MACRO HIGHLIGHTS & STRATEGY

FEBRUARY 1ST 2016

OUR ROUNDUP:

- Central banks strike a chord with investors
- The Fed treads carefully
- Why doesn't the Fed sell some assets?

MARKETS

CENTRAL BANKS STRIKE A CHORD WITH INVESTORS

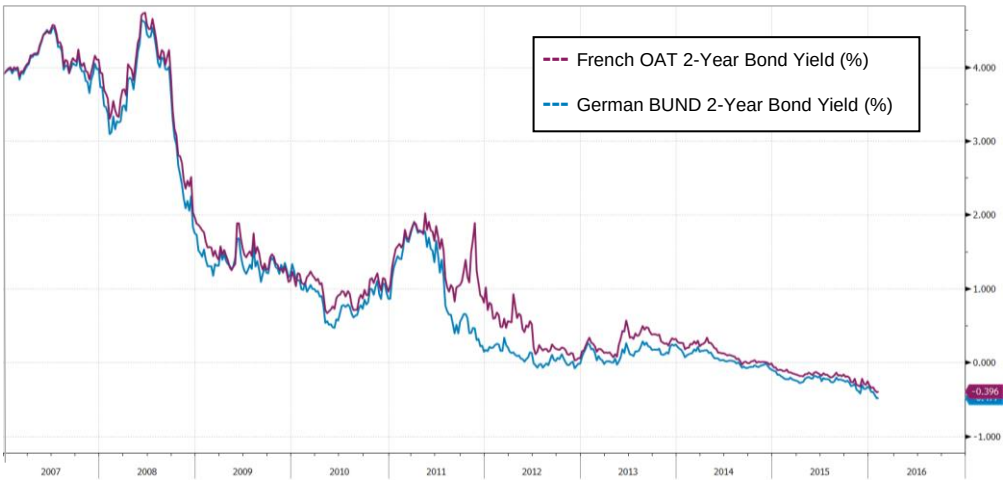
As expected, the US Federal Reserve (Fed) decided against raising rates again at its latest meeting, offering instead relatively neutral comments. **While Janet Yellen has not ruled out a rise in March, she was cautious in her assessment of the US economy** (see page 2). She is supported in this by the latest GDP figures, which expanded at an annualised rate of +0.7% in the fourth quarter.

The news that was music to investors' ears came from Haruhiko Kuroda – and was echoed by Mario Draghi last week. **The governor of the Bank of Japan (BoJ) moved interest rates into negative territory** for certain deposits. The objective is twofold:

- to discourage banks from parking excess cash at the central bank, and
- to encourage them to give the economy a boost by expanding both corporate and private lending.

Implicit in the BoJ's move is an acknowledgement of the secular weakness of the Japanese economy and the damage that the strengthening yen is having on the country's inflation outlook. The BoJ acted boldly, not waiting for the outcome of the annual wage talks in the spring and their impact on inflation.

Investors believe that the main central banks are determined to maintain extremely loose monetary policy if necessary. When it comes to spurring economic growth and countering the risk of deflation, it's no holds barred. Investors now feel the ECB and the SNB should go further in this direction at subsequent meetings.



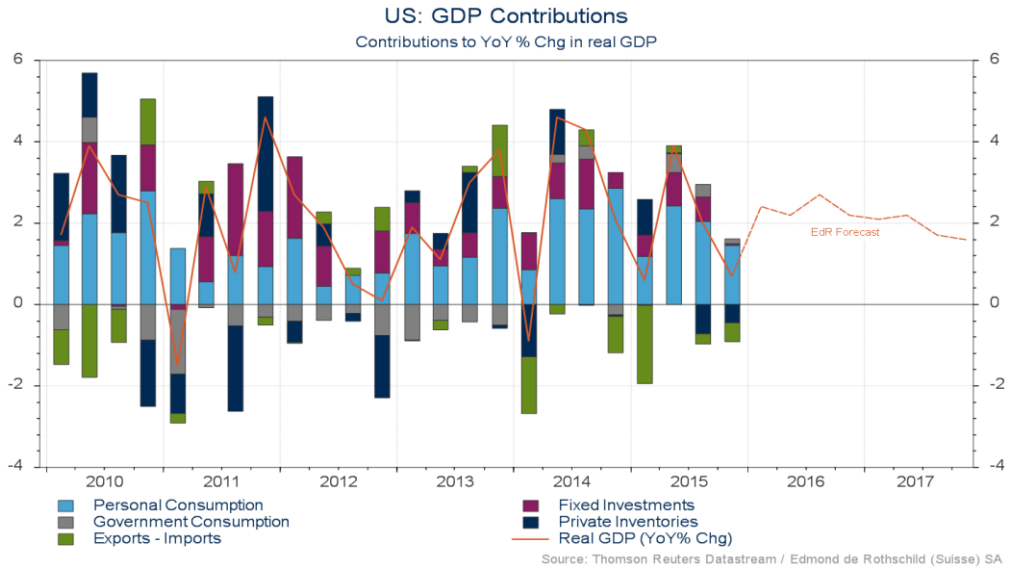
In response, the stock markets advanced and bond yields receded. Two-year bonds in both Germany and France even hit an all-time low, tunnelling into negative territory (see above chart). **On the currency markets, the yen, euro and Swiss franc all lost ground to the dollar.**

