MACRO HIGHLIGHTS & STRATEGY

JANUARY 4TH 2016

OUR ROUNDUP:

- Stockmarkets have kicked off the new year with steep declines.
- Our macroeconomic scenario sees 2016 as a transition year.
- The US has entered a new era of monetary tightening.
- Growth is back to stay in the Euro Zone.
- After five years of capital flight, the emerging markets are starting to look fairly valued.

MARKETS

THE BEST THING TO HAVE IN 2016 WILL BE GOOD HEALTH

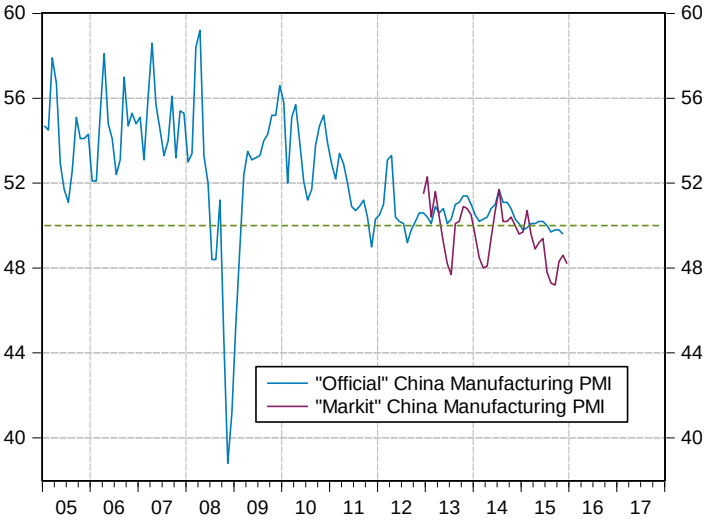
After ending 2015 without any fanfare, stockmarkets around the world are off to an inauspicious start in 2016. **Today (4 Jan.) trading was suspended in Shanghai and Shenzhen after the local benchmarks respectively plunged 6.9% and 8.2%** (see chart below). Earlier attempts to steady prices with brief interruptions had failed. At 13.34 local time, officials called a halt to trading for the day to prevent another rout like the one last summer.

Chinese Equities: Shanghai & Shenzhen CSI 300 Index

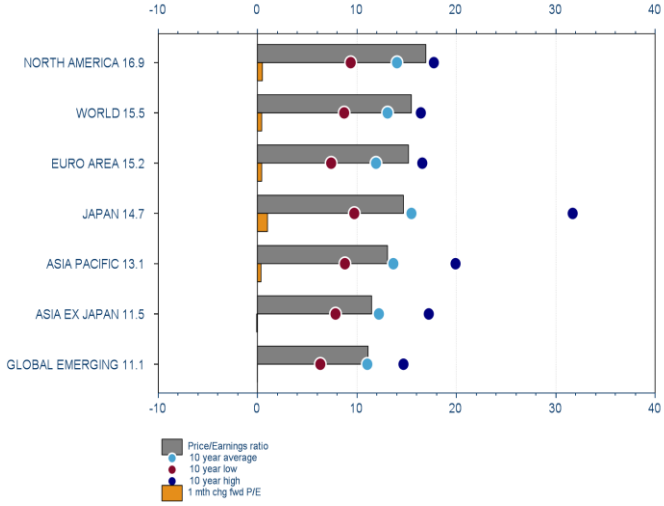
Investors were mainly reacting to weak data from China's manufacturing sector. The Markit purchasing managers index (PMI) was down for the seventh time in eight months, falling to 48.2 points in December from 48.6 previously. This was well below the 50-point dividing line between expanding and contracting activity in industry (see left-hand chart below).

Yet the punters in Shanghai and Shenzhen had another worry: the six-month ban on selling large shareholdings will soon expire. The measure was imposed by China's authorities on 8 July, in a bid to prevent stock prices from falling further, and will end on 8 January.

China: Purchasing Managers Indices



Equity Valuation by Region (12m Forward PE)



The first hours of trading in equities this year have reinforced our view on the global economy. Manufacturing, particularly in China, is clearly not in the best of shape. This alone is capable of generating heavy volatility in financial markets and more frequent periods of stress. **After a seven-year bull run, equities are no longer cheap** (see right-hand chart above). The Tokyo stockmarket was also hit by nervousness this morning, with the Nikkei 225 index shedding over 3%.

Yet we mustn't ignore the good showing of services. As we point out later (see article on p.9), a recovery in the emerging economies will require an upturn in China to be sustainable. Recent data lend weight to the scenario of a soft landing. Chronic overcapacity in China's manufacturing sector has led to a divergence in momentum compared with services, illustrating the country's gradual transition towards a consumption-based economy. Moreover, the authorities' determination to make China a major power is backed by colossal firepower. Credit conditions are still restrictive, so we can expect to see more accommodative action by the PBoC this year. Reform plans are under way and efforts to shore up state

companies and rein in local government debt have come at the right time. We will be following these developments closely.

Services around the globe are underpinned by private consumption, which is itself getting a boost from job creation, reviving credit and tame structural inflation. In the US, the UK and China, wage growth is kicking in as well.

MACRO-ECONOMIC SCENARIO

2016, A HIGH-RISK TRANSITION YEAR FOR THE GLOBAL ÉCONOMY

This first issue of the year for *Macro Highlights & Strategy* is given over to the main economic themes that will shape 2016. For 15 years our scenario has reflected the top-down view taken by the Private Banking division's economists. Our aim is to be as clear and accurate as possible, although this is only part of our analysis. And it must not be viewed as a set of investment recommendations.

