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BCA House View Matrix

September 28, 2018
Periodical

STRATEGY OUTLOOK
2018 Q4 Strategy Outlook: Desynchronization Is Back

In this Issue:

Highlights

- **Macro outlook:** Global growth will continue to decelerate into early next year on the back of brewing EM stresses and an underwhelming policy response from China.
- **Equities:** Stay neutral for now, while underweighting EM relative to DM stocks. Within DM, overweight the U.S. in dollar terms.
- **Bonds:** Global bond yields may dip in the near term, but the longer-term path is firmly higher.
- **Currencies:** The dollar is working off overbought conditions, but will rebound into year-end. EM currencies will suffer the most.
- **Commodities:** Favor oil over industrial metals. Precious metals will also remain under pressure until the dollar peaks next year, before beginning a major bull run as inflation accelerates.

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I. Economic Outlook

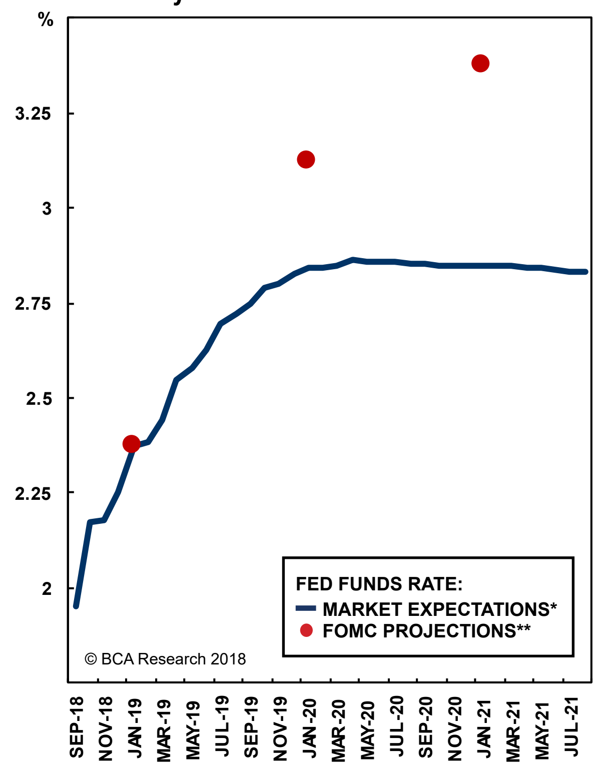
The Fed Can Hike A Lot More

If 2017 was the year of a synchronized global growth recovery, 2018 is turning out to be a year where desynchronization is once again the name of the game. The U.S. economy continues to fire on all cylinders, while much of the rest of the world is struggling to stay afloat.

The divergence in economic outcomes has been mirrored in central bank policy. The Fed is now hiking rates once per quarter whereas most other major central banks are still sitting on their hands.

How high can U.S. rates go? The answer is a lot higher than investors anticipate. Market participants currently expect the Fed funds rate to rise to 2.37% by the end of this year and 2.84% by the end of 2019. No rate hikes are priced in for 2020 and beyond.

CHART 1
Markets Expect No Fed Hikes Beyond Next Year



* REFERS TO EXPECTATIONS OF THE AVERAGE DAILY FED FUNDS RATE DURING THE MONTH AS DISCOUNTED BY THE FED FUNDS FUTURES MARKET.
** FOMC MEDIAN PROJECTIONS FROM SEPTEMBER 2018.

The Fed dots are somewhat higher than market expectations (**Chart 1**). The median dot rises to about 3.4% in 2020-21, but then falls back to 3% over the Fed's longer-run horizon.

Both investors and the Fed have apparently bought into Larry Summers' secular stagnation thesis. They seem convinced that rates will not be able to rise above 3% without triggering a recession.

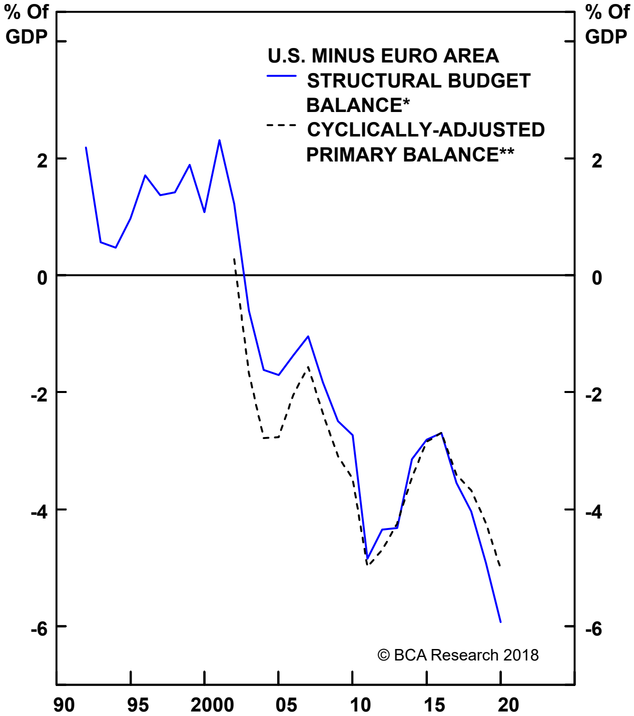
While we have a lot of sympathy for Summers' thesis, it must be acknowledged that it is a theory about the long-term determinants of the neutral rate of interest. Over a shorter-term cyclical horizon, many factors can influence the neutral rate. Critically, as discussed last week, most of these factors are pushing it higher:

› Fiscal policy is extremely stimulative. The IMF estimates that the U.S. cyclically-adjusted budget deficit will reach 6.8% of GDP in 2019. In contrast, the euro area is projected to run a deficit of only 0.8% of GDP (**Chart 2**). The relatively more expansionary nature of U.S. fiscal policy is one key reason why the Fed can raise rates while the ECB cannot.

› Credit growth has picked up. After a prolonged deleveraging cycle, private-sector nonfinancial debt is increasing faster than GDP (**Chart 3**). The recent easing in The Conference Board's Leading Credit Index suggests that this trend will continue (**Chart 4**).

CHART 2

Fiscal Policy Is More Expansionary In The U.S. Than In The Euro Area



* THE STRUCTURAL (CYCLICALLY-ADJUSTED) BUDGET BALANCE IS THE GOVERNMENT'S ACTUAL FISCAL POSITION EXCLUDING THE ESTIMATED BUDGETARY CONSEQUENCES OF THE BUSINESS CYCLE. IT IS DESIGNED IN PART TO PROVIDE AN INDICATION OF THE MEDIUM-TERM ORIENTATION OF FISCAL POLICY.
** THE CYCLICALLY-ADJUSTED PRIMARY BALANCE IS THE CYCLICALLY-ADJUSTED BALANCE EXCLUDING NET INTEREST PAYMENTS (INTEREST EXPENDITURE MINUS INTEREST REVENUE).
SOURCE: IMF.

CHART 3

U.S. Private-Sector Nonfinancial Debt Is Rising At Close To Its Historic Trend

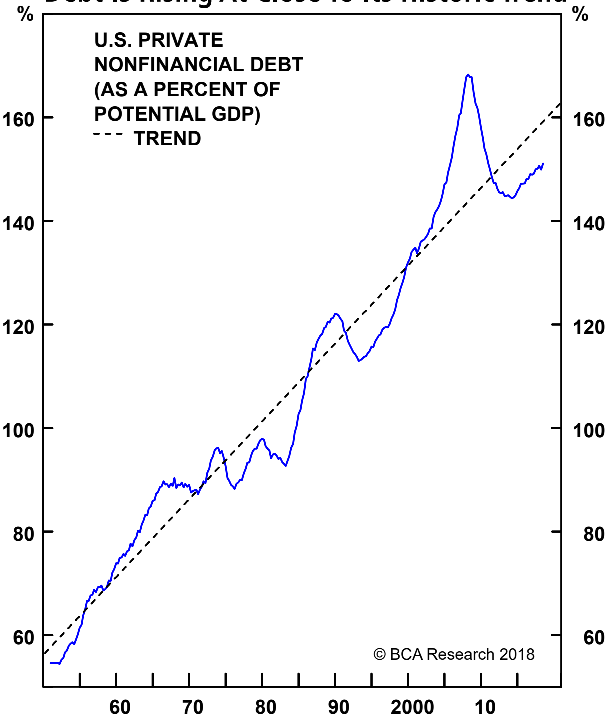
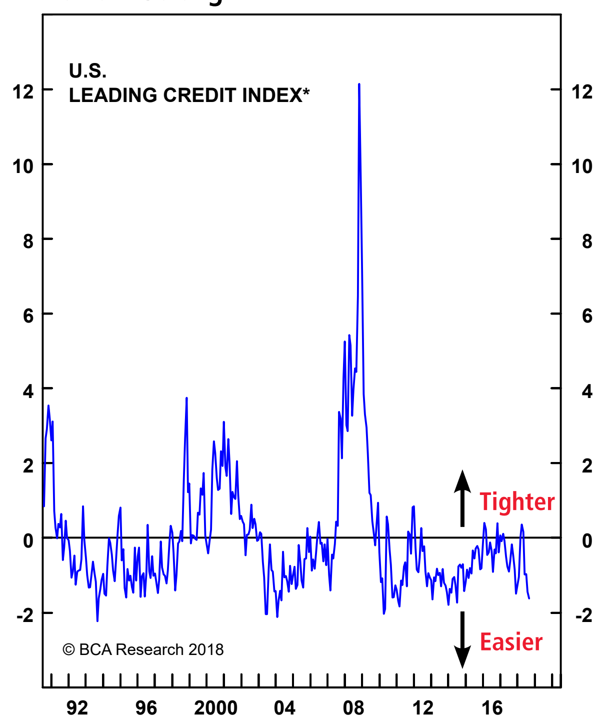


CHART 4

U.S. Credit Growth Will Remain Strong



* BASED ON THE FOLLOWING SIX FINANCIAL INDICATORS: 2-YEAR SWAP SPREADS, 3-MONTH LIBOR MINUS 3-MONTH TREASURY-BILL YIELD SPREAD, DEBIT BALANCES AT MARGIN ACCOUNTS, INVESTOR SENTIMENT (BULLISH LESS BEARISH), SENIOR LOAN OFFICER C&I LOAN SURVEY: BANK TIGHTENING CREDIT TO LARGE AND MEDIUM FIRMS, AND SECURITY REPURCHASES FROM THE TOTAL FINANCE-LIABILITIES SECTION OF FEDERAL RESERVE FLOW OF FUNDS REPORT.
SOURCE: THE CONFERENCE BOARD.

› Wage growth is accelerating. Average hourly earnings surprised on the upside in August, with the year-over-year change rising to a cycle high of 2.9%. This followed a stronger reading in the Employment Cost Index in the second quarter. A simple correlation with the quits rate suggests that there is plenty of upside for wage growth (**Chart 5**). Faster wage growth will put more money into workers' pockets who will then spend it.

› The savings rate has scope to fall. The personal savings rate currently stands at 6.7%, more than two percentage points higher than what one would expect based on the current level of household net worth

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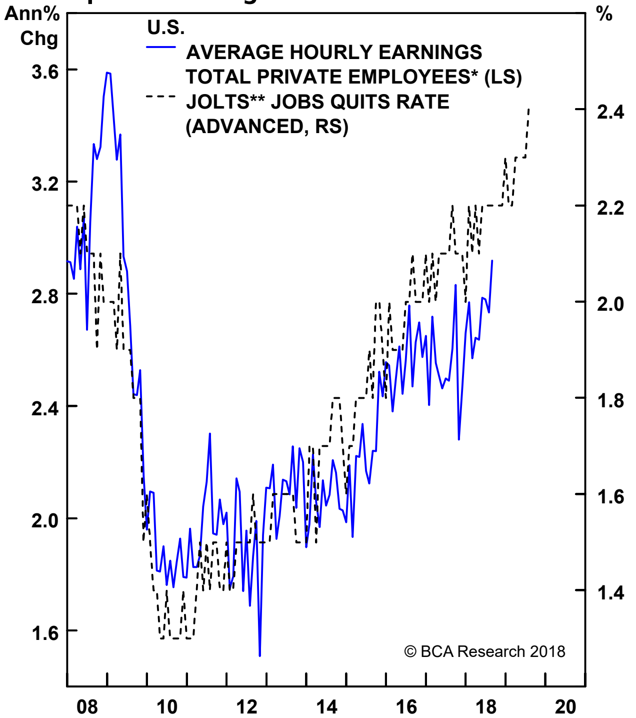
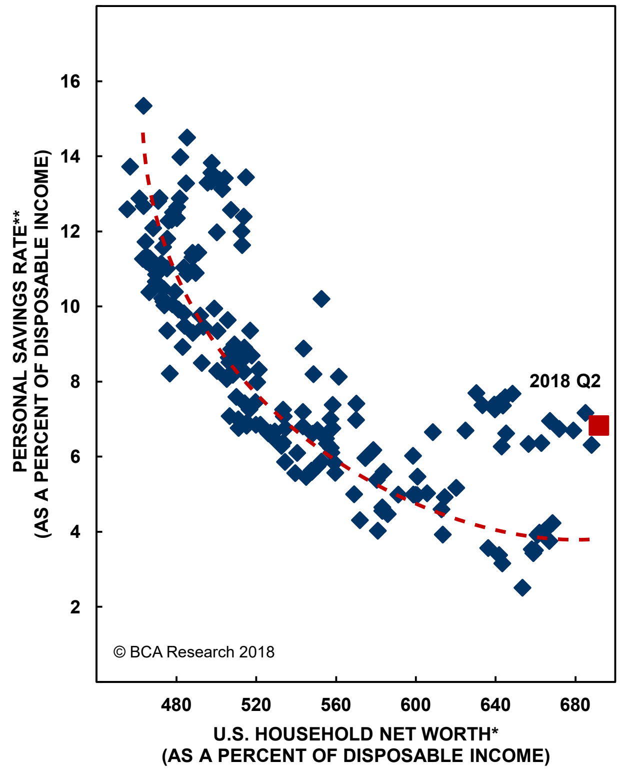
CHART 5
The Quits Rate Is Signaling Upside For Wage Growth



* NOMINAL EARNINGS, PRIVATE NONFARM PAYROLLS.
** JOB OPENINGS AND LABOR TURNOVER SURVEYS (JOLTS), ADVANCED BY 12 MONTHS.
SOURCE: BUREAU OF LABOR STATISTICS.

CHART 6
The Personal Savings Rate Has Room To Fall



* BASED ON FLOW OF FUNDS DATA.
** BASED ON BUREAU OF ECONOMIC ANALYSIS (BEA) DATA.

(**Chart 6**). If the savings rate were to fall by two points over the next two years, it would add 1.5% of GDP to aggregate demand.

A back-of-the-envelope calculation suggests that these cyclical factors will permit the Fed to raise rates to 5% by 2020, almost double what the market is discounting.[1]

An Absence Of Major Financial Imbalances Will Allow The Fed To Keep Raising Rates

The past three recessions were all caused by financial market overheating rather than economic overheating. The 1991 recession was mainly the consequence of the Savings and Loan crisis, compounded by the spike in oil prices leading up to the Gulf War. The 2001 recession stemmed from the dotcom bust. The Great Recession was triggered by the housing bust. Today, it is difficult to point to any clear imbalances in the economy.

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1 Depending on which specification of the Taylor rule one uses, a one percent of GDP increase in aggregate demand will increase the neutral rate of interest by half a point (John Taylor's original specification) or by a full point (Janet Yellen's preferred specification). Fiscal policy is currently about 3% of GDP too stimulative compared to a baseline where government debt-to-GDP is stable over time. Assuming a fiscal multiplier of 0.5, fiscal policy is thus boosting aggregate demand by 1.5% of GDP. Nonfinancial private credit has increased by an average of 1.5 percentage points of GDP per year since 2016. Assuming that every additional one dollar of credit increases aggregate demand by 50 cents, the revival in credit growth is raising aggregate demand by 0.75% of GDP, compared to a baseline where credit-to-GDP is flat. The labor share of income has increased by 1.25% of GDP from its lows in 2015. Assuming that every one dollar shift in income from capital to labor boosts overall spending on net by 20 cents, this would have raised aggregate demand by 0.25% of GDP. Lastly, if the personal savings rate falls by two points over the next two years, this would raise aggregate demand by 1.5% of GDP. Taken together, these factors are boosting the neutral rate by anywhere from 2% (Taylor's specification) to 4% (Yellen's specification). This is obviously a lot, and easily overwhelms other factors such as a stronger dollar that may be weighing on the neutral rate.

