MACRO HIGHLIGHTS & STRATEGY

WEEK OF 6 JUNE 2016

OUR ROUNDUP:

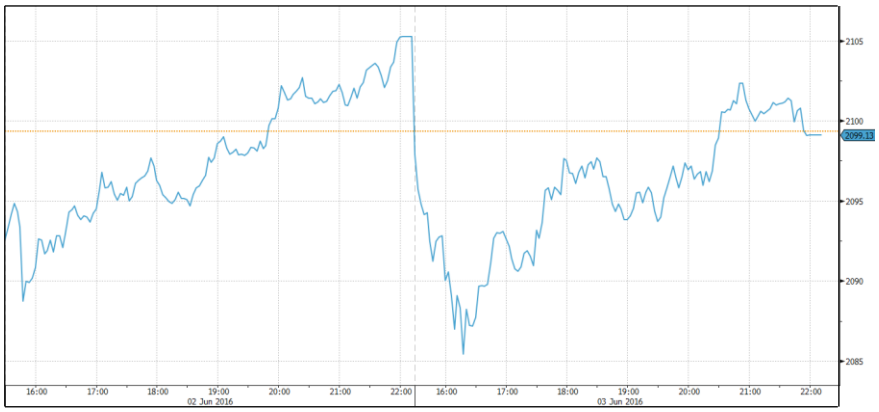
- **Markets: The next rate hike won't be in June**
  - US jobs data disappointed, but investors aren't bothered
- **United States: The Fed's focus on financial conditions**
  - Long-term interest rates will remain structurally low due in part to surplus liquidity and savings worldwide
- **Switzerland: Can it surmount the strong franc?**
  - Growth is on the verge of accelerating as manufacturing sentiment picks up
  - Lower housing prices could tamp down on consumer spending

MARKETS

THE NEXT RATE HIKE WON'T BE IN JUNE

Last Friday's US jobs data were uninspiring. Only 38,000 jobs were added in May after a poor showing in April as well. Strikes in the telecoms sector (idling 35,000 workers) and a decline in temporary help services (-21,000) weighed heavily. The figures fell short of the 100,000 jobs that have to be added to absorb new entrants into the labour market.

S&P 500 (2-3 June 2016)



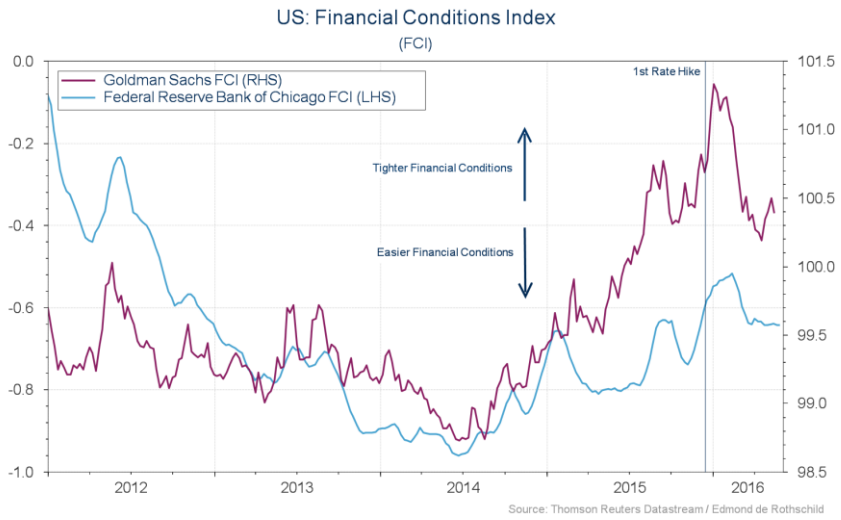
The concomitant dip in the unemployment rate to 4.7% offers only cold comfort, as it was the result of a decline in the working population.

Before we start worrying, we need to wait and see whether the May figures were a blip or the start of a new trend. One factor to keep in mind is that, once full employment was reached, **we expected job creation to slow to around 100,000 per month. The markets may be thinking the same thing, since they rebounded before the day was out** (see chart on the first page).

