

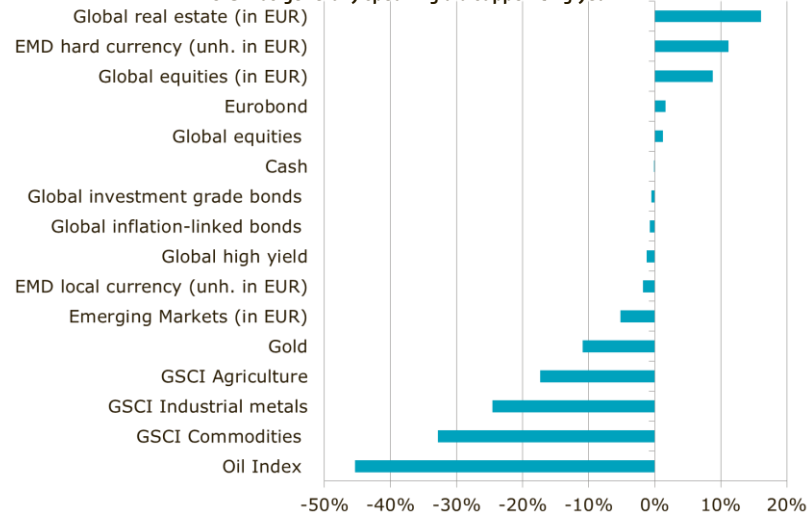


Multi-asset markets outlook

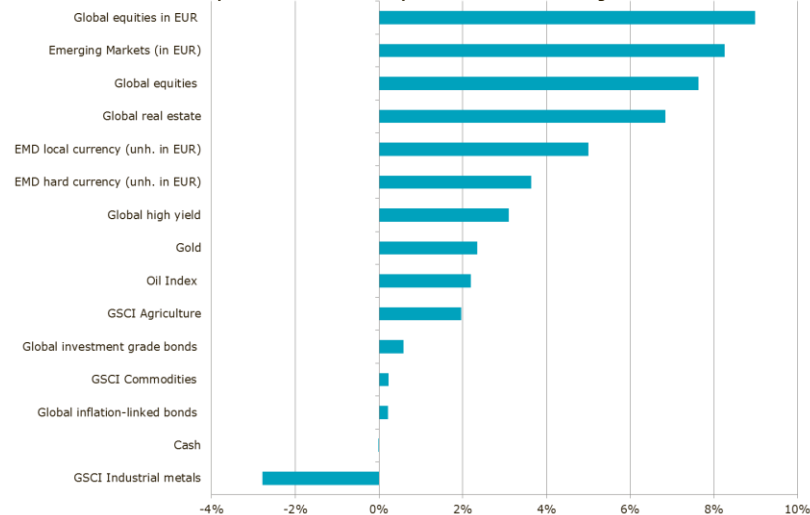
January 2016

General overview

2015 was generally speaking a disappointing year



Multi-asset performance over the past six months: nothing but winners

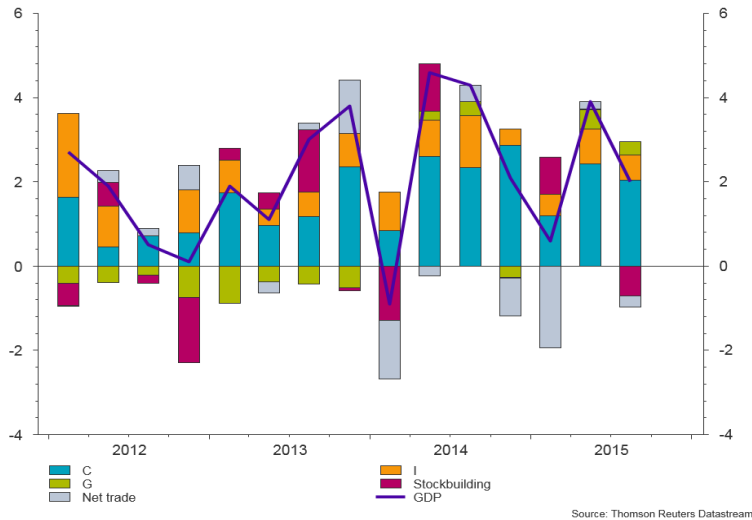


— We can be relatively short with respect to our look-back assessment of 2015: disappointing. No, the US economy did not accelerate; no, the Emerging Economies did not rebound; and no, we did not get a good return on most assets. Oil continued to suffer, which put a drag on US credit markets and raised doubts about the strength of the world economy as a whole, depressing equity markets. Sure, there were positives out there as well – the exceptions to the rule. The Eurozone did not collapse, with the economy actually doing better than expected. Real estate managed to yield a solid return, or at least those whose values are calculated in euros without using a hedge, that is.

— Good riddance. Or not? 2016 started with a bang, with Chinese stocks down by almost 12% for the year. This might sound pretty bad if this was a report written in February, but we have only had 4 trading days in the year, indicating that it has been a horrific start to 2016. As we saw last August, international stock markets reacted negatively to the sell-off, surrendering all of 2015’s gains in the first trading day, with further losses added during the week. Are we worried? Sure: every time markets correct in an aggressive fashion, you should be worried. However, China stock markets live a life of their own and offer poor longer-term guidance for financial markets overall. With the US service industry and labor market strong, we stick to our risk-on positioning for now.

United States

US economy is cruising at an unexciting speed, driven by consumption



ISM manufacturing is deteriorating further

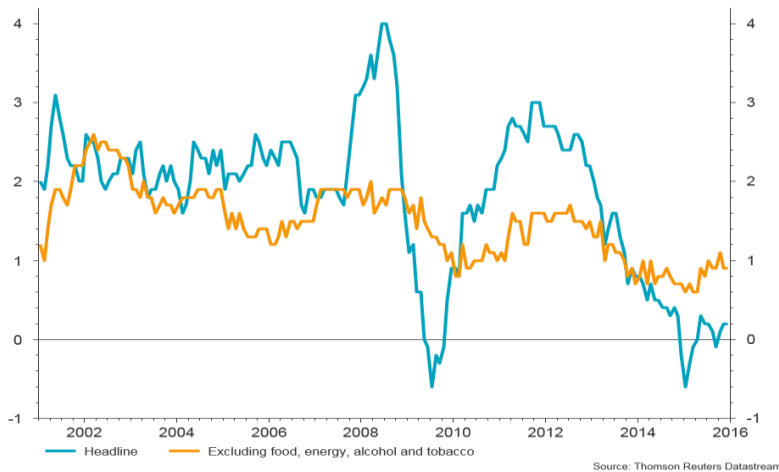


— The third estimate of Q3 GDP growth showed the US economy to be on an unexciting growth path, mostly driven by domestic consumption. A worrisome development is the continuing deterioration of the ISM manufacturing index. Of course, some sectors (energy, chemicals) of the US economy are suffering due to oil prices developments, but for the US economy as a whole they should be considered a boon. The trade-weighted appreciation of the US dollar in the course of 2015 is on the other hand clearly weighing on US growth. Q4 growth will be probably in line with that of Q3, resulting in a growth rate of about 2.5% for the whole of 2015. For 2016 we expect at least a comparable growth rate, with risks primarily on the upside. Strong labor market developments will pave the way to higher wage growth and stronger consumer spending.

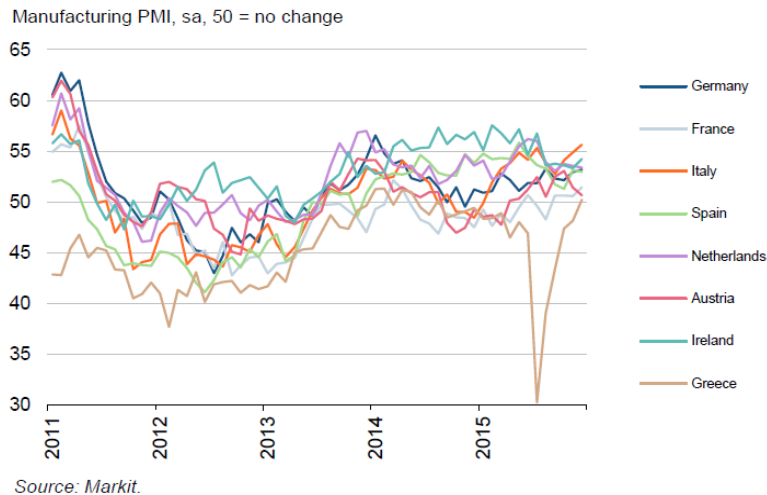
— After endlessly debating the issue, the Fed finally hiked interest rates in December. Recent declines in oil prices will drive headline CPI – currently 0.5% on a yearly basis – lower again, so there is no pressure on the Fed to hike again on short notice. The Fed will probably take a wait-and-see attitude for the time being given heightened geopolitical risks (Middle East) and ongoing weakness in China. Rising tensions between Iran and Saudi Arabia were probably inevitable given the recent rapprochement between Iran and the US. We consider it unlikely that this will deteriorate into an outright war.