1. **Global expansion is mainly being driven by the developed countries**
   GDP growth in the US and the Euro Zone is above trend while Japan is emerging from recession. China has managed to stabilise growth between 6% and 7%.
   RISK: An economic slowdown in any of these regions would be contagious.

2. **Private consumption is underpinning demand**
   Household spending is being kept buoyant by job creation, growth in lending and tame structural inflation. Consumption will be especially robust in countries with strong wage growth (i.e. the US, the UK and possibly Japan).
   RISK: Weakness in capital investment and international trade would cancel out the benefits of this trend.

3. **Among the emerging countries, expansion is being led by China**
   While Brazil and Russia struggle to shake off recession, China's authorities are striving to change their economy's growth model. Rising private consumption will help the services sector become more resilient while expanding trade among the emerging markets will strengthen China's influence in this group of countries.
   RISK: A hard landing in China would pose a major threat to global growth.

4. **Inflation will turn up sharply at the beginning of the year and then level out**
   It will remain below central banks' target rates.
   RISK: Surging wage growth or oil prices would rekindle fear of inflation.

5. **There will be no more surprises from central banks**
   The Fed will raise short-term rates 100 basis points a year. So will the BoE, though starting from a later date. The ECB, the BoJ and the SNB will maintain an accommodative stance by continuing to print money.
   RISK: The Fed and the BoE could both be "behind the curve" (i.e. late in relation to the business cycle) or could be perceived as being so.

6. **Sovereign yields will go up…**
   But relatively low growth potential, large-scale money printing in Europe and Japan and the glut of global savings will prevent 10-year yields from climbing to more than 3.1% in the US, 2.9% in the UK, 1.2% in the Euro Zone, 0.7% in Japan and 0% in Switzerland.
   RISK: Worries about inflation would push yields up higher and faster.

   …while corporate spreads will narrow
   Historically yield differentials between corporate and sovereign bonds narrow when the Fed tightens its monetary policy. At their present levels corporate yields cover the underlying risk. It is time to consider this segment with renewed interest.
   RISK: If yields rise too far too fast, they will wipe out the gains on the spread.

7. **Equity markets are richly valued**
   Earnings growth will be positive, primarily across Europe. However, this could be more than counterbalanced if market P/Es continue to edge down.
   RISK: Unpleasant economic developments could end the bull run in equities.

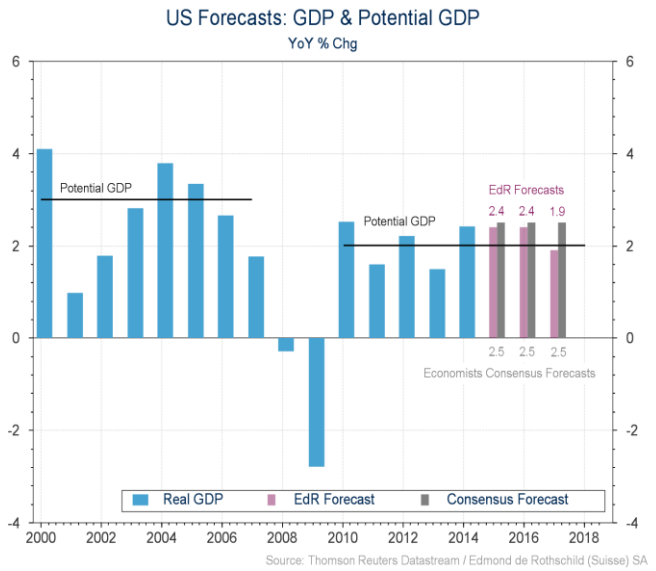
8. **In the emerging markets, priority should be given to the ones that are undertaking reforms**
   It is now possible to buy emerging assets, an essential part of the global financial scene, at reasonable prices. Preference should be given to India, Mexico and countries in Eastern Europe, which all have robust fundamentals, trade heavily with the developed economies and are undertaking reforms.
   RISK: If global growth is too weak, the upside potential of the emerging markets will be limited.

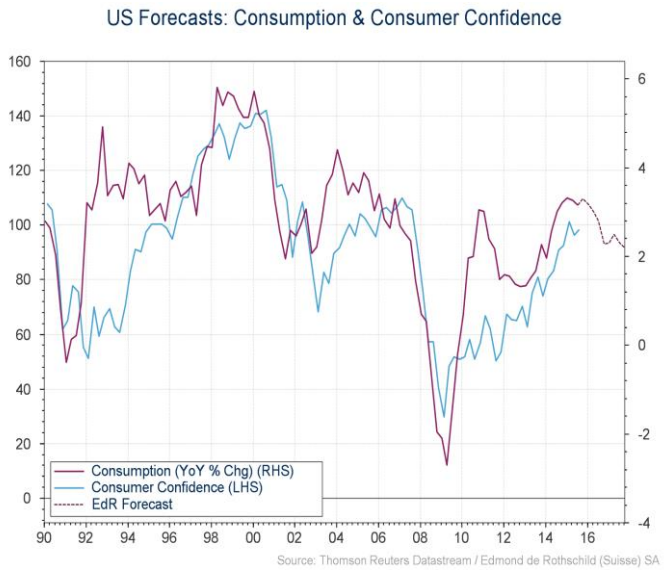
9. **The dollar is appreciating but is starting to look expensive**
   The dollar and the pound are benefiting from the divergence in monetary policy between the Fed and the BoE, on the one hand, and the rest of the world, on the other. Yet the currency market already priced in a good part of this situation in 2014 and 2015. We expect the greenback to reach 1.01 vs the euro, 135 vs the yen, 1.61 vs the pound and 1.03 vs the Swiss franc.
   RISK: With the dollar already overbought, there seems to be too much open interest on the long side.

