US, all equity markets have once again revealed positive performance figures so far, with Japan (+4.5%) clearly leading the return ranking on the equity side. Since the end of September, yields rose across the government bond markets of our asset universe, leading Bund yields back into marginally positive territory again. Spreads on Southern European debt rose slightly, owing to political uncertainties in Italy. In that sense, preferring the US to the euro area on the equity side proved correct. Yet, underweighting equities in general was not rewarding.

Further sell-off in bonds unlikely

With respect to monetary policy, the Fed will continue to prepare markets for a rate hike in December, whose market impact should be limited. On the contrary, the ECB will probably extend its QE program beyond March 2017 and even widen the eligibility criteria of the asset universe. Thus, we do not consider the recent increase in yields to prove the start of a deeper sell-off in global bonds.

Unfavorable political environment for equities

Political imponderables are still bearing the elevated risk of setbacks to equity markets. In particular the US market is threatened by the uncertainties related to the presidential elections.

Cautious active positioning advisable

Under these conditions, we deem a continued cautious active positioning advisable. The allocation stance is again characterized by a by a small tactical overweight in European bonds at the expense of equities, particularly the US ones, where valuations are stretched and rising unit labor costs continue to burden earnings.

Forecast Tables

Growth

	2014	2015	2016f	2017f
US	2.4	2.6	1.6	2.2
Euro area	1.2	1.9	1.5	1.2
Germany	1.6	1.5	1.7	1.3
France	0.7	1.2	1.2	1.0
Italy	0.2	0.6	0.6	0.4
Non-EMU	2.9	2.4	2.1	1.5
UK	3.1	2.2	2.0	1.3
Switzerland	2.0	0.8	1.0	1.3
Japan	- 0.1	0.6	0.6	0.8
Asia ex Japan	6.4	6.1	6.1	5.9
China	7.3	6.9	6.7	6.3
Central/Eastern Europe	1.8	0.1	1.3	2.5
Latin America	0.6	- 0.6	- 1.4	1.1
World	**3.5**	**3.3**	**3.0**	**3.3**

Inflation

	2014	2015	2016f	2017f
US	1.6	0.1	1.2	2.2
Euro area	0.4	0.0	0.3	1.3
Germany	0.8	0.1	0.4	1.4
France	0.6	0.1	0.2	1.2
Italy	0.2	0.1	0.0	1.0
Non-EMU	1.2	0.1	0.8	2.7
UK	1.5	0.0	0.8	3.1
Switzerland	- 0.0	- 1.1	- 0.4	0.2
Japan	2.7	0.8	- 0.3	0.3
Asia ex Japan	3.3	2.4	2.8	2.9
China	2.0	1.4	2.1	2.0
Central/Eastern Europe	5.8	9.3	5.1	4.6
Latin America	5.1	6.2	6.3	4.6
World	**2.8**	**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-M Money Market Rates	**27.10.16***	**3M**	**6M**	**12M**
USA	0.89	1.10	1.25	1.45
EUR	-0.32	-0.35	-0.35	-0.35
JPN	-0.02	-0.02	-0.05	-0.05
UK	0.40	0.40	0.40	0.40
SWI	-0.73	-0.75	-0.75	-0.75
10-Year Bonds	**27.10.16***	**3M**	**6M**	**12M**
Treasuries	1.80	1.85	1.90	2.00
Bunds	0.10	0.10	0.15	0.20
BTPs	1.54	1.55	1.55	1.60
OATs	0.38	0.40	0.45	0.55
JGBs	-0.06	-0.02	0.00	0.00
Gilts	1.17	1.20	1.25	1.25
SWI	-0.44	-0.40	-0.35	-0.30
Spreads	**27.10.16***	**3M**	**6M**	**12M**
GIIPS	134	135	130	125
Covered Bonds	60	60	55	55

Corporate Bond Spreads	**27.10.16***	**3M**	**6M**	**12M**
IBOXX Non-Financial	123	120	115	115
IBOXX Sen-Financial	115	120	120	120
Forex	**27.10.16***	**3M**	**6M**	**12M**
USD/EUR	1.09	1.07	1.08	1.11
JPY/USD	105	106	107	107
JPY/EUR	114	113	116	119
USD/GBP	1.22	1.16	1.16	1.23
GBP/EUR	0.89	0.92	0.93	0.90
CHF/EUR	1.08	1.09	1.09	1.11
Equities	**27.10.16***	**3M**	**6M**	**12M**
S&P500	2139	2105	2095	2065
MSCI EMU	108.5	108.0	107.0	106.0
TOPIX	1381	1370	1355	1350
FTSE	6987	6960	6910	6810
SMI	7916	7845	7760	7680

*average of last three trading days

3-Months Horizon

		Low	Forecast	High
Government Bonds	*10-Year Bunds*	0.09	0.10	0.11
	10-Year Treasuries	1.63	1.85	2.07
	10-Year JGBs	-0.03	-0.02	-0.01
	10-Year Gilts	0.99	1.20	1.41
	10-Year Bonds CH	-1.94	-0.40	1.14
Equities	*MSCI EMU*	101.0	108.0	115.0
	S&P500	2007	2105	2203
	TOPIX	1262	1370	1478
	FTSE 100	6604	6960	7316
	SMIC	7468	7845	8222
Currencies	*USD/EUR*	1.03	1.07	1.11
	JPY/USD	102	106	110
	GBP/EUR	0.89	0.92	0.95
	CHF/EUR	1.06	1.09	1.12

12-Months Horizon

		Low	Forecast	High
Government Bonds	*10-Year Bunds*	0.17	0.20	0.23
	10-Year Treasuries	1.54	2.00	2.46
	10-Year JGBs	-0.08	0.00	0.08
	10-Year Gilts	0.88	1.25	1.62
	10-Year Bonds CH	-0.47	-0.30	-0.13
Equities	*MSCI EMU*	92.2	106.0	119.8
	S&P500	1885	2065	2245
	TOPIX	1125	1350	1575
	FTSE 100	6161	6810	7459
	SMIC	6911	7680	8449
Currencies	*USD/EUR*	1.04	1.11	1.18
	JPY/USD	98	107	116
	GBP/EUR	0.84	0.90	0.96
	CHF/EUR	1.06	1.11	1.16

*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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