Q3 2018

GENERALI INVESTMENTS

Investment View

The beginning of the end

Content

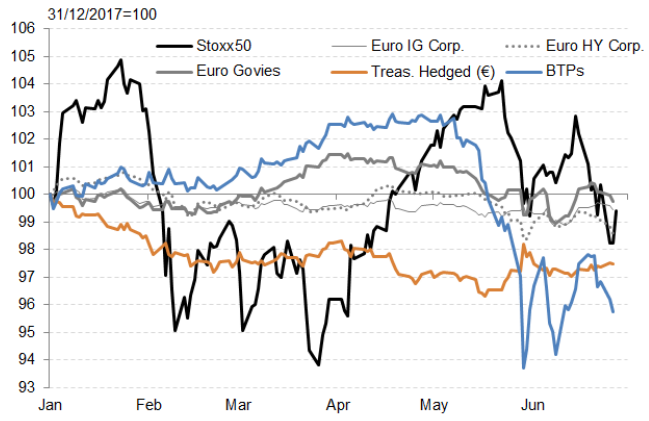
Global View

- **The beginning of the end: not all measures agree we are in late US cycle, but we are getting there. At this stage of the cycle Equities should be favoured over Fixed Income. Credit spreads in particular tend to turn before stocks. The extreme richness of US High Yield deserves particular attention. The switch from Equities to Bonds is unlikely to happen before 10y Treasuries get closer to 3.50% - the danger zone in our books.**
- **The near-term outlook remains blurred by international trade tensions (a topic into the US mid-term election) and European political uncertainty. We still retain an overweight in stocks, but an even smaller and defensive one. Also keep the OW in cash. We tactically reduce our duration short recommendation to minimal.**
- **We identify four canaries in the coalmine, from least to most threatening: higher oil prices, a stronger USD (bad for EM), rising volatility and widening credit spreads.**
- **Risk-free bonds have struggled to benefit this year from the many idiosyncratic shocks. That is because inflation is rising and central banks are normalising policy – the Fed now forcefully so. We keep an underweight in Govies, more so in EUR non-core than core, given the likely tensions over the Italian budget this autumn.**
- **Not all sectors of Credit are equal. USD High Yields appears very rich, worryingly so given record leverage there and the rising rates. EMBI is relatively cheap. Reassuringly, longs in € credit have been reduced sharply. EUR Financials (UW) are cheap vs Non-Financials (OW), but exposed in the near term to sovereign stress.**

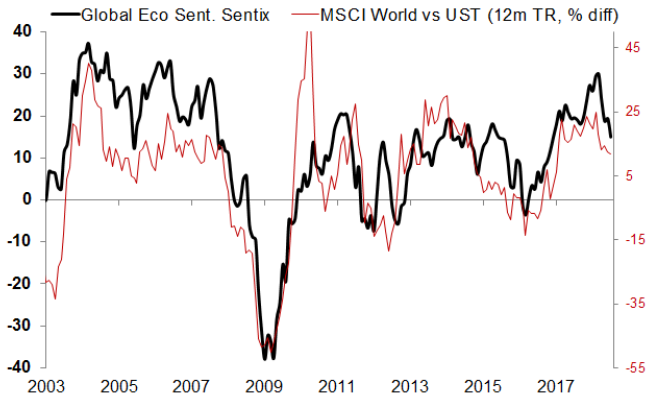
2018 a mediocre year for financial returns. Fed normalisation is a major drag. Trade tensions and European political developments not helping either.

Three months ago we opened our quarterly report on concerns that trade tensions were unlikely to fade into mid-year, which, along with ongoing Fed tightening, implied a "rather defensive (tilt) in our tactical allocation recommendations." Markets enjoyed some relief in early Q2 but concerns have resurfaced since late May. Risk sentiment has suffered from i) a deepening of the **international trade** tensions; ii) a Fed-led **USD rebound** that has added pressure on EM markets; iii) a failure of the **euro area economy** to rebound strongly following a disappointing Q1; and iv) political developments in **Italy**. European equities did manage to recover in early Q2, with the year-to-date total return of the Euro Stoxx surging from -6% in late March to +4% on 22 May. But it is now back to around zero (Graph 1). Remarkably, despite the many idiosyncratic shocks (to the above add the early February flash crash, the Libor-OIS widening in late Q1 and the Turkish and Argentine crises), safe assets have not rallied this year. The German sovereign bond index has barely delivered +1% year-to-date, and Treasuries (hedged in EUR) are deep into the negatives. This should not surprise in an environment where inflation is picking up and central banks are normalizing policy (Fed) or projecting to do so (ECB). This echoes our warning in late 2017 that this year would prove mediocre in term of asset performance.

Graph 1: YEAR-TO-DATE TOTAL RETURN PAINFUL FOR 'LONG-ONLY'



Graph 2: GLOBAL EQUITIES VS TREASURIES… GROWTH MATTERS



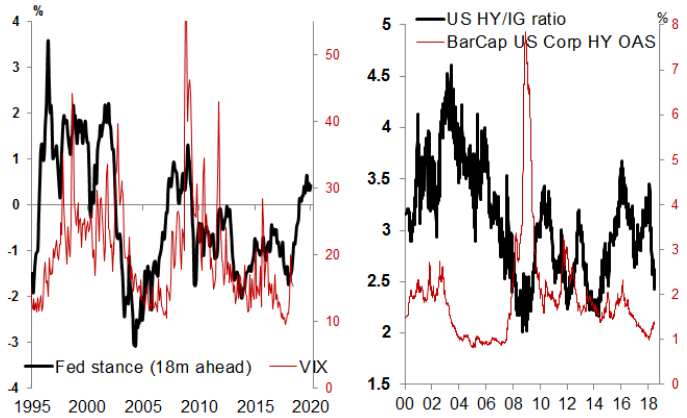
Equities still likely to beat Fixed Income, but near-term performance likely to be lukewarm

Is it time to climb the wall of worry and start increasing allocations to equities again? This looks premature still. We continue to expect equities to outperform Fixed Income assets over the next 3 to 12 months. This outperformance, measured on a 12-month basis, has diminished recently, but has not reversed (Graph 2). However we have further scaled down our total return expectations for EA stocks for the next 3 months to a minor positive (still +6% in EUR expected over 12 months).

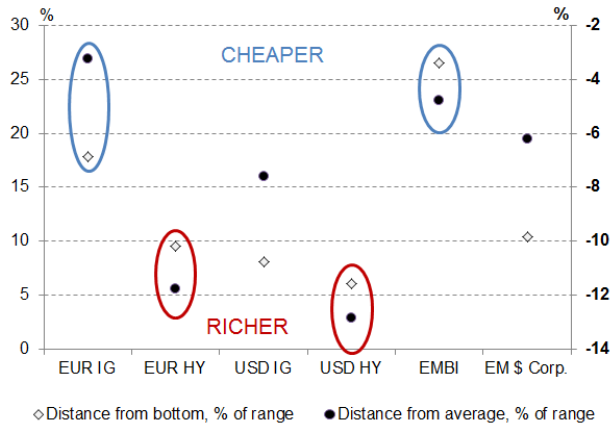
Looking for the canary in the coalmine

The trade war is likely to make headlines news into the US mid-term election (November). President Trump's political agenda is such that the bar is high for him to soften the tone on trade. However he will also want to advertise positive achievements - not just punitive tariffs that trigger retaliation – and will not be entirely insensitive to the feedback of Corporate America and Mr Markets (US equities, USD/CNY etc). So the trade narrative keeps us cautious, but risks there now look fairly symmetric. We are more concerned about political instability in Europe, where a weakened Merkel faces both an immigration crisis and fiscal largesse in Italy when the budget debates heats up in late summer.

Graph 3: TOUGHER FED ➔ HIGHER VOL, EXPOSING $ HY (RICH)



Graph 4: HISTORICAL VALUATION IN THE CREDIT SPACE



The canaries in the coalmine, from least to most threatening: oil, USD, rising volatility and widening credit spreads

On top of the economic and political risks above, we will be watching four areas of financial distress. 1) A persistent rise in the **oil prices** would further deteriorate the growth/inflation mix. We are not losing sleep over this just yet, as the supply/demand dynamics are likely to cap prices. Global growth has also become less sensitive to the oil price, if only because a rise supports capex in the shale sector. 2) A continued rise in the **US dollar** has largely contributed to the poor performance of EM assets this year, most specifically on FX and debt markets. Again, this does not top our list of risks. EM fundamentals are generally stronger than in 2013 (taper tantrum) and the late nineties (Asian crisis), and the USD potential is limited by the twin deficits and ageing US cycle. 3) **Rising volatility as the Fed** cycle matures. We offered insight about this in the spring edition of this quarterly. By some measures (real short-term rates vs natural rate of interest) the Fed has entered restrictive territory, which usually implies a rise in both financial volatility (Graph 3a) and the stock-bond correlation. 4) A **widening in credit spreads**, especially in the US High Yield sector, in an environment of record US corporate leverage (non-financial corporate debt at 73% of GDP) and rising rates (Graph 3b).

Allocation recommendations

Those risks, in our books, do not support a preference for 'risk-free' bonds. First, they are at least partially priced in, following the correction of the past month (though the build-up again of short equity volatility positions should raise eyebrows).

Underweigh Govies, both in core (small) and the non-core (larger UW) sectors. Minor short duration. Avoid the belly.

Second, safe bonds are struggling to benefit from risk-adverse developments. Real yields are still very low (especially in Bund, around -1.25% in 10y) yet global growth is resilient and economic surprise indices have likely hit a low in the euro area; inflation expectations have picked up but have further upside. So we **retain an underweight in government bonds, in euro both in the core and to an even larger extent non-core sectors.** Stress on BTPs has eased off since the nadir of late May. Yet the risk-reward mix remains negative into the autumn, as tax cuts, spending increases and market-unfriendly reforms (pensions) raise the risk of a rating downgrade (Moody's in the front line). A one-notch cut would bring the sovereign rating just one level above High Yield and reverberate into the financial sector. Our **duration recommendation remains short but has been reduced to minimal**. Like in September, in EUR rates we still view the belly of the curve as least attractive given the excessive pullback in rate hike expectations following the dovish guidance from the ECB (rates unchanged through summer 2019). To **hedge the risk of a turbulent summer** (risk-off), we like zero-cost 6m conditional bullish 2-5y flatteners (through receivers).

