



**GENERALI**  
INVESTMENTS

# Market Perspectives

When it rains, it pours

December 2018 / January 2019



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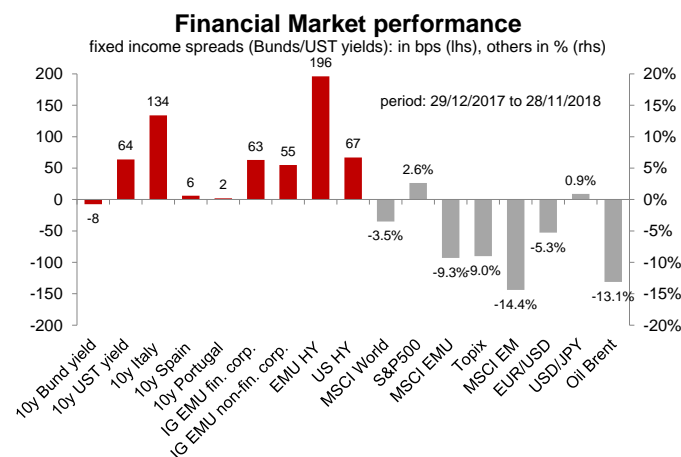
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# Global View

Vincent Chaigneau / Thomas Hempell

- The autumn has confirmed that 2018 will be ‘annus horribilis’ for global financial assets. Credit markets are bleeding and October was the worst month for stocks since 2012. November has only seen a tentative stabilisation.
- The trade war remains the wild card. But somewhat milder forward guidance from the ECB and Fed should offer support into the finish line.
- While risks have risen, a deeper global slowdown is not around the corner. Amid more attractive entry points, we slightly extend a tilt towards IG credit and keep a small overweight in equities.

When it rains, it pours. Already the Flash crash in February was severe; then October saw the most severe monthly equity sell-off (MSCI World) since 2012. A further drawdown by mid November aggravated the year-to-date losses. Tech stocks entered bear market territory. Pressures on corporate bonds also mounted, taking EUR IG credit spreads to their highest since 2016 – exacerbated by a sharp drop in oil prices hitting US HY. Trade war risks, weaker economic data and fading central bank support are weighting on sentiment. As we go to press a slightly softer Fed is offering some relief, however.



Concerns about the ongoing **political** landscape are still ranking high, and December is packed with decisive events. The fiscal stand-off between the Italian and the EU remains unresolved. The British government and the rest of the EU struck a deal, but parliamentary approval in the UK remains unlikely on 11 December. This will keep investors nervous, though we deem the no-deal scenario (crash Brexit) unlikely. Trade war concerns keep lingering. Barring a last-minute Sino-US deal at the G-20 meeting (Nov 30/Dec 1), higher US tariffs on US\$ 200bn of Chinese exports will mark the next step in an escalating trade conflict. EU/US trade talks have neither yielded progress so far, feeding fears of punitive tariffs on European cars (and reverse EU action).

**Economic** worries have mounted, too. In the euro area, poor Nov. Flash PMIs have dampened hopes for a swift recovery from a sluggish Q3 GDP (0.2%qoq) on the reversal of temporary factors in the car industry. And in the US, underwhelming housing and capex indicators suggest that this year's rise in rates is starting to bite.

And yet we caution that market pricing has turned too pessimistic. Robust labor markets and healthy consumption will cushion the slowing of global growth. Recent policy support in China should also prevent a hard landing; EM economies are generally set to hold up well.

Nervous investors are turning to central banks. What degree of market stress will be needed to slow Fed and the ECB policy normalization? Persistent inflation risks in the US do require further hikes. But President Powell has just given the first subtle hint of a more dovish tilt, suggesting that rates may be **close to neutral**. The ECB remains determined to close the era of QE this year. But it will stress its flexibility on Dec.13 and is likely to deliver a rather dovish message through forward guidance on the rate cycle and the reinvestment policy (duration, operation twist, possible reallocation from sovereigns to credit).

Bonds	28/11/18*	3M	6M	12M
10-Year Treasuries	3.06	3.15	3.25	3.40
10-Year Bunds	0.35	0.45	0.55	0.90
<b>Corporate Bonds</b>				
BofaML Non-Financial	139	140	145	145
BofaML Financial	153	150	155	160
<b>Forex</b>				
EUR/USD	1.13	1.12	1.15	1.20
USD/JPY	114	113	111	108
<b>Equities</b>				
S&P500	2700	2710	2665	2685
MSCI EMU	114.6	117.0	113.0	116.0

\* avg. of last three trading days

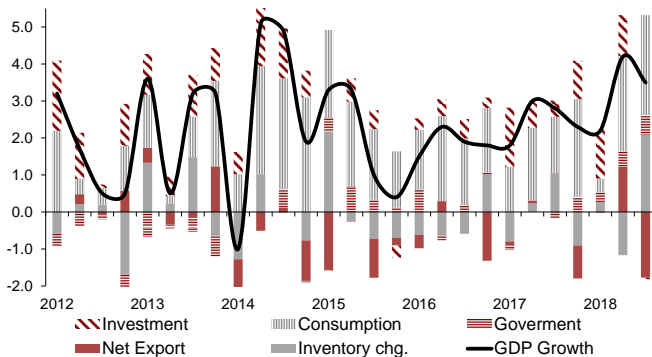
## More attractive entry points in credit

We acknowledge the risks on both the economic outlook and political fronts. But the severe autumn correction looks exaggerated. Global growth is slowing only moderately. The trade war is the wild card but Trump can't ignore stock markets and growth as he looks forward to the 2020 election. The ECB and Fed meetings may provide small support to Risk. The Dec. 11 Brexit deal rejection is consensual. We take advantage of the wider credit spreads to re-weight slightly EUR IG Credit. We see a moderate rebound in stocks into the turn of the year. EA core yields are at the low end of the trading range – we slightly extend the underweight there. We continue to favor a cautious stance on BTPs, but given the costs of carry and fading newsflow, we slightly reduce our underweight position.

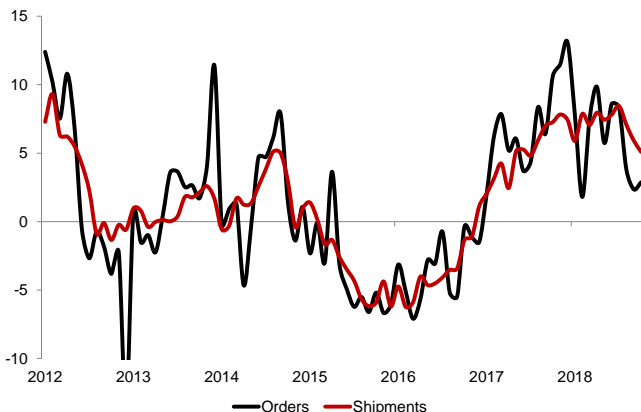
# USA

Paolo Zanghieri

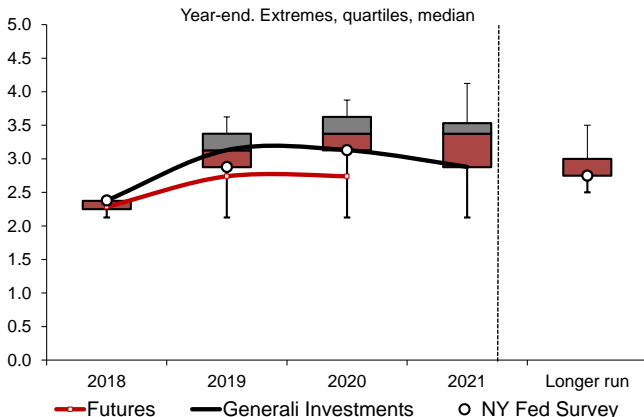
**Contributions to GDP growth**  
% qoq annualized, seasonally adjusted



**Durable goods (% chg. yoy)**  
Ex. Transportation & Defense



**Appropriate path and forecasts for the Fed funds rate**  
Year-end. Extremes, quartiles, median



- After the strong Q3 reading, GDP growth is set to soften at the end of the year, dampened by weak capex and net trade. Growth will likely average 2.9% in 2018, before sliding to 2.5% next year.
- The labor market continues to power ahead, with wage growth nearing 3% yoy. Inflation is catching up gradually; we expect the core rate to reaccelerate to a 2.6% yoy peak next year.
- Communication by the Fed took a dovish turn, but markets are overreacting. We still expect four rate hikes by the end of 2019.

In Q3, GDP increased by a better-than-expected 3.5% (yoy ann.). We expect a marked deceleration for Q4, leading to a respectable 2.9% yoy growth for the year as a whole. While consumption still benefits from strong labor income, with the additional support of falling fuel prices, capex appears weaker than expected. Orders and shipments continued to slow down, in line with business surveys showing higher uncertainty related to the evolution of the trade tensions. Moreover, the more interest rate sensitive items of domestic demand are starting to feel the pinch of tighter financial conditions. This and the rapid fading of the fiscal stimulus in the second half of next year will lead GDP growth to slide to 2.5% in 2019.