UNITED STATES

A NEW ERA BEGINS

The US economy will continue to grow at about the same rate in 2016 as it did last year. Our models point to a pace of 2.4%, somewhat above the 2% trend line. However, the momentum underlying this rosy outlook is not as firm as it seems. GDP growth could dip below its long-term potential in the second half of 2016 or in 2017 (see left-hand chart below).

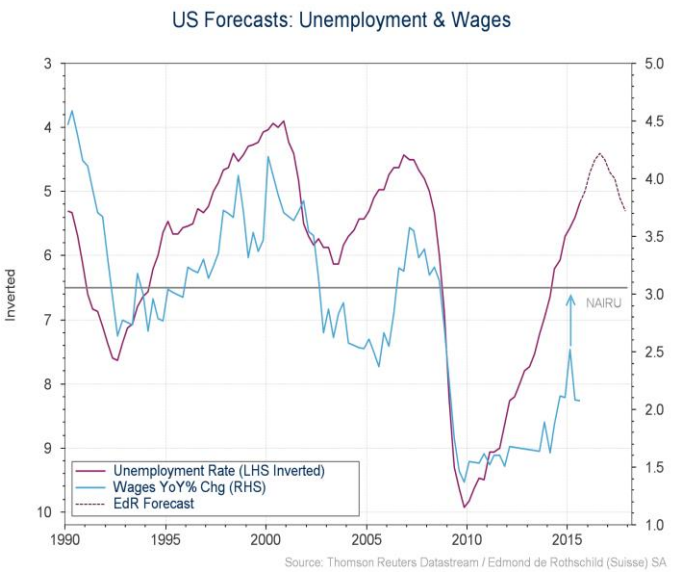


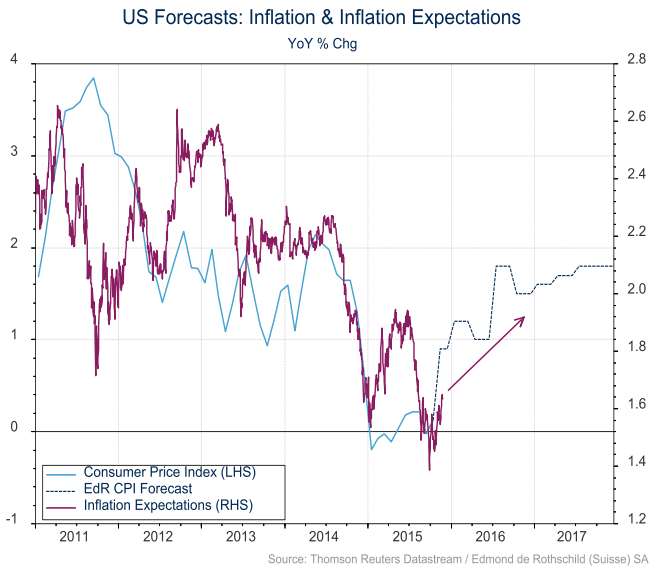


American consumers will continue to provide the main impetus of overall expansion, with household spending increasing at about 2.8% this year. This is a promising forecast, knowing that private consumption accounts for roughly 65% of US GDP. Growth in consumer spending will be spurred by rising wages, given the significantly improving labour market. Unemployment is expected to decline even further to a low of 4.4% (see left-hand chart below).

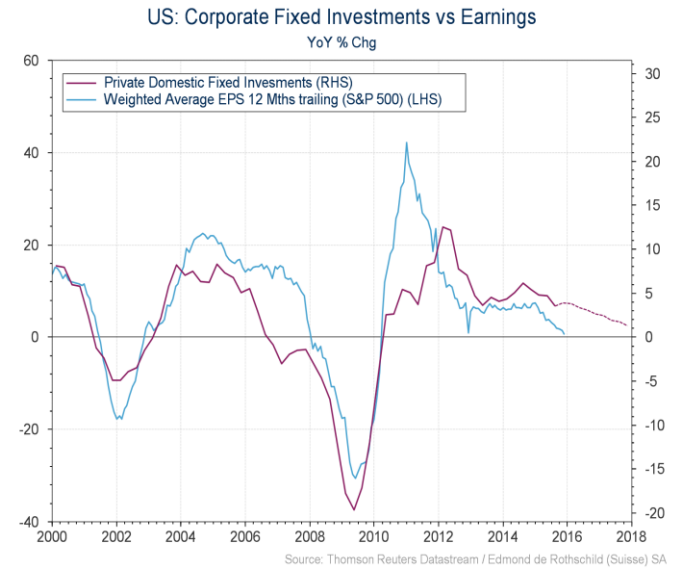
As a consequence of this strong domestic demand, inflation will accelerate at last as the “base effect” of low oil prices is factored out. If energy prices steady at current levels, headline inflation should turn up sharply in the first quarter of 2016 and then stabilise below the Fed’s 2% target rate. Inflation expectations are also likely to take off in the current quarter (see right-hand chart below).

