



RICHES
FLORES
RESEARCH

GLOBAL MACRO & THEMATIC
INDEPENDENT RESEARCH

CLOUDS GATHERING ON RISKY ASSETS

CONFERENCE MAY 13, 2014

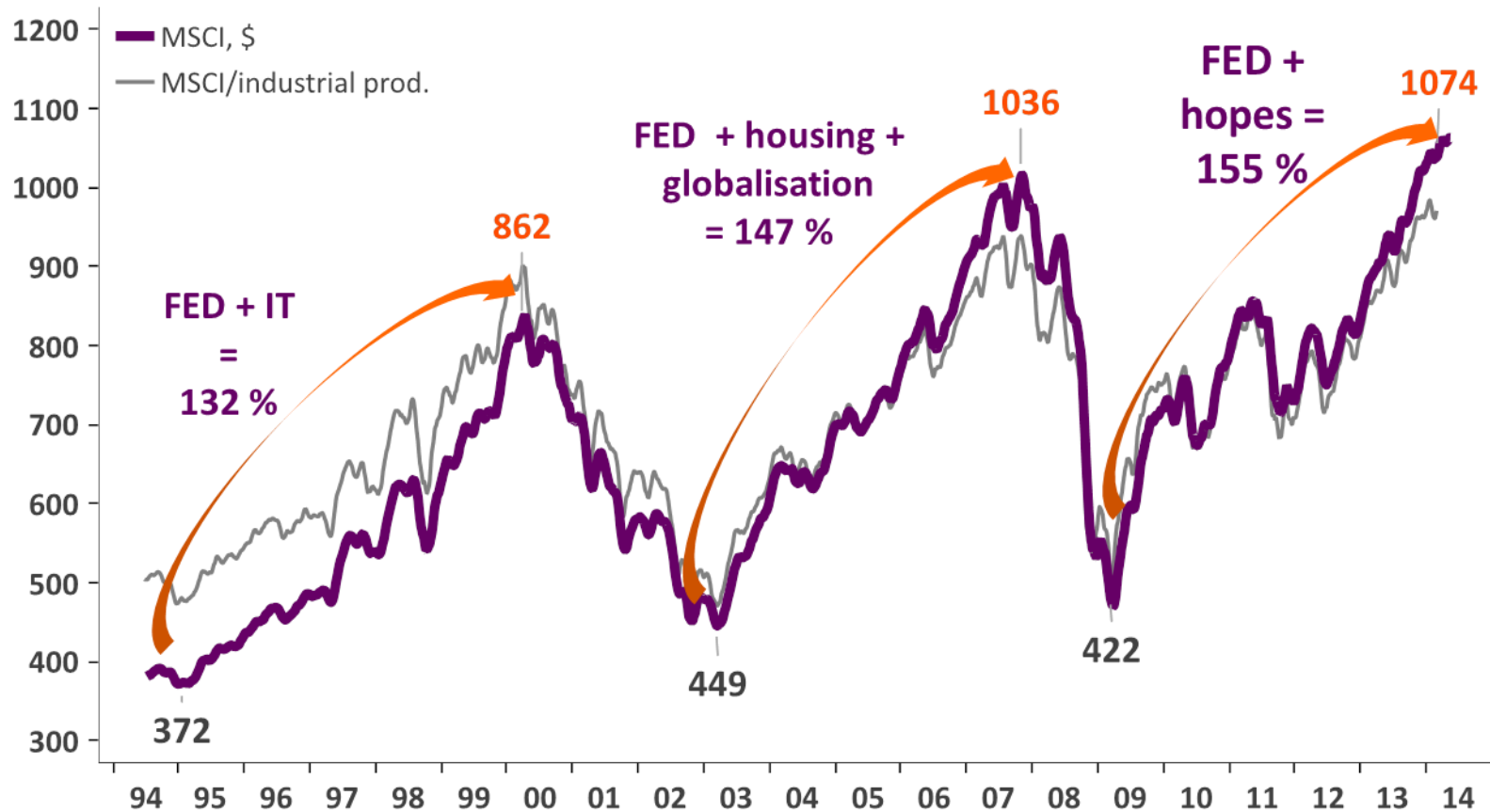
V. RICHES-FLORES

UNTIL NOW, EVERYTHING HONKY DORY...



But for how much longer?

MSCI World Index



Sources: RichesFlores Research, Macrobond

Main drivers of expected returns

QE

1

- *Restoration of finance mechanisms*
- *Less onerous deleveraging*
- *Support to housing/wealth effect*

ECB/EMU

2

- *Channeling extreme risk*
- *Consolidation of European construction in long run*
- *German inflation with rebalancing effects*

**SCIENTIFIC
REVOLUTION**

3

- *Productivity, investment, cycle extension*
- *Exceeding physical limits of growth*
- *Hopes of higher yields*

**EMERGING
MARKETS**

4

- *Burgeoning middle class*
- *Renewing global demand*
- *Development of financial markets*

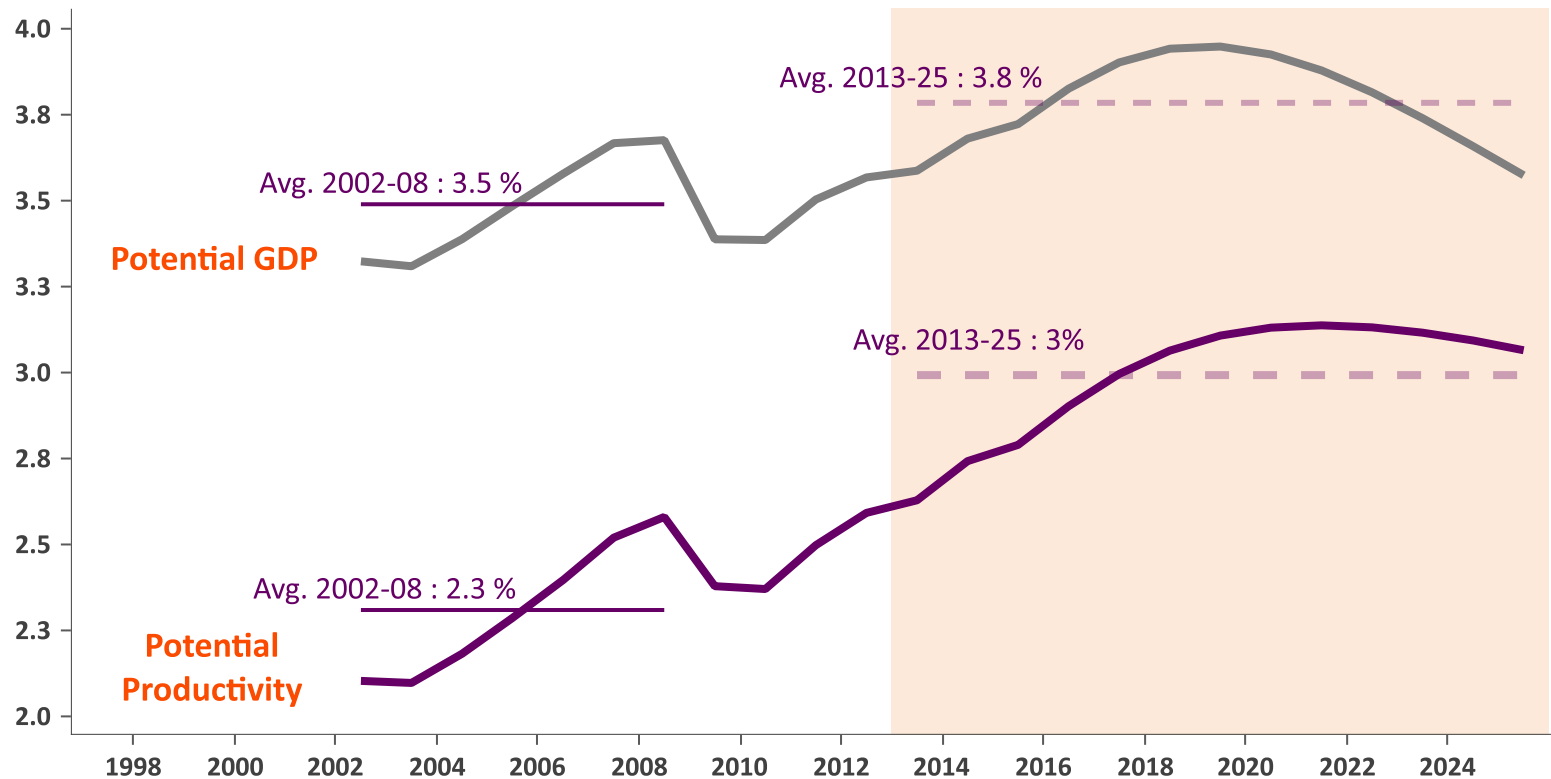
**FRONTIER
MARKETS**

5

- *New sources of supply*
- *Investment diversification*

“The Great Moderation 2.0”. A utopia propped up with big firepower

Potential GDP and Productivity Growth of The Global Economy According to OECD Long-Term Forecasts



Sources: RichesFlores Research, Macrobond

* See John Normand, JP Morgan Chase & Co, London, May 8 2014

The reality: without the sugar coating

- **QE** – *U.S. growth drivers are too damaged to not be affected by end to QE*
 - Whether QE ends or continues, long-term interest rates will not rise, they will fall
- **EMU** – *Deflation, no surprise. The survival of the EMU will require more - and different - firepower. This will take time*
 - The ECB forced to take action over the long haul... up to calling for fiscal easing?
- **Productivity** – *The innovation era not coinciding with the economic cycle*
 - Productivity gains have stalled. investment is soft. the profit cycle is stagnant
 - The current cycle does not resemble a lasting cycle in the least bit
- **Emerging markets** – *From source of growth to source of instability*
 - The “Next Eleven” do not have the critical mass or stability to replace China
 - The halt to the globalization process has robbed the global economy of its biggest EM growth driver

QE

U.S. growth drivers are too weak to
be taken off QE without serious side
effects

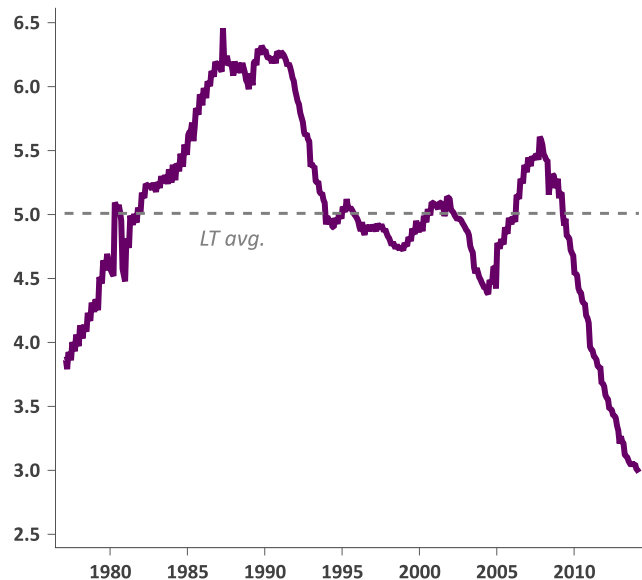
Limits of a necessary but insufficient exercise

- **The bank bailouts provide no certainty on normalization of finance conditions:**
 - The cost of debt has plummeted but not its volume: weak demand
 - Economy rife with uncertainty: supply held in check
- **Housing prices have risen too quickly, penalizing rather than bolstering the recovery**
 - Prices have returned to pre-crisis levels while the volume of transactions are still at all-time lows
 - Service industry growth has been hit and employment along with it
- **The growth potential of the U.S. economy is deteriorating**
 - Economic weakness precludes monetary policy normalization
 - Tapering may not make it to the finish line. No room for rate hike

The cost of deleveraging

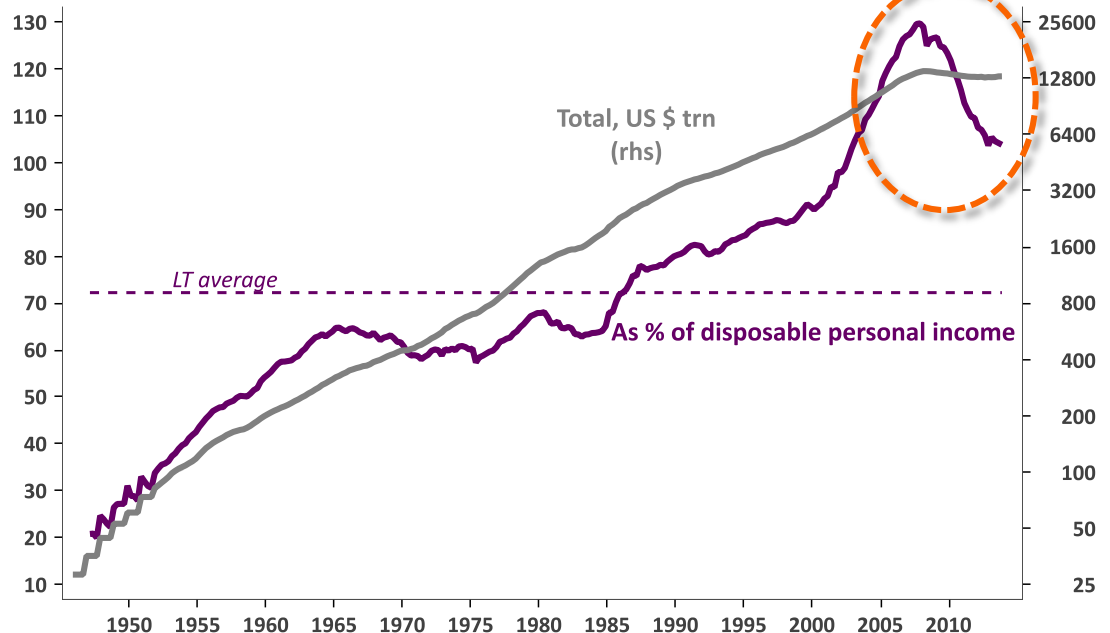
The cost of debt has plummeted yet the fall in the rate of indebtedness has been very slight. For housing starts to return to their long-term average (1.5m/year), indebtedness would have to return to its pre-crisis level...

