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Equity Outlook

Rising interest rates also bring opportunities

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- **First half of this year was marked by rising interest rates and trade wars:** The source of increased volatility on the global equity markets was the US. Starting with speculations about rising interest rates and ending with protracted disputes of trade policies between the US and the rest of the world.
- **High valuation of equity markets:** Based on Société Générale's forecasts there should be corrections on the main global equity markets in the following 12 months.
- **The likelihood of stricter ECB monetary policy will rise:** Higher interest rates should be negative on the stock market as a whole. However, companies with a healthier capital structure may not feel so strongly about their impact.
- **Commodity companies, carmakers and financial institutions in equity portfolios:** These sectors have shown that they fare well in times of rising yields thanks to strong cash flow and low debt.
- **Interesting investment stock tips:** Axa, Daimler, Erste Group, Glencore, Infineon Technologies, Ingenico


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Prague Stock Exchange statistics

	2013	2014	2015	2016	2017	6/2018
PX Index (eoy)	989	947	956	922	1,078	1,064
Change (CZK)	-4.8	-4.3	1.0	-3.6	17.0	-1.3
Change (USD)	-8.9	-16.7	-7.0	-6.9	41.1	-5.8
Traded volumes (CZK m)	184,571	158,222	169,202	163,580	140,741	74,930
Traded volumes (USD m)	9,461	7,648	6,941	6,687	6,002	3,558
Market capitalization (CZK m)	1,074,426	1,018,162	1,011,989	1,020,891	1,208,467	1,266,440
Market capitalization (USD m)	54,189	44,434	40,696	39,844	56,888	56,898

Source: PSE, Bloomberg, Economic & Strategy Research, Komerční banka

KB/SG recommendations for the PSE titles

Company	Price	Target price	Recomm.	From date	Year high	Year low
Avast	68.5	95.8	Buy	14.VI.18	73.0	62.5
CEZ	575.0	620.0	Buy	11.VI.18	590.0	397.1
CME	85.2	109.3	Buy	27.VII.17	105.5	77.9
Erste Bank	935.8	1,230.0	Buy	12.II.18	1,057.9	863.6
Kofola	299.0	-	-	-	426.0	275.0
Komercni banka	940.5	-	-	-	1,013.0	879.0
Moneta Money Bank	78.1	93.0	Buy	6.III.18	86.3	74.5
O2 CR	262.0	270.0	Hold	18.IX.17	289.8	251.4
PFNonwovens	904.0	in review	Under revision	13.IX.17	1,021.0	777.0
Philip Morris CR	15,220.0	17,546.0	Buy	22.VIII.17	18,060.0	14,560.0
Stock Spirits	66.8	-	-	-	91.5	46.5
Unipetrol	377.0	-	-	-	389.0	288.0
VIG	614.0	673.0	Buy	3.III.17	731.0	595.0

Source: PSE, Bloomberg, Economic & Strategy Research, Komerční banka

Companies overview

	Price	Monthly	year-to-date change		Avg. daily volumes	
	CZK	change	CZK	USD	1-6/2018	1-6/2018
Company	26-Jul-18	(%)	(%)	(%)	(CZK m)	(USD m)
Avast	68.5	7.9	n.a.	n.a.	1.8	0.1
CEZ	575.0	3.1	15.8	12.5	181.9	8.3
CME	85.2	-2.6	-15.1	-17.4	5.6	0.3
Erste Bank	935.8	2.9	4.6	1.6	86.2	3.9
Kofola	299.0	-5.1	-28.7	-30.7	2.5	0.1
Komercni banka	940.5	3.7	2.8	-0.1	148.6	6.8
Moneta Money Bank	78.1	3.3	-5.3	-7.9	97.7	4.5
O2 CR	262.0	2.1	-3.9	-6.6	22.6	1.0
PFNonwovens	904.0	-2.0	10.1	7.0	2.3	0.1
Philip Morris CR	15,220.0	1.3	-8.1	-10.7	19.8	0.9
Stock Spirits	66.8	-1.9	-14.5	-16.9	2.8	0.1
Unipetrol	377.0	0.7	0.2	-2.6	19.4	0.9
VIG	614.0	1.8	-8.4	-10.9	6.7	0.3

Source: PSE, Bloomberg, Economic & Strategy Research, Komerční banka

US markets are leading

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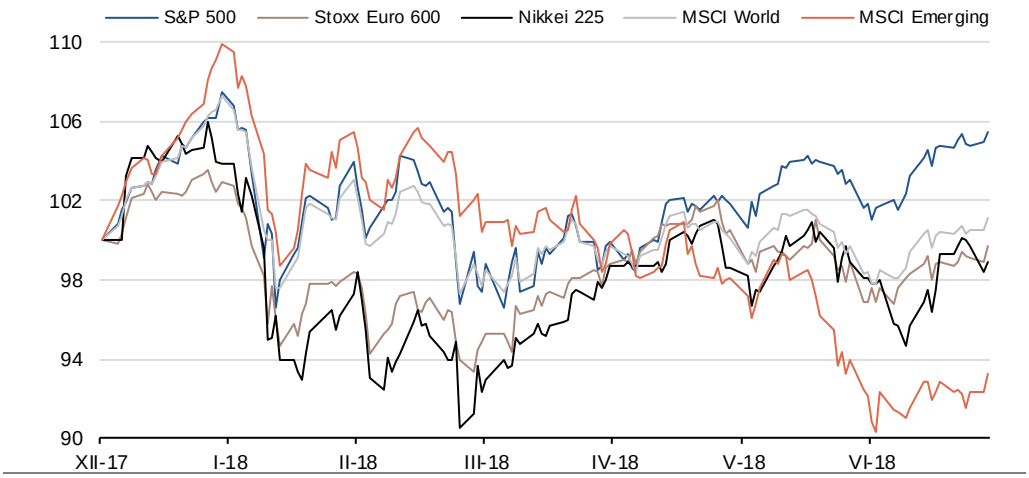
The first half of this year was in the sign of increased volatility on global equity markets. Since the beginning of the year, the market grew as the 4Q17 earnings season was sound and there was no major negative news. At the end of January, two major forces began to influence the volatility and market sentiment. First was the imposing of tariffs for some products imported to the US. The second was speculation regarding interest hikes by the Fed. For the first half of the year there were positive macroeconomic conditions and economies were doing well, which was subsequently reflected in the results seasons, especially for 1Q18, which was one of the best quarters in the past several years. Within the S&P 500, revenues were expected to grow 7.3% and net profit 18.4%. The reality was even better as the revenues grew an average of 8.2% and net profit 23.9%. The energy sector was the most successful as it built upon rising oil prices on the markets. For example the Brent crude oil rose to $79 per barrel at the end of the second quarter from $67 per barrel at the end of 2017.

