

Q4 2018



GENERALI
INVESTMENTS

Investment View

The next shoe to drop



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Global View – The next shoe to drop

- Were EM markets the first shoe to drop in the context of monetary policy normalization? That conclusion does not pass our test. But the poorer growth/inflation mix and central bank plans do make the financial environment more fragile. Lesson from the beach: pick assets more selectively, but diversify your hedges.
- There will be plenty of icebergs to navigate in Q4, such as the trade war (continued), the Italian ructions, US mid-term elections and final A50 negotiations. The world is a dangerous place, but sentiment and positioning lead us to re-weight slightly towards equities and credit, starting from our cautious allocation this summer.
- The next shoe to drop is maybe not where you think. We see only a modest rise in EUR core bond yields over Q4, but let us not forget that German Bunds have been the single biggest beneficiary of PSPP, which will end soon. We keep an underweight in EUR Govies. Stay defensive on BTPs into the May 2019 European election.
- We have seen enough decompression in EUR cash credit spreads for now. Investors have cut their long. We are moving from short to neutral, still preferring shorter but riskier credits. But the asset class will be a prime victim of policy normalization eventually, with sectors like US High Yield trading at very dear levels.
- We stay long cash but less so, and move back to small overweight in equities. Hard currency sovereign debt should be a target for those willing to bottom fish EM assets. Near-term dollar strength remains a drag in other EM sectors; G10 FX volatility has lagged EMFX volatility sharply, but may be about to catch up.

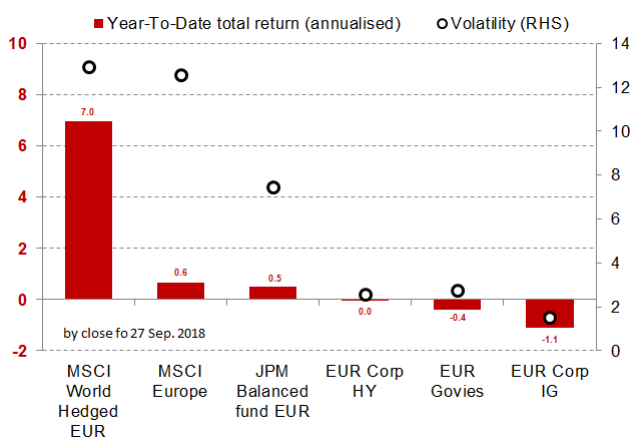
The rising dispersion in asset performance supports the idea that we are moving into late cycle

2018 a difficult year for asset performance – as expected.

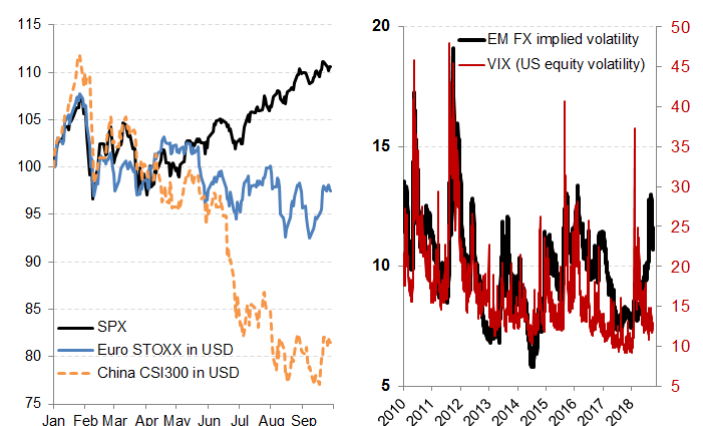
Hello, late cycle. Three months ago ([‘The beginning of the end’](#)) we spent a great deal of effort looking at asset performance through the cycle. We concluded that by some metrics we are not in late cycle just yet, but are getting close to it. Certainly global markets have started to behave this way. US stocks have outperformed Fixed Income, as should be expected (stocks turn only when we get much closer to recession). Another typical feature of late cycle is the rising dispersion in performance. Earlier in the recovery, the tide (easy policy, modest valuation, improving economic sentiment) was lifting all boats, especially in the risk asset space. Not anymore. Q3 2018 saw striking divergence, not least between stocks in the US (strong), Europe (flattish) and China (bearish). Likewise, stress in EM markets failed to significantly infect developed markets (Graph 2).

Lessons from the beach. We knew that the deteriorating growth/inflation mix would make 2018 a tougher year for asset performance. The year-to-date performance of EUR assets is mediocre (Graph 1), from flattish for MSCI Europe and High Yield credit to negative for EUR Govies and Investment Grade credit. No surprise there – if anything the resilience of Bund yields has made FI returns so far slightly better than we expected. Developments this summer have taught us that at this

Graph 1: A POOR YEAR FOR TOTAL RETURN IN EUR ASSETS



Graph 2: HELLO LATE CYCLE... HIGH PERFORMANCE DISPERSION



Investors need to turn more selective in the asset allocation, but also make sure that hedging strategies are diversified.

The Q4 icebergs: trade war, Italian ructions, US election, conclusion of A50 negotiation

Central bank normalization continues, at different stages and paces

Sentiment and positioning support cautious upgrade in risk taking

stage of the cycle investors need to be more selective in the asset allocation, but also make sure that hedging strategies are diversified, as shocks may hit selected segments of the global markets with limited propagation.

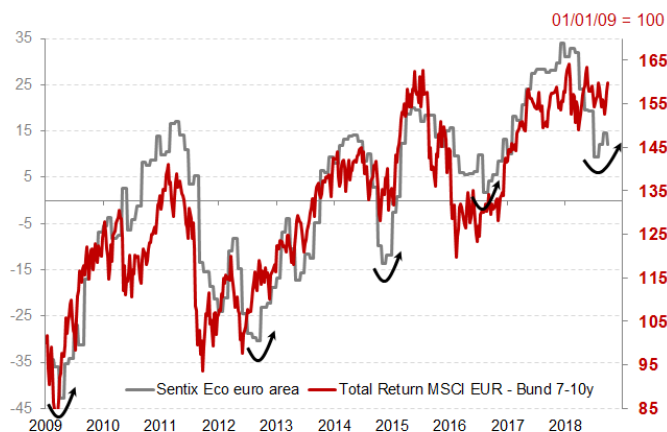
Q4 is about navigating the icebergs

The coming quarter includes plenty of risk events. The trade war is well priced in, but the US Administration is still mulling tariffs in the auto sector; also tariffs on \$200bn of Chinese exports are due to jump from 10% to 25% at the turn of the year, putting yet more pressure on global trade and making it harder to bottom fish EM assets. As we go to press the Italian government has announced budget plans (deficit planned at 2.4% of GDP for 2019 and beyond) – see our special section. Expect ructions with the EC and European partners, and a confrontational stance into the May 2019 European election. Also rating downgrades are likely in October. This is almost certain for Moody's, if not S&P – one notch only (to Baa3), with (rising) risk of a negative outlook. The US mid-term election (6 November) should deliver a split Congress (not a major market mover we think but still uncertain). Finally Q4 sees the conclusion of the Article 50 negotiation (Brexit). A deal by mid (or late) November is more likely than not, but it remains to be seen whether it will be ratified by the UK Parliament – not clear given the lack of support from hard Brexiters and Labour (who requires customs union participation). 'No deal' would mean no transition (from April 2019 to end 2020), i.e. chaos from spring next year. This looks too dangerous to be true, yet a rejection would lead to a political crisis, hence maximum uncertainty.

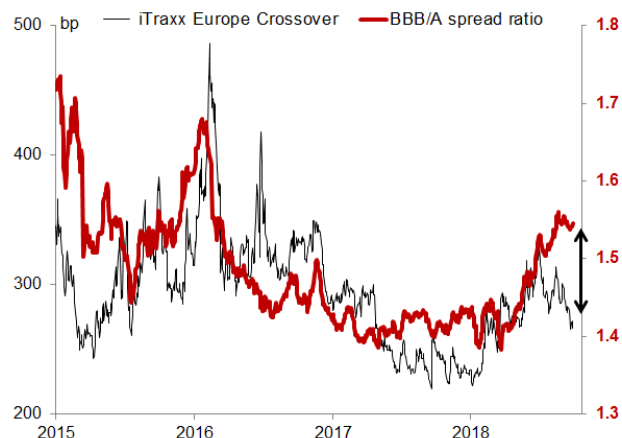
The end of easy. The above risks (and more, e.g. Brazil election) need to be seen in the context of continued central bank normalization. With inflation picking up, if more rapidly in the US than the euro area, the Fed will stick to the pace of one hike per quarter, while the ECB QE will end by the turn of the year. As we showed before, as the Fed progresses into neutral/restrictive (depending on the metrics) water, financial volatility should be up. Also expect long-term euro rates to rise as liquidity conditions start to tighten, following a remarkable resilience of Bunds this year in the face of rising Treasury yields.

➔ Based on the above, it is tempting to retain a defensive allocation. That being said, both sentiment and positioning have adjusted, enough we think to re-weight slightly towards EUR equities and credit. The deteriorating economic sentiment has kept a lid on European equities, but this seems to be turning (Graph 3). We haven't seen investor capitulation (except maybe in FX/USD) but significant outflows from selected assets, such as EM equity and debt markets or EUR credit.

Graph 3: EUR ECONOMIC SENTIMENT VS STOCK/BOND



Graph 4: ENOUGH SPREAD DECOMPRESSION FOR NOW?



EUR government bonds as a prime candidate for normalization, even though Italian auctions will keep a lid on Bund yields in the near term. Keep underweight EUR Govies.

Move from underweight to neutral in EUR credit, still preferring short-term and riskier credit to long-dated and safer corporate underweight. Medium-term, the asset class however is a prime victim of policy normalization.

Small overweight in equities. Selected opportunities in EM, especially hard currency sovereign debt.

G10 FX volatility (too low) the next shoe to drop?

