GENERALI INVESTMENTS

Market Perspectives

Patience is a virtue

February 2019

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This document was completed on November 30, 2018

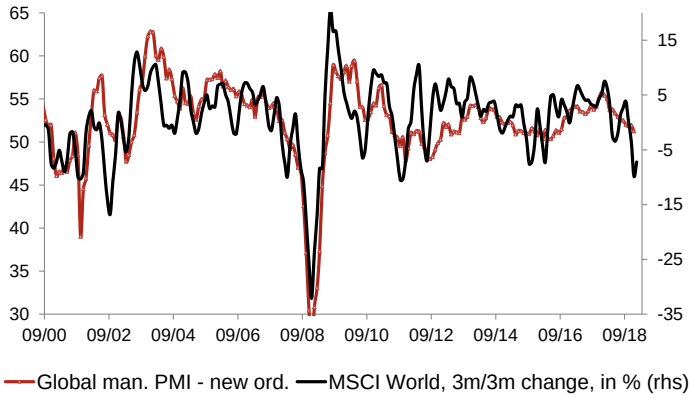
Global View

Vincent Chaigneau / Thomas Hempell

- **Underwhelming macro data and lingering political uncertainties (trade war, Brexit, US government shutdown) offered little support to global markets into the new year.**
- **Yet risk assets have been climbing a wall of worry since Christmas, rebounding nicely from a panic sell-off in December. More dovish central banks, Chinese policy support and hopes of a US/China trade deal are reassuring investors that policy makers will address downside risks.**
- **We subscribe to Fed's Powell underlying message: patience is a virtue. We trim but retain a pro-risk allocation tilt, slightly reduce our underweight in Govies and keep an overweight in credit.**

Sunny spots are rare this winter. Economic data in in Europe and China have continued to underwhelm. Key euro area indicators including PMIs, Ifo and Sentix are at multi-year lows, following a sharp contraction in industrial production in Q4. China reported a slump in trade and the slowest annual growth in three decades. Large multinationals downgrading earnings expectations are pointing to demand shortfalls in the country. Concerns about a trade war, a no-deal Brexit and the US government shutdown are lingering. One of the few bright spots is the unabated strength of the US labor market.

Global economy and equities



And yet markets have found a bottom. After extending losses in December, global stocks staged a vigorous rebound into the new year. The MSCI World has recovered more than 10% from the Christmas trough; spreads on High Yields and EM hard currency bonds have narrowed sharply. In fact, many risky assets are back to early-December levels. EM assets, which led the 2018 global rout, have even advanced beyond those levels.

So what has changed? First, the December sell-off marked a capitulation in sentiment (excessive pessimism) and positioning (e.g. massive outflows from Credit funds). Second, global policy makers have sent soothing messages. Most prominently, the Fed has turned cautious. Chair Powell has pledged to be "patient" before raising US rates any further – a dovish message that was even strengthened at the Jan 30 FOMC meeting.

Dovish Fed signals echoed by ECB

This dovish shift is being echoed by a more alert ECB, whose council unanimously acknowledged that risks had "shifted to the downside", making a new round of TLTROs in mid-year increasingly likely while the odds of a first rate hike are shifting from 2019 to 2020. China announced various new stimulus measures, including income tax cuts, lower reserve requirements for banks and a central bank bills swap aimed at boosting liquidity. Neither of these adjustments in isolation will trigger a rebound in the global momentum. But investors are taking comfort from policy makers taking note of the changed global backdrop.

At the same time, the more fragile macro and market backdrop may have increased pressure on the US and China to prevent a further escalation of the trade conflict. A full solution by early March is unlikely, but a temporary fudge could help and soothe global uncertainties. Finally, the longest ever partial US government shutdown has been terminated, at least for now. The economic damage and voters' disapproval may help to raise the bar for a repeated shutdown over the coming months in the conflict between Trump and the Democrats.

Bonds	**29/01/19***	**3M**	**6M**	**12M**
10-Year Treasuries	2.74	2.80	2.85	2.90
10-Year Bunds	0.20	0.30	0.45	0.60
Corporate Bonds				
BofaML Non-Financial	145	155	160	175
BofaML Financial	152	170	175	190
Forex				
EUR/USD	1.14	1.14	1.16	1.20
USD/JPY	109	109	108	105
Equities				
S&P500	2650	2660	2645	2555
MSCI EMU	114.2	114.0	111.5	109.0

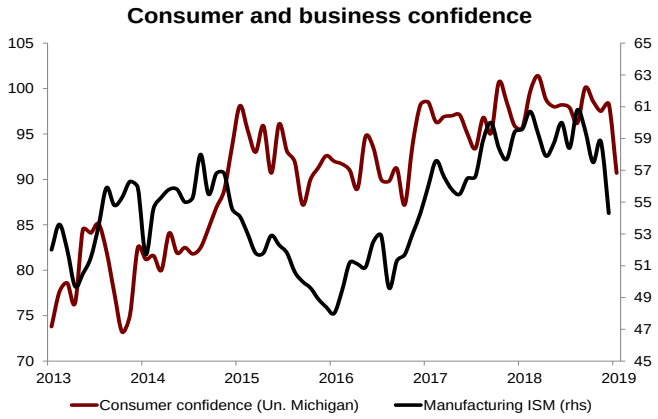
* avg. of last three trading days

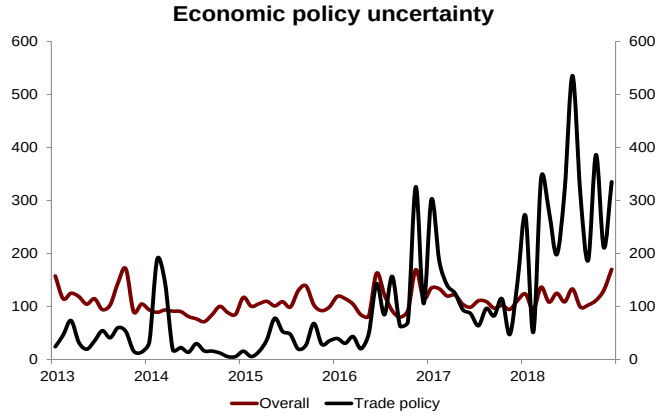
Reasons to be patient

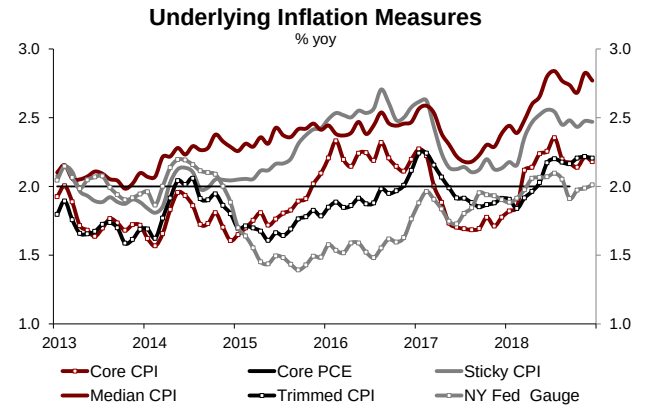
Patience is a virtue: we now trim slightly but retain the pro-risk tilt in our portfolios. Equity markets have recovered – but still price a gloomier outlook than we deem justified (see chart). Core yields still look too low fundamentally, though with global sentiment now fragile and central banks more prudent, any rise there will be moderate. We further reduce our underweight in Southern European bonds, after the (fudged) agreement on the fiscal budget between Italy and the EU has decreased the near-term risk of a political clash. We maintain a moderate overweight in credit.

USA

Paolo Zanghieri







- **Softer global trade, political uncertainty and tighter financial conditions have negatively affected activity in the final months of the year and will remain a drag. Growth likely averaged 2.9% in 2018, and will ease to 2.3% this year.**
- **The long government shutdown has drastically reduced data availability; we expect it to have a strong but transitory impact on Q1 GDP, but to impinge on confidence. The labor market remains strong, with wage growth above 3% yoy.**
- **The Fed turned even more dovish, stating that for the time being it plans no further rate increases. Yet we think that at least one more hike is warranted.**

Data availability for the final months of 2018 and the beginning of the year has been reduced by the government shutdown triggered by the clash between the Congress and President Trump on the budget. Softer indicators like business surveys, however, point to a slowdown in activity, especially in the manufacturing sector, as a consequence of slower global trade. Consumer confidence weakened too, reflecting political uncertainty and the December drop in equity prices. The long pause in federal government activity will depress growth in Q1, but the following quarter will see a rebound. We expect tighter financial conditions and uncertainty to take their toll on capex and net export, offsetting still buoyant consumer spending. This and the rapid fading of the fiscal stimulus in the second half of the year will lead GDP growth to slide to 2.3% in 2019, still above potential.

The labor market powers ahead, with stable inflation

The increase in the unemployment rate to 3.9% in December reflected a higher participation rate as solid wage growth (3.2% yoy) pushed people to go back looking for employment. Yet core inflation stood at just 2.2% in December, also a consequence of the pass-through of lower commodity prices and slower than expected healthcare inflation. We expect a further mild increase, leading the core rare to a peak at 2.4% in Q3.