Global equity market

Source: Bloomberg, MSCI World index

Development of main equity indices since the beginning of the year



Source: Economic & Strategy Research, Komerční banka, Bloomberg; *data as of 25 July 2018

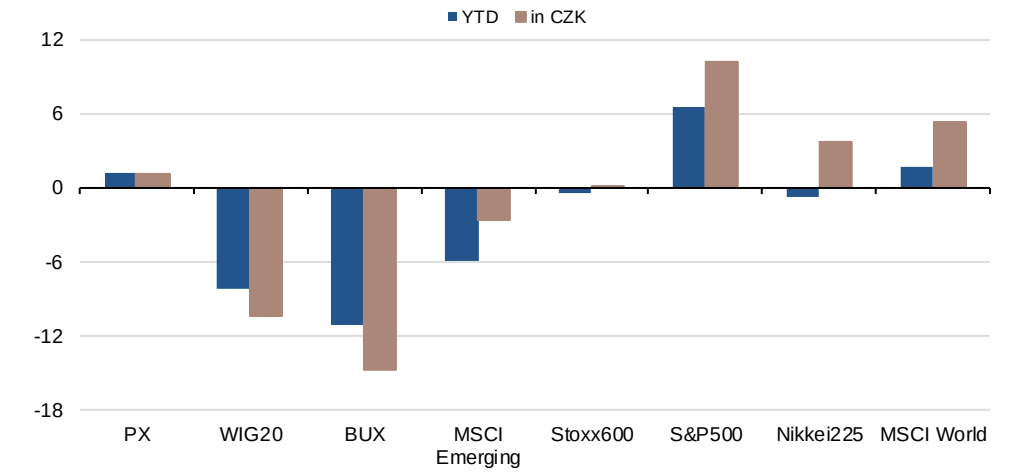
Markets were damaged by speculations of interest rates hikes by the Fed in the US. Equity markets were hit the most at the beginning of February, when there were massive sell-offs due to speculations of hikes. For example, on 5 February, the Dow Jones index fell by a record 1,175 points. This was the biggest point loss in its entire history. The American central bank increased the interest rates two times, at the end of February and in mid-June, 25bp each.

Severe volatility was brought to the markets by changes in global trade policy started by US President Donald Trump, beginning at the end of January with import tariffs of 30% for solar panels and 20% for washing machines. In March, the second wave of import tariffs took place. This time it was 25% on steel and 10% on aluminium. A temporary exception for these tariffs was provided to the most important trade partners of the US, i.e. the European Union, South Korea, Canada and Mexico. In April, China responded as it was hit the most by the tariffs. China created a list of 128 American products (e.g. wine and pork), for which they imposed up to 25% import tariffs. Trump's administration reposnded quickly with a threat of imposing import tariffs on selected Chinese goods (e.g. televisions, medical devices and batteries) in a total amount of $50bn. China prepared a list of American goods (e.g. soybeans, chemicals and cars) in the same amount of $50bn as a retaliation. Trump responded with another threat that he would increase the amount of affected Chinese goods by another $100hn. After that, there was a period of fragile peace lasting one month. It seemed the US

and China would make a deal about mutual cooperation. China agreed on increased purchases of American products and services. The US, on the other hand, was ready to postpone or even cancel the imposition of import tariffs on Chinese goods in the total amount of $150bn. At the end of May, the exception on import tariffs on steel and aluminium for American trade partners ended. In mid-June, the US announced new tariffs on Chinese goods in a total amount of $34bn that will be effective starting in July and at the same time the US suggested another list of Chinese goods in the amount of $16bn. The European Union imposed import tariffs on selected American goods (e.g. motorcycles and bourbons) in the amount of more than $2bn. Trump threatened immediately to impose 20% import tariffs on European cars. China prepared a list of American goods in a total amount of $50bn on which China imposed tariffs. Trump retaliated with the threat to impose 10% tariffs on Chinese goods in the amount of $200bn. Subsequently, this threat was extended to total Chinese imports to the US, which amount to more than $500bn.

Despite very active trade policy and changes in monetary policy, the US equity markets were able to reach the highest performance from the group of monitored markets. The S&P 500 index strengthened more than 6% since the beginning of this year. European and Japanese equity markets ended with small losses just below zero. The European Central Bank didn't increase interest rates for now as the US did, which is positive for local markets. On the other hand the earnings season in Europe wasn't as astonishing as it was in the US. The revenues of companies grew 1.9% and net profit 3.2%. The MSCI Emerging index lost 6%, whereas the MSCI World index grew almost 2% in the first half of the year.

PX vs. other stock indices in 2018 (%)



Source: Economic & Strategy Research, Komerční banka, *data as of 25 July 2018

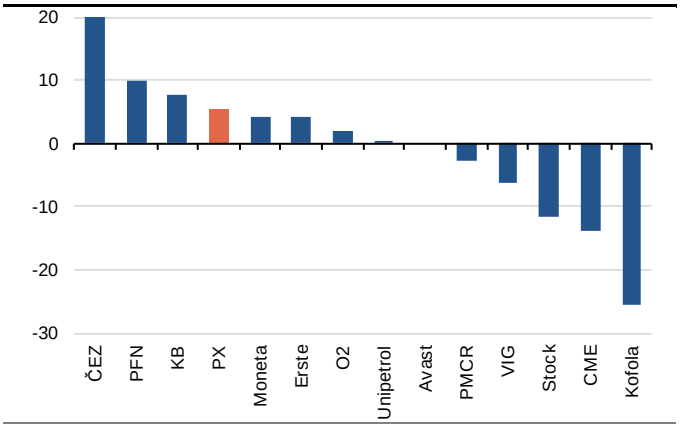
The Prague Stock Exchange is still ahead of its regional peers.

The Prague Stock Exchange grew 6.4% in 1H17 and 10% in 2H17. Since the beginning of this year, there is a profit of 1.1%. Despite this small increase the PSE did pretty well in comparison with its CEE peers. The Hungarian BUX decreased more than 11%, and Poland WIG20 dropped 8% in the comparable period. The chart above shows that the performance of the PSE was around the levels of the global equity index MSCI World (+1.7%). The only region that registered serious gains was the US. In CZK equivalents, the best performing markets are the US and Japanese indices together with MSCI World. USD and JPY have strengthened against the CZK since the beginning of the year.

ČEZ, PFN and Komerční banka are the winners for the highest appreciation in 1H18.

The first half of the year was quite balanced from the performance perspective of individual stocks on the Prague Stock Exchange. The largest gain of more than 23% was reached by the energy giant ČEZ. Its stock price gradually rose since the beginning of the year supported by rising prices of electricity on the market. At the same time the stock price was influenced by speculations about potential company transformation due to the project of building new power plant blocks. By the end of this year, it should be known how the new blocks will be financed, whether solely by ČEZ or through a company transformation with the role of investor will be in the hands of the Czech government. Second place belongs to the textile company PFNonwovens with a gain of almost 10%. The growth was supported by sound financial results as 4Q17 EBITDA grew 8.7% to €13.7m followed by 7.6% growth in 1Q18. Another positive for PFN was the end of speculations about PFN leaving the PSE. During the general meeting in June, this topic wasn't discussed. Third place belongs to Komerční banka, which grew almost 8%. The main index of the Prague Stock Exchange, the PX, grew 5.6% when calculating dividends.

Prague stocks incl. dividends in 2017 (%)



Source: Economic & Strategy Research, Komerční banka, *data as of 25 July 2018

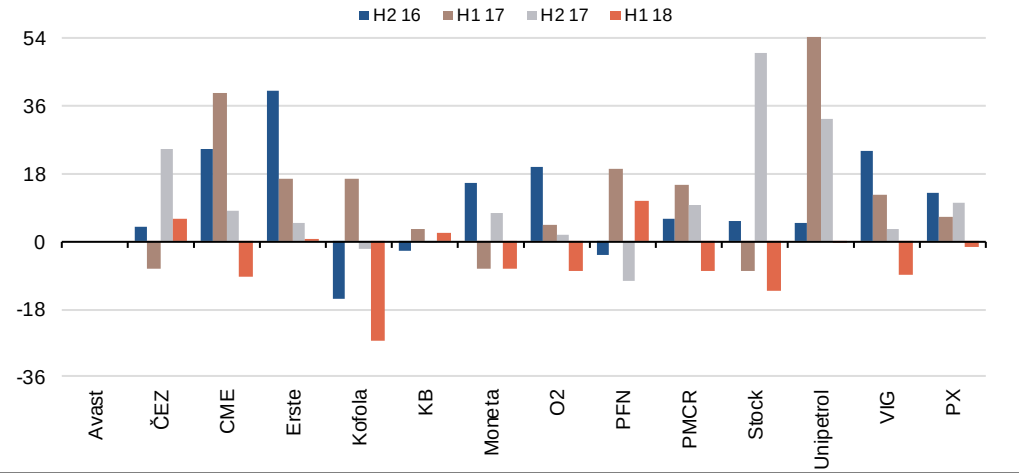
The biggest drop in price belongs to Kofola due to the sale of a stake from one of its largest shareholders.