Allocation recommendations

The next shoe, not where you think? One may consider that the EM markets (equity, debt and FX) were the first shoe to drop, in a context of monetary policy normalization. This may be a hasty conclusion: our analysis shows that the EM sell-off this summer was mostly a function of the trade war and idiosyncratic forces (Turkey, Argentina, Brazil), not so much the Fed. Still, the 'end of easy' exposes global markets to corrections, broad or localized. Counterintuitively, the next shoe may not sit in areas that tend to suffer from a rise in risk aversion. EUR government bonds remain a prime candidate for normalization. 10-year real Bund yields still trade in the -1.0% region (average of DBRI 2026 and 2030), offering poor value. Let us not forget that German public securities have been the biggest beneficiary of PSPP (€500bn purchased), and more so when considered as a percentage of the debt outstanding. Arguably the Italian auctions will put a lid on German yields in Q4. Still, we retain an underweight in EUR Govies, both core and non-core. We stay defensive towards BTPs as we see little room for improvement *before* the European election. Progress towards EU integration has been disappointing, and not just because of Italy; political developments in Germany and the immigration crisis are also major drags.

EUR credit markets are also exposed to the rise in risk-free yields, so not a favorite. That said, we cut our underweight and move to neutral. Graph 4 shows that decompression in the cash market has been substantial, and positioning is now healthier (investors no longer overweighed). The medium-term outlook stops us from going long: credit spreads tend to turn before equity markets, and selected segments of credit are very dear, not least US high Yield... another 'shoe' to consider. In EUR we continue to prefer short-term and riskier credit (BBB and HY) to long-dated and safer – a strategy that has already brought nice dividends over the past six months.

We stay long cash, but less so. We reallocate towards credit and equity markets, moving back to small overweight in stocks. Global equity prices this year have lagged earnings, hence multiple have deflated a bit. Global and euro economic surprises are no longer a drag. EM markets offer selected opportunities, though near-term USD strength remains a drag. Hard currency sovereign debt offers best value for now, with EMBI spreads looking wide vs. US HY or EM corporates. EMFX volatility looks high relative to G10 FX vol, and the latter may be a 'shoe' too given the fragilities coming from the trade war, the Trump/Fed tensions and unusual/joint USD/oil price strength.

Table 1: MACRO FORECASTS (annual changes, in %)

	Growth			Inflation		
	2017	2018f	2019f	2017	2018f	2019f
US	2.3	2.8	2.5	2.1	2.5	2.3
Euro area	2.5	2.0	1.7	1.5	1.7	1.6
Germany	2.2	1.9	1.7	1.8	1.8	1.8
France	2.3	1.7	1.6	1.0	1.8	1.6
Italy	1.5	1.1	0.9	1.2	1.3	1.3
Non-EMU	1.8	1.5	1.6	2.5	2.3	2.1
UK	1.7	1.3	1.5	2.7	2.5	2.2
Japan	1.7	1.0	1.0	0.5	1.0	1.0
Asia ex Japan	6.1	6.1	6.0	2.2	2.8	2.9
China	6.9	6.5	6.3	1.6	2.1	2.3
CEE	3.9	2.9	1.8	5.0	5.8	6.9
Latin America	0.8	0.7	1.7	4.3	3.9	4.2
World	3.7	3.6	3.5	2.3	2.8	2.9

Table 2: FINANCIAL FORECASTS (current as of 26 Sep, 3-day average)

10-Year Bond Yields	Current*	3M	6M	12M
US	3.07	3.10	3.20	3.30
Germany	0.54	0.55	0.70	0.90
Italy	2.88	3.45	3.35	3.50
Japan	0.13	0.10	0.10	0.10
Forex	Current*	3M	6M	12M
EUR/USD	1.17	1.16	1.19	1.23
USD/JPY	113	114	115	115
EUR/GBP	0.89	0.93	0.92	0.91
Equities	Current*	3M	6M	12M
S&P500	2912	2905	2930	2930
MSCI EMU	124.9	125.0	128.5	127.0

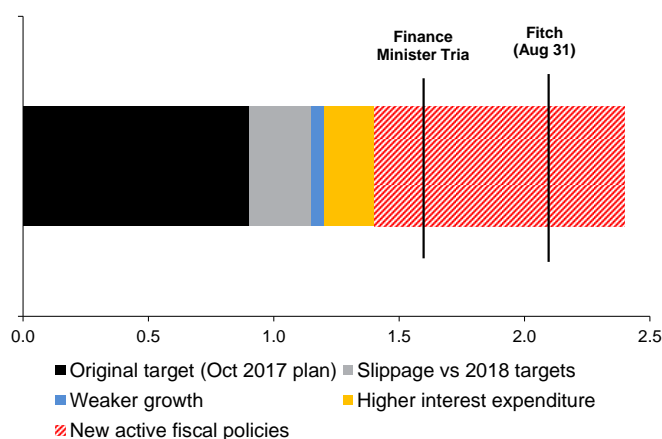
Italy: Sticking to the facts

- Concerns over fiscal discipline under the new Italian government dominated during the summer. The 10-year BTP-Bund spread retested late May's highs, before declining in September amid reassuring comments on budget targets.
- However, on September 27 the government unveiled its official plan to increase the deficit to 2.4% of GDP in 2019-2021. The previous government had committed to a deficit of 0.9% in 2019 and a broadly balanced budget by 2020.
- The European Commission will oppose to such a significant deviation, possibly by starting the Significant Deviation Procedure, the last formal step before opening the Excessive Deficit Procedure. Moreover, Italy will almost certainly face negative actions by rating agencies, with Moody's likely to be the first to cut the rating to Baa3.
- Our Debt Sustainability Analysis suggests that the debt-to-GDP ratio is likely to remain on a slightly downward path in the short term, as the positive boost to growth and still low funding costs will offset the increase in the deficit. However, the failure to restore fiscal discipline would significantly increase the risk of explosive debt trajectories.

Deputy Prime Ministers Di Maio and Salvini pushed for higher deficit targets to implement their costly electoral promises

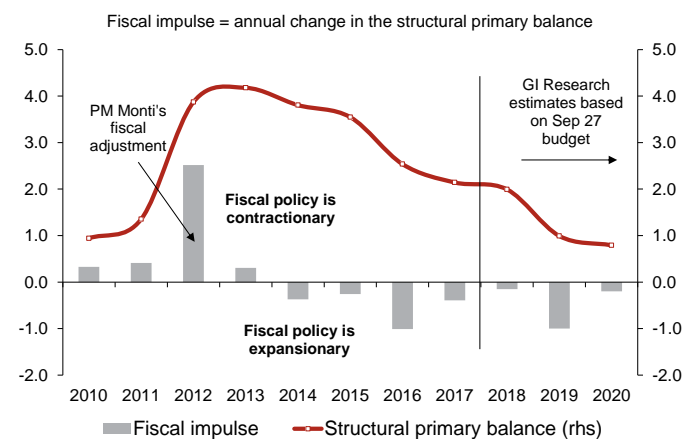
After the sharp rise in Italy's risk premiums in late Q2 following the formation of the Lega-M5S government, volatility remained elevated throughout the summer due to investors' concerns over fiscal discipline. The 10-year BTP-Bund spread temporarily retested the highs seen in late May amid speculations that the deficit-to-GDP ratio could exceed 3%. Reassuring comments by Finance Minister Tria – who insisted for a deficit of 1.6% in 2019 – favored a retightening in September. But spreads widened again sharply after the government announced a higher-than-expected deficit target of 2.4% for 2019-2021. The previous government had committed to a deficit of 0.9% in 2019 and a broadly balanced budget by 2020.

Graph 1: ITALY'S 2019 BUDGET TARGET



In % of GDP

Graph 2: CHANGE IN THE STRUCTURAL PRIMARY BALANCE



In % of GDP

A further weakening in an already weakened fiscal position

The structural primary surplus already deteriorated by more than 2 pp from 2013 to 2018

The increase in the deficit planned by the M5S-Lega government comes after several years of expansionary fiscal policies. Indeed, the sharp tightening experienced between late 2011 and 2013 under PM Monti's government – the structural primary surplus (SPS) rose from 1.4% to 4.2% of GDP – was largely reversed by several easing measures undertaken under PM Renzi and Gentiloni's cabinets, which have reduced the SPS to just around 2% of GDP in 2018. According to our calculations based on preliminary information about the 2019 budget, an overall deficit of 2.4% of GDP is consistent with a further deterioration in the SPS of

around 1.0 pp in 2019 and 0.2 pp in 2020. This would bring the SPS to less than 1% of GDP, a level not seen since 2010.

Such a big deviation from budget targets will inevitably exacerbate the clash between the government and the European Commission (EC) as Italy was supposed to improve its structural balance by 0.6 pp in 2019. The EC will receive the budget draft by October 15 and will have until end-November to express its opinion and to ask for amendments. Given the extent of the breach, the EC may even decide to initiate the Significant Deviation Procedure, the last formal step before opening the Excessive Deficit Procedure. Italy is also likely to face downward pressure on its rating. Moody's is likely to cut its assessment from Baa2 to Baa3 soon and a negative outlook by S&P (Oct 26) cannot be excluded.

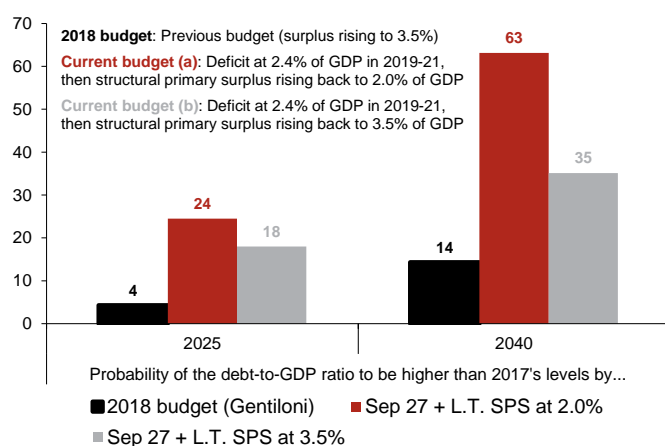
Higher risk of explosive debt trajectories over the longer run

We perform a Debt Sustainability Analysis to assess the impact of the new budget. Despite the further planned deterioration in the SPS, the debt-to-GDP ratio is likely to remain on a downward trajectory until 2025 thanks to the still falling average cost of funding and the above-potential growth dynamics.

