

2015 Global Outlook

Global Fixed Income & Economics Research

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When Two Worlds Collide...



After a period of historically low volatility, driven in part by the predictability of Fed policy, the macro world has come to life in recent months. We expect this awakening to continue over 2015, with changes in both relative economic performance and monetary conditions across regions driving major shifts in capital flows and asset pricing.

Of course, such changes are, by their nature, uncertain and rarely orderly. As the cold fronts from some central banks collide with the warm fronts from others, at the very least, we expect more market storms than seen in the past few years.

We expect the divergence in short rates between regions to widen further and the US dollar to continue to rise against most currencies. Credit markets are likely to remain volatile but outperform, while securitized products should benefit from better fundamentals as well as some positive technicals. Higher US rates might prompt footloose capital to leave Emerging Markets, although we think that specific countries are vulnerable, rather than the whole asset class.

For equity markets, 2015 could be a year of two halves: we expect the S&P 500 to rally to 2200 by mid-year, notwithstanding an increase in volatility, but to give up some of the gains in the second half as the Fed comes into play.

DISCLOSURE APPENDIX AT THE BACK OF THIS REPORT CONTAINS IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS.

Table of Contents

Foreword	3
Credit Suisse's Top Ten Trades for 2015	4
Executive Summary	7
2015 Global Macro Outlook	8
The World Economy in 2015.....	11
Oil in 2015: Lower, or Much Lower Prices?	25
Defining New Frontiers	29
Why Barriers to Policy Divergence Will Not Hold	31
Pressure Points for Capital Flows into Fed Tightening	37
Coping with Higher US Rates	47
USD Rally: How Far and For How Long?	55
Expected Returns & Risk Analysis.....	59
Tail Risk Hedging	67
2015 Global Product Outlook	70
Credit.....	73
Global Leveraged Finance	73
European Credit	79
Latin America Corporate Credit.....	84
Emerging Markets	87
Global Equities	95
Foreign Exchange	101
Global Interest Rates	107
US Rates	107
European Rates	112
Securitized Products	117
Agency MBS.....	118
Non-Agency MBS.....	120
CMBS	121
European SP	124
Global Demographics and Pensions.....	127
Technical Analysis	131
Credit Suisse Forecasts	135

Foreword

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Seven years since the onset of the “Great Recession,” a ray of sunshine is breaking out in parts of the global economy. At the same time, however, the cloud of deflation continues to hang over other regions, while concerns about structural conditions remain a universal theme.

Declining fertility in most major economies over the past half century has caused slowing growth of working-age populations and, in some major economies, outright shrinking of workforces. This makes it harder to generate GDP growth at the customary rates of the past. Meanwhile, medical advances that have extended life spans have created larger claims on GDP to support burgeoning numbers of older citizens.

The G-20, representing about 80% of global GDP, is finalizing its Annual Summit in Brisbane, Australia, as we draft this note. The keystone agenda item is a goal of raising global GDP by 2 percentage points over the medium term. The motivation is obvious, and success is much to be hoped for.

We note, however, that whatever the longer-term trend, much of financial life resonates with the shorter-term cyclical fluctuations. Think of the trend as climate and the cyclical fluctuations as weather. Whether to carry an umbrella or put on sunglasses is a decision informed by the weather forecast. Similarly, in financial life, most of what happens any month or quarter (and probably even any year) reflects the cyclical ebb and flow of economic conditions.

Cyclically, the global economy is showing a remarkable divergence of performance, with these fluctuations exacerbating underlying structural differences. The general reluctance to use fiscal stimulus – indeed, sometimes aggressive efforts to tighten fiscal policy, as with the large American tax increases of 2013 and the Japanese VAT hike of 2014 – has left the job of supporting economies to the central banks. Whether easy money did the trick or not, the US and the UK are enjoying a sturdy improvement in business conditions, most visible in labor markets. Not surprisingly, therefore, balance sheet expansion has long since ceased at the Bank of England and has just concluded at the Federal Reserve. We expect both central banks to begin to take away the punch bowl (or at least dilute the strength of the cocktail) in 2015.

Meanwhile, cyclical circumstances in Japan and the euro area are far more challenged, with the Bank of Japan and the ECB plunging more determinedly into balance sheet expansion programs as they attempt to put the deflation genie back in the bottle.

This is the first time in many years that financial markets have been asked to absorb such a striking disparity in monetary policy settings. When combined with the normal uncertainties associated with the beginning of a US tightening cycle, it would be no surprise if market participants consider a broader range of possible outcomes as the cold fronts from some central banks clash with the warm fronts from others. At the very least, we expect more market storms than seen in the past few years as the two worlds collide.

The market barometer of financial volatility was mostly stuck on “Fine” in the past two years as all major central bank policy settings pointed in the same direction. With monetary policies now set to blow hotter in some places and cooler in others, we expect the barometric pressure of market volatility to fluctuate. Both volatility and the “vol of vol” look likely to rise in 2015.

The essays that follow explore fundamental business-cycle conditions in major blocs of the global economy and draw what we see as the implications for financial life, including broad themes and specific favored trade ideas. We hope that you find these essays useful in developing your 2015 strategies, and we look forward to continuing to work with you as the year unfolds.

We thank you, our readers and clients, for the business relationships we share and for the personal and professional growth that interacting with you provides. We wish you great success in finishing 2014 and mapping your strategies for 2015.

Credit Suisse's Top Ten Trades for 2015

1. Sell EURUSD

Rationale: We expect further monetary policy divergence next year, with the ECB moving toward full-blown QE while the Fed commences the first tightening cycle in ten years at the June FOMC.

The Trade: Sell EURUSD at 1.2475 with a target of 1.1500.

Primary Risk: Lack of anticipated policy divergence.

2. Buy TOPIX Currency Hedged

Rationale: Bank of Japan balance sheet expansion should re-enforce an asset-allocation shift into inflation hedges (equities and property), earnings revisions remain excellent (and are not driven by the weaker yen), and valuations are cheap.

The Trade: Buy the TOPIX at 1377, targeting 1520, currency hedged.

Primary Risk: Abe popularity declines to levels that force the return of pre-Abe policies.

3. Buy FX Implied Volatility

Rationale: A tug-of-war around unconventional ECB policy amid deflation risk and general elections in Spain and Portugal in 2015 should lead to higher implied volatility as the year progresses.

The Trade: Buy 1y->1y EURUSD FVA. Entry 8%, targeting 11%.

Primary Risk: A generalized decline in the EURUSD vol surface.

4. Sell Front-End USD Rates

Rationale: We expect the Fed to hike 75bp-100bp by the end of 2015 as the FOMC begins the slow process of removing the "emergency monetary stimulus."

The Trade: Buy risk/reversal in Dec-15 Eurodollars (long 98.75 puts versus 99.625 calls). Entry 0bp net premium, targeting 15bp.

Primary Risk: Fed tightening expectations being pushed into 2016.

5. EUR 10s30s Flatteners

Rationale: The long end in EUR swaps looks too steep relative to the front end and is too optimistic on the effectiveness of sovereign QE, in our view. Flatteners should perform well in either a sharp rally or a sell-off and act as a good hedge to pro-QE trades.

The Trade: Establish 10s30s EUR flattener at 74bp, targeting 60bp.

Primary Risk: Large-scale ECB buying in the 10y area of the curve.

6. Sell Gold

Rationale: Gold remains very expensive relative to historical norms, with carrying costs becoming more penal as US interest rates begin to rise. Our technical analysts target a fall to \$950 by end-2015.

The Trade: Sell XAUUSD at \$1167, targeting \$950.

Primary Risk: Delayed Fed tightening.

7. Overweight US CMBS Credit

Rationale: CMBS is highly leveraged to the ongoing recovery in US nominal incomes and has underperformed in the recent credit re-rally.

The Trade: Overweight CMBS, targeting 15bp-20bp of tightening.

Primary Risk: A re-weakening of the US economy.

8. Buy US BB HY versus US CCC HY

Rationale: Lower-rated names tend to underperform during Fed tightening as a result of their higher refinancing exposure.

The Trade: Overweight BB HY, at a spread of 311bp, and underweight CCC HY, at a spread of 857bp, targeting a spread widening between these categories of 125bp.

Primary Risk: Delayed Fed tightening.

9. Buy Front-End EUR Peripherals

Rationale: This is an attractive and relatively protected carry trade that should benefit from further ECB easing measures.

The Trade: Buy 2y Spanish bonds. Entry yield 0.47%, target 0.15% yield.

Primary Risk: Weakening European fundamentals with no commensurate policy response.

10. Buy Indian Bonds Against Paying Low Yielders

Rationale: Falling inflation in India creates an outlook for policy rate cuts that is still not fully priced. Supply constraints imply buying sell-offs in India and any increase in foreign quotas. In contrast, Israel's rates could underperform substantially in 2015 given rich valuation, high-beta to (rising) US Treasuries, and an improving growth outlook.

The Trade: Buy India 2019 bonds against paying 4y-5y Israel IRS.

Primary Risk: Unfavorable inflation dynamics in India.

For more on these trades and their rationale and risks, please see the linked sections of this report.

Executive Summary

The core view presented in our *2015 Global Outlook* is that [the Federal Reserve will raise interest rates around the middle of the year](#), thereby marking the beginning of the end of the longest period of financial repression in the developed world since immediately after the Second World War. This process will occur even though Europe, Japan, and, to a degree, China face a far less rosy outlook – 2014 ends with economic policies in all of them subject to significant change.

We do not expect the adjustment away from exceptional stimulus to be rapid or straightforward but [believe that US interest rate markets currently price too little into the front end of the curve](#) for the likely pace of Fed tightening. Similarly, merely the expectation that US rates can rise should be enough to [drive substantial capital flows to the benefit of the dollar](#).

For financial markets that have adapted to the expectation of semi-permanent zero nominal interest rates, the changes are likely to be profound at many levels. At the same time, as investors have extended duration and credit risk exposure to lock in yield, [the micro structure of markets has evolved toward reduced sell-side capacity to intermediation and increased availability of market liquidity for retail investors](#).

This is not a combination that encourages thoughts of stability when central bank policy tightens! Because an expectation that the US economy will remain strong lies at the heart of our outlook, the implications within the US credit markets are mixed: we advocate [trading out of US HY CCCs](#) as a result of their exposure to Fed tightening but think that [CMBS should benefit from the improving quality of the underlying collateral](#).

At a portfolio level, this makes for less exciting returns: we expect lower Sharpe ratios amid increased financial market volatility. [FX implied volatility is an attractive way to gain exposure to this theme, in our view. At a product level, we think that duration-sensitive assets are most exposed](#) and also [highlight a number of EM economies that we expect to be tested by the change in Fed policy](#).

With so many moving parts, a lot can go wrong. We are conscious that expectations for a similar sell-off in US rates and a rally in the dollar were disappointed in early 2014, when the polar vortex took hold of the US economy. Even today, after a year of sustained gains in US employment, the notion that the Federal Reserve might tighten appears wrong-headed to many (especially outside the US).

The reasons for doubt are various, and although we think that the US ultimately will prove resilient, these concerns are likely to come and go as the year unfolds:

- With the BoJ and perhaps the ECB engaging in QE, the scale of G3 policy divergence is likely to be the largest since German re-unification. We think that QE outside the US will make it easier for the market to adjust to Fed tightening. [We are particularly constructive on non-US equity markets in 2015](#), while we also expect [euro credit](#), [peripheral front ends](#), and [ECB-eligible ABS](#) to deliver excess returns.
- Falling goods and commodity price inflation may be seen as a deterrent to tightening, as seen, for example, in the latest BoE inflation report, but [we think that the fall in oil prices is supply-driven](#) and will ultimately act as a growth stimulus.
- Similarly, [the absence of wage inflation has held back policy tightening in the US \(and the UK\), but we think that this is likely to change in 2015](#).
- Finally, the euro area continues to struggle to implement coherent policy measures to boost aggregate demand and banish deflation risk decisively. Elections in 2015 entail greater political risk than in 2014, but on balance, we expect policymakers to contain European financial risks either through QE or Europe's specialty: "muddle through."

[Net, for asset allocators, this leaves us with a central portfolio recommendation of overweighting non-US equities and risky credit and being long the dollar. We also review liquidity risk management strategies, which we expect to be a source of two-way risk and opportunity in 2015.](#)

2015 Global Macro Outlook

2015 Core Views

The World Economy in 2015

- In 2015, we expect improved global growth and a mid-year increase in US interest rates. The ECB and the BOJ remain in easing mode, and the policy outlook in the rest of the world varies considerably.
- The risk that global growth remains sluggish is high, and a lack of meaningful improvement outside the US could lead to a sharp increase in the dollar and a significant reorientation of capital flows.
- Most regions should see decreasing growth headwinds in 2015, although geopolitical uncertainties, volatile oil prices, and moderating Chinese growth remain concerns.

Oil in 2015: Lower, or Much Lower Prices?

- In 2015, we expect oil markets to find a new, lower price range around \$92 per barrel (/b) for Brent – nearly 20% lower than the \$110/b average of each of the last three years and 12% below the estimated \$103/b 2014 average. Most of the risk, in our view, is on the supply side.
- Aside from by now-familiar risks to exports from sovereign producers across MENA and worries on the demand side focused on Europe and China; the critical variable, in our view, is Saudi Arabia. We assume that it will continue to balance oil markets – much like the "central banker of oil" should.
- But the Kingdom may be deciding to abandon its swing producer role. And if the Saudis were to continue to over-supply oil markets, then prices would fall much further. A 2015 "equilibrium" could be \$80 Brent, down fully 25% from 2014, or lower.

Why Barriers to Policy Divergence Will Not Hold

- Policy divergence will be a key theme of 2015. We expect monetary policy to tighten in the US and UK and ease in the euro area, Japan, and other Asian economies.
- But three issues have led markets to question whether policy in the US and UK will, in the end, diverge from the rest:
 - weak or no growth in the euro area;
 - low CPI inflation on the back of falling commodity and goods prices; and
 - an absence of wage inflation in the US and UK despite a tightening labor market.
- We acknowledge the risks but believe that, in the end, they will prove largely immaterial to the prospect of US and UK tightening next year.

Pressure Points for Capital Flows into Fed Tightening

- Following a long period of widespread financial repression, the prospect of Fed tightening awakens a host of opportunities, especially for money market investors and in FX markets.
- We believe that it will also highlight pressure points resulting from changes in market structure that increase risk concentration and raise the likelihood of price gaps.
- In particular, we focus on how retail investors' access to liquidity has improved, how these investors tend to be trend-following, and how, in some sectors, they have grown to represent 25%-30% of the market.

2015 Global Macro Outlook

2015 Core Views

Coping with Higher US Rates

- Fed tightening should lessen Europe's gravitational pull on US yields; we expect a belly-led sell-off to deliver more curve flattening than is currently priced.
- We expect the impact of higher US yields on European yields to be contained but expect a modest steepening in EUR 2s10s and peripheral spread tightening. The gradual pace of UK rate hikes should contribute to Gilts outperforming Treasuries.
- For EM, we expect a potentially volatile "transition" toward a "new equilibrium" distinguished by greater risk differentiation.

USD Rally: How Far and For How Long?

- We expect spread widening in the USD's favor above and beyond what's already in the price. This means that our cyclical framework is USD-positive.
- Our view is based on cyclical US economic outperformance, structural flows such as GPIF-related outflows from Japan, as well as the prospect of further monetary easing from other major central banks, such as the ECB.
- Current NEER USD valuation is cheap compared to longer-term averages.

Expected Returns & Risk Analysis

- Our base case for 2015 includes another year of strong returns in global equities and modestly negative returns in fixed income.
- Better-than-expected global economic growth should improve returns over the base case, while subdued growth should reverse return expectations, with fixed income outperforming and equities returning slightly negative.
- Our Black-Litterman-type asset allocation model favors equities at the expense of other assets but recommends maintaining the benchmark allocation to risky fixed income in the base case.

Tail Risk Hedging

- Navigating the increasingly common occurrence of "rare" tail risk events and unprecedented policy actions has become crucial for investors.
- We outline systematic strategies that exhibit three key features of tail risk hedging: (1) asymmetrical payout (high return in periods of stress, little or no performance erosion in normal market conditions); (2) high liquidity in the instruments traded; and (3) the ability to be positioned accurately to absorb tail risk events.

The World Economy in 2015

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2015 Core Views

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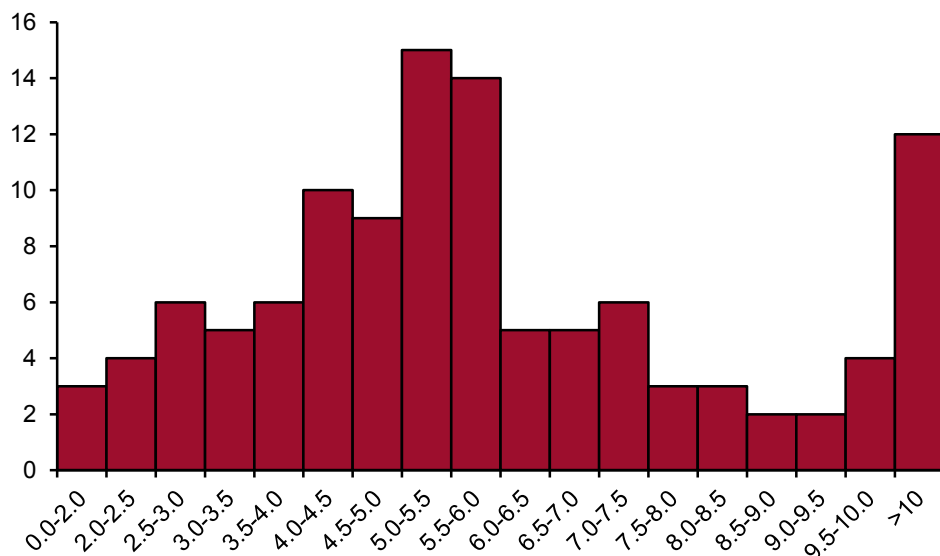
Policymakers whose decisions are based on domestic objectives tend to disrupt growth, markets, and policies oceans away. It has always been this way. And in 2015, this feature of the world is likely to be as controversial as ever.

The Fed is likely to hike in 2015, despite uncertainty in other major economies

Sometime next year, the Federal Reserve is likely to raise interest rates for the first time since June 29, 2006, before many current market participants began their careers. This occurs at a time of considerable uncertainty in other major parts of the world economy.

The Fed will act because the US unemployment rate and core inflation trend are both close to their expected long-run averages.

Exhibit 1: Annual average unemployment (1900-2013)



Source: Credit Suisse, Bureau of Labor Statistics, NBER

Although extremely easy policy is no longer obviously necessary from a US perspective, things look different viewed from other parts of the world. Global growth disappointed in 2014 and slowed through most of the year.

In Europe and Japan, further monetary stimulus is being considered to counter weak growth. Chinese growth appears to be structurally slowing, and the performance of many emerging market economies has been disappointing. Some investors believe that a global disinflationary trend remains in place.

Which view is correct? A US economy firm enough for Fed hikes or a global economy so weak that all central banks must remain in deflation-fighting mode?

A hiking Fed could still be an accommodative Fed

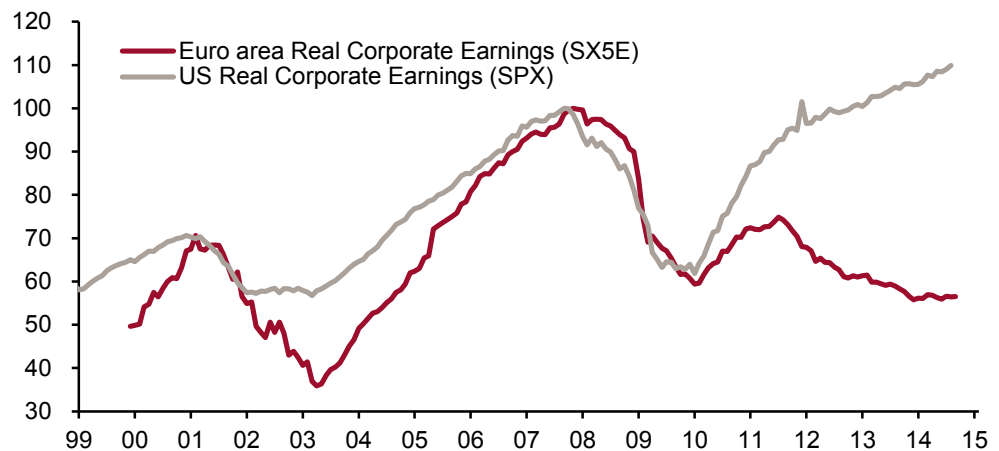
The answer might be that both are true. US hikes, even if they push the fed funds range up to 1%-1.25% by the end of next year, will leave real rates sharply negative and far below GDP growth. A hiking Fed could still be an accommodative Fed.

In addition, Fed hikes might strengthen the dollar, providing some reflationary relief to Europe and Asia, where it will be most welcome.

The market response to these changes will depend critically on how well the global economy recovers in 2015. If global growth improves, the economies with the largest output gaps – such as the euro zone – may see risky asset prices bounce sharply from depressed levels. The huge gap between corporate earnings in the US and Europe hints at massive room for improvement.

Exhibit 2: US and EA real corporate earnings

12m trailing EPS, indexed to pre-crisis peak



Source: Credit Suisse, Thomson Reuters Datastream

Improving business and consumer confidence in Europe could cause credit demand to pick up – making any given amount of monetary stimulus more effective. We believe that such a dynamic has already occurred in the US and UK.

We could imagine a very different scenario, however, in which global growth remains muted even with a stronger dollar and capital flows strongly to the higher yielding US.

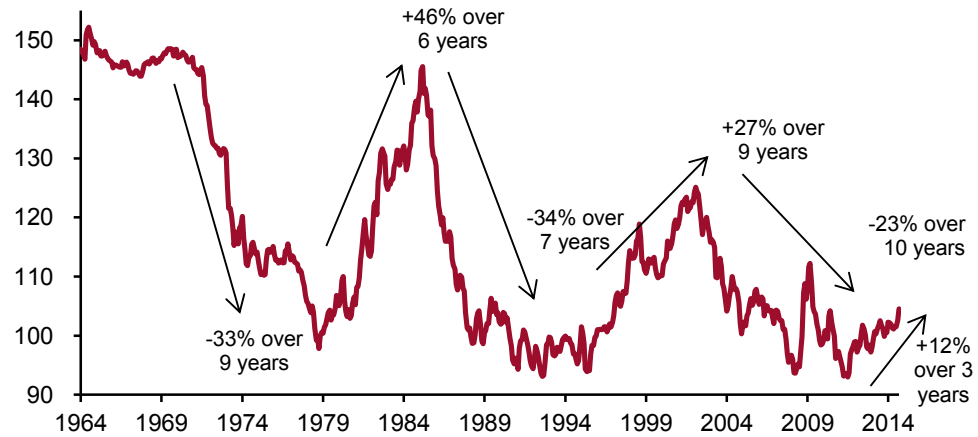
Those who are convinced by low terminal rate arguments should be mindful that such views contain implicit assumptions for hard-to-forecast variables, such as capital flows and energy prices. If, in the coming years, the Fed believes that “neutral” policy is appropriate, an environment that supports strong foreign demand for US duration and credit risk might require higher short-term rates than the market currently expects. Otherwise, low credit spreads and longer-term rates could undermine the purpose of higher short-term rates. Falling oil prices could create a similar dynamic.

We are concerned about excesses from years of zero rates

Meanwhile, we are concerned about excesses caused by years of zero rates. Specifically, we worry about the behavior in recent years of investment managers whose liability structure or other mandates have forced them to target unrealistically high returns in a zero-rate environment.

Strong nominal growth, global zero interest rate policy, and abundant liquidity can hide a lot of credit risk. A key risk in the next few years is that much of the world economy suffers from chronically disappointing nominal growth while rising US rates and expectations of dollar strength suck capital away, exposing risks that have been ignored.

Exhibit 3: USD real effective exchange rate



Source: Credit Suisse, Haver Analytics®

Large-scale reorientations of capital flows have the potential to cause disruptions

Large-scale reorientations of capital flows come along only occasionally and always have the potential to cause disruptions, particularly in economies that are financially underdeveloped, are disproportionately dependent on commodity prices, or are chronically large net debtors.

Global growth must improve while US hikes begin...

Therefore, it is imperative that global growth picks up while the US hikes begin. Otherwise, although a stronger dollar might help fight disinflation, a wave of financial stress may occur in economies whose credit assets looked attractive in a world of zero rates and a weak dollar but which will have trouble competing with positive yields on "safe" US assets amid a positive dollar trend.

...as the world will blame US policymakers if rising rates lead to crises

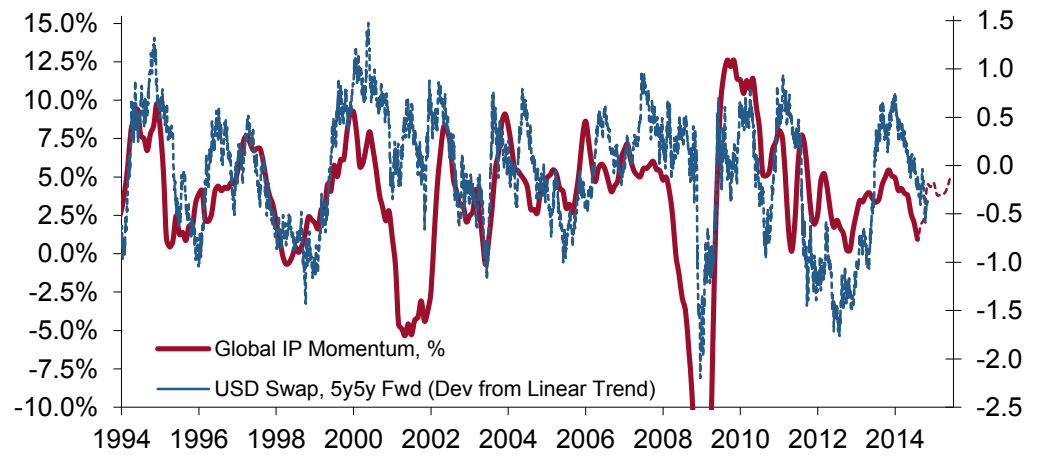
This would revivify an old debate that has raged for a century. Ever since the demise of the gold standard and the beginning of true countercyclical monetary and fiscal policy, the world has faced difficulties, because policy is almost always conducted with domestic objectives in mind and few international coordination mechanisms.

The world will blame US policymakers if rising rates lead to crises amid fragile global growth. This dynamic is not dissimilar to the current state of affairs in Europe, where a German economy experiencing low unemployment has very different policy objectives from its neighbors.

It is even possible that negative global impacts of a US tightening cycle will affect US growth and render correct the market's apparent current expectations of very low terminal rates. Similarly, Germany's tight [fiscal] policy is damaging for its neighbors, and a fragile European economy ultimately threatens Germany.

Growth is the answer to these problems, but will growth occur?

Exhibit 4: Global IP momentum versus USD 5y5y forwards



Source: Credit Suisse

REVIEW OF 2014

As we pen this 2015 outlook, we are acutely aware that 2014 began with many investors extrapolating recent trends and predicting stronger global growth, higher yields (the US 10y had hit 3%), and a strong US dollar. And that for a variety of reasons these predictions proved ill-founded over the first half of the year. Given that knowing where we have come from is a key factor in accurately predicting where we are going, in this box, we reflect on 2014, the year that was.

2014 began with many investors extrapolating strong global growth. However, rather than picking up further, global growth had already peaked at a strong clip and was set to slow dramatically in 1Q, with three-month/three-month global IP growth falling from 5.5% in November 2013 to around zero mid-year. Unsurprisingly, rather than moving higher, against this growth backdrop, yields almost everywhere came down sharply, while the dollar fell modestly over the first six months of the year.

The reasons for slow growth in 1H 2014 were complicated. 1Q US GDP fell sharply, owing to a combination of low exports to China, inventory adjustment, cold weather, and a quirky fall in health care spending, probably related to the difficulties of accounting for the effects of the Affordable Care Act. However, the most reliable and countable measures of US economic performance – such as retail sales, jobs growth, and nominal income growth – held up through this period, which was followed by 4.5% and 3.5% growth in the next two quarters, respectively.

After a weak 1Q, US economic strength contrasted with that in the rest of the world

Mid-year US economic strength contrasted with the rest of the world. Japan's 2Q VAT tax hike had a much bigger impact on domestic consumption than was generally expected. Japan suffered huge declines in industrial production in the second quarter, followed by a disappointing recovery in the third.

The rest of Asia may have been affected by Japan's weakness as well as other factors. By late summer, it was clear that Chinese growth was disappointing and that many of the smaller Asian economies were also languishing.

By our estimates, the EEMEA region's growth rate slowed to 2.2% in 2014 from 2.5% in 2013. However, the growth performance was divergent across the region. Real GDP growth accelerated in all CE3 countries to 2.5%-3.0% in 2014, driven by stronger exports to the euro area in 1H 2014 and a pick-up in domestic demand. Elsewhere in the region, however, real GDP growth slowed as a result of idiosyncratic developments – Russia's geopolitical problems, Turkey's aggressive monetary policy tightening in early 2014, South Africa's labor strikes in the platinum and manufacturing sectors, and Israel's military involvement in Gaza.

In Europe, a recovery seemed to be under way, but sometimes, it seemed that Europe's business sector and investors did not notice. Consumer spending and investment in Europe have trended up since 1Q 2013, but the latter appears to have slowed recently. Exports from Europe to Asia held up in the first half of the year, but in recent months, global sales expectations and investment intentions from Europe-based firms appear to have lunged lower, and the market has reacted to this.

Inflation continues to complicate the European outlook

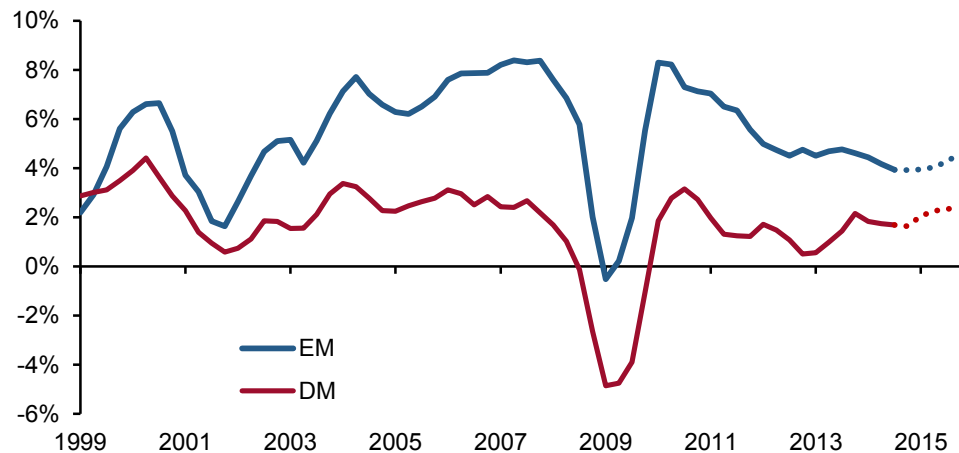
Complicating matters is that inflation, almost always a statistical process that lags growth by several quarters, has remained low in most economies, but especially in Europe. Headline inflation below 0.5% and core inflation below 1% have prompted the ECB to unveil TLTROs and asset purchases, but those new policies have also increased uncertainty about the European outlook, especially in economies such as Germany, where there is widespread skepticism about the efficacy of non-traditional monetary policy.

A look ahead

Global growth is unlikely to be as weak in 2015 as it was in 2014. Our assumptions on regional performance support a global recovery with 3%-5% growth next year in global industrial production and goods demand and global GDP growth slightly above 3%, compared to 2.6% in 2014.

Exhibit 5: 2015 GDP growth should accelerate in DM and EM

Real GDP growth (yoy %)



Source: Credit Suisse

US

We expect US GDP to grow better than potential, thanks to labor strength and oil weakness

We expect US real GDP growth to average 3%, better than potential growth, which is just above 2%, in our view. The labor market recovery appears to be on a sustainable path, with positive feedback effects into credit growth, consumer confidence, and business confidence. Fiscal drag is diminishing in 2014 and should remain modest. Also, the recent fall in energy prices, if sustained, would deliver a substantial “tax cut” for the household sector worth about 0.7% of disposable income, or about \$80 billion. Combined with continued steady growth in jobs, and perhaps a firming in nominal wage growth, real household income should be strong in the first half of 2015, underpinning consumer demand.

Moderate growth in residential investment is likely, although tight credit standards and a dearth of qualified first-time homebuyers are working against a more full-bodied recovery. While it's premature to assess the impact, a new effort by US agencies to relax mortgage credit availability could alter this dynamic.

The plunge in crude oil prices could lower headline inflation toward 0.5% by spring of next year. Core PCE inflation is expected to edge up modestly in 2015 but remain below 2%. Tighter labor markets and firming shelter inflation should impart some upward pressure, but weakness in the global economy should leave goods prices subdued.

We expect the fast-improving US labor market to prompt a Fed hiking cycle from June 2015. Our baseline expects the fed funds rate target to be hiked to a range of 1.00%-1.25% by year-end 2015. The key risk to this view is low core inflation.

Risks to growth are broadly balanced

Risks to the overall growth outlook are broadly balanced. Easing domestic financial conditions could be reinforced by global capital flows, especially if global growth does not recovery strongly. Lower gasoline prices could produce a larger positive shock to non-energy spending than we expect. Business investment and household formation look overdue for faster recoveries than in recent years. Also, the unemployment rate could fall faster than FOMC projections (again), as a strong cyclical recovery in labor force participation is unlikely.

Downside risks include anemic growth in Europe and China and a rising trade-weighted dollar exchange rate, with both affecting corporate profits and exports negatively. A disorderly market adjustment to Fed hikes is another risk. Substantially lower oil prices could depress new investment in the energy sector. A new round of federal budget showdowns is also possible, particularly if Republicans are galvanized by winning the Senate.

Europe

Having accelerated out of recession in 2013, the euro-area economy has suffered a modest slowdown since the spring. This was partly driven by external factors – weaker demand in Asia and geopolitics (Russia/Ukraine). Investment plans have been scaled back, but overall domestic demand has been resilient.

With most deleveraging over, we expect Europe GDP to grow at 1.1%

Cyclical momentum now looks to be bottoming at levels consistent with anemic but positive growth, reflecting the turn globally. We think that there's scope for the domestic recovery to strengthen. The euro area has suffered an unusually prolonged deleveraging cycle, with brutal balance sheet adjustments in the private, public, and, more recently, financial sectors. With the conclusion of the ECB's comprehensive assessment of the banking sector, we think that the worst of that deleveraging is now over. With credit easing measures now being implemented by the ECB, there's scope for stronger demand growth in 2015. Overall, we expect 1.1% GDP growth next year.

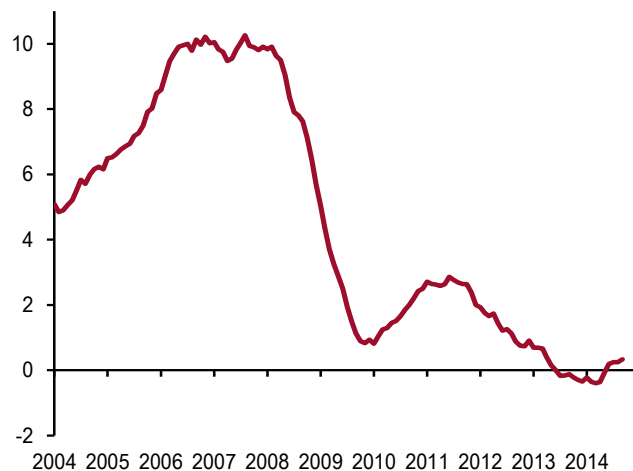
We foresee more easing, including government debt purchases

Risks remain. Weak growth and a bloated current account surplus leave the euro area unduly sensitive to external growth. And the ongoing structural slowdown in China presents a headwind to exporting economies such as Germany. A weaker euro would help offset that, stimulating those economies whose tradeable sector is more price sensitive, such as France and Spain. But that may require more ECB easing. We think that will come – the recent move to a more active expansion of its balance sheet will, we think, involve the purchase of government debt next year. Inasmuch as persistently lower inflation is likely to keep markets concerned about the risks of deflation, it should also keep the ECB expansionary.

Political risk may also resurface next year. Greece may have another General Election in 1H, raising the prospect of a more confrontational approach to its official creditors. And then Portugal and Spain both go to the polls at the end of the year. High levels of unemployment raise the risk of political turbulence there as well.

Exhibit 6: Euro-area bank deleveraging is easing

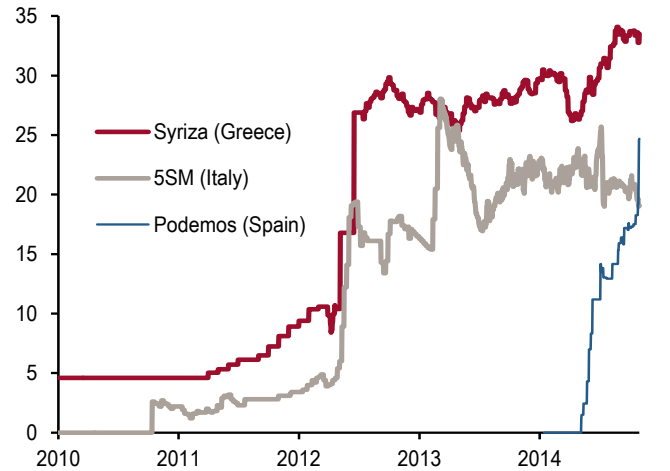
Credit to the non-financial private sector in the euro area, yoy %



Source: Credit Suisse

Exhibit 7: Political risks are not diminishing

Intention votes by the largest non-mainstream party in Greece, Spain and Italy



Source: Credit Suisse

UK growth should remain above-trend, and wage strength should lead to an MPC hike in the first half of 2015

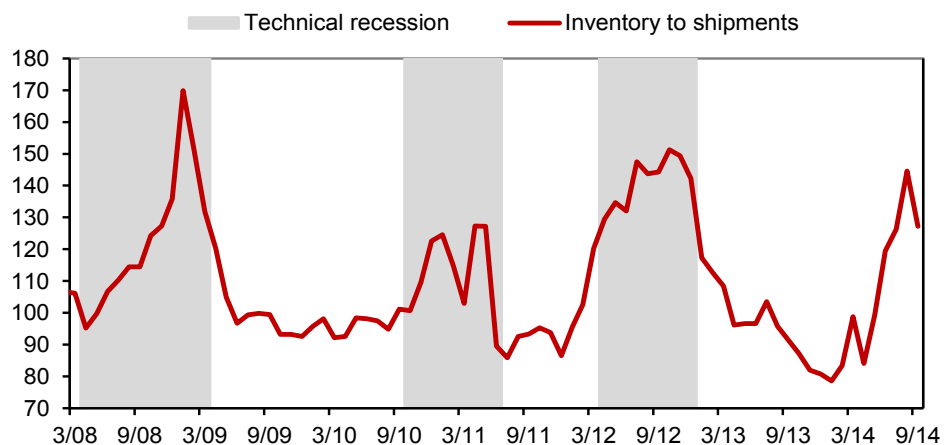
By contrast to the euro area, the UK economy has grown rapidly over the past year, and even if momentum has recently slowed, we expect growth to maintain an above-trend pace. Corporate confidence, investment, and employment intentions remain solid, and a combination of strong investment and consumer spending looks self-sustaining. Rapidly declining unemployment should continue in 2015, pushing the rate down well below 6% and, we think, start to generate upward pressure on pay growth. Although the tone from the Bank of England is currently dovish, a tighter labor market generating higher wage growth should change that. So we expect the MPC to start raising rates in the first half of next year, taking them to 1.5% by the end of 2015 and 2.5% by the end of 2016.

Similar to the euro area, the key uncertainty is politics. The outcome of the May General Election is extremely uncertain. Given that the UK's large fiscal deficit still requires correction, it is possible that a change of government could precipitate a more restrictive fiscal stance that would dampen demand growth and consequently negate the need for further monetary tightening.

Japan

Japan suffered from stagflation in 2014, as rising import prices and consumption taxes drove headline inflation above 3%. Real wages and consumption collapsed, the manufacturing inventory-to-shipments ratio spiked (in particular for consumer durables – see Exhibit 8), and the labor market (hours worked and job offers) visibly deteriorated.

Exhibit 8: Japan's inventory-to-shipments ratio for durable consumer goods (2010=100)



Source: BLOOMBERG NEWSSM

These headwinds persist and will limit the private-sector recovery in 2015, although there are sources of relief as the initial impact of the tax increase erodes. Falling CPI inflation and improving real household income should underpin a partial consumption recovery. The decline in real wages has boosted corporate profitability, and capex should benefit from ongoing recovery and a replacement cycle in machinery. Real net exports also should continue to contribute positively to GDP growth. However, ongoing cyclical recoveries in capex and exports will not be enough to re-accelerate private-sector economic activity in 2015. Ultimately, capex and net exports have a declining sensitivity to both the real cost of capital and the real exchange rate, due to overseas outsourcing of production.

Headwinds from 2014 should persist into 2015, and QE effectiveness should be diminished

The surprise decision by the BoJ on 31 October to speed up the pace of its monetary base printing through more aggressive JGB monetization is unlikely to alter the outlook materially. As a result of a "saturation" problem for commercial banks' excess reserve holding, we question the sustainability of more aggressive QE, under the new JGB purchase target (about 10 trillion yen per month, equivalent to 86%-87% of gross issuance of JGBs, including

redemption bonds) in a technical sense. More importantly, structural impediments – such as aging demographics, a sharp rise in energy costs due to the shutdown of nuclear power plants, remaining weak productivity of the services sector, and stubborn pessimism among households about the future course of real disposable (after-tax) income – are reducing the effectiveness of QE.

All in all, we think that growth will decelerate somewhat in 2015

The direction of fiscal policy is unlikely to change much, with steady and gradual tightening on the way. The government now looks in favor of postponing the second VAT hike (from 8% to 10%) by 18-24 months into 2017, and we expect the other austerity measures, such as downsizing of the social security program, to be introduced to make up for the prospective tax revenue loss for 2015/2016. Although we do not rule out the government opting by year-end for another package of economic relief measures centered on subsidies to lower-income households and local governments suffering weak fiscal positions, we expect a negligible GDP impact. As structural reform initiatives necessary to raise the potential growth rate are expected to be implemented slowly, we do not see any strong reason to upgrade the economy's longer-term outlook. All in all, we believe that the real GDP growth rate is unlikely to accelerate into CY2015.

China

Chinese policymakers appear to be focused on the quality of structural reforms rather than GDP growth. Ideally, this will improve long-run growth sustainability by optimizing resource allocation. However, the short-term costs are high, especially for an economy that has shown increasing signs of vulnerability since 2008.

GDP growth should moderate, as policy focuses on structural reforms

We expect GDP growth to moderate further, to 6.8% in 2015 from 7.4% in 2014, an already-low number by recent Chinese standards. Depressed margins and abundant capacity are likely to continue to affect investment growth negatively. Changing incentives among economic agencies also matter. For instance, political risks from the anti-corruption campaign have significantly reduced local officials' desire for visible prosperity, delaying project approvals regardless of their quality.

Reform-induced political and economic uncertainties have also overshadowed household income and wealth growth. However, we expect overall consumption to be relatively resilient next year, if property prices stabilize at low levels, service-sector income growth should improve and saving rates decline. These assumptions partly rely on policy success in rebalancing the economy toward consumption and away from investment. Housing policies have significantly eased, particularly for non-speculative buyers.

Fiscal or credit policy measures are unlikely; monetary policy should accommodate stability

Despite moderating growth, aggressive counter-cyclical fiscal or credit policy is very unlikely unless systemic distress occurs. We expect monetary policy to accommodate economic transitions and prevent liquidity crises from debt service rollover. Despite this year's debt-maturity extension in the local bond market, we expect significant debt rollover in early 2015, a risk possibly magnified by a likely soft patch in growth. Besides guiding inter-bank rates lower with recently introduced quantitative policy instruments, there is a decent chance that the PBoC will cut deposit rates and reserve requirements and try to boost bank loan-to-deposit ratios in response to persistent economic weakness.

Latin America

Latam GDP growth should accelerate to 3.3% from 1.7%

Growth dynamics in Latin America ex-Brazil are likely to improve in 2015, with real annual GDP growth accelerating to 3.3% from 1.7% in 2014. The headline number, however, disguises the idiosyncratic factors that are apt to shape country-specific dynamics. We expect above-potential growth in Mexico driven by favorable momentum in the US economy, as well as local dynamics related to structural reforms in the energy sector. Colombia may also benefit from similar drivers, as investments related to the 4G infrastructure program start to materialize. Chile and Peru, on the other hand, are likely to show stronger annual GDP growth than in 2014, aided by meaningful fiscal and monetary

stimuli, particularly in Chile's case. These economies, however, should continue to grow below rates recorded in 2010-2013. Ecuador is likely to continue growing near potential, although stress in fiscal accounts is becoming increasingly evident as expenditures outpace government revenues. Finally, in our central scenario, GDP growth in Argentina and Venezuela will also accelerate somewhat, although these economies should remain highly vulnerable to external and domestic shocks given weak macroeconomic fundamentals and policy frameworks.

Domestic policies will affect Venezuela and Argentina; other regions face external risks

The main risks for the region continue to be external, with the exception of Argentina and Venezuela. In these two countries, the domestic policy mix has created unsustainable macroeconomic conditions that will eventually need to be addressed. The risks associated with lower oil prices will be especially relevant for exporters such as Venezuela, Colombia, Ecuador, and Mexico. Some of these countries are likely to face challenges in their fiscal accounts, with possible spillovers into growth through lower government spending or investment. Mexico appears to have hedged its net energy exposure, and therefore, spending is unlikely to materialize, even if oil prices continue to fall. The Venezuelan case is especially sensitive given the liquidity needs of the economy. Meanwhile, structurally lower growth in China is likely to hurt GDP growth prospects for metal exporters such as Chile and Peru, at least until these countries diversify their growth engines away from mining. Higher interest rates in the US will also present an important challenge to the region given the effect that a slowdown in asset purchases from abroad, or an outright reversal of short-term capital flows, could have on asset prices. Mexico is particularly vulnerable to this risk, given the very large foreign holdings of government securities in the domestic market (36% of total outstanding).

Brazilian policy uncertainty remains high following President Dilma Rousseff's reelection for the 2015-2018 term. We expect a moderate change in fiscal policy, with the primary surplus increasing from 0.6% of GDP to 1.0%-1.5% of GDP in 2015. This is unlikely to be sufficient to stabilize the gross debt-to-GDP ratio. Meanwhile, we expect the central bank to hike by another 75bp next year following the recent surprise 25bp hike to 11.25%, which continued the tightening cycle that began in May.

The exchange rate remains highly dependent on domestic policy decisions, commodity prices, and US monetary policy. We expect the currency to depreciate from R\$2.40/US\$ to around R\$2.60/US\$ by the end of 2015. As a result of a depreciating currency and the expected fiscal and monetary policy adjustments, inflation is unlikely to fall from the current level of 6.7% year over year to 4.5% in the next couple of years.

Deceleration in household consumption should slow Brazilian GDP growth

We expect GDP growth of 0% in 2014 and 0.6% in 2015, as a result of deceleration in household consumption. Higher interest rates, high inventory levels, and low business confidence is likely to lead to continuously weak investment growth. The resumption of economic activity from 2016 onward depends on credibility gains from more austere fiscal and monetary changes that would suffice to reduce the risks of a downgrade of Brazil ratings to a level below investment grade.

EEMEA

EEMEA (ex-Russia) GDP should expand modestly

Although we expect a sharp contraction in Russia's real GDP in 2015, the rest of the EEMEA region is likely to grow modestly stronger compared to 2014. In 2015, we expect Russia's real GDP to contract 1.5% because of the sharp decline in global oil prices and the adverse impact of the sanctions that were imposed on Russia by the West following the geopolitical developments related to Ukraine. Although Russia's real GDP growth has held up well so far this year, we expect the brunt of unfavorable impact of sanctions to occur in 4Q 2014 and 1H 2015. In the rest of the region, we expect real GDP growth to pick up modestly on average. Although we expect Turkey and Poland to maintain their real GDP growth rates

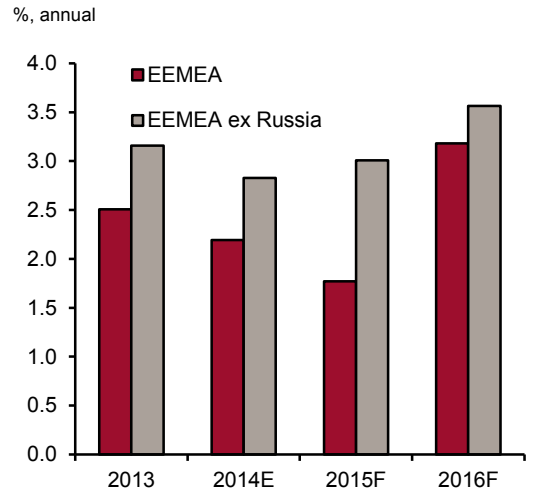
The impact of Russian sanctions should be felt in 4Q 2014 and 1H 2015

at 3.3% and 3.1%, respectively, and the Czech Republic at 2.4% in 2015, we expect South Africa's real GDP growth to rise to 2.5% (from 1.2% in 2014) and Israel's real GDP growth to increase to 3.2% (from 2.1% in 2014) as the domestic factors that constrained their growth performance in 2014 have dissipated. As Hungary seems to be exhausting its room for further monetary and fiscal stimulus and given the sluggish economic activity in the euro area, we expect Hungary's real GDP growth rate to slow to 2.0% in 2015 from a projected 3.0% in 2014.

EEMEA countries are exposed to higher US rates, weak economic activity in the euro area and the ECB's associated policy actions, slower investment demand in China, and lower commodity prices at varying degrees. Although Turkey, the CE3, and Israel stand to gain from the terms-of-trade shock driven by the sharp decline in global oil prices, Russia stands to lose. South Africa is positioned to benefit from the global oil price decline but is negatively affected by lower metals prices and slowing investment demand in China. Meanwhile, the CE3 remains exposed to the lingering crisis in Ukraine and the weak economic activity in the euro area, but it may benefit from further monetary policy easing by the ECB.

We expect the central banks of Russia and Turkey to ease monetary policy in 2015 (in view of the expected decline in inflation in these two countries) and the central banks of Hungary, Israel, Poland, and South Africa to tighten in the second half of the year. South Africa's and Turkey's large current account deficits will continue to keep their exchange rates vulnerable to changes in global liquidity conditions, which might lead to a different monetary policy outlook than we currently pencil in for these countries in 2015, with adverse implications for their growth outlook.

Exhibit 9: EEMEA region's real GDP growth



Source: National authorities, IHS Global Insight, Credit Suisse

HOW WILL TIGHTENING WORK? THE FED'S EXIT STRATEGY

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In the pre-crisis days, a Federal Reserve policy tightening was a straightforward affair. The Fed reduced the amount of reserves it supplied to the banking system, and the overnight rate at which banks traded those reserves amongst each other (the federal funds rate) went up. In fact, once the process was well understood, just the act of announcing a funds rate hike was sufficient to raise rates, with reserve reductions coming shortly thereafter.