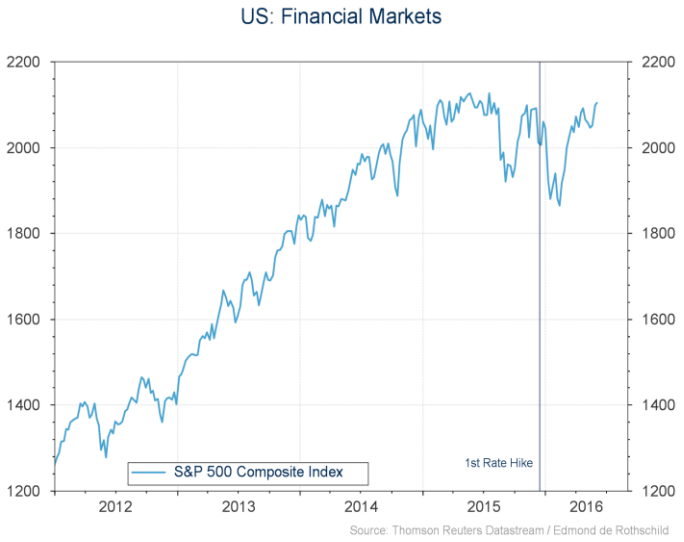
UNITED STATES

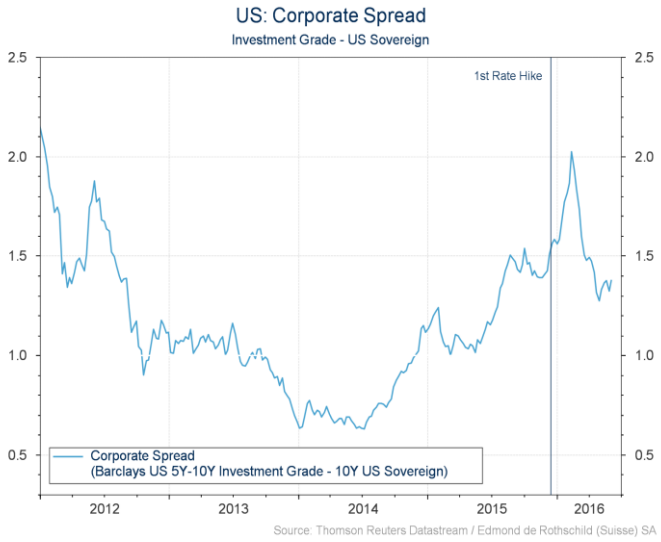
THE FED'S FOCUS ON FINANCIAL CONDITIONS

The US Federal Reserve (Fed) has been looking hard at the economy's **financial conditions** over the past few quarters. This catch-all term refers to a number of factors that help determine economic behaviour and the future course of the economy, such as the state of the markets, yield spreads, the yield curve, the dollar and surveys of lending standards. Monetary policy affects each of these factors, as can be seen clearly following the Fed's first rate hike last December when financial conditions tightened markedly (see chart below).