## Core inflation to edge slightly up

The unemployment rate is stable at 3.7%, the lowest level in almost 50 years, and the economy continues to create jobs at a very strong rate, 250k in October, or more than the double of what is needed to stabilize unemployment. This is stimulating unemployed persons to go back into looking for a job, contributing to moderate wage growth, which picked up to 2.8% yoy in October. Higher input costs will be increasingly passed on to consumers, against a background of strong demand and with the diminishing boons from the cut in corporate taxes. As a result, core inflation will resume its upward drift after the retrenchment to 2.1% yoy seen in October, peaking at 2.6% yoy by Q3 2019. This should translate into core PCE inflation ending next year at 2.3% yoy, 0.2 pp point above the Fed forecast.

## The Fed to hike rates four times by end-2019

Despite a tighter labor market and the perspective of higher inflation, markets have repriced down the expected path of Fed rates, on the back of a weakening global cycle, tighter financial conditions and uncertainty on the actual impact of tariffs. Communication by FOMC members turned dovish, but markets appear to have overreacted. We stick to our call of another rates hike in December and three more in 2019. We expect the Fed to hike rates in March and June next year and then pause to assess the effect of the tightening cycle; The third and final hike will depend heavily on the outlook for the economy in H2.



# Euro Area

Martin Wolburg

- In November, key sentiment indicators weakened further fostering concerns about growth.
- We still think that solid domestic activity will set the tone and that growth will rebound in Q4.
- While we expect the ECB to end QE in December, it will likely adopt a more dovish stance on rate hikes at its meeting on December 13.

In November, the vast majority of euro area indicators surprised on the downside. Most noteworthy, the composite PMI continued to decline further (from 53.1 to 52.4) thereby reaching the lowest level since December 2014. Also, consumer confidence receded again and in Italy and France it even fell to multi-year lows.

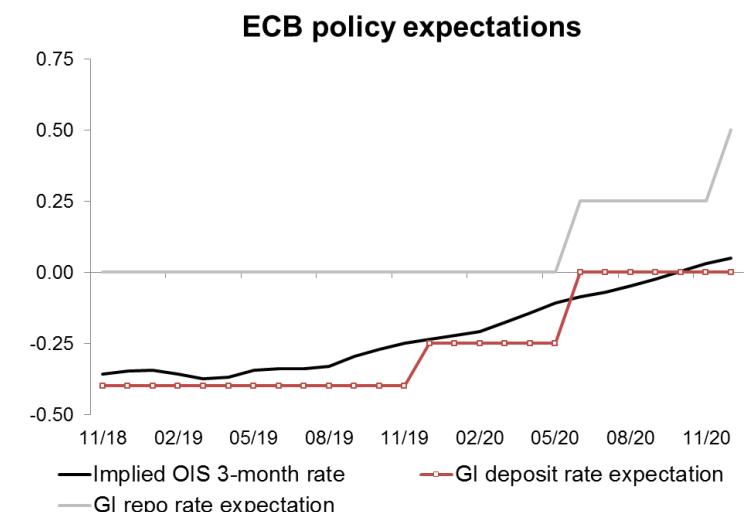
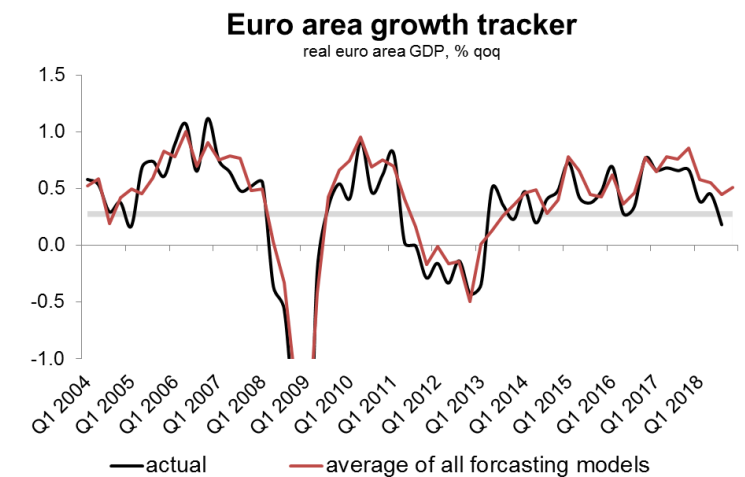
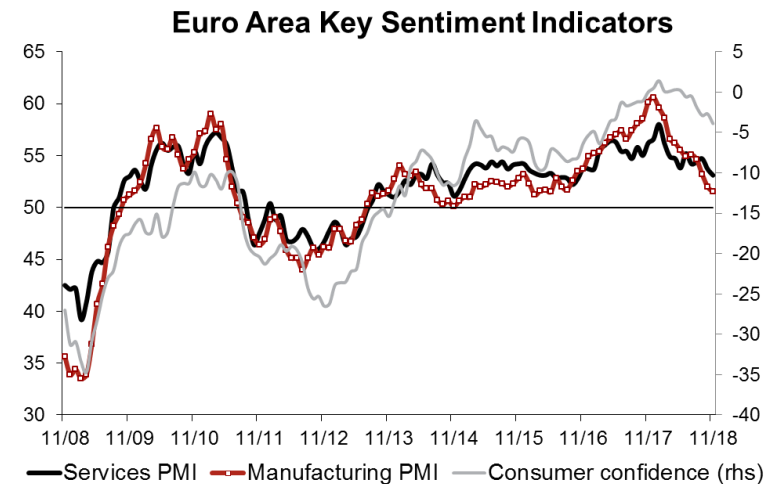
While the continued drop in confidence clearly is a negative signal, it also has to be kept in mind that real activity data should look less negative: The drop in industrial production ahead of the introduction of new car emission testing regime in September will unwind and according to our calculations lift euro area GDP growth by almost 0.1 pp in Q4. Also, falling euro denominated oil prices (-1.1% yoy in Nov., from +35.6% yoy in Oct.) will dampen headline inflation and increase purchasing power. With labor market improvement continuing and capacity utilization above normal, implying ongoing investment activity, domestic demand is set to remain solid. Last, albeit key sentiment indicators weakened they are still consistent with growth around potential at least.

All in all, we look for a rebound of GDP growth towards 0.4% qoq in Q4, up from 0.2% qoq in Q3. We stick to our growth forecast of 1.9% for 2018 and of 1.6% for 2019. That said, a crash Brexit, US tariffs on EU cars, an escalation of the US/China trade dispute or a further escalation of the EU-Italian budget struggle would worsen the outlook significantly.

## ECB stays on normalization track

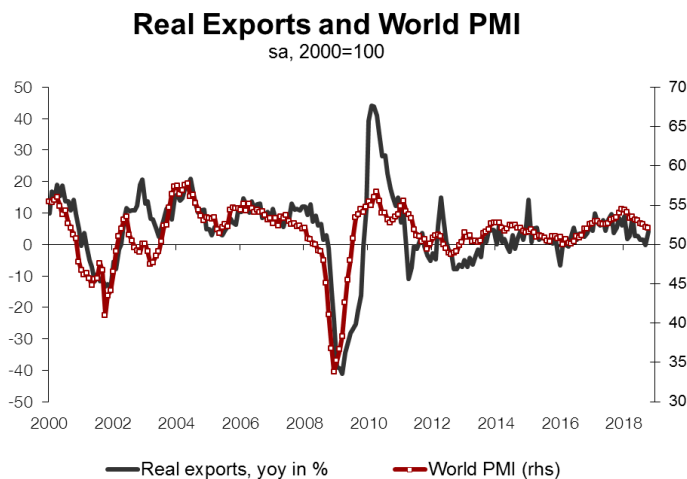
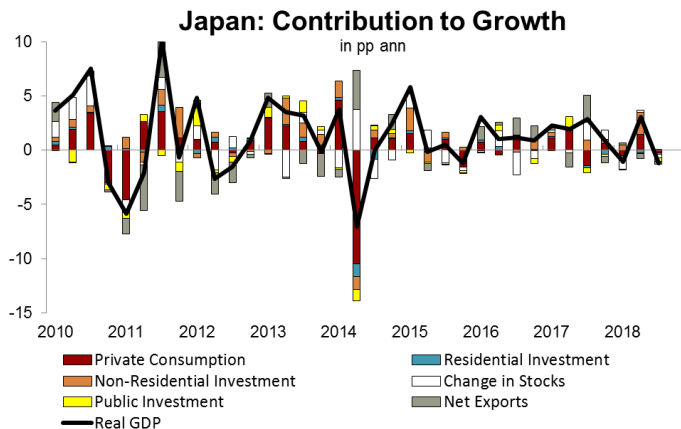
At its meeting on December 13 the ECB Governing Council will have to adjust its growth and inflation projections down. However, latest comments from Council members suggest that they see the fundamentals for solid domestic demand and implicitly also policy normalization still in place.

We expect the ECB to end QE in December but to adopt a dovish wording regarding the timing of the first rate hike, given high uncertainties and the latest negative surprises. A first rate hike in December 2019 now seems most likely to us. Moreover, the ECB will outline its post QE reinvestment policy. Most importantly, forwards guidance with respect to the reinvestment period appears likely.



# Japan

**Christoph Siepmann**



- According to the first estimate, Japan's GDP receded by 1.2% qoq annualized in Q3.
- As the drop was mainly driven by natural disasters, data started to rebound in October.
- Core-core inflation remained low, adding to the case of no substantial change in monetary policy ahead of the sales tax hike in October 2019.

