Global Equity Strategy

Research Analysts

Andrew Garthwaite
44 20 7883 6477
andrew.garthwaite@credit-suisse.com

Marina Pronina
44 20 7883 6476
marina.pronina@credit-suisse.com

Robert Griffiths
44 20 7883 8885
robert.griffiths@credit-suisse.com

Yiagos Alexopoulos
44 20 7888 7536
yiagos.alexopoulos@credit-suisse.com

Nicolas Wylenzek
44 20 7883 6480
nicolas.wylenzek@credit-suisse.com

Alex Hymers
44 20 7888 9710
alex.hymers@credit-suisse.com

STRATEGY

The critical issue: China and China plays

In our opinion, China's combination of a triple bubble (with the third biggest credit bubble, the biggest investment bubble and second biggest real estate bubble of all time) remains the biggest risk to the global economy.

We believe the time to be worried about bubbles bursting is when (i) excess investment leads to deflation (China has close to record deflation), (ii) house prices fall (they are currently down by a record amount), (iii) we see FX outflows (which are now close to record highs), (iv) deposit growth slows down sharply (they are close to a record low), and (v) the labour market shows signs of full capacity (the job offer to application ratio is at an all-time time high). Furthermore, nominal GDP growth has fallen to 5.8%, only a third of average levels.

However, there are some signs of near-term improvement: (i) house prices have stabilised (temporarily, we think), (ii) the current account has improved (which creates more monetary flexibility), (iii) there are signs of policy proactivity (as shown last week with the government's moves to stabilise the equity market), and (iv) the Credit Suisse Premier Li indicator is ticking up. Nevertheless, we believe that if house prices fall 15% or deposit growth falls to zero, China's real GDP growth will slow to sub-3%.

We raise mining to benchmark from underweight: It is the best performing sector following tightening turning points in US monetary policy; the iron ore price is close to a 115-year low in real terms; capex to sales is at a 12-year low; dividend and P/B relatives are close to extremes; and nearly a third of iron ore production is below the cash cost, which is often a signal for production discipline. There are plenty of risks, as signalled by Chinese M2 and the rebar price. We continue to prefer mining to oil.

We lower European autos to benchmark owing to our ongoing concerns on German autos, where 41% of profits come from China, and the euro/yen. We stay overweight of auto components and think Continental European car sales will rise by c20% over the next two years; thus, we remain positive on French and Italian autos, but underweight the German OEMs.

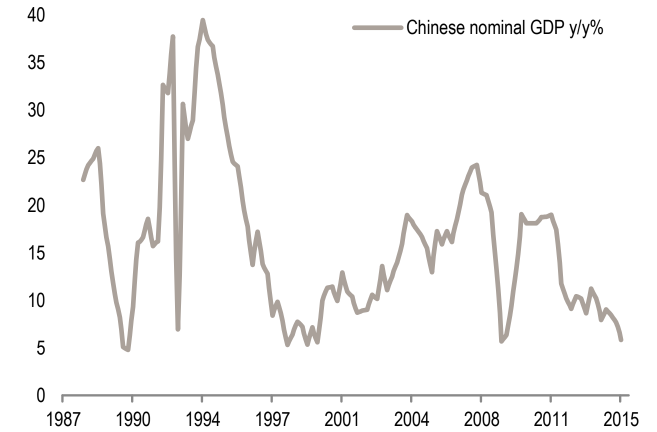
We remain underweight on China-related plays unless valuations are clearly cheap. We therefore remain **underweight luxury** (Burberry, LVMH); **capital goods with China exposure** (SKF, Sandvik); **bulk chemical companies** (BASF); **testing companies**; the **Australian dollar and Australian equities** as well as the areas of Chinese equities where valuations are extremely extended (Shenzhen SME).

Table of contents

The team wishes to acknowledge the contributions made to this report by Revelino Sequeira, Pranali Deshmukh, and Dhruv Krishna employees of CRISIL Global Research and Analytics, a business division of CRISIL Limited, a third-party provider of research services to Credit Suisse.

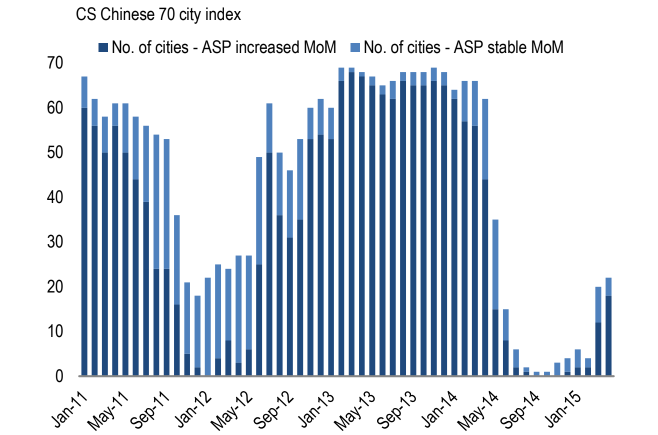
Key charts

Figure 1: Chinese nominal GDP is close to a 30-year low of just 6%



Source: Thomson Reuters, Credit Suisse research

Figure 2: House prices have started to rise in several Tier 1 and 2 cities month on month

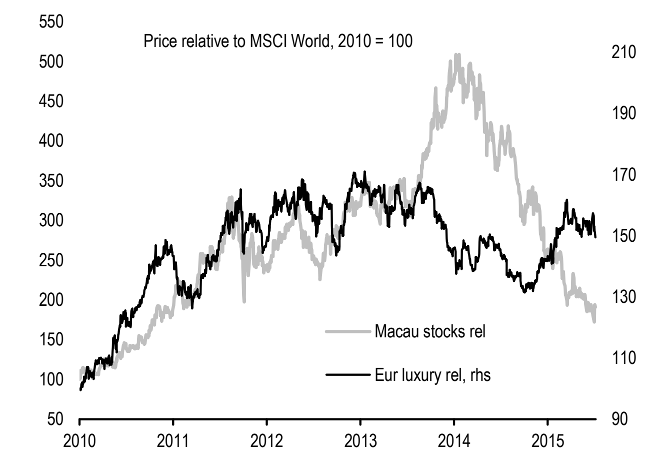


Source: Credit Suisse research

Figure 3: The price to book relative of the sector is more than one standard deviation depressed

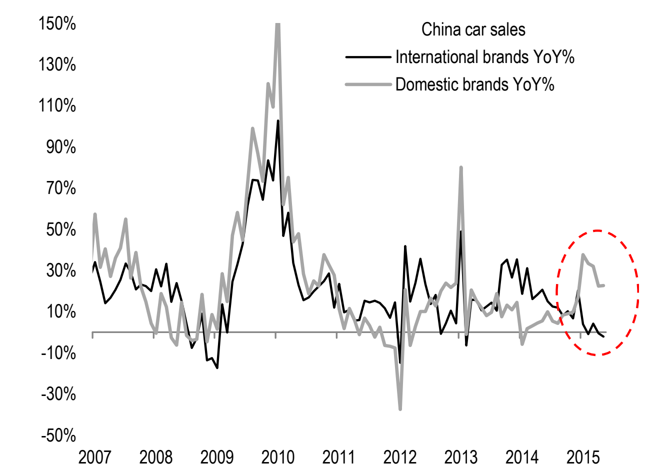
Source: Thomson Reuters, Credit Suisse research

Figure 4: European luxury goods stocks continue to decouple from Macau casino stocks



Source: Thomson Reuters, Credit Suisse research

Figure 5: Sales of domestic brands in China are up 22% YoY, while sales of international brands are down 2% YoY



Source: Credit Suisse European Autos team, Credit Suisse China Autos team

Figure 6: The Shenzhen SME index (small and younger start-ups typically) is extremely extended

Source: Thomson Reuters, Credit Suisse research

The critical issue: China and China plays

We have the following key conclusions:

1. **A Chinese hard landing still remains the biggest long-term macro risk** that we see globally;
2. **Near-term there appears to be some resilience in the economy** that means a hard landing can be postponed;
3. We increase our weightings in **mining to benchmark** and stick with our **underweight in luxury goods**. We downgrade **European autos to benchmark**, reflecting our caution on the Chinese exposure of the European car producers (but we remain overweight auto components). We stick with our underweight of certain capital and chemical goods stocks that face both the competitive threat from China, as well as deteriorating end markets in China. We stick with our long-standing bearish view on the Aus$ and Australian equities in general;
4. **On Chinese equities, we remain benchmark** (having upgraded them last November), but we would be overweight the 'old economy' shares and underweight the 'new' (i.e. Shenzhen SMEs, ChiNext);
5. A slowdown in Chinese GDP growth below 3% would make us bearish on global growth.

What are our main concerns?

We have the following main concerns on China:

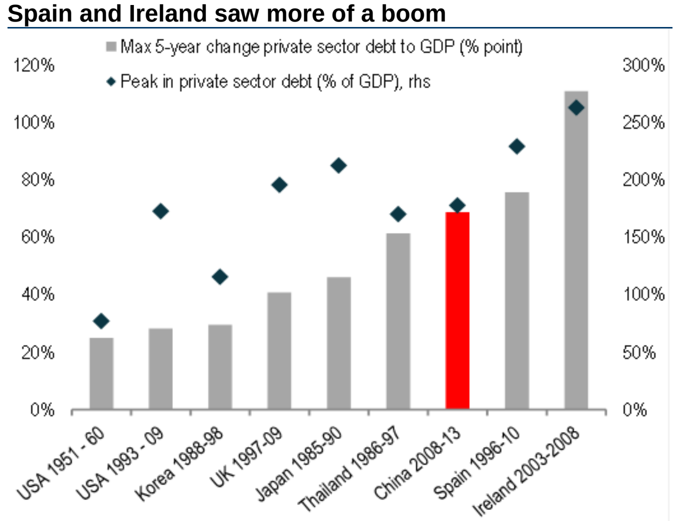
1. **Growing credit bubble**

China has had the third biggest credit bubble over a 5-year period of any country in our database. Moreover, private sector debt is now 40% above trend and it is more extended than was the case even in the US at the peak of its credit bubble (and the BIS points out that historically, a financial crisis has been preceded by credit being more than 10% above trend).

Figure 7: **China's private sector debt to GDP stands at 196%, some 40 percentage points above trend**

Source: Thomson Reuters, Credit Suisse research

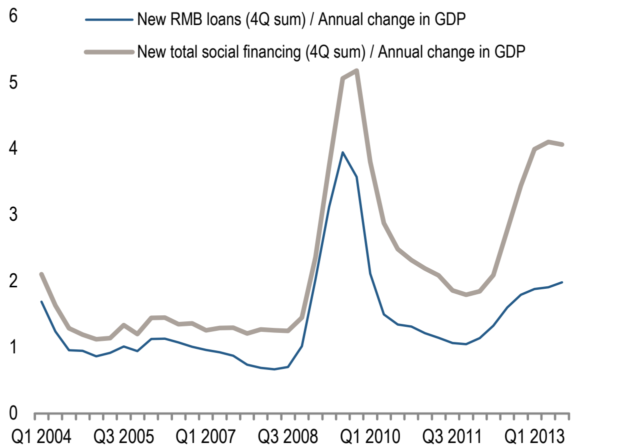
Figure 8: **The credit boom (relative to GDP) in China has been greater than most other credit booms seen—only Spain and Ireland saw more of a boom**



Source: Thomson Reuters, Credit Suisse research

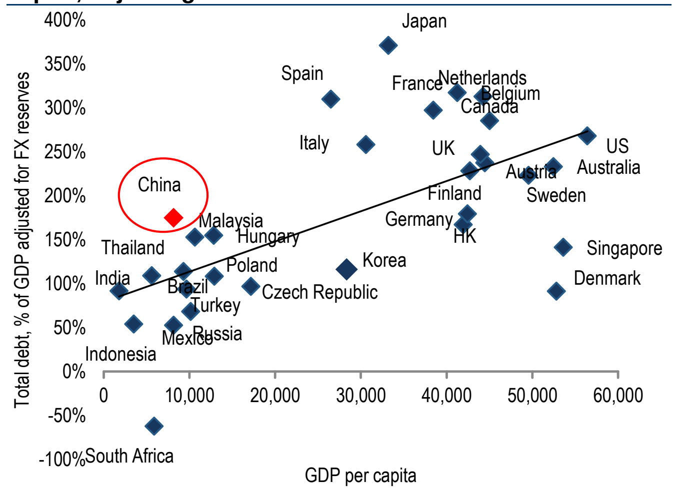
The sensitivity of growth to credit has continued to fall if we look at the change in a unit of nominal GDP growth per percentage point change in credit.

Figure 9: China requires 4x as much new debt to create an extra unit of GDP than was the case three years ago



Source: Thomson Reuters, Credit Suisse research

Figure 10: China looks overleveraged for its GDP per capita, adjusting for FX reserves

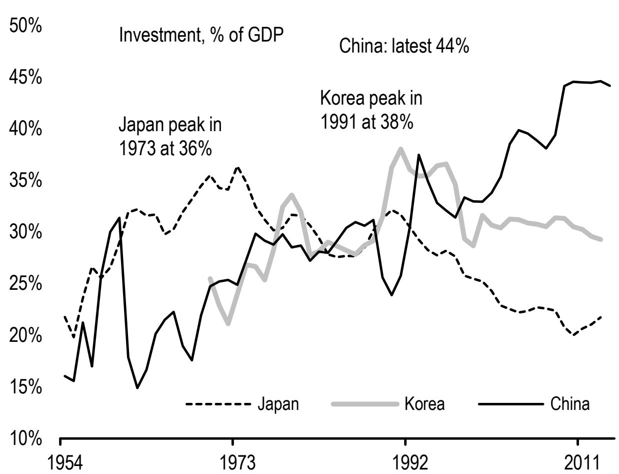


Source: Thomson Reuters, Credit Suisse research

2. A record investment bubble

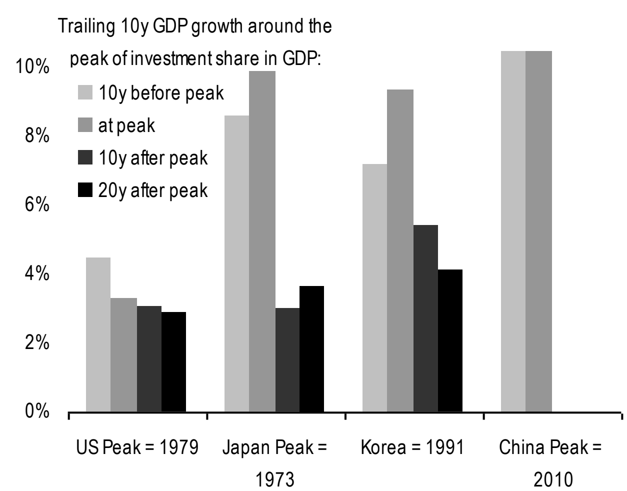
We continue to see the investment share of GDP being higher than any other country in modern history has ever had, even those that went through rapid industrialisation.

Figure 11: China's investment share of GDP is already considerably higher than it ever was in Japan and Korea



Source: Thomson Reuters, Credit Suisse research

Figure 12: An economy's growth tends to slow significantly once the investment share of GDP has peaked



Source: Thomson Reuters, Credit Suisse research

Typically a move from investment to consumption-led growth leads to a halving of the growth rate. While investment is a flow concept, the stock of investment is also high in some areas. According to the US Geological Survey, China has consumed more cement in the past three years than the US did in the entire 20th century. Moreover, China has a higher density of motorways per capita than both the UK and Japan.

3. A housing bubble

Finally, we think that there is a clear cut housing bubble. Almost by the nature of a bubble, the participants are reluctant to acknowledge that it is one. But three factors indicate that it is a bubble:

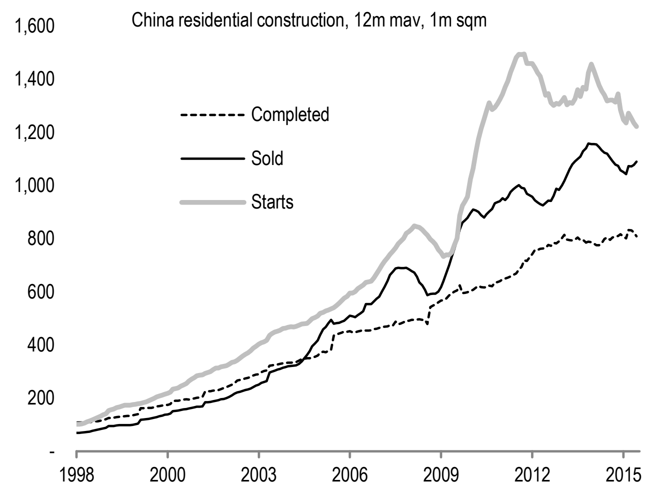
- **The size of real estate as a share of GDP:** This is now triple that of the US at its peak and similar to peak levels in Spain and Ireland (Moody's claim that real estate is around 23% of GDP, directly and indirectly);
- **Overbuild:** Housing starts are 12% above housing sales, and vacancy rates, according to the SHFO are 15% to 23%. Inventories in third and fourth-tier cities are now equivalent to 5 years' worth of demand, and 18% of completed homes have become vacant.

Figure 13: **Real estate investment as % of GDP is very similar to peaks seen in Spain and Ireland**

	Investment, % GDP	
	Total real estate	Residential
Spain - peak	21.5%	12.1%
Ireland - peak	21.5%	14.1%
China - current	18.7%	9.1%

Source: Thomson Reuters, Credit Suisse research

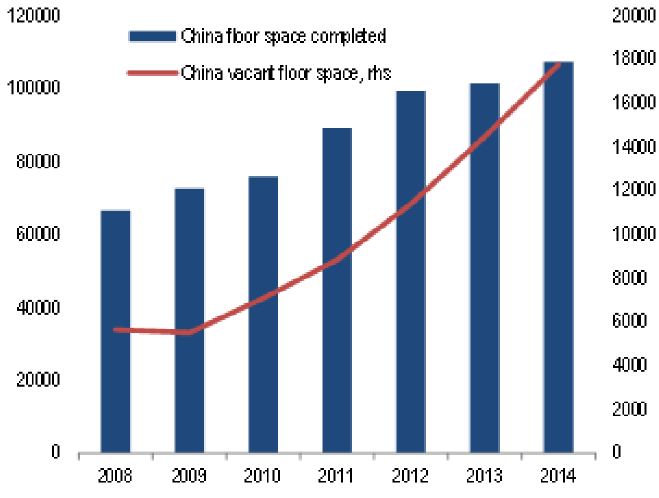
Figure 14: **Housing starts are 12% above housing demand**



Source: Thomson Reuters, Credit Suisse research

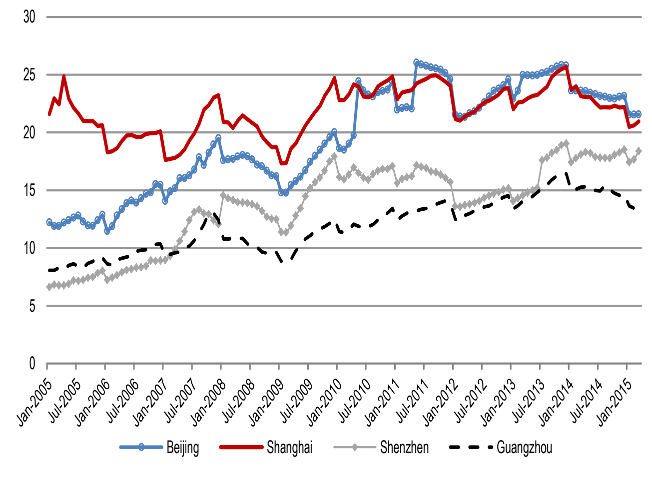
- **Overvaluation:** It is hard to get clear cut data, but house price to wage ratios appear excessive by any standard (even central London) and this is assuming three income earners per household. The rental yield is very low (officially it is 2.4% but in many instances it is a lot lower) compared to mortgage rates of 5.1% and the Yu'e Bao money market fund rate of 4.2% (with 14 day SHIBOR running at 3%).

Figure 15: **Vacant floor is 18% of floor space completed**



Source: Credit Suisse research

Figure 16: **Home price-to-income ratios have stabilised around 14-22x in key Chinese cities**



Source: Credit Suisse research

Of course, the debate is over the leverage in real estate, but in our opinion, if there has been a credit bubble at the same time as a housing bubble, then it is highly likely that leverage has found itself into housing. For example, housing developer Evergrande announced on April 16th it would allow buyers to get a full refund any time before the delivery of housing units (which is usually 6-12 months after pre-sales).

Our concern is that a triple bubble in housing, credit and investment comes with the significant risk of a hard landing. The question is when?

What might precipitate a hard landing in China?

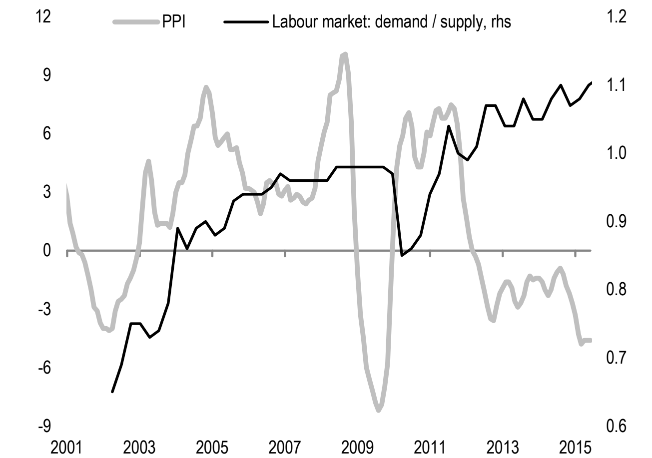
Many of the factors above are not new. We have long thought that the danger of a bubble ending in a hard landing is when the following occurs:

1) Overinvestment leading to deflation

Overinvestment has led to overcapacity which in turn appears to be leading to deflation.

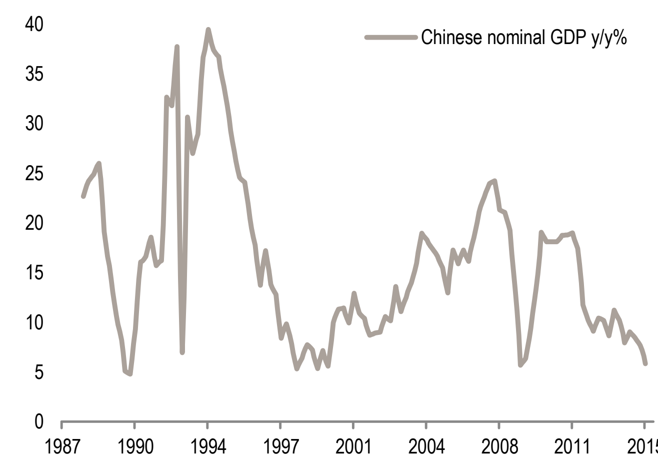
Deflation is apparent if we look at the PPI deflator, retail sales deflator or GDP deflator. Critically, this is causing nominal GDP growth to be a just a third of the level averaged over the past 30 years, at 5.8%.

Figure 17: **Producer price deflation continues to worsen**



Source: Thomson Reuters, Credit Suisse research

Figure 18: **Chinese nominal GDP is close to a 30-year low of just 6%**



Source: Thomson Reuters, Credit Suisse research

This deflation is resulting in a high real cost of funding (the real cost of funding is c7% using the GDP deflator).

2) Asset price deflation

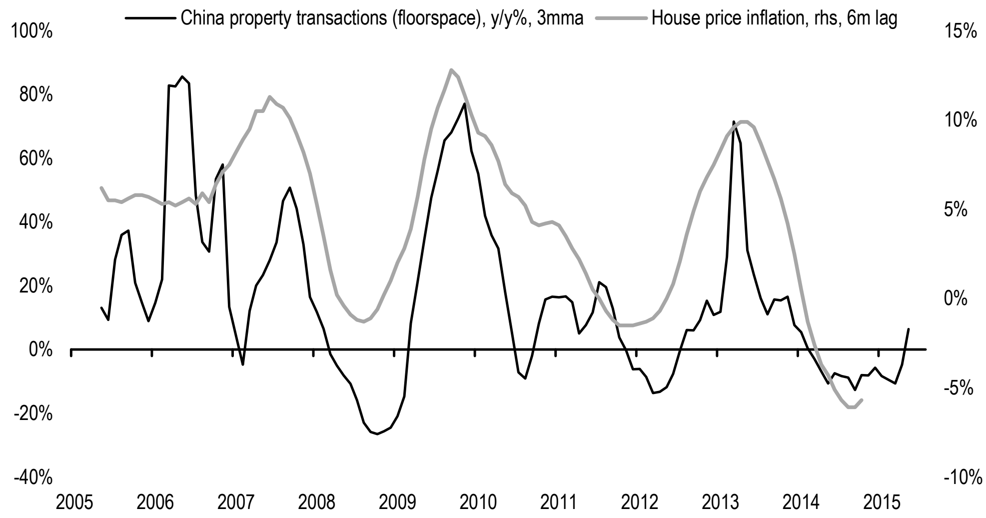
House prices are now falling at a record annual rate – the first time they have fallen without it being policy induced. With housing accounting for just over half of total household assets, the negative wealth impact could be significant. The moves in the housing market are much more important to us than the move in the equity market.

Ultimately, we think the impact of the sell-off in Chinese equities on the real economy will be relatively limited. This is because, as noted above, equities are only 10% of household wealth (at peak; just over 5% at the turn of the year). In addition, Chinese equities are back to levels reached as recently as March, which in our view means consumption patterns are unlikely to have shifted meaningfully. Finally, free float is only 40%, limiting the private sector and retail exposure to losses (in passing, even in the October 1987 crash in US equities, the household savings ratio did not rise).

Financial market linkages could be more dangerous, however. Our Chief China economist Dong Tao estimated in his piece *Is It Beijing's turn to say "whatever it takes"?,* 9 July 2015, that China has about RmB 3.7tn in margin financing through brokers' leverage, structured products and equity collateral financing. The possible ripple effects through other asset classes, including housing, are hard to predict given a lack of visibility.

The much bigger issue is the loss of confidence in the ability of macro policy to work and the clear reversal in de-regulation that the recent market support measures represent. Moreover, it is acceptable in our opinion to support an undervalued market (say Hang Seng in 1998), but far more problematic when parts of the equity market appear to be on bubble valuations.

Figure 19: **House prices are down 6% Y/Y, but housing transactions have stabilised**

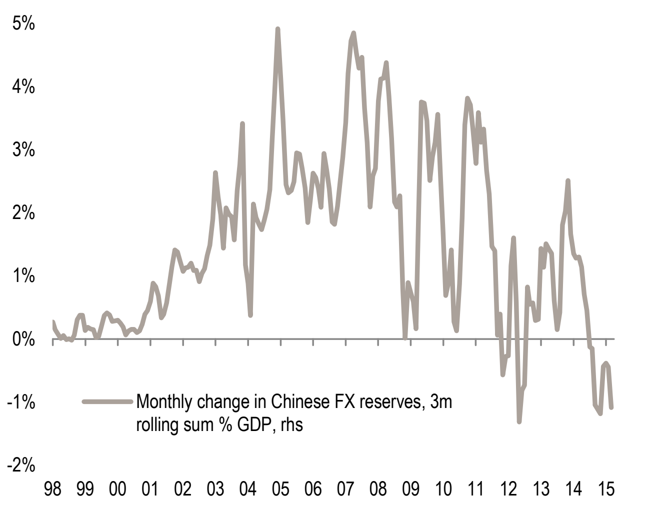


Source: Thomson Reuters, Credit Suisse research

3) Policy efforts to ease liquidity are not proving wholly effective

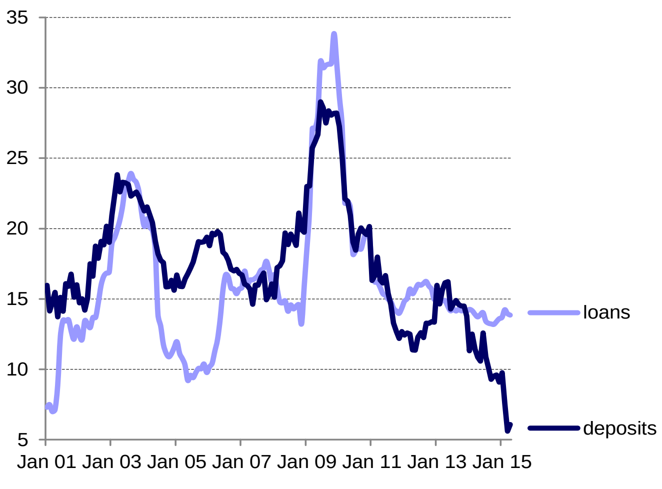
The main source of internal liquidity has been bank deposits, but deposit growth is now the lowest on record at just 6%. The main source of external liquidity has been FX flows, but outflows are now close to the worst on record.

