



1 MONTH IN 10 SNAPSHOTS

June 2016



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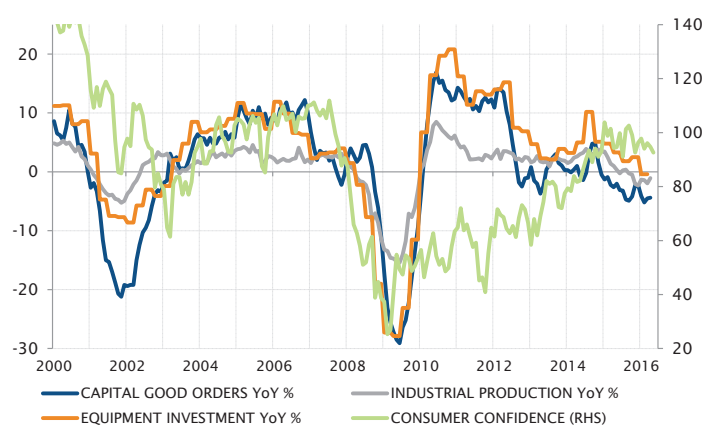
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1. United States - Growing unease about activity

- This summer will mark 7 years of growth for the US economy since the financial crisis, already one of the largest expansion cycles in history. While there may be no obvious imbalance that could potentially threaten the cycle as yet (unlike the investment boom in the late 1990's or the housing bubble in the 2000's), there are increasing questions about continued growth.
- Several economic indicators have been pointing to a loss of momentum: industrial activity has been contracting since 2015, dampened by the drop in oil-related investment spending and the impact of a stronger US dollar. These developments have weighed on corporate profits and also led to a tightening in financing conditions as banks become more cautious after a sustained increase in corporate indebtedness.
- Until recently, the consumer, service-related sector had held firm but, since the beginning of the year, even this domestic (and largest) segment of the US economy has lost steam. Service sector activity indices have weakened, consumer confidence is edging down and job creations have surprisingly slowed down recently. This softer trend in many key indicators is now fueling a sense of uneasiness about the strength of the US expansion.

**Most indicators currently point
to a loss of economic momentum**

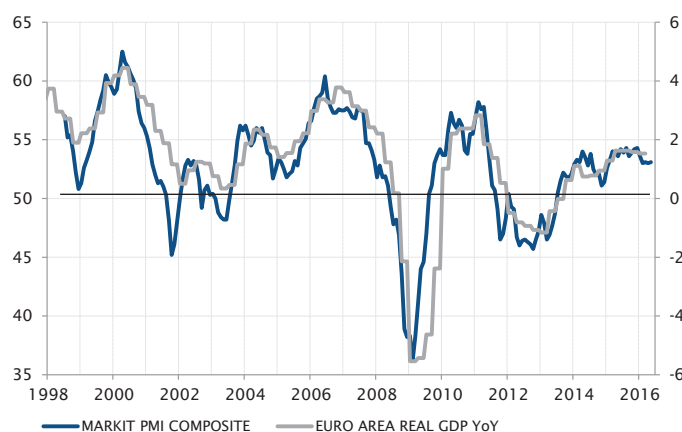


Source: Datastream

2. Euro area - Growth remains firm

- Unlike the US, the Eurozone growth cycle is only 3 years old. Indeed, the Old Continent went through a “recession-of-its-own” from 2011 to 2012 after the brisk adjustment in public finances required by the “sovereign debt crisis”. Currently, domestic growth drivers are still in a recovery phase as consumption benefits from declining unemployment and businesses gradually resume investment spending.
- The latest economic indicators point to a continuation of growth in 2016 that is only slightly below the pace of 2015 as the support from lower energy prices and a lower euro has dissipated. PMI indicators are consistent with GDP growth around 1.5%. Confidence has bounced up after the softness of the first quarter and it is still at a high level. While the periphery may slow down somewhat as fiscal stimuli fade away, in Spain in particular, growth remains firm in Germany.
- As much as the endogenous recession of 2011/12 was out of sync from an expanding global economy, the current expansion in the euro area therefore appears sufficiently domestic-driven to be shielded from global growth turbulence, to a certain extent. Nevertheless, it still relies heavily on maintaining a stimulating economic policy environment.