Japan had been repeatedly hit by natural disasters in Q3. As a result, its real GDP receded by 1.2% qoq annualized. All main demand components contributed negatively, with net exports, private consumption and an inventory effect almost on par, followed by private non-residential investment. However, as the reasons were largely one-off events, October data began to show the expected rebound. Real exports shot up by 6.3% mom, after a sharp drop in the month before. Real imports recovered even more strongly by 7.0% mom. Nevertheless, fluctuations aside, we expect real export growth to be less supportive, going forward, as world activity has begun to slow amid the US fiscal policy stimulus likely having peaked. Moreover, the US-China trade conflict could well have negative repercussions across Asia, and for Japan first reports are out, that semiconductor production equipment demand from China has recently slowed. In line with exports, industrial production also began to re-normalize, improving by 2.9% mom. The two-month outlook by METI sees the further development also positive (Nov. 0.6%/Dec. 2.2% mom), resulting in a stark rebound of 3.9% qoq in Q4. Retail sales also moved up by 3.5% yoy and we expect private consumption in Q4 to contribute again positively to GDP growth in Q4.

## Wage pressures to stay low

Japan's headline inflation rose to 1.4% yoy in October. However, the main drivers were food and energy. Food prices rose by 2.4% yoy, with fresh food inflation shooting up to 10.8% yoy, while energy prices rose by 8.9% yoy. Accordingly, excluding these items, core-core inflation BoJ style (ex fresh food and energy) remained unchanged at 0.4% yoy. The "traditional" measure ex food and energy was even lower at 0.2% yoy. Given the recent strong drop in oil prices, the upward pressures from energy prices will start abating soon. Moreover, service inflation – which is a better indicator for domestic wage pressures – remained stuck at 0.2% yoy. Recent press reports indicate, that the Japanese Trade Union Confederation (Rengo) will not adopt stronger wage demands in 2019 than in 2018. Combined, we see a downside risk for our inflation forecast of 1% in 2019. This will also tend to increase the hurdle for the BoJ to change its monetary policy soon. BoJ Governor Kuroda recently ruled out abandoning the short-term negative interest rate (while he acknowledged its negative side effects), suggesting no substantial policy move ahead of the sales tax hike in October 2019.

Main Forecasts <sup>1)</sup>	2016	2017	2018f	2019f
<b>GDP</b>	<b>1.0</b>	<b>1.7</b>	<b>0.9</b>	<b>1.3</b>
<b>Consumer spending</b>	<b>0.1</b>	<b>1.0</b>	<b>0.6</b>	<b>1.1</b>
<b>Government consumption</b>	<b>1.3</b>	<b>0.1</b>	<b>0.5</b>	<b>1.1</b>
<b>Investment</b>	<b>1.1</b>	<b>2.6</b>	<b>1.9</b>	<b>3.6</b>
<b>Inventories</b>	<b>-0.2</b>	<b>-0.1</b>	<b>0.2</b>	<b>0.0</b>
<b>Net trade</b>	<b>0.5</b>	<b>0.5</b>	<b>0.2</b>	<b>-0.2</b>
<b>Domestic demand</b>	<b>0.6</b>	<b>1.2</b>	<b>0.6</b>	<b>1.6</b>
<b>Consumer prices</b>	<b>-0.1</b>	<b>0.5</b>	<b>1.0</b>	<b>1.0</b>
<b>Unemployment rate<sup>2)</sup></b>	<b>3.1</b>	<b>2.8</b>	<b>2.4</b>	<b>2.2</b>
<b>Budget balance<sup>3)</sup></b>	<b>-3.6</b>	<b>-4.3</b>	<b>-3.7</b>	<b>-2.8</b>

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

# China

Christoph Siepmann

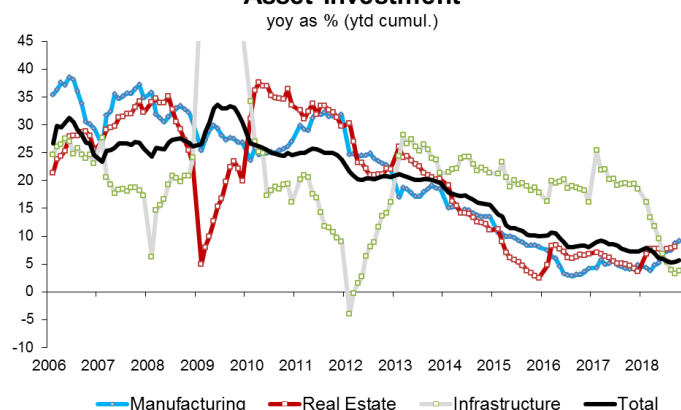
- China's October real activity data came in mixed while overall credit growth continued to soften.
- Fiscal policy easing started to become visible in infrastructure investment. However, policy support looks cautious rather than "massive".
- Political signals on the US-China trade conflict remained inconclusive. A short-term US-China deal would help to not worsen China's slowing.

China's October real activity data were a mixed bag. On the positive side, industrial production increased marginally by 0.1 pp to 5.9% yoy and fixed asset investment rose from 5.4% yoy ytd to 5.7% yoy ytd. The latter was supported by a turn-around in infrastructure investment. On a yoy basis, the growth rate of this component shot up to 7.5% yoy in October, from a slightly negative reading in the month before. This acceleration had been expected before as part of China's fiscal policy easing and over the last months, local governments had issued infrastructure bonds already up to their quota. However, ytd infrastructure investment improved only to 3.8% yoy ytd, compared to more than 16% at the beginning of this year. A positive surprise also came from trade data as export growth edged up to 15.6% yoy, defying expectations that the first month with additional US tariffs on US\$ 200 bn fully in place would result in some deceleration. While the general US import pull, some front-loading of US imports and the depreciation of the yuan might help explaining the figure, such resilience is unlikely to last. With regard to the downside surprises, retail sales eased significantly from 9.2% yoy to 8.6% yoy. In volume terms, it decelerated even more to 5.6% yoy, after 6.4% yoy before. One reason is auto sales, which primarily suffer from a base effect. However, other items receded as well. By contrast, recent press reports signal new record highs in online sales at the Singles' Day (Nov. 11). Meanwhile, CPI inflation remained constant at 2.5% in October, after especially pork prices had strongly risen before due to the African Swine flu epidemic.

## More calibrated policy easing ahead

Regarding the outlook, China continues to face the repercussions from the trade conflict and the regulatory tightening. Despite the RRR cut, total social financing growth continued to decrease. Strong formal bank lending could not fully compensate for receding shadow banking items. Thus, monetary easing has so far been rather cautious. This is also true for fiscal policy. We expect further easing ahead, calibrated to defend reasonable annual growth (6.3% in 2019) while at the same time intended not to worsen local government or SoE debt substantially or to promote a resurfacing of shadow banking risks. Political signals regarding the trade conflict remained inconclusive so far. As the conflict runs much deeper than only trade figures, i.e. to geopolitical rivalry, we stay cautious. However, a ceasefire on tariffs (watch G20 summit) would be of help not to additionally worsen China's current slowing.

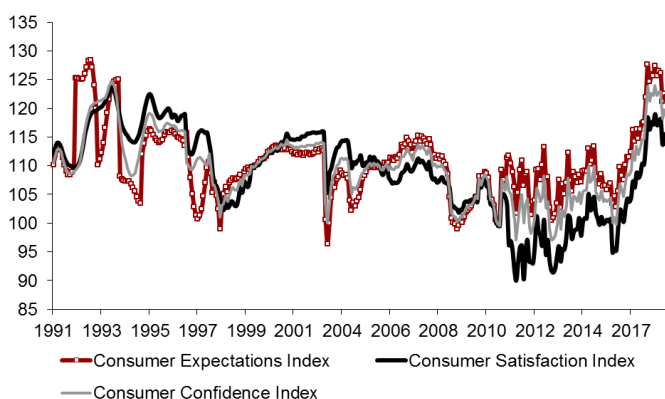
China: Growth of Urban Fixed Asset Investment



China: Purchasing Manager Indices: Manufacturing

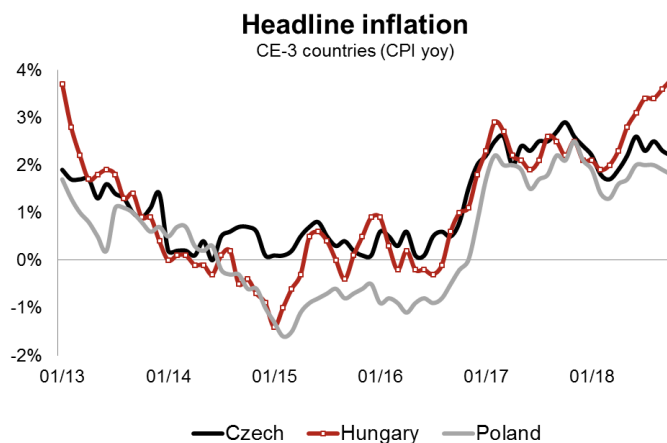
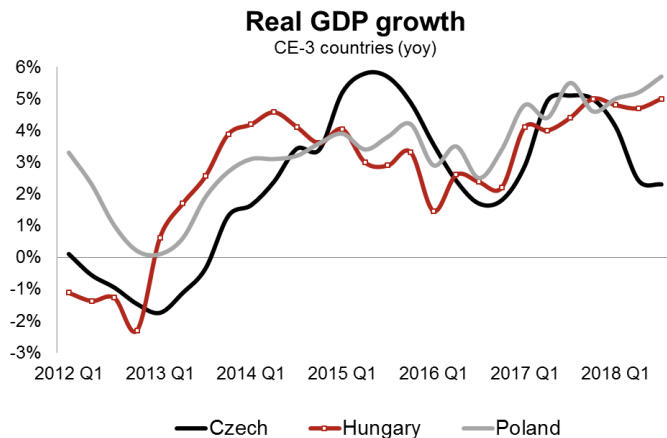


China: Consumer Confidence



# Central and Eastern Europe

Radomír Jáč



- Preliminary Q3 data show a divergence in GDP growth with a slowdown in the Czech Rep. and an unexpected acceleration in Hungary and Poland. PMI surveys imply a slower growth for Q4.
- Inflation is also mixed. It accelerated in Hungary, remains above the inflation target in the Czech case, while Polish CPI fell further below 2% yoy.
- The Czech CNB raised its key interest rate again in November but may stay on hold in December. The Hungarian central bank is likely to tighten conditions via changes in unconventional tools.