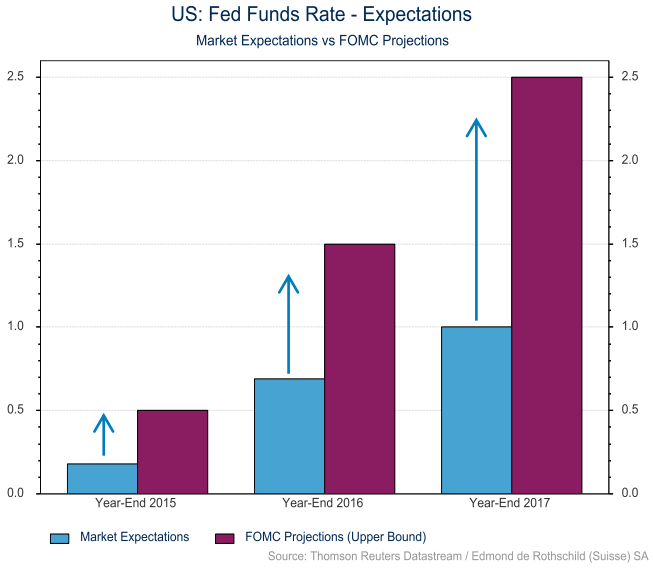
However, monetary tightening and the dollar’s concomitant muscle-flexing will continue to weigh on the trade balance and on industrial production. US exports will also be hurt by weak global demand and rising producer prices. Companies will remain reluctant to spend on new plant and equipment throughout 2016, with capex growing at just 3.2% compared with an average of 5.3% over the past five years (see right-hand chart on next page).





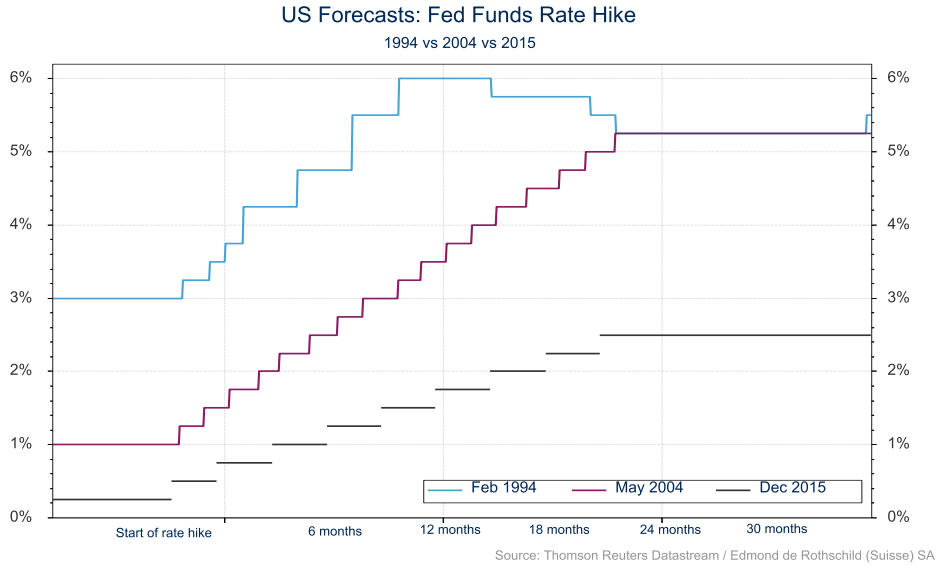
Finally, 2016 will be marked by a new era of monetary tightening. After remaining ultra-accommodative for ten years, the Federal Reserve (Fed) raised interest rates on 16 December and will continue to ratchet them up at regular intervals. We expect the US central bank to increase its federal funds rate by a total of 100 basis points this year (see chart on following page). Given the outlook for growth and inflation, as well as the lag in US monetary policy that has built up in recent years compared with the business cycle, the Fed should be able to keep its promise to tighten regularly.





The majority of investors do not share this view and anticipate only two 25bp upticks in 2016 (see right-hand chart above). Sixty per cent of economists believe the Fed will raise rates again only once this year, in

March. The bond market has priced in these perceptions. If it has to reverse course and align itself with the Fed's projections, there will be considerable disappointment.