Exhibit 10: Why this tightening cycle will be unique

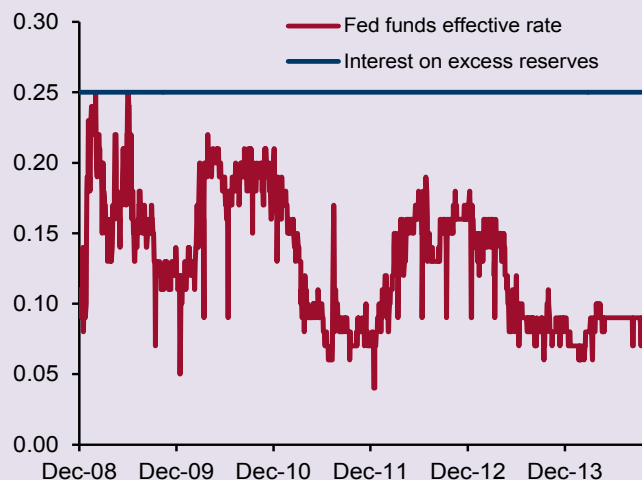
Bank reserves, two-week reserve maintenance period averages, \$bn



Source: Federal Reserve, Credit Suisse

Exhibit 11: A potential hazard on the path to normalcy

Daily interest rates, %



Source: Federal Reserve, Credit Suisse

Rate hikes are more complicated today. As a result of the Fed's successive rounds of asset purchases, or QE, its balance sheet is five times larger than it was when the financial crisis began in the summer of 2007. Excess reserves in the banking system, which were virtually nonexistent before 2008, have grown to \$2.6 trillion (Exhibit 10). Tightening policy with this much cash in the banking system requires special tools and a plan. The Fed has developed both.

The Fed's exit strategy tools

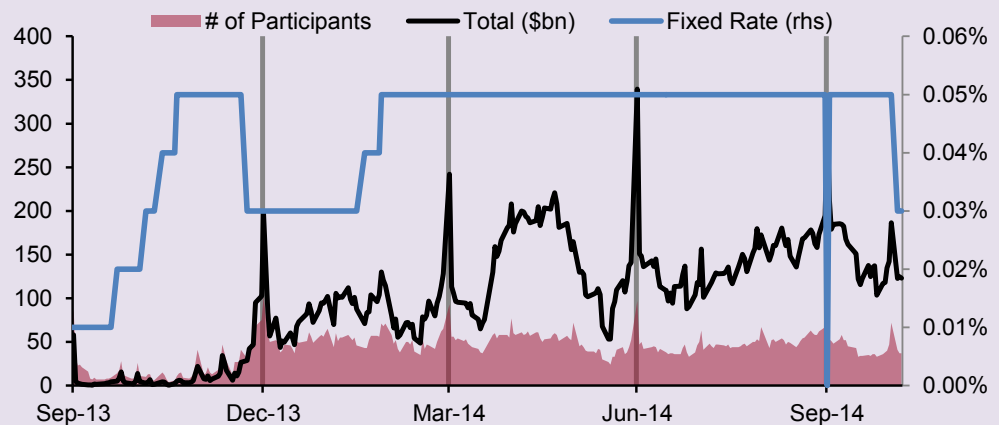
Fed funds rate – The Fed plans to continue targeting a range for the fed funds rate (probably 25bp wide), which is the weighted average of brokered overnight, unsecured lending/borrowing between banks. The Fed has indicated that it may amend the definition of the effective rate, but as of this writing, it has not given guidance on how this may change. One relatively straightforward change would be to add bilateral, non-brokered fed funds trades to those currently being incorporated.

IOER (Interest on Excess Reserves) – The Fed wants to utilize this administered rate as its primary exit tool, but due to structural issues with the fed funds market (e.g., Government Sponsored Enterprises can lend into the market, but they cannot borrow), IOER has been a very porous floor. Since IOER's introduction in late 2008, the effective funds rate has never exceeded IOER, even though IOER was meant to serve as a lower bound (Exhibit 11).

O/N RRPs – In our view, overnight reverse repurchase operations are the single best method to control overnight rates. The repo market is relatively large and liquid compared with that for fed funds, and the addition of 2a7 money market mutual funds (MMMFs) and agencies as counterparties makes O/N RRP's more effective.

The Fed has chosen to use RRP as a “backup” tool partly owing to concerns that in a crisis, MMMFs will pull their short-term loans to banks and deposit the funds at the RRP.

Exhibit 12: Overnight reverse RP utilization



Source: the BLOOMBERG PROFESSIONAL™ service, Federal Reserve, Credit Suisse

Term Deposit Facility (TDF) – If we think of the banks’ reserve accounts at the Fed as special types of demand deposits that pay 0.25% per year, the TDF is like a “certificate of deposit” for several days or weeks that will presumably pay more interest. The TDF should be helpful in neutralizing bank reserves temporarily, but it is unlikely to have a significant impact on the fed funds effective rate unless it grows very large.

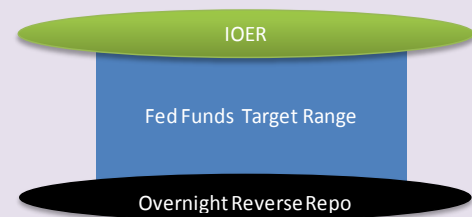
Traditional Temporary Open Market Operations (TOMOs) – Limited to dealers, traditional reverse repos that drain reserves may eventually be utilized, but the ability of dealers to do the size necessary was the primary reason we believe the Fed looked to expand its counterparty list. Traditional TOMOs but with the expanded counterparties might be a method in the future to conduct monetary policy.

Traditional Permanent OMOs – Outright sales of Fed assets would be included in this category. Before going this route, the Fed has indicated that it intends to shrink its balance sheet passively at first by not reinvesting proceeds from its MBS holdings and perhaps by reinvesting less than 100% of its Treasury debt roll-off. We suspect that the Fed would consider the sale of long-duration assets if the yield curve inverts or gets too flat for comfort – a “quantitative tightening” of sorts.

In mid-September, the Fed described its [Policy Normalization Principles and Plans](#), updating an exit strategy last released in June 2011. The goal, in the longer run, would be to “hold no more securities than necessary to implement monetary policy efficiently and effectively, and [to] hold primarily Treasury securities, thereby minimizing the effect of Federal Reserve holdings on the allocation of credit across sectors of the economy.”

Exhibit 13: The plan in a diagram

The Fed intends to move the fed funds rate into the target range primarily by adjusting IOER and by using O/N RRP and other supplementary tools as needed.



Source: Federal Reserve, Credit Suisse

Oil in 2015: Lower, or Much Lower Prices?

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2015 Core Views

- In 2015, we expect oil markets to find a new, lower price range around \$92 per barrel (/b) for Brent – nearly 20% lower than the \$110/b average of each of the last three years and 12% below the estimated \$103/b 2014 average. Most of the risk, in our view, is on the supply side.
- Aside from by now-familiar risks to exports from sovereign producers across MENA and worries on the demand side focused on Europe and China; the critical variable, in our view, is Saudi Arabia. We assume that it will continue to balance oil markets – much like the "central banker of oil" should.
- But the Kingdom may be deciding to abandon its swing producer role. And if the Saudis were to continue to over-supply oil markets, then prices would fall much further. A 2015 "equilibrium" could be \$80 Brent, down fully 25% from 2014, or lower.

This content is based on the Equity Research energy team's reports – [Oil Sense: What If, 'Five Stages of Grief' After A Price Shock](#), 28 October 2014; [Oil Prices Fall into a Lower Range](#), 30 September 2014; and [Brent Oil at a Tipping Point – Part II](#), 14 October 2014. Please refer to these reports for more information and important disclosures.

High prices have suppressed demand growth, prompting investment into frontier developments

We think that the Saudis will manage s/d to achieve a stable higher price range

Politics, politics, politics – no different in 2015

Oil, perhaps like gold, remains the commodity that frequently, and often for uncomfortably long stretches of time, refuses to obey the simplest rules of economics or common sense. Essentially, it remains a political commodity. So it should perhaps not be a surprise that within weeks of oil prices having reached a "new normal" in excess of \$100 in the middle of June 2014, there began a precipitous slide, which at the time of writing has not relented yet. More likely than not, we will at the end of 2014 print the first quarter average price below \$100 in four years.

Although it is tempting to believe that oil prices north of \$100/b were never going to be sustained, the commodity has traded above its cost curve for more than 13 years now; and did so, except in only two quarters in the middle of the GFC, thanks largely to astute management by Saudi Arabia, its swing producer.

High and rising prices last decade invited not much in the way of incremental supply capacity before the GFC; but they did suppress demand growth, and they did prompt massive investments into frontier developments. The quick return of "high" prices after the GFC then nurtured the shale revolution, which in turn has morphed into record growth of oil supplies in the US.

Accelerating growth of supply in North America, plus the sudden return of oil exports from Libya in July, finally tipped Brent oil out of its \$100/b-\$120/b trading range.

- And after this fundamentals-driven tipping point was reached, the oil price retreat was helped along by corollary selling that was inspired by **the strengthening US dollar, prospects for rising interest rates, and a few bouts of risk-off trading.**
- At the core, however, remains this fundamental imbalance of a creeping supply surplus that is adding to inventories and that has already shifted the shape of the Brent futures curve into a contango back in August 2014.

And that is when something should have begun to stir in Saudi Arabia.

- We think that it did. And we think that the Saudis will again manage oil supply/demand fundamentals to achieve a fairly stable, relatively high oil price range (see [Oil Prices Fall into a Lower Range](#), 30 September 2014).
- So when oil markets fell by another 10% in early October, we surmised that the market was getting ahead of itself and that, although risks of a meltdown were growing, the mechanics of Saudi sales practices and decision-making had simply delayed the Saudis' reaction (see [Brent Oil at a Tipping Point – Part II](#), 14 October 2014).

- For completeness' sake, we recently also addressed concerns from the many who fear that the Saudis have already decided "to let oil markets go" to crash the price and "weed out" inefficient producers. Our supply-side sensitivity reported was cast in behavioral terms (see [Oil Sense: What If, 'Five Stages of Grief' After a Price Shock](#), published 28 October 2014).

Going forward, either the Saudis cut oil supplies or they do not

Unless the Saudis cut supply, the industry will be forced to adjust

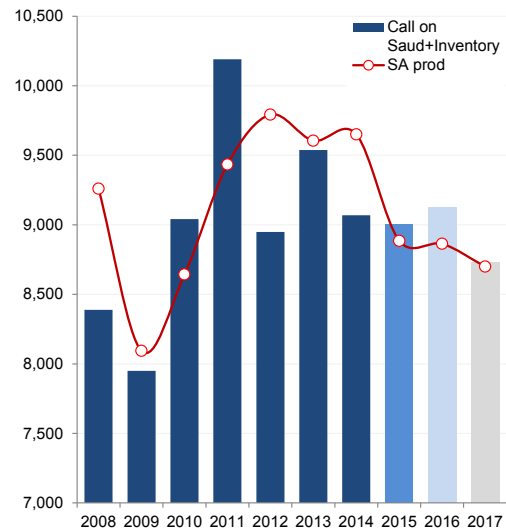
Nearing the end of 2014, oil markets are still out of kilter, in over-supply. Inventories are growing (seasonally adjusted). Unless the oil market's self-appointed central banker of oil cuts supply (which remains the most likely scenario, in our view), lower prices will force the industry to adjust – by cutting supply incrementally across the many mature oil fields of the world as lower investments exacerbate decline rates and most visibly by decelerating growth from shale and tight oil basins in North America.

That alternative specter of much lower oil prices is the simplest way to illustrate the Saudi "dilemma" and **the most powerful argument against the notion that the Saudis will instigate an oil price war.**

At this stage, we believe that Saudi policy has not been fully formed and that, in any case, momentous decisions like these are not taken lightly. We do not assume that Saudi Arabia will need to cut back its market share endlessly. Instead, our estimated balances out to 2017 suggest that the Kingdom will reduce its average annual production to levels that were normal before the Arab Spring (see Exhibit 14).

Exhibit 14: Call on Saudi Arabia (kb/d)

Call on SA crude oil + inventory = global oil demand less non-Opec all liquids, processing gains; Opec oil and SA non crude.



Source: Credit Suisse, the BLOOMBER PROFESSIONAL™ service

2015 central scenario and two outliers

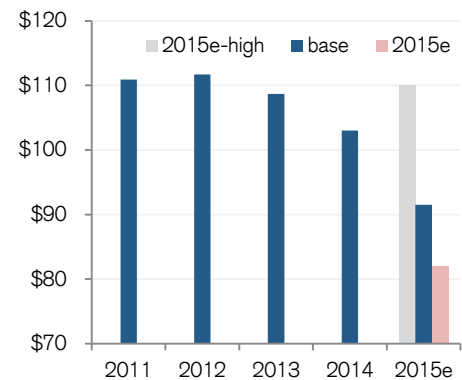
Our base case involves US production growth and some improvement in demand

Our base case, and the two alternative 2015 oil price paths, frame most issues for what promises to be another year rife with unpredictable political events. Our central case involves the following:

- Ongoing great growth of US oil production remains at the core of another year of super-normal non-Opec supply growth – in 2015 amounting to 1.2 million b/d (a more than 2% increase).
- **Demand should improve**, but that growth is unlikely to balance **on its own. Although oil product consumption growth is likely to accelerate from 2014's ~1% year-over-year rate, we expect growth of no more than 1.3 million barrels per day (Mb/d), or 1.4%, in 2015, which is higher than consensus.**

Exhibit 15: Brent oil prices

\$/b Brent (annual average of prompt futures month)



Source: National sources, Credit Suisse

We note that the call on Opec would therefore stay roughly the same next year. Still, Saudi Arabia faces a two-part problem:

1. The 2014 balance left too much room to build inventory.
2. In addition, we assume that, in year-average comparison terms, supplies will grow from Libya (for which we hold current production constant); Iraq (from where Kurdistan exports are growing), and Iran (with looser sanctions in 2015).

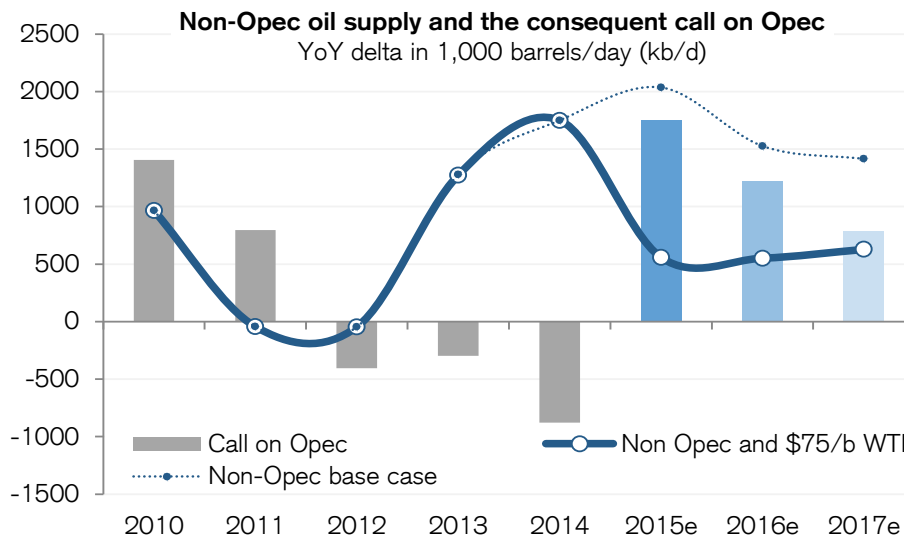
In our base case, Saudi production falls by 1 Mb/d, still above the pre-Arab Spring range

In short, in our base case, the call for Saudi Arabia's crude oil (and global inventories) goes down by nearly 1 Mb/d. As a one-off step down, a commensurate reduction of the Kingdom's production is manageable. Its year-average output would simply fall to 8.6 Mb/d – which is still north of the range of 8.0 Mb/d to 8.5 Mb/d that was normal before the Arab Spring and before the GFC. Higher per-barrel revenue would also leave gross export earnings unchanged.

In case we are wrong – in an oil price-negative way

Obviously, the 3Q 2014 bear trend in oil prices could simply extend on a lack of global economic growth. Here let's assume that Saudi production stays at 9.6 Mb/d next year – which, given that there is still no evidence or even a reliable indication that the Saudis are cutting back, is an increasingly worrying /realistic scenario, in our view.

Exhibit 16: Without a Saudi supply cut, in an extended low-oil-price environment (of \$80-ish Brent), non-Opec supplies would eventually adjust sharply lower



Source: Credit Suisse

In another scenario, lack of global growth could extend the bear trend in prices

If we simply straight-line Saudi production at 2014 levels in our global supply/demand balances for 2015, there would be a surplus of more than 1 Mb/d.

- To accommodate that surplus, futures curves would fall into a steeper contango (in excess of \$0.70/b between the months, or a year-over-year time spread of >\$8/b.
- In addition, the long-dated part of the curve would deflate, as at some point, the upstream oil industry (in the US and elsewhere) would cut back activity, which in turn would deflate the cost of drilling and completing oil wells.
- The five-year average of long-dated Brent prices (ticker CO36) is still \$97/b, but its early-November reading had already dropped to \$90. That is still \$4/b north of our central-case long-run target. Should a low-price environment take hold, \$80/b may be more reasonable. In sum, Brent oil prices could fall to the \$60/b range.

- In due time, a new equilibrium would establish itself. And our sensitivity analysis suggests that much less US production growth would occur in a year, with US benchmark WTI at \$75/b (Brent equivalent \$82/b).

And so, the global oil balance would correct by trimming non-Opec flow (see Exhibit 16).

In case we are wrong the other way

Any number of politically driven supply risks in MENA could send prices higher

Any one of a string of supply risks could materialize between now and the end of next year. Caught in an oil bear market, it is easy to lose sight of a still-rising trend of production capacity losses across MENA. But nowhere in the region is stability spreading. Following are "politically driven" oil supply risks in the order that we worry about them (note that each involves oil exports of 1.5 million b/d to 2.6 million b/d):

- **Iraq's** south produces a 2.6 Mb/d oil export stream in a world in which spare capacity is currently only about half that. And there is as yet no organized armed force able to hold large swathes of territory against IS.
- **Libya's** oil had reached close to zero by mid-2013. Libya stayed off line until the middle of July 2014. Flows are back to only half of the 1.5 Mb/d pre-2011 average. In the middle of an ongoing civil war, nothing in Libya has settled yet.
- **Iran** sanctions could tighten. Some 1 Mb/d of its capacity is idle. Negotiations with Tehran are scheduled to end on 24 November 2014. Failing the reaching of an "adequate" deal, the newly Republican US Congress could seek to tighten sanctions, which could in turn invite retaliation.
- **Nigeria's** 2015 presidential elections could cause tensions to reach the breaking point there, as could stresses in **Algeria** and **Venezuela**.

Conclusion

The bear market in oil unfolded fast in late summer 2014, surprising many. Its extent and suddenness (especially the return of significant Libyan exports) may equally have surprised the Saudis. Their late-ness to react may be just that. And encumbered (or blessed) with a slow, consensus-based decision-making process, the Saudi supreme councils may take their time and watch at least some of the uncertainty (e.g., Iran negotiations, Libya's exports, US shale oil growth, Eurozone economic perils, etc.) play out.

In our view, however, IF demand fails to accelerate, IF Libya stays on line, IF Iran sanctions loosen moderately, and IF other sovereign-oil-suppliers don't fall over; THEN the Saudis will cut (if only because their customers won't want their oil). Oil prices would then find a new range only moderately lower in the \$90s next year.

Defining New Frontiers

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2015 Core Views

- The Age of Financial Repression has been both long and a source of surprisingly durable profitability for investors.
- Yet, it leaves a very unfamiliar landscape for the start of a Fed-tightening cycle: new frontiers need to be mapped out.
- We examine where the stresses are most likely to appear, where the scope for divergence is greatest, and how investment strategies need to adapt.

We see falling commodity prices as a demand stimulus rather than a threat

The first question is whether, regardless of the case for tightening within the US, the macro backdrop in the rest of the world is strong enough to allow it to take place.

[In the first essay in this section, our co-head of Global Economics, Neville Hill, addresses the primary challenges that are commonly raised against Fed tightening](#), namely the decline in goods and commodity price inflation, the absence of wage inflation, and the threat of new stress-inducing financial risk from the euro area. We see falling commodity prices as a demand stimulus rather than a threat, expect wage dynamics in the US and UK to change in 2015, and expect sufficient control by the ECB to avoid conditions that could force Fed tightening to be aborted.

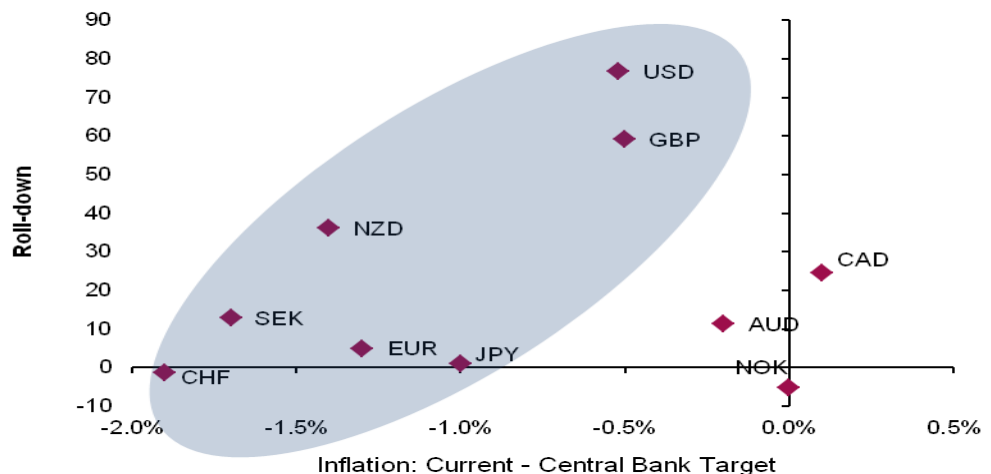
If correct, we are set for the largest policy divergence since the turn of the 1990s' combination of US recession and German unification-inspired boom. [Our head of FX Strategy, Shahab Jalinoos, sees this as providing the conditions for a sustained dollar rally](#) given that the starting point is one where the dollar is relatively cheap from a historical standpoint, where rate spreads have already moved, and where Fed QE has impeded investors from gaining access to US securities.

We expect the rates market reaction to be dominated by changes on the USD curve

By contrast to FX, where policy drivers come from three sources, [our co-heads of Global Rates Strategy, Helen Haworth and Carl Lantz, expect the rates market reaction to be dominated by changes on the USD curve](#). They expect the front end of the USD curve to do the lion's share of the work, with volatility in EUR and JPY rates depressed and still holding back the back end of the USD curve, albeit to a lesser degree than in 2014. This will allow rate spreads between USD and other G3 markets in the belly of the curve to continue to push higher while, in our minds, also raising questions about the sustainability of the very low carry offered in commodity-exposed G10 markets (see Exhibit 17).

Exhibit 17: G10 rates carry is mostly a function of inflation progress versus target, with some notable exceptions

Roll-down from 1y, 1yr to spot 1yr rates



Source: Credit Suisse

Viewed from an overall portfolio level, this leaves us with a central portfolio recommendation to overweight non-US equities and risky credit and be long the dollar. Whereas in the period of financial repression, liquidity was effectively "guaranteed" by the nature of the central banks' intervention, in the new environment, liquidity-protection strategies become much more important. We see this as a two-way source of risk and opportunity in 2015.

Why Barriers to Policy Divergence Will Not Hold

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2015 Core Views

- Policy divergence will be a key theme of 2015. We expect monetary policy to tighten in the US and UK and ease in the euro area, Japan, and other Asian economies.
- But three issues have led markets to question whether policy in the US and UK will, in the end, diverge from the rest:
 - weak or no growth in the euro area;
 - low CPI inflation on the back of falling commodity and goods prices; and
 - an absence of wage inflation in the US and UK despite a tightening labor market.
- We acknowledge the risks but believe that, in the end, they will prove largely immaterial to the prospect of US and UK tightening next year.

Can the policy divergence we expect be delivered?

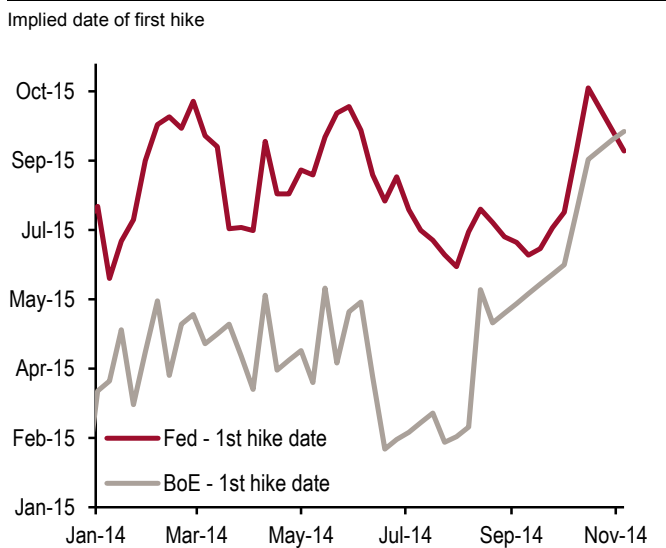
A key issue for 2015 will be whether the policy divergence we expect – the Fed and BoE moving toward tightening and the ECB and BoJ expanding their balance sheets – can be delivered in practice.

The timing and the pace of tightening remain most questionable

For markets, it's the prospect of the tightening in the US and UK that remains the most questionable.

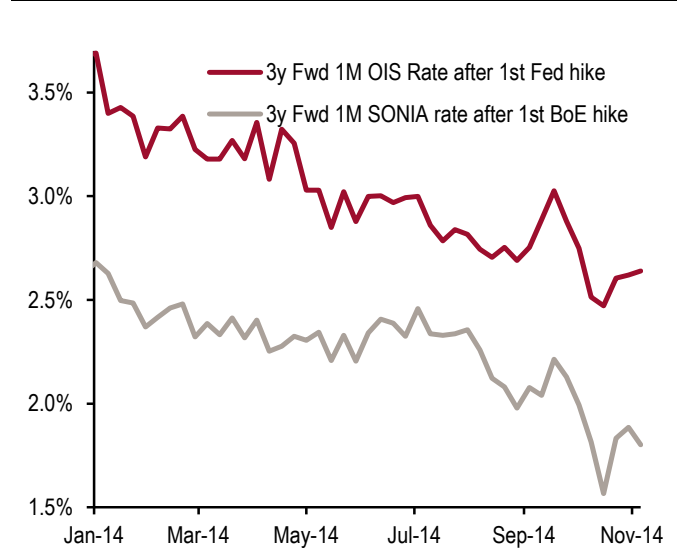
The timing of the first rate hike has largely been perceived by markets as being state contingent, given the emphasis both central banks have placed on unemployment and pay growth. Consequently, most of the volatility in the front end of both curves in the past year has come from changes in the evaluation of when rates will start rising. Exhibit 18 shows the extent to which expectations for "lift-off" of tightening has varied. That volatility has not extended to the market's expectation of the pace of tightening or the terminal rate, which, as Exhibit 19 shows, has steadily fallen through the course of the year.

Exhibit 18: Plenty of uncertainty about policy lift-off



Source: Credit Suisse

Exhibit 19: Expectations of the scale of policy tightening have been steadily pared back



Source: Credit Suisse

Markets are currently pricing that both central banks will raise rates later, rather than sooner, in 2015 – and that tightening cycles will be slow and limited.

There are several reasons why markets may hold that view. In part, it may reflect forward guidance from both central banks. And it may also mean that concepts such as the "new neutral" and "secular stagnation" are resonating with market participants.

We see three reasons why markets are pricing a later "lift-off" and slower tightening...

But we think there are three key issues inhibiting the ability of markets to challenge this guidance and consensus.

- A concern that a further slowdown, or even continued weak growth, in the euro area will be a sufficient drag on global growth to impair or prevent policy "lift-off" in the US and euro area.
- Lower global commodity and industrial goods prices, which could generate extremely low headline (and core) CPI prints early next year, sufficient to keep tightening at bay.
- Low wage growth, despite sharp falls in unemployment. If that persists, it could suggest greater slack in labor markets than assumed, consistent with a later "take-off" and more gradual tightening path.

The first two are external shocks. As we discussed, ultimately, domestic economic conditions in the US and UK will determine the timing and pace of policy tightening (see [The World Economy in 2015](#)). External factors only matter inasmuch as they can render domestic conditions less conducive to that policy tightening.

...which we expect to diminish over the next few months

And we think all three factors will prove less of an impediment to policy tightening than markets currently assume. As that becomes apparent next year, markets could both bring forward the date of the first rate hike and raise their expectations of the terminal rate.

Will Europe be a drag on the world (again)?

Having seen a steady, but hardly vigorous, recovery in economic activity, business, and consumer confidence since the end of euro area's recession in early 2013, European cyclical indicators started rolling over in the spring and have delivered a steady run of negative economic surprises since.

That has raised concerns that the euro area may be about to relapse back into recession. As the economic and financial disruption of the 2011-13 euro crisis was sufficient to prompt easing from both the Fed and the Bank of England, a repeat performance would plausibly derail the case for them to tighten.

While still a risk, weakness in Europe is unlikely to deliver a shock to growth, as it did in 2011-13

Although [we expect euro-area growth to improve modestly](#), a prolonged phase of weak or no European growth could still have little or no impact on policy in the US or UK. The impact of a prolonged economic stagnation in continental Europe would have a very different effect on domestic conditions in other economies than the crisis of 2011-13, in our view. It's important to distinguish between the crisis conditions in that period – and their impact on growth and policy elsewhere – and downside risks to the current outlook.

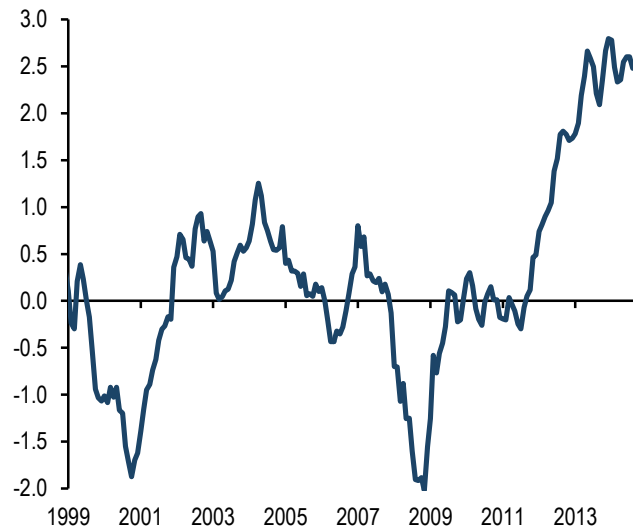
The euro-area recession and crisis saw an extraordinary tightening of fiscal, financial, and monetary conditions that, in turn, delivered a precipitous drop in domestic demand on a scale similar to that seen in the great recession. That collapse had a palpable impact on growth elsewhere. That can be evidenced in a couple of ways.

The counterpart to the slump in domestic demand was a surge in the euro area's current account surplus (Exhibit 20) worth almost 3 percentage points of GDP: a good proxy for the magnitude of the shock that the euro area crisis delivered to the rest of the global economy.

The euro area's contribution to annual global goods demand growth can be seen in Exhibit 21. Between 1994 and 2007, this contribution averaged just 0.6pp. But during the worst of the crisis, it was subtracting close to percentage point from global goods demand. Europe was an unusually large drag on global growth.

Exhibit 20: The euro area crisis of 2011-13 delivered a huge demand shock to the rest of the world

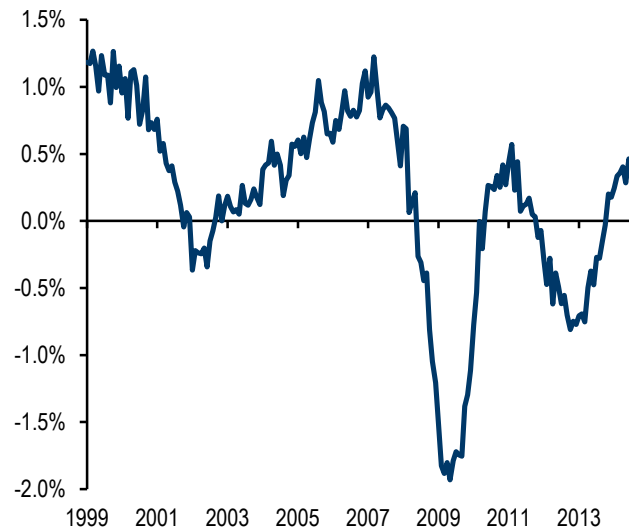
Euro-area current account surplus as % GDP



Source: Credit Suisse

Exhibit 21: ... which is now over

Euro-area contribution to global goods demand growth, y/y%



Source: Credit Suisse

Since the end of the recession, euro-area demand has slowly recovered. The downside case for the euro area would involve that demand growth remaining anemic or weakening back toward zero. That would clearly dampen global goods demand growth but not deliver a shock to growth on the magnitude of that seen in 2011-12.

In the event of what we see as an extreme tail risk – a return to crisis conditions capable of delivering another slump in demand – many assets in the euro area would need to be repriced, not least peripheral sovereign and bank debt.

So although a prolonged period of weak or no European demand growth would have implications for rates markets in the euro area, both in terms of the likely policy response from the ECB and risks of deflation, it's not clear that the read-across to domestic economic and policy conditions in other parts of the global economy would be significant enough to push growth away from its recent trend. To the extent to which weak euro-area growth is a problem, we think it would be more so for emerging Asian, rather than developed, economies.

Disappointing economic performance in the euro area would not be sufficient to hold back policy tightening elsewhere

So we don't think disappointing euro-area economic performance will be sufficient to prevent the economic conditions for policy tightening in the US or UK from emerging.

That's one risk, of course. Our central view is that markets have become too gloomy about the prospects for European growth. And although we don't expect a sharp and vigorous recovery, the extent to which markets are handicapping tightening from the Fed and Bank of England on the back of expectations of a negative economic shock from Europe may mean they're vulnerable to a run of upside surprises in the euro area.

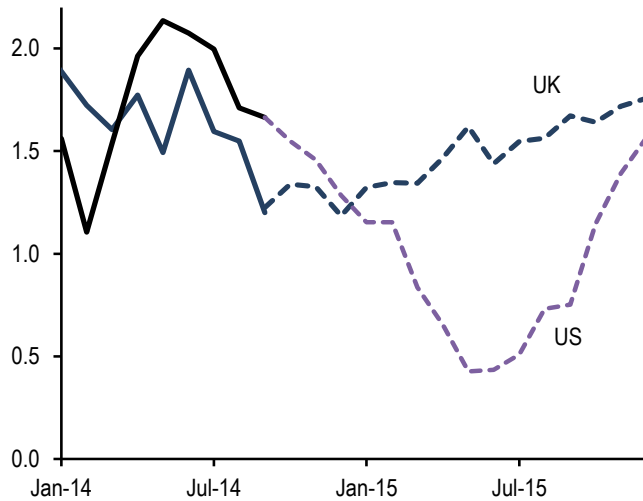
Low inflation, strong growth

At face value, CPI inflation in both the US and UK is unlikely to present the central banks with a compelling reason to tighten next year. Quite the opposite. The recent fall in oil and other commodity prices, as well as subdued global goods inflation, should make for some extremely low headline (and possibly core) CPI prints early next year.

The effects of the recent drop in oil prices on the path for inflation are considerable. Our projections for headline inflation in both the US and UK – on the basis of current oil prices – are shown in Exhibit 22. And the slowdown in global industrial growth this year should also keep a lid on inflation next year. Our measure of G3+ cyclical core inflation is unlikely to rise in the first half of 2015 (Exhibit 23) given the persistence of a modest global output gap this year.

Exhibit 22: Headline inflation should be low in the US and UK next year

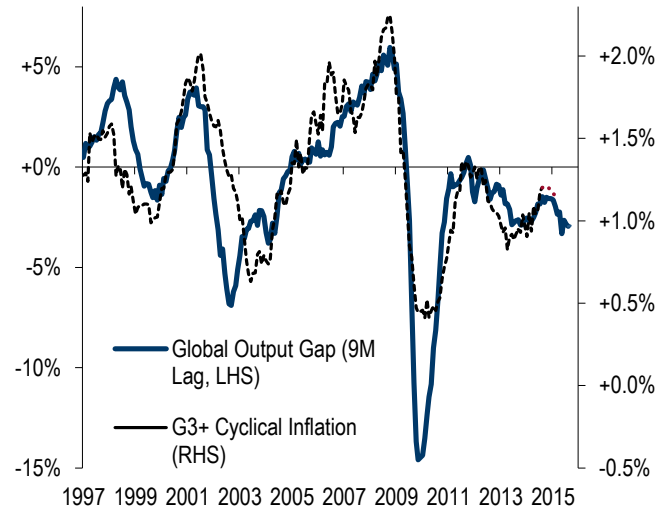
US and UK CPI, y/y%



Source: Credit Suisse

Exhibit 23: Weak global growth in 2014 should keep core inflation subdued in 2015

Global output gap and cyclical inflation



Source: Credit Suisse

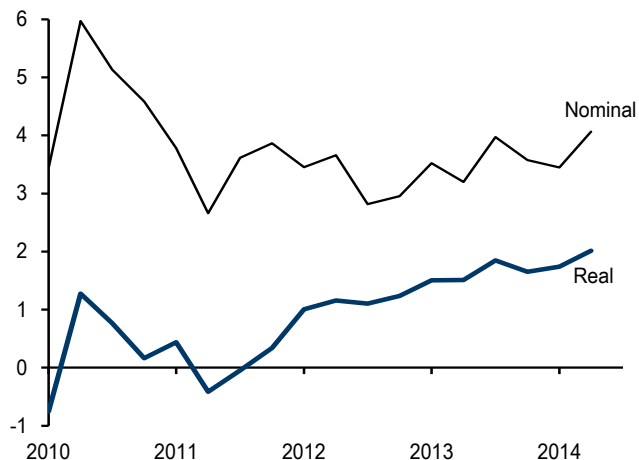
The recent drop in inflation is due to external pressures and should support demand growth

That's not obviously a set of conditions to make for central bank tightening. But this drop in inflation would largely be due to external rather than domestic inflationary pressures. So it would represent a positive terms of trade shock and should consequently support real domestic income and demand growth in the US and UK (and, indeed, the euro area and Japan), especially if nominal income growth – for households and firms – remains resilient.

The UK's experience in the wake of the great recession is a good illustration. Although nominal consumer spending growth has been fairly stable – at around 3.5%-4.0% since 2011, real spending growth has not. High headline inflation – driven by rising import and energy prices as well as increases in indirect taxes – was powerfully negative for consumer demand in 2010-11, and the subsequent easing of upward pressures on CPI inflation has led to a recovery in real incomes and spending. Exhibit 25 shows the boost to US households' cash flows that should come from the recent fall in the oil price.

Exhibit 24: Lower imported inflation can mean stronger growth

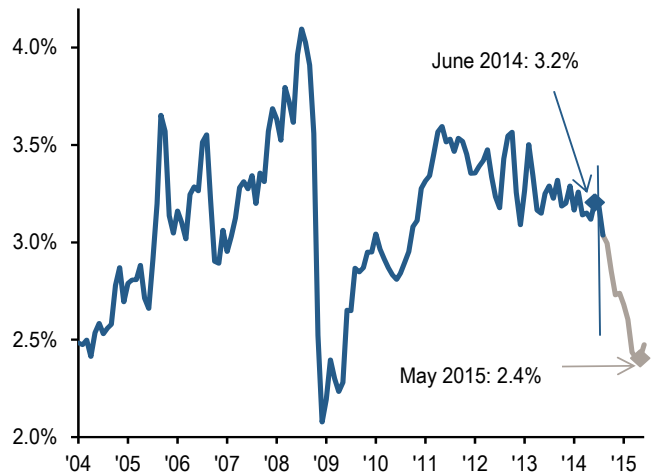
UK nominal and real consumer spending, y/y%



Source: Credit Suisse

Exhibit 25: The US gasoline tax cut

US gasoline spending as % nominal disposable income



Source: Credit Suisse

Low inflation, in this case, is linked to cyclical strength and should support policy normalization

We remain focused on lower oil prices as a key risk

There's a tendency to regard low inflation as a reason for central banks to maintain a dovish stance regardless of the cause. But inasmuch as policy tightening is really contingent on these economies maintaining solid demand growth consistent with a further tightening in their labor markets (see below), low inflation driven by weak energy and imported goods prices should make tightening more, not less, likely.

To the extent to which there is a difference between the central banks, the Bank of England seems more sensitive to the prospect of low inflation than the Federal Reserve. Low UK inflation in 1Q may keep the BoE from tightening until later in the year. But if we're right about wage growth picking up (see below), then low inflation should only delay, not cancel, prospective rate hikes, as stronger real wages boost demand. By contrast, recent commentary from the Fed has indicated no change to its reaction function in the face of commodity-driven lower inflation.

Of course, it matters why commodity and energy prices are so weak. If the sharp fall in oil prices is due to a significant weakening in global demand growth – be it from the euro area or elsewhere – then the cyclical shock could outweigh the boost to real incomes. However, [we think much of the fall is due to stronger supply](#). That certainly fits with our observation of global demand: there's little to suggest a recent downturn.

So we see low inflation prints in the US and UK next year as being correlated with cyclical strength, not weakness, in those economies. And consequently we see them as being correlated with eventual policy normalization, not loosening, there.

But lower oil prices could also fuel policy divergence. Inasmuch as a further fall in energy prices would push inflation down in other economies as well, so it may prompt some central banks to ease further. For example, negative inflation prints in the euro area – even if driven by oil prices – would pressure the ECB to ease further. And we now expect policy easing in some Asian economies next year on the back of a lower inflation prospect.

Wages: keeping it simple

Although unemployment rates have normalized in the US and UK, wage growth has not. Nominal wage growth in both economies remains unusually low. That may be seen as suggestive of a "new normal" of lower nominal magnitudes consistent with low terminal rates or be indicative of there being considerably more slack in these economies than a simple observation of the unemployment rate would suggest. Both observations would be consistent with a tightening cycle that starts later and is limited in development.

That leaves fixed income markets vulnerable to labor market strength, especially regarding pay, as we get closer to policy "lift-off" in the US and UK.

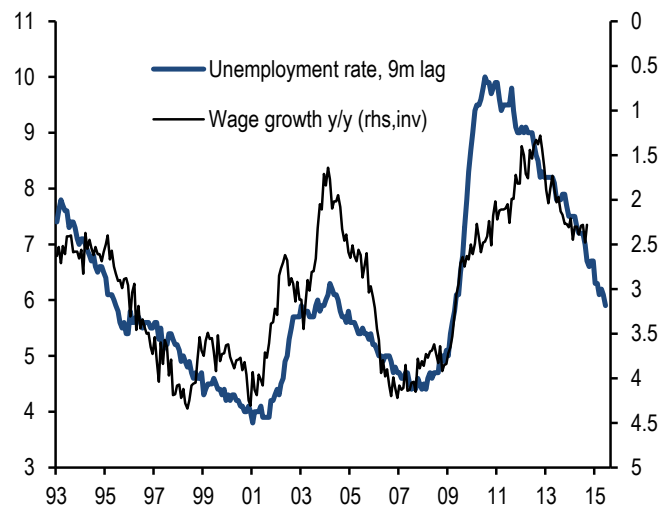
The unemployment rate continues its downward trend

Compared to the volatility we've seen in markets timing the first hike, the downward trend in unemployment rates in the US and UK has been steady and remorseless. For all the detailed analysis on the dynamics of labor demand and supply in both economies, a downward trend line would have been an effective tool to forecast the unemployment rate in the past year.

Given resilient GDP growth and labor demand, we see no compelling reason to expect unemployment to deviate from these downtrends in the near term. If we are correct, unemployment rates could fall below 5½% in 2Q next year: to levels where there is tentative evidence of a "kink" in the Phillips curve.

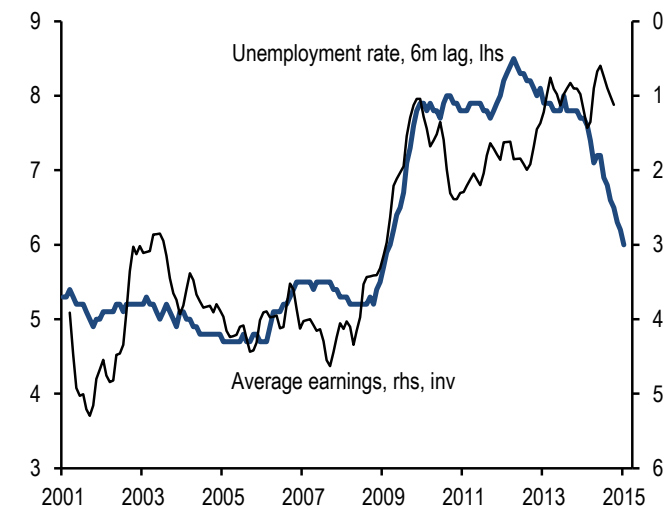
[As we wrote back in September](#), we think there's still a good relationship between unemployment and wage growth in both economies. Although that looks more robust in the US than the UK, we think the unusually weak wage growth in the UK may be a consequence of an extended lag between unemployment and pay as well as possible deficiencies in the data (inasmuch as most survey indicators do point to rising wage costs).

Exhibit 26: US unemployment and wage growth



Source: Credit Suisse

Exhibit 27: UK unemployment and wage growth



Source: Credit Suisse

Churn is now set to increase, which should support a cyclical pick-up in wage growth

One reason for past weakness in pay may be the relative lack of churn (moves from job to job) in those labor markets. Although unemployment rates are approaching historical norms, mobility rates in these labor markets are not. The absence of "churn" until now may well have retarded a pick-up in pay growth. We think that with unemployment now normalized, churn will increase as firms increasingly hire from competitors, rather than from the pool of unemployed. That should support a cyclical pick-up in pay growth.

Economic conditions are consistent with tightening in 1H 2015

Consequently, we think low wage growth at the moment is not reflective of a "new normal" in labor markets but a very normal lag between a recovery in labor markets and pay. Consequently, we expect wage growth to pick up in both the US and UK next year, challenging markets to re-evaluate both the timing, pace, and scale of any monetary policy tightening.

Markets are likely to question the speed and path thereafter

In all, then, we think the features of the global economy that currently mean markets are cautious about convincingly pricing for policy divergence will prove chimerical. There's good reason to expect domestic economic conditions in both the US and UK to be consistent with the start of monetary policy tightening in the first half of next year and for markets to then question whether the slow and low path for policy rates thereafter.

Pressure Points for Capital Flows into Fed Tightening

Justifying the end with the means

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2015 Core Views

- Following a long period of widespread financial repression, the prospect of Fed tightening awakens a host of opportunities, especially for money market investors and in FX markets.
- We believe that it will also highlight pressure points resulting from changes in market structure that increase risk concentration and raise the likelihood of price gaps.
- In particular, we focus on how retail investors' access to liquidity has improved, how these investors tend to be trend-following, and how, in some sectors, they have grown to represent 25%-30% of the market.

After a fallow period, we expect capital flows through 2015 to be emboldened by a significant new set of asset-allocation themes:

- The expected first Fed rate hike since 2006 re-establishes a meaningful market for money market and Treasury investors. Related to this, the provision of new marginal G3 liquidity into the global financial system will swing from USD into JPY and EUR.
- This creates direct opportunities in cross-currency basis, but more broadly, it signifies a change in the nature of pricing support for many assets. Reflecting the dollar's role as financial system numeraire and funder of last resort, USD liquidity has by far the broadest impact on asset prices.
- This does not automatically imply a bearish adjustment for securities markets. After all, periods of JPY weakness have often been associated with broad increases in risk appetite. However, transitioning away to other currency funding is very likely to create much greater differentiation in relative value as well as act as a direct source of new volatility for financial markets as the change in correlation structure of the shift in funding has a significant impact on asset weighting in portfolios.
- The final level at which the change in central bank policy matters is at the naïve level of "what is there I can buy?" For the last year, the Fed has overseen a dramatic slowing in the effective net supply of US fixed income assets, but that will reverse in 2015. Increasing net supply in the highest-yielding G3 currency at a time when the ECB and BoJ are likely to be crowding investors out of the markets suggests to us that dollar deficit funding will look after itself next year.
- At a micro level, innovations in market structure affect our assessment of risk concentration. The ease of access to market liquidity for retail investors has created a natural accelerator for flows at a time when the sell side's balance sheet has declined, thereby weakening the shock absorbers of the market overall. Retail accounts for 14% of the US fixed income market, 25% of European HY, and 25%-30% of EM local currency funds. Within the latter, we highlight HUF, MYR, and ZAR as the most exposed markets.
- The net of these seems likely to result in lower Sharpe ratios across securities markets and a greater role from FX to expected portfolio returns in 2015.

A macro summary of expected capital flows

We expect a change in the direction of and motivation behind capital flows in 2015

Across our *2015 Outlook*, we highlight a number of opportunities associated with what we expect to be a significant change in both the direction of and the degree of stress behind capital flows:

- Widening interest rate differentials at the front end of the curve and ongoing outperformance of US domestic demand [drive our expectation of a stronger dollar](#).
- The shift within the G3 of marginal liquidity provision from USD to EUR and JPY creates a [significant opportunity in cross-currency basis as EUR becomes a funding currency](#).
- The significant relative tightening of US monetary policy creates an environment where we expect [implied volatility to rise](#) and [Sharpe ratios in fixed income markets to fall](#).

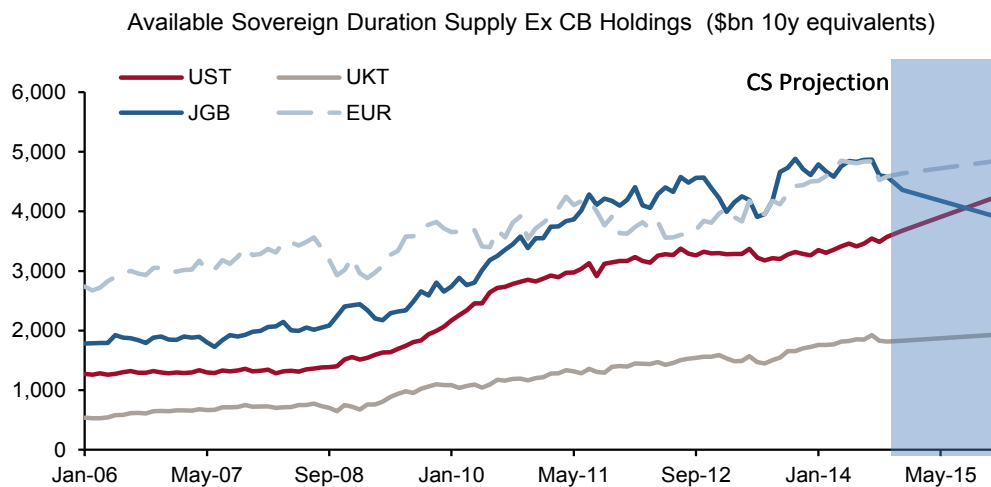
We also believe that 2015 will see a significant change in the motivation for capital flows.