Interest Payments on Mortgages, as % of Disposable Personal Income



Sources: RichesFlores Research, Macrobond

US Personal Debt

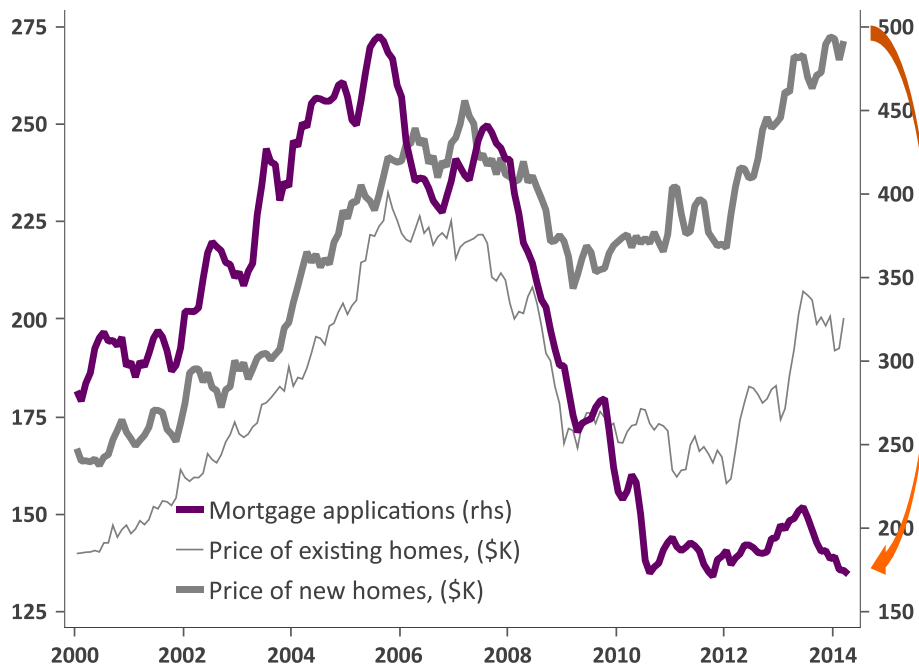


Sources: RichesFlores Research, Macrobond

Rising housing prices is not bolstering the recovery, it's holding it back

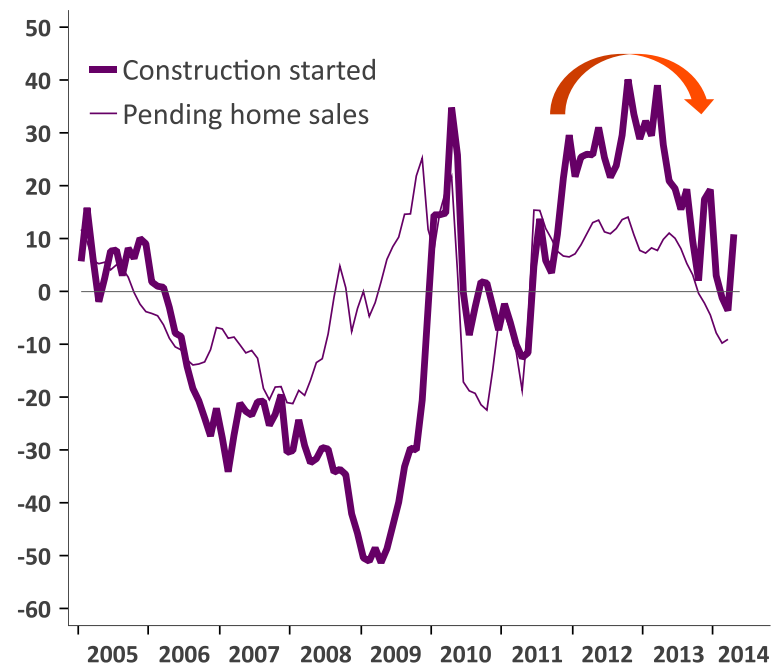
A lack of supply and acquisitions by institutional investors have increased prices too quickly. Prices are now too high and are preventing economic normalization; sensitivity to interest rates is extreme.

Mortgage Applications and Real Estate Prices



Sources: RichesFlores Research, Macrobond

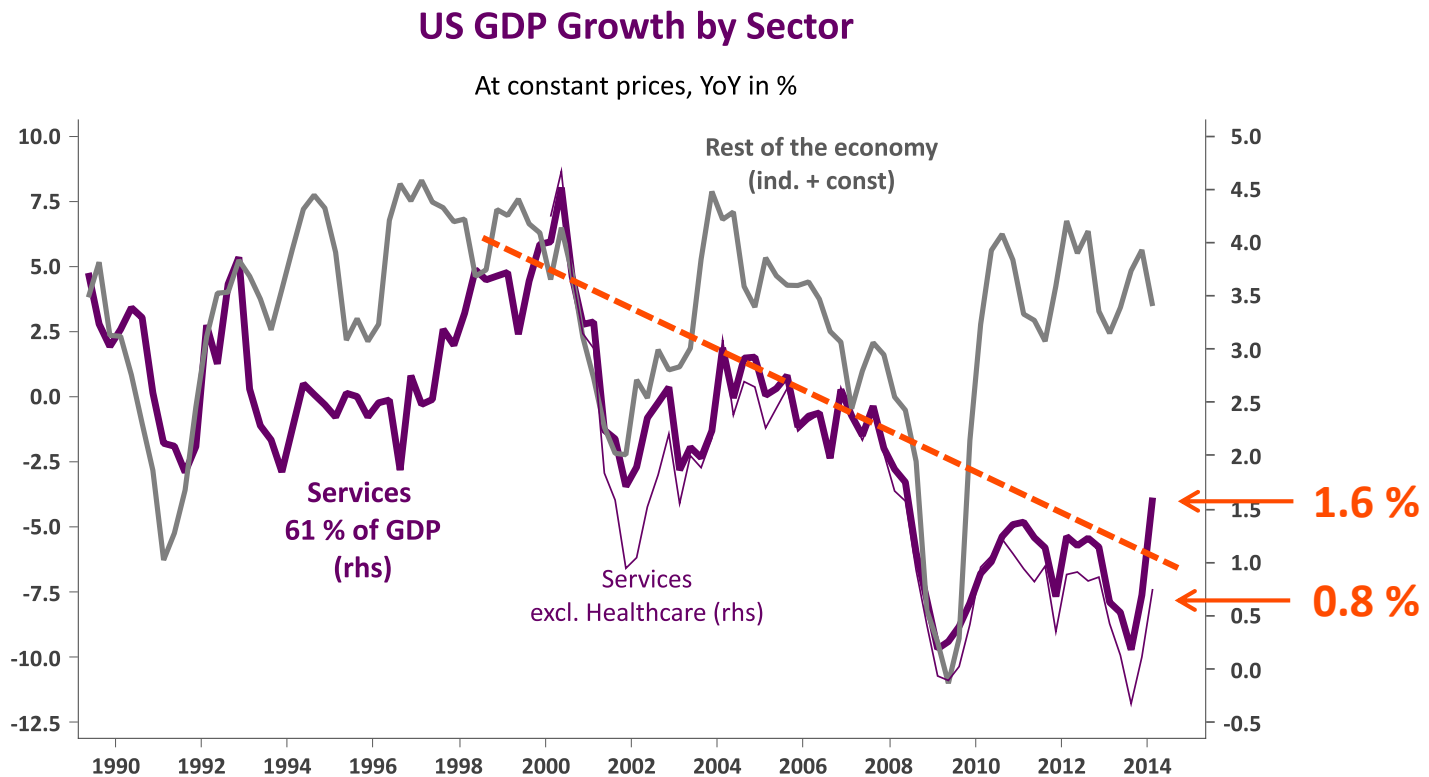
Real Estate Indicators, YoY in %



Sources: RichesFlores Research, Macrobond

Erosion of the service industry as a growth driver

In decline for the past decade, service industry growth has not recovered from the 2008 crisis. The Q1 rebound was the result of increased health spending in the wake of the implementation of Obamacare.

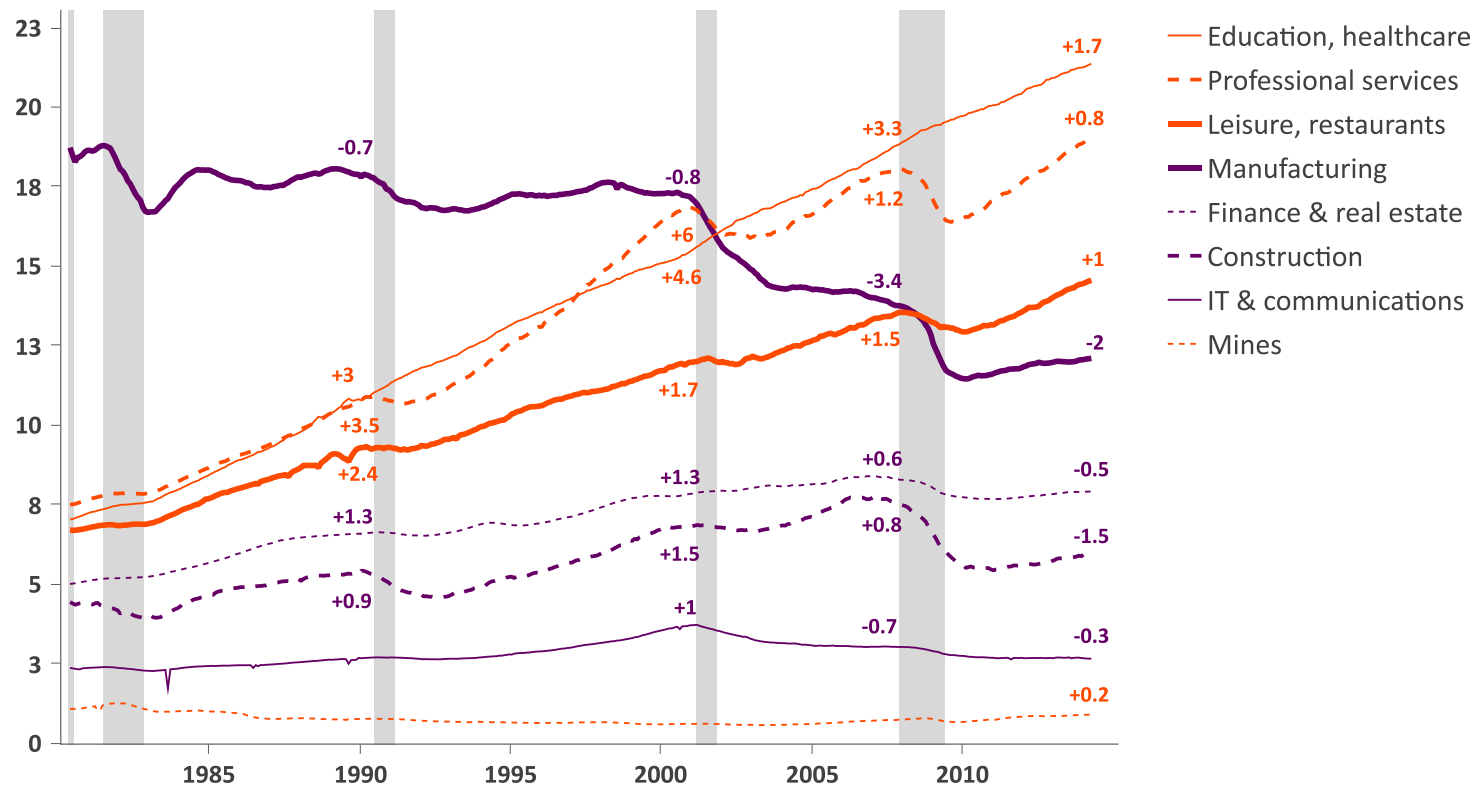


Sources: RichesFlores Research, Macrobond

Jobs growth is structurally shaky

Many sectors that have traditionally created jobs are no longer playing such a role. Low-qualified jobs are suffering the most.

Nonfarm Payroll and Changes from Peak to Peak in Millions

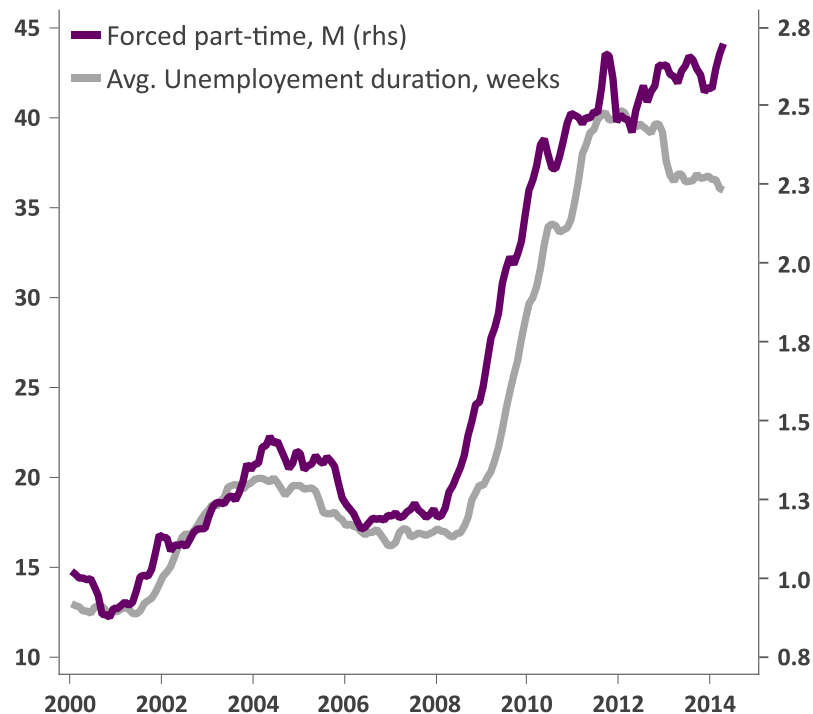


Sources: RichesFlores Research, Macrobond

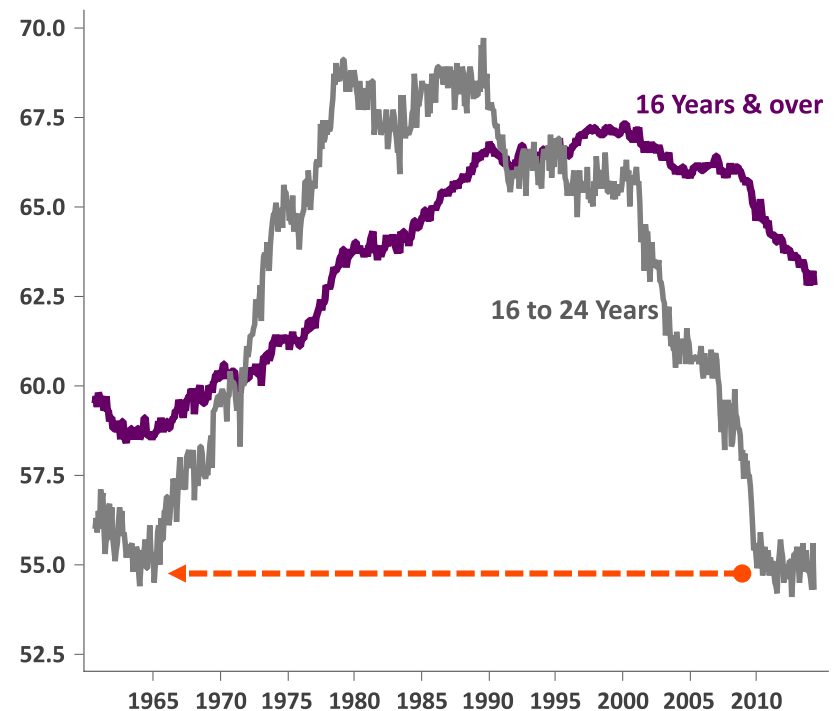
Job shortage, discouragement, less mobility are hurting growth potential

Forced part-time positions are growing in number; the participation rate of young people is plummeting; mobility of Americans continues to decline (20% in the early 90s, 11% in 2013).

