MACRO HIGHLIGHTS

WEEK OF 12 SEPTEMBER 2016

OUR HIGHLIGHTS:

- **Economists' insight: The ECB will be even more accommodative…in the future**
  - No change in ECB monetary policy but asset purchase programme is likely to be extended beyond March 2017.
  - We don't believe that the rebound of PMIs in the UK points to an improving economic outlook.
- **Special: The Swiss economy has recovered from the Frankenschock**
  - Exports, which are now buoyed by increased public spending, are again fuelling GDP growth.
  - After two years of deflation, inflation is about to become positive again.
- **Focus on China: From monetary to fiscal policy**
  - The People's Bank of China is shifting from monetary policy tools to fiscal measures.
  - This means that Chinese GDP growth is unlikely to deliver any surprises to the upside. Government measures should focus on boosting private consumption.

ECONOMISTS' INSIGHT

THE ECB WILL BE EVEN MORE ACCOMMODATIVE…IN THE FUTURE

The highly anticipated 8 September meeting of the European Central Bank (ECB) resulted in no change to monetary policy. The ECB did not adjust its deposit rate (-0.40%) or main refinancing rate (0.00%), and repeated its pledge to continue purchasing EUR 80bn in bonds every month until the end of March 2017 "or beyond, if necessary".

That said, we expect the ECB to continue its asset purchase programme beyond March 2017. The ECB noted that it would look at changes to the rules governing asset purchases given the shortage of eligible bonds. **In our view, this statement does not just clarify a technical aspect but also signals that the ECB will continue the programme beyond the first quarter of 2017.**

Our conclusion is corroborated by the new projections put out by the ECB's economic staff. The updated figures differ only slightly from the June ones (see table below), which means that the ECB is counting on a very slow rise in inflation towards its 2.0% target.

Queried on the absence of further announcements following this meeting, Mr Draghi noted that the staff's projections had not changed enough to merit any immediate measures. **These remarks are a clear indication that, at this point, the ECB does not believe that the Brexit referendum will substantially affect the growth outlook in the Eurozone.**

Eurozone statistics published last week appear to bear this out. Second-quarter GDP growth was +0.3% quarter on quarter and +1.6% year on year (Q1: +0.5% and +1.7%, respectively). And PMI indicators, which were resilient in July and slipped only slightly in August (the Manufacturing PMI went from 52.0 to 51.7, while the Services PMI dropped from 52.9 to 52.8), point to continued growth in the Eurozone.

New projections by ECB staff

	2016	2017	2018
GDP growth			
Sept. projections 16	1.7%	1.6%	1.6%
June 2016 projections	*1.6%*	*1.7%*	*1.7%*
Inflation			
Sept. projections 16	0.2%	1.2%	1.6%
June 2016 projections	*0.2%*	*1.3%*	*1.6%*

We would not be surprised if, following the 8 December meeting, the ECB announces plans to extend the asset purchase programme beyond March 2017 at the same time that it announces a change in the rules (especially regarding the allocation by country).

PMI surveys in the UK delivered a surprise when they bounced back after dropping in July. The Manufacturing PMI rose from 48.3 in July to 53.3 in August, while the Services PMI went from 47.4 to 52.9. What this means for the country's economic outlook is hard to say. Back when the results of the Brexit vote were announced, these indicators dropped sharply. Their recovery in August is probably a sign of declining pessimism that may owe something to the measures announced by the BoE on 4 August. Along these same lines, retail sales in July held firm, which can be interpreted as reassuring. But they may have gotten a boost from tourism (following the drop in the pound) and from consumers who, expecting inflation to rise, bought earlier than planned. **The key variable for the UK's economic outlook will be the level of investments.** The uncertainty surrounding the Brexit negotiations are likely to put a damper on investment decisions. According to the Confederation of British Industry (CBI), investment plans in the UK, measured from June to August, are at their lowest level in four years. The UK is also facing serious international pressure to speed up its negotiations with the EU. On 5 September, on the eve of the G20, Japan

threatened to move Japanese companies out of the UK if the British government could not guarantee ongoing future access to the European market. Until some real visibility is achieved, the investment outlook in the UK is unlikely to improve.

