Market Perspectives

Poison of uncertainty

September 2019

Content

This document was completed on August 30, 2019

Global View – Poison of uncertainty

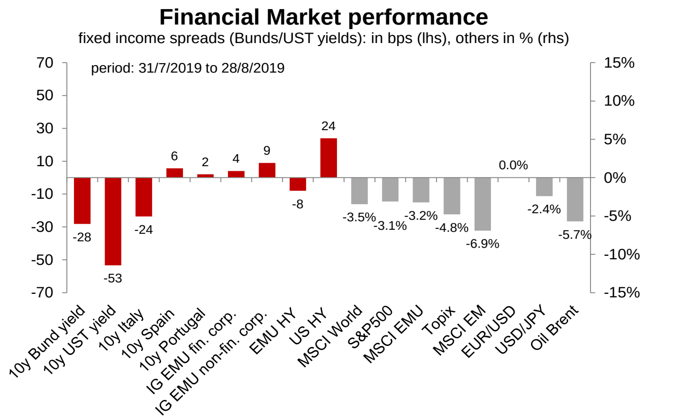
Thomas Hempell

- **Ruthless policy is rattling markets. Trump is ramping up pressure on China, while British PM Johnson is suspending parliament for under-pinning his determinedness to deliver Brexit.**
- **Uncertainties are poison for the economy and risk sentiment alike. The fiscal side remains hesitant. The duty of accommodation falls on central banks again, but policy effectiveness is in doubt.**
- **Yields are unlikely to bounce back soon. Looming ECB asset purchases and an intense search for yield keep supporting Credit. The risk of equity setbacks has risen, but cautious investor positioning and low yields keep us constructive.**
- **We trim overall risk weights, though,– especially in equities – as the balance of risks has deteriorated.**

Political risks are back with a vengeance. New US tariffs on China (and an ensuing tit-for-tat), British PM Johnson's flirt with a crash Brexit and a new financial crisis in Argentina have intensified recession fears. Investors headed for safe havens, depressing yields to fresh lows. Equities suffered, but partially recovered as US-China talks resumed and the Italian political crisis was resolved.

Consumers withstand global headwinds – for now

The continued increase in global political uncertainties remains the key drag on global economic activity. In most countries, manufacturing is in recession and trade stagnating. But so far the strong labor markets in the US and rising wages have helped the consumer to withstand the souring mood in businesses.



There are mounting cracks, though. After an 0.1% contraction in Q2 Germany may already have fallen into recession given the Ifo's August fall to an almost 7-year low. China reported the weakest pace of industrial growth in 17 years. And the inversion of the 2/10y US yield curve suggests that the world's biggest economy is no longer immune to the loss in global momentum. Prolonged worries over trade and Brexit will continue to weigh.

US President Trump still has a strong case to ultimately seek a compromise with China. The new tariffs on US$ 300 bn of imports from China will primarily hurt consumer goods and thereby his voters. And as we argued earlier, a recession would jeopardize his 2020 reelection chances. But Trump is increasingly attacking China and the Fed simultaneously. He may escalate the conflict even further, while attributing a slowdown to the Fed's reluctance to cut rates aggressively. "Who is our bigger enemy, Jay Powell or Chairman Xi?", he asked on Twitter.

Even more disruptive for Europe would be a Crash Brexit. PM Johnson insisted on the Oct. 31 deadline ("do or die") and even prorogued the British parliament for five weeks. A hard Brexit can still be avoided (via a deal or another extension, if Parliament manages to upset the PM's agenda). But compared to early summer, the risk of a no deal have increased considerably.

Encouragingly, the political crisis in Italy after the breakup of the Lega/M5S government seems to be headed for a new PD/M5S coalition which reduces the risks of snap election in the critical phase of drafting the 2020 budget.

Bonds	28/08/19*	3M	6M	12M
10-Year Treasuries	1.50	1.45	1.45	1.40
10-Year Bunds	-0.70	-0.70	-0.70	-0.65
Corporate Bonds				
BofaML Non-Financial	109	100	90	80
BofaML Financial	111	105	100	90
Forex				
EUR/USD	1.11	1.10	1.12	1.15
USD/JPY	106	105	105	104
Equities				
S&P500	2878	2915	2945	2985
MSCI EMU	118.8	120.0	120.5	120.5

* avg. of last three trading days

The case for a strong fiscal stimulus is growing. But governments are unable (Italy) or unwilling (Germany) to act, or facing Congress hurdles (US). This leaves the burden of accommodation on central banks again. The ECB will deliver boldly in September (see euro area section) and also the Fed is set to cut rates.

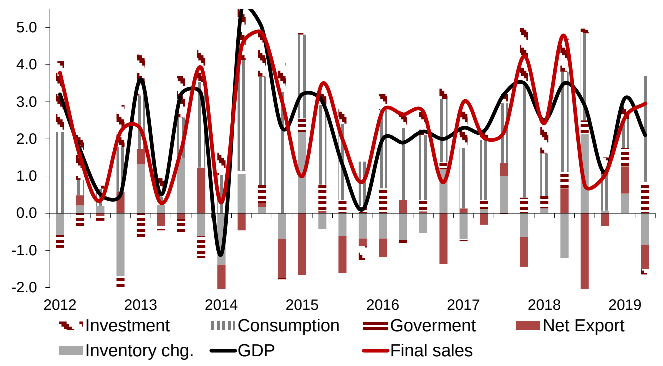
This makes a rebound in yields unlikely – deeply compressed levels notwithstanding. Despite shaken risk sentiment, Credit (esp. longer dated paper) will benefit from the search for yield and a revival of ECB bond purchases. We thus favor these assets over short-dated Govies. Given the elevated risks, we generally trim the size of active tactical weights (including long equity and duration). We maintain but cut back more visibly our overweight in equities while neutralizing our underweight in Cash. We lower our EUR/USD forecast on weaker data, higher risks and the more accommodative ECB.

USA

Paolo Zanghieri

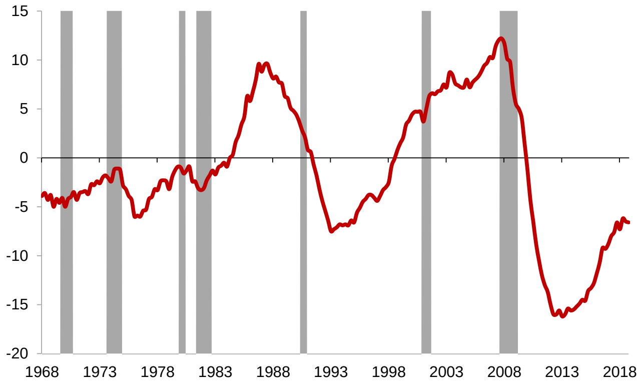
Contributions to GDP growth

% qoq annualized, seasonally adjusted



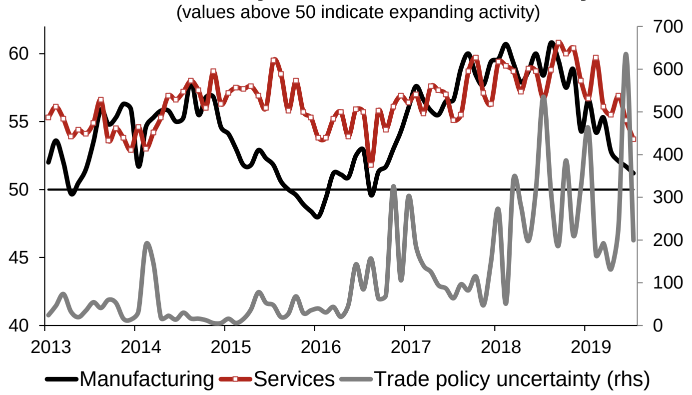
Credit Gap and recessions

Deviation from trend of the private non financial sector credit to GDP ratio. Source BIS. Shaded areas: recessions



ISM activity indexes and uncertainty

(values above 50 indicate expanding activity)



- **The escalation in trade tensions bodes ill for investment activity. We lowered our 2019 growth forecast to 2.1% from 2.4%.**
- **The pick up in regulated healthcare prices and the increasingly strong impact on tariffs will raise inflation over the next months, but without giving the Fed any leeway to stop policy easing.**
- **After the 25 bps cut in July, we expect two more cuts by the end of the year, meant to cushion the impact of uncertainty on economic activity.**

The fallout of trade tensions is increasingly bearing on the US outlook. Investment and net exports contributed negatively to Q2 growth which was kept at a decent 2.1% qoq annualized by household consumption. We expect the mood in the business sector to put an increasingly strong drag on investment, and household purchases are at risk of negative confidence swings. Therefore, we lowered our growth forecast for 2019 from 2.4% to 2.1% and trimmed our 2020 projection from 1.7% to 1.6%. This means a more elevated risk of recession over the next twelve months. Our model based on signals from financial markets give an over 35% probability of a recession, but a strong mitigating factor is the fact that private sector debt is lower than at the onset of the 2008 crisis and that low interest rates keep debt servicing at manageable levels.

