GENERALI INVESTMENTS

Market Perspectives

2018 – Shock 2

June 2018

Content

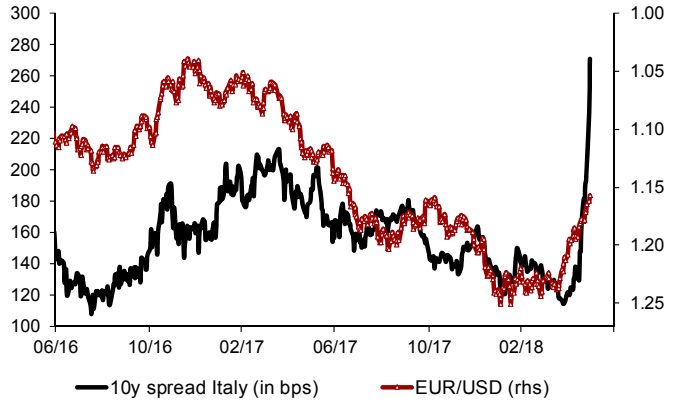
Global View

Vincent Chaigneau / Thomas Hempell

- **Financial stress has increased significantly, partly on a USD bounce and largely on Italian political developments.**
- **The latter are of course less global than the February flash crash. But they do highlight concerns about structural and persistent EMU fragilities that are unlikely to fade quickly.**
- **The global economic backdrop remains favorable, however, while bond markets have already strongly discounted recent political events.**
- **This may help to cushion the detrimental impact on risky assets. But acknowledging for the threat from further corrections near term, we scale down our overall active tactical positions, especially the overexposure to equities.**

Political uncertainties in Italy are back to the fore. Following a coalition program presented by the M5S and Lega coalition envisaging strong fiscal expansion, President Mattarella rejected the nomination of Eurosceptic Paolo Savona as Finance Minister, making snap elections after summer likely. This has brought market concerns about EMU stability back into focus. The threat of further rating downgrades is casting a shadow over the BTP market and has sent yields on 10-year BTPs soaring to above 3% for the first time in four years. The risk premium – the spread of 10-year yields over Bunds – temporarily reached 300 bps, the highest level since 2013, while the EUR/USD has dropped by 4%.

BTP/Bund spread and EUR/USD



EMU debt concerns back in market focus…

The violent market reaction follows a long spell of resilience on Italian bond market - even after the inconclusive general election outcome on March 3, risk premia on Italian debt had come down. Political events in Spain did not help either, after the centrist Ciudadanos party announced to withdraw support to the minority government of PM Rajoy, urging for snap elections. At the same time, macro data in the euro area has continued to weaken, defying market hopes for a recovering economic momentum.

The global macro backdrop has turned more challenging, too. A significant rebound in the US dollar has exerted market pressures on EMs, while the threat of protectionist tariffs keeps looming. The Fed remains on course to hike rates amid (moderately) rising price pressures.

…while global macro backdrop still reassuring

On the reassuring side, however, the global economy still looks set to expand healthily. The US economy is underpinned by solid job gains, rebounding investment (with higher oil prices actually supporting capex) and the sizeable fiscal stimulus provided by the Trump administration. Major EM economies are expanding (India), recovering (Brazil, Russia, South Africa) or holding up (China). And despite softness in the euro area, global new orders as reflected in the manufacturing PMI point to resilience for the coming months.

Bonds	28/05/18*	3M	6M	12M
10-Year Treasuries	2.95	2.90	3.00	3.10
10-Year Bunds	0.41	0.30	0.60	0.90
Corporate Bonds				
BofaML Non-Financial	103	110	115	120
BofaML Financial	119	135	135	135
Forex				
EUR/USD	1.17	1.14	1.16	1.20
USD/JPY	109	108	109	112
Equities				
S&P500	2723	2715	2710	2740
MSCI EMU	127.6	127.0	128.5	130.0

* avg. of last three trading days

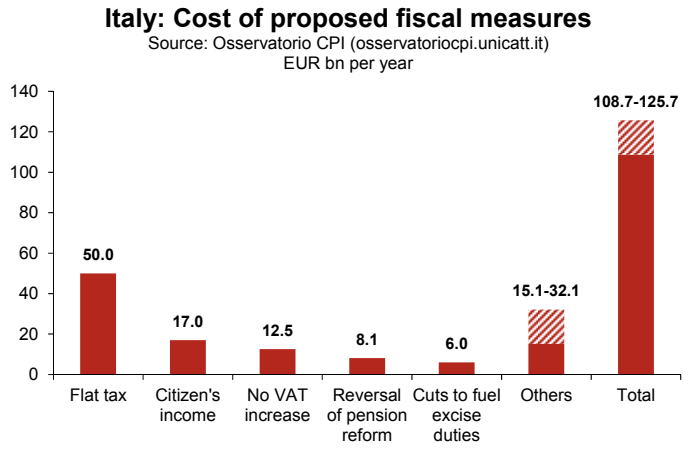
Scaling down exposure to equities

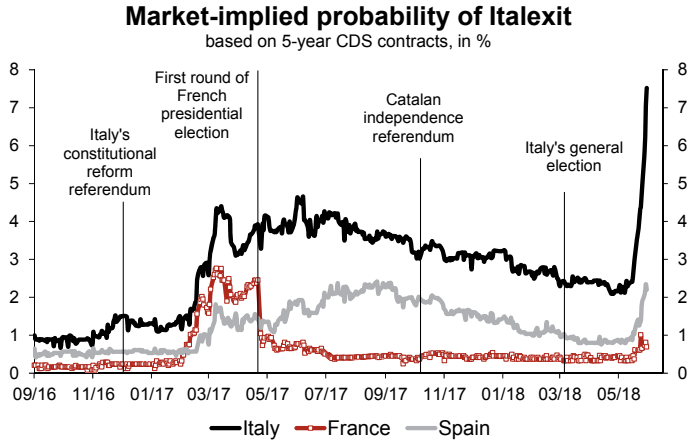
Our allocation stance favoring cash and underweighting peripheral sovereign and corporate bonds should still pay off. Credit spreads have rebounded (up 100+bp in HY, with Financials typically underperforming Non-Financials) but remain low by historical standards and exposed to contagion. In a more risk-friendly environment the narrowing potential would be limited and total return would suffer from the rebound in risk-free yields. We stay defensive on non-core sovereigns but see selected opportunities, e.g. the surge in short-dated BTP yields has infected Spain and Portugal, with 5-year spreads to Germany soaring to resp. 83 bps and 130 bps.

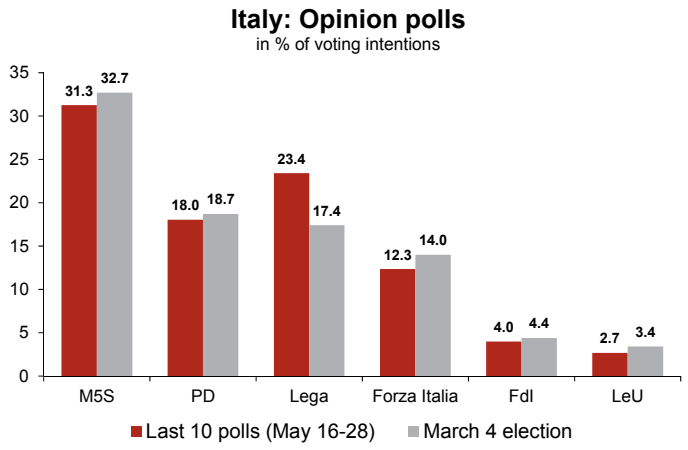
Our allocation, however, has suffered from the rally in 'risk-free' bonds (10y Bund yields down some 30bp in the two weeks to 30 May) and equity correction. In an environment of persistent high political uncertainties and softer macro indicators, the equity risk premium could rise further. Acknowledging for the higher overall risk, we scale down active tactical positions – thus also reducing our equity overweight and core bond underweight.

Focus on Italy

Luca Colussa







- **Italian politics has come back into investors' focus since mid-May. The prospect of a M5S-Lega deal and the chaos surrounding the attempts to form a government triggered an unprecedented spike in volatility, especially of BTPs.**
- **The situation remains very fluid, but new elections (most likely after the summer) seem to be the most likely scenario.**
- **News about electoral alliances and opinion polls will be key signposts to watch. An increasing support for a center-right coalition and a de-escalation in the Eurosceptic rhetoric would ease market concerns, while a revival of the M5S-Lega coalition may further feed market tension.**

After a muted reaction to the unprecedented victory of non-mainstream parties in the March 4 election, market tensions eventually erupted and Italian assets suffered heavy losses. The prospects of a government led by the Five Star Movement (M5S) and the right-wing Lega fueled investors' concerns due to their aggressive expansionary fiscal measures – worth more than €100 bn or 6% of Italian GDP – but especially because of the confrontational attitude versus EU institutions. The crisis worsened further after President Mattarella announced last Sunday (May 27) the failure of the M5S-Lega attempt after he rejected Professor Paolo Savona – who argues about the need of a "plan B", i.e. an exit from the euro area – as Finance Minister. Investors started to speculate about imminent snap elections, and the market-implied probability of an "Italexit" soared to 7.5%, well above the highs seen before the French election last year.

Snap elections likely to take place after the summer

While the political situation remains very fluid, we believe that a snap election after the summer (September/October) is the most likely scenario. In this case, the key signposts to watch are the decisions about electoral alliances (especially whether the center-right coalition will run again united, as we expect) and opinion polls. The latter point to a strengthening of the Lega, at the expense of all other political parties, including the M5S.