Conclusively, the most losing investment with a loss of more than 25% is Kofola. Since the beginning of the year, its stock price was almost constant in the CZK410 to CZK420 range. The first drop occured due to unconvincing 1Q18 financial results, as the company recorded a loss of CZK68m. A serious decline in stock price took place in June as a result of the sale of a part of the stake in the company from one of its main shareholders, the CED company. The sale was made in the form of accelerated bookbuilding for a price of CZK270 per share. This caused a massive drop of almost 18% in the share price on the equity market. The result of this transaction was an increase in free float on the market to almost 15% as the sold share was 8.5%.

The Prague Stock Exchange said goodbye to Fortuna and welcomed Avast.

Two significant changes happened on the Prague Stock Exchange in the first half of the year. The first change took place in February on the general meeting of gaming company Fortuna. The GM decided to delist Fortuna stock from both the Prague and Warsaw stock exchanges. Since May, the stock was delisted from the main market of the PSE and was traded only on the unregulated free market. Subsequently, on 8 June, the stock was delisted from the Warsaw Stock Exchange which also was the last trading day on the Czech free market. The second change occured approximately three weeks before Fortuna was completely delisted. Technological company Avast with Czech origins started trading through a dual listing on the PSE on 14 May. One month after entering the PSE, Avast had qualified to become a member of the main PX index of the PSE with 6.1% weight.

Development of Czech stocks excl. dividends (performance in %)

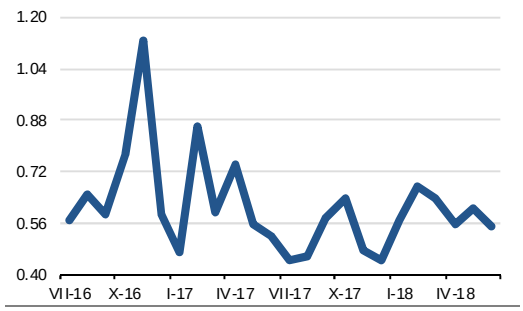


Source: Economic & Strategy Research, Komerční banka

ČEZ, Komerční banka and Moneta Money Bank are the three most traded titles on the Prague Stock Exchange.

For the first six months of this year, trading activiy grew slighly in comparison with the end of the last year. But it is lagging behind the comparable period of the last year. The average daily trading volume for last year was CZK550m. ČEZ kept its winning position, representing around 30% of traded volume. Smaller issuances moderated their increased activity as the share on traded volume of the five largest stocks increased from 87% (in 2H17) to 90% (in 1H18). Komerční banka, with its 25% share on traded volume, ranked second in the ranking of the most traded titles on the Prague Stock Exchange followed by Moneta Money Bank with 16% and Erste Group with 14%. Five of the most traded titles were traditionally topped by O2 Czech Republic with 4%. Between 1H18 and 2H17 the most significant drop in average monthly traded volume was registered by the textile company PFNonwovens as it decreased from CZK270m to CZK48m.

Average daily trading volume (CZKbn)



Source: PSE, Bloomberg, Economic & Strategy Research, Komerční banka

Equity markets outlook

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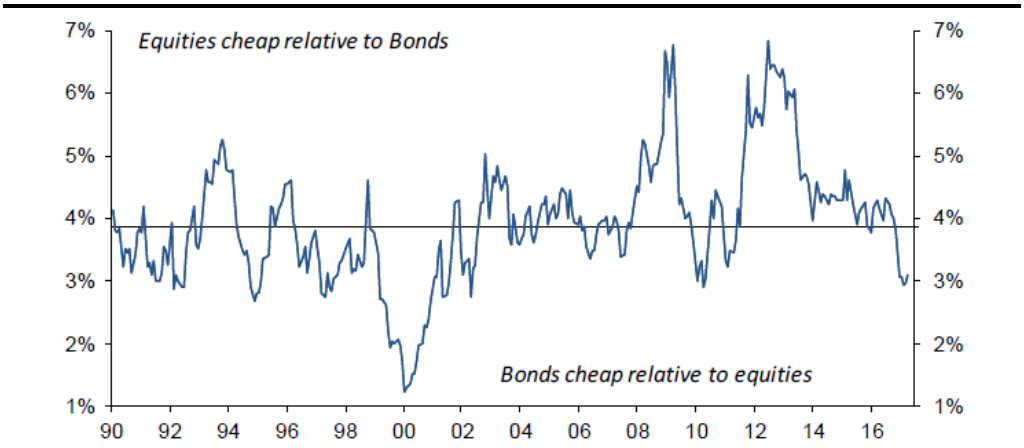
Société Générale keeps the weight of equitites in its global portfolio at 40% with an underweight recommendation.

Our outlook for the equity markets is based on the forecasts and recommendations of Société Générale's reports *Multi Asset Portfolio – Expect less for longer* (published on 6 June, 7:38 CET) and *The Big Picture – Don't follow the herd* (published on 31 May, 17:37 CET). Société Générale didn't significantly change the structure of the risk profile of its global asset allocation portfolio. The last meaningful change occured at the end of last year, when SG reduced the weight for equities from 50% to 40% and changed the recommendation to underweight in its asset allocation portfolio. We recommend paying increased attention to market developements due to the global background, which is influenced by trade wars, the tense geopolitical situation in the Middle East (impacting oil prices), rising populism (mainly stemming from anger over migration and perceived inequalities) and uncertainty in the monetary policy area (Fed, BoE, BoJ or ECB). All of these factors have created a relatively unsettled environment for financial assets. On the other hand there is still a very healthy macroeconomical environment and companies are experiencing solid financial results. **To sum it up, Société Générale kept the exposure for equities at the level of 40% in its global asset allocation portfolio.**

SG has made only one change in weightings of individual asset classes in its global portfolio, as it increased the weight for government bonds (+2pp to 32%) at the expense of corporate bonds (-2pp to 5%). In the equities asset class, the weight of emerging markets grew (+3pp to 10%) due to an increased focus on China equities, which benefit from reasonable growth, increased accessibility and a low correlation with developed equities. At the same time, we reduce Japanese equities (-3pp to 7%), which is consistent with the shift in SG's yen exposure.

We see a downside potential to our major US and European equity targets for the next 12 months. Stretched valuations, rising bond yields, a high-volatility regime and growing trade tension could weigh on equity index performance.

US equity risk premium well below the long-term average



Source: SG Cross Asset Research/Global Asset Allocation; Multi Asset Portfolio – Expect less for longer on 6 June 2018, 7:38 CET

Potential for future growth of the US equity market is strongly limited.