The Czech GDP growth remained stable at 2.4% yoy in Q3, which is nevertheless still the weakest growth since end-2016. The other two countries surprised with a growth acceleration: from 4.7% yoy to 5.0% yoy in Hungary and from 5.2% yoy to 5.7% yoy in case of the Polish GDP. That said: PMI surveys point to a slower pace of expansion for Q4 and we think that GDP growth in both Hungary and Poland will slow in 2019 but should still remain very solid.

The CE-3 countries offer a mixed picture also on inflation. The Hungarian CPI accelerated further in October and at 3.8% yoy it stands above the target, set at 3%. The MNB looks through the CPI increase, as a large part was driven by commodity prices and an excise tax change, but the higher CPI is supportive to expectations that the central bank will try to tighten monetary conditions in Hungary in H1 2019. Both Czech and Polish inflation declined thanks to food prices but the Czech CPI at 2.2% yoy still remains above the target of 2%. The CNB thus keeps a tightening bias. The Polish CPI (1.8% yoy in October) stays well below the target set at 2.5%. The NBP raised its forecast for Polish headline inflation in 2019 to 3.2% but this should not have any immediate impact on its policy, as this increase should be driven mainly by electricity prices.

## Regional monetary policy outlook remains divergent

The CNB raised its key interest rate (by 25 bps to 1.75%) again in November, mainly reflecting the strong wage growth and the underperformance of the Czech wage growth and the underperformance of the Czech crown. This was the fifth rate hike since the start of 2018 and the CNB's new forecast implies stable rates for December. The next rate hike should come in February 2019 and the CNB rates may be steady for several quarters afterwards.

The Hungarian MNB is likely to announce new changes in its unconventional tools at its MPC meeting in December. Financial conditions in the Hungarian economy are loose and the MNB indicated intention for a gradual change. We expect the MNB to increase its O/N deposit rate (currently at -0.15%) in H1 but the key base rate is unlikely to be increased from its current level of 0.90% before H2 2019.

The Polish NBP may keep its wait-and-see stance, as any increase in inflation will be mainly driven by energy prices. The first interest rate hike may come only in H2 2019.

Main Forecasts	2017	2018f	2019f	2020f
<b>Czech Republic</b>				
GDP	4.5	2.8	2.7	2.7
Consumer prices	2.5	2.2	2.3	2.0
Central bank's key rate	0.50	1.75	2.00	2.50
<b>Hungary</b>				
GDP	4.2	4.6	3.4	3.0
Consumer prices	2.4	2.9	3.2	3.0
Central bank's key rate	0.90	0.90	1.25	1.75
<b>Poland</b>				
GDP	4.8	5.2	3.9	3.3
Consumer prices	2.0	1.8	3.0	2.8
Central bank's key rate	1.50	1.50	2.00	2.50
GDP and consumer prices: annual % change; CB interest rate: in %, year-end				



# Bonds/Fixed Income Strategy

Florian Späte

- Driven by political risks and disappointing macroeconomic data core government bond yields fell across the curve in November. However, as inflation expectations dropped even more, real yields did not change.
- The end of QE and the still solid growth outlook pave the way for higher yields further down the road. But, in the short term political challenges and low oil prices are likely to limit any meaningful increase.
- After a roller coaster ride Southern European government bond spreads finished the month almost unchanged compared to the end of October. Going forward, we do not see a major move in either direction.

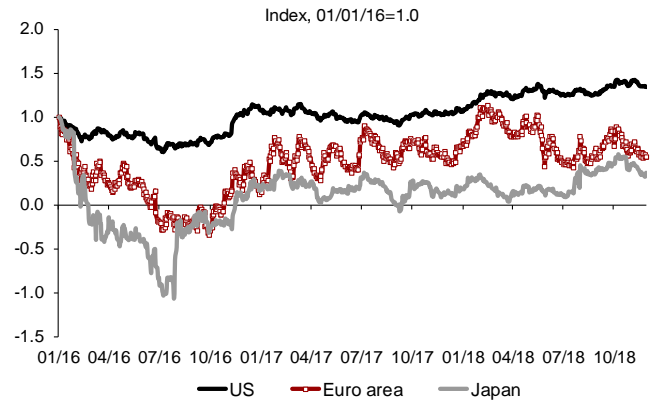
The increase in core yields at the start of November turned out to be temporary. Growing concerns about a hard Brexit and no lasting easing of tensions regarding Italy's budget plans triggered safe haven flows. What is more, weak macroeconomic data and a dovish shift of central banks contributed to lower core yields across the curve.

Noteworthy, real yields did not follow and remained around the October level. The drop in inflation expectations is remarkable. Since the start of the quarter 10-year US inflation swaps retreated by 26 bps and their euro area counterpart by 16 bps. Beside the disappointing economic data releases, the drop in oil prices was the main factor. Over the last eight weeks crude oil decreased by more than 30% to the lowest level for more than a year.

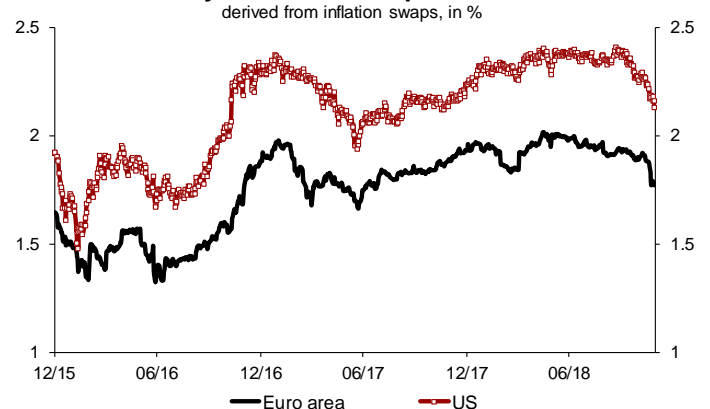
## Scope for higher yields remains limited short term

There are several opposing effects on core yields going forward. To start with, the growth outlook remains supportive for higher yields. While the euro area is expected to grow around potential, the US is seen to remain above potential – at least in the short term. In addition, financial markets have gone a bit too far with respect to future central bank steps. Most recently, Fed President Powell recognized that key rates have come just below the neutral level (in contrast to more hawkish comments only a few weeks ago). However, financial markets have priced only two further hikes (each 25 bps) until the end of 2019. Our forecast (and the Fed's own projections) foresees four hikes. Beside the one in December (which is close to certain), we expect three further hikes in the course of next year. Financial markets have become more cautious with regard to the ECB as well. The 2-year 1-year Eonia rate is only slightly above zero and the 4-year 1-year Eonia (as a proxy for the long-term expectations) is 0.70% (down from 0.90% in October). Although we expect the ECB to only cautiously hike key rates, current market expectations appear too cautious. A real key rate well below zero far into the future does not

