IIF Weekly Insight

RISK STILL LOOKS UNDERPRICED

AUGUST 21, 2014

- **Rebound from summer market correction leaves equities richly valued, bond yields low**
- **Rising short rates support USD rally**
- **Fed hawks flap wings**
- **Euro Area growth softens**
- **China: softer data, policy reaction expected**
- **Bitcoin—end of summer update**

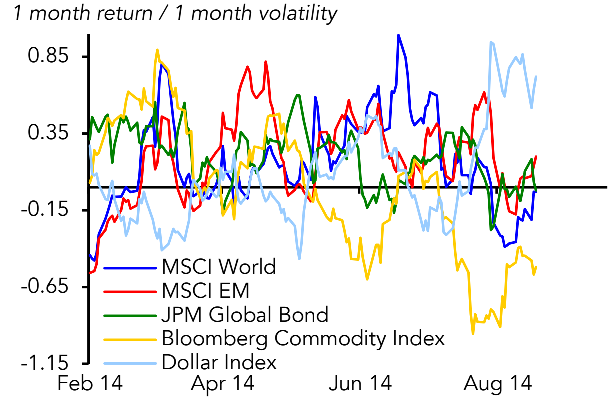
1. Rebound from summer market correction leaves equities richly valued, bond yields low: As August winds down, a glance around the investment landscape suggests that concerns about geopolitical tensions and valuations have had little lasting impact on investor sentiment. In a move consistent with previous 5-7% declines over the past 2 years, the MSCI World Index has largely recovered from its mid-summer correction. Some key market variables, such as volatilities and rates are still at fairly low levels, while the S&P 500 is testing all-time highs. As Fed exit nears, bringing in an unprecedented market backdrop, the key question is whether volatility will return to levels seen during previous QE's and whether rates will rise more quickly than the markets currently anticipate.

Chart 1.1 shows moving window Sharpe ratios (1-month returns divided by 1-month volatility) for key asset indices: in recent weeks, commodities are the least desirable, while the dollar pays most per unit of risk borne. World and EM equities and global bonds fall somewhere in the middle. A closer look at equities in Chart 1.2 shows expected return estimates using a standard methodology; expected returns are calculated as the sum of the real equity risk premium, current real 10 year yields and latest CPI print. The real equity risk premium is the sum of the earnings growth (IIF GDP growth forecast) and the dividend yield for each index less the real bond yield. Although the second half of the year has only just begun, year-to-date returns for many equities are above or approximately at 2014 expected returns. According to this calculation, Europe and Japan could surprise to the upside, while equities in some EM markets could well disappoint (India in particular).

Following the FOMC minutes and ahead of tomorrow's Jackson Hole speech by Fed Chair Yellen, U.S. short term rates and the U.S. dollar have moved higher. Fed Funds futures prices reveal that market participants expect a rate increase sometime in July/August 2015. Chart 1.3 shows the evolution of U.S. forward rates in the 1 year and 5 year maturity spectrum with 1 year rates increasing decisively while the 5-year is still drifting lower since the start of the year. The flattening of the yield curve needs to be interpreted with a grain of salt: while the movement in the 10-year since the beginning of the year indicates a downward revision in growth and inflation, the move in the 5-year rates appears to be in part technical in nature as a result of

1.1 Risk-adjusted Returns for Select Asset Classes

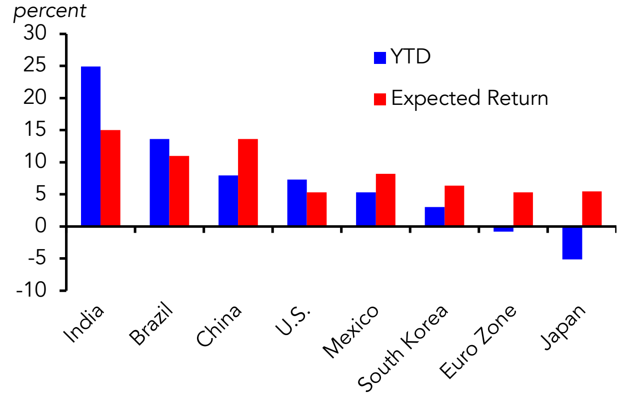
1 month return / 1 month volatility



Source: Bloomberg, IIF.

