The UniCredit Macro & Markets 2018 Outlook

Macro Research
Strategy Research
Credit Research

15 November 2017

"Solid growth and attractive markets in 2018. Caution for 2019"

- **Macro:** We forecast a continuation of strong global growth in 2018, with the US enjoying a short-term boost from tax cuts, the eurozone retaining solid momentum and EM being in generally good shape. Major central banks are likely to withdraw stimulus very gradually. Growth prospects look less favorable in 2019.
- **FI:** 10Y USTs will probably peak around 2.75% in 2018, with curve-flattening remaining the dominant theme. We see the 10Y Bund yield rising to 0.80% by end-2018. As pressure from the ECB's QE program recedes, the upward move should be primarily driven by an increase in real yields.
- **FX:** The dollar's correction lower towards equilibrium is likely to continue. EUR-USD remains undervalued and should approach its fair-value level of 1.25 by the end of 2018, supported by the ECB's QE tapering and a return of portfolio flows in the euro area.
- **Equities:** The uptrend in eurozone equities is likely to extend into 2018 despite already expensive P/E valuations. We anticipate a strong 1H18 with potential price gains of up to 15%, with consolidation or slight weakening in 2H18.
- **Credit:** Credit profiles of European corporates will remain well supported fundamentally as well as by ECB purchases. Nevertheless, very stretched valuations make credit vulnerable to market volatility. We expect bond spreads to widen slightly.
- **CEEMEA**: We remain constructive on flows into EM FI and EM FX, although increasing differentiation is required; more specifically, we prefer externally-balanced countries with improved domestic fiscal positions and high real rates. In corporate credit, we maintain a preference for sub-investment-grade credit.

Link to webcast   Link to presentation

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Executive Summary

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- This report presents our updated forecasts for 2018 and our first attempt to quantify 2019. We expect 2018 to be another year of strong global economic growth – of about 3.9%, slightly firmer than in 2017 – and only marginally less accommodative monetary policies by the major central banks. We are more concerned about 2019.

- There are several key reasons why we regard the present strength in global growth as sustainable for at least another year: it is fueled by a strong acceleration in global trade back towards normal growth rates as well as by an accommodative policy mix in virtually all the most important countries. These factors have contributed to an increasingly well-composed mix of demand factors, most importantly a pickup in investment, and, as a result, the divergence in growth across countries has fallen to just about the lowest it has been in decades.

- We expect the US economy to expand by 2.6% in 2018, receiving a (small) short-term boost from the planned tax reform. In this context, the Fed is likely to deliver three rate hikes next year which, along with good (temporary) growth and some overheating, will likely push 10Y USTs to a peak of 2.75% over the course of 2018.

- Meanwhile, the eurozone should cruise through next year at continuously good growth rates, for an annual average of about 2.3%, thereby continuing to close the output gap and generate a very moderate upward drift in core inflation. However, even in a year's time, the ECB will still very unlikely be able to forecast inflation at its target within the forecasting horizon, therefore, net asset purchases will probably continue to the end of 2018 and the forward guidance on interest rates will likely remain in place. Caught between an upward pull from the US, continued ECB purchases and strong eurozone growth amid low inflation, 10Y Bund yields are likely to end 2018 at around 0.80%. Sovereign spreads will probably widen marginally at times next year – mainly in reaction to domestic political uncertainties – but investors' appetite for periphery bonds is likely to remain robust for most of 2018 given still-accommodative ECB and appealing carry. We think EUR-USD will soon resume its upward trend, ending next year at around our estimate of fair value of 1.25.

- Growth in the CEE region will probably remain buoyant in 2018. We expect the CEE-EU countries to outperform and expand by 4% thanks to their trade openness, as well as continued strong EU transfers and private sector inflows. The absence of macroeconomic imbalances will provide scope for further, albeit gradually diminishing, policy support.

- While valuations of some asset classes are approaching historical highs, the overall environment is likely to remain supportive for several risky asset classes, particularly eurozone equities and emerging markets. Indeed, history suggests that when the cycle is mature, and the economy is running above potential – as is the case in both the US and, to a lesser extent, the eurozone – equities and commodities outperform. We see no particular reason why this should be different this time, especially since monetary policies will remain accommodative by historical standards. In credit, current stretched levels and a pickup in supply do not leave any room for further spread compression and might well see 2018 ending with slightly wider spreads than at present.

- Even an ever so gradual withdrawal of monetary stimulus by both the Fed and ECB will begin to separate the weaker emerging markets (in terms of need of external financing) from the stronger ones. Following a period of impressive inflows into EM funds, the last month has seen a marked slowdown in such flows. We do not think this is reason for general EM concern, but it may well be a first warning light starting to flash for the most fragile EM countries.

- Our 2018 forecasts are based on the assumption that oil prices will remain above USD 60/bbl for the next several months, but that tensions in the Middle East will not lead to measurable supply shocks. As a result, we have penciled in a gradual decline in oil prices starting next spring, bringing them back to the USD 55-60/bbl range.

- However, we consider Saudi Arabia's recent elevation of tensions with Iran to historical levels to present the single-greatest short-term risk to our forecasts. The destabilization of Lebanon raises the risk of further proxy (or real) wars between the two major Middle Eastern powers, and/or the involvement of Israel. If there were to be significant supply shocks to oil and higher prices for a longer period, this would raise headline inflation in the US and Europe, creating the "wrong type" of inflation. The cost to growth in such a scenario should lead the central banks to slow – or even abandon – their withdrawal of monetary stimulus.

- While – on balance – we are comfortable with the outlook for 2018, we are more skeptical about the general economic and market outlook for 2019, not least because of the combination of a very mature recovery in the US, politics and stretched asset valuations.

- We are concerned about the impact on US growth of the political fragmentation in Washington once the planned tax reform has had its short-term positive effect on US equities. In Europe, we worry about the gaping political vacuum in the UK as the risk of a hard Brexit rises, and the effects on the UK economy and – if to a much lesser extent – on its key trading partners.

- However, we take comfort in the prospect of a significant move during 2018 towards closer Continental European integration under French-German leadership, a prospect made more likely by the threatening external political environment. Better coordination of policies, a greater focus on investment, progress on a capital markets union and stronger stabilization mechanisms against asymmetric shocks will benefit longer-term growth in Europe.

- On balance, we expect US growth to start to slow measurably during 2019, which – on the Fed's historical reaction function – should end the bank's hiking cycle in about eighteen months and flatten the yield curve even further. In our base case, following three rate hikes in 2018, the Fed will manage to get only one hike in early 2019 before weakness in the US economy becomes visible.

- 2019 will also likely see sequential growth in the eurozone beginning to slow towards potential, but – as our base case – we think the pace of expansion will still be strong enough to keep core inflation on a modest upward trend, allowing the ECB to start raising the deposit rate in mid-2019 and bring it back to zero towards the end of 2019. As markets start to anticipate a growth downturn, equities will probably begin to weaken – typically with nearly a twelve-month lead.

- Growth in CEE-EU countries will probably ease in 2019 in line with global trends and on the back of lower EU transfers. However, at 3.5%, the pace of expansion is likely to remain above potential.

- Finally, we are very aware that the robust economic outlook may well be overshadowed at any moment by what has turned out to be a very concerning geopolitical outlook. Apart from the obvious "event risks" – from shorter-term confrontations to outright war – we worry about the medium-term effects on cross-border trade and investment, as well as on conflict resolution, of the ongoing US withdrawal from its leadership role as global defender of liberal democracy and multilateralism. And we worry about the rollback of liberal democracy and the inevitable damage to market-based economies in several countries around the world, including in some parts of Central and Eastern Europe.

Global

The global economy: as good as it gets

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The global economy is having its best run in seven years. Spurred by a rebound in global trade and synchronized recoveries in consumption and investment across both advanced and emerging markets (EM), global real GDP is expected to grow 3.9% in 2018, up from the 3.6% likely in 2017, before slipping slightly to 3.5% in 2019. Less brisk growth expectations for 2019 largely stem from the anticipated slowdown in the US. From an historical perspective, the pace of global expansion should remain slightly above its long-term average in 2018, but close to it in 2019 (see left chart).

We see four major factors underpinning the sustainability of the global recovery and its continuation into 2018: the rebound in global trade, an increased synchronization of growth, a shift in composition from consumption to investment, and broadly accommodative economic policies.

Further strong global trade

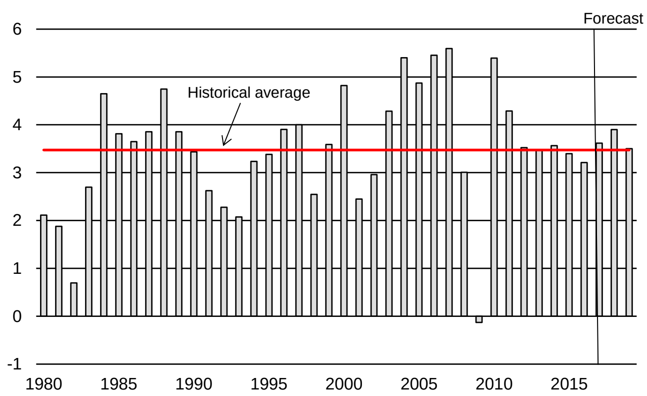
The rebound in global trade, which is seen as a proxy for global demand, is set to continue into 2018. We anticipate an increase of about 4%, roughly in line with what we have seen in 2017. Export volume growth has been accelerating markedly in the last few quarters in industrialized countries and in EM (see right chart). UniCredit's Global Leading Indicator, along with various leading indicators compiled by the OECD, point to continued sustained growth in trade. Moreover, trade elasticity (i.e. the ratio of global trade growth to global GDP growth) has risen from persistently low levels in previous years to slightly above 1 as of late. The major reason for this is the simultaneous and broad-based recovery across many countries. We also expect global trade to remain robust into 2019 with the projected moderate loss in momentum (to +3¼%) largely due to the anticipated slowdown in the US.

Synchronized expansion

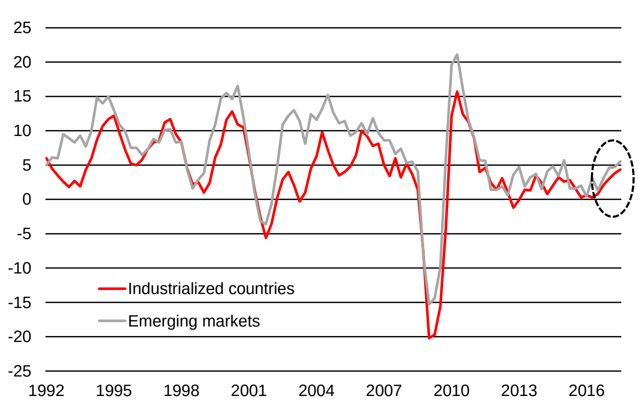
Global growth has not only firmed, but it has also become more synchronized, broadening across countries, both industrialized and EM, as well as extending to the eurozone periphery. Synchronized expansions tend to reinforce each other via positive spillover effects and to be more durable and difficult to derail with ad-hoc shocks or policy mistakes. The greatest degree of synchronization in global growth is evident in business and consumer confidence, reaching multi-year highs in many countries.

GLOBAL ECONOMIC RECOVERY TO CONTINUE IN 2018

Global real GDP growth, in % yoy



Real exports, in % yoy (3Q17 reading equals July/August)



Source: IMF, CPB, UniCredit Research

Shift towards investment

Furthermore, the composition of global growth is now shifting from consumption to investment and has become more balanced. In turn, this makes the expansion more sustainable and lasting, as growth is no longer so reliant on a single driver and new investment adds to capacity and growth potential. The combination of higher exports, rising business confidence, low and closing spare capacity, and the low cost of capital all bode well for accelerating capex spending. Indeed, capital goods orders, which are closely linked to investment, have already picked up sharply.

Economic policies to support growth

Finally, economic policies will remain growth-supportive. Despite the ongoing monetary policy normalization in the US and the gradual tapering of asset purchases by the ECB, monetary policies will remain strongly accommodative by historical standards in the major advanced economies. This, in turn, should enable EM to maintain lax monetary stances and to continue benefitting from the ample global liquidity and low borrowing costs. Fiscal policies will also remain stimulative, with strong growth boosting revenues and enabling governments to spend more, especially with borrowing costs at historic lows.

Return to pre-crisis growth rates unlikely

This said, a return to growth rates much above 4%, as had been the case before the global financial crisis, is unlikely, with many of the previously existing growth drivers no longer in place. The advances in trade and financial globalization that underpinned the rapid expansion in the 2000s have now been halted or reversed; the commodity price cycle has run its course, and important global growth drivers, such as the bubble in the US residential property market or China's double-digit growth rates, no longer exist. Finally, damage from the global financial crisis and a decade of insufficient investment have significantly undermined potential growth.

Global growth to moderate in 2019 due to US slowdown

Looking beyond 2018, we expect some moderation in global growth in 2019, largely because of an expected slowdown in the US. Current US expansion is already the third longest on record, and scope for continued above-potential growth is waning, with the economy very close to full employment. Furthermore, the fiscal stimulus is likely to fizzle out in 2019 after tax cuts temporarily lifting growth in 2018. A potential key risk would be the slowdown already starting earlier.

In the eurozone, the broad-based recovery is likely to continue in 2018 with some easing in 2019. Consumption and investment are set to increasingly feed into each other next year, while solid global growth provides a good buffer against a stronger euro exchange rate.

In the UK, GDP growth already fell to the bottom of the G7 in 1H17 and it is likely to remain there through 2018. We expect the Brexit talks to move on to trade in December 2017, which will require the UK to cave in to the EU27's demands on the Brexit bill. Eventually there will likely be a deal, including a transition and an outline of the future relationship, but it is unlikely to be concluded until the last minute.

Global inflationary pressures to increase moderately

As spare capacity continues to fall, we expect global inflationary pressure to build up, but only moderately. While there might be near-term upside pressure on prices, reflecting the recent rise in oil prices, we think this will only be transitory, as it has been driven by geopolitical concerns rather than fundamentals. We expect the Brent price to remain above USD 60/bbl for the next several months, with a gradual decline starting in spring likely to bring it back to the USD 55-60/bbl range. With inflation pressures likely to remain subdued, the major central banks should not rush to implement policy tightening that could endanger the global recovery.

EM growth well supported

The combination of a robust growth in the industrialized countries, resurging global trade and firming commodity prices has also underpinned a broad-based synchronized recovery in EM. Growth in EM has been reinforced by the resurgence in capital inflows and asset prices, both of which have now returned to or exceeded their pre-tapering levels (see left chart). We expect aggregate growth in EM to peak at 4.9% in 2018, up from the 4.6% likely in 2017, before slipping back towards 4.5% in 2019, mostly in response to the expected slowdown in the US.

Most of the EM growth will come from China and India

Most of the growth impetus in EM will come from China and India. These two countries, which account for 40% of EM population and 47% of EM GDP, stand out due to their sheer size and demographics, and have been consistently posting some of the fastest growth rates globally. This said, growth in China is set to continue moderating, to 6.5% in 2018 and 6.0% in 2019 from the 6.8% likely in 2017, as the authorities try to contain excessive leverage and the environmental damage from the fast industrialization in the past. In India, by contrast, growth is set to accelerate to 7.4% in 2018 and 7.8% in 2019 from 6.7% expected in 2017, as temporary disturbances caused by the monetary reform ebb and reforms introduced by the Modi administration begin to bear fruit.

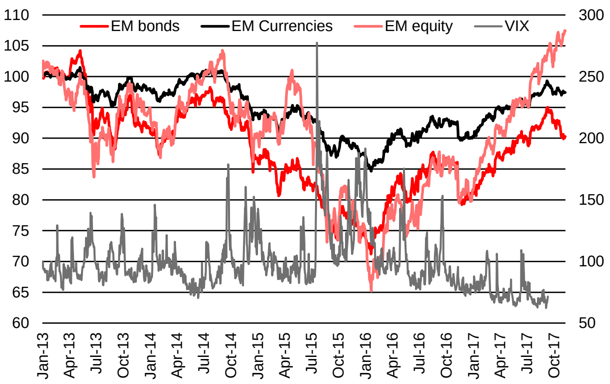
The rest of the EM will grow much more slowly

The rest of the EM universe, however, will likely see much more moderate expansion; 3.8% in 2018 and 3.5% in 2019, up from 3.3% in 2017 (see right chart). There will be significant divergence across geographical regions, with the strongest growth in Asia (above 6% for the next two years), and in CEE-EU[1] (4% in 2018 and 3.5% in 2019). The recovery will be much more muted elsewhere, with Latin America expected to have the weakest growth at just under 2%.

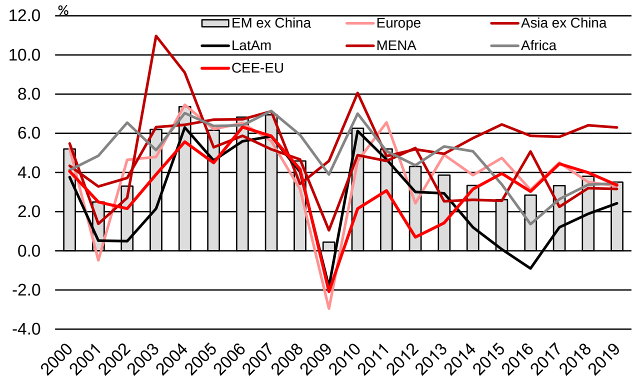
Drivers of the divergences among EM

These divergences reflect both different economic structures and the quality of economic policies. In emerging Asia, growth will benefit the most from the boost in foreign demand coming from China and India, while in CEE-EU it will be buoyed by the robust recovery in Europe and in global trade. In both regions, macroeconomic imbalances are modest and resilience to global shocks stronger. By contrast, commodity-dependent economies such as most of Latin America and the Middle East and Africa (MENA), have been lagging, with the recent recovery in commodity prices, while helping restore growth, insufficient to help activity return anywhere near the pre-2013 pace. This has been especially apparent where the pace of the adjustment to the lower commodity prices has lagged such as MENA and parts of Latin America.

EM ASSET PRICES SURGE, VOLATILITY AT RECORD LOW



EM GROWTH PICKS UP, LED BY ASIA & CEE-EU



Source: Bloomberg, IMF, UniCredit Research

[1] The CEE countries that entered the EU in 2004-07 and have not yet adopted the euro: Bulgaria, the Czech Republic, Hungary, Poland and Romania

Modest imbalances in most of EM, but with some exceptions

With commodity prices just high enough to provide a lifeline to commodity exporters but not nearly as high as to cause major C/A pressure, macroeconomic imbalances in most of the EM have been modest. Moreover, resurgent capital inflows to EM have also upheld their external positions and help appreciate currencies. Given the solid near-term growth outlook, prospects for only a gradual withdrawal of the monetary accommodation and the likelihood of a weaker dollar, we expect capital inflows to EM to remain solid, at least through next year. While we see significant risks in a few countries (South Africa, Argentina and Turkey to name a few), we think that as a whole, the current surge in inflows to EM has a solid footing and some more scope to continue.

Geopolitical risks

Despite the favorable global outlook, a number of risks remain. Especially geopolitical risks abound. The most disruptive among them would potentially be a further intensification of tensions in the Middle East, and especially the stand-off between Saudi Arabia and Iran. A cutback in the oil supply could lead to a strongly rising oil price instead of the gradual decline we penciled in from spring 2018 onwards. Higher headline inflation in the US and Europe, and hence the “wrong type” of inflation, would hurt growth and lead major central banks to slow – or even abandon – their withdrawal of monetary stimulus. Another important geopolitical risk is the possible escalation of the tensions around North Korea.

Risk of early US slowdown

From a fundamental perspective, the US slowdown could kick in earlier than anticipated. Instead of “only” materializing in 2019, the US economy may already lose momentum in the further course of 2018. Besides the mature stage of the current recovery, the absence of tax cuts could lead to such an early cooling.

Risk of protectionism

Prospects of increased trade protectionism in the US and high debt levels, especially corporate debt in China, are also key risks to watch. The former is likely to affect Latin America and especially Mexico the most, while potential moves by the Chinese authorities to contain the rapid rise in debt might lead to a sharper slowdown in China than currently expected, with significant repercussions for global growth, especially in Asia.

Risk of faster withdrawal of policy stimulus by Fed & ECB

A stronger than currently expected recovery in the US and the eurozone could lead to higher inflationary pressure and to a faster withdrawal of the policy stimulus by the Fed and the ECB. Given the already tight labor market, such risks are presumably far more pronounced in the US than in the eurozone. International financial markets might react sharply to such a scenario with adverse effects on economic growth. The long run of a very accommodative financial environment has left several governments in EM increasingly complacent, with structural reforms and much-needed fiscal adjustment delayed. This complacency has left a number of countries highly dependent on foreign financing and/or commodity exports increasingly exposed to even moderate shifts in market sentiment. While we do not expect widespread turbulence, asset prices and capital flows to EM will be affected, and countries with higher external imbalances, such as Turkey, Argentina, and South Africa, will see their resilience tested.

US

The last hurrah

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2018 should be another great year for the US economy. On track to expand 2.2% in 2017, we project real GDP to rise by an even stronger 2.6% next year. The acceleration will be driven in part by a tax cut that we expect to temporarily lift growth during the summer. As the impact of the stimulus fades, however, momentum will likely begin to slow towards the end of the year and fall below longer-term potential in the second half of 2019. This perceptible loss of momentum reflects our view that the US economy is heading for a downturn in 2020. Strong growth in 2018 will therefore be the last hurrah of the current expansion.

The third-longest expansion on record continues – for now

The US is currently enjoying one of the longest recoveries on record. This month, the expansion is already in its 101st month, which makes it the third-longest on record dating back to the 1850s (see chart 3). And in 2018, this recovery will not only continue but should even show some additional momentum, as real GDP is likely to accelerate to 2.6%, from 2.2% in 2017, before slowing again in 2019. Our forecast assumes that the Trump administration and Republicans in Congress will eventually be able to agree on a tax cut package by the end of this year or early next year that will temporarily lift growth during the summer. Moreover, our baseline forecast continues to assume that the administration will refrain from imposing tariffs or other measures that would significantly restrain global trade.

Republicans need something to show at midterm elections

To be sure, the passage of a tax cut is still not a done deal. The main reason why we chose to include a stimulus again for next year is the sense that, after the embarrassing failure to repeal Obamacare, Republicans are likely to be more willing to compromise on taxes as they desperately need to have one political victory ahead of the upcoming midterm elections (see box below for more on the elections). With first steps already taken, including the passage of a budget resolution and the release of detailed tax plans by both the House of Representatives and the Senate, we think the odds for moderate stimulus are slightly better than even, which is good enough to incorporate the effects into our baseline forecast, even as the risk of another legislative disappointment is not negligible.

USD 1.5tn tax bill

We assume that the tax plan will add USD 1.5tn to the deficit over the next decade, in line with the financial leeway provided by the budget resolution. That translates into USD 150bn per year, or about 0.8% of GDP. The bulk of tax cuts will be on the corporate tax side, while revenues from personal income taxes are projected to remain largely unchanged as the removal of various deductions will mostly offset the impact of lower rates. As we argued in our *Economics Thinking* on 26 September 2017, we think that corporate tax cuts mostly benefit higher-income earners who are the owners of businesses, while the impact on economic growth is modest. And the fact that stimulus is to occur at a time when the economy is essentially at full employment further reduces the estimated multiplier (see *Economics Thinking*, 21 November 2016). All told, we expect the tax reform to add 0.2pp to growth in both 2018 and in 2019, with the peak impact felt in the middle of next year. So overall, the growth effect of the tax reform will most likely be quite limited and short term (see chart 1).

Slowdown in underlying growth

In the absence of fiscal stimulus, economic activity would most likely begin to slow already at the beginning of next year. As the combined boost from positive wealth effects, the rebound in energy-related capex and the buoyant global economy gradually fades, real GDP growth should come down from 3% during the summer to about 2% by the end of next year, and to a mere 1¼% by the end of 2019 (see chart 2). In any scenario, consumer spending remains the major growth engine, supported by a healthy labor market.

The pace of consumption growth, however, will slow due to a combination of weaker employment gains (as the economy has essentially reached full employment), higher inflation and a more stable savings rate. The latter has halved since mid-2015, falling from 6% to 3% in reaction to asset-price gains and higher gas prices, thus providing a significant boost to consumer spending over the past several months. Business fixed investment should maintain its healthy momentum for the time being, as the energy-related rebound of the past couple of quarters is gradually replaced by a temporary boost from the tax cuts. Government spending will be largely flat, as the tax cuts are in part offset by expenditure cuts for non-defense discretionary outlays. Finally, net exports will once again become a drag on growth, as the global economy loses some momentum and import gains move back up to a pace that is more in line with domestic demand.

FISCAL STIMULUS TO DELAY THE GROWTH SLOWDOWN BY A FEW QUARTERS

Chart 1: Real GDP, qoq (%, annualized)

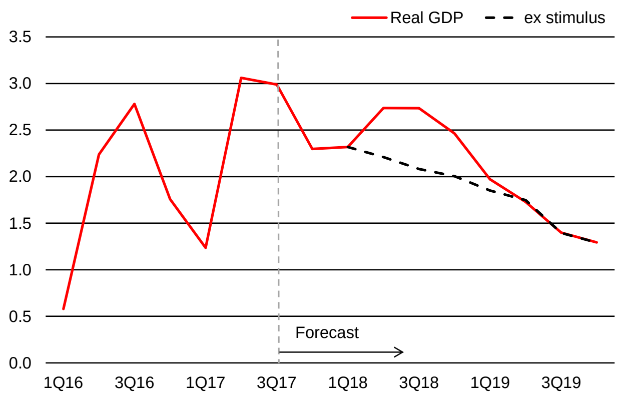
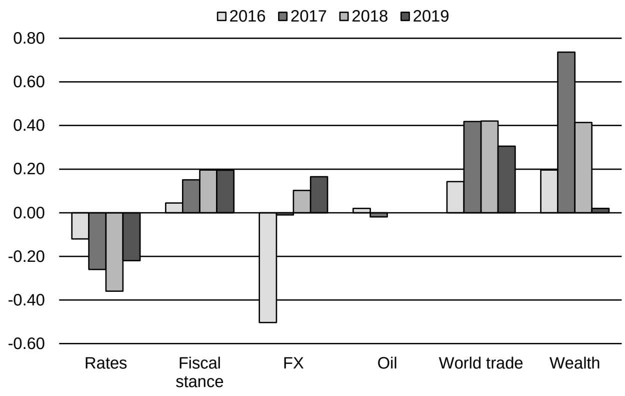


Chart 2: Impulse to real GDP growth (pp)



Source: BEA, UniCredit Research

Cyclical downturn on the horizon

With the expansion being as mature as it is, one has to begin asking the question about the timing of the next downturn. To be sure, research by the San Francisco Fed suggests that expansions do not die of old age. But there are empirical developments that are beginning to flash dark yellow, if not red: Our own recession model, which is based on the jobless rate, investment spending and compensation measures, actually assigns a 70% probability to a downturn starting within the next two years, and a whopping 93% probability that it will begin within the next three years (see chart 4). Other measures that historically have turned well before an economic downturn are beginning to show first signs of deterioration as well. These include rising delinquency rates for consumer loans and weaker demand for C&I and commercial real estate loans, and, of course, the flat yield curve. All told, we think that the economy will enter the next downturn in 2020. As sentiment indicators and economic momentum begin to deteriorate well ahead of that, we anticipate GDP growth to fall below its longer-run potential rate in the course of 2019.

A risk is the downturn already starting even earlier than that. After all, our recession model assigns a high probability to the beginning of a recession already within the next two years, i.e. by mid-2019. That would mean that growth rates would start to ease already at the turn of 2018/2019. The main reason why we are leaning towards a more constructive interpretation of the projected probabilities is that the Fed's monetary policy stance (which does not directly enter the model) is "easier" this time than it has been in the past. This should reduce the nearer-term risk of a downturn – but it does not alter our underlying view that the end of the expansion is getting nearer.

IT'S TIME TO SERIOUSLY THINK ABOUT THE END OF THE RECOVERY – RECESSION MODELS ARE ALREADY FLASHING RED

Chart 3: Length of expansion periods, years

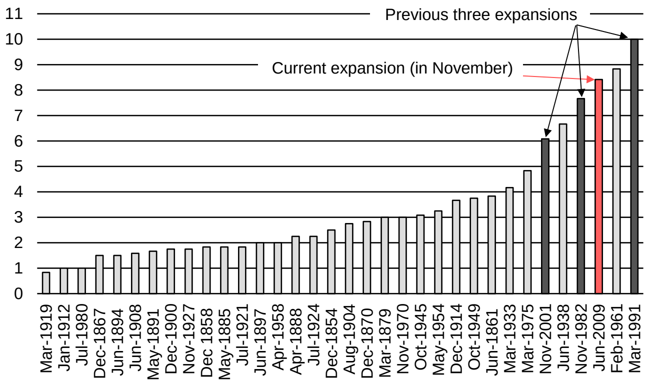
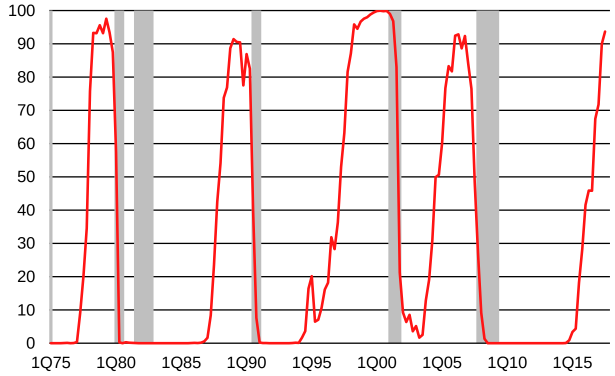


Chart 4: Probability of a recession starting within three years (%)



Source: NBER, UniCredit Research

Inflation remains a puzzle – but should trend higher

One of the main puzzles during the current recovery, not only in the US but in most developed countries, has been the lack of inflation. We, however, continue to believe that the Phillips curve still applies, which means that the diminishing slack in the economy will eventually push inflation higher. In line with the prevailing view among Federal Reserve officials, we think that the renewed weakness in core inflation rates during the summer was mostly caused by transitory factors. As the impact of these factors starts to fade, inflation rates should begin to pick up again in early 2018, and we expect the core CPI rate to rise back above 2% in 2Q18 and the core PCE deflator to hit the Fed's 2% target in 2H18 (see chart 5).

Fed likely to continue to gradually raise rates until mid-2019

Against this backdrop, the Federal Reserve will continue to gradually withdraw policy accommodation, as designated Fed Chair Jerome Powell is unlikely to deviate from his predecessor's path. With balance-sheet normalization underway and on auto pilot, the sole focus is on the normalization of the fed funds target rate. Following another 25bp hike at the end of this year, we project three more moves next year, followed by another one in the first half of 2019 (see chart 6). By then it will have reached a level of 2.50%, at which point the Fed will most likely stop hiking as sentiment indicators and actual growth rates should begin to weaken in the run-up to the expected downturn in 2020.

