MACRO HIGHLIGHTS

WEEK OF 25 JULY 2016

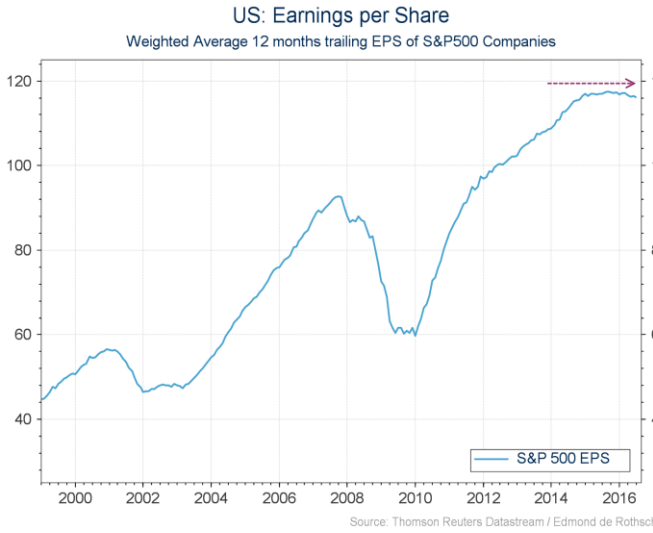
OUR HIGHLIGHTS:

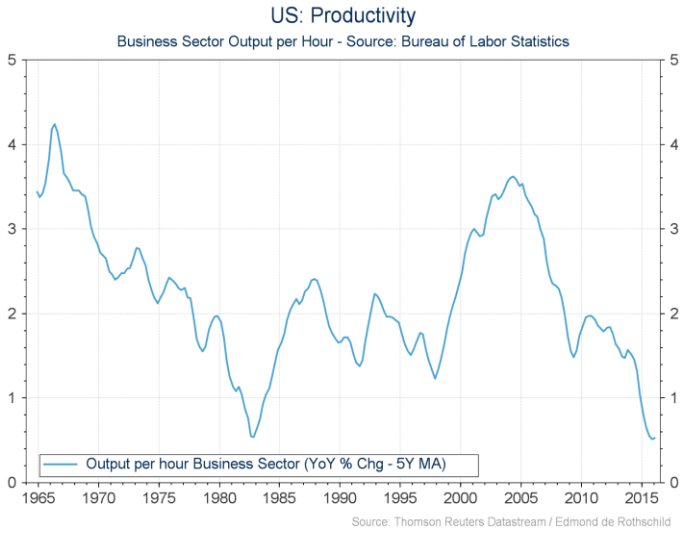
- **Our outlook of the week: When corporate earnings line up with macro trends**
  - Corporate earnings have plateaued in the past few quarters, in step with the macroeconomic scenario.
  - They could find support in GDP growth, which we still expect to be around 2%.
- **Emerging-market focus: Political limbo in Turkey following the failed coup**
  - Turkey has been caught up in a cloud of political uncertainty for some time now.
  - Domestic assets will remain under pressure, although another overthrow attempt seems unlikely.

OUR OUTLOOK OF THE WEEK: WHEN CORPORATE EARNINGS MEET UP WITH MACRO TRENDS

By Lisa Turk, Economist, US, l.turk@edr.com

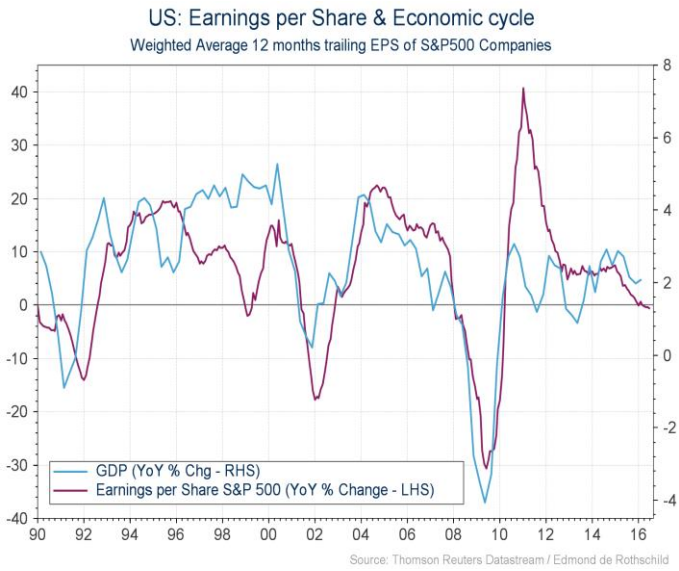
Corporate earnings in the USA have plateaued in recent quarters, in line with the macroeconomic scenario (see left-hand chart). EPS figures across the board are slightly lower in 2016 than they were in 2015.