Trade woes weigh on sentiment and prop up inflation

The announcement of an increase of the existing tariffs and their extension of practically all imports from China is another blow to business sentiment. In July, the manufacturing ISM plunged to 51.2, the lowest level in more than two years, signaling that activity is barely growing. At the same time there is increasing evidence that the tariff-related increase in import prices is gradually feeding though consumer prices. This and the ongoing unwinding of past price controls on healthcare are the main driver of the uptick in core inflation, up to 2.2% yoy in July. This will continue in the final months of the year, but will not affect the Fed decisions as it does not signal stronger demand pressures. Indeed, expected inflation continues to trend lower.

The Fed to cut rates by 75 bps this year

After the 25 bps cut in July, the Fed has grown increasingly worried about the global growth outlook and the heavy impact policy uncertainty is having on business decisions. In his speech at the Jackson Hole conference, Chair Powell refrained from indicating a clear path for monetary easing, but we think that the Fed will cut rated again by 25 basis points in September and in Q4 (October or December). However, these cuts will just reduce the likelihood of a further slowdown, without offsetting the negative impact from weaker global growth and heightened political uncertainty.

Euro Area

Martin Wolburg

- **The weakening of activity continued. While still driven by the external sector, there are signs that domestic activity also loses some ground.**
- **Germany and Italy are likely to fall into technical recession while we see euro area growth at only 1.0%/0.9% in 2019/20.**
- **We continue to expect bold ECB policy action in September including a depo rate cut and QE.**

Over the summer months, indicators continued to signal a weakening of the euro area growth momentum. The major driver remained the export-oriented manufacturing sector. Here, business sentiment was deeply depressed and consistent with shrinking output. In June, industrial production (-1.6% mom) as well as goods exports (-0.6% mom) fell and forward-looking indicators like new orders in the PMI survey signal no swift turn to the better.

Signs for contagion of domestic economy

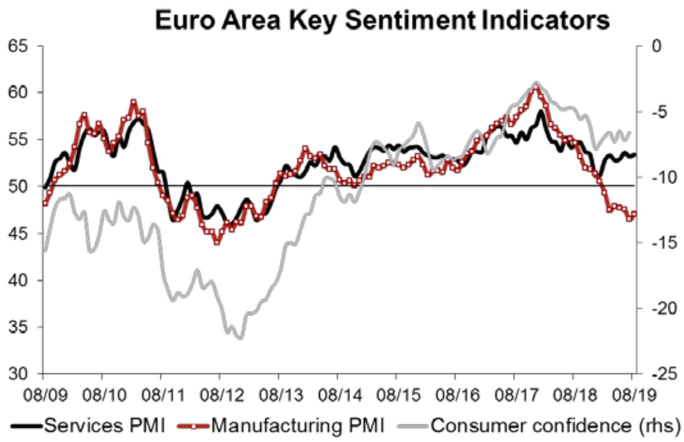
Moreover, there are increasing signs that the domestic economy which so far largely stayed robust will also be affected. The employment component in the composite PMI weakened (to 51.8 in Aug.) to a three-year low. Production expectations, which are a key gauge for investment activity, are down to the lowest level since June 2013. With respect to countries, the export-driven German economy already shrank in Q2 and in August the Ifo index fell to the lowest since Nov. 2012, a time when German output receded. GDP contracted also in the very export-dependent Italian economy and we see no turn to the better in Q3 either. The latest political woes come on top.

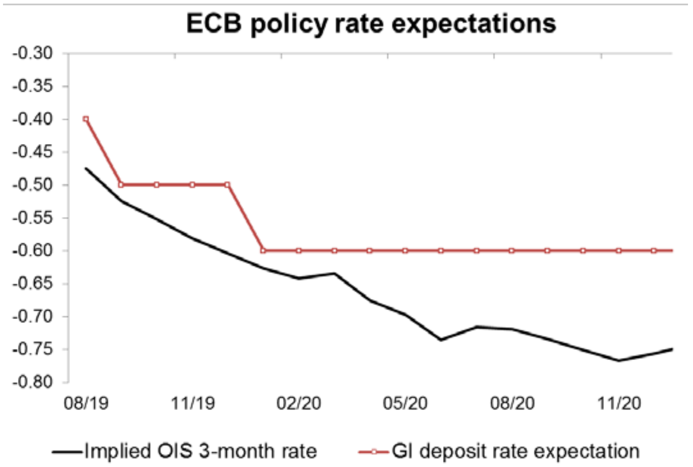
Brexit and trade war evolution key

Looking ahead, the question whether the euro area will just go through a soft patch or enter a sustained downturn critically depends on the two major sources of uncertainty and headwinds to activity: the Brexit and the trade war evolution. We assume that a crash Brexit will be avoided and that trade tensions at least will not escalate further. Therefore, we think that the euro area will not fall into recession and that growth improves again in 2020. However, due to a weak H2/2019 we see annual growth next year at only 0.9%, after 1.0% this year.

Bold ECB action in September

We think that the ECB will communicate bold measures at its Sep. 12 meeting amid a worsening of its macro projections. We continue to look for a restart of QE, a 10 bps deposit rate cut, the strengthening of the forward guidance and the introduction of a tiered deposit rate system. Also, the door for further action will be left wide open. That said, financial conditions are already favorable and we doubt that even very bold ECB action can overcome the headwinds from the global economy and uncertainty on the near term outlook.



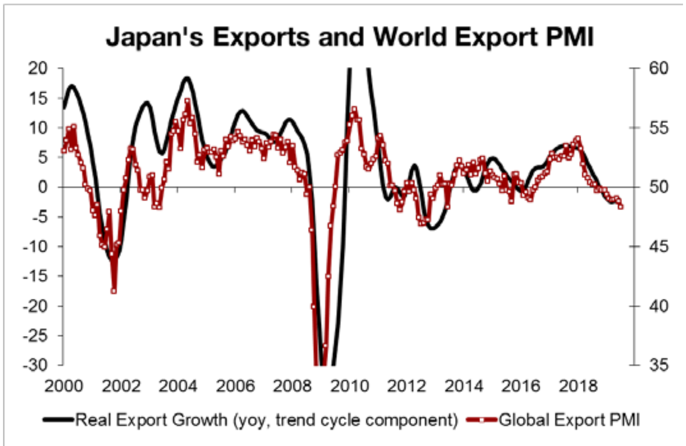


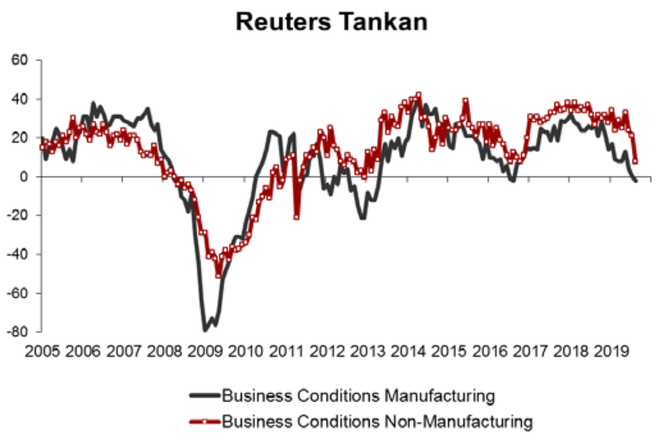
Japan

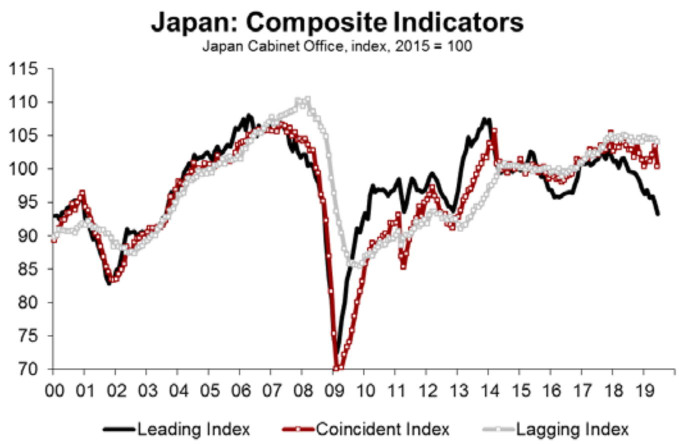
Christoph Siepmann

- **Japan's Q2 GDP surprised on the upside, largely due to a less strong drag from net exports.**
- **Q3/Q4 will see strong fluctuations due to the sales tax hike to be raised on Oct. 1.**
- **Nevertheless, we see underlying growth in Japan to weaken, putting downward pressure on inflation and keeping the BoJ alarmed to act.**

According to the first preliminary print, Japan's real GDP increased by 1.8% qoq annualized (0.4% qoq) in Q2. The result surprised on the upside, mainly as the drag on GDP from net exports was much smaller than forecast due to softer imports. On top, government consumption rose significantly to 3.8% qoq ann. Meanwhile, private consumption recovered from its weakness in Q1 largely as expected, increasing by 2.5% qoq ann. Details show that purchases of consumer durables shot up 4.3% qoq (18.3% qoq ann), most likely already driven up by the looming sales tax hike on Oct. 1 from 8% to 10%. Back in 2014, when the first part of this tax hike was implemented (from 5% to 8%), private consumption rose by 8.1% qoq ann in the quarter before, but dropped by 17.7% qoq ann thereafter. We see less volatility this time, (i.e. a rise of 3% qoq ann in private consumption in Q3, but a drop by about 7% qoq ann in Q4) as the hike is smaller and the government prepared fiscal measures to support private consumption and smooth volatility.