However, the longer-term outlook looks increasingly challenging. Indeed, a failure to restore fiscal discipline would materially increase the risk of explosive debt trajectories. Bringing the SPS back to 2018's levels (at around 2%) by 2024 would be insufficient to stabilize the debt-to-GDP ratio, which would climb to above 150% by 2040. A SPS of 3.5% of GDP – the long-term level included in the 2018 budget law – seems necessary to ensure a downward debt trajectory over the longer-run. Using Monte-Carlo simulations, we calculate that the probability of the debt-to-GDP ratio rising above the 2017's levels (131.2% of GDP) by 2040 would climb to more than 60% under the current budget and a long-term SPS of 2.0% of GDP. This compares with a probability of 14% under the adjustment path envisaged by the 2018 budget plan approved by Gentiloni's government.

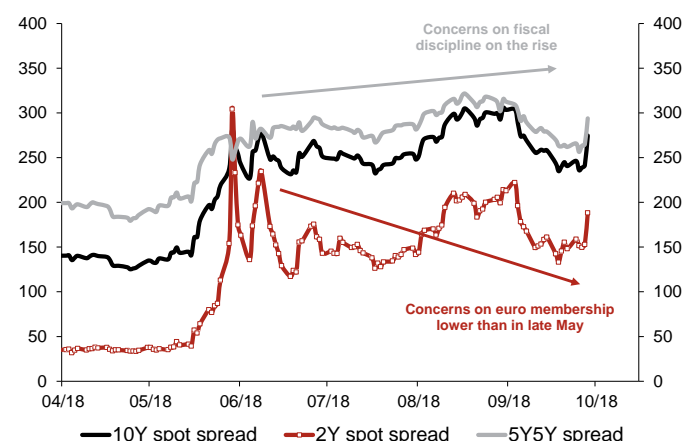
While the outlook for debt sustainability is still benign in the short term, fiscal discipline is key to put the debt ratio on a credible downward trajectory

Graph 3: PROBABILITY OF RISING DEBT-TO-GDP RATIO



Based on the percentiles of the debt-to-GDP ratio distribution (1000 Monte-Carlo simulations for each budget scenario)

Graph 4: BTP-BUND SPREAD CURVE



Based on zero-coupon curve, in bps

Markets are repricing the risks linked to the Italian budget. If we decompose the 10-year BTP-Bund spread in the 5-year spot and the 5y5y forward spreads (see Graph 4), the latter clearly shows the rising concerns over budget discipline (while the 5-year spot leg is a good proxy for woes on euro membership). The lack of a credible adjustment path will likely keep weighing on BTPs in the coming weeks.

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Macroeconomic Outlook

- Global growth has passed its peak and became more uneven among countries. Largely idiosyncratically driven crisis among emerging economies like Turkey and Argentina contrast with above potential US growth.
- Looking ahead, the outlook is subject to several downside risks. An escalation of the trade tensions especially between the US and China as well as an unorderly Brexit are key concerns. Moreover, political tensions emanating from the 2019 budget proposal in Italy have the potential to dent confidence in the euro area.
- While acknowledging these risks, we expect growth in the US and China to moderate but to stay solid. Euro area activity will likely maintain its strength with strong domestic activity providing a cushion.
- We expect the Fed as well as the ECB to proceed on their policy normalization path amid signs of higher underlying inflation. We forecast four Fed rate hikes until the end of 2019 and look for a first ECB rate hike in September 2019, following the end of QE in December 2018.

Global growth is leveling off but an EM crisis is not on the cards

Following a period of synchronized global growth, the activity pattern turned more heterogeneous over the course of this year and lost some momentum. The global manufacturing PMI – a good gauge for the growth momentum – receded from 54.4 in January to 52.5 in August. This movement has also been driven by a crisis in some emerging markets. Here, rising US interest rates brought structural weaknesses to the fore. This applies for instance to Turkey where a weak external position and unsustainable domestic policies amid political tensions with the US triggered a sharp market sell-off. Likewise, the peso crisis in Argentina was triggered by concerns over large twin deficits and poor communication over an IMF programme. That said, a full blown emerging market crisis is not forthcoming in our view. Fundamentals like current account deficits generally look much more solid than in 1998 and 2013.

Trade war major global downside risk

Escalation of trade conflict between the US and China major global risk

The confrontation between the US and China shows no signs of moderating and the US mid term election, in mid November, provides a catalyst for a further step up in anti trade rhetoric and measures. In September the Trump administration applied tariffs on about another 200 US\$ billion of goods purchased from China and threatened to extend them to almost all the Chinese export. China vowed to retaliate, but the much smaller size of US export on which tariffs could be applied, raised the risk that the government starts targeting US firms operating in China with administrative measures. This could potentially disrupt worldwide supply chains. The restrictions already enforced and those announced are starting to affect the Chinese economy, growth of which is already exposed to tighter credit conditions. Should exports come under further pressure the government stands ready to deploy fiscal measures to reach its targets (6.5% this year, at least 6.2% in 2019).

The situation appears less confrontational as far as the proposed tariffs on imported cars are concerned; talks between the US and the main trade partners (chiefly the EU) continues and could bring about a revision of the trade arrangement currently in place without any traumatic change. On NAFTA, the bilateral US-Mexico deal should pave the way to an overhauling of the agreement, involving also Canada.

US growth now close to cyclical peak

Growth in the US is not feeling the pinch of higher import prices. Worries on trade have appeared so far in some commentaries, while the business confidence, especially in manufacturing remains near the cyclical peak. Latest data confirm our expectation of growth just below 3% this year, with the unemployment rate solidly below 4%. Fading support from fiscal policy and the lagged effect of past rate hikes will slow down growth in 2019. Inflation is belatedly picking up, with the core rate already at the 2% Fed target and expected to climb higher. The impact of tariffs on

growth and inflation appears at this stage manageable, but a further escalation triggering global value chains would inevitably affect business sentiment and capex decisions.

Euro area domestic activity a cushion to downside risks

The euro area weathered the deteriorating external environment quite well, thanks to strong domestic demand. Economic activity remained stable at 0.4% qoq in the first two quarters of this year. The common currency area's trade exposure to the currently fragile economies is rather low. However, this is not the case for China which is not only the fourth biggest export market (accounting for 1.4% of euro area GDP) but also a pacemaker for economic activity in East Asia. European exporters will clearly suffer from the uncertainty emanating from the US related trade tensions.

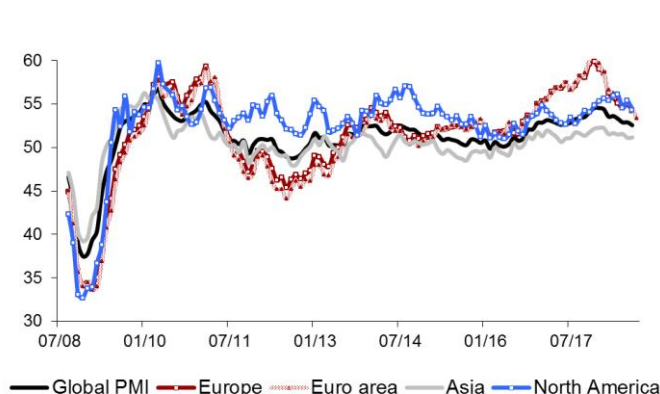
We find that the euro area is currently in a good shape and could withstand external headwinds quite well. The key reason is that the growth of consumption – with a share of 54% of GDP – remains supported by ongoing employment (+0.4% qoq in Q2/2018) and firming wage growth (compensation per employee +2.3% yoy, highest since Q4/2011). In spite of higher uncertainties, business expectations as well as capacity utilization are still way above normal while financing conditions remain favorable, underpinning the need for investment spending. All in, we expect the euro area to maintain the current growth momentum and thereby stick to our below-consensus forecast of 2.0% in 2018 and 1.7% in 2019.

Ongoing labor market improvement makes EA resilient against external shocks

Unorderly Brexit and woes related to Italy major risks for the EA

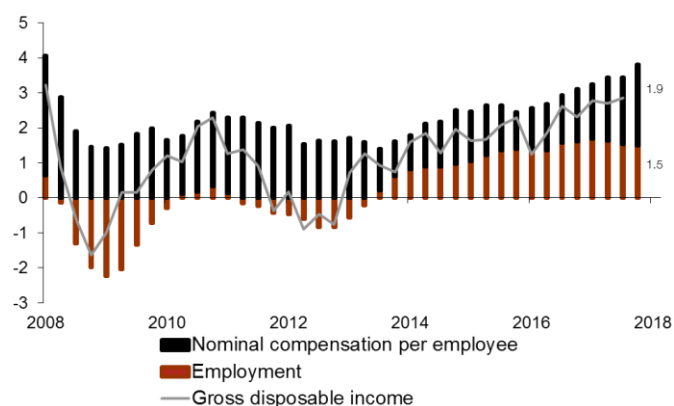
While we think that the euro area can withstand global headwinds relatively well, this is less the case for unorderly Brexit and woes emanating from Italy. In case the negotiations about an orderly Brexit were to fail, a recession in the UK would follow in 2019 in our view. Depending on the degree of possible offsetting policy responses, euro area annual growth could be reduced by up to 0.5 pp in each of the next two years.

Graph 1: GLOBAL MANUFACTURING PMIs



values above 50 denote expansion, weighted average by region

Graph 2: WAGES AND EMPLOYMENT DRIVE EA INCOME GROWTH



in %, yoy

Italy's economic performance lagged considerably behind its European peers over the past years. Economic confidence deteriorated more than in the rest of the euro area implying a further weakening of activity in the euro area's third biggest economy. Its stalling would imply a downside risk to aggregate growth. Moreover, woes related to the submission of the latest deficit targets (see special chapter on Italy) have the potential to create negative spillovers to confidence among euro area firms and consumers.