Reduce corporate underweight. Overweigh EUR Non-Financial sector. UW Financials despite relative cheapness but look forward to reverse later this year. Prefer low rating (BBB/BB) and

We retain an **underweight in corporate bonds, yet again a reduced one**. EUR credit spreads are still negatively correlated to Bund yields – a diversification benefit – but that relation has become asymmetric, with spreads widening more when the Bund rallies than they narrow when the Bund sells off. Graph 4 offers a historical view of spreads in different sectors. The High Yield sector, especially in the US is very stretched – avoid. EMBI (hard currency sovereign EM debt) is relatively attractive: overweigh. EUR IG spreads have moved away from the bottom, and we actually now recommend an **overweight in the non-financial sector**. With default rates set to stay low we prefer low rating (BBB/BB) and short maturity to high rating and long maturity. EUR Financials are cheap vs Non-Fins, but unlikely to catch-up before yields increase and in the near term are exposed to sovereign stress (Italy); we under-weigh that sector but will be looking to increase later this year.

Small OW equities, prefer defensive sectors still.

The analysis of the economic and financial cycles teaches us that as we enter a more mature phase of the cycle, equities outperform Fixed Income. **Credit spreads turn before stocks**. We retain a small overweight in stocks, but still prefer Value and Defensive (underweigh Cyclicals). We stick to our OW in cash.

Table 1: MACRO FORECASTS

	Growth			Inflation		
	2017	2018f	2019f	2017	2018f	2019f
US	2.3	2.7	2.4	2.1	2.5	2.2
Euro area	2.5	2.0	1.7	1.5	1.6	1.6
Germany	2.2	1.9	1.7	1.8	1.7	1.7
France	2.0	1.7	1.6	1.0	1.6	1.5
Italy	1.5	1.1	0.9	1.2	1.2	1.2
Non-EMU	1.8	1.6	1.6	2.5	2.4	2.2
UK	1.7	1.4	1.5	2.7	2.6	2.3
Japan	1.7	1.0	1.1	0.5	1.0	1.0
Asia ex Japan	6.1	6.0	5.9	2.2	2.9	2.9
China	6.9	6.5	6.2	1.6	2.1	2.1
CEE	3.9	3.2	2.6	5.0	5.2	5.7
Latin America	0.8	1.4	2.1	4.3	3.6	3.7
World	3.7	3.6	3.5	2.3	2.8	2.7

Annual changes, in %

Table 2: FINANCIAL MARKET FORECASTS

10-Year Bond Yields	**Current***	**3M**	**6M**	**12M**
US	2.89	3.00	3.10	3.25
Germany	0.33	0.40	0.60	0.95
Italy	2.82	2.95	3.10	3.15
Japan	0.03	0.05	0.10	0.10
Forex	**Current***	**3M**	**6M**	**12M**
EUR/USD	1.17	1.17	1.20	1.23
USD/JPY	110	110	111	112
EUR/GBP	0.88	0.88	0.88	0.89
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	2732	2760	2750	2790
MSCI EMU	123.5	125.0	127.5	128.0

*current as of June 26, 3-day average

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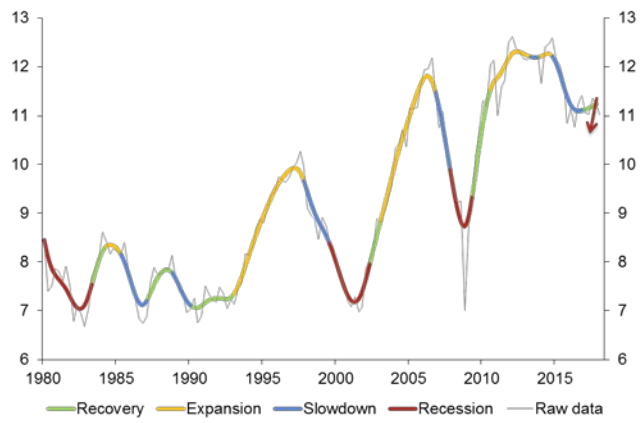
Late-Cycle Asset Performance

- **The extremely long duration of the upswing in the US raises concerns on whether the economy is entering a late stage of the cycle, characterized by slower growth and shrinking margins.**
- **We found that, historically, in this part of the US business cycle equities outperform long-term sovereign bonds in total return terms and corporate spreads widen, in both the US and euro area.**
- **However, despite the record long expansion, the US economy has not yet entered a late stage. The tax reform added to strong domestic demand triggering an acceleration of employment and a recovery in profitability.**
- **As a complementary assessment, we analyze the relative performance of total returns of equities over government bonds at different brackets of the 10Y bond yield. We find that equities usually outperform for levels of the long term yield below 3.5% in late cycles.**
- **Our conclusion is that we have moved away from the goldilocks environment for equities and, even if in no danger zone yet, we are moving towards a less comfortable zone.**

Late cycle features slower growth and shrinking profits…

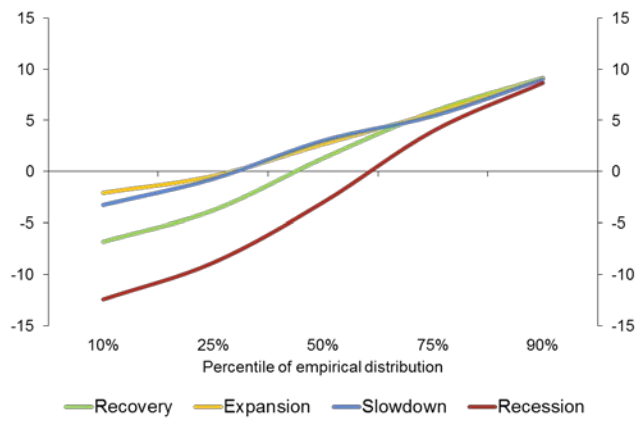
The record long expansion of US GDP and the gradual pick-up in inflation has started raising concerns about the beginning of the end of the current cyclical upswsing. With the economy entering a late stage of the cycle, changes in the relative performance of assets would also warrant shifts in asset allocation. We tried to assess which phase of the business cyle the US economy is in by looking at the behaviour of a few macroeconomic variables (employment, labor cost and inflation). Moreover, using the profit-to-GDP-ratio we characterize four phases of the cycle: recovery, expansion, slowdown and recession (Graph 1).

Graph 1: US BUSINESS CYCLE INDICATOR



Based on US corporate profits/GDP

Graph 2: US BUSINESS CYCLE: EQUITY VS 10Y TREASURY



Quarterly relative total return performance, in %

US economy not yet in late cycle due to fiscal stimulus

…but the US economy is still not there, thanks to the fiscal boost

Importantly for asset allocation, we found that the US business cycle has not yet reached the late cycle phase. Against a backdrop of solid domestic demand, the tax reform implemented at the end of 2017 and the subsequent increase in government spending have somewhow stretched the length of the upswing. Employment growth is then picking up and profitability is staging a (so far) mild recovery.

In the late stage of the business cycle, US equities generally outperform 10-year Treasuries in total return terms

We found that the median excess return of equities over Treasuries does not deteriorate significantly moving from expansion towards slowdown phase and the median relative performance is negative only for recession phases (Graph 2). Indeed, in the late stage of the business cycle (characterized by slower growth and cost pressures weighing on profits), US equities generally outperform 10-year Treasuries in total return terms. Moreover, the corporate spread tends to widen.

Regarding European assets, we also found that the stages of the US business cycle have a significant impact on European assets. In other words, the US cycle dominates EU assets' behavior, too.

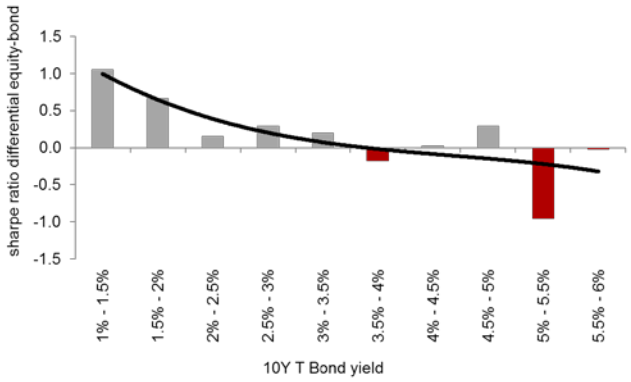
Critical yield levels for late-cycle equity outperformance

We then turned to the financial cycle, and analyzed what happens to the relative performance of US equities over bonds at different levels of some key financial variables. We find that the 10-year US Treasury yields play en especially important role.

A switch from equity to bonds unlikely when the 10 Year T-bond yields are below 3.5%

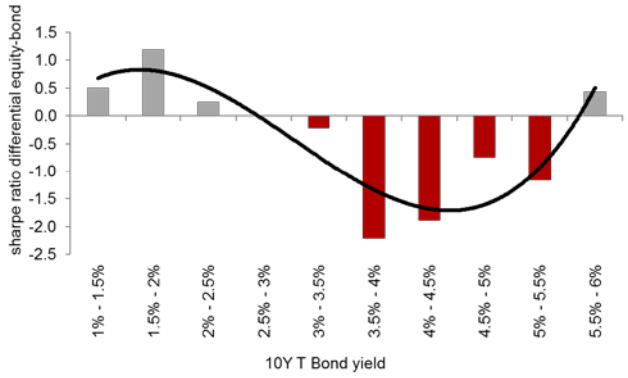
We have taken into account not only the median relative equity-bond return, but also the worst relative performance (maximum drawdown), given that investors make their decisions also looking at what can be the worst loss they could incur. The message coming from Graph 3 is that 3.5% is an important threshold for Treasury yields: When they moves towards the 3.5%-4% bracket, the quarterly relative performance of equity vs bond worsens. In terms of relative drawdowns (Graph 4), the relative performance of equity vs bond becomes negative in the 3-3.5% bracket and beyond.

