October 23, 2015

Can Q4 Save the Year? An Overview of our Key Assertions

No Chinese crash-landing. Fears of a global slowdown overblown. Truce called in the currency war. Opportunities for investment in "risky" assets.

Key Assertions

- Summer concerns over China are confirmed
- Financial markets have succumbed to uncertainty
- Improvement in economic fundamentals sparked undue concern
- Fed has postponed monetary policy normalization until December 2015
- Fewer opportunities on bond markets
- Global liquidity still growing overall
- Truce called in the currency war
- Swiss franc continues to weaken
- Investment opportunities on financial markets and in "risky" assets
- European equities enjoying positive factors

From one crisis to another; after Greece, China sparks fresh concerns.

Investors' risk perception changed considerably in August and September, sparking at times hefty profit taking on some markets. The Greek crisis had already significantly ground down confidence in Europe in the 2nd quarter, until a solution was found in July. Equities markets started to settle down again and, for a short time at least, were able to take into consideration the improved financial situation in the United States and Europe, if only for a short while.

A few days of solid recovery on the stock markets enabled equity indices to once again come close to the peaks that they reached in April, before uncertainty returned front and center stage with the surprise devaluation of the renminbi sparking fresh concern.

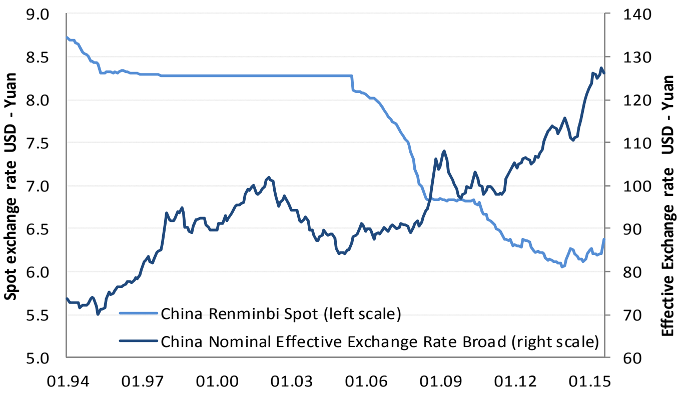
Since then, the situation in China has been the subject of increasingly alarmist speculations.

Investor confidence stood strong when confronted with drops in Chinese equities between May and July, but could no longer fly in the face of new concerns sparked by the devaluation, as well as the possible effects a Chinese slowdown would have on world growth.

Weak Chinese exports, a manufacturing PMI once again below 50, the risk of a currency war, and Chinese consumers' waning confidence due to the collapse of the equities market are the factors most often-cited to justify an increase in financial risk.

Fears of a significant devaluation of the renminbi soon proved to be blown out of proportion. First of all, the dollar appreciated by +4.7%, to close the quarter on a slight +2.3% increase.

Nominal Effective Exchange Rate Renminbi and USD spot



Sources: Bloomberg, BBGI Group SA

Over the same period, the euro/renminbi exchange rate appreciated +10% and closed the quarter up +5% (the yen also climbed +6%). Nevertheless, concerns over China were still becoming a reality, and macroeconomic news which was a little gloomier elsewhere seemed to constantly confirm the risk of a global slowdown.

In this context, financial markets once again saw profit-taking. In one week, the European market plunged -12%, the Japanese index lost -13%, and equities dropped -10% in the United States, whilst Switzerland managed to curb the fall at -9%.

However real the improvement to economic fundamentals in most developed countries, it has been de facto cast into doubt by these worrying prospects.

The Federal Reserve's policy of sitting on its hands is doing nothing to reassure markets, and is planting the seeds of doubt

Uncertainty linked to international factors seems to have rather tripped up the US Federal Reserve. Following its last meeting in September, it did not dare set the wheels of interest rate policy normalization in motion, despite the fact that this step is expected as a marker of confidence in the robustness of US growth.

Despite growth being revised to +3.9% in the 2nd quarter, and an unemployment rate heading ever closer to 5%, Fed Chief Janet Yellen planted seeds of doubt, by speaking of international factors, rather than the mere lack of inflationary risks, in order to justify their sitting on their hands.

FOMC members, however, seem to remain convinced of the economy's vim, and generally speaking would like to see a rate increase before the end of the year.

The main economic issue remains US GDP growth

We believe that the main issue affecting the impending developments on the financial market is linked to a greater degree to how strong the economic situation in the United States is judged to be, and to its ability to coax other regional economies into contributing to renewed acceleration of world growth.

We suspect that the risk of the Chinese economy crash-landing is overstated.

In the Eurozone, the recovery is taking root and could hit +1.5%/ year, propped up by spending and credit growth. In the United Kingdom, GDP could even exceed +2.5% thanks to a rise in households' disposable income and the ongoing increase in real estate and services.

In terms of interest rates, recent concerns led to fresh decreases, but we believe that the risk of a global slowdown has been blown out of proportion, and renewed drops in long-term rates seem increasingly unlikely.

