Q2 2018

GENERALI INVESTMENTS

Investment View

It's spring, but the clouds haven't cleared

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Global View

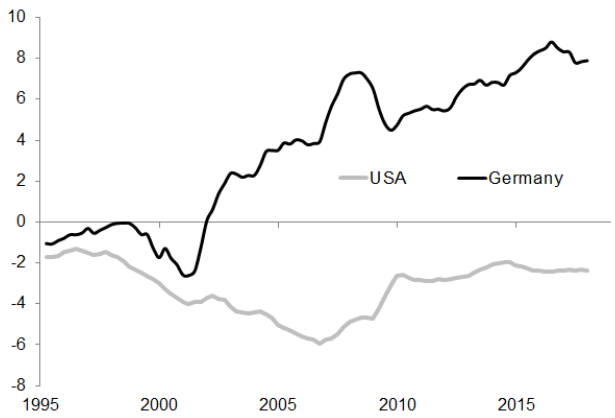
- **It's spring, but the clouds haven't cleared. Fears of a trade war and disruptive geological developments are rising and represent downside risks to an otherwise positive economic outlook. While global growth remains solid, the regional rebalancing and US fiscal stimulus create new fragilities.**
- **The pick-up in US inflation, the fiscal stimulus and ongoing dollar weakness all support the idea of a tougher Fed. We show the intimate link between the Fed stance and the financial cycle. As the Fed gets more restrictive, rates and equity volatility rise; so does the stock-bond correlation. All this should lead to de-risking and de-leveraging, keeping us rather defensive in our tactical allocation recommendations.**
- **Bond yields can rise but will not explode. For now we keep an underweight in Govies, but the aforementioned risks imply a lower degree of conviction.**
- **We still like EUR IG credit, given the technical support and negative spread correlation with Bund yields (for now). Risks in High Yield credit are too heavily skewed. We like EUR equities on a medium-term basis, but keep our overweight minimal (wait for better entry level). We tactically overweight cash and covered bonds.**

US Foreign policy hawks create downward risk for global capex and growth and upside risk for financial volatility

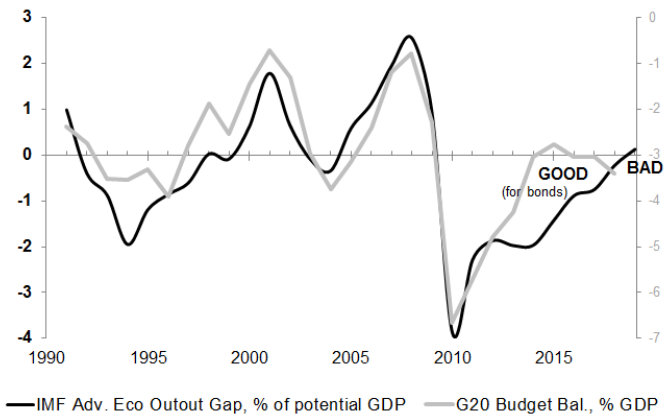
As we enter spring uncertainty has increased by a few notches, not least because President Trump's actions are raising fears of a trade war and disruptive geological developments. Sanctions on Steel and Aluminium are seen as having minimal impact on the global economy, but actions against China on intellectual property are more significant and may be a factor of escalation. So far Trump has focused on China, but pressure on Europe, not least Germany and its near-8% current account surplus (Graph 1), is also mounting. Trade wars are a lose-lose strategy and would potentially hurt growth while boosting inflation. The turnover in the US Administration is also a cause for concern, as the influence of trade and geopolitical hawks is clearly growing. For instance the nomination of John Bolton as national security adviser sharply increases the threat that the US will withdraw from the Iran nuclear deal.

In our 2018 Outlook we warned about tougher market conditions and meagre financial returns over 2018; the above geopolitical developments only make the outlook for risky assets (equities and credit in particular) a touch more challenging.

Graph 1: CURRENT ACCOUNT BALANCES, % OF GDP



Graph 2: FISCAL POLICY NO LONGER CONTRA-CYCLICAL



Global economy solid but disruptive forces are mounting

World growth set to be stable (and strong) in 2018, but regional rebalancing creates new risks

The global economy remains solid, but as we said before, the growth-inflation mix is deteriorating. US inflation has started to surprise on the upside, e.g. the core CPI has been running at a 3.13% annual pace in the three months to February. Positive economic surprises in the Eurozone and China in 2017 will not be

repeated this year; if anything, surveys show that growth in the Eurozone is cooling off from the booming pace of H2 2017. True, the US and EM ex-China will grow faster this year, so that world growth should be fairly stable. This rebalancing however creates new fragilities in the system:

US fiscal stimulus will tend to make the Fed more hawkish

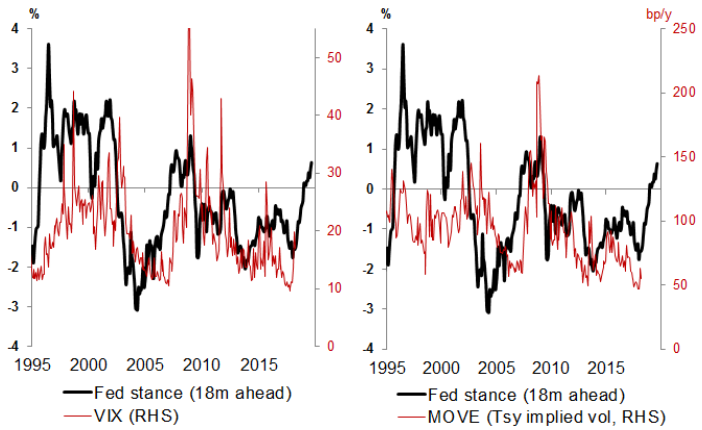
Increased risk of 'boom and bust' scenario

- First, the size of the US fiscal stimulus is unprecedented at such an advanced stage of the cycle (second longest ever US growth cycle). Already European rules had injected some pro-cyclicality in fiscal policy; President Trump's policy choices strongly add to that (Graph 2). The easing of fiscal policy, just when global overcapacities are quickly vanishing, could push inflation, and bond yields, higher. The fiscal stimulus will surely make central banks – at least the Fed – more hawkish. Already Fed speakers have talked up the risk of overheating in 2019, and the blue dots are crawling higher. In short, the risk of a 'boom and bust' scenario has increased. Finally, the boost to US demand also risks widening the US current account, making President Trump potentially more hawkish on trade.

Unusual FX response to rates will widen the gap between Fed and ECB/BoJ

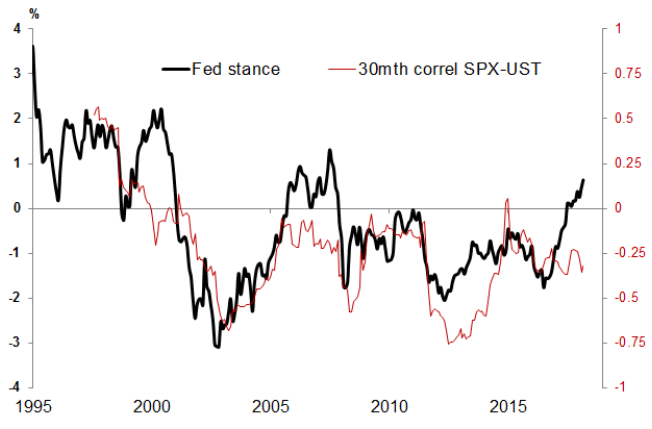
- Second, the US twin deficit partly explains recent US dollar losses, despite an absolute and relative rise in US yields. The breakdown between rates and FX is also a source of instability. A 'normal' FX response would have seen a stronger US dollar, which all else being equal would make the Fed more prudent. A weaker euro and yen would have helped the ECB and BoJ normalise policy a bit faster. Instead, the unusual FX response will widen the gap between the Fed and the others (ECB and BoJ), and this wide split we fear will create FX volatility. The widening lag and interest rate gap make the hedge of FX positions even more expensive for European and Japanese investors willing to buy Treasuries. The recent US money market tensions also add to the hedging cost. This makes Treasuries even less attractive for international investors and puts more upside pressure on UST yields.

Graph 3: TOUGHER FED STANCE WILL SUPPORT RISE IN VOLATILITY



Fed stance: 2y real rate minus R* (Laubach-Williams One-Sided)

Graph 4: STOCK-BOND CORRELATION SET TO RISE AS FED TIGHTENS



Fed stance: 2y real rate minus R* (Laubach-Williams One-Sided)

Fed stance about to hit financial cycle

Fed's rate normalization will support recovery in both rates and equity volatility

The Fed delivered another rate hike in March, as widely expected. With the Fed target range at 1.50-1.75%, policy rates are still low by historical standards. However, if we trust generally accepted estimates of the natural rate of interest (R*), policy is actually starting to enter restrictive territory. The implications for global markets are considerable. As Graphs 3 indicates, rates and equity volatilities tend to track the Fed stance with a lag of about 18 months. If history is any guide, they should start to pick up now. Possibly the fiscal stimulus and easy ECB/BoJ policies will create some more space and delay that adjustment. But the rise in equity volatility this year suggests that the ball has started to roll already.

