MACRO HIGHLIGHTS & STRATEGY

MARCH 7TH 2016

OUR ROUNDUP:

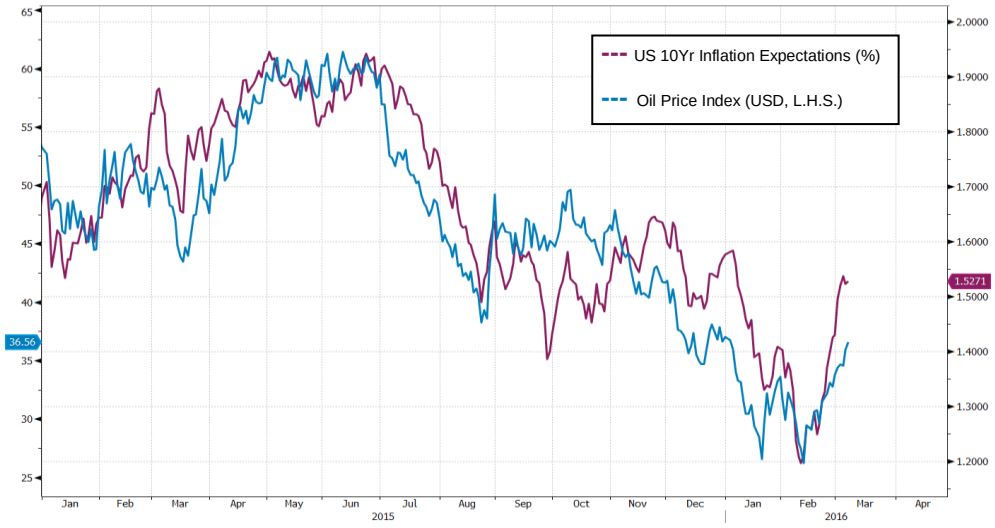
- Even deflation fears have a silver lining
- Is deflation a threat in the USA?
- Are we missing the point on China?

MARKETS

EVEN DEFLATION FEARS HAVE A SILVER LINING

The sharp drop in oil prices in the past two years has weighed on inflation levels worldwide. **It has also spooked some investors into thinking that deflation was once again around the corner.** This explains why inflation expectations are so low on the bond markets (see chart). Yet the economy is growing fast enough to drive prices upward – albeit moderately – especially in the USA (see article on page 3).

Oil price index & US inflation expectations



In truth, bond-market expectations are not always an effective proxy for expected inflation. They derive from bond prices, and they take into account a liquidity premium and a number of technical factors. Significant distortions can therefore exist between bond prices and economic reality. This was clearly the case in recent months.

