MACRO HIGHLIGHTS

WEEK OF 24 OCTOBER 2016

OUR HIGHLIGHTS:

- **Economists' insight: China – Short-term gain, long-term pain**
  - With GDP growth stabilising at 6.7%, the government is likely to engage in less budgetary stimulus, which will in turn limit the 2017 growth outlook.
  - A high level of debt, a declining return on productive investments and limited progress in structural reforms are all problems that the government cannot ignore.

- **Focus on the ECB: Quantitative easing will not end in 2017**
  - Mario Draghi did not deny that the ECB's asset purchase programme would eventually come to an end…
  - … but the programme should carry on beyond March 2017…
  - …which will help contain upward pressure on sovereign yields in the Eurozone.

ECONOMISTS' INSIGHT

CHINA – SHORT-TERM GAIN, LONG-TERM PAIN

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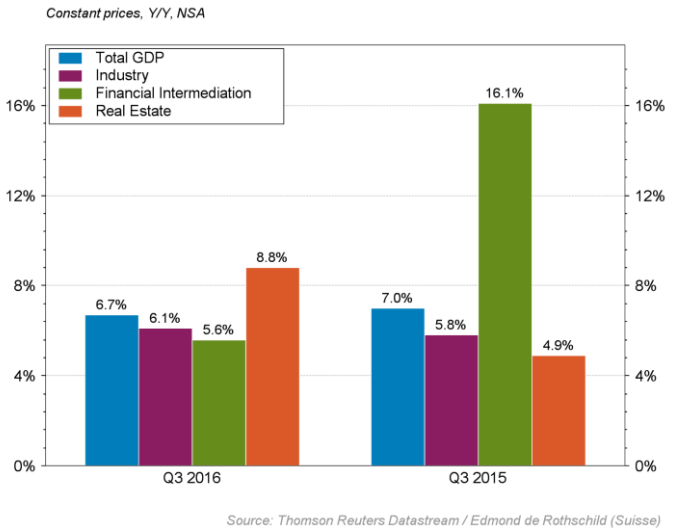
For the third quarter running, China's GDP growth was 6.7%, with the economy's subsectors growing at around the same rate. This indicator has been remarkably stable, which seems to confirm that Beijing is employing budgetary and monetary stimulus to attain the full-year GDP growth target of 6.5-7%. With economic activity stabilising, the government is likely to engage in less infrastructure spending, which will in turn limit the 2017 GDP growth outlook.

In the longer term, however, the government will not be able to ignore problems like the high level of debt, production overcapacity, a declining return on productive investments and only limited progress in the area of structural reforms. **The use of the 'traditional' levers of credit and infrastructure spending to maintain current growth levels will end up exacerbating structural imbalances and only make it more difficult to solve these problems in the future.**

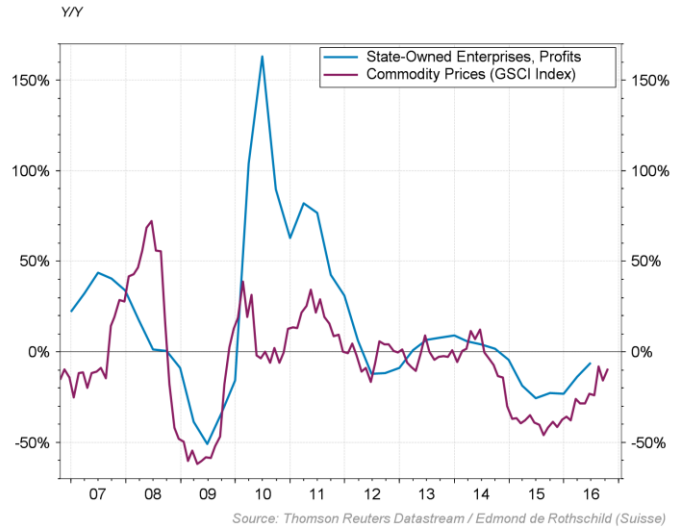
The individual sectors do not point to any significant change in Chinese growth trends. The secondary sector (+6.1%), which includes manufacturing and construction, is still in the consolidation phase that began at the end of 2015, while the tertiary sector has picked up (+7.6%) following the sharp deceleration experienced previously in the financial sector.