UNITED STATES

THE FED TREADS CAREFULLY

At the latest meeting of the Federal Open Market Committee (FOMC), the Fed did not change its monetary policy, letting the fed funds rate fluctuate in a range between 0.25% and 0.50%. **Its statement was strikingly neutral**, avoiding any overt optimism or pessimism (see table on page 3). The stock markets were nevertheless disappointed. They were expecting a more accommodative tone, like last September when the Fed conveyed its concerns about falling oil prices, commodities and the strength of the dollar. Is the Fed less worried about recent market behaviour?

The FOMC was cautious in its assessment of the US economy, recognising that fourth-quarter growth was below expectations. GDP showed a year-on-year growth rate of 1.8% versus our 2% projection. The negative balance of trade and the significant inventory drawdown are the main causes (see chart below). What really worries us, however, is slack corporate spending. **The Fed also confirmed that inflation was lower than initially expected and would remain so in the short term**, largely owing to low energy prices. The Fed firmly believes, however, **that this too will pass and that in the medium term inflation will reach the 2% target.** Support will come from a jobs market that continues to improve and rising consumer spending.



The Fed is keeping its options open for March. It was cautious in its comments on how the uncertain global growth outlook could affect the US economy *("The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook.")*. We will keep a close eye on economic data over the next two months as we assess the likelihood of a rise in interest rates in March.

JANUARY FOMC MEETING	DECEMBER FOMC MEETING
Information received since the Federal Open Market Committee met in December suggests that labor market conditions improved further even as economic growth slowed late last year.	Information received since the Federal Open Market Committee met in October suggests that economic activity has been expanding at a moderate pace.
[…] Survey-based measures of longer-term inflation expectations are little changed, on balance, in recent months.	[…] Some survey-based measures of longer-term inflation expectations have edged down.
Inflation is expected to remain low in the near term, in part because of the further declines in energy prices, but to rise to 2 percent over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further.	Inflation is expected to rise to 2 percent over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further.
The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook.	Overall, taking into account domestic and international developments, the Committee sees the risks to the outlook for both economic activity and the labor market as balanced.

UNITED STATES

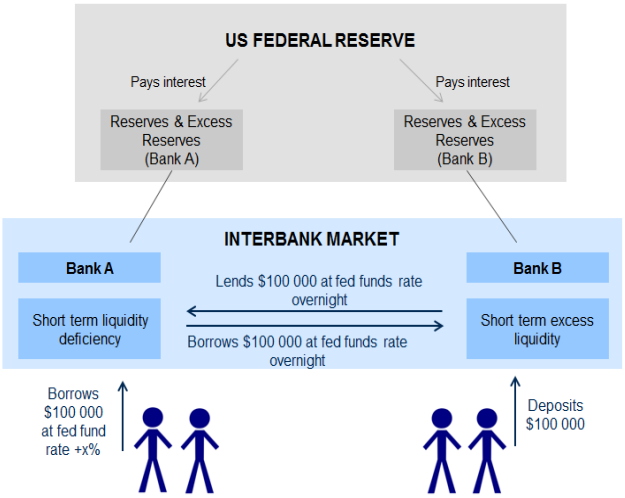
WHY DOESN'T THE FED SELL SOME ASSETS?

