Q2 2016

Investment View

Investing amid lingering global growth worries

Content

Global View

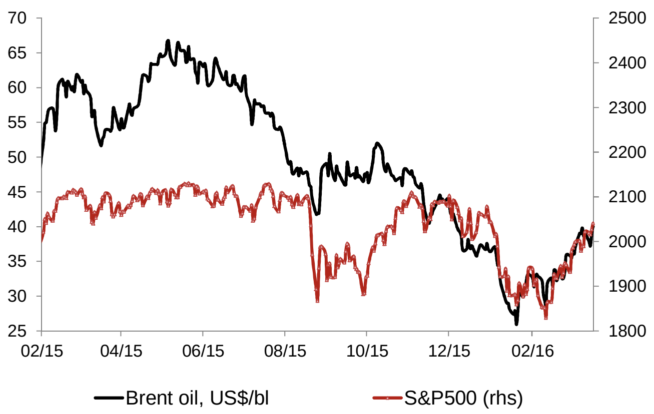
- **Global financial markets entered 2016 with the sharpest new-year losses for equities in decades, before recovering more lately. Key triggers for the high volatility were the gyrations in the oil price and concerns the global growth.**
- **While we deem fears of a global recession and broad-based deflation in the advanced economies exaggerated, current growth concerns on financial markets will not be dismissed easily amid weaker economic indicators.**
- **Following the recent recovery rally, the risk of renewed setbacks for equities remains high in this environment. By contrast, European high-quality corporate bonds are shielded by extended assets purchases by the ECB.**
- **Yields on core government bonds are poised to remain depressed over a very long period of time also due to the even more accommodative stance by the major central banks.**

Global equity markets had their worst start into a new year in decades, before recovering by March

While global financial markets reacted with striking resilience to the first rate hike by the Fed in in December, the mood changed dramatically at the outset of this year. The steep fall in the oil price and worries about the Chinese equity market and the yuan exchange rate triggered the worst start of equity markets into a new year for decades. European equities temporarily lost 17.5%. Spreads on high-yield bonds spiked on concerns that oil firms may fall victim to the slide in oil prices. Market-based inflation expectations fell sharply, depressing yields on Bunds and Treasury bonds alike. The yield on 10-year Bunds temporarily fell to 11 bps.

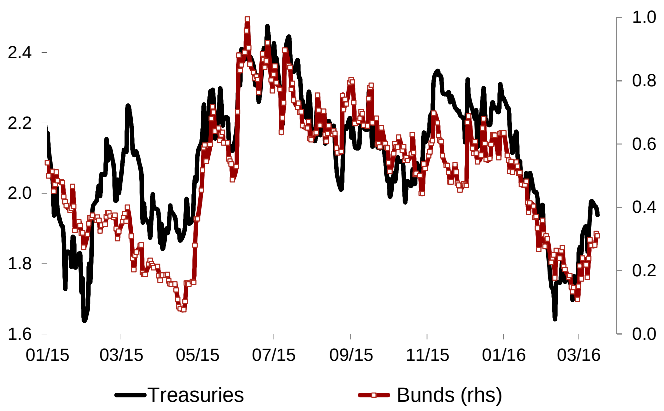
Since mid February, markets generally recovered from their earlier losses, helped by a stabilizing oil price, bold new policy measures by the ECB and a more cautious Fed. By mid March, US equities even recovered to levels prevailing at the start of the year. Yields on European core government bonds, however, barely recovered, with 10-year Bund yields hovering closely above 20 bps and maturities up to eight years showing negative yields.

OIL PRICE AND US EQUITIES



Graph 1

GOVERNMENT BONDS



Graph 2;10-year maturities, in %

Doubts about the effectiveness of monetary policy

Most of the current global growth concerns relate to outright weak data in industrial production, which is slowing in China and remains in outright contraction in Russia and Brazil. In the advanced economies, receding energy production is weighing heavily on the numbers, and there have also been signs that the slowdown may be spilling over into the more relevant service sector. The sharp rise in global risk premia triggered uncertainty and a tightening of financial conditions that may induce firms and consumers to freeze spending on investment and durable goods. In this sense, there is a risk of a negative feedback loop between deteriorating economic data and a further rise in risk aversion.

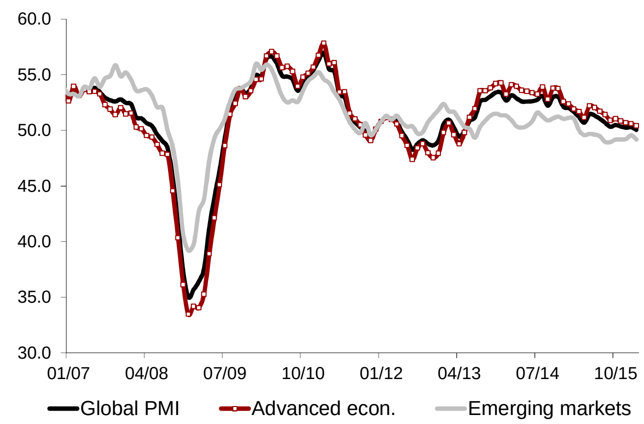
Major central banks have assumed a more accommodative stance…

Central banks around the world have assumed a more accommodative stance in this environment. The Bank of Japan cut its deposit rate into negative territory, the People's Bank of China lowered reserve requirement ratios and the Fed stayed on hold and lowered its key rate projections. Most boldly, the ECB revealed a new huge package of measures in March, including a deposit rate cut, extended purchases of assets (which now also include non-financial corporate bonds) and released new long-term liquidity with much more favorable conditions for banks.

… but market doubts about the effectiveness of monetary policy persist

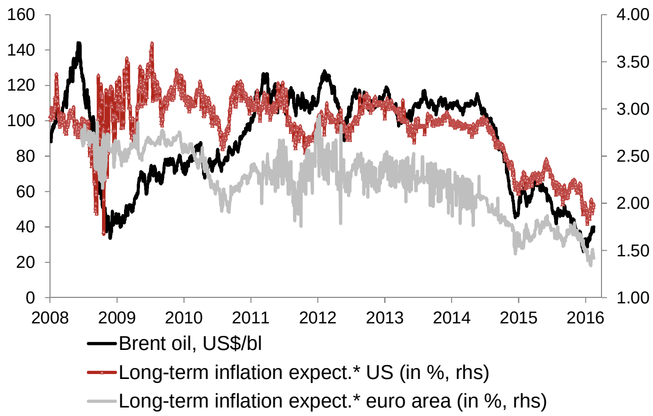
While especially the ECB helped to stabilize risk sentiment, doubts about the power of central banks persist. Despite the new accommodative measures, market-based measures of inflation expectations remain very low. There have also been mounting worries that central bank measures targeted at boosting demand and inflation may ultimately backfire. With central banks increasingly driving key rates and bond yields into negative territory, the profitability of banks is increasingly under scrutiny. This has not only severely hurt bank valuations, but may also undermine the ability of banks to extend credit to firms and households going forward.

MANUFACTURING PURCHASING MANAGER INDEX



Graph 3; index points

OIL PRICE AND INFLATION EXPECTATIONS



Graph 4; *expected average inflation 2021-2016 implied by inflation swaps

Global risks not to be dismissed swiftly

Looking ahead, the recent skepticism about the state of the world economy will not be dismissed quickly by incoming data. In the near term we anticipate some further weakening in economic momentum, largely due to ongoing headwinds to exports from sluggish world trade and the postponement of investment decisions. Growth in China is unlikely to fall off a cliff, but a continued gradual deceleration of economic growth will keep worries about a looming steeper fall in activity alive.

'Leave' vote by British voters in EU referendum a major risk to the outlook

In the euro area, the economic outlook will remain burdened by political uncertainties. British voters will decide on June 23 whether the UK will leave the EU. The immediate economic damage from a Brexit would primarily fall on the UK. It could well take two years for the UK and the EU to negotiate the terms of a Brexit. This period would be characterized by large political and legal uncertainties, drawing on investment. The British pound would weaken on draining capital inflows to the UK. But also the rest of the EU may suffer from rising political strains if a Brexit boosts nationalist and disintegrating forces in the Union amid the refugee crisis and disputes over the right approach to fiscal consolidation. This poses downside risks for the medium-term outlook also of the European economy as a whole.