Capital flows have been focused on assets that benefitted from central bank liquidity injection

In 2012-2014, the dominant waves of capital allocation were to capture excess returns from undervalued assets benefitting from central bank liquidity injection. Initially, the opportunity was most compelling in distressed European sovereigns, credit, and mortgages, but this was rapidly joined by the opportunity in Japanese equities as the yen started to devalue.

These flows were incentivized all the more by the fact that the Fed restricted investors from accessing large parts of the US fixed income securities market by buying what amounted to virtually all of the new supply in some periods for its own account.

Exhibit 28: 2015: We expect a significant redistribution in net duration supply

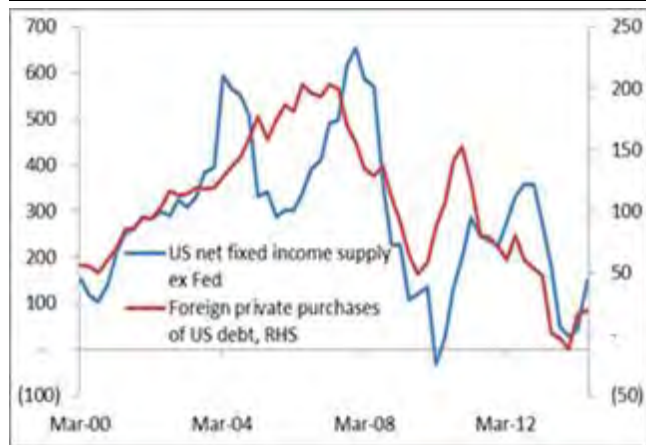


Source: Credit Suisse

In 2015, the Fed will be reinvesting the maturing paper it owns but no longer crowding out foreigners from new supply. The result, as shown in Exhibit 28, is a major redistribution of net duration available to the market as central bank policy in Japan in particular and the euro area to a lesser extent remains designed to force a change in economic behavior through aggressive portfolio constraints.

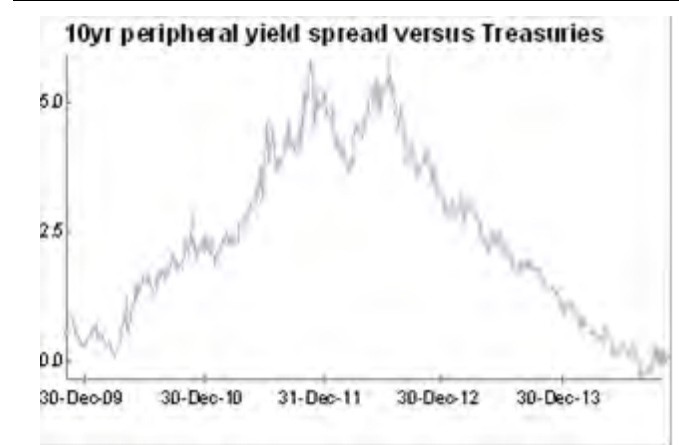
Exhibit 30 provides a reminder that the opportunity in European fixed income that encouraged capital inflow during 2012-2013 has now very clearly come to an end. Hence, although, as our FX strategists have noted, the funding dynamics for the dollar have looked rather precarious during the period of Fed asset purchases, Exhibit 29 suggests that increased net supply to the market of US securities is very likely to create its own demand (for the dollar).

Exhibit 29: The ending of Fed purchases creates an opportunity for foreign investors



Source: Credit Suisse, Federal Reserve

Exhibit 30: At least in fixed income, the opportunity in Europe has ended



Source: Credit Suisse

We expect volatility to rise and Sharpe ratios to fall as markets are less deep and balance sheets are contained

This prospect of a significant reorientation of capital flows at a time when markets are less deep and the sell-side balance sheet tightly constrained argues in favor of volatility, lower Sharpe ratios, and potential disruption as investors' desire to rebalance portfolios for the new environment conflicts with the market's capacity to accommodate that flow.

One particular concern we highlight is that innovations in market structure in providing the promise of market liquidity to retail investors creates a natural accelerator for flows, particularly in response to negative returns.

In the section below, we set out evidence for this behavior across a range of markets, highlighting where exposure is likely to be largest.

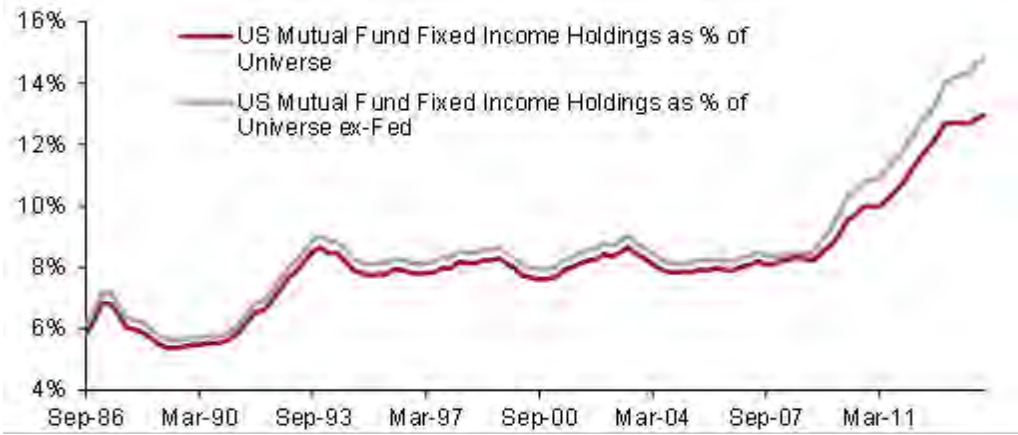
Detailing the effects of retail

US fixed income

- US fixed income mutual funds hold a markedly larger share of the fixed income universe than they did pre-crisis. Mutual funds' fixed income assets had been steady at about 8% of the universe over the decade and a half prior to 2009. Since then, however, the growth of fixed income funds has outpaced the growth of the broader universe to account for nearly 13% as of the end of the second quarter of 2014. As we show in Exhibit 31, when we account for the reduction in supply available to the market due to the increase in Fed purchases through the period, retail accounts for around 15% of the investable universe.

Exhibit 31: Mutual funds' holdings account for nearly 13% of the fixed income universe, up from a steady pre-crisis share of 8%

Fixed income includes Treasuries, agency, and GSE-backed securities, munis, and corporates

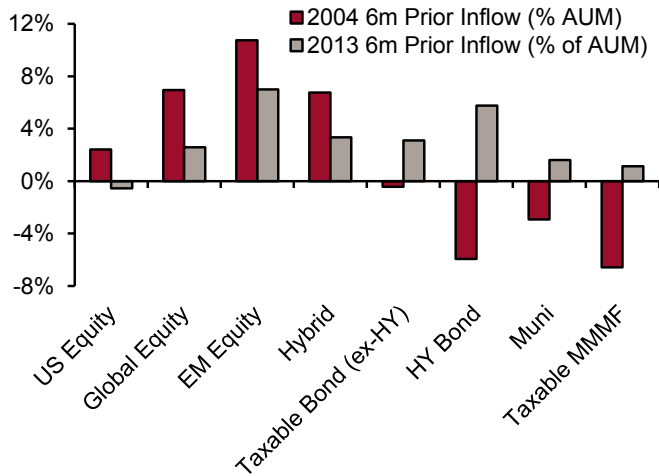


Source: Credit Suisse, Federal Reserve, Haver Analytics®

Retail investors showed greater sensitivity to fixed income performance in prior hiking cycles

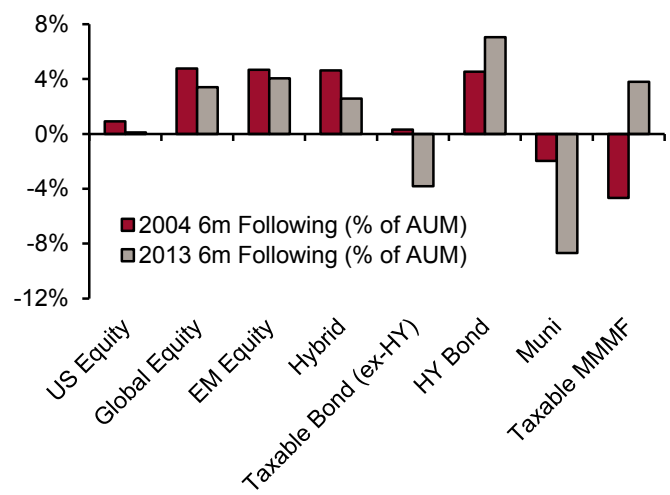
- In considering the potential outlook for fund flows as the US heads toward a hiking cycle, the experiences of two prior cycles can offer some insight. Past experience suggests that retail money will remain an area of sensitivity for fixed income markets, with retail flows into and out of fixed income relatively highly correlated with the prior months' returns.
- The Fed's 2004 hike cycle was a fairly well telegraphed process that proceeded at the now-infamous "measured pace." 2013's "taper tantrum" came as far more of a shock, taking the market by surprise and delivering a surge in volatility that the hike cycle in the prior decade did not.
- Monthly mutual fund flow data show a relatively pronounced rotation out of fixed income and into equities over the six months prior to the first hike in June 2004. This doesn't come as a huge surprise given the Fed's gradual adjustment toward a tightening bias. The build-up to 2013's episode was conversely marked by across-the-board inflows, with US equity funds being the lone exception (which was fairly consistent and did not mark a clear departure from prior trends).
- The ensuing period after the first hike in 2004 saw a general reversal of the outflows from taxable bond funds (including high yield), while the trends in the other sectors continued. Last year saw relatively significant outflows from municipal bond funds and taxable ex-high yield, while high yield and money market mutual funds stood out as better performers amid taper talk. Although high yield funds did experience one month of outflows before inflows resumed, it took all the way until February 2014 for taxable bond funds ex-high yield to have a month of positive net new cash.

Exhibit 32: Prior to the 2004 hiking cycle, there was a pronounced rotation toward equities and away from fixed income



Source: Credit Suisse, ICI, Haver Analytics®

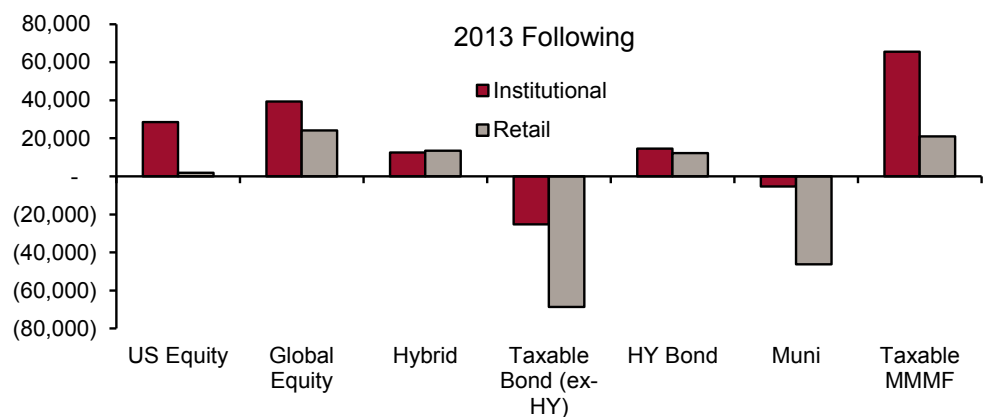
Exhibit 33: The 2013 taper-talk shock spurred outflows from taxable ex-high yield and municipal bond funds



Source: Credit Suisse, ICI, Haver Analytics®

- The notable outflows from taxable and municipal bond funds highlight the importance of retail investors in the current landscape. Retail cash accounts for slightly more than half of taxable bond funds' total net assets but made up 70% of the total cash outflow over the six-month window. Retail cash dominates the municipal bond fund universe – it accounted for over 85% of total net assets last year – while also proving relatively less sticky in making up for 90% of the total six months' outflow after taper talk started.

Exhibit 34: The two sectors that experienced large redemptions last year were driven by substantial retail outflows, highlighting the importance of the retail investor in the current landscape



Source: Credit Suisse, ICI, Haver Analytics®

Institutional investor flows are much less correlated to hiking cycles

- Retail cash accounts for substantial portions of both taxable bond and domestic equity funds' total net assets. In both 2004 and 2013, retail investors showed greater sensitivity to fixed income performance than equity performance, with taxable bond fund flows showing a much more pronounced lag to fixed income total returns than was the case with equity funds and equity returns. The same does not hold, however, for institutional investors, whose behavior has shown a much less pronounced correlation – either contemporaneously or with a lag – in both instances.

Exhibit 35: Aggregated bond fund returns led retail taxable bond fund flows by one month, while institutional and equity investors' behavior correlates less with returns

Correlation between inflows as a percentage of AUM and asset class returns; Fund flows same, 1 month, and 2 months following asset class returns
2004 period: 6m prior to, 18m following first hike; 2013 period: May 2013 to August 2014

Flow Lag	Retail			Institutional			Aggregate		
	0m	+1m	+2m	0m	+1m	+2m	0m	+1m	+2m
2004 Bonds	14%	59%	30%	14%	10%	17%	19%	42%	24%
2004 Equities	20%	23%	26%	-21%	3%	2%	25%	20%	22%
2013 Bonds	31%	63%	43%	23%	31%	35%	26%	49%	44%
2013 Equities	27%	8%	21%	-6%	-31%	10%	24%	-10%	-19%

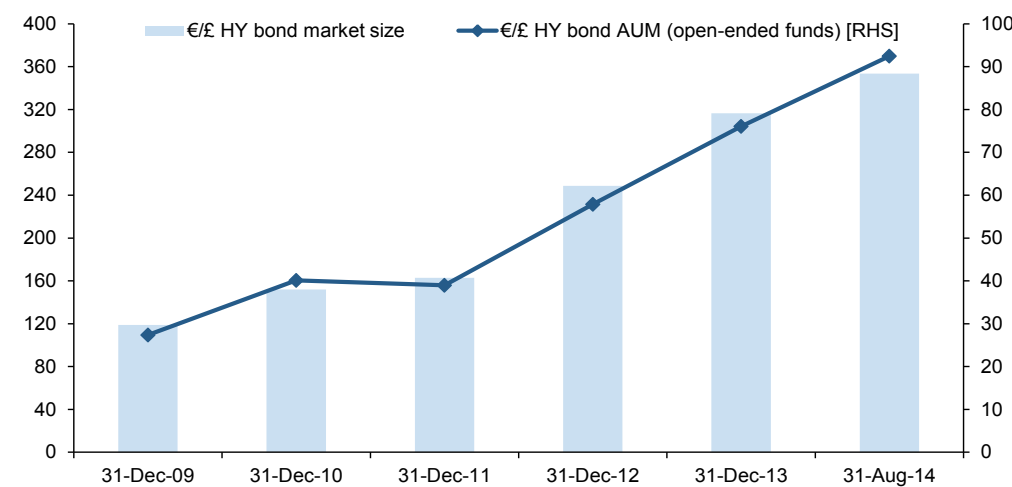
Source: Credit Suisse, ICI, the BLOOMBERG PROFESSIONAL™ service

European HY

Draghi prompted significant monthly inflows to European high yield

- In a similar vein, for European high yield corporate bonds, we observe that the amount of bonds sitting in open-ended funds¹ now equates to €90 billion, which as a proportion of the overall market equates to approximately 25%. This proportion has remained stable over recent years.

Exhibit 36: European high yield corporate bonds – overall market size versus size of open-ended funds



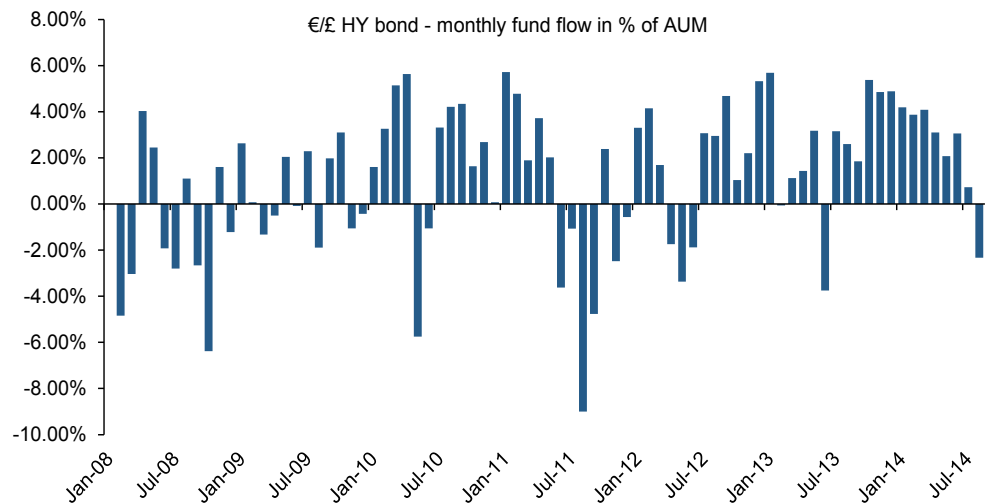
Source: Credit Suisse, Lipper, the BLOOMBERG PROFESSIONAL™ service

Significant outflows from open-ended funds over a short period of time can affect market prices

- What stands out against this backdrop is the concentration of monthly inflows since Draghi's "Whatever it takes" speech in July 2012. It is unclear how much of these inflows are inter-currency (i.e., from USD and JPY investors) and how much are intra-currency (i.e., from EUR investors in other assets, such as investment-grade corporate bonds).
- However, what is clear is that a period of sharp outflows (whether or not they are linked to US monetary policy tightening) is important for short-term price action. For example, a repeat of August 2011 (i.e., a 9% outflow in one month) could see up to €8 billion of high yield bonds being sold by open-ended funds to meet these redemptions. This compares to our estimate of \$2 billion to \$3 billion of European high yield bond inventory across dealers. This mismatch illustrates why significant outflows from open-ended funds over a short period of time can have a substantial impact on market prices.

¹ Otherwise known as mutual funds, pooled funds, or unit trusts.

Exhibit 37: European high yield corporate bonds – monthly fund flows (% AUM)



Source: Credit Suisse, Lipper

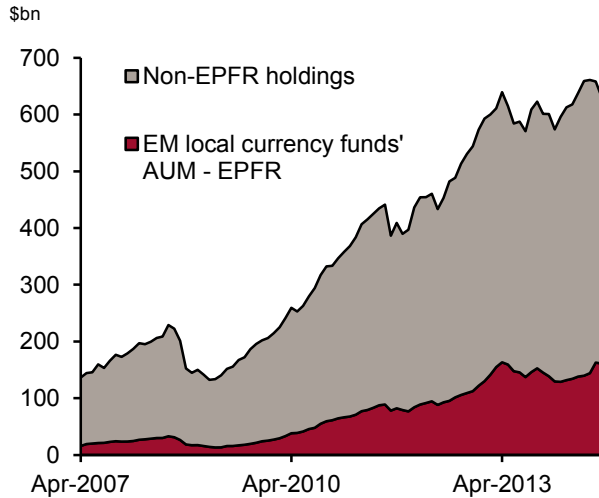
EM local currency markets

The EM local currency market has grown rapidly as investors have sought diversified exposure to the EM universe

- The EM local currency asset class has been one of the major beneficiaries of the Fed’s QE’s and the post-2008/2009 crisis global low interest rate environment. According to our calculations, the asset class – which we measure by the sum of nonresidents’ holdings in the core ten EM markets (EM-10²) – has grown rapidly to \$600 billion in September 2014 from \$117 billion at the beginning of 2007 (Exhibit 38). (See more detail about our data and calculations [here](#).)
- We estimate that about half of foreign holdings are benchmarked to EM indices and to global indices (Exhibit 39). The rapid increase in the asset class was accompanied, and partly led, by growing demand for dedicated EM local currency funds, which provide a diversified exposure to the EM universe. In addition, improving fundamentals in a few EM countries paved the way for the inclusion of selected EM markets – such as Mexico, Malaysia, Turkey, and South Africa – in global bond benchmarks. In terms of non-benchmarked money, our understanding is that the primary holders are EM regional funds, sovereign wealth funds, central banks reserve managers, and hedge funds. This breakdown is not usually available, but 2013 Korea data give us a good insight into the diversification demand from central banks. Foreign central banks accounted for 42% of the total foreign holdings in Korean government bonds, of which Asian central banks held a large share. Actual central bank holdings might vary across markets, but we expect these investments to be relatively sticky, as these holdings still account for a small share of overall foreign assets.

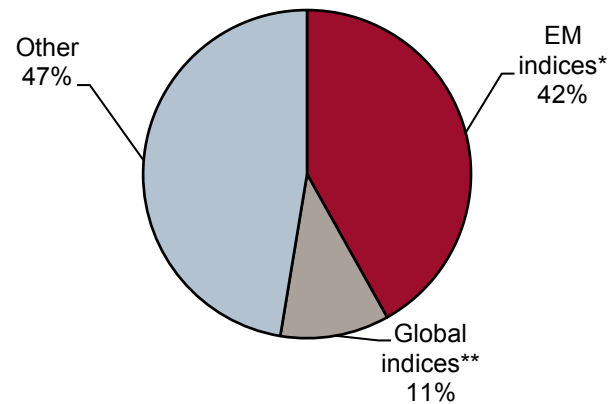
² EM-10: Russia, Turkey, S. Africa, Poland, Hungary, Brazil, Mexico, Thailand, Malaysia, and Indonesia.

Exhibit 38: Foreign holdings in EM-10 local currency bonds



Source: National authorities, EPFR Global, Credit Suisse

Exhibit 39: EM holdings breakdown



* JPMorgan's GBI-EM. **Citi's WGBI and Barcap's Global Aggregate. Our calculations are based on the index providers' estimations of money tracking their indices.

Source: National authorities, Credit Suisse

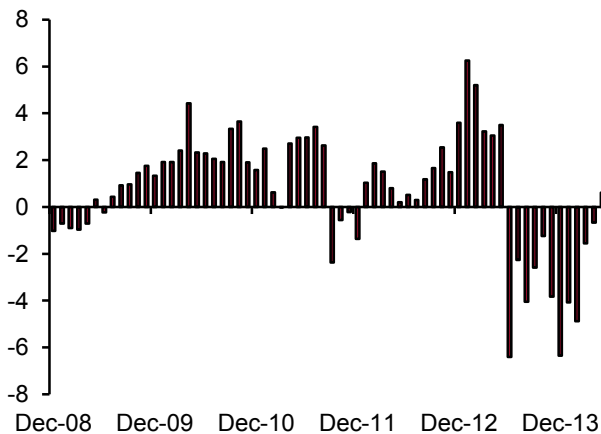
EM asset prices still are very exposed to the market's perceptions of EM expected returns

- EM retail funds, which account for about half of benchmarked funds (on our estimate), recorded sizable outflows of \$37 billion between June 2013 and September 2014 (Exhibit 40). Most of these outflows took place in 2H 2013 right after the Fed's "taper talk." From a historical perspective, this period was probably the single most challenging for these funds. For example, during this period, EM funds recorded 11 months of consecutive outflows (between June 2013 and April 2014), surpassing even the 9 months of outflows at the heart of the 2008/2009 crisis.
- Despite massive outflows from EM retail funds, overall EM local currency government bond markets continued to attract net inflows, suggesting that non-retail investors were net buyers (Exhibit 41) following the "taper talk." This pattern is in line with the [BIS's analysis](#) suggesting that EM retail investors are typically faster to exit in response to losses.
- Despite the past months' allocation shift toward non-retail holdings, retail money remains a big portion of the asset class – probably at least on the order of 25%-30%, by our estimations.³ Against this backdrop, we think that EM asset prices are still very much exposed to big shifts in markets' perceptions of EM valuations or expected returns in 2015.

³ This number is simply calculated as the AUM of EM retail funds that report to EPFR divided by our estimation of total non-residents' holdings in EM-10. Our understanding is that the EPFR sample covers most of the EM retail money, but we acknowledge that this number is an underestimation.

Exhibit 40: EM retail funds have not recovered yet from the “taper talk”...

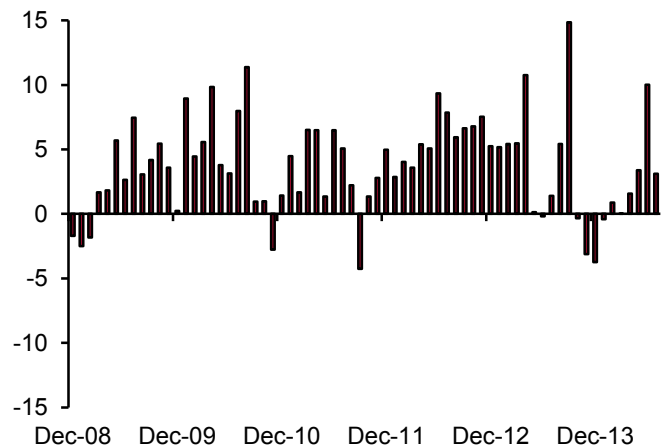
Monthly inflows to local currency government EM retail funds (\$bn)



Source: National authorities, EPFR Global, Credit Suisse

Exhibit 41: ...but overall flows into EM bonds have been much more resilient

Cumulative inflows into local currency bonds in Brazil, Thailand, Turkey, Russia, South Africa, and Poland (\$bn)



Source: Haver Analytics®, Credit Suisse

We look at countries with the greatest sensitivity to potential disruption

In highlighting the greatest market sensitivity to potential disruption, Exhibit 43 shows a matrix of the level of exposure to foreign flows (non-residents’ holdings in local currency government bond as a percentage of GDP) against a measure of retail money holdings (our estimate of the retail money in the non-residents’ holdings). In both cases, a higher number represents a greater risk. We draw the following conclusions based on this matrix:

- **Hungary, Malaysia, and South Africa appear to have the greatest structural sensitivity to outflows.**

Non-residents’ holdings of local currency government bonds in these three markets range between 13% and 15% of GDP. In the cases of Malaysia and South Africa, these sizable positions were mainly built during the post-2008/2009 crisis period (Exhibit 42). This structural weakness suggests that these three local markets could underperform in the case of a sizable broad-based outflow shock from EM local currency bonds.

- **Indonesia, Turkey, and Brazil seem structurally less risky on this metric.**

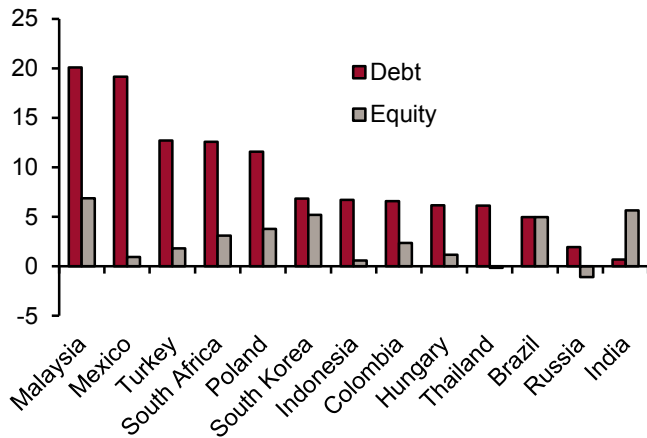
Perhaps somewhat surprisingly, these three “fragile (five)” economies structurally stand out as being the least sensitive to rapid outflows, in our matrix. In the cases of Indonesia and Turkey, non-residents’ holdings in local currency government bonds are equal to about 4.5% – only slightly more than half of the (8.1%) EM average. Brazil specifically also stands out with a small portion of retail holdings of 12% – about one-third that of the (34%) EM average. Still, we note that long-duration rates in Brazil (and Mexico) have the highest correlation and beta to US rates in the EM universe. That could make these rate markets quite vulnerable if EM outflows are triggered by higher UST yields.

- **Retail money dominates holdings in Colombia and Russia, but non-residents’ holdings are small.**

According to our calculations, retail money holdings in Colombia and in Russia account for ~80% and ~53% of the total non-residents’ holdings, respectively. This retail money is largely benchmarked to the GBI-EM index, by our understanding. However, the fact that foreign holdings in these two markets are relatively small (in GDP terms) makes these markets potentially more resilient to negative flow shocks, in our view.

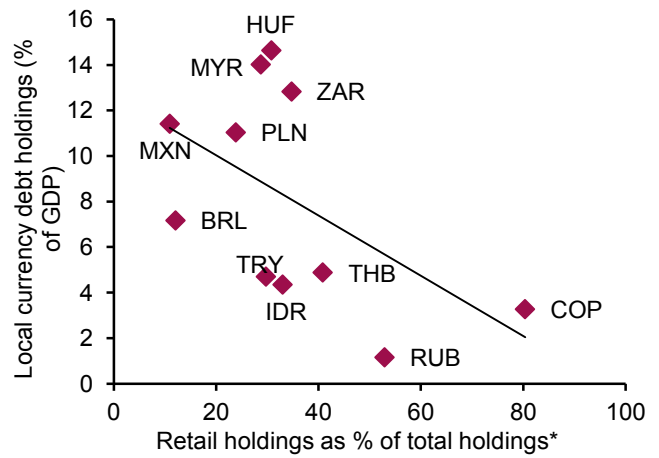
Exhibit 42: Post-2008/9 portfolio inflows in most EM markets were largely in the form of debt

Cumulative portfolio inflows since mid-2009 (% of GDP)



Source: National authorities, EPFR Global, Haver Analytics®, Credit Suisse. BoP data on foreign portfolio liabilities. Data for MYR from BNM and stock exchange.

Exhibit 43: Which markets are structurally more exposed to outflows?



* We calculate the retail holdings based on country allocation of retail funds reporting to EPFR and the AUM of EM funds that report to EPFR (see footnote at the previous page).
Source: National authorities, EPFR Global, Credit Suisse

Coping with Higher US Rates

Impact on the curve, Europe, EM, and Credit

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2015 Core Views

- Fed tightening should lessen Europe’s gravitational pull on US yields; we expect a belly-led sell-off to deliver more curve flattening than is currently priced.
- We expect the impact of higher US yields on European yields to be contained but expect a modest steepening in EUR 2s10s and peripheral spread tightening. The gradual pace of UK rate hikes should contribute to Gilts outperforming Treasuries.
- For EM, we expect a potentially volatile “transition” toward a “new equilibrium” distinguished by greater risk differentiation.

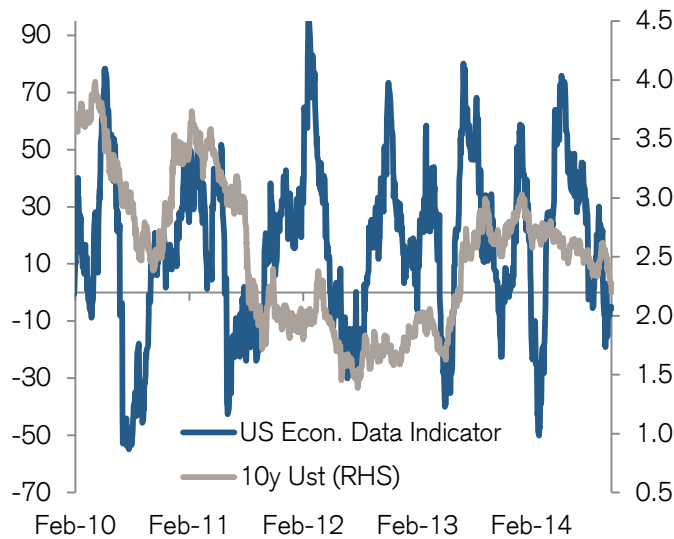
We expect the first Fed rate hike for the cycle to occur in June 2015 and for the Fed to have hiked in four 25bp increments by year-end. Current market pricing projects not only a later start but also a much slower pace that implies, in part, a reasonable likelihood that hikes occur only at alternating meetings. We see it as far more likely that once the Fed decides to move, it will move at or near a pace of one hike per meeting.

One of our recurring themes from our 2014 publications has been the dependence of long rates on global concerns – particularly fears of a “triple-dip” recession in Europe that cuts short the Fed’s intended course of rate normalization. Exhibits 44 and 45 show that US Treasury 10y yields have indeed been more correlated with European data than US data.

Barring an unexpectedly sharp turn in European economic prospects, therefore, we expect the early part of the Fed tightening cycle to deliver curve flattening that exceeds that priced by the forwards.

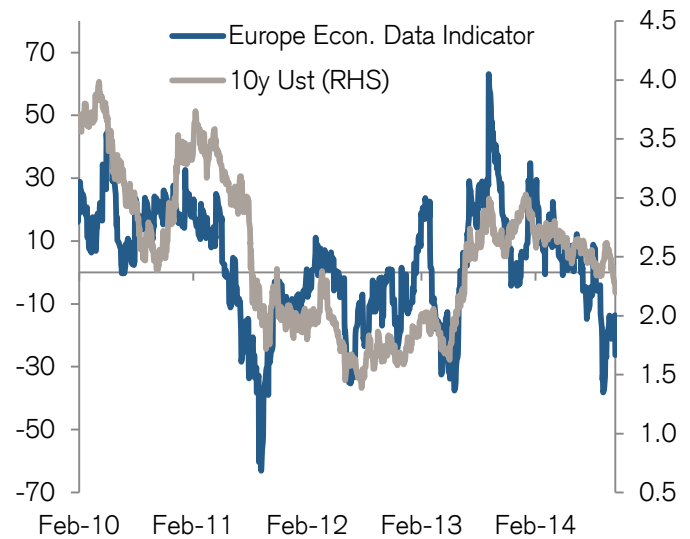
US yields have been more correlated with European data than US data

Exhibit 44: 10y US yields versus US economic data composite



Source: Credit Suisse

Exhibit 45: 10y US yields versus EUR economic data composite

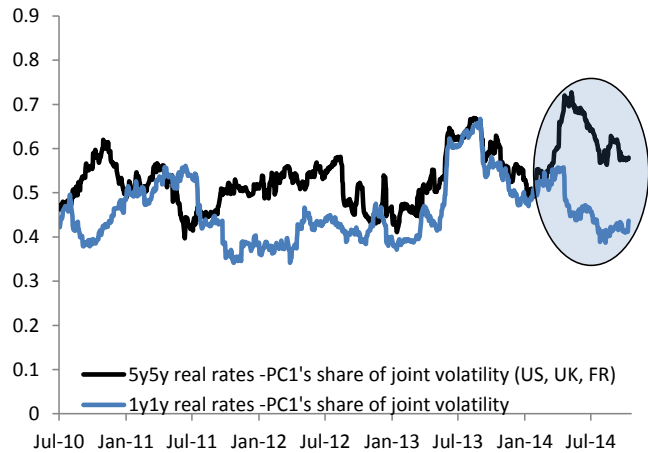


Source: Credit Suisse

The gravitational pull of Europe should lessen as the Fed tightens

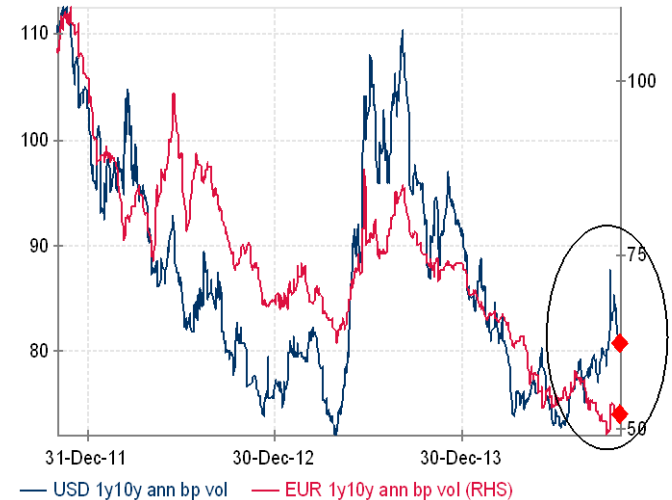
Still, we do expect the gravitational pull of Europe to lessen as we enter the Fed tightening phase. The vol market appears to have recently begun to take this theme on board with an increasing divergence between 1y10y USD and EUR rate vol. This, despite the high trailing correlation, suggests that the US will at least become an even higher beta market.

Exhibit 46: Longer-dated forward rates have shown a higher degree of co-movement than shorter-dated forwards...



Source: Credit Suisse

Exhibit 47: ...but vol markets are beginning to suggest that this correlation will lessen as Fed hikes approach



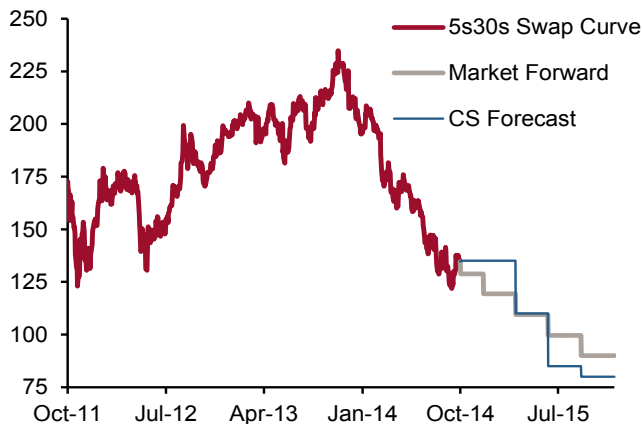
Source: Credit Suisse Locus

Tightening is likely to deliver more curve flattening than is priced

Our USD flattening theme is already reflected to some extent in the forwards, although not fully. Exhibits 48 and 49 show that the market already prices for significant flattening of the 5s30s swaps curve (45bp from here by end-2015), but our forecasts assume even more aggressive flattening of 55bp. In addition to global growth concerns weighing on long-dated yields, we expect the inflation risk premium to be slow to recover as rents remain nearly the only piece of core services inflation to be running above the Fed's 2% target. Core goods remain essentially flat, while food and energy have been in decline, led by energy.

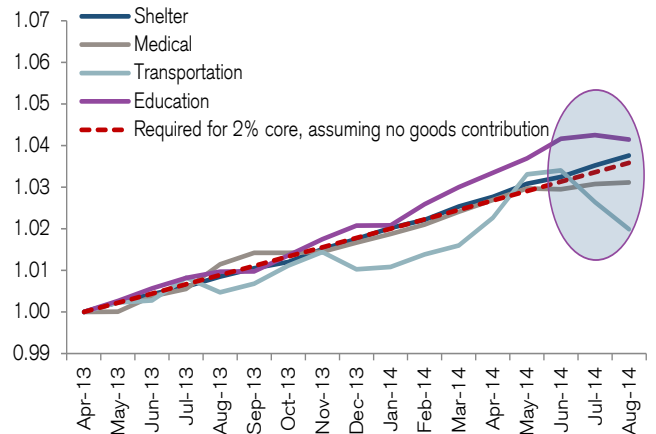
Exhibit 48: Our forecasts call for even more substantial flattening of the 5s30s curve than is currently priced in the forwards

CS Swaps curve forecast assumes unchanged swap spreads



Source: Credit Suisse

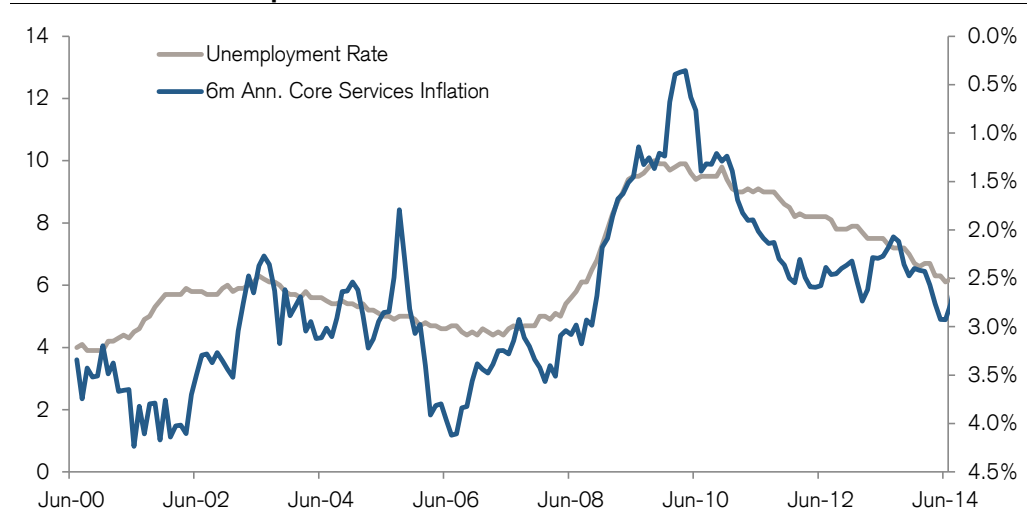
Exhibit 49: Shelter is the only component of core services delivering an inflation rate consistent with 2% core



Source: Credit Suisse

We do observe a Phillips curve for core services inflation given the large share of labor in the underlying cost of these services and expect core service inflation to pull overall inflation higher as wages accelerate in 2015. This is likely to take time to play out, however, as real wages remain somewhat high relative to the level of employment.

Exhibit 50: The Phillips curve is alive and well for core services inflation



Source: Credit Suisse

Muted European reaction to higher US yields likely

A slow, steady hike in US rates should mean a contained European reaction

The European reaction to US rate rises, both in the core and periphery, depends in large part on the speed of the increase in US yields. In the expected environment of a slow, steady hiking cycle with less follow-through than usual further out the curve, we expect the impact on European yields to be contained.

US-Germany yield divergence could be sustained or even widen

EUR 2s10s should steepen. The 10y US-German yield differential already stands at ~150bp, pricing in significant divergence; we think that this divergence can be sustained and could even widen depending on the relative economic paths. Provided that European inflation stabilizes, we would expect a move higher in US yields to feed through to EUR 10s with a low beta (currently 0.5) and steepen the EUR 2s10s curve. In this scenario, curvature should rise, led by the 10y sector.

We believe that further declines toward deflation would also weigh on US yields, reducing the potential for further yield divergence; by contrast, a faster-than-expected pick-up in European growth and inflation should lead to a narrowing of the yield differential.

We think that the cleanest way to express the divergence view is through front-end spreads, which better reflect monetary policy divergence, rather than 10y+ spreads, which are more subject to global factors. But we note that the vol market has already built in a significant premium for divergence across the curve. Exhibit 51 shows the

Exhibit 51: Market-implied US-EUR spread

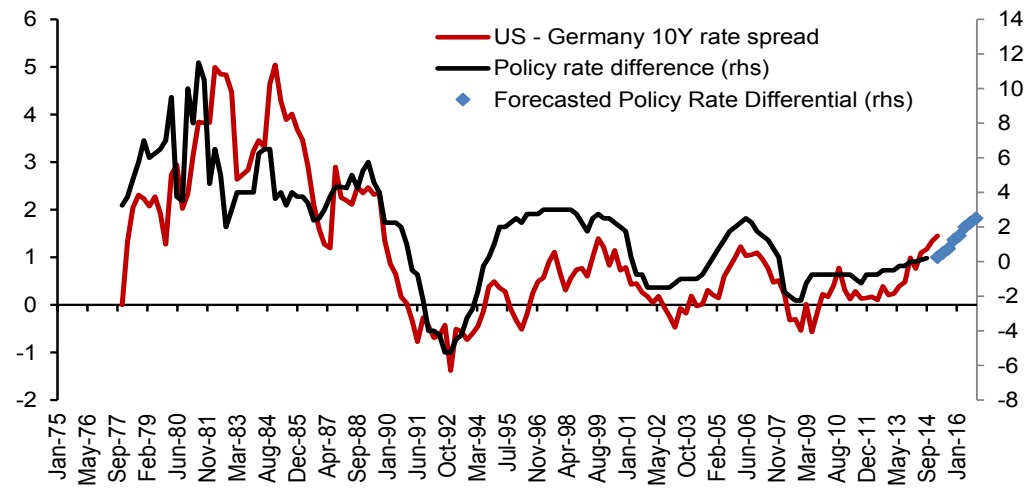
All-in breakeven cost includes rolldown

	2y	5y	10y	30y
All-in breakeven spread	211	206	169	139
1y forward spread	139	169	155	130
Spot spread	50	131	141	123

Source: Credit Suisse Locus

vol market-implied US-EUR spreads for 2y, 5y, 10y, and 30y tails versus the current spot spreads. [We discuss our preferred expressions in the Rates section.](#)

Exhibit 52: Our rate forecasts suggest continued divergence



Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

We recommend trading the periphery through spread tighteners. We discussed the implications of higher US rates on the periphery in detail in [Global Rates Atlas: From Summer storm to August calm](#). Provided that US rates rise based on improving growth expectations, rather than increased inflation or term premia, we believe that the resultant feed through to improved peripheral growth expectations should dominate any increase in debt-funding costs on peripheral debt dynamics, resulting in tighter peripheral spreads.

Rising US rates typically lead to higher peripheral rates but tighter spreads

Historically rising US rates have tended to result in higher peripheral rates but tighter spreads (Exhibit 53); we also find that the beta of peripheral yields and spreads to US rates has reduced through the year, indicating reduced sensitivity. Absent a sharp increase in US rates, we expect that to be maintained. The potential for peripheral-driven spread weakness is a separate issue, which we discuss in the [European Rates section](#).

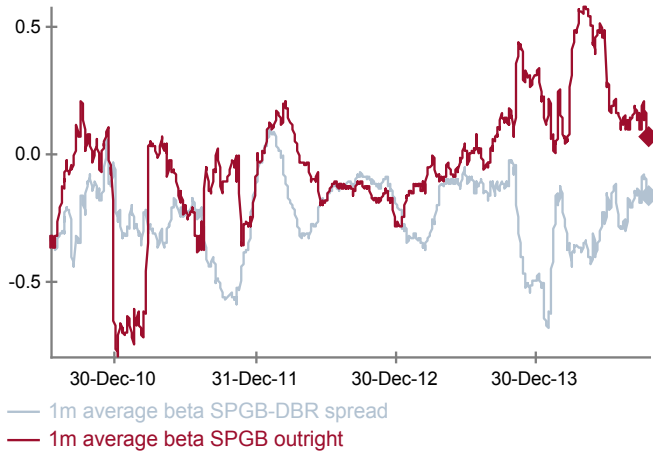
Gilt yields should follow Treasuries higher in 2015, and we expect Gilts to outperform Treasuries

UK rate hikes should be gradual, and Gilts should outperform Treasuries. We expect Gilt yields to follow Treasuries higher in 2015, with 2y and 5y spreads driven by the respective monetary policy paths of the Fed and the BoE. Wage growth remains very low in the UK (Exhibit 54) and is likely to be the key factor that determines which central bank moves first. In the UK, the MPC wants to see a pick-up in earnings to give it confidence that households will be able to withstand higher rates.

Higher household debt, coupled with continued economic headwinds from ongoing fiscal austerity and euro area weakness, means that the peak in UK rates should be lower than in the past and that Gilts should outperform Treasuries.

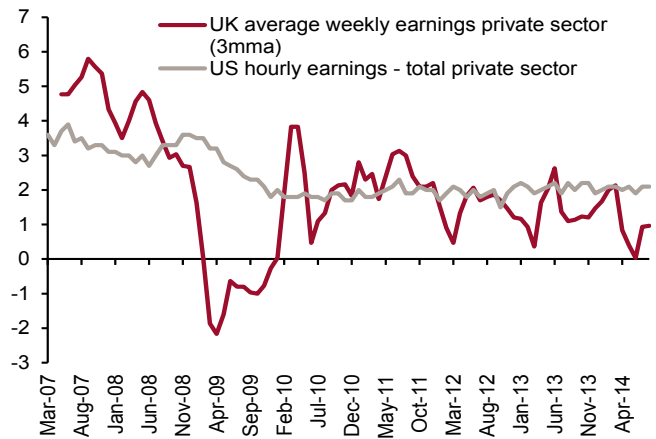
Exhibit 53: Peripheral yields tend to rise if US yields rise, but peripheral spreads tend to tighten

3m beta of SPGB-DBR spread to 10y UST.



Source: Credit Suisse Locus

Exhibit 54: UK wage growth is surprisingly low – outright and versus the US



Source: Credit Suisse

Do higher US yields matter for EM?

The taper experience has strongly shaped market expectations when it comes to the impact of higher Treasury yields on emerging markets. Historically, however, there is no clear pattern between Treasury yields and EM performance.

Historically, there is no clear pattern between Treasury yields and EM performance

What past experience suggests is that, as for peripheral Europe, the driver of rates matters. Typically, higher US rates have followed stronger US/G3 growth, which has benefited EM economies more than the initial phase of higher yields has hurt them, as various studies (e.g., the [2014 IMF spillover report](#)) show.

Conceptually, we think of the EM response as a two-stage process:

1. the "transition" to US higher rates
2. the "new equilibrium" once the initial repricing has occurred (i.e., a world in which capital is more costly and, possibly, scarcer)

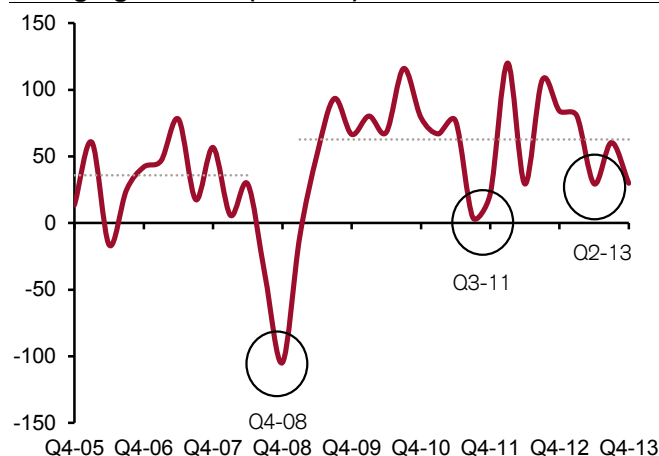
However, even modest flows out of EM could trigger significant volatility this time around

"Transition" has tended to coincide with modest volatility for risky assets in the run-up to the first hike. We believe that this cycle threatens to be somewhat different for EM, given the extended period of low interest rates and unprecedented inflows into EM assets and given that any stock adjustment in the financing of EM assets occurs against the backdrop of much-reduced liquidity in [credit markets in general and EM in particular](#). In that environment, even modest capital flows out of EM assets, once rates markets start to price a sustained tightening cycle, risk triggering significant bouts of volatility, in our view.

As long as US yields rise slowly, EM spreads should remain high

From a longer-term perspective, low rates have only been one of the factors behind strong inflows into EM assets, as Exhibit 55 shows. The development of EM local debt and hard currency corporate debt markets represents a natural diversification in an environment of (relative) stability across EM that is unlikely to reverse, in our view. Moreover, as long as US yields rise gradually, rate differentials are likely to remain elevated for many EMs and should prompt continued demand for EM fixed income in an overall low-rate environment.