Europe

Lower energy costs kept a lid on inflation



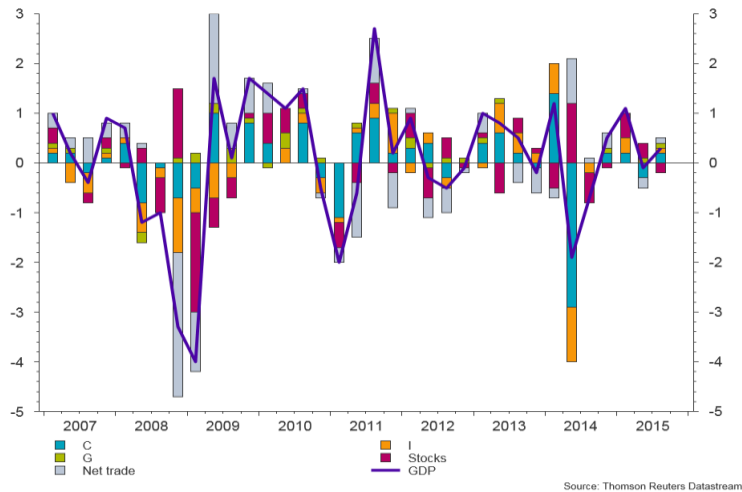
Italy is ahead of the pack



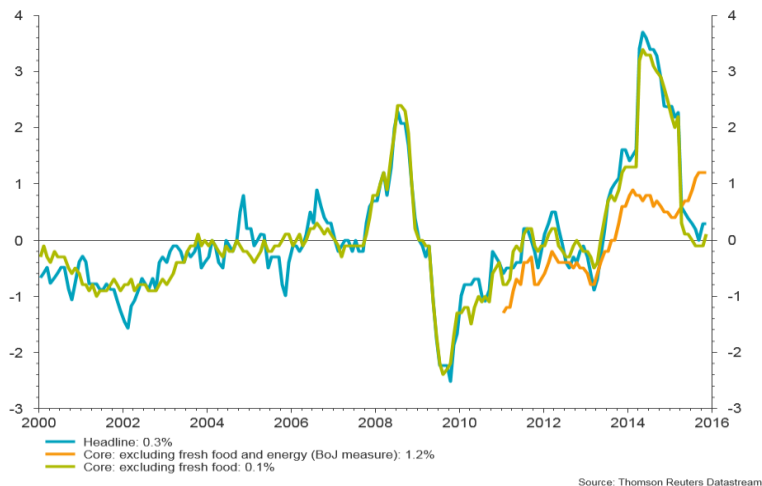
- In 2015 the euro area probably grew by a less than impressive 1.5%, mostly driven by an upsurge in domestic demand. Fortunately, despite disappointing growth, the unemployment rate is coming down rapidly, towards 10.7% in November 2015. Growth will continue to strengthen in the course of 2016, helped by a weak euro, a further decline in the oil price, additional government spending due to the influx of refugees, and a mild winter.
- The Markit PMI suggests that the third-largest economy, Italy, is ahead of the pack after years of disappointing growth, helped by impressive reforms and ongoing political stability. Still, growth will be lower than in Spain in 2016. No major elections are scheduled in the EU for 2016, so the populist threat remains distant for the time being. A vote for a 'Brexit' in a UK referendum could, however, be a major shock.
- Earlier promises by ECB President Mario Draghi to increase inflation 'quickly', suggesting more stimulus, weren't backed up by a majority of the decision-making council, disappointing financial markets. Nevertheless, the ECB will continue to buy bonds for the foreseeable future at a pace of EUR 60 billion a month. Oil price developments will push headline inflation down into deflationary territory. As the recovery gathers pace, this development won't push the ECB into additional action. The 2% target will remain far out of reach.

Japan

Japanese economy is apparently strengthening



The BoJ was comforted by the rise in core inflation



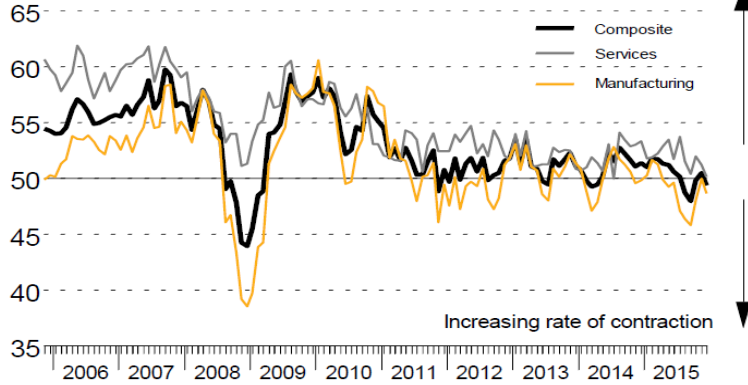
- A rather large revision of Q3 2015 GDP figures, showed a modest rebound of growth for the Japanese economy instead of the earlier reported technical recession. Of course, revisions of this magnitude lead to a distrust of figures in general. To what extent can we trust the new numbers? However, recent figures do indeed suggest that the Japanese economy is doing relatively well. Although November industrial production figures were weaker than expected, real exports are doing fine. Q4 GDP growth is probably in line with Q3, paving the way for a growth rate for 2015 of about 0.7%, comfortably above trend (0.3% due to poor demographics). Some further strengthening in 2016 is our baseline scenario.
- The Bank of Japan (BoJ) was pretty upbeat about exports and corporate sentiment during its December meeting. It lengthened the average maturity of its JGB purchases and increased its ETF purchases, expressing its intention to buy future ETFs that are composed of stocks issued by firms which are proactively making investments in physical and human capital.
- Oil price developments are of course a positive for the Japanese economy, though they will probably push headline inflation again below 0% in the coming months. The BoJ probably won't change its current stance on QE for the time being, pointing towards the rising trend in its preferred core inflation measure.

Our highlight this month: China

The Chinese economy is again contracting

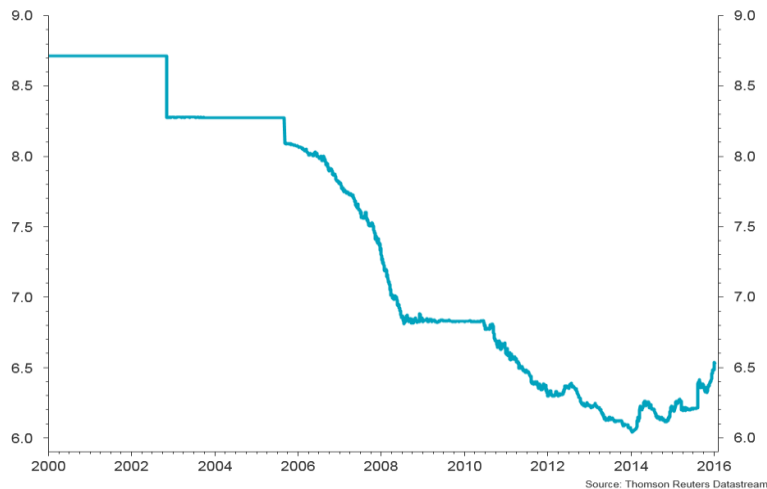
Caixin China Output PMI

50 = no change on previous month, S.Adj.



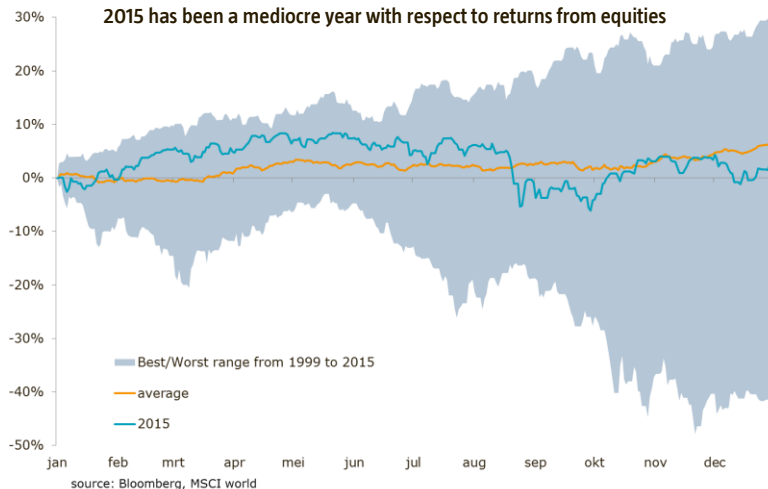
Sources: Markit, Caixin

China is allowing gradual yuan depreciation

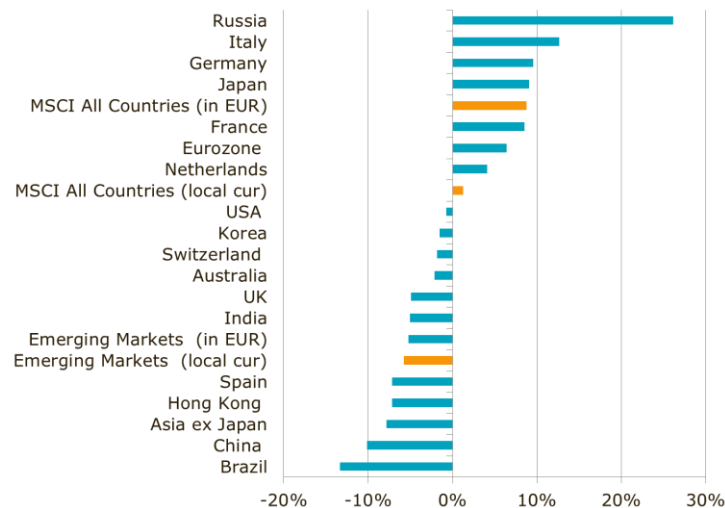


- The Chinese economy continued to disappoint over the course of 2015 and has probably missed its growth target of 7.0%. The Chinese authorities have tried to speed up growth by a host of smaller measures, but the results have so far been less than impressive. The growth target for the next five years remains at a relatively high and ambitious 6.5%. It is likely that Chinese policymakers will resort to additional monetary and fiscal stimulus to be able to reach the 6.5% growth rate in 2016. An inevitable rise in the overall debt ratio will be taken for granted.
- Despite assurances by President Xi Jinping and Prime Minister Li Keqiang that a further depreciation of the yuan vis-à-vis the US dollar is out of the question, the yuan has gradually depreciated nonetheless. After the botched 2% devaluation in August 2015, the yuan has been allowed to depreciate an additional 2% over the course of the last two months at a more gradual pace. Formally, the yuan is no longer pegged to the USD, but to a basket of currencies.
- Despite the slowdown and gradual rebalancing of the Chinese economy, a so-called 'hard landing' remains a very remote possibility. Domestic demand remains strong, partly due to increased public spending, and the lower oil price is a boon for the Chinese economy.