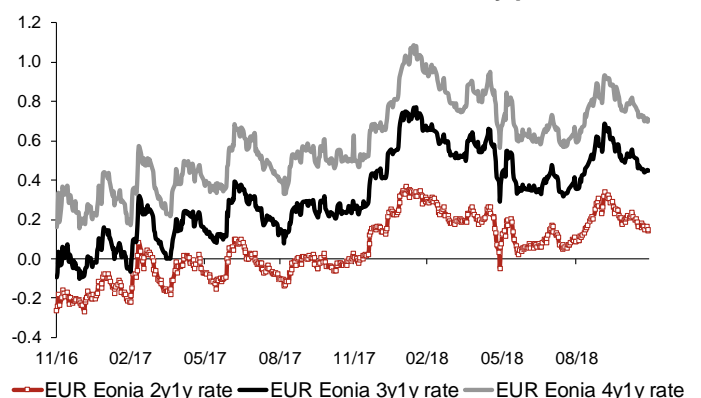
10-Year Bond Yields Since 2016



10-year Inflation Expectations

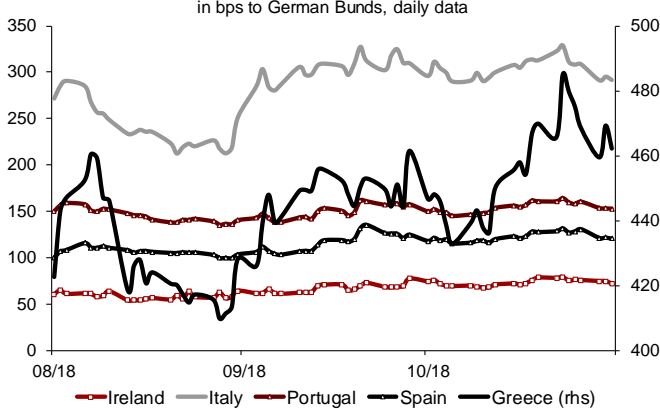


Future ECB hikes not sufficiently priced

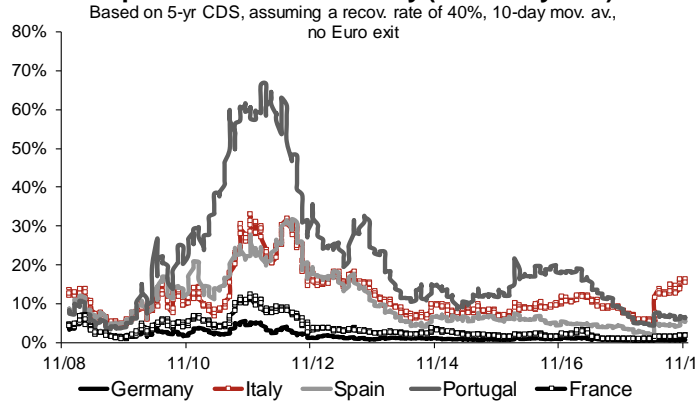


# Bonds/Fixed Income Strategy

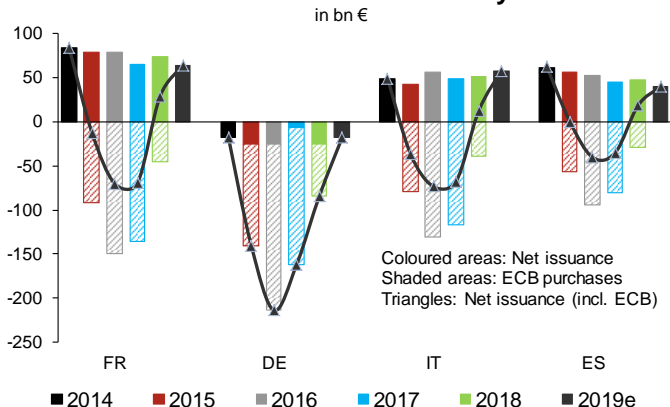
## 10-year Sov. Spread Euro Area Peripherals



## Implied Default Probability (within 5 years)



## EGB: Net Issuance Activity



look sustainable.

Though, there are several obstacles preventing a sharp increase in core yields in the near term. The lower oil price will dampen future headline inflation. Receding inflation expectations in recent weeks signal that financial markets do not look through this completely. In addition, the political headwinds are unlikely to vanish going forward. Even assuming a hard Brexit will ultimately be avoided (which is far from certain), the persisting concerns about a trade war and the unresolved issue about Italy's fiscal stance is likely to trigger from time to time safe haven flows.

All in, we see leeway for core yields to rise going forward. In the near term, they are expected to creep only moderately higher. Further down the road, particularly Bund yields (on the back of a less dovish ECB) have scope to rise a bit more.

### Stabilization of peripherals at the end of November

Initially, Italy's path of confrontation with the EU Commission spooked financial markets. Weak economic data and a not well-received issuance of a new sovereign bond triggered an increase of Italy's risk premium. Later on, the situation stabilized after there were tender signs of a more constructive stance of the Italian government. Other non-core bond markets retraced the development, albeit with a lower beta. Hence, financial markets continue to differentiate between Italian government bonds and other non-core sovereign bonds. This is highlighted by the implied default probability, too. While non-core bonds showed a similar pattern in recent years, Italian BTPs have decoupled since spring 2018. However, it is important to stress that even the BTP spread and the implied default probability of Italy remain well below the levels marked in 2011 and 2012 (see chart).

### Fate of BTP remains linked to political developments

The development of BTPs will be closely linked to the political decisions in the coming weeks. While the EU Commission recommended the opening of an excessive deficit procedure for Italy, the Ecofin has not approved it. Although the final green light would not constitute a major surprise for financial markets, it can still burden BTPs. However, the timing is not determined yet.

In our base scenario, we forecast Southern euro area sovereign bonds to muddle through for the time being and to basically trend sideways. While primary markets will slow markedly in the weeks to come, they will awake in January again. As the ECB will not increase its holdings of sovereign debt, this is a burden for non-core markets. However, the increased spread levels are seen to shield Southern European bond markets somewhat against seasonal fluctuations going forward.

# Corporate Bonds

Florian Späte

- Euro area IG corporate bonds continued to suffer in November. Option-adjusted spreads have widened by 16 bps to the highest level since Q1 2016 and the yield level rose by 14 bps to 1.27%.
- There is leeway for a stabilization in the near term as valuations are no longer dear as defaults are seen to remain on a low level for the time being and balance sheets are in rather good shape.
- Further down the road, however, the challenging environment is here to stay and the technical support will ease in 2019.

The sell-off of EA IG corporate bonds continued unabated in November. After spreads had widened by 15 bps in October, they increased by another 16 bps to 145 bps. Meanwhile they are back to the level as of Q1 2016 – the Corporate Sector Purchase Programme was announced in March 2016. Financial and non-financial spreads moved in lockstep (both widening by 16 bps). Although underlying yields fell slightly in November, the direction for yield levels was determined by the spread move. The EA IG corporate yield level rose by 14 bps to 1.27%. Thus, the total return year-to-date is down to -1.3%. EA IG corporate bonds are heading for the worst annual performance since 2008.

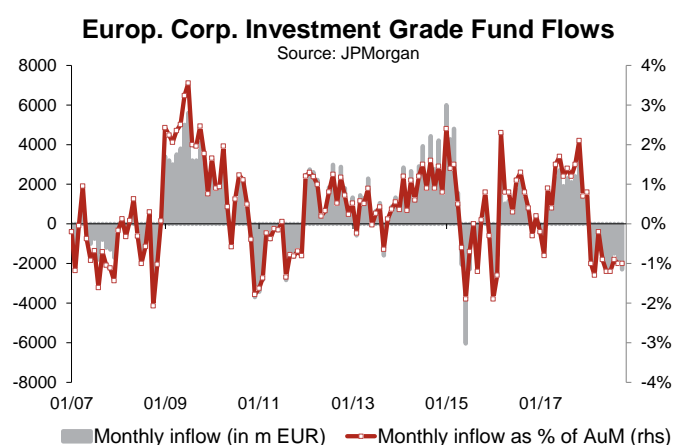
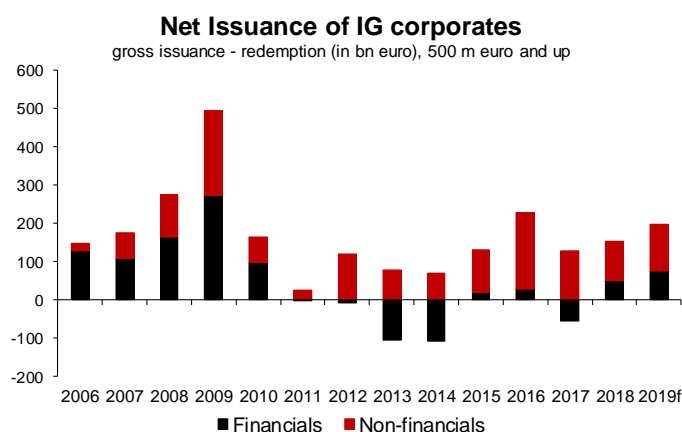
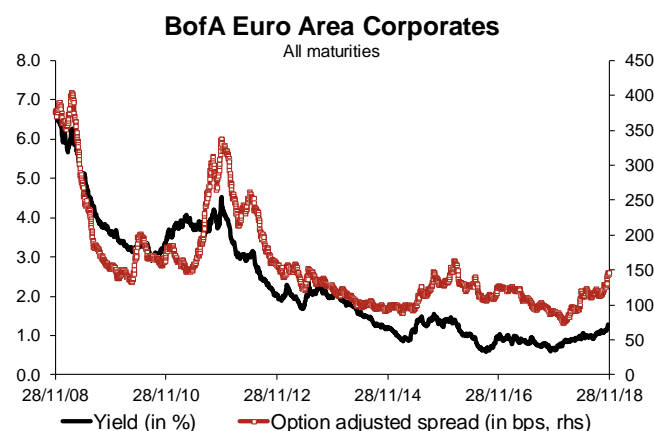
## Some stabilization near term possible, but ...

After the strong spread widening valuations do no longer appear extremely dear. Based on current fundamentals, corporate bonds are about fair. In fact, given the very low level of defaults and a growth rate around potential valuations have even become slightly cheap. What is more, primary markets will slow down significantly in the weeks to come and the ECB will remain active in the market for a few more weeks. All in, we see scope for corporate bond spreads to stabilize going into year-end.

## ... challenging environment is expected to linger

From January onwards the ECB will only reinvest maturing bonds. Not only does this imply the withdrawal of a price-insensitive buyer without limits, but also the trickle down effect of displaced investors from the government bond market will disappear. This is happening at a time when private demand is lackluster at best. Since February there has been a continuous monthly outflow of funds. This is the longest period since 2007 (see chart). What is more, issuance has already been healthy in 2018 and there will be even more supply next year.

