Q4 2016

Investment View

Coping with political uncertainties and divergent monetary policies

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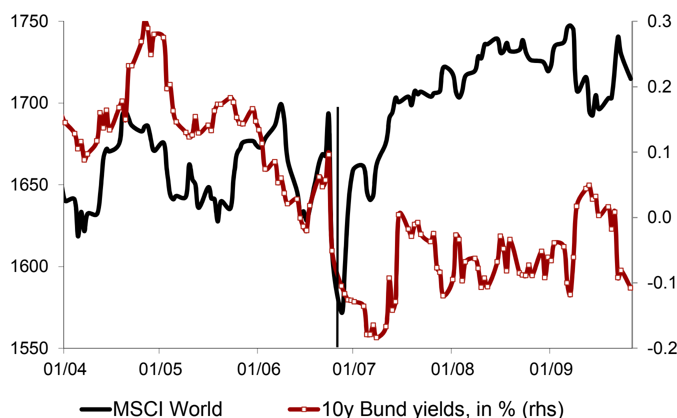
Global View

- **Global financial markets have weathered the uncertainties in the wake of the UK's Brexit vote with remarkable resilience, while the adverse economic effects in the euro area have been much smaller so far than widely feared.**
- **Looking ahead, we anticipate a moderate slowdown in the euro area economy on easing investment and softening economic expansion in China. Global growth may yet accelerate slightly going into 2017 on a pick-up in growth in the United States and ending recessions in Russia and Brazil.**
- **Global equity markets have widely recouped most of the losses after the Brexit decision, despite a less favorable growth outlook. After this strong recovery, we deem the risks of setbacks on equity markets as high. This holds in particular for US stocks, whose valuations are stretched.**
- **By contrast, we anticipate European bond markets to remain underpinned by the large ECB's asset purchases, which are likely to be prolonged beyond March 2017 amid the persistently weak inflation outlook.**

Risky assets recovered swiftly from their initial sell-off in the wake of the Brexit vote

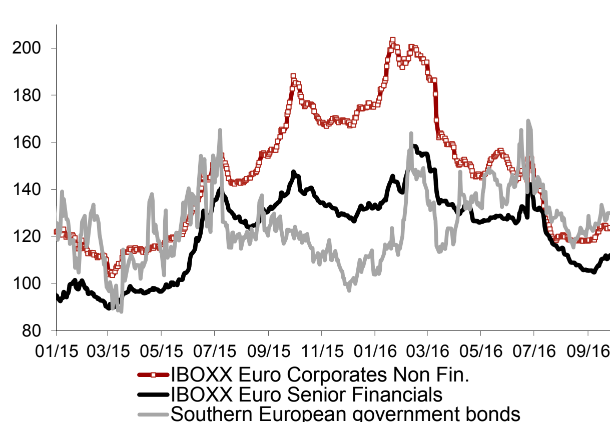
The UK's vote to leave the EU on June 23 created large uncertainties, both about the economic fallout and the repercussions on global financial markets. A key concern was that political uncertainties could trigger a spiral of financial market stress and deteriorating global growth prospects. With hindsight, markets have weathered the fallout of this unprecedented event with remarkable resilience and the fallout on economic sentiment has been much smaller so far than widely feared. Following a slump over the early days right after the Brexit decision, equities started to recover quickly in July. At the time of writing, most major equity markets stand at higher levels than before the surprising 'Leave' decision by British voters. Similarly, following a short spike at the end of June, risk premia on Southern European government bonds as well as corporate bonds have come down further. By contrast, the yields on European core bonds have barely risen from their fall into deeper negative territory right after the British decision. Also, the British pound has not recovered and is more than 12% weaker against the US dollar than before the referendum.

BREXIT AND FINANCIAL MARKETS



Graph 1

RISK PREMIA ON EURO AREA DEBT



Graph 2; duration-adjusted spreads over Bunds, in bps

Moderate Brexit fallout so far

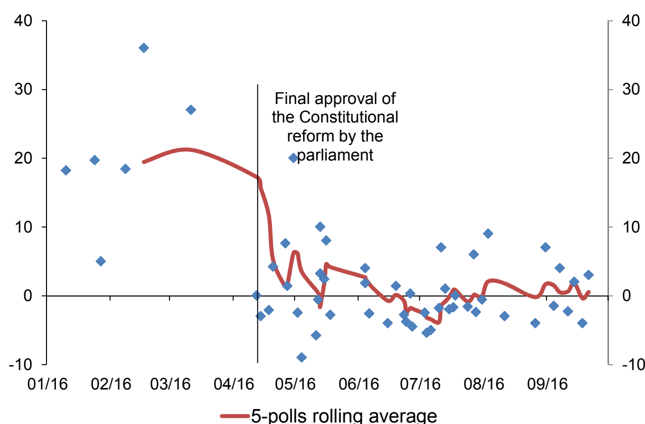
Meanwhile, the fallout on the euro area economy has been moderate so far. The outlook for the industrial sector in the euro area deteriorated, with the manufacturing PMIs weakening, albeit only moderately. That said, data for the much more dominant services sector even inched up slightly in July and August, as did reported numbers

for retail sales. This resilience has largely soothed concerns about a sharper deterioration in the economic outlook. In the UK, both the manufacturing and services PMI rebounded sharply in August from an initial slump right after the Brexit vote.

Brexit vote to cool euro area growth mainly on postponed or frozen investment decisions amid higher uncertainties

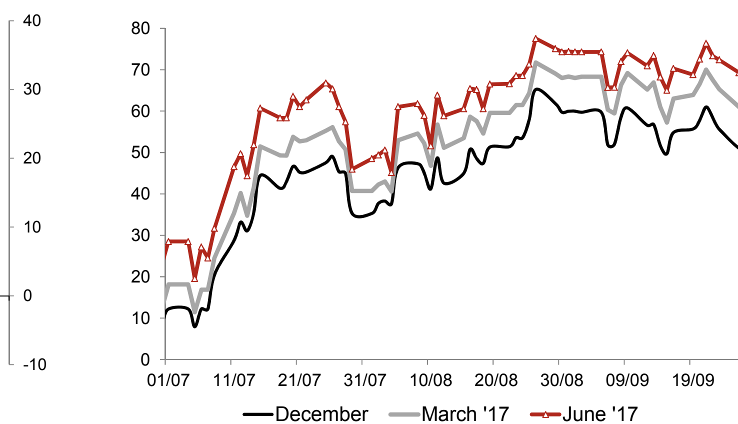
Looking ahead, we anticipate the further economic fallout of the Brexit decision to remain contained, but still show up in hard numbers. For the UK, we anticipate a growth slowdown, but a recession now seems likely to be avoided. While consumption in the euro area will extend healthily over the coming months, the larger political and economic uncertainties should weigh on investment. This will trigger a moderate slowdown in growth by year end. We also anticipate the pace of economic expansion in China to soften more visibly over the months to come. Following more robust data over the summer months, the Chinese government is likely to unwind its stimulus measures going forward, drawing annual growth rates closer towards 6%.

POLLS ON ITALIAN CONSTITUIONAL REFERENDUM



Graph 3; net lead of "Yes" over "No", in pp

PROBABILITY OF FED RATE HIKE PRICED BY MARKETS



Graph 4; % prob. that FFR is 0.5-0.75% or higher

This contrasts our outlook for the US, where a fading drag from inventories and robust consumption will take annualized growth to above 2% over the second half of the year. Among emerging markets, it is mainly the large economies of Brazil and Russia which will gear up overall growth, exiting from their deeper recessions.

Divergent monetary policies are about to become more visible

Amid this uneven macroeconomic outlook, divergent monetary policies are about to become more visible over the remainder of the year. The ECB is likely to relax the eligibility criteria of its asset purchase program, in order to overcome looming scarcity issues for some papers. Moreover, we anticipate Mr. Draghi and his colleagues to announce an extension of the asset purchase program to beyond March 2017. Also the Bank of England seems on track to extend its monetary accommodation, while the Bank of Japan has also vowed to remain accommodative for longer. In an overhaul of its monetary policy, it stepped up its inflation commitment and introduced a cap on government bond yields at its September meeting. This stands in striking contrast to the stance of the Federal Reserve. It left its key rate unchanged in September and cut its longer-term rate projections, but gave strong hints that it intends to hike the Fed Funds rate this year. We deem December the most likely date for this step, a timing only reluctantly priced by markets so far.

