Market Compass Special

Outlook

2015

Welcome to
UniCredit
Private Banking

Index

2015 - OUTLOOK

The newsletter is prepared with data from: 12.12.2014.
Source: Global Investment Strategy, Bloomberg

Scenario

2015 - OUTLOOK

SIGNS OF IMPROVEMENT

The global economy is moving resolutely towards **stronger growth**, with an estimate of 3.8% / 4% for the coming year, up from 3.3% / 3.5% in 2014. This positive forecast is primarily due to less stringent fiscal policies, the continuation of expansionary monetary policies, dropping oil prices and a gradual easing of geopolitical tensions. Although recovery will be led by the United States, the Eurozone will also contribute to the upward trend, albeit to a lesser extent. Emerging countries, China and India foremost, will instead be sustained by an improved global context.

In this scenario, our **asset allocation** continues to favour equity markets, emerging markets bonds and, once again, alternatives, whereas our opinion on Europe remains neutral. As for the past quarter, our **overweight position on US equities** stands out, supported by the solid earnings of US companies. Our positive view on Japan is confirmed, together with an underweight position on emerging markets and a neutral position on the Pacific area.

Moving on to **fixed income**, our **preferences are once again emerging markets**, at the expense of core government bonds and corporates as a whole. Looking towards Europe, we're confirming a neutral position on **peripheral markets**, as our spread targets on Bunds were achieved and we estimate there's limited room for further improvement over the short term.

On the corporate front, we're confirming **underweight on high yield and investment grade bonds**, due to the worsening quality of new issues and a growing liquidity risk for the former, and high evaluations compared to equity for the latter. We're moving to **underweight on commodities**, due to the slowdown in Chinese demand and the effects of the shale gas revolution in the USA.

In conclusion, a possible sharp rise in bond yields in the US, which could slow growth, will need to be monitored, together with an acute slowdown in the Chinese economy, and the risk of the beginning of a deflationary spiral in Europe, as well as geopolitical tensions in Ukraine and the Middle East.

Scenario

2015 - OUTLOOK

INVESTING REQUIRES A CLEAR MIND

Prospects, risks, opportunities: our strategy for the next quarter is based on several key assumptions, formulated by analyzing the recent market trends.

Manuela D'Onofrio, Head of Global Investment Strategies, helps with the detailed analysis of the situation, to be able to understand how the world's largest economies will move in the coming year 2015.

Manuela D’Onofrio
Head of Global Investments
UniCredit Group

Will the **global economy** strengthen its growth in 2015?

“In 2015, the **global economic recovery** will be mostly driven by the **United States**, while the Eurozone is expected to experience modest growth, constantly seeking a balance between austerity and development, and policy convergence between the different nations making up the Union. Special attention will be paid to the ECB’s next moves, as it could very well implement a quantitative easing, even buying up the sovereign debt of member countries. In the Far East, Japan is looking for the most effective measures to get out of a twenty-year period of deflation, while China will continue to grow at a good pace, albeit slower.”

Where is **Europe** moving after the slowdown in 2014?

“The Old Continent will return to grow at a rate of around 1%, a figure that is rather modest but shows that we’re now on the road to recovery. Supporting the Eurozone’s economy, in particular, is the easing of austerity policies, which should leave more room for investments, and a more expansionary monetary policy than in 2014. The markets look to the ECB and the possibility that the Eurotower adopts ”unconventional” measures. In other words, as ECB President Mario Draghi would put it - ***quantitative easing***. Germany will confirm its solid standing, whereas France will show more weakness. Italy, after yet another negative result in 2014, should be due to get out of its recession.”

The **USA** is experiencing a strong recovery. What’s behind this performance?

“**2015 will be an American year**. Indeed, the United States, with a GDP of nearly 3%, will be the engine of global growth, exerting a positive effect and leading the other developed countries, starting from the Eurozone. The US recovery is based on solid foundations - **increased consumption** and investment, both private and corporate. Add to this outlook improvements in the job market, falling oil prices and a recovery in real estate, and the prospects for the coming year are very encouraging.”

Can **Japan** win its battle with deflation?

“The ambitious goals of monetary and fiscal policy of *Abenomics*, named after their promoter, Prime Minister Shinzo Abe, have unfortunately not provided the desired results. Despite the strong support of the Bank of Japan (BoJ), the spectre of **deflation** has returned to hover over the Asian powerhouse, so that for 2015 a new and substantial program of quantitative and qualitative monetary expansion has already been prepared. The **weak yen**, the only true positive result obtained, is boosting competitiveness and growth in corporate earnings for export oriented businesses, also aided by expected reductions in taxation.”