BoJ under pressure to act

While durable consumer goods demand will support industrial production in the very short term, the global exports PMI, the electronics PMI as well as the export climate all remained on low levels or even deteriorated further, weighing on output. Additional fluctuations are likely due to the announcement of fresh US tariffs on China, while Japan could likely struck a trade deal with the US. Japan's real exports rose slightly in July, as one-off effects from ship deliveries boosted the results. Nevertheless, according to the monthly Reuters Tankan, firms see the underlying trend as weakening. It also signaled deteriorating conditions to have started to spill over into non-manufacturing. Moreover, Japan's composite leading indicator accelerated its downturn. All in, we see growth this year at 0.8% (a slight upward revision from 0.6% due to the strong Q2), followed by 0.2% in 2020. Moreover, we see downward pressures on inflation to pick up and expect headline inflation at 0.7% this year and 0.9% in 2020 including the sales tax hike (but at 0.3% yoy without). Slowing inflation, weaker exports, the escalation of the trade war and the current yen appreciation are putting pressure on the BoJ to act. Given that Q3 data will likely come in on the strong side (ahead of the tax hike) and the possible, negative impact on regional bank's profitability, we see the BoJ starting to act only with milder measures in September (widening the band for 10y yields). A short-term rate cut by 20 bps is likely to follow in December.

China

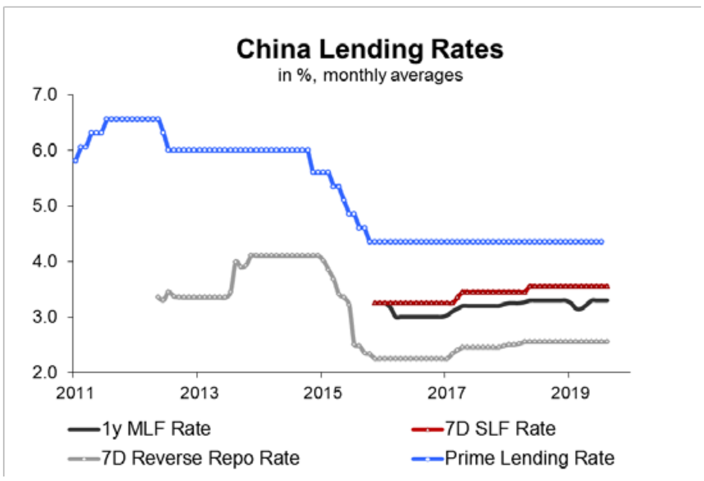
Christoph Siepmann

- **The US-China trade conflict escalated further with mutual rounds of fresh tariffs. Moreover, Trump dubbed China a currency manipulator and asked firms to leave China.**
- **Monthly data resumed their downtrend, raising pressures for more policy support.**
- **The PBoC reformed the Loan Prime Rate (LPR) fixing, allowing for more flexibility ahead.**

Early August, US President Trump announced to impose a 10% tariff on so far untaxed imports from China worth about US$ 300 bn (to start in two tranches on Sep. 1/mid-Dec.). China retaliated in late August, raising tariffs by 5pp/10pp on US$ 75 bn, to which Trump responded by hiking tariffs on already previously taxed imports from 25% to 30%. The new tariffs are likely to lead to an additional loss of China's GDP by about 0.5 pp, which comes on top of the estimated 0.9 pp that will accrue over time from already existing tariffs. The effects from the trade war as well as the global slowing (and other idiosyncratic risks) continue to weaken the Chinese economy. Monthly data came again in on the soft side in July. Especially industrial production growth diminished to 4.8% yoy, after having shot up to 6.5% yoy in June. Investments and retail sales softened slightly. Infrastructure fell back again. The downward pressures on the manufacturing sector are also visible in PPI inflation, which dropped slightly below the zero line.

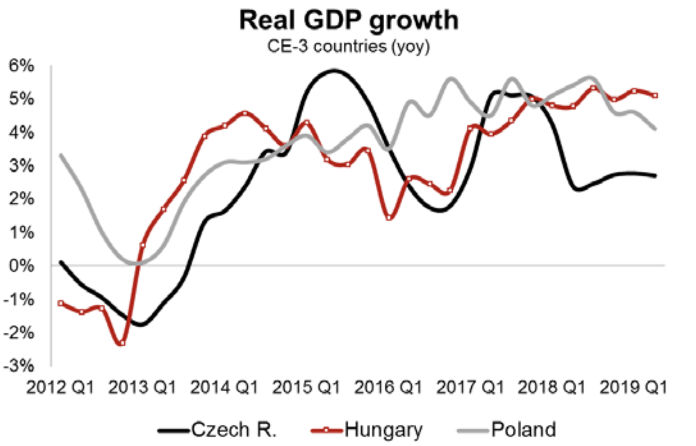
Beijing likely to sterilize negative trade war effects

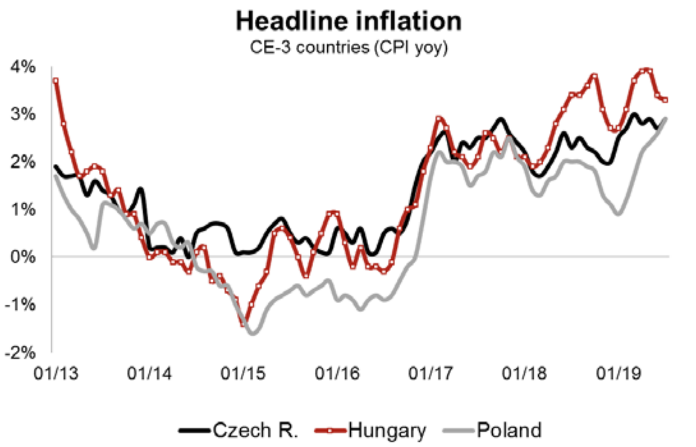
Against this backdrop, China's economic policy continues to face a dilemma. On the one hand, it clearly had to break up with previous stimulus concepts (via LGFV and SOEs) which led to a strong increase in non-financial sector debt (256% of GDP, IMF estimate) and prompted the forced de-risking of the shadow banking sector. On the other hand, China aims to fulfill its 2019 growth target of 6%-6.5%. Given the trade war, Beijing will likely step up its policy support, but only to the extent necessary to compensate for the losses ahead. Thus policy measures are very much dependent on the further development of the trade war, which we do not expect to be resolved quickly although trade talks will likely resume in September. The PBoC has recently added some flexibility to its monetary policy by reforming the fixing of the LPR which will be based now on 18 instead of 10 banks and made with reference to the 1-year Medium-Term Lending Facility (MLF) instead of the 1-year benchmark lending rate. Fixing will be once a month on the 20th, but the first one in August only brought about a reduction by 6 bps to 4.25% (1-year MLF rate is at 3.3%). Given the headwinds for the Chinese economy we expect the PBoC to cut the MLF rate by 25-50 bps over about the next six months and the RRR by about 75 bps. Fiscal policy will likely further support households and SMEs, but in a limited fashion (compensating 0.5 pp of GDP loss). However, if the trade war escalated, these numbers would clearly be stepped up.



Central and Eastern Europe

Radomír Jáč





Main Forecasts	2017	2018	2019f	2020f
Czech Republic				
GDP	4.5	2.9	2.4	2.0
Consumer prices	2.5	2.1	2.8	2.3
Central bank's key rate	0.50	1.75	2.00	2.00
Hungary				
GDP	4.3	5.0	4.7	3.2
Consumer prices	2.4	2.9	3.4	3.4
Central bank's key rate	0.90	0.90	0.90	1.00
Poland				
GDP	5.0	5.2	4.1	3.6
Consumer prices	2.0	1.7	2.1	3.0
Central bank's key rate	1.50	1.50	1.50	1.75

GDP and consumer prices: annual % change; CB interest rate: in %, year-end

- **The CE-3 economies reported solid GDP growth for Q2 according to preliminary data. The growth is shielded by domestic demand, which so far allowed the region to overcome the negative impact from slower euro area growth.**
- **Inflation stands above central banks‘ targets in all three countries. However, sentiment in the global economy leads the CE-3 central banks to look through the higher CPI data.**
- **Hungarian MNB is the only CE-3 central bank that may tighten its policy in September.**

The CE-3 economies kept solid performance in Q2. While GDP growth in the Czech Republic (0.6% qoq) and Poland (0.8% qoq) was close to expectations, Hungary surprised on the upside with growth at 1.1% qoq. In response to the Q2 data we slightly increased our forecast for 2019 GDP growth in case of Hungary and the Czech Republic. Historical revision of Polish GDP data led us to slightly reduce the outlook for 2019.