A patient Fed will hike at least once more

The Fed has turned significantly more dovish, acknowledging the higher risks surrounding the economic outlook. At the January meeting it stated that it does not consider any further hike for the time being, but that it will have to assess data before taking any other step. Our outlook for the economy is consistent with at least one more hike, likely in H2 this year. The Fed may stop the runoff of the balance sheet earlier than expected (in H1 2020); this implies that its final size will not be too far from market estimates of 3.5 US$ tn.

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Euro Area

Martin Wolburg

- **In Q4 growth failed to accelerate from subdued levels and the January PMIs weakened again implying a weak start into the year.**
- **We revised our 2019 growth expectation down to 1.2% and see a crash Brexit and intensifying trade conflicts as outstanding downside risks.**
- **The ECB will have to adjust its macro outlook to the downside and we see an increased risk that it will postpone its first (depo) rate hike into 2020.**

The negative news flow on euro area activity indicators continued over the past two months. Most importantly, industrial production did recover from its weakness in Q3 (largely attributed to a one-off effect in Germany) but surprisingly fell by 1.7% mom in November. The preliminary Q4 growth rate was reported at 0.2% qoq. Moreover, the January flash PMIs receded again with the composite PMI falling to the lowest level since July 2013 amid employment creation losing steam. This reading implies a meagre Q1 GDP growth rate of just 0.1% qoq.

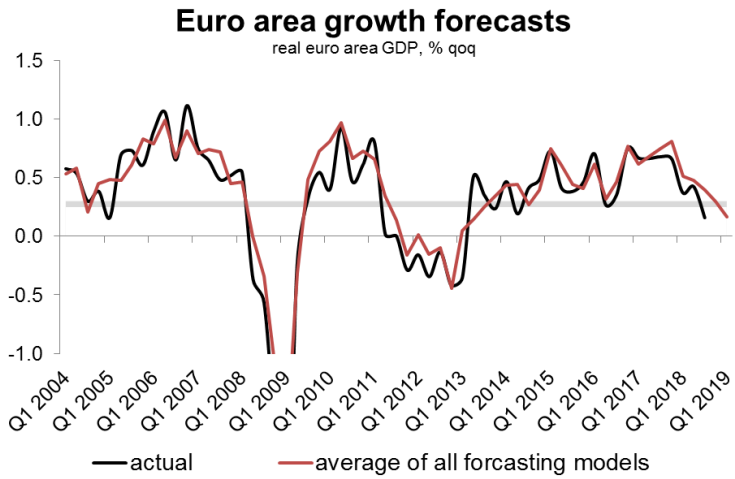
Uncertainty biting amid prevailing downside risks

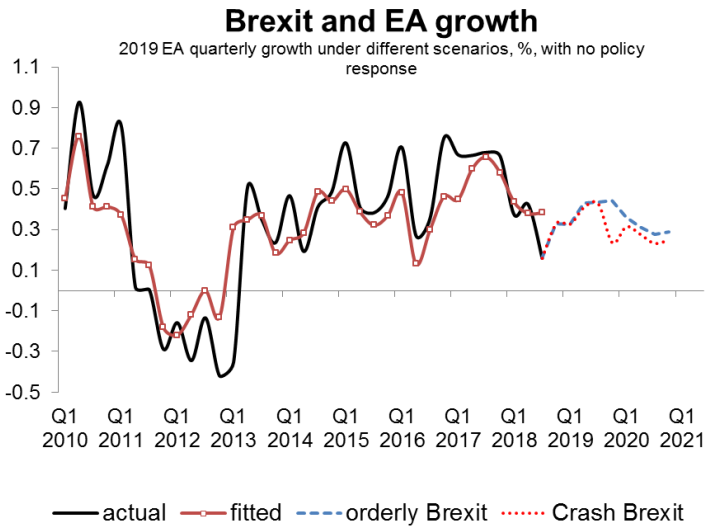
The reasons behind the disappoint start into the year are manifold. First, export orders stabilized at subdued levels suggesting a less supportive international environment with tariffs and uncertainties from trade conflicts biting. For the euro area the risk of US car tariffs is looming. Second, whereas the German flash composite PMI advanced for the first time since August 2018, the French equivalent plummeted to 47.9 due to deteriorating service sentiment that we largely attribute to the yellow vest protests. Third, the Brexit drama is approaching its climax and business leaders are increasingly concerned about the risk of a crash Brexit. In such a case we would expect euro area activity to stall and annual growth to be reduced by about ½ pp in 2019.

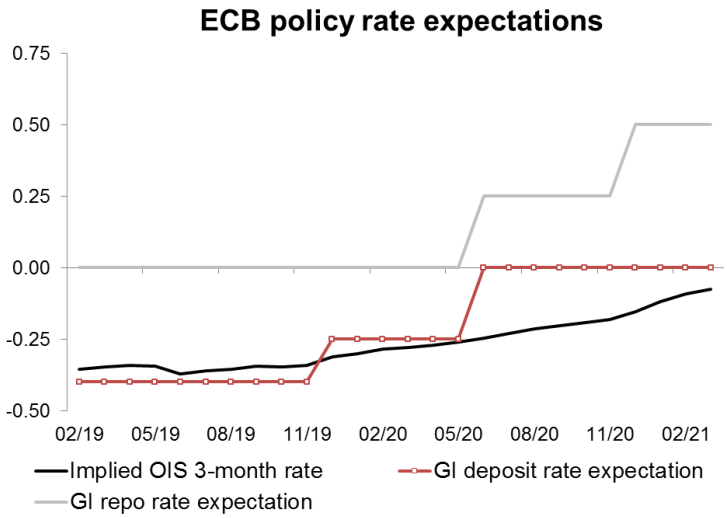
All in all, we revised our growth forecasts for 2019 down to 1.2% (from 1.4%) and still see risks on the downside.

ECB acknowledges downside risks to growth

At its January 24 meeting, the ECB had to acknowledge that the growth risks have shifted to the downside. However, President Draghi said that the ECB was still in assessment mode and would discuss policy implication at the March meeting when updated macro projections will be released. The adopted tone was rather dovish and it became clear the ECB is flirting with a new TLTRO which could in our view already be announced at the March meeting. Moreover, we see an increased risk that the ECB will postpone the timing of its first (depo) rate hike into 2020.

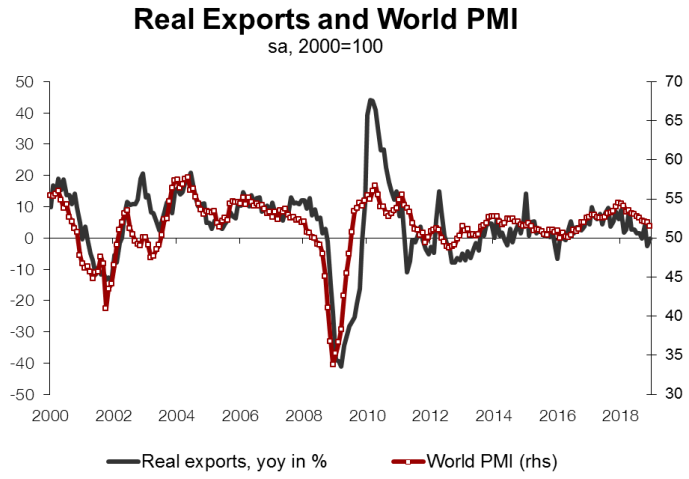


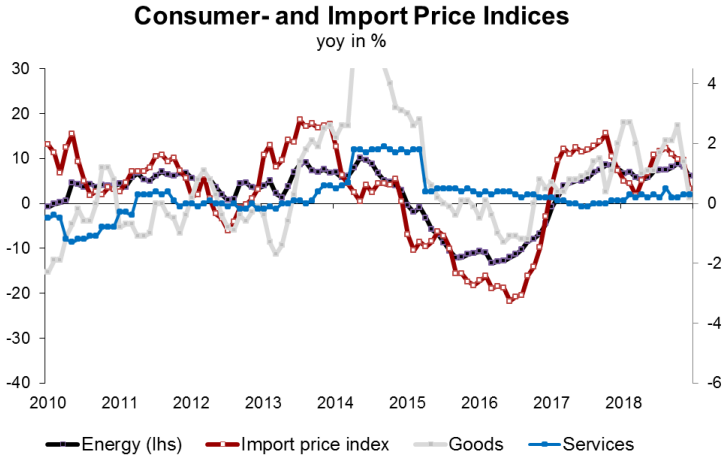




Japan

Christoph Siepmann





Main Forecasts[1)]	2017	2018	2019f	2020f
GDP	1.7	0.8	0.9	0.4
Consumer spending	1.0	0.6	1.2	-0.2
Government consumption	0.1	0.6	1.0	1.1
Investment	2.6	0.9	1.8	0.8
Inventories	-0.1	0.1	-0.1	0.0
Net trade	0.5	0.0	-0.1	0.0
Domestic demand	1.2	0.6	1.2	0.4
Consumer prices	0.5	1.0	0.9	1.4
Unemployment rate[2)]	2.8	2.4	2.2	2.2
Budget balance[3)]	-4.3	-3.7	-2.8	-2.8