Normalization of monetary policy to continue

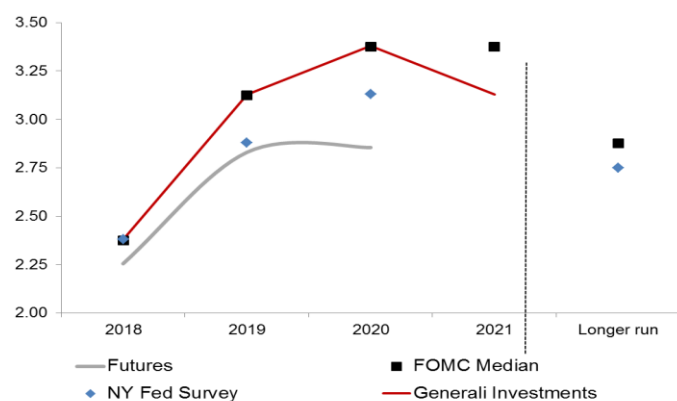
Fed hikes to continue until 2020

After the September increase, the Fed confirmed its commitment to raising rates again in December. Three more hikes are expected for 2019, followed by a final one in 2020. The Fed indicated to keep the Fed funds rate at around 3.4% for 2021 as a whole. The gradual rise in inflation and only a moderate risk of financial turbulences should ease the hard task of withdrawing monetary stimulus without triggering a deep growth slowdown. Our forecast up to 2020 is in line with the Fed projections. However, we think that the weakening of growth after that date will increase the risk of a recession, leading to at least a rate cut in 2021.

ECB expected to launch gradual normalization cycle in September 2019

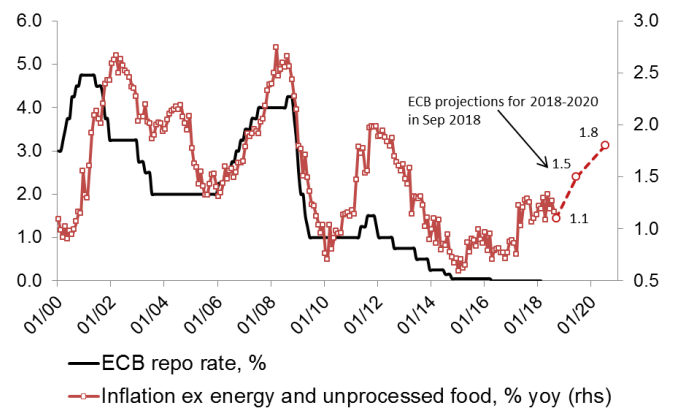
After having reduced the volume of monthly asset purchases to € 15 bn in October, the ECB remains on track to end QE in December. That said, monetary policy will remain accommodative also thereafter. While the ECB had already stated to reinvest maturing APP purchases, details were not yet given. We look for some forward guidance on the reinvestment period (e.g. at least two years) in order to moderate the rise in the term premium. Moreover, given all the uncertainties surrounding the macro outlook, we expect the ECB to only cautiously lift key rates. Here, the increase in core inflation (forecast to rise by 1.5% in 2018 and 1.8% in 2019) will be crucial. Stronger wage growth, positive import price growth, a closing of the output gap and the latest rise in oil prices all hint in this direction. Having announced to keep key rates at the present level for at least through summer 2019, we now look for a deposit rate hike (by 15 bps) in September 2019 and a lift to 0% by March 2020. That said, the materialization of downside risks to activity and inflation will induce the ECB to further postpone the start of the key rate normalization cycle.

Graph 3: EXPECTED PATH FOR FED FUND RATES



%

Graph 4: ECB KEY RATE AND UNDERLYING INFLATION



%

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Fixed Income

- After volatile trading until August, international government bond yields eventually rose in September. While the US curve flattened, the euro area curve steepened moderately – reflecting the different stances of the Fed and the ECB.
- Although the leeway for higher yields appears more limited in the near term given the reached levels and current market positioning, the increasing inflation pressure and growth above potential are likely to pave the way for higher yields in the medium term.
- The BTP/Bund spread remained elevated in the third quarter. Given the uncertainty about the fiscal stance of the government and the confrontational attitude towards the EU, there is scope for an even higher risk premium in the course of the fourth quarter. Other Southern European bonds are unlikely to withstand this completely.

International yield curves shifted upward in the third quarter (flattening US curve, but steepening euro area one)

International government bond markets moved on balance sideways in July and August as concerns about emerging markets and the confrontational stance of the Italian government prevented an upward trend. Eventually, more hawkish comments by central banks triggered an upward shift of international yield curves in September. On balance, 10-year US yields rose by 22 bps to 3.08% and 10-year Bund yields by 23 bps to 0.53%. The noticeable adjustment of market expectations with respect to future rate hikes by the Fed, however, led to a further flattening of the US yield curve. In contrast, the rather dovish forward guidance by the ECB continued to anchor at least to some extent the short end of the euro area yield curve. Hence, the euro area curve steepened moderately in the course of the third quarter.

Core yields to continue the upward trend

Looking forward, the way is paved for a further increase in core yields. Since the end of June, financial markets have priced in an additional key rate hike by the Fed until the end of 2019. Still, only three hikes are discounted which is at odds with the Fed dots (and our forecast) which point to four hikes during this period. A tight labor market, growth above potential (at least for still some quarters) and inflation around target are likely to keep the Fed on its course of quarterly rate hikes for the time being. Moreover, a term premium close to zero does not appear sustainable. Future key rate hikes in combination with a loose fiscal policy in an economy at full employment are seen to trigger a high term premium. Therefore, we do not expect the 3-year/10-year curve to invert over the course of 2019. The main factor which stands in the way of higher US yields in the near term, is the current short positioning. The balance of non-commercial traders is close to a record low. But, it is unlikely that this will prevent higher US yields in the medium term.

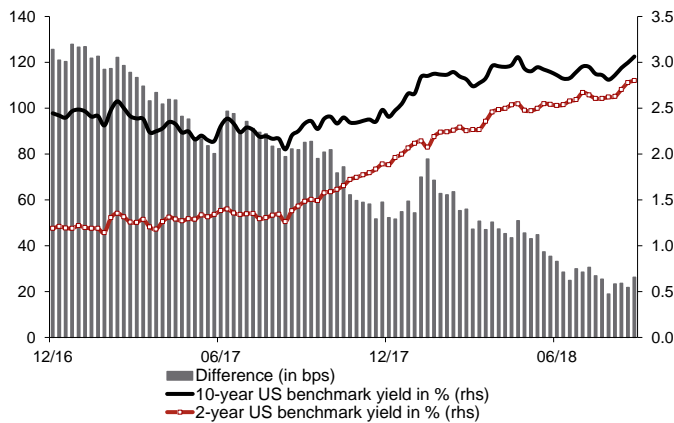
All in, there is scope for 10-year US yields to rise to 3.30% on a 12-month horizon (to 3.10% on a 3-month horizon). 3-year US yields are expected to rise to 3.25% on a 1-year horizon (to 3.0% on a 3-month horizon).

Despite the increase, euro area core yields still on an unsustainably low level – ECB's commitment continues to anchor short-dated yields

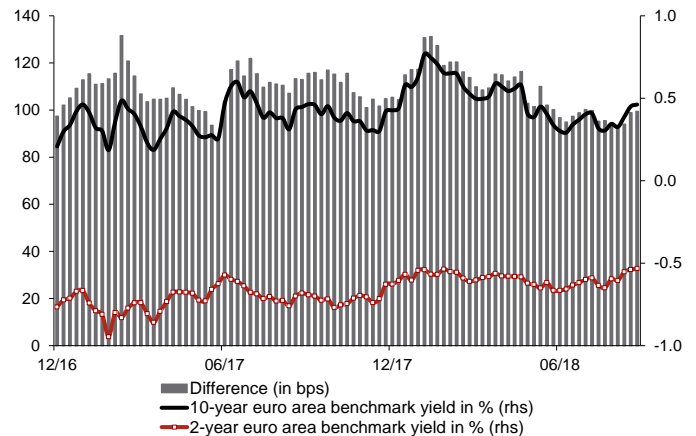
The fundamental case for higher euro area core yields is even stronger. Based on 10-year inflation swaps, the 10-year real yield is around -1.1%. While this is 20 bps higher than at the end of May, it is still at fundamentally-not-justified levels. This applies even more as macroeconomic data have rebounded in recent months. Going forward, euro area growth is forecast to remain above potential and the inflation pressure is seen to increase. The contribution of the ECB is a bit more complicated. On the one hand, the central bank reduces its monthly asset purchases from €30 bn to €15 bn from October onwards and will end the QE programme by the end of 2018. On the other hand, the ECB stressed its forward guidance. This commitment stands in the way of a strong increase in euro area core yields. Particularly, short-dated core yields have only limited scope for a meaningful re-pricing for the time being. Accordingly, the euro area yield curve is expected to

steepen somewhat further in the months to come. In addition, the situation in Italy is unlikely to ease lastingly in the weeks to come. Hence, euro area core bonds will serve as a safe haven.

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



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



Overall, we see limited scope for higher 10-year Bund yields on a 3-month horizon (0.55%). Nevertheless, given the low current income, the total return is expected to be in slightly negative territory. On a 12-month horizon there appears to be more room for higher yields (0.9%) and the total return will be clearly negative.

News flow out of Italy to remain the dominant driver for BTPs

Southern European bond spreads moved on balance sideways in the third quarter. Driven mainly by the news flow on the Italian budget law, particularly the BTP/Bund spread was rather volatile. Nevertheless, in contrast to previous periods of market stress, contagion to other bond markets from the fiscal issue in Italy was limited.

Going forward, uncertainty is expected to remain high. The government's plan to seek a 2.4% budget deficit in 2019 (and in 2020 and 2021) is unlikely to be the final target. More details on the budget will be announced on October 15. It will then be scrutinized by the EU Commission and during the subsequent negotiation process some adjustments are likely. Beside the final headline number, the underlying assumptions will be critically analyzed by market participants. Hence, the news flow with respect to the budget law and the attitude towards the EU in general are likely to remain the dominant factors for determining the BTP/Bund spread for the time being. A confrontational stance might pay off in the eyes of the government and enables it to shift the responsibility for not fulfilling election promises. Taking into account the likely actions by rating agencies (see special chapter on Italy), there is leeway for an even higher BTP/Bund spread in the course of the fourth quarter. Accordingly, the total return outlook for BTPs is negative in the short term and market participants are advised to position accordingly.

In this environment other Southern euro area bond markets will not remain completely unscathed. Although the current market stress is correctly seen as an idiosyncratic issue, a higher risk premium for Italy will drive up other sovereign bond spreads to some extent as well. Therefore, short-dated maturities should be preferred versus longer-dated ones.