Job Market Indicators



Participation Rate of Labor Force



Sources: RichesFlores Research, Macrobond

Sources: RichesFlores Research, Macrobond

ECB/EMU

As expected, fiscal tightening, monetary paralysis and the rising euro have all led to deflation. The survival of the EMU will require an extra step...in a different direction

Deflation, here we are

1

- *Inflation excluding taxes is down to 0.25% in the EUM and negative in eight countries*
- *Domestic and international prices are under pressure*
- *Household anticipations are falling*

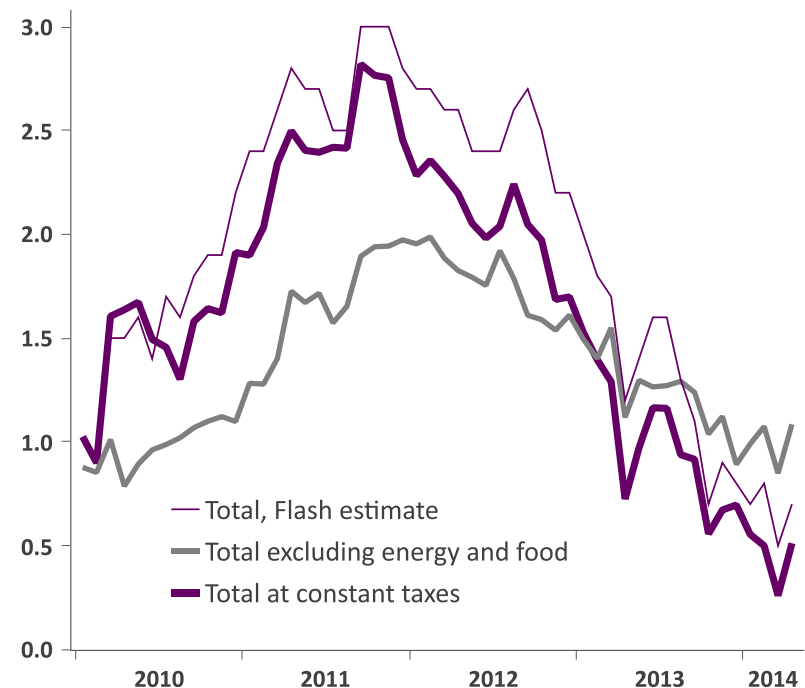
2

- *Pro-cyclical fiscal policy is largely to blame*
- *Monetary policy, which is de facto pro-cyclical given inaction, worsens the mix*

3

- *Reversing the trend will be difficult:*
 - *Chronic lag of ECB action*
 - *Rising euro*
 - *Fiscal adjustment continues*
 - *Global environment*

Inflation in Euro Area

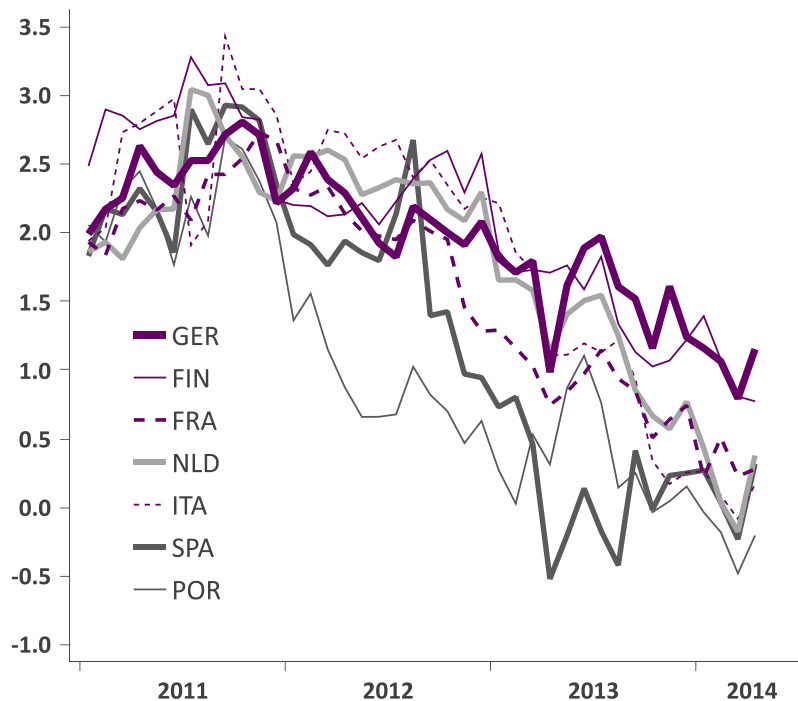


Sources: RichesFlores Research, Macrobond

Germany and northern eurozone countries are following down the same path

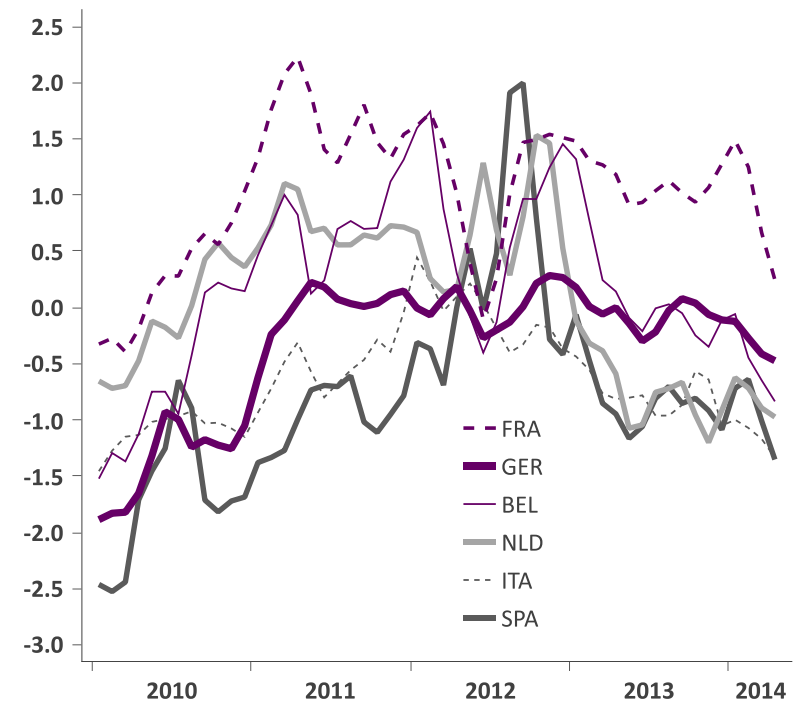
Too integrated to be decoupled. Germany's economy is not robust enough to transform easy monetary conditions into inflation.

Inflation at Constant Taxes



Sources: RichesFlores Research, Macrobond

Households Perceptions on Future Inflation

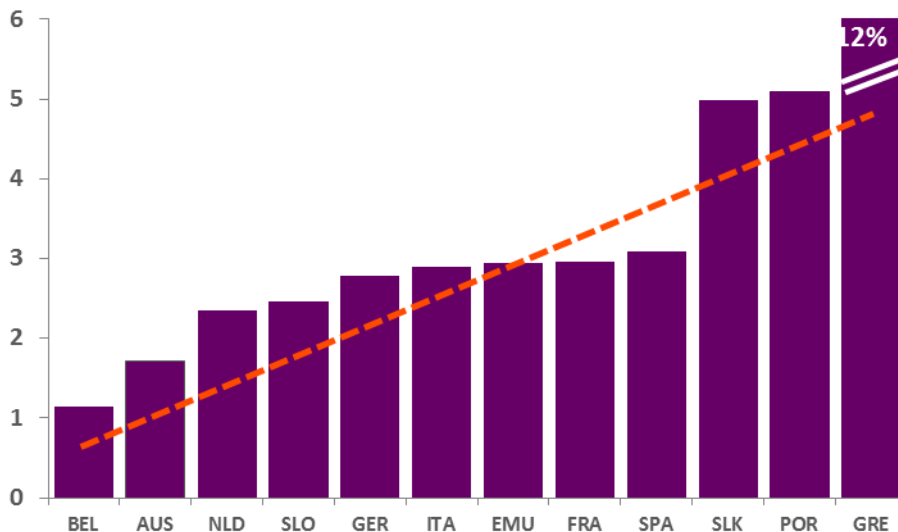


Sources: RichesFlores Research, Macrobond

Here's why...

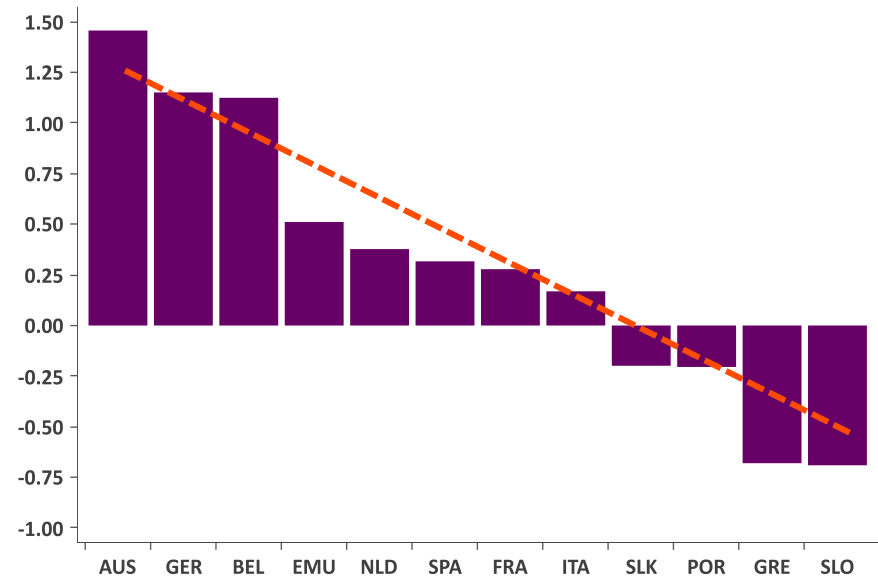
The #1 cause of inflation is draconian fiscal restraint. To offset austerity, the euro will need to collapse to historical lows...

Fiscal Tightening : 2010 - 2013
Change of the structural primary balance in % of GDP



Source: RichesFlores Research, base AMECO

Annual Inflation at Constant Taxes, March 2014

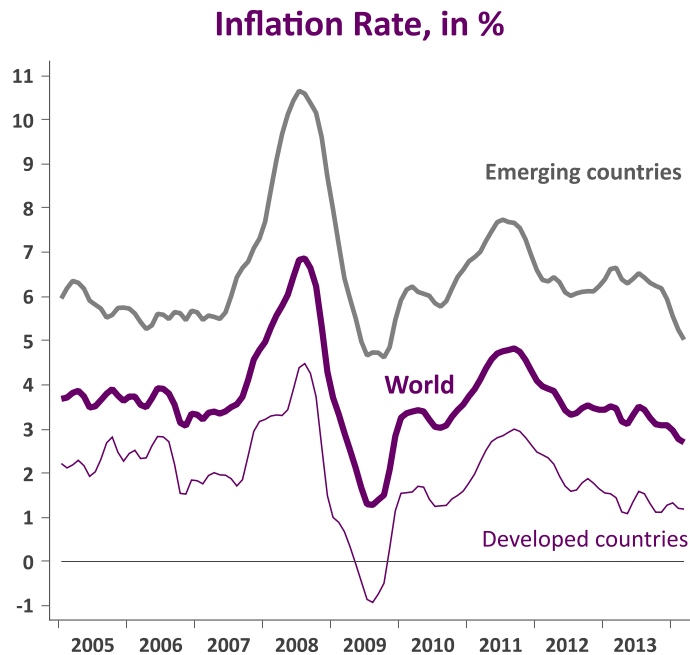


Sources: RichesFlores Research, Macrobond

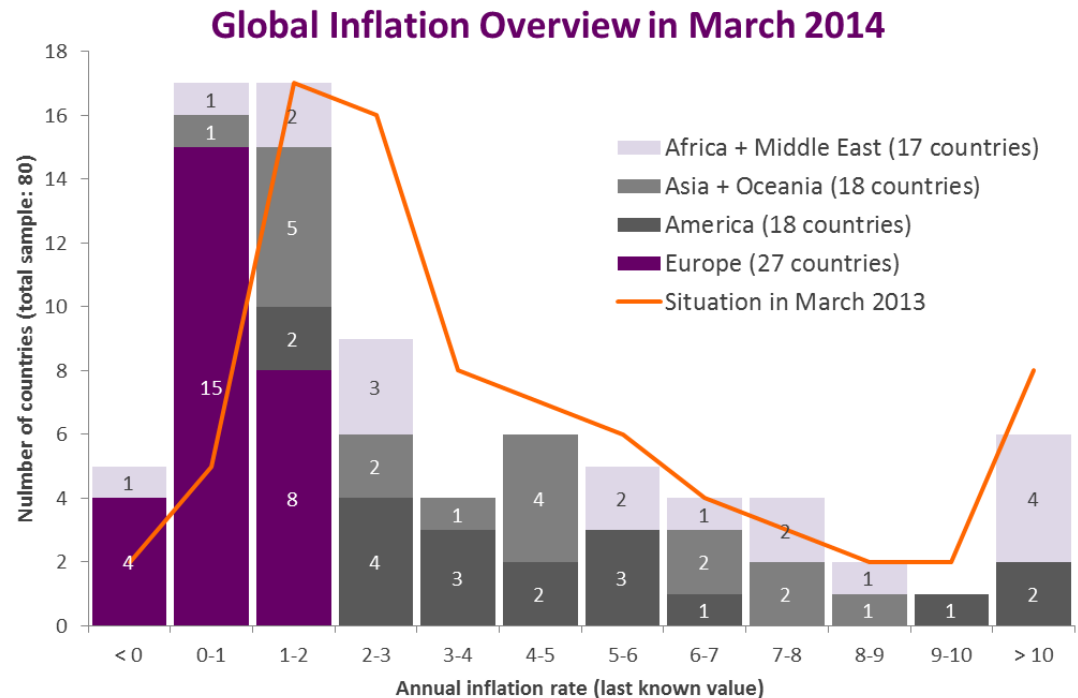
Global environment is not helping

Disinflation is gaining ground on a global scale, to 2.7% in March, its lowest since 2009.

39 countries/80 have inflation of less than 2% currently.



Sources: RichesFlores Research, Macrobond



Sources: RichesFlores Research, IMF, Macrobond

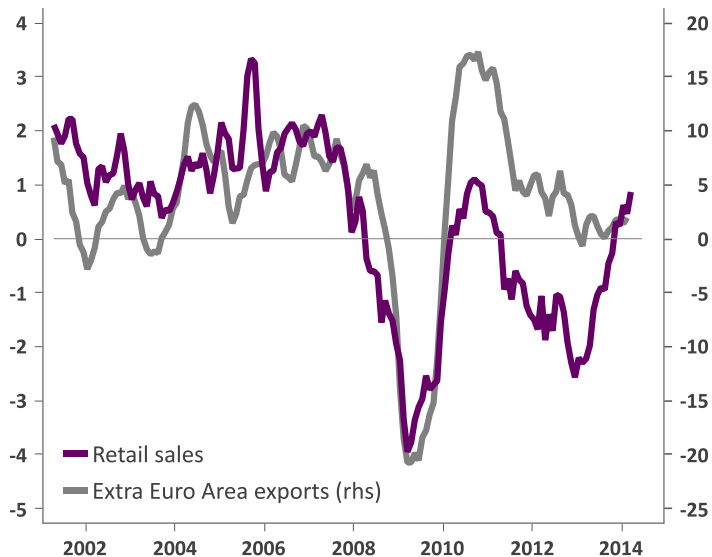
[Global inflation: see details in our latest monitor](#)

Economic indicators are not strong enough to counter risk of contagion

The recovery, driven by domestic demand, is vulnerable to the passing of time; domestic drivers cannot be supported without export support... but the export environment is deteriorating.