Are **China‘s** efforts to stimulate domestic demand working?

"China's growth in the second quarter and activity data for July have **positively surprised** investors. In the period between April and June, GDP has reached 8.1%, which is a strong rebound from the 5.8% recorded in late March. Investments in durable goods have grown, driven by an increase in **public investment** in infrastructure and by the data coming from the real estate market, which were better than expected. In coming months we expect a **consolidation** of the economic cycle and adoption of "mini-stimulus" measures by the government, given its strong commitment to the goal of 7.5% growth in 2014."

Asset Allocation

2015 - OUTLOOK

OUR ASSET ALLOCATION FOR 4Q 2014

Asset Class

Equity
Alternative funds

Real Estates

Commodities
Bonds
Cash

Equity	Commodities	Bonds
USA Japan	Gold Oil Industrial metals	Emerging Markets
Europe Pacific ex Japan		Governments Corporate Investment Grade and High Yield
Emerging Markets		

overweight

neutral

underweight

WHAT WE NEED TO KEEP AN EYE ON

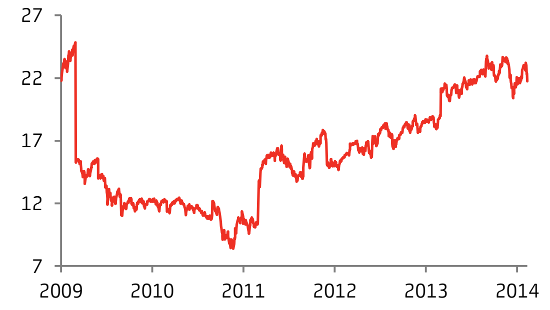
The most destabilizing element for any forecast could be a **return of the crisis in the Eurozone**. The latest economic surveys show a significant weakening, and the International Monetary Fund has highlighted the weakness of the recovery, emphasizing the risk of deflation. Not to mention the fact that deep structural differences continue to persist between the various countries in the Union, often divided among themselves by strong political disagreements that could prevent the ECB from expanding its balance sheet up to 1 trillion euros, as announced by Draghi.

In the US, the improved economic situation that is driving an increase in jobs, consumption and inflation, could lead the Federal Reserve to start **raising official interest rates** earlier than expected, which could trigger a market correction.

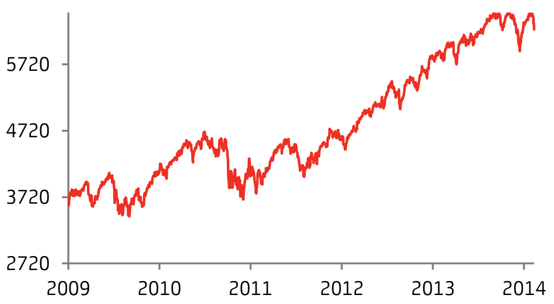
In Asia, China is expected to slightly moderate its speed of growth by a percentage point. If this slowdown would transform itself into **sharp slowdown**, there could be global consequences, such as a decline in the pace of foreign trade with negative effects for all emerging economies.

In the background are still all the usual geopolitical tensions. In particular, the possibility of an escalation in the Ukraine and in Syria, along with a broadened risk of terrorism in the Mediterranean, could cause a sharp rise in oil and gas prices, with a negative impact on global growth prospects, as well as triggering a run on so-called *safe* investments.

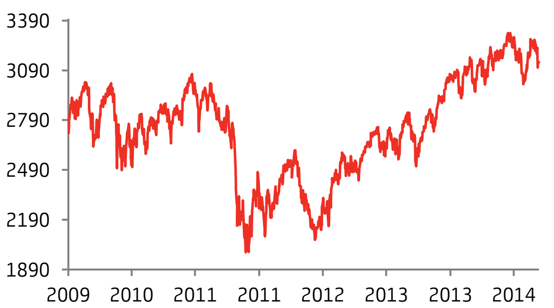
P/E Ratio of EuroStoxx50



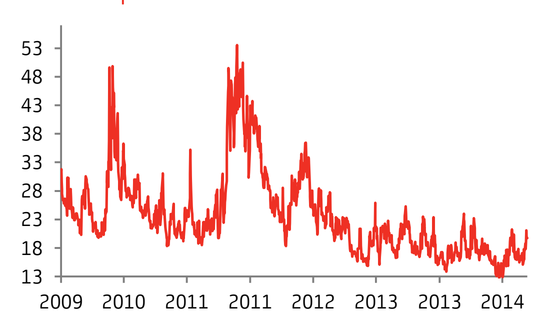
Msci World Index



EuroStoxx Index



VIX European Index



Equity

THE CHOICE IS ON USA AND JAPAN

The US economy as the engine of global growth and expansionary monetary policies in Europe and Japan support **our preference for equities.** Evaluations remain favourable in a relative comparison with bonds and offer a very attractive dividend yield. However, return in 2015 will be single-digit and more volatile as a result of concerns about a possible slowdown in growth, particularly in Europe, as well as uncertainty on the timing of the Fed's raising rates and geopolitical risks.

