2020-21: DEFENDING GROWTH AT ALL COSTS

Global Economic Outlook
as of January 2020
LESSONS LEARNED FROM 2019

1. US-China rivalry escalated at a rapid pace
   The US average import tariff increased from 3.5% in 2018 to close to 8% in 2019. **Lessons learned**: a continuation of very high uncertainty, at least until the 2020 election. While tariffs shaved -0.2pp off global GDP growth, we estimate the annual cost of uncertainty at -0.3pp of global GDP growth. China has prioritized economic transformation over stabilization, with measured stimulus. **Lessons learned**: The global economy will have to rely less on Chinese policy action to support growth.

2. Environmental focused regulations had global repercussions
   The regulatory shock in the automotive sector has almost pushed Germany into recession and had global repercussions. Major climate events (fires in the US, Brazil and Australia) occur at more frequent pace. Concomitantly, the new European Commission announced a Green Deal that will include a Just Transition Mechanism worth EUR100bn. **Lessons learned**: The implementation of new green and ESG policies has started to bite companies, with further adjustments to be seen and new initiatives to support energy transition.

3. (Geo)political and social risk has soared
   Increasing inequality over the past decade and high fiscal pressures on households have resulted in outbreaks of social crisis in several countries. Unexpected protests escalated across regions, such as Hong Kong, several countries in Latam (Chile, Colombia), and France. Geopolitical tensions also prevailed in the Middle East, particularly between Saudi Arabia and Iran. **Lessons learned**: A more reactive and redistributive fiscal policy is to be expected to respond to growing social tension. The pace of structural reforms will slow down amid growing reform fatigue.

4. Monetary policy has come to the rescue and helped avoid a broad-based recession
   Monetary policy’s reaction to the external shock was swift and sizeable in 2019. The number of central banks initiating a monetary policy easing has reached a record high since 2009. Both the Fed and the ECB did not hesitate to increase the use of unconventional monetary policy tools to inject liquidity while cutting interest rates further. **Lessons learned**: The protracted usage of unconventional monetary policy tools has pushed interest rates into negative territory. Efficiency is put to the test.
1. **Global economic growth** to remain muted in 2021-21 after bottoming out at the turn of 2019

2. **US-China trade tensions** should not escalate, nor de-escalate much further in 2020

3. **The US** to further explore higher public and corporate debt when face with electoral uncertainty

4. **The global economy cannot rely on a new Chinese bazooka** stimulus

5. **Eurozone growth below potential** at +1.0% and +1.3% in 2020-21 respectively

6. **Monetary policy is the safety net** for growth and markets. Mind negative spillovers

7. **Persistently high social discontent** will call for fiscal policies to become more redistributive

8. **Domestic sectors** will continue to outperform

9. **(Unusually) low volatility** and correlation between asset classes for longer

10. **A -4% depreciation of the Dollar** depreciation is expected to support Emerging Markets assets
BUSINESS CONFIDENCE IS IMPROVING FROM LOW LEVELS THANKS TO MONETARY EASING

The cycle of monetary policy easing continued in Q4 2019 which should boost activity in H1 2020. We expect one rate cut in March 2020 in the US and one by the ECB in April.

Global monetary impulse rebounded above LT average in October 2019, but more needs to be done to boost growth above its current levels.
Trade growth could bottom out but not significantly accelerate in 2020 (+1.8%), in 2021 higher demand should lift trade (+2.5%) amid a lasting trade feud but no significant U.S.-China escalation.

U.S.-China mini-deal not a game changer, only superficial. But tariff escalation unlikely: (i) 86% of goods in tranche 4b come from China (i.e. no substitution possible); (ii) consumer goods would see biggest increases in tariff coverage; (iii) 2020 US election
The trough in global growth is expected in Q4 2019 due to the US, China and Japan, followed by moderate growth in the absence of a fiscal and monetary bazooka.

Global GDP growth should go back to 2016 levels in 2021 supported by very accommodative monetary policies and higher fiscal support, notably from China and the US.
November 03, 2020
US presidential election
Predicted outcome:
55% Democrats win
45% Republicans win
(Trump re-election)

Trade tensions China/US
Trade feud: Phase 1-deal not a game changer, phase 2 issues much harder to solve.
No significant U.S.-China escalation or improvement.

