COMMERZBANK
The bank at your side

Your Asset Management

Additional information on your 2018 reporting

Table of contents

Editorial

Michael Kohl,
Head of Commerzbank
Asset Management

Dear Readers,

Pessimists fear the global economy could be weakening substantially, driven by high government debt, monetary policy tightening, rising interest rates, but mostly because of political crises. Optimists disagree and refer to the current economic realities. They argue that despite numerous challenges, the global economy chugged along quite nicely in 2018 and once again expanded by an above-average rate. It seems to be more robust than the subdued market sentiment would suggest.

So here we are again: is the glass half full or half empty?

Forecasts see global economic growth at 3.5% in 2019, which is nearly as high as in 2018. As in recent years, economic trends will differ across the major economic regions. Economic momentum is likely to slow somewhat in the US and China, while euro area economic growth will probably stabilise, contrary to current pessimistic expectations. The US–euro area growth gap will remain wide, though. We expect that over the course of the year, policymakers will find sustainable solutions for major economic policy conflicts, such as Brexit, the US-driven global trade conflict and the Italian budget conflict. Economic trends in the emerging markets have stabilised. The temporary US economic boom in 2018, which was essentially driven by massive tax cuts and a substantial public expenditure increase is running out of steam and economic momentum will soften in 2019. However, the US will continue to be a global growth engine. Global recession risks are low in our view, and market participants have already priced in many risks, which leaves room for upside surprises and thus opportunities.

Looking back, 2018 was not a good year for investors, particularly if they had significant exposure to risky assets. Safe haven assets, such as German Bunds or gold, provided more stability but failed to deliver attractive returns, similar to the situation in prior years. Investors, hoping for higher interest rates in the euro area in the short to medium term will be disappointed. Thus, successful asset allocation will remain key in 2019 for achieving attractive returns in 2019 and beyond. We simply cannot identify a single asset class or region that would justify investors to put a large chunk of money into, because it has such an outstanding risk-return profile. Equity investments will continue to be the cornerstone of our diversified asset allocation in 2019, as the equity asset class still offers the best return prospects. While we are disappointed in the performance outcome for 2018, we remain fully convinced that clever asset allocation will provide the foundations for sustainable investment success.

In our view, the glass remains half full. This, however, will translate into attractive returns only if investors ensure that they implement proper risk diversification.

In this publication, Chris-Oliver Schickentanz, our Private Banking CIO, will provide you with a detailed 2019 financial market outlook. In another article, Patrick Mertens, Asset Management's Head of Investment Strategy, will review 2018 and explain Asset Management's positioning for 2019.

My team and I hope that you and your family will enjoy reading this publication, and we would like to take this opportunity to wish you all a happy, healthy and prosperous year 2019!

Sincerely,

Michael Kohl

Market report

Chris-Oliver Schickentanz,
Chief Investment Officer (CIO)

What do the stars say about 2019?

Towards the end of each year, popular newspapers and magazines usually publish horoscopes, predicting the events of the coming year, and trends for the different zodiac signs in terms of professional success, family and health. We do not know what the stars have to say about the financial market trends, but our analysis reveals that 2019 will neither be a stellar year, nor will it end in disaster.

Persistent

While global economic momentum is likely to weaken modestly in 2019, recession risks will remain extremely slim. We forecast the global economy to expand by 3.5%. The US will extend its economic rebound, making it the longest on record, while Europe is enjoying its longest expansion phase in decades. The global economy shows a lot of stamina, but investors also need to acknowledge that the economic upswing has entered its final stage.

Divergent

Some of the current financial and economic trends will continue in 2019. Differences in growth rates, for example, will remain wide between the US and the euro area (2.5% vs. 1.7%). Interest rate differentials between USD and EUR are likely to keep widening somewhat earlier in the year. At some point, though, market participants will price in their expectations for the year 2020. Then, current trends will reverse as the Fed might already be in the final stage of its monetary policy normalisation trend in 2020, while the ECB policy normalisation will gain momentum in the same year.

Varied

In 2019, political events will once again cause financial market trends to vary over time. At the end of March, Brexit will become a reality – either soft Brexit with a long transition period as currently envisioned in the negotiated agreement, or disorderly Brexit. The current global trade conflict will continue to linger as well. The trade conflict potentially has a big impact on the global economy, which is why the outcome will determine market trends.

Turbulent

In the late stage of an economic cycle, market volatility usually increases. This is understandable. Many investors are nervous and respond to a few negative headlines or data, assuming that a recession has finally arrived, even if this does not turn out to be true initially. Therefore, it comes as no surprise if investors frantically move in and out of the different asset classes at times.

Modest

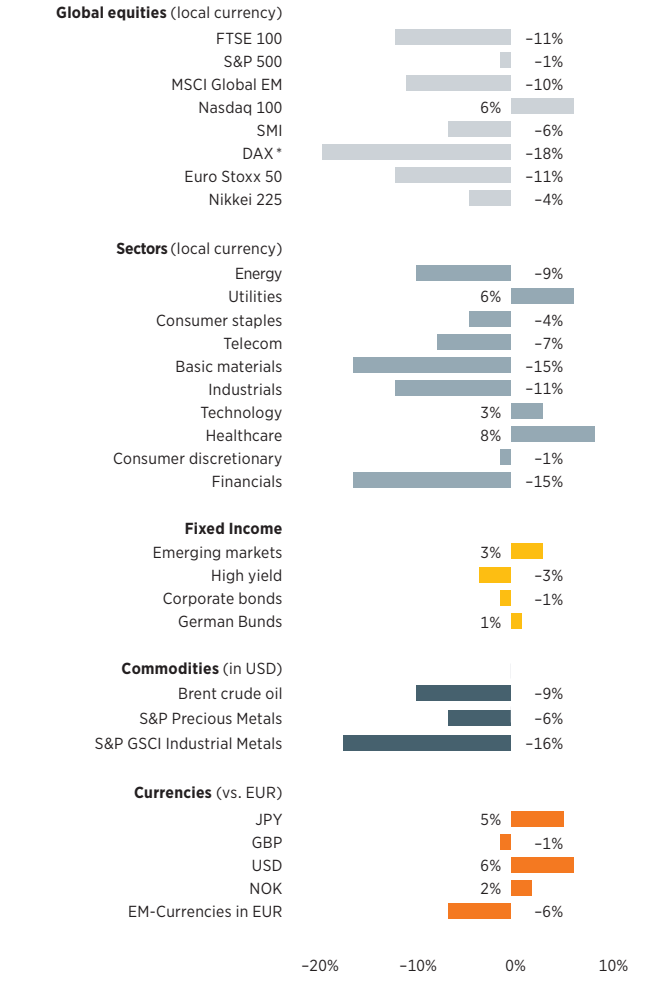
Following a weak 2018, the performance outlook for 2019 remains modest but positive. This is in line with our prevailing and well-communicated long-term outlook. We forecast returns to be below average historic returns. Equities are likely to register small gains, while bonds will probably lose value. Open-ended real estate funds, which help to diversify the portfolio, will continue to generate stable returns.

