EDMOND DE ROTHSCHILD

MACRO HIGHLIGHTS

WEEK OF 19 SEPTEMBER 2016

OUR HIGHLIGHTS:

- **Economists' insight: Yields are sharply up despite disappointing economic figures from the USA**
  - The latest US economic data have disappointed, yet 10-year Treasury yields continued to rise as did sovereign yields in other developed countries.
  - Expansionary monetary policy nevertheless remains on track, as confirmed by the SNB and BoE.

- **Special guest – Michel Lagier: Is Japan still the Empire of the Rising Sun?**
  - The BoJ's balance sheet rose from 30% to 80% of GDP in three years. Despite these efforts, inflation dropped back below zero at the end of 2015.
  - The government is shifting towards Abenomics 2.0, which reworks the three arrows. Fiscal austerity has been set aside, and the consumption tax increase has been pushed off until October 2019.
  - Japan will have to consider opening up to immigration in view of its ageing population.

ECONOMISTS' INSIGHT

YIELDS ARE SHARPLY UP DESPITE DISAPPOINTING ECONOMIC DATA

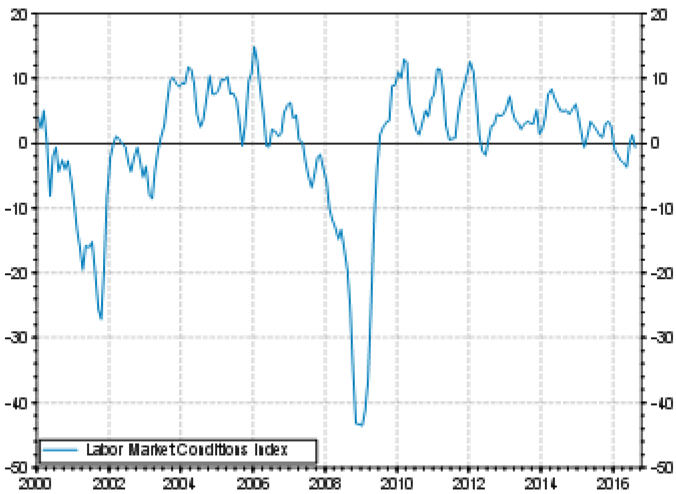
US purchasing managers' indexes, which are published by the Institute for Supply Management (ISM), revealed declining confidence in August in both manufacturing and services (see left-hand chart on the next page). The Services PMI continues to point to expansion, yet the extent of its downturn, from 55.5 to 51.4, was surprising. An industry-by-industry analysis of this sector shows that consumer spending fared less well in August, as shown by the latest retail sales figures. Health Care, Educational Services, Real Estate and Public Administration all reported growth.

These unexpected figures were accompanied by a disappointing employment indicator: the Labor Market Conditions Index, one of the key numbers the Fed looks to, slipped back into negative territory (see right-hand chart on the next page). This indicator has 19 components, two of which appear to account for the decline: 1. the percentage of companies that plan to hire has contracted, and 2. workers who choose to leave their job are having more trouble finding a new one. The first factor is not surprising, given the current full-employment situation and the growing disconnect between employers' needs and the skills on offer. In addition, we expect Q3 GDP to rise under our core scenario.

Consumer spending in particular weighed on the non-manufacturing ISM indicator

Source: Thomson Reuters Datastream/ Edmond de Rothschild (Suisse)

The Fed's labour market indicator dropped below zero in August



Source: Thomson Reuters Datastream/ Edmond de Rothschild (Suisse)

These disappointing reports should have pushed long-term interest rates downward, yet US bond yields continued to rise. Between 7 and 13 September, the 10-year Treasury yield rose by 19 basis points to 1.73%. **This rise paralleled a similar movement by sovereign yields in most developed countries.** For example, over the same period, German and British 10-year yields climbed by 19 and 23 basis points, respectively, to 0.07% and 0.91%. The Japanese 10-year yield added only 4 basis points during this period but had already risen sharply in August from a low of -0.29% on 27 July and sat at the symbolic level of 0.00% at close on 12 September.