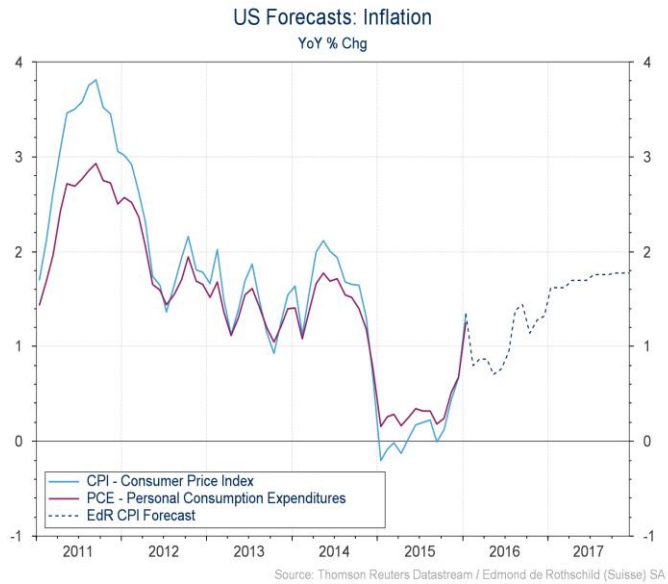
US bond market performance

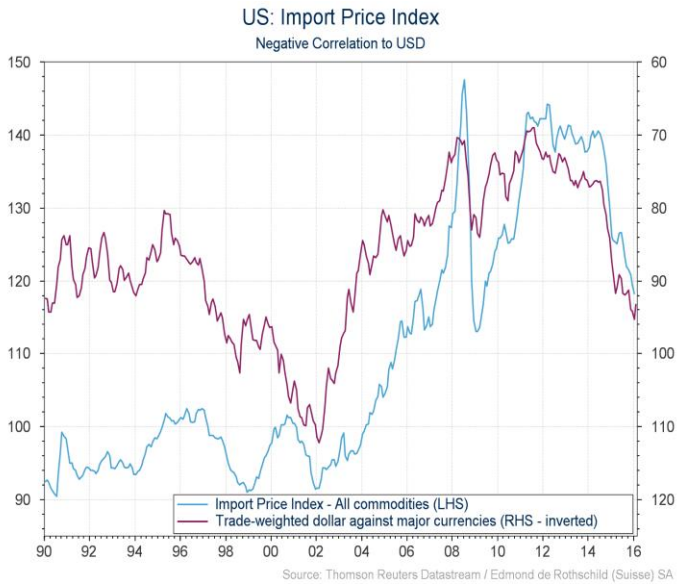
From the macroeconomic and technical perspectives, inflation-indexed bonds (TIPS) present a golden opportunity to generate unexpected profits. The proof: in the past two weeks, TIPS continued to perform very well, while conventional treasuries lost ground (see chart above). The upswing in inflation expectations serves to offset the rise in nominal rates, so real interest rates are inching up more slowly. They are even declining at this point.

UNITED STATES

IS DEFLATION A THREAT IN THE USA?

While deflation fears are spreading around the world, the USA is a safe harbour with prices on a firm upward track. The two key indicators, the Consumer Price Index (CPI) and the Personal Consumption Expenditure Deflator (PCE), revealed year-on-year inflation of 1.4% and 1.3%, respectively, in January. But before we pop the cork: the recent uptick in inflation owes primarily to the base effect (see box on page 6), which was heavily influenced by the price of oil. And because of the base effect, inflation will drop below 1% from next month through August (see left-hand chart). Will persistently low inflation feed the risk of deflation, where prices fall in all sectors?