SPECIAL

THE SWISS ECONOMY HAS RECOVERED FROM THE FRANKENSCHOCK

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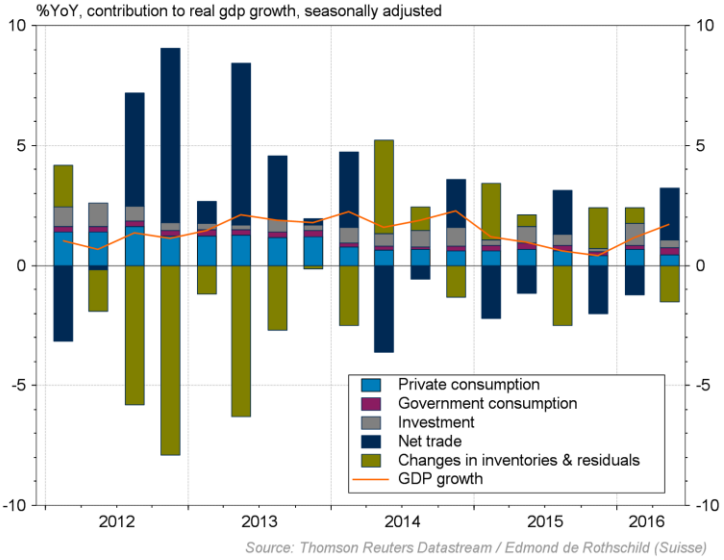
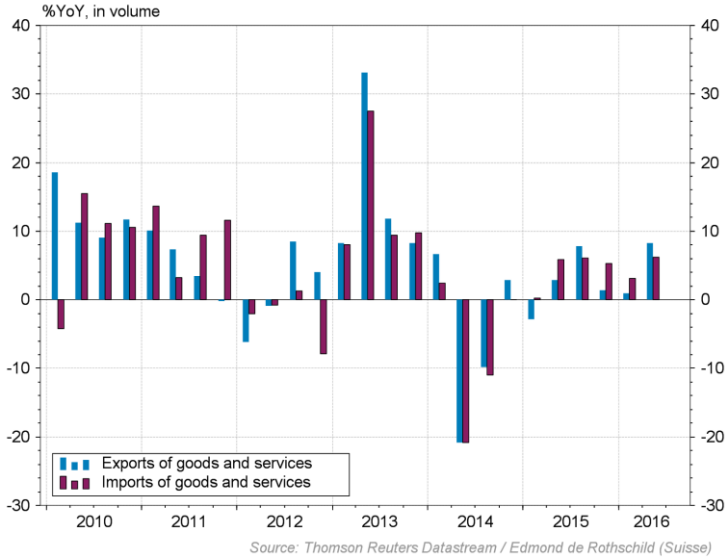
The Swiss economy posted Q2 GDP growth of +0.6% quarter on quarter, its fastest pace in 18 months. This figure, underpinned by public spending (+1.7% q-o-q) and exports (+4.6% q-o-q), came in ahead of expectations (see charts below).

Swiss GDP is highly dependent on exports…



… which are extremely volatile



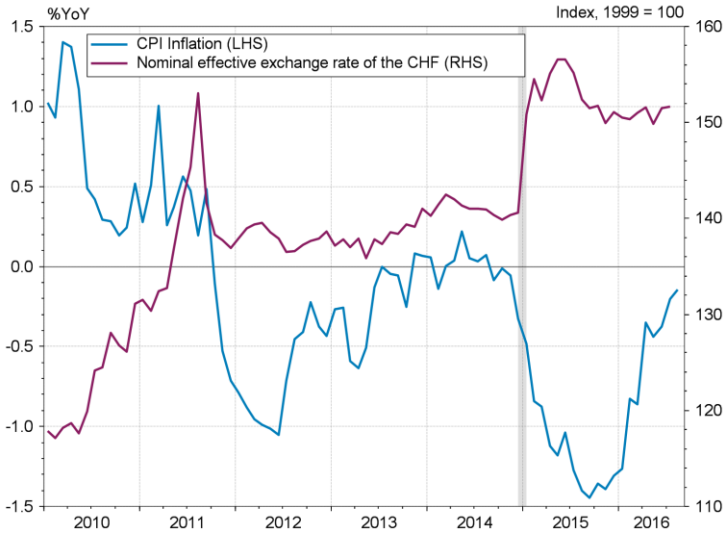
The expansion in public spending is the result of the Swiss government's procyclical strategy, which lifted an economy that slowed in 2015 (+0.8% versus +2% in 2014). This debt-brake strategy consists of generating a budgetary surplus during boom periods and spending more during economic lulls. Under this strategy, public debt fell from 49% of GDP in 2004 to 33.5% in 2015, and the government is now able to stimulate growth without putting pressure on public finances. Exports benefitted from two factors: the effect of the Swiss franc's rise after the Swiss National Bank (SNB) scrapped its currency peg with the euro in January 2015 has dissipated and exporters have implemented efficiency and cost-cutting measures in response to the SNB's move. These measures gave a boost to productivity, which showed positive year-on-year growth for the first time since early 2014 (+0.1% in Q2).