The global economy

And it keeps growing and growing ...

The current economic expansion in the US is the longest in recent history. Obviously, this raises the question as to whether the next recession is just around the corner. After all, the political environment determined by the global trade conflict, Brexit and concerns about Italy provides a headwind for economic growth. Nevertheless, we have a high conviction that the global economic expansion will last for at least two more years, even if economic momentum is likely to slow somewhat.

Performance overview asset classes 2018
Performance between 31.12.2017 and 13.12.2018

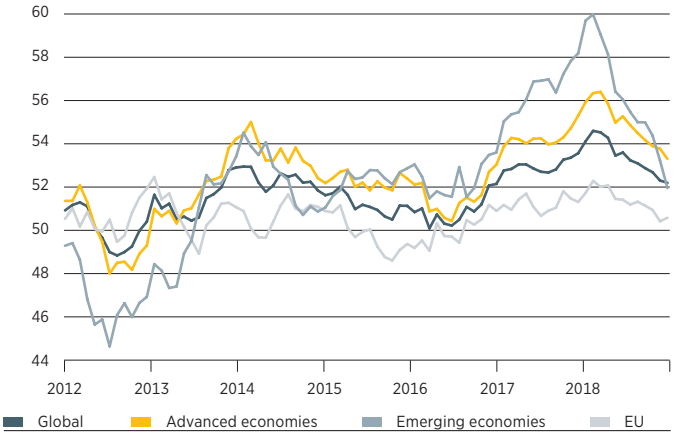


Status: 13.12.2018 Source: Commerzbank, Bloomberg
* DAX: Price Index

Slowing momentum in the US ...

Global GDP growth is likely to slow in 2019. The US economy will benefit less from the recent tax reform implemented by the Trump government. In 2018 many companies have already taken advantage of new opportunities to repatriate taxable profits held abroad and have used the cash to increase their investments in the US. In 2019, this effect will abate, lowering US GDP growth by between 0.2 and 0.3 percentage points. In addition, Trump's leeway with respect to fiscal spending has shrunk considerably since the Democratic Party regained a majority in the House of Representatives. In other words, further fiscal stimulus is probably off the cards.

Purchasing managers' indices in a downward trend as of late
Index value (50 = neutral)



Source: Commerzbank CM, Bloomberg

... in China ...

Chinese GDP growth will probably soften as well. This is due to punitive tariffs on nearly half of Chinese exports to the US as well as high private sector debt. Chinese policymakers will try to mitigate these headwinds through a stimulus package. We expect them to cut taxes, increase fiscal spending and implement investment incentives. This would pave the way for a still respectable GDP growth rate in excess of 6% in 2019.

... and Europe

Following a significant slowdown in 2018, the euro area economy is likely to remain soft in 2019. However, while the euro area economy will continue to lag behind growth in other regions, on balance the economic upswing will continue, as extremely low interest rates will underpin domestic demand.

Market report

Recession risks remain low

While global economic momentum will soften, recession risks for 2019 (and 2020) are low. During the long expansion, the major economies have not built up unsustainable imbalances, usually indicating elevating recession risks. The numerous geopolitical risk factors are not strong enough either to choke the robust global economic expansion in the short term. We expect the global trade war to be reduced to a bilateral trade conflict between the US and China. The Italian budget woes will not trigger another government debt crisis, and Brexit will mostly hurt the UK economy.

Conclusion

We forecast the global economy to expand by 3.5% in 2019, which is a fairly respectable rate. However, as the global economic upswing is in its last stage and as momentum is slowing, investors will be very nervous and at times anticipate a recession which is not there yet. Therefore, financial market volatility is likely to remain high in 2019.

Central banks

ECB approaches policy normalisation

After five years of a zero-interest monetary policy, in 2019 the European Central Bank (ECB) will embark on a long path of policy normalisation. It will face significant hurdles, as economic conditions differ widely in the euro area countries. The ECB rate hike path will be extremely shallow, and monetary policy normalisation will take a long time, with policy rates not reaching the level of inflation for years to come. The situation is completely different in the US, where policy rates could well peak in 2019. As a result, prevailing international policy rate trends would reverse in the year 2020.

The ECB timetable

The ECB will begin its monetary policy normalisation process in early 2019. In January it will stop buying government and corporate bonds on a net basis. At that stage, the ECB will hold bonds worth EUR 2.8 trillion. The ECB will reinvest interest income and repayments, though. Thus, the ECB will still buy bonds amounting to EUR 150 bn in 2019, without expanding its balance sheet.

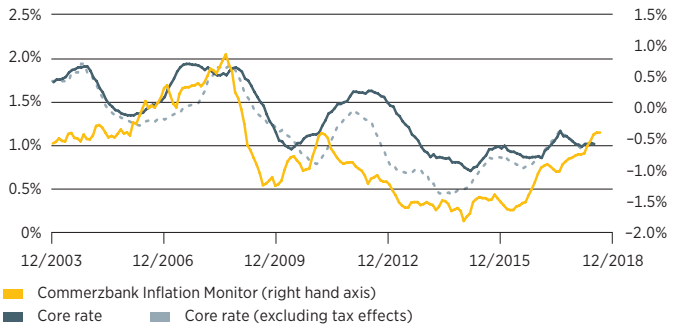
The ECB is unlikely to adjust its policy rates before the first quarter of 2020. Initially, the ECB will probably start moving its negative deposit rate (currently at –0.4%) gradually towards zero level. Later in 2020, it is likely to raise its main repo rate from 0% to 0.25%. Given the fragile state of the euro area economic rebound, the ECB will need to proceed with caution and raise rates only once per quarter. The ECB monetary policy will be strictly economic data-dependent.

Uncertainty remains high

It is highly uncertain whether the ECB will be able to implement its policy normalisation plan, which is based on a continuation of the current economic rebound. If the US economy were to enter a recession in 2021, the euro area economy would be severely impacted as well, and ECB policy normalisation would certainly be off the table. In a different scenario of a slowdown instead of an outright recession, the ECB would be forced to keep policy rates stable after having implemented only a few rate increases. We conclude that even in the best case economic scenario for the euro area, savers will have to remain very patient and will not be compensated for inflation for a few years to come.

