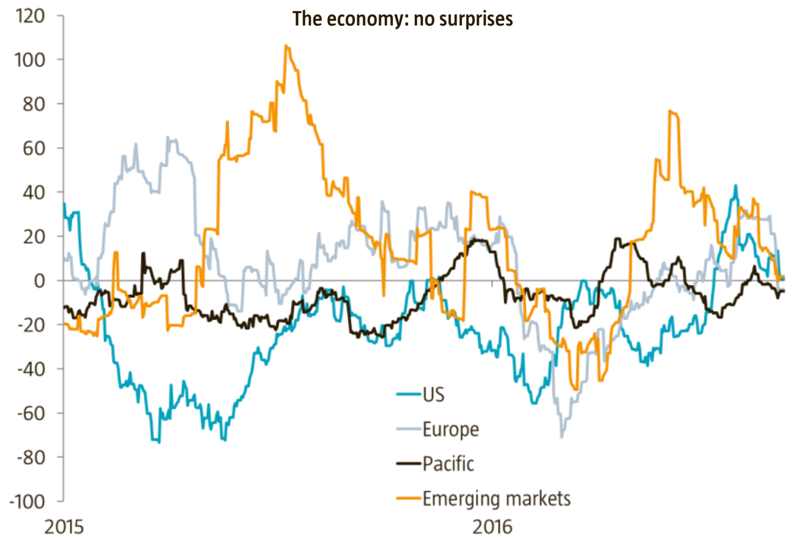
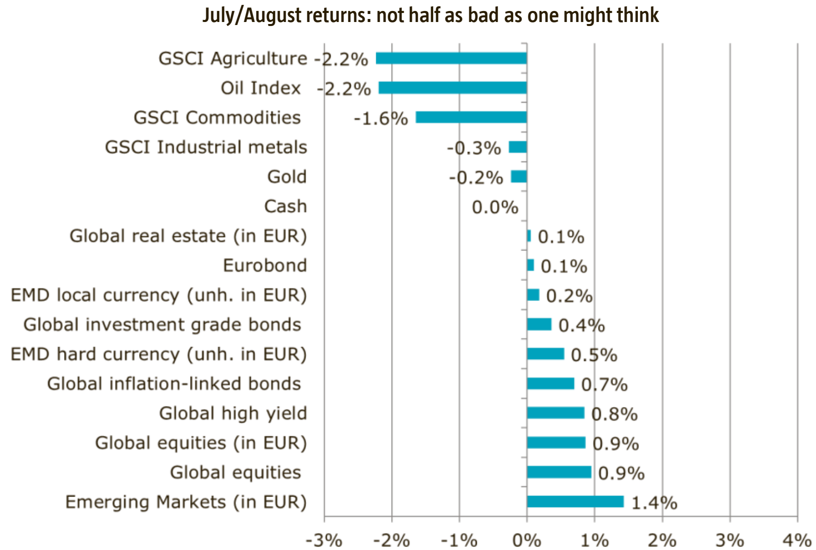
ROBECO

Multi-asset markets outlook

September 2016

General overview





– "So what happened in financial markets while I was away?" This is the typical question that you ask yourself when you return from holiday. Sure, you looked at markets from time to time, you probably tried to grab a newspaper now and then, but you never experience the markets like you do sitting behind your desk. It takes about a day to find an explanation for all the spikes and turns that took place while you were gone. A day to get back into the swing of things?

– Not so this time, for the simple reason that there have hardly been any spikes and turns. Sure, currencies moved erratically at times, but neither bonds nor stocks moved much during the past two months. Both the VIX (equities) and the MOVE (bonds) index reached their year-low in August; so much for the rise in volatility normally seen in the August-September period.

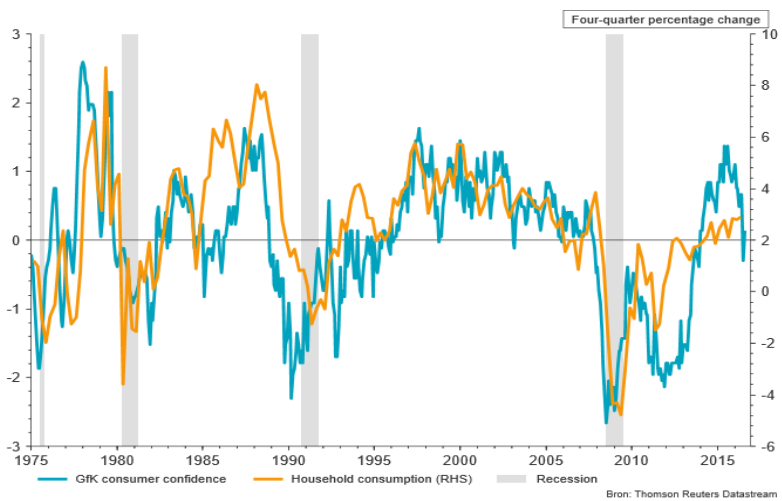
– The lack of volatility is closely linked to the absence of a leading theme in financial markets, coupled with a lack of direction coming from the macroeconomic data. The Citi-surprise index for the four major economic blocks all moved to the 5-points deviation range, roughly a fifth of the average deviation. The data proved too little to either push the Fed to hike rates, or the Bank of Japan to stay on hold, leaving the markets to just simply drift along.

Economy

Our highlight this month: Brexit, the aftermath

Bank of England's Agents Survey: investment intentions don't bode well

UK GfK consumer confidence is rebounding and household consumption is strong for now



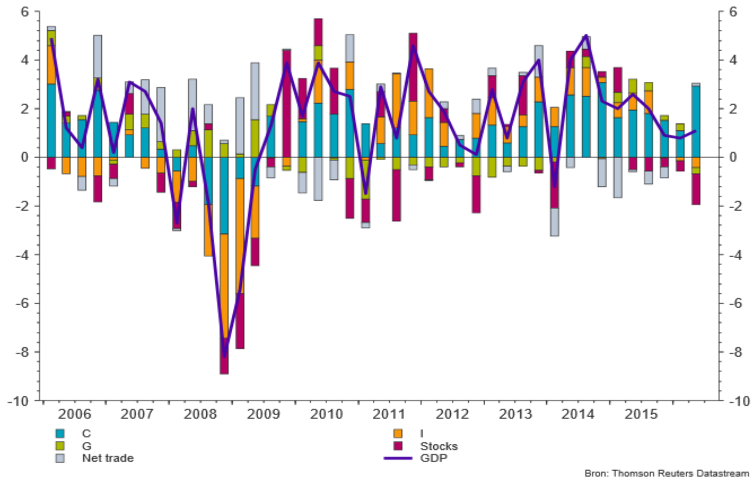
- The initial shock of the June Brexit vote to the UK economy has been cushioned by the fall in the pound and preemptive measures by the Bank of England. Nevertheless, the medium-term outlook does not look good as it is likely that ongoing uncertainty around Brexit will hamper investments in the UK economy, as seen by the survey of investment intentions. The weak pound will furthermore push up inflation. It is unlikely that workers will be fully compensated due to the ongoing uncertainty over future relations between the UK and EU.

- The UK government has not outlined its priorities over whether continued access to the EU internal market or the control of migration is of paramount importance. Divisiveness within the UK cabinet is the main reason. It is against the interest of the EU to offer the UK a cheap 'Brexit lite', as this would threaten the cohesion of the rest of the bloc, especially now that French presidential and German general elections start to loom. The UK government will therefore have to make hard choices. It is understandable that new Prime Minister Theresa May is playing for time. This lack of decisiveness and an uncooperative stance of the EU suggests an ongoing stalemate damaging the UK investment climate.

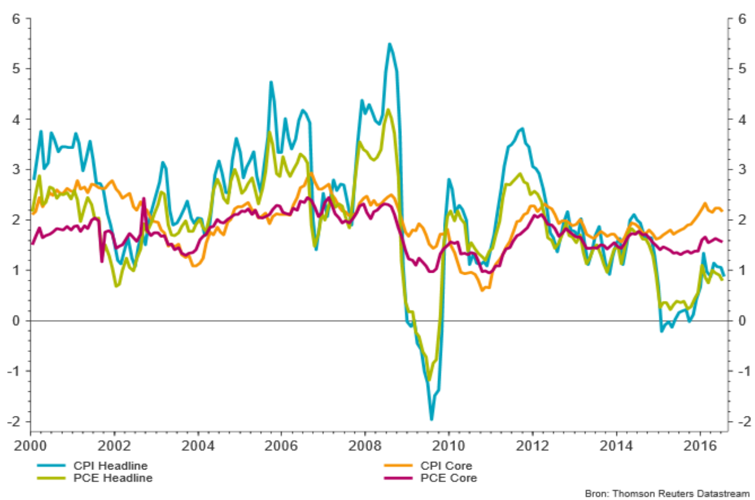
- So far, there is little evidence that Brexit is increasing political centrifugal forces within the rest of the EU, which would threaten EU investments.