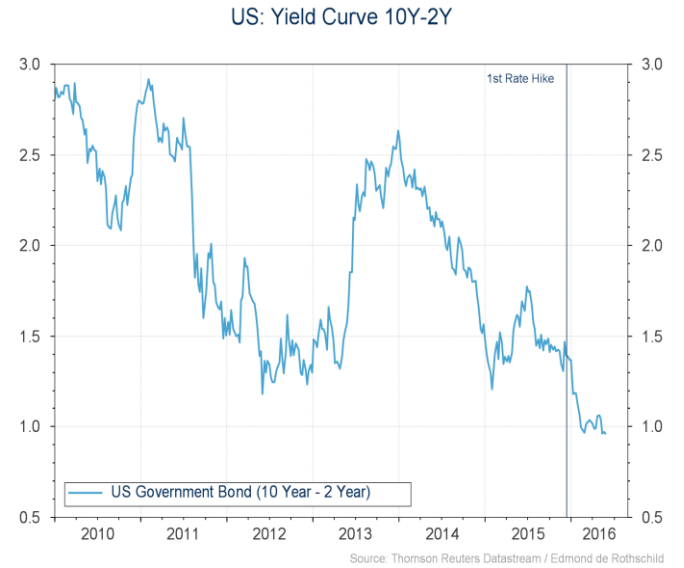


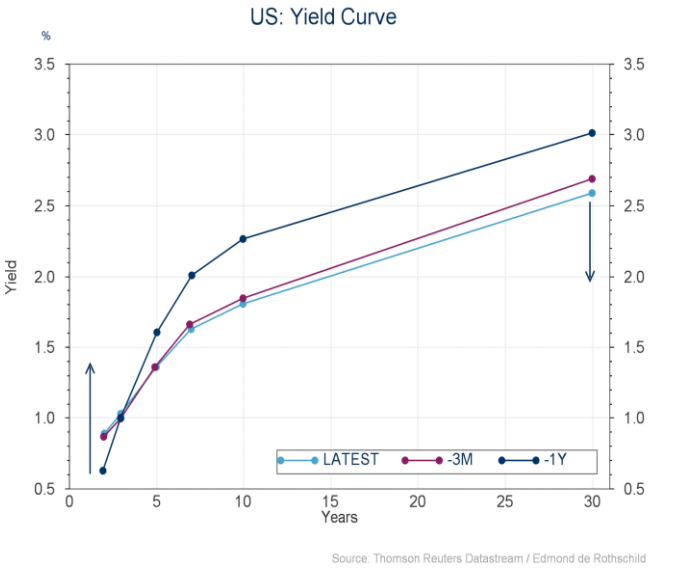
The Fed responded by dialling down its discourse at the start of the year. **And since that time, most of these factors have reversed course**: the dollar has stabilised, markets are up and corporate spreads have narrowed (see charts below).





But one key variable, the yield curve, continues to flatten (see charts below). Long-term interest rates generally rise when monetary policy enters a tightening phase, yet that is not happening here. There are several reasons for this:

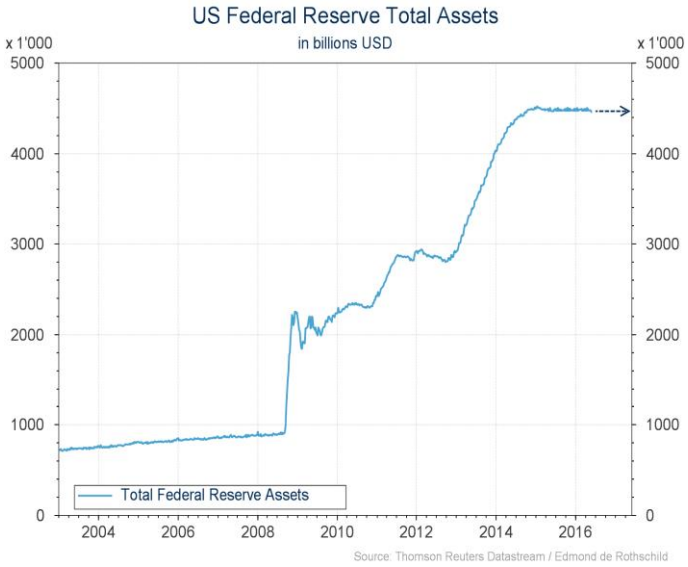


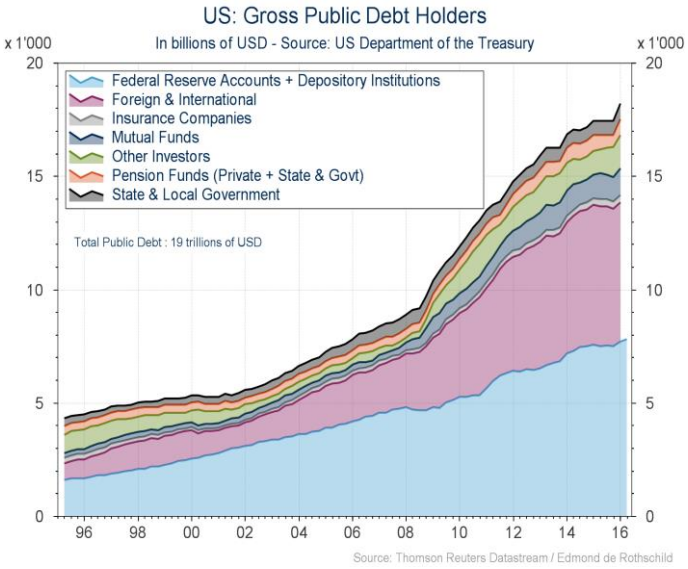


- First, long rates trend upward in this scenario because monetary conditions are generally tightened at the start of an economic cycle. But that is not the case here. The US economy has been growing faster than its potential GDP rate for the past few years, **which means that the Fed started to raise rates well into the cycle**.

- **Surplus liquidity** channelled into the markets around the world has driven up demand for US Treasuries and put downward pressure on long-term interest rates in the USA. Two other factors are at play:
    - The **Fed reinvests in Treasuries in its portfolio as they mature** (and has given no indication that it would reduce its balance sheet; see left-hand chart below). With the Fed holding 23% of government debt, these are hefty amounts being reinvested (see right-hand chart below).

    - **The European Central Bank and the Bank of Japan's unorthodox monetary policy is holding those countries' interest rates down**. This makes US debt more attractive and encourages international investors to engage in carry trades targeting US Treasuries (see right-hand chart below).

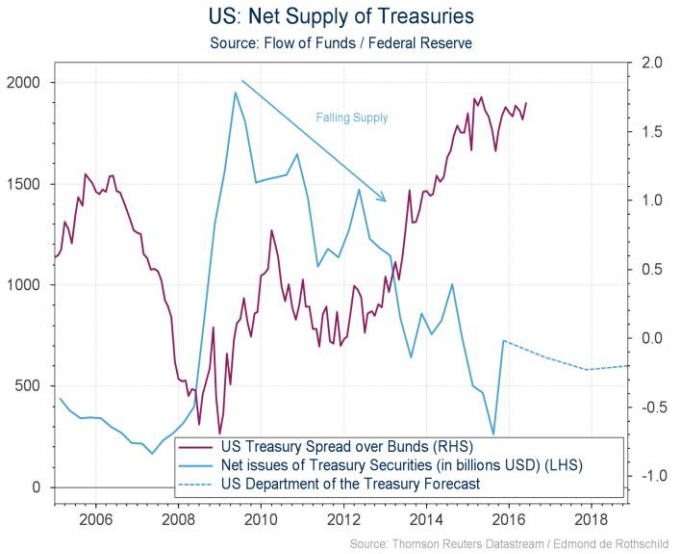


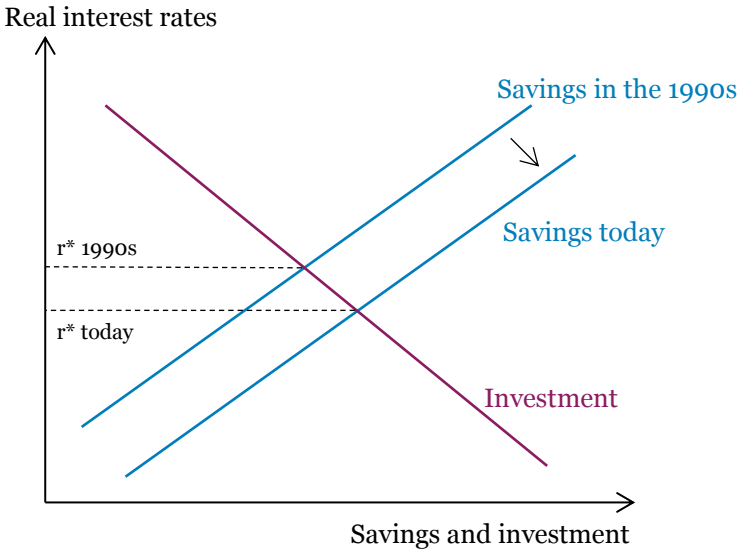


- **Insurance companies, mutual funds and pension funds** are another source of demand for Treasuries (see right-hand chart below). These financial institutions, which are contractually obliged to achieve a certain return, have to invest in high quality and highly liquid assets that still offer a positive return. They invest in long-term Treasuries rather than short terms T-bills in pursuit of the higher payoff.