Equities (I)



Price returns in regional equity markets in 2015



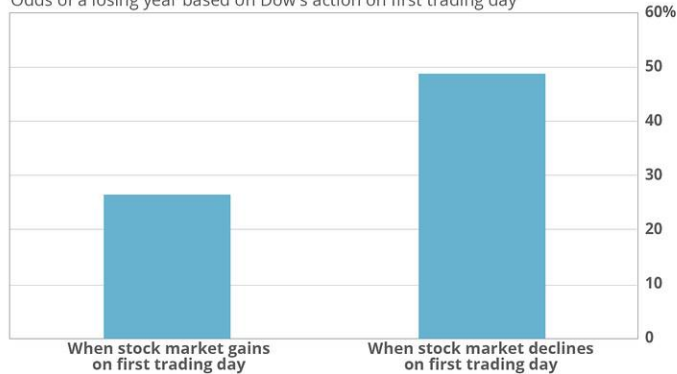
- Much in line with the performance of the other asset classes, 2015 turned out to be a disappointing year for equities. On a total return basis the MSCI world index managed to eke out a return of 1.3% in local terms. Translated into euros, the result was a much better +8.8%, but that was of course purely the result of the decline of the euro relative to most other currencies.
- The first months of the year were strong, with Eurozone stocks for example rising as much as 20% in the first four months. The party did not last though, as concerns about the strength of the world economy started to surface, while the weakness in commodity prices also had an adverse impact on the US manufacturing sector. Still, markets managed to hold on top their gains until August, when the collapse of Chinese stocks, combined with the weakening of the Chinese yuan, triggered a 10% sell-off in most major stock markets. From that point onwards stocks recovered, but concerns about the strength of the world economy continued to hamper returns until the end of the year.
- From a regional perspective, probably the most striking element has been the weak performance of most emerging markets, with the exception of Russia. Weaker economic growth, disappointing earnings growth and geopolitical tensions have been the main reason for this underperformance.

Equities (II)

A negative start to the year seems to reduce the odds for a positive return to a flip of the coin

A bearish omen

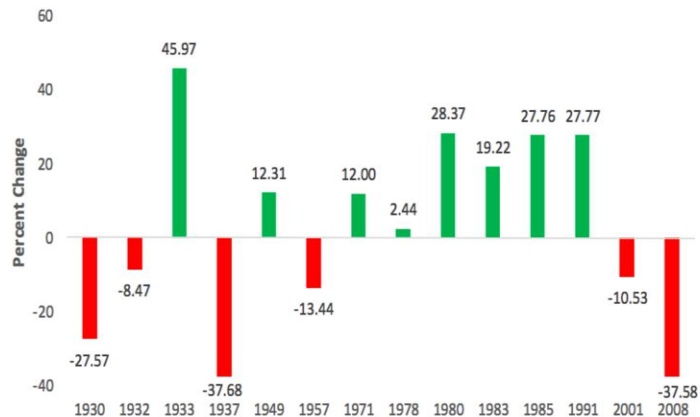
Odds of a losing year based on Dow's action on first trading day



Note: Odds calculated based on Dow's full-year direction following the first trading day; 1896 to 2015 Source: Hulbert Financial Digest

Companies continue to prefer share buybacks above 'risky' investments

S&P 500 Rest of Year Return Following a 1%+ Decline to Start Year



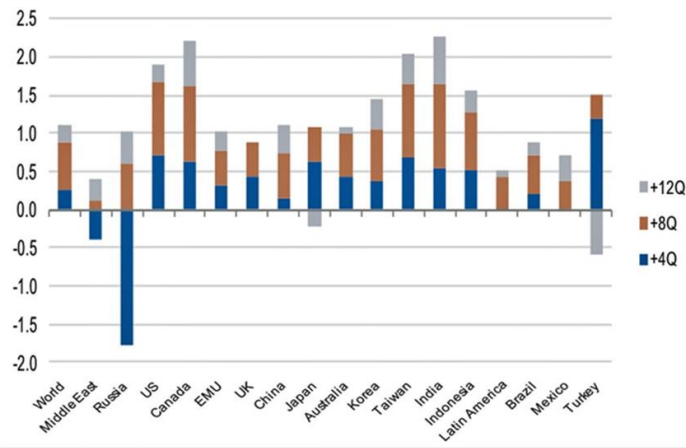
- So much for 2015: what will 2016 bring? If the first day of trading is anything to go by, the answer appears to be 'nothing nice'. Chinese stocks closed the first day 7% lower, ruining sentiment in all the major stock markets for the day. Weaker-than-expected manufacturing data, as well as the steady slide of the yuan vis-à-vis the dollar, once again raised concerns about the strength of the Chinese economy. Selling pressures were further fed by the expected ending of the insider selling ban on 8 January. It was not just China that weighed on the markets though, as the escalation of the Iran-Saudi conflict as well as a weak US ISM manufacturing report also took their toll.

- But does the first day of trading in the year hold any predictive power for the rest of the year? Although a bit of number crunching can indeed suggest that it does (see the chart above for example), we do not read too much in it: one day's trading is far too noisy to lead to useful predictions for the year ahead. The first negative day of trading may seem to coincide with lower odds of a positive annual return, but so does the 11th, the 19th, the 27th, the... you catch the drift: this might just be the outcome of randomness rather than anything else. Neither are we impressed by the claim that a steep decline of stocks (>1%) on the first trading day is a bad omen for stocks: 8 out of the 14 years when this happened ended with a (strong) positive return for the year as a whole (see chart II).

Equities (III)

The positive effects of the oil price decline take some time to feed through the system

Cumulated impact on GDP from a \$20/b decline in oil prices



Source: SG Cross Asset Research/Economics

US stocks are not cheap, but are not in a bubble either

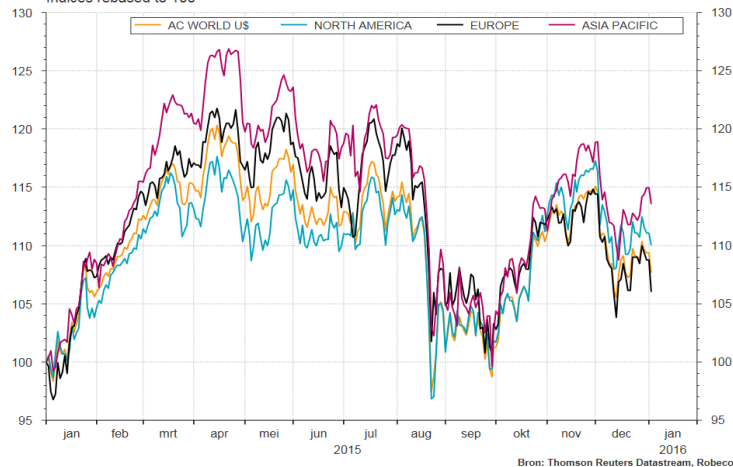


- Stock market returns for the year are not determined on a specific day of trading, but rather depend on the underlying fundamentals, sentiment, liquidity, risk appetite and the availability of alternatives. Although it is hard to deny that sentiment has weakened in recent weeks, the question is whether it is enough to determine the fate of stocks for the year to come. Our answer is still no, but it should be stressed that this is closely linked to economic developments in the US, which have been weaker than we would have liked to see. The ongoing slump in the manufacturing industry related to the drop in oil prices and the strengthening of the dollar, as well as developments in the High Yield markets – rising yields, liquidity problems – could, potentially drag down the economy as a whole, which would certainly result in a negative scenario for stocks. Although feasible, we continue to believe it to be an unlikely scenario. The US service sector is still healthy, employment growth has been solid, and consumer spending will be supported by the increase in disposable income due to lower oil prices, while consumer debt has been reduced in recent years. The second obvious risk – a hard landing of the Chinese economy – is also deemed to be a remote possibility. The weaker yuan, the lower oil price and stimulative measures should help to turn the economy around, irrespective of what the volatile Chinese stock market does. All in all, we believe the current selling pressures to be of passing nature and stick to our overweight position in stocks.