United States

US consumption is driving GDP growth, investment is worrying



Headline inflation is down, core is roughly stable



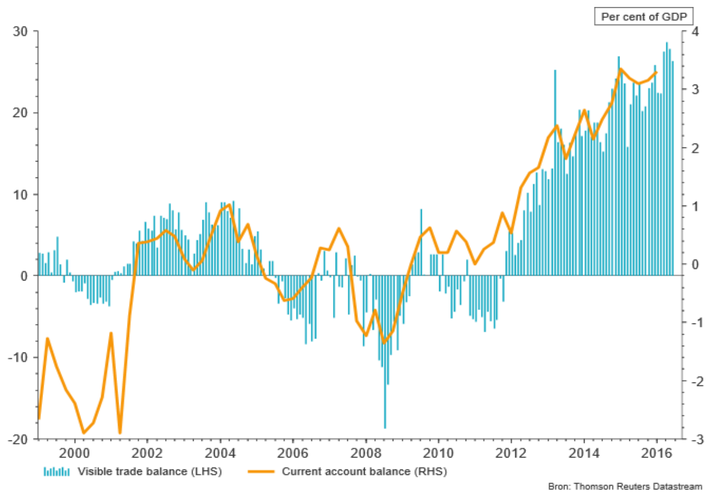
- The unexpected dip in the ISM manufacturing index below 50, and the less-than-consensus non-farm payrolls (still a healthy 151,000) makes it unlikely that the Fed will hike interest rates in September. It is more likely that a cautious Fed will signal a December hike, skipping November due to the US elections.

- US inflation has stabilized recently. Its base effects will probably push the headline rate higher in the coming months, putting additional pressure on the Fed to act, as core CPI is already trending above the implicit target rate of 2.0%. Recently, OPEC has succeeded in talking up the oil price, followed by a concordance with Russia. As both are responsible for about half the world's output, their agreement is not without significance. Of crucial importance will be the attitude of the new entrant to the market, Iran. We reckon with an oil price stabilizing at around USD 50 a barrel.

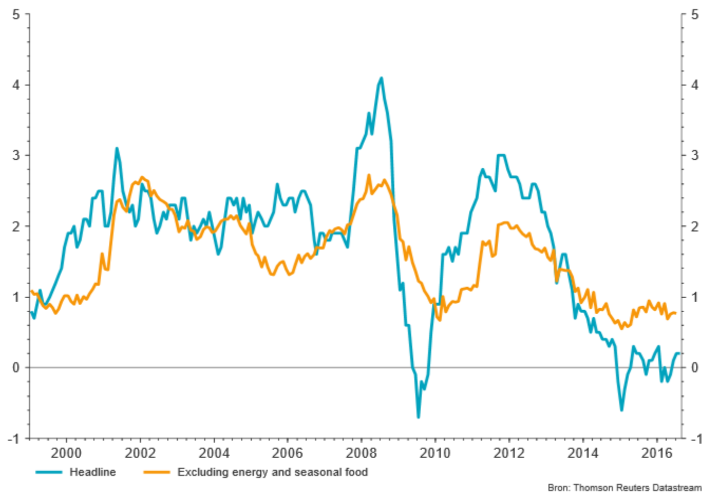
- Economic growth this year has been disappointing, despite a steadily improving labor market. As we are approaching the November elections, increasing protectionist rhetoric could lead to a general postponement of investments, further reducing economic growth. As both the main presidential candidates are suggesting more fiscal stimulus next year, partly as a consequence of increasing investments in infrastructure, a rebound in the course of 2017 is likely.

Europe

The Eurozone's rising current account surplus shows it's a deflationary force



Euro area core inflation is moving sideways



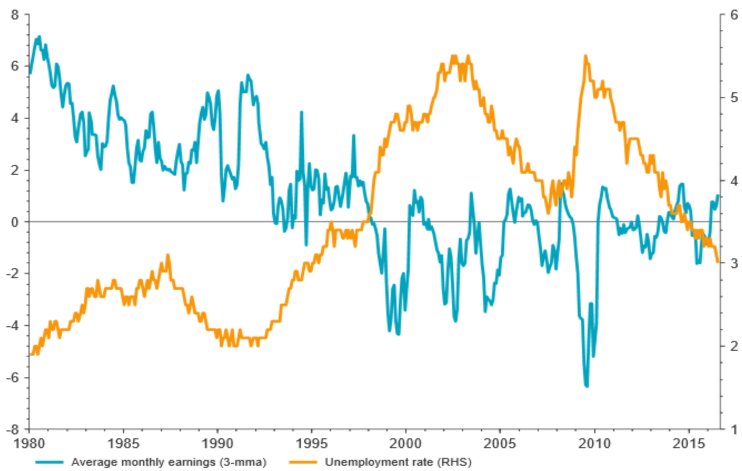
- 'Steady as she goes' would be an apt description of economic developments in the Eurozone. However, recent forward-looking indicators suggest a weakening German economy, fortunately compensated by peripheral strength. The rising current account surplus of the EU area suggests it is becoming a deflationary force in the world economy.

- The ECB is unlikely to act aggressively. Inflation is low, but deflation is not an immediate threat as core inflation has risen above zero once again. A stabilizing oil price would also mean a rise in inflation the coming months due to base effects. ECB president Mario Draghi will probably hint that the central bank will address the scarcity problem of German government bonds later this year and may extend its asset-buying program beyond March 2017.

- Peripheral bond spreads remain very tight. The ongoing political stalemate in Spain is not spooking markets. The main risk would be a defeat of Italian PM Matteo Renzi in a referendum on constitutional reform, likely to be held in November. Recent polls suggest a neck-and-neck race, though the appeal of the Eurosceptic Five Star Movement could weaken, as key aides to the Roman mayor recently resigned. Renzi though has apparently been backtracking, saying he would resign if defeated, probably throwing the Eurozone into turmoil again.

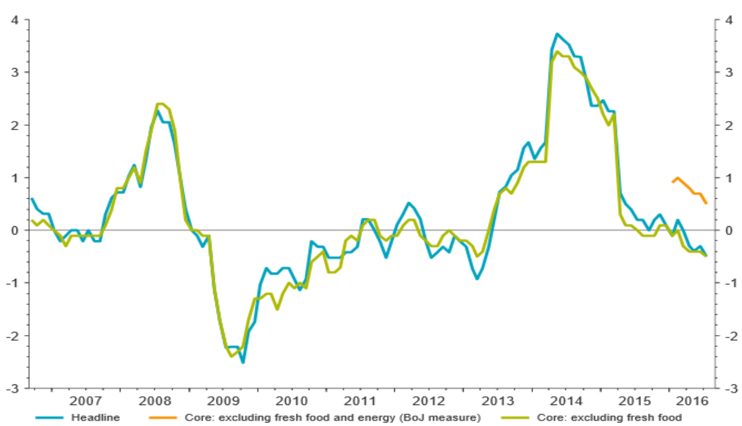
Japan

Japan's unemployment level is the lowest in 21 years



Bron: Thomson Reuters Datastream

Japan is drifting towards deflation



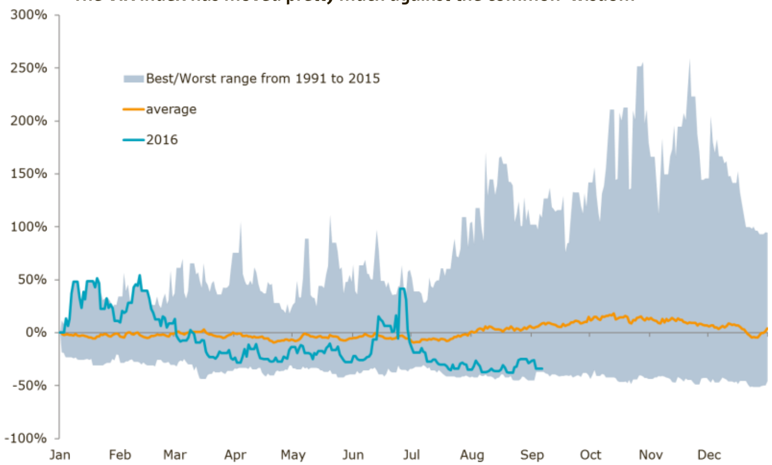
Bron: Thomson Reuters Datastream

- The Japanese economy is showing a zig-zag pattern. Q2 GDP growth disappointed, signaling a near standstill. The economy would have contracted in the quarter were it not for a rise in public investment after the government front-loaded infrastructure spending. Consumer spending failed to take off, despite the fact that Japan's unemployment rate continues to fall, even reaching 3% in July, the lowest rate for 21 years and close to levels considered to be full employment by the Bank of Japan (BoJ). Fundamentally, Japan's growth potential has fallen. That means the government should continue with structural reforms, not just stimulus.