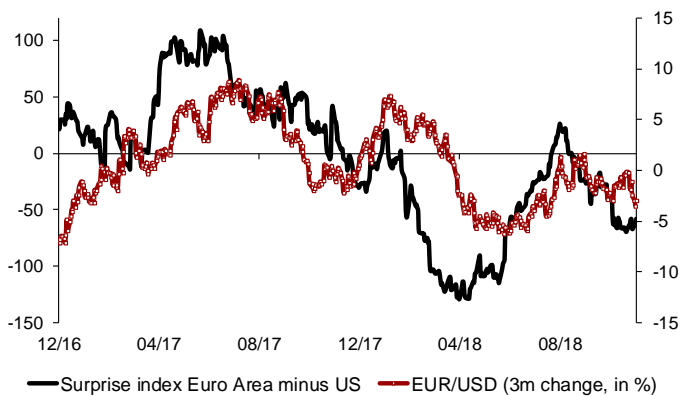
Beside this meagre technical picture, fundamentals will not support corporates next year. The growth outlook for 2020 (which will determine spread developments next year) will likely worsen and the ECB will start its (cautious) key rate cycle. Above all, the political challenges will not vanish (e.g. trade conflict, Italy's budget plans). Hence, investors are advised to act cautiously further down the road.



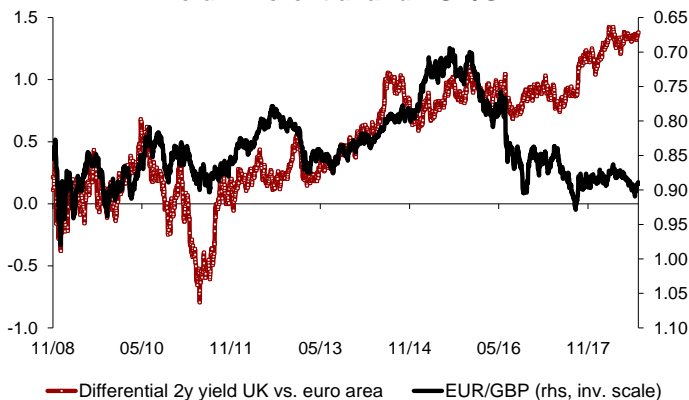
# Currencies

Thomas Hempell

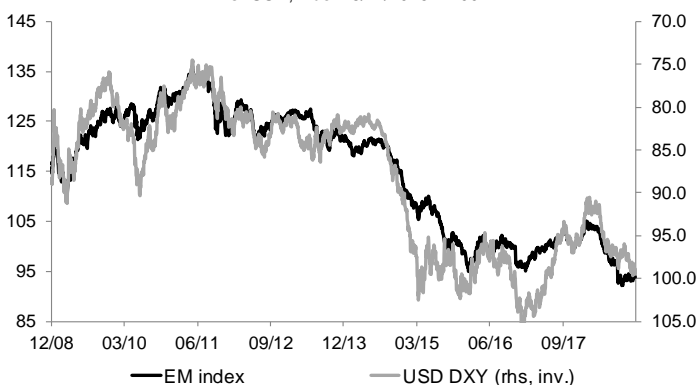
**Economic data surprises and EUR/USD**



**Yield Differential and EUR/GBP**



**EM FX and USD DXY**  
vs. USD; index: 8/11/2016 = 100



- Weak euro area data and political uncertainties will keep a lid on EUR/USD near term.
- Peaking US growth and rising euro area core rates, however, point to EUR/USD rising back to 1.20 over 2019, though.
- An initial parliamentary rejection of May's Brexit deal may weigh on sterling near term. But avoiding a no-deal 'crash' Brexit is still feasible and has the potential to ultimately lift sterling.

The EUR/USD keeps hovering in the 1.12-1.15 range. Recent data weakness in the euro area, continued uncertainties about the fiscal spat between Italy and the EU and ongoing trade concern make a EUR rebound unlikely in the short term. Barring a no-deal Brexit and a sharp escalation of the situation in Italy, however, we deem the USD upside largely exploited.

Further into 2019, a EUR/USD recovery is on the cards, though. The US fiscal stimulus is peaking, while growth in the euro area is to recover from temporary effects with solid consumption a key anchor of domestic demand. We expect Bund yields to ultimately rise from current depressed levels, helping to marginally narrow the huge transatlantic yield gap over the course to 2019. The reversing US/EA divergence and a recovery in EA surprise indicators (which have disappointed for most of this year) will bring the first ECB rate hike in more than eight years into market focus. We now expect this step only for end 2019 (vs. Q3 2019 envisaged before), which is one reason why we lower our 12m forecast from 1.23 to 1.20 – but still see more upside further out.

## Sterling already at heavy discount

The British pound (GBP) was trading at a more than 10% political discount vs. EUR after the Brexit vote in 2016 according to our multivariate estimates and this gap has widened by another 5pp over recent weeks. Also the gap vs. simple yield differentials (see mid chart) highlights the dominant effect of Brexit concerns on the GBP. If PM May's deal with the EU is surprisingly accepted by parliament on Dec 11, this would be followed by a meaningful GBP rally. In fact, we still deem it somewhat more likely than not that ultimately a no-deal ('crash') Brexit can be avoided. A likely initial rejection of the deal in parliament, however, and subsequent weeks of political uncertainty may still weigh on sterling near term.

Following the striking fall over summer, EM currencies have stabilized in November, defying the further USD strength vs. majors (see bottom chart). Continued headwinds from higher US rates, a slowing global economy and ongoing trade risks make a broad EM FX rebound unlikely near term. With real effective exchange rates already very low, we anticipate stability for EM currencies going into 2019. Any stronger rebound, however, seems unlikely before a US-China trade deal can be struck – and this does not yet seem imminent.



# Equities

Michele Morganti / Vladimir Oleinikov

- Equities in the euro area (EA) suffered losses due to softer macro surprises, higher spreads and lingering trade, Brexit and Italian risks.
- The EA PE has so far discounted the growth deterioration and the implied equity risk premium has reached a level which is second only to the ones experienced in 2011-2012 and 2009.
- Valuations in some risky areas continue to be near extremely low levels: we confirm our constructive short-term stance on equities (but not full OW).
- The 2019 should be tough due to monetary stimulus reduction, higher US yields, lingering exogenous risks and peaking growth. Over 12 months, we forecast returns of 6% for the EU (the US: 3%) but the bulk of it should occur in the next few months while the 2019 could be very volatile.
- Stay neutral EM. OW: Korea, India, CEE and Brazil.

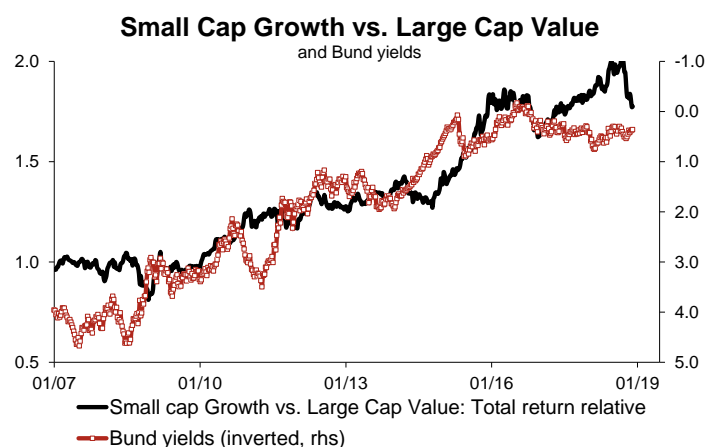
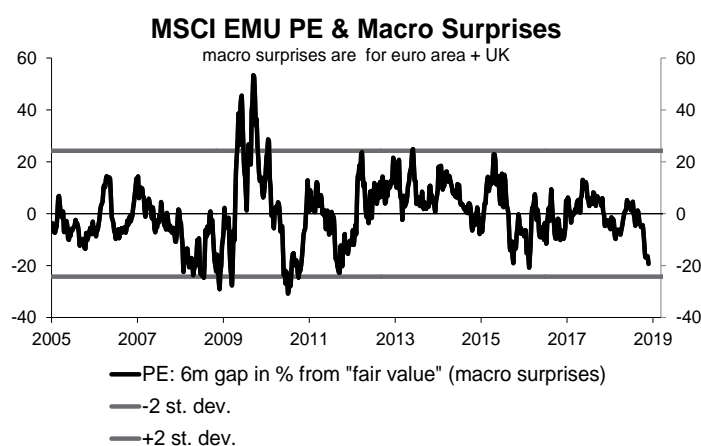
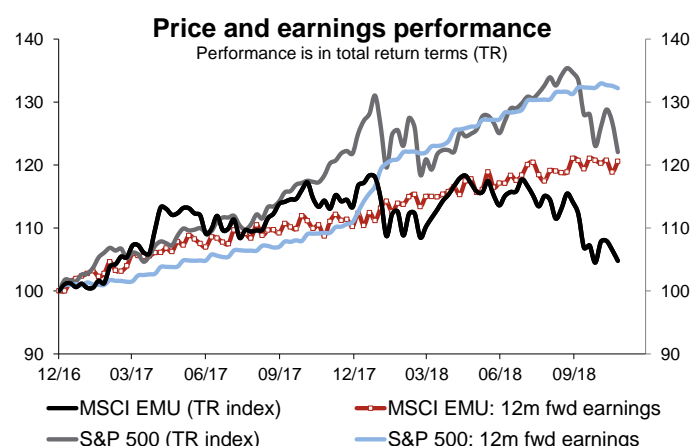
Over the last month, equities have shown a mixed performance. The EA equities had suffered losses (-0.9%) due to softer macro surprises in the EA, higher spreads and lingering trade, Brexit and Italian risks. Despite a modest performance (+1.4), the US equities, helped by lower yields (-12 bps) and stable macro surprises, outperformed the other markets. The Japanese market had a positive performance as well (+0.5%). Cyclical underperformed defensive and Value moved in line with Growth style. EM did better than DM.