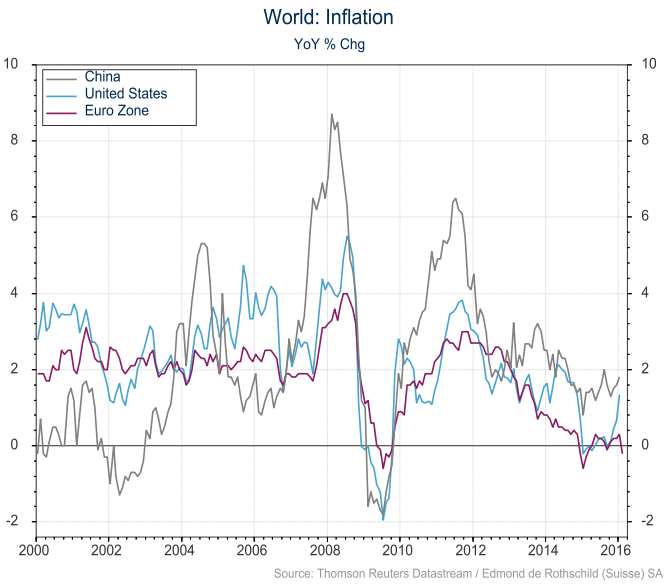


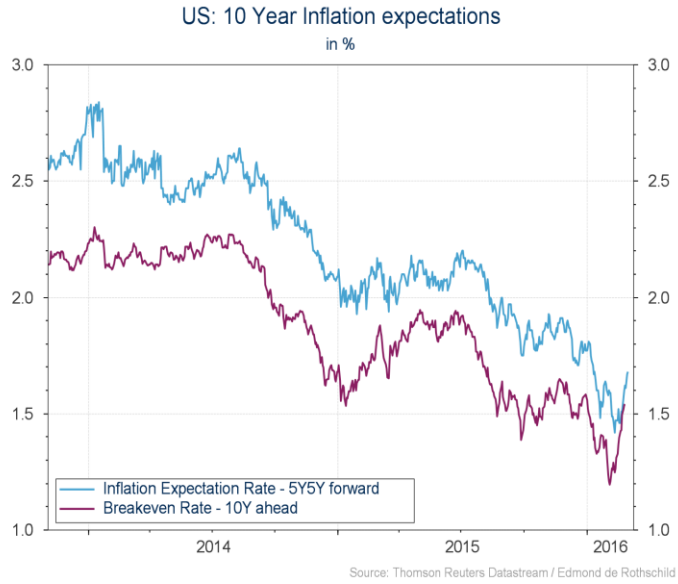


A number of factors amply demonstrate that deflation is a real risk:

- **The strength of the dollar leads to imported disinflation** (see right-hand chart above). This trend is set to last: we expect the dollar to rise slightly by the end of the year, and the USA will remain a net importer of oil and goods.

- **Low prices on imported goods – not the result of currency effects but rather of weak global demand and falling inflation worldwide – lead to imported deflation** (see right-hand chart above and left-hand chart below).

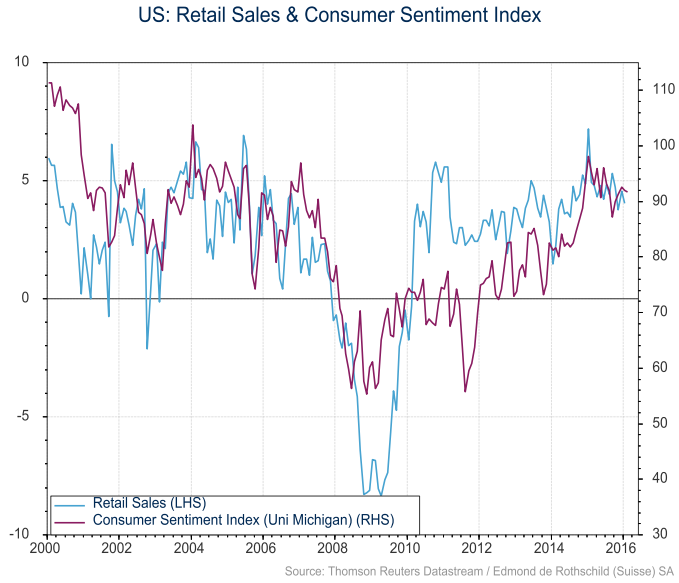


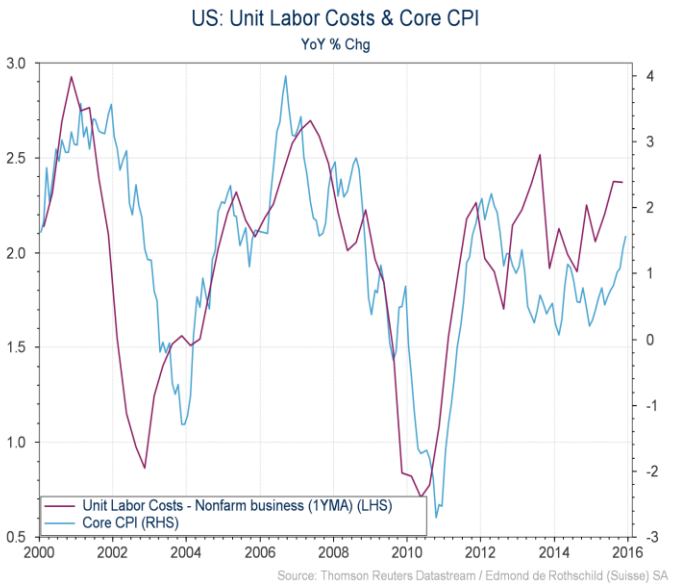


- **Bond market measures of inflation expectations 10 years out are very low**, far from the Fed's 2% inflation target (see right-hand chart above). This means that the bond market feels that the drop in oil prices will have a lasting impact on the prices of all goods and services.