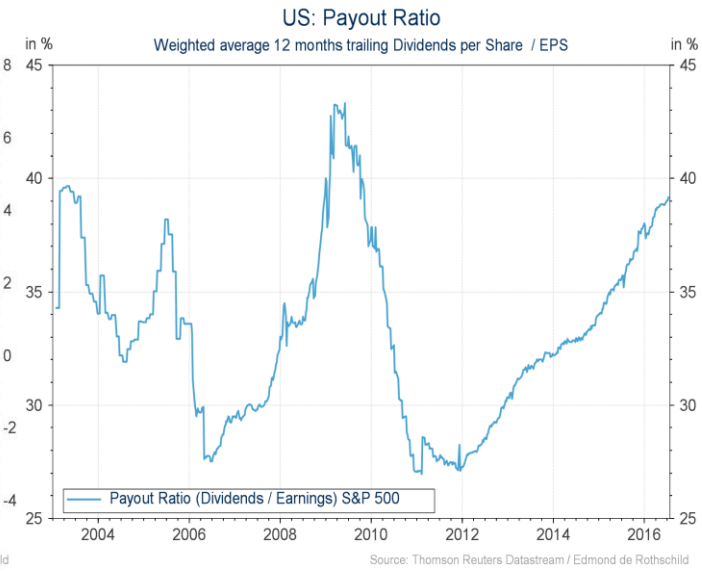




A number of macroeconomic factors are behind the soft earnings cycle in the past few months:

- a tight job market, which pushes up the wages paid by companies,
- productivity that continues to decline (see right-hand chart on the previous page), and
- lower potential GDP growth since the financial crisis, at only 2%, versus 3% between 1990 and 2007. The impact of this lower growth level is clearly reflected in sales and earnings figures. Historically, aggregate corporate earnings tend to track GDP growth (see left-hand chart below).





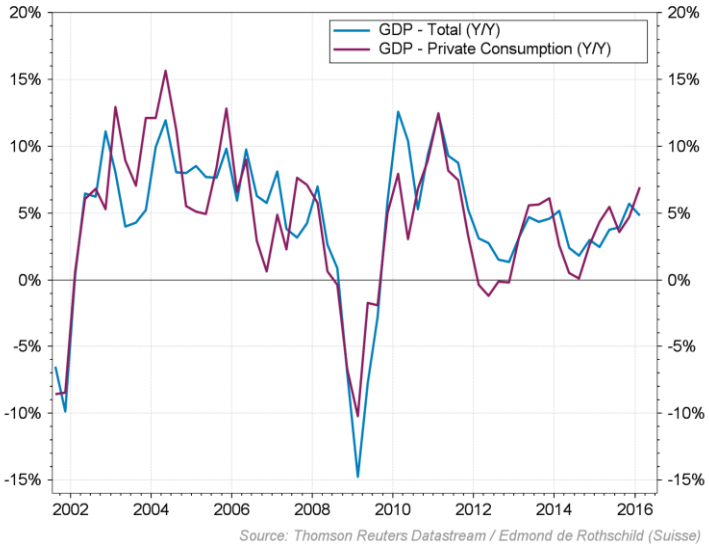
Preliminary indications that the job market is saturated suggest a late-cycle economy in the USA. **But corporate earnings growth could find support over the next few quarters in GDP growth, which we forecast at 1.9% for 2016 and 2.2% for 2017 (bracketing the potential growth level of 2%). We expect economic activity to be fuelled by the property sector and solid consumer spending**. But even if earnings remain firm, capital spending and wage increases will be contained – companies are focusing at this point on paying out a dividend and buying back their own shares (see right-hand chart above).