Some subsectors of the economy that historically show divergent growth levels are now quite comparable: they range from +5.6% for the financial sector, which has been slowing after the 2015 financial bubble burst, to +8.8% for the property sector, which has been buoyed by the rise in lending (see left-hand chart). After four years of deflation, producer price inflation has returned to positive territory thanks mainly to rising commodity prices. This is providing a breath of fresh air to the manufacturing sector, which is still hampered by production overcapacity (see right-hand chart).

Real estate is recovering and financial intermediation is returning to normal



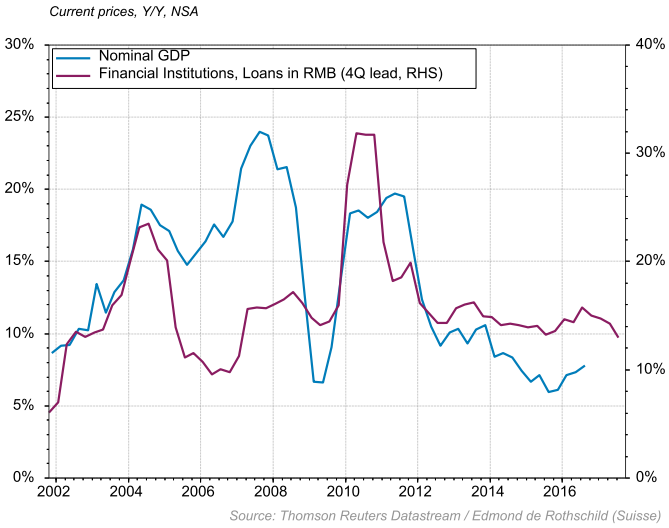
Manufacturing is being supported by commodity prices



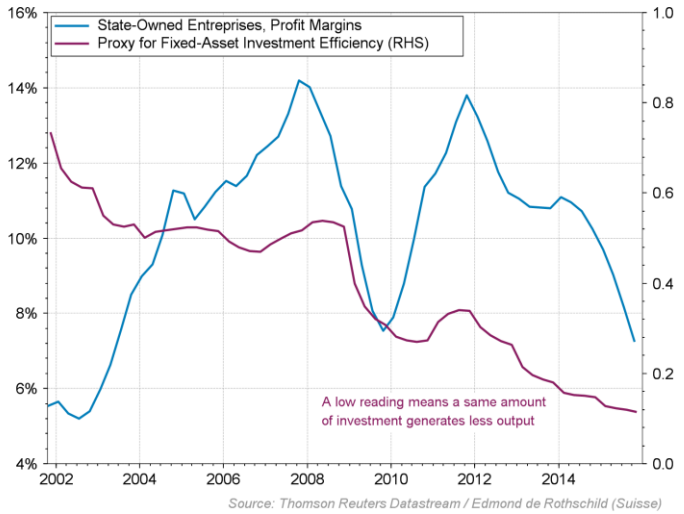
In September, new loans amounted to CNY 1.720 trillion. This amount is lower than those seen at the start of the year during the peak of the government's stimulus effort, but is still quite high relative to historical levels. The growth in bank lending is less volatile and remains unchanged at 13%, which is lower than at the start of the year.

These figures suggest that, **with Chinese GDP growth now levelling off, the government is likely to dial down its infrastructure spending, which is financed by intensive credit creation**. This view is reinforced by the message that Beijing has conveyed to banks instructing them to rein in mortgage lending and bring shadow banking under control. That said, even if credit is held in check, it is still a policy tool that the government can use to significantly influence the course of domestic economic activity (see left-hand chart on the next page).

Scaled-back credit should limit GDP growth in 2017



The investment productivity and state enterprises' profitability are down



There is a limit to how much the government can count on the use of credit. Since 2010, China has experienced a sharp rise in its debt level relative to the added value generated by its economy. There is little risk of implosion, in view of limited capital account openness and the high level of domestic savings (46% of GDP). But the government's desire to open Chinese financial markets to the world will be thwarted by such a high level of debt, especially since cleaning up bank balance sheets does not appear to be on the agenda.