These are key factors that must be closely monitored. A long period of deflation can be disastrous for a modern economy with significant debt and must be avoided at all costs. Yet the USA has the economic strength and monetary and fiscal policy tools needed to avoid such a scenario:

1. **Overall domestic demand is very strong in the USA, which favours inflation.**[1] Retail sales, a leading indicator of consumption growth, are robust, with 4% year-on-year growth in January (see left-hand chart below).

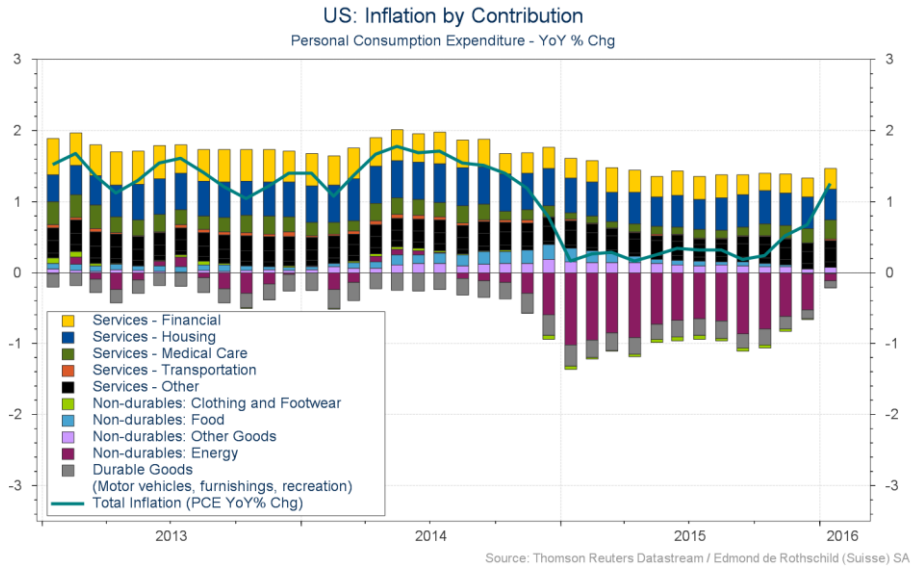




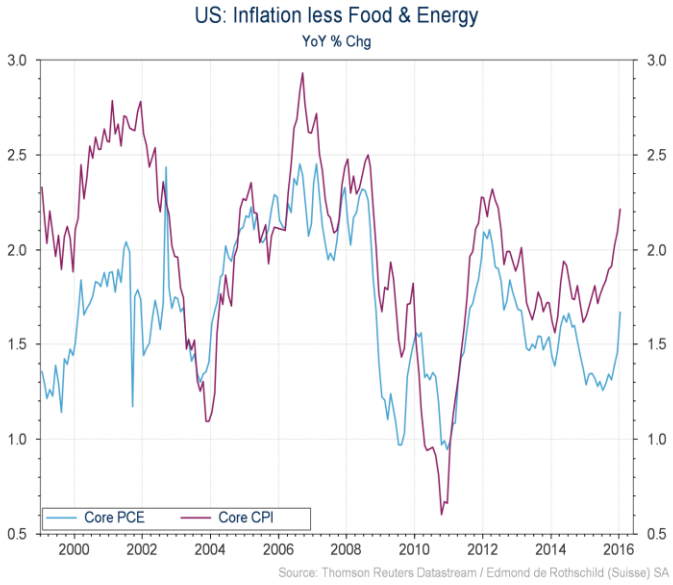
Consumer spending has expanded by 3% on average for the past year, and low petrol prices at the pump – 0.48$/litre, which corresponds to a 25% decline over one year – support this trend. Labour market pressures are also on the rise. The latest job creation figures provided a positive surprise, with 242,000 jobs created in February – more than 2.4 times the number needed to absorb new workers on the labour market. The unemployment rate has reached what the Fed considers the equilibrium level (4.9%), and the participation rate on the labour market has risen considerably, reversing the downward trend seen over the past 10 years. This full-employment environment puts upward pressure on salaries and inflation (see right-hand chart above).