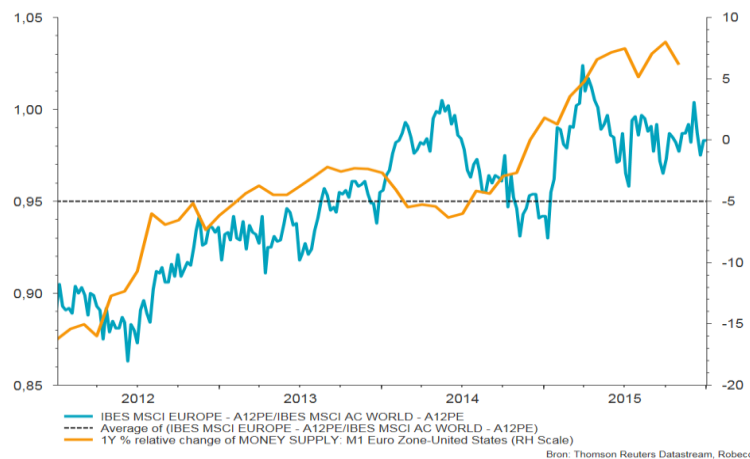
Developed Market Equities

Momentum for stocks has deteriorated

Regional equity performance YTD in euro
Indices rebased to 100



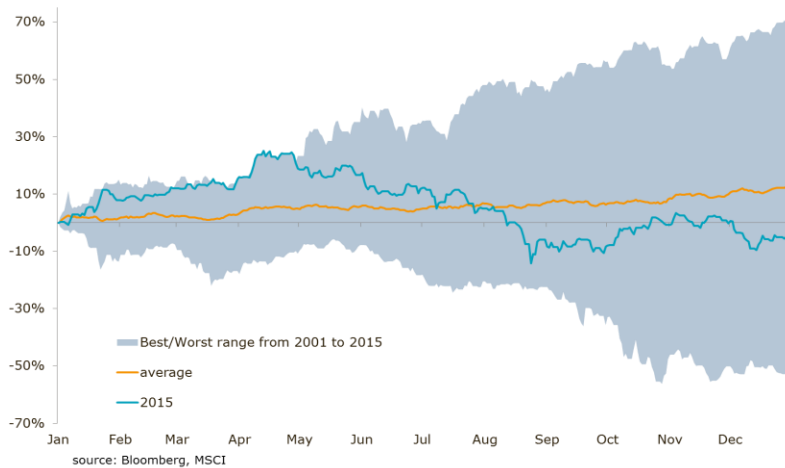
Europe is not particularly cheap, especially given diminished additional QE expectations



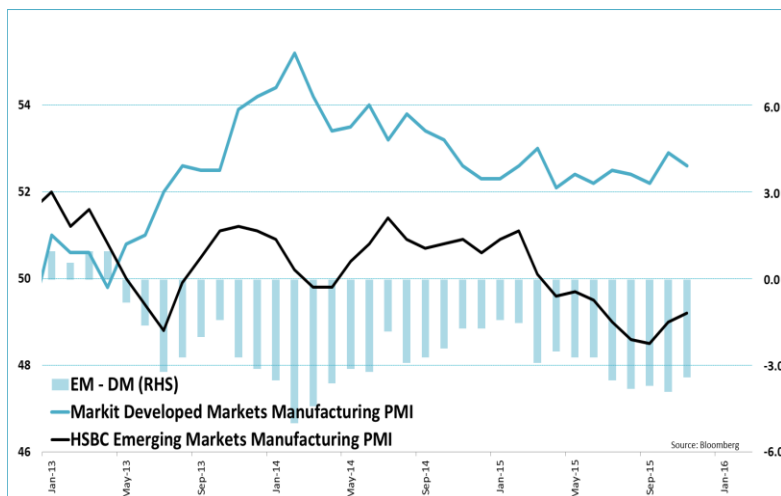
- 2016 was marked by an ugly start to the year for developed market equities, with momentum worsening across regional equities. In this risk-off climate, Japan, a traditionally defensive equity play, has the strongest cards from a momentum perspective. European equities took a hit with 1-month momentum in euros at minus 3.8%.
- Looking ahead for developed market equities, we continue to favor Europe and Japan compared to the US, although the environment is getting less positive for Europe. From a valuation point of view, the gap between the US and the Eurozone on CAPE metrics still favors Europe. But the gap has not widened recently. Also, on a 12-month forward P/E multiple, Europe is trading above its 10-year historical average discount versus the US. This relative multiple has been closely linked to relative money growth in the Eurozone versus the US. Given the diminished expectations of additional QE in the Eurozone, the contribution of price appreciation to returns has been reduced. This implies that earnings growth has to take over as the dominant driver of equity returns in Europe. Solid business expectations indicators, sluggish wage growth and cheap currencies imply both Japanese and Eurozone earnings will likely improve further, while an uptick in wage growth and the slowdown in manufacturing activity show the US earnings outlook remains dim.

Equities: Emerging vs Developed (I)

Another year of losses for Emerging Equities



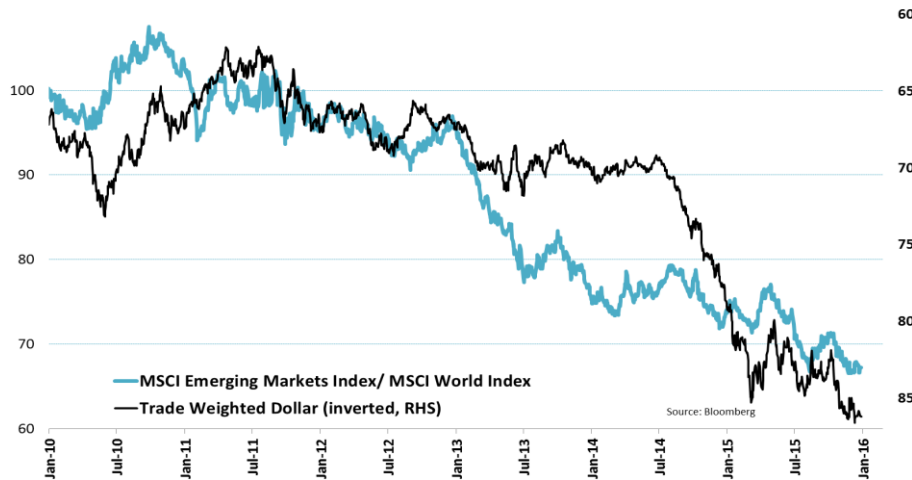
China's 1-year benchmark rate



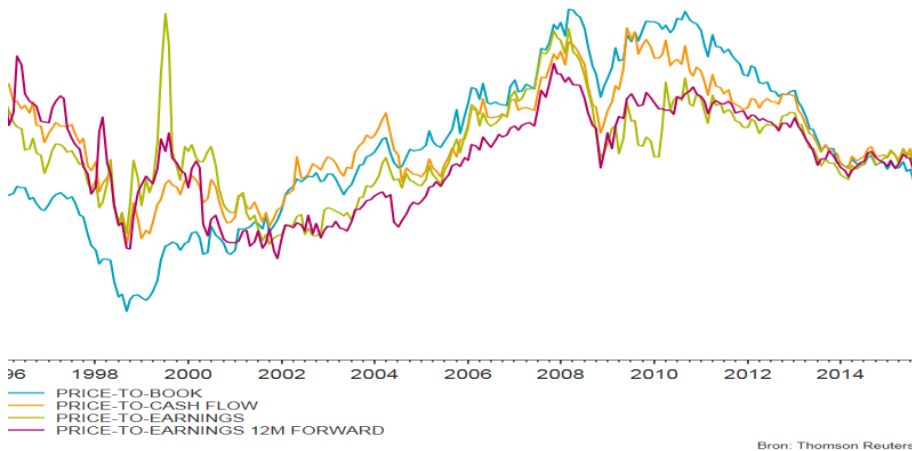
- Another year, another severe underperformance of emerging market equities. Measured in euros, emerging markets fell more than 5% last year, while developed equities rose more than 10%.
- To some extent, 2015 represented a perfect storm for emerging equities. We saw slowing growth and economic imbalances – China being the most explicit case, of course – along with political turmoil in countries such as Brazil and Russia. Other negatives included falling commodity prices (the correlation between the mining sector and emerging markets remains stubbornly high) and the continuous rise in the US dollar (reflecting central bank divergence for the first time since the financial crisis). Taken together, these factors brought emerging markets down to their knees last year.
- Perhaps it is better to say that it is not the strong US dollar but weak emerging currencies which tell the story of 2015, because while emerging market currencies fell 15% against the US dollar, they also fell 7% against the euro. Emerging currency depreciation was the common mechanism through which the troublesome economic and fundamental situation of emerging countries was (partly) reflected.

