



MACRO HIGHLIGHTS & STRATEGY

APRIL 11TH 2016

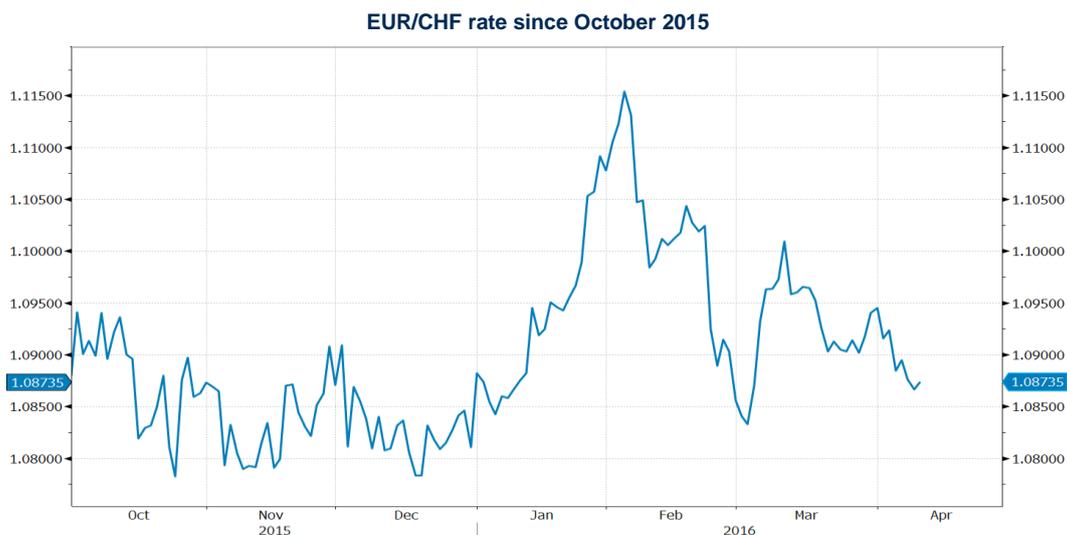
OUR ROUNDUP:

- ▶ **Markets: The Swiss franc cannot fall “naturally”**
 - The SNB has taken over the job of investing abroad from Swiss companies.
 - As long as that is the case, the franc will not be able to weaken sustainably.
- ▶ **United States: The Fed ignores the Taylor Rule**
 - The fed funds rate deviates considerably from its “optimal” level.
 - Fed independence is essential for the US economy’s long-term stability.

MARKETS

THE SWISS FRANC CANNOT FALL "NATURALLY"

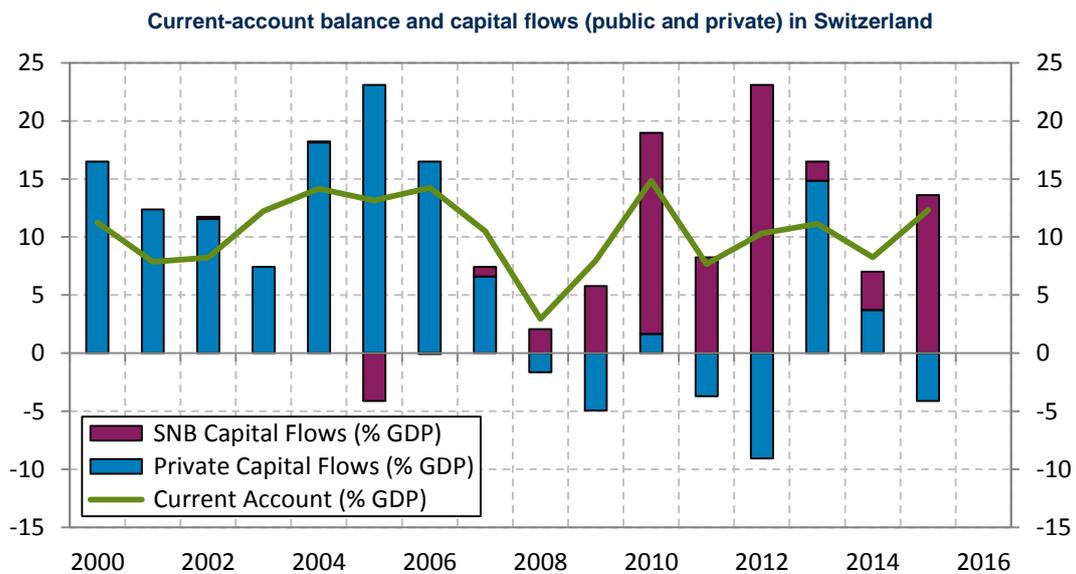
The Swiss franc suddenly lost ground against the euro in January. By 4 February the EUR/CHF rate reached 1.1200, its highest level since the Swiss National Bank (SNB) scrapped its euro/franc floor rate on 15 January 2015. Now it has come back down to 1.0873 (see chart below).