Continuation in growth of the US stock index S&P 500 is limited based on SG predictions. The US equity market is already pricing in a rebound in growth and inflation. With the return of volatility, we expect the S&P 500 to remain in a 2500-2800 range for the rest of the year. Under SG's scenario, the S&P 500 already hit its peak in January. The rise in bond yields and Fed rates should be a headwind against further US equity rerating. The mid-term

elections in November are likely to be a source of volatily for equity markets. The earnings season for the first quarter was one of the strongest in past years. This allowed the equity markets to partially absorb higher bond yields. The earnings season for the second quarter should also be pretty sound. As can be seen in the chart on the previous page, the equity risk premium is significantly moving away (towards 3%) from its long-term average of 3.9%. This can make the US equity market more vulnerable to even a small increase in bond yields. In other words we can say that investors in American equities don't get an adequate return for holding the equities in comparison with investors in bonds.

Strong EUR and GBP together with rising bond yields will drag the markets down, whereas the opposite effect will come from the positive economic situation.

The future development of EuroSTOXX 50 will be influenced by two contradictory trends. The positive economic momentum on one side and a stronger EUR and higher bond yields on the other. We see some limited upside potential for core markets such as France and Germany. Both the Italian and Spanish equity markets will likely be more affected by any tension on the credit market, as their overall credit ratings are relatively weak. In the UK, SG nudges up its FTSE 100 year-end target to take into account higher commodity price forecasts. Nevertheless SG expects the index to be under pressure from weak domestic demand and stronger GBP.

Asian markets still offer potential for growth of stock indices, but it is necessary to focus on domestic stories.

Asia EM equities are not insulated from the risk-off sentiment caused by Italian politics and the tightening in financial conditions in the US. With external vulnerabilities increasing, SG thinks it is time to focus on the domestic stories in Asia as the risk is rising for exporters. SG turns strategically positive on Chinese onshore equities. The strategic bull case for Japan equities is intact.

SG/KB outlook for equity indices

Index	Last price	IX.18	XII.18	III.19	VI.19	XII.19	change
	26-Jul	*est.*	*est.*	*est.*	*est.*	*est.*	*1 year (%)*
S&P 500 (USA)	**2,846**	**2,600**	**2,500**	**2,400**	**2,300**	**2,100**	**-19.2**
DJ Stoxx 600 (Europe)	**389**	**380**	**360**	**340**	**325**	**300**	**-16.5**
FTSE 100 (UK)	7,653	7,400	7,000	6,500	6,200	6,000	-19.0
CAC 40 (France)	5,466	5,400	5,200	5,000	4,800	4,300	-12.2
DAX 30 (Germany)	12,757	12,500	12,000	11,500	11,000	10,000	-13.8
FTSE MIB (Italy)	21,719	20,000	19,000	18,500	18,000	16,000	-17.1
IBEX 35 (Spain)	9,775	9,200	8,700	8,400	8,000	7,300	-18.2
Nikkei 225 (Japan)	**22,587**	**22,000**	**23,800**	**23,700**	**23,500**	**23,000**	**4.0**
HSCEI (China)	11,021	12,250	12,600	12,600	12,400	11,800	12.5
KOSPI 200 (South Korea)	297	325	335	325	320	300	7.8
Nifty50 (India)	11,130	10,800	11,300	11,000	11,100	10,600	-0.3
MSCI AC Asia ex-Japan	678	730	760	760	750	710	10.6
PX (KB/SG, market prices)	**1,091**	**1,140**	**1,190**	**1,250**	**1,250**	**1,300**	**14.6**
PX (KB/SG, consensus)	**1,091**	**1,150**	**1,210**	**1,270**	**1,290**	**1,342**	**18.3**

Source: SG Cross Asset Research (Multi Asset Portfolio from 6 June 2018); Economic & Strategy Research, Komerční banka

Based on a macroeconomic prognosis, SG assumes a decrease in stock indices, whereas based on expected target prices of individual stocks there should be growth in stock indices.

The table above shows an overview of estimated target prices for stock indices based on SG analysis. Forecasts of the target price of the Czech PX index are the only exception, as we prepare them internally at Komerční banka. SG expects the arrival of a recession in the US at the turn of 2019 and 2020. The development of the economy in the US has a significant influence on global equity markets, where the US recession would cause declines in stock indices. Equity markets include in their valuation the development of the economy six to nine months ahead. This would mean the end of the second quarter next year. This is the reason SG forecasts are negative and count with declines on the main global stock indices in the following 12 months. For the sake of comparability with our methodology of estimating a target price for the PX index, we have used the consensus of target prices and weights (source: Bloomberg) of each individual stock from Stoxx 600 and S&P 500 indices. This allowed us to calculate the estimated target price for the following 12 months. The result is approximately 10% upside potential for S&P 500 and 11% upside potential for Stoxx 600.

Financials remain the most recommended sector by SG.

From a sectoral perspective in Europe, the recovery of the EMU economy, decreasing unemployment and rising wages should support consumption and growth in cyclical sectors. From the consumer sector, we prefer **automobiles & parts.** The current environment should also still be positive for **financials,** including the insurance sector. In light of the expected higher demand for oil, we recommend buying **oil & gas.** We also newly recommend overweight **aerospace & defence** as a good hedge against the Italian political turmoil.

Rising interest rates do not bode well for highly leveraged consumer staples and telecoms.

Among the losers in the current environment are utilities, telecoms and other sectors, for which the expected increase in bond yields will be a big headwind. For the utilities it is recommended to reduce exposures to the benefit of durables, apparel & luxury which we recommend to overweight.

Our outlook for the Czech equity market remains positive.

The Prague Stock Exchange could deliver a solid return in the following 12 months. We adopt a bottom-up approach because the PX index consists of only 13 issues, with the five largest usually having a combined weight of almost 80%. Of the most traded blue chips, we actively cover nine companies (including SG's coverage of Erste Group shares). For valuing other stocks, we use two approaches, i.e. the actual market price and the market consensus. An average of these two estimates shows potential growth of around 16% over the one-year horizon (see the table above) with an estimated dividend yield of 4.4%.

We see financial stocks as very attractive on the PSE.

We believe financial stocks are among the most attractive on the Prague Stock Exchange. Out of the financial institutions quoted on the stock exchange we cover together with SG **MONETA Money Bank, Vienna Insurance Group and Erste Group all have a *Buy* recommendation, which offers a total return of 19%, 11% and 32%, respectively.** In general, the European banking sector should benefit from favourable economic conditions, strong household consumption and investment activity. Additionally, Czech banks are well-capitalised.

Among other stocks, we newly recommend to ***Buy* stocks of technological company Avast**. We started covering Avast in June, one month after their initiation of trading on the Prague Stock Exchange. We see a great potential in stock price of Avast due to successful acquisitions and improvements of the product portfolio. **We also recommend buying shares of ČEZ**, whose price should grow due to rising prices of electricity on the markets. Further ***Buy* recommendations are for media group CME and tobacco producer Philip Morris Czech Republic**. We keep our *Hold* recommendation for O2 Czech Republic and the recommendation for textile company PFNonwovens is currently under review.

