MACRO HIGHLIGHTS

WEEK OF 3 OCTOBER 2016

OUR HIGHLIGHTS:

- **Economists' insight: An honour for the yuan**
  - The yuan will now be among the currencies in the IMF's Special Drawing Rights basket, an encouraging sign of China's ongoing integration in the global financial system.
  - Trust in the yuan will take time to build. In the short term, the Chinese currency should remain under pressure.

- **Focus on share buybacks and dividends: Will Eurozone companies follow in the footsteps of their US counterparts?**
  - The low interest rate environment has led to a rise in debt levels among non-financial corporations.
  - US companies have used the additional resources on share buybacks and dividends rather than fixed investment.
  - The same may happen in Europe in the next few quarters, as debt issuance is sharply up among European companies.

ECONOMISTS' INSIGHT

AN HONOUR FOR THE YUAN

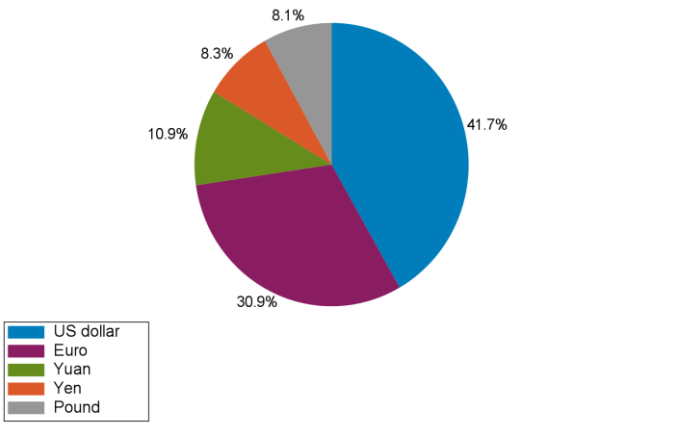
On 1 October, the yuan will join the elite group of currencies that make up the International Monetary Fund's Special Drawing Rights, something that the Chinese government has been looking forward to for a long time. This move marks China's latest step towards greater integration in the global financial system, although it is unlikely to be accompanied by a significant appreciation of the yuan.

The IMF's Special Drawing Rights (SDR) are international reserve assets that supplement IMF member countries' official currency reserves. If member countries need to modify the composition of their currency reserves, they can sell SDRs to other member countries in exchange for the currencies in the basket. These instruments proved useful in 2009 during the financial crisis, when they helped restore global liquidity and supplemented member countries' official currency reserves.

The value of an SDR is set daily on the basis of a basket of currencies whose individual weighting depends on the extent of their use in commercial and financial transactions. This basket is composed of the US dollar, the euro, the yen and the pound sterling – and now the yuan, with a weighting of 11% (see left-hand chart).

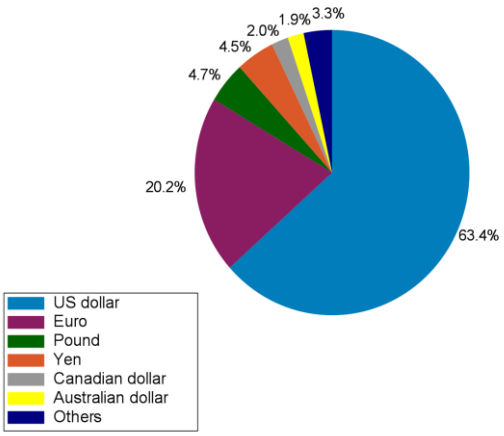
A Special Drawing Right is not a currency but rather a virtual claim on the currencies that make up the underlying basket. **The inclusion of the yuan will affect how the value of the SDR and related interest rates are calculated, but it does not mean that central banks will be forced to increase their yuan-denominated reserves.**

The yuan will have the third-highest weighting in the SDR basket



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

Breakdown of official currency reserves worldwide

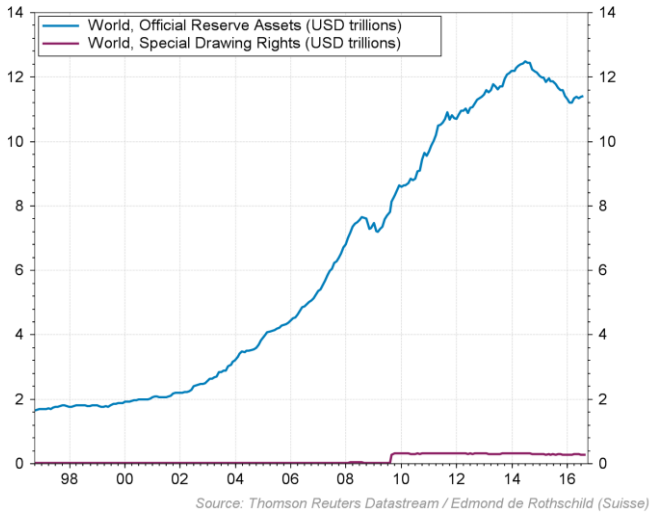


Source: Thomson Reuters Datastream / IMF COFER, Edmond de Rothschild (Suisse)