On the down side, private domestic demand disappointed: consumer spending was stable versus the previous quarter, and investments shrank (-0.7%). However, and to put this number into perspective, while investments in Q2 may have declined versus the previous quarter, the Q1 figure underwent a sharp upward revision. This means that in the first six months of the year investments grew at their fastest pace since a year and a half (+1.5%).

In the next few quarters, the Swiss economy will be supported by an export sector that is on a firm uptrend and by a pick-up in domestic demand. While public spending cannot continue expanding at such a high rate, investments are likely to gain momentum in view of improving economic prospects. Consumer spending appears set to improve slightly, as suggested by the latest retail sales figures, which accelerated for the first time since the start of the year. **The Swiss economy should meet or even beat our 2016 growth forecast (+1.1%)**, even if the next two quarters will probably not be as strong as Q2.

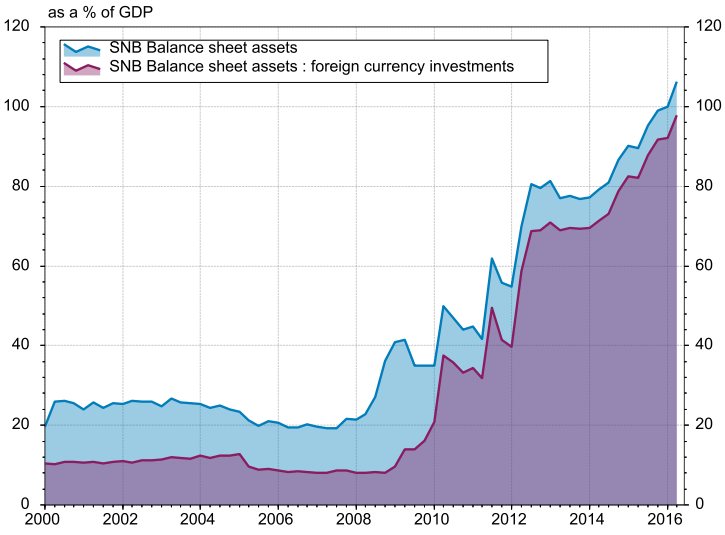
Prices in Switzerland were stable in August (-0.1% quarter on quarter, and -0.1% year on year). After 24 months of deflation, **we now expect inflation to turn positive in Q4 and continue on that path in 2017 (+0.3%).** The end of deflation can be attributed to several factors. First, the impact of the removal of the currency peg has worn off (see left-hand chart), and, with the franc stabilising since then, import prices have stopped falling. In addition, rising oil prices since the start of the year will help push up prices, while at the same time the SNB maintains its expansionary monetary policy (see right-hand chart).

The impact of the removal of the currency peg has worn off



Source: Thomson Reuters Datastream / Edmond de Rothschild (Suisse)

The SNB continues to intervene on the markets



Source: Thomson Reuters Datastream / Edmond de Rothschild (Suisse)