Elections in Europe
Feb 2020: Slovakia (Smer-SD expected to win), Italian regional election in Emilia Romagna and Calabria
Dec 2020: Romania (Liberals expected to win)
Sept/Oct 2021: Germany (CDU/Greens coalition expected to win with higher public investment for greening the economy)
Sep 2021: Russia Duma (United Russia expected to win)
Oct 2021: Czechia (ANO expected to win without a majority)
Nov 2021: Bulgaria (GERB expected to win)

Latin America unrests
- Bolivia: high risk for companies, tensions remain with clashes between pro and anti Morales
- Brazil: October 2020 local elections (challenging for Bolsonaro’s new party), risk of social tensions with public sector reform
- Chile: April 2020 (referendum on Constitution), October 2020 (local elections and potential election of constitutional convention). Expect more social protests + uncertain business environment
- Colombia: protests against pro-business reforms. Recent constitutional blow to tax reform should hamper confidence and delay reforms. Risk is increasing.
- Ecuador: mass protests triggered by the decision to scrap fuel subsidies, which was overturned. Future IMF disbursements at risk
- Peru (January 2020): early parliamentary elections after President dissolved Congress. No clear majority. Expect delay in reforms + policy instability

Elections in Africa
Oct 2020: Morocco (PJD expected status-quio with poor majority and delayed entry into office)
Oct 2020: Ivory Coast (Ouattara expected to be re-elected but with political instability)
Nov 2020: Burkina Faso (Kaboré expected to be re-elected but with period of political paralysis)
Nov 2020: Egypt (status quo to be expected)
Dec 2020: Ghana (either incumbent Nana Akufo-Addo or former president John Mahama to win)

Elections in Asia
Jan 2020: Taiwan (Tsai expected to be re-elected)
Apr 2020: South Korea (governing Democratic party expected to win)
Sep 2020: HK (risk for governing pro-Beijing parties to lose, given ongoing pro-democracy protests)
By April 2021: Singapore (governing PAP expected to win)
Oct 2021: Japan (governing LDP expected to win)

Key Summits
G7: June 10-12, 2020
G20: November 21-22, 2020

Middle East main tension points
Large scale anti-government protests in Lebanon, Iraq and Iran
- Iran: impact of US withdrawal from JCPOA and new US sanctions, as well as potential counter measures.
- Parliamentary election in February as a potential source of geopolitical tension
- Lebanon: political uncertainties and potential new proxy war between Saudi and Iran
- Yemen: Sunni v. Shia
- Saudi vs. Iran, incl. Straits of Hormuz, revisited
- Qatar vs. Saudi Arabia, UAE, Bahrain, Egypt (blockade)
- Israel: impact of Jerusalem recognition by the US
- Turkey: US sanctions

November 03, 2020
US presidential election
Predicted outcome:
55% Democrats win
45% Republicans win
(Trump re-election)
MONETARY POLICY WILL REMAIN THE SAFETY NET FOR GROWTH AND MARKETS

Sources: IHS, Allianz Research
There is a higher potential to support households (and consumption) given the trends in corporate vs personal income taxes since the last crisis and rise in social tensions.

Most fiscal stimulus will come under the form of higher social and infrastructure spending. Europe announced EUR100bn allocated for the Green Deal (0.8% of GDP). The fiscal impulse will be more positive in 2021 as the US will spend more and China will maintain its efforts of stabilization.
WHAT DOES IT MEAN FOR COMPANIES? MORE LEVERAGE, WEAKER PROFITABILITY

In the short-term, the fall in interest rate growth differential has opened the door for more sustainable debt financing...

...but over the medium-term, credit risks remain elevated given the high corporate debt levels

Sources: BIS, Euler Hermes, Allianz Research

Below long-term average corporate margins and too limited pricing power given the prolonged weakness of demand, increase liquidity risk for companies in the medium run

Sources: Euler Hermes, Allianz Research
The upside trend in global insolvencies, as measured by our Global Insolvency Index, is confirmed for 2019 (+9%) with still a noticeable increase in Asia and Latam. We expect this trend to continue in 2020, for the 4th consecutive year, mainly due to the prolonged weakness of demand. The easing of global monetary and financial conditions will contribute to limit the pace of the increase, but the rise will remain broad-based with a rise across all regions and a majority of countries (4 out of 5).
## WHAT DOES IT MEAN FOR MARKETS? AN OVERVIEW

