MACRO HIGHLIGHTS & STRATEGY

MARCH 14TH 2016

OUR ROUNDUP:

- Can the dollar still rise against the euro?
- Paperchase in China
- Is the Mexican peso overvalued?

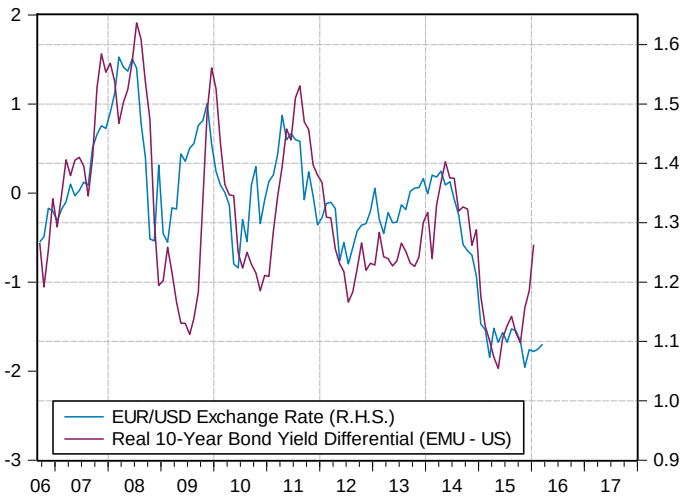
MARKETS

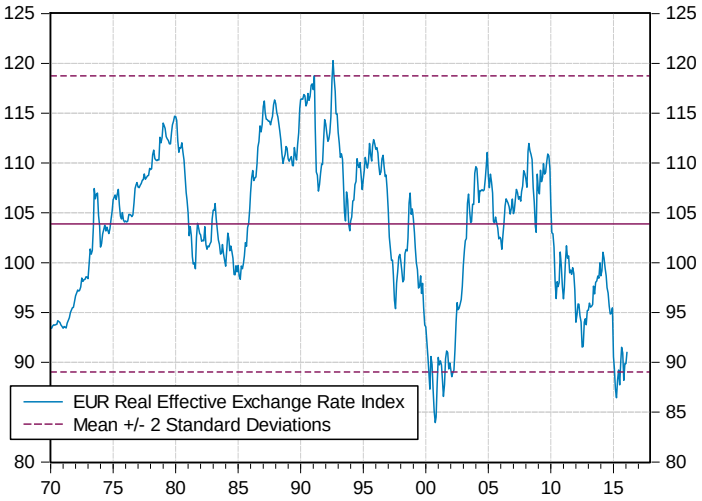
CAN THE DOLLAR STILL RISE AGAINST THE EURO?

Since hitting a low in 2011, the dollar has consistently risen against most other currencies. Can this trend continue, or is it reaching an end? On the other side of the equation, the euro hasn't stopped losing ground, especially since May 2014. In a very convincing speech, Mario Draghi noted that, in a low-inflation environment, the strength of the single currency is a *"cause for concern"*. Could the euro depreciate further, or is it now bottoming out? Let's have a look at the factors that affect the most scrutinised exchange rate on the planet.

EUR/USD exchange rate and yield differential

Euro: real effective exchange rate (JPM)





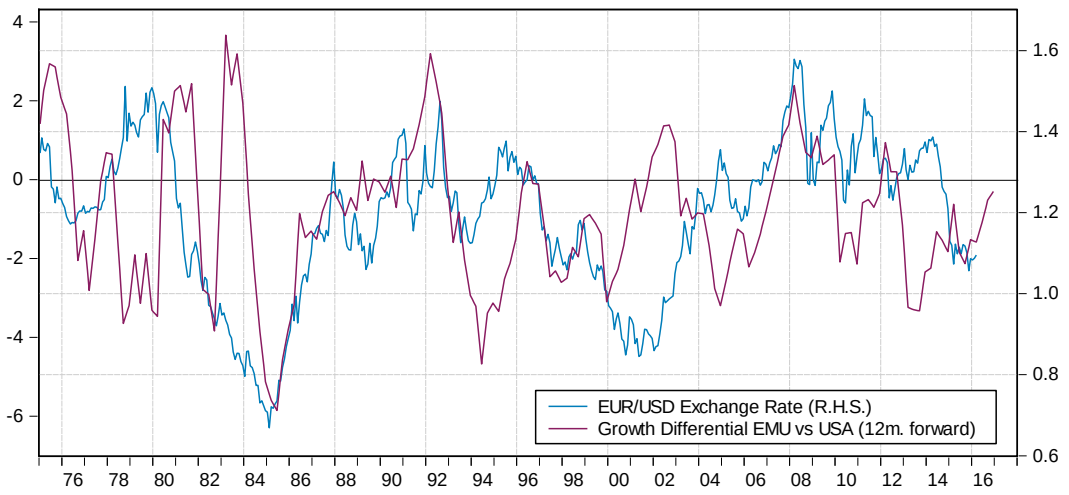
We will begin with factors that could push the euro up and the dollar down:

- **The first point – one of two crucial points in our analysis – is that the real yield differential very clearly favours a rise in the euro** (see left-hand chart on the first page). This indicator shows that real US yields are falling significantly faster than European ones, but this owes solely to the rise in US inflation. This trend could however be dampened in the near future, either by a drop in prices in the USA or by an offsetting rise in dollar yields.