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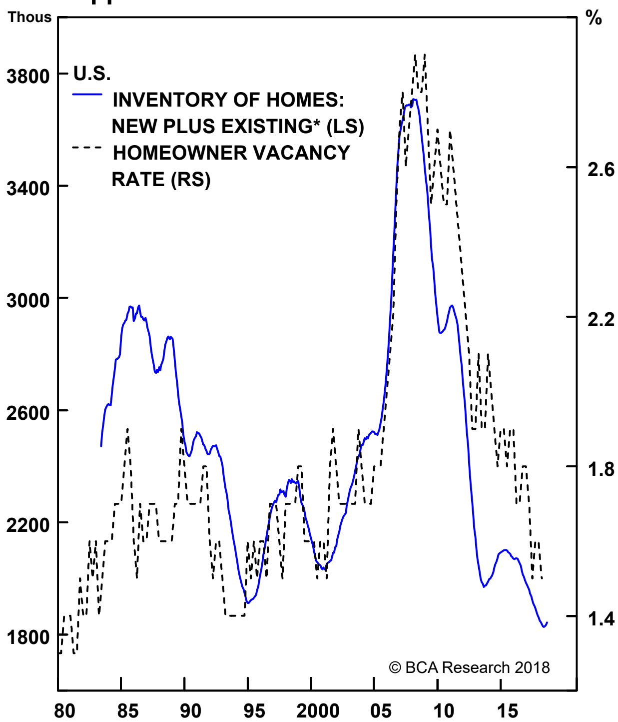
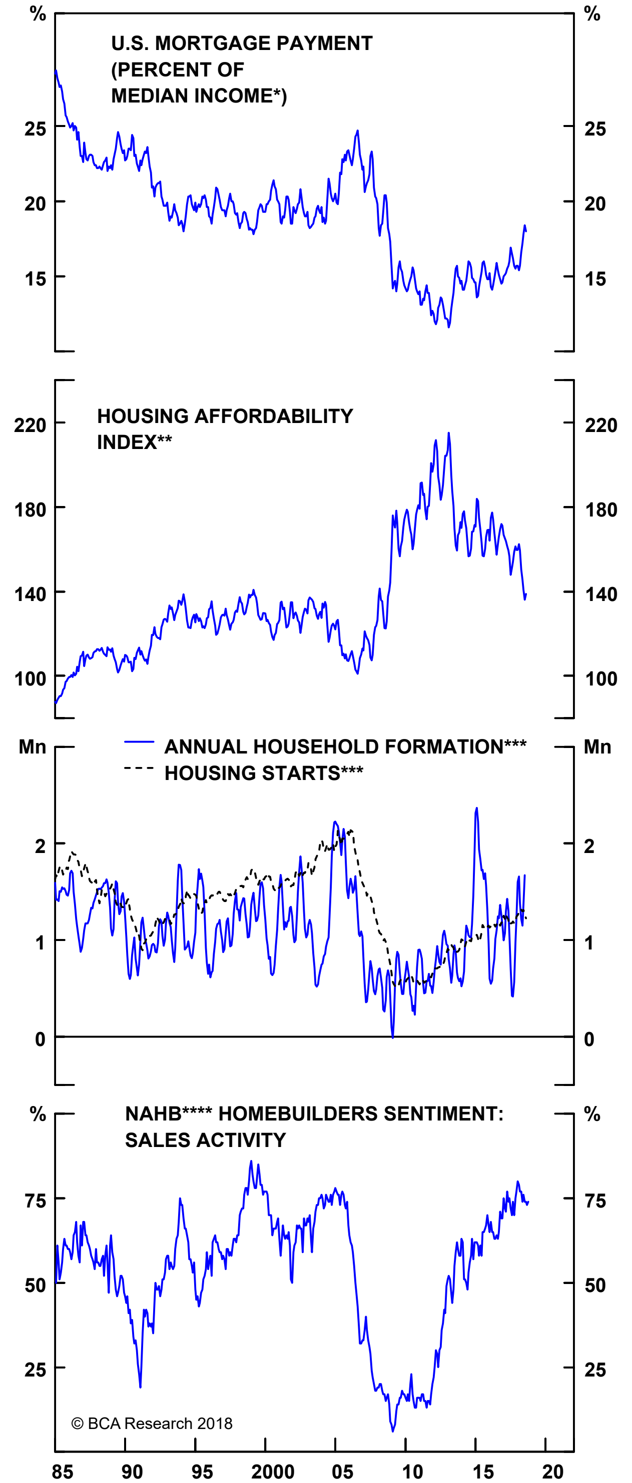
CHART 7
Low Housing Inventories Will Support Home Prices And Construction



* SHOWN AS A 12-MONTH MOVING AVERAGE.

CHART 8
Housing Affordabiity Is Not Yet Stretched



* SOURCE: NATIONAL ASSOCIATION OF REALTORS.
** SOURCE: MORTGAGE BANKERS ASSOCIATION.
*** SHOWN AS A 3-MONTH MOVING AVERAGE.
**** NATIONAL ASSOCIATION OF HOME BUILDERS.

True, housing activity has been weak for much of the year. However, unlike in 2006, the home vacancy rate stands near record-low levels (**Chart 7**). Tight supply will limit downside risks to both construction and home prices. On the demand side, low unemployment, high consumer confidence, and a rebound in the rate of new household formation should help the sector. Despite elevated home prices in some markets, the average monthly payment that homeowners must make to service their mortgage is quite low by historic standards (**Chart 8**). The quality of mortgage lending has also been very high over the past decade, which reduces the risk of a sudden credit crunch (**Chart 9**).

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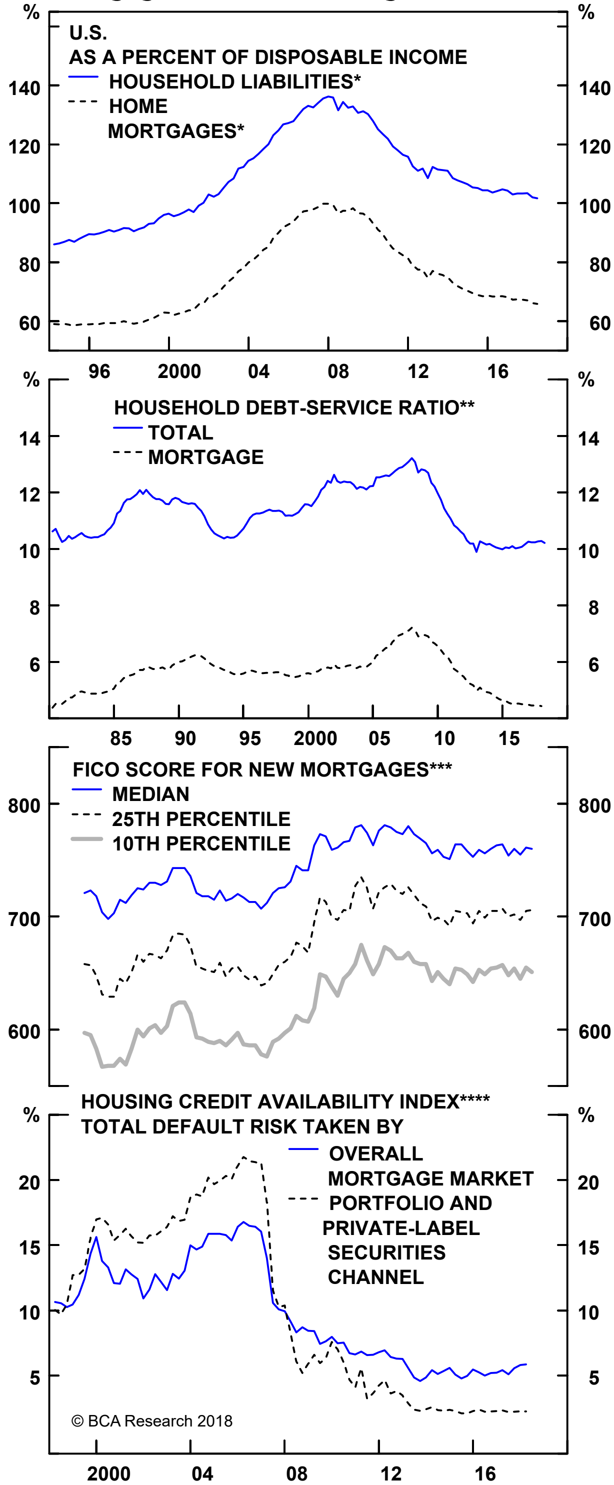
CHART 9

Mortgage Lenders Are Being Prudent



* SOURCE: FLOW OF FUNDS.
** SOURCE: FEDERAL RESERVE.
*** SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
**** SOURCE: URBAN INSTITUTE HOUSING FINANCE POLICY CENTER.

Unlike housing debt, there are more reasons to be concerned about corporate debt. The ratio of corporate debt-to-GDP has risen to record-high levels. So-called “covenant-lite” loans now make up the bulk of corporate leveraged loan issuance.

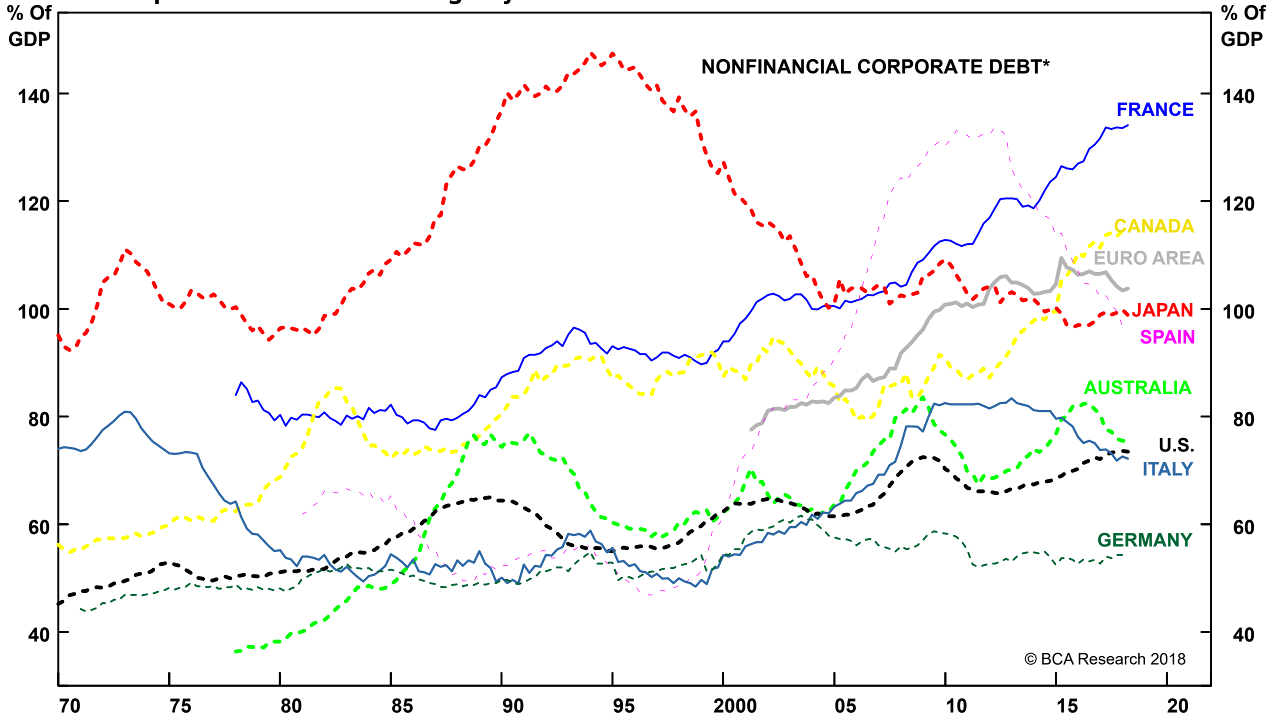
While there is no doubt that the corporate debt market is the weakest link in the U.S. financial sector, some perspective is in order. U.S. corporate debt levels are quite low by global standards. Corporate debt in the euro area is more than 30 points higher as a percent of GDP than in the United States (**Chart 10**). Moreover, the interest coverage ratio – EBIT divided by interest expense – for U.S. corporates is still above its historic average (**Chart 11**). While this ratio will fall as interest rates rise, this will not happen very quickly. Most U.S. corporate debt is at fixed rates and average maturities have been rising. This reduces both rollover risk and the sensitivity of debt-servicing costs to higher short-term rates.

An increasing share of U.S. corporate debt is held by non-leveraged investors. Bank loans account for only 18% of nonfinancial corporate sector debt, down from 40% in 1980 (**Chart 12**). This is important, because what makes a spike in corporate defaults so damaging is not the direct impact this has on the economy, but the second-round effects rising defaults have on financial sector stability.

In any case, we already had a dress rehearsal for what a corporate debt scare might look like. Credit spreads spiked in 2015. Default rates rose, but the knock-on effects to the financial system were minimal. This suggests that corporate America could handle a fair bit of monetary tightening without buckling under the pressure.

CHART 10

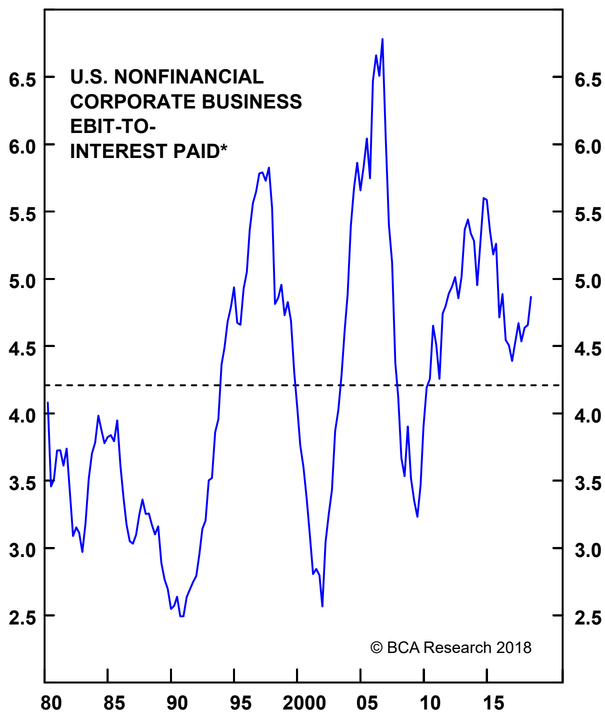
U.S. Corporate Debt Not That High By Global Standards



* SOURCE: BIS.

CHART 11

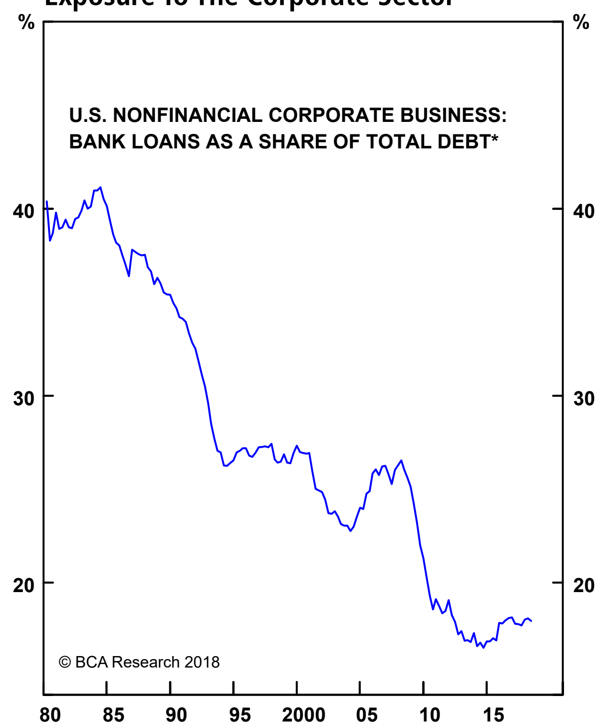
Interest Coverage Ratio Is Above Its Historic Average



* SOURCE: BUREAU OF ECONOMIC ANALYSIS.
NOTE: HORIZONTAL DASHED LINE REPRESENTS MEAN FROM 1980 TO PRESENT.

CHART 12

Banks Have Been Reducing Their Exposure To The Corporate Sector



* BANK LOANS DEFINED AS THE SUM OF DEPOSITORY INSTITUTION LOANS AND MOTRGAGES; CORPORATE DEBT DEFINED AS THE SUM OF DEBT SECURITIES AND LOANS.
SOURCE: U.S. FLOW OF FUNDS AND BUREAU OF ECONOMIC ANALYSIS.

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The Fed And The Dollar

If the Fed is able to raise rates substantially more than the market is discounting while most central banks cannot, the short-term interest rate spread between the U.S. and its trading partners is likely to widen. History suggests that this will produce a stronger dollar (**Chart 13**).