- The government's **Treasury debt supply has dropped in recent years**. The government is issuing less debt because, with a narrowing budget deficit, its funding needs have declined (see left-hand chart below). The government also tends to meet its funding needs with short-term T-bills rather than long-term Treasuries. All these factors tend to pull long-term interest rates downward.

- **The global saving glut is a structural cause of declining long-term rates**. With the supply of saving outpacing global investment, the interest rates that link the two have fallen (see right-hand chart below). Unlike in prior decades, however, the lower interest rates have not boosted investment demand.





Conclusions:

- **Long-term interest rates should remain structurally low given global imbalances and surplus liquidity and savings that will not be absorbed any time soon.**

- The Fed, one of whose missions is to stabilise the financial system, will do what it can to **make financial conditions less sensitive to monetary policy**.

- **US growth will benefit from easing financial conditions and persistently low long rates**. This will encourage households, which have reduced their debt in recent years, to borrow more and could give a boost to consumer spending and the property market.

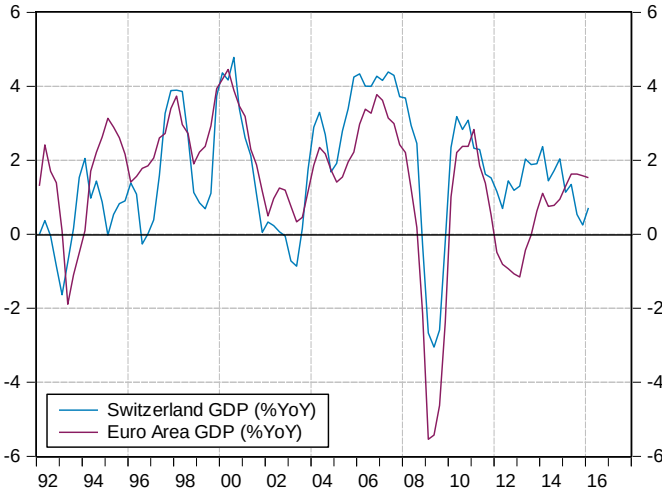
- **Several caveats are in order**:
  - This low interest-rate scenario does not mean interest rates will not rise, but that they will rise less quickly than in previous cycles.
  - A scenario of robust growth and structurally low long rates can lead to financial bubbles and wide market swings. Something to keep in mind.

SWITZERLAND

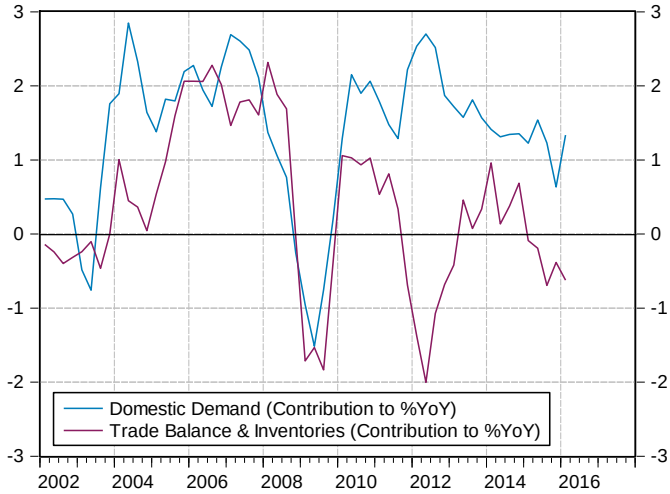
CAN IT SURMOUNT THE STRONG FRANC?

Switzerland has delivered positive growth despite the obstacle posed by the strong franc. Gross domestic product (GDP) rose by 0.1% in the first quarter of 2016. That equates to a +0.7% year-on-year rise, in line with our estimates. Economic activity was fuelled by consumer spending and by corporate spending on both construction and capital goods. The trade balance and public spending, however, weighed on growth (see right-hand chart).