Risk from US elections and Italian referendum

While European economics and politics are still digesting the fallout from the UK's Brexit decision, the autumn will bring about two further political events that have the potential to affect financial markets. In the US, presidential elections on November 8

Presidential elections in the US and the Italian constitutional referendum pose key political risks in the fourth quarter

are due. A victory of the Republican candidate Donald Trump may trigger a rise in global political uncertainties, with the candidate envisaging an isolationist and protectionist stance on immigration and trade. Later on December 4, Italian voters will decide on whether to agree on the changes in the constitution, which would sharply reduce the size and powers of the Senate. If passed, the reform is not only a key step in streamlining legislation and overcoming institutional gridlock, but it would also mean an important victory for PM Matteo Renzi and his ambitions to reform Italy's economy. If the bill is rejected, however, this would prove a major political setback. While Renzi may opt to stay PM even after defeat, doubts about Italy's reform capabilities will rise, fuelling concerns about the country's already meager long-term growth prospects and the sustainability of public debt.

MACRO FORECASTS

	Growth			Inflation		
	2015	2016f	2017f	2015	2016f	2017f
US	2.6	1.5	2.1	0.1	1.2	2.2
Euro area	1.9	1.5	1.1	0.0	0.3	1.3
Germany	1.5	1.7	1.2	0.1	0.4	1.4
France	1.2	1.2	1.0	0.1	0.3	1.2
Italy	0.6	0.6	0.4	0.1	0.0	0.9
Non-EMU	2.4	2.0	1.3	0.1	0.8	2.7
UK	2.3	1.7	1.0	0.0	0.8	3.1
Japan	0.6	0.6	0.8	0.8	- 0.1	0.4
Asia ex Japan	6.1	6.0	5.8	2.4	2.8	2.9
China	6.9	6.5	6.1	1.4	2.1	2.0
CEE	0.1	1.4	2.5	9.3	5.3	4.9
Latin America	- 0.5	- 1.1	1.1	6.2	6.4	4.7
World	3.2	2.9	3.2	2.3	2.4	2.7

Table 1; annual changes, in %

FINANCIAL MARKETS FORECASTS

10-Year Bond Yields	**Current***	**3M**	**6M**	**12M**
US	1.61	1.70	1.75	1.85
Germany	-0.09	-0.15	-0.05	0.05
Italy	1.20	1.20	1.25	1.30
Japan	-0.04	-0.02	0.00	0.00
Forex	**Current***	**3M**	**6M**	**12M**
USD/EUR	1.12	1.09	1.08	1.11
JPY/USD	101	102	103	103
GBP/EUR	0.86	0.88	0.86	0.85
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	2163	2110	2100	2090
MSCI EMU	106.7	105.5	104.5	104.0

Table 2; *current as of September 26, 3-day average

European yields to stay low amid elevated risk of equity setbacks

US equities are particularly exposed to the risk of setbacks, while European yields will stay low for longer

Against this background and following the marked recovery rally seen over the summer months, we deem the risks of setbacks on equity markets as high. This holds in particular for US stocks, whose valuations are stretched. What is more, they are likely to face headwinds from a looming next rate hike by the Fed and a continued margin squeeze from rising unit labor costs in the United States.

By contrast, we anticipate European bond markets to remain underpinned by the large ECB asset purchases, which are likely to be prolonged amid the persistently weak inflation outlook. While the upcoming Italian referendum bears some risks for Italian bonds, the continued search for yield and the demand by the ECB are likely to prevent a more generalized increase in the risk premium on Southern European sovereign debt more generally. As a result, yields on European bonds are unlikely to pick up visibly any time soon.

In the current global market backdrop we overall prefer a prudent allocation stance. In particular, we favor a reduced exposure to US equities and a moderate overexposure in European government bonds and investment grade corporate bonds.

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Macroeconomic Outlook

- **Key sentiment indicators proved surprisingly resilient in the wake of the Brexit decision, both in the UK as well as in the euro area. Therefore, we have lifted our growth expectations slightly. That said, over the months to come we expect the Brexit fallout together with various political euro area uncertainties to induce a slowdown of activity.**
- **In the US, growth is expected to accelerate in the final part of the year, when the uncertainty related to the election will fade. Residual slack in the labor market will lead the Fed to a very measured monetary tightening.**
- **Regarding China, we expect structural weaknesses to come to the fore again in the second half of the year.**

UK weathered Brexit decision better than expected

In the month after the Brexit decision (June 23), UK sentiment indicators dropped strongly, reflecting the massive shock and pointing to the possiblility of the UK to slide into recession in H2. The BoE responded in early August by a large monetary package; including a cut in Bank Rate to 0.25% and an extension of the QE program by £ 60 bn to £ 435 bn among other measures. Moreover, it almost pre-announced another key rate cut later this year. However, in August survey indicators, especially PMIs, rebounded markedly, even outpacing their pre-Brexit levels. Subcomponents like new orders and new export orders also came in on the strong side, suggesting the rebound to be more than just a flash in the pan. Furthermore, retail sales not only proved astonishingly resilient but even accelerated, pushing the retail growth rate to a very high reading of about 6% yoy over the last two months. In contrast to consumption indicators, the outlook for investment is still much more blurred. Generally, we still expect the uncertainty impact of leaving the EU trade bloc to be more lasting than the private consumption impact. Nevertheless, a recession in H2 has become less likely and all in, the UK seems to have weathered the Brexit better than initiallly expected. We revised our GDP forecast for 2016 up to 1.7%, and 1.0% for 2017. In September, the BoE confirmed its intention of a rate cut, although a discusssion whether monetary policay had been too generous already started. On top, we expect the inflation risks to become more prominent again as PPI input prices soared already to 7.6% yoy amid the depreciation of the pound, suggesting some inflation pressures in the pipeline.

Moderate Brexit fallout on the euro area, but more to come

Euro area surprisingly resilient to Brexit shock so far …

Following the Brexit decision, the fallout on the euro area remained surprisingly contained. While a marked weakening of sentiment right after the referendum had been expected, the actual data flow was even more benign than expected in our so called ‘moderate scenario’. Clearly, forward-looking indicators took a hit: business expectations, for instance, lost some ground and consumer confidence also weakened. In contrast, comprehensive indicators for current activity like the composite PMI almost remained stable. With a reading of 52.9 in August the composite PMI is only 0.2 index points below the pre-referendum level. Hence, the reaction pales if compared to the one to the previous major shock, the Lehman default. The data suggest that output in the euro area will continue to grow unabatedly with a rate of 0.3% qoq in Q3.

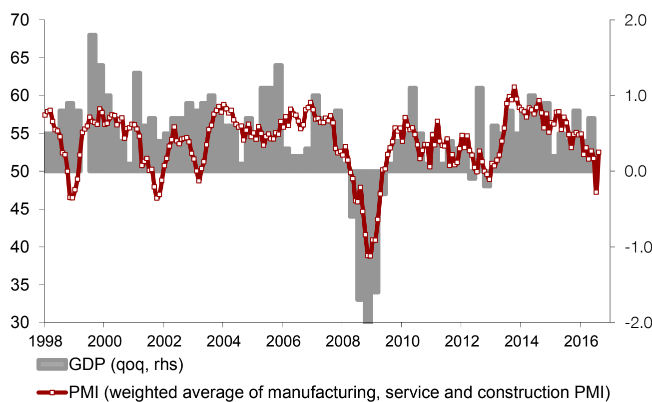
… but we still expect activity to moderate

Looking ahead, however, we think that more negative Brexit fallout will materialize. The effect of the depreciation of the British pound against the euro has not run its course yet and will impact activity with a lag of six to nine months. Moreover, we expect the Brexit negotiations to be tough and detrimental to business sentiment. On top, there are various idiosyncratic factors which will, in our view, also drag on sentiment: The Italian referendum outcome (Dec 4) is uncertain, there is a significant risk that there will be another round of elections in Spain and, on the European level, tensions on how to deal with the refugee crisis and about the future of the EU are not conducive to growth either. These factors unfold in an environment of weak global activity. However, employment expansion continues (+0.4% qoq in Q2) and will – to-

gether with the highly accommodative ECB policy stance, still low oil prices and a slightly supportive fiscal policy stance, back domestic activity. In sum, we continue to expect ongoing growth but look for a moderation of the growth rate towards year-end. Given the benign Brexit fallout, we lifted our growth expectation for 2016 to 1.5% (from 1.3%) but continue to see a deceleration in 2017 to 1.1% (from 0.9% before).