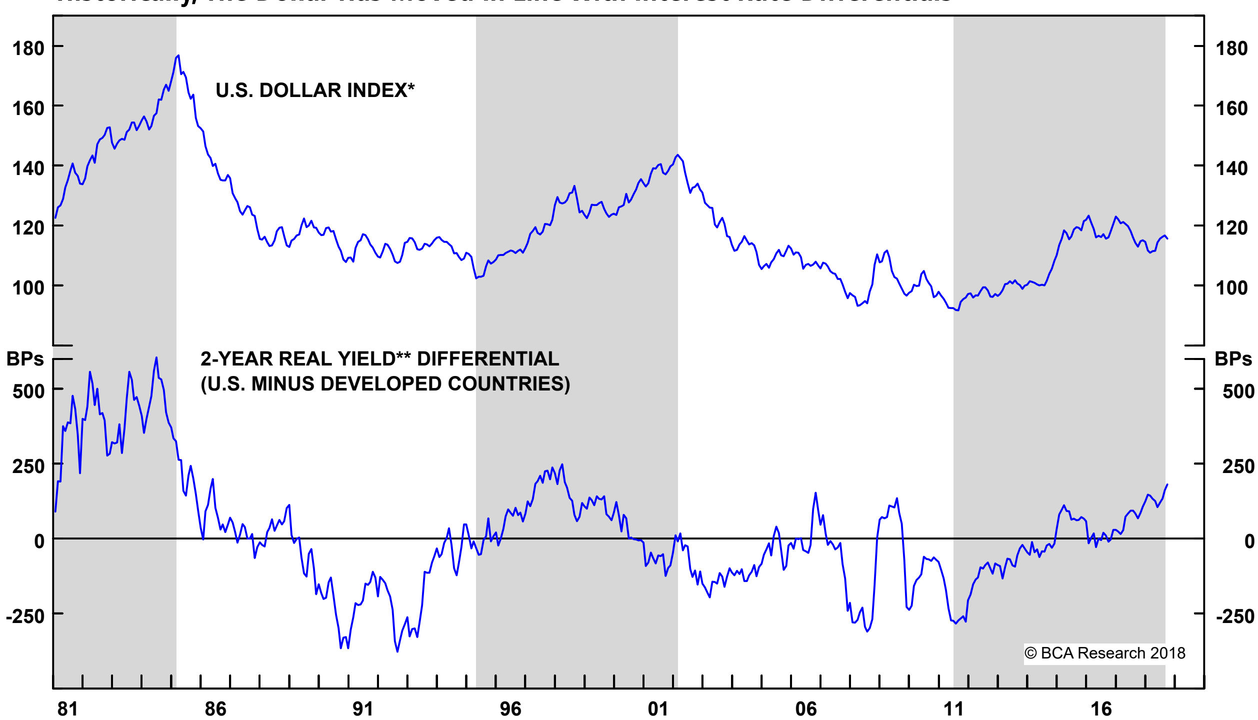
Some have speculated that the Trump administration will intervene in the foreign-exchange market in order to drive down the value of the greenback. We doubt this will happen, but even if such interventions were to occur, they would not be successful.

Presumably, currency interventions would take the form of purchases of foreign exchange, financed through the issuance of Treasurys. The purchase of foreign currency would release U.S. dollars into the financial system, but the sale of Treasury securities would suck those dollars back out of the system. The net result would be no change in the volume of U.S. dollars in circulation – what economists call a "sterilized" intervention. Both economic theory and years of history show that sterilized interventions do not have lasting effects on currency values.

The Fed could, of course, provide funding for the Treasury's purchases of foreign exchange, leading to an increase in the monetary base. This would be tantamount to an unsterilized intervention. However, such a deliberate attempt to weaken the dollar by expanding the money supply would fly in the face of the Fed's efforts to cool growth by tightening financial conditions. We highly doubt the Fed's current leadership would go along with this.

CHART 13

Historically, The Dollar Has Moved In Line With Interest Rate Differentials



* SOURCE: BANK OF ENGLAND AND BIS.
** 2-YEAR NOMINAL YIELD DEFLATED BY CONSUMER PRICE INDEX.
NOTE: SHADED AREAS DENOTE PERIODS OF MAJOR DOLLAR APPRECIATION.

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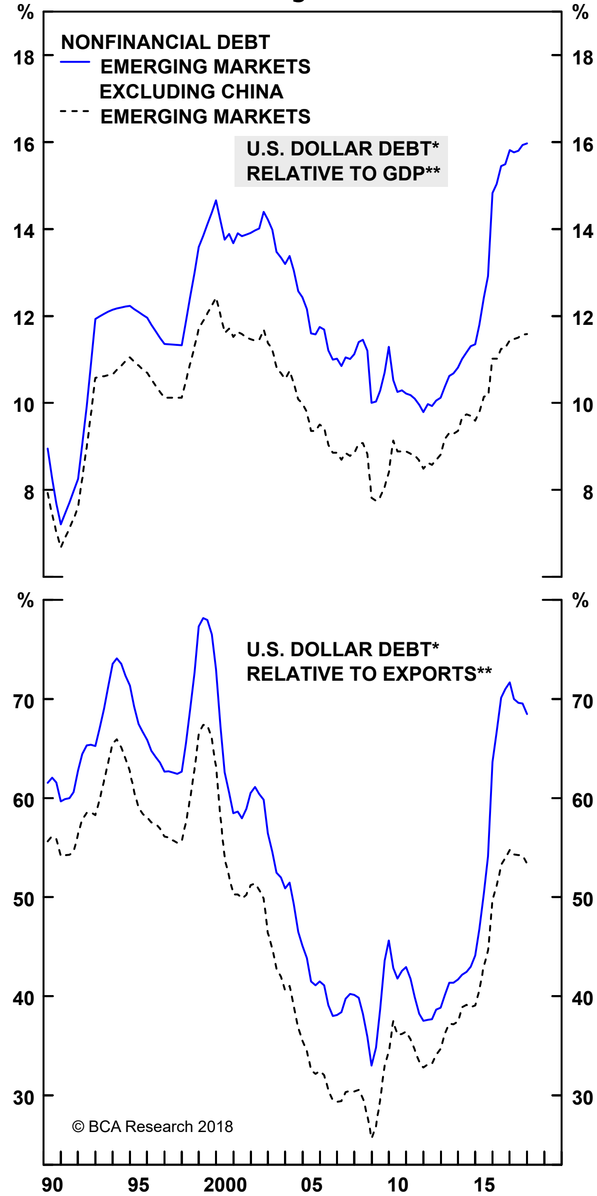
Emerging Markets In The Crosshairs

The combination of rising U.S. rates and a stronger dollar is bad news for emerging markets. Eighty percent of EM foreign-currency debt is denominated in dollars. Outside of China, EM dollar debt is now back to late-1990s levels, both as a share of GDP and exports (**Chart 14**).

The wave of EM local-currency debt issued in recent years only complicates matters. If EM central banks raise rates to defend their currencies, this could imperil economic growth and make it difficult for local-currency borrowers to pay back their loans.

Rather than hiking rates, some EM central banks may simply choose to inflate away debt. Consider the case of Brazil. The fiscal deficit stands at nearly 8% of GDP and government debt has soared from 60% of GDP in 2013 to 84% of GDP at present (**Chart 15**). Ninety percent of Brazilian sovereign debt is denominated in *reais*. The Brazilian government won't default on its debt *per se*. However, if push comes to shove, Brazil's central bank can always step in to buy government bonds, effectively monetizing the fiscal deficit. This could cause the *real* to weaken much more than it already has.

CHART 14
EM Dollar Debt Is High



* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS (BIS) AND WORLD BANK. BIS DATA FROM 2000. BACK ESTIMATES FOR THE 1990-2000 PERIOD ARE BCA CALCULATED BASED ON EXTERNAL DEBT DATA FROM THE WORLD BANK'S INTERNATIONAL DEBT STATISTICS.
** SOURCE: IMF.

Chinese Stimulus To The Rescue?

When emerging markets last succumbed to pressure in 2015, China saved the day by stepping in with massive stimulus. Fiscal spending and credit growth accelerated to over 15% year-over-year. The government's actions boosted demand for all sorts of industrial commodities. The stimulus measures in 2015 followed an even greater wave of stimulus in 2009.

While these stimulus measures invigorated China's economy and helped put a floor under global growth, they came at a price: China's debt-to-GDP ratio has swollen from 140% in 2008 to over

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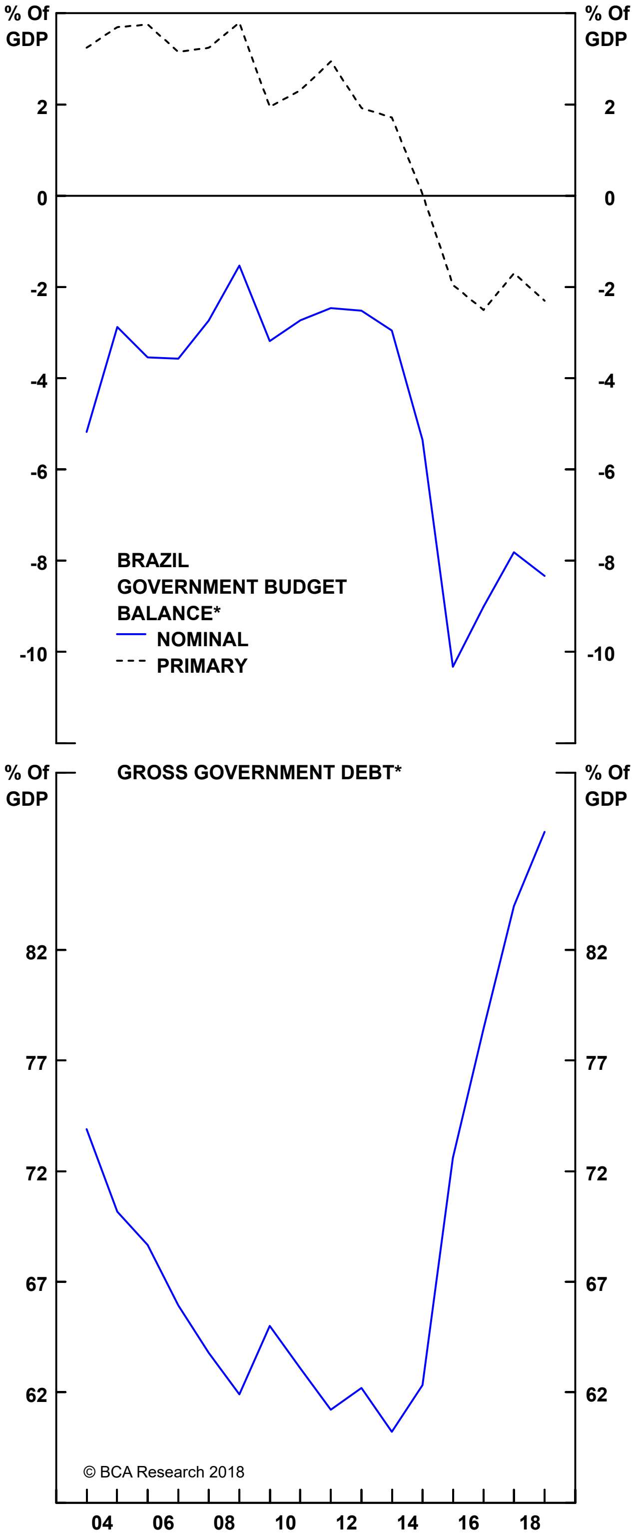
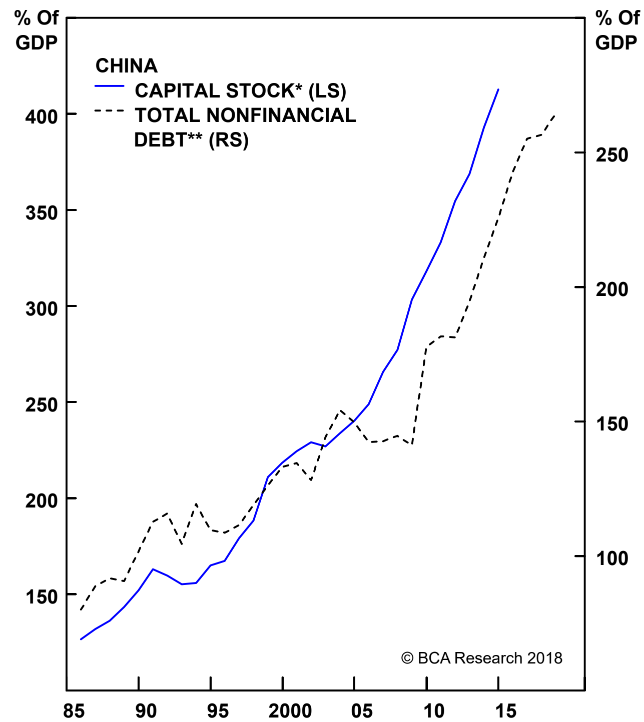
CHART 15
Brazil's Perilous Fiscal Position



* SOURCE: IMF.

CHART 16
China: Debt And Capital Accumulation Went Hand In Hand

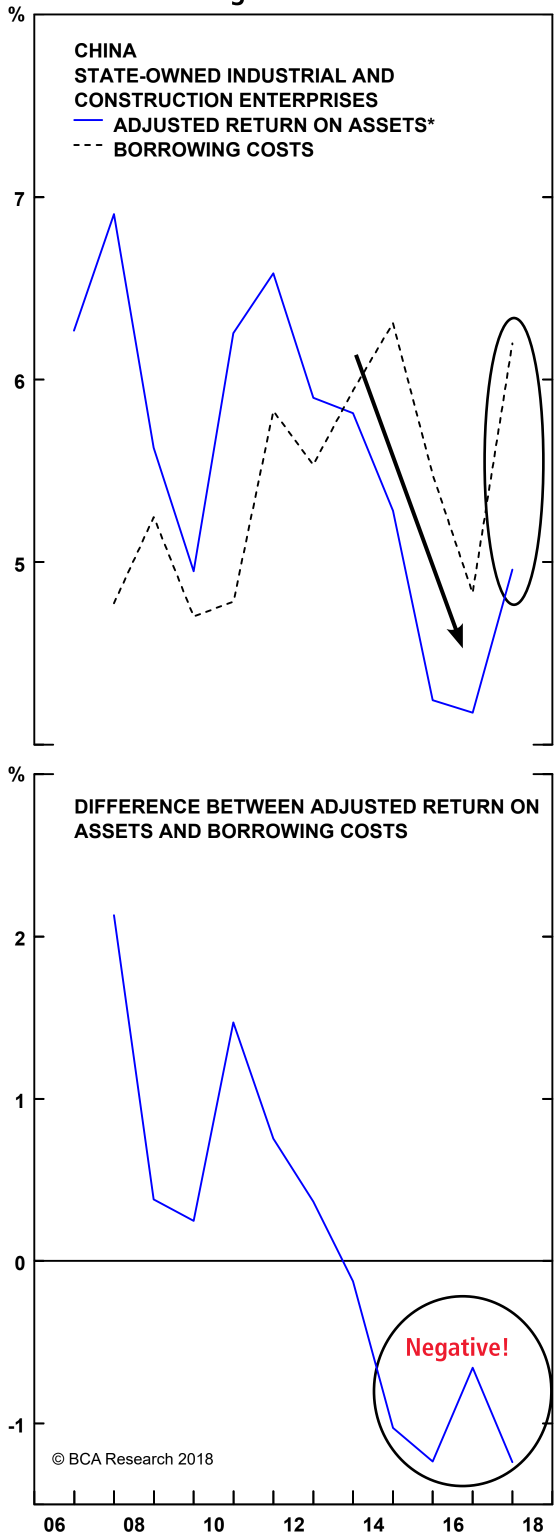


* BASED ON 2011 CURRENT INTERNATIONAL PURCHASING POWER PARITY DOLLARS. SOURCE: PENN WORLD TABLES.
** NONFINANCIAL PRIVATE DEBT PLUS PUBLIC DEBT; SOURCE: IMF AND BIS.

250% at present, which has endangered financial stability (**Chart 16**). Excess capacity has also increased. This can be seen in the dramatic rise in the capital-to-output ratio. It can also be seen in the fact that the rate of return on assets within the Chinese state-owned enterprise sector, which has been the main source of rising corporate leverage, has fallen below borrowing costs (**Chart 17**).

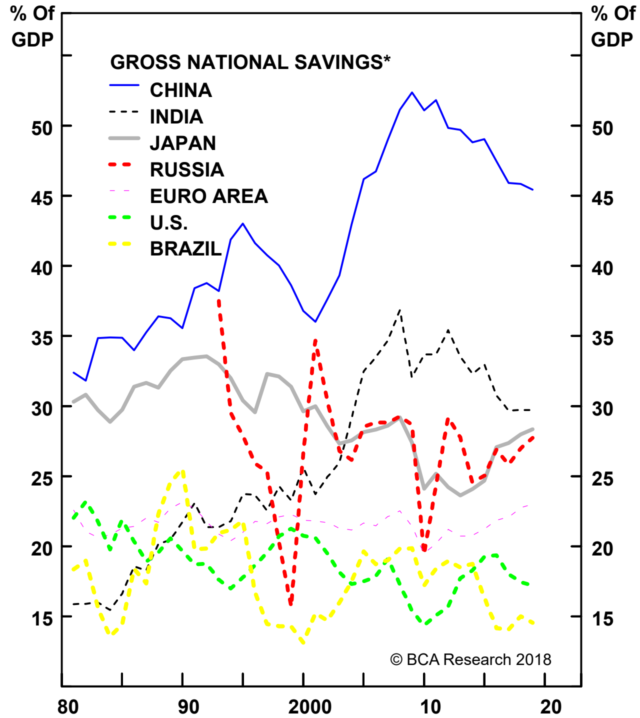
Chinese banks are being told that they must lend more money to support the economy, while ensuring that their loans do not turn sour. Unfortunately, that is becoming an impossible feat.

CHART 17
China: Rate Of Return On Assets Below Borrowing Costs For SOEs



* ADJUSTED FOR INTEREST EXPENSES.