FURTHER NORMALIZATION OF MONETARY POLICY STANCE AS INFLATION GRINDS HIGHER

Chart 5: Consumer Price Index, yoy (%)

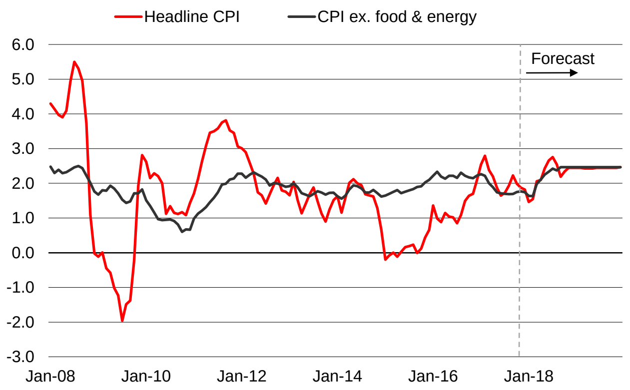
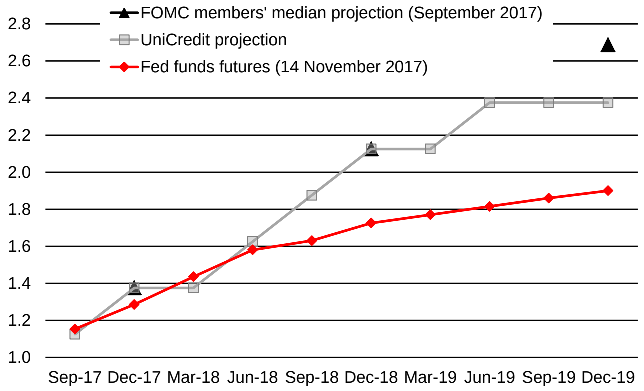


Chart 6: Fed funds target rate (%)



Source: BLS, Federal Reserve, Bloomberg, UniCredit Research

Box: Republicans will most likely continue to control Congress after midterm elections

US midterm elections will be held on Tuesday, 6 November, 2018. All 435 seats in the House of Representatives and 33 of the 100 seats in the Senate will be contested. Despite low approval ratings for both President Trump and Congress, we expect Republicans to be able to retain a majority in both chambers of Congress.

In the House of Representatives, so-called gerrymandering (redistricting that favors one political party) has favored Republicans since the early 1990s. Most recently, during the 2016 elections, Republican candidates combined only won 50.5% of total votes, but gained 55.4% of all seats. In addition, Republicans tend to fare better in midterm elections than in years with presidential elections. All this will make it extremely hard for Democrats to actually win a majority of seats in the House.

In the Senate, Republicans currently hold a 52-48 majority. And the odds of Democrats picking up seats at the upcoming elections are slim as only 8 of the 33 Senators up for election are Republicans, while 23 are Democrats and 2 are Independents, who caucus with the Democrats.

Eurozone

Broad-based recovery in full swing

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The broad-based recovery is likely to continue in 2018, with GDP set to rise by a further 2.3%. We expect headline inflation to remain weak, but the ongoing narrowing of the output gap should keep core inflation on a shallow upward trend. This is likely to allow the ECB to stop QE at the end of 2018 and start raising the deposit rate in mid-2019.

GDP to rise by 2.3% in 2018

For the eurozone, 2017 was a strong year, with GDP growth likely to average 2.3%. Prospects remain very favorable, and we forecast GDP will rise by a further 2.3% in 2018. This projection comes with a slight deceleration in sequential growth to an annualized pace of just above 2%, from about 2.5% in 2017. The upswing is firing on all cylinders. Improving fundamentals with regard to consumption and investment are increasingly feeding into each other, while solid global growth provides a good buffer against FX-related drag. In this context, still-weak inflation allows the ECB to maintain very accommodative financial conditions. GDP growth is likely to ease to 1.9% in 2019, as we expect the global environment to start becoming less supportive in the final part of our forecast horizon. Overall, our projections are consistent with the eurozone recording another two years of above-trend growth, raising to six the total count since this recovery started in mid-2013.

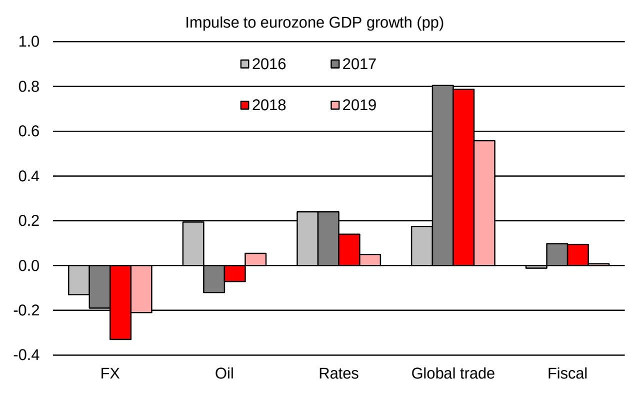
Strong global trade offsets the FX drag

The slight easing in sequential GDP growth in 2018 relative to 2017 will mainly be explained by currency appreciation and moderation in the growth impulse from the interest-rate channel, as the downward trend in bank lending rates starts bottoming out. The growth impulse from global trade should remain sizeable and in line with that of 2017, while the impact from fiscal policy and from oil prices is likely to remain small. Interestingly, GDP revisions over the course of 2017 have lifted the pace of the eurozone recovery, which, ex post, looks materially stronger than initially reported. This closes, to a large extent, the gap that had opened up over time between bullish survey indicators and less-strong hard data. Given that revisions of growth data tend to display a pro-cyclical pattern, this story might well repeat itself in 2018.

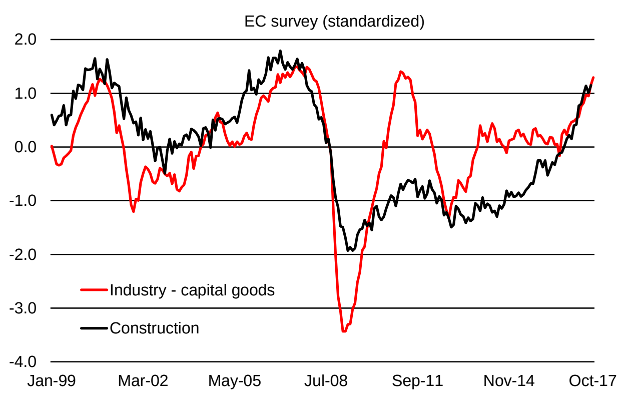
Investment enjoys good fundamentals

Domestic demand is likely to remain strong. We forecast that fixed investment will expand by about 4% in 2018, which is very similar to the growth rate recorded in 2017. The recovery in investment has gained traction and broadened. Business sentiment is at a decade high both for companies producing capital goods and those operating in the construction sector – the latter being the most domestic sector of all. This upswing is supported by a mix of rising profitability, solid liquidity positions and loose financial conditions, including falling cost of equity capital as well as low bank lending rates and capital market rates.

SOLID GLOBAL TRADE OFFSETS THE FX DRAG



INVESTMENT UPSWING BROADENS



Source: Bloomberg, EC, ECB, CPB, UniCredit Research

Demand for corporate loans to finance fixed investment is rising, but firms remain net lenders to the rest of the economy. This confirms the pattern in place so far in this upswing, which stands in stark contrast to the "normal" recoveries before the crisis; currently, firms are still mainly financing investment through internally generated funds, which contributes to explaining lackluster credit growth even as the business cycle strengthens. We suspect this trend still reflects post-crisis adjustment and deleveraging and we do not expect a reversal soon.

Consumers in very good shape

Private consumption in 2018 is likely to confirm a healthy pace of growth of close to 2%. This is supported by solid job creation, which has pushed household confidence to its highest level since 2001. This GDP recovery has been characterized by comparatively high elasticity of employment growth to economic activity amid inertia in wage growth, and this trend has even intensified in 2017 as GDP momentum has accelerated. In 2018, the employment-compensation mix is unlikely to change significantly, leaving new hiring as the main driver of growth in household disposable income. One key uncertainty in the consumption outlook is related to the future trajectory of the savings rate, which is currently hovering around historically low levels. Given upbeat sentiment and ultra-low interest rates, this is not surprising. However, the decline of the savings rate hides very heterogeneous developments across countries. For example, dissaving has been substantial in Spain and Portugal, mainly reflecting improved household confidence in the wake of good progress on growth and job creation. From now on, private consumption in these two countries will have less scope to outpace disposable income, indicating a likely slowdown in consumer outlays ahead. We do not expect this to hold for the eurozone as a whole.

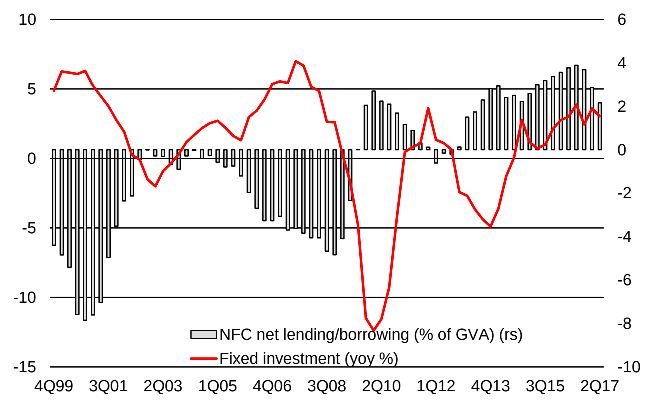
Exports to slow but only moderately so

We expect export growth to weaken slightly in 2018, to 4-4.5%. A stronger currency and broad stabilization in the growth rate of global trade argue for a softer impulse from extra-area exports, but intra-area trade is likely to remain resilient as domestic demand continues to expand solidly. The contribution of net exports to GDP growth in 2018 is likely to be slightly positive to broadly neutral. However, this discounts strong performance by imports. Therefore, is not indicative of the importance of the export channel in supporting the eurozone recovery.

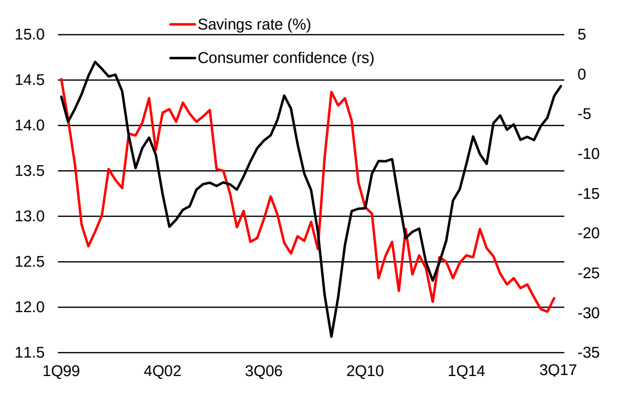
GDP by country

In 2018, we forecast broadly stable growth in the three largest euro area countries. In Germany and France, GDP will probably grow by 2.3% and 1.8% respectively. For Italy, we project growth of 1.5%. In Spain, the pace of recovery will probably slow, to 2.7% from 3.1% in 2017: this should be regarded as normalization from high levels rather than as a genuine loss of momentum, and it assumes that the impact from the Catalonia crisis will be small. More details on forecasts for individual EMU countries can be found in the country sections.

INVESTMENT RECOVERS, WHILE FIRMS KEEP DELEVERAGING



BULLISH CONSUMERS DRAW DOWN SAVINGS



Source: EC, ECB, Eurostat, UniCredit Research

Price stability not in sight

We expect headline inflation to average 1.5% in 2018 and 1.4% in 2019, thus remaining below the ECB's objective throughout our forecast horizon. These numbers stem from a continuation of the shallow rising trend in core inflation (1.2% in 2018 and 1.4% in 2019, after a likely 1.0% in 2017) and from our oil-price assumptions, which envisage Brent crude oil staying above USD 60/bbl in 1H18 in the wake of Middle East tensions, and falling back thereafter.

Sources of volatility

In our projections, volatility in the monthly inflation path is mainly caused by base effects on energy and (to a lesser extent) food, as well as calendar effects related to the timing of Easter. Base effects are likely to temporarily lower headline inflation in the first months of 2018, given that the price of energy and fresh food rose strongly in early 2017. Instead, calendar effects will likely generate noise in March, April and May (both in 2018 and 2019) as holiday-sensitive items respond strongly to the different timing of Easter. This calendar effect proved sizeable in 2017, and we have included similar volatility in our forecasts. Importantly, none of these effects should have any impact on underlying inflation, which will be the key variable to watch for the ECB.

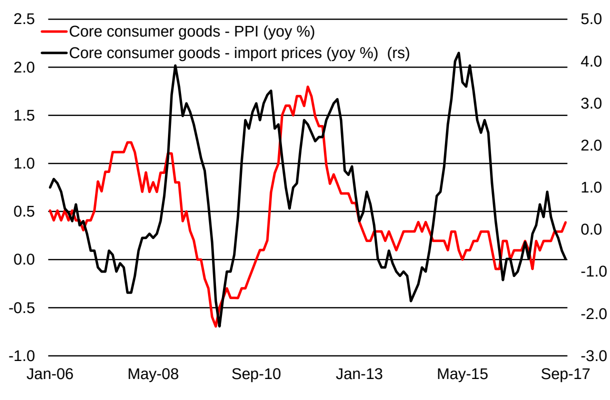
Reduced FX pass-through

Pipeline pressure generally remains weak. At the first stage of the price-formation chain, import prices of core consumer goods (excluding food and energy) have even been recording outright contraction, with the latest leg of weakness probably mainly reflecting the impact of currency appreciation. However, at an intermediate stage of the price chain, producer prices for core consumer goods have displayed much lower responsiveness to import prices, basically remaining flat for the last few years. This indicates a reduced degree of FX pass-through to prices, which is fully consistent with a growing number of empirical findings.

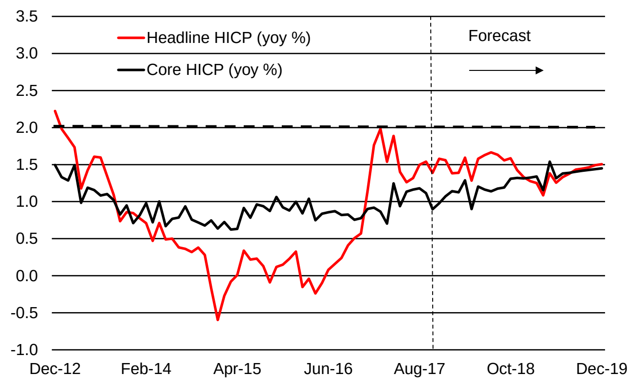
Mind the (output) gap

Economic slack remains the main fundamental driver of underlying price pressure. Our analysis has shown that weakness in core inflation and wage growth recorded in the eurozone so far in this recovery phase – which may seem puzzling – is actually not anomalous if one allows for: **1.** a larger output gap than suggested by official estimates, and **2.** sufficiently long time lags, which we estimate to be about a year (see *Economics Thinking* – "Eurozone, weak core inflation and wages reflect substantial slack"). Regardless of the exact estimate of eurozone growth potential, there should be no doubt that economic slack has been reabsorbed at a fast clip in the last year or so, and our GDP projections imply that it will continue to decline throughout the forecast horizon. This strengthens our confidence that core inflation will move along a slow recovery trend in the next two years, and probably beyond. Our point estimate for core inflation is 1.3% at the end of 2018 and 1.4-1.5% at the end of 2019.

FX PASS-THROUGH HAS DECLINED



SHALLOW UPWARD TREND IN CORE INFLATION



Source: Eurostat, UniCredit Research

QE likely over at end-2018, first rate hike in mid-2019

A gradual normalization of monetary policy is underway, as persistent undershooting of inflation is being progressively tempered by scarcity issues and side effects of the QE program, including potential risks to financial stability further down the road. Starting in January, the ECB's net asset purchases will slow to a monthly pace of EUR 30bn. They will continue until at least September 2018, and ECB President Mario Draghi's hint that QE will not stop suddenly suggests a further extension beyond that date, although probably at a reduced pace. The ECB's forward guidance continues to place the first interest-rate increase "well past" the end of net asset purchases. However, this guidance does not reflect a commitment, only an expectation, which can be adapted to changing economic and financial conditions.

Slow exit from QE…

If our projections for GDP and CPI are broadly on track, over the course of 2018, the ECB is likely to grow increasingly confident that diminishing spare capacity will push underlying price pressure in the desired direction. The upcoming rounds of collective bargaining in Germany should be consistent with this picture, showing moderate acceleration in the growth rate of (effective) wages from 2.5% in 2017 to about 3%. However, we do not expect any clearly hawkish shift in ECB rhetoric, given our forecast that headline inflation in the eurozone will remain below 2% with core prices on a shallow upward trend. Rather, 2018 will probably see a slow drift towards the exit from QE, with the ECB bound to stress that the persistence of its monetary stimulus will be less dependent on the flows of its purchases and more dependent on the large stock of its QE portfolio – jointly with negative rates and forward guidance.

…with a short taper in 4Q18

After September 2018, we expect the ECB to opt for a quick tapering, which would take net asset purchases to zero by the end of 2018. We assume that "well past" means at least six months. Therefore, interest-rate normalization will probably start in mid-2019 with a 20bp increase in the deposit rate, followed by a similar move at the end of 2019 (when the refi rate is also likely to be raised, to 0.25%). This path would imply an exit from negative rates after more than five years. Risks are tilted towards a longer period of unchanged policy rates, mainly due to the expected weakness in inflation throughout the forecast horizon.

Risks scenarios

In a dovish scenario where growth and inflation disappoint but do not fall off a cliff – for example, in 2018, GDP rises at an annualized pace of 1.5%, with headline and core inflation at around 1% – the ECB would probably extend QE for another six to nine months into 2019 at a reduced monthly pace of EUR 10-20bn, leaving the program open-ended. The easing of financial conditions would come from (small) additional asset purchases and, especially, from the repricing of the first interest rate hike into 2020. Importantly for the ECB, such an extension of QE might be manageable without changing the capital-key framework of the program.

In a hawkish scenario where growth and inflation in 2018 surprise to the upside – for example, GDP expands north of an annualized 2.5%, and headline inflation moves towards 2% with the core rate close to 1.5% – the ECB would probably stop its purchases in September, drop the "well past" reference and pave the way for a rate hike in December 2018.

The ECB lags the Fed by four years

Even after net asset purchases have fallen to zero and negative rates have come to an end, the ECB will be nowhere close to shrinking its QE portfolio. The upswing in the eurozone is lagging that in the US by approximately four years – mainly due to the sovereign debt crisis – and the asynchrony of the two business cycles has resulted in the ECB consistently following the Fed's policy with a similar lag of about four years. The Fed stopped QE in October 2014, while the end-date for the ECB could be December 2018. The Fed started to raise the policy rate at the end of 2015, and the ECB is unlikely to start raising the deposit rate before mid-2019. This pattern could help one to pin down a tentative time for QE unwinding by the ECB. Considering that the Fed only started to reduce its portfolio of securities in October, and under the (strong) assumption that past regularities will also hold in the future, a lag of four years implies that the ECB could begin to gradually stop reinvesting its QE portfolio between 2021 and 2022 – if a new downturn does not hit the eurozone before then.

The road to further European integration

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Conditions have never been so favorable to implement reforms of the European architecture. The election of Emmanuel Macron as French president has been the potential game changer, given his unprecedented platform that has revived hopes for an acceleration in the process of European economic and political integration. Angela Merkel's re-election has made this change possible, and a strong cyclical recovery helps create a once-in-a-lifetime opportunity that should not be wasted. Given the high stakes, striking the right balance between proactivity and gradualism will be critically important.

Mr. Macron already laid out his vision of Europe at the end of September, two days after the general election in Germany. His project envisages: 1. more coordination of fiscal policy, both in terms of corporate tax policies and public investment; 2. a common budget and a common finance minister. The common budget would have two main purposes: financing several "common public goods" such as security and defense, and supporting member countries hit by asymmetric shocks, but with the possibility of broadening the scope for intervention; 3. the creation of a subgroup representing eurozone countries within the European Parliament, to improve democratic accountability within the eurozone.

Merkel will make concrete proposals once the new government is formed

The German proposal has not been outlined yet. This is inevitable, because the coalition talks between the so-called Jamaica parties have yet to be concluded and approved by party members (in the case of the FDP and the Greens). Therefore, first concrete proposals from Mrs. Merkel are likely to come at the beginning of 2018 at the earliest. In any case, we expect the new German government to have a pro-European agenda. Contrary to what is often feared, the FDP will not be a stumbling block in the way of further European integration, to which they are not opposed in general. They demand the creation of a (true) common foreign policy, the creation of a European army and the realization of synergies for joint defense spending, i.e. all areas on which a lot of work has already been done in Paris and Berlin. Furthermore, in case of disputes within a newly formed Jamaica coalition, Mrs. Merkel is likely to make use of the so-called "chancellor principle", which ensures that the German chancellor is responsible for all major government policies, including European issues and initiatives.

Joint financing of certain public goods seems likely

Overall, on both sides there appears to be the political will to move towards joint financing of certain common public goods. Several other countries share this stance, which also enjoys strong democratic support – the Eurobarometer survey shows an overwhelming majority of European citizens in favor of a common strategy in areas such as security, defense, foreign policy, etc. This increases the probability of a successful outcome. Concrete implementation will then have to deal with a number of non-trivial practical issues, including the optimal degree of spending centralization.

Common budget: the key challenges

The creation of a common budget poses more challenges as there seem to be different opinions about its main purposes, financing and firepower. This debate might overlap with the one on the next EU budget (covering 2020-2026), which is likely to gain traction in 2H18 when the European Commission will finalize its proposals, including for transfers between EU member states.

France and Germany hold different views

On the one hand, Mr. Macron appears keen to create a strong budget at once, although the proposed financing – via green and digital taxes – is not up to the task at hand, while Paris' proposal for the scope and framework of the budget remains unclear.

On the other hand, Mrs. Merkel seems to favor a more realistic "small" fund that would be replenished gradually with contributions from the national budgets. This fund would essentially have a stabilization purpose – by providing countries hit by asymmetric shocks with loans that would have to be repaid – and would categorically rule out permanent transfers across member states. Germany wants to place this fund within the ESM mainly for two reasons.

First, because this would not require changes to the EU treaties and to German Basic Law: therefore, an intergovernmental deal would make the whole process much faster and less uncertain. Second, because Berlin wants access to the fund to be conditional on increased surveillance of national fiscal policies, which, however, should not be subject to political interference. This is why Germany asks that conditionality is enforced by the ESM, and not by the European Commission.

Conditionality: how tough?

How this conditionality is implemented in practice will be a sticking point in the negotiations. Conditionality should not go as far as that of a "program situation", which implies loss of national sovereignty, stigma, and, potentially, excessively pro-cyclical policies. If Germany were to push for something along these lines, or for the inclusion of stricter collective action clauses in government bond documentation, or even automatic maturity extension of government bonds, the new fund would not stand a chance. Berlin knows that, and is unlikely to go that far.

A stabilization fund has better chances to be implemented than a common budget

Concretely, we expect the creation of a stabilization fund for eurozone countries that would complement the national budget stabilizers in the event of a severe asymmetric shock. The shock that hit Finland in the late 2000s is a case in point, as recently indicated by the Governor of Banque de France, Villeroy de Galhau. ESM Chairman Klaus Regling has suggested that Ireland might be the next country in line if it were hit by a particularly hard Brexit.

It will have a small size…

The size of the fund would have to be proportionate to its objective. The size of 1-2% of GDP suggested by Mr. Villeroy de Galhau and Mr. Regling is probably indicative of the likely size of the new tool in the longer term. In practice, it is likely that the build-up in capital might only be gradual and will take some time, even though a limited paid-in capital could generate sizeable firepower if the structure of the "new" ESM fund were to replicate that of the "old" ESM.

Instead of raising fresh money, already available financial means from the old ESM fund could also be channeled into the new one. The ESM currently has untapped firepower of EUR 376bn out of EUR 500bn. However, such a rededication seems unlikely, as it would require the consent of all eurozone governments and/or parliaments. Furthermore, weakening the ESM's firepower could lead to less credibility in crisis times in the eyes of financial investors.

..with contributions from a group of the willing

Both German and French officials seem open to the possibility that some countries might not participate in the stabilization fund, at least initially, as they may not want to spare the money or do not support further integration. However, this would not stop the project, consistently with Mr. Macron's support for "integration of the willing". In general, this approach would de facto institutionalize a multi-speed Europe, with eurozone countries (or most of them) as "core Europe" likely more willing to pursue further integration than non-eurozone EU members.

Harmonization of corporate tax rates in Germany and France

We also expect Germany and France to start a gradual harmonization of their corporate tax rates. Ideally, this could represent the first step towards a full integration of German and French markets by 2024, as envisaged by Mr. Macron in his speech at the Sorbonne. This would translate into convergence of the rules applied to businesses in the two countries, from corporate law to bankruptcy law – a "field experiment" of what a Capital Markets Union may look like in the not-too-distant future. After all, when it comes to cushioning asymmetric shocks, private money flows are more important to share risks than fiscal instruments, and a capital markets union is certainly politically easier to be agreed upon than a fiscal union.

The need for macroeconomic and fiscal convergence

As a final consideration, we note that the long-overdue drive towards deeper integration in policy areas such as defense and security will not, as such, be able to foster macroeconomic and fiscal convergence across the euro area. The same holds true for gradual harmonization in corporate tax rates in Germany and France. Macroeconomic and fiscal convergence across the EMU ultimately depends on structural reforms aimed at raising potential growth at the national level. This is an important factor to be considered. We agree with ECB executive board member Benoit Coeure when he claims that it is precisely this lack of convergence that explains the mistrust between eurozone countries, which, in turn, hampers progress in reforms aimed at making the eurozone infrastructure more resilient. The uncertainty regarding the scope and the practical implementation of the new stabilization fund reflects this.

The process will probably take time…

Over our two-year forecast horizon, progress in macro and fiscal convergence within the euro area will probably be uneven and overall limited. While the political landscape is very favorable for structural reforms in France where President Emmanuel Macron has a strong democratic mandate to overhaul the country, this might not hold true for other two systemic players, namely Italy and Spain. The likely formation of a broad and heterogeneous government coalition following general elections in the former, and ongoing fragility of the minority government in the latter, are not ideal conditions for an acceleration of domestic reform momentum.

Moreover, in a number of countries – especially those with the largest scars from the sovereign debt crisis – public opinion does not seem ready yet to endorse a framework where a broader sharing of national sovereignty is offered in exchange for an equally proportional sharing of risks. Consequently, and also given the gridlock on the risk-weighting of banks' sovereign exposure, any breakthrough in the negotiations for completing the banking union with a common deposit guarantee scheme remains unlikely, for now.

…but there is reason for hope

However, from a longer-term perspective, we see scope for cautious optimism. The establishment of a eurozone stabilization fund, although small, could be a first step towards the goal of a common eurozone budget and a eurozone finance minister, as proposed by Mr. Macron. The ESM could then be transformed into the European Monetary Fund (EMF) with greater financial means and a broader surveillance mission, similar to the one run today by the European Commission. In addition, and in order to show commitment, Germany and France could announce the final goal of appointing a eurozone finance minister who runs the EMF and reports to a euro-group within the EU parliament. However, such an ambitious move would need changes in the EU treaties ratified by all countries and modifications to German Basic Law.

Germany

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- We expect the German economy to largely continue its recovery in the next two years. After 2.2% in 2017 (on a non-working-day-adjusted basis), GDP growth is likely to be 2.3% in 2018 and 1.9% in 2019 (see left chart). Given the slowdown in the US and lower momentum in global trade, we expect some moderation in the second half of 2019.

- Please note that there are no differences between the non-working-day and working-day-adjusted growth figures in 2018 and 2019, as there are no calendar effects. For 2017, we expect GDP growth of 2.5% on a working-day-adjusted basis.

- We think the German economy is about to experience the longest (but not strongest) recovery phase in more than 50 years. The latest rise of 0.8% qoq in 3Q17 marked the seventeenth increase in the last 18 quarters. Only the recovery after the first oil-price shock in the mid-1970s had been somewhat longer (18 increases in 19 quarters; see right chart).

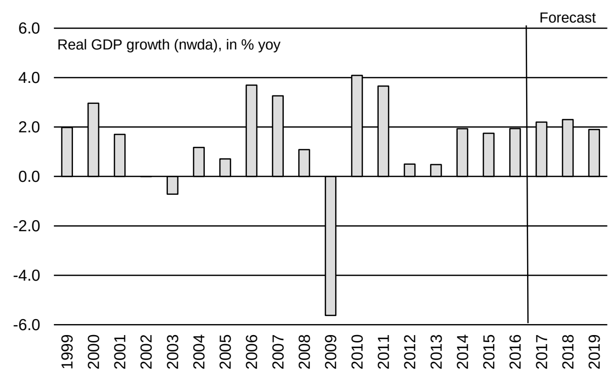
- The major drivers of the ongoing recovery are both exports and internal demand. German manufacturing companies are likely to benefit further from the expansion of global trade. As a result, we expect capex spending to continue its (volatile) recovery in the next few quarters. This is also indicated by the further pick-up in bank lending to the non-financial corporate sector. Private consumer spending will rise robustly, given the build-up in new jobs, solid wage increases and subdued inflation pressure. Activity in the construction sector will remain brisk, as signaled by new record-high levels in business sentiment and a significant overhang of building permits over completions in 2016.

- In the further course of 2018, there are important collective bargaining rounds in the pipeline (metal sector; construction, chemical industry; public sector). At the economy-wide level, we expect (effective) wage rises of about 3% next year after 2½% in 2017.

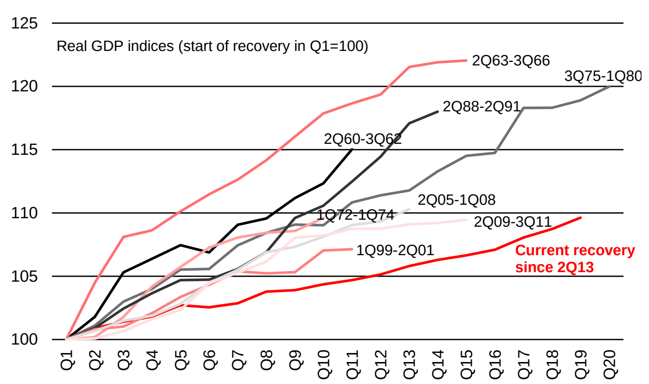
- Despite somewhat higher wage dynamics, we expect price pressure to remain subdued, since companies' leeway to pass on higher prices is still limited. For headline inflation, we expect 1.6% in 2018 and 1.5% in 2019 (core rate 1.4% in 2018 and 1.5% in 2019).

- A Jamaica coalition is the most likely scenario, as other formations have already been denied. Given the ongoing negotiations between the Jamaica coalition parties, there are major uncertainties in the fiscal policy outlook for 2018 and 2019. The status quo is a broadly neutral fiscal policy. However, this may change, especially from 2019 onwards, with at least moderate tax cuts and higher infrastructure spending.

