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Global
Equity Research
Investment Strategy

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STRATEGY

Fiscal QE: when, where, and how to play it

Markets are underestimating the probability of 'fiscal QE': In our opinion, the likelihood of some form of fiscal QE by one of the G4 central banks over the next 3-5 years is high, for the following reasons: i) given the age of the US cycle, history suggests there is a 60% chance of a US recession within the next three years; this would require real rates to fall by 5%, which is very hard to achieve; ii) conventional QE is having increasingly unwelcome side-effects (e.g. banks' NIMs falling, 'zombie' capitalism, and potential housing bubbles); iii) fiscal QE is effective (the multiplier on government spending is 1.8x, and there is a shortage of infrastructure investment in many developed markets); iv) it's more acceptable politically, as it can target the median household via construction jobs and tax cuts/incentives; and v) we believe that strong structural disinflationary forces (technology, China) will continue to make it hard for central banks to hit their inflation targets. Ultimately, central banks' holdings of domestic government debt could be swapped into very long-dated zero coupon bonds, meaning increased government spending has little financing impact.

We rank the likelihood of fiscal QE by region: Based on shortage of existing infrastructure, need for stimulus, how constrained monetary tools are and policy flexibility, we think Japan is most likely to conduct some form of fiscal QE, followed by the UK, the US and lastly the euro area.

We identify five types of fiscal QE: The most likely of these is implicit (governments spend while central banks print) or funding of profitable infrastructure projects. We think Japan is most likely to move first but will probably resort to tax cuts/spending (given its high-quality infrastructure). Within the UK, we believe infrastructure QE is most likely to occur within 3-5 years. While political hurdles to undertaking infrastructure QE are greater in the Eurozone, we describe a form of revamped Juncker Plan which might work legally, practically and logically but would need a crisis and time to organise.

Equity and sector implications: We focus on stocks that would benefit from infrastructure QE and look attractive regardless. We introduce an overweight on European construction (previously no weighting), as the construction share of GDP is at a 20-year low (Travis Perkins and Assa Abloy look cheap on Credit Suisse HOLT® with eCAP awards), and stay overweight cement (LafargeHolcim). The outlook for US non-residential construction looks attractive, with a compelling need to upgrade infrastructure (Halma, Wolseley). We like defence companies with strong local content benefit (Thales). We include a sensitivity analysis based on a 5% increase in construction/defence spending for the respective companies. Into fiscal QE, real rates should fall, which would re-rate equities (US P/E multiples could rise to c18x on our fair value model). The fall in real rates would also support the gold price (where, anyway, central bank diversification could lead to a sixfold increase in gold demand). US names that would benefit from the themes above (with an eCAP and cheap on HOLT) are: Johnson Controls, Raytheon, General Dynamics.

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Fiscal QE: when, where, and how to play it

Consistently, investors have been asking us what happens next with monetary policy.

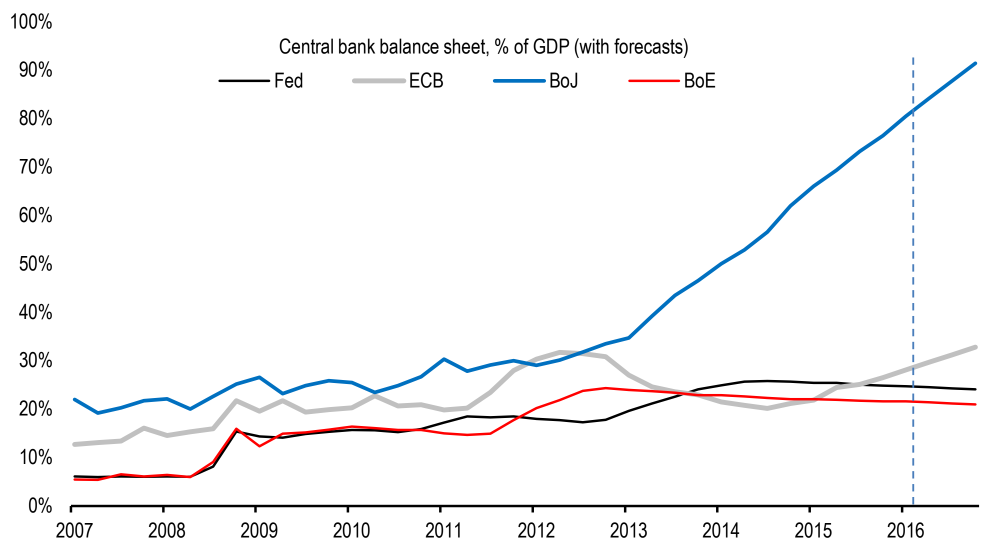
We would highlight four key points:

1. We think monetary QE can go further but its impact is clearly diminishing and, in some areas, counterproductive.
2. We do not believe policy makers will 'give-up' and thus at some point fiscal QE/expansionary fiscal policy will likely be implemented. This could be implicit or explicit.
3. We would recommend buying fiscal QE plays with optionality on infrastructure and/or construction spending. In other words, we would focus on companies related to construction that we find attractive regardless.
4. The start of some type of fiscal QE could lead to a sharp rise in nominal bond yields but a fall in real bond yields. Thus, ironically, gold and banks could both outperform at the same time. We think it would be in all likelihood a big boost for equities.

Where next for policy?

The BoJ balance sheet by the end of this year will be over 90% of GDP, compared to c.33% for the ECB and just 24% for the Fed.

Figure 1: G4 central bank balance sheets as a proportion of GDP



Source: Thomson Reuters Datastream, Credit Suisse research

The limits of conventional QE

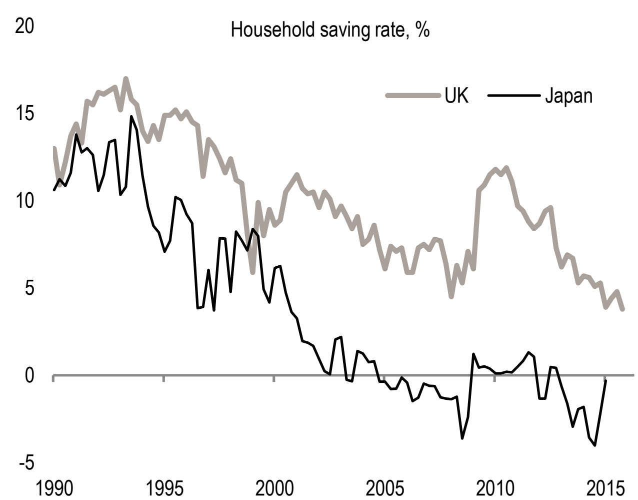
Each of the main transmission channels of conventional QE are now more limited:

- **Currency weakness:** ultimately, FX wars are a zero sum game. Countries that don't adopt QE face currency strength, in turn forcing them to cut rates and/or adopt QE. This works until we get very widespread negative yields – already there are c.$10.4trn of negative yielding government bonds.
- **Raising asset prices:** this happens on the back of a fall in real rates which forces up asset prices and partly via the real balance effect. While this is of benefit to asset owners (who are inevitably at the upper end of the wealth spectrum), it is of little benefit

to the asset poor, with wage earners also a relative loser. Moreover, most fixed income assets look already very expensive, while US equities trade close to fair value on both of our models.

- **Reduce household savings rates:** in some countries, such as the UK and Japan, the household savings rate is already close to historical lows.
- **Encourage corporates to invest:** not only do lower rates and a lower cost of capital penalise savings, but the more the equity market rises, the more expensive it is to buy rather than build capacity (i.e. Tobin's Q), incentivising corporates to invest. Clearly investment ratios are low in Europe though this is not the case in the US or Japan. Moreover, much of the over-investment has occurred in China (in areas such as commodities, petrochemicals, refining) and with China accounting for 24% of global capex (but only 10% of global consumption), it has offset much of the 'under-investment' in the developed world.
- **Reduced cost of funding for government debt:** this should serve to encourage governments to be less prudent. This transmission mechanism does still work; though there has been little evidence of this passing through to a greater willingness to pursue expansionary fiscal policy.

Figure 2: Household saving rates in Japan and the UK are near historic lows



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 3: The latest recovery has been of longer duration than average, but of smaller magnitude

Start date	End Date	Duration (No of Quarters)	Trough to peak (%)	% above previous peak
Mar-50	Jun-53	13	24.4%	
Mar-54	Jun-57	13	12.7%	9.8%
Mar-58	Mar-60	8	12.6%	9.7%
Dec-60	Sep-69	35	53.7%	51.6%
Sep-70	Sep-73	12	13.8%	14.3%
Dec-74	Dec-79	20	21.4%	20.2%
Jun-80	Jun-81	4	3.0%	1.3%
Sep-82	Jun-90	31	38.5%	36.3%
Dec-90	Dec-00	40	42.3%	41.2%
Sep-01	Sep-07	24	17.9%	17.8%
Mar-09	Latest	29	14.8%	10.5%
Average		21	24.0%	22.5%
Median		20	19.7%	17.8%

Source: Thomson Reuters Datastream, Credit Suisse research

Although impossible to prove, we think that conventional QE has actually been more effective than investors realise because, in real terms, the recovery in GDP has been understated. This is because the extent of deflation via the internet is being clearly underestimated (e.g. Airbnb, Uber), and there is no measurement of products that we used to pay for but now receive for free. If we look at the US, real GDP is now only 11% above its previous peak (the normal recovery sees GDP being 23% above previous peak), but if, as is quite possible, deflation has been underestimated – say by c1% a year – then GDP would indeed be closer to 15% above previous peak.

Indeed, the counterfactual is difficult to establish, but a lack of QE or asset purchase programmes by central banks would, in all likelihood, have led to a very much more severe recession than that which occurred (given the interlinkages of the global financial system and banks' ownership of government bonds).

Why fiscal QE…eventually?

- The next recession will likely require more firepower than monetary QE now has

The NBER, the body responsible for defining the expansion and contraction periods of the US business cycle, have noted in their research that there is always a good chance of a recession in the medium term once recoveries have become established, as shown in Figure 4. The monetary response to recessions has tended to be significant, with real rates cut by, on average, 4 to 5 percentage points. Clearly, there is likely to be nowhere near such scope to cut real rates by this amount when we hit the next recession (short of inflation sharply overshooting).

Figure 4: Most established economic expansions see a recession within the next 3-5 years

	Three+ year old expansions - percent of time recession within:		
	2 years	3 years	5 years
Japan	30%	40%	54%
Germany	53%	74%	98%
UK	28%	40%	63%
US	43%	63%	88%

Source: Lawrence Summers, Washington Post

Figure 5: Into a recession, the average cut in the real Fed funds rate has been 4-5%

	Real funds rate easings		
	Start	Final	Easing
May-60	1.9	-0.1	2.0
Aug-66	3.1	0.7	2.3
Nov-70	4.5	-0.9	5.4
Nov-74	6.4	-1.6	8.0
May-81	8.7	-0.1	8.8
Sep-84	7.6	3.4	4.2
Nov-90	5.5	0.1	5.4
Dec-00	4.8	-0.4	5.2
Aug-07	3.3	-1.1	4.4
Average easing			5.1

Source: Lawrence Summers, Washington Post, Bloomberg, BEA

Indeed, on the Federal Reserve's estimates, the $600bn QE2 programme boosted the level of real GDP by a little over 0.5%. However, clearly QE2 was far more effective than QE today would be because there was a degree of financial stress, higher long term US bond yields (both corporate and government), and higher rates globally; thus, realistically, QE 4 would probably be half as potent as QE 2 and therefore require the Fed balance sheet to potentially rise by 40% to 60% of GDP, from 24% of GDP now.

- The challenge of generating inflation and reasonable nominal GDP growth remains

Central banks, in general, have inflation targets of around 2% p.a. mandated upon them (e.g. the BoJ, BoE, ECB, and, to some extent, the Fed). While there is cyclical disinflation owing to the size of the output gap in Europe and globally, we believe that there is clearly an overriding theme of structural forces keeping 'core' inflation (i.e. ex-oil and food) rates low. This comes largely from two sources.

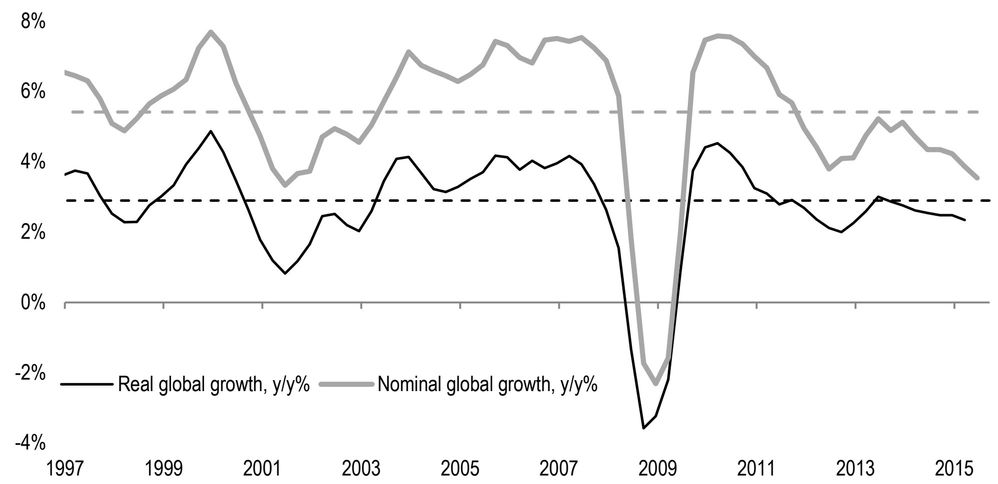
i. **Disruptive technology:** we strongly believe that technological advances have contributed to disinflationary forces globally, through creating price visibility (e.g. Priceline), reducing demand via the sharing economy (e.g. Airbnb), and reducing barriers to entry. We would liken some of these forces to the late 19th century, where UK CPI fell by a third (in this case, owing to significant technological advancements including the opening of the Suez Canal, canned food, and steam ships, amongst many others).

ii. **China exporting deflation:** China accounts for nearly a quarter of global investment, but only 10% of global consumption and thus has to export its excess investment – as we have seen in the case of steel, oil refining or bulk chemicals. The worry is that c.60% of investment (but only 22% of GDP) is by SoEs, where the RoE achieved is just 3%, and sometimes lower. Moreover, in many areas

China is moving up the value added curve more quickly than expected (see *Global Equity Themes: China's Competitive Threat*, 18 January).

The net result is that nominal GDP growth remains very weak by historical standards, despite the recovery in real GDP having been fairly steady, and this is what some form of fiscal QE/expansionary fiscal policy has to address.

Figure 6: Nominal GDP growth has weakened substantially, but growth in real terms has been far more robust

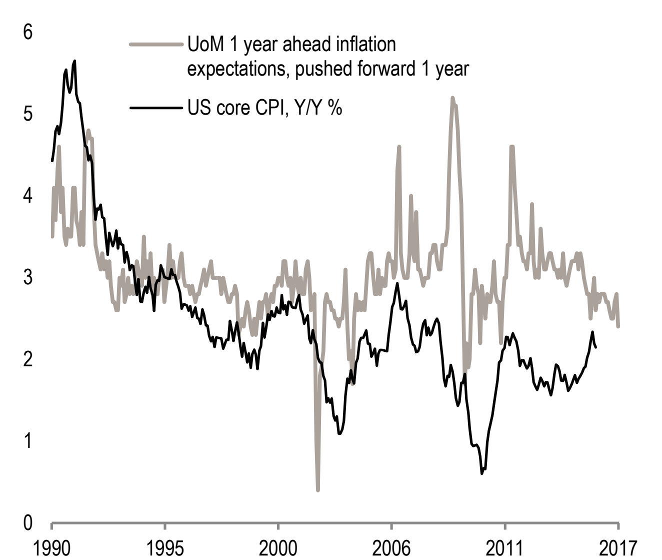


Source: Thomson Reuters Datastream, Credit Suisse Global Strategy & Economics

- Thus far, fiscal and monetary policy have largely lacked coordination

Governments' fiscal tightening has, to some extent, offset the impact of unusually loose monetary policy. Fiscal consolidation in the US, euro area and UK was significant enough to have more than offset easing that followed the financial crisis (i.e. since 2008, fiscal policy has tightened on a cumulative basis).

Figure 7: Actual inflation has fallen short of that expected over the past 10 years



Source: Thomson Reuters Datastream, Credit Suisse research

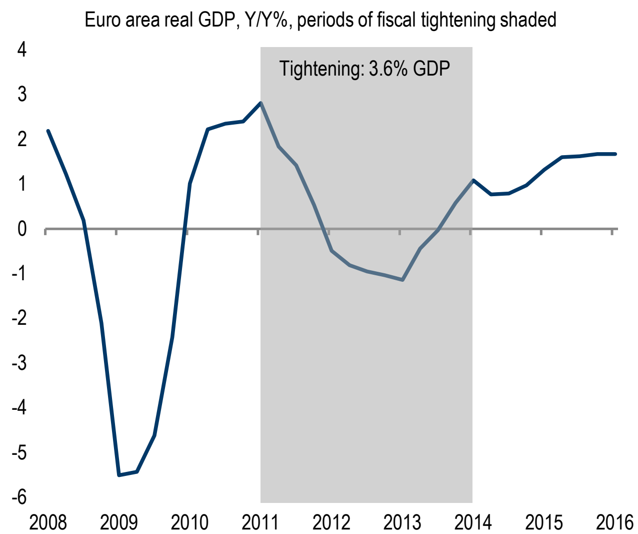
Figure 8: Advanced economies have seen significant fiscal tightening in the post-crisis period

% GDP	Post-crisis fiscal easing	Subsequent cumulative fiscal tightening to 2015	Net fiscal policy change since crisis
Euro area	2.82	3.53	Tighter
UK	4.96	5.15	Tighter
US	6.31	6.38	Tighter
Japan	5.38	3.13	Looser

Source: Thomson Reuters Datastream, Credit Suisse research

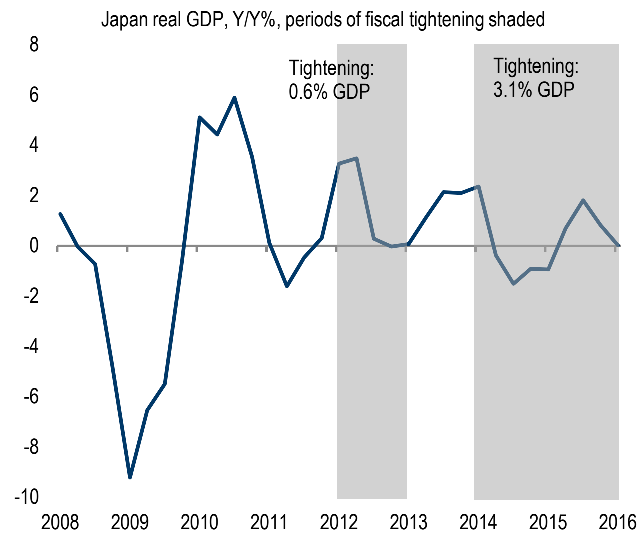
Indeed, as our economists highlight, in the case of the euro area and Japan, there is a clear link between governments' tightening of fiscal policy and either a return to recession or slowing of growth.