- More broadly, looking at the euro's performance against all other currencies, the real effective exchange rate is 2 standard deviations below its long-term average (see right-hand chart on the first page). This type of situation arises occasionally but should not last long.

- The growth differential becomes less penalising for the euro, since growth in the eurozone tends to accelerate while it slows in the USA (see chart below). The impact of this factor could decline because economic activity in the eurozone is losing steam. Indeed, consumer spending figures point to slowing momentum in the next few quarters.

EUR/USD exchange rate and growth differential



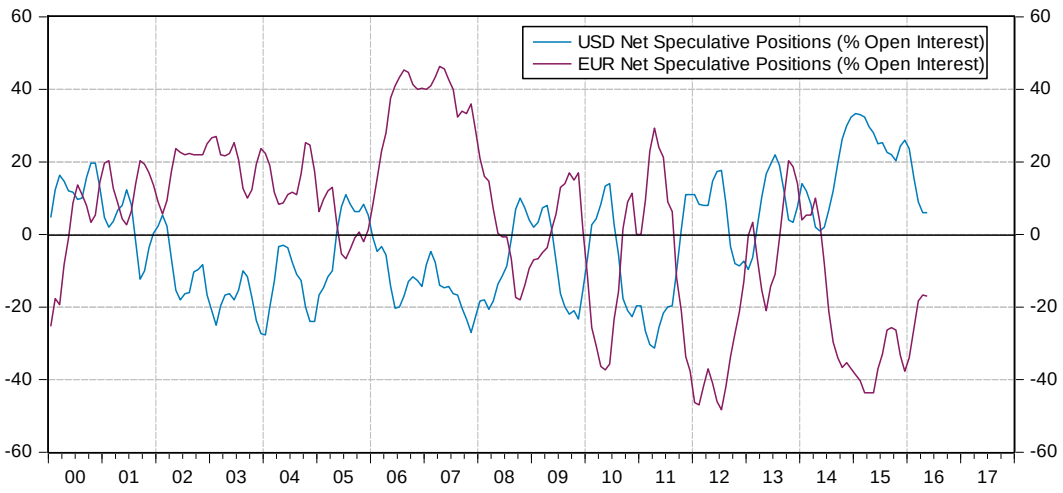
- The recent uptick in commodity prices, including the much talked about oil prices, works in favour of the currencies of producer countries and against the dollar. The contagion effect could therefore weaken the dollar against other currencies, including the euro.

- Contrary to popular wisdom, if the UK left the European Union, capital flows toward the eurozone would get a boost, at least in the short term. British Prime Minister David Cameron is actively campaigning to keep his country in the EU, but there is no shortage of Brexit partisans, including within his own party. This means rough going for the pound sterling – but smoother sailing for the euro – until the referendum in the UK on 23 June.

- The US political situation is also unstable and will only get more so as the election approaches. The 2016 presidential campaign will fuel volatility on the forex market, driven in part by the fact that the Democratic and Republican camps are both facing a level of internal opposition that is unprecedented in modern times.

- Another factor that helps account for short-term volatility is speculative positions, which are showing less euro selling (see chart below). This is a sign that forex traders no longer really expect the euro to drop sharply. The situation is the opposite when it comes to the dollar, where buying is on the decline.

Traders' speculative positions: USD & EUR

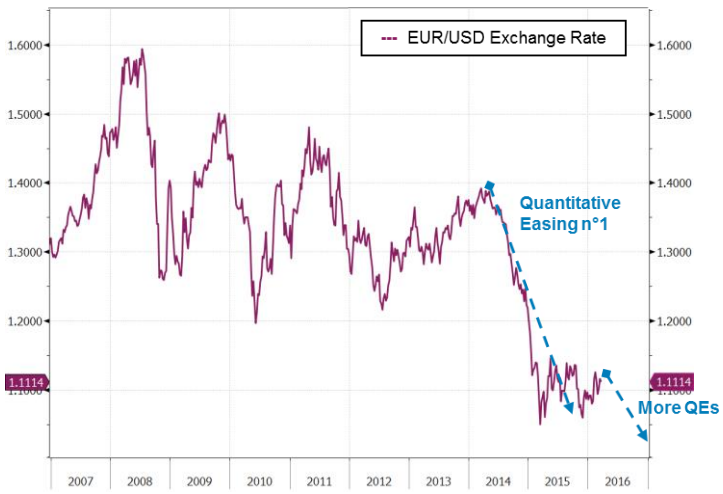


Now for a look at factors that could further push the euro down against the dollar:

- **This is the second crucial point of our analysis: money creation by the European Central Bank (ECB) is diluting the value of the euro,** just like quantitative easing by the US Federal Reserve (Fed) undercut the dollar from 2009 to 2014 (see charts below).