Economic growth: Switzerland vs Euro Zone (%YoY)



Switzerland: Contribution to growth (%GDP, YoY)



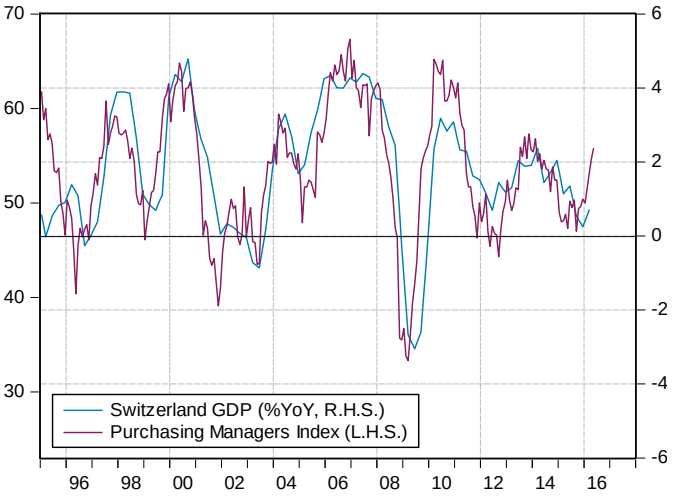
The Swiss economy fared less well than the Euro Zone, which turned in full-year growth of +1.5% (see left-hand chart above). But the future is bright: **growth is on the verge of accelerating as manufacturing sentiment picks up.** The PMI and the KOF economic barometer are sharply up, pointing to an economic improvement in the coming months. The PMI has climbed 5.8 points in four months to reach its highest level since February 2014 (see left-hand chart below).

With consumer confidence rising, the employment outlook stable and the franc weakening slightly, all systems are go. **We expect the Swiss economy to grow by +1.1% in 2016.** Estimates from the main economic institutes range from +0.8% to +1.4%.

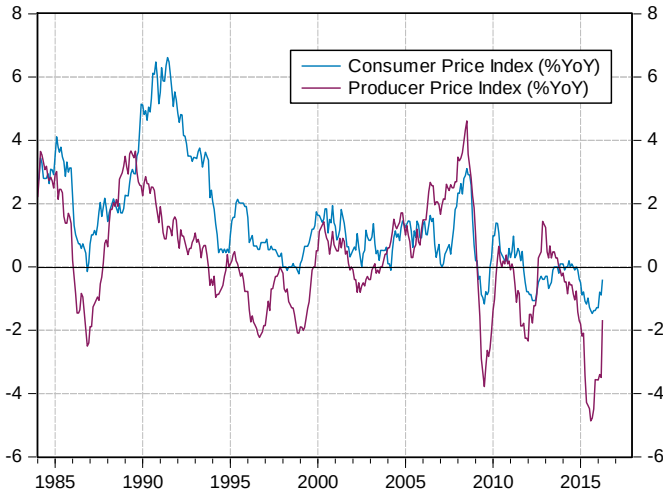
That said, it will take time for the recovery to take root. We expect growth of only +1.2% in 2017 versus the consensus estimate of +1.6%. Like the Gotthard tunnel (see box), the Swiss economy will have to get past the obstacle posed by the strong Swiss franc before growth will top 2%. This will require some serious effort. **The currency will have to weaken further or companies will have to improve productivity levels.**

> The longest tunnel in the world recently opened in Switzerland. The 57-kilometer Gotthard tunnel will facilitate travel between northern and southern Europe. It is part of the Rhine-Alpine corridor, which directly links the port of Rotterdam on the North Sea with the port of Genoa on the Mediterranean. With Europe unsettled by the migrant crisis and the prospect of the UK leaving the European Union, Swiss President Johann Schneider-Ammann noted that the tunnel would "help bring people and business communities together".