Equities: Emerging vs Developed (II)

USD strength is negative for emerging markets



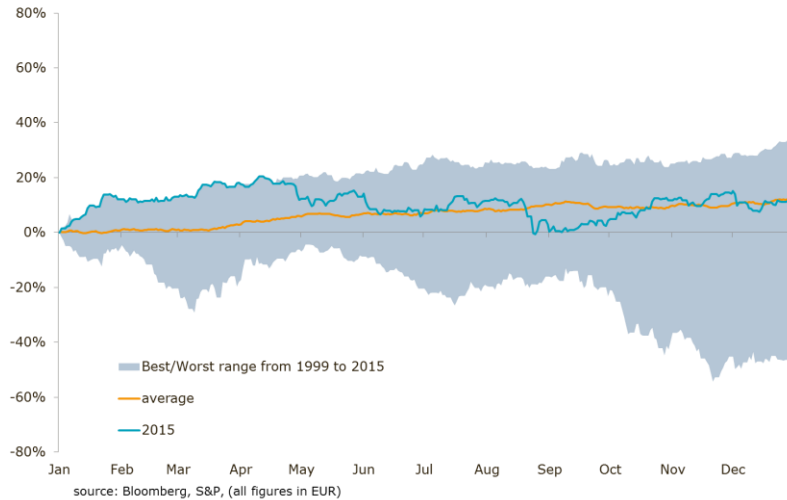
The valuation discount between markets has narrowed
EM versus DM equity valuation



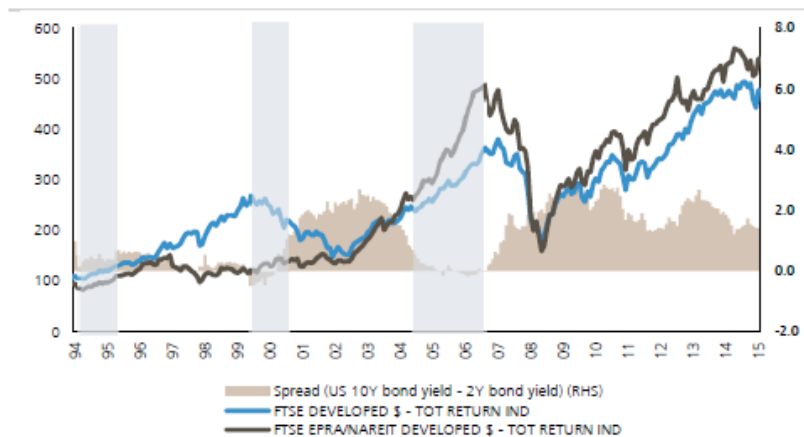
- So what's in store for 2016? We agree to a certain extent that (some of) the imbalances have improved, that some emerging currencies appear cheap and that the valuation of (some) emerging markets has become attractive. However, at this point we think it's too early to remove our underweight.
- First, a number of emerging countries have issues with excessive debt. Unfortunately, this is most apparent in the world's second-biggest economy, China. Second, relative growth momentum has not yet turned; an 'unofficial' Chinese PMI of just 48.2 confirms this. The emerging market manufacturing PMI has trailed its developed market counterpart for 32 consecutive weeks. Third, although the Fed will take it slowly, Fed tightening will continue. Historically this has been bad news for emerging assets. Fourth, company fundamentals are not so great either, particularly as earnings growth and return on equity lag. Fifth, growth in developed economies is decent, but not impressive, and will not really kick-start emerging economies.
- Over the course of 2016 the overall picture of emerging markets could improve, but for now we stay underweight. We are taking a wait-and-see approach after being underweight for most of the last couple of years.

Real estate

Performance of real estate in perspective



Equities and listed property performance during recent Fed rate hike periods

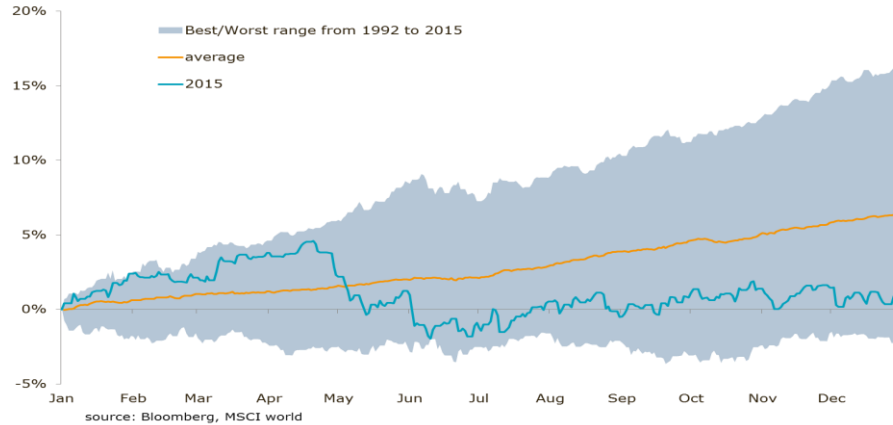


Source: UBS, DataStream. Grey shading is Fed rate hikes period

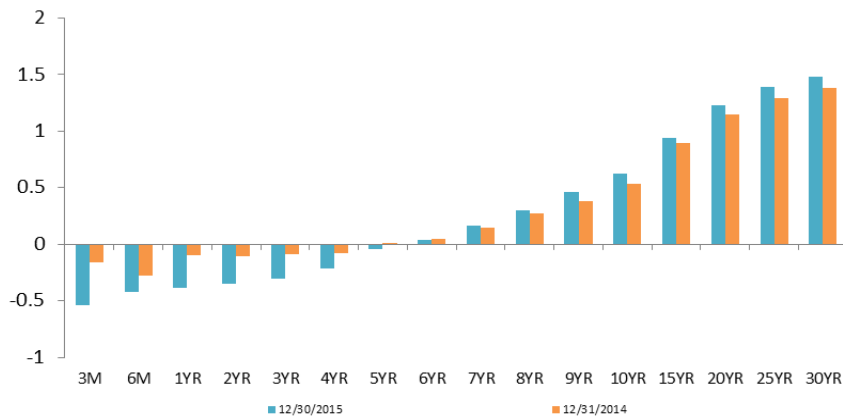
- Real estate turned out to be one of the best asset classes in 2015; with the euro as base currency, the return was 12.3% The S&P Developed Property Index denominated in US dollars closed a little above 0%, but outperformed global equities. The correlation with US interest rates was very strong, but during the year this effect faded away somewhat. Initially the market was afraid of a rate hike in the US, but when Fed finally announced the hike in December, real estate actually rose immediately afterwards.
- As we have noted earlier, a rate hike doesn't have to be bad news for real estate. Listed real estate is mostly funded with long-term money, so the development of long-term interest rates is more important. We expect interest rates to rise at a gradual pace in the coming year as economic growth continues.
- Real estate valuation is still stretched in most areas in developed markets, especially in the US and UK. In Japan, the BoJ has increased its J-REIT purchasing limit and now has room left to support the market for longer than was previously expected. This does not really makes J-REITS less expensive though. Despite the high valuation we think real estate can offer decent returns compared to equities, so we remain neutral on the asset class.

AAA Bonds (I)

Total return for German government bonds was extremely volatile



German curve steepened yoy reflecting the impact of the ECB's asset purchase program

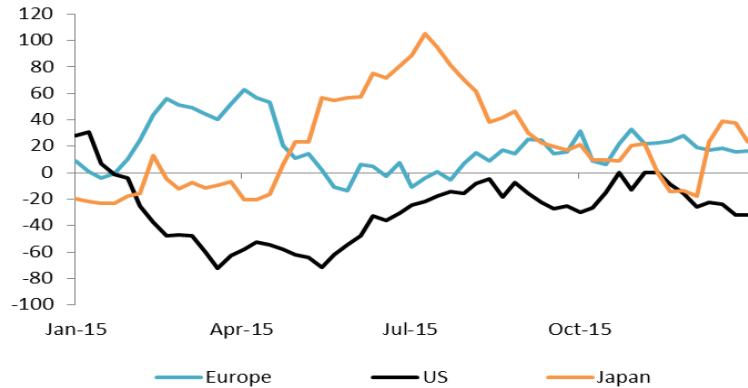


Source: Bloomberg

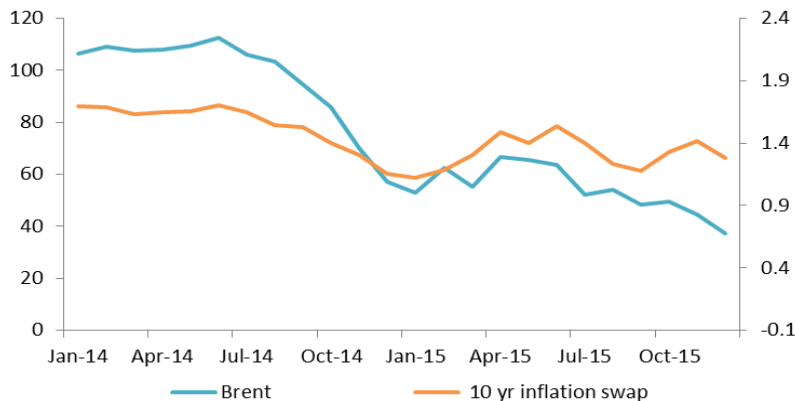
- Looking at the marginal rise in German bond yields of only 10 basis points from the start of the year, one could be tempted to conclude that 2015 was a very boring year for bonds. But when you zoom in a bit closer it soon becomes apparent that it was an extraordinary year, as the 10-year moved in a broad range of roughly 100 basis points. This volatility was a consequence of the cross current caused by the rule-based asset purchase program of the ECB against an improving economic backdrop with still extremely low inflation.
- Things stayed exciting until December, when the central banks of the three major economies in the world all held meetings, with the markets eagerly awaiting guidance on things to come. The stakes were high: the Fed was expected to tighten, while the ECB and BoJ were expected to ease.
- The Fed indeed delivered in line with expectation and the BoJ practically in line with expectations, but the ECB didn't. The market had widely expected a very proactive ECB, as inflation remained too low for comfort. After all, the inflation rate has been the most important determinant of recent ECB policy. In the end the ECB failed to live up to expectations. This is important as it could mark the end of last year's investment theme of expecting ever-increasing policy divergence.