Low core inflation, but expectations are on the rise

HVPI excluding energy, food and beverage (dotted line: excluding tax effects), change in % y-o-y; Commerzbank Inflation Monitor



Source: Commerzbank CM, Bloomberg

US policy rates to peak soon

The situation with regard to the US is quite different. In H1 2019 the Federal Reserve will continue to raise rates once a quarter by 0.25%. Then, however, investors can slowly prepare for a peak in policy rates. This is because US economic momentum should slow in H1 2019 and, as a result, wage and inflation pressures should abate. Overall, the Fed will raise policy rates fewer times in 2019, compared to four times in 2018. The rate outlook for 2020 is highly uncertain and fully data-dependent.

Conclusion

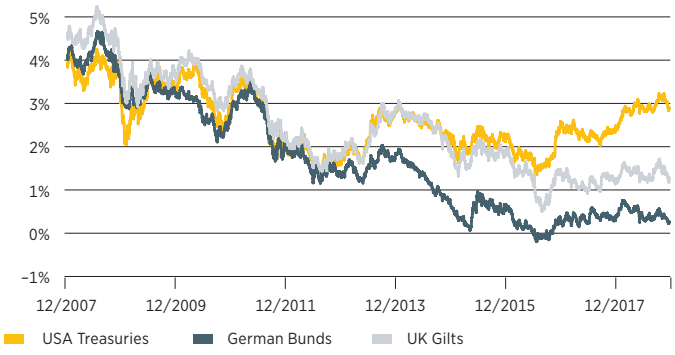
While monetary policy normalisation will finally begin in Europe in 2019, the Fed is already entering the final stage of its rate increase cycle. Savings accounts and money market instruments will continue to pay EUR-based savers and investors very little interest for years to come, by far not enough to compensate for inflation, and are no investment alternative.

Our 2019 outlook for the different asset classes

Bonds and currencies

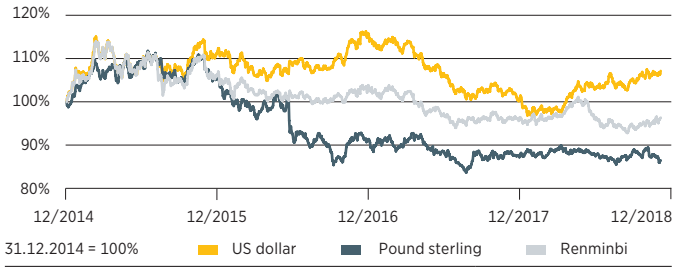
Bond investors will once again face a difficult environment in 2019. EUR investors who shy away from currency risks will either have to be content with meagre yields or will have to run significant credit risks. At some point in 2019, the EUR interest disadvantage will start to shrink, which argues against broad-based EUR weakness.

Major bond yield trends for ten-year government bonds



Source: Commerzbank, Bloomberg

US dollar is strengthening again



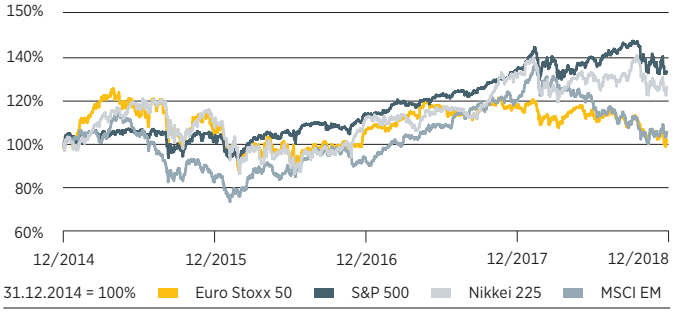
Source: Commerzbank CM, Bloomberg

We focus on flexible investment concepts and well-considered maturity management as well as diversifying into short-maturity high-yield and emerging-market bonds.

Equities

Following a weak year 2018 in the equity markets, 2019 is likely to be similarly challenging. Global economic growth still looks solid, which means that corporate profits and dividends should continue to increase. In addition, valuations have fallen significantly as of late, which leaves investors better positioned to achieve a positive equity performance, going forward. However, headwinds will be coming from a slowing global economy, falling profit margins and potential event risks, which will all lead to periods of elevated market volatility. We favour a flexible equity allocation approach – driven by our rule-based system relating to our flexible allocation funds.

Disappointing returns in 2018



Source: Commerzbank, Bloomberg

Commodities

In 2019, commodity price trends will continue to differ widely in the different sub-segments energy, precious metals and industrial metals. The latter are likely to suffer from softening Chinese demand as a result of the trade conflict. Notwithstanding robust demand, oil prices will be driven by volatile supply (OPEC production/Iran sanctions/expanding US shale oil production). Precious metal prices will be driven by rising interest rates and central bank sales.

I wish you a successful year of investing in 2019!