EMU : Retail Sales and Exports

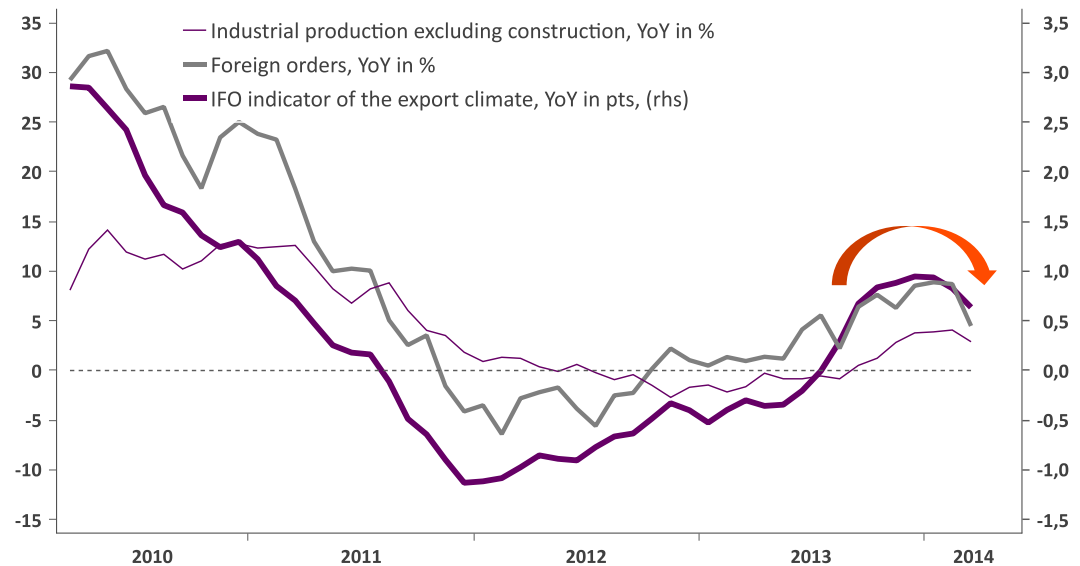
YoY in %, volumes



Sources: RichesFlores Research, Macrobond

Orders, Export Climate and Production in Germany

12M changes, 2MMA



Sources: RichesFlores Research, Macrobond

Deflation, a poison with multiples effects

Sapping
structural
growth

INVESTMENT EROSION by the increase in real interest rates
and falling profitability
DEMAND DELAYED as consumers expect prices to be lower in
the future

Inflating debt

MORE EXPENSIVE DEBT by the increase in real rates
HIGHER DEBT by the drop in nominal demand
EROSION OF CREDIT by the increase in real interest rates and
the drop in solvency of economic participants

Appreciating
currency

HIGHER REAL YIELD
PURCHASING POWER PROTECTED

**THE CURRENT POLICY IS A DEAD-END... BUT ADMITTING IT
WILL TAKE TIME**

Scientific and technological revolution

Progress is unprecedented and
absolutely critical but application
requires time

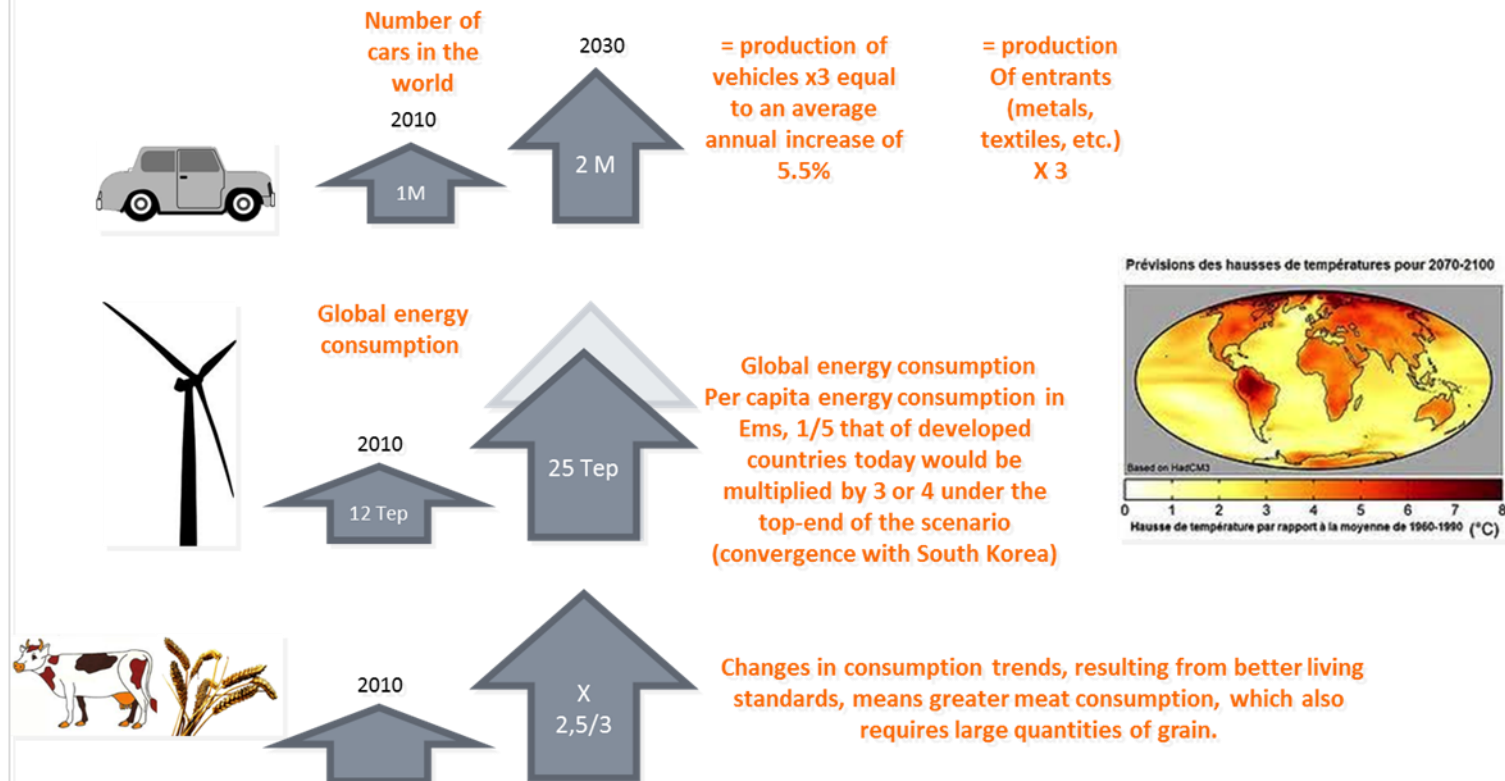
Innovation takes time

- **Innovations: absolutely critical for surpassing the physical limits of global development and getting around the rarefaction of resources**
 - Energy/Water/Space
 - Soil/Agriculture/Food
 - Labor
- **Progress is breathtaking, applying it remains to be seen, answers are still lacking in many areas**
 - From Nano technologies to biosciences, advances are often spectacular
 - But the time from discovery to using discoveries can be long: resistance to change in lifestyles and production processes, political disarray, etc.
 - The innovation cycle is not dovetailing with the business cycle
 - The present cycle is not being boosted by this progress
 - Productivity and investment are stagnant and profit growth is wilting. What is going to keep the cycle going?

An imperative for surpassing the physical limits of the planet's development

Slide taken from the presentation "Emerging markets: what has changed" from 2/12/12
French version available at
www.richesflores.com

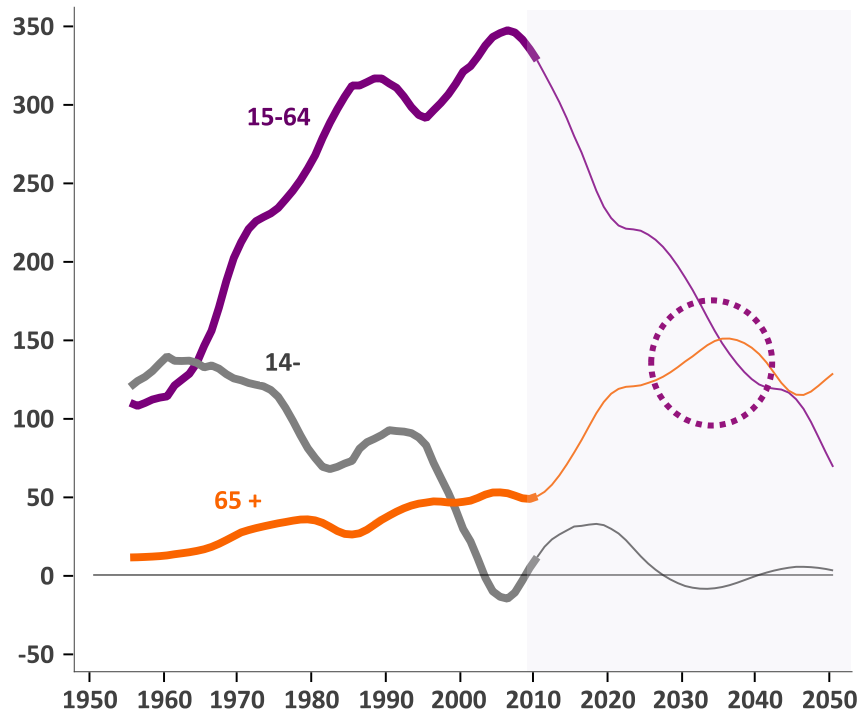
Explosion in needs: a few numbers



Substituting increasingly rare labor with productivity: a dire necessity

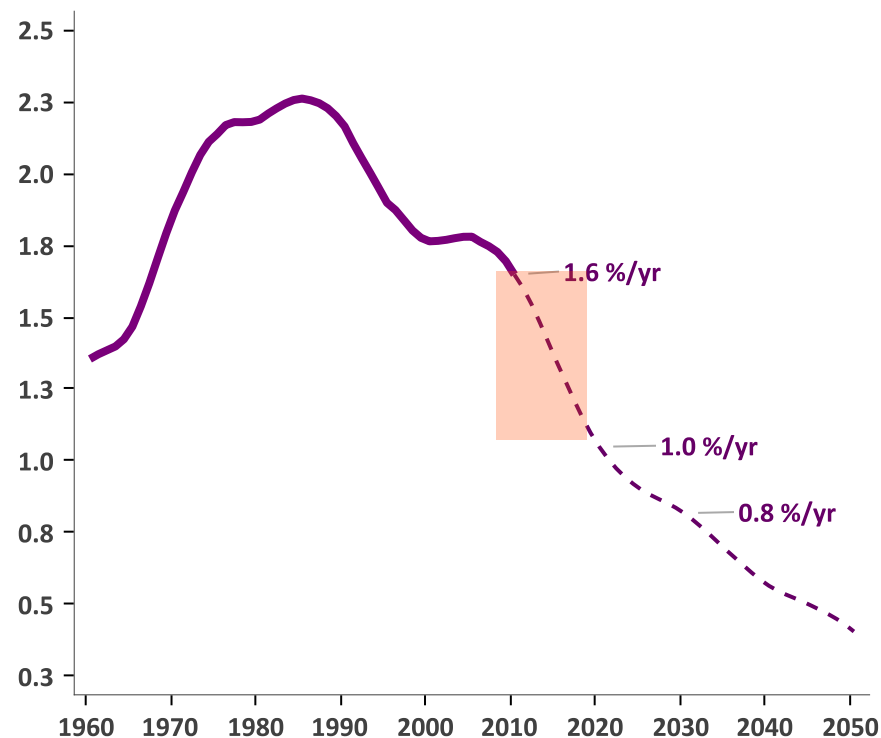
Global Population Growth By Age Category

5Y growth, in millions



Sources : RichesFlores Research, Macrobond

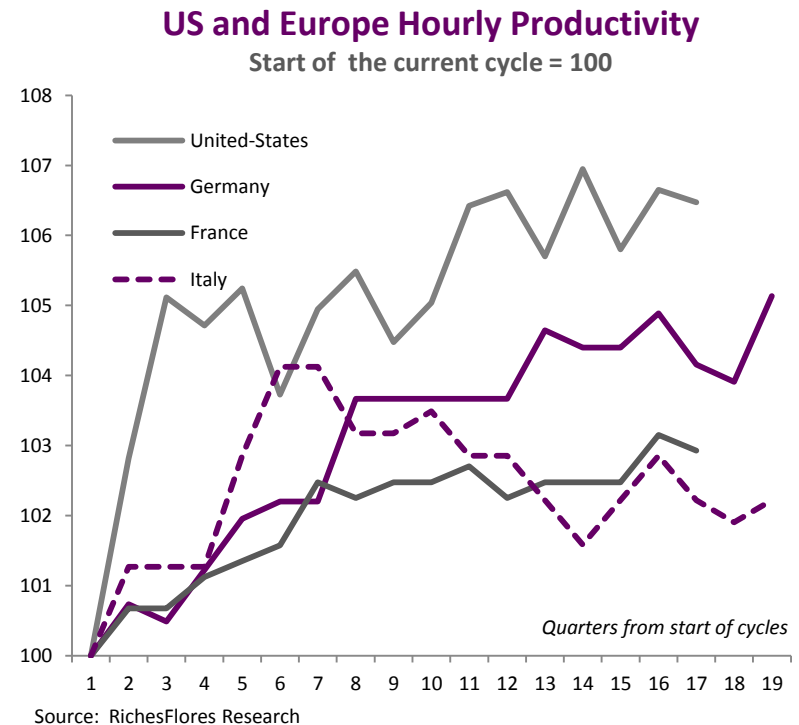
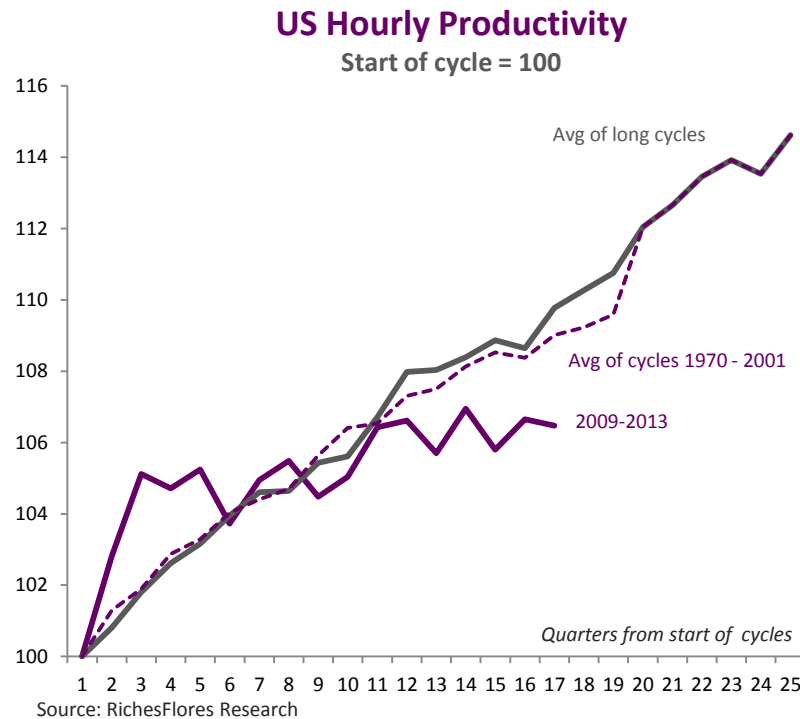
Average Annual Growth Rate of Global Working Age Population, 10Y avg.



Sources: RichesFlores Research, UNO, Macrobond

Positive effects from innovation are lacking for the time being

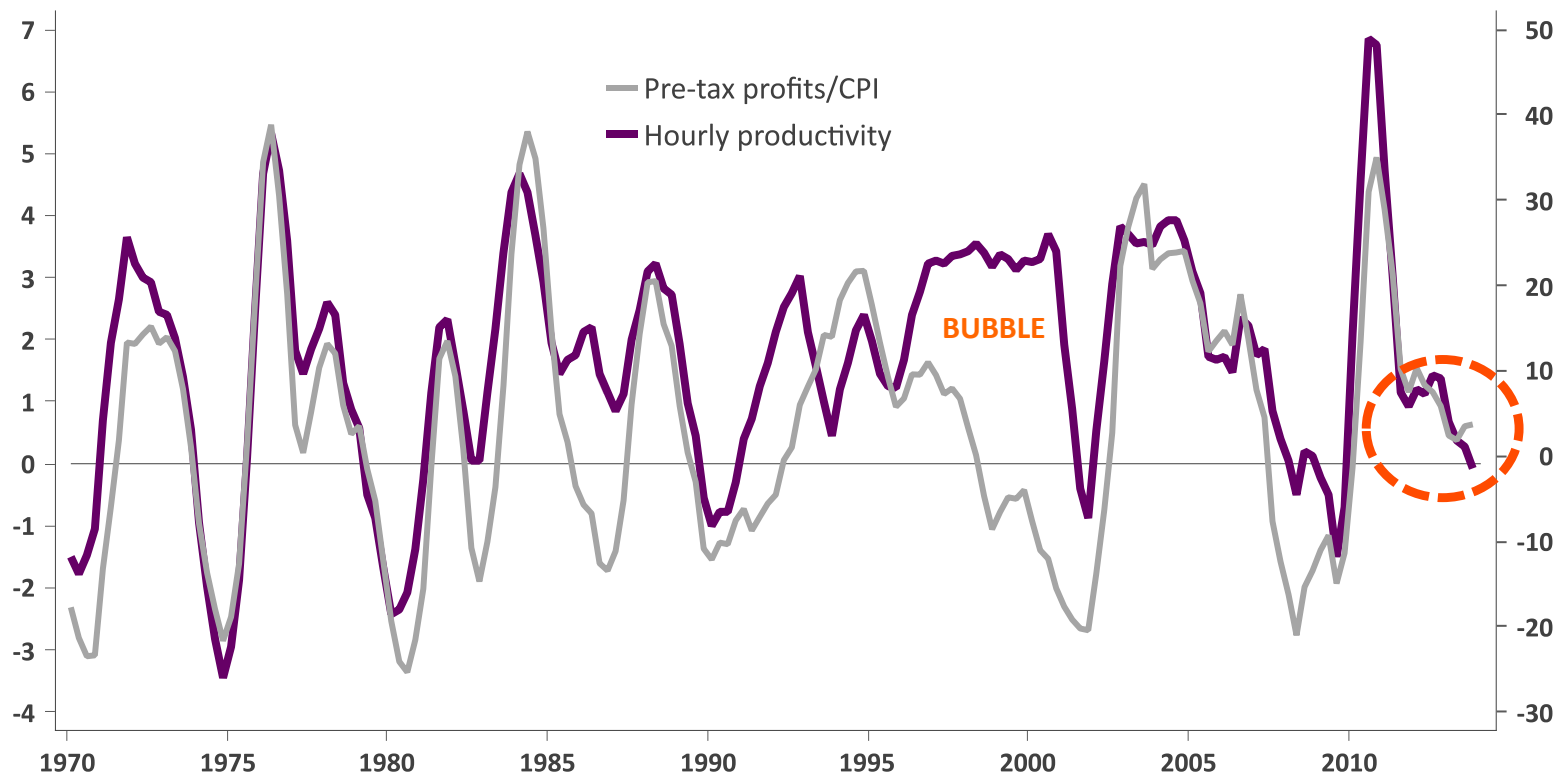
Productivity gains have been very slow in the present cycle in the advanced countries while falling in the main EMs.