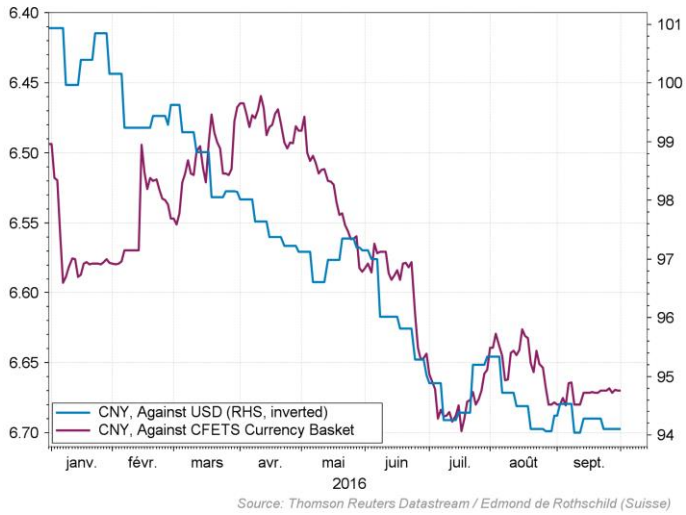
The yuan is not currently considered a reserve currency, unlike the Swiss franc and the Canadian dollar, which represent a small fraction of central banks' international currency reserves although they are not part of the IMF's SDR basket (see right-hand chart). A total of USD 285 billion worth of SDRs have been allocated to member countries, which is a small amount compared to the USD 11,413 billion currently held in official currency reserves (see left-hand chart on the next page). **Given the amounts at stake, inclusion in the SDR basket is a largely honorary distinction, and the real challenge for Beijing now is to have the yuan adopted as a reserve currency. That will make Chinese financial assets very attractive to central banks and international investors, who hold little of these assets** (only around 1-2% of domestic financial assets).

But achieving the status of reserve currency will take a long time. The yuan will first have to win the trust of international central banks. It will depend on other factors too, such as the yuan's upside and liquidity, the growth and depth of domestic asset markets, the Chinese economy's openness to foreign capital and the credibility of the People's Bank of China.

Beijing now targets reserve currency status



The yuan's double depreciation so far in 2016



Investors and central banks cannot ignore a number of unhealthy signs: capital controls aimed at easing downward pressure on the yuan, capital flight and the Chinese government's intervention during the 2015 stock market crash (topped off by the suspended trading of numerous shares).

Inclusion in the SDR basket is clearly a step forward in terms of China's integration in the global financial system. That said, short-term dynamics like slowing domestic GDP growth and the strengthening US dollar are likely to push the yuan slightly downward (see the Macro Highlights of 20 June). The yuan's presence in this basket could even exacerbate this currency's short-term volatility, since the People's Bank of China will have less incentive to prop up its value (see right-hand chart).

The yuan's elevated status represents international recognition of China as a key economic and financial player, but it raises questions about the openness of the country's capital account and about the development of its financial markets. **The effort to win international credibility for the yuan really starts now.**

FOCUS ON DIVIDENDS AND SHARE BUYBACKS

WILL EUROZONE COMPANIES FOLLOW IN THE FOOTSTEPS OF THEIR US COUNTERPARTS?