Bond-stock correlation to rise as Fed continues to tighten, leading to de-risking and de-leveraging

Most importantly, as the Fed gets more restrictive, the correlation between bonds and stocks tend to rise and switch to positive (Graph 4). This is clearly not helpful for diversified portfolios, which execrate a concomitant drop in stock and bond prices. The rise in correlation usually leads to de-leveraging and de-risking, adding to negative market developments.

Table 1: MACRO FORECASTS

	Growth			Inflation		
	2017	2018f	2019f	2017	2018f	2019f
US	2.3	2.7	2.4	2.1	2.2	2.3
Euro area	2.5	2.3	1.8	1.5	1.4	1.6
Germany	2.5	2.3	1.7	1.8	1.7	1.9
France	1.7	1.9	1.7	1.1	1.2	1.5
Italy	1.5	1.3	0.9	1.3	1.1	1.2
Non-EMU	1.9	1.8	1.6	2.5	2.5	2.2
UK	1.8	1.6	1.5	2.7	2.7	2.3
Japan	1.6	1.5	1.3	0.5	1.0	1.1
Asia ex Japan	6.1	6.0	5.9	2.2	3.0	2.9
China	6.9	6.5	6.2	1.6	2.4	2.1
CEE	3.7	3.1	3.2	5.0	4.6	4.9
Latin America	0.9	1.8	2.3	4.3	3.8	3.7
World	3.7	3.7	3.6	2.3	2.7	2.7

Annual changes, in %

Table 2: FINANCIAL MARKETS FORECASTS

10-Year Bond Yields	**Current***	**3M**	**6M**	**12M**
US	2.86	3.00	3.05	3.20
Germany	0.55	0.70	0.85	1.05
Italy	1.90	2.10	2.30	2.55
Japan	0.03	0.05	0.10	0.25
Forex	**Current***	**3M**	**6M**	**12M**
EUR/USD	1.23	1.26	1.28	1.30
USD/JPY	106	105	106	109
EUR/GBP	0.87	0.88	0.89	0.90
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	2648	2680	2705	2725
MSCI EMU	122.2	120.5	125.0	127.5

*current as of March 23, 3-day average

Allocation recommendations

Bond yields still heading north, if slowly

10-year Treasury yields are threatening to break above a descending canal in place since 1990. A break would be a negative technical signal. Although the aforementioned trade/geopolitical risks make the bearish bond case less compelling, we retain a defensive view on government bonds. This is tactically expressed in both an underweight in Govies and a short duration bias. To be clear, though we expect 10-year Treasury and Bund yields to trade above their forwards in 12 months, we see the rise as moderate. We attach a very low probability to an explosion towards 'old normal' levels, if only because global non-financial leverage is at a record high (the economy could not afford a large rise in yields) and risky assets would react negatively (flight-to-quality and liquidity would cap bond yields). In other words, the right-end tail of the distribution for 'risk-free' yields is very thin.

On a medium-term basis, prefer equities to govies and credit. Prefer EUR credit over US

High-quality euro area High Grade credit spreads have remained directional, i.e. they have widened as Bund yields retreated from the mid-February peak. Such negative correlation between risk-free yields and credit spreads offers diversification benefits for now, and IG yields have been fairly stable in EUR. We recommend a small overweight there, as the ECB's purchases and the sound fundamentals still offer support for now. Slowly decrease exposure as we approach the end of CSPP (expected in Q4 2018) and plan to switch from non-financials towards financials in H2. Our total return expectations for high-yield credit are similar to those for IG, but the risks in HY are heavily skewed to the right side, supporting an underweight. We retain a small overweight in European equities, given the positive 12-month total return expectation, yet fear near-term losses – hence our preference for defensive strategies. As we warned after the flash crash of early February (Was it just a bad dream?), a test of 2500 (S&P500) in spring/summer looks more likely than not. We are news-dependent, but will treat that as a buying opportunity.

Our biggest tactical allocation overweights go to cash and covered bonds just now, as we look for better entry levels in other asset classes in spring and summer

Our biggest tactical allocation overweights go to cash and covered bonds just now, as we look for better entry levels in other asset classes in spring and summer. We keep a positive exposure towards inflation (mind the oil price).

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Macroeconomic Outlook

- **The global economy continues to grow healthily, with solid domestic demand in the advanced economies complemented by a pick-up in growth in EM economies.**
- **That said, the Goldilocks environment is getting increasingly challenged by mounting price pressures and a maturing cycle in the advanced economies. Euro area growth is plateauing, while the expansion in the US is likely to ease only next year thanks to the tailwinds from the tax reform.**
- **Inflation pressure is building on closing output gaps, supported by higher oil prices. This will be most visible for the US, but also in the euro area underlying inflation is set to trend higher over the months to come.**
- **Central banks will become more assertive on monetary policy normalization. Following the March hike, we expect the Fed to lift its key rate by another cumulated 75 bps this year. The ECB will in our view end QE in autumn and prepare markets for a first rate hike next year.**
- **The biggest risk to our constructive scenario is the emergence of a trade war given the latest US actions.**

Solid domestic demand in the advanced economies is supported by a pickup in growth in EMs ex China

The global economy remains on a sound footing, with the synchronized expansion still having legs. Consumption in the advanced economies remains underpinned by employment growth and a pickup in wages, while investment is recovering globally. Forward-looking indicators remain at elevated levels. Somewhat slower growth in China will be more than offset by accelerating activity in Brazil, India and Russia. More generally, emerging markets ex China are supported by recovered commodity prices and lower policy rates. The weak dollar is helping, too, stimulating smaller open EM economies via exports, with demand for international goods and services – often priced in USD – growing.

That said, forward-looking indicators have become toppish, while rising price pressure strengthens the case for policy normalization.

Compared to December, however, the growth/inflation mix has deteriorated. Indicators for the advanced economies look toppish and have disappointed (upgraded) expectations more recently, especially in the euro area. The announcement of tariffs by US President Trump has raised the risks to growth from an outright trade war (see below). Meanwhile, inflation pressures – especially in the US – are mounting, strengthening the case for faster monetary policy normalization, even though the ECB and the Bank of Japan have signaled to still proceed very cautiously. In a nutshell, the still prevalent Goldilocks scenario of decent growth and muted inflation is getting increasingly challenged.

US tax reform delays moderation, euro area growth plateauing

US tax reform to lead to stronger growth in 2018

Following a steady recovery after the Great Financial Crisis, US output was 16% above the pre-crisis level with the output gap closed at the end of 2017. Expansion is still set to accelerate somewhat further this year, thanks to the US tax reform that entered into force in January 2018. Moreover, in February additional Federal spending was decided by the Congress. This large fiscal boost occurs at a time when the labor market is already running hot. Since October, the unemployment rate has been resting at 4.1%, the lowest level since late 2000, while new jobs are still being created at a strong pace (February saw a 313k increase in non-farm payrolls). Hence, consumption activity will remain well supported. Investment activity shows signs of strengthening anyway as skill shortages increasingly emerge, supporting labor-saving investment. With the tax reform as an additional driver, capital expansion will take a key role in pushing activity. All in all, we see US growth to accelerate to 2.7% in 2018, from 2.3% last year. Looking further down the road the boost from the tax reform will weaken. We see growth moderating to 2.4% in 2019, which is still above potential, though.

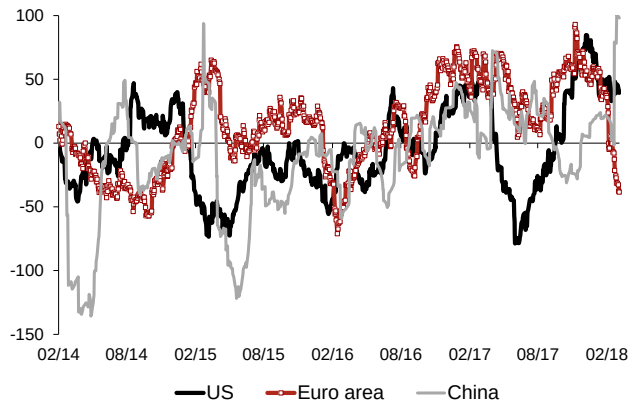
With a reading of 2.5% in 2017, euro area growth was the strongest since 2007. This cyclical upswing was backed by a supportive global environment and the extremely accommodative monetary policy stance of the ECB over the past few years.

With solid employment creation (+0.3% qoq in Q4/2017) underpinning consumption activity and investment growth, euro area growth stands on a sound footing.