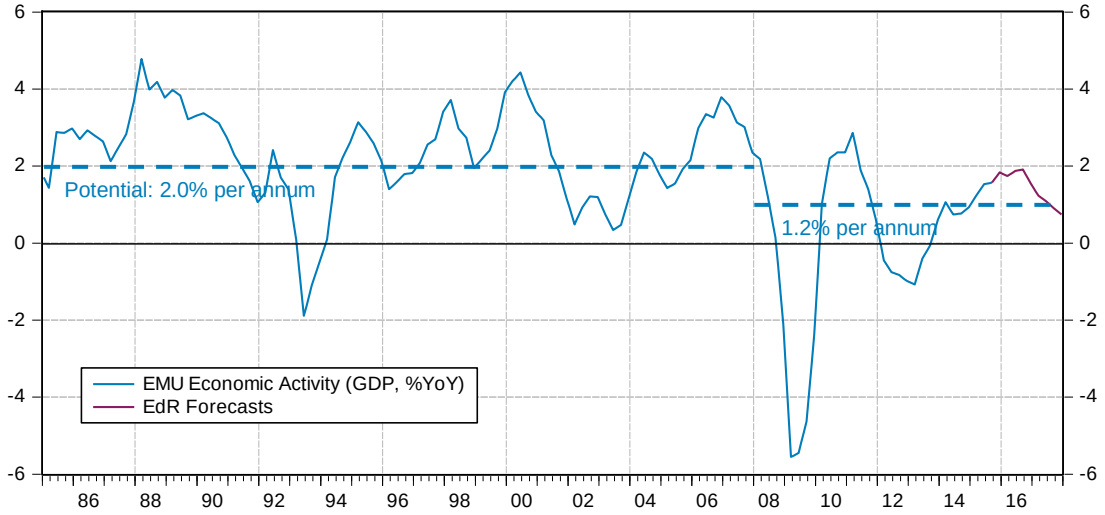
EURO ZONE

GROWTH IS BACK ON TRACK AT LAST

Growth in the Euro Zone has settled back in positive territory. Our econometric models forecast 2% expansion in the region's Gross Domestic Product (GDP) during the first six months of 2016. The rate could subsequently fall back somewhat, but there is no cause for alarm. Growth simply cannot stay sustainably above its 1.2% trend line.

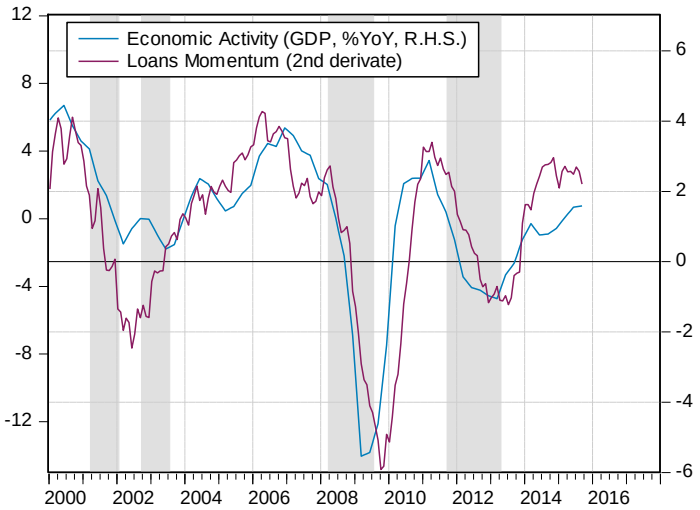
The monetary policy of the European Central Bank (ECB) has contributed to the Euro Zone's economic upswing. After shoring up the banking system from 2008 to 2014, the ECB finally opted for massive liquidity injections that began in early 2015 and will continue this year. This quantitative easing will pay off by restoring confidence, depreciating the euro and reviving credit. All these factors will boost economic activity throughout Europe.

Euro Area Economic Activity (GDP, %YoY)

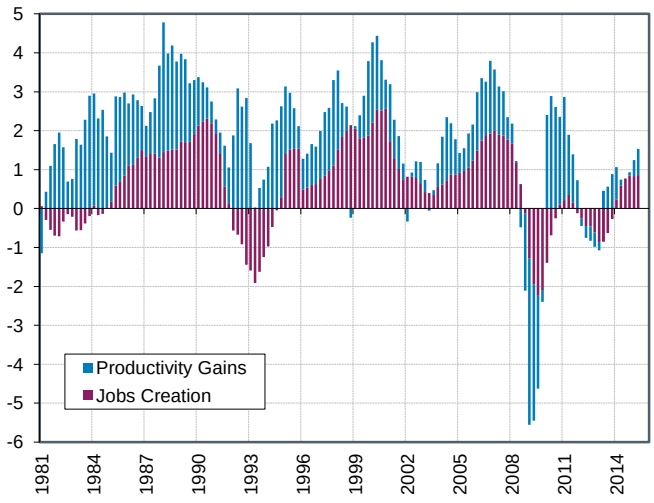


For the first time since 2008 job creation in Euroland is trending upwards (see right-hand chart below). This will sustain growth by helping to boost consumers' purchasing power, their sentiment and, ultimately, their spending.