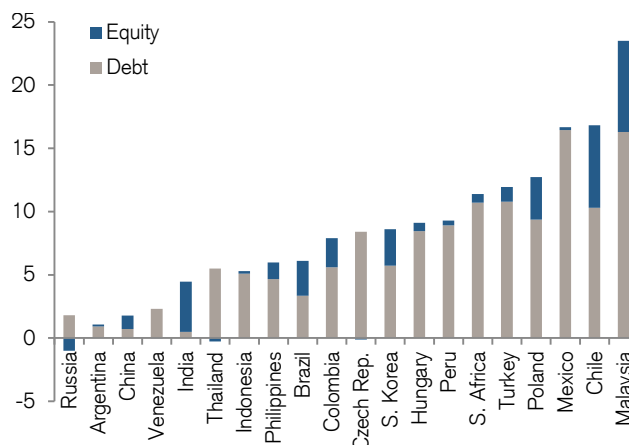
Exhibit 55: Gross portfolio inflows to selected emerging markets (USD bn)



Note: Our selection includes Argentina, Brazil, Chile, Colombia, Czech Rep., Hungary, India, Indonesia, Korea, Malaysia, Mexico, Philippines, Peru, Poland, Russia, South Africa, Turkey, Venezuela (Q3-4 2013 data for Peru and Venezuela are Credit Suisse estimates).

Source: IMF, Credit Suisse

Exhibit 56: Cumulative gross portfolio inflows between 2010 and 2013 (as % of GDP)



We expect greater risk differentiation to be the main feature of the "new equilibrium"

We therefore expect greater risk differentiation to be the main feature of the "new equilibrium," rather than wholesale capital exodus. The question is whether or not large inflows at low rates have created dependencies and vulnerabilities that could be exposed in a world of higher real interest rates? We highlight five criteria:

- EMs that benefitted from large portfolio inflows may be at risk:** Malaysia, Chile, Mexico, Poland, Turkey, and South Africa have been the biggest beneficiaries of capital inflows among the major EM economies,⁴ with cumulative flows of over 10% of GDP between 2010 and 2013.
- EMs with persistent current account deficits may have to adjust:** Turkey, South Africa, Peru, Brazil, Colombia, Chile, and Indonesia ran current account deficits above 3% in 2013. Mexico and the Czech Republic ran more modest deficits, but portfolio inflows financed over half of it, by our estimates.
- A reversal in foreign holdings of local debt may put pressure on interest rates and exchange rates:** Foreign investors have absorbed a large share of local currency debt in several EMs. Foreign ownership of local currency government securities stood above 30% in Malaysia, Peru, Poland, Indonesia, Mexico, Hungary, and South Africa as of August 2014, by our estimates.
- Private-sector debt rollover may become challenging, especially where leverage is high:** Strong credit growth has caused private-sector debt to rise above 100% of GDP in China, Hong Kong, Korea, Malaysia, Hungary, Singapore, Taiwan, and Thailand.⁵
- The scope for policy responses:** Beyond classic policy tightening in response to tighter global liquidity conditions (with negative impact on growth), most EM economies have accumulated sizable FX reserves, which can serve to mitigate the impact of portfolio outflows. Moreover, adjustment through FX depreciation is also an option for several EMs with manageable FX-denominated liabilities, as long as inflation remains under control.

⁴ We focus our analysis on the major EM economies: Argentina, Brazil, Chile, Colombia, Czech Rep., Hungary, India, Indonesia, Korea, Malaysia, Mexico, Philippines, Peru, Poland, Russia, South Africa, Turkey, and Venezuela.

⁵ Hong Kong's private-sector leverage has been boosted by debt issuance of Chinese corporates. Hungary's private-sector debt is partly due to the banking sector's external liabilities and to inter-company lending from foreign parents to local subsidiaries, but foreign debt declined significantly over the past few years.

Credit spreads show historical robustness

Historical precedent from the past 30 years suggests that credit spreads tend to stay tight during tightening cycles. Exhibit 57 illustrates US high yield spreads versus 2y US yields for the four major tightening cycles in this period, beginning in 1987, 1994, 1999, and 2004.

While credit has tended to be stable through prior tightening cycles, the fallout from the end of QE remains uncertain

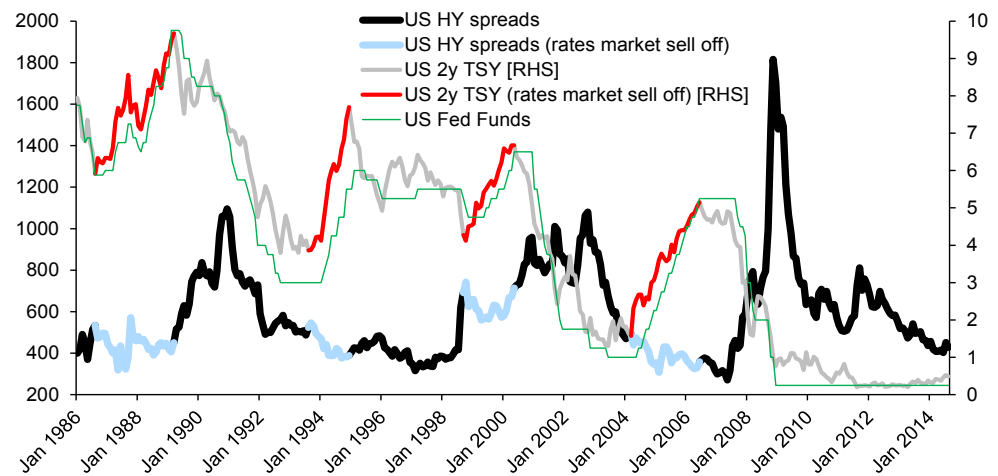
For each of these four tightening cycles, the broad trend has been stable or falling credit spreads:

- 1994 and 2004: The overall trend was tightening credit spreads.
- 1999: Credit spreads initially tightened before widening toward the end of the tightening phase.
- 1987: After initial tightening, spreads remained stable thereafter, with the exception of the 19 October 1987 equity-market crash.

Might this cycle be different because of QE? The unwinding of QE in the coming cycle is a potential headwind to the historical pattern of credit spreads remaining robust.

Exhibit 57: US high yield spreads versus 2y UST – historical precedence over the past 30 years suggests that credit spreads remain robust during tightening cycles

US high yield spread-to-worst versus 2y US Treasury yield and US fed funds rate
Periods of increasing government yields highlighted.



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

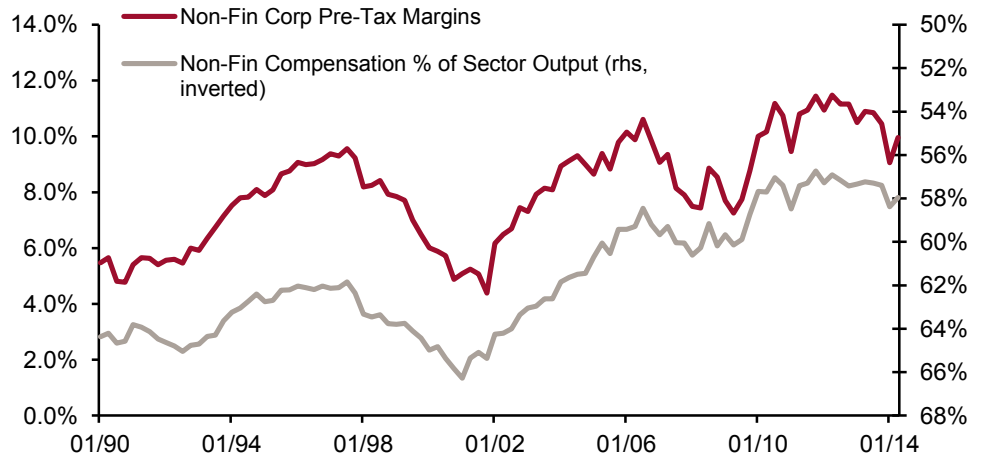
Still, US corporate credit fundamentals remain mostly positive, and presumably, Fed tightening will occur only with the real economy growing on trend or better. Moreover, the Fed is likely to remain fairly transparent – keeping vols suppressed, further supporting spreads.

Wage growth could trouble US firms, but margins and coverage ratios should remain strong

A sharp climb in wage growth would perhaps be one of the larger worries for US firms, given that margins are likely near their peak. However, remaining labor market slack and global competition should prevent rampant wage growth. Given that inflation is likely to increase along with a higher wage profile, we believe that margins and coverage ratios are likely to remain strong enough that the defaults and downward ratings transitions will not pick up meaningfully until well into any Fed-hiking cycle.

Exhibit 58: Modest wage gains are unlikely to dampen margins significantly

Non-financial corporate margins and compensation as a percentage of non-financial GDP.



Source: Credit Suisse, Federal Reserve

USD Rally: How Far and For How Long?

Still bullish into 2015

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2015 Core Views

- We expect spread widening in the USD's favor above and beyond what's already in the price. This means that our cyclical framework is USD-positive.
- Our view is based on cyclical US economic outperformance, structural flows such as GPIF-related outflows from Japan, as well as the prospect of further monetary easing from other major central banks, such as the ECB.
- Current NEER USD valuation is cheap compared to longer-term averages.

Happy days

G10 FX is historically driven by growth and interest rate differentials

Growth and interest rate differentials are commonly accepted as important drivers of FX direction in the G10 space, especially when inflation is universally low and not a major contributor to changes in real effective exchange rates. This is particularly relevant when these differentials significantly diverge beyond embedded market expectations.

Exhibit 59: Past, present, and future

Market expectations (%)				
	2y swap	1y2y swap	2y swap	1y2y swap
Currency	1 year ago	1 year ago	Current	Current
USD	0.43	0.93	0.72	1.55
EUR	0.48	0.79	0.21	0.29
GBP	0.79	1.28	1.07	1.62
JPY	0.22	0.26	0.16	0.18
AUD	2.96	3.60	2.76	2.91
NZD	3.42	4.27	3.90	4.14
CAD	1.42	1.85	1.42	1.74

USD-ccy rate differentials (bps)				
	2y swap	1y2y swap	2y swap	1y2y swap
Currency	1 year ago	1 year ago	Current	Current
EUR	(5)	14	51	125
GBP	(36)	(35)	(35)	(7)
JPY	21	67	56	136
AUD	(252)	(267)	(204)	(136)
NZD	(299)	(334)	(318)	(259)
CAD	(99)	(92)	(70)	(19)

CS forecasts vs market expectations				
	1y2y swap	2y yield	US-ccy 1y2y spread	US-ccy 2y spread
Currency	Current	CS end-2015 forecast	Current	CS end-2015 forecast
USD	1.55	2.00		
EUR*	0.29	(0.05)	125	205

*German benchmark

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

The basic argument is that strong growth and relatively high returns attract capital and create space for FX appreciation in countries that are net recipients of such flows. Only if existing financial imbalances are unusually large (e.g., an especially big current account or fiscal deficit) is there a pressing case for wondering whether currency valuation questions can undermine the sustainability of such flows.

Structural flows also need to be considered

Beyond these cyclical drivers, there are also structural flows that need to be considered, as these often generate the seemingly frequent occasions when exchange rate movements appear to have little relationship to fundamentals. In this section, we consider both cyclical and structural dimensions and conclude that USD strength is likely to persist in 2015.

Cyclical picture

In Exhibit 59, we consider what the market has already priced in for key interest rate differentials (themselves good proxies for growth outcomes) and compare that with Credit Suisse’s house view.

It’s clear that the market has already priced in a “Fed exit” and “policy divergence” to some extent given that 1y2y rates are much higher in the US than current rates and also that rate differentials are already priced to move in the USD’s favor.

The 29 October FOMC statement certainly helped to restore faith that the Fed is prepared to move on with exit from ultra-easy monetary policy despite concerns that weak global growth and low inflation could delay matters. This embedded expectation also raises an important hurdle for USD bulls. As 1H 2014 proved, when these expectations aren’t realized, the USD tends to suffer.

Rate differential expectations not being realized led the USD to underperform in 2014

Coming into 2014, the market was USD bullish for similar growth and policy divergence reasons. But, in practice, the weakness in US growth in 1H 2014, combined with ECB stubbornness and the BOJ largely sitting on its hands, led to initial rate differential expectations not being realized and the USD underperforming.

Exhibit 60: The recent USD rally is a small move for the USD, relative to history



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

What about Credit Suisse's forecasts?

Our economists continue to believe that the Fed will hike rates by 100bp in 2015, starting at the June FOMC meeting. Despite US rates having backed up from their recent lows, this still leaves us expecting a more hawkish Fed than the market is pricing. Our equity strategists are also very constructive on US economic developments and the likely benefits for the USD ([Global Equity Strategy: The mighty dollar: why, and implications](#)).

Meanwhile, in most other regions, we expect further moves toward monetary easing to remain a key risk for the market to consider. In particular, we note the possibility of the ECB having to buy sovereign debt in 2015 as a means of expanding its balance sheet more dynamically. And the market is actively debating whether more European countries can follow Switzerland and the Czech Republic and have EUR floors against their currencies (Sweden is one possible candidate).

This embeds the idea that further policy easing outside the US is not simply a EUR story. So as the rate differential forecast above shows, Credit Suisse expects spread widening in the USD's favor above and beyond what's already in the price. This means that our cyclical framework is USD-positive.

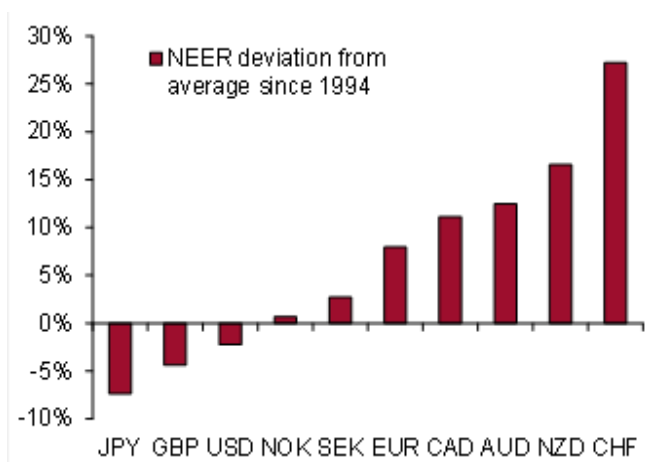
We expect spread widening in the USD's favor above and beyond what's in the price

Back to the future?

A look at the USD Index over the past 20 years (see Exhibit 60 above) shows that, from a longer-term perspective, neither is current USD valuation exceptionally rich nor is the USD rally seen in the past few months especially aggressive. Most FX valuation models also do not register the USD as expensive. One simple approach is to use one similar to what the RBNZ did in the case of NZD ([Unlucky thirteen](#)). If we compare the current NEER valuation with longer-term averages, the USD still registers as cheap (see Exhibits 61 and 62). This further encourages our bullish view on the greenback.

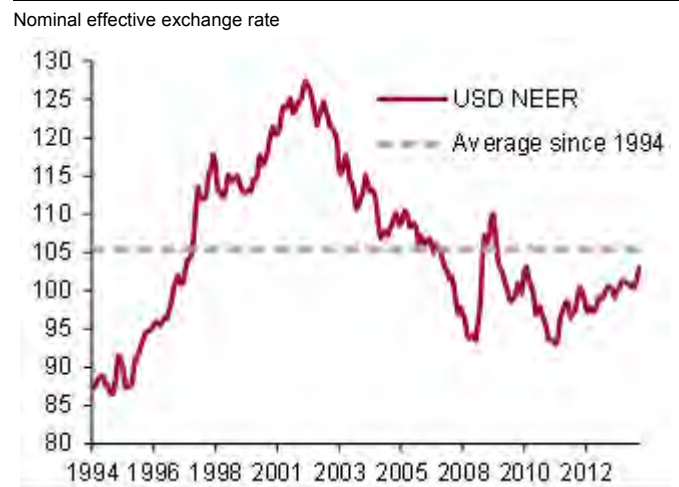
USD still registers as cheap, in our view

Exhibit 61: Relative NEER valuations



Source: Credit Suisse, BIS

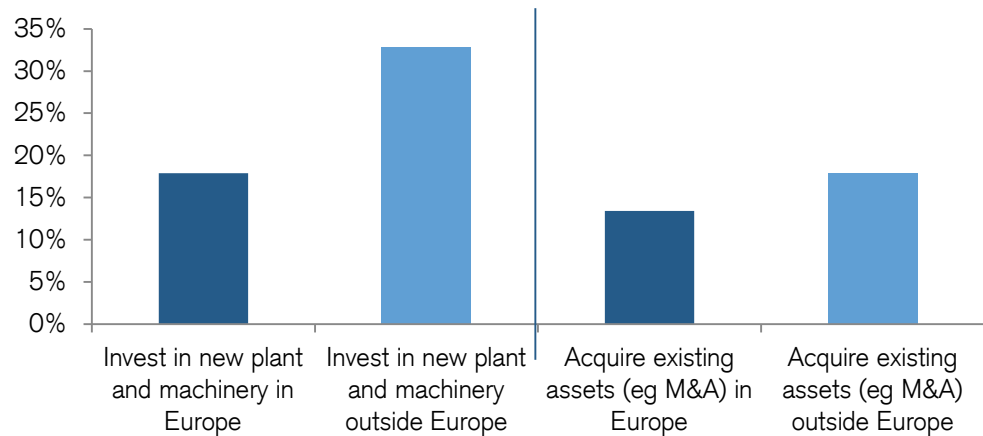
Exhibit 62: Historical USD NEER doesn't look expensive



Source: Credit Suisse, BIS

And beyond the simple macro numbers, there are grassroots signs of a key driver of USD strength in the late 1990s – strong foreign appetite for direct investment in the US. As Exhibit 63 shows, Credit Suisse's own corporate survey ([CS Executive Panel: Fact and fiction](#)) shows that Europeans are more inclined to invest outside Europe than inside. Given the US's typical role as a beneficiary of such flows, this encourages us to think that the net FDI flow picture that has supported EURUSD in recent years could soon turn.

Exhibit 63: “If you are planning on increasing corporate spending, which one do you prefer?”



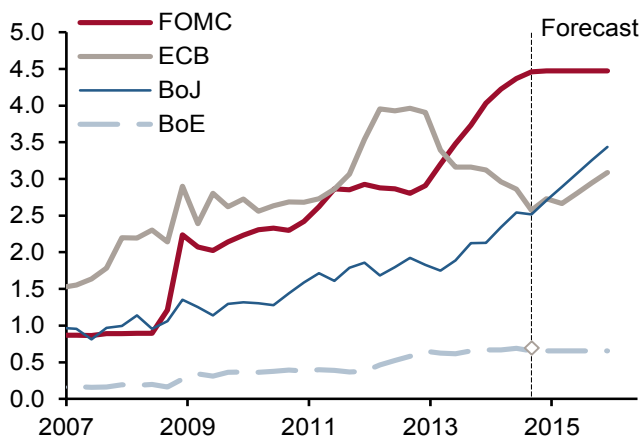
Source: Credit Suisse

Can anything hold the dollar back?

At this stage, an obvious question to ask is whether it is possible to repeat some form of the 50% 1995-2001 DXY rally. After all, as Exhibit 65 shows, in some cases, rate differentials have already done a lot of work in that direction. An obvious answer is that we need to factor in the impact of three rounds of Fed QE between 2009 and 2014 – relative balance sheet size changes clearly had a big impact on market perceptions of how the USD should trade. Indeed, looking at US capital flows, we consider it likely that QE had an important role in prompting US private capital to push overseas to look for returns (Exhibit 64). So the primary risk to our view remains a reversion to US economic weakness sufficient to bring the prospect of Fed bond buying back onto the table or at least to eliminate the Fed rate hikes in the price over the next couple of years.

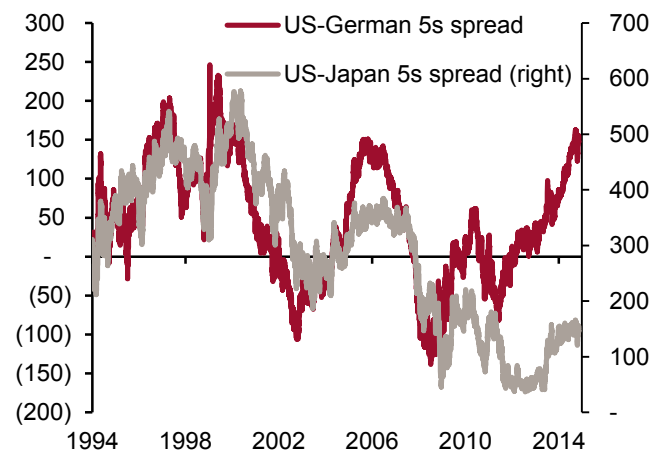
Exhibit 64: Fed balance sheet expansion hurt the USD

Central bank balance sheet size (USD trillion)



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 65: Some rate differentials are back at late-1990s levels seen during the USD's last bull market



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Expected Returns & Risk Analysis

Base case heavily favors equities, with reduced allocations to spread markets and government bonds

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We favor overweights in equities and underweights in lower-risk fixed income markets

2015 Core Views

- Our base case for 2015 includes another year of strong returns in global equities and modestly negative returns in fixed income.
- Better-than-expected global economic growth should improve returns over the base case, while subdued growth should reverse return expectations, with fixed income outperforming and equities returning slightly negative.
- Our Black-Litterman-type asset allocation model favors equities at the expense of other assets but recommends maintaining the benchmark allocation to risky fixed income in the base case.

Our recommended asset allocation for 2015 is summarized in Exhibit 66. We again favor overweights in equities, with underweights in lower-risk fixed income markets. The benchmark weight in risky fixed income should be maintained, in our view. We expect returns in fixed income markets to be fairly correlated as a result of decreased liquidity and potential central bank tightening.

We have overlaid our portfolio recommendations with model-generated weights using a Black-Litterman-type asset allocation model. This allows us to quantify the implications of our asset-return forecasts. The deviations from benchmark that the model suggests appear to be in line with our broader market recommendations. We discuss this quantitative approach in more detail below.

Exhibit 66: Recommended portfolio allocation

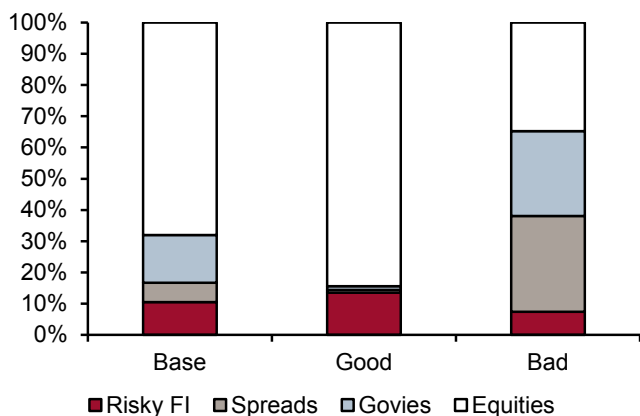
Global asset classes; base case

Asset Class	CS Recommendation	Benchmark Weight	2015 Model Weight
Government	Underweight	28%	16%
Credit and Spread Markets	Underweight	14%	7%
Risky Fixed Income	Market Weight	4%	5%
Equities	Overweight	54%	72%

Source: Credit Suisse

Exhibit 67: Recommended allocation

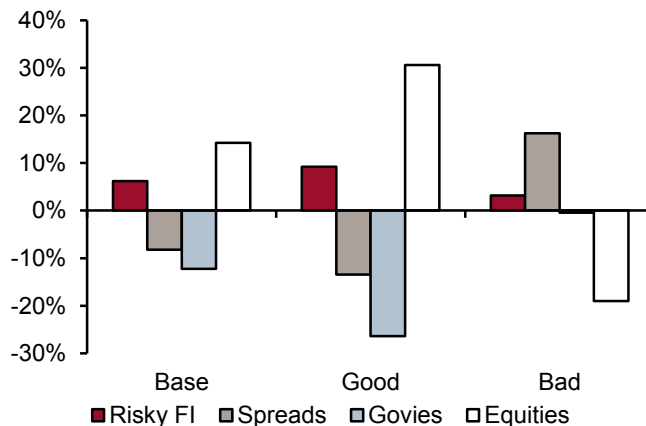
Global asset classes



Source: Credit Suisse

Exhibit 68: Deviation from benchmark weights

Global asset classes



Source: Credit Suisse

The base case in 2015 is strong returns in global equities (most indices returning double digits), accompanied by slightly negative performance in fixed income returns. We provide our full list of return expectations by index in Exhibit 73 at the end of this section.

We have input these index return forecasts into our Black-Litterman-type allocation model to calculate how our return expectations might translate into an investor portfolio. This model factors in historical performance and future return expectations to arrive at an optimized portfolio weighting. We have calibrated the model to achieve a long-only allocation and present the results scaled to a fully invested portfolio to highlight the relative allocation preferences. The charts in this section show the model's output as recommended deviations from a benchmark portfolio (Exhibits 69, 70, 71, and 72). The benchmark used was based on the market caps of the underlying indices. For more information on our Black-Litterman asset allocation methodology, we refer readers to [Macro Tactics: policy innovations and toolkit additions](#) (7 November 2013).

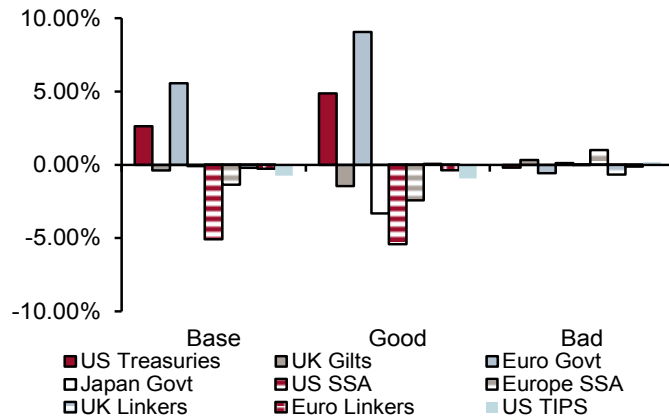
Additionally, we have included return forecasts for good and bad economic scenarios, referring to better-than-expected and worse-than-expected global growth, respectively.

Our primary takeaways from the analysis are as follows:

- **Overall**, the model favors equities over fixed income, in line with our market views. In the good economic scenario, the model increases equity and risky fixed income exposures and reduces other fixed income allocations further. However, in the bad scenario, the model recommends holding the benchmark weight in risky and government securities while reducing equity exposure somewhat.
- **We observe a strong preference for sovereign debt** in the developed markets, especially European government bonds in the base case. Additionally, the model favors US Treasuries over sub-sovereigns in the US and Europe. In the good scenario, there is decreased allocation to Japanese sovereign debt, while other allocations remain stable.
- **In an adverse economic scenario**, the model recommends virtually no deviation from benchmark in government bonds, which may indicate that fixed income investors are already well positioned for a stall in global growth.
- **In risky fixed income**, we see a strong preference away from emerging market corporates in the base and good scenarios and increased allocation to US high yield, in particular. This partly reflects the expected outperformance of the US HY index but discounts similarly strong expected returns in European HY.
- **In equities**, the model prefers a decreased allocation in US equities in the base and good cases in favor of increased weightings in European and Japanese stocks. However, in the event of worse-than-expected economic growth, investors should push farther into US equities and out of other developed markets, according to the model results.
- **Model allocations in spread markets** shift toward US MBS and out of US Agencies and European covered bonds. The Euro CBI allocation is dramatically reduced in a good economic scenario but slightly increased in the bad case. The allocation in Japanese corporates should be cut in all three scenarios.

Exhibit 69: Deviation from benchmark weights

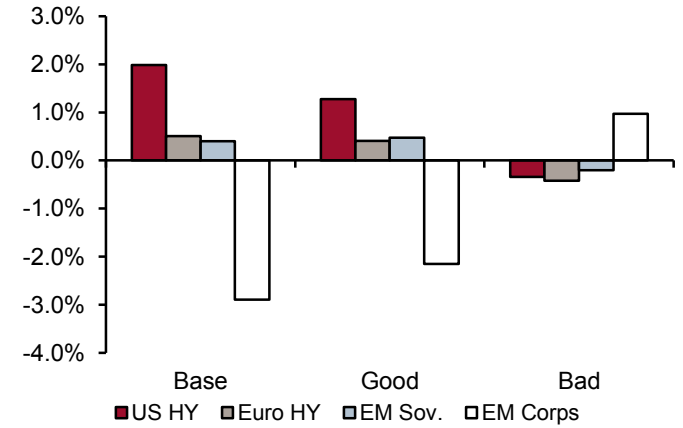
Government and near-government securities



Source: Credit Suisse

Exhibit 70: Deviation from benchmark weights

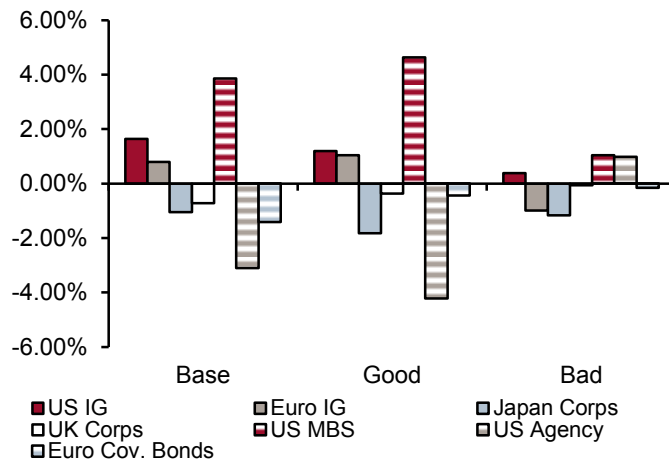
Risky fixed income



Source: Credit Suisse

Exhibit 71: Deviation from benchmark weights

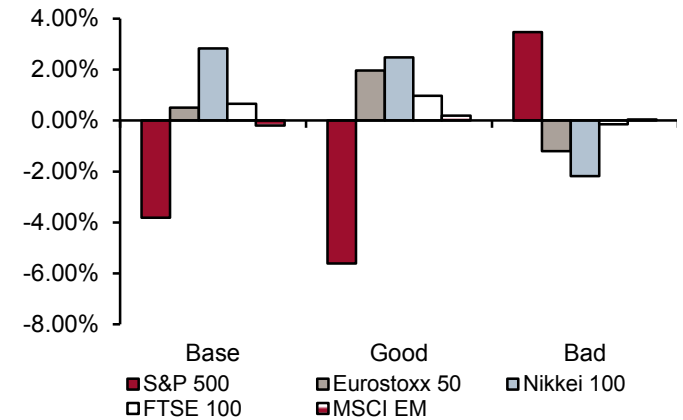
Spreads



Source: Credit Suisse

Exhibit 72: Deviation from benchmark weights

Equities



Source: Credit Suisse

Exhibit 73: 2015 scenario-based expected returns

Forecast returns refer to the performance of a reference index and may not equate to a specific investment product. They may also not match the forecasts for specific products carried in the rest of this publication.

	Index	Base Case	Alternate Scenarios	
			Good	Bad
Fixed income – government and agencies				
US Treasuries	USGI	-4.5%	-6.1%	2.6%
UK Gilts	UKTI	-6.1%	-13.0%	4.9%
Euro Government	EURGI	-0.1%	-0.6%	1.7%
Japan Government	JGI	-1.8%	-4.2%	1.0%
US SSA	SASI	-4.1%	-4.1%	1.2%
Europe SSA	EASI	-1.3%	-2.7%	2.8%
UK Linkers	GILI	-3.4%	-3.4%	-3.4%
Euro Linkers	EILI	-1.3%	-2.3%	1.1%
US TIPS	TIPS	-4.6%	-6.5%	3.5%
Fixed income – credit and spread markets				
US IG	LUCI	-1.9%	-6.4%	9.1%
Euro IG	LEI EUR	0.0%	0.1%	0.2%
Japan Corporates	LJCI	-0.1%	-0.4%	-0.1%
UK Corporates	LEI GBP	-3.2%	-1.4%	3.1%
US MBS	MTGI	-1.7%	-1.5%	6.3%
US Agency	LUAI	-3.4%	-5.1%	3.8%
Euro Covered Bonds	CBI	-2.0%	-0.8%	1.5%
Fixed income – risky spread				
US HY	DLJHVAL	5.0%	6.3%	0.2%
Euro HY	DLJWVLHE	4.5%	4.5%	3.0%
EM Sovereign	SBI	2.8%	4.0%	3.8%
EM Corporates	EMCI	1.6%	-0.1%	4.7%
Equities				
S&P 500	SPX	8.0%	10.0%	-2.0%
Eurostoxx 50	SX5E	14.0%	25.0%	-7.0%
Nikkei 100	NKY	23.0%	25.0%	-10.0%
FTSE 100	UKX	9.0%	12.0%	0.0%
MSCI EM	MXEF	14.0%	22.0%	-5.0%

Source: Credit Suisse

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Liquidity – rethinking strategies for a seller's market

Changes in market structure that have been observed for a long period of time are likely to matter far more in an environment of conflicting central bank policy.

In our [2014 Global Outlook](#), we discussed how the impact of regulation in reducing intermediation capital would, over time, raise required risk premiums, demand for liquidity-protecting strategies, and, under stress, intensify cross-asset correlation (see in particular the sections: [Reshaping the financial system – Liquidity Required](#) and [Persistent Deleveraging - Liquidity: You'll miss me now that I'm gone!](#)).

Reviewing the opportunity set one year later, we are able to observe [the impact of October's market distress on the portfolio hedges that investors sought for risky assets](#): USD rates shorts were cut, JPY longs were established, and SPX downside exposure bought. Based on our earlier work and this market experience, we suggest a range of exposures that investors should consider as hedges for our primary macro scenario and for the two risk cases that we consider, as described above.

Exhibit 74: Selected hedge exposures for 2015 core and risk scenarios

	Central case	Good economy	Bad economy
Rates	Terminal rates stay contained, hence USD money market steepeners or USD 5s30s flatteners best hedges, but rates likely to see steady rather than rapid adjustments. Vol expected to be well-behaved and focused on USD front end	Terminal rate expectations rise. Low carry makes strategies paying longer forward rates attractive in USD and GBP rates and to some extent also in EUR. Rates vol picks up across the curve, making rates hedges attractive.	Tightening expectations are removed, causing a significant rally in USD rates in particular. Rates vol is likely to be elevated in the rally and then shift to a lower range. Rates offer attractive hedges in this scenario.
FX/equities	Policy divergence favors USD longs versus G10 and a pick-up in FX volatility. Equity-based hedges unlikely to benefit from a sustained rise in volatility.	This scenario works least well for FX or equity hedging exposure. We expect pro-risk currencies to outperform CHF and JPY in particular and expect vol to fall.	Favored hedges in this scenario gravitate away from USD to JPY-bullish strategies. Equity downside structures would be heavily bid and vol rise.

Source: Credit Suisse

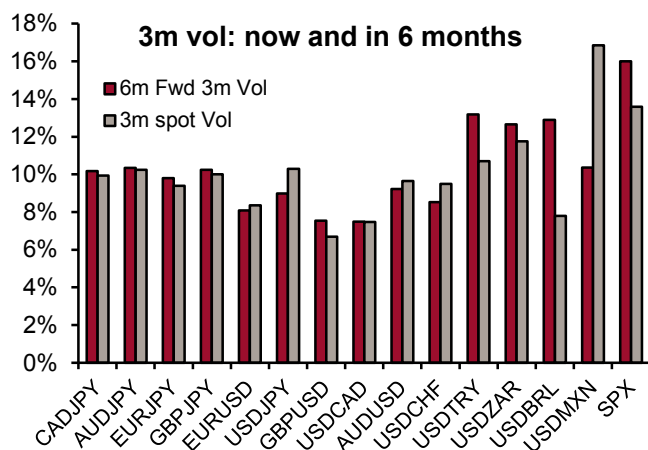
Consider hedges through forward vol

One area where risk premium currently appears to be underpriced is forward volatility. Exhibits 75 and 76 visually summarize our analysis, showing how forward vol levels compare with spot vol levels currently, as well as a long-run trading range.

Forward vol is fairly low during the time period that our economists expect the Fed to raise rates

Focusing on three-month (3m) implied volatility, six months forward (6m fwd), thereby looking at option expiries covering the mid-2015 period when our economists expect the Fed to begin the process of raising rates away from the zero bound, we find that forward vol is fairly low for most G10 and USD/EM FX pairs (and also for the S&P 500) compared to the level of spot 3m vol and to the long-run range for spot 3m vol. Compared with the post-crisis period, we observe that forward vol for most assets in our list is at the very low end of its range. As shown in Exhibit 76, forward vol is below the 30th percentile of the range, with USDTRY and USDBRL being notable exceptions, as was the case for long-dated spot vol discussed above.

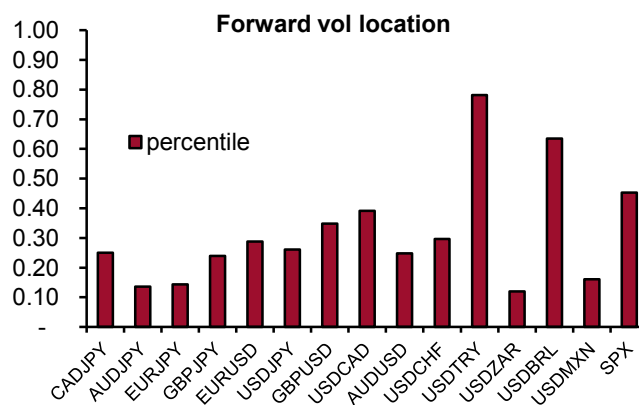
Exhibit 75: Despite the possibility of an upcoming Fed hiking cycle, 6m fwd vol is generally low



Source: Credit Suisse

Exhibit 76: And it also appears low when considered within a long-run vol range

Percentile for current level forward vol versus long-run range of 3m spot vol



Source: Credit Suisse

Although our tactical bias is to be long vol, for 2015 as a whole, we look on this as very much a two-way process:

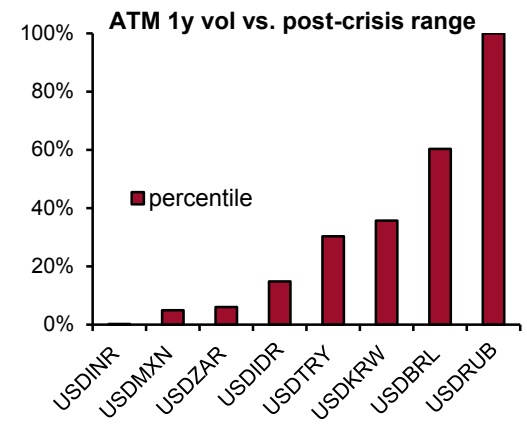
- **Holders of risky assets need to establish portfolio protection** for outturns where their underlying assets are likely to underperform and hence be exposed to liquidity withdrawal.
- **Other market participants may be offered advantageous terms to offer liquidity** (e.g., via implied volatility or skew at a higher-than-normal premium).

At this point, the range of such assets offering generous compensation is limited. In fact, for many of them, risk premiums appear rather under-priced by historical standards. For instance, EM FX vols for some of the most liquid USD/EM pairs sit very low within their long-run ranges (see Exhibit 77), as is the case for equity vol generally (using the low level of the VIX as a proxy) and for EM equities in particular.

The best opportunities for liquidity provision trades come from those sharing our view of EUR underperformance

This argues for a highly selective approach for those considering liquidity provision trades. We believe that the best opportunities come for those sharing our view of sustained EUR underperformance [through the construction of "synthetic credit" exposure](#) involving the sale of EUR/EM limited upside.

Exhibit 77: USD/EM vol sits low in range



Source: Credit Suisse

Although the currency that most clearly stands out from Exhibit 77 is the Russian ruble, with 1y implied vol trading at the 100th percentile of its post-crisis range, the extent of geopolitical risk and the impact of lower oil prices on the economy offer full justification for this pricing.

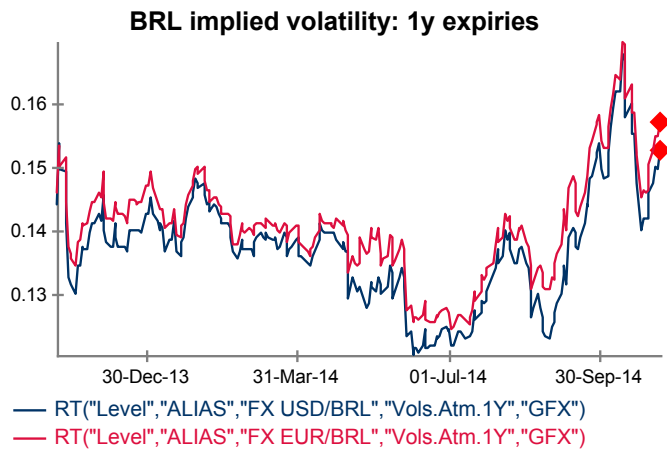
By contrast, we find the risk/reward in BRL more favorable: implied volatility for USDBRL and EURBRL stands at unusually high levels, both against other EM FX pairs and its own history. Although vols have fallen from the pre-election highs, the recent pick-up has brought them back above 15% for 1y options (see Exhibit 78).

We, therefore, favor expressing the view through the sale of low-delta EURBRL upside. USDBRL offers a more liquid way to express the same view, but we are reluctant to recommend it given our expectation for Fed rate hikes to start sooner and go faster than the market discounts.

Indicatively, selling a 1y EURBRL call of approximately 25% delta generates a premium of 3% of EUR notional (spot ref 3.1840) and results in a terminal breakeven point at just above 4.14 (i.e., investors suffer a net loss if EURBRL trades above this level at expiry). This point is roughly 30% higher than current spot and 17.5% higher than the 1y forward. Exhibit 79 puts the risk/reward of the trade in the context of the 10y EURBRL history, with both the call strike and the breakeven point being higher than 10y highs.

Exhibit 78: BRL implied vols are somewhat lower than the pre-election highs but still very elevated...

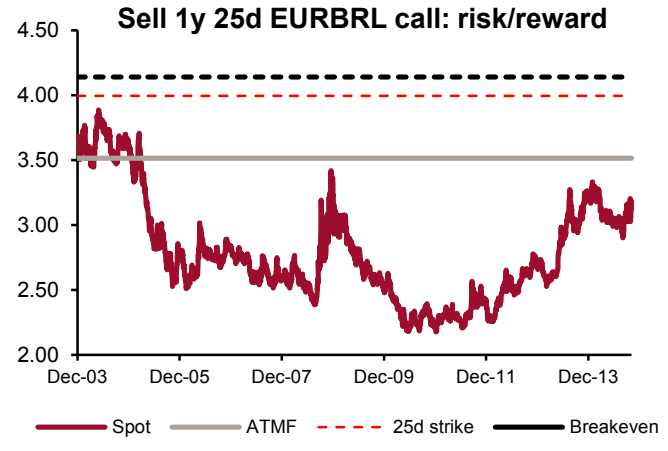
Implied volatility for USDBRL and EURBRL ATM 1y options



Source: Credit Suisse Locus

Exhibit 79: ...Resulting in favorable risk/reward for investors willing to sell calls

Breakeven and strike for selling 1y EURBRL call of 25% delta



Source: Credit Suisse; Bloomberg

For investors unwilling to assume the risk of potentially unlimited losses that would come from the sale of a naked call option, an alternative expression offering limited downside would be the sale of a call spread instead. Selling a 1y 1x1 call spread with 25-delta and 15-delta strikes would limit the maximum loss potential at just below 10% of the EUR notional, net of premium received. The price investors have to pay for limited exposure would come in the form of receiving a smaller premium, at about 1.25% of notional, or less than half of the premium received for selling a naked 25-delta call.

Tail Risk Hedging

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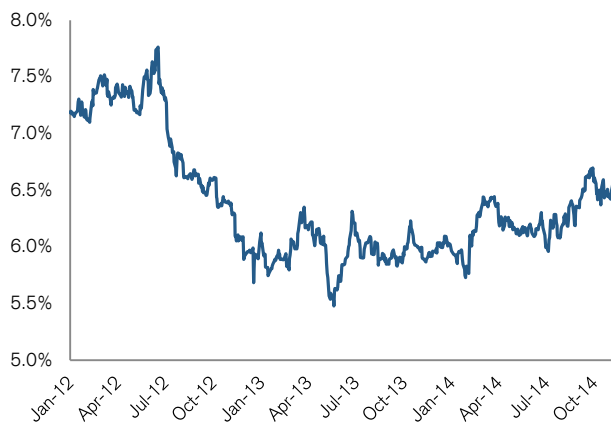
2015 Core Views

- Navigating the increasingly common occurrence of “rare” tail risk events and unprecedented policy actions has become crucial for investors.
- We outline systematic strategies that exhibit three key features of tail risk hedging: (1) asymmetrical payout (high return in periods of stress, little or no performance erosion in normal market conditions); (2) high liquidity in the instruments traded; and (3) the ability to be positioned accurately to absorb tail risk events.

Although tranquil markets and low volatility often lead to higher risk appetite and leveraged positions, such periods also provide investors with the opportunity to enter into portfolio hedging positions at a reduced cost. Following a multi-year bullish run of the US stock market, a sharp sell-off occurred in mid-October as a result of macroeconomic concerns; the sell-off was subsequently reversed. Along with the recent pick-up in macro markets' volatility, this has brought the issue of tail risk hedging back into the spotlight. Therefore, we revisit the idea of tail risk hedging in this piece.

Exhibit 80: SPX option skew indicates that the cost of hedging is climbing from low levels

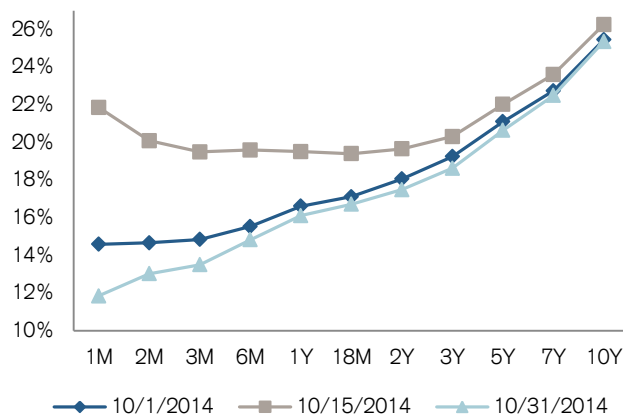
Skew measured by 1y 20% OTM put implied volatility – ATM put implied volatility



Source: Credit Suisse, Credit Suisse Locus, the BLOOMBERG PROFESSIONAL™ service

Exhibit 81: October's sell-off led to an inverted volatility term structure on SPX in the short end

Data as of 11/7/2014

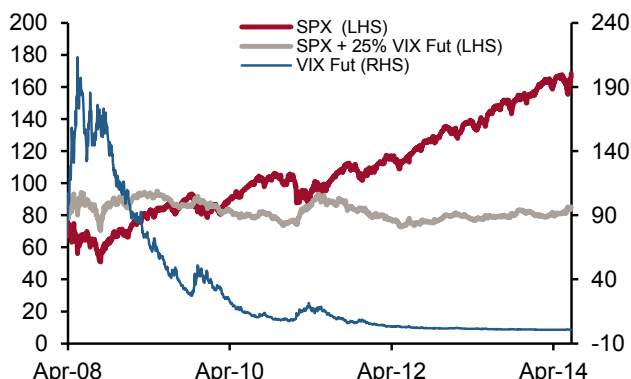


Source: Credit Suisse

Investors want cost-effective portfolio solutions that deliver returns during downturns while stabilizing costs during normal markets

Traditional options-based tail risk hedging strategies help protect against sudden market downturns, but these strategies experience consistent losses in normal market conditions. Investors are looking for cost-effective portfolio management solutions that focus on delivering returns during downturns while stabilizing costs during normal markets. In Exhibit 81, we plot the S&P 500 VIX Short-Term Futures index, a conventional hedge that provides exposure to a daily rolled long position in the first and second VIX futures contract months, against the S&P 500. The chart also shows the effect of a 25% VIX Futures overlay on the S&P 500. Although the overlay mitigated drawdown in 2008, it significantly eroded performance during normal periods.

**Exhibit 82: Cumulative index performance,*
April 2008 to October 2014**



**Exhibit 83: Performance* statistics, April 2008 to
October 2014**

	S&P 500	VIX Futures	S&P 500 + 25% VIX Futures
Annual Return	9.70%	-43%	-1.10%
Annual Volatility	22%	63%	15%
Sharpe Ratio	0.44	-0.69	-0.07
Max Drawdown	52%	99%	31%

* Past performance should not be taken as an indication or guarantee of future performance. Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

* Past performance should not be taken as an indication or guarantee of future performance. Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

To mitigate the shortfalls of traditional hedging strategies, Credit Suisse has developed a suite of systematic tail risk hedging strategies across asset classes and investment styles. We examine four specific strategies in this piece: DVOL, Cheapest Slide, Dynamic Tail, and CSTOPS.

In Exhibit 84, we provide a brief description of each strategy, along with the trade signals and underlying instruments.

Exhibit 84: Summary of tail risk hedging strategies

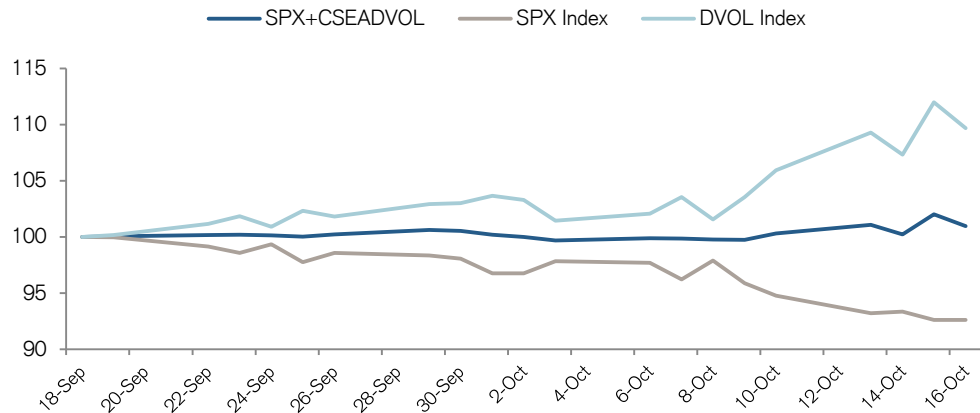
	BBG Ticker	Launch Date	Description	Indicator	Instruments Traded
CS Defensive Volatility Index	CSEADVOL	9/26/2012	Gains long exposure to S&P 500 implied volatility at lowest possible cost of carry based on the relative roll yield along the term structure.	Always long volatility, adjusts leverage according to slope of the VIX futures curve	S&P 500 VIX short- and medium-term futures (SPVXSP and SPVXMP)
CSTOPS	CSTSERUS	8/1/2011	Trades Eurodollar/Euribor futures and US and Eurozone bond futures with tenors ranging from three months to ten years when the model detects upward momentum in these futures.	Momentum signal	8 Eurodollar/Euribor futures and 6 US and Eurozone bond futures
CS Cheapest Slide index	CSEACHPS	12/8/2011	Gains long exposure to Euro Stoxx 50 implied volatility at lowest possible cost of carry by positioning itself at the most advantageous point on the term structure	Always long volatility, adjusts leverage according to expected roll yield	Forward starting variance swaps on SX5E
CS Equity Dynamic Tail Hedge index	CSEADYTL	7/15/2011	Systematically sells delta-hedged ratio put spreads when signals indicate extreme negative market scenarios	CDS spreads on European companies, Euro Stoxx 50 skew	Listed ratio put spreads on SX5E

Source: Credit Suisse

With the October downturn, Exhibit 85 shows the performance of DVOL as a case study. As SPX declined a dramatic 7.4% in about a month's time from its mid-September high, DVOL gained 9.6% in the same period. From a portfolio perspective, an equally weighted portfolio with the SPX Index overlaid with DVOL would generate a 1% return.