Figure 9: Euro area growth weakened significantly during the 2011-14 period of fiscal consolidation…



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 10: …tightening of fiscal policy had similar effects on growth in Japan



Source: Thomson Reuters Datastream, Credit Suisse research

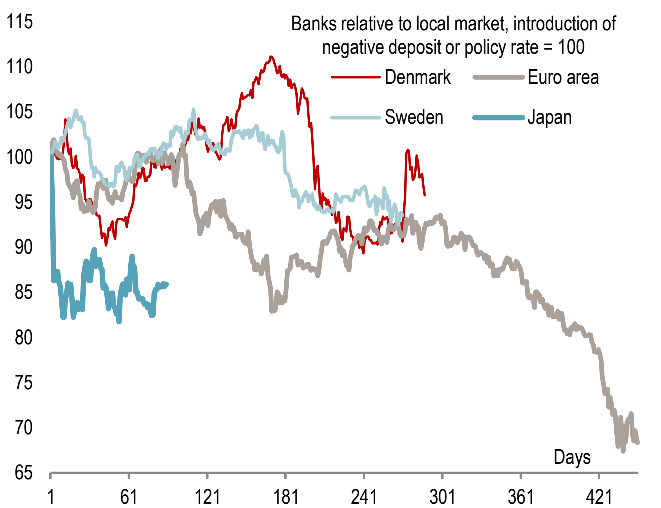
- Conventional QE is having some unwelcome side-effects in four areas

i. **It encourages 'zombie' capitalism:** QE keeps the cost of debt low, and thus the hurdle rate for corporates falls, too, increasing the risk that unprofitable projects are invested in.

ii. **It hits the profitability of banks:** as interest rates fall and the yield curve flattens, banks' NIMs are compressed, reducing bank profitability and thus, in the longer run it is likely to make banks less willing to lend. The literature supports this idea, with papers by the Bank of England and BIS suggesting that the positive effects of low interest rates (chiefly a fall in NPLs and thus provisioning) are outweighed by the negative effect of low rates on interest income.

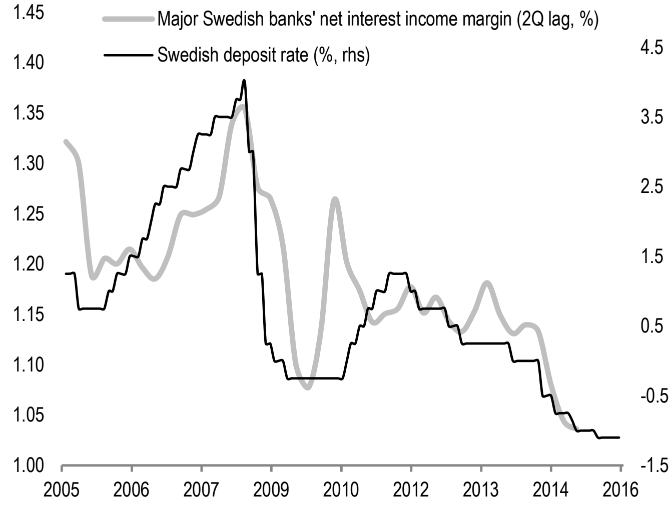
For the euro area, in particular, where the health of the banking system is such a critical factor for GDP growth (given that 88% of corporates employ less than 10 people, and these corporates find it difficult to access credit markets, thus c.75% of lending growth occurs via the banking system), negative rates ran the risk of being particularly destructive. We would note now though that policy makers appear to have de-emphasised negative rates.

Figure 11: Bank equity has sold off sharply in reaction to negative rates



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 12: The fall in interest rates has compressed banks' NIMs in Sweden



Source: Thomson Reuters Datastream, Credit Suisse research

iii. **It risks overly inflating real estate prices:** not only does this become a social problem, but also potentially becomes a source of growing financial imbalances and economic instability. Perhaps one of the clearest examples of this is Sweden.

iv. **It may encourage consumers to save more:** contrary to one of the intended effects of QE (to encourage spending at the expense of saving), by hitting pension liabilities, whether on or off the balance sheet, or income streams from savings, consumers might actually be encouraged to save more. We find that evidence of the latter is mixed: the Japanese savings rate has fallen to minus 0.3% yet the savings rate has risen in Sweden, Switzerland and Denmark since implementation of negative rates.

- A more effective policy economically

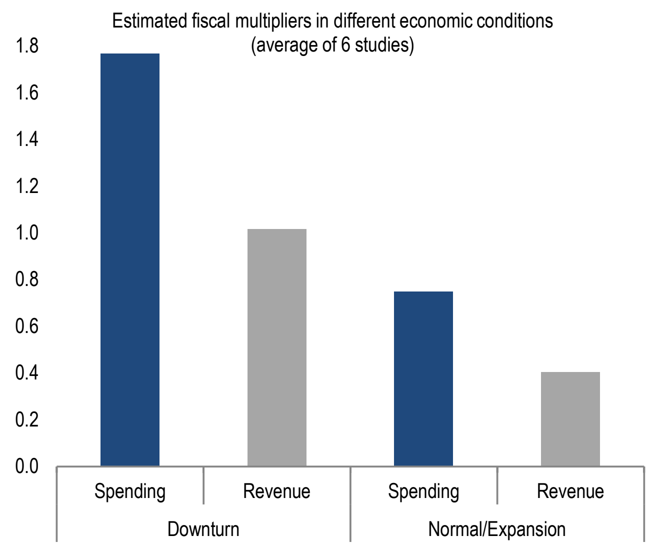
Any form of fiscal spending would immediately add to economic activity, whereas monetary policy only attempts to stimulate activity via intermediation. Furthermore, the economic multiplier on government spending – estimated at 1.8x into a downturn – is almost twice that for tax cuts (because tax cuts can be saved, particularly into an economic downturn when the incentive for saving is higher), making it the most effective form of fiscal policy easing. There is little point increasing government deficits via tax cuts if the household sector, fearing substantial future tax hikes to fund the budget deficit, offsets the tax cut by increasing its savings rate.

Finally, infrastructure spending should also alleviate bottlenecks and thus boost productivity by reducing the 'hidden' drag on growth from inefficiency that arises from infrastructure in a poor state of repair and, as we discuss below, can of course be profitable in itself.

■ Fiscal QE could be beneficial for the low end worker, which is politically expedient

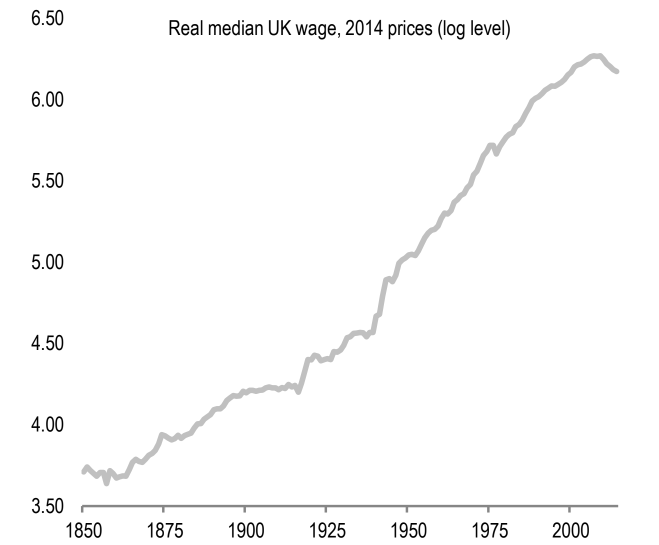
Monetary QE has boosted asset prices, but has had only a negligible impact on wages, and thus tends to be unpopular politically. The chart below illustrates the recent stagnation in the real median UK wage, which has fallen by the greatest amount on record over the past 150 years. This is partly largely because of the impact of technology and outsourcing. We believe that fiscal QE could be targeted to benefit the low end work either directly (raising tax thresholds or pension income for the poorer households) or, more likely, indirectly by targeting construction/infrastructure related projects that tend to employ the lower income earner.

Figure 13: The multiplier for fiscal spending is much greater than for revenue, particularly in a downturn



Source: Credit Suisse European Economics team

Figure 14: In real terms, the average UK wage has fallen by the most on record since 1850



Source: Bank of England, Credit Suisse research

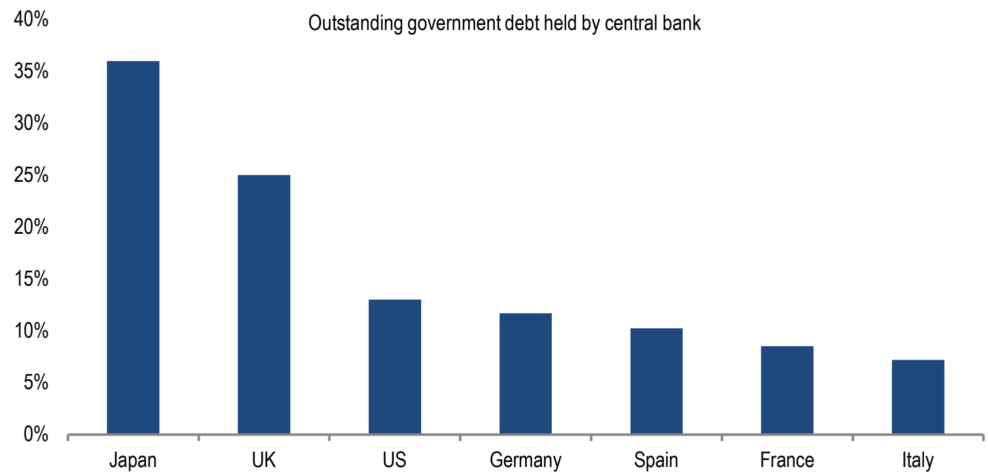
The cancellation of debt

Clearly, once governments embark on some form of fiscal QE, the issue quickly arises whether there needs to be some form of cancellation of government debt.

If there is fiscal QE to finance profitable infrastructure projects, then there will be no increase in net government debt. This is partly why we suspect this course of action will eventually be taken.

The major central banks own up to 36% of their outstanding domestic government debt. It is possible that a central bank could just swap its holdings into very long dated zero coupon bonds or even zero coupon perpetual bonds and thus the central bank holdings of government debt would have no financing impact on government funding.

Figure 15: The BoJ and BoE already have significant holdings of outstanding government debt



Source: Thomson Reuters Datastream, The BLOOMBERG PROFESSIONAL™ service, Credit Suisse

If we take the case of Japan, government debt excluding that held by central banks is still high, at 155% of GDP (cf headline government debt to GDP of 246%). But it is quite possible that QQE and the deposit rate cuts could push, say, the 40-year JGB yield down to zero (the 30-year yield in Switzerland is already just 5bps). The government could then issue a zero yielding, zero coupon, long-dated JGB and either announce a swap of existing JGBs into the new instruments or simply convert the debt it buys (via QQE) into the long-dated zero coupon bonds. Eventually, in this scenario, we think the BoJ would convert all outstanding JGBs into zero yielding, zero coupon, long-dated bonds, or even perpetuals (at the current rate of asset purchases, the BoJ is buying nearly 10% of outstanding JGBs per year).

A similar programme to that described above could be used elsewhere.

Which is the most politically practical and feasible form of fiscal QE?

We, along with Credit Suisse's co-head of global economics, Neville Hill, would categorise the various types of fiscal QE as follows:

- **Implicit fiscal QE**

This form of policy easing is nothing new, but simply whereby fiscal and monetary policy are aligned, with government spending increasing at the same time as central banks undertake conventional monetary QE. This has effectively already happened in both the US and UK in 2009, where, alongside QE, there was fiscal easing of 1.9% and 3.3% of GDP respectively (it was just that, as discussed above, huge fiscal tightening followed this).

How feasible? Probably the most feasible policy path given that, to some degree, it is the path already taken by a number of governments. Of the G4 central banks, the greatest hurdle faced would be by the ECB, where the European Fiscal Compact effectively limits fiscal flexibility of euro area member states unless there is a severe recession or potentially an exceptional downturn (as defined by an annual fall in real GDP of at least 2% and between 0.75-2% respectively). Otherwise, the only time slippage has been allowed is if structural reform is currently underway. Clearly, an agreement to temporarily or permanently amend the Fiscal Compact would be very difficult unless there was a recession.

Japan, to some extent, already appears to be going down this route with a probable supplementary budget of ¥5-10trn and a postponement of the next consumption tax hike for 30 months (until September 2019) – according to Nikkei, 28 May.

- **Profitable infrastructure spending (which would not add to government net debt)**

This would take the form of central banks purchasing infrastructure bonds, perhaps issued by public financial institutions, to fund infrastructure spending. For this spend to be profitable, the projects would have to be financed via tolls and the ensuing projects would need to take place in areas where there is a clear shortage of existing infrastructure.

This is likely to be a highly effective form of stimulus as it is both profitable (and thus not add to government debt), should boost productivity (if there is a shortage of infrastructure), boosts growth (if there is a shortage of domestic demand), has a high multiplier and can be politically prudent (as it helps predominantly lower end workers who as above have lost out to technology and globalisation).

How feasible? To us, this would also seem a relatively feasible policy path. As above, there is a shortfall of infrastructure spending in parts of Europe, the UK and US. In the case of such profitable projects, the government could act as a catalyst or partner for private capital, perhaps by providing guarantees or loans. Clearly, this is legally the most complex in the euro area but even then we can see potential ways around it, for example by buying Infrastructure Bonds in the secondary market issued by the European Investment Bank (EIB).

- **Unprofitable infrastructure spending**

This is much like the above, but not necessarily profitable – either because there is already an excess of infrastructure projects (for example, 'bridges to nowhere'), or it is not financed by tolls.

How feasible? This could prove more problematic than the above. If the central bank were acquiring the infrastructure bonds to finance such projects, they would face the possibility of default on these bonds if projects could not cover their costs. If these defaults were large enough, they might start to undermine the central bank's capital position. Clearly, the central government could underwrite losses that the central bank would make but the hurdle for infrastructure not financed by tolls would likely be higher.

- **Straight 'helicopter money'**

Government spending funded directly by central bank purchases of very long term debt. The central bank then either holds this debt to maturity, or de facto cancels government debt through the process highlighted above.

How feasible? Such a policy would be likely to face significant institutional and political challenges, being the end-game of debt monetisation. So-called helicopter money could involve social or physical infrastructure projects in the first instance or, failing that, straight tax cuts or – perhaps more likely – the underwriting of public pension commitments. Clearly, this would be difficult to implement in Europe but not so difficult perhaps in Japan, the UK or the US (where, according to our US economist, the Treasury is the "holding" company of the Federal Reserve and to some extent the discussion is irrelevant as central banks could just pursue a form of implicit fiscal QE when the political pressure for such a form of action becomes acute (i.e. into a recession). In Europe, it is legal for the ECB to buy government bonds in the secondary markets and in several instances the ECB have pursued courses of action (such as the SMP, ERM or OMT) which had been thought to be outside of their mandate.

- **'Helicopter money' via the banking system**

Central banks could lend to banks at negative rates on the condition that they lend on to consumers or corporates at zero rates. This policy would essentially be a more extreme version of the TLTRO II programme begun by the ECB, and would represent a slow motion recapitalizing of the banking system.

How feasible? Such a policy would fit into existing institutional channels. But ultimately, we think governments would rather direct their largesse and in turn potentially get the political credit for it.

Figure 16: Forms of fiscal QE and potential constraints they would face

	Extent of policy innovation	Political hurdles	Legal hurdles
Implicit fiscal QE	Nothing new: combining loose monetary policy and asset purchases with expansionary fiscal policy	Low, but may need a recession (in euro area, can suspend fiscal targets if GDP falls 0.75% or more)	None (but would require a recession in the euro area)
Infrastructure spending - profitable	A previously-tested form of stimulus, though central bank involvement in buying infrastructure bonds would be an innovation	Low, provided projects are profitable and thus do not affect net debt	More complex in the euro area, but can set up a Juncker-type mechanism
Infrastructure spending - unprofitable	A previously-tested form of stimulus, though central bank involvement in buying infrastructure bonds would be an innovation	High	More complex in the euro area, but can set up a Juncker-type mechanism
Helicopter money - via banks	Fairly extreme, but there are similarities with the ECB's TLTRO and BoE's FLS schemes	Significant	Low
Helicopter money - directly financed by central bank	The greatest departure from conventional QE. Untested by G4 central banks	Huge	Huge (except perhaps Japan)

Source: Credit Suisse estimates

Which regions are likely to do 'infrastructure QE' first?

Below, we try to quantify both the need and likelihood of fiscal/infrastructure-focused QE being implemented. This is simply judged based on the following factors:

i. **The need for stimulus:** we proxy this by looking at nominal GDP growth over the past 5 years and the unemployment rate versus its 15-year average; weak nominal growth and unemployment above average score well.

ii. **Whether monetary weapons are running out:** we judge this by looking at the central bank balance sheet as a proportion of GDP and nominal 10-year government bond yields; a large balance sheet as a proportion of GDP and low nominal bond yields score well.

iii. **Effectiveness of infrastructure QE:** very simply, we would judge the efficacy of such a policy on whether or not there is an existing infrastructure shortfall; a low WEF infrastructure quality and global ranking score well.

iv. **The ability to implement fiscal QE:** this depends largely on central bank policy flexibility and fiscal constraints imposed on the government, which we score from 1-5, with 5 being the greatest degree of flexibility.

Treating the euro area as a composite (using data for Germany, France, Spain and Italy) leaves the likelihood ranking with Japan first, followed by the UK second, then the US and finally the euro area.