## Still high VIX and risk premium, lower macro surprises

Investors' sentiment remains very cautious due to above mentioned risks. As a result, the implied equity risk premium (a measure for risk aversion) in the EA has increased year-to-date by 150 bps, from 7.2% to 8.8%, a level which is second only to the ones experienced during 2011-2012 and 2009 years. This picture is mirrored by the increased standard deviation of analysts' earnings estimates (near a cyclical peak), which is also a proxy for uncertainty. Furthermore, rising BAA yields and inflation are contributing to a downward pressure on price/earnings (PE) and this trend is not going to change in the next quarters. Lastly, both the global GDP momentum and the global macro surprise index show weakness, albeit, for the time being, nominal growth remains overall around trend.

## Pricing in a lot short term

Valuations in some risky areas continue to be near extremely low levels: Italy, Auto, EM and financials, in particular. EA's PE already discounts the ongoing growth deterioration (s. chart). Furthermore, the Value has started overperforming Growth, which is good for the EA relative to the S&P. European banks (a value sector, with big weight in the EMU index) have also stabilized, overperforming in last month with a positive performance of 1.5%.



# Equities

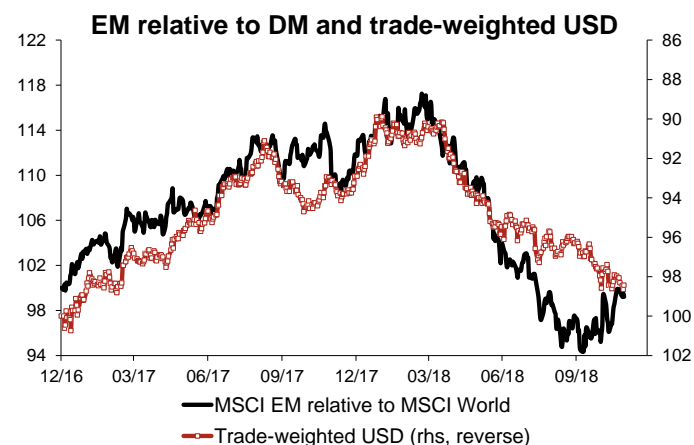
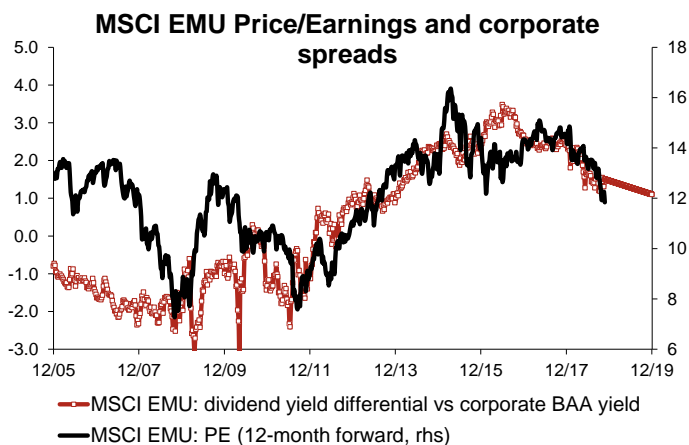
Markets	Price / Earnings *		Price / Book *		Price / Cash Flow *		Dividend Yield *		Avg. Discount, %	
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %	Disc. (-1M), %
WORLD	14.5	16.0	2.1	1.9	9.8	8.8	2.7	2.7	3.2	-0.6
USA	15.9	15.3	3.0	2.4	11.3	9.9	2.1	2.2	11.5	9.4
JAPAN	12.4	15.5	1.1	1.3	7.3	7.1	2.4	1.9	-13.3	-15.8
UK	11.6	13.8	1.5	1.8	7.6	7.9	4.9	4.0	-14.1	-12.5
SWITZERLAND	14.8	15.4	2.3	2.2	10.3	11.2	3.8	3.3	-6.0	-6.3
EMU	11.9	14.1	1.4	1.5	7.2	6.5	4.0	3.9	-4.0	-4.1
FRANCE	12.4	14.3	1.4	1.5	7.8	6.9	3.8	3.7	-2.2	-1.4
GERMANY	11.6	15.0	1.4	1.5	7.5	6.7	3.7	3.3	-7.1	-7.3
GREECE	12.0	12.8	1.9	1.6	6.2	6.0	6.1	3.9	-9.8	-3.9
ITALY	9.7	15.2	1.1	1.2	4.9	4.7	5.2	4.7	-13.5	-14.6
PORTUGAL	13.9	12.7	1.6	1.7	5.5	5.9	5.1	4.5	-3.9	-0.3
SPAIN	10.9	12.9	1.1	1.6	5.1	5.1	4.9	5.1	-10.1	-12.5
EURO STOXX 50	12.1	13.2	1.4	1.5	7.4	6.2	4.1	4.2	2.7	0.2
STOXX SMALL	14.9	14.5	1.7	1.7	9.5	8.3	3.3	3.2	3.7	4.1
EM, \$	10.7	14.5	1.4	1.6	6.6	7.7	3.3	3.1	-15.7	-20.9
BRAZIL	11.4	9.0	1.8	1.7	7.1	13.7	4.2	4.3	-3.2	-4.3
RUSSIA	4.7	7.0	0.6	0.9	3.0	4.5	8.2	3.8	-54.8	-52.9
INDIA	17.6	14.5	2.6	2.7	11.7	11.5	1.7	1.6	3.6	-1.4
CHINA	10.7	13.0	1.4	1.7	6.9	7.5	2.7	3.0	-9.0	-18.9

Note: The first four markets (ex World) are based on the main local indices, the rest on the corresponding MSCI indices.

\*Multiples are based on 12m forward estimates; PEs are since 1987, the rest since 2003.

Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.

Source: Thomson Reuters Datastream, IBES estimates.



In addition to this, the German economy could experience some rebound in Q4, thus contributing to sustaining sentiment. Lastly, while the G20 outcome remains a wild card, the Fed stance has recently turned more dovish, (albeit becoming more data dependent and so more unpredictable in the future). Thus, we confirm our constructive short-term stance on equities and while further downside is not excluded, we think November could represent a good entry point for the next 1-2 months. That said, decreasing monetary stimulus, credit tensions along with political and trade risks keep us from exploiting full OW. Technical indicators from MS and BofA (based on valuation, risk and positioning), we follow since long time, have also not come in the extreme territory, yet. Meaning that sentiment could become even worse before turning up again.

## 2019 will be tough

2019 will be a very difficult year due to higher US yields, credit spreads and inflation, with peaking US GDP and NIPA profits' momentum. The ongoing monetary stimulus reduction will add to uncertainties triggered by EU elections and trade frictions. A stronger TW euro should also put additional pressure on EU equities. Thus, we keep a cautious view for the next year, waiting for markets to fully digest changing monetary and credit environment. We are slightly OW cyclicals vs. defensives. OW: Utilities, Industrials, Discretionary and Financials. Oils, being stretched vs. macro fundamentals, are temporarily UW. Pharma is slightly UW with Real Estate, Materials and IT. Household and TLC are neutral (TLC increasingly appealing on margin stabilization and M&A story). OW Value vs. Growth. Being a proxy for growth, Small Cap Growth is at risk (UW vs. Large Cap Value). On a 12-month horizon, we forecast positive returns (EU: 6% and the US: 3%) but the bulk of it should occur in the next few months while the 2019 could be very volatile.

## Neutral EM: to suffer from greater macro uncertainty

EM equities recovered some of the losses incurred before (+5.5%). EM valuation shows a discount of 16% vs history. While earnings estimates for 2019 have decreased for most of EM markets, they have again increased for the CEEs, and Russia (+4%). YTD, the Russian equities have outperformed EMs by 15%. They have grown in line with their fundamentals but still remain at PE of 4.7, rather cheap versus history (1 st. deviation below). Furthermore, Russian earnings still lie 17% below trend. US sanctions and frictions with Ukraine in the run-up to presidential elections (March 2019) in the Ukraine may affect investment sentiment. Geopolitical uncertainty is in general to weigh on EM via lower growth and higher risk premium. Within the EM universe, we keep favoring Korea, India, along with the CEE markets and Brazil.