A center-right alliance between the Lega and the more pro-EU Forza Italia and a de-escalation in the Eurosceptic rhetoric would help to ease market concerns. On the other hand, a revival of the M5S-Lega government and a confirmation of the tough stance towards EU institutions would contribute to keep the tension high. The announcement of a joint electoral list between the M5S and the Lega (the least likely scenario in our view) may represent the least market-friendly scenario as the two parties combined may secure the 2/3 majority required to amend the constitution without the need for a confirmation referendum.

USA

Paolo Zanghieri

- **Following a better than expected Q1, data for the second quarter point to a further acceleration. GDP is expected to increase by 2.7% in 2018.**
- **Core inflation stood at 2.1% in April, and we expect it to end the year at 2.3%. The surge in oil price lifted headline inflation to 2.5%. It should hoover around this level for the rest of the year.**
- **The minutes of the May Fed meeting showed a slightly higher tolerance for higher inflation. However, we stick to our view of three more rate hikes this year, the next one in June.**

Data on Q2 activity point to an acceleration in growth after a solid Q1 GDP reading (2.2% qoq annualized). The sharp and persistent increase in oil price will eat into disposable income, slowing down consumption growth. However the overall impact on growth should be almost fully offset by higher capex by oil producers. Growth should peak at 2.7% this year, before reverting quickly to the 1.7% estimated trend growth rate.

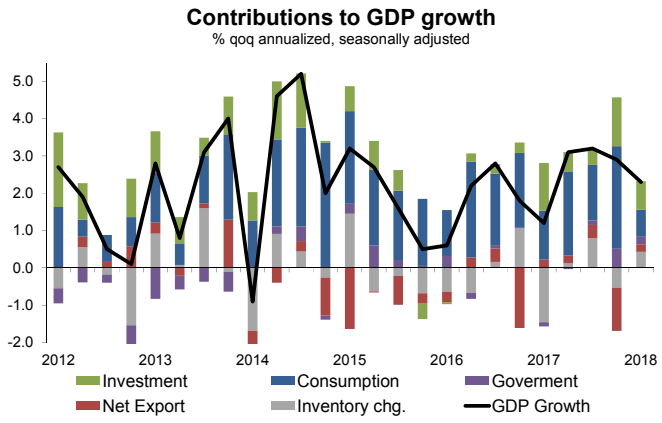
Political uncertainty remains the key downside risk to our forecast, as trade-related tensions are not decreasing and add to frictions about North Korea and the collapse of the deal with Iran. An escalation in uncertainty could lead firms to slowdown investment plans.

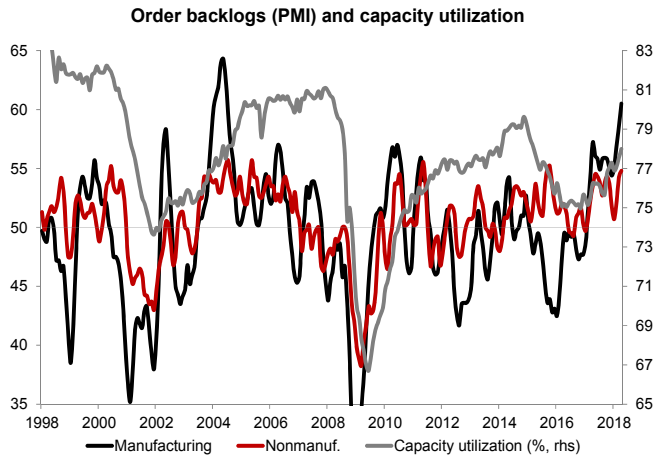
Core inflation at 2.1% and unemployment below 4% ...

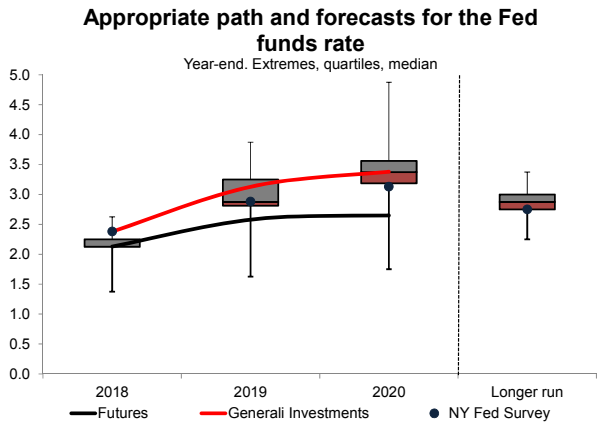
Core CPI inflation stood at 2.1% in April, while the acceleration in the energy component pushed up the headline rate from 2.4% to 2.5%. Forward looking indicators, especially those from the PMI, point to a higher backlog of orders and input costs. In the end we see the core rate to creep up to 2.3% by the end of the year, with risks tilted slightly to the upside. Looking through the volatile data for April, the labor market continues to tighten gradually: the unemployment rate stood at 3.9%, only 01 pp above the level the Fed forecasts for the end of the year. We think that the residual slack in the labor market is minimal, so the unemployment rate will further dip and bring wage growth up from the current 2.7% yoy to around 3% in the second half of the year, also helped by firmer expected inflation.

.....appears consistent with four rate hikes this year

The minutes of the May FOMC meeting did not add much to the outlook for policy rates. Some remarks on current wage weakness were interpreted as dovish and the insistence on the symmetric nature of the 2% inflation target hinted at a tolerance for higher inflation. However, the fundamentals have not changed and therefore we still expect a total of four rate hikes this year. The next one will be delivered at the next FOMC meeting on June 12.

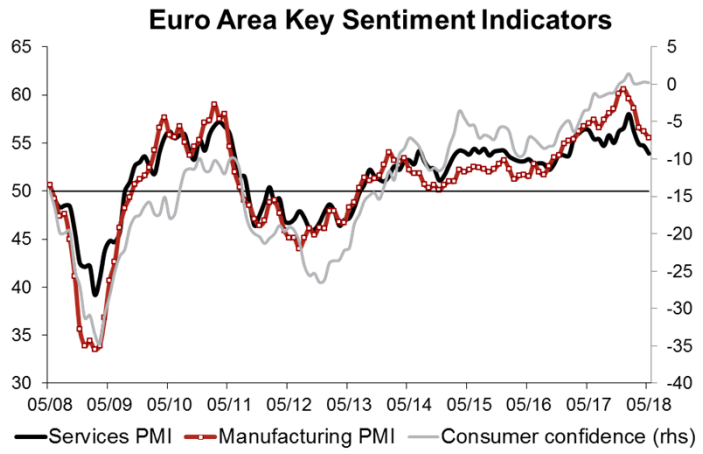


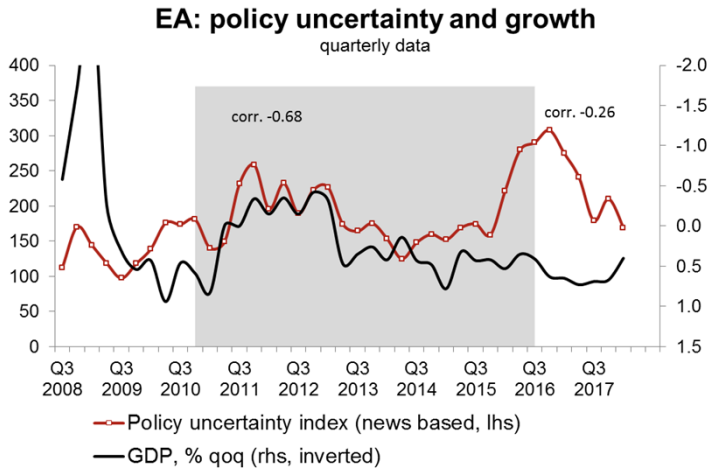


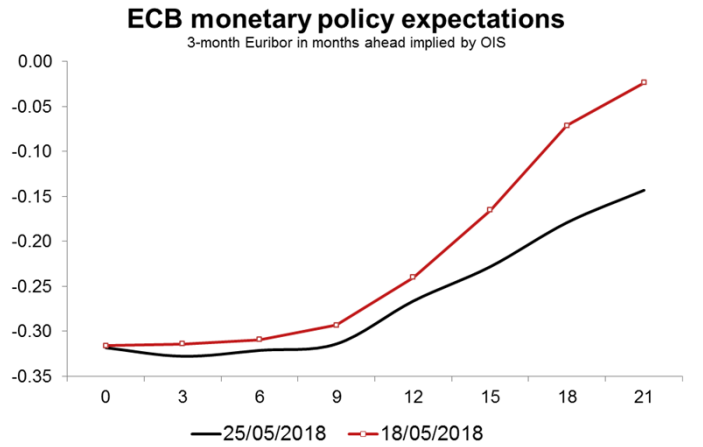


Euro Area

Martin Wolburg







- **In May, the deterioration of key sentiment indicators continued and also expectation components eased further.**
- **Given the political woes in Italy and the looming risk of US tariffs on European exports, downside risks are primarily related to political uncertainty.**
- **We expect the ECB to react to political woes only if the integrity of EMU is in danger and to maintain a wording consistent with ending QE in June.**

The Q1 GDP flash estimate was reported at 0.4% qoq (down from 0.7% qoq), in line with our expectation based on a weaker hard data flow at the outset of the year.

Weakening of sentiment continued in May

While hard data for Q2 are still missing, sentiment indicators for May continued their downturn. The composite PMI receded to 54.1, the lowest since November 2016, with both service (from 54.7 to 53.9) and manufacturing sentiment (from 56.2 to 55.5) trending lower. Also, forward-looking components within the survey also continued their way down while clearly remaining above their respective long term averages. The major bright spot is consumer confidence that remained stable at elevated levels.