Graph 3: US RISK ADJ. MEDIAN RETURN INDEX EQUITY-BOND



3m returns

Graph 4: US RISK ADJ. WORST RETURN INDEX EQUITY-BOND



1°percentile, 3m returns

We have moved away from the best environment for equities, but are not in the danger zone yet

Turning to the current situation and the outlook for yields, this analysis implies that we have moved away from the goldilocks environment for equities towards a less comfortable one. However, we are clearly far away from the level of yields which are correlated with a very negative equity versus bonds performance. Overall, the analysis based on yield levels is less supportive for equity longs than to the findings of the late-cycle and profit-cycle approaches.

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Macroeconomic Outlook

- **Global growth is leveling off, particularly in the euro area. That said, a stronger global slowdown does not yet seem imminent. The US economy is reassuringly strong, domestic demand in the euro area still solid and China resilient.**
- **Risks of overheating prevail in the US, with the procyclical fiscal stimulus adding to steady consumption and investment. The Fed is set to continue its pace of quarterly rate hikes well into next year.**
- **Emerging markets (EMs) are feeling the pinch from higher US rates and a stronger US dollar. While individual EMs (Turkey, Argentina) remain under severe pressure, a broad EM crisis is not imminent. Overall, EM fundamentals are in a much better shape than in 2013 (taper tantrum) or the late 1990s (Asian crisis).**
- **Despite the recent slowing, growth in the euro area will not to fall below potential, but there is limited leeway for a rebound. While the ECB will terminate QE at the end of this year, a first rate hike seems unlikely before September 2019.**
- **Downside risks to the outlook have increased considerably, though. Most prominently, an escalation of the trade conflict between the US and its trading partners has the potential to disrupt supply chains and dent business sentiment.**
- **In the euro area, political uncertainties have increased with the new Italian government taking a much more defiant stance towards the EU, while fragilities within the German coalition have risen sharply.**

Global growth is leveling off, but a sharper slowdown is not on the cards

Following a buoyant start into the year, the global economy has leveled off while risks to the outlook have risen. The data disappointment has been particularly pronounced in the euro area, but also global trade activity has turned from the 2017 boom into a drag. That said, a stronger global slowdown does not seem imminent. The US continues to expand strongly, underpinned by solid consumption, firming investment and a big fiscal stimulus. Growth in China is resilient and on course of slowing only gradually, while other EMs are expanding healthily (India) or recovering (Russia/Brazil). Strikingly, once stripping out the euro area, the global manufacturing PMI has come down by just 0.7 points from the January peak, while the indicator for services is still above the 2017 average, pointing to solid domestic demand in the advanced economies.

EMs feel the pinch of rising US rates and the strong dollar

That said, the benign, goldilocks, environment prevailing at the turn of the year is getting challenged. Mounting price pressures in the US, on a tight labor market and the pro-cyclical fiscal stimulus will leave the Fed on track to pursue its pace of quartely rate hikes well into next year, while the central bank's balance sheet continues to shrink. EMs increasingly feel the pinch from rising US rates and the stronger US dollar. Amplified by concerns about individual EMs (Argentina, Turkey, Brazil) on idiosyncratic reasons, currencies and assets have come under pressure since April, reversing the trend of falling EM policy rates.

Broad EM crisis is not likely thanks to generally improved fundamentals

Overall, however, a broader EM crisis is not on the cards in our view. Fundamentals (C/A, productivity growth, FX reserve coverage) have improved over recent years while higher commodity prices have helped energy and metals exporters. Furthermore, unlike during the 2013 taper tantrum, aggregate EM real effective exchange rates are below the longer-run average, containing the risks from a correction from overvaluation.

Fundamentals for euro area growth still solid

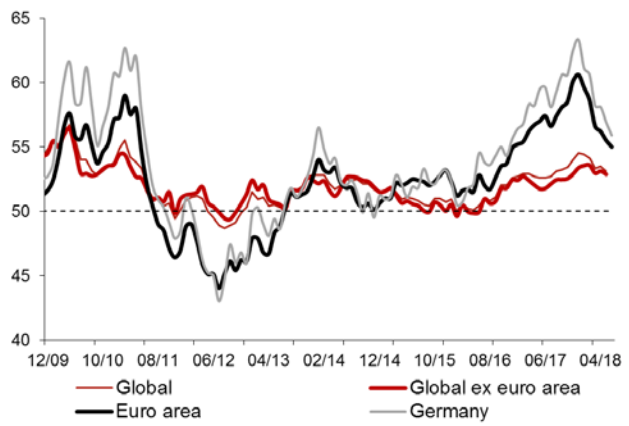
Growth concerns have been running high especially regarding the euro area. Following exceptionally strong readings last year, quarterly growth has almost halved from 0.7% in Q4 2017 to 0.4% in Q1. Moreover, key sentiment indicators like the PMIs weakened until May and only showed some rebound in June thereby confirming all in all the message of less vigorous growth in 2018. Forward-looking expectation components also weakenend, pointing to only limited leeway for a rebound.

Euro area growth sustained by solid labor market and not to fall below potential

That said, the economic fundamentals are still solid. Most importantly, employment continues to grow (Q1/2018 +0.4% qoq) while wage increases have also improved, underpinning consumption. With capacity utilization as well as production expectations still clearly above the long term average, investment activity is likely to pick up further, too. All in all, we expect the euro area economy to continue to expand at rates in line or above potential, but our growth forecast (2.0% this year and 1.7% next) remain below consensus estimates (2.2% and 1.8% respectively).

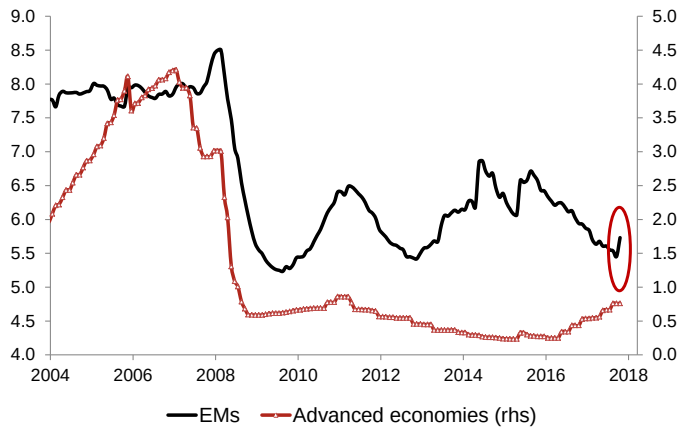
Following more than three years of QE, the ECB announced in June to terminate its asset purchases at the end of this year, after a period of tapering from October to December. Behind this decision mainly stands an improved inflation outlook, according to which core inflation will reach the just below 2% target by 2020. However, the ECB also made clear that it will leave key rates at the present level for at least through the summer of 2019. Moreover, the dovish wording accompanying the announcement that QE ends emphasized the downside risks, the data dependency of monetary policy and the fact that QE is part of a broader toolbox. The ECB had continously stated that it will reinvest the redemptions of the assets purchased also after the end of the net asset purchases for the time being. More details on this issue will likely be provided at the July meeting. While we now expect the ECB to lift its key rate for the first time in September 2019, we see the risks tilted to a further postponement of the first rate hike since 2008.

Graph 1: GLOBAL MANUFACTURING PMI



Values above 50 denote expansion

Graph 2: GLOBAL POLICY RATES



in %, weighted by GDP (PPP)

Trade War and European Politics Major Downside Risks

Effect on confidence key to assess fallout from trade conflict between the US and the Rest of the World

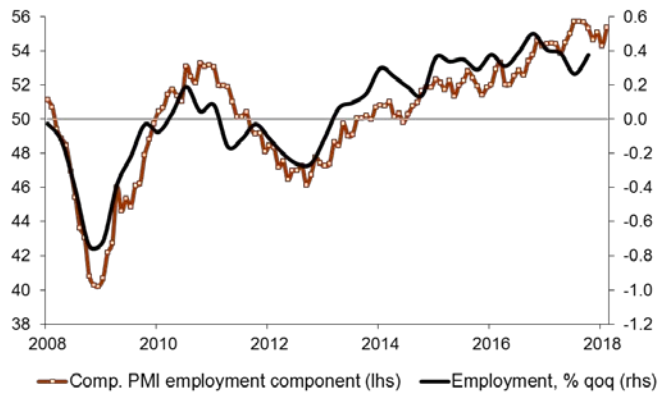
Looking ahead, the solid macroeconomic setting faces various political threats. The major risk to the global economy is the further intensification of the trade dispute between the US and its major trading partners that can easily morph into an outright trade war. Following the imposition of tariffs on steel and aluminium, the US trading partners have announced or already implemented retaliation measures. Moreover, Trump put in place additional tariffs on US$ 50 bn of imports from China and announced to tackle additional imports of up to US$ 400 bn, which would then cover about 90% of the US imports from China. Regarding the EU, he plans to levy a 20% tariff on car imports. The US is the biggest export market for European cars amounting to € 36 bn (0.33% of GDP) in 2016, with Germany being most exposed. As it stands now, the trade conflict is far more severe than initially thought. While its direct impact will not be strong enough to derail growth, the adverse effects on

confidence and medium term investment decisions are much more uncertain and can easily alter the picture, especially in case of a further escalation. In such a case, dampening effects on global activity would also be expected.

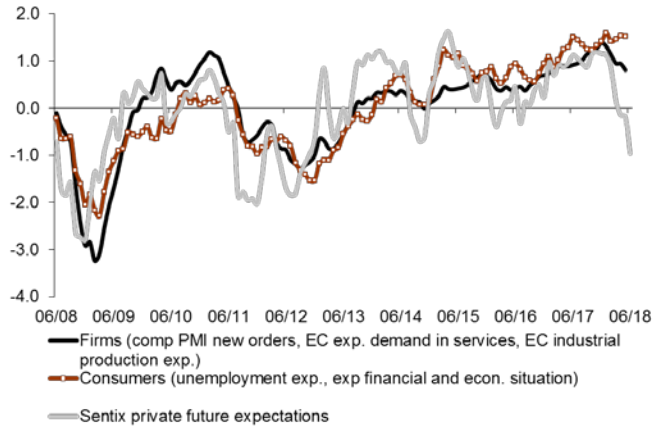
Fierce political situation in the EU to additionally drag on confidence

Within the euro area, political tensions have also increased as of late. Following the formation of the new euroskeptical government in Italy, concerns over fiscal discipline come to the fore. A persistent deterioration of the deficit in response to the implementation of the measures agreed in the coalition agreement (whose fiscal costs sum up to above €100 bn) would jeopardize debt sustainability. An unwillingness of the government to comply with the Fiscal Compact would lead to a clash with the EU Commission following the presentation of the new budget in autumn. Although the new Finance Minister reassured the market that euro membership was not under discussion, uncertainty about public debt sustainability and tensions between the government and the EU may drag on investment sentiment.