This situation is particularly worrisome given the fact that **the use of credit has changed little since the major stimulus plans of 2009.** Capital investments remain high, but they are often concentrated in unprofitable sectors and projects. This is true for the entire manufacturing economy and is especially apparent in state-owned enterprises (see right-hand chart).

In conclusion, the effects of the stimulus measures put in place at the start of the year should continue to be felt through the end of 2016. China should end the year with GDP growth in line with its target of 6.5-7%. We have therefore adjusted our GDP growth forecast to 6.70% for 2016.

Yet growth in 2017 is likely to be hurt by the restrictive measures adopted by a number of large cities in response to an overheating property market and by the scaling back of credit creation. If the government decides to support economic growth in the short and medium term by delivering more stimulus to the real economy, it will have to deal with a number of issues sooner or later, including the debt level, the declining marginal return on productive investments and the failure to make more progress on structural reforms aimed at boosting consumer spending. With this in mind, the effort to hit current GDP growth targets will exacerbate structural imbalances and make it more difficult to achieve the long-term objectives of opening up Chinese financial assets to international investors and expanding the proportion of consumer spending in the economy.

FOCUS ON THE ECB

QUANTITATIVE EASING WILL NOT END IN 2017

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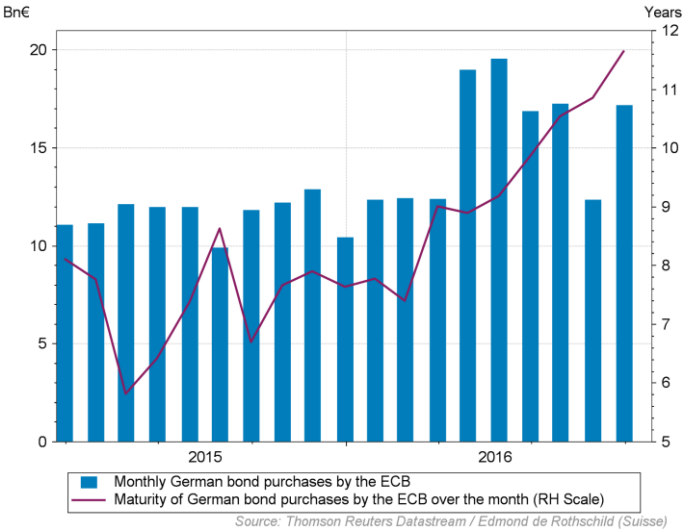
As we expected, the European Central Bank (ECB) did not change its monetary policy at its 20 October meeting. It did not change its deposit rate (-0.10%) and its main refinancing rate (0.00%)It repeated its intention to continue purchasing 80 billion euros in bonds every month "until the end of March 2017, or beyond, if necessary". At the press conference, Mr Draghi nevertheless added some key details to the monetary policy outlook. **He highlighted that quantitative easing was not about to end and that the ECB's deposit rate would remain negative.** This information could ease upward pressure on European yields, which had edged upwards on fears that the ECB's bond purchase programme would soon be ended.

First of all, Mr Draghi clearly stated that the ECB would take a decision at its 8 December meeting. He reiterated that, at that point in time, the ECB would have its staff's new macroeconomic forecasts (through 2019) along with the conclusions of the report on changes that could be made to the rules of its bond purchase programme. He added that this decision would define the monetary policy environment for the coming weeks and the coming months.

