



GENERALI
INVESTMENTS

Outlook 2019

As the tide goes out...



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Global View – As the tide goes out...

- As the tide of easy monetary policy slowly goes out, global markets face another challenging year.
- Yet 2019 will be very different from 2018, as the US economy is set to fall off its pedestal; the Fed will pause this summer, if not before. The great regional divergence of 2018 will thus end, and with it the impressive USD rally. This should bring selective relief to Emerging Markets, assuming the world economic landing continues to be soft.
- As the US economy soon celebrates its longest cycle ever, fears of a downturn will not vanish. This creates a toxic asymmetry for risky assets: limited upside, larger downside.
- Yet there is too much pessimism about a global – and more particularly European – hard landing just now: the late 2018 capitulation has created oversold conditions. We will start with a prudent overweight in equities and credit. Quality will be of the essence in 2019, like in all late cycles. We retain a long cash position, as well as a short in EUR Govies. We go nimble on duration, and see better value in playing that through derivatives.

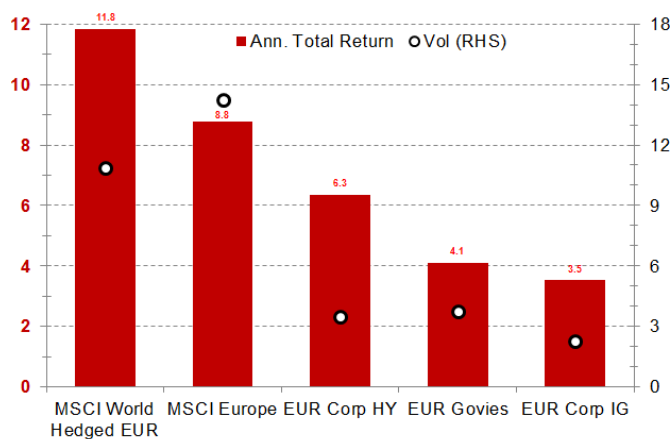
We thought 2018 would be tough for asset returns and financial conditions...it only got worse than we expected

When it rains, it pours: such was the lesson of 2018, a year that experienced two particularly painful risk-off episodes in early February and in the autumn. In our [2018 Outlook \(Out of Rehab\)](#) we had warned about a difficult year for asset returns, due to both a deteriorating growth-inflation mix and elevated asset price valuations; it proved worse than we expected for equities. We had stressed the need to avoid assets exposed to larger than expected *Fed tightening*, a *Chinese slowdown* and a pick-up in *idiosyncratic risk* events (p6). Those drags all materialized, and more: we underestimated the eruption of the *trade war* and the extent of the *euro area (EA) slowdown*. All this led many asset classes to deliver negative total return in 2018 (Graph 2), in a sharp reversal of the ‘goldilocks’ years (Graph 1).

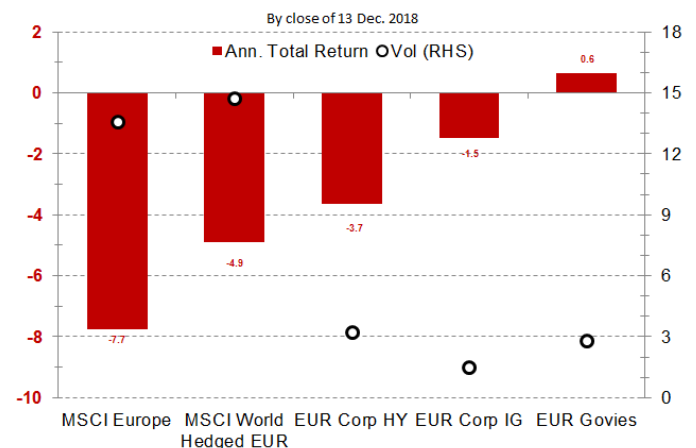
2019 a challenging year again, but in a different way

Now 2019: global markets face another challenging year as the global economy continues to slow and the Fed policy no longer stands as accommodative (real key rate now close to R-star). Yet with the US economy set to fall off its pedestal, it will be very different from 2018. Though we see poor total returns in Fixed Income assets (especially EUR), our approach to risk taking remains very selective and tactical. Indeed as the US growth soon reaches a new record length, late-cycle fears will persist: downside tail risks are much fatter than the upside one.

Graph 1: TOTAL RETURN AND RISK - 2013-2017



Graph 2: YEAR-TO-DATE



Slower global growth, but less regional divergence

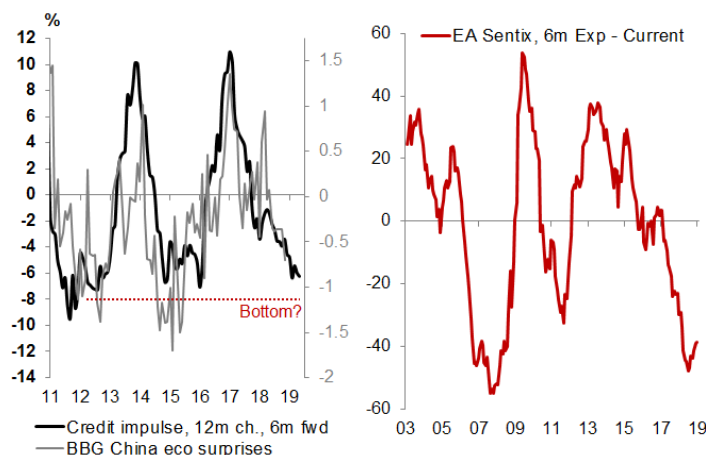
World growth will continue to slow in 2019: we see 3.4%, down from 3.6% in 2018 and 3.7% in 2017. The slowdown was very modest in 2018, yet it came after a buoyant 2017, which had seen consistent upward revisions, especially in the EA. Growth downgrades in 2018 proved far more damaging to risky assets. Another toxic feature of 2018 was the divergence between a booming US economy – thanks to president Trump’s procyclical fiscal boost – and a significant slowdown in other major economies such as the euro area and China. This supported the US dollar and added to pressure on already fragile Emerging Markets (Argentina, Turkey).

Expect some regional re-convergence in 2019, towards a soft landing. Surely the EA and China will slow further, but the impact on asset prices may be limited: a lot of bad news is already priced in. Expectations about the EA economy have deteriorated sharply relative to current conditions (Graph 3b), by some measures almost as much as in 2007 (ahead of the Great Financial Crisis, GFC). Policy tightening in China undermined the credit impulse in China (Graph 3a), but recent and ongoing monetary and fiscal support policy support should keep growth comfortably above 6.0% in 2019. The focus instead should shift to the US: the question is not whether the economy will slow down, but by how much (in our books to 2.4%, down from 2.9% in 2018). This rebalancing of regional growth carries an important investment theme: dollar strength should run out of steam. This matters particularly for Emerging Markets (EM) currencies (Graph 4) and assets, given the close correlation between EMFX as a group and the performance of EM assets relative to Developed Markets (DM). In particular we see selective value in EM equities and sovereign hard currency debt (EMBI). The latter already offered resilience relative to battered DM credit markets in H218 – a signs of things to come.

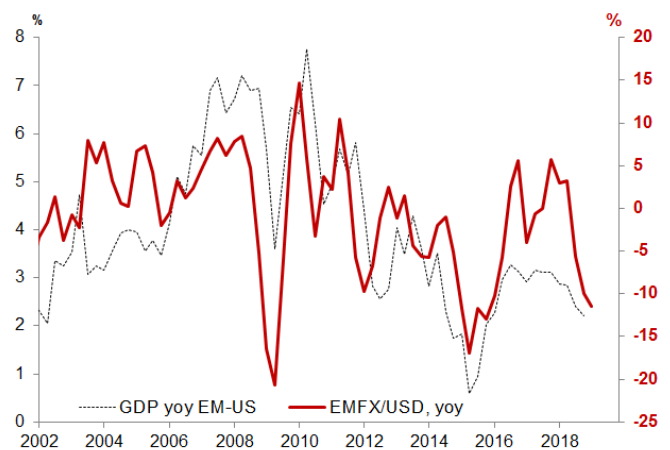
Rebalancing of global growth likely to end USD strength...

... This should bring selected relief to Emerging Markets (EM) currencies and assets

Graph 3: LOTS OF BAD NEWS PRICED IN CHINA AND EURO AREA



Graph 4: US GROWTH OUTPERFORMANCE HAS HURT EMFX BADLY



Fed blinks, trade war a wild card, volatile politics

Fed not (completely) finished. We expect two more Fed hikes in H1 2019 before the Fed blinks. A final hike in late 2019 is possible but highly conditional. The pause in the rate hike cycle may come even earlier, as the Fed, now close to neutral stance, becomes more dependent on economic data and financial conditions. Any Fed pause should bring some relief: as the saying goes, “markets stops panicking when central banks start panicking”. Yet a pause will not be enough to support a U-turn in risk appetite, for at least two reasons. First, global markets tend to react to policy normalization with a lag: as the Fed leaves the ‘easy’ territory, financial condi-

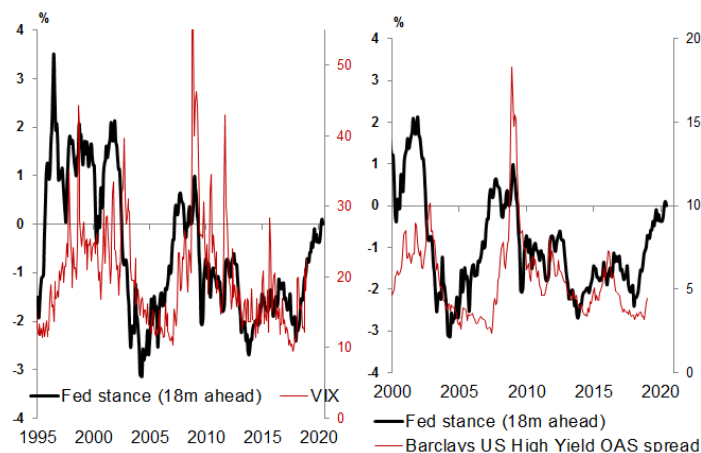
Old age of the US growth cycle creates an asymmetry for risky assets: limited upside, larger downside

tions tend to deteriorate, e.g. through a rise in financial volatility and credit spreads (Graph 5). Second, concerns about the age of the cycle will not disappear. Assuming the US economy grows in H1, by mid-2019 the cycle will celebrate its 10-year anniversary, matching the longest on record (1991-2001). This anniversary is keeping many investors awake at night, and creating an asymmetry for risk assets: limited upside, larger downside.

The trade war, of course, remains a wild card. Though end 2018 saw apparent progress in the US-China negotiations, the outcome is still hard to predict. The war is here to stay, given the strategic battle towards economic, technological and military supremacy. But President Trump, who will be looking forward to the 2020 election, probably cannot afford a full-blown trade war that would be mutually destructive. One tail risk is that he would instead turn to Europe and impose tariffs on autos; this would be a terrible blow in particular to the German economy. Our central scenario also includes a soft Brexit and some de-escalation in the EU-Italy stand-off. Expect nervous trading nevertheless into the European elections in late May.