Budget law and the general attitude of Italian government towards the EU the main factors for Southern euro area sovereign spreads in the fourth quarter

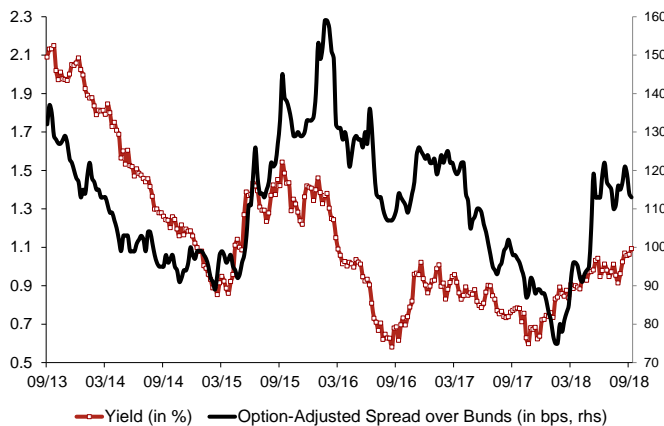
Corporate Bonds

- Euro area corporate bond spreads were on a roller coaster in the third quarter. After a friendly start, spreads came under pressure, but re-tightened again in September. Still, due to higher underlying yields, the yield level rose slightly.
- While the fundamental situation by and large is still sound, technicals will increasingly burden euro area corporate bonds. Slightly widening spreads and increasing underlying yields are seen to trigger a negative return going forward.
- Financials reduced the year-to-date underperformance thanks to rising core yields and receding concerns over Italy's budget. In the near term, we see only a minor spread widening and a similar total return vs Non-Financials.

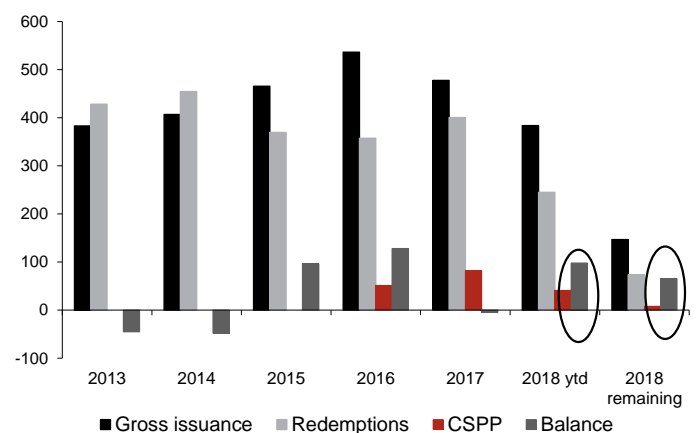
Roller coaster of euro area corporate bonds in the third quarter. Slightly negative total return due to higher underlying yields.

Concerns about turmoil in emerging markets (e.g. Argentina, Turkey) and the fiscal stance of Italy were offset by an improved macroeconomic data flow in the third quarter. Eventually, euro area corporate bond spreads tightened by 7 bps to 114 bps. However, the increase in sovereign yields ultimately gained the upper hand and triggered an increase in corporate yields. Meanwhile, the corporate yield level exceeded the 1% threshold. At 1.06% euro area IG corporate bonds have reached the highest level since the first quarter of 2016. The total return in the third quarter was slightly negative – with Financials slightly outperforming Non-Financials.

Graph 1: BofAML EURO AREA IG CORPORATE BONDS



Graph 2: EA IG CORPORATE BONDS: SUPPLY/DEMAND



In bn euro, 500 m euro and up

Technicals to deteriorate further in the months to come putting upward pressure on corporate bond spreads

Looking ahead, the technical situation is expected to dominate the future development of corporate bond spreads. In particular, the balance between supply and demand is forecast to deteriorate. To start with, the fund flows into IG corporate bonds have been negative since February. In light of the subdued outlook this is unlikely to change. What is more, the ECB will reduce its monthly purchases from €30 bn to €15 bn from October onwards and will end net purchases by the end of the year. Accordingly, the support by the central bank will be much lower going forward. At the same time, not least due to a higher M&A activity supply is likely to remain on an elevated level. Moreover, corporates have already started to make up some of the lost ground in spring. Accordingly, in contrast to previous years the flow analysis points to some spread widening in the months to come.

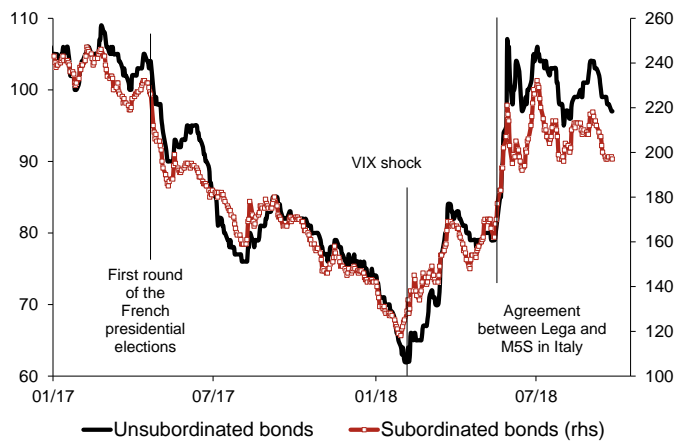
Fundamental situation to remain benign

However, the fundamental situation of euro area IG corporate bonds is still decent. The leverage is not excessive, the funding costs are low on historical comparison

and the free cash flow remains on an upward trend. What is more, corporate bond spreads have increased since the start of the year pricing already the more challenging situation. Hence, the leeway to a further spread widening appears rather limited in the months to come (for Non-Financials: 3-month forecast 110 bps, 12-month forecast 120 bps).

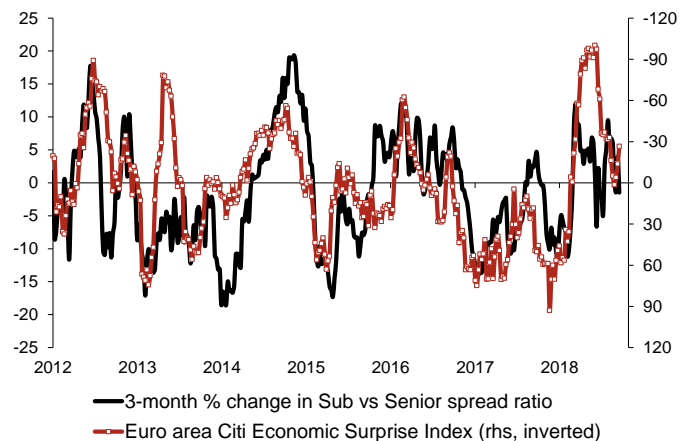
Given the combination of a further increase in underlying yields and a low default risk going forward, investors are advised to prefer lower quality corporate bonds rather than lengthen the duration. Moreover, sectors most exposed to a potential escalation of the trade conflict should be avoided.

Graph 3: ICE BofAML EUR IG FINANCIAL BOND SPREADS



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

Graph 4: SUB/SENIOR SPREAD RATIO AND ECONOMIC SURPRISES



ICE BofAML indices

Higher rates helping Financials, but Italy still on the radar screen

After a significant underperformance vs Non-Financials in H1 2018, EUR IG Financial corporate bonds outperformed in Q3 – mostly in September – thanks to the decline in the BTP-Bund spread and the rise in core yields (positive for banks' profitability). The ICE BofAML Euro Financial index gained 0.15% in total return terms, as the carry and the 13 bps decline in the Option-Adjusted Spread (OAS) offset the negative contribution coming from the increase in the underlying Bund yields (+19 bps). Subordinated bonds (total return: +1.41%, OAS down by 29 bps to 197 bps) more than halved the year-to-date underperformance vs Senior ones (total return: -0.24%, OAS down by 7 bps to 97 bps), also helped by the rebound in euro area macro surprises from record-low levels (see Graph 4).

After the retightening of spreads, valuation looks less compelling compared to the end of June levels, with Italian Financials remaining a special case. In particular, it is worth noting that Italian Senior Financials have failed to recover after the sharp widening experienced in H1 (OAS down by 7 bps to 177 bps in Q3, after +100 bps in H1). With regard to the outlook for the broader index, we expect a mild increase in the OAS (from 121 bps to 125 bps over 3 months and 135 bps over 12 months) as Financials remain exposed to risks related to the situation in Italy. This implies a better total return than core government bonds, but still a slightly negative one. Moreover, we expect Financials and Non-Financials to post similar performances.

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Italian Senior Financials have failed to recover as concerns on upcoming budget law remain high

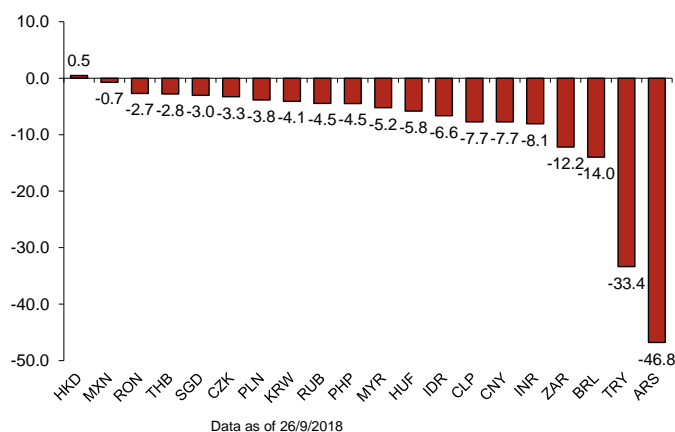
Currencies

- EM currencies have weakened sharply over the summer, led by worries about Argentina and Turkey. With trade war concerns lingering and the USD/CNY to strengthen, pressures are unlikely to abate soon. But since a broader EM crisis is not on the cards and the sell-off is already advanced, this may offer selective buying opportunities.
- The USD is close to peak against the euro. Global trade worries and concerns over Italy and a no-deal Brexit will keep a lid on the euro short term. Further out, however, the support to the USD will fade on easing outperformance of the US economy and a rising US twin deficit.
- The USD/JPY has recoupled to the yield differentials. Expect a weaker yen on higher US yields, even though global trade worries and valuation considerations should limit the downside.

