AQUILA

Flash

8 points for Q4 2015

- **The US economy is on track/doing well**
- **Eurozone's economy is growing steadily**
- **Current comment on China is too negative**
- **The Fed will make its first rate move this December**
- **The ECB will expand its QE program in terms of both size and time-scale**
- **The Bank of Japan could expand its QQE program as early as this October**
- **We still hedge EUR back into CHF but keep USD unhedged**
- **Recent stock market losses aren't the beginning of long-term equity weakness**

The US economy is doing well.
Following a reported 3.9% growth rate for the second quarter the latest Beige Book from the Fed indicates that a decent rate of expansion continued during the summer. Industrial production and consumer spending are currently laggards in the expansion process but the labor and housing markets are developing well. We don't think the slowdown in emerging market economies will have much impact on the US economy whose exports amount to less than 10% of overall GDP. There is, however, the risk that an impasse over the upcoming Budget could lead to a shutdown of all Federal programs deemed "non-essential". Congress has recently pushed the decision on a shutdown back to December when it will be considered alongside the necessary increase in the Federal borrowing limit. It would not surprise us if we saw an outbreak of Washington "political theater" along the lines of that which occurred in October 2013 when a 16 day Federal shutdown cost the economy around 0.2% of GDP.

The Eurozone economy is experiencing a phase of moderate growth.
The Eurozone economy seems to be stuck in a trend of steady but rather modest growth. At the level of individual countries, Spain stands out with a year on year growth rate of 3.1% in the second quarter. Although not a member of the Eurozone, the UK's growth rate in the second quarter – 2.6% year on year – is also worth noting. France, on the other hand, registered a zero quarterly growth rate in the second quarter. The Eurozone economy is being supported by the weak euro, much lower oil prices than a year or two ago and the expansionary monetary policy stance of the ECB. Given recent readings for Europe's Purchasing Manager Indices, which are significantly above the 50 threshold that indicates expansion, it seems that the Eurozone has not been negatively impacted in any serious way by the present troubles in emerging market economies.

Current comment on China is too negative.
The way the Chinese economy is being reported, especially in the English language press, is remarkable. Turbulence and declines in the Chinese stock market and the depreciation of the yuan are being interpreted as signs of serious economic weakness. In fact, the published economic data are not as bad as portrayed, although the picture they give is admittedly mixed. We believe that the measures that have already been put in place – regarding fiscal and monetary policy as well as regulation – will bring about at least a stabilization of the economy in the fourth quarter of this year.

The Fed will probably raise rates in December.
The Fed had so prepared markets for a rate rise in September that investors seemed prepared to look beyond the event. It is most unfortunate that the Fed passed on its opportunity to

move. A modest step towards a more normal monetary policy stance would have improved investor confidence. It seems that 13 out of 17 Fed governors still expect a first rate rise this year and the Fed's forecast of a 0.375% rate for the year-end is now pretty near the market's expectation at 0.25%. Given this, we forecast a first move in December which we think will be taken positively by the markets.

The ECB will expand its QE program in terms of both size and time-scale.
In the most recent press conference Mario Draghi indicated more than once that the ECB is prepared to use all its options in framing monetary policy. Already the possibility had been raised of increasing the planned total for purchases. New ground has now been staked with the suggestion that the ECB's QE program might run beyond its scheduled end in September 2016. On our calculations, the ECB, if it used all its options, could end up buying around 2,600 bn. euros worth of bonds instead of the initial 1,100 bn. euro target. Were the 60bn. euro monthly purchase rate to be maintained, a 2,600bn euro total purchase target would require that the program be extended by at least two years. We would not be surprised if the ECB were to announce further steps to scale up its QE program within the next three to six months.

The Bank of Japan could expand its QQE program as early as this October.
The Bank of Japan's inflation forecasts still lie significantly above those of the market. The Japanese central bank will next publish its macro forecasts at the end of October. A further reduction in the published forecast for inflation could provide the trigger for another expansion of its bond buying program. We expect the Bank of Japan to announce further measures of monetary expansion by April 2016 at the latest.

Our US dollar exposure is unhedged but we continue to hedge euro exposure back into Swiss francs.
Since the middle of July the Swiss franc has been on a weakening trend and on September 11 the Swissie stood above 1.10 to the euro for the first time since mid-January when the SNB lifted its "floor" for the franc against the euro. Switzerland's trade surplus, its strong current account surplus and superior performance in terms of inflation do not seem to fit with recent trends for the Swiss franc. On the other hand, SNB purchases of foreign currencies, the fact that the franc still trades above its purchasing power parity and, perhaps most importantly, Switzerland's loss of attraction as a place to keep assets are all plausible explanations for those trends. As a weakening franc might turn out to be the harbinger of a still weaker euro we continue to hedge euro exposure back into francs. Our US dollar exposure, however, remains unhedged.

Recent stock market losses aren't the beginning of long-term equity weakness.
As soon as investors had marked the latest Greek crisis as being over, markets became gripped by fears of an abrupt slowdown in the world economy. The Fed's decision not to raise rates in September bought the simmering anxiety to boiling point amid concerns that the substantial sell-off in markets since mid-August could represent the beginning of much longer-term period of equity weakness or a bear market. But bear markets generally occur in the context of recessions and, while we recognize that the world economy has weakened, we still don't expect a recession. Thus we regard recent equity declines as a nasty correction rather than representing the start of long-term weakness. Recent hysteria as to the risk of a global recession should die away allowing the equity markets to make gains over the remainder of the year.

Aquila & Co. AG, 2. October 2015