MACRO HIGHLIGHTS & STRATEGY

WEEK OF 27 JUNE 2016

OUR ROUNDUP:

- **Markets: Brexit – the path of uncertainty**
  - Long-term political uncertainty should fuel risk aversion among investors.
  - Once again, the initial focus will be on monetary policy rather than budgetary measures.
- **United States: Property market – still some upside**
  - With the supply of residential properties showing signs of saturation, construction should remain firm.
  - Demand is driven by affordable prices, healthy household finances and an influx of young buyers.
  - Property prices could rise further.
- **Emerging markets: China – lending starts to level off**
  - The surge in credit should ease as stimulus measures are dialled down.
  - The money supply provides some insight into the real economy.

MARKETS

BREXIT – THE PATH OF UNCERTAINTY

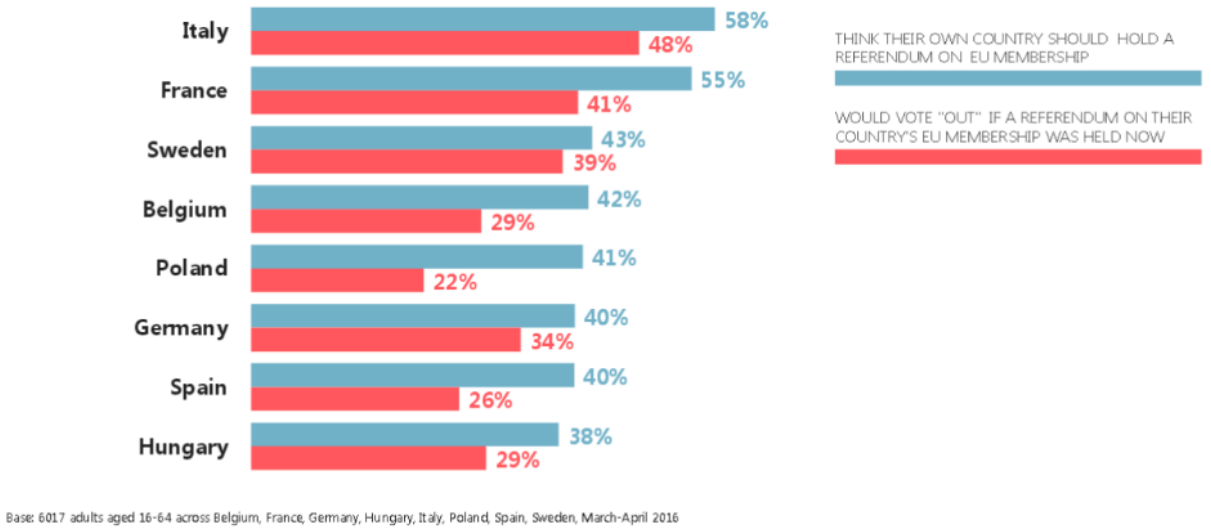
The shock wave created by the Brexit vote has diminished investors' appetite for risky assets: global equity markets shed an estimated USD 2.080 trillion on Friday alone, according to Standard & Poor's.

The initial surprise is now likely to give way to **a period of political transition marked by a high level of uncertainty on the financial markets**. The UK is in no hurry to invoke Article 50 of the Lisbon Treaty, which sets the terms for withdrawing from the European Union. David Cameron has announced his resignation, effectively leaving it to the next prime minister, come October, to handle the difficult negotiations with the 27 remaining member states. The negotiations could be further complicated or even blocked if any new agreements require the approval of the House of Commons, where 463 of the 650 MPs are against leaving the EU. The possible secession of Scotland adds to the intrigue.

Euro Zone countries will have to maintain a **unified political discourse for the European project to remain viable and for the growth outlook to remain stable**. Yet a wide range of views on how the negotiations should be handled have already been aired. And domestic politics in various member states

will only complicate the mix. Over the next two years Eurosceptics and their demands will be an issue in key elections in France, Germany and the Netherlands. And the election in Spain last weekend highlighted a number of sticky issues, such as the challenge of coalition-forming, compliance with the budgetary measures recommended by the European Commission, and sovereign debt in peripheral countries.

Survey: Should your country hold a referendum on remaining in the in EU? How would you vote?



Source: Ipsos Global

Given the political uncertainty and the challenge of coordinating fiscal policy, **central banks are very likely to have to step into the breach.** The Bank of England, the European Central Bank, the Bank of Japan and even the Fed will all engage in monetary creation until governments come up with appropriate budgetary measures. **The low interest-rate environment is set to last for a while**.