EM FX have been under pressures on idiosyncratic crisis in Turkey and Argentina, but the broader market move was strongly related to mounting trade war fears

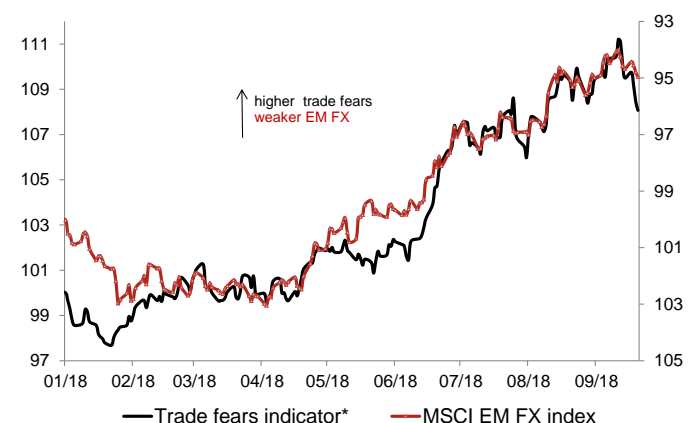
Emerging market currencies remained under pressure over the summer months. The Turkish lira plummeted on an escalating political conflict with the US in early August and an only very reluctant policy response. Only in September, the Turkish central bank raised interest rates sharply to 24%, helping to stabilize the currency. Argentina addressed market pressures more forcefully, but a weak communication strategy by the government still left the peso vulnerable to further losses. Weak economic data in South Africa and high political risks ahead of the presidential election in Brazil added to the headwinds to EMs. In contrast to the 2013 'taper tantrum', however, the carefully communicated Fed tightening is not a broader source of trouble: actually EM FX have been positively related to US short-term yields. Of much greater concern is the escalating trade conflict between the US and China (along various other trading partners). A "trade fear" indicators we built on the basis of relative performance of particularly exposed stocks and sensitive currency pairs reveals that trade worries have been the dominant driver of the recent broader EM FX moves against the USD (see Graph 2).

Graph 1: EM FX PERFORMANCE VS USD



April 30 to Sept 24, 2018

Graph 2: TRADE FEARS S AND EM FX



*equally weighted Stoxx600 vs auto sector, Fathom US China Exposure Index (inv.), JPY/KRW and USD/AUD, end 2017 = 100

Persisting near term pressures on EM FX

Persistent trade tensions and a weaker CNY to weigh on EM FX near term...

Near term, pressures on EM are likely to persist. US President Trump is unlikely to switch to a more compromising stance ahead of the mid-term elections in early November. We also see moderate further weakness in CNY/USD over the coming

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

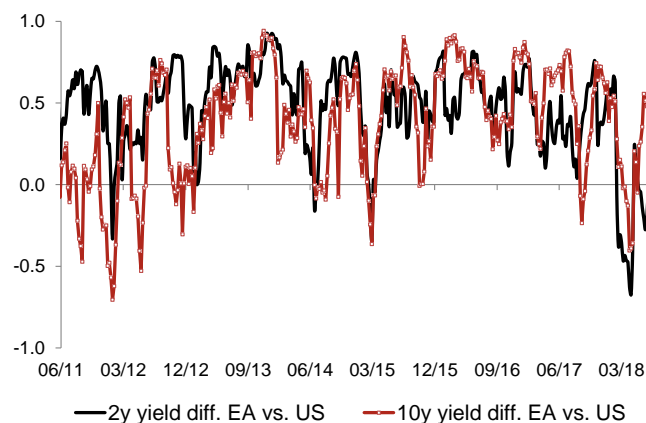
US economic outperformance is set to peter out in 2019, removing a key source of dollar support

weeks, which does not help broader EM FX. That said, valuation yardsticks based on real effective exchange rates and purchasing power parity suggest that depreciation pressures have already advanced quite far. Since a broader EM crisis is not on the cards in our view, this may offer selective buying opportunities for medium-term investors.

US dollar close to peak versus the euro

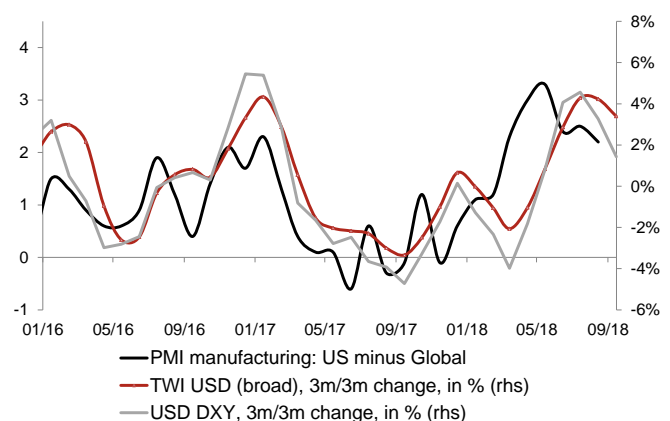
In June we flagged that uncertainties on Italy and trade woes posed near-term risks for the EUR/USD to temporarily break below 1.15. This view has materialized, and we still see risks for the EUR/USD tilted to the downside, with market concerns over the Italian budget unlikely to ebb quickly. Looking further down the road, the EUR/USD is close to peak, though, and we anticipate it to break through 1.20 again in early 2019. The Fed will remain on the course of quarterly rate hikes, but correlation with yield gaps shows that this no longer impresses the FX markets. The growth impact of the US fiscal stimulus will reach its peak in Q4, with US cyclical outperformance over the rest of the world to peter out next year. This will remove a key source of USD strength seen over the past year (see Graph 4). The rising US twin deficit is another headwind. Conversely, the euro will be supported by a C/A surplus and mounting anticipation of a first ECB rate hike in Q3 2019. Volatility may rise however. While an outright FX intervention against US dollar strength seems unlikely, any renewed signs of USD strength may provoke further verbal intervention by the US administration. We may also see a catchup of G10 FX volatility (still low) with the sharp increase in EM FX vols seen over the recent weeks.

Graph 3: EUR/USD DECOUPLING FROM YIELD GAPS



correlation coeff. between %EUR/USD and bps yield gap changes, 2m rolling window, based on weekly data

Graph 4: US DOLLAR AND US ECONOMY VS GLOBAL



USD/JPY upside on higher US yields

USD/JPY has recoupled with US yields, supporting the case of some further moderate upside

After strongly defying yields moves in the first half of the year, the USD/JPY has recoupled to US Treasury yields. With the latter likely to creep higher over the coming months and Japanese yields still held back by the BoJ's yield curve control, the yield gap will continue to widen to the favor of the US dollar. That said, the move may well be subject to rising volatility. The yen is already dear in valuation terms (with the effective exchange rate 20% below historical average and USD/JPY 11% above purchasing power parity). And bouts of risk aversion amid the lingering trade war may also trigger "safe haven" demand for the Japanese currency.

Equities

- Enduring US recovery phase and still contained yields advocate an OW in equities.
- We prefer balanced allocation between EMU and the US (slightly OW). OW Japan, SMI, UK, value and quality.
- While risks remain still high, they are mostly priced in over the last quarter.
- We maintain our cautious view but with a more constructive stance short term, expecting the bulk of returns over the next six months. Thereafter, from early 2019, we see increasing risks of a temporary set-back due to reducing monetary stimulus, lower GDP momentum and increasing yields.
- We are constructive on EMs (currently neutral), favoring India, Korea and CEE countries.

We maintain our cautious view but since early September we adopted a more constructive stance - limited overweight from underweight.

In the quarter, global markets maintained an upward trend (+6% the MSCI World total return, TR) mainly due to the US market (+7.4% the S&P 500) and Japan (+7%). The VIX decreased further from around 16 to 12.5, contributing to the improved investors' sentiment. Positive market triggers were an enduring robust macro trend in the US, good reporting seasons and higher oil prices (+2.7%, positively contributing to earnings growth). As we envisaged in our June update, the last quarter was not immune from risks, with euro area (EA) equities (EMU index, +1.5%) unable to outperform the US. The defensive SMI (+5.6%) outperformed the EA while the FTSE UK 100 (an undervalued and under owned index) ranked poorly (-0.7%), mainly due to Brexit fears. Finally, European banks underperformed, together with the auto sector, materials, Italian MIB and EMs (zero, -1%, -4%, +0.7, and -1%, respectively). More defensive sectors like insurance, pharma and oil overperformed (+7%, +5% and +4.7%, respectively), together with industrials (3.5%). While

Graph 1: MSCI EMU: PE AND BAA YIELD

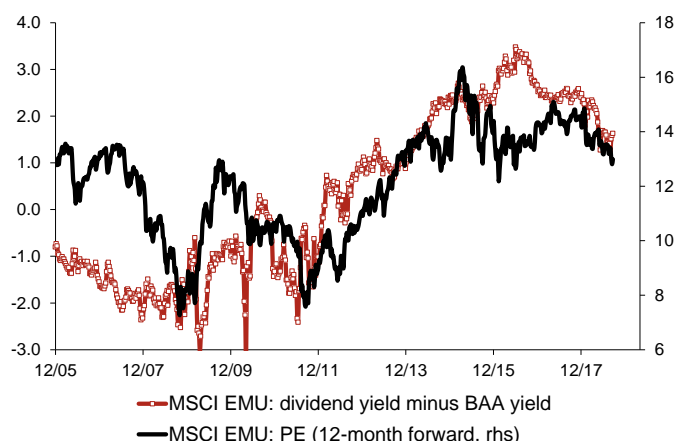


Table 1: PERFORMANCE AND PE CONTRACTION

Index	%TR	DY	%Price	%Earnings	%PE
MSCI World	6.3	1.98	4.3	14.1	-8.6
S&P 500	10.6	1.55	9.0	18.7	-8.1
MSCI EMU	1.5	2.83	-1.3	7.6	-8.3
TOPIX	1.5	1.20	0.3	9.7	-8.6
FTSE100	1.0	3.31	-2.3	11.5	-12.4
SMI	-0.5	3.33	-3.8	5.7	-9.1
FTSE MIB	2.4	3.27	-0.8	15.8	-14.4
MSCI EM (\$)	-8.0	2.07	-10.1	1.3	-11.2
MSCI Brazil	4.9	2.88	2.0	29.6	-21.3
MSCI Russia (\$)	7.1	4.37	2.7	19.3	-13.9
MSCI India	4.3	1.32	3.0	5.6	-2.5
MSCI China	-9.4	1.79	-11.2	8.0	-17.7

* changes are YTD

remaining cautious, we got more prone to risk from early September (limited OW from former underweight) as markets seem to have incorporated more current risks after the downturn which brought EU markets slightly below the levels at the end of June. For the mid-term (i.e. 6 - 12-months) we are constructive, in particular, on the European and Japanese indices, where we see a 6% TR, albeit more probable in the first 6 months than thereafter.