Euro area growth to moderate in 2018 but to stay solid

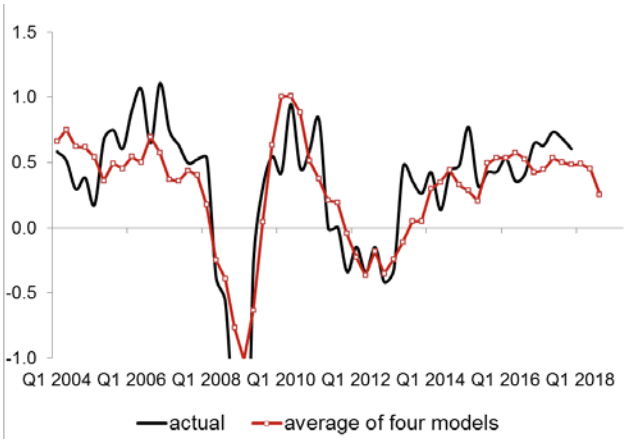
However, most recently key sentiment indicators like the PMI weakened significantly. While growth will remain solid, the momentum is easing. With the euro area output gap likely closed this year and with the effective euro likely to strengthen further (after rising by an average of 1.2% per month since November), a cyclical moderation looks imminent. Moreover, the impulses from monetary policy will peter out. Therefore, we see quarterly growth rates to soften from the 0.6% qoq seen at the end of last year but to remain in line with growth at or above potential. For 2018 and 2019 and we look for annual growth rates of 2.3% and 1.8%.

Graph 1: ECONOMIC DATA SURPRISES VS EXPECTATIONS



Citi economic surprise index

Graph 2: EURO AREA: EXPECTATIONS PREDICTING GROWTH



Euro area GDP, % qoq, act. and estimated by forward-looking indicators

Inflation pressure to unfold more meaningfully

Underlying inflation pressure to increase in the US as well as the euro area

Inflation remained muted over the last few years. In 2015, global inflation fell to a low of 2.2% and had recovered to just 2.3% in 2017. For 2018 and 2019 we expect it to strengthen on a global scale. A key factor is higher oil and commodity prices as a result of a synchronized global upswing. With the output gap being closed (euro area) or even positive (US), cyclical price pressure in the advanced economies will rise. Moreover, in the US the unwinding of (telecom related) base effects in March will lead to a visible rise in annual CPI inflation (Feb.: 2.2% yoy) as well as the core inflation (Feb.: 1.8% yoy). In the euro area, the strong euro dampens import prices. However, survey evidence points to rising underlying price pressure and we expect core inflation to rise to 1.5% yoy towards year-end, up from 1.2% yoy now.

Monetary policy normalization ahead

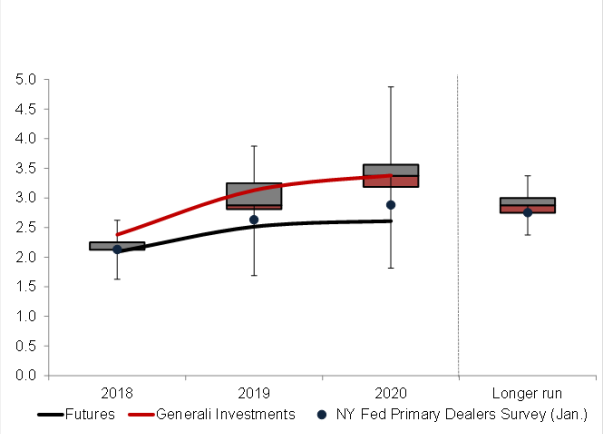
Fed to lift key rate four times in 2018, ECB to end QE and to prepare first rate hike

In an environment of solid growth and higher trending inflation, monetary policy support will be reduced. This concerns first of all the US, where the Fed lifted its key rate to the 1.5% to 1.75% corridor in March. Fed officials recently showed increased confidence in recovering inflation and adopted a more hawkish tone. We expect more and more FOMC members to see the need for further hikes and look for three additional rate increases (to 2.25%- 2.5%) this year.

In contrast, the ECB is at a much earlier stage. While still conducting QE (buying € 30 bn per month at least until September), it dropped the QE easing bias at its March meeting but also stroke a dovish tone highlighting the downside risks to inflation. We

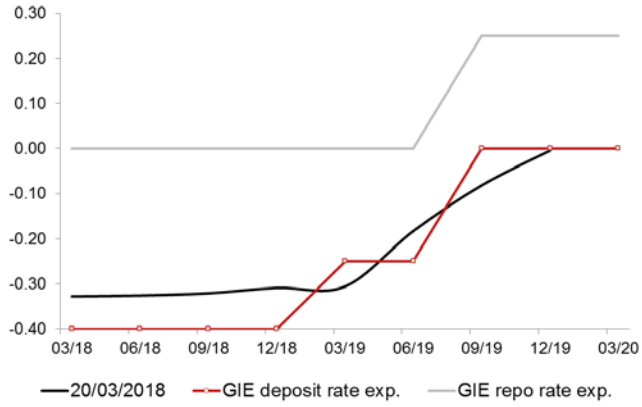
continue to expect that the ECB ends QE in Q4 2018 and look for a first deposit rate hike only in H1 2019 (from -0.4% to -0.25%), followed and a 25 bps rate hike in H2 2019 (lifting the deposit rate to 0.0% and the repo rate to 0.25%).

Graph 3: PROJECTOINS OF THE FED FUNDS RATE



Year-end, box plots refer to projections by FOMC members

Graph 4: ECB MONETARY POLICY EXPECTATIONS



3-month Euribor implied by OIS vs GIE policy rate expectations

Trade war a key risk to the outlook

US-Chinese trade war a major risk for global activity

Our overall benign global macro scenario rests on the assumption that recent trade tensions between the US and its trading partners do not escalate into a broad trade war. However, more recently President Trump announced across-the-board tariffs of 25% and 10% on steel and aluminum imports, hinting to exceptions to EU countries. The 2017 US goods trade deficit likely was at 4.2% of GDP. President Trump wants to reduce it and argues that other countries make use of unfair practices. Moreover, further trade restrictions were announced against China, mainly related to controversies on intellectual property. However, Chinese officials declared that they would retaliate in case the announced tariffs become effective. As a result, if worse comes to worse, the conflict may turn into a broader trade war. This would have undoubtedly negative effects on growth while boosting inflation. Markets and firms have digested various political uncertainties in 2017 well but a trade war would go at the heart of globalization. Therefore, already the threat of a trade war alone bears the risk of eroding confidence and dampening activity.

A second, more medium-term factor that needs to be watched carefully is the progress European leaders make on the overhaul of the EMU architecture. According to the EU Leader's Agenda, the aim is to take key decisions at the Council meeting on June 28/29. We view progress towards a banking union (especially in the fields of NPLs and deposit insurance scheme) as inevitable for the medium term stability of the euro area and look for an agreement on this issue. Also, we deem the establishment of a European Monetary Fund likely. Far-reaching proposals towards some kind of common fiscal policy could ease EMU fiscal policy but are highly unlikely to find the needed broad-based political support. The inability of leading politicians to bridge their differences regarding the completion of the banking union is a key political risk to us, even though the near-term consequences would be much less severe than the risk from escalating trade tensions.

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Fixed Income

- **Particularly US government bond markets came under pressure in the first quarter as both monetary and fiscal policy contributed to higher yields. Euro area bond markets could not escape this tendency and the curve bear steepened.**
- **Although the current positioning can remain an obstacle in the near term, the way is paved for higher yields on both sides of the Atlantic given the robust economic environment and less accommodative central banks.**
- **Although euro-sceptical parties prevailed in the Italian elections, peripheral government bonds have performed better than euro area core bonds since the start of the year. However, the current complacency of financial markets is unlikely to continue and Southern European bond spreads are seen to widen moderately in the second quarter.**

Bearish environment triggers weakest performance of US Treasuries in a first quarter since 1999

International government bond markets had a weak start into 2018. Yields rose strongly across all tenors in the first weeks of the year. Even the temporary turbulence on equity markets and the rise in volatility did not trigger a lasting flight to quality. The main reason for the development was the extraordinary experiment by the US administration which switched to an expansive fiscal policy although the economy is already operating close to full capacity. Consequently, the Fed signaled a more hawkish stance given the increasing inflation pressure. In contrast, the ECB adopted an all in all dovish tone in the first quarter. This contributed to a moderate setback of euro area yields towards the end of the first quarter.

On balance, US yields rose by around 40 bps in the first quarter. Due to the repricing of the future Fed policy by financial markets particularly short-dated yields increased and triggered a moderate flattening of the US curve. In the euro area, the belly of the curve suffered most with 7-year yields rising by around 15 bps. Very short-dated yields moved sideways on balance and very long-dated yields even decreased slightly. It is noteworthy that the increase in nominal yields is almost entirely due to higher real yields. Inflation expectations hardly moved upwards in the US and fell slightly in the euro area.

Financial markets still underestimate future Fed hikes

Extraordinary economic experiment in the US: Expansive fiscal policy in an economy close to full employment will pave the way for a further yield increase

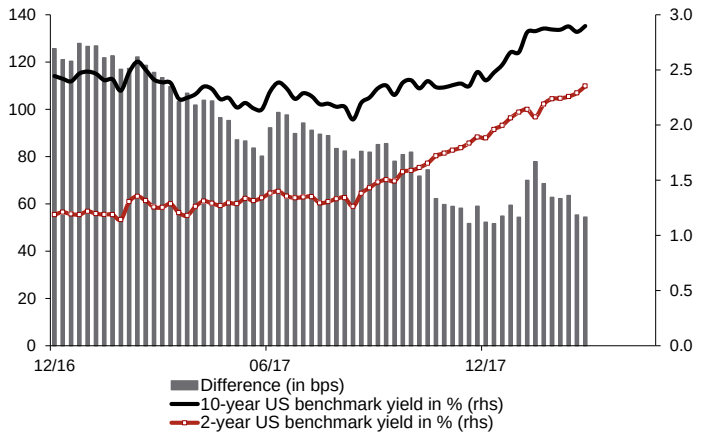
Given the unusual economic environment characterized by a combination of easier US fiscal policy and an economy growing above potential, the way is paved for higher yields going forward. To start with, although financial markets' expectations have adjusted already upwards in recent months, the future key rate hikes are still not priced adequately. We expect that the Fed will switch to quarterly hikes for the time being and forecast an upper bound of the Fed Funds Rate of 3.25% by the end of 2019. While financial markets have only discounted three to four additional hikes until the end of next year, there appears to be scope for six further steps in this time.