- BoJ Governor Haruhiko Kuroda has expressed some caution on further lowering the negative short-term interest rate. He believes to do so would hit the profits of financial institutions and increase pension liabilities for corporates, and with that, possibly negatively affect producer and consumer confidence. Nevertheless, he thinks there is still ample space for further cuts in the negative interest rate. Any action is probably dependent on the USD/JPY exchange rate. Furthermore, there remains plenty of room for an increase in quantitative easing, which we expect to be announced after the BoJ policy meeting on 20-21 September. A possible broadening of QQE (quantitative and qualitative easing) would entail the BoJ buying the bonds of local governments and public corporations that fund projects including railways, power plants and sewers.

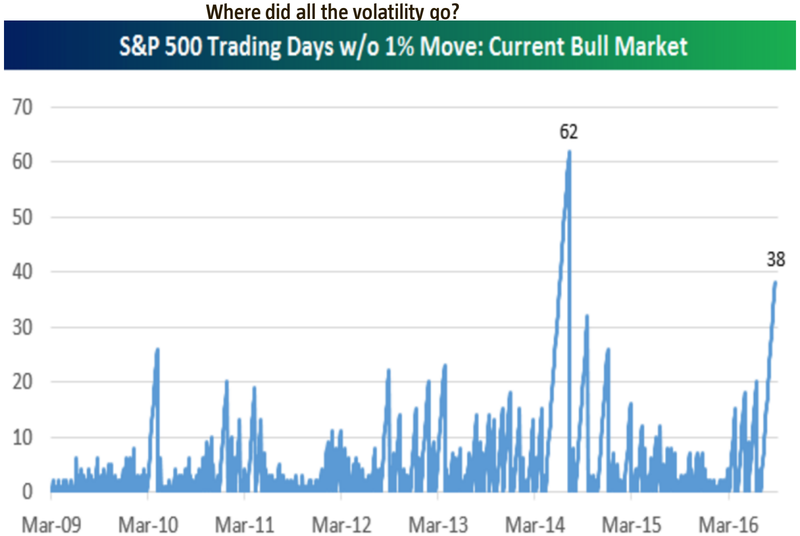
Equities (I)

The VIX index has moved pretty much against the common 'wisdom'



source: Bloomberg, VIX index

Where did all the volatility go?

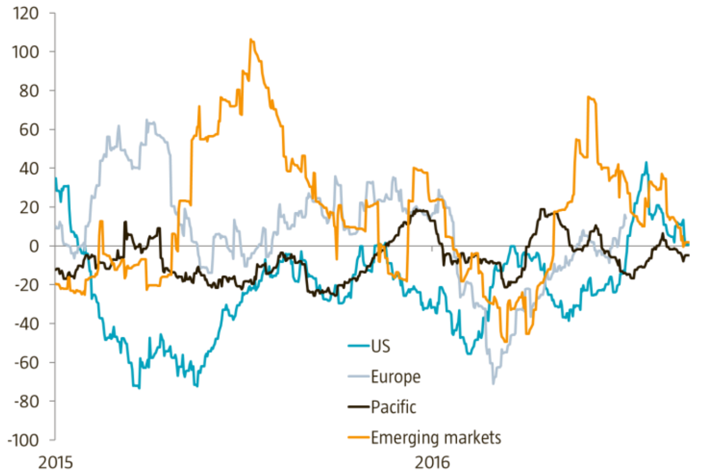


- 2016 is shaping up to become a pretty atypical year when based on a number of commonly held 'wisdoms' with respect to stocks. The negative January was no foreboding that stocks would underperform for the year as a whole, and 'selling in May' turned out to be a bad call, while the most remarkable development over the past two months has been the steady decline in volatility. As we discussed last month, the track record of higher volatility in the August-October period is one that stands the test of time. Either looking at the VIX index (since 1990), or realized volatility (S&P500 since 1928), it is clear that the post-summer period has the tendency to be the most volatile of the year. Not so in 2016: stocks (and in fact bonds and most other assets) have moved in a remarkably close trading range since mid-July. The VIX has reached its lowest level this year.

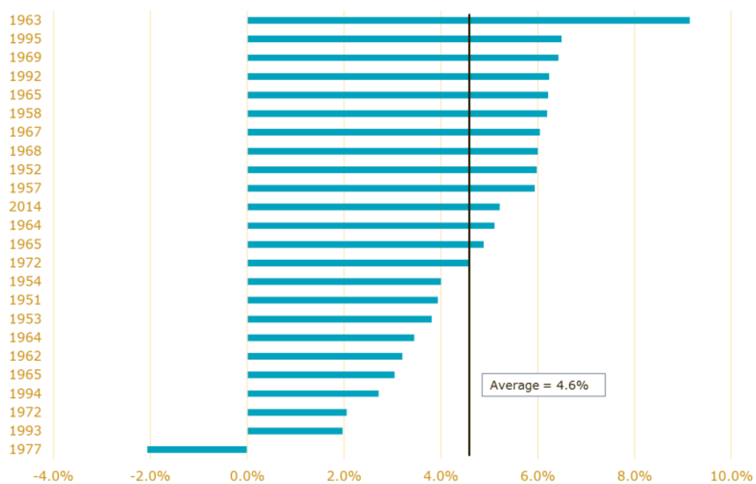
- The cause of this drop in volatility is easy to explain: no big market-moving themes have emerged over the past two months. Oil has been in a trading range of between USD 42-50 for four months now, no longer possessing the market-moving abilities it had earlier this year. Central banks at the same time have been in a wait-and-see mode, scrutinizing the data to assess whether they can hike rates (Fed) or whether more stimulus is needed (BoJ). As it happens, this scrutinizing was a pretty easy task to complete, as most of the data points were in line with expectations, and they provided no outspoken signal to expect a >>

Equities (II)

As expected, the correlation between oil and stocks has declined markedly



The S&P 500 had an average two-month return of 4.6% in a low volatility trading environment



- change in policy. The Citi-surprise index for all four regions steadily moved in a 5-point range from zero, which is the level at which all data is exactly in line with expectations. The end of the Q2 earnings season; no big political events (apart from the US elections); no important financial occurrences (the Italian banking sector is still there, the UK is still in the EU, Greece is still in the euro); they all helped to push financial markets into an end-of-summer lull.

- Is this lack of volatility something to worry about? On the one hand, the answer is no: we have seen these low-volatile periods before, and they usually do not last much longer than two months. It is the longer-lasting low-volatility periods that tend to be harmful, as these prompt investors to take more risks in order to chase returns. With the strong volatility seen at the start of the year, investors are still fully aware of the potential risks.

- On the other hand, the answer is yes, *given* our current short position in stocks, that is. In the absence of volatility, stocks have the natural tendency to drift higher. This can be clearly seen in the chart to the left, where we have plotted the two-month price return of the S&P 500 in periods where daily changes fell within a +/-1% trading range for the whole period. During the 24 times this **>>**

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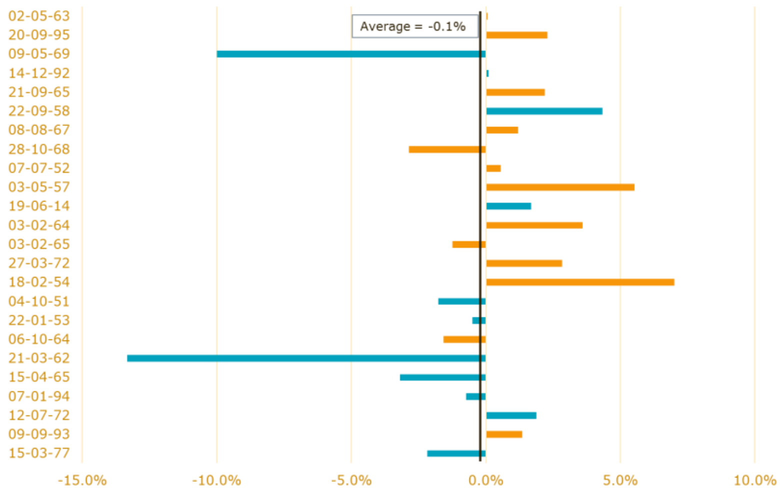
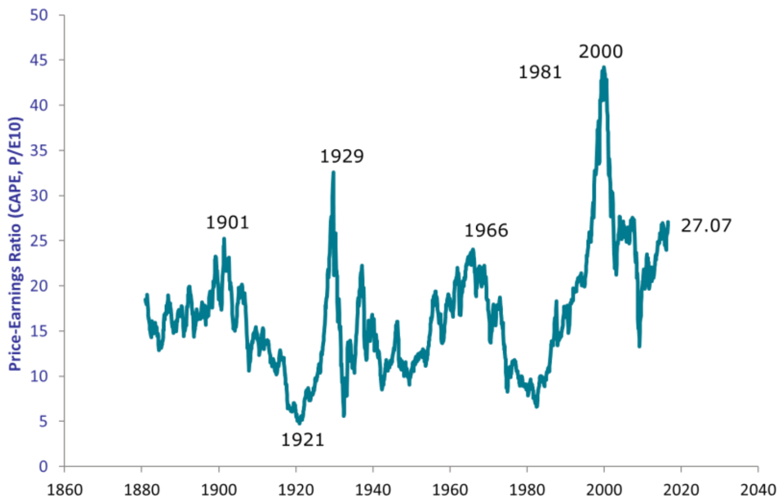
Equities (III)