Our 2015 preference on equities is first and foremost for **USA** and **Japan**. For the US, we're convinced by the solid results in the economy, and for the Japan the falling yen is still a determining factor, favouring exports. We remain neutral on the Pacific ex Japan and confirming **underweight position on emerging markets**. Contained growth figures, combined with geopolitical risk in Eastern countries, push us to remain **neutral on Europe.** However, we're ready to move our view in positive terms in the event of more relaxed austerity policies and the launch of a QE that involves the purchase of government bonds by the ECB.

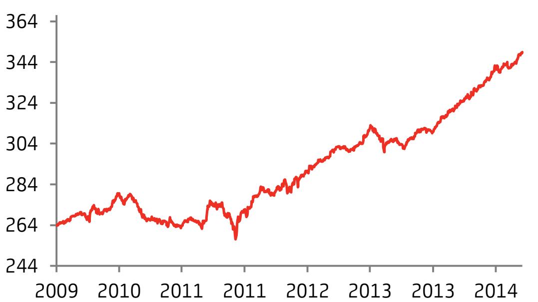
Among factors that should be monitored are the risk of a **deflationary spiral in Europe**, combined with the danger of political disagreements between countries. Less probable factors, as highlighted in recent months, are a **sharp contraction of the Chinese economy** and a significant rise in yields on US Treasury securities. The backdrop to this scenario is the geopolitical situation, with mounting tensions in Ukraine, Syria and Iraq.

Fixed Income

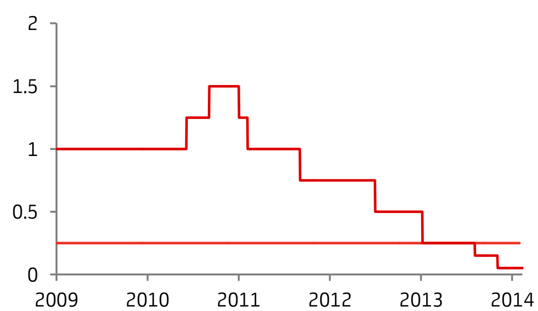
A DIVERGENT SCENARIO

Generic Euro 10y Government Bon

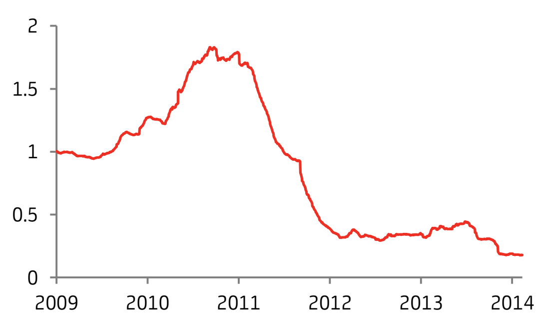
JPMorgan Global Bonds Price Index



ECB and FED Target Rates



Euribor 6 months



For the G4 (USA, Great Britain, Eurozone, Japan) there are **expectations of divergent monetary policies**, especially in light of divergent economic cycles in different geographical areas. Government bonds and corporate US bonds will thus be vulnerable to the Fed's gradual normalization policy on interest rates, which we expect as starting in mid-2015, while European bonds will be supported by the ECB's foreseen expansionary policy. Emerging markets bonds will offer interesting yield opportunities on a selective basis.

Specifically, we remain **negative** on the US securities, core Europe, and corporates at a global level. We confirm our **overweight position on emerging markets debt** (hard and local currencies). Here we prefer securities issued by countries with stronger fundamentals. Divergent monetary policies between Europe and the US will probably maintain a weak upward pressure on Bund yields, favouring European bonds over US securities. For the moment, we're keeping **neutral position on government bonds from peripheral countries**, which have reached our objectives in terms of spread compared to Bunds. Nonetheless, we have a positive long term opinion on government bonds from peripheral countries, especially in the case of QE by the ECB, with the purchase of sovereign debt.

Among the risks which could influence this scenario, we highlight **an intensification in geopolitical risk**, with a consequent increase in demand for "safe havens„ and decline in yields, and a possible return of the crisis in the Eurozone, with a sharp slowdown in China and implications for emerging economies.