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

- **Japan's growth has likely rebounded from the natural disasters in Q3, but less than previously expected.**
- **Due to increasing headwinds from international trade, we revised down our growth forecast for 2019 to 0.9%.**
- **The BoJ is not expected to move until after the sales tax hike in October.**

After Japan had been repeatedly hit by natural disasters in Q3 which resulted in a drop of GDP by 2.5% qoq ann., the fourth quarter saw some of the expected rebound. However, exports increased only softly in December. In sum, merchandise exports expanded by 1.7% qoq in Q4, unable to level off the drop in Q3 by 2.7% qoq. On the other hand, imports accelerated further, implying the contribution of net export to Q4 GDP growth likely be negative. In line with exports, industrial production also saw two months with negative growth rates (Nov./Dec.), but the initial rebound in October was strong enough to make up for the Q3 drop. Looking ahead, headwinds from the international environment have intensified amid slowing growth rates around the globe. The slowdown in China will especially limit capital goods exports. Japan's Nikkei PMI receded markedly in January to 50 index points, driven down not least by a further large drop in PMI new export orders. Moreover, the monthly Reuters Tankan receded substantially, driven by manufacturers, while the service sector was much less affected. Given the weaker outlook to exports, a meaningful uptrend to industrial production has also become less likely. On top, the US-Japan trade talks will resume near term. Press reports indicate that the starting point will remain on goods, while the US will press to broaden the picture also to services. For some (agricultural) goods Japan can offer to reduce tariffs in line with the TPP agreement, from which the US dropped out. However, worries remain concerning possible tariff threats on Japanese car exports to the US.

Consumption to rise ahead of the sales tax hike

On the domestic side, private consumption has likely rebounded in Q4 from its small drop in Q3. Retail sales increased yoy in December and services, which were especially hit by the natural disasters, have probably rebounded. Private consumption is likely to rise before the planned sales tax hike in October and then drop in Q4 2019. The government is mulling action to smooth this pattern. The two supplementary fiscal packages plus the initial budget could lead to a fiscal impulse of 0.5 pp of GDP. Nevertheless, given the international headwinds, we revise our 2019 growth forecast down to 0.9%, from 1.3% before. We expect the BoJ to hold its monetary policy constant until after the sales tax hike. The recent appreciation of the yen vs the US-dollar underlines this view.

China

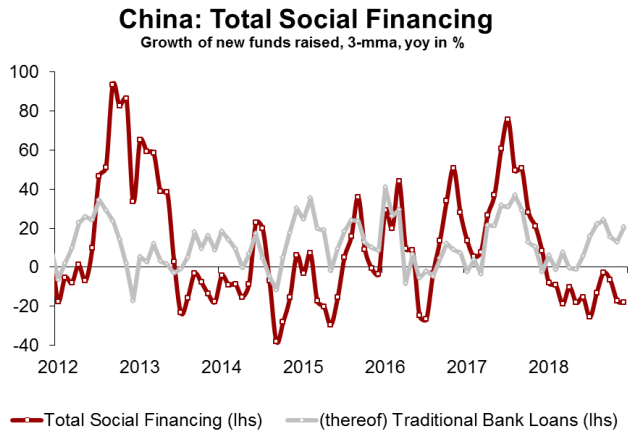
Christoph Siepmann

- **China's GDP growth weakened in Q4 to 6.4% yoy, moderately down from 6.5% yoy in Q3.**
- **Given the current domestic as well as international headwinds, we expect China's growth to continue moderating in H1. A positive outcome concerning the US trade talks could bring some relief.**
- **More support from economic policy seems likely but Beijing has ruled out a "flood" of stimulus.**

China's official Q4 2018 GDP growth came in at 6.4% yoy, confirming the ongoing slowing of the economy. Annual 2018 growth weakened to 6.6%, after (a downward revised) 6.8% in 2017. 2018 growth is at the lowest level in 28 years. Alongside with GDP data, China published also its monthly activity set for December. IP growth normalized to 5.7% yoy, after a surprisingly low reading of 5.4% yoy in November. Meanwhile, urban investment growth was unchanged at 5.9% yoy on a cumulative basis. Fiscal policy support – which typically shows up in the infrastructure subcomponent – improved but the turn-around was limited to 5.8% yoy in December, from negative readings in Q3. By comparison, infrastructure investment rose by close to 20% in 2017, i.e. current readings do not show strong fiscal demand. Clearly, Beijing broke up with the typical policy measures of the past, relying more on stimulating private demand via tax cuts.

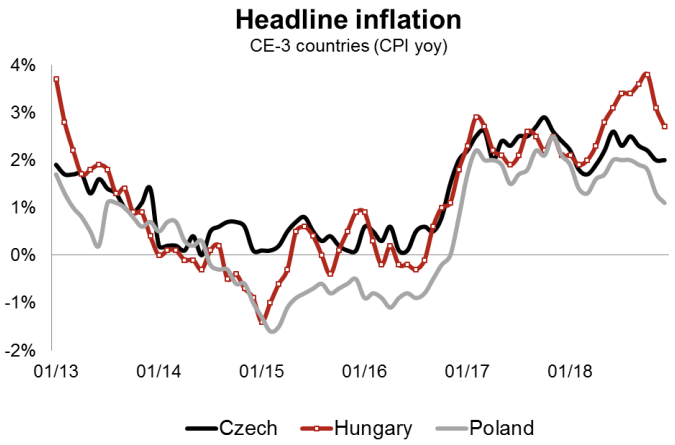
More monetary and fiscal policy easing ahead

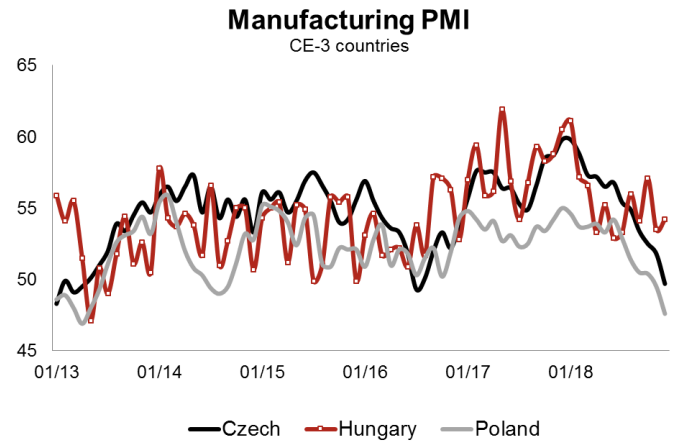
After already providing tax relief of RMB 1.3 tr (1.4% of GDP), China will likely top this by additional measures worth RMB 1.5 tr. Income tax cuts have already been expanded this year by adding another six deduction items to the four introduced last year. On the corporate side, especially SMEs stand to benefit from more measures, while plans are being discussed to also reduce the valued added tax. Official announcements will likely be made at the National People's Congress (NPC) in early March. PM Li Keqiang also recently iterated that growth must remain within a reasonable range, suggesting a calibrated policy stance. One important item regarding calibration will be the outcome of the US-China trade talks. If these talks fail, US tariffs on US$ 200 bn are set to rise from 10% to 25% on March 2. However, based on Trump's positive remarks, markets have been less worried recently. Monetary policy also continued to ease. The PBoC cut the RRR by a total of 100 bps in January (effective on Jan 15 and 25, ahead of the Chinese New Year on Feb. 5). It also introduced a swap line to boost liquidity. Fresh bank credit (new yuan loans) was again ample in December. According to our calculations, new bank credits grew by 19.5% in total 2018. However, new Total Social Financing (the broadest credit measure in China available) saw a strong decline 14%, due to the regulatory tightening. Recently, press reports suggested that China has already reduced its growth target for 2019 to a range of 6.0% to 6.5% (to be announced at the NPC) to which we agree, forecasting 6.2% in 2019.



Central and Eastern Europe

Radomír Jáč





Main Forecasts	2017	2018e	2019f	2020f
Czech Republic				
GDP	4.5	2.8	2.7	2.7
Consumer prices	2.5	2.1	2.0	1.9
Central bank's key rate	0.50	1.75	2.00	2.50
Hungary				
GDP	4.4	4.8	3.4	3.0
Consumer prices	2.4	2.9	3.2	3.0
Central bank's key rate	0.90	0.90	1.25	1.75
Poland				
GDP	4.8	5.2	3.9	3.3
Consumer prices	2.0	1.7	2.3	2.7
Central bank's key rate	1.50	1.50	1.50	1.75

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

- **The CEE economies feel the impact of a slower growth in the euro area. However, the region should outperform also in 2019, as it should still benefit from a strong domestic demand.**
- **Headline inflation moderated in all CE-3 countries in late 2018 but core CPI picture is mixed, which leads to differences in monetary policy stance.**
- **The Hungarian MNB states readiness for tighter monetary conditions, while the Polish NBP keeps a wait-and-see stance. The Czech CNB turned more cautious due to mounting external risks.**

The overall growth performance in the CE-3 region should remain solid, supported by household consumption and investment expenditure. However, there are clear signals of a negative impact of external conditions, i.e. of a slower growth in the euro area. This is visible in manufacturing PMIs. We think that particularly Hungary and Poland should decelerate from their dynamics recorded in 2018 with the growth remaining in both cases strong.