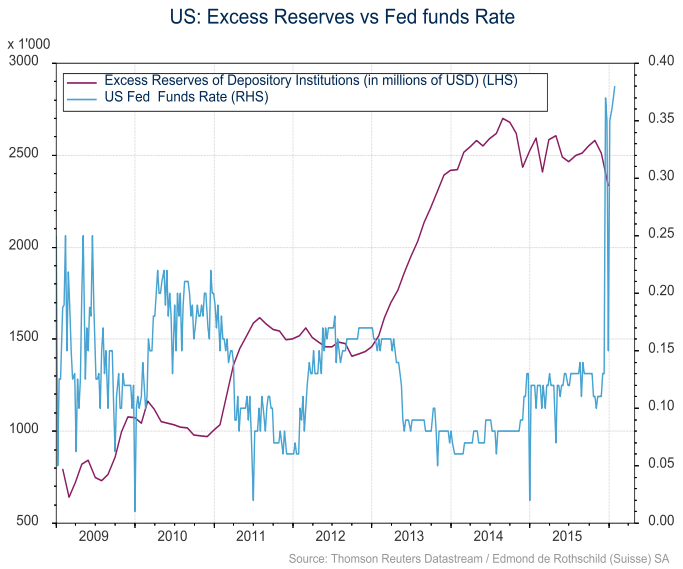
The Fed is not ready to reduce the size of its balance sheet this year. Economic agents are highly sensitive to anything that could push the fed funds rate higher, and so the question of reducing the Fed's balance sheet will not be discussed as quickly as initially expected. The Fed prefers to continue supporting the US economy without putting any upward pressure on long-term interest rates. When it comes to short-term rates, the Fed is using unprecedented methods to normalise its monetary policy.

The rate that the Fed acts through to implement its monetary policy is the **fed funds rate, also called the interbank rate.** Banks lend each other cash in order to keep up the level of reserves required by the Fed or to cover their overnight cash needs. The Fed's main lever for influencing liquidity levels is its open-market operations.

Historically, this is the monetary policy tool that the Fed turns to the most. In its open-market operations, the Fed buys securities from banks in cash. The amount of liquidity in the banking system therefore rises, the banks' reserves grow and their cash needs diminish. This leads to a decrease in interbank lending, which in turn puts downward pressure on the fed funds rate. Monetary tightening works in the opposite direction.

The Fed does not set the fed funds rate directly. It acts by adjusting the level of liquidity on the interbank market so that banks experience a need for – or a surplus of – liquidity. The desired result is that the fed funds rate hovers within the target range, which has been [0.25% to 0.5%] since 16 December 2015.



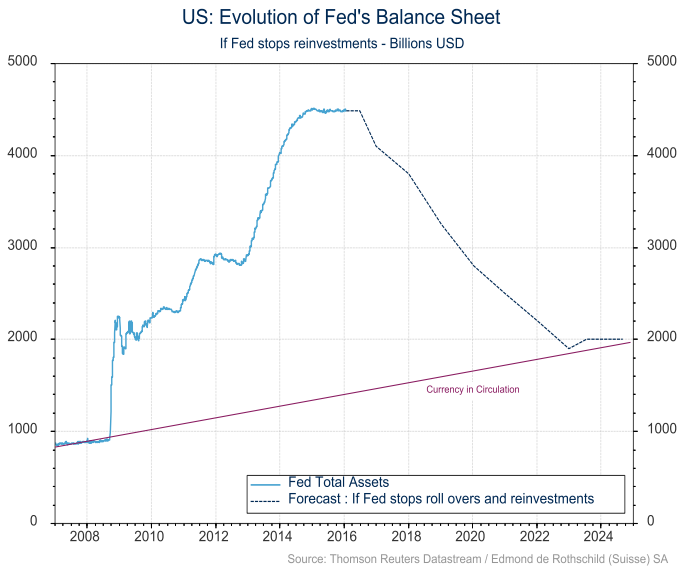


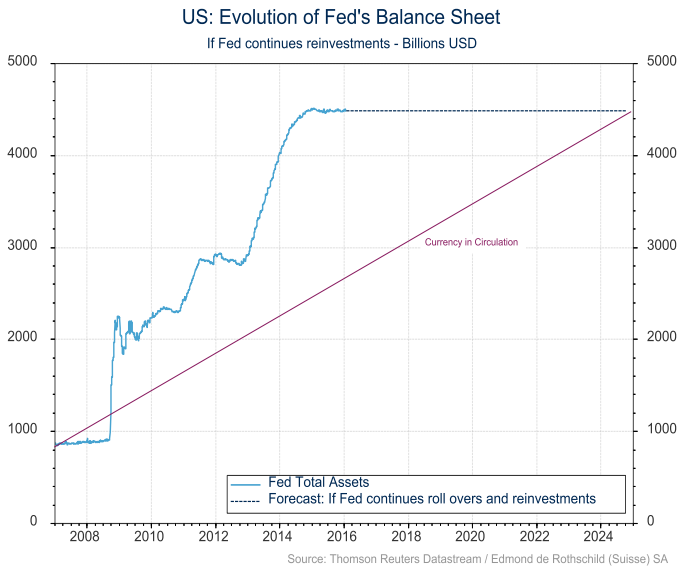
Under its **quantitative easing programme (QE), which ran from 2008 to 2014, the Fed applied downward pressure on the fed funds rate through its open-market operations.** Banks were flooded