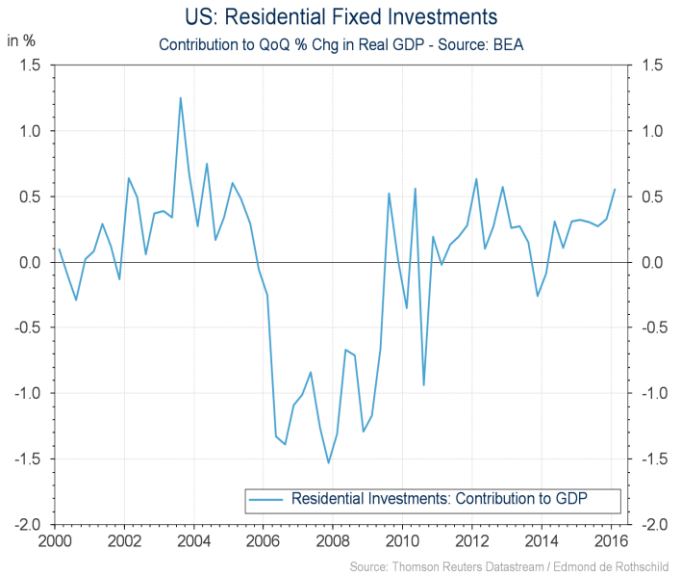
Mathilde Lemoine looked at a number of these issues in her latest weekly Column, and in the next few days the Economic Research department will publish an in-depth analysis of the impact of the Brexit vote on the US, European and emerging-market economies.

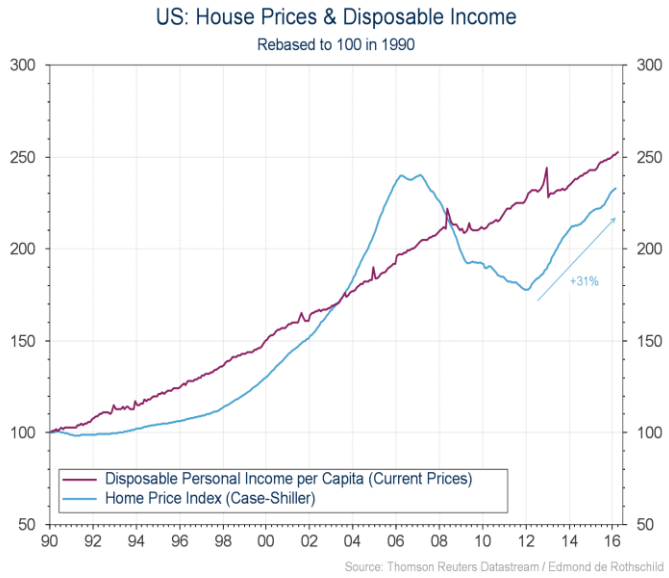
UNITED STATES

STILL SOME UPSIDE ON THE PROPERTY MARKET

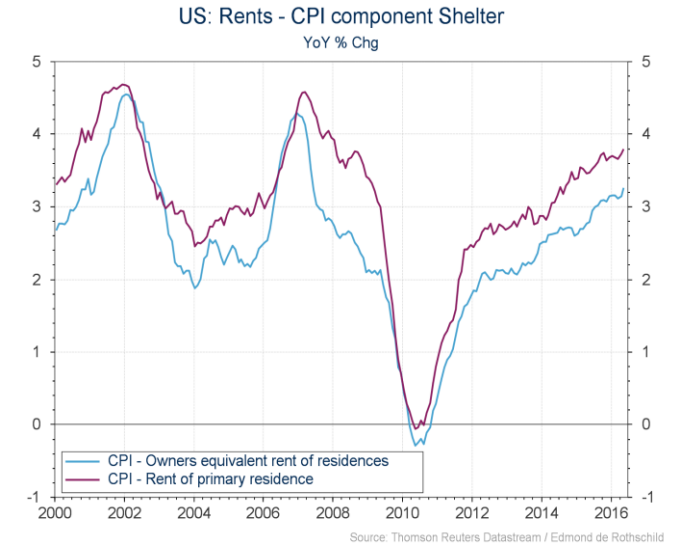
In the wake of the 2008 financial crisis, the US Federal Reserve (Fed) set extremely low interest rates. The aim was to boost the economic recovery, first through corporate lending and then through the property market. **Since 2011, the property market has boosted GDP through investment in residential**