OUR GROWTH FORECASTS AT A GLANCE



IN THE RUN-UP TO THE LONGEST RECOVERY



Source: FSO, Bloomberg, UniCredit Research

France

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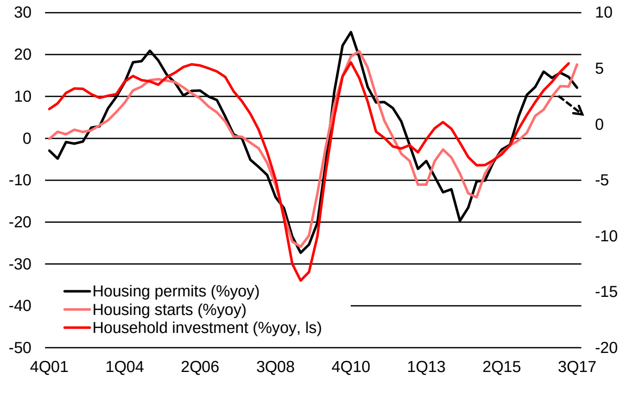
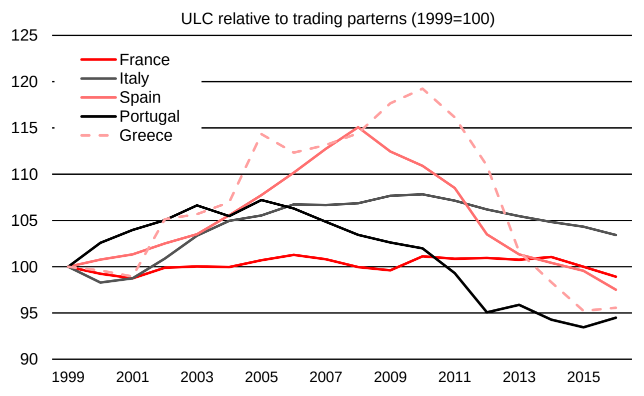
- The French economy is likely to record another solid performance in 2018. Our baseline scenario foresees stabilization in yearly GDP growth at 1.8% (the same pace as in 2017), with quarterly GDP expanding at an annualized rate of about 2.0%. A consolidation of the improvement in consumption and investment fundamentals will more than offset the impact associated with the fading of several technical factors that boosted growth in 2017, i.e. the return to normal of economic activity in the agrifood, refining and electricity sectors after 2016's disruptive shocks. GDP growth is likely to slow down to 1.6% in 2019.
- Domestic demand will probably remain the main engine of growth in 2018. Private consumption growth is likely to accelerate (from 1.2% in 2017 to about 1.5% in 2018) amid revived consumer confidence, a moderate pick-up in nominal disposable income growth and room for a decline in the savings ratio, currently up to the highest level since 3Q14. Gross fixed investment is likely to expand at a pace close to that recorded in 2017 (about 3.5%), thanks to resilient investment activity by non-financial corporates, sustained by favorable financing conditions and improved profit margins. Household investment growth will probably ease from a solid level, while public investment is likely to record positive growth after five consecutive years of contraction. Meanwhile, exports are likely to remain supportive (at about 4.0%), mainly driven by demand from emerging markets. However, given the solid performance of domestic demand and thus imports, net exports' contribution to GDP growth might end up being negative, albeit less that in the previous years.
- The government recently revised up the 2018 deficit target from 2.6% to 2.8%, due to the Constitutional Court's ruling in favor of abolishing the 3% dividend tax (worth EUR 10bn). This one-off factor aside, the fiscal stance is planned to be mildly restrictive as a bold structural effort in reducing expenditure (worth 0.4% of GDP) will finance an equally bold reduction in taxes, including a reduction of wealth taxes and the introduction of a 30% unified tax on interest income, dividends, and capital gains (0.3% of GDP). The overall impact on GDP is likely to be negligible, given that spending cuts may prove less contractionary if they target inefficiencies, while the reform of capital taxation should improve competitiveness.
- Next year's fiscal policy will reflect a broader, longer-term government strategy aimed at **1.** reducing public spending from 55% of GDP in 2016 to 51% by 2022, which would create room for a gradual fiscal consolidation and tax relief. A comprehensive spending review will be finalized by 1Q18; **2.** boosting investment, employment and competitiveness via further labor and tax reforms and the creation of a new EUR 57bn fund to support firms' investment plans. The fund endowment will mainly be allocated to enhance research and innovation, where French investment has been lagging behind, with negative implications for the country's total factor productivity –while France does comparatively well on labor productivity.

HOUSEHOLD INVESTMENT LIKELY TO HAVE PEAKED



REFORMS WILL ADDRESS WEAK COMPETITIVENESS



Source: ECB, INSEE, UniCredit Research

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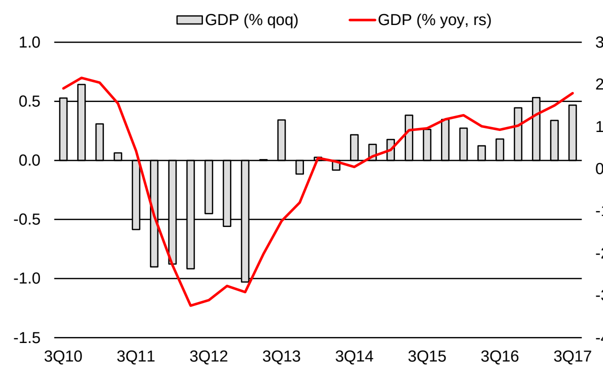
- After a slow start, Italian growth has finally picked up, fueled by both external and domestic demand. In 2018, satisfactory growth is expected to continue. The tailwinds from the favorable external environment are likely to prevail over domestic political uncertainty, before gradually losing steam during 2019. After 1.6% growth in 2017, we project GDP will rise by 1.5% in 2018 and by 1.2% in 2019.

- Unsurprisingly, Italian export growth has been accelerating in sync with global demand growth, creating a very promising environment for businesses; foreign turnover has risen by 6% since end-2016, manufacturing output is up by 4% and the manufacturing PMI has hit its highest level since 2011. Moreover, despite faster inflation, in 2017, private consumption is on track to provide key support to growth, given that nominal labor income and financial wealth have been growing moderately and consumer confidence has improved, prompting moderate dissaving.

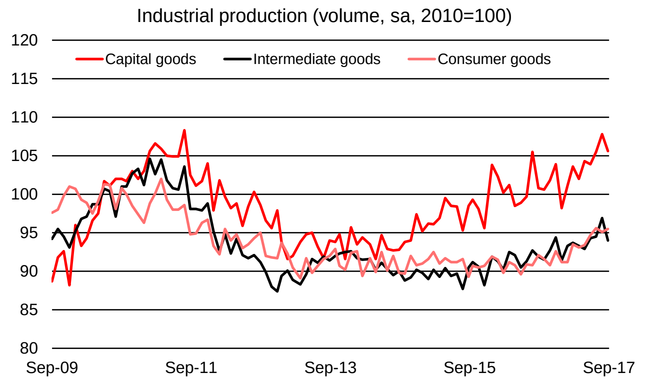
- With no substantial changes in global demand growth or to the ECB's monetary policy, the positive growth impulse is projected to continue in 2018. We forecast only a moderate slowdown in exports and private consumption and pencil in an acceleration in fixed investment. The deceleration in export growth is expected to be driven chiefly by the euro's strengthening, as well as by a slowdown in potential demand from some important trading partners (for example, the UK). Our scenario involves an upbeat view of investment in machinery and equipment and in innovation. We have seen a distinct performance so far in the production of capital goods (which is usually a good proxy for capex dynamic). The positive impact from renewed fiscal incentives and from fundamentals – growing demand and profitability and low lending rates – is not expected to change materially. Accelerating investment activity will increasingly spill over to lending growth, with positive feedback effects.

- The labor market recovery has featured much more positives than negatives thus far, and the outlook remains encouraging. Employment is likely to record its third year of growth of around 1% in 2017, with a slowdown in hiring expected to occur in 2018 and 2019. However, this deceleration is likely to be moderate, also thanks to a renewal of fiscal incentives for firms hiring younger workers with permanent contracts. This will help ameliorate concerns about the quality of new jobs, fueled by the prevalence of temporary contracts in 2017. The unemployment rate is projected to fall towards 10%, but the ongoing reduction of inactive workers will slow the downward trend. Last but not least, the wage outlook will also benefit from the renewal of public sector employee work contracts, after several years of wage freezes.

GOOD GROWTH TO CONTINUE IN 2018



WE ARE UPBEAT ON INVESTMENT



Source: Istat, UniCredit Research

Election outcome: no clear winner, but worst case unlikely

Italy will go to the polls in 2018 with a new electoral law

Italy will go to the polls in 2018 to elect a new parliament. The mandate of the current parliament will expire in mid-March, but it is likely that the president of the Republic will dissolve parliament earlier, after parliamentary approval of the 2018 Budget Law. Thus, new elections are likely to be held towards end-1Q18.

The new voting system, which just became law, will be applied to both the Lower House and the Senate. Around two thirds of the seats will be distributed proportionally, with the remaining one third assigned in first-past-the-post constituencies. Candidates in these constituencies can also be supported by a pre-election coalition, which, however, will not require political parties to committee ex-ante to a common coalition program or a PM candidate.

M5S is likely to battle the center-right coalition …

… while the center-left parties are still struggling

The latest opinion polls indicate that the Five Star Movement (M5S) has a vote share slightly below 30%, implying that it has the highest chance of becoming the leading party in parliament. However, we expect the M5S to avoid any pre-election coalition, therefore only a final vote share well above 35% will secure it enough seats in parliament to increase its chance of forming a government. Center-right parties, mainly consisting of Forza Italia and the right-wing Northern League and Brothers of Italy, are very likely to form a pre-election coalition. The latest polls assess the coalition's vote share at around 35%, increasing their chances to gain the highest number of seats, although this coalition would fall well short of an absolute majority. In the center-left space, we have the Democratic Party (PD), currently rated slightly above 25%, and several center and left-wing parties, which might become part of a broad center-left coalition. The total vote share of these small center and left parties is about 10% when including left-wing parties (mainly MdP), which struggle the most to establish an alliance with the PD's leader Matteo Renzi. A final decision to form a wide pre-election coalition might allow the center left to become competitive. Currently, the probability of such a coalition is too close to call.

Italy is unlikely to avoid a hung parliament …

… but chances are higher for a broad coalition of mainly pro-Europe parties

Therefore, we expect a hung parliament and stalemate to be the most probable outcome, forcing political parties to form a post-election coalition, which might look different from the pre-election ones. Past experience shows that the creation of a post-election coalition able to win a majority in parliament has the highest chances of materializing. Thus, we attribute a low probability (20%) to a stiffening of positions of the political parties, which may result in Italy holding new elections again in 2018. In terms of post-election coalitions, we see the following two scenarios, which may have a similar probability of happening: **1.** the distribution of seats will broadly confirm a tri-polar system. In this case, we expect a government supported by a broad coalition mainly consisting of pro-Europe parties, led by a politician or high-standing person; **2.** center-left parties struggle to form a pre-election coalition and the center right has the highest chance of forming a government. Then, the final outcome between Forza Italia and the populist Northern League – which may be boosted by its higher support in the center-North regions – will be key. In case of similar performance of both, given Forza Italia's ability to attract post-election support from center-parties, we expect a mediation towards more moderate stances (particularly, on Europe) to prevail.

A populist coalition

In addition, a final scenario might be one in which an M5S-led populist government comes to power, with the support of the Northern League and Brothers of Italy. This would require a strong showing by M5S, resulting in it winning more than 35% of the votes, which would probably be sufficient for the president of the Republic to give M5S the mandate to try to form a government. This is currently not indicated by the polls and by the outcome of the regional elections over the past few years. Therefore, this scenario has the lowest probability of happening, but it is likely to be perceived as the worst-case by financial markets, due to the risk of an unwinding of previous reforms and, potentially, the beginning of a debate to reform the EU treaties – which, in the end, would be self-defeating for this government.

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Spain

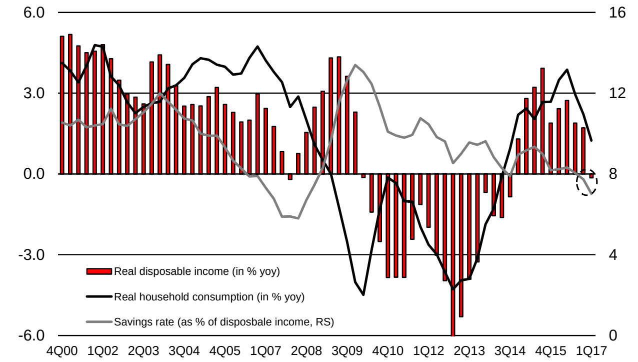
- Spain's economic expansion, which started four years ago, is set to continue over our forecast horizon, albeit at a slower pace. We expect GDP growth to decelerate from 3.1% in 2017 to 2.7% in 2018 and to 2.1% in 2019. Domestic demand, and particularly private consumption, will remain the main engine of growth but will progressively lose its shine as the pace of job creation eases and pent-up demand is absorbed. In addition, after the sharp decline recorded recently, the household savings rate will likely stabilize. Investment, which also benefits from dynamic external demand, will likely continue to grow solidly, whereas the fiscal stance will probably remain broadly neutral. Net exports will likely add to growth thanks to solid global trade offsetting the FX drag and improving competitiveness.

- The main downside risk to our scenario is a deterioration of the Catalan crisis. This would increase uncertainty and dampen consumption and investment spending. Accurately assessing the impact of such an unprecedented shock, which has a common component that affects the whole Spanish economy and an idiosyncratic one that hits Catalonia only, is beyond the prediction power of any economic model. However, and taking the estimates with a pinch of salt, stress scenarios carried out by the Bank of Spain or the independent fiscal watchdog AIReF point to GDP-growth losses of 0.4-1.2pp for 2018.

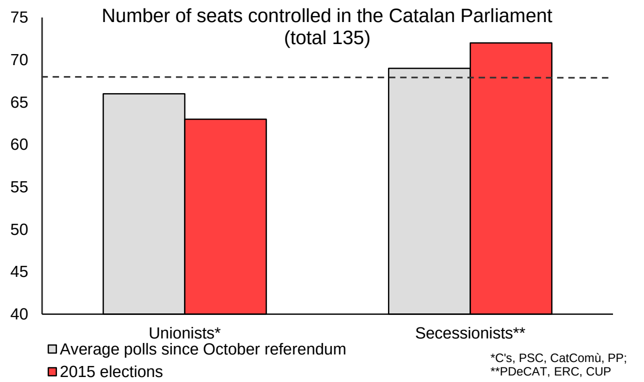
- Catalonia will hold new regional elections on 21 December. As of now, the secessionists are leading the polls by a small margin. If they have the upper hand, Madrid will likely trigger again Article 155 of the constitution at the cost of heightening tension. However, with the electoral campaign being just at the beginning, the unionists can still fill the gap and gather enough support to win the election, opening the way for a quick resolution of the crisis and for negotiations to reform the constitution in a federalist way. Considering that the majority of Catalans favor more autonomy instead of full independence, it would be strategically wise for the central government to show a willingness to reform the constitution beforehand, thus allowing a moderate force to emerge victorious from the ballot box. Even if it is a close call, this is our baseline scenario. Regardless of the outcome, the immediate aftermath of the vote might generate tensions between the two factions. Yet, the peaceful nature of these movements should prevent an escalation of the crisis.

- The Catalan crisis has delayed the approval of the 2018 budget. The Basque Nationalist Party (PNV), whose votes are key for passing the bill, will wait for PM Mariano Rajoy to solve the Catalan crisis. This could happen in early January. Otherwise, Madrid will continue to operate on monthly budget extensions and is expected to reduce the deficit-to-GDP ratio to 2.4% from 3.1%. In terms of substance, the slim parliamentary support will prevent the central government from adopting ambitious measures and most of the adjustment will be due to windfalls from strong economic performance. The deficit target for the regions is set at 0.4% of GDP, while public-spending growth is capped at 1.3% (nominal terms). On the tax front, the myriad of VAT exemptions remain in place.

LIMITED SCOPE FOR FURTHER DISSAVING



CATALAN ELECTIONS: A CLOSE CALL



Source: Eurostat, Polling sources, UniCredit Research

Austria

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- Austria will start 2018 with a new government following the outcome of the general election on 15 October 2017. Sebastian Kurz, currently foreign minister, will probably head a coalition government of the Austrian People's Party and the Austrian Freedom Party as Federal Chancellor. We expect to see a more liberal economic policy than that prevailing under the present coalition, which comprises the Austrian Social Democrats and the Austrian People's Party. Participation of the EU-critical Freedom Party in governing the country's affairs is unlikely to have any harmful effects on Austria's European policy.

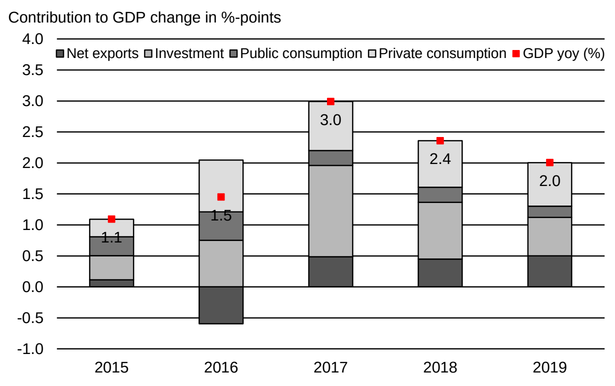
- In 2017, economic growth accelerated to about 3%, supported by the upturn in global trade, which boosted demand for investment, and by sustained strong consumption. While the economic upswing will continue on a broad scale, we expect the momentum to slow to 2.4% and 2.0% in 2018 and 2019, respectively.

- Foreign trade will also make a positive contribution to economic growth in 2018-19. The economy will, however, be driven mainly by domestic demand, although at a more moderate pace. Investment activity will lose some of its momentum; after two years of strong growth, it will ease off in the areas of plant and equipment as well as construction. Although the positive effects of the 2016 tax reform have tapered off, the growth impetus from private consumption will ease only slightly as the sustained improvement of the labor market has supported spending through increases in disposable income.

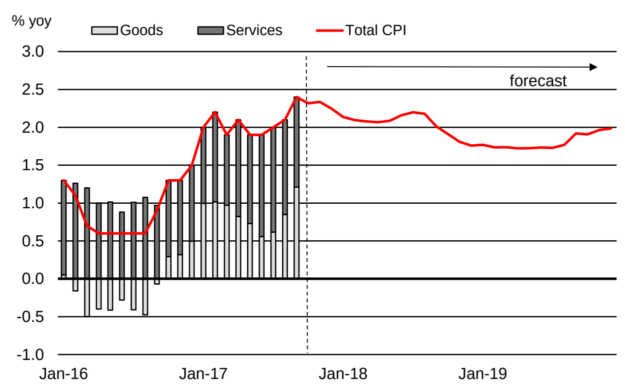
- We expect inflation to have risen to an average 2.1% in 2017 following a continuation of the price increases at the beginning of the year due to commodity price trends, now discernible in many segments of the service sector and driven by demand. Given strong economic growth and demographic trends, we believe that the services industry and rents will continue to exert strong upward pressure in 2018. Inflation will probably average 2.1% in 2018, and will once again be among the highest rates in the euro area.

- Austria's budget and debt situation will benefit from the favorable economic developments. The country's deficit amounted to an estimated 0.7% of GDP in 2017, undershooting the original deficit target of 1.2%. A draft budget for 2018 has not yet been prepared. While the economy will remain robust, the expansive measures announced in the run-up to the election will at least check any further reduction of the deficit. Nevertheless, total public debt, which in 2017 is likely to have returned to below 80% of GDP, will continue to decline.

ECONOMIC GROWTH ON A BROAD SCALE



INFLATION PERSISTS AT 2% YOY



Source: Statistik Austria, UniCredit Research

UK

It's all about Brexit

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UK economic growth fell to the bottom of the G7 in the first three quarters of 2017 and it is likely to stay there through at least 2018. While firmer global growth is supporting the UK economy, its relative growth prospects are weak as Brexit-related uncertainty and the prospect of a less open economy weigh on economic activity. We expect GDP growth of 1.5% in 2017, 0.8% in 2018 and 1.2% in 2019. Higher uncertainty than usual surrounds these forecasts given the outlook is highly dependent on the outcome of Brexit negotiations.

A deal is likely but not until the last minute

Our base case is that Brexit talks will move on to trade and a transition at the 14-15 December Council meeting, which will require the UK to cave in to the EU27's demands on the Brexit bill. Still, the most difficult negotiations lie ahead: a key problem is that Theresa May's party cannot agree on what it would like the future relationship to be. Eventually there will likely be a deal (since the alternative is so bad), including a 2-year transition and a rough outline of the future relationship, but it probably will not be concluded until the last minute (1Q19). The resolution of uncertainty surrounding the transition in 1Q19 will lift growth slightly. The future relationship, which will likely be a free trade agreement similar to the EU-Canada arrangement, will take many years to conclude and result in a less open, less productive, UK economy.

Employment growth to slow

Employment has been robust and the unemployment rate has fallen to a 42-year low of 4.3%. Ahead, employment growth will likely slow reflecting the UK economy being close to full employment, reduced net immigration, and the slowdown in economic activity (employment growth lags GDP growth by around two quarters). Therefore, future GDP growth will largely have to come from productivity growth, which has repeatedly disappointed in large part because of weak business investment, which is now being hit by Brexit-related uncertainty.

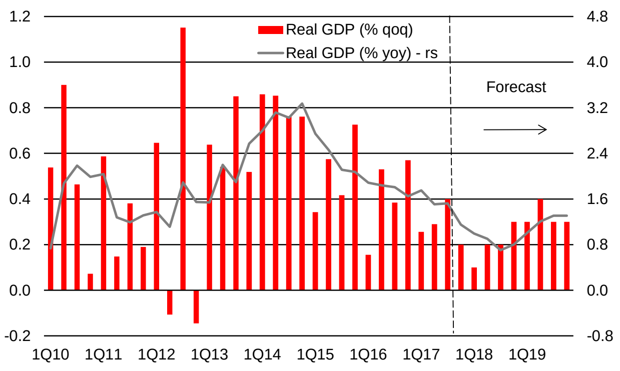
Inflation has probably peaked

Inflation probably peaked in late 2017 and will fall materially in 2018 towards the 2% target as the upward effect from past sterling depreciation starts to fade. Importantly, we do not expect domestically-generated inflationary pressure to materially pick up. Despite little or no labor market slack, wage growth has been weak, even after accounting for the weakness in productivity growth. It suggests the sensitivity of wage growth to labor market slack has reduced, perhaps due to heightened uncertainty recently and this is likely to persist.

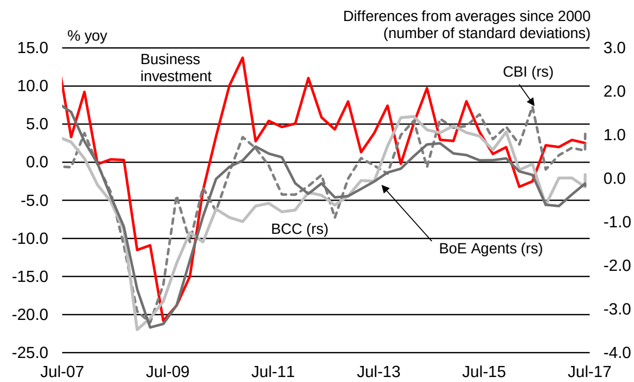
The MPC is likely to remain on hold throughout 2018

The MPC raised the bank rate by 25bp in November to 0.50% and communicated that it was happy with financial market expectations of just two 25bp hikes over the next two years. However, UK economic activity is slowing, headline inflation will fall next year, domestically-generated inflationary pressure is weak, inflation expectations are well anchored, and Brexit-related uncertainty remains high. Therefore, we expect the MPC to remain on hold in 2018 and hike just once in 2019, in 2Q19.

GDP FORECASTS



BUSINESS INVESTMENT INTENTIONS



Source: BCC, BoE, CBI, ONS, UniCredit Research

Switzerland

Stronger growth but less accommodative SNB only in 2019

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We expect the Swiss economy to grow 1.8% in 2018 and 1.6% in 2019 (2017: +0.9%; see left chart), The acceleration is especially driven by exports, but also by domestic demand. The comparatively weak performance in 2017 as a whole is largely caused by sluggish growth in the first half of the year. We expect a stronger recovery to have already materialized in the third quarter of 2017 (the corresponding growth figure will be released at the end of November).

Switzerland to benefit strongly from global trade

With a high export share of roughly two-thirds in terms of GDP, Switzerland is expected to benefit markedly from the ongoing and synchronous recovery in global trade in 2018. The encouraging outlook for the eurozone, and Germany in particular, bodes well for Swiss companies, given strong trade links. Furthermore, recent CHF depreciation on a trade-weighted basis has been boosting the competitiveness of Swiss exporters. As a result, leading indicators such as the KOF and the Manufacturing PMI have gone up further in the last few months from already high levels.

Recovery in domestic demand

The improving external environment should increasingly spill over to domestic demand. Especially capex spending of companies is expected to rise briskly after capacity utilization already jumped in the second quarter of 2017 (latest available figure). Private consumer expenditures and housing activity are likely to be supported by a significant rise in employment and sustained population growth thanks to immigration.

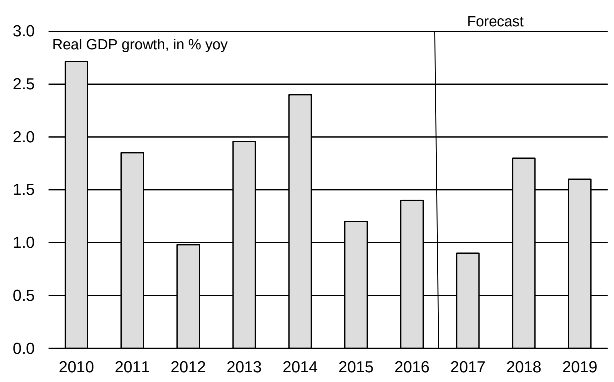
Gradual rise in inflation

We expect inflation to rise gradually to 0.9% in 2018 and 1.3% in 2019 (2017: +0.5%). Major drivers will be the rise in the Brent oil price (in the short term), depreciation of the Swiss franc, rising prices in trade-partner countries and an absorption of spare capacity domestically.

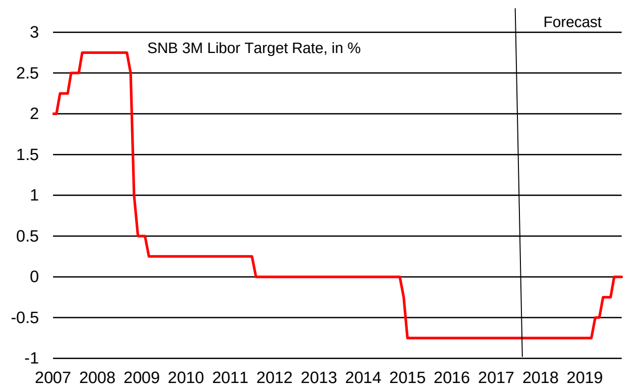
Some monetary policy normalization in 2019

As a small, open economy, Swiss monetary policy is highly dependent on the leading central banks, especially the ECB. Accordingly, the SNB is likely to remain on hold in 2018, in line with the recent announcement of “dovish tapering” by the ECB. The SNB will also almost certainly continue to state its willingness to intervene in FX markets until both growth and inflation are on a sustainably firmer footing. We think that there will be a first rate hike by 25bp to minus 0.5% in the second quarter of 2019 (see right chart). And we expect two additional rate hikes of 25bp each to a level of 0% by year-end 2019.

OUR GROWTH FORECASTS AT A GLANCE



SNB: SOME NORMALIZATION ONLY TO COME IN 2019



Source: Bloomberg, UniCredit Research

Sweden & Norway

Firmer growth, monetary tightening is getting closer

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The Swedish economy is likely to continue growing nicely and above its potential in 2018, with real GDP growing by about 3.0%, the same pace as in 2017. The main drivers will likely be the expansionary fiscal and monetary policy at home, the cyclical and broad-based recovery in capex in advanced economies, mainly in the euro area and the US and the acceleration of GDP growth in emerging markets. Favorable developments in key export markets are forecast to lead to an upturn in Swedish exports and capex. However, being Sweden a country strongly exposed to trade and dependent on international developments, this bright outlook has some lingering risks related to global developments (see the section on global growth).

GDP to increase by about 3% in 2018 and to ease somewhat in 2019

In 2019, in line with other advanced economies, GDP growth in Sweden is expected to slow to 2.5%. Some tightening in both fiscal and monetary policy, a deceleration in housing investment and some weakening in global trade are likely to be the main drivers.

Inflation close to 2%: policy normalization to start in 4Q18

On the back of the strong growth outlook and our projections for core inflation to stabilize at around 2%, we expect the Riksbank to remain on hold for most of 2018 and to continue to closely monitor the ECB's next steps and SEK developments in FX markets. However, the Swedish central bank has been carefully weighing up risks related to financial stability, and we think that monetary policy normalization will start in 4Q18. The repo rate will then probably be raised by 25bp each quarter, until it reaches 0.50% in 3Q19.

Norway: firmer GDP in 2018, slowdown in 2019

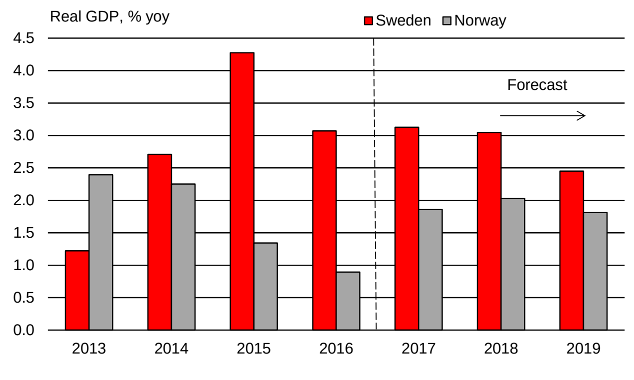
The Norwegian economy is recovering from the low GDP growth seen in 2016, which was caused by the severe contraction in oil investment. The driving forces behind the recovery is the steady process of enterprises adjusting to lower energy prices, the ongoing transition towards a less oil-dependent economy and the supportive monetary and fiscal policies. The mainland economy is likely to expand by 2.0% in 2018 (from 1.9% in 2017), while the projected growth rate for overall GDP is 1.6% (from 1.5%).

During 2019, in line with other advanced economies, both mainland and overall GDP growth are expected to ease somewhat, to 1.8% and 1.6% respectively. As in Sweden, some tightening in both fiscal and monetary policy at home, lower global trade and a decrease in housing investment are the reasons for the expected slowdown.

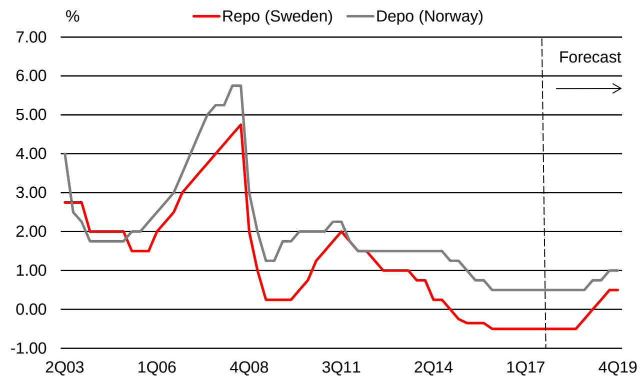
Norges Bank on hold until end-2018; two hikes in 2019

On the back of low core inflation, Norges Bank will probably keep monetary policy unchanged until the end of 2018. In 2019, with CPI-ATE likely to rise closer, but below the 2.5% target, two 25bp hikes are on the table. We expect them to occur in 1Q19 and 3Q19, soon after the Riksbank raises rates.

OUR GDP FORECASTS



HIKING CYCLE TO BEGIN TOWARDS THE END OF 2018



Source: Norges Bank, Riksbank, Statistics Norway, Statistics Sweden, UniCredit Research

CEE Region

The party goes on

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The exceptionally favorable external backdrop has provided a major boost to CEE; in terms of growth, 2017 is set to be the region's best year for a decade. Economic growth has not only accelerated, but has also become more synchronized, with all countries in the region now growing, for the first time since 2007. Activity has gained traction everywhere except for Serbia and Ukraine, where the strong external impetus has been partly offset by supply-side shocks.