Sincerely,

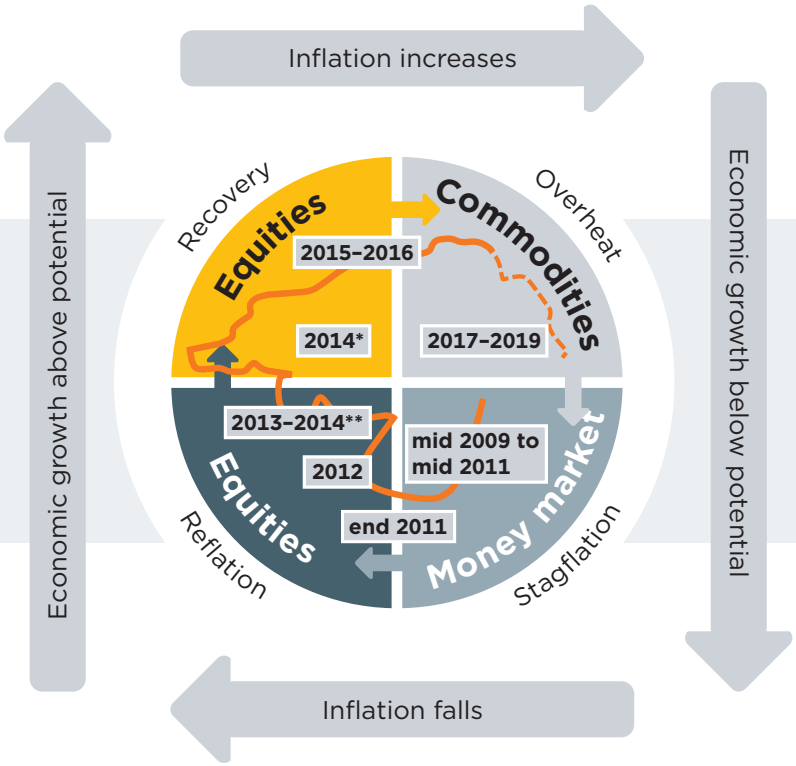
Chris-Oliver Schickentanz

Market report

What was, what is and what could be:
2017 – 2018 – 2019 at a glance

2017	2018	2019
• Synchronised global economic growth	• Increased growth divergence	• Growth softens, but remains above the potential rate
• US Federal Reserve reduces extent of monetary easing; three rate hikes	• US Federal Reserve continues to raise policy rates	• US rate increase cycle approaches its final stage
• Weaker US dollar/strong emerging markets	• US dollar strength/ weak emerging markets	• US dollar weakness/emerging markets to stabilise
• Historically low volatility	• At times elevated volatility	• Elevated volatility in all asset classes
• "Buy the dip"; Investors regarded sell-offs as buying opportunities	• Risky asset prices trend lower	• Investment strategy requires a significantly higher flexibility

Late cycle economic boom
Stages of the economy according to the investment clock



* 2nd half of 2014 ; ** 1st half of 2014

Patrick Mertens, Head of Commerzbank Investment Strategy Asset Management

Our investment hypotheses for 2019

Increased uncertainty

- Global economy still grows at an above-potential rate
- Global economic momentum softens
- Increased macroeconomic uncertainties

Tighter financing conditions

- Tighter financing conditions than in previous years
- US interest rates have increased
- Global monetary policy still supportive, despite higher policy rates

Lower return for the same risk

- Risky assets still pay a fair premium, but it is falling
- Lower returns in many asset classes
- Volatility is on the rise; active risk management becomes more important
- Investors need to diversify into different return sources

Interview with Patrick Mertens

What were your expectations at the beginning of 2018?

About 12 months ago, we had meticulously worked to prepare for a new year in the financial markets. We based our investment strategy on the core thesis that robust global economic growth would continue, albeit at a slightly lower momentum. We were aware of the significant challenges lying ahead: euphoric sentiment for US equities, high valuations of technology companies, political trouble spots, such as the Italian election outcome, Brexit, US monetary policy and numerous geopolitical conflicts in the Middle East.

Still in January, we took advantage of one of the best equity market starts into a new year in many years, and reduced our exposure in regions (emerging markets, US) and sectors (technology) which performed particularly well.

How did you respond to the first setback for equities in spring? How did you position the portfolios?

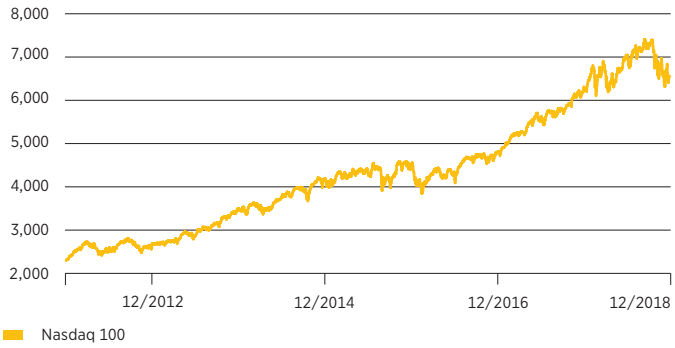
We were well prepared for the first mini-crash in February, which brought dramatic price losses in certain parts of the market. In April we began adding to our equity allocation in a weak market, as we expected corporate profits to rise. This definitely paid off for our portfolios. Already in mid-May we became more cautious again as a number of political events raised market uncertainty throughout the summer. Corporate uncertainty rose because of massive punitive import tariffs against China and trade threats against the EU, Mexico and Canada, which also caused global economic growth to slow down. To this day our investment behaviour continues to be impacted by the US-driven global trade conflict. Other political topics weighing on financial markets were the struggling Brexit negotiations, the new populist government in Italy, fresh sanctions against Iran and the Turkey crisis. Therefore, we decided to significantly shrink our portfolio risk exposure in summer by reducing risks in virtually all asset classes.

There was one exception to the risk-averse trend, though: US technology shares registered significant price gains. We were too defensively positioned in technology as well as US equities during this stage, as we considered the technology sector to be overvalued – just like German Bunds – from our investment philosophy perspective.

Following a successful meeting between Juncker and Trump, we were too optimistic during the summer months, as we continued to bet on our trade conflict de-escalation scenario, which turned out to be wrong. The global trade conflict will continue to be a main market driver in 2019. Following

Market report

Correction of overvalued technology shares



Source: Commerzbank, Bloomberg

improved chances of a de-escalation after a successful G20 summit, Trump crushed any hopes of a fast solution through another round of verbal attacks.

Looking back, what worked well for you and where did things go wrong?

In the past few years, we have been able to actively manage predictable hurdles ahead of a political event in an appropriate time frame and with positive results. The 2016 Brexit vote and European and US elections are good examples of our political risk management. We were able to limit losses, hedge risks and take advantage of opportunities when markets sold off. As a result, we were able to significantly outperform our benchmarks in recent years, particularly towards the end of 2017. Unfortunately, we were unable to continue this positive trend in 2018, as our relative performance was impacted by ongoing political uncertainties, a marked deterioration of European corporate earnings trends and economic troubles in the emerging markets. On balance, due to these circumstances, we generated a performance which – according to our standards – is not satisfying. As promised early in the year, we applied a very flexible asset allocation approach in all asset classes. We reduced risks early on in richly valued markets, for example by lowering our exposure in high-yield, emerging-market and corporate bonds. However, all our measures and exposure adjustments were not sufficient to generate a positive active performance relative to benchmarks. Falling underlying bond yields disproportionately benefited our conservative benchmark. In the second half of the year, we were able to significantly limit market-driven losses and stabilise our portfolio performance. This was due to our more defensive positioning implemented in August, a risk reduction in our bond sleeve as well as lower commodity and equity exposure.

Are the current negative equity market trends a harbinger of a coming global recession, similar to that of 2008/09?

In mid-October 2018 US equity markets finally started to reflect growing fears of a significant global economic slowdown. This was when the Nasdaq index peaked and crude oil prices began to fall. Previously, economic data trends had deteriorated in China and Europe in particular. US economic trends became more uncertain because of a softening housing market and the potential impact of higher interest rates as a result of accelerating wage inflation.