CHART 18
China Saves A Lot

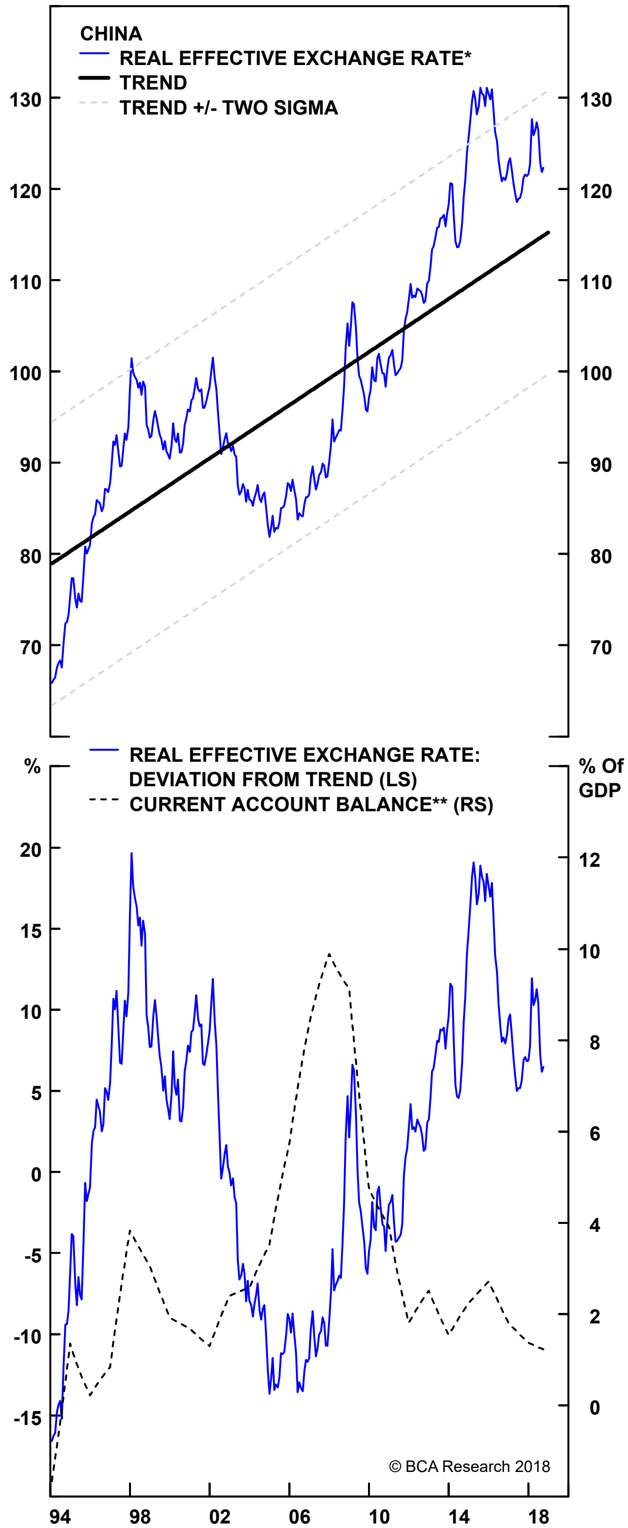


* SOURCE: IMF.

The Chinese economy produces too much and spends too little. The result is excess savings, epitomized most clearly in a national savings rate of 46% (**Chart 18**). As a matter of arithmetic, national savings must be transformed either into domestic investment or exported abroad *via* a current account surplus. Now that the former strategy has run into diminishing returns, the Chinese authorities will need to concentrate on the latter. This will require a larger current account surplus which, in turn, will necessitate a relatively cheap currency.

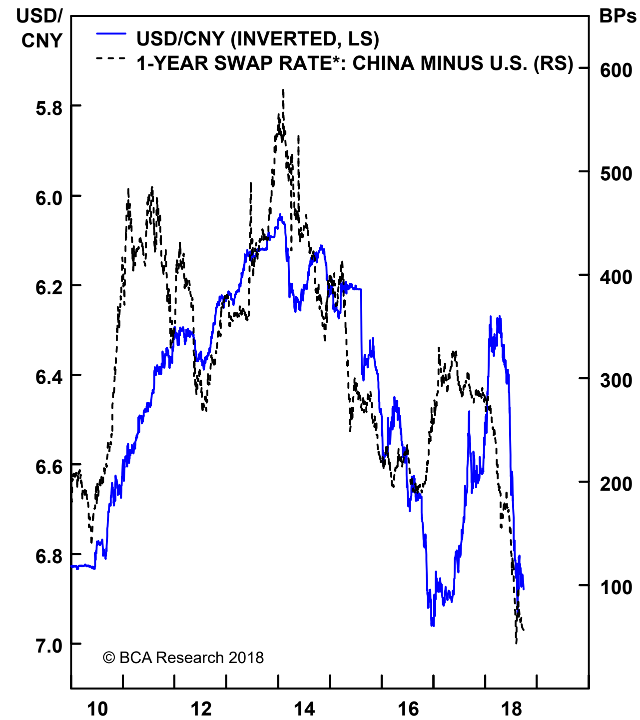
Above-average productivity growth has pushed up the fair value of China's real exchange rate over time. However, the currency

CHART 19
The RMB Is Still Quite Strong



* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS (BIS).
** SOURCE: IMF WORLD ECONOMIC OUTLOOK.

CHART 20
USD/CNY Has Tracked China-U.S. Interest Rate Differentials



* SOURCE: BLOOMBERG FINANCE L.P.

still looks expensive relative to its long-term trend line (**Chart 19**). Pushing down the value of the yuan against the dollar will not be that difficult. **Chart 20** shows that USD/CNY has moved broadly in line with the one-year swap spread between the U.S. and China. The spread was about 3% earlier this year. Today, it stands at only 0.6%. As the Fed continues to raise rates, the spread will narrow further, taking the yuan down with it.

Unlike standard Chinese fiscal/credit easing, a stimulus strategy focused on weakening the yuan would hurt other emerging markets by undermining their competitiveness in relation to China. A weaker yuan would also make it more expensive for Chinese companies to import natural resources, thus putting downward pressure on commodity prices.

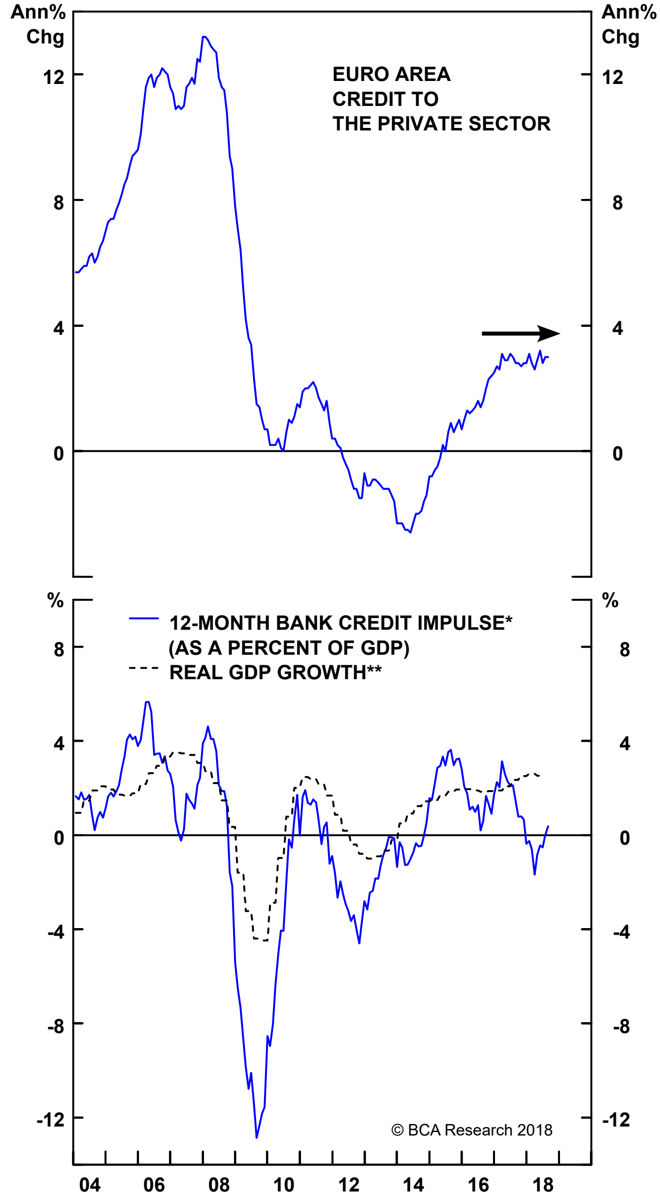
The Euro Area: Back In The Slow Lane

After putting in a strong performance in 2017, the economy in the euro area has struggled to maintain momentum this year. Growth is still above trend, but the overall tone of the data has been lackluster at best, with the risks to growth increasingly tilted to the downside.

Weaker growth in China and other emerging markets certainly has not helped. However, much of the problem lies closer to home. Bank credit remains the lifeblood of the euro area economy. The 12-month credit impulse – defined as the change in credit growth from one 12-month period to the next – tends to track GDP growth (**Chart 21**).[2] Euro area credit growth accelerated over the course of 2017, but has been broadly stable this year. As a result, the credit impulse has fallen, taking GDP growth down with it.

CHART 21

Euro Area Credit Growth Has Flatlined



* 12-MONTH CHANGE OF THE 12-MONTH CHANGE IN CREDIT TO THE PRIVATE SECTOR AS A PERCENT OF 4-QUARTER MOVING TOTAL GDP.
** ANNUAL PERCENT CHANGE OF 4-QUARTER MOVING TOTAL.
SOURCE: ECB.

It will be difficult for euro area GDP growth to increase unless credit growth starts rising again. So far, there is little sign that this is about to happen. According to the latest euro area bank lending survey, while banks continue to ease standards for business loans, they are doing so at a slower pace than in the past. A net 3% of banks eased lending standards in the second quarter, compared to 8% in the first quarter. Loan demand growth has been fairly stable. This suggests that loan growth will remain positive, but is unlikely to increase much from current levels.

2 Recall that GDP is a flow variable (how much production takes place every period), whereas credit is a stock variable (how much debt there is outstanding). By definition, a flow is a change in a stock. Thus, credit growth affects GDP and the change in credit growth affects GDP growth. Euro area private-sector credit growth accelerated from -2.6% in May 2014 to 3.1% in March 2017, but has been broadly flat ever since. Hence, the credit impulse has dropped.

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Worries about the health of European banks will further constrain credit growth. European banks in general, and Spanish banks in particular, have significant exposure to the most vulnerable emerging markets (**Chart 22**).

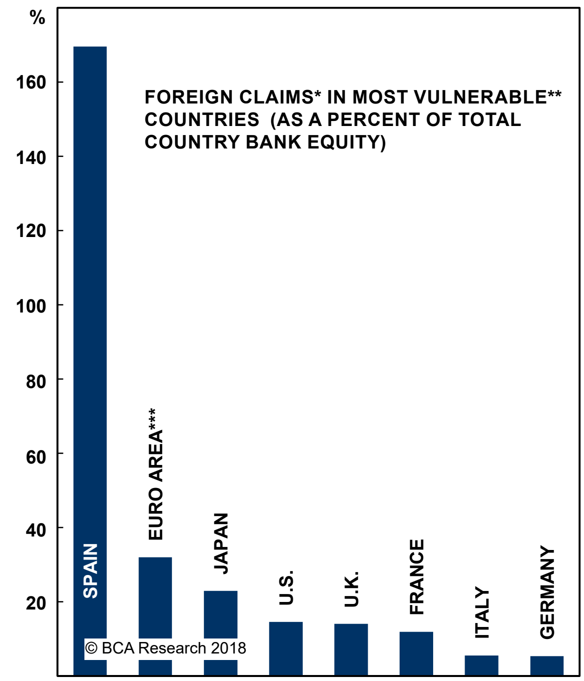
Concerns about the ability of the Italian government to service its debt obligations will also restrain bank lending. Investors breathed a sigh of relief last month when the Italian government signaled a greater willingness to pare back next year's proposed budget deficit, in accordance with the dictates of the European Commission.

Tensions remain, however, as evidenced by the fact that the ten-year spread between BTPs and German bunds is still 120 basis points higher than in April (**Chart 23**). The European political establishment is terrified of the rise in populism across the region and would love nothing more than to see Italy's populist parties implode. This means that any help from the ECB and the European Commission will only arrive once a full-fledged crisis is underway.

Anyway, it is far from clear that a smaller budget deficit would actually translate into a lower government debt-to-GDP ratio. Like China, Italy also has a private sector that saves too much and spends too little. A shrinking population has reduced the need for firms to invest in new capacity. The prior government's pension cuts have also incentivized people to save more for their retirement. The result is a private sector savings-investment surplus that stood at 5% of GDP in 2017 compared to close to breakeven a decade ago (**Chart 24**).

CHART 22

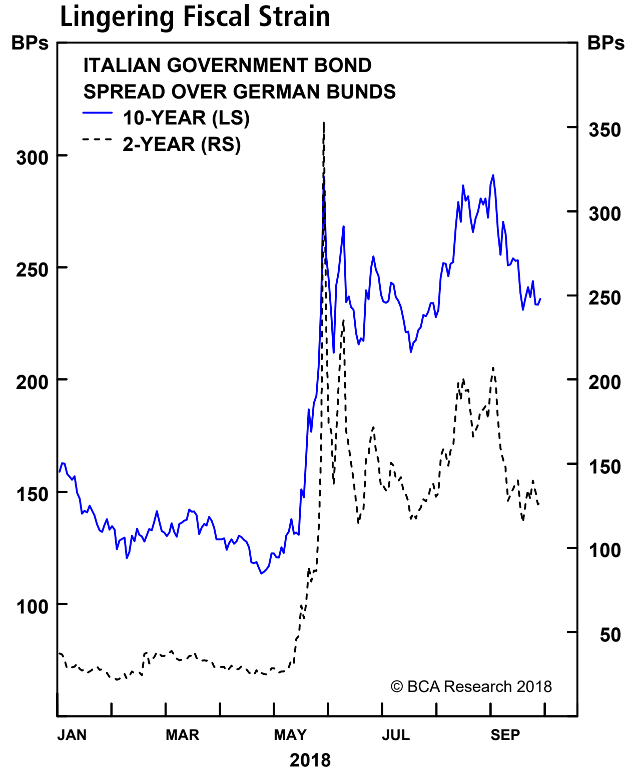
Spain Most Exposed To Vulnerable EMs



* BASED ON BIS DATA.
** INCLUDES ARGENTINA, TURKEY, BRAZIL, COLOMBIA, MEXICO, CHILE, SOUTH AFRICA AND INDONESIA, AS PER OVERALL VULNERABILITY INDEX (PLEASE REFER TO CHART 7 IN *GLOBAL INVESTMENT STRATEGY WEEKLY REPORT*, "HOT DOLLAR, COLD TURKEY," DATED AUGUST 17, 2018.)
*** SUM OF GERMANY, FRANCE, ITALY AND SPAIN.

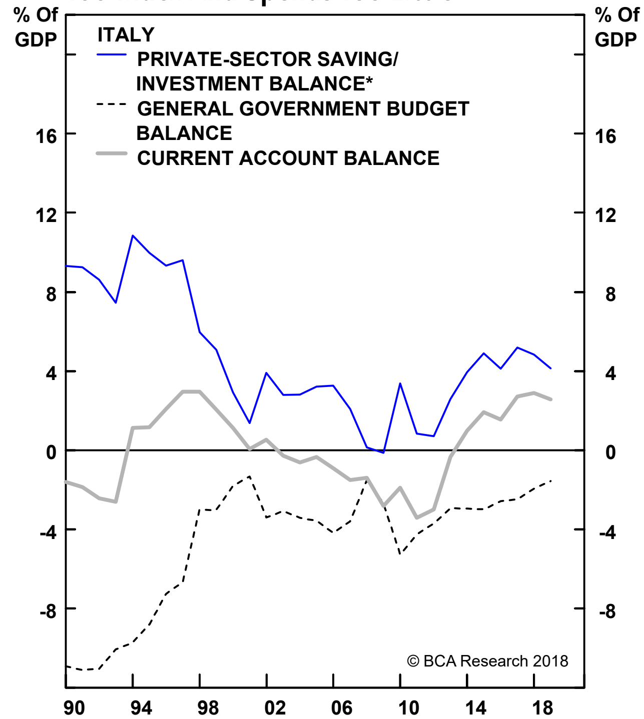
CHART 23

Italian/Bund Spreads Signal Lingering Fiscal Strain



Unlike Germany, Italy cannot export its excess production because it does not have a hypercompetitive economy. Nor does it have the ability to devalue its currency to gain a quick competitiveness boost. This means that the Italian government has to absorb excess private-sector savings with its own dissavings – a fancy way of saying that it has to run a large budget deficit. This has effectively been Japan's strategy for over two decades. However, unlike Japan, Italy does not have a lender of last resort that can unconditionally buy government debt. This raises the risk that Italy's debt woes will resurface, either because the government abandons austerity measures, or because the lack of fiscal support causes nominal GDP to stagnate, making it all but impossible for the country to outgrow its debt burden.

CHART 24
Italy: Private Sector Saves Too Much And Spends Too Little



* CALCULATED AS THE CURRENT ACCOUNT MINUS GENERAL GOVERNMENT NET LENDING / BORROWING.
SOURCE: IMF.

Receding Policy Puts

The discussion above suggests that many of the "policy puts" that investors have relied on are in the process of having their strike price marked down to deeper out-of-the-money levels. Yes, the Fed will ease off on rate hikes if U.S. growth is at risk of stalling out completely. However, now that the labor market has reached full employment, the Fed will welcome modestly slower growth. Remember that there has never been a case in the post-war era where the three-month average of the unemployment rate has risen by more than a third of a percentage point without a recession taking place (**Chart 25**). The further the unemployment rate falls below NAIRU, the more difficult it will be for the Fed to achieve the proverbial soft landing.

