GLOBAL OUTLOOK

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2016 GLOBAL OUTLOOK - An Overview

Economics

Global Economy In A Holding Pattern

Global economy in a holding pattern

Global GDP growth is likely to remain below past recoveries around 3.0% for 2016. With expectations slightly above 2015, there is limited room for upside surprise. Global manufacturing continues its 2-year slide with scant evidence of a reversal. The limited opportunity indicates that asset appreciation will remain subdued, with the Fed's gradual path to be shallower than "dots" indicates. Developed economic is in a mid-cycle phase with accommodating monetary policy supporting growth. Due to weak demand and low commodity prices, growth in emerging markets is more uncertain.

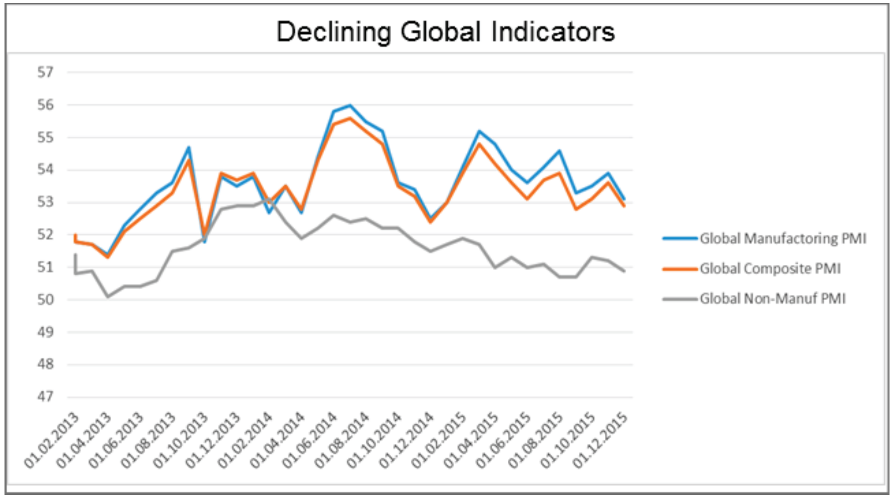
The US marginal recovery continues for the 6th year, allowing the Fed to begin normalization. Our expectations are of 2.6% growth, nearly unchanged from 2015. Domestic demand is solid enough to offset USD lead export, non-competiveness and weak energy sector. With labor markets firming, the deleveraged consumer will participate with spending. A healthy consumer will boost housing and business investments with the ability to handle moderate rise in borrowing cost. However, growing profits will become harder for companies as labor costs accelerate, labor productivity growth is modest, and interest rates are rising.

ECB and BoJ will stay accommodating

The ECB's efforts to debased the Euro has successfully invigorated Europe's exports and domestic economy. A reduction of deficits has freed investment and supports growth. While the debt burden is steadying, it remains too high and will impeded policy case in a cyclical economic downturn. Hence, the ECB will stand ready to extend its QE program. In Japan, stimulus has supported economic conditions. Yet with inflation still below the BoJ 2% target, more monetary policy stimulus would hardly be justified.

Emerging markets a risk

On emerging markets, large economies that are facing external deficit and dependence on commodity exports will struggle. Within emerging markets, Asia is in a relatively strong position with significant foreign reserves, limited external debt, flexible exchange rate and policy elasticity. Yet, growth rates of China, India and Southeast Asia are doubtful to see substantial enhancement in 2016 compared to 2015.



Economics — China: Between Credibility And Competitiveness

Uncertainty from China

Chinese financial markets experienced drama last week. Stock markets crashed twice, triggering the highly controversial circuit breakers. The emergency shutdown put in place by Chinese authorities then prevented markets from going any lower. The breakers halted trading after merely 15 minutes after a 5 % decline in an underlying benchmark, the CSI 300. Limits in Chinese equities markets are set for 7 %, the session is closed for the rest of the day. It happened on the 7th of January and China stocks traded only 15 minutes that day.