Given the sound fundamentals, the weakening of sentiment came as a surprise to us. The looming threat of US tariffs not only on steel and aluminium but also cars according to the recent developments might have contributed to weaker new export orders. However, the uncertainty related to the increased political risks emanating from Italy will additionally drag on sentiment, going forward. In 2017 markets and firms largely ignored political risks but the situation in Italy might be a different story, especially if EMU breakup speculations come to the fore again.

All in all, we stick to our euro area below consensus growth forecast of 2.1% in 2018 and 1.7% in 2019. For the reasons just mentioned, we see the risks tilted to the downside.

ECB to turn more reluctant on policy normalization?

At its meeting on June 14, the ECB will most likely adjust its inflation outlook (2018/19: 1.4%) to the upside and the growth outlook to the downside (2018/19: 2.4/1.9%). While from a macro perspective the ingredients for policy normalization are still in place, weaker macro data and political risks have prompted markets to adjust their ECB monetary policy expectations to the downside (see lower graph). We do not expect the ECB to act on country-specific risks but only on euro area wide factors or threats to the integrity of EMU. We expect the ECB to acknowledge for the increased overall uncertainty and to maintain a dovish wording. QE until year-end 2018 remains our base case and presently we still deem a first rate hike in mid-2019 likely.

Japan

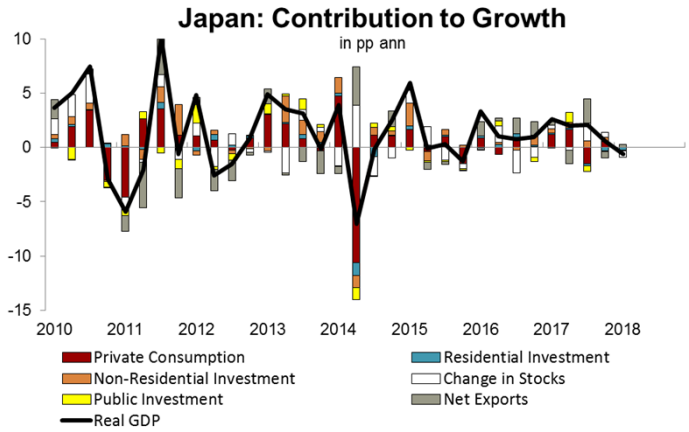
Christoph Siepmann

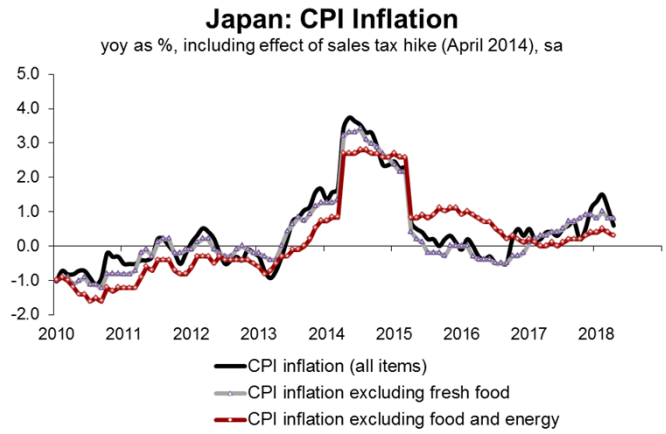
- **Japan's Q1 GDP growth receded by 0.6% qoq annualized, slightly worse than markets had expected.**
- **Sentiment indicators in Japan have come off, but are still at comfortable levels, thereby supporting the view of a rebound in Q2.**
- **April headline inflation dropped to 0.6% yoy, but current oil price hikes and the depreciation of the yen will likely push up inflation again in summer.**

According to the first print, Japan's Q1 GDP growth receded by 0.6% qoq annualized, slightly worse than markets had expected. The main reason was stagnant private consumption, probably to a large extent dampened by bad weather effects. However, also private business investment came in broadly flat, after decent growth rates over the last quarters. In sum, domestic demand diminished by 0.3% qoq ann, exacerbated by a negative inventory contribution of 0.6 pp qoq ann, but slightly softened by a 0.2 pp ann contribution from net exports. Looking into Q2, as weather effects will abate, households' consumption is likely to rebound. This the more as Japan's labor market is tight and compensation on a rising trend, although base wage increases are still tiny. Investment is also likely to see some support ahead of the 2020 Olympics, labor saving investment against the background of Japan's worsening demographics, and capacity replacement needs. Short-term indicators like the PMI or the Reuters Tankan have markedly come off compared to their elevated levels at the turn of the year, so arguing also for a rebound from the Q1 GDP drop, although amid less momentum than before. Finally, exports had a very good start into Q2 which could hint towards a rising contribution of net exports to GDP again. Nevertheless, new export orders do not support the view that the current strong increase will be lasting. They probably also reflect the US probe into car imports, one of the most important Japanese export goods (Japan has also not been exempted from the US steel and aluminum tariffs). All in, due to the disappointing start into the year and some loss in momentum, we revised our GDP forecast for 2018 slightly down to 1.0%, after 1.3% before.

Latest inflation numbers down again

Japan's headline inflation receded to 0.6% yoy in April (from 1.5% in February and 1.1% in March), mainly related to the end of a spike of fresh food prices in Q1. However, also core inflation excluding fresh food diminished to 0.7%, slowing from 0.9% yoy in March after a previous boost from mobile phone prices. Given the strong increase in oil prices and the recent depreciation of the yen, inflation rates are likely to trend up again. This poses a slight upside risk to our current inflation forecast of 1.0%. However, as these factors are temporary, they do not offer grounds for the BoJ to act in the short term.



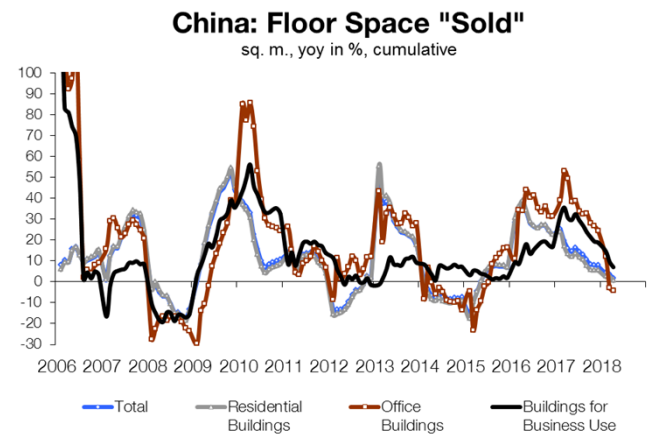


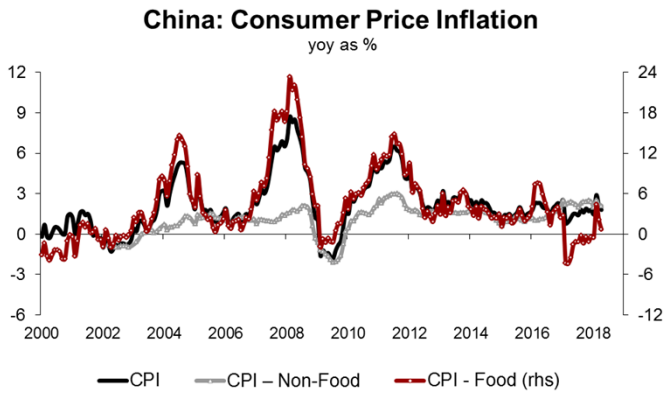
Main Forecasts[1)]	2016	2017e	2018f	2019f
GDP	1.0	1.7	1.0	1.1
Consumer spending	0.1	1.0	0.6	1.0
Government consumption	1.3	0.1	0.5	1.1
Investment	1.1	2.6	2.0	1.9
Inventories	-0.2	-0.1	0.2	0.0
Net trade	0.5	0.5	0.2	0.0
Domestic demand	0.6	1.2	0.6	1.1
Consumer prices	-0.1	0.5	1.0	1.0
Unemployment rate[2)]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

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

China

Christoph Siepmann





- **China's April macro data set gave a more mixed result, supporting the view of a mild slowing.**
- **While bank credit growth overall remained robust, total social financing continued to contract.**
- **The recent US-China trade deal brought an initial relief but was questioned again of late.**

China's April macroeconomic data came in a bit mixed, supporting the view that the economy is slightly slowing. On the positive side, industrial production growth bounced back from its weak reading in the month before, advancing by 7% yoy. Apart from the help of a positive base effect, the number also benefitted from an extra working day. On the other hand, nominal aggregate demand components revealed some slowing. Retail sales diminished to 9.4% yoy, after 10% yoy in March. More importantly, fixed asset investment receded to 7.0% yoy on a cumulative basis, loosing momentum of about 1 pp since the beginning of the year. Within this component, investment in real estate stayed surprisingly stable so far, diminishing only slightly to a cumulative 10.3% yoy ytd. Nevertheless, nominal real estate sales came off further from its peak around the turn of the year and "real" sales (as measured by floor space sold in sqm) continued their slide to the lowest reading since mid-2015. In accordance, house price inflation also kept softening to 4.7% yoy in April, significantly down from its 2016-peak of more than 12% yoy. Meanwhile, external demand stayed strong in April with a growth rate of about 12% yoy, while imports even grew by more than 21% yoy. After in the two previous months hefty fluctuations in export growth blurred the view on its underlying strength, the recent April data did not suggest that global demand for China's products has weakened so far. But looking ahead, given the loss in global business cycle dynamics (especially in Europe), a less strong export growth seems likely. On the monetary side of the economy, the situation is rather unchanged. CPI inflation continued to recede due to slowing food prices, while core-inflation stayed at 2.1%. The TSF credit impulse remains largely negative. Like in the months before, China continued to limit credit growth, in part driving shadow banking credit back into the more supervised banking sector.