Moreover, the current term premium is still close to zero. Taking into account future key rate hikes, the strong increase in Treasury supply (taking into account the expansive fiscal policy and the Fed's shrinking balance sheet) and higher inflation pressure, this is hardly sustainable. In fact, based on current variables, our term premium model already indicates a valuation gap of around 30 bps. This is the strongest deviation for 13 years. Not least due to the forecast increase in bond market volatility the term premium is likely to rise going forward and will contribute to an increase in longer-dated US yields.

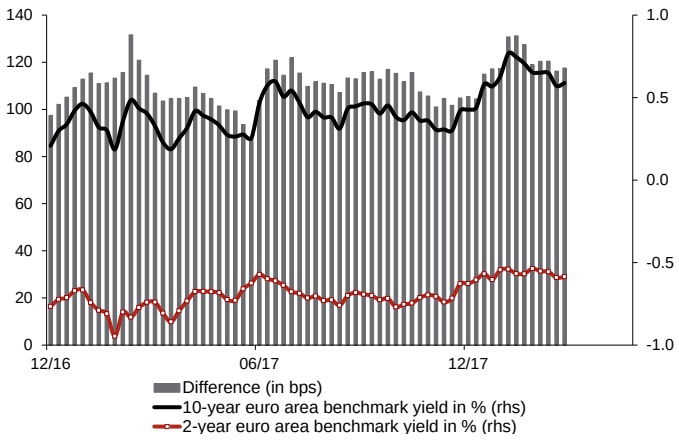
But, one caveat applies. Higher US yields is a consensus view and financial markets are already positioned for this development. Currently, there is the second strongest net-short positioning of non-commercial traders over the last 10 years. While this is expected to remain a strong constraint in the short run, it is unlikely to prevent higher yields in the medium term. On a 3-month horizon, we forecast 10-year US yields to achieve the 3% threshold and to rise further to 3.20% on a 12-month view. Although

markets are pricing already a further flattening of the 3-yr/10-yr curve to 25 bps, there is scope for a flattening towards 15 bps given the more hawkish Fed stance.

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



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



Dovish ECB to limit any yield increase in the euro area – for the time being

Despite the increase in recent months, the most noteworthy feature of euro area core yields is the extremely low real yield level. As inflation pressure is seen to rise only sluggishly in the euro area, the forecast yield increase is likely to be driven by higher real yields. And there is ample scope for higher real yields: both the 10-year real yield at -0.90% and the 5-year 5-year forward real yield at -0.40% are hardly sustainable. What is more, although the ECB actions in the medium term are fairly priced (one repo hike in 2019), the longer-term outlook is much too cautious. Taking the 4-year 1-year forward yield as a proxy for the expected terminal ECB key rate, the current level of around 0.70% is much too cautious.

To sum up, there is scope for euro area core yields to rise going forward. While the asymmetric reaction to macroeconomic data releases indicates a short positioning of financial markets, the toppish macroeconomic indicators are a headwind for higher yields in the near term and the high hedging costs for US-dollar investments will increasingly divert funds into the euro area, the upward trend is expected to prevail. Although a flattening of the 3-year/10-year curve is unlikely in the short run, as soon as the ECB shifts gears and signals an end of the very accommodative monetary policy stance, the yield curve has scope to flatten.

Difficult election result in Italy ignored by financial markets

The spread of Southern European government bonds tightened significantly and are currently trading close to long-term lows. Even the BTP/Bund spread narrowed considerably in the first quarter. The challenging election outcome in Italy including the unexpectedly strong appearance of euro-skeptical parties in the general elections did not impact financial markets lastingly.

Noteworthy complacency by financial markets given the strong result of euro-skeptical parties in the general elections in Italy unlikely to prevail

In the short term, the political developments and particularly the formation of a new government will be the main factor determining the future path of the BTP/Bund spread. However, as euro-skeptical parties have eased their stance on an Italexit recently and due to the continuation of a cyclical recovery, any potential spread widening is likely to remain limited. Still, a government led by a euro-skeptical party would leave its mark and is likely to trigger a spread widening. This applies even more as a drop in budgetary consolidation efforts looks quite likely – if the election program of the several parties is any guide.

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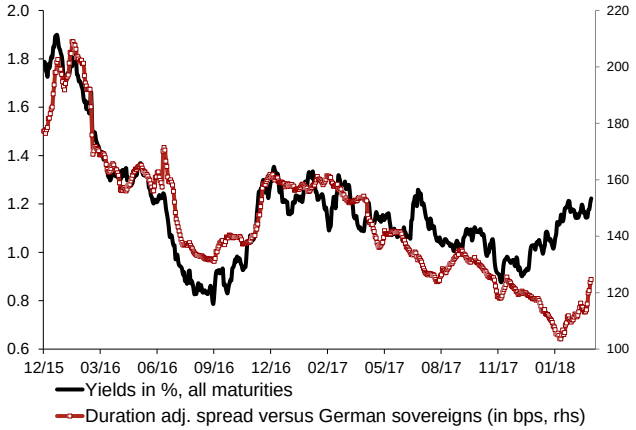
Corporate Bonds

- **After a strong start into the year euro area corporate bonds came under pressure and spreads widened. The increase in underlying yields also contributed to higher corporate yields, which have reached the highest level since summer 2017.**
- **While any further spread widening is expected to remain contained in the short term, the environment is seen to deteriorate in the medium term. Hence, investors should position for a more significant spread widening from H2 onwards.**
- **Financial bonds continued to underperform Non-Financial ones, mainly due to the first quarterly loss of Subordinated bonds since Q3 2015. After the recent sell-off, we upgrade Subordinated bonds vis-à-vis Senior ones back to neutral.**

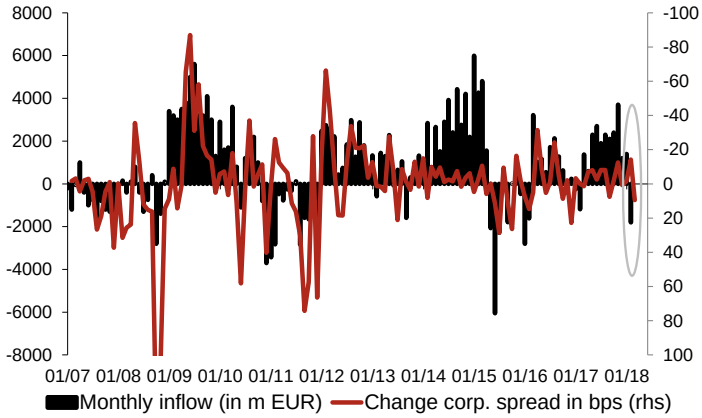
Roller coaster ride of IG corporate bond spreads in Q1 – Long-term trough marked at the beginning of February not sustainable

At the start of the year, euro area IG corporate bond spreads continued its strong performance and marked a new long-term trough at the beginning of February. However, since then spreads have widened significantly in the wake of toppish macroeconomic indicators, concerns about an escalation of lingering international trade tensions and – most recently – a strong increase in new issuances. On balance, euro area IG corporate bond spreads have widened by 10 bps to 128 bps since the end of 2017. Moreover, the upward movement of government bond yields triggered higher corporate yields as well (from 1.04% to 1.21%). Overall, since the end of last year, euro area IG corporates have achieved a total return of -0.6%.

Graph 1: IBOXX EURO AREA IG CORPORATE BONDS



Graph 2: EUROPEAN CORPORATE IG FUND FLOWS



Source: JP Morgan

The sound fundamental situation of euro area corporates in combination with the ECB's Corporate Sector Purchase Programme (CSPP) is likely to keep the current goldilocks scenario alive for the time being. But, given the still ambitious valuation, the scope for a considerable spread tightening in the months to come appears limited.

Receding fund inflows in combination with forthcoming termination of the CSPP and increased net issuance do not bode well for corporate bonds in the medium term

Rather the medium-term outlook is challenging as the environment is seen to become more difficult. To start with, the correlation between government yields and corporate spreads has become positive in recent years. In light of the increased level of net debt, corporates are likely to be negatively affected by the forecast increase in yields. Moreover, taking into account the strong relationship between historic returns and fund inflows, the meagre return does not bode well for future inflows. The chart above signals that this will burden corporate bonds going forward.