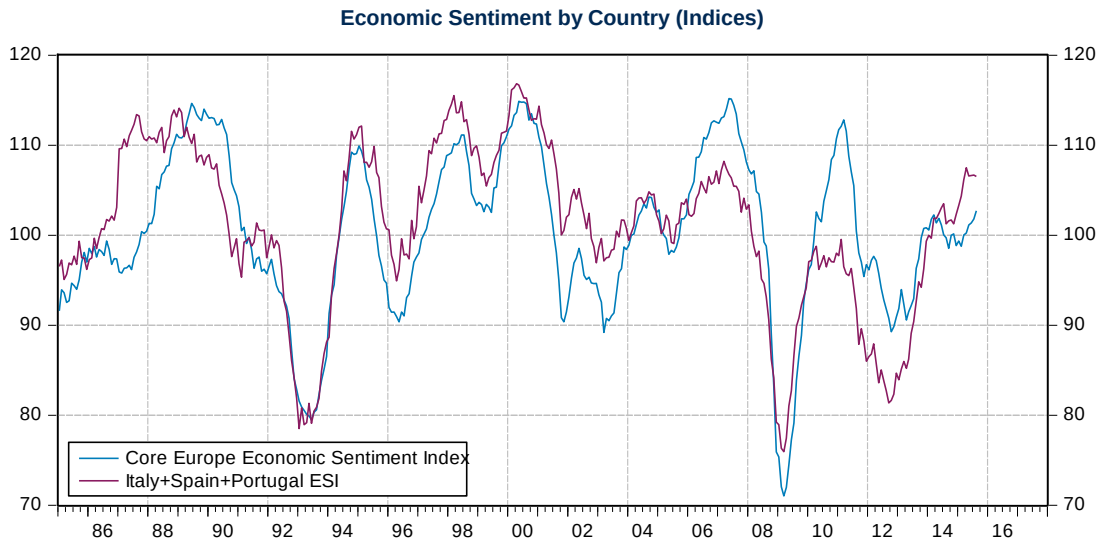
GDP Growth vs Momentum in Lending



Breakdown of GDP: Productivity Gains and Job Creation



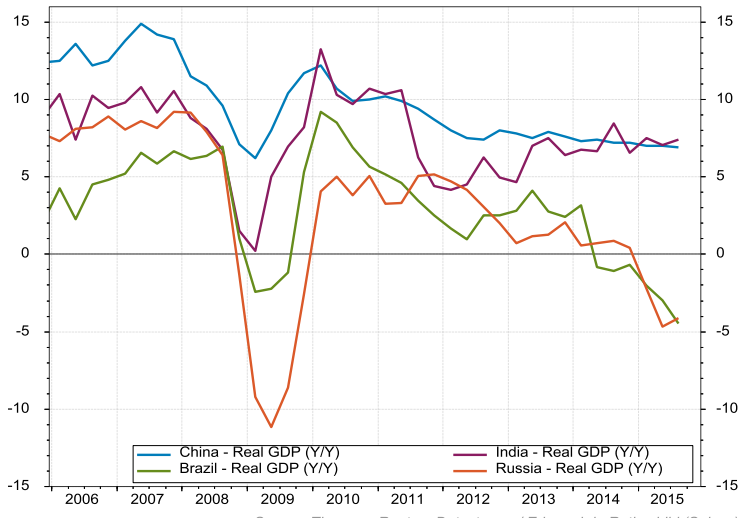
The peripheral countries have been first in line to benefit from the recovery. Four years of budget cuts and reforms are starting to pay off. Italy, Portugal and Spain, in particular, are now enjoying stronger growth momentum than the zone's core members (Germany, France and the Netherlands) (see chart below).



EMERGING MARKETS

CHINA IS THE MAIN SOURCE OF GROWTH… AND RISK

Not once in 2015 did the emerging countries seem capable of shaking off their five-year-old funk. Adding to the slump in most commodities, China's stockmarket was hit by a steep sell-off and the yuan depreciated unexpectedly. Political uncertainty in Turkey, Russia and Brazil did not help matters. To cap it all, the US Federal Reserve's long hesitation before finally raising interest rates undermined all the emerging currencies.



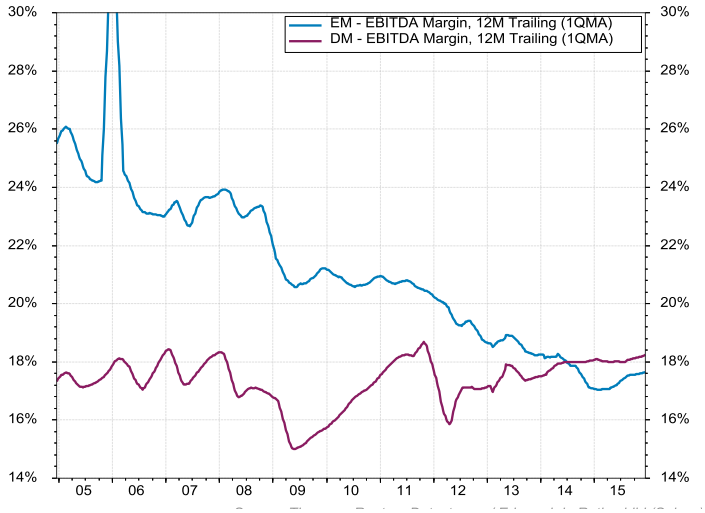
The emerging stockmarkets have a dim track record: for five years now they have underperformed their developed counterparts. 2016 is dawning with a host of questions. **Is it mad to think that the emerging economies will re-experience a super-cycle like the one in the 2000s?** Is their current slump a mere conjunction of temporary factors or does their long-term growth potential need to be revised downward? Will the BRICs develop at a similar pace or will fundamental disparities between them result in diverging stockmarket performances (see chart on previous page)?

An economic vs structural downturn: historical background

A number of factors that used to work in the emerging markets' favour have turned tail. Economic growth worldwide has slowed, commodity prices have slumped, the US Federal Reserve has adopted a more hawkish stance and the dollar has strengthened. Yet these factors do not explain everything. **The fundamentals of the emerging economies have also changed significantly since the 2002-08 boom years, lending legitimacy to investors' mistrust in the intervening period.**

At the turn of the millennium, US consumers went deep into debt to maintain their robust spending, providing a choice export market for Asian manufacturers. Commodity-producing countries like Brazil, Russia and South Africa were drawn into this growth spiral, which came to an abrupt halt in 2008 when the subprime implosion ended America's credit binge. With exports no longer able to drive expansion alone, the emerging economies, led by China, turned to industrial projects, infrastructure investment and other vast programmes of fiscal stimulus. This economic reversal led to a decoupling of growth rates in the emerging regions (where activity remained robust) and in the developed world (where it stagnated). But in 2011 the slump in the industrialised countries caught up with their emerging counterparts, which began to stumble and become prey to increasing capital flight.