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<thead>
<tr>
<th></th>
<th>2020</th>
<th>2021</th>
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<tbody>
<tr>
<td><strong>EMU</strong></td>
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<td>Policy rate (deposit rate)</td>
<td>-0.6</td>
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<td>10y Bund</td>
<td>-0.1</td>
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<td>10y Swap</td>
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<td>Corporate IG spread (bp)</td>
<td>100</td>
<td>105</td>
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<td>MSCI EMU (TR, % p.a.)</td>
<td>3.1</td>
<td>4.8</td>
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<td><strong>USA</strong></td>
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<td>Policy rate</td>
<td>1.25</td>
<td>1.50</td>
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<td>10y UST</td>
<td>1.9</td>
<td>2.3</td>
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<tr>
<td>Corporate IG spread (bp)</td>
<td>120</td>
<td>130</td>
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<tr>
<td>MSCI USA (TR, % p.a.)</td>
<td>2.1</td>
<td>2.0</td>
</tr>
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</table>

*Source: Allianz Research*
GLOBAL ECONOMY: DOWNSIDE AND UPSIDE RISKS

High Medium-term economic impact

- Escalation in global trade dispute
- Emerging market debt crisis
- Climate change crisis
- Oil price shock
- Longer manufacturing recession
- US credit event
- HK spillover
- Major central bank policy error
- Trump impeachment
- No Deal Brexit
- Italexit
- Chinese debt crisis

Likelihood

- High: Partial rollback of existing U.S. tariffs
- Medium: Moratorium on trade protectionism
- Low: Large FTAs (EU-China / EU-USA)
- Very Low: Global Green Deal
- Lowest: Major technological innovation

High Negative Medium-term economic impact Positive

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UNITED STATES

01
The labor market proved more resilient than expected and the monetary policy turned more expansionary than initially thought. This reduced the probability of recession in H1 2020.

We are now in the longest cycle of expansion in the US. This is also the slowest, suggesting stronger footing for this cycle. We expect 2% of growth in 2021 compared with 1.6% in 2020 and 2.3% in 2019.

Sources: Bloomberg, Euler Hermes, Allianz Research
US: FISCAL SUPPORT TO INCREASE AFTER THE ELECTIONS

Biden is much less aggressive in terms of tax hikes for companies and wealthy people. He only intends to rise this amount of tax by USD 3.4 trillion compared with USD 30 trillion for Warren and Sanders.

A too liberal approach of fiscal approach would endanger the US debt sustainability. We expect a Democrat win (55% probability), albeit with a trajectory close to Biden’s proposal as any new US Democrat President would have to compose with the Congress.
The Fed will explore lower levels of unemployment rates. This will boost wage growth and contribute via low interest rates to stronger demand in residential investment.

The global shock on trade impairs profits of US large companies, which have large exposure to foreign demand.

US investment, except residential investment, is badly oriented, even if the stabilization of external conditions will bring some support.
The impeachment procedure does not seem to have any influence on President Trump’s approval rate for now. However, it can open Pandora’s box by increasing Trump’s Anger Index.

Times of higher anger correspond with more frequent tariffs threats triggering a strong correction in equity markets.
US 10Y YIELDS: A CAUTIOUS NORMALIZATION

- Our base line scenario shows a continuous climb from current levels to a fundamental upper-range of 2.3% at the end of 2021.

- At 2.3% by the end of 2021 long-term UST yields will be between fair value and slightly overvalued.

- 10y UST yields are expected to remain roaming below our fundamental fair value estimate (1.9%) before the 2020 elections to be followed by long slow climb on the back of subdued future but positive economic optimism and reanchored inflation expectations.

- The base line path finishes the forecasting timeframe 2021 with a steeper yield curve that should however reverse in afterwards.

Sources: Refinitiv, Allianz Research

Model's standard deviation: 50 - 60bps
Since the beginning of 2015 changes in UST long-term yields (represented by our fundamental model residual), can be explained by a mix between changes in inflation expectations and changes in monetary policy expectations. Currently, changes in monetary policy expectations are of upmost importance in the determination of long-term UST yields.

Our proprietary model of market-based inflation expectations shows that the upside potential of inflation expectations is limited (50bps). As current fundamental inflation valuations show that at 1.6% long-term inflation expectations are correctly priced-in, if were markets to start discounting a sizeable fiscal stimulus (reflation), the upside potential in the inflation component of long-term US yields would be capped at ~2%.
US IG: POSTPONING THE CREDIT RERISKING

- US investment grade corporates are expected to remain anchored around current levels (100-120bps) in 2020 as a combination of a dovish Fed and the proximity of the US presidential elections should not grant a free ticket for markets to take strong positions.