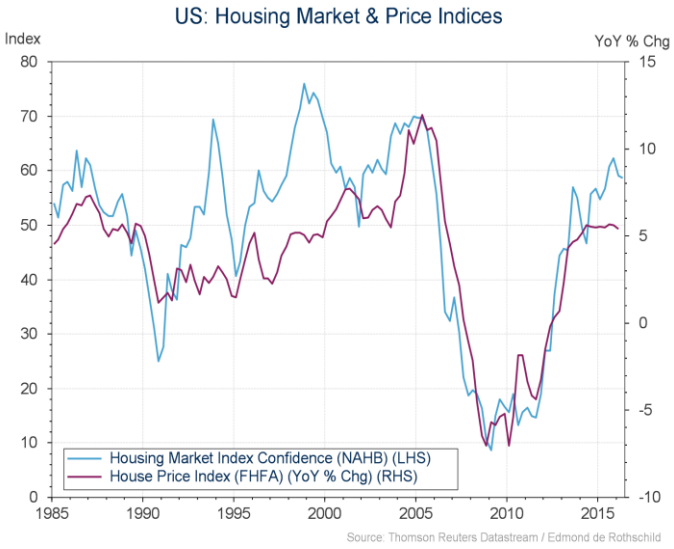
construction, adding 0.24% per quarter on average (see left-hand chart). The property market surge was fuelled by very low interest rates, declining unemployment and affordable prices.





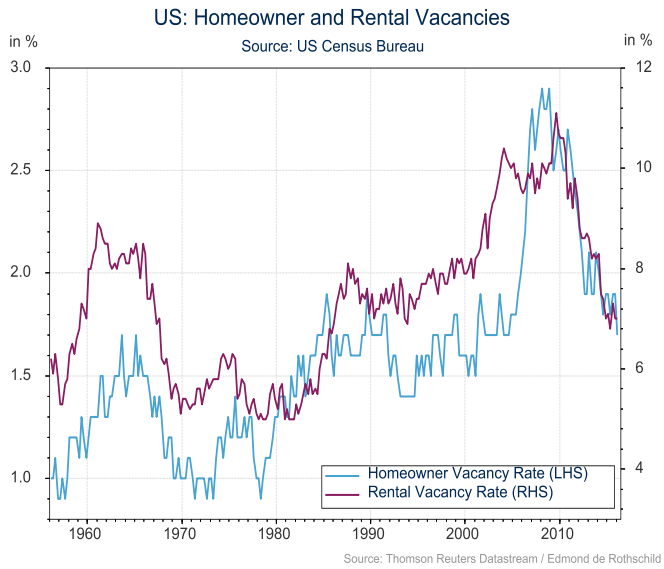
The Case-Shiller home price index has now reached levels last seen in 2006 (see right-hand chart above). At the same time, rents are rising by 3.5% per year and account for 33% of overall price inflation (see left-hand chart below). But the Federal Housing Finance Agency (FHFA) reports that house prices have been rising at a constant full-year rate of 5% on average for the past few quarters (see right-hand chart below). **What sort of upside is left on the property market? Are property prices indicative of where we are in the overall economic cycle?**