The Eurozone shows continued growth

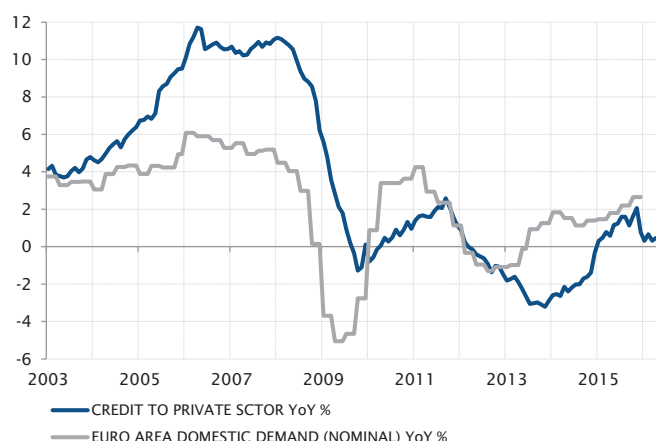


Source: Datastream

3. Euro area - Credit is the fuel for expansion

- The economic recovery in the Eurozone is “gradually proceeding” according to Mr. Draghi. Still, to continue, this dynamic needs fuel and this fuel, for market economies, is credit designed to finance business investment.
- Of course, the ECB has already managed to significantly ease rates for large companies and banks that have access to bond markets. Market financing conditions are now historically attractive, even for subordinated instruments, allowing issuers to fulfill regulatory requirements at rates that do not excessively penalize their results while still attracting investors in search of yield.
- However, in Europe, unlike in the US, business financing comes predominantly from the banking sector, especially for small & medium size corporations. This explains the emphasis put by the ECB on stimulating bank lending to corporates as it is essential to the continued expansion. In June the central bank will conduct the first round of its conditional liquidity injections, financing to banks at very attractive conditions (possibly negative rates), provided they use this liquidity to expand their commercial loan portfolio.
- The ECB has had good reason to target specifically the bank lending channel. By offering liquidity at rates that can allow banks to maintain some profitability, the central bank intends to revive credit growth. Indeed, after a welcome recovery in 2015, credit to the private sector has almost stalled and is not growing fast enough to sustain economic expansion. As much as credit growth that was too fast in the 2000's had harmful effects, credit growth that is too slow is now threatening the ongoing expansion.

Credit growth is necessary for economic expansion



Source: Datastream

4. Japan - The economy needs some more

- The Japanese economy grew at a +1.7% annualized rate over the first quarter. While above expectations, this does not change the assessment of the current trend in the Archipelago: the growth trend of the early months of Abenomics has slumped and Japan is barely growing, if at all.
- By all measures, from broad activity indices to more specific ones such as the domestic-sensitive confidence of small businesses, the economy failed to embrace a sustained growth trend. After having eased monetary policy at an unprecedented scale, the Bank of Japan now appears powerless, as shown by the uninterrupted appreciation of the yen since the introduction of negative interest rates four months ago.
- If monetary policy is no longer able to stimulate activity, fiscal policy remains the only tool left, even with public debt already at 250% of GDP. Prime Minister Abe has therefore announced a postponement of the VAT rate hike scheduled in early 2017. In the meantime, he is considering increasing public spending in order to "reignite" Japanese growth. The dire economic situation leaves little choice but to move forward on the same stimulus path that has so far failed to get the economy out of its trap.

Japan needs another electroshock

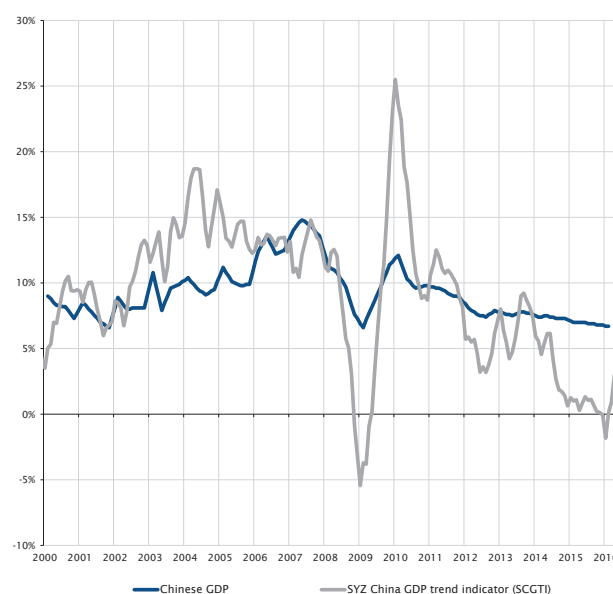


Source: Datastream

5. China - A structural lower growth in the future

- In recent months Chinese officials have been trying to stimulate or stabilize growth around 6.5% levels by reviving credit growth.
- At the beginning of the year, China was one of the main worries that led to tumbling markets.
- Since then, the recent rebound witnessed in China's activity (see the uptick in the SCGTI) is again fading away as the authorities are unwilling to let credit-fuelled growth further imbalance their heavily indebted economy. Moreover, the pick up in activity came mostly from the real estate sector that was supported by aggressive policies. Nevertheless, the structural slowing growth trend remains in place.
- Although the Chinese economy is showing new signs of weakness, it is very likely that the trend towards easing of lending conditions will continue but at a slower pace as some rumours from Chinese officials indicated. They seemed to agree that the economic growth recovery will likely be in a "L" shape rather than a "V" or a "U" one, the latter being undermined by the fact that adding leverage has a lower marginal impact and is increasing systemic risks.
- The new aim of the government has therefore moved from promoting and stabilizing growth to controlling and reducing systemic risks in the system.