The first question is whether the Chinese market crash reveals a deep underlying crisis and whether the current economic transition from an export-driven model to a domestic economy is not as successful or smooth as forecasted. We believe this January's yuan devaluation has triggered fears about the true state of the China's economy. Since 2005, its currency has appreciated 33% against the U.S. dollar. In August 2015, China devalued the yuan by 4.7%, and the currency has already lost around 1.5% against the greenback since the beginning of this year. Clearly, the People's Bank of China (PBoC) has finally decided to engage in a currency war through competitive devaluation in order to stimulate the exports. Looking at the fundamentals of the Chinese economy, it is obvious that the double-digit growth prints seen during the first decade of this century are over. Even so, current growth is more than decent: The most recent GDP data (Q3 2015) printed at 6.6% year-on-year, well above the figure for the U.S., stalling around 2%. And a comparison with European countries is pointless. Another important point to understand is the widening spread between yuan exchange rates during the second half of 2015. Let's recap: the CNH is traded out of China and is a free-floating currency, while the CNY is traded in mainland China and the exchange rate is set by the government. The point is that, to maintain confidence in the yuan - now included in the IMF's Special Drawing Rights

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China must constantly monitor the spread between the CNH and the CNY against the dollar. The spread increased constantly during the second half of 2015, triggering speculation and capital outflows. The PBoC then decided to intervene in the FX market in order to narrow the CNY/CNH gap by buying back CNH. However, this move diminished the liquidity of the offshore currency and drastically increased the overnight rate. The overnight deposit rate jumped to 66.8% the first week of January. Yet, it is now around 8%. As a result, betting against the CNH, and thus arbitraging a CNY/CNH spread, is very expensive. Downside pressures on the CNH are very limited, but devaluing the CNY (which is now valued at almost the same rate as the CNH against the dollar) has clearly sent the wrong signal about the Chinese economy, resulting in a risk-off sentiment that has driven Chinese stocks lower.

After years of breakneck growth, China is looking for revenues other than the return on huge investments made during the last decade in real estate and factories. And in this period of global turmoil, China is struggling to find those revenues. Meanwhile its industrial sector profits declined by 1.4% year-on-year last December for a straight sixth month decline. The depressionary global economy, as well as weak domestic demand, have put the PBoC in a situation where intervention was necessary. This is evident in the fact that the Chinese producer price index continues to plummet, printing at -5.9% year-on-year. Last but not least, China has provoked a huge credibility issue by changing the stock market rules. Hence, investors may be wary of putting their money into a country where rules can be changed overnight.

Economics | The Euro Zone Will Be Put To The Test In 2016

The year 2015 was a turbulent one for the euro zone as the Greek debt crisis returned to the front stage after a period of hibernation that lasted since 2011. Despite the fact that an agreement was reached between Greece and its creditors (mostly at the expense of Greece), the Greek situation is not resolved yet and should come back under the spotlights as soon as February this year. Indeed, Greek officials expressed the need to find a deal on debt relief with its euro zone creditors as soon as possible in order to avoid a replay of the 2015 drama. The Greek story is on the backburner for now but should draw the market's attention pretty soon.

Another crack

Besides the Greek situation, another cracks start to appear in the unity of the European Union. After embracing the austerity measures imposed by Brussels for years, Spanish people raised their voice and put an end to the two-party system that lasted for over three decades. The two newcomers are the anti-austerity party Podemos and centrist Ciudadanos. Both have emerged from the popular discontent over corruption, massive unemployment - the second highest in the euro zone, after Greece, with more than 20% of active population - and an anaemic economic growth. Spanish people want changes. Unfortunately, the Greek story tell us that European creditors are not really prone to loosen their grip when talking money, meaning that Spain could become a "new" Greece, which is one of the biggest fear of the market.

Should I stay or should I go?

This is going to make the headlines for 2016, will UK stays within the European Union? David Cameron has promised a referendum on UK membership in the European Union, which should takes place before the end of 2017. The crux of the so-called Brexit is the control of immigration as the UK government wants a reform of the EU governance in order to be able to better control the flow of immigrants to the United Kingdom. A Brexit could potentially trigger a recession while, for the first time in years, the euro zone just started to see light at the end of tunnel. Since a Brexit would hurt both the UK and euro zone economy, the uncertainty surrounding the matter will weigh on the single currency until either the EU agrees to the UK requests or, if they go all the way to the referendum, UK voters chose to stay within the EU - an exit would definitely bring the EUR lower.