OUR RESEARCH FOCUS: POLITICAL LIMBO IN TURKEY FOLLOWING THE FAILED COUP

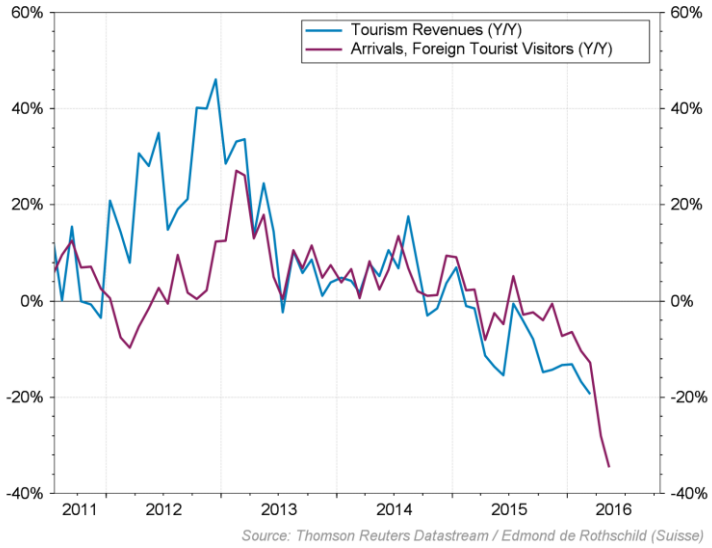
By François Léonet, Economist, Emerging countries, f.leonet@edr.com

President Recep Erdogan and Prime Minister Binali Yildirim remain in place following the aborted military coup. The overthrow attempt met with little support from the people, who filled the streets in a show of defiance against the plotters. **The experience served to strengthen President Erdogan and legitimise his efforts to modify the constitution from a parliamentary democracy to a presidential democracy**. Such a change would give the president broader decision-making authority.