US-China trade conflict formally put on hold

Regarding the US-China trade conflict, both sides agreed in mid-May to put their tariff threats on hold, in return for a Chinese commitment to significantly increase purchases of goods and services. The US initially demanded a reduction of its bilateral trade deficit by (an unrealistic) US$ 200 bn. In fact, China will aim at markedly increase the purchase of US energy and agricultural products. Moreover, China will lower its tariffs on cars from 25% to 15%. However, the US most recently said it will uphold its tariff threats to have a leverage regarding intellectual property rights negotiations. Thus, the situation has not cleared and underlying tensions are likely to remain.

Central and Eastern Europe

Radomír Jáč

- **The CEE region reported robust economic growth in Q1 with a positive surprise seen in data from Poland and Hungary.**
- **While inflation is still below target, data for April confirm the view that it is recovering in Q2 in the region, due to growing fuel price and very likely also thanks to core inflation.**
- **The CE-3 currencies were hit by the EURUSD fall and by the sell-off in the EM currencies. This can be a sensitive issue mainly for the Czech CNB.**

Data for Q1 reported a stronger than expected GDP growth for Poland (1.6% qoq) and also for Hungary (1.2% qoq), while the Czech GDP with a growth rate at 0.5% qoq was slightly below the CNB forecast. We revised up our call for the full-year 2018 GDP growth for Poland and Hungary, and left it unchanged for the Czech Republic. This means that we expect growth below the Czech CNB forecast, we are in line with the Hungarian CB forecast for Hungary and above the central bank forecast for Poland.

Inflation remains below target in all CE-3 countries but data for April confirm the view that headline inflation will move higher in Q2 due to the growing fuel price and very likely also due to the expected increase in core inflation related to the strong capacity utilization. The recent depreciation of the CE-3 currencies is an additional factor that may push inflation higher in the upcoming months.

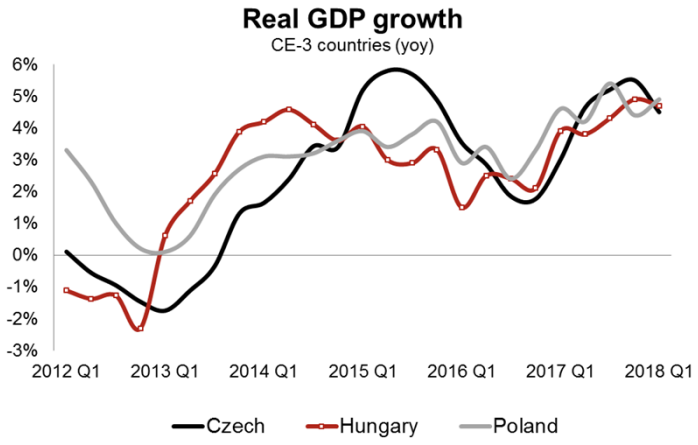
The regional currencies were hit by the EURUSD fall in the past weeks and also by the aversion against Emerging Markets. The weaker currency represents a pro-inflationary risk mainly in the small open economies such as the Czech Republic and Hungary. However, we think that the economic fundament is in favor of a recovery of the CE-3 currencies after the recent sell-off.

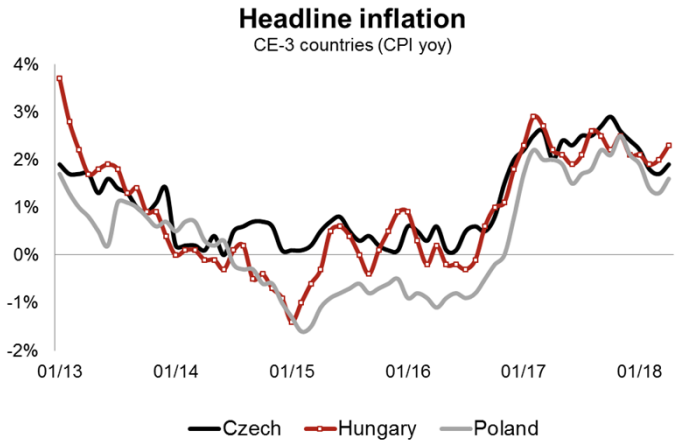
Weaker Czech crown may lead to a faster rate hike

Monetary policy was unchanged in the CE-3 countries in May. The Polish NBP confirmed its wait-and-see stance, which implies stable interest rates until H2 2019. The Polish economy is less sensitive to exchange rate fluctuations and the NBP key rate (1.50%) is well above the level of the Czech and Hungarian policy rates.

The Hungarian MNB maintains the call that the loose monetary conditions are needed. However, the HUF fell to its record low against the EUR recently and the MNB may shift its wording a bit in order to improve the sentiment vs. the Hungarian currency.

The Czech CNB says explicitly that the weaker CZK may lead to a faster increase in interest rates. The CNB forecast published in early May operated with the next rate hike (by 25 bps from current 0.75%) for Q4 but it at the same time expected the CZK to firm below 25 EUR in Q2. The weaker CZK will lead the CNB to raise its rates at the August meeting in our opinion, which should have positive impact on the CZK exchange rate afterwards.



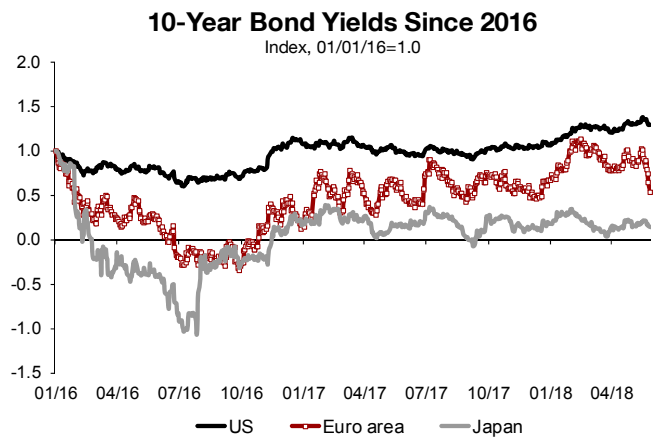


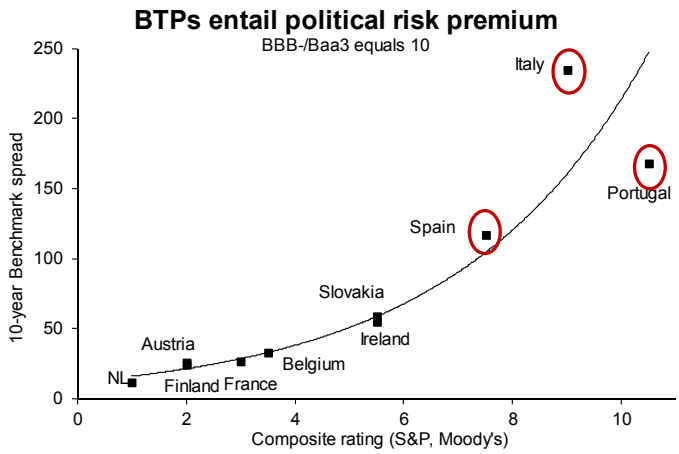
Main Forecasts	2016	2017	2018f	2019f
Czech Republic				
GDP	2.5	4.6	3.2	2.9
Consumer prices	0.7	2.5	1.9	1.9
Central bank's key rate	0.05	0.50	1.00	1.50
Hungary				
GDP	2.1	4.2	4.2	3.0
Consumer prices	0.4	2.4	2.6	3.0
Central bank's key rate	0.90	0.90	0.90	1.25
Poland				
GDP	2.9	4.6	4.5	3.5
Consumer prices	-0.6	2.0	2.0	2.5
Central bank's key rate	1.50	1.50	1.50	2.00

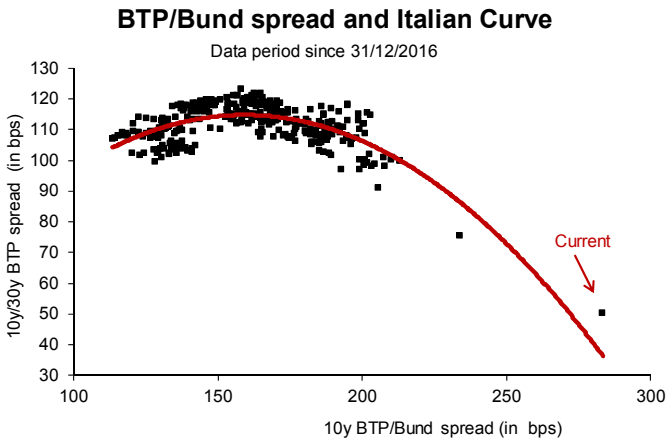
GDP and consumer prices: annual % change; CB interest rate: in %, year-end

Bonds/Fixed Income Strategy

Florian Späte







- **After moving sideways most of the month, particularly euro area sovereign core yields fell significantly in recent days due to the political turmoil in Italy. While inflation expectations held up well, euro area real yields are almost back to historical lows.**
- **As the political uncertainty is likely to remain elevated for the time being, volatility is expected to persist. Despite the strong BTP/Bund spread widening a further underperformance of BTPs cannot be excluded.**
- **In this environment, we suggest to keep but to reduce the short duration. Particularly, Southern European bonds are vulnerable to a possible negative political news flow.**

On balance, government bond yields on both sides of the Atlantic decreased across all maturities in May. Particularly, the belly of the curve performed well while the drop in short-dated and very long-dated yields was more limited. Moreover, the drop was much more pronounced in the euro area where safe haven flows triggered by the political turmoil in Italy supported Bunds. This has resulted in a further widening of the transatlantic yield spread to new long-term highs.