A number of factors would argue for a weaker franc, the first being that it is already grossly overvalued. In terms of purchasing power parity (PPP), for example, its fair value against the euro would be about 1.30. So by that measure, the franc's depreciation in January is easy to justify. **Yet other forces are keeping the Swiss currency high and could push it higher still.** They include Switzerland's positive current-account balance, the franc's real interest rate differentials, its safe-haven status, the risk of Brexit in the UK and currency speculation.

Besides the uneasy balance between these variables, **we would like to emphasise another key point: the Swiss franc does not fall "naturally".** When it weakens from time to time, as it did in January, this is because the central bank is at work behind the scenes. It lowered its deposit rate to -0.75% a bit over a year ago and continues to intervene massively in the forex market. Since the onset of the 2008 financial crisis **the SNB has taken over the job of investing abroad from Swiss exporters**, who have stopped doing so (see chart below). It has exported capital by buying foreign currency with francs.



So far this year the SNB has already added some CHF 16 billion to its assets. This is revealed in the constantly rising value of sight deposits, indicating that the movement is not over.

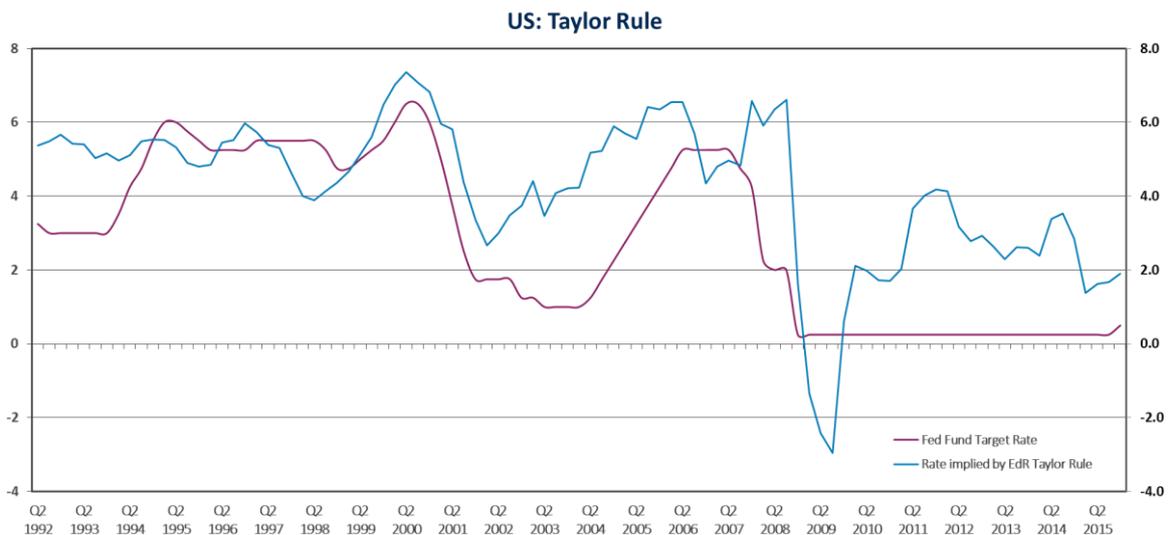
Clearly the Swiss franc is unable to weaken "naturally". The SNB does what it can but cannot work miracles. This situation is reinforced by current economic, political and financial conditions. In the coming quarters the EUR/CHF exchange rate will likely go on ranging between 1.02 and 1.12. Swiss francs are worth holding onto.