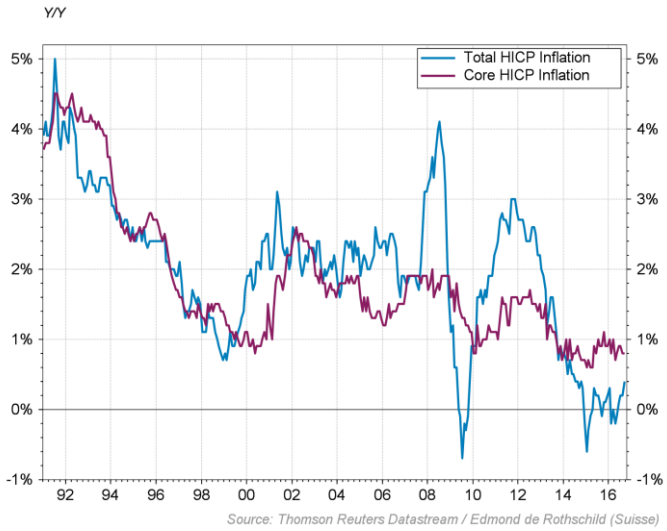
The ECB should announce at that time whether or not it intends to continue its bond purchase programme beyond the March 2017 end date that it has maintained since the end of 2015. It should also say whether it intends to change the rules governing purchases under this programme. **The programme cannot carry on for much longer with the current constraints that the ECB has set for itself** (where purchases are weighted by the countries' capital key at the ECB) **because it will soon run out of eligible securities** (see left-hand chart on the next page).

In addition, Mr Draghi provided some answers in terms of when the quantitative easing programme may end. Speculation on this topic had risen sharply after a news agency published an article on 4 October reporting that, according to ECB sources, a gradual slowdown in the pace of monthly purchases was being contemplated. Mr Draghi of course acknowledged that the quantitative easing programme would come to an end and he added that, when that time came, the ECB would gradually scale back its monthly purchases rather than ending them abruptly. Yet he suggested that the programme would not end soon, adding that the ECB did not discuss this option at the meeting and that the sources cited by the press were uninformed.

Under its rules, the ECB ends up having to purchase very long-term German bonds



Underlying inflation in the Eurozone is low



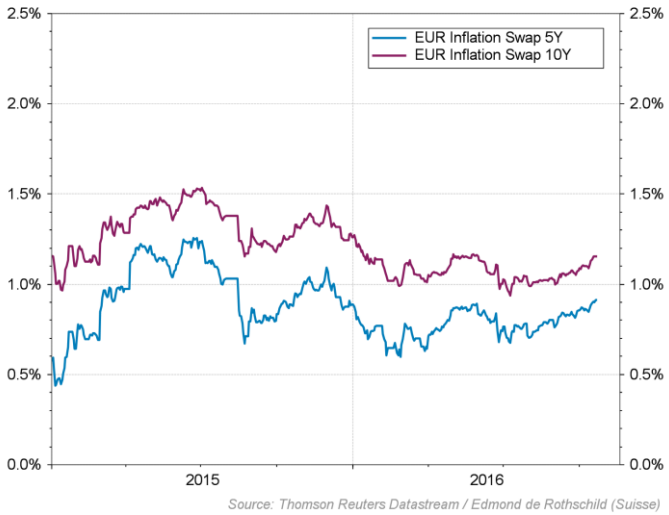
He also stated that the monetary easing programme had to remain in place so that the ECB could achieve its inflation target. He emphasised that the ongoing rise in overall inflation (which went from 0.2% in August to 0.4% in September) was driven mainly by rising energy prices, and he added that there are no signs yet of a convincing upward trend in underlying inflation. Underlying inflation held steady at 0.8% in September (see right-hand chart). He clarified the fact that the ECB's inflation forecasts were based on the assumption that current financing conditions – including the expansionary monetary policy – would remain unchanged. This means that **the ECB is likely to carry on with quantitative easing if it wants inflation to grow in line with its forecasts**.

At the same time, Mr Draghi confirmed that the ECB had no intention of changing its negative deposit rate policy in the coming months. Questions about whether or not this measure would remain in place have gained momentum since the ECB's quarterly bank lending survey. The latest survey showed that, for the first time into in two and a half years, most banks intended to tighten credit standards for non-financial corporations in the fourth quarter, owing in part to the losses caused by the ECB's negative interest rate. Mr Draghi played down this point and noted that, according to the survey, loan supply and demand conditions in the non-financial private sector had improved in the third quarter. He also said that the negative interest rates were discussed at the meeting and that the ECB still believes that they do not interfere with the transmission of its monetary policy.