Graph 3: EURO AREA EMPLOYMENT PROSPECTS



Graph 4: EA AGGREGATE EXPECTATION INDICATORS



weighted average of z-scores of key expectation components

Tensions in German government and diverging stances on fiscal policy to make reforms on the EU level more difficult

In Germany, the ruling coalition has come under enormous pressure. The minister of the interior is at add odds with the Chancellor on immigration policy and threatens to send registered asylum seekers back to the EU country where they had been registered. If he were to do so, the Chancellor would likely have no choice but to dismiss her minister which would highly likely cause the coalition to burst. This would not only increase political uncertainty (new elections might become necessary) for Germany but also lead to a prolonged reform standstill at the European level. The EU summit on June 28/29, which had not ended at the time of writing, was unlikely to come up with a major overhaul of EMU and had to focus on migration. Overall, high flying expectations that followed the Macron reform proposals last year have not materialized and progress continues to be only gradual. The unwillingness of several core countries to accept further direct or indirect fiscal transfers and the inclination of some countries under stress to repeatedly challenge fiscal rules will keep a more meaningful overhaul of the European instiutional framework an enterprise for the longer run.

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Fixed Income

- **Driven by an adverse political news flow, euro area core government bond yields dropped and peripheral bond spreads widened in the second quarter. In contrast, US yields shrugged off any disturbances and – supported by a healthy macroeconomic data flow and a slightly more hawkish Fed – rose across the curve.**
- **Although the news flow is unlikely to change significantly for the better in the months to come, the prerequisites for higher yields are still given. Accordingly, we forecast slightly creeping up euro area core yields on a three month horizon and a more determined upside move further down the road.**
- **Given the fragile political situation in the euro area and the euro-sceptical course of the new Italian government, a lasting tightening of the BTP/Bund spread is not on the cards in the near term. Despite the limited contagion, other Southern European bond spreads will most likely be affected as well.**

International government bond markets sailed in rather calm waters until mid of May when concerns about the political development rattled financial markets and triggered a strong drop in core yields. Although they have slightly recovered since then, they remain well below the level as of end of March. This applies at least to euro area core yields. While US yields rose on balance in the second quarter, euro area core yields fell across all maturities. This implies that the transatlantic yield spread has widened to new historical highs in recent weeks.

Diverging macroeconomic news flow and monetary policies triggered a further widening of the transatlantic yield spread in the second quarter

Beside the unstable political situation in Italy and concerns about a lack of fiscal consolidation and an euro-sceptical course of the new government, the macroeconomic news flow and the monetary policy diverged further in the second quarter. While the US data releases were on balance in line with a growth rate above potential, the stream of macroeconomic data on this side of the Atlantic was weaker than expected. In addition, the announcement by central banks strengthened the monetary policy divergence. On the one hand, the US central bank raised the upper limit of the key rate to 2.00% in June and signalled its readiness to hike by another 50 bps over the course of the year. On the other hand, the ECB managed to announce a very dovish EA tapering. The strong forward guidance will limit any significant yield increase (at least in the short term).

Politics to determine development on bond markets near term

Going forward, international bond markets are seen to remain under the influence of political events. Given different views about the future of the euro area among European governments and the appropriate approach to handle current problems, concerns about the perspective of the euro area are unlikely to vanish in the short term. This will trigger further safe haven flows and support particularly euro area core government bonds.

Extremely low real yields in the euro area appear unsustainable given the sound macroeconomic environment

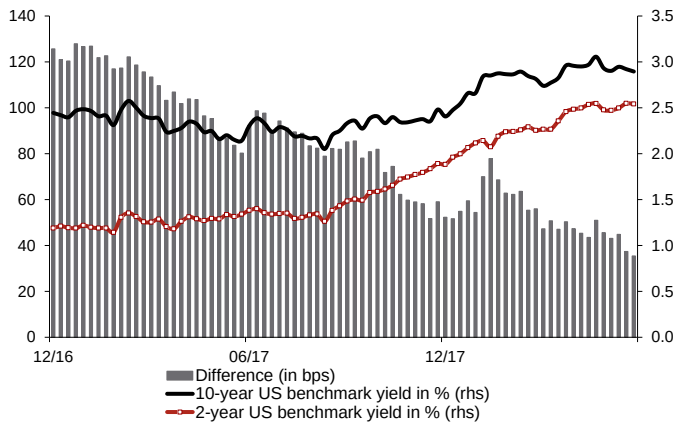
Still, the macroeconomic preconditions for higher yields remain in place. To start with, inflation expectations were hardly impacted by the turbulences and increased further in the second quarter. Going forward, the way is paved for upward creeping inflation rates in the months to come. In this respect euro area real 10-year yields at -1.30% (close to the historical trough of -1.40% marked in spring 2015) is clearly at odds with the macroeconomic outlook. What is more, the euro area macroeconomic data flow is likely to stabilize at a still solid level in the weeks to come (assuming the trade conflict does not escalate). As US macroeconomic releases point to a healthy (above trend) growth rate as well, core yields on both sides of the Atlantic have some scope to rise going forward.

This applies even more as markets appear too cautious with respect to central banks. While currently only three further key rate hikes by the Fed (each by 25 bps) are priced until the end of 2019, the Fed's dots (and GI Research) signal five additional hikes during this period. Regarding the ECB, the scope for any key rate

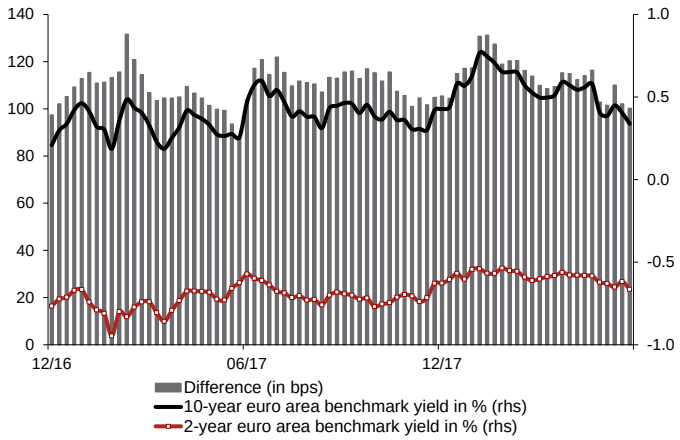
Underpricing of future ECB key rate hikes makes medium-dated euro area core bonds vulnerable to a setback

hike was dampened by the recent dovish ECB statement. However, the ECB will ultimately switch to a less dovish stance which is not priced currently. The 4y1y OIS rate is currently only slightly above 0.6%. Although we expect a first depo rate hike only in H2 2019, the terminal ECB key rate will not be below 2%. This is at odds with current market pricing and will result in a need for adjustment. While the short end of the curve is seen to remain well anchored by the ECB's strenghtened forward guidance, medium-dated yields are likely to rise more strongly. Hence, investors are recommended avoiding the belly of the curve and to prefer the wings.

Graph 1: US: SHORT- AND LONG-DATED GOVERNMENT YIELDS



Graph 2: EA: SHORT- AND LONG-DATED GOVERNMENT YIELDS



All in, US and euro area core yields are likely to increase moderately on a three month horizon. Further down the road, the bear market is likely to continue (not least due to the termination of the ECB's QE programme). However, the forward guidance by the ECB is seen to trigger a bear steepening. In contrast, further Fed hikes will lead to a continuation of the flattening of the US yield curve.

Lasting settling of conflicts in the euro area rather unlikely

It is noteworthy that the significant BTP/Bund spread widening since May has had only a limited effect on other peripheral bond markets. As long as the existence of the EMU is not questioned, this is unlikely to change. The improved institutional setup in the euro area, the solid current economic environment and the ECB, which would act if necessary, help to limit the impact of the BTP/Bund spread on other markets. However, a complete detachment will not occur either.

Uncertain political environment to burden particularly BTPs in the near term, some easing in the course of 2019 likely

In the months to come, we expect the new Italian government to follow a rather confrontational course. On the one hand, the fiscal easing intended by the coalition conflicts with the fiscal consolidation targets. At latest in autumn, this conflict will intensify when the new budget plans for 2019 are submitted to the EU Commission. On the other hand, the cooperation within the EMU will become more difficult as the euro-sceptic policy stance of the new government will complicate the search for compromises. In this uncertain environment a lasting re-tightening of the BTP/Bund spread appears rather unlikely in the near term.

Further down the road, we expect a more conciliatory approach of the Italian government. This is seen to reassure markets in the course of 2019 and to trigger a moderate re-tightening of spreads (but not to levels marked in spring 2018).