Weak productivity gains = weak profit growth

Hourly Productivity and Real Profits of US Companies

YoY in %, 2MA

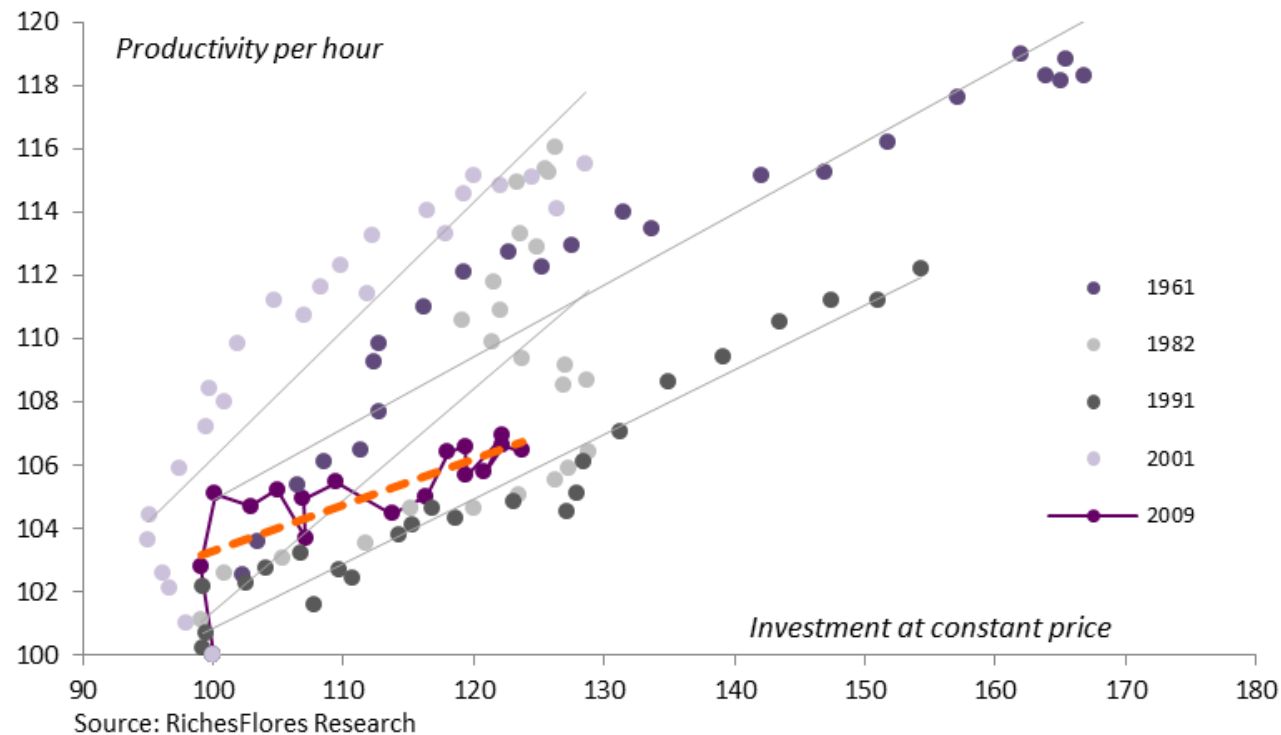


Sources: RichesFlores Research, Macrobond

Chronic weakness in investment = shorter cycles

Tepid productivity gains and profit growth reduce investment growth and prevent from extending the cycle.

Productivity and Investment during US Growth Cycles



Emerging markets

From source of growth
to source of instability

China: more than just a blip

Severe slowdown

All indicators are worrisome

- On the external front (anemic exports, stagnant – at best – imports)
- On the domestic front: consumption is starting to sag, private investment is faltering

Spreading fast

China's troubles spreading fast

- In Asia and in other emerging markets
- For other exporters of manufactured products and basic industrial products
- To commodities and global inflation

Difficult resolution

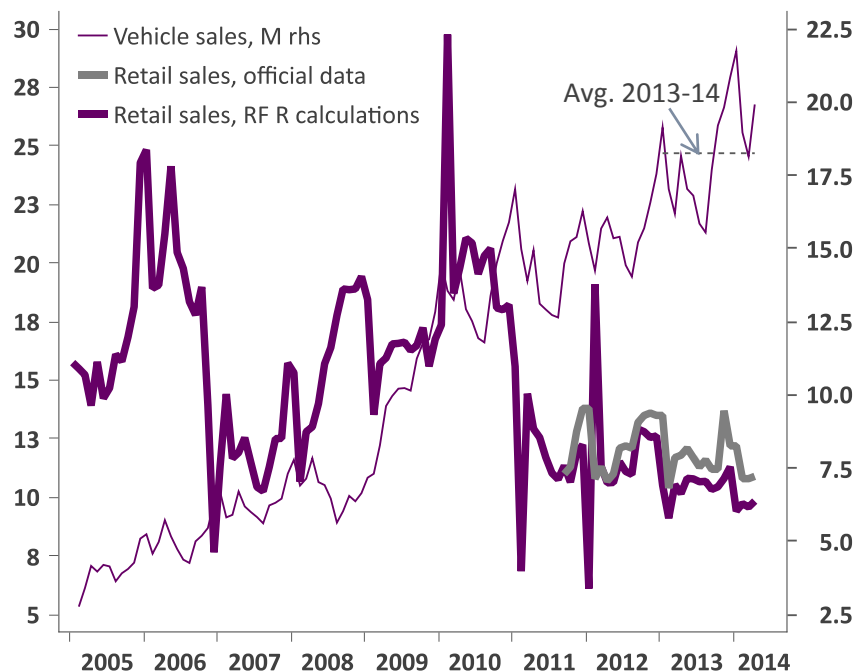
Industrial transition, ageing of the population, deleveraging... all impediments to structural growth
Domestic drivers cannot be the sole sources of growth

Does China have any other way out besides a depreciating currency?

The situation is worsening

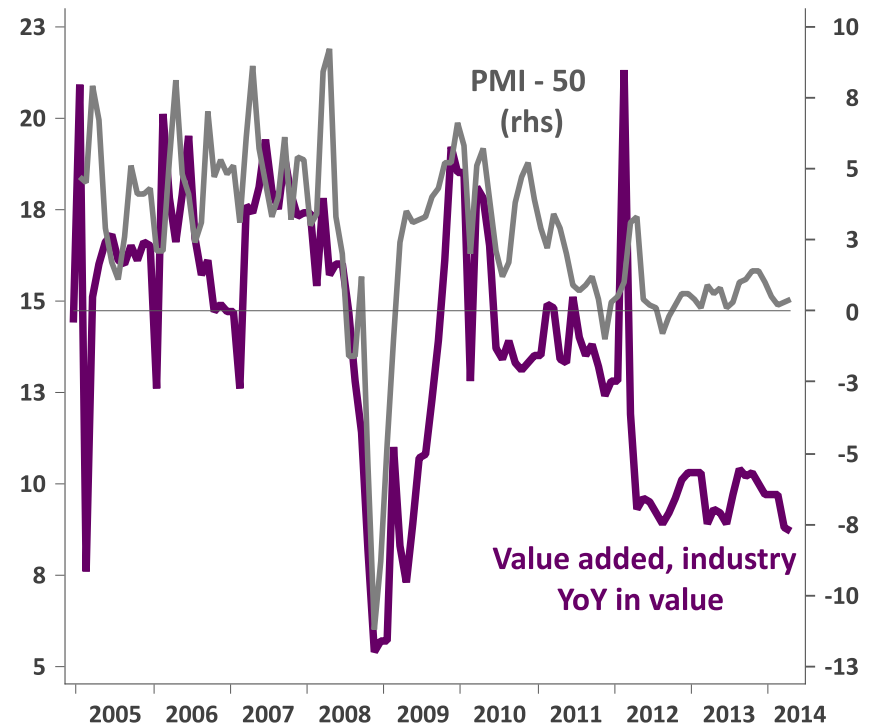
Retail sales growth and industrial production at lowest levels. Automobile sales fluctuating at their recent average.

Annual Retail Sales Growth and Vehicle Registrations, Volume



Sources: RichesFlores Research, Macrobond

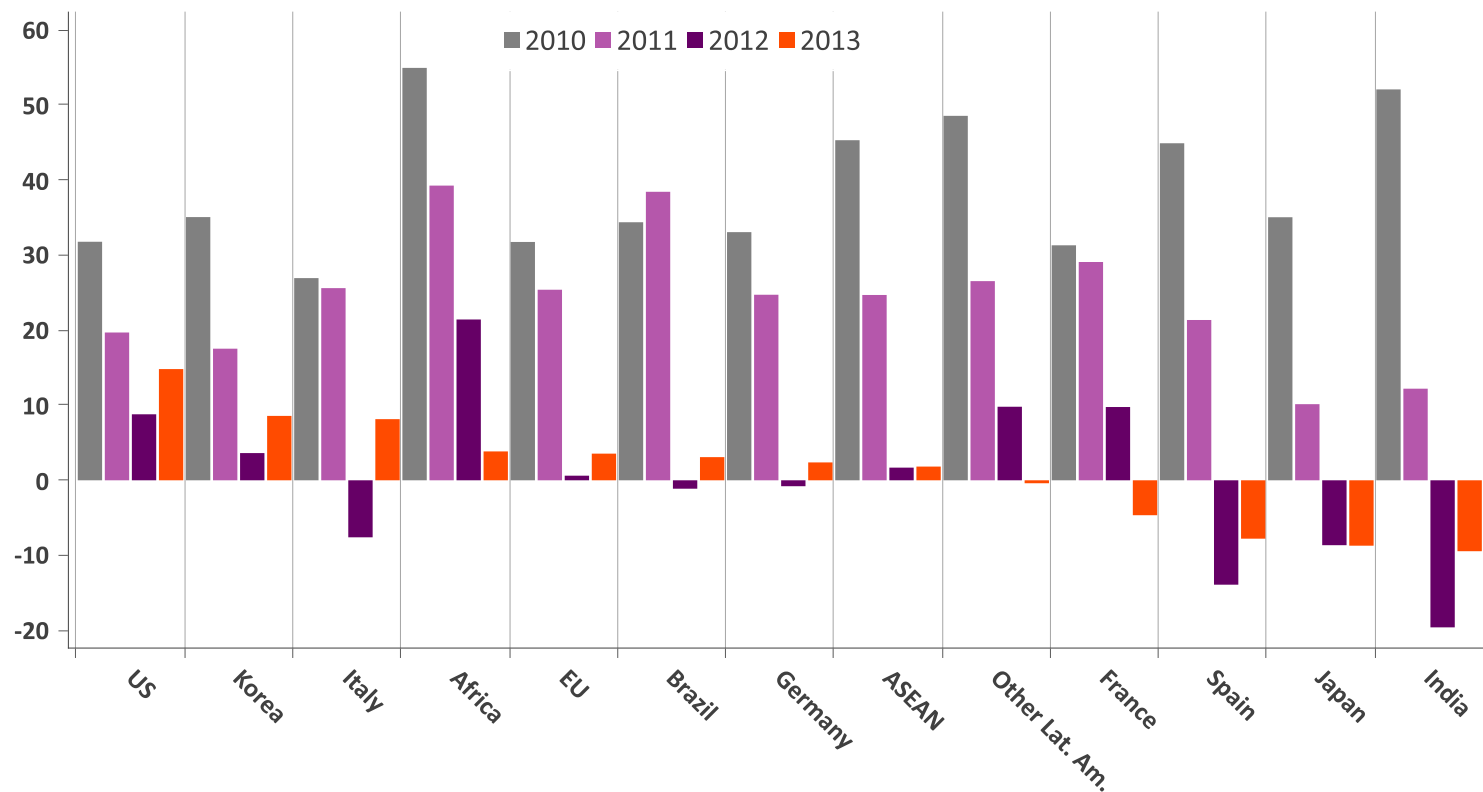
Industrial Production and PMI in China



Sources: RichesFlores Research, Macrobond

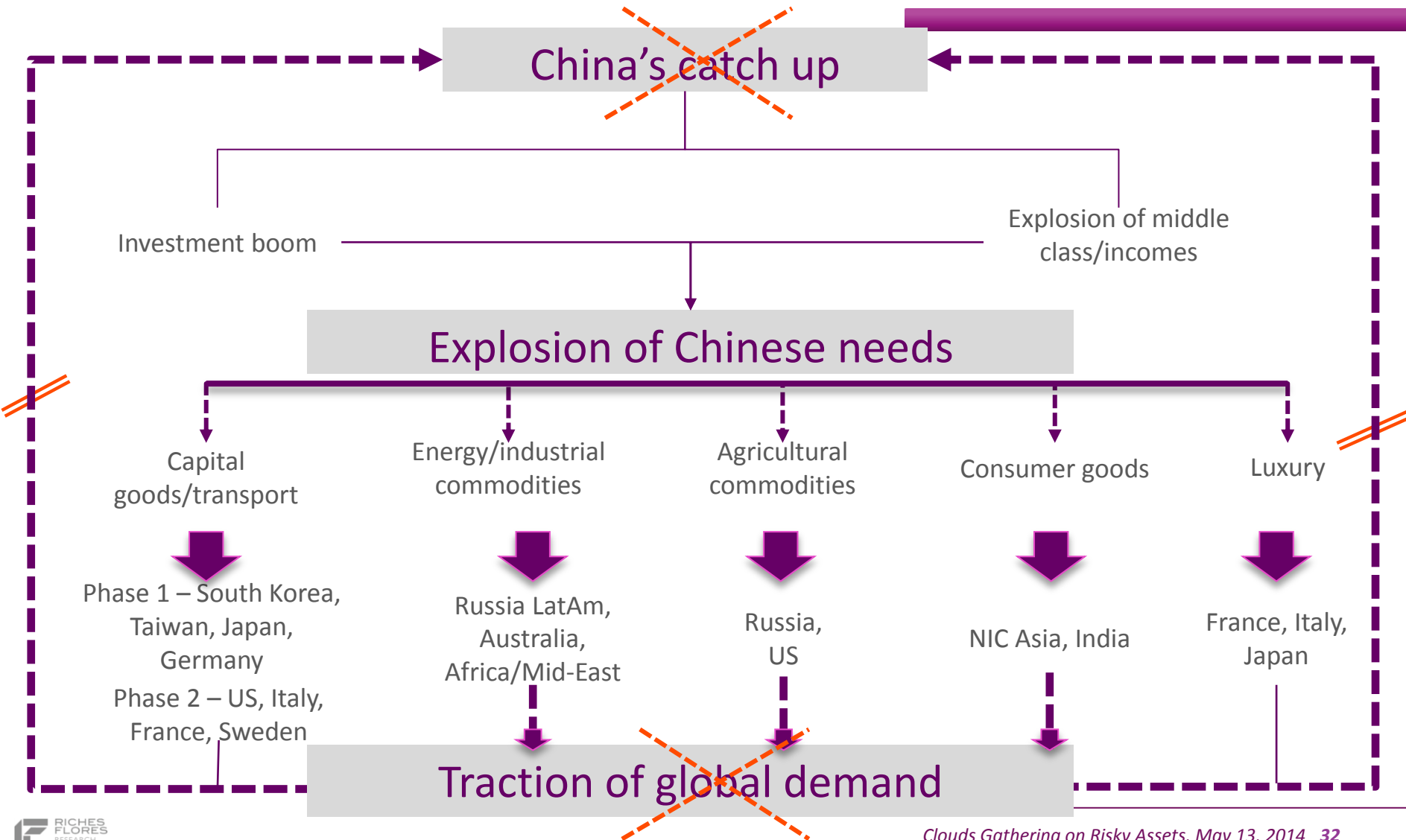
Chinese markets, driver of the 2010-2011 recovery, missing in action since 2012