Exhibit 85: Overlaying DVOL Index with SPX Index mitigates severe drawdowns*

Data as of 10 Nov 10 2014

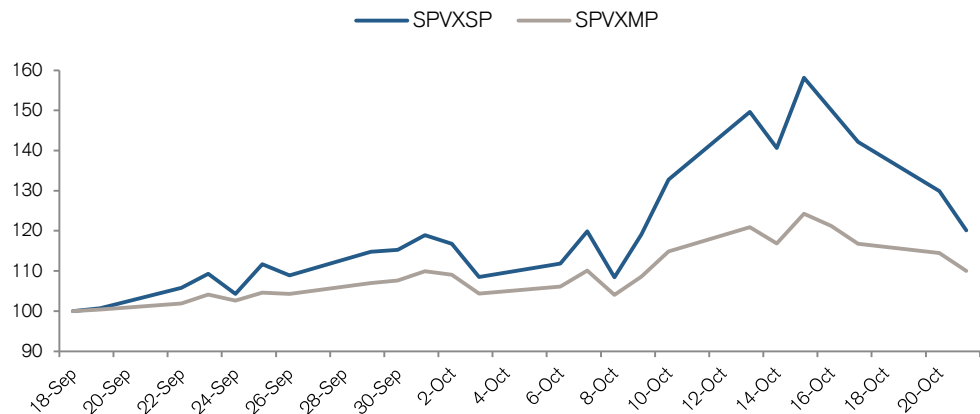


* Past performance should not be taken as an indication or guarantee of future performance.
Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

DVOL correctly positioned itself by maxing out its 40% VIX futures exposure to the Short-Term VIX Futures Index (SPVXSP) based on VIX futures term structural signals. Exhibit 86 shows that the Short-Term VIX Futures Index experienced a more dramatic gain compared to the Medium-Term VIX Futures index (SPVXMP).

Exhibit 86: Short-Term VIX Futures Index spiked more than Medium-Term VIX Futures Index in October*

Data as of Nov 10, 2014



* Past performance should not be taken as an indication or guarantee of future performance.
Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Conclusion

Tail-risk hedging comes at a cost. However, we believe that it is essential from an asset-allocation perspective to reduce severe losses. It requires the hedging component to exhibit asymmetrical payout (i.e., high returns during market drawdowns and low erosion during normal market conditions). It is also important that investors are positioned correctly with liquid instruments during such market downturns, such as was the case with DVOL in October, to hedge effectively.

2015 Global Product Outlook

Product	2015 Core Views	2015 Thematic Trade Ideas
Global Leveraged Finance	<ul style="list-style-type: none"> ■ If the Fed starts a tightening cycle mid-year, high yield should underperform, especially CCCs, which have the most refinancing risk. Loans should outperform bonds in this environment. ■ In Europe, weak economic performance may be met by strong central bank intervention. Performance will depend on the timing and size of that intervention. In its absence, performance should be below coupon. ■ If Fed policy does not change, sell-off/recovery cycles may continue, driven by uncertainty about macro events and low dealer inventory. 	<ul style="list-style-type: none"> ■ We expect BB bonds to outperform in US high yield and CCCs to underperform once rate hikes begin. ■ We favor B over BB in European high yield and look for value selectively in CCC bonds of stronger capital structures. ■ We recommend overweighting loans when the yield difference with bonds approaches parity.
European Credit	<ul style="list-style-type: none"> ■ European credit is still "all one trade"; the absence or return of systemic risk is the call. ■ But 2015 could well be the year that "all one trade" breaks down sharply. ■ In the modal case of a year that looks like 2014, credit should offer strong excess returns. 	<ul style="list-style-type: none"> ■ We recommend staying overweight credit in a fixed income portfolio. ■ Financials should outperform in the modal case but are exposed to the risk case. ■ We view corporates as a "safe haven" that may be supported even more by ECB intervention, but we are on the alert for profit challenges.
Latin America Corporate Credit	<ul style="list-style-type: none"> ■ For Latam corporate credit, we foresee mixed earnings performance, with divergence across regions and sectors. We favor select Mexican and Andean corporates and prefer credits in infrastructure, consumption, and utilities with solid liquidity. 	<ul style="list-style-type: none"> ■ In Latam corporates, we prefer HY over HG given the more attractive spread pick-up to similarly rated US corporates, but we caution that selectivity in credit selection is key.
Emerging Markets	<ul style="list-style-type: none"> ■ 2015 should be a tougher year for emerging market fixed income, but the asset class is unlikely to crash across the board, and we still see opportunities. ■ Growth in EM economies is relatively weak, and current account positions (cash flows in a macro sense) are weaker than during previous Fed's tightening cycles. ■ Still, the recent fall in commodity prices and comfortable valuations in many of the high-yielding markets suggest some room for EM duration to outperform in 2015. 	<ul style="list-style-type: none"> ■ We recommend bullish duration in India and Indonesia and a market weight in Russia, and we suggest paying low-yielding rates (preferably Thailand or Israel) to hedge long rate exposures. ■ We like curve steepeners in Malaysia, South Africa, Thailand, and Turkey local markets and in the Brazilian CDS curve. ■ We favor receiving front-end rates in Brazil, Chile, and Mexico.

2015 Global Product Outlook

Product	2015 Core Views	2015 Thematic Trade Ideas
Global Equities	<ul style="list-style-type: none"> ■ We remain optimistic on equities for the first half of 2015 but fear a significant market correction in the second half. Consequently, our year-end forecast for the S&P 500 is 2,100, below our mid-year target of 2,200. ■ In 2015, central bank balance sheets are likely to expand at a more rapid rate than in 2014. This helps to support excess liquidity and equity valuations. ■ We expect profit margins to peak toward the end of 2015 as labor regains pricing power and borrowing costs move higher. We are 4% below consensus for US EPS growth in 2015. 	
Foreign Exchange	<ul style="list-style-type: none"> ■ Markets have systematically mispriced the likelihood of policy divergence surprises outside of the all-encompassing impact of a less accommodative Fed. ■ Continued EUR weakness also is likely to be a significant problem for other European currencies as their central banks try to find ways to compensate for low inflation and weak exports. The idea of EUR floors for currencies such as SEK may gain ground. ■ JPY should stay on the back foot, although we think that implied volatility is underpriced. The AUD and NZD are likely to suffer from weak commodity prices, with the former also needing to face down the impact of possible macro-prudential regulation. 	<ul style="list-style-type: none"> ■ We favor short EUR positioning against USD, CAD, and selected EM currencies where carry is particularly elevated and domestic negatives are largely priced in. ■ We recommend being long volatility via FVAs and volatility swaps in EURUSD, EURAUD, and EURGBP. ■ We argue in favor of exploiting dips in USDJPY toward 114 or below as an opportunity to establish fresh long positions. But we prefer options to spot for view expression given that implied volatility appears underpriced.
US Rates	<ul style="list-style-type: none"> ■ The curve should flatten aggressively in 2015, with 5s30s collapsing by more than is currently implied by the forwards. ■ Europe should exert less of a drag on US yields as we enter the Fed tightening cycle, ultimately allowing 10s to sell off toward our year-end forecast of 3.35%. ■ We expect TIPS breakevens to rise off their current depressed levels next year as oil deflation slows and core inflation gradually moves back toward 2%; we remain cautious, however, and look for a better tactical opportunity to establish longs in TIPS breakevens. 	<ul style="list-style-type: none"> ■ We like 5s30s flatteners. ■ We recommend being short EDZ5 via risk reversals.

2015 Global Product Outlook

Product	2015 Core Views	2015 Thematic Trade Ideas
<u>European Rates</u>	<ul style="list-style-type: none"> ■ Our core scenario is for muddling through: The ECB tries to tread the fine line of doing just enough; hurdles to sovereign QE remain higher than the market is pricing. ■ In this environment, growth remains low, inflation is positive, and Bunds trade in a range. Tactical trades dominate. ■ Political risks and ECB QE uncertainty are likely to increase peripheral volatility. 	<ul style="list-style-type: none"> ■ We recommend being long 2y Spain. ■ We like EUR 10s30s flatteners. ■ We favor 3y2y EURUSD FX basis swap wideners. ■ We suggest being short 10y UKT ASW.
<u>Securitized Products</u>	<ul style="list-style-type: none"> ■ We generally maintain a positive outlook across the various securitized products, with spreads expected to stay range bound or tighten, to various degrees. ■ Sector performance, as a function of forecasted changes in supply and demand technicals, is a common key theme across the sub-sectors, but unlike in prior years, there is some divergence in the outlook for the various markets. ■ Fundamentals are neutral to positive across the various credit sectors. 	
<u>Global Demographics and Pensions</u>	<ul style="list-style-type: none"> ■ Not paying proper attention to historically unprecedented demographic changes is affecting both fiscal and monetary policy effectiveness. Understanding changing ageing and consumption/savings patterns as well as asking “what is optimal fiscal policy” requires better understanding of demographics. ■ In our view, monetary policy is also ineffective in an ageing world, and voting patterns of the old have effects on inflation and distribution. The older populations borrow less and have less need for credit than poor populations. We think that monetary policy makers ought to actively and effectively monitor personal income and wealth distributions as well as asset prices. 	
<u>Technical Analysis</u>	<ul style="list-style-type: none"> ■ The USD has achieved our first target, but we remain bullish. ■ We expect 5s30s bond curves in Germany and the US to flatten. ■ We are bearish gold. ■ We are bullish China. 	<ul style="list-style-type: none"> ■ We recommend buying the USD on setbacks. We remain bullish USDCAD for our 1.1666/1.1766 target. ■ We suggest looking to establish 5s30s German and US flatteners. ■ We recommend staying short gold for our \$1000 target.

Credit

Global Leveraged Finance

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2015 returns and spreads driven by tightening liquidity environment in the US and central bank actions in Europe

2015 Core Views

- If the Fed starts a tightening cycle mid-year, high yield should underperform, especially CCCs, which have the most refinancing risk. Loans should outperform bonds in this environment.
- In Europe, weak economic performance may be met by strong central bank intervention. Performance will depend on the timing and size of that intervention. In its absence, performance should be below coupon.
- If Fed policy does not change, sell-off/recovery cycles may continue, driven by uncertainty about macro events and low dealer inventory.

2015 Thematic Trade Ideas

- We expect BB bonds to outperform in US high yield and CCCs to underperform once rate hikes begin.
- We favor B over BB in European high yield and look for value selectively in CCC bonds of stronger capital structures.
- We recommend overweighting loans when the yield difference with bonds approaches parity.

We project 5% total return for US high yield and 4% for US loans in 2015

US high yield and leveraged loans

Our 2015 return forecast for US high yield is 5% and for U.S. leveraged loans 4%. If the Fed raises the fed funds rate in 2015, as we now expect, high yield should have a below-coupon year, and weaker credits should perform worse. As the central bank drains liquidity from the financial system, the major risk is refinancing risk. If history is a guide, after the rate hike cycle ends high yield should perform well as long as the economy remains healthy. Leveraged loans should perform somewhat better relative to their coupon at a 4% 2015 return, with less volatility. Loans have the potential to receive a boost late in the year as a result of yield pickup from rate hikes.

Defying expectations coming into the year, Treasuries performed strongly in 2014 year to date, buoying high yield return for much of the year. The 5y Treasury yield decreased by 13bp year to date to 1.61%, while the CS HY Index yield increased by 37bp to 6.14%.

Exhibit 87: CS High Yield Index yield versus 5y Treasury yield

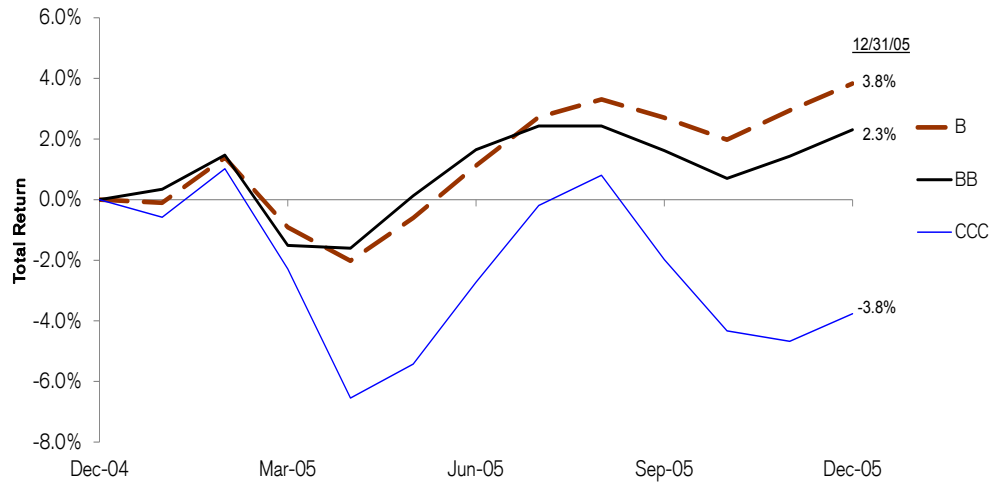


Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

At the current level of 480bp, we see room for the high yield spread to absorb a rate increase, particularly against the backdrop of economic expansion expected in 2015. We think that the most comparable period is 2005, during the previous tightening cycle.

Lower-rated credit has historically underperformed as liquidity risk has increased during rate hike cycles

Exhibit 88: High yield returns by rating, 2005

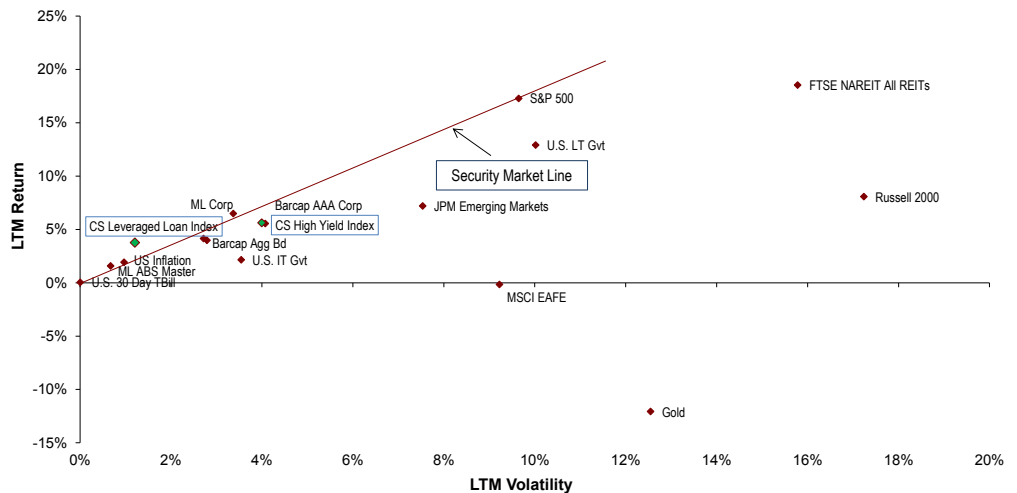


Source: Credit Suisse

We project a 1%-3% default rate for high yield bonds in 2015 and 0%-2% in 2016, compared to the LTM October 2013 rate of 2.13%. Other than a couple of legacy LBOs from before the recession, defaults are expected to remain low through 2016. Companies that are encountering problems generally do not have near-term triggers, such as maturities or liquidity issues, to induce a default before 2017.

Despite the underperformance, loans have been more resilient to the volatility affecting the market over the past 12 months. Exhibit 89 illustrates the risk-adjusted return of the CS Leveraged Loan Index position above the security market line.

Exhibit 89: Risk and return of various assets, LTM October 2014

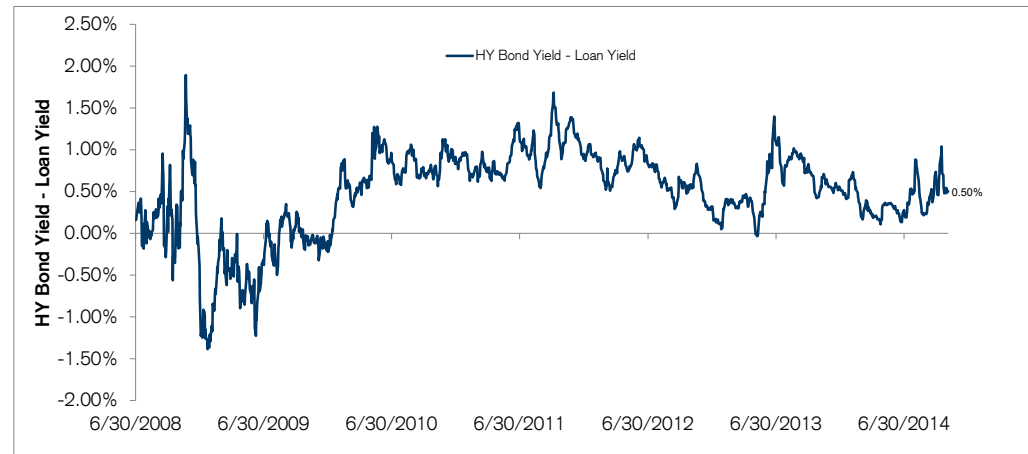


Source: Credit Suisse

Our leveraged loan return projection of 4% takes into account the close relationship between loan yields and bond yields (90%+ correlation since 2001). The CS Leveraged Loan Index yield, calculated to a three-year refinancing, is currently 5.24%, 50bp lower

than the CS High Yield Index yield of 6.14%. The average difference between these yields has been 68bp since December 2009, and a low point in 2014 was reached in late April at 11bp.

Exhibit 90: High yield bond yield less leveraged loan yield

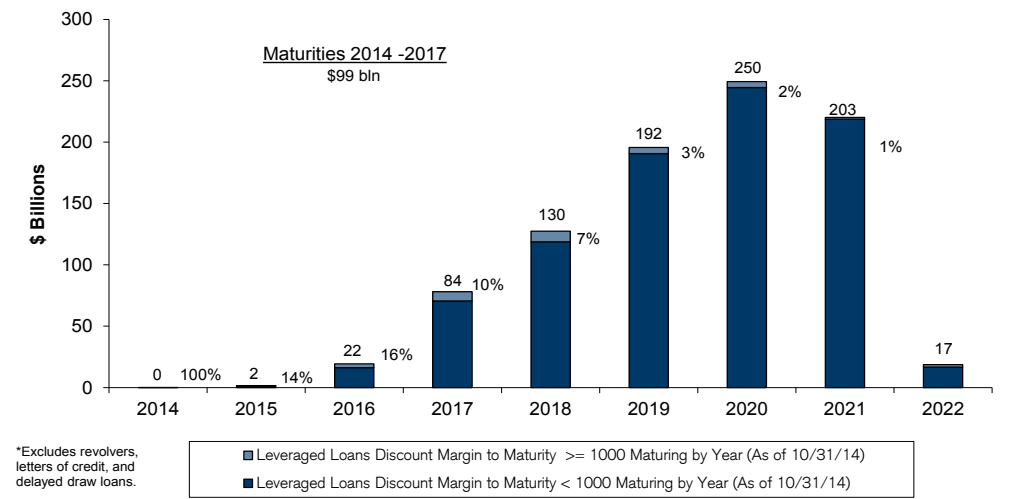


Source: Credit Suisse

We project a 0%-2% default rate for loans in 2015 and 2016, a decrease from the LTM October level of 3%. We note that 2.7% of the current default rate comes from TXU, which will roll off the default rate next April. As with high yield, the loan default environment remains minimal. Exhibit 91 illustrates that loans totaling \$33 billion face value, or 3.6% of all loans outstanding, are trading with a discount margin to maturity of greater than 1000bp. Of these, the face value of loans maturing by 2016 is \$3.3 billion, or 0.4% of the total.

We expect the default rate for leveraged loans to remain low in 2015 and 2016

Exhibit 91: Leveraged loans maturing by year, discount margin to maturity >1000bp



*Excludes revolving letters of credit, and delayed draw loans.

Source: Credit Suisse

European high yield and leveraged loans

We project 4.5% for European high yield and 3.5% for European loans in 2015

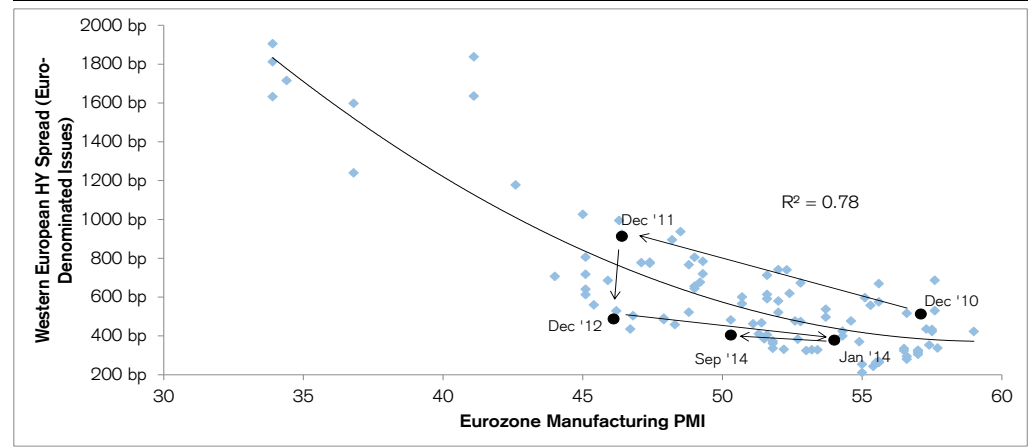
Our 2015 return forecast for 2015 European high yield is 4.5% and for European loans 3.5%. We expect that European leveraged finance market performance in 2015 will depend more on economic conditions than it has in recent years, along with the possibility of strong intervention by the ECB. Late 2014 witnessed a recoupling of the European leveraged

finance markets with negative economic indicators. Following the suggestion in September that the ECB would undertake a QE program, Bund yields (particularly the front end of the curve) are pegged lower and not expected to rise meaningfully in the near term. Therefore, rate movement should play a limited role in returns in 2015. The leveraged finance markets also continue to be affected by bouts of volatility, exacerbated by the impact of retail fund flows and headline risk following the implosion of Phones4U. Despite these risks and the weak economic environment, the default risk in Europe is very low through 2016.

Exhibit 92 shows the regression for the relationship between the Eurozone Manufacturing PMI and spread. Since 2012, the spread to PMI relationship has implied that the market was overvalued. The pickup in PMI in early 2014 reached a level such that the actual high yield spread approached the PMI implied spread. However, the Eurozone Manufacturing PMI readings have become weaker in recent months, hitting a year low of 50.3 in September.

Late 2014 witnessed a recoupling of European leveraged finance markets with negative economic indicators

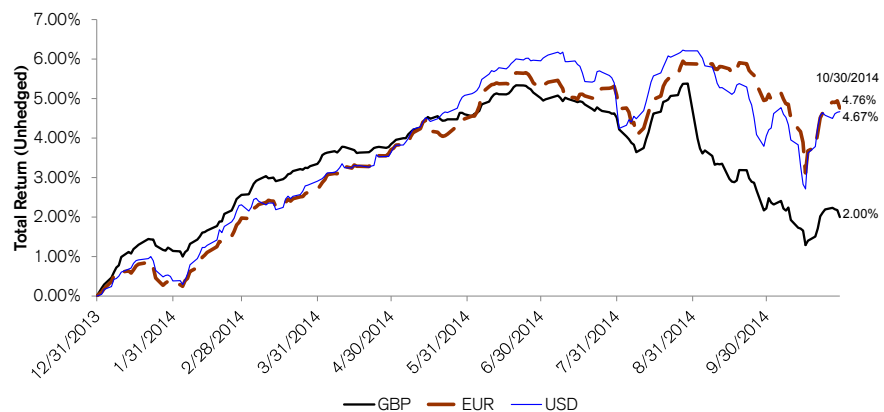
Exhibit 92: Eurozone Manufacturing PMI versus Western European HY spreads



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

The European high yield market was shaken by the high-profile default of Phones4U in early September. Sterling-denominated bonds, in particular, have faced increased pricing pressure following the Phones4U default. Exhibit 93 illustrates the underperformance of GBP-denominated bonds, which have returned 2.00% year to date, compared to 4.76% for EUR-denominated bonds and 4.67% for USD-denominated bonds.

Exhibit 93: Western European high yield return by currency (unhedged)

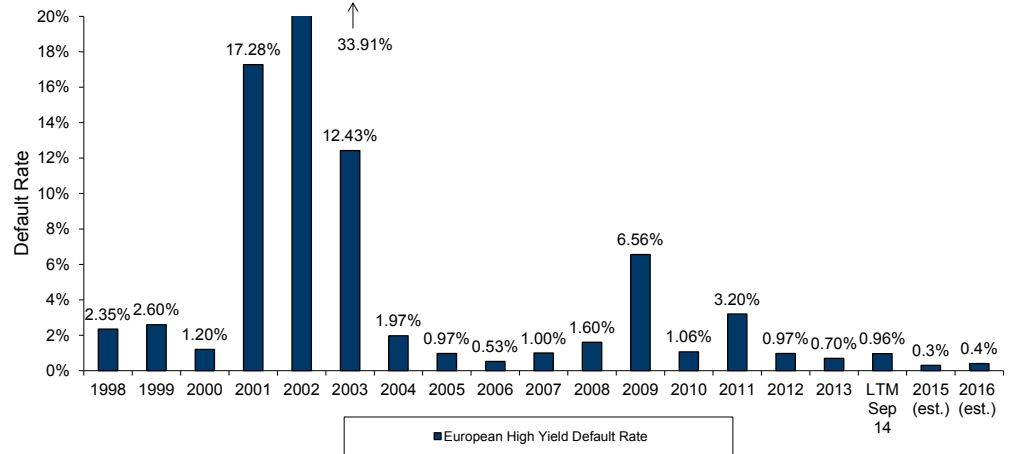


Source: Credit Suisse

We project a very low 0%-1% default rate for European high yield in 2015, continuing the low default trend of the past two years. The young average age of bonds in the European market is a factor in the low default rate. The market has increased its size by more than four times since 2009, meaning that the majority of deals are relatively new and problems have yet to develop.

European high yield defaults are projected to remain very low despite the economic environment

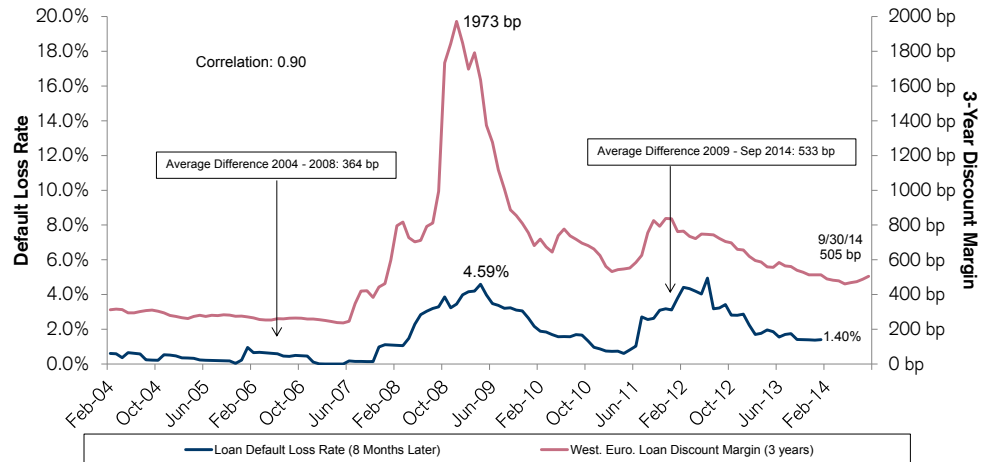
Exhibit 94: Western European high yield default rates and projections



Source: Credit Suisse

Notwithstanding the uptick to 505bp at 30 September 2014, the discount margin of European loans has steadily declined since late-2011 highs. The loan market was directly affected by bank illiquidity during the European crisis but continues to show signs of healing, including the lower default loss rate. The loan market is working through the remaining problems from the LBO boom, and this will lead to lower default rates in the next two years.

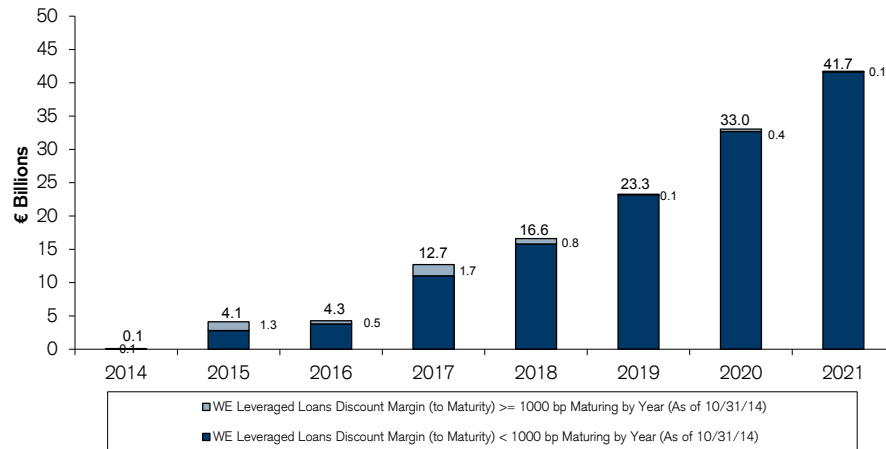
Exhibit 95: Western European leveraged loan discount margin versus default loss rate



Source: Credit Suisse

We project European loan defaults of 1%-3% in 2015 and 1%-2% in 2016, a decrease from the October LTM default rate of 3.0%. Overall, there is €5.4 billion trading above a 1000bp discount margin, or 3.8% of the market, reflecting the declining default risk in European loans compared to previous years. Through 2016, there is €1.8 billion trading over 1000bp, or 1.25% of the market.

Exhibit 96: Western European institutional leveraged loans maturing by year, discount margin to maturity >1000bp (as of 31 October 2014)



Source: Credit Suisse

Exhibit 97 is a summary of our projections for returns and defaults for high yield and leveraged loans

Exhibit 97: Leveraged finance return and default projections

Performance Annual Total Return	Actual 2013	YTD 10/30/2014	Projected 2014	Projected 2015
US High Yield Bonds	7.53%	4.38%	5.5%	5%
US Leveraged Loans	6.15%	2.60%	4%	4%
W. European High Yield (Hedged in €)	9.10%	4.26%	5.5%	4.5%
W. European Lev. Loans (Hedged in €)	8.73%	2.20%	3%	3.5%

Default Rate Summary	Actual 2013	LTM Sep-14	Projected 2015	Projected 2016
US High Yield Bonds	0.91%	2.12%	1% - 3%	0% - 2%
US Leveraged Loans	1.46%	3.03%	0% - 2%	0% - 2%
W. European High Yield (Hedged in €)	0.70%	0.96%	0% - 1%	0% - 1%
W. European Lev. Loans (Hedged in €)	3.05%	3.08%	1% - 3%	1% - 2%

Source: Credit Suisse

European Credit

Rinse and repeat

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2015 Core Views

- European credit is still "all one trade"; the absence or return of systemic risk is the call.
- But 2015 could well be the year that "all one trade" breaks down sharply.
- In the modal case of a year that looks like 2014, credit should offer strong excess returns.

2015 Thematic Trade Ideas

- We recommend staying overweight credit in a fixed income portfolio.
- Financials should outperform in the modal case but are exposed to the risk case.
- We view corporates as a "safe haven" that may be supported even more by ECB intervention, but we are on the alert for profit challenges.

Much like the pre-crisis period, we see no reason for next year to be substantially different from the last unless and until things go badly wrong in a macro-political sense. They will eventually, in our view, but the chances in any given year are still relatively low and the incentive structure still suggests that the marginal pricers of credit in Europe can ignore "fat-tail" outcomes.

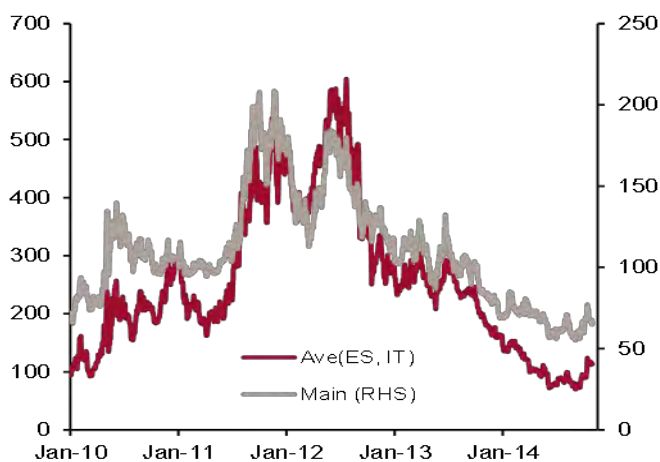
The biggest micro risk is profit weakness driven by continued weak growth that is not weak enough to trigger the fat tail. So we see two negative risk scenarios: some single-name weakness driven by moderate underperformance and a return to crisis conditions driven by sharp underperformance. The positive risk scenario is that the euro area gets time for free from the falling oil price.

European credit is still "all one trade"

For now, but perhaps not indefinitely, credit is still "all one trade" to a striking degree, with correlations particularly strong between the relative performance of the banking sector and sovereigns. We take this as confirmation that the issues underlying the banking system remain alive and essentially national in nature: the bank-sovereign loop is held in abeyance, in our view, by the correlation that has prevailed since "whatever it takes" but has not gone away; we still expect the banking system to be a major transmission channel for the stock losses to be taken in the system.

Exhibit 98: It's still all one trade...

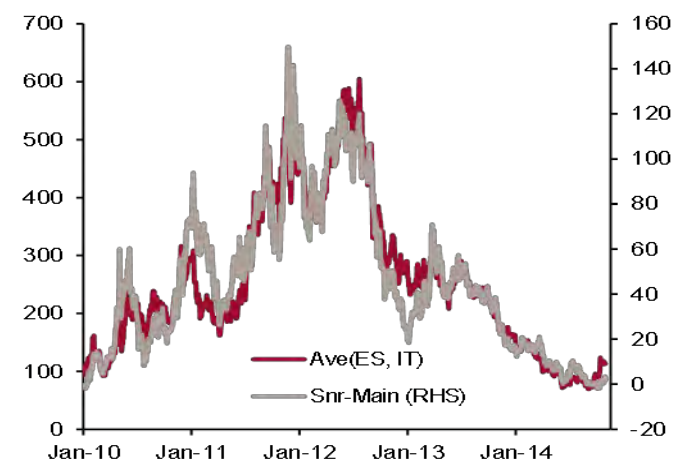
iTraxx⁶ Main active contract ("Main") and average of ES and IT 5y sovereign CDS



Source: Credit Suisse

Exhibit 99: ...but 2015 could be the end for this

iTraxx Financial Senior active contract less Main and average of ES and IT 5y CDS



Source: Credit Suisse

⁶ iTraxx is a registered trademark of the International Index Co Ltd.

A simple read of the above charts suggests, to the left, that the iTraxx Main is still attractive relative to systemic risk, whose price is most likely to continue to fall anyway, and, to the right, that the Senior index is a leveraged play relative to iTraxx Main in the event of such a fall.

But we stress that the absence of systemic risk is the key driver here and the judgment to be made; we reiterate to what an extraordinary extent European credit is still "all one trade."

"Whatever it takes" created a global rates bloc

Individually, France, Germany, or Italy could never "fight the Fed" but correlated they can

The correlation that this leads to has an important side effect; we see it as the main reason why the euro area's economic challenges have had such a dominant impact on the global rates market. Individually, France, Germany, or Italy could never "fight the Fed" but correlated (whether ultimately sustainably or artificially is irrelevant for now) they can. Our view is that the divergence between US and euro rates is now near its practical maximum; we expect either major economic weakness in Europe to complicate the Fed's task and/or prevent the Treasury market selling off (essentially the story in 2014) or European "business as usual" – weak but not negative growth – to be accompanied by steady, but potentially unstable, global bond-market weakness.

Lower oil prices should be bullish for European credit

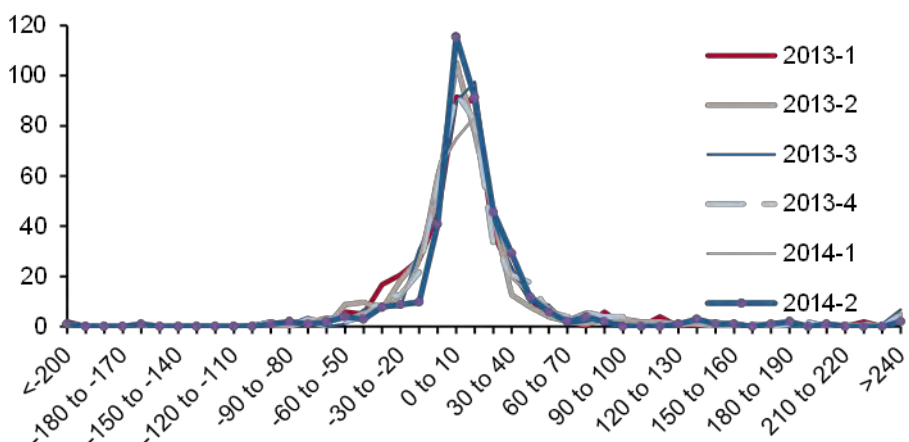
One supportive element in this regard is oil prices; we regard the sharp decline as exogenous, driven by the well-covered supply increases, rather than an endogenous response to weak growth. See [Oil in 2015: Lower, or Much Lower, Prices?](#) in this report. This is not universally good news for credit: some single-name weakness in the US is directly attributable to oil prices. But in Europe this is less of a factor, and the over-riding imperative is growth. An exogenous driver like lower oil should be a bullish factor, in our view, despite the possible effect on earnings dispersion.

Profits are not yet an issue, but trouble is brewing in Europe

Earnings dispersion is at very low levels, which we see as very supportive of credit. Our data is current through 2Q,⁷ and the oil-price decline has been a 3Q phenomenon, but through 2Q, the picture was striking. We show our customary histograms of year-over-year quarterly earnings changes for S&P non-financial companies over the last several quarters.

Exhibit 100: No sign of US profit challenges in 2Q...

Histogram of yoy pct changes in adjusted EPS for S&P non-financials over last six quarters, normalized to 400 names



Source: Credit Suisse

⁷ We have some 3Q data, but it is too early to be representative.

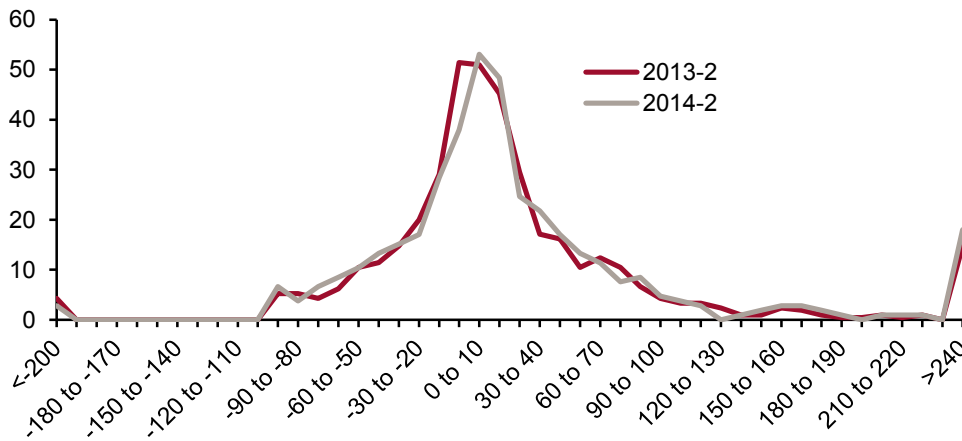
We see no sign of meaningful profit challenges in the US or Europe

In 2Q, the distribution is more peaked (at the 0%-10% gain point) than for any of the last six quarters. Far more important to our analysis, the tail of companies reporting declines in earnings is much thinner. The oil price may change this, but as of 2Q, there was no sign of meaningful profit challenges at all.

Additionally for Europe, we show a similar distribution for 2Q 2013 and 2Q 2014, based on the universe of companies with >€500 million market cap and normalized to the same 400 names.

Exhibit 101: ... nor in Europe despite a wider and remarkably suspicious distribution

Histogram of yoy pct changes in adjusted EPS for European non-financials > €500 million market cap in 2Q 2014 and 2Q 2013, normalized to 400 names



Source: Credit Suisse

If economic performance fails to improve, earnings distress could increase sharply

Recent economic weakness is more likely to show up in 3Q (some HY issuers already show strong effects from this), but as of 2Q, all was well. We note the much flatter distribution among European names, reflecting the heterogeneous economic performance. This is not good for credit but is suppressed as an issue by the general correlation, in our view. Plus the proportion of companies losing money has not risen. We leave for another day the fact that this histogram shows clear signs of a tendency not to show earnings declines greater than 100% (i.e., losses). But we tentatively conclude that if economic performance does not improve, earnings distress could increase very sharply.

There is clear risk that 2015 means the end of our "all one trade" period

We note that in macro markets correlations have broken down at the end of 2014, and a clear risk is that 2015 means the end of our "all one trade" period, with single-name risk – even default risk – driving increasing dispersion and alpha in credit markets.

Spread forecast

We expect another 20% narrowing in euro IG spreads with 138bp excess return in 2015

There are increasing risks around the modal forecast that need examining, but for now, we present our modal outlook for euro IG spreads to the end of 2015, unadorned by risk scenarios. Modally, we expect a 20% narrowing in spreads.

A complication is that we are bullish into year-end 2014, so we split the forecast into two parts, with a cumulative 178bp excess return made up of 40bp in 2014 and 138bp in 2015.

Exhibit 102: Our modal "more of the same" forecast suggests continuing excess returns

Spread to benchmark and excess returns (bp) for the Credit Suisse LEI in our modal forecast

LEI €	Beginning	End	DV01	Excess return
Now – Dec 14	78	72	5.5	40
Dec 14 – Dec 15	72	60	5.5	138

Source: Credit Suisse

Our main expectation is for "more of the same." We called our modal scenario a year ago "US normalizes before Europe." That is what has happened and what we expect to continue. But risks are increasing.

In the modal scenario, credit should be expected to generate strong excess returns, even from current levels (we are reminded of the late pre-crisis period). However, rates dominate total returns in the IG space. The excess returns we still see as possible are helpful, but an important constraint has emerged in rates, in that 2014, in our view, took the market pricing of that divergence to the limit. Hence we believe that a US rates sell-off is conditioned on Europe continuing at least partial normalization. The main risk scenario will be that Europe underperforms more strongly, but as briefly examined above, oil makes that less likely, in favor of increasing the chance of a global upward growth surprise.

Our deep concerns about systemic instabilities in the euro area are balanced with a nearer-term pragmatic, and for now still bullish, view

We see the weaker-growth scenario leading to a political deterioration and a renewed need to focus on the fat-tail scenario. At that point, the whole "all one trade dynamic" would, of course, risk going into sharp reverse, so a return to crisis conditions provides the "extreme risk scenario." On current trends,⁸ we expect that with probability 1 on some horizon (ten years?) but not one year. And we stick with our "traders' option" analysis, now two years old, which suggests that the rational pricing for fat-tail risk tends towards zero unless a crisis is identifiably at hand. This still allows us to balance our deep concerns about systemic instabilities in the euro area with a nearer-term pragmatic, and for now still bullish, view.

ECB intervention in the corporate market is another potential factor to consider; the BoE's purchases announced in early 2009 were extraordinarily effective, admittedly in very different market conditions and with a very different agenda. We [think](#) that the ECB will struggle to achieve substantial balance sheet expansion through this mechanism (the linked publication suggests around €150 billion; the BoE's program was £50 billion, although far less than this was purchased).

But that is not the point. We see the point as being that the ECB recognizes a severe challenge posed by the euro area's large banking system and wants to incentivize the credit transmission mechanism into the public markets and out of the banks. Related, it wants to squeeze the banks' lending down into the middle market.

The effect on our market is a positive structural change, which we expect anyway but which is becoming increasingly urgent as the years pass. We have never been concerned about the supply implications.

ECB involvement would support IG, with a spillover into higher-rated HY spreads

ECB involvement, incentivized by its recognition of the problem posed by the banking system, underlies that and would, in our view, shift equilibrium spreads narrower. In our modal scenario, we expect the ECB to eventually embark on a corporate bond purchasing program, probably starting in 1Q 2015. This should be highly supportive for the IG corporate bond market. Moreover, with IG spreads being pulled toward zero, we expect spillover into the spreads of higher-rated HY issuers.

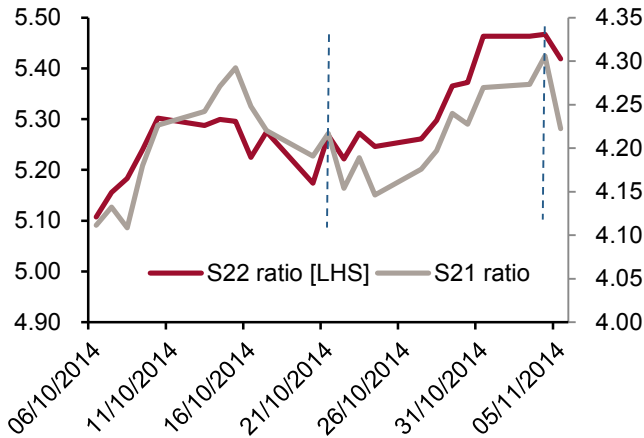
We think that current CDS index pricing supports this view: after the initial Reuters headline on 21 October 2014 about the ECB potentially buying corporate bonds, non-dealers sold a large amount of iTraxx Main protection, which resulted in an outperformance of iTraxx Main versus Xover. This lasted until the second Reuters article on 4 November 2014 about the division on the ECB's governing council, which decreased the perceived probability of such a program and thus reversed some of this decompression, as shown in Exhibit 103.

⁸ This caveat is so strong that it makes any statement accompanying it worthless; we apologize. But the point is that in the European context, it requires stress and pressure to change current trends, so we see these as inevitable over the horizon unless there is a structural improvement in growth, which we have reason not to expect, despite a possible oil-driven upturn. On our game-theory analysis, we expect such stress to be even more radical than in 2010-2012.

In addition, we see in Exhibit 104 that the Xover S22/21 roll widened during this decompression phase. Given that the main difference between Xover S21 and S22 is driven by a group of high-spread, high-beta food and retail issuers, this shows, in our opinion, that the market rightly priced for increased HY dispersion in case of an ECB corporate bond program.

Exhibit 103: Xover/Main decompression measured by the ratio of their spreads in S22 and S21 between the two Reuters articles

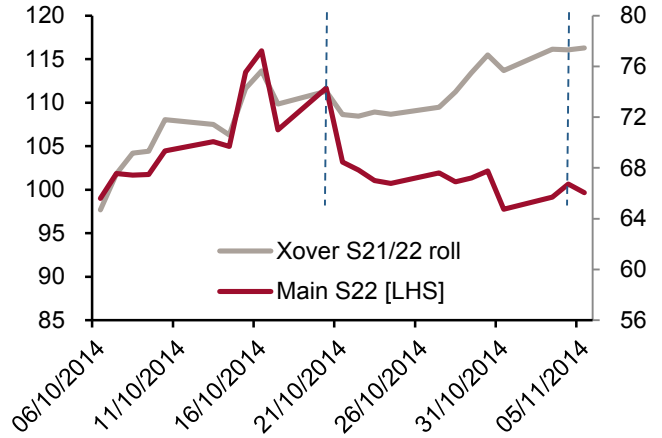
The dotted lines indicate the timing of the two Reuters articles



Source: the BLOOMBERG PROFESSIONAL™ service

Exhibit 104: Xover S22/21 roll underperforms as the market prices HY divergence in case of an ECB corporate bond program

The dotted lines indicate the timing of the two Reuters articles



Source: Credit Suisse

Latin America Corporate Credit

We prefer Latam HY over Latam HG, but selectivity is key

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Mixed performance is expected for 2015, driven by divergence across economies and sectors

2015 Core Views

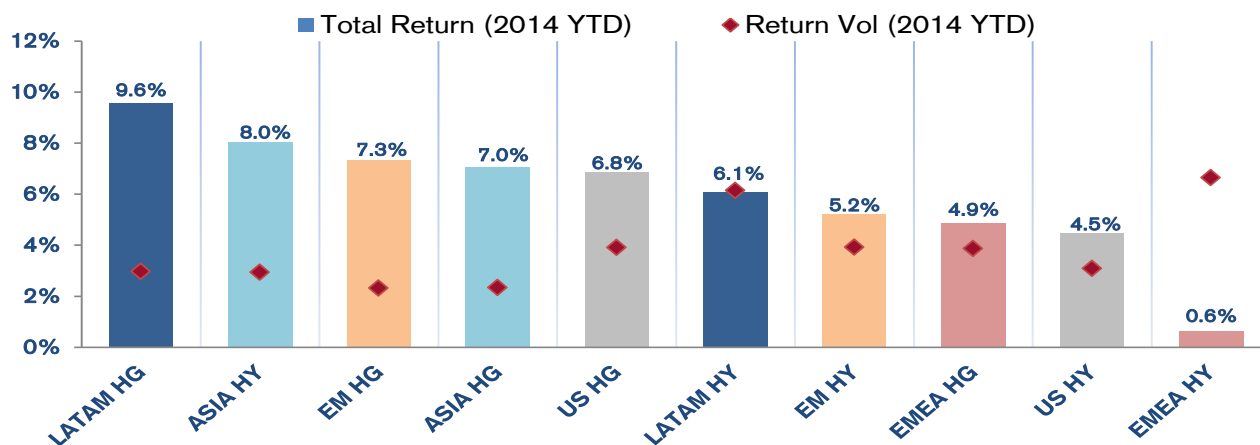
- For Latam corporate credit, we foresee mixed earnings performance, with divergence across regions and sectors. We favor select Mexican and Andean corporates and prefer credits in infrastructure, consumption, and utilities with solid liquidity.

2015 Thematic Trade Ideas

- In Latam corporates, we prefer HY over HG given the more attractive spread pick-up to similarly rated US corporates, but we caution that selectivity in credit selection is key.

On the Latam corporate front, we expect mixed performance in 2015, reflecting divergence across economies and sectors. While the CS Latam HG and HY corporate indices have outperformed US benchmarks year to date in 2014, we believe that challenges are emerging, including continued economic weakness in Brazil, currency volatility, and a negative commodity pricing outlook. Latam HG corporates include a heavy weighting of commodity sector companies (metals & mining and oil companies comprise 46% of Latam HG), and within Latam HY, there are a number of challenged sectors, such as sugar & ethanol, PDVSA (which represents 17% of the market value of the Latam HY index), and Chilean HY. On the positive side, we see a favorable outlook for economic growth in Mexico, reflecting benefits from increased infrastructure spending, energy sector reform, and correlation to the US recovery. Select Andean and Caribbean corporates in sectors such as utilities, banks, telcos, and consumption should continue to perform well.