1.2 Select Country Equity Expected Returns vs. Ytd Returns

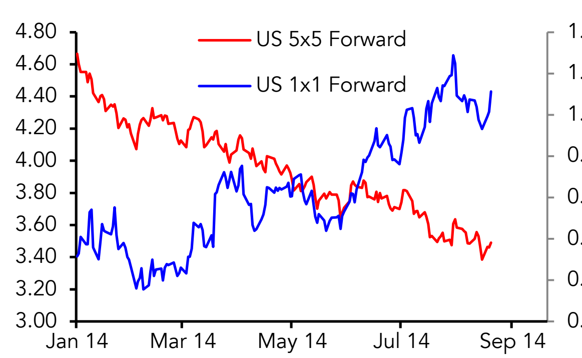
percent



Source: Bloomberg, IIF.

1.3 Flattening Yield Curve

percent, 5x5 year *percent, 1x1 year*



Source: Bloomberg, IIF.

Stronger dollar impact across the board.

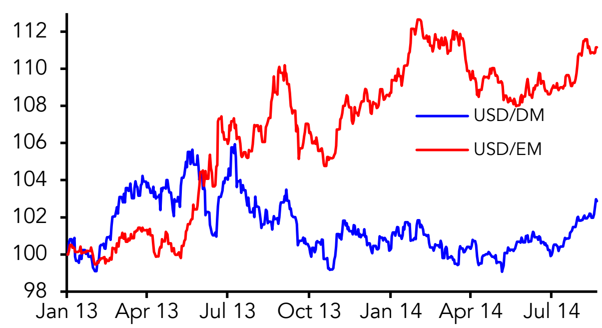
fixed income investors moving away from the short end towards the belly of the curve.

2. Rising short rates support USD rally: The relatively hawkish tone of the FOMC minutes (see below) has given further impetus to the dollar rally. Since early July, the greenback has gained 3% against G10 and 2% against EM currencies (Chart 2.1). While growing expectations of a stronger dollar have depressed FX carry trade returns, with FX volatility picking up from its mid-summer lows, substantial high-return carry trade differentials continue to lure investors into certain carry trades, notably NZD and AUD (Chart 2.2). While the dollar move has pushed the EUR to its lowest level since September of last year—a boon for the Euro Area economy if sustained—pressures on EM currencies have also intensified. Notably, Columbian peso (1%), and Turkish lira (0.7%) extended their earlier losses while Brazilian pared (0.6%) earlier gains (see our recent reports on Brazil and Turkey).

Gold bugs just can't catch a break: Two key drivers of gold prices, real rates and the dollar, are depressing the yellow metal. Real rates, which had declined under the weight of the Fed's expanding balance sheet are expected to head higher as the tightening cycle gets underway. The stronger dollar has also not helped: together these factors have sent gold to $1280/oz—almost a 4% drop from the beginning of August. Oil, traditionally sensitive to a stronger U.S. dollar, dropped with WTI approaching $94/bbl, down almost 13% from its highs at the end of June, notwithstanding continued security concerns in the Middle East.

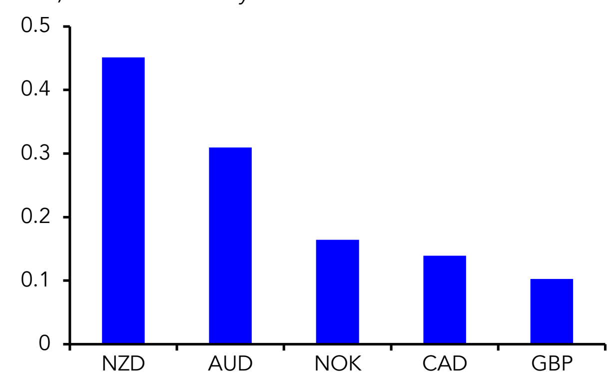
3. Fed hawks flap their wings: The Fed's July 29-30 meeting minutes came in on the hawkish side. Participants agreed that "both recent improvement in labor market conditions and the cumulative progress over the past year had been greater than anticipated." In addition, some participants thought that realized and expected progress warranted a "relatively prompt move toward reducing policy accommodation." There was some debate around the new language in the FOMC statement characterizing the economy as suffering from "significant underutilization of labor resources", which some members seemed to view as exaggerated. Committee members disagreed about the extent of remaining slack in the labor market. Some viewed the rapid decline in the unemployment rate as indicative of overall labor market improvement, but many participants still believe that the remaining slack is greater than suggested by the unemployment rate, pointing in particular to continued elevated rates of long-term unemployment and part-time employment for economic reasons, as well as the continued low participation rate (Charts 3.1 and 3.2).

2.1 U.S. Dollar
index, end-2012=100



Source: Bloomberg, IIF.