[1] In most cases deflation is accompanied by a collapse in overall demand. Weak consumer spending forces manufacturers to lower their prices and then wages – and the vicious circle commences.

2. **The current low inflation rate is not consistent with the underlying growth of the US economy. Weak oil prices are distorting overall inflation figures** (see chart below).



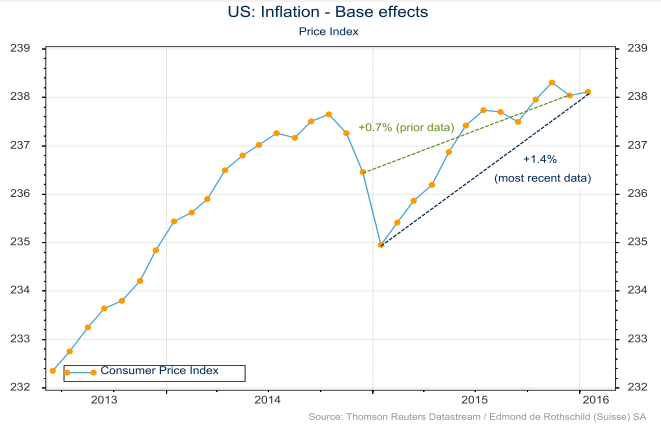
A more meaningful inflation figure, excluding food and energy, reflects the true strength of the US economy. The Core PCE price index – the Fed's preferred indicator – is up 1.7% year-on-year, very close to the 2% inflation target. The Core CPI is even higher, at 2.2% (see chart opposite). As long as prices are rising in most sectors, deflation should not be a real concern. Core inflation is indeed a sign of a healthy US economy.



3. Lastly, **the Fed itself represents a solid pillar of support if deflation were to become a real threat**. As Ben Bernanke, the former chair of the Federal Reserve, puts it in his famous paper *Deflation: Make sure "it" doesn't happen here* (2002), the Fed is responsible for maintaining price stability and therefore must attempt to contain any significant upward or downward movements. "*I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States and, moreover, that the U.S. central bank […] has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief.*" In reality, the Fed is now seeking to gradually 'normalise' its monetary policy in order to avoid a sharp pickup in inflation, which is also finding its way back to normal levels.

At this point, the risk of deflation in the USA is low. Prices are increasing across the board with the exception of oil and commodities prices, which remain low. If the labour market and consumer spending continue on their current path, the deflation scenario will fall by the wayside. We are nevertheless keeping a close eye on the rising risk of deflation in the rest of the world. If strong deflation took root globally, the USA could be dragged down with it.

**Base effect: Year-on-year inflation rose sharply in January, not because of a significant change in prices versus the previous month but because of the change in inflation 12 months earlier. In January 2015, inflation experienced a steep decline, and this made the January 2016 figure stand out all the more.