UNITED STATES

THE FED IGNORES THE TAYLOR RULE

The US presidential candidates have not missed the opportunity to question the power of the Federal Reserve (Fed) and the independence of its monetary policy. The 2015 Federal Reserve Transparency Act, designed to hold the Fed accountable for its actions and make it adopt **a clear, predetermined rule for setting its key interest rates**, is currently in the hands of the Senate. The proposed rule is an equation indicating the adjustment to be made to the federal funds rate, at any given time, depending on changes in inflation and economic growth. The famous Taylor Rule, to which the Fed occasionally refers, deals with this subject. The bill before the US Senate marks a reaction to **the zero interest rate policy which the Fed pursued from 2009 to 2015 and which deviated considerably from the interest rate recommended by the Taylor Rule** (see chart below and box on p.4).



The two schools

The debate is nothing new. Two schools of thought have opposed each other for years regarding what they see as the optimal method for achieving the price stability and full employment objectives that comprise the Fed's mandate. Should the US central bank be using a discretionary policy like the one it pursues now or should it follow a stricter mathematical formula instead?

- Some think that following a **Taylor-type rule** is a simple, transparent method that consumers, companies and investors could easily understand. It would enable them to anticipate the Fed's monetary policy and thus prevent uncertainty. This school accuses the Fed of straying too far from



the optimal rate measured by the classic Taylor Rule and thus of having been too accommodative for too long after the financial crisis.

- Others think that a method like the one currently used by the Fed, which includes **a qualitative judgment by the governors**, is more flexible and therefore better suited to the cyclical nature of the American economy. It allows the Fed to react to economic data and the expectations of economic agents. Though less foreseeable for the markets, it confers greater independence on the Fed governors and enables them to respond to crises better.

The Taylor Rule

In 1933 the US economist John Taylor proposed an equation to determine **the optimal** key interest rate based on the following economic variables:

$$\begin{aligned}
 \text{Key rate} &= \underbrace{r^*}_{\text{Real equilibrium interest rate}} + \underbrace{i}_{\text{One-year inflation rate}} + \underbrace{0.5 \times (i - i^*)}_{\text{Gap between current inflation rate and Fed target rate}} + \underbrace{0.5 \times (y - y^*)}_{\text{Gap between real GDP and potential GDP}} \\
 &= \underbrace{r^*}_{\text{Real equilibrium growth rate}} + \underbrace{i}_{\text{One-year inflation rate}} + \underbrace{0.5 \times (i - i^*)}_{\text{Gap between current inflation rate and Fed target rate}} + \underbrace{0.5 \times (y - y^*)}_{\text{Gap between real GDP and potential GDP}} \\
 &= \underbrace{r^* + i}_{\text{Nominal growth rate}} + \underbrace{0.5 \times (i - i^*) + 0.5 \times (y - y^*)}_{\text{Changes depending on overheating or contraction}}
 \end{aligned}$$

* = variables with an * are unknowns that have to be approximated

i^* = inflation rate that ensures medium-/long-term price stability, set by the Fed at 2%

y^* = potential GDP, i.e. the sustainable, long-term trend level that an economy can reach if all its production facilities are used in a context of full employment and stable inflation