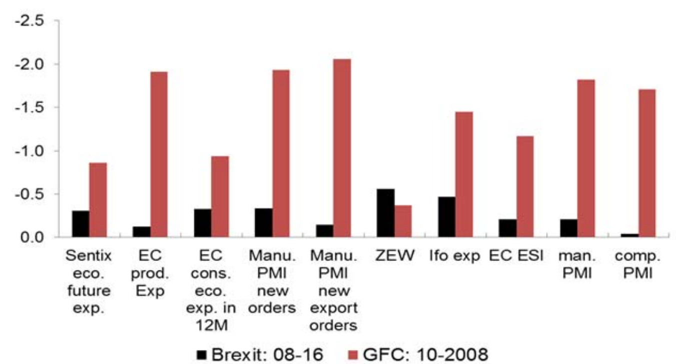
Given muted growth in the year to come and the ongoing spillover of the past oil price decline into core inflation, we expect underlying inflation to remain low and to hardly rise from the current level of 0.8% yoy. Also, inflation expectations remain stubbornly low. Therefore, we think that the ECB will have to extend its QE program beyond March 2017. In our view, this announcement will come in December, when the update of the macro projections (growth 2016/17 of 1.7%/1.6%) will likely be revised down and the extension of the forecast horizon to 2019 sees inflation still considerably below target at that time. In order to be able to do so, the ECB needs to overcome the problem that under the current design Bunds will become scarce towards year-end. Following hints from the September meeting, we expect the ECB to announce adjustments in October and deem an increase in the issuer limit for non-CAC (Collective Action Clause) bonds most likely. As we foresee the ECB to expand its asset purchases by six months to September 2017, more program adjustment will be needed. Here, purchases below the deposit rate yield floor seem to be likely to us.

UK: GDP GROWTH AND WEIGHTED PMI INDICES



Graph1; in %, index points

EURO AREA: MODERATE FALLOUT ON SENTIMENT



Graph 2; change in z-scores of forward looking indicators 08/2016, inverted scale, compared to change in the Great Financial Crisis (GFC)

US: strengthening growth, inflation picks up

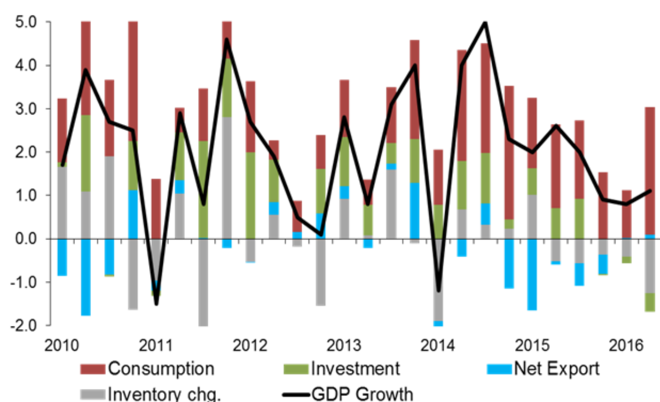
Growth to pick up in the final part of the year

In the US, the disappointing growth performance in H1 was, to a large extent, due to abnormal destocking, and therefore, we expect a rebound starting from Q3. Net trade has started to improve and this will add to solid consumption in propping up GDP. Concerning investment, the first indications for Q3 are consistent with a mild rebound after two quarters of contraction. Yet, no sizeable contribution to growth will materialize before Q4, once (and to the extent that) the large uncertainty related to the election dissipates. Fiscal policy will remain mildly supportive all along 2017, but the plans proposed by the presidential candidates to reform taxation and expand expenditure in key areas (especially infrastructures), will not be translated into policies before 2018. We expect GDP to grow by 1.5% in 2016, before accelerating to 2.1% next year. Employment has continued to grow at a sustained pace, and between June and August 232K jobs per month were created on average. The steady increase in the number of persons who restart looking for a job and the evidence from business surveys (which show that the lack of skilled labor is becoming an increasingly important issue) signals that employment is rapidly reaching its equilibrium value. This is going to put further

Fed to continue its very cautious monetary stance

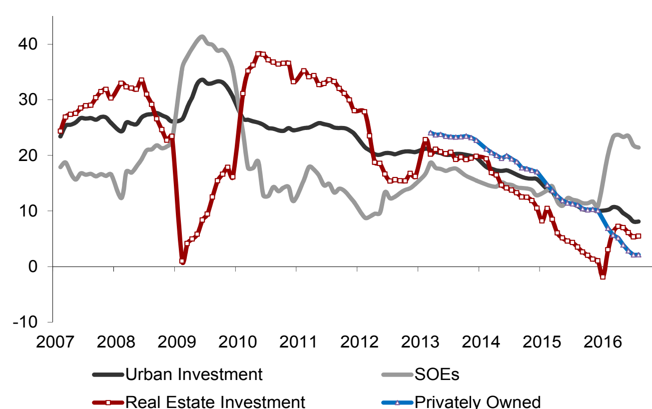
pressure on wages. The resulting acceleration in unit labor costs, which is already harming profitability, will eventually show up in core inflation. The drag of low energy prices on headline inflation will slowly fade and we expect inflation to average 1.2% this year before picking up to 2.2% in 2017. The outlook of solid, but moderate, growth, limited inflationary pressures, and a still difficult external environment characterized by loose monetary policy will limit the scope of monetary normalization. The Fed will remain extremely cautious, raising rates at most once in the final part of this year and twice in 2017.

US: CONTRIBUTIONS TO GDP GROWTH



Graph 3; qoq % chg annualized

CHINA: URBAN INVESTMENT AND COMPONENTS



Graph 4; yoy as % (ytd cumulated figures)

China's structural weaknesses to come to the fore again

China's investment growth started to plateau

Since late last year, China's government had pushed aggregate demand in order to compensate the weak external outlook, limit the impact of structural problems and to stabilize growth. This influence has become most visible in infrastructure and SoE investment (see graph 4). While the government infrastructure investment is off balance and thus no data is available, we estimate the additional investment outlays in this sector together with SoEs amounted to more than 2% of GDP during this year. In addition, the real estate market also witnessed a rebound. Due to the reduction in necessary down payments and other restriction on the local levels, property sales jumped up in early summer by rates of more than 50% yoy, also driving real estate investments up. Against this background and the stabilization of producer prices, manufacturing PMIs rose slightly above the 50 index point threshold. IP growth moved basically sideways in a small band between 6.0% yoy and 6.3% yoy. However, given this stabilization, we expect that the structural issues of overcapacities especially in mining and steel, high local government and SoE debt, and the needed structural shift from investment to more consumption to come more and more to the fore again. The latest investment figures show this component to have plateaued and the government is likely in our view to cautiously withdraw some of its support. Therefore, we see China's structural issues to gain prominence again and growth to slow in a controlled fashion over the winter half year again.

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Fixed Income

- **Government bond markets digested the Brexit vote quickly and core yields on both sides of the Atlantic trended slightly upwards in the course of Q3. Markets were influenced by central banks, but, all in, developments were rather muted.**
- **Going forward, the transatlantic yield spread is expected to widen driven by a diverging monetary policy stance. While another key rate hike is forecast to trigger moderately higher US yields, the continuation of the ECB's QE program is likely to keep euro area core yields on an extremely low level.**
- **Despite the Brexit vote, peripheral bonds performed well and, on balance, spreads tightened in the course of Q3. However, in light of the looming economic and political risks, a cautious stance appears appropriate going forward.**

International government bond markets in calm waters given the quiet market environment in Q3

The good sentiment on government bond markets prevailed at the beginning of the third quarter and in many cases, new historical yield troughs were marked. However, the on balance benign post-Brexit news flow and the lacking of a severe economic impact of the Brexit vote triggered a swing in sentiment. 10-year Bund yields moved slightly upwards from -0.13% to -0.09%. The movement in the US was a little bit more distinct. The expectation of a forthcoming key rate hike by the Fed led the complete US curve higher. While 10-year Treasury yields rose by 14 bps to 1.61%, 2-year US yields increased from 0.58% to 0.75%.

It is noteworthy that this slight upward trend was not triggered by real yields. In fact, real US yields remained around current levels and real euro area core yields even fell slightly. Therewith, the expansive monetary policy stance by most central banks continues to ensure a negative real yield in almost all major countries. All in all, yield developments in the third quarter remained rather muted and the volatility (particularly on euro area bond markets) fell further to very low levels.

Central banks to set the tone in Q4 2016

Financial markets too complacent about future Fed key rate hikes – leeway for US yields to rise

In light of the lackluster growth environment, international bond markets are likely to get their direction from central banks' behavior in Q4. To start with, in the US the way is paved for a further key rate hike in Q4, most likely in December. Although the Fed signaled once again its data dependency and a key rate hike is only priced with a probability of less than 60%, we stick to our view of a further step in December. As this is not completely priced and further hikes in 2017 are hardly priced either, corresponding signals by the Fed will impact US yields across the curve. The current complacency is not justified and financial markets are likely to adjust their expectations about the future course of the Fed. In addition, headline inflation will rise in the months to come from the current level of 1.1%. Not only due to higher energy prices but also due to upward pressure on wages, we see the average inflation rate in 2017 at 2.2%. This is forecast to leave its marks in higher inflation expectations (10-year inflation swaps currently below 1.9%) and, ultimately, in higher US yields.