AAA Bonds(II)

Economic surprises: US weakness was mainly due to the manufacturing side



Inflation expectations follow oil price movements on a like-for-like basis



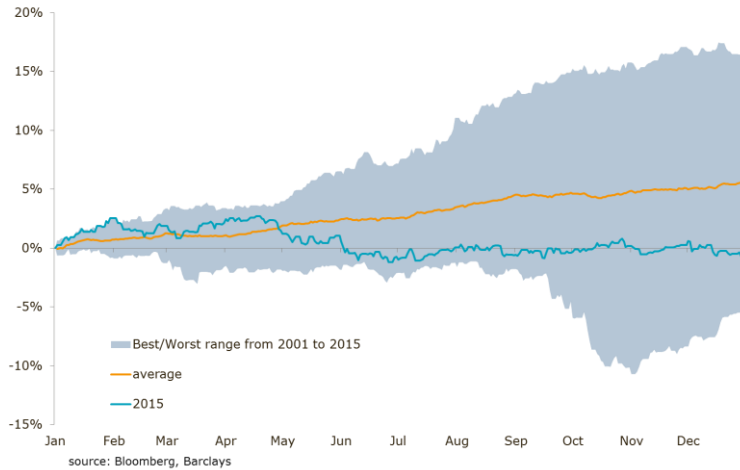
Source Bloomberg

- Data remained positive in Japan and Europe. US data was weaker as the economy deals with the aftershocks of a stronger dollar and a drop-off in energy capex. The weakness was mainly in manufacturing, while the service side of the economy remains resilient. What we found most peculiar last year was the almost like-for-like movement in oil prices and medium to longer-term inflation expectations. This is something we would expect from shorter-term inflation expectations. Given this dynamic and the recent massive drop in oil prices, we should expect the negative drag on inflation to stay with us longer than initially assumed.

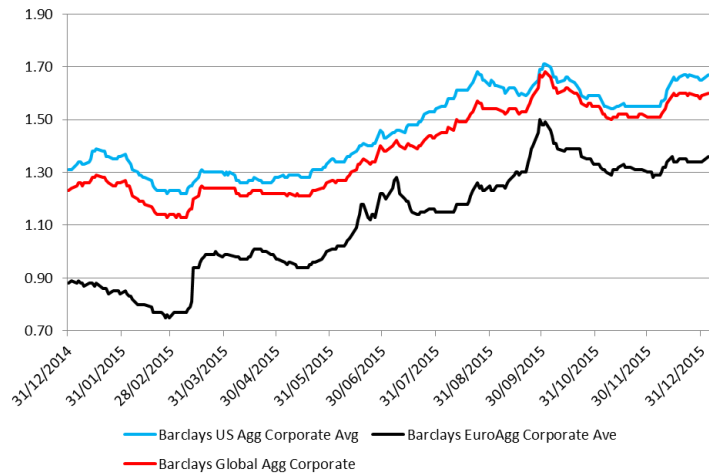
- So what are we looking for this year? A further rise in bond yields! The base case for this is that we think that the economy (in the developed world) will continue to remain on a strengthening path, slowly but still continuously improving. The US will lead the move higher and other yields will more or less move along with it. The degree to which European markets will follow suit will depend on ECB policy. Currently we think that it is prudent to assume that the bar is currently higher for the ECB to beef up its purchasing program further, and with current policy setting fully priced, European rates will remain susceptible to higher US rates.

Investment Grade Credits

Small negative returns from global credits



Rising spreads in Europe and the US

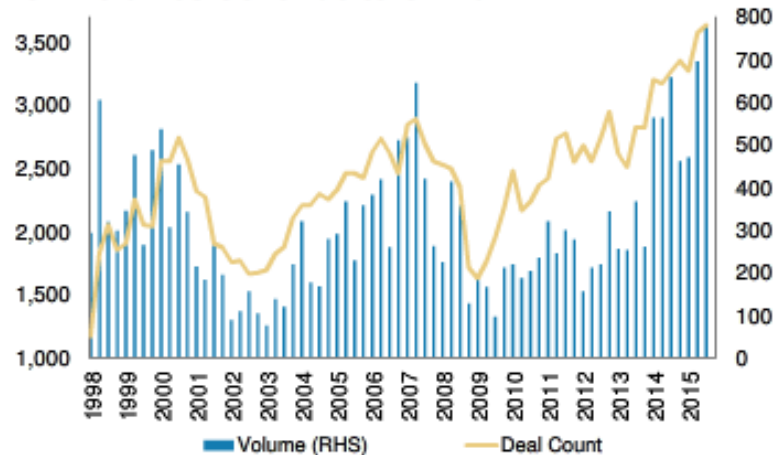


- Investment grade credit investors faced a small negative total return in 2015. On a global level, the Barclays Global Credit Index hedged to euros lost 0.5%. In the second quarter of the year, after interest rates on government bonds started to rise from their unnaturally low levels, credit spreads began to rise as well.
- In Europe, the turmoil around Greece at the beginning of the summer and the Volkswagen scandal in September were responsible for two peaks in spread development. In the US, the road to higher spread levels was less bumpy, and in the second half of the year, spreads remained fairly stable between 1.5% and 1.7%. As the Global Credit index is closely related to the US index, we see the same pattern over there.
- The December meeting of the ECB was disappointing for credits as well. It was expected that the bond buying program would be extended and high-end credits could be part of the program as well, but this did not happen. However, European credits remain relatively attractive. The European economy shows stable growth, and for now, a further slowdown in commodity prices won't harm European credits that much. We expect spreads in Europe to tighten a bit, offering a small positive return this year.

Investment Grade Credits

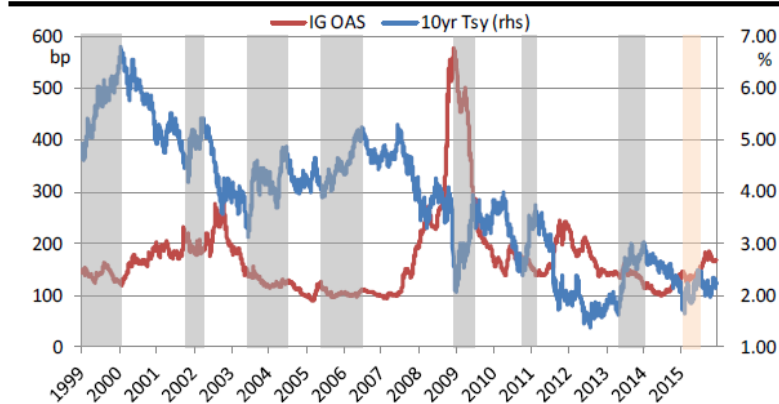
M&A activity in the US is still increasing

M&A Volumes Continue to Climb



A strong rebound was seen in US credit returns

Ex. 24a: Over the past 17 years, the seven periods of rising rates have been accompanied by spread *tightening* for the IG corporate market

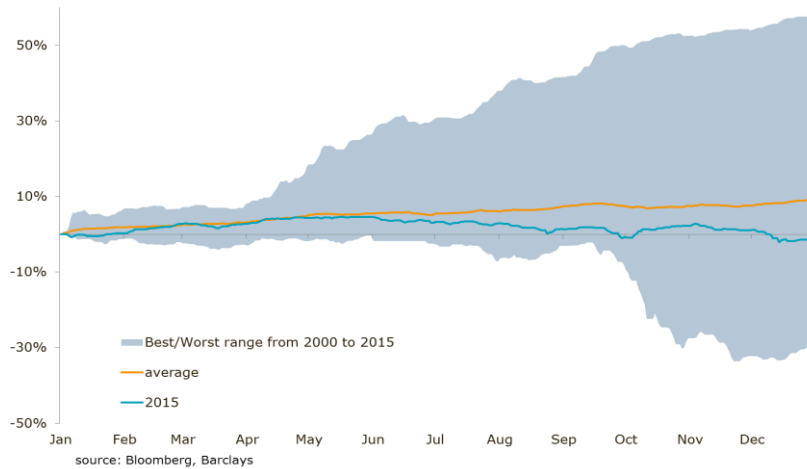


Source: SG Cross Asset Research, Bloomberg

- As we noted, US credit spreads were fairly stable in the second half year of 2015. At the same time, leverage in the US rose again, as low rates were attractive for financing M&A deals, which reached a record level in 2015. A quarter of the issuance in 2015 was used for M&A activity, mainly in the Tech and Health Care sectors, compared to about 10% in 2014. We expect this trend to continue in 2016.
- In December, the Fed took the widely expected rate hike step. We expect interest rates in the medium and long-term buckets to rise gradually as well. A rise in interest rates isn't bad news for credits. In the past, spreads have tightened in periods when the interest rates rose. That said, for 2016 we expect US spreads to hover around their current values as commodity market risk and growing leverage outweigh the benefits of economic growth.
- As we expect government interest rates to have a bias to rise, credits can offer a higher yield for a somewhat higher risk level to government bonds. In that perspective high yield bonds are more attractive than credits. We recommend a neutral position on credits, keeping the above nuance in mind. We have a preference for European credits over US credits.

