AQUILA

Flash

8 points for Q3 2015

- **The US economy is recovering after a weak first quarter**
- **The Eurozone is showing modest but steady growth**
- **The Chinese government can and will do more to support the economy**
- **The Fed will start raising US interest rates this year**
- **The ECB will not terminate its QE program ahead of schedule**
- **The Bank of Japan is set to pump liquidity into markets at an even faster rate**
- **Chances are high that the Greece crisis will amount to a "storm in a teacup"**
- **The world's geo-political trouble spots remain explosive**

The macroeconomic and monetary policy environment remains supportive for "risk assets". Despite likely interest rate rises in the US, greater uncertainty over trends in China and the problems associated with Greece, we remain overweight in equities.

The US economy is recovering after a weak first quarter.
The 0.2% decline in US GDP reported for the first quarter was a disappointment. This outturn partly reflected the impact of lower oil prices which led to a near 50% cut in investment by America's oil sector. Secondly those lower oil prices did not boost consumer spending in the early months of the year as had been expected. But US economic data trends have improved in the second quarter. Although industrial production and consumer spending remain on the weak side, other series – for example, those relating to the housing and labor sectors as well as consumer confidence indicators – are showing better trends. We believe that the very important consumer sector will improve in the second half of the year and, on this basis, forecast an overall growth rate for the US economy of 2.5% for 2015.

The Eurozone is showing modest but steady growth.
The 0.4% growth rate reported for the Eurozone economy in the first quarter indicates that Europe is on a trajectory of moderate growth. The fact that PMI readings for the manufacturing and service sectors are significantly above the 50 mark suggests that Europe's growth trend will continue. This development will be supported by the weak euro, low oil prices, growth in the Eurozone's export markets as well as the stimulative monetary policies of the ECB and more stable fiscal trends. With such tailwinds in place, we forecast that the Eurozone economy will grow by 1.5% this year.

The Chinese government can and will do more to support the economy.
China continues to have a lot of room for maneuver, regarding fiscal and monetary policy and the approach to regulation, so that the government is in a position to put the economy onto the desired growth path. Government moves in recent weeks – including a fourth cut in interest rates since November and directives to various institutions to support a stock market which has fallen sharply since mid-June - are evidence of this room for maneuver. Admittedly, such measures have a whiff of panic about them and do not appear to have had much impact thus far. While this may make investors cautious and encourage some to doubt the government's ability to turn the situation round, we are convinced that the government will do whatever is necessary to avoid a serious collapse of the economy and that it will eventually be successful in reestablishing a path of sustainable growth.

The Fed will start raising US rates this year.
The median forecast of FOMC members for the Fed funds rate at the end of 2015 is 0.625%. The market's forecast, as indicated by Fed funds futures, is just 0.25%. Thus, the Fed's monetary policy committee is suggesting two rate rises this year while the market is suggesting just

one. The timing of the Fed's first rate move is "data dependent". Fed Chairman Janet Yellen has stated that the Fed needs clearer signals that an economic recovery is in place before moving to raise rates. On our assessment of the US economy, a first rate move is more likely in September than December.

The ECB will not terminate its QE program ahead of schedule.

The ECB is on track with its plan to buy EUR 60bn. worth of bonds on a monthly basis up till September 2016. Better demand trends and a shift in the inflation data have encouraged some to suggest that the ECB will terminate its QE program ahead of schedule. But the thinking of Maynard Keynes is well entrenched among ECB policy makers. Not only will calls for an early termination of the program fall on deaf ears, there is in our view a greater likelihood that the program will be extended.

The Bank of Japan is set to pump liquidity into markets at an even faster rate.

The Bank of Japan's inflation forecasts remain well above those accepted in the markets. The Bank of Japan is next due to publish its macroeconomic forecasts in mid-July. Should the projection for inflation be yet again reduced, the Bank of Japan might be encouraged to further expand its QE (bond-buying) program, most likely in October. However, any such expansion would seem to have limits given that the Bank of Japan already owns around half the government's outstanding debt.

Chances are high that the Greece crisis will amount to a "storm in a teacup".

In our view Grexit need not cause a serious dislocation in financial markets. Relative to the situations in 2011 and 2012 contagion risks for the other countries on the Eurozone's periphery are now much lower as the ESM, OMT and the ECB's QE (bond-buying) programs are now established. Even were all the Eurozone's credits to Greece to be written off, overall Eurozone indebtedness would rise by a manageable 2% of GDP. In any event, Greece accounts for just 0.3% of world output and is therefore an economic pigmy. The Greek playbook – which may soon involve the establishment of a parallel currency, something which in turn would make an eventual Grexit more likely – will probably continue to concern markets for a bit longer. But later this year one may look back on recent events as having merely been a "storm in a teacup".

e world's geo-political trouble spots remain explosive.

The world's well-recognized trouble spots have fallen out of the headlines recently. But they have not become any the less explosive. Russia is still set on extending its influence. In the East China Sea, the positions of China and Japan are aggressively entrenched. In the South China Sea, China is building up its infrastructure, thus unsettling neighboring countries. Meanwhile the Middle East is in chaos.

The environment remains supportive for equities.

The macroeconomic as well as monetary policy environment remains broadly supportive for "risk assets". Despite likely interest rate rises in the US, greater uncertainty over trends in China and the problems associated with Greece, we remain overweight in equities**.**

Aquila & Co. AG, 8. July 2015