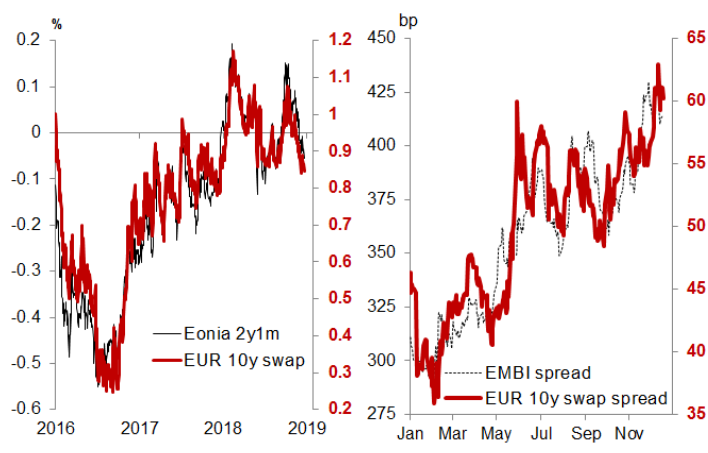
(Geo)political risk still a wild card, not least that of tariffs on autos

Graph 5: FED TIGHTENING HURTS FINANCIAL CONDITIONS



Fed stance: 2y real Treasury yield minus R-star

Graph 6: DOVISH ECB PRICING AND RICH BUND ASSET SWAPS



Another tough year for Fixed Income

Last man standing of 2018: EUR government bonds – with the exception of Italian BTPs – have delivered meager but positive returns over the past year, offering better resilience than we had expected. To a large extent this is because of the deterioration in the appetite for risk, and their safe-haven status. Note however that the latter did not really work out for US Treasuries (negative total returns in 2018: nearly -4% for the Bloomberg/Barclays UST index hedged in EUR). Indeed in late cycle the correlation between stocks and bonds tend to rise (before turning down abruptly when recession forces show their ugly heads). We fear EA bonds will be exposed to the same (if smaller) dangers that undermined Treasuries in 2018: net supply (net of central bank buying) will increase substantially and the ECB will try to deliver a first hike (though not before Q4 2019 we think). 10-year Bund yields near 0.25% still appear rich, and this is sourced in the deep investor belief that the ECB will never be able to normalize policy: 2-year forward 1m Eonia is still negative! The safe-haven status is also priced dearly: 10-year Bund swap spreads are above 60 bps, less than 25 bps from the peak reached during the GFC of 2008 and the euro area sovereign crisis of 2011/2012. With 10-year real Bund yields still around -1.0%, we go into 2019 with an under-weight in EUR Govies. We have reduced our underweight (UW)

Little value in EUR Govies at those dear levels

Derivatives offer cheap alternative to outright short duration positions

Prefer EUR Credit over Govies in the near run as credit markets look oversold for now as positioning has turned dramatically since spring...

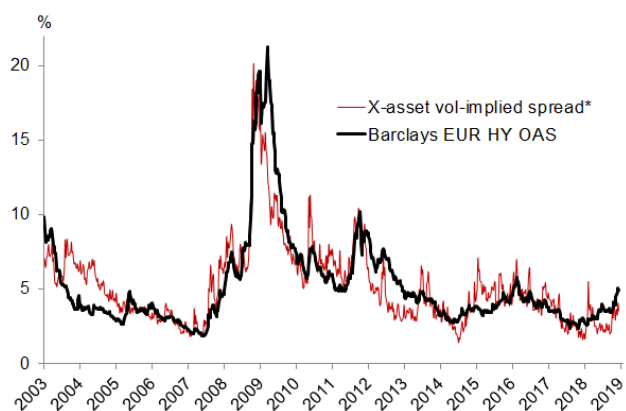
... but spreads will end the year wider

recommendation in BTPs but stay defensive into the May 2019 European Parliament election.

The upside for yields is limited, given the aforementioned asymmetry. Short duration positions are costly in carry, particularly in Europe where the yield curve slope remains substantially positive. There are alternatives to outright short positions. Typically, the EUR curve (e.g. 2-30y) remains very directional: it has flattened aggressively through the bond rally this autumn. It will steepen if yields start to increase again, and more so as long-end supply will flourish in Q1; conditional bearish steepeners are a cheap alternative to outright shorts. Also consider this: the two large equity sell-offs of 2018 followed a rise of some 40 bps in 10-year Treasury yields. Lesson: elevated leverage (global debt) implies that any substantial rise in yields punishes risk assets. Hence the limited upside potential in USD yields: it makes sense to sell out-of-the-money (OTM) payers to fund protection in risky assets.

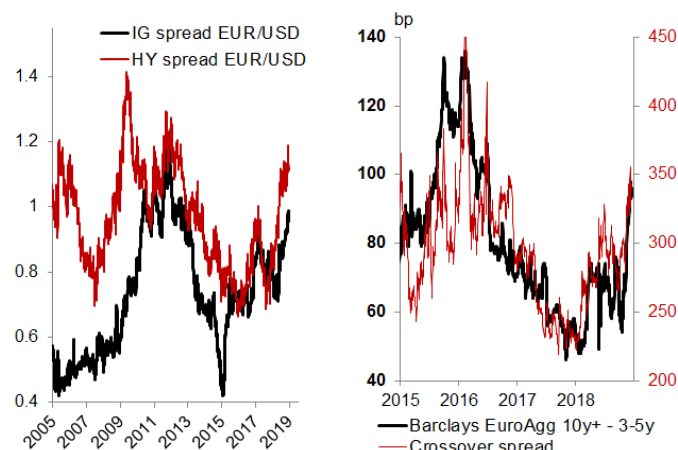
While credit markets look oversold, especially in Europe where spreads now appear too large vs. the US (Graph 8a), some further spread widening is likely over the year, amid fading central bank support and softer growth. Credit markets were beaten severely in Q4, e.g. the widening in spreads was large compared to the average rise in volatility across asset classes (Rates, FX and Equity) – see Graph 7. Positioning since the summer has reversed sharply, with many investors going from long to short, outright or relative to benchmarks. We will be looking for some relief at the start of 2019. Mind the asymmetry, however: once the US economy turns down (we do not see a recession around the corner), spreads can go much wider (Graph 7). Hence our OW in early 2019 will be small, tactical and prudent. Though our total return forecasts do not differ greatly, we do prefer Investment Grade over High Yield. Not only spreads are wider, but the credit spread curve is also much steeper (Graph 8b), which makes credit duration less despicable. Still, the curve tends to be directional when defaults are low, so could go steeper in 2019.

Graph 7: EUR HIGH YIELD SPREADS VS X-ASSET VOLATILITY



* Based on our in-house implied volatility index (stocks, bonds, G10 FX)

Graph 8: EUR SPREADS LARGE VS US; STEEPER CREDIT CURVE



Equities now looking over-sold, and valuation less frightening. Mind the asymmetry...

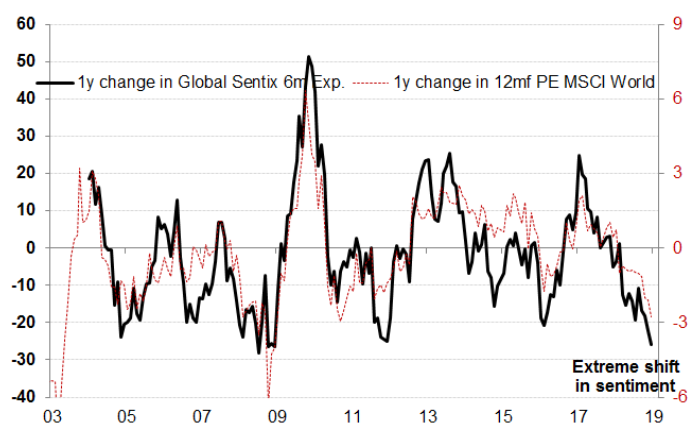
Equities: slower earning growth but much cheaper valuation

Slightly positive (low single digit) total returns in equities are our central case. The late 2018 sell-off was exaggerated, especially in Europe where economic sentiment has collapsed. Consensus earnings growth forecasts are still too high (we see earnings growth in the 4-5% region on both sides of the Atlantic, i.e. lower than consensus near 10%), but valuation has strongly deflated. The sharp adjustment in valuation reflects an equally brutal change in sentiment towards the global economy (Graph 9). The one-year change in global economic sentiment (Sentix) is as bad as when we sent into the 2008 GFC. Our dynamic measure of EA economic sentiment has not only dropped sharply but is also nearly as low (outright level) as during the sovereign debt crisis! This pessimism was matched by massive outflows from equity funds in mid-December, suggesting capitulation from investors eager to prevent 2018 portfolio performance from going from bad to worse.

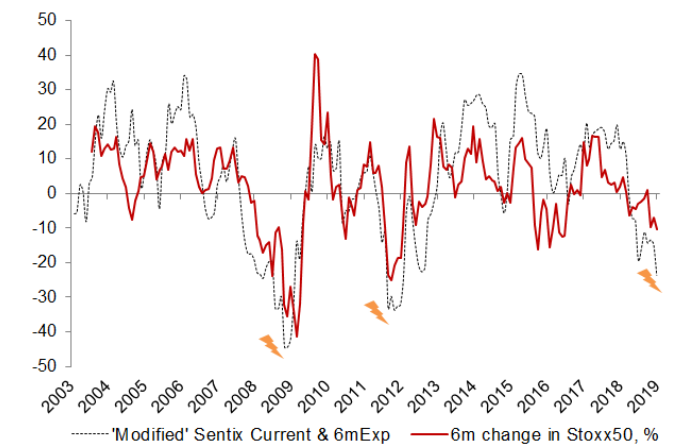
Yet we must conclude in outlining again the asymmetry that characterizes late cycle markets, and more so as the US slowdown is virtually inevitable (see economic section). Truth is that we predicted but underestimated both the extent and impact of the EA slowdown in 2018, which was also inevitable after the economy punched well above its weight in 2017 (+2.5% growth). Some US business surveys, such as the manufacturing ISM (59.3), remain sky high. It is certain that they will come off; some rate-sensitive sectors like housing and business investment are already showing signs of fatigue. We will thus structure hedges and favor defensive strategies: OW undervalued sectors like Utilities, Telecoms, Industrials (and more tactically, Financials); small OW Value vs Growth; OW Quality (low leverage, low EBITDA volatility, resilient sales growth) and countries like Switzerland).

The rest of this report offers more granularity on the economy, asset classes and allocations. We wish you good reading and investments in 2019.

Graph 9: EXTREME SHIFT IN ECONOMIC SENTIMENT HAS HURT PEs



Graph 10: EA ECONOMIC SENTIMENT TOO DEPRESSED?



$$\text{Modified Sentix} = (\text{Current} + 6\text{M Exp.})/2 + 0.7 \times (6\text{M Exp.} - \text{Cur.})$$

NEW! ‘Core Matters’ Publication

- In this new publications series, we direct your attention to long-term economic trends and strategic investment themes.
- Our first two releases provide insights into asset performance in mature economic cycles and the economic and financial implications of ageing societies. In a forthcoming release, we scrutinize investment opportunities arising from China’s rising technological ambitions.

With our new publication series *Core Matters* we enrich our views on global macro and markets with strategic long-term investment themes. We embrace developments, analyses and trends that in our view have the potential to pass the test of time throughout the tides of high-frequency data releases and market moves.

Equities have held up well in earlier late-cycle episodes, but pressures on corporate spreads tend to mount

In a first piece from late summer, we investigated the **empirical patterns of late-cycle asset performance**. The current US expansion is soon to become the longest in modern history and we ask how to best position in a maturing cycle. Analysing data since the early 1980s, we find that US equities tend to outperform long-term sovereign bonds during late-cycle episodes, while corporate spreads tend to widen rather early. With the current cycle maturing, this suggests it is too early to rush out of equities but sends a note of caution on exposure to corporate bonds.



Ageing societies face slower growth, lower short-term rates and rising price pressures while equity sectors exposed to ageing themes will benefit

In the second edition we investigate the **economic and financial market consequences of ageing societies**. Ageing and shrinking working population will lower growth and structural short-term interest rates but add to price pressures in our opinion. We look into the equity sectors most exposed to ageing and likely to benefit. The increasing importance of private retirement provisions also open new opportunities in the insurance and Asset & Wealth management sectors.

China’s technological ambitions may be delayed but not derailed by US resistance

In a third issue, to be published soon, we examine the **"Made in China 2025"** strategy, a comprehensive, government-led blueprint to transform the country into an advanced manufacturing leader. Growing international unease and pressure from the US may delay this strategy – certainly from a communication point of view the government seems to have gone very quiet on the matter – but is unlikely to derail it. We identify sectors in the Chinese market that are set to benefit from China’s technological agenda.