Barring a 'Leave' vote of British voters, we are more confident that in the medium term data will ultimately dissolve key aspects of current market worries. First of all, while external risks have risen, we do not expect the US to fall into a recession. Also in the euro area, domestic demand - boosted by the low oil price and recovering labor market - should hold up and weather external headwinds from slowing EMs. And Chinese policy makers still have plenty of fiscal and monetary ammunition to keep the slowdown of the economy under control.

Deflation fears for advanced economies appear overstated

Price pressures in the euro area will remain very low for much longer. However, we deem worries about a looming deflationary period for advanced economies exaggerated. Price pressures in the US will continue to gradually increase, not fall. Neither do we expect a deflationary wave coming from China. Chinese policy makers will not deliberately opt for a sharp devaluation of its currency, since this would incur a huge reputational loss for the leadership and is unlikely to bring about meaningful economic benefits. More realistically, there is a risk that accelerating capital outflows out of China would test the central bank's ability to keep the yuan stable. But these can still be borne by China owing to large current account surplus and the option of tighter capital controls.

GROWTH AND INFLATION OUTLOOK

	Growth			Inflation		
	2014	2015	2016f	2014	2015	2016f
US	2.4	2.4	1.5	1.6	0.1	1.3
Euro Area	0.9	1.5	1.1	0.4	0.0	0.4
- Germany	1.6	1.4	1.2	0.8	0.1	0.7
- France	0.2	1.1	1.0	0.6	0.1	0.5
- Italy	-0.3	0.6	0.8	0.2	0.1	0.6
Japan	-0.1	0.5	0.7	2.7	0.8	0.1
Asia ex Japan	6.2	5.8	5.7	3.3	2.2	2.5
- China	7.4	6.9	6.4	2.0	1.4	1.4
Central/Eastern Europe	1.9	0.1	0.2	5.6	8.9	6.3
Latin America	1.0	-0.6	-1.1	10.4	13.6	19.1
World	2.8	2.6	2.2	2.3	1.6	2.2

f = forecast

Table 1; annual changes, in %

FINANCIAL MARKETS FORECASTS

10-Year Bonds	**Current***	**3M**	**6M**	**12M**
US	1.93	1.95	1.95	2.00
Euro area	0.29	0.30	0.40	0.50
Japan	-0.03	-0.03	0.00	0.03
Forex	**Current***	**3M**	**6M**	**12M**
USD/EUR	1.12	1.12	1.12	1.13
JPY/USD	112	114	116	118
GPB/EUR	0.78	0.81	0.79	0.79
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	2028	1980	1935	1940
MSCI EMU	105.9	102.5	100.0	101.0

* as of March 18, 3-day average

Table 2; bond yields in % p.a.

Defensive asset allocation over the coming months

Moderate underweight in equities until market fears are dismissed more visibly by economic data

Overall, financial markets are surrounded by a huge amount of risks. Unlike in earlier years after the Great Financial Crisis, the capability of central banks to act as ultimate saviors of economics (and financial markets) is no longer taken for granted. With the global economic momentum easing, we do not anticipate a sustainable rebound in risk sentiment in the near term. Instead, following the recent recovery, we deem repeated setbacks on stock markets more likely while government bonds (and to some extent also high-quality corporate bonds in the euro area) should prove more protected by the massive asset purchase program by the ECB. For the next months, we therefore favor a more defensive approach, characterized by a moderate underweight in equities and an increased exposure to high quality fixed income products.

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Macroeconomic Outlook

- **Over the first quarter of the year, concerns about global activity came to the fore amid weakening oil prices and elevated uncertainty contributed to market volatility and a worsening of financial conditions.**
- **We deem these fears overdone and interpret the lower oil price, to a large extend supply-driven. Growth in the emerging world and especially China is likely to weaken for structural reasons, but we do not expect an unorderly slowdown albeit the downside risks from Emerging Markets are significant.**
- **In the US, we see the recovery continuing at a slightly lower rate on the back of strong domestic demand amid a tightening labor market. However, given high external risks, the Fed will err on the side of caution and raise rates only very gradually.**
- **Activity in the euro area showed signs of weakening but we do not expect a fall into recession. That said, there are various uncertainties (e.g. Brexit, refugee crisis) that have the potential to dent activity further. The latest surprisingly bold ECB action will reduce the probability of downside risks but is unlikely to provide a further boost to activity.**

From an economic perspective the start into 2016 was challenging. At the outset of the year the fall in oil prices gained momentum, marking a trough at $ 26 b/Brent on January 20. As markets interpreted this movement as a harbinger of a marked global slowdown amid negative news from the banking sector, volatility rose sharply and risky assets suffered. Financial conditions deteriorated, thereby increasing concerns about the effect on real activity. Negative macro surprises not only from the emerging world, especially China, but on top of this also from the US and the euro area contributed to global concerns. On a global scale, the manufacturing purchasing manager index (PMI) receded to the threshold, dividing expansion and contraction and also the more domestically-determined services PMI weakened. In the euro area, worries were aggravated by risks related to the refugee crisis, the Brexit and various idiosyncratic factors, e.g. political stalemate in Spain.

Looking ahead, while burdening factors on global activity and downside risks clearly persist, we do not expect a sharp slowdown or even a recession. A key factor behind this view is the oil price. Its drop is primarily due to the fact that oil production since-mid-2014 has systematically exceeded oil consumption, which has continued to rise. Here, it is rather factors like the inability of the OPEC to limit production and the prospect of the Iran coming back to the world oil market that pushed oil prices down, than weaker demand in response to slowing activity. However, a supply-induced oil price fall is conducive to global growth and especially benefits oil importing economies.

China to slow in a controlled way

Regarding China, we do not expect that growth concerns will be dissolved quickly. Overcapacities that are centered in the property markets, mining and real-estate-related sectors will continue to weigh on growth. Press reports state that this issue will be tackled more seriously now. Therefore, about two million workers will likely lose their jobs while the closure of firms will cause non-performing loans to rise. These measures will weigh on China's growth (by about 1/4 pp this year), but not push the economy in downward-spiral. In the years to come this process will have to continue. That said, we think that China will continue to buffer this inevitable adjustment. Monetary and fiscal policy are already supportive and we expect that the degree of accommodation will be increased further. Likewise, targeted single measures like the cut of down payments for home buyers in some cities are already in place or will be implemented. Hence, while we deem a reduction of growth to 6.4% (from 6.9% in 2015) likely, we do not expect China to fall off a cliff either. While the situation in the emerging world will clearly remain challenging (e.g. Brazil), there are also some signs of stabilization ahead. For instance, we expect Russia to emerge from a prolonged recession in mid-2016.

Solid US growth

Domestic activity in the US to sustain growth

In the US, key indicators like the services PMI showed deterioration in sentiment, as slower global growth, higher uncertainty and a worsening of financial conditions took their toll. Net exports have taken out half a percentage point from growth in the second half of 2015 and will continue to provide a negative net contribution this year, however to a decreasingly degree as the lagged effect from the dollar depreciation gradually fades. Moreover, the oil price fall is a two-edged sword in the US, which, over the past years, also became a net exporter of (shale) oil. Lower oil prices also dragged on oil-related investment activity. That said, lower oil prices also lifted profits in non-oil companies and boosted consumption so that on balance the US economy will experience oil-price induced tailwinds this year. This takes place against the backdrop of ongoing labor market improvements. Employment growth averaged 207k in the first two months of the year, while the unemployment rate receded to 4.9%, which is around the equilibrium level and is heading to 4.6% by the end of the year. Therefore, we think that sound domestic activity will continue to drive the US economy over the course of the year. That said, the risks are on the downside and are primarily related to global activity.

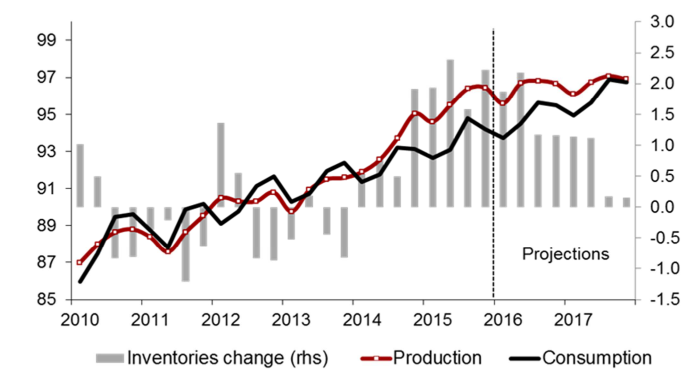
Fed to err on the side of caution due to elevated risks

In an environment of a tightening labor market, wage growth is on the rise. Stronger wages as well as the fast growth in rents have already pushed core inflation above the 2% threshold. The readings on the headline index are still heavily influenced by volatile energy prices, but with slowly increasing oil prices, we see headline inflation rate inching up towards 2% yoy by the end of the year; up from 1.0% yoy as of February. Given the dominating downside risks to activity, the US central bank rather errs on the side of caution and lowered the path of expected future rate hikes at its March meeting. The Fed now pencils in only two 25 bps rate hikes for this year, compared with four envisaged in December. We even deem it likely that the Fed goes only for one further hike this year. As a matter of fact, the worsening of financial conditions induced by the latest financial woes is equivalent to monetary tightening.