Expected domestic corporate events in the following months

Date	Company	Event
27 July	Kofola ČeskoSlovensko	2Q18 earnings announcement
31 July	Pegas Nonwovens	2Q18 earnings announcement
2 August	Unipetrol	2Q18 earnings announcement
7 August	O2 Czech Republic	2Q18 earnings announcement
8 August	Komerční banka	2Q18 earnings announcement
8 August	CME	2Q18 earnings announcement
13 August	MSCI	2Q18 earnings announcement
22 August	Erste Group	2Q18 earnings announcement
23 August	MSCI	2Q18 earnings announcement
28 August	Stock Spirits Group	2Q18 earnings announcement
25 September	Fortuna Entertainment Group	1H18 earnings announcement
23 October	Unipetrol	3Q18 earnings announcement
25 October	Kofola ČeskoSlovensko	3Q18 earnings announcement
2 November	ČEZ	3Q18 earnings announcement
7 November	Vienna Insurance Group	3Q18 earnings announcement
12 November	Pegas Nonwovens	3Q18 earnings announcement
15 November	Philip Morris ČR	3Q18 earnings announcement

Source: Bloomberg, companies

Foreign markets

S&P 500 (USA)

Source: Bloomberg

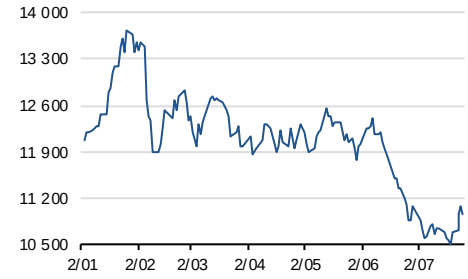
Stoxx 600 (Europe)

Source: Bloomberg

Nikkei 225 (Japan)

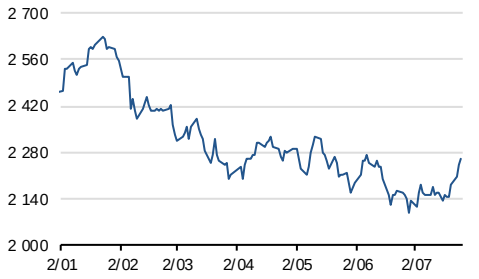
Source: Bloomberg

HSCEI (China)



Source: Bloomberg

WIG 20 (Poland)



Source: Bloomberg

BUX (Hungary)

Source: Bloomberg

Rising rates do not mean diversion from stocks

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The probability of higher interest rates in the EMU will increase.

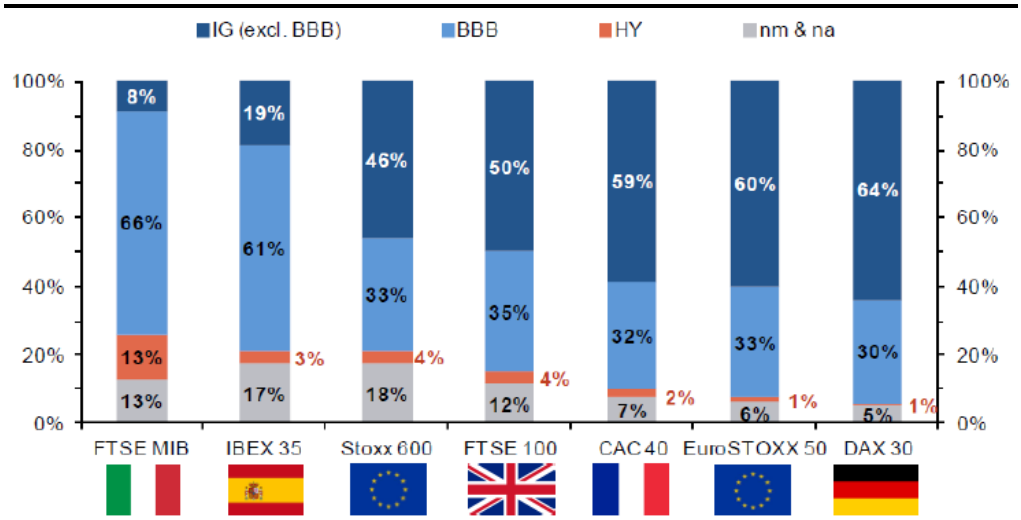
The efforts of some central banks to tighten monetary policy are a reason for increased volatility on world financial markets. While the U.S. interest rate hiking cycle is already priced into financial asset prices, in the case of EMU, no monetary tightening is expected by markets. There is almost a 100% probability that key ECB rates will remain unchanged until the end of this year. For the first half of 2019, markets are partially preparing for a moderate rate hike. **We expect the likelihood of a stricter monetary policy in the EMU to grow gradually by the end of the year, which should be reflected in an increase of market interest rates and yields.**

Higher interest rates tend to have a negative impact on stock market valuation, from the theoretical point of view. First, they mean higher financing costs that lead to lower company profitability. The second explanation is through valuation models, when the estimated future cash flows are discounted to the present value by a higher discount rate, to being reflected in their lower present value and therefore lower stock valuation. We can thus assume the future monetary policy tightening will have a negative impact on the development of the stock market as a whole.

Companies with an investment rating grade should be able to better deal with higher rates.

Despite this, we cannot lump all the stocks or sectors together. **Companies with a speculative rating are more sensitive to the movement of interest rates.** The low financing cost combined with economic expansion has led to many companies, through better debt ratios, gaining higher credit ratings from rating agencies, and many of them having shifted from speculative to investment grade. On the other hand, there may be a deterioration of the ratings during the period of rising rates and potential economic downturn, resulting in massive selloffs of shares of companies with speculative rating grades. Based on that, we prefer stocks of companies with an investment grade. Looking at the composition of European equity indices, Germany or France are preferred countries. On the contrary, we recommend avoiding Italian or Spanish stocks.

Composition of equity indices according to rating grades



Note.: IG and BBB groups are investment rating grades; HY – high-yield or speculative grade; grey columns represent companies without any credit rating
Source: SG Cross Asset Research/Equity Strategy, The Big Picture – Bulls beware

In the incomplete second decade of this century, we have seen several periods of growth in market interest rates and yields, as shown in the following graph.

Since 2010, the financial markets have experienced several yield growth periods

Source: SG Cross Asset Research/Equity Strategy, The Big Picture – Bulls beware

Growth in interest rates and yields has been beneficial in some sectors.

Historical experience shows there are sectors that have succeeded in these times. These are, above all, sectors that are significantly less indebted, generating a positive operating cash flow that is high enough to cover investments and reduce corporate debt. In this group of companies, we find commodity companies, semiconductors, carmakers and their suppliers or technology firms. Of course, we cannot omit financial institutions. Higher rates raise bank interest margins and improve the financial results of insurance companies. The following table provides an overview of the sectors that have succeeded or failed in the period of rate and yield growth.