Likewise, the "China stimulus put" – the presumption that most investors have that the Chinese authorities will launch a barrage of fiscal and credit easing at the first sign of slower growth – has become less reliable in light of the government's competing objectives namely reducing debt growth and excess capacity. The same goes for the "ECB put." Yes, the ECB will bail out Italy if the entire European project appears at risk. But spreads may need to blow out before the cavalry arrives.

Meanwhile, just as the aforementioned policy puts are receding, new policy risks are rising to the fore, chief among them protectionism. We expect the trade war to heat up, with the Trump administration increasingly directing its ire at China. Trump's macroeconomic policies are completely at odds with his trade agenda. Fiscal stimulus will boost aggregate demand, which will suck in

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CHART 25

Even A Small Uptick In The Unemployment Rate Is Bad News For The Business Cycle

* SHOWN AS A 3-MONTH MOVING AVERAGE.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS; CIRCLES IN THE CHART DENOTE THE TIMES WHEN THE 3-MONTH MOVING AVERAGE OF THE UNEMPLOYMENT RATE INCREASED BY MORE THAN ONE-THIRD OF A PERCENTAGE POINT FROM RECENT LOWS.

more imports. An overheated economy will prompt the Fed to raise rates more aggressively than it otherwise would, leading to a stronger dollar. All this will result in a wider trade deficit. What will Trump tell voters two years from now when he is campaigning in Michigan and Ohio about why the trade deficit has widened rather than narrowed under his watch? Will he blame himself or Beijing? No trophy for getting that answer right.

II. Financial Markets

Global Equities

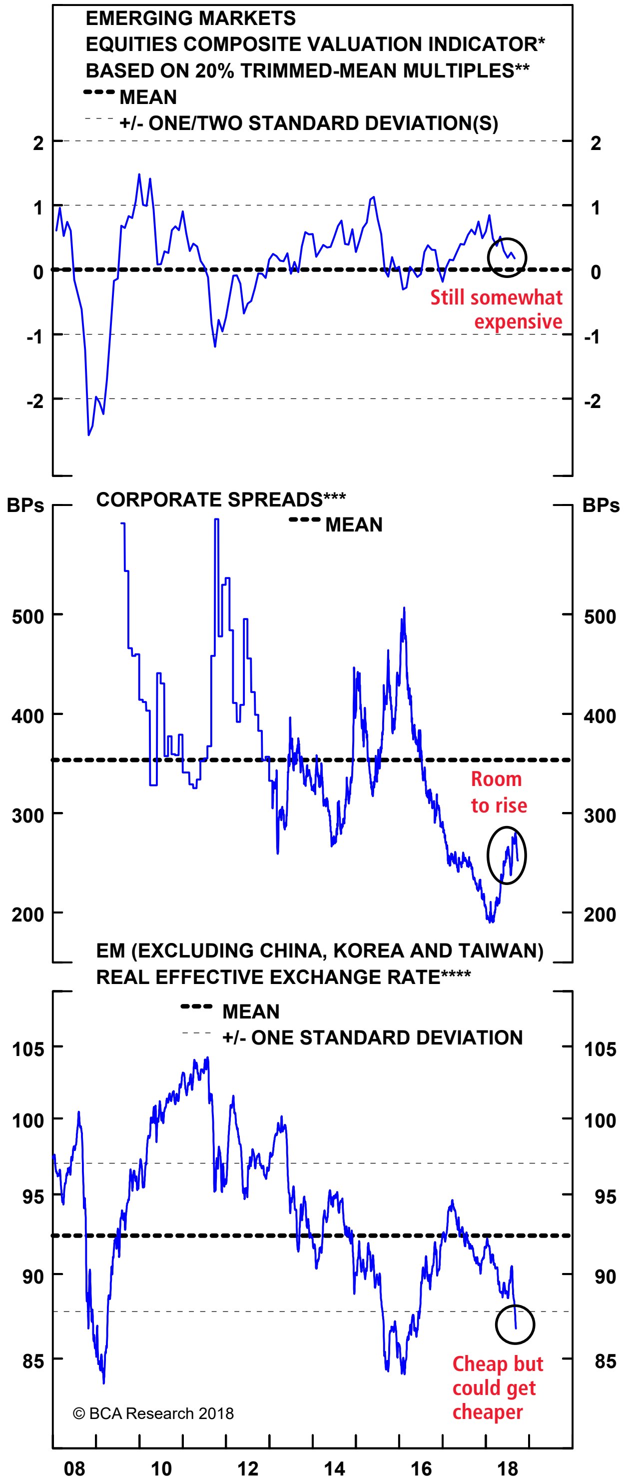
The combination of slower global growth, rising economic vulnerabilities outside the U.S., and a more challenging policy environment caused us to downgrade our view on global equities from overweight to neutral in June,[3] while reiterating our preference for developed market equities relative to EM stocks.

For now, we are comfortable with our bearish view towards emerging market stocks. While EM equities have cheapened, they are not yet at washed out levels (**Chart 26**). Bottom fishers still abound, as evidenced by the fact that the number of shares outstanding in the MSCI iShares Turkish ETF has almost tripled since early April (**Chart 27**).

3 Please see *Global Investment Strategy Special Report*, "Three Policy Puts Go Kaput: Downgrade Global Equities To Neutral," dated June 20, 2018.

CHART 26

EM Assets: Valuations Not Yet At Washed Out Levels



* BASED ON TRAILING AND FORWARD PRICE-TO-EARNINGS, PRICE-TO-BOOK VALUE, PRICE-TO-CASH EARNINGS RATIO, AND DIVIDEND YIELD, STANDARDIZED. SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION) AND IBES.

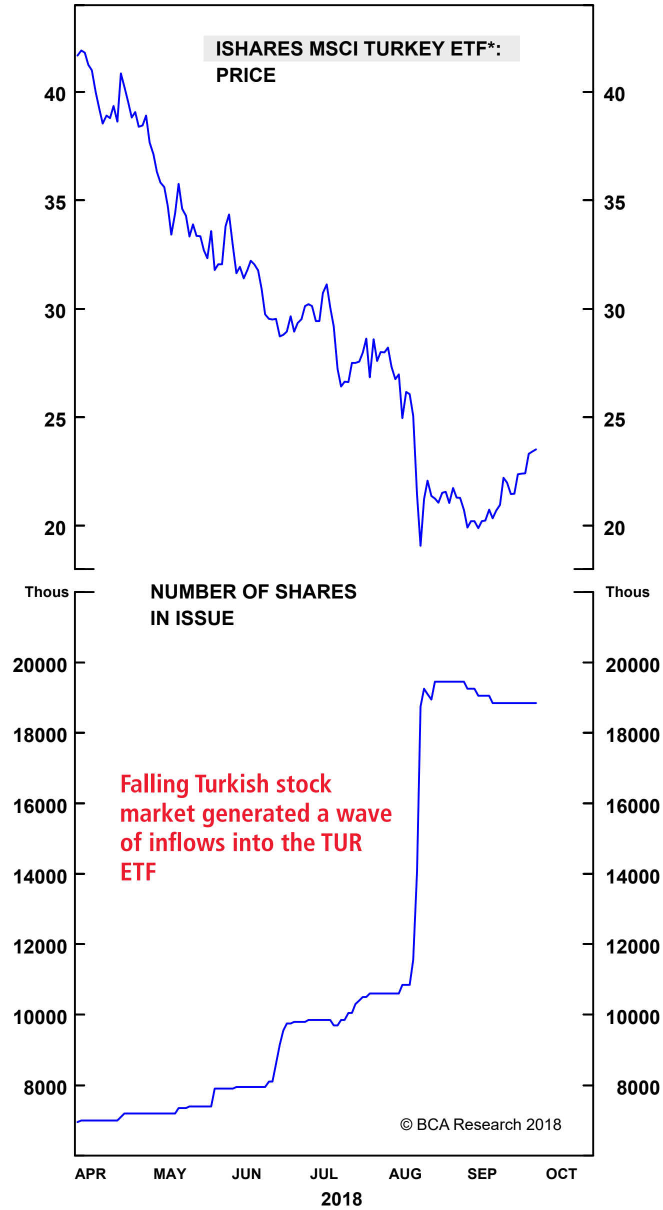
** BASED ON 50 INDUSTRY SUB-SECTORS BY TRIMMING TOP 10% AND BOTTOM 10% SERIES.

*** CORPORATE AND QUASI-SOVEREIGN OPTION-ADJUSTED SPREADS; SOURCE: BLOOMBERG BARCLAYS INDICES.

**** INCLUDES 16 DEVELOPING ECONOMIES, EQUITY MARKET CAP WEIGHTED; BASED ON AVERAGE OF PPI AND CPI. BASED ON J.P. MORGAN CHASE & CO. DATA.

CHART 27

EM Bottom Fishers Still Abound



* SOURCE: BLOOMBERG L.P. AND THOMSON REUTERS/ DATASTREAM.

At some point – probably in the first half of next year – investors will liquidate their remaining bullish EM bets. At that point, EM stocks will rebound. European and Japanese equities should also start to outperform the U.S., given their more cyclical nature.

As far as the absolute direction of the S&P 500 is concerned, the next few months could be challenging. U.S. stocks have been able to decouple from those in the rest of the world, but this state of affairs may not last. Recall that the S&P 500 fell by 22% peak-to-trough between July 20 and October 8, 1998, in what otherwise was a massive bull market. We do not know if there is another Long-Term Capital Management lurking around the corner, but if there is, a temporary selloff in U.S. stocks may be hard to avoid.

Such a selloff would present a buying opportunity over a horizon of 12-to-18 months. If we are correct that cyclical forces have lifted the neutral rate of interest, it will take a while for monetary policy to reach restrictive territory. This means that both fiscal and monetary policy will stay accommodative at least for the next 18 months. As such, the S&P 500 may not peak until 2020.

Appendix A – **Chart I** presents a stylized diagram of where we think global equities are going. It encapsulates three phases: 1) a challenging period over the next six months, driven by EM weakness; 2) a blow-off rally in equities starting in the middle of next year; 3) and finally, a recession-induced bear market beginning in late-2020. **Appendix B** also presents our valuation charts, which highlight that long-term return prospects are better outside the United States.

Fixed Income

After advocating for a long duration strategy for much of the post-crisis recovery, BCA declared "The End Of The 35-Year Bond Bull Market" on July 5, 2016, the very same day that the 10-year U.S. Treasury yield hit a record closing low of 1.37%.

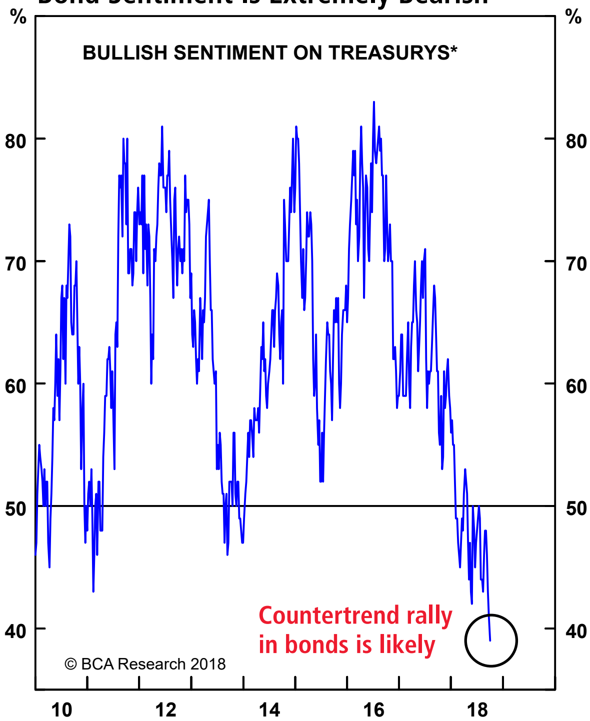
Cyclically and structurally, we continue to expect U.S. bond yields to rise more than the market is discounting. As noted above, the Fed is underestimating how high rates will need to go before they reach restrictive territory. This means that the Fed will end up behind the curve in normalizing monetary policy, causing the economy to overheat and inflation to rise above the Fed's comfort zone.

Granted, the Fed is willing to tolerate a modest inflation overshoot. However, a core PCE reading above 2.3%, which is at the top end of the range of the Fed's own forecast, would prompt the Fed to expedite the pace of rate hikes. A bear flattening of the yield curve – a situation where long-term yields rise, but short-term rates go up even more – would be highly likely in that environment.

Over a shorter-term horizon spanning the next six months, the outlook for yields is more benign. The combination of a stronger dollar, slower global growth, and flight-to-quality flows into the Treasury market from vulnerable emerging markets can cap yields. Add to this the fact that sentiment towards bonds is currently extremely bearish (**Chart 28**), and a temporary countertrend decline in yields becomes quite probable.

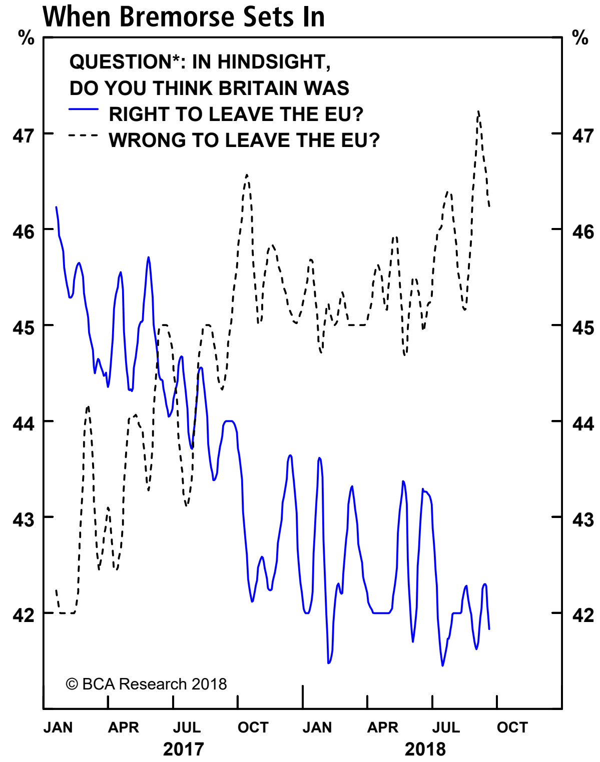
Developed market bond yields in general are likely to follow the direction of U.S. yields, both on the upside and the downside, but in a more muted manner. Outside the periphery, euro area yields have less scope to fall in the near term given that they are already so low. European yields also have less room to rise once global growth bottoms next year because the neutral rate of interest is much lower in the euro area than in the United States.

CHART 28
Bond Sentiment Is Extremely Bearish



* SOURCE: MARKETVANE.NET.

CHART 29
When Bremorse Sets In



* BOTH SERIES SHOWN AS 15-DAY MOVING AVERAGES.
SOURCE: WHAT UK THINKS.

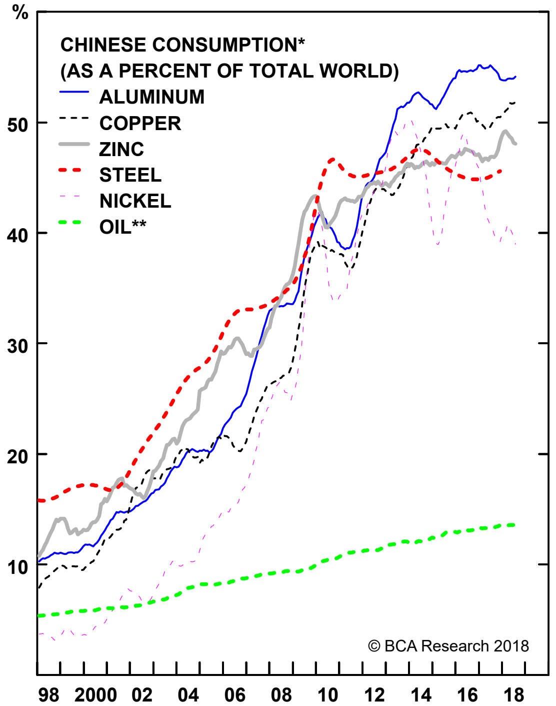
Ironically, a more dovish ECB would help reduce Italian bond yields, as higher inflation is critical for increasing Italian nominal GDP. Since labor market slack is still elevated in Italy, continued monetary stimulus would also lift wages in core Europe more than in Italy, helping to boost Italy's competitiveness relative to the rest of the euro area.

Japanese yields have plenty of scope to rise over the long haul. An aging population is pushing more people into retirement, which will cause the national savings rate to fall further. A decline in the savings pool will increase the neutral rate of interest in Japan. Instead of raising the policy rate, the Japanese authorities will let the economy overheat, generating inflation in the process. This will cause the yield curve to steepen, particularly at the very long end (e.g., beyond 10 years) which is the part of the yield curve that is the least susceptible to the BoJ's yield curve control regime. We are positioned for this outcome through our short 20-year JGB/long 5-year JGB trade recommendation. **Appendix A** – **Chart II** shows our expectations for the major government bond markets over the coming years.