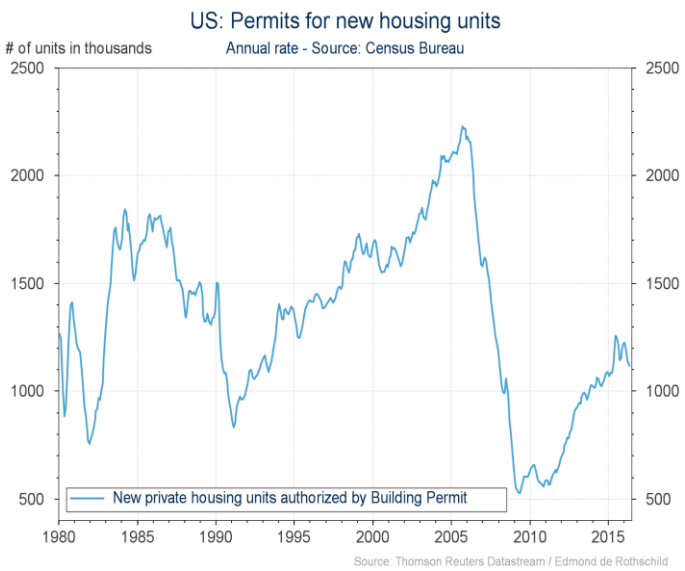




Supply

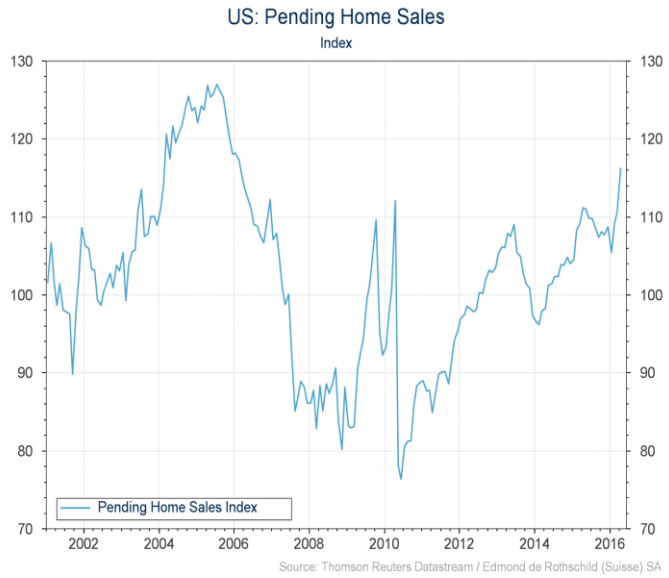
In terms of supply, the property market may be nearly saturated. Home and rental vacancy rates are down (see left-hand chart below), and this decline in supply translates into upward pressure on prices. New building permits have been flat at around 1,200,000 per year since mid-2015 (see right-hand chart below). On the other hand, sentiment among builders is solid (Housing Market Index – see right-hand chart above), which could imply a rise in the construction of new housing. This could buoy growth in the USA for at least another few quarters.





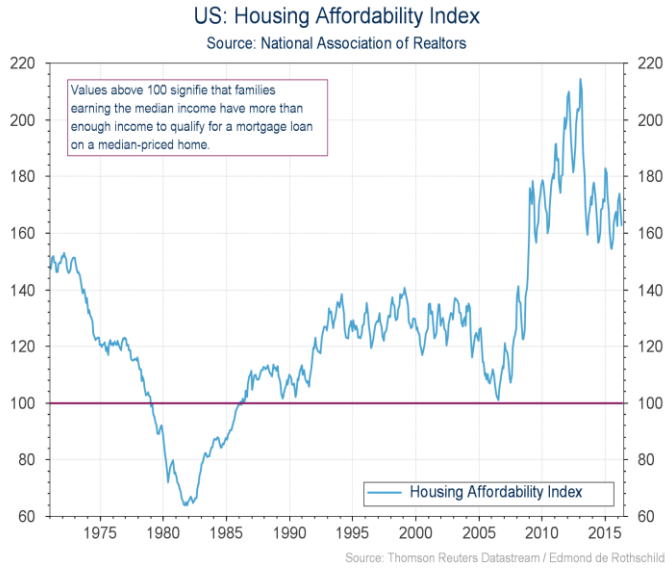
Demand

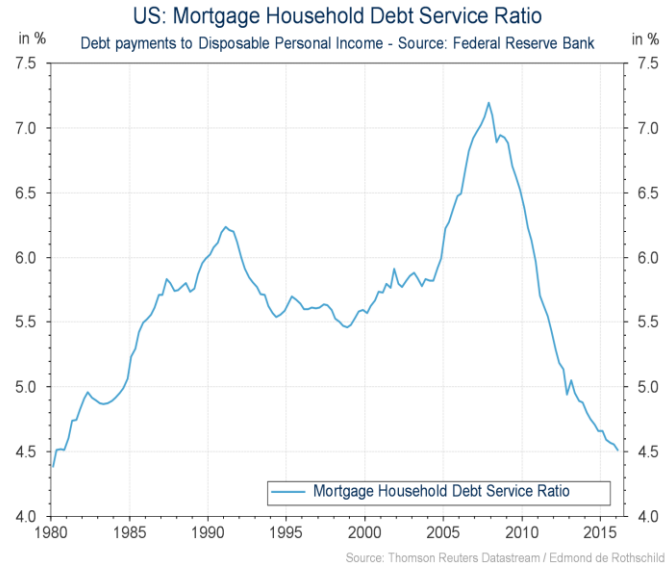
On the other side of the equation, indicators are still suggesting a sharp rise in demand. Pending home sales, which in most cases lead to a deal two or three months later, reflect strong consumer demand (see left-hand chart below). Along these same lines, mortgage applications to buy a home are rising slowly but surely (see right-hand chart below).