Figure 20: **FX outflows are close to an all-time high**



Source: Thomson Reuters, Credit Suisse research

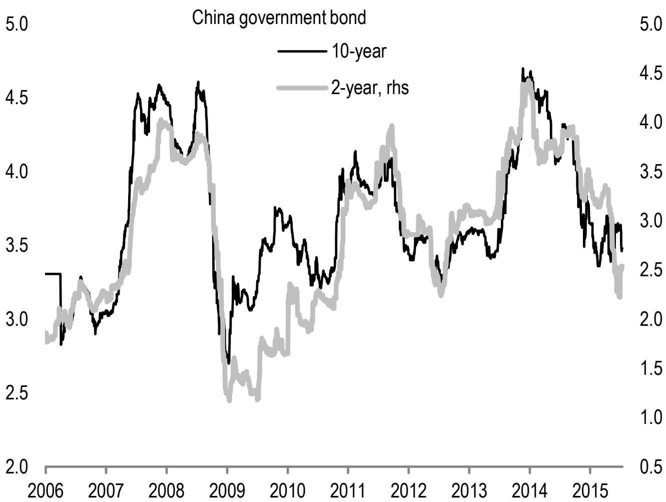
Figure 21: **Deposit growth for banks has slowed sharply**



Source: Credit Suisse research

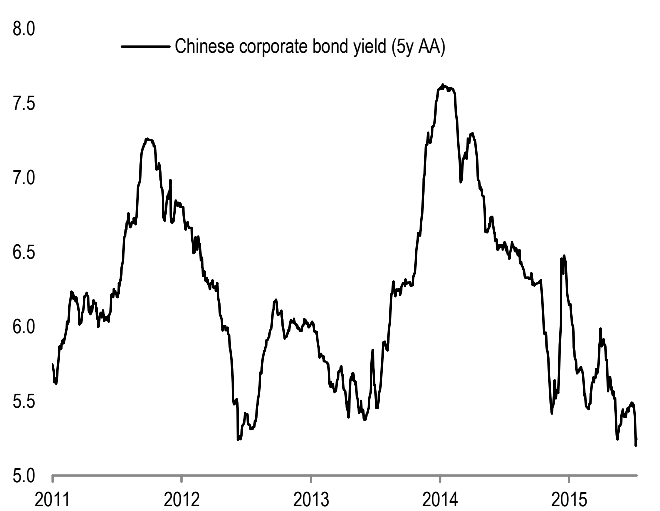
The net result is that, in spite of the sharp drop in the 2-year note yield, the 10-year bond yield and the corporate bond yield are not falling due to a loss of liquidity from the foreign exchange market (i.e. the PBOC buying RmB to support the currency and selling dollars, thereby reducing money supply).

Figure 22: The 2-year yield continues to fall, whereas the 10-year seems to have stabilised



Source: Thomson Reuters, Credit Suisse research

Figure 23: Corporate bond yields have not responded very much in the past 6 months to all the monetary easing



Source: Thomson Reuters, Credit Suisse research

Why is this happening? It might be because the Chinese government wants to support the RmB ahead of a potential SDR inclusion (though the recent stock market support measures, however, imply that the capital account will not be opened up as quickly as expected) but more realistically, it is likely to be a function of high short-term external debt (at 7% of GDP). Thus, we would wonder whether the PBOC do not want the RmB to weaken until the SOEs have unwound their dollar debt.

One of the most fundamental problems, as the World Bank highlights, is the repression of savings (via a regulated deposit rate) that in effect has been the key subsidy for both investment and real estate. This subsidy is now being removed as the capital account is being opened up.

The FT highlighted earlier this month research from the World Bank suggesting that the Chinese government retains effective control over 95% of banks' assets (compared to 74% in India and 40% in Russia and Brazil) and, in their view, this has the potential to affect the stability of the system.

4) When supply-side constraints are reached in the labour market

As illustrated in Figure 17 above, the job offer to applicants ratio is now at an all-time high, suggesting that there might be a shortage of unskilled workers. The CAI (the Institute of Population and Labour Economics at the China Academy of Social Affairs) shows that the proportion of the population in agriculture is now just 20% (with 278m workers already working outside their hometown).

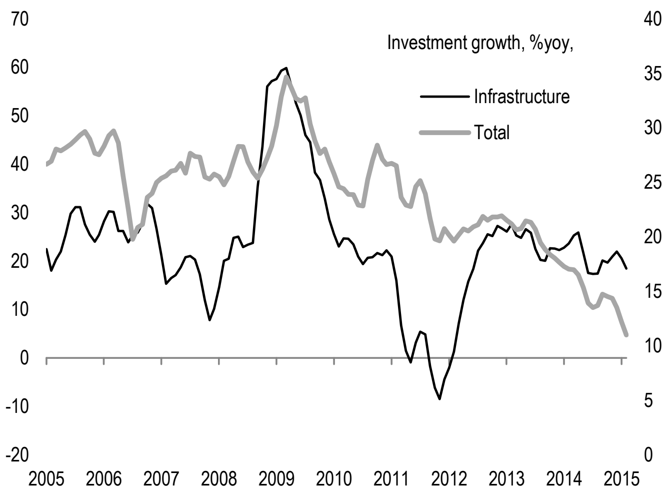
Clearly, a very high job offer to applications ratio combined with deflation is consistent with an ongoing margin squeeze.

5) Despite strong infrastructure investment, total investment growth is slowing

What has been slightly concerning is that there has been reasonable infrastructure investment this year (it has been up 22%), and yet total investment growth has slowed to 11% Y/Y.

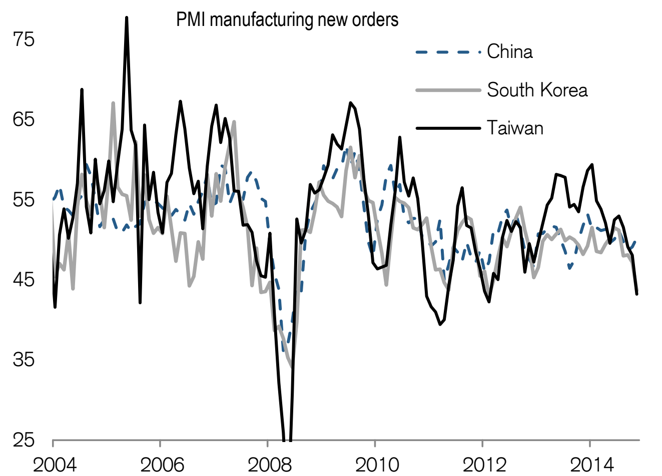
One other area of concern is the recent fall in PMIs in Korea and Taiwan. Although they usually tend to lag the Chinese growth indicators, and so the fall might just be a reaction to the weakness in Chinese GDP in Q1, they could be a sign of a more meaningful slowdown; hence we have to monitor these PMIs carefully.

Figure 24: **Infrastructure investment is growing by 22% y/y, but total investment growth has slowed to 11%y/y**



Source: Thomson Reuters, Credit Suisse research

Figure 25: **PMI new orders in Korea and Taiwan, which tend to correlate with those of China, have fallen sharply**



Source: Thomson Reuters, Credit Suisse research

What are the key catalysts for a hard landing?

If house prices fall by 15% or more, then we think that we are likely to get a hard landing and the authorities risk running out of fiscal firepower. We suspect that if house prices fell by that much, then the LTV threshold would be absorbed. Moreover, with housing contributing to a third of local government revenue, 56% of banks' collateral and around a fifth of GDP, the knock-on impacts could be immense.

Twice in the past, NPLs have risen above 20%. If this were to happen again, on the current credit-to-GDP ratio, the cost of recapitalising the banks could easily be 50% of GDP, not to mention the deterioration in the fiscal position on account of the loss of fiscal revenue. At that point, most of fiscal flexibility would be used up; however, the authorities would still have the ability to expand monetary policy, cut rates and RRR.

The second catalyst we see for a hard landing would be if deposit growth at banks stopped, as this would essentially limit the ability of banks to roll over loans to SOEs, in our opinion.

Some recent signs of improvement

The above provides a highly problematic strategic backdrop; **however, there are pieces of good news that, in our view, mean the hard landing is likely to be postponed:**

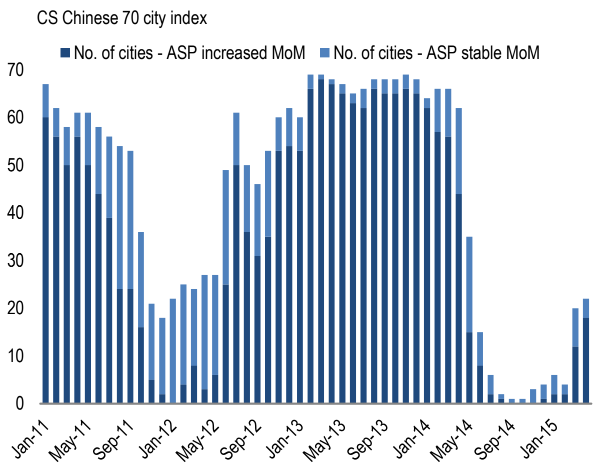
1. Some stabilisation in house prices

There have been signs since the start of the year that house prices in Tier 1 and Tier 2 cities have stabilised, and with it housing turnover has stabilised. This is critical, given that half of household wealth is accounted for by housing.

2. The current account remains in surplus

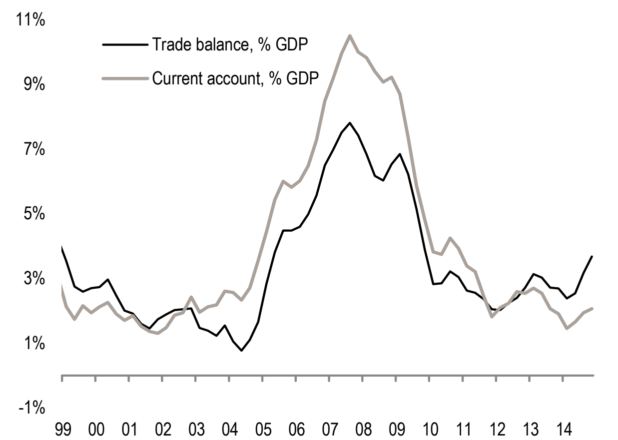
The trade surplus has risen to a 5-year high, supporting a current account surplus of 2% of GDP, and this helps to allow more monetary flexibility – without it, there would be an even greater outflow of FX reserves. Export growth returned back to positive levels for the first time in four months, while import growth continued to fall (albeit at a lower rate), which further supports the widening of the trade balance surplus.

Figure 26: House prices have started to rise in several Tier 1 and 2 cities month on month



Source: Credit Suisse research

Figure 27: The Chinese current account and trade surplus have risen in recent months



Source: Thomson Reuters, Credit Suisse research

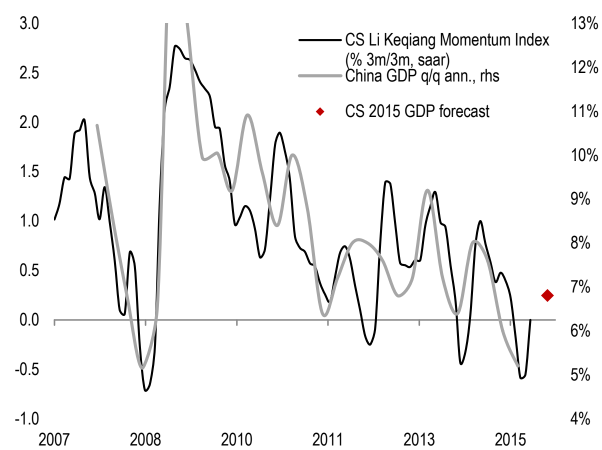
3. There is still policy flexibility

China has government debt to GDP of 56% of GDP officially, but our economists think it may be even higher. Lending rates are 6.9% and the loan to deposit ratio is 69% with a reserve requirement ratio of 18%. Recently, the ceiling on the LDR has been suspended (it has been approved by the State Council but not formally ratified by parliament). China has net foreign assets of 44% of GDP and thus it could print money, allowing the currency to weaken and boost net foreign assets.

4. There are some signs of a small improvement in macro lead indicators

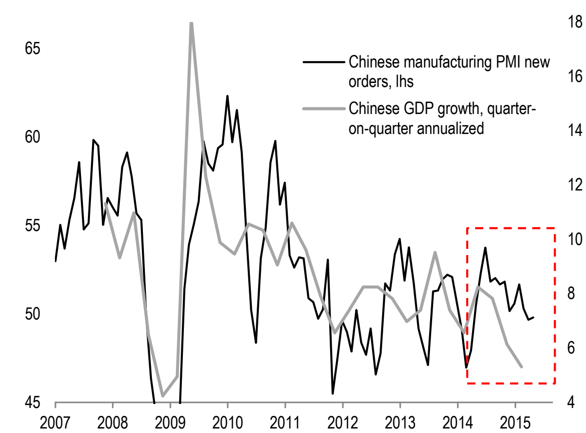
Credit Suisse's Li Keqiang index (a composite of real economy indicators including electricity consumption, railway cargo and bank lending) has turned up slightly, such that it is now consistent with GDP growth of 6.5% (admittedly below our economists' full-year 2015 growth forecast of 6.8%). Manufacturing PMI new orders have also stabilised.

Figure 28: The Premier Li indicator has just turned up, consistent with GDP growth of c6.5%



Source: Thomson Reuters, Credit Suisse estimates

Figure 29: Chinese manufacturing PMI new orders versus China GDP growth



Source: Thomson Reuters, Credit Suisse research

How much of a threat does a hard landing in China pose to the global economy?

On data from the IMF, China's economy has contributed more than a third of global growth over the past five years. Although China's GDP growth is now slower than a decade ago (at 6.8% from 12%), the economy is clearly substantially larger: in 2015 the IMF estimate that it will be three times the size it was in 2007 in dollar terms. China can slow therefore, while making the same contribution to global GDP growth as it has historically. (The Chinese economy on current exchange rates is $11.2trn but $19trn on a PPP basis which would make China 15% of global GDP on current exchange rates and 17% of GDP on official IMF PPP data).

Were China's real GDP growth to slow to 3% in 2015 (and assuming simplistically no spill-overs to global GDP), China's contribution to global GDP growth would slow by 0.5pp. That would imply that global growth in 2016 would be 2.7%, against an IMF forecast of 3.2%. This would keep global growth at the same levels as in 2014 and 2015, with an acceleration in the US, Europe and Japan counterbalancing the weakness in China to a large extent. If we were to assume a trade multiplier of two, then global GDP growth would slow to 2.2%. There are however three offsets:

- Although China is the world's second largest economy, it matters far more for output than it does for demand. Chinese imports accounted for 2.5% of global GDP in 2014, compared to 3% for the US and 3% for the Euro area, and this figure is likely to overstate the impact on the rest of the world, as this includes a large part of intermediate goods that are assembled in China before shipping abroad to meet demand elsewhere (think, for example, the iPhone). According to the OECD-WTO TiVA database, only 62% of imports in China in 2009 were to meet end-demand in China.

- The consumer share of GDP of 37% in China has to rise as the economy moves away from an investment-led growth model (and thus Chinese imports would have to rise). As a result, if the slowdown in China is accompanied by a fall in the current account surplus, implying that savings decline faster than investment, China in effect will be adding net demand to the world.

- On the OECD global model, the world economy accelerates as global commodity prices fall (largely because the commodity importing nations have a lower savings ratio than the commodity exporting nations). Thus, each 10% off the oil price adds 0.1-0.2% to global GDP.

Consequently, on net terms we think that if GDP were to slow to 3% in China, global GDP could still grow by 2.6% and that would still be above the Q1 growth rate of 1.6%.

Figure 30: China has contributed c40% to global GDP growth over the past five years

Source: Thomson Reuters, Credit Suisse estimates

Figure 31: A pick-up in growth in the US, Europe and Japan has the potential to counterbalance a significant slowdown in Chinese demand

Real GDP growth, y/y% (IMF estimates)	% World GDP	2014	2015	2016
US	24%	2.4	2.5	3.0
Euro area	16%	0.8	1.5	1.7
UK	4%	2.9	2.4	2.2
Japan	6%	-0.1	0.8	1.2
China	15%	7.4	6.8	6.3
India	3%	7.3	7.5	7.5
Brazil	3%	0.1	-1.5	0.7
Russia	2%	0.6	-3.4	0.2
World		2.7	2.6	3.2
World (if Chinese growth slows to 3% in 2016)		2.7	2.6	2.7

Source: Thomson Reuters, Credit Suisse research

European mining: upgrading to benchmark

What are the positives?

We would highlight the following main supports for the European mining sector:

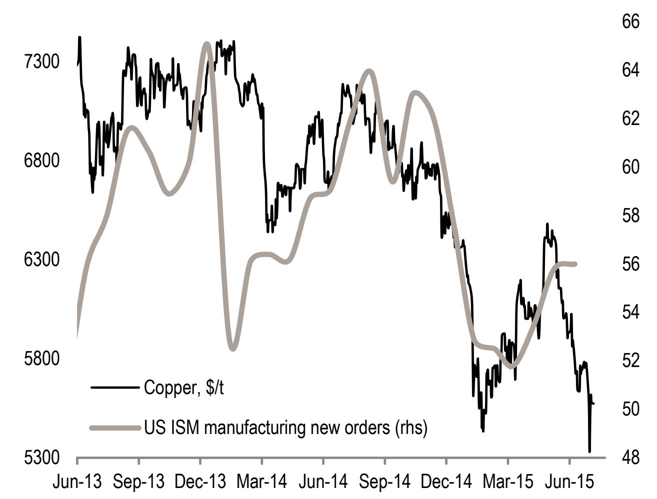
1. **Metals have significantly underperformed the cycle, and iron ore is approaching 100-year lows in real terms**

- Metals have been underperforming the cycle

From a cyclical perspective, a notable disconnect between metals prices and economic lead indicators has now opened up. This is most apparent when we compare copper with ISM manufacturing new orders in the US, an index our economists cite as the best gauge of the global cycle.

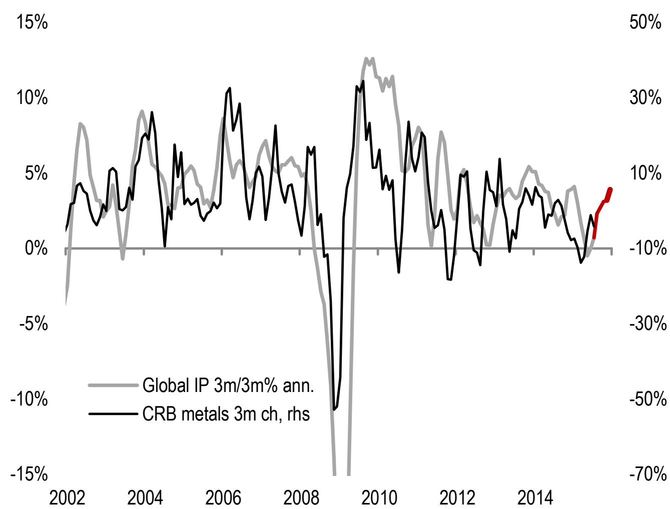
Metals prices have tended to track global IP momentum, as illustrated below. Our economists believe that global IP momentum has troughed and is beginning to accelerate (their forecast is highlighted in red in the chart; see their piece *Global Cycle Notes*, 8 July 2015), which should be a cyclical positive for metals prices.

Figure 32: **Copper is significantly underperforming the cycle**



Source: Thomson Reuters, Credit Suisse research

Figure 33: **Historically, metals prices have tracked IP momentum, which our economists believe will continue to accelerate**

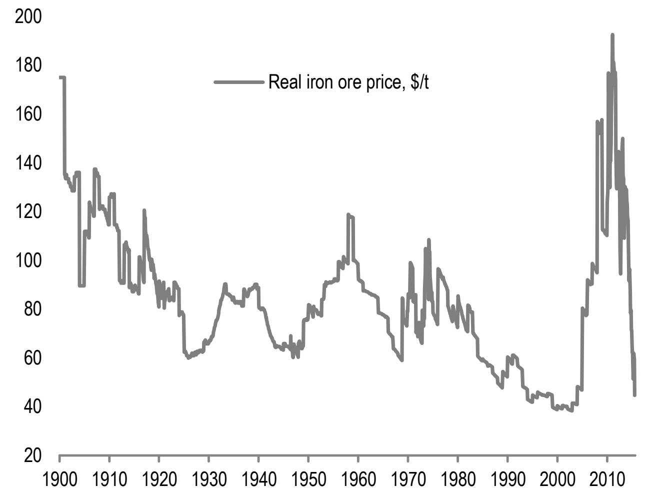


Source: Thomson Reuters, Credit Suisse research

- Some metals prices are close to all-time lows in real terms

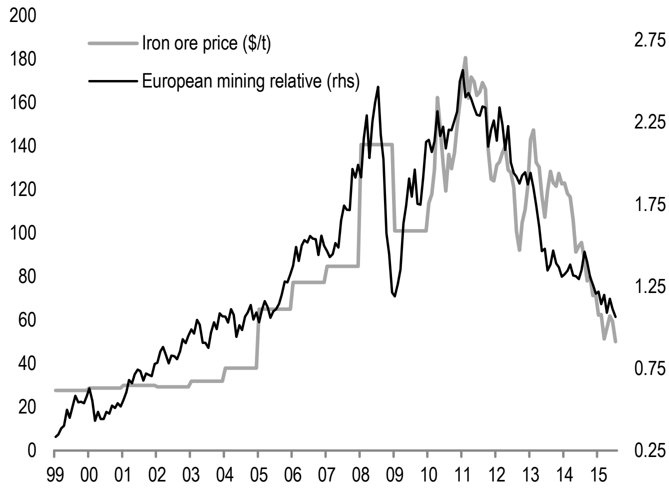
Taking a longer-term perspective, the iron ore price is now down 77% from its peak and in real terms is now just 14% above its 115-year low of $39, suggesting downside risk from here is limited. We would also note that the European mining sector has arguably already priced in much of the weakness in iron ore we have experienced.

Figure 34: The real iron ore price is back close to an all-time low



Source: Credit Suisse European mining team, Thomson Reuters, Credit Suisse research

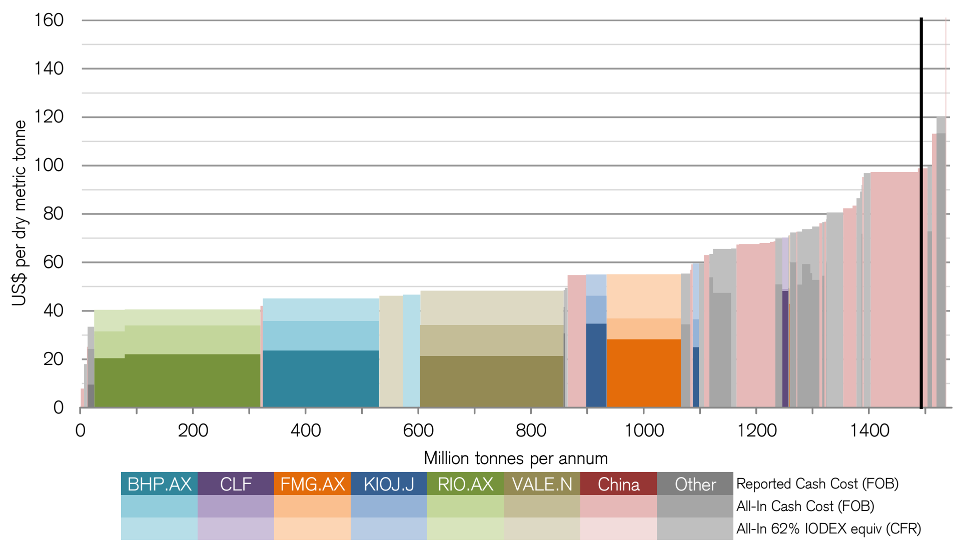
Figure 35: The European mining sector appears to have priced in much of the weakness in iron ore



Source: Thomson Reuters, Credit Suisse research

We have consistently believed that into a bear market, around a third of production needs to fall below the cash cost (and cash cost curves tend to be more flexible than investors realise). If a third of copper and iron ore falls below the cash costs, then the cost curves would imply a price of $40/t for iron ore and $1.60-1.70/lb for copper. We are now not far from those levels in the case of iron ore, but remain some distance above them in the case of copper (which is currently $2.52/lb).

Figure 36: At around $50/t for iron ore, a significant proportion of production falls below cash cost



Source: Credit Suisse European Mining Team

While the consensus is still a little too optimistic (Bloomberg consensus still anticipates commodity prices rising, with copper forecast to be $6431/t at the end of the year and iron ore at $56), it has come down notably in recent weeks.

2. A more supportive macro environment in the near-term

We would highlight the following near-term macro supports for the sector:

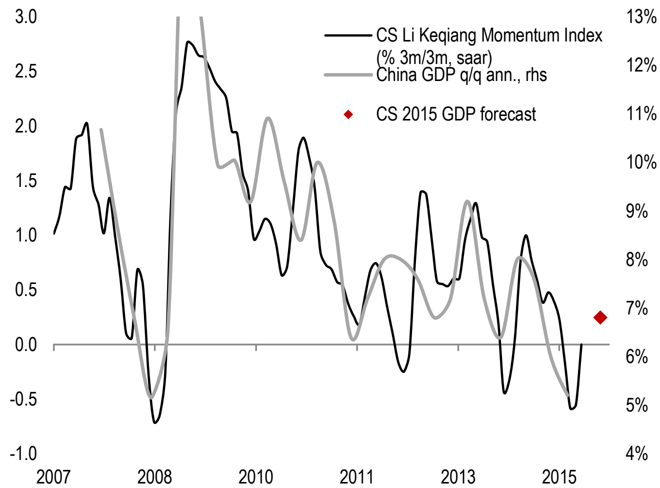
- Some signs of temporary stability in the Chinese economy

Most importantly, as highlighted in the overview section, there are signs of recovery in China's housing market with house prices up by 0.2% month-on-month in May. We think it will be short-lived, but this to us is one of the most critical variables.

Our economists' Li Keqiang index has turned higher, and is now consistent with Chinese GDP growth of c.6.5% (admittedly this remains below CS' full year forecast of 6.8% growth). In addition, in recent days both lending and export growth data have surprised positively.

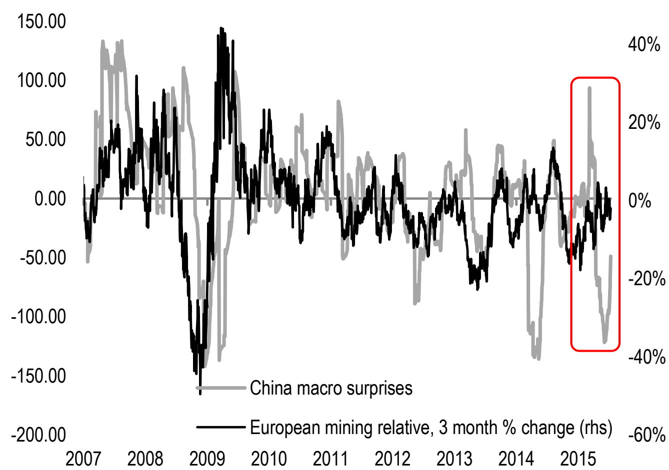
Chinese macro surprises, which have tended to correlate with the relative performance of mining, are moving higher. Our economists remain of the view that Chinese policy makers will pursue further policy easing.

Figure 37: **The Li Keqiang index has picked up, and is now consistent with growth of 6.5%**



Source: Thomson Reuters, Credit Suisse estimates

Figure 38: **Chinese macro surprises have also picked up from low levels, and that used to be good guide for the relative performance of mining**



Source: Thomson Reuters, Credit Suisse research

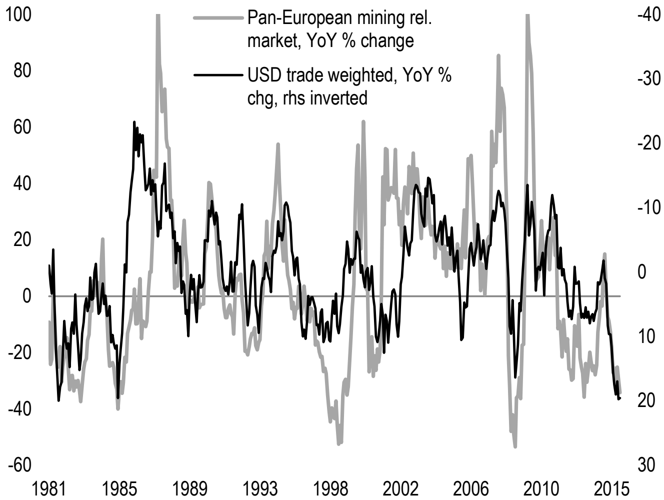
- We believe the dollar has performed most of its upward move

The mining sector tends to underperform through periods of dollar strength. As we have discussed elsewhere, while we are not bearish on the dollar, we would note that historically the first Fed rate rise has historically represented a local peak in the trade weighted. Following the last four major rate rises, the dollar has fallen in value.