Headline CPI moderated at year end, reaching exactly the target level set at 2% in the case of the Czech Republic and falling below the 3% target (to 2.7% yoy) in Hungary. However, core inflation rose further in both countries, which keeps the local monetary policy makers on alert. Poland remains a different story with both headline and core CPI extending their decline well below the target set at 2.5%. This allows the Polish central bank to keep a wait-and-see policy stance with a vision of stable interest rates in 2019 and possibly also in 2020.

Global risks to weigh on regional monetary policy

The CNB left its key interest rate unchanged at 1.75% in December after delivering four hikes in a row at previous meetings. The CNB will present new quarterly forecast in early February. We expect the new forecast to imply only moderate monetary policy tightening for 2019 due to the slowing global growth and related risks for the Czech economy. The CNB Board seems to be split in the opinion whether to raise interest rates already in February or keep them stable for several monetary policy meetings until situation in the global economy clarifies.

The Hungarian MNB says that it will focus on core CPI when assessing persistence of inflationary developments and declares readiness for the gradual and cautious normalization of its policy. We expect new measures on this front in late March. The normalization will begin with modification of unconventional instruments. This means that the MNB will start to limit liquidity supply via swap operations, which could be followed by an increase in O/N deposit rate from its current level of -0.15%.

Poland is likely to keep monetary policy interest rates on hold in 2019. Both the actual CPI level and expectations of price developments for 2019 are not pushing the NBP towards tightening of monetary conditions.

Bonds/Fixed Income Strategy

Florian Späte

- **A continuation of the weak data flow has triggered a further drop in euro area yields since the start of the year. In contrast, despite ongoing political turmoil US yields slightly increased – particularly at the short end of the curve.**
- **Going forward, there is some scope for higher core yields on both sides of the Atlantic. The lack of support from central banks in combination with still robust growth is seen to drive yields up. But, political concerns are likely to limit the movement.**
- **Southern European government bond spreads have tightened further in recent weeks. Given the approaching European elections and the deteriorating growth environment, above all Italian sovereign bonds appear vulnerable.**

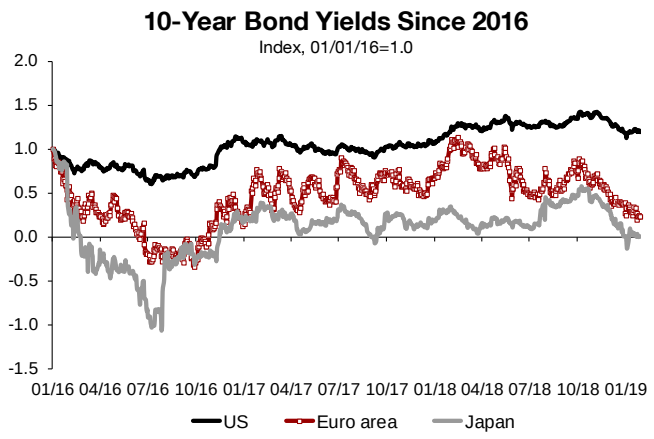
US and euro area government bond yields diverged in January. While euro area yields continued the downtrend which has started at the beginning of October, US yields backed up moderately (especially at the short end of the curve). Stabilizing US macro data and higher oil prices (WTI up by almost 20%) supported this turnaround (10-year US yields increased by 5 bps in January). In contrast, euro area macroeconomic data came in below expectations and even an improved sentiment for risky assets was not able to stop the downtrend in long-dated euro area yields (10-year yields fell from 0.24% to 0.20%).

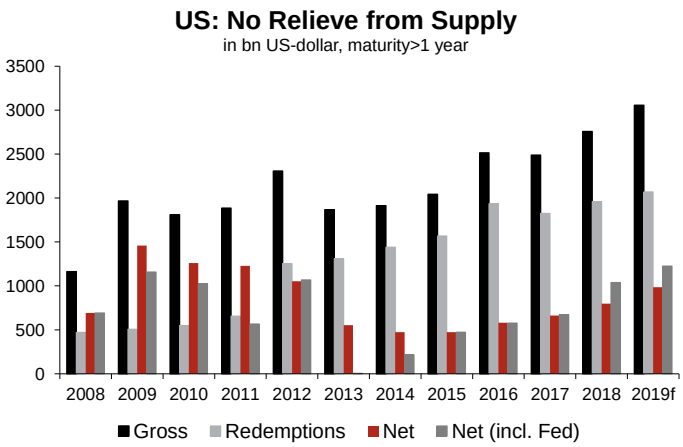
This divergence is mainly due to different developments in inflation expectations. Particularly short-dated US inflation swaps increased in January. Consequently, the US real yield curve has hardly changed since the start of the year. By contrast, despite the increase in oil prices euro area inflation expectations even fell slightly. Eventually, euro area real yields did hardly move across the curve either.

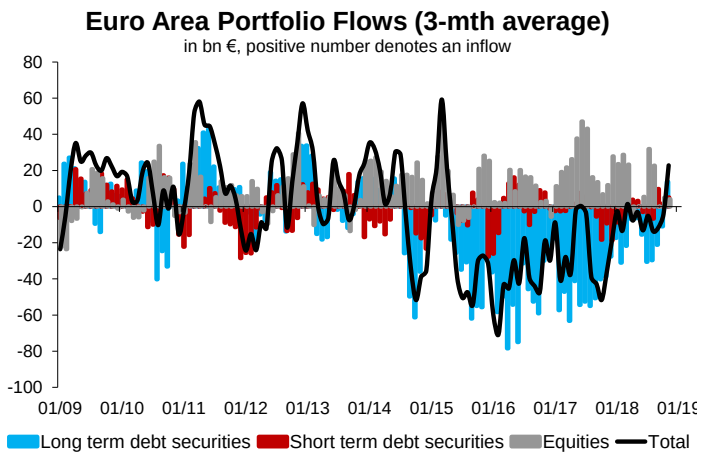
Strong supply of Treasuries to lead US yields up

Despite the economic and political uncertainties prevailing, there appears to be some more scope for higher US yields in the months to come. To start with, there is a wall of government bond supply that has to be digested by financial markets in 2019. Restricting the analysis to bonds with a maturity of at least one year, more than US$3000 bn US Treasuries will be issued this year which is the highest level ever. As the Fed is seen to not reinvest more than US$200 bn of maturing Treasuries, investors will have to take down more than US$1200 bn net supply in 2019. As non-domestic investors are unlikely to increase their holdings substantially, the imbalance between demand and supply suggests that there is an upward pressure on US yields in 2019.

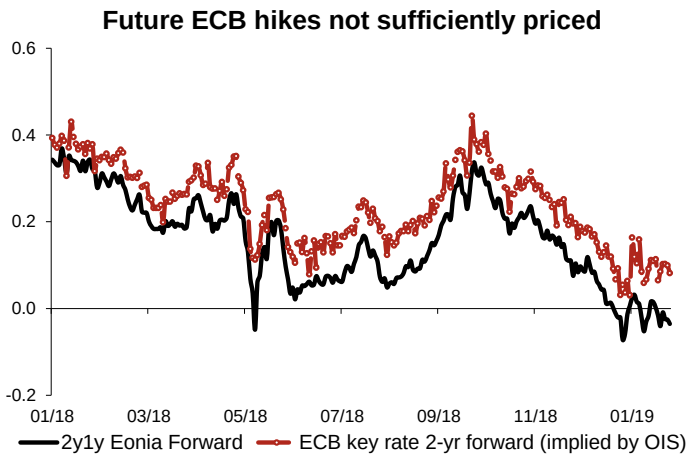
In addition, financial markets do not price any rate hike in 2019 and even expect a first cut in 2020. This appears too cautious. For the time being growth will remain around potential and particularly the labor market shows continuing