Performance of the European sectors in periods of rate and yield growth

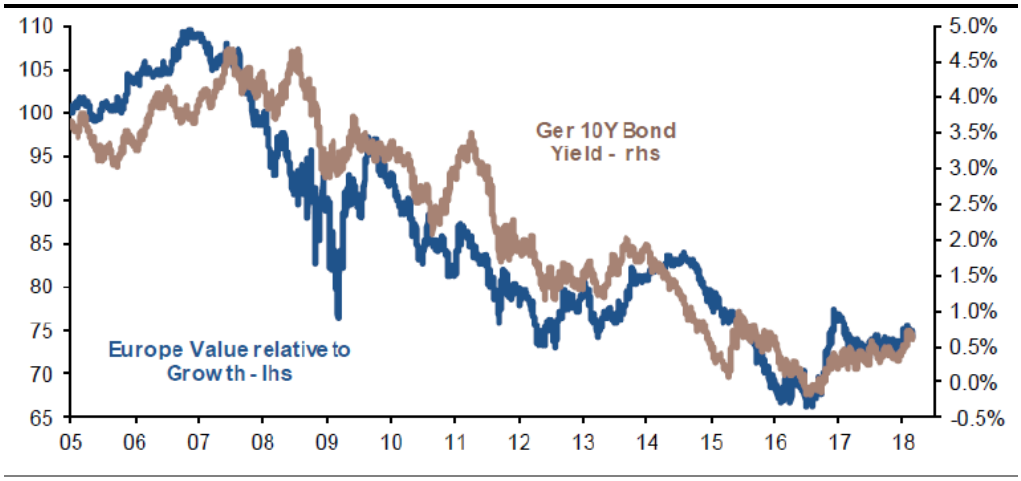
Periods of outperformance	Avg. relative performance		Period 1	Period 2	Period 3	Period 4	Period 5
5	15%	**Metals & Mining**	9%	15%	9%	38%	6%
5	15%	**Semiconductors**	44%	6%	7%	14%	3%
5	11%	**Auto & Comp**	18%	17%	1%	13%	6%
5	6%	**Aerospace & Def**	2%	10%	1%	10%	7%
4	8%	**Banks**	-16%	8%	5%	37%	5%
4	7%	**Construction Mat.**	20%	1%	2%	15%	0%
4	5%	**Capital Goods**	12%	6%	-1%	5%	2%
4	5%	**Insurance**	7%	1%	-4%	17%	2%
4	3%	**Durables & Apparel**	1%	-1%	2%	10%	4%
4	1%	**Hotels & Rest**	4%	6%	3%	-8%	1%
3	9%	Oil services	30%	-4%	-5%	20%	4%
3	-1%	Media	-9%	3%	2%	-6%	3%
2	7%	Tech. Hardware	-6%	52%	-4%	-27%	17%
2	4%	Chemicals	20%	-6%	-1%	7%	0%
2	3%	Div Financials	-2%	8%	0%	15%	-3%
2	0%	Oil & Gas	5%	1%	-3%	-4%	0%
2	0%	Software & IT Services	9%	-9%	1%	0%	-3%
2	-1%	Construction	4%	5%	-1%	-9%	-3%
2	-6%	Food Retailing	-15%	-2%	0%	-17%	5%
1	-2%	Transportation	-12%	7%	-1%	-2%	-1%
1	-2%	Retailing (spec)	-5%	-1%	6%	-6%	-7%
1	-6%	Health care eqts	-3%	-11%	2%	-18%	0%
0	-6%	**Telecom**	-10%	-2%	0%	-11%	-7%
0	-6%	**Pharma & Biotech**	-2%	-10%	-1%	-12%	-7%
0	-8%	**Utilities**	-4%	-5%	-1%	-22%	-6%
0	-9%	**HPC**	-6%	-11%	-1%	-21%	-5%
0	-10%	**Real Estate**	0%	-15%	-8%	-22%	-7%
0	-11%	**Tobacco**	-28%	-9%	-2%	-12%	-3%
0	-11%	**Beverages**	-11%	-9%	-2%	-28%	-3%
0	-11%	**Food products**	-7%	-13%	-4%	-24%	-7%
3		MSCI EMU Index	16%	8%	-3%	18%	-3%
		Ger 10Y Bond Yields	141 bps	84 bps	92 bps	54 bps	42 bps

Source: Datastream, SG Cross Asset Research/Equity Strategy

Growth stocks with higher indebtedness should fall behind the rest of the market.

The distinction between value and growth shares provides an interesting view of their development. The chart below shows that growth stocks have outperformed value shares in the period of declining yields. These companies often generate insufficient cash flow due to high investments, which they have to finance by increasing debt. However, lower interest rates support fast-growing profitability even through lower funding costs. Nevertheless, the anticipated increase in rates will make loans granted more expensive, which will limit the future profits and valuations of these companies. **Therefore, we rather recommend shares of value companies with low indebtedness** that are able to repay their debts from the generated cash flow and possibly finance their investments themselves. At the same time, these companies usually offer a stable dividend policy.

Performance of value relative to growth stocks vs. bond yield



Source: SG Cross Asset Research/Equity Strategy, The Big Picture – Bulls beware

Commodity companies, carmakers and financial institutions belong among the preferred sectors.

Summarising the above, we can state there exist opportunities for stock investors even in the period of interest rate and yield growth. Within Europe, we prefer German or French stocks as a result of their generally higher rating, which should not be so sensitive to the rising cost of financing. We think value shares are more attractive as these companies have strong cash flow generation that allows them to easily repay debt, which results in a healthier capital structure. **According to us, the representatives of the commodity companies, carmakers and financial institutions should not be missing from the stock portfolio during the expected growth of rates and yields.**

Interesting investment opportunities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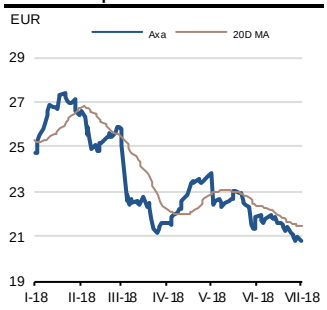
On the previous lines, we introduced sectors that might benefit from the anticipated future developments of interest rates. In this chapter, we would like to offer tips of specific stocks that have proved to fare well in times of rising yields. Recommendations and target prices are based on a fundamental analysis of colleagues from Société Générale.

Axa (Buy, 12m target price = €30, TSR = 49.7%)[1]

Axa stock price

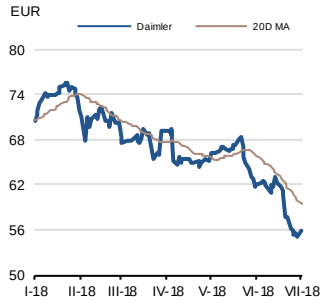


Source: Bloomberg

Axa is a French insurance group that had revenues in the amount of €100bn and net profit of €6.2bn in 2017. Axa operates in five segments, the largest of which is life insurance and savings, which together account for 60% of total annual revenues. Life and savings products include savings, retirement, life insurance and health insurance offerings. This division serves around 40 million customers in 30 countries around the globe. The second main segment is non-life insurance with its 30% share on total revenues and offers commercial and personal auto, homeowners, property and liability insurance. The remaining 10% of revenues comprises three segments; asset management, international insurance and banking. Globally across all segments Axa serves more than 100 million clients in 60 countries. The most significant geographical segment is Central and Eastern Europe, which provides 30% of annual revenues. The last released results were for the financial year of 2017. The company had exceeded the estimates of the market by 7% to €6.2bn in net profit. Revenues slightly dropped by 2% to €98.5bn. According to the last analysis of Société Générale published on 7 June, the shares of Axa are being traded for the lowest P/E multiples on the market (approximately 8x, whereas the sector average is above 10x). At the same time, the company provides one of the highest dividend yields over 6% (whereas the sector average is over 5%). SG has a *Buy* recommendation for Axa stocks with a target price of €30 per share.