China - GDP growth (YoY) and SYZ China trend indicator

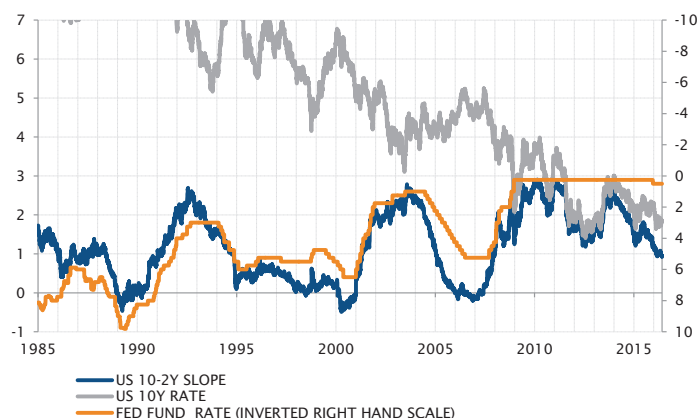


Source: Datastream

6. US rates - A flatter yield curve without Fed intervention

- During three decades, there has been a strong link between the evolution of the Fed's short term rate (Fed Fund rate) and the slope of the US yield curve (difference between long and short term interest rates). When the Fed was easing monetary policy (i.e. cutting the FF rate), the curve steepened as long term rates were declining less rapidly. And when the Fed tightened its monetary policy, the curve tended to flatten as long term rates were capped by expectations of less upward pressure on growth and inflation going forward.
- This relationship doesn't hold anymore: with the Fed Fund rate at almost zero for more than seven years, the slope of the yield curve has de facto changed only with fluctuations of long term interest rates, themselves driven by growth and inflation expectations. The sluggishness of global growth and the lack of inflationary pressure have pushed long term US rates to historical lows, engineering a flattening of the curve without the Fed's intervention (the 25bp hike last December being largely symbolic in the overall picture). This already depressed level of long term rates and light steepness of the curve limits the room for tightening available to the Fed.

The US curve flattens before the Fed can really hike

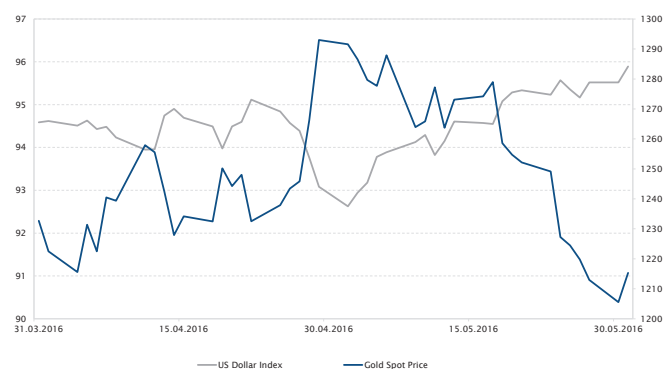


Source: Datastream

7. Gold - Decline of the precious metal in a stronger dollar environment

- At the beginning of the year, the Fed's more cautious approach with respect to increasing its key rates, which reduced upward pressure on the dollar (-5.2% vs. euro YTD as of the end of April), also helped the recovery of gold prices (+21.6%).
- Nevertheless, in May, markets focused again on a possible Fed rate hike in June combined with potentially better global growth prospects. We saw a repricing of different assets. The dollar strengthened (+2.9% in May), while on the other hand gold erased some of its yearly gains (-6.0%). The greenback also weighted on other asset classes during the month as for example emerging markets with EM debt, currencies and equities finishing in red numbers.
- Gold is usually used as a diversifier in portfolios to hedge against a weaker dollar. During the month, the precious metal traded with a negative correlation to the USD i.e. a rising dollar with precious metals edging down. These two assets reached a very high negative correlation not seen since 2014. Moreover, gold's lost its shine somewhat and some outflows in gold ETFs accelerated during the month of May.

Gold price and US Dollar Index evolution



Source: Bloomberg

8. Equities - Underperformance of European banks when yields fall

- After a bumpy beginning of the year, the futures market (in relation to Federal funds rate) barely anticipated an increase in rates following last December when Fed members thought that they would be able to raise rates four times in 2016. One of the major impacts was felt on US 10Y Treasury yield that went down from 2.27% at the end of December to 1.85% at the end of May.
- On the other front, so far, 2016 has been a particularly complicated year for investors who bet on European banks. On a YTD basis the sector is down -16.3% against -5.0% for the Stoxx 600 as a whole.
- The correlation between banks in Europe and US 10Y Treasury yields has been very strong i.e. when yields go down banking stocks fall, and when yields increase banking equities also rise.
- Actually, higher interest rates could mean higher net interest margins for banks, making them more profitable and attractive. This relationship works as long as global financial markets are not destabilized by higher yields that will not be supportive for bank equities.