Figure 17: Japan scores at the top of our fiscal QE likelihood scorecard

	WEF infrastructure		Public investment, % GDP		Nominal GDP	Unemployment	Central bank B/S	10-yr gov yield	Policy flexibility	Average
	Score	Rank	7yr chg, p.p.	Absolute	Growth, %	Dev. From 15-yr avg, p.p.	% GDP	%	1 to 5 (5 = flexible)	z-score
	5%	*5%*	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*	*30%*	
Japan	6.2	7	-0.1	3.3	1.0	-1.2	81%	-0.2	5	0.68
UK	5.3	24	-0.8	2.6	2.5	-1.1	22%	1.4	5	0.11
US	5.8	13	-1	3.2	3.3	-1.8	25%	1.6	4	-0.19
Euro area*	5.5	22.5	-0.9	2.6	2.9	0.6	28%	0.6	2	-0.21

**GDP weighted figures for Germany, France, Spain, Italy*

Source: Thomson Reuters Datastream, WEF, Credit Suisse research

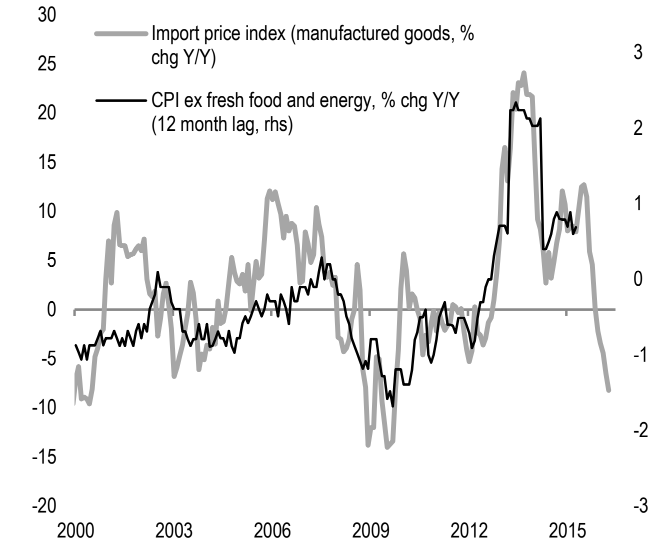
- Japan: probably straight 'helicopter money'

Japan is most likely to resort to this sort of policy, in our view. The central problem for Japan is that, as things stand, Japanese PMIs are already consistent with a recession and USDJPY is consistent with deflation. We find that nearly all of inflation has come from higher import prices; the recent appreciation of the yen has led to a fall in import prices, which now implies a fall in core CPI. Indeed, our economists forecast CPI ex-food and energy inflation to fall to just 0.3% by end-2016.

Figure 18: Japanese manufacturing PMIs suggest near zero GDP growth

Source: Thomson Reuters Datastream, Markit, Credit Suisse research

Figure 19: The fall in import prices implies a return to deflation on core price measures



Source: Thomson Reuters Datastream, Credit Suisse research

Moreover, Japan has used up a lot of monetary flexibility, with the BoJ balance sheet by year-end at close to 90% of GDP (and by end-2017 or mid-2018 the BoJ, who already own 36% of JGBs, will run out of assets to buy without insurance companies/banks breaching their liquidity requirements).

In Japan, the fiscal law generally prohibits the central bank from directly funding government spending, but it can be changed by a simple majority in the Lower House (Article 5 of the BoJ Act allows the central bank to underwrite government spending if "…as a result of a decision reached in the Diet"). In deferring the sales tax rise to October 2019, citing the risk of a 'Lehman-scale crisis', Shinzo Abe has invoked a sense of emergency, suggesting that a hurdle to further action is low. Moreover, 5 of the 9 members of the BoJ's policy board are now appointed by Abe, suggesting that he has significant control over the BoJ (which previously used to be controlled by the MoF). A supplementary budget, reported to be up to 1% to 2% of GDP (as reported in Nikkei), is now expected in Autumn.

On our scorecard, Japan scores extremely highly for the quality of existing infrastructure (thanks in part to prior infrastructure-focused fiscal stimulus), which, on our methodology, counts against it pursuing this form of fiscal QE.

Thus, in Japan we think QE would take the form of tax cuts financed de facto by the central bank (whether this is implicit or explicitly so). This would generate inflation given Japan is close to full employment (with a job/offer to applications ratio at a 30 year high).

- The UK: infrastructure spending

In the UK, although the central bank retains ultimate operational independence, the 1998 Act permits the Chancellor to specify what price stability consists of and what the economic policy of the government is – two factors which relate directly to the bank's monetary policy objectives – and in some sense can thus guide policy setting. Indeed, Neville Hill, Credit Suisse's co-head of economics, highlights that the Chancellor can de facto set the mandate of the Bank of England (the 1998 Act states "…the Treasury, after consultation with the Governor of the Bank, may by order give the Bank directions with respect to monetary policy if they are satisfied that the directions are required in the public interest and by extreme economic circumstances").

Through the crisis, we note it was the government which led the way in driving the Bank of England to pursue policy innovation. In January 2009, it was the Chancellor who instructed the Bank of England to set up an asset purchase programme (albeit one which, initially, was financed through the issuance of bonds); it was not instigated by the Bank of England.

In addition, as noted in the table above, the UK's infrastructure score from the WEF's ease of doing business ranking is relatively poor for a developed nation at 24, plus public investment is at the lower end of those in this cross-sectional sample at 2.6% of GDP, having fallen by 0.8p.p. since the start of the government's austerity plan. There would, therefore, appear to be appetite for infrastructure investment.

It is fairly easy to envisage a situation where the Chancellor authorises the BoE to buy Infrastructure Bonds issued by, say, a UK Infrastructure Bank with the oversight of the UK Infrastructure Regulator, who is there to ensure each project is profitable (and that is easily achievable because the government can set the tariff so that projects are profitable). We think the political pressure for such a policy would likely grow if it looked like the Labour Party were to win a general election, with Jeremy Corbyn, the leader of the opposition, likely advocating 'People's QE' into the next crisis, whereby the BoE would directly fund government spending.

- The euro area

The euro area may be considered the region least likely to pursue a policy of fiscal QE though ironically it is where it is most needed, in our view (owing to the shortage of domestic demand, the spare capacity in the labour market and the shortage of infrastructure in countries such as Italy).

Figure 20: Existing infrastructure in Italy is of poor quality, and public investment in Spain has contracted sharply over the past 7 years

	WEF infrastructure		Public investment, % GDP	
	Score	Rank	7yr chg, p.p.	Absolute
Italy	4.1	66	-1.2	2.3
Spain	5.7	14	-2.8	2.3
Germany	5.9	11	-0.1	2.2
France	5.9	10	-0.8	3.4

Source: Thomson Reuters Datastream, WEF, Credit Suisse research

Our European economists make the point that any political agreement in Europe tends to take time and happen only into a crisis and thus Europe would likely be behind the UK, Japan or US in promoting fiscal QE. But on the Global Equity Strategy team, we wonder whether a form of fiscal QE could happen earlier than expected, albeit perhaps in a muted form via the Juncker plan mechanisms already in place.

The mechanics of the Juncker plan are that €21bn of seed capital, via guarantees from the European Commission and the EIB, were made available to allow the EIB to issue up to €60bn of bonds, which in turn could be invested in projects worth €315bn (as explained in more detail by the FT, November 2014). To date, the European Fund for Strategic Investments has approved €12.8bn worth of projects which, the European Commission estimate, will trigger €100bn of investment (with 80% of that from private capital). This has been considered a success by the EC, who have proposed to extend the plan beyond its planned end in 2018.

To really fuel the plan, however, we think it is quite possible that the ECB could buy bonds from the EIB. The EIB could have seed capital injected into it according to the capital key (this could be leveraged up 15x according to the Juncker plan). The infrastructure projects could be apportioned in line with the capital key. Moreover, an independent European Infrastructure Body could be set up to ensure that each project is profitable on a P&L basis (or indeed the EIB, ECB or EC could oversee this).

Neville Hill highlights that it is legal for the ECB to do some form of TLTRO whereby banks are only offered the funding advantage if they lend money at the rate of zero to the corporate or household sector. In order to solve the problem of low take-up that has been associated with previous refinancing operations, the subsidised cost funding could be made so favourable that banks in effect couldn't turn it down – say a TLTRO charged at minus 100bp. Thus the difference between fiscal and monetary QE essentially vanishes.

- The US

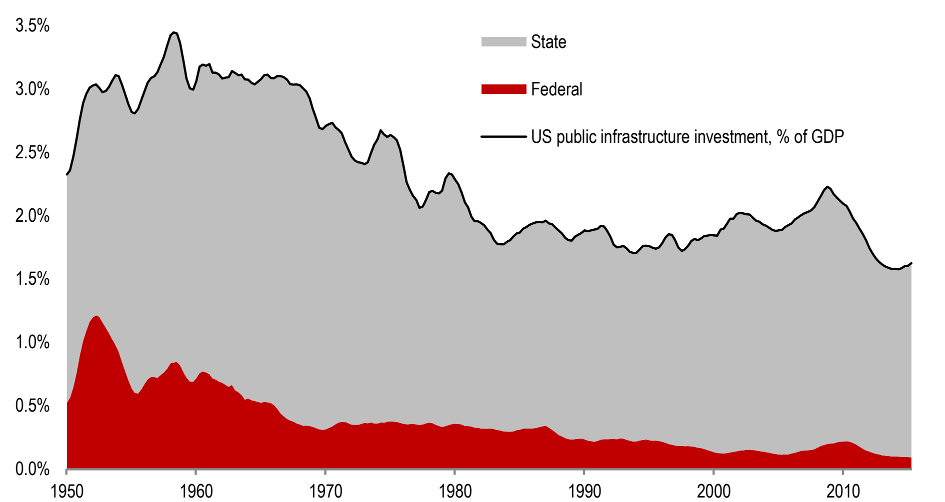
Back in 2009, the US government instituted a stimulus programme, with fiscal easing of 1.9% of GDP, and indeed eased fiscal policy hugely in 1933/4, with nominal government expenditures increasing c.60%, as the US came off the gold standard and invoked the 'New Deal'. Into another crisis/recession, we think it would be relatively easy to assume Congress/the President agree on some form of stimulatory fiscal policy. This could easily just be financed by a Fed that is expanding QE.

In the US, both Hillary Clinton and Donald Trump have talked about the need to boost infrastructure, with the former planning for a total of up to $500bn in federally supported investment over a five-year period.

The US scores relatively low on our fiscal QE scorecard given its relatively (and perhaps surprisingly) high infrastructure score, robust nominal GDP growth, and still considerable scope for conventional QE (bearing in mind the Fed balance sheet is as a proportion of GDP much smaller than that of Europe or Japan) and nominal yields are much higher. Indeed, our economists expect growth to be sufficiently robust to allow two rate hikes this year.

Nevertheless, public infrastructure investment as a proportion of GDP is very low and we believe that when the next recession comes, there will likely be too little monetary firepower for conventional QE to work. Thus, we would expect some form of infrastructure related QE to be implemented but more likely the implicit form – for instance, QE could be expanded at the same time as Congress passes a bill to boost public infrastructure spending.

Figure 21: Public infrastructure investment in the US is depressed



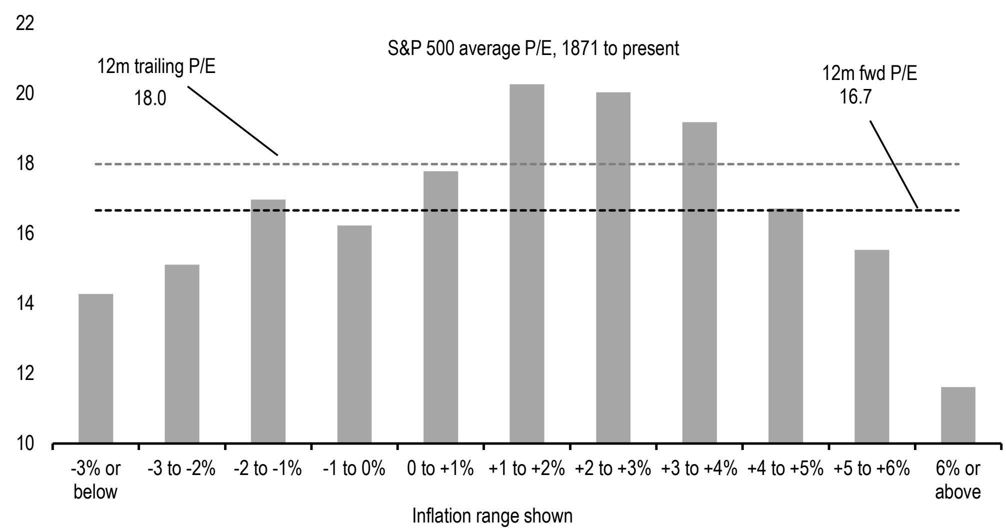
Source: Thomson Reuters Datastream, Credit Suisse research

Who are the potential winners?

Equities

In our opinion, fiscal QE would provide a tailwind for equities. Essentially, equities are an inflation hedge and fiscal QE is likely to result in an increase in inflation expectations (with bonds being a deflation hedge).

Figure 22: P/Es re-rate until inflation rises to above 3%



Source: Robert J. Shiller, Thomson Reuters Datastream, Credit Suisse research

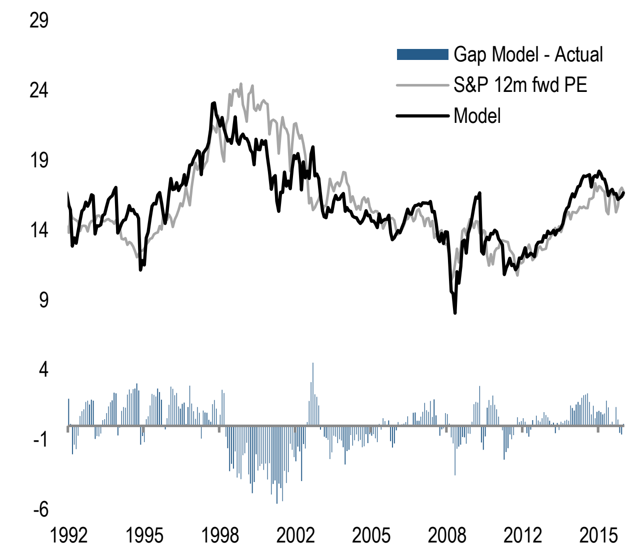
We believe real bond yields are likely to fall as inflation rises more than nominal yields which are essentially capped by QE. While, under normal circumstances, falling real yields are negative for equities (as real yields tend to fall in line with growth expectations), on this occasion we believe that the fall in real yields would re-rate real assets. This is due to the following formula:

Real dividend yield = Real bond yield + Equity Risk Premium - Real DPS growth

Thus if the real bond yield were to fall by for example 50bp, the equilibrium dividend yield would fall by a corresponding amount helping to re-rate assets.

This is supported by our fair value P/E model which estimates the 12-month forward P/E to rise by 0.89 as real yields fall by 1pp.

Figure 23: Our 12-month forward P/E model for the S&P suggests a fair value P/E of 16.7x



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 24: P/E model specifications

	FY3 EPS growth	12m fwd EPS dispersion	US lead indicator - dev. from trend	10y TIPS yield	Policy uncertainty, 12mma
Latest	12.2	4.7	0.7	0.2	117
Coefficent	0.67	-0.90	0.19	-0.89	-0.05
t-value	16.3	-6.3	1.8	-9.3	-10.2
	Intercept				
Coefficent	19.1		Current 12m fwd P/E	16.5	
t-value	23.1		Model	16.7	
			Upside (downside)	**0.9%**	
R2	69%				
adj. R2	68%				

Source: Thomson Reuters Datastream, Credit Suisse research

Additionally, a rise in nominal bond yields would quickly result in losses for holders of government bonds, which would likely result in a significant switch from bonds to equities.

The following screen shows the fiscal QE plays that we discuss below, which have also been awarded a HOLT eCap, indicate upside on HOLT and are Outperform-rated by CS analysts.

Figure 25: Fiscal QE plays with an eCap and an Outperform rating

		-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	eCap Award	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Travis Perkins	X	13.1	82%	12%	1.6	-16%	4.8	2.8	31.8	-2.8	-0.8	2.1	Outperform
Assa Abloy 'B'	X	22.4	141%	10%	5.1	36%	3.6	1.7	1.7	-3.6	-1.9	2.7	Outperform
Eaton	X	14.2	89%	15%	1.9	-13%	7.4	3.5	4.9	0.8	0.5	2.6	Outperform
Johnson Controls	X	10.7	127%	-16%	2.8	32%	1.5	2.7	23.3	3.5	0.4	2.2	Outperform
Regal Beloit	X	12.2	77%	-7%	1.3	-23%	11.9	1.6	63.2	-7.9	-2.7	2.6	Outperform
Rexnord	X	14.2	89%	-8%	3.7	-27%	7.0	0.0	17.4	-1.1	-0.6	2.6	Outperform
Raytheon 'B'	X	18.3	115%	25%	4.0	107%	6.3	2.1	9.7	1.5	0.5	1.7	Outperform
General Dynamics	X	14.6	92%	4%	4.1	48%	5.1	2.1	1.1	1.4	-0.7	1.9	Outperform

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

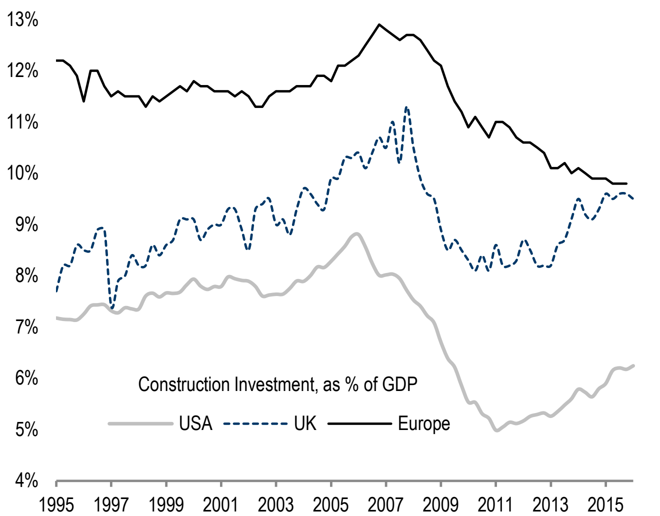
Construction

With around 40% of construction demand being infrastructure related, the sector would be a significant winner from infrastructure type projects. We see four additional supports for the sector, giving us enough reasons to introduce an overweight weighting on construction even in the absence of a fiscal QE programme. These supports include:

- **Non-residential construction as a proportion of GDP near 20-year lows:** European construction as a share of GDP is close to 20-year lows, indicating significant pent-up construction demand, while US construction also remains below its 20-year norm, despite picking up since 2011.