We expect solid growth to be largely sustained in 2018

We expect growth momentum to be largely sustained in 2018, with a modest slowdown due to policy tightening in a few countries in order to avoid overheating. However, in 2019 we expect a broader moderation in growth due to the expected global slowdown, tighter monetary conditions and, for the region's EU members, lower EU transfers. Even so, growth across CEE should remain well above potential and above that of most other EM (see charts below).

CEE-EU countries outperform

While everybody has benefitted from the global environment, the magnitude of the gains has varied across countries. CEE-EU countries have done better than the rest of the region, resulting in faster and more balanced growth, an absence of macroeconomic imbalances, and greater resilience to external shocks. In 2017, growth in the CEE-EU countries will likely peak at 4.6%, the fastest pace since 2007, before ebbing to a still solid 4.0% in 2018 and easing to 3.5% in 2019.

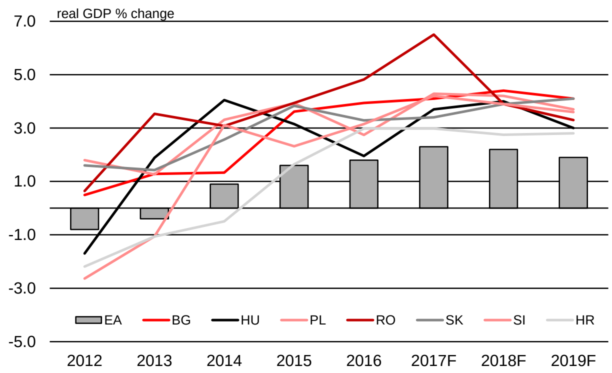
The EU members have performed the best in CEE thanks to several factors: First, the rebound in Europe and in global trade has benefitted them the most thanks to their trade openness and close integration into the global production chains. Second, the CEE-EU countries have been able to utilize to the fullest the policy space afforded by the accommodative global environment. Monetary policy has been kept lax with interest rates at record lows, while buoyant revenues upheld by above-potential growth have left space for significant easing without jeopardizing fiscal balances. Third, increased EU fund absorption has provided a powerful boost to public investment and growth, especially in the countries with the best EU absorption, such as Hungary and Poland.

This said, growth through 2019 in CEE-EU countries will remain well above potential, estimated at 2.5-3%. Several years of strong growth have opened positive output gaps in all CEE-EU countries, with the Czech Republic, Romania and Hungary having the largest deviations. The result has been sharply tightening labor markets, gradually rising core inflation and, in the case of Romania, a widening C/A deficit.

While the strong euro and low imported inflation should keep headline inflation broadly in check, in the Czech Republic and Romania inflation will remain above central bank targets and exceed the target temporarily in Hungary arguing for a policy response (see charts on next page).

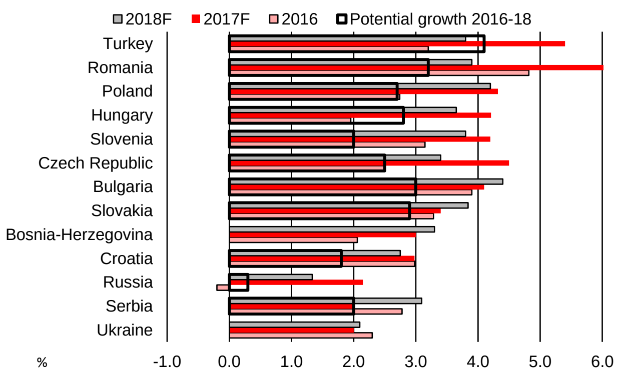
STRONG SYNCHRONIZED EXPANSION IN CEE…

The growth outlook for CEE remains robust…



…WELL ABOVE POTENTIAL

…with growth rates well above potential



Source: Statistical Offices, Haver, UniCredit Research

Central banks: policy responses will vary

Policy responses will vary, however. The Czech central bank, facing the tightest labor market by far, already raised its policy rate by 50bp in 2017 with another 100bp likely in 2018. Romania will follow suit in 2018 with a total of 75bp worth of hikes. In Hungary, by contrast, the central bank will look through the rise in inflation in an effort to contain the persistent appreciation pressure stemming from the structurally large C/A surplus. In Poland, we expect no change in interest rates in 2018, with inflation still in check thanks to the influx of foreign workers that have helped to ease labor market pressures a bit. Irrespective of the expected hikes, monetary policies are set to remain accommodative, with real policy rates staying negative due to the rise in inflation.

Diminished scope for fiscal easing

Similarly, the robust growth ought to provide some scope for fiscal accommodation in most countries in 2018 – but less so in 2019. Among the CEE-EU, Romania alone would need to tighten fiscal policy the most in 2018 to prevent the deficit from breaching the 3% of GDP threshold and triggering the EC's Excessive Deficit Procedure. More broadly, significant fiscal adjustment will be needed to offset some of the massive easing of recent years and prevent the further widening of the C/A deficit, which, at around 4% of GDP, will be the largest in CEE-EU in 2018. Hungary and Slovakia look likely to tighten fiscal stance as well.

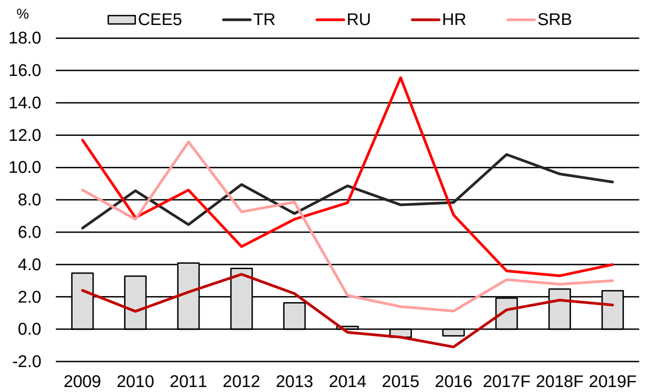
Massive policy stimulus provided a short-term boost to growth in Turkey

Outside Central Europe, the strongest growth in 2017 is likely to have been in Turkey, with real GDP increasing 5.5%, the second highest in CEE after Romania. While growth has also benefitted from the rebound in EU demand (and the normalization in trade relations with Russia), domestic demand remains the key driver, with a fiscally-supported surge in consumption complemented by a jump in government-guaranteed bank lending. With scope for policy stimulus more limited next year as the authorities balance the desire to boost growth ahead of the 2019 presidential and parliamentary elections and the need to preserve financial stability, global liquidity tighter, and with the favorable base effects gone, we expect a marked slowdown in growth in 2018 and 2019, to 3.8% and 3.5%, respectively, in line with potential.

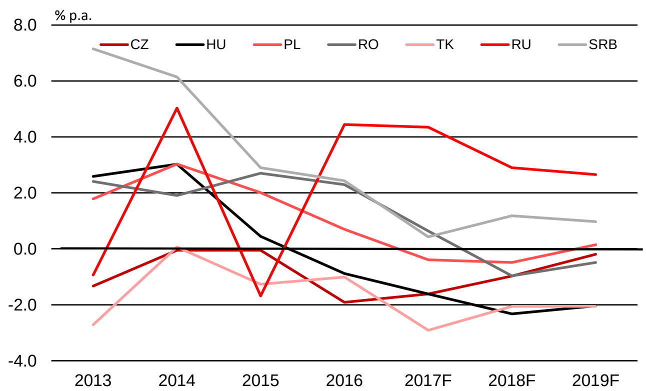
However, the large policy stimulus has led to a marked increase in macroeconomic imbalances. The TRY remains under persistent downward pressure and Turkish government bonds have underperformed their EM peers. Inflation remains stuck in the double digits and is unlikely to ease anywhere near the target in the foreseeable future, with the CBRT torn between demands from politicians to support growth and the need to sustain financial stability, reluctant to act decisively. Still, with inflation well above target, the TRY weak and global liquidity set to tighten, the CBRT has no choice but to keep interest rates on hold at least until 2Q18, with some scope for a slight easing afterwards, but only if exchange rate pressure eases.

INFLATION RISING BUT MOSTLY UNDER CONTROL

Low imported inflation to keep reflation in check…



…keeping interest rates mostly negative despite rate hikes



Source: Ministries of finance, Eurostat, UniCredit Research

With a large C/A deficit, Turkey is the most vulnerable in CEE to shifts in sentiment

More worrisome is that the rise in inflation has been accompanied by a marked widening in the C/A deficit, to perhaps 5.4% of GDP in 2017 from 3.8% in 2016, and is likely to approach 6% in 2018-19. While most of this year's widening reflects terms-of-trade losses caused by the rise in oil prices, the underlying C/A deficit has remained little changed at around 7% of GDP. This deficit, which is mostly structural and reflects the large savings-investment gap, has been exacerbated by the recent large policy stimulus and presents a serious potential risk to financial stability (see charts below).

Consequently, Turkey is the only country in CEE with sizable external vulnerabilities. While the C/A deficit has been widening, capital inflows have been declining since 2015 and are now insufficient to cover the deficit, resulting in a steady drawdown of FX reserves since the start of 2017. Moreover, some 80% of the net financing through September 2017 came from volatile portfolio inflows, mostly reflecting foreign purchases of Turkish TRY government bonds, driven by the large carry and the global hunt for yield. With reserves at a post-crisis low in net terms, Turkey's vulnerability to even slight shifts in market sentiment is high and rising as global liquidity tightens.

In Russia, we expect the further easing of monetary policy to be modest through 2018…

In Russia, by contrast, economic policies have been geared towards disinflation. In this respect, the CBR has excelled, succeeding in halving inflation from a year ago to 2.7% in October 2017. While some of this decline reflects one-off and temporary factors, as well as firmer oil prices, most of the credit goes to the CBR, which has maintained one of the tightest monetary stances in the world with a real policy rate of 6.5%. Still, the CBR remains cautious, citing elevated inflation expectations and the fledging recovery as potential risks. We expect the pace of further policy-rate cuts to be cautious, with the terminal rate of 6.5% unlikely to be reached before early 2019.

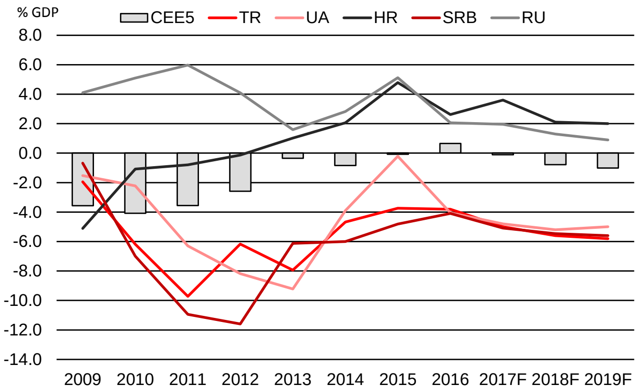
..and to be still upheld by prudent fiscal policy

Unlike Turkey, the CBR's tight monetary stance has been supported by prudent fiscal policies. Despite higher-than-budgeted oil prices and the presidential election in March 2018, the headline deficit has been cut significantly both relative to 2016 and the budget, leaving the underlying stance largely neutral in 2017. While we expect some easing in early 2018, the fiscal stance looks likely to remain prudent, underpinned in part by a new, tougher fiscal rule.

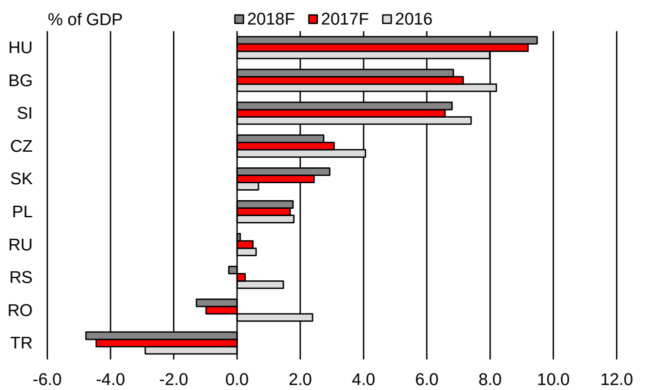
Despite headwinds from the CBR's very tight monetary stance, US sanctions, and no support from fiscal policy, growth has returned to Russia in 2017. Buoyed by a recovery in consumption afforded by a drop in inflation and RUB stability as well as stepped-up investment by state-owned energy, real GDP is likely to grow at around 2% in 2017. The rise in oil prices has played a role, too, but perhaps less so than in the past, with the economy now having mostly adjusted to lower oil prices.

EXTERNAL POSITIONS MOSTLY SOLID EXCEPT FOR TURKEY

Current accounts mostly in balance or in surplus...



...with extended basic balances in surplus except in Turkey, Romania



Source: Central banks, national statistical institutes, UniCredit Research

In 2018-19 and beyond, widespread structural rigidities will weigh on Russian growth

The outlook looks less promising, however. Despite the favorable global outlook and firmer oil prices, we expect growth to ease to 1.7% in 2018 and 1.5% in 2019, with the cyclical pickup running its course and demand increasingly shifting to imports. Even so, these growth rates will remain above Russia's greatly diminished potential. Given significant structural rigidities and increasing supply-side constraints, Russia could face secular stagnation over the medium term, with potential growth at less than 1%, in the absence of major reforms.

Despite the poor growth outlook, Russia looks resilient to global shocks, with the C/A in moderate surplus and capital inflows on the rise amid a still-attractive carry trade and an improving economy. With FX reserves ample and principal repayments modest, Russia's external position is solid, with the odds of financial markets disturbance limited as long as oil prices remain above USD40/bbl. However, the possibility of a further tightening of the US sanctions will remain an important risk and source of uncertainty in the near term likely to deter investors.

Risk remains plentiful, but fewer and less disruptive

While there are still plenty of risks, there are fewer than before and with potentially less disruptive impact. Earlier concerns about the future of the EU related to the election cycle in Western Europe and Brexit have mostly faded. At the same time, disagreements between some CEE EU members and the EU, most notably on migrant quotas, are somewhat overblown (and chiefly addressed to a domestic audience), with none of the CEE EU members able to afford a split given their strong dependence on EU funds for investment and EU markets for exports.

In particular, new geopolitical risks have emerged

However, new geopolitical risks have emerged, with the recent rise in tensions in the Middle East the biggest potential problem. While for most of CEE the spillover from an eventual escalation of tensions between Saudi Arabia and Iran would mostly be limited to a rise in oil prices and the impact on global trade, for Turkey the consequences could be much more severe given its proximity to the region and extensive economic and political ties with both adversaries.

Turkey is most vulnerable if market sentiment shifts

Turkey is also most vulnerable in the region to a potential shift in market sentiment. These risks are likely to build up going into 2018 as the Fed continues reducing its balance sheet and proceeds with the rate hikes. If the shift in risk appetite results in a reversal or halt of portfolio inflows, a major financial disturbance cannot be ruled out, with steep TRY depreciation, a jump in interest rates, and eventually a deep recession.

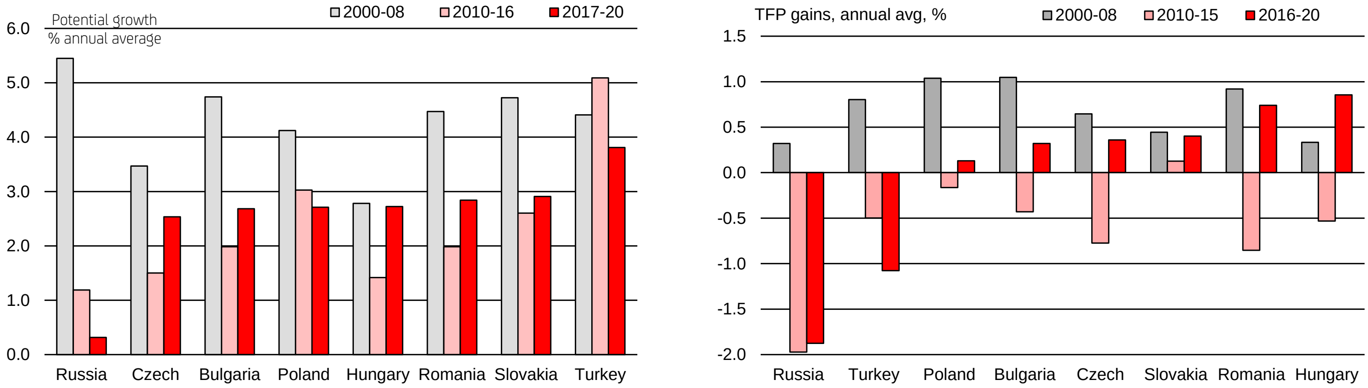
Policy complacency has become the main issue

Domestically, policy complacency has moved center stage. Afforded in part by the very favorable external environment and strong growth, structural reforms have been put on hold and a number of countries have embarked on spending sprees and populist policies.

POTENTIAL GROWTH HAS YET TO RECOVER, PRODUCTIVITY STILL LOW

Potential growth remains lower than before the crisis…

…with productivity gains lagging



Source: UniCredit Research

While this trend is visible in most of Central Europe, it has been particularly strong in Romania, and Turkey. While the favorable external environment is likely to prevent major problems in the former two, such policies would reinforce medium-term headwinds to growth posed by the low potential growth and productivity, delaying the convergence of incomes to those in the rest of the EU (see charts above).

China

Set for a slowdown

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We expect GDP growth to slow from 6.8% to 6.5% in 2018 and to 6.0% in 2019. The slowdown will be primarily driven by the normalization process that is taking place in the property market as a result of home-purchase restrictions and tighter conditions for mortgages, and by a less buoyant global trade in 2019. On the expenditure side, private consumption will likely hold up well thanks to rising real incomes, while the fiscal stimulus (corporate tax cuts and public investments) that was adopted ahead of the Nineteenth National Congress of the Communist Party to maintain growth momentum will likely be reined in. Although Beijing is set to be more selective in picking the projects to invest in, regional development initiatives like the Belt and Road and the Beijing-Hebei-Tianjin Corridor will largely remain unaffected by the tightening of the purse strings given their strategic importance. Real estate investment, which in several cities has grown faster than demand, is expected to cool gradually as targeted macro-prudential measures to limit speculative excesses start to bite. On the trade front, Chinese exports should remain supported by a bright global outlook and a weaker currency.

Socialism with Chinese characteristics

The slowdown will also come from Beijing's strategic shift from short to long-term economic goals. The power consolidation of President Xi marks the beginning of a new stage in China's development: slower growth, but of better quality. During his speech at the Congress, he deemphasized the role of GDP growth, never referring to the 6.5% annual target, and outlined his idea of "socialism with Chinese characteristics", which is centered around three pillars: **1.** better income distribution between regions through regional infrastructures; **2.** more emphasis on industrial and technological innovation through a stronger role of the private sector and the clean-up of SOEs; **3.** stronger focus on quality-of-life metrics like environmental protection, the provision of basic public services and a fight against speculation in the housing market.

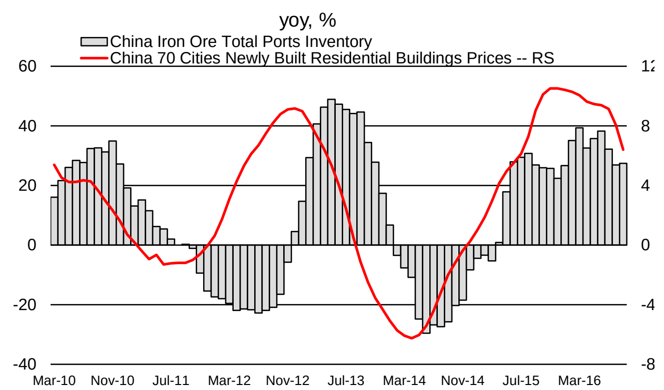
Monetary-policy settings to remain unchanged given still-subdued CPI

With CPI inflation probably staying around 2%, the PBoC will likely focus on financial stability through ad-hoc measures like lending quotas or tighter interbank market regulation. Over our forecasting horizon, we see the lending rate remaining at 4.35% and the RRR stable at 17%.

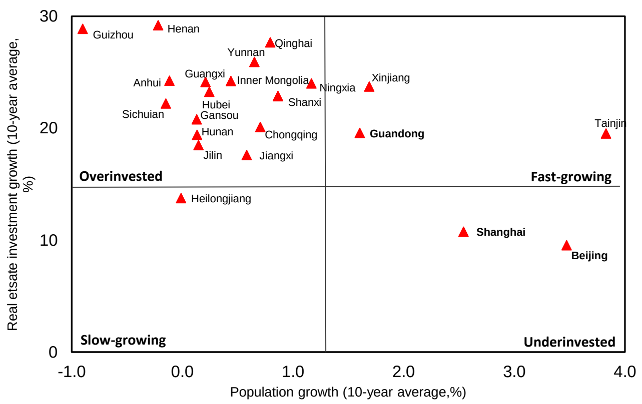
Cautious policy on capital-account and FX reform is likely to remain in place

The PBoC's governor, Zhou Xiaochuan, has recently made references to rising financial risks in China. These seem to signal a much stronger requirement for deleveraging (than what has already been seen) and the need to push strongly ahead with capital-account and FX reform. However, with his tenure ending soon, we do not expect drastic changes in the quarters ahead. More importantly, ongoing de-leveraging and pressure on assets (including housing) will require more capital to be kept onshore. Hence, authorities are likely to keep tight controls on the capital account, encouraging more flexibility on inflows (incurrence of financial liabilities) rather than on outflows (incurrence of assets abroad). This should ensure a more gradual CNY depreciation path against the USD, and we forecast 6.70 and 6.75 by the end of 2018 and 2019 respectively.

THE REAL ESTATE SECTOR IS SLOWING



HUGE REGIONAL VARIATION IN HOUSING ACTIVITY



Source: NBS, IMF, UniCredit Research

Cross Asset Strategy

Risky assets have more upside

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- Solid global growth, still-supportive monetary policy and late-cycle asset rotation from fixed income to stocks suggest that the recent risky assets rally will extend into 1H18. Stretched valuations however warrant caution. We prefer euro area and EM equities to US ones.
- Fixed income will likely struggle to deliver positive returns in 2018, but the hunt for yield is not over and EM bonds are best positioned to benefit from this.
- Commodities might surprise thanks to rising demand for industrial metals.

OUR VIEW AT A GLANCE

Equities			Core bonds					
US equities	**EA equities**	**EM equities**	**US bonds**	**EU core bonds**	**EU Credit**	**EM bonds**	**Commodities**	**Cash**
▽▽◆△△	▽▽◇▲▲	▽▽◇▲△	▼▼◇△△	▼▼◇△△	▽▼◇△△	▽▽◇▲△	▽▽◇▲△	▽▽◆△△

Underweight ▼▼ Neutral ◆ Overweight ▲▲

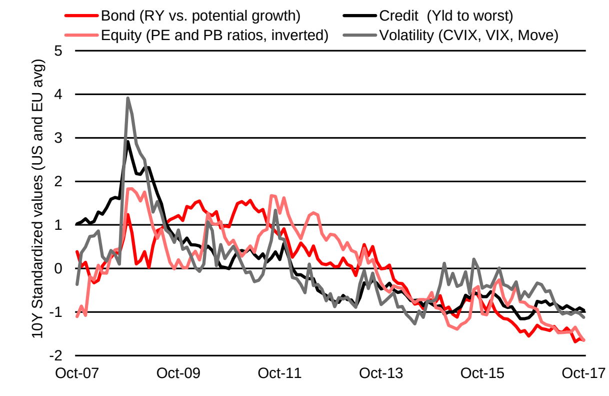
Source: UniCredit Research

It has been a great year for equities, the MSCI World Index has returned 18% YTD, its best performance in four years. Meanwhile, fixed income in developed markets has managed to stay afloat overall. EM equities (32%) and EM hard-currency bonds (8%) have fared especially well. The Bloomberg commodity index fell slightly; the rally in metals nearly offset the negative returns of the agriculture and energy sub-indices. We are approaching 2018 with very high equity valuations (in the US, more than in the EU and EM), with bonds yields not too far from record lows and with credit spreads extremely tight. A strong macro backdrop, still-accommodative monetary policy and abundant liquidity should further support risky assets and possibly commodities into 1H18, while fixed income will struggle to deliver positive returns. However, as the market starts pricing in a higher probability of a US slowdown in 2019, uncertainty will rise. We forecast sideway moves for risky assets starting from 2H18.

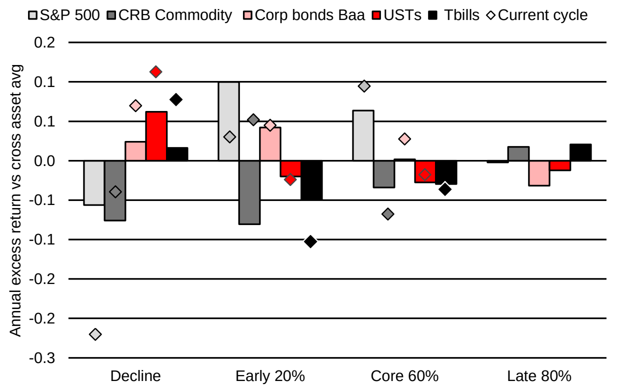
A synthesis of recent market moves

By running principal-component analysis (a statistical technique used to reduce a large dataset into fewer uncorrelated variables capturing most of variability in the overall set) on 175 asset returns, we singled out the three most significant market trends for 2017: **1.** the rally in global equities, backed by improving growth prospects (especially in the euro area); **2.** commodities recovery in 2H17 after a weak 1H17, and **3.** the sideway moves in Bund yields, breaking their correlation with risk-aversion measures (e.g. JPY, gold) but remaining the main driver of EUR-denominated fixed-income assets. Are the trends here to stay?

A RICH ASSET UNIVERSE



CYCLICAL PERFORMANCE (US, 1954-2017)



Source: Haver, Thomson Datastream, Bloomberg, UniCredit Research

Which assets are best positioned to benefit from a mature economic cycle?

It is not uncommon to see equities outperforming in a relatively mature stage of the economic cycle. This is what we found when studying assets performance across US cycles for the past sixty years[2]. In spite of historically high valuation, late-cycle portfolio rotation should benefit equities further. The right chart on the previous page displays the over- or under performance of the considered assets compared to the average performance of all assets during each stage of the economic cycle. We found that cash and government bonds offer the best hedges during a downturn, as they benefit from the easing of monetary policy. As growth picks up, credit performance improves, and, progressively, equities benefit as well. When the cycle is mature, and the economy runs above potential, equities and commodities outperform. Finally, as growth slows down and markets start anticipating a downturn, equities begin to weaken (with nearly twelve months lead). Currently, the US economy is growing at about potential and is arguably in the late stage of one of the longest economic cycle since 1950s. Based on cyclical patterns, equities and commodities should still be preferred to fixed income, at least as long as the chances of there being a growth slowdown in the next 12 months remain low.

Reconciling cyclical performance with recent market trends

Asset-performance rotation across the cycle needs to be reconciled with the recent market trends, in light of the current macro and policy outlook. Business confidence indicators stand at very high level in the US and in the euro area and have shown no material sign of slowing down. At the same time, EM PMIs are moving north. Monetary policy remains supportive and liquidity very abundant, even though, at the margin, central-bank support is diminishing. The ECB's balance sheet will continue to expand throughout 2018 but at a slower pace than in the past. In the US, the Fed has started to reduce its balance-sheet. On the official rates front, risks of a hawkish surprise in the euro area appear limited, while Fed rate hikes will likely be gradual and unlikely to weigh on risk appetite significantly. All in all, monetary policy should continue to provide a tailwind for global markets, albeit less than it did in 2017. The strong macro backdrop and still-abundant liquidity have put a lid on global risk-aversion measures, which price in very little uncertainty. This leaves the market exposed to unexpected geopolitical or economic developments.

We prefer stocks to bonds and suggest adding some selected commodities

Solid global growth, still-supportive monetary policy and late-cycle asset rotation from fixed income to equities suggest that the recent rally among risky assets will extend into 1H18. Stretched valuations however warrant caution. In this respect, we see more upside among euro-area and EM equities. In spite of limited inflationary pressure, fixed income will likely struggle to deliver positive returns in 2018. Term premia are historically low, and rates are expected to rise (albeit moderately) from low levels. Cyclical analyses suggest the best days for credits are likely over. Low carry levels, especially in the euro area, where credit spreads trade at historical lows, are set to heighten corporate-bonds' correlation with risk-free rates. Investors will likely keep on seeking unexploited pockets of carry, which would benefit EM bonds. Commodities have performed well historically in the late stage of the cycle. Global demand composition is shifting from consumption to investment, and the expected increase in capex spending should be supportive of industrial metals.

Risks

A few significant risks factors might weigh on risk appetite over the course of 2018. Our baseline scenario already envisages a growth slowdown in the US in 2019, which might start to weigh on the performance of global equities from 2H18. The prospect of increased protectionism in the US and the high corporate debt in China are two additional economic risks that need to be watched closely due to their global spillover potential. An escalation in geopolitical tensions in the Middle East and/or in North Korea would be particularly disruptive. Increased geopolitical uncertainty would benefit energy and precious metals, with the latter having more upside based on current levels.

2 The cyclical analysis is part of our cross asset toolbox. We will describe it in more detail in a separate research note to be published in the near future.

FI Strategy

US: we expect 10Y USTs to rise towards 2.75% by summer 2018 while the curve continues to flatten

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- We expect 10Y USTs to peak around 2.75% during 2018. The momentum towards higher yields is most likely driven by an increase in 10Y BEI slightly above 2% with the 10Y real yield anchored at 0.5%.
- Curve-wise, we expect an upward parallel shift in early 2018 driven by improving growth, reduction of the Fed's balance sheet and increasing late-cycle inflation. However, flattening remains the dominating story as the year progresses, front-running a growth slowdown in 2019.
- 10Y swap spreads are expected to stay within a limited range of -5bp to +5bp during 2018 based on higher deficits while financial conditions are expected to remain benign.

We expect 10Y USTs to rise towards 2.75% during 2018 on the back of growth acceleration during the summer months as well as a reduction of the Fed's balance sheet. 10Y breakeven inflation rates (BEI) will, in our view, accelerate to levels slightly above 2% based on a return of inflation towards the US central bank's 2% target for core PCE after 2Q18.

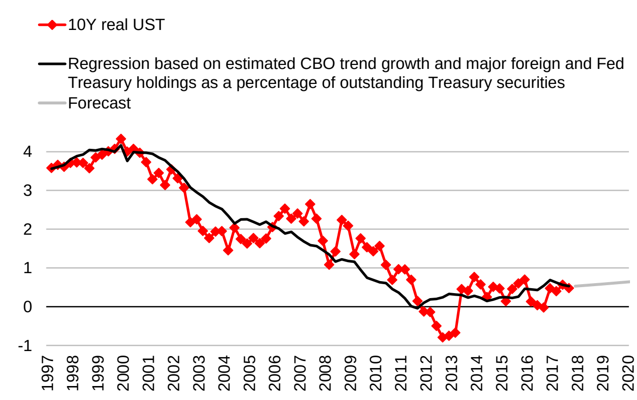
10Y real rate to increase only slowly with 0.5% still an important anchor

The 10Y real yield is likely to stay anchored around 0.5% with only a minor tendency to increase in the short term. In the left chart below, we model the 10Y real UST yield vs. the CBO estimate for potential growth, and the Fed's and major foreign holders' Treasury exposure as a percentage of marketable Treasury debt. For the past four years, 10Y real yields traded within an extremely narrow band between -0.1 and +0.8% (average 0.39%), well aligned with the model fit. With the current CBO trend growth estimate (1.7% for 2017 - 2020), we expect a stable size of major foreign holdings as a percentage of marketable Treasury debt at 40% and the size of the Fed Treasury holdings to shrink towards 12% in 2019 due to the reduction of the balance sheet. This would imply an increase in the 10Y real yield towards 0.74% by YE18 and 0.87% by YE19. For 2018, this is a reasonable estimate, and we expect the 10Y UST real rate to increase from its current level of 0.47% towards the 0.6-0.7% area. We are nevertheless skeptical regarding a further increase in 2019 when a slowdown becomes more visible with real GDP falling below potential.

