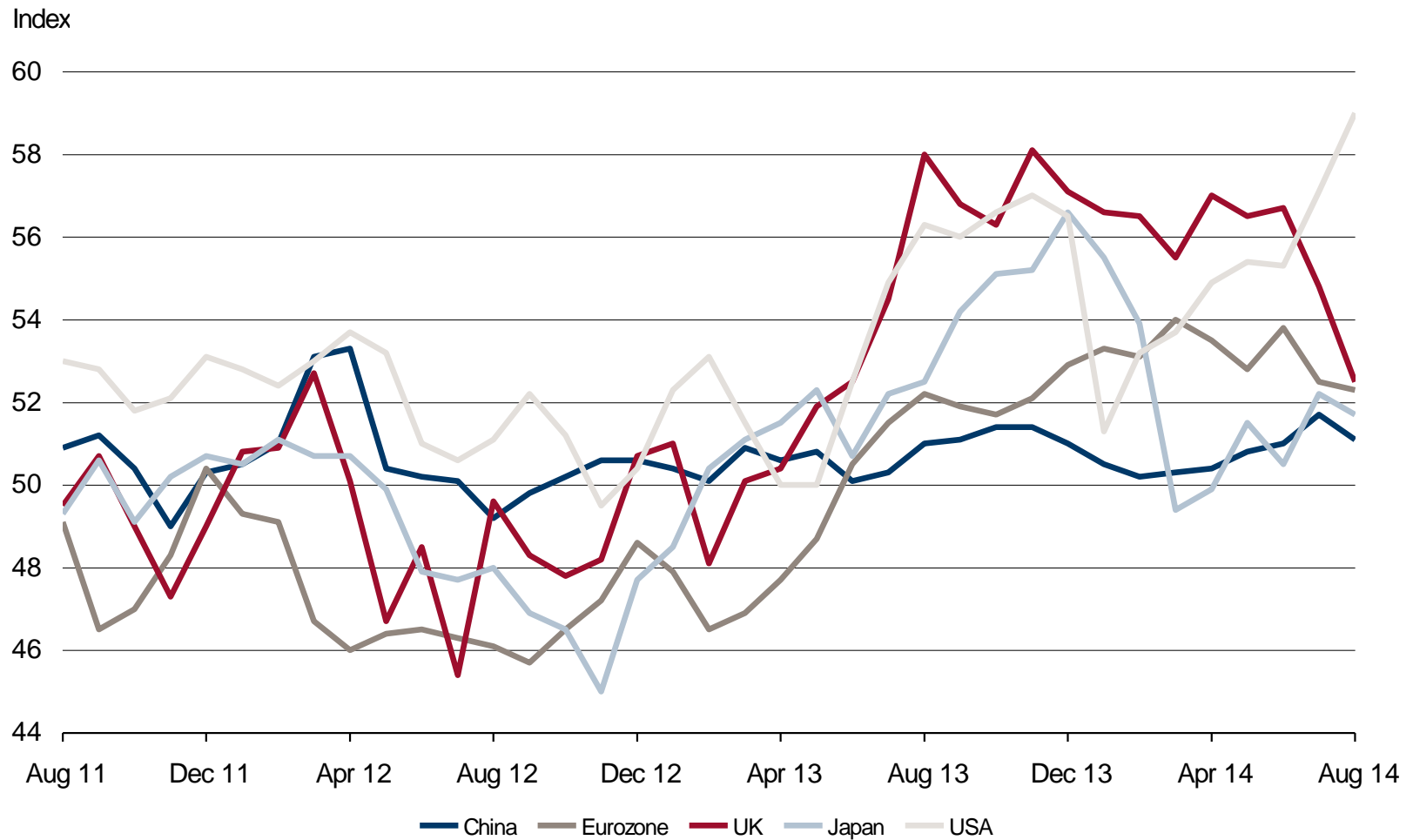


Economic & Capital Market Analysis & Investment Strategy

October - 2014

Produced by: Robert Parker,
Senior Advisor – Investment Strategy & Research

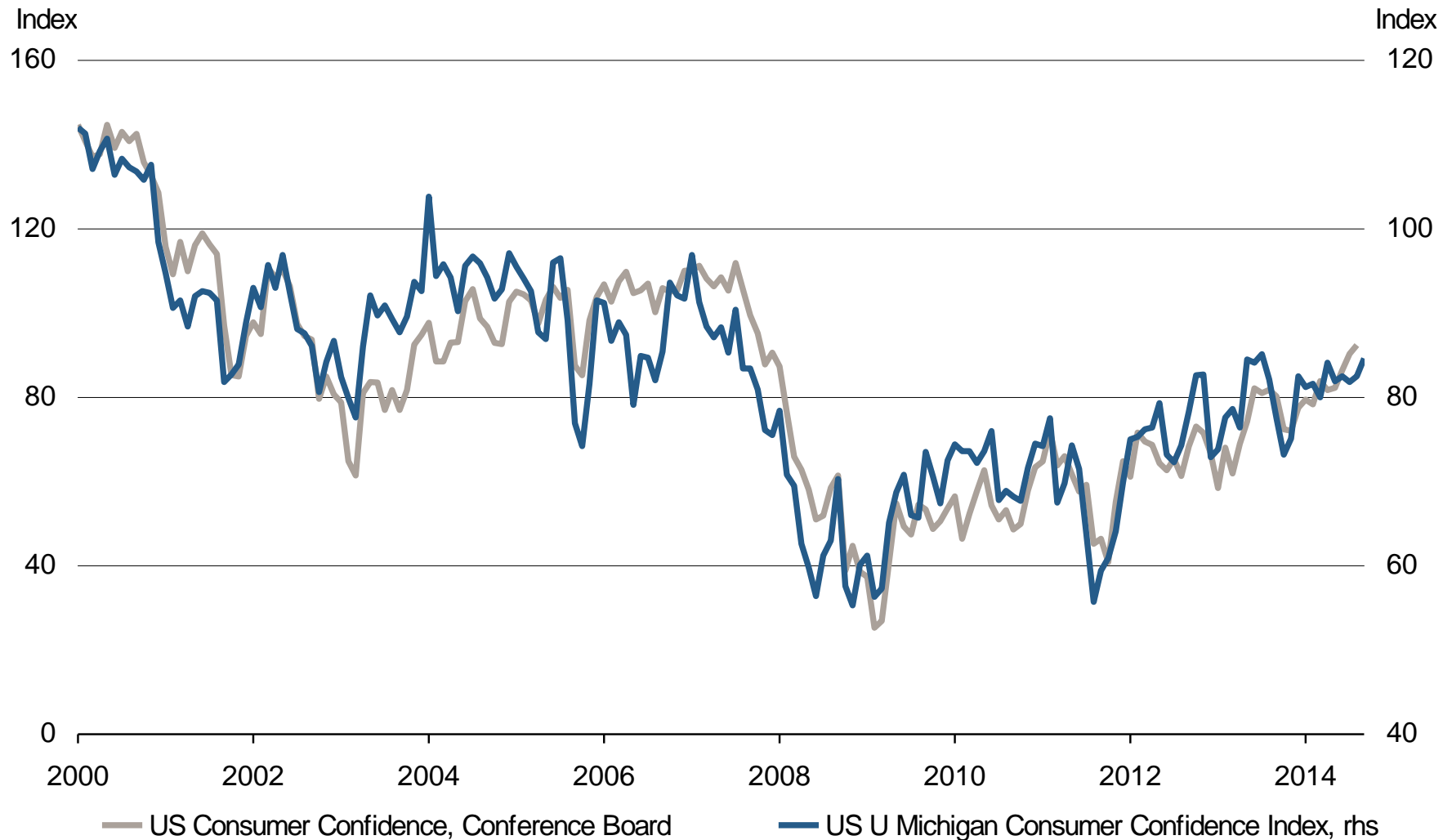
China, Eurozone, UK, Japan, US PMI



Last data point: 30.09.2014

Source: Bloomberg, Credit Suisse / IDC

US Consumption: Consumer confidence indices

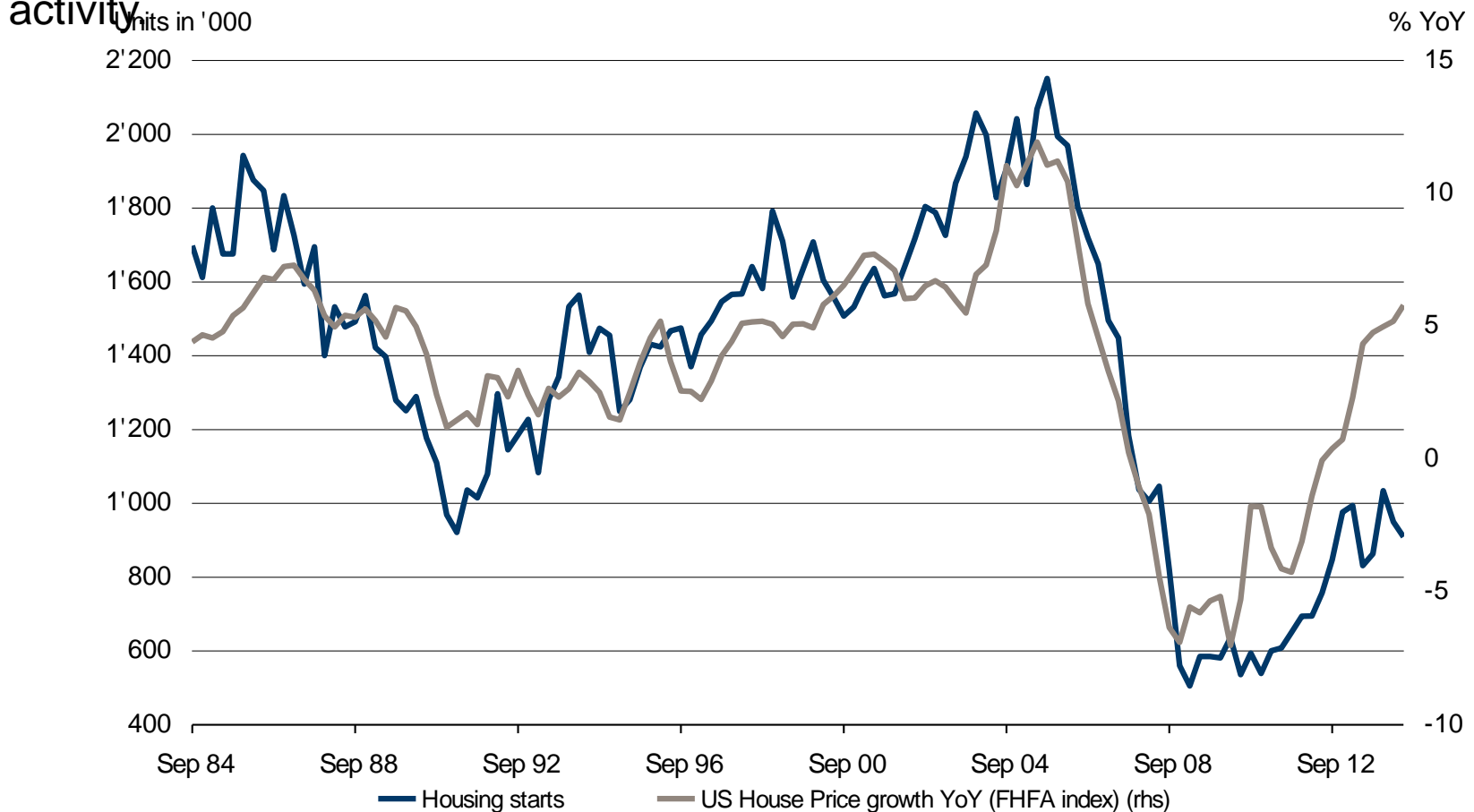


Last data point: 30.09.2014

Source: Bloomberg, Credit Suisse / IDC

US housing starts and house price growth

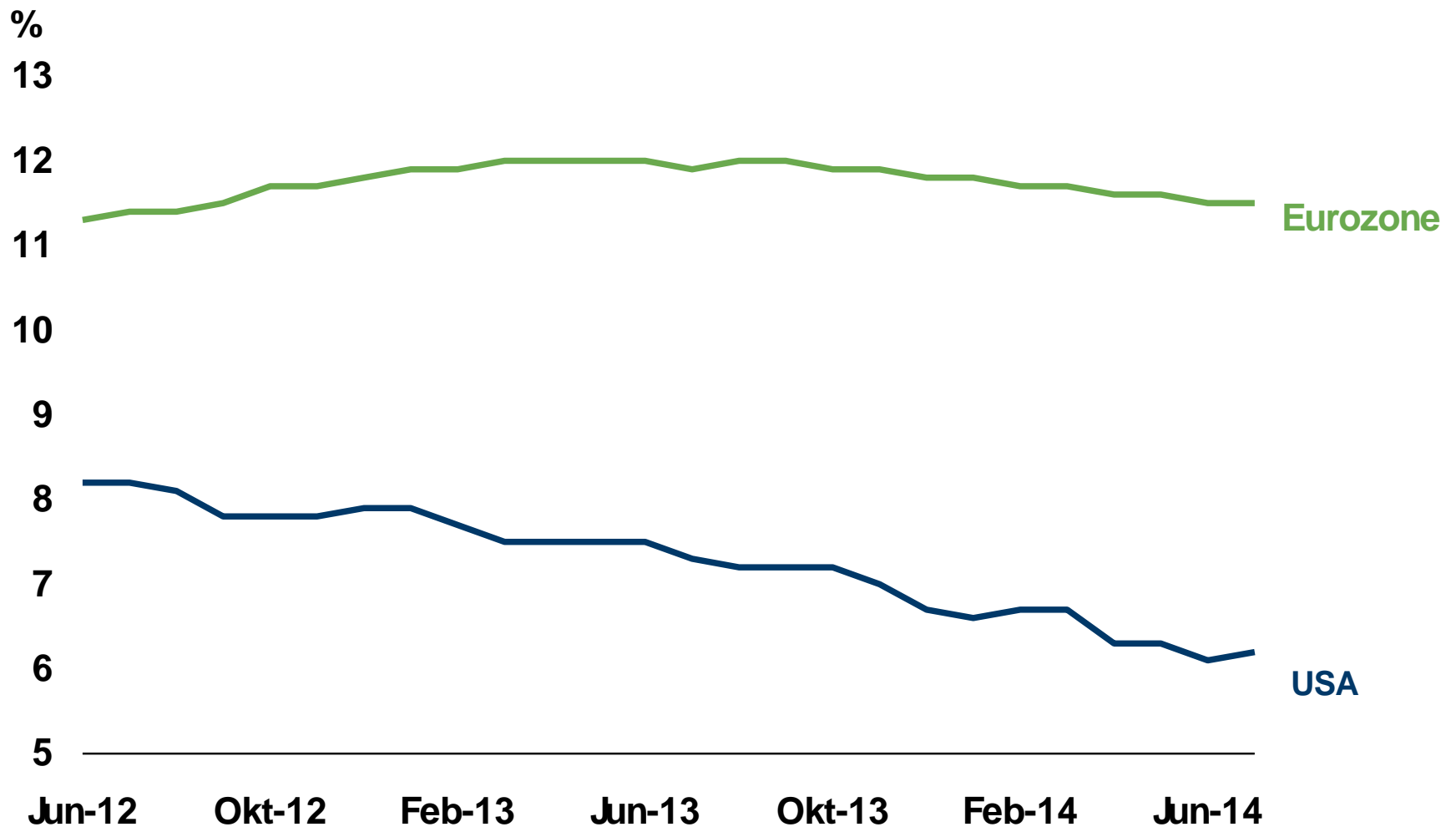
Strong correlation between house price growth and home building activity



Last data point: 30.06.2014

Source: Bloomberg, Datastream, Credit Suisse / IDC

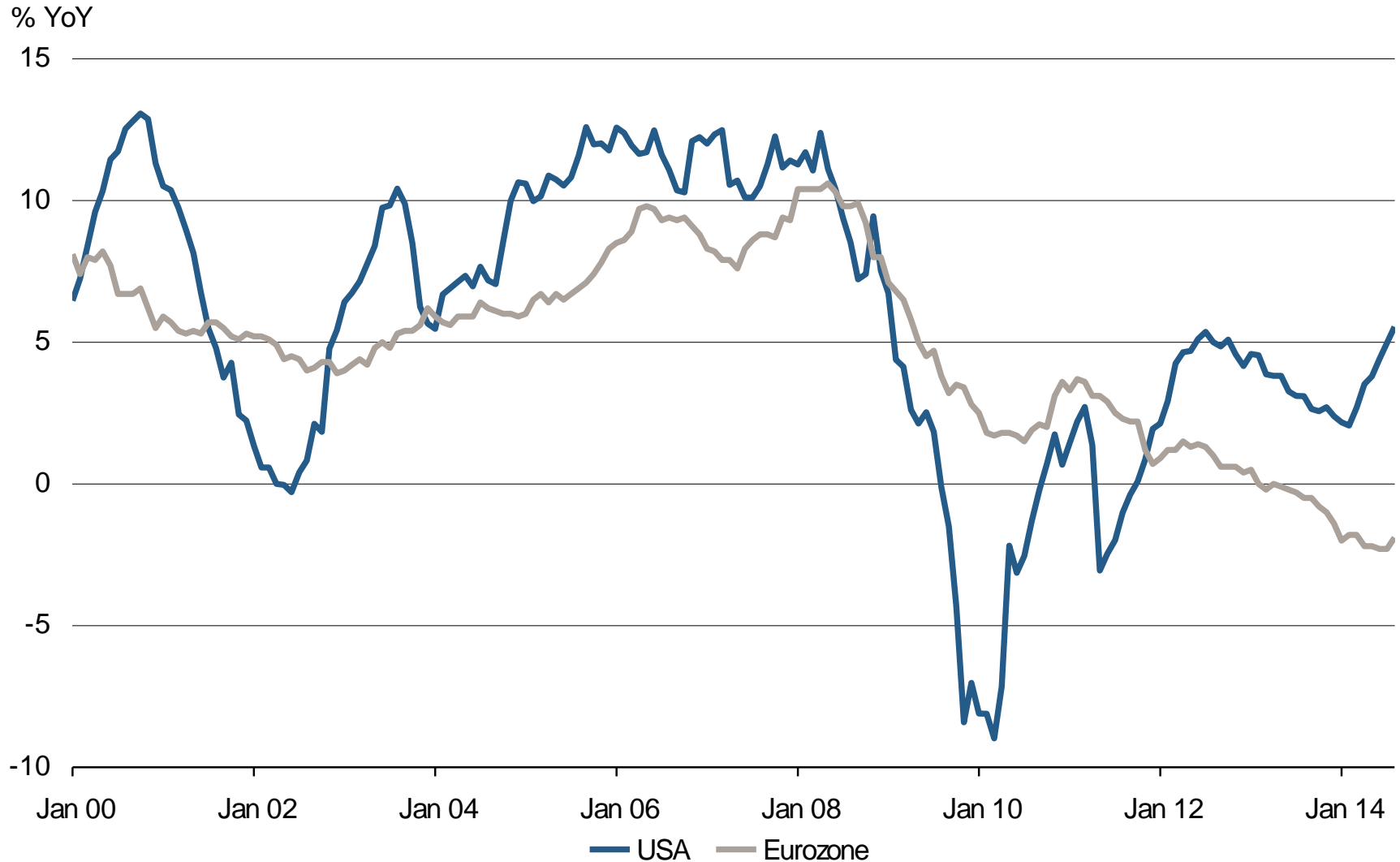
Unemployment Rate in US and Eurozone



Last data point: 15.08.2014

Source: Datastream, Credit Suisse / IDC

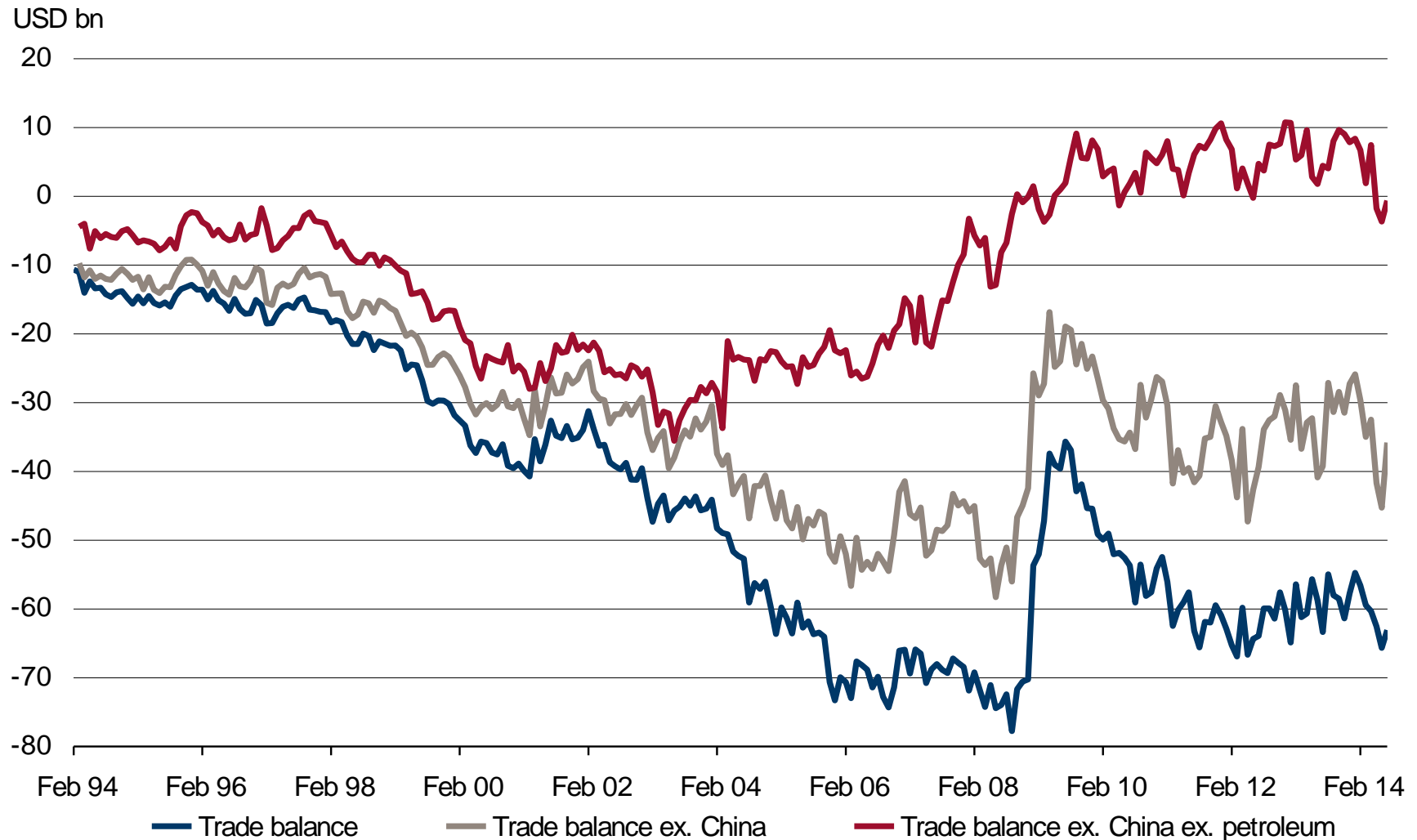
Lending: Bank credit to the private sector