- The slow structural widening in investment grade corporate spreads within the 2020/2021 time span is fueled by the beginning of a mild corporate risk repricing as a direct consequence of the implied shift of the ongoing discussion on corporate debt sustainability.

- Importantly, our base linescenario is based on the empirical fact that the Fed stops hiking when credit spreads are rapidly widening.

** Index: ICE Bank Of America United States Corporate Index
IG: Investment grade ; OAS: Option Adjusted Spread
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Our proprietary corporate spreads model shows no much room for narrower spreads in 2020 and extremely muted widening forces over the forecasting period. The combination of the muted widening potential with the Fed’s prescribed hiking path limits the fundamental implied re-risking of corporate spreads in the 2020-2023 timespan.

By looking at the US corporate debt level consistent with the current interest to EBITDA ratio it is clear that US corporate debt is being massively underestimated. This non-negligible imbalance may well be a source of extreme downside risk beyond 2023 with no clear sign of a circuit break mechanism that would alleviate this US credit event.
MSCI USA: PLEASE DON’T STOP THE MUSIC

MSCI USA TOTAL RETURN (in EUR)

- Trade war remains unsolved and investors temperamental on trade news
- Mini-cycle: earnings growth forecasts will likely to be revised down
- Equities further fueled by share buybacks and financed by cheap debt
- Yield hunting attracts more investors
- The sugar rush from the fiscal stimulus fades away
- The volatility may occur within a year
- Democrat president might reverse Tax Cuts and Jobs Act of 2017

Sources: Refinitiv, Allianz Research

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CHEAP DEBT AND SHARE BUYBACKS – FUEL FOR THE MARKET

USA: Net Debt to EBITDA

EMU: Net Debt To EBITDA

EM: Net Debt to EBITDA

Sources: Refinitiv, Allianz Research
High valuations in the US restrains the growth potential. Valuations are inflated by the technology sector. The EMU and EM are fairly valued based on the long-time average of the Cyclically Adjusted Price/Earnings ratio.

Sources: Refinitiv, Allianz Research
Private consumption may not perform as well as in 2019 going forward, as the labour market has deteriorated and the support of past fiscal reforms peters out.

Investment slowed in 2019. The real estate sector has been the bright spot, while investment in infrastructure and manufacturing slowed.

Trade tensions, the global slowdown and weak business sentiment mean that China will continue to slow. We expect GDP to grow by 6.2% in 2019, 5.9% in 2020 and 5.8% in 2021.
CHINA: FURTHER POLICY EASING TO COME, IN A MEASURED WAY

Fiscal easing will continue in 2020, mostly through infrastructure. We expect 2.7% of GDP of fiscal support in 2020, vs. 5.7% in total over 2018-2019.

On the monetary side, the PBOC should continue easing, in a prudent way. In 2020, we expect the policy rate to be cut by 30bp, and the Reserve Requirement Ratios by 150bp.

The housing sector may not be used as a cyclical stabiliser this time. Housing and construction policies are unlikely to be loosened, as authorities are more concerned with housing affordability.
China’s total debt stands at c.260% of GDP, which is similar to the US and the Eurozone.

Several bailouts this year have raised concerns on banking sector stability, in particular for smaller (city-level and rural) banks.

The share of SME loan balance provided by urban and rural banks went up from 43% at the end of 2015 to 52% at the end of 2018.
EUROZONE

03
EUROZONE: GREEN SHOOTS ON THE SUPPLY SIDE AND RESILIENCE ON THE DEMAND SIDE

The high levels of inventories started to correct in Q3 and should continue to do so in Q4. This should support a pick-up in industrial production in Q1 2020.

While employment growth has clearly slowed down in most Eurozone countries in 2019, it remains clearly positive. Household consumption should be also propped up by still solid wage growth.
M1 & Eurozone real GDP growth (y/y, %), 2 quarters lead

Sources: Refinitiv, Euler Hermes, Allianz Research

M1 – the inflation-adjusted money supply suggests that an uptick in Eurozone GDP growth is around the corner. We expect the ECB to continue to ease policy in 2020 with one additional rate cut to be implemented in H1, continue QE until end-2020 and remain on hold in 2021.