Decomposing Credit Risk

- The repricing in credit spreads has accelerated in Q4 2018. In order to better understand the drivers of the spread widening, we perform cross-section multivariate regressions on non-financial corporate spreads and estimate the market-implied compensation for key risk determinants, including rating, duration, country and sector risks.
- First, it is worth to highlight that the “basic risk” in our approach – the compensation for a AAA-rated senior bond, issued by a German firm – has moved higher this year, but is still well below its historical highs. A further upward adjustment looks consistent with our expectations of a further widening in corporate spreads in 2019.
- Second, the repricing in the rating risk is more advanced. The BBB vs A-rated bond premium has already moved back to its historical average. Similarly, investors have repriced the spread duration risk quite aggressively, with the spread premium embedded in longer-dated bonds at the highest level since the launch of the CSPP in March 2016.
- Our analysis also shows a shrinking spread discount for CSPP-eligible bonds. Finally, Italian and UK bonds and the Automotive sector clearly reflect the negative news flow over the budget, Brexit negotiations and the trade war.

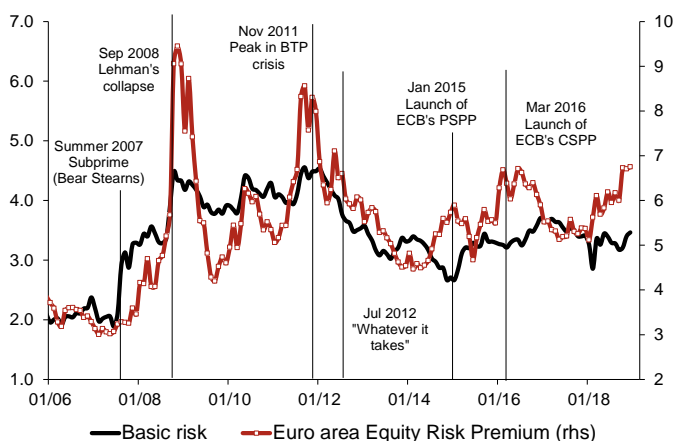
The repricing in credit risk premiums accelerated notably in the fourth quarter. In order to better understand the drivers of the spread increase, we perform a cross-section multivariate regression on Option-Adjusted Spreads (OAS) based on up to almost 2000 Investment Grade (IG) non-financial corporate bond securities for each month since January 2006. In this way, we estimate the market-implied compensation for the key determinants of credit spreads.

Our analysis shows that the cross-section multivariate regression is able to explain nearly 88% of spread dispersion since 2006

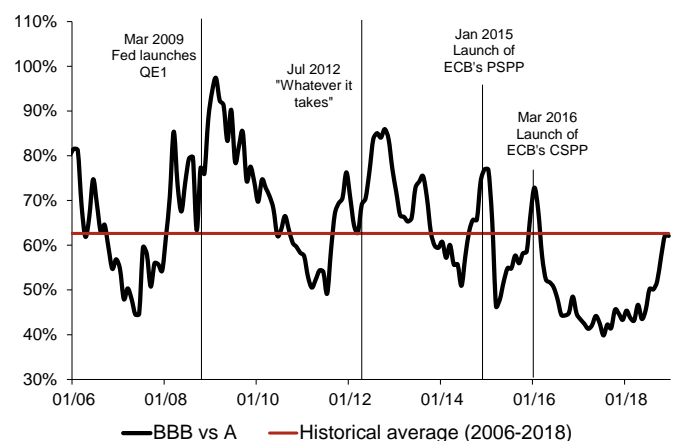
BBB vs A-rated spread premium already back to historical mean

We define the common component of corporate spreads as “basic risk”. More precisely, in our approach this is the estimated market-implied compensation for a AAA-rated senior bond, issued by a German firm, belonging to the Utility sector (the largest one in the IG non-financial corporate bond index). Our analysis suggests that the basic risk has increased since the start of the year, but it remains well below the

Graph 1: BASIC RISK AND EQUITY RISK PREMIUM



Graph 2: BBB-RATED vs A-RATED BOND PREMIUM



Source for ERP: Datastream, Absolute Strategy Research

% impact on Option-Adjusted Spreads (BBB vs A-rated bonds)

historical highs seen during the Great Financial Crisis and the Sovereign Debt Crisis in the euro area. It is worth noting the high correlation between the basic risk for corporate bonds and the Equity Risk Premium (Graph 1). The latter points to a further rise in the basic risk. This is consistent with our expectations of a further widening in corporate bond spreads during 2019.

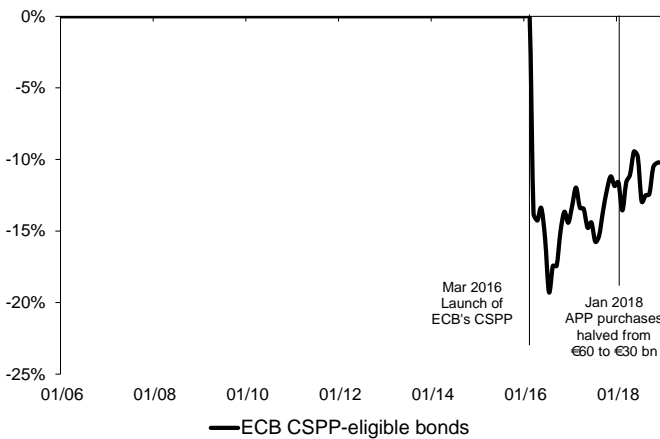
The spread premium for BBB-rated bonds vs A-rated ones has already risen back to its historical average

On the other hand, the repricing in the **rating risk** – lower-rated bonds pay a higher spread – seems more advanced. The estimated premium between BBB-rated and A-rated bonds has already climbed back to its historical average (Graph 2). The option-adjusted spread (OAS) of BBB-rated bonds is now 62% larger than the one of A-rated bonds, compared to a premium between 40% and 45% in the first half of 2018. Similarly, investors have repriced the **duration risk** quite aggressively. The spread premium embedded in longer-dated bonds is at the highest level since the launch of the ECB’s Corporate Sector Purchase Programme (CSPP) in March 2016.

The spread discount of CSPP-eligible bonds keeps falling

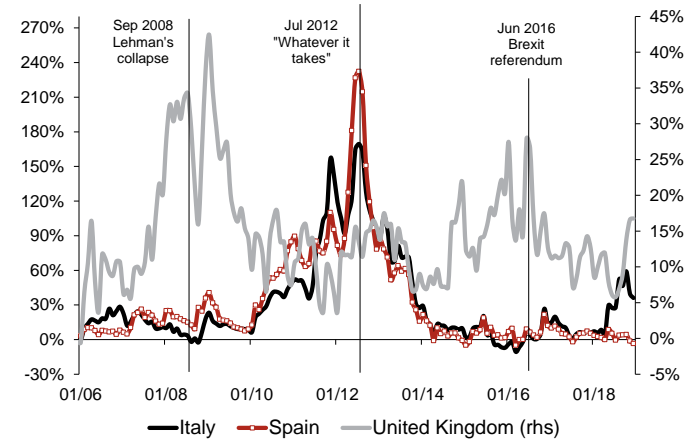
Another important factor to monitor is the spread discount embedded in bonds that are eligible for the ECB’s bond purchase program (**CSPP**). The discount peaked at around 20% soon after the announcement of the CSPP in March 2016 and it has then gradually declined (Graph 3). The ECB’s net purchases will stop at year-end.

Graph 3: DISCOUNT FOR CSPP-ELIGIBLE BONDS



% impact on Option-Adjusted Spreads (vs non-eligible bonds)

Graph 4: COMPENSATION FOR COUNTRY RISK



% impact on Option-Adjusted Spreads (German firms = 0)

The country risk premium embedded in Italian and UK corporate bonds stands in the 7th decile of the empirical distribution since 2006. Most of the other countries stand in the first decile (lowest premium).

Moreover, at the last meeting the ECB did not unveil any plan to redirect reinvestment proceedings from public into private bonds. As a result, we expect the spread discount embedded in CSPP-eligible bonds (currently at around 10%) to shrink further in 2019.

Country risk should also be monitored. The “Whatever it takes” speech by President Draghi in July 2012 and the subsequent ECB’s actions have contributed to remove country-risk premiums across euro area corporates. However, political woes in Italy have led to a resurging country risk premium for Italian corporates (Graph 4) this year. We estimate the percentage impact on Italian corporate spreads to be around 35%. On the contrary, no contagion has been evident in Spanish and Portuguese corporate bonds. Moreover, it is worth to highlight that the messy Brexit negotiations are weighing on UK corporates. The estimated country risk premium is around 17%, the highest level since H2 2016, but well below the levels of almost 30% seen after the Brexit referendum in June 2016.

Finally, the estimated **sector risk** premiums confirm the difficulties faced by the Automotive sector. The current spreads for the Automotive sector are 48% larger than Utility (all other factors being equal). This compares with an historical average of 13%. Despite the year-to-date underperformance, we see scope for the sector to remain under pressure due to trade war concerns and dwindling demand in China.

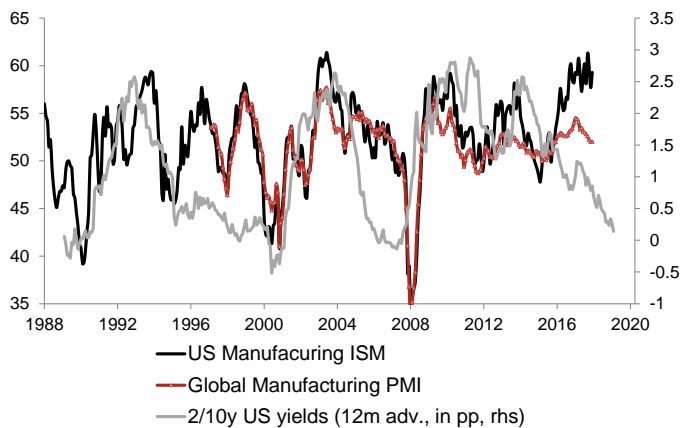
Macroeconomic Outlook

- The threats from a trade war, no-deal Brexit and Italian debt are weighing on the economic outlook, already clouded by recent data weakness. The global economy will lose momentum in 2019, but a recession is not around the corner.
- US growth is set to slow from the near 3% rate in 2018 as the fiscal stimulus will start to fade. Yet consumption, propelled by an exceptionally strong labor market, will continue to support activity. Core inflation will grind higher and the Fed seems set to deliver further two interest rate increases in 2019. Another hike is possible if activity remains strong.
- Based on solid domestic activity, growth in the euro area is set to stabilize at around potential in 2019 while risks are on the downside. We expect the ECB to embark on a first deposit rate hike in December.
- China's growth will slow gradually, overshadowed by trade war risks. But solid growth in India and CEE and a tentative recovery of most battered EMs will largely help to almost maintain the past year's pace of EM expansion.

The US were 2018 star performer, while euro area data disappointed high expectations

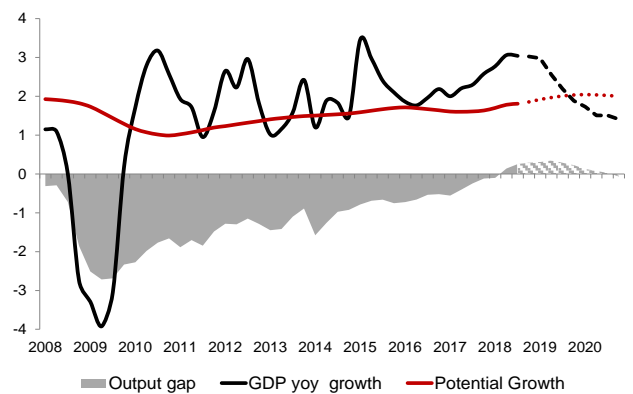
What started as a 'goldilocks' year with a widely synchronized expansion and subdued inflation is drawing to a close with investors concerned about global growth and the impact of monetary policy tightening. 2018 saw global trade growth retreating already before the trade war concerns intensified over the summer. The euro area was particularly affected, with economic data disappointing expectations for most of the year. The US, by contrast, have been the star performer, with annual growth to miss the 3% mark only by a small margin. Emerging markets (EMs) were unsettled by idiosyncratic crises in Argentina and Turkey, but predictions of an EM meltdown proved wide of the mark.