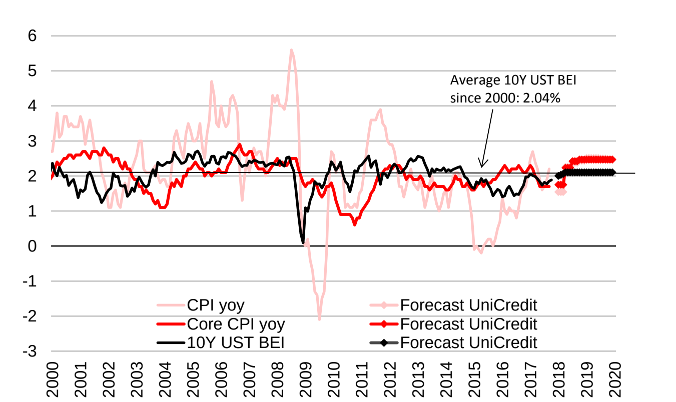
10Y BEI expected slightly above 2%

A lasting impulse for slightly higher nominal yields during 2018 comes from inflation, and we expect 10Y BEI rates to reach levels slightly above 2.0%. According to our forecast, headline and core PCE deflators will reach the 2% target in 3Q18, which is likely to move 10Y BEI

10Y REAL RATE WELL ANCHORED AROUND 0.5%, RISING ONLY SLOWLY …



… WITH 10Y BEI EXPECTED TO RISE SLIGHTLY ABOVE 2%



Source: CBO, Bloomberg, UniCredit Research slightly above 2%, albeit we do not expect the build-up of a more pronounced inflation risk premium. After years of undershooting the inflation target due to cyclical factors, declining energy prices but also secular factors such as globalization and automation, we do not expect 10Y BEI to increase much beyond 2.1% on a lasting basis, which is in line with the long-term average since 2000 at 2.04% (right chart above).

On the way to an (almost) flat curve in 2019

Regarding curve dynamics, this points to ongoing flattening with momentum gaining traction during 2H18. We expect yields at the front end of the curve to increase alongside the three rate hikes by the Fed during 2018. This implies moderate but steady flattening in the 2-10s spread, which is also much aligned with markedly slowing economic momentum in 2019 (left chart below). With the Fed tightening one more time in 2019 but the long end already reflecting the growth slowdown, the flattening may gain further traction throughout 2019. With the key rate at 2.50%, we see a good chance that, at some point during the latter part of 2019, the curve is almost completely flat. Our YE19 target is at 10bp compared to a two-year forward at 42bp. For the 10-30s spread, we see no impulses to decouple from the 2-10s momentum. This implies further flattening, with the momentum starting to accelerate later in 2018 and reaching a level around 20bp late in 2019 compared to the two-year forward around 28bp.

10Y swap spread to stay within a limited range

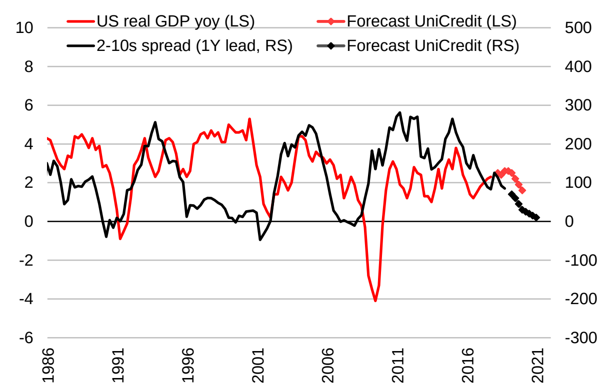
After trading within a narrow range between -10bp and 0bp for most of 2017, we expect the 10Y swap spread to trade within a tight range. Foreign official holdings increased during 2017, a trend that is likely to continue and put pressure towards higher spreads while the increase in the US budget may work in the opposite direction. As we do not expect acceleration in risk aversion or a severe worsening in financial conditions in 2018, our base case is for a range between -5 and +5bp.

Risk balance tilted towards the left tail

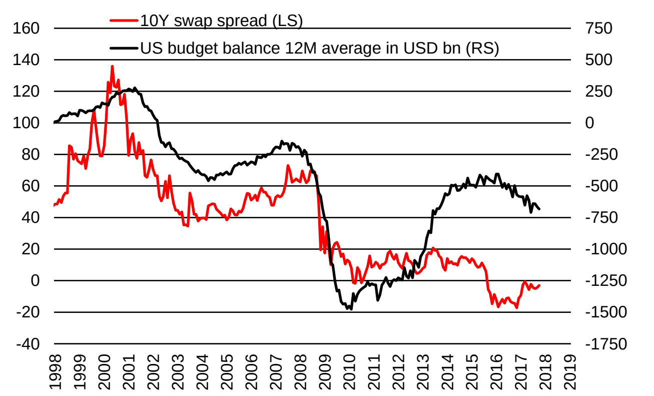
As is always the case, the balance of risk contains both left and right tails, with the majority currently skewed towards the left tail. As stated in the global overview, the main risks are primarily centered on geopolitical tensions in the Middle East but also North Korea. In this case, flight-to-quality bids into US-Treasuries as well as delayed rate hikes by the Fed may keep the curve at or below current levels with the 10Y UST, depending on the severity of the crisis, touching 2% again.

As a right tail risk, we may underestimate BEI rising sharply above 2% as core inflation accelerates towards 2.5% during 3Q18, which – combined with an increase in the 10Y real rate to 0.7% – leads to an increase in the nominal 10Y UST above 3% as the Fed will not accelerate its tightening. Coupled with a higher US deficit due to US tax reform, one may see the return of the “bond vigilantes”. This is also one of the rare scenarios under which we see the likelihood of a bear-steepening of the US curve.

THIS TIME IS NOT DIFFERENT: US CURVE DYNAMIC PRETTY MUCH IN LINE WITH FORMER CYCLES



10Y SWAP SPREAD TO STAY WITHIN A NARROW RANGE BETWEEN –5 AND +5BP



Source: Bloomberg, UniCredit Research

Eurozone: lower QE pressure to unlock yield rise

- We expect the 10Y Bund yield to rise to 0.80% and the 10Y swap to 1.20% by the end of 2018. As pressure from the ECB's QE program recedes, the upward move should be primarily driven by an increase in real yields. Some spillover from the US market should also help. Breakeven inflation is unlikely to rise meaningfully given the tame inflation outlook.
- The short end should be anchored by high excess liquidity in early 2018, with a rise in swap and OIS rates only once ECB hikes come into focus. We expect 2Y swap rates of 0.05% at the end of 2018, reflecting a modest cheapening of the Schatz/swap spread.
- 2018 should remain supportive for core-periphery spreads given the ECB's forward guidance. Investor's appetite for periphery bonds should also be driven by their substantially higher carry compared to that of core bonds.

A brief recap of 2017: 10Y yields slightly up and modest curve steepening

In the eurozone, rates have moved broadly sideways and within narrow ranges in 2017: the 10Y swap is currently around 20bp higher than at the beginning of the year. The 2Y swap has declined modestly and is currently trading at -0.20%. As a result, the 2/10Y has steepened modestly and currently trades at around 100bp. The German curve has mostly mirrored the swap curve: the 10Y Bund has traded in an (historically) narrow 45bp range. The 2Y Schatz has shown a high level of volatility and currently trades at -0.75%, 55bp through swap.

Inflation expectations have remained weak

Breakeven inflation has fallen in the first part of the year and recovered afterwards. The 10Y German BE trades at around 125bp, in line with the beginning of the year. The 5Y5Y forward inflation trades at 170bp, slightly lower than at the start of the year and roughly unchanged compared to when QE begun. Accordingly, real long-term yields have stayed deeply negative.

Yield spread vs. Bunds have tightened

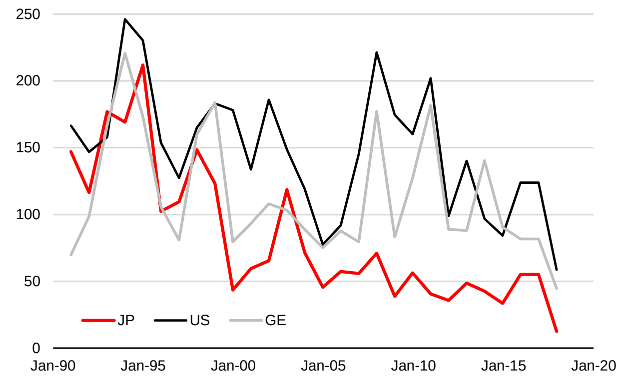
EGB spreads vs. Bunds have tightened significantly reflecting the improved political situation in the eurozone. YTD, total returns clearly show that the low yield level (negative for short tenors) of eurozone core bonds has turned into losses, even with an only minor rise in yields, while carry trades have been profitable.

Yields in 2018: the tricky triangle at work

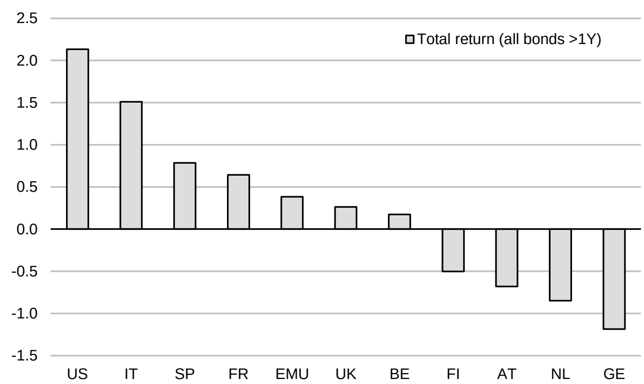
When looking at 2018, eurozone bond markets will remain pushed and pulled by three different forces: strong economic fundamentals, political uncertainty and monetary policy. In a nutshell, with the downward pressure on yields exerted by QE diminishing significantly, real yields should better align with the sound growth environment. BEs are unlikely to rise meaningfully given the tame inflation outlook.

Combining the two impulses, we expect a modest rise in nominal long-term yields, mostly driven by the real side component. We think the 10Y Bund yield will rise towards 0.80% and the 10Y swap towards 1.20% by the end of 2018.

10Y YIELDS YEARLY RANGE: DWINDLING VOLATILITY



YTD RETURNS



Source: Bloomberg, UniCredit Research

In 2019, we see case for a further modest rise in the long-end, coming mainly from higher real yields. That further real yield normalization can occur in 2019 is an extremely uncertain forecast given that we expect US yields to start correcting downward due to slowing GDP growth.

Why we expect yield to rise modestly in 2018

Persistently low Bund yields at present indicate complacency on the effect that fading ECB demand will have. Here are the main reasons why we expect (core) yields to rise in 2018.

The ECB will buy less!

The most important one is that downward pressure exerted by QE will drop dramatically. In gross terms, APP purchases will shrink from EUR 780bn to about EUR 300bn. We estimate that this equals a decline in the notional amount of PSPP purchases from EUR 570bn to EUR 180bn (a bit more if, as we expect, QE purchases do not end abruptly after September). This will be a larger decline than that of net supply in the eurozone, which we expect to shrink by around EUR 30bn to around EUR 180bn. As a result, net supply after QE in 2018 will be zero or positive for most issuers. With downward pressure from QE diminishing, real yields will have more room to slowly realign with growth.

The reduction in PSPP flows should already be felt in 1Q18, when we project a highly positive amount of net supply in the eurozone (around EUR 85bn) at the same time as ECB net purchases will fall. And as we approach the end of the year, markets will have to adjust further to a world with no ECB net buying.

Sound growth to lift real yields

We also expect upward pressure on yields from the growth environment. Real GDP growth in the eurozone has accelerated in 2017 and we expect it to consolidate at 2.3% in 2018. This should put some pressure on real long-term yields, which currently trade deeply negative. As the eurozone bond market (and especially Germany) has been heavily affected by QE, we prefer to use the (real) swap curve to assess the level of real yields. The 10Y real swap rate currently trades at -0.65%, a level highlighting a misalignment of around 50bp relative to measures of economic strength such as potential GDP growth. Our analysis indicates that 25-35% of mispricing is corrected each quarter, hence we should expect around a 30-40bp correction in real swap rates by the end of 2018.

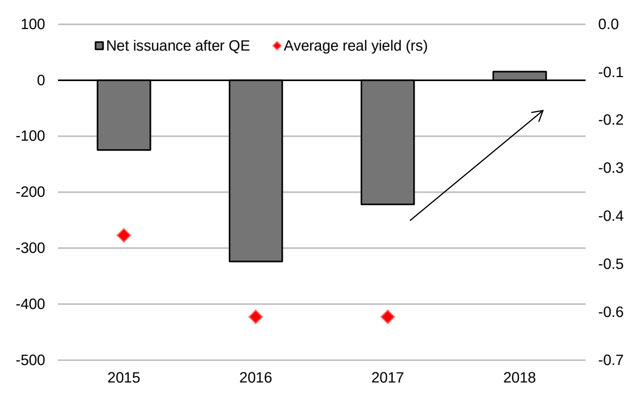
Normalization of ECB policy rates will enter the debate

As we approach the end of QE, investors will increasingly focus on policy rate normalization. As investors start contemplating that negative rates are on sunset boulevard, pressure will materialize on the negative-yielding part of the curve. The belly looks particularly exposed.

Spillover effect from the US

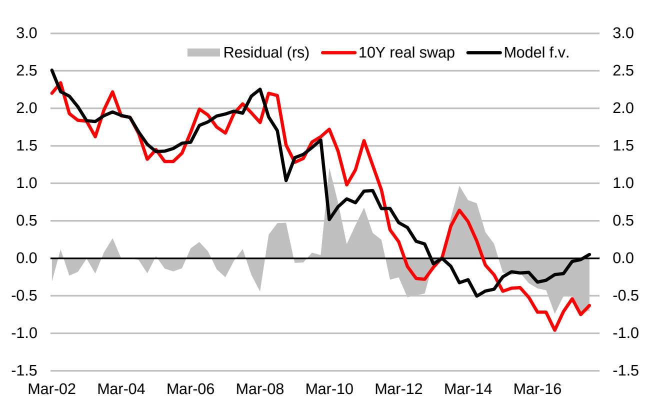
Another factor that should lead to higher yields in the eurozone is related to our expectation of a modest rise in US yields, combined with the yield spread between USTs and Bunds already being stretched. The magnitude of this effect is difficult to estimate: as the right-hand chart below shows, the correlation between 10Y yields across markets is subject to sharp changes through time. The sign, however, has always been positive.

ECB "SQUEEZE" WILL EASE TREMENDOUSLY



Net issuance after QE = gross issuance – redemptions – QE (EUR bn)

REAL 10Y SWAP RATES: CHEAP VS. GROWTH



Source: Bloomberg, UniCredit Research

Yield rise to be slow: be mindful of headwinds!

While we expect yields to move higher, it is important to take into account there are important headwinds that are likely to slow the adjustment:

First, we expect inflation to remain low in the coming two years, with the core averaging 1.2% next year and 1.4% in 2019. A low inflation environment is per se unlikely to prompt strong selling in Bunds and is also likely to keep alive investors speculation that QE will ultimately need to be extended.

The second source of headwind is specific to the German market where net supply after QE will remain negative, even if less extreme compared to this year and the previous two. We expect QE purchases of German assets to amount to around EUR 45/50bn in notional terms, higher than the EUR 15/20bn net issuance we expect from Germany (considering also the agencies that are included in the program). The imbalance, as in recent years, will be particularly large for sovereign bonds. As QE flows remain supportive, any Bund selling will require investors to increasingly focus on the flow rather than the stock implication of tapering.

The short end: upward pressure only in late 2018 when ECB hikes come into focus

We expect 2Y yields to trade sideways until ECB rate hikes come on the radar screen in late 2018. The OIS and swap curve should respond more directly while 2Y Bund yields will be heavily influenced by the swap spread dynamics. Cheapening of the Schatz/swap spread (related to lower ECB buying pressure at the short end) will be limited by still robust demand related to regulatory purposes and to the fact that high excess liquidity pushed some investors (which don't have access to the ECB deposit facility) to hold short–dated German paper. We expect the 2Y swap to end 2018 at 0.05% and the 2Y Schatz at -0.40%, reflecting a moderate cheapening vs swap. from the current -55bp to around -45bp area.

2/10Y to steepen further

Because the short-end is likely to remain pegged, our expectations for an upward correction in the long imply a further, albeit modest, steepening of the 2/10Y, particularly in the first quarters of next year.

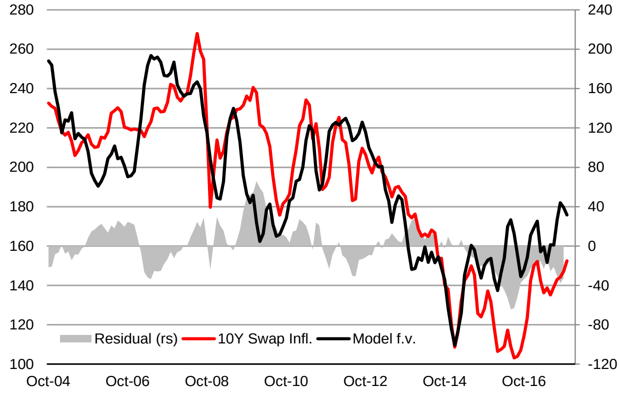
10/30Y: steep, only modest flattening in sight

The 10/30Y currently trades at 90bp, close to historical highs. This reflects a steep real yield curve (around 60bp), and here we see little case for more steepening. The 10/30Y BE spread is around 30bp and we do not see case for a steeper BE curve either. If anything, our outlook for a gradual yield normalization calls for a moderate flattening, originating from the real-yield side.

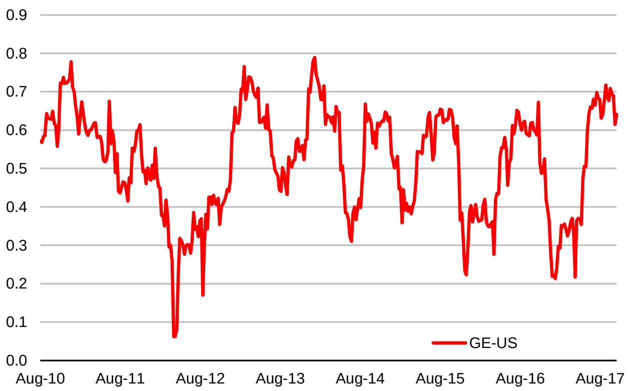
BEs: no support from inflation

Investors have become used to low inflation: market-based inflation expectations are rather low and the BE curve is pretty flat, pointing to a subdued path for forwards.

10Y BE: CHEAPNESS VS. FAIR VALUE LIKELY TO PERSIST



10Y NOMINAL YIELDS : INTERNATIONAL CORRELATION



6-months rolling correlation

Source: Bloomberg, UniCredit Research

Our fair value model for eurozone BEs indicates that the 10Y swap inflation should be trading at around 180bp, well above the market level (150bp). However, BE inflation has consistently undershot the fair value in the last two years, mainly reflecting investors' concerns about secular stagnation. Given our forecasts for only a very moderate increase in core inflation, we have no reason to expect this undershooting to be corrected in 2018.

ECB forward guidance to keep yield hunting alive

The outlook for stable ECB policy rates well into 2019 creates an environment that is supportive for carry trades. We want to issue a warning here: while the very low level of yields in core eurozone countries clearly creates an incentive to buy bonds of higher-yielding countries, the incentive to prefer credit risk relative to duration risk has become less strong during the year. As the right chart below shows, the pick-up offered by a portfolio of 5Y periphery bonds relative to a 10Y Bund has tightened to the lowest level since the start of QE.

Periphery spreads to stay supported for most of year but watch out for end of QE

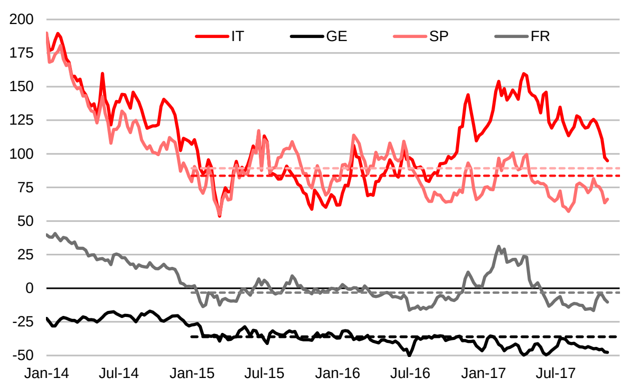
We expect sovereign-credit spreads in the eurozone to receive support from both a sound growth picture and carry trades. Support is likely to weaken in the final part of 2018 for three reasons: first, QE flows will diminish. Second (and related), with some policy-rate normalization in sight, carry trades will become less attractive. Profit taking on this potentially crowded trade is likely to put pressure on spreads. Finally, we expect growth to start to moderate in late 2018.

Politics will add to this general trend, possibly creating temporary volatility. For example, Italy's general election is likely to put some pressure on the BTP/Bund spread. But with tail scenarios less likely than in the past, investor concern should also be lower. Spanish credit spreads have been only marginally affected by the Catalonian crisis. The situation is now improving, and we see little case for bouts of volatility.

Main risks to our forecasts

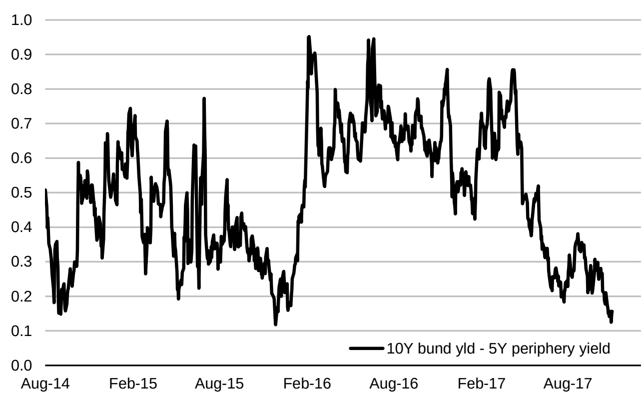
Downside risks to our forecasts are an increase in geopolitical tensions or a deterioration of growth in the US or China. In these scenarios we expect flight to quality to push 10Y core yields back towards 2017 lows. Over a longer horizon, the negative growth shock may well turn out to be supportive of the periphery, because any substantial prolongation of QE would also require a change in the program parameters. Upside risks would come from a faster-than-expected increase in inflation, which would weigh on BEs. Furthermore, an unexpected rise in inflation would prompt speculation that the ECB would have to abandon its forward guidance, with negative repercussions for credit spreads.

10Y SWAP SPREADS IN RECENT YEARS



The dotted lines show the average from Jan15 to Aug16

CREDIT SPREAD VS. DURATION RISK: AN INCREASINGLY TOUGH CHOICE



Source: Bloomberg, UniCredit Research

FX Strategy

Convergence to equilibrium – Part II

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- The downward convergence of the US dollar towards equilibrium will continue in 2018; we forecast a 5% depreciation in the trade-weighted USD.
- EUR-USD should approach fair value (1.25) by the end of next year as a result of favorable valuations, the ECB's QE tapering and a return of portfolio flows on account of solid growth and reduced political risk premiums in the euro area.

2017 has seen a (long overdue) downward correction in the USD. It has been aided by the US administration's ongoing messy handling of politics and the pickup in growth in the rest of the world, but the fact of the matter is that the greenback had long been substantially (and stubbornly) overvalued.

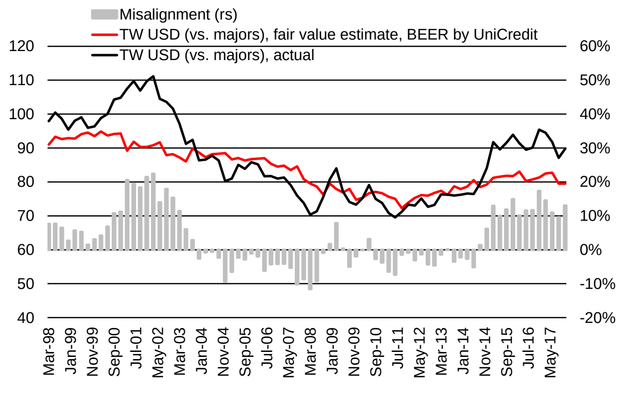
In 2018 our central scenario envisages further USD depreciation – albeit slower, as the gravitational pull of overvaluation is now weaker than it was a year ago. We expect a trade-weighted (TW) USD depreciation of around 5% for 2018. Our fair valuation framework (a combination of long and short-term fair value models) suggests that, on a TW basis, the USD is now just over 10% above the level that could be justified by fundamentals. This compares with a misalignment of 19% during the second half of 2016 (see left chart below). So, "convergence to equilibrium" is set to continue.

We forecast a 5% depreciation in the TW USD in 2018

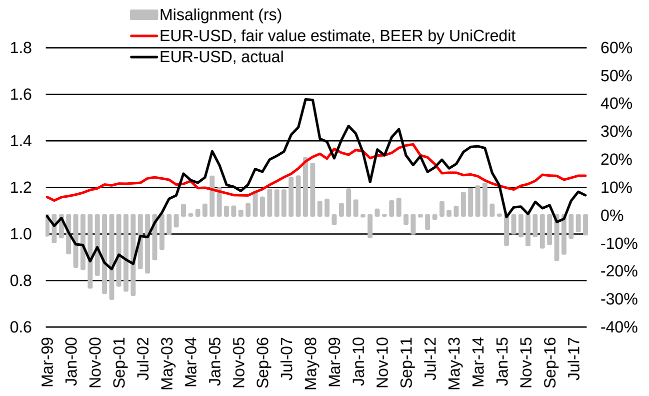
In our view, the upward USD move since early September of this year is largely attributable to technical reasons. The build-up of extreme dollar short positioning eventually led speculative investors to square some of these positions as short-term indicators were flagging stretched/overbought conditions. However, underlying fundamentals have not changed. If anything, cleaner positions should whet investors' appetites to re-engage in "short dollar" trades again before too long.

Additionally, our call for a lower dollar is in line with historical norms at similar stages of the Fed's tightening cycle (we expect four more rate hikes before the Fed rate peaks, which implies that we are currently mid-way through the hiking path). More often than not, the USD tends to peak at the beginning of the hiking cycle but starts depreciating as the target rate increases, most likely because the growing maturity of the business cycle, in combination with tighter financial conditions, start weighing on growth and growth expectations at home.

US DOLLAR DOWNWARD CORRECTION IN FULL SWING



EUR-USD STILL UNDERVALUED DESPITE 2017 RALLY



Source: Bloomberg, Haver, UniCredit Research

Admittedly this is not a typical tightening cycle, but the dollar depreciation so far this year (as the Fed has hiked twice so far with one more 25bp increase widely anticipated in December) seems to suggest that this historical pattern remains at play.

And the implementation of US tax reform – whatever the minor variations – is unlikely to turn things around this time. As discussed in our US country section, tax cuts should produce a modest temporary boost to growth but will not fundamentally alter the long-term trajectory of the economy. In fact, it is not at all clear whether these measures will have any positive effect on the dollar. Ultimately, it is a plan that foresees deterioration in domestic fiscal balances without even attempting to address the US productivity issue. Fundamentally, the widening of the deficit should actually be dollar-negative.

Risks to our scenario

Of course there are both upside and downside risks to our scenario.

Any development that puts downside pressure on sentiment and global risk appetite would lead to "flight to safety" and likely cause dollar strength, mostly against high-beta and liquid EM FX. In such an environment, JPY would strengthen – as a risk-off trade – while the implications for the euro are less clear given that the currency's correlation with risk assets has varied greatly over time. An escalation of tensions between Saudi Arabia and Iran (or any other geopolitical risk flaring up) poses perhaps the most immediate risk to our bearish dollar forecasts, mostly – in this case - against high-beta risk sensitive currencies. Other risks that could lead to a resumption of dollar strength include a pronounced Chinese growth slowdown (potentially triggered by the Chinese authorities moving too aggressively to curb credit growth) and/or US growth/inflation surpassing our expectations, prompting the Fed to tighten more.

On the other hand, dollar downside could accelerate if the slowdown in the US arrives earlier than we expect. In this scenario, EUR could appreciate at a faster clip – at least initially – as the market starts pricing out some Fed rate tightening, and the yen would get a further boost higher. However, high-beta currencies such as AUD, NZD, CAD and liquid EM FX would most likely weaken on concern about the spillover to global growth.

EUR-USD should converge to fair value (1.25) in 2018

Turning to the euro, we forecast further gains in 2018 and extending into 2019. Our target for end-2018 is at 1.25 (in line with current equilibrium estimates) and 1.28 for end-2019. Relative to forwards we are more bullish, as they price-in a 2.7% appreciation for 2018 and another 2.7% in 2019. We see three arguments that support our constructive view:

Valuation: As a mirror image of the USD overvaluation, EUR-USD has remained undervalued for quite some time (see right chart on previous page). The process of convergence to equilibrium has started and has further to run. This is underpinned by persistently strong economic tailwinds and the pricing out of political risk premiums. A notable feature is that investment as a percentage of GDP in the eurozone is rising, but remains below pre-2007 levels. This has two immediate implications from an FX perspective: first, it highlights robustness in good underlying fundamentals, increasing conviction in our call for more euro upside; and second, as investment (one of the cornerstones of our fair valuation framework) continues to be on an upward trend, moving towards higher historical averages, there will be a tendency for EUR-USD fair value to increase (moderately) further, putting more upside pressure on spot.

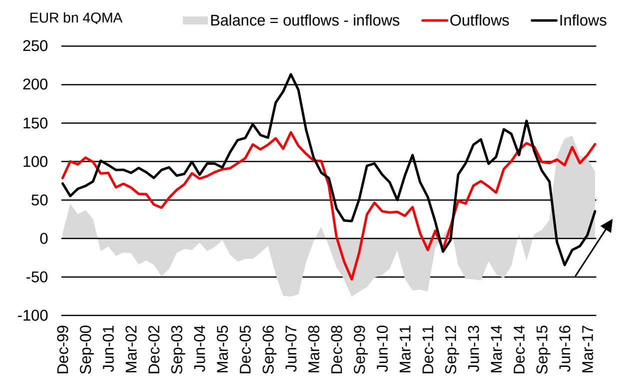
Monetary policy: The market is now relatively well placed and priced for the gradual normalization in Fed policy. This implies that the typical cyclical currency response to FOMC tightening (USD peaks as investors gear up for monetary policy tightening but generally weakens as it gets underway) is in full swing. In contrast, ECB tapering has only recently been announced and implementation will start in January 2018. Though this withdrawal of monetary policy accommodation will be a very gradual process, it still signals an end to ultra-expansionary policy. Since the announcement, rates in the euro area have declined which –

as discussed in our FI section – is suggestive of a mispricing that should (admittedly, gradually) correct. In other words, the divergence in US-eurozone monetary policies should be less pronounced in 2018 and 2019 than it has been over the last two years. This should be good for EUR-USD.