- We believe bond yields will continue to rise

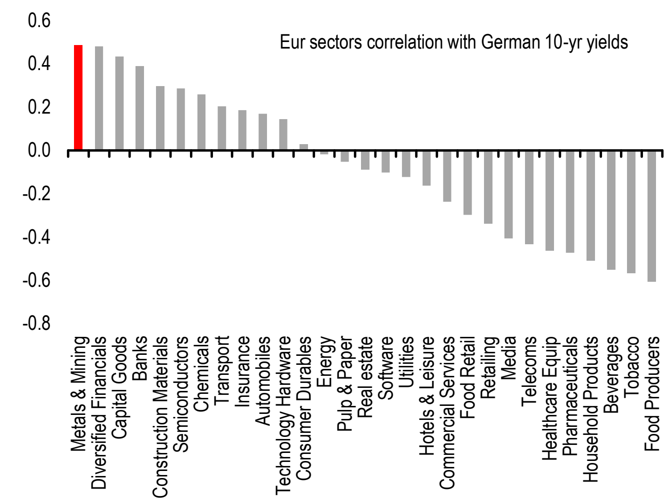
Our fixed income team forecast that the 10-year US Treasury yield will end 2015 at 2.65% and the 10-year Bund yield will rise to 1.0%. The mining sector has historically had the greatest positive correlation with the Bund yield of any European sector.

Figure 39: European mining's relative performance closely tracks the trade weighted dollar



Source: Thomson Reuters, Credit Suisse research

Figure 40: Mining has the strongest correlation of all European sectors with the Bund yield



Source: Thomson Reuters, Credit Suisse research

- The first Fed rate rise, historically, has been positive for the sector

Our economists recently reduced their expectations for monetary tightening, and now expect one 25bps rate hike in September, and four hikes in 2016 (see their piece: *Fed Outlook: Reduced Urgency, Increased Risks*, 8 July 2015). While rate rises may not be as rapid as we expected earlier this year, we still believe the resilience of the US economy will ultimately drive the Fed to tighten policy. And following major tightening turning points in US monetary policy, Basic Resources has been one of the strongest performing sectors.

Figure 41: Post major turning points in US monetary policy, Basic Resources has been among the strongest performing sectors

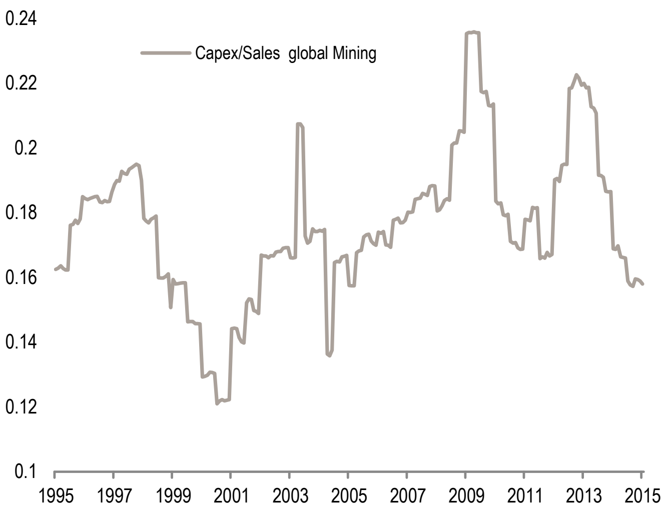
Average, European sectors	Average sector relative performance post rate rises				
	+1 month	+3 months	+6 months	+12 months	+18 months
Basic Resources	4%	8%	8%	-1%	7%
Chemicals	2%	3%	4%	0%	8%
Oil & Gas	3%	3%	-1%	4%	6%
Construction	3%	2%	-2%	-4%	-4%
Industrial Goods	1%	2%	2%	2%	3%
Autos	0%	1%	-3%	-11%	-13%
Real Estate	3%	0%	-6%	-7%	-9%
Technology	-2%	0%	22%	30%	26%
Insurance	-3%	0%	-2%	-1%	8%
Telecoms	-1%	-1%	11%	3%	-13%
Utilities	-1%	-2%	-7%	-5%	-4%
Retail	0%	-2%	-5%	-13%	-13%
Financial Services	0%	-2%	-5%	-5%	-3%
Banks	-2%	-2%	-4%	-6%	-1%
Healthcare	0%	-2%	-9%	-3%	2%
Travel & Leisure	3%	-3%	-5%	-7%	-11%
Personal H/H Goods	-1%	-3%	-6%	-5%	-2%
Media	0%	-3%	7%	10%	2%
Food & Bev	0%	-5%	-12%	-8%	-4%

Source: Thomson Reuters, Credit Suisse research

3. Are we beginning to see the first signs capex discipline?

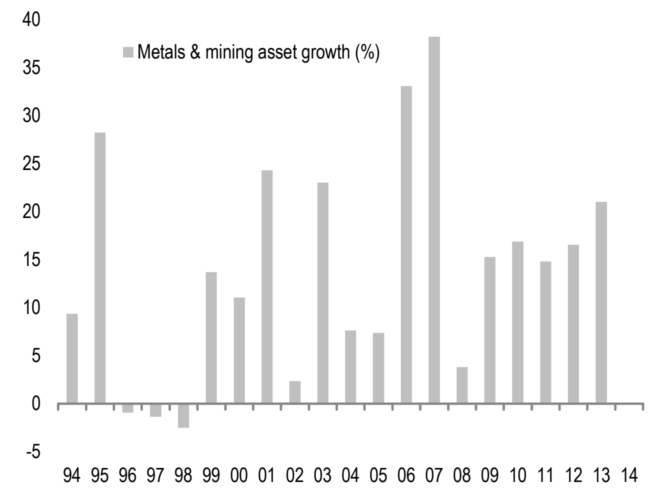
Capex to sales is now at its lowest since 2004 and there may even be hints of capital spending falling even further: Vale, for example, said it would 'manage' more standard grade iron ore (and subsequently announced a cut in iron ore production of 25m tonnes of higher-cost supply on July 14th), and BHP said it would delay a planned expansion in capex in 2017. On HOLT, asset growth (the change in invested capital) for the UK mining sector fell to zero in 2014.

Figure 42: **Global mining capex to sales has adjusted, but is still well above troughs seen in recent decades**



Source: Thomson Reuters, Credit Suisse research

Figure 43: **Asset growth on HOLT for the UK mining sector fell to zero in 2014**



Source: Credit Suisse HOLT

4. Elements of valuation are attractive

On the most basic measures of value, P/B and dividend yield, relative valuations offer a degree of support, with both now significantly more than one standard deviation cheap relative to their long-run averages.

Figure 44: **The price to book relative of the sector is more than one standard deviation depressed**

Source: Thomson Reuters, Credit Suisse research

Figure 45: **While the sector's dividend yield is almost 2 standard deviations above average**

Source: Thomson Reuters, Credit Suisse research

For most of the major miners, even at current depressed commodity prices, 2016 FCF yields are forecast to be reasonable, especially when compared to the IOCs.

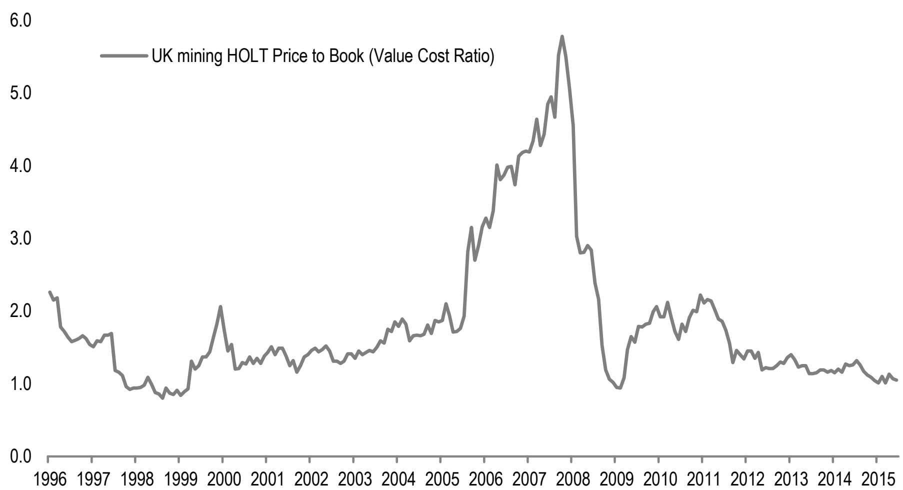
Figure 46: **Major miners' 2016 forecast FCF yields**

	Free cash flow yield 2016			
	RIO	BHP	AAL	GLEN
CS Base case (2016: Iron ore $45, copper $2.65)	2.40%	4.30%	6.70%	11.00%
Spot (Iron ore $50, copper $2.53)	2.60%	2.80%	4.80%	4.90%

Source: Credit Suisse European Mining Team

We would also note from a valuation perspective that the mining sector is looking cheap relative to replacement value. We can proxy this by looking at the value to cost ratio on Credit Suisse HOLT®, which has just dipped below 1 (i.e. it is cheaper to buy than build). HOLT's fair value methodology also implies 58% upside potential for the UK diversified mining sector.

Figure 47: **The value to cost ratio of the mining sector has just dipped below 1**



Source: Credit Suisse HOLT

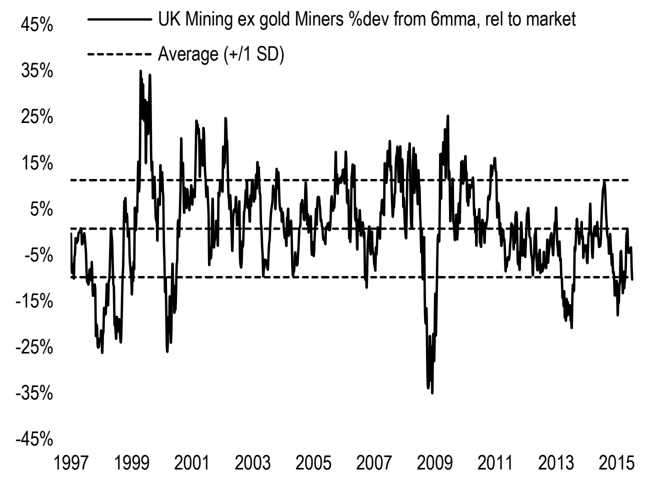
5. The sector is approaching oversold territory

Following recent underperformance, the mining sector is now around 1 standard deviation oversold.

6. Australian dollar weakness partially offsets commodity price weakness

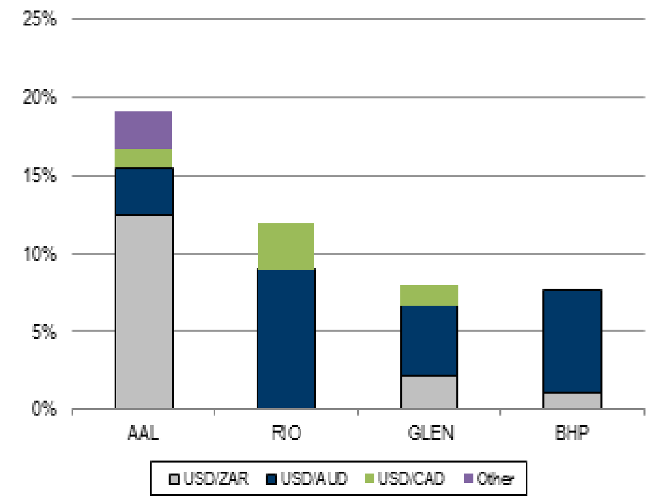
The Australian dollar has fallen by around 23% since its recent peak in October 2013, and for Rio Tinto, a 10% fall in the AUD adds around 8% to EPS. In that regard, currencies offer something of a buffer against falling commodity prices. However, we do admit that in the longer term, lower commodity currencies also serve to lower the industry cost structure, slowing any supply response on the part of the producers, offsetting the positives in the longer term.

Figure 48: **The sector is approaching 1 standard deviation oversold**



Source: Thomson Reuters, Credit Suisse research

Figure 49: **Impact of a 10% move in FX on EPS of the major miners**



Source: Credit Suisse European Mining Team

7. **Miners, in contrast to IOCs, tend to be the lowest cost producers and far more concentrated**

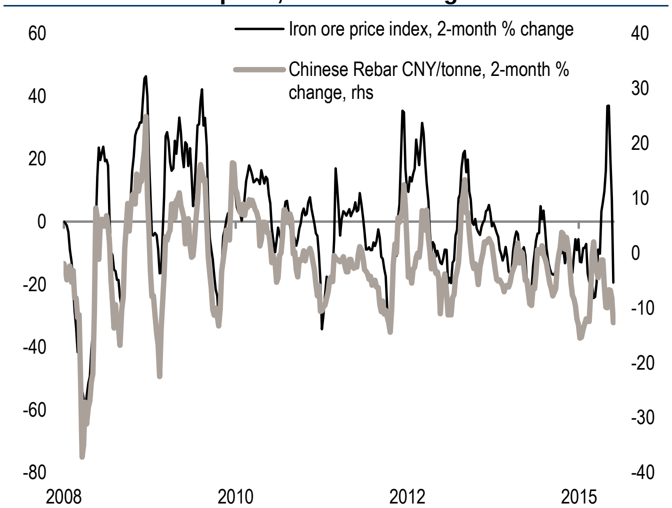
In some instances, the quoted players are the lowest cost producers, and thus in a bear market are much better off than oil producers. Moreover, the quoted sector has far fewer players for certain commodities.

What are the negatives?

However, we can't bring ourselves to be any more optimistic as:

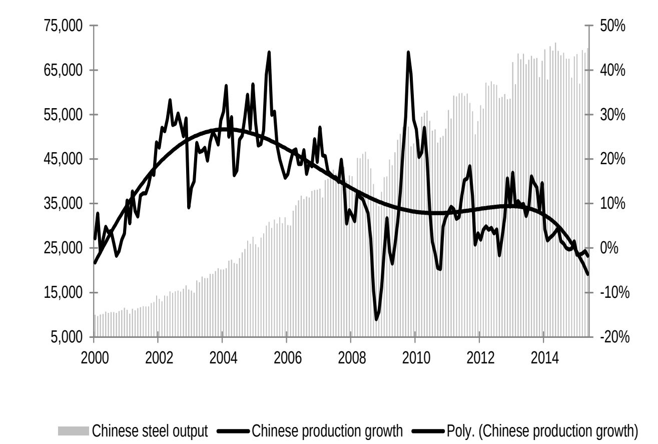
1. **In recent months, there has been a significant disconnect between the Rebar rate and iron ore.** This gap has closed as the iron ore price has fallen, but the Rebar price continues to point to further downside.

Figure 50: **In recent days the iron ore price has caught down to the Rebar price, the two having disconnected**



Source: Thomson Reuters, Credit Suisse research

Figure 51: **Chinese steel production is still trending downward**



Source: Thomson Reuters, Credit Suisse research

In the past decade, the mining sector has only been able to decouple from iron ore prices for a period of 24 days.

Figure 52: Periods of mining sector outperformance in an environment of falling iron ore prices tend to be both brief and rare

Period start	Period end	Length (days)	% Change in UK mining rel to Global	% Change in Iron Ore Price
23/10/2008	04/11/2008	12	22.2%	-22.0%
12/08/2009	04/09/2009	23	2.8%	-26.9%
04/10/2011	27/10/2011	23	9.2%	-27.4%
09/01/2014	14/02/2014	36	13.5%	-7.1%
Average		24	12.0%	-20.8%

Source: Thomson Reuters, Credit Suisse research

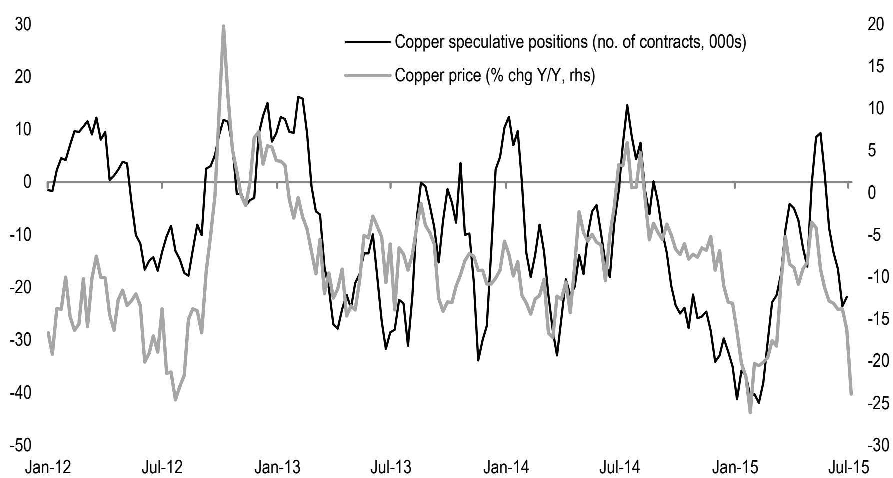
In our view, the trough of the iron ore cycle will be when marginal producers are forced to scale back their production. The good news is that net debt to EBITDA on 2016 CS estimates is 4.0x for Fortescue. The bad news is that their cash cost of production could be as low as $39/tonne (and that is for 62.5% grade iron).

2. Any weakness in the RmB is likely to bring with it weakness in commodity prices

This is because of the unwinding of financing positions. Peking University Business School estimates that 70% of refined copper imports were used for financing purposes (with the SHFE accounting for 38% of copper inventories from just 4% in 2009). Thus, as the RmB weakens or rates falls, the financing unwinds.

Net speculative positions in copper have fallen back but remain off the lows seen at the start of this year. Ordinarily, however, the copper price tracks speculative positions down with a lag, but on this occasion it appears to have fallen first.

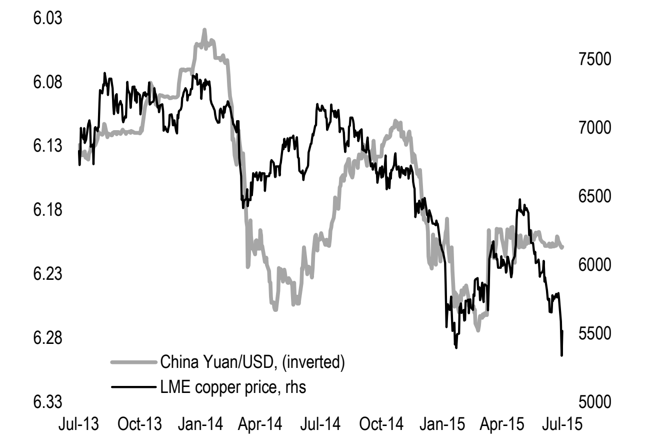
Figure 53: Net speculative positions in copper remain off the lows seen in the early part of this year



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

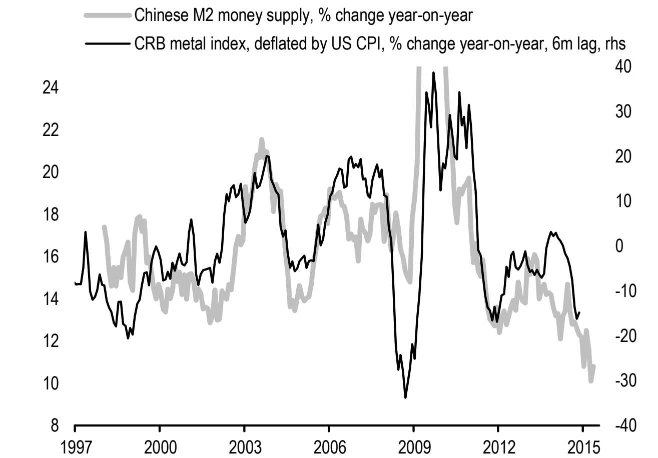
3. Chinese M2 growth is consistent with a 20% fall in industrial commodity prices from current levels.

Figure 54: A weakening of the RmB is problematic for the copper price (because copper is used for financing)



Source: Thomson Reuters, Credit Suisse research

Figure 55: Chinese money supply growth, which has broadly tracked metals prices, is consistent with a 20% fall in real commodity prices from current levels



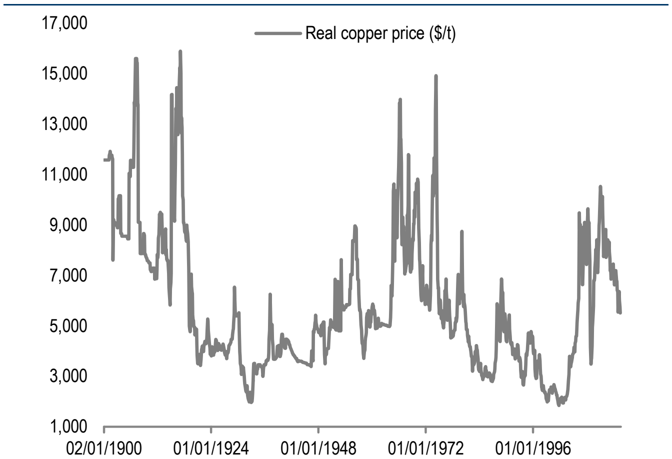
Source: Thomson Reuters, Credit Suisse research

4. A renewed bull market in commodities requires real commodities prices to be clearly cheap, which is not the case as yet in aggregate.

The real copper price is around 160% above its 100-year low, and has fallen by around 55% from its local peak (in contrast to a near 80% decline in the iron ore price). As highlighted already, when a commodity is in excess supply, we believe that up to a third of production has to fall below the cash cost, and that is nearly 30% lower for the copper price. Meanwhile, as noted above, Chinese money supply growth is consistent with a further 20% fall in real commodity prices.

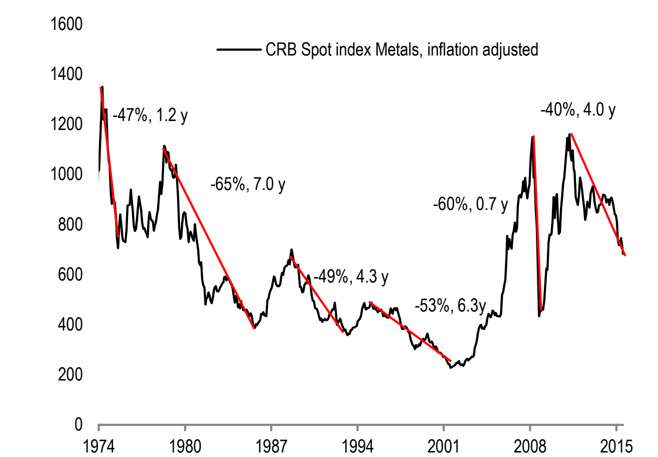
Looking at a broader index, real metals prices are down 40% from their 2011 peak. Bear markets in metals over the last 40 years have tended to see peak to trough losses of between 50% and 65%, again pointing to further downside for prices from here.

Figure 56: The real copper price isn't especially low relative to its long-run history



Source: Thomson Reuters, Credit Suisse research

Figure 57: Real commodity prices have fallen 40% from their 2011 peak, but historically, bear markets have seen corrections of 40-65%



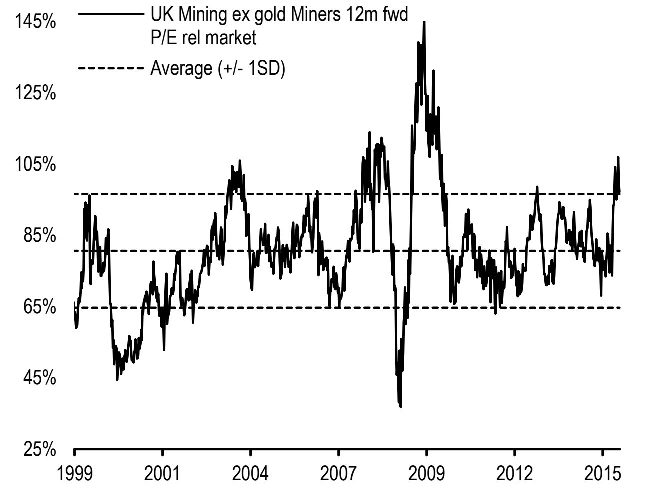
Source: Thomson Reuters, Credit Suisse research

5. PE multiples are not attractive given downgrades

While P/B and DY relatives make the sector optically very attractive from a valuation perspective, the sector's extremely weak earnings momentum has driven a significant re-rating. On a forward PE basis, the UK mining sector is at a one standard deviation forward premium relative to the market. (Though admittedly in cyclical sectors, this is ordinarily the case at the trough of the cycle).

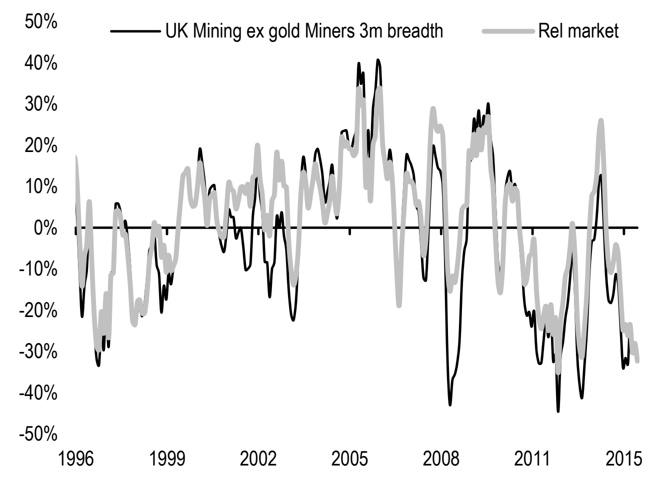
6. Earnings revisions are extremely weak, but approaching levels from which historically they have bounced

Figure 58: **The UK mining sector is at a 1 standard deviation PE premium to the market**



Source: Thomson Reuters, Credit Suisse research

Figure 59: **Earnings momentum is extremely weak, though historically it has bounced from these levels**



Source: Thomson Reuters, Credit Suisse research

As we have seen in the case of oil or GSK, the market does not tend to reward dividends being paid out of debt or disposals. This is, in our view, why GSK, which has adopted such a strategy, is on a 2015E dividend yield of 7.3%.

We prefer mining to oil

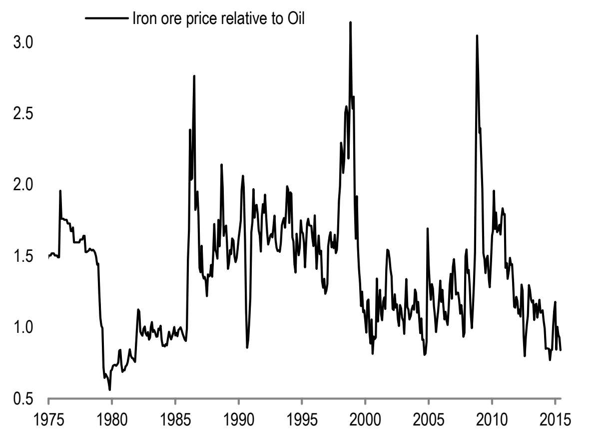
We continue to prefer mining to oil for reasons highlighted in our piece, *Upgrade capital goods, go underweight IOCs, add to mining* in March:

- The mining sector has better dividend cover and FCF than oil. In addition, the dividends are not nearly as scrip heavy;
- As lower-cost producers, miners (such as Rio or BHP for iron ore) are better placed to weather the commodity price slump;
- The ratio of the iron ore price relative to oil is at the bottom end of its historic range;
- Iron ore has a longer proven and probable reserve life;
- The mining sector has a more cartelised market structure – the top 4 producers account for 70% of seaborne iron ore;
- Less political or taxation risk compared to oil.

If there are areas we like, it would be commodity trading (now that most of the investment banks have exited this area) – this clearly favours Glencore.

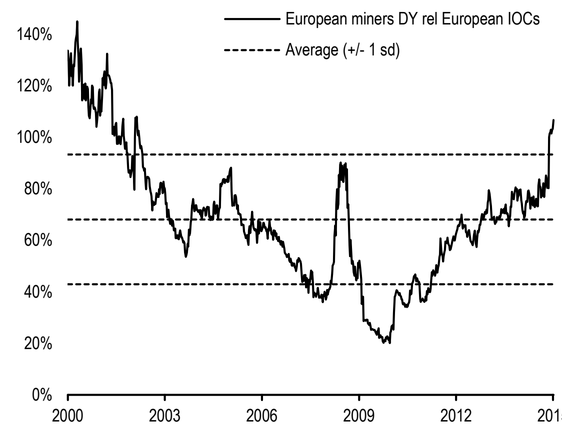
While many of the fundamentals in copper look good (high depletion rates, a market potentially entering deficit within two years, four times more copper is used in electric cars than normal cars and typically more copper is used as grid and telecom networks are extended). The dominant issue remains that 43% of end demand is China and as already mentioned when there is excess supply, prices need to fall below the cash cost of production. If copper price were to fall to the same point on the cost curve as occurred in the case of thermal coal or iron ore, then the copper price would fall by c20% from current levels. The more tactical concern is that financing issues as highlighted above.