Volatile oil prices in 2018 in US dollars

Source: Commerzbank CM, Bloomberg

All this prompted US Federal Reserve Chairman Jerome Powell to send a clear signal to market participants in mid-November that the Fed might pause its policy rate increases. US policymakers have no interest in pushing the global economy into a new crisis. We are convinced that Chinese policymakers are willing to contribute to a sustainable solution of the trade conflict with the US and to take advantage of available monetary easing options in order to stimulate the economy. Furthermore, economic trends seem to be robust in many other regions, despite the punitive import tariffs imposed. Even Europe, the eternal "sick man" of the global economy, is likely to achieve GDP growth above the region's potential rate in 2019, despite a slow start into the year. Thus, we have little doubt that the global economy will continue to expand in 2019.

2019 guidelines for our asset management mandates

1. **Late-cycle global economic expansion: more growth, but at a slower pace**
Our strategy remains geared to an economy which has entered the economic overheating stage. In summer 2018 we implemented a more robust and more defensive positioning compared to early 2018, thus taking account of growing economic and financial market warning signals.

2. **Central banks: the focus shifts to the ECB**
US interest rates will continue to increase modestly; the ECB will start to verbally prepare market participants in the second half of 2019 for an upcoming first rate hike. The interest rate and growth advantage of the US economy will shrink, which will impact exchange rates. The focus will shift to the ECB's monetary policy.

3. **Less risky bond exposure: the need for flexible strategies**
We increase the average rating of portfolio holdings and become more defensive by extending duration in high-quality bonds; addition of high-yield bonds and emerging market bonds with short maturities. Flexible management will be the key to success.

4. **A more defensive equity sleeve as a success factor**
Shift to a more neutral positioning – away from a significant overweight, but avoiding an outright underweight positioning; we will increase our positioning to either side when clear trends emerge. Focus on defensive quality stocks with substantial dividend payments.

5. **Systematic commodity approach**
Commodities are excellent for diversification purposes within an optimal portfolio and help to protect against inflation risks. In 2019 we will focus on rule-based and systematic commodity positioning.

6. **Additional return sources from supplementing strategies**
Aside from cash and short-term liquidity, strategies with a low correlation to traditional investments are required for diversification purposes in 2019. We focus on transparent, rule-based concepts which reduce portfolio risks and provide return opportunities in a weak market environment.

7. **Optimal investment structure as a risk management cornerstone, supplemented by systematic investments**
We slightly reduced risk budgets in our portfolios of the respective risk profiles and are currently preparing for a possible stagflation or a reflation scenario. We expect this optimal investment structure to fundamentally pave the way for success, supplemented by systematic investments to produce a positive absolute performance if our base case scenario for 2019 materialises.

Are you already prepared for a potential stagflation scenario?

While we think it is highly unlikely that the global economy will face a recession anytime soon, we have been working on a plan B in case we see a further global growth deterioration for quite some time now. This is why we have been purchasing supplementary strategies in very defensive asset management mandates as a means of diversification from traditional asset classes.

These investment instruments are often a counterpart to traditional investments in all asset classes and thus help with the fine-tuning of the portfolio diversification. Particularly in times of economic slowdowns, when correlations of the equity and bond asset classes often increase, market-neutral strategies, for example, provide attractive return opportunities because of their absolute return approach.

This is why we gradually optimised our portfolio allocations by adding these exclusive and attractive strategies, which has already helped to stabilise portfolio performances in the fourth quarter of 2018.

Market report

Financial markets are increasingly driven by political events. What can we expect for 2019 in this respect?

Historically, the impact of political events on asset prices was usually short-lived. Unfortunately, this was different in 2018; a gradual global trade conflict escalation, the Italian budget dispute and Brexit all had a lasting market impact. From today's perspective, it is difficult to envision easy and sustainable solutions to these political issues. However, as in previous years, these political risks are on our radar, and we work with thorough scenario analyses to have an adequate response readily available. One example: with respect to Brexit, we have been cautious for a while and implemented a currency-hedged underweight position for UK equities. In a constantly uncertain environment – such as during the trade conflict escalation in mid-September – we will not automatically raise our risky asset allocation but will respond with greater caution. We still think that major sell-offs, similar to the situation in 2015/2016, offer attractive buying opportunities, which are likely to materialise in 2019.

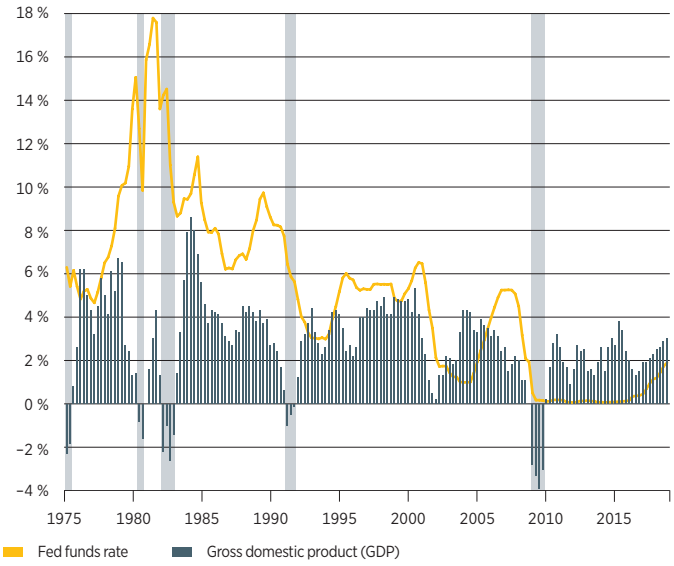
Looking ahead, what will you do to generate positive portfolio returns in 2019?

Looking at 2019, we can identify a number of positive and negative factors. The global economic upswing is likely to continue, making it one of the longest uninterrupted global expansions in history. Economic momentum is poised to slow, though, as the effects of the global trade conflict and lower stimulus from the US tax reform will take its toll. As a result, corporate earnings will probably continue to grow, but potentially less than in a traditional economic upswing. At the same time, central banks are likely to continue their path towards a more normal monetary policy. The ECB will end its net bond purchases at the end of 2018, but the first policy rate increase is unlikely to happen before early 2020. In contrast, Fed policy rates will probably peak soon.

How is this all reflected in our portfolio stance? On balance, we expect a constructive environment for risky assets (equities, commodities, equity-like fixed income segments) in 2019. We also forecast volatility to be very high at times in the different asset classes. Therefore, we will once again show plenty of flexibility when implementing our investment strategy.