Last data point: 29.08.2014

Source: Datastream, Credit Suisse / IDC

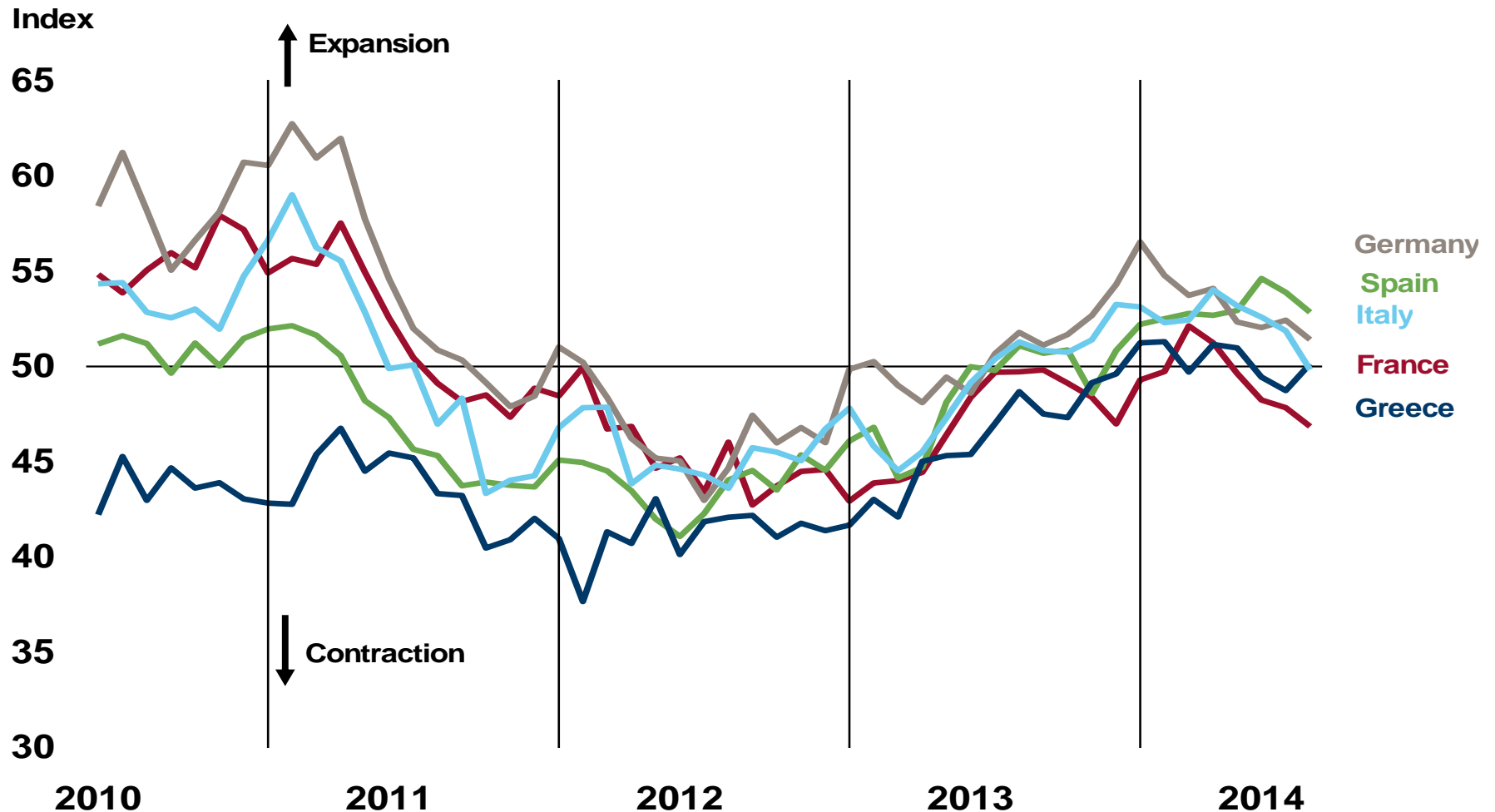
US Trade: balances total, excluding China, ex. petroleum



Last data point: 31.07.2014

Source: Bloomberg, Datastream, Credit Suisse / IDC

Continental European PMI's



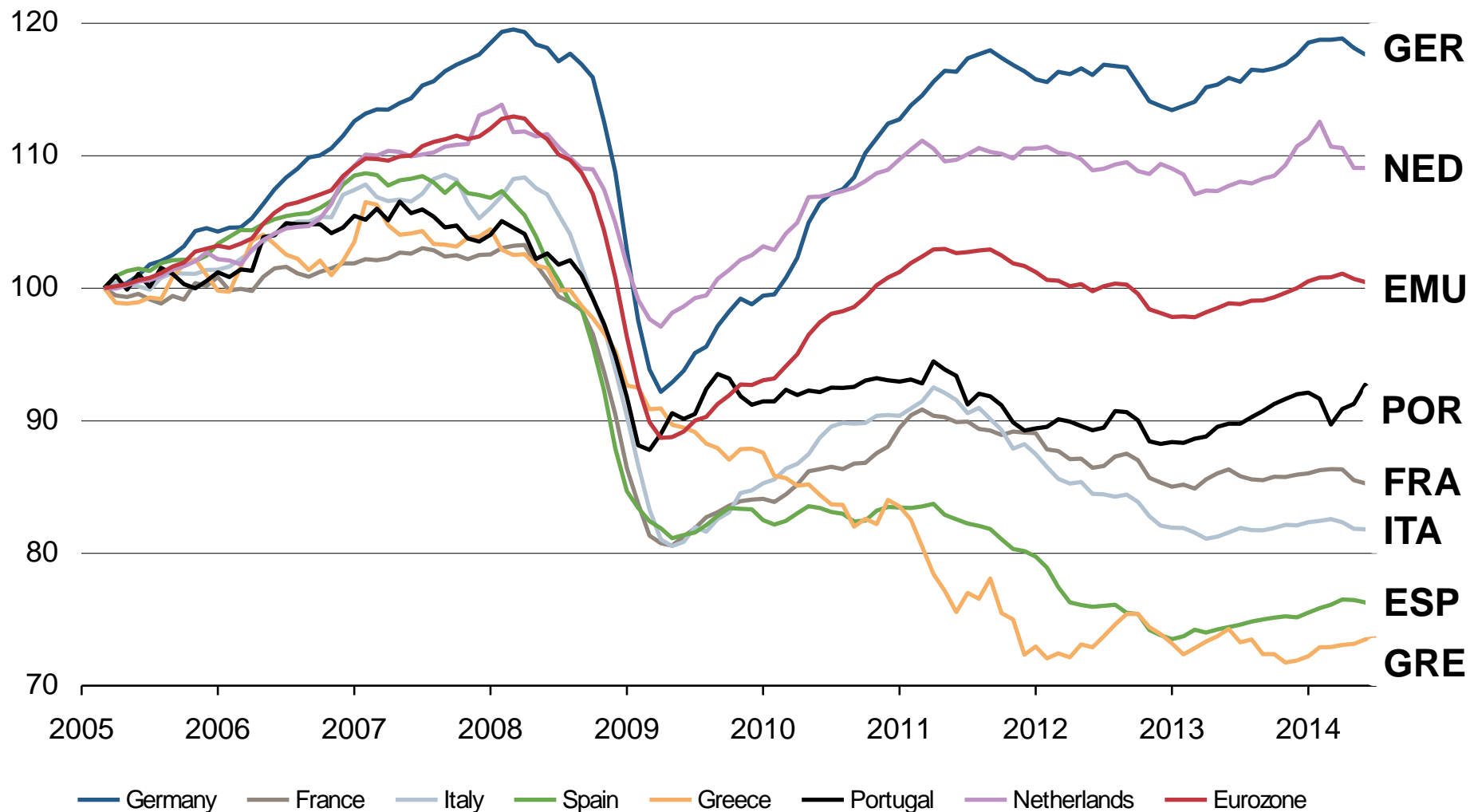
Note: Series are weighted by 2009 nominal GDP

Last data point: 31.08.2014

Source: Bloomberg, Credit Suisse / IDC

Manufacturing production trends diverging

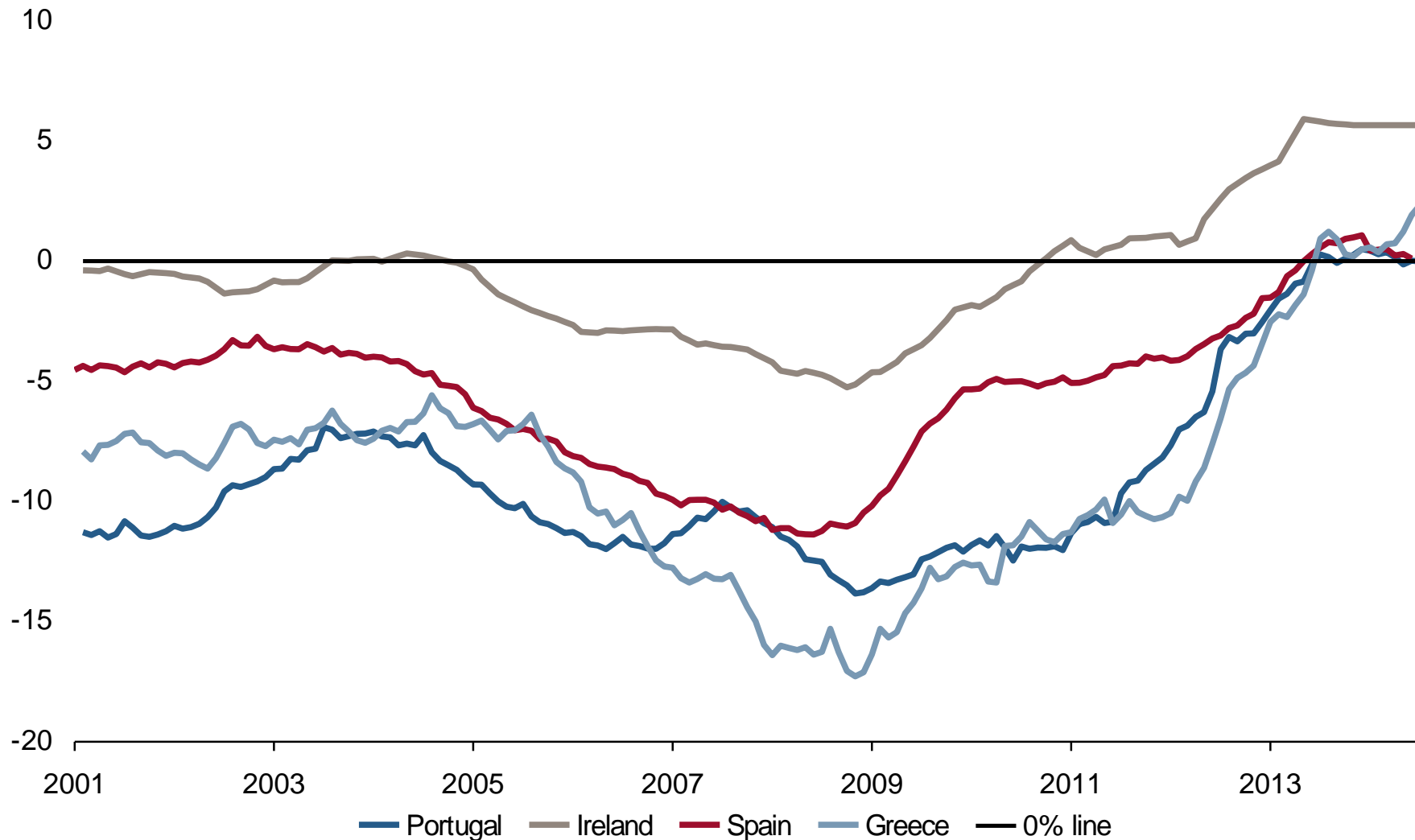
Index, 3M moving average, 2005=100



Sources: Datastream, Credit Suisse / IDC

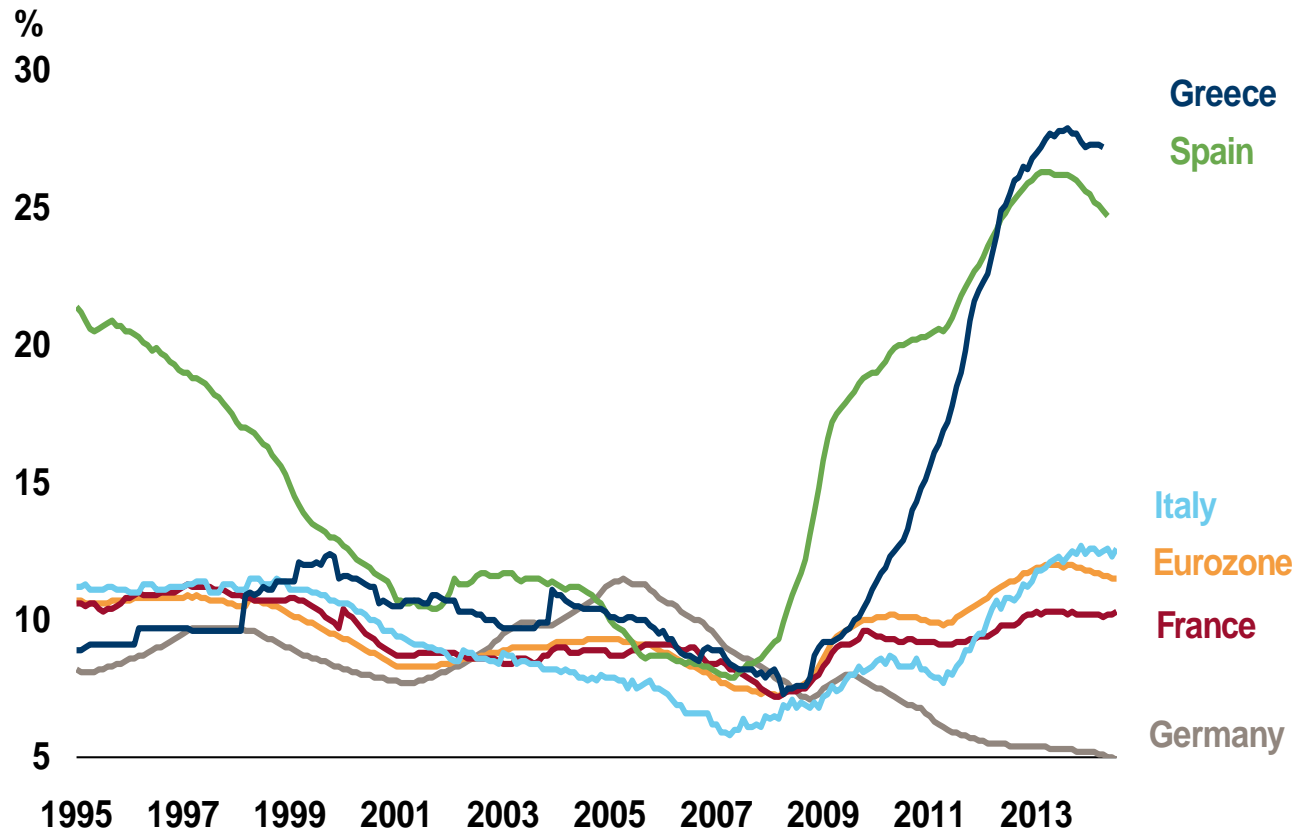
EU Current account imbalances are healing