It is noteworthy, that inflation expectations held up well. 10-year US inflation swaps dropped by only 6 bps and euro area ones even trended sideways. This implies that euro area real yields fell significantly. In fact, although the macroeconomic data still point to growth at least in line with potential, the 10-year real yield is almost down to the historical trough marked in spring 2015.

Political turbulence to prevent a rise in core yields

Although there is a risk that the macroeconomic dataflow will not improve in the weeks to come, the case for the US and the euro area to grow above trend remains valid. While this is likely to give core yields on both sides of the Atlantic tailwind, we doubt that there is scope for a lasting increase in the near term.

This is mainly due to the political situation in Italy. Although Bunds will be impacted more than Treasuries, it is unlikely that US yields will be able to completely withstand the developments in Italy. Already in recent days markets have started to question future Fed hikes. Meanwhile, only three further hikes are priced until the end of 2019. Although we regard this as too cautious, it is unlikely to change in the near term. On a 3-month horizon, we expect 10-year US yields to move to 2.90% and on a 12-month horizon to increase to 3.10%.

However, the market focus is likely to be directed to the euro area. As the formation of a government is likely to finally fail, Italy is heading for snap elections – most likely already in summer. According to current polls, the Five

Bonds/Fixed Income Strategy

Star Movement (M5S) and the League together are supported by almost 60% of voters. If these political forces decide to build a coalition, they will likely secure a stable majority in parliament (even a 2/3 majority for passing constitutional reforms cannot be excluded). During the campaign euro-sceptic statements and electoral promises which put fiscal stability at risk will scare markets and will keep market participants on their toes. Hence, a lasting calming of the situation is not on the cards and safe haven flows are expected to prevail. In this environment risk appetite is seen to remain low which will support core government bonds and burden more risky fixed income papers – most of all BTPs.

Accordingly, euro area core yields are forecast to remain on a depressed level for the time being. While a further strong decrease is at odds with the still solid growth and the slowly normalizing inflation environment, the political uncertainty will likely prevent higher yields. Given that the situation stabilizes further down the road, however, there is scope for higher Bund yields in the medium term.

Political concerns to keep BTPs under pressure

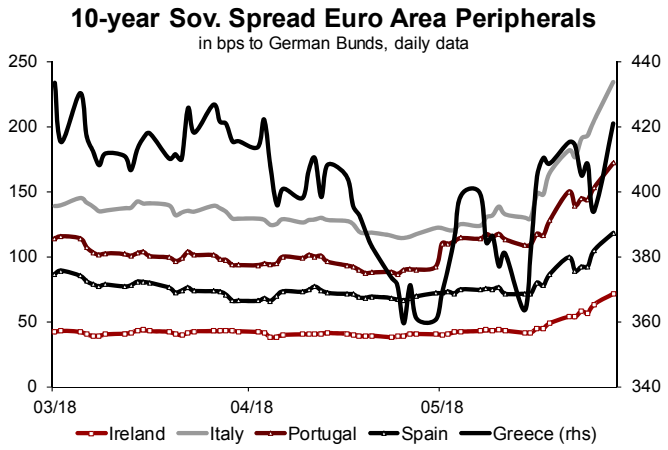
The underperformance of BTPs in recent days is mainly due to the draft plan by the M5S and the League which put public finance at risk and the strong anti-euro rhetoric accompanying the formation of the coalition. Meanwhile, 2-year BTP/Bund spreads are on the highest level since summer 2012 and BTPs include a significant political risk premium. Another indication that financial markets started pricing debt sustainability concerns is the strong flattening of the curve (margin calls and redenomination risk could play a role here as well). While short-dated spreads widened by almost 300 bps within one month, very long-dated ones increased by less than 100 bps.

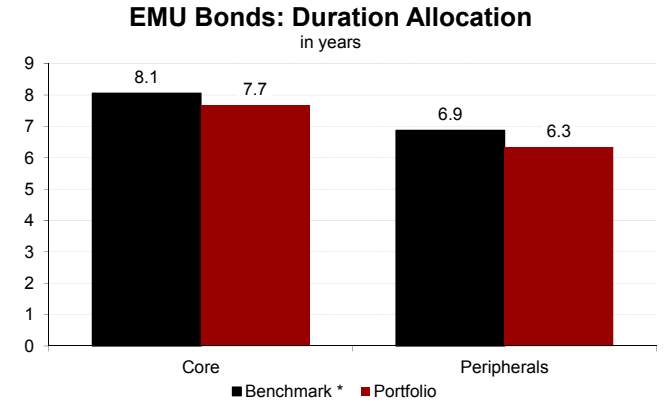
Depending on future polls and political developments, a further increase in BTP spreads cannot be excluded (in addition, Moody's placed Italy's rating on review for downgrade). This applies even more as the ECB is unlikely to step in as market developments reflect risks in Italy, rather than euro area factors. Moreover, the political will to agree to a conditional precautionary credit line with the EU is not in sight.

So far, the contagion to other Southern euro area bonds has been limited. Although spreads widened to annual highs, markets regard the crisis mainly as an Italian one. As long as the existence of the euro area is not called into question, this is unlikely to change going forward.

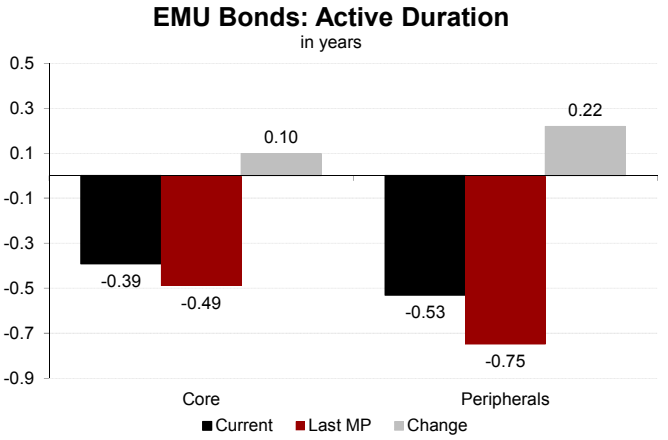
Our portfolios

Considering the uncertainty we continue recommending a cautious stance and stay defensive. But, taking into account the strong underperformance of peripheral bonds, we suggest to diminish the very short duration (-0.53 yr vs. -0.75 yr before).



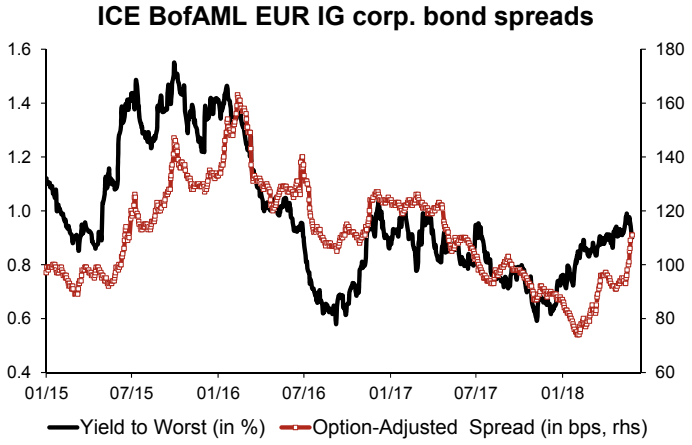


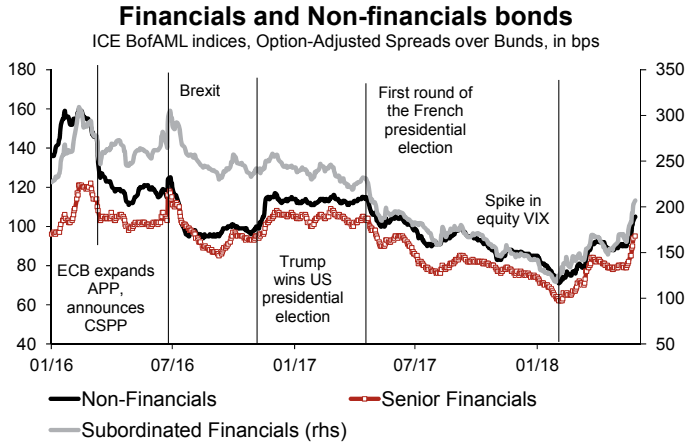
* JPMorgan EMU Government Bond Index

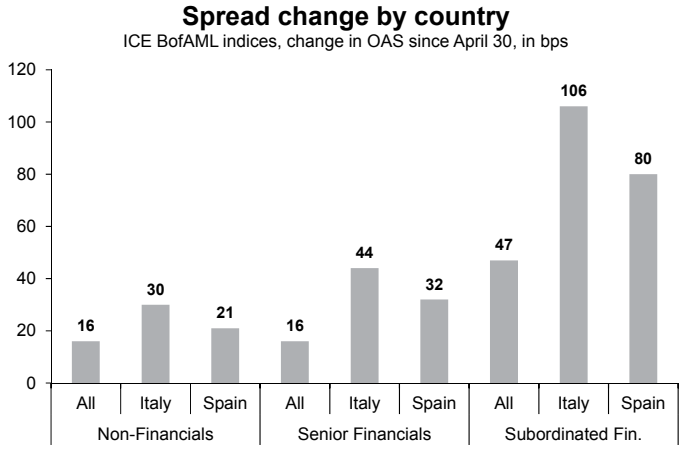


Corporate Bonds

Luca Colussa







- **EUR IG corporate bond spreads widened 18 bps in May, the largest monthly move since Sep 2015. That said, the total return was basically flat, thanks to the drop in the underlying Bund yields.**
- **Financial bonds – and the subordinated ones in particular – underperformed due to the resurgence in sovereign risk premiums.**
- **Despite the recent sharp moves, we see further upside potential for corporate bond spreads in the near term, due to negative spillovers emanating from the Italian political situation.**

After the benign environment in April, EUR Investment Grade (IG) corporate bond spreads moved decisively upwards. The Option-adjusted spread (ICE BofAML index) widened to 111 bps (until May 28), a 18 bps increase since end-April. This was the largest monthly spread widening since September 2015 (soon after the renminbi revaluation). That said, the total return was basically flat (+0.05%), thanks to the sharp fall in Bund yields.