The policy mix in the Eurozone remains very supportive. Since 2019 fiscal policy is providing some tailwind and will continue to do so in 2020/21.
## THE GREEN DEAL: LIMITED UPSIDE

The new European green deal: wide ranging and ambitious full decarbonisation 2050, -50-55% 2030

- Strongest impact of incremental measures: Transport, energy; strong likelihood of EU ETS tightening/reform
- Carbon border tax: Controversial measure, in silage with new industrial policy, positive for industrials, metals, energy intensives, potential for wide ranging secondary impact

### EU Commission nnounced policy

<table>
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<th>Policy</th>
<th>Sectors</th>
<th>Time frame</th>
<th>Potential impact</th>
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<tr>
<td>Review Emissions Trading Directive</td>
<td>All</td>
<td>Expect 2020s</td>
<td>Eur 4.3bn for each Eur 1/t resulting CO2 price increase on incremental purchased credits</td>
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<tr>
<td>End fuel tax exemptions</td>
<td>Airlines, shipping</td>
<td>Likely 2020s</td>
<td>+15% fuel cost increase for each Eur 0.14 fuel tax</td>
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<td>Extend carbon trading to marine</td>
<td>Shipping</td>
<td>Likely 2020s</td>
<td>Eur 215bn to 2030</td>
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<td>Reduce Co2 allocations to airlines</td>
<td>Airlines</td>
<td>Expect 2020s</td>
<td>Eur 7bn to 2030</td>
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<tr>
<td>Revision Energy Taxation Directive</td>
<td>Energy</td>
<td>Expect 2020s</td>
<td>Eur 1.1bn for 1%</td>
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<td>Reduce auto emissions from 95g/km to nil</td>
<td>Automotive, energy</td>
<td>2030s</td>
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<td>Assess inclusion of road transport in EU ETS</td>
<td>Road transport</td>
<td>Possible mid 2020s</td>
<td>Eur 157bn to 2030</td>
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<td>Smart mobility strategy</td>
<td>Automotive, road transport, energy</td>
<td>2020</td>
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<td>Green ICT sector</td>
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<td>Possible late 2020s</td>
<td>Tightening obsolescence and recycling; energy consumption and efficiency mandates</td>
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<td>Renovation wave initiative</td>
<td>Construction</td>
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<td>Rising demand for construction</td>
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<td>EU ETS Innovation Fund</td>
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<td>Review all agriculture and forestry legislation</td>
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<td>Review air, water, chemicals legislation</td>
<td>Chemicals, industrials</td>
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<td>Resubmit Eurovignette for heavy trucks</td>
<td>Road transport</td>
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<td>Facilitate smart integration</td>
<td>Energy, industrials</td>
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<td>EU wide plan to close emissions ambitions gap</td>
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<td>Potentially 2021</td>
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<td>Industrial strategy</td>
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<td>Construction productions/regulations revision</td>
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<td>Energy, industrials</td>
<td>Likely 2020s</td>
<td>Greater distinction/bonus malus rules</td>
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<tr>
<td>Negative</td>
<td>Neutral to negative</td>
<td>TBC</td>
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</table>

Sources: EU, Allianz Research calculations
Monetary policy is not the only, nor the major force pushing interest rates down. Excess savings are in the driving seat.
AUTOMOTIVE SECTOR: FRAGILE AND UNEVEN RECOVERY FROM REGULATORY CONSTRAINTS

As expected, 2019 has been chaotic for monthly sales due to the implementation of the WLTP in Sept 2018 which created a strong basis effect.

2019 will ended almost stable thanks to the German market (+4% expected) while some markets are struggling to recover (Spain, UK).

Yet, the German industry has been strongly impacted, with a extended loss in volume of production and exports.

2020 will remain challenging, with a small decline in new registrations (-1%) due to a prolonged 'wait-and-see' attitude of the demand - despite a faster rolling out of new vehicles, notably low-emitting ones, and aggressive price competition ahead of the CO2 emission requirements for 2021.

We expect a better outlook for 2021 (+1% in new registrations) when the European EV will take off more significantly.

Sources: national sources, IHS, Allianz/Euler Hermes Research

New passenger cars registrations cumulative 12 months (y/y change)

German market and industry (in millions of vehicles)

Sources: VDA, IHS, Allianz/Euler Hermes Research

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GERMANY: INVENTORY HEADWINDS TO ABATE, BUT PRODUCTION REBOUND NOT IN THE CARDS

Following a notable inventory correction over the past year, the worst is probably behind us. Going forward we expect the negative growth impact from stocks to fade.

A marked restart in production is not in the cards looking at incoming order activity. Instead we only expect a moderate industrial recovery.
Domestic demand has become much more important to German GDP growth in recent years, in particular private consumption.