Graph 1: US YIELD CURVE AND GLOBAL ACTIVITY



index points (lhs), percentage points (rhs)

Graph 2: US: GROWTH AND OUTPUT GAP



in %

Fears of a trade war, a no-deal Brexit, Italian debt and market volatility weigh on the 2019 outlook

The recent sharp flattening of the US yield curve (see Graph 1) has unsettled investors. The escalation of the US/China trade war and the threat of US tariffs on cars are adding to this unease. A no-deal Brexit would have severe economic consequences for Britain and the Continent. And concerns about the level of Italian debt and the fiscal stand-off with the EU are casting a long shadow over the euro area. Also, a further intensification of market volatility may prove detrimental for the real economy.

Downside risks to the outlook thus abound. But a recession is not around the corner. Consumption, a key component of demand in the advanced world, will remain underpinned by strong labor markets, rising wages and low energy prices.

Trade uncertainties, Brexit concerns and higher US rates are weighing, but the decent outlook for consumption and high capacity utilization still make a point for investment to hold up. A due slowing of the Chinese economy will be cushioned (though not averted) by new fiscal measures, while EMs more generally seem set to largely keep this year's rate of expansion. Barring an escalation in the key risks mentioned (trade war, Brexit, Italian debt), we anticipate global growth to cool only mildly from 3.6% this year to 3.4% in 2019, even though downside risks prevail.

US: still solid growth, a cautious Fed will continue to raise rates

Annual growth in the US will slow to still solid 2.4% from close to 3% in 2018. The improvement in the labor market may extend somewhat further, with the unemployment rate to hit 3.5% (a 50-year low). This will keep wages increasing at more than 3% yoy and sustain consumption growth. The fiscal package will continue to provide a positive, but rapidly decreasing stimulus. Capex growth will weaken, as tighter financial conditions start to bite and trade uncertainties weigh on investment decisions. Tighter markets for labor and goods will continue to feed through to inflation, offsetting the impact of lower oil prices. We expect the core rate to end the year at 2.4%.

With inflation slightly above the Fed's 2% target and the unemployment rate falling to around 1 pp below the equilibrium value, the Fed will have scope to continue to hike rates; we expect two to three more rises, leading the Fed Funds Rate to around 3%. As repeatedly suggested by Chair Powell, in the final part of the hiking cycle, the Fed will be driven primarily by the data flow and how it stacks up against expectations; its moves will become less predictable. After two further hikes in H1 2019 we expect the Fed to pause. A third move is unlikely to be triggered before end-2019 and would require macro data to remain very solid in H2.

On the political front, tensions on trade are likely to resurface as the campaign for the 2020 presidential election heats up. The split Congress delivered by the 2018 mid-term election will not permit significant changes in tax policy. But the risk of a temporary shutdown has increased if the two parties fail to agree on the budget.

Euro area to weather headwinds

Following the past year's slowdown of growth from exceptionally strong levels, the momentum is set to stabilize in 2019. The projected average 2019 growth rate of 1.5% is partially due to statistical effects from a weak H2 2018 that has been held down by temporary factors (vehicle emission test disruptions, protests in France). The fundamentals for a domestically driven recovery remain in place. Consumption will remain supported by the ongoing labor market improvement amid sustained healthy wage increases. Also, lower oil prices will support purchasing power. With capacity utilization still one sigma above the historical mean, the ingredients for solid investment remain in place. There are thus good reasons to be confident that these sound fundamentals are strong enough to weather external headwinds.

That said, the risks to our outlook remain tilted to the downside. Apart from trade war concerns, they are also related to domestic factors like a 'crash' Brexit that would likely cause a temporary stalling in activity and a blow to confidence on top of country-specific issues (e.g. yellow vests in France, Italy's struggle with the EU on the budget).

The ECB announced the end to QE in 2018 but also made clear that it will only carefully normalize monetary policy while maintaining an easing bias. Most importantly, it has pledged to continue to reinvest maturing bonds of its asset purchase program for an extended period even after the first rate hike. The evolution of core inflation will be key for the timing of the ECB's first rate hike. With wages per employee up by 2.5% yoy in Q3/2018, upward pressure on underlying inflation in the pipeline and survey indicators implying sustained cyclical upward pressure, we

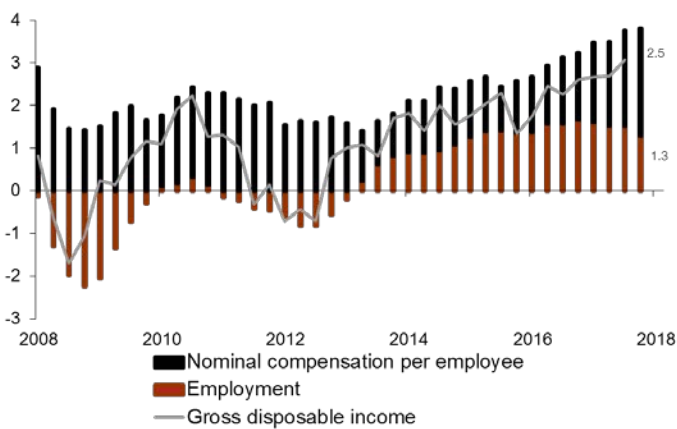
US consumption keeps growth above 2%, inflation increases very gradually as unemployment hits a 50-year low

Euro area domestic activity strong enough to sustain solid growth

ECB to hike rates in December 2019 but favorable financing conditions still remain in place

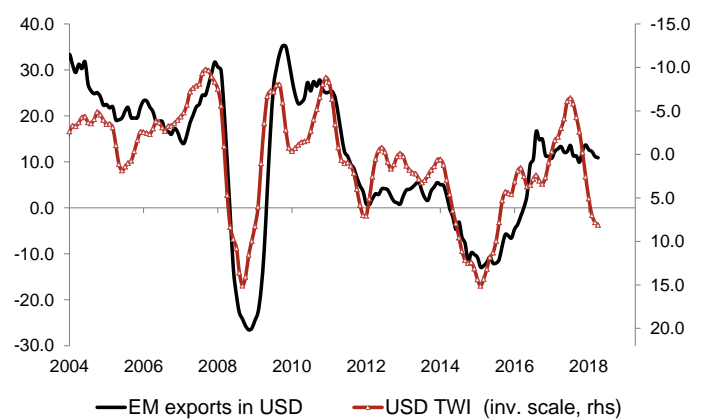
expect the ECB to embark on a first (depo) rate hike by 15 bps in December 2019. However, should activity fall below potential or be seriously at risk of doing so, we would expect the ECB to postpone the timing of its first rate hike to 2020. We expect the ECB to follow the experience of the Fed and to fully reinvest the stock of maturing QE purchases for three years, i.e. until end- 2021. Hence, in spite of policy normalization steps, the ECB will continue to contribute to favorable financing conditions.

Graph 3: EA RECOVERY WELL SUPPORTED BY INCOME GROWTH



in % yoy

Graph 4: EM EXPORTS AND TRADE-WEIGHTED US DOLLAR



in % yoy, 3mma, exports weighted by GDP (PPP)

Weaker US growth and risk from a trade war are headwinds to EMs, but a weaker USD should provide some relief

EM growth to soften only slightly, cushioned by a weaker USD

Growth in China is set to slow further in 2019 and beyond. Frictions from the Sino-US trade conflict are adding to the downside risks. That said, the government is cutting taxes and fees by about 1.5% of GDP, while the PBoC will buffer its regulatory tightening of Chinese loan markets with further cuts in banks' reserve requirements.

Weak spots like Argentina and Turkey are set to recover gradually from their 2018 slump, with C/A deficits adjusting. Momentum will gain traction in Brazil and South Africa, while India seems set to roughly maintain its growth speed of around 7.5%. Also the CEE region will continue to enjoy solid growth thanks to robust domestic demand. An escalation of the US/China trade conflict is a key wildcard, with many EM exports exposed to international value chains. Slowing US growth will be a headwind, too. That said, a weaker US dollar (see Currency chapter) should help exports and ease recent pressures towards monetary tightening.

Global growth geared towards moderation, not a sharp slowdown of growth

Overall, the global picture is geared to a moderation, not a sharp slowdown in growth. Amid plenty of political and trade risks, however, the risks to the outlook are tilted to a somewhat faster deceleration. The major central banks will not abandon their policy normalization, but turn more data-dependent approach amid a more uncertain outlook to the global economy.

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Fixed Income

- While international yields rose most of the year, the upward movement was strongly reversed due to falling inflation expectations and growth concerns in the final quarter of 2018. However, financial markets have gone too far and have become too pessimistic. Accordingly, there is scope for yields to rise across the curve in 2019.
- Notwithstanding political risks, a less supportive supply/demand ratio in combination with key rate hike expectations on both sides of the Atlantic will likely gain the upper hand. Total returns in euro terms are forecast to be negative.
- The fate of Italian sovereign bonds is seen to remain linked to the political developments. A lasting BTP spread tightening from current levels is not on the cards. The volatility of other non-core bonds is forecast to remain much lower.

Further transatlantic yield spread widening over the course of 2018

Until the start of Q4 international government bond yields rose largely in line with our expectations stated one year ago. But, since then a combination of political and economic factors drove yields down on both sides of the Atlantic. Triggered by a strong decrease in oil prices (around 30% in Q4) inflation expectations fell strongly. Meanwhile, 10-year inflation swaps are on the lowest level since summer 2017. Against it, real yields have risen over the course of 2018. Meanwhile, despite the setback in Q4, particularly real yields in the US are on a multi-year high.

Central banks to pave the way to higher yields in 2019

Due to disappointing economic data and the tightening of financial conditions financial markets have rightly lowered the path of future key rates in the US and in the euro area. By now, only one additional key rate hike by the Fed (on top of the one in December 2018) is priced for 2019. What is more, investors have started to speculate about a first key rate cut as soon as 2020. We regard the current pricing as too pessimistic. Assuming a nominal neutral key rate in the range between 2.75% and 3.00%, financial market pricing implies that the US central bank will stop just below the neutral rate. However, in order to slow the US economy, the Fed will have to raise key rates above the neutral level. Accordingly, we forecast the US central bank to hike up to three times in 2019. That said, particularly the third step (expected in Q4 2019) is likely to be dependent on the macroeconomic development. This applies even more in case financial conditions continue to tighten. Still, with growth above potential, a labor market characterized by an unemployment rate below the long-term equilibrium level and rising core inflation the way is paved for a more aggressive Fed than currently expected.

Too dovish market expectations for future central bank policies

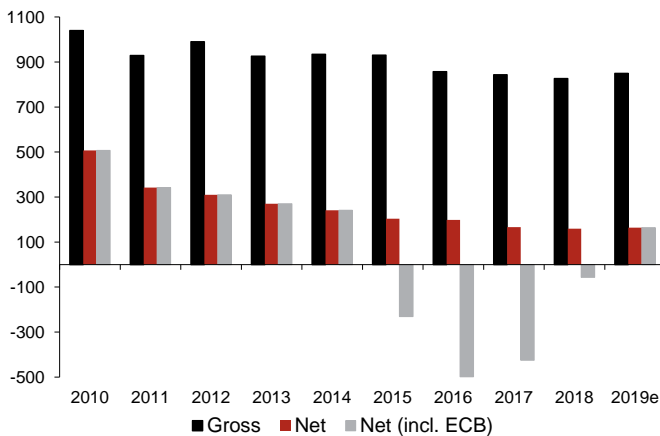
A similar argument applies to the euro area. Intact drivers of domestic demand like a tightening labor market are likely to trigger a growth rate of at least around potential. In addition, core inflation is seen to finally rise over the course of 2019. In contrast, with 2-year inflation swaps at around 1.1%, financial markets do not expect any rising trend. Given leading inflation indicators, markets' expectations are likely to be adjusted during 2019, triggering a repricing of ECB expectations.

The supply/demand balance will support higher yields on both sides of the Atlantic as well. In the US, gross supply will reach the highest level ever (more than \$3000 bn) and net supply is seen to rise from close to \$800 bn to almost \$1000 bn. Even more will have to be taken down by the private sector as the Fed will not reinvest more than \$200 bn of redeeming Treasuries. The burden is expected to be on domestic investors as foreign investors have only sluggishly increased their holdings over the recent years. Overall, the ex-ante imbalance between demand and supply suggests an upward pressure on US yields in 2019.