The Federal Reserve will undoubtedly increase its key interest rates by 0.25% in December, and the Bank of England should follow suit in February.

This first step in normalizing monetary policy will probably only have a very limited effect on financial markets, as from a macroeconomic point of view it should not give rise to any doubts as to whether the current trend will consolidate.

No crash-landing for China; concerns about world growth blown out of proportion

The Chinese economy is certainly slowing down, but this is not a new phenomenon, and it is undoubtedly no more intense today than it was a few months ago.

Equally, it should be noted that Chinese GDP is increasingly influenced by the services sector, the contribution of which may be underestimated in GDP calculations.

Furthermore, a slowdown in industrial activity and exports cannot entirely explain away global growth figures. That said, we believe that the recent debate focusing on the repercussions of the Chinese slowdown for other developed economies, as well as the potential impact of a new rate-setting policy are blown out of all proportion.

Only a small proportion of American and European exports head to China, and the transmission of lower Chinese demand will certainly hit commodities suppliers harder than it will these large economies.

US, European and British GDP growth seems to be in large part propped up by spending in domestic sectors. Risk for the next few quarters seems to be clearly overstated and growth prospects should consolidate.

Equities markets could take advantage of this new rebalancing of risk, which will undoubtedly tip the scales away from bond markets.

Opportunities on the bond markets are drying up considerably

Normalization of monetary policy in the United States could come any day now, with the Bank of England likely to follow suit in the first quarter.

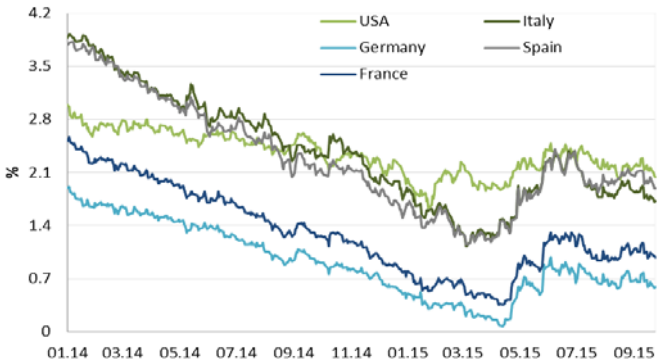
Recent drops in long-term interest rates are certainly only due to renewed uncertainty regarding world

economic growth, sparked by the risk of a Chinese crash-landing. We believe this risk to be overstated.

Over the last five months, long-term interest rates have seen at times significant upward movement when economic confidence was at its peak, before plummeting back down close to levels seen in April, when the Chinese risk was first emerging. In the United States, the ten-year rates leapt from 1.65% to 2.4%, whilst in Europe the rates for German Bunds (bonds) literally took off, jumping from 0.05% to 1% in the space of just a few days. These rates then dropped back down to 2% and 0.2% respectively.

Today, the risk lies in rates being pushed upwards again.

10 Year Government Rates



Sources: Bloomberg, BBGI Group SA

However, the outlook is just about positive for bonds in US dollars, due to a combination of two factors in their favor- a relatively attractive yield and upward forecasts for the US dollar. On the other hand, the outlook is only very marginally positive for bonds in euros, mainly due to the current low rates, which could be set to last due to the ECB's asset-buying program.

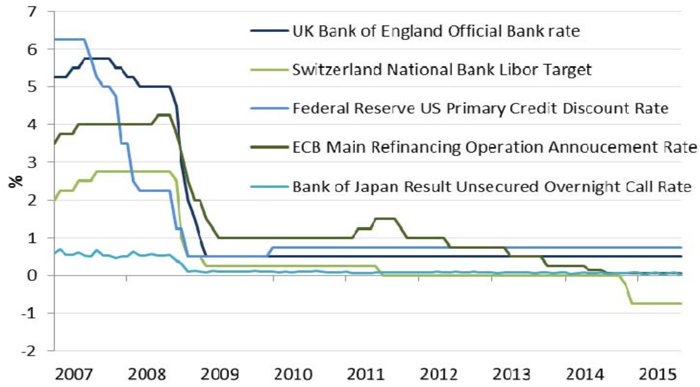
Within the context of improved economic prospects, we would opt for a reduced overall duration.

Progressive normalization of key interest rates and global liquidity growth

The date of the upcoming increase in rates is yet to be confirmed, but we believe that the Federal Reserve will act in December.

The decision taken during the last meeting with the FOMC to leave interest rates unchanged was certainly more influenced by the lack of inflation and international uncertainty than by perceived changes to the strength of the US economy.

Key Interest Rates (EUR, CHF, GBP, USD, JPY)



Sources: Bloomberg, BBGI Group SA

Indeed, inflationary pressures have been largely contained by a strong dollar, falling crude oil and commodity prices, and a still limited rise in labor costs. Nonetheless, the unemployment rate could soon drop below 5% and finally spark the tensions on the labor market that the Fed has been waiting for. This would justify an increase in interest rates. We believe that monetary policy normalization will therefore be undertaken very gradually following an initial hike in December.