12M average in % of GDP



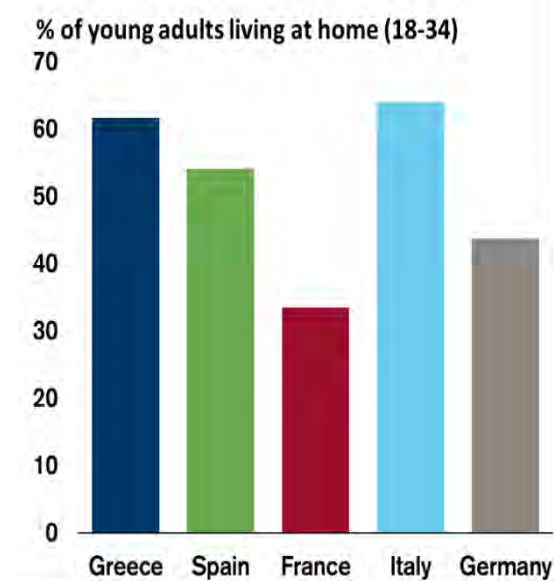
Source: Datastream, Credit Suisse

Eurozone Unemployment Rate



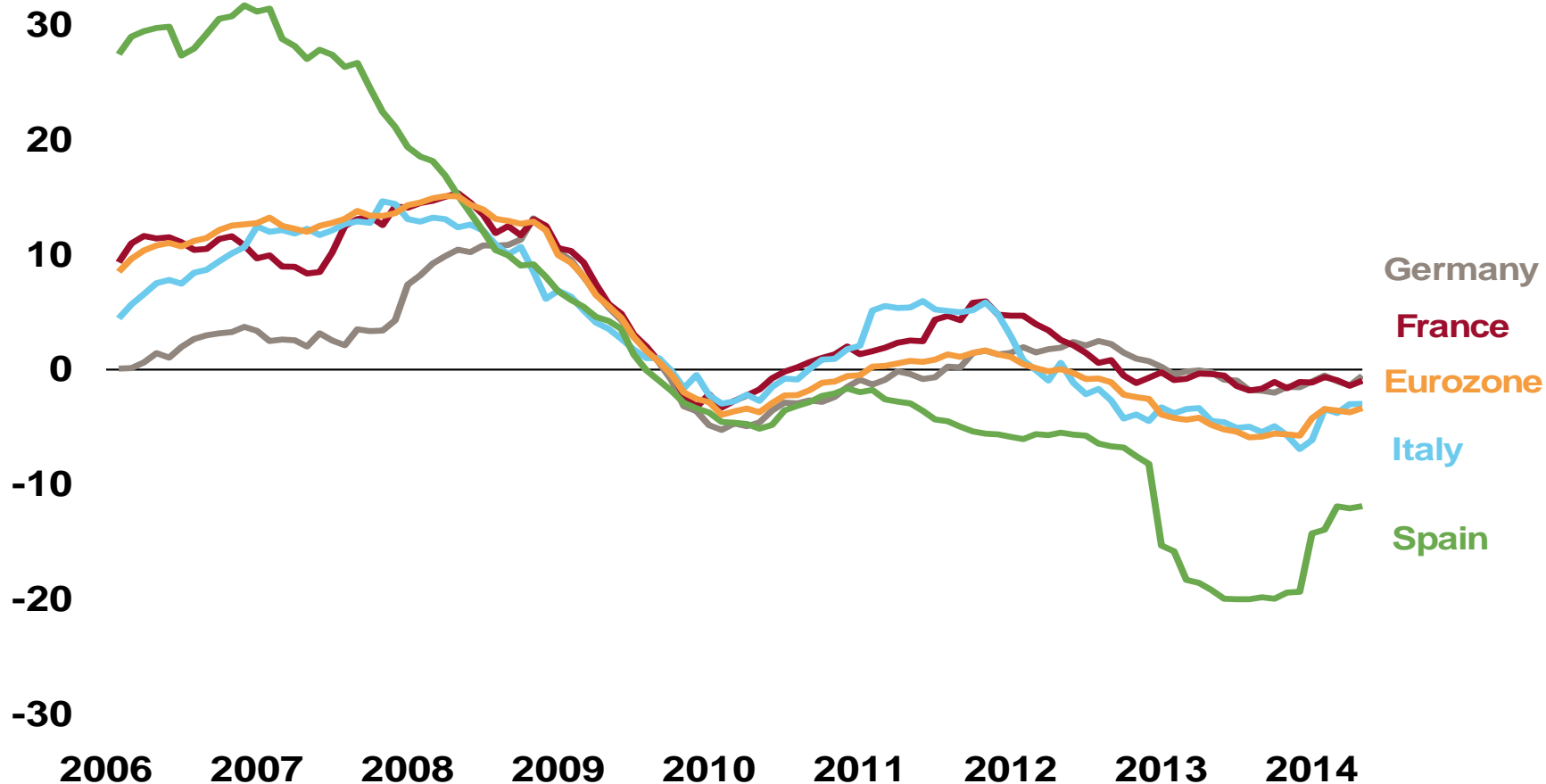
Last data point: 15.07.2014

Source: Datastream, Credit Suisse / IDC



EMU - Loans to non-financial corporations

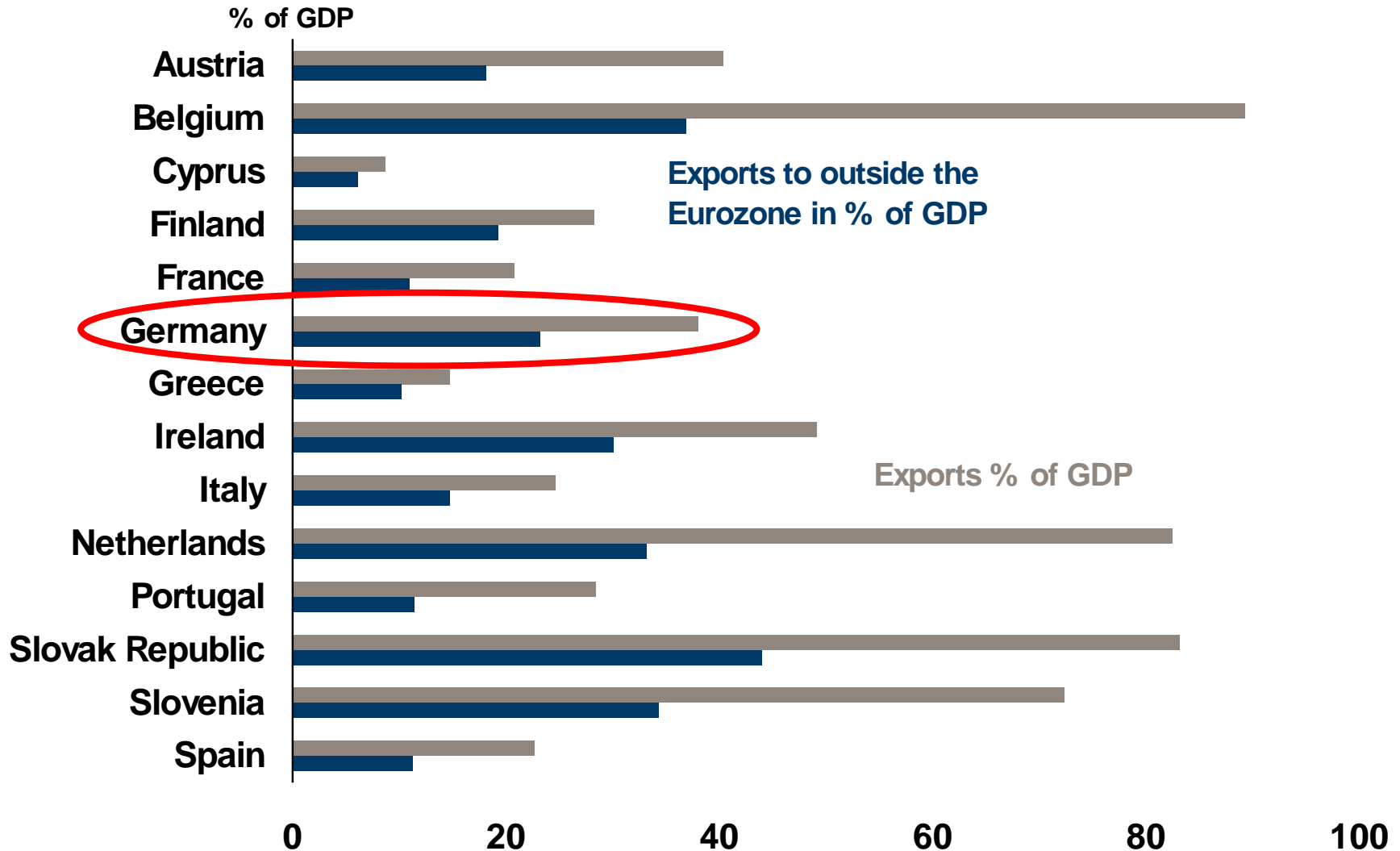
% YoY
40



Last data point: 31.07.2014

Source: Datastream, Credit Suisse

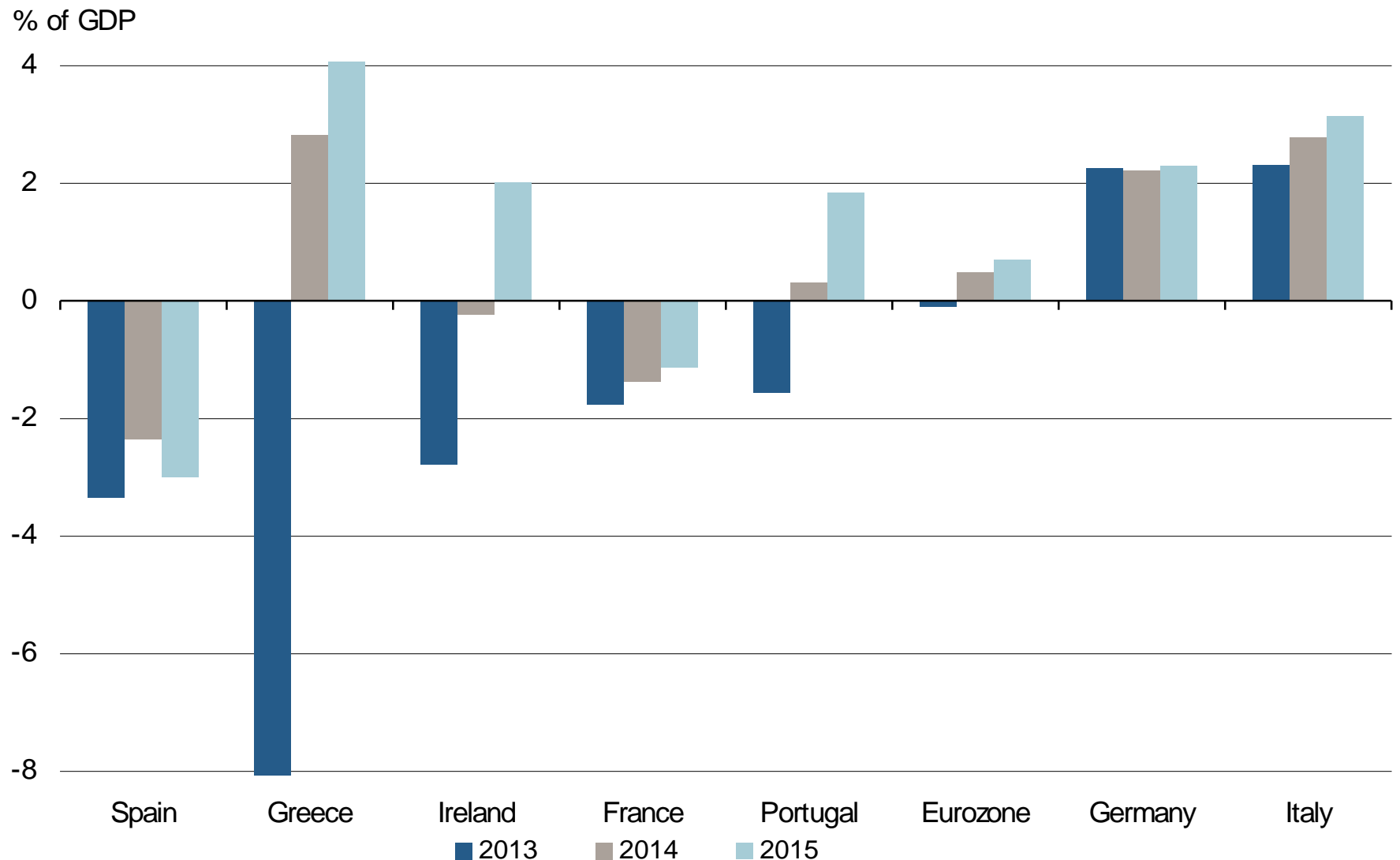
Exports to outside the Eurozone in % of GDP



Last data point: 31.12.2013

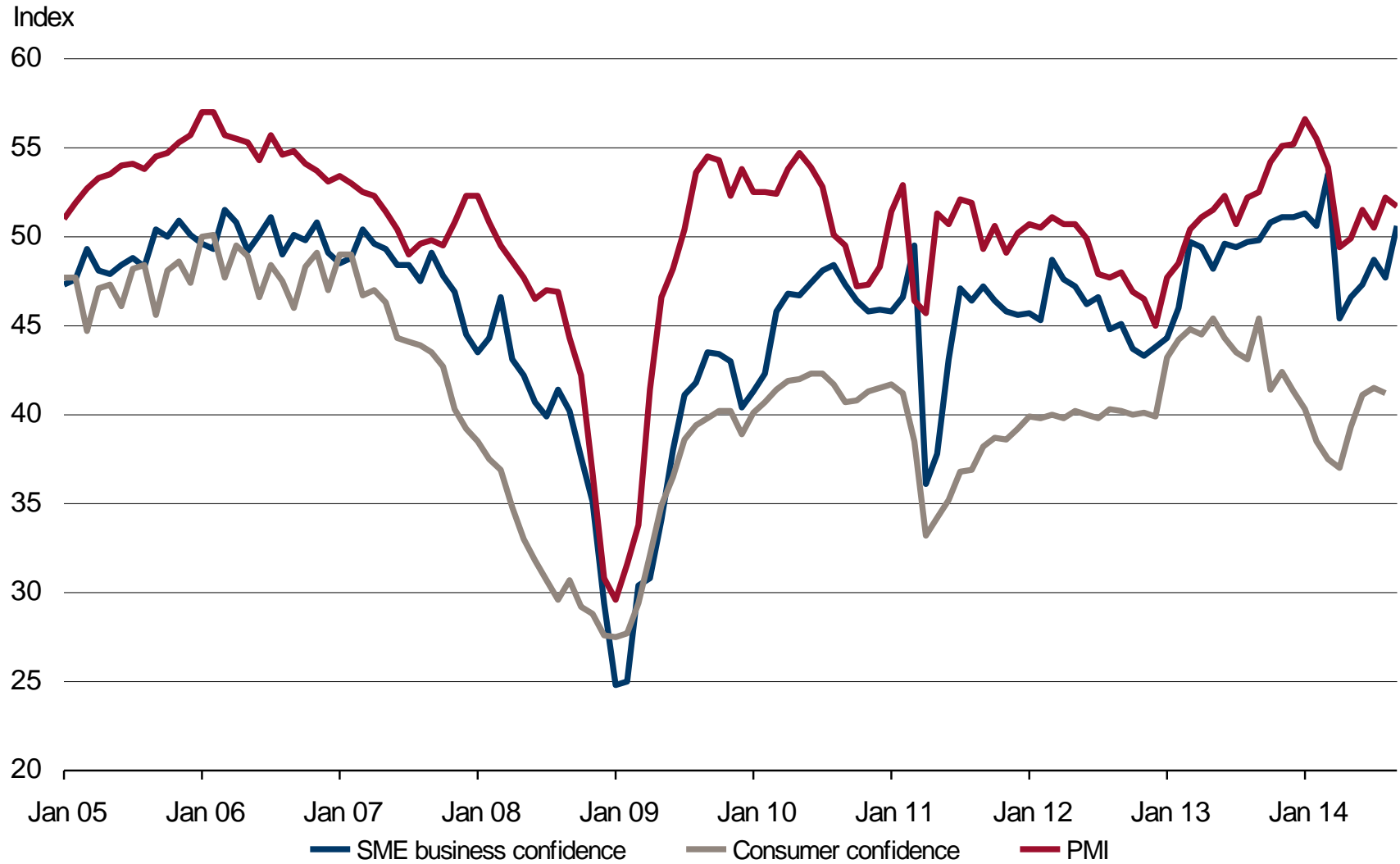
Source: Datastream, Credit Suisse / IDC

Budget balances (before interest) have much improved



Source: Datastream, Credit Suisse / IDC

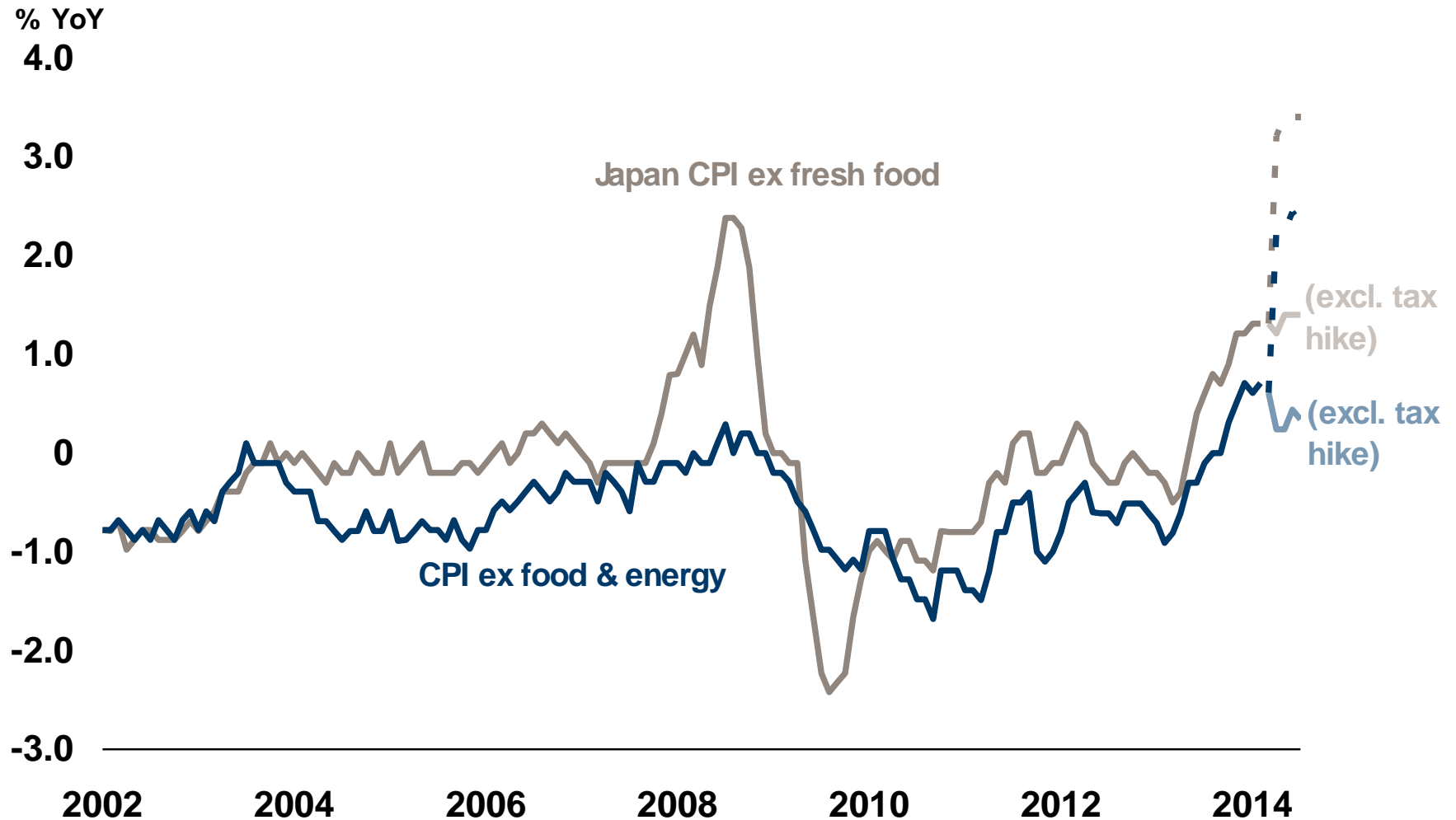
Japan: Sentiment indicators rebound after April 2014 VAT hike