Private consumption accounts for 72% of Turkey's GDP



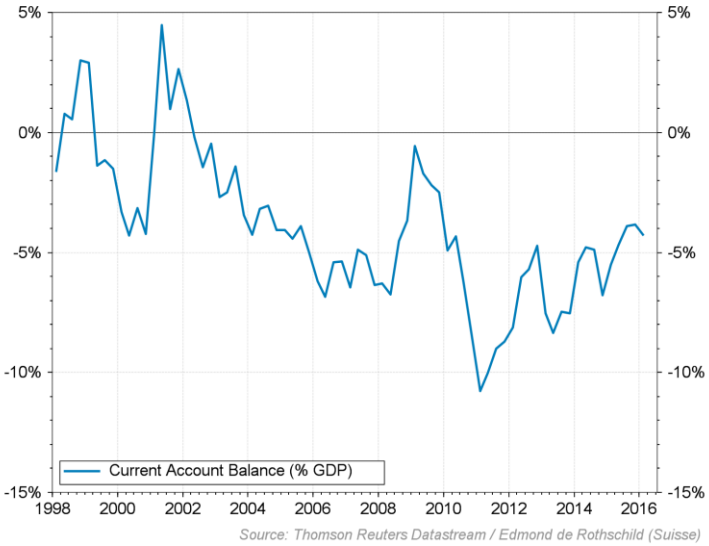
Tourism revenues are down



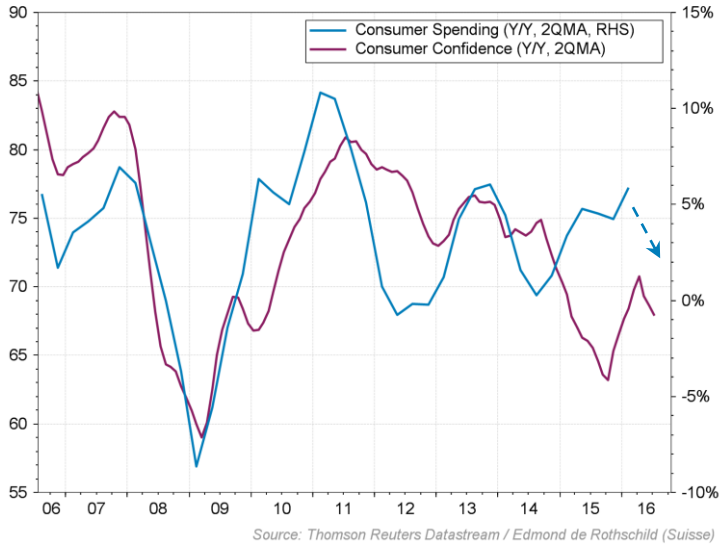
The government quickly regained control over the situation, but the political uncertainty is not over. It will affect the country's growth outlook and the valuation of domestic assets, with investors demanding more in terms of risk premium. While the coup attempt was not expected, it is not an isolated event. **Turkey has been fraught with political tensions for a long time**. These tensions are evident at the international level (exposure to the political situation in the Middle East, likelihood of further terrorist attacks and the country's role in the migrant crisis in Europe) and domestically (constitutional amendments desired by the AK Party, the chance of early elections and the Kurdish dilemma).

These sources of instability weigh heavily on investment decisions concerning a country whose net foreign asset position is one of the weakest among the major economies. The government's declaration of a three-month state of emergency and the spiral of arrests – mainly among civil servants, judges and teachers – create institutional uncertainty that will complicate economic matters and hold back investment. Nor will these developments help get the tourism sector – 4% of GDP and a key source of foreign currencies – out of its current rut (see right-hand chart above).

Turkey's current account balance has long been a concern



Lower confidence weighs on consumer spending



The current account deficit has improved recently but remains high at 4.1% of GDP. This means that the country depends on foreign financing, which is mainly in the form of foreign bank loans along with bond flows (see left-hand chart).

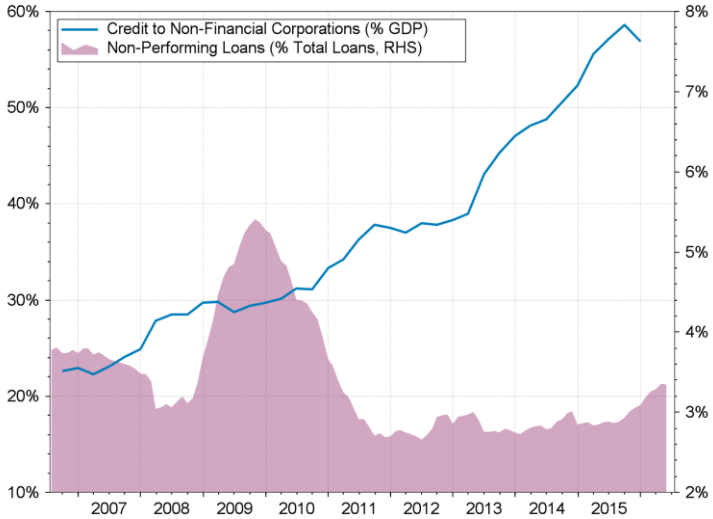
While the consequences of the coup attempt remain to be assessed, **the Central Bank of the Republic of Turkey (CBRT) reacted carefully by moderating its reflationary monetary policy**. It trimmed its overnight lending rate by only 0.25% to 8.75%, which is a smaller cut than in recent months (-0.5%). The decision to keep key rates relatively high was aimed at stabilising the lira, which is needed to ensure foreign capital inflows. This monetary tweaking seems judicious given the low chances of another overthrow attempt. The upper ranks of the Turkish military were not involved in the coup, and the scope of arrests and suspensions – some 60,000 people are said to be affected – is certainly dissuasive. Once current tensions abate, selling pressure on the lira subsides and capital flows stabilise, the central bank will resume its monetary policy cycle.