with liquidity after selling their bonds[1] to the Fed, ending up with more than USD 2.5 trillion in reserves (see right-hand chart above). This reduced banks' structural need to borrow cash and thus partly dried up the interbank market, driving the fed funds rate downward. These low rates served the Fed's purpose of stimulating growth and spurring inflation. After seven years of this unprecedented monetary policy, the Fed decided to bring its policy back to normal by again raising this rate.

To achieve this, the most commonly used method in the past and the most obvious choice given the circumstances would be for the Fed to **sell government debt that it bought under QE (or let these bonds mature,** see left-hand chart below) **instead of replacing them as they mature**.

1. Banks would buy these bonds, which would reduce their cash levels. The fed funds rate (a short-term rate) would then rise in step with the demand for interbank lending.
2. The supply of long-term bonds on the market would increase, pushing their price downward and long-term interest rates upward.



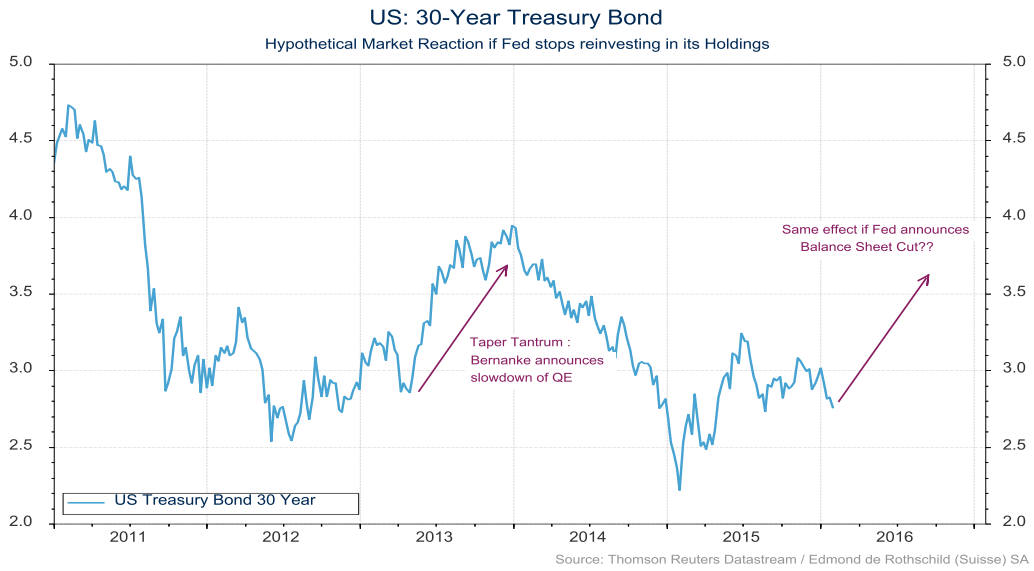


RAISING SHORT-TERM RATES, NOT LONG-TERM ONES

The Fed has a new dilemma on its hands now. **In order to avoid putting the brakes on economic activity and to support consumer credit, it does not want to put any upward pressure on long-term interest rates (see chart below)**. It focussed its efforts on the property market in 2008, when it acquired long-term consumer loans; it does not want to penalise this market too soon. **The Fed is thus refraining from reducing the size of its balance sheet in the short term, which means it continues to reinvest**

[1] Like mortgage-backed securities and federal agency bonds.

in the bonds[2] (see right-hand chart above). In a recent statement, it noted that reducing the balance sheet will be considered once the fed funds rate has largely normalised *("…and [the Fed] anticipates [reinvesting principal payments and rolling Treasuries] until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.").*



So how does the Fed raise the short-term fed funds rate and reduce banks' liquidity levels? It is using two methods: **higher interest rates on banks' excess reserves,** and **a combination of a Reverse Repurchase Program and a Term Deposit Facility**.