Commodities

CAUTION ON OIL AND GOLD

In 2015, the factor that will most influence the commodities is the prospect of a global recovery. **Concerns over economic growth** in Europe and China, the strong US dollar, abundant cereal crops and a structural change in demand / supply. The majority of these factors should persist even during 2015, and this asset class will have a **limited interest**.

Therefore, we moved to **an underweight stance**, compared to the neutral during the Q4 2014. In terms of demand, our judgment is linked to the expected slowdown in China during 2015 and the effect of energy saving policies, while on the supply side the shale gas revolution in the US and the increase in crude oil production in some countries.

We're reviewing our position on **gold**, for which we are **cautious**. Indeed, the upswing in gold prices is slowed by a strong US dollar, and by the prospect of rising real yields. We also **remain cautious on crude oil**: in fact, we think that an outlook of structural weakness is looming over the markets, due to record supplies, which have profoundly changed the fundamentals of the industry. We're also **negative on industrial metals**, because of high stock levels, the slowdown in China and excess supply, and we remain **neutral on agricultural commodities**.

The **major risk elements** for this outlook are an unpredictable return to risk aversion, which could increase investor interest in gold as a safe haven., a tightening of geopolitical tensions and the possibility of an agreement between OPEC countries to cut production and cause a sharp increase in the price of oil.

Real Estate

FLEXIBLE AND ABSOLUTE RETURN AS VALID ALTERNATIVE TO BONDS

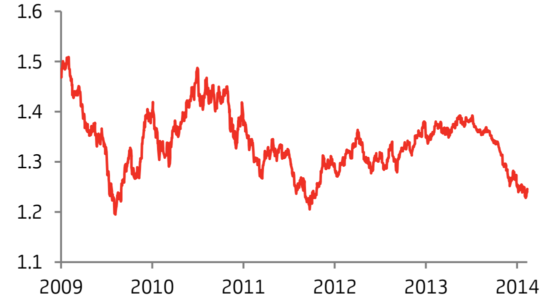
In an outlook of gradual normalization of rates and near zero yields in money markets due to a more expansionary ECB policy, investments in flexible funds with absolute returns are confirmed a **viable alternative** to traditional products specializing in fixed income and liquidity investments. Regarding the real estate sector, we'll see an improvement in the market, especially in the US, even though at a rather slower pace. The outlook remains positive nonetheless, in light of an increase in prices which, still represents a clear signal of a recovery.

We're therefore confirming an **overweight position on alternative investments**, given that these funds can play an important role in diversification to bonds, allowing investors to focus on instruments such as securitizations on mortgage loans and consumer credit, normally closed to traditional bond products. We confirm our **neutral position on real estate.**

The **most critical elements** are linked to renewed instability in the financial markets, which could feed investors' risk aversion and affect demand for sophisticated products. A sudden **rise in yields** in the US, however, would have negative effects on the full recovery of the housing markets.

Forex

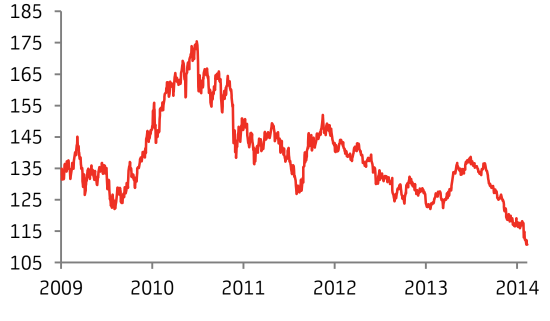
EURUSD



Gold

Crude Oil

DJ AIG Commodity Index



DOLLAR STRENGTHENS, EURO CONFIRMS ITS WEAKNESSES

Solid growth in the US will lead to a **strengthening of the dollar**, especially with respect to the euro. The dynamics between these two currencies are affected by a growth differential expected in the two areas, and by the divergent monetary policies of their respective central banks. Indeed, in 2015 the Fed is expected to reduce market stimulus, while the ECB is expected to adopt a decidedly expansionary behaviour.

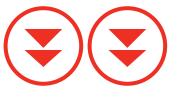
The US is showing a solid improvement in macroeconomic conditions, with an expected GDP growth of around 3% next year. Conversely, a weak recovery will characterize the Eurozone as well as Japan. Yet another factor in favour of the US currency is the spread on 2-year bonds between the USA and Germany, which is expected to expand further. However, flows from foreign investors directed towards European assets, and the current account surplus are factors that play against a sharp fall of the euro. Even the **Japanese yen should continue to depreciate**. Further accommodating measures by the Bank of Japan and the decision by the state's public pension fund to increase the weight of investments abroad will again put pressure on the Japanese currency.