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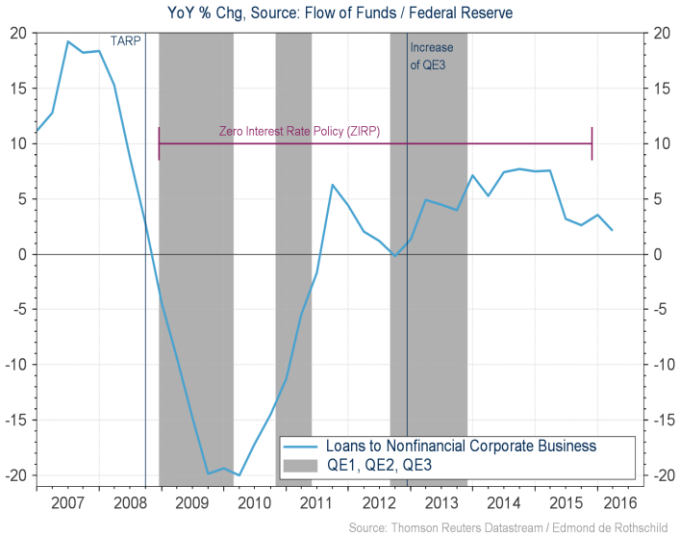
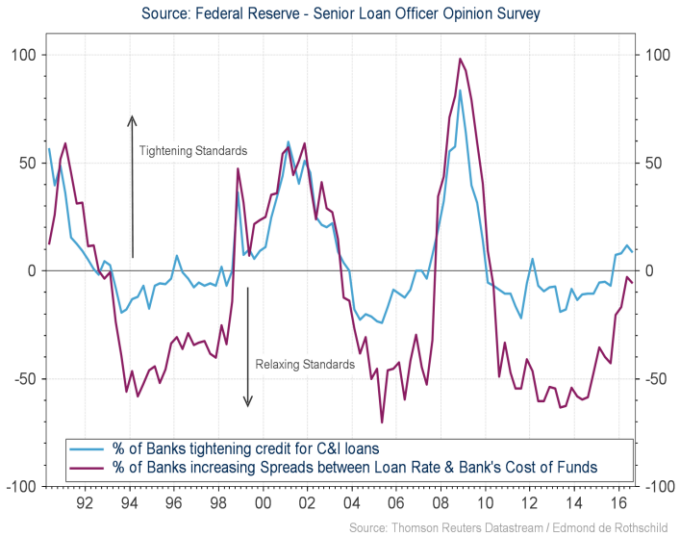
The US Federal Reserve (Fed), criticised for keeping the Fed funds rate too low for too long, is aware that US companies are not using their additional resources for the intended purpose. Rather than taking advantage of low interest rates to invest in capital assets, many of them have bought back shares and paid out dividends. As the European Central Bank (ECB) continues to loosen its monetary policy, Eurozone companies could be tempted to follow the same path. Low interest-rate financing, which central banks put in place in a context of low nominal GDP growth, disrupts the market's role in allocating capital.