Growth of Chinese Imports by Country 2010-2013, in %



Sources: RichesFlores Research, Macrobond

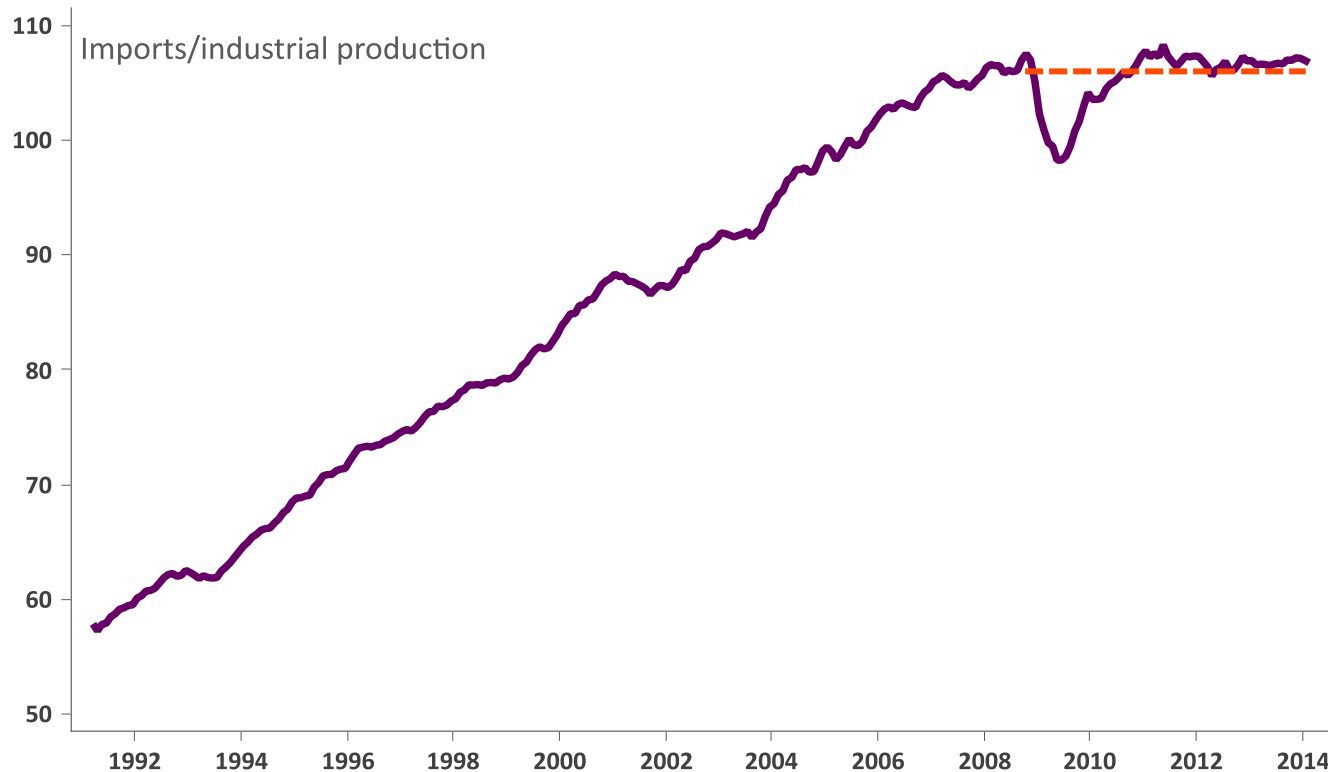
The mechanism is stuck for the rest of the world and, consequently, for China itself



Global economic lethargy, crux of the break with the pre-crisis period

... The price of reducing current account imbalances

Import Content of World Production



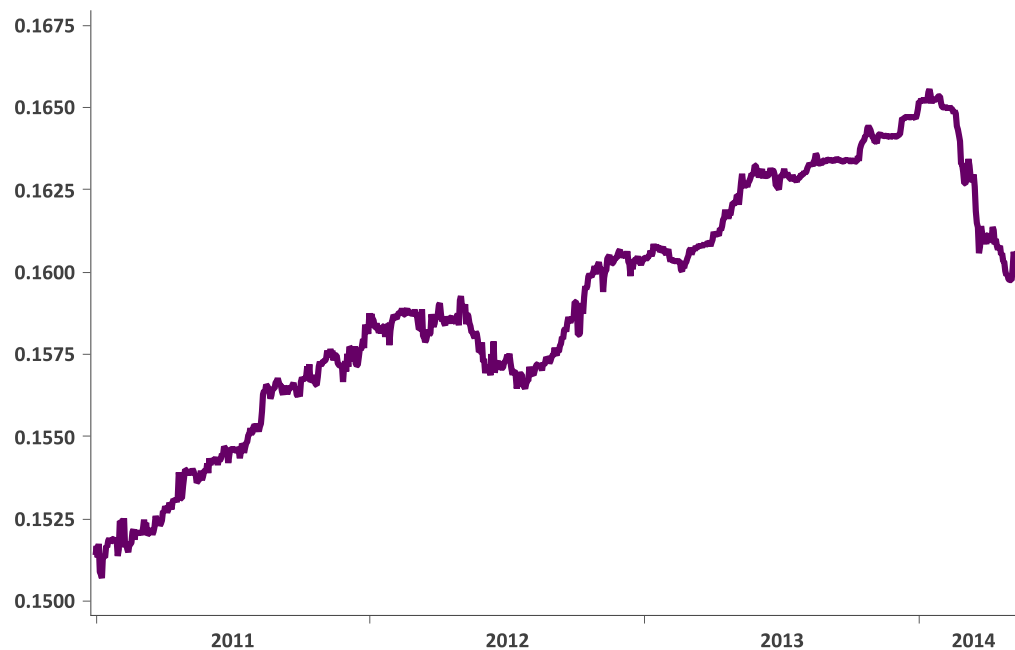
- Loss of potential global economic growth
- Loss of knock-on effects as a growth driver
- Trade tensions
- Currency wars
- M&A stimulated, temporarily...

Sources: RichesFlores Research, Macrobond

After the U.S., Japan and China... the currency wars are well underway

The devaluation of the yuan is not an option for China. Difficult to fathom how it would not spread regionally and beyond.

Exchange Rate: Yuan Versus Dollar



Sources: RichesFlores Research, Macrobond

Depreciation of the RNB

- Needed to offset loss of competitiveness
- Few domestic impediments (lack of inflation)
- **The movement may continue**
- Loss of competitiveness in the rest of Asia and **greater currency risk in the region**
- **Japan will relaunch a more aggressive policy shortly**

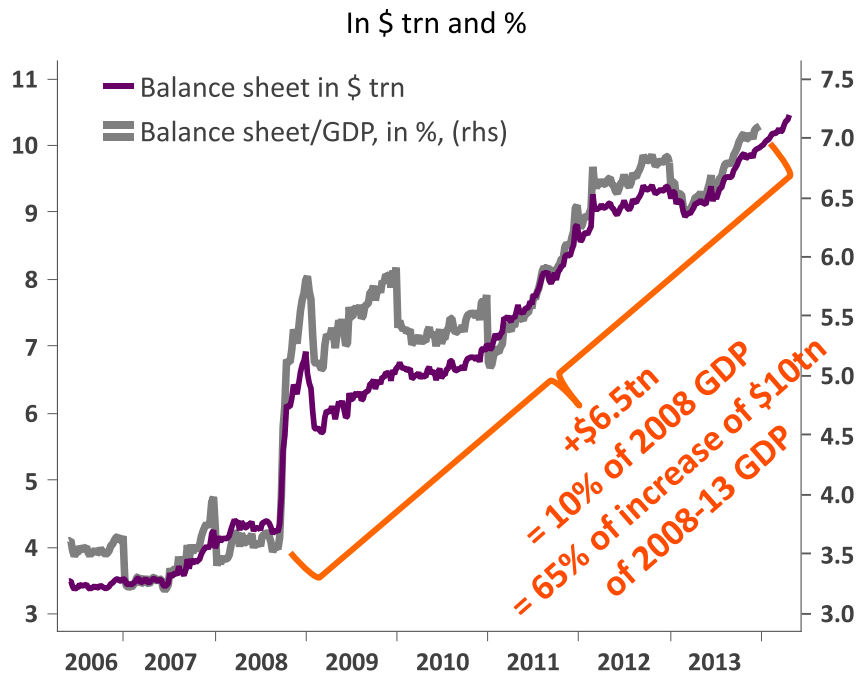
End of QE: a farewell to illusions

The time has come to be more discerning on
risky assets

"Big 4" balance sheets: +\$6.5T since 2008, i.e. 65% of global GDP growth

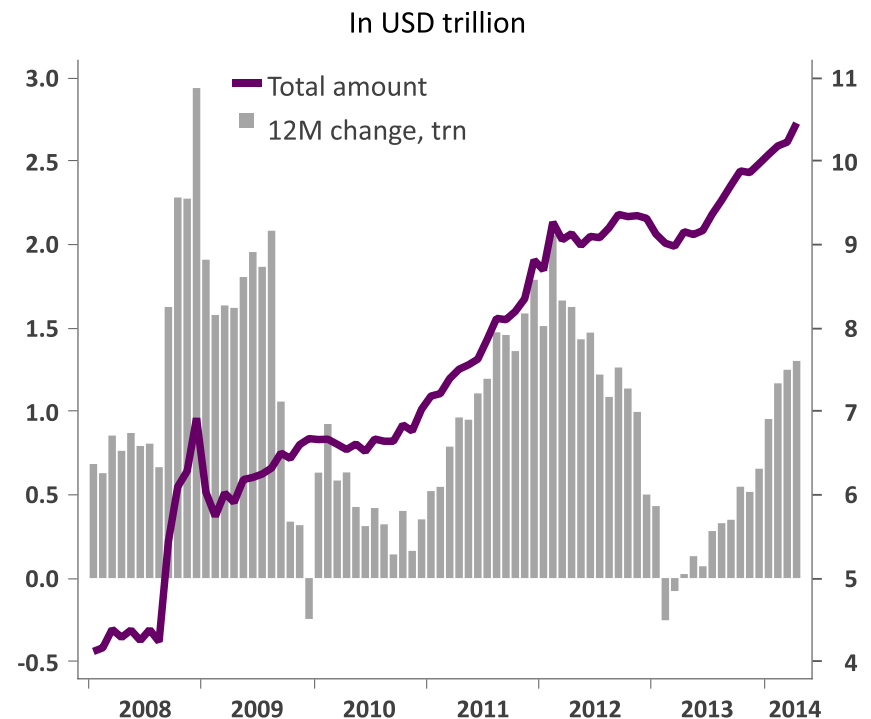
Can it go on? Can we do without it?

Balance Sheet of 4 Biggest Central Banks and World GDP



Sources: RichesFlores Research, Macrobond

"Big 4" Aggregate Balance Sheet

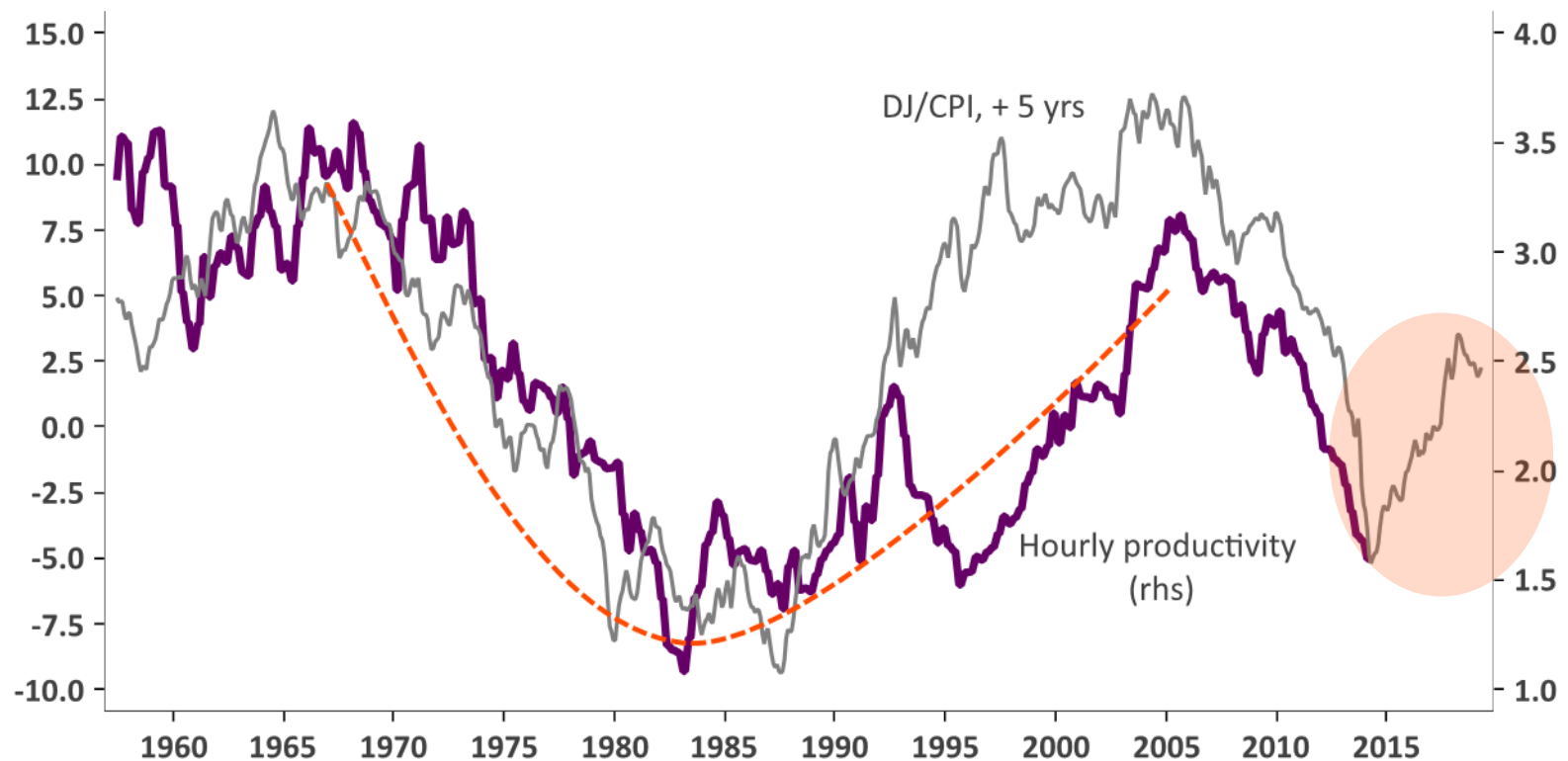


Sources: RichesFlores Research, Macrobond

The risk of having overpaid for the promise of productivity seems high

Long-Term Cycle of US Productivity and Dow Jones Real Performance

Annual growth rate, 10Y avg, in %, 2MMA



Sources: RichesFlores Research, Macrobond

Anticipations of a long cycle overpaid, too?