We expect markets to react rather positively to this first rise.

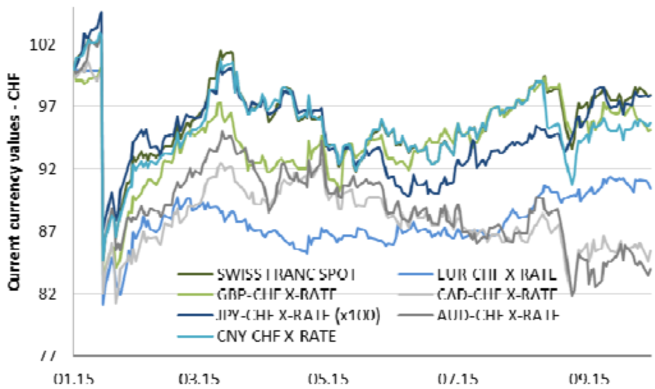
In Europe, everything has already been tied up since the start of the year. The ECB will provide mass liquidity to the Eurozone to the tune of €60 billion per month until 2016. The first few weeks of the ECB's activities were colored by their desire to change investors' perceptions. Henceforth, the ECB's balance sheet shows liquidity injections worth €475 billion. The latest comments by the head of the ECB, Mario Draghi, also betrayed their desire to convince investors of the renewed determination to revitalize growth by any means possible, potentially even dropping key interest rates back below zero again. In Asia, the Bank of Japan had already announced its liquidity injection program, totaling the same amount- US $60 billion. It seems reluctant to stray from this strategy following the policy's encouraging first results.

Overall, between 2008 and 2014, global liquidity was sustained by the actions of the Fed and the Bank of England. Now, with their liquidity injections, the European and Japanese Central Banks have taken up the torch. This trend should continue through the end of the year and into 2016. In the United States and the United Kingdom, normalization will be a long time coming, and will have no major effect on liquidity, we believe. In Europe and Japan, however, monetary policy will continue to favor key interest rates close to zero for at least another few quarters.

Truce called in the currency war; the Swiss franc continues to weaken

Over the last few quarters, currency markets have been significantly affected by the contrasting fates of different regions' economic dynamics. The United States and the United Kingdom have seen their respective currencies appreciate considerably, piggy-backing on better economic results and favorable interest rate differentials. In the light of improved prospects in Europe and Japan, the upcoming quarters should be largely characterized by currency stabilization. We believe that the weakening of the Swiss franc will be driven by the upswing in global growth. As such, the Swiss franc should slide against the US dollar and the euro, as well as against the Canadian and Australian dollars and certain emerging currencies to a greater degree.

7 Main Currencies Against CHF (base 100)



Sources: Bloomberg, BBGI Group SA

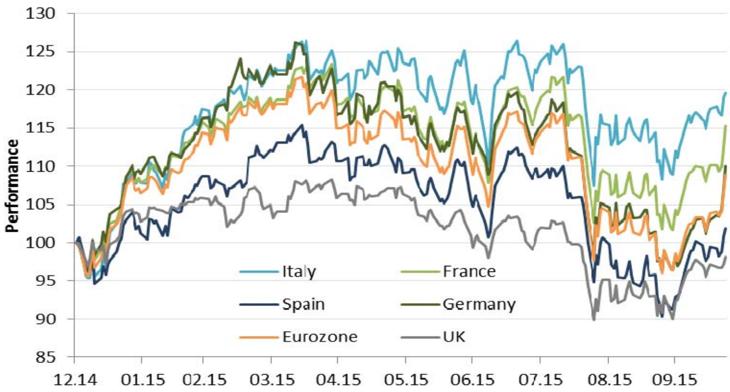
Our short-term forecasts for the US dollar/Swiss franc point to the exchange rate stabilizing between 0.95 and 1.02. In such a context, we believe that the euro/Swiss franc exchange rate should continue to rise, approaching 1.15.

European assets enjoying positive factors

The correction on equities markets in Europe (-17%) was significantly higher than in the United States, Switzerland and Japan (-7%) over the last three months.

The euro's bounce back and the Chinese crisis have been the factors that have meted out the greatest punishment to the Eurozone. We believe that these two factors have obscured favorable economic developments and improved financial prospects.

Equities Markets in Europe



Sources: Bloomberg, BBGI Group SA

The recent drop in equity prices has had a positive effect; a decrease in the valuation of European assets. They are now trading at 13x 2015 profits and 12x 2016 profits. As it currently stands therefore, the valuation of European assets is sitting below the average for the last three years. Growth in profit for 2016 stands at less than +4%, which leaves considerable room for improvement.

The outlook for European equities seems attractive. We have therefore prioritized the Eurozone in regional allocation.

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