Persistent worries and a shortage of foreign capital flows would eventually have a negative impact. The CBRT cannot afford to keep interest rates high for too long because of the dampening effect on private consumption and demand for credit. The low level of foreign currency reserves limits the scope for open-market operations, while high external debt is another constraint. This scenario would call for a significant cut to interest rates in order to boost domestic economic activity. Forex would be the adjustment variable in this case, as a sharp drop in the lira would spark inflation, cut into consumer spending and directly threaten GDP growth.

The shock of uncertainty following the coup attempt is bound to disappear sooner or later. That said, international investors will probably require a higher return to hold Turkish assets, as the political risk will

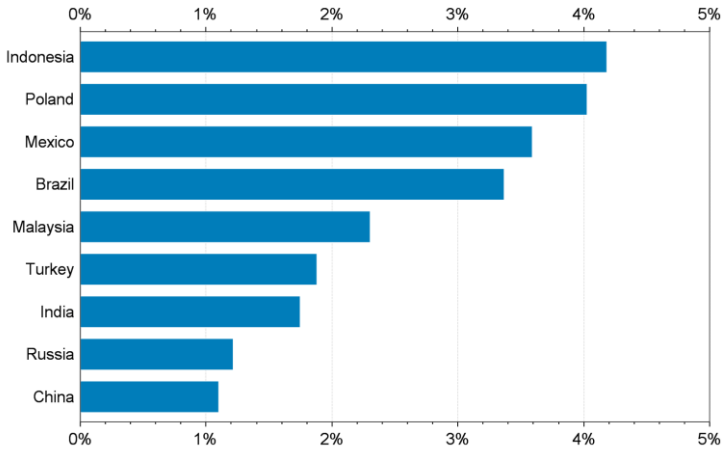
remain more acute for a long time to come. **President Erdogan's ability to bring the situation under control was good news, but his insistence on expanding his own decision-making authority is fuelling fears of authoritarianism. This will destabilise the business environment** and lead to a decrease in investment in the country.

Private debt rose sharply



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

Emerging markets: some examples of real returns



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

Domestic assets are therefore expected to remain under pressure. Real returns on the bond market, for example, are certainly attractive compared to those of developed countries but are not much better than what can be found in other emerging countries with lower political risk. The boom in private debt in recent years raises two important questions – that of refinancing the loans and bad debts – especially since the banking sector accounts for 41% of the domestic stock index (see left-hand chart). Unfavourable comments by the rating agencies will not help matters.

AFTER SHORT SUMMER BREAK, WE WILL RESUME PUBLISHING THIS REPORT ON 22 AUGUST

ECONOMIC FORECASTS

Contributions to global GDP growth

Economic Activity	GDP 2015	GDP 2016 Economist Estimates	GDP 2017 Economist Estimates	Country Weights	Contribution 2016
United States	2.4%	1.9%	2.2%	23.6%	14.5%
Canada	1.2%	1.3%	2.0%	1.9%	0.8%
Euro Area	1.5%	1.5%	1.2%	14.5%	7.0%
Germany	1.5%	1.5%	1.3%	4.2%	2.0%
France	1.1%	1.4%	1.1%	2.9%	1.3%
United Kingdom	2.2%	1.5%	0.5%	3.5%	1.6%
Switzerland	0.8%	1.0%	1.5%	0.7%	0.2%
Russia	-3.7%	-0.8%	1.3%	1.6%	-0.4%
Japan	0.6%	0.5%	0.8%	5.1%	0.8%
China	6.9%	6.5%	6.3%	18.4%	38.6%
India	7.4%	7.5%	7.7%	3.4%	8.3%
Brazil	-3.7%	-3.5%	1.0%	1.9%	-2.1%
Mexico	2.5%	2.4%	2.7%	1.5%	1.2%
Others	3.9%	4.8%	6.0%	16.7%	26.1%
WORLD	**3.1%**	**3.1%**	**3.4%**	**100%**	**100%**