Equities

Low volatility loses its power to move stocks higher eventually



... the Shiller PE is at its highest level since 2007



- has occurred since 1930, there was only one period (Spring 1977) which yielded a negative return: in all of the remaining 23 times the result was positive, with returns markedly in excess of the longer-term average. Stocks rose 4.6% on average during these low-vol trading environments, compared to the longer-term average price return of 1.2% for a two-month timeframe. Forecasting a low-vol trading period can therefore be a very profitable trading strategy.

- Profitable as it may be, it is also pretty useless in the current situation. In order to clarify that, we have looked at the two-month returns *following* two months of low volatility. The average return over the subsequent two months was -0.1%. In the chart top left, the orange color depicts the years in which volatility continued to be low for another month: the average return for those months was 1.4%, pretty close to the longer-term two-month average return you would get in a random chosen period. To put it differently, if you are able to identify a low-vol trading period in advance, it can be pretty profitable; but once it has already been in place for two months, the magic has stopped working. What's more, the odds of the low-volatility trading environment continuing for three months is not that high. We continue to see numerous risks (expensive US stocks, pressure on earnings, uncertain outlook for China, high debt), which is why we stick to our call for now.

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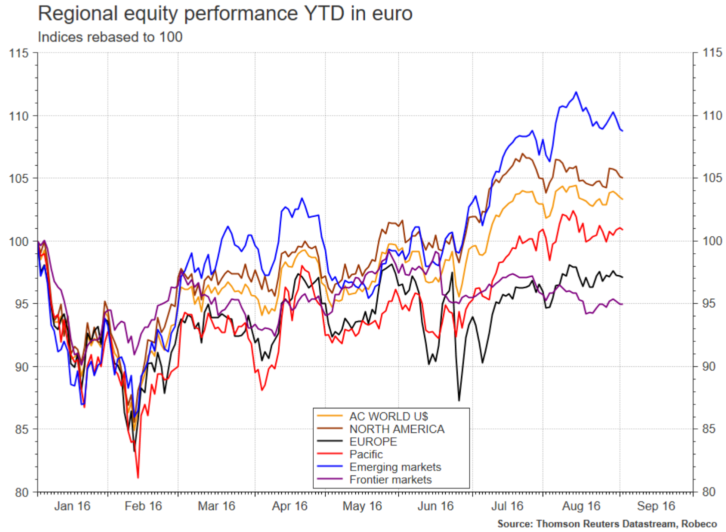
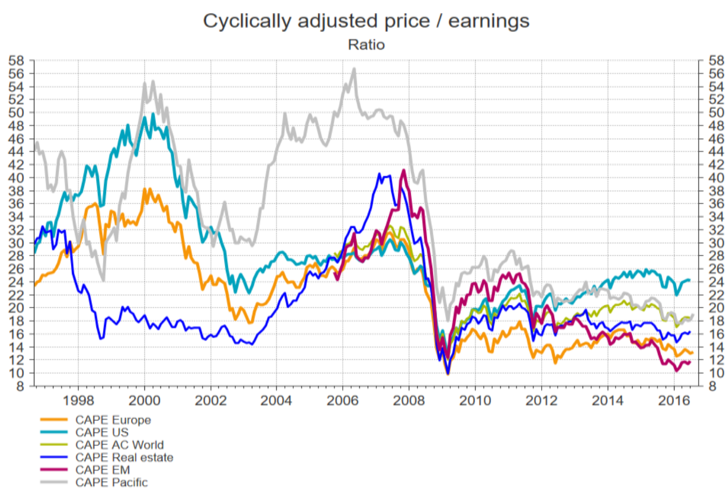
Developed Market Equities

Equities

The US still leads developed markets YTD



Europe shows a discount to the US

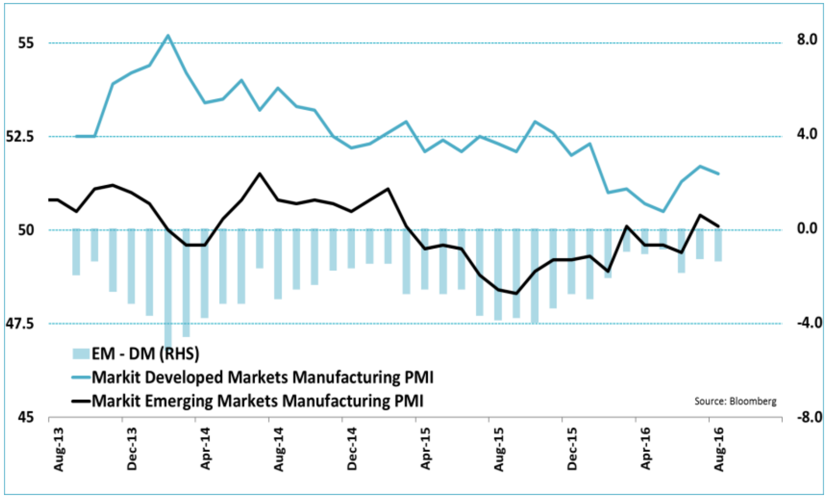


- Investors should have shunned the 'sell in May' seasonality factor, as equity momentum on a one-month basis in euros has improved for developed market equities, with Europe now showing the strongest momentum. European equities seemed to have shrugged off fears about the potential Brexit fallout. Pacific equities have struggled, partly as market doubts remained elevated about the space left for further Japanese central bank policy easing. US equity short-term momentum has been somewhat weaker compared to Europe, but kept positive as well, on the back of a weaker US dollar and improving consumption data. Longer-term momentum (12m-1m) favors US equities within developed markets.

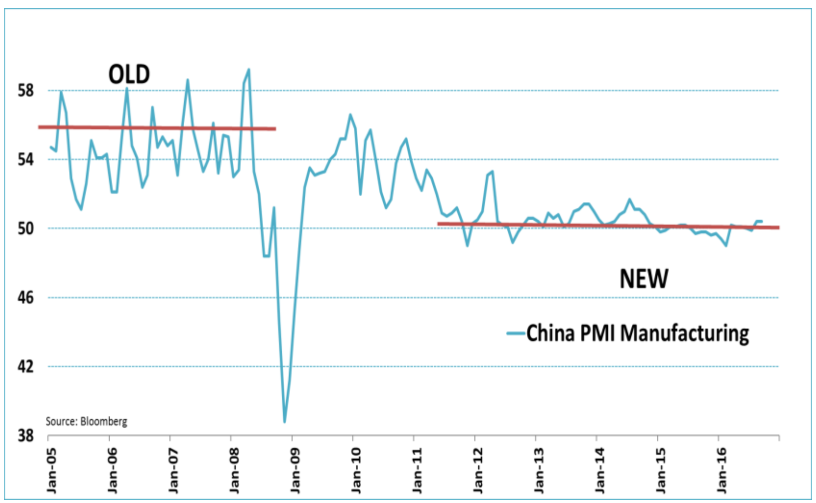
- Developed equity valuations based on CAPE increased last month, as sentiment improved somewhat on the expectation that the Fed will remain on hold, with price appreciation outpacing actual earnings growth. Looking at forward P/E, European equities still show a slightly above-average discount versus the US, but, being a higher beta play, have become less cheap recently due to global equity momentum improving. We expect weaker Q3 figures from the UK to hurt European equites more compared to the US. With the Fed likely to hike only after the US elections, relative valuation is of less concern in the near term. We therefore prefer US and Pacific equities over European equities.

Equities: Emerging vs Developed (I)

Emerging vs. developed markets manufacturing PMI



China manufacturing PMI



- In August, emerging market equities performed better than those in developed markets, which benefited our relative preference of the former over the latter.