Euro area recovery to continue at a slower speed

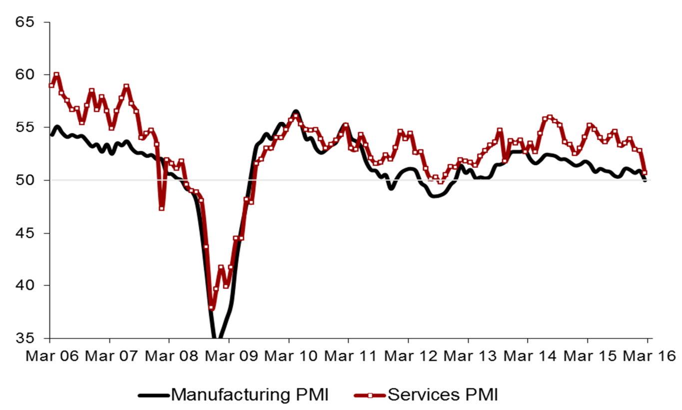
In the euro area, the first two months of the year also showed a weakening of key sentiment indicators. While these indicators still remained consistent with ongoing growth, the deterioration of forward-looking components hints at slower activity in the quarters to come. Like the US, activity in the euro area is hampered by a weak global environment. But on top of this come additional European specific factors contributing to uncertainty. The refugee crisis sparks concerns about the future of European inte-

LIQUID FUELS: PRODUCTION, CONSUMPTION AND INVENTORIES



Graph1; mn barrels per day, source: EIA

GLOBAL ACTIVITY INDICATORS



Graph 2; index points of respective purchasing manager index

Weaker global growth and Europe-specific risks major burden for activity

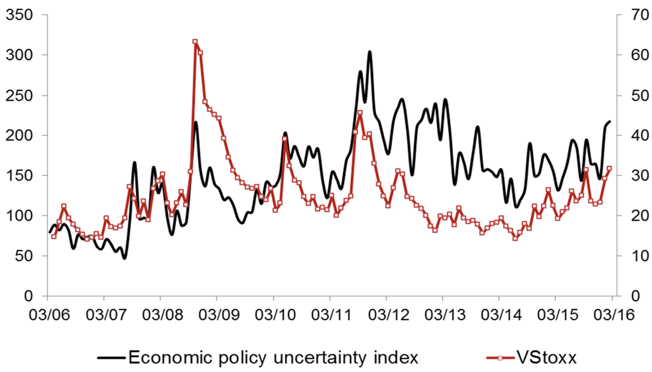
gration. If, for instance, the Schengen Agreement would be abolished permanently, the resulting rise in transport costs could, according to the French government, induce a long term loss of 0.8 pp of gross domestic product. Moreover, it now became clear that there will be a Brexit referendum on June 23. Polls show a neck-to-neck race between the 'yes' and the 'no' camp. In case that the British vote for leaving the European Union, simulations show that the UK would primarily suffer economically. In 2016, British growth would likely be dampened by about one percentage point. Activity in the euro area would suffer less, but as a Brexit would be a precedent, it would very likely foster discussions about further exits from the European Union and strengthen separatist forces, thereby hampering activity additionally. Last but not least, there are various country-specific risks, for instance the inability of parties to form a new government in Spain that will, according to latest polls, also prevail in case of new elections.

The evolution of uncertainty, as well as of the global environment, is key for the euro area growth path. The fundamentals are still favorable, employment continues to expand, the unemployment rate recedes, and wage growth is stable, while capacity utilization is even slightly above normal. This year's drop in oil prices will be an extra tailwind for activity and is likely to lift growth by about 0.2 percentage points. Moreover, fiscal policy will be slightly supportive with the risk of becoming even expansionary, due to refugee-related expenses and fiscal slippage in some member countries. All in all, we see good reasons that the recovery continues, but given elevated uncertainty we have adjusted our 2016 growth forecast to 1.1%.

Bold action by ECB in March not to be followed by further action soon

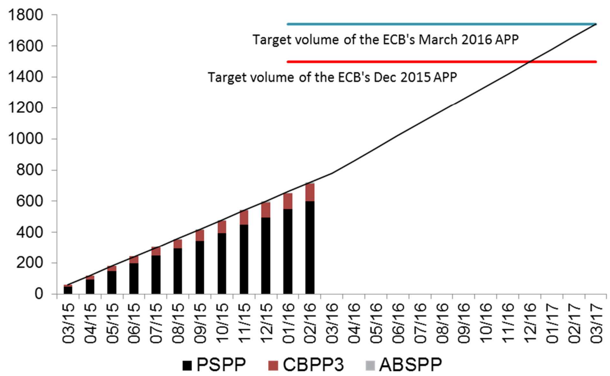
Due to falling oil prices euro area headline inflation digged back into negative territory in February (-0.2% yoy) and is likely to average only 0.4% in 2016. Hence, 2016 will be the fourth consecutive year with inflation close to zero. This, as well as global downside risks and worsened financial conditions, induced the ECB to embark on bold measures in March. Most importantly, the deposit rate was cut to -0.4% (from -0.3%), the volume of monthly asset purchases now also includes non-financial corporate bonds and was raised to € 80 bn (from € 60 bn), and banks are offered new and very attractive targeted longer term repo operations at zero or even negative costs, depending on loan creation. These measures will buffer some of the worsening of financial conditions and therefore shield the recovery. Unless some downside risks will jeopardize the recovery, further measures are not at the horizon in our view.

EURO AREA UNCERTAINTY INDICATORS



Graph3; index points

ECB'S QE PROGRAM



Graph4; bn. EUR

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Fixed Income

- **A string of negative news contributed to a risk-off sentiment at the start of the year. In the wake of this, core government bond yields on both sides of the Atlantic fell in the course of Q1.**
- **Going forward, US yields are unlikely to increase given our more cautious outlook for US growth and future Fed hikes. Euro area yields, however, are expected to rise moderately as current inflation expectations appear not sustainable.**
- **Peripheral bond spreads widened temporarily in the first half of February due to concerns about a new debt crisis but recovered all losses later. Increased ECB buying and the relative attractiveness of Southern European bonds is expected to contribute to a solid performance in 2016.**

Risk-off sentiment supports core government bonds in Q1 2016

Until the end of February the only direction for core bond yields on both sides of the Atlantic was downwards. Driven by weak macroeconomic data, falling commodity prices and even concerns with respect to the banking sector, a strong risk-off sentiment controlled financial markets. Consequently, long- and short-dated core yields fell significantly. Both, real yields and inflation expectations contributed to the drop. In the US, 2-year and 10-year Treasury yields fell to 0.65% and 1.65%, respectively. In the euro area, 2-year Bund yields marked a new historical low at -0.58% and 10-year yields fell to 0.11% − only marginally above the historical trough marked last spring. Since then, particularly US yields have recovered triggered by higher inflation expectations. Overall, US Treasuries have yielded a positive total return of 1.7% year-to-date and euro area core bonds even 2.7%.

Only modest increase in core yields going forward

Compared to the end of last year, we have adjusted our growth and inflation forecasts for the US and the euro area downwards. What is more, we expect only one rate hike by the Fed until the end of 2016 (down from four hikes at the end of the 2015). In this environment, long-dated US yields are unlikely to move significantly upwards in the months to come.