FOCUS ON CHINA

FROM MONETARY TO FISCAL POLICY

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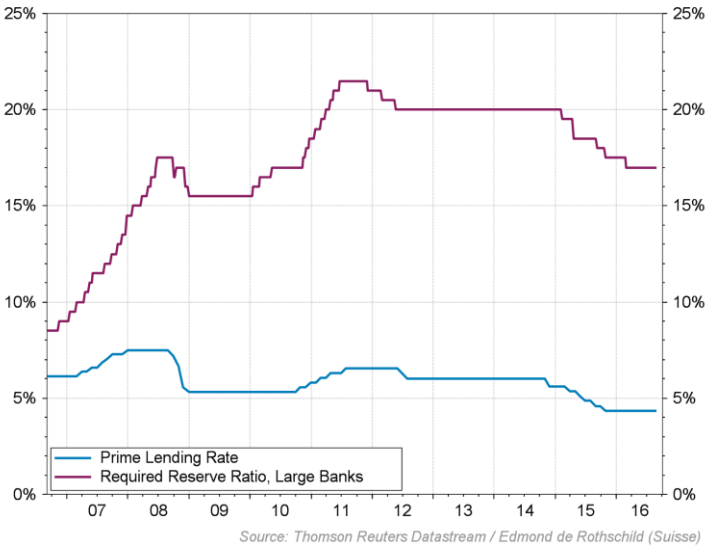
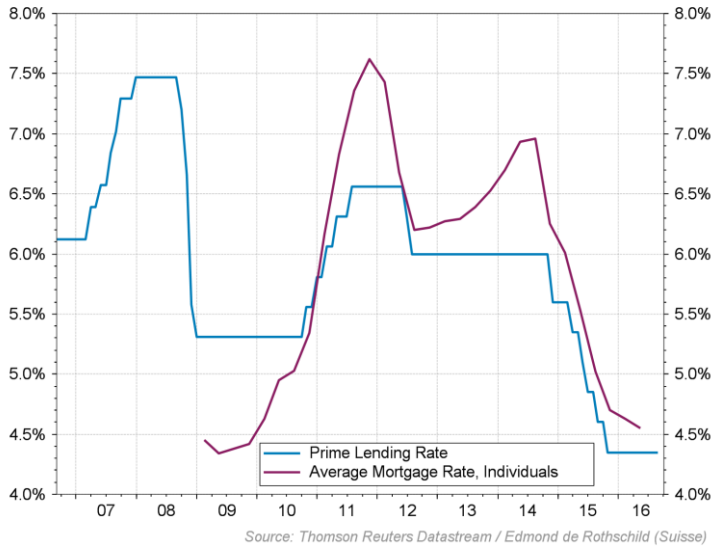
At the start of 2016, the Chinese government embarked on an intense policy to support GDP growth through increased infrastructure spending. **So far this year, the People's Bank of China** (PBoC) **has shifted away from the monetary policy tools – including prime interest rates and banks' reserve requirement ratios – that it had used so many times in 2015** (see left-hand chart below). The Chinese authorities now prefer to pull other levers. This is clearly seen in the scope of the credit-based stimulus enacted in Q1, which amounted to 40% of GDP. This approach derives from the structure of the world's second-largest economy, which differs in many ways from developed economies.

Since the end of 2015, Beijing has tended to refrain from systematically cutting rates as a way to spur economic activity. It wants to avoid putting downward pressure on the yuan – although with USD 3.201 trillion in currency reserves it could certainly prop it up – and prevent valuation bubbles on certain assets, especially in the property sector.

Monetary tools have not been used extensively in China in 2016



The prime lending rate and the mortgage rate



Historically, one side effect of interest-rate cuts has been to push down mortgage interest rates and spark demand for property (see right-hand chart on the previous page). **Property is particularly attractive for investment and diversification purposes in an economy where alternatives to saving are few and far between.** Yet property markets differ widely from region to region, which means that an interest-rate cut will not have the same impact all across the country. Coastal provinces, which are faster-growing and have a higher population, will see a rapid and steep rise in property prices. Northern provinces, which are more industrial and thus harder hit by a slowdown in

manufacturing activity, will remain depressed by a housing glut following years of overinvestment. The cycle of cuts in the prime-lending rate that began in 2015 is clear proof of this: the price of newly built homes in the main cities climbed by 20% year on year while the average price remained stable (+0.2%).

The Chinese authorities are now focused on more targeted measures that take these regional disparities into account. Recently, property markets in some regions have been overheating, leading the government to introduce targeted restrictions rather than tightening access to credit by raising prime rates. Examples of targeted measures include limits on the ability to purchase secondary residences and higher down-payment requirements.

A move to expand regulation of the shadow-banking system is driven by a similar mindset. In this case too, **recent history shows that a more accommodative interest-rate policy tends to overinflate the mass of credit in the economy through these informal and relatively unregulated channels**. Here too, targeted measures like stricter oversight of wealth management products – products that offer high returns, that are often designed to finance sectors hobbled by limited credit, and that have an estimated value of CNY 23.5 trillion – are aimed at gaining more control over shadow-banking activities and, more broadly, the country's debt.

So rather than attempting to influence economic activity through a policy of hard-to-manage rate cuts, Beijing is focusing on stimulating economic activity through credit while at the same time controlling the level of liquidity in the financial system through a number of specific instruments (see table below).