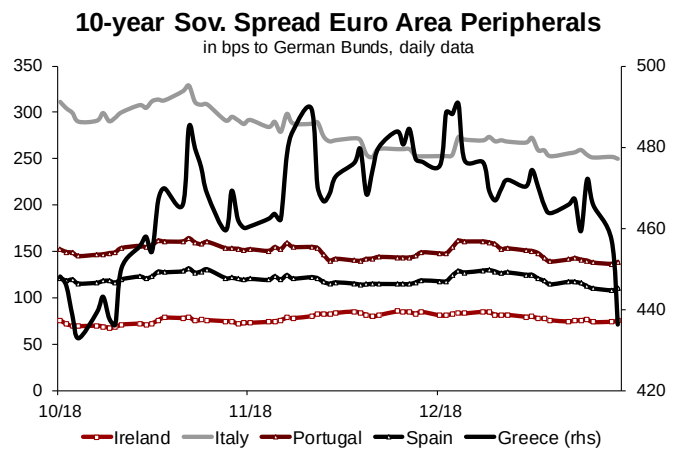


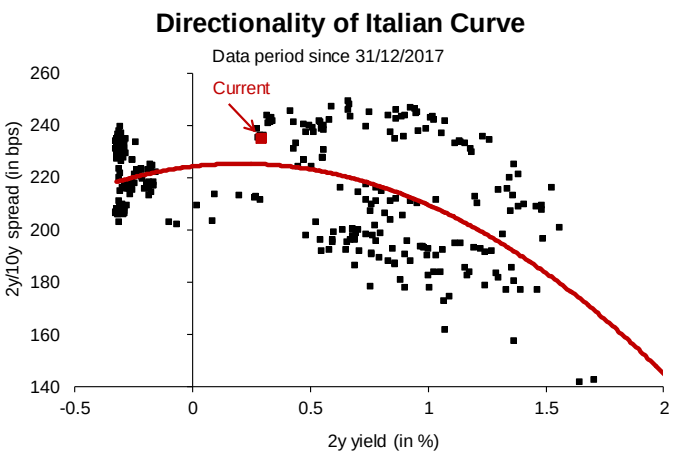




Bonds/Fixed Income Strategy







strength. Hence, we forecast the Fed to hike again and do not rule out another one H2 2019. This is seen to trigger a further bear flattening of the curve, including even an inversion of the curve in H2.

Markets too cautious about future ECB policy

Similar arguments apply for euro area core yields. Not only gross sovereign bond supply is likely to increase in 2019, but more importantly, there will be no net demand by the ECB (although the central bank will continue to hold about 25% of the EGB market as the ECB will reinvest about €170 bn of maturing bonds). Hence, net supply will rise to the highest level since 2014. At least there are tentative signs that foreigners return to the market. While many non-domestic market participants were crowded out by the ECB's QE in recent years, there has been a positive inflow in recent months (see chart). Assuming this trend continues, European government bond markets are well positioned to weather the end of QE – although the net effect will remain a negative one.

Still, financial markets are too pessimistic regarding the monetary policy outlook. In recent months they have scaled back future key rate expectations. Meanwhile, the ECB is forecast to remain on hold in 2019 (not even a depo rate hike) and a first repo rate hike is currently priced only for 2021. But, beyond the drop due to lower energy prices, inflation will not fall in 2019 and the drop in inflation expectations does not appear sustainable in an environment of quarterly growth recovering towards potential. Eventually, markets are forecast to adjust expectations which is seen to trigger higher core yields. But, one caveat applies. Political concerns (particularly about a no-deal Brexit) will stand in the way of a significant upward move in yields in the coming weeks.

Rally of Italian BTPs unlikely to last

Southern European government bonds continued to perform well in January despite the usual heavy supply at the start of the year. Especially Greek bonds rallied, but also Spanish and Italian sovereign bond spreads have tightened since the start of the year. The increased likelihood of a new TLTRO supported non-core bonds – particularly Italian BTPs.

In the short term, there is room for a further tightening, but we doubt that the rally will last very long. The deterioration of the growth outlook and the upcoming European elections which will likely produce eurosceptical headlines during the campaign in combination with the end of QE is forecast to drive spreads up in the months to come. With respect to BTPs, we regard the spread curve steepening as overdone. While the 2-year BTP/Bund spread erased more than 80% of the widening, the 10-year BTP/Bund spread fell by only 25% from the peak marked in October 2018.

Corporate Bonds

Florian Späte

- **Euro area corporate bonds recovered after a weak start into the year. On balance, option-adjusted spreads tightened and corporate yields fell. The rally occurred although the economic data flow was far from reassuring and supply was strong.**
- **Although the fundamental situation of euro area corporates appears still sound, the technical situation sounds a note of caution. There are still many unanswered questions and serious risks ahead.**
- **Hence, there could be some scope for the recent spread tightening trend to continue, but we doubt the rally will last and expect spreads to re-widen again further down the road.**

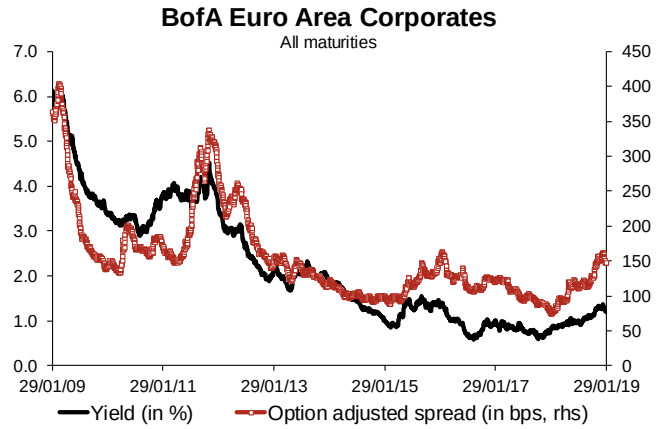
Euro area (EA) corporate bonds were on a roller coaster ride in January. After a poor start into the year, they rebounded strongly and have yielded a positive return year-to-date. The option-adjusted spread of EA corporate spreads tightened on balance by 7 bps. While the spread of non-financials tightened by 5 bps, the one of financials even narrowed by 9 bps (still, both are strongly overshadowed by the spread tightening of High Yields by 47 bps). Thanks to lower underlying yields, the IG corporate yield level decreased by 9 bps to 1.20%. Thereby, the better sentiment for risky assets spilled over to corporate bond markets and credits were able to digest the poor macroeconomic data flow well.

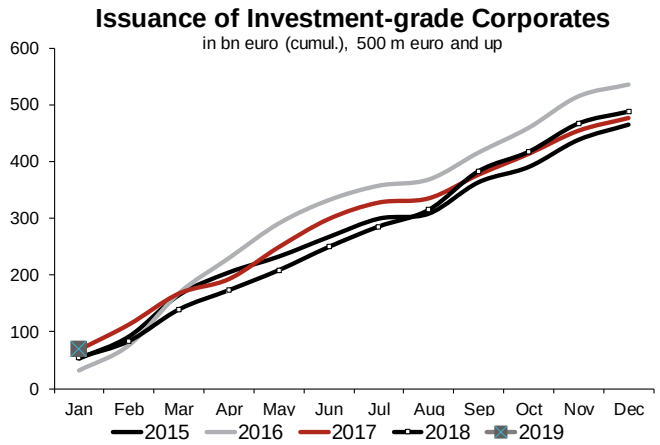
It is noteworthy that the spread tightening occurred despite a rather strong issuance activity. Restricting the analysis to corporates with at least €500 m, bonds amounting to almost €70 bn have been placed already in January. This is around 13% of the expected annual issuance in 2019 (on average 11% is issued in January). This shows that there is healthy demand for corporate bonds even though inflows have not turned yet. Although there is no monthly data available, the weekly numbers indicate at least that the outflows slowed in January.

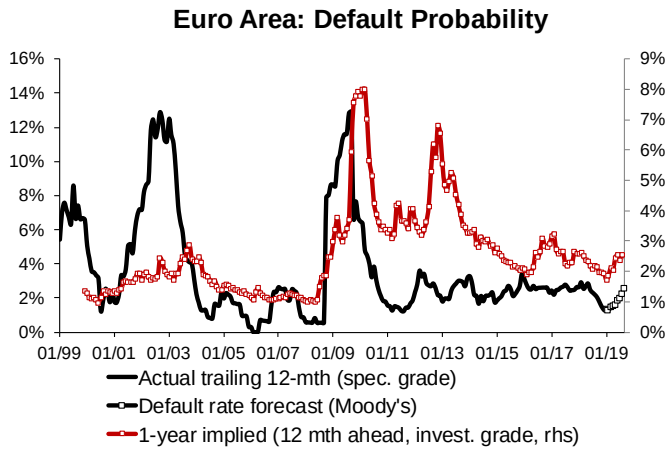
Rally of corporate bonds unlikely to continue

Still, the environment is expected to remain challenging and we doubt that the recent rally will continue. Acknowledging the still sound fundamental situation (12-mth trailing default rate fell to 1.3% in December – the lowest level for more than 10 years), the corporate bond markets will struggle to digest the lack of ECB demand (in 2018 the ECB bought almost €50 bn of corporate bonds). Moreover, a no-deal Brexit can still not be excluded and the trade conflict between the US and China is far from being settled.

All in, euro area IG corporate bonds might benefit from the current improved sentiment for risky assets for the time being, but further down the road the less benign technical situation is forecast to trigger wider spreads.