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

Comments

- The GDP growth rates shown above are actual for 2015 and projections for 2016 and 2017.
- 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 3.2% for 2016, a good estimate of this 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)	412	0.0%	6.3%	4.9%	-1.8%
United States (S&P 500)	2'171	0.1%	6.6%	7.4%	1.4%
Euro Area (DJ EuroStoxx)	320	1.0%	6.7%	-4.8%	11.2%
United Kingdom (FTSE 100)	6'729	0.2%	9.4%	10.1%	-1.4%
Switzerland (SMI)	8'229	0.4%	5.9%	-3.8%	1.1%
Japan (NIKKEI)	16'383	0.7%	11.3%	-11.8%	11.0%
Emerging (MSCI)	869	0.0%	8.5%	11.3%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.58%	0.1%	-0.1%	6.9%	2.1%
Euro Area (7-10 Yr)	-0.03%	0.1%	1.4%	6.3%	1.0%
Germany (7-10 Yr)	-0.03%	0.2%	0.5%	7.2%	0.9%
United Kingdom (7-10 Yr)	0.83%	0.1%	2.0%	9.3%	0.7%
Switzerland (7-10 Yr)	-0.52%	-0.3%	0.0%	4.0%	3.7%
Japan (7-10 Yr)	-0.25%	0.1%	0.6%	4.6%	1.4%
Emerging (5-10 Yr)	4.33%	0.0%	3.0%	11.1%	1.6%
United States (IG Corp.)	2.82%	0.1%	1.7%	8.6%	-0.8%
Euro Area (IG Corp.)	0.50%	0.2%	1.9%	5.6%	-0.5%
Emerging (IG Corp.)	3.62%	0.2%	2.7%	10.1%	-2.3%
United States (HY Corp.)	6.63%	0.3%	3.3%	12.9%	-3.5%
Euro Area (HY Corp.)	3.47%	0.4%	2.7%	5.5%	0.3%
Emerging (HY Corp.)	7.59%	0.5%	3.1%	14.8%	3.6%
United States (Convert. Barclays)	46	0.8%	6.2%	7.1%	-0.8%
Euro Area (Convert. Exane)	7'237	0.6%	2.3%	-3.5%	7.6%
Real Estate					
World (MSCI)	210	1.5%	7.6%	12.7%	1.0%
United States (MSCI)	225	1.3%	7.6%	14.3%	4.6%
Euro Area (MSCI)	233	3.5%	8.7%	14.8%	16.1%
United Kingdom (FTSE)	6'428	0.0%	-3.4%	-2.5%	9.4%
Switzerland (DBRB)	3'864	0.2%	3.3%	7.7%	4.6%
Japan (MSCI)	246	2.0%	7.9%	-7.9%	0.9%
Emerging (MSCI)	104	0.7%	3.1%	7.1%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	541	n.a.	-0.1%	-1.6%	-0.7%
Distressed	727	n.a.	-0.5%	0.0%	-5.3%
Event Driven	578	n.a.	-0.5%	-2.5%	-6.3%
Fixed Income	302	n.a.	-0.5%	-0.2%	0.6%
Global Macro	871	n.a.	0.7%	-1.5%	0.2%
Long/Short	643	n.a.	-1.9%	-5.0%	3.6%
Managed Futures (CTA's)	323	n.a.	4.2%	2.0%	-0.9%
Market Neutral	260	n.a.	-2.5%	-3.5%	1.7%
Multi-Strategy	525	n.a.	-0.1%	0.7%	3.8%
Short Bias	29	n.a.	-1.4%	-7.2%	2.4%
Commodities					
Commodities (CRB)	420	-2.4%	-0.6%	10.9%	-15.2%
Gold (Troy Ounce)	1'320	-1.0%	-0.2%	24.3%	-10.6%
Oil (Brent, Barrel)	43	-5.1%	-7.6%	21.3%	-35.9%
Currencies					
USD	97.1	0.1%	1.8%	-1.5%	9.3%
EUR	1.10	-0.3%	-0.3%	1.2%	-10.2%
GBP	1.31	0.1%	-0.7%	-10.9%	-5.4%
CHF	0.99	-0.6%	-1.3%	1.0%	-0.8%
JPY	104.7	1.3%	-2.6%	14.8%	-0.4%

Source : Bloomberg

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

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