Exhibit 105: Latam corporates have outperformed US benchmarks year to date



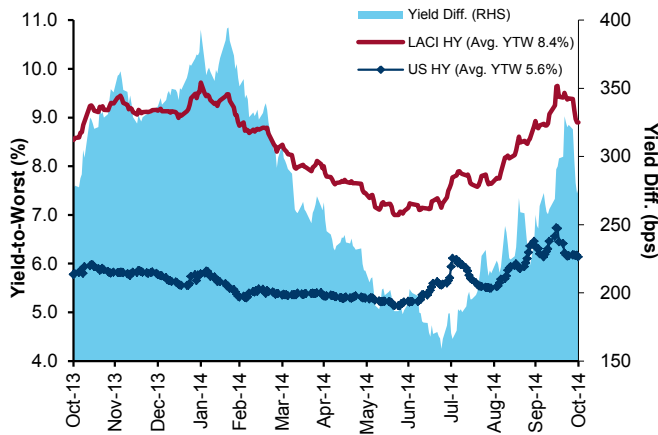
Source: Credit Suisse. Data are as of October 31, 2014

We prefer Latam HY over Latam HG corporates, but selectivity is key

We prefer Latam HY over Latam HG given the more attractive spread pick-up to US indices and the potential for credit improvement to absorb rising rates. The CS Latam HY index currently trades at more than 275bp wide to US HY (versus the three-year historical average for Latam HY of about a 250bp spread pick-up), whereas the CS Latam HG index is currently 110bp wide to US HG (versus the three-year historical average of 125bp).

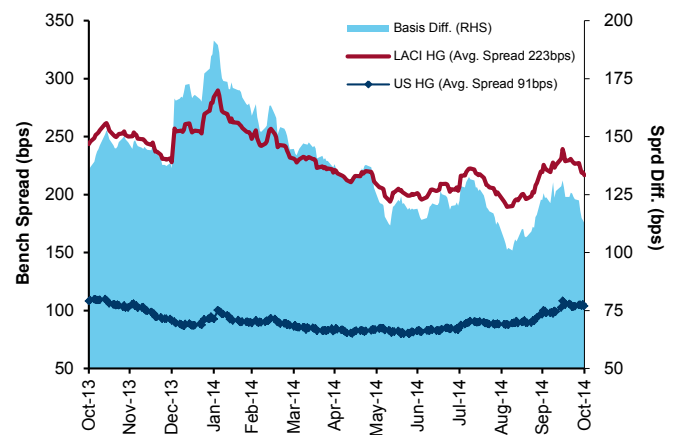
We believe that credit selectivity remains critical, especially in an environment of challenging trading liquidity. We favor credits with solid liquidity positions and neutral to improving cash flow. Within countries and sectors, there is a significant potential differential between winners and losers; thus, management quality is critical. We highlight that many individual Latam corporates are currently trading at historical tight, with positive credit outlooks already priced in.

Exhibit 106: Latam HY spreads to US HY are moderately wide



Source: Credit Suisse. Data are as of October 31, 2014

Exhibit 107: Latam HG spreads to US HG are moderately tight

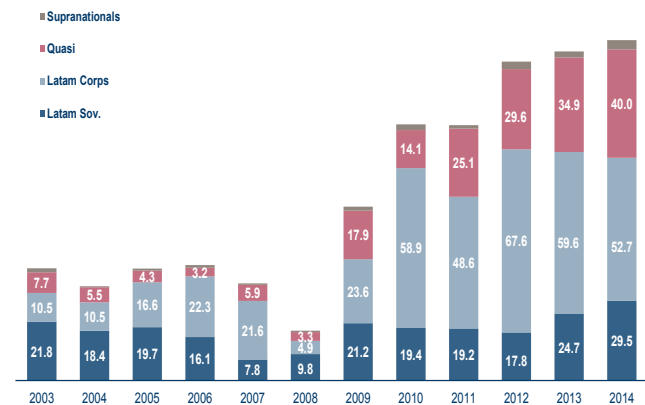


Source: Credit Suisse. Data are as of October 31, 2014

Latam corporate new issuance is likely to ease from its record pace but remain strong

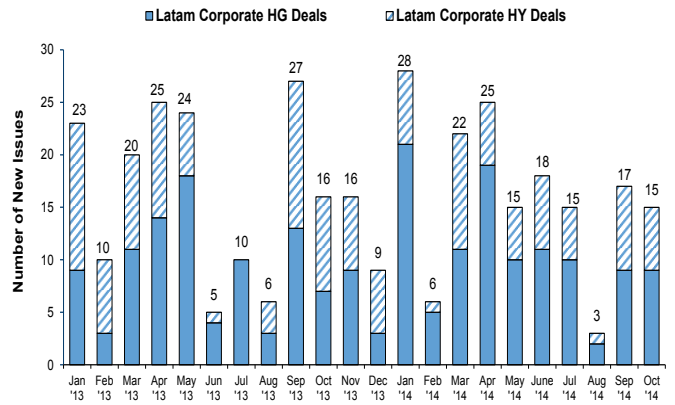
Latam corporate new issuance is already having a record year, with US\$97 billion of debt issued year to date through 164 new issues (versus US\$96 billion raised in 191 new issues in 2013, including quasi-sovereigns and supranationals). While recent market volatility and increasing investor selectivity have moderated the pace of new issuance, we still foresee solid Latam US dollar issuance trends into 2015, particularly in sectors such as banks, infrastructure, and Mexican oilfield services. With relatively low absolute US dollar rates (and rising local market rates in a number of countries), we believe that Latam corporates will continue to pursue liability management by tapping the market to refinance at lower coupons. Additionally, we expect first-time issuers to come to market, increasing the importance of bottom-up credit work and bond selection.

Exhibit 108: Annual Latam corporate new issuance has been robust in recent years (US\$)



Source: Credit Suisse. Data are as of October 31, 2014. Includes Corporates, quasi-sovereigns and supranationals.

Exhibit 109: High number of Latam corporate new issues makes deal analysis challenging



Source: Credit Suisse. Data are as of October 31, 2014. Includes Corporates, quasi-sovereigns and supranationals.

Emerging Markets

A tough year ahead, but opportunities exist

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We are reluctant to count on funds from Europe and Japan to support EM yields until the funds are more visible

2015 Core Views

- 2015 should be a tougher year for emerging market fixed income, but the asset class is unlikely to crash across the board, and we still see opportunities.
- Growth in EM economies is relatively weak, and current account positions (cash flows in a macro sense) are weaker than during previous Fed's tightening cycles.
- Still, the recent fall in commodity prices and comfortable valuations in many of the high-yielding markets suggest some room for EM duration to outperform in 2015.

2015 Thematic Trade Ideas

- We recommend bullish duration in India and Indonesia and a market weight in Russia, and we suggest paying low-yielding rates (preferably Thailand or Israel) to hedge long rate exposures.
- We like curve steepeners in Malaysia, South Africa, Thailand, and Turkey local markets and in the Brazilian CDS curve.
- We favor receiving front-end rates in Brazil, Chile, and Mexico.

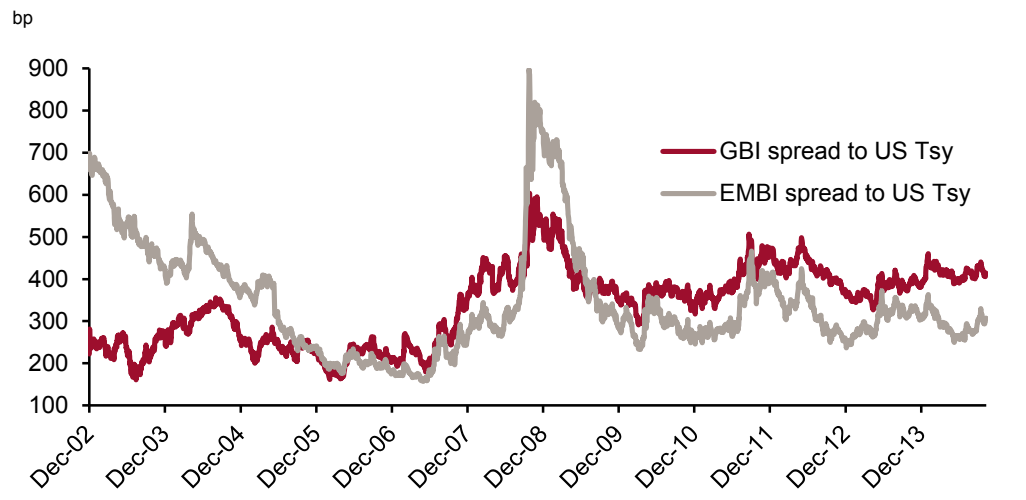
Next year should be a tougher year for emerging market fixed income, but the asset class is unlikely to crash across the board, and we still see opportunities. Our focus is currently on markets where spreads and real yields are high, external positions are stable or improving, and inflation should soften enough to make rate cuts credible. In contrast, we recommend reducing exposure to most of the lower-yielding markets. Specifically, we recommend the following:

- Bullish duration in India and Indonesia and a market weight in Russia;
- Curve steepening in Malaysia, South Africa, Thailand, and Turkey;
- Receiving front-end rates in Brazil, Chile, and Mexico; and
- Positioning for underperformance in Poland, Hungary, and Israel.

Our outlook for higher US yields next year implies weaker flows into EM bonds (see the [Capital Flows section](#) for a broader discussion) and pressure for EM yields to follow. Increased monetary stimulus from the ECB and BoJ may lead to flows from these regions into EM markets that replace some North American money. However, we are reluctant to count on funds from Europe and Japan to support yields in a wholesale fashion across EM until they are more visible. For example, Japanese investors, and particularly retail investors, have historically had yield hurdles for EM carry trades that are higher than on offer in much of the EM universe at present.

Several factors work to check, or at least qualify, a negative outlook for EM fixed income. First, the rise in US yields, as we discuss above, is fairly modest at about 100bp for US 10s to 3.35%. The GBI's yield of about 6.5% is slightly high within its historical range, with the exception of the 2008/2009 global crisis and 2011 Greece crisis periods (Exhibit 110). This offers some room for higher-yielding markets to absorb modestly higher US yields.

Exhibit 110: GBI spread to 10y US Treasury yields is slightly high in its historical range

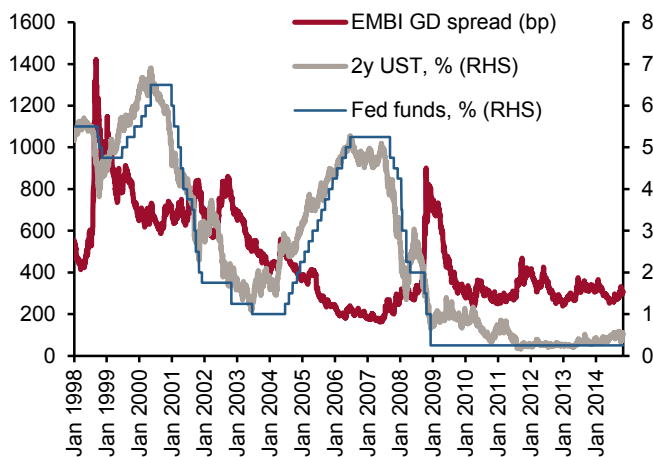


Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

EM fixed income trades largely as a credit asset, and credit tends to perform well in the early stages of Fed hiking cycles

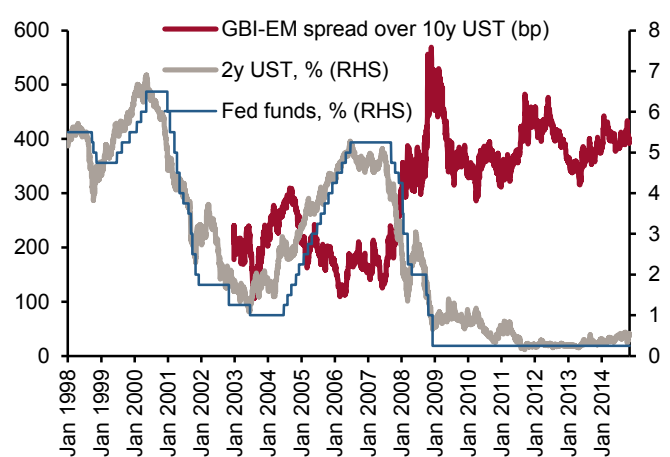
Another consideration is that EM fixed income trades largely as a credit asset, and credit has historically tended to perform well in the early stages of new Fed tightening cycles, as Exhibit 111 shows. At the beginning of hiking cycles, growth and cash flows tend to be strong and credit stress low. Comparable history for EM local currency interest rates is limited, but it shows that EM local currency spreads tightened throughout most of the Fed's 2004-2006 tightening cycle, outperforming US Treasuries substantially during the first nine months of the Fed's tightening cycle as EM credit spreads tightened (Exhibit 112).

Exhibit 111: EM credit spread during UST cycles



Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Exhibit 112: EM local currency spreads during UST cycles



Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Slower growth in China implies a major headwind for commodity exporters

Key differences for EM in this cycle are that growth in EM economies is relatively weak and that current account positions (cash flows in a macro sense) are weaker than before. Our economists' forecast that US and even European growth will rise next year suggests a more supportive background for EM economies. However, the degree of improvement is likely to be slight and biased heavily to the US. Importantly, our forecast for slower growth in China implies a major continuing headwind for commodity exporters and, in Asia, for Korea and Malaysia because of their large export share of GDP going to China.

Exhibit 113: EM export exposure to G3 and China

(as % of national GDP)

	G3+China	G3+China (ex-US)	US	Euro Area	Japan	China
Malaysia	28%	18%	10%	7%	5%	6%
Singapore	25%	16%	9%	8%	3%	5%
Hungary	23%	20%	3%	18%	1%	2%
Vietnam	22%	14%	9%	6%	4%	3%
Czech Republic	21%	19%	2%	17%	0%	1%
Taiwan	21%	14%	7%	5%	3%	6%
Thailand	21%	14%	7%	5%	4%	4%
Chile	17%	12%	5%	5%	3%	5%
Hong Kong	17%	12%	5%	6%	2%	4%
Korea	15%	10%	5%	4%	2%	4%
Poland	15%	13%	1%	13%	0%	1%
Mexico	14%	2%	12%	1%	0%	0%
Israel	13%	6%	7%	4%	1%	1%
Russia	13%	10%	3%	8%	1%	2%
Philippines	11%	7%	4%	2%	3%	2%
South Africa	10%	8%	2%	4%	1%	2%
Indonesia	10%	7%	3%	3%	3%	2%
China	8%	4%	4%	3%	1%	
Turkey	8%	6%	2%	6%	0%	1%
Argentina	6%	5%	2%	3%	0%	1%
India	6%	4%	2%	3%	0%	1%
Brazil	5%	4%	1%	2%	0%	1%

Source: OECD, Credit Suisse; Note: There is no corresponding data for Venezuela and Colombia

The recent fall in commodity prices, particularly oil, is offsetting the weakness of developed market economies but along highly differentiated lines. Exhibit 114 shows that Korea, India, Israel, Thailand, and Turkey should experience large improvements in trade balances and possibly growth as domestic incomes rise, while Brazil, Chile, Colombia, Russia, and Venezuela should suffer substantial losses.

Exhibit 114: Summary table of commodity price impact of EM current accounts

Country	Current account sensitivity to 10% price decline			Net impact of commodity price changes (since 30 June)*
	Food	Energy	Metals	
Brazil	-0.3	0.0	-0.2	-0.3
Mexico	0.1	-0.1	0.0	-0.1
Colombia	0.0	-0.9	0.0	-2.2
Chile	-0.3	0.6	-1.7	1.0
Peru	0.2	0.0	-0.8	0.2
Argentina	-0.8	0.1	0.0	-0.8
Venezuela	0.3	-2.1	-0.1	-4.9
Russia	0.2	-1.7	-0.1	-3.9
Turkey	-0.1	0.7	0.2	1.5
South Africa	0.0	0.5	-0.8	1.2
Poland	0.2	0.4	0.0	1.2
Hungary	-0.3	0.6	0.2	1.1
Czech Republic	0.1	0.6	0.2	1.5
Israel	0.2	0.6	0.1	1.6
India	-0.1	0.6	0.1	1.4
Indonesia	-0.2	0.1	0.0	0.0
Malaysia	-0.3	-0.6	0.3	-1.7
S. Korea	0.2	1.0	0.2	2.6
Thailand	-0.5	1.2	0.5	2.4
China	0.0	0.3	0.3	0.8

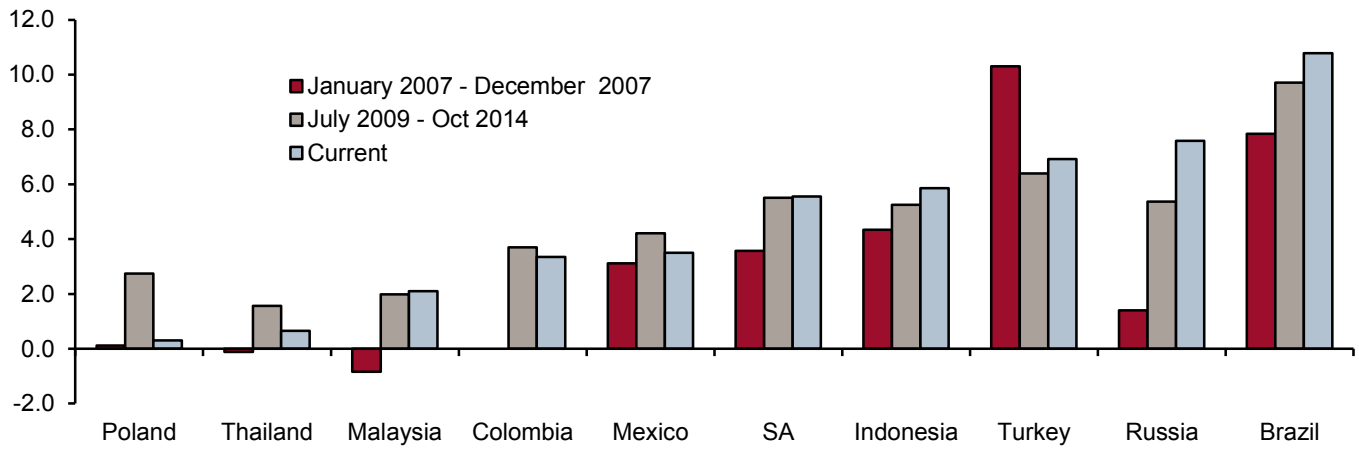
* We focus on the terms of trade impact and run our analysis based on USD prices. A separate question relates to the fiscal impact, in which case an analysis in local currency terms, which also captures recent EM FX moves, would be more appropriate. Russia and Chile are the two countries for which the results are significantly different due to the sharp depreciation in their respective currencies.

Source: Credit Suisse, The UN Commodity Trade Statistics Database, the BLOOMBERG PROFESSIONAL™ service

An important implication of this for the countries that are benefiting from terms-of-trade improvements is that this is reducing currency risk to local currency positions. India, Korea, and Turkey stand out, as the benefits to their current account and inflation from lower oil prices create an outlook for policy rate cuts. Thailand also benefits significantly, and we do not rule out an interest rate cut early in 2015, although we think that improving growth would lead the central bank to reverse this by year-end should it cut.

Returning to yield and spread levels, on average, EM spreads to Treasuries are high enough to suggest some room for EM duration to outperform. However, as Exhibit 115 shows, this is concentrated in Russia, Brazil, Indonesia, Malaysia, and, to some extent, South Africa. Spreads in most other local currency markets look skinny to us, leading us to expect duration in these markets to weaken in line with the US or, more likely, underperform.

Exhibit 115: Current 5y EM swap rate spread to US swaps versus pre-crisis average and average since 2009

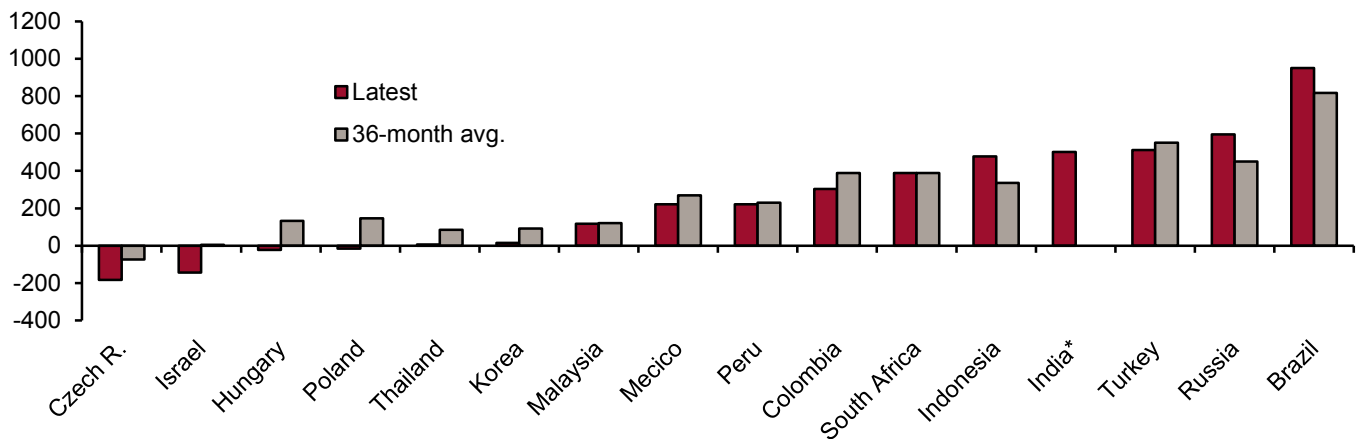


Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse. Data for the pre-crisis period are unavailable for Colombia

Another way to view valuation is to extract the local currency premium implied in overall spreads by subtracting CDS spreads as a proxy for dollar-denominated country risk. On this metric, spreads in Russia, Brazil, Indonesia, and India stand out as being particularly high, while pricing of local currency risk looks too low in the CE3, Israel, Korea, and Thailand (Exhibit 116).

Exhibit 116: 5y local currency premium

5y local currency bond yield minus 5y CDS minus 5y US Treasury yield (bp)



* 36-month average is not available.

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

If macro conditions improve, fixed income in Brazil and Russia could become attractive

In Brazil and Russia, economic and policy uncertainties currently justify these high risk premia, in our view. However, combined with recent depreciation of the BRL and RUB, they imply that if macro conditions improve, fixed income in these countries could become attractive even in an environment of rising US yields.

What to do?

Latin America

- **We recommend tactically receiving short-end rates in Brazil, Chile, and Mexico.** In Brazil, the pre-CDI swaps curve is pricing in too many hikes in the policy rate in the front end. Our economists expect 75bp of additional hikes between 2014 and early 2015 (for a terminal rate of 12.0%), while the curve is pricing more than 200bp of hikes in the next ten months. We recommend receiving the short end on spikes or putting on steepeners in the short end in Apr'15 versus Oct'15-Jan'16 pre-CDI rates. A receiver in Apr'15 at 11.75% (onshore) would break even if the central bank hikes 50bp in December and January and 25bp in March. In Chile, the short end of the swaps curve is not pricing in any cuts, while we believe that the central bank is likely to cut the policy rate next year once inflation starts to subside. In Mexico, the TIIE curve remains too steep, even in the short end. The roll-down in the short end is attractive. We recommend receiving tactically 1y1y when the spread versus 1y TIIE is more than 100bp.
- **We have no conviction in duration.** In our view, the long end of the pre-CDI curve in Brazil will trade correlated with global risk sentiment and, more importantly, will react to policy responses by the government. Overall, we are bearish duration in Brazil, but we acknowledge that any perceived adjustments in the fiscal stance by the government would be likely to make the curve flatter, while disappointments on this front could steepen the curve. In Mexico, we don't see significant drivers in the long end of the TIIE and Mbonos curve. In our base-case scenario of tighter monetary policy in the US, the long end looks vulnerable, particularly given the large participation of foreign investors in that part of the curve.
- **In credit, valuations in Brazil look attractive, with spreads around 180bp, but wider risk premia are possible.** Fiscal efforts in 2015 will be key to avoid a credit rating downgrade to below investment grade. However, political and economic constraints (mainly weak growth) could make this required adjustment insufficient to avoid a downgrade. One way to position in Brazil, therefore, is to put on steepeners in 5s10s CDS. This trade is flat versus carry and roll. In Argentina, despite near-term risks, technicals remain supportive. Appetite for Argentine paper remains strong, particularly among high yield and distressed funds; even if short-term valuations could look expensive after the recent rally, they still appear cheap over the medium to long term.

EEMEA

- **We recommend market-weight positions in Russia.** Inflation could surprise on the downside as a result of weak domestic demand and base effects. The ruble could show positive gains given high carry and aggressive re-pricing in 2014 despite weak fundamentals. Geopolitics are likely to continue to weigh on credit sentiment but could ease if the Ukraine situation stabilizes.
- **We like curve steepeners in Turkey and South Africa.** Front-end rates could push lower as a result of the favorable impact of the oil price shock on inflation and current accounts. A sizable front-end re-pricing, such as 2H 2013 "taper talk," is not our base case, given relatively cleaner positioning and comfortable valuation. Elevated credit risks would keep the long-end of the curves vulnerable.
- **We suggest positioning for underperformance in Poland, Hungary, and Israel.** Rich valuation (Exhibit 116) and high foreign participation (in the cases of Poland and Hungary) keep these markets vulnerable to sizable re-pricing in 2015, especially in case euro-area economic activity surprises on the upside.

Asia: high yielders likely to rally

- **We recommend long duration in India.** Indian bonds stand out as having the best value in NJA. Inflation is falling, and the sharp drop in commodity prices should accelerate the move lower. We expect the RBI to begin cutting its policy rate in 2Q 2015. The OIS market is priced for cuts, but bonds have lagged the move and still offer value. In particular, we expect the RBI to ease further bond access for foreign investors next year, increasing demand for bonds.
- **We think that bounces in the 10yr yield to 8.5%** provide a favorable environment for Indonesian investors. High yields, fuel price reforms, slowing credit growth, and our expectation for markets to gradually price policy rate cuts for 4Q 2015 support our constructive bias.
- **We favor bear steepening in low yielders.** We expect Asia's low-yield markets to be relatively more vulnerable.
 - In **Malaysia**, real interest rates and FX support for bonds has fallen such that valuations are unlikely to be sustained in the absence of foreign inflows. Domestic investors have been net sellers and will require significantly higher yields to switch to buying given widespread expectations for Malaysia's central bank to hike rates.
 - In **Thailand**, markets are already pricing in a dovish Bank of Thailand (BoT) and weak recovery. In contrast, we expect a gradual improvement in Thai growth in 2015 to turn the BoT's bias more hawkish by late 2015. We think that markets are vulnerable to improving economic conditions and expect bond and swap curves to bear steepen in 2015.
 - Credible policy action should have a similar impact on **Korea** bond and swap curves.
- **We expect relative outperformance in Singapore and Hong Kong.** Favorable demand-supply dynamics should allow Singapore and Hong Kong fixed income markets to outperform in a bearish UST backdrop.

Global Equities

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Supportive of equities for 2015, with an S&P 500 target of 2,100 at year-end

2015 Core Views

- We remain optimistic on equities for the first half of 2015 but fear a significant market correction in the second half. Consequently, our year-end forecast for the S&P 500 is 2,100, below our mid-year target of 2,200.
- In 2015, central bank balance sheets are likely to expand at a more rapid rate than in 2014. This helps to support excess liquidity and equity valuations.
- We expect profit margins to peak toward the end of 2015 as labor regains pricing power and borrowing costs move higher. We are 4% below consensus for US EPS growth in 2015.

Why a good first half?

We think there are several fundamental supporting arguments for equities:

1) Equity risk premium still abnormally high

On our model, the ERP is 6.5%. This is still extreme relative to a long-run average of 3.2%.

Exhibit 117: US ERP is 6.5% on IBES consensus numbers and 5.4% on our earnings assumptions

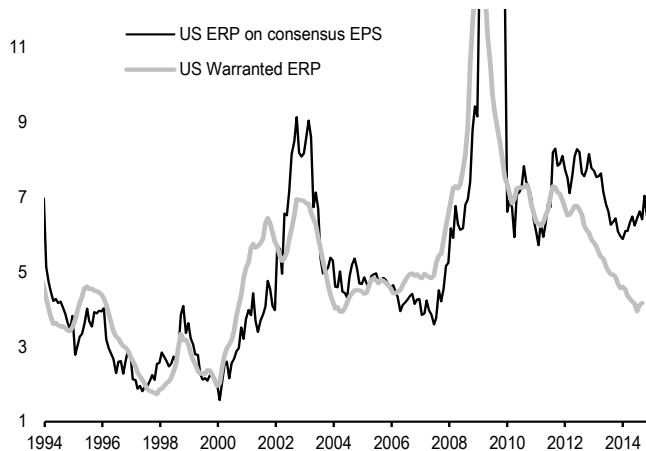
US ERP	12mth fwd EPS	12-24mth fwd EPS growth	3-5yr fwd EPS growth	ERP
ERP on 12m forward consensus EPS estimates	\$127.6	11.4%	10.9%	6.5%
ERP on our EPS forecasts	\$123.7	6.4%	6.4%	5.4%
Historical 110- year average equity risk premium				3.2%

Source: Thomson Reuters Datastream, Credit Suisse Equity Research

This content is based on the views published in [Global Equity Strategy: Raising equity targets](#), 17 September 2014. Please refer to this report for more information and important disclosures.

We believe that the appropriate ERP can be proxied by the stage of the cycle (which we proxy by the deviation of US lead indicators from trend) and credit spreads. These indicators suggest that the ERP should be about 4.2%.

Exhibit 118: The gap between the actual and warranted equity risk premium remains abnormally high



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Exhibit 119: Our model, based on the output gap and credit spreads, implies a warranted ERP of 4.2%

Model inputs	Coeff.	t-value	Current
US lead indicator - dev. from trend	-0.70	-13.7	1.36
BAA Corp. bond spread	0.75	5.2	2.39
Model output			
US warranted ERP (consensus, operating)			4.2
Current ERP on consensus EPS			6.5
ERP on Credit Suisse EPS			5.6
Post-1991 average			4.4
RSQ	0.72		
St. error of estimate	1.28		
Intercept	3.3		

Source: Thomson Reuters Datastream, Credit Suisse Equity Research

We highlight that many other proxies on the equity risk premium are consistent with an even lower ERP. We see neither bond yields nor earnings correcting by the amount required to normalize the equity risk premium, and thus, it is equity prices that rise.

2) The response to deflation

Central banks are likely to respond to deflationary risks by printing money

If there is a deflationary/disinflationary growth hit, then we think that central banks will respond by printing money and thus boosting equity markets. The risk is if there is a growth shock combined with a period of sufficiently high inflation or sufficiently low unemployment, meaning that central banks do not respond with more QE. We also believe that central banks ultimately will end up preferring to take an inflationary risk rather than the opposite. Clearly, equities are an inflation hedge (no longer gold!); bonds are a deflation hedge.

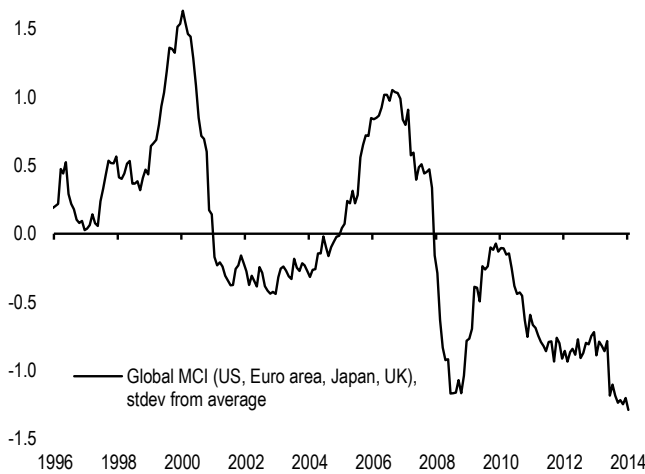
3) Excess liquidity

Central bank balance sheets are likely to expand further, supporting global equities

Our proxy on excess liquidity, which follows the Bank of England's methodology in calculating the excess growth in money supply over nominal GDP, is growing at 4.5%, consistent with a 10% re-rating. Moreover, in 2015, central bank balance sheets are likely to expand at a more rapid rate than in 2014. If we assume that the ECB expands its balance sheet by half of the €1 trillion to which it has committed, and factoring in the latest announced plans by the BoJ, that would imply a 13% expansion in global central bank balance sheets in dollar terms in 2015, after a 5% expansion in 2014.

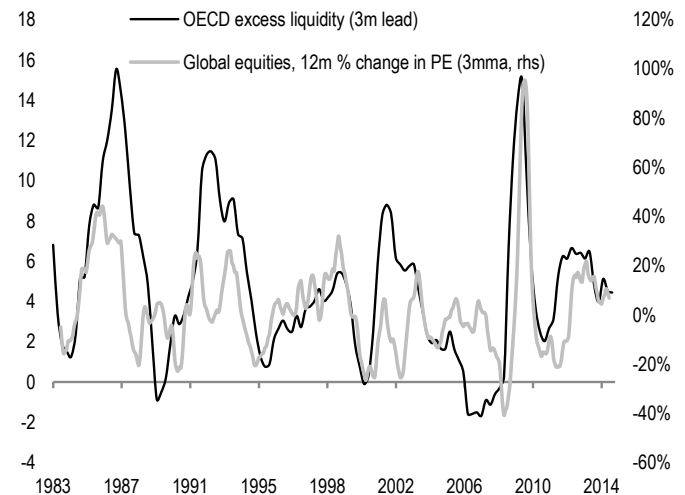
This helps to support excess liquidity and global equities.

Exhibit 120: Our Global Monetary Conditions Index remains extremely loose on our indicator



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Exhibit 121: Global excess liquidity is consistent with a re-rating of global equities of about 10%



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

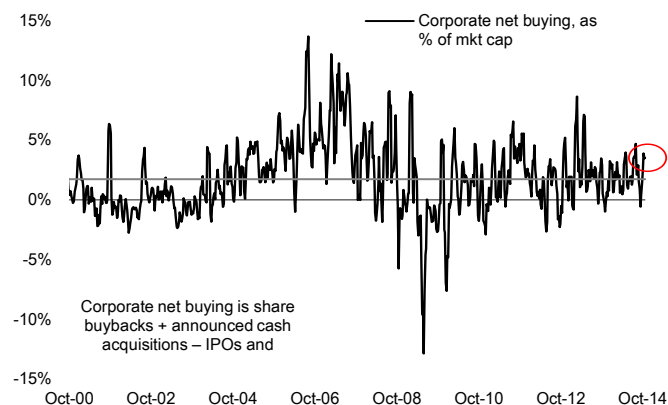
4) Positioning

Corporate buying could expand further

The key buyer of the equity market has been, and will continue to be, the corporate sector. Corporate net buying since the market low in the US has been approximately \$2.4 trillion in aggregate. More recently, corporate net buying has stepped up to 3.5% of market cap, double its norm.

We calculate that if companies with leverage below the 20-year market average returned to normal levels, then the US and European corporate sector could buy \$1.59 trillion and \$622 billion of equity, respectively, amounting to 8% of non-financial market cap in the US and 6% in Europe.

Exhibit 122: US corporate net buying rose to 3.5% of market cap, double its average



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Exhibit 123: If net debt/EBITDA were to rise above 20-year market average...

	US	Europe
Non-financial corporate sector	If companies with net debt/ebitda < market 20-yr avg relever to that level	
% mkt cap with net debt/Ebitda < mkt (ex financial) 20-yr avg	73%	58%
Underleverage (\$bn)	1,588	622
% non-financial market cap	10%	8%
% impact on non-financial EPS	8%	6%

Source: Credit Suisse Equity Research

We believe that the rolling Sharpe ratio will at some stage encourage investors to make the switch between bonds and equity (or rather make the corporate bond to equity switch).

Since the start of 2008, total net buying of equities on EPFR data has been just 1% of that of bonds, and US pension fund weightings in equities are low by historical standards.

5) Earnings growth

Global earnings do not yet capture the strength seen in US and European results

The most recent results season has seen both US and European earnings surprises close to record levels. However, global earnings breadth has yet to respond positively as dollar strength weighs on US estimates. Despite some currency headwinds, in our view, there is upside to revenue forecasts in the US given our economists' GDP forecasts

Our models suggest EPS growth of 11.9% and 13.4% in US and Europe, respectively, in 2015, some 4% below consensus in both cases. We continue to highlight that two-thirds of the times that earnings are revised down, markets rally; the problem for markets has historically been when earnings fall by 5% or more.

Exhibit 124: Our 2015 S&P 500 EPS forecast is 4% below consensus ...

Model inputs, % chg	Coeff.	t-value	2014E	2015E	2016E
US Real GDP	3.4	3.0	2.0%	3.0%	3.0%
Non-fin. corporate GDP deflator	6.0	2.6	1.6%	1.9%	2.0%
Total costs (ULC+NULC)*	-7.2	-5.9	0.9%	1.6%	1.7%
USD trade-weighted	-0.4	-1.5	5.0%	7.0%	5.0%
*ULC= Unit labour costs, NULC (nonlabor unit costs = 53% depr./13% interest/ 34% taxes)					
Model output - S&P 500 operating EPS					
IBES consensus			\$117.2	\$131.1	\$146.0
Credit Suisse			\$117.2	\$125.8	\$135.9
IBES consensus, y/y%			7.9%	11.9%	11.3%
Credit Suisse, y/y%			8.0%	7.4%	8.0%

Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Exhibit 125: Our 2015 European EPS forecast is 13.4%

Expl. Variables:	Coeff.	Latest	2014E	2015E	2016E
Euro-area GDP yoy%	3.8	0.8	0.8	1.6	1.7
Euro-area PPI yoy%	4.0	-0.1	0.2	1.6	1.6
Euro-area unit labour costs yoy%	-1.3	0.5	-1.0	-1.1	1.2
Euro TWI yoy%	-0.1	1.9	-5.0	-5.0	-5.0
Intercept	-1.1				
R2	0.60				
MSCI EMU EPS, yoy			4.6%	13.4%	10.9%
IBES Consensus			8.6%	17.4%	11.6%

Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Looking at EBITDA margin ex tech in the US, Europe, and Japan shows that margins are only close to normal levels. We highlight that 26% and 38% of the margin improvement in the US has come from a lower interest and a lower tax charge, respectively. The interest charge does not become a drag on earnings until the BAA bond yield rises above 5.5%.

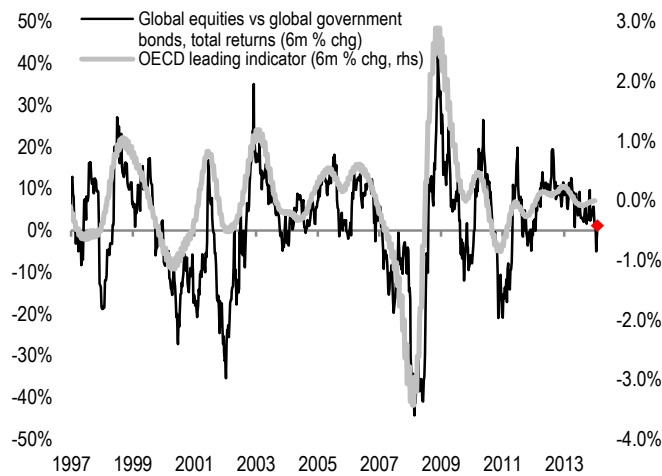
To get a rise in the global tax rate, we think, would require capital controls. We continue to believe that the troubling time for earnings will come in the US some 10 months after labor gets pricing power and on average not until 21 months after labor has pricing power. **This would imply that profit margins peak around the end of 2015.**

Markets are pricing a significant slowdown in growth, which we do not expect

6) Market proxies consistent with a sharp slowdown in growth

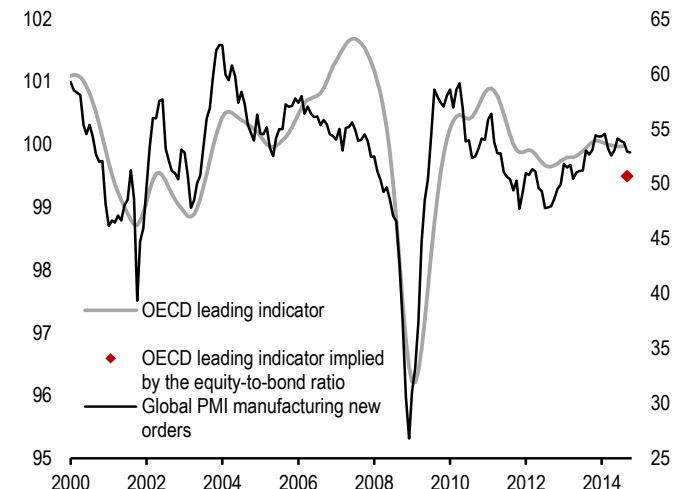
If we look at the ratio of equity to bond returns, it is consistent with OECD lead indicators falling by 0.5% and thus PMI new orders falling to 50 (itself consistent with 3% global GDP growth), yet current OECD lead indicators imply PMI new orders of 54.

Exhibit 126: The ratio of equity to bonds is consistent with a slowdown in the OECD leading indicator ...



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Exhibit 127: ... and global PMI New Orders falling to 50



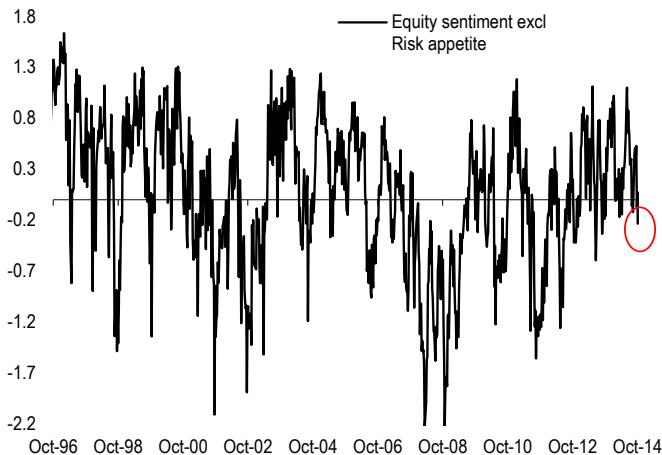
Source: Thomson Reuters Datastream, Credit Suisse Equity Research

If we look at the ratio of cyclicals to defensives, it is now the lowest since 2009 and consistent with IFO falling to 94 (equivalent to -0.7% German GDP growth). Even risk appetite is implying ISM new orders falling to 45. **In our view, this is too pessimistic.**

7) Tactical indicators neutrally positioned

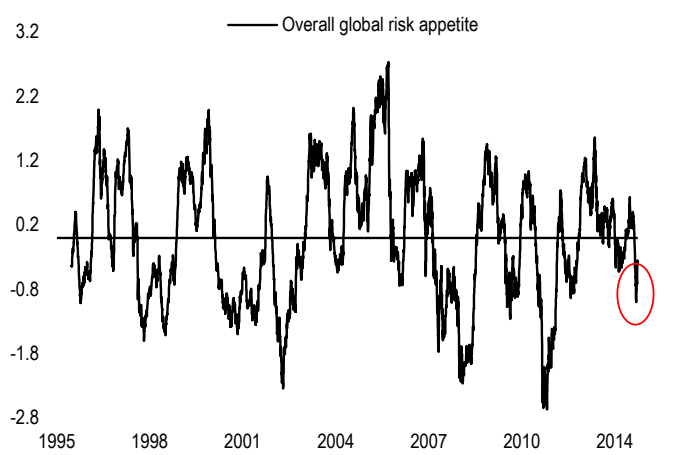
Even at the time of writing, prime broking net long positions are well below their norm despite the S&P being at new highs.

Exhibit 128: Our equity sentiment indicator is neutral



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Exhibit 129: Global risk appetite is 0.4 std below neutral



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

What about the second half of 2015?

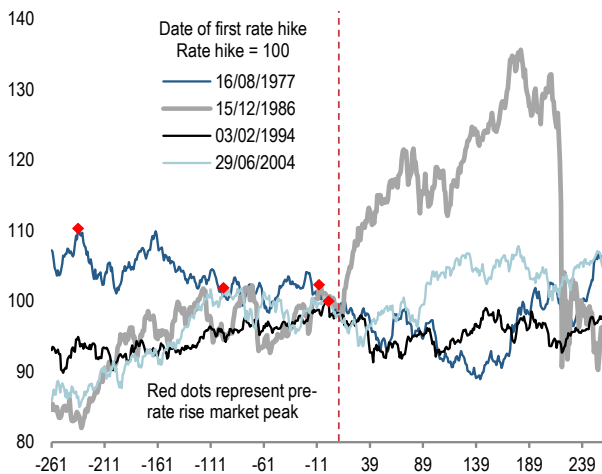
There are two events that we think could lead to a 10% correction:

The first Fed rate hike

Markets only fall by a few percentage points following the first Fed hike

Historically, equity markets tend to peak no earlier than four months before the first rate rise and have fallen by only a few percent on average. After the first rate hike, however, investors have been able to buy equity markets 6%-11% lower.

Exhibit 130: Prior to the first rate hike, there is hardly any correction in the S&P 500



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Exhibit 131: After the first rate hike, it has been possible to eventually buy the S&P 500 at levels that are 6%-11% cheaper

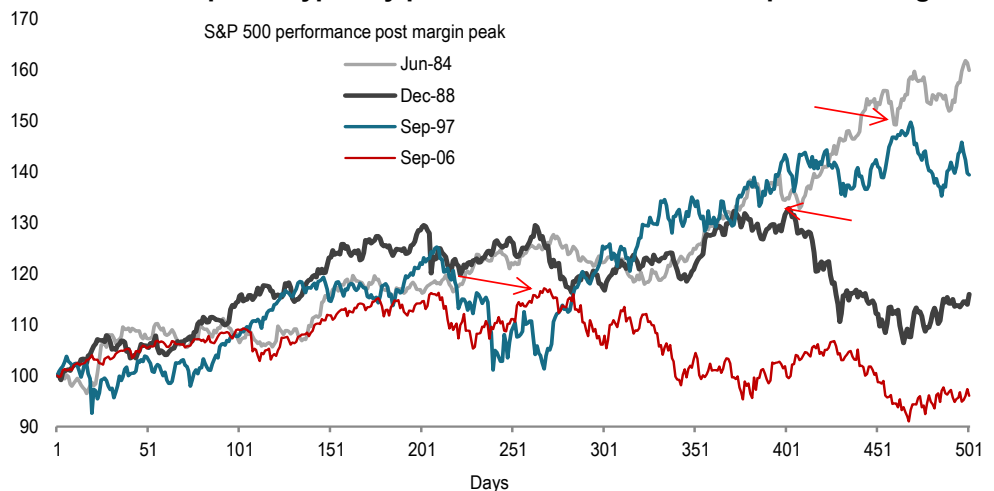
Date of first rate rise	Date of market trough	Max correction following a rate rise	# months to market trough	% chg in 6 months after rise
16/08/1977	06/03/1978	-11.2%	7	-9.4%
15/12/1986	04/12/1987	-9.5%	12	21.9%
03/02/1994	04/04/1994	-8.9%	2	-4.6%
29/06/2004	12/08/2004	-6.2%	1	6.8%
Average		-9.0%	5	3.7%

Source: Thomson Reuters Datastream, Credit Suisse Equity Research

Pricing power in the US labor market

Wage growth is now showing clear signs of accelerating in the US. We believe that labor will get pricing power when unemployment hits 5.4% and that is likely to be in Q2 2015. History, therefore, would suggest that profits margins are likely to peak toward the end of 2015. Importantly, equity markets can continue to rise after profits margins peak, but nevertheless, we would not be surprised if there were a 10%-15% correction.

Exhibit 132: US equities typically peak 12-18 months after the peak in margins



Source: Thomson Reuters Datastream, Credit Suisse Equity Research

What are the key risks?

High yield

High yield spreads typically widen three months prior to a bear market by 115bp. However, 60% of the time, this is a necessary but not a sufficient condition for a bear market. We agree with our house view on credit and point out that banks are not underperforming as spreads widen.

US rates

As discussed above.

Continental European politics

We agree with the view that the ECB will do QE and that Europe is not as bad as investors believe, not least because bank balance sheets have stopped contracting and domestic demand indicators have held up better than IP (see [Deflation in Europe: Unlikely, but what if?](#))

Chinese property

We believe that China real estate is the epicenter of the triple bubble of credit, investment, and housing. Currently, real estate prices are down five months in a row. We have, however, seen some modestly encouraging signs recently in terms of an improvement in property turnover and developers post Golden Week (and the government measures to increase the LTV from 30% to 70% for second homes and reduce mortgage rates by approximately 30%).

Foreign Exchange

Volatility pricing still fails to account for policy divergence

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2015 Core Views

- Markets have systematically mispriced the likelihood of policy divergence surprises outside of the all-encompassing impact of a less accommodative Fed.
- Continued EUR weakness also is likely to be a significant problem for other European currencies as their central banks try to find ways to compensate for low inflation and weak exports. The idea of EUR floors for currencies such as SEK may gain ground.
- JPY should stay on the back foot, although we think that implied volatility is underpriced. The AUD and NZD are likely to suffer from weak commodity prices, with the former also needing to face down the impact of possible macro-prudential regulation.

2015 Thematic Trade Ideas

- We favor short EUR positioning against USD, CAD, and selected EM currencies where carry is particularly elevated and domestic negatives are largely priced in.
- We recommend being long volatility via FVAs and volatility swaps in EURUSD, EURAUD, and EURGBP.
- We argue in favor of exploiting dips in USDJPY toward 114 or below as an opportunity to establish fresh long positions. But we prefer options to spot for view expression given that implied volatility appears underpriced.

We expect interesting opportunities in FX as markets have mispriced the likelihood of policy divergence

We think that idiosyncratic stories will continue to play a large role in driving price action in G10 FX in 2015. The recent jump in implied volatility in EUR and JPY crosses triggered by recent monetary policy action in Europe and in Japan highlights how markets have systematically underpriced the likelihood of policy divergence surprises outside of the all-encompassing impact of a less accommodative Fed. We think that this trend will continue to provide interesting opportunities in the FX space in coming months.

The BoJ has reinforced our bearish view on JPY

JPY: Implied volatility is underpricing fiscal policy risk

The combination of the Bank of Japan kicking up QQE ([BoJ QQE decision](#)) and the GPIF announcing its new portfolio allocation ([GPIF press release](#)) targets has reinforced our bearish view on JPY. Political risk is also in play as the market considers the possibility of a new general election as soon as December 2014. We now forecast **USDJPY 120 in 3 months and 125 in 12 months**.