At first sight the situation in the euro area appears more benign as gross and net supply will not change considerably compared to 2018. However, the ECB just confirmed that the QE programme will be terminated at the end of 2018 and that it will only reinvest maturing bonds. Taking this into account, net supply will reach the

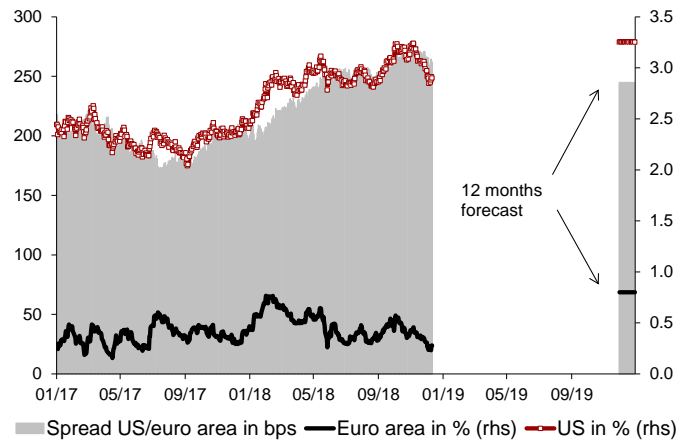
highest level since 2014. However, at least the ECB will not reduce its stock and will continue to hold around 25% of all outstanding euro area government bonds. All in, bond supply will likely remain manageable in the euro area in 2019, but the momentum will deteriorate noticeably compared to 2018.

Graph 1: EURO AREA SOVEREIGN BOND ISSUANCE



in bn €, maturity > 1 year

Graph 2: 10-YEAR TRANSATLANTIC YIELD SPREAD



Assuming no political accident, international core yields to increase over the course of 2019

Under these circumstances, there is scope for international core yields to rise across the curve. Given the low level still prevailing, particularly euro area core yields are expected to rise. Until the end of 2019, 10-year Bund yields will likely reach 0.75% and 10-year Treasury yields are seen to end the year at 3.20%. This means that euro area and US government bonds (hedged) are forecast to yield a negative total return in 2019.

Muddling through remains base scenario for BTPs in 2019

However, there are several political risks to this outlook. Among others, a hard Brexit remains an event with a non-negligible probability, the conflict between the Italian government and the EU can still escalate (see below), and the smoldering trade war can to some extent also prevent the forecast yield increase to materialize.

BTPs to remain hostage to political developments

On euro area government bond markets, Italian bonds performed worst in 2018. The formation of an euro-sceptical government in May and the presentation of a more expansive budget law in autumn triggered a meaningful spread widening. By now, BTPs entail a risk premium of up to 100 bps. Assuming the government remains in power, this is unlikely to change sustainably going forward. Notwithstanding their heterogenous strategic objectives, both ruling parties ride on the wave of euro-scepticism. Hence, conflicts with the EU are likely to revive now and then. Though a strict confrontational stance is unlikely as pressure from markets is expected to discipline the government. In this environment, BTP/Bund spreads are seen to remain very volatile in 2019. However, depending on the political news flow, there will be longer periods in which the risk premium will decrease.

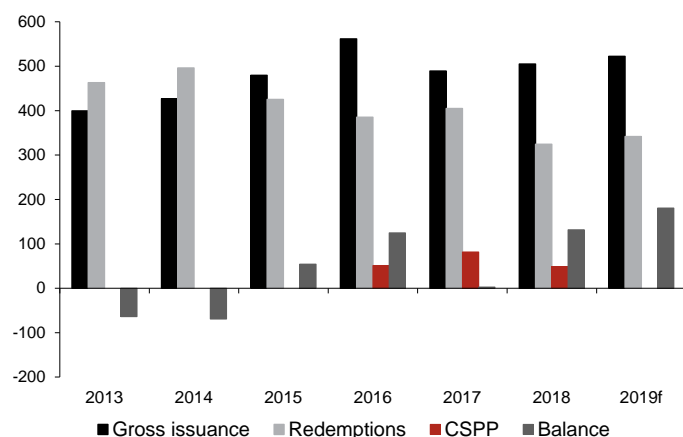
Other non-core bond markets are likely to trace the BTP market, but with a lower beta and, hence, less volatility. They are seen to be much more determined by the macroeconomic development. On balance, we do not expect non-core spreads to widen considerably over the course of 2019.

Corporate Bonds

- After a poor performance in 2018, the environment for euro area Investment Grade corporate bonds is expected to remain challenging in 2019 as well. Despite a more attractive valuation, spreads are likely to widen further.
- Particularly non-financials will be burdened by the end of QE. To limit risks and to preserve capital, investors are advised to focus on domestic oriented and short-dated non-financial corporate bonds in 2019.
- Financial bond spreads are expected to keep widening too. Abundant banks' supply to replace TLTRO funding maturing in 2020 will add to a less supportive macro outlook and to political tensions in the euro area.

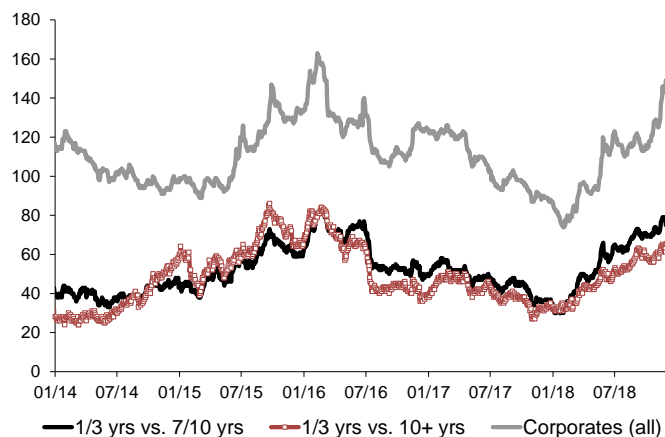
Although euro area Investment Grade corporate bond spreads have widened strongly in 2018 and are back to the level when the ECB announced its Corporate Sector Purchase Programme in Q1 2016, a further spread widening is likely in 2019.

Graph 1: EA IG CORPORATE BOND SUPPLY



in bn €; 500 m and up

Graph 2: BofA ML EA IG CORPORATE BONDS: CURVE STEEPNESS



option-adjusted spreads in bps

Less benign supply/demand ratio to trigger a further spread widening in 2019

There are several factors which will continue to burden this asset class. To start with, slightly higher net issuance and higher redemptions contribute to a moderate increase in gross supply. More importantly, the ECB has just announced to end its QE programme. After buying corporate bonds worth almost €50 bn in 2018, the central bank will only reinvest maturing corporate bonds in 2019 (little more than €6 bn). Hence, the private sector will have to take down the highest net issuance since 2009 (around €180 bn). At the same time, a meagre total return outlook will limit inflows which tend to be procyclical. This pattern – discernible already in 2018 – is seen to prevail. In addition, the economy is forecast to slow (although it will remain at least around potential), but core inflation is expected to rise eventually over the course of 2019 triggering higher underlying yields. Moreover, several non-negligible political risks (e.g. Italy, Brexit, trade conflict) have the potential to burden the market even more. All in, despite the spread widening in 2018, there is more leeway for spreads to rise in 2019 (in the low double-digit range). This widening is forecast to go hand in hand with a further steepening of the spread curve (see graph 2).

Non-financials to feel the consequences of ECB withdrawal

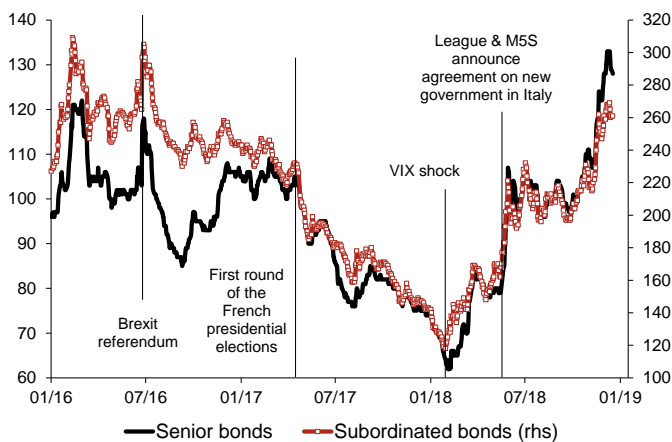
Defaults of non-financial corporate bonds have fallen further over the course of 2018 and are forecast to remain well below the average in 2019. Even more, the funding situation is favorable and due to the fact that the average coupon is still

above the average yield, they are expected to ease even further. But, due to the end of QE net issuance will increase from less than €75 bn to more than €125 bn.

Negative total return due to spread widening and increase in underlying yields in 2019

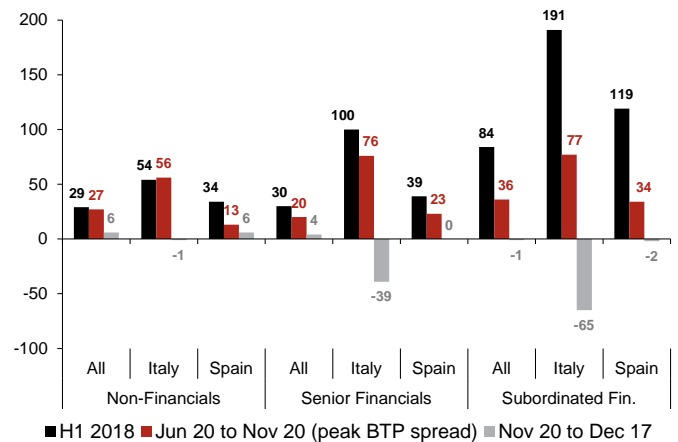
For the first time in the last 20 years we expect for the second year in a row a negative total return in 2019. In this environment capital preservation is key. Accordingly, we recommend overweighting short-dated non-financials versus long-dated ones. What is more, due to the risks emanating from the global trade conflict, we prefer domestic oriented non-financial corporates.

Graph 3: ICE BofAML EUR INV. GRADE FINANCIAL BOND SPREADS



Option-Adjusted Spread over German Bunds, in bps

Graph 4: SPREAD CHANGE BY COUNTRY



ICE BofAML indices, change in Option-Adjusted Spread, in bps

Italian (€ 250 bn) and Spanish banks (almost € 200 bn) have been the main beneficiaries of TLTRO funding

Replacement of TLTRO funding to weigh on banks' net issuance

Similarly to non-financial bonds, also financial corporate bonds posted negative total returns in 2018. Financials slightly underperformed Non-Financials in H1, largely reflecting political woes in Italy, but then recovered as the latter were more affected by the fading ECB purchases. Overall, the EUR IG Financial bond index lost 1.23% in total return terms as the Option-Adjusted Spread (OAS) rose by 68 bps to 159 bps, the highest level since the Brexit referendum in June 2016. In this risk-off environment, Senior bonds (-0.63%) outperformed Subordinated ones (down by 3.11%), while Italian bonds suffered heavy losses (OAS: +137 bps).

The repricing in financial bond spreads is set to continue in 2019. While in the short term we see scope for a pause, we expect the OAS to increase by 15 to 20 bps by end-2019. In addition to a less supportive macro environment and political woes in Europe, European banks will have to tap financial markets to replace maturing TLTRO funding in 2020, at least partially. Indeed, to avoid a funding cliff (especially for Italian banks) the ECB will likely offer a substitute, although at less favorable conditions. According to the "Risk assessment of the European Banking System" recently released by the European Banking Authority, European banks' net issuance will rise from € 108 bn in 2018 to € 114 bn in 2019 and € 155 bn in 2020. The implementation of MREL and TLAC capital requirements and wider spreads on subordinated instruments will likely result in a further abundant supply of bail-in-able senior bonds.