USD/CHF & and money creation by the Fed

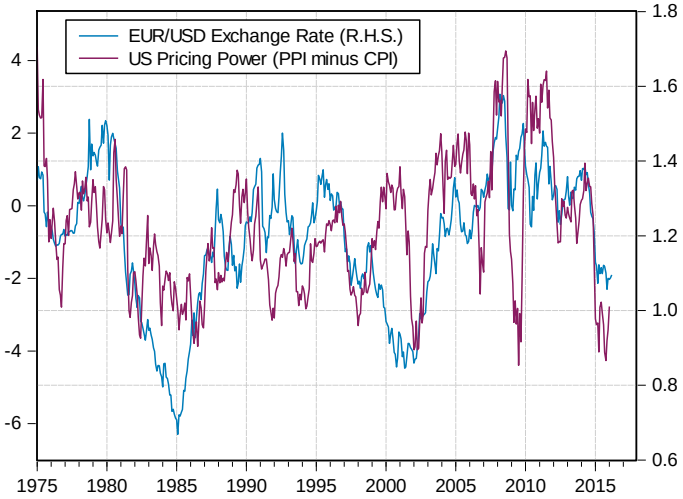
EUR/USD & money creation by the ECB

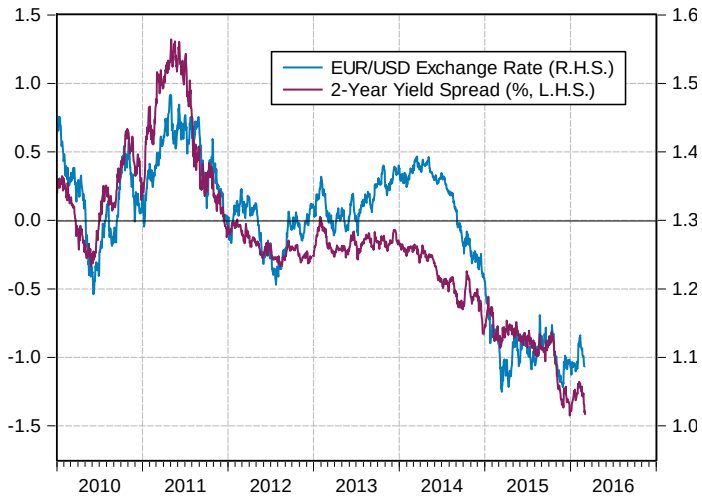


- A second, oft-overlooked but important factor is the US inflation differential – producer prices are rising faster than consumer prices – which supports the dollar. This means that, with the fall in commodity prices, companies recovered some pricing power and were able to improve margins in some segments (see left-hand chart below).

EUR/USD & pricing power in the USA

EUR/USD & and 2-year yield spreads





- The third point will interest investors. The widening of the 2-year yield spread makes carry trades more attractive. It is becoming easier for traders to borrow euros in order to invest in dollars and pocket the premium (see right-hand chart above). We should see more of this in the next few quarters. Each time the Fed raises its key interest rates going forward – or if investors merely expect this to happen – the yield spread will tend to push the dollar upward.

  Recent turmoil in the financial sector has convinced the markets that the Fed will not raise rates in 2016. But since the Fed kicked off its effort to normalise monetary policy at the end of 2015, it is unlikely to ignore the excellent health of the US economy because of uncertainties in Asia or surplus oil production. The Fed will have to act sooner or later in view of recent jobs data and inflation levels.

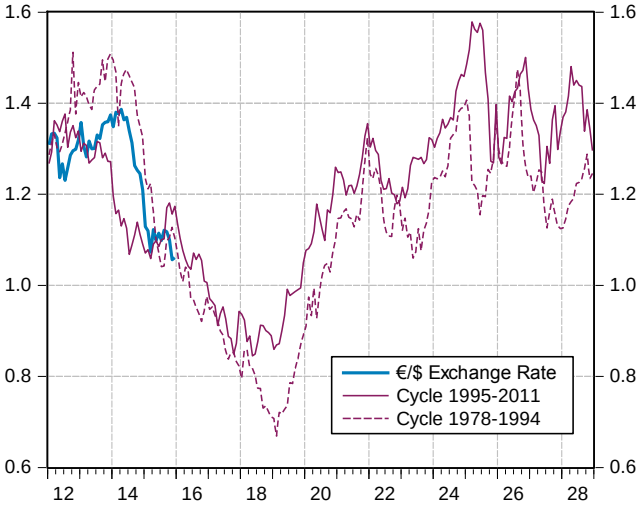
Finally, there are a number of factors that, while not explanatory in nature, could also weigh on the euro versus the dollar.