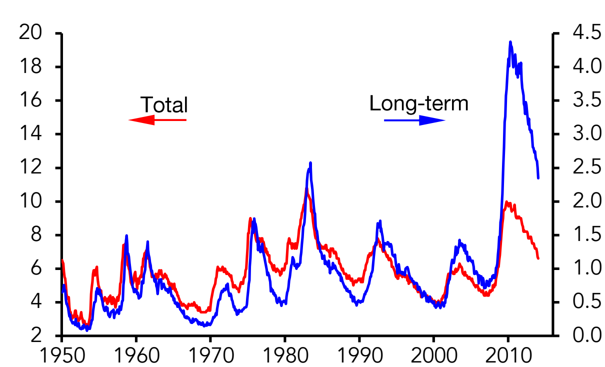
2.2 Carry-to-Risk Ratio*
ratio, USD financed carry trade



Source: Bloomberg, IIF.

*2-yr interest rate differential over 60-days of 3 month implied FX volatility

3.1 Unemployment Rate
percent of labor force, long-term = 27 weeks and more



Source: BLS.

Euro Area stalls, but expect a pickup in second half of 2014

Regarding the Fed's exit strategy, members agreed that it was vital to "communicate a clear plan" to the public well before the first rate hike. Participants also expressed general support for the approach proposed by staff, including to maintain a target range for the federal funds rate (which is currently set at 0 to 0.25%) for some time after the rate hike, presumably in order to have greater flexibility in the early phase of policy firming. Most members favored reducing or ending portfolio reinvestments after the first increase in the target range.

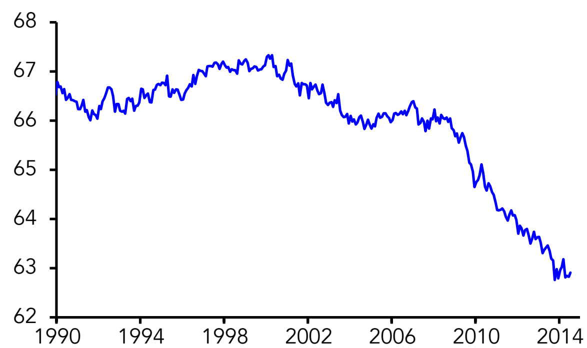
4. Euro Area recovery stalls in Q2, PMIs soften in August: Last week's flash GDP report proved a disappointment, showing a rise in the region's output by just an annualized 0.2% q/q in Q2, down from 0.8% in Q1, and much less than suggested by the PMI surveys (that were consistent with growth of around 1%q/q, saar). Looking at the country breakdown, some countries, such as Spain, the Netherlands and Portugal grew strongly at above 2% q/q, while activity was very weak in the largest three economies in Q2: Italy slipped back into recession, stagnation persisted in France, while Germany suffered a surprise 0.6%q/q, saar fall after a strong start to 2014. Although components have not been released yet, national statistics offices said that fixed investment and exports were weak spots in Germany and France, while household consumption held up better in both countries (Chart 4.1).

At least in part, the growth setback in Q2 can be attributed to a combination of one-off factors, most notably the unseasonably warm winter that brought forward the usual spring upsurge in construction in Germany (as the mirror image of such weather effects, Dutch output bounced back in Q2, after gas production plummeted in Q1). Moreover, the timing of Easter and other holidays led to weaker production in Q2 than usual. But even accounting for these factors, the growth outcome surprised on the downside.

We continue to expect a pickup in the second half of 2014. Besides the reversal of temporary factors, the region should benefit from a strengthening global economy, notably Asia, a weaker euro, and easing bank lending standards. At the same time, downside risks have heightened, related to the potential intensification of geopolitical risks, as the Russian sanctions will impact trade and may hit confidence more broadly. Reflecting such concerns, today's flash PMI report showed weakening in manufacturing confidence in both Germany and the Euro Area as a whole. (Chart 4.2 and 4.3, next page).