Nevertheless, as US growth will remain low by historical standards (and the Fed recently lowered its long-term growth rate to 1.8%) and taking into account that US yields are already high in international comparison, a significant increase in yields is not on the cards. On a 3-month horizon, 10-year yields are likely to rise by around 10 bps and on a 12-month horizon, an additional increase of 15 bps appears likely. At the shorter end of the curve, the upward movement can be slightly more pronounced.

In the euro area, the ECB takes the opposite position. Although some market participants were disappointed recently as the central bank did not announce any change to its running QE program, we do not regard this as a signal that the ECB has already reached the end of the line. The scarcity of German Bunds is still looming and given the current yield level around half of outstanding Bunds are not eligible for the QE

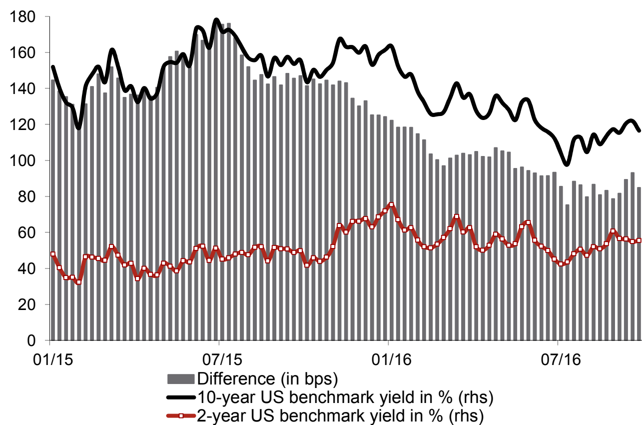
program. Without adjustment, the ECB will have reached the issuer limit by the end of the year. Hence, an easing of criteria (increase in issuer limit from 33% to 50% as the most likely step) is seen to take place already in October.

Despite expected adjustment of eligibility criteria for QE program in Q4, scarcity of Bunds unlikely to vanish for good

While this helps to continue the program as scheduled until March 2017, it is not sufficient for an extension of the program. However, given that inflation and inflation expectations are well below the ECB's medium-term target, an extension of the program beyond March 2017 is likely. Hence, the scarcity issue will not vanish and German Bunds will remain well supported by the ECB purchases. Moreover, looming event risks in Q4 in combination with a deteriorating liquidity is forecast to increase the currently very low volatility. This can induce safe haven flows and is generally considered an additional factor to keep euro area core yields on a low level.

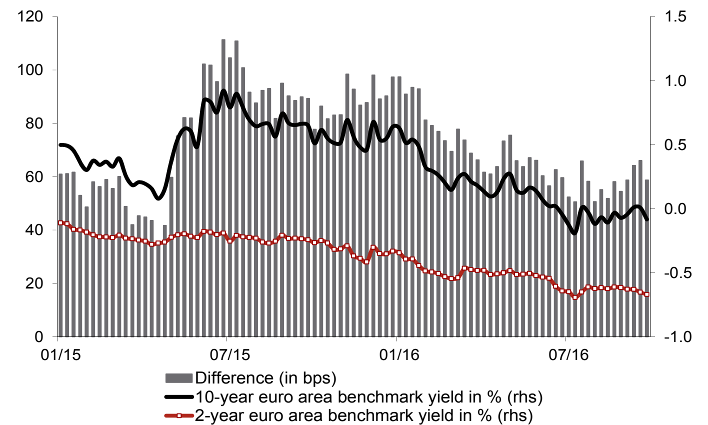
However, the continued moderate economic rebound and higher inflation rates stand in the way of significantly lower yields. In the short term, a slight decrease appears likely, but on a 12-month horizon – assuming the end of QE approaching then – even slightly higher yields are possible.

US: SHORT- AND LONG-DATED GOVERNMENT BOND YIELDS



Graph1

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



Graph 2

Event risk to burden peripheral bonds in Q4

Peripheral bonds digested the Brexit vote well and spreads tightened in Q3. However, the performance was not even. While Spanish bonds outperformed, although a government has not been formed successfully yet, Italian and in particular Portuguese bonds came under pressure towards the end of the period under review.

Spread tightening of peripheral bonds unlikely to continue in Q4 given the looming event risks

Going forward, the positive and negative factors will likely nearly cancel each other out. On the one hand, the ongoing ECB purchases and the forecast program extension as well as the attractive carry will be welcomed by markets. On the other hand, there are non-negligible event risks in the months to come. To mention a few, DBRS will announce its rating decision about Portugal in October, the US Presidential elections will take place in November, and the constitutional referendum in Italy will be held in December. All in, we expect spreads to widen moderately in this environment. The outperformance of Spain versus Italy is likely to continue at least until the referendum. The forecast decrease in core yields, however, will support investors so that they should earn around the carry in Q3.

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Corporate Bonds

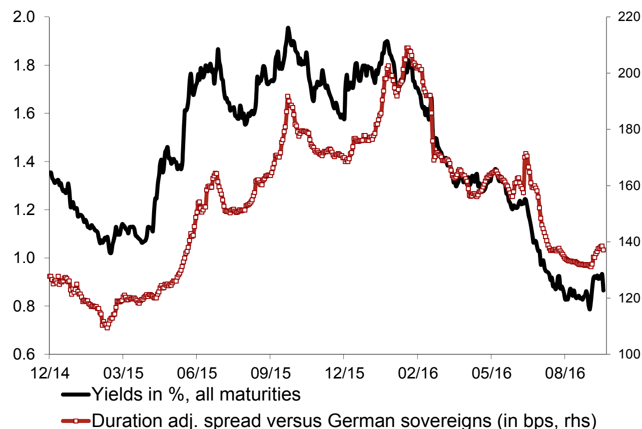
- **Corporate bonds digested the Brexit vote well. Supported by the ECB's Corporate Sector Purchase Program (CSPP), spreads continued to tighten and the corporate yield level marked a new historical low in the course of Q3.**
- **High supply and slowly deteriorating balance sheet ratios of non-financials are concealed by the CSPP for the time being. Non-financial spreads are likely to tighten on a 3-month horizon, but the trend is forecast to peter out thereafter.**
- **Also Financials proved resilient, with Subordinated bonds outperforming. Looking forward, while Senior Financials will keep proving defensive, the Subordinated segment will be exposed to high regulation-driven supply needs.**

Ongoing strong performance of IG corporates in Q3; financials outperforming non-financials for the first time since Q4 2015

Since the start of the third quarter, euro area Investment Grade (IG) corporate bonds have performed well again. The duration adjusted corporate bond spread narrowed by 27 bps to 138 bps. Therewith, corporates have weathered the surprising Brexit vote well. Supported by a positive market sentiment and the good post Brexit news flow, the corporate yield level fell on balance from 1.16% to 0.86%. Temporarily, even a new historical low at 0.79% was marked. This contributed to a total return of 2.0% in Q3. It is noteworthy that it is the first time since Q4 2015 that financial corporates yielded a higher total return than non-financial corporates (2.1% versus 1.9%).

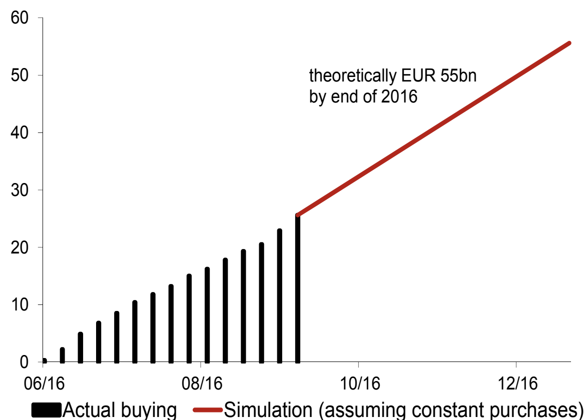
US IG corporates marched in lockstep with their European peers. Although the leverage of US corporates has reached high levels and the Fed is about to hike, the attractive carry and the forecasted moderate acceleration of growth in the coming months were sufficient to lead US spreads to the lowest level for more than one year.