Daimler (Buy, 12m target price = €72, TSR = 30.7%)[2]

Daimler stock price



Source: Bloomberg

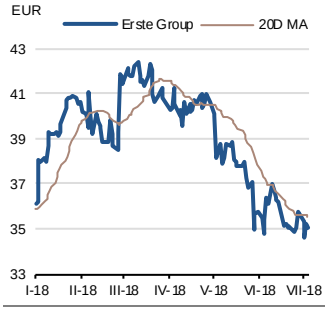
Daimler is a German producer of personal and commercial vehicles. The main brand of the company is Mercedes-Benz, which accounted for almost twothirds of total revenues in 2017 (Mercedes personal cars = 58% and commercial vehicles = 8%). Remaining Daimler divisions are trucks, buses and financial services. In 2017 the total revenues reached €164bn and net profit €10.5bn. Currently, Daimler invests in autonomous driving systems and vehicles with electric engines. This year, the company acquired a 25% share in Car2Go, which deals with smart cars rentals. This is another direction Daimler is heading in the future. This year's topics are import tariffs between the US and China, which have an influence on part of Daimler's US production exported to China. It will hit mainly SUVs (almost 60,000 cars in 2017), as China plans to impose tariffs in the amount of 40%. Daimler started a huge reorganisational plan called Project Future this year. It plans to establish three separate legal entities that will each be dedicated to specific business activities – personal cars and light commercial vehicles, trucks and buses and financial services. According to the management of the company, this change will lead to more flexibility in adaptation to market changes. Results for 1Q18 were quite good even though below analysts' expectations. Revenues grew 3% to €39.8bn yoy. Adjusted EBIT (by the infulence of transition to IFRS 9 and IFRS 15) grew 8% to €3.3bn and adjusted EBIT margin grew 40bp to 8.4%. SG has a *Buy* recommendation for Daimler stocks with a target price of €72 per share.

[1] Société Générale's analysis: "Axa – Four reasons to buy Axa" published on 7 June 2018 at 7:09 a.m.

[2] Société Générale's analysis: "Daimler – Tariff headwinds but core business remains robust" published on 25 June 2018 at 7:57 a.m.

Erste Group (Buy, 12m target = €48, exp. return = 36.9%)[3]

Erste Group shares

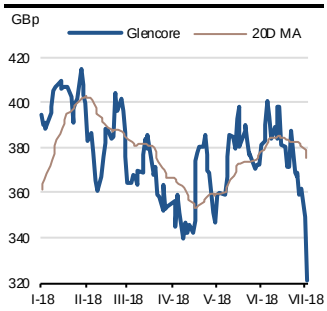


Source: Bloomberg

Erste Group is an Austrian banking group founded in 1819 as the first savings bank in Austria. Through its network of approximately 2,600 branches, it operates in seven countries in Central and Eastern Europe (Austria, Czech Republic, Slovakia, Hungary, Romania, Serbia and Croatia) and offers financial and advisory services to retail as well as corporate clients. Thanks to its close cooperation with banks in five other countries, it offers products further in Slovenia, Bosnia and Herzegovina, Montenegro, Macedonia and Moldova. The bank's shares became publicly traded in 1997 to expand its retail business in Central and Eastern Europe. After many acquisitions and solid organic growth, it has become one of the largest financial houses in the region. The results for the first quarter were not so bright, with net interest income and financial results lagging behind expectations. On the other hand, income from fees and commissions was slightly surprising, which was also helped by the cooperation with Austrian insurance company Vienna Insurance Group. The integration of products including insurance into the new digital platform, George, should allow for expansion of its services, increasing market share and further improving the bank's profitability. While net profit exceeded market expectations, this was due to an impairment writeback. Management made no changes in its outlook for this year when it presented its quarterly results. The persisting favourable macroeconomic environment should continue to help maintain positive developments that should encourage the creation of new loans. This is reflected, among other things, at low risk costs. A gradual increase in interest rates by central banks in the region should positively influence the bank's interest margin. Erste Group's shares are among the five most recommended bank shares of Société Générale. It has a *Buy* recommendation for the bank with a target price of €48 per share.

Glencore (Buy, 12m target = GBp420, exp. return = 34.3 %)[4]

Glencore shares



Source: Bloomberg

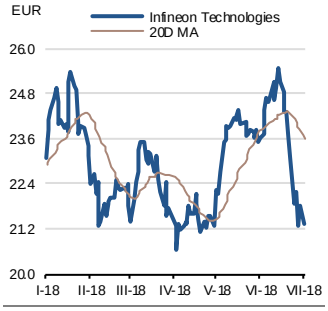
Glencore is one of the world's largest globally diversified natural resource companies with its headquarters in Baar, Switzerland. Around the world, it employs approximately 146,000 people in mining and metallurgical sites, oil production assets and agricultural facilities. The three main segments are metals and minerals such as copper, zinc and aluminum, energy products, especially coal, and agricultural products, especially cereals, cotton, sugar and oilseeds. An important part of the business is commodity marketing, through which Glencore ensures their transportation, storage and processing. Major customers include steel producers, carmakers, energy companies, and refinery and food product manufacturers. The company entered the market in 2011 and used the proceeds for acquisitions. So far the largest is the acquisition of Xstrata in 2013, supplying coal, zinc and copper. Prior to that, Glencore acquired Canadian company Viterra, which secured access to the North American cereal market. It had already previously operated in this area in Europe, Russia and Australia. Société Générale has included its shares among the most preferred titles in its Premium List. Currently, they hold a *Buy* recommendation with a GBp420 target, although it dropped from GBp470 in April due to a stronger British pound, higher costs on capital and increased commodity price volatility. Shares are also currently affected by developments in Congo, where political and regulatory risks overshadow the assumptions for higher coal and copper prices. High commodity exposures and strong cash flow creation, which allows a high dividend payout with a yield above 6%, are in favor of higher valuation. Management has also reduced significant debt in recent years.

[3] Société Générale's analysis: "Erste Group – Optimism bruised but enthusiasm undiminished" published on 7 May 2018 at 7:08 a.m.

[4] Société Générale's analysis: "Glencore – Buy rating reiterated despite increased DRC risks" published on 6 April 2018 at 6:24 p.m.

Infineon Technologies (Buy, 12m target = €28, exp. return = 22.8 %)[5]

Infineon Technologies shares

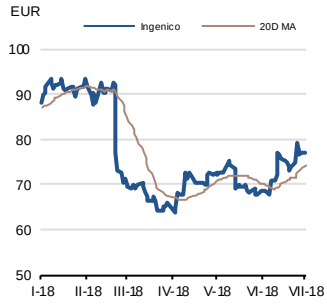


Source: Bloomberg

Infineon is a German leading semiconductor supplier specialising in automotive, industrial, power and security chip solutions. The company is the world's second largest semiconductor supplier in Automotive, first in industrial power control, first in standard MOSFET power transistors (power management) and first in microcontroller-based chip ICs (chip card and security). Its key customers are Automotive OEMs, capital goods (electrical and mechanical engineering, aerospace), network vendors, security and smart card providers, etc. Infineon has significant exposure to key growth drivers in the semiconductor markets in automotive electrification and industrial automation. It has consistently grown its top line by roughly 9% p.a. over the cycle since its IPO in 2001. Infineon shares were listed in 2001 and since then have increased sales by an average of 9% per year. In June, management introduced a new strategy for the next year with organic growth of over 10%. It also increased its medium-term outlook for growth to 9% from the previous 8%. This improvement is mainly due to higher investments at 15% of sales compared with the previous 13%. The company disposes of net cash. Due to investments, it pays a lower dividend when its yield reaches slightly above 1%.