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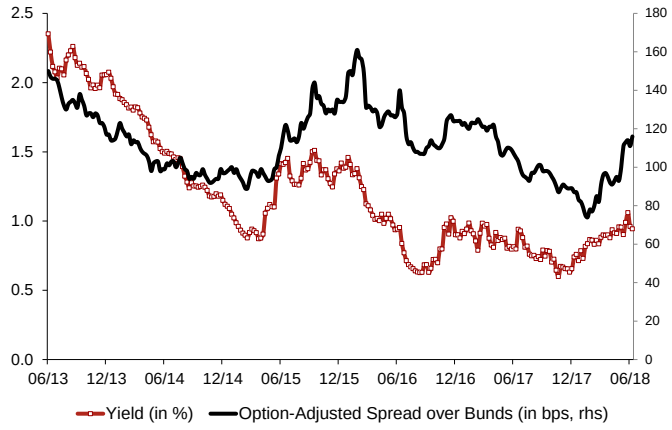
Corporate Bonds

- **After a friendly start into the second quarter, euro area IG corporate bonds came under strong pressure driven mainly by political turmoil in Italy. Despite the decrease in underlying Bund yields, the corporate yield level rose on balance.**
- **The sound economic environment and ECB purchases will cap any spread widening in the near term. But, higher underlying yields and a still ambitious valuation make an investment in corporates rather unattractive for the time being.**
- **Financials kept underperforming, mostly due to the losses in subordinated bonds. Despite the more attractive valuation, we prefer to maintain a cautious stance as the negative spillovers from Italy's political woes should persist.**

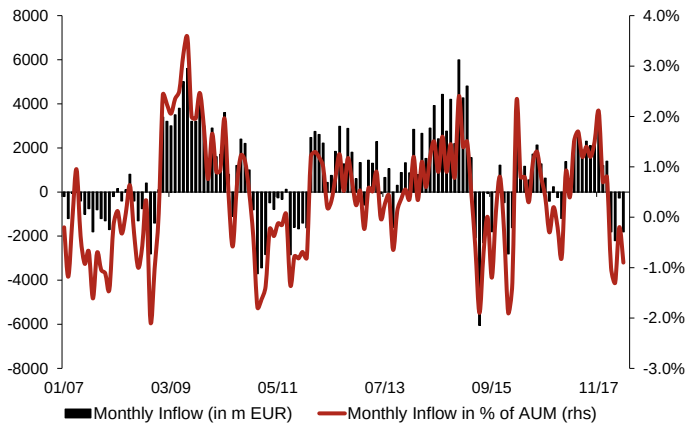
String of negative news flow has triggered a strong spread widening of corporate bond spreads since May

While euro area IG corporate bonds remained complacent at the start of the quarter and shrugged off any disturbances with respect to the macroeconomic and political environment, spreads have finally widened since mid of May. On balance, option-adjusted spreads widened more than 20 bps to 117 bps in the second quarter, with financials underperforming non-financial corporate bonds. The increase in the corporate yield level was less strong as underlying yields decreased. Still, the yield increase by almost 10 bps triggered a negative performance quarter-to-date of 0.1%. Beside the political turbulences in Italy which burdened particularly financial corporates, the intensifying trade war concerns in combination with weakening macroeconomic data affected the whole asset class.

Graph 1: BAML EURO AREA IG CORPORATE BONDS



Graph 2: EUROPEAN IG CORPORATES FUND FLOWS



Source: JP Morgan

Given still ambitious valuation the way is paved for a further moderate widening of corporate bond spreads

Looking ahead, the scope for tighter spreads remain rather limited. Although the economic environment is likely to remain solid and the ECB will continue its QE programme until the end of the year (although unlikely to reach Q1 levels again), the future environment is seen to become more challenging. The low total returns will keep the flow of funds on a low (or even negative) level. Financial markets' concerns regarding the stance of the new government in Italy is unlikely to ease in the short term. Moreover, it is far from certain that euro area governments will find a common solution with respect to migration and an advancement of the institutional set-up of the euro area. Finally, a potential escalation of the trade conflict with corresponding consequences for the growth outlook cannot be excluded.

Therefore, in light of a still ambitious valuation the way is paved for a further moderate corporate bond spread widening in the months to come. Taking into

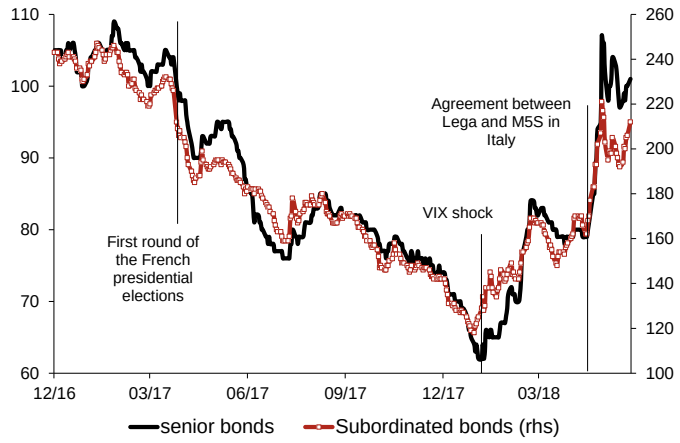
account the expected increase in underlying yields, investors are recommended preparing for a negative total return in the coming months.

Limiting risks by overweighting short-dated corporate bonds

Combination of forecast increase in underlying yield and spread widening increases the attractiveness of short-dated corporate bonds

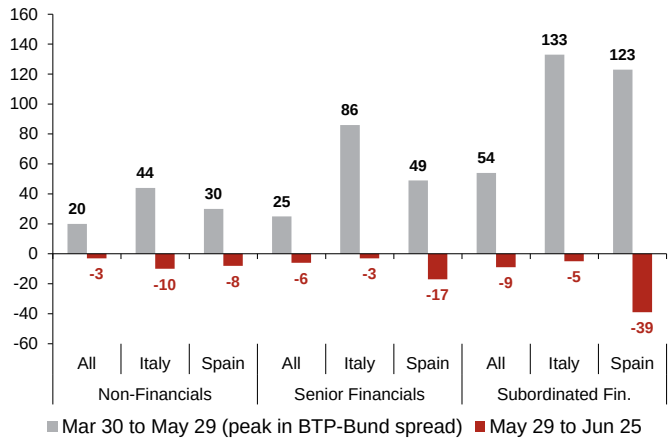
In this environment less vulnerable investments are key to preserve capital. An appropriate way to achieve this is to overweight short-dated, low-rated corporates, but to underweight long-dated, high rated ones. This helps to maintain the current income, while being protected versus markt-to-market losses to a large extent. The expected increase in underlying yields will hurt long-dated corporates much stronger. What is more, in a spread widening environment the credit curve tends to steepen. Given the sound economic outlook defaults are forecast to remain low for the time being, thereby anchoring the spread of short-dated corporate bonds.

Graph 3: ICE BofAML EUR IG FINANCIAL BOND SPREADS



Option-Adjusted Spread (OAS) over German Bunds, in bps

Graph 4: SPREAD CHANGE BY SECTOR AND COUNTRY



ICE BofAML indices, in bps

Financials hostage of sovereign risk despite cheap valuation

After the recent sell-off, Subordinated bonds look more attractive vis-a-vis senior ones, we upgrade them back to neutral

EUR IG Financial corporate bonds underperformed non-financials again in Q2, mostly due to the losses suffered by subordinated bonds. Indeed, while the total returns of senior financials and non-financials were broadly aligned (-0.22% and -0.02% respectively) and close to zero thanks to the sharp drop in Bund yields, subordinated financials fell by 1.45% due to the marked widening in risk premiums. The option-adjusted spread (OAS) of subordinated financials rose by 44 bps to 212 bps, the one of senior bonds by 18 bps to 101 bps, the highest levels since the French presidential elections in spring 2017. The escalation in political risk in Italy was the key driver of the repricing, along with lower Bund yields (negative for profitability). Italian bonds suffered a massive spread widening – senior financials widened by more than 80 bps – and so far have failed to recover meaningfully.

Our fair-value models suggest that financial bond spreads are attractive, both in absolute terms and relative to non-financials. But, we believe that the Italian political situation will remain a key risk factor, despite the limited share of Italian bonds in the index (around 5%). We expect the spread on IG financials to rise to 135 bps over the next six months (from 128 bps), and to move sideways in H1 2019. Hence, in the short-term we maintain a preference for non-financial bonds, waiting for the end of ECB's purchases to reverse the stance between the two towards year-end.

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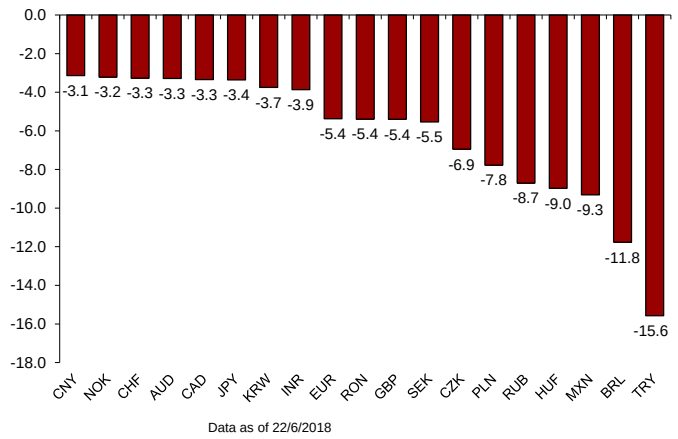
Currencies

- **The USD remains underpinned short term especially vs. EMs on US economic outperformance, Fed rate hikes and a more vulnerable risk sentiment. Following the recent rally, however, we see only limited further USD upside.**
- **Medium term, by contrast, pressures on the US dollar from a rising twin deficit, political uncertainties and the maturing US cycle are likely to prevail.**
- **The EUR/USD seems caught in the 1.15-1.20 range short term, with downside risks from EMU uncertainties and correcting speculative long EUR positions. Medium term, however, we see the EUR/USD resuming its upward trend again on fading USD strength, the ECB's termination of QE and structural EUR support from the euro area's elevated C/A surplus as well as capital inflows.**
- **Support to CHF and JPY on uncertainties over politics in Italy and an escalating global trade conflict will persist for a while. This will soften, but unlikely reverse the structural upward trend in the EUR/CHF.**

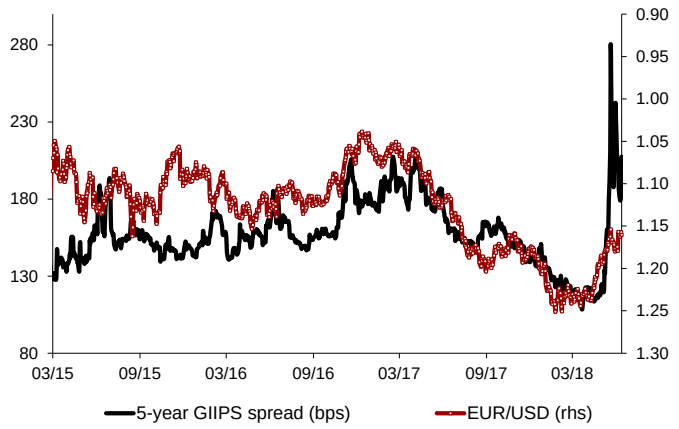
Broad-based USD strength over Q1, helped by US cyclical strength, Fed rate hikes and shakier risk sentiment

The USD rallied broadly and strongly over the past quarter, underpinned by an outperforming US economy, continued Fed rate hikes and shakier global risk sentiment. Strength against EMs was exacerbated by idiosyncratic stress in some countries like Argentina and Turkey. Unlike during the 2013 taper tantrum, however, EMs were generally not in the centre of USD strength, with the EUR and other major currencies also retreating visibly against the Greenback.