Last data point: 30.09.2014

Source: Bloomberg, Datastream, Credit Suisse / IDC

Japan: inflation incl./excl. tax hike effects



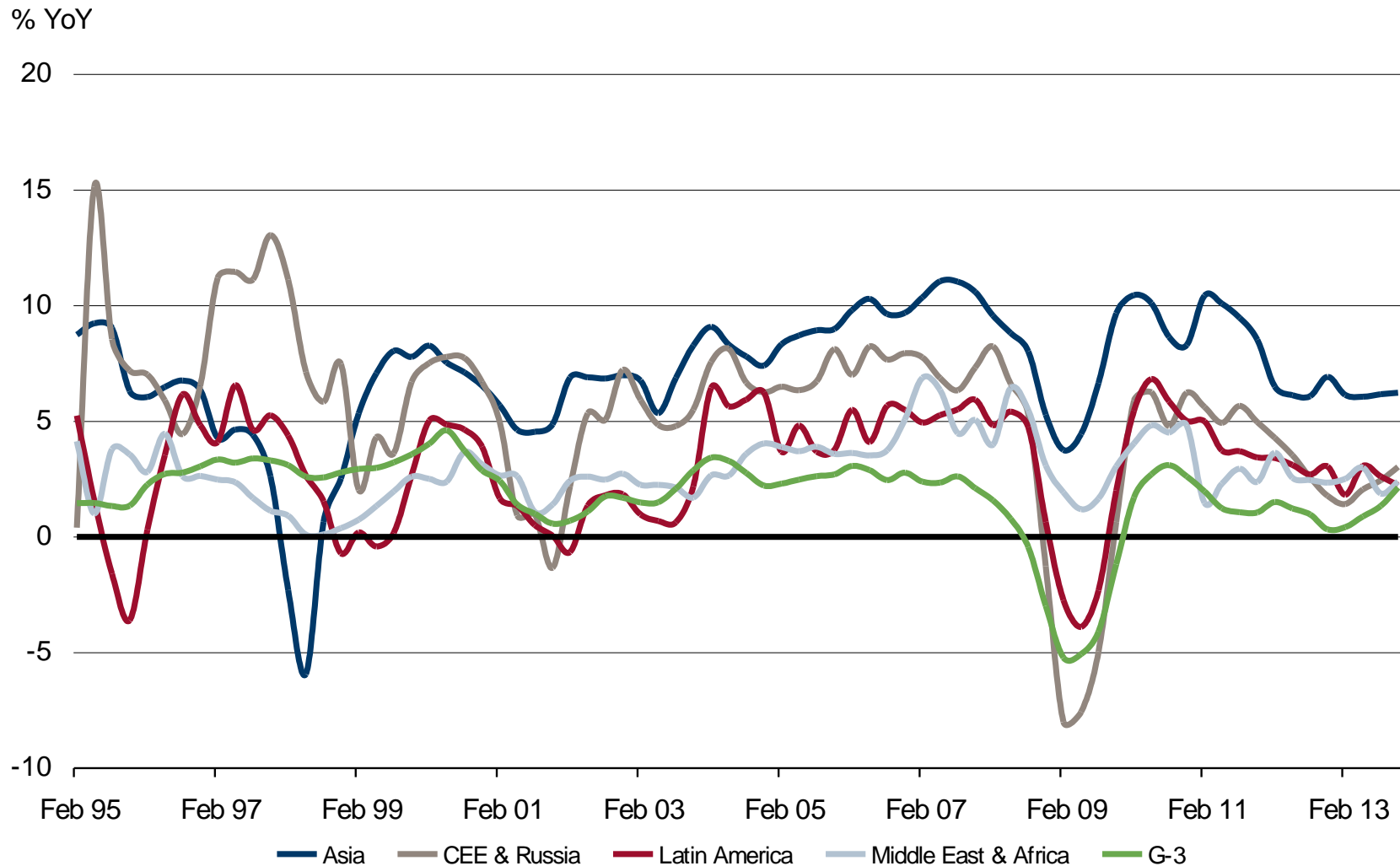
Last data point: 15.07.2014

Source: Datastream, Credit Suisse / IDC

Abenomics' "third arrow": so far no hit

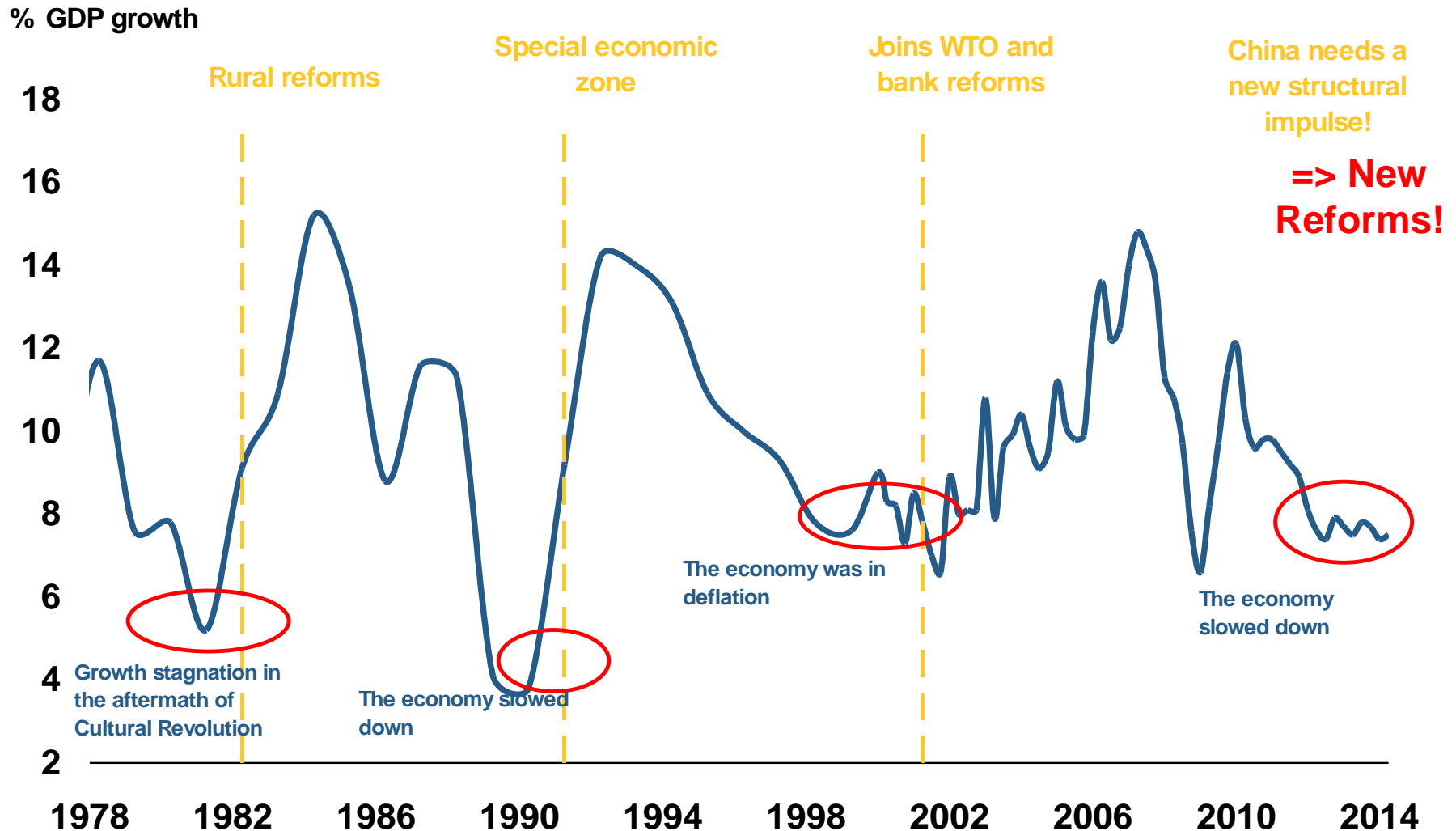
	Status	Impact on potential growth
Allowing for substantial immigration	politically not acceptable	very high
Trans-Pacific Partnership (TPP)	Negotiations currently stuck	high
Liberalize inflexible labor market	Only modest reform propositions	high
Promote female labor participation (abolish negative tax incentives)	Review by end of 2014	high
Electricity reform (more competition, restart nuclear power)	decided	medium
Health care reforms	some measures taken, more to come	medium
Tax policy (lower corporate taxes, higher consumption taxes)	decided	low
Deregulation in special economic zones	decided	low
Enhance corporate governance	implemented	low
Push GPIF towards riskier asset allocation	action expected in Aug/Sep	low
Deregulate heavily protected agriculture sector	Some reform bills announced for 2015	low

Real GDP growth: Outperformer Asia



Source: Datatsream, IMF, Credit Suisse / IDC

China: economic growth in the past



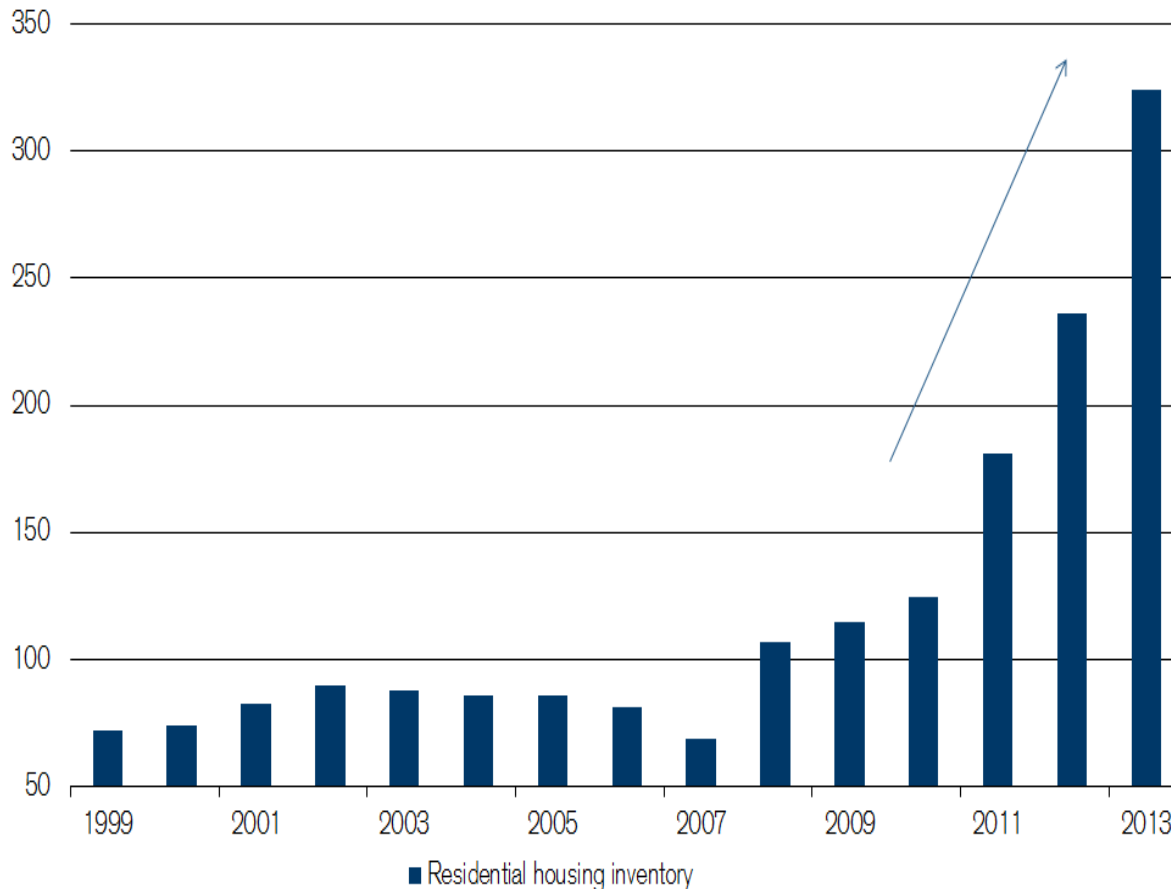
Last data point: 15.05.2014

Source: CEIC, Datastream, Credit Suisse / IDC

China's greatest growth risk: Real estate downturn

Why is this cycle different?

Floor space in millions of square meters

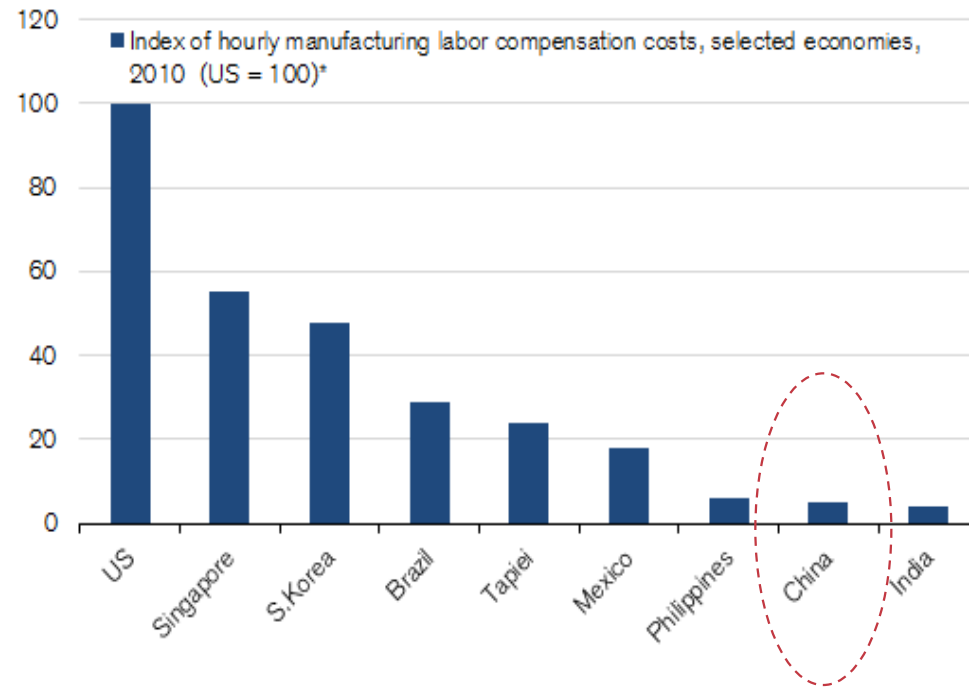
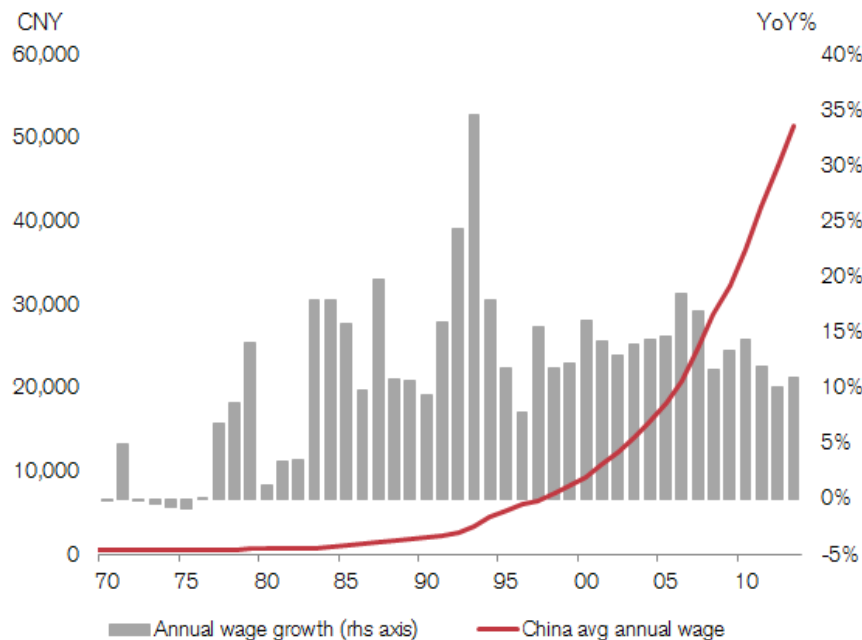


Source: CEIC, Credit Suisse

- ☐ Oversupply situation worsening
- ☐ Price overvaluation
- ☐ Tightening in shadow banking
- ☐ Declining workforce
- ☐ Upward pressures on interest rates from liberalization
- ☐ Anti-corruption campaign

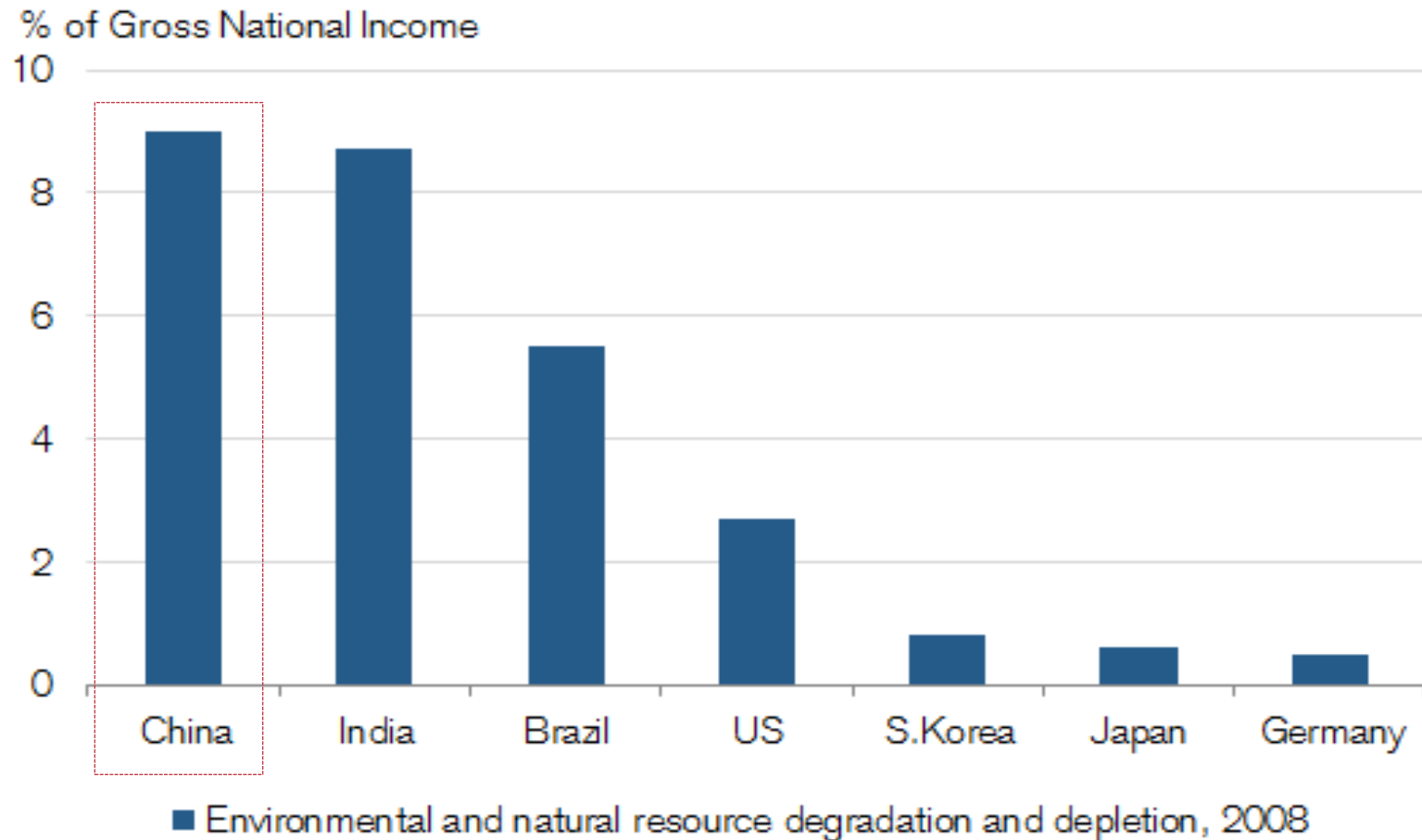
The end of low cost labor?...