Current low level of euro area inflation expectations not sustainable

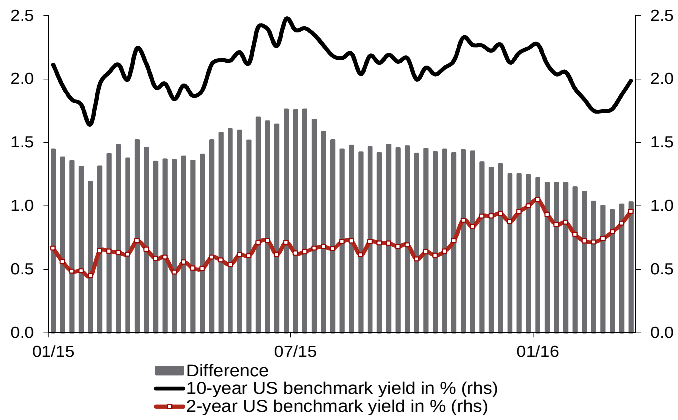
The situation is similar but not completely alike in the euro area. While inflation expectations rebounded in the US in line with increasing commodity prices, they remained at very low levels in the euro area. 10-year euro area inflation swaps not only marked a new historical low at 0.98% at the end of February, but they have only recovered slightly since then. Despite a strong upward movement of the oil price, stabilizing macroeconomic data and rising equities, the 10-year euro area inflation swap is still only at 1.11%. We regard the lingering economic concerns as the main reason for the lack of a recovery. Several economic surprise indicators are still at very low levels and show that market participants see the euro area more affected by the global growth weakness than the US.

However, although we are more cautious with respect to the euro area growth outlook we do not forecast a recession. Hence, economic surprises are expected to normalize again in the months to come which will contribute to a moderate upward movement of euro area core yields from very depressed levels in the months to come.

What is more, the new bold measures announced by the ECB at the beginning of March sent a strong signal to financial markets that the central bank is willing and able to act. While many technical details are not clear yet, Draghi stressed that the ECB is not satisfied with the current level of inflation expectations. As we expect the euro area headline inflation to move upwards in the months to come, current deflation concerns are forecast to diminish. In this environment inflation expectations are seen to rise as well. Although the scarcity of Bunds is not sustainably solved yet and further extraordinary measures by the ECB in the near future cannot be excluded, we expect long-dated Bund yields to increase going forward. Given prevailing uncertainties, however, the extent is likely to be limited. We forecast 10-year Bund yields to climb to 0.3% on a 3-month horizon and to 0.5% on a one-year horizon.

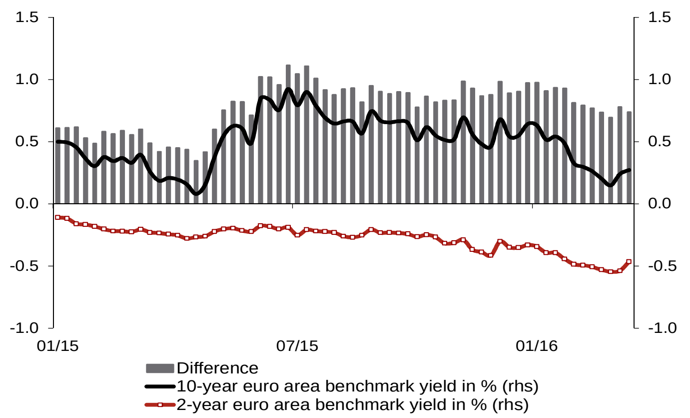
This implies that the 10-year transatlantic yield spread will not widen further in the months to come. In fact, our forecasts imply that the gap will even come down to 150 bps on a one-year horizon. At the short end of the curve, however, there is some leeway for a wider transatlantic spread. While the short end of the euro area curve is seen to remain anchored by the ECB's forward guidance, short-dated US yields can trend upwards over time. Hence, the 2-year gap is expected to widen from 130 bps currently to around 150 bps on a twelve month horizon.

US: SHORT- AND LONG-DATED GOVERNMENT BOND YIELDS



Graph1

EURO AREA: SHORT- AND LONG-DATED GOVERNMENT BOND YIELDS



Graph 2

Peripheral bonds to achieve positive return in the months to come

Southern European bonds could not completely escape the risk-off sentiment in the first half of February. Although they recovered lost ground, spreads are still wider than they were at the end of 2015. However, (with the exception of Portugal) they achieved a positive total return, across all countries the average return year-to-date is 1.3%.

Despite looming risks, the relative attractiveness of Southern European bonds in combination with the ECB support is expected to trigger moderate spread tightening

The weaker growth outlook, political concerns in Portugal (minority government) and in Spain (difficult government formation and new elections looming), the possibility of a Brexit and the emergence of euro-skeptical parties indicate that forecasting the future spread development has become more risky in recent months. However, we expect that these factors are at least balanced by other factors. To start with, the ECB has increased the monthly purchases by €20 bn. This will include purchases of government bonds. This is not only a signal for market participants but also a strong additional technical support. Moreover, the central bank is pretty aware of the problems of the banking sector and some new measures are aimed at this sector. From a relative point of view, peripheral bonds have become more attractive as 10-year peripheral bonds yield more than three times as much as core bonds (up from less than two in H1 2015). In addition, issuance activity is already well advanced. For example, due to the lack of redemptions Italy has almost achieved its complete 2016 target.

Consequently, although the forecast spread tightening will not completely make up for the expected increase in Bund yields peripheral bonds are seen to outperform core ones. All in all, a low positive total return on a twelve-month-horizon appears feasible.

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Corporate Bonds

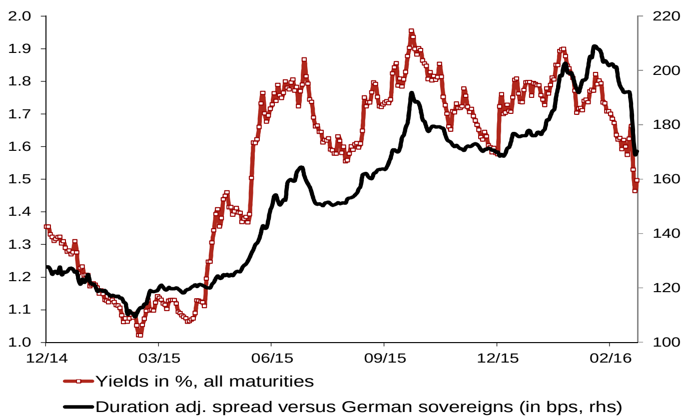
– **Driven by economic and political concerns, corporate bond spreads initially widened sharply in the first quarter. However, due to an improving sentiment they have recovered the lost ground since mid February.**
– **The still sound fundamentals, in combination with the announced buying of non-bank investment grade (IG) bonds by the ECB, are expected to trigger a further spread tightening of non-financial bonds in the months to come.**
– **Financial corporate bonds underperformed due to the worries over the impact of negative rates on banks' profitability. The new TLTRO announced by the ECB will buy time to fix capital shortfalls, thus easing systemic risk concerns.**

Despite a volatile start into the year, on balance strong performance of euro area IG corporate bonds in Q1

Corporate bond spreads were on a roller coaster ride in the first quarter. Due to concerns regarding the growth outlook for China and the situation of the manufacturing sector in developed markets in combination with worries about the situation in the euro area, spreads widened sharply between the start of the year and mid of February. Duration adjusted spreads rose from 177 bps to 209 bps. Since then, however, spreads have re-tightened as macroeconomic data stabilized and the sentiment improved. On balance, spreads have even narrowed slightly since the start of the year. Supported by decreasing underlying yields, corporate yields fell on balance by around 30 bps to just below 1.50% – the lowest level since spring 2015. Consequently, euro area IG corporate bonds performed well and achieved a total return of nearly 2.0% year-to-date. In line with recovering commodity prices, non-financials outperformed financial bonds.

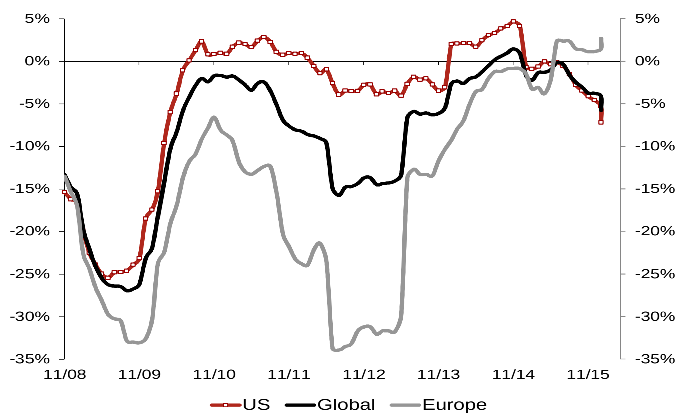
Going forward, the recent ECB decision to include IG non-bank bonds in its QE program is expected to drive corporate bond markets to a large extent. We regard this as a pretty radical step and the impact on markets can hardly be underestimated. Although a number of technical details are still unclear (including the amount of monthly purchases), the ECB as a new buyer in the market, sends a strong signal to market participants. What is more, the impact will not remain restricted to non-financials, but it is expected to spread to other market segments as well.