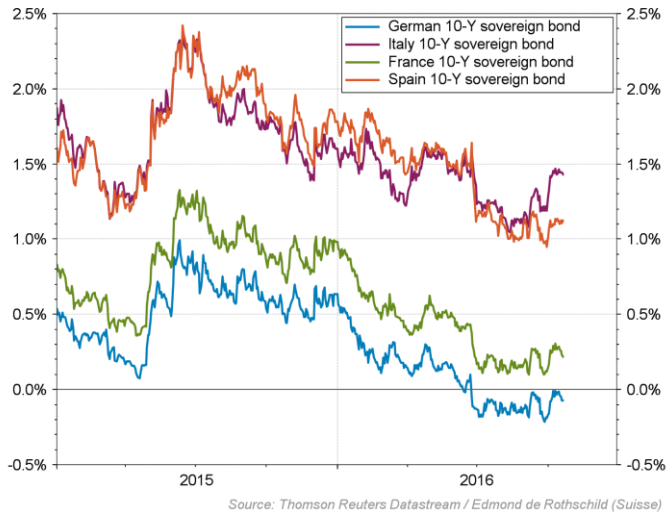
These comments confirm that the quantitative easing and negative interest rate policy is not about to end soon and should go a long way towards easing upward pressure on sovereign bond yields in the coming months. The uptrend seen in sovereign yields since the end of September stems in part from an increase in inflation expectations in the wake of rising oil prices. But the rise in sovereign bond yields

reflects mostly an increase in the bond term premium[1] in response to fears that the ECB's purchase programme would soon come to an end. This can be seen, for instance, in the week of 3 October when fears of a slowdown in the ECB's purchases first arose. The yield on the 10-year bund climbed 11bp to reach 0.02%, as the 10-year inflation swap rose 2bp to 1.12% (see charts). **The likelihood that quantitative easing will continue after March 2017 should help bring the term premium back down.**

Increasing inflation expectations…



…only partly account for rising yields



Implications:

- We still believe the ECB will announce its intention to extend the end date of the quantitative easing programme at its 8 December meeting. We expect the bond purchases to continue at a pace of 80 billion euros per month through September 2017. In our view, the ECB should remove the rule on the allocation of purchases by country.

- The ECB does not intend to taper its purchases, and this should reduce upward pressure on long-term sovereign yields. In an environment in which international investors are still hunting for yields, we see only limited further upside on bond yields in core Eurozone countries.

- If the ECB announces its intention to maintain its very loose monetary policy in December, this could push the euro slightly downward. We expect the euro/dollar exchange rate to be 1.08 at the end of 2016.

[1] The 'term premium' is defined as the additional yield that investors require to hold a long-term bond rather than a series of short-term bonds (see *"What We Do and Don't Know about the Term Premium", Federal Reserve of San Francisco*, July 2007). This premium declines when demand for long-term bonds increases, which is what happens when a central bank puts a bond purchase programme in place.

OUR GDP GROWTH AND INFLATION FORECASTS

REAL GDP GROWTH (%)	2013	2014	2015	2016f	Consensus	2017f	Consensus
United States	1.5	2.4	2.4	1.9	1.5	2.2	2.1
Japan	1.4	-0.1	0.6	0.7	0.6	1.3	0.8
Eurozone	-0.2	0.9	1.5	1.7	1.5	1.1	1.3
Germany	0.4	1.6	1.4	1.6	1.8	1.2	1.3
France	0.6	0.6	1.3	1.4	1.3	0.9	1.1
Italy	-1.8	-0.3	0.6	1.1	0.8	1.1	0.8
Spain	-1.7	1.4	3.2	2.8	3.1	2.2	2.1
Portugal	-1.1	0.9	1.5	1.2	1.0	1.6	1.2
Luxembourg	4.4	4.1	4.9	3.7	3.4	4.1	2.7
Europe ex-Eurozone							
United Kingdom	1.9	3.1	2.2	1.0	1.8	-0.2	0.8
Switzerland	1.8	1.9	0.9	1.1	1.5	1.2	1.5
Sweden	1.2	2.4	3.8	3.6	3.1	2.9	2.3
Israel	3.2	2.7	2.5	2.8	2.6	3.0	3.0
Emerging Markets							
China	7.7	7.3	6.9	6.7	6.6	6.0	6.4
Brazil	3.0	0.1	-3.9	-4.3	-3.2	0.7	1.0
India	6.3	7.0	7.3	7.5	7.5	7.3	7.7