1. **Setting the interest paid on excess reserves** (**I**nterest **O**n **E**xcess **R**eserves – IOER) is a new tool in the Fed's monetary policy toolbox. If the Fed increases the interest rate on excess reserves, banks will have no incentive to lend money on the interbank market at a rate below what they can earn on their excess reserves.** So the fed funds rate automatically rises.
2. While the Fed can increase the fed funds rate this way, another problem arises: **surplus cash pouring into the economy.** When the economy is strong, banks can find more attractive risk-return opportunities in fixed income, or they may park their money in alternative assets (such as property or private equity) that pay more than the interest

** In reality, the fed funds rate is just below the rate applied to excess reserves. When the IOER was introduced in 2008 (at 0.25%), it was meant to serve as a floor for the fed funds rate, since banks would have no incentive to lend cash at a rate below what they were being paid for their excess reserves. But in practice, the fed funds rate ended up being lower than the IOER rate. Government-subsidised financial institutions (such as Fannie Mae and Freddie Mac) that hold reserve accounts with the Fed but are not permitted to earn interest on these accounts agreed to lend their cash at a rate that is slightly below the IOER rate. Increasing the rate paid on excess reserves therefore has a magnet effect on the fed funds rate and is used to set the upper end of the range (which is currently 0.50%).

[2] For government debt, this is referred to as rolling over, because the Fed buys the same type of debt. When it comes to MBSs and federal agency bonds, however, the Fed reinvests in them at maturities that may differ from the previous ones.

earned on excess reserves. But the risk remains of surplus cash and excess reserves flooding the real economy, which could cause overheating and drive inflation up.

A second tool designed to absorb surplus cash was therefore put into place. The **Reverse Repurchase Program (RRP)** and **Term Deposit Facility (TDF)** enable banks to lend this liquidity overnight to the Fed, which sets the interest rate it pays.

The interest rate used for RRP and TDF transactions is the lower end of the target fed funds range (currently 0.25%). But why would banks lend their cash (against collateral) to the Fed at such a low rate? The key here is that banks pay a fee on the size of their balance sheet. By lending cash to the Fed, the banks remove that amount from their balance sheet and their fee goes down.

There are two overall points to keep in mind as the Fed tightens its monetary policy:

1- For now**, the Fed** wants to avoid slowing the economy's growth and hurting the real-estate market. It is therefore **not reducing the size of its balance sheet**, which would **put upward pressure on long-term interest rates**.
2- The **Fed is controlling the rise in short-term rates** by increasing the amount of interest it pays on banks' excess reserves. And it is draining surplus liquidity from banks' balance sheets through the use of reverse repurchase agreements and term deposits.

ECONOMIC FORECASTS

Contributions to global GDP growth

Economic Activity	GDP 2014	GDP 2015 Economist Estimates	GDP 2016 Economist Estimates	Country Weights	Contribution 2016
United States	2.4%	2.4%	2.4%	23.2%	0.56%
Canada	2.4%	1.2%	1.8%	2.0%	0.04%
Euro Area	0.9%	1.5%	1.6%	14.5%	0.23%
United Kingdom	2.6%	2.2%	2.2%	4.0%	0.09%
Switzerland	1.9%	0.8%	1.2%	0.8%	0.01%
Russia	0.5%	-3.7%	-0.8%	1.9%	-0.01%
Japan	0.2%	0.6%	1.0%	4.9%	0.05%
China	7.4%	6.9%	6.5%	17.8%	1.16%
India	4.7%	7.4%	7.4%	3.6%	0.26%
Brazil	0.1%	-3.7%	-2.8%	2.1%	-0.06%
Mexico	2.1%	2.5%	2.8%	1.6%	0.04%
Others	4.4%	3.5%	4.4%	23.6%	1.04%
WORLD	**3.4%**	**3.1%**	**3.4%**	**100%**	**3.4%**

Source : Bloomberg Momentum (vs Last Estimates) Performance (Over \ Under)

Comments

- The GDP growth rates shown above are actual for 2014 and projections for 2015 and 2016.
- Each country's weighting is based on its GDP in US dollars as calculated by the World Bank.
- Contributions to global expansion are calculated by multiplying the GDP growth of each country by its weight. The sum of the contributions works out to 3.4% for 2016, a good estimate of next year's global GDP growth.