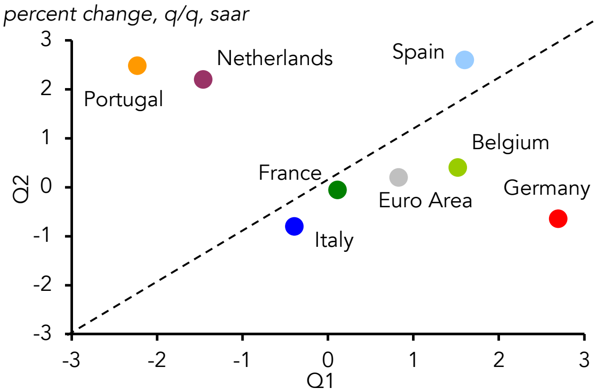
Sluggish activity and very low inflation (HICP fell to 0.4% oya in July, from 0.5% in June) is building the case for further mone-

3.2 U.S. Labor Force Participation Rate
percent



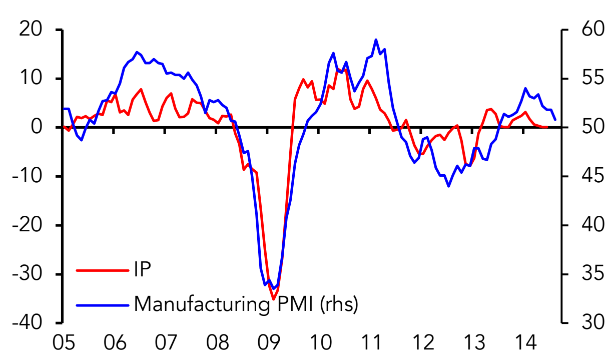
Source: BLS.

4.1 Euro Area GDP Growth: 2014 Q2 vs. 2014 Q1
percent change, q/q, saar



Source: Datastream.

4.2 Euro Area Industrial Production and Manufacturing PMI
percent, 3m/3m, saar *diffusion index, sa*



Source: Datastream.

Expect more targeted stimulus in China

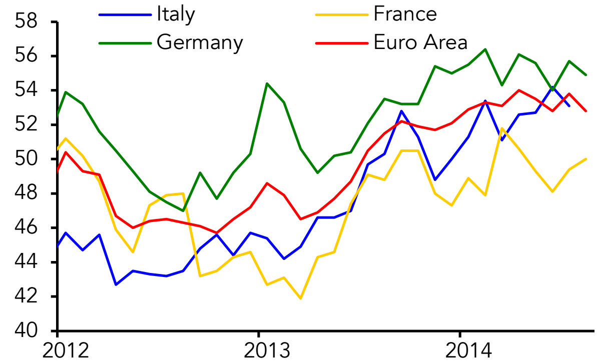
tary stimulus. However, barring further marked deterioration, the ECB will probably wait and see the impact of the measures it set out June, particularly the TLTRO which starts to take effect in September.

5. China: softer data, policy reaction expected: July data suggested some modest easing in the growth momentum (Chart 5.1). Industrial production growth fell to 9% yoy from 9.2% in June, and retail sales also slowed down modestly. The growth of fixed asset investments remained on a cooling trend, declining to 15.6% in July from an average of 17.2% in the second quarter of 2014. On a brighter note, newly started investment growth jumped to 20.8% from 7.6% during the same period, while exports rose a strong 14.5% in dollar terms. The official PMI rose to 51.7 in July from 51.0 in June, making it the highest reading this year.

Despite the relaxation of restrictive measures by more local governments, coupled with greater mortgage support to homebuyers, property prices continued to slide and the contraction in home sales deepened. The average housing prices in the 100 largest cities declined 0.8% mom, the largest decline in recent years while housing sales declined 17.9% yoy (Chart 5.2). The change in market conditions appears to be taking place across a broad front, as the government also reported that the number of cities with price drops in July increased to 64 out of a sample of 70. Small developers who have relied heavily on shadow banking and are exposed to lower-tier cities with housing oversupply are becoming particularly vulnerable to potential defaults.

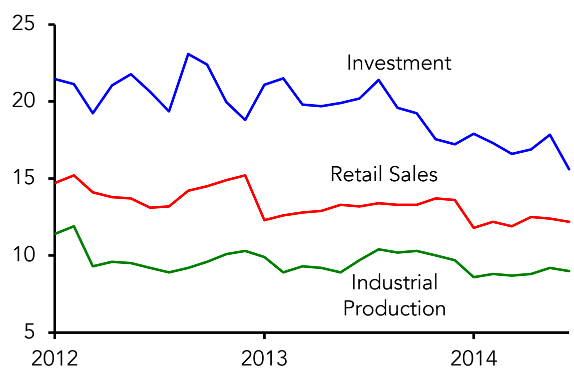
Policymakers have already provided targeted growth stimulus measures aimed at keeping growth in the ballpark of its 7.5 % target for 2014 as a whole and we expect more countercyclical efforts in coming months to contain downside risk to the economy. Given the desire to gradually slow credit expansion and shadow banking, the authorities have so far refrained from across-the-board cuts in reserve requirements and policy rates, but have tweaked the system to provide a more aggressive stance. While Total Social Financing (TSF) dropped to RMB273.1bn in July from RMB1.97tn in June, interbank interest rates have moved down to 3.3% in late August, consistent with an easing bias. In keeping with the policy of using selective measures as needed, the PBOC has further provided RMB12bn rediscount to its local branches in August, which will be used to encourage bank lending to small business and the agriculture sector. Moreover, the State Council has called for measures to lower financing costs and pressed banks to keep lending.