**Stoxx 600 Banks Price Index
and US 10Y Treasury Yield**

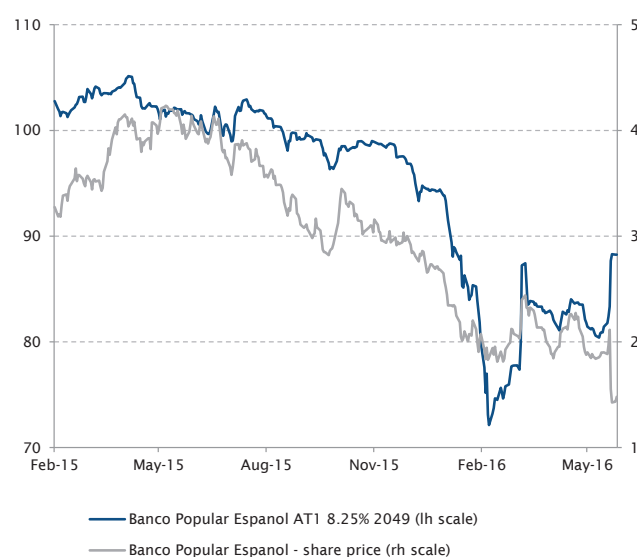


Source: Thomson Reuters Datastream

9. Spanish banks - Shareholders feel the pain!

- Shareholders of the Spanish lender Banco Popular Espanol felt the pain as the stock plunged more than 30% after an capital raising announcement. Banco Popular decided to sell an additional 2bn shares at 1.25EUR per share, a steep 47% discount, generating a significant dilution for current shareholders.
- The environment remains challenging for equity holders of Spanish banks as a number of financial institutions are forced by the regulator to increase capital against losses on their sub and non-performing loans books. The key issue is that all banks are not equal in terms of bad debt since some banks addressed this issue early on by selling their portfolios of bad debt, while there is still a number of banks which have done little to relieve their burden.
- On the other hand, bond holders enjoyed the news as illustrated by the move on the CoCo. The bond gained approximately 8 points on the news as buffer strengthening via capital increase makes regulatory capital instruments less risky. For investors willing to build exposure in this sector, selectivity remains the key element as under capitalized banks will likely follow the same path as Banco Popular.

Banco Popular ATI bond and share price

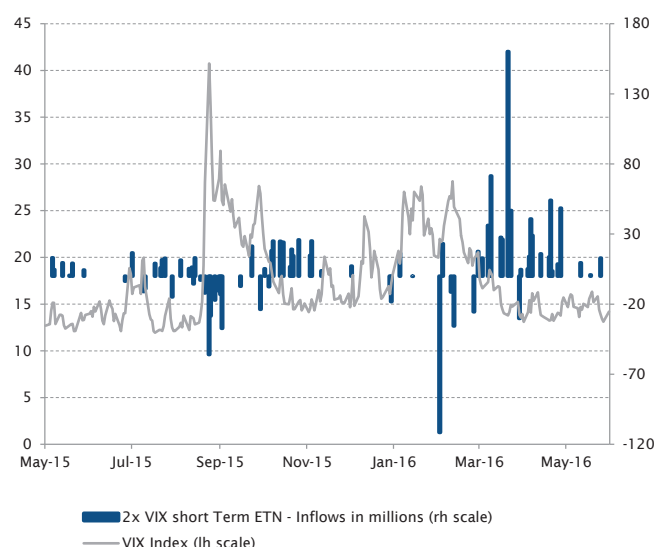


Source: Bloomberg

10. Volatility - VIX revisits 2015 lows

- As the momentum in stock rally builds up, volatility as measured by the traditional VIX index falls back to August 2015 levels, despite a number of uncertainties not being cleared up. On the unknown side, the pace of rate hikes by the Fed remains and longer term events such as the US election remain unclear. On the known side, one has to acknowledge that US macro figures are improving while oil prices, which weighed on the market this year, have stabilized to comfortable levels for the time being.
- After strong inflows in March and April in long VIX ETF (TVIX), few investors took the opportunity to create or add to their insurance strategy. In May, the inflows into the TVIX have been slow, showing that investors are probably under invested and not willing to spend too much performance on insurance products.
- However, as historically the VIX rarely falls below the 10 mark, unhedged investors could take the opportunity to allocate capital to hedging strategies, being long TVIX or more sophisticated convex strategies in order to cushion any reversal of the current rally in US equities.

VIX index and long VIX ETF inflows



Source : Bloomberg