Resurging sovereign risk weigh on corporates

The key trigger to the significant spread widening was the escalation in political tensions in Italy and the consequent spike in sovereign risk premiums, which affected also other Southern European countries. Banks' equity prices were badly hit and financial corporate bonds underperformed non-financial ones. In particular, while Senior Financials performed more or less in line with Non-Financials (both up by 16 bps to 95 and 105 respectively), Subordinated Financial bonds suffered a much more severe setback. The spread on the latter widened by 47 bps to 207 bps, the highest level since President Macron's election in spring 2017. The total return was clearly negative: -1.52%. Italian and Spanish corporate bonds underperformed massively. In the Financial bond arena, the spread widening was twice (Spain) and three times (Italy) as large as the average one (see chart at the bottom page).

Negative spillovers from Italian politics likely to last

The chaotic situation in Italy (with new elections likely after the summer) and its negative spillovers in terms of higher sovereign risk in the euro area are likely to last, at least in the near term. As a result, we believe European corporate bond spreads have further room to widen. Financials are likely to continue to underperform Non-Financials.

That said, the still benign economic environment, the ongoing ECB's purchases and a potential further decline in Bund yields can limit the total return drawdown for corporate bonds of euro area core countries, while Southern European ones are likely to remain particularly exposed to the repricing of sovereign risk.

Currencies

Thomas Hempell

- **The USD continued to rally in May, while the EUR came under additional selling pressures on political uncertainties in Italy.**
- **Near term, the EUR/USD may suffer somewhat further on the political uncertainties and a reduction in net long EUR speculative positions.**
- **With political uncertainties around Italy unlikely to abate soon, we also expect now a much shallower EUR/USD recovery in the medium term.**

The US dollar continued to rally in May, with the trade-weighted USD strengthening to the highest levels since December last year. The EUR/USD weakened by another 4%, a retreatment by almost 10 cents since early February. Until mid May, the USD recovery had been primarily been carried by outperforming US economic data (and disappointing ones since March in the euro area). The latest leg lower in the EUR/USD, however, has been triggered by the sharp rise in political uncertainties in Italy, after President Mattarella had frustrated the bid by populist M5S and Lega to form a government and refused to accept Eurosceptic economist Paolo Savona as finance minister.

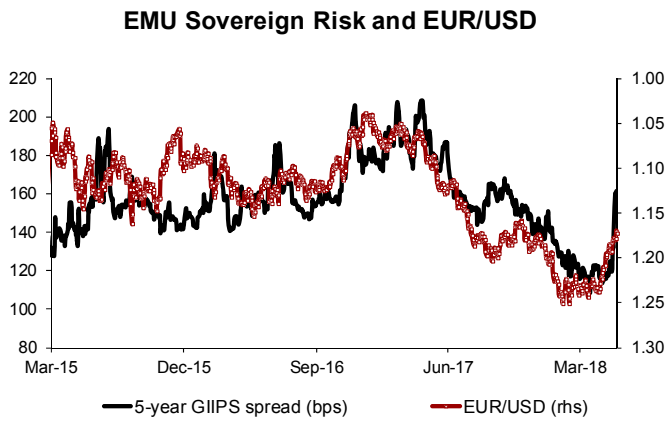
Political uncertainties weighing on the EUR

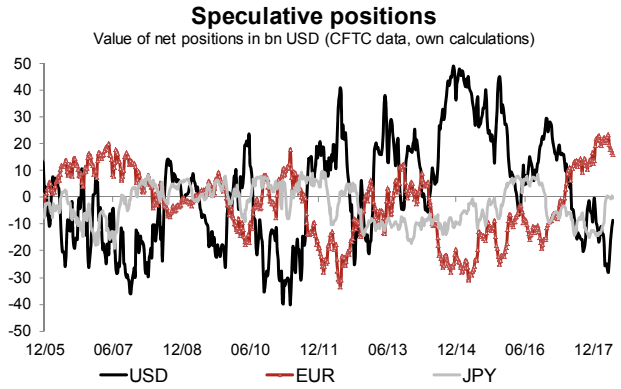
Near term, the euro may suffer somewhat further from the political uncertainties. While we still believe that euro area growth will hold up well, the risks of negative spill-overs to sentiment have risen (see chapter on Euro Area). Net long EUR speculative positions remain high and may be prone for a further unwinding over the next weeks (see mid chart).

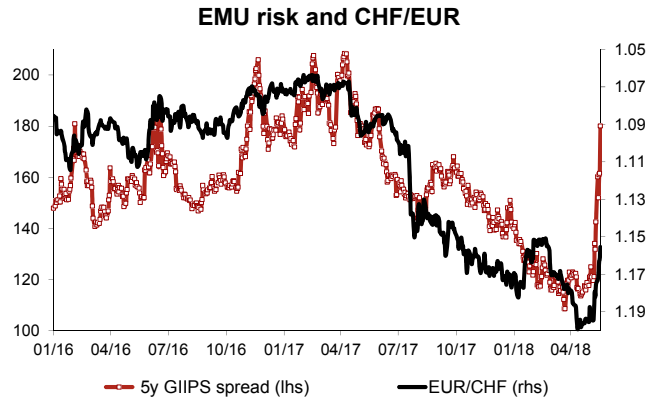
The medium-term path for the EUR/USD is surrounded by even higher uncertainties now. But barring an outright escalation of the political crisis in Italy into wider EMU break-up fears, we still see scope for the EUR/USD to recover in the medium term, helped by a current account surplus and first ECB rate hikes looming for mid 2019. At the same time, the rising twin deficit in the US and moderate overvaluation point to USD weakness in the medium term. Given recent events and market moves, however, we have substantially cut our 12–month forecasts from 1.28 to 1.20.

CHF benefitting from renewed EMU doubts

After consistently recovering over the past months on unwinding safe-haven flows, the EUR/CHF has retreated sharply amid the recent spike in EMU concerns. Near term, there may be some further gains for the CHF over the coming weeks. Fundamentally, however, the CHF remains strikingly overvalued, which is why for the 12-month view we still pencil in a EUR/CHF recovery to a downward revised target of 1.18.

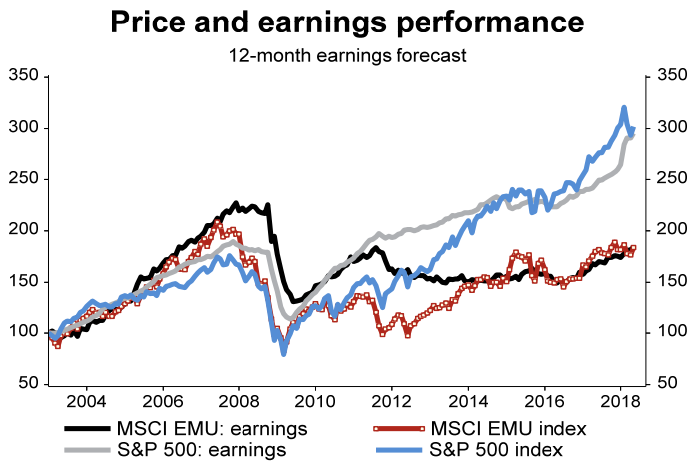


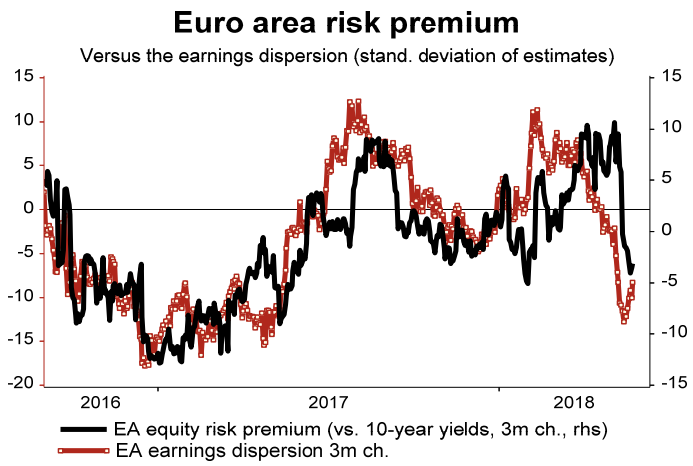


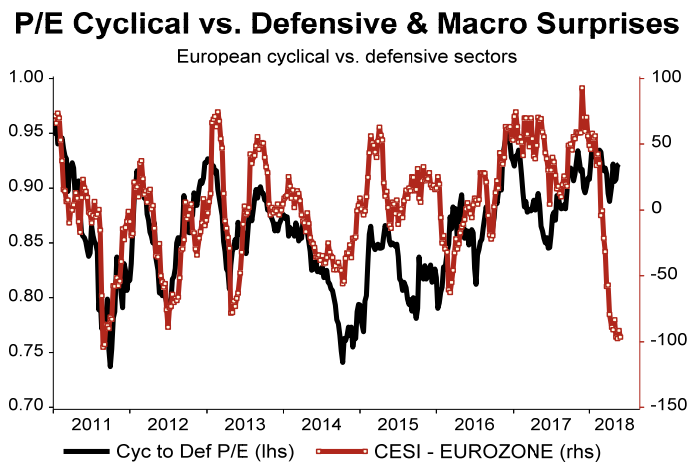


Equities

Michele Morganti / Vladimir Oleinikov







- **Markets were hit by escalating Italian risk at the end of the month, after a good start characterized by a decrease in volatility.**
- **We reduce the equity overweight: The good reporting season and the bulk of the dividend season are now behind us and investors positioning is still dangerously tilted towards the most cyclical sectors.**
- **The EA macro momentum is losing steam while inflation pressure in the US will continue to retain the Fed on the hawkish side, with possible renewed increase in equity volatility.**
- **Lastly, the credit risk in Italy has recently skyrocketed, affecting the EA equities overall. We do not expect uncertainty to abate anytime soon.**
- **That said, for the next 12 months, we forecast total returns of nearly 6% in the EA and Japan due to contained overvaluation, good earnings growth and still limited pressure from higher yields.**