IBOXX EURO AREA CORPORATES



Graph1

ECB: CSPP HOLDINGS



Graph 2; in bn EUR, weekly data

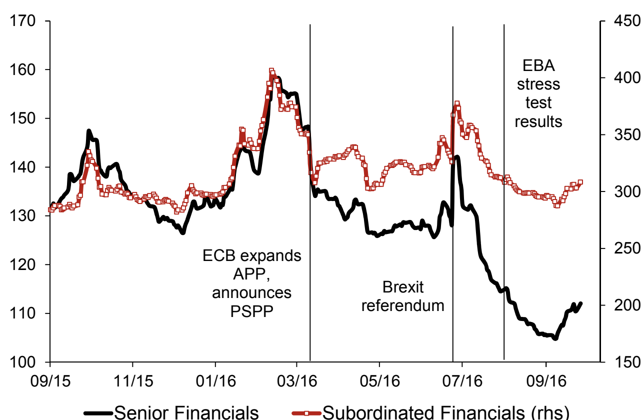
Given the strong tightening since the start of the year, the leeway for future tightening appears more limited. Moreover, the very low yield level limits future total returns for euro area IG corporates. However, on top of the CSPP, there are further factors which will support corporate bonds in the months to come. After a period of fund outflows between Q2 2015 and Q1 2016, flows have turned positive again in recent months. Demand is expected to remain strong given the uncertain market environment. Compared to other euro denominated fixed income assets, corporates still offer an attractive pick-up. While the yield level is extremely low, the spread level is still in line with the historical average. Hence, given the accommodative stance of the ECB and the growth environment, the valuation of euro area IG corporates is still broadly fair.

CSPP conceals deteriorating fundamentals of non-financials

Worsening fundamentals of non-financials balanced by ECB QE – nevertheless, bulk of spread tightening over

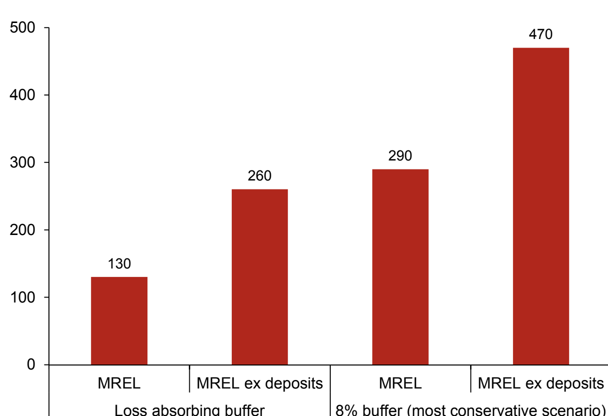
After the summer break, the ECB has sped up its purchases of corporates. According to recent data, the ECB will buy at least € 8bn/month on average. This will continue to support non-financials strongly. But, this demand meets a high supply. In September alone, gross issuance of non-financials has been more than € 30bn so far. As redemptions sum up to only € 9bn, the net issuance is already above € 20bn. Moreover, the fundamentals have deteriorated in recent years. The leverage of non-financials is on the highest level since 2010 and the interest charge coverage has fallen, too – although not to worrisome levels yet. All in, until the end of 2016, non-financial spreads have leeway to tighten, but the bulk of the tightening has already gone.

IBOXX EURO AREA IG FINANCIALS



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

EU BANKS: LOSS ABSORBING FINANCING NEEDS



Graph 2; Source: EBA, data in EUR bn

Regulation-driven supply to weigh on Subordinated Financials

Financial corporate bonds proved resilient in the third quarter, defying the concerns over a more significant impact following the Brexit vote. Both iBoxx IG Senior Financials and Subordinated duration-adjusted spreads tightened considerably, respectively by 24 bps to 112 bps and 52 bps to 308 bps. This has contributed to the positive total return performance, with the most risky segment (+3.7%) outperforming Senior Financials (+1.6%).

Poor banks' profitability and regulation-driven supply needs will weigh on Subordinated bonds in particular

The more dovish stance of central banks, the reduced appeal for negative interest rate policies, the overall reassuring results of the European Banking Authority (EBA) stress test and better macro surprises all contributed to the positive performance. However, we do not anticipate this trend to continue as several headwinds remain in place. Indeed, banks' profitability remains weak due to the low yield environment, with conduct risk losses (e.g. Deutsche Bank) posing further downward pressure. Moreover, banks will have to increase their loss absorbing buffers in order to comply with Basel III regulation. According to the EBA, EU banks would face financing needs between €130 bn and € 470 bn to meet the Minimum Requirement for own funds and Eligible Liabilities (MREL) targets. The issuance of subordinated instruments will play an important role in this process. Therefore, the spreads of Subordinated bonds are likely to come back under pressure over the medium term, while Senior Financials' ones should remain broadly flat (target: 115 bps).

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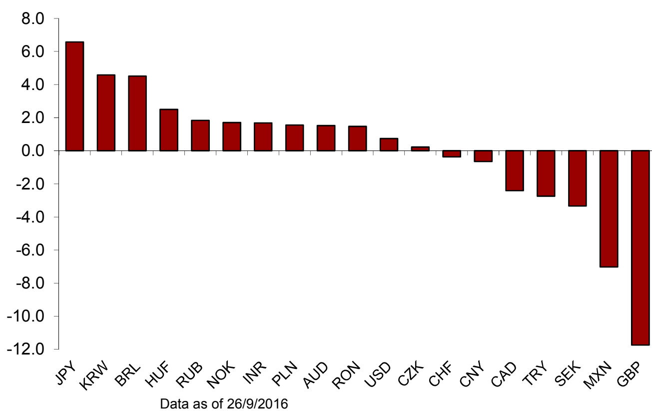
Currencies

- **Following the British ‘Leave’ vote in the EU referendum, the British pound has moderately extended its large losses incurred over the first days after the vote. The yen has soared on concerns about future bond purchases by the BoJ, while the EUR/USD has proven quite stable in a tight trading range.**
- **Looking ahead, we anticipate some US dollar strength on a correction of currently underpriced US rate hike expectations. This should also be visible in the EUR/USD, which is likely to inch lower over the coming months.**
- **We see continued depreciation pressures on the British pound, while the Swiss National Bank will continue to cap the underlying strength in the Swiss franc via intervention on forex markets.**
- **The Chinese yuan is likely to resume its trend weakening against the US dollar, while markets are right to not price any sharper devaluation of the Chinese currency.**

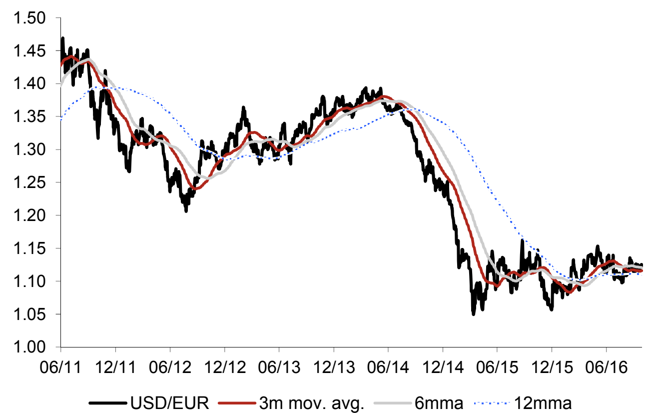
Following the slump after the Brexit vote on June 23, the British pound has moderately extended its losses against the US dollar and the euro alike. At the same time, the Japanese yen rose sharply despite global risk sentiment recovering swiftly after the initial sell-off in late June. A key reason was mounting concerns that the Bank of Japan may proceed more cautiously with its bond purchase program. Despite already very low valuations on fundamental grounds, the Mexican peso came under renewed selling pressures on concerns about the potential fallout of a victory of Donald Trump in the US presidential elections. Meanwhile, the EUR/USD was barely changed and remained in a relatively tight trading range.