Turning to credit markets, high-yield credit typically underperforms in the latter innings of business-cycle expansions, a period when the Fed is raising rates. Thus, while we do not think that U.S. corporate debt levels will be a major source of systemic financial risk for the broader economy, this is hardly a reason to be overweight spread-product. A more cautious stance towards credit outside the U.S. is also warranted.

CHART 30

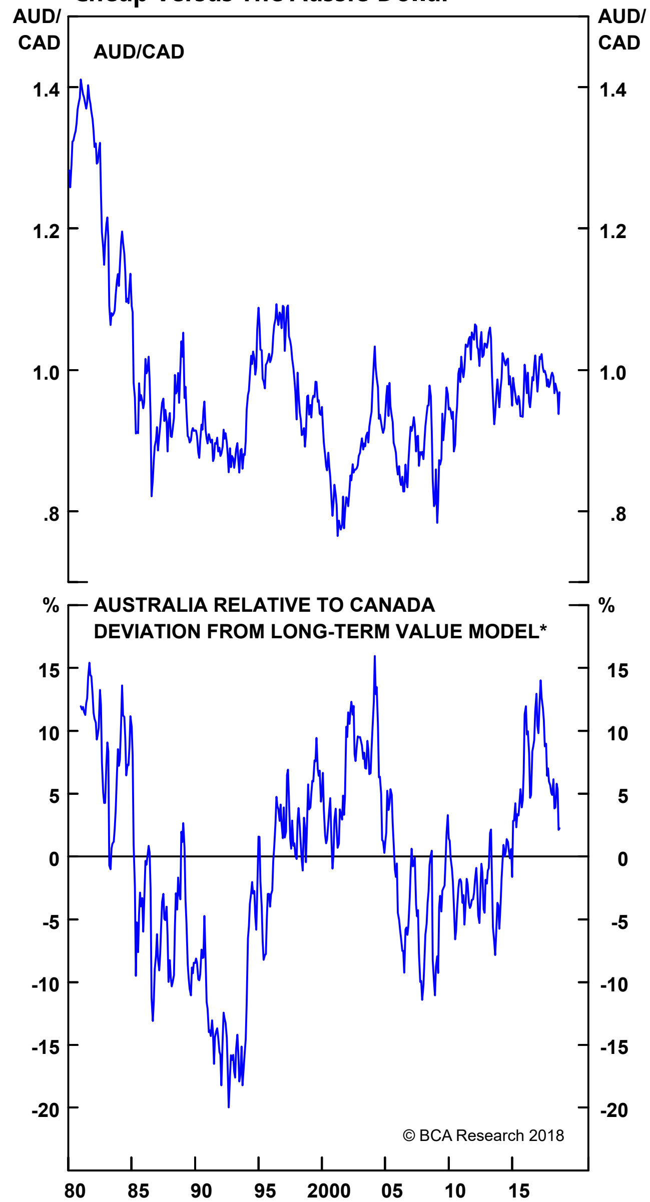
China Is A More Dominant Consumer Of Metals Than Oil



* SHOWN AS 12-MONTH MOVING AVERAGES. SOURCE: WBMS AND EIA.
** CRUDE OIL AND LIQUID FUEL.

CHART 31

Canadian Dollar Still Somewhat Cheap Versus The Aussie Dollar



* REAL EFFECTIVE EXCHANGE RATE MODEL BASED ON PRODUCTIVITY TRENDS, THE CUMULATIVE CURRENT ACCOUNT, AND COMMODITY PRICES.

Currencies And Commodities

The dollar is working off overbought conditions, but will rebound into year-end, as EM tensions intensify and hopes of a massive credit/fiscal-fueled Chinese stimulus package fizzle. EM currencies will weaken the most against the dollar over the next three-to-six months, but the euro and, to a lesser extent, the yen, will also come under pressure.

Granted, the dollar is no longer a cheap currency, but if long-term interest rate differentials stay anywhere close to current levels, the greenback will remain well supported. Consider the dollar's value against the euro. Thirty-year U.S. Treasurys currently yield 3.20% while 30-year German bunds yield 1.12%, a difference of 208 basis points. Even if one allows for the fact that investors expect euro area inflation to be lower than in the U.S. over the next 30 years, EUR/USD would need to trade at a measly 82 cents today in order to compensate German bund holders for the inferior yield they will receive.[4] We do not expect EUR/USD to get down to that level, but a descent into the $1.10-to-$1.12 range over the next six months is probable.

4 For this calculation, we assume that the fair value for EUR/USD is 1.32, which is close to the IMF's Purchasing Power Parity (PPP) estimate. The annual inflation differential of 0.47% is based on 30-year CPI swaps. This implies that the fair value for EUR/USD will rise to 1.52 after 30 years. If one assumes that the euro reaches that level by then, the common currency would need to trade at 1.52/(1.0208)^30=0.82 today.

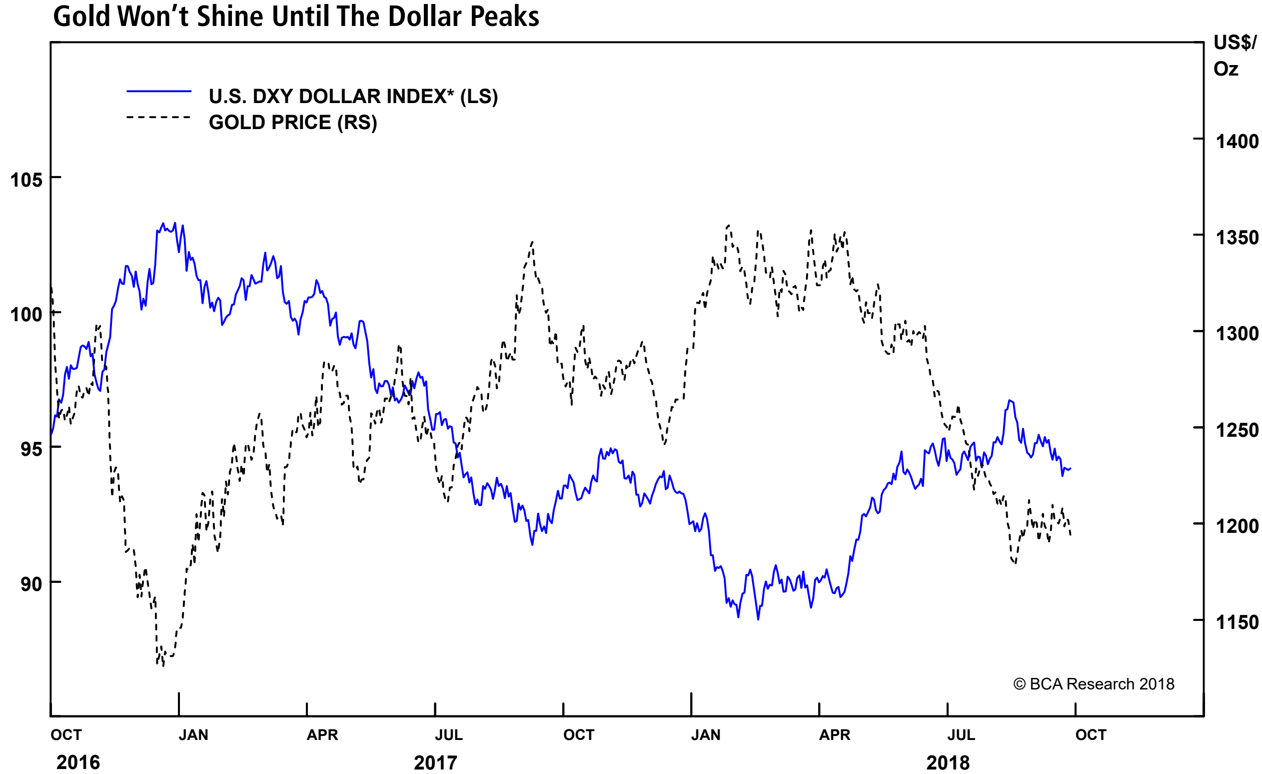
Sterling will remain hostage to Brexit negotiations. It is impossible to know how talks will evolve, but our bias is to take a somewhat pound-positive view. The main reason is that support for Brexit has faded (**Chart 29**). Opinion polls suggest that if a referendum were held again, the "bremain" side would almost certainly prevail. Lacking public support for leaving the EU, it is unlikely that British negotiators could simply walk away from the table. This reduces the odds of a "hard Brexit" outcome. Indeed, a second referendum that leads to a "no-Brexit" verdict remains a distinct possibility.

The combination of slower global growth and a resurgent dollar is likely to hurt commodity prices. Industrial metals are more vulnerable than oil. China consumes around half of all the copper, nickel, aluminum, zinc, and iron ore produced around the world (**Chart 30**). In contrast, China represents less than 15% of global oil demand.

The supply backdrop for oil is also more favorable than for metals. Not only are Saudi Arabia and Russia maintaining production discipline, but U.S. sanctions against Iran threaten to weigh on global crude supply. Further reduction in Venezuela's oil output, as well as potential disruptions to Libyan or Iraqi exports, could also boost oil prices.

CHART 32

Gold Won't Shine Until The Dollar Peaks



* SOURCE: BLOOMBERG FINANCE L.P.

The superior outlook for oil over metals means we prefer the Canadian dollar relative to the Aussie dollar. While AUD/CAD has weakened in recent months, the Aussie dollar is still somewhat expensive against the loonie based on our long-term valuation model (**Chart 31**). We also see an increasing chance that Canada will negotiate a revamped trade deal with the U.S., as Trump focuses his attention more on China. Should this happen, it will remove the NAFTA break-up risk discount embedded in the Canadian dollar.

Finally, a few words on precious metals. Precious metals typically struggle during periods when the dollar is appreciating (**Chart 32**). Consequently, we would not be eager buyers of gold or other precious metals until the dollar peaks, most likely around the middle of next year. As inflation starts to accelerate in late-2019 and in 2020, gold will finally move decisively higher.

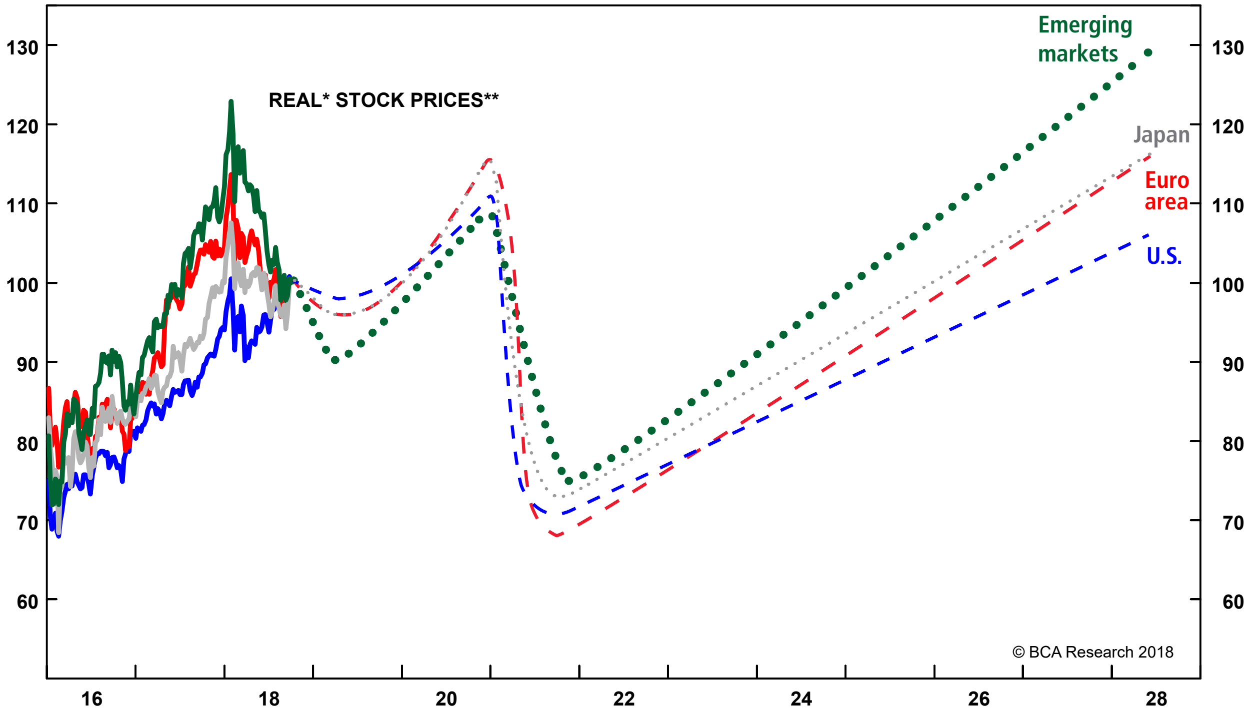
Appendix A – **Chart III** and **Chart IV** present an illustration of where the major currencies and commodities are heading.

Peter Berezin, Chief Global Strategist
Global Investment Strategy
peterb@bcaresearch.com

APPENDIX A

APPENDIX A CHART I

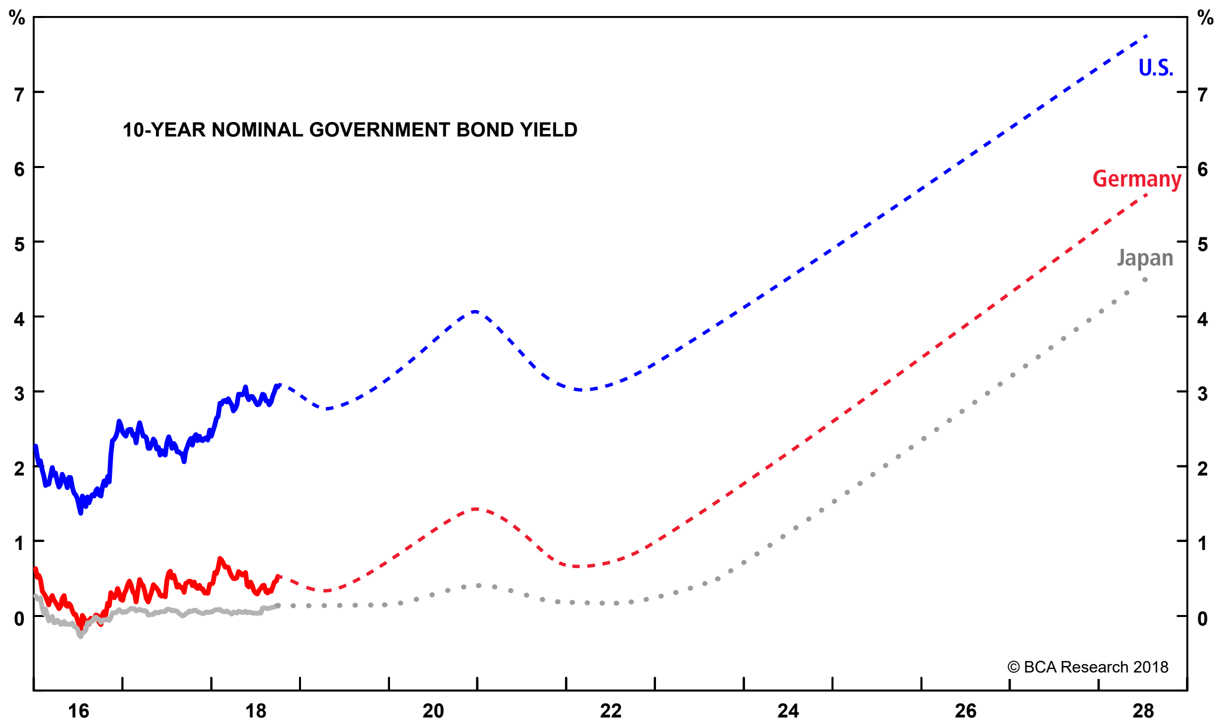
Market Outlook: Equities



* DEFLATED BY HEADLINE CONSUMER PRICE INDEX.
** SHOWN REBASED SEPTEMBER 2018 = 100 AND IN U.S. DOLLAR TERMS; SOURCE: MSCI INC.
NOTE: DASHED LINES REPRESENT FORECASTS.

APPENDIX A CHART II

Market Outlook: Bonds



NOTE: DASHED LINES REPRESENT FORECASTS.