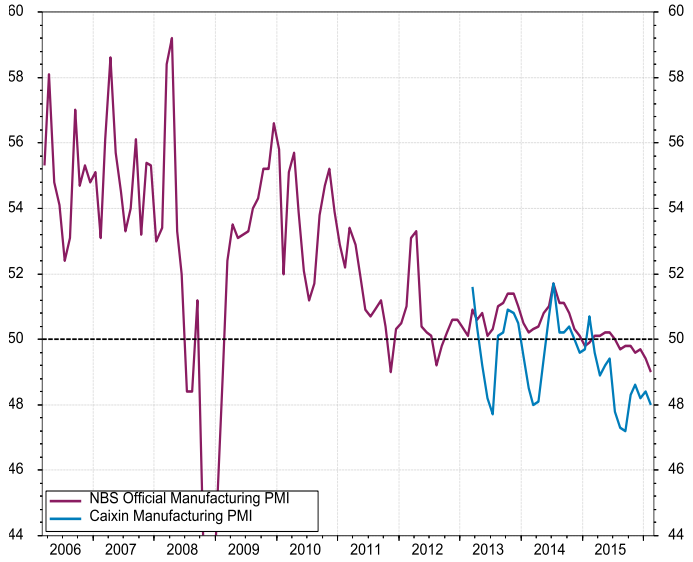
CHINA

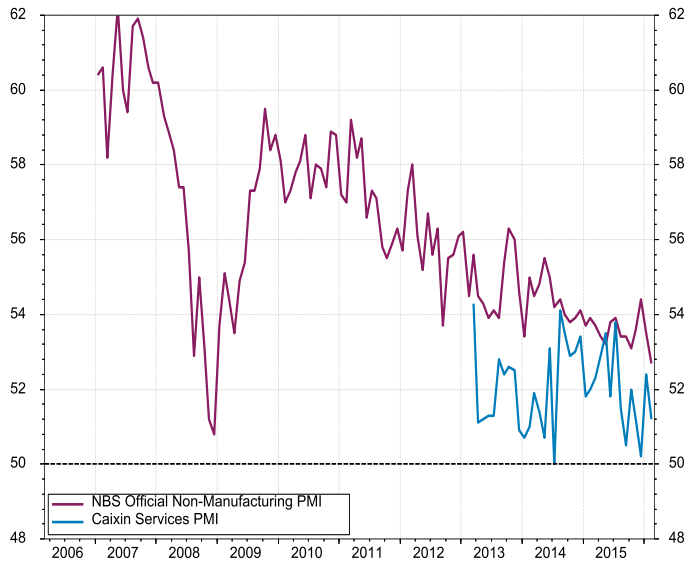
ARE WE MISSING THE POINT ON CHINA?

It has become a ritual. As soon as China's leading manufacturing indicators are approved for publication, questions arise as to the sustainability of domestic growth and whether a soft or hard landing is in the works. February was no exception to the rule despite a number of positive signals recently, including a significant increase in bank lending, easing monetary conditions and a calmer renminbi in the wake of the G20 talks.

- **While February figures confirm the slowdown in Chinese manufacturing, they are generally in line with the trend over the past few quarters** (see left-hand chart below[2]). And this one figure cannot reliably predict China's future growth, especially since the Chinese New Year took place during the period.

[2] A reading below 50 indicates a contraction in economic activity, while a reading above 50 means economic activity is expanding.





- The transition of China's growth model towards service-oriented activities will not be without its bumps. The recent decline in manufacturing is justified and will last a while. **The sub-components of manufacturing indicators do not point towards an upturn in manufacturing activity in the short term, but the government has fiscal and monetary tools to prevent the indicators from heading south too abruptly**. The services sector is showing resilience, and this bodes well for an expansion in mass private consumption (see right-hand chart).

- February's figures confirm the deceleration in Chinese manufacturing, **but the real concern is to be found in the jobs sub-component**. Any decline in this indicator is particularly meaningful considering the fact that a number of State-owned manufacturing groups are instructed to maintain a surplus workforce. Mass layoffs, even if justified economically by the low productivity of these State-owned groups, would make a negative impression on international investors.

  If this sub-component falls, the problems may then spread from manufacturing to the services sector via the labour market. Something to watch closely in the coming months.