The risk element in this outlook is the assumption that the **ECB will adopt a less expansionary behaviour** than is expected by the market. The result would be a sharp appreciation of the euro. Furthermore, the increase in geopolitical tensions could push investors towards safe currencies, particularly the yen.

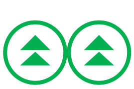
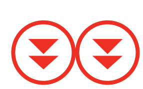
Portfolio

2015 - OUTLOOK

OUR PORTOLIO SELECTION IN SUMMARY

ASSET CLASS	VALUATION	RATIONALE
Equity		We remain bullish on equities because of the improving macro momentum, especially in US, accommodative monetary policies and still favorable valuations relative to bonds.
Fixed Income		Better-than-expected US macro data and expensive valuation relative to equity make this asset class vulnerable.
Commodities		We moved from neutral to underweight on commodities. The slowdown in China, the oversupply in the oil and the use of the shale gas in the US will penalize the prices of industrial metals and oil.
Alternatives		Alternative Investments may play an important role as bond substitutes.
Cash		“Zero interest policies” penalize monetary investments.

EQUITY	VALUATION	RATIONALE
USA		The strength of the US economy and good future corporate earnings visibility are elements supportive for our overweight on US equities, although their valuations are close to a correct value (fair value).
Europe		We remain neutral on European equities regard to weak economy and geopolitical risks. However, policies are less restrictive and the drop in oil prices and the euro will help the profitability of enterprises.
Japan		We remain overweight (in hedged FX), thanks to expectations of a further weakening of the yen that stimulate exports.
Pacific ex Japan		The Australian market is linked to commodities and RBA continues to underline the risks related to rising housing market prices. However, the high dividend yield (4.4%) supports asset class.
Emerging Markets		We keep a marginal underweight on EM. They are still vulnerable to increasing US treasury yields, disappointing news about their growth, falling commodity prices and geopolitical risks.
Frontier Markets		Long term investment opportunity.

 strong overweight  overweight neutral  underweight  strong underweight

Portfolio

2015 - OUTLOOK

OUR PORTOLIO SELECTION IN SUMMARY

BONDS	VALUATION	RATIONALE
Governments		In the short term Bund yields are expected to consolidate at current levels but in the long-term view is negative. We tactically move to a neutral stance on Peripherals (BTPs) having reached our spread targets vs Bunds as we see limited scope for a further spread tightening in the short term. However on a longer horizon we keep our constructive view on the asset class.
Corporate Investment Grade		Vulnerability to higher Core yields and less compelling valuations relative to stocks.
Corporate High Yield		We keep our negative stance on High Yield corporate bonds, as the risk/reward is no more appealing given the worsening quality of new issuances and the lack of liquidity. The latter lead us to hasten the exit strategy, though in the short term the search of yield may still favors HY .
Emerging Markets		Improving backdrop and attractive yield pick-up vs Core Govies. We prefer hard and local currencies debt of countries with strong fundamental and massive foreign currency reserves.

COMMODITIES	VALUATION	RATIONALE
Gold		We moved our stance to negative from neutral. Falling investment demand, the strengthening of the dollar and expectation to rise of US yields puts pressure on gold prices.
Oil		We changed our stance to negative. "New normal" for oil: the production records and the shale gas revolution in the US have changed the fundamentals of the oil market. The appreciation of the dollar penalizes oil price.
Industrial metals		High level of stockpiles, slowdown in China, supply surplus, penalizes price.
Agriculturals		No major catalysts in the short term, supply surplus.

strong overweight   overweight   neutral   underweight   strong underweight

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1. Information related to the past results of a financial instrument, index or investment service are not indicative of future results.

2. If an investment is denominated in a currency other than the investor's currency, the value of the investment may be subject to strong fluctuations in relation to exchange rates and have an adverse effect on the investment's profitability.

3. Investments that offer high yields may be subject to strong price fluctuations as a result of credit rating downgrades. In the event of bankruptcy on the part of the issuer, investors may lose their entire capital outlay.

4. High volatility investments may be subject to sudden and substantial decreases in value, generating potentially significant losses at the time of sale with respect to the entire capital invested.

5. Extraordinary events may make it difficult for investors to sell or liquidate some investments, or obtain reliable information on their actual value.

6. Where the information refers to a specific tax treatment, it should be noted that fiscal factors depend on the client's individual situation and may be subject to change in the future.

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