A crucial year

The year 2016 will definitely be a tough one for the European Union and the euro zone as all the issues outlined above will be the key catalysts for the next twelve months. As you can see the downside is massive compared to the potential upside as the ECB is struggling with Europe's deflation problem. We expect EUR/USD to reach 1.04 by year-end as the ECB would ensure a weak euro to spur the economic recovery.

Economics | US Inflation And Fed Rate Curve

Improvement but subdued inflation

With the Feds first rate hike behind us, investors are now focused on potential policy path. According to the Feds official forecast, the US economy is expected to reach full employment in 2016. It generally accepted that full employment in the US is around 4.75% to 5.25%, with lower end most likely being reached mid-year, following the current trajectory of job creation. With the US at full employment, wages growth should accelerate. Labor shortages and therefore bargaining power for higher wages, will generate at least steadily rising wage inflation. In a broad sense, this will be good for the US consumer. A healthier consumer with lower debt and higher savings should view wage growth as final input for improved economic sentiment. A confident consumer will be a positive for smoothing a choppy economic cycle, however spillover into broader inflation is less certain. At this stage in the normal business cycle, such a tight labor market would have already been generating higher wages (breakdown of the Phillips curve).

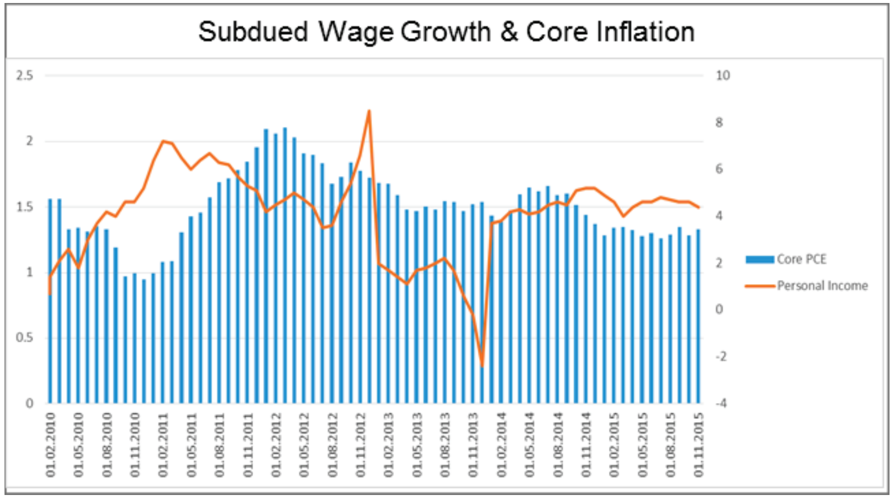
Why no wage growth?

There are two primary theories as to why wage growth remains stagnant. The first is that productivity remains low. A lack of productive growth indicates that profits will fail to increase thus proving an inability for employers to increase wages. Secondly, there is the fall in participation which distorts the perception of a tighter labor market. Yet in reality low labor participation suggest there are plenty of candidates waiting on the sidelines, ready to relieve labor shortages. Traditional dynamics of inflation have already been called into question during the 2007-2009 recession. Today's issues are just an continuation of the quandary. The problem with the current fed projections are the expectations of a normal transmission mechanism.

The sustained appreciation of the trade-weighted dollar will lower import prices for core goods, in turn indicating a greater fall in core CPI and core PCE inflation.

Strong USD and low oil price

However, with subdued wage growth and broader disinflationary pressure from a strong USD, weak global demand and low energy prices it's unlikely that the Fed will meaningfully move near 2% inflation target. With a subdued below target inflation outlook, Yellen's fear of slamming on the brakes feels questionable. Therefore the aggressive four 25bp hikes also seems a bit overdone. We anticipate a shallower rate path ending 2016 at 1.00%.