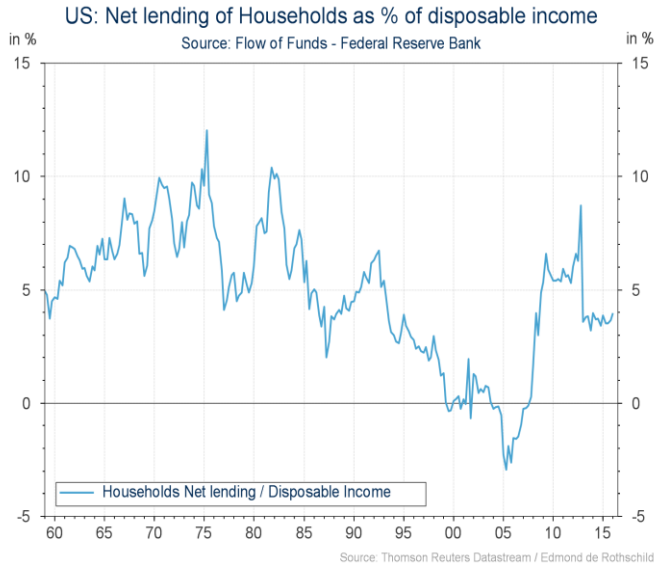
Demand for property therefore appears to be on a firm uptrend:

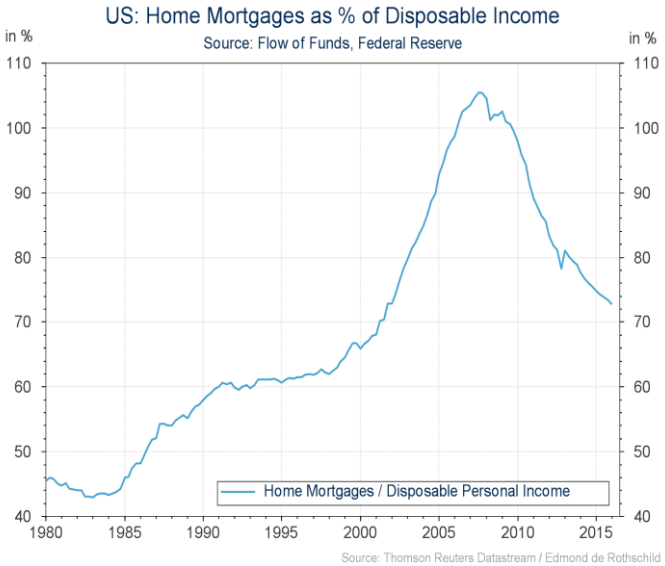
1. **The property market is still affordable, which encourages consumers to invest.** A reading above 100 on the Housing Affordability Index (see left-hand chart below) means that a US family with a typical level of income can easily qualify for a mortgage loan on a typical house. The reading is currently at around 170, which is very high. Consumers also have enough disposable income to easily cover their interest payments, as seen in the right-hand chart below.