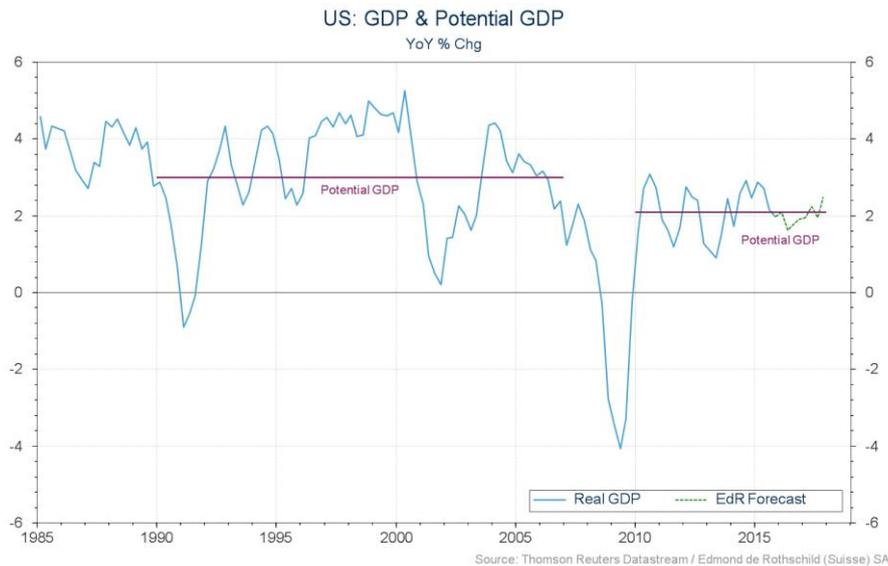
r^* = real equilibrium interest rate, i.e. the rate that is compatible with balanced long-term economic growth (GDP at trend and stable inflation).

r^* is commonly equated with real potential growth y^* .

Simply stated, **the Taylor Rule uses growth (r^*) and inflation (i) to calculate the optimal level for the US federal funds rate.** In John Taylor's initial study r^* was set at 2%. Today it is widely agreed that r^* should be equated with the real potential growth rate (see chart below). The fed funds rate is thus based on a stable nominal rate of potential growth which is adjusted up or down if the US economy is overheating or contracting. **Changes to the fed funds rate therefore mainly depend on two pairs:**

- the gap between actual inflation and the target rate ($0.5 \times (i - i^*)$)
- the gap between actual growth and its potential rate ($0.5 \times (y - y^*)$)

The rule recommends an accommodative monetary policy (with low interest rates) when growth is below trend or when inflation is below its 2% target. It recommends a restrictive policy (with high interest rates) in the opposite case.

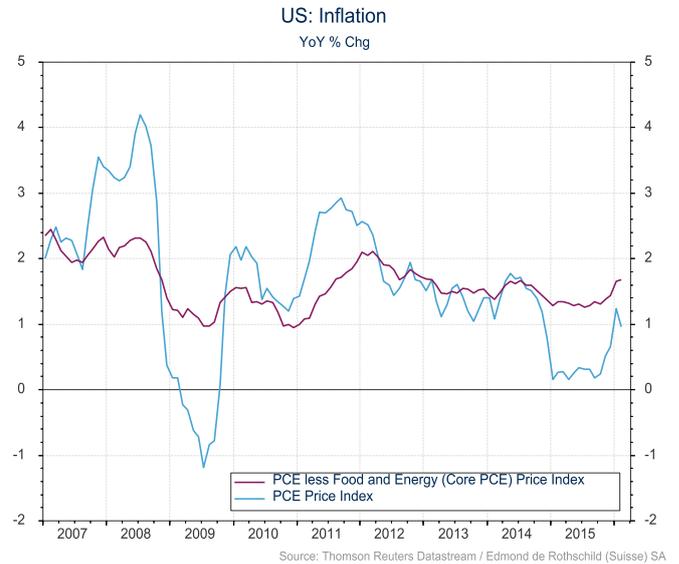
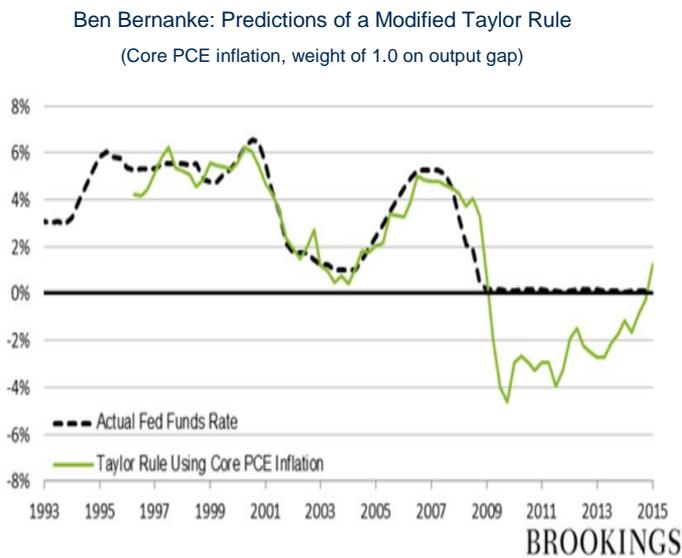