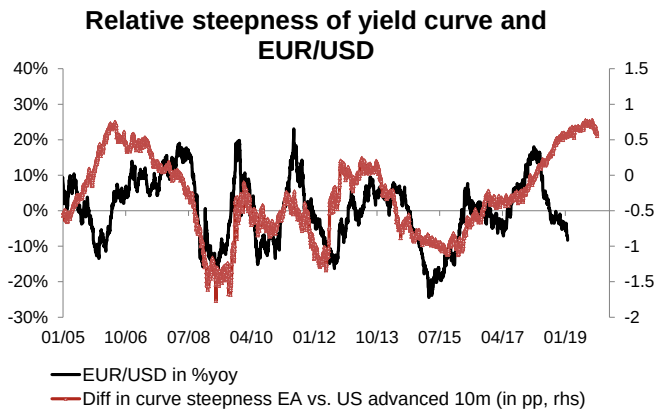


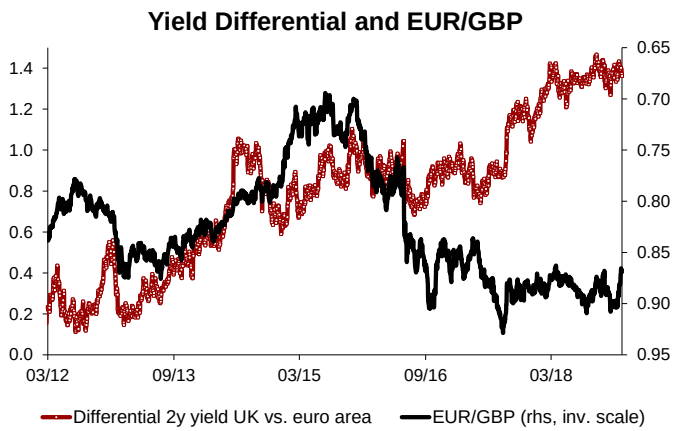


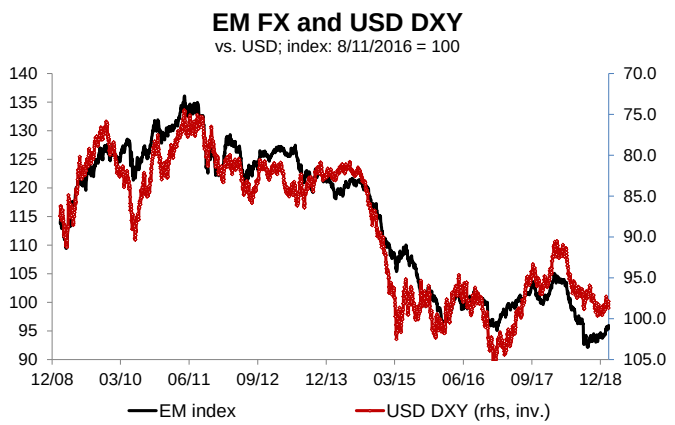


Currencies

Thomas Hempell







- **The EUR/USD still has upside potential this year. But a sustainable lift-off will require more reassuring data, higher Bund yields and easing political risks.**
- **Sterling is already pricing a lot of Brexit optimism. A sustained rally, however, would need stronger evidence that a no-deal Brexit can be ruled out.**

Data disappointment in the euro area and falling Bund yields keep weighing on the single currency, preventing it from benefitting from falling Italian spreads and the dovish Fed twist (Chair Powell signaling "patience" and markets dropping all US rate hike expectations for 2019). One reason for the sluggish euro response is the ECB's acknowledgement of increased downside risks to the outlook. A first ECB rate hike may be postponed into next year. This undermines an important trigger of a rebound in the undervalued EUR. With euro area data weakness not yet showing signs of a bottoming out, the euro will keep struggling to break out of its 1.13-.16 trading range on a sustained basis near term.

That said, we still anticipate solid domestic demand in the euro area to keep the upper hand and see a return to potential growth over H1 2019. This will contrast with the more protracted US slowing on a gradually fading fiscal stimulus. The more mature US cycle is mirrored in a much flatter US yield curve – usually a harbinger of EUR/USD strength (see upper chart). But a significant easing of political risks (trade war, Brexit) and a move higher in Bund yields is required before the EUR/USD can start its way to the upside with more vigor towards our 1.20 year-end target.

Sterling already reflecting lots of Brexit optimism

The British pound (GBP) has rallied on easing Brexit worries, with markets anticipating great determinedness by the House of Commons to prevent a no-deal solution. FX option markets show persistent unease, but increasingly discount an extension of the March 29 deadline. Given the still around 10% political discount entailed in sterling, a Brexit agreement with the EU would still leave sizeable upside to the pound. But after the 3% bounce vs. EUR since Jan 9, it will struggle to sustain a rally amid persistent uncertainties and the UK's attempt re-negotiate the Irish backstop.

After the 2018 fall, EM currencies have been holding up well since the autumn. The dovish Fed has helped, but we do not see much further meaningful support from this side, given markets' already very dovish US rate pricing. A US/China agreement on trade may trigger a wider relief. But we deem a fudge ahead of the March deadline more likely than a true trade agreement given the complexity of the dispute (which includes the trade balances, intellectual property rights and market access) and the big strategic differences between US and China.

Equities

Michele Morganti / Vladimir Oleinikov

- **In January, equities rallied after the huge setback experienced since October last year.**
- **Relevant drivers of last years' setback were Fed tightening, milder global growth, higher credit yields and lingering political risks.**
- **The Q4 reporting season looks decent so far but only after huge downgrades. We forecast consensus earnings to continue to be reduced.**
- **Short term, investors' sentiment has deteriorated sharply, raising chances of continuing rebound albeit with limited upside from here. We stay only slightly OW equities and balanced US and EMU.**

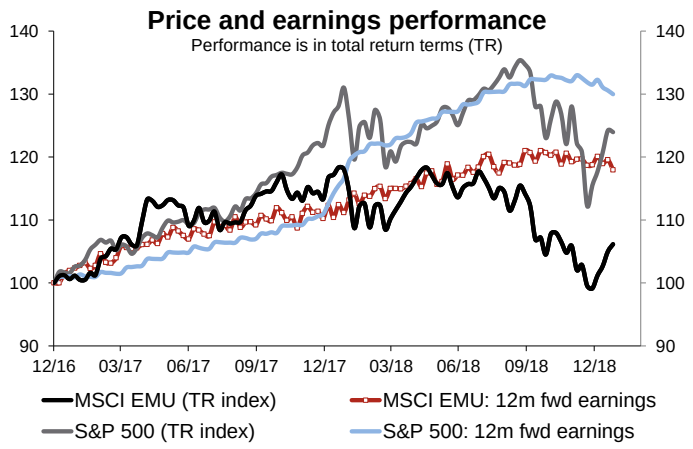
In January, equities rallied after the huge setback experienced since October last year. Indeed, on December 24th the S&P 500 was at 2,350, a too violent retracement given the level of the macro indicators. Sentiment and funds' outflows were extreme, too, and as a consequence technical indicators we follow (based on fundamentals, flows, correlations and different risk measures) turned in "buy" territory, albeit only slightly so.

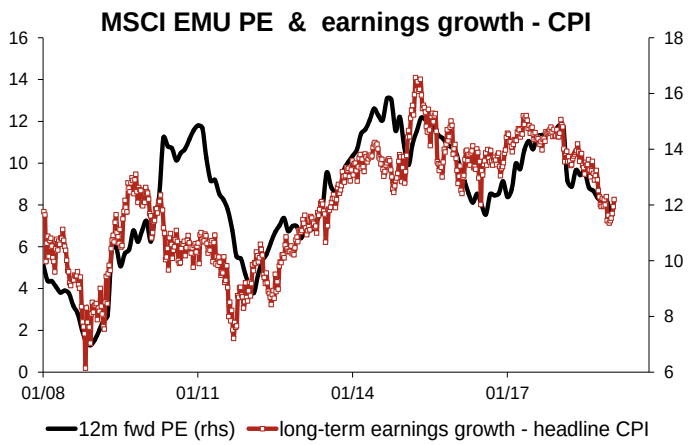
The EMU index overperformed marginally the US market (+6% vs +5.4%). MIB 40 (+8%), the EM index (+6.7%) and China (8%) did particularly well. The defensive and underowned UK market underperformed (+1.6%) together with the Topix (+4.2%). European Cyclicals and small caps overperformed defensives (+7% and 8.8% vs +3.6%, respectively).

Drivers of Q4 2018 setback

We think the 2018 equity market weakness and PE contraction has five relevant explanations. First of all, the "normalization" of monetary stimulus (especially by the Fed, which tends to influence global markets) has induced higher equity volatility, like in the past cycles. Higher volatility normally induces a higher equity risk premium (usually measured by the spread of earnings yield over 10-year government bond yield). Second, the global GDP growth remains decent but its momentum is decreasing. A lower growth momentum tends to compress multiples. Thirdly, the increased inflation (esp. headline) since the bottom experienced in 2015-2016 contributes to an increase in the COE through higher yields, and more in general by the deterioration of the growth-inflation mix. Fourth, the cost of equity has been lifted also by the increase in credit yields, putting pressure on market multiples.

Lastly, exogenous risks have fueled the investors risk aversion and volatility, putting at risk investment decisions by firms. We refer to the Italian frictions with European Commission the lack of unity over European economic integration, uncertainty over Brexit and trade frictions between the US, China and European exporters.