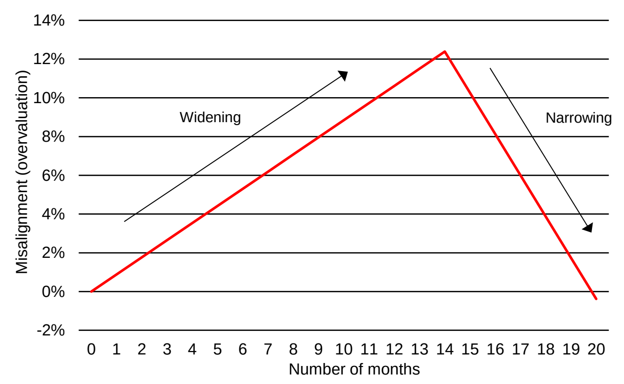
Portfolio flows: Since late 2016, there has been convincing evidence that portfolio flows are returning to the euro area following years of foreign investors sharply reducing their exposure to the region's assets. This process is far from over as the portfolio balance (outflows minus inflows) is still far from its long-run average (see left chart below) and remains out of sync with the improved economic outlook and lower region-specific political risk. The return of portfolio money – especially into the equity market – should be an additional factor supporting the exchange rate.

Risks are broadly balanced. Upside risks stem mostly from the possibility of euro overshooting – a typical feature of previous cycles – during which EUR-USD closes the undervaluation gap and then rises prominently above fair value as market momentum overpowers fundamentals in the short-to-medium term (see right chart below). This time, the ECB's inclination to keep euro gains capped will prevent a fast and significant overshooting, though it still represents a risk. On downside risks, the possibility of a faster Fed tightening cycle in case US growth/inflation surprise on the upside could halt or reverse this year's euro appreciation.

PORTFOLIO INFLOWS RETURNING TO THE EURO AREA



TYPICAL PATH OF EUR-USD OVERSHOOTING



Source: Haver, Bloomberg, UniCredit Research

EUR-GBP above 0.90 in 2018; but GBP-USD will likely appreciate

Sterling forecasts gave us the biggest headache when the team sat down to discuss our models and views. The main problem is the lack of a valuation anchor, because we simply do not yet know the extent of the structural damage inflicted on the UK economy by the EU referendum result and the associated surge in business and household uncertainty.

It will take some time before data are able to give us sufficient information to enable us to consider whether our valuation models will have to change significantly. Additionally, and although economics will be an important driver for sterling these next couple of years, we believe politics (Brexit negotiations and the stability of the British government) will overshadow everything else. So, in the end, our forecasts amount to our best estimates about the process and the end game of negotiations.

As far as the process is concerned, our "country section" for the UK gives the broad picture of what to expect until early 2019. In our view, two things stand out:

First, sterling volatility is likely to rise as the two sides continuously measure their bargaining strengths (or, in the case of the UK, its perception of them), potentially flexing their muscles with announcements and headlines hitting the market, occasionally causing confusion which ultimately generates volatility. Hence, there is value in owning sterling volatility. Second, given our strong belief that the UK needs the EU far more than the EU needs the UK, the UK government will likely cave-in to the EU's proposal for the amount of the settlement bill in order to move on with trade talks. And this may be perceived as supportive of sterling – mostly against the USD (on account of the dollar downtrend that we envisage for 2018).

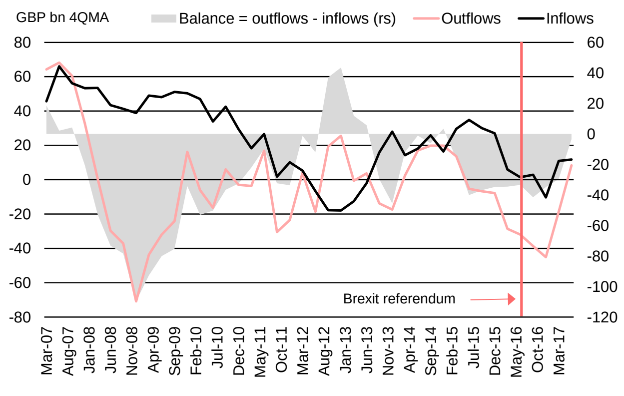
The end game is likely to be one in which both parties agree on a transition period so that the UK avoids dropping to the "void" from a cliff. Of course it is unlikely to be plain sailing, but once we get there, this is likely to manifest as a stronger support for sterling. These past few months have shown the market thinks that levels between 1.30 and 1.33 embed a reasonable Brexit risk premium. Insofar as an agreement on a transitional period reduces that premium, it becomes more likely that cable will gain traction above that level, converging and likely exceeding 1.40 in 1Q19.

As for monetary policy, we don't think it will have an important role during 2018. The slowing of the UK economy – with growth likely continuing to lag that of G7 – should be enough to keep the BoE on hold until the end game on Brexit negotiations is reached. This is corroborated by the fact that the inflation rise is entirely due to past sterling depreciation (i.e. not domestically generated); therefore, household real income will continue to be squeezed as wage growth remains stagnant – though some improvement is likely further out as inflation eases somewhat.

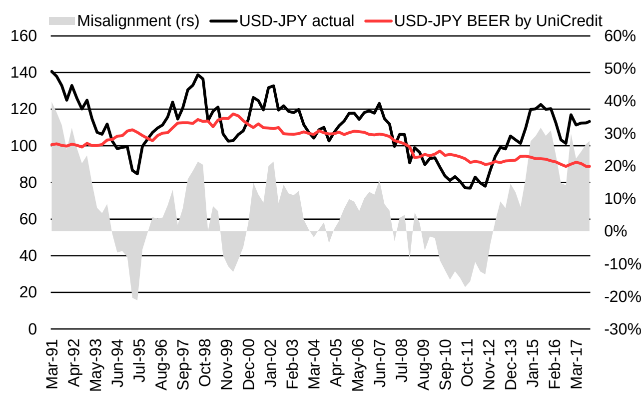
On balance, we forecast EUR-GBP rising to 0.92 in the first half of 2018 and consolidating towards 0.91 by end-2018. In 2019, the likely agreement of the transition period should exert downward pressure on EUR-GBP, which, however, we think will be offset by expectations about the ECB raising rates in mid-2019. We think EUR-GBP will end 2019 around 0.90. On the other hand, we expect to see a gradual appreciation (but with higher short-term volatility) in GBP-USD, mostly on account of a weak USD. We forecast GBP-USD at 1.37 by end-2018, and at 1.42 by end-2019. Our EUR-GBP forecasts are roughly in line with forwards but our GBP-USD targets are more bullish, i.e. 3% higher than forwards in 2018 and 5% higher in 2019.

The risk, of course, is that negotiations prove to be even more difficult and/or the end game leaves the UK with no agreement on a transitional period. This would be outright GBP bearish, not just because of speculators selling sterling but also because uncertainty will trigger further portfolio outflows from the economy (see left chart below) placing the currency under additional strain.

ACCELERATION OF OUTFLOWS A KEY RISK FOR STERLING



A STILL SIZEABLE JPY UNDERVALUATION



Source: Bloomberg, Haver, UniCredit Research

Bearish outlook for USD-JPY

We see USD-JPY depreciating to 108 by end-2018 (a decline that is 2.5% more than forwards) and further accelerating its descent to 100 by end-2019 (significantly lower than forwards, which currently price it at 108). Our bearish USD-JPY view is based upon three pillars.

First, it is the valuation argument. Based on our BEER by UniCredit equilibrium framework, USD-JPY's fair value is around 89, meaning that the current overvaluation stands at nearly 30%, one of the highest divergences since 1991 (see right chart on previous page). So aside from our "weak dollar" story there is a JPY-specific element of misalignment. This has been caused by the BoJ's QQE and yield curve management, which have kept Japanese 10Y yields close to zero for a long period of time. However, it is true that the gap started closing on two occasions but in both cases the convergence process was interrupted. The first one occurred on the back of Donald Trump's election as US president one year ago, when markets were dominated by "Trump euphoria". This has largely been priced-out and, based on our expectation of US fiscal developments, it is unlikely that it will turn out to be a sustainably supportive factor for the dollar. The second occurred this September alongside the general USD rebound. As discussed previously, we think this was mainly a technical correction driven by extreme USD shorts, and did not really reflect any change in fundamental developments. Therefore, our view is that it will fizzle out quite quickly. Additionally, similar divergences in the past (of around – or higher than – 20%) have corrected over a period of one-to-two years.

Second, we expect that the market will be somewhat surprised by the BoJ in the course of 2018. The re-appointment of Haruhiko Kuroda as BoJ governor implies the continuation of a dovish tone by the central bank. That said, the reality of the matter is that inflation bottomed out in 2016 and has increased throughout 2017. At 0.7% yoy (CPI ex-fresh food) it is still significantly below the 2% target, but, in our view, it is the trend that matters: a forward-looking central bank ought to take this into account. On the economic front, GDP growth has accelerated over the past three quarters, led to a great extent by a pick-up in business investment. The output gap is closing and we think that this will gradually start to translate to even higher inflation, prompting the central bank to step back from its dovishness slightly. The first thing would be to drop the yield curve management that has kept Japanese 10Y yields artificially low. If we are right in this assessment, then we would expect meaningful upside for the yen.

Finally, what happens to the yen will also be a function of global risk aversion. Our expectation is that risk assets will hold up well in 2018, mostly in the first half. That said, this is not necessarily negative for the yen. It is worth remembering that in 1H17, global equities rose by 8% but USD-JPY weakened by 4% (while the TW JPY was up a more modest 1%). However, as equities start to move sideways in the latter part of 2H18 and come under some pressure in 2019 – on the back of the US slowdown that we expect - historical correlations should reassert themselves, putting further downside pressure on USD-JPY.

EUR-CHF correction towards fair value (1.20) to continue

Following two years of range-bound EUR-CHF trading between 1.06 and 1.12, the exchange rate has risen substantially in the second half of this year and is now close to 1.16, its highest level since the Swiss National Bank removed the FX floor of 1.20 in January 2015. The significant depreciation of the Swiss franc led the SNB to acknowledge in September that the CHF overvaluation had reduced. However, as discussed in the "country section" for Switzerland, we think the SNB will be very cautious next year about becoming less dovish in its monetary policy.

Given the importance of exchange rate effects for inflation in Switzerland, which remains low, the SNB welcomes the depreciation of the Swiss franc as it supports the (modest) positive inflation dynamics and the return of the trade-weighted real effective exchange rate to its long-term average (for a more in-depth discussion of the SNB's valuation framework and our take on what it means for exchange rates, please refer to *FX Perspectives* "EUR-CHF: faster convergence to fair value"). We see EUR-CHF as being on track to appreciate further towards fair value, with recent dynamics in portfolio investment flows supporting the correction (see left chart below). We keep our EUR-CHF forecast of 1.20 for 2018. At 1.20, EUR-CHF will be in fundamental equilibrium according to our BEER model. Together with a risk shakeup in 2019, this leads us to expect a sideways movement in EUR-CHF with a weakening bias in 2H19 to 1.18 at the end of 2019.

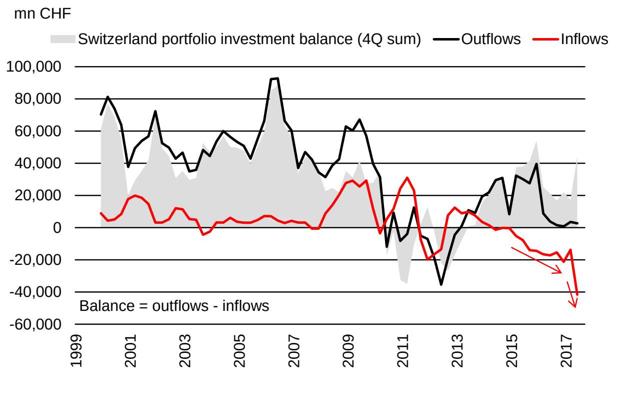
NOK and SEK strengthening will likely be very gradual

Our BEER model continues to show an extreme undervaluation for the Nordic currencies. The overvaluation of EUR-NOK currently stands at around 25% and that of EUR-SEK above 30%, with the misalignment even more pronounced against the USD (on account of the continuing overvaluation of the dollar). We have long argued that improving economics in Norway and Sweden argue for an – at least partial – correction. Real rate differentials in the two regions are far lower than suggested by the historical relationship between inflation and yields (as illustrated for Norway in the right chart below). The Norges Bank and the Riksbank have remained stubbornly dovish, which basically explains a large chunk of the misalignment that has remained in place for the past few years (see *FX Perspectives* "BEER update: why undervaluation of the Nordics has been persistent"). It seems rather unlikely that this stance will change over the next couple of quarters – especially in Norway where inflation has lost some of its momentum. Hence, both central banks should continue to be an important hurdle to meaningful currency upside.

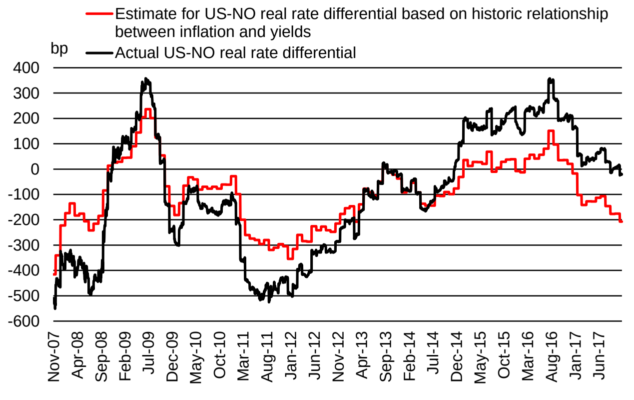
As discussed in the "country section" for Norway, we expect the Norges Bank to remain on hold throughout 2018. This is slightly more dovish than market expectations, which are indicating a 80% probability of a hike next year. Based on our real rate differentials, we still see some room for EUR-NOK depreciation. However, we are less bullish on the NOK compared to forwards, as we expect a dovish Norges Bank to slow down the adjustment process and keep the currency in undervalued territory for longer. We see EUR-NOK at 9.10 by end-2018, and around 8.90 over 2019.

The case for the SEK is similar, although the deviation from fundamentally justified levels is even larger. Economic growth and employment numbers in Sweden remain very healthy, and inflation is now close to the Riksbank's target, with CPIF oscillating around 2% since April. Still, the Riksbank remains firmly focused on a sustainable return of inflation to the 2% target in the country, a process that would be slowed down by SEK appreciation. This makes it likely that rate hikes in Sweden will be gradual. We expect the first 25bp hike by the Riksbank in late 2018, followed by three more rate hikes in 2019.

REVERSAL OF SWISS PORTFOLIO INVESTMENT FLOWS



DOVISH NORGES BANK PUTTING PRESSURE ON REAL RATES



Source: Bloomberg, Haver, UniCredit Research

Given that most of this is already priced in by rates markets, EUR-SEK depreciation should still be limited to 9.55 by end-2018, followed by further moderate decline to 9.40 at the end of 2019.

Commodity currencies: upside, but with limited potential

A scenario in which the USD further corrects its overvaluation should be generally positive for the three commodity currencies. That said, upside potential may be somewhat limited, due to their central banks' determination to proceed very cautiously with the tightening cycle (and forward curves are already pricing-in some interest rate hikes – see the left chart below). Additionally, although the external environment will remain supportive of risk assets, commodity prices and high-beta currencies in 2018, the scope for some slowing down of Chinese growth and our view that US growth will materially cool down in 2019 are likely to represent some headwinds – potentially in late 2018 and onwards.

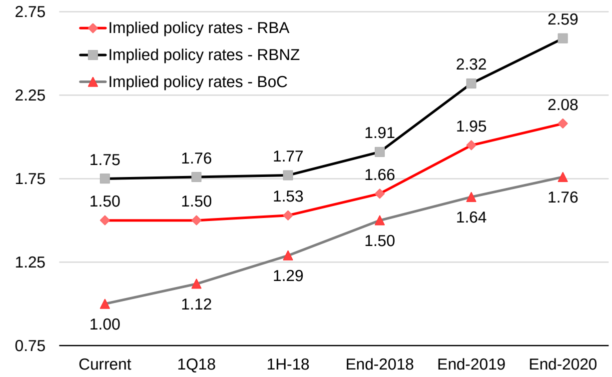
AUD-USD is already trading 11% above its "fair value"

Australian fundamentals are solid, but the RBA has already flagged its resistance to joining other central banks in normalizing interest rates due to the high level of household debt and weak wage growth. The next move will be upward, but the RBA is not in a rush to do that and the strength of the AUD is also seen as slowing economic recovery and inflation. The Australian forward curve does not look mispriced by reflecting a 60% chance of one rate hike in the next 12 months and a 90% chance of two moves in the next 24. As AUD-USD is already trading over 10% above its fair value, we think AUD-USD will reflect USD downside in 2018, rising to 0.82 by end-2018, before retracing towards 0.79 at end-2019.

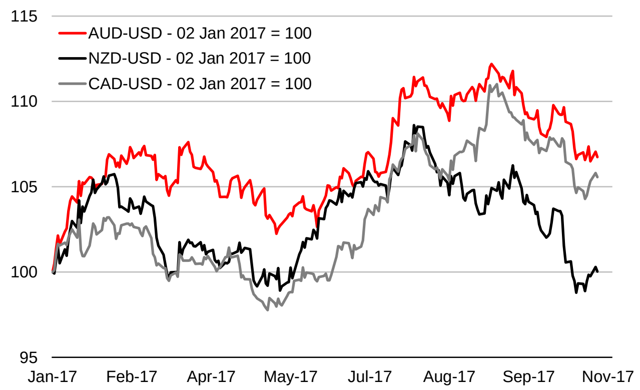
NZD outlook mixed on account of RBNZ mandate changes

In contrast to AUD-USD, NZD-USD, at 0.70, is now in line with its fair value after slipping back to early-2017 levels (see the right chart below). Its upside potential for 2018-19 looks vulnerable, however, due to pressure the new Labor-led government is exerting on the RBNZ. Full employment will be added to the price stability target which suggests an increased possibility of monetary policy tightening being delayed. The NZ forward curve is pricing-in a 75% chance of three rate hikes in the next 24 months, but under the new policy framework, the RBNZ could start normalization after the RBA. This potential delay has already been reflected in the AUD-NZD rally to new 18M highs in October. We think that NZD-USD is unlikely to exceed 0.72 in 2018 and 2019, which implies that AUD-NZD will stay firm at around 1.13-1.14.

COMMODITY CURRENCIES: ENOUGH TIGHTENING PRICED-IN, BUT RBNZ CAN DELAY INTEREST RATE NORMALIZATION



COMMODITY CURRENCY PERFORMANCE YTD: POLITICAL PRESSURE WIPED OUT NZD'S 2017 GAINS



Source: Bloomberg, UniCredit Research

CAD to converge towards its fair value against the USD

Turning to Canada, Governor Stephen Poloz contributed to the USD-CAD pullback towards 1.30 after the low at 1.2062 hit in September by reiterating that the BoC will be cautious with future rate changes after the two hikes in July and September 2017. The Canadian forward curve is fully pricing in another 25bp rate hike in six months, two in one year and three in two years, which seems quite reasonable given the healthy economic growth in Canada so far.

(GDP was up 3.7% yoy in 1Q18 and 4.5% yoy in 2Q18). In that respect, we see the CAD as having the biggest upside potential of all major commodity FX, since valuation is a tailwind (not a headwind) and the BoC is unlikely to surprise the market on the dovish side from hereon. The fact that geopolitical risk is back in the oil market, keeping prices relatively elevated should be another positive factor the CAD, at least for most of 2018. We forecast USD-CAD down to 1.20 by end-2018 and steady around 1.20/1.22 in 2019

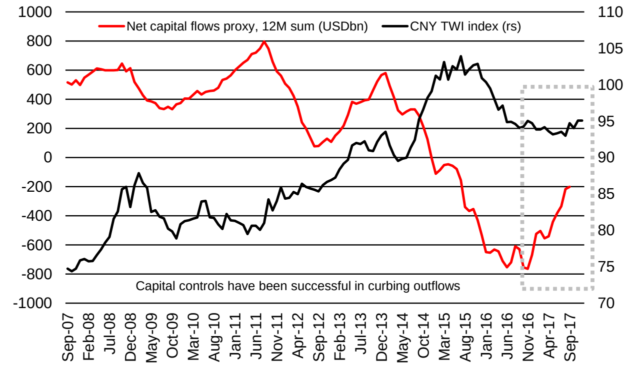
Only modest CNY depreciation going forward

Stepping outside the G10 FX universe and turning to China, we pencil in continued CNY weakness, but at a more moderate pace: USD-CNY at 6.70 for end-2018 and 6.75 for end-2019. We first lowered our USD-CNY forecasts substantially in July, for the following reasons: **1.** the policy priorities of the authorities had shifted in favor of stability (over FX and capital-account reform) and **2.** our assumption that the trade weighted CNY would be kept in broader ranges (in contrast to the downtrend seen over 2015-16).

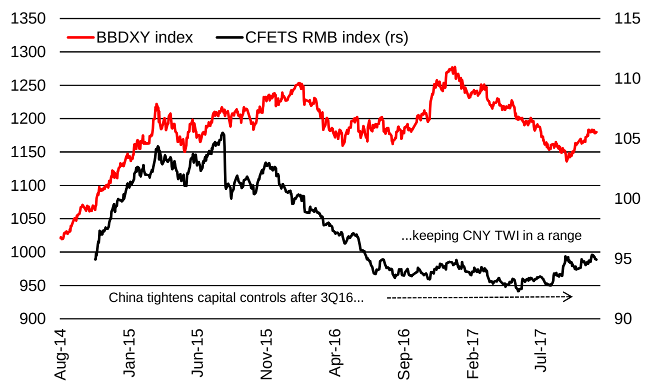
The changes at the Politburo (highest level of government) have now given President Xi Jinping much more power in guiding policy, and he is emphasizing stability (over reform) while tackling the issue of de-leveraging. At the same time, PBoC Governor Zhou Xiaochuan – who is extremely pro-FX reform and in favor of capital account reform – is set to retire. Given the large changes underway and the transition likely to last for quarters, we believe the authorities will continue to keep a tight lid on capital outflows (see left chart), while improving the conditions for capital inflows, as has been the case recently.

While capital controls will continue to weigh on the ability of locals to export capital abroad (though not entirely prevent all forms of outflows), the desire to export capital will be closely linked to developments in growth, and especially the housing market, in our view. As our economists expect house price growth to slow, we believe that this, over time, will increase the desire of locals to diversify their asset holdings abroad.

CAPITAL CONTROLS HAVE SUCCESSFULLY CURBED OUTFLOWS…



…ALLOWING POLICY MAKERS TO STABILIZE CNY TWI IN A RANGE



Source: Bloomberg, UniCredit Research

Equity Strategy

Uptrend in eurozone equities set to continue

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- We see the uptrend of eurozone equities continuing into 2018 on the back of a solid growth environment and despite equities already being quite expensive in terms of P/E valuations. In this respect, P/E valuations in the US are more stretched than in Europe, which, among other factors, renders European equities more attractive than US stocks.
- Our 2018 year-end targets are 3850 points for the Euro STOXX 50, 14500 for the DAX and 24500 for the FTSEMIB, i.e. all up about 10% from current levels. In the first half of 2018 even higher levels (up to +15%) are highly likely.
- However, the second half of 2018 will be characterized by increasing volatility and a broad sideways trend, given the moderation in the growth environment in 2019 and beyond. Marginally less accommodative conditions by key central banks, on the other hand, will pose no significant risk to equity markets, in our view.

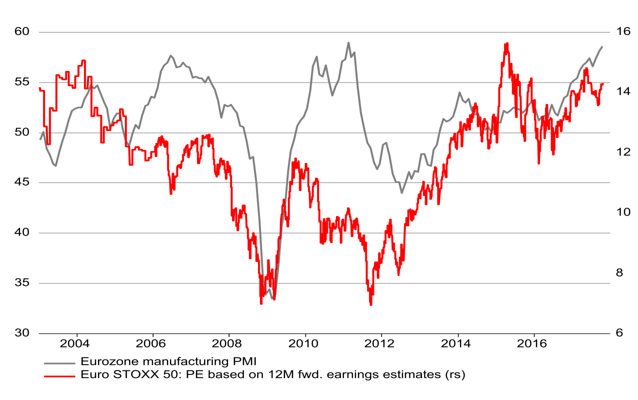
Equity market to remain strong in 1H18

The current bull market in global equities is one of the strongest in more than four decades. Our baseline scenario is another positive year for eurozone equity markets. This is particularly true for the first half of 2018 as the current economic momentum in the eurozone will further support the equity market over the next few months. The positive trend in earnings estimates should continue in 2018, however, with a slightly lower growth rate of 9% compared to about 10% in 2017. We expect this supportive environment will be reflected in valuations remaining elevated in 1H18. This offers a market potential for 1H18 that is above our year-end targets, meaning, the Euro STOXX 50 could reach a level as high as 4000 and the DAX as high as 15000 index points.

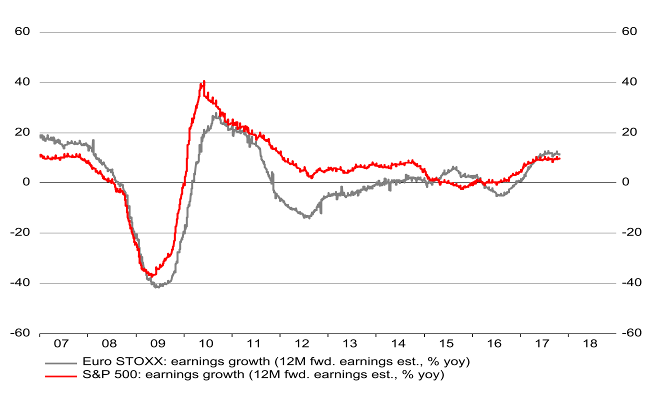
2H18 is likely to see increasing volatility and lower P/Es

Following a fairly positive environment for equities in the first half of 2018, we expect an increase in equity market volatility and lower P/E valuations in the second half of 2018. The main reason for this is that even more stretched valuations will meet an economic outlook for 2019 that is likely to gradually deteriorate towards the end of 2018, with slowing economic momentum, particularly in the US, and investors may start to worry about the prospects of US equity markets. In the eurozone, economic leading indicators will likely also moderate somewhat towards the end of next year, but only gradually. The left chart below shows the correlation between the eurozone manufacturing PMI and the P/E ratio of the Euro STOXX 50. In the past, slowing economic leading indicators have led to declining P/E ratios. This means that P/E ratios will most probably be lower at the end of 2018 than they are currently.

MANUFACTURING PMI AND P/E VALUATION



GROWTH OF EARNINGS ESTIMATES: EUROZONE AND USA



Source: Thomson Datastream, UniCredit Research

We think a decline in the Euro STOXX 50 P/E from 15 currently to 13.5 has to be expected in a scenario of a gradually slowing economic growth. The current Euro STOXX 50 P/E ratio is among the top 10% of the distribution over the last fifteen years; a P/E of 13.5 would still be among the top 25%. Even if earnings estimates are currently for growth of around +9% in 2018 and 2019, a declining P/E ratio limits the remaining market potential and has, in the past, led to significantly rising volatility.

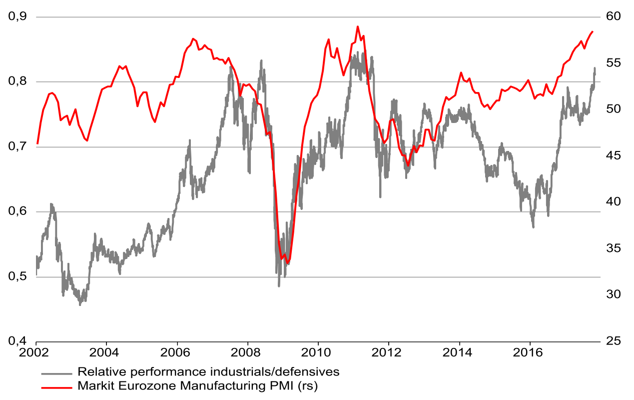
2018: eurozone equities should outperform the US market

The eurozone will continue to grow at rates not far below those of the US. Moreover, the continuing solid growth of global trade, alongside the higher export ratio of eurozone companies compared to their US counterparts is a further advantage that European companies have over their US peers. This supports the case for eurozone companies achieving higher earnings growth than those in the US. The US P/E ratio being at its highest since the tech bubble (currently at the top 5% of the distribution over the last fifteen years), while eurozone P/E has not reached such an extreme level (currently at the top 20% of the distribution over the last fifteen years) also makes euro area equities more attractive. The right chart above highlights that eurozone equities (broad Euro STOXX index) are already expected to achieve higher earnings growth rates than those in the S&P 500. We think this will continue and become even be more pronounced in 2018.

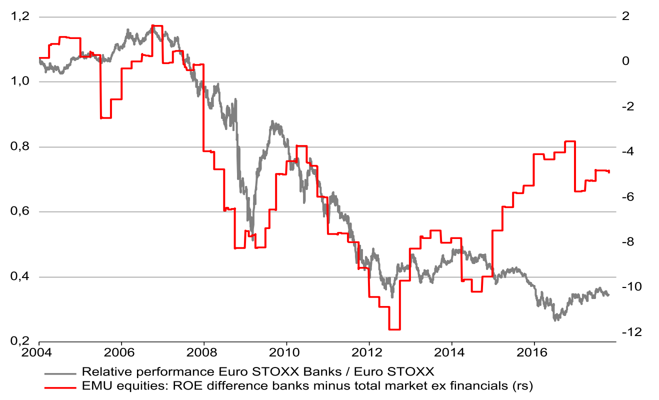
In 2019, pressure on equity markets is likely to increase

In terms of risk factors, equity markets are clearly vulnerable to geopolitical risk; in particular events that would have the potential to impact global trade. However, even if such geopolitical risks do not materialize, we are concerned about equity markets beyond 2018 as the current economic cycle is already quite advanced. Our economists forecast that global growth will slow in 2019, particularly in the US. There is also the risk of a recessionary development in the US in 2020. That means it is highly likely that 2019 will be dominated by slowing economic growth globally, resulting in rising uncertainty among equity investors. If such an economic environment were to materialize, the current consensus earnings growth estimates of +9% in 2019 for the Euro STOXX 50 (or 8% for the DAX) would be too high. Moreover, the current consensus earnings growth estimate of +10% for the S&P 500 in 2019 (similar to the one for 2018 and higher than the corresponding estimate for the eurozone) appears to be over the top, given our expectations of slowing economic growth momentum and a more pronounced economic slowdown in the US than in the eurozone. Consequently, we expect that 2019 will be dominated by a highly volatile equity market environment, with equity markets most probably declining. Depending on the degree of economic weakness in 2019 and the outlook for 2020, a decline of 10-20% for the S&P 500 has to be considered as a possibility. For the Euro STOXX 50 (and the DAX) a smaller decline of up to 10% in 2019 appears to be conceivable in such an economic environment.