# Asset Allocation

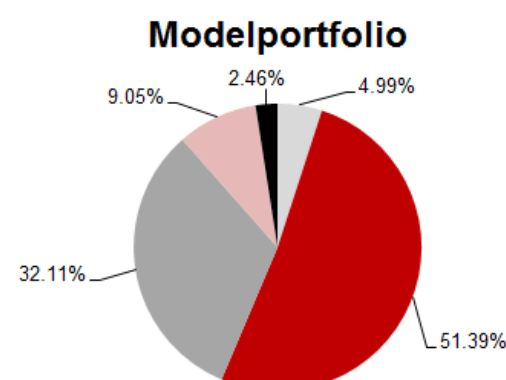
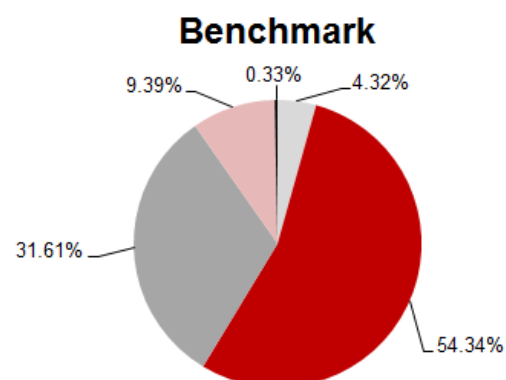
Thorsten Runde

- In November (until November 28<sup>th</sup>), only the European equity markets in our investment universe continued to loose value but to a significantly smaller degree (around -0.9% each). All other equity markets performed positively.
- Apart from 10Y+ core government bonds (-0.4%) and 10Y+ Spanish government bonds (-0.5%), all other core and peripheral maturity buckets performed positively. With total returns ranging from 1.0% to 1.6% BTPs have been the top performing fixed income markets so far.
- Over the same period, non-financial investment grade corporate bonds as well as financial ones revealed negative performance figures across all maturity buckets, like in the previous month. With -2.1%, high yield non-financial corporates lost the most in value.
- We maintain a small overweight in equities, keep the overweight in cash, and continue to prefer a short duration.
- We raise the exposure to IG corporates preserving the underweight in financials.
- We further reduce short positions on BTPs (costly in carry) and add to core underweight.

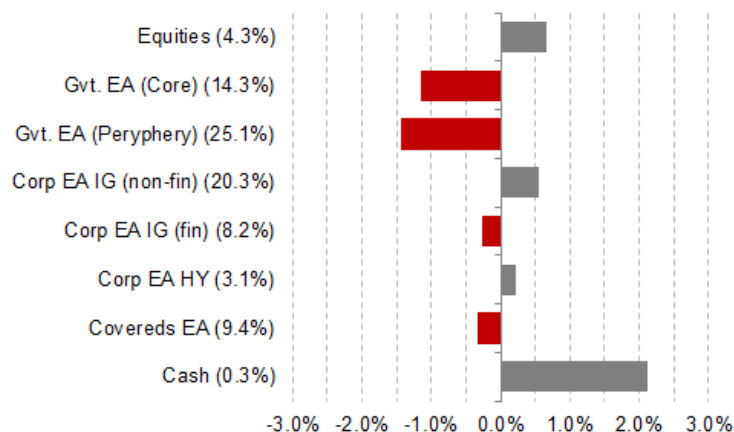
In November, the economic, monetary, and political environment was not too different from the previous month. The macro backdrop remained solid, the Fed is continuing its strategy of gradual rate hikes, and the trade war as well as Italexit concerns are persisting, although the latter eased somewhat. This led to a strong recovery in BTPs. E.g. the 10Y+ segment gained roughly 1.6% compared to a loss of more than 2% in the course of October. Against this backdrop, the underweight in peripheral government bonds contributed negatively to relative performance of the model portfolio. The largest positive contributions could be achieved by the underweight positions in medium- to long-dated IG corporates as well as the overweight in cash.

## Cautious pro-risk stance still advisable

Just as the risk environment as a whole has been pretty stable for quite some time, this is our proposed allocation stance, apart from minor adjustments. In particular, we continue to recommend a moderate overweight in equities against the backdrop of still solid macro conditions and sound earnings and valuations. Though still at risk we do not expect something major to happen which could trigger a sell-off in BTPs until yearend. In that sense, we reduce their underweight by taking money out of core government bonds. This measure is not recommended to generate extra returns, but primarily to save the higher carry. The strong correction in credit spreads offers attractive entry points. Thus we advise to raise exposure to IG corporates.



## Active Positions in selected Sub Asset Classes\*



\*Benchmark weights in parentheses

# Forecast Tables

## Growth

	2016	2017	2018f	2019f
US	1.6	2.2	2.9	2.5
<i>Euro area</i>	1.9	2.5	1.9	1.6
Germany	2.2	2.2	1.7	1.5
France	1.1	2.3	1.7	1.6
Italy	1.3	1.6	1.0	0.8
<i>Non-EMU</i>	1.9	1.8	1.5	1.6
UK	1.8	1.7	1.3	1.5
Switzerland	1.6	1.6	2.5	1.7
Japan	1.0	1.7	0.9	1.3
<i>Asia ex Japan</i>	6.2	6.1	6.1	6.0
China	6.7	6.9	6.5	6.3
Central/Eastern Europe	1.4	3.9	3.0	1.8
Latin America	- 1.3	0.8	0.3	1.1
<b>World</b>	<b>3.1</b>	<b>3.7</b>	<b>3.6</b>	<b>3.4</b>

## Inflation

	2016	2017	2018f	2019f
US	1.3	2.1	2.5	2.4
<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
Central/Eastern Europe	5.2	5.0	6.3	8.0
Latin America	6.3	4.3	4.0	4.2
<b>World</b>	<b>2.3</b>	<b>2.3</b>	<b>2.8</b>	<b>3.0</b>

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

## Financial Markets

<b>3-month LIBOR</b>	<b>28/11/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
USD	2.71	2.55	2.70	3.10
EUR	-0.36	-0.35	-0.35	-0.30
JPY	-0.11	-0.05	-0.05	0.00
GBP	0.89	0.85	0.90	1.05
CHF	-0.74	-0.75	-0.75	-0.75
<b>10-Year Bonds</b>	<b>28/11/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
Treasuries	3.06	3.15	3.25	3.40
Bunds	0.35	0.45	0.55	0.90
BTPs	3.27	3.50	3.65	3.90
OATs	0.74	0.85	0.95	1.30
JGBs	0.09	0.10	0.15	0.15
Gilts	1.39	1.45	1.55	1.70
SWI	-0.06	0.00	0.05	0.15
<b>Spreads</b>	<b>28/11/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
GIIPS	211	220	225	215
BofAML Covered Bonds	63	60	60	65

\*average of last three trading days

<b>Corporate Bond Spreads</b>	<b>28/11/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
BofAML Non-Financial	139	140	145	145
BofAML Financial	153	150	155	160
<b>Forex</b>	<b>28/11/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
EUR/USD	1.13	1.12	1.15	1.20
USD/JPY	114	113	111	108
EUR/JPY	129	127	128	130
GBP/USD	1.28	1.26	1.32	1.40
EUR/GBP	0.88	0.89	0.87	0.86
EUR/CHF	1.13	1.12	1.14	1.16
<b>Equities</b>	<b>28/11/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
S&P500	2700	2710	2665	2685
MSCI EMU	114.6	117.0	113.0	116.0
TOPIX	1643	1680	1645	1705
FTSE	7019	7165	6970	7090
SMI	8908	9095	8780	9040

## 3-Months Horizon

Government Bonds	10-Year Bunds	0.40	0.45	0.50
	10-Year Treasuries	2.76	3.15	3.54
	10-Year JGBs	0.09	0.10	0.11
	10-Year Gilts	1.20	1.45	1.70
	10-Year Bonds CH	-0.02	0.00	0.01
Equities	MSCI EMU	111.0	117.0	123.0
	S&P500	2614	2710	2806
	TOPIX	1574	1680	1786
	FTSE 100	6871	7165	7459
Currencies	SMIC	8736	9095	9454
	EUR/USD	1.08	1.12	1.16
	USD/JPY	108	113	118
	EUR/GBP	0.86	0.89	0.92
	EUR/CHF	1.09	1.12	1.15

## 12-Months Horizon

Government Bonds	10-Year Bunds	0.80	0.90	1.00
	10-Year Treasuries	2.59	3.40	4.21
	10-Year JGBs	0.12	0.15	0.18
	10-Year Gilts	1.26	1.70	2.14
	10-Year Bonds CH	0.13	0.15	0.17
Equities	MSCI EMU	103.1	116.0	128.9
	S&P500	2481	2685	2889
	TOPIX	1454	1705	1956
	FTSE 100	6466	7090	7714
Currencies	SMIC	8230	9040	9850
	EUR/USD	1.13	1.20	1.27
	USD/JPY	98	108	118
	EUR/GBP	0.80	0.86	0.92
	EUR/CHF	1.10	1.16	1.22

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



# Imprint

<b>Head of Research:</b>	Vincent Chaigneau (vincent.chaigneau@generali-invest.com)
<b>Head of Macro &amp; Market Research:</b>	Dr. Thomas Hempell, CFA (thomas.hempel@generali-invest.com)
<b>Team:</b>	Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com) Luca Colussa, CFA (luca.colussa@generali-invest.com) Radomír Jách (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)
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**In Italy:**  
Generali Insurance Asset  
Management S.p.A. Società di  
gestione del risparmio

Piazza Tre Torri  
20145 Milano MI, Italy

Via Niccolò Machiavelli, 4  
34132 Trieste TS, Italy

**In France:**  
Generali Insurance Asset  
Management S.p.A Società di  
gestione del risparmio

2, Rue Pillet-Will  
75009 Paris Cedex 09, France

**In Germany:**  
Generali Insurance Asset  
Management S.p.A Società di  
gestione del risparmio

Tunisstraße 19-23  
50667 Cologne, Germany

**[www.generali-investments.com](http://www.generali-investments.com)**

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