High Yield (I)

High Yield Performance in 2015



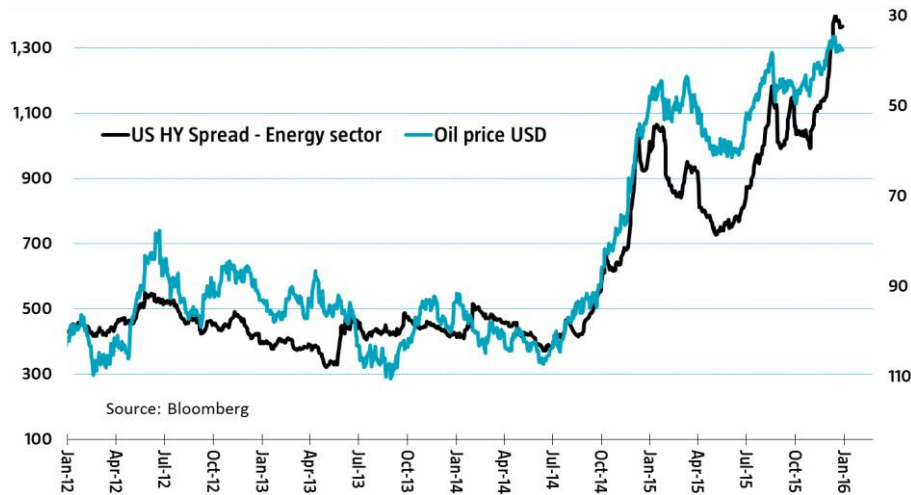
High yield spreads since 2011



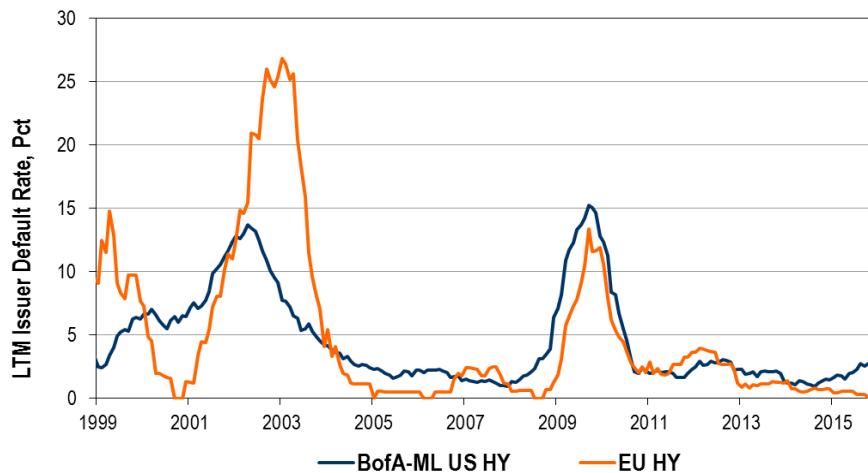
- A rough ride. That about sums up the year for high yield bonds: a year characterized by the very poor performance of one particular sector within the high yield universe. The commodity collapse ignited a series of defaults in the energy and materials sector, pulling down the asset class as a whole. For 2015 global high yield bonds, hedged to euros, lost 1.2%.
- The average high yield spread widened for a second year as commodity prices continued to fall. The chart on the bottom left shows how spreads started to widen from the middle of 2014, which neatly coincides with the peak in oil prices, which have since fallen by 60%. Other commodities continued their multi-year downtrend as well. US shale gas companies are among the victims of lower commodity prices. Their weight in the index has increased considerably over the last couple of years, and quite a few of them have gone bankrupt, while energy spreads rose 40% in 2015.
- Despite the severe deterioration in the commodity sector, other sectors have held up pretty well so far. A slow, but certain improvement of economic growth in the developed world, in combination with ever-lower financing costs have shielded the asset class from any real damage so far.

High Yield (II)

Spreads on high yield energy companies



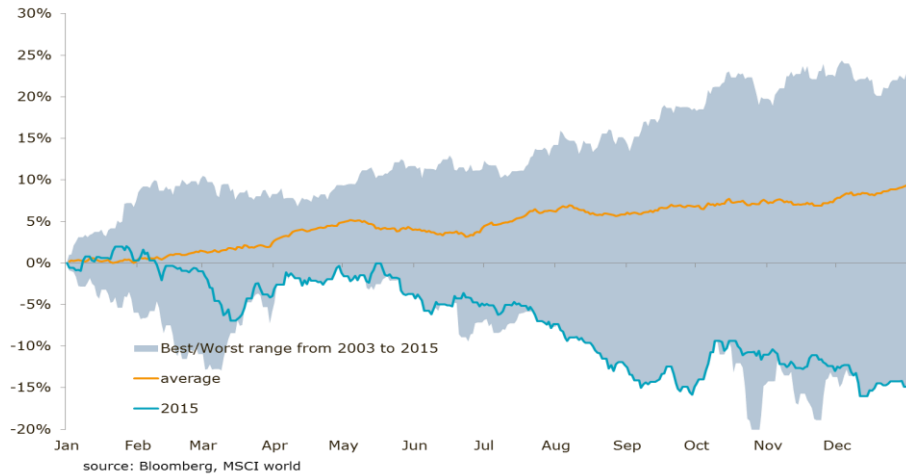
High yield default rates



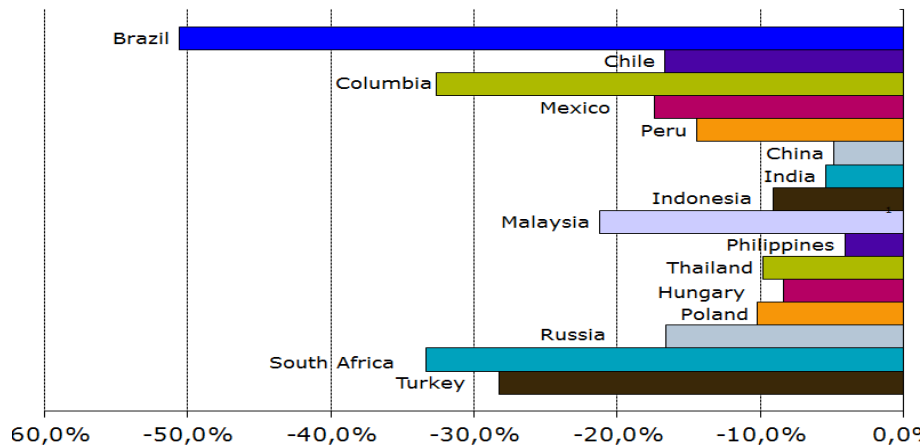
- That brings us to the outlook for this year. We continue to think there is value in high yield given our base case economic outlook. We do not expect a US recession at this point in time, and some stabilization of commodity prices could occur in the coming months. That said, the bottom may not have been reached yet. Our biggest risk remains China, which will do its best to keep the economy from slowing too much, a strategy that resembles kicking the can down the road.
- The current yield to maturity on global high yield bonds averages more than 8%, which looks pretty rich in a world of almost zero, or negative interest rates. Last time we emphasized that this yield should represent a significant liquidity risk premium, as the closure of the Third Avenue fund reminded us.
- In our base case economic scenario the overall default rate will increase, given the certain rise in the number of commodity-related defaults, but not to the extent which current spreads seems to imply. We must add here that another major leg down in commodity prices – a lack of visibility on economic growth, and/or an sustained increase in volatility – could make this a potentially painful trade. And that is something we must try to avoid at all times!

Emerging Market Debt (I)

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



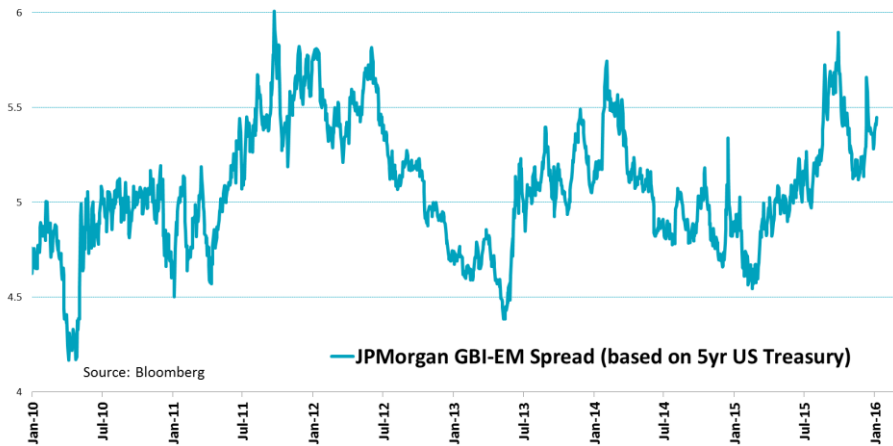
Emerging market currencies against the US dollar
CURRENCIES 52 week Change