This steep rise in sovereign yields is probably, in part, an upward correction following their sharp drop in response to the Brexit vote. **This movement also reflects a growing belief among some investors that monetary policies have reached their limits** and that central banks will have trouble maintaining negative interest rates for much longer and will have to halt their bond purchases. **We disagree with this assessment. We believe that monetary expansion is firmly on track, as confirmed by recent monetary policy decisions in Switzerland and the UK.**

The Swiss National bank (SNB) has indeed confirmed its intention to abide by its negative interest rate policy and to continue intervening on currency markets. Following its meeting on 15 September, it kept its deposit interest rate at -0.75% and noted its intention to limit the franc's rise through market interventions. Importantly, while raising its 2016 GDP growth estimate from 1.0-1.5% to 1.5%, it also lowered its inflation forecast for 2017 and 2018 in view of the "slightly less favourable global economic outlook". Despite the improving Swiss economy, the SNB expects inflation of only 0.2% in 2017 and 0.6%

in 2018, and this is in line with its decision to keep its deposit interest rate at -0.75% for the foreseeable future.

The SNB's new inflation forecasts

	2016			2017				2018				2019		2016	2017	2018
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
Sept. 2016 with Libor at -0.75%		-0.2	0	0.3	0.1	0.1	0.2	0.3	0.5	0.6	0.8	1	1.3	-0.4	0.2	0.6
June 2016 with Libor at -0.75%	-0.4	-0.1	0.1	0.3	0.2	0.3	0.4	0.6	0.8	1	1.2	1.4		-0.4	0.3	0.9

The Bank of England (BoE) looks set to cut interest rates again before the end of the year, as we expect. It too left its monetary policy unchanged at its 15 September meeting. But it noted that, despite better-than-expected UK data for the recent period, it still planned to cut its benchmark rate again this year.

SPECIAL GUEST

IS JAPAN STILL THE EMPIRE OF THE RISING SUN?

Michel Lagier, Investment Specialist, m.lagier@edr.com

After Japan's economy peaked in 1990, it became mired in decades of deflation. Still today, the value of the Nikkei 225 is half what it was then, and land prices are at their lowest since 1980. This collapse was not a question of chance but the result of a series of disastrous decisions: interest rates were kept too high for a long time, and it took far too long to recapitalise the banking system, which had been destroyed when the bubble burst at the end of 1980s; fiscal policy was tightened just before the 1998 Asian crisis; and more recently, Japan was hit by the global recession in 2008 and the destruction of its nuclear plants during the 2011 tsunami owing to insufficient safety precautions. To top things off, the Japanese population is ageing at an alarming rate. This demographic trend slows productivity gains – the economy's growth potential – and is a burden on the national budget.

Statistics, 2016 estimates	Japan	USA	Eurozone
Public debt service as a % of GDP	0.4	2.8	1.9
Primary budget balance as a % of GDP	-4.9	-0.6	0.9
Public receipts as a % of GDP	35.7	33.6	46.5
Net public debt as a % of GDP	131.7	90	72
Household savings as a % of income	2.1	5.2	(*)10.4
Current account balance as a % of GDP	3.4	-2.5	3.8
Inflation %	0.1	1.1	0.2
Unemployment rate %	3.1	4.9	10
Deviation of GDP from its potential	0.1	-1.8	-1.5

(*) Germany

Source: OECD

Former Prime Minister Junichiro Koizumi was the first to put in place policy guidelines (Honebuto no hōshin) aimed at kicking off in-depth reforms. He went after commercial banks' non-performing loans and tried to privatise the postal-savings system. Unfortunately, these efforts failed. It was not until December 2012 that a second knight in shining armour arrived on the scene, Prime Minister Shinzo Abe, who was close to Koizumi. He quickly came up with a new strategy, **Abenomics, with three main components (or 'arrows'): monetary easing, fiscal expansion and structural reform.**