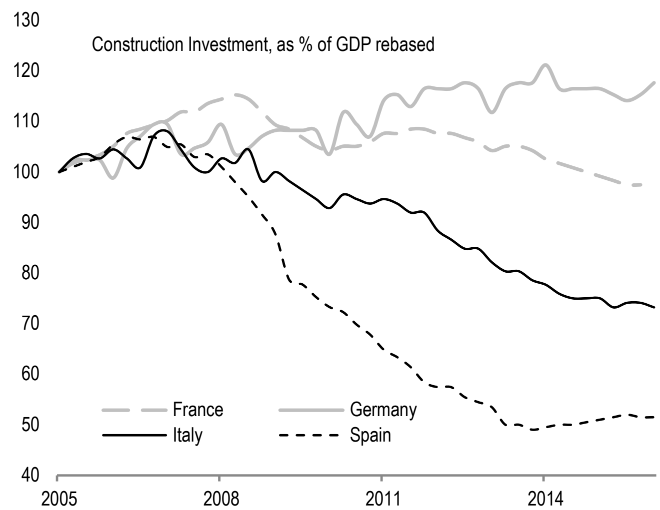
Within Europe, not surprisingly, the periphery has seen the biggest slowdown in construction.

Figure 26: Construction investment is below its norm in the US and Europe



Source: Thomson Reuters Datastream, Credit Suisse research

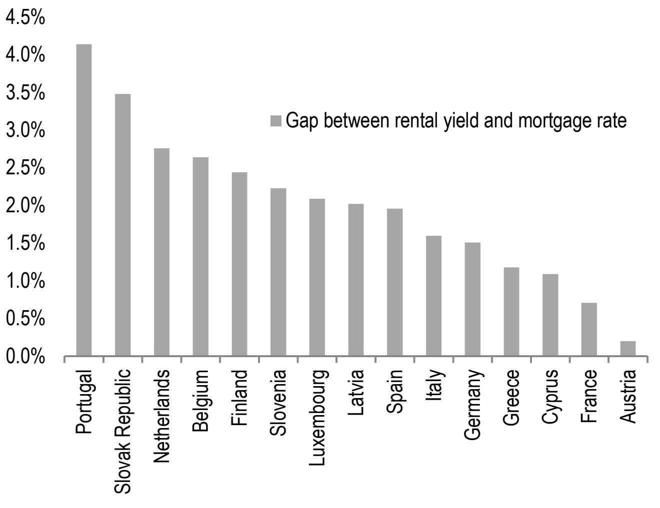
Figure 27: Construction has been particularly weak in the periphery



Source: Thomson Reuters Datastream, Credit Suisse research

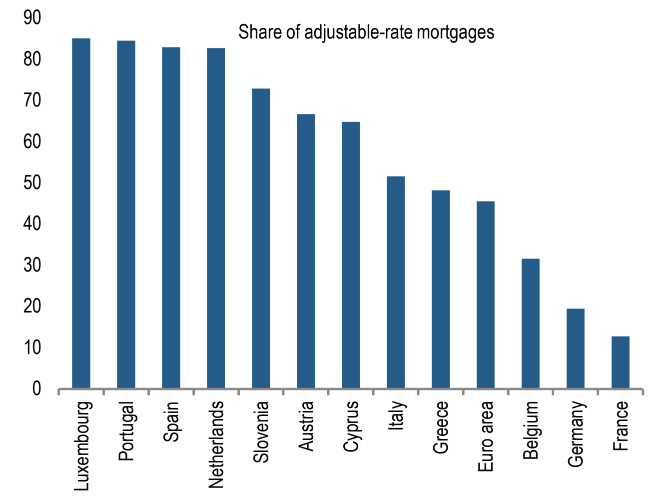
- **The residential cycle should improve:** mortgage rates remain below rental yields in many European countries, making investments in residential property very attractive, likely leading to higher house prices and increased construction. The impact of this should be particularly strong in core Europe, where around 80% of mortgages are fixed, allowing investors to lock in cheap funding for a longer period of time.

Figure 28: The gap between rental yields and mortgage rates is supportive of house prices



Source: Thomson Reuters Datastream, Credit Suisse research

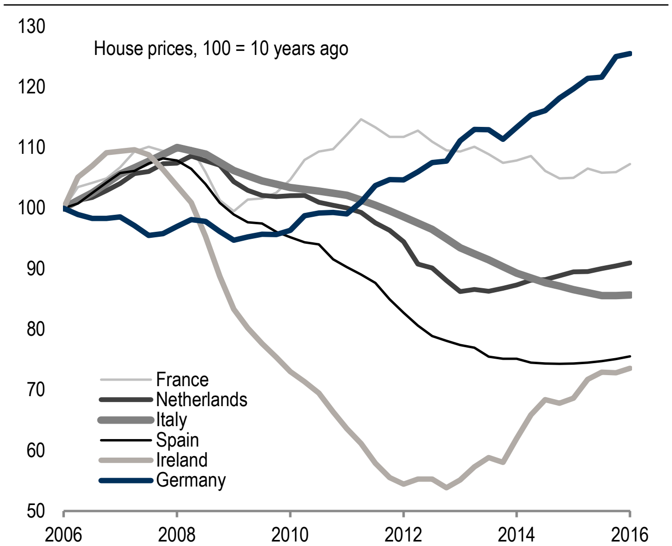
Figure 29: The majority of mortgages in euro area are adjustable-rate, with the exception of Germany and France



Source: Thomson Reuters Datastream, Credit Suisse research

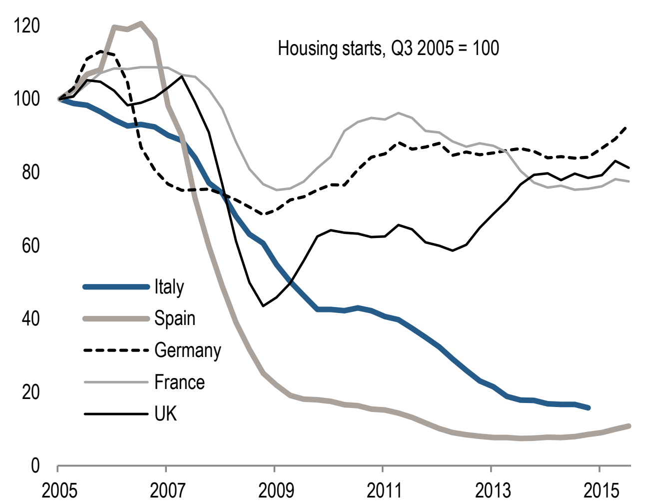
- **House prices are now rising in most major European countries:** despite this, they are still below their pre-crisis peak in all major countries but Germany. On the back of the ongoing European recovery and with the cost of borrowing for households to purchase houses the lowest in more than a decade, we think house prices are likely to rise further. This should help housing starts, which seem to be picking up (or have troughed) in most European countries.

Figure 30: House prices are rising in most euro area countries



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 31: Housing starts across European countries

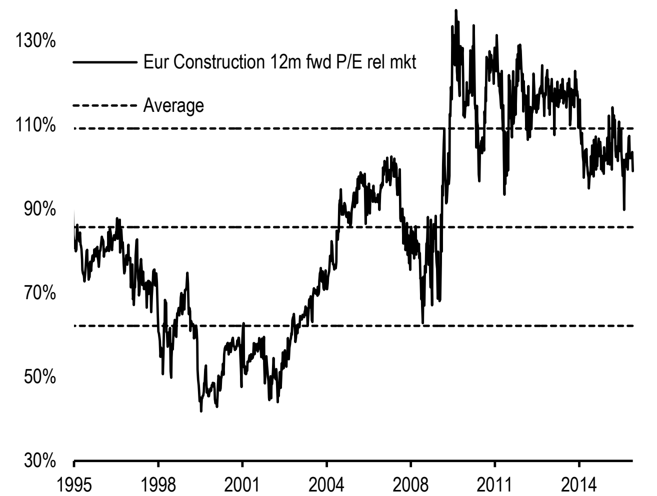


Source: Thomson Reuters Datastream, Credit Suisse research

- **A relatively non-disrupted sector:** as we have discussed many times before, we are currently in a period of nearly unprecedented technological disruption challenging traditional business models alongside increased competitive and deflationary pressure from China. While nearly every sector is at least to a certain degree impacted by this, we think construction remains one of the few that is experiencing very little disruption.

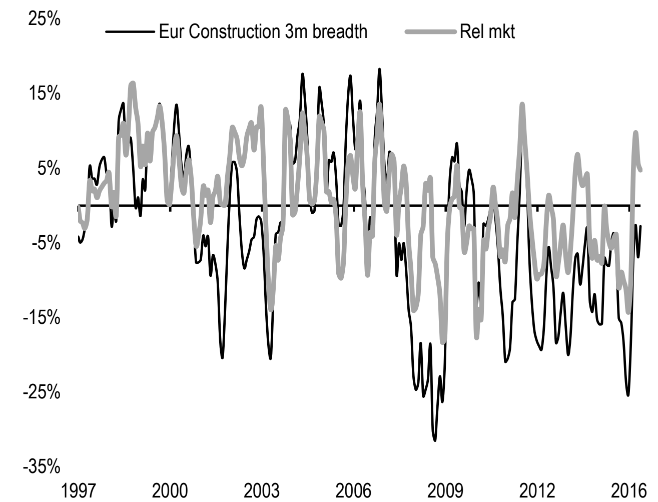
European construction companies trade close to the lower end of their post crisis range on 12-month forward P/E relative, and earnings momentum is now better than the market.

Figure 32: European construction stocks trade close to the lower end of their post crisis range



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 33: Earnings momentum of European construction plays is better than the market



Source: Thomson Reuters Datastream, Credit Suisse research

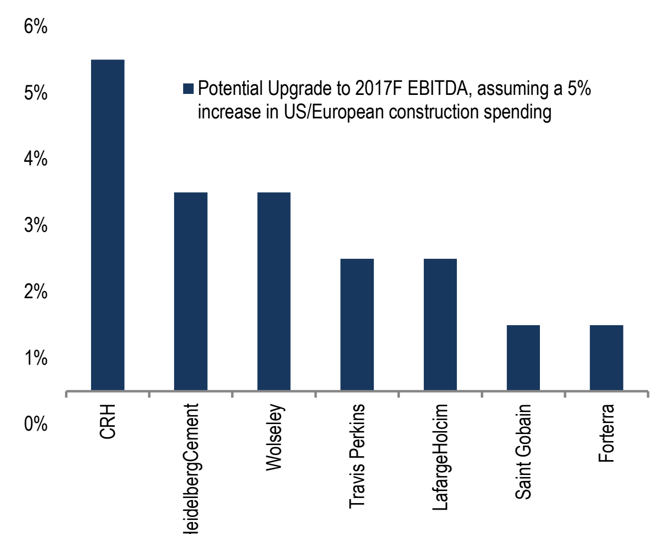
The below table shows European construction companies with the biggest exposure to public construction spending covered by our sector team. The chart below also shows the stocks' earnings sensitivity to a pick-up in US and European construction investment by 5%. Based on this, CRH, HeidelbergCement and Wolseley would be the biggest beneficiaries of a pick-up in spending, in our view.

Figure 34: European construction companies and their exposure to public construction spending

	Sales exposure			Exposure To Public Sector/ Infrastructure	Group Exposure To Developed Market Public Spend/Infrastrcuture
	North America	Europe	Total Developed Market		
CRH	55%	35%	90%	50%	45%
HeidelbergCement	35%	35%	70%	50%	35%
Wolseley	85%	15%	100%	30%	30%
Travis Perkins	0%	100%	100%	25%	25%
LafargeHolcim	22%	22%	44%	50%	22%
Saint Gobain	15%	65%	80%	25%	20%
Forterra	0%	100%	100%	20%	20%
Average					**28%**

Source: Credit Suisse European Building team

Figure 35: Sensitivity of construction stocks' EBITDA to an increase in construction spend



Source: Credit Suisse European Building team

We screen below for European construction stocks under Credit Suisse coverage.

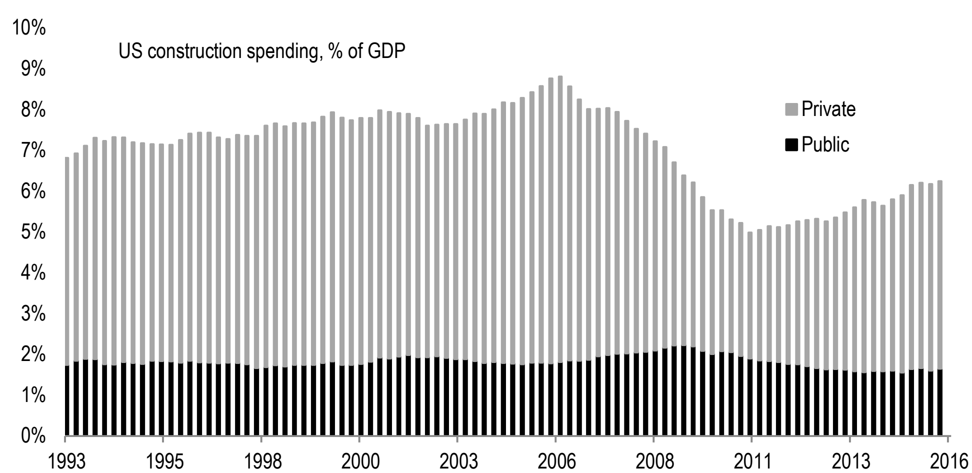
Figure 36: European construction plays

	-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Crh (Dub)	15.5	91%	7%	na	na	6.0	2.5	9.2	-2.4	-0.6	2.3	Neutral
Forterra	7.5	44%	na	na	na	na	3.4	na	na	na	2.0	Outperform
Heidelbergcement	13.5	79%	12%	1.1	-13%	5.3	2.1	17.8	1.3	-2.2	2.2	Underperform
Lafargeholcim	16.6	97%	16%	0.8	-49%	10.8	3.6	-0.4	-0.7	-3.0	2.7	Outperform
Saint Gobain	15.5	97%	40%	1.2	-3%	7.0	3.2	-1.2	-3.1	-2.0	2.3	Underperform
Travis Perkins	13.2	82%	11%	1.7	-14%	4.6	2.7	27.0	-2.8	-0.8	2.1	Outperform
Wolseley	14.0	87%	16%	3.6	53%	4.0	2.8	6.8	-1.2	1.1	2.6	Outperform

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

While US construction as a share of GDP has already picked by more than 1pp since its trough at the end of 2010, this has been mainly driven by the private sector with US public construction spending only slightly above its 20-year low. We highlight in more detail below the outlook for non-residential construction.

Figure 37: While US private construction picked up, public construction remains subdued



Source: Thomson Reuters Datastream, Credit Suisse research

Companies exposed to a further pick-up in US construction include Vulcan Materials and Martin Marietta (both Not Rated).

Figure 38: Stocks exposed to a further pick-up in US construction

	-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Vulcan Materials	28.7	169%	-19%	3.5	42%	2.4	0.6	-31.5	7.2	-0.3	1.8	Not Rated
Martin Mrta.Mats.	22.4	131%	12%	3.0	10%	2.3	0.9	-15.6	10.8	2.8	2.0	Not Rated

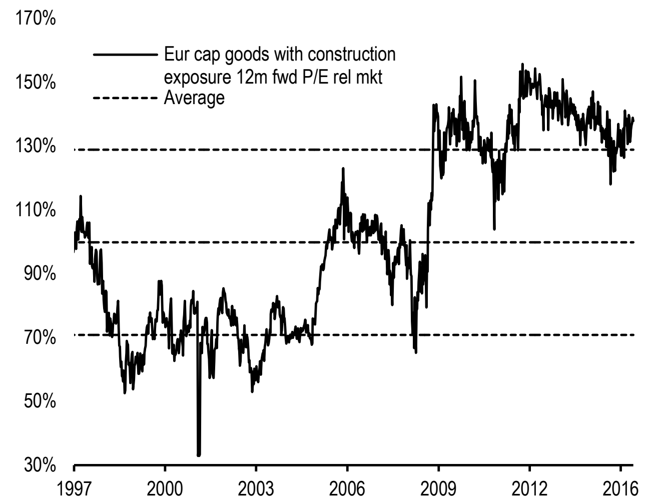
Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

Construction-exposed capital goods companies

On the back of increased construction and infrastructure spending we would also look at capital goods companies with exposure to construction spending in the US and Europe.

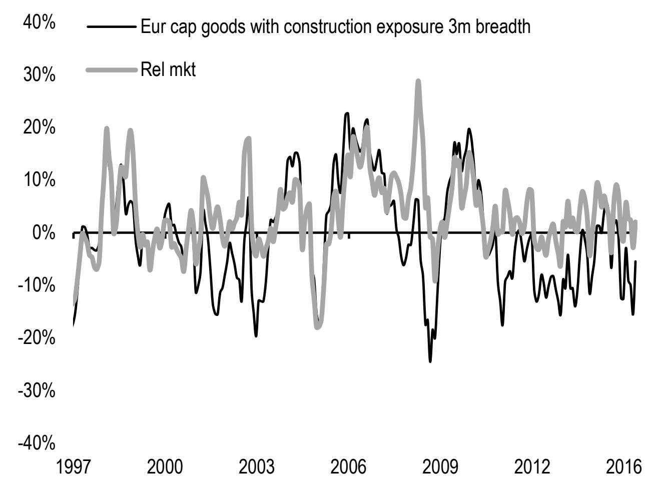
While construction-exposed capital goods companies look relatively expensive on 12-month forward P/E relative to their long-term average, they are trading in line with their post-crisis norm. Earnings momentum is arguably negative but in line with the market.

Figure 39: Construction-exposed capital goods stocks trade in line with their post 2009 norm…



Source: Thomson Reuters Datastream, Credit Suisse research

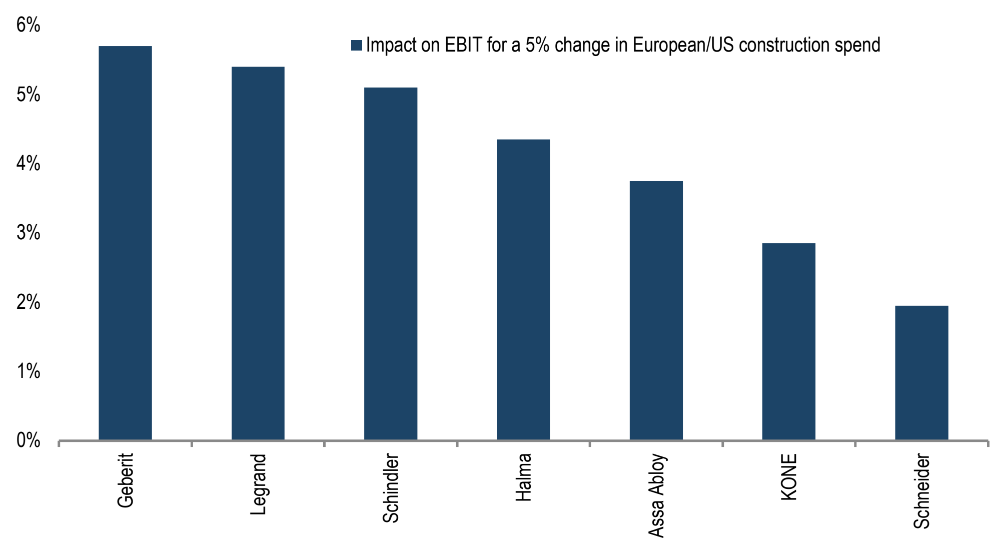
Figure 40: … and earnings momentum is in line with the market



Source: Thomson Reuters Datastream, Credit Suisse research

The chart below shows the EBIT sensitivity of European capital goods companies (with construction exposure) to a 5% pick-up in European construction spend.