Headline CPI stands above the inflation target in all three CE-3 economies. Inflation rose to 2.9% yoy in July, in both the Czech economy (target: 2%) and Poland (target: 2.5%). Hungarian CPI moderated to 3.3% yoy against the target at 3%. The increase seen in the Polish CPI since the start of 2019 is quite notable. In Hungary, we expect upward pressures on core CPI (3.2% yoy in July) to renew, as the economy clearly runs above its potential.

Hungarian MNB may tighten its policy slightly

The domestic situation would actually call for tighter monetary policy in the CE-3 but external factors lead the regional central banks to keep their policy unchanged (the Czech Republic, Poland) or to implement only mild adjustments via liquidity operations (Hungary).

The Czech CNB left its key rate unchanged at 2.00% at a meeting held in early August. The CNB also presented fresh macro forecast. The forecast would point to a slight rate hike now and interest rate cuts in H1 2020. However, the CNB decided to stay on hold and expects interest rates to remain unchanged for several quarters, saying that the next move can be in either direction.

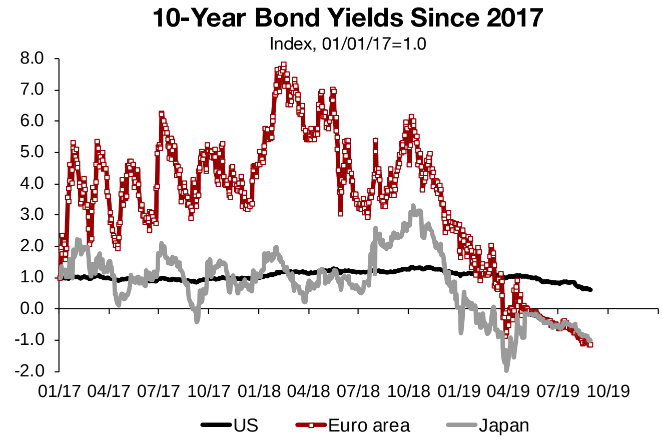
The Hungarian MNB kept interest rates unchanged with the base rate at 0.90% and O/N deposit rate at -0.05%. However, it tightened monetary conditions gradually via a lower liquidity supply in swap tenders. The MNB will reassess its policy stance in September when it will update its macro forecast. We think that a further cut in liquidity supply is likely but the MNB will aim at only marginally increasing in money market rates.

The Polish NBP keeps interest rates on hold (the key rate at 1.50%) and majority of the MPC still prefers a wait-and-see stance. New macro forecast, due in November, may spur the debate on possible changes. Still, external risks are likely to lead to stable NBP rates well into 2020.

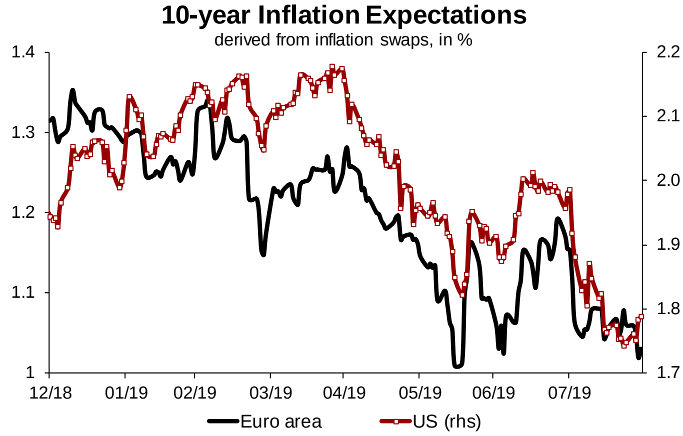
Bonds/Fixed Income Strategy

Florian Späte

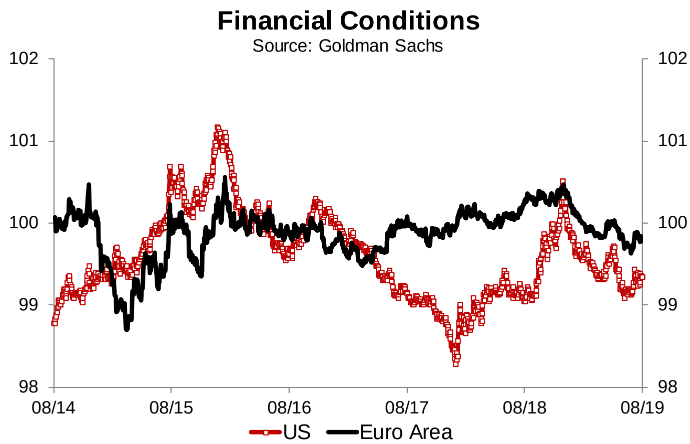
- **International government bond markets rallied in August. Driven by a worrying political news flow sovereign yields fell across all maturities – with many markets marking new historical lows.**
- **Going forward, we see little leeway for higher yields given forthcoming key rate cuts and little reason for economic optimism in the short term.**
- **While euro area sovereign bond spreads widened slightly, Italian BTPs lived their own life driven by the political news flow. Ultimately, the formation of a new government will pave the way to a further spread tightening.**



In contrast to the usual pattern of diminished economic and political news flow during summer holidays, this year was much more exciting. Several political developments kept market participants on their toes in August. Most noteworthy, the US/China trade dispute intensified further as new tariffs were announced. What is more, the likelihood of a no-deal Brexit has increased. UK Prime Minister Johnson signaled his commitment to exit the EU in any case by the end of October and the prorogation of the UK Parliament until the mid of October will restrict the parliament's opportunities to prevent a hard Brexit. Finally, the break up of the coalition in Italy fueled concerns of an even more euro-sceptical stance.



In this environment, government bond markets rallied. Most noteworthy, US yields fell strongly across all maturities. 10-year US yields decreased by more than 50 bps to 1.50% and 30-year yields fell even more. At less than 2% they have reached a new historical low. Euro area sovereign yields declined as well and marked new historical troughs across all maturities in August. Still, the transatlantic yield spread tightened. Although inflation expectations fell slightly in the US (roughly stable in the euro area), the bulk of the bond market rally is due to lower real yields.

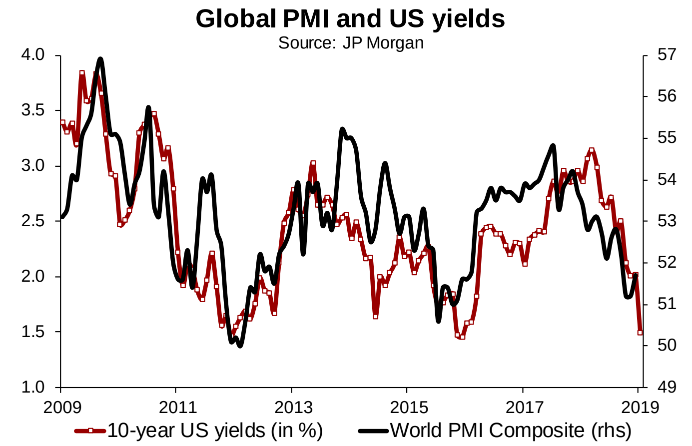


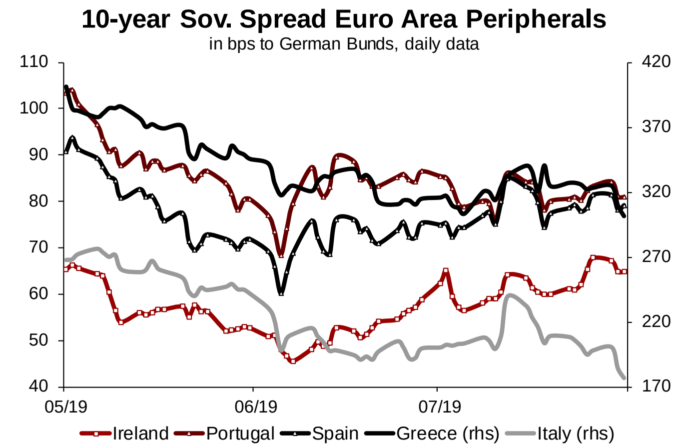
Little leeway for a strong yield reversal in September

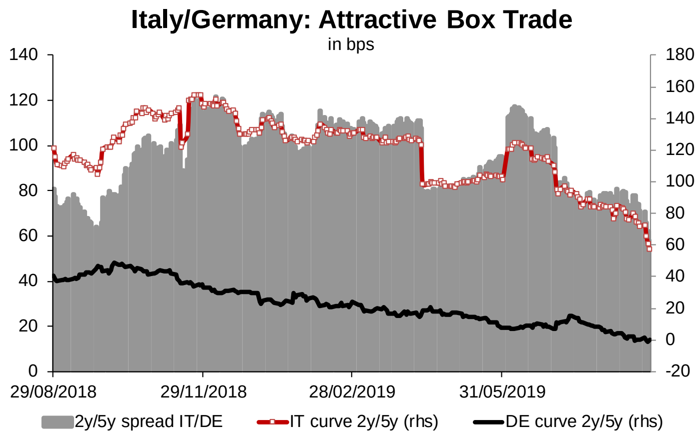
In the weeks to come, central banks will come into the focus again. The ECB is expected to deliver a bold package (see for more details in the euro area section) and the Fed is expected to cut by another 25 bps. If anything, with lower equities and wider credit spreads financial conditions have tightened since the last central bank meetings. What is more, the recent economic data give little reason for optimism. Not only does the US labor market appear to be less strong than expected (total hours worked are already declining), but it seems that the negative spillovers from the manufacturing sector to the non-manufacturing one are increasing as well.