Oddly, these three periods marked by such widely differing growth dynamics also brought a continuous decline in the return on capital invested in the emerging economies (see left-hand chart below). This deterioration, regarded as not at all worrying during the two expansion phases, has in recent years become the main variable in these regions' weakness. Taking this argument further, **the major problem now lies in flagging corporate profitability: margins have been falling relentlessly and are below the level in the developed economies** (see right-hand chart below). The decline is mainly rooted in wage growth, which is far outdistancing productivity gains in the emerging countries.



The big challenge facing the emerging countries at present is to overcome this poor business performance and bring profitability back into line with its potential rate.

Towards a structural turnaround?

Sluggish global expansion is crimping the chances of emerging companies increasing their sales. Nor can they rely on borrowing to shore up profitability, as they did amply in 2009-10 when their governments embarked on vast spending programmes. **As a consequence, these countries now have their backs to the wall and have been forced to reassess a growth model flawed by the inefficient allocation of capital and resources**. Some, such as India, Mexico and China, are pursuing a new paradigm that involves undertaking structural reforms. Others like Brazil lack the necessary leeway or political resolve to do likewise.

Trade flows have also changed in recent years. While emerging exporters formerly got a big leg up from robust consumption in the developed countries, particularly America, now the trend is towards increasing trade among the emerging economies themselves. Thus **any economic upswing in the bloc as a whole will have to be driven by intra-regional synergies**. Clearly, though, growth prospects are not promising enough at present to foresee such a convergence. So, for investors, the name of the game is to pick and choose, with a focus on Mexico and Eastern Europe, which are either benefiting from growth momentum in the developed world, and India, which can claim strong organic expansion.

Finally, a recovery in the emerging economies will require an upturn in China to be sustainable. Recent data lend weight to the scenario of a soft landing. Chronic overcapacity in China's manufacturing sector has led to a divergence in momentum compared with services, illustrating the country's gradual transition towards a consumption-based economy. Moreover, the authorities' determination to make China a major power is backed by colossal firepower. Credit conditions are still restrictive, so we can expect to see more

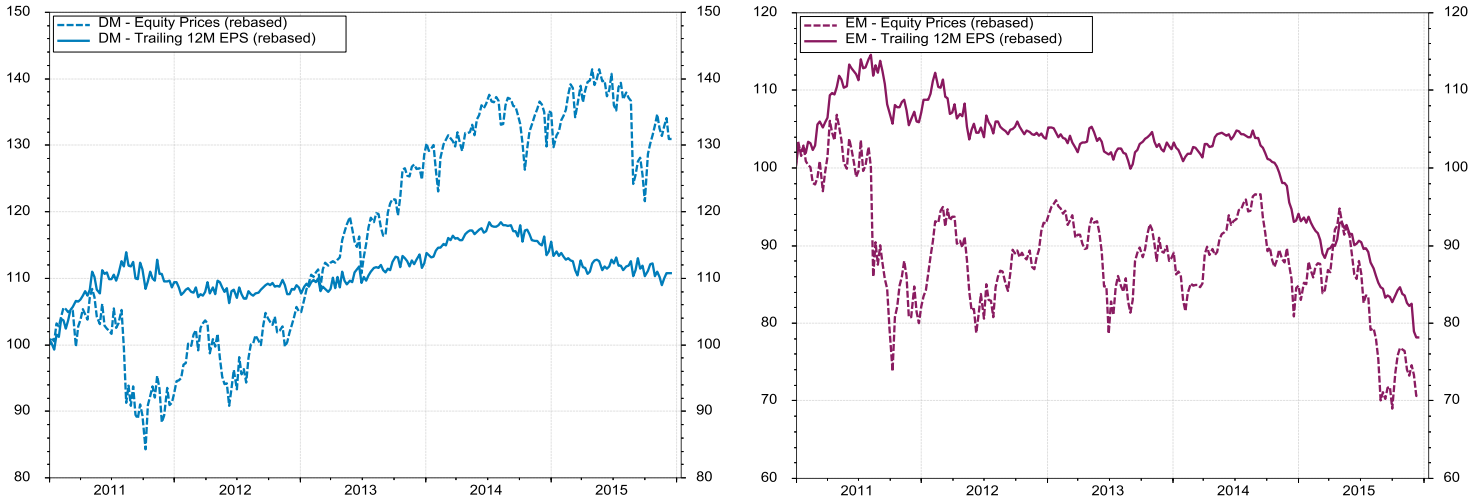
accommodative action by the PBoC this year. Reform plans are under way and efforts to shore up state companies and rein in local government debt have come at the right time. We will be following these developments closely.

Market implications

As we can see, a turnaround in the emerging markets' dynamics will have to combine a stabilisation of the Chinese economy, real progress in structural reforms and improved corporate profitability. **This last prerequisite is not only the big question mark for 2016 but also the factor that is holding back the progression of equities near term**.

Still, the emerging markets have a high trump card in their hand. Equities in these countries have seen massive capital flight since 2011, with the result that they are now fairly valued (see charts below). **So, while their downside potential has not been exhausted altogether, it has clearly been significantly reduced**.