We are reluctant to push beyond these targets as the October move by the BoJ might limit the scope for additional stimulus in 2015. The large number of dissenters on the BoJ board – the vote was a close 5-4 decision – suggests that monetary policy purists at the BoJ have serious doubts about the proposed path. Markets also judged the recent BoJ move as partly a political one designed to pave the way for PM Abe to push through a decision to raise the consumption tax again in 2015. In this context, a decision not to pursue this option if an early election is held in December would be controversial. After all, one reason that Kuroda's BoJ has been so accommodative and the international community so accepting of JPY weakness has been Japan's willingness to push through fiscal tightening and take some punishment for longer-term benefits. If Japan's politicians now make it clear that they are not prepared to take fiscal pain (Arrow 2 of the "Three Arrows") and just want FX-inspired gain (linked to Arrow 1), it is possible over time that the market will question whether the BoJ can stay as easy as it is and/or whether the international community will accept persistent JPY weakness at a time when most other developed economies are also struggling to create inflation. This is all the more true if there is only limited progress on Arrow 3 (structural reforms).

Exhibit 133: The relative change in the quantity aspect of QQE is diminishing

	End-2012 (actual)	End-2013 (actual)	End-2014 (projected)	End-2015 (projected)
Prior Monetary Base Projections (¥tr)*	138	202	270	340
Current Monetary Base Projections (¥tr)**	138	202	275	355
Incremental change			+1.9%	+4.4%

*Assumes ¥70 trillion in purchases
 **Assumes ¥80 trillion in purchases in 2015

Source: Credit Suisse, Bank of Japan

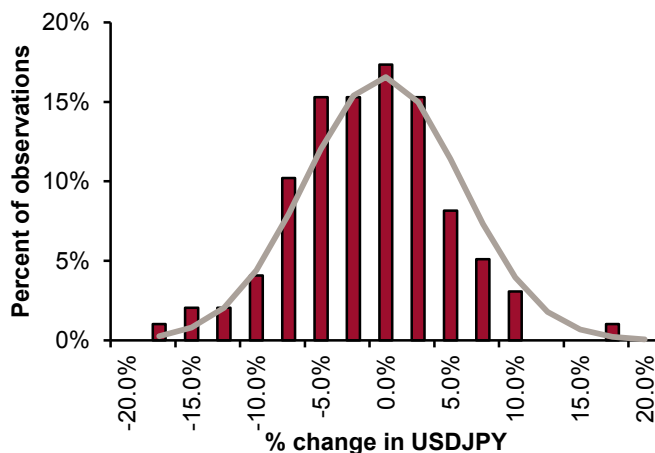
Capital outflows spurred by existing monetary policy and the GPIF are key to further JPY weakness.

This analysis leaves capital outflows spurred by existing monetary policy and the GPIF as the key to further JPY weakness going forward. Obviously, stronger overseas data that lead to rate differentials widening against the JPY would also help. There is also a possibility that USDJPY moves well beyond our forecast levels if there is a disruptive impact on Japanese capital flows, especially if there is a “buyer’s strike” in the JGB market that results in locals looking to buy mainly overseas debt in the expectation that policymakers have left the JPY totally exposed in the face of bond buying / money printing without some degree of fiscal tightness as an offset. This leads us to another important idea:

Implied volatility looks too low compared to 2Q 2013 (Exhibit 135). Although the risk-reversal skew is now essentially flat out to the nine-month tenor in USDJPY, the skew is still far from 2013 levels. As such, we are hesitant to recommend trades that either sell JPY volatility or position for a renewed shift in favor of JPY puts in the risk-reversal skew, as levels are not extreme enough to make such trades especially attractive. We prefer instead to argue in favor of exploiting dips in USDJPY to 114 or below as an opportunity to establish fresh long positions. And we similarly favor buying JPY volatility, with one-year levels below 10% attractive. Indeed, **a key risk to our core view** would be that the **BoJ is forced into action again if inflation fails to pick up** in 1H 2015. If this leads the market to price in still more unorthodox monetary policy – for example, **radical action such as the BoJ buying foreign bonds** – USDJPY could move a lot higher still.

Exhibit 134: Bucketing USDJPY quarterly returns

Distribution of quarterly % changes in USDJPY since 1990



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 135: USDJPY implied volatility looks too low

USDJPY 2m implied volatility



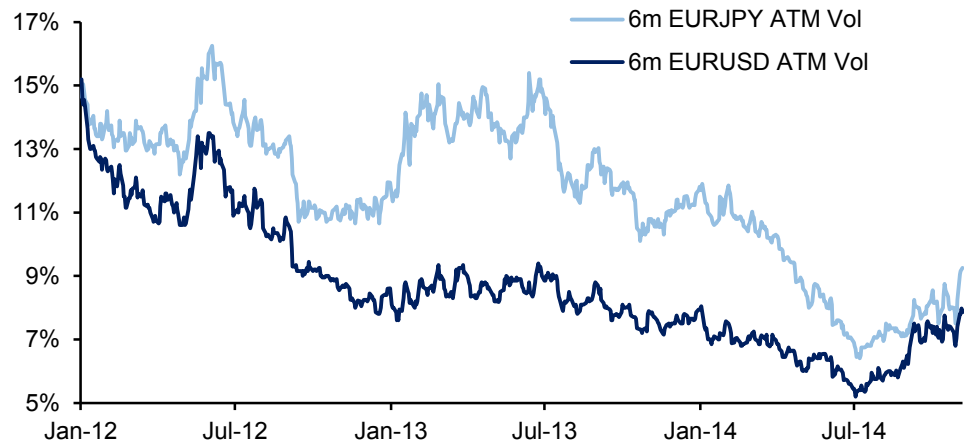
Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

EUR: Back in play

We have lowered our EURUSD forecast again

We now expect **EURUSD of 1.20 in 3 months and 1.15 in 12 months**, with risks skewed to the downside. As Exhibit 136 shows, FX volatility is rising from a low base, which signals the potential for larger movements ahead than the market has been used to over the past year.

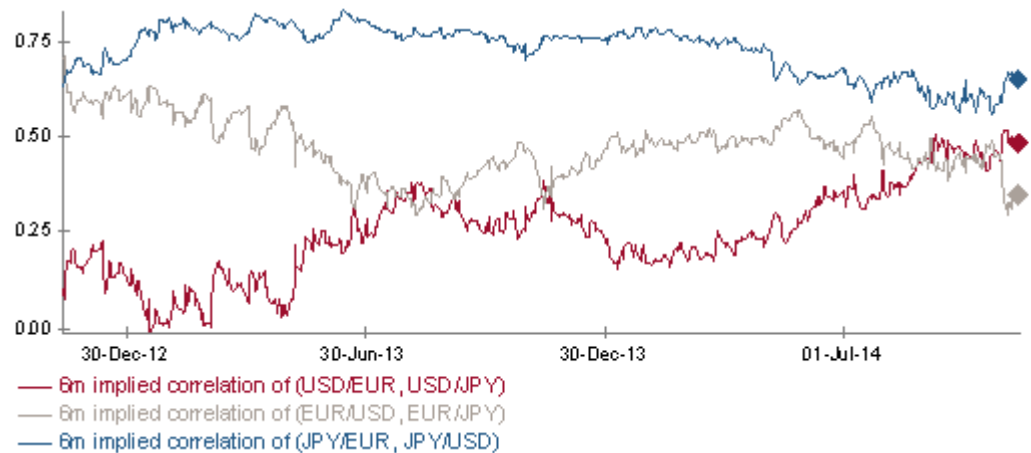
Exhibit 136: Implied volatility is starting to rise from a low base



Source: Credit Suisse Locus

The sharp market reaction to the 6 November ECB press conference was another good example of underpriced policy expectations. In recent weeks, EUR had taken a back seat to USD and JPY developments. As Exhibit 137 shows, option-implied correlations had suggested that EUR-specific drivers of direction would not be a dominant theme in the FX market in the months ahead. In our view, as long as the ECB remains in play to introduce full-scale sovereign QE ([European Economics and Strategy: ECB – Keeping the finger on the policy trigger](#)), this expectation is wrong, and the market needs to consider more seriously the possibility of EUR as a driver of direction.

Exhibit 137: The market is not seeing the EUR as being in play



Source: Credit Suisse Locus

Since we last changed our EURUSD forecast on [24 September](#), we have seen both a confirmation of tapering by the Fed and enough strong US payrolls data for our US economists to incorporate 100bp of Fed rate hikes between June and December 2014. Combined with the ECB arguments outlined above, we think that there is sufficient “monetary divergence” to justify a further downgrade in our EURUSD forecasts.

The rest of Europe may be forced to deal with it

Downside pressure on the EUR is likely to complicate policy for currencies closely linked to the euro area, exacerbating pressure from low inflation and struggling exports.

This may be most pressing in Sweden. As the Riksbank has cut the policy rate to zero, there is very little scope to deliver more easing in a conventional manner. Strong similarities to the CHF and CZK cases – that is low inflation, struggling exports, no desire to boost credit growth unnecessarily, and too small a domestic market to enable a impactful QE – suggest that SEK is a prime candidate for an FX floor ([versus EUR](#)). This is no 1Q 2015 matter and not our base case, but any downside pressure on EURSEK, combined with disappointments in inflation, could quickly make such a scenario probable.

Meanwhile, the EURCHF floor appears under market scrutiny at the moment, especially as gold referendum risks are looming. We continue to believe that SNB will do its utmost to defend the floor, but it is not clear this will be enough to raise domestic inflation.

Finally, the UK and Norway have for now been fortunate not to have inflation rates near zero. However, the scope for monetary policy divergence has come into question in the UK, and with the housing market cooling, we expect further downside in GBPUSD ([GBP: A turn in events](#)). Meanwhile, NOK, after the renewed bout of currency weakness, may sustain its inflation rates, but only to have to deal with an oil investment slowdown after oil prices have approached critical levels for the project pipeline ([NOK: Going under](#)).

Overall, it is highly questionable if EUR will fall versus this group of currencies, which mostly would hope for weak exchange rates themselves. We rather see the block facing downward pressure versus the USD, at moments mirroring and at moments even underperforming the EUR.

Australia: Weak commodity prices do not tell the full story

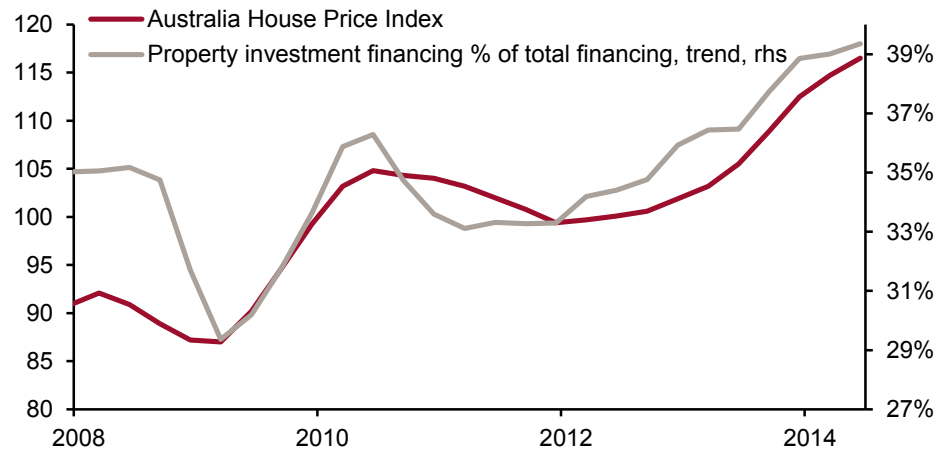
We are bearish AUD on weak commodity prices and Australian financial regulation

The continued decline in key commodity prices (i.e., iron ore) and moderating Chinese growth expectations – our China Economics team downgraded its 2015 GDP forecast from 7.8% to 6.8% ([Reassessing the growth prospects](#)) – are at the core of our bearish view on AUD. **We forecast AUDUSD of 0.83 in 3 months and 0.78 in 12 months.** Our bearish view on AUD rests, however, on more than just poor commodity prices. Specifically, we think that the upcoming overhaul of Australian financial regulation could add downside risks to AUD that markets might not be fully pricing in.

This month's Financial System Inquiry (Murray Report due to be presented to the government in November) and the possibility of resulting macro-prudential measures could also be the first steps toward quelling investment property and financial stability concerns. Specifically, any recommendations designed to suppress the rate of investor property accumulation would signal a major change in Australian financial policy and would weigh against a key reason that the market has not priced in lower Australian rates going forward.

In the case where macro-prudential issues dominate the final report, the RBA would likely be able to keep policy rates lower than it otherwise could, with negative implications for the AUD. The interim report released in July placed a great deal of emphasis on issues related to the stability of the financial sector and systemic risk. And there has been increasing focus of late in Australian commentary on issues such as low risk weights for mortgages for bank capital accounting purposes that many think incentivize lenders to favor such lending as opposed to more productive business lending (Exhibit 138).

Exhibit 138: Investment lending is taking an ever larger share of total housing finance, and prices are responding



Source: Credit Suisse, Australian Bureau of Statistics

Non-dollar NAFTA bloc has its problems too but should outperform the rest of G10

Australia is unlikely to be the only country to suffer from deteriorating Chinese growth and ensuing pullback in commodity prices. We think that the decline in energy prices, if extended, could affect **MXN** in particular. Aside from the negative but limited impact on oil exports per se, we believe that the key risk in **MXN** is that global investors have been buying local securities aggressively in recent years on expectations that the long-awaited energy reform would attract FDI.

The decline in oil prices, combined with the recent increase in the visibility of Mexico's longstanding security problems, could, in our view, complicate the decision-making process for foreign investors looking to buy long-term Mexican assets. As such, we think that macro investors waiting for a foreign capital onslaught might be disappointed. With foreign ownership in the local bond market up to 36% of total outstanding issues (the all-time high was 37.3%), we also think that the prospect of the Fed tightening in 2015 might be another source of risk for **MXN**, especially with real rates now at zero.

Energy prices are also a source of concern for **Canada**, but the stronger macro domestic backdrop and the prevalence of overly bearish views in the market bring us to believe that Canada could outperform the rest of the commodities currency complex in 2015.

More positively, the aggressive expansion in mining capacity seen in Australia and Chile in recent years has not taken place in Canada, as the economy as a whole has slowly moved toward a more services-oriented growth model. This implies low risks of FDI outflows, relative to the rest of the commodities complex. Also, unlike most of its fellow energy-focused economies, Canada has not experienced a surge in non-resident portfolio inflows in recent years and is therefore less likely to suffer from a tightening in interest rate differentials in the USD's favor. **We forecast USDCAD of 1.15 in 3 months and 1.17 in 12 months.**

Global Interest Rates

US Rates

Approaching lift-off

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2015 Core Views

- The curve should flatten aggressively in 2015, with 5s30s collapsing by more than is currently implied by the forwards.
- Europe should exert less of a drag on US yields as we enter the Fed tightening cycle, ultimately allowing 10s to sell off toward our year-end forecast of 3.35%.
- We expect TIPS breakevens to rise off their current depressed levels next year as oil deflation slows and core inflation gradually moves back toward 2%; we remain cautious, however, and look for a better tactical opportunity to establish longs in TIPS breakevens.

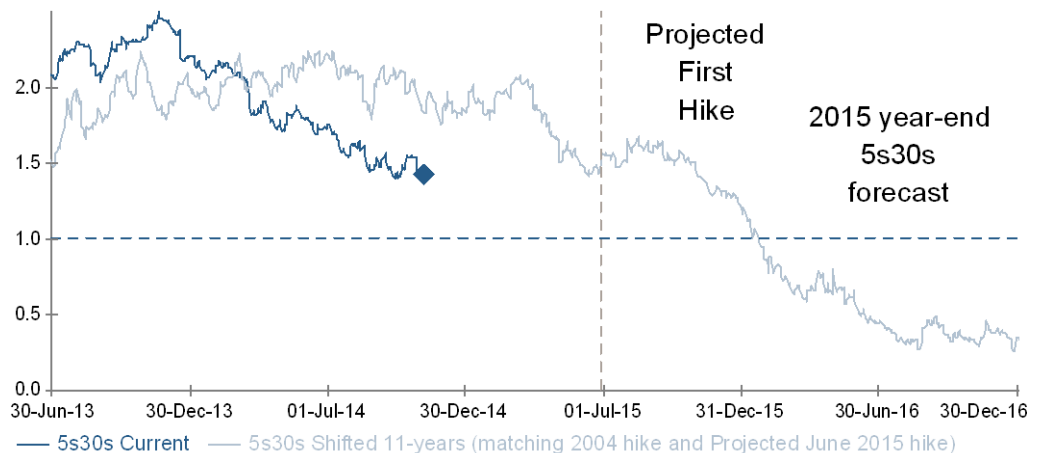
2015 Thematic Trade Ideas

- We like 5s30s flatteners.
- We recommend being short EDZ5 via risk reversals.

The Fed is likely to start formally raising rates in June 2015, in our opinion. We expect the Fed to hike four times by year-end 2015, raising the target range 100bp from its current 0-25bp window. Current market pricing paints a much different outlook, implying a later start and slower pace to hikes; we expect that once the Fed decides to go, it will be inclined to do so nearly once every meeting.

Although curves are likely to be somewhat slower to flatten than they were in the 2004 hiking cycle given that they have flattened significantly already, we expect the recurring theme of global concerns driving the long end to continue into next year and favor 5s30s flatteners, looking for a 100bp 5s30s curve by year-end. A potential risk to this is a re-steepening of the curve on diminished demand for long-end duration.

Exhibit 139: Although the 5s30s curve is further along in its flattening than it was prior to the 2004 hike cycle, we see scope for another ~45bp of flattening in 2015



Source: Credit Suisse Locus

We expect 10y Treasuries to sell off about 100bp to 3.35% by the end of 2015

That said, although we expect the delivered flattening early on in the cycle to exceed that priced by the forwards, Europe should exert less of a drag on US yields as we enter the Fed tightening cycle. We expect 10y Treasuries to sell off about 100bp to 3.35% by the end of next year.

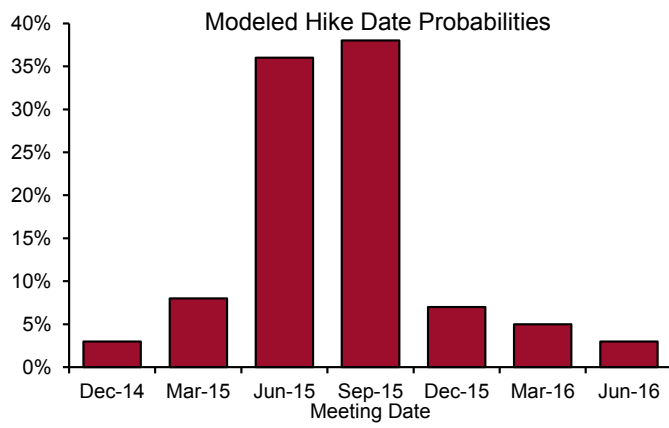
This slight break with Europe is already starting to be reflected in the vol market, with 1y10y USD and EUR rate vol showing signs of breaking with what had been a high trailing correlation. As this divergence continues, we expect the US to become an even higher beta market.

We expect volatility to increase once there is a clearer consensus on the outlook for Fed tightening

We see scope for increased volatility to arise once the market converges toward a clearer consensus on the outlook for Fed tightening. We estimate that the market is definitively assigning the highest probability of a first rate hike to the June and September meetings (assuming that hikes begin at a press conference meeting). That said, convergence toward an even more definitive consensus is still inevitable prior to hikes beginning, and when that does happen, it may be a somewhat disruptive process.

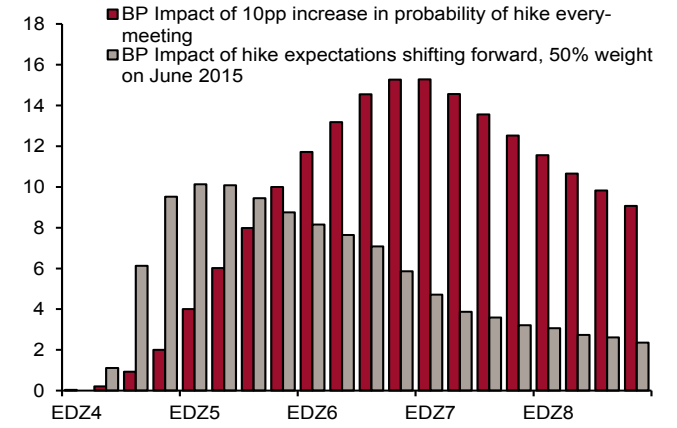
Highly vulnerable to a reassessment, in our view, is the current market pricing for the pace of Fed hikes. With the market assigning a very low likelihood to hikes happening at a pace of once every meeting (we estimate that current pricing implies about a 20% weight to this outcome), front-end curves appear vulnerable if and when a shock causes this to adjust.

Exhibit 140: The market is focused on a late-Q2/Q3 hike next year, but there is still scope for adjustment



Source: Credit Suisse

Exhibit 141: The market is vulnerable to any reassessment of hike expectations, and we view the pace of hikes as a particular risk



Source: Credit Suisse

We see it as more likely that the market's expectation for the timing of hikes adjusts first, whereas its assessment of the pace may not shift until the hiking process is already under way. We therefore favor being short EDZ5 and prefer expressing this via risk reversals to take advantage of skew having cheapened substantially. We favor selling 99.625 strike calls on EDZ5 and buying 98.75 puts at zero cost. The strike on the call we favor selling is richer than EDZ5 has traded. A risk to this trade is that hikes begin later and/or more slowly than is currently priced.

With our expectation that shorter rates will be more a function of domestic policy and economic developments than longer maturities, we expect a similar dynamic between vol on shorter- and longer-dated tails. This would be most acute in the

Exhibit 142: Thanks to skew cheapening, our put recommendation can be funded by selling a call struck at a yield below EDZ5's all-time richest level



Source: Credit Suisse Locus

forementioned scenario in which the market reconsiders its view on the timing and pace of hikes, with the 3y-5y part of the curve likely particularly vulnerable, while moves higher in yield further out may be a more gradual process.

Outlook for TIPS breakevens

TIPS breakevens should rise, in our view

We expect TIPS breakevens to rise off their current depressed levels next year as oil deflation slows and core inflation gradually moves back toward 2%.

Even though, as of this writing, oil prices have not yet found a floor, the sharp fall of the past few months is approaching the two-standard-deviation band at which prices have historically slowed their deflation rate (Exhibit 143).

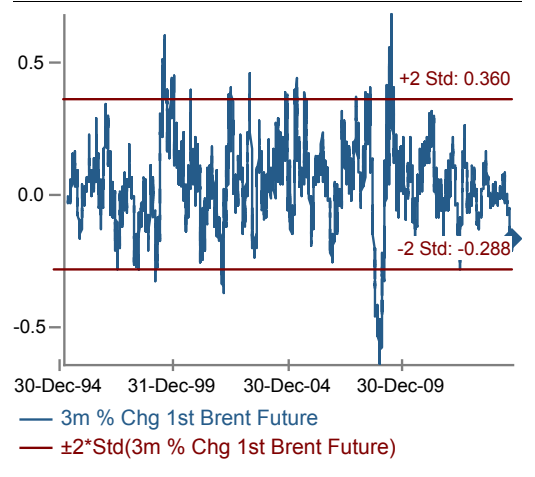
Our energy strategists expect some persistence in the current weakness during the first quarter of 2015 that would subside toward 4Q 2015 (see their report [here](#)). This profile for oil should allow TIPS to regain some of their recent losses.

As we noted in a [previous publication](#), the TIPS market is not currently pricing meaningful inflation risk premiums at various tenors on the curve, with the front pricing for ~1.8% year-over-year ex-energy inflation.

Further out on the curve, 5y5y breakevens are pricing approximately 30bp of inflation risk premium, above the Fed's 2% target but still 20bp below its August peak and three-year average level of 2.5%.

As oil prices stabilize, core inflation should regain importance as a driver of inflation expectations. On that front, we expect Owners' Equivalent Rent to rise modestly above 3% during the first half of 2015 before decelerating toward its current rate.

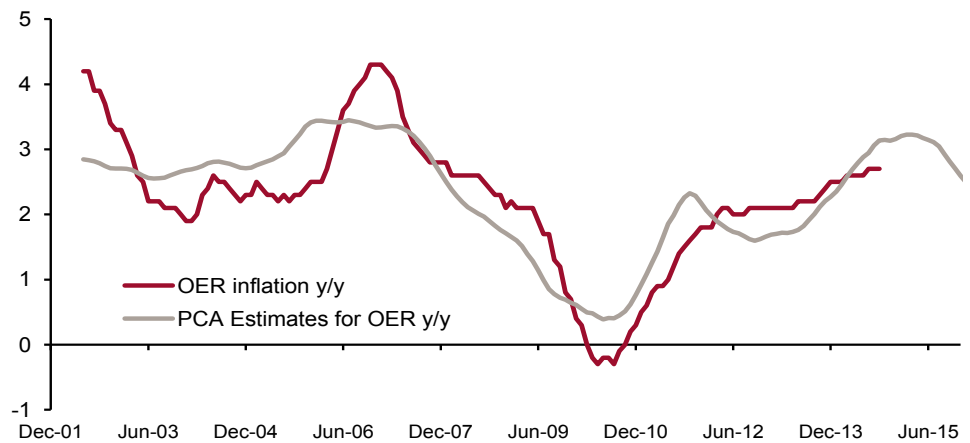
Exhibit 143: Stretched oil prices decline



Source: Credit Suisse Locus

Exhibit 144: We expect core inflation to continue to be supported by elevated shelter inflation in the first half of 2015

In percent



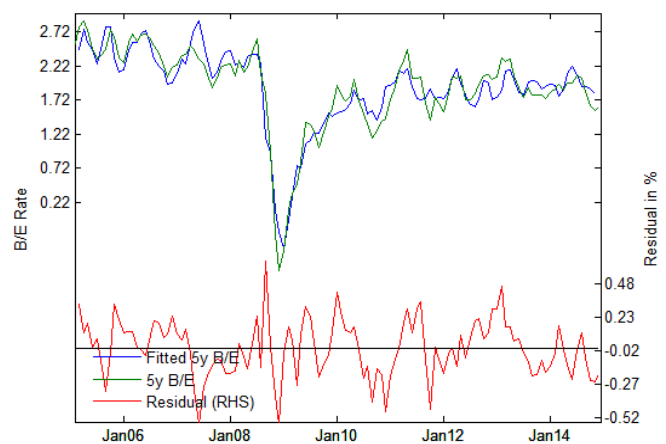
Source: Credit Suisse

It remains to be seen whether the recent weakness observed in other services components, particularly medical services inflation, will persist or fade. This will be key given that goods remain in slight deflation. Our base-case scenario for medical inflation is the Medicare-driven disinflation (discussed in the [past](#)) fades, giving way to a ~3% year-over-year rate going forward (for context, 2.7% year-over-year services inflation is needed for 2% core inflation).

Breakevens are likely to move closer to their fundamental fair values as inflation risk premium is slowly repriced

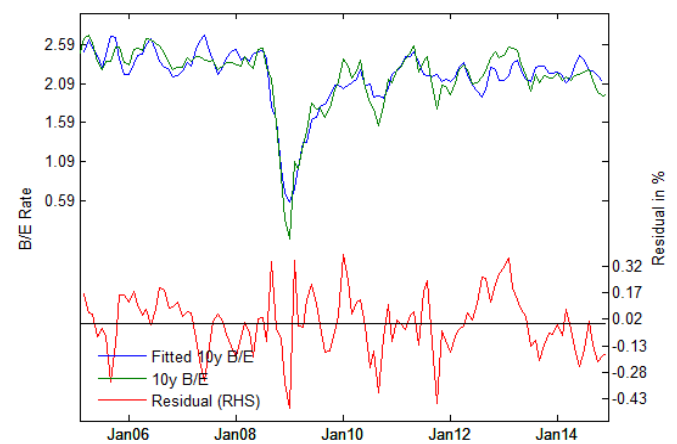
In sum, gradually rising core and stable oil prices should allow for the inflation risk premium to be slowly repriced on the TIPS curve, taking breakevens closer to their fundamental fair values. Indeed, our fundamental models suggest that TIPS breakevens across the curve are noticeably cheap. Specifically, we find 5y and 10y breakevens to be 30bp and 20bp cheap, respectively. 3y BEIs appear 15bp cheap on the same basis. We therefore maintain a fundamentally bullish bias on TIPS breakevens into 2015.

Exhibit 145: 5y TIPS breakevens fair value



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 146: 10y TIPS breakevens fair value



Source: Credit Suisse

One downside risk to our outlook is further deceleration in the medical services component of CPI. Over the past year and a half, this category has faced downside pressure from mandated cuts to Medicare providers followed by slower inflation in private insurers' payments.

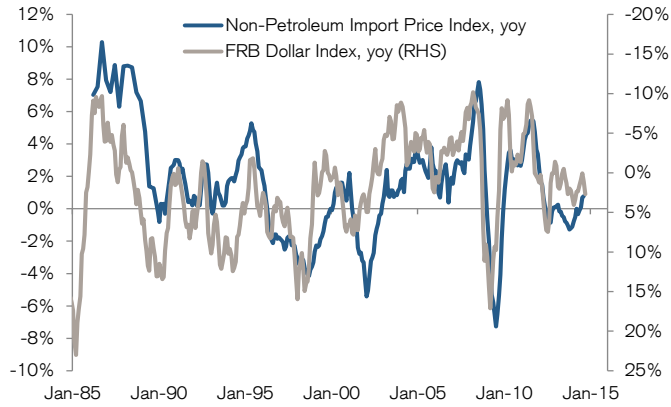
Little exchange rate pass-through into inflation

We expect the impact of dollar strength on inflation to be limited

One of the recent themes in the US rates market has been the speculation that US dollar strength could put downward pressure on inflation. Our analysis suggests that the impact of dollar strength on inflation is quite limited.

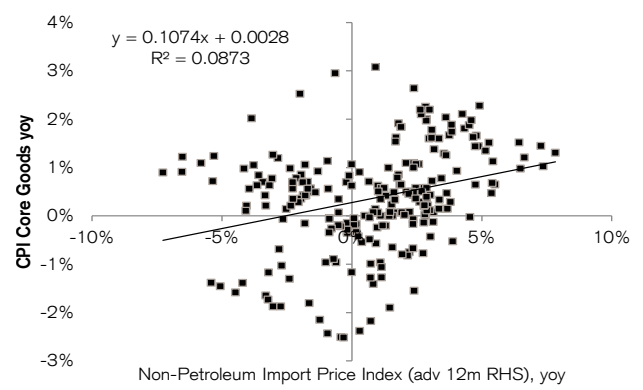
As discussed in a [previous publication](#), the current appreciation of the dollar in trade-weighted terms (3% year over year) should translate into a decline of only 0.02pp to headline inflation one year ahead via lower import prices.

Exhibit 147: US dollar strength matters for non-petroleum import prices ...



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 148: But import prices do not have a strong pass-through into core goods inflation in the US



Source: Credit Suisse

European Rates

Walking the line

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2015 Core Views

- Our core scenario is for muddling through: The ECB tries to tread the fine line of doing just enough; hurdles to sovereign QE remain higher than the market is pricing.
- In this environment, growth remains low, inflation is positive, and Bunds trade in a range. Tactical trades dominate.
- Political risks and ECB QE uncertainty are likely to increase peripheral volatility.

2015 Thematic Trade Ideas

- We recommend being long 2y Spain.
- We like EUR 10s30s flatteners.
- We favor 3y2y EURUSD FX basis swap wideners.
- We suggest being short 10y UKT ASW.

The path to QE remains uncertain and likely choppy

Our core scenario for 2015 is for Europe to continue to muddle through, and we expect yields to remain range bound against a backdrop of low growth and low, but positive, inflation. We provide four main scenarios in Exhibit 150 below, outlining market implications for each before summarizing our core views.

The focus is likely to remain on the ECB in 2015, but [the hurdles to QE remain high](#). Although continued data weakness may ultimately force the ECB's hand, the path to that point is more uncertain and likely volatile than the market is pricing.

In our view, the ECB's preference is clearly to wait and watch the impact of current policy measures; hope the currency continues to weaken, helped by a stronger US economy; and put pressure behind the scenes on politicians to provide fiscal stimulus. Sovereign

purchases in the absence of determined and coordinated fiscal stimulus are unlikely, we believe, to have the necessary real-economy impact, but it seems that politicians have some way to go to reach this point.

Peripheral spreads are likely to be volatile

The political calendar (Exhibit 149) and ECB policy uncertainty make the periphery a key focal point in 2015, and we expect peripheral market performance to be a key driver for rates markets next year. A QE announcement following a period of renewed peripheral spread weakness would enable the ECB to have a greater market impact, which may speak for waiting. Depending on the cause of spread weakness, it could also, however, be a difficult time for the ECB to buy peripheral debt as we discuss in [The ECB's Balancing Act](#), raising the question of whether purchases should come with conditions attached.

If the ECB does do sovereign QE, this also opens up additional peripheral risk if the economic data do not improve as outlined in our scenarios: the risks of holding highly indebted peripheral sovereign bonds would jump considerably.

Exhibit 149: Political risks return in 2015

Date	Event
Jan-15	Opinion by the Advocate General at the European Court of Justice on the OMT case.
Q1 2015	Greek programme evolution and potential parliamentary elections.
May-15	Spanish regional elections.
May-15	Election in the United Kingdom.
Sept-15 to Oct-15	Election in Portugal.
Dec-15	Elections in Spain.

Source: Credit Suisse

Core scenario: Muddle through without deflation

- **Muddling through – range trading environment (45%):** Growth remains lackluster, but deflation is avoided. We expect Bund yields to range trade between 0.7% and 1.4%, with the upper end conditional on US yields rising. Front-end peripheral spreads should remain a more protected carry trade, but long-end dynamics will be driven by rising political risks, the election calendar, and structural reforms. No major reflationary policy favors grinding flattening in 10s30s. Front-end US-EUR spread divergence has room to continue.
- **Downside risks to growth without more ECB action – spread widening environment (10%):** The ECB remains focused on credit rather than quantitative easing despite further deterioration in the growth data. Bund yields can fall below 0.7%, ASW will widen, and peripheral spreads should be driven wider by the 2y-5y area. US-EUR spread convergence across the curve becomes a central theme in this scenario, with Europe dragging down US yields.
- **Downside risks to growth prompt ECB QE with questionable impact (30%):** The ECB pulls the trigger on sovereign QE, which prompts a rally in both core and peripheral markets on the announcement. But the longer-term outlook will depend on economic data – a failure of QE to be pro-cyclical could see Bund yields remaining very low and raise peripheral risks.
- **Positive growth shock (15%):** European growth improves faster than expected (either through ECB policy action or otherwise), stabilizing long-term inflation expectations. Core yields should rise, led by the 5y-10y sector. Peripheral spreads should be the main beneficiary, with spreads tightening across the curve. The US-EUR spread differential could narrow in time, as European rates play catch-up with the US.

Exhibit 150: Scenario analysis – trade the range but be prepared for positive shocks

Market implications	Central	Downside - no policy response	Downside - with ECB response	Upside
Core yields	No sharp repricing of yields Yields react to US outlook with low beta	Lower yields and flatter curve	Yields rally on announcement but questionable longer-term impact	Higher yields and core curves led by 10y
Periphery	Spreads grind tighter	Spreads widen led by 2-5y	Spreads tighten near term, but risks increase if data don't improve	Spreads tighten led by 10y
US-EUR 10y spreads	Divergence	No divergence	Divergence on announcement	Convergence in time led by Europe
Probability	45%	10%	30%	15%

Source: Credit Suisse

Current market pricing is in between our two most likely scenarios (combined probability of 75%), so there is a fair amount priced. The opportunity set is, therefore, skewed toward the two extreme scenarios of either outright deflation or a positive growth shock. We think that the market is more vulnerable to the latter scenario, hence with yields rising more than the forwards.

Market outlook

Core: Modestly bearish 10y duration. We expect yields to drift higher as US yields rise, and we forecast 1.35% for 10y Germany by end-2015, 20bp higher than the market forwards. Our base case is, therefore, for a small negative absolute return on a one-year horizon (excluding transaction costs and taxes).

The front end of the curve (out to 3y) should be anchored by ECB forward guidance and liquidity policy. We express this front-end view by [receiving EUR 2y1y versus the US](#).

EUR 10s30s are likely to flatten

Curve and curvature: We expect EUR 10s30s to flatten and 5s10s30s to cheapen. The long end of the EUR curve has remained steep due to (1) yield grab shifting to the 10y point, (2) regulatory drivers reducing demand for 30y paper, and (3) market positioning for ECB QE to be reflationary in the back end of the curve (further discussion [here](#)).

Given that we believe the market is too optimistic regarding sovereign QE and we expect renewed peripheral spread volatility, we expect the long end to flatten (Exhibit 151).

We view long-end flatteners as a long straddle position – working either in a sharp rally or a sharp sell-off given current market pricing. Exhibit 152 shows that EUR 5s10s30s is at extremely rich levels already, so if there is a deflation shock, the long end has to catch up with the rally in 10s, and hence 5s10s30s should move higher. Conversely, a positive growth shock should challenge the richness of the belly of the curve.

Trade: EUR 10s30s flatteners @ 77bp; target 60bp; stop 85bp

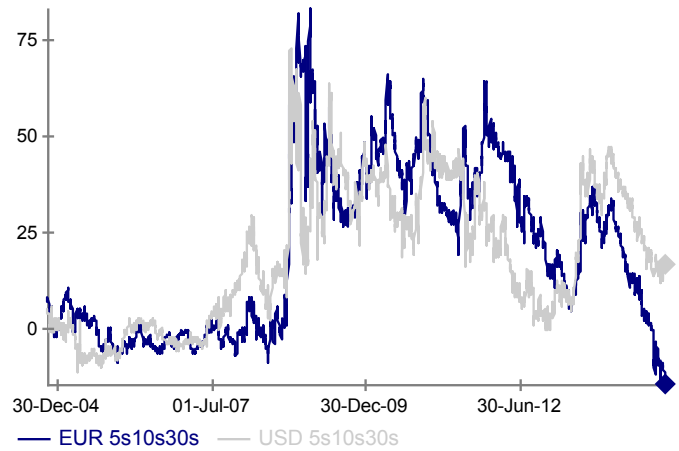
Risks include the ECB cutting the Deposit Rate even further into negative territory or the ECB starting QE faster than we expect, with purchases concentrated at the 10y point.

Exhibit 151: EUR 10s30s flatteners are a good hedge to peripheral spread widening



Source: Credit Suisse Locus

Exhibit 152: EUR 5s10s30s at extreme levels and out of line with global long-end flattening



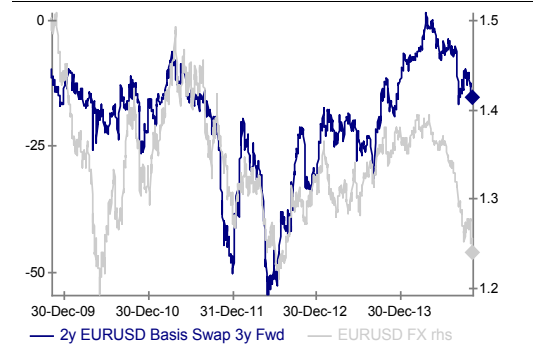
Source: Credit Suisse

We suggest playing ECB-Fed divergence through EURUSD x-ccy basis wideners

EURUSD: We suggest playing the euro as the new funding currency via FX basis wideners. We find the US-EUR divergence theme most compelling in 3y-5y spreads for 2015. We also expect the theme of the euro as the “new funding currency” to dominate next year. Our FX strategists forecast that EURUSD FX will reach 1.15 in 12 months.

We expect foreign corporates to exploit the low-yielding European environment to fund issuance, which is then likely to be swapped back into domestic currency (or into USD). We expect this focus on euro issuance to pressure the EURUSD FX basis swap wider.

Exhibit 153: EURUSD FX basis wideners are an alternative to €/€ FX shorts



Source: Credit Suisse Locus

2y-3y peripheral longs are attractive on risk-adjusted carry basis

Trade: receive EURUSD 3y2y basis @ -15bp; target -30bp; stop -5bp

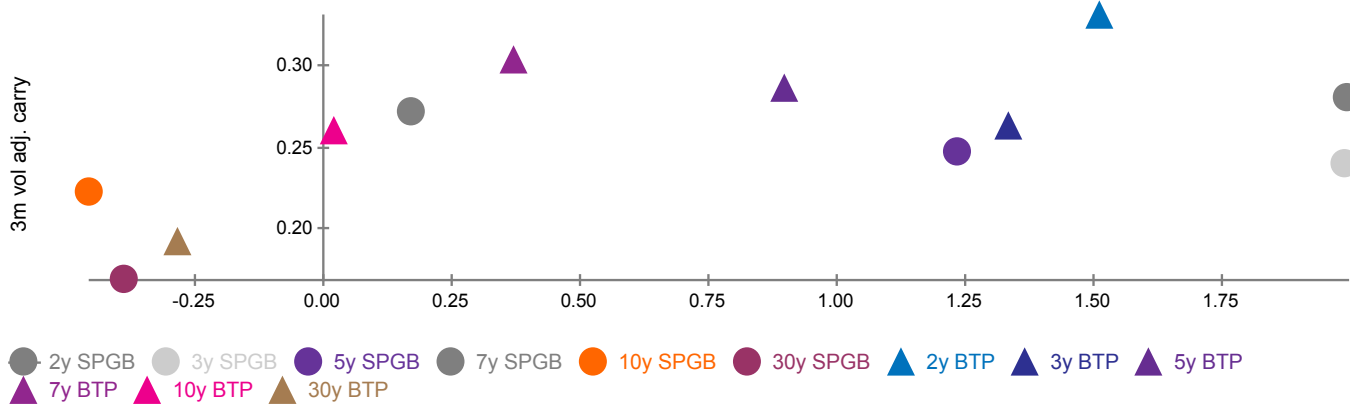
Peripheral spreads are likely to be more volatile in 2015. We believe that increased political risks and uncertainty about ECB policy will bring back peripheral market volatility after the calm of 2014.

The periphery front end should be the least sensitive to these risks, and given that we consider a return to 2012 levels of credit risk unlikely, we think that front-end carry trades in Italy and Spain continue to make sense from a risk-reward perspective.

2y Spain and Italy carry positively 7.7bp and 11.9bp, respectively, over the next three months. Exhibit 154 shows that 2y-3y bonds offer relatively attractive volatility-adjusted carry.

Exhibit 154: Periphery front end remains attractive, while the long end appears rich

x-axis 3m zscore, y-axis 3m vol adjusted carry



Source: Credit Suisse Locus

Given that we believe considerable uncertainty remains about the future path of ECB policy and positions in the belly are currently trading very binary to that, we are not advocating longs here – particularly because, as shown in Exhibit 154, risk-adjusted returns and entry levels are less attractive for the 5y+ sector than for shorter maturities.

The announcement of large-scale asset purchases should bull flatten the 2s5s and 2s10s curves, while political uncertainty, lower growth expectations, and no ECB QE should bear steepen these curves.

Trade: Buy 2y Spain @ 0.44%; target 0.15%; stop 0.6%

European inflation: we see room for further downside. [We expect](#) HICP 5y5y to remain below 2% unless our upside scenario materializes. In our core middle-through scenario, the risk premium in long-dated inflation swaps may become even more negative, pushing HICP 5y5y toward the 1.70%-1.80% range. We favor cash over swaps and expect the beta to nominals to be high. We like EUR 5s10s real rate steepeners as a cheap 2015 bearish hedge.

Money markets: We expect flatter curves in whites/reds. As discussed in [Atlas, 30 October 2014](#), we believe that forthcoming TLTROs are at risk of disappointing (the December operation and subsequent ones). With QE still uncertain, and existing purchase programs likely to take time to build up a sufficient buffer of liquidity, we see clear risks of liquidity tightening at the start of 2015 as a result of maturing 3y LTROs and volatile autonomous factors; we expect sufficient cash levels from 3Q 2015. We are, therefore, biased toward higher rates out to Jun-15 and suggest looking to receive further out (up until Sep-16 due to first TLTRO repayments).

UK Rates

Duration and curve view

We think that yields will move only gradually higher in 2015. A continuation of strong domestic data and higher Treasury yields should exert upward pressure on UK rates. However, the absence of a synchronized global recovery (notably weakness in the euro area), as well as the persistence of disinflationary pressure, is likely to temper any rise in yields. Furthermore, given increased political risk in the euro area in 2015, gilts may once again benefit from flight-to-quality flows.

GBP 2s5s are likely to steepen initially as “gradual and limited” are challenged

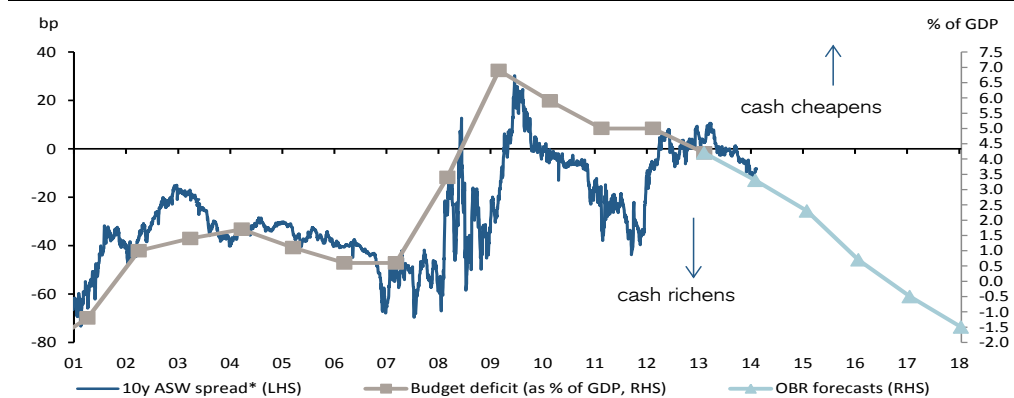
Given that the market is already pricing a high probability that the MPC will continue to provide a large amount of monetary accommodation in the years ahead, we look for 2s5s to initially steepen when rates rise, to reflect the risk that the tightening cycle might not be quite so “gradual and limited.” But as we get to within one quarter of the first hike, the curve should flatten and resume the historical trend that we saw in earlier hiking cycles.

Meanwhile, we expect 10s30s to bear flatten as yields rise. This is not only supported by ongoing structural demand for the long end but also by international trends, such as the prevalence of an unsynchronized global recovery, global disinflationary pressure, the continued grab for yield, and lower risk premia. On the curve, we look for 5s to underperform, as has typically been the case ahead of previous hiking cycles.

The main risks to our view are as follows:

- Wages/inflation don't pick up as we expect, or the MPC begins to adopt a more cautious stance on the outlook for the domestic economy. In this case, we think that 2s5s will flatten again as the market starts to question whether rate rises are even a story for 2015.
- If the ECB does sovereign QE, we would expect a knee-jerk sell-off in gilts, causing yields to rise above our forecasts. But ultimately what matters is if it will be effective; only if the data improves should we see a sustained rise in yields.

Exhibit 155: 10y ASW spreads should cheapen if fiscal position worsens



Source: Credit Suisse Locus, OBR

* Convention used is cash – swap

Bearish ASW spreads on fiscal and political risks

The upcoming UK general election in May 2015 provides ripe conditions for fiscal and political uncertainty to build, and hence we recommend being short 10y ASW spreads (see Exhibit 155). Given how tight the polls are, a coalition seems the most likely outcome at present, but there is a great deal of uncertainty about what the exact make-up of that will be. A Labour-led government is likely to imply looser fiscal policy. However, given that the “easy cuts” have arguably already been made, the Conservatives may also find it difficult to reduce the deficit further. In addition, a Conservative victory would raise “Brexit” fears, with current polls showing that opinion remains very divided (see [The ECB's Balancing Act](#) for details).

Securitized Products

A work in progress

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We generally maintain a positive outlook across the various securitized products, with spreads expected to stay range bound or tighten, to various degrees

The importance of supply and demand technicals is a common key theme across the various sub-sectors

2015 Core Views

- We generally maintain a positive outlook across the various securitized products, with spreads expected to stay range bound or tighten, to various degrees.
- Sector performance, as a function of forecasted changes in supply and demand technicals, is a common key theme across the sub-sectors, but unlike in prior years, there is some divergence in the outlook for the various markets.
- Fundamentals are neutral to positive across the various credit sectors.

We generally maintain a positive outlook across the various securitized products. We expect credit spreads to generally tighten, while Agency RMBS spreads should remain largely range bound.

Sector performance, as a function of forecasted changes in supply and demand technicals, is a common key theme across the various sub-sectors. Although this is often an important topic in our *Outlook* pieces, the dynamics usually tend to move in sync. However, in the coming year, we expect some interesting divergences. In addition to the technical factors, fundamental performance and its impact on legacy credit problems, the prospect of a rise in US interest rates, and, of course, potential regulatory changes are persistent and common topics across the various securitized products sectors.

From a pure size perspective, the biggest supply and demand changes are occurring in the Agency market, with the Fed recently ending its mortgage purchase program. Nonetheless, we expect the Fed to remain a significant force in the MBS market, through reinvestments, which we expect it to continue to make throughout the forthcoming year, before tapering these reinvestments in 2016. We believe that MBS spreads will remain range bound for much of the year, but this could lead to a series of tactical trades over the coming months.

Just as the Fed is pulling back, the ECB is getting ready to ramp up its ABS purchases. We estimate that it could add €50 billion to €75 billion over the next two years, leading not only to further spread tightening but also to increased supply and an expansion of the investor base, with the tighter spreads likely to push investors further down the capital stack as well as into other European securitized product sectors.

We see the potential for large increases in gross supply in both non-agency RMBS and CMBS next year, but net supply is still likely to be negative, a benefit for both sectors. We expect RMBS fundamentals to remain somewhat static in the near term but are more optimistic over the medium term. For commercial properties, we expect continued performance improvement, as the economy remains a lagged demand driver and the financing markets stay accommodating. Both sectors are also expected to continue to address the remaining legacy credit issues, as well as additional issues as maturities ramp up in CMBS and as IO recasts surge on the RMBS side.

Further progress has been made on the regulatory front, but more work clearly needs to be done. Although items such as QM, risk retention, and the Liquidity Coverage Ratio (LCR) rules have been attended to (a positive), the market's attention will turn to implementation, which also creates some level of uncertainty. Additionally, a few other regulatory changes are yet to be resolved and finalized.

Agency MBS

Continuity for now, potential break later

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MBS basis is likely to remain a series of tactical trades rather than a structural trade in 2015, with potential for higher vol in the second half as the end of Fed reinvestments draws closer

Net demand should exceed supply by roughly \$50 billion

2015 Core Views

- (Declining) vol is supportive for now; tight valuations are likely to cost later.
- Higher-coupon and IO carry trades should continue to benefit on receding prepays.
- Net/gross issuance is \$93 billion/\$915 billion. Banks' and money managers' demand should comfortably absorb net supply.

MBS basis outlook

We expect the MBS basis to remain a series of tactical trades rather than a structural trade for 2015. Range-bound rates, declining vol, and reasonably attractive carry should be a positive near term, with the potential for occasional mean-reversion tactical short opportunities.