Figure 60: The ratio of iron ore to oil is at the lower end of its historic range



Source: Thomson Reuters, Credit Suisse research

Figure 61: While the dividend yield of the miners is high relative to the IOCs, and mining dividends are better covered by FCF



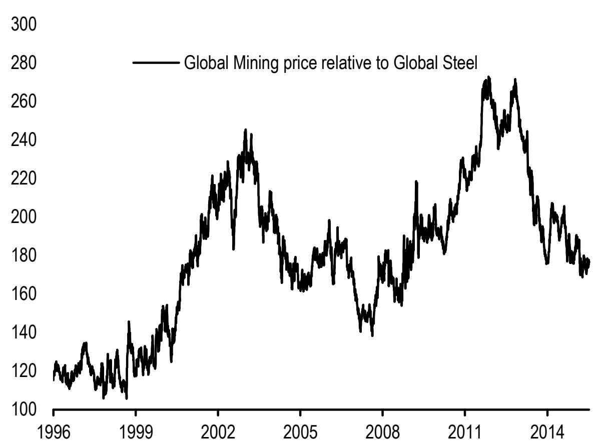
Source: Thomson Reuters, Credit Suisse research

…and we prefer mining to steel

There has been a bounce in steel in Europe in recent months owing to the implementation of additional trade barriers earlier this year with the EU having imposed anti-dumping duties on certain types of electrical steel from China, Japan, Russia, South Korea and the US.

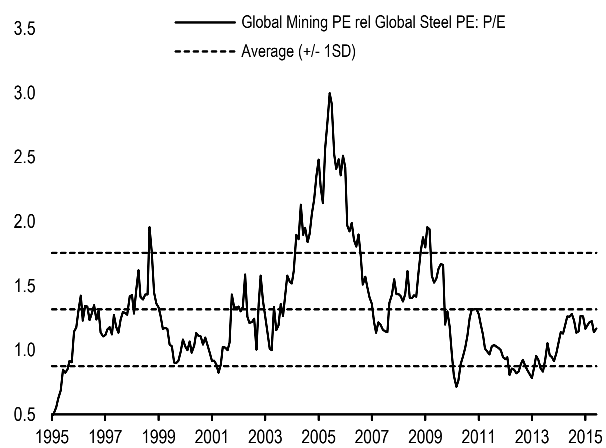
However, we continue to find the steel sector unattractively valued against mining (the PE of mining relative to steel remains below average) and believe that the industry structure of mining is more attractive as it does not compete as much against Chinese producers and has fewer players.

Figure 62: The price relative of mining to steel is close to its decadal low



Source: Thomson Reuters, Credit Suisse research

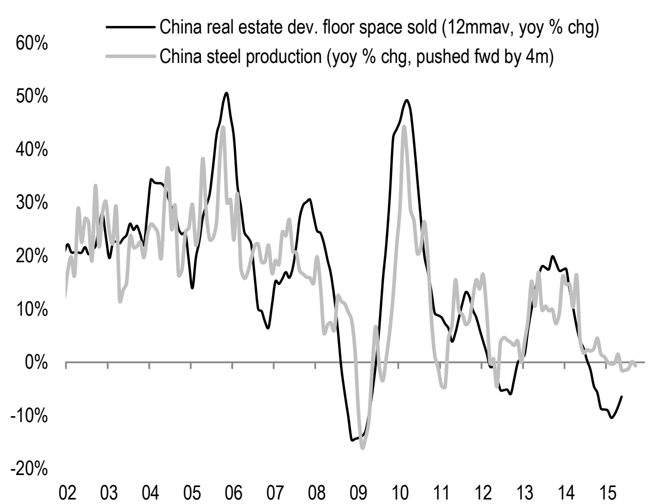
Figure 63: The PE of mining relative to steel is below average



Source: Thomson Reuters, Credit Suisse research

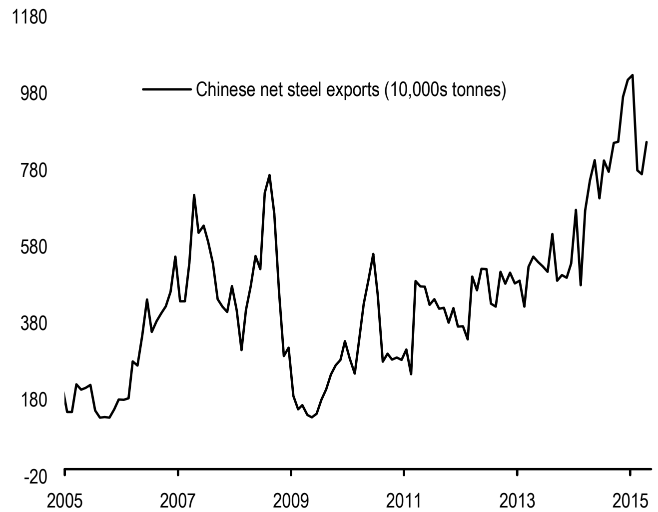
What is clear is that as Chinese domestic demand for steel (proxied below by floor space sold) has weakened, so China has turned to the export market to clear its stocks, with net steel exports strong.

Figure 64: **Steel production has not weakened by as much as one would have expected given the slowdown in real estate**



Source: Thomson Reuters, Credit Suisse research

Figure 65: **As a result, China appears to have turned to the export market, with steel export volumes strong**



Source: Thomson Reuters, Credit Suisse research

Outperform- and Neutral-rated European mining companies

Below we show a simple screen of Outperform- and Neutral-rated European mining companies.

Figure 66: **Outperform- and Neutral-rated European mining companies**

	-----P/E (12m fwd) ------			------ P/B -------		2015e, %		HOLT	2015e 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
Anglo American	11.2	79%	2%	0.7	-64%	6.7	6.3	85.8	-28.7	-7.4	3.1	Outperform
Antofagasta	18.6	132%	29%	1.6	-35%	5.5	2.1	56.1	-32.8	-10.4	3.0	Neutral
Bhp Billiton	18.1	129%	62%	1.5	-55%	7.0	6.6	83.0	-20.8	-14.9	2.7	Neutral
Boliden	9.6	68%	15%	1.8	4%	5.5	3.1	92.0	-3.7	1.2	2.5	Outperform
Glencore	12.5	89%	17%	1.0	-38%	10.3	4.7	43.4	-19.3	-3.7	2.5	Outperform
Rio Tinto	14.5	103%	18%	1.7	-50%	3.4	5.7	42.6	-32.3	-9.2	2.6	Neutral
Kaz Minerals	378.8	2690%	2697%	0.7	-72%	-92.6	0.0	-60.7	-166.0	0.5	2.7	Outperform
Vedanta Resources	-153.4	nm	na	1.2	-50%	-11.3	9.1	63.6	-2,272.1	-7.3	2.4	Neutral

Source: MSCI, IBES, Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

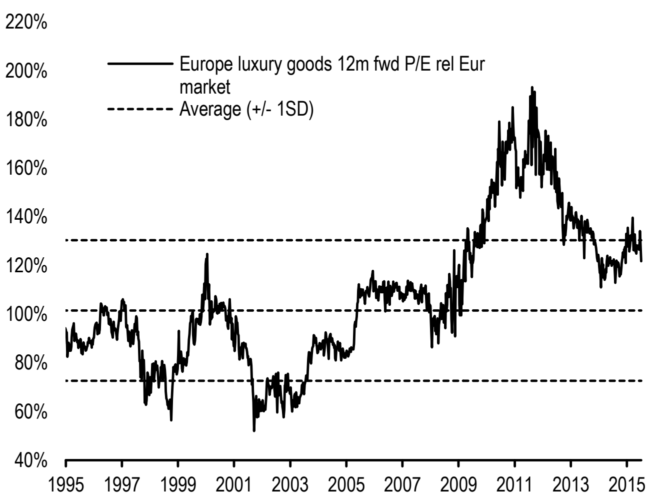
Luxury goods: remain underweight

We have the following concerns about the luxury goods sector:

1. Valuation is extended

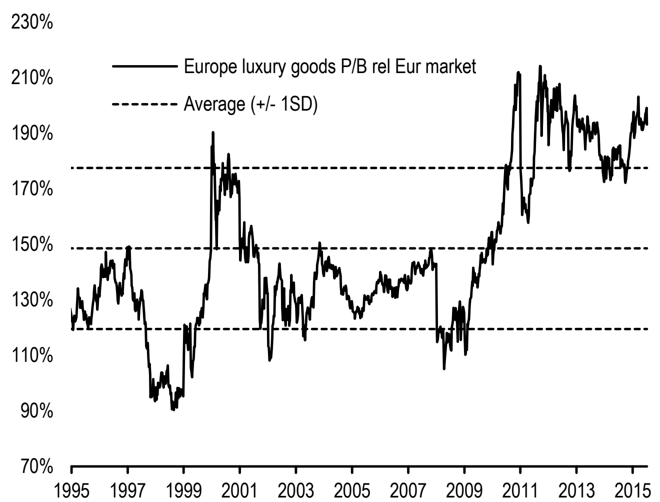
Despite their underperformance of 9% since mid-March, European luxury stocks are still trading significantly above their long-run average on 12m forward P/E and P/B relative to the wider market (we show valuations for global luxury goods in Appendix 1 which shows a similar picture).

Figure 67: **Europe luxury goods P/E relative to the market is 0.7 standard deviation above average**



Source: Thomson Reuters, Credit Suisse research

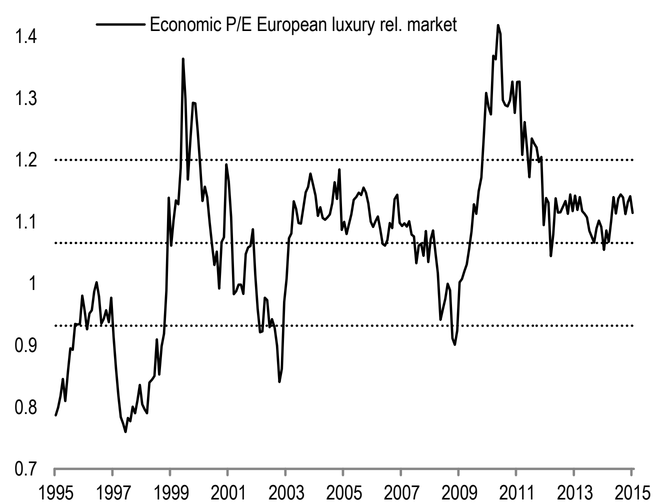
Figure 68: **Europe luxury goods P/B relative to the market is also 1.5 standard deviation above average**



Source: Thomson Reuters, Credit Suisse research

Furthermore, luxury is trading above its norm on HOLT's Economic P/E relative. These extended valuations are unsurprising given the extent to which luxury has outperformed over the last six years.

Figure 69: **European luxury is trading above its norm on HOLT's Economic P/E relative**



Source: CS HOLT, Credit Suisse estimates

Figure 70: **European luxury goods have substantially outperformed the broader market since 2009**

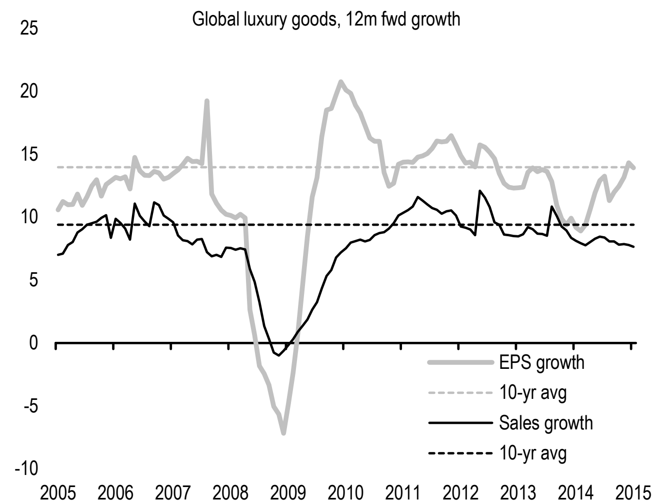
Source: Thomson Reuters, Credit Suisse research

2. Revenue estimates are still quite optimistic

The IBES consensus 12-month revenue estimate for the global luxury sector is c8%, only slightly below its 10-year average. Earnings estimates are close to their norm. In our view, these consensus revenue estimates appears overly optimistic, given that:

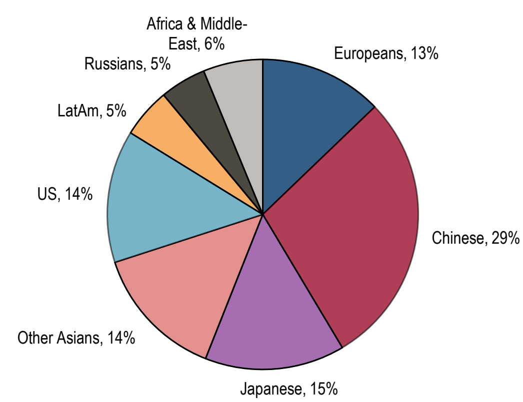
- Around 30% of the European luxury sector's revenues come from China, and Chinese luxury spend per unit of wealth is 14x higher than Europeans' and 3x higher than that of the Japanese, according to our analyst, Guillaume Gauville. We have little doubt that total wealth in China will keep growing, but we think the ratio of luxury consumption per unit of wealth is likely to decrease given the severity of the anti-corruption campaign. In addition, we wonder whether the record fall in house prices – with housing accounting for c.50% of household assets – may also negatively impact luxury spending.
- 11% of total spend comes from Russia and OPEC, and the fall in oil prices suggests that spending from these areas will remain depressed. We are more bearish than the consensus on oil (see *Oil: excess speculation*, 27 May).

Figure 71: **12-month forward sales growth expectations are close to their 10-year average**



Source: Thomson Reuters, Credit Suisse research

Figure 72: **Around a third of sales for European luxury goods companies are to Chinese consumers**



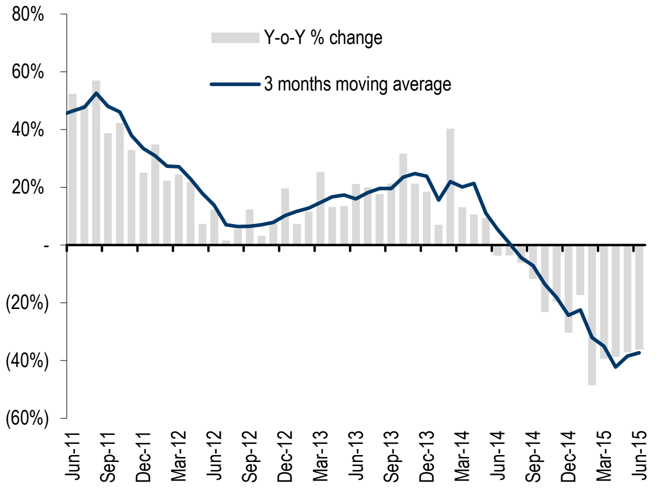
Source: Company data, Credit Suisse European Luxury goods team's estimates

Our analyst, Guillaume Gauville, highlights that given the cost of renewing leases (which are c20% To 25% of operating expenses), at least, 5% revenue growth is needed to maintain the current level of profits.

3. The proxies on Chinese luxury spending are all depressed

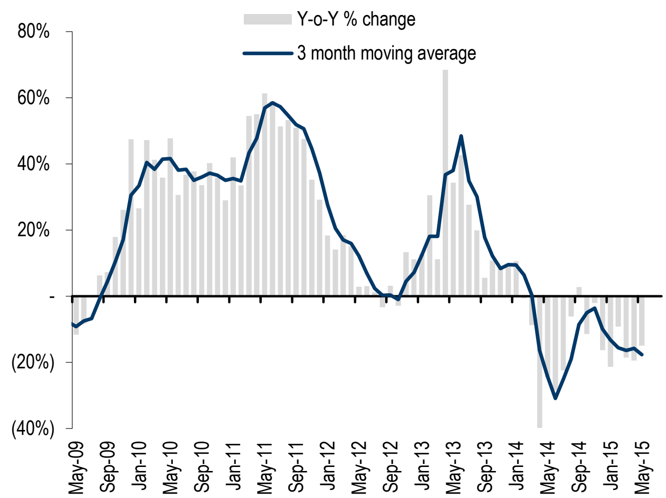
Proxies on luxury spending, including Macau casino revenues, HK watch and jewellery sales and Swiss watch exports, are all depressed.

Figure 73: Macau casino revenue growth – a proxy for Chinese high-end spending – has been falling sharply



Source: Macau Gaming Inspection and Coordination Bureau, Credit Suisse European Luxury goods team research

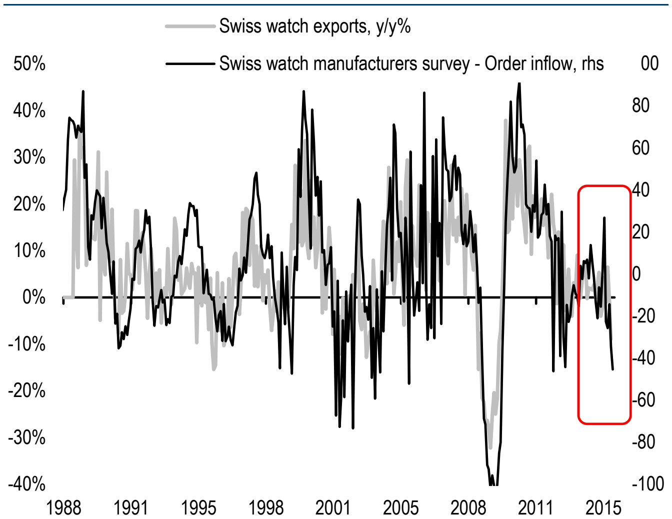
Figure 74: HK watch and jewellery volume growth has also been negative



Source: Hong Kong Census & Statistics department, Credit Suisse European Luxury goods team research

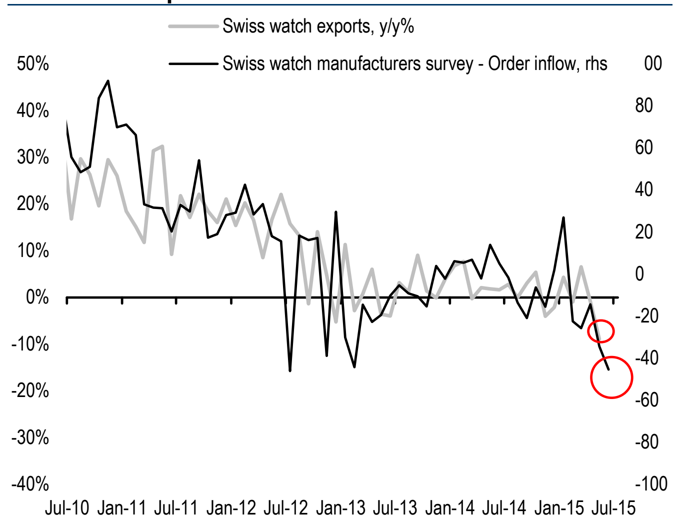
According to the Swiss KOF industry survey of watches, annual growth in order inflows has fallen sharply, and typically this leads to a decline in Swiss watch exports.

Figure 75: New watch Swiss exports typically follow Swiss new orders for watches…



Source: Thomson Reuters, Credit Suisse research

Figure 76: … but recently new orders have fallen more than watch exports



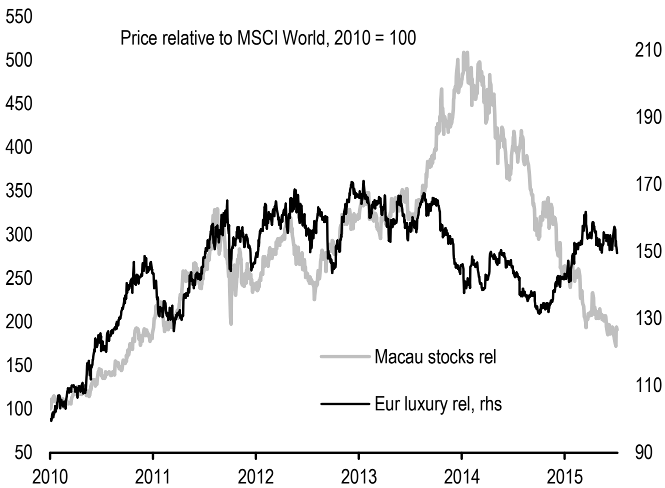
Source: Thomson Reuters, Credit Suisse research

4. Who leads the luxury goods sector: Chinese banks or Macau casino stocks?

We think Macau casino stocks are a more logical guide to overall demand for luxury. And, as our analyst Kenneth Fong points out, it is the Macau casino stocks that are the most depressed of the China-related plays currently.

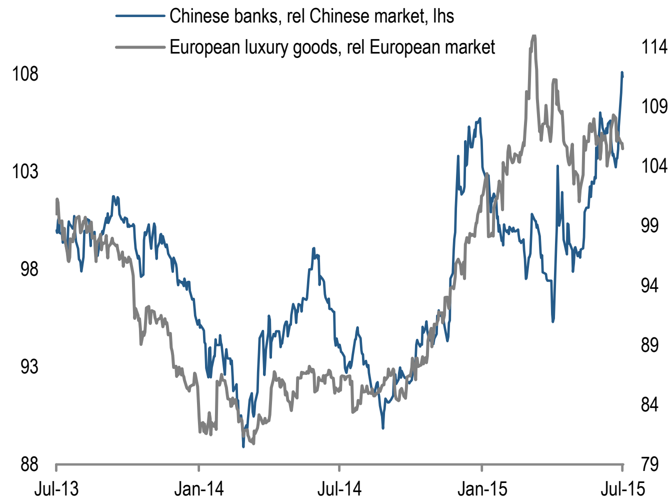
Chinese banks have correlated quite closely with luxury stocks in the past two years but from here, we struggle to see how banks can outperform in the long run when property developers are close to making new price relative lows (clearly the majority of banks' collateral is in property), as illustrated in Figure 78.

Figure 77: **European luxury goods stocks continue to decouple from Macau casino stocks**



Source: Thomson Reuters, Credit Suisse research

Figure 78: **Chinese banks had tended to correlate quite closely with the luxury goods sector**

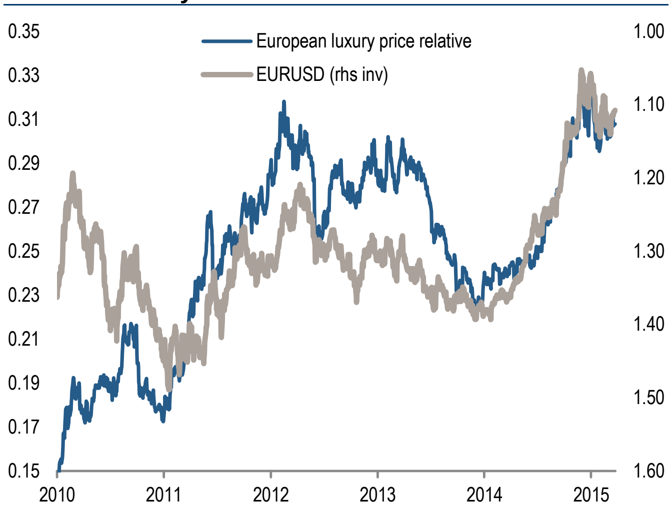


Source: Thomson Reuters, Credit Suisse research

5. We still think that that it is too early to be bearish of the euro

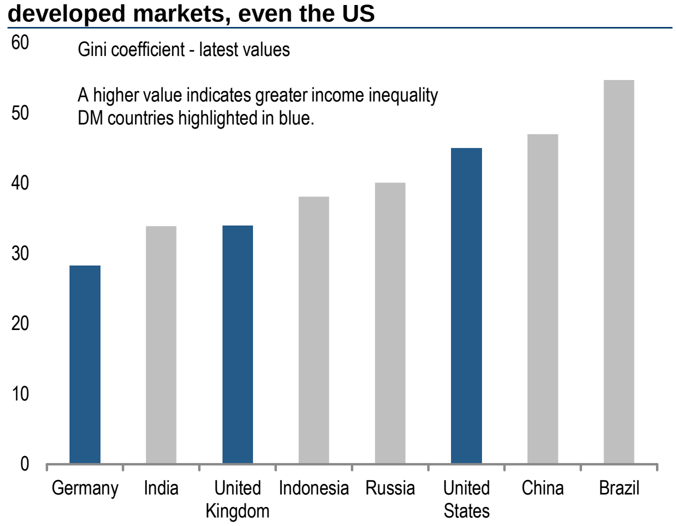
The relative performance of the luxury sector has tended to be very sensitive to the euro given the sector's transactional exposure to euro weakness (it has much of its manufacturing base in Europe and sells abroad).

Figure 79: **The luxury stocks have tended to outperform as the euro has weakened, with the largest transactional mismatch of any sector**



Source: Thomson Reuters, Credit Suisse research

Figure 80: **Inequality, as measured by the Gini coefficient, is now significantly higher in some GEMs than within developed markets, even the US**



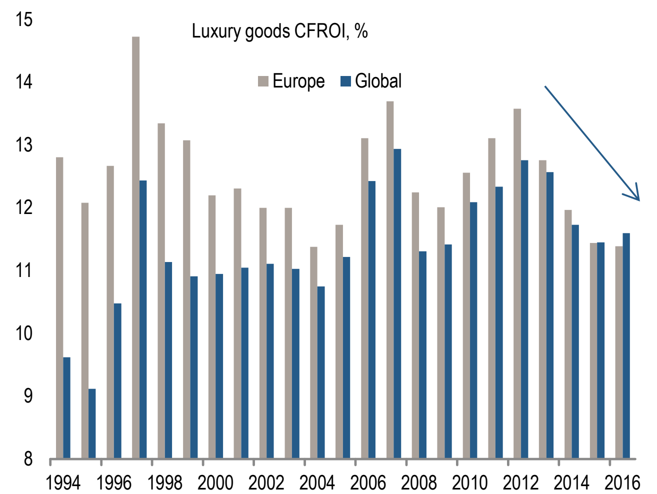
Source: Thomson Reuters, Credit Suisse research

6. Could inequality of income be set to fall?

The luxury sector has benefitted in recent years from a strong growth in income and wealth among those at the upper end of the wealth distribution, and thus widening inequality. However, we think many of the trends that allowed this to develop are now diminishing. Namely, falling commodity prices (which help consumers and hurts the owners, and in many countries commodity ownership is highly concentrated); the trough in bond yields (the fall in bond yields helped to re-rate financial assets, in general); the rise of more re-distributive policies (a trend arguably captured in the recent UK budget which, in effect, proposed a very sharp rise in the minimum wage) and to some extent the reduction in outsourcing (as China is no longer cheap enough to justify such a degree of production outsourcing).

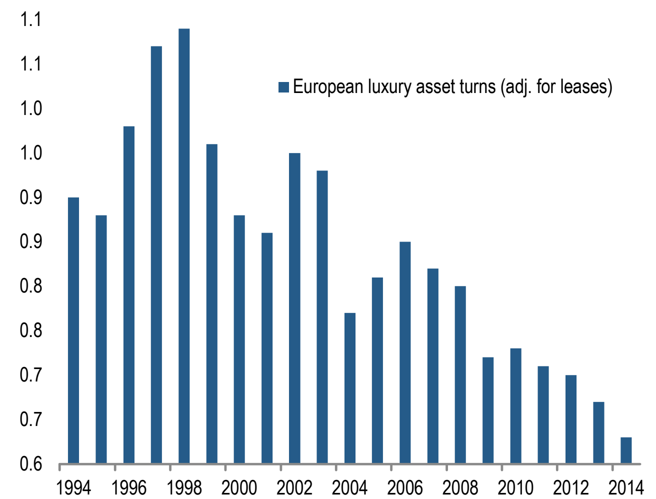
7. On HOLT, adjusting for off balance sheet items such as capitalised leases (properties are leased often as opposed to owned), then the return on capital looks less impressive

Figure 81: **Luxury goods' CFROI® has been deteriorating since 2012… if we capitalise leases**



Source: Credit Suisse HOLT, Credit Suisse research

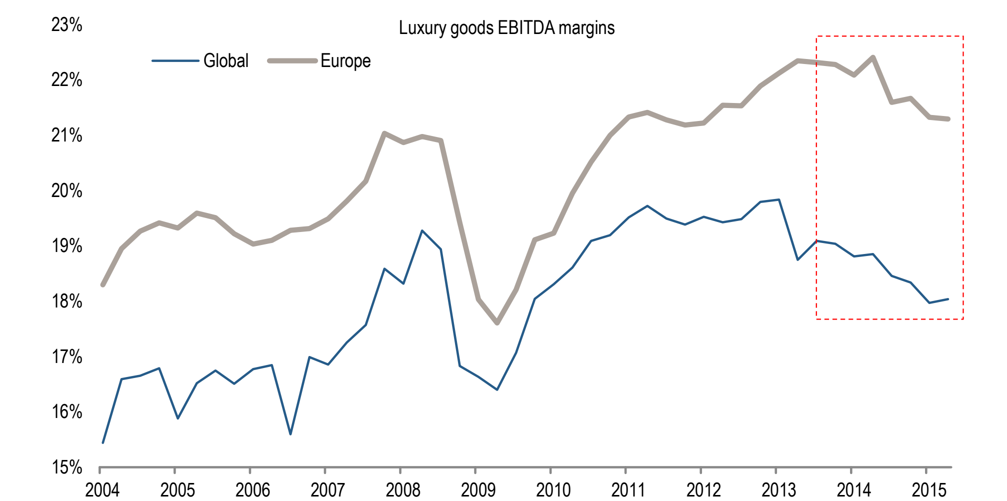
Figure 82: **European luxury goods' asset turns have been falling since 1998, if we capitalise leases**



Source: Credit Suisse HOLT, Credit Suisse research

We would also note that margins appear to have peaked.