Economic growth & business confidence (%YoY)



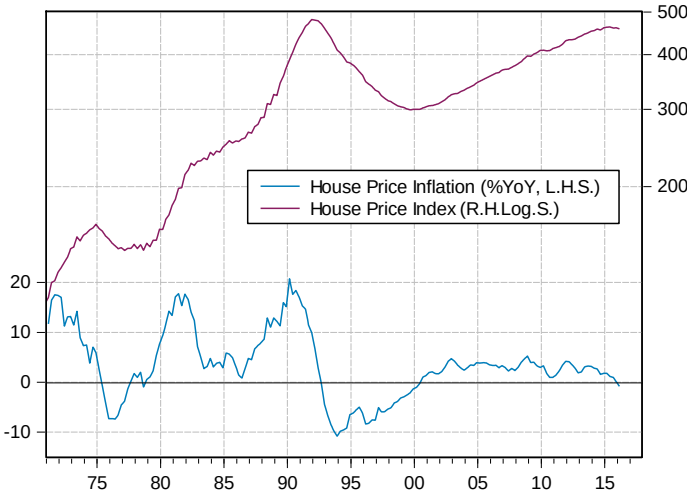
Inflation: consumer & producer prices (%YoY)



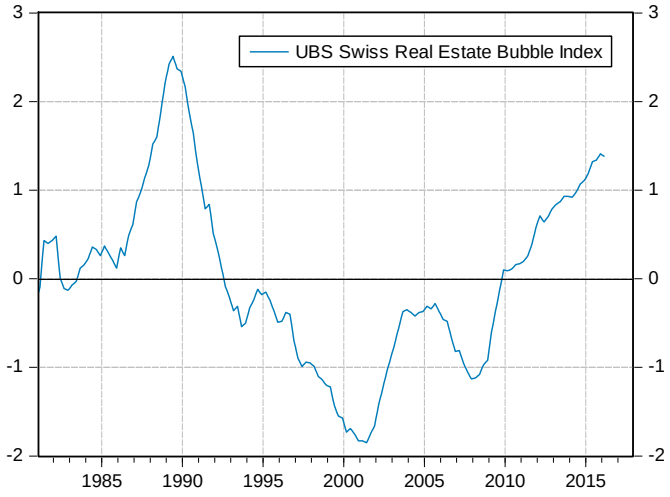
While consumer prices have declined by a cumulative 3.1% over the past five years, producer prices have dropped by 6.9% over the same period (see right-hand chart). This suggests that downward pressure on prices is not the result of a demand shock, as is the case in true deflationary phases. **The fact that companies still wield some pricing power shows that the drop in producer prices stems from a supply shock** following the franc's sharp rise and the downward trend in commodity prices.

Property prices are of particular interest nowadays. After rising since 2000 at an average pace of 2.9% per year, **they recently headed south** (see left-hand chart). The Swiss housing market was overheated for several years (see right-hand chart) thanks to high levels of household wealth and historically low mortgage interest rates.

House Prices (Index & %YoY)



Real Estate Bubble (Index)



The Swiss National Bank, with the help of the Swiss government, has sought to address this situation in the past few years. It has, for example, adjusted the required down payment, accelerated amortisation schedules, and increased the counter-cyclical capital buffer applied to lending banks. **Housing prices have now stopped rising.**

This will go a long way towards avoiding a bubble and achieving long-term economic growth. What is not clear is the extent to which consumer spending in Switzerland will decline as a result.