Economics

Bank of Japan May Be Forced To Increase Stimulus

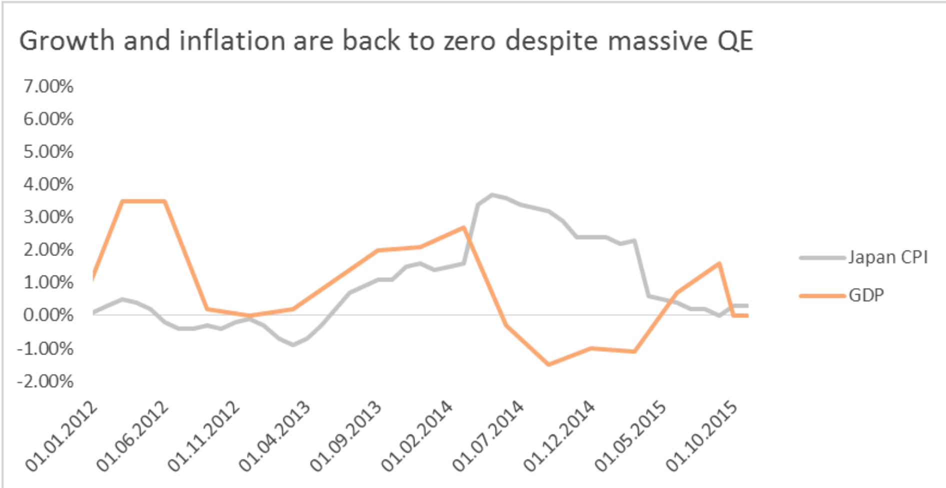
Disinflation dominates

The Japan situation may look concerning because of the lack of inflation over the last decade, the astonishing debt-to-GDP ratio over 230% and the weak growth trend (1% in 2015). The Bank of Japan has even recently announced that it starts considering cutting its 2016 inflation outlook at its next policy meeting later this month. This would largely be due to lingering low commodity prices. We also believe that Japanese policymakers have largely underestimated the pace of the decrease in crude oil prices. Anyway, there is something that seems more than obvious, the 2% inflation target won't be reached this year. A few months ago, this objective was targeted for the end of 2016.

Against this backdrop, we firmly believe that the yen is going to continue to appreciate. The Japanese currency has been often used as a safe haven currency during risk-off periods. The Chinese stock markets crash has by the way triggered flows of capital toward the yen. In addition, the true state of the U.S. economy remains uncertain and the pace of the Fed tightening looks still unclear to financial markets. Those uncertainties make the Japan's paradox, a slowing economy against a stronger currency. Hence, it is clear that Japan needs the global economy to recover. Indeed, its safe haven status is definitely not helping the country. This is likely to drive down inflation as Japanese consumers will tend to pay the imported goods at a lower price. A stronger yen is playing against the current monetary policy. Nonetheless, even at current level, we do not consider that the yen is being overvalued.

When looking at some fundamentals aspects, we may judge that the overall situation is improving. The current account printed for November well above expectations at 1.14 trillion yen in surplus for 17 straight months. It provides some support to Shinzo Abe, Japan's prime minister, who is struggling to spur the Japanese Economy with his Abenomics.

Yet, it is the smallest surplus since last June when surplus was stimulated from tourism boosted by a weaker yen. On the contrary the trade balance went back into deficit at -271 billion yen. For the time being, the price of crude oil is set to continue falling and should spur a boost in the trade balance in the near future.The yen is now trading around 116 yen for one dollar. We think that over the coming years, the BoJ will be forced to add more stimulus in the economy in order to fight against the strengthening nature of the yen. We have reasonable evidence that the central bank will definitely step up its bonds purchases. Japan is already all-in, hence it would not make much sense to stop right now the monetary policy without risking a larger and deeper recession. In addition, Nikkei is already declining sharply. Over the last month, the Japanese index has lost almost 10%. Despite what policymakers are saying, the BoJ does not have much room to react especially if global uncertainties around subsequent Fed rate hikes and global turmoils persist.