Japan's central bank, the Bank of Japan (BoJ), launched its arrow first. In 2013, BoJ Governor Haruhiko Kuroda embarked on an aggressive government bond-purchasing programme worth $500 billion per year. This was raised to $800 billion in October 2014. The goal was to quickly reach an inflation rate of 2%. The yen then fell 20% against the dollar, raising hopes that deflation had been conquered. Consumer prices also climbed in 2014 at an annual rate of 3%. The good times did not last, however, and inflation dropped to zero at the end of 2015. Not losing hope, Mr Kuroda tried to surprise the market in January 2016 by lowering short-term rates to -0.1% (see charts below). Unfortunately, the yen gained strength and inflation dropped back into negative territory. **But the BoJ spared no effort: its balance sheet grew from around 30% of GDP in 2013 to nearly 80% in 2016.** In the space of three years, Japan caught up with the USA and the UK.

Inflation caused by monetary stimulus was short-lived

Source: Thomson Reuters Datastream/ Cabinet Office, Edmond de Rothschild (Suisse)

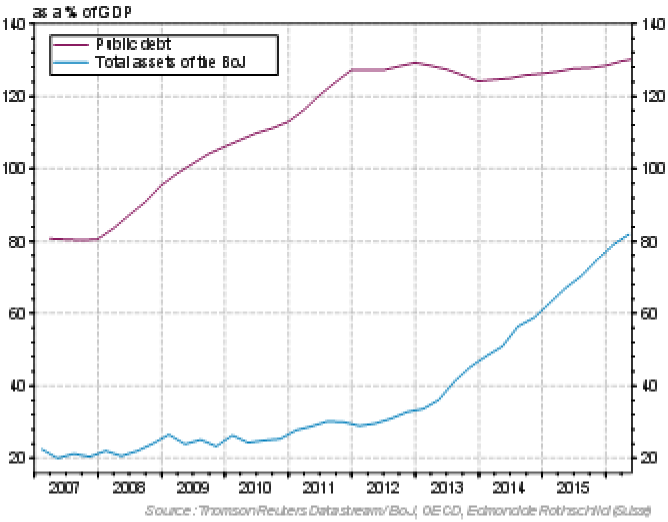
Cutting the deposit rate caused the yen to rally, which was the opposite of the intended goal

Source: Thomson Reuters Datastream/ BoE, BoJ, Edmond de Rothschild (Suisse)

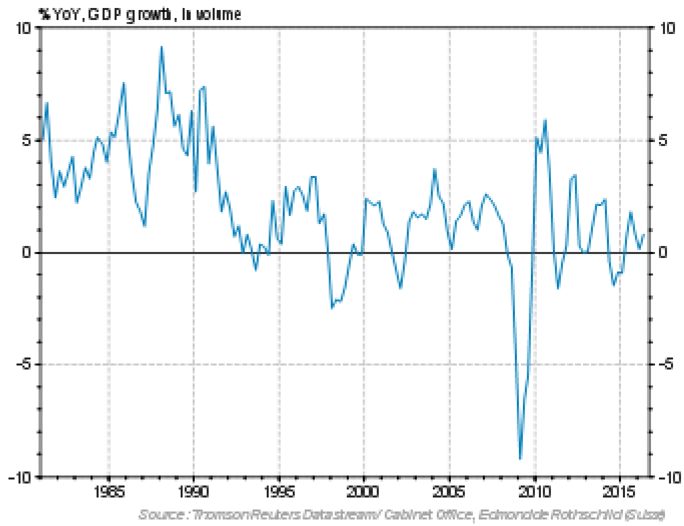
Given these poor results, the way forward is unclear. Monetary measures continue to expand, yet the marginal return is diminishing. **Creating excess liquidity also has a number of side effects. For one, it distorts the allocation of resources: negative interest rates penalise savings, which are used to finance productive investment; and banks, seeing their profits suffer, hesitate to expand lending volumes, especially to SMEs.** The BoJ's massive purchase of government bonds has also dried up this market, which limits its scope for future buybacks. The monetary authorities are now turning to corporate bonds and the stock market, which could inflate valuations. Some observers expect even more extreme measures, such as helicopter money. This refers to dropping banknotes from the sky, but in reality, the BoJ would subscribe bonds directly from the government and monetise public debt, which would be used to finance infrastructure spending. These could be perpetual zero-coupon bonds, meaning they would never be redeemed and would not add to the cost of debt service. Admittedly, the cost of debt service is not very high right now (0.4% of GDP, see table) because interest rates are low, but it could rise quickly if interest rates pick up. Yet Mr Kuroda does not seem particularly keen on this approach, fearing a speculative bubble and citing legal constraints.