US policy rates – at what level will it start hurting?

Real Gross domestic product, change in % y-o-y; Fed funds rate in % p.a.



Source: Commerzbank CM, Bloomberg

We have meticulously analysed financial market trends and our strategy implementation in 2018. The insights gained will help us to further develop our investment and selection process. We will also draw specific conclusions and implement measures that will help to improve our performance.

One example: so far we have been relying on a fundamental approach to selecting our commodity investments. This approach will be replaced by a multilevel and systemic commodity allocation process that has been successfully tested. Similar to the rule-based equity allocation management, it is our goal to respond even more efficiently in all asset classes to the elevated market volatility.

Sincerely,

Patrick Mertens

Risk management enhancements – our rule-based equity allocation management

Since January 2017 we have been managing our equity allocation through a rule-based model. This investment approach focuses on loss protection. In the past two years we achieved an excellent track record with our rule-based equity allocation management based on ETFs, which is why we decided to take this approach a step further last summer. Since the end of May 2018 we have implemented the respective signals via two mutual funds managed by Commerzbank:

Commerzbank Flexible Allocation Funds Euroland

Commerzbank Flexible Allocation Funds USA

The implementation of the rule-based equity allocation management via mutual funds offers a number of advantages, for example:

- implementation at lower costs vs. direct ETF trading
- it is fast and devoid of emotion
- lower liquidity requirements, as customers no longer need to hold liquidity in their accounts

The anchor point of our model and the decisions:

Conservative asset manager

- **Capital preservation is the highest priority.** We are convinced that a strategy to minimise losses delivers more sustainable success than a strategy based purely on maximising returns.
- **Long-term approach.** The rule is: the higher the risks incurred, the longer is the required investment horizon.
- A rational evaluation of **risk and return factors** during the decision-making process.

Aktive risk manager

- Decisions are based on **systematic rules** instead of emotions.
- **Contrarian allocation approach** to take advantage of **attractive and independent opportunities** during periods of elevated volatility as well as in strong bull markets.
- **Binary decision trees.**
- A number of **risk indicators, stress tests** as well as **scenario analyses** are being taken into account.

How exactly does our model work?

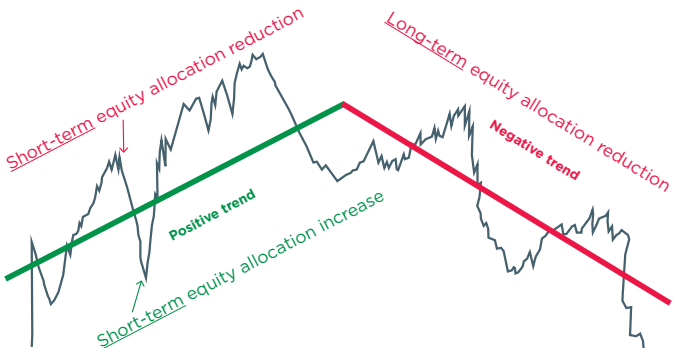
We focus on two equity indices, each of which is very significant in the respective investment region: this is the EuroStoxx50 for Europe and the S&P 500 for the US. We take into consideration technical indicators (e.g. Bollinger bands) for these indices on a daily basis. In the absence of a signal, we maintain a neutral allocation in these markets in line with the respective investment profile. When the model sends out a negative signal we sell the neutral position, while we double it when it sends out a positive signal. In a downward trend we generally run a short position, i.e. the fund's equity allocation is close to zero.

At a glance:

1. Hedged mode (to 0% – short signal)

2. Long mode: significantly higher allocation (to 180% – long signal)

3. Neutral mode: neutral signal (100% investment position) = allocation in line with index

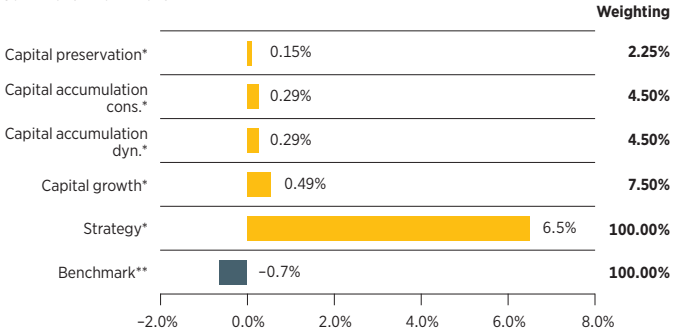


2018 performance overview – significant outperformance compared to benchmark:

Since implementation on 19 January 2017, we have received 60 signals – 27 for the EuroStoxx 50 as well as 33 for the S&P 500. Not all signals proved to be right and added to performance, but overall the systematic approach delivered a significant outperformance over benchmark.

Risk management enhancements – our rule-based equity allocation management

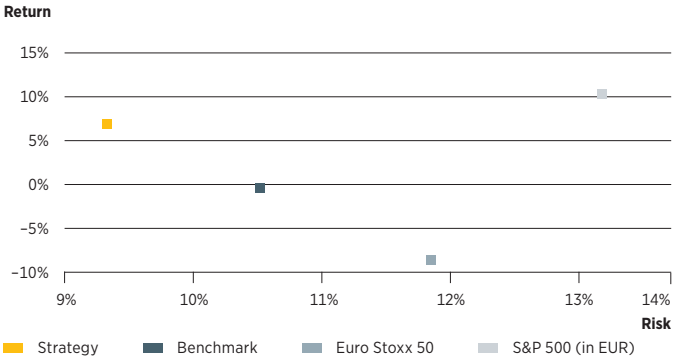
Performance and performance contribution
30.12.2016 – 10.12.2018



Source: Commerzbank, Bloomberg

The risk-return chart shows as well that the model is successful: risk – measured as volatility on the x-axis – is markedly lower than for the indices, while returns (y-axis) are, nevertheless, higher than benchmark returns.

Risk-return chart



Source: Commerzbank, Bloomberg

In mid-October, when US indices plunged, both funds quickly moved into short-mode, which lowered the equity allocation in portfolios to a level much below their long-term strategic allocation.

Conclusion

This innovative enhancement in line with our Asset Management's investment philosophy provides attractive added value in the portfolios.

* Strategy based on global equities
** Benchmark: 60% Euro Stoxx 50; 40% S&P 500 (in EUR)

Your reporting at a glance

In connection with the end-of-year reporting 2018, you hereby receive various records from your Commerzbank. On the following pages, we provide you with some additional information regarding the current reporting for your asset management and, in particular, your statement of assets held. Furthermore, we discuss the end-of-year portfolio statement and the tax records you will receive.