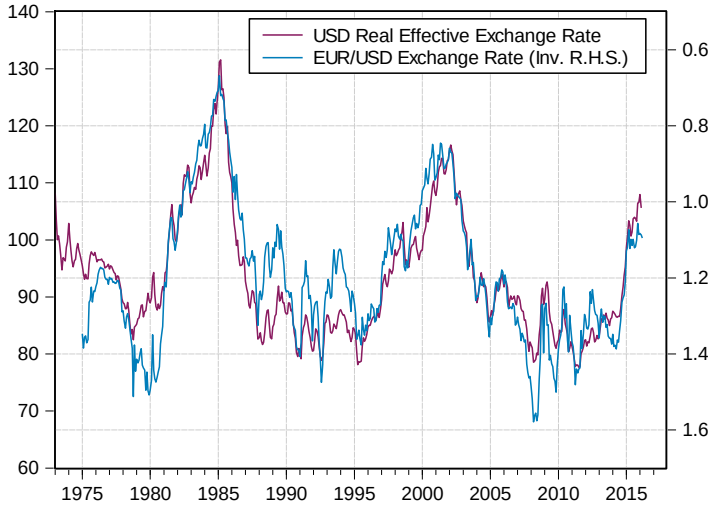
- The dollar's rise against the euro in recent years has been rather steep. But there is nothing special about this latest cycle. In fact, it looks surprisingly similar to the two previous ones (see left-hand chart). We would also point out that dollar rallies tend to last for a long time.

- Recently, the dollar climbed less sharply against the euro than against other currencies (see right-hand chart). But the trend could still reassert itself.

EUR/USD & previous cycles

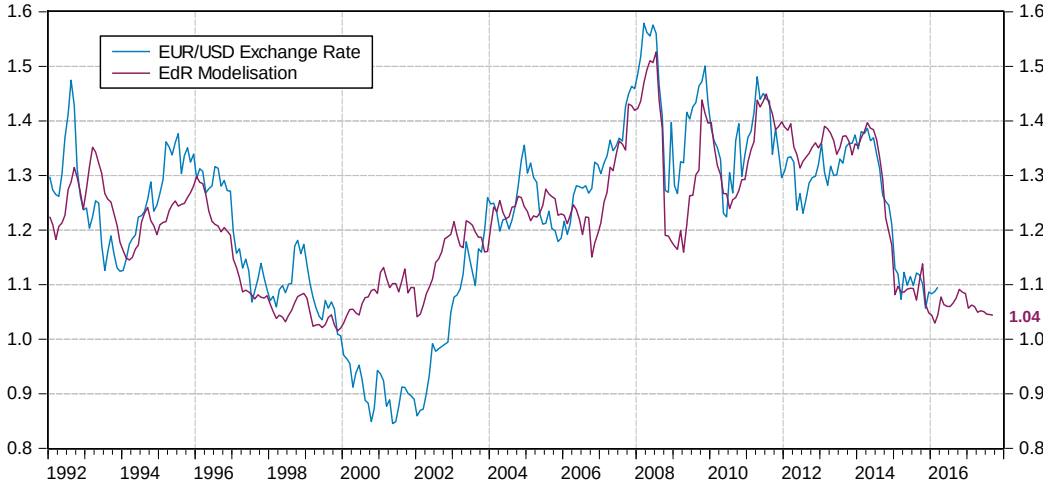
Dollar exchange rate





In view of our econometric model, which takes into account most of the explanatory factors discussed here, **we expect the EUR/USD exchange rate to remain just above parity through the end of the year** (see chart below). That said, keep in mind that although the euro's downtrend has not yet ended, it is slowing. The dollar gained 13% on it in 2014 and 10% in 2015. Let's be reasonable for 2016: +5% would largely suffice.

EUR/USD and econometric model



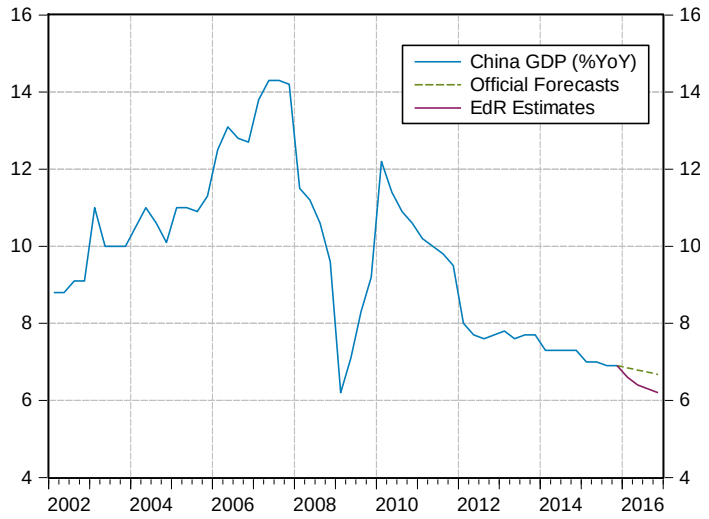
In conclusion, we will summarise our analysis by looking at the problem from the other side. Not expecting the dollar to rise against the euro in the current environment would be tantamount to ignoring the impact of rising US interest rates and simultaneously underestimating the impact of money creation in Europe. As the saying goes: ***never fight the central banks.***

EMERGING MARKETS

PAPERCHASE IN CHINA

Between the structural slowdown and the need to maintain strong growth in order to double the country's GDP from its 2010 level by 2020, the Chinese government's balancing act is far from over. The meeting of the National People's Congress represents an opportunity for the government to review China's growth strategies – and the major risks it faces.