Some instruments used by the People's Bank of China

Instruments	Main purpose
Prime rates	To set the benchmark rate for deposit and lending operations.
Reserve requirement ratio	The portion of a financial institution's deposits that must be held at the central bank. This figure depends on the size of the financial institution.
OMO – *Open Market Operations*	The purchase and sale of securities in order to influence the level of liquidity in the banking system.
SLF – *Standing Lending Facility* MLF – *Medium-Term Lending Facility* PSL – *Pledge Supplementary Lending* SLO – *Special Lending Operations*	Operations with different maturities aimed at influencing the level of liquidity and interest rates.
Window guidance	A dialogue between the central bank and commercial banks on the general orientation of monetary policy and lending activities.

Source: Goldman Sachs

We expect **this overall approach to remain in place for the coming months. China will inject credit on occasion in order to meet its full-year growth target of +6.5%,** while drawing on its arsenal of measures to manage liquidity in the economy. The large number of tools at the government's disposal makes it difficult to clearly identify the impact of its measures. That said, the property-market and shadow-banking examples discussed above suggest a relatively unaccommodating or even restrictive attitude. This trend is apparent in credit growth, which contracted from +12.5% in March to +10.9% in July.

Still, Beijing looks set to continue supporting GDP growth through fiscal measures. The official target of a public deficit equal to 3% of GDP in 2016 will probably have to be raised, as it was in 2015.

We can take comfort in the fact that the authorities are framing their actions more carefully and measuring out their support for the economy. But this also means that Chinese GDP growth is unlikely to deliver any surprises to the upside. We still expect Chinese GDP growth to decelerate in 2016-2017. While steps have been taken to reduce the production capacity of state-owned enterprises, **broader government measures should focus on private consumption**. The ultimate success of China's economic transition will be measured against that variable.

OUR 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	2.2
Japan	1.4	-0.1	0.6	0.7	0.5	1.3	0.7
Eurozone	-0.2	0.9	1.5	1.7	1.5	1.1	1.3
Germany	0.4	1.6	1.4	1.6	1.6	1.2	1.2
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	2.9	2.2	2.1
Portugal	-1.1	0.9	1.5	1.2	0.9	1.6	1.0
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	1.6	-0.2	0.7
Switzerland	1.8	1.9	0.9	1.1	1.0	1.2	1.4
Sweden	1.2	2.4	3.8	3.6	3.1	2.9	2.4
Israel	3.2	2.7	2.5	2.8	2.6	3.0	3.0
Emerging Markets							
China	7.7	7.3	6.9	6.5	6.5	6.0	6.3
Brazil	3.0	0.1	-3.9	-4.3	-3.5	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	-0.1	0.6	0.7
Eurozone	1.4	0.4	0.0	0.2	0.3	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	1.1
Spain	1.5	-0.2	-0.6	-0.1	-0.4	0.9	1.3
Portugal	0.4	-0.2	0.5	0.6	0.6	1.3	1.3
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	2.2
Switzerland	-0.2	0.0	-1.1	-0.5	-0.5	-0.1	0.3
Sweden	0.4	0.2	0.7	0.9	0.9	1.5	1.6
Israel	1.5	0.5	-0.6	-0.3	-0.3	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	8.6	7.3	5.5
India	9.9	6.7	4.9	5.1	4.9	4.8	5.3

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	1.05
Japan	0.10	0.10	0.10	-0.10	-0.10	-0.10	-0.20
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	-0.80	-1.00	-0.85
Sweden	0.75	0.00	-0.35	-0.50	-0.50	0.00	-0.50
Israel	1.00	0.25	0.10	0.10	0.10	0.50	0.45
Emerging Markets							
China	6.00	5.60	4.35	3.85	3.95	3.35	3.95
Brazil	10.00	11.75	14.25	14.00	13.70	13.50	11.40
India	7.75	8.00	6.75	6.50	6.35	6.50	6.30