Graph 1: FX PERFORMANCE VS USD



Graph 2: EMU SOVERIGN RISK AND EUR/USD



March 30 to June 21, 2018

USD to remain underpinned near term

USD strength unlikely to fade quickly…

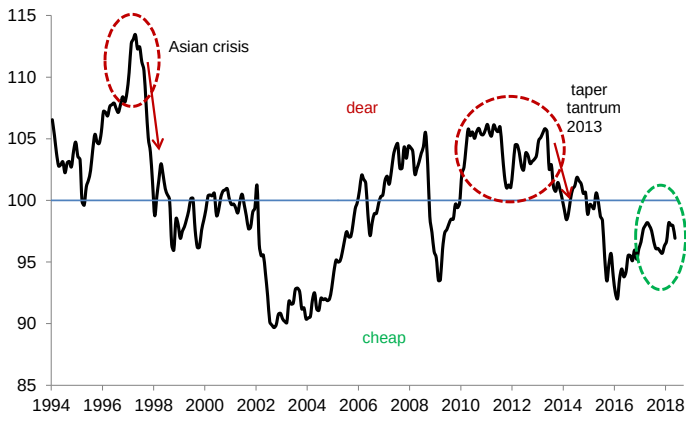
Looking ahead, these factors of USD support are unlikely to fade quickly. What is more, political uncertainties about fiscal policy and the tough stance on Europe by the new Italian government and the more dovish stance by the ECB may keep USD demand high. Speculators may well continue to unwind their still substantial net long EUR positions.

Weak EM currencies (TRY, ZAR, BRL) seem prone to suffer somewhat further, too, amid ongoing concerns about escalating trade conflicts with the US and less robust global risk sentiment. Importantly, however, we do not see the recent EM weakness as the harbinger of a broad-based EM crisis. EM fundamentals are generally much more solid than during the 2013 taper tantrum (let alone the 1997/98 Asian crisis). Aggregate EM current accounts are in surplus, productivity growth is recovering, EM

… but a broad EM crisis is not on the cards thanks to overall improved fundamentals

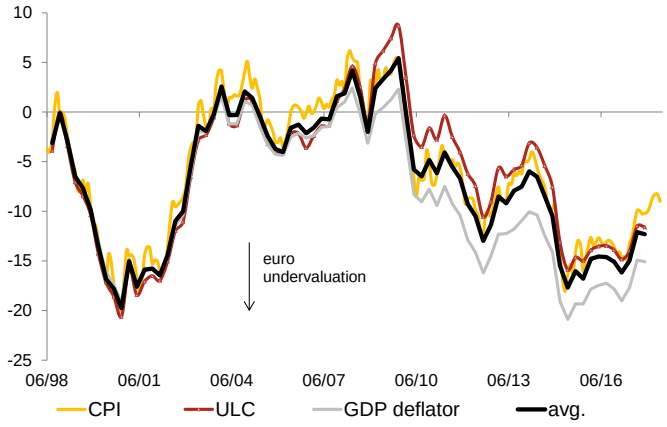
reserves coverage improving and rising commodity prices are a relief for exporters of energy and metals. In striking contrast to the mentioned critical previous episodes, EM effective exchange rates (adjusted for inflation) are even trading slightly below their long-term average (see Graph 2; prev. page), pointing to no due broad-based correction on valuation grounds.

Graph 3: EM REAL EFFECTIVE EXCHANGE RATES



avg. of 15 major EM trade-weighted exchange rates, inflation based, long term avg. = 100

Graph 4: ECB HARMONIZED COMPETITIVENESS INDICATORS



in % vs Q4/1998 (time of euro introduction)

Downside risks to EUR/USD mainly confined to short term

Despite short-term risk to the downside from EMU politics and US outperformance, the medium term outlook for the EUR/USD is to the upside

We acknowledge risks that the EUR/USD may break below the 1.15 short term with concerns about Italy increasingly seconded by worries about the stability of the German government, jeopardzing hopes of meaningful EU reforms before the campaign for EU parliamentary elections (due in May 2019) will start. Further out, however, we see the EUR/USD resuming its upward trend in the medium term again. USD strength is to fade once an easing fiscal impluse lays bare the late-cycle stage of the US economy and the necessity of a lower USD helping to attract foreign money to finance the US large and growing twin deficit. Reversely, the ECB's termination of QE and structural EUR support from an elevated C/A surplus and capital inflows will support the euro. The euro also still appears undervalued both on purchasing power parity (EUR/USD >1.30) and competitiveness indicators (trade-weighted EUR undervalued by 12%, see chart).

Currencies perceived as safe havens, most notably CHF and JPY, are likely to remain underpinned over the coming weeks on uncertainties over politics in Italy and global trade. This will soften, but – barring an escalation of EMU strains – unlikely reverse the structural upward trend in the EUR/CHF. The CHF remains strongly overvalued, and growing confidence in ECB policy normalization and easing doubts about EMU stability will likely guide the EUR/CHF closer towards 1.20 again over the next twelve months.

USD/JPY may rise, with the rising US yields outweighing fundamental support to the JPY

By contrast, the yen remains fundamentally undervalued and Japan's elevated current account balance is likely to support the yen. That said, FX correlations with yields are recovering. With US yields set to rise and Japanese ones held back by the BoJ's yield curve control, the gravitational pull higher in the USD/JPY from yields is likely to prevail over the coming months.

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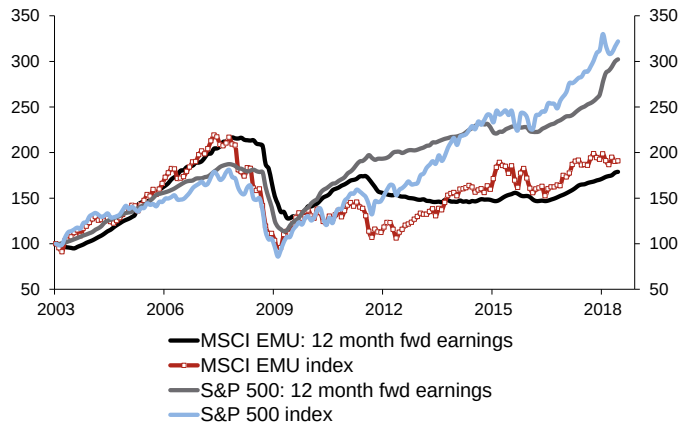
Equities

- **Escalating Italian risk in May affected markets. We do not expect uncertainty to abate anytime soon.**
- **We reduce the equity overweight and stay cautious short term: The good reporting season and the bulk of the dividend season are 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.**
- **That said, we remain constructive for the next 12-month, expecting total returns of around 6% in the EA and Japan.**
- **We are neutral on EM short-term, but we are positive beyond, favoring India, Korea and the CEE countries.**

The credit risk in Italy has recently skyrocketed, affecting banks and the EA equities overall.

In the quarter, markets bounced back (+1.8%) after the fall started in mid-January (nearly -9% for the EMU in total returns – TR- terms). The VIX decreased from around 22 to 15, contributing to the improved investors' sentiment. Positive triggers were also an enduring robust macro trend in the US, a stronger dollar (positive for euro area- EA - equities), and higher oil prices (+7%). As we envisaged in our March update, the last quarter was not immune from risks. Indeed EMU index was unable to outperform the US one, notwithstanding the stronger dollar. The defensive FTSE UK 100 (an undervalued and under owned index) ranked first among global indices in terms of TR. Finally, European financials underperformed, while more defensive sectors like retail, oil, pharma and household, overperformed. After the rally, risks continue to be high and we see very limited positive returns in 3 months, decreasing further our overweight in equities. For the mid-term (i.e. 12-months) we are more constructive and for the European and Japanese indices we see a 6% total return as sustainable, which compares with a negative return expected from the fixed-income world. But we stay cautious at present, buying future market dips.

Graph 1: PRICE AND EARNINGS PERFORMANCE



(01/01/2003 = 100)

Table 1: EQUITY MARKETS VALUATION DASHBOARD

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	15.4	16.0	2.2	1.9	10.4	8.7	2.6	2.7	9.3
USA	16.5	15.3	3.0	2.3	11.8	9.9	2.0	2.2	16.2
JAPAN	13.4	15.6	1.2	1.3	7.8	7.1	2.2	1.9	-5.5
UK	13.5	13.8	1.7	1.8	8.8	7.9	4.2	4.0	-0.4
SWITZERLAND	14.7	15.4	2.2	2.2	10.4	11.2	3.8	3.3	-7.2
EMU	13.3	14.2	1.5	1.5	7.9	6.4	3.6	3.9	6.4
FRANCE	14.0	14.4	1.5	1.5	8.6	6.9	3.4	3.8	8.8
GERMANY	12.7	15.1	1.6	1.5	8.0	6.7	3.3	3.3	3.2
GREECE	12.4	12.8	1.6	1.6	7.4	6.0	5.0	3.9	-1.6
ITALY	11.2	15.3	1.2	1.2	5.6	4.6	4.6	4.6	-1.3
PORTUGAL	16.8	12.7	1.9	1.7	6.4	5.9	4.5	4.5	12.9
SPAIN	11.8	12.9	1.2	1.6	5.3	5.1	4.5	5.1	-4.4
EURO STOXX 50	12.9	13.3	1.5	1.5	7.6	6.2	3.9	4.2	7.4
STOXX SMALL	17.1	14.4	1.9	1.7	10.5	8.3	2.9	3.2	17.2
EM, $	11.2	14.5	1.5	1.6	7.2	7.7	3.1	3.1	-9.0
BRAZIL	9.6	9.0	1.5	1.7	6.0	14.0	4.7	4.3	-17.8
RUSSIA	5.3	7.1	0.6	0.9	3.3	4.5	7.4	3.7	-46.4
INDIA	18.2	14.4	2.7	2.7	12.2	11.5	1.6	1.6	8.0
CHINA	11.9	13.0	1.6	1.7	7.8	7.6	2.4	3.0	1.9