Lower quality to be favored over longer duration

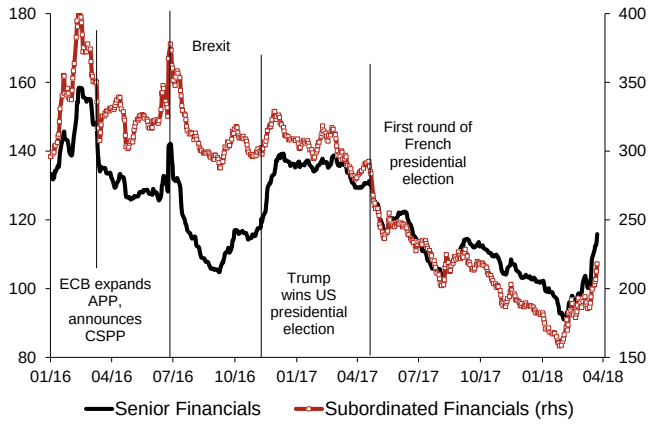
The high capacity utilization will ultimately trigger higher corporate investments and a stronger issuance activity. What is more, the ECB will most likely withdraw from the

CSPP in autumn. Hence, the lower forecast fund inflow comes at a bad time. On a 1-year horizon, there is scope for an additional spread widening of euro area IG non-financial corporate bonds to around 140 bps (from 119 bps currently).

To secure an adequate current income level investors should prefer low-rated bonds versus long-dated ones

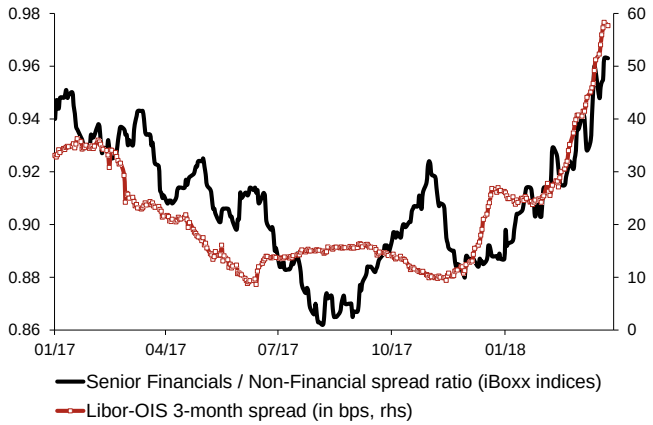
In this environment, investors should already position for rising spreads. As a considerable deterioration of the fundamental outlook is not in sight, but the way is paved for higher yields, we recommend favoring low-rated corporates over longer maturities. Moreover, a weighted barbell strategy (HY and A-rated corporates) offers a similar current income as a BBB bullet strategy, but tends to outperform in periods of increasing spreads. Finally, in the medium term, non-financials are seen to underperform financials given the termination of the CSPP and increasing yields.

Graph 3: IBOXX EUR-DENOMINATED IG FINANCIAL BOND SPREADS



Spread vs German Bund (duration-adj.), in bps

Graph 4: SENIOR FIN. / NON-FINANCIALS SPREAD RATIO AND LIBOR-OIS SPREAD



Widening Libor-OIS spread in the US weighing on Financials

EUR IG Senior Financial corporate bonds slightly underperformed Non-Financials in Q1 2018 for the third quarter in a row. The duration-adjusted spread increased by 14 bps to 116 bps, the highest level since June 2017. The underperformance was mainly driven by the ongoing ECB purchases of Non-Financials and the sharp increase in the Libor-OIS spread in the US (see Graph 4), a market stress indicator signaling concerns over the shortage of US dollars in the system. The latter was caused by the cash repatriation encouraged by the US tax reform and the faster-than-expected policy normalization by the Fed. While this factor can continue to weigh on Financials for some time, we do not expect any major underperformance vs Non-Financials thanks to solid growth and still falling sovereign spreads in the euro area. We foresee a sideways spread movement for Senior Financials over 3 month (iBoxx duration-adjusted spread to 115 bps) and a mild widening over a 1-year horizon (to 130 bps).

After the recent sell-off, Subordinated bonds look more attractive vis-à-vis Senior ones, we upgrade then back to neutral.

In this context, Subordinated bonds suffered the first quarterly loss in total return terms (-1.51%) since Q3 2015 as the duration-adjusted spread widened by 36 bps to 218 bps. After the recent selloff, we terminate the slight underweight position on Subordinated bonds vs Senior ones initiated at end-October 2017. Subordinated bonds can outperform Senior bonds by 50-100 bps in total return terms over a 1-year horizon thanks to the reduced leverage and rising profitability.

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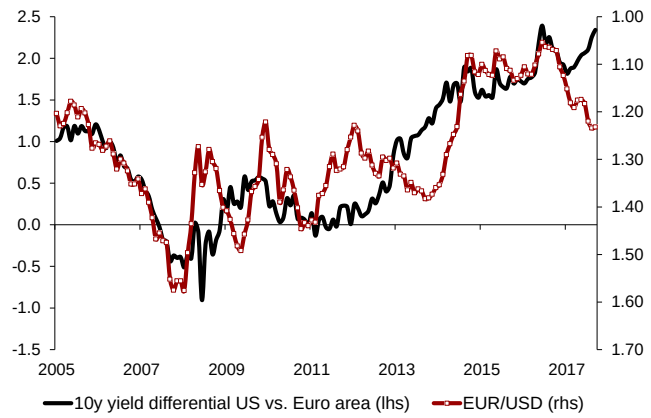
Currencies

- **The first quarter of this year witnessed a striking collapse in correlations between yield differentials and FX moves. Despite a continued rise in US rates, the USD weakened against the EUR and even more so against the JPY.**
- **Looking ahead, we anticipate the EUR/USD to rise further over the rest of this year closer to 1.30. This is largely due to marked support to the euro from capital inflows, anticipated global reserve diversification and the ECB's looming termination of QE in Q4 and a subsequent first rate hike next year.**
- **Pressures on the US dollar may ease but are unlikely to vanish. A rising twin deficit (current account and fiscal balance) and political uncertainties are likely to prevent the USD from benefiting from continued rate hikes by the Fed.**
- **The JPY/USD will remain supported short term by trade uncertainties and Japan's strong current account position. That said, with a first rate hike by the BoJ still far distant, the yawning yield gap with the US should keep it on a moderately weaker side on a 12-month view.**

The US dollar has been beaten by perhaps excessive pessimism regarding US politics

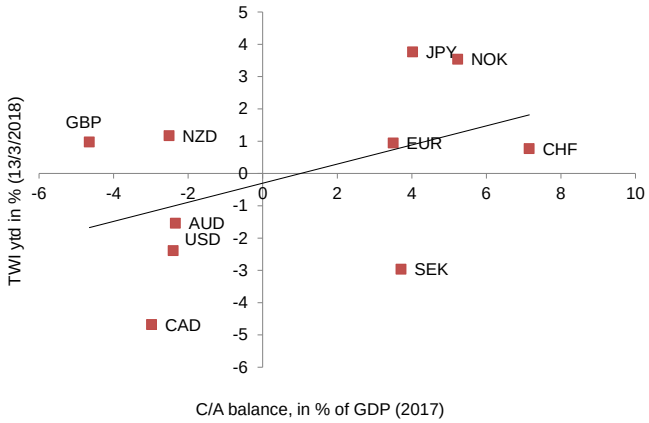
In a striking move, the US dollar decoupled from long-standing correlations with international yield differentials at the start of this year. Despite a rise in US yields and a more hawkish Fed outlook, the US dollar broadly weakened against other major currencies. The JPY/USD rallied by more than 7% year-to-date (as of March 23), while the EUR/USD has gained 3%. An outright trigger for this sharp divergence from the gravity of yields is hard to fix. But with global central banks pursuing a normalization of their ultra-accommodative policies, fundamentals come back into focus again. Year-to-date, currencies backed by current account surpluses have tended to outperform (see Graph 2).

Graph 1: YIELD DIFFERENTIAL AND EUR/USD



Yield differential in pp

Graph 2: CURRENCIES BACKED BY C/A SURPLUSES OUTPERFORMING



EUR/USD to trend upwards

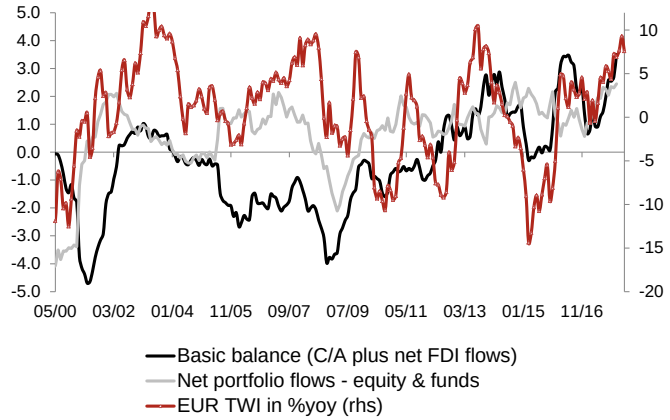
Looking ahead, we expect the EUR/USD to trend further upwards. Markets have widely shrugged off political risks for the euro area arising from the hung parliament in Italy after the March elections. While these uncertainties will continue to linger, progress on EU integration (steps towards a banking union, extension of ESM competencies) are likely to reassure investors about the political resilience of the euro area. This will likely also underpin foreign direct investments and equity flows into the euro area which – apart from the current account surplus – have been an important support for the euro over the past quarter (see Graph 3, next page). And while the

ECB has softened its tone somewhat to the dovish side recently, we still see it on a sustained path towards policy normalization. With the end of QE in Q4 approaching and the ECB preparing markets for its first rate hike since mid 2011, we expect the euro to benefit from the exit from the ultra-accommodative stance by the ECB.