Why has Fed policy deviated from the Taylor Rule?

Based on growth and inflation data, the Taylor Rule has recommended a federal funds rate of about **2% since 2011, well above the zero rate set by the Fed** (see chart on p.3). Even though former Fed Chairman Ben Bernanke succeeded in devising a modified Taylor Rule, recommending a rate below zero between 2009 and 2015 (see left-hand chart on following page), the Fed mainly used its discretionary power to set monetary policy during that period.

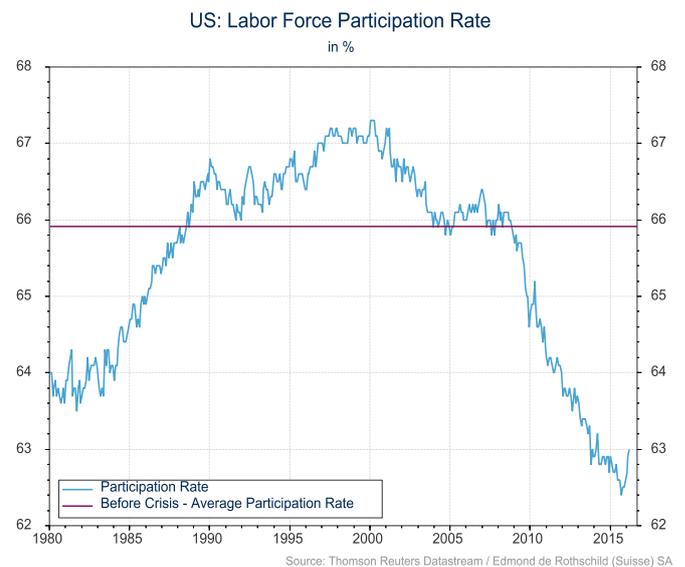
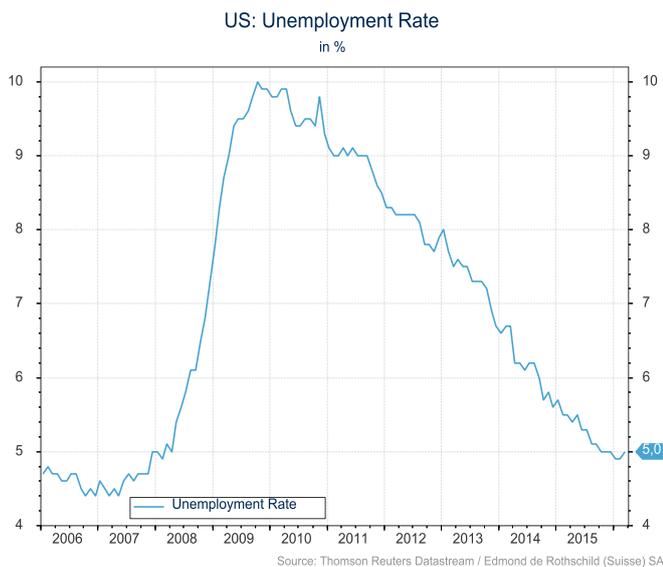
Some factors actually argue for a higher federal funds rate:

- **The core inflation rate**, which excludes food and energy prices, **has been around 1.5% a year** since 2009 (see right-hand chart on following page). That is below the Fed's 2% target, but not far enough below to justify zero interest rates.
- Real GDP has risen by roughly 2% a year on average over the same period, in line with its new potential rate (see chart above), requiring a higher key interest rate than the one set by the Fed.