Now the government is shifting towards Abenomics 2.0, which reworks the three arrows. Fiscal austerity has been set aside, and the consumption tax increase, designed to reduce the huge budget deficit (-4.9% of GDP, see table) and stabilise the massive public debt (131.7% of GDP, see table and left-hand chart below), has been postponed again, from April 2017 to October 2019. At the same time, an additional stimulus package worth 5.6% of GDP has been approved, although this package is mainly a series of measures meant to boost the job market. The actual amount will be less than half of the amount announced. Closer links between monetary and fiscal policy as seen here are increasingly popular in western countries as well.

Expansionary monetary and fiscal policies have sharply increased both public debt and the BoJ's balance sheet…



… without managing to give Japanese GDP any lasting impetus



In any event, these fiscal and monetary policies definitely have a short-term effect on economic activity. Because they do not increase productivity, they do not improve the growth trend or push up wages over the long term (see right-hand chart above). Wages have been pulled downward by stagnating domestic demand, the retirement of relatively well-paid baby boomers and a shift in jobs from the secondary sector to the tertiary sector, which pays less. And it is impossible to create inflation expectations without increasing household income. What is needed is a structural reform programme, especially in the area of employment. Abenomics 2.0 seeks to increase the participation rate, particularly among women. It also targets the high level of discrimination evident in part-time jobs by expanding social benefits and improving day care for children. A higher minimum wage is under consideration. The programme will address job-market flexibility and employee mobility. The agricultural sector is to be deregulated, and imports will be boosted (trade agreements under the Trans-Pacific Partnership). At this point, spending on food takes up too much of household budgets and cuts too much into their purchasing power. **In addition, Japan will need to pry open its doors to greater immigration in order to offset the ageing population.** In view of what is happening in Europe, this will not be easy. But if Japan wishes to regain its lost prosperity, it will have to buckle down and implement the necessary measures.

OUR GROWTH AND INFLATION FORECASTS

REAL GDP GROWTH (%)	2013	2014	2015	2016f	Consensus	2017f	Consensus
United States	1.5	2.4	2.4	1.9	1.5	2.2	2.2
Japan	1.4	-0.1	0.6	0.7	0.5	1.3	0.7
Eurozone	-0.2	0.9	1.5	1.7	1.5	1.1	1.3
Germany	0.4	1.6	1.4	1.6	1.6	1.2	1.2
France	0.6	0.6	1.3	1.4	1.3	0.9	1.1
Italy	-1.8	-0.3	0.6	1.1	0.8	1.1	0.8
Spain	-1.7	1.4	3.2	2.8	2.9	2.2	2.1
Portugal	-1.1	0.9	1.5	1.2	0.9	1.6	1.0
Luxembourg	4.4	4.1	4.9	3.7	3.4	4.1	2.7
Europe ex-Eurozone							
United Kingdom	1.9	3.1	2.2	1.0	1.6	-0.2	0.7
Switzerland	1.8	1.9	0.9	1.1	1.0	1.2	1.4
Sweden	1.2	2.4	3.8	3.6	3.1	2.9	2.4
Israel	3.2	2.7	2.5	2.8	2.6	3.0	3.0
Emerging Markets							
China	7.7	7.3	6.9	6.5	6.5	6.0	6.3
Brazil	3.0	0.1	-3.9	-4.3	-3.5	0.7	1.0
India	6.3	7.0	7.3	7.5	7.5	7.3	7.7