- Despite the targeted stimulus and increase in liquidity. China's manufacturing PMIs did not move all that much in August. For more than four years now the manufacturing PMI has hovered around 50, a clear decoupling from pre-crisis levels (see chart). As consumer spending hasn't picked up either, GDP growth has probably slowed again somewhat. In addition, in recent weeks a growing number of Chinese cities have 're-imposed' property curbs (mostly an increase in downpayments), also negatively impacting growth.

- For other Asian countries the economic outlook has improved somewhat, South Korea being the most important exception. In Russia, economic conditions have improved markedly as commodity prices have recovered. Also, Europe may lift some of the sanctions against Russia next year. The impeachment of Brazil's President Dilma Roussef confirms the divide between the country's people and politicians. Her successor, Michel Temer, has pledged austerity to restore Brazil's credit rating. While that may be positive for (debt) investors, the road to recovery will be a long one.

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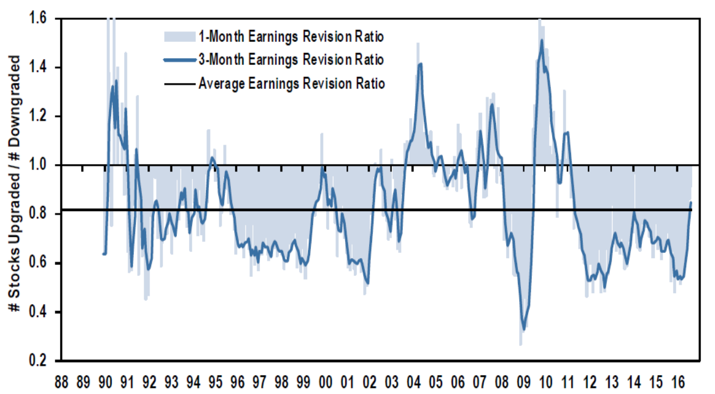
Equities: Emerging vs Developed (II)

Earning estimates are moving up

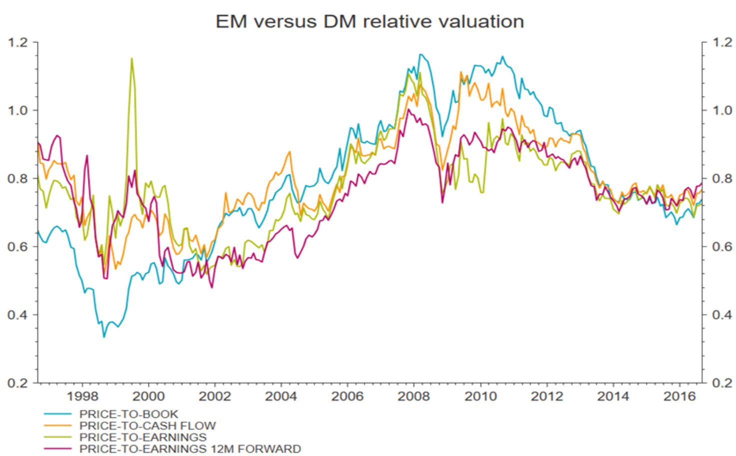
Chart 13: Trends in Earnings Expectations – Global Emerging Markets



Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, IBES

The valuation discount between emerging and developed markets

Source: Thomson Reuters Datastream, Robeco



Source: Thomson Reuters Datastream, Robeco

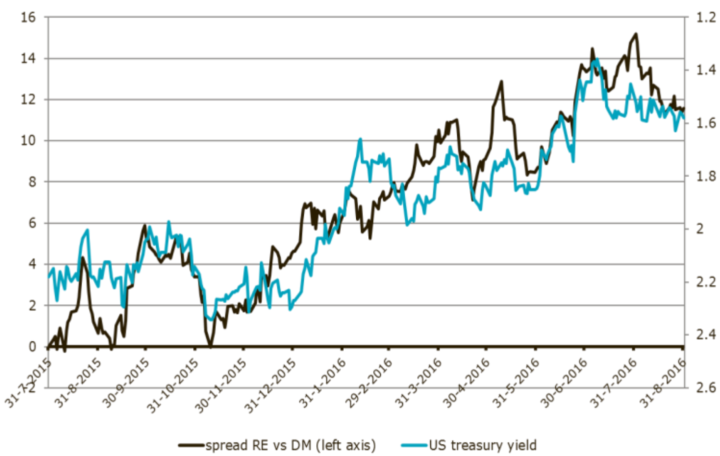
- One import factor that has made us more positive about emerging markets is earnings. Until recently, earnings-per-share had continuously fallen since 2013. Compared to the beginning of this year, earnings are up a healthy 14%. In addition, earnings revisions are also recovering, and are now above the long-term average.

- Combined with attractive valuations, which has been the case for quite some time now, investors are turning to emerging market equities once again. This too is helped by the notion held by many investors that many of the problems that could derail the global economy and/or stock markets are occurring far away from emerging markets.

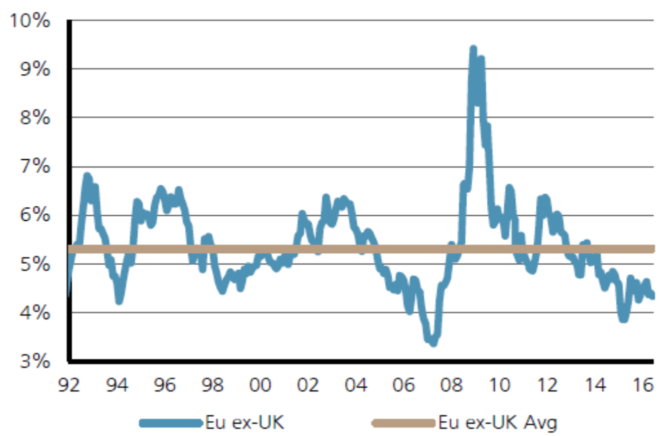
- But this could quickly reverse of course. We would like to stress that at this point the recovery in the relative performance of emerging equities over their developed market peers is fragile. Growth is improving, but very modestly. The US dollar remains an important risk as we do not rule out another Fed rate hike this year. Also, any sign of slower growth and lower commodity prices will negatively impact emerging markets. For now we stick to our relative preference for emerging markets, however.

Real estate

The relative performance of real estate



European real estate is still attractive from a 'search for yield' perspective



Source: Worldscope, I/B/E/S, DataStream, UBS estimates, as of 31 Aug 2016.

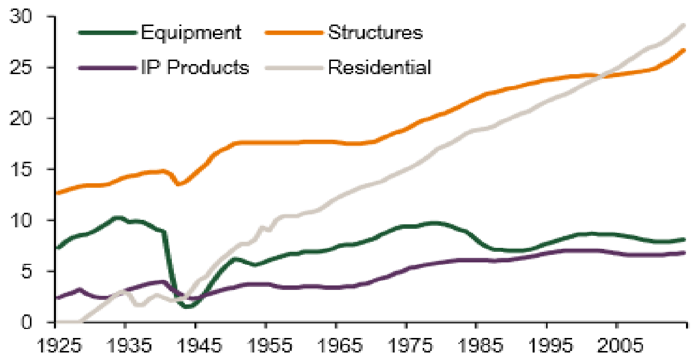
- Global interest rates rose in August, so real estate values declined. The strong relationship between US interest rates and global property performance still holds. The S&P Developed Property index (in USD) declined 2.8%, underperforming global equities by approximately 2.5%.

- European real estate recovered from the post-Brexit sell-off in real estate last month. While the ECB keeps buying nearly everything on the bond markets, investors searching for yield can keep an eye on real estate. The current dividend yield is still relative attractive. In Europe there are no signs of increasing interest rates. In Japan, the government is set to announce a new round of stimulus measures. We don't expect the amount of JREITs that is purchased monthly (90 trillion yen) to rise, as the market distortion is already significant at this point.

- On 1 September, real estate became the 11th sector in MSCI sector classification. Before, real estate was part of the financial sector. The new sector has a weight of around 3.6% in the MSCI World Index. Not much attention was paid to the change, since most of the reshuffling took place in the sector's ETF branch. All in all, our neutral stance on real estate remains intact.

AAA Bonds (I)

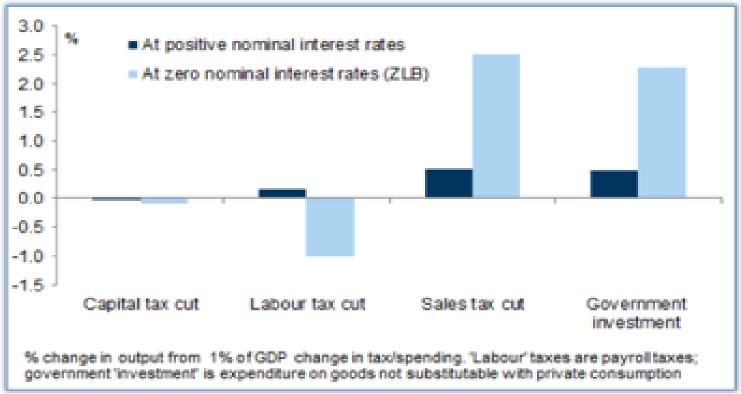
The average age of US government fixed assets in years



Source: Bureau of Economic Analysis

Note: Structures make up about 80% of the net stock of government fixed assets.