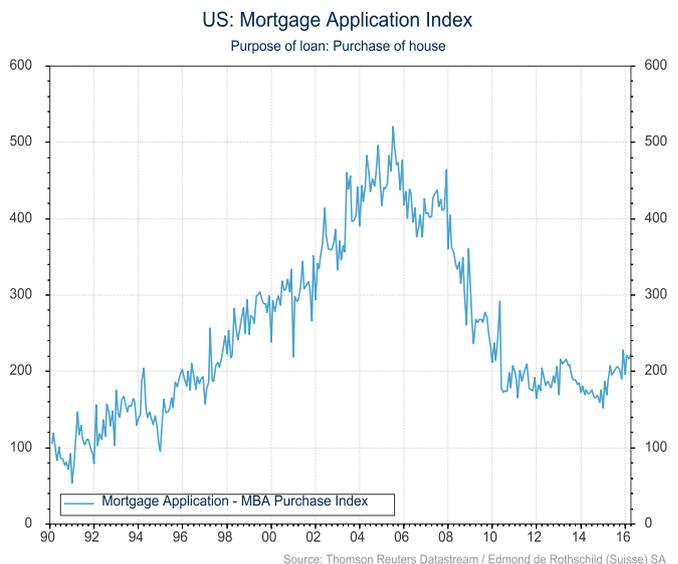
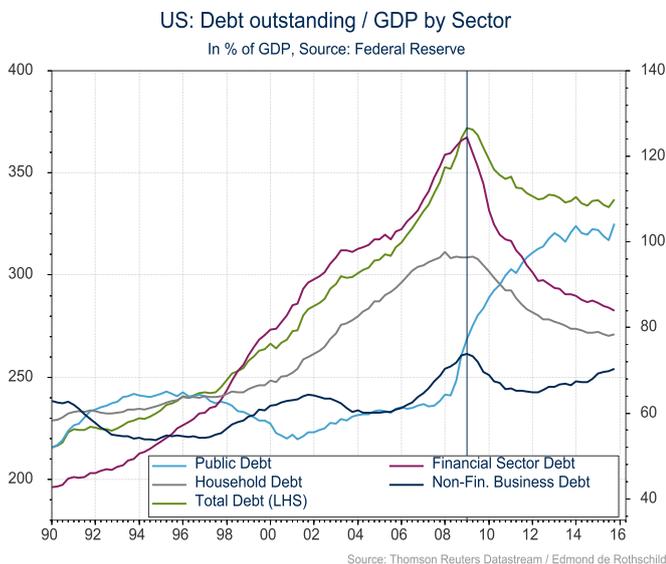
But the monetary policy pursued by the Fed until end-2015 was justified by many other factors that are not included in the Taylor model.

- First of all, the US economic recovery would not have been as strong if the Fed had not kept interest rates at zero and had not introduced quantitative easing (QE) over that long period. Moreover the frequent changes to the federal funds rate recommended by the Taylor Rule deterred the governors from following it.
- **Given the unprecedented scale of the financial crisis**, Bernanke did everything in his power to eliminate systemic risk and prevent Japanese-style deflation compounded by recession. Ultra-accommodative monetary policy over a protracted period seemed the only answer.