As the political woes are unlikely to disappear in the weeks to come, there is little scope for higher sovereign yields despite the strong bond market rally in August. Financial

Bonds/Fixed Income Strategy







markets have priced in an economic downturn. With no improvement of the economic backdrop in the offing, even the current very low level appears reasonable (see chart on the left). After all, 10-year US yields have fallen by around 170 bps from the cyclical peak in November 2018. If history is any guide, there is more to come. Accordingly, we forecast US yields to slide further in the coming months. On a 12-month horizon, we forecast 10-year yields to decrease by another 10 bps to 1.40%.

Given the strong international interconnection, euro area core yields will struggle to recover from the historical lows. What is more, in addition to the measures to be announced in September, the ECB is expected to keep some powder dry. The expectation of further monetary action (including possibly also sovereign QE) will stand in the way of higher yields as well. However, the yield level reached and speculations about some fiscal easing in the euro area is forecast to prevent a further decrease. On a 12-month horizon, even slightly higher yield levels are likely – assuming the euro area manages to avoid a recession. Accordingly, the transatlantic yield spread has leeway to tighten further in the months to come.

New Italian government to soothe markets – for now

With some exceptions non-core euro area sovereign bond spreads widened slightly in August (most noteworthy, Greek bond spreads tightened further and our cautious stance of Irish bonds paid out well as Brexit concerns took their toll). In contrast to this rather calm trading, the BTP/Bund spread was much more volatile.

Concerns about a snap election in autumn triggering a Lega-led euro-sceptical government contributed to a 10-year BTP/Bund spread widening of 40 bps within one week. However, the surprise formation of a new coalition government (Movimento 5 Stelle (M5S) and Partito Democratico (PD)) erased concerns about snap elections for the time being and spreads tightened in the aftermath. In fact, spreads have narrowed to the lowest level since May 2018 and the 10-year BTP yield level fell below 1% for the first time ever.

Going forward, there is scope for a further spread tightening. The PD is an outright euro-friendly and well-established party which is likely to ringfence to some extent the M5S. What is more, the very low yield environment and speculations about future sovereign QE continue to favor BTPs as well. We expect the Italian yield curve to flatten more (and our 2-year/5-year Italy/Germany box trade to perform well further on).

However, the structural problems in Italy remain unresolved for the time being. In case the rather unstable new government does not tackle these issues, the Lega might be able to make a comeback – combined with a more adverse financial market reaction.

Corporate Bonds

Elisa Belgacem

- **Credit markets took a breath in August after a very strong year-to-date performance but the rate component continued to drive yields lower with nearly 50% of the Euro IG space displaying negative yields.**
- **The technicals remain supportive as the ECB should resume its CSPP already this year and the search for yields intensifies given the absence positive yielding alternatives in the fixed-income world. On the other hand our slightly more cautious views both on Trade war and Brexit is gradually providing less comfort on fundamentals.**
- **Overall, we expect technicals to be stronger until year-end resulting in tighter spreads led by both duration and risk-appetite. We should also see further discrimination between idiosyncratic stories given the lack of compensation for risk premia in absolute terms combined with the very mature economic cycle.**

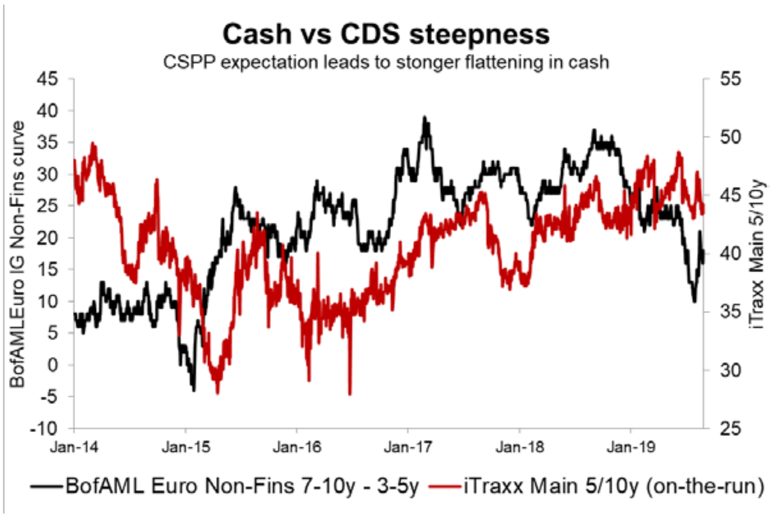
Despite the large share of credit markets displaying negative yields, we continue to expect the ECB to resume its corporate sector purchase program (CSPP) that could start as early as October while the eligible universe should be similar to CSPP1 (excluding banks). The recent performance within credit is definitely incorporating those anticipations. Cash continues to out-perform CDS since June, especially on the long end. Non-financials have largely out-performed financials year-to-date all across the rating spectrum while overall the sell-off in credit has been less pronounced than in equities in total return terms.

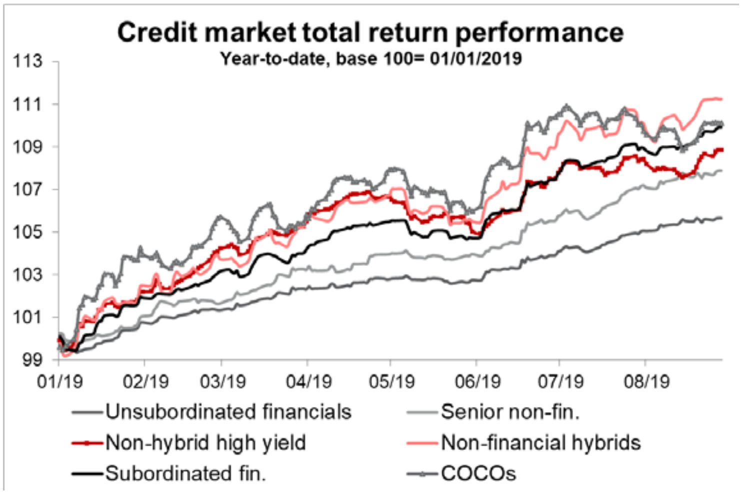
Indeed we consider that a CSPP announcement is not yet fully in the price. Overall, we forecast EA IG corporate bond spreads to tighten by up to 10 bps over the next three months. We also keep our preference both for long-dated credit vs. short dated and non-financials versus financials as we think that there is still room for further valuation divergence between eligible and non-eligible assets until the ECB effectively starts to buy.

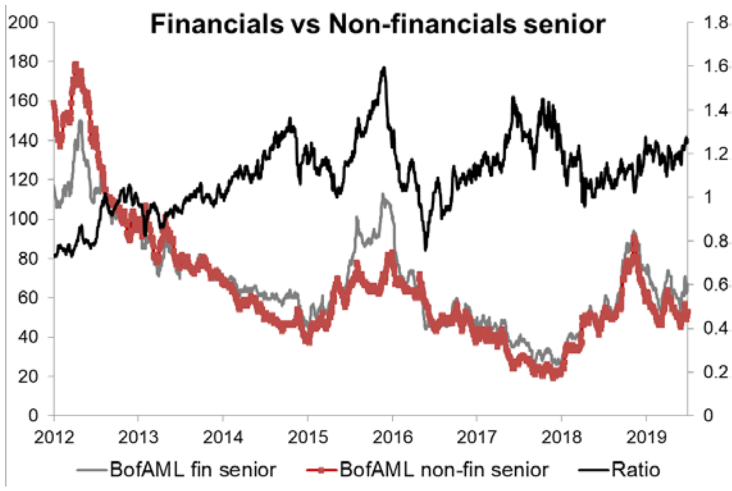
Nonetheless, because of our slightly more cautious view both on the trade war and the Brexit we turn slightly more cautious on fundamentals but the central banks' support appears stronger.