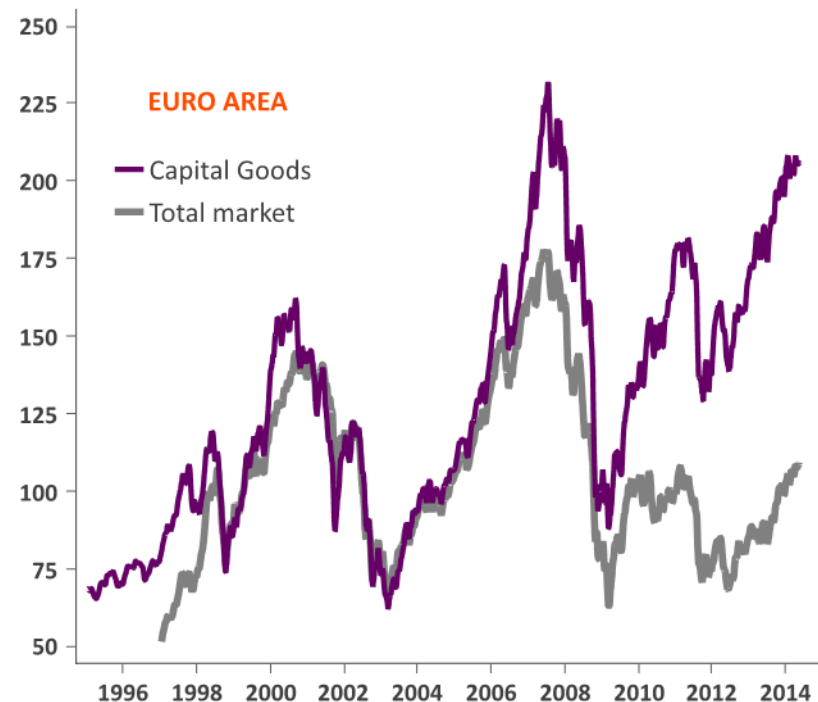
Relative levels of industrial stocks being called into question

MSCI World, 2002=100



Sources: RichesFlores Research, Macrobond

MSCI EURO, 2002=100, EUR



Sources: RichesFlores Research, Macrobond

The German market from another perspective

The German market has been the main beneficiary of hopes from emerging markets since the mid-2000s. It has the greatest exposure to a turnaround in structural anticipations.

MSCI EUR Capital Goods and German Investment Goods Orders, YoY in %



Sources: RichesFlores Research, Macrobond

Relative Performance of DAX

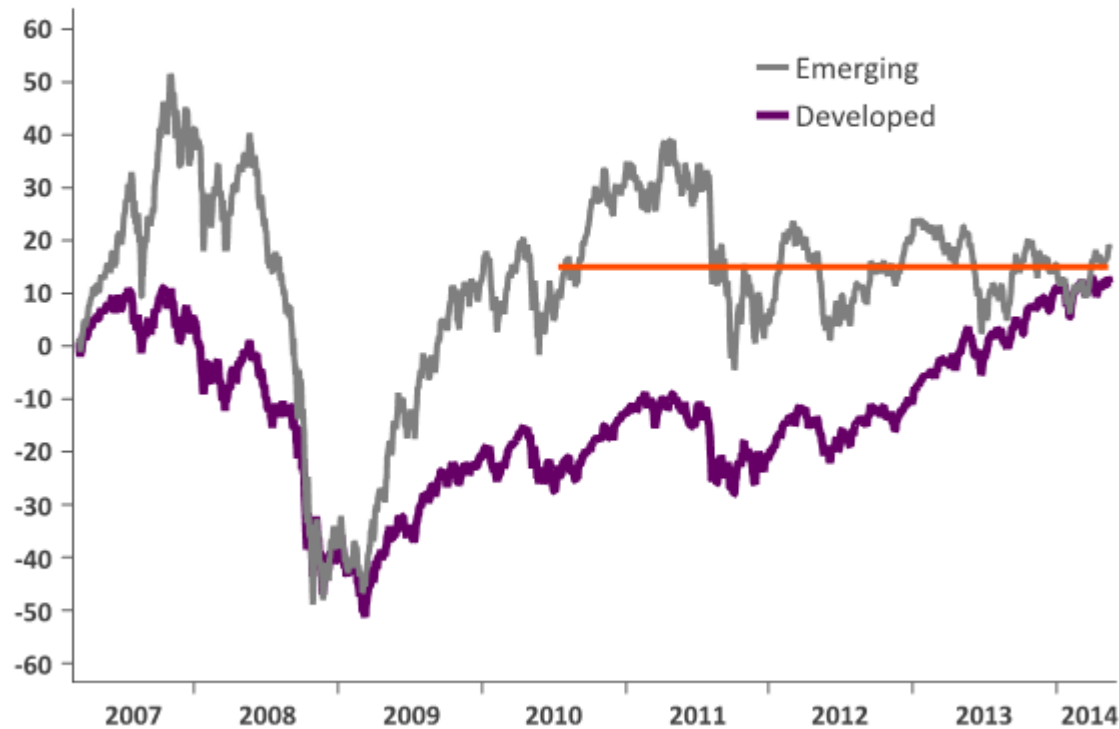


Sources: RichesFlores Research, Macrobond

Emerging markets: a precarious balance, threatened by haywire environment

Performance since March 2009

In \$, in %



Sources: RichesFlores Research, Macrobond

Performance since March 2009

U.S.: +189%

U.K.: +148%

EMU: +107%

Japan: +60%

HK: +138%

South Korea: +125%

China: +72%

Brazil: +52%

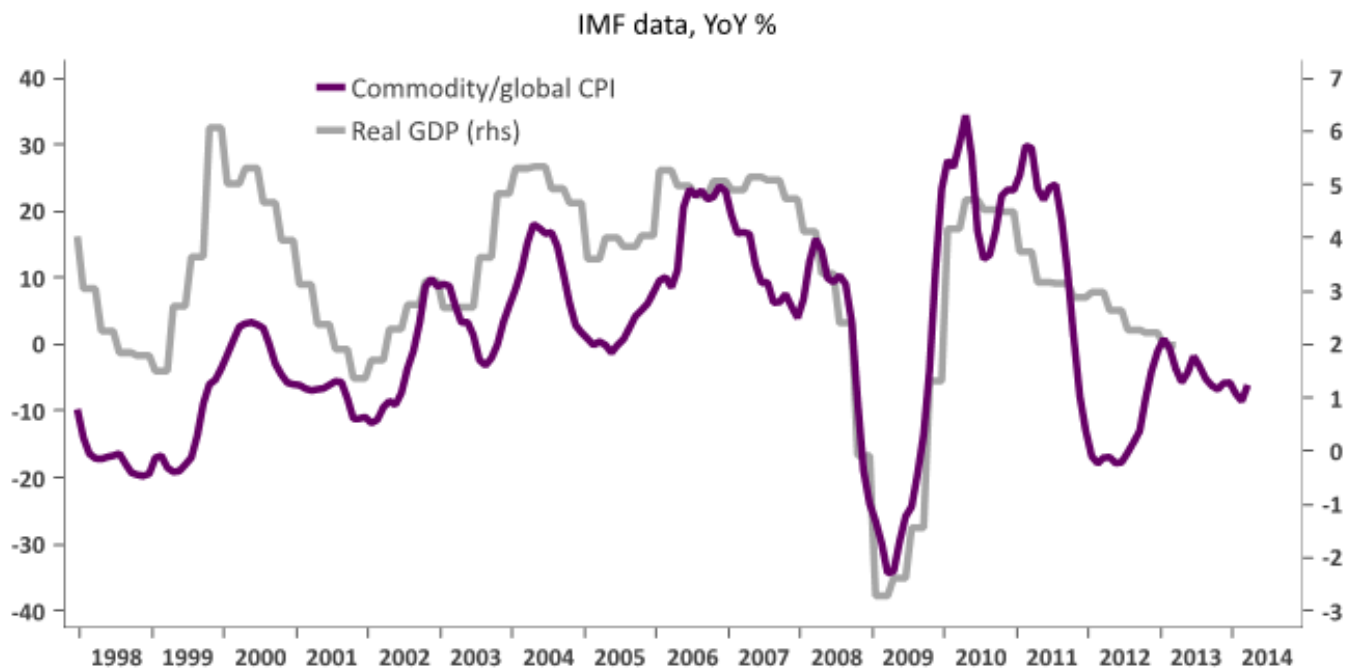
China overseas: +292%

Frontier mkts: +138%

Commodities, not yet time for a recovery

Growing disruptions but no fundamental argument for rising prices. The uncertain environment and the fall in long-term interest rates form a less unfavourable picture for precious metals.

World GDP and Real Prices of Commodity Excluding Energy



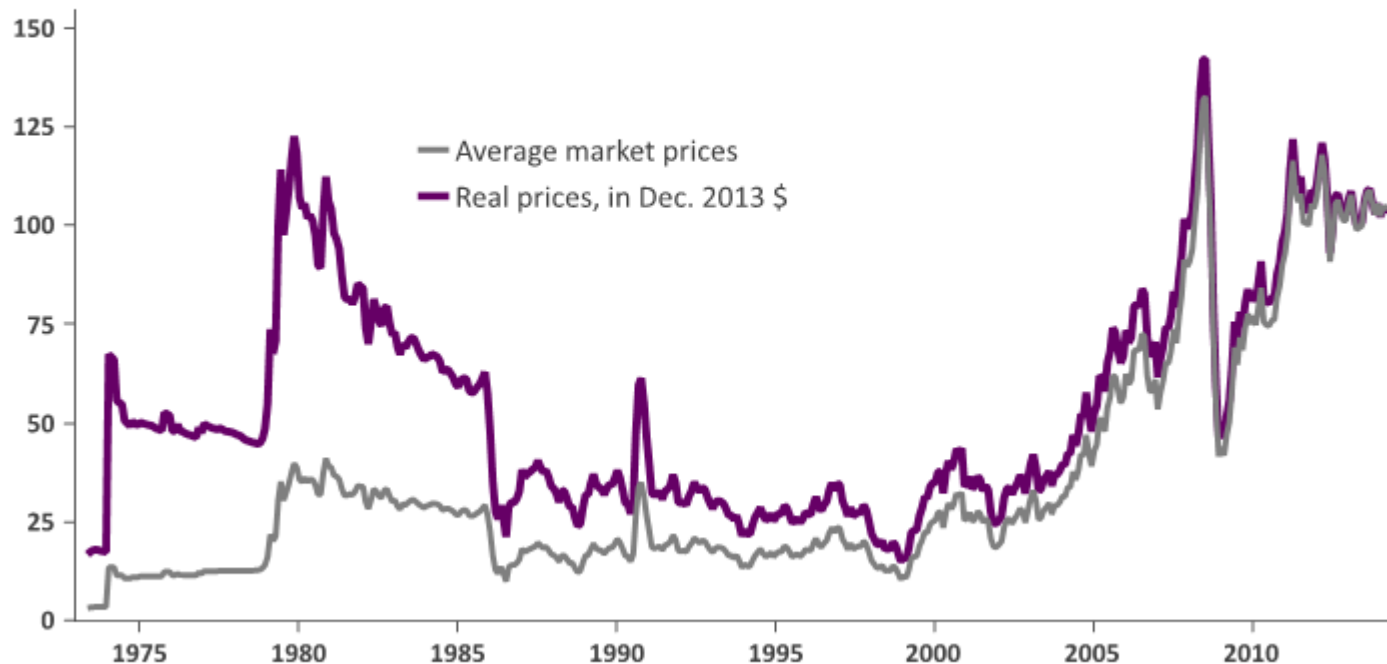
Sources: RichesFlores Research, Macrobond

Oil, revision of expectations

Downwards revisions by the consensus should win out over the geopolitical risk premium. Prices should fall.

Oil Prices, Average Prices (Brent, WTI and Dubai)

\$/barrel

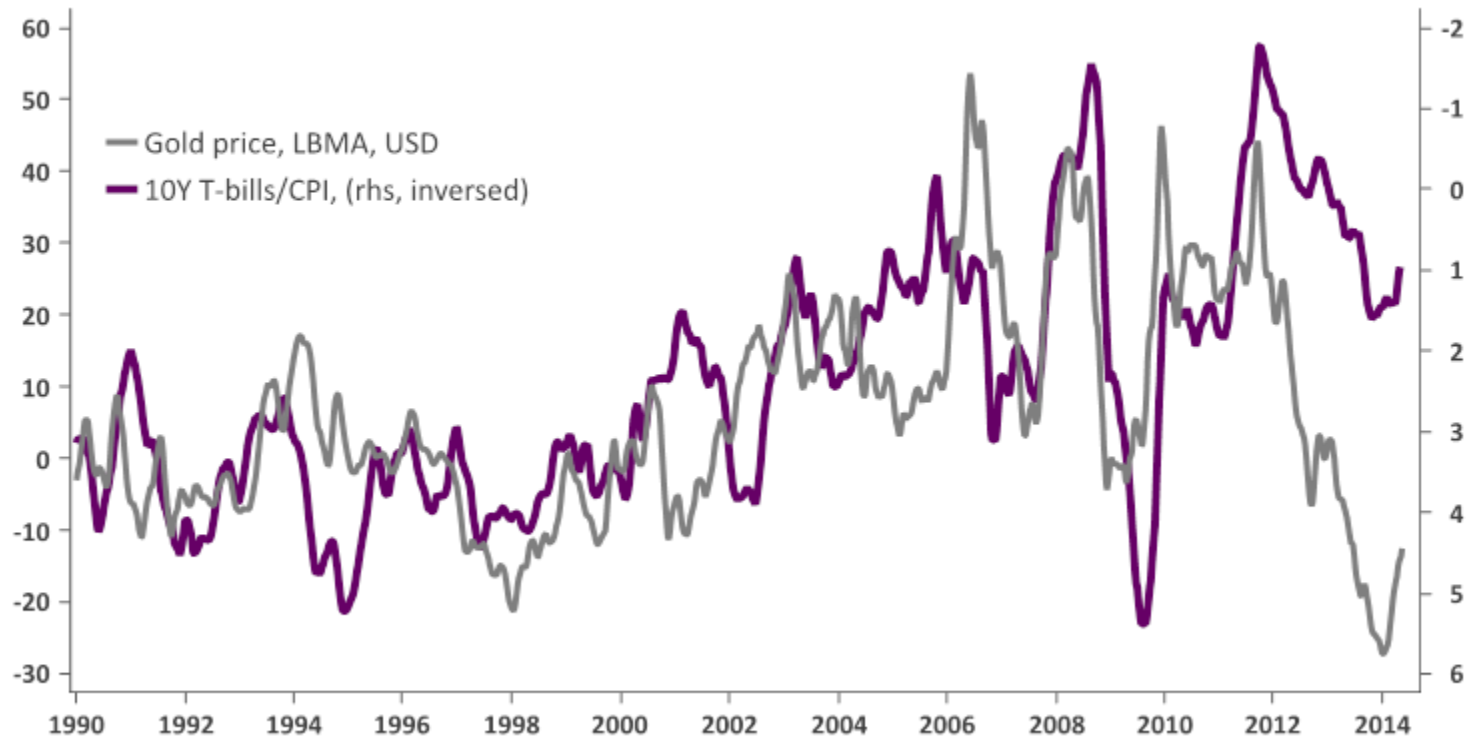


Our **2015 target:**
\$90 vs. \$104 in
March, but the
risk range falls to
\$75/barrel

Sources: RichesFlores Research, Macrobond

Gold prices are firming up but still exposed to the upside risk of real interest rates

Gold Price and Long-Term Real Interest Rates



Sources: RichesFlores Research, Macrobond

Another bond rally in the cards

The global economic situation is too precarious
to cope with an end to the Fed's QE...
long-term interest rates will fall

QE: the overdose forced to phase out treatment too soon

- **End-2012: the Fed goes overboard**
 - Injections half as big as the monthly \$85bn in firepower would have been enough to keep financial markets under control; smaller stimulus wouldn't have encouraged speculation and would have forced the ECB to take action sooner.
- **Early 2014: the Fed pulls back too soon**
 - QE comes under increasing fire for indulging the markets while failing to boost jobs.
 - The Fed cannot continue to inject so much money forever.
 - But the economic situation has not fundamentally changed...The Fed loses credibility, the markets don't follow along, long rates fall, the dollar tumbles.
- **The other central banks take their turn at the front, belatedly: the BoJ, BoC, ECB...**
 - Too late, initiatives to pump liquidity into the system no longer have an effect.
 - Instead, competitive exchange rate policies become more attractive.