- **It took time for the US labour market to firm up again.** The unemployment rate did not fall back to its pre-crisis level until last year (see left-hand chart on previous page). Wage growth was stagnant and the US working population shrank significantly (see right-hand chart on previous page). Until end-2015 the Fed did not want to raise rates in view of the persistently low utilisation of labour.
- **The US consumer credit market struggled to recover after the subprime implosion.** Initially only non-financial companies and state governments started borrowing again (see left-hand chart below). Households and financial institutions still lacked confidence. The devastated mortgage industry likewise went through a painful process of adjustment.



Since last year, however, the US labour and credit markets have improved considerably. Job creation is robust again and mortgage lending is increasing (see right-hand chart below). But while these developments explain why the Fed started normalising its monetary policy in December, they do not warrant a quick alignment of the federal funds rate with the Taylor Rule. The Fed's policy committee still disagrees on the domestic economic outlook and the present international environment does not call for aggressive monetary tightening.

The Fed should continue to rely on the qualitative judgment of its Open Market Committee to set monetary policy. **Forcing it to follow the Taylor Rule in lock-step, for the sake of greater transparency, could turn out to be counter-productive.** Concessions by Congress will therefore be necessary to preserve the central bank's **independence, an essential prerequisite for the long-term stability of the American economy.** Since the onset of its current tightening cycle, the Fed has used its discretionary power wisely. When the markets reeled in January and February, the dollar shed 3.7% of its value, the S&P 500 finally steadied and the 10-year Treasury yield fell from 2.3% to 1.7%.