CONSUMER PRICE INDEX (%)	2013	2014	2015	2016f	Consensus	2017f	Consensus
United States	1.5	1.6	0.1	1.3	1.2	2.3	2.2
Japan	0.4	2.7	0.8	0.2	-0.1	0.6	0.7
Eurozone	1.4	0.4	0.0	0.2	0.3	1.1	1.3
Germany	1.6	0.8	0.1	0.5	0.4	1.3	1.5
France	1.0	0.6	0.1	0.3	0.3	0.8	1.2
Italy	1.2	0.2	0.1	0.1	0.0	0.8	1.1
Spain	1.5	-0.2	-0.6	-0.1	-0.4	0.9	1.3
Portugal	0.4	-0.2	0.5	0.6	0.6	1.3	1.3
Luxembourg	1.7	0.7	0.1	0.7	0.0	1.4	1.7
Europe ex-Eurozone							
United Kingdom	2.6	1.5	0.0	1.4	0.7	3.5	2.2
Switzerland	-0.2	0.0	-1.1	-0.5	-0.5	-0.1	0.3
Sweden	0.4	0.2	0.7	0.9	0.9	1.5	1.6
Israel	1.5	0.5	-0.6	-0.3	-0.3	1.2	1.0
Emerging Markets							
China	2.6	2.0	1.4	2.1	2.0	2.4	2.0
Brazil	6.2	6.3	9.0	8.9	8.6	7.3	5.5
India	9.9	6.7	4.9	5.1	4.9	4.8	5.3

OUR MONETARY POLICY FORECASTS

KEY RATES (%)	2013	2014	2015	2016f	Consensus	2017f	Consensus
United States	0.25	0.25	0.50	0.75	0.70	1.25	1.05
Japan	0.10	0.10	0.10	-0.10	-0.10	-0.10	-0.20
Eurozone	0.25	0.05	0.05	0.00	0.00	0.00	0.00
Europe ex-Eurozone							
United Kingdom	0.50	0.50	0.50	0.25	0.15	0.25	0.15
Switzerland	0.00	-0.25	-0.75	-1.00	-0.80	-1.00	-0.85
Sweden	0.75	0.00	-0.35	-0.50	-0.50	0.00	-0.50
Israel	1.00	0.25	0.10	0.10	0.10	0.50	0.45
Emerging Markets							
China	6.00	5.60	4.35	3.85	3.95	3.35	3.95
Brazil	10.00	11.75	14.25	14.00	13.70	13.50	11.40
India	7.75	8.00	6.75	6.50	6.35	6.50	6.30

OUR CURRENCY FORECASTS

FOREIGN EXCHANGE*	2013	2014	2015	2016f	Consensus	2017f	Consensus
Dollar							
EUR/USD	1.37	1.20	1.08	1.08	1.09	1.04	1.10
USD/JPY	105	120	120	116	104	121	110
GBP/USD	1.66	1.56	1.47	1.24	1.28	1.20	1.31
USD/CHF	0.89	0.99	1.00	1.00	0.99	1.00	1.02
USD/CNY	6.05	6.21	6.49	6.70	6.75	6.90	6.85
Euro							
EUR/JPY	144	144	130	125	113	126	121
EUR/GBP	0.83	0.77	0.73	0.87	0.85	0.87	0.84
EUR/CHF	1.23	1.20	1.09	1.08	1.08	1.04	1.12
EUR/SEK	8.85	9.44	9.17	9.53	9.30	9.60	9.00