May was split into two phases. After a good start, in the final part of May equities were affected by the spike in the Italian risk premium. In total return (TR) terms, the MSCI World index is up by 1.3% in the month, S&P 500 3%, the Nasdaq 5.3%, UK 3.4%, while MSCI EMU is only slightly up and the FTSE MIB has underperformed losing 7%. The MSCI EMU index retraced already 3% from May's peaks and its TR is still +2.8% year-to-date. In the first phase, the market reacted positively to several triggers. First of all, the equity volatility (VIX) continued to decline reaching the level of 12% from the spike above 30% in January. Furthermore, the reporting season gave further confirmation of global healthy earnings growth. This induced a decrease in the dispersion of analyst earnings' forecasts. A lower standard deviation of analyst forecasts is usually associated with a lower risk premium, i.e. higher index prices. Additionally the EUR/USD lost 4% in the month, helping to soften some of the negative pressure that the strong dollar exerted on the firms' sales made outside the EA. Finally, macro surprises in the EA have declined too rapidly since the beginning of the year, reaching a level below the trough experienced in Q1 2016 and similar to the one in 2011. So, there is scope to see macro surprises stabilizing going forward, albeit lying in negative territory for still some time.

Equity overweight reduced: more cautious short term

Having said this, we decided to reduce the equity weight in our recommended portfolio. After the rally occurred since March (nearly +9%), the EA upside potential was reduced while risks continued to be tilted on the upside. At this stage the market discounts quite well the good reporting season, has absorbed the bulk of the dividend season and fully discounted the advantages of the tax reform in the US.

Equities

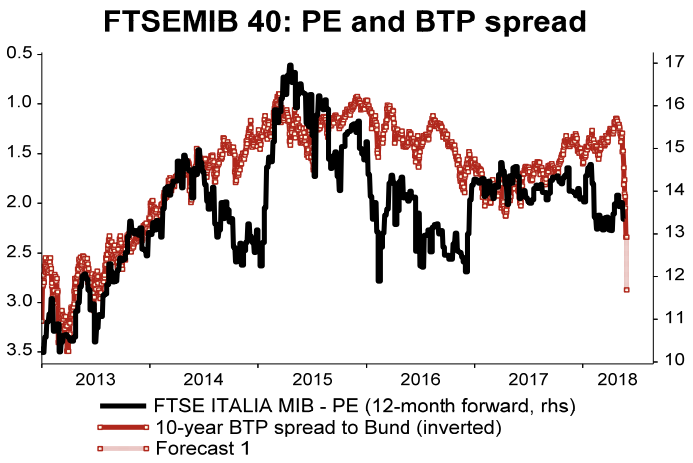
Furthermore, the macro momentum in the EA should give confirming signs to have surpassed the peak of the cycle. In this respect, investors positioning is still dangerously tilted towards the most cyclical sectors. Additionally, a higher USD and higher US yields are putting pressure on the EM stocks. But above all, equity markets have still not discounted four Fed's hikes for this year and inflation pressure, especially in the US, should maintain the Fed on the hawkish side and ignite higher volatility. A higher oil price could start weighing on the economic momentum and both the geopolitical and trade risk could also trigger sudden spikes in the investors' risk aversion. Finally, the credit risk in Italy has recently skyrocketed, affecting the EA equities overall, notwithstanding the small weight of Italian equities in the MSCI EMU index (nearly 5%). Unfortunately, such risk will not abate anytime soon and testifies a broader EU impasse towards further integration, inappropriate response to lagging European growth and high public debt in Italy. Under such circumstances our suggestion is to maintain a reduced overweight in equities, a defensive sector bias, low exposure to periphery and reduced (to small underweight) exposure to banks. The latter are particularly vulnerable to reduced growth forecasts, higher sovereign risk and non-increasing bond yields. On a 12-month horizon we maintain a TR of 5-6% for the EA and Japan, waiting to buy again once the Italian risk looks more manageable.

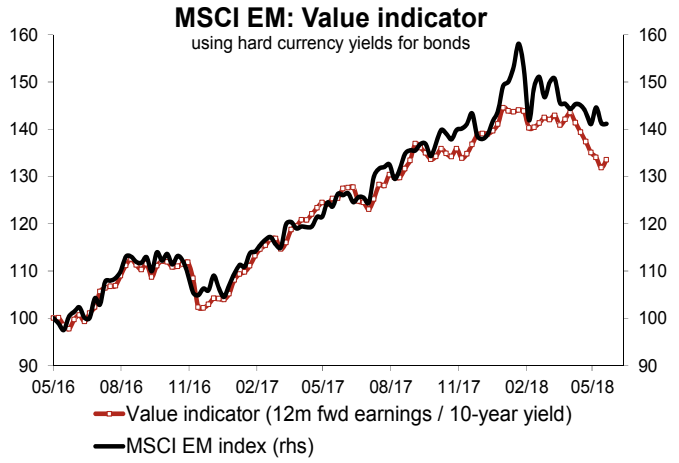
EM: to suffer from elevated uncertainty

Based on multiples, the EM stocks have become marginally dearer (at 5.7% discount versus history). EM earnings' estimates have slightly decreased, with the exception of Russia and Brazil (+2%). They both benefited from higher oil and commodity prices. The inclusion of 230 China-listed shares into the MSCI EM index (in June and September) is likely to unleash a surge of foreign inflows into the country's stock markets (just like in 2017). Even though the risk of a trade war between the US and China has diminished, the MSCI China is much more expensive in terms of multiples (having a premium of 7.4% vs its history) than the MSCI EM. Its relative earnings trend remains unfavorable and the Chinese economy is expected to slow down. Short term, the EM stocks are to be pressured further by increased financing costs: in May, EMBI spreads have increased by 17 bps, while the trade-weighted dollar has risen by 2.2%. EM exports are falling and are likely to suffer more as a result of elevated uncertainty in the euro area. On a longer term view, the EMs are to benefit from supporting macro development, improved global trade momentum, relatively lower valuations, stabilizing oil prices. We favor India along with Korea and CEE countries, while maintaining a prudent stance on China.

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	15.5	16.0	2.2	1.9	10.5	8.7	2.6	2.7	10.0
USA	16.5	15.3	3.0	2.3	11.8	9.9	2.0	2.2	15.8
JAPAN	13.8	15.6	1.3	1.3	8.0	7.1	2.2	1.9	-3.2
UK	13.9	13.8	1.8	1.8	8.9	7.9	4.2	4.0	1.9
SWITZERLAND	14.9	15.4	2.2	2.2	10.5	11.2	3.8	3.3	-5.8
EMU	13.5	14.2	1.6	1.5	7.9	6.4	3.5	3.9	7.2
FRANCE	14.5	14.4	1.6	1.5	8.8	6.9	3.3	3.8	12.1
GERMANY	12.9	15.1	1.6	1.5	8.0	6.6	3.2	3.3	4.7
GREECE	11.4	12.8	1.5	1.6	6.5	6.0	5.3	3.9	-11.6
ITALY	11.1	15.3	1.2	1.2	5.5	4.6	4.6	4.6	-2.7
PORTUGAL	17.3	12.6	1.9	1.7	6.6	5.9	4.4	4.5	15.2
SPAIN	11.9	12.9	1.2	1.6	5.2	5.1	4.5	5.1	-4.4
EURO STOXX 50	13.2	13.3	1.5	1.5	7.7	6.1	3.8	4.2	9.0
STOXX SMALL	17.3	14.4	2.0	1.7	10.5	8.2	2.9	3.2	18.6
EM, $	11.7	14.5	1.5	1.6	7.4	7.7	2.9	3.1	-5.7
BRAZIL	10.5	9.0	1.5	1.7	6.6	14.0	4.3	4.3	-11.6
RUSSIA	5.6	7.1	0.7	0.9	3.5	4.5	6.8	3.6	-39.6
INDIA	17.7	14.4	2.6	2.7	11.9	11.5	1.6	1.6	5.9
CHINA	12.5	13.0	1.7	1.7	8.3	7.6	2.2	3.0	7.4

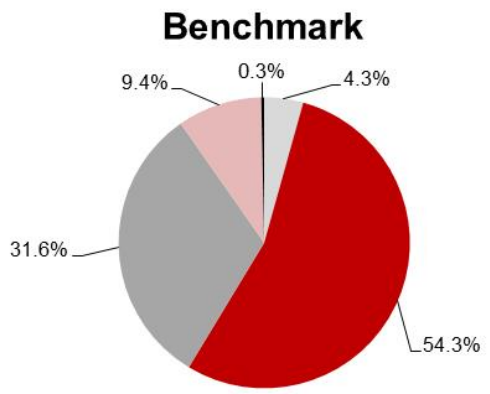
Note: The first four markets (ex. World) are based on the main local indices, the rest on the corresponding MSCI indices.
Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003.
Discount in % to historical average: blue and negative numbers = undervaluation. Red and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