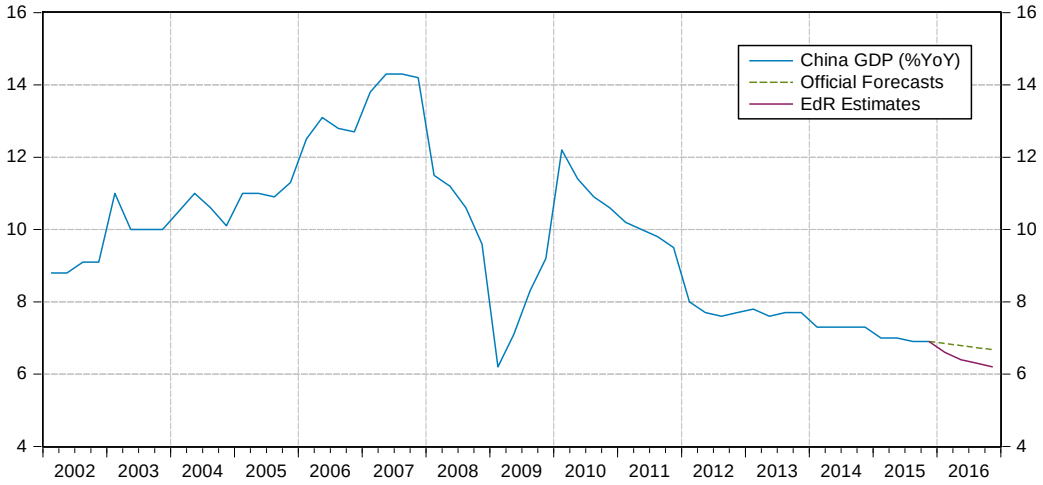
Soft landing or hard landing?

These two terms, which invariably arise whenever the Chinese economy is mentioned, **have a quantitative aspect but a much more important subjective one**. Two meanings of hard landing can be used.

- Strictly speaking, a hard landing means an economy experiences a sharp growth slowdown or even enters into recession after a period of solid growth. **China, which has been losing steam since**

2011, does not fit this description. An external shock such as the bankruptcy of a major industrial concern, tensions within the banking sector or a debt crisis would be sufficient to cause economic activity to contract significantly. These risks exist but are contained for now.

- More concretely, a hard landing may be diagnosed when economic growth drops below a given threshold that no longer generates – or perhaps even destroys – jobs. The ensuing social discontent can shake a country's political foundations. In China, this GDP growth threshold is estimated to be around 5.5-6%, which is below the current growth level (6.9%) and below our 2016 forecast. **According to this definition, China is indeed flirting with a hard landing**. And if we set aside the oft-disparaged official figures and look at indicators that give an idea of actual economic growth, this scenario is even more plausible. These latter indicators point to around 5.5% growth.



The conclusion depends, then, on the meaning of hard landing and on the figures used to assess it. **We forecast a gradual slowdown in Chinese GDP growth to 6.2% by the fourth quarter of this year, which is in line with a soft-landing scenario** (see chart above). The first half of the year, for example, will be affected by the curb on margin financing, a practice that took advantage of the boom in domestic equities in early 2015. But the lending boost combined with tax and monetary stimuli will partly offset the persistent surplus in manufacturing capacity.

What if this never-ending debate over a soft or hard landing was irrelevant? The Chinese government could use its massive resources to prop up growth over the coming years and ensure the economy experiences a soft landing. While appealing in the short term, the long-term cost of this approach would be steep because Beijing would only pull those growth levers it wishes to get away from: chronic overinvestment in manufacturing and infrastructures. On the other hand, a hard landing, although painful in the short term, would signal the end of past methods, sharply reduce investors' expectations and gradually bolster the services sector.

From where we sit, **the Chinese government took a misstep in providing a precise numerical GDP growth target through 2020**, at 6.5% per year. This figure puts pressure on the Chinese economy, offers little leeway to the government and does not ensure that services-related activities will be promoted over manufacturing and infrastructures.

This figure also seems overly ambitious compared to our forecasts, even though one can be sure that the government will use everything in its arsenal to achieve the 6.5% growth target.