- **The focus is on economic growth, at the expense of other worrying issues** including high debt, inefficient state-owned corporations and the accumulation of risks in the banking sector. The 2016 growth target is 6.5-7%, in line with previous statements coming out of Beijing but above our full-year forecast of 6.4% (see chart and last week's edition of Macro Highlights & Strategy). We reiterate what we consider the government's misstep in announcing a quantified growth target, which leaves the authorities little leeway in the event of a growth shock.



- **With an expected deficit of 3% of GDP, the government's fiscal talk is solidly accommodative.** The same is true for monetary policy, as reflected in expected growth in the money supply and lending (+13%) and likely cuts in key interest rates and bank reserve requirements. **These measures should support short-term economic activity but increase long-term risks, especially in the area of debt**. And we cannot rule out the rather bleak scenario in which the country's high debt level is worsened by bad debts, which appear to be sharply underestimated in official figures. Capital spending is expected to grow by 10.5% and be used mainly to finance infrastructures, social policies and some tax cuts.

- **Jobs are also a key consideration in the transition towards greater consumer spending.** As in 2015, the goal is to create 10 million jobs. This goal was beaten in 2015, with 13 million jobs created. Implicit in this discussion is the quality of the newly created jobs and how the inevitable reclassification of surplus labour currently working in the manufacturing sector will be orchestrated.

- On a positive note, **the government seems to sense the urgency of reforming state-owned manufacturers**. Few details have surfaced, but one thing is certain: absorbing the production overcapacity will take time. Beijing announced its intention to reduce steel and coal production capacity by 10% in the next few years and set up a fund worth USD 15 billion for affected workers. More information in this regard should be forthcoming.

- **The property market – like the country itself – is a study in contrasts and requires some harmonising.** While housing prices soar in the big cities, the market is sluggish in smaller ones owing to an oversupply. Recent measures to alleviate the situation, including a reduction in the required down payment to buy property, will have to go further to avoid a meltdown.

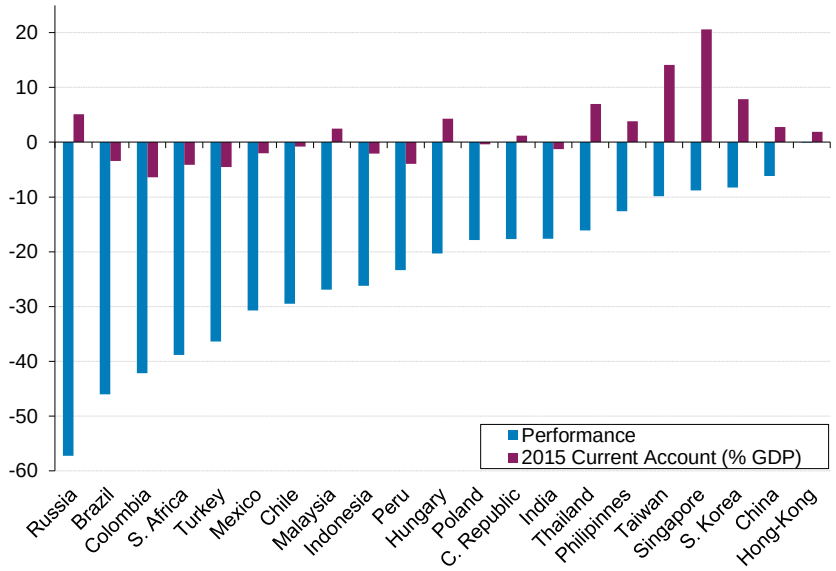
EMERGING-MARKET CURRENCIES

IS THE MEXICAN PESO OVERVALUED?

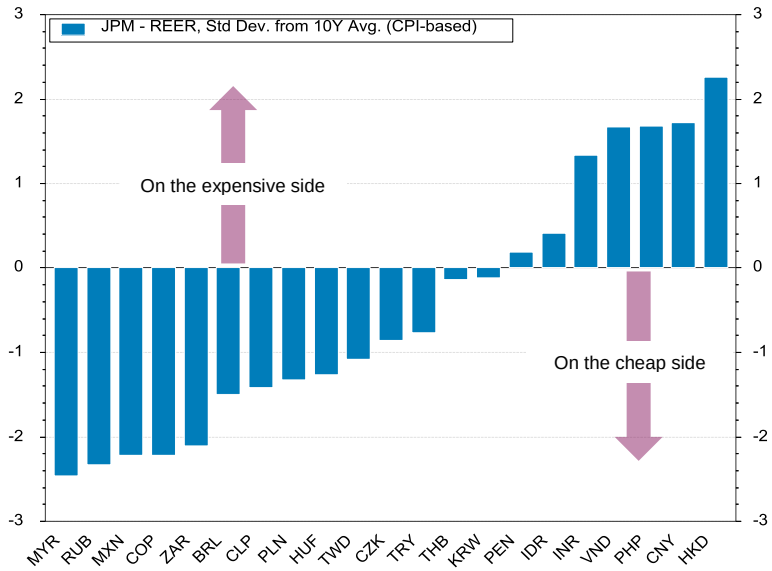
May 2013: Ben Bernanke announces that the Fed would begin to taper its bond buybacks. This announcement – logical in view of US economic growth – was also meant to prepare investors for gradual monetary tightening, which culminated in the interest-rate hikes at the end of 2015. **But Bernanke's statement was a severe blow for emerging-market currencies, as it meant a reduction in liquidities being injected into the financial system**. The results are clear: to date, all of these currencies have depreciated against the dollar. While they have all gone down, some have dropped more than others.