US: lending to non-financial corporations has dropped since 2015

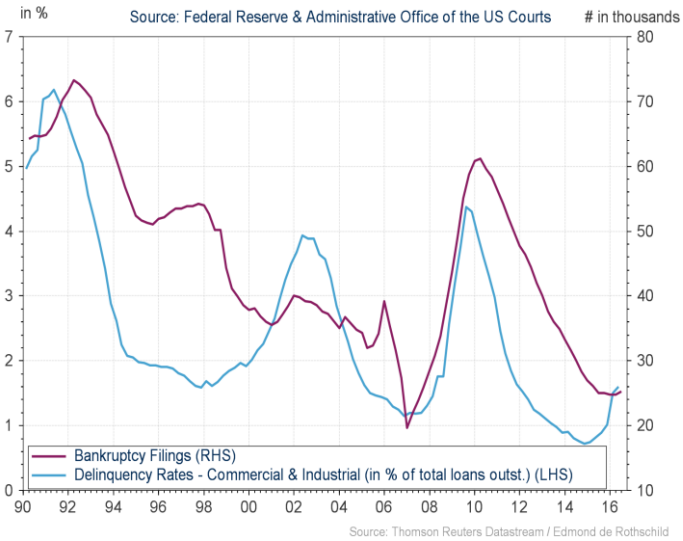


US: banks are tightening lending conditions

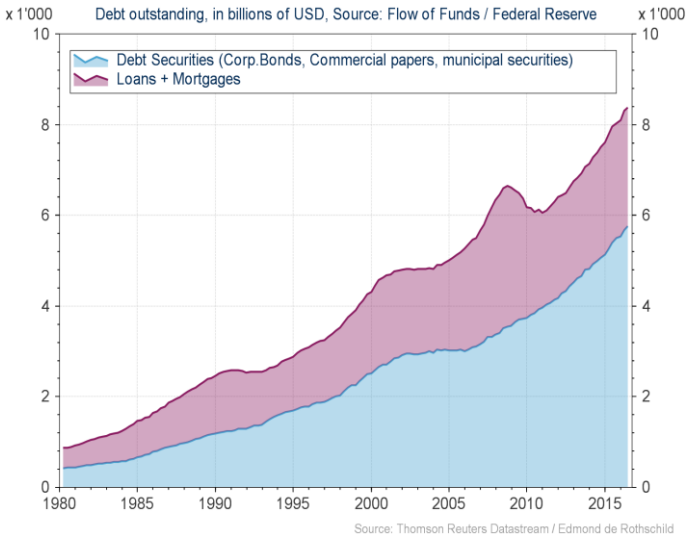


It was only after the Fed's second round of quantitative easing that loans to non-financial corporations began to grow (left-hand chart). **While credit growth reached a solid 7.5% in 2014, it is now losing steam** following the move by banks to tighten lending conditions (see right-hand chart). With corporate debt back at pre-crisis levels and the delinquency rate – when payments are more than 90 days overdue – up from 0.7% at the start of 2015 to 1.6% in the second quarter of 2016, banks are now being more careful (see left-hand chart on the next page).

US: Delinquency rates are rising

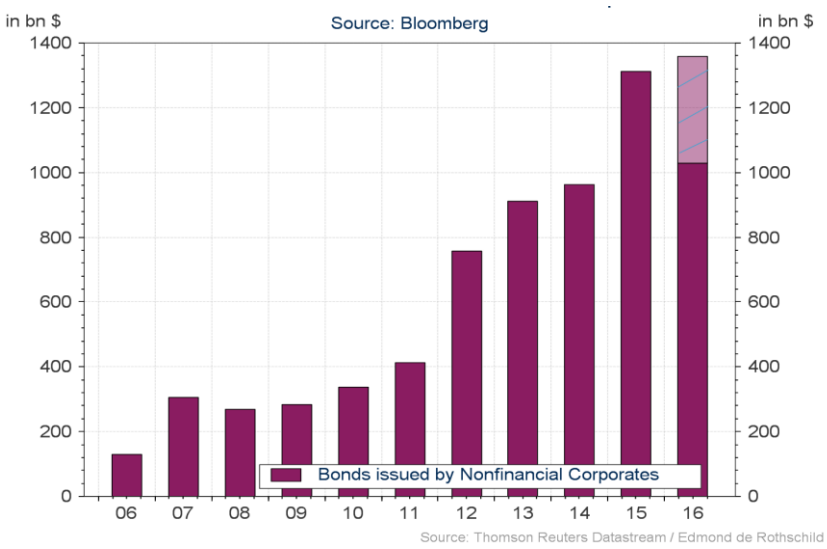


US: Corporate bonds account for nearly 60% of corporate debt



But companies have managed to diversify their sources of financing, turning to the bond market more than ever. Corporate bonds now account for nearly 60% of US companies' debt, versus 51.7% in 2009 (see right-hand chart above). Corporate bond issuance rose by 36% between 2014 and 2015, and so far in 2016 issuance is up 9.6% on the same period one year earlier (see chart below). If new issues continue at this pace, 2016 will be a record year. Companies thus took advantage of the bond market's low interest rates – around 3.5% in September 2016 – to increase borrowing.

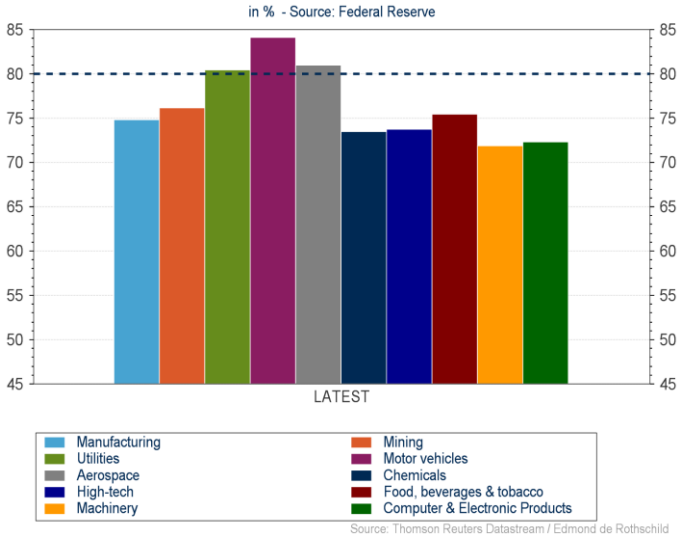
US: New corporate bond issuance is at an all-time high