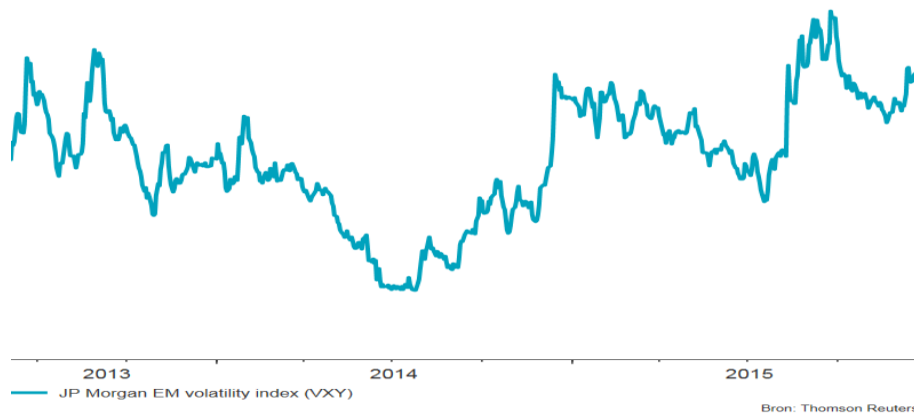
- Comparable to emerging market equities it was a bad year for emerging market local currency debt. Measured in US dollars (the most common way to look at emerging market debt) the asset class fell roughly 15%. Taking into account the depreciation of the euro leaves us with a negative return of more than 5%.
- Last year can be summarized by just one chart, shown at the bottom left. Emerging currencies experienced one of their worst years on record, pulling down the whole asset class. The Brazilian real and the South African rand made the list of the worst-performing currencies of 2015, but the chart shows that emerging currencies depreciated massively across the board.
- This depreciation underpins our view that the structural headwinds that emerging countries are facing are reflected through weaker currencies. Emerging countries have had to cope with everything from increasing current account imbalances and lower credit ratings, to outright recessions. The commodity rout made things worse for countries like Brazil, which has now reached junk status. Some of this depreciation can be attributed to US dollar strength, but that does not take away the unenviable situation emerging countries found themselves in in 2015.

Emerging Market Debt (II)

EMD vs the trade-weighted US dollar



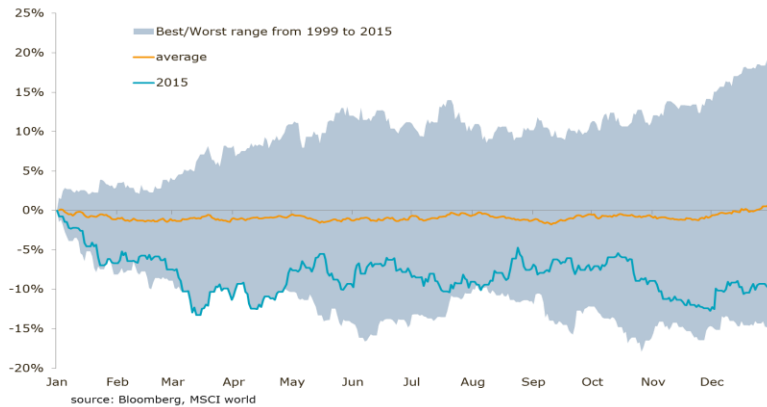
EMD yield vs High Yield
EM FX volatility since 21/05/13
Index



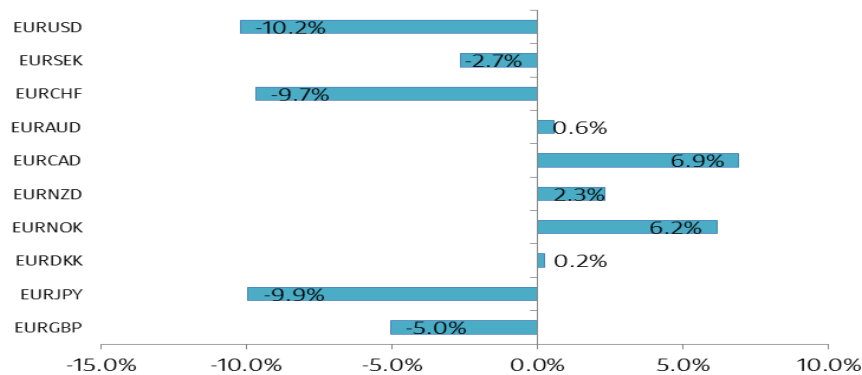
- We start 2016 with a neutral weighting for emerging market debt. One important reason for this is that we expect emerging currency depreciation to ease over the course of the year. Unlike last year we do not expect a simultaneous weakening of all emerging currencies. For some countries, such as Indonesia and Mexico, things look a bit more positive, while the valuation of others (South Africa for example) is starting to look appealing. Together with a current yield-to-maturity of over 7%, which is on the rich side compared to developed market government bonds, we are not as negative on emerging debt as we have been before.
- However, there are negatives as well. First, investor sentiment has worsened in recent weeks, intensifying the risk averse stance towards emerging markets. Second, the depreciation of the yuan will most likely keep emerging currency volatility high for the foreseeable time. Third, at least part of the higher yields are explained by poorer countries such as Brazil and Russia. Their troubles are far from over at this point. Fourth, any further dollar appreciation remains a headwind for emerging debt performance .

FX (I)

2015 was a terrible year for the euro....



...though the euro was not the biggest loser of 2015

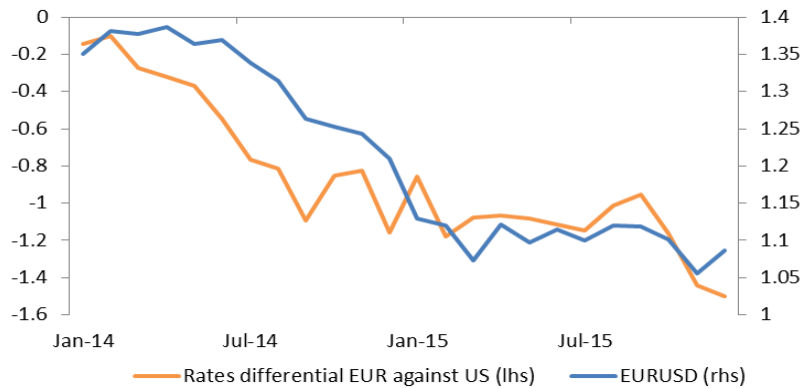


Source: Bloomberg

- Looking back on 2015, the euro was one of the weaker currencies within G10. It was not the weakest however, as the commodity currencies managed to underperform the euro: the Canadian dollar and the Norwegian krona were the worst performers overall. Not coincidentally are these the more oil-sensitive currencies. The year-on-year performances of G10 currencies reflect the dominant themes of 2015 almost perfectly: a weak euro and weak commodity prices.
- In early 2015 the ECB did what most thought would have been impossible: it widened its monetary policy tools and started a broad asset purchase program. A direct consequence of this was that the US dollar strengthened aggressively. This caused strains across several markets with commodities and emerging markets as the main victims. The pain wasn't only felt across emerging market currencies but also within G10 pairs. Commodity currencies experienced severe downward pressure as a result. The higher interest rates that most of these currencies offered were either seen as unsustainable or insufficient given their circumstances. So while the difference between the interest rate differential (aka policy divergence) was an important determinant for the EUR/USD exchange rate, it was completely irrelevant for the commodity crosses.

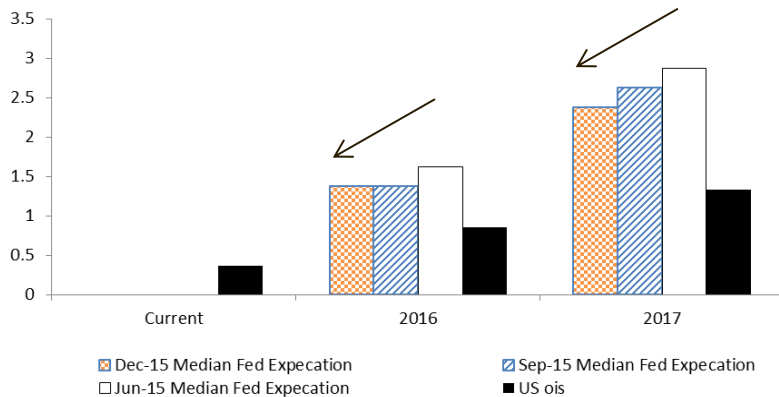
FX (II)

Rates differential is still important for EUR/USD



Source: Bloomberg

The Fed lowered rate expectations compared to September but a disconnect between the Fed and the market remains



Source: Bloomberg

- For 2016 we expect central banks to remain a dominant force for currency markets. While in 2015 one could assume that most major central banks would remain in easing mode, in 2016 this might no longer be the case. We don't necessarily expect other central banks to quickly follow the Fed, but we could see monetary policy turning more reactive and less proactive. The disconnect between what the ECB delivered at its last meeting and what the market expected might be the first sign of this. However, the jury on this is still out. The fact is that a more reactionary ECB will be less of a drag on the euro. Unlike the ECB, the BoJ didn't disappoint, but it didn't surprise either. In 2015 the BoJ had every opportunity to crank up monetary policy a notch as growth disappointed, and it failed to reach its inflation target, but it still refrained from doing so. So we expect dollar strength to be determined mainly by what the Fed does, rather than what other central banks do.
- Our base case for 2016 remains that the US dollar will strengthen. At the last meeting, Fed chairman Janet Yellen convinced the market that this is not a normal tightening cycle; it will be slower, with rates not rising as much as in previous cycles. However the difference in rate expectations between the Fed and the market remains. When the economic data in the US starts to pick up we think this will support the US dollar.

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