IBOXX EURO AREA CORPORATES



Graph1

TRAILING 12-MONTH RATING DRIFT



Graph 2; (upgrades - downgrades)/(rated issuers)

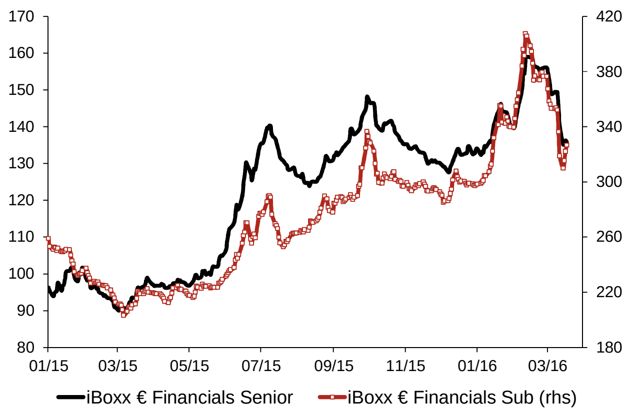
Defaults of non-financials to remain on a rather low level

Although euro area non-financial IG corporate bonds have achieved already a positive return of well above 2% since the start of the year, there is leeway for a continua-

Sound fundamental situation of non-financials and low underlying yields pave the way to a continuation of the rally

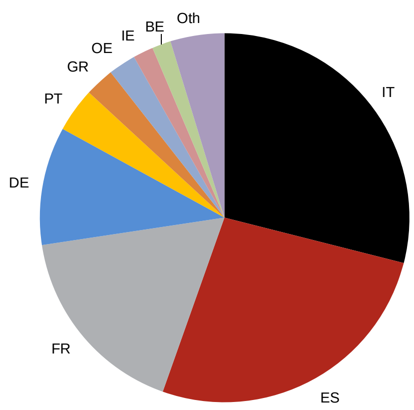
tion of the rally. On the one hand, underlying yields are forecast to remain on a low level and particularly short- and medium-dated yields are expected to rise only moderately in the months to come. On the other hand, spreads are still on a historically rather high level. This is noteworthy as the fundamental situation is still sound. The trailing 12-month default rate in Europe fell to 3.1% in February. This is below the historical average and it is expected to remain at this level in 2016. What is more, the trailing 12-month rating drift remained in positive territory for the ninth consecutive month. It rose to a long-term high of 2.7% in February. This is in sharp contrast to the US, where it fell to the lowest level since 2010.

IBOXX EURO AREA FINANCIAL CORPORATES



Graph1; Spread vs German Bund (duration adj), in bps

EXISTING TLTRO: ALLOCATION BY COUNTRY



Graph 2; Estimates based on national central banks' balance sheets

New ECB measures a mixed bag for financial bonds

Financial corporate bonds underperformed non-financial during the first quarter. Mounting concerns over the adverse impact of more and more negative rates on banks' profitability led to a significant widening in spreads. IG Senior Financial bonds spreads tightened almost back to year-start levels (136 bps, +2 bps, iBoxx index, duration-adjusted spread), while the risk premia on IG Subordinated Financials remained 28 bps above at 327 bps.

Peripheral banks are set to benefit the most from the new TLTRO II, while negative rates will continue to harm profitability at a system level

The recent measures announced by the ECB will contribute to ease systemic risk concerns. The design of the four new 4-year Targeted Longer-Term Refinancing Operations (TLTRO) is more convenient compared to the past, as banks will now be able to draw money at as low as the deposit rate (depending on their future lending performance), and with no early repayment trigger in case of failure in reaching the benchmark loan target. TLTRO II will benefit peripheral banks in particular, providing more time to the weakest ones to address capital shortfalls and change their business model. On the other hand, increasing excess liquidity in the system, "remunerated" at negative yields, will continue to exert downward pressure on banks' profits, especially in core economies. All in all, we expect IG Senior Financials spreads to remain broadly unchanged on a 1-year horizon, with the mildly positive impact of ECB measures to be compensated by the likely negative spillovers from the US credit market amid the gradual tightening in credit conditions overseas.

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Currencies

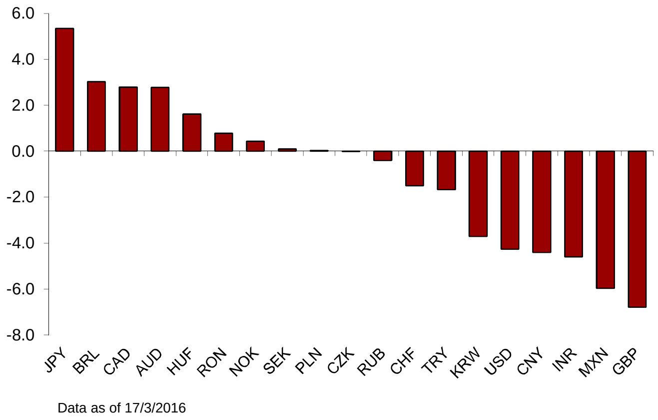
- **Amid the risk-off mode during the start of the year, the Japanese yen (JPY) soared broadly, whereas the British pound came under pressure on mounting concerns over the impending Brexit referendum announced for June 23.**
- **The euro strengthened more lately to levels close to 1.13 USD/EUR.**
- **Looking ahead, we no longer anticipate material strength of the US dollar vs. euro. The Fed is likely to proceed only very cautiously in normalizing its monetary policy while a continued risk-off environment underpins the euro.**
- **Chinese authorities will continue to intervene on FX markets to prevent a sharp sell-off in the yuan vs. the US dollar amid current capital outflows. In the medium term, however, we expect some moderate weakening in the CNY/USD.**

Sterling sold off on Brexit fears, while investors sought the yen amid strong safe haven flows

The broad risk-off sentiment on financial markets at the start of the year was strongly reflected by a sudden bout of strength in the Japanese yen (JPY). It soared 10% against the US dollar, climbing to levels close to 111 JPY/USD last seen in November 2014. Meanwhile, the British pound sold off against all major currencies on mounting market worries about the impact of a potential Brexit on the British economy and the continued capital inflows to finance the still sizeable current account deficit.

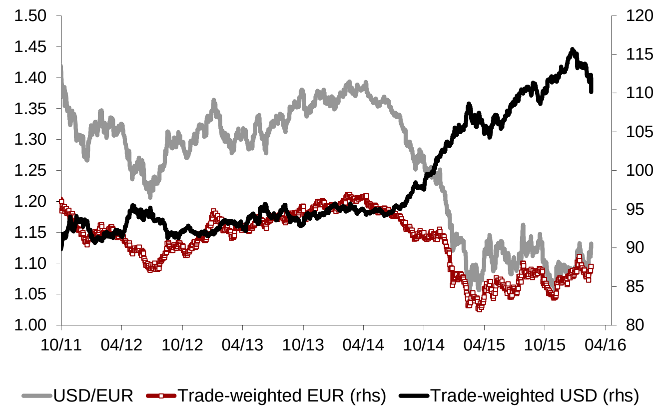
The EUR/USD has been proving remarkably resilient over past quarters on a trend basis. Following disappointment over the less aggressive than expected move by the ECB in December, the euro gained some ground against the Greenback. Compared to the steep fall in the EUR/USD until March last year, however, the EUR/USD has remained in a range between 1.05-.15 USD/EUR, even though more lately, unwinding rate hike expectations for the Fed lifted the euro to 1.13 USD/EUR. The trade-weighted US dollar retreated from its peak reached in January.