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%	1.8%	2.3%	23.6%	13.4%
Canada	1.2%	1.5%	2.1%	1.9%	0.9%
Euro Area	1.5%	1.5%	1.6%	14.5%	6.9%
Germany	1.5%	1.6%	1.6%	4.2%	2.1%
France	1.1%	1.4%	1.5%	2.9%	1.3%
United Kingdom	2.2%	1.9%	2.1%	3.5%	2.1%
Switzerland	0.8%	1.2%	1.6%	0.7%	0.3%
Russia	-3.7%	-1.0%	1.1%	1.6%	-0.5%
Japan	0.6%	0.5%	0.5%	5.1%	0.8%
China	6.9%	6.5%	6.3%	18.4%	37.9%
India	7.4%	7.5%	7.6%	3.4%	8.2%
Brazil	-3.7%	-3.8%	0.8%	1.9%	-2.3%
Mexico	2.5%	2.5%	2.8%	1.5%	1.2%
Others	3.8%	5.2%	6.1%	16.7%	27.7%
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)	404	0.3%	1.4%	2.5%	-1.8%
United States (S&P 500)	2'099	0.0%	2.0%	3.7%	1.4%
Euro Area (DJ EuroStoxx)	322	-1.9%	2.4%	-4.4%	11.2%
United Kingdom (FTSE 100)	6'277	-0.9%	1.0%	1.6%	-1.4%
Switzerland (SMI)	8'168	-1.7%	4.3%	-4.5%	1.1%
Japan (NIKKEI)	16'580	-1.1%	3.1%	-11.8%	11.0%
Emerging (MSCI)	816	1.1%	-0.4%	3.5%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.72%	1.3%	0.8%	5.6%	2.1%
Euro Area (7-10 Yr)	1.15%	0.4%	1.0%	4.7%	1.0%
Germany (7-10 Yr)	0.08%	0.6%	1.2%	5.7%	0.9%
United Kingdom (7-10 Yr)	1.28%	1.2%	1.8%	5.8%	0.7%
Switzerland (7-10 Yr)	-0.40%	0.8%	1.1%	3.2%	3.7%
Japan (7-10 Yr)	-0.11%	0.0%	0.0%	3.3%	1.4%
Emerging (5-10 Yr)	4.82%	0.9%	1.0%	7.2%	1.6%
United States (IG Corp.)	3.02%	0.9%	0.5%	6.1%	-0.8%
Euro Area (IG Corp.)	0.77%	0.4%	0.5%	3.5%	-0.5%
Emerging (IG Corp.)	3.95%	0.6%	0.5%	6.6%	-2.3%
United States (HY Corp.)	7.37%	0.2%	0.9%	8.5%	-3.5%
Euro Area (HY Corp.)	4.13%	0.3%	0.6%	4.1%	0.3%
Emerging (HY Corp.)	8.50%	0.8%	1.3%	10.0%	3.6%
United States (Convert. Barclays)	44	0.5%	1.6%	2.5%	-0.8%
Euro Area (Convert. Exane)	7'246	-0.9%	1.2%	-3.4%	7.6%
Real Estate					
World (MSCI)	199	1.0%	0.9%	6.1%	1.0%
United States (MSCI)	209	0.6%	1.4%	5.5%	4.6%
Euro Area (MSCI)	222	-0.6%	4.2%	8.5%	16.1%
United Kingdom (FTSE)	6'615	-0.2%	-0.9%	0.3%	9.4%
Switzerland (DBRB)	3'781	-0.1%	-1.0%	5.2%	4.6%
Japan (MSCI)	254	-1.0%	0.0%	-5.1%	0.9%
Emerging (MSCI)	97	1.2%	-1.3%	-1.2%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	540	n.a.	0.3%	-1.9%	-0.7%
Distressed	724	n.a.	1.6%	-0.4%	-5.3%
Event Driven	575	n.a.	1.7%	-2.9%	-6.3%
Fixed Income	303	n.a.	1.4%	0.2%	0.6%
Global Macro	867	n.a.	0.3%	-2.0%	0.2%
Long/Short	647	n.a.	-0.7%	-4.5%	3.6%
Managed Futures (CTA's)	320	n.a.	-3.0%	1.2%	-0.9%
Market Neutral	266	n.a.	-0.9%	-1.2%	1.7%
Multi-Strategy	520	n.a.	0.4%	-0.2%	3.8%
Short Bias	29	n.a.	-4.3%	-5.2%	2.4%
Commodities					
Commodities (CRB)	426	2.4%	3.9%	11.0%	-15.2%
Gold (Troy Ounce)	1'244	3.3%	-3.9%	17.2%	-10.6%
Oil (Brent, Barrel)	50	0.2%	10.1%	37.2%	-35.9%
Currencies					
USD	94.1	-1.4%	0.3%	-4.6%	9.3%
EUR	1.14	1.9%	-0.5%	4.5%	-10.2%
GBP	1.44	-1.5%	-0.1%	-2.2%	-5.4%
CHF	0.97	2.0%	0.0%	3.0%	-0.8%
JPY	107.1	3.8%	0.0%	12.3%	-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