OUR CURRENCY FORECASTS

FOREIGN EXCHANGE*	2013	2014	2015	2016f	Consensus	2017f	Consensus
Dollar							
EUR/USD	1.37	1.20	1.08	1.08	1.09	1.04	1.10
USD/JPY	105	120	120	116	104	121	110
GBP/USD	1.66	1.56	1.47	1.24	1.28	1.20	1.31
USD/CHF	0.89	0.99	1.00	1.00	0.99	1.00	1.02
USD/CNY	6.05	6.21	6.49	6.70	6.75	6.90	6.85
Euro							
EUR/JPY	144	144	130	125	113	126	121
EUR/GBP	0.83	0.77	0.73	0.87	0.85	0.87	0.84
EUR/CHF	1.23	1.20	1.09	1.08	1.08	1.04	1.12
EUR/SEK	8.85	9.44	9.17	9.53	9.30	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)	416	-1.3%	-1.1%	6.2%	-1.8%
United States (S&P 500)	2'127	-0.9%	-1.0%	7.3%	1.4%
Euro Area (DJ EuroStoxx)	321	-2.3%	-1.2%	-3.1%	11.2%
United Kingdom (FTSE 100)	6'666	-2.6%	-2.9%	10.9%	-1.4%
Switzerland (SMI)	8'175	-1.3%	-1.1%	-3.6%	1.1%
Japan (NIKKEI)	16'729	-2.1%	-1.4%	-11.5%	11.0%
Emerging (MSCI)	889	-2.2%	-2.0%	14.4%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.71%	-0.3%	-0.9%	6.3%	2.1%
Euro Area (7-10 Yr)	0.07%	-0.5%	-0.9%	6.0%	1.0%
Germany (7-10 Yr)	0.07%	-0.7%	-1.2%	6.6%	0.9%
United Kingdom (7-10 Yr)	0.91%	-0.9%	-1.7%	9.7%	0.7%
Switzerland (7-10 Yr)	-0.37%	-0.6%	-1.4%	2.7%	3.7%
Japan (7-10 Yr)	-0.01%	-0.1%	-0.7%	2.5%	1.4%
Emerging (5-10 Yr)	4.26%	-0.2%	-0.2%	12.5%	1.6%
United States (IG Corp.)	2.88%	-0.8%	-0.8%	8.4%	-0.8%
Euro Area (IG Corp.)	0.50%	-0.3%	-0.4%	5.6%	-0.5%
Emerging (IG Corp.)	3.51%	-0.4%	-0.3%	11.0%	-2.3%
United States (HY Corp.)	6.52%	-0.2%	0.7%	14.7%	-3.5%
Euro Area (HY Corp.)	3.43%	-0.7%	0.2%	6.8%	0.3%
Emerging (HY Corp.)	7.52%	-0.1%	0.7%	16.9%	3.6%
United States (Convert. Barclays)	45	-0.7%	-1.0%	8.3%	-0.8%
Euro Area (Convert. Exane)	7'271	-1.0%	-0.7%	-3.0%	7.6%
Real Estate					
World (MSCI)	202	-2.3%	-3.1%	9.1%	1.0%
United States (MSCI)	213	-2.6%	-3.4%	8.5%	4.6%
Euro Area (MSCI)	231	-3.9%	-5.3%	13.8%	16.1%
United Kingdom (FTSE)	6'569	0.0%	0.8%	-0.4%	9.4%
Switzerland (DBRB)	3'797	-0.7%	-2.4%	5.1%	4.6%
Japan (MSCI)	235	0.1%	-1.7%	-11.7%	0.9%
Emerging (MSCI)	104	-2.6%	-4.4%	7.3%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	547	n.a.	1.1%	-0.5%	-0.7%
Distressed	735	n.a.	1.1%	1.0%	-5.3%
Event Driven	587	n.a.	1.5%	-1.0%	-6.3%
Fixed Income	305	n.a.	1.1%	0.9%	0.6%
Global Macro	874	n.a.	0.3%	-1.3%	0.2%
Long/Short	652	n.a.	1.3%	-3.8%	3.6%
Managed Futures (CTA's)	328	n.a.	1.6%	3.7%	-0.9%
Market Neutral	262	n.a.	0.9%	-2.7%	1.7%
Multi-Strategy	530	n.a.	1.1%	1.7%	3.8%
Short Bias	26	n.a.	-8.1%	-14.7%	2.4%
Commodities					
Commodities (CRB)	414	0.6%	-0.5%	10.0%	-15.2%
Gold (Troy Ounce)	1'325	-1.6%	-1.3%	24.7%	-10.6%
Oil (Brent, Barrel)	46	0.8%	1.8%	31.6%	-35.9%
Currencies					
USD	95.4	0.6%	-0.4%	-3.3%	9.3%
EUR	1.12	-0.1%	0.5%	3.5%	-10.2%
GBP	1.32	-1.9%	2.3%	-10.6%	-5.4%
CHF	0.97	-0.4%	-0.1%	2.9%	-0.8%
JPY	102.1	-0.1%	-0.9%	17.7%	-0.4%

Source : Bloomberg Momentum (1-week / 1-month / 3-month) Performance (Negative \ Positive)

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