Wages are no longer as low as before, and there is a need to enhance productivity gains and human capital to maintain manufacturing competitive edge



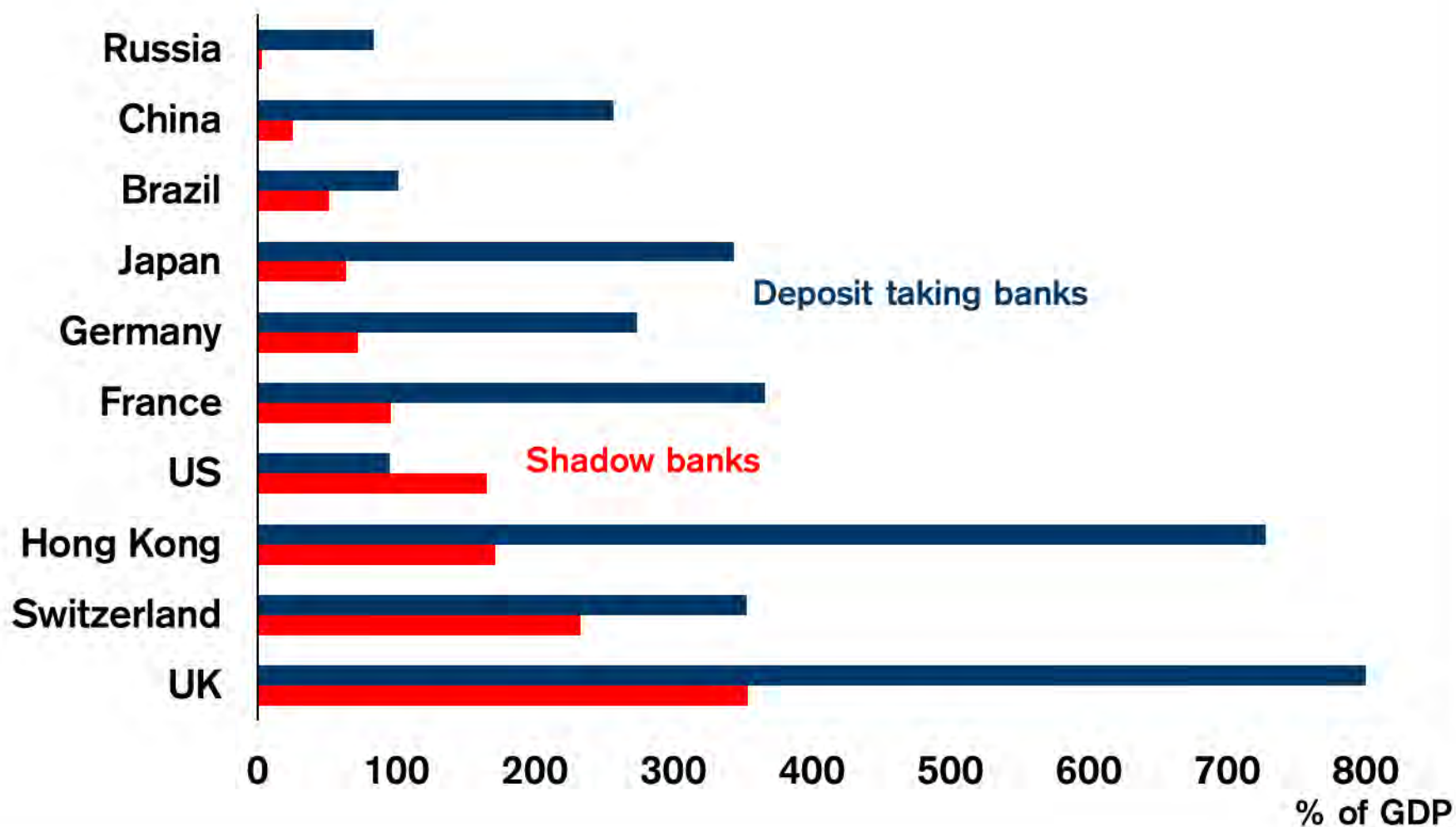
Source: * "Growing beyond the Low-Cost Advantage" by Zhuang, Vandenberg and Huang (2012), CEIC, Credit Suisse

Environmental degradation has not been taken seriously until recently



Source: "China 2030 – Building a Modern, Harmonious, and Creative Society" by the World Bank and the Development Research Center of the State Council, China; Credit Suisse

Shadow banking vs. traditional institutions



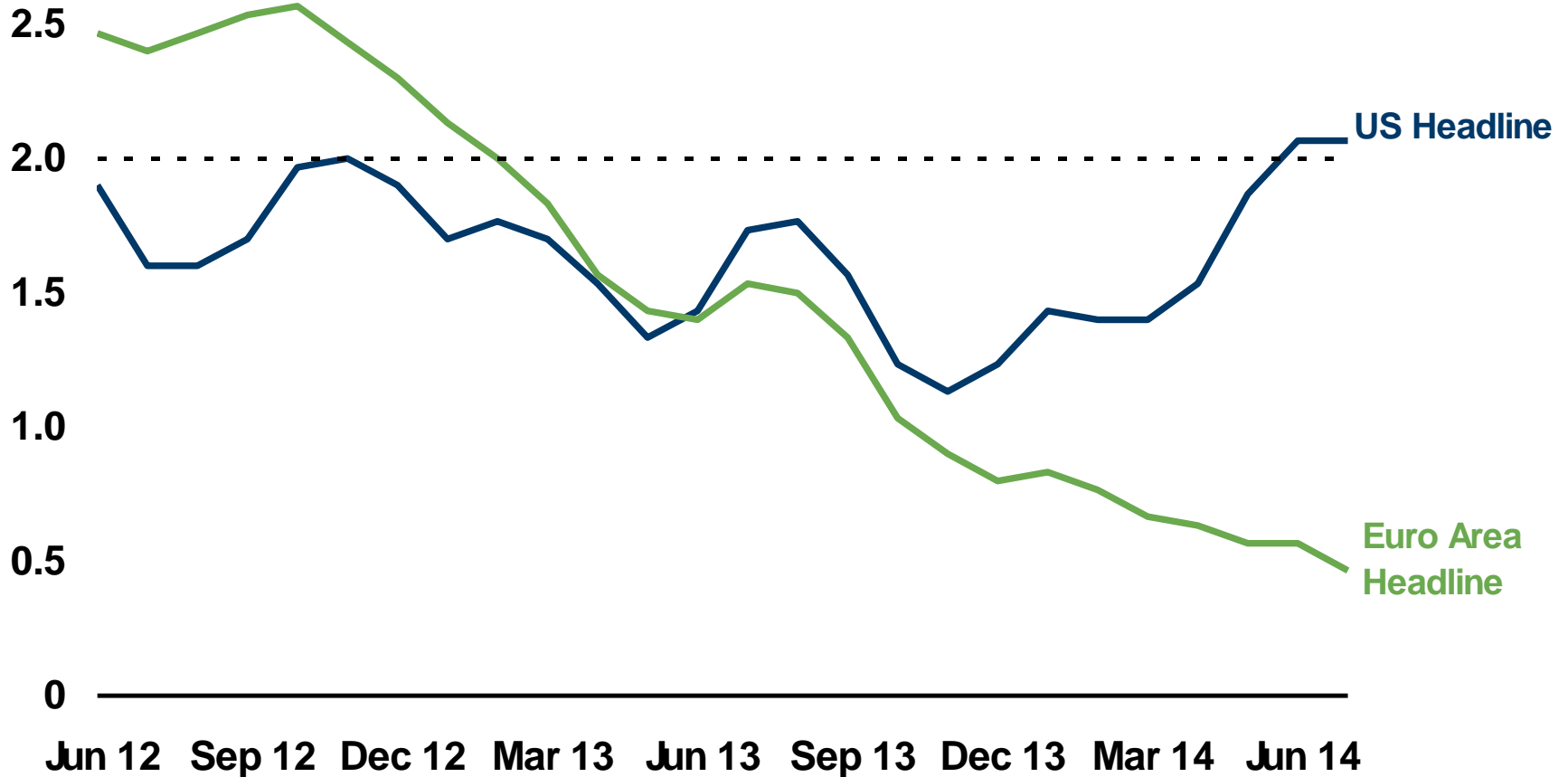
Last data point: 2012

Source: Financial Stability Board, Credit Suisse

US and Eurozone inflation

% YoY, 3 mts MA

3.0



Last data point: 10.08.2014

Source: Bloomberg, Datastream, Credit Suisse / IDC

Forecast Table GDP and inflation

	GDP			Inflation				GDP			Inflation		
Country / region	2013E	2014	2015	2013E	2014	2015	Country / region	2013E	2014	2015	2013E	2014	2015
Global	3.0	3.1	3.5	2.8	3.3	3.2	Non-Japan Asia	6.0	6.0	6.0	3.9	3.6	3.9
G-3	1.2	1.5	2.1	2.0	1.6	1.6	China	7.7	7.4	6.9	2.6	2.3	3.0
BRIC	5.8	5.6	5.6	4.8	4.4	4.5	Hong Kong	2.9	2.8	2.6	4.3	3.5	3.0
EM-8	5.6	5.5	5.6	4.6	4.3	4.5	India (fiscal year)	4.9	5.5	6.3	9.0	8.0	7.5
USA	2.2	2.1	3.0	1.5	2.0	2.0	Indonesia	5.8	5.3	5.5	6.4	6.5	6.7
Canada	2.0	2.3	2.5	0.9	2.1	1.9	South Korea	2.8	3.7	3.7	1.3	1.9	2.5
Eurozone	-0.4	0.8	1.3	1.3	0.6	0.8	Singapore	4.1	3.5	3.5	2.4	1.7	1.3
Germany	0.2	1.5	1.7	1.6	0.8	1.1	Thailand	2.8	1.2	4.0	2.2	2.4	2.8
Italy	-1.8	-0.2	0.7	1.3	0.2	0.6	CEE & Russia	1.7	1.2	2.1	5.1	6.0	5.1
France	0.3	0.5	1.2	1.0	0.7	0.9	Poland	1.6	3.2	3.0	0.9	0.4	1.6
Spain	-1.2	1.2	1.6	1.5	0.0	0.5	Russia	1.3	0.5	1.5	6.8	7.3	5.4
United Kingdom	1.7	3.2	2.7	2.6	1.6	1.9	Turkey	4.0	2.6	3.3	7.5	8.5	7.0
Norway	2.0	2.0	2.0	2.1	2.0	2.0	Latin America	2.4	1.3	2.1	7.3	11.3	9.7
Sweden	1.5	2.2	2.7	0.0	0.0	1.3	Argentina	2.9	-1.0	0.0	10.6	33.0	30.0
Switzerland	1.9	1.4	1.6	-0.2	0.1	0.5	Brazil	2.3	0.2	0.9	6.2	6.2	6.0
Japan-Pacific	1.7	1.4	1.4	0.8	2.7	1.9	Mexico	1.1	2.3	3.3	3.8	4.0	3.7
Japan	1.5	1.0	1.1	0.4	2.8	1.8	Middle East & Africa	3.6	3.8	4.2	4.6	5.2	5.3
Australia	2.4	3.1	2.8	2.4	2.5	2.4	GCC	4.1	4.2	4.4	2.9	3.0	3.2
New Zealand	2.4	3.3	3.0	1.1	2.2	2.2	South Africa	1.9	1.5	1.9	5.8	6.4	5.9

G-3: EMU, Japan, USA. EM-8: Brazil, China, India, Indonesia, South Korea, Mexico, Turkey and South Africa.

GCC: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE. Regional figures are PPP-weighted.

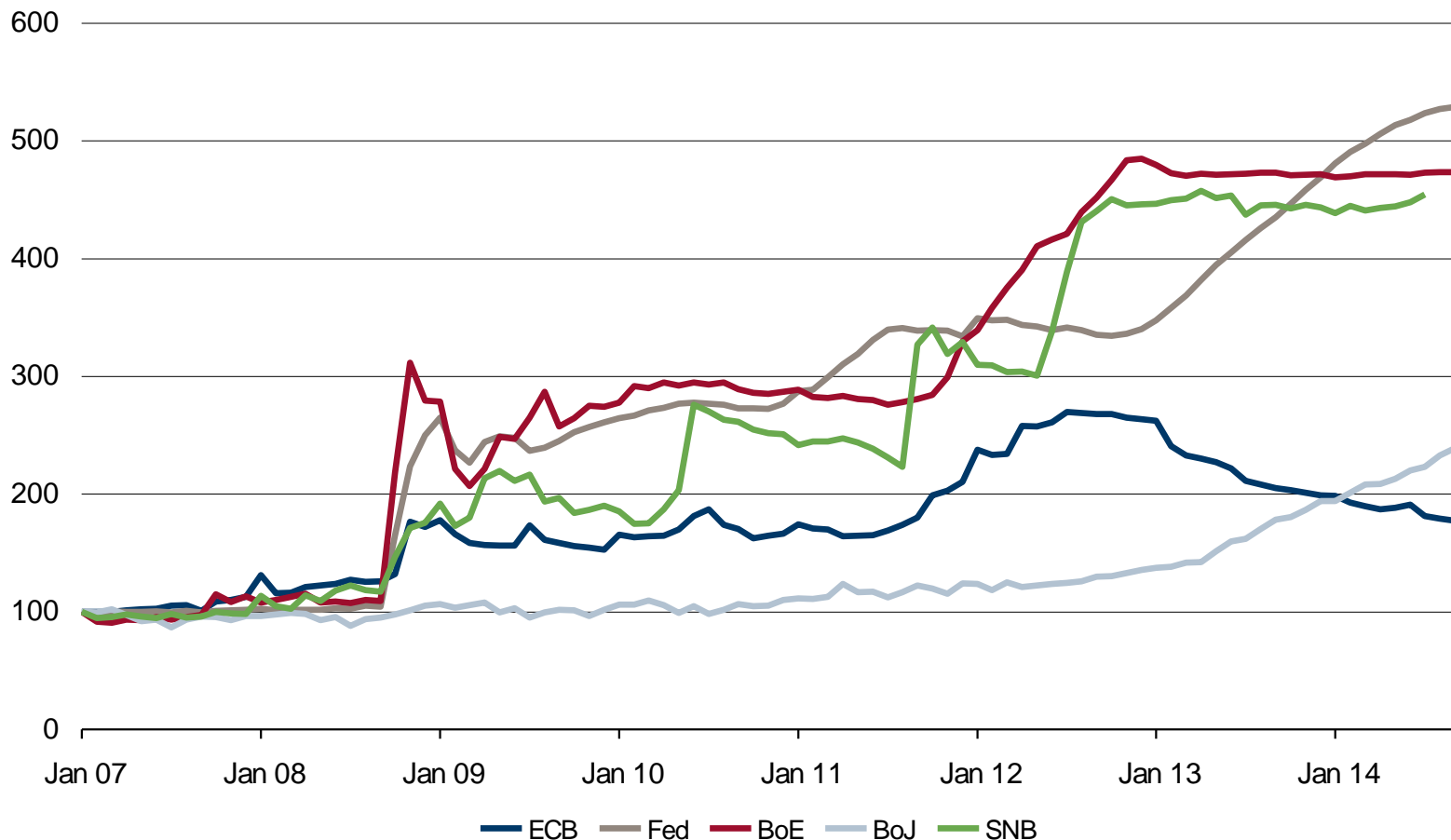
Source: Credit Suisse

Last data point: 29.09.2014

Source: Bloomberg, Datastream, Credit Suisse / IDC

Central Bank balance sheets

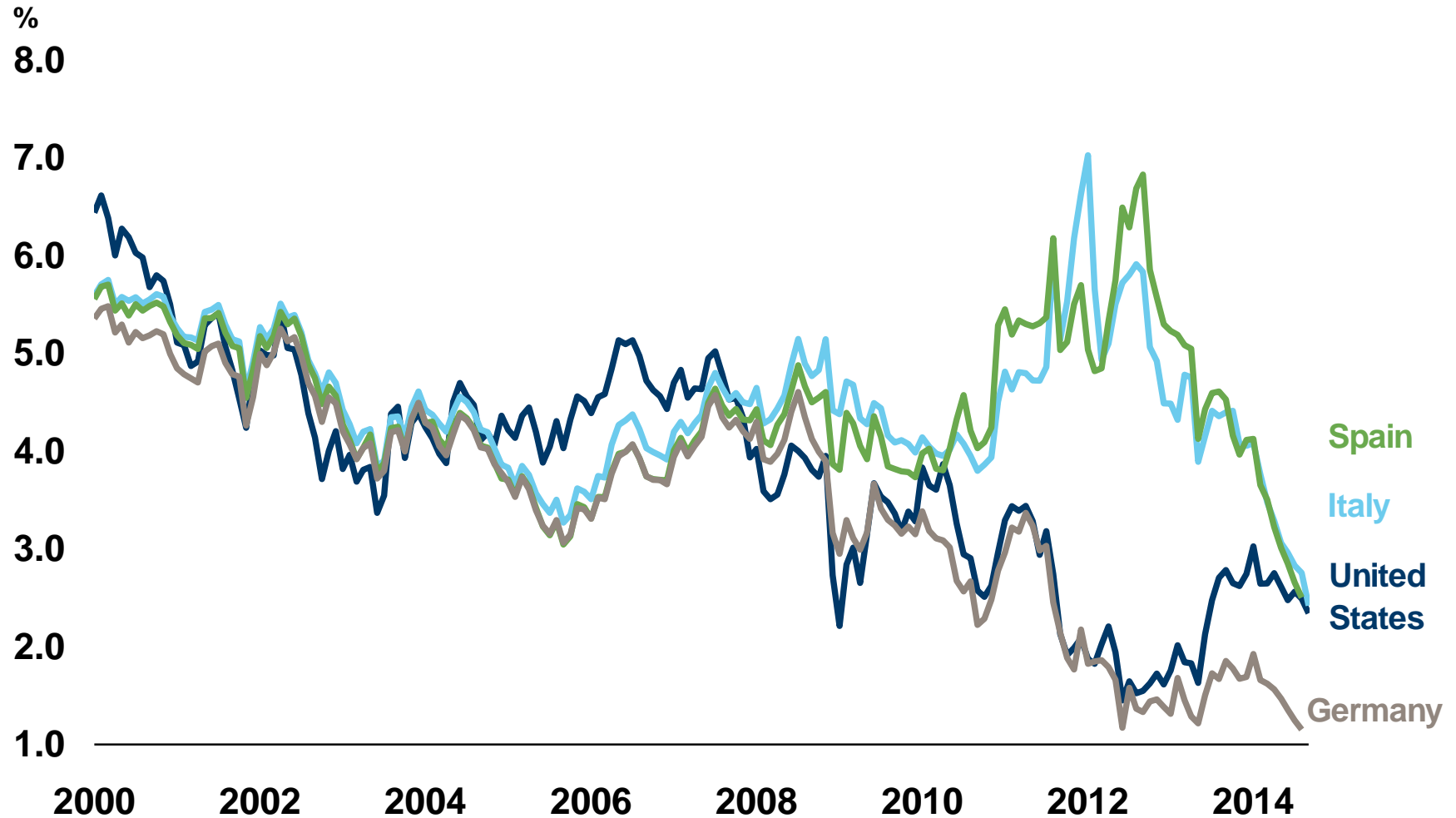
central bank assets, indexed, 01.01.2007 = 100



Last data point: 26.09.2014

Source: Datastream, Credit Suisse / IDC

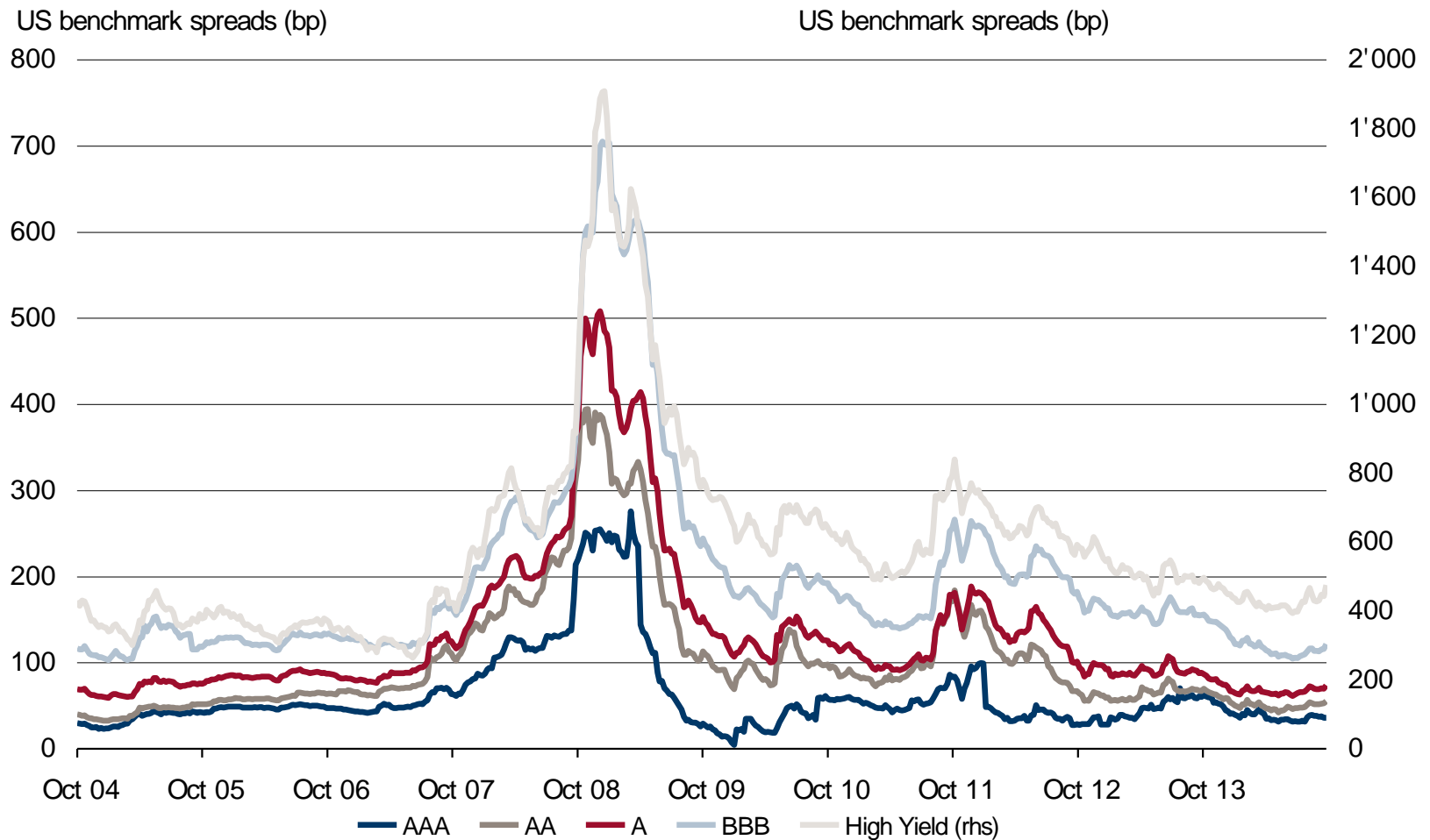
10-Year Gov. Bond Yields: US, Italy, Spain and Germany