Figure 83: **Luxury goods net margins have peaked**



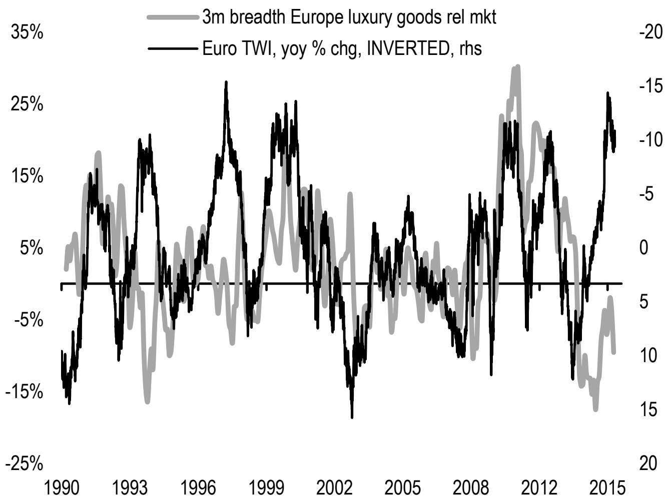
Source: Thomson Reuters, Credit Suisse research

8. Earnings revisions have started to deteriorate again

Ordinarily, currency weakness should have driven much stronger earnings momentum for the European luxury sector than has been apparent. The fact earnings momentum has been so weak on this occasion is perhaps a sign of deteriorating fundamentals in the industry.

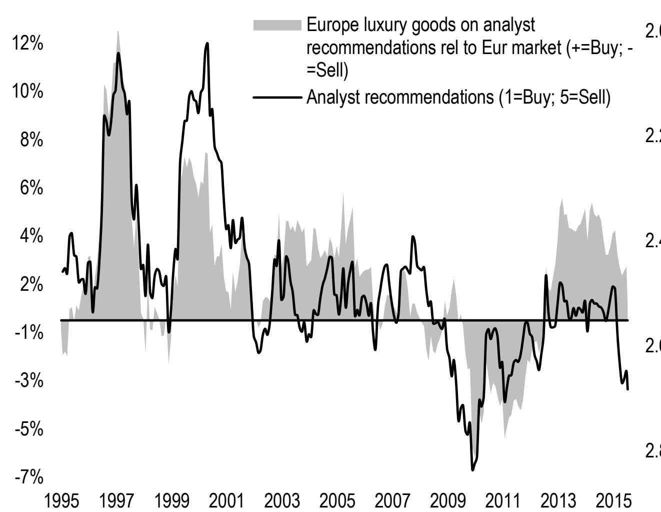
9. Sell-side positioning is still positive on the sector

Figure 84: **Relative earnings revisions of the luxury goods sector versus the Euro TWI Y/Y**



Source: Thomson Reuters, Credit Suisse research

Figure 85: **Relative net buy recommendations are still mildly positive**



Source: Thomson Reuters, Credit Suisse research

However, we see the following positives for the luxury goods sector:

- **Barriers to entry for the luxury goods sector remain higher than for most other sectors** given the following features:

  (i) Luxury goods brands are anchored in history (Hermes was founded in 1837, for example);

  (ii) They have become important to the aspirations of the new middle classes in emerging markets;

  (iii) There is limited production capacity (given the artisanal aspect to many of the production processes, such as watchmaking and champagne production);

  (iv) The sector benefits from highly vertically integrated business models (limiting the dependence on suppliers) and low price elasticity of demand.

Stocks

Below we show European luxury goods under Credit Suisse coverage on our composite scorecard.

Figure 86: European luxury goods stocks covered by Credit Suisse analysts

	-----P/E (12m fwd) ------			------ P/B -------		2015e, %		HOLT	2015e 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
Salvatore Ferragamo	22.4	122%	-5%	9.5	-17%	5.3	1.9	-20.6	0.2	-0.1	2.9	Outperform
Hermes Intl.	31.6	172%	5%	10.1	33%	2.2	1.0	-17.9	1.1	2.5	3.1	Neutral
Kering	15.1	83%	-6%	1.9	-31%	3.7	2.6	0.1	-7.5	0.3	2.8	Underperform
Lvmh	18.7	102%	0%	3.6	-10%	4.6	2.4	3.5	0.9	2.2	2.5	Underperform
Burberry Group	18.8	102%	6%	4.9	-14%	4.9	2.4	7.5	-5.3	-3.7	2.6	Underperform
Richemont N	18.0	98%	85%	3.0	5%	4.7	2.2	8.2	2.7	-3.9	2.4	Outperform
Boss (Hugo)	17.7	97%	8%	8.3	28%	4.1	3.9	13.2	-6.1	-0.4	2.4	Outperform
The Swatch Group 'B'	14.4	78%	-60%	2.1	-29%	6.0	2.1	55.5	-4.0	-0.4	2.6	Outperform

Source: MSCI, IBES, Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

We reduce European auto manufacturers to benchmark (and are underweight German autos)

On the Global Equity Strategy team, we are positive on European domestic demand and have recommended investing in the European recovery story in car sales. As a result, we have been, and remain, positive on the French and Italian car producers, and the auto components. In March, however, we halved our overweight in the sector, reflecting worries about euro resilience and China.

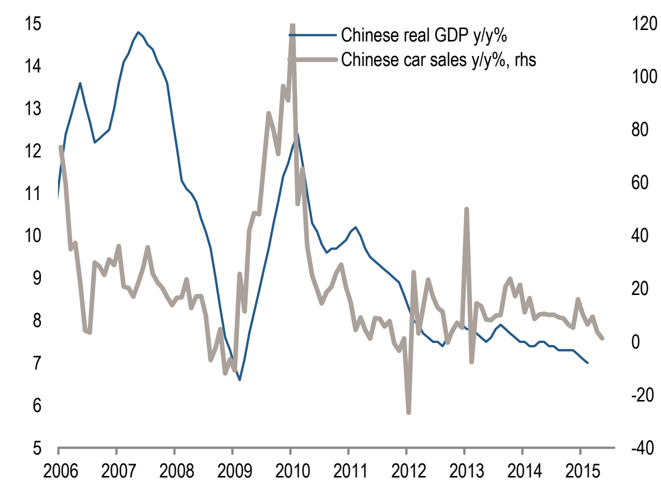
We now take auto manufacturers down to benchmark because of our concerns on the German autos (which are more exposed to China, and account for 80% of the European autos index market cap). We think investors should be underweight the German autos, in aggregate (which our autos team would implement via BMW and VW; see their report, *European Auto OEMs: Initiating with a cautious view – China and Europe key downside risks*, also published today.)

The issues with the Chinese-exposed auto producers are the following:

1. **More than 40% of their profits come from China at a time when demand is slowing, margins are under pressure and the competition from domestic brands is increasing**

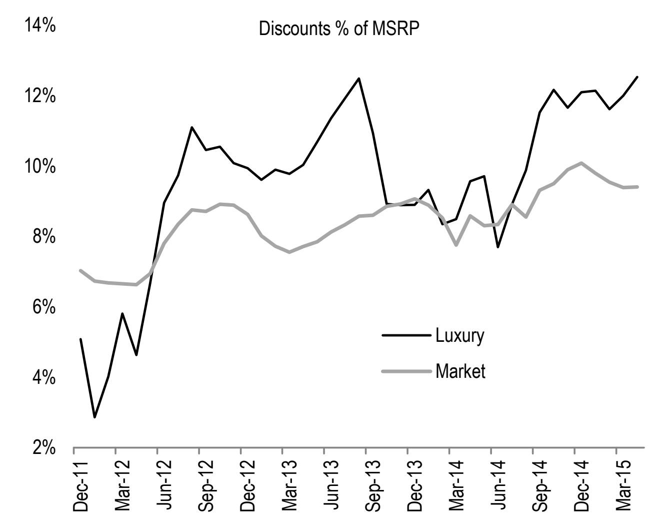
The slowing down of the domestic economy and the anti-corruption campaign is having an impact on car sales, which are growing by only 1% y/y. As a result, capacity utilisation in car manufacturing has fallen by almost 10pp in the past two years to just 60%.

Figure 87: **A slowdown in Chinese GDP growth does not bode well for car sales, with year on year car sales now growing at just 1%**



Source: Thomson Reuters, Credit Suisse research

Figure 88: **Price pressures, especially on luxury brands, are increasing**

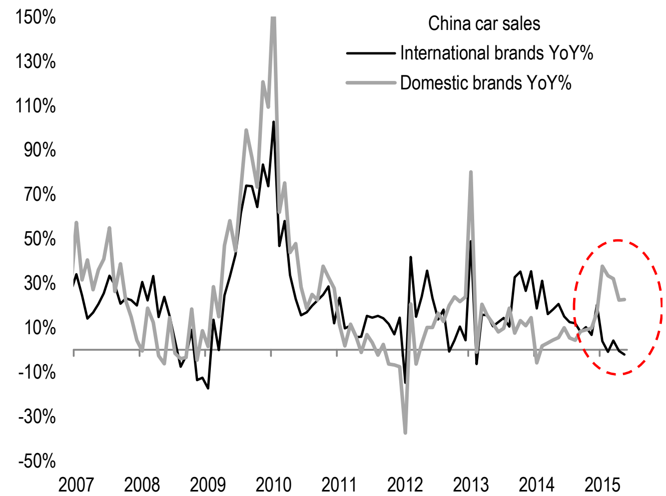


Source: Credit Suisse European Autos team, Credit Suisse China Autos team

On pricing, up until recently, foreign brands were able to charge 50-100% higher price on some models in China compared to Europe. However, tighter regulation, parallel imports and dealership rebates (in BMW's case, €1,500 per car) are all putting pressure on margins, especially on luxury brands.

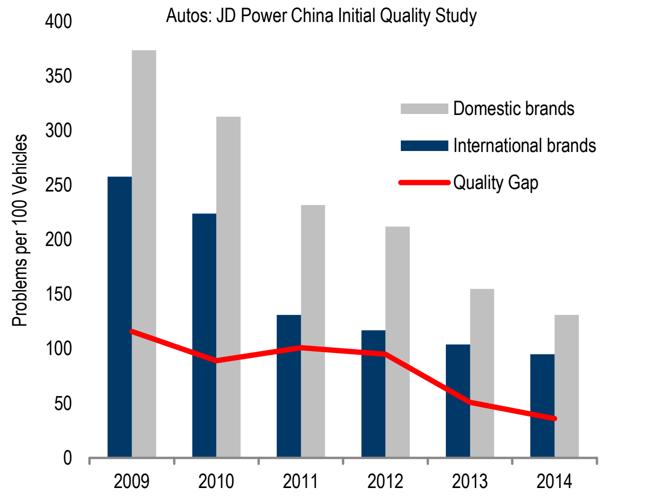
In addition, increasing competition from local brands is also creating a problem. Car sales of local brands are up 22% y/y, while sales of international brands are down 2%. The quality gap between domestic auto brands and international brands has narrowed significantly over the past five years, according to the JD Power Survey. The Chinese car companies now account for 30% of the market – we think that this will rise from here.

Figure 89: Car sales of domestic brands in China are up 22% YoY, while sales of international brands are down 2% YoY



Source: Credit Suisse European Autos team, Credit Suisse China Autos team

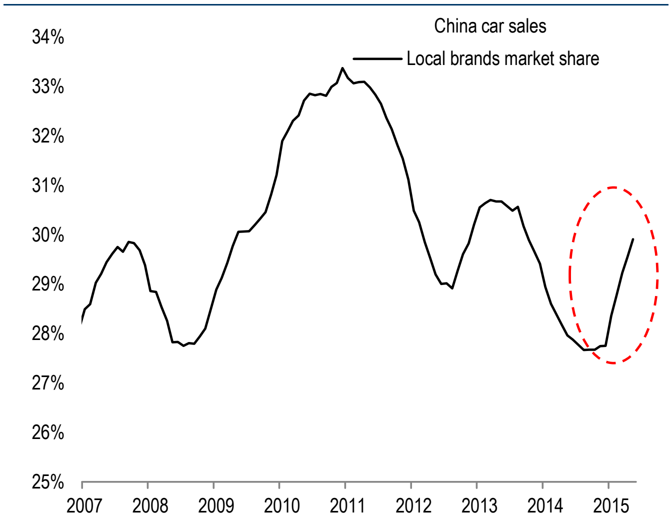
Figure 90: The quality gap between domestic auto brands and international brands in China has narrowed significantly over the past five years



Source: JD Power, Credit Suisse research

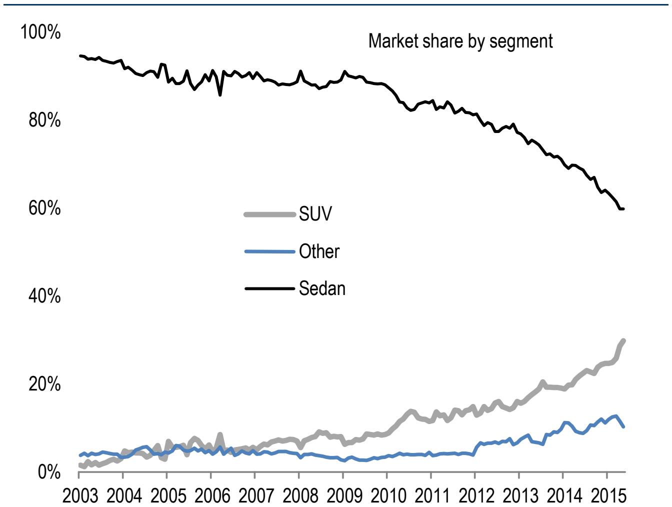
Moreover, there is a clear shift in demand trends from sedans to SUVs. Many of the foreign brands are focused on sedans, which is the area of the market most vulnerable to the anti-corruption campaign, in our view, as the latter is particularly impacting the luxury/higher-priced segment. The growth area, instead, has been SUVs in Tier 3 and 4 cities. This market has a lower margin and is less well served by the foreign brands. This has meant domestic market share has risen (by 3% points this year).

Figure 91: Chinese local brands have started to increase their market share in China



Source: Credit Suisse European Autos team, Credit Suisse China Autos team

Figure 92: There has been a shift in demand from sedans to SUVs in the past years



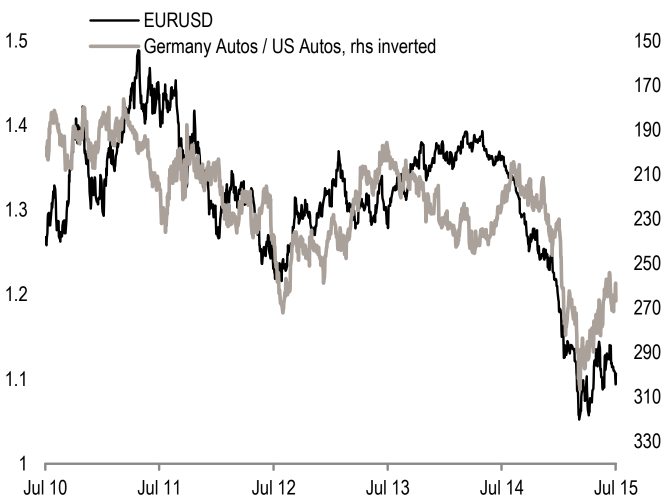
Source: Credit Suisse European Autos team, Credit Suisse China Autos team

2. German autos are a play on the euro

Given their international exposure, German autos are correlated with the euro: they outperform their international peers when the euro weakens and vice versa.

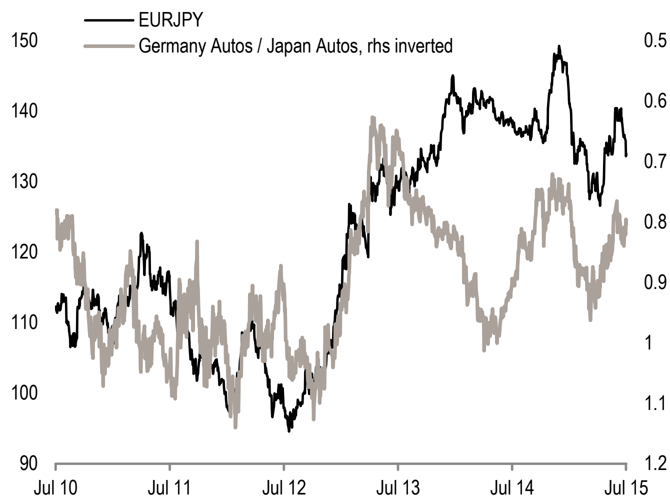
As we have discussed in the past, we are not that pessimistic on the euro and do not think it will weaken substantially from current levels.

Figure 93: German autos tend to underperform US ones when the euro strengthens against the dollar…



Source: Thomson Reuters, Credit Suisse research

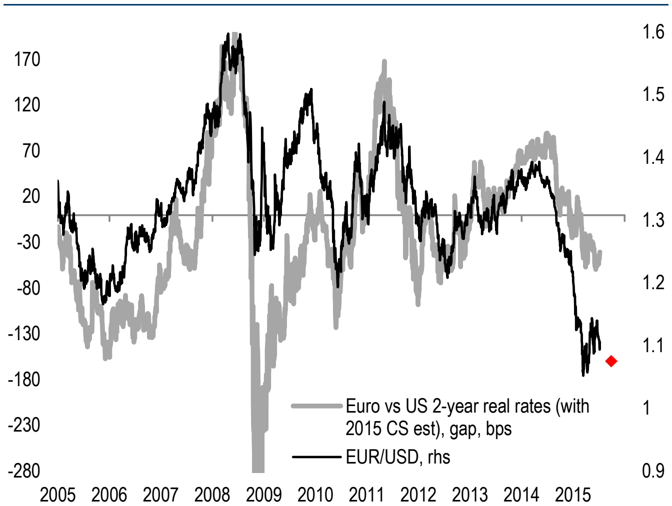
Figure 94: …and similarly tend to underperform Japanese autos when the euro strengthens against the yen



Source: Thomson Reuters, Credit Suisse research

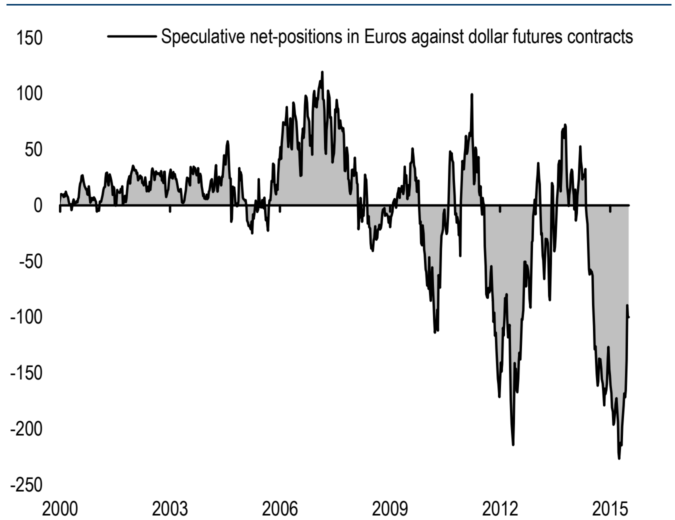
Our concern on the Euro is that, even on the CS year-end forecast of 1.25% 2-year note yield in the US, real rate differentials only imply that the Euro/$ should be at 1.10, especially at a time when relative growth momentum is consistent with a much stronger euro. We would also note that historically the dollar has stopped rallying when the Fed has raised rates in the past. Despite that, positioning remains extended, with speculators still appearing uncomfortably short the euro against the dollar.

Figure 95: The 2-year note yield differential is consistent with a EUR/USD of 1.10 if we use our rates strategists' forecasts



Source: Thomson Reuters, Credit Suisse research

Figure 96: Net speculative positions are still short the euro against the dollar



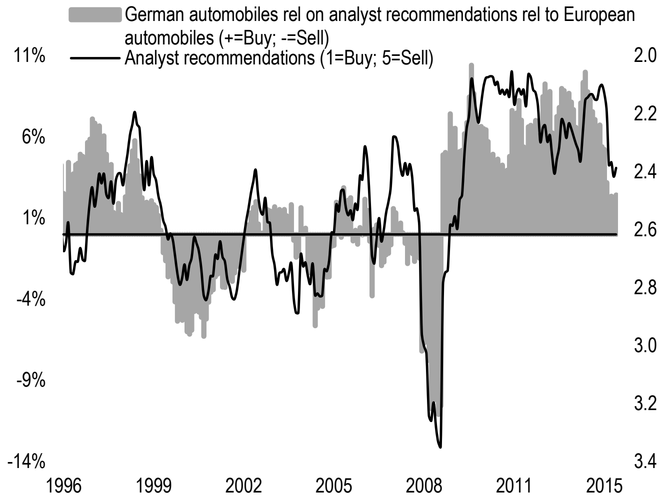
Source: Thomson Reuters, Credit Suisse research

3. Earnings revisions have rolled over and the sell-side is still optimistic

Figure 97: German autos relative earnings revisions have rolled over…

Source: Thomson Reuters, Credit Suisse research

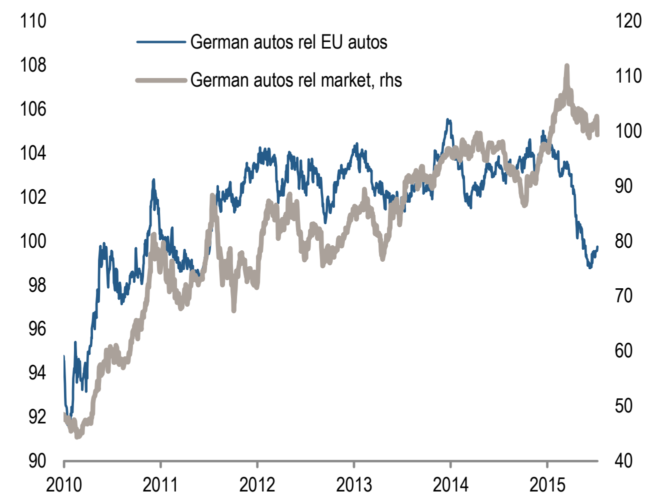
Figure 98: …and they are still favoured by sell-side analysts relative to their European peers



Source: Thomson Reuters, Credit Suisse research

On the positives, German autos have underperformed their peers YTD and they do not look expensive on 12-month forward P/E relatives.

Figure 99: German autos have outperformed the overall market, but have underperformed their peers over the past year



Source: Thomson Reuters, Credit Suisse research

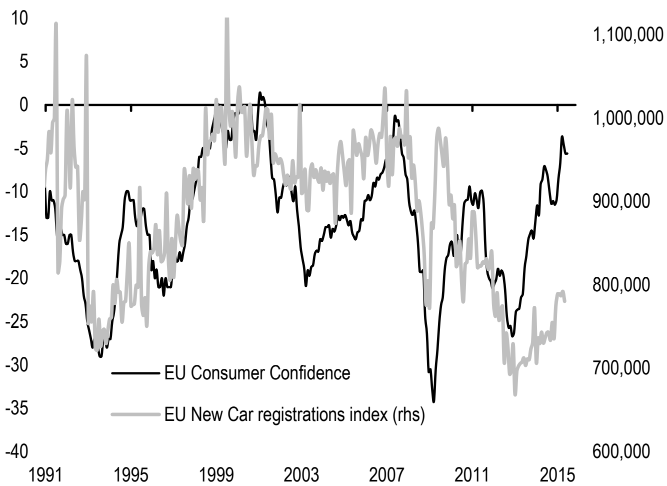
Figure 100: The 12-month forward P/E of German autos relative to the market is below average

Source: Thomson Reuters, Credit Suisse research

We stress that we still recommend exposure to the European autos sales story via the French and Italian producers

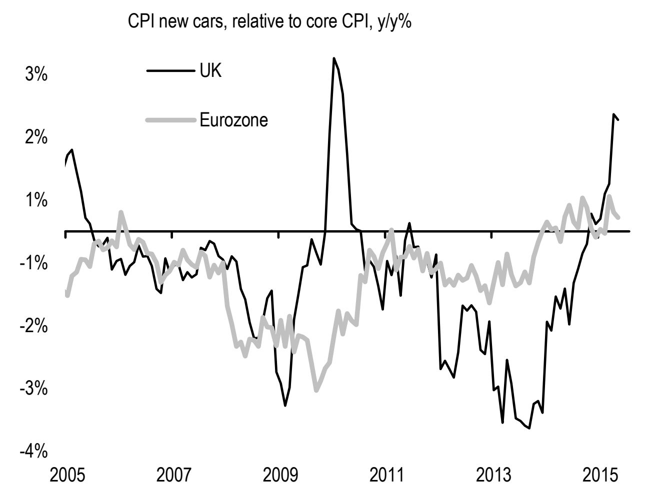
- Consumer confidence suggests that European car sales should rise by c20%, and pricing in both the euro area and UK is particularly attractive. The Italian and French car markets in particular have the biggest growth potential, according to our analysts.

Figure 101: **Rebounding European consumer confidence is consistent with a c20% rise in car sales**



Source: Thomson Reuters, Credit Suisse research

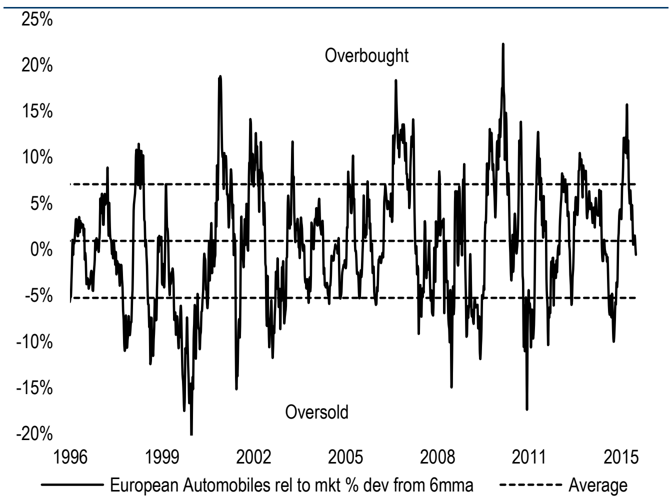
Figure 102: **Auto pricing (for new car sales) continues to rise in the euro area and the UK**



Source: Thomson Reuters, Credit Suisse research

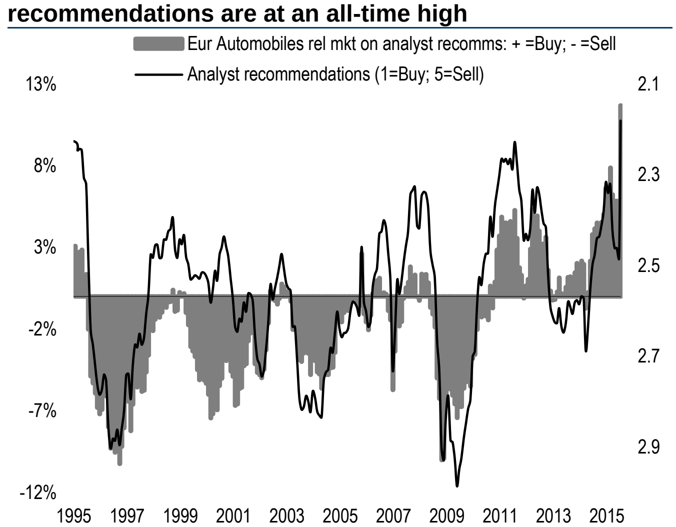
- The autos sector at one point had been both very overbought and over-loved. The former has adjusted, the latter has not (i.e. sell-side net buy recommendations are at an all-time high).