Index	%TR	DY	%Price	%Earnings	%PE
MSCI World	-3.0	2.26	-5.4	12.1	-15.6
S&P 500	0.8	1.89	-1.3	17.2	-15.7
MSCI EMU	-6.6	2.68	-9.5	6.8	-15.3
TOPIX	-12.4	1.76	-14.3	8.1	-20.7
FTSE100	-7.2	3.55	-11.1	10.8	-19.7
SMI	-1.4	3.04	-4.7	6.5	-10.5
FTSE MIB	-6.3	3.27	-9.8	15.6	-22.0
MSCI EM ($)	-8.5	2.39	-11.1	-2.2	-9.1
MSCI Brazil	26.8	4.47	21.9	28.6	-5.2
MSCI Russia ($)	12.1	6.33	5.2	26.3	-16.7
MSCI India	-0.3	1.49	-1.9	6.3	-7.7
MSCI China	-11.9	1.69	-13.7	7.2	-19.5

* changes are since Dec-17, earnings and PEs are 12-month forward

Equities

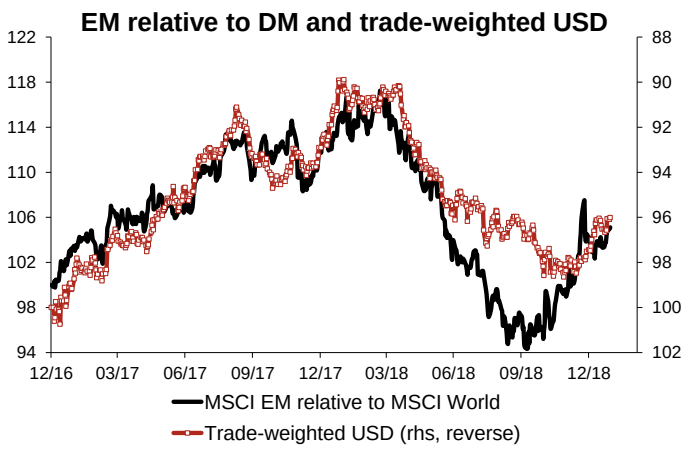
Analysis of the median stock: Q4 2018 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q3 2018	Q4 2018	Q3 2018	Q4 2018	Q4 2018
S&P	22.73 %	17.12 %	7.41 %	5.63 %	33.8%
Stoxx	4.69 %	5.82 %	7.28 %	6.35 %	11.7%
Euro Stoxx	9.17 %	25.57 %	7.89 %	6.35 %	7.5%
Topix	5.58 %	(2.09)%	3.69 %	3.62 %	20.7%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q3 2018	Q4 2018	Q3 2018	Q4 2018	Q4 2018
S&P	3.39 %	2.34 %	0.45 %	0.50 %	33.8%
Stoxx	0.44 %	0.48 %	0.42 %	0.71 %	11.7%
Euro Stoxx	(6.59)%	6.08 %	0.48 %	0.79 %	7.5%
Topix	(3.36)%	1.73 %	(0.89)%	(0.61)%	20.7%

Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %
WORLD	14.3	16.0	2.1	1.9	9.5	8.8	2.8	2.7	0.4
USA	15.4	15.3	2.8	2.4	10.8	9.9	2.2	2.2	7.2
JAPAN	11.7	15.5	1.1	1.3	6.8	7.1	2.6	1.9	-19.7
UK	11.6	13.8	1.5	1.8	7.4	7.9	5.1	4.0	-15.8
SWITZERLAND	14.9	15.4	2.3	2.2	10.3	11.2	3.7	3.3	-4.9
EMU	12.1	14.1	1.4	1.5	7.2	6.5	3.9	3.9	-3.4
FRANCE	12.5	14.3	1.4	1.5	7.5	6.9	3.9	3.7	-3.9
GERMANY	11.6	15.0	1.4	1.5	7.4	6.7	3.7	3.4	-7.5
GREECE	12.5	12.8	2.0	1.6	6.6	6.0	5.7	4.0	-3.2
ITALY	9.9	15.2	1.1	1.2	5.0	4.7	5.2	4.7	-12.1
PORTUGAL	14.1	12.7	1.7	1.7	5.4	5.9	5.0	4.5	-2.9
SPAIN	11.1	12.9	1.2	1.6	5.1	5.1	4.9	5.1	-9.4
EURO STOXX 50	12.1	13.2	1.4	1.5	7.2	6.2	4.2	4.2	1.6
STOXX SMALL	14.8	14.4	1.7	1.7	9.2	8.3	3.3	3.2	3.2
EM, $	11.3	14.5	1.4	1.6	7.0	7.7	3.2	3.1	-11.7
BRAZIL	12.4	9.1	1.9	1.7	7.9	13.7	4.0	4.3	4.1
RUSSIA	5.2	7.0	0.7	0.9	3.3	4.5	7.5	3.8	-44.2
INDIA	17.3	14.5	2.5	2.7	11.3	11.5	1.7	1.6	1.2
CHINA	10.7	12.9	1.4	1.7	6.9	7.5	2.7	3.0	-8.1

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.



A decent US Q4 season but after huge downgrades…

The Q4 reporting season has started (34% of US firms reported, only 12% in the EU). Earnings growth in the US vs previous quarter looks lower (yoy), remaining solid in absolute terms, while it is weaker in Japan (21% reported). We expect a modest reporting season, which is to start from a lower base as analysts have already slashed their estimates down quite aggressively since October. Analysts expect yearly growth rates to continue to decrease for both earnings and sales, reaching a trough in Q3 2019. We agree on such a declining pattern, but expect the final 2019 outcome for earnings to be lower than current forecasts: nearly half of the consensus (2-4% for both the US and EMU vs 6% and 8.6%, respectively), with risks pointing to the downside.

Conclusions

Short term, sentiment has deteriorated sharply, raising chances of continuing rebound albeit with limited upside from here. Market sentiment is sustained by a more dovish central banks' stance, easing policies in China, lower Brexit risks and, lastly, increasing expectations of a China-US truce by early March. That said, still not cheap valuation in the US, the global macro slowdown and political risks should maintain total returns highly volatile in 2019 and only slightly positive thanks to dividend yields, the latter being higher for European indices and Japan. We are still balanced between EMU and the US or only slightly OW EA. We are OW cyclicals vs. defensives, UK, Japan and Switzerland and undervalued sectors: Telecom, Utilities, Industrials, discretionary and Financials. Oils are UW with Pharma, Real Estate, Materials and IT. Staples are neutral. UW Small cap Growth vs Large cap Value. Neutral Quality. Balanced Value and Growth, both OW vs the MSCI Europe.

EM: to benefit from improving investment sentiment

Over the last month, EM equities recovered by 7% and market multiples are at a discount of 12% vs history. Earnings estimates have been lowered over the last month across the board except for small CEE countries. Looking ahead, the positive drivers for EM performance would be expected weakening US dollar and a pause by the Fed. In the current month, the investment sentiment is to be supported by de-escalation expectations on US-China talks on March 1. In addition, earnings revisions for EMs have recently become positive compared to developed equities (using positive vs negative revisions).

The Brazil's PE is already above one standard deviation above historical average but the market should receive further support from significant increase in Brazil consumer confidence and forthcoming pension reform discussions. Within the EM universe, we also favor Korea, India, along with the CEE markets.