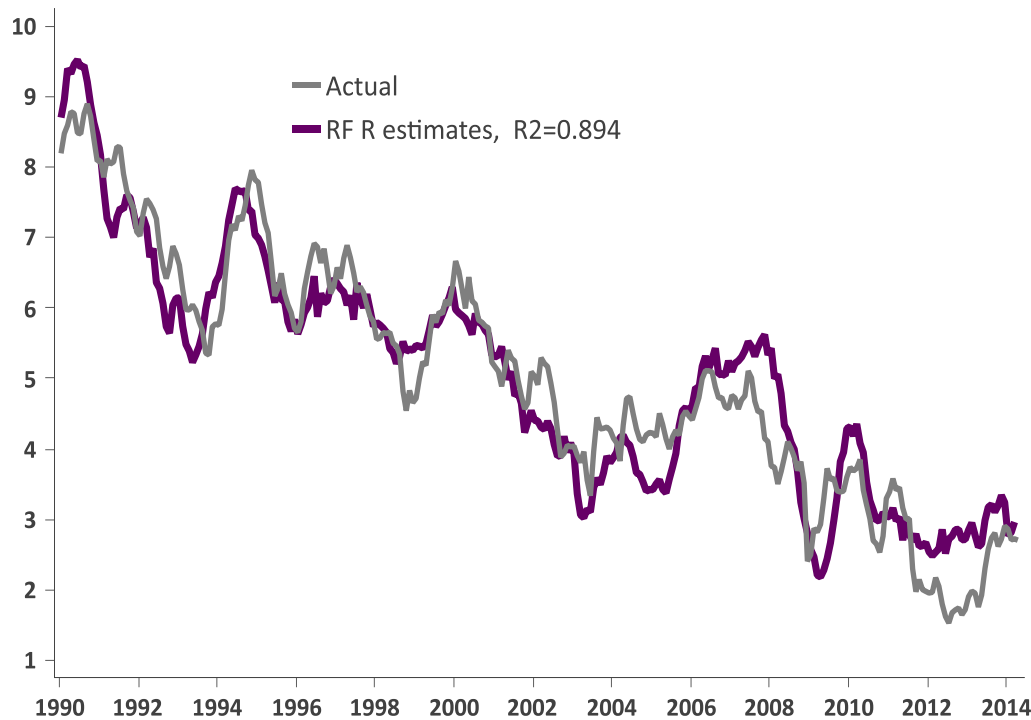
Preferred scenario for the U.S.

	Probability
• U.S. growth remains lower than expectations (rebound >3% in Q2, then instability around 2% r.a.).....	65%
• The Fed will not see its tapering through to the end. Ideally, it will continue to inject \$25-35m from autumn.....	51%
• Regardless, U.S. rates will decrease	
➤ The 10Y will break the 2.50% barrier again,.....	75%
➤ then the 2.25% mark in early 2015.....	55%

10Y U.S. rates fall below 2.50%

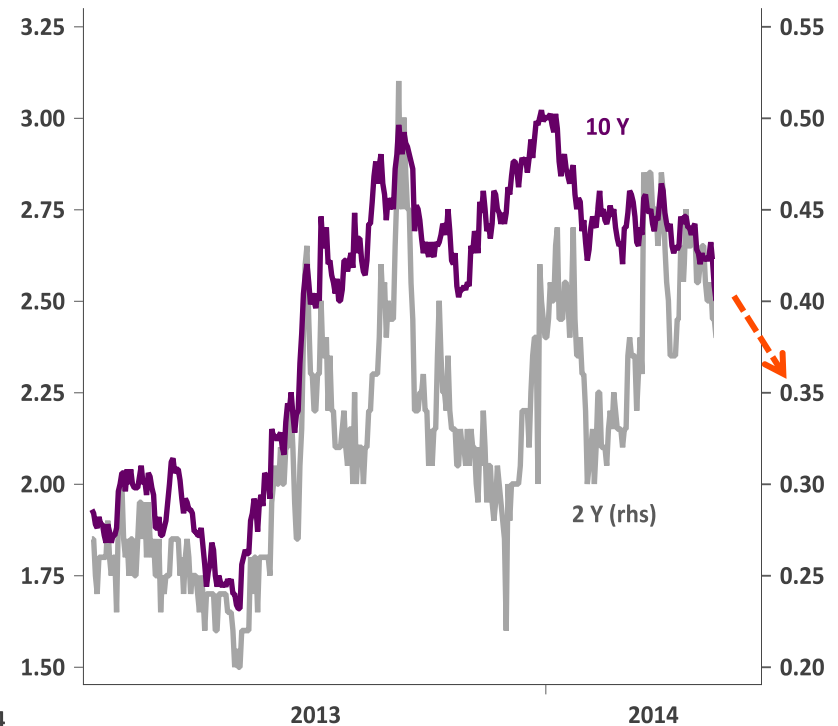
The American 10Y is valued accurately and should therefore fall as rate hike expectations recede (2Y will fall).

10Y T-Bills: Actual and Estimated



Sources: RichesFlores Research, Macrobond

Government Bonds Yields



Sources: RichesFlores Research, Macrobond

QE: the ECB takes action

- **June: the ECB is doing the ground work**

- Downwards revision to official inflation forecasts
- Rate decrease likely:
 - ❖ repo to 0.10% (from 0.25%); negative deposit rate (-0.15%)

- **Q4 2014: more wide-scale action**

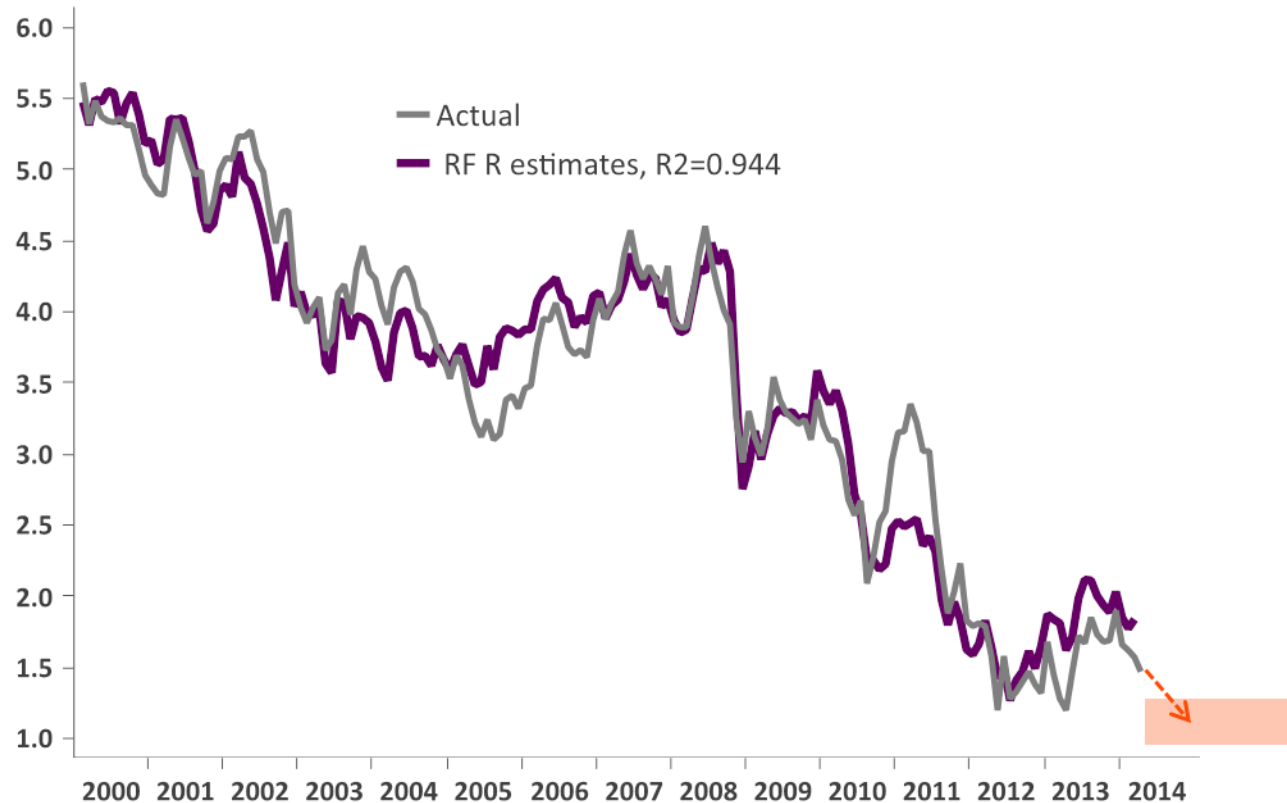
- LTRO with strings attached (in exchange for corporate receivables as collateral?)
- Asset purchases? Possible but more likely later on
- Call for review of timing of fiscal constraints in 2015?

- **LT rates on the decline, the euro's drop is very moderate**

- German rates fall to 1.0-1.25%
- The peripheral markets receive only a temporary lift from change in ECB strategy
- The euro falls toward USD 1.35 but the change in Fed anticipations short-circuits the fall. Our scenario is unchanged at USD 1.38-1.40 on a mid-2015 horizon

German rate heading towards 1%

10Y Bunds



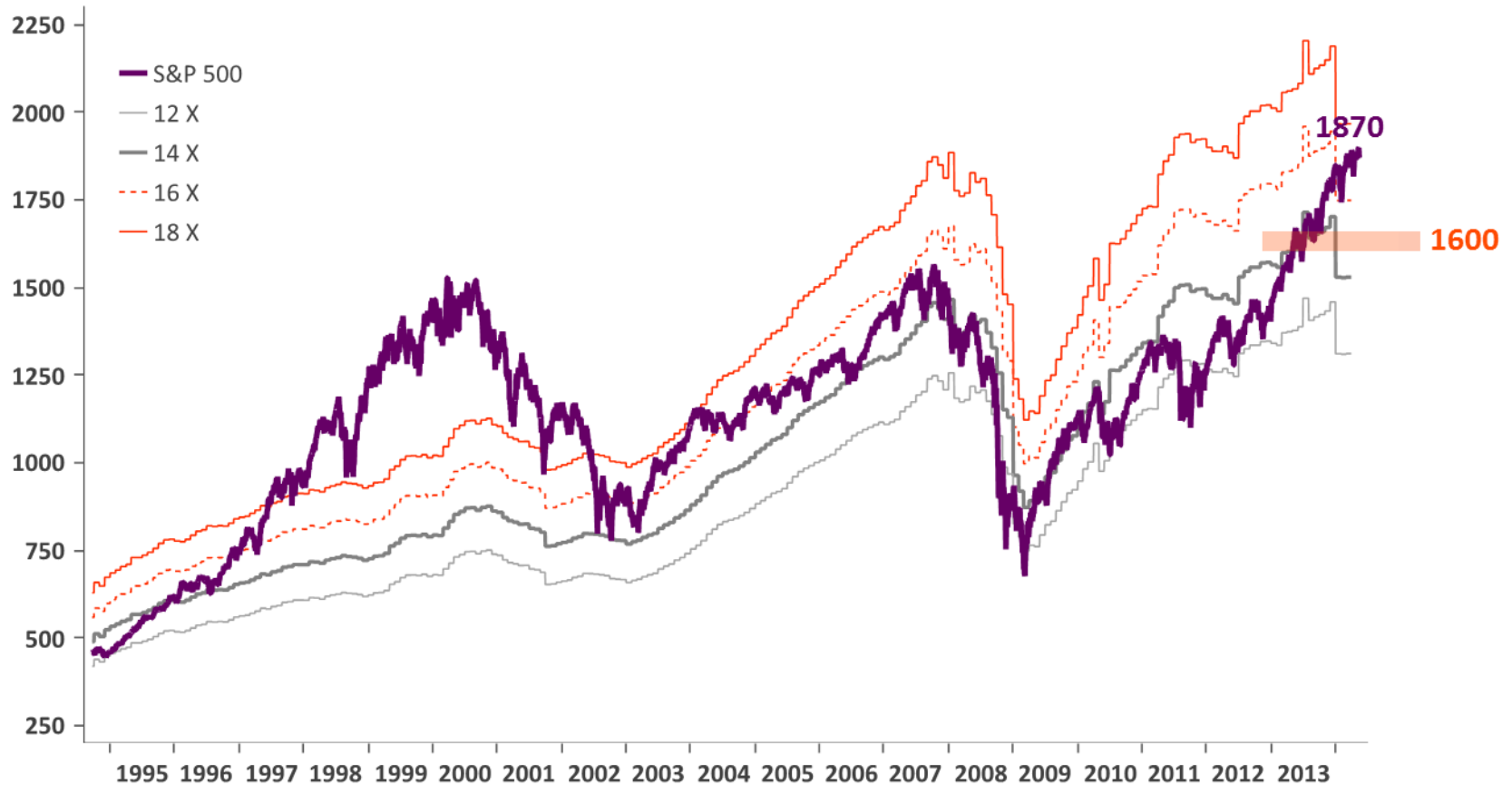
Sources: RichesFlores Research, Macrobond

Positive factors for sectors underpinning equity market growth

- **Falling long-term interest rates and commodities provide a lifeline for economic growth**
 - Growth sectors are shielded by the dual effect of low rates and developments on the innovation front
 - The banking sector is moderately impacted by the deflationary premium as the ECB unleashes its heavy artillery
- **The U.S. market is not so overpriced**
 - The fall in long rates and diminishing expectations of a rate hike will help the S&P 500 stabilize above 1.600 points and restore more sustainable multiples (14x)
 - Uncertainty remains high and the situation fragile

S&P 500: target 1.600 to mid-2015

US S&P 500 and 12M Forward EPS Multiples



Sources: RichesFlores Research, Macrobond

The Euro STOXX stems losses vs. the S&P but falls below the 300 bar



Sources: RichesFlores Research, Macrobond

Conclusion

		UNDERWEIGHT ASSETS	NEUTRAL	OVERWEIGHT ASSETS
EQUITIES	US			
	Core EURO AREA			
	Peripherals			
	JAP			
	EM			
SOVEREIGNS	US			
	Core EURO AREA			
	Peripherals			
	JAP			
	EM			
CORPORATE BONDS	US			
	EUR			
	JAP			
COMMODITY	OIL			
	Industrial s			
	Gold			
FOREX	USD			
	EUR			
	JPY			
	CHF			
	GBP			
	CNY			
	EM			
	EUR			

Macro-economic overview: 2014-2015

Global Macro-Economic Forecast

Real GDP growth in %	2013	2014	2015
WORLD*	2.8	3.2	2.8
US	1.9	2.6	2.0
EMU	-0.3	1.0	0.9
-Germany	0.5	1.6	1.2
-France	0.2	1.0	0.8
-Italy	-1.8	0.5	0.3
-Spain	-1.4	0.7	0.4
JAPAN	1.8	2.0	1.0
CHINA	7.5	6.8	6.5
BRAZIL	2.1	2.5	1.3

*at 2012 PPP exchange rates

Source: RichesFlores Research

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INDEPENDENT RESEARCH**



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