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%	2.2%	23.2%	14.7%
Canada	2.4%	1.2%	1.5%	2.0%	0.9%
Euro Area	0.9%	1.5%	1.6%	14.5%	6.8%
Germany	1.6%	1.5%	1.7%	4.2%	2.1%
France	0.4%	1.1%	1.4%	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%	0.9%	4.9%	1.3%
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%	-3.3%	2.1%	-2.0%
Mexico	2.1%	2.5%	2.6%	1.6%	1.2%
Others	5.8%	4.4%	6.3%	16.4%	30.1%
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)	387	3.9%	4.4%	-2.6%	-1.8%
United States (S&P 500)	2'000	2.7%	4.7%	-1.7%	1.4%
Euro Area (DJ EuroStoxx)	319	3.5%	4.1%	-6.5%	11.2%
United Kingdom (FTSE 100)	6'139	1.9%	5.9%	0.2%	-1.0%
Switzerland (SMI)	7'963	1.9%	1.0%	-8.3%	1.1%
Japan (NIKKEI)	16'911	5.1%	-0.1%	-10.5%	11.0%
Emerging (MSCI)	791	6.9%	7.1%	-0.3%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.90%	-0.9%	-0.4%	3.5%	2.1%
Euro Area (7-10 Yr)	1.33%	-0.6%	0.5%	2.9%	1.0%
Germany (7-10 Yr)	0.22%	-0.7%	0.6%	4.1%	0.9%
United Kingdom (7-10 Yr)	1.46%	-0.7%	0.6%	3.8%	0.7%
Switzerland (7-10 Yr)	-0.40%	0.0%	1.1%	3.3%	3.7%
Japan (7-10 Yr)	-0.05%	-0.1%	0.9%	2.8%	1.4%
Emerging (5-10 Yr)	4.85%	1.3%	2.8%	3.3%	1.6%
United States (IG Corp.)	3.56%	0.2%	0.7%	1.0%	-0.8%
Euro Area (IG Corp.)	1.03%	0.1%	0.6%	1.3%	-0.5%
Emerging (IG Corp.)	4.41%	1.0%	2.0%	2.1%	-2.3%
United States (HY Corp.)	8.69%	3.0%	3.6%	1.6%	-3.5%
Euro Area (HY Corp.)	5.58%	1.4%	1.0%	-0.3%	0.3%
Emerging (HY Corp.)	10.23%	2.6%	3.4%	2.6%	3.6%
United States (Convert. Barclays)	42	2.1%	4.1%	-2.2%	-0.8%
Euro Area (Convert. Exane)	7'121	1.0%	0.4%	-5.0%	7.6%
Real Estate					
World (MSCI)	188	4.1%	4.1%	-0.5%	1.0%
United States (MSCI)	197	4.0%	3.3%	-1.2%	4.6%
Euro Area (MSCI)	209	2.9%	2.7%	-0.3%	16.1%
United Kingdom (FTSE)	6'570	0.4%	-0.2%	-0.4%	9.4%
Switzerland (DBRB)	3'700	0.4%	1.3%	2.8%	4.6%
Japan (MSCI)	264	2.2%	0.1%	-2.0%	0.9%
Emerging (MSCI)	95	7.0%	8.7%	-4.5%	-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)	379	3.4%	2.1%	-0.1%	-15.2%
Gold (Troy Ounce)	1'272	3.2%	6.4%	19.7%	-10.6%
Oil (Brent, Barrel)	39	10.4%	12.9%	7.4%	-35.9%
Currencies					
USD	97.6	-0.7%	0.5%	-1.1%	9.3%
EUR	1.10	0.8%	-2.0%	0.9%	-10.2%
GBP	1.42	1.8%	-1.8%	-3.8%	-5.4%
CHF	1.00	-0.1%	-1.3%	0.3%	-0.8%
JPY	113.6	-0.8%	2.0%	5.9%	-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