The extent to which a given currency was affected depends on the state of the country's current accounts.[1] **The currencies of countries carrying a current-account deficit were hit harder than those of countries with a surplus.** The Fed's remarks signalled a drop in the international capital needed to refinance these countries' deficits. Asian countries with high exports saw their currencies lose little ground to the dollar, while countries with a current-account deficit – and which may also have had a high exposure to commodities – saw a steeper drop in their currencies (see chart).

[1] Current accounts indicate, among other things, the balance of trade, which is the difference between a country's imports and exports. A current-account surplus means that a country is a net lender to the rest of the world.



An alternative approach to this question, through effective exchange rates, paints a similar picture.[2] **Looking at historical valuations, Asian currencies are the most expensive while the currencies of countries that run a current-account deficit and/or that export commodities are significantly cheaper** (see chart). This wide disparity suggests that it may be overblown. Did the current-account situation alone underpin the favour shown to Asian currencies? Does this factor alone still justify these currencies' valuation premium? Probably not. **The Fed's monetary tightening cycle has begun, and the relevant factors are now to be found elsewhere, including in China.**

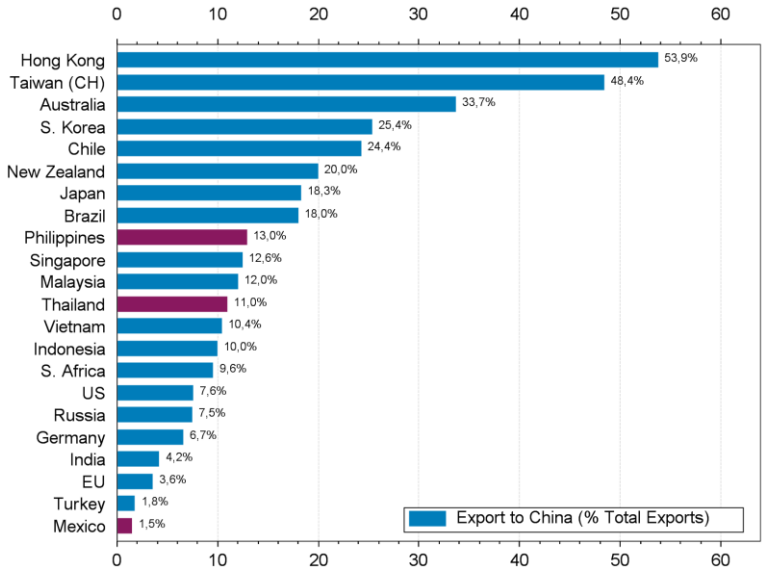


[2] The effective exchange rate is a weighted average of a country's currency relative to the currencies of its trading partners.

Beijing has issued a growth target that appears overly ambitious in view of an economic slowdown that looks set to last. And the fact that the government is keeping expectations high by "freezing" the 2016 growth target at 6.5-7% increases the likelihood of disappointment. In addition, although the renminbi has stabilised recently, it should resume its downward path against the dollar, which will in turn put further pressure on the currencies of its main trading partners.

Using these two variables, we are able to identify highly valued currencies – a legacy of their countries' current-account surplus – that are exposed to the uncertainties of China's growth and currency.

- The Philippine peso and the Thai baht benefited from the relative safety provided by their current-account surplus. These currencies are expensive in terms of effective exchange rates, while their export breakdown by country reveals significant exposure to Chinese-related factors (see charts). The moderate value added of these exports (often assembly components) will be hurt by downward pressures on the renminbi, which tend to drive up the cost of products imported by China. **These currencies will therefore come under real pressure.** Indeed, since the summer of 2015 when the renminbi was unexpectedly devalued, these currencies have been more sensitive to moves by the renminbi. In addition, both Thailand and the Philippines face some political uncertainties in the form of a constitutional referendum in July and a presidential election in May, respectively.