FX PERFORMANCE OVER PAST THREE MONTHS



Graph 1; vs. euro, in % (as of March 17)

US DOLLAR AND EURO



Graph 2; TWI Indices: 01/2005 = 100

Turning neutral on EUR/USD outlook

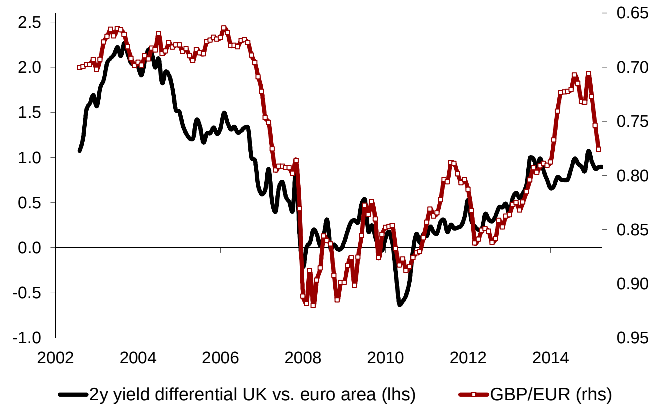
Monetary policy divergence has lost much of its power on the EUR/USD

We have been advocating a fall in the EUR/USD since early 2014 on the ground that the sharp divergence in monetary policy between the Fed and the ECB would raise the yield differential far enough to see the US dollar rallying. Over recent weeks, this underlying force has lost its power. Most importantly, mounting external risks and tighter financial conditions have dented the odds of material rate hikes by the Fed. With also the Fed striking a much more cautious tone at its March meeting, we anticipate only one further increase in the Fed Funds Rate this year. Furthermore, a less favorable global risk environment will undermine carry trades, which also leaves the impact of further monetary policy accommodation on the exchange rate eroded. On these grounds, we now anticipate a sideways trend in the EUR/USD over the coming months.

Sterling may sell off strongly on a 'Leave' vote in the Brexit referendum on June 23

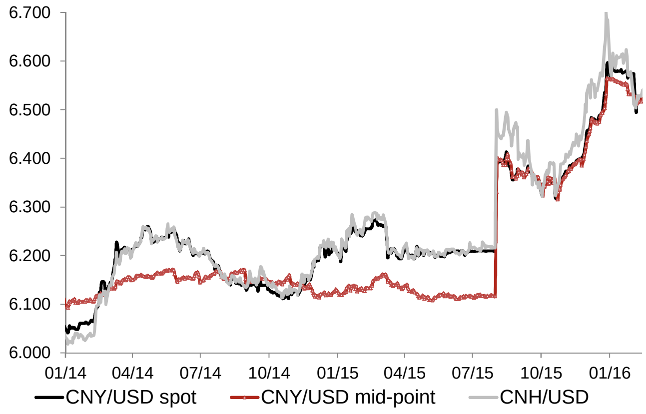
The fate of the strongly pressured British pound will be closely tied to the prospective outcome of the Brexit referendum on June 23. A 'Leave' vote would likely trigger a sharp sell-off in sterling to levels around 0.90 GBP/USD on a rising risk premium and - most importantly - subsiding capital inflows that are required to finance the UK's sizeable current account deficit. In case of a 'Remain' vote, we would see a reversal of recent losses in the GBP/EUR. But even in this event, we do not expect the pound to rise beyond 0.70 GBP/EUR in this instance, given the less compelling force of monetary policy divergence also for the pound.

YIELD DIFFERENTIAL AND GBP/EUR



Graph 3

CHINESE YUAN VS. US DOLLAR



Graph 4

A resilient yuan near term, moderate weakness further out

The Chinese yuan (CNY) has continued to unnerve markets. In fact, the global sell-off in January was also triggered by mounting fears of a looming sharp devaluation of the Chinese currency. As we have laid out in earlier occasions, we deem these fears overdone. On the contrary, Chinese authorities have spent US$ 580 bn in reserves over the 12 months to February just to prevent the yuan from sliding.

A sharp devaluation of the yuan would severely damage the repuation of the Chinese leadership while barely helping the economy

Instead of a deliberate devaluation, a more realistic risk is that the speed of current capital outflows out of China may accelerate, ultimately forcing China to give up on its currency intervention. However, a substantial part of the capital flight observed over recent months can be associated with Chinese corporates paying back parts of their foreign-denominated debt burden. These repayments may last for a while, but will not suffice for the Chinese central bank to run out of reserves. Meanwhile, a sharp devaluation would have the potential to hugely damage the reputation of the Chinese authorities, while the economic benefits would be very limited (or even negative if such a move triggers a moderate EM crisis). We therefore do not expect the PBoC to give up on its massive intervention. Following a period of CNY stability, we do see the fundamental case for a moderately weaker yuan in the medium term. But this weakening is likely to be rather gradual, with the Chinese central bank very eager to prevent depreciation expectations from becoming entrenched.

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Equities

- **Our view remains cautious on equities for the next 3 months.**
- **Investors need to be reassured about earnings growth perspectives while PEs are not at discount anymore. The effectiveness of monetary policies remains to be tested and no further ECB or Fed actions are expected short term.**
- **EA equities are our favored mid-term choice together with Japan, which is not a short-term choice.**
- **EM: external conditions are improving, but economic momentum and reforms are missing. We remain selective.**

We forecast a flat-to-slightly negative total return for equities on a 12-month view. We see the next months to be still at risk. After the rally, market multiples are not cheap anymore, while earnings growth is missing and monetary polices look less effective than before.

Over the next months, equities remain vulnerable as earnings growth is weak and market multiples slightly above historical average

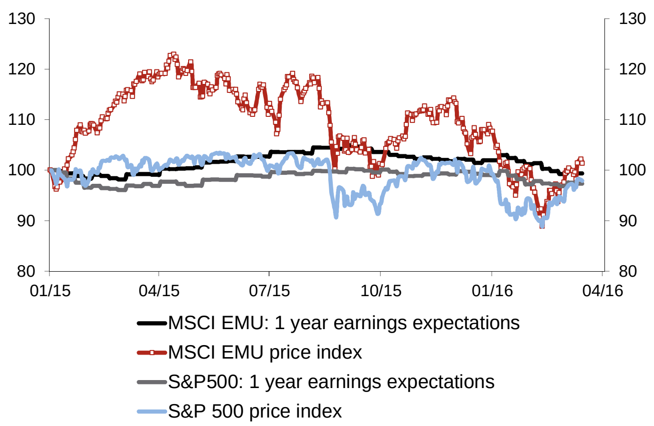
We are cautious short term and prefer defensive indices

During the last three months, equities' performance was negative in particular for Italy (-12.5%) and Japan (-12%). The lower beta markets like S&P and UK FTSE overperformed (+1.8% and +2.5%, respectively). The MSCI EMU rallied by 8% over the last month but earnings estimates, inflation expectations and the macro news flow remain overall subdued. A stronger currency is also putting pressure on EA and Japanese earnings. For the Topix in particular, IBES profit estimates for 2016 are +14% vs. ours +5.6%. Current market prices are aligned to earnings trend since 2015, after having reached a 10% discount in the quarter. As a result, equities are now more vulnerable to negative news flow. Similarly, the higher level of PE is now consistent with the macro surprise index (no more at discount). Equity risk premia in the euro area (EA) should remain high as growth expectations stay weak, politics is dysfunctional, investors' positioning high and volatility vs. bonds increased. We expect US high yields to also remain vulnerable, thus lowering the appeal of US equity free-cash flow yields.

Positioning in the euro area remains high while the effectiveness of monetary policy is still put in question

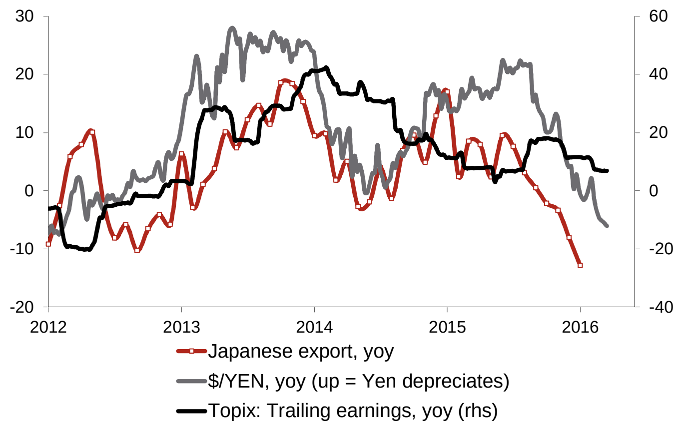
While it turned more dovish recently, the Fed's narrative is still unclear as is the Chinese authorities' credibility when managing investors' concerns on growth, currency and non-performing loans. In US, tax receipts are falling and together with higher wages growth this does not bode well for the NIPA profits evolution (GDP-based profits).

PRICE AND EARNINGS PERFORMANCE



Graph 1; (01/01/2015 = 100)

JAPANESE EXPORTS AND TRAILING EARNINGS



Graph 2

Regional equity markets: EA to overperform US only if relative growth expectations improve. Japan suffers from a stronger yen and too high 2016 IBES profit estimates.