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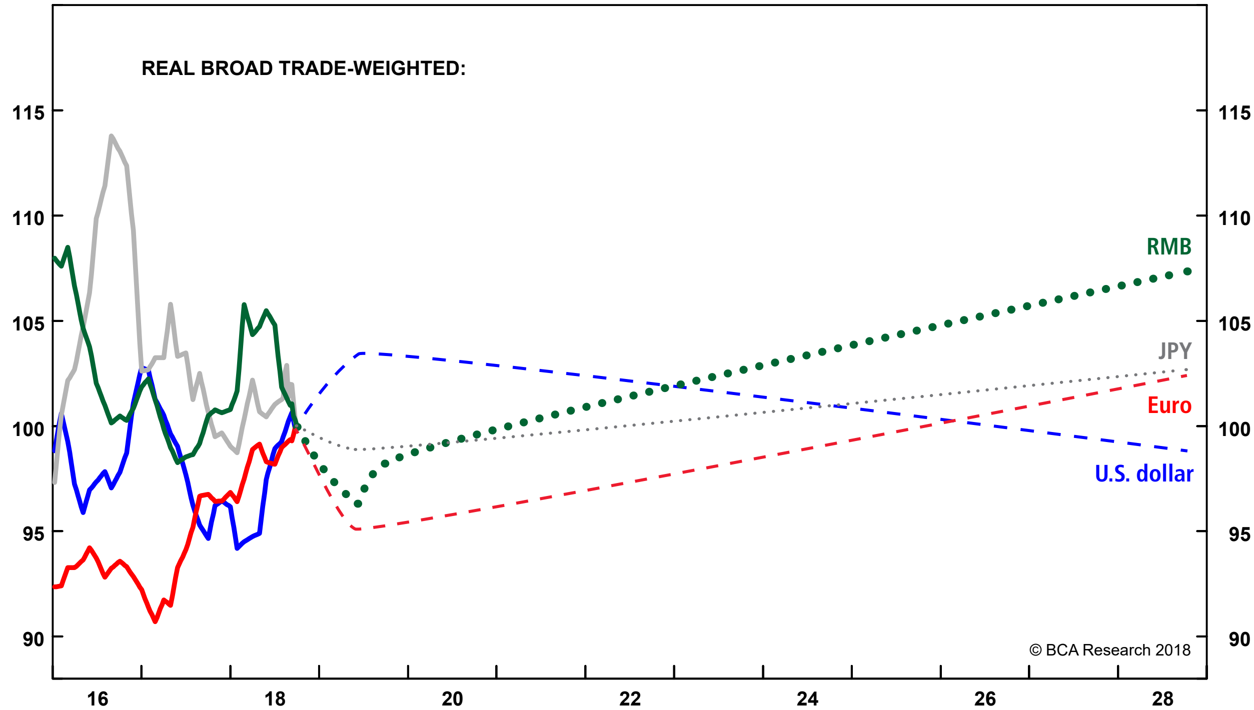
APPENDIX A CHART III

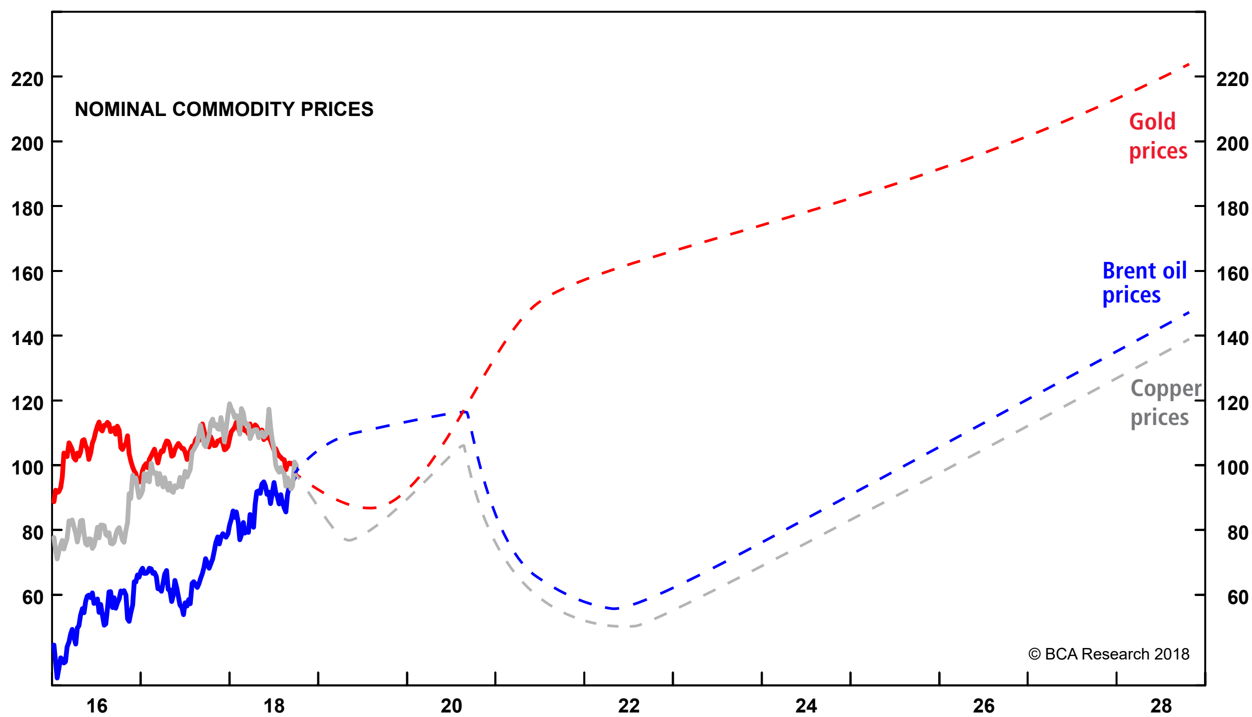
Market Outlook: Currencies



NOTE: SERIES REBASED TO SEPTEMBER 2018 = 100;
SOURCE FOR HISTORICAL DATA IS THE FEDERAL RESERVE AND THE BIS; AND DASHED LINES REPRESENT FORECASTS.

APPENDIX A CHART IV

Market Outlook: Commodities



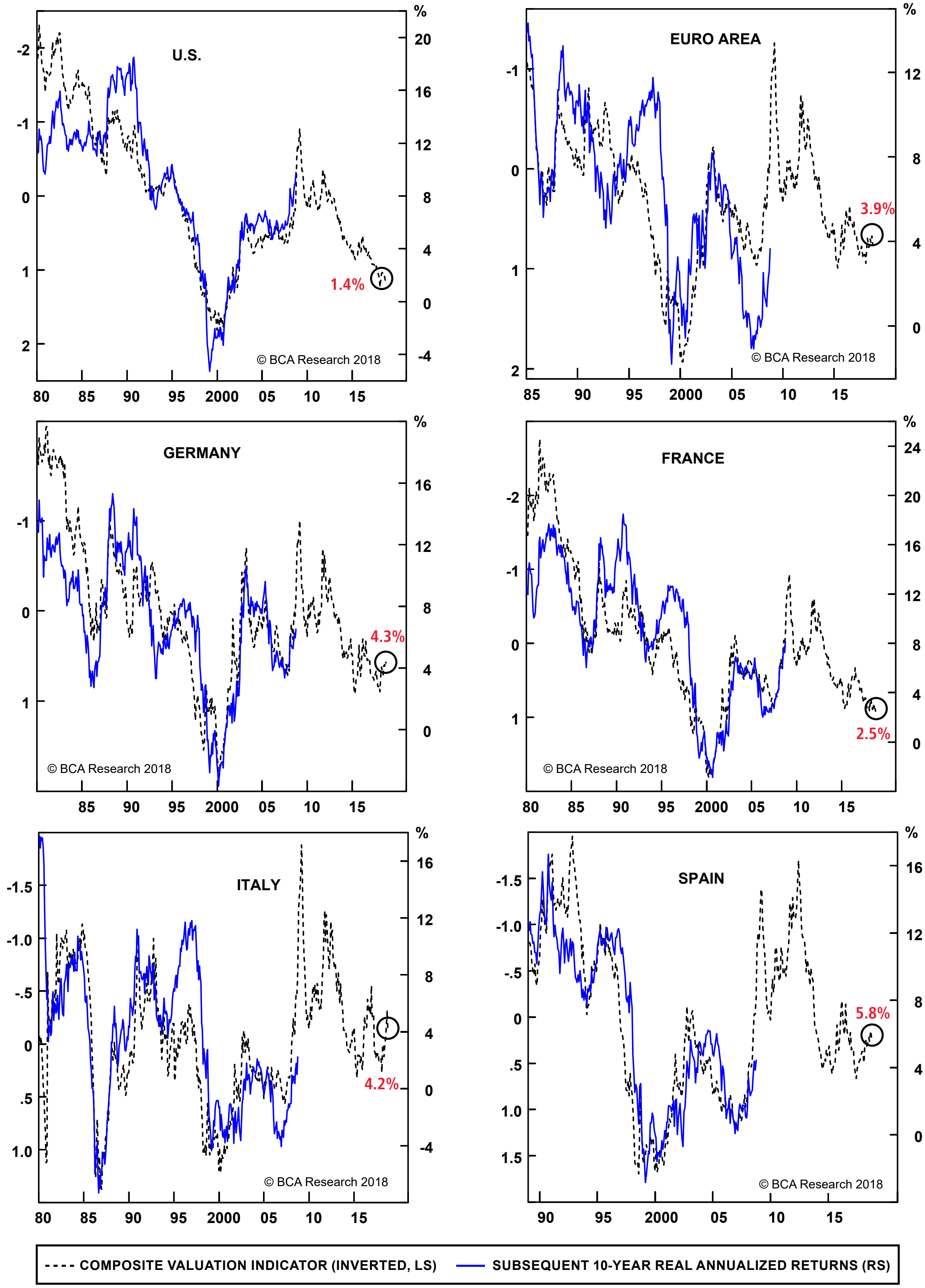
NOTE: SERIES REBASED TO SEPTEMBER 2018 = 100; DASHED LINES REPRESENT FORECASTS.

BCA RESEARCH

APPENDIX B

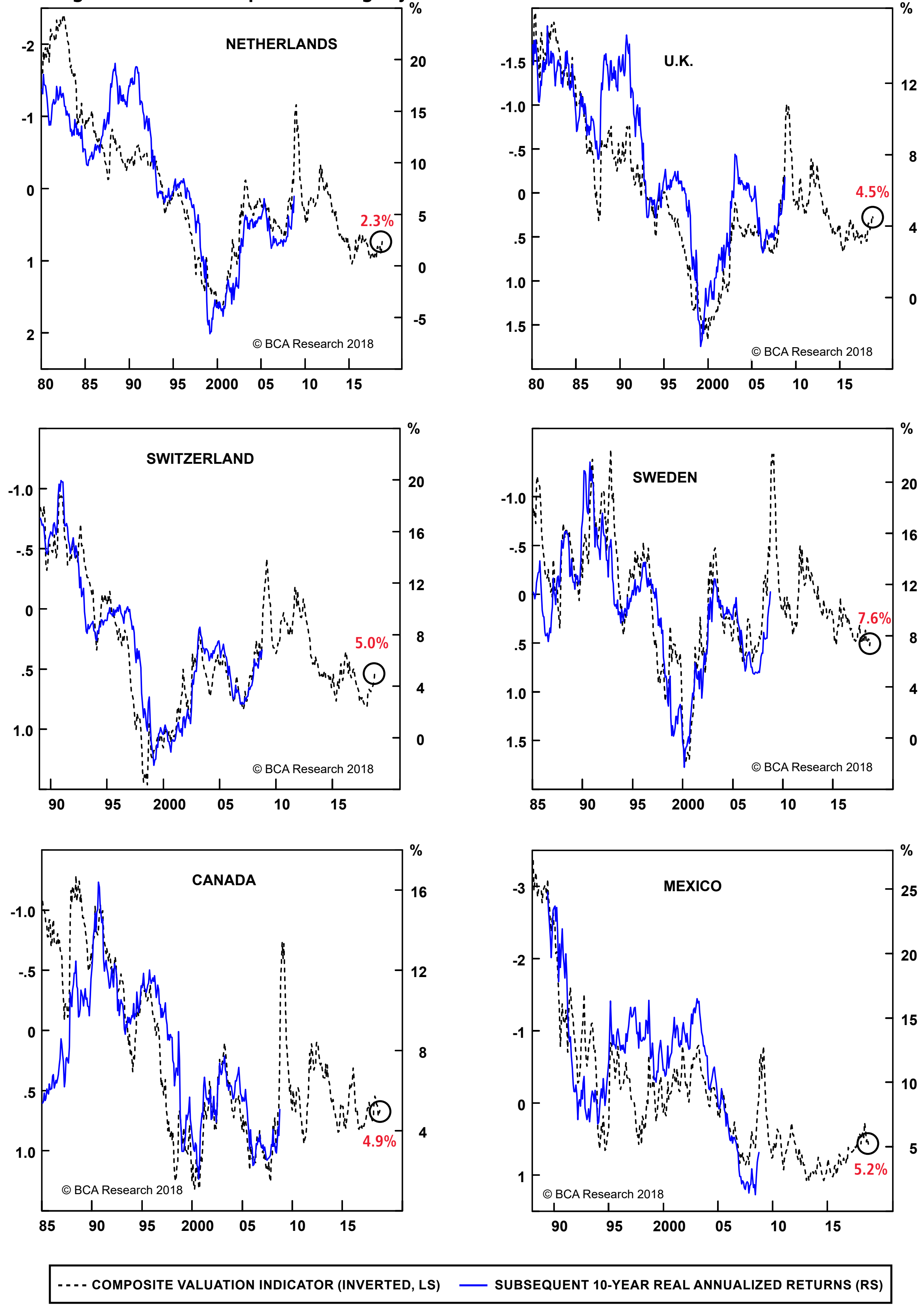
APPENDIX B CHART 1

Long-Term Return Prospects Are Slightly Better Outside The U.S.



APPENDIX B CHART 1

Long-Term Return Prospects Are Slightly Better Outside The U.S.



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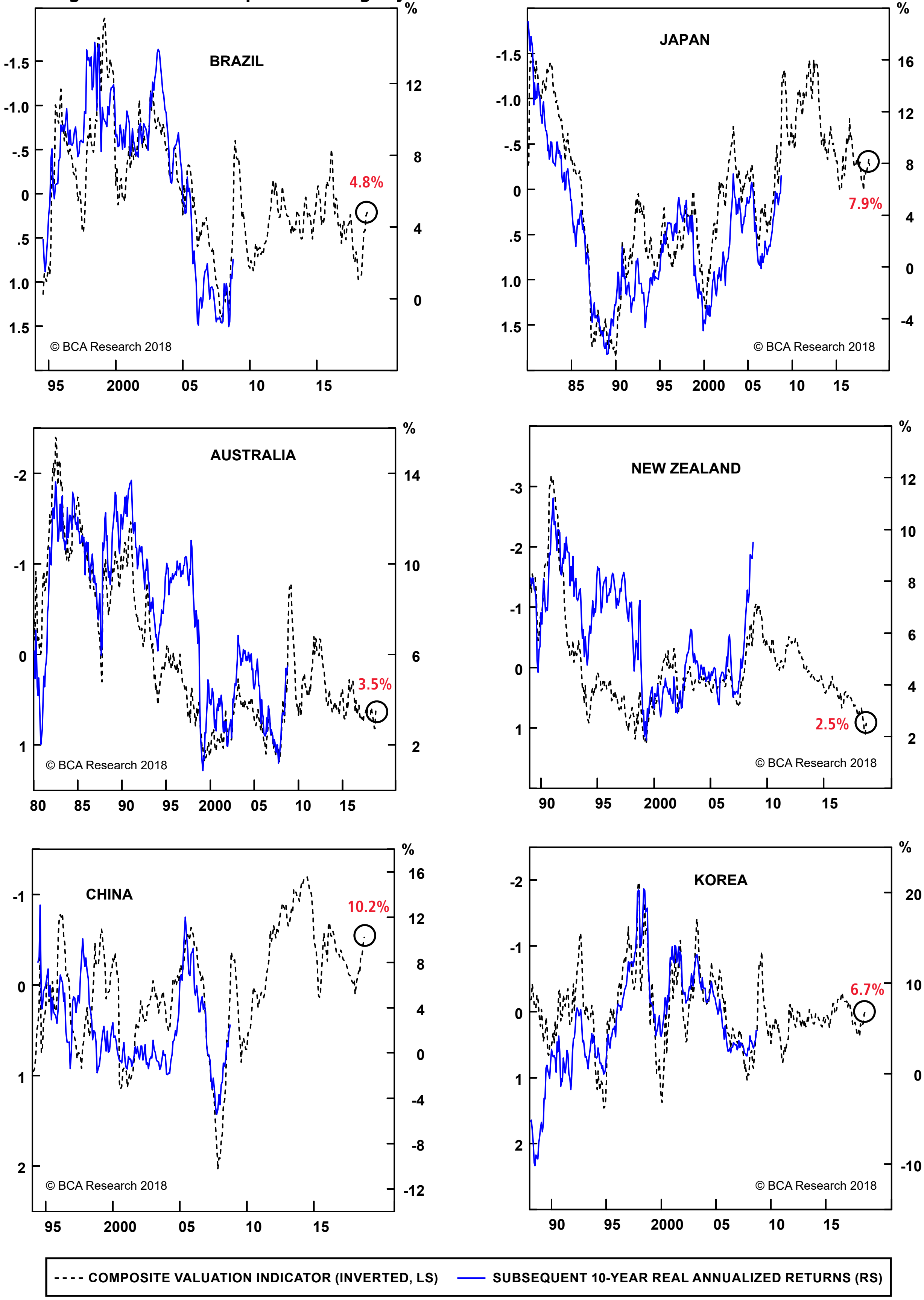
Long-Term Return Prospects Are Slightly Better Outside The U.S.