Figure 103: **The sector is neutral on our price monitor**



Source: Thomson Reuters, Credit Suisse research

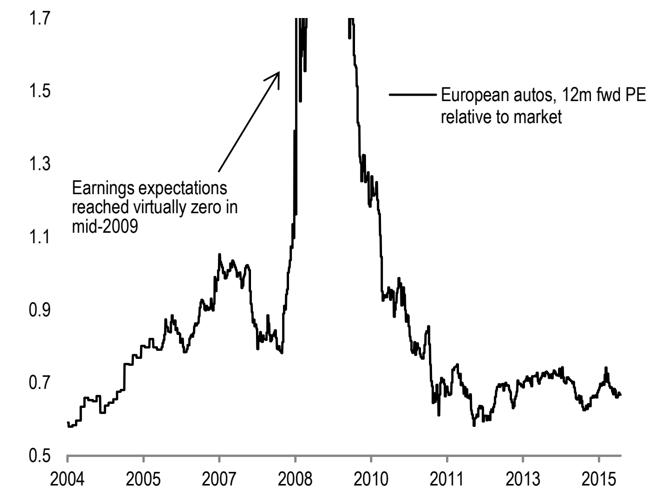
Figure 104: **Sell-side analyst relative net buy recommendations are at an all-time high**



Source: Thomson Reuters, Credit Suisse research

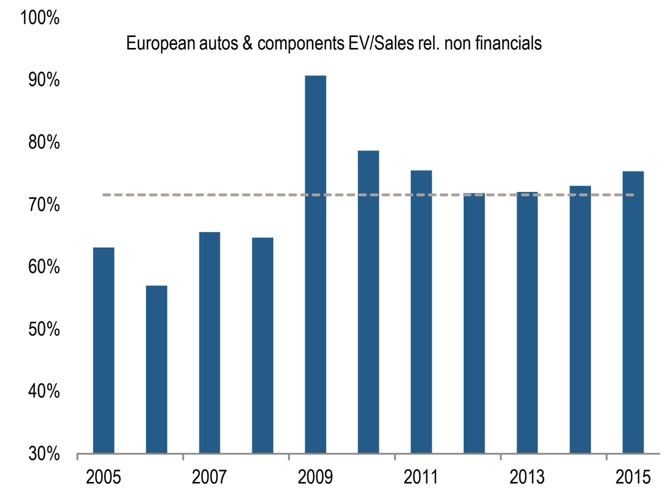
- In aggregate, valuations of pan European autos are neutral. European autos 12-month forward P/E relative is below its long-run average, while EV-to-sales relative to the market is slightly above its norm. Bearing in mind that autos are higher RoE businesses, they should, if anything, be trading on higher P/E relatives, in our view. The European auto sector has reduced leverage and improved profitability in recent years.

Figure 105: European autos 12-month forward P/E relative is slightly below its long-run average



Source: Thomson Reuters, Credit Suisse research

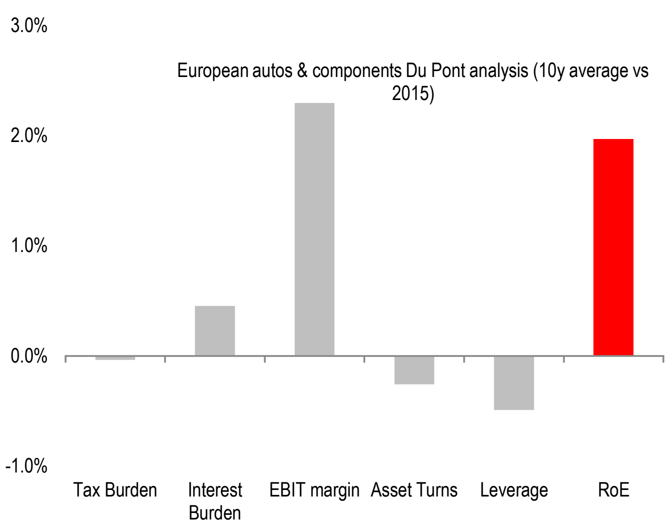
Figure 106: European autos EV-to-sales relative to the market is below its norm



Source: Thomson Reuters, Credit Suisse research

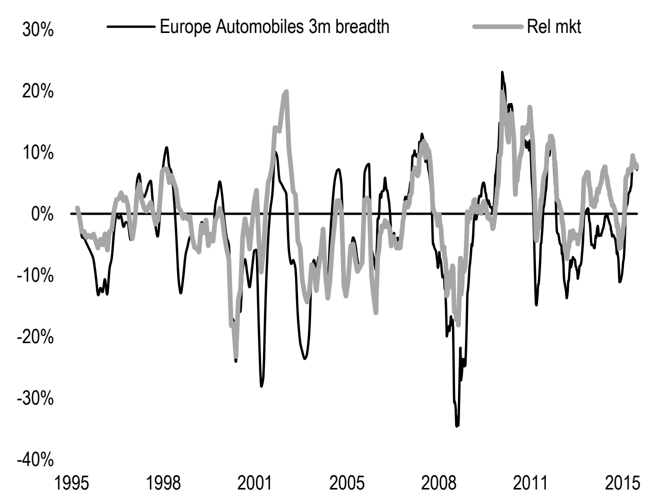
- Earnings revisions are better than the market and rising.

Figure 107: The European auto sector has reduced leverage and improved profitability in recent years



Source: Thomson Reuters, Credit Suisse research

Figure 108: European autos price earnings revisions are strong



Source: Thomson Reuters, Credit Suisse research

Below we show a screen of the European auto producers.

Figure 109: Screen of European autos stocks

	-----P/E (12m fwd) ------			------ P/B -------		2015e, %		HOLT	2015e 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
Fiat Chrysler Autos.	11.4	111%	-44%	1.6	19%	17.5	0.1	1.2	-8.6	3.3	2.7	Outperform
Renault	8.5	83%	-40%	1.1	1%	3.7	2.6	99.1	-0.5	2.4	2.4	Outperform
Peugeot	12.6	123%	-42%	1.5	77%	3.5	0.0	83.8	34.2	0.2	2.6	Neutral
Daimler	10.1	99%	-29%	2.0	28%	3.9	3.5	98.8	8.1	2.8	2.0	Neutral
Bmw	9.6	94%	-31%	1.7	-26%	4.9	3.6	109.0	-0.8	3.1	2.9	Underperform
Volkswagen Pref.	8.0	78%	-4%	1.1	-7%	7.6	2.7	72.0	0.2	1.3	2.2	Underperform

Source: MSCI, IBES, Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

Clearly, we believe the best way to play a stronger rebound in car sales in Europe is via Renault and Fiat as above.

China-exposed capital goods

We show European capital goods names with significant sales exposure to China. We believe the sector faces both an end-market threat and, in some instances, a Chinese competitive threat.

Figure 110: China-exposed European capital goods stocks

Name	Sales exposure to China	Price perf rel Europe, 12m	-----P/E (12m fwd) ------			------ P/B -------		2015e, %		HOLT	2015e Momentum, %		Consensus recommendation (1=Buy; 5=Sell)	Credit Suisse rating
			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		
Kone 'B'	30%	7%	21.1	132%	51%	11.7	58%	5.1	3.5	-37.9	0.0	2.6	3.3	Outperform
Schneider Electric	13%	-13%	15.3	95%	-5%	1.9	-14%	5.7	3.1	13.7	-3.3	0.9	2.7	Not Rated
Abb Ltd N	13%	-12%	17.3	108%	9%	2.8	-85%	5.7	3.6	9.1	-8.8	-3.9	3.0	Not Rated
Philips	13%	-3%	15.3	96%	13%	2.0	-3%	3.0	3.4	15.8	-8.6	2.6	2.7	Not Rated
Skf 'B'	12%	2%	13.3	83%	20%	3.9	37%	4.3	3.1	14.5	5.6	1.3	2.8	Underperform
Atlas Copco 'A'	12%	11%	18.6	116%	45%	7.5	63%	5.1	2.7	35.0	-0.5	-0.2	2.7	Outperform
Kuka	12%	76%	26.9	168%	37%	5.2	108%	1.7	0.7	-25.0	-12.6	6.1	3.6	Not Rated
Alfa Laval	10%	-21%	16.1	101%	11%	3.7	-8%	5.8	2.9	21.2	-8.2	0.7	3.4	Neutral
Siemens	10%	-8%	13.9	87%	-14%	2.6	-8%	6.1	3.7	47.9	-6.9	0.2	2.6	Not Rated
Sandvik	7%	-7%	15.8	99%	2%	3.6	-2%	6.6	3.8	10.9	1.5	0.5	3.0	Underperform

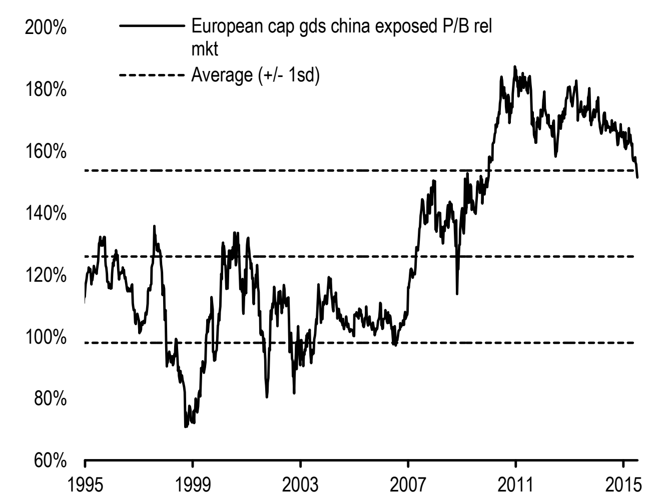
Source: Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

If we look at those capital goods companies with a high China exposure, then we can see in aggregate that the index has not been that weak or de-rated significantly. We would expect further downside for some names.

Figure 111: China-exposed cap goods have only underperformed marginally over the past three years…

Source: Thomson Reuters, Credit Suisse research

Figure 112: …and whilst they have de-rated slightly, they are still expensive on P/B relative to the market



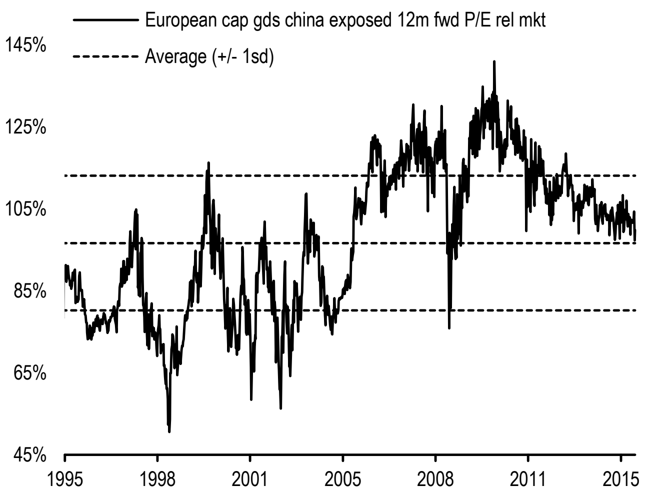
Source: Thomson Reuters, Credit Suisse research

We would highlight two risks in general:

1) Exposure to China: especially to capital spending and construction end markets, both of which look to be the weakest components of growth. We think that the investment share of GDP would need to fall to 40% from over 44% and if GDP growth is just 6%, then that means FAI growth would be just 4% from a CAGR of 24%.

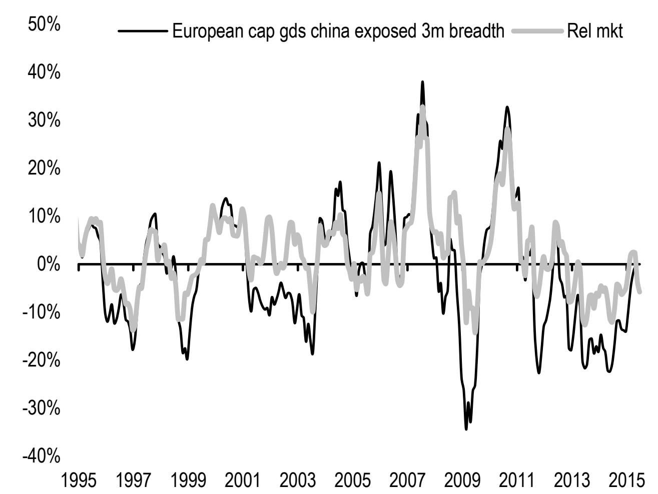
2) The growing competitive risk from China: this is particularly in the bearings space (our analysts have written about this at length for SKF), low-end construction and mining equipment (e.g. Sandvik) and railway equipment.

Figure 113: The sector looks neutrally valued on P/E…



Source: Thomson Reuters, Credit Suisse research

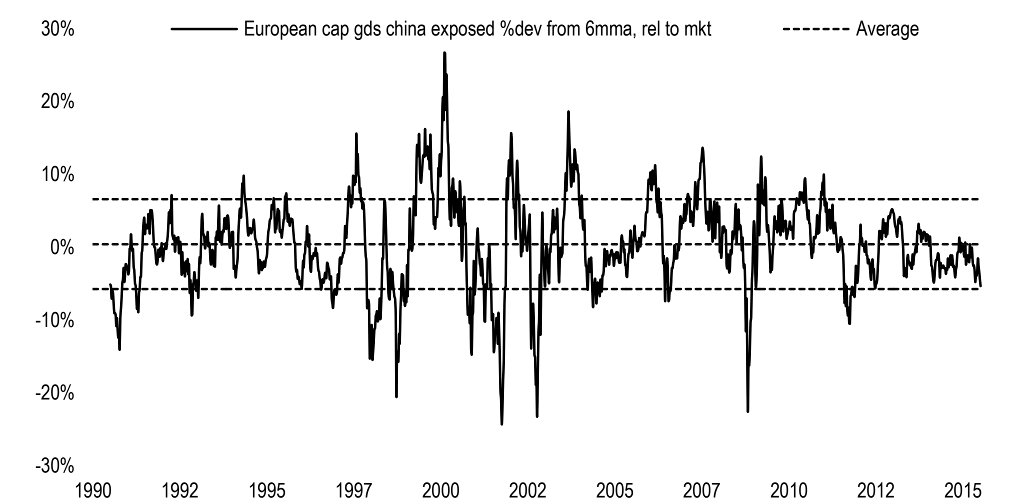
Figure 114: …though relative earnings momentum has rolled over and is negative



Source: Thomson Reuters, Credit Suisse research

However, we would admit that, tactically, these names look oversold.

Figure 115: European China-exposed capital goods appear c0.9std oversold on price momentum



Source: Thomson Reuters, Credit Suisse research

The names on which we would potentially be more positive are those which are a play on the industrial automation theme. China's industrial robot density relative to developed markets remains low and this is at a time when the government is encouraging greater automation within production lines. In our view, this creates a strong structural growth story, with particular upside for foreign manufacturers as barriers to entry within the sector are higher than the rest of the capital goods space.

China as a competitive threat

This is a theme that we have emphasised consistently since 2009. Our fear is that excess investment has to be exported. An abnormally low cost of capital (channelled via SOEs), increased R&D (which is now 2% of GDP versus 0.6% just over a decade ago) and the large number and greater quality of graduates (in 2014 according to the US Department of Education China had twice the number of graduates as the US) allow China to move up the value added curve.

We have seen examples of this in solar, wind, railway equipment, low-end mobile and chemicals. China now has a patent life that is longer than the US and in some areas is as high quality. The main barriers to entry are via the aftermarket or manufacturing niche products.

There have been two forms of competition that we worry about – first, low quality products where China switches production from the domestic market to the export market when demand slows (as seen in carbon steel and aluminium), and second, China moving up the value added curve (autos, artificial sweeteners, chemicals, capital goods, wind, solar, power generation).

In particular, our European chemicals analysts would highlight names such as: BASF, which competes in 50% of its businesses with China and 100% of its chemical businesses with China SOEs (whose RoE is abnormally low), and Lanxess, which has 26% of sales to Asia and half of rubber exports go to China. Our capital goods team continues to be cautious on SKF and Sandvik.

Other areas include artificial sweeteners (Tate and Lyle's Sucralose brand, though we admit they have already taken actions to scale back production and attempt to compete on a smaller scale), wind power (e.g. Vestas, though obstacles for Chinese manufacturers exporting on a large scale to Western markets remain for now) and SUV car sales (see our auto downgrade section above).

Figure 116: **Stocks which face a Chinese competitive threat**

	-----P/E (12m fwd) ------			------ P/B -------		2015e, %		HOLT	2015e 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
Basf	13.9	86%	9%	2.7	23%	4.5	3.5	47.2	-0.1	1.8	2.9	Underperform
Lanxess	18.6	116%	50%	2.3	4%	0.2	1.1	6.1	5.7	2.1	2.5	Neutral
Skf 'B'	13.0	84%	20%	3.8	35%	4.5	3.2	12.6	3.6	0.6	2.8	Underperform
Sandvik	15.3	99%	1%	3.4	-4%	6.8	3.9	11.7	-0.9	-0.3	3.0	Underperform
Tate & Lyle	14.4	70%	22%	2.5	-7%	na	5.4	15.0	-15.1	-5.8	3.1	Neutral
Vestas Windsystems	20.5	133%	-23%	4.5	-19%	na	1.3	-40.6	11.9	5.1	2.7	Neutral

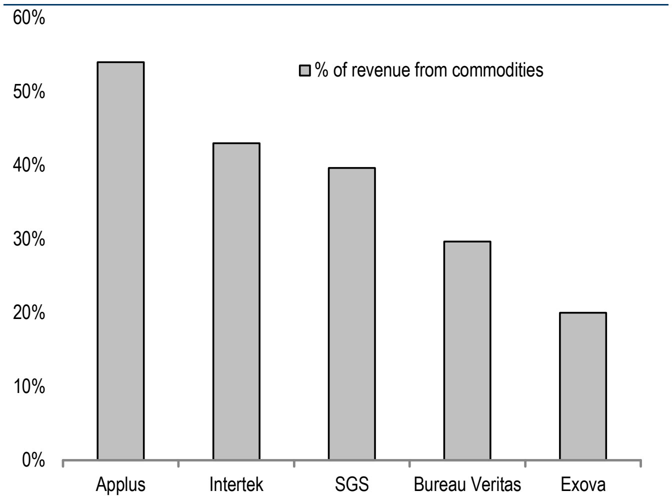
Source: MSCI, IBES, Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

We keep to our underweight of global testing companies

Global testing companies are negatively impacted by China in two ways:

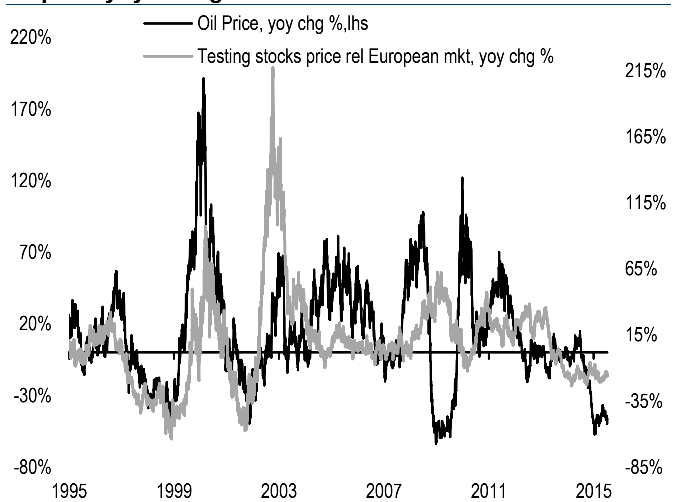
Commodity exposure: A bear market in commodities is bad for their revenues as nearly a third of their revenues are commodity related. We continue to be cautious on the oil price (not least with the IEA warning that oil was 'massively oversupplied', with supply growing at 3.1mpd, and demand up 1.4mbd). In that context, we would note that testing stocks should have performed worse given the fall in the oil price, as shown below.

Figure 117: **% of revenue from commodities**



Source: Credit Suisse European Support Services research team

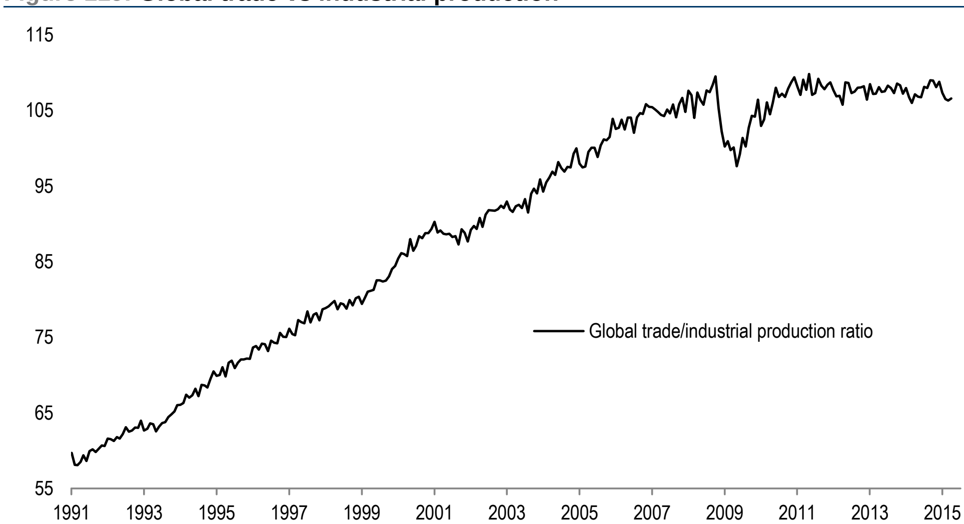
Figure 118: **Testing stocks price relative yoy versus the oil price yoy change**



Source: Thomson Reuters, Credit Suisse research. This is market-cap weighted average of Bureau Veritas, Intertek, Exova, SGS Surveillance

Global trade: As China slows, so does global trade. As we show below, global trade is underperforming global IP, and thus the secular growth of this sector seems to be over, at least for now.

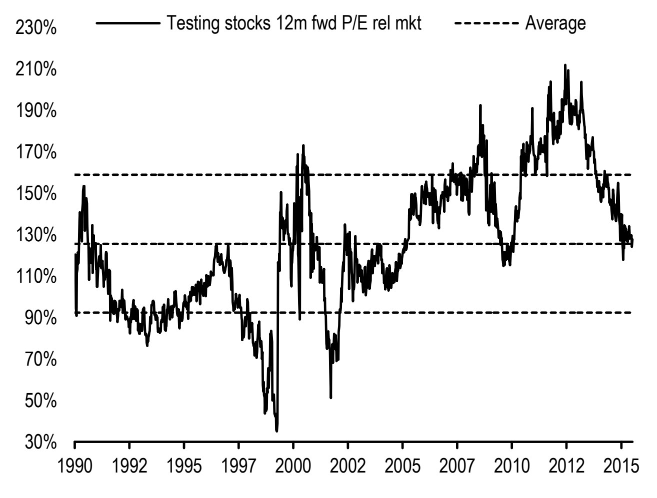
Figure 119: **Global trade vs industrial production**



Source: Thomson Reuters, Credit Suisse research

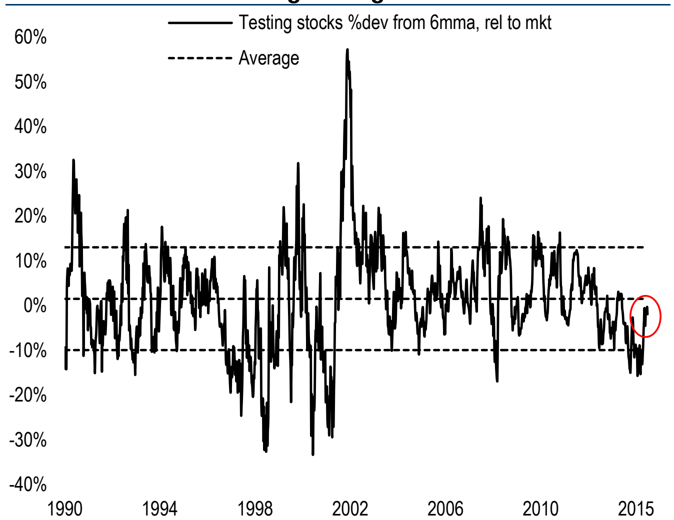
Admittedly, **relative valuations** have fallen. The P/E of the testing stocks relative to the market is now back to neutral, while P/B relative is below average. We believe, however, that the end of the super cycle for both testing and commodities should see valuation move to an unambiguously cheap level, as opposed to neutral. Finally, we would note that, unlike many of the other China plays, this sector is not oversold.

Figure 120: **Testing stocks relative to the market are trading at a neutral level on 12-month forward P/E…**



Source: Thomson Reuters, Credit Suisse research. This is market-cap weighted average of Bureau Veritas, Intertek, Exova, SGS Surveillance

Figure 121: **Testing companies price relative: 0.3std below its 6-month moving average**



Source: Thomson Reuters, Credit Suisse research. This is market-cap weighted average of Bureau Veritas, Intertek, Exova, SGS Surveillance

Stock screen

Below we show testing stocks on our aggregate scorecard:

Figure 122: **Testing stocks on our aggregate scorecard**

	-----P/E (12m fwd) ------			------ P/B -------		2015e, %		HOLT	2015e 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
Bureau Veritas Intl.	19.4	104%	10%	8.1	-23%	4.6	2.6	-15.7	0.8	1.7	2.6	Neutral
Intertek Group	17.2	92%	0%	4.9	-75%	5.0	2.2	11.5	-0.9	-0.1	3.0	Neutral
Exova Group	15.0	96%	-5%	na	na	12.9	1.8	103.7	-0.6	2.7	2.0	Outperform
Sgs 'N'	20.2	108%	4%	5.5	-8%	4.8	4.2	-7.8	1.1	1.9	3.0	Neutral

Source: MSCI, IBES, Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

What about the Shanghai A and MSCI China?

We have been benchmarking China since November 2014. We see the following supports for the market.

1. **The government seems to be willing to stand behind the stock market, apparently at whatever the cost.**

The PBOC is effectively lending money to the CSF to lend to brokers who, in turn, buy equities. It is exceptionally unusual to see this happening in a market which is not clearly undervalued. The CSRC crackdown on short selling (it stated it would 'strictly punish' short sellers) seemed particularly aggressive.

2. **Turnover appears to point to a bubble, but aggregate valuations are not extended on P/E relative to the US.**

The P/E of Shanghai A relative to the S&P 500 is only at neutral levels compared to its 10-year average. As shown in Appendix 2, MSCI China 12-month forward P/E relative to the US is c.0.5std below average.

Figure 123: **Market turnover appears to point to a bubble…**

Source: Thomson Reuters, Credit Suisse research

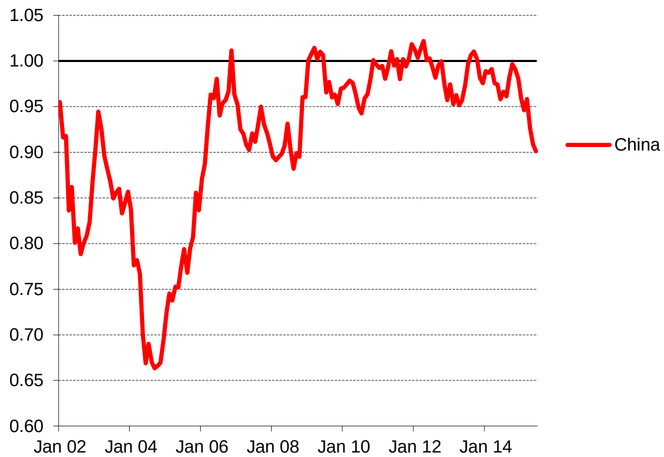
Figure 124: **…but Shanghai A is trading in line with its average relative to the S&P 500 on 12-month forward P/E**

Source: Thomson Reuters, Credit Suisse research

3. **There are limited alternatives for speculation with house prices having experienced a record Y/Y fall, and the deposit rate at just 2%.**
4. **Chinese banks' deposits relative to market cap are at 257%, more than five-fold the ratio in the US and more than double that in Japan.**
5. **There has been little foreign participation.** Foreign investors mostly missed the rally. They account for 1.6% of turnover, on the latest available data. The North Bound participation rate has been just 8% of what it could have been.

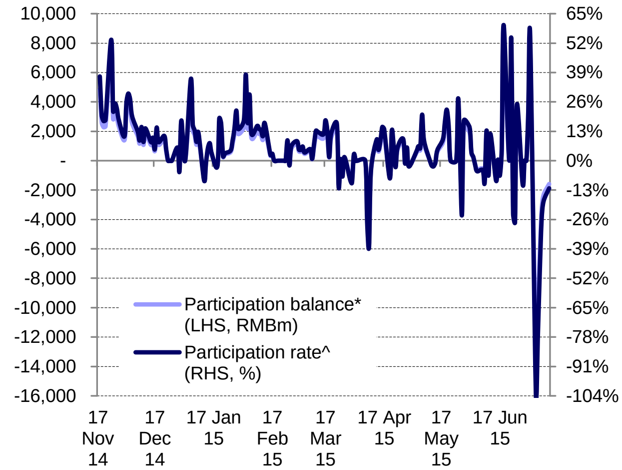
For more details, see Alexander Redman's note, *China: A bubble in the Middle Kingdom?*, published 29 May 2015.

Figure 125: **GEM equity fund positioning in China versus MSCI**



Source: EPFR, Credit Suisse Global Emerging Markets Equity Strategy team's research

Figure 126: **In aggregate, the North Bound participation rate has been just 8% of its possible total**

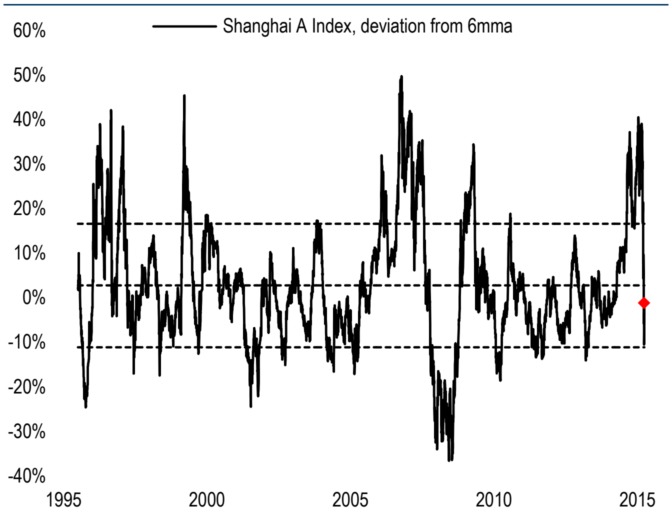


Source: Credit Suisse Global Emerging Markets Equity Strategy team's research

6. The market went from being overbought to oversold

On previous occasions when the Shanghai A moved from being this overbought to this oversold, the equity market rallied by an average of 11% in the following six months.