The nominal basis to 10y swaps should trade in the low 50s to about 60bp range, and the current coupon OAS should range in the low to high teens, in our view. Current valuations are in the middle of these ranges, making us neutral to marginally positive on the sector.

In the base case, we expect the Fed to end/taper reinvestments in early 2016. This is likely to cause some volatility in the basis performance in 2H 2015 as a result of market anticipation.

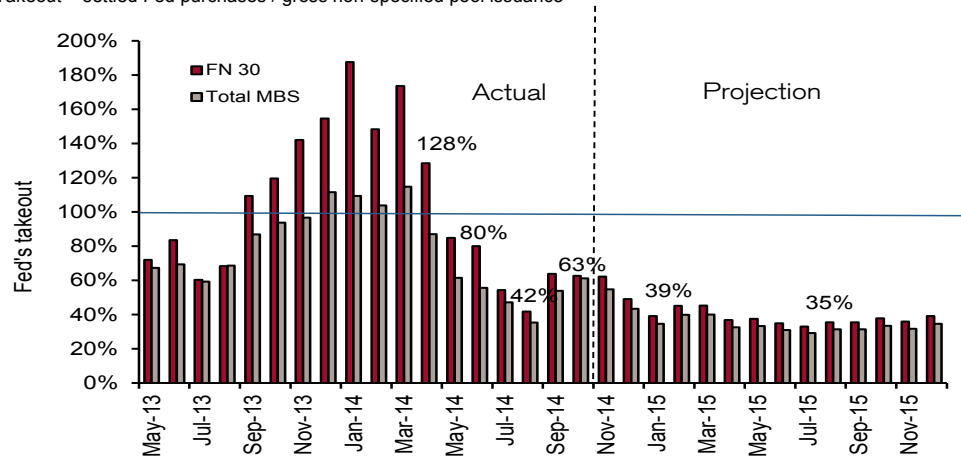
Supply/demand

We project net and gross issuance of \$93 billion and \$915 billion in a base scenario averaging a 4.25% mortgage rate in 2015.

We expect the full amount of the Fed's MBS paydowns to be reinvested through 2015, followed by a tapering in 2016. We estimate that the Fed's gross MBS purchases will total roughly \$210 billion in 2015, with net purchases amounting to \$6 billion. These gross and net purchase amounts are roughly 50% and 3%, respectively, of the 2014 amounts. Despite this reduction, the Fed's presence in the mortgage market is likely to remain significant, given that its MBS reinvestment should account for roughly one-third of non-specified pool gross issuance (which is roughly half the 2014 average) under our base case (Exhibit 156).

Exhibit 156: Fed takeout should range between 35%-40% and 30%-35% of non-specified FN 30 and overall pool issuance in 2015

Takeout = settled Fed purchases / gross non-specified pool issuance



Source: Credit Suisse

Overall, we expect net demand to exceed supply by roughly \$50 billion next year based on bank demand of \$40 billion and money manager short covering of roughly \$75 billion (Exhibit 157). This should more than absorb the \$93 billion in organic net issuance. We expect that the other institutional participants will be relatively modest in their impact (\$15 billion supply from GSE portfolios, \$10 billion in foreign investor demand, and \$2 billion in REIT demand). We note that the money manager demand should be back end-loaded and materialize only after spreads widen somewhat. That said, this short covering could occur for relatively modest spread changes, perhaps in the context of 10bp of spread widening.

Exhibit 157: Net supply/demand outlook for 2015

Institution	Demand (\$B)
Organic supply (net issuance)	-93
GSEs	-15
Fed	6
Banks	40
Money managers	75
Foreign investors	10
REITs	25
Excess demand	48

Source: Credit Suisse

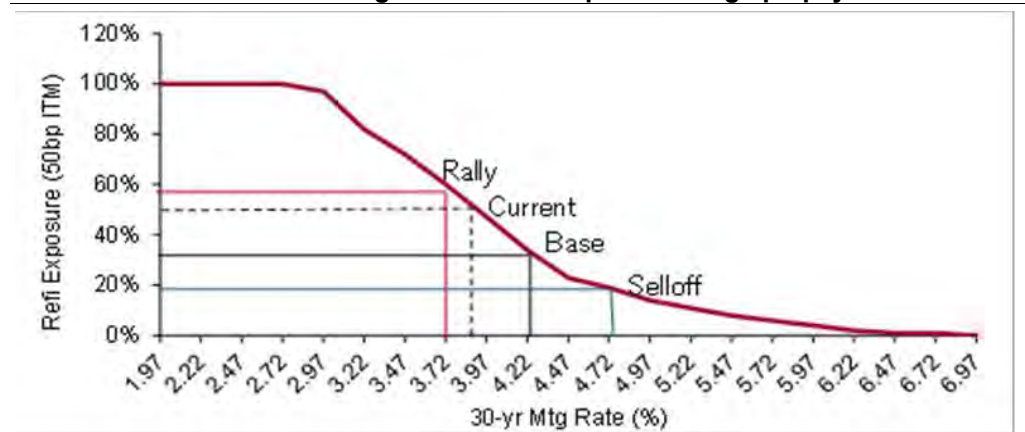
We project a benign prepayment and convexity outlook for 2015

Prepayment and convexity outlook

Prepayments should be mostly benign in 2015, barring a sharp rates rally potentially driven by worsening global weakness and a bleed-through to the US. In our base case of a 4.25% mortgage rate, roughly 33% of MBS are refinancable (50+bp in the money), which corresponds to relatively muted refi activity (Exhibit 158). A sell-off to 4.75% would lower the refinancable population to 18% and further choke off refis. On the other hand, refinancability rises to 60% at a 3.75% mortgage rate, which should result in a meaningful refi pick-up in 2013 and 2014 vintage 30-year 3.5s and 4s. These cohorts are very negatively convex given their loan balances, clean to pristine credit profile, and limited prior refi opportunities. That said, convexity hedging should remain fairly contained given modest absolute speeds, limited GSE hedging, and an increase in non-bank servicers who do not actively hedge their MSRs. Hedging flows should remain approximately \$5 billion of 10y equivalents per 5bp rate move in either direction for most of the anticipated mortgage rate range next year.

Prepay risk in high coupons is very muted. Under our base case, we expect a moderate speed slowdown of 3-4 CPR from current levels in these coupons. Furthermore, some convergence in speeds between core HARP cohorts (2006-2008) and seasoned (2003-2005) vintages is likely. A persistent rally in primary mortgage rates would be likely to counteract burnout in core-HARP cohorts and slow the speed convergence rate between older and newer vintages. We discount any potential prepayment impact from FHFA's HARP outreach efforts. Early data from target cities corroborate our view.

Exhibit 158: The base case mtg rate for 2015 implies a benign prepayment outlook



Source: Credit Suisse

Non-Agency MBS

A work in progress

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2015 Core Views

- We remain positive on legacy RMBS heading into 2015. While the fundamental picture seems somewhat static in the near term, we believe that negative net issuance and medium-term improvements can drive spreads slightly tighter from these levels.
- The biggest risks posed to RMBS in 2015 would be limited improvement in fundamental performance (and a subsequent turn in market sentiment).
- We project \$15 billion from new issue Jumbo collateral, as well as \$15 billion in CRT transactions.

Legacy RMBS outlook

We are positive on legacy RMBS as negative net issuance and medium-term improvements drive spreads tighter

We remain positive on legacy RMBS heading into 2015. Although the fundamental picture seems somewhat static in the near term, we believe that negative net issuance and medium-term improvements can drive spreads slightly tighter from these levels. We expect the credit curve to remain relatively flat, with more leveraged positions remaining in demand. We prefer Alt-A ARMs and POA Dupers, given their carry and potential fundamental upside. In addition, we are positive on GSE credit risk-sharing last cash flows versus legacy RMBS.

We believe that loss severities will remain stable across all sectors, even as home prices continue to rise. This is mostly due to the rising concentration of highly delinquent loans populated in judicial states. We expect the increased variable costs associated with the extended liquidation timelines for these loans to continue to offset severity benefits from declining LTVs across all sectors.

The concentration of these adversely selected, highly delinquent judicial loans in the pipeline will continue to increase, as we have seen in recent years. We believe that modifications will also contribute to elevated timelines in the short to medium term, as the vast majority of modifications are performed on loans less than two years delinquent. These factors are likely to hold severities at their elevated levels, in our view.

Modification rates to remain steady at 1.0%-1.5%, with recently delinquent, high-LTV loans the most likely to be modified, in our view

Over the past several years, modification rates have held steady with 1.0%-1.5% of delinquent loans modified each month. We expect these levels to persist through 2015, partially owing to elevating levels of remodifications of previously modified loans. Recently delinquent, high-LTV loans will be the most likely to be modified, in our opinion. We also believe that modification performance will remain consistent, with some improvement counterbalanced by a higher share of remodifications. Although modifications will lower severities in the long term, they are likely to contribute to elevated levels in the near term.

The last of the IO recasts begin en masse in 2015, with just over \$100 billion in loans recasting from 2015 to early 2018. About \$20 billion is Alt-A current loans that are due to recast sometime in 2015, with another \$20 billion following in 2016. We believe that the recast experience of 2010-2012 can provide some insight into IO performance, with one large caveat: many of these borrowers have much lower LTVs than their predecessors. We find that LTV is a critical driver of recast performance; lower-LTV borrowers are much more likely to prepay and much less likely to roll delinquent.

Alt-A/POA and Subprime CDRs have been stable in 2014, and we expect them to remain consistent in the near term. On the one hand, declining short sales will be a headwind for CDRs. On the other hand, the rising proportion of delinquent loans concentrated in judicial states and increasing foreclosure to REO roll rates will support CDRs. We believe that the effects from these drivers will continue offsetting one another in 2015.

Prepayments in Prime Fixed and Alt-A Fixed collateral have slowed in 2014 by nearly 20%, even as LTVs continue to improve. However, prepayment speeds, controlling for LTV and rate incentive, are relatively in line with the 2011-2012 experience. We believe that a non-traditional media effect, with all-time lows in mortgage rates followed by quickly rising rates, caused a spike in prepayments across most sectors. Prime ARM post-reset speeds, in our view, validate this. However, credit prepaes present a different story, particularly Alt-A post-reset ARMs. While less credit-impaired sectors have seen declines in prepayment speeds, Alt-A ARMs, Option ARMs, and Subprime speeds have held relatively firm. We believe that a slowly opening credit box, along with LTV improvements, will support prepayment speeds in these spaces.

Legal settlements are likely to remain a key theme in 2015

Legal settlements are likely to remain a key theme in 2015. ResCap became the first global settlement to make a payment in 2014, while JP Morgan and Citi announced global settlements that are in various stages of progress. In addition, the CW settlement approval hearings continue to move forward. Another major development has been the number of individual deal settlements, with 2014 seeing more than a handful of such payments made.

We forecast \$15 billion in new jumbo issuance in 2015

New issuance of private-label Prime jumbo is about \$8 billion and on pace to finish between \$9 billion and \$10 billion for the year. We believe that the solidification of the Qualified Mortgage (and subsequent matching of Qualified Residential Mortgage) and risk-retention rules will bring some additional securitization activity but that banks will remain a strong bid for loans given the steepness of the curve. We believe that 2015 will see \$15 billion in new jumbo issuance. 2015 might also bring the first wholly non-QM transaction as originators ramp up their production.

Agency CRT issuance to date has exceeded \$10 billion. Of that, \$4.8 billion has been IG rated, with \$1 billion A-rated and the remainder BBB. To date, the agencies have sold credit protection on \$400 billion in collateral, or roughly 8%-10% of their current book of business. We project \$15 billion in issuance next year, with perhaps new structures (such as a true senior-subordinate structure) in store.

CMBS

Return to normalcy

2015 Core Views

- Our forecasted improvement in the underlying property markets is, by extension, overall very positive for the CMBS market.
- Rising rates may pose some challenges for prices to rally, but financing, and improving fundamentals more than counterbalance them.
- Increasing CMBS maturities should not pose a large credit problem but will accelerate the paydowns in the legacy universe and the shift in focus toward recently issued bonds.

We consider it likely that the commercial real estate markets will continue to improve in the coming year, extending the recovery into its fifth year. The ongoing improvement of the underlying property markets is also, by extension, overall very positive for the CMBS market, and we maintain a constructive outlook for this sector.

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The performance of commercial real estate, over the past few years, has largely mirrored what has occurred across the broader US economy

The performance of commercial real estate, over the past few years, has largely mirrored what has occurred across the broader US economy. Improvement in the economic landscape, including steady job growth, has increased the demand for space; occupancy and rental rates have gradually risen and, along with it, so too have property level cash flows.

Our economists note that there is a range of evidence that points to a stronger underlying trend in the US expansion. Their base-case forecast, as laid out in more detail above, is that GDP growth is better than potential and that the labor market recovery appears to be on a sustainable trend. They also note that the underlying path has been remarkably steady and that the US economy has proven insensitive to global shocks, and they see little on the horizon that could change that. Furthermore, the risks appear to be broadly balanced, with the biggest concern being growth in Europe and China.

An improving economy has once again raised the specter of higher rates. We discussed the challenge of rising interest rates for the commercial real estate market in last year's outlook. Higher rates may not only affect commercial real estate price performance (through higher cap rates and borrowing costs) but could also affect the supply, demand, and credit performance of CMBS.

Although there are challenges for CMBS in a higher-rate environment, there are also mitigating factors that serve to counterbalance them

We believe that our general conclusions, about the impact of rising rates, from a year ago still hold. Although there are challenges for CMBS in a higher rate environment, there are also mitigating factors that serve to counterbalance them. We argue that the commercial real estate and financing markets are even better positioned today to handle rising rates than they were just a year ago.

While cap rates may increase in a rising rate environment, we believe that they lag interest rate moves and will not rise one-for-one with Treasury yields. In addition, some of the forecasted increase will be partially, if not fully, offset by further improvements in property-level fundamentals and cash flows that accompany a well-performing economy.

As a result, we believe that commercial real estate prices will be able to extend their multi-year rally, and we project that they may rise in the low to mid-single digits over the course of 2015. One popular index shows that prices are back to their all-time high, set in late 2007, while others show them already well above the prior peak. The major property markets have led the way, so far, but we believe that the leadership is starting to change. Secondary markets seem poised to outperform the major markets in the coming year. The third-tier markets have also lagged in the recovery, and we believe that they will continue to do so as capital gravitates toward the next layer of geographic regions where the economic recovery will take hold.

Although the improving economy has helped, other factors have also been large contributors to the retracement in real estate prices over the past five years.

We are strong believers that the availability of CRE financing plays a large role in commercial real estate price performance. We view the expansion of credit, over the past few years, as a large contributor to the sector's strong performance. We believe that lending availability will continue to increase in 2015 as both the demand and the supply for funds escalates. The improvement has been broad based, across lending platforms, including banks, insurance companies, and securitized lenders. The recent exception is the GSEs, which lend on multifamily properties. They have curtailed their lending to some degree, but the growth of the other providers has more than made up for it.

For CMBS, the private-label market should continue to expand in 2015, and we believe that issuance could reach \$135 billion to \$140 billion across all deal types

For CMBS, the private-label market should continue to expand in 2015, and we believe issuance could reach \$135 billion to \$140 billion across all deal types (relative to an estimated \$95 billion to \$100 billion in 2014). Agency CMBS could add an additional \$60 billion or so (versus our current estimate of \$56 billion for 2014).

Our forecasted increase in CMBS issuance is largely demand-driven and emanates from two specific trends we see remaining in place. The first is the large growth in real estate transaction volume. Year to date, we have seen transactions increase nearly 20%, versus the same period in 2013. The relative value offered by US commercial real estate has attracted both domestic and international buyers. The non-US buyers are likely drawn to the market by the relatively high yields, a condition that appears likely to stay in place over the coming year.

Demand for financing is also likely to rise from the increase in maturing loans expected in 2015 (and continuing over the next two years as well). Financing needs are likely to go up in general but specifically for current CMBS loans, which should also help to boost volume. While there is a large focus on 2015 maturities, we believe that there could be a pull-forward effect as borrowers, with maturities in 2016 and 2017, seek to lock in longer-term financing at today's relatively low mortgage rates before the anticipated increase.

We do not expect the large set of maturing loans to pose a significant credit problem for CMBS in 2015

We do not expect the large set of maturing loans to pose a significant credit problem for CMBS in 2015, despite market-wide concerns. If the financing markets stay robust, as we expect, we estimate that more than 85% of the upcoming maturities will be able to successfully pay off near, or before, their maturity date. This reflects a more sanguine view, than the consensus, about the effect of these impending maturities.

In addition, we believe that the trend toward a higher pace of defeasance and prepayments will remain in place. This has the dual effect of both increasing the demand for financing as well as lowering the future funding obligations implied by the 2015-2017 maturities. A move to a higher interest rate environment could have a small negative impact on the refinance success rate, but given the forecast for interest rates, we believe that this effect will be contained.

A rise in commercial real estate prices and improving fundamentals have led to an improvement in the legacy CMBS credit picture

A rise in commercial real estate prices and improving fundamentals have led to an improvement in the legacy CMBS credit picture. That said, a significant amount of legacy problem loans is yet to be resolved. Given the progress made on the delinquent loan bucket, and the reduced pace of new problems, we expect a slight decline in liquidations in 2015, relative to the past two years. However, although the dollar volume may decline, slightly, the pace will remain steady, or rise, as a percentage of the outstanding legacy balance.

The declining balance of the legacy CMBS universe will be an important area of focus in 2015 for several reasons. First, although it is no surprise that the size of the legacy universe is shrinking, we believe that the pace of the decline should accelerate over the next year, given our expectations for loan maturities, prepayments, and liquidations.

This "denominator effect" could affect the headline credit statistics, creating more volatility and potentially cause misleading interpretations of trends. If the pace of loan paydowns is faster than the resolution of problem loans, which is a distinct possibility, the delinquency rate will rise even if there are no new credit problems. The smaller the outstanding legacy balance becomes, the bigger this effect.

As the legacy market continues to shrink, participant focus will continue to shift away from that sector and toward more recently issued bonds

Second, as the legacy market continues to shrink, participant focus will continue to shift away from that sector and toward more recently issued bonds (2011 and on). We have already seen this start to occur in some sectors, such as synthetic CMBS (CMBX), but the trend is likely to become more pronounced in the cash market over the coming year.

Last, we believe that accelerating paydowns will be an influential factor in determining net CMBS supply over the coming year. While we are looking for fairly robust private-label issuance, we believe that the paydowns and liquidations could largely neutralize this and that net issuance will be fairly close to flat in 2015. Many CMBS investors are likely to redeploy the proceeds from their paydowns back into the CMBS market. This, plus the expectation of new investment dollars flowing to the sector, is a very positive technical factor for the marketplace, in our view.

We also believe that the overall market, both the legacy and recently issued sector, is likely to become subject to additional tiering. On the legacy side, this process has been unfolding slowly over the past few years as loans have been resolved. The increased pace of resolutions brings greater clarity to investors' loss forecast at the bond, deal, cohort, and sector levels. As more clarity on losses on these problem loans is achieved, less weight should be placed on negative tail risk scenarios across deals, cohorts, and the legacy sector as whole. This is a positive dynamic for spreads at the top part of the capital stack and, perhaps, some of the more cuspy bonds.

We also believe that the overall market, both the legacy and recently issued sector, is likely to become subject to additional tiering

On the recently issued side, we are firm believers that the credit underwriting has deteriorated over the past few years and is likely to continue to do so, as the competition to originate remains strong. The risks of more highly leveraged loans is masked, to some degree, by both the lack of seasoning (the more risky loans were recently underwritten and generally take some time to default) as well as rising prices and real estate fundamentals. Nevertheless, as time moves on, we believe that there will be defaults in the more recent deals and that credit-quality differentials will likely emerge both between various deals as well as based on issuance timing.

Given our expectations for ongoing improvement in the underlying collateral, as well as the sector's relative value, we believe that parts of the CMBS market offer opportunity, and we expect the sector to continue to perform well in 2015. The risks to our outlook largely mirror those of the past several years. Jumps in global market volatility have been a major source for CMBS spread widening in recent years. However, we argue that the sensitivity to these, the beta for the sector, has been reduced. A rapid rate rise that is not accompanied by a commensurate improvement in the economy is also a risk, but we believe that the probability of this is somewhat remote. We also believe that regulatory changes, such as the implementation of risk-retention rules in a couple of years, or the risk that the terrorism insurance backstop (TRIA) is not renewed present potential obstacles and uncertainties that bear monitoring.

European SP

Come on, ECB, light my fire

2015 Core Views

- ECB purchases are a game-changer for the European ABS markets.
- Spreads are likely to tighten further, with 8y Spanish RMBS reaching 40bp.
- We expect €115 billion in placed issuance, a ~55% increase from 2014.

The prospect of imminent ECB action has changed the outlook for the European ABS markets, with implications for investor participation and risk appetite, spread performance, and issuance.

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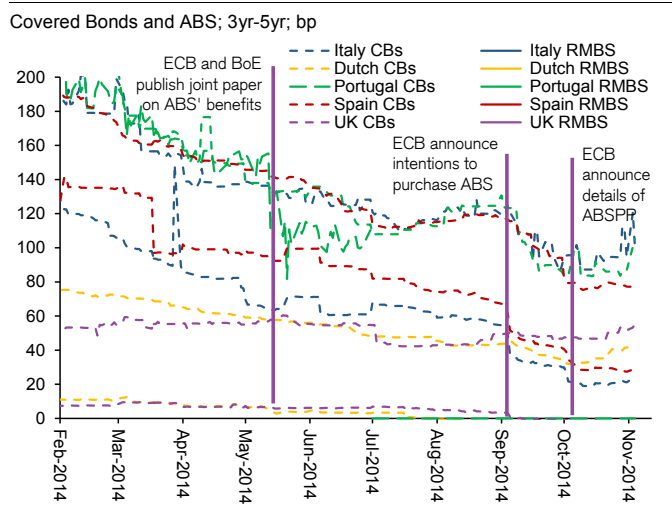
Despite being long-rumored, the ECB's announcement of planned ABS purchases came more suddenly than expected on 4 September, resulting in up to 50bp of spread tightening for 7yr+ peripheral RMBS paper (Exhibit 159). ECB-eligible paper now trades at 15bp to 50bp through non-eligible depending on jurisdiction, a dynamic we expect to continue.

ECB purchases are due to start within the next couple of weeks. We estimate that of a total European ABS universe of €860 billion, circa €570 billion is eligible, although as we outlined in [ECB ABS purchases: Not about size](#), a large proportion of this is retained.

Spreads are set to rally further once ECB purchases start

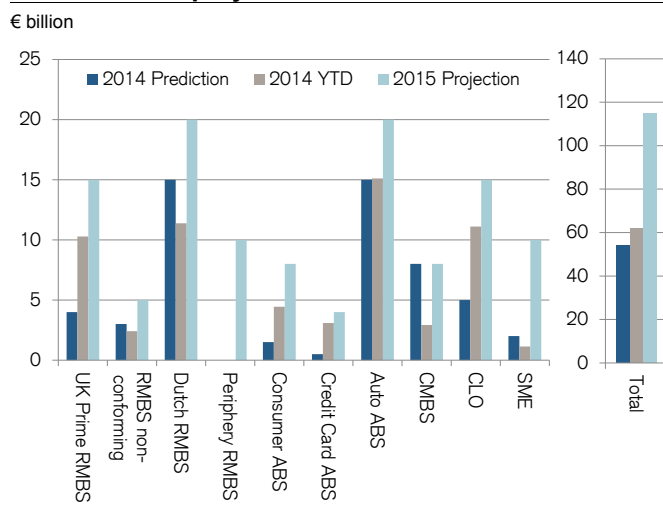
We believe that the ECB will be a price taker, seeking to establish a market-clearing price that doesn't overly crowd out investors. That said, we expect spreads to take a further, meaningful leg tighter once purchases start. We believe that Spanish 8yr RMBS can reach 40bp should the ECB's purchases prove consistent and sustained. Ensuring that purchases are structured in this way, we believe, is key to keeping volatility low – an important factor for attracting greater investor involvement in the asset class.

Exhibit 159: Spread evolution since ECB announcements



Source: Credit Suisse, Markit

Exhibit 160: European securitized products placed new issuance projections



Source: Credit Suisse, IFR, Informa GM

ECB purchases are likely to total €50 billion to €75 billion over two years

The aim of the ECB's involvement, in our view, is to revitalize the ABS market to stimulate credit provision to SMEs, particularly in the periphery. Purchase sizes do not, therefore, need to be large; we estimate that the ECB can buy €25 billion to €50 billion over two years based on expected primary and secondary market activity. The large unknown is the amount of inventory and retained the ECB may be able to source. While banks do not seem inclined to reissue retained, a few large blocks could quickly increase overall purchase amounts. In total, therefore, we estimate €50 billion to €75 billion in purchases over the two years.

We expect placed new issuance of €115 billion in 2015

As outlined in Exhibit 160, we project total placed new issuance of €115 billion in 2015, an increase of ~55% from the expected €75 billion to be issued this year. We expect consumer ABS, CLOs, and core RMBS to be the main drivers, with some SME and peripheral RMBS likely to be issued after an extended absence, although new origination is the obstacle for the latter. Again, the large uncertainty is the amount of retained reissuance – we expect some and expect the percentage of retained deals (66% so far year to date) to decline in 2015.

2015 should also see further clarity on the regulatory environment, which should be an added positive, encouraging greater investor involvement; uncertainty about the likely outcome of key regulations (the LCR, Solvency II, Basel risk weights, etc.) has made it hard for investors to properly assess the asset class. We expect regulations to continue to moderate slightly in favor of ABS, although not sufficiently to present a level playing field vis-à-vis covered bonds or underlying loans.

Greater investor involvement and investor rotation are likely if the ECB's purchase plan is well structured

Finally, we expect the ECB's participation to expand the active investor base, particularly if volatility remains contained. As spreads compress, investors are also likely to be forced further down the capital structure and into other assets, such as CLOs and CMBS. If properly structured, the ECB's purchases should, therefore, result in deeper markets and strong performance across the majority of European SP in 2015, not just eligible paper. As this occurs, we expect the involvement of non-bank issuers in the market to increase.

As discussed in the [European rates section](#), a risk to our constructive ABS market view would be peripheral sovereign-driven risk off, leading to spread widening across multiple asset classes.

Global Demographics and Pensions

A demographic view of macro-policy ineffectiveness

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2015 Core Views

- Not paying proper attention to historically unprecedented demographic changes is affecting both fiscal and monetary policy effectiveness. Understanding changing ageing and consumption/savings patterns as well as asking “what is optimal fiscal policy” requires better understanding of demographics.
- In our view, monetary policy is also ineffective in an ageing world, and voting patterns of the old have effects on inflation and distribution. The older populations borrow less and have less need for credit than poor populations. We think that monetary policy makers ought to actively and effectively monitor personal income and wealth distributions as well as asset prices.

Recent policy ineffectiveness is partly due to ignorance about demographic heterogeneity

Assessing macro policy ineffectiveness in the face of changing demographics

We argue that policy ineffectiveness post 2008 is partly due to ignorance about demographic heterogeneity across consumers and workers. We document how different changing demographics (ageing as well as behavior) negate the impact of recent policy. We review some recent progress in monetary and fiscal models, suggesting that even more needs to be done to incorporate endogenous behavioral responses. Our thesis is in line with behavioral economics and finance as well as experimental economics. Workers produce the aggregate GDP, whereas consumers consume the bulk of the GDP. **Consumer sentiment and worker psychology are important and not exogenous.** George Akerlof and Robert Shiller (2009) in *Animal Spirits* state that human psychology drives the economy and explain why it matters for capitalism.

Policy needs to change along with consumers and workers across business cycles and economies

Historically unprecedented demographic changes

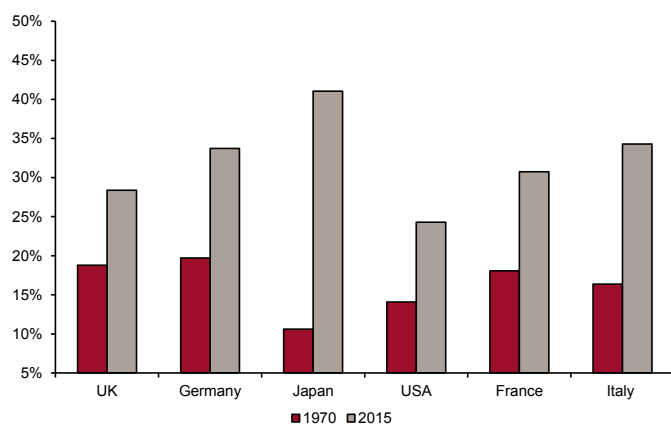
Unprecedented changes have occurred in the median age and population shares of the 60+ and 80+ age groups.

- The increased **median age** in 2015 (projected) versus 1970 illustrates this for the G6: the UK (34.2 to 40.5 years), Germany (34.1 to 46.3 years), Japan (28.8 to 46.5 years), the US (28.2 to 37.7 years), France (32.5 to 41 years), and Italy (33 to 45 years). In Japan, the US, and the UK, the median age has increased by 61.4%, 33.39%, and 18.48%, respectively. In the past, increases of this magnitude in median age took 200-300 years to achieve. **Individuals are living longer, but more importantly, their life-cycles⁹ have changed as consumers and workers.** In previous research,¹⁰ we showed how consumers and workers have varied in behavior across different economies and over different business cycles, arguing the need for differential policy responses over the business cycle and across economies.
- In Exhibits 161 and 162, we highlight the change in **population shares of the 60+ and 80+ age groups**. The share of the 60+ age group increased (over 1970-2015) in Japan, Italy, and the US by 287%, 109%, and 73%, respectively; the share of the 80+ age group increased (over 1970-2015) in Japan, the UK, and the US by 771%, 116%, and 103%, respectively.

⁹ Credit Suisse Demographics Research report, [Longer lives, changing life cycles: exploring consumer and worker implications](#) (July 2011)

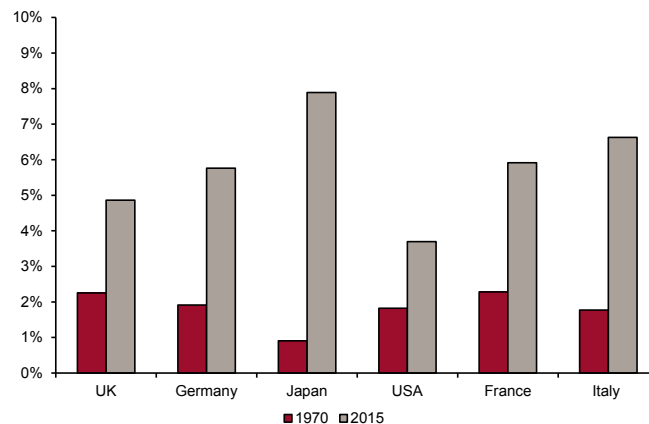
¹⁰ Credit Suisse Demographics Research, [Demographic dynamics over business cycles and crises: What matters is how different](#) (21 June 2013)

Exhibit 161: Share of 60+ years old in 1970 and 2015



Source: Credit Suisse, UN

Exhibit 162: Share of 80+ years old in 1970 and 2015



Source: Credit Suisse, UN

- **Generational changes**, with multiple generations of retirees and four to five generations co-existing, are historically unprecedented. This exacerbates fiscal pressures, and non-recognition of this by policy makers has led to the negation of intended policy effects.

Fiscal policy can be constrained by expenditures on pensions, healthcare, and long-term care

This changing age structure has implications for GDP growth as it affects working-age population growth, labor productivity growth, and labor utilization growth.¹¹ Fiscal policy is also very constrained by expenditures on account of pensions, healthcare, and long-term care (nearly 20% of GDP in EU28). High debt burdens in the absence of good GDP growth lead to fiscal unsustainability. We also showed¹² how increased **income inequality and youth unemployment** threaten social stability.

Exhibit 163: Changing age-specific consumer expenditure shares, 2005 and 2013

	Japan		USA		Germany		UK	
	2005	2013	2005	2013	2005	2013	2005	2013
Under 20	0.5%	0.4%	0.2%	0.2%	0.3%	0.3%	0.2%	0.2%
20-29	8.1%	6.3%	9.2%	8.7%	10.9%	9.9%	9.4%	11.0%
30-39	16.6%	14.8%	19.1%	17.3%	15.3%	11.5%	24.4%	20.7%
40-49	18.4%	20.1%	23.6%	19.7%	19.8%	18.7%	24.6%	25.3%
50-59	22.9%	18.1%	20.5%	21.7%	19.9%	23.4%	20.3%	19.7%
60+	33.5%	40.3%	27.4%	32.5%	33.9%	36.2%	21.1%	23.1%

Source: Credit Suisse, Euromonitor

Exhibit 163 displays the changing consumer expenditure patterns by age, showing that there has been a dramatic shift in consumption shares of the older age groups. This contradicts the common perception that the old do not spend. The old are wealthier than most economists and policy makers expected them to be and are spending differently from expectations as well.

Exhibit 164 displays gender and age-specific activity rates over time, with 1983-2013 showing that female labor force activity rates have increased but still exhibit a large gap to males, especially at older ages. There has been a marked decrease in economic activity rates for lower age groups, reflecting youth unemployment and increased skills requirements for the young.

¹¹ Credit Suisse Demographics Research (2009), [A demographic perspective of economic growth](#)

¹² Credit Suisse Research 2014 *Global Outlook* (19 November 2013) – [Youth unemployment and income inequality](#), p 23-26

Exhibit 164: Changing economic activity rates by age and gender, 1983 and 2013

Percentage

Age group	Germany				United Kingdom				United States			
	1983		2013		1983		2013		1983		2013	
	Female	Male	Female	Male	Female	Male	Female	Male	Female	Male	Female	Male
15-24	47.1	53.7	48.7	52.9	58.6	69.9	56.7	60.7	61.9	72.5	53.5	56.6
25-34	60.1	92	79.7	90.4	56.3	95.6	77.5	93.3	69	94.2	73.5	89.2
35-44	58.2	97.8	82.9	95	67	96.3	79.7	92.7	68.7	95.2	74	90.7
45-54	51.5	95.1	84	92.7	67.3	93.4	81.5	90.2	61.9	91.2	74.1	85.6
55-64	26.5	62.9	60.7	74.4	34.7	71.5	55.3	70.7	41.5	69.4	59.2	70
65+	2.7	6.6	3.6	7.7	3.3	8.3	7.1	13.1	7.8	17.4	14.9	23.5

Source: Credit Suisse, ILO

However, past research papers on the age structure have not **adequately considered** the changing behavior of different age groups, as shown in Exhibits 163 and 164.

Voting preferences of an aging population may contribute to lower inflation

Monetary policy in an ageing world needs to be very different, as older people respond differently to interest rate changes than younger people do.¹³ Also, the balance sheet-expanding unconventional monetary policy has been criticized as a not-so-good substitute for the lack of active fiscal policy. This raises issues about not just the zero lower bound for monetary policy to be effective but also the credibility of fiscal policy. **Voting power also matters for monetary policy effectiveness.** Bullard et al (2012) show that when the old have more influence on the redistributive policy, the economy has a relatively low steady-state level of capital and a relatively low rate of inflation. They suggest that aging population structures may contribute to observed low rates of inflation or even deflation.

Monetary policy: models, rules, and application

The Taylor rule in monetary policy specifies how much the central bank should change the nominal **interest rate** in response to changes in inflation, output, or other economic conditions. Advocates of this popular rule argued that not setting the policy rates as per the rule has kept rates much lower. They state that simple implementation of the Taylor rule¹⁴ would have kept rates higher and influenced the economy far more effectively since 2008. Woodford (2012) calls for the need to develop **robust approaches** to forecast-targeting procedures as an extension of Taylor’s research program. We think that there is a need for **modified Taylor rules incorporating greater complexity and demographics.**

Robustness of models is at the heart of dynamic macro-econometric modeling by Lars Hansen and Thomas Sargent.¹⁵ In their application of Risk Sensitive Optimal Control theory dealing with model misspecification (as an extension to the earlier rational expectations), they state that **model misspecification and how to deal with it** concern researchers, central bankers, and every macroeconomist. This approach develops further the theory of “bounded rationality in macroeconomics,”¹⁶ which aimed to explain dynamic transitions and equilibrium dynamics while also advancing modeling of consumers.

K. G. Nishimura and E. Takats (2012)¹⁷ considered the impact of **baby-boomer retirements in 22 countries** over 1950-2010. They argue that when baby-boomers joined the work force starting in the late 1960s and started saving, money supply and property prices rose. They find that **monetary stability contributes to long-run property-price stability.**

¹³ Patrick Imam (2012) and James Bullard et al (2012) attribute monetary policy ineffectiveness to ageing and voting patterns of the old and behavioral responses to central bank policy tools.

¹⁴ Koenig, Leeson, and Kahn (2012) in "The Taylor Rule and Transformation of Monetary Policy" present an assessment from different perspectives of the success and simplicity of Taylor rules pre-crisis and in inflation targeting EM countries.

¹⁵ Robustness (2008), by Lars P Hansen and Thomas J Sargent, Princeton University Press.

¹⁶ "Bounded Rationality in Macroeconomics (1993)," Thomas J Sargent, Clarendon Press.

¹⁷ BIS (2012), "Ageing, Property Prices and Money Demand"

M. Piazzesi and M. Schneider (2008) find that volatility of house prices is explained by the fact that some households are **confused about the difference between real and nominal interest rates**, while other households understand it. Disagreement about real interest rates also drives up house prices, as noted in Akerlof's and Shiller's *Animal Spirits*.

Why is fiscal policy inadequate?

In "Fiscal Policy after the Financial Crisis," A. Alesina and F. Giavazzi¹⁸ address some of the scientific evidence pertaining to counter-cyclical fiscal policy, public debt levels, and inter-generational debt transfers, highlighting that the effects of fiscal policy are heterogeneous across business cycles and also across countries.

In the latest **16th Geneva Report** on the world economy, Buttiglione, Lane, Reichlin, and Reinhart (2014) study debt dynamics and note that the world has not yet begun to deleverage and that **global debt to GDP is at an all-time high**. They argue that deleveraging and slower nominal growth are interacting in a vicious cycle, making deleveraging harder and exacerbating the global slowdown. They note that **cross-border dimensions of leverage** are important as they affect cross-border flows and asset prices.

In *New Dynamic Fiscal Policy* (2010), N.R. Kocherlakota¹⁹ provides a normative analysis of the level of taxes we should have. He considers optimal asset income taxes, optimal asset income tax system, optimal bequest taxes, and intergenerational transmission mechanisms. These incorporate individual agents with **differing degrees of heterogeneity and risk aversion**.

Conclusions

Policy needs to reflect demographic changes to be effective

Policy needs to track and actively monitor demographic changes (consumer and worker behavior) at aggregate and sub-aggregate levels to be effective. Modern dynamic monetary and fiscal policy is evolving slowly toward incorporating less-than-perfect rationality and decision making of consumers and workers but much more needs to be done.

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¹⁸ "Fiscal Policy after the Financial Crisis", edited by A Alesina and F Giavazzi (2013), University of Chicago Press

¹⁹ *New Dynamic Public Finance* (2010), N.R. Kocherlakota, Princeton University Press

Technical Analysis

Stronger for longer

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2015 Core Views

- The USD has achieved our first target, but we remain bullish.
- We expect 5s30s bond curves in Germany and the US to flatten.
- We are bearish gold.
- We are bullish China.

2015 Thematic Trade Ideas

- We recommend buying the USD on setbacks. We remain bullish USDCAD for our 1.1666/1.1766 target.
- We suggest looking to establish 5s30s German and US flatteners.
- We recommend staying short gold for our \$1000 target.

Our first USD bull target has been achieved, and consolidation is expected

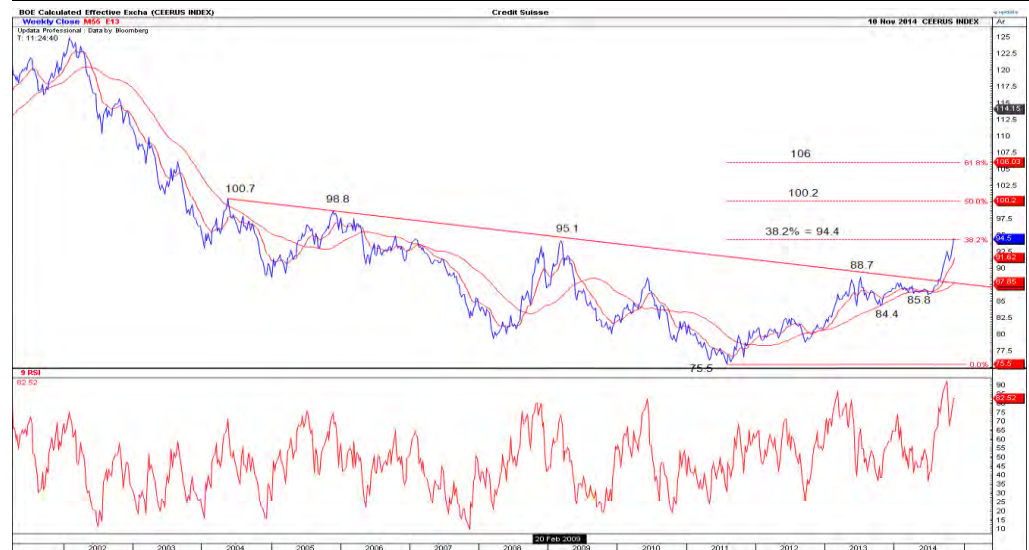
Medium term, we continue to believe that a more significant USD bull trend is under way

First USD target has been achieved, but we remain bullish

We turned decisively bullish the USD back in July 2014 following a break of key downtrend resistance from May 2004 and completion of a bullish “triangle” continuation pattern. The subsequent strong rally has now seen the **US\$ TWI (BoE)** achieve our 94.4/95.1 first core target – the 38.2% retracement of the entire 2002/2011 bear trend and 2009 high. Given the importance of this resistance, this is expected to cap for now, for what indeed may turn out to be a lengthy phase of consolidation. However, we view the break seen in July as pivotal from a long-term perspective and the trigger for a much more significant bull market for the Greenback.

For the **US\$ TWI**, consolidation beneath 95.1 should thus be allowed for, with support for a setback placed at 92.6 initially, ahead of price, 38.2% retracement, and 55-day average support at 91.2/91. Our bias is for this latter area to hold and for an eventual break above 95.1 in due course. Above 95.1 should then clear the way for a further gain to 100.2/100.7 – the 50% retracement of the 2002/2011 bear market and 2004 high. Below 91 would suggest that a deeper (but still-corrective) setback can emerge, back to the “neckline” to the medium-term base at 88.8/87.8, which we expect to prove solid support.

Exhibit 165: US \$ Trade Weighted Index (BoE) – weekly



Source: Uputa, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

DXY \$ Index above 89.92 would mark a much larger base

For the **DXY \$ Index**, the completion of a base similarly leaves the market approaching our 88.71/89.92 target zone – the 2009 and 2010 highs and the 38.2% retracement of the entire 2001/2008 bear market – which is seen as critical long-term resistance. With RSI momentum not confirming the latest move higher, this also suggests that the USD rally should take a breather and that a consolidation phase should emerge. A setback is thus favored, with support placed at 86.75 initially, then 86, with 84.47 ideally holding any deeper retracement.

Bigger picture, above 89.92 would mark a much larger base, with 92.30/60 seen as just an initial target.

USDCAD remains one of our favored longs

In terms of favored **trade ideas** to express a bullish USD view, these remain **USDCAD**, where we maintain our 1.1666/1.1766 long-held target; **USDJPY**, where we target 120.00; **NZDUSD** for .7371/32; and **USDBRL**, where we see scope for an eventual move to measured objectives at 2.7395, potentially up to 2.7655.

Exhibit 166: USDCAD – weekly



Source: CQG, Credit Suisse

5s30s German and US curves are expected to extend their flattening

The past year has seen curves flatten aggressively. Although we think that this is becoming overdone at the front end, with 2s10s in Germany, for example, close to its major target and important support, the long end is still seen as having further scope to flatten by some further distance yet, with some major reversals in place in the US and Europe.

5s30s Germany holds a medium-term top

For the **5s30s German bond curve**, the break below 166/161bp has seen a medium-term top established. We look for 170bp to ideally cap to keep the risk flatter for a break below the recent 155bp low/50% retracement to target 143.5bp next and eventually what we expect to be better support at 132/127bp – the measured target from the top, the 2012 low, and 38.2% retracement of the entire 2008/2013 steepening.

Above 170bp would alleviate the immediate flattening bias, but only a move above 180bp would suggest that the top has been neutralized.

5s30s US below 140/136bps should see its flattening resume

The **5s30s US bond curve** is consolidating at the lower end of its medium-term channel at 140bp/136. While 159bp caps, however, we would give the downside the benefit of the doubt for now, looking for a move back to 140/136bp. A break below here should resolve the range lower to target 122bp, then our core target of 109/104bp – the 2008 lows and 61.8% retracement of the 2006/2010 steepening.

Above 159bp would instead see a base established, opening the door for a recovery back to 170bp initially, ahead of 177bp, and potentially as far as 184bp – the 38.2% retracement of the 2013/2014 flattening. However, we would view a move to here as a fresh opportunity to establish a flattener.

Exhibit 167: 5s30s German bond curve – weekly



Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Exhibit 168: 5s30s US bond curve – weekly



Source: Credit Suisse

1. Establish a 5s30s German bond curve flattener at 165/170bp. Also add on a close below 155bp. Take profit at 132bp.
2. Establish a 5s30s US bond curve flattener at 175bp. Also add on a close below 140bp. Take profit at 110bp.

Gold has formed a bearish “triangle” continuation pattern

Gold below \$1180 completes a large bear “triangle”

Gold has resolved the former range that had held since June last year to the downside on the recent breakdown below pivotal support at \$1180. This has not only turned the medium-term trend lower again but has also confirmed a large bearish “triangle” continuation pattern. Additionally, further USD strength, which we expect in 2015, should add fuel to the negative bias.

We target \$1087 and eventually \$946/29

Indeed, with a major top still in place (that was established throughout 2011/2013), we remain bearish for \$1087 next, the 50% retracement of the entire 1999/2011 former bull market. We allow for a bounce here before moving on to the \$1044 low of 2010. We again allow for an initial hold here but expect a breakdown in due course to test psychological support at \$1000 next, with the measured objective from the “triangle” and the 78.6% retracement level of the 2008/2011 rally at \$946/29.

Resistance shows at \$1180/1200 initially, ahead of \$1235 and then \$1251/55, with \$1264 ideally capping to maintain a bearish outlook.

Trade Idea: Holding an existing short, stop above \$1264, for \$1000.

Exhibit 169: Gold (spot) – weekly



Source: CQG, Credit Suisse

We are bullish China

The **Shanghai Composite** has been rallying and outperforming in the emerging market space since July this year, and we continue to favor this outperformance (c.f. lower panel below). Outright index strength has now extended to a cluster of key resistance levels, starting at 2422 (the medium-term downtrend) ahead of the 38.2% retracement of the 2009/2013 downtrend at 2471 and then the late-2011 high at 2478.

Above 2478 should confirm a medium-term base for Chinese equities

A close above 2478 would, in our view, establish an important medium-term bullish reversal. If achieved, this should provide the platform for a more sustained phase of strength to 2664 initially, followed by the July 2011 high and 61.8% retracement at 2827/56, where we would expect a tougher barrier. The measured target from the base, however, would be set higher at 2960 – 20% higher than current levels.

Support shows at 2390 initially, with a break below 2280/70 needed to negate the immediate upside bias.

Exhibit 170: Shanghai Composite – weekly



Source: Uptdata, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Credit Suisse Forecasts

Exhibit 171: Credit Suisse Interest Rate forecasts

US – Treasuries	Last	2015 1Q	2015 2Q	2015 3Q	2015 4Q
Fed Funds	0-0.25	0-0.25	0.25-0.50	0.50-0.75	1.00-1.25
2y Yield	0.54	0.65	1.25	1.75	2.00
5y Yield	1.64	1.90	2.25	2.65	2.90
10y Yield	2.37	2.65	2.85	3.10	3.35
30y Yield	3.09	3.45	3.55	3.70	3.90
UK - Gilts	Last	2015 1Q	2015 2Q	2015 3Q	2015 4Q
Base Rate	0.50	0.75	1.00	1.25	1.50
2y Yield	0.67	0.90	1.30	1.60	1.90
5y Yield	1.55	1.90	2.20	2.35	2.60
10y Yield	2.24	2.50	2.75	2.85	3.00
30y Yield	2.96	3.10	3.20	3.25	3.35
Euro - German Benchmarks	Last	2015 11	2015 2Q	2015 3Q	2015 4Q
ECB Repo	0.05	0.05	0.05	0.05	0.05
2y Yield	-0.06	-0.05	-0.05	-0.05	-0.05
5y Yield	0.12	0.10	0.20	0.30	0.40
10y Yield	0.82	0.95	1.15	1.25	1.35
30y Yield	1.75	1.80	1.95	2.05	2.15

Source: Credit Suisse; Note: Last values as of 11 November 2014

Exhibit 171: Credit Suisse FX Strategy forecasts

Major Currencies									
vs. USD	EURUSD	USDJPY	GBPUSD	USDCHF	USDCAD	AUDUSD	NZDUSD	USDSEK	USDNOK
3m	1.200	120.00	1.558	1.008	1.150	0.830	0.735	7.750	7.250
12m	1.150	125.00	1.533	1.070	1.170	0.780	0.709	8.087	7.565
vs. EUR	EURJPY	EURGBP	EURCHF	EURCAD	EURAUD	EURNZD	EURSEK	EURNOK	
3m	144.00	0.770	1.210	1.380	1.446	1.634	9.300	8.700	
12m	143.75	0.750	1.230	1.346	1.474	1.622	9.300	8.700	
Emerging Currencies									
vs. USD	USDCNY	USDHKD	USDINR	USDIDR	USDKRW	USDMYR	USDPHP	USDSGD	USDTHB
3m	6.140	7.750	62.00	12300	1100	3.280	45.50	1.275	32.60
12m	6.120	7.750	63.00	12600	1133	3.380	46.00	1.285	33.00
vs. USD	USDRUB	USDTRY	USDZAR	USDILS	USDBRL	USDMXN	USDHUF	USDPLN	USDTWD
3m	44.04	2.364	11.25	3.90	2.400	13.40	320.0	4.200	29.80
12m	42.15	2.465	11.50	3.90	2.550	13.10	325.0	4.100	29.90

Source: Credit Suisse

Exhibit 172: Credit Suisse Global Leveraged Finance Strategy forecasts

	Total Returns (%) 2015 Projections	2015 Issuance Projections	Default Rates (%) 2015 Projections	Default Rates (%) 2016 Projections
US High Yield Bonds	5%		1%-3%	0%-2%
US Leveraged Loans	4%		0%-2%	0%-2%
W. European High Yield (Hedged in €)	4.5%	€125 bn	0%-1%	0%-1%
W. European Lev. Loans (Hedged in €)	3.5%	€110 bn	1%-3%	1%-2%

Source: Credit Suisse

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