A big fiscal stimulus package is unlikely unless the economic outlook deteriorates further, but German domestic demand will benefit from a very supportive policy mix.

Fixed investment growth looks set to cool notably given the weak GDP growth outlook, subdued capacity utilization rates and lingering elevated uncertainty.
French manufacturing sector entered later into recession mode, but destocking into the car supply chain is now triggering a deterioration of the output. Pharmaceuticals and transport equipment still in growing mode.

The consumer will save the day, but no free lunch: Durable goods (construction, household equipment) will be among winners. But consumer spending will continue to experience a glass ceiling as a result of the impact of the pension reform on household saving behavior.
ITALY: SLOW RECOVERY WITH LINGERING POLITICAL RISK

Real GDP and components

Italy will show the same growth pattern as euro area, however less dynamic, with consumption being a backbone of growth and investment with weaker momentum.

With new coalition, redenomination risk has been entirely priced out. If government succeeds in reestablishing some fiscal credibility, credit risk premium should also narrow, especially in QE context.
**SPAIN: CONSUMPTION STABILIZING, EXPORTS SLOWING, COMPANY MARGINS DOWN**

Higher labor costs => lower competitiveness => slower exports. Stable but slow consumption, slowing investment. Political fragmentation mean no structural reforms; social spending as a quick win.

(-) Savings ratio increasing; (-) Job growth is slowing. (+) Higher wages should be a buffer for consumption. Companies pass it on margins, that are steadily decreasing (43% of GVA, vs. peak of 44.2%); still higher than Eurozone average.
The impact on GDP growth is positive for all parties. We estimate GDP growth at 1.8% in 2021 for Labor led coalition and 1.6% for Conservatives majority

55% of UK firms reported that Brexit was one of their top three sources of uncertainty in November. The stock absorption will continue to be a drag on growth

Consumer confidence remains weak despite pledge of fiscal spending through tax cuts that have helped the index improve in the past elections.

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EUR 10Y SWAP: UNDER THE ECB’S WATCH

- The base line scenario shows a continuous climb from current levels to a comfortable 0.3% at the end of 2021.
- 10y EUR swaps are expected to remain close to our fundamental fair value estimate (0.2%).
- On the inflation side, inflation expectations are not expected to show signs of a clear repricing over the forecasting period as underlying inflation is not expected to substantially accelerate.
- The EMU rates prospect implies a slight fundamental yield overvaluation at the end of the forecasting period.

Sources: Refinitiv, Allianz Research
**10Y BTP: LOCKED-IN BY THE ECB**

A spread level significantly over 200bp would require repricing of redenomination risk which can either be triggered by political activism or emergence of doubts over robustness euro area architecture. BTPs are only expected to enter in such a described situation in our global recession scenario.

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**Spread decomposition of Italy 10y vs Germany 10y**

- **Redenomination risk premium**
- **Idiosyncratic risk premium**

Sources: Refinitiv, Allianz Research

* Using variance decomposition of BTP yield movements in systemic part (explained by decoupling from Germany) and idiosyncratic part

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EUR IG: FUNDAMENTALS HAVE NO POWER

- EUR investment grade corporates are expected to remain anchored at current levels in 2020 as the ECB market presence should not grant a free ticket for markets to take strong positions.

- Importantly, the ECB market presence is expected to keep equity volatility anchored at current levels until the end of the forecasting period which is a key input for corporate spread widening.

- The slow but steady increase (~105bps) should reflect the anticipation of the ECB’s market withdrawal.

Sources: Refinitiv, Allianz Research

** Index: ICE Bank Of America Euro Corporate Index
IG: Investment grade ; OAS: Option Adjusted Spread

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EMU EQUITIES: TIME FOR THE COMEBACK

MSCI EMU PRICE FORECAST

- Low valuations leave some room for European equities to catch up
- No trade tensions between the US and Europe
- Stable growth across the region and mild earnings recovery
- German economy recovers after almost technical recession and lifts European equity market
- Diminished risk of the hard Brexit brings back the confidence
- The volatility may occur within the year

Sources: Refinitiv, Allianz Research
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EMERGING MARKETS

04
The growth fatigue is broadening in Emerging Markets: open economies still hit by the protectionism wave, but quite closed economies such as India, Russia and South Africa also disappointed.