FX PERFORMANCE AFTER BREXIT REFERENDUM



Graph 1; vs. euro since June 23, in %

USD/EUR SPOT AND MOVING AVERAGES



Graph 2

EUR/USD to edge down to lower end of trading range

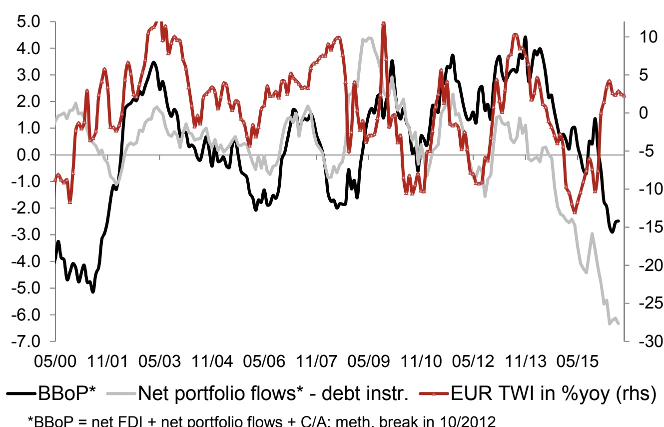
Divergent monetary policies by the Fed and the ECB to become more visible in the EUR/USD exchange rate

The EUR/USD has been trading in a tight trading range between 1.09-1.15 USD/EUR for most of this year, with the Brexit vote in the UK only temporarily weakening the euro. Looking ahead, we do not anticipate triggers that would move the EUR/USD out of this trading range over the remainder of the year. That said, the outlook for central banks and rising hedging costs are likely to drive the EUR/USD towards the lower end of the trading range over the coming months. This should be in the first place the result of the divergent monetary policies pursued by the Fed and the ECB. Discounting less than two US rate hikes by end of 2018, markets are still underestimating the willingness by the Fed to normalize rates amid a solid labor market and recovering core inflation in our view. By contrast, we anticipate the ECB to extend its QE program to beyond the currently targeted March 2017. The widening transatlantic

Depreciation pressures on the British pound to continue to prevail

yield gap will be supportive for the US dollar. At the same time, the costs of hedging US dollar exposure – which is largely determined by short-term rates – will rise further from the 1.70% currently paid for 1-year contracts. As a result, the huge net outflows in long-term debt portfolio investment from the euro area (€ 425 bn over the twelve months to July) could exert a stronger effect on the exchange rate if euro area investors prefer to leave a larger part of their foreign debt unhedged. At the same time, however, an anticipated moderate increase in the oil price will partially offset the appreciation pressures on the US dollar.

BROAD BALANCE OF PAYMENTS AND TRADE WEIGHTED EURO



Graph 3; BBoP data as 12m rolling sum, in % of GDP

CHINESE YUAN AND DEVALUATION UNCERTAINTIES

Graph 4

In the meanwhile, we anticipate depreciation pressures on the British pound (GBP) to continue to prevail, with the formal Brexit decision yet to be triggered, the Bank of England leaning towards further monetary policy accommodations and the UK's current account deficit still very wide. As far as the Swiss franc (CHF) is concerned, the Swiss National Bank will continue to intervene decisively in the FX markets to prevent a CHF strengthening amid the continued monetary policy accommodation by the ECB. Following the rally over recent months, the Japanese yen (JPY) is likely to trend slightly weaker, with the Bank of Japan still committed to further monetary policy accommodation and US yields likely to rise moderately.

Higher US rate expectations to weigh on EM currencies

A guardedly more hawkish shift in US rate expectations should limit the upside to emerging markets currencies more generally. We also anticipate downside risks to EM currencies – and the Mexican peso (MXN) in particular – from the upcoming US presidential elections. In case of a victory of Donald Trump, worries about a protectionist shift in US trade policy could weigh on sentiment towards EMs particularly exposed to trade with the US.

Gradual weakness in the CNY/USD amid greater market trust that a sharp yuan devaluation is not on the cards

We also anticipate a continued, albeit controlled depreciation of the Chinese yuan (CNY) against a broadly stronger US dollar on rising US rate expectations. A further CNY depreciation bears much less risks of sudden capital outflows out of China than earlier this year. The contained forward volatility in the CNY/USD reflects regained market trust that Chinese authorities will not aim for a sharp devaluation of the CNY (see Graph 5). This gives the People's Bank of China (PBoC) greater leeway to proceed with guiding the yuan moderately weaker towards 6.85 CNY/USD without unsettling global financial markets.

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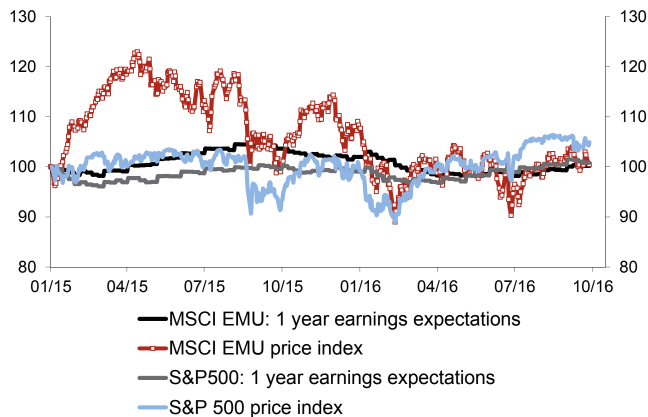
Equities

- **While recent good market momentum could last for a while, we forecast a slight negative return for the next three months and a marginally positive one in a year. We favor the euro area (EA) vs. the S&P 500.**
- **Given neutral valuations, a setback in the EA could be used to increase positions as higher capacity utilization, low input costs and supportive monetary conditions should help earnings to bottom out in yoy terms.**
- **We overweight the FTSE 100 and stay neutral on Japan and EMs. US is expensive and margins' perspectives are poor.**
- **EM: Tactically prudent. Still constructive on a mid-term view, favoring India, Korea and the smaller CEE countries.**

Macro resiliency and partial recovery from deflationary trends are translating into bottoming earnings growth

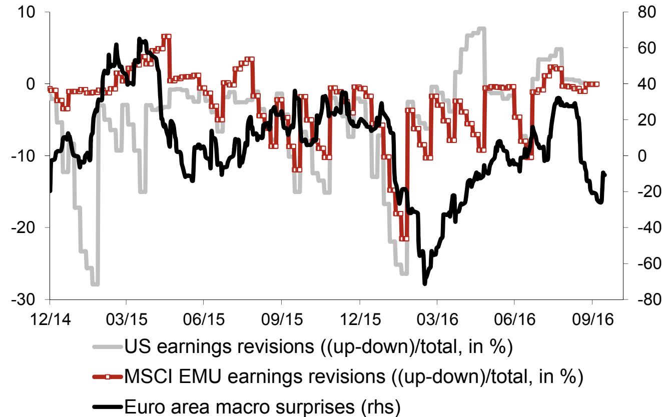
The economic resiliency after the Brexit surprised investors. Dovish monetary policies, plunging yields and spreads, stabilizing USD and commodity prices were then coupled with better global manufacturing and exporter's momentum. As a result, equities trended higher, in particular where the currency weakened: Emerging Markets (EM) and the UK. Over the last three months, the latter outperformed (+14%) the MSCI EMU (+11%), the US (+8%) and the Topix (+10%, reluctant BoJ and a strong yen). Flows favored Ems, too. While declining YTD, cumulated flows into European equities, since 2015, remain positive (negative in the US). We favor the EA over the expensive US in an equity portfolio.

PRICE AND EARNINGS PERFORMANCE



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

MSCI EMU: EARNINGS REVISIONS AND MACRO SURPRISES



Graph 2

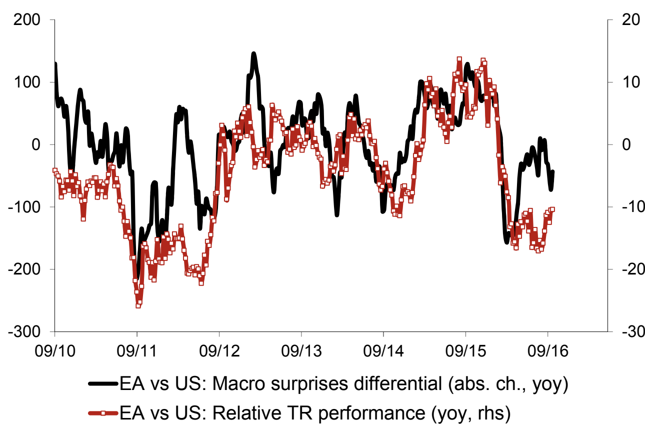
Market complacency at risk in 3-6 months

Earnings revisions have approached a cyclical high and the Q2 reporting season showed a better tone vs. Q1, even if signaling a persistent low growth for the median sector (zero for the US and -2.7% for the EA). While the good momentum could extend for a while, political risks and some softening of the macro momentum lead us to forecast mildly negative returns in 3 months. Additionally, we expect higher volatility of bond yields, which together with the next Fed's hike and stretched US valuations, could generate temporary woes. As we forecast a slightly positive total return for EA equities on a 12-month horizon, we would profit from future setbacks. Low input and financial costs, stabilizing yields and yield curve trends, a dovish ECB plus higher capacity utilization and profit growth (+6% in 2017 vs. current -5%) should produce a slight overperformance of the EA vs. the US. The Topix performance will remain a function of a depreciating yen (BoJ induced). EA models are positive (negative for the US) even with lower-than-consensus earnings projections. Additionally, the Fed's hikes usually do not penalize the EA vs. the US. On the contrary, stabilizing or even