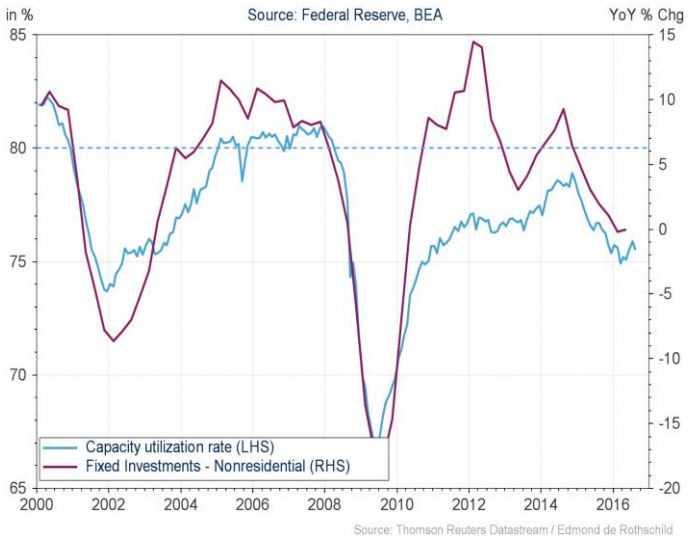
A significant proportion of the borrowings was used to pay dividends and buy back shares, two trends that are sharply up over the same years. Yet this practice has been condemned by Ben Bernanke and by some members of the FOMC. At the FOMC meeting of 26-27 July 2016, it was mentioned that **low interest rates were meant to stimulate fixed investment in support of long-term GDP growth rather than to encourage share buybacks and dividend payments, which were considered a poor use of resources.**[1]

Companies are not investing more in fixed capital because their production capacities have not been fully used in recent years. They have thus little incentive to invest more in machines and equipment. Even today, capacity utilisation is below 80% in most sectors (see charts below). Capital expenditure projects are just not profitable.

US: Capacity utilisation is below 80% in most sectors



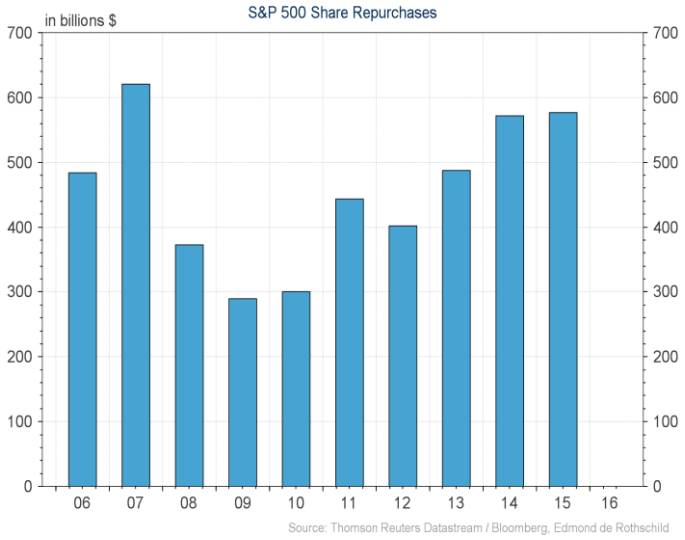
US: The decline in fixed investment owes in part to low capacity utilisation



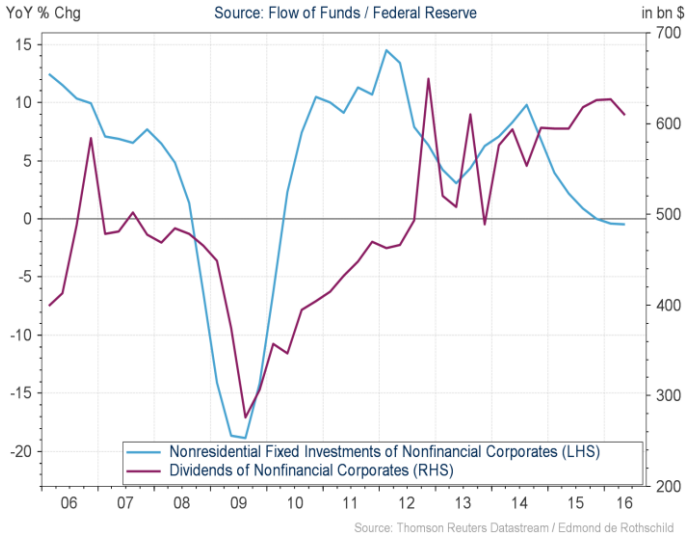
Companies have used their resources for two other purposes: to increase dividends first and then to buy back shares (see charts on the next page). Shareholders benefit from both of these actions, as dividends provide them with income and share buybacks boost share prices. Buybacks not only serve to lift share prices, they also improve companies' earnings per share (since they reduce the amount of shares on the market). In 2015, dividends rose 5.1% and share buybacks were up 1.9%.