Last data point: 07.09.2014

Source: Bloomberg, Credit Suisse / IDC

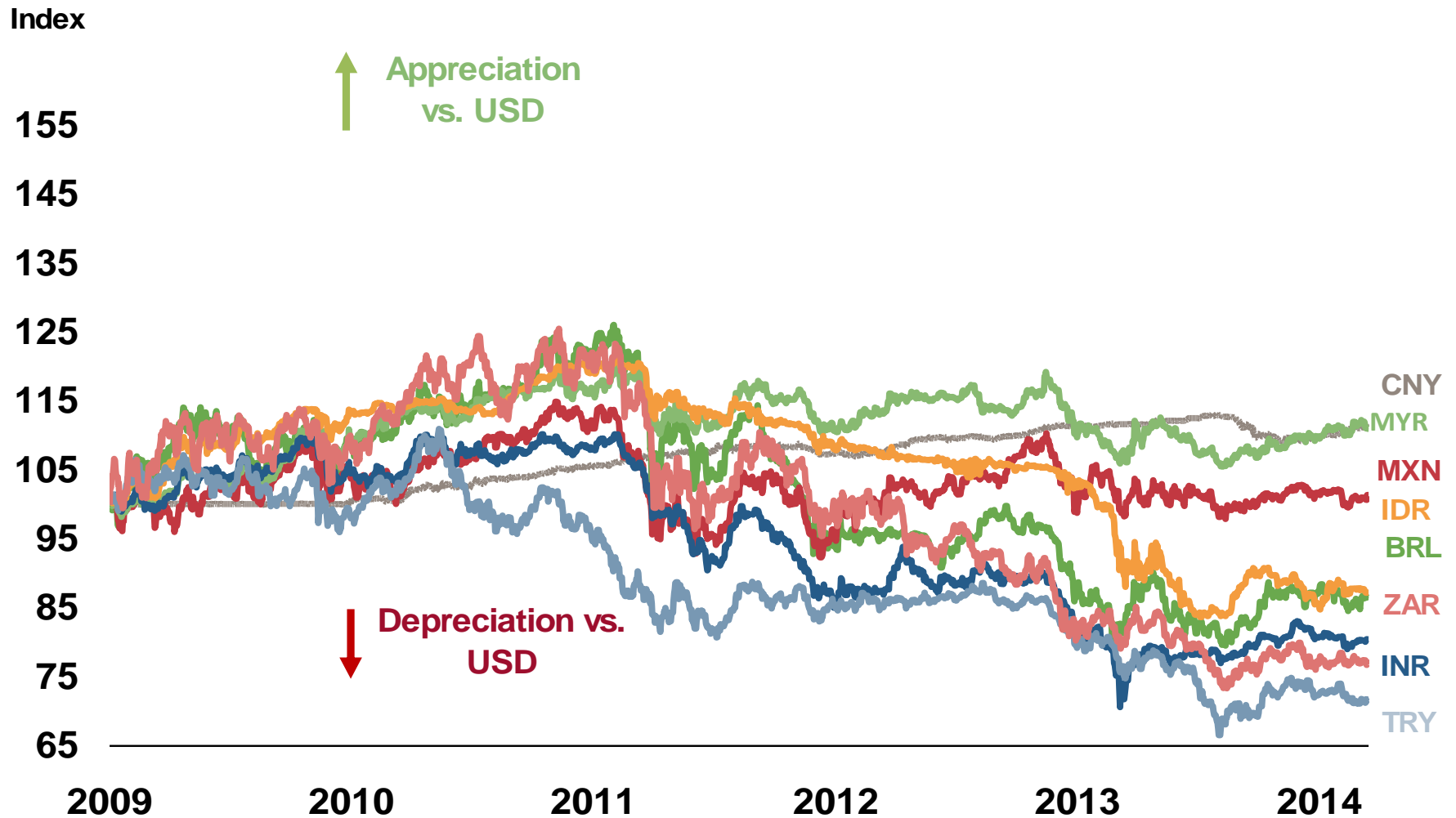
US credit spreads by rating categories



Last data point: 28.09.2014

Source: Bloomberg, Credit Suisse / IDC

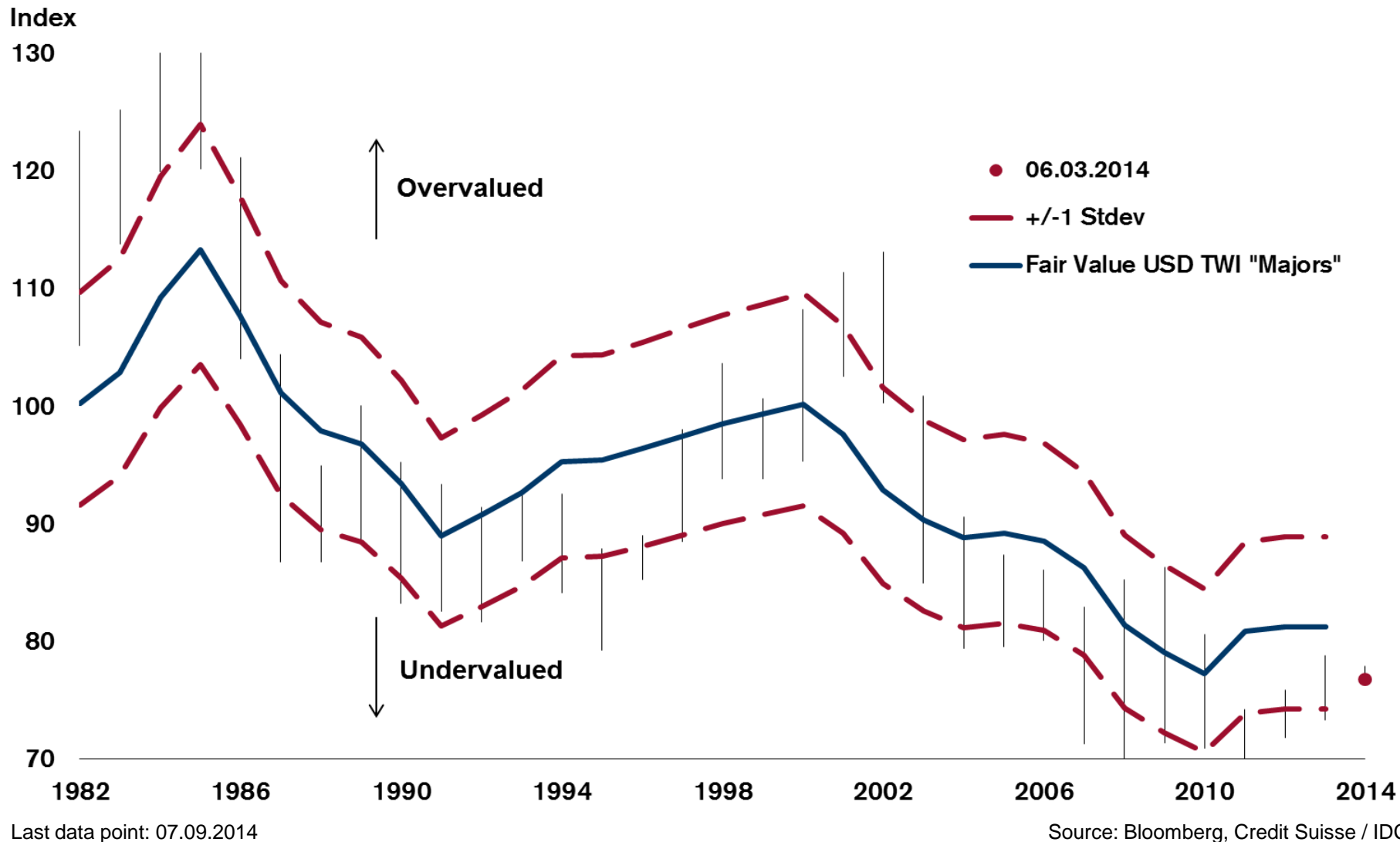
EM currencies against the USD



Last data point: 07.09.2014

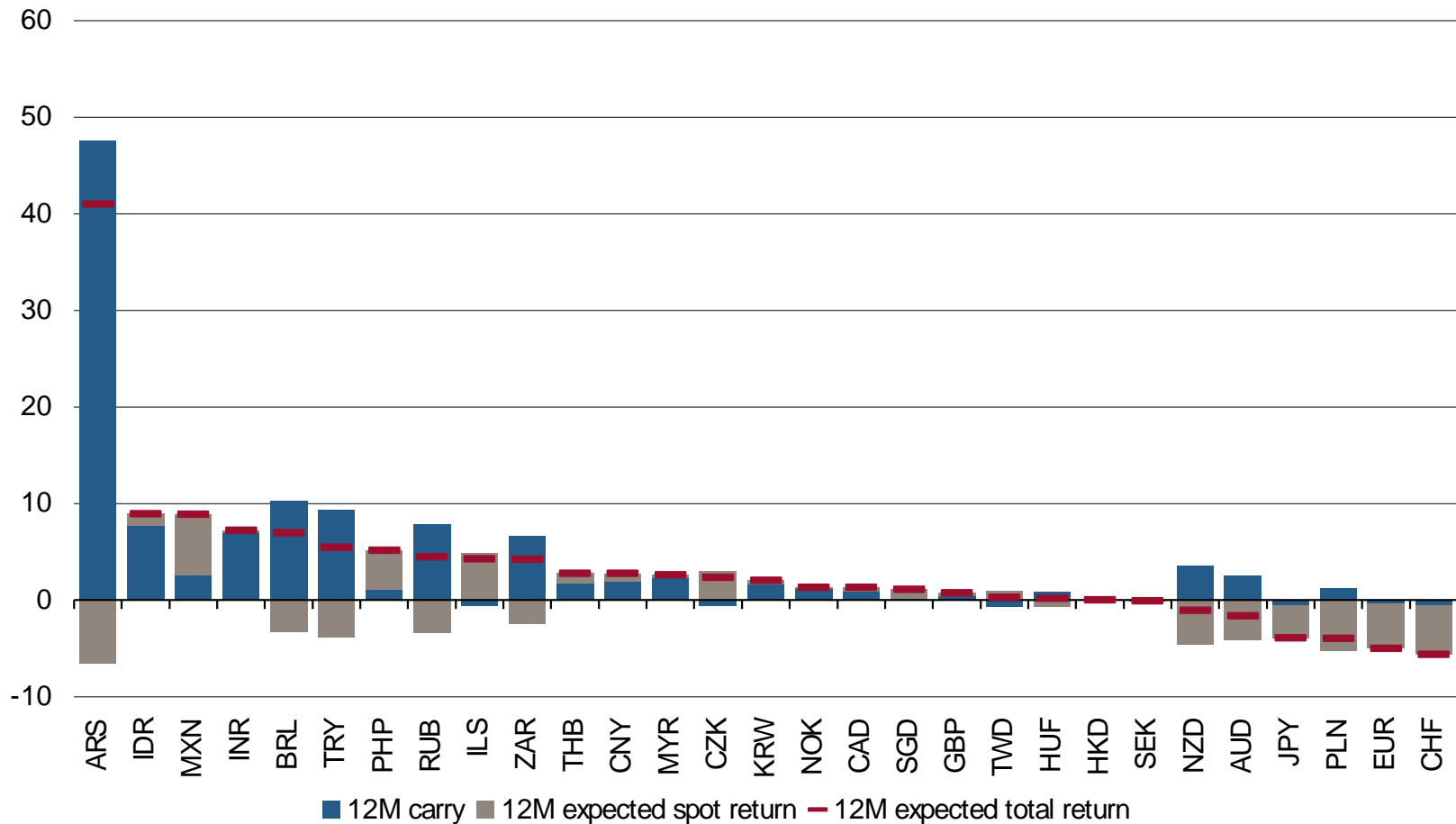
Source: Bloomberg, Credit Suisse / IDC

USD is relatively cheap



Global FX expected 12M total return

expected 12M total return in % vs. USD



Last data point: 26.09.2014

Source: Bloomberg, Credit Suisse / IDC

Performance - MSCI World

MSCI World (lc)



Last data point: 29.09.2014

Source: Datastream, Credit Suisse / IDC

CS Risk Appetite



Last data point: 22.09.2014

Source: Credit Suisse / IDC

Global Defensives to Cyclical Ratio



Last data point: 29.09.2014

Source: Datastream, Credit Suisse / IDC

12-month forward P/E - MSCI World

12-month forward P/E



Last data point: 22.09.2014

Source: Datastream, Credit Suisse / IDC

12-month forward P/E - S&P 500

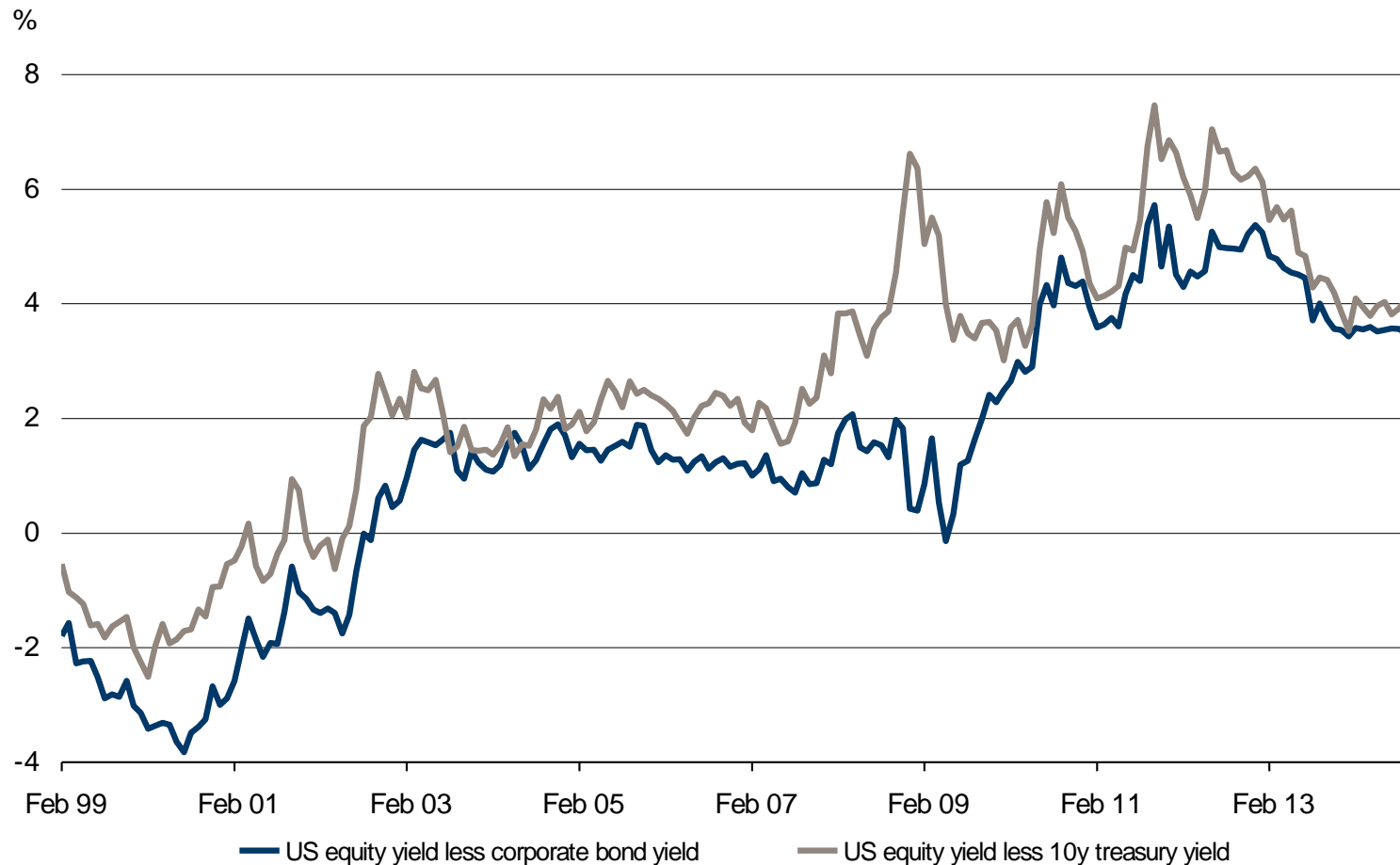
12-month forward P/E



Last data point: 26.09.2014

Source: Datastream, Credit Suisse / IDC

US forward equity yield less corporate and government bond yields

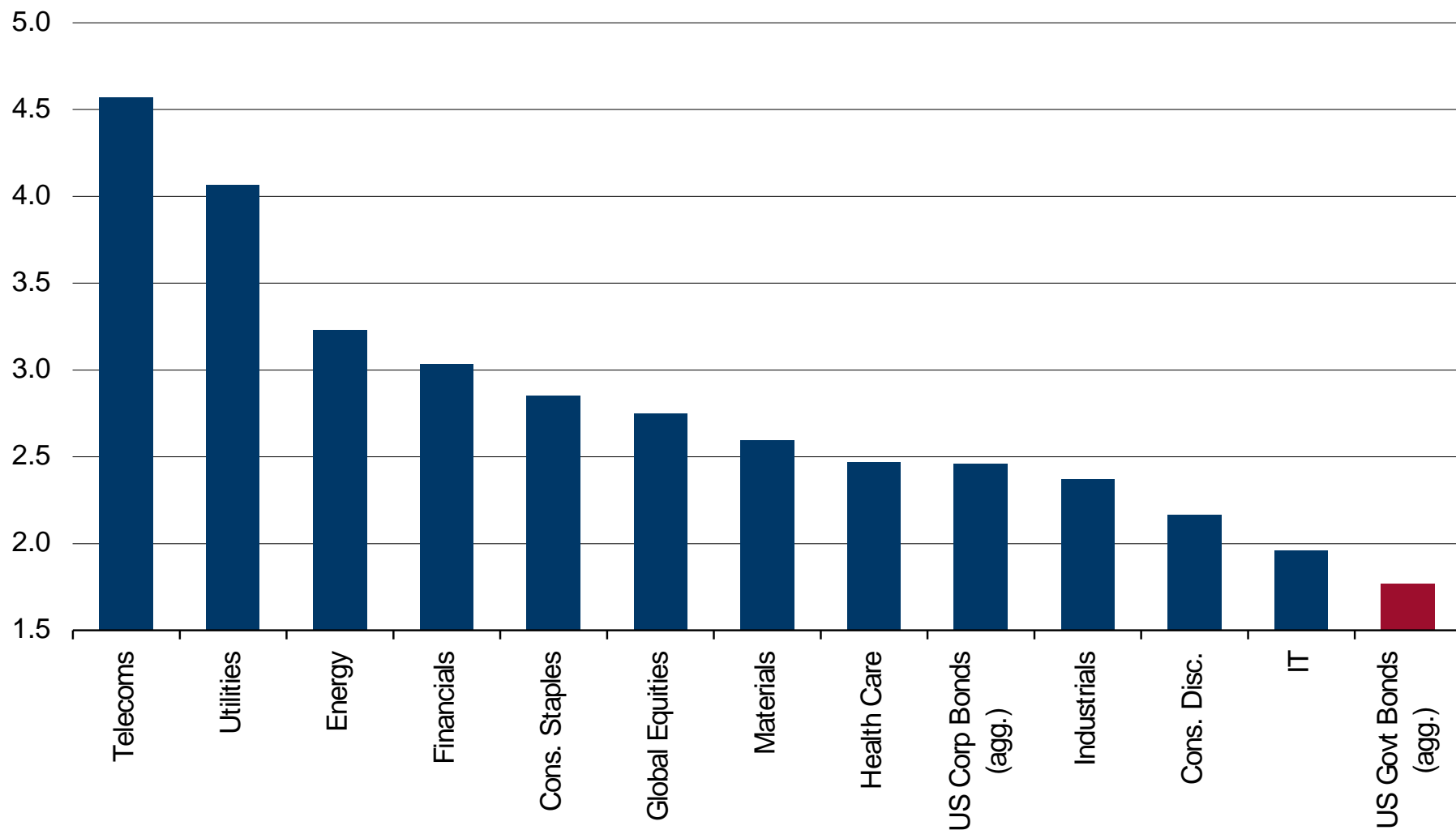


Last data point: 30.09.2014

Source: Datastream, Credit Suisse / IDC

Global Equity Sector Dividend Yield vs. US Bonds

(in %)