Figure 41: EBIT sensitivity of European capital goods companies to a 5% increase in European construction



Source: Credit Suisse European Capital Goods research, Credit Suisse estimates

We acknowledge that some of the European capital goods companies with construction exposure also have significant exposure to China (e.g. Kone). Within the European universe we would therefore particularly highlight Geberit, Schindler, Assa Abloy and Halma; all have more than 70% of sales coming from Europe and the US and a HOLT eCap award.

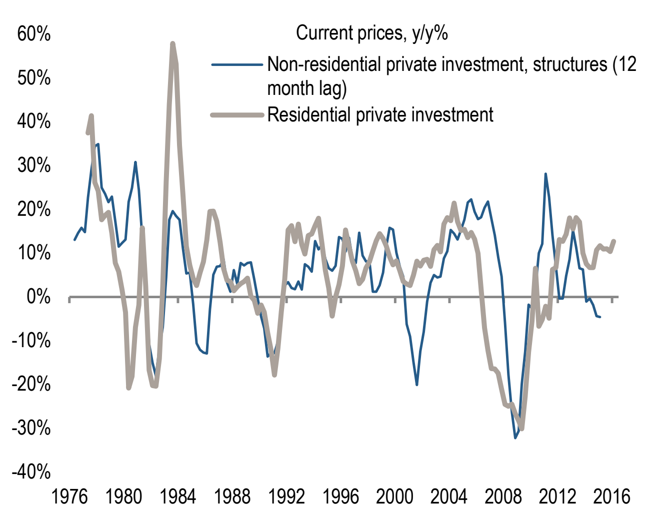
Figure 42: European capital good stocks with construction exposure

					-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Segment Exposure	Sales Exposure to US	Sales Exposure to Pan Europe	eCAP award	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Kone 'B'	Elevators & Escalators	15%	44%	-	21.4	133%	52%	8.4	39%	5.1	3.7	-38.4	-0.6	-1.5	3.3	Outperform
Schindler 'P'	Elevators & Escalators	28%	43%	X	24.7	153%	60%	7.1	100%	3.8	1.6	na	1.1	0.7	2.6	Outperform
Assa Abloy 'B'	Security systems	36%	41%	X	22.5	140%	8%	5.2	38%	3.5	1.7	0.4	-3.6	-2.0	2.7	Outperform
Geberit 'R'	Sanitary systems	4%	91%	X	24.2	150%	43%	9.5	102%	3.5	2.5	-3.1	1.1	1.5	2.4	Outperform
Prysmian	Power grids/ cables	15%	64%	-	15.2	94%	32%	3.6	1%	7.5	2.1	-8.2	0.5	1.9	2.1	Outperform
Nexans	Power grids/ cables	17%	49%	-	17.4	108%	19%	1.7	92%	1.7	1.1	7.9	-3.3	-3.4	2.7	Neutral
Thyssenkrupp	Elevators & Escalators	19%	62%	-	14.7	61%	15%	3.5	95%	0.8	1.2	42.4	-4.6	-1.5	2.3	Outperform
Legrand	Low voltage systems for buildings	19%	49%	X	21.8	135%	35%	3.5	30%	4.7	2.4	-5.0	-2.3	-0.2	2.4	Outperform
Halma	Building & Infrastructure safety components	31%	42%	X	24.5	198%	54%	6.5	72%	3.9	1.4	-37.8	0.4	0.4	2.8	Outperform

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

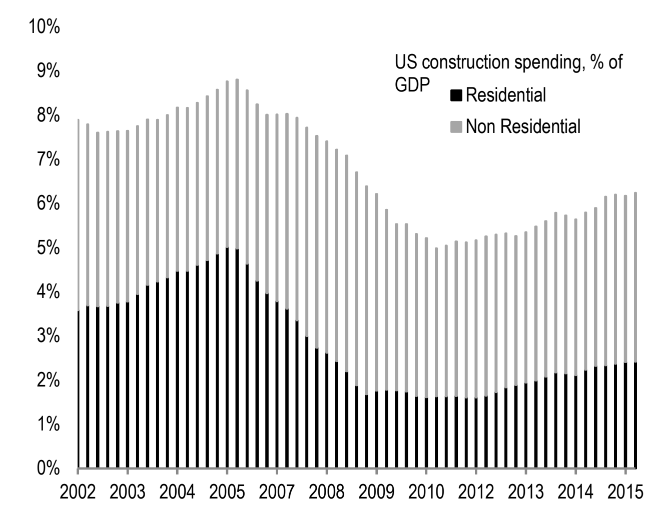
Even in the absence of fiscal QE, we are bullish on the US construction cycle (especially non-residential construction). Non-residential construction tends to lag residential construction by c18 months with residential construction currently growing at 12.7% y/y while non-residential investment is falling at 4.6%. Furthermore, non-residential construction is currently running at only 3.8% of GDP, close to a 15-year low.

Figure 43: Non-residential investments tends to lag residential investments by 12 months



Source: Thomson Reuters Datastream, Credit Suisse research

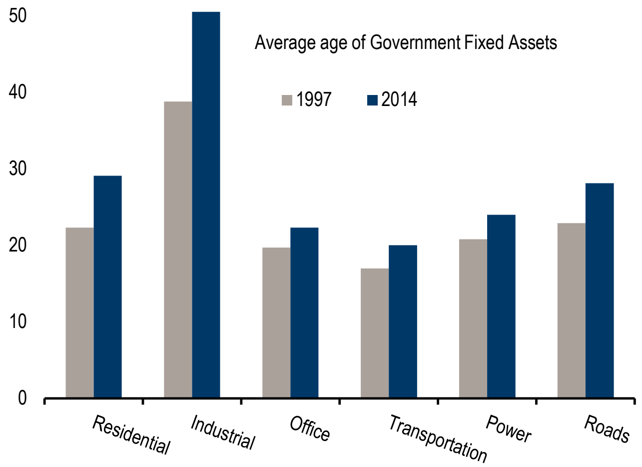
Figure 44: Non-residential construction is c40% of US construction



Source: Thomson Reuters Datastream, Credit Suisse research

We would highlight that US infrastructure has aged significantly since 1997 (e.g. the average road aged by five years and the average industrial structure by 12 years) and the funding gap until 2025 is now estimated to be c$1.4trn according to the American Society of Civil Engineers. There seems to be some change in policy with the US Congress recently passing a new five-year $305bn infrastructure bill – the first large infrastructure spending commitment in over eight years.

Figure 45: The US infrastructure is ageing…



Source: BEA, Credit Suisse research

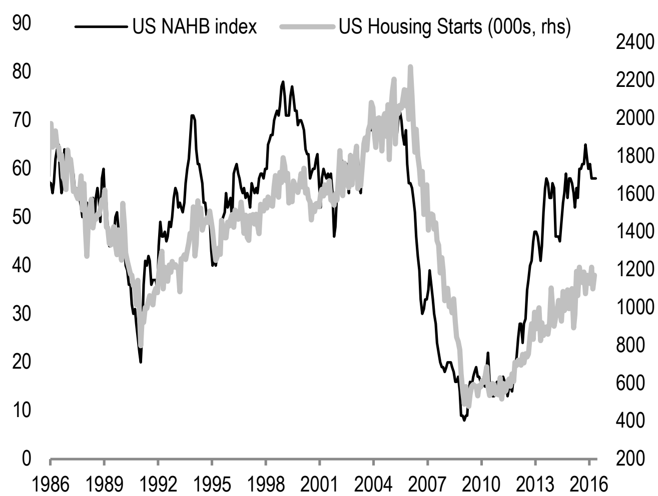
Figure 46: … and the funding gap is running at $1.4trn until 2025

Investment funding gap - 2016 through 2025	In $bn	As % of total needs
Surface Transportation	1101	54%
Water/Wastewater	105	70%
Electricity	177	19%
Airports	42	27%
Inland Waterways & Marine Ports	15	41%
Total	**1440**	**43%**

Source: ASCE, Credit Suisse research

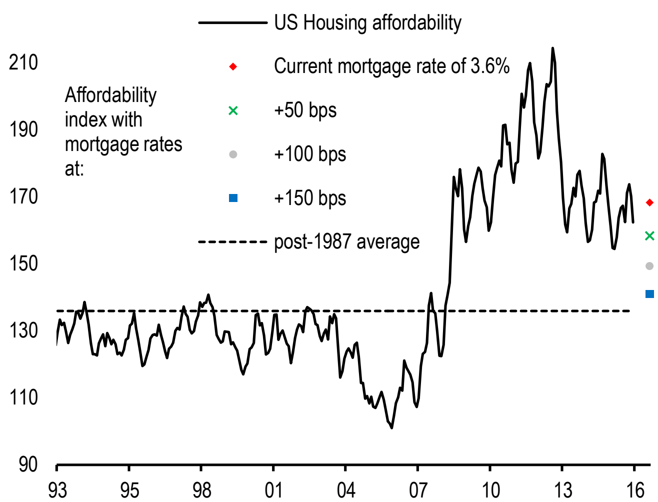
Despite seeing the biggest upside to the non-residential cycle, we continue to remain bullish of the residential cycle. The NAHB index is consistent with 1.7m housing starts (compared to 1.1m now) as well as housing as % of GDP picking up to 5.2% (in line with its pre-crisis norm and compared to 3.6% now) while affordability continues to look high.

Figure 47: NAHB implies housing starts of 1.7m vs. 1.1m currently



Source: Thomson Reuters Datastream, Credit Suisse research

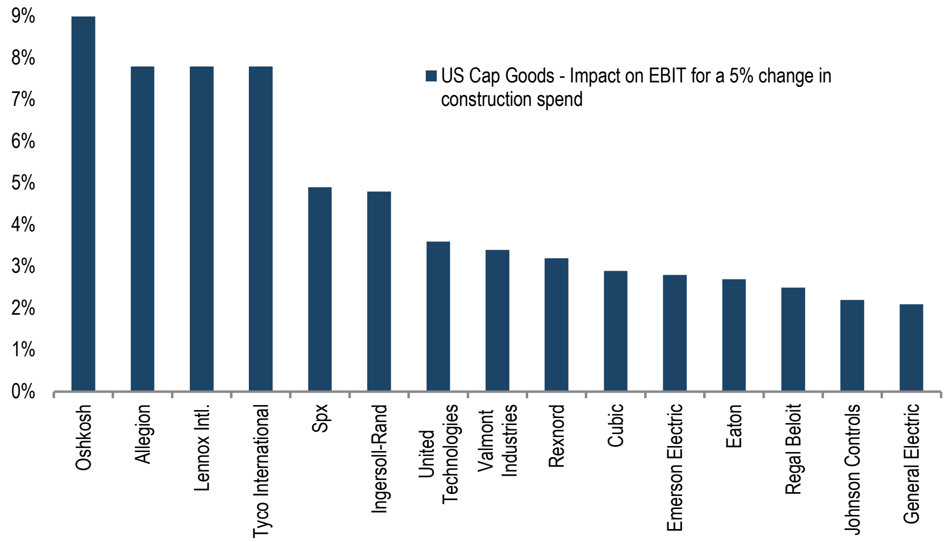
Figure 48: Housing affordability is still attractive



Source: Thomson Reuters Datastream, Credit Suisse research

In the US, Julian Mitchell, our US Electrical Equipment/Multi-Industry Analyst, and Jamie Cook, our US capital goods analyst, highlight below the capital good stocks exposed to increased construction and infrastructure spending and their earnings sensitivity to a 5% pick-up in US and European construction.

Figure 49: US cap goods stocks and their exposure to a 5% pick-up in US/European construction



Source: Credit Suisse US Capital Goods research, Credit Suisse estimates

Of these, the following are cheap on 12-month forward P/E relative, have upside on Credit Suisse HOLT and are Outperform-rated by our team in the US: Johnson Controls, Regal Beloit and Rexnord.

Figure 50: US capital good stocks with construction exposure

		-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Segment Exposure (%)	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Allegion	Security Systems	19.2	120%	-3%	254.6	409%	4.7	0.7	-36.2	0.0	1.0	1.6	Outperform
Cubic	Public Transport Systems	20.2	126%	15%	1.4	-15%	na	0.7	16.7	0.9	2.2	2.2	Outperform
Emerson Electric	Low Voltage for Buildg/HVAC Components	16.1	100%	-8%	4.2	9%	7.4	3.7	-7.1	1.5	0.8	3.0	Outperform
Eaton	Low Voltage for Building	14.0	87%	11%	1.9	-14%	7.4	3.5	4.7	0.8	0.5	2.6	Outperform
General Electric	Grids	18.7	116%	-4%	2.9	-29%	4.3	3.1	-10.3	-0.3	-2.4	2.2	Outperform
Honeywell Intl.	Fire & Security Systems/Building Controls	16.6	103%	6%	4.8	29%	5.5	2.1	10.9	1.1	0.3	1.9	Neutral
Ingersoll-Rand	HVAC	15.6	97%	37%	0.0	-98%	6.2	2.0	-11.4	4.8	0.8	2.1	Outperform
Johnson Controls	HVAC/Building Controls	10.8	124%	-18%	2.8	32%	1.5	2.7	21.7	3.5	0.4	2.2	Outperform
Lennox Intl.	HVAC	19.7	123%	40%	60.8	516%	4.1	1.1	-34.9	4.4	-0.1	2.5	Neutral
Regal Beloit	HVAC Components	12.0	75%	-10%	1.3	-24%	11.9	1.6	61.2	-7.9	-2.7	2.6	Outperform
Rexnord	Water Management Systems	13.5	84%	-15%	3.6	-31%	7.3	0.0	21.0	-1.1	-0.6	2.6	Outperform
Spx	HVAC/Public Transport Systems	12.9	80%	230%	1.9	-59%	6.2	0.0	-29.9	-10.8	-4.2	2.3	Outperform
Tyco International	Fire & Security Systems/Building Controls	19.6	103%	205%	4.5	64%	4.6	2.0	-38.0	-1.0	0.5	2.3	Neutral
United Technologies	E&E/HVAC systems/Building Controls	15.0	93%	-5%	3.1	-10%	6.0	2.6	-0.9	0.7	0.4	2.3	Neutral
Valmont Industries	Grids/Roadway Lighting	20.9	130%	31%	3.3	35%	5.2	1.1	-12.8	0.7	-3.6	2.8	Underperform
Oshkosh	Construction Machinery	14.5	91%	15%	1.9	-4%	8.8	1.6	14.6	11.7	3.6	2.3	Underperform
Deere	Agricultural Machinery	23.0	145%	60%	4.0	26%	4.6	2.8	-6.8	-9.8	-0.8	2.9	Outperform

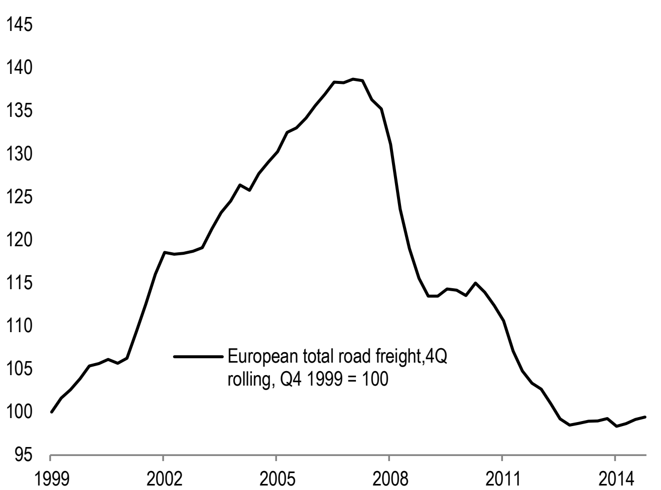
Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

Infrastructure

We like infrastructure names for the following reasons:

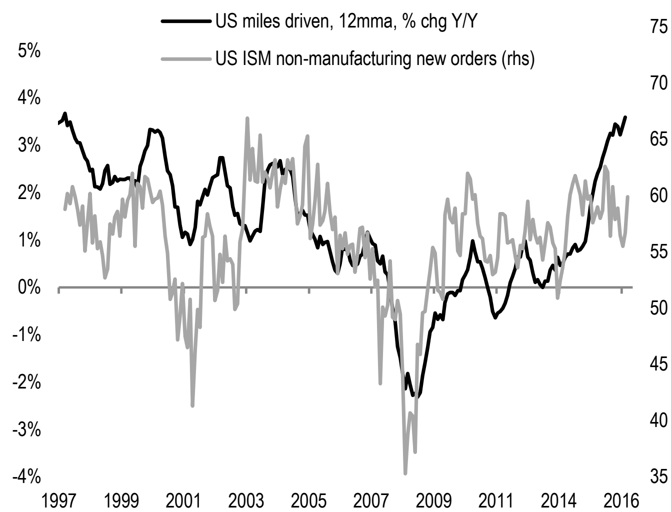
- Downside protection: if none of the big central banks chooses to implement fiscal QE, real rates are likely to fall further, helping infrastructure stocks, which tend to have very long durations (especially the Spanish infrastructure names)
- Upside potential into an economic recovery: if there is a stronger than expected economic recovery, then we get a pick-up in miles driven (aided anyway by the fall in petrol prices). 2% on GDP usually adds around c1.4% to miles driven; an industrial recovery leads to a pick-up in truck volumes.
- The fall in petrol prices means more miles driven per unit of GDP (as illustrated in the example of ISM new orders, a proxy on the cycle, versus miles driven, which are growing strongly).