[1] *"[…]In addition, several [members] expressed concern that an extended period of low interest rates risked intensifying incentives for investors to reach for yield and could lead to* ***the misallocation of capital*** *and mispricing of risk, with possible adverse consequences for financial stability."*

US: Share buybacks on the rise since 2010

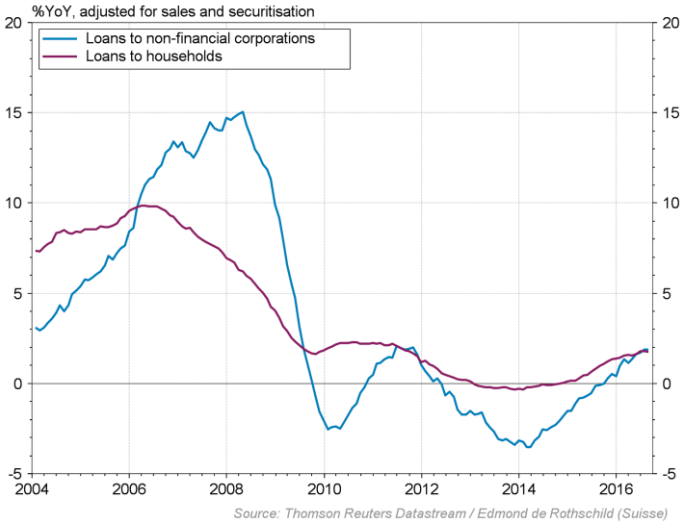


US: Dividends grew throughout QE

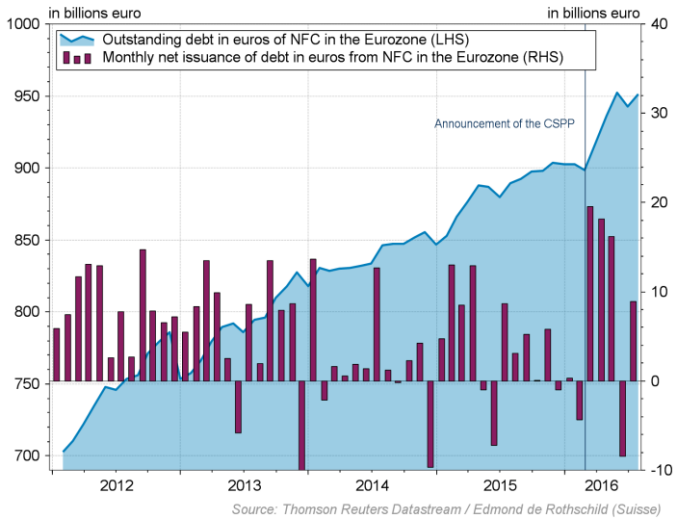


The situation in the USA may be instructive for the Eurozone, where companies are increasing debt levels through bank loans and bond issues. Loans to Eurozone companies have been picking up since the end of 2015 thanks to the ECB's loose monetary policy and to targeted longer-term refinancing operations (TLTRO). In addition, euro-denominated corporate bond issues have risen sharply since the Corporate Sector Purchase Programme (CSPP) was announced in March 2016 (see right-hand chart below).

Eurozone: Loans to companies are picking up slowly



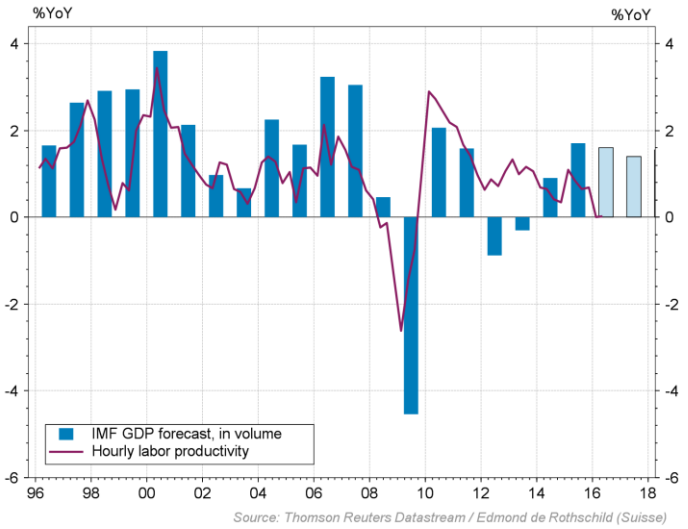
Eurozone: Corporate debt issuance has gotten a boost from the CSPP