Figure 127: **The Chinese equity market is trading 0.3 standard deviations below its six-month moving average on our price momentum monitor, having currently become one std oversold**



Source: Thomson Reuters, Credit Suisse research

Figure 128: **On previous occasions when the Shanghai A moved from being this overbought to this oversold, the equity market rallied by an average of 11% in the following six months**

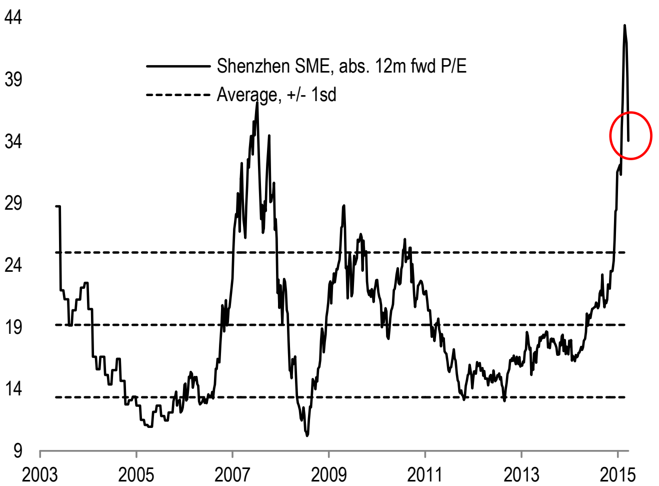
	Shanghai A % change after…			
Date	1 month	3 months	6 months	12 months
22-Sep-97	7.1%	7.1%	8.0%	12.9%
23-Dec-99	7.9%	27.7%	41.5%	50.4%
22-Jan-08	-4.2%	-31.0%	-37.6%	-56.0%
06-May-10	-8.3%	-3.0%	14.1%	4.4%
Median	**1.5%**	**2.0%**	**11.1%**	**8.7%**
Median ex-2008	**7.1%**	**7.1%**	**14.1%**	**12.9%**

Source: Thomson Reuters, Credit Suisse research

However, we see the following problems:

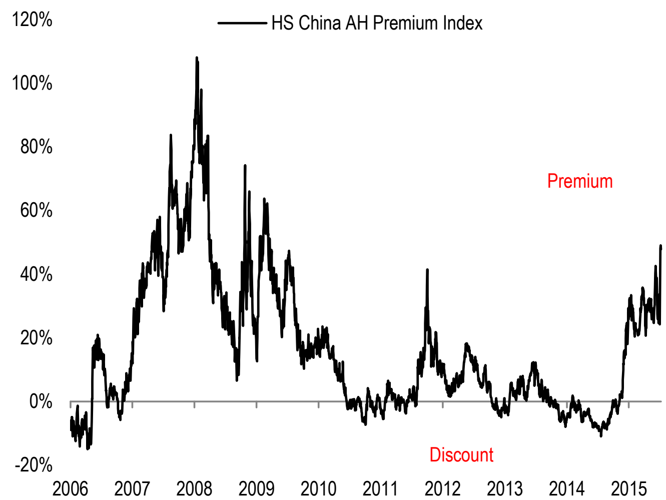
- There is a bubble in parts of the equity market, in particular the Shenzhen SME where valuations are more than two standard deviations above average.
- The A/H premium will not return to its previous peak because of arbitrage mechanisms that have been set in place (with the A/H premium at 48% currently).

Figure 129: **The Shenzhen SME index (small and younger start-ups typically) is extremely extended, though it has corrected**



Source: Thomson Reuters, Credit Suisse research

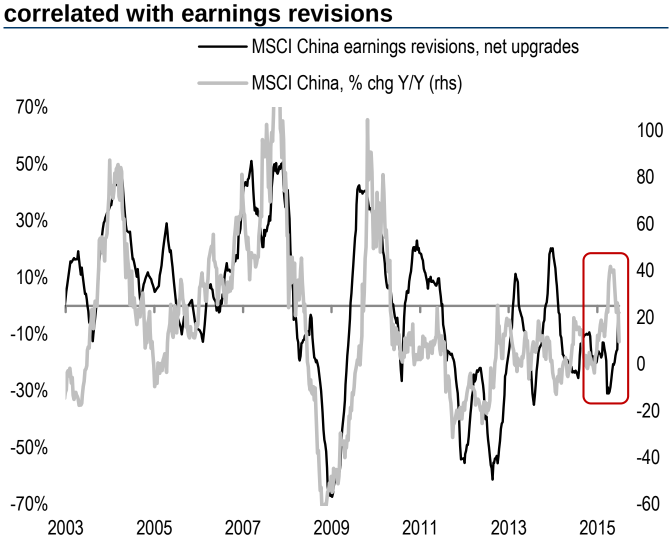
Figure 130: **Chinese A shares trade at a 48% premium to H shares**



Source: Thomson Reuters, Credit Suisse research

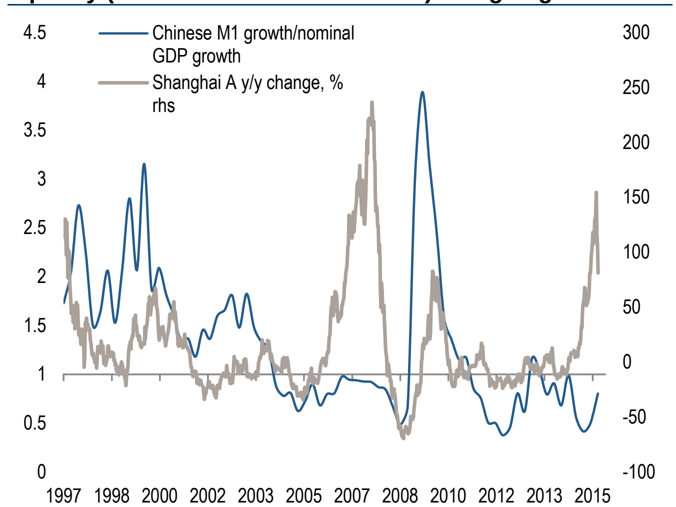
- Earnings revisions have been poor, and this historically has been a bad signal, with the equity market tending to correlate with earnings momentum, as illustrated in Figure 131. In our view, one of the key reasons for the poor earnings momentum is the squeeze on margins caused by record PPI deflation and a shortage of unskilled workers as highlighted above.
- Excessive liquidity is slowing, and normally as that happens, the stock market falls.

Figure 131: **China equity market performance tends to be correlated with earnings revisions**



Source: Thomson Reuters, Credit Suisse research

Figure 132: **Shanghai A had been rising despite excess liquidity (M1 relative to nominal GDP) being negative**



Source: Thomson Reuters, Credit Suisse research

- We see some signs of excessive manipulation and that is ordinarily problematic.

Stocks

Our China equity strategist Vincent Chan's top picks are shown below:

Figure 133: Our China equity strategist, Vincent Chan's top picks on our aggregate scorecard

	-----P/E (12m fwd) ------			------ P/B -------		2015e, %		HOLT	2015e 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
Indl.& Coml.Bk.Of China	6.0	52%	-39%	1.4	-38%	na	5.3	12.2	-3.0	-0.3	1.9	Outperform
China Pac.In.(Group) 'H'	16.1	138%	-12%	2.6	-7%	na	2.0	17.4	4.4	-0.6	2.1	Outperform
Xinjiang Goldwind Sctc. 'H'	12.0	77%	-31%	2.3	43%	na	3.7	-16.7	14.7	10.3	1.9	Outperform
Geely Automobile Hdg.	9.7	90%	-4%	1.6	-74%	11.2	1.2	41.3	-1.4	2.2	2.3	Outperform
Kweichow Moutai 'A'	16.2	80%	-38%	5.3	-31%	23.2	2.0	123.1	4.0	4.8	1.6	Outperform
Aia Group	19.2	164%	14%	3.2	23%	na	1.1	-5.1	3.6	-0.5	1.9	Outperform
China Merchants Bank 'H'	7.0	60%	-42%	1.4	-52%	na	3.9	-4.7	-1.0	3.1	2.3	Outperform
China Unicom (Hong	15.6	96%	-28%	1.0	-38%	-3.8	2.2	129.9	3.9	-0.8	2.5	Outperform
China Mobile	14.4	89%	-18%	1.9	-55%	2.5	2.9	38.0	-3.5	-0.4	2.3	Outperform

Source: MSCI, IBES, Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

Alexander Redman, our GEM equity strategist, is neutral on China, while Sakthi Siva, our Asian strategist, is overweight on China.

Chinese banks: underweight

We agree with Sanjay Jain, our head of NJA bank research, that banks are likely to outperform in the second half of 2015 driven by government policy intervention (e.g. a cut of the RRR, which could fall a lot more than expected given that cutting rates just weakens the RmB), a temporary stabilisation in the real estate market and policies that allow the banks to reduce their RWAs by as much as 10% (i.e. by swapping local government loans for bonds).

However, we remain structurally underweight on Chinese banks due to the following reasons:

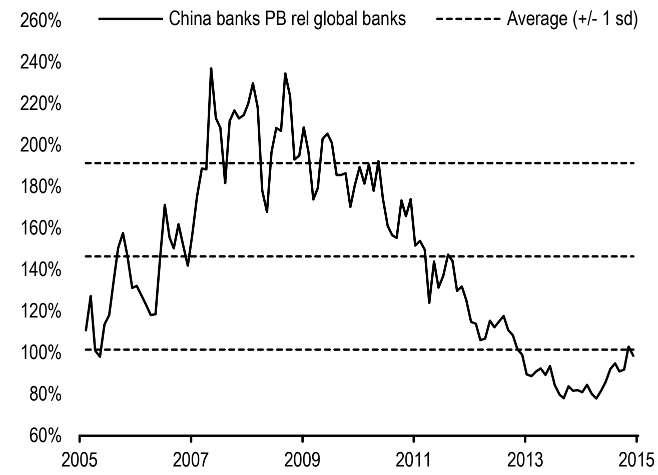
(1) Chinese banks are cheap for a reason:

It is currently easy to argue that Chinese banks are attractively valued, trading one standard deviation below their average on 12m forward P/E and P/B multiples relative to their global peers and looking cheap on HOLT.

Figure 134: China banks P/E relative to global banks

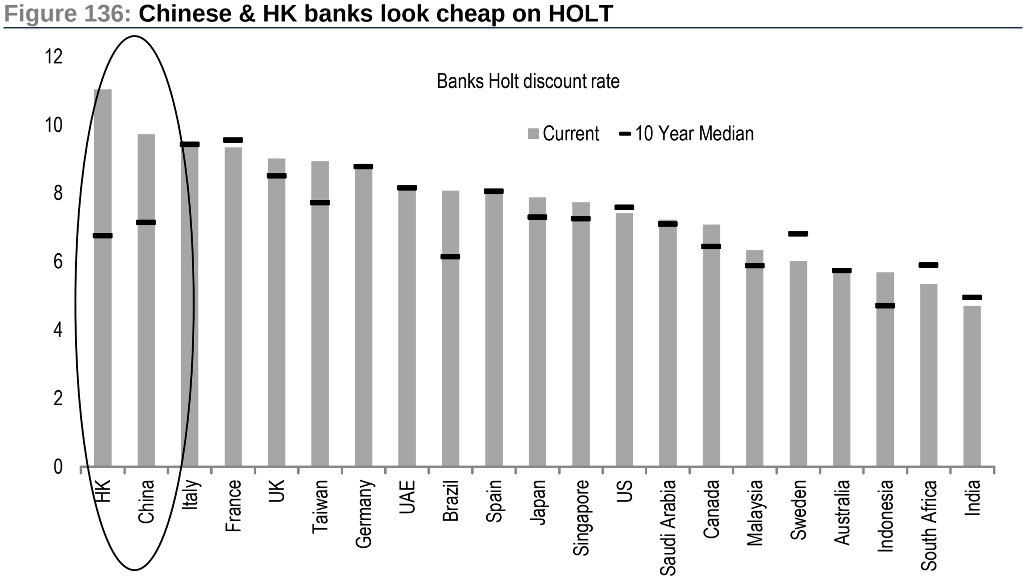
Source: Thomson Reuters, Credit Suisse research

Figure 135: China banks P/B relative to global banks



Source: Thomson Reuters, Credit Suisse research

Figure 136: Chinese & HK banks look cheap on HOLT

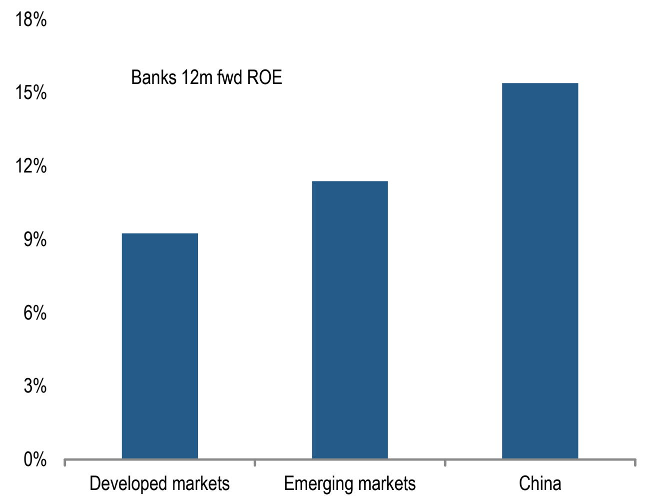


Source: Thomson Reuters, Credit Suisse research

However, in our opinion, Chinese banks are considerably less attractive if we consider that they are overearning. This is reflected in the banks' profits as a proportion of GDP, which are nearly triple those of the UK, US or Europe (something that deregulation of the deposit rate and new competition through e-banking should change).

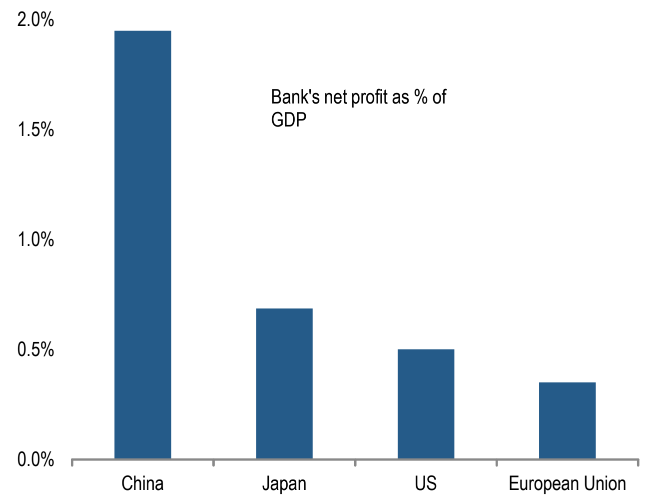
Above all, banks seem to be overly optimistic on NPLs. They are discounting a mid-cycle NPL of 9.4% (they trade on 4.1x PPOP compared to a norm of 5.2x PPOP (since Jan 2008). 1.1x of PPOP equates to 4% of total gross loans. With a 50% coverage ratio, this would equate to an additional 8% of NPLs on top of Q1 2015 NPLs of 1.4%), but we believe if property prices fall 20% or more, NPLs will rise more than 20%.

Figure 137: Chinese banks still seem significantly more profitable than banks in other regions



Source: Thomson Reuters, Credit Suisse research

Figure 138: Banking profits as a % of GDP



Source: Thomson Reuters, Credit Suisse research

(2) Pessimistic outlook on profitability:

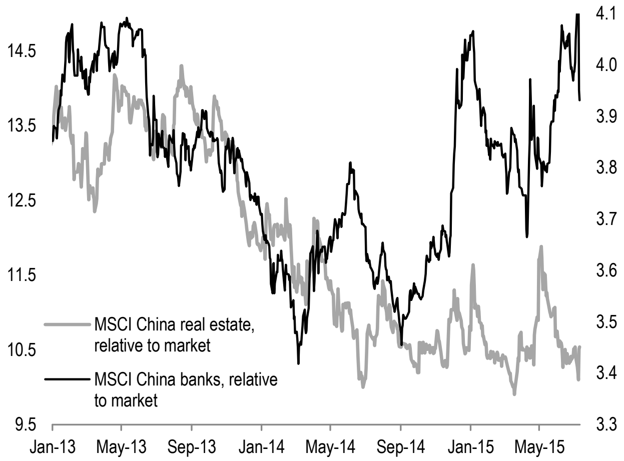
Sanjay Jain highlights that in addition to the questionable asset quality (as discussed above), the other key earnings drivers for Chinese banks, particularly margins and loan growth, look weak, resulting in flat consensus EPS growth estimates for 2015 and 2016.

On the Global Equity Strategy team we would point out that Chinese banks seem to enjoy an unusually high level of profitability compared to other regions, and this in our view suggests that they over-earn. We also worry about the threat of internet banking to existing business models.

(3) Chinese banks have already outperformed real estate plays:

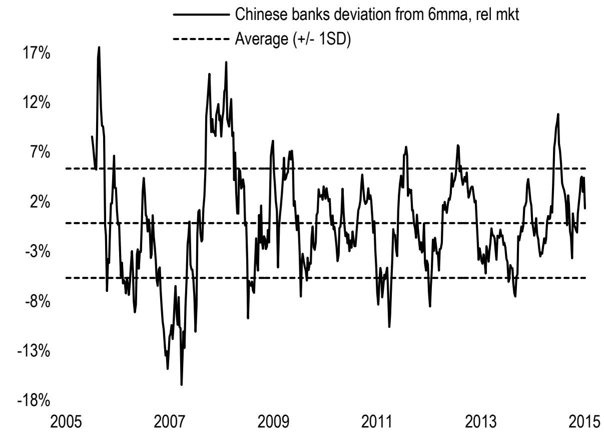
The fate of the Chinese banks is closely correlated to the Chinese real estate sector both via bank assets (a quarter is real estate related) and collateral (over half is real estate related). Yet Chinese banks have already significantly outperformed the real estate sector over the past nine months, limiting their upside potential. Furthermore, on price momentum relative to the broader market, Chinese banks are slightly overbought, and given the recent movements in the Chinese stock market, we are convinced there should be more attractive Chinese sectors.

Figure 139: Chinese banks vs Chinese property developers



Source: Thomson Reuters, Credit Suisse research

Figure 140: Chinese banks' price momentum rel to the Chinese market



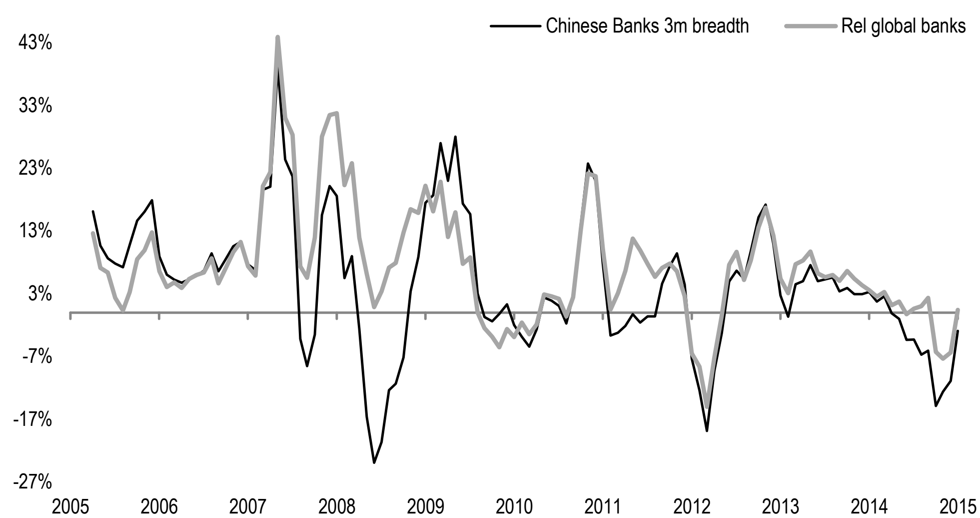
Source: Thomson Reuters, Credit Suisse research

What are the positives?

As Sanjay Jain highlights, Chinese banks remain plays on government support, and the Chinese government has already introduced measures to allow banks to swap their Local Government Financing Vehicle and regular loans into local government bonds (i.e. longer maturity) which can be repoed and carry a reduced risk weight. In addition, our China economist Dong Tao expects further RRR cuts by the PBoC to increase liquidity. We would also highlight that if the government was keen for Chinese banks to raise equity, it would have a vested interest in keeping their price to book ratio valuation above 1.

Furthermore, we would note that the earnings momentum of Chinese banks relative to the market has rebounded sharply and recently turned positive.

Figure 141: Absolute and relative earnings momentum of Chinese banks is rebounding



Source: Thomson Reuters, Credit Suisse research

Hong Kong equities – looking better than Chinese equities

In our view, Hong Kong equities look more attractive than Chinese equities for two key reasons:

- Valuations - Hong Kong listed equities are trading in line with their average on a 12m forward P/E multiple and trading on a small discount to the market on P/B relative (and close to a 10-year low relative to global equities).

Figure 142: **Hong Kong equities are trading in line with their long-run average on a 12m forward P/E multiple**

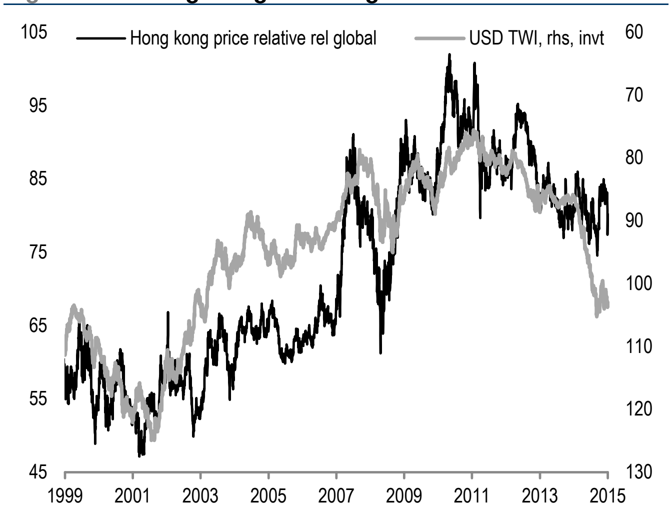
Source: Thomson Reuters, Credit Suisse research

Figure 143: **Hong Kong equity market: P/B relative to global market**

Source: Thomson Reuters, Credit Suisse research

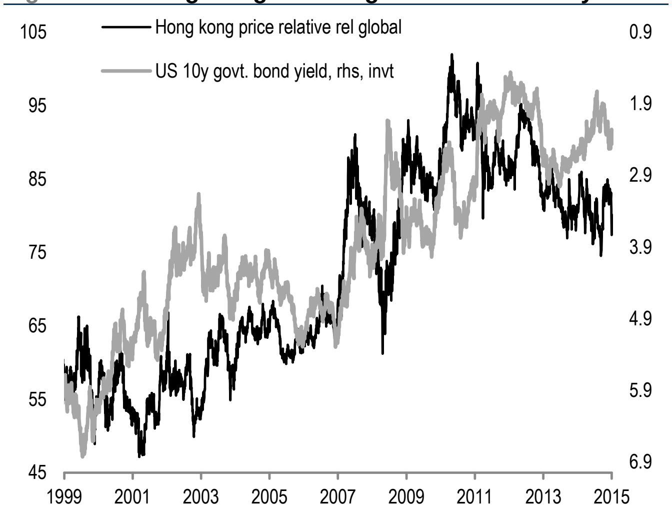
- Key macro variables seem to be in the price - Hong Kong equities underperform when the USD strengthens and the bond yield rises. HK equities do appear to be pricing in close to a 4% 10-year US bond yield.

Figure 144: **Hong Kong relative global vs USD**



Source: Company data, Credit Suisse estimates

Figure 145: **Hong Kong relative global vs US bond yield**



Source: Company data, Credit Suisse estimates

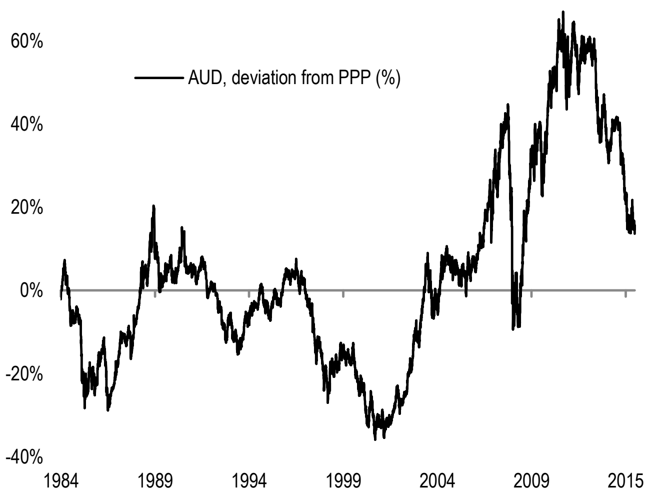
We acknowledge that Sakthi Siva, our Pan-Asian strategist, has an overweight stance on HK equities in a Pan-Asian context.

We reiterate our underweight of Australia

We remain bearish on Australian equities and the Australian dollar, as we have been for the past three years. Our concerns include the following.

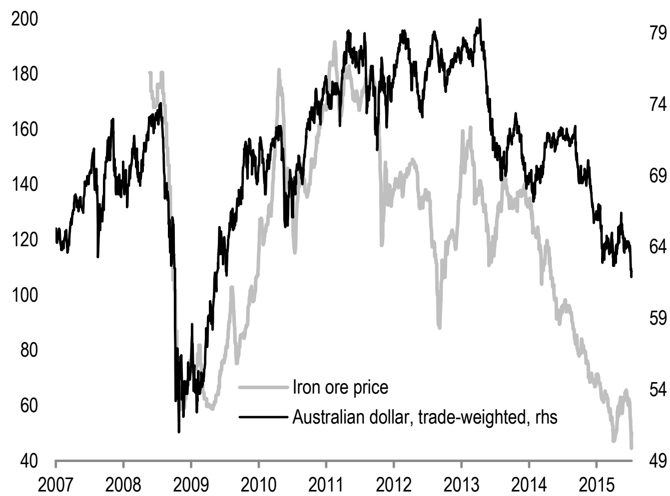
1. **The Australian dollar is still looking c13% expensive on PPP** and has held up significantly better than what would have been expected given the fall in industrial commodity prices or iron ore prices.

Figure 146: **The Australian dollar is 13% overvalued against the OECD's estimate of PPP…**



Source: Thomson Reuters, Credit Suisse research

Figure 147: **…and has remained elevated relative to iron ore prices**

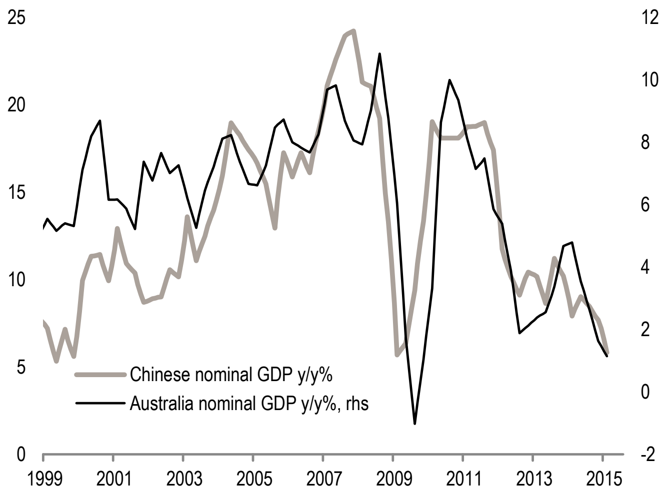


Source: Thomson Reuters, Credit Suisse research

2. **Australia exports 5% of GDP directly to China, but China has accounted indirectly for significantly more of Australian growth.**

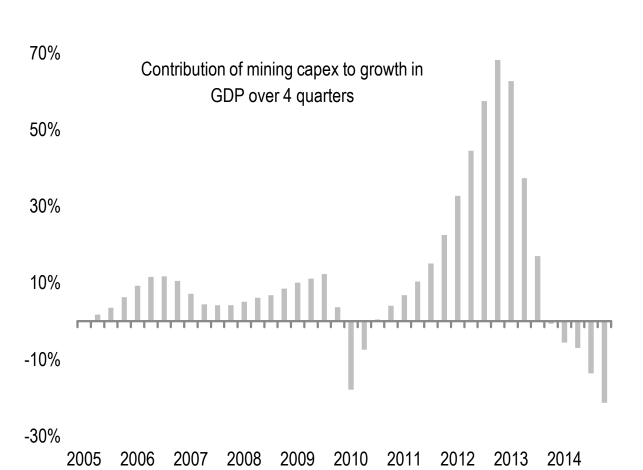
The growth in mining exports has accounted for 40% of GDP growth over the past year. Mining capex, which was contributing 70% to GDP growth at its peak, is now a significant drag, taking 20% off growth. Mining capex is still 5% of GDP and only 11% down from its peak; our economists think that mining capex normalisation is likely to subtract 1.5-2% pa from GDP over the next few years. We would also note that much of the mining capex has recently been LNG, but for new LNG projects to be economic, the AUD/USD has to fall below 0.6 (and there is a threat that LNG contracts end up being renegotiated to gas, as the US could start to export LNG at the turn of the year). Finally, 15-20% of new homes have been bought by investors based in China over the past five years.