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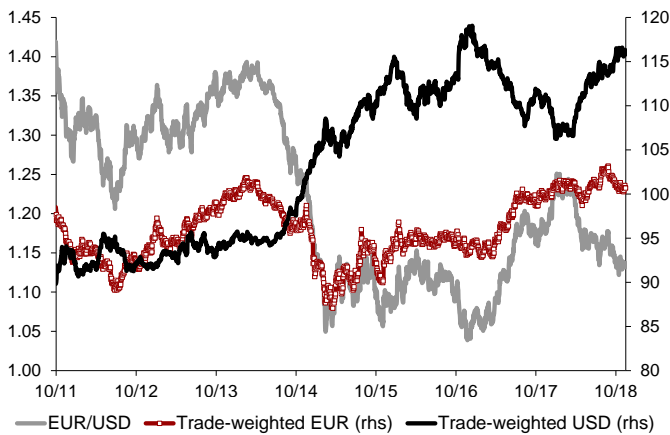
Currencies

- **US dollar strength was the name of the game of 2018, thanks to US outperformance amid a strong procyclical fiscal stimulus. The air for the Greenback is getting thin, however.**
- **Short term, trade war concerns and political uncertainties may still underpin the US currency.**
- **By end-2019, however, we expect past year’s USD gains to be largely pared on global growth convergence and an unwinding of stretched speculative positions.**
- **The British pound is in the hands of politics and the terms of the impending Brexit. Uncertainties will weigh near term, but an orderly ‘deal’ exit from the EU leaves scope for a visible rebound of sterling in spring.**
- **EM currencies are trading generally cheaply, while we deem risks of a broad EM crisis as low. We take a guardedly constructive view for 2019, but more cautiously so for European investors.**

2018 was the year of the US dollar, boosted by a procyclical fiscal stimulus

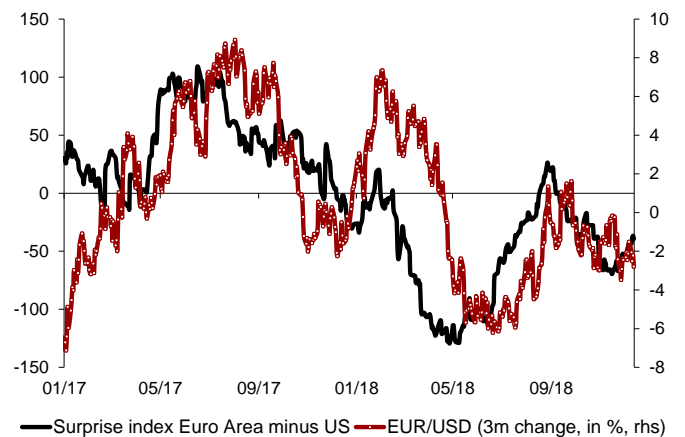
It has been the year of the Greenback. By mid-December, the USD has strengthened by more than 5% against major currencies and 9% in broad trade-weighted terms, largely reversing its losses from the previous year (though not so against the euro). The air for the USD is getting thin. Short term, trade war uncertainties, risks of a no-deal Brexit and Italian debt woes may keep the dollar underpinned. And while the Fed is shifting from a largely predetermined to a much more data-dependent approach to further rate hikes, the two hikes priced by markets for the remainder of this cycle (incl. the December rate hike) are too cautious. Over the next months, we expect EUR/USD to remain range-bound around 1.13.

Graph 1: US DOLLAR AND EURO



TWI Indices: 01/2005 = 100

Graph 2: ECONOMIC DATA SURPRISES AND EUR/USD



Fading US outperformance to weigh on USD

Fading US economic strength to be mirrored by a weaker Greenback

The USD outlook further out is yet to the downside, especially against EUR, JPY and GBP. A key driver will be the economic cycle: 2018 USD strength owed very much to the surprising strength of the US economy which sharply contrasted largely persistent data disappointment in Europe (see Graph 2). With the US fiscal stimulus gradually unwinding, US annualized growth rates are set to fall from the 3.5% in Q3 towards the 2% mark over the next year. Foreign investors will turn more reluctant in providing required capital inflows amid a widening twin deficit and with the Fed unwinding its holding of Treasuries and MBS.

Shift in speculative positions likely to add to USD headwinds

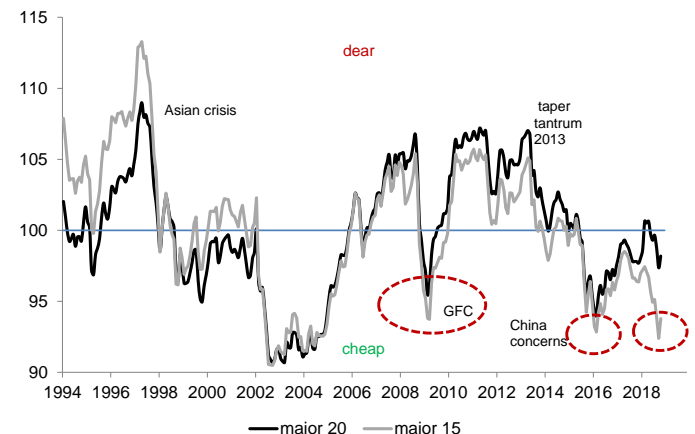
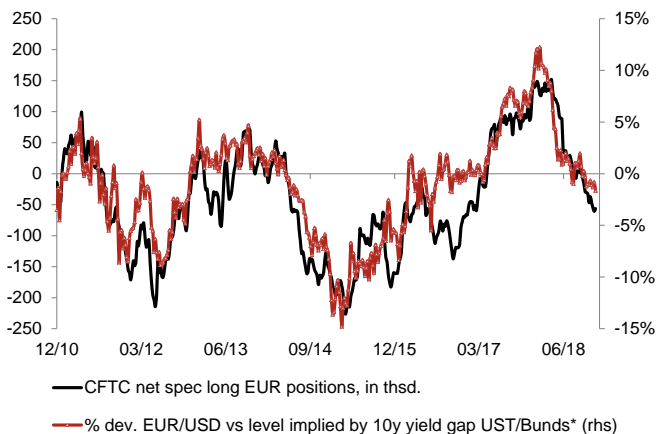
Short-term, trade uncertainties and political risks in Europe to hold back the EUR/USD

Currently large long USD speculative positions add to the corrective forces. After controlling for the impact of changes in the 10-year transatlantic yield spreads, the almost US\$ 60 bn shift in speculative positions in favor of the USD since April accounts for a roughly 10% shift in the EUR/USD (see Graph 3). A turn in stretched speculative interest will likely burden the USD. With the ECB approaching its first deposit rate hike towards the end of the year, we also expect the transatlantic yield gap to narrow somewhat to the favor of a higher EUR/USD.

Politics will matter, too. We still deem it most likely that a no-deal Brexit will ultimately be avoided. This may in the first place strongly support GBP (after remaining under pressure amid extending political brinkmanship), but the EUR/USD would benefit, too. We also anticipate stronger verbal pressure by US President Trump against USD strength, with the US trade deficit continuing to widen (with the 12-month sum having grown by US\$ 104 bn to US\$ 604 bn since Trump's election victory). The EUR/USD should trade range-bound over the next months, but we expect a significant leg higher to 1.20 by year-end 2019.

Graph 3: POSITIONING AND EUR/USD DEVIATION FROM YIELD MOVES

Graph 4: EM REAL EFFECTIVE EXCHANGE RATES



* based on 3y rolling regression EUR/USD vs. 10y yield gap

avg. of major EM FX, inflation adj., long-term avg. = 100

We are guardedly constructive on EM FX, but a stronger EUR/USD dents the return outlook for European investors

We also have a guardedly constructive outlook on EM currencies. After suffering severely this year (with JPM EM FX index down by 10%), EM currencies now look generally cheap. This holds both against the US dollar but also in inflation-adjusted trade-weighted terms. Our index compiled of the average of the 15 most widely traded EM currencies is now well below the long-term average and at similar levels as in 2009 (Global Financial Crisis) and 2016 (China concerns). Weak spots in the EM space notwithstanding, we expect no broader EM crisis thanks to overall rather healthy fundamentals. So easing US dollar strength should also help EM FX to hold up rather well next year, even though it could prove a rather volatile ride amid the persisting uncertainties.

A key concern is the Sino-American trade war. A further escalation in the trade war will weigh on the Chinese currency. In fact, we anticipate the USD/CNY to break the symbolic 7.00 threshold earlier in 2019, even though not by a very high margin. This will keep a lid on the broader EM FX space (most notably so in Asia). Finally, while we are guardedly constructive on EMs vs. USD, the outlook is more challenging for European investors base, where EM FX returns will be curbed by a stronger euro.

Equities

- Equities dropped in 2018 notwithstanding good earnings growth. Negative factors were decreasing monetary stimulus, increased inflation and corporate yields, softer macro surprises, spikes in US 10-year rates and intensifying trade, Brexit and Italian risks.
- We remain cautious for the next 12 months as we see the above-mentioned factors to continue to cap price-earnings. We forecast only slightly positive total returns and mainly thanks to dividend yields. We favor a balanced allocation between EMU and the US; OW UK, Japan and Switzerland and neutral on EMs.
- Risks remain high but after the recent set-back a near-term stabilization is likely. Tactically OW cyclicals vs. defensives. OW undervalued sectors like TLC, Utilities, Industrials, Discretionary and Financials. Oils are UW with Pharma, Small cap, RE, Materials and IT. Limited OW on Value, OW on Quality and neutral on Growth.

PE's downgrade by nearly 20% YTD due to reducing monetary stimulus, peaking growth momentum, higher credit yields and inflation plus high exogenous risks

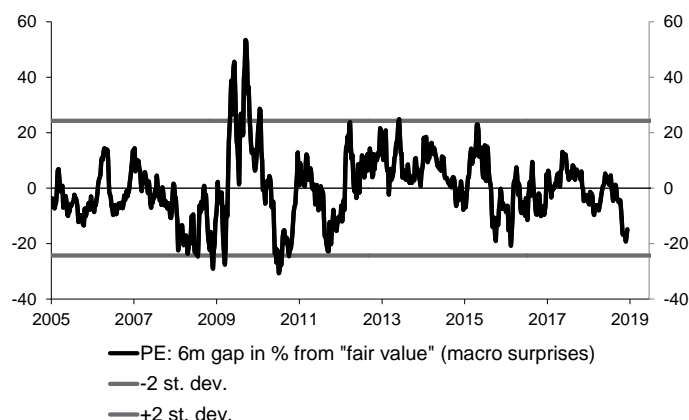
Equities dropped in 2018 notwithstanding good earnings growth. Negative factors were softer macro surprises, the volatility in US 10-year rates, higher corporate yields and intensifying trade, Brexit and Italian risks. In 2019 we see higher inflation, credit stress, decreasing monetary stimulus (inducing higher volatility) plus political and trade risks to continue to cap price/earnings expansion. We consequently stay on the cautious side. That said, the very negative price action in Q4 (MSCI World: -10%) looks exaggerated given a weakening but overall still decent earnings growth. Short term, market prices have the chance to stabilize temporarily after this overreaction. For the next 12 months, however, we forecast negative price returns, and, thanks to dividend yields, slightly positive total returns (TR) mainly in European and EM countries (+2-2.5% for Europe and Japan, and +0.5% for the US, all in local currency). Risks are tilted to the downside. A stronger trade-weighted euro is to add to euro area (EA) negatives next year, while IT/FAANG issues (higher relative valuation, higher inventories, competition and reputational risk) will weigh on the US.