Lower monetary stimulus inducing lower market multiples

Hawkish central banks' stance (Fed in particular), reducing monetary stimulus and softer macro momentum, along with political and trade risks, will continue to cap

EA macro surprises have improved and the US remains in a recovery phase (not late cycle), thus favoring equities.

price-earnings expansion and keep us still on the cautious side (limited overweight position). Indeed, year-to-date, the 12-month PE declined for all relevant markets: average -7.5% for the US and EMU (refer to table 2). Only thanks to high earnings growth, markets were able to achieve positive TR, with the exception of EMs. The current level of market volatility (VIX) remains also dangerously low, as the Fed funds rate is expected to increase further into the next year. Early 2019, we could also assist to a peaking momentum of the US GDP growth and tax reform stimulus, while 10-year rates should trend higher than current levels. This would ultimately trigger a further deterioration of the growth/inflation mix, inducing higher credit spreads and a possible negative reaction by risky assets.

Getting constructive short term notwithstanding lingering risks

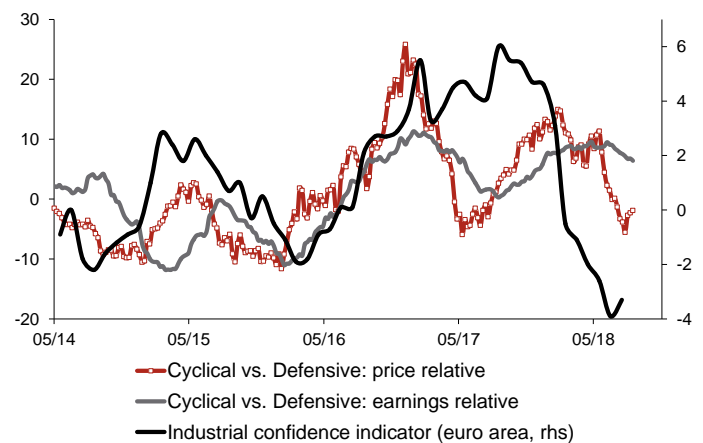
That said, the price action till early September has been particularly negative in some risky areas: Italy, EM, autos and financials. So, while maintaining our cautious view, we became more constructive, albeit not exploiting the full OW position yet (only moderately so) also because investors positioning doesn't show signs of capitulation. In particular, EU autos show a 30% discount to historical valuations, EU banks' ones are near 2016 lows (not there yet) and Italian PE relative to EMU is lower than in 2012. Lastly, EM market multiples show an appreciable discount to history, too. Short-term models for the EMU index shows a potential 3% increase while they were neutral before. Macro surprises in the EA have also recovered visibly from cyclical lows at the time when the valuation discount to the US is quite high versus history and the trade-weighted euro is more supportive for EA earnings. Furthermore, a late-cycle approach to asset allocation identifies the US to be still in a recovery phase and with contained bond yields and supports an OW position in

Table 2: EQUITY MARKETS VALUATION DASHBOARD

Markets	Price / Earnings *		Price / Book *		Price / Cash Flow *		Dividend Yield *		Avg. Discount, %
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	
WORLD	15.6	16.0	2.3	1.9	10.6	8.7	2.5	2.7	11.3
USA	16.9	15.3	3.2	2.4	12.1	9.9	2.0	2.2	19.4
JAPAN	13.6	15.6	1.3	1.3	8.1	7.1	2.2	1.9	-2.8
UK	12.8	13.8	1.7	1.8	8.3	7.9	4.4	4.0	-4.5
SWITZERLAND	15.1	15.4	2.3	2.2	10.4	11.2	3.7	3.3	-4.0
EMU	13.2	14.1	1.5	1.5	8.0	6.5	3.6	3.9	6.6
FRANCE	13.8	14.3	1.6	1.5	8.6	6.9	3.4	3.7	8.7
GERMANY	12.5	15.1	1.5	1.5	7.9	6.7	3.3	3.3	0.9
GREECE	12.9	12.8	2.0	1.6	6.7	6.0	5.7	3.9	-2.6
ITALY	11.0	15.2	1.2	1.2	5.4	4.7	4.7	4.6	-3.3
PORTUGAL	15.8	12.7	1.9	1.7	6.2	5.9	4.5	4.5	9.5
SPAIN	11.4	12.9	1.2	1.6	5.3	5.1	4.7	5.1	-6.5
EURO STOXX 50	12.7	13.2	1.5	1.5	7.6	6.2	4.0	4.2	5.9
STOXX SMALL	16.5	14.4	1.9	1.7	10.0	8.3	3.1	3.2	12.8
EM, \$	11.2	14.5	1.5	1.6	7.0	7.7	3.1	3.1	-10.5
BRAZIL	10.2	9.0	1.6	1.7	6.4	13.8	4.6	4.3	-12.9
RUSSIA	5.3	7.0	0.7	0.9	3.4	4.5	7.4	3.7	-43.7
INDIA	18.3	14.5	2.7	2.7	11.9	11.5	1.6	1.6	7.7
CHINA	11.0	13.0	1.5	1.7	7.1	7.6	2.6	3.0	-5.6

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

Graph 2: EUROPE: CYCLICAL VS. DEFENSIVE SECTORS



(6M % chg)

We see total returns of 6% in the EA and Japan as possible in the next 6/12 months, 2.5% for the US. The first 6 months should see the bulk of positive returns.

equities in the short term. Finally, equity flows look subdued vs. bonds' ones and corporate cash flows in the G4 countries still surpass the capital expenditures by a wide margin; the contrary was true in the years 2000 and 2007.

Our models suggest possible total returns of 6% in the EA and Japan in the next 6/12 months, but only 2.5% for the US, given valuation exuberance and expectations for higher yields (and higher HY spreads) and peaking growth momentum. The first 6 months should see the bulk of positive returns. Indeed, by early next year – once the market would have already recovered from current levels – higher US 10-year rates and continuing Fed's hikes could then trigger temporary set-backs.

We prefer balanced allocation between EMU and the US. We stay overweight on UK, Japan and Switzerland. Cyclical underperformed appreciably and EA macro

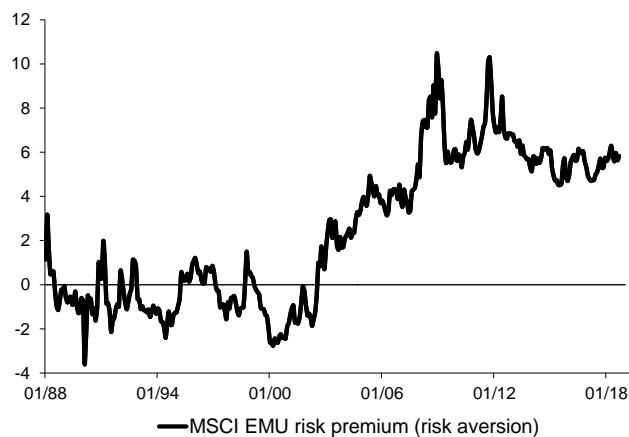
By early next year - once the market would have already recovered from current levels – higher US 10-year rates and continuing Fed's hikes could then trigger temporary setbacks.

surprises are rebounding, with US macro momentum firm and Chinese authorities ready to offset any significant GDP weakness: we go neutral on cyclicals vs. defensives from UW. OW: discretionary and insurances. We move oils, pharma, household and TLC from OW to neutral; and industrials and diversified financial from UW to neutral. Both materials and IT are kept as UW. We recommend only a limited OW on Value – supported by valuation, increasing yields and fading growth expectations for the US IT sector - compensated by an OW on Quality and neutral on Growth.

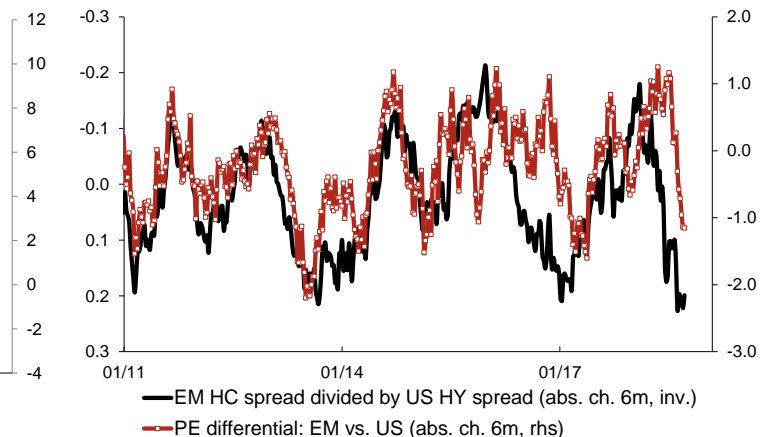
EM: though market priced in a lot, still cautious short term

Over the quarter, Emerging markets (EM) have come under pressure, decreasing by 1.2%. While stronger trade-weighted dollar (+0.9%) and increasing hard-currency

Graph 3: MSCI EMU: RISK PREMIUM



Graph 4: EM VS US & EM HC SPREAD VS. US HY SPREAD



12m fwd earnings yield minus EMU 10-year gov. yield

EM: wait for a better entry point. Earnings are expected to become even softer with lingering trade risks.

bond yields (+18bps) did play a negative role, it was in our view more trade war concerns coupled with slowing global growth, softer commodity prices, falling money supply in China and crises in Argentina and Turkey that led EM equities lower. Since January 2018, the EM stocks experienced a correction by around 20% and now look rather cheap. Indeed, multiples are at a discount of 11% versus their historical average. Likewise, their cyclically-adjusted PE is almost one standard deviation below history. The MSCI China has corrected even more (-23%) becoming slightly undervalued (6%). Furthermore, for the first time since one year, our short-term models (based on earnings, yields, exports, and corporate spreads) indicate a positive potential (+6%). Falling money supply is not supportive, even though the PBoC is ready to jump in, should growth become too weak. That said, we take a cautious stance on Chinese equities due to softening earnings momentum coupled with trade-war risks. Fed tightening seems to be priced in in the short term and the EM performance relative to developed equities has quite a bit undershot the trade-weighted dollar. EM earnings, however, are expected to become even softer. Geopolitical risks, trade war and contagion concerns along with slowing Chinese growth are likely to keep uncertainty elevated and represent a key reason to stay cautious in the near term. We would maintain a neutral position on EMs and would wait for a better entry point to benefit from lower valuations and higher projected GDP growth (vs DMs) and keep favoring Korea, India, along with the CEE markets.