Finally, your personal advisor will be pleased to provide you with additional information regarding all themes pictured in this publication and will answer any other questions you might have.

When will you receive which records?

Reported records		Date
1	Regular reporting / Statement of assets held / Market report	With this letter
2	End-of-year portfolio statement	Will be sent out early in January
3	Tax records	
	3.1 Annual tax certificate	Will be sent under separate cover, presumably in March
	3.2 Statement of income	Will be sent under separate cover, presumably in March

Your reporting documents

1 Regular reporting

1.1 End-of-year reporting

End-of-year reporting comprises, among others, your portfolio statements, income credited and your statements of account for the last reporting period of the past year.

1.2 Statement of assets

Your statement of assets provides you with a full overview of your financial assets. In addition to the current prices of your securities, the statement also reflects prorated accrued interest on fixed-income securities and the credit balance of your investment account. Furthermore, the income generated as well as fees and charges incurred within the reporting period are shown in the statement of assets. The performance overview reflects your investment performance for the reporting interval as well as for the year as a whole. You will also find the performance of a benchmark in relation to your securities portfolio for comparison purposes.

2 End-of-year portfolio statement

The end-of-year portfolio statement, which we are obliged to prepare and send to investors in accordance with the Securities Account Act, will be sent to you in early January. The individual portfolio account items are valued on the basis of the so-called uniform valuation prices. These are determined and published by a working group of the association of German banks in cooperation with the securities information data service. This may lead to minor valuation differences in relation to the end-of-year statement of assets (cf. no. 1.2). The end-of-year portfolio statement contains neither prorated accrued interest on fixed-income securities nor a report of your credit balance as at the reference date. It is intended to provide you with assistance in verifying the securities held with our Bank.

If you maintain an O&F portfolio for options and futures contracts with us, you will receive a separate O&F end-of-year portfolio statement.

Valuation of securities account items in the statement of assets

In specific cases, slight differences may arise in the statement of assets in relation to the prices reflected in the annual securities account reconciliation (cf. no. 2). The annual securities account statement is based on uniform valuation prices for tax purposes, determined in accordance with coordinated guidelines of the associations in the credit industry. Since the statement of assets should be as up to date as possible for you, when preparing the report we do not wait for the so-called uniform valuation prices, which are only available at a later date. Accordingly, in the securities account statement we evaluate the individual securities account items at the prices prevailing at the end of the year and available at the time of preparing the report. The following principles apply to the valuation of the securities in your portfolio in connection with the preparation of the statement of assets: on each banking business day, the Bank carries out an evaluation of the underlying portfolio under the asset management mandate. This evaluation is made on the basis of current securities exchange prices or other market prices at which the securities can be sold. If no current market prices or prices determined independently by issuers or confirmed prices are available, then the securities account items will be valued on the basis of relevant historic prices or other estimated prices available.

3 Tax records

Your private capital gains as well as net proceeds of sales are reflected in the annual tax certificate and in the statement of income. You will find detailed explanatory notes on the structure and content of the tax records in the reference texts to the annual tax certificate and the statement of income at www.commerzbank.de/hinweise_jer. Alternatively, you can also obtain these from your branch.

3.1 Annual tax certificate

You will receive your annual tax certificate presumably in March. In accordance with the statutory provisions and an official specimen laid down by law, in particular the tax certificate reflects the extent of the capital income generated in the past calendar year 2018 on your securities, forward transactions and interest earned on your investment accounts as well as withholding tax (capital gains tax, solidarity surcharge and church tax, if applicable) as well as foreign (withholding) tax

already or still to be taken into account. In the event that you did not file an application for a certificate on the extent of losses not yet settled with Commerzbank AG at the end of the year, this loss certificate will be part of the annual tax certificate. If you submitted an application to us for exemption from income tax for your investment income in the past year, the income will be exempted from withholding tax up to the extent of your saver's allowance. Only investment income beyond this is liable to deduction of tax at source. On account of statutory regulations, the extent of your saver's allowance claimed is likewise included in your annual tax certificate. If an application for tax exemption is in hand for different accounts/securities portfolios with an identical account holder, losses will be netted once only at the end of the year. Nettable losses (negative capital gains) are netted against profits (positive capital gains) of another account of the same client. This may result in a reduced utilisation of the tax allowance and/or a capital gains tax credit note. This will also apply, if still accountable withholding tax amounts are netted against amounts of capital gains tax withheld. Losses are reported in accordance with this loss netting that extends to include all the client's account numbers. If spouses/registered partners submitted a joint application for exemption from taxation, the losses will be reported after the netting of losses has been carried out for both spouses/registered partners. Please note that the netting of losses may have already reduced or even completely settled any previously existing losses.

3.2 Statement of income

The statement of income serves to explain the annual tax certificate or – if applied for – the loss certificate along with detailed information on income on capital assets you generated in the income period from 01.01.2018 to 31.12.2018. In addition to current income, such as interest payments on investment accounts, dividends paid out, interim profits collected as well as income from investment fund units, this statement also reflects profits and losses (including accrued interest on bonds) from the sale of securities and capital growth realised, along with gains and losses of sales resulting from forward transactions. Moreover, the statement of income includes premiums collected on options. Expenses are only certified to the extent that they arose in connection with the account and/or portfolio management (securities custody fees and remuneration for management services). Actual other expenses incurred (e.g. securities custody fees) are not deductible. Ancillary costs of acquisition and sale (such as charges or expenses) are taken into account in determining the assessment basis for tax purposes.

In the case of agreed all-in fee models, for instance, the transaction cost share specified in the Asset Management Agreement may be taken into account as a lump sum for tax purposes provided it does not exceed 50% of the all-in fee. In this case, individual costs of sale – apart from third-party charges being passed on – may not be taken into account. If you have entered into the relevant supplementary agreement with Commerzbank AG, the Bank will only take account of the transaction cost share for private investors fully liable to income tax in Germany – subject to a change in the opinion of the fiscal administration (currently depending on the variant adopted by Asset Management, up to 50% of the lump-sum fee incl. value added tax) – in the loss settlement fund "Miscellaneous" as a deductible expense.

3.3 Church tax

For church members we will automatically pay the church tax on capital gains tax to the inland revenue if the capital gains exceed the lump sum for savers (single persons: EUR 801; jointly assessed persons: EUR 1,602). To simplify the process, we request information on your religious affiliation each year from the Federal Central Tax Office (Bundeszentralamt für Steuern – BZSt). If you would not like the Federal Central Tax Office to send encrypted information on your religious affiliation, you may object to this procedure by 30 June each year (www.formulare-bfinv.de, "Kirchensteuer" = church tax). A blocking notice already applied for remains in force until revoked; we will not withhold any church tax in this event. In the following year, you will be obliged to submit a tax return for assessment of church tax.