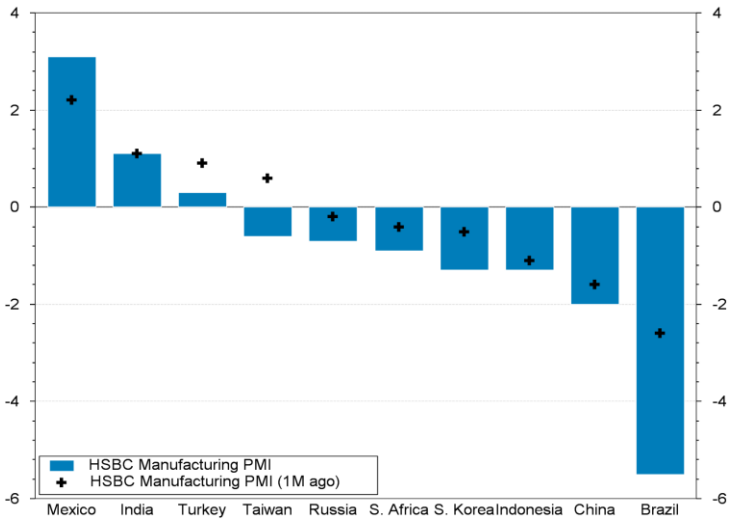


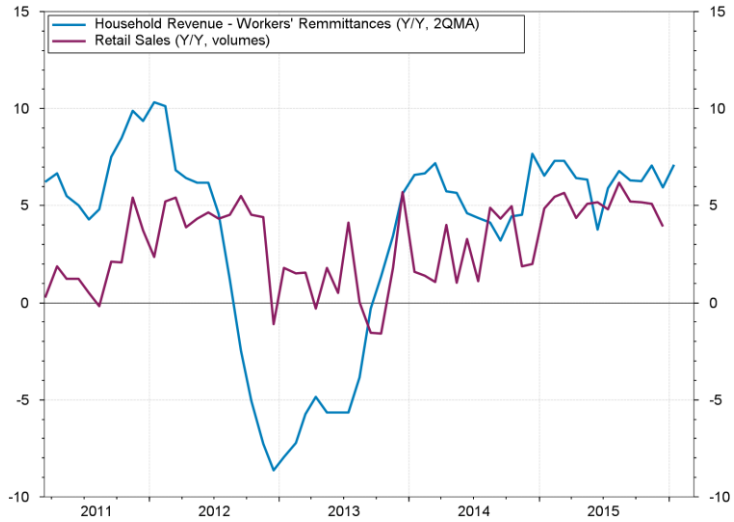
Inversely, currencies with a low valuation – because they are overly penalised by a current-account deficit – and low exposure to all things China now stand out. The Mexican peso is the best example.

- **With 80% of its exports going north of the border, Mexico has few direct links with the Chinese behemoth**. Its manufacturing sector, which is currently being driven by reindustrialisation, is among

the most dynamic among emerging markets (see left-hand chart below). The country's links to the USA also take the form of workers' remittances to the home country. These remittances, which account for 2.5% of the country's GDP, have a real impact on consumer spending. The country's consumer spending should receive a further boost from the strong US labour market (see right-hand chart below). Notably, Mexico is one of the only major emerging markets to undertake needed structural reforms.

Although the outlook for emerging-market equities is modest in 2016, investors can find opportunities in related asset classes, including currencies.