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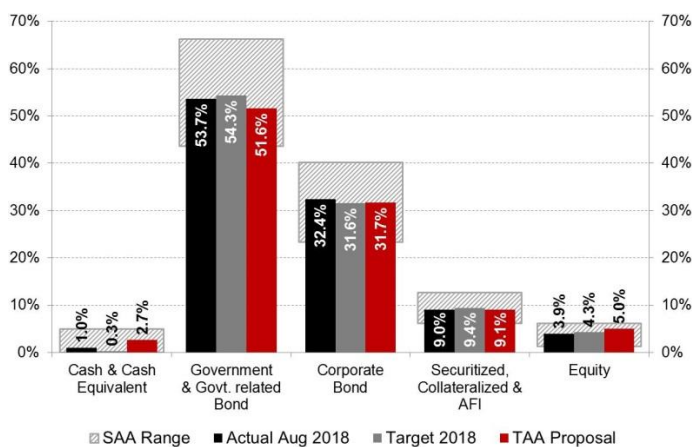
Asset Allocation

- Concerns about a global trade war, the political situation in Italy, selective trouble spots in emerging markets, and the refueled Brexit uncertainty will continue to keep a tight grip on markets.
- With the overall global economic picture remaining solid, though, we continue to favor an overweight in equities and cash at the expense of bonds, as we did in our last quarterly review in June.
- Amid the above-mentioned risks, however, we refrain from exploiting the full scope for tactical positioning leading in general to a slightly more cautious allocation stance than at the beginning of Q3.

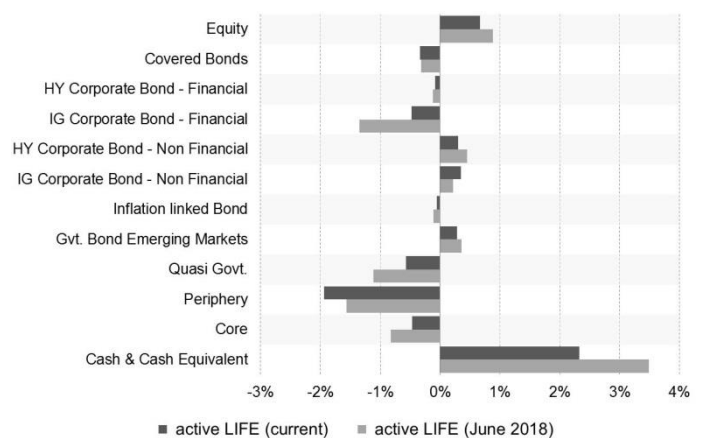
Tactical pro-risk stance to be maintained with a further reduced degree of aggressiveness

The US continues to grow strongly and also in the euro area growth is expected to stay above potential. Fed and ECB proceed further in normalizing their policy. Thus moderately rising core yields will limit the attractiveness of fixed income investments in general. On its own, this continues to favor a risk-friendly tactical orientation of the portfolio (see Graph 1). However, compared to the recommendation for Q3 provided in June, we reduce the aggressiveness of the allocation by sticking closer to the benchmark weights in principle (see Graph 2) in order to take the “political” risks

Graph 1: LIFE STRUCTURES AND BANDWIDTHS AT SAA LEVEL 1



Graph 2: LIFE ACTIVE POSITIONS COMPARED TO LAST QUARTER'S INITIAL RECOMMENDATION



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

In pp; Periphery = Italy & Spain

sufficiently into account.

Duration gap to be reduced across all fixed income market segments

Having said that, the underweight in peripheral government bonds is further extended as short-term the political uncertainties in Italy bear the risk of a spread widening. In Comparison to the initial tactical recommendation for Q3 the active position in equities is slightly reduced. Compared to the last monthly revision, though, we recommend to raise the equity exposure again as we deem compensating market movements most likely after the underperformance in summer. The overweight in cash is maintained as well as the short stance on duration, though both at reduced levels too. The latter is achieved by consistently reducing the duration gap for each and every fixed income market segment. Within these segments we recommend to overweight the short-term maturities at the expense of the mid- to long-term buckets.

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Forecasts

GROWTH

	2016	2017	2018f	2019f
US	1.6	2.3	2.8	2.5
<i>Euro area</i>	1.8	2.5	2.0	1.7
Germany	2.2	2.2	1.9	1.7
France	1.1	2.3	1.7	1.6
Italy	1.0	1.5	1.1	0.9
<i>Non-EMU</i>	2.0	1.8	1.5	1.6
UK	1.8	1.7	1.3	1.5
Switzerland	1.4	1.1	2.2	1.7
Japan	1.0	1.7	1.0	1.0
<i>Asia ex Japan</i>	6.4	6.1	6.1	6.0
China	7.1	6.9	6.5	6.3
CEE	1.4	3.9	2.9	1.8
Latin America	- 1.3	0.8	0.7	1.7
World	3.2	3.7	3.6	3.5

INFLATION

	2016	2017	2018f	2019f
US	1.3	2.1	2.5	2.3
<i>Euro area</i>	0.2	1.5	1.7	1.6
Germany	0.4	1.8	1.8	1.8
France	0.3	1.0	1.8	1.6
Italy	- 0.1	1.2	1.3	1.3
<i>Non-EMU</i>	0.7	2.5	2.3	2.1
UK	0.7	2.7	2.5	2.2
Switzerland	- 0.4	0.5	1.0	1.0
Japan	- 0.1	0.5	1.0	1.0
<i>Asia ex Japan</i>	2.6	2.2	2.8	2.9
China	2.0	1.6	2.1	2.3
CEE	5.2	5.0	5.8	6.9
Latin America	6.3	4.3	3.9	4.2
World	2.3	2.3	2.8	2.9

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	EM Gvt. Bonds Spreads	Current	3M	6M	12M
USD	2.38	2.45	2.70	3.15	Latin America	487	485	480	465
EUR	-0.35	-0.35	-0.35	-0.25	Asia ex Japan	201	208	210	212
JPY	-0.04	-0.05	0.00	0.05	CEE	143	138	133	128
GBP	0.80	0.80	0.90	1.05	Forex	Current	3M	6M	12M
CHF	-0.73	-0.75	-0.75	-0.75	EUR/USD	1.17	1.16	1.19	1.23
10Y Government Bonds	Current	3M	6M	12M	USD/JPY	113	114	115	115
US	3.07	3.10	3.20	3.30	EUR/JPY	133	132	137	141
Euro-Area	0.54	0.55	0.70	0.90	GBP/USD	1.32	1.25	1.29	1.35
France	0.85	0.90	1.05	1.25	EUR/GBP	0.89	0.93	0.92	0.91
Italy	2.88	3.45	3.35	3.50	EUR/CHF	1.14	1.13	1.15	1.17
Japan	0.13	0.10	0.10	0.10	Equities	Current	3M	6M	12M
UK	1.61	1.65	1.70	1.80	S&P500	2912	2905	2930	2930
Switzerland	0.06	-0.05	0.05	0.20	MSCI EMU	124.9	125.0	128.5	127.0
10Y Spreads	Current	3M	6M	12M	TOPIX	1815	1830	1875	1885
Covered Bonds	49	50	50	55	FTSE	7521	7505	7650	7630
GIIPS	161	195	185	180	SMI	9071	9100	9240	9220
Corporate Bond Spreads	Current	3M	6M	12M					
BofaML Non-Financial	108	110	115	120					
BofaML Financial	121	125	130	135					

As of 26.09.18 (3-day-average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

Government Bonds (10Y)	US	2.71	3.10	3.49
	Germany	0.48	0.55	0.62
	UK	1.37	1.65	1.93
	Switzerland	-0.04	-0.05	-0.06
	10Y-GIIPS Spread	170	195	220
Spreads	EUR Covered Bond Spread	43	50	57
	Euro Corporate Spread (Non-Fin)	99	110	121
	Euro Corporate Spread (Sen-Fin)	113	125	137
	EM Latin America Spread	439	485	531
	EM Asia Spread	187	208	229
	EM Europe Spread	123	138	153
	EUR/USD	1.12	1.16	1.20
Forex	USD/JPY	109	114	119
	EUR/GBP	0.90	0.93	0.96
	EUR/CHF	1.10	1.13	1.16
	S&P500	2,800	2,905	3,010
Equities	MSCI EMU	118.5	125.0	131.5
	TOPIX	1,712	1,830	1,948
	FTSE 100	7,190	7,505	7,820
	SMI	8,736	9,100	9,464

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Government Bonds (10Y)	US	2.48	3.30	4.12
	Germany	0.75	0.90	1.05
	UK	1.30	1.80	2.30
	Switzerland	0.19	0.20	0.21
	10Y-GIIPS Spread	130	180	230
Spreads	EUR Covered Bond Spread	42	55	68
	Euro Corporate Spread (Non-Fin)	98	120	142
	Euro Corporate Spread (Sen-Fin)	110	135	160
	EM Latin America Spread	361	465	569
	EM Asia Spread	160	212	264
	EM Europe Spread	98	128	158
	EUR/USD	1.16	1.23	1.30
Forex	USD/JPY	105	115	125
	EUR/GBP	0.85	0.91	0.97
	EUR/CHF	1.11	1.17	1.23
	S&P500	2,707	2,930	3,153
Equities	MSCI EMU	112.9	127.0	141.1
	TOPIX	1,607	1,885	2,163
	FTSE 100	6,962	7,630	8,298
	SMI	8,399	9,220	10,041

*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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