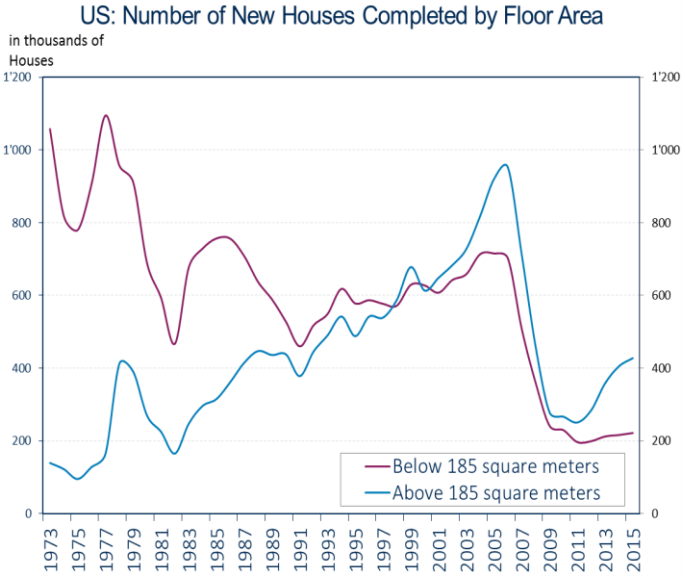


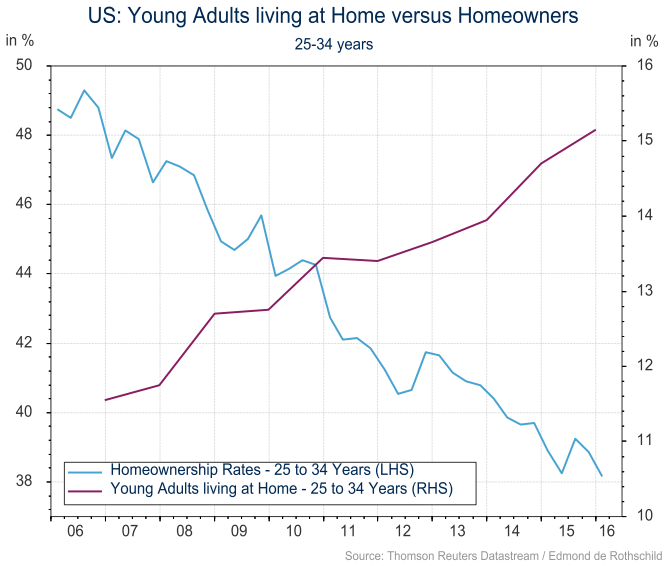
2. Consumers can also afford to invest in property today. **After paying down their debt for the past seven years, they are in much better financial straits** and their net borrowing currently equals 4% of disposable income (see left-hand chart below). Mortgage debt now represents only 70% of their disposable income versus 105% in 2007 (see right-hand chart below). Consumers were hit very hard by the subprime crisis and do not want to find themselves in the same situation as in 2007. But they have the capacity to borrow more. This comfortable position should boost demand for property.





3. **Young Americans did not play much of a role in the property market recovery.** For one thing, while the construction of large homes accelerated starting in 2011, the pace of construction of small homes remained flat (see left-hand chart below). This meant that young first-time buyers, who commonly opt for smaller properties, were largely excluded from the property market turnaround. At the same time, the rate of young homeowners decreased (38%) while the proportion of people between the ages of 25 and 34 still living with their parents rose (see right-hand chart below).
This imbalance had both structural causes, including the high burden of student debt, and economic ones, as young people and first-time job seekers were disproportionately affected by the financial crisis and unemployment. The economic causes are currently receding. Unemployment among 25- to 34-year-olds is 5%, wages are increasing and confidence is on the rise. **More young people will want to buy property, and the increase in demand will push up prices.**





Conclusions

- With the supply of housing limited and demand growing, home-building should expand further and property prices should continue rising for a few more quarters. The US price index will be supported by the uptrend in property prices, and GDP will get a boost from spending on residential construction. This should underpin 1.9% growth through the end of 2016 and 2.2% in 2017, despite the drop-off in non-residential private investment (see our macroeconomic outlook for more details).
- Are rising property prices a sign of an overheating economy? This one indicator is not enough to tell us where we are in the economic cycle. Property lending is a procyclic indicator: when it picks up speed, the output gap is positive. But it says nothing about when the current cycle will end.