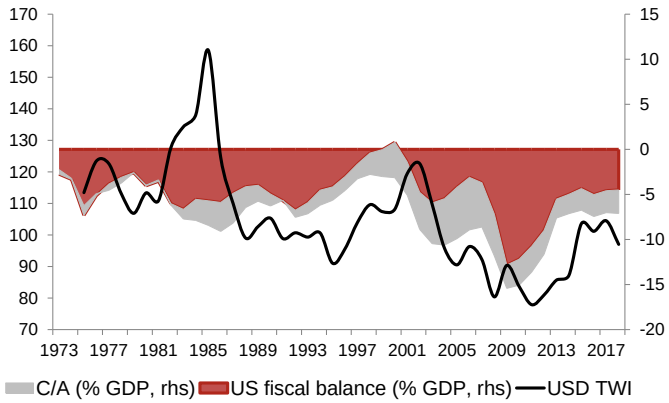
Pressures on USD to soften but not to fade

Reversely, while pressures on the US dollar may moderate thanks to improving growth and a more hawkish Fed, political risks and a rise of the twin deficit (current account plus fiscal balance) are likely to remain a burden to the US dollar. Additional moderate upside pressures on the EUR/USD may also result from a diversification of USD holdings by global reserves managers, with the share of reserves held in EUR still at depressed levels and confidence in the euro area recovering. Overall, we see the EUR/USD trending towards levels around 1.30 over a 12-month view.

Graph 3: EXTERNAL BALANCE ITEMS AND TRADE-WEIGHTED EURO



Graph 4: US TWIN DEFICITS AND US DOLLAR



External balance items as 12-month rolling sum, in % of GDP

Yen up on global trade concerns, but to soften medium term

JPY a good hedge against the threat of a global trade war; but the base case is for medium term weakness

The Japanese yen has been in strong demand this year, thanks to healthy Japanese growth, a stronger market focus on fundamentals and mounting concerns about trade frictions after US president Trump announced the introduction of tariffs. In fact, the risk scenario of an outright escalation of these announcements into a global trade war may easily push the USD/JPY below the 100 threshold. Short-term, we expect the yen to maintain its recent gains on lingering trade concerns. Further out, however, we deem the sharp divergence from yawning yield differentials vs. the US as not sustainable. With the Bank of Japan remaining the clear laggard in the global trend towards monetary policy normalization, we see the USD/JPY at levels closer to 110 on a 12-month horizon.

GBP/EUR to weaken, but the outlook has improved after the transition deal to smooth the implementation of Brexit

We still believe that GBP/EUR is likely to weaken, due to broad-based euro strength. Brexit uncertainties and economic underperformance of the UK. That said, the transitional deal reached with the EU, including a compromise on Northern Irland, and an anticipated rate hike by the BoE in May have limited the downside to sterling. As a result, we have lowered the 12-month forecast for EUR/GBP to 0.90 from 0.92 before.

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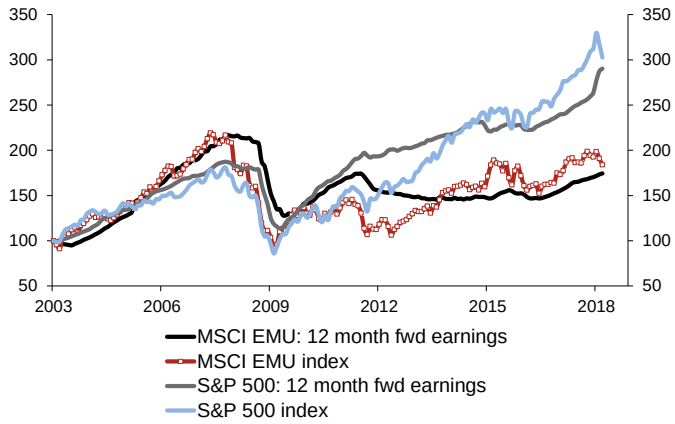
Equities

- **We are constructive on a 12-month horizon due to high earnings' growth and still contained 10-year rates.**
- **Cautious short term: recommend only a small overweight and a defensive country and sector allocation.**
- **Euro area (EA) and Japan are overweight in 12 months being cyclical and cheaper. Support comes also from monetary policies and earnings growth. While defensive short term, the US should underperform later on due to higher valuations and increasing yields.**
- **Short term neutral on EMs. Still positive mid-term, due to attractive relative valuations, a faster GDP growth and the positive effects from the weak US dollar. We favor India, Korea and the CEE countries. Still prudent on China.**

Negative return in the last 3 months: the reduction of the monetary stimulus struck with the bullish investors' senti-ment and positioning

The MSCI World achieved a negative total return (TR) year-to-date (-2.7%). The MSCI EM index experienced a positive return (1.5%) as a good macro momentum was coupled to a weak USD which in turn favors good financing conditions in developing countries. Up to mid-January investors showed a too strong confidence that central banks would have remained slow and cautious for longer in reducing the monetary stimulus. This represented a risk for financial conditions and risk taking in the developed world which is now materializing at the time when market multiples remain higher than history. Indeed, due to increasing inflation (declining negative output gaps and improving labor markets), central banks are adopting a more hawkish communication stance, confirming the path for higher rates in the US and a fading QE program in the euro area (EA). This strikes with the bullish investors' sentiment and positioning and causes us to remain prudent short term with only a small overweight on equities and a defensive sector as well country bias. Having said this, we continue to see equities to get support from improved macro and earnings growth, a low cost of capital, low oil prices and attractive free-cash-flow yields. US equities are expensive, but EA, Japanese and Asia's valuations are not too far from their averages. So, starting from current levels, we would slowly increase positions on set-backs. Projected earnings growth and dividend yields (in the EA 6% and 3.4%, respectively) back up a TR for both the EA and Japan of almost 7% in 12 months. Such returns are still attractive vs. bonds' ones which we forecast to be in negative territory.

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	15.1	16.0	2.1	1.9	10.2	8.7	2.7	2.7	6.2
USA	16.2	15.3	2.9	2.3	11.6	9.8	2.1	2.2	12.7
JAPAN	13.2	15.6	1.2	1.3	7.6	7.1	2.3	1.9	-8.0
UK	12.9	13.8	1.6	1.8	8.4	7.9	4.6	4.0	-6.1
SWITZERLAND	15.0	15.4	2.3	2.2	11.0	11.2	3.8	3.3	-4.7
EMU	13.3	14.2	1.5	1.5	7.8	6.4	3.6	3.9	5.5
FRANCE	14.0	14.4	1.5	1.5	8.4	6.8	3.5	3.8	6.8
GERMANY	12.3	15.1	1.5	1.5	7.9	6.6	3.3	3.3	0.8
GREECE	12.9	12.8	1.6	1.6	7.3	6.0	4.4	3.9	2.6
ITALY	12.0	15.3	1.2	1.2	5.7	4.6	4.4	4.7	2.0
PORTUGAL	16.5	12.6	1.8	1.7	6.4	5.9	4.6	4.5	10.1
SPAIN	11.7	13.0	1.2	1.6	5.1	5.1	4.5	5.1	-5.9
EURO STOXX 50	12.7	13.3	1.4	1.5	7.5	6.1	4.0	4.2	5.3
STOXX SMALL	16.3	14.3	1.8	1.7	10.1	8.2	3.0	3.2	13.4
EM, $	11.9	14.6	1.6	1.6	7.4	7.7	2.9	3.1	-4.3
BRAZIL	12.2	9.0	1.7	1.7	7.7	14.1	3.6	4.3	2.5
RUSSIA	6.1	7.1	0.7	0.9	3.5	4.5	6.3	3.6	-33.6
INDIA	17.1	14.4	2.6	2.7	11.4	11.5	1.7	1.6	2.8
CHINA	12.7	13.0	1.7	1.7	8.0	7.5	2.2	3.0	7.5

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

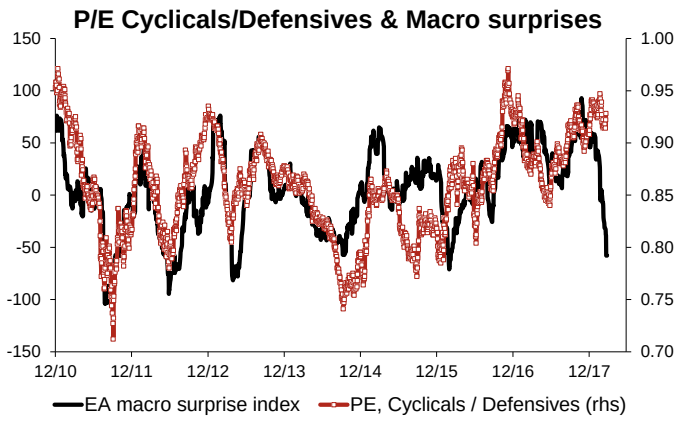
Cautious short term: sector defensive and balanced EA vs. the US