Table 1: PRICE / EARNINGS (PE) CONTRACTION

Index	%TR	DY	%Price	%Earnings	%PE
MSCI World	-5.0	2.20	-7.2	11.9	-17.0
S&P 500	0.5	1.84	-1.3	19.1	-17.1
MSCI EMU	-11.4	2.63	-14.0	7.7	-20.1
TOPIX	-10.7	1.79	-12.5	9.3	-20.0
FTSE100	-8.9	3.64	-12.6	14.6	-23.7
SMI	-5.7	3.15	-8.9	6.4	-14.4
FTSE MIB	-12.8	2.93	-15.8	17.2	-28.1
MSCI EM (\$)	-14.8	2.12	-16.9	0.6	-17.4
MSCI Brazil	14.1	3.41	10.7	31.4	-15.8
MSCI Russia (\$)	5.3	5.63	-0.3	26.9	-21.4
MSCI India	-2.6	1.47	-4.1	5.3	-8.9
MSCI China	-16.5	1.72	-18.2	6.3	-23.0

* changes are YTD

Graph 1: MSCI EMU PE & MACRO SURPRISES



macro surprises are for euro area + UK

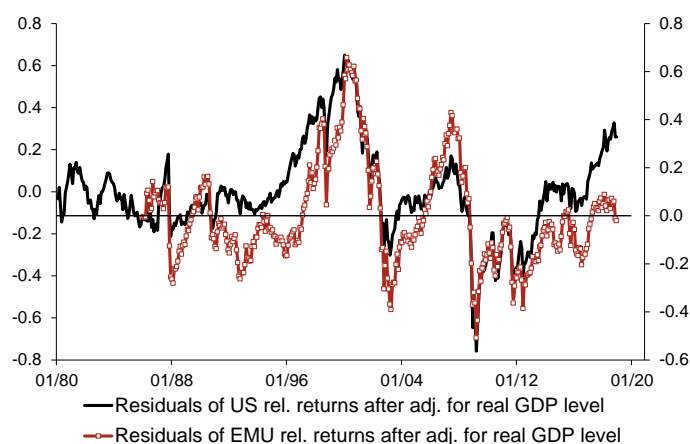
PE capped in 2019 with near-term stabilization likely

In order to assess the above-cited 12-month returns we use different valuation approaches like: target PE multiples and risk premium and DDM. We looked to the relationship of PEs with nominal and real yields, inflation and BAA yields. The result is that we judge as fair a lower-than-historical average PE level (12-month forward): 15X for S&P and the SMI and 12.5X for MSCI EMU, Topix and the FTSE 100. Given

We forecast +0.5% total returns for the S&P500, +2% for EMU, +2.5% for EU ex EMU and 3% for Japan in the next 12 months. Risks tilted on the downside.

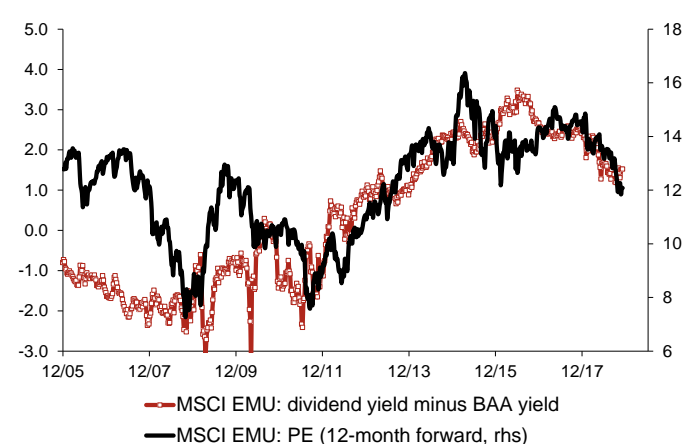
our more prudent forecast of earnings growth in 2019 (nearly half the level of consensus) and assuming an average risk premium in line with the post-2008 average, we see a theoretical mid-single digit negative TR for the S&P 500 and a positive one for Europe (5%). That said, in the next quarters the political and trade risks could reduce the ability of the EMU index to outperform the US. At the same time, buybacks (1%-1.5%) and solid free-cash-flow generation could help limit the downside potential for the US. All in all, we forecast +0.5% TR for the S&P500, +2% for EMU, +2.5% for EU ex-EMU and 3% for Japan in the next 12 months. We favor a balanced allocation between EMU and the US over 3/6 months. We stay OW UK, Japan and Switzerland and are neutral on EMs. The EMU index is cheaper than the S&P 500, but such valuation cushion is partially offset by exogenous risks and the expected appreciation of the trade-weighted euro.

Graph 2: US AND EMU EQUITY RETURNS VERSUS BONDS



Returns are in logs and adjusted for real GDP level

Graph 3: MSCI EMU: RISK PREMIUM USING BAA YIELDS



In details, we forecast for both IBES and NIPA earnings a decent growth of 4% in 2019 vs nearly 9% of consensus. US earnings will remain well above historical trend (+30% vs -3% for EMU and -8% for EM). Peaking US GDP growth momentum and tax reform effects plus increasing wages will trigger a deterioration in the earnings momentum in H2 next year. Investors will also discount already in 2019 a likely further slowdown in GDP growth in 2020. Concerning valuation, the US index looks expensive also when measured against the GDP trend or using the cyclically-adjusted Shiller PE (currently at nearly 30X vs. an average of 16X or 21X when past inflation level was similar to current one).

Stay overweight on cheaper sectors with a tilt on cyclicals in the short term

Risks still high but near-term bounce likely as PEs temporarily discount negative macro surprises and riskier equities show big undervaluation vs history

In the last quarter, the price action has been particularly negative in some risky areas like Italy, autos, EMs and financials. Their valuations show big discount vs history and vs the current level of macro surprises. Q4 should also see stabilization in quarterly growth of EA GDP after the recent softer momentum. Lastly, global equity outflows have increased substantially: We maintain our cautious view but market prices have chance to stabilize temporarily.

We are tactically slightly OW cyclicals vs. defensives as price action was quite severe in the last weeks and our regression models see upside for cyclicals (like industrials) based on the current state of macro variables that we use as an input in the models. In general we prefer undervalued sectors like TLC, Utilities, Industrials, Discretionary and Financials. Oils are temporarily UW (stretched vs. macro fundamentals) but we will consider reentering the sector on further weakness.

Pharma is slightly UW, too, along with Real Estate, Materials and IT. Pharma and IT are also Growth proxies which we tend to underweight vs. Value ones. We see Small Cap Growth at risk (UW) vs Large Cap Value due to higher relative valuation.

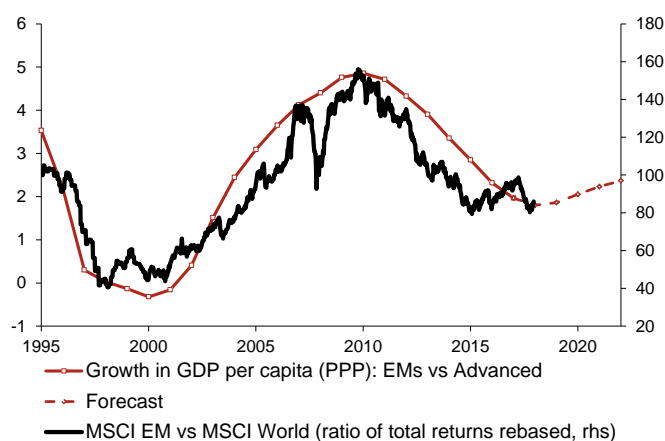
That said, we recommend a limited OW on Value, an OW on Quality and neutral on Growth. Value needs higher yields to outperform and EA ones have been range-bounding at best in 2018 (with Bund yield decreasing). We foresee higher yields in 2019 so that we maintain our constructive view on Value but not full overweight: due to the risks weighing in the EA (politics, trade, Italy etc.) and the relative valuations of Value vs Growth (no more as cheap as in mid-2018).

Table 2: EQUITY MARKETS VALUATION DASHBOARD

Markets	Price / Earnings *		Price / Book *		Price / Cash Flow *		Dividend Yield *		Avg. Discount, % Disc. (-1M), %	
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.		
WORLD	14.0	16.0	2.1	1.9	9.5	8.8	2.8	2.7	0.0	3.9
USA	15.2	15.3	2.8	2.4	10.8	9.9	2.2	2.2	7.0	10.4
JAPAN	12.0	15.5	1.1	1.3	7.0	7.1	2.5	1.9	-16.7	-14.4
UK	11.4	13.8	1.5	1.8	7.4	7.9	5.0	4.0	-16.3	-12.1
SWITZERLAND	14.7	15.4	2.3	2.2	10.1	11.2	3.8	3.3	-7.0	-4.8
EMU	11.8	14.1	1.4	1.5	7.1	6.5	4.0	3.9	-5.3	-2.3
FRANCE	12.2	14.3	1.4	1.5	7.4	6.9	3.9	3.7	-4.7	0.3
GERMANY	11.2	15.0	1.3	1.5	7.2	6.7	3.8	3.3	-10.5	-5.9
GREECE	12.5	12.8	2.0	1.6	6.5	6.0	5.9	4.0	-5.1	-9.2
ITALY	9.3	15.2	1.0	1.2	4.7	4.7	5.4	4.7	-17.0	-13.4
PORTUGAL	13.8	12.7	1.6	1.7	5.5	5.9	5.1	4.5	-4.0	-4.5
SPAIN	10.6	12.9	1.1	1.6	5.0	5.1	5.0	5.1	-12.3	-9.5
EURO STOXX 50	11.8	13.2	1.4	1.5	7.1	6.2	4.2	4.2	-0.3	3.8
STOXX SMALL	14.5	14.5	1.7	1.7	9.2	8.3	3.4	3.2	0.6	6.0
EM, \$	10.5	14.5	1.3	1.6	6.5	7.7	3.4	3.1	-17.4	-18.4
BRAZIL	11.0	9.0	1.7	1.7	6.8	13.7	4.2	4.3	-6.2	-7.1
RUSSIA	4.9	7.0	0.6	0.9	2.9	4.5	8.0	3.8	-52.9	-53.8
INDIA	17.4	14.5	2.5	2.7	11.5	11.5	1.7	1.6	2.6	2.9
CHINA	10.3	13.0	1.4	1.7	6.7	7.5	2.8	3.0	-11.4	-13.1

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 4: EMS VS ADVANCED ECONOMIES



Returns are in logs and adjusted for real GDP level

GDP growth and equities

EM: rebound expected in the short term, with upside capped

EM equities have lost (YTD: -14%) as a result of stronger USD, lower growth, liquidity tightening and higher US rates. Their price trend has appreciably undershot that of earnings. The upside of the rebound is to be capped by greater macro uncertainty and gradually moving up US policy rates in 2019 and central banks' balance sheet reduction. The slowdown in China should weigh on global trade, maintaining EM earnings under pressure. Despite the trade war truce declared at the G20 summit, disruptions (Huawei CFO's arrest) and trade issues will probably stay with us for longer, representing along with US corporate credit main risks to the downside. A pause by the Fed, weaker USD and weaker oil prices reduce external pressures for EMs.

A pause by the Fed, weaker USD and weaker oil prices reduce external pressures for EMs.

That said, we overweight EMs in the balanced portfolio but recommend to stay neutral within equity space. The EMs political landscape - with Asia (India, Indonesia, the Philippines, and Thailand) standing out - is to be characterized by several key events in 2019, which are to keep volatility high. Due to current risks, valuations are at a discount of 18% vs history and the cyclically-adjusted PE one standard deviation below norm. In H2 2019, the EMs should benefit in relative terms from expected weaker US dollar as well as from lower valuations and higher projected GDP growth (vs DMs). We overweight Korea, India, CEE and slightly Brazil.

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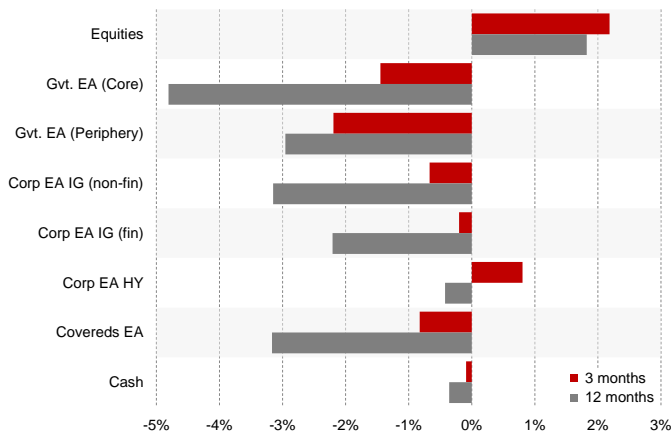
Asset Allocation

- In 2018 the rise in financial volatility, particularly through the February Flash Crash and Q4 equity sell-off, highlighted the need to be nimble and build up protections as we get closer a 'late cycle' environment.
- In 2019 this will all the more be true as the cycle gets ever more mature and policy normalization slowly continues.
- We will start the year with a tactical pro-risk stance, against the backdrop of the recent market correction we deem exaggerated. Risk asset valuation has deflated significantly.
- This tactical view is unlikely to hold throughout the year, as the US slowdown eventually keep investors nervous. Quality will be a key investment theme in 2019.