EMERGING MARKETS

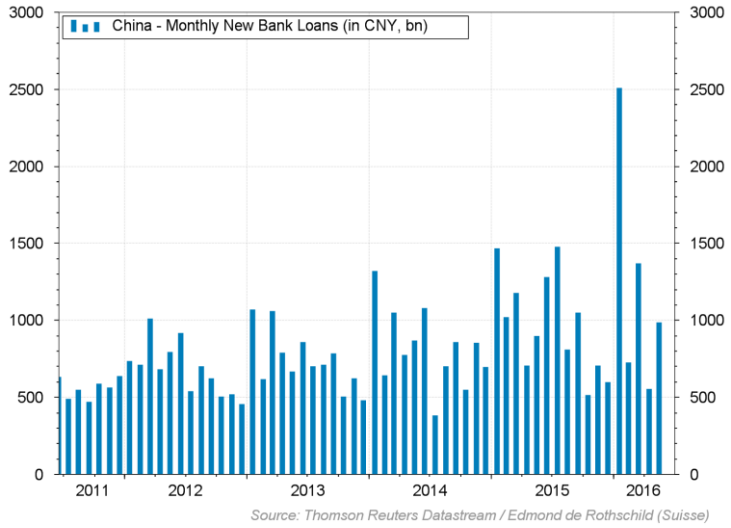
CHINA – LENDING STARTS TO LEVEL OFF

Lending in China appears to be levelling off after picking up speed from mid-2015 (see left-hand chart). Bank lending rose only 14.4% in May and should continue to ease, with the Chinese government ratcheting back its economic stimulus versus the first quarter of 2016. This should reassure investors that the government is serious about reining in the country's debt. **But newly created credit is being used mainly for infrastructure-related purposes rather than for supporting the economy's shift towards services and consumer spending**.

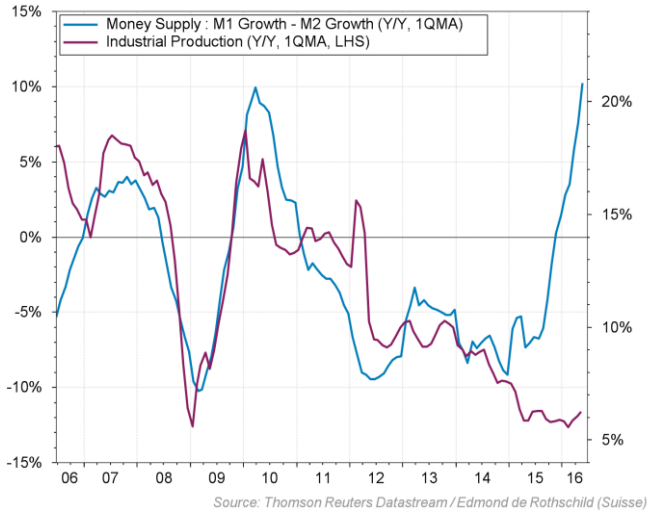
The government can also be lauded for the restrictions it has imposed on the shadow-banking sector. These seem to be paying off, as total social financing – a broad measure of lending that includes some of these off-balance sheet vehicles – has slowed to +12.6%. This improvement is due in part to a reduction in

bankers' acceptance bills – instruments designed to serve as commercial guarantees but often used to back off-balance-sheet loans.

Monthly credit creation in China



Industrial production and money supply



The growing gap between the M1 and M2 money supply is a red flag when it comes to the use of liquidity in China's real economy. Companies with capital spending plans usually park their liquidity in financial instruments that can be easily converted into cash, like demand deposits – which are a component of M1. If they do not have capital projects in the pipeline, they tend to place their cash in less liquid instruments that earn more interest, such as money-market funds or savings account – which are components of M2. So when M1 grows faster than M2 – indicating a preference for instruments that can be easily converted into cash – companies usually have spending projects in the works. Historically, China's industrial production sector has conformed to this trend (see right-hand chart).

Since 2015, however, the disconnect between these two variables suggests that the liquidity held by companies is not necessarily being channelled to capital spending any more. A number of factors are at work here, one of which is that companies are discouraged from investing by persistent overcapacity in the manufacturing sector.

Sooner or later, **the Chinese government will have to address this problem of surplus capacity, failing which future credit creation will lose its punch**.