Ingenico (Buy, 12m target price = €98, TSR = 38.4%)[6]

Ingenico stock price



Source: Bloomberg

Ingenico Is a French global company providing payment solutions including software, hardware and related services through all channels. These channels are point-of-sale terminals, mobiles and online payments. Revenues for 2017 were in the amount of €2.5bn; two thirds of these were generated by the point-of-sale (POS) terminals segment and the rest from transaction services. POS terminals are the primary market for Ingenico. Currently, the market is under control by two main players, Ingenico and VeriFone. Ingenico has established a specialised division few years ago, which offers complete payment solutions across all channels and countries. The company is therefore capable of providing payment solutions to all subjects, from individual entrepreneurs and their e-shops to transnational corporations carrying out cross-border payments. Ingenico operates more than 32 millions of POS terminals in approximately 170 countries all over the world, where Europe and America together represent a 40% share on total revenues. Concerning margins, Ingenico (in 2017 EBITDA margin = 20.4%, gross margin = 41.2%) outperforms its competitors VeriFone (EBITDA margin = 12.0%, gross margin = 39.7%) and PAX Global (EBITDA margin = 17.3%, gross margin = 40.6%). The results for 1Q18 were slightly below expectations, as the revenues decreased 5% to €581m yoy. This was mainly due to the drop of 15% in POS terminals segment, which was partly compensated by growth of 7% in transaction services. Despite the adverse development at the beginning of this year, the management of the company confirmed its guidelines for the whole year. They expect double-digit growth of revenues in transaction services and decent growth of the POS terminals segment. Société Générale expects total revenues to grow 4% to 6% and has a *Buy* recommendation for its stocks with a target price of $98 per share.

[5] Société Générale's analysis: "Infineon Technologies – Growth acceleration supported by a significant capex hike" published on 14 June 2018 at 7:03 a.m.

[6] Société Générale's analysis: "Ingenico – 1H18 results likely to be hit by tough comps and FX; gradual recovery over 2018" published on 2 July 2018 at 7:27 a.m.

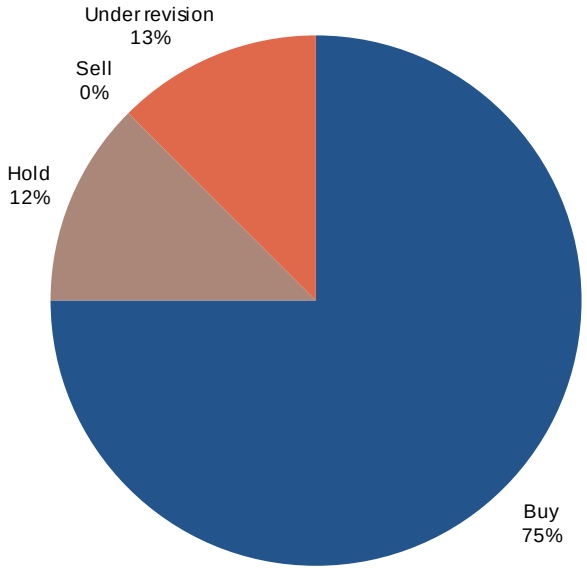
The recommendation in this document and/or the document itself was not disclosed to the issuer before its dissemination.

This recommendation is not updated at regular intervals. The date of the next update has not yet been determined and finally will be influenced by relevant changes of the facts used as the ground for this recommendation to reflect proper development in the industry and/or the analyzed company.

The main methods Komercni Banka is using for setting target price for stocks are discounted free cash flow analysis and sector comparison. Other methods may also be used if deemed appropriate by the analyst (e.g. sum of parts valuation, discounted dividend valuation, discount / premium to NAV). Target price is set for the time period of 12 months. Komercni Banka is using three grades of investment recommendation: buy, hold and sell. The recommendation is set for the time period of the next three to six months. The most important factor for setting the recommendation is the difference between actual market price and target price calculated by KB equity research. The recommendation should reflect also other factors the analyst expects to influence the stock and market in the time period of the next 3-6 months, i.e. target price substantially above current price does not automatically mean a buy recommendation for the next 3-6 months. Valuation methods and factors key for setting the recommendation are explained in the text of each analysis.

The chart below shows the structure of grades of valid investment recommendations of equity research of KB Economic & Strategy Research (8 recommendations).

Investment recommendations of KB equity research



Source: Economic & Strategy Research, Komerční banka

KB Equity Research ratings on a 12 month period

BUY: absolute total shareholder return forecast of 15% or more over a 12 month period.

HOLD: absolute total shareholder return forecast between 0% and +15% over a 12 month period.

SELL: absolute total shareholder return forecast below 0% over a 12 month period.

Total shareholder return means forecast share price appreciation plus all forecast cash dividend income, including income from special dividends, paid during the 12 month period. Ratings are determined by the ranges described above at the time of the initiation of coverage or a change in rating (subject to limited management discretion). At other times, ratings may fall outside of these ranges because of market price movements and/or other short term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by research management.

Overview of recommendations and relationships with particular issuers

	CEZ	O2 CR	CME	Philip Morris CR	Pegas Nonwovens	Vienna Insurance	Fortuna	MONETA Money Bank	Avast
Overview of last investment research and recommendations related to stocks of particular issuers									
Recommendation	Buy	Hold	Buy	Buy	In revision	Buy	End of	Buy	Buy
Target Price	CZK 620	CZK 270	USD 5	CZK 17546	In revision	EUR 26	coverage	CZK 93	GBp 342
Date	11.6.2018	18.9.2017	27.7.2017	22.8.2017	17.5.2018	3.3.2017	9.5.2018	6.3.2018	15.6.2018
Overview of investment researches and recommendations for last 12M (quarterly)									
Recommendation	Buy	Hold	Buy	Hold	Sell		Sell	Buy	
Target Price	CZK 542	CZK 267	USD 4.2	CZK 13500	CZK 876		CZK 198	CZK 90	
Date	20.9.2017	31.1.2017	27.4.2017	25.5.2017	13.9.2017		4.1.2018	17.8.2017	
Recommendation	Hold	Buy	Buy	Buy	Sell		Buy	Buy	
Target Price	CZK 44	CZK 267	USD 3.7	CZK 13500	CZK 876		CZK 198	CZK 95	
Date	14.9.2016	9.12.2016	10.3.2017	13.6.2016	13.9.2017		30.11.2017	9.6.2017	
Recommendation	Buy	Hold			Hold		In revision	Buy	
Target Price	CZK 420	CZK 260			CZK 876		In revision	CZK 90	
Date	12.2.2016	22.3.2016			19.4.2017		9.11.2017	6.9.2016	
Recommendation					Buy		Hold		
Target Price					CZK 863		CZK 128		
Date					20.5.2016		12.6.2017		
Valuation methods	DFCF	DFCF DDM	DFCF	DDM	DFCF DDM	DDM ERM	DFCF	DFCF DDM ERM	DFCF
Frequency of rec. (per year)	twice	twice	twice	twice	twice	twice	twice	twice	twice
Direct or indirect share (5% or more) of the issuer of the registered capital of KB	no	no	no	no	no	no	no	no	no
Other significant financial interest of KB and/or its linked persons in the issuer	no	no	no	no	no	no	no	no	no
KB direct or indirect share (0.5% or more) of the registered capital of the issuer.	no	no	no	no	no	no	no	no	no
Author's direct or indirect share (0.5% or more) of the registered capital of the issuer.	no	no	no	no	no	no	no	no	no
Significant financial interest in the issuer of the persons participating in elaboration of inv. research and rec.	no	no	no	no	no	no	no	no	no
Relationships of Komerční banka with particular issuers									
KB Management or co- management of public offerings in the past 12 month	no	no	no	no	no	no	no	no	no
Agreements or contractual relations for providing investment services with the issuer	KB can have concluded agreements with the issuer for providing investment services. This information is protected by bank secret and could not be disclosed.								
Agreement with the issuer on production and dissemination of the research	no	no	no	no	no	no	no	no	no
KB market making for common stocks of the issuer	no	no	no	no	no	no	no	no	no

Note: DFCF – Discounted free cash flow model, DDM – Discounted dividend model, ERM – Excess return model
Source: Economic & Strategy Research, Komerční banka

We do not include our one-off short-term recommendations based on Société Générale's analyses to this overview.

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