Normalizing macro conditions, dovish monetary policy and stabilizing margins should induce an outperformance of the cheaper EA vs the US

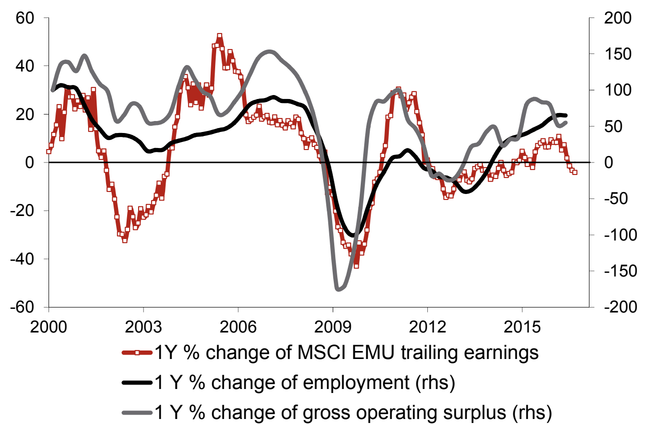
higher US 10-year rates or steeper yield curves tend to favor the EA which is more cyclical in nature. Wild cards are represented by investors' outflows from Europe, political impasse and declining 2017 profit estimates in the next months (currently at 13% yoy vs. ours of 6%). The US should show a lower earnings growth and this, coupled with a more hawkish Fed and high PEs (16.9X vs. 13.5X of EA), should result in a negative US total return in 12 months. Mid-term, higher unit labor costs (ULC) and low GDP growth should maintain US earnings' growth subdued notwithstanding the recent profit bounce of NIPA (GDP-based) as well S&P trailing profits. Exporters' sales, in particular, rebounded due to a "less negative" momentum of global trade, commodities, manufacturing sector and a stable dollar. But we think NIPA profits remain at risk and with them in perspectives also the S&P trailing earnings and capex growth. Indeed, while being below the cyclical peak of Q4 2015, ULC growth stays above their historical average due to higher growth in wages and low productivity. The mild rebound in growth from H2 2016 will only marginally offset the drag on margins coming from high ULC. While our estimate for 2016 S&P trailing earnings (118$ p.s.) is close to the consensus of 117$, we have a much lower forecast for 2017 (121$ versus the consensus of 132$), which results in a 2017 earnings growth of merely 2.5%. This picture represents a risky one for the index given the high valuations.

MACRO SURPRISES AND MARKET PERFORMANCE



Graph 3; Euro area versus US (total return)

EA: LABOR MARKET AND CORPORATE PROFITS



Graph 4

Regional markets: EA and Japan to overperform US

We favor the EA over the US in an equity portfolio. We overweight the UK (with less emphasis after the rally) and keep EM neutral. The "cyclical" EA index gets support from a resilient economy, stabilizing yields and profits, a weaker euro, low cost of debt and a dovish ECB. We are neutral on Japan due to weak profits and the strong yen. Among the positives, we cite the relatively affordable valuations, stabilizing consumptions, industrial production and fiscal policy (in H2). The timing of the BoJ action is uncertain but it will try to maintain expectations high in the next months, stabilizing the yen from here. Within European sectors, a less negative macro assessment is worth a neutral stance on Financials. Risks to banks' business model add to the highest beta vs. both the GDP and the Stoxx 600 (1.3). Banks remain also impaired due to low growth, low rates, regulation, high NPLs and new competition. But some variables are getting "less negative" and the sector is underowned together with insurances and commodity-related stocks. NIRP (negative interest rate policy) looks indeed less in fashion recently and credit spreads have tighened. Futhermore, valuations are polarized in Europe as ever. The "value" stocks could slowly gain more interest by investors given a resilient macro momentum and stabilizing yields. Financials together with Oils and Telecoms are the highest in rank among the "value" stocks and banks' price-

to-book values are low if compared to the relative ROE trend and the one of credit loans. Finally, their earnings estimates have lost 50% since mid-2011. We favor a balanced portfolio with small overweight on IT, transportation and TLC. We retain a temporary underweight on pharma and are neutral on commodities.

EM: still constructive but tactically more prudent short term

We are of the view that the impact on EM from the Fed hike expected in December is of limited extent

Over the last three months, Emerging markets have rallied, outperforming the MSCI World by 7.6 pp. The positive sentiment was driven by rising oil and commodity prices and a stabilizing US dollar. Short term, we are less bullish as the price performance reached so far has clearly decoupled from the earnings performance and market multiples are now aligned to history. That said, we remain constructive on a mid-term view. The international monetary backdrop remains supportive with DM central bankers signaling chances for further easing (ECB, BoE and BoJ) and this in turn provides EM central banks with a leeway to cut rates. While the Fed hike expected later in December could have some impact, we reckon its extent to be rather limited as the situation with credit, oil, current accounts, and growth is in much better shape now compared to 2013.

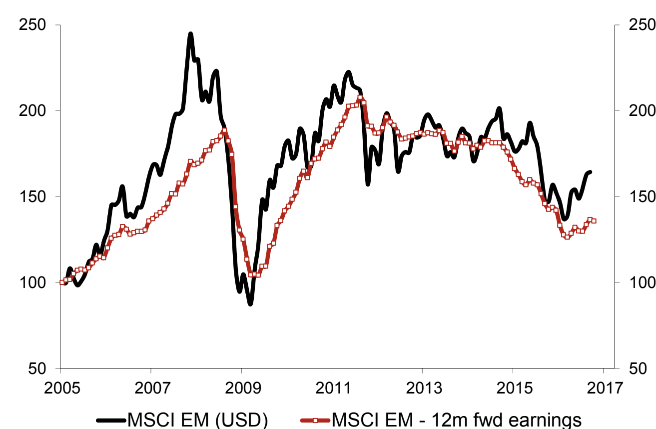
EQUITY MARKETS VALUATION DASHBOARD

Markets	PE		PB		PCF		DY		Avg.
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	Discount
USA	16.9	11.4	2.6	14.2	11.3	17.0	2.2	1.5	10.3
JAPAN	13.6	-52.8	1.1	-13.1	6.9	-0.6	2.3	23.6	-22.5
UK	15.5	12.3	1.8	-2.9	9.1	16.8	4.0	1.9	6.1
SWITZERLAND	16.4	7.4	2.2	0.1	12.8	15.8	3.7	14.3	2.2
EMU	13.5	-4.3	1.4	-8.9	7.1	13.2	3.8	-4.3	1.1
FRANCE	13.6	-4.9	1.3	-10.1	7.6	14.5	3.8	-0.4	0.0
GERMANY	12.7	-16.4	1.5	1.8	7.6	18.5	3.3	-3.6	1.9
GREECE	12.8	0.1	1.3	-16.1	6.4	9.1	3.6	-9.3	0.6
ITALY	11.4	-26.3	0.8	-33.1	4.0	-11.6	5.3	14.0	-21.2
PORTUGAL	15.1	21.8	1.7	-2.9	6.0	3.6	4.8	4.9	4.4
SPAIN	12.6	-2.9	1.1	-33.8	4.6	-9.8	4.9	-5.5	-10.3
EURO STOXX 50	13.1	-0.9	1.3	-11.4	6.7	13.5	4.2	-1.9	0.8
STOXX SMALL	15.4	10.0	1.7	3.8	6.7	-16.5	3.1	-4.5	0.4
EM, $	12.6	-13.9	1.4	-10.6	7.5	-2.9	2.7	-24.4	-0.7
BRAZIL	12.6	45.1	1.4	-18.1	7.1	-51.9	3.5	-20.4	-1.1
RUSSIA	5.7	-20.2	0.6	-37.4	3.6	-22.0	5.1	51.2	-32.7
INDIA	17.7	24.7	2.7	3.0	11.9	4.2	1.6	-2.7	8.7
CHINA	12.4	-4.6	1.4	-18.0	7.6	2.1	2.3	-27.8	1.8

Note: Discount in % to long-run norm; blue and negative numbers = undervaluation. Red and pos. numbers = overvaluation; PEs are since 1987, the rest is since 2003. In case of DY, a discount means the market had a higher DY, meaning the market is at premium for this multiple. 12m f = expected in 12 months
Source: Thomson Reuters Datastream, IBES estimates.