Figure 51: Cargo transported on European roads seems to have troughed



Source: Thomson Reuters Datastream, Credit Suisse research

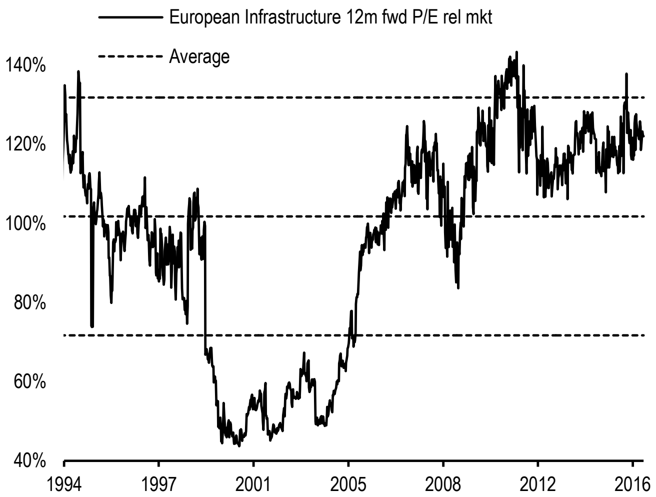
Figure 52: US miles driven are growing ahead of economic momentum



Source: Thomson Reuters Datastream, Credit Suisse research

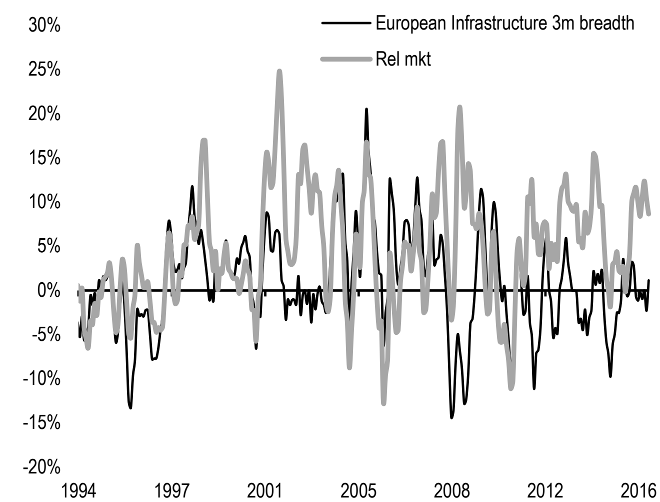
- Construction exposure: as discussed above, we remain bullish on construction, especially in Continental Europe and many of the big infrastructure names such as Eiffage and Vinci have significant contracting businesses making up around 80-85% of group revenues. Furthermore, a pick-up in construction is likely to help currently very low construction margins (c2-4%), with half of that coming from public construction investment.
- Another undisrupted sector: infrastructure stocks are potentially even less disrupted by new technologies and Chinese competition than the construction sector (see above).
- Infrastructure stocks don't look too expensive, trading in line with their post-crisis norm on 12-month forward P/E relative, and earnings momentum is better than the market.

Figure 53: Infrastructure stocks trade in line with their post crisis norm on 12m forward P/E relative



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 54: Earnings momentum is better than the market



Source: Thomson Reuters Datastream, Credit Suisse research

The below screen shows European infrastructure stocks and their construction exposure. Of these, OHL and Eurotunnel have upside on HOLT.

Figure 55: European infrastructure stocks

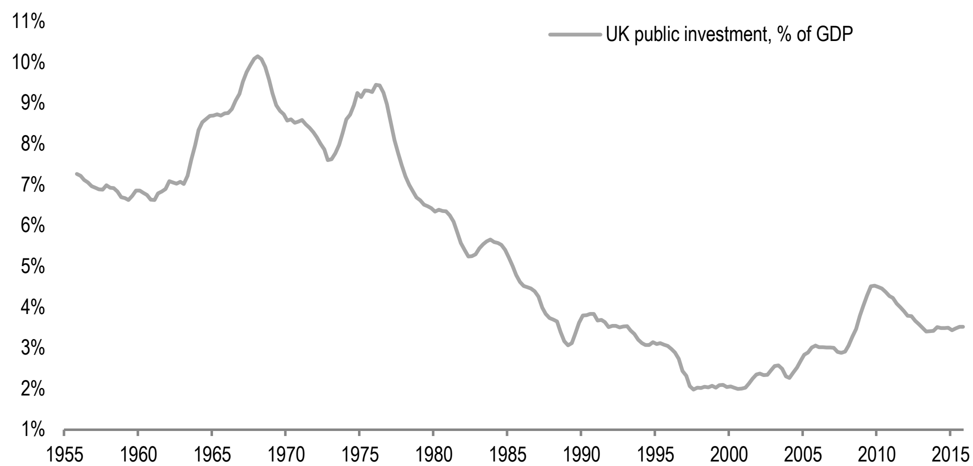
	-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Eiffage	15.2	94%	49%	1.9	22%	6.1	2.4	-72.4	1.3	-0.3	2.4	Not Rated
Ferrovial	27.0	168%	74%	2.3	10%	2.7	3.8	-64.5	5.9	-3.5	2.0	Not Rated
Obrascon Huarte Lain	8.3	52%	-14%	0.5	-71%	-17.6	3.6	91.1	-28.7	-2.7	3.0	Not Rated
Vinci	15.6	97%	20%	2.4	17%	5.7	3.0	-21.4	3.3	-0.4	2.1	Not Rated
Hochtief	22.0	137%	16%	3.7	141%	8.5	2.1	-37.9	12.4	-6.5	3.2	Not Rated
Abertis Infraestructuras	17.5	117%	3%	3.8	47%	6.4	5.0	-41.4	0.8	-0.3	2.7	Not Rated
Atlantia	18.3	123%	-2%	2.9	-16%	14.4	4.2	-22.5	-0.8	1.1	2.1	Not Rated
Groupe Eurotunnel	42.0	281%	-48%	3.7	113%	3.6	2.2	17.4	-4.6	-1.4	2.1	Not Rated
Bouygues	16.1	100%	-26%	1.3	-41%	3.1	5.6	-7.6	3.3	-1.5	3.2	Neutral

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

UK – construction/infrastructure-related plays

In the UK, we think increased infrastructure spending fueled by fiscal QE/easing on infrastructure would benefit two sets of companies: contractors and outsourcing. Public investment as a proportion of GDP is very low.

Figure 56: UK public investment as a share of GDP remains low



Source: Thomson Reuters Datastream, Credit Suisse research

Contractors, such as Balfour Beatty, WS Atkins and Carrillion have substantial exposure to construction spending. In fact, up to 52% of revenue comes from public construction investment. Furthermore, WS Atkins and Carrillion have substantial pension deficits (26% and 34% of market cap, respectively) and rising yields would help to reduce the gap between pension assets and liabilities.

Figure 57: UK construction contractors

			-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Construction Exposure	Pension obligations as a % of market cap	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Carillion	25%	34%	7.8	49%	-19%	1.2	-38%	14.8	6.9	-32.1	-0.5	2.9	2.4	Not Rated
Balfour Beatty	30%	9%	17.5	109%	48%	2.0	-82%	-7.6	1.5	-81.0	-24.6	-4.1	2.1	Not Rated
Interserve	31%	0%	5.0	31%	-53%	0.9	-57%	4.1	7.9	184.1	4.2	-1.3	1.9	Not Rated
Atkins (Ws)	52%	26%	11.6	61%	-22%	6.6	-66%	na	3.1	37.9	-1.9	-1.4	2.1	Not Rated

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

Outsourcing might not be the most obvious play, but we would argue that fiscal easing might involve renewing prisons, improving immigration facilities and spending on other forms of social infrastructure. This would benefit stocks like Serco.

Cement

We discussed reasons for staying overweight the cement sector in *China: the key issue, and how to play it*, 10 May. Aside from being a clear beneficiary of any acceleration in construction activity following implementation of fiscal QE, we would highlight the following positives for the sector:

1. **Risks posed by China possibly overstated**

We believe that concerns over potential Chinese dumping of cement, as was seen with steel, are overdone. Although there is a need for reduction in Chinese cement production capacity, the risk of this capacity being exported on an international scale is low, in our view. Though international shipping rates are cheap, Chinese producers would require control of international port distribution terminals to export cement in any meaningful quantity.

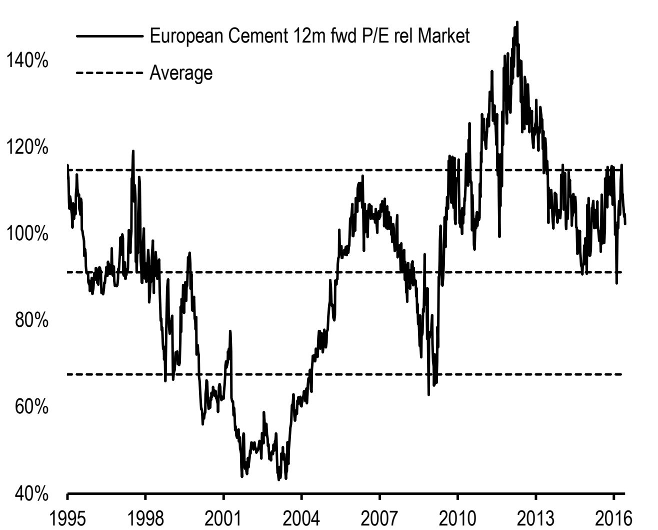
In addition, there are some signs of rationalisation from China with the government proceeding with plans to eliminate low-grade cement capacity. Credit Suisse's China Basic Materials analyst, Trina Chen, highlights that the three industries China is seeking to rationalise in particular are steel, cement and paper. If authorities eliminate the PC 32.5 capacity, as is planned, then capacity utilisation would rise to 88% over the next two years, from 77% now.

2. Valuations look reasonable, but FCF is far more attractive

Traditional valuation metrics for cement producers look reasonable. The sector is not particularly cheap on P/E, but its price-to-book relative is particularly low. This reflects the relatively low ROE achieved by the sector, a by-product of historical overinvestment.

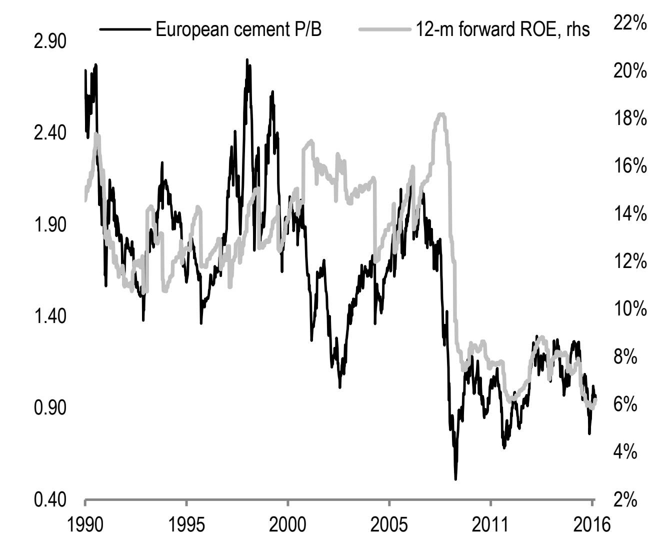
Harry Goad, our Building Materials analyst, believes that the industry leader, LafargeHolcim, can raise its FCF yield to 10% and 14% in 2016/17E, respectively, by almost eliminating growth capex. Whether this will encourage rationalisation from the other major European producers remains to be seen, though we would highlight that the market is currently discounting no improvement in the sector's RoE (the P/B is trading in line with the level indicated by 12m forward consensus RoE).

Figure 58: European cement producers are not cheap on P/E relative, trading on a par with the market…but margins are depressed



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 59: …however, on P/B relative, they appear cheap – trading at a 40% discount to the market and 1.9std below average



Source: Thomson Reuters Datastream, Credit Suisse research

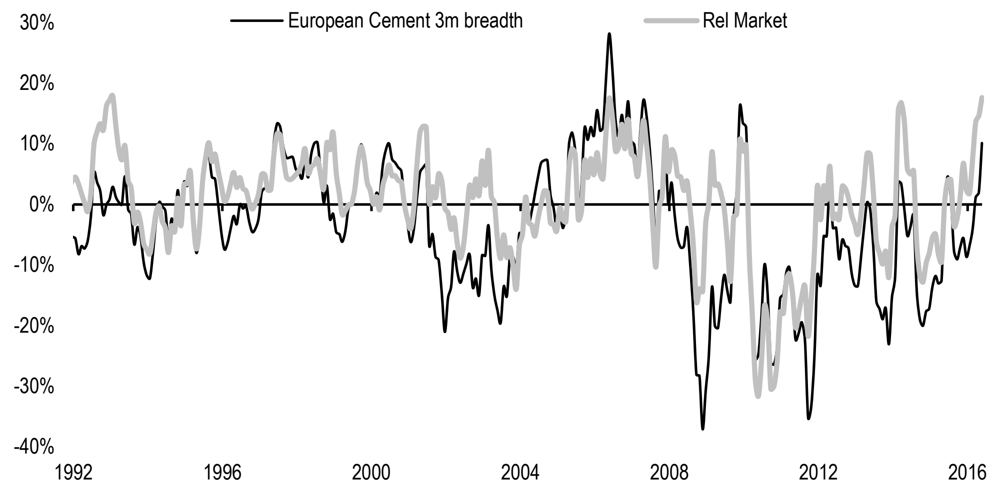
3. Consolidation has led to an improved market structure

There has been some degree of consolidation, with the top three names now controlling 25% of global ex-China market share (and much more regionally), arguably improving pricing ability.

4. Earnings momentum looks particularly strong

Earnings momentum for the cement sector is much better than for the market, with net earnings upgrades now also strongly positive.

Figure 60: Earnings momentum for cement stocks is particularly strong



Source: Thomson Reuters Datastream, Credit Suisse research

We screen below for Outperform- and Neutral-rated cement stocks under Credit Suisse coverage.

Figure 61: Cement stocks under Credit Suisse coverage that are Outperform- or Neutral-rated

	-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Lafargeholcim	16.6	97%	16%	0.8	-49%	10.8	3.6	-0.4	-0.7	-3.0	2.7	Outperform
Cemex Spn.Adr 1:10	27.4	161%	-31%	1.1	-15%	9.9	0.0	na	91.3	-2.4	2.2	Outperform
Taiwan Cement	16.5	97%	-12%	1.1	-26%	na	4.3	-20.1	-16.6	-9.0	2.6	Outperform
Cemex Latam Holding(Bog)	13.1	77%	2%	1.7	-29%	8.5	0.8	-30.8	-5.5	-4.1	2.3	Outperform
Semen Gresik	11.1	65%	-33%	2.0	-21%	12.5	3.5	83.0	-2.9	-2.9	2.7	Outperform
Ultratech Cement	26.7	156%	57%	4.6	30%	3.8	0.3	-12.6	-3.3	-3.8	2.1	Neutral
Taiheiyo Cement	8.6	51%	-76%	1.1	-6%	na	2.1	37.3	-7.4	-6.7	2.2	Neutral
Cementos Argos	25.5	149%	58%	1.7	59%	na	1.7	-24.8	7.0	0.5	3.0	Neutral
Cementos Pacasmayo Adr	15.5	91%	-2%	1.7	2%	5.5	2.2	na	-5.2	4.2	2.7	Neutral
Ict.Tunggal Prakarsa	13.2	77%	-47%	2.5	-56%	7.8	5.0	36.0	-5.6	-6.7	3.1	Neutral

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

Steel

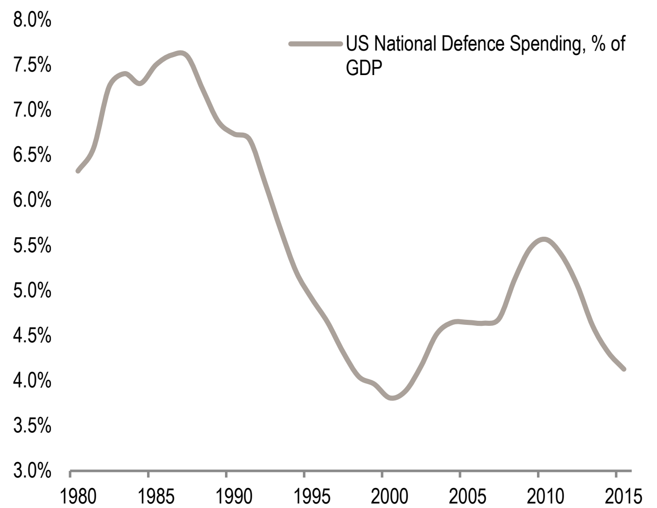
We moved to underweight metals and mining back in March (having raised in Q4 2015) largely to our China-related concerns.

The issue with the sector is that only around 20% of global finished steel demand comes from the US, Europe, and Japan, with around 40% of this demand being construction-related. Assuming that half of this construction demand is infrastructure-related implies that less than 5% of global steel demand is linked directly to developed-market infrastructure investment. This indicates that a 20% rise in developed market infrastructure projects would add only 1% to global steel demand – we do not think this is enough to make a significant difference to the sector, which, to us, largely remains a play on Chinese real estate, China's infrastructure, and Chinese capacity shutdowns.

Defence stocks

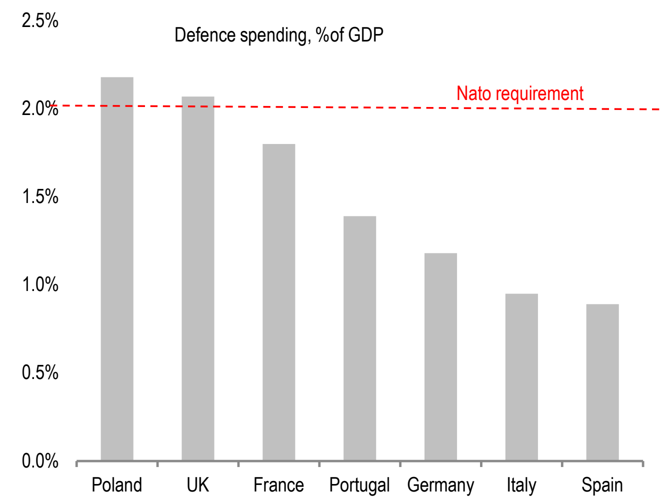
We believe that if there is any form of fiscal easing, it would likely feed through to the local content of defence spending. The defence budget of most developed nations is below both its norm or below where it should be according to alliance requirements. In fact, US defence spending is close to a 35-year low and none of the major European nations (with the exception of the UK and Poland) meets the 2% NATO requirement.