Long-dated CSPP eligible space has further room to perform until the ECB effectively starts to buy

Finally, we noted in July that the first CSPP had its strongest impact on the riskiest segments of credit markets like AT1, corporate hybrids and high yield and that it should not be different this time. We stick to this view after the summer since those high-beta instruments have proved extremely resilient. Among them we have a preference for corporate hybrids as we view the risk reward as one of the most attractive within the credit world.







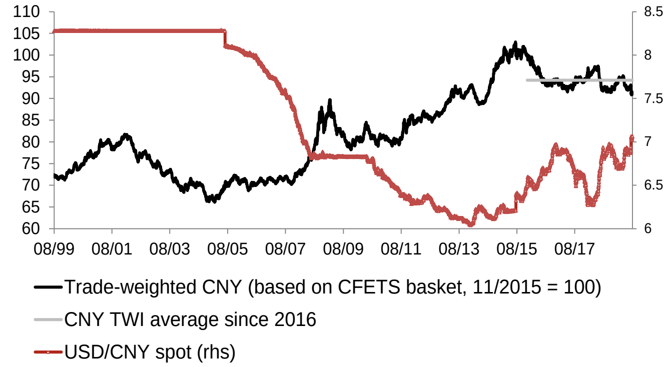
Currencies

Thomas Hempell

- **Amid mounting risks to euro area activity, looming bold ECB action and rising Brexit risks we revise our EUR/USD forecasts down.**
- **We now see higher risks of EUR/USD temporarily falling below 1.10. That said, with the US neither immune to a further slowing, high USD valuation and higher verbal intervention risk, we still expect a rebound going into next year.**
- **CNY weakness has been grabbing the headlines in August. Barring a sharp escalation of the trade war, we see USD/CNY rising only moderately further from the levels reached.**

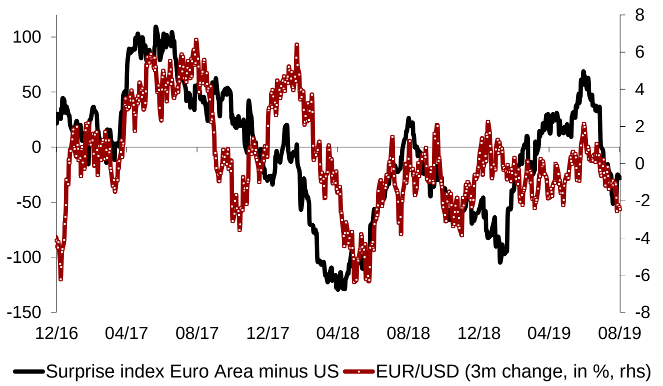
The intensifying US/China trade war has boosted JPY and CHF as safe havens in August, while the EUR/USD was hovering sideways around 1.11. The decision by Chinese authorities to allow the USD/CNY breaking through 7.00 sparked concerns that the trade war may morph into a currency war. EM currencies suffered broadly, also losing about 4% vs. USD.

Chinese yuan



The monthly rise in USD/CNY (+3.8% as of Aug 29) was set to the sharpest since 1994. China's sudden willingness to give in to rising market pressures also bears a clear warning message to the US. But the bar for China to widen the trade conflict to a currency war of aggressive devaluation is high. The heavy use of the counter cyclical factor in USD/CNY reflects Chinese efforts to tame the depreciation. Furthermore, CNY weakness also weighs on EM FX more generally (and thereby greatly mitigating the effect on the trade-weighted exchange rate, see upper chart). It may upset China's other trading partners (in particular the euro area members) and risks triggering capital flight and a sell-off in Chinese markets. Barring a full-blown escalation of the trade war, we thus expect only a limited further rise in USD/CNY to 7.30 by year-end.

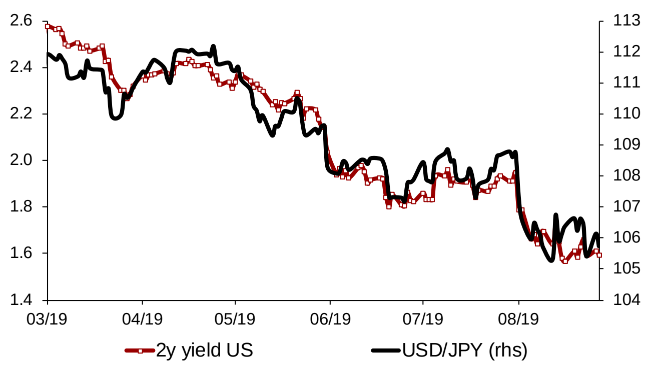
Economic data surprises and EUR/USD



Revising lower our EUR/USD outlook

The sideways move in EUR/USD has been in line with our short-term neutral view. Yet, the balance of risks has shifted to the detriment of the single currency. Amid mounting risks to euro area activity, expected bold action by the ECB and the higher risk of a no-deal Brexit, the EUR/USD may temporarily fall below 1.10. With the US economy not immune to a further slowing, high USD valuation and mounting intervention risk, we still expect a rebound going into next year.

USD/JPY and Fed expectations



The JPY has extended this year's rally amid the escalating trade war. The drop in USD/JPY, however, largely reflects the continued decline in US rates. While the JPY still remains undervalued fundamentally, a near-term stabilization in US rates should also keep a lid on the yen – with only limitedly more upside for the rest of the year.

Equities

Michele Morganti / Vladimir Oleinikov

- **In the last month, equities performed poorly: geopolitical risks increased and macro momentum stayed poor.**
- **It is the story of two tales: the market is pricing in a slower economy plus higher risks but low yields provide cushion. This supports riskier assets, although we see future returns lower vs history.**
- **Current investors' sentiment is very gloomy and the implied equity risk premium (a measure of risk aversion) is near last December's level, the highest since 2013. Current stellar overvaluation of Growth vs Value has also been matched only in year 2000.**
- **We maintain a constructive outlook on equities, while acknowledging lingering risks short term.**

Over the last month, equities booked in losses. The MSCI EMU has performed slightly worse than S&P (-4.6% vs -4.2%). The MSCI EM index and FTSE 100 showed the worst performance (-7.5% and -6.5%), while the SMI outperformed (-2.1%).

European styles showed once again a defensive attitude by investors: Growth and Defensives outperformed the Value and Cyclical stocks.

Slower growth and higher geopolitical risks

It is the story of two tales: the market is pricing a slower economy plus lingering geopolitical risks but lower yields and spreads provide cushion. Let's see the negatives first.

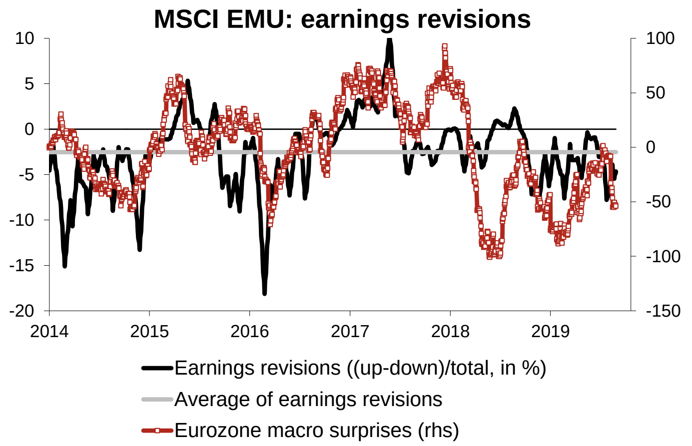
A decelerating GDP growth, the poor firms' confidence (export-oriented and manufacturing sectors are flirting with recession) and threats coming from Brexit, Italy and trade maintain the earnings revisions in negative territory, especially in the euro area (EA). This could continue in the short term as Trump's stance remains too volatile. Recently, the US yield curve inverted and together with other models, it signals a higher chance of recession in the next 1-2 years.

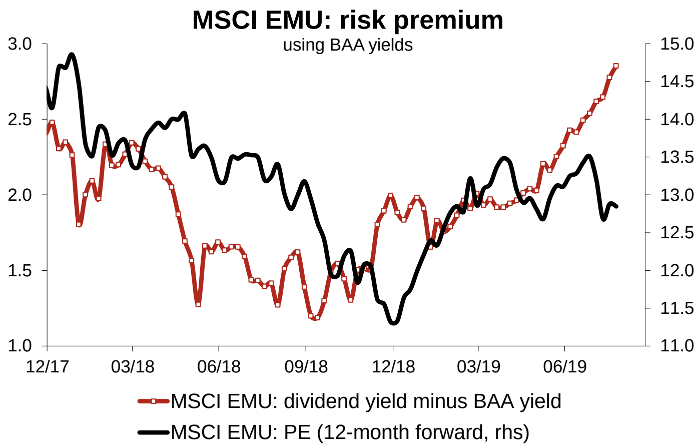
Furthermore, due to the latest reallocation of national income (BEA), US NIPA profits were revised down. This was counterbalanced by an increase in personal income, higher saving rate (to an extraordinary 8%) and ULC. As a result, yearly growth of NIPA profits went slightly in negative territory, deserving our attention from now on. Profit growth is currently being also pressured by a lingering strong USD and weak oil prices.