CONSUMER PRICE INDEX (%)	2013	2014	2015	2016f	Consensus	2017f	Consensus
United States	1.5	1.6	0.1	1.3	1.2	2.3	2.2
Japan	0.4	2.7	0.8	0.2	-0.2	0.6	0.5
Eurozone	1.4	0.4	0.0	0.2	0.2	1.1	1.3
Germany	1.6	0.8	0.1	0.5	0.4	1.3	1.5
France	1.0	0.6	0.1	0.3	0.3	0.8	1.2
Italy	1.2	0.2	0.1	0.1	0.0	0.8	1.0
Spain	1.5	-0.2	-0.6	-0.1	-0.4	0.9	1.3
Portugal	0.4	-0.2	0.5	0.6	0.7	1.3	1.1
Luxembourg	1.7	0.7	0.1	0.7	0.0	1.4	1.7
Europe ex-Eurozone							
United Kingdom	2.6	1.5	0.0	1.4	0.7	3.5	2.3
Switzerland	-0.2	0.0	-1.1	-0.5	-0.4	-0.1	0.3
Sweden	0.4	0.2	0.7	0.9	0.9	1.5	1.5
Israel	1.5	0.5	-0.6	-0.3	-0.4	1.2	1.0
Emerging Markets							
China	2.6	2.0	1.4	2.1	2.0	2.4	2.0
Brazil	6.2	6.3	9.0	8.9	8.8	7.3	5.5
India	9.9	6.7	4.9	5.1	4.9	4.8	5.2

OUR MONETARY POLICY FORECASTS

KEY RATES (%)	2013	2014	2015	2016f	Consensus	2017f	Consensus
United States	0.25	0.25	0.50	0.75	0.70	1.25	1.00
Japan	0.10	0.10	0.10	-0.10	-0.10	-0.10	-0.10
Eurozone	0.25	0.05	0.05	0.00	0.00	0.00	0.00
Europe ex-Eurozone							
United Kingdom	0.50	0.50	0.50	0.25	0.15	0.25	0.15
Switzerland	0.00	-0.25	-0.75	-1.00	-0.70	-1.00	-0.65
Sweden	0.75	0.00	-0.35	-0.50	-0.50	0.00	-0.45
Israel	1.00	0.25	0.10	0.10	0.10	0.50	0.30
Emerging Markets							
China	6.00	5.60	4.35	3.85	4.27	3.35	4.20
Brazil	10.00	11.75	14.25	14.00	13.55	13.50	11.20
India	7.75	8.00	6.75	6.50	6.20	6.50	6.05

OUR CURRENCY FORECASTS

FOREIGN EXCHANGE*	2013	2014	2015	2016f	Consensus	2017f	Consensus
Dollar							
EUR/USD	1.37	1.20	1.08	1.08	1.10	1.04	1.10
USD/JPY	105	120	120	116	104	121	105
GBP/USD	1.66	1.56	1.47	1.24	1.25	1.20	1.28
USD/CHF	0.89	0.99	1.00	1.00	1.00	1.00	1.00
USD/CNY	6.05	6.21	6.49	6.70	6.75	6.90	6.85
Euro							
EUR/JPY	144	144	130	125	114	126	116
EUR/GBP	0.83	0.77	0.73	0.87	0.88	0.87	0.86
EUR/CHF	1.23	1.20	1.09	1.08	1.10	1.04	1.10
EUR/SEK	8.85	9.44	9.17	9.53	9.45	9.60	9.00