Notwithstanding an exceptional positive reporting season, equities retraced year-to-date (YTD). The increasing chances for a reduced monetary stimulus triggered a high-

Short term we remain cautious and buy only on setbacks. We continue to adopt a defensive sector bias and balanced US vs. EA equities

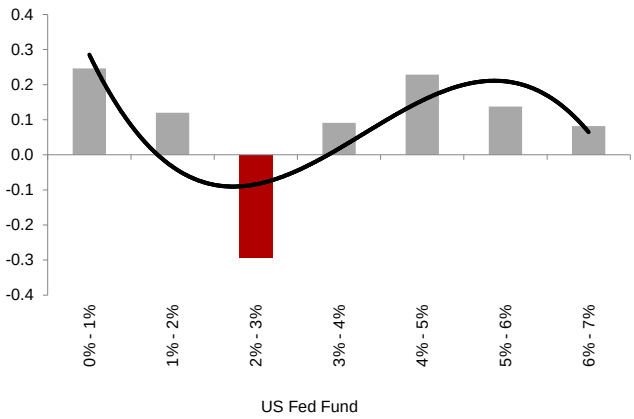
er volatility. Huge positions based on ETF and other financial instruments betting on persistent low volatility are suffering but will take time to revert. Stronger currencies in the EA and Japan added to the negatives, inducing the MSCI EMU and the Topix TR to underperform the US one: -8.4% (Topix) and -4.3% (EMU) vs. -2.8% (S&P 500). The US enjoyed a weaker USD, the earnings' boost derived from the Trump's tax reform (+9% in 2018), better macro surprises and healthy IT earnings momentum. That said, the market remained biased towards cyclicals, avoiding defensive countries, especially the ones capped by the Brexit: UK -9% TR and the SMI -7.4% YTD. Short term, risks do persist. We see 4 Fed's hikes this year but the fourth is not yet discounted. Consensus and positioning was still overall bullish up to one week ago. Macro surprises are rolling over, signaling the economy should not accelerate further from here. Outflows from US high yields credit funds now last since many months and this doesn't bode well for equities, too, the US ones especially. Trade frictions are rising and exporters' earnings could be revised down in the next months. Lastly, not only the equity volatility stays higher in absolute terms, it is also increasing versus the bonds' one, maintaining higher also the equity risk premium, a measure for risk aversion. For the time being, we adopt only a small overweight in equities, a defensive sector bias and keep a balanced exposure between the US and the EA. We stay slightly overweight UK, Japan and SMI. More defensive in European sectors, favoring oils, telecoms, insurance (banks are neutral), discretionary ex-retail and having less material, healthcare equipment, IT and expensive industrials. We maintain a positive bias on Value, domestic recovery and capex baskets.

Graph 2: P/E CYCLICALS/DEFENSIVES & MACRO SURPRISES



European cyclical vs defensive sectors

Graph 3: US: Z-SCORE MEDIAN RI EQUITY-BOND



3m returns, data after 2000

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

European and Japanese equities could experience a TR of 7% in the next 12 months

Once investors better incorporate the new inflation expectations and factor in the central banks' plan to reduce the monetary stimulus as well as a weaker macro momentum, we think European and Japanese equities could experience a total return of around 7% in the next 12 months, with US equities likely to underperform due to higher valuations and higher yields. We would reduce in this case the UK and SMI weight favoring more cyclical indices and sectors (banks included). Our earnings' growth forecasts back such a view (US +19% and EA and Japan +8% and +2%, respectively) together with a high and sustainable dividend yield in the EA at 3.4%. The pressure coming from higher bond yields is not going to structurally derail the equity performance versus bonds' one yet. We performed quite a deep study on this topic, looking to how and when rising yields hurt US equity returns in relative terms versus bonds' ones in the past. Two main results: the best scenario for equities' vs. bonds' returns is behind us. But, the threshold of 2-3% for the Fed fund rate is critical both

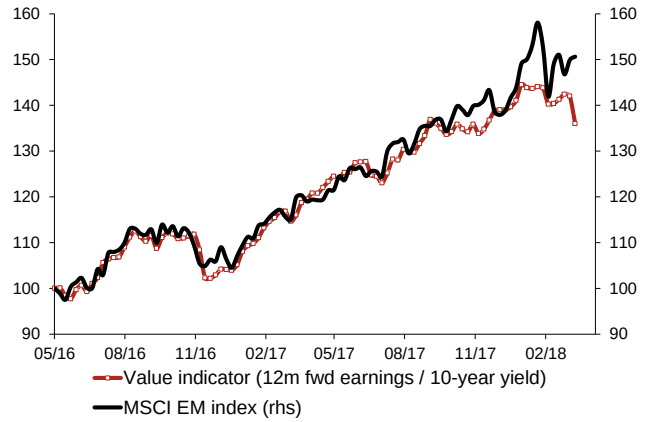
for the median relative returns and relative drawdowns: we are not there yet and the US is more advanced than the EA in this process. The level of 3.5% seems also the threshold for US 10-year rate above which equity returns start to suffer versus bond returns and US PEs get more volatile.

EM: to remain under pressure in the short term

EMs should benefit from higher earnings growth and relatively lower valuations in the medium term

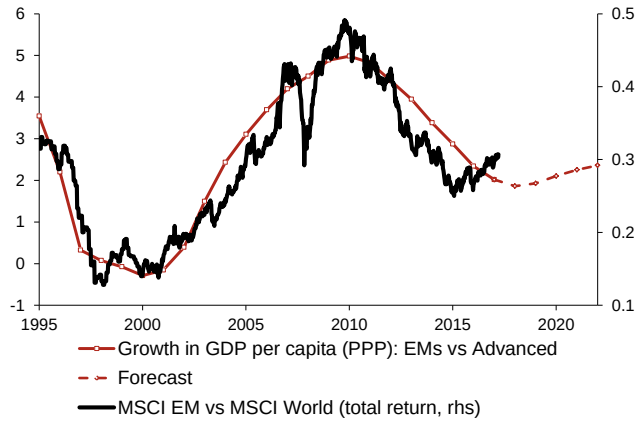
Over the last three months, Emerging markets (EM) have risen by 6.6%, outperforming the MSCI World (USD) by 6.2 pp. Whereas yields and EMBI spreads have increased, the weaker dollar (-2.8%, improving financing conditions) along with higher commodity prices (+12% for oil) and improving macro conditions caused upward earnings revisions and supported the markets. The "value indicator" (comprised of EM fundamentals, i.e. earnings and yields), shows some overvaluation. The market's PE based on 12-month forward earnings is almost one deviation above the average since 2001. Markedly higher yields represent a burden for valuations even if less than in 2013 (taper tantrum) as the situation with current accounts, forex reserves, credit, oil and economic growth is in much better shape now. In the short term, we expect EM equities to be pressured by increased valuations, Fed stance and higher equity vola-

Graph 4: MSCI EM: VALUE INDICATOR



using hard currency yields for bonds

Graph 5: EMS VS ADVANCED ECONOMIES



GDP growth and equities

tility. Once Fed expectations are repriced, EMs are to benefit from higher growth in nominal GDP, earnings and population and relatively lower valuations vs. DM. Strong DM growth should also offset in part higher US yields via robust EM exports. Certain elements of Trump's „America First" strategy would maintain the dollar weak and may result in an economic boost for emerging markets. Risks come from geopolitical and trade frictions, local political risks in Brazil (elections due in October 2018) and spiking US yields. The CEE market is the most undervalued globally. In the short term, it is to benefit from resilient macro surprises. In the longer term, the support to come from solid economic growth of smaller CEE countries and sound Russia's macro fundamentals (acknowledged by recent Russia's sovereign upgrade to IG rating by S&P). The region has quite a high dividend yield (4.9%) and is to capitalize on a superior earnings trend versus price, when compared to the EM universe, and increasing margins. We estimate the risk of increasing geopolitical tensions to be contained. 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 (high valuations, trade frictions, high non-performing loans).