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)	375	1.9%	-6.0%	-6.0%	-1.8%
United States (S&P 500)	1'940	1.8%	-5.0%	-5.0%	1.4%
Euro Area (DJ EuroStoxx)	319	1.2%	-6.3%	-6.3%	11.2%
United Kingdom (FTSE 100)	6'004	3.1%	-2.5%	-2.5%	-1.0%
Switzerland (SMI)	8'290	0.6%	-5.7%	-5.7%	1.1%
Japan (NIKKEI)	17'865	3.3%	-8.0%	-8.0%	11.0%
Emerging (MSCI)	742	4.5%	-6.5%	-6.5%	-14.7%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.92%	1.1%	3.2%	3.2%	2.1%
Euro Area (7-10 Yr)	1.34%	1.1%	2.5%	2.5%	1.0%
Germany (7-10 Yr)	0.34%	1.3%	3.3%	3.3%	0.9%
United Kingdom (7-10 Yr)	1.59%	1.1%	3.1%	3.1%	0.7%
Switzerland (7-10 Yr)	-0.28%	0.6%	2.1%	2.1%	3.7%
Japan (7-10 Yr)	0.06%	1.2%	1.5%	1.5%	1.4%
Emerging (5-10 Yr)	5.10%	1.0%	0.7%	0.7%	1.6%
United States (IG Corp.)	3.58%	0.3%	0.5%	0.3%	-0.8%
Euro Area (IG Corp.)	1.11%	0.7%	0.9%	0.8%	-0.5%
Emerging (IG Corp.)	4.65%	0.9%	0.1%	0.1%	-2.3%
United States (HY Corp.)	9.44%	1.2%	-1.4%	-1.5%	-3.5%
Euro Area (HY Corp.)	5.85%	1.0%	-1.5%	-0.9%	0.3%
Emerging (HY Corp.)	11.17%	1.1%	-1.0%	-1.0%	3.6%
United States (Convert. Barclays)	41	0.2%	-5.3%	-5.3%	-0.8%
Euro Area (Convert. Exane)	7'207	0.0%	-3.9%	-3.9%	7.6%
Real Estate					
World (MSCI)	181	2.0%	-4.6%	-4.6%	1.0%
United States (MSCI)	192	0.6%	-4.0%	-4.0%	4.6%
Euro Area (MSCI)	207	2.0%	-1.6%	-1.6%	16.1%
United Kingdom (FTSE)	6'557	0.2%	-0.6%	-0.6%	9.4%
Switzerland (DBRB)	3'641	0.8%	0.5%	0.5%	4.6%
Japan (MSCI)	264	9.5%	-2.2%	-2.2%	0.9%
Emerging (MSCI)	87	5.3%	-12.6%	-12.6%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	550	n.a.	-0.8%	-0.8%	-0.7%
Distressed	727	n.a.	-0.7%	-0.7%	-5.3%
Event Driven	593	n.a.	-1.3%	-1.3%	-6.3%
Fixed Income	303	n.a.	0.2%	0.2%	0.6%
Global Macro	885	n.a.	-2.1%	-2.1%	0.2%
Long/Short	677	n.a.	0.0%	0.0%	3.6%
Managed Futures (CTA's)	317	n.a.	-2.2%	-2.2%	-0.9%
Market Neutral	269	n.a.	1.6%	1.6%	1.7%
Multi-Strategy	521	n.a.	0.2%	0.2%	3.8%
Short Bias	31	n.a.	4.8%	4.8%	2.4%
Commodities					
Commodities (CRB)	368	1.8%	-2.4%	-2.4%	-15.2%
Gold (Troy Ounce)	1'122	1.5%	5.7%	5.6%	-10.6%
Oil (Brent, Barrel)	35	7.2%	-7.1%	-7.1%	-35.9%
Currencies					
USD	99.3	-0.1%	0.7%	0.7%	9.3%
EUR	1.09	0.3%	0.2%	0.2%	-10.2%
GBP	1.43	0.3%	-3.0%	-3.0%	-5.4%
CHF	1.02	-0.7%	-1.8%	-1.7%	-0.8%
JPY	121.3	-2.5%	-0.6%	-0.9%	-0.4%

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

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EDMOND DE ROTHSCHILD

EDMOND DE ROTHSCHILD (SUISSE) S.A.

Rue de Hesse 18 – 1204 Geneva - T. +41 58 818 91 91
Avenue Agassiz 2 – 1003 Lausanne - T. +41 21 318 88 88
Rue de Morat 11 – 1700 Fribourg - T. +41 26 347 24 24
Beethovenstrasse 9, 8002 Zurich - T. +41 44 818 81 11

www.edmond-de-rothschild.ch