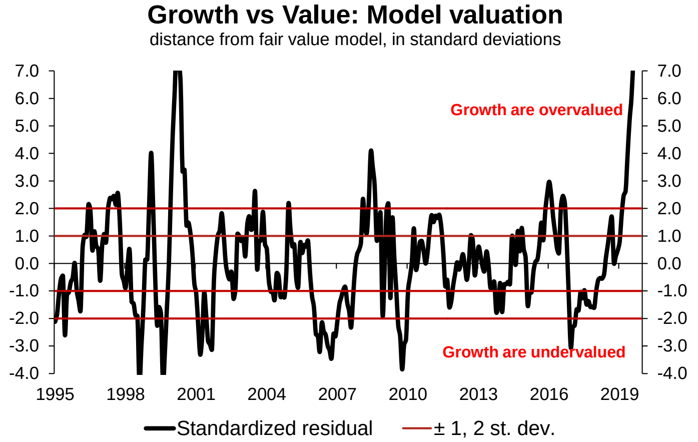
Where are the positives? Yields, spreads & sentiment

Market's negative price action was already quite strong in the last month. For example, EU banks lost 11% and, at present, their PE shows a huge discount vs the MSCI Europe's one, the largest since year 2000.

Growth stocks overvaluation vs Value ones is near 7 standard deviations above norm. As yields stay low and the economy does not give signs of bottoming out, there is little



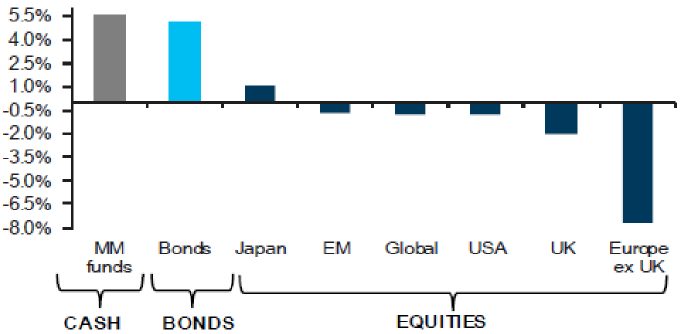




Equities

Bond vs equity flows

YTD flows to various asset classes (%AUM)

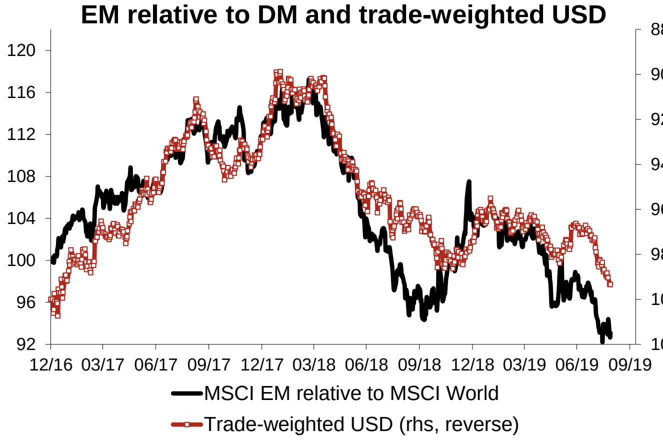


Source: Barclays Research

Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.	Avg.
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %	Disc. (-1M), %
WORLD	15.3	16.0	2.2	1.9	10.1	8.8	2.7	2.7	5.9	10.8
USA	16.5	15.3	3.0	2.4	11.6	10.0	2.1	2.2	12.9	19.2
JAPAN	12.0	15.4	1.0	1.3	6.8	7.1	2.8	1.9	-21.5	-16.3
UK	11.6	13.8	1.5	1.8	7.5	7.9	5.1	4.0	-15.7	-7.0
SWITZERLAND	16.4	15.4	2.5	2.2	11.4	11.2	3.4	3.3	4.7	5.4
EMU	13.0	14.1	1.4	1.5	7.5	6.5	3.8	3.9	1.2	3.7
FRANCE	13.5	14.3	1.5	1.5	8.0	7.0	3.7	3.7	3.2	5.6
GERMANY	12.5	15.0	1.4	1.5	7.7	6.7	3.6	3.4	-4.1	-1.5
GREECE	12.9	12.8	2.1	1.6	6.9	6.1	5.2	4.0	4.2	13.7
ITALY	10.7	15.1	1.2	1.2	5.0	4.7	4.9	4.7	-7.6	-6.8
PORTUGAL	14.5	12.8	1.8	1.7	5.4	5.9	5.0	4.5	-0.6	3.1
SPAIN	10.9	12.9	1.1	1.6	4.7	5.1	5.1	5.1	-13.8	-10.8
EURO STOXX 50	12.9	13.2	1.5	1.5	7.6	6.3	4.0	4.2	6.5	9.4
STOXX SMALL	15.1	14.5	1.7	1.7	9.2	8.4	3.3	3.2	2.1	4.4
EM, $	11.5	14.4	1.4	1.6	6.7	7.5	3.3	3.1	-13.1	-8.5
BRAZIL	11.9	9.1	1.8	1.7	7.6	13.5	3.8	4.3	0.9	6.7
RUSSIA	5.2	7.0	0.7	0.9	3.6	4.4	8.5	4.0	-44.7	-39.8
INDIA	17.7	14.6	2.4	2.7	11.2	11.5	1.8	1.6	-0.8	-3.3
CHINA	10.7	12.9	1.4	1.7	7.0	7.5	2.6	3.0	-7.9	-3.6

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

EM relative to DM and trade-weighted USD



chance to invert such trends. Having said this, the extreme polarization in sectors and style trends reveals how investors' sentiment is gloomy at present.

Furthermore the EMU risk premium (a measure of risk aversion), which is implied in current equity prices, earnings estimates and 10-year yield levels, is the highest since 2013, surpassed only during 2012 and 2008-9. Low inflation expectations and, more importantly, structurally dovish Central banks are triggering lower 10-year rates and credit spreads, inducing a fall in the cost of capital (COE). For example, the spread of dividend yield minus BAA yield continued to increase in the month passing from 120 bps, at the bottom in 2018, to the current 280 bps. With lower yields, history suggests that equity returns vs bond ones are less at risk, showing more contained worst drawdowns.

Lastly, equity outflows continued to be significant in the month, especially for EMU equities and sentiment is, of course, very gloomy, too. In a recent survey, investors estimated the chance of a recession to be the highest in the last eight years. They are most bullish on bonds since 2008, have the highest net equity protection since the same year and the lowest allocation in equity.

Still constructive on equities after all

We expect volatility to remain high short term, especially due to trade and Brexit risks. For this reason we adopt a more cautious stance but we still maintain an overweight position on equities. Inside equities, we have an OW on EU ex EMU. We recommend a neutral position on EMU vs the US (euro hedged). We also stay neutral on EMs and Japan. We are neutral on cyclicals vs. defensives and OW only on Utilities and discretionary ex-auto. UW: Real Estate, Materials and IT. Limited OW on Momentum and Low Leverage. Neutral Quality, and Growth vs Value.

EM: to be pressured by decreased investment sentiment in the short term, mid-term positive

In August, EM equities have suffered losses (-8%) due to mounting trade tensions and lingering strong dollar. The market multiples are trading at a discount of 13% vs norm, while the conventional PE, in particular, is marginally above the historical average taken since 2001. Earnings estimates have been revised down for most of the countries except for Russia (+1%) and Hungary (+1.7%). In the shorter term, the risk of the trade war is to further affect corporate sentiment and to put pressure on EM markets. In the longer term, weakening US dollar, low valuations and structurally superior GDP growth would be drivers of future outperformance of EM equities. Within the EM universe, we favor Brazil along with the CEE markets (ex. Turkey). We tactically adopt a neutral stance on Korea and India, waiting for a better entry point (fiscal stimulus or lower entry prices).

Asset Allocation

Thorsten Runde

- **In the course of August (*until August 28th*), all asset classes in our investment universe apart from cash and equities, revealed positive total return figures.**
- **Like in the months before, the strongest gains have been recorded in the 10Y+ segment of the fixed income arena; this time clearly led by quasi govies (+7.1%) followed by core govies (+6.0%) and covered bonds (+5.8%).**
- **In the HY segments financials and non-financials showed similar results between +0.4% and +0.5%.**
- **Equities dropped by a good -3% on average over the past four weeks thereby clearly marking the lower end of the performance ranking.**
- **Looking ahead, we suggest reducing the overweight in equities and at the same time raising the cash exposure to neutral. For the fixed income part of the model portfolio we recommend to slightly reduce the overall active positioning and thus the long duration stance.**

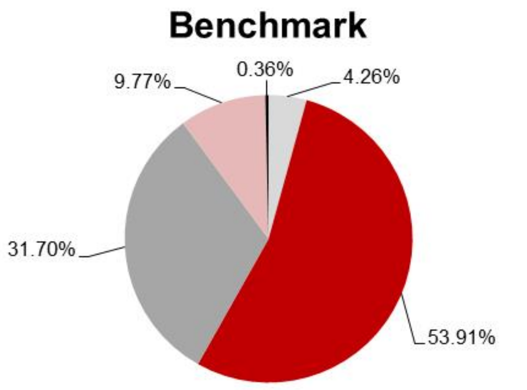
With the trade war between the US and China reaching the next stage of escalation the global economy is facing stronger headwinds. Political imponderables in Italy and the UK reinforce this effect even further. Calls for fiscal impulses to accompany expansionary monetary policy measures are increasing. Under these conditions, investors have increasingly been pushed into safe havens, driving EUR yields to new record lows and longer-dated fixed income total returns into equity-like dimensions.