Figure 62: US defence spending as a proportion of GDP is close to a 35-year low



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 63: Most European countries don't meet the NATO requirement



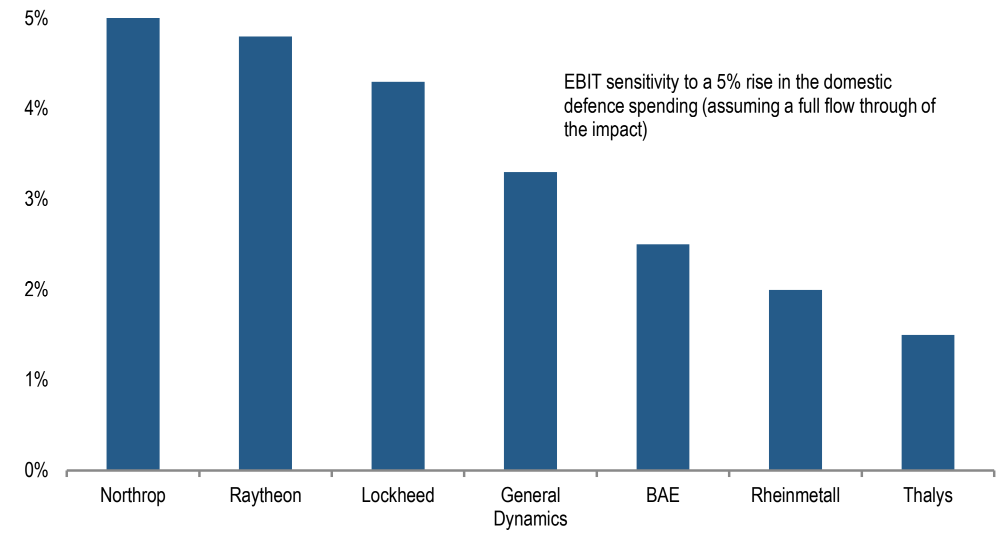
Source: NATO, Credit Suisse research

Because of this, many countries have committed to increase their spending on defence in spite of being under pressure to reduce their budget deficits. NATO Secretary General Jens Stoltenberg stated, "The forecast for 2016, based on figures from allied nations, indicates that 2016 will be the first year with increased defence spending among European allies for the first time in many, many years" (FT, 30 May) with France and Germany committing to increase spending by 8.4% and 6% between 2015-2019. In addition, both Hillary Clinton and Donald Trump have committed to an increase in the defence budget if they were to be elected.

However, we believe that from an economic and social point of view, governments will choose to spend money on defence projects where there is a high local content. Consequently, we screen only for defence companies with a high portion of their revenues coming from their home country.

The below chart highlights the earnings sensitivity of defence companies to a 5% increase in their domestic defence budget.

Figure 64: Defense companies and their earnings sensitivity to domestic defence spending



Source: CS defence research, Credit Suisse estimates

Figure 65: European and US defence stocks and the revenue exposure to their local government

		-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Sales from local govt (%)	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Northrop Grumman	83%	19.1	119%	57%	7.1	269%	4.7	1.6	-33.2	4.3	-0.6	2.3	Neutral
Lockheed Martin	80%	18.8	117%	18%	23.4	153%	6.3	2.8	-36.7	0.4	0.4	2.5	Neutral
Raytheon 'B'	65%	17.7	110%	19%	4.0	101%	6.4	2.2	11.6	1.5	0.5	1.7	Outperform
General Dynamics	57%	14.4	89%	1%	4.1	46%	5.1	2.1	1.8	1.4	-0.7	1.9	Outperform
Bae Systems	25-30%	12.4	77%	2%	5.2	72%	2.9	4.4	-6.1	-2.0	1.6	2.2	Underperform
Thales	20%	17.5	108%	29%	3.5	64%	5.5	2.0	13.2	3.5	2.6	2.3	Outperform
Rheinmetall	13%	12.3	77%	-1%	1.7	10%	3.1	2.4	33.9	4.3	1.5	2.2	Neutral

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

Gold

We believe gold would be a medium- to long-term winner from fiscal QE, albeit likely experiencing an initial sell-off as markets react to a higher level of nominal yields.

The recent support for gold has come from a more widespread implementation of negative rates. There are nearly $12trn of central bank reserves globally, and in some instances central banks have a surprisingly small amount of their reserves in gold. For example, according to the IMF, the PBOC has only 2.2% of its official reserve assets in gold, whereas the Bundesbank has c.69% (data as of March 2016 and April 2016, respectively).

We calculate that if the major central banks were to increase their gold holdings to 20% of reserve assets, incremental gold demand would be over 6x current annual demand. Clearly, fiscal QE, if it were successful, would diminish the need for negative rates, and in that sense might be thought of as a negative for gold.

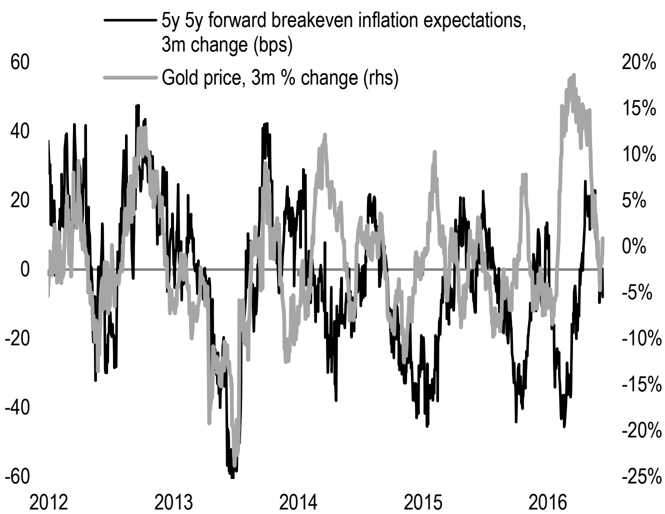
Figure 66: Central banks increasing their gold holdings to 20% of reserve assets would significantly increase global gold demand

	World Official Gold Holdings as of June 2016		Assuming an increase to 20% of reserves, tonnes	Additional demand, tonnes
	Tonnes	% of reserves		
US	8,133	75%	-	-
Germany	3,381	69%	-	-
Italy	2,452	69%	-	-
France	2,436	65%	-	-
Spain	282	20%	-	-
Russia	1,477	16%	1,897	420
UK	310	9%	691	380
Switzerland	1,040	7%	3,149	2,109
India	558	6%	1,762	1,205
Japan	765	3%	6,108	5,343
China	1,808	2%	16,043	14,234
Brazil	67	1%	1,752	1,685
		Total additional demand, tonnes		**25,377**
		Total additional demand, multiple of yearly demand		**6.1x**

Source: World Gold Council, Credit Suisse research

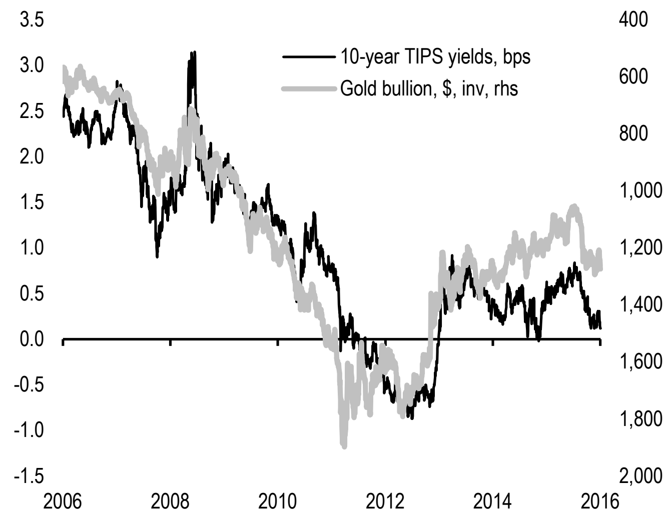
However, in our view, the implementation of a large-scale fiscal QE programme would lead to real bond yields falling as central banks would *de facto* cap nominal yields, while inflation expectations should rise.

Figure 67: An increase in inflation expectations generally sees the gold price rise



Source: Thomson Reuters Datastream, Credit Suisse research

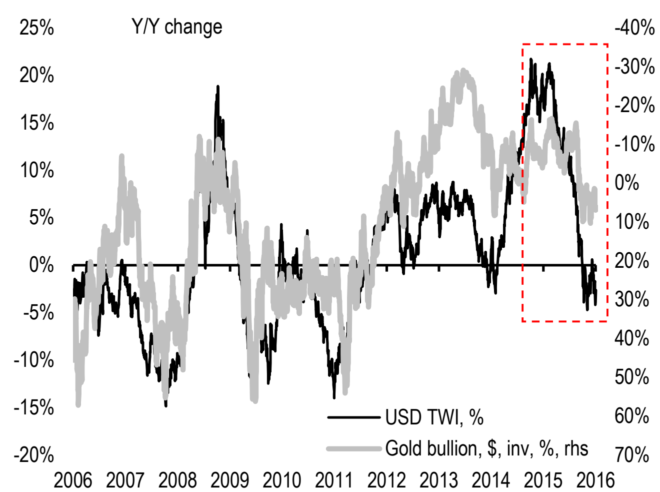
Figure 68: Falling real rates tend to boost gold prices and vice versa



Source: Thomson Reuters Datastream, Credit Suisse research

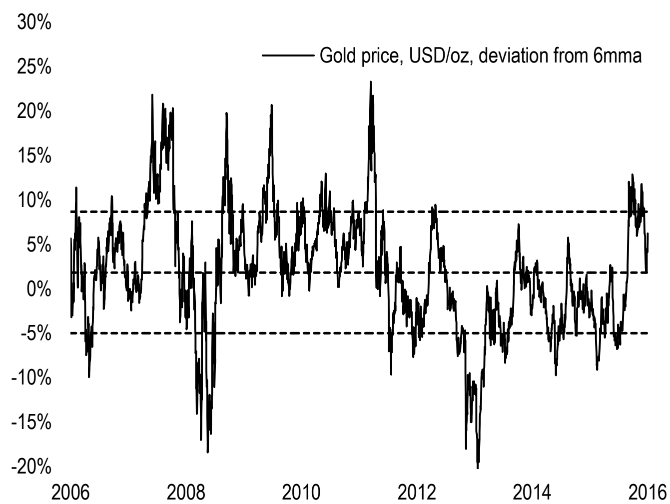
We believe that there are two other key drivers of the gold price: i) the dollar, as shown below (we are mild dollar bears); and ii) the risk of a financial crisis, which makes investors seek perceived 'safe havens'. While we are mildly bearish of the dollar, we see the financial system being less at risk than normal. We would note that gold is no longer overbought, only slightly above its six-month moving average.

Figure 69: A weaker dollar is generally positive for the gold price



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 70: Gold is marginally above neutral on price momentum

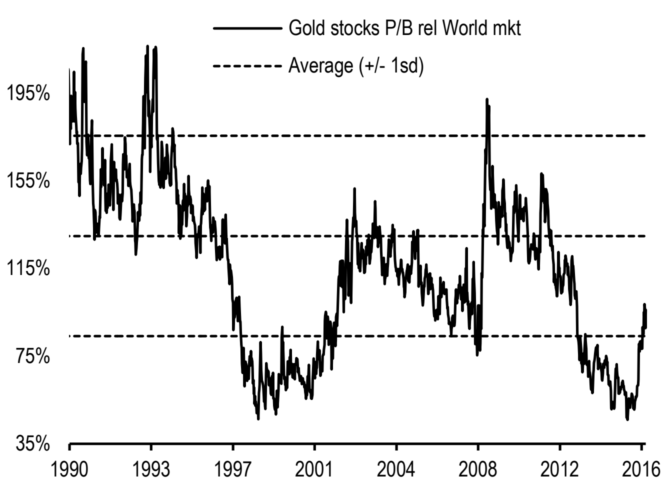


Source: Thomson Reuters Datastream, Credit Suisse research

Gold stocks

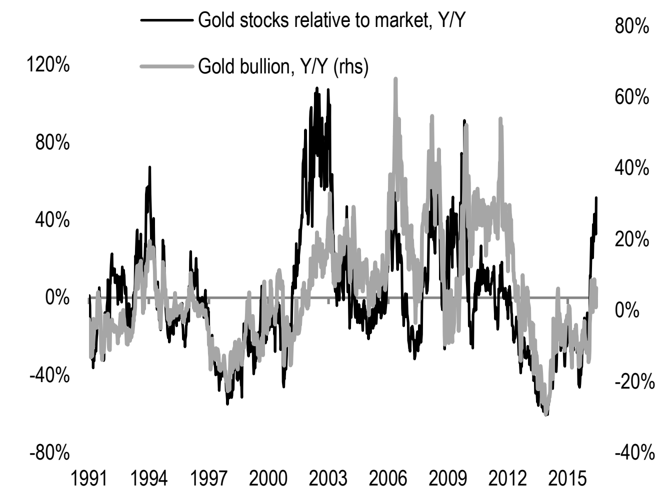
Although we believe that a direct investment in gold is a better way to play a rising gold price than indirect investments in gold mining stocks, we highlight the indirect plays below, which are generally high-beta plays on the gold price. On price-to-book relative to the market – the metric we view as least distorted by the cycle for resource companies – gold miners appear relatively attractively valued, trading at a 4% discount to global equities, versus an average 30% premium. We would, however, note that gold stocks now appear overbought and have overshot the level implied by the gold price.

Figure 71: Gold stocks' P/B relative to the global market is c.0.7sd below average



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 72: Gold stocks have outperformed by more than the gold price would imply



Source: Thomson Reuters Datastream, Credit Suisse research

We screen below for gold miners with a market cap above $1bn that are Outperform-rated by CS analysts.

Figure 73: Outperform-rated gold stocks

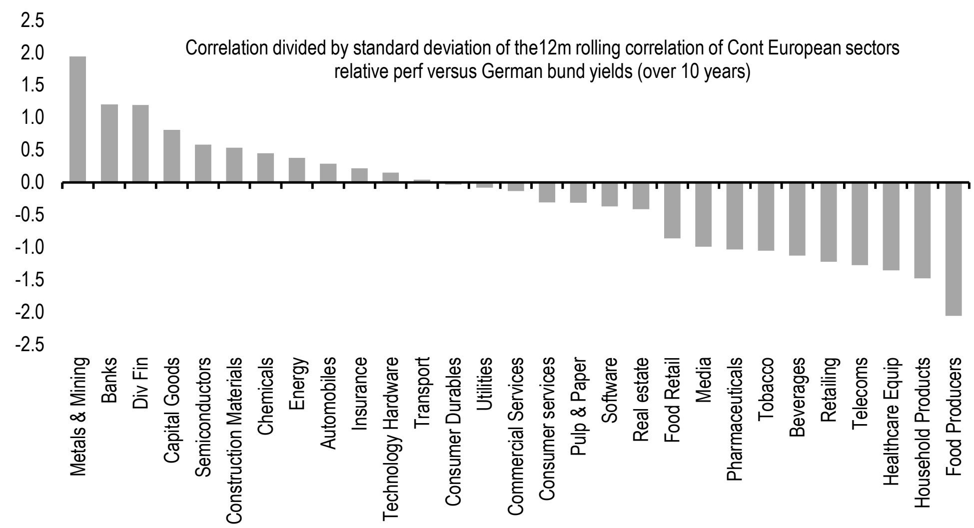
	-----P/E (12m fwd) ------			------ P/B -------		2016e, %		HOLT	2016e Momentum, %			
Name	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
Newmont Mining	24.8	106%	-16%	1.7	-31%	4.0	0.3	16.3	105.2	6.6	2.7	Outperform
Zijin Mining Group 'H'	18.3	78%	7%	1.5	-68%	na	2.5	na	-15.5	18.2	2.2	Outperform
Detour Gold	48.3	206%	-36%	2.1	4%	3.1	0.0	-11.7	141.4	7.4	2.0	Outperform
Tahoe Resources	23.1	98%	-58%	1.7	-33%	1.2	1.7	6.6	39.5	26.7	1.9	Outperform
Acacia Mining	15.9	68%	37%	1.2	21%	5.6	1.2	80.8	41.5	2.0	2.8	Outperform

Source: Thomson Reuters, I/B/E/S, Credit Suisse HOLT, Credit Suisse estimates

The sector implications of a rise in nominal yields

We believe that any form of large-scale fiscal easing is likely to lead to a rise in nominal bond yields. Rising yields usually favour financials and hurt consumer staples. This is supported by the below chart showing the correlation of sector performance with bond yields adjusted for the volatility of the correlation. Clearly, if nominal yields rise when there is fiscal QE, banks should outperform and consumer staples underperform.

Figure 74: Consumer staples are among the most negatively correlated sectors with bond yields, even standard deviation adjusted

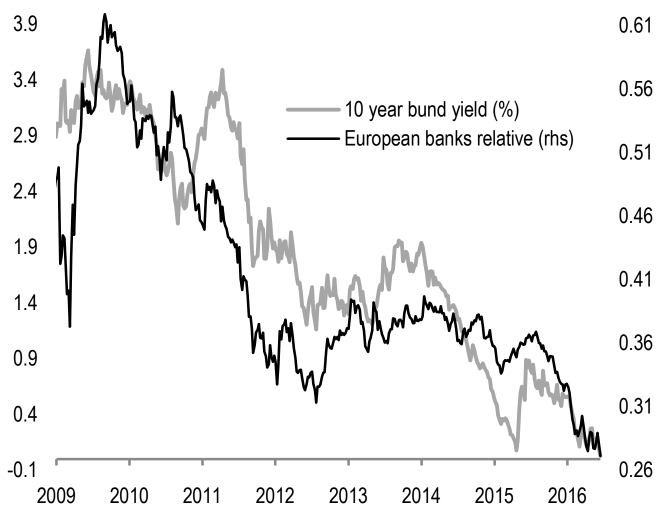


Source: Thomson Reuters Datastream, Credit Suisse research

Banks

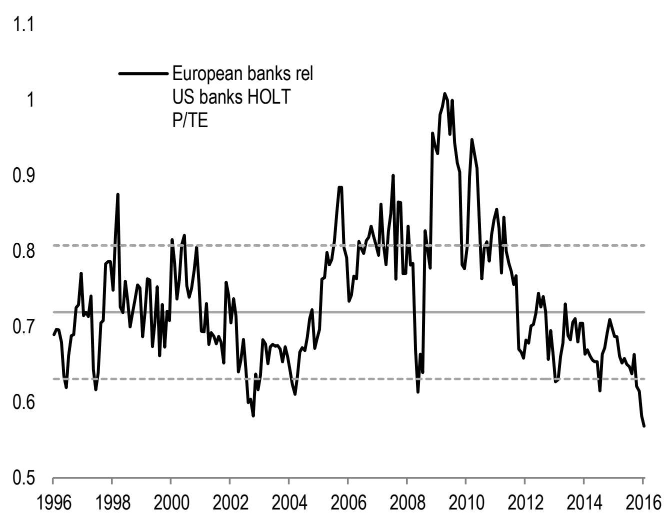
- The relative performance of banks is closely correlated to bond yields, and banks are consequently one of the best performing sectors in an environment of rising yields.
- Valuation relative to the US: European banks trade at a 20-year low relative to US banks on P/TE.