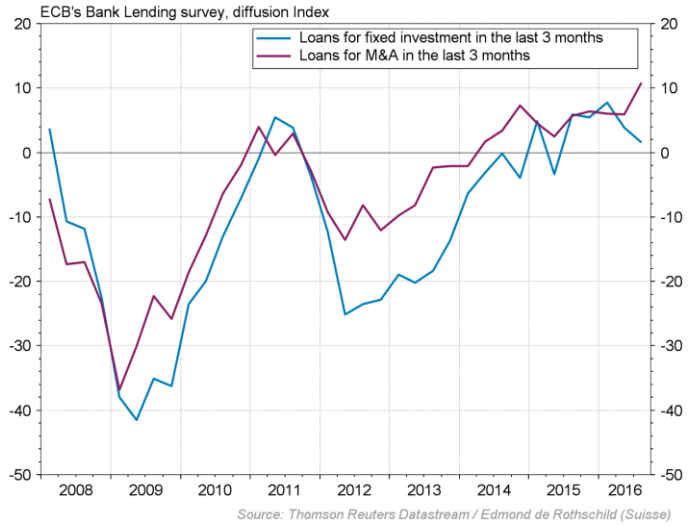
However, just like in the USA, economic conditions are not ripe for a corresponding rise in fixed investment. Hourly productivity growth in the first part of this year (+0% YoY) is at its lowest level since the Eurozone was created – excluding the period corresponding to the last financial crisis – while the external environment remains uncertain (see left-hand chart below). **The lacklustre GDP growth outlook may tempt companies to take advantage of cheap borrowing to boost their share price through share buybacks or to pay dividends rather than investing massively in capital assets.**

ECB bank lending surveys in the Eurozone appear to confirm this trend. These surveys provide insight into the factors that affect companies' demand for credit. The surveys do not have a category called "Financing to buy back shares", but "Financing for mergers/acquisitions and corporate restructuring" can serve as a proxy for these activities that do not generate fixed investment. We see that banks reported an increase in credit demand for fixed investment in 2015, but that this dynamic already appears to be weaker in 2016. On the other hand, the number of banks that reported an increase in credit demand for mergers/acquisitions and corporate restructuring continues to increase (see right-hand chart below).

Eurozone: The GDP growth outlook is lacklustre



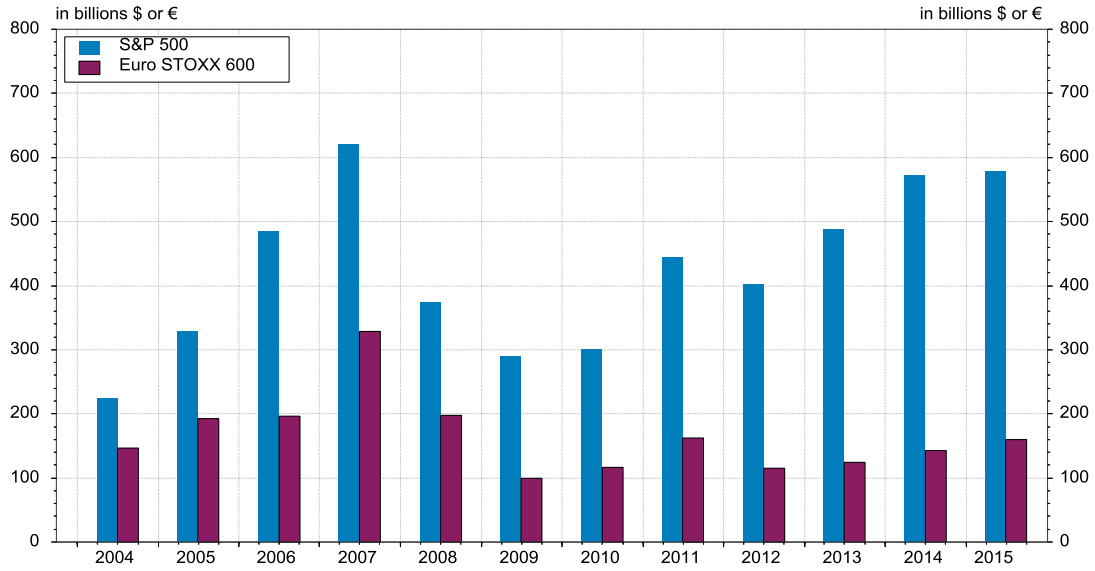
Eurozone: Financing for fixed investment already appears to be weakening