EUROZONE MANUFACTURING PMI AND RELATIVE PERFORMANCE OF INDUSTRIALS VS. DEFENSIVES



EMU BANKS: ROE RELATIVE TO THE MARKET EX FINANCIALS



Source: Thomson Datastream, UniCredit Research

Overall, this means that, in our view, the first half of 2018 will most probably witness a cyclical peak in the current upward trend of equity markets globally. We see a high risk that the 1H18 equity market highs will not be reached again in the second half of the year, or even in 2019.

Sectors: cyclicals initially remain attractive

As outlined above, the re-rating of eurozone equity markets should continue in 1H18. We expect this will be mainly lead by industrials, namely by capex-related, investment driven cyclicals[3] and materials[4]. We already have an overweight recommendation for capex-related sectors. Fixed investment will be an important driver of the eurozone economy also in 2018. Therefore, we expect a continuation of these investment-driven sectors in the coming months. With regard to Materials, we upgrade Basic Resources to overweight (for Chemicals, we already have an overweight recommendation). The main reason for the upgrade is the late cycle character of commodity producers, with significantly increasing positive earnings revisions.
However, over the course of the year, with the probability of decreasing economic momentum in 2019, more consumer-oriented, defensive "Stable Growth" sectors[5] should become more attractive. Declining leading indicators normally indicate an outperformance of defensive sectors (see left chart above).

Banks have the potential to expand their outperformance in 1H18 with well-distributed GDP growth continuing, loan growth accelerating to finance investments by smaller businesses and the curve steepening (moderately) with ECB tapering. The focus of the recovery story of European banks remains on solid revenue momentum, loan growth and successful cost cutting.

Strong banking sector supports outperformance of Italy

We reiterate our overweight recommendation on banks. Financials constitute 36% of the FTSE Italia All Share index. This high proportion is the reason why we expect Italy to outperform within the eurozone equity market, in line with the banking sector. In the last two years, eurozone banks have been very successful in increasing their return-on-equity ratios (ROE). While the ROE of eurozone banks is still below that of eurozone non-financials, on average, the pace of recovery has been surprisingly strong over the last two years (see right chart above). This development confirms our view that eurozone banks are on the right track toward continuing business trend normalization.

Risks to our positive view will increase in 2H18

We expect that US GDP growth rates will start to slow gradually in the second half of 2018 and become more pronounced in 2019, while eurozone growth is more steady over this time period. The main risk to our constructive equity market view would be a surprisingly strong economic downturn already in 2018, provoked by political or geopolitical incidents. This would also lead to significant pressure on the current high P/E ratios, along with sharply higher volatility. In such a risk scenario, the move to defensive sectors would come sooner and be much more pronounced than we currently forecast (as outlined above, we do not expect increasing pressure on equities before 2019). In such a case, strongly increasing market volatility has to be expected, which could lead to a temporary decline in the Euro STOXX 50 P/E ratio to between 10 and 12. Even with unchanged earnings estimates for 2019, that would result in an interim Euro STOXX 50 level of between 2800 and 3300, about 10-25% below the current index level.

[3] Capex-related sectors: Construction & Materials, Industrial Goods & Services, Technology
[4] Materials: Basic Resources, Chemicals
[5] "Stable Growth" sectors: Food & Beverage, Health Care and Personal & Household Goods

Credit Strategy

Credit remains fundamentally well supported and benefits from the CSPP, but stretched valuations are quite vulnerable

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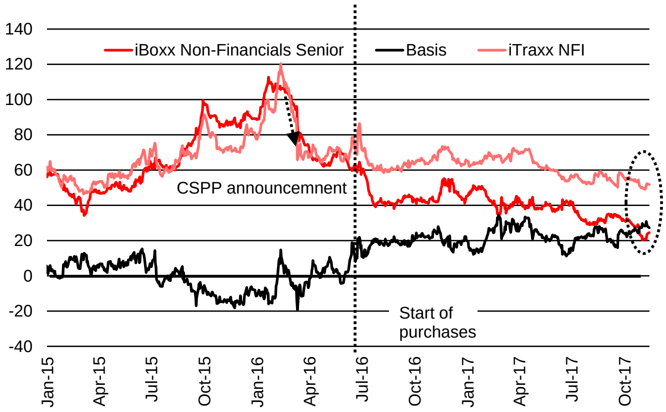
- Credit profiles of European corporates will remain well supported fundamentally (driven by benign economic conditions) as well as by technical demand from the CSPP.
- Nevertheless, valuations are very stretched given that, in some cases, spreads are trading inside expected loss rates, leaving little premium for other risk factors, such as market, migration and liquidity risks.
- Consequently, we expect bond spreads to move considerably wider from current levels and to adjust to levels more in line with fundamentals, as reflected by synthetic indices, in particular when the impact of the CSPP fades in the second half of the year. Hence, risks for wider spreads are likely to come from technical factors, such as rising supply and declining technical demand, rather than from deteriorating company fundamentals.

While company earnings will remain well supported by the benign economic backdrop, credit investors are unlikely to benefit much due to increasingly shareholder-friendly measures

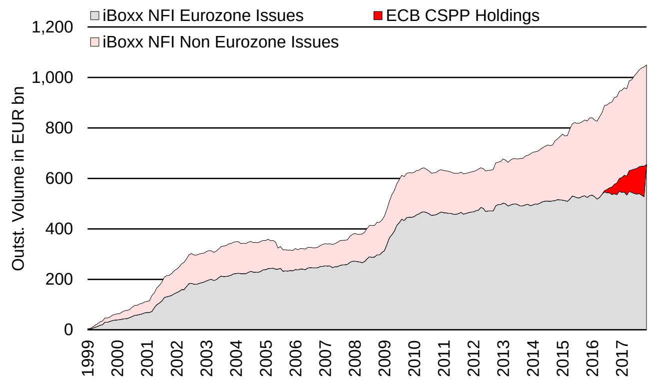
Earnings of European corporates will remain well supported due to the ongoing benign economic conditions in the eurozone. However, credit investors are unlikely to benefit from this economic environment. As we have outlined above, credit is a typical early-cycle asset class that benefits the most at the early phase of a recovery. At more advanced stages of the business cycle, credit becomes less attractive, as valuations tend to be tight and the risk of mark-to-market losses due to increasing yields starts to rise. Moreover, at this stage, corporate policies tend to be increasingly focused on shareholder-friendly measures (M&A, dividend increases, share-buybacks), which are usually detrimental to credit profiles. Other company-related assets further down in the capital structure, such as equities, become much more attractive as the business cycle matures.

IMPACT OF THE CSPP ON CREDIT MARKETS

Synthetic versus cash bond spreads prior to and during the CSPP



CSPP holdings in comparison to iBoxx outstanding amount



Source: UniCredit Research

As the CSPP is playing a dominant role at the moment, any tapering will leave credit spreads under material widening pressure

As part of the ECB's QE measures, the Corporate Sector Purchase Program (CSPP) has been a major force driving spreads to new record lows and it will continue to be a dominant factor, at least up until September 2018. The direct impact of the CSPP on corporate credit spreads becomes apparent, when comparing cash bond spreads, which are compressed by the technical demand from the ECB, with the corresponding synthetics credit indices that are not affected by the purchases (see left chart above). The gap between these two time series is about 30bp at the moment, which is a good estimate of the impact of the CSPP on eligible assets. Moreover, the right chart above indicates the significant volumes involved. So far, the ECB has purchased more than the net supply of corporate new issuance (defined a gross issuance less redemptions). The grey area, which marks the eligible assets that were not purchased by the ECB has diminished. As the CSPP plays such a dominant role in credit markets, any tapering will have crucial implications on credit markets, despite the fact that monetary policy conditions will become only marginally less accommodative over the course of the year. As a consequence, we expect corporate credit spreads to widen at least 30bp (i.e. the amount of the positive bias), if not somewhat more, towards the end of next year as the ECB plans to scale back purchases.

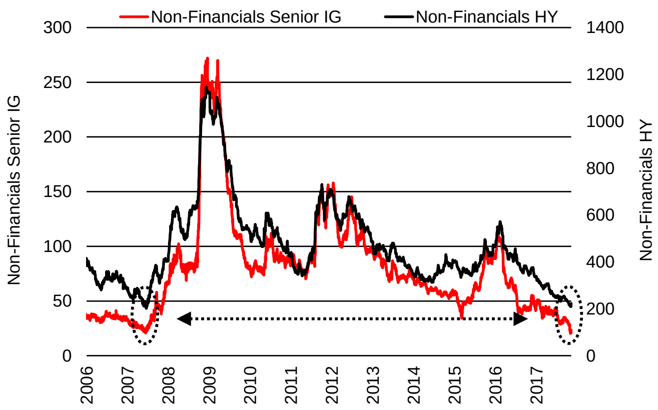
However, the recent squeeze in credit markets compressed spreads to new all-time lows (see left chart below), i.e. to levels that leave almost no risk premium to compensate for the various risk factors involved in corporate bond markets other than pure default risk. This will leave credit markets in a vulnerable position and likely quite sensitive to potential spread-widening triggers.

Cash credit spread curves are partly trading inside expected loss rates

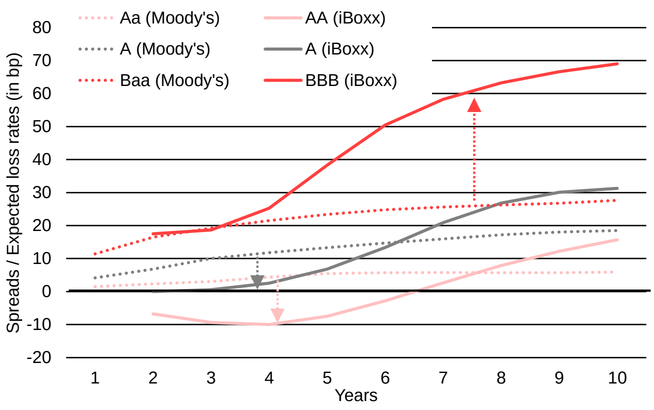
In order to highlight the extent of this compression, we compare the current spread environment with expected credit loss rates derived from default probabilities as reported by rating agencies. The right chart below shows the current term structure of credit spreads by ratings alongside the expected loss rates for a time horizon of up to ten years. The comparison reveals that at current valuations, credit spread curves of single-A and better rated companies for time horizons of up to five years are trading inside the corresponding expected loss rates. BBB-rated spreads are trading at about the expected loss rates up until the four-year and somewhat above the these levels for longer time horizons. This is an inherently unstable situation, and although such valuations could last for quite a while (as witnessed in the period between 2005 and 2007), it is also quite likely that spreads will widen quickly when the perception of investors changes.

CORPORATE CREDIT SPREADS TRADE AT HISTORIC LOWS AND PARTLY INSIDE EXPECTED LOSS RATES

iBoxx spreads recently fell to new all-time lows …



… resulting in spread curves trading partly inside expected loss rates



Source: iBoxx, UniCredit Research

While credit fundamentals will remain broadly supportive in Europe, they will likely continue to deteriorate in the US, due to rising indebtedness and increasing financing costs

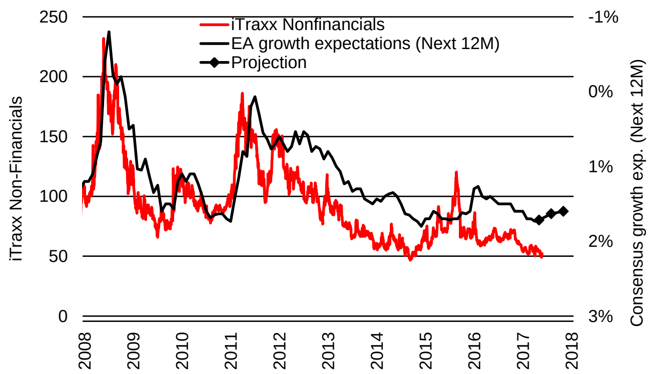
Our macro credit model comparing synthetic credit spreads with 12M forward consensus growth expectations suggests that, over the coming year, economic conditions will remain sound. Moreover, credit protection ratios, such as the interest coverage ratio (ICR), will remain very favorable for European companies, as highlighted by the right chart below. Over the last two years, the ICR for European companies improved due to rising earnings, declining interest costs and only moderately rising debt levels. This development is in stark contrast to the US, where the ICR has been deteriorating for three years. The latter comes despite rising earnings for US companies, as a massive increase in debt levels (median net debt among non-financials in the S&P 500 has increased almost threefold since the financial crisis) as rising interest rates more than offset earnings growth. Going forward, we expect that this decoupling of the credit cycle in the US and Europe will continue, as a slowing growth momentum in the US will likely not allow earnings growth to keep track with rising funding costs and debt levels.

Due to the high share of US issuers in EUR-denominated corporate bond markets, European credit investors are exposed to the more advanced US credit cycle

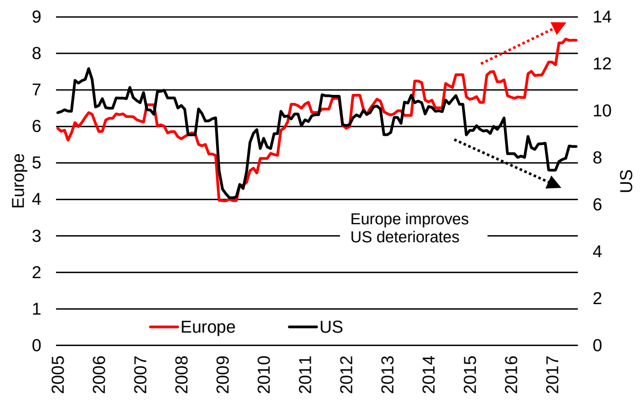
However, the fact that the US earnings cycle is much more advanced than the European one is indeed also a topic for European credit investors, as over the last three years, the volume of EUR-denominated corporate bonds issued by in North American companies has increased significantly, from a market share of below 5% to almost 20%. In terms of country share, North American companies now rank number two behind France and have a higher share than German companies. Moreover, since the ECB does not purchase non-eurozone bonds under its CSPP, the share of North American corporate bonds in private bond portfolios will likely be higher than 20%. This leaves a significant amount of European credit investors quite exposed to the US credit cycle. Hence, a stronger-than-anticipated slowdown in economic conditions in the US, could indeed affect European markets and could serve as a trigger for spread widening.

CREDIT FUNDAMENTALS

Economic conditions will remain supportive over the coming year…



…with European credit protection ratios at new highs



Source: iBoxx, UniCredit Research

Investment conclusion

At current levels, credit spread valuations are so tight that there is no compensation for risk factors other than the expected loss. This is an inherently unstable situation, and although such valuations could last for quite a while (as illustrated in the period until 2007), it is also quite likely that spreads will widen quickly when the perception of investors changes. Hence, we recommend seeking opportunities outside this universe. If tied to IG corporate credit, investors should opt for shorter durations (to reduce sensitivity to widening risk), but move to lower credit qualities (such as BBB), which still offer positive carry and spreads at least in line with expected loss rates.

CEEMEA Strategy

Constructive EM, but differentiation will remain critical

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- Bigger picture, we remain constructive on flows into EM, reasoning that current inflows, while stellar, are by no means excessive.
- We like local-currency bonds in several countries, especially where real rates and currency valuation are attractive, but differentiation will be required, especially in countries for which FX remains a vulnerability to overall returns.
- Our central assumptions on global growth and US monetary conditions argue for a constructive stance towards EMFX, but differentiation will be required. We like RUB and CZK over TRY and RON.
- EM and emerging European credit should remain range bound, and we maintain a preference for sub-investment-grade credit, notably BB rated issues.

Flows to EM fixed income (FI) funds since 2016 have been nothing short of impressive, with cumulative inflows exceeding USD 80bn, even accounting for the brief hiatus following the US elections in November 2016. However, there are three points suggesting that, barring temporary short-term setbacks into year-end, this may very well continue.

Flows into EM FI have been impressive over the past 18 months…

…yet, they remain a fraction of EM flows seen in past cycles

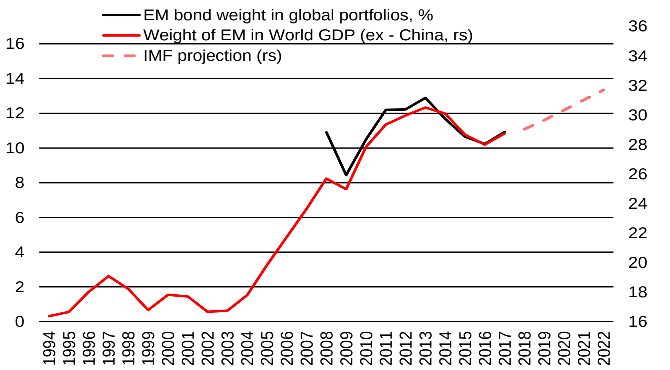
First, cumulative flows in the latest inflow period starting in 2016 have just been a reversal of the outflows that followed the taper tantrum event and the USD strength that ensued. Second, when we rescale the cumulative flows for each wave of inflows as a proportion of the AUM, we find that the current wave of flows is proportionally smaller than previous ones we have examined, such as those in 2005-08 and 2009-13. Third, it is worth pointing out that – on IIF data – an estimated 13% of global portfolio AUM are currently being allocated to EM bonds and equities combined, which is short of the 15% average since 2008 and the peak of 18% in 2010.

However, there are strong fundamental factors arguing for a rising allocation to EM FI…

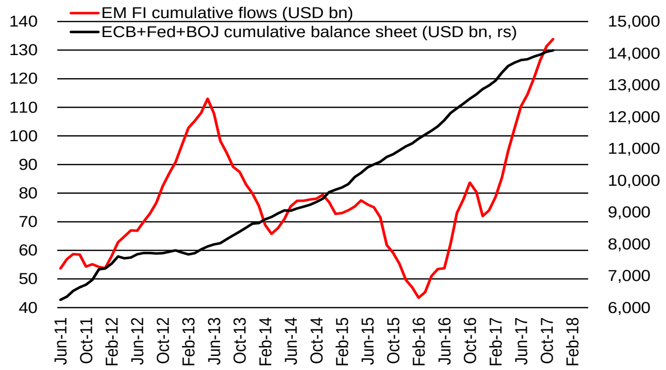
In addition to the technical factors noted above, fundamental considerations also argue for a higher strategic investment allocation being given to EM fixed income. First, there is some evidence that allocations to EM FI have evolved in line with the weight of EM (ex-China) in global GDP (left chart). The IMF projects a rising EM weight in global GDP to nearly 32% in 2022 from 28% currently. Second, a portfolio-optimization analysis across several FI assets (in which we maximize mean-variance returns and obtain risk parity with quarterly rebalancing) suggests the ideal weight for EM FI should be in the vicinity of 20%, double the current allocation.

FUNDAMENTALS ARGUE FOR LARGER EM FI ALLOCATIONS IN THE MEDIUM TERM

EM FI allocations have increased in line with EM weight in global GDP



Flows to EM appear disconnected from central bank balance sheet expansion



Source: IIF, IMF, Bloomberg, UniCredit Research

…and DM policy normalization, in itself, is unlikely to dent our conviction

For a more detailed analysis, please see our Focus: "EM bonds, what's not to like" on page 23 of the *CEE Quarterly*).

Furthermore, in as much as balance-sheet expansion in the developed world has suppressed risk-free rates and helped EM asset valuation, it is not entirely clear that the evolution of bond flows into EM has been critically supported by such easy monetary policy (right hand chart on prior page). That is not to say that these dynamics have not been important for EM, and balance-sheet unwinding could have some impact.

Fundamental sovereign considerations will remain important

But our point is that this is not the sole driver: one cannot sell EM exposure and "run to the hills" on the fear of tighter monetary policy coming from the US, or a slower pace of accommodation from the ECB. Fundamental EM considerations such as growth, external balances, the quality of sovereign balance sheets and inflation dynamics remain crucial to the call on EM fixed income.

What we like: POLGB, OFZ and HGB selectively

In terms of our preferences, we continue to like POLGBs- particularly the 10Y part of the curve – which has so far lagged the rally in bunds and the zloty still appears slightly undervalued. We also like OFZs, and any weakness should be seen as an opportunity to gain exposure. Even as inflation has fallen, the CBR should maintain a gradual easing path. Real rates remain attractive and the strong external balances provide stability on the FX front. We like HGBs, but are more selective here. We prefer the 3-5Y part of the curve with local banks likely to support that part of the curve, and also maintain a long recommendation on 2025 bonds as the NBH puts further unconventional measures in place to flatten the yield curve.

What we dislike for now, but could re-consider on further cheapening: ROMGB and TURKGBs

We do not think that ROMGBs are interesting at current levels, given the continued policy uncertainty, overvaluation of the RON and likely upside surprises in inflation. Value could be created at some point, but we are not there yet. Similarly, while we rode the rally in TURKGBs over 1H17, conditions will become more challenging given the deteriorating inflation expectations. Inflation could ease from December 2017, but beyond base effects, there are no strong signs of disinflation coming through. A strong CBRT response could stabilize the situation and create conditions for a relief rally. But again, we are not there yet.

We like paying short-end CZK rates

We do not think that CZGBs offer value across the curve and we continue to dislike the short-end in particular. We recommend paying 1Y CZK IRS as we expect the CNB to hike rates in excess of market expectations.

For EMFX, global growth and US monetary conditions matter most

We maintain a constructive stance overall towards EMFX given the synchronized global recovery our economists anticipate and with financial conditions globally likely to remain relatively easy. Our analysis on EM currencies shows that two factors explain broader EM currency movements: global growth dynamics (which we proxy using raw industrial metal prices) and US monetary conditions (which we proxy using US real yields). The drivers work in opposite directions, i.e. a rise in raw industrial prices helps EMFX and a rise in US real yields hurts EMFX. But global growth turns out to be much more important as a driver. Specifically, our analysis suggests that a sharp rise in US real yields (north of 20bp) would be required to wipe out the positive effect on EMFX coming from a 1% rise in raw industrial prices (See *FX Perspectives* "EMFX & the 'Trump Tantrum' – why this time could be different").

Our central scenario argues for a constructive EMFX stance but differentiation will be required

Our central scenario points to rising industrial metal prices as growth becomes more investment-driven. At the same time, our fixed income strategists estimate that US real rates are close to fair value and are unlikely to deviate from current levels. Given our assumptions, further appreciation in EM currencies should be expected. However, differentiation will remain the name of the game: we like currencies of countries with good (or improving) external balances and either high real yields or compelling valuation signals.

What we like in CEEMEA FX: RUB and CZK

In this regard, in CEEMEA, our topic picks are the RUB and the CZK. For the RUB, the inability of private sector outflows to recycle the current account surplus points to ongoing appreciation pressure. With the CBR remaining averse to rebuilding FX reserves aggressively, the currency will bear this appreciation pressure. Even with the CBR set to ease policy further, real rates will remain elevated, offering further support to the currency. In the case of the CZK, strong external balances as well as productivity differentials (right chart) point to ongoing appreciation.

Where we are most bearish: TRY and RON

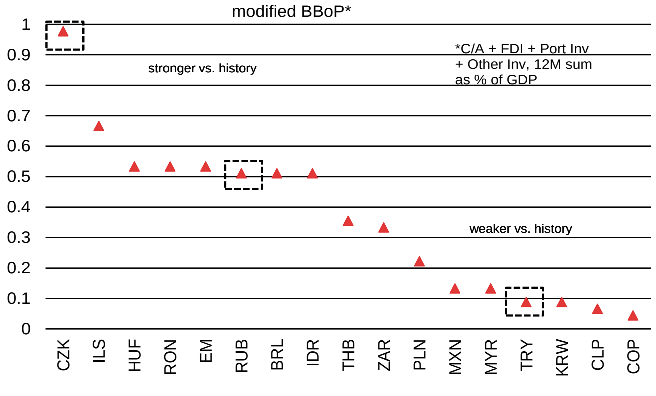
On the other hand, a combination of weakening external balances, deteriorating inflation, overly lax fiscal stance as well as questionable monetary policy response keeps us bearish on the TRY and the RON. While in a number of models the TRY looks very undervalued, in our opinion, the conditions are not in place for a recovery: real rates are far too low, and the current account deficit (which we expect to widen further next year) is being inadequately funded. With net FX reserves low and the CBRT unlikely to tighten policy, the TRY will remain under depreciation pressure. A sharp tightening in monetary conditions that slows domestic demand and, in turn, compresses the current account deficit would make us more optimistic. However, this seems unlikely. Romania, on the other hand, is seeing a transition in policy regime to allow for more FX flexibility while moving towards "pure" inflation targeting. But with the balance of payments sharply deteriorating, the currency should remain under depreciation pressure.

The "mixed" bags: PLN, HUF and ZAR

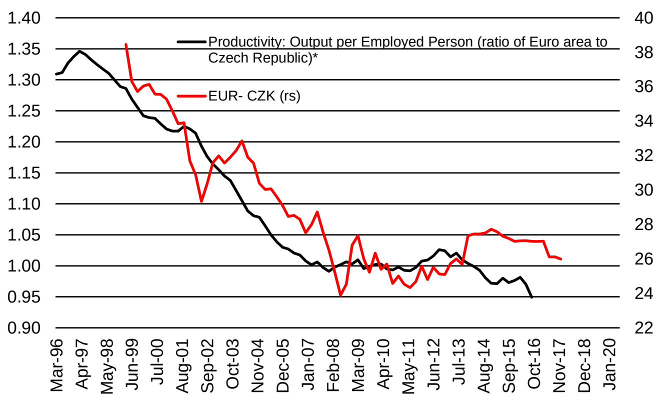
Finally, currencies like the PLN, the HUF and the ZAR are seen as "mixed" bags. We remain constructive on the PLN: while higher growth argues for a stronger currency, but so far balance-of-payments flows have not provided enough support. However, next year we expect a recovery in capital inflows, including EU funds. That should allow the currency to strengthen, assuming the NBP refrains from accumulating FX reserves (like in 2016). The NBP is unlikely to provide a catalyst; we expect unchanged rates through 2018. For the HUF, extremely lax monetary policy and a clear goal to keep the currency weak are the main obstacles to the currency embarking on an appreciation path. On the other hand, with easier monetary policy yielding diminishing returns, the central bank's balance sheet continuing to contract and external balances stellar, the currency is unlikely to weaken meaningfully from here. Finally, the ZAR will remain under pressure as weak growth and uncertainty over the direction of future policy will most likely result in a local currency rating downgrade (to sub-investment grade) in the months ahead. Nevertheless, external balances, which have been an important driver for the currency in the past, have been improving. Thus, these currencies should remain range-bound but extreme movements in either direction will present opportunities, in our view.

EXTERNAL BALANCES REMAIN KEY TO OUR THOUGHT PROCESS IN EMFX

External balances remain key to our EMFX analysis



Productivity differentials argue for further CZK appreciation



Source: Bloomberg, Haver, UniCredit Research

Emerging European credit shows decent performance YTD

Amid strong demand for EM assets, emerging European corporate credit looks back at a decent performance in 2017: the region's 5.4% YTD credit return is only slightly below the JPM CEMBI Broad index (5.6%). This is less than African (9.2%) and LatAm (9.8%), but well above Asian (3.5%) and Middle Eastern (1.5%) credit returns. EM and emerging European corporates' performance was in line with sovereign credit, though well below those of equities: the MSCI EM index is up by 31% YTD. The regional performance also reflects investors' preference for EM sub-investment rated credit: C, B, and BB rated EM corporate credit returned 20%, 8.2% and 6.9% respectively compared to 4.2% YTD for IG credit. We continue to expect high yield emerging European credit to outperform as investors' appetite for yield, coupled with a constructive view on the region's fundamentals, holds.

Preference remains for BB rated high yield credit

At 5.8%, emerging European corporate credit offers a decent yield, compared to, e.g. 4.1% on BB rated ML HY. As our left hand chart shows, the ratio of the two spreads is two standard deviations above its one year mean. As our right hand chart shows, however, in the euro-denominated IG sphere, the CEE component of the iBoxx NFI index offers only a slim premium. We believe that this relative attractiveness, coupled with solid global economic growth and firm commodity prices, should be supportive for regional credit. Our preference remains, however, for the BB rating bracket. At the same time, as was the case this year with number of credit events (Agrokor, Otkritie, B&N Bank) and (geo)political hot spots (e.g. Turkey, Saudi Arabia and Korean peninsula), investors continue to differentiate among credit, which limits the spillover risk into the asset class.

New bond supply to be neutral next year

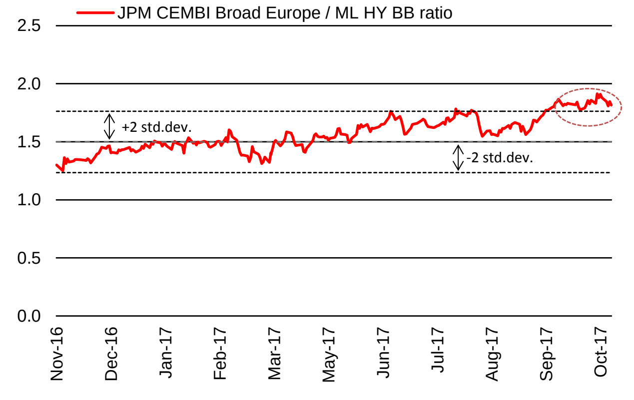
New bond supply should be neutral for emerging European corporates. We expect similar issuance next year to this year's issuance, when USD 42.8bn in new issues have been placed by regional corporates YTD, almost 60% more than in the same period last year. The majority is likely to come again from Russian corporates (40% YTD), though slightly less than this year. The lower supply from Russian corporates should, however, be counterbalanced by higher supply from other CIS – notably Kazakh – corporates. Turkish and CEE corporates are expected to place similar amounts as this year.

On balance, we expect range bound moves in EM corporate credit risk premia in 2018

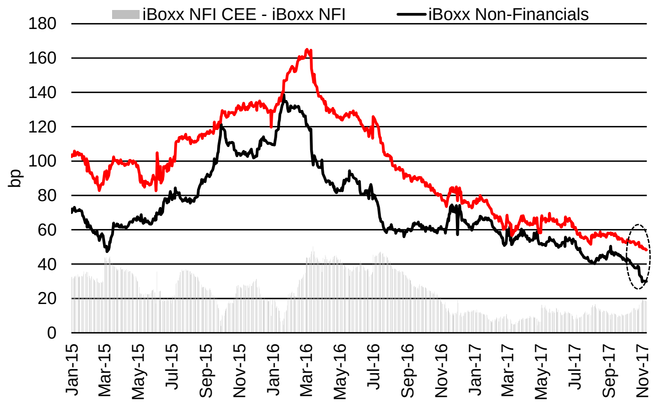
On balance, in our base scenario we expect EM and emerging European credit to move sideways around current levels next year, i.e. around 300bp for the JPM CEMBI Broad index and 370bp for its emerging European component, with a preference for sub-investment grade credit, notably BB rated issues. Russian credit risk premia appear to have reached a floor. However, the overall economic-growth picture in Russia and the financial sanctions are having the effect of disciplining the corporate policy of Russian issuers.

EMERGING EUROPEAN CORPORATES STILL OFFER VALUE VS. MAJOR MARKETS

JPM CEMBI Broad/ML HY BB index ratio



iBoxx NFI implied CEE component vs iBoxx NFI



Source: Bloomberg, JPM, ML, Markit, UniCredit Research

Consequently, we believe that as long as sanctions are in place and new issuance out of region is restricted, we should see some spreads tightening – albeit at much slower pace than has been seen to date, because the yields are already very tight compared to other EM credit.