ECONOMIC FORECASTS

Contributions to global GDP growth

Economic Activity	GDP 2014	GDP 2015	GDP 2016 Economist Estimates	Country Weights	Contribution 2016
United States	2.4%	↓ 2.4%	↓ 2.0%	23.2%	13.6%
Canada	2.4%	→ 1.2%	↑ 1.6%	2.0%	0.9%
Euro Area	0.9%	→ 1.5%	→ 1.5%	14.5%	6.4%
Germany	1.6%	→ 1.5%	↑ 1.6%	4.2%	2.0%
France	0.4%	↓ 1.1%	↓ 1.3%	3.1%	1.2%
United Kingdom	2.6%	↓ 2.2%	↓ 1.9%	4.0%	2.2%
Switzerland	1.9%	↓ 0.8%	→ 1.2%	0.8%	0.3%
Russia	0.5%	↑ -3.7%	↑ -1.3%	1.9%	-0.7%
Japan	0.2%	→ 0.6%	→ 0.6%	4.9%	0.9%
China	7.4%	→ 6.9%	→ 6.5%	17.8%	34.0%
India	4.7%	→ 7.4%	→ 7.5%	3.6%	7.9%
Brazil	0.1%	↓ -3.7%	→ -3.6%	2.1%	-2.2%
Mexico	2.1%	→ 2.5%	↑ 2.5%	1.6%	1.1%
Others	5.8%	4.4%	6.7%	16.4%	32.4%
WORLD	3.4%	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 2014 and 2015 and projections for 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 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)	394	↓	-0.5%	↑	2.9%		-0.6%		-1.8%
United States (S&P 500)	2'048	↓	-1.2%	↑	3.6%		0.8%		1.4%
Euro Area (DJ EuroStoxx)	316	↓	-1.0%	↓	-1.2%		-8.8%		11.2%
United Kingdom (FTSE 100)	6'206	↑	1.1%	↓	1.7%		0.8%		-1.0%
Switzerland (SMI)	7'792	↑	1.8%	↓	-1.5%		-9.8%		1.1%
Japan (NIKKEI)	15'751	↓	-2.1%	↓	-5.1%		-16.2%		11.0%
Emerging (MSCI)	817	↓	-1.1%	↑	3.9%		3.2%		-14.6%
Bonds (Bloomberg/EFFAS)									
United States (7-10 Yr)	1.74%	↑	0.5%	↑	1.4%		5.3%		2.1%
Euro Area (7-10 Yr)	1.19%	↑	0.2%	↓	0.7%		4.3%		1.0%
Germany (7-10 Yr)	0.12%	↑	0.4%	↓	0.7%		5.3%		0.9%
United Kingdom (7-10 Yr)	1.41%	↑	0.4%	↓	0.3%		5.0%		0.7%
Switzerland (7-10 Yr)	-0.36%	↑	0.2%	↓	-0.5%		3.0%		3.7%
Japan (7-10 Yr)	-0.09%	↑	0.1%	↓	-0.2%		3.0%		1.4%
Emerging (5-10 Yr)	4.70%	↓	0.1%	↑	2.0%		5.2%		1.6%
United States (IG Corp.)	3.12%	↓	0.6%	↑	2.8%		4.5%		-0.8%
Euro Area (IG Corp.)	0.80%	↓	0.3%	↑	1.5%		3.0%		-0.5%
Emerging (IG Corp.)	4.07%	↓	0.2%	↑	2.1%		4.6%		-2.3%
United States (HY Corp.)	8.29%	↓	0.3%	↑	2.0%		4.0%		-3.5%
Euro Area (HY Corp.)	4.76%	↓	0.1%	↑	2.1%		2.1%		0.3%
Emerging (HY Corp.)	9.51%	↓	0.0%	↑	2.7%		5.4%		3.6%
United States (Convert. Barclays)	43	↓	-0.4%	↑	2.9%		0.9%		-0.8%
Euro Area (Convert. Exane)	7'154	↓	0.0%	↑	0.8%		-4.6%		7.6%
Real Estate									
World (MSCI)	197	↓	0.5%	↑	5.8%		4.7%		1.0%
United States (MSCI)	208	↓	-0.2%	↑	7.0%		4.8%		4.6%
Euro Area (MSCI)	222	↓	1.3%	↑	8.8%		6.6%		16.1%
United Kingdom (FTSE)	6'632	↓	0.2%	↑	0.9%		0.6%		9.4%
Switzerland (DBRB)	3'754	↑	1.0%	↑	2.0%		4.6%		4.6%
Japan (MSCI)	252	↑	-0.5%	↓	-2.8%		-5.7%		0.9%
Emerging (MSCI)	99	↓	-0.1%	↑	4.1%		-0.1%		-6.8%
Hedge Funds (Dow Jones)									
Hedge Funds Industry	536		n.a.	↑	-1.1%		-2.5%		-0.7%
Distressed	709		n.a.	↓	-1.2%		-2.5%		-5.3%
Event Driven	564		n.a.	↑	-1.8%		-4.8%		-6.3%
Fixed Income	297		n.a.	↓	-1.1%		-1.8%		0.6%
Global Macro	866		n.a.	↓	-1.6%		-2.1%		0.2%
Long/Short	647		n.a.	↓	-1.8%		-4.5%		3.6%
Managed Futures (CTA's)	340		n.a.	↑	3.2%		7.4%		-0.9%
Market Neutral	264		n.a.	↓	-0.7%		-1.9%		1.7%
Multi-Strategy	514		n.a.	↓	-0.8%		-1.3%		3.8%
Short Bias	33		n.a.	↓	-3.1%		6.1%		2.4%
Commodities									
Commodities (CRB)	383	↓	-0.1%	↓	0.9%		1.0%		-15.2%
Gold (Troy Ounce)	1'248	↑	2.5%	↓	-0.9%		17.5%		-10.6%
Oil (Brent, Barrel)	41	↑	8.3%	↓	5.3%		14.7%		-35.9%
Currencies									
USD	94.1	↑	-0.4%	↓	-2.2%		-4.6%		9.3%
EUR	1.14	↓	0.1%	↑	2.2%		5.0%		-10.2%
GBP	1.42	↑	-0.2%	↓	-1.0%		-3.4%		-5.4%
CHF	0.95	↓	0.4%	↑	2.9%		5.0%		-0.8%
JPY	108.2	↑	2.9%	↑	5.2%		11.1%		-0.4%

Source : Bloomberg

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

Performance (Negative \ Positive)



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