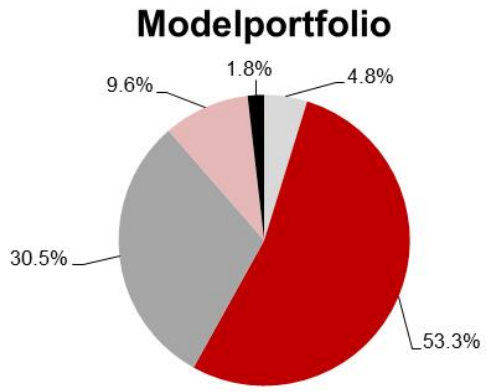




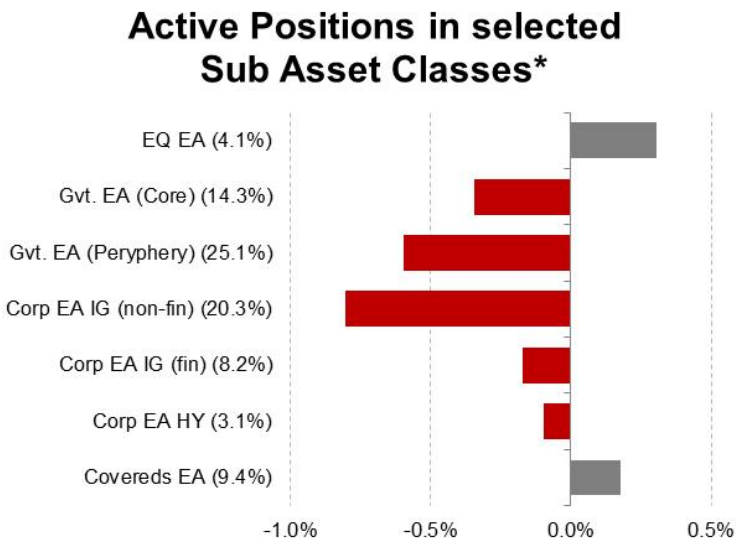
Asset Allocation

Thorsten Runde





Equities
Government Bonds
Corporate Bonds
Covered Bonds
Cash



Benchmark weights in parentheses

- **Since the end of April the developed equity markets of our investment universe roughly gained 3.6% on average.**
- **Government bond yields slightly decreased for core markets leading to positive total returns.**
- **In contrast spreads on BTPs widened, pushing the return figures for the periphery into negative territory.**
- **Triggered by Italian political woes corporate spreads widened too on average. As a result, apart from non-financial IG bonds, corporates revealed negative total returns.**
- **Our picture of upward trending yields basically remains intact. Equities are also still expected to have upside potential medium term.**
- **Thus, we confirm our recommendation of an over-weight in equities and cash at the expense of government bonds (core and periphery) and credit (IG as well as HY).**
- **However, as markets already moved a lot into the expected direction and against the backdrop of the large political uncertainties in Italy the aggressiveness of the allocation stance should be reduced significantly.**

The strong development of the developed equity markets and the spread widening of long-date peripheral bonds fitted particularly well to the corresponding over- and underweight positions. In contrast the decrease in core yields and the development of the IG non-financial spreads caught us on the wrong foot. Nevertheless, all in, last month's recommended tactical allocation stance paid off quite well.

Stance to remain pro-risk, but much less pronounced

Looking ahead, we expect economic surprise indicators to recover from current low levels, which should offer moderate support to equities. Ongoing monetary policy normalization should slowly lift yields further. The unstable political situation in Italy is a major risk for both FX markets and selected European assets – Italian ones in particular – in the near term. Risks for HY bonds remain heavily skewed to the widening side in the medium term.

In essence, we recommend to maintain the same invest-ment foci as in the previous month, i.e. overweights in equities and cash as well as underweights in nearly all fixed income asset classes. Against the backdrop of several risk factors, notably the imponderables resulting from Italian politics, however, our recommendation is to significantly reduce all active positions.

Forecast Tables

	2016	2017	2018f	2019f
US	1.5	2.3	2.7	2.4
Euro area	1.8	2.5	2.1	1.7
Germany	1.9	2.5	2.2	1.7
France	1.1	1.7	1.9	1.7
Italy	1.0	1.5	1.2	0.9
Non-EMU	2.1	1.9	1.7	1.6
UK	1.9	1.8	1.5	1.5
Switzerland	1.4	1.1	2.0	1.8
Japan	1.0	1.7	1.0	1.1
Asia ex Japan	6.4	6.1	6.0	5.9
China	7.1	6.9	6.5	6.2
CEE	1.5	3.9	3.0	2.6
Latin America	- 1.3	0.8	1.5	2.2
World	**3.2**	**3.7**	**3.6**	**3.5**

	2016	2017	2018f	2019f
US	1.3	2.1	2.5	2.2
Euro area	0.2	1.5	1.5	1.6
Germany	0.4	1.8	1.7	1.9
France	0.3	1.1	1.2	1.5
Italy	- 0.1	1.3	1.1	1.2
Non-EMU	0.7	2.5	2.4	2.2
UK	0.7	2.7	2.6	2.3
Switzerland	- 0.4	0.5	0.8	1.0
Japan	- 0.1	0.5	1.0	1.0
Asia ex Japan	2.6	2.2	2.9	2.9
China	2.0	1.6	2.1	2.1
CEE	5.2	5.0	5.2	5.7
Latin America	6.3	4.3	3.6	3.7
World	**2.3**	**2.3**	**2.7**	**2.7**

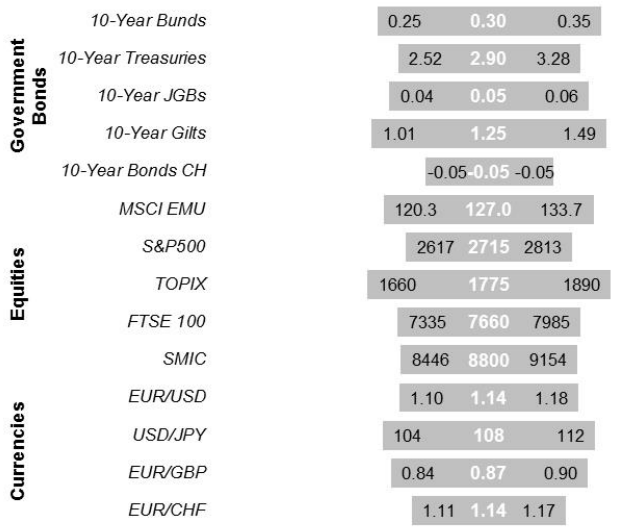
Financial Markets

3-month LIBOR	**28/05/18***	**3M**	**6M**	**12M**
USD	2.32	2.45	2.55	2.70
EUR	-0.35	-0.35	-0.35	-0.30
JPY	-0.03	-0.05	0.00	0.05
GBP	0.61	0.60	0.65	0.85
CHF	-0.73	-0.75	-0.75	-0.75
10-Year Bonds	**28/05/18***	**3M**	**6M**	**12M**
Treasuries	2.95	2.90	3.00	3.10
Bunds	0.41	0.30	0.60	0.90
BTPs	2.51	2.80	3.00	3.10
OATs	0.72	0.70	0.95	1.20
JGBs	0.04	0.05	0.10	0.10
Gilts	1.35	1.25	1.55	1.70
SWI	-0.01	-0.05	0.10	0.25
Spreads	**28/05/18***	**3M**	**6M**	**12M**
GIIPS	162	185	175	165
Covered Bonds	78	80	80	80

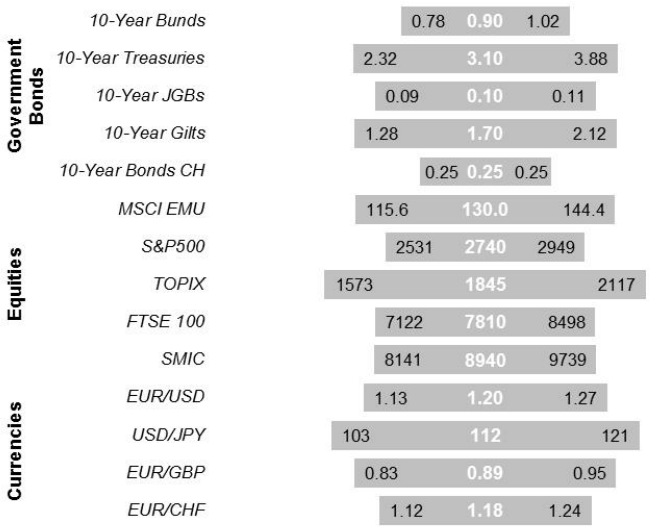
*average of last three trading days

Corporate Bond Spreads	**28/05/18***	**3M**	**6M**	**12M**
BofaML Non-Financial	103	110	115	120
BofaML Financial	119	135	135	135
Forex	**28/05/18***	**3M**	**6M**	**12M**
EUR/USD	1.17	1.14	1.16	1.20
USD/JPY	109	108	109	112
EUR/JPY	127	123	126	134
GBP/USD	1.33	1.31	1.32	1.35
EUR/GBP	0.88	0.87	0.88	0.89
EUR/CHF	1.16	1.14	1.15	1.18
Equities	**28/05/18***	**3M**	**6M**	**12M**
S&P500	2723	2715	2710	2740
MSCI EMU	127.6	127.0	128.5	130.0
TOPIX	1773	1775	1805	1845
FTSE	7726	7660	7700	7810
SMI	8768	8800	8960	8940

3-Months Horizon



12-Months Horizon



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

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