Risks to the central scenario and implications

In terms of risks to our central scenario, the following stand out **1.** a more pronounced Chinese slowdown, **2.** the Fed turning more hawkish in response to upside growth surprises, **3.** an escalation of geopolitical risks (Saudi Arabia and Iran) and **4.** a US recession arriving earlier than expected.

For EM, we believe risk no **1.** will be most concerning to the extent that a slowdown in Chinese investment growth weighs on commodity prices, which are seen as crucial for revenue streams for several prominent EM countries. Risk no **2.** would be a concern especially for those countries with weak external balances, low FX reserves and high levels of FX debt (like Turkey), but in our view, for most EM a more hawkish Fed need not be a problem if accompanied by a strong upward trend in EM/global growth.

Risk no **3.** would lead to an oil supply shock and may initially affect risk-sentiment across the board. However, it will likely manifest itself in upward surprises to inflation for the major energy importers, including several countries in Asia. With respect to EM credits, recent experience with geopolitical hotspots showed that investors differentiate between markets, which limits spillover risks to other markets.

However, historically when global trade was in better shape and such a supply shock was evident (e.g. in 2007), Asian central banks responded by allowing a faster pace of FX appreciation to contain imported inflation (rather than raising interest rates). This, however, is not necessarily the case for central banks in other regions. Hence, a supply shock could create interesting divergences in EM.

Finally, risk no **4.** would likely initially result in weakness for EM currencies (and equities), especially for those countries dependent on US growth, such as Mexico and several countries in North Asia. However, a US recession should provide underlying support for EM fixed income to the extent it allows EM central banks to keep policy accommodative.

Oil

The supply glut is set to continue amid geopolitical risk

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We see Brent prices averaging USD 62/bbl in 2018 and USD 59/bbl in 2019. Geopolitical risk is back in the oil market and will likely keep prices above USD 60/bbl in the first half of 2018, despite a persisting supply glut. Oil inventories in OECD economies remain at historically high levels – currently amounting to around 3,000mn barrels. In addition, in the US, the number of drilled but uncompleted wells that can be activated almost immediately is high. The American oversupply is reflected in the Brent-WTI price spread, which has averaged about USD 4/bbl since June and suggests an imminent pickup in US oil exports.

Middle East uncertainty to be temporary

The recent move of Brent prices above USD 60/bbl has been driven by unexpected, but likely temporary, developments in the Middle East. First, the purge of leading figures in Saudi Arabia caught markets by surprise but should be seen as a domestic issue with no impact on Riyadh's energy strategy. Second, the proxy-war between Iran and Saudi Arabia in Yemen and Lebanon has intensified, but risks for an all-out war are low. Finally, the referendum on Kurdish independence inflamed tensions between Iraq's federal government and its autonomous Kurdish region. This created short-term shipping disruptions in an area that holds one third of Iraq's total oil reserves. Although tension remains high, Baghdad has regained control of key Kurdish oil fields and output disruptions in the world's fourth largest producer are unlikely.

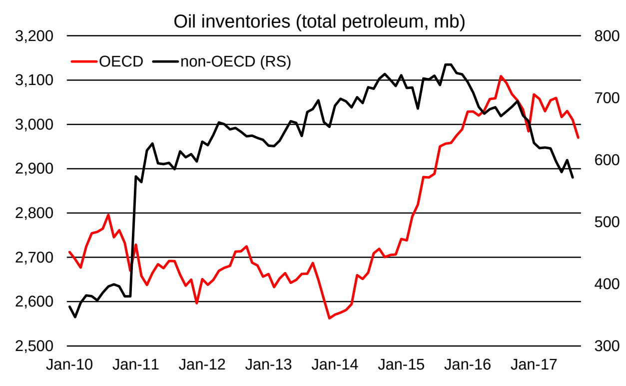
New production cut agreement is a done deal…

We expect oil prices to move back to the USD 55-60/bbl trading area once these factors dissipate, even if the situation in Yemen/Lebanon might not normalize quickly. A reiteration (but nothing more ambitious than that) of the OPEC/non-OPEC deal is priced in. Ahead of OPEC's annual meeting, which is to be held on 30 November, there is a willingness among the cartel's main actors to strike a deal. Recently, Riyadh and Moscow have strengthened their relationship by holding a high-level summit, and a series of investment agreements accompanied by constructive statements have reaffirmed their production pledge. Even Iran, where production has increased after US sanctions were lifted, has confirmed its willingness to cooperate.

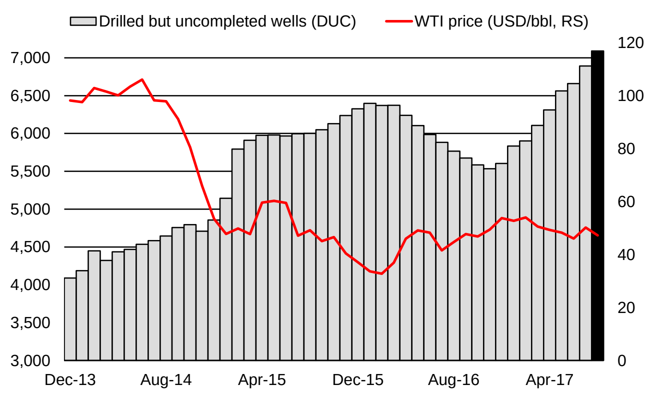
… but it will likely be unambitious

As far as November's OPEC meeting is concerned, we expect the following: **1.** the deal to be prolonged through the end of 4Q18, **2.** the production cut to be increased to about 2mn b/d from 1.8mn b/d, **3.** Nigeria to be added to the deal (but not Libya, where the political situation is still too unstable for a credible commitment) and **4.** the export cap for Saudi Arabia (at around 6.6-6.8mn b/d) to be referenced. There is likely to be discussion about a gradual exit strategy from the cut, but any announcement on this will likely be postponed into the first half 2018, once the status of the inventory drawdown is clearer. If excess supply is meaningfully absorbed, then the deal will not be extended further into 2019.

STUBBORNLY HIGH INVENTORIES



READY TO BE UNTAPPED



Source: EIA, UniCredit Research

Table 1: Annual macroeconomics forecasts

	GDP (%)			CPI inflation (%)			Central Bank Rate (EoP)			Government budget balance (% GDP)			General government debt (% GDP)			Current account balance (% GDP)		
	2017	**2018**	**2019**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**
World	**3.6**	**3.9**	**3.5**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
US	**2.2**	**2.6**	**2.0**	**2.1**	**2.3**	**2.4**	**1.50**	**2.25**	**2.50**	**-4.3**	**--4.3**	**-4.5**	**108.1**	**108.6**	**108.4**	**-2.4**	**-2.7**	**-2.8**
Eurozone	**2.3**	**2.3**	**1.9**	**1.6**	**1.5**	**1.4**	**0.00**	**0.00**	**0.25**	**-1.2**	**-1.1**	**-1.0**	**89.0**	**87.5**	**86.1**	**3.0**	**3.1**	**3.0**
Germany	2.2*	2.3*	1.9*	1.7	1.6	1.5	-	-	-	1.0	0.5	0.0	65.1	62.4	60.5	7.9	8.1	7.8
France	1.8	1.8	1.6	1.0	1.1	1.0	-	-	-	-2.9	-2.7	-3.0	96.9	97.1	97.0	-3.0	-2.7	-2.5
Italy	1.6	1.5	1.2	1.2	1.1	1.1	-	-	-	-2.1	-1.7	-1.4	131.8	130.9	129.4	2.6	2.4	2.4
Spain	3.1	2.7	2.1	2.0	1.7	1.6	-	-	-	-3.1	-2.4	-1.7	98.4	96.9	95.5	1.7	1.9	1.9
Austria	3.0	2.4	2.0	2.1	2.1	1.9	-	-	-	-0.7	-0.6	-0.5	78.5	75.5	73.2	2.1	2.1	2.2
Greece	1.1	2.0	1.8	1.0	1.1	1.0	-	-	-	-0.8	0.6	0.8	177.0	175.5	173.0	-0.5	-0.3	0.1
Portugal	2.5	1.9	1.7	1.3	1.2	1.1	-	-	-	-1.4	-1.4	-1.1	126.2	124.1	123.0	0.1	0.2	0.2
Other EU																		
UK	1.5	0.8	1.2	2.7	2.5	2.0	0.50	0.50	0.75	-3.0	-3.5	-2.5	90.4	92.0	93.0	-4.0	-3.5	-3.0
Sweden	3.1	3.0	2.5	1.9	1.9	2.2	-0.50	-0.25	0.50	1.0	1.0	1.0	39.5	37.5	35.5	5.0	5.0	5.0
Norway	1.9	2.0	1.8	1.9	1.6	1.8	0.50	0.50	1.00	4.5	4.5	4.5	34.7	33.0	34.0	4.3	4.1	4.1
Poland	4.3	4.2	3.7	1.9	2.0	2.1	1.50	1.50	2.25	-2.4	-2.7	-2.5	51.6	50.9	50.5	-0.2	-1.1	-1.5
Czech Rep.	4.0	3.4	2.5	2.4	2.6	2.2	0.75	1.50	2.00	0.2	-0.6	-1.0	34.7	33.7	33.3	0.3	0.2	0.0
Hungary	4.0	4.0	3.0	2.6	3.0	3.3	0.90	0.90	0.90	-2.4	-2.4	-2.2	72.0	69.4	67.4	3.1	2.5	2.4
Others																		
Switzerland	0.9	1.8	1.6	0.5	0.9	1.3	-0.75	-0.75	0.00	0.3	0.4	0.1	29.5	28.6	28.8	9.3	8.8	9.0
Russia	2.1	1.3	1.5	2.9	4.0	4.0	8.0	7.0	6.5	-2.2	-2.0	-1.4	12.3	13.4	14.7	2.0	1.3	0.9
Turkey	5.4	3.8	3.5	10.8	9.5	8.6	8.0**	8.0**	8.0**	-3.4	-3.2	-3.1	30.4	29.7	29.2	-5.4	-5.6	-5.9
China	6.8	6.5	6.0	1.8	2.1	2.1	4.35	4.35	4.35	-3.7	-3.5	-3.5	47.0	49.5	50.0	1.5	1.6	1.6
Japan	1.6	1.4	1.0	0.4	0.8	1.0	-0.10	-0.10	0.00	-4.5	-4.3	-4.0	240.0	240.0	239.0	3.8	3.8	3.7

*Non-wda figures. Adjusted for working days: 2.5% (2017), 2.3% (2018) and 1.9% (2019); **Effective cost of funding set by the CBRT based on the mix of the liquidity provided under the various facilities: 12.3% (2017), 11.8% (2018) and 11.3% (2019).

Source: UniCredit Research

Table 2: Quarterly GDP and CPI forecasts

REAL GDP (% QOQ, SA)

	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
US (annualized)	3.0	2.3	2.3	2.7	2.7	2.5	2.0	1.7	1.4	1.3
Eurozone	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Germany	0.8	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
France	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Italy	0.5	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2
Spain	0.8	0.7	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.4
Austria	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Other EU										
UK	0.4	0.2	0.1	0.2	0.2	0.3	0.3	0.4	0.3	0.3
Sweden	1.1	0.7	0.6	0.7	0.7	0.6	0.6	0.6	0.6	0.6
Norway	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Poland (% yoy)	4.7	4.2	3.9	4.4	4.3	4.2	3.8	3.5	3.9	3.6
Czech Republic	-0.2	0.3	1.1	1.2	0.8	0.8	0.6	0.5	0.3	0.3
Hungary (% yoy)	3.6	4.8	4.5	4.3	3.6	3.8	3.2	3.0	2.9	2.9
Others										
Switzerland	0.5	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.3
Russia	0.1	0.2	0.3	0.3	0.4	0.5	0.4	0.4	0.3	0.2
Turkey (% yoy)	0.2	0.1	1.1	1.2	1.1	0.9	0.9	0.9	0.8	0.7

CPI INFLATION (% YOY)

	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
US	2.0	1.9	1.7	2.4	2.5	2.4	2.4	2.4	2.4	2.5
Eurozone	1.5	1.5	1.5	1.5	1.6	1.4	1.2	1.3	1.4	1.5
Germany	1.7	1.6	1.6	1.6	1.5	1.5	1.5	1.5	1.5	1.4
France	0.9	1.1	0.9	1.1	1.3	1.2	1.0	1.0	1.0	1.0
Italy	1.1	1.0	0.7	1.0	1.3	1.4	1.2	1.1	1.1	1.2
Spain	1.8	1.6	1.7	1.6	1.9	1.7	1.4	1.5	1.6	1.9
Austria	2.2	2.3	2.1	2.1	2.2	1.9	1.8	1.8	1.9	1.9
Other EU										
UK	2.8	3.1	2.8	2.6	2.4	2.2	2.0	2.0	2.0	2.0
Sweden	2.2	2.1	2.1	1.9	1.8	1.7	1.8	2.2	2.4	2.4
Norway	1.5	1.3	1.3	1.6	1.5	1.8	1.9	1.8	1.8	1.6
Poland	1.9	2.0	2.0	2.3	2.1	1.8	1.8	1.8	1.8	1.8
Czech Republic	2.5	2.6	2.4	2.7	2.7	2.3	2.2	2.2	2.2	2.2
Hungary	2.4	2.2	2.2	2.2	2.2	2.2	2.2	2.3	2.3	2.3
Others										
Switzerland	0.5	0.8	0.8	0.9	0.9	1.0	1.1	1.3	1.4	1.5
Russia	3.3	2.7	3.0	2.8	3.4	4.1	4.0	4.0	4.0	4.1
Turkey	10.6	10.8	10.2	9.4	10	9.3	9,3	9.2	9.2	8.8

Source: UniCredit Research

Table 3: Comparison of annual GDP and CPI forecasts

GDP (%)

	UniCredit			IMF (Oct-17)			European Commission (Nov-17)			OECD (Jun/Sep-17)*		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
World	**3.6**	**3.9**	**3.5**	3.6	3.7	3.7	3.5	3.7	3.7			
US	**2.2**	**2.6**	**2.0**	2.2	2.3	1.9	2.2	2.3	2.1	2.1	2.4	-
Eurozone	**2.3**	**2.3**	**1.9**	2.1	1.9	1.7	2.2	2.1	1.9	2.1	1.9	-
Germany	2.2**	2.3**	1.9**	2.0	1.8	1.5	2.2	2.1	2.0	2.2	2.1	-
France	1.8	1.8	1.6	1.6	1.8	1.9	1.6	1.7	1.6	1.7	1.6	-
Italy	1.6	1.5	1.2	1.5	1.1	0.9	1.5	1.3	1.0	1.4	1.2	-
Spain	3.1	2.7	2.1	3.1	2.5	2.0	3.1	2.5	2.1	2.8	2.4	-
Austria	3.0	2.4	2.0	2.3	1.9	1.5	2.6	2.4	2.3	2.2	1.7	-
Greece	1.1	2.0	1.8	1.8	2.6	1.9	1.6	2.5	2.5	1.1	2.5	-
Portugal	2.5	1.9	1.7	2.5	2.0	1.7	2.6	2.1	1.8	2.1	1.6	-
Other EU												
UK	1.5	0.8	1.2	1.7	1.5	1.6	1.5	1.3	1.1	1.6	1.0	-
Sweden	3.1	3.0	2.5	3.1	2.4	2.1	3.2	2.7	2.2	2.7	2.3	-
Norway	1.9	2.0	1.8	1.4	1.6	1.9	1.5	1.6	1.8	1.3	1.5	-
Poland	4.3	4.2	3.7	3.8	3.3	3.0	4.2	3.8	3.4	3.6	3.1	-
Czech Rep.	4.0	3.4	2.5	3.5	2.6	2.3	4.3	3.0	2.9	2.9	2.6	-
Hungary	4.0	4.0	3.0	3.2	3.4	2.8	3.7	3.6	3.1	3.8	3.4	-
Others												
Switzerland	0.9	1.8	1.6	1.0	1.3	1.6	0.9	1.8	1.8	1.5	1.9	-
Russia	2.1	1.3	1.5	1.8	1.6	1.5	1.7	1.6	1.5	2.0	2.1	-
Turkey	5.4	3.8	3.5	5.1	3.5	3.5	5.3	4.0	4.1	3.4	3.5	-
China	6.8	6.5	6.0	6.8	6.5	6.3	6.8	6.5	6.2	6.8	6.6	-
Japan	1.6	1.4	1.0	1.5	0.7	0.8	1.6	1.2	1.0	1.6	1.2	-

CPI INFLATION (%)***

	UniCredit			IMF (Oct-17)			European Commission (Nov-17)			OECD (Jun-17)		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
US	**2.1**	**2.3**	**2.4**	2.1	2.1	2.6	2.0	2.1	2.2	2.5	2.2	-
Eurozone	**1.6**	**1.5**	**1.4**	1.5	1.4	1.7	1.5	1.4	1.6	1.2	1.4	-
Germany	1.7	1.6	1.5	1.6	1.5	2.0	1.7	1.5	1.6	1.9	1.6	-
France	1.0	1.1	1.0	1.2	1.3	1.6	1.1	1.2	1.5	1.3	1.2	-
Italy	1.2	1.1	1.1	1.4	1.2	1.4	2.0	1.4	1.5	1.5	1.3	-
Spain	2.0	1.7	1.6	2.0	1.5	1.7	2.0	1.6	1.7	2.3	1.4	-
Austria	2.1	2.1	1.9	1.6	1.8	2.1	1.2	0.8	1.3	2.1	1.8	-
Greece	1.0	1.1	1.0	1.2	1.3	1.4	1.5	1.4	1.5	1.4	0.8	-
Portugal	1.3	1.2	1.1	1.6	2.0	2.1				1.6	1.4	-
Other EU												
UK	2.7	2.5	2.0	2.6	2.6	2.2	2.7	2.6	2.1	2.8	2.7	-
Sweden	1.9	1.9	2.2	1.6	1.6	1.7	1.8	1.6	1.7	1.6	1.8	-
Norway	1.9	1.6	1.8	2.1	2.0	2.2	2.1	2.2	2.4	1.9	1.8	-
Poland	1.9	2.0	2.1	1.9	2.3	2.5	1.6	2.1	2.8	2.3	1.8	-
Czech Rep.	2.4	2.6	2.2	2.3	1.8	2.0	2.4	2.1	2.0	2.3	2.2	-
Hungary	2.6	3.0	3.3	2.5	3.2	3.0	2.3	2.6	3.0	3.0	3.0	-
Others												
Switzerland	0.5	0.9	1.3	0.5	0.6	0.9	0.5	0.2	0.2	0.5	0.4	-
Russia	2.9	4.0	4.0	4.2	3.9	4.0	3.9	3.7	3.5	4.2	4.0	-
Turkey	10.8	9.5	8.6	10.9	9.3	8.8	11.0	8.5	7.4	10.4	8.1	-
China	1.8	2.1	2.1	1.8	2.4	2.5	-	-	-	1.5	2.0	-
Japan	0.4	0.8	1.0	0.4	0.5	1.1	0.4	0.8	1.2	0.6	1.0	-

*The OECD GDP forecasts are those published in the September 2017 edition of the *OECD Interim Economic Outlook* for all countries except Spain, Austria, Greece, Portugal, Sweden, Poland, the Czech Rep., Hungary, Switzerland, Russia and Turkey, where the numbers are those published in June 2017.
**Non-wda figures. Adjusted for working days: 2.5% (2017), 2.3% (2018) and 1.9% (2019).
***UniCredit forecasts refer to CPI with the exception of Spain, where HICP is used. IMF and OECD inflation forecasts refer to the CPI except for eurozone countries, where HICP is used. EC inflation forecasts refer to the HICP, except for the US, where CPI is used. Please note that in the UK, CPI and HICP coincide.

Source: IMF, European Commission, OECD, UniCredit Research

Table 4: FI forecasts

INTEREST RATE AND YIELD FORECASTS (%)

	Current	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
EMU									
Refi rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25
Depo rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	-0.20	0.00
3M Euribor	-0.33	-0.35	-0.35	-0.35	-0.35	-0.10	-0.10	0.10	0.10
2Y Schatz	-0.74	-0.70	-0.65	-0.55	-0.40	-0.30	-0.20	-0.10	0.05
5Y Obl	-0.34	-0.25	-0.15	0.00	0.15	0.25	0.30	0.40	0.50
10Y Bund	0.39	0.50	0.55	0.70	0.80	0.90	0.95	1.00	1.00
fwd		0.53	0.59	0.66	0.72	0.78	0.85	0.91	0.98
30Y Bund	1.27	1.35	1.40	1.50	1.55	1.60	1.65	1.70	1.70
2/10	113	120	120	125	120	120	115	110	95
2/5/10	-33	-30	-20	-15	-10	-10	-15	-10	-5
10/30	85	85	85	80	75	70	70	70	70
2Y EUR swap	-0.20	-0.18	-0.12	-0.05	0.05	0.15	0.20	0.25	0.30
5Y EUR swap	0.21	0.30	0.35	0.45	0.55	0.65	0.70	0.80	0.85
10Y EUR swap	0.86	0.95	1.00	1.10	1.20	1.30	1.35	1.40	1.35
US									
FedFunds	1.25	1.50	1.75	2.00	2.25	2.25	2.50	2.50	2.50
3M Libor	1.41	1.65	1.90	2.15	2.40	2.40	2.50	2.50	2.50
2Y UST	1.65	1.85	2.10	2.30	2.45	2.50	2.50	2.50	2.50
5Y UST	2.02	2.20	2.40	2.50	2.60	2.65	2.60	2.57	2.55
10Y UST	2.34	2.55	2.70	2.75	2.75	2.75	2.70	2.65	2.60
fwd		2.44	2.48	2.52	2.56	2.59	2.63	2.66	2.70
30Y UST	2.81	2.95	3.05	3.05	3.00	3.00	2.95	2.90	2.80
2/10	69	70	60	45	30	25	20	15	10
2/5/10	5	0	0	-5	0	5	0	-1	0
10/30	47	40	35	30	25	25	25	25	20
2Y USD swap	1.84	2.05	2.30	2.50	2.65	2.70	2.70	2.70	2.70
10Y USD swap	2.32	2.55	2.70	2.80	2.80	2.80	2.75	2.70	2.65
UK									
Key rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75
10Y Gilt	1.31	1.40	1.40	1.45	1.50	1.50	1.55	1.60	1.60
fwd		1.42	1.47	1.52	1.57	1.62	1.67	1.72	1.77

Spreads	Current	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
10Y UST-Bund	195	205	215	205	195	185	175	165	160
10Y UST-Gilt	103	115	130	130	125	125	120	115	110
10Y Gilt-Bund	91	90	85	75	70	60	55	50	50
10Y BTP-Bund	144	175	160	130	140	150	150	150	145
10Y BTP-swap	97	130	115	90	100	110	110	110	110
10Y EUR swap-Bund	47	45	45	40	40	40	40	40	35
10Y USD swap-UST	-2	0	0	5	5	5	5	5	5

Source: Bloomberg, UniCredit Research

Table 5: FX forecasts

EUR	Current	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	3M	6M	12M	BEER*	Deviation**
G10														
EUR-USD	1.18	1.20	1.22	1.23	1.25	1.26	1.27	1.28	1.28	1.20	1.22	1.23	1.25	-5.6%
EUR-CHF	1.17	1.17	1.18	1.19	1.20	1.20	1.20	1.19	1.18	1.17	1.17	1.19	1.21	-3.3%
EUR-GBP	0.90	0.92	0.92	0.91	0.91	0.90	0.89	0.90	0.90	0.92	0.92	0.91	0.77	16.9%
EUR-JPY	134	133	134	134	135	135	133	131	128	134	135	134	111	20.7%
EUR-NOK	9.72	9.40	9.30	9.20	9.10	9.00	9.00	8.90	8.90	9.51	9.34	9.20	7.57	28.4%
EUR-SEK	9.95	9.80	9.70	9.65	9.55	9.50	9.45	9.40	9.40	9.85	9.74	9.65	7.33	35.7%
EUR-AUD	1.56	1.52	1.53	1.52	1.52	1.54	1.57	1.60	1.62	1.54	1.54	1.52	1.80	-13.3%
EUR-NZD	1.72	1.71	1.72	1.73	1.74	1.75	1.76	1.80	1.83	1.74	1.74	1.73	1.79	-3.9%
EUR-CAD	1.51	1.48	1.49	1.49	1.50	1.51	1.52	1.55	1.56	1.50	1.50	1.49	1.47	2.7%
EUR-TWI	98.8	98.3	99.1	99.6	100.7	100.8	101.1	101.5	101.4	98.1	98.8	99.6		
CEEMEA & CHINA														
EUR-PLN	4.25	4.16	4.12	4.12	4.10	4.08	4.12	4.09	4.10	4.15	4.14	4.10	4.36	-2.5%
EUR-HUF	312	312	313	310	313	311	311	310	313	312	313	312	342	-8.8%
EUR-CZK	25.6	25.2	25.1	25.0	25.0	25.0	25.0	25.0	25.0	25.3	25.1	25.0	31.6	-19.0%
EUR-RON	4.64	4.63	4.65	4.61	4.68	4.65	4.67	4.65	4.70	4.63	4.65	4.65		
EUR-TRY	4.60	4.73	4.67	4.77	5.19	5.36	5.43	5.44	5.70	4.69	4.71	4.99		
EUR-RUB	71.4	68.5	70.0	71.0	73.2	74.7	75.5	76.6	77.0	68.6	69.9	71.7		
EUR-ZAR	17.0	16.9	16.8	16.7	16.6	16.6	16.9	17.0	17.3	17.0	17.0	16.5		
EUR-CNY	7.84	7.86	8.05	8.19	8.38	8.44	8.53	8.63	8.64	7.85	8.04	8.22		

USD	Current	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	3M	6M	12M	BEER*	Deviation**
G10														
EUR-USD	1.18	1.20	1.22	1.23	1.25	1.26	1.27	1.28	1.28	1.20	1.22	1.23	1.25	-5.6%
USD-CHF	0.99	0.98	0.97	0.97	0.96	0.95	0.94	0.93	0.92	0.98	0.96	0.97	0.97	2.1%
GBP-USD	1.32	1.30	1.33	1.35	1.37	1.40	1.42	1.42	1.42	1.30	1.32	1.35	1.62	-18.5%
USD-JPY	113	111	110	109	108	107	105	102	100	112	110	109	88.7	27.4%
USD-NOK	8.21	7.83	7.62	7.48	7.28	7.14	7.09	6.95	6.95	7.93	7.66	7.48	6.06	35.5%
USD-SEK	8.40	8.17	7.95	7.85	7.64	7.54	7.44	7.34	7.34	8.21	7.98	7.85	5.86	43.3%
AUD-USD	0.76	0.79	0.80	0.81	0.82	0.82	0.81	0.80	0.79	0.78	0.79	0.81	0.69	10.1%
NZD-USD	0.69	0.70	0.71	0.71	0.72	0.72	0.72	0.71	0.70	0.69	0.70	0.71	0.70	-1.4%
USD-CAD	1.27	1.23	1.22	1.21	1.20	1.20	1.20	1.21	1.22	1.25	1.23	1.21	1.18	7.6%
USTW$	89.4	88.3	87.2	86.4	85.3	84.7	84.1	83.6	83.6	88.8	87.6	86.4	79.5	12.5%
USD-DXY	93.5	92.3	90.9	90.1	88.8	88	87.1	86.4	86.2	92.7	91.4	90.1		
CEEMEA & CHINA														
USD-PLN	3.59	3.47	3.38	3.35	3.28	3.24	3.24	3.20	3.20	3.46	3.39	3.33	3.49	2.9%
USD-HUF	263	260	257	252	250	247	245	242	245	260	256	254	274	-4.0%
USD-CZK	21.7	21.0	20.6	20.3	20.0	19.8	19.7	19.5	19.5	21.1	20.6	20.3	25.3	-14.2%
USD-RON	3.92	3.86	3.81	3.75	3.74	3.69	3.68	3.63	3.67	3.86	3.81	3.78		
USD-TRY	3.88	3.94	3.83	3.88	4.15	4.25	4.28	4.25	4.45	3.91	3.86	4.06		
USD-RUB	60.3	57.1	57.4	57.8	58.5	59.3	59.4	59.8	60.2	57.1	57.3	58.3		
USD-ZAR	14.3	14.1	13.8	13.6	13.3	13.2	13.3	13.3	13.5	14.2	13.9	13.4		
USD-CNY	6.62	6.55	6.60	6.66	6.70	6.70	6.72	6.74	6.75	6.54	6.59	6.68		

Forecasts are end-of-quarter / end-of-month forecasts.

*BEER values are fair value estimates based on our Behavioural Equilibrium Exchange Rate model (see *UniCredit Global Themes Series* "Introducing BEER by UniCredit", 3 September 2013).
**Deviation between current value of the exchange rate and the fair value estimate

Source: Bloomberg, UniCredit Research

Table 6: Risky assets forecasts

EQUITY AND CREDIT FORECASTS

	Current	Mid-2018	End-2018
Equities			
Euro STOXX 50	3,530	4,000	3,850
DAX	12,950	15,000	14,500
FTSE MIB	22,090	25,500	24,500
Credit**			
iBoxx Non-Financials Senior	25	35	60
iBoxx Financials Sen	23	30	50
iBoxx High Yield NFI	235	260	350

Source: Bloomberg, UniCredit Research

Table 7: Oil forecasts

BRENT FORECASTS

	Current	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Brent (USD/bbl, avg)	61.6	64	62	60	60	58	58	60	60

Source: Bloomberg, UniCredit Research

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n.a.

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RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

Interest bearing securities

Company	Date	Rating	Currency	Target price
n.a.	n.a.	n.a.	n.a.	n.a.

Stock market indices

Sector/index	Date	Rating
Basic Resources	18/11/2016	Overweight
Food & Beverage	18/11/2016	Neutral
Utilities	18/11/2016	Neutral
Insurance	02/12/2016	Neutral
Real estate	02/12/2016	Underweight
Chemicals	22/12/2016	Overweight
Industrial Goods & Services	22/12/2016	Overweight

Sector/index	Date	Rating
Oil & Gas	22/12/2016	Underweight
Technology	22/12/2016	Neutral
Utilities	22/12/2016	Underweight
Basic Resources	09/03/2017	Neutral
Chemicals	12/04/2017	Neutral
Technology	12/04/2017	Overweight
Food & Beverage	12/04/2017	Overweight
Chemicals	22/09/2017	Overweight
Basic Resources	22/09/2017	Underweight
Oil & Gas	06/10/2017	Neutral
Basic Resources	15/11/2017	Overweight

Overview of our ratings

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Recommendations relative to an index:
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Marketweight (MW): We recommend having the same portfolio exposure in the name as the respective iBoxx index. We expect that the average total return of the instruments of the issuer is equal to the total return of the index.

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Underweight (UW): We recommend having a lower portfolio exposure in the name as the respective iBoxx index. We expect that the average total return of the instruments of the issuer is less than the total return of the index.

Outright recommendations:

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Sell (S): We recommend selling the respective instrument for investors who already have exposure. We expect that the total return of the instruments of the issuer is less than the yield.

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Overweight (OW): We recommend having a higher portfolio or index weight in the sector as the benchmark. We expect that the average total return of the sector is greater than the total return of the benchmark.

Underweight (UW): We recommend having a lower portfolio or index weight in the sector as the benchmark. We expect that the average total return of the sector is less than the total return of the benchmark.

If not otherwise stated daily price data refers to pre-day closing levels and iBoxx bond index characteristics refer to the previous month-end index characteristics.

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