*end of period data

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)	413	-0.5%	-1.5%	5.6%	-1.8%
United States (S&P 500)	2'146	-0.9%	-1.9%	6.3%	1.4%
Euro Area (DJ EuroStoxx)	322	-0.7%	0.1%	-3.9%	11.2%
United Kingdom (FTSE 100)	6'840	1.7%	-0.6%	12.8%	-1.4%
Switzerland (SMI)	8'252	-0.1%	0.8%	-3.8%	1.1%
Japan (NIKKEI)	16'492	-2.6%	-0.4%	-12.3%	11.0%
Emerging (MSCI)	898	1.0%	-1.2%	15.5%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.67%	-0.3%	-0.8%	6.0%	2.1%
Euro Area (7-10 Yr)	-0.02%	0.1%	-0.3%	6.2%	1.0%
Germany (7-10 Yr)	-0.02%	0.2%	-0.3%	6.9%	0.9%
United Kingdom (7-10 Yr)	0.81%	0.0%	-0.9%	9.7%	0.7%
Switzerland (7-10 Yr)	-0.41%	0.0%	-0.9%	2.7%	3.7%
Japan (7-10 Yr)	-0.06%	0.3%	-0.2%	2.8%	1.4%
Emerging (5-10 Yr)	4.31%	-0.2%	-0.6%	12.2%	1.6%
United States (IG Corp.)	2.89%	-0.2%	-0.9%	8.2%	-0.8%
Euro Area (IG Corp.)	0.49%	0.0%	-0.2%	5.6%	-0.5%
Emerging (IG Corp.)	3.58%	-0.5%	-1.0%	10.4%	-2.3%
United States (HY Corp.)	6.61%	-0.3%	-0.2%	14.3%	-3.5%
Euro Area (HY Corp.)	3.53%	-0.2%	-0.1%	6.6%	0.3%
Emerging (HY Corp.)	7.58%	-0.2%	0.0%	16.7%	3.6%
United States (Convert. Barclays)	46	0.0%	-0.6%	8.3%	-0.8%
Euro Area (Convert. Exane)	7'261	-0.1%	-0.2%	-3.2%	7.6%
Real Estate					
World (MSCI)	201	-0.7%	-2.3%	8.3%	1.0%
United States (MSCI)	210	-0.9%	-2.4%	7.5%	4.6%
Euro Area (MSCI)	229	-0.6%	-4.1%	13.2%	16.1%
United Kingdom (FTSE)	6'544	-0.4%	0.4%	-0.7%	9.4%
Switzerland (DBRB)	3'795	0.2%	-1.1%	5.3%	4.6%
Japan (MSCI)	230	-3.3%	-1.4%	-13.7%	0.9%
Emerging (MSCI)	105	0.7%	-4.2%	8.1%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	550	n.a.	0.5%	0.0%	-0.7%
Distressed	742	n.a.	1.0%	2.0%	-5.3%
Event Driven	595	n.a.	1.3%	0.3%	-6.3%
Fixed Income	308	n.a.	0.8%	1.6%	0.6%
Global Macro	875	n.a.	0.2%	-1.1%	0.2%
Long/Short	655	n.a.	0.4%	-3.4%	3.6%
Managed Futures (CTA's)	318	n.a.	-3.1%	0.5%	-0.9%
Market Neutral	262	n.a.	0.1%	-2.6%	1.7%
Multi-Strategy	535	n.a.	0.9%	2.6%	3.8%
Short Bias	26	n.a.	-3.3%	-17.5%	2.4%
Commodities					
Commodities (CRB)	421	0.1%	-1.4%	10.1%	-15.2%
Gold (Troy Ounce)	1'316	-0.5%	-1.7%	23.9%	-10.6%
Oil (Brent, Barrel)	45	-4.7%	-10.2%	25.3%	-35.9%
Currencies					
USD	95.9	0.3%	1.5%	-2.7%	9.3%
EUR	1.12	-0.5%	-1.3%	2.8%	-10.2%
GBP	1.30	-1.7%	-1.3%	-12.0%	-5.4%
CHF	0.98	-0.2%	-1.7%	2.4%	-0.8%
JPY	101.7	0.8%	-1.3%	18.2%	-0.4%

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

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