The effectiveness of public sector investments



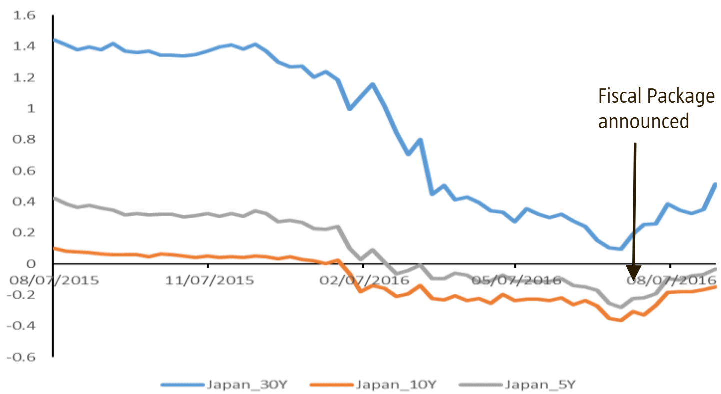
Source: Eggertsson (2011)

– Government bond markets are being kept hostage by the central banks, but none of the hostages seem to mind, as the will to break free is completely absent. This is not so surprising as most major asset classes generated a positive return in the year to date: so why change a good thing?

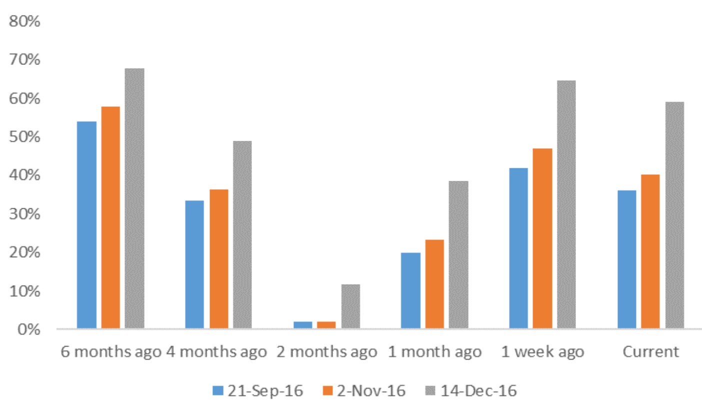
– What then might trigger a change in the status quo? Well, first of all the realization is growing that we are getting closer to the point of monetary policy saturation – not only from an implementation perspective (ECB and BoJ), but also from an effectiveness perspective. Just to be clear, we are by no means against monetary policy. It will always be incredibly important during episodes of financial distress, as it has proven time and time again. However, it feels like we have reached the limits of what monetary policy can achieve by itself, and the time has come to adjust the mix and skew it more towards fiscal policy. Given the current ultra-low rates and the massive amounts of liquidity in the system, this seems to make sense, as one would expect fiscal support to be extremely effective in such an environment. Fortunately we are starting to see some movements toward more fiscal spending, the most visible being Japan's plans. And Japan is not alone: new fiscal packages have been announced in South Korea, Canada and China.

AAA Bonds(II)

Japanese bonds started to move upwards around the fiscal package announcement



The probability of a Fed hike in September is still low



Source Bloomberg

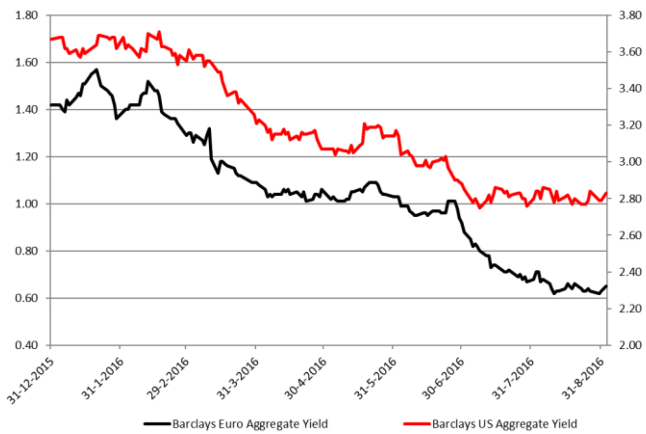
- Also, both the main contenders for the US presidency are in favor of fiscal spending, and Europe seems to be taking a more pragmatic approach towards fiscal austerity (Spain and Portugal not being fined for breaking EU budget rules). Fiscal spending works with a long time lag, but we think that credible plans can alter expectations, and could have an instant impact on the future path of rates.

- In the near term we think however that bonds will continue to be driven by the ebbs and flows of demand and supply, where central banks policy seem to be the driving force on the demand side. We expect no changes from the Bank of England (BoE) and ECB, although we do think that at some point in the fourth quarter the market will start demanding clarity from the ECB about what happens after March 2017. From the Fed we would tend to expect some action, but given the low expectations of market participants, we don’t think the US central bank will move in September, as it isn’t in its interest to spook the markets.

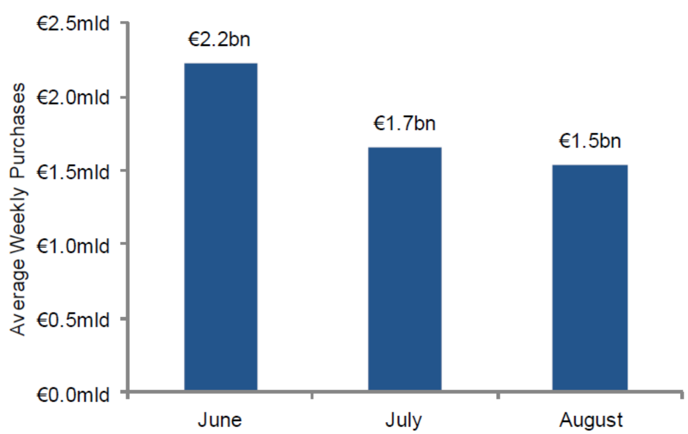
- We entered into a small underweight in bonds as we think that after the summer there is a window in which supply can temporarily outweigh demand. Also, if oil stays at the current level, some upward pressure may develop in inflation due to year-on-year changes in the oil price.

Investment Grade Credits (I)

European yields kept falling during the summer



CSPP since it started



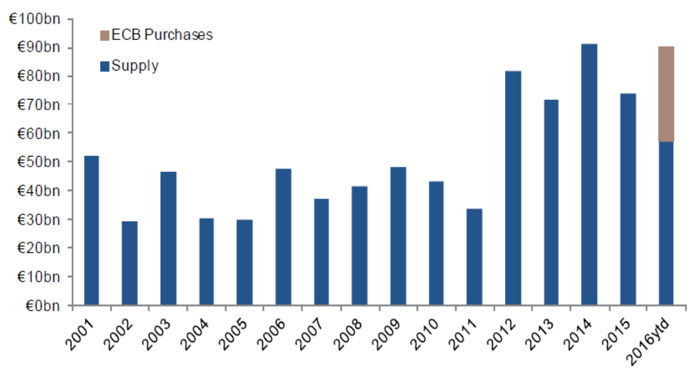
- Just before the summer started, European credit yields fell through the 1% barrier, and under influence of the continuing buying of credits by the ECB, they declined further in the last two months to almost 0.60% at the end of August. Of course, spreads also have fallen, and now the 1% spread barrier is in sight. The European credit spread closed at 1.08% on 31 August, almost 40 basis points lower than the day after the Brexit referendum result on 24 June.

- In the early days of August, the Bank of England announced some new economic stimulus measures to counter the Brexit backlash, including a GBP 10 billion package of UK corporate bond buying. This received a warm welcome on the financial markets, but its size is limited compared to the ECB's CSPP program.