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Asset Allocation

- **The global expansion remains strong with indicators still close to long-term highs. At the same time risks of market disappointments are rising, in particular as price pressures recover.**
- **Major central banks are expected to enforce their efforts to policy normalization.**
- **Risky assets should still benefit from the intact economic environment although with a higher exposure to rising volatility amid extreme valuations.**
- **Government bonds on the other side should suffer from the normalization trend.**
- **Against this backdrop we basically set our investment focus on equites, covered bonds, euro area investment grade corporates and cash. We recommend avoiding government bonds, high yield corporates, and US corporates in general.**

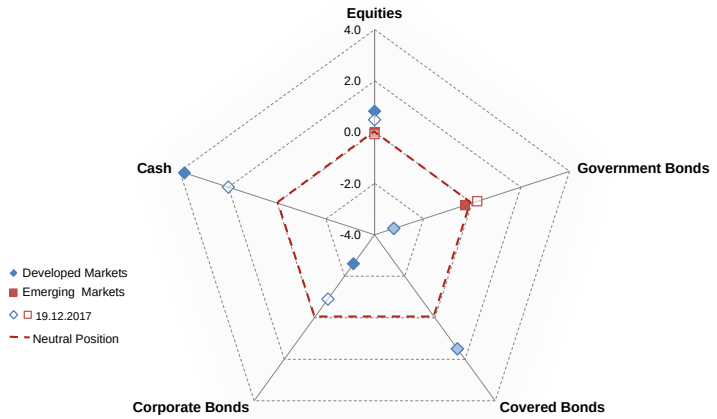
Macro backdrop still benign, but increased risks to the growth outlook

The overall macro backdrop remains benign and the global economy continues to expand. That said, the favorable combination of strong growth and low inflation is deteriorating noticeably and the risks to the growth outlook have increased. Mounting ventures of a trade war are of particular concern. A further escalation of the tensions between the US and China might heavily weigh on the global economy. As economic sentiment already looks toppish, the high expectations appear more susceptible to disappointment. Furthermore, price pressures while still contained are mounting, most visibly so in the US.

A more assertive monetary policy normalization to trigger pickup in volatility

Major central banks are expected to enforce their efforts to policy normalization, preparing markets for less liquidity growth and higher rates. This is expected to trigger a pickup in volatility for equities as well as for yields, although from still low levels for the latter. Thus, global market conditions are expected to become more challenging in general.

Graph 1: MODELPORTFOLIO (TAA – RADAR SCREEN)



active positions in percentage points

Prefer selected equity markets and euro area credit over government bonds

Under these conditions, our allocation recommendation is not too different from the last quarter's one. We basically set our investment focus on equites, covered bonds, euro area investment grade corporates (to a lesser extent) and cash. We recommend avoiding government bonds (core as well as periphery), high yield corporates, and US corporates in general.

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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	2.3	1.8
Germany	1.9	2.5	2.3	1.7
France	1.1	1.7	1.9	1.7
Italy	1.0	1.5	1.3	0.9
Non-EMU	2.1	1.9	1.8	1.6
UK	1.9	1.8	1.6	1.5
Switzerland	1.4	1.0	1.9	1.8
Japan	1.0	1.6	1.5	1.3
Asia ex Japan	6.4	6.1	6.0	5.9
China	7.1	6.9	6.5	6.2
CEE	1.4	3.7	3.1	3.2
Latin America	- 1.3	0.9	1.8	2.3
World	**3.2**	**3.7**	**3.7**	**3.6**

Inflation

	2016	2017	2018f	2019f
US	1.3	2.1	2.2	2.3
Euro area	0.2	1.5	1.4	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	2.5	2.2
UK	0.7	2.7	2.7	2.3
Switzerland	- 0.4	0.5	0.8	1.0
Japan	- 0.1	0.5	1.0	1.1
Asia ex Japan	2.6	2.2	3.0	2.9
China	2.0	1.6	2.4	2.1
CEE	5.2	5.0	4.6	4.9
Latin America	6.3	4.3	3.8	3.7
World	**2.3**	**2.3**	**2.7**	**2.7**

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

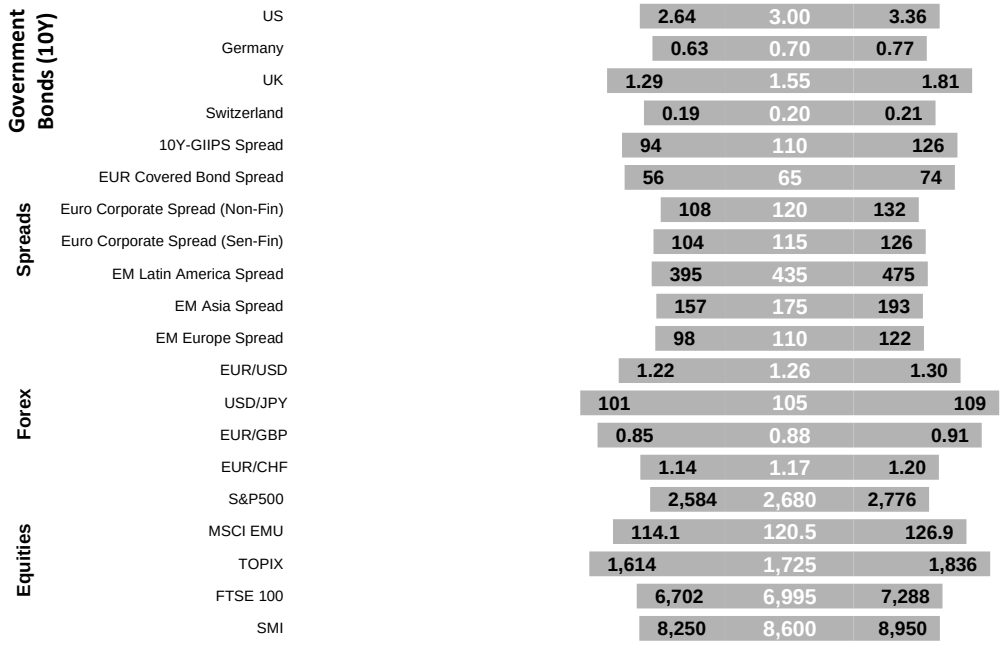
Financial Markets

3-month LIBOR	**Current**	**3M**	**6M**	**12M**
USD	2.28	2.30	2.55	2.90
EUR	-0.39	-0.35	-0.35	-0.35
JPY	-0.05	-0.05	0.00	0.05
GBP	0.65	0.75	0.80	1.05
CHF	-0.74	-0.75	-0.75	-0.75
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	2.86	3.00	3.05	3.20
Euro-Area	0.55	0.70	0.85	1.05
France	0.79	0.95	1.10	1.30
Italy	1.90	2.10	2.30	2.55
Japan	0.03	0.05	0.10	0.25
UK	1.47	1.55	1.60	1.75
Switzerland	0.07	0.20	0.25	0.35
10Y Spreads	**Current**	**3M**	**6M**	**12M**
Covered Bonds	67	65	65	70
GIIPS	106	110	112	115
Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
IBOXX Non-Financial	119	120	125	140
IBOXX Sen-Financial	114	115	120	130

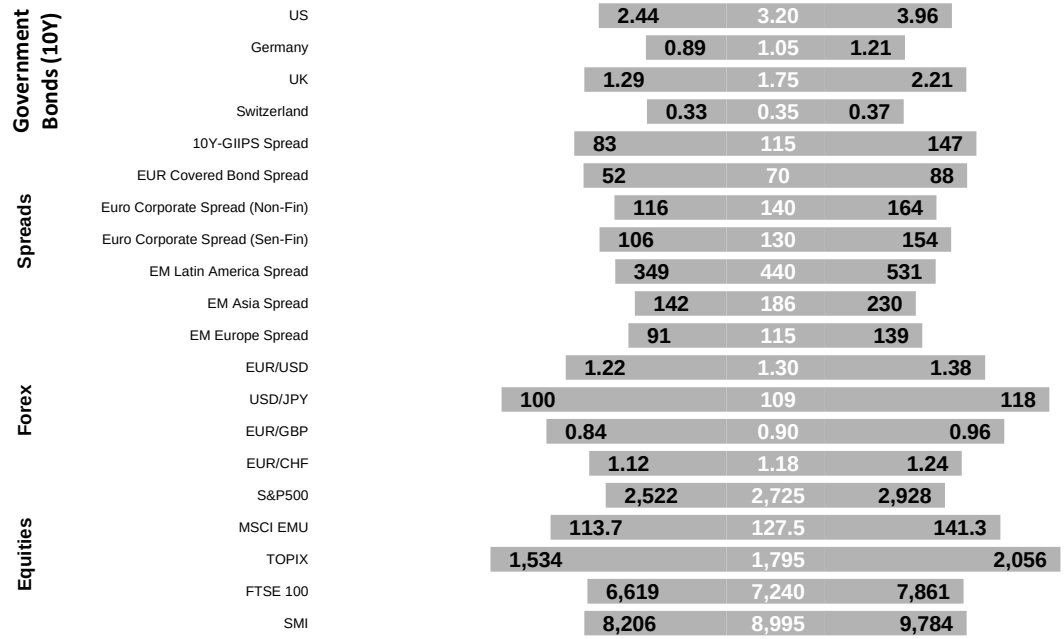
EM Gvt. Bonds Spreads	**Current**	**3M**	**6M**	**12M**
Latin America	428	435	440	440
Asia ex Japan	170	175	180	186
CEE	112	110	110	115
Forex	**Current**	**3M**	**6M**	**12M**
EUR/USD	1.23	1.26	1.28	1.30
USD/JPY	106	105	106	109
EUR/JPY	130	132	136	142
GBP/USD	1.41	1.43	1.44	1.44
EUR/GBP	0.87	0.88	0.89	0.90
EUR/CHF	1.17	1.17	1.18	1.18
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2648	2680	2705	2725
MSCI EMU	122.2	120.5	125.0	127.5
TOPIX	1703	1725	1745	1795
FTSE	6971	6995	7120	7240
SMI	8664	8600	8840	8995

As of 23.03.18 (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 1 month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

Imprint

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