Table 1

EMERGING MARKETS: PROFITS AND PRICE



Graph 5

Judging by several market multiples, the Chinese market has, after the rally, become slightly more expensive versus the EM index. It has now a valuation premium of around 2% versus its own history, whereas the EMs, on the same measures, are fair. Chinese industrial profits surged further to 20% in August, but it remains to be seen if other sectors' earnings follow. While the market can get support short term from the recent better macro data, concerns over Chinese growth and credit (near 200% of GDP for the private non-financials) still remain in place for the medium term. Moreover, our macro-based models still indicate a negative potential of nearly 8% over the next three months. In relative terms we favor India and Korea, which are characterized by positive earnings revisions and a good value momentum, as well as smaller CEE countries (showing resilient/increasing earnings).

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Asset Allocation

- **The economic impact from the Brexit vote has been largely confined to the UK so far, with sentiment indicators in the rest of Europe affected only mildly.**
- **Risky assets have recovered quickly from the Brexit decision shock at the end of June, while bond yields remained at lower levels than before the vote.**
- **After the recent recovery, setbacks on stock markets become likely in the short term. European government bonds and IG non-financial corporates will remain backed by ECB purchases.**
- **This argues for maintaining a defensive allocation stance, characterized by a moderate underweight in equities mostly in favor of non-financial corporate bonds.**

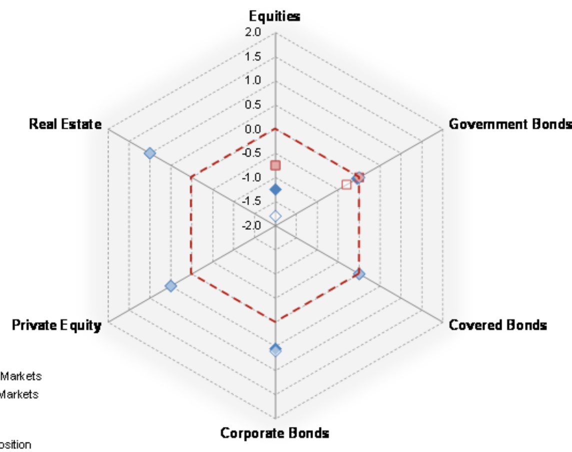
Fallout from Brexit less severe than widely feared

Overall, the economic fallout from the Brexit vote has turned out less negative than anticipated so far. Despite a recently somewhat weaker macroeconomic data flow, the impact on the global economy appears to be limited. Hence, moderate, but positive growth rates are expected. While in the euro area and in China growth is seen to decelerate moderately, an easing drag from inventories and a mild investment recovery will likely lift US growth in H2.

Financial markets to stay in risk-off mode

Looking ahead, after the recent recovery amid continued political (US presidential elections, Italian referendum, …) and economic (Brexit fallout, ...) risks as well as stretched valuations, particularly in th US, setbacks on stock markets appear likely in the short term. European government bonds and IG non-financial corporate bonds should continue to benefit from the ongoing support by the ECB.

MODELPORTFOLIO: TAA – RADAR SCREEN



Graph1; active positions in percentage points

Underweight in equities to be maintained

Thus, particularly in the short term, we recommend to underweight equities, especially US stocks. In return, a slight overall overweight in European bonds seems appropriate. Apart from non-financial coporate bonds, we do not see significant differences in the return figures to be expected for the individual fixed income market segments. On a six to twelve months view, a moderate overexposure in European credit seems advisable.

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Forecasts

GROWTH

	2014	2015	2016f	2017f
US	2.4	2.6	1.5	2.1
Euro area	1.1	1.9	1.5	1.1
Germany	1.6	1.5	1.7	1.2
France	0.7	1.2	1.2	1.0
Italy	- 0.3	0.6	0.6	0.4
Non-EMU	2.9	2.4	2.0	1.3
UK	3.1	2.3	1.7	1.0
Switzerland	2.0	0.8	1.0	1.3
Japan	- 0.1	0.6	0.6	0.8
Asia ex Japan	6.4	6.1	6.0	5.8
China	7.3	6.9	6.5	6.1
CEE	1.8	0.1	1.4	2.5
Latin America	0.6	- 0.5	- 1.1	1.1
World	**3.4**	**3.2**	**2.9**	**3.2**

INFLATION

	2014	2015	2016f	2017f
US	1.6	0.1	1.2	2.2
Euro area	0.4	0.0	0.3	1.3
Germany	0.8	0.1	0.4	1.4
France	0.6	0.1	0.3	1.2
Italy	0.2	0.1	0.0	0.9
Non-EMU	1.2	0.1	0.8	2.7
UK	1.5	0.0	0.8	3.1
Switzerland	- 0.0	- 1.1	- 0.4	0.2
Japan	2.7	0.8	- 0.1	0.4
Asia ex Japan	3.3	2.4	2.8	2.9
China	2.0	1.4	2.1	2.0
CEE	5.8	9.3	5.3	4.9
Latin America	5.1	6.2	6.4	4.7
World	**2.8**	**2.3**	**2.4**	**2.7**

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

FINANCIAL MARKETS

3-month Money Market	**Current**	**3M**	**6M**	**12M**
US	0.86	1.00	1.20	1.40
Euro-Area	-0.32	-0.35	-0.35	-0.35
Japan	-0.02	-0.05	-0.10	-0.10
UK	0.38	0.30	0.30	0.30
Switzerland	-0.75	-0.75	-0.75	-0.75
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	1.61	1.70	1.75	1.85
Euro-Area	-0.09	-0.15	-0.05	0.05
France	0.14	0.10	0.20	0.30
Italy	1.20	1.20	1.25	1.30
Japan	-0.04	-0.02	0.00	0.00
UK	0.71	0.80	0.85	0.90
Switzerland	-0.50	-0.55	-0.45	-0.35
10Y Spreads	**Current**	**3M**	**6M**	**12M**
Covered Bonds	58	55	55	55
GIIPS	129	135	130	125
EM Gvt. Bonds Spreads	**Current**	**3M**	**6M**	**12M**
Latin America	462	480	485	500
Asia ex Japan	188	210	207	204
CEE	143	139	137	133
Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
IBOXX Non-Financial	123	120	115	115
IBOXX Sen-Financial	111	115	115	120
Forex	**Current**	**3M**	**6M**	**12M**
USD/EUR	1.12	1.09	1.08	1.11
JPY/USD	101	102	103	103
JPY/EUR	113	111	111	114
USD/GBP	1.30	1.24	1.26	1.31
GBP/EUR	0.86	0.88	0.86	0.85
CHF/EUR	1.09	1.09	1.09	1.11
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2163	2110	2100	2090
MSCI EMU	106.7	105.5	104.5	104.0
TOPIX	1346	1325	1310	1325
FTSE	6880	6790	6720	6660
SMI	8249	8090	8015	8010

As of 26.09.16 (3-Day-Average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

Category	Asset	Low	Mean	High
Government Bonds (10Y)	US	1.49	1.70	1.91
	Germany	-0.16	-0.15	-0.14
	UK	0.70	0.80	0.90
	Switzerland	-0.61	-0.55	-0.49
Spreads	10Y-GIIPS Spread	113	135	157
	EUR Covered Bond Spread	47	55	63
	EM Latin America Spread	413	480	547
	EM Asia Spread	179	210	241
	EM Europe Spread	114	139	164
	Euro Corporate Spread (Non-Fin)	105	120	135
	Euro Corporate Spread (Sen-Fin)	101	115	129
Forex	USD/EUR	1.05	1.09	1.13
	JPY/USD	98	102	106
	GBP/EUR	0.85	0.88	0.91
	CHF/EUR	1.06	1.09	1.12
Equities	S&P500	2,001	2,110	2,219
	MSCI EMU	98	106	113
	TOPIX	1,212	1,325	1,438
	FTSE 100	6,456	6,790	7,124
	SMI	7,655	8,090	8,525

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Category	Asset	Low	Mean	High
Government Bonds (10Y)	US	1.41	1.85	2.29
	Germany	0.02	0.05	0.08
	UK	0.71	0.90	1.09
	Switzerland	-0.50	-0.35	-0.20
Spreads	10Y-GIIPS Spread	80	125	170
	EUR Covered Bond Spread	39	55	71
	EM Latin America Spread	354	500	646
	EM Asia Spread	127	204	281
	EM Europe Spread	76	133	190
	Euro Corporate Spread (Non-Fin)	84	115	146
	Euro Corporate Spread (Sen-Fin)	88	120	152
Forex	USD/EUR	1.04	1.11	1.18
	JPY/USD	95	103	111
	GBP/EUR	0.80	0.85	0.90
	CHF/EUR	1.04	1.11	1.18
Equities	S&P500	1,872	2,090	2,308
	MSCI EMU	88	104	120
	TOPIX	1,094	1,325	1,556
	FTSE 100	5,969	6,660	7,351
	SMI	7,048	8,010	8,972

* 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.

Imprint

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