- The CSPP program is well underway, and the ECB is more aggressively buying bonds than was expected. It seemed this summer that the ECB bought whatever it could buy. While supply is always very weak during the summer, the ECB kept on buying, pushing yields and spreads even lower. For the coming month we expect that the ECB's strong market influence will continue. Although supply will gain momentum in the last months of the year, the ECB will just increase the amount of bond purchases, and so the downward pressure will continue. **>>**

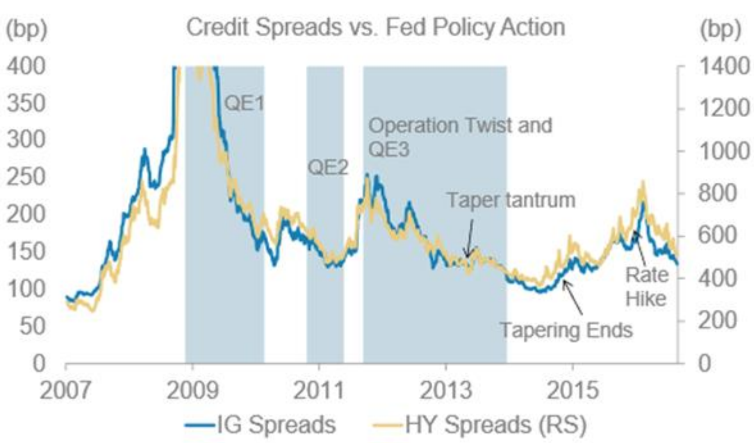
Investment Grade Credits (II)

ECB purchases in relation to total supply



Source: SG Cross Asset Research/Credit

The end of Fed easing is negative for US credits



- Don't be surprised when European credit spreads fall below 1% in the coming period. We don't expect the current political turmoil in Europe, nor the rising supply, to outweigh the ECB's actions. Besides that, despite their low yields, European credits are still more attractive than European government bonds.

- In the US, a rate hike is being discussed again after a series of promising economic data. However, we don't expect a rate hike before December. This is expected to be good news for credit markets, as spreads reacted negatively on signs of an end to monetary easing. US credits are late in the credit cycle, with high leverage and increasing defaults in the credit arena (albeit still relatively low). Of course, US credits are expensive, but for the yield-seeking investor there are some possibilities left, though you should tread carefully. In contrast to what happened in Europe, US credit yields were quite stable during the summer.

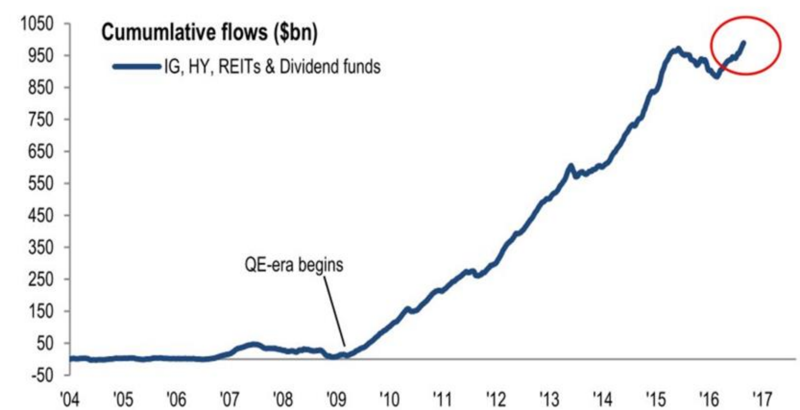
- We have an overweight position in European credits as the ECB will be in the market as the 'ultimate buyer' for the coming period. Possible political turmoil in Europe won't change that. We expect spreads to tighten further, with investors looking at alternatives that have slightly more yield, such as financial credits. These credits are not in the CSPP universe (yet).

High Yield (I)

Global high yield spreads

Inflows into higher-yielding assets

Chart 1: Euphoric fund flows to assets tied to "zero-rate" expectations



Source: BofAML Global Investment Strategy, EPFR Global

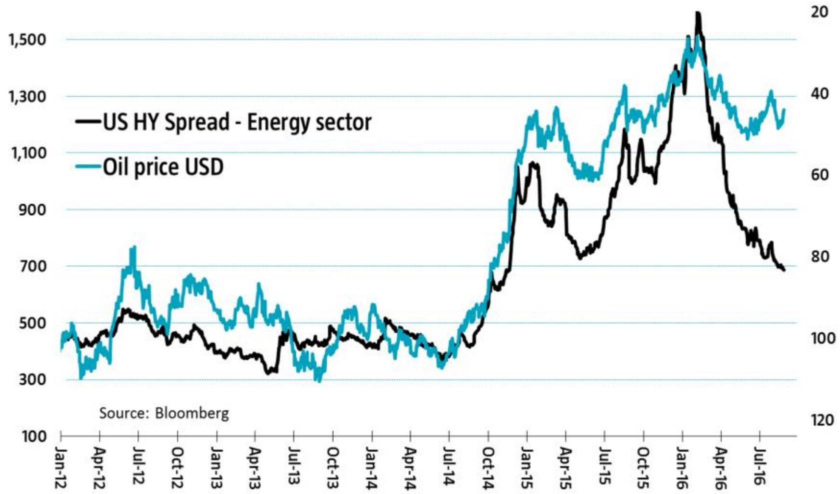
- Another month, the same trend. High yield spreads continued to tighten globally as the risk-on attitude of investors continued in August. At the end of last month the average spread equaled 487 basis points, down from 530 at the end of July. High yield bonds were among the best performing asset classes in August.

- In general the story for high yield bonds has not changed all that much. Reasonable (not great) economic conditions without any significant negative growth shocks, in combination with an increasing amount of negative yielding debt, draw investors to higher yielding assets. As the chart on the bottom left shows, fund flows towards higher yielding assets have increased strongly as yields on government bonds fell.

- Falling government bond yields also help the asset class as refinancing is relatively cheap. This offsets the increased leverage and deterioration of balance sheets in some parts of the high yield universe. In addition, high yield companies have taken advantage of the low rates, shifting the maturity wall outwards.

High Yield (II)

US high yield energy sector spread



Number of defaults globally

- The other side of the story is, however, that valuations have become less compelling, particularly when we take into account the fact that the US is already quite late in the credit cycle, a phase in which historically spreads start to widen. Obviously, this is no regular credit cycle, as central banks are heavily influencing flows.

- In the energy sector, things are also starting to look a bit elevated. The oil shock has wiped out the weak energy companies – a couple of energy-related companies still go bankrupt every week – but the chart on the top left shows that credit spreads have tightened very significantly. The complete lack of credit widening in the latest brief spell of falling oil prices could point to some complacency.

- High yield defaults remain concentrated in the US, and primarily in the commodity-related sectors. Without any negative growth shocks, we see little risk of the start of a broader default cycle. Valuations compared to (European) government bonds remain attractive. However, as some of the attractiveness has vanished and the asset class remains vulnerable to a change in risk attitude, we stick with the smallest possible overweight for now.

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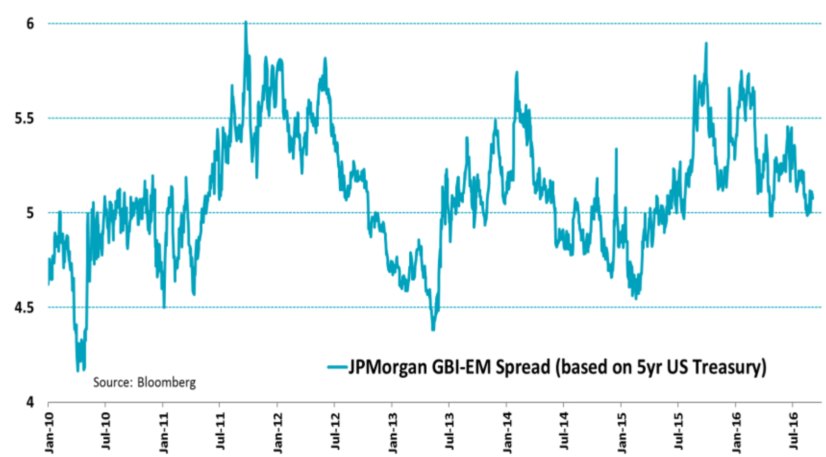
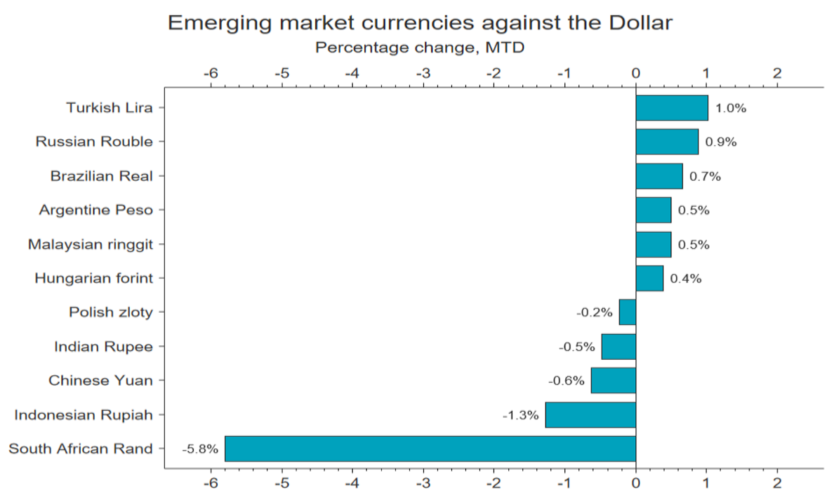
Emerging Market Debt (I)

Emerging Market Debt spread based on the 5-year US Treasury yield



Emerging market currencies versus the US dollar



- After a couple of strong months, emerging market debt took a breather in August. Measured in euros the asset class returned 0.5%. For the most part, the return was capped because of a rise in the 5-year US Treasury yield, which is used to determine the emerging market debt spread. The spread itself ended in August close to its lowest level in over a year, underpinning the attractiveness of the asset class to investors searching for yield.