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

Cautious stance short term: further lowering equity overweight

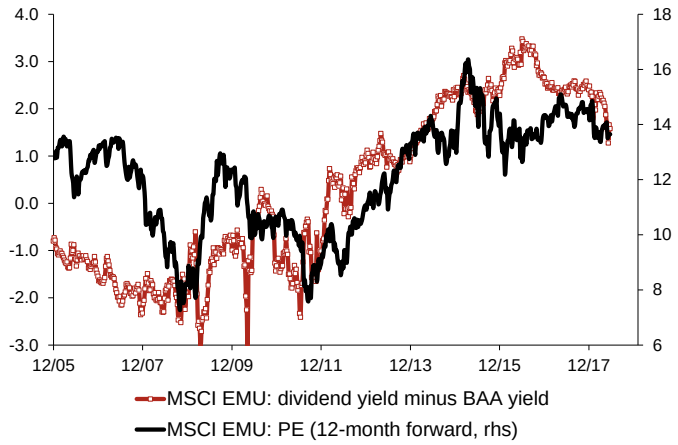
In our opinion, in the next three months, equity performance will be hostage of hawkish central banks' stance (reduced monetary stimulus), softer macro momentum, and a still dangerously cyclically tilted positioning. Inflation pressure in the US will continue to retain the Fed on the hawkish side, with possible renewed increase in equity volatility. Positioning indicators show investors' stance as being only neutral and not bearish yet. This ultimately let the market vulnerable to possible

Cautious short-term: Marginal upside in 3 months, with the EA unable to outperform the US.

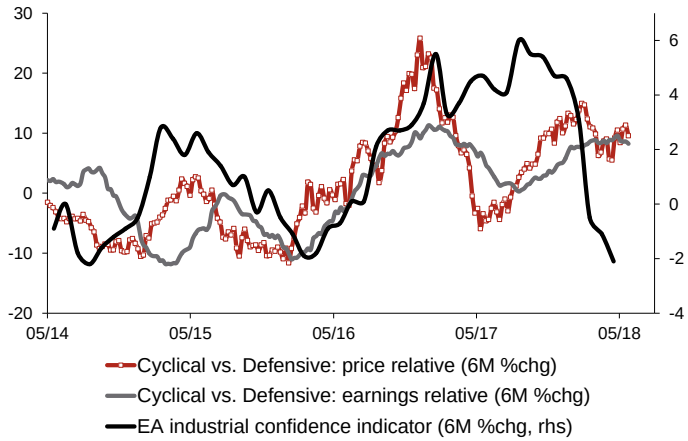
negative news flow. Higher sovereign risk in Italy is also affecting EA equities and we do not expect uncertainty to abate soon. In the short term, valuations are not cheap enough to offset risks, being at premium of 5% in the EA and 16% in the US, while the increased BAA yield is putting pressure on market PEs (price earnings) and on the relative attractiveness of the dividend yield vs the credit yield. Furthermore, the good reporting season and the bulk of the dividend season are now behind us. Risks of trade frictions and policy uncertainty have increased, too, including EU disagreement on imigration, centralized investments and progresses towards a political and financial union. Finally, pressure on European banks should stay for longer due to: lingering higher Italian risk, EM risk contagion on Spanish banks, softer macro momentum in the EA and recent expectations of a postponed ECB first hike from Q2 to Q3 2019. In part such risks have been factored in, as showed by the noticeable decrease in the Italian PE or the increased valuation discount of the European banks vs. the broader index. That said, we do not see positive triggers yet, able to reverse the current negative momentum.

We see only marginal upside in 3 months, with the EA unable to outperform the US. We stay overweight UK, Japan, SMI and defensive EU sectors. Neutral EM. EU cyclical sectors show richer multiples while macro momentum slows, we keep a

Graph 2: MSCI EMU: PE AND BAA YIELD



Graph 3: EUROPE: CYCLICAL VS. DEFENSIVE SECTORS



lower weight. We are overweight on the most undervalued sectors, less risky and less overbought, with safer earnings revisions: insurance, pharma, discretionary, oils. Materials, comm. & prof. services, and IT hardware are put on underweight. Banks are slightly underweight (with diversified financials). We will use next weak market phases to re-increase exposure to cyclical and financials in particular.

Mid-term positive: Buy the dips, overweight EA and Japan

Positive mid-term view: still in a recovery phase (no late cycle), yields not to hurt yet.

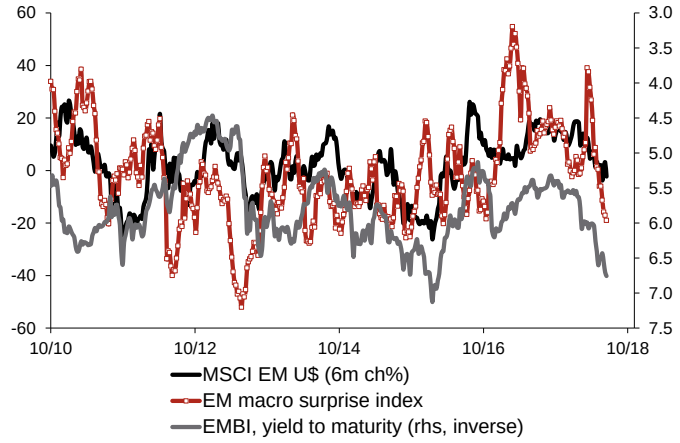
For the next 12 months, we are constructive on equities, forecasting a safe total return of 6% in the EA (with a dividend yield of 3.4%) and Japan; slightly higher for the UK and the SMI indices. Ex-US, overvaluation is contained - still high risk premium vs. history- with still good earnings growth, a stronger momentum of corporate cash flow vs. capex one, and still limited pressure from higher yields. We are also not yet in late cycle phase, which tends to be supportive for equity performance versus bond one. EU GDP growth looks resilient enough to produce an estimated earnings growth of 8% and 6% this year and the next (which is below consensus). Furthermore, our expectations of higher volatility in the next months are not such to derail the equity performance relative to the bond one. As said, we remain positive on the Topix, too. Japanese inflation pressures will rise only moderately, so the BoJ will not move before the impact of the October 2019 sales

tax hike will be digested. Decent nominal GDP growth, a prolonged dovish stance by the BoJ and a somewhat weaker yen will keep supporting Japanese equities. A more shareholder friendly attitude and high firms' cash levels will also prove supportive. On the contrary, we expect subdued return (3%) for the US due to higher valuations, increasing yields and unit labor costs.

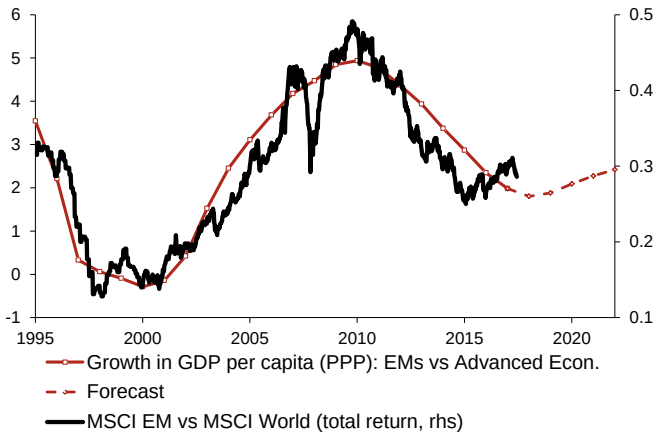
EM: Burdened by high uncertainty short-term

Over the last three months, Emerging markets (EM) have lost 8%, underperforming the MSCI World in USD dollars terms by 10 pp. The Indian market has, on the other

Graph 4: EMERGING MARKETS AND MACRO SURPRISES



Graph 5: GDP GROWTH AND EQUITIES: EMs VS AEs



EM: buy on dips. Faster GDP growth, lower valuations and recovered commodity prices to benefit EM equities beyond the short term.

hand, gained 5%. Based on multiples, the EM stocks have become appreciably cheaper and are now traded at 9.0% discount versus history. While increased commodity prices gave some support, increasing yields and EMBI spreads (62 and 50 bps, respectively) along with significantly stronger US dollar (+5.6) put EM under pressure. Judging by the "value indicator" comprised of EM fundamentals (earnings and yields), EM equities still remain a bit overvalued. Earnings have been largely revised down, the exception being earnings of the Brazilian and Russian markets, which have come about due to higher oil and commodity prices. The EM prices have, however, fallen much more than their 12-month forward earnings expectations. As a result, the market's PE based on 12-month forward earnings has come back to its historical average of 11.2 (taken from 2001). EM stocks are to be pressured in the short term further by increased financing costs (higher yields, spreads and USD), softer macro surprises and elevated uncertainty on global trade and EU woes. Especially trade tensions between the US and China continue to simmer and there remains a risk of further escalation. Generally, though, EM equities should be supported by generally better improved fundamentals compared to 2013. Once Fed expectations are repriced, the EMs are to benefit from supporting macro development, improved C/A balance and productivity growth, lower valuations and recovered commodity prices. We forecast a total return of 10% in 12 months. Risks come from geopolitical and trade frictions, a sudden substantial re-appreciation of the USD and spiking US yields. Overall, we continue to be constructive mid-term on EMs and still favor India along with Korea and CEE countries, while maintaining a prudent stance on China.