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%	2.1%	23.2%	14.3%
Canada	2.4%	1.2%	1.5%	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%	2.1%	4.0%	2.5%
Switzerland	1.9%	0.8%	1.2%	0.8%	0.3%
Russia	0.5%	-3.7%	-1.5%	1.9%	-0.8%
Japan	0.2%	0.6%	0.7%	4.9%	1.0%
China	7.4%	6.9%	6.5%	17.8%	34.0%
India	4.7%	7.4%	7.4%	3.6%	7.8%
Brazil	0.1%	-3.7%	-3.4%	2.1%	-2.1%
Mexico	2.1%	2.5%	2.6%	1.6%	1.2%
Others	5.8%	4.4%	6.5%	16.4%	31.4%
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)	392	1.2%	11.2%	-1.4%	-1.8%
United States (S&P 500)	2'022	1.2%	10.8%	-0.6%	1.4%
Euro Area (DJ EuroStoxx)	328	1.1%	14.2%	-5.5%	11.2%
United Kingdom (FTSE 100)	6'158	-0.9%	11.8%	-0.6%	-1.0%
Switzerland (SMI)	8'008	0.2%	8.1%	-8.1%	1.1%
Japan (NIKKEI)	17'234	-0.4%	7.9%	-10.9%	11.0%
Emerging (MSCI)	801	1.3%	12.4%	1.0%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.96%	-0.8%	-2.5%	2.7%	2.1%
Euro Area (7-10 Yr)	1.22%	0.3%	0.5%	3.2%	1.0%
Germany (7-10 Yr)	0.25%	-0.3%	-0.7%	3.8%	0.9%
United Kingdom (7-10 Yr)	1.56%	-0.6%	-1.9%	3.2%	0.7%
Switzerland (7-10 Yr)	-0.29%	-1.1%	-0.3%	2.2%	3.7%
Japan (7-10 Yr)	-0.04%	-0.3%	0.1%	2.4%	1.4%
Emerging (5-10 Yr)	4.83%	0.2%	3.6%	3.5%	1.6%
United States (IG Corp.)	3.52%	0.5%	0.7%	1.5%	-0.8%
Euro Area (IG Corp.)	0.98%	0.4%	1.0%	1.7%	-0.5%
Emerging (IG Corp.)	4.36%	0.5%	2.5%	2.6%	-2.3%
United States (HY Corp.)	8.53%	1.2%	7.3%	2.8%	-3.5%
Euro Area (HY Corp.)	5.09%	1.7%	4.5%	1.4%	0.3%
Emerging (HY Corp.)	10.09%	0.9%	5.6%	3.5%	3.6%
United States (Convert. Barclays)	43	1.3%	10.5%	-0.9%	-0.8%
Euro Area (Convert. Exane)	7'150	0.4%	4.3%	-4.7%	7.6%
Real Estate					
World (MSCI)	191	1.6%	12.6%	1.1%	1.0%
United States (MSCI)	201	2.0%	14.2%	0.7%	4.6%
Euro Area (MSCI)	215	2.8%	13.3%	2.5%	16.1%
United Kingdom (FTSE)	6'573	0.0%	0.5%	-0.3%	9.4%
Switzerland (DBRB)	3'774	2.0%	3.7%	4.8%	4.6%
Japan (MSCI)	259	-1.7%	8.7%	-3.7%	0.9%
Emerging (MSCI)	98	2.7%	14.4%	-1.9%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	542	n.a.	-1.4%	-1.4%	-0.7%
Distressed	717	n.a.	-1.4%	-1.4%	-5.3%
Event Driven	575	n.a.	-3.0%	-3.0%	-6.3%
Fixed Income	301	n.a.	-0.8%	-0.8%	0.6%
Global Macro	880	n.a.	-0.6%	-0.6%	0.2%
Long/Short	659	n.a.	-2.8%	-2.8%	3.6%
Managed Futures (CTA's)	329	n.a.	4.0%	4.0%	-0.9%
Market Neutral	266	n.a.	-1.2%	-1.2%	1.7%
Multi-Strategy	519	n.a.	-0.5%	-0.5%	3.8%
Short Bias	34	n.a.	9.5%	9.5%	2.4%
Commodities					
Commodities (CRB)	385	1.8%	6.2%	1.7%	-15.2%
Gold (Troy Ounce)	1'257	-0.4%	4.0%	18.4%	-10.6%
Oil (Brent, Barrel)	38	2.8%	27.1%	10.4%	-35.9%
Currencies					
USD	96.4	-0.7%	0.5%	-2.3%	9.3%
EUR	1.11	0.9%	-0.3%	2.4%	-10.2%
GBP	1.44	0.7%	-0.5%	-2.5%	-5.4%
CHF	0.99	0.9%	0.1%	1.6%	-0.8%
JPY	113.6	-0.2%	0.8%	5.8%	-0.4%

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

Disclaimer

This brochure was prepared by Edmond de Rothschild (Suisse) S.A., 18 rue de Hesse, 1204 Geneva, Switzerland. Edmond de Rothschild (Europe), located at 20 boulevard Emmanuel Servais, 2535 Luxembourg, Grand Duchy of Luxembourg, and subject to the supervision of the Luxembourg Commission de Surveillance du Secteur Financier (CSSF), and Edmond de Rothschild (France), a société anonyme (public limited company) governed by an executive board and a supervisory board with capital of EUR 83,075,820 and with its registered office at 47 rue du Faubourg Saint Honoré, 75008 Paris, subject to the supervision of the French Autorité de Contrôle Prudentielle et de Résolution (ACPR), limit themselves to making this brochure available to clients at their offices and branch offices.

The figures, comments, analyses and investment research contained in this brochure reflect the opinion of Edmond de Rothschild (Suisse) S.A. on market trends, formed on the basis of its own expertise and the economic analyses and the information in its possession at this time. The figures, comments, analyses and investment research contained in this brochure may no longer be current or relevant when the investor reads this brochure owing to its date of publication or changes in the markets.

Each analyst mentioned in this document certifies that the views expressed about the evaluated companies and securities reflect the analyst's personal opinion. Their remuneration is not tied directly or indirectly to the specific recommendations and opinions expressed in this document. Details on the rating methodology used by Edmond de Rothschild (Suisse) S.A. are available free of charge on request.

Neither Edmond de Rothschild (Suisse) S.A., Edmond de Rothschild (Europe) nor Edmond de Rothschild (France) may be held liable for a decision to buy, sell or hold based on the aforementioned commentaries and analyses under any circumstances.

Furthermore, neither Edmond de Rothschild (Suisse) S.A., Edmond de Rothschild (Europe) nor Edmond de Rothschild (France) may be held liable for harm incurred by an investor as a result of the contents or availability of this brochure.

This brochure is intended solely to provide general, preliminary information for the investors consulting it and should not be used as a basis for any decision to buy, sell or hold.

Edmond de Rothschild (Suisse) S.A. recommends that each investor obtain the different regulatory descriptions of each financial product before any investment in order to analyse the risk and form his or her own independent opinion, with the assistance of advisers specialising in these matters if necessary, so as to ensure that the investment is appropriate to his or her financial and tax situation.

Past performance and volatility are not a reliable guide to future performance and volatility, and may vary over time.

This information may not be used or reproduced in whole or in part.

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