Key Emerging Markets, such as EM Asia and EM Europe still have a leeway to ease. Positive surprises could come from Brazil, Russia, Eastern Europe. Bad surprises could come from trade hubs (HK, Singapore, Taiwan), Mexico, Colombia, Saudi Arabia and Middle East. Weak spots prevailing: Argentina, Turkey, South Africa.
Capital flows are fickle. Their recovery is somewhat subdued, but push (low rates in advanced economies) and pull (higher yields in emerging markets) are financing a strong pipe of primary issuance in high-yield EM and frontier markets.

The current yield seeking environment is conducive to too much debt accumulation in countries with low domestic savings, so unable to repay at the end with a higher likelihood.
We expect Asia-Pacific GDP growth at 4.3% in 2019, 4.2% in 2020 and 4.5% in 2021.

There are policy buffers in place. Central banks are in easing mode, as inflationary pressures in most countries are relatively subdued.

On the fiscal side, China, India, Japan, the Philippines and South Korea will implement relatively large support. More is needed in countries that have much fiscal leeway, such as Singapore, Indonesia, Taiwan and Thailand.
Wage growth has peaked in most economies (but still rising in Slovakia and Bulgaria).

Yet it remains elevated, reflecting labor shortages in most countries. It affects corporate margins as firms can pass on the rising costs only partly to consumers (CPI inflation remains moderate).

Monetary policy is already loose in many countries. Inflationary pressures remain present in some countries (Czechia, Romania, Hungary, Slovakia). Russia and Turkey likely to cut rates further in Q1 2020 but will need to watch currency volatility.
After stalling in 2019 (+0.6% exc. Venezuela), LatAm will miss the 2% threshold of growth in 2020 (+1.3%) for the 7th straight year. In 2021, GDP growth should accelerate to a modest +2.2%.

Monetary and fiscal policy leeway

Sources: IMF WEO, Euler Hermes, Allianz Research

Most central banks have already eased monetary policy. Few countries have fiscal leeway: Chile will increase social spending next year. Hot spots for 2020: Colombia and Mexico. Brazil’s risk picture improving but window for reform is narrowing.
LATAM: REDISTRIBUTION AND POLITICAL REFORMS NEEDED TO RESPOND TO PROTESTS

Confidence in political institutions, satisfaction with democracy and perception of progress have almost halved since 2010. This is one clear pattern that could explain renewed social demands and protests.

Lost decade: in the 2010s see that Latin American countries have either lagged the U.S. per capita growth or converged at a much slower rate compared to the 2000s and compared to other main EM.
Growth is disappointing in many countries in Africa from those exhibiting a deceleration from a high to an intermediate level to those where growth disappeared almost completely.

Low growth is the way for a deterioration of the payment behavior, as shown particularly in Morocco (+7% in 2019 and +5% in 2020) and South Africa (+6% and +4%).
US-IRAN: PARTIAL DÉTENTE, REGIONAL INSTABILITIES

<table>
<thead>
<tr>
<th>Lasting de-escalation (but not necessarily conflict resolution) (5%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Oil price:</strong></td>
</tr>
<tr>
<td>• Average oil price of 62 USD/bbl (Brent) in 2020</td>
</tr>
<tr>
<td><strong>Iran actions:</strong></td>
</tr>
<tr>
<td>• No further direct retaliatory actions against the US</td>
</tr>
<tr>
<td>• Continued moderate non-compliance with JCPOA, but no acceleration</td>
</tr>
<tr>
<td>• Moderate actions by Iran proxies against US allies in the region</td>
</tr>
<tr>
<td><strong>US actions:</strong></td>
</tr>
<tr>
<td>• No further US sanctions</td>
</tr>
<tr>
<td>• No further US attacks</td>
</tr>
<tr>
<td><strong>Elsewhere in the Middle East:</strong></td>
</tr>
<tr>
<td>• Iraq: US and NATO remain on site, maintaining the status quo</td>
</tr>
<tr>
<td>• Syria: increasing influence of Russia and Turkey</td>
</tr>
<tr>
<td>• Israel and Lebanon: no impact</td>
</tr>
<tr>
<td><strong>Global capital markets:</strong></td>
</tr>
<tr>
<td>• Some ST volatility (already seen); no LT impact</td>
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</tbody>
</table>