Last data point: 29.09.2014

Source: Datastream, Credit Suisse / IDC

Close correlation between JPY/USD and Nikkei 225

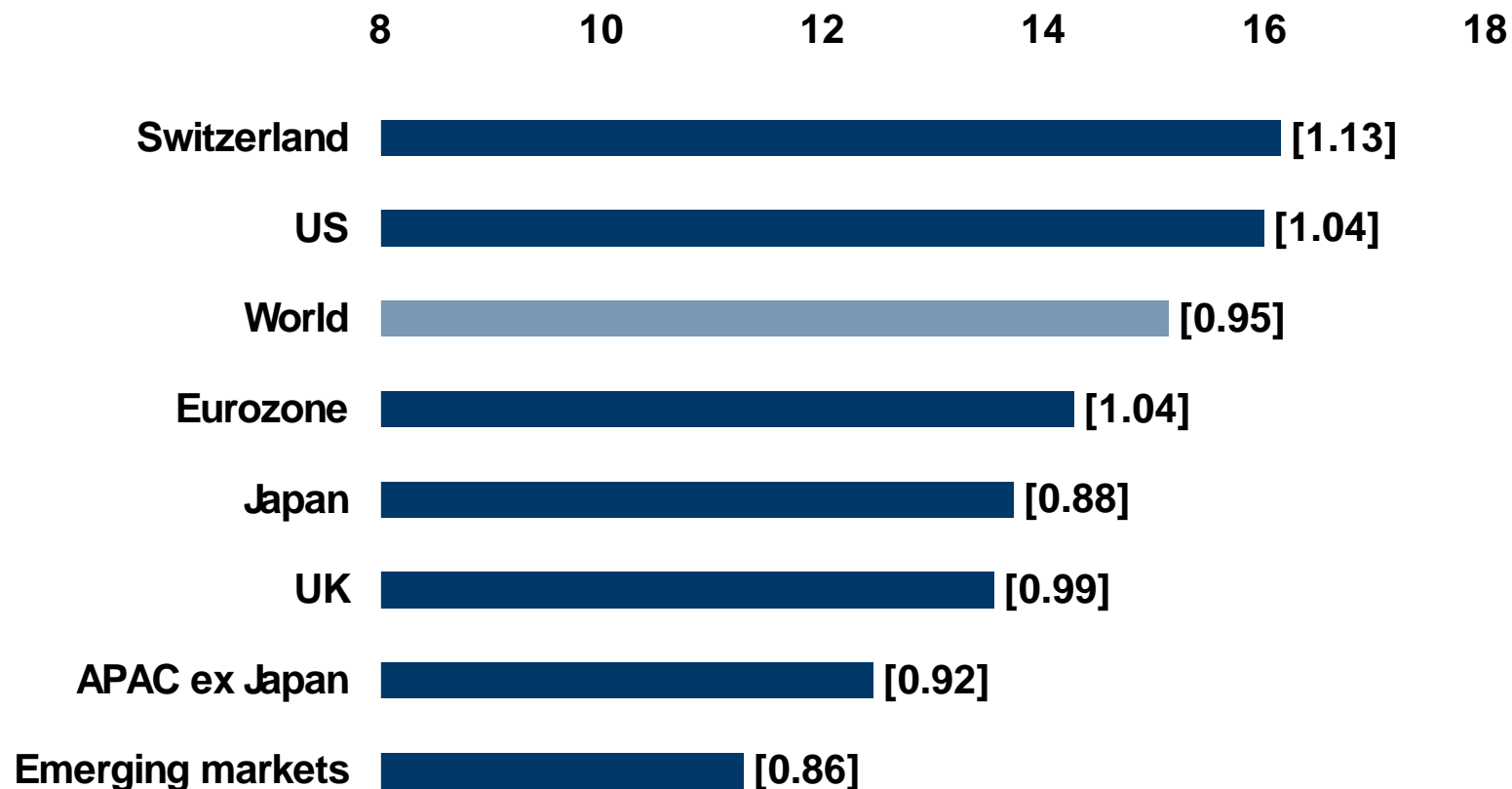


Last data point: 29.09.2014

Source: Datastream, Credit Suisse / IDC

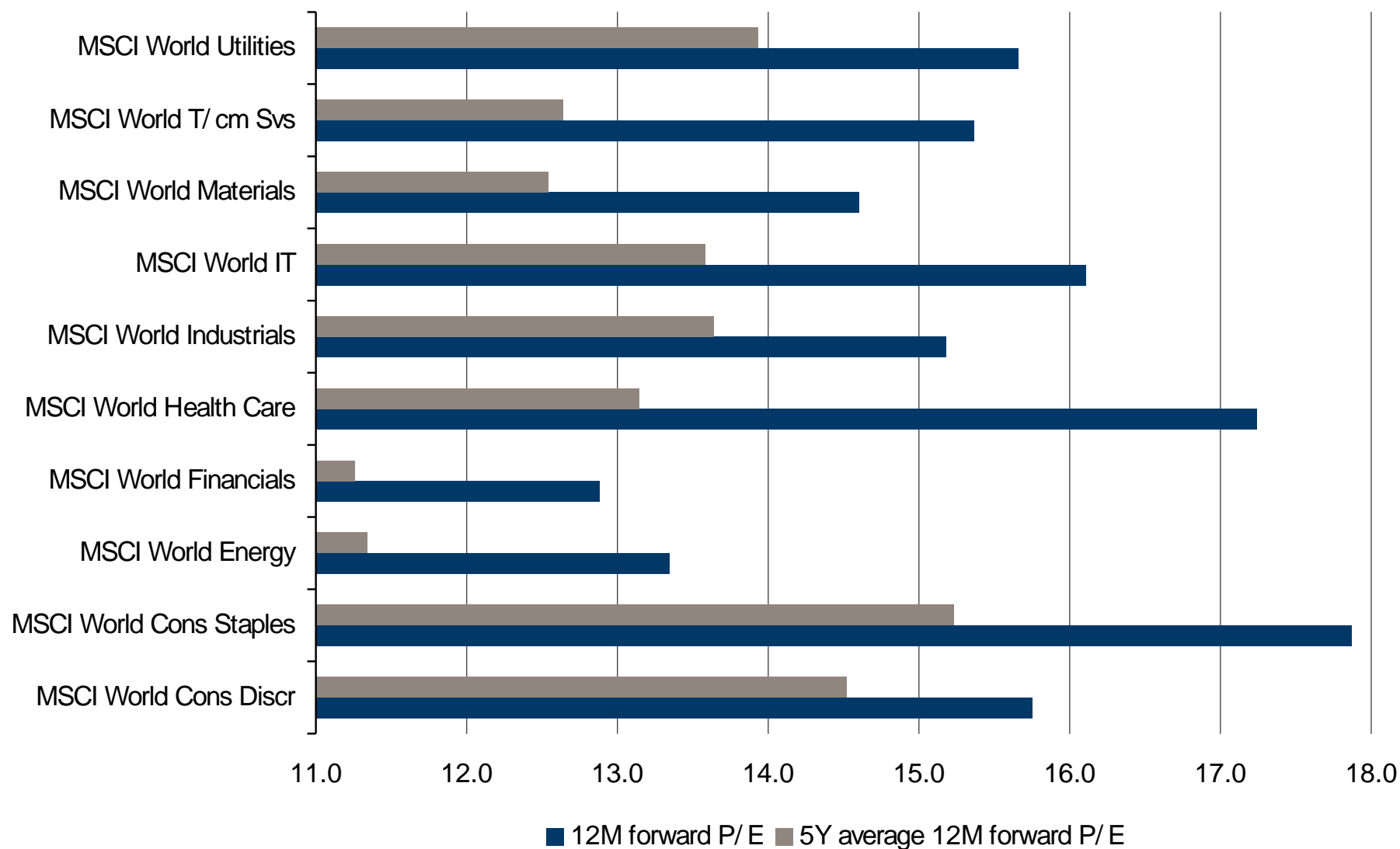
P/E valuation country overview

12-mths fwd. P/E (comparison to LT average in brackets)



LT average comparison reflects 12 months forward Price-Earnings ratio relative to 30 year average, except Japan, where a 10 year average was used.

MSCI World Sector PEs

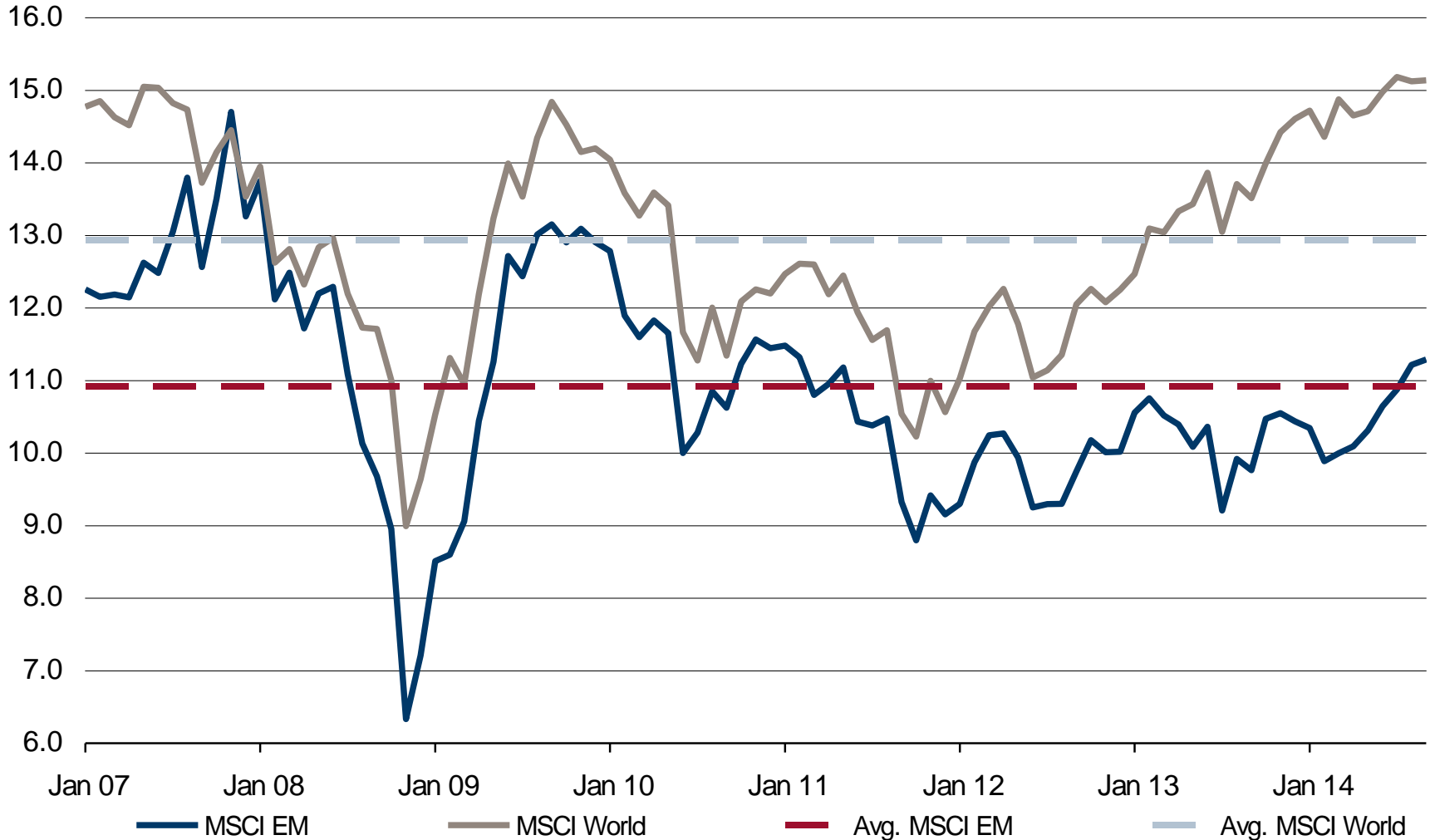


Last data point: 29.09.2014

Source: Datastream, Credit Suisse / IDC

12M forward P/E EM vs World

12M forward P/E

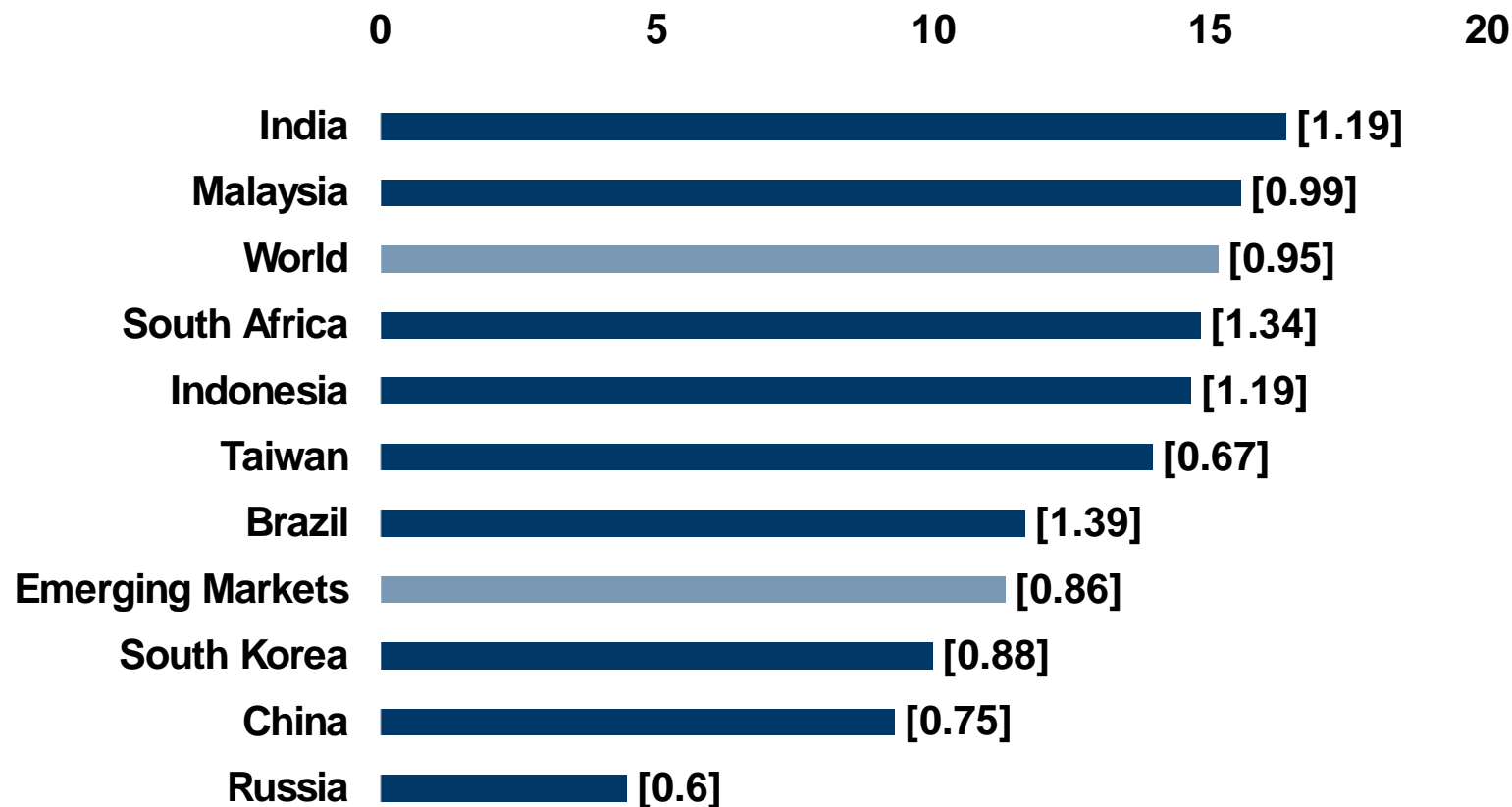


Last data point: 29.09.2014

Source: Datastream, Credit Suisse / IDC

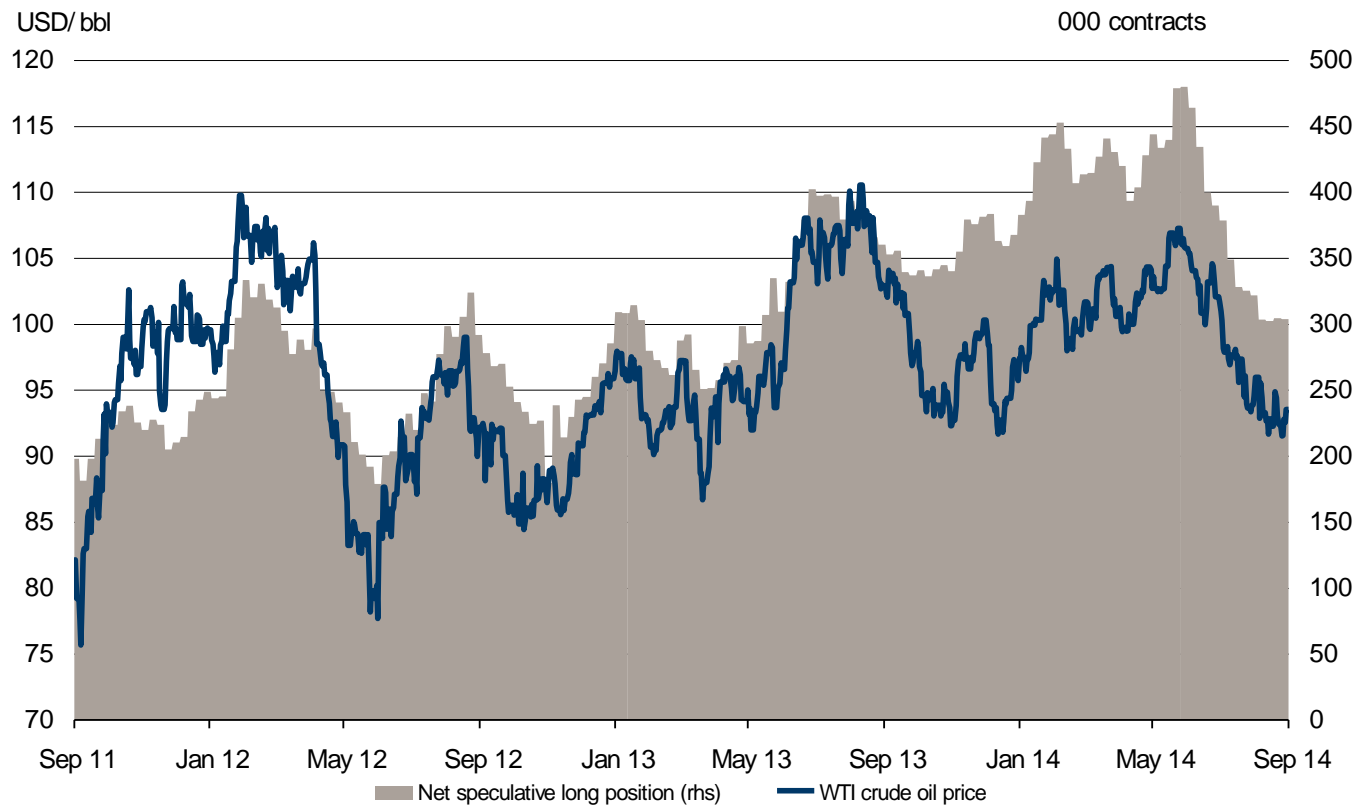
Emerging Markets P/E valuations

12-mths fwd. P/E (comparison to LT average in brackets)



LT average comparison reflects 12 months forward Price-Earnings ratio relative to 30 year average, except Japan, where a 10 year average was used.