4.3 Euro Area: Composite PMI
diffusion index, 50=breakeven



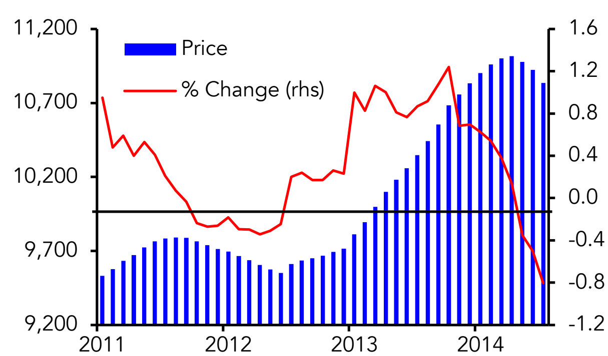
Source: Bloomberg.

5.1 China: Economic Indicators
percent change oya



Source: CEIC.

5.2 China: Average Housing Price in 100 Cities
RMB per square meter *% mom*



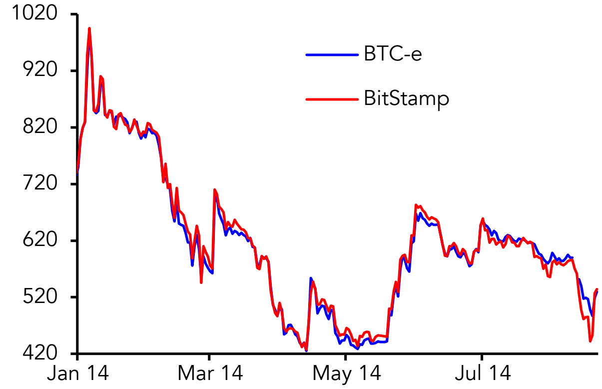
Source: China Real Estate Index System, IIF estimates.

The bitcoin revolution continues.

6. Bitcoin—end of summer update: On Monday, August 18, bitcoin prices experienced a flash-crash on the BTC-e exchange. Prices drifted lower until three trades, for a little more than one bitcoin, filled at $309. This triggered a high volume series of automated trades that were subsequently filled between $309 and $400. This temporary crash, however, did not leave a lasting impact, nor did it undermine confidence in the crypto-currency, as prices recovered after the drop. Bitcoins are currently trading again above 500 but still below early August highs (Chart 6.1).

On the regulatory side, the Australian Tax Office (ATO) released its guidelines on how bitcoin-based businesses and individual users will be taxed. Comparable to guidelines issued by the U.S. and Singapore, it does not regard bitcoins as "money." Bitcoins would be treated similar to other non-cash or barter transactions, increasing the threat of double-taxation. The guidelines are not yet legally binding, and no implementation timeline has been provided. Last month, New York became the first state to suggest regulation for virtual currency firms, or "BitLicense" to ensure consumer protection, prevent money laundering, and cyber-security – today the Department of Financial Services announced that it would extend the comment period on proposed changes by 45 days. Three of the biggest Chinese bitcoin exchanges released a letter today in response to New York's regulatory initiative warning that the proposed rules were too broad. The UK Treasury will explore the potential role of crypto-currencies in Britain's economy. South Africa's first bitcoin ATM came to Johannesburg, while Manhattan's first bitcoin ATM opened for business today.

6.1 Bitcoin Prices on Major Exchanges (Daily Highs)



Source: Bitcoinchart.

What to Watch For Next Week:

Monday: Germany IFO Survey (Aug), Israel Monetary Policy Meeting

Tuesday: U.S. Durable Goods Orders (Jul), S&P Case Shiller HPI (Jun, 2Q), Hungary Monetary Policy Meeting

Wednesday: Turkey Monetary Policy Meeting

Thursday: Euro EC Economic Sentiment (Aug), U.S. GDP (2Q second estimate), Japan Retail Sales (Jun) and IP prelim. (Jul)

Friday: Euro HICP Flash (Aug) and Unemployment Rate (Jul), U.S. Personal Income (Jul), Colombia Monetary Policy Meeting

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