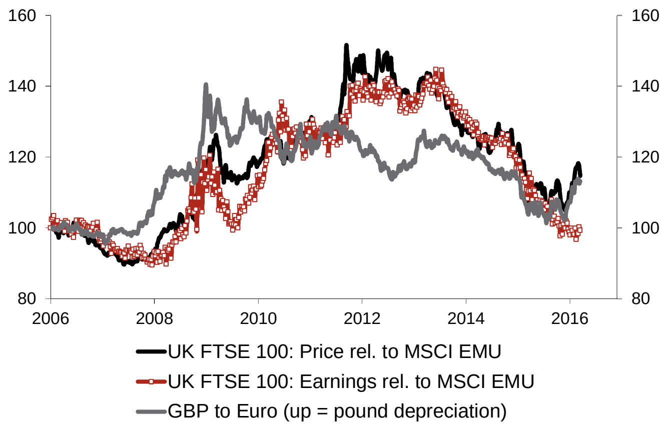
During the set-back, markets' performance was driven by the relative risk profile: The US equities moved sideways and outperformed the MSCI EMU due to its more defensive nature and a weaker dollar. By contrast, the EA and Japanese equities have been pressured by their cyclical nature. EM equities experienced a relief (+11% over the last two weeks), benefiting from a stabilization of the US dollar and the oil price (+20% for WTI). Short term we prefer defensive markets like the US, UK and the Swiss one over the euro area, EM and Japan. Swiss multiples are slightly more attractive than the MSCI EMU index. As diversified financials are undervalued, together with discretionary and industrial sectors, the SMI could offer some shield, should equity markets continue to recover. Other than its defensive nature vs. EA (more staples and less industrials), the UK market could eventually anticipate a better earnings trend, should the pound continue to depreciate. In this case we could expect the UK market to overperform in local currency also because investors' positioning remains very low.

Mid-term, euro area and Japan to outperform

There are already mid-term positives at work, but additional relevant conditions are further required for markets to move structurally higher. The USD and oil price should continue to stabilize, investors' preference for cash is the highest since 2001 and equity allocation remains very low. Oil demand-supply imbalances should decline in the next quarters. The latter is increasingly positive for EM, inflation expectations and, in part, for credit. Further temporary relief could also come from the ECB and the Fed more dovish stance.

But investors need to be reassured about the Fed's policy, the US avoiding a pronounced economic weakness and China continuing to reform (as other EMs), while managing yuan expectations and banks' NPL's (credit here is dangerously increasing again). EA needs to restore confidence over the continuation of structural reforms and the effectiveness of its politics (monetary, fiscal and related to banks' NPL's as well capital rules). Moreover, more clarity is needed on the outcome of the Brexit referendum which could induce other countries to mirror the UK experience.

UK FTSE 100: EARNINGS VS. MSCI EMU



Graph 3; total returns and earnings in local currency

EQUITY MARKETS VALUATION DASHBOARD

Markets / Indices	Market multiples avg. discount	PEG adj. by ROE and cost of equity	PEG (2016 earnings)	DY - 10Y	M1 trend (yoy)	Price Gap vs. M1 trend
USA	6.1	2.0	1.5	0.4%	↓	→
JAPAN	-23.4	1.9	1.3	2.4%	↘	↑
UK	1.5	2.8	2.1	3.0%	↗	↑
SWITZERLAND	-0.3	2.4	2.1	3.9%	↘	↘
EMU	3.4	2.1	1.3	3.0%	↘	↑
EM ($)	-10.7	2.1	0.9	-2.6%	↑	↑
BRAZIL	-17.6	3.5	1.1	-10.6%	↓	↓
CHINA	-15.3	1.6	0.8	0.0%	↑	↑
SHANGHAI	-16.0	2.6	2.0	-0.2%	↑	↑
INDIA	-1.6	2.0	1.0	-5.7%	↗	↑
KOREA	-13.8	1.9	0.8	0.1%	↘	↑
MEXICO	10.3	2.2	1.2	-4.0%	↓	↑
RUSSIA	-35.8	5.9	3.4	-4.5%	↗	↘
Global Average	-4.0	**-0.1**	**-1.1**	**-1.2%**		

Note: the first four markets are represented by major local indices, the rest is from MSCI.
PEG is PE divided by long-term growth. COE = risk-free + 6% x Beta. (Beta: vs. MSCI World)
Monetary gap is relative to price changes.
Discount in % to long-run norm; Multiples used: PE, PB, PCF, and DY.
Blue and negative numbers = undervaluation. Red and pos. numbers = overvaluation

Graph 4

US market multiples remain at risk due to low sales growth, increasing ULC and declining margins. On a mid-term perspective, EA and Japan are more attractive, should their GDP and employment growth remain on track. In this case their earnings growth should continue to surpass the US one (as it was the case in 2015 already). Our mod-

Mid-term, oil and USD stabilization are net positive for EMs together with subdued investors' positioning

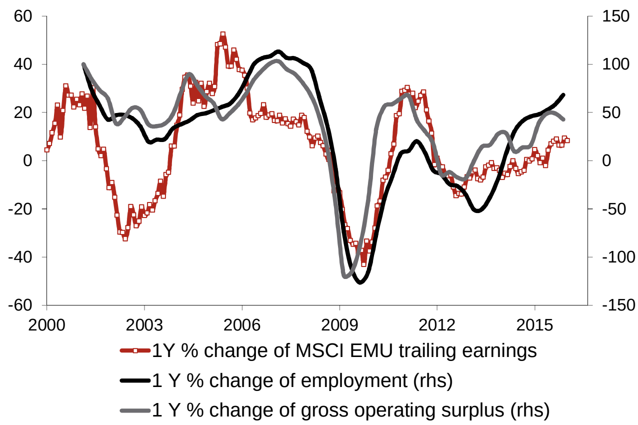
els for Japan and EA are in positive territory, even taking into account further decline of earnings forecasts, especially for Japan. Within Europe we like discretionary, telecoms and financials. We are exposed to the "value" theme (neutral on oils) because of its extended relative undervaluation and better relative earnings revisions. We are tactically slightly overweight European banks as their underperformance has anticipated a further slowdown of the economy. The positioning is one of the lowest globally and the relative undervaluation has reached a cyclical low while revisions seem to be on a cyclical trough. The limited and tactical overweight is justified by the high sector beta, the pressure on net interest income (NII) and tough regulation.

EM: better sentiment but overhaul is not yet completed

Over the last three months Emerging markets (EM) have outperformed the MSCI World by 3%, following the recovery of oil prices from January 20th. Looking ahead EMs are to benefit from further stabilization of commodity prices and the US dollar, providing some relief to hard currency corporate debt. Other positive factors for EMs are low valuations and declining outflows. In some cases (Brazil, Russia, Indonesia), monetary policies are playing also more favorably.

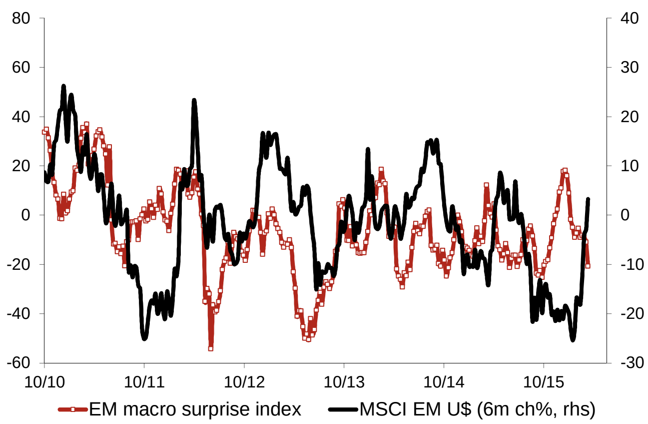
But the economic momentum remains poor and in perspectives only slowly stabilizing versus that of the developed world. Aggregate savings continue to decline and global trade volumes remain poor. Short term we remain cautious as the earnings estimates are under pressure, macro momentum being weak, debt rising and productivity-enhancing reforms lagging.

EA: LABOR MARKET AND CORPORATE PROFITS



Graph 5

EMERGING MARKETS AND MACRO SURPRISES



Graph 6

In sum, while external conditions have somewhat improved and investors' positioning remains extremely low (as for commodities), we think it is too early to buy EM agressively. China is cheap (following Vietnam and Russia) but our macro-based models have turned negative recently. While China growth is weakening, it additionally struggles to restore its credibility in trying to manage expectations on the yuan. In relative terms we favor India, Korea and the smaller CEE countries. We still do not like Brazil due to struggling politics, the lack of reform momentum, the still gloomy growth outlook and the declining earnings trend relative to other EM markets.