Economics | Moment of Truth For Switzerland

One year anniversary since SNB ditched the peg

One year ago to the day, the SNB decided to unpeg the Swiss franc from the single currency, triggering a tsunami on the FX market. Unlike the obvious immediate negative consequences, which mainly affected market participants, the true, long-term effects on the Swiss economy only became apparent gradually throughout the year. Initially, people expected the fall-out to be disastrous for the Swiss economy but ultimately the outcome was not quite so negative. However, we do believe that Swiss companies have already used all the possible tools at hand to protect both their business and their employees by substantially reducing their margins and cutting costs to minimum. The first real cracks in the Swiss economy began to appear in late 2015 and the downside adjustment process will continue throughout 2016 as the economy exits the eye of the storm and braces itself for the hard part. Pressure on the labour market will increase gradually with certain companies likely transferring to cheaper locations as the long-term effects of a strong CHF start to kick in. As a consequence the upward pressure on the Swiss franc should weaken to some extent as investors find better investment opportunities abroad. However, we believe that this effect will mitigated by the myriad of political uncertainties across the European complex, including Brexit, Podemos in Spain, Greek debt crisis and deflationary pressure, as well as the rising probability of an increase of the ECB's QE. We therefore expect EUR/CHF to move sideways in 2016 but we definitely do not rule out some more volatile moves. The SNB will likely remain sidelined as it does not have enough firepower to battle the ECB; however President Jordan may still cut rates further if needed.

From a politico-economic standpoint, 2016 will also be a critical year as Swiss people will have to vote on key matters that will define the main lines of the country's relation with the European Union. Indeed, the willingness of Switzerland to preserve its independence creates massive risk for this export-oriented economy. It will start on February 28th with the vote on an initiative that seeks to enforce the deportation of convicted foreigners. The first text was already approved by Swiss voters but the Swiss people's Party believes that the Parliament watered down the original text - in an attempt to comply with EU regulation and to protect the access to European markets - and wants now to enforce its application. The people will also have to vote on a ban on financial speculation of food and agricultural commodities. Commodity trading is therefore at stack in Switzerland, just as well as all the jobs and revenues stemming from it. The approbation of this initiative will most likely hurt badly the Swiss economy, forcing companies and investors to start looking abroad for new opportunities.

Over the coming year, taking into account all the facts exposed above, we believe that EUR/CHF will mostly trade range-bound with in much more volatile environment, with a target at 1.08 for year-end. For now, EUR/CHF is holding ground above 1.09 in spite of an overwhelming global risk-off sentiment.

Commodities

Oil Limited Upside

$45 / barrel in 2016

Oil faces significant challenges in 2016 despite its already low pricing. Mounting fundamental issues meanwhile, will likely keep Brent and WTI prices around $45/barrel in 2016. The lifting of US sanctions will keep the spread between Brent and WTI tight. Steady supply glut, on-going concerns over the economic outlook of China, disagreement among OPEC members and even El-Nino driven warmer winter weather will ensure that prices remain low. The risk to this baseline scenario, and prolonged price shifting higher would be a deep supply shock with a major producer coming off-line.

Supply glut continues

Expectation that producers would quickly halt activities as prices slide have not happened. In fact, while high-cost suppliers have slowed production, many have increased supplies. US rig counts have dropped by 65% in 2015, yet actually oil production has fallen only marginally. Now the lower revenues per barrel requires suppliers to produce more in order to fill budget short falls. OPEC continues to produce over 1 million barrels of crude oil per day in excess. The December 4th OPEC meeting reinforced the group's commitment to a low cost strategy in order to gain market shares and subsequently pushed competitors out. Should Iran sanctions get lifted, there is a strong probability that Saudi Arabia will engage an Intra-OPEC price war by dumping crude into the market in order to halts Iran's ability to gain market shares.

Non- OPEC oil production such as Russia and Canada have benefited from weaker currencies and foreign exchange gains to cover costs. Finally, refiners have been a heavy buyer of crude, but inventories are maxed and US refiners will start to shut down in February to retool. Lack of upstream demand will put additional pressure on crude prices.

March recovery story

However, by mid-year the effect of lower prices will likely curtail production, providing a marginally recovery. According to the IEA, investment in oil projects has fallen by 20%. The lack of new investments indicate that when wells come off-line, they stay off-line. In the background, demand for oil has steadily increased despite the weak global manufacturing. However, we anticipate that improvement in China, due to policy accommodations and fiscal spending, will rejuvenate the world's second largest oil consumer.

However, upside in oil will be limited. Revenue starved producers indicate they stand ready to unleash supplementary productions when prices improve. Shales drilling in particularly have the ability to quickly adjust to changing prices. US oil production has been more buoyant than expected as producers cut cost to survive. The highly standardized aspect of drilling shale wells and ability for operators to fine tune production gives them a dynamic aspect not witnessed in conventional oil producers.

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