Figure 75: Banks have underperformed as Bund yields have fallen



Source: Thomson Reuters Datastream, Credit Suisse research

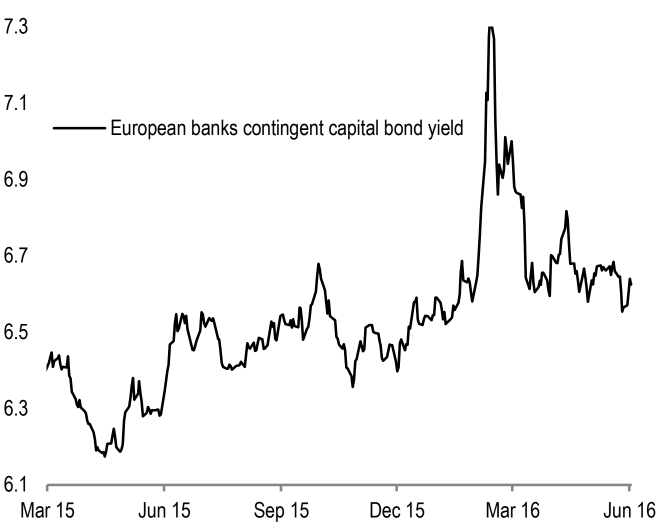
Figure 76: European banks trade at a 20-year low relative US banks on P/TE



Source: Credit Suisse HOLT, Credit Suisse research

- Banks are pricing in too much risk: we think that banks' cost of equity should be 8.6% (c.2% above the permanent write-down CoCo where the price goes to zero if CT1 falls below a certain level) and using our banks team's ROE forecast for 2017 (10.6%) suggests that banks should trade on 1.4x book. We think banks should trade on a 20% discount to fair value to reflect the risks (tax, litigation, regulation) and thus trade to 1.1x book compared to 0.81x now (c.25% upside potential; more with book value per share rising c5% a year).

Figure 77: European banks' contingent capital bond yield is 6.6%



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 78: Assuming a mid-cycle RoE of 9.6%, they should be trading at a P/TB of 1.4x (versus 0.81x currently)

$$\frac{P}{TB} = \frac{RoE - g}{CoE - g} \Rightarrow$$

$$\frac{P}{TB} = \frac{10.6\% - 3\%}{8.6\% - 3\%} \Rightarrow$$

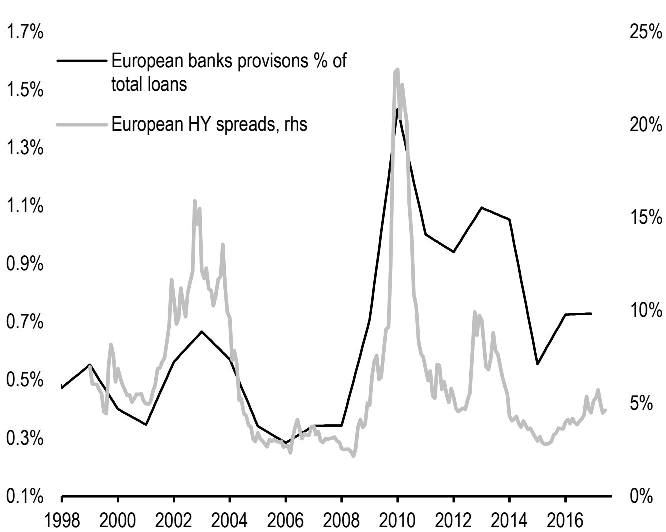
$$\text{Fair value } \frac{P}{TB} = 1.4x$$

Source: Thomson Reuters Datastream, Credit Suisse research

- We think that the key driver of profits is, in the following order: NIMs, provisioning, loan growth, cost cutting potential and fee income. While investors have focused on NIMs, we suspect that there has been too little focus on the other areas.

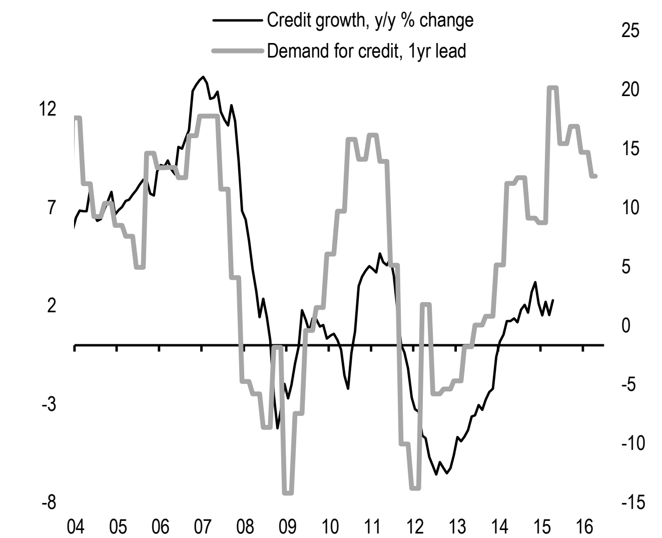
- Provisions are likely to fall: we think investors have underestimated the likely improvement in provisioning for European banks (for the US banks, the decline in provisioning accounted for nearly 80% of the improvement in earnings), with provisions still running above the level suggested by credit spreads. In our opinion, the key drivers of provisions are employment growth and real estate values (which is the majority of collateral), with both of these factors likely to support falling provisions over the next 12 months.

Figure 79: European HY spreads suggest downside to provisioning



Source: Company data, Credit Suisse estimates

Figure 80: Credit demand is in line with a large pick-up in credit growth



Source: Company data, Credit Suisse estimates

- Loan growth is already up 2% year on year for corporate and household and demand suggests that this is likely to grow further.

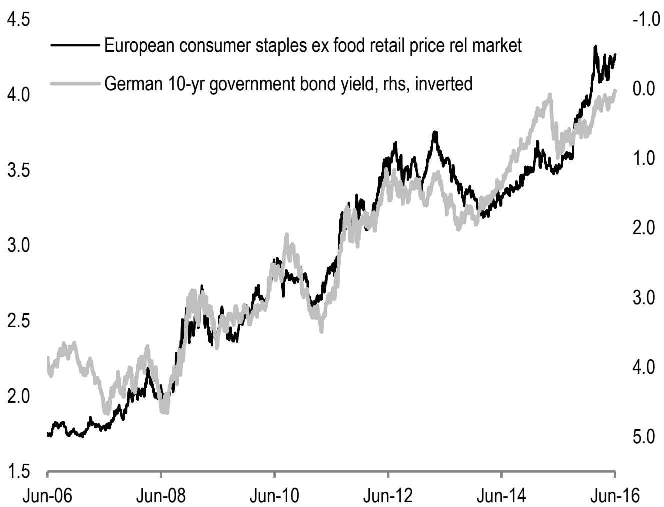
We particularly like retail banks as they benefit the most from improvements in house prices, household deposits rates are still above 1% in some countries (Italy, the Netherlands and France), there is disproportionately scope for cost synergies in retail banking, and there is less dis-intermediation risk.

Consumer staples

In an environment of rising bond yields, we would expect consumer staples to underperform due to the following reasons:

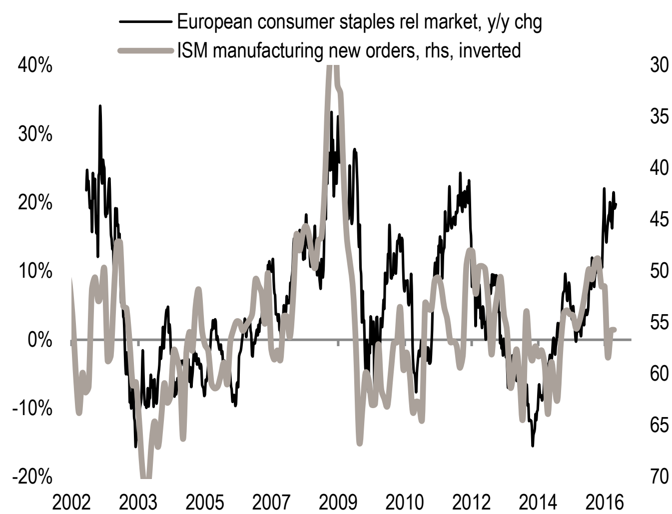
- Consumer staples are the most inversely correlated sector to bond yields in Europe. They are not only pricing in deeply negative 10-year Bund yields but also a sharp fall in US economic lead indicators (ISM falling to c.43).

Figure 81: Consumer staples tend to underperform if bond yields rise…



Source: Thomson Reuters Datastream, Credit Suisse research

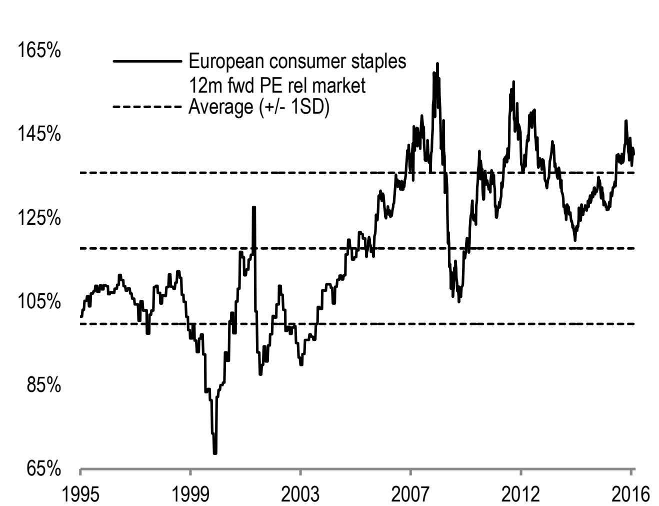
Figure 82: …and have outperformed by more than suggested by ISM



Source: Thomson Reuters Datastream, Credit Suisse research

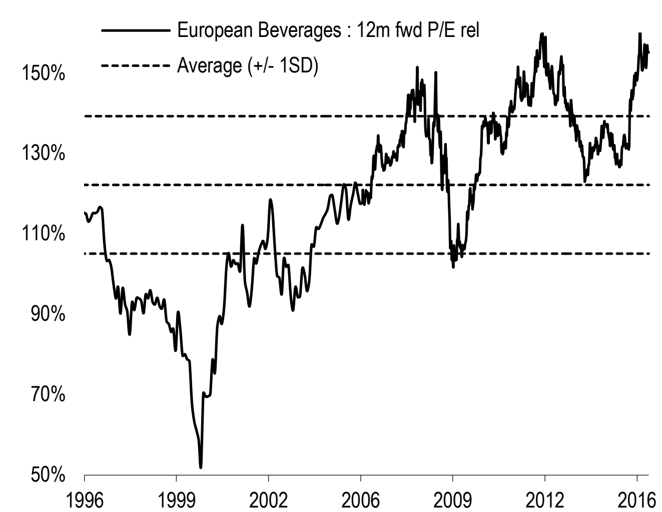
- European consumer staples look expensive on 12-month forward P/E relative to the market, with beverages in particular trading nearly two standard deviations above their norm – an all-time high.

Figure 83: European consumer staples are trading close to all-time highs on 12-month forward P/E…



Source: Thomson Reuters Datastream, Credit Suisse research

Figure 84: … with beverages in particular looking extremely expensive



Source: Thomson Reuters Datastream, Credit Suisse research

Appendix – Dividend scorecard

Figure 85: Insurance scores at the top of our dividend attractiveness scorecard

Europe ex UK Sectors	6m chg in 2016e EPS	6m chg in 2016e DPS	DY 2016e	FCFY - DY 2016e	Weighted Z-score
Insurance	0.9%	2.4%	5.5%	4.2%	0.60
Real Estate	4.9%	6.2%	3.9%	na	0.48
Automobiles	6.9%	2.1%	3.7%	2.2%	0.36
Telecoms	-3.5%	2.0%	4.7%	3.5%	0.33
Commercial Services	2.6%	5.1%	3.5%	1.9%	0.32
Technology HW	-26.4%	21.0%	4.1%	1.9%	0.29
Media	-3.7%	3.8%	4.2%	2.1%	0.28
Banks	-9.4%	-3.8%	5.5%	na	0.16
Food & Drug Retail	0.6%	4.4%	3.0%	2.0%	0.15
Capital Goods	1.1%	2.9%	3.1%	2.0%	0.13
H&P Products	3.6%	4.7%	2.4%	0.4%	0.11
Transportation	-2.5%	3.1%	3.2%	2.5%	0.08
Software & Svs	4.6%	7.2%	1.7%	3.3%	0.07
Food, Bev & Tobacco	-2.4%	4.2%	2.6%	3.3%	0.00
Pharmaceuticals	-2.7%	-0.7%	3.1%	2.2%	-0.07
Materials	-6.7%	1.1%	3.0%	1.6%	-0.12
Retailing	-2.1%	-0.3%	2.7%	0.5%	-0.13
Healthcare	1.1%	6.0%	1.3%	2.4%	-0.13
Consumer Durables	-5.1%	2.1%	2.5%	3.1%	-0.15
Energy	-28.9%	-0.4%	5.2%	-1.2%	-0.24
Semiconductors	0.1%	0.0%	1.1%	3.8%	-0.38
Diversified Financials	-33.4%	-14.1%	3.4%	na	-1.14

Source: Thomson Reuters Datastream, Credit Suisse research

Companies Mentioned *(Price as of 14-Jun-2016)*

AVIVA Plc (AV.L, 403.8p)
AXA (AXAF.PA, €19.3)
Abertis (ABE.MC, €12.8)
Acacia Mining (ACAA.L, 337.5p)
Allegion (ALLE.N, $67.63)
Assa Abloy (ASSAb.ST, Skr161.3)
Atkins WS (ATKW.L, 1200.0p)
Atlantia (ATL.MI, €22.08)
BAE Systems (BAES.L, 475.0p)
Balfour Beatty (BALF.L, 227.3p)
Bouygues (BOUY.PA, €26.54)
CRH (CRH.I, €25.15)
Carillion (CLLN.L, 259.2p)
Cementos Argos, S.A. (CCB.CN, peso11540.0)
Cementos Pacasmayo (CPAC.N, $9.0)
Cemex (CX.N, $5.9)
Cemex Latam Holdings, S.A. (CLH.CN, peso12640.0)
Cubic Corporation (CUB.N, $41.4)
Deere & Co. (DE.N, $85.15)
Detour Gold Corporation (DGC.TO, C$30.41)
Eaton Corporation (ETN.N, $60.44)
Eiffage (FOUG.PA, €62.13)
Emerson (EMR.N, $52.02)
Erste Bank (ERST.VI, €20.8)
Ferrovial SA (FER.MC, €17.355)
Forterra (FORT.L, 165.0p)
Geberit (GEBN.S, SFr360.0)
General Dynamics Corporation (GD.N, $139.43)
General Electric (GE.N, $30.44)
Groupe Eurotunnel SA (GETP.PA, €10.515)
Halma (HLMA.L, 933.0p)
HeidelbergCement (HEIG.DE, €70.59)
Hochtief (HOTG.F, €110.467)
Honeywell International Inc. (HON.N, $115.51)
Indocement (INTP.JK, Rp16,150)
Ingersoll-Rand Plc (IR.N, $63.66)
Interserve (IRV.L, 292.2p)
Intesa Sanpaolo (ISP.MI, €1.91)
Johnson Controls Inc (JCI.N, $44.5)
Kone Corporation (KNEBV.HE, €38.95)
Lafargeholcim (LHN.S, SFr39.3)
Legrand SA (LEGD.PA, €46.34)
Lennox International (LII.N, $135.42)
Lockheed Martin Corporation (LMT.N, $239.7)
Martin Mari Mat (MLM.N, $181.67)
NN Group NV (NN.AS, €26.19)
Newmont Mining (NEM.N, $35.15)
Nexans (NEXS.PA, €40.94)
Northrop Grumman Corporation (NOC.N, $216.91)
OHL (OHL.MC, €4.019)
Oshkosh Corporation (OSK.N, $45.06)
Prudential (PRU.L, 1196.5p)
Prysmian (PRY.MI, €20.12)
RSA Insurance Group (RSA.L, 449.7p)
Raytheon Company (RTN.N, $135.76)
Regal Beloit (RBC.N, $57.54)
Rexnord Corporation (RXN.N, $21.47)
Rheinmetall (RHMG.DE, €54.94)
SPX (SPXC.N, $14.85)
Saint-Gobain (SGOB.PA, €36.7)
Schindler-Holding AG (SCHP.S, SFr173.0)
Schneider Electric (SCHN.PA, €52.71)
Semen Indonesia (SMGR.JK, Rp8,800)
Serco (SRP.L, 106.2p)
Swedbank (SWEDa.ST, Skr167.6)
Tahoe Resources Inc. (THO.TO, C$16.43)
Taiheiyo Cement (5233.T, ¥252)
Taiwan Cement (1101.TW, NT$31.3)
Thales (TCFP.PA, €71.55)
Thyssen Krupp AG (TKAG.DE, €17.4)
Travis Perkins (TPK.L, 1741.0p)
Tyco International, Ltd (TYC.N, $43.3)
UBI Banca (UBI.MI, €2.61)
Ultratech Cement Ltd (ULTC.BO, Rs3320.1)
United Technologies Corp (UTX.N, $101.19)
VINCI (SGEF.PA, €62.18)
Valmont Industries (VMI.N, $132.83)
Vulcan Matls (VMC.N, $114.17)
Wolseley (WOS.L, 3524.0p)
Zijin Mining Group Co., Ltd (2899.HK, HK$2.29)

Disclosure Appendix

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Outperform (O) : The stock's total return is expected to outperform the relevant benchmark* over the next 12 months.

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**Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe. For Australian and New Zealand stocks, the expected total return (ETR) calculation includes 12-month rolling dividend yield. An Outperform rating is assigned where an ETR is greater than or equal to 7.5%; Underperform where an ETR less than or equal to 5%. A Neutral may be assigned where the ETR is between -5% and 15%. The overlapping rating range allows analysts to assign a rating that puts ETR in the context of associated risks. Prior to 18 May 2015, ETR ranges for Outperform and Underperform ratings did not overlap with Neutral thresholds between 15% and 7.5%, which was in operation from 7 July 2011.*

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