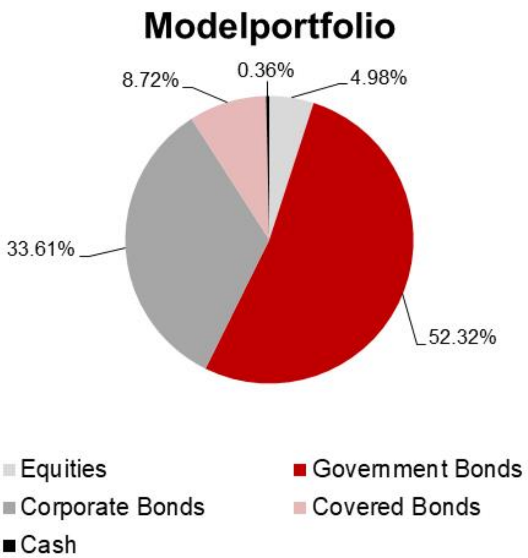
Despite the negative performance of equities our model portfolio has still found itself pretty well aligned. Although the overweight in equities clearly contributed negatively to the overall TAA result, the latter remained in the two-digit positive territory with a good +11 bps. Particularly, overweighting the long maturity buckets at the expense of the short ones paid off very well.

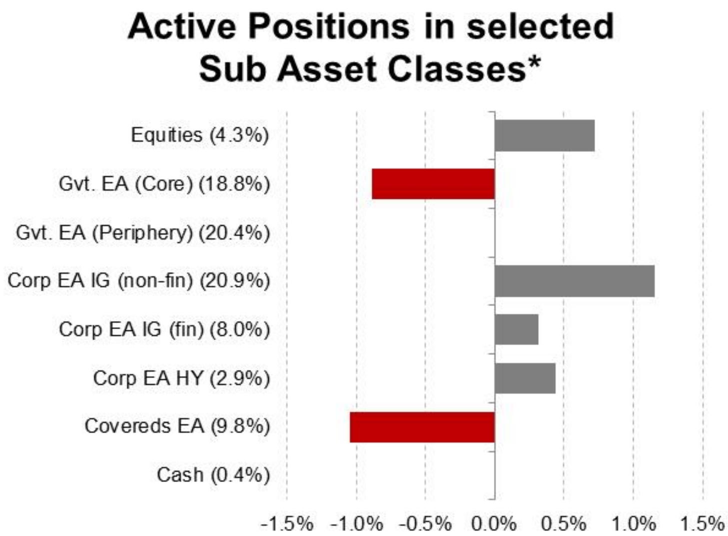
Pro-risk tilt at a scaled back intensity

As the main burden of stimulating the economies continues to lie with the central banks, yields are unlikely to recover soon significantly. Looming ECB asset purchases and an intense search for yields keep supporting credit. The risks of equity setbacks have risen. But reserved investor positioning and the search for attractive yields keep us constructive.

Looking ahead, we confirm our tactical setup of being long risk and long duration, though at a scaled back intensity. In detail, we suggest to reduce the overweight in equities in favor of raising the cash exposure to neutral. For the fixed income part of the model portfolio we recommend to slightly reduce the overall active positioning thus and the long duration stance.







*Benchmark weights in parentheses

Forecast Tables

Growth

	2018	2019f	2020f	2021f
US	2.9	2.1	1.6	1.8
Euro area	1.9	1.0	0.9	1.1
Germany	1.5	0.5	0.7	1.3
France	1.6	1.1	0.9	1.8
Italy	0.7	- 0.1	0.3	0.6
Non-EMU	1.5	1.4	1.3	1.6
UK	1.4	1.3	1.2	1.5
Switzerland	2.5	1.3	1.5	1.6
Japan	0.8	0.8	0.2	0.8
Asia ex Japan	6.2	5.7	5.7	5.6
China	6.6	6.2	6.0	5.8
Central/Eastern Europe	3.0	1.3	2.6	2.9
Latin America	0.1	0.1	1.9	2.0
World	**3.6**	**2.9**	**3.1**	**3.2**

Inflation

	2018	2019f	2020f	2021f
US	2.4	1.9	2.0	2.1
Euro area	1.7	1.3	1.4	1.4
Germany	1.8	1.5	1.5	1.5
France	1.9	1.2	1.4	1.6
Italy	1.1	0.8	1.1	1.1
Non-EMU	2.3	1.9	2.0	1.8
UK	2.5	2.0	2.1	1.8
Switzerland	0.9	0.6	0.7	1.0
Japan	1.0	0.7	0.9	0.8
Asia ex Japan	2.6	2.7	2.7	2.7
China	2.1	2.4	2.3	2.2
Central/Eastern Europe	6.1	7.0	5.7	5.2
Latin America	4.0	4.0	3.7	3.6
World	**2.7**	**2.6**	**2.6**	**2.5**

Regional and w orld aggregates revised to 2015 IMF PPP w eights; Latin America Inflation excluding Argentina and Venezuela

Financial Markets

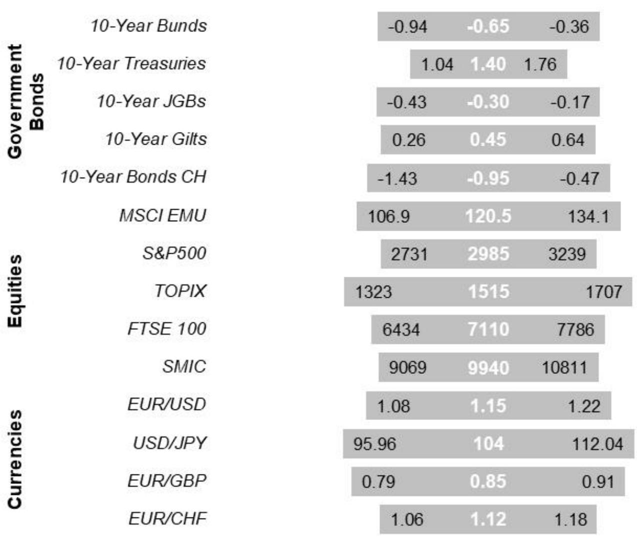
3-month LIBOR	**28/08/19***	**3M**	**6M**	**12M**
USD	2.13	2.10	1.80	1.70
EUR	-0.45	-0.45	-0.50	-0.50
JPY	-0.08	-0.10	-0.30	-0.30
GBP	0.76	0.80	0.80	0.80
CHF	-0.84	-0.85	-0.85	-0.85
10-Year Bonds	**28/08/19***	**3M**	**6M**	**12M**
Treasuries	1.50	1.45	1.45	1.40
Bunds	-0.70	-0.70	-0.70	-0.65
BTPs	1.17	1.00	0.95	0.95
OATs	-0.41	-0.45	-0.45	-0.40
JGBs	-0.27	-0.25	-0.25	-0.30
Gilts	0.48	0.45	0.45	0.45
SWI	-1.00	-1.00	-1.00	-0.95
Spreads	**28/08/19***	**3M**	**6M**	**12M**
GIIPS	137	130	125	120
BofAML Covered Bonds	47	40	40	40

Corporate Bond Spreads	**28/08/19***	**3M**	**6M**	**12M**
BofAML Non-Financial	109	100	90	80
BofAML Financial	111	105	100	90
Forex	**28/08/19***	**3M**	**6M**	**12M**
EUR/USD	1.11	1.10	1.12	1.15
USD/JPY	106	105	105	104
EUR/JPY	118	116	118	120
GBP/USD	1.22	1.18	1.26	1.35
EUR/GBP	0.91	0.93	0.89	0.85
EUR/CHF	1.09	1.08	1.11	1.12
Equities	**28/08/19***	**3M**	**6M**	**12M**
S&P500	2878	2915	2945	2985
MSCI EMU	118.8	120.0	120.5	120.5
TOPIX	1486	1490	1500	1515
FTSE	7100	7150	7150	7110
SMI	9753	9930	9910	9940

*average of last three trading days

3-Months Horizon

12-Months Horizon



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

Imprint

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Issued by:	Generali Insurance Asset Management S.p.A., Research Department Version completed on August 30, 2019
Sources for charts and tables:	Thomson Reuters Datastream, Bloomberg, own calculations

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