As a result:

- **Growing levels of debt among non-financial Eurozone corporations**, fuelled by the ECB's monetary policy, **could lead to capital being returned to shareholders in the form of share buybacks and/or dividend payments**, as has been the case in recent years in the USA (see chart below).
- **Yet the scope and duration of share buybacks in Europe may fall short of what has been seen in the USA**, because the European corporate bond market is less developed.

Will share buybacks be as extensive in the Eurozone as in the USA?



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

OUR GDP 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)	418	0.6%	-0.3%	7.0%	-1.8%
United States (S&P 500)	2'161	0.7%	-0.7%	7.5%	1.4%
Euro Area (DJ EuroStoxx)	327	0.9%	-1.9%	-2.8%	11.2%
United Kingdom (FTSE 100)	7'112	2.4%	1.3%	15.6%	-1.4%
Switzerland (SMI)	8'212	0.0%	-1.5%	-4.0%	1.1%
Japan (NIKKEI)	16'736	0.9%	-1.3%	-11.3%	11.0%
Emerging (MSCI)	912	0.7%	1.5%	17.4%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.63%	-0.3%	0.2%	6.8%	2.1%
Euro Area (7-10 Yr)	-0.09%	-0.2%	0.3%	6.8%	1.0%
Germany (7-10 Yr)	-0.09%	-0.1%	0.5%	7.9%	0.9%
United Kingdom (7-10 Yr)	0.74%	-0.3%	0.2%	10.9%	0.7%
Switzerland (7-10 Yr)	-0.55%	0.3%	0.9%	4.1%	3.7%
Japan (7-10 Yr)	-0.07%	0.1%	0.5%	3.1%	1.4%
Emerging (5-10 Yr)	4.22%	0.1%	0.6%	13.3%	1.6%
United States (IG Corp.)	2.83%	-0.1%	-0.1%	9.1%	-0.8%
Euro Area (IG Corp.)	0.46%	-0.2%	0.0%	5.9%	-0.5%
Emerging (IG Corp.)	3.53%	-0.1%	-0.5%	10.8%	-2.3%
United States (HY Corp.)	6.28%	0.6%	0.8%	15.8%	-3.5%
Euro Area (HY Corp.)	3.50%	0.0%	-0.4%	7.0%	0.3%
Emerging (HY Corp.)	7.05%	0.4%	1.1%	18.3%	3.6%
United States (Convert. Barclays)	46	1.1%	1.2%	10.4%	-0.8%
Euro Area (Convert. Exane)	7'291	0.4%	-0.6%	-2.8%	7.6%
Real Estate					
World (MSCI)	201	-2.0%	-1.9%	9.0%	1.0%
United States (MSCI)	209	-3.6%	-3.7%	7.2%	4.6%
Euro Area (MSCI)	231	-0.7%	-3.9%	14.3%	16.1%
United Kingdom (FTSE)	6'595	0.2%	0.6%	0.0%	9.4%
Switzerland (DBRB)	3'842	1.5%	0.3%	6.6%	4.6%
Japan (MSCI)	231	1.0%	-0.8%	-12.6%	0.9%
Emerging (MSCI)	105	-1.3%	-0.7%	8.2%	-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)	418	-0.7%	1.0%	10.4%	-15.2%
Gold (Troy Ounce)	1'289	-2.8%	-2.8%	21.4%	-10.6%
Oil (Brent, Barrel)	50	7.7%	7.2%	37.5%	-35.9%
Currencies					
USD	96.2	0.8%	0.4%	-2.4%	9.3%
EUR	1.12	-0.4%	0.2%	2.8%	-10.2%
GBP	1.28	-2.0%	-4.0%	-13.4%	-5.4%
CHF	0.98	-1.0%	-0.1%	2.2%	-0.8%
JPY	102.5	-2.0%	0.9%	17.3%	-0.4%

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

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