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%	→ 2.3%	23.6%	14.2%
Canada	1.2%	→ 1.4%	→ 2.0%	1.9%	0.8%
Euro Area	1.5%	→ 1.5%	→ 1.6%	14.5%	6.9%
Germany	1.5%	↑ 1.7%	→ 1.6%	4.2%	2.2%
France	1.1%	↓ 1.4%	↓ 1.3%	2.9%	1.3%
United Kingdom	2.2%	↓ 1.8%	↓ 2.1%	3.5%	2.0%
Switzerland	0.8%	→ 1.2%	→ 1.6%	0.7%	0.3%
Russia	-3.7%	↑ -0.9%	→ 1.2%	1.6%	-0.5%
Japan	0.6%	↓ 0.6%	↑ 0.8%	5.1%	0.9%
China	6.9%	→ 6.5%	↓ 6.2%	18.4%	37.9%
India	7.4%	→ 7.5%	↓ 7.6%	3.4%	8.2%
Brazil	-3.7%	↑ -3.5%	↓ 0.9%	1.9%	-2.1%
Mexico	2.5%	→ 2.4%	↓ 2.7%	1.5%	1.2%
Others	3.8%	5.1%	6.1%	16.7%	26.8%
WORLD	**3.1%**	**3.2%**	**3.5%**	**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)	388	-1.4%	-2.0%	-1.3%	-1.8%
United States (S&P 500)	2'037	-1.6%	-1.7%	0.8%	1.4%
Euro Area (DJ EuroStoxx)	293	-1.9%	-6.6%	-10.8%	11.2%
United Kingdom (FTSE 100)	6'020	2.0%	-1.0%	0.6%	-1.4%
Switzerland (SMI)	7'683	0.4%	-4.7%	-9.2%	1.1%
Japan (NIKKEI)	15'309	-4.2%	-9.4%	-20.8%	11.0%
Emerging (MSCI)	806	0.1%	2.8%	2.6%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.48%	0.5%	2.8%	7.0%	2.1%
Euro Area (7-10 Yr)	-0.10%	0.3%	0.8%	4.9%	1.0%
Germany (7-10 Yr)	-0.10%	0.6%	1.9%	6.8%	0.9%
United Kingdom (7-10 Yr)	0.95%	0.5%	2.9%	7.2%	0.7%
Switzerland (7-10 Yr)	-0.54%	0.2%	1.8%	3.9%	3.7%
Japan (7-10 Yr)	-0.19%	0.3%	0.8%	4.0%	1.4%
Emerging (5-10 Yr)	4.77%	0.4%	1.9%	7.8%	1.6%
United States (IG Corp.)	2.93%	0.3%	1.9%	6.8%	-0.8%
Euro Area (IG Corp.)	0.78%	-0.2%	0.7%	3.6%	-0.5%
Emerging (IG Corp.)	3.89%	0.4%	1.4%	7.2%	-2.3%
United States (HY Corp.)	7.34%	0.5%	1.4%	9.3%	-3.5%
Euro Area (HY Corp.)	4.66%	-0.6%	-0.6%	2.8%	0.3%
Emerging (HY Corp.)	8.35%	0.5%	2.1%	11.3%	3.6%
United States (Convert. Barclays)	43	-1.2%	-0.9%	0.8%	-0.8%
Euro Area (Convert. Exane)	7'076	-0.6%	-2.6%	-5.6%	7.6%
Real Estate					
World (MSCI)	196	-0.6%	0.5%	4.7%	1.0%
United States (MSCI)	210	-0.2%	2.1%	6.3%	4.6%
Euro Area (MSCI)	216	1.2%	-2.1%	5.6%	16.1%
United Kingdom (FTSE)	6'653	0.7%	0.4%	0.9%	9.4%
Switzerland (DBRB)	3'763	-0.2%	-0.2%	4.3%	4.6%
Japan (MSCI)	228	-2.8%	-11.1%	-14.7%	0.9%
Emerging (MSCI)	97	1.0%	3.8%	-0.9%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	542	n.a.	0.4%	-1.5%	-0.7%
Distressed	730	n.a.	0.8%	0.4%	-5.3%
Event Driven	581	n.a.	1.0%	-1.9%	-6.3%
Fixed Income	304	n.a.	0.1%	0.3%	0.6%
Global Macro	865	n.a.	-0.2%	-2.2%	0.2%
Long/Short	656	n.a.	1.4%	-3.2%	3.6%
Managed Futures (CTA's)	310	n.a.	-3.2%	-2.1%	-0.9%
Market Neutral	266	n.a.	0.2%	-1.0%	1.7%
Multi-Strategy	525	n.a.	0.9%	0.8%	3.8%
Short Bias	29	n.a.	-0.7%	-5.8%	2.4%
Commodities					
Commodities (CRB)	424	-1.7%	4.8%	11.5%	-15.2%
Gold (Troy Ounce)	1'327	3.1%	9.4%	25.0%	-10.6%
Oil (Brent, Barrel)	46	-1.8%	-3.2%	31.3%	-35.9%
Currencies					
USD	96.3	2.9%	0.8%	-2.3%	9.3%
EUR	1.10	-2.7%	-0.9%	1.4%	-10.2%
GBP	1.32	-9.9%	-9.5%	-10.2%	-5.4%
CHF	0.98	-1.6%	1.8%	2.5%	-0.8%
JPY	101.6	2.3%	8.6%	18.4%	-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