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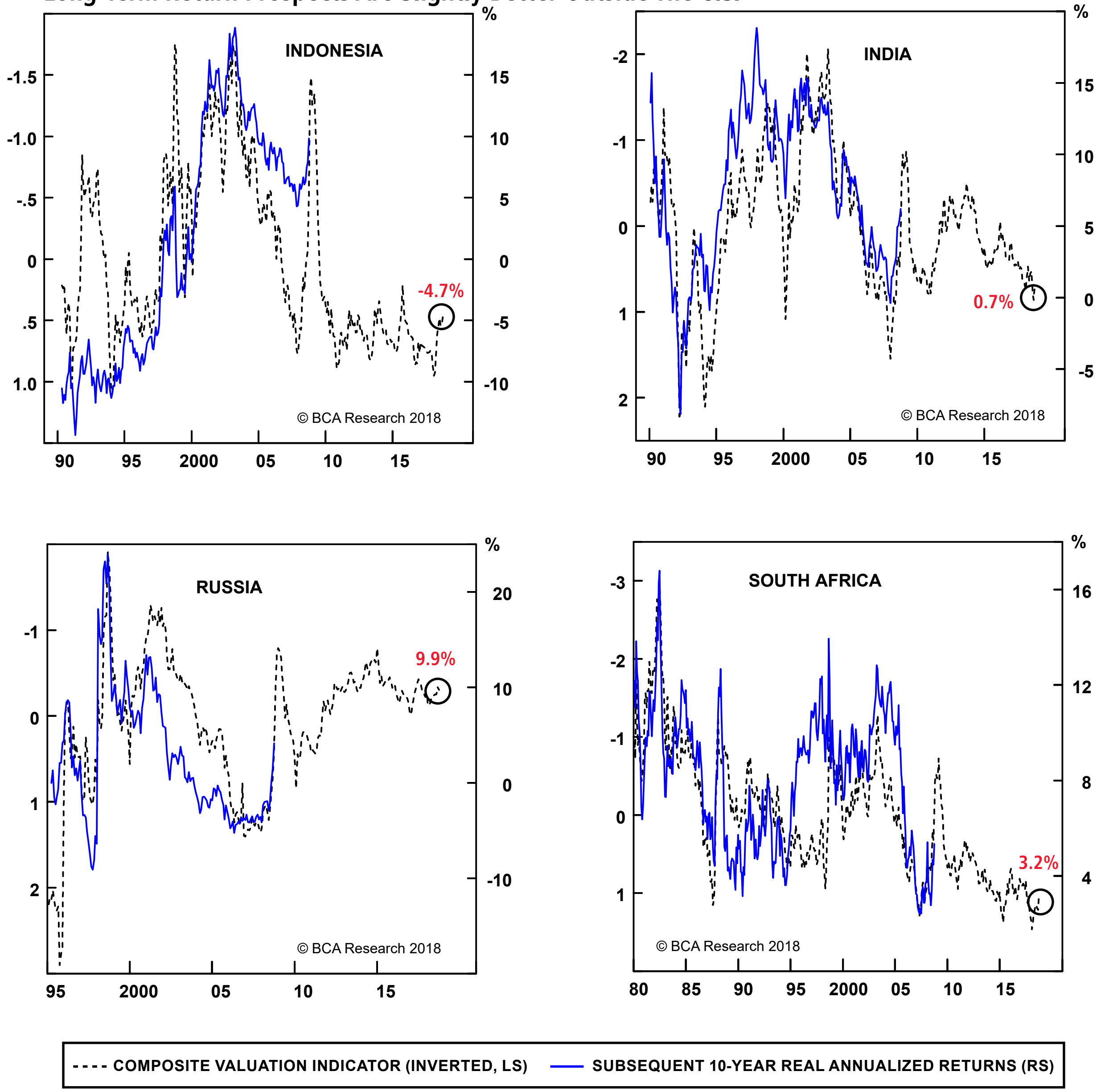
APPENDIX B CHART 1

Long-Term Return Prospects Are Slightly Better Outside The U.S.



Strategy & Market Trends*

	EQUITY PRICES / WORLD BENCHMARKS**	BOND YIELDS	SHORT RATES	CURRENCY VS. US$
U.S.	UP	UP	UP	
CANADA	FLAT	UP	UP	FLAT
JAPAN	UP	FLAT	FLAT	DOWN
AUSTRALIA	FLAT	UP	UP	DOWN
U.K.	FLAT	UP	UP	FLAT
EURO AREA	UP	UP	FLAT	DOWN
EMERGING ASIA	DOWN	FLAT	FLAT	DOWN
LATIN AMERICA	DOWN	FLAT	FLAT	DOWN

* EXPECTATIONS FOR THE COMING 12 MONTHS.
** DM EQUITY PRICES RELATIVE TO WORLD BENCHMARK EXPRESSED IN LOCAL CURRENCIES. EM EQUITY PRICES RELATIVE TO WORLD BENCHMARK EXPRESSED IN USD.

NOTE: ITALICIZED AND BOLDED TEXT INDICATES A CHANGE IN THE VIEW.

Tactical Trades

The purpose of this section is to provide investment ideas independent of our asset allocation model or direct market forecasts. Once recommended, we will monitor the investment recommendation until we close it out.

TRADE	INCEPTION LEVEL	INITIATION DATE	RETURN-TO-DATE	STOP	COMMENTS
LONG FED FUNDS JUNE 2019 FUTURES / SHORT FED FUNDS DECEMBER 2020 FUTURES	100	SEP 20/2018	0.5 BPS	-25 BPS	
LONG U.S. DOLLAR / SHORT CHINESE YUAN	6.837	SEP 20/2018	0.4%	-5.0%	
SHORT AUSTRALIAN DOLLAR / LONG CANADIAN DOLLAR	0.975	JUN 28/2018	3.4%	-5.0%	
SHORT AUSTRALIAN DOLLAR / LONG JAPANESE YEN	87.958	FEB 01/2018	5.9%	-5.0%	

NOTE: STOPS ARE BASED ON DAILY CLOSING LEVELS. PLEASE NOTE THAT ALL CURRENCY TRADE CALCULATIONS INCLUDE COST OF CARRY.

Strategic Recommendations

This table summarizes our longer-term strategic recommendations. Some of these positions may not necessarily be consistent with our "Tactical Trades."

POSITION	INCEPTION LEVEL	INITIATION DATE	RETURN-TO-DATE	CHANGE FROM PREVIOUS WEEK	COMMENTS
EQUITY RECOMMENDATIONS					
LONG ISHARES MSCI EMERGING MARKET ETF (EEM) / LONG MARCH 15 2019 PUT OPTION (STRIKE PRICE: 41)	100	SEP 20/2018	0.1%	N/A	
LONG MSCI ALL COUNTRY VALUE INDEX / SHORT MSCI ALL COUNTRY GROWTH INDEX	100	MAR 29/2018	-3.9%	-0.6%	
LONG CHINA H-SHARE INDEX / SHORT EM EQUITIES[1]	100	FEB 23/2017	-2.9%	1.1%	
FIXED INCOME RECOMMENDATIONS					
LONG U.S. 30-YEAR GOVERNMENT BOND / SHORT GERMAN 30-YEAR GOVERNMENT BOND (UNHEDGED)	100	MAR 01/2018	1.5%	1.2%	
LONG 30-YEAR TIPS BREAKEVEN (LONG U.S. 30-YEAR TIPS / SHORT U.S. 30-YEAR TREASURY)[2]	100	MAR 01/2018	1.4%	0.4%	
SHORT JAPAN 20-YEAR / LONG JAPAN 5-YEAR GOVERNMENT BOND	100	AUG 24/2017	0.9%	0.3%	
LONG JAPANESE 10-YEAR CPI SWAP	22 BPS	MAR 31/2016	16 BPS	0.0 BPS	
LONG GERMAN 10-YEAR CPI SWAP	151 BPS	FEB 27/2015	38 BPS	2.8 BPS	
CURRENCY RECOMMENDATIONS					
SHORT EURO / LONG BRITISH POUND	0.9033	AUG 03/2017	2.0%	-0.3%	
SHORT EURO / LONG RUSSIAN RUBLE	68.65	JUL 06/2017	-1.9%	2.7%	
SHORT EURO / LONG CANADIAN DOLLAR	1.5132	MAY 18/2017	1.7%	0.1%	
LONG U.S. DOLLAR (DXY INDEX)[3]	86.915	OCT 31/2014	9.2%	1.2%	

1 CURRENCY UNHEDGED; THE CORRESPONDING ETFS FOR THIS TRADE ARE THE HANG SENG INVESTMENT INDEX FUNDS SERIES: H-SHARE INDEX ETF (2828 HK), AND THE ISHARES MSCI EMERGING MARKETS ETF (EEM US). THE HANG SENG CHINA ENTERPRISE INDEX COMPRISES OF CHINA H-SHARES (CHINESE STOCKS AVAILABLE TO INTERNATIONAL INVESTORS) CURRENTLY TRADING ON THE HONG KONG STOCK EXCHANGE.
2 EQUALLY-WEIGHTED BASKET. HEDGE CURRENCY EXPOSURE.
3 TO TRACK THE PERFORMANCE OF THIS RECOMMENDATION, WE USE THE FOLLOWING SERIES: BLOOMBERG BARCLAYS 30-YEAR TIPS ON-THE-RUN INDEX, AND BLOOMBERG BARCLAYS 30-YEAR TREASURY NOMINAL COMPARATOR INDEX.

Trades Closed In 2015-2018

TRADE	INCEPTION LEVEL	INITIATION DATE	CLOSING DATE	REALIZED P&L	TYPE OF TRADE
SHORT GOLD	1225	DEC 10/14	JAN 23/15	-5.0%	TACTICAL
LONG S&P 500 / SHORT WTI	100	OCT 2013	FEB 6/15	126.5%	STRATEGIC
LONG GERMAN 10-YEAR BUNDS / SHORT JAPANESE 10-YEAR JGBs	100	JUL 2013	FEB 27/15	13.5%	STRATEGIC
LONG GREEK STOCKS	716.38	JAN 30/15	MAR 9/15	15.0%	TACTICAL
LONG GOLD	1235	FEB 6/15	MAR 9/15	-5.0%	TACTICAL
LONG U.S. DOLLAR / SHORT JAPANESE YEN	111.94	OCT 31/14	APR 10/15	7.5%	TACTICAL
LONG INDIAN STOCKS / SHORT INDONESIAN STOCKS	5.29	OCT 24/14	APR 24/15	-5.0%	TACTICAL
UNDERWEIGHT COMMODITY-MARKET EQUITIES	100	NOV 22/13	MAY 8/15	19.2%	STRATEGIC
LONG CRB METALS INDEX / SHORT WTI CRUDE OIL	100	MAY 08/15	JUN 05/15	-5.0%	TACTICAL
LONG S&P DIVIDEND ARISTOCRATS / SHORT NASDAQ	0.3370	OCT 24/14	JUN 05/15	-5.0%	TACTICAL
LONG GLOBAL CYCLICALS / SHORT GLOBAL DEFENSIVES*	100	MAY 01/15	JUL 3/15	-5.0%	TACTICAL
LONG CHINA H-SHARE INDEX**	11922.56	MAY 23/14	JUL 3/15	50.0%	TACTICAL
SHORT CHINA A- SHARE INDEX / LONG CHINA H-SHARE INDEX	100	JUN 06/15	JUL 3/15	26.4%	STRATEGIC
LONG ITALIAN 10-YEAR GOV'T BONDS	5.878%	AUG 10/12	JUL 17/15	30.5%	STRATEGIC
LONG EURO AREA BANK STOCKS	50.12	JAN 16/15	SEP 24/15	5.9%	TACTICAL
LONG 30-YEAR U.S. TREASURYS / SHORT S&P 500	100	JUN 12/15	OCT 02/15	17.9%	TACTICAL
LONG 12-MONTH NDF USD/CNY	6.4025	MAR 06/15	OCT 02/15	2.5%	TACTICAL
LONG 2.1 UNIT OF U.S. BARCLAYS HIGH YIELD CORPORATE BOND INDEX / SHORT ONE UNIT OF S&P 500	100	OCT 22/15	NOV 26/15	-5.0%	TACTICAL
SHORT NASDAQ 100 MAR 2016 FUTURES	4,692.50	NOV 06/15	JAN 20/16	16.2%	TACTICAL
LONG CHINESE A-SHARES AND H-SHARES	100	JUL 01/15	MAY 19/16	-27.0%	STRATEGIC
SHORT EURO / LONG JAPANESE YEN	139.15	JUN 01/15	JUN 16/16	19.4%	STRATEGIC
SHORT EUROPEAN EQUITIES (U.S. DOLLAR TERMS)	100	JUN 09/16	JUN 24/16	8.2%	TACTICAL
LONG U.S. 30-YEAR / SHORT U.S. 10-YEAR GOV'T BONDS	96 BPS	FEB 07/14	JUL 08/16	22.5%	STRATEGIC
SHORT BRITISH POUND / LONG SWEDISH KRONA	13.16	NOV 12/15	AUG 11/16	19.1%	TACTICAL
LONG 10-YEAR U.S. TREASURYS / SHORT 10-YEAR GERMAN BUNDS	100	AUG 15/14	OCT 27/16	18.5%	TACTICAL
LONG SPANISH 10-YEAR GOV'T BONDS / SHORT ITALIAN 10-YEAR GOV'T BONDS	16 BPS	OCT 15/15	DEC 8/16	6.2%	TACTICAL
LONG CHINESE BANK EQUITIES	100	MAY 19/16	JAN 19/17	32.3%	STRATEGIC
SHORT U.S. DOLLAR / LONG RUSSIAN RUBLE	64.59	NOV 19/15	JAN 19/17	20.1%	STRATEGIC
SHORT NASDAQ 100 MAR 2017 FUTURES	4820.50	AUG 23/16	FEB 23/17	-10.0%	TACTICAL
SHORT U.S. / LONG BASKET OF EURO AREA, JAPANESE, AND CHINESE EQUITIES***	100	FEB 6/15	FEB 23/17	-10.0%	STRATEGIC
SHORT S&P 500	2389.52	MAY 4/17	JUN 15/17	-2.0%	TACTICAL
SHORT EURO / LONG U.S. DOLLAR	1.1205	MAY 25/17	JUN 29/17	-1.6%	TACTICAL
SHORT JAPANESE, GERMAN AND SWISS 10-YEAR GOV'T BONDS	100	JUL 5/16	JUN 29/17	5.3%	STRATEGIC
SHORT FED FUNDS JAN 2018 FUTURES	98.79	APR 20/17	JUL 6/17	11 BPS	TACTICAL
OVERWEIGHT AUSTRALIA (ADD CURRENCY HEDGE)****	100	JAN 23/09	JUL 20/17	59.5%	STRATEGIC
OVERWEIGHT NEW ZEALAND (ADD CURRENCY HEDGE)****	100	JAN 23/09	JUL 20/17	74.2%	STRATEGIC
LONG BRITISH POUND / SHORT JAPANESE YEN	132.01	AUG 11/16	AUG 3/17	9.9%	TACTICAL
SHORT FED FUNDS JUN 2018 FUTURES	98.55	JUL 6/17	SEP 7/17	-18 BPS	TACTICAL
LONG BRENT OIL DEC 2017 FUTURES	49.33	MAY 4/17	SEP 21/17	13.8%	TACTICAL
SHORT S&P 500	2585.64	NOV 16/17	NOV 30/17	-2.0%	TACTICAL
LONG 2-YEAR USD/ SAUDI RIYAL FORWARD CONTRACT	3.89	DEC 10/15	JAN 11/18	-2.9%	STRATEGIC
LONG GLOBAL INDUSTRIAL STOCKS / SHORT GLOBAL UTILITIES	100	SEP 29/17	FEB 1/18	12%	TACTICAL
LONG AUSTRALIAN DOLLAR / SHORT NEW ZEALAND DOLLAR	1.0815	APR 25/14	FEB 1/18	-1.8%	STRATEGIC
SHORT ONE UNIT OF EUR/USD & LONG 1.5 UNITS OF 30-YEAR U.S. TREASURYS VERSUS 30-YEAR GERMAN BUNDS	100	JAN 25/2018	FEB 6/18	-2.5%	TACTICAL
SHORT FED FUNDS DEC 2018 FUTURES	98.6500	SEP 7/2017	FEB 6/18	70 BPS	TACTICAL
LONG S&P 500 / SHORT U.S. BARCLAYS HIGH YIELD CORPORATE BOND INDEX	100	JAN 11/2018	FEB 15/18	-5.0%	TACTICAL
SHORT U.S. 30-YEAR GOVERNMENT BOND	100	JUN 29/2017	MAR 1/2018	3.8%	STRATEGIC
LONG EUROPE AND JAPAN / SHORT U.S. EQUITIES	100	FEB 23/2017	JUN 19/2018	-5.4%	STRATEGIC
LONG SWEDISH KRONA / SHORT SWISS FRANC	0.1156	JUL 16/2017	AUG 15/2018	-6.3%	TACTICAL
AVERAGE RETURN	-	-	-	**11.9%**	-
CUMULATIVE RETURN	-	-	-	**549.2%**	-

* CYCLICALS INCLUDE MATERIALS, ENERGY, INDUSTRIALS, AND CONSUMER DISCRETIONARY; DEFENSIVES INCLUDE TELECOM, CONSUMER STAPLES, AND HEALTH CARE.
** LONG CHINESE BANKS FROM MAY 23, 2014 UNTIL OCTOBER 17, 2014; LONG CHINESE A SHARES FROM OCTOBER 17, 2014 TO FEBRUARY 13, 2015.
*** EQUALLY-WEIGHTED BASKET. HEDGE CURRENCY EXPOSURE.
**** CURRENCY HEDGE ADDED AS OF SEPTEMBER 26, 2014.

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