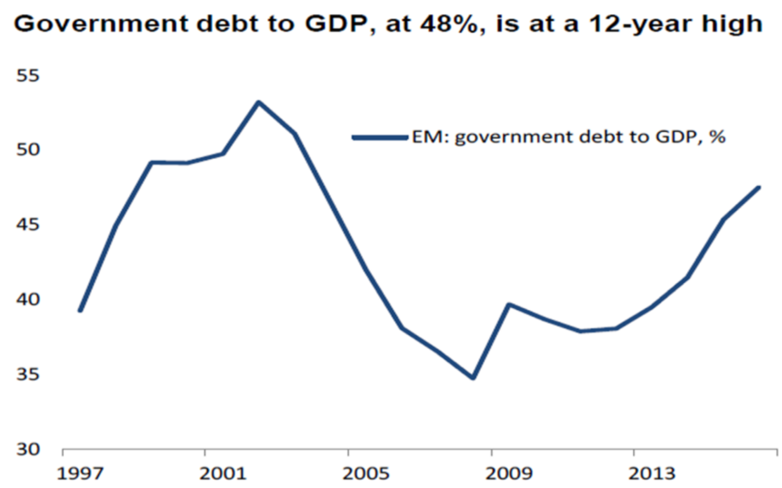
- On average, emerging currencies hardly moved in August, but as the chart on the bottom left shows, differences between currencies were distinct. The South African rand was hit after political tensions increased. The long-time ruling ANC has become split over several issues, including the presidency of Jacob Zuma, which has resulted in a loss of support among South Africa's population. This political uncertainty has caused the rand to fall.

- Political tensions have increased in other emerging countries as well, making more emerging currencies vulnerable to negative shocks. Good examples are Brazil and Turkey. In addition, emerging currencies will come under renewed pressure once investors accept that the Fed is going to normalize interest rates.

Fixed Income

Emerging Market Debt (II)

Government debt



Yield of EMD vs. high yield

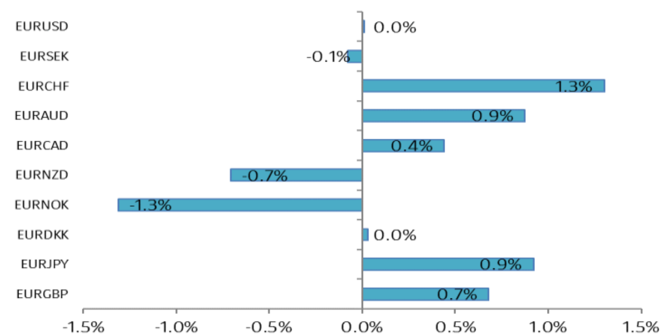
- From a fundamental perspective, things look reasonable. Growth is picking up, albeit very modestly. The inflation outlook is generally benign, although risks linger in some countries, for example in Brazil. Also, emerging currencies remain prone to sell-offs, as they offer an instrument to solve imbalances and/or a reversal in risk appetite. A positive here is that, on average, current account balances have improved.

- An interesting development to keep an eye on is the gradual increase in debt-to-GDP ratios, which have climbed to the highest level in 12 years. However, as the absolute level of debt-to-GDP is 'only' at 48%, this does not pose an imminent risk. That said, any slowing of economic growth will force a number of emerging countries to increase government spending, as growth levels are already pretty soft. This could push up debt-to-GDP ratios further.

- We stay neutral on emerging market debt. The latest data indicate that the Fed will likely hike in December and not September, adding to the positive sentiment. But emerging market currencies could depreciate once investors really start pricing in rate hikes. In addition, political risks have increased, which is reason for some cautiousness.

FX (I)

Monthly returns of G10 currencies



Source: Bloomberg

UK numbers are holding up much better than expected

Bloomberg, Morgan Stanley Research

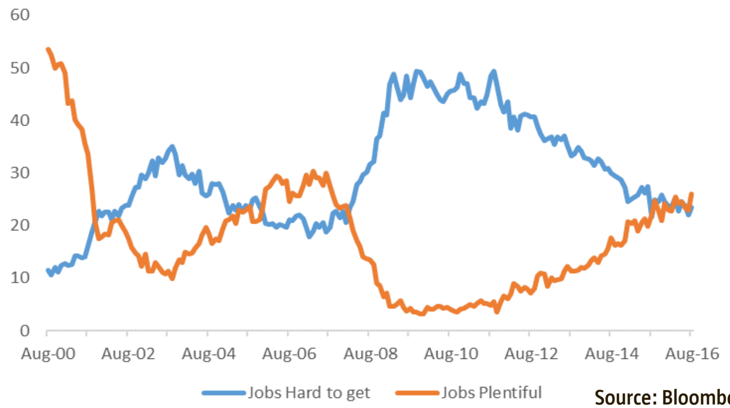
- Based on the monthly returns of August, it is difficult to find a common theme. The two strongest currency within the G10 were both commodity currencies, but while the Norwegian krona is mostly seen as a oil proxy, this is definitely not the case for the New Zealand dollar, where normally milk prices are seen as a signal for how terms of trade are developing.

- What is probably more interesting is what wasn't a theme in August, namely the comeback of possible rate hikes in the US. The Fed has slowly been running out of excuses not to hike, such as dissipating risk from international developments, massively improving financial conditions (fresh highs for the S&P 500 and tightening spreads), and a jobs market that has maintained its positive momentum. Yes, we concede that headline inflation still isn't where the Fed wants it to be, but this may still not warrant the currently extremely loose monetary policy, especially as core inflation rates have increased.

- What is also troubling is that the Fed is not transmitting a coherent message. It kind of resembles the ECB under the helm of Jean-Claude Trichet. Ultimately we think this is damaging and will eat into the Fed's credibility. We were looking for a hike this year and still are, but our conviction level is fading a bit, due to **>>**

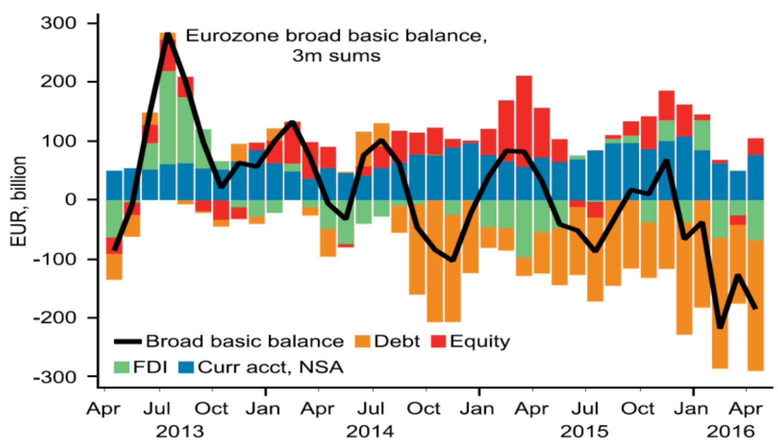
FX (II)

US jobs market has reached an important inflection point



Source: Bloomberg

Money leaving the Eurozone needs to continue to prevent currency strength



Source: Bloomberg and BNP

- the last manufacturing ISM number that was below expectations. The strange thing is that while the US figure was weaker, the UK's PMI reading was surprisingly strong, and firmly above 50. This was by the way not the only strong number out of the UK; retail sales and consumer confidence also rebounded. The direct Brexit fallout appears limited, which prompted us to close our long US dollar/short British pound position, which had served us well as a Brexit hedge. We do not think that the UK is out of the woods, but the positive data flow and the fact that almost everyone is positioned for a weakening of sterling will make the pound susceptible to sharp movements. We will look for better levels to re-enter short pound positions.

- We remain overweight the US dollar against the euro. Up until now this pair hasn't delivered what we expected. The pair remained in a tight range (between 1.09 and 1.14) during the second part of the year. This is mainly due to a disappointing Fed, but local conditions also played their part. For one, European numbers held up better than expected. Also, the positive Eurozone current account needs to be compensated by continued capital outflows to prevent it becoming a prop for the euro. The ECB also needs to start guiding the market on the future of its asset buying program. If the ECB fails to address this timely and properly, we risk looking at a stronger euro.

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