<table>
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<tr>
<th>Intensified but controlled confrontation (60%)</th>
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<td><strong>Oil price:</strong></td>
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<tr>
<td>• Average oil price of 66 USD/bbl (Brent) in 2020</td>
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<tr>
<td><strong>Iran actions:</strong></td>
</tr>
<tr>
<td>• Further retaliatory actions against targets with links to the US, most likely through proxies in the region</td>
</tr>
<tr>
<td>• Acceleration of non-compliance with JCPOA</td>
</tr>
<tr>
<td>• Attacks against oil infrastructure and shipping of GCC states</td>
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<tr>
<td><strong>US actions:</strong></td>
</tr>
<tr>
<td>• US sanctions stepped up in 2020, but with limited or no impact as existing sanctions already pose maximum impact</td>
</tr>
<tr>
<td>• “Proportionate” retaliation in the event of attacks on US assets</td>
</tr>
<tr>
<td><strong>Elsewhere in the Middle East:</strong></td>
</tr>
<tr>
<td>• Iraq: US + NATO possibly forced out; greater influence of Iran; resurgences of IS possible</td>
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</table>

<table>
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<tr>
<th>Full-fledged war (35%)</th>
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</thead>
<tbody>
<tr>
<td><strong>Oil price:</strong></td>
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<tr>
<td>• Average oil price of 80 USD/bbl (Brent) in the 12 months following the outbreak</td>
</tr>
<tr>
<td><strong>Iran actions:</strong></td>
</tr>
<tr>
<td>• Further direct retaliatory actions against US targets, possibly also outside the region</td>
</tr>
<tr>
<td>• Acceleration of non-compliance with JCPOA</td>
</tr>
<tr>
<td>• Attacks against oil infrastructure and shipping of GCC states</td>
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<tr>
<td>• Blocking of Strait of Hormuz</td>
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<tr>
<td>• Attacks on Iranian soil</td>
</tr>
<tr>
<td><strong>Elsewhere in the Middle East:</strong></td>
</tr>
<tr>
<td>• Iraq and Syria: US and NATO forced out; greater influence of Iran, Russia and Turkey; resurgences of IS possible</td>
</tr>
<tr>
<td>• Lebanon: increased political instability</td>
</tr>
<tr>
<td>• Israel: Hamas, Islamic Jihad and Hezbollah will join in a war against Israel</td>
</tr>
<tr>
<td><strong>Global capital markets:</strong></td>
</tr>
<tr>
<td>• ST volatility. Significant LT impact on MSCI only if oil prices remain at 80 USD/bbl for longer. Gold price to be likely winner.</td>
</tr>
</tbody>
</table>
**Lebanon:** History of huge twin deficits

- Unsustainably high twin deficits have made Lebanon highly dependent on capital inflows (remittances from expats and aid flows mainly from Gulf region).
- This financing model is now at risk...
- …as confidence in both the fragile political system and the banking system is unravelling rapidly.
- The risks of stepped-up USD shortages, LBP devaluation, liquidity stress in the banking sector (bank runs), shortages of basic goods, non-payment risks for imports, and of a debt restructuring have risen.
- “Soft” capital controls introduced by Lebanese Banking Association (such as restrictions on transfers abroad, caps on USD withdrawals).

**Saudi Arabia:** Oil still determines growth

- OPEC+ agreed oil output cuts implemented

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**Graphs:**

1. **Fiscal balance (% of GDP)**
2. **Current account balance (% of GDP)**
3. **Real GDP growth (%)**
4. **Oil price (USD/bbl)**
5. **Bank Deposits (% y/y)**
6. **Import cover (months)**

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**Sources:**
- IHS Markit, IMF, Allianz Research
- Byblos Bank, IMF, Allianz Research
- National statistics, Allianz Research

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**Lebanon:** Bank deposits and FX reserves down

- Recession in H1 2019.
- Monetary easing (in line with US Fed) and heavy fiscal stimulus is underway.
- Yet, annual GDP growth to remain weak as long as the “OPEC+ agreed oil output cuts” remain in place (agreed until March 2020; we expect an extension at least until end-2020).
EM EQ: EM EQUITIES HAVE DISAPPOINTED FOR A LONG TIME

EM equities vs EMU equities: relative total return in common currency terms (unhedged)

EM vs EMU: Equities and Bonds relative unhedged total return

Deviation from trend - (R.H.S)
Equities - MSCI EM / MSCI EMU
Long-term trend

Sources: Refinitiv, Allianz Research
Allianz Research – Capital Markets Research
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INVESTMENT FLOWS & RETURNS: A CHICKEN AND EGG PROBLEM?

NET ISSUANCE OF U.S ETF's SHARES: EMERGING MARKETS

- 12-month ETF issuance at annual rate (LHS)
- MSCI EM Perceived rate of return (RHS)

Sources: Refinitiv, Allianz Research