*end of period data

RETURNS ON FINANCIAL ASSETS

Major benchmarks and currencies

Markets Performances (local currencies)	Last Price	1-Week (%)	1-Month (%)	Year-to-Date (%)	Last Year (%)
Equities					
World (MSCI)	415	1.3%	-1.0%	6.3%	-1.8%
United States (S&P 500)	2'150	1.2%	-0.5%	7.1%	1.4%
Euro Area (DJ EuroStoxx)	333	2.6%	1.6%	-0.4%	11.2%
United Kingdom (FTSE 100)	7'052	0.7%	1.3%	15.9%	-1.4%
Switzerland (SMI)	7'960	-0.1%	-3.4%	-6.1%	1.1%
Japan (NIKKEI)	17'365	2.0%	3.5%	-7.9%	11.0%
Emerging (MSCI)	918	2.7%	0.2%	18.3%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.76%	0.1%	-0.8%	5.9%	2.1%
Euro Area (7-10 Yr)	0.03%	0.2%	-0.5%	6.2%	1.0%
Germany (7-10 Yr)	0.03%	0.2%	-0.8%	6.8%	0.9%
United Kingdom (7-10 Yr)	1.10%	0.4%	-2.4%	8.2%	0.7%
Switzerland (7-10 Yr)	-0.48%	0.0%	0.2%	3.6%	3.7%
Japan (7-10 Yr)	-0.07%	0.0%	0.1%	2.9%	1.4%
Emerging (5-10 Yr)	4.26%	0.8%	-0.1%	13.4%	1.6%
United States (IG Corp.)	2.88%	0.1%	-0.2%	8.8%	-0.8%
Euro Area (IG Corp.)	0.51%	0.1%	-0.4%	5.6%	-0.5%
Emerging (IG Corp.)	3.52%	0.4%	0.1%	11.2%	-2.3%
United States (HY Corp.)	6.12%	0.6%	1.5%	17.0%	-3.5%
Euro Area (HY Corp.)	2.93%	0.5%	0.9%	8.0%	0.3%
Emerging (HY Corp.)	7.10%	0.6%	1.1%	19.3%	3.6%
United States (Convert. Barclays)	46	1.7%	0.0%	9.7%	-0.8%
Euro Area (Convert. Exane)	7'323	0.7%	0.8%	-2.3%	7.6%
Real Estate					
World (MSCI)	196	1.5%	-4.4%	6.3%	1.0%
United States (MSCI)	205	0.8%	-4.9%	5.5%	4.6%
Euro Area (MSCI)	223	3.2%	-5.1%	10.0%	16.1%
United Kingdom (FTSE)	6'605	0.3%	0.4%	0.2%	9.4%
Switzerland (DBRB)	3'757	-0.7%	-0.2%	4.6%	4.6%
Japan (MSCI)	239	5.3%	3.8%	-9.7%	0.9%
Emerging (MSCI)	103	3.6%	-4.3%	6.2%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	551	n.a.	0.1%	0.1%	-0.7%
Distressed	747	n.a.	0.7%	2.7%	-5.3%
Event Driven	595	n.a.	0.1%	0.4%	-6.3%
Fixed Income	310	n.a.	0.8%	2.4%	0.6%
Global Macro	876	n.a.	0.1%	-1.0%	0.2%
Long/Short	655	n.a.	0.1%	-3.2%	3.6%
Managed Futures (CTA's)	313	n.a.	-1.7%	-1.3%	-0.9%
Market Neutral	264	n.a.	0.6%	-2.0%	1.7%
Multi-Strategy	538	n.a.	0.6%	3.2%	3.8%
Short Bias	25	n.a.	1.1%	-18.4%	2.4%
Commodities					
Commodities (CRB)	422	0.3%	-0.3%	10.7%	-15.2%
Gold (Troy Ounce)	1'269	0.5%	-5.3%	19.5%	-10.6%
Oil (Brent, Barrel)	49	-0.6%	10.7%	38.8%	-35.9%
Currencies					
USD	99.0	1.1%	3.7%	0.4%	9.3%
EUR	1.09	-1.2%	-3.6%	-0.1%	-10.2%
GBP	1.21	-1.7%	-6.8%	-17.9%	-5.4%
CHF	1.00	-0.9%	-3.0%	0.3%	-0.8%
JPY	104.8	-0.9%	-4.3%	14.7%	-0.4%

Source : Bloomberg

Momentum (1-week / 1-month / 3-month)

Performance (Negative \ Positive)

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