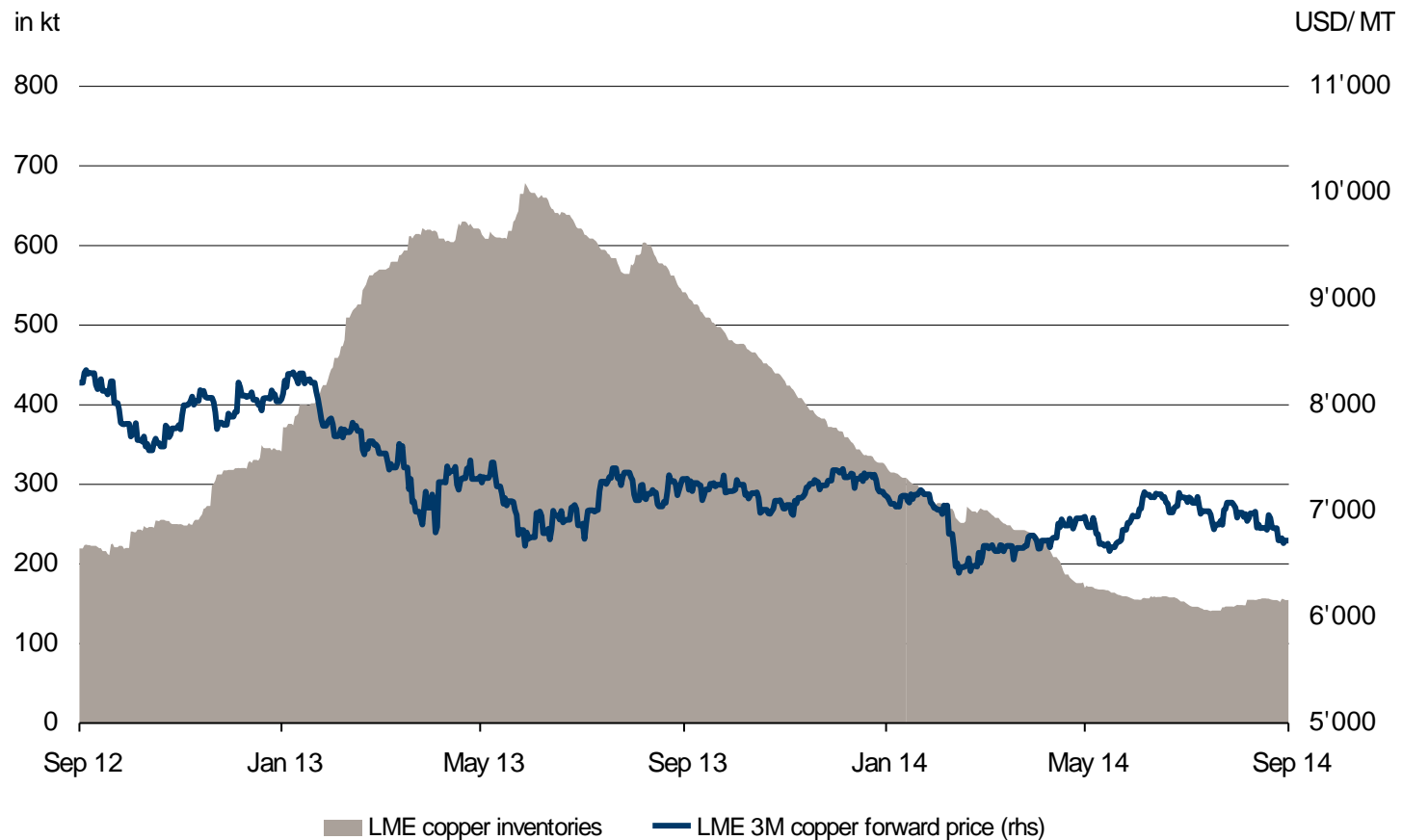
WTI crude oil vs. speculative net longs



Last data point: 29.09.2014

Source: Datastream, Bloomberg, Credit Suisse / IDC

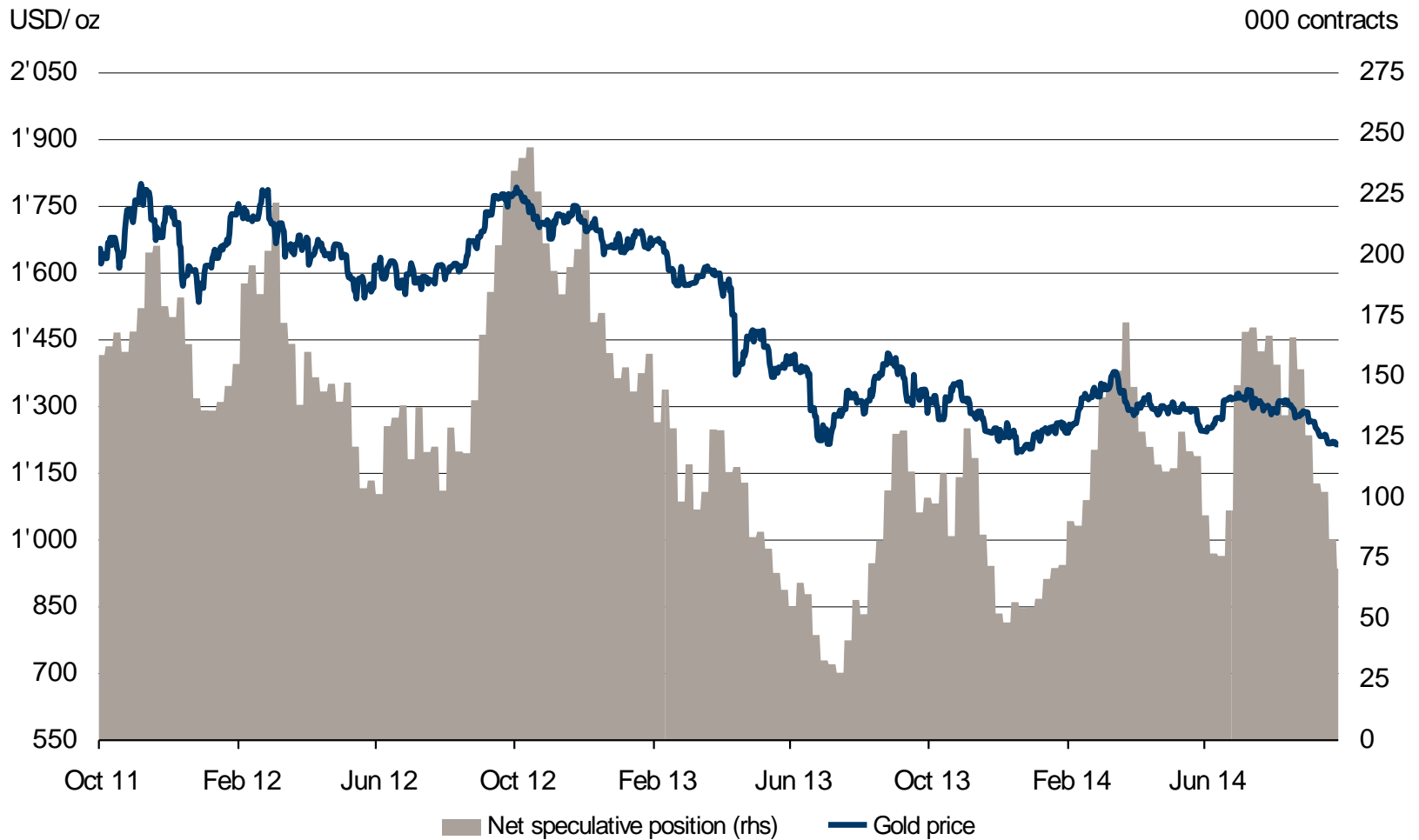
Copper price vs. inventories



Last data point: 28.09.2014

Source: Bloomberg, Credit Suisse / IDC

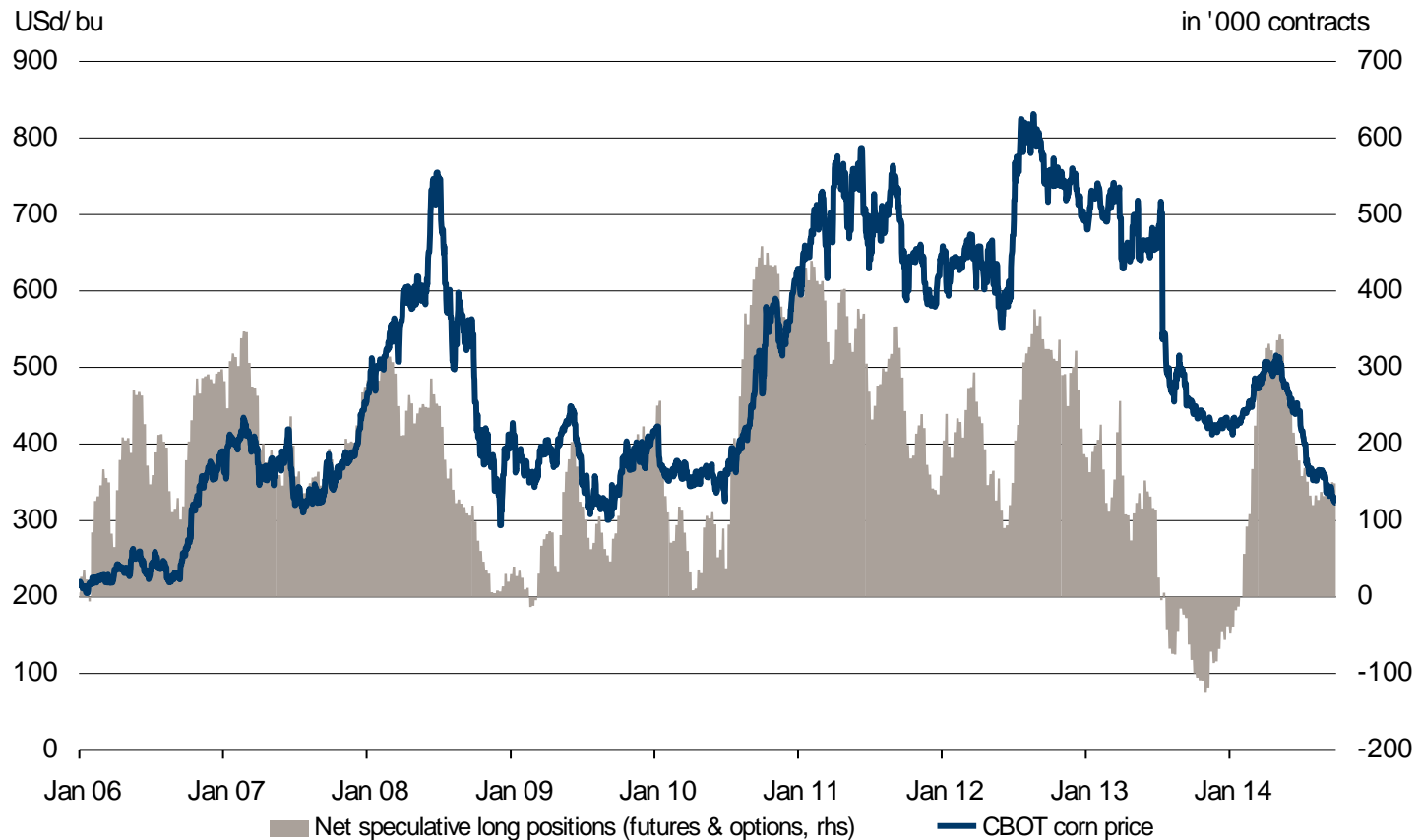
Gold price vs. speculative net longs



Last data point: 28.09.2014

Source: Bloomberg, Credit Suisse / IDC

Corn price vs. speculative net longs



Last data point: 28.09.2014

Source: Bloomberg, Credit Suisse / IDC

Conclusions:

Geopolitical, Economic and Policy Questions:

- Geopolitical risks are shifting. Whereas lower oil prices imply that Middle East risk is having a reduced impact on capital markets and the Russian/Ukrainian situation is now largely being ignored by investors, risks in Hong Kong/China and in Europe have risen. It is assumed that the demonstrations in Hong Kong will not escalate but a new source of political instability in China has been created , while in the Eurozone, the increased popularity of the anti Euro/nationalist parties has increased. In the UK, UKIP will reduce the probability of a Conservative victory at the May election , in Greece , Syriza is trying to force an Election while in France the popularity of the National Front has continued to grow. In Europe, pressure will intensify to ease fiscal policies to accompany the easy monetary policy, while likewise in China, pressure will remain intense to avoid a hard landing to offset political risks.
- US economic indicators remain robust and although the 2Q annualised growth rate of 4.6% cannot be maintained, a sustained growth rate of approximately 3% is achievable. Headline unemployment is on track to decline towards 5.6% by end 2014 or early 2015 while the stronger US dollar and lower commodity prices will constrain the uptrend in inflation which should be limited to 2.2% yoy by early 2015.

Conclusions:

Geopolitical, Economic and Policy Questions:

- After the Fed ends Quantitative Easing in October, the process of raising the Funds Rate will be slow to underwrite the recovery and reflecting the more subdued inflation outlook. However, with nominal GDP growth of approximately 5%, a series of minor rate increases is likely in 2015 with it remaining appropriate to forecast a year end Funds Rate of 1–1.25.
 - While the ECB has achieved a weaker Euro, it still faces the challenges of temporarily weak growth in Germany, trend weakness in France and Italy, a Eurozone unemployment rate still at an elevated 11.5%, low inflation at less than 0.5% and weak credit demand (as evidenced by the poor demand of only Euro 83 bn at the September TLTRO round). Although a programme of purchasing Government bonds still has a number of technical problems, increased ECB action in purchasing bank loans and corporate debt is likely. The initiative to boost the asset backed securities markets will continue.
-

Conclusions:

Geopolitical, Economic and Policy Questions:

- Given that German wages are increasing , unemployment is low (below 7%), the weak Euro is boosting exports (up 4.7% mom) , the impact of Russian geopolitical risk on business sentiment should now decrease while arguably Eurozone monetary policies are far too easy for the German economy , German growth should now recover towards year end and in early 2015 and should accelerate towards 2% annualised. The weakness of the Euro should reduce deflationary risks. However, Italian growth will remain stagnant while French growth is likely to remain below 0.5% annualised.
- Abenomics has successfully achieved an end to Japanese deflation with the National CPI at 3.3% yoy while BoJ QE has led to a decline in the Yen to around 110. However , the slow pace of structural reform implies that for the next year, policy will rely on the BoJ QE programme and growth will, on trend, remain at 2% annualised or below.

Conclusions:

Geopolitical, Economic and Policy Questions:

- Chinese data is consistent with a trend moderation in growth for the remainder of 2014 towards 7% and in 2015 to 6.5% but does not suggest a “hard landing” . The problems in Chinese shadow banking are progressively being dealt with and the sharp slowdown in the real estate markets is being offset by easier lending and new building permits. PBoC continues to inject liquidity to underwrite the economy. Although, evidence is required of a clear implementation of the Modi government’s reforms, the Indian economy is starting to show signs of improvement with trend growth over the next year likely to approach 6% while the slow decline in inflation towards 7% is intact. The RBI may be able to reduce interest rates, albeit slowly, starting in early 2015.
 - In contrast , the Brazilian and Russian economies are stagnating with Brazilian growth likely to be close to zero over the next year , partly due to weak commodity prices but also due to a high nominal and real interest rate regime . Sanctions on Russia are clearly having an impact as evidenced by the need for support from the Sovereign wealth funds and by negative flows within the banking system . Growth will struggle to be positive for the next year.
-

Capital Markets Conclusions:

- The slow pace of monetary normalisation by the Federal reserve and the subdued level of inflation will result in the rise in US Treasury yields being unusually slow given 5% nominal GDP growth . However , it remains appropriate to forecast 10 year yields close to 3% at end 2014 and 3.2 – 3.4% by mid 2015. Bund yields will remain low given ECB policies but given the correlation between bond markets are likely to rise to 1.5% by mid 2015 particularly given the outlook for German recovery . Bund/US Treasury spreads will widen in favour of US Treasuries . Likewise , the increase in JGB yields will be limited by BoJ support through QE and 10 year yields by mid 2015 are unlikely to rise above 80 bps.
- Within the Eurozone, ECB policies should keep Spanish 10 year spreads relative to Bunds less than 120 bps and while Italian macro data is less favourable, the constraints on the budget deficit will limit spreads to 150 bps. Portuguese spreads will remain close to 200 bps with France less than 40 bps. The only source of Eurozone volatility will be Greece where concerns over a bailout exit , the strength of the banks through the AQR process and political risk will prevent 10 year spreads narrowing back though 500 bps.

Capital Markets Conclusions:

- Corporate credit risk is unlikely to deteriorate given the trend improvement in earnings , the low level of leverage , strong cash flows, the high level of surplus liquidity and historically low default rates. Consequently the recent setback in corporate bond markets represents a buying opportunity with investment grade spreads trading around 60 bps and high yield spreads narrowing back towards 300 bps. The widening in US dollar emerging debt spreads back to close top 300 bps represent likewise a buying opportunity with spreads likely to normalise close to 250 bps .
- In local currency, Brazilian 10 year yields above 12% are unsustainable and a move back to 11% is likely while Indian and Indonesian yields should move slowly towards 8%. However, given capital flows, Russian and Turkish yields will remain well above 9%.

Capital Markets Conclusions:

- In FX markets, the positive factors for the US dollar remain the improvement in the trade account due to reduced energy imports , the positive growth differential and divergent monetary policies with interest rate spreads moving in favour of the US dollar against the European currencies and the Yen. Consequently, a reversal in the Yen back to 105 is unlikely and similarly, the Euro will not move back towards 1.30 . By end 2014, a central case forecast would be a Euro rate of 1.23-25 with a break below 1.20 in 1H15; likewise the Yen should depreciate further to 115 by 1H15. Other European currencies will move in line with the Euro while the Canadian and Australian dollars will decline to 1.13 and 0.86 respectively over the next 3 months. Amongst the Emerging currencies, the improvement in the Indian current account and interest rate differentials should protect the Rupee at 63 while a further decline in the Rupiah beyond 12k is unlikely. The Brazilian Real and Turkish lira are now heavily oversold and should consolidate respectively close to 2.45 and 2.30.

Capital Markets Conclusions:

- Investor equity market positions are cautious as evidenced by sentiment indices and by the relative valuation of defensive sectors relative to cyclical sectors. While the prospect of QE ending in the US, geopolitical risk, weak Eurozone data, uncertainty over the Euro AQR results, fragile Chinese data and in a number of markets stretched valuations, all suggest that equity markets will struggle and that there is a risk of a correction, a number of counter veiling factors are market supportive. Positive factors are the slow pace of Fed tightening, the strength of the US recovery, the weakness of the Euro boosting German and Eurozone recovery, the easy monetary policies being pursued in Europe, Japan and China, the probable reduced impact of geopolitical factors, positive corporate earnings growth, improved dividends and M&A activity, narrow credit spreads and weak commodity prices. The central case remains that equity markets are vulnerable to a series of corrections but that a trend “bear” market will not occur.

Capital Markets Conclusions:

- However, market performance is likely to remain divergent . Although downside risk in the US is limited , QE and valuations will limit gains in the S&P in the near term. Within Europe, the lack of further fixed income spread compression could lead to profit taking in the Spanish and Italian markets, while the Greek market is vulnerable to political uncertainty. The Austrian market should recover once the ECB AQR tests are completed.
- In Asia, the Japanese market is supported by QE, a weak Yen and trend inflation above 2%. The South Asian markets are vulnerable to profit taking and switching in to the cheaper North Asian markets of China, Korea and Taiwan. Elsewhere in Emerging markets, Central Europe should benefit from an improvement in the German economy and the German markets, although investor appetite towards the cheap Russian market will remain limited. In Latin America, although Mexico is expensive, it should benefit from the sustained upturn in the US. Brazil will remain under pressure unless there is a change in government and the market's ability to advance is constrained by high Bond yields.

Capital Markets Conclusions:

- In commodity markets, industrial metals, energy and soft commodities are largely oversold and the anticipated downward moves in prices have largely been completed, with copper forming a base at US\$6.6k per tonne and Brent at US\$90-95 pb. In contrast, gold appears to have further downside.

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