Corporate profits and equity benchmarks in the developed and emerging markets



In summary 2016 will mark a transition year for the emerging countries, with the best illustration again being China. **Although the prospect of short-term gains is probably limited, investors have a real opportunity to reconsider the place of the "EM" theme within a diversified portfolio**. 2016 could mark a good starting point for those who are willing to gradually (re)build a position on these countries, whose contribution to global GDP will continue grow.

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%	2.5%	2.5%	23.2%	0.58%
Canada	2.4%	1.2%	1.8%	2.0%	0.04%
Euro Area	0.9%	1.5%	1.7%	14.5%	0.25%
United Kingdom	2.6%	2.4%	2.3%	4.0%	0.09%
Switzerland	1.9%	0.9%	1.2%	0.8%	0.01%
Russia	0.5%	-3.8%	-0.5%	1.9%	-0.01%
Japan	0.2%	0.6%	1.1%	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%	-3.5%	-2.5%	2.1%	-0.05%
Mexico	2.1%	2.5%	2.8%	1.6%	0.04%
Others	4.4%	3.3%	4.8%	23.6%	1.14%
WORLD	**3.4%**	**3.1%**	**3.6%**	**100%**	**3.6%**

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 3.6% 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)	399	-0.7%	-1.8%	n.a.	-1.8%
United States (S&P 500)	2'044	-0.8%	-1.6%	n.a.	1.4%
Euro Area (DJ EuroStoxx)	338	-0.3%	-5.5%	-2.2%	11.2%
United Kingdom (FTSE 100)	6'138	-0.2%	-1.7%	-1.8%	-1.0%
Switzerland (SMI)	8'688	1.8%	-1.9%	-1.5%	1.1%
Japan (NIKKEI)	18'451	0.9%	-3.5%	-3.1%	11.0%
Emerging (MSCI)	794	-1.2%	-2.4%	n.a.	-14.8%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	2.23%	-0.2%	-0.9%	0.0%	2.1%
Euro Area (7-10 Yr)	1.47%	0.3%	-1.3%	0.0%	1.0%
Germany (7-10 Yr)	0.58%	0.2%	-1.3%	0.0%	0.9%
United Kingdom (7-10 Yr)	1.91%	-0.3%	-1.3%	0.0%	0.7%
Switzerland (7-10 Yr)	-0.04%	-0.3%	-2.8%	0.0%	3.7%
Japan (7-10 Yr)	0.26%	0.1%	0.5%	0.0%	1.4%
Emerging (5-10 Yr)	5.16%	0.1%	-1.5%	0.0%	1.6%
United States (IG Corp.)	3.63%	-0.1%	-1.2%	0.0%	-0.8%
Euro Area (IG Corp.)	1.21%	0.0%	-0.9%	0.0%	-0.5%
Emerging (IG Corp.)	4.65%	0.0%	-1.5%	0.0%	-2.3%
United States (HY Corp.)	8.96%	0.3%	-2.8%	0.0%	-3.5%
Euro Area (HY Corp.)	5.38%	-0.6%	-2.5%	0.0%	0.3%
Emerging (HY Corp.)	10.64%	0.2%	-2.9%	0.0%	3.6%
United States (Convert. Barclays)	43	-0.3%	-1.4%	n.a.	-0.8%
Euro Area (Convert. Exane)	7'498	0.4%	-1.6%	n.a.	7.6%
Real Estate					
World (MSCI)	190	-0.1%	0.9%	n.a.	1.0%
United States (MSCI)	200	0.2%	1.8%	n.a.	4.6%
Euro Area (MSCI)	210	0.3%	-3.2%	n.a.	16.1%
United Kingdom (FTSE)	6'593	0.3%	0.5%	n.a.	9.4%
Switzerland (DBRB)	3'581	0.6%	2.3%	n.a.	4.6%
Japan (MSCI)	270	-0.4%	-1.2%	n.a.	0.9%
Emerging (MSCI)	100	-0.3%	1.4%	n.a.	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	555	n.a.	0.2%	n.a.	0.1%
Distressed	732	n.a.	-0.8%	n.a.	-4.6%
Event Driven	601	n.a.	-1.2%	n.a.	-5.1%
Fixed Income	302	n.a.	0.1%	n.a.	0.4%
Global Macro	903	n.a.	1.4%	n.a.	2.3%
Long/Short	677	n.a.	-0.1%	n.a.	3.6%
Managed Futures (CTA's)	324	n.a.	3.7%	n.a.	1.3%
Market Neutral	265	n.a.	-1.0%	n.a.	0.1%
Multi-Strategy	520	n.a.	0.2%	n.a.	3.6%
Short Bias	30	n.a.	-3.3%	n.a.	-2.3%
Commodities					
Commodities (CRB)	379	0.4%	-0.2%	n.a.	-15.2%
Gold (Troy Ounce)	1'073	0.3%	-1.0%	1.0%	-10.6%
Oil (Brent, Barrel)	36	-1.0%	-16.9%	1.1%	-35.9%
Currencies					
USD	98.2	0.3%	-0.1%	-0.4%	9.3%
EUR	1.09	-0.5%	0.3%	0.5%	-10.2%
GBP	1.48	-0.7%	-2.3%	0.2%	-5.4%
CHF	1.00	-0.3%	0.1%	0.6%	-0.8%
JPY	119.0	1.2%	3.5%	1.1%	-0.4%

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

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