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Asset Allocation

- **Over the next six to twelve months, financial markets will continue to be threatened with various risks. Growth concerns will prevail in an environment where monetary policy seems to have already fired its best shots.**
- **Against this backdrop, further corrections on the equity markets are deemed likely.**
- **High quality corporate bonds will be promoted by the low-yield environment from a carry perspective but also by the ECB's purchasing program.**
- **Compared to last quarter, this argues for a more defensive allocation stance, characterized by a moderate underweight in equities in favor of high quality fixed income assets.**

Numerous risks to burden financial markets

Over the next six to twelve months, we consider financial markets to be burdened by numerous risks. Worries about the economic situation in China and concerns about a contagion to developed markets are expected to last. In Europe, political factors like the Brexit and the refugee crisis will continue to drag on markets.

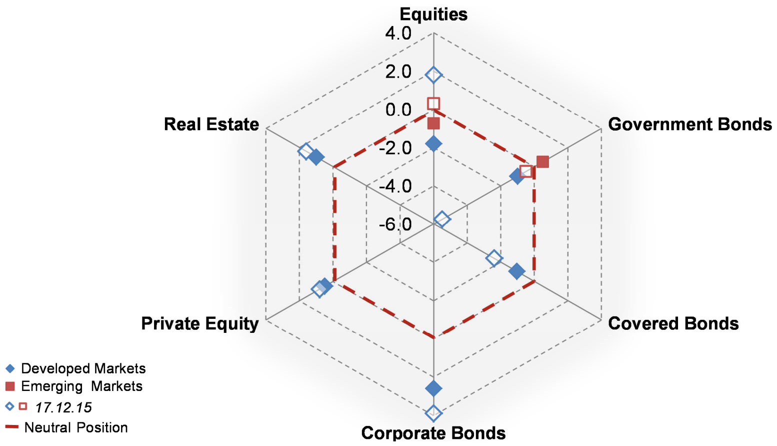
Setbacks on equity markets likely in the near term

With the global economic momentum losing steam, a sustainable rebound in risk sentiment is not our base scenario in the near term. In contrast, we expect setbacks on the equity markets to be observed repeatedly. Government bonds and – with the most recent enhancement of the ECB's purchasing program – high quality corporate bonds in the euro area should, in one way or the other, be insulated from the above mentioned threats.

More defensive allocation stance

Compared to last quarter, this argues for a less aggressive alignment of the model portfolio in general. In particular, we recommend a more defensive allocation stance in a sense that equities should be moderately underweighted in favor of high quality fixed income assets.

MODELPORTFOLIO: TAA – RADAR SCREEN



Graph1; active positions in percentage points

High quality fixed income assets to be preferred

Despite the general backing of the government bond sector by the ECB, the exposure on the fixed income side should primarily be concentrated on corporate bonds and peripherals at the expense of the core markets as the former are clearly more attractive from a carry perspective.

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Forecasts

GROWTH

	2013	2014	2015	2016f
US	1.5	2.4	2.4	1.5
Euro Area	- 0.2	0.9	1.5	1.1
- Germany	0.4	1.6	1.4	1.2
- France	0.7	0.2	1.1	1.0
- Italy	- 1.8	- 0.3	0.6	0.8
Non-EMU	1.5	2.6	2.3	2.2
- UK	1.7	2.8	2.2	2.1
- Switzerland	1.8	1.9	0.8	1.2
Japan	1.5	- 0.1	0.5	0.7
Asia ex Japan	5.9	6.2	5.8	5.7
- China	7.7	7.4	6.9	6.4
Central/Eastern Europe	1.9	1.9	0.1	0.2
Latin America	2.6	1.0	- 0.6	- 1.1
World	**2.5**	**2.8**	**2.6**	**2.2**

INFLATION

	2013	2014	2015	2016f
US	1.5	1.6	0.1	1.3
Euro Area	1.4	0.4	0.0	0.4
- Germany	1.6	0.8	0.1	0.7
- France	1.0	0.6	0.1	0.5
- Italy	1.3	0.2	0.1	0.6
Non-EMU	1.8	1.0	0.0	0.7
- UK	2.6	1.5	0.0	0.6
- Switzerland	- 0.2	- 0.0	- 1.1	- 0.7
Japan	0.4	2.7	0.8	0.1
Asia ex Japan	3.5	3.3	2.2	2.5
- China	2.7	2.0	1.4	1.4
Central/Eastern Europe	5.3	5.6	8.9	6.3
Latin America	7.5	10.4	13.6	19.1
World	**2.0**	**2.3**	**1.6**	**2.2**

FINANCIAL MARKETS

3-month Money Market	**Current**	**3M**	**6M**	**12M**
US	0.64	0.70	0.80	0.90
Euro-Area	-0.24	-0.30	-0.30	-0.30
Japan	0.00	-0.05	-0.10	-0.15
UK	0.59	0.60	0.70	0.90
Switzerland	-0.75	-0.75	-0.80	-0.80
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	1.93	1.95	1.95	2.00
Euro-Area	0.29	0.30	0.40	0.50
Japan	-0.03	-0.03	0.00	0.03
UK	1.51	1.55	1.55	1.60
Switzerland	-0.29	-0.30	-0.25	-0.20
10Y Spreads	**Current**	**3M**	**6M**	**12M**
Covered Bonds	75	75	70	70
GIIPS	115	110	105	105
EM Gvt. Bonds Spreads	**Current**	**3M**	**6M**	**12M**
Latin America	587	620	640	650
Asia ex Japan	239	255	250	238
CEE	167	168	166	164
Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
IBOXX Non-Financial	163	160	155	150
IBOXX Sen-Financial	135	135	135	140
Forex	**Current**	**3M**	**6M**	**12M**
USD/EUR	1.12	1.12	1.12	1.13
JPY/USD	112	114	116	118
JPY/EUR	126	128	130	133
USD/GBP	1.43	1.38	1.42	1.43
GBP/EUR	0.78	0.81	0.79	0.79
CHF/EUR	1.09	1.10	1.11	1.12
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2028	1980	1935	1940
MSCI EMU	105.9	102.5	100.0	101.0
TOPIX	1364	1315	1280	1305
FTSE	6172	6050	5945	5955
SMI	7911	7750	7630	7660

As of 17.03.16

FORECAST-INTERVAL* – 3-MONTHS HORIZON

Government Bonds (10Y)	US	1.69	1.95	2.21
	Germany	0.25	0.30	0.35
	UK	1.34	1.55	1.76
	Switzerland	-0.36	-0.30	-0.24
Spreads	10Y-GIIPS Spread	90	110	130
	EUR Covered Bond Spread	64	75	86
	EM Latin America Spread	534	620	706
	EM Asia Spread	215	255	295
	EM Europe Spread	139	168	197
	Euro Corporate Spread (Non-Fin)	142	160	178
	Euro Corporate Spread (Sen-Fin)	118	135	152
Forex	USD/EUR	1.08	1.12	1.16
	JPY/USD	110	114	118
	GBP/EUR	0.78	0.81	0.84
	CHF/EUR	1.07	1.10	1.13
Equities	S&P500	1,882	1,980	2,078
	MSCI EMU	95	103	110
	TOPIX	1,194	1,315	1,436
	FTSE 100	5,757	6,050	6,343
	SMI	7,306	7,750	8,194

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Government Bonds (10Y)	US	1.47	2.00	2.53
	Germany	0.41	0.50	0.59
	UK	1.29	1.60	2.11
	Switzerland	-0.08	-0.20	-0.32
Spreads	10Y-GIIPS Spread	65	105	145
	EUR Covered Bond Spread	50	70	90
	EM Latin America Spread	466	650	834
	EM Asia Spread	140	238	336
	EM Europe Spread	97	164	231
	Euro Corporate Spread (Non-Fin)	110	150	190
	Euro Corporate Spread (Sen-Fin)	102	140	178
Forex	USD/EUR	1.05	1.13	1.21
	JPY/USD	109	118	127
	GBP/EUR	0.75	0.79	0.83
	CHF/EUR	1.05	1.12	1.19
Equities	S&P500	1,742	1,940	2,138
	MSCI EMU	85	101	117
	TOPIX	1,066	1,305	1,544
	FTSE 100	5,345	5,955	6,565
	SMI	6,723	7,660	8,597

* The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the 1 month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

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