3.4 Disclosure of Asset Management fee for customers entitled to a pre-tax deduction

Starting in January 2019, we will discontinue regular reporting of Asset Management for the latter's customers entitled to pre-tax deductions, and have thus dispensed with the need to prepare such redundant records.

In future, the Asset Management fee charged, as in the case of a securities account fee possibly agreed, will exclusively be reflected in the statement of account. The latter, as a whole, contains the features necessary to be included in an invoice.

As a rule, the Asset Management fee is always charged in the middle of the month following the end of a given quarter.

Information on the Investment Tax Reform Act (Investmentsteuer-reformgesetz – InvStRefG)

On 1 January 2018, the Investment Tax Reform Act (Investmentsteuerreformgesetz – InvStRefG) came into force. The objectives of the legislative amendments to taxation of investment funds include equal treatment for tax purposes of domestic and foreign investment funds (adjustment to EU law), the avoidance of special tax constructions and simplified taxation of income derived from investment funds.

As far as the application of partial exemption rates and advance lump sum are concerned, we would like to provide you with information from the perspective of a private investor resident in Germany who is subject to liability under taxation law.

1. Fictitious sale of investment fund units as at 31 December 2017

At the investor level – in compensation for certain income being subjected to corporation tax as well as the lack of accountability of foreign withholding taxes at the investment fund level – as of 1 January 2018 parts of the distribution of the advance lump sum and profit on the sale of investment fund units will remain tax-exempt (referred to as a partial exemption).

The extent of the partial exemption of all investment income generated in 2018 is as follows for a private investor who is fully liable to taxation:

- 30% for equity funds (investment of at least 51% in capital participations, e.g. equities)
- 15% for mixed funds (investment of at least 25% in capital participations)
- 60% for real estate funds (investment of at least 51% in real estate and real estate companies)
- 80% for real estate funds (investment of at least 51% in foreign real estate and real estate companies)
- 0% for all other investment funds

Example of a partial exemption:

Distribution of an equity fund in the amount of EUR 1,000.00.

Assumptions: no exemption order, loss settlement fund "Other" is equal to zero, no non-assessment certificate exists.

Of the EUR 1,000.00 payout, 30% (EUR 300.00) is tax-exempt due to the partial exemption for equity funds. For private investors, EUR 700.00 therefore is liable to taxation and subject to German capital gains tax (KESt) plus the solidarity surcharge (SolZ) as well as church tax (KiSt), if applicable.

2. Advance lump sum

At the beginning of 2019, for the first time a so-called advanced lump sum will be charged for the preceding calendar year. It serves as a minimum tax payable (basis for tax assessment purposes) if the payouts of an investment fund were lower in the preceding year than a risk-free market interest rate achievable, published by the German Federal Ministry of Finance at 0.87% for 2018 (referred to as a basic interest rate*). This is to ensure that a minimum amount is liable to taxation on the investor side even in the case of non-distributing investment funds or investment funds with low distributions.

In economic terms, the advance lump sum reflects a kind of anticipatory taxation on future value increments. Accordingly, the advance lump sum taxable during the holding period is deducted from the sales profit actually generated on the sale of the investment units. This serves to prevent double taxation.

The extent of the advance lump sum is limited to the increase in value of the investment fund during the calendar year (taking account of disbursements, if any) and cannot be negative. In the calendar year of the fund unit acquisition, the advance lump sum decreases by 1/12 for each full month preceding the month of acquisition. No advance lump sum applies in the year of the sale of investment fund units since non-distributed income may already be included in the proceeds of the sale and, therefore, in the taxable proceeds of the sale in question.

The advance lump sum is deemed to have been paid to the investor on the first working day of the following calendar year. The tax booking entries possibly resulting from the advance lump sums payable for 2018 are expected to be finalised by the end of January 2019. These entries are made without a prior liquidity inflow (cashless capital gains). Existing exemption orders, non-assessment certificates as well as any losses possibly taken into account (settlement fund "miscellaneous") are taken into account for tax deduction purposes.

How is the advance lump sum calculated?

Advance lump sum (2019) = basic income less distributions

Basic income = redemption price of the investment fund unit at the beginning of a calendar year (2018) x risk-free basic interest rate* x 70%, but no more than the increase in value of the investment fund unit in the calendar year plus distributions within the relevant calendar year.

Example for calculating the advance lump sum payable:

Assuming the basic interest rate amounts to 0.87%; an investor acquires a share in a non-distributing bond fund (no partial exemption) on 5 January 2018. The unit price at the beginning of the calendar year 2018 amounts to EUR 100.00; the last unit price fixed in 2018 is to amount to:
a) EUR 99.00
b) EUR 100.50
c) EUR 102.00

The advance lump sum to be applied on 2 January 2019 is as follows:

a) EUR 0.00
EUR 100.00 x 0.87% x 70% = EUR 0.61 but the maximum increase in value in calendar year 2018. Owing to the loss in value, no advance lump sum is to be applied.

b) EUR 0.50
EUR 100.00 x 0.87% x 70% = EUR 0.61 but the maximum increase in value in calendar year 2018 amounts to EUR 100.50 – EUR 100.00.

c) EUR 0.61
EUR 100.00 x 0.87% x 70% = EUR 0.61, since the basic income is lower than the increase in value in calendar year 2018.

Further particulars on the advance lump sum are available at www.commerzbank.de/vorabpauschale.

3. Asset management and investment funds

Commerzbank AG Asset Management uses a stringent process to select investment funds, including exchange traded funds (ETFs). This selection process is aligned on the basis of a "best-in-class approach" to the design of a successful investment strategy and is thus closely linked to risk management.

Against this backdrop, while Asset Management will take account of the structural changes due to the investment tax reform in its selection decisions, the market and instrument-related optimisation of the investment strategy remains in the foreground as the primary objective.

*The basic interest rate is derived from the long-term government bond yield. It relies for guidance on the interest rate calculated by Deutsche Bundesbank according to the term structure of interest rates data for the first day of securities exchange trading of the year. The Federal Ministry of Finance publishes the relevant interest rate in the Federal Tax Gazette.

Commerzbank AG
Head Office:
Kaiserplatz
Frankfurt am Main
www.commerzbank.de

Postal address
60261 Frankfurt am Main

PC-PK_VV JU-2_2018