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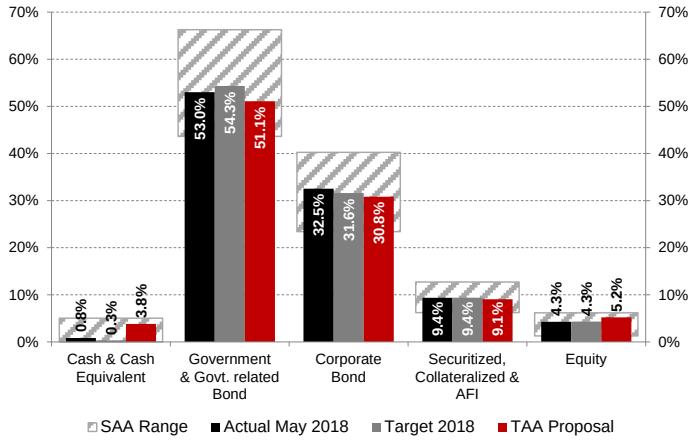
Asset Allocation

- **Political risks mainly arise from the escalating conflicts between the US and its trade partners as well as the turmoil in Italy, while emerging markets are suffering from a stronger US dollar.**
- **Despite these higher risks and weaker euro area data, the overall global economic picture remains solid, underpinned by a sustained expansion in the US. A robust economic environment, recovering inflation and central banks continuing to withdrawing support from markets still favors a prudent stance on duration, with yields likely to rise.**
- **We continue to tactically overweight equities (in life portfolios only) and cash at the expense of bonds. However, within fixed income, short maturities should be overweighed. Against the backdrop of the aforementioned risks, the recommended active positions are not fully exhausting the eligible strategic range.**

Overall economic backdrop still in favor of a tactical pro-risk stance, but less pronounced

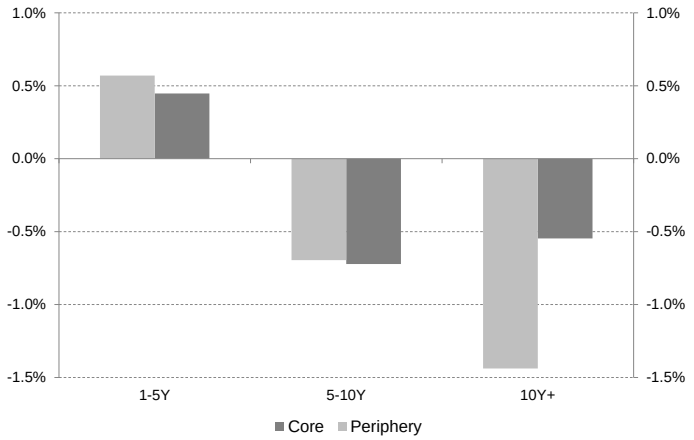
The overall framework of a still resilient global economy and further rising yields lets us confirm the basic basic alignment of the TAA proposal in favor of equities and cash at the expense of bonds (see Graph 1), however more prudently than before due to the several risk factors. Central banks' move to the exit still favors a cautious stance on duration. This prudent duration stance is consistently reflected by the active positioning across maturity buckets, i.e. the short maturities are overweighed whereas the mid to long maturies are underweighed (see Graph 2).

Graph 1: LIFE STRUCTURES AND BANDWIDTHS AT SAA LEVEL 1



Excl. Alt. Equity, Real Est., and Other Inv.; rescaled; GI perimeter

Graph 2: LIFE ACTIVE POSITIONS BY MATURITY BUCKET



In bps; Euro Area Government Bonds; Periphery = Italy & Spain

Despite a general underweight in bonds, short maturities to be overweighed

This recommendation does not only hold for core and peripheral sovereign debt but thoughout all fixed income asset classes actively in our universe, in particular covered bonds and IG corporate bonds. In the case of IG non-financials, the recommended moderate overweight is also concentrated in shorter maturity buckets. But the preference for non-financial bonds also reflects their higher attractivity vs financials in the short-term and their distinctively lower capital charge, leading to the same preference (non-fin. over fin.) in the high-yield sector.

Despite the headwinds to EMs resulting from the strong USD and the trade war, we see some value in high-rated oil producing countries in particular for hard currency denominated sovereign debt. This apllies in particular compared to financial corporates (HY as well as IG), taking into account the higher capital costs resulting from solvency requirements.

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Forecasts

GROWTH

	2016	2017	2018f	2019f
US	1.5	2.3	2.7	2.4
Euro area	1.8	2.5	2.0	1.7
Germany	1.9	2.2	1.9	1.7
France	1.1	2.0	1.7	1.6
Italy	1.0	1.5	1.1	0.9
Non-EMU	2.1	1.8	1.6	1.6
UK	1.9	1.7	1.4	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	3.2	2.6
Latin America	- 1.3	0.8	1.4	2.1
World	**3.2**	**3.7**	**3.6**	**3.5**

INFLATION

	2016	2017	2018f	2019f
US	1.3	2.1	2.5	2.2
Euro area	0.2	1.5	1.6	1.6
Germany	0.4	1.8	1.7	1.7
France	0.3	1.0	1.6	1.5
Italy	- 0.1	1.2	1.2	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**	**2.8**	**2.7**

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

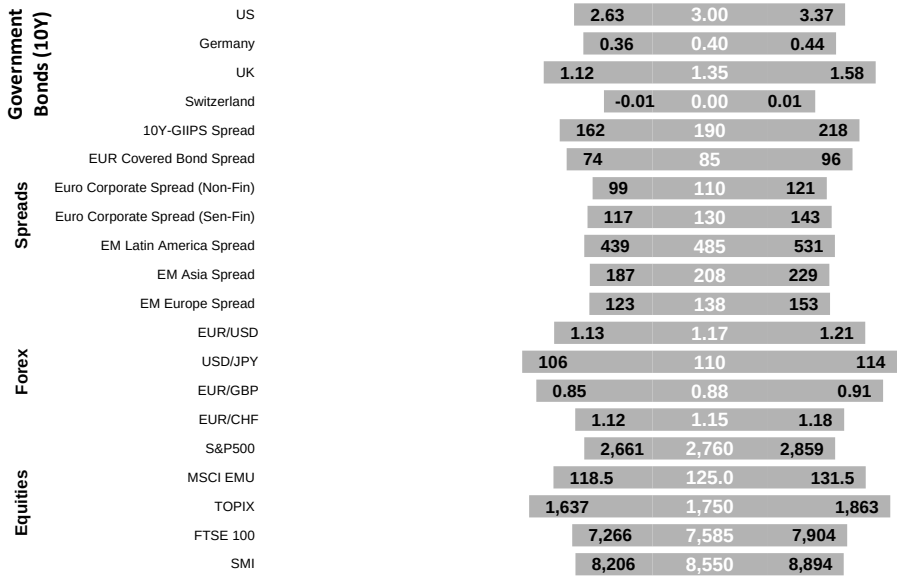
FINANCIAL MARKETS

3-month LIBOR	**Current**	**3M**	**6M**	**12M**
USD	2.34	2.45	2.70	3.10
EUR	-0.37	-0.35	-0.35	-0.30
JPY	-0.05	-0.05	0.00	0.05
GBP	0.66	0.80	0.90	1.05
CHF	-0.73	-0.75	-0.75	-0.75
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	2.89	3.00	3.10	3.25
Euro-Area	0.33	0.40	0.60	0.95
France	0.72	0.75	0.95	1.30
Italy	2.82	2.95	3.10	3.15
Japan	0.03	0.05	0.10	0.10
UK	1.31	1.35	1.55	1.70
Switzerland	-0.03	0.00	0.10	0.25
10Y Spreads	**Current**	**3M**	**6M**	**12M**
Covered Bonds	82	85	85	85
GIIPS	182	190	185	165
Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
BofaML Non-Financial	109	110	115	120
BofaML Financial	128	130	135	135

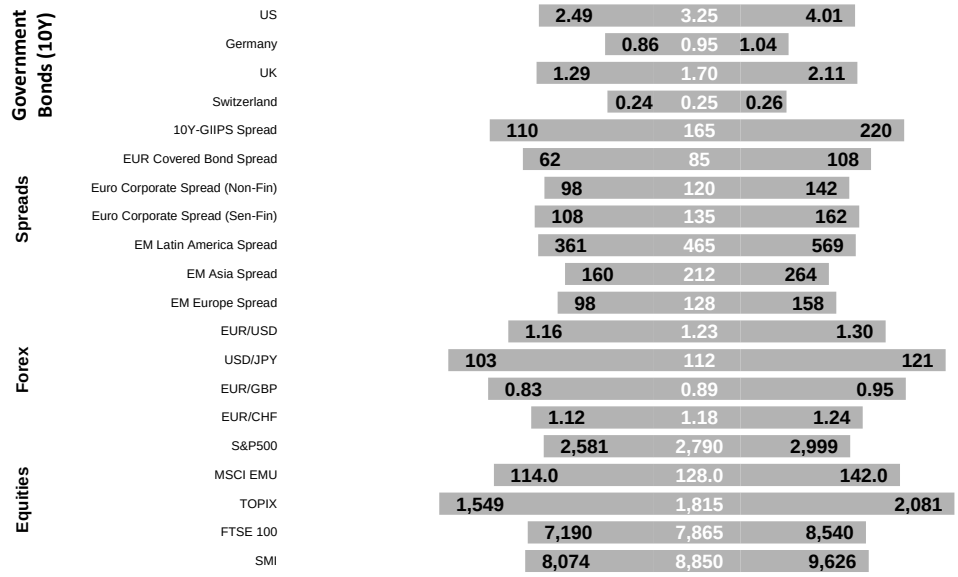
EM Gvt. Bonds Spreads	**Current**	**3M**	**6M**	**12M**
Latin America	487	485	480	465
Asia ex Japan	201	208	210	212
CEE	143	138	133	128
Forex	**Current**	**3M**	**6M**	**12M**
EUR/USD	1.17	1.17	1.20	1.23
USD/JPY	110	110	111	112
EUR/JPY	128	129	133	138
GBP/USD	1.33	1.33	1.36	1.38
EUR/GBP	0.88	0.88	0.88	0.89
EUR/CHF	1.15	1.15	1.17	1.18
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2732	2760	2750	2790
MSCI EMU	123.5	125.0	127.5	128.0
TOPIX	1735	1750	1785	1815
FTSE	7577	7585	7690	7865
SMI	8518	8550	8790	8850

As of 26.06.18 (3-day-average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON



FORECAST-INTERVAL* – 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, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

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