Asset Allocation

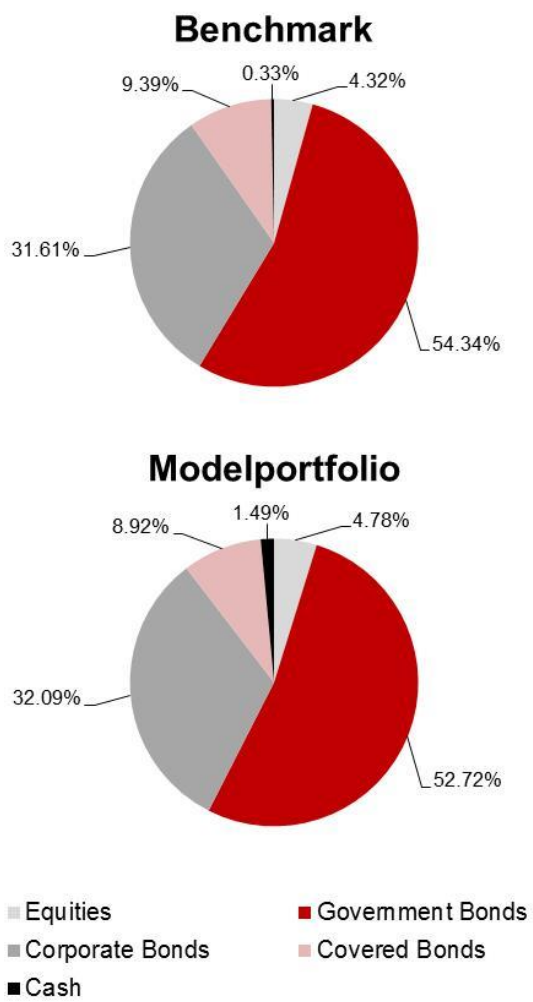
Thorsten Runde

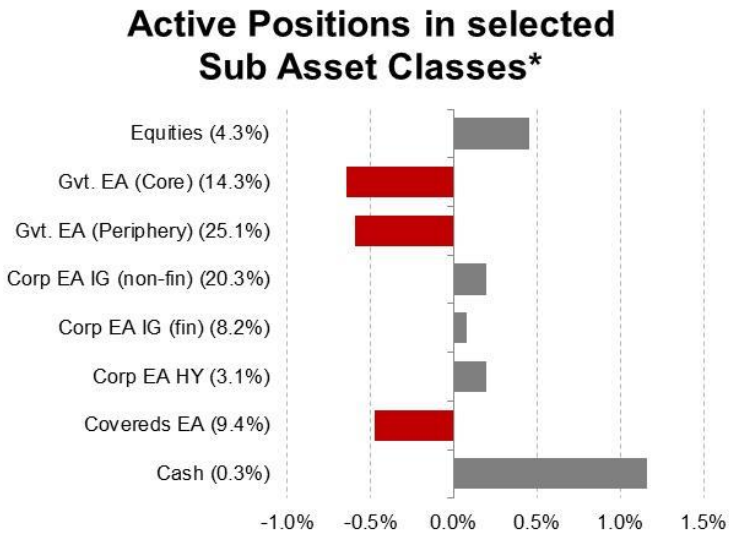
- **In January 2019 nearly all covered asset classes have revealed positive performance figures so far.**
- **Equity markets in particular made up a good portion of their losses from December and thus represented the top positions in the return ranking, just opposite to the previous month when they were the taillight.**
- **Core and peripheral government bonds also performed positively throughout but at a distinctively lower level than equities and the benchmark. Only the 10Y+ segment for Core and Spanish government bonds outperformed the benchmark.**
- **Over the same period, high-yield corporates and long-dated investment grade corporates outperformed the benchmark whereas the shorter ones tended to underperform. This applies to both financials and non-financials.**
- **We maintain an overweight in equities, EM government bonds, as well as cash and continue to prefer a short duration, everything to a slightly reduced extent.**
- **The overall positive active position in credit remains fairly unchanged.**
- **We slightly reduce the underweight in Core and Peripheral government bonds as well as covered bonds.**

In the course of December 2018, global growth concerns and trade war worries reinforced risk aversion on global financial markets, with core bond yields falling and several equity markets experiencing massive losses. Positive news from the US/China trade talks, dovish Fed comments and new Chinese policy measures announced reassured markets somehow from Christmas onwards. In particular equity markets rebounded making up a good portion of their losses from December. Thus staying overweight in equities has been the main driver to keep the TAA contribution in positive territory. In turn, running a comparably high overweight in cash while the benchmark performance was significantly positive had a negative impact on the TAA result.

Allocation stance to be smoothened further

The combination of disappointing data and risen downside risks to global growth as well as earnings will definitely limit the upside potential for risky assets in 2019. However, despite the recent recovery, we still deem most risky assets oversold. Thus, particularly for equities a further short-term rebound appears realistic. In that sense we recommend to smoothen the allocation stance further by reducing active weights in general and thus active risk. That said, we maintain a small tilt towards risky assets to account for short-term upside potentials.





Benchmark weights in parentheses

Forecast Tables

Growth

	2017	2018e	2019f	2020f
US	2.2	2.9	2.3	1.6
Euro area	2.5	1.9	1.2	1.4
Germany	2.2	1.6	1.2	1.3
France	2.3	1.5	1.1	1.2
Italy	1.6	0.9	0.4	0.6
Non-EMU	1.8	1.4	1.6	1.8
UK	1.7	1.3	1.5	1.8
Switzerland	1.6	2.7	1.7	1.7
Japan	1.7	0.8	0.9	0.4
Asia ex Japan	6.1	6.2	5.9	5.9
China	6.9	6.6	6.2	6.2
Central/Eastern Europe	3.9	2.8	1.6	2.5
Latin America	0.6	0.3	0.9	2.2
World	**3.6**	**3.6**	**3.2**	**3.3**

Inflation

	2017	2018e	2019f	2020f
US	2.1	2.5	2.0	2.2
Euro area	1.5	1.8	1.6	1.7
Germany	1.8	1.9	1.7	1.9
France	1.0	2.0	1.7	1.6
Italy	1.2	1.3	1.2	1.4
Non-EMU	2.5	2.3	2.1	2.0
UK	2.7	2.5	2.2	2.0
Switzerland	0.5	1.0	0.9	1.0
Japan	0.5	1.0	0.9	1.4
Asia ex Japan	2.2	2.6	2.9	2.8
China	1.6	2.1	2.3	2.3
Central/Eastern Europe	5.0	6.1	7.2	5.8
Latin America	4.3	4.0	4.0	3.7
World	**2.3**	**2.8**	**2.8**	**2.8**

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

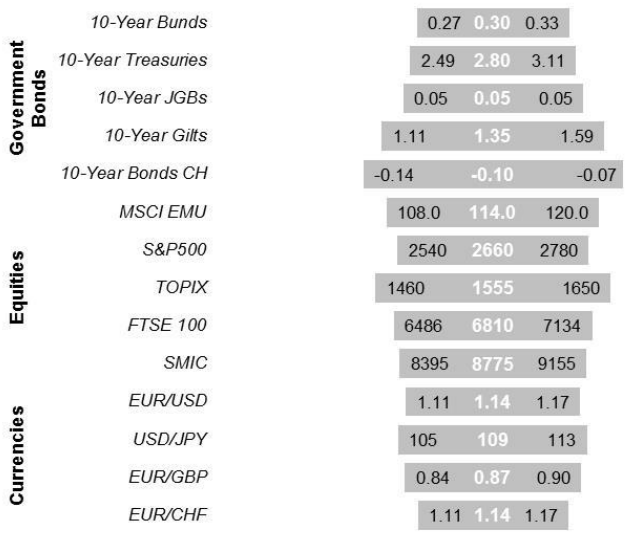
Financial Markets

3-month LIBOR	**29/01/19***	**3M**	**6M**	**12M**
USD	2.75	2.80	2.90	3.10
EUR	-0.33	-0.35	-0.35	-0.35
JPY	-0.09	-0.05	-0.05	0.00
GBP	0.92	0.85	0.90	1.05
CHF	-0.70	-0.75	-0.75	-0.75
10-Year Bonds	**29/01/19***	**3M**	**6M**	**12M**
Treasuries	2.74	2.80	2.85	2.90
Bunds	0.20	0.30	0.45	0.60
BTPs	2.65	3.10	3.00	3.40
OATs	0.61	0.75	0.95	1.05
JGBs	0.00	0.05	0.10	0.10
Gilts	1.28	1.35	1.45	1.60
SWI	-0.19	-0.10	0.05	0.15
Spreads	**29/01/19***	**3M**	**6M**	**12M**
GIIPS	179	210	195	210
BofAML Covered Bonds	67	70	70	75

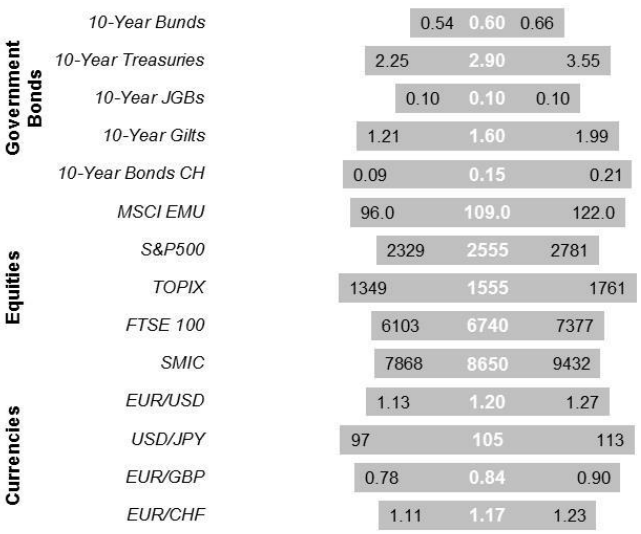
*average of last three trading days

Corporate Bond Spreads	**29/01/19***	**3M**	**6M**	**12M**
BofAML Non-Financial	145	155	160	175
BofAML Financial	152	170	175	190
Forex	**29/01/19***	**3M**	**6M**	**12M**
EUR/USD	1.14	1.14	1.16	1.20
USD/JPY	109	109	108	105
EUR/JPY	125	124	125	126
GBP/USD	1.32	1.31	1.36	1.43
EUR/GBP	0.87	0.87	0.85	0.84
EUR/CHF	1.13	1.14	1.16	1.17
Equities	**29/01/19***	**3M**	**6M**	**12M**
S&P500	2650	2660	2645	2555
MSCI EMU	114.2	114.0	111.5	109.0
TOPIX	1560	1555	1550	1555
FTSE	6797	6810	6740	6740
SMI	8907	8775	8675	8650

3-Months Horizon



12-Months Horizon



*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, exponentially weighted. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

Imprint

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Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

In Italy:
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