Short term a tactical pro-risk stance might still be advisable

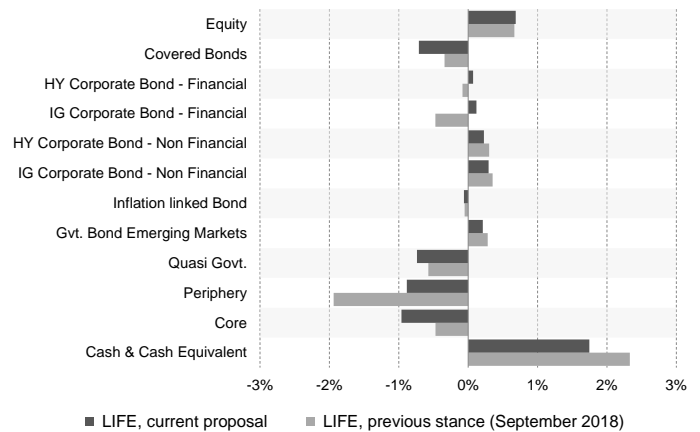
Short term we recommend maintaining a pro-risk stance and in particular to stay overweighted in equities and high yield credit. This however is primarily due to the conviction that the most recent corrections seen in these asset classes have been overdone. Further into 2019 we see market sentiment as being threatened by persisting political imponderables like a global trade war, a potential no-deal Brexit, and fiscal worries concerning Italy. Nearly all signs are pointing towards higher yields in the US. Similar is true for the euro-area where the ECB will end QE. Thus,

Graph 1: AGGRegateD total return forecasts



Hedged into EUR

Graph 2: Active Positions



In pp; Periphery = Italy & Spain

Challenging environment for tactical asset allocation in 2019

acting on the assumptions of rising yields across the board total return expectations become significantly negative for all fixed income markets on a 12-months horizon. The withdrawal of central banks and the rising yields are expected to trigger a spread widening on credit markets. This will in particular bring total return expectations for corporates even deeper into the negative range on a 12-months view. Although global growth is levelling off in 2019 it will still be supportive for earnings growth but to a much lower degree. We still expect moderately positive average total returns for equities however only kept in positive territory by dividend payments.

All in, the environment is getting less favorable for risky assets in 2019 and thus the tactical positioning more challenging. This might favor a less risk-prone stance in general and require an even closer look at the short-term recommendations.

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Forecasts

GROWTH

	2016	2017	2018f	2019f
US	1.6	2.2	2.9	2.4
<i>Euro area</i>	1.9	2.5	1.9	1.5
Germany	2.2	2.2	1.6	1.4
France	1.1	2.3	1.5	1.3
Italy	1.3	1.6	0.9	0.7
<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	2.7	1.7
Japan	0.6	1.7	0.9	1.3
<i>Asia ex Japan</i>	6.2	6.1	6.2	6.0
China	6.7	6.9	6.6	6.3
CEE	1.4	3.9	2.9	1.8
Latin America	- 1.2	0.8	0.3	1.1
World	3.1	3.7	3.6	3.4

INFLATION

	2016	2017	2018f	2019f
US	1.3	2.1	2.5	2.3
<i>Euro area</i>	0.2	1.5	1.8	1.6
Germany	0.4	1.8	1.9	1.7
France	0.3	1.0	2.0	1.7
Italy	- 0.1	1.2	1.3	1.2
<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	2.6	2.9
China	2.0	1.6	2.1	2.3
CEE	5.2	5.0	6.3	8.0
Latin America	6.3	4.3	4.0	4.0
World	2.3	2.3	2.8	3.0

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	Corporate Bond Spreads	Current	3M	6M	12M
<i>USD</i>	2.80	2.80	3.00	3.25	<i>BofAML Non-Financial</i>	147	150	160	165
<i>EUR</i>	-0.36	-0.35	-0.35	-0.30	<i>BofAML Financial</i>	159	160	175	180
<i>JPY</i>	-0.11	-0.05	-0.05	0.00	Forex	Current	3M	6M	12M
<i>GBP</i>	0.90	0.85	0.90	1.05	<i>EUR/USD</i>	1.13	1.13	1.15	1.20
<i>CHF</i>	-0.73	-0.75	-0.75	-0.75	<i>USD/JPY</i>	113	113	110	108
10Y Government Bonds	Current	3M	6M	12M	<i>EUR/JPY</i>	128	128	127	130
<i>US</i>	2.89	3.05	3.15	3.20	<i>GBP/USD</i>	1.26	1.27	1.32	1.40
<i>Euro-Area</i>	0.27	0.40	0.50	0.75	<i>EUR/GBP</i>	0.90	0.89	0.87	0.86
<i>France</i>	0.73	0.85	0.95	1.15	<i>EUR/CHF</i>	1.13	1.12	1.14	1.16
<i>Italy</i>	2.96	3.25	3.40	3.55	Equities	Current	3M	6M	12M
<i>Japan</i>	0.04	0.10	0.15	0.15	<i>S&P500</i>	2599	2660	2595	2555
<i>UK</i>	1.27	1.40	1.50	1.70	<i>MSCI EMU</i>	111.0	113.5	109.5	109.0
<i>Switzerland</i>	-0.08	0.00	0.05	0.15	<i>TOPIX</i>	1601	1650	1630	1610
Spreads	Current	3M	6M	12M	<i>FTSE</i>	6832	6915	6710	6645
<i>GIIPS</i>	197	210	215	205	<i>SMI</i>	8710	8930	8670	8650
<i>BofAML Covered Bonds</i>	00	70	70	75					
<i>BofAML EM Gvt. Bonds (in USD)</i>	312	305	305	310					

As of 17.12.18 (3-day-average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

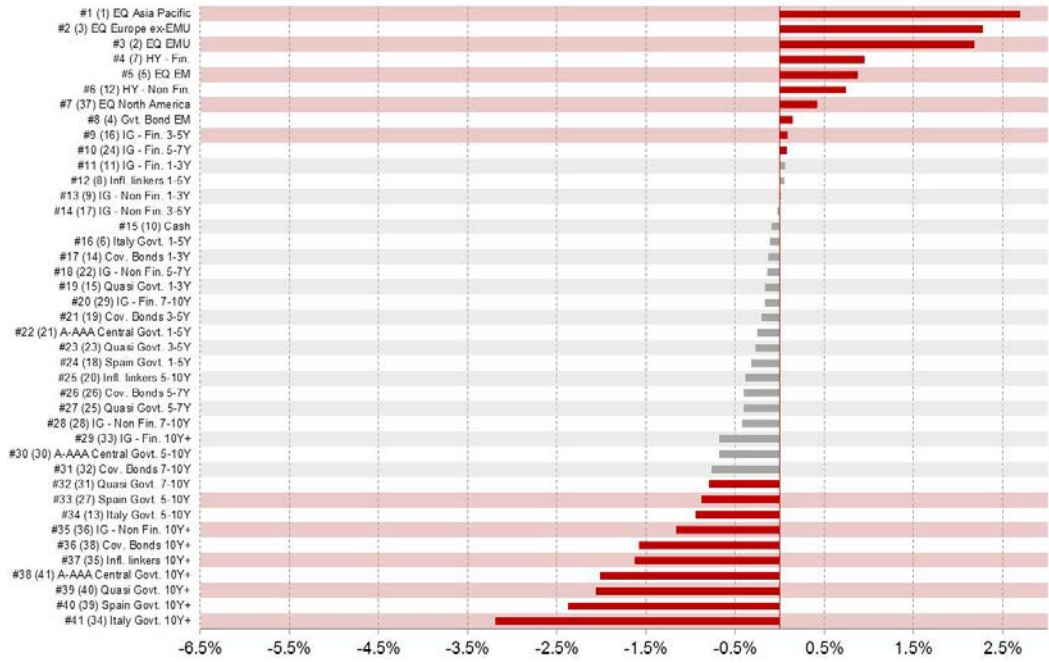
Government Bonds (10Y)	US	2.74	3.05	3.36
	Germany	0.35	0.40	0.45
	UK	1.16	1.40	1.64
	Switzerland	-0.05	0.00	0.05
	10Y-GIIPS Spread	167	210	253
Spreads	BofAML Covered Bonds	59	70	81
	BofAML IG Non Financial	132	150	168
	BofAML IG Financial	141	160	179
	BofAML EM (in USD)	275	305	335
Forex	EUR/USD	1.10	1.13	1.16
	USD/JPY	109	113	117
	EUR/GBP	0.86	0.89	0.92
	EUR/CHF	1.09	1.12	1.15
Equities	S&P500	2,556	2,660	2,764
	MSCI EMU	107.9	113.5	119.1
	TOPIX	1,556	1,650	1,744
	FTSE 100	6,596	6,915	7,234
	SMI	8,569	8,930	9,291

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Government Bonds (10Y)	US	2.52	3.20	3.88
	Germany	0.65	0.75	0.85
	UK	1.24	1.70	2.16
	Switzerland	0.08	0.15	0.22
	10Y-GIIPS Spread	130	205	280
Spreads	BofAML Covered Bonds	52	75	98
	BofAML IG Non Financial	131	165	199
	BofAML IG Financial	145	180	215
	BofAML EM (in USD)	249	310	371
Forex	EUR/USD	1.13	1.20	1.27
	USD/JPY	99	108	117
	EUR/GBP	1.13	1.20	1.27
	EUR/CHF	99	108	117
Equities	S&P500	0.80	0.86	0.92
	MSCI EMU	1.10	1.16	1.22
	TOPIX	2,346	2,555	2,764
	FTSE 100	96.6	109.0	121.4
	SMI	1,402	1,610	1,818

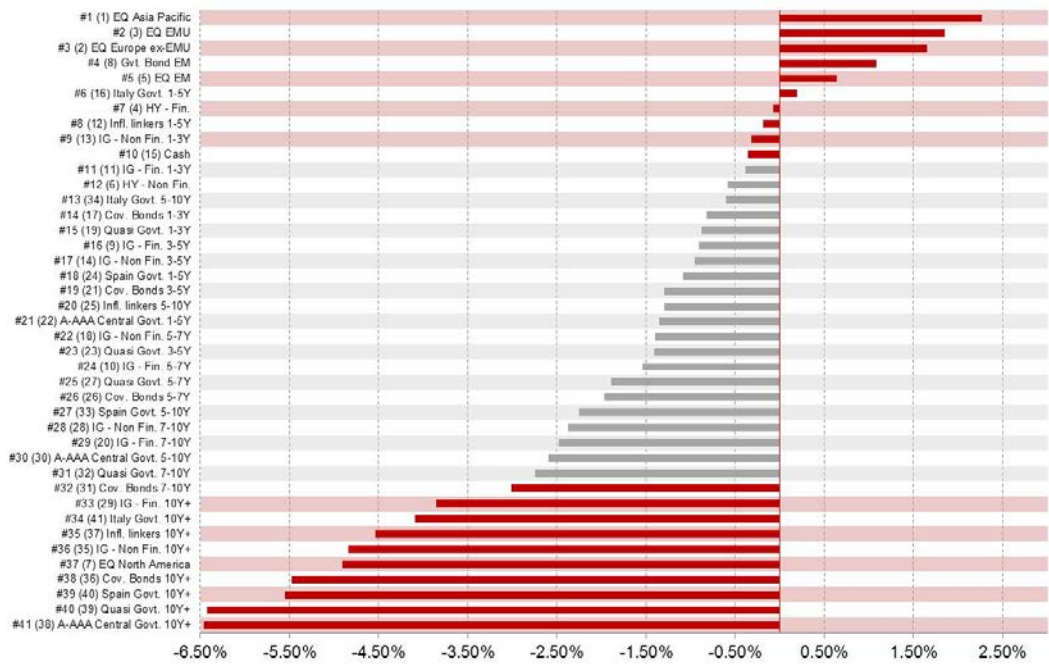
*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

TOTAL RETURN FORECASTS* – 3-MONTHS HORIZON



*hedged into EUR; 12-months rank in brackets; Cut-off: 07.12.2018

TOTAL RETURN FORECASTS* – 12-MONTHS HORIZON



*hedged into EUR; 3-months rank in brackets; Cut-off: 07.12.2018

Imprint

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