Figure 148: Australian nominal GDP is correlated with Chinese nominal GDP



Source: Thomson Reuters, Credit Suisse research

Figure 149: Mining capex had contributed 70% to growth in GDP at peak (adding 2.5pp to GDP growth), but is now a significant drag (subtracting 0.8pp from GDP growth)



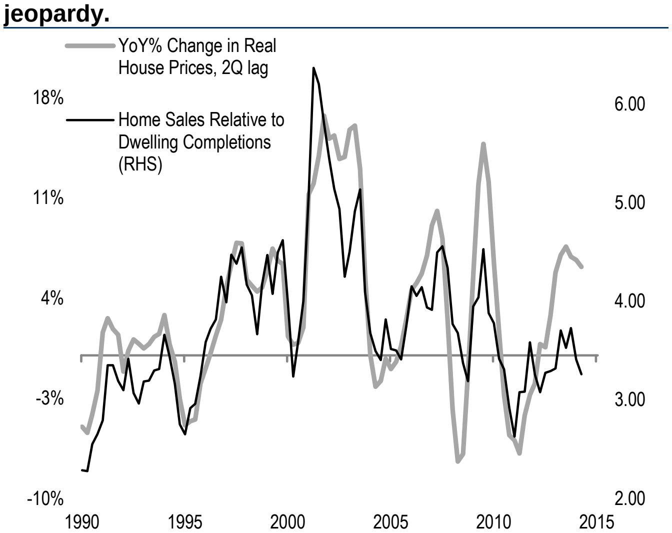
Source: Thomson Reuters, Credit Suisse research

3. Housing investment has been a bulwark of the economy and has limited the growth slowdown

Housing investment has increased by 20% over the past five years (see *Australia: China's extended property boom, 6 May 2015*).

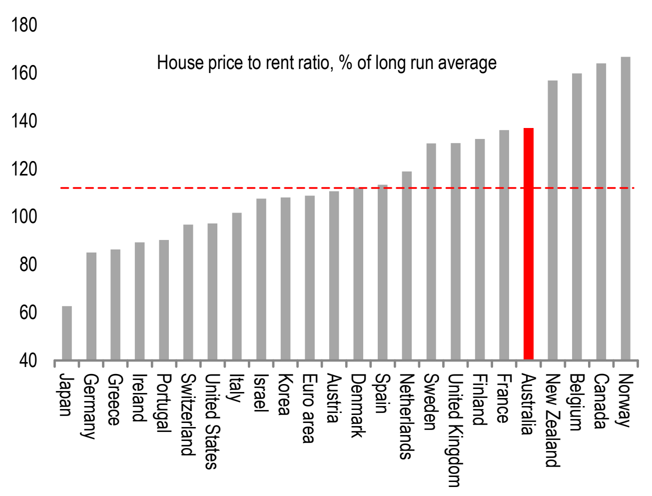
However, with new dwellings (a proxy on supply) increasing relative to housing sales (a proxy on demand) and extreme amounts of household leverage, we find ourselves concerned on this front.

Figure 150: The multi-year upswing in housing appears in jeopardy.



Source: Thomson Reuters, Credit Suisse research

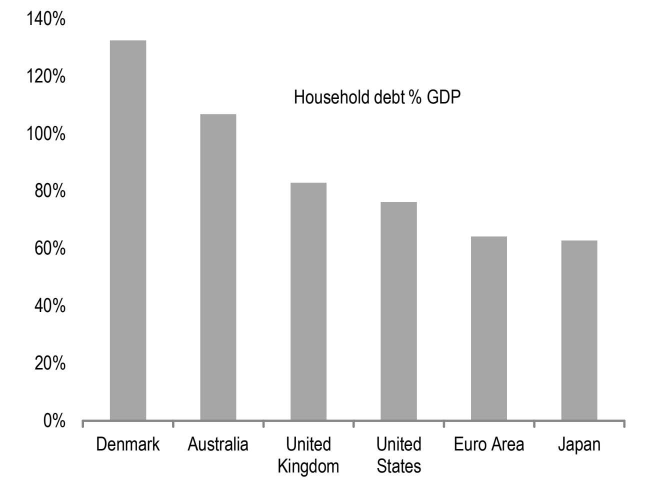
Figure 151: On a price to rent basis, Australian house prices are expensive relative to their history



Source: Thomson Reuters, Credit Suisse research

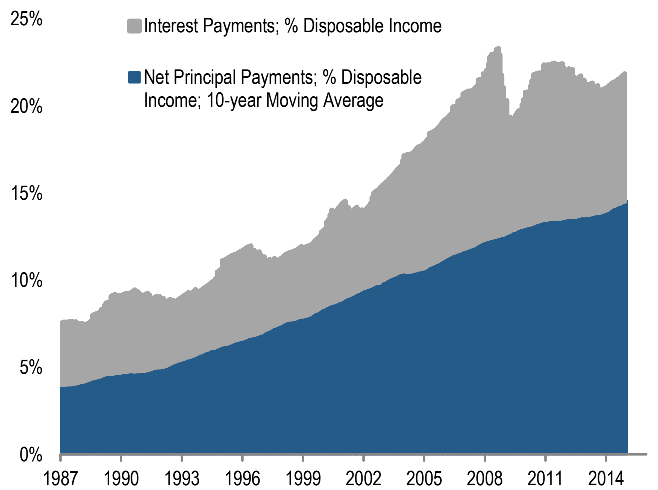
Australian housing is expensive relative to history, and household debt to GDP is 110% (the second highest in the world). More of a concern is that the mortgage debt service ratio is close to an all-time high of 22% of disposable income.

Figure 152: Australia's household debt to GDP ratio is the highest of any major region and only Denmark has a higher ratio



Source: Thomson Reuters, Credit Suisse research

Figure 153: The mortgage service ratio remains high

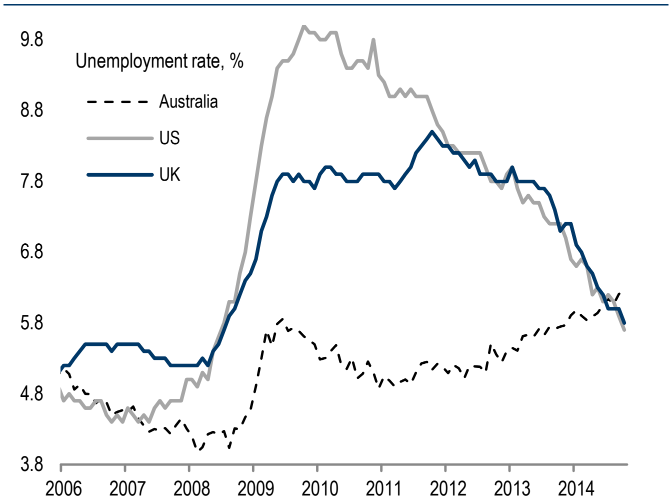


Source: Thomson Reuters, Credit Suisse research

4. This is the first time in 13 years that Australia has a higher unemployment rate than either the US or the UK

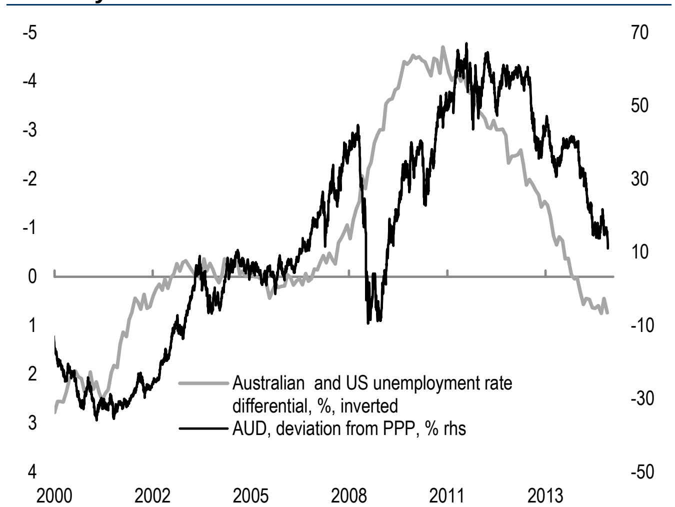
The last time this happened, the Australian dollar was 20% undervalued against PPP.

Figure 154: The Australian unemployment rate is now above that of the US and UK



Source: Thomson Reuters, Credit Suisse research

Figure 155: The unemployment rate differential between Australia and the US is consistent with a cheaper currency



Source: Thomson Reuters, Credit Suisse research

Australia would need to have employment growth of around 1.7% to keep the unemployment rate stable, and we do not believe that this will happen; thus pressure on the RBA to ease policy is likely to remain.

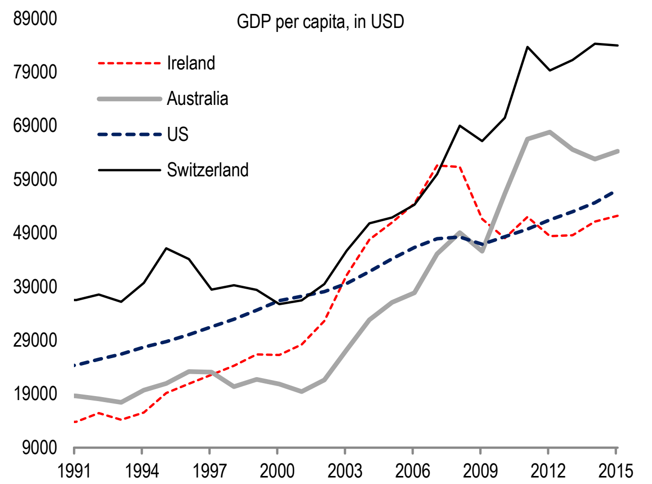
5. GDP per capita is a good litmus test.

Australian GDP per capita is currently 13% above the US and comparable to Ireland's in 2007. We think this might be too high, given the structural headwinds the economy is facing. A period of below trend growth is probably needed, in order to correct the imbalances (e.g., private sector leverage, current account deficit, currency overvaluation).

6. The AUD has been a carry trade.

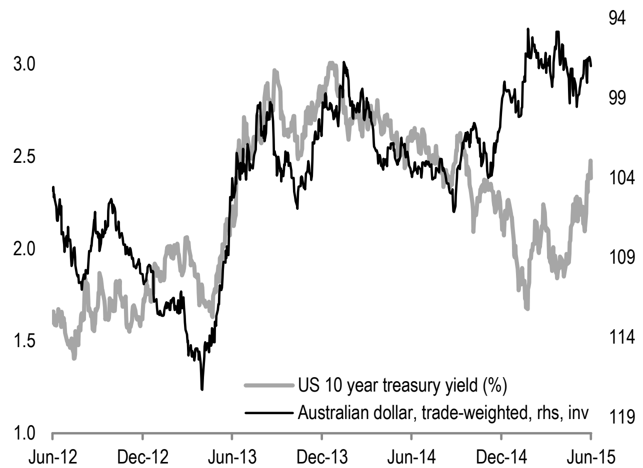
The AUD has been one of the carry trade currencies and thus should underperform if US bond yields rise further (and the RBA cut rates further).

Figure 156: Australian GDP per capita is 13% above that of the US and comparable to that of Ireland in 2007



Source: Thomson Reuters, Credit Suisse research

Figure 157: A rise in 10-year US Treasury yields would place pressure on the AUD



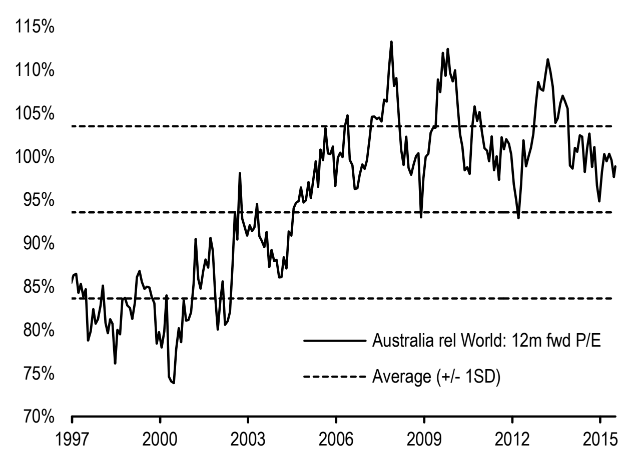
Source: Thomson Reuters, Credit Suisse research

What about Australian equities?

We would be underweight on Australian equities in a global context, as we do not think the valuations are sufficiently depressed on a relative basis to offset the risks, and our bearish view on the AUD is a further challenge for international investors. In that context, we would highlight the following points:

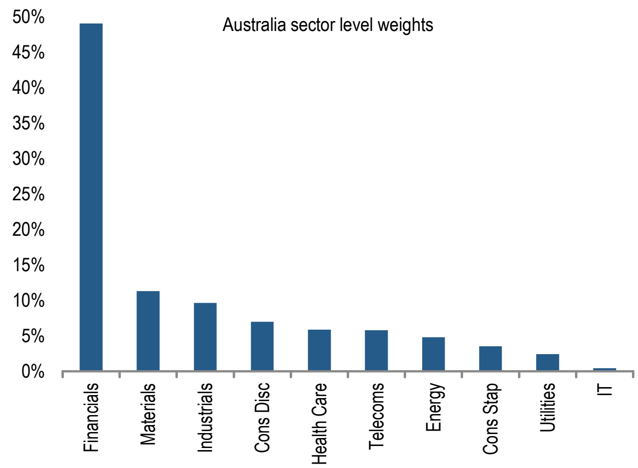
- The market in aggregate is not cheap on a relative 12-month forward P/E multiple;
- Financials account for almost 50% of the index market cap (with materials down to only 10% from 30% four years ago).

Figure 158: On a forward P/E basis relative to global markets, Australian equities are 0.5 std above average



Source: Thomson Reuters, Credit Suisse research

Figure 159: Financials account for almost 50% of the Australian equity market cap



Source: Thomson Reuters, Credit Suisse research

- The Australian banks' market cap per capita is the highest of any nation other than Switzerland and Sweden. Mortgage debt and cost of servicing are high and house prices are extended relative to history. Also, the bank regulator has recently been stricter (with APRA seeing it likely that Australian major banks would have to increase their capital ratios by at least 200bps to be comfortably positioned in the fourth quartile versus international peers (see our banks' analyst note).

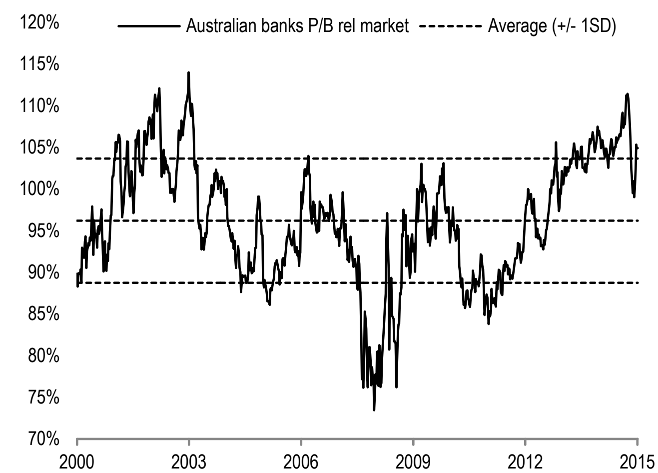
  The question is whether the RoE of 16% can be sustained. Our view is that banks will come under pressure if dividends start to be threatened, and that might occur when house prices start to fall. Our Australian banks team is optimistic of the sector and believe that the de-rating has been significant enough (*Bank Sector Valuations*, 15 June).

Figure 160: **Market capitalisation per capita is high**

	Banks market value ($m)	Population (m)	Per Capita Market Cap in $
Switzerland	255,074	8	31,884
Sweden	137,000	10	14,219
Australia	319,322	23	13,768
United Kingdom	425,296	64	6,670
United States	1,297,461	317	4,099
Japan	367,263	127	2,884
Euro area	700,814	349	2,007
China	402,026	1,361	295

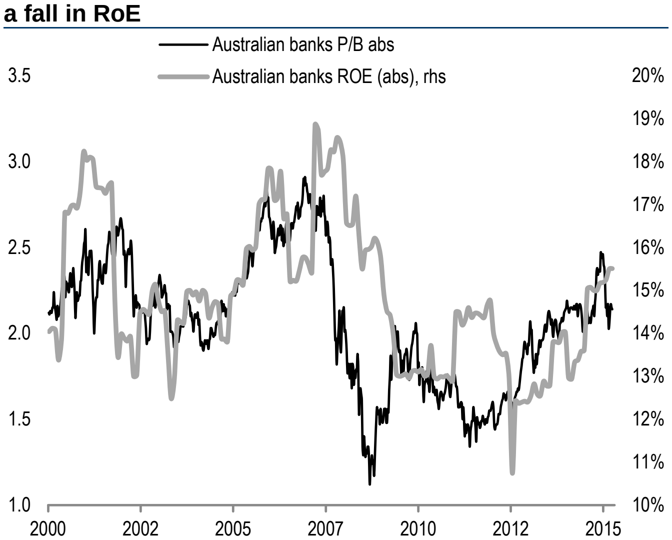
Source: Thomson Reuters, Credit Suisse research

Figure 161: **Australian banks' P/B is extended relative to the market**



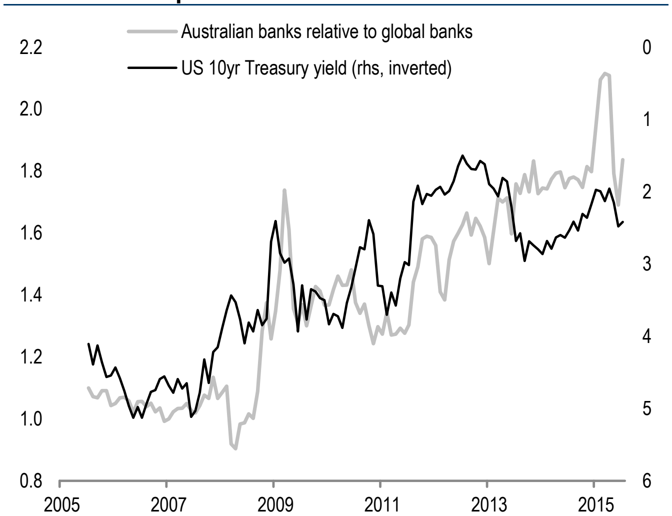
Source: Thomson Reuters, Credit Suisse research

Figure 162: **Australian banks' P/B is potentially pricing in a fall in RoE**



Source: Thomson Reuters, Credit Suisse research

Figure 163: **Rising US yields have tended to be negative for the relative performance of Australian banks**

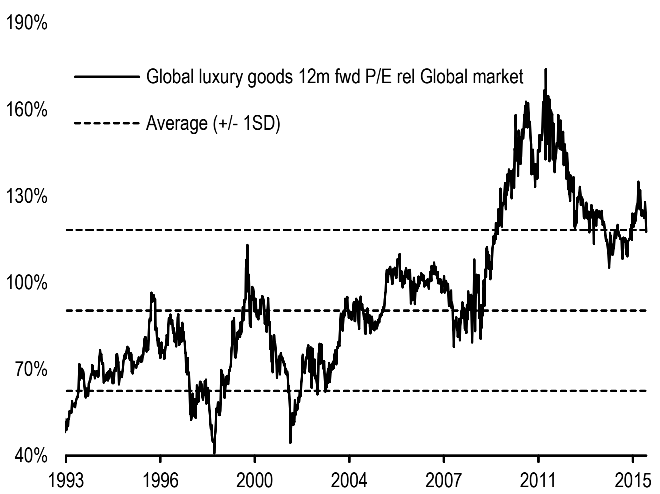


Source: Thomson Reuters, Credit Suisse research

Appendix

Appendix 1: Luxury goods

Figure 164: **Global luxury goods P/E relative to the market is 0.9 standard deviation above average**



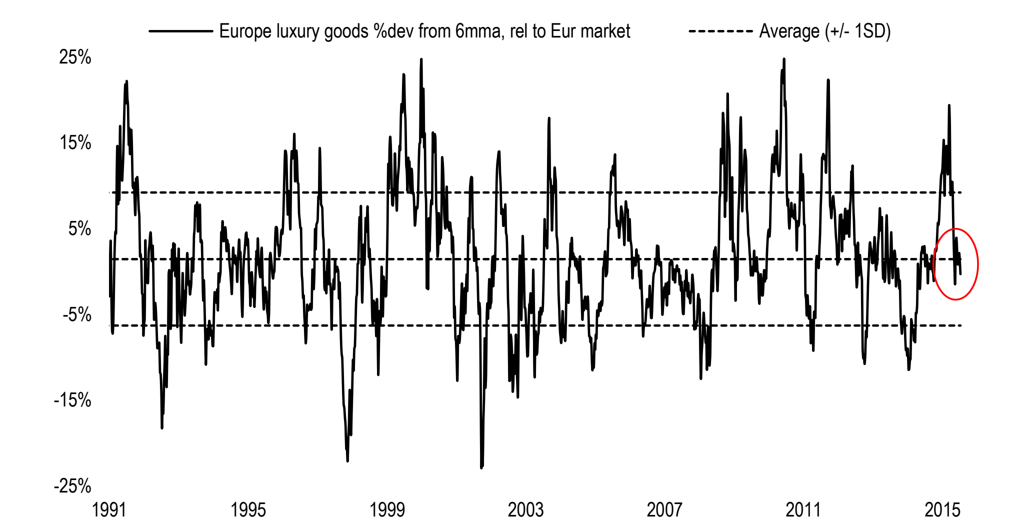
Source: Thomson Reuters, Credit Suisse research

Figure 165: **Global luxury goods P/B relative to the market is 1.2 standard deviation above average**

Source: Thomson Reuters, Credit Suisse research

Relative price momentum (i.e. percentage deviation from its 6-month moving average) is only neutral.

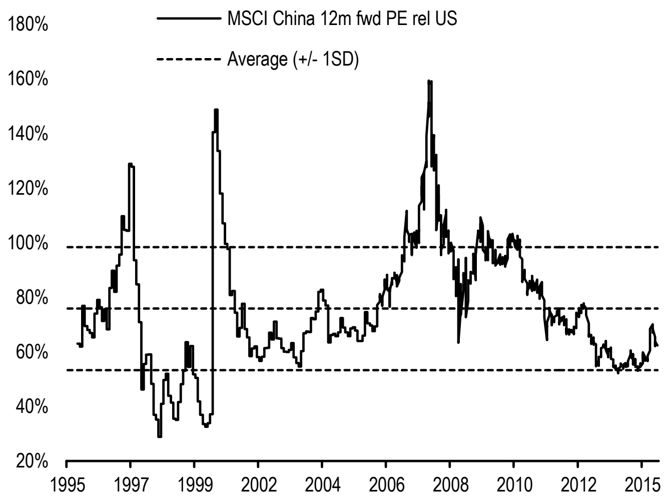
Figure 166: **European luxury goods price momentum is back to neutral**



Source: Thomson Reuters, Credit Suisse research

Appendix 2: China equities

Figure 167: MSCI China 12-month forward P/E relative to the US is c.0.5std below average



Source: Thomson Reuters, Credit Suisse research

Appendix 3: Sector weighting changes

Figure 168: Sector weightings table

	Over/underweighting score	Benchmark weight (a)	Recommended weight (b)	Difference from benchmark (bps) (b-a)	Change from previous (score)
Software & Services	1.50	1.7	2.4	80	
Commercial Services & Supplies	1.25	1.3	1.6	31	
Telecoms	1.20	4.9	5.9	92	
Media	1.20	2.7	3.2	50	
Banks	1.13	12.3	13.8	144	1
Hotels & Leisure	1.12	1.2	1.3	12	
Semiconductors & Semiconductor Equipment	1.10	0.9	1.0	8	
Pharmaceuticals & Biotechnology	1.08	12.7	13.6	86	
Transportation	1.06	1.5	1.6	7	
Insurance	1.05	6.0	6.3	23	
Automobiles & Components	1.02	3.4	3.5	3	-5
Capital goods	1.00	8.1	8.0		
Chemicals	1.00	4.0	3.9		
Utilities	1.00	3.9	3.8		
Household & Personal Products	1.00	3.3	3.3		
Metals & Mining	1.00	2.3	2.3	-3	1
Health Care Equipment & Services	1.00	1.3	1.3		
Food & Staples Retailing	1.00	1.2	1.2		
Technology Hardware & Equipment	1.00	0.9	0.9		
Construction Materials	1.00	0.8	0.8		
Pulp & paper	1.00	0.3	0.3		
Diversified Financials	0.90	3.5	3.1	-39	
Consumer Durables & Apparel	0.90	2.8	2.5	-31	
Beverages	0.85	3.4	2.9	-54	
Retailing	0.80	1.5	1.2	-32	
Real Estate	0.80	1.3	1.1	-28	
Energy	0.80	6.9	5.5	-149	
Food Products	0.74	3.9	2.9	-105	
Tobacco	0.65	1.8	1.2	-65	
Total		**100.0**	**100.0**		

Source: Thomson Reuters, Credit Suisse research

Companies Mentioned *(Price as of 13-Jul-2015)*

ABB (ABBN.VX, SFr19.76)
AIA Group (1299.HK, HK$50.55)
Alfa Laval (ALFA.ST, Skr146.9)
Anglo American Plc (AAL.L, 878.2p)
Antofagasta (ANTO.L, 667.0p)
Atlas Copco (ATCOa.ST, Skr233.4)
BASF (BASFn.DE, €83.1)
BHP Billiton (BHP.AX, A$26.41)
BMW (BMWG.DE, €94.97)
Boliden (BOL.ST, Skr159.5)
Burberry Group (BRBY.L, 1613.0p)
Bureau Veritas (BVI.PA, €20.78)
China Merchants Bank (3968.HK, HK$21.7)
China Mobile Limited (0941.HK, HK$95.75)
China Pacific (2601.HK, HK$34.25)
China Unicom Hong Kong Ltd (0762.HK, HK$11.46)
Cliffs Natural Resources (CLF.N, $3.52)
Compagnie Financiere Richemont SA (CFR.VX, SFr77.95)
Daimler (DAIGn.DE, €83.53)
Evergrande Real Estate Group Ltd (3333.HK, HK$4.56)
Exova (EXO.L, 166.0p)
Fiat Chrysler Automobile (FCHA.MI, €13.13)
Fortescue Metals Group Ltd (FMG.AX, A$1.72)
Geely Automobile Holdings Ltd (0175.HK, HK$3.71)
GlaxoSmithKline plc (GSK.L, 1386.5p)
Glencore (GLEN.L, 250.4p)
Hermes International (HRMS.PA, €339.2)
Hugo Boss (BOSSn.DE, €103.3)
Industrial & Commercial Bank of China (1398.HK, HK$5.78)
Intertek (ITRK.L, 2389.0p)
KAZ Minerals Plc (KAZ.L, 193.2p)
Kering (PRTP.PA, €164.85)
Kone Corporation (KNEBV.HE, €35.91)
Kumba Iron Ore (KIOJ.J, R119.82)
Kweichow Moutai Co., Ltd (600519.SS, Rmb257.75)
LVMH (LVMH.PA, €162.0)
Lanxess (LXSG.DE, €54.47)
PSA Peugeot Citroen (PEUP.PA, €18.42)
Philips (PHG.AS, €23.92)
Renault (RENA.PA, €91.91)
Rio Tinto (RIO.L, 2600.5p)
Rio Tinto (RIO.AX, A$51.53)
SGS Surveillance (SGSN.VX, SFr1735.0)
SKF (SKFb.ST, Skr190.3)
Salvatore Ferragamo SpA (SFER.MI, €26.41)
Sandvik (SAND.ST, Skr92.55)
Siemens (SIEGn.DE, €93.77)
Swatch Group (UHR.VX, SFr384.4)
Tate & Lyle (TATE.L, 516.0p)
Vale (VALE.N, $5.9)
Vedanta Resources PLC (VED.L, 447.6p)
Vestas (VWS.CO, Dkr368.1)
Volkswagen (VOWG_p.DE, €205.8)
Xinjiang Goldwind Science & Technology Co., Ltd. (2208.HK, HK$16.26)

Disclosure Appendix

Important Global Disclosures

The analysts identified in this report each certify, with respect to the companies or securities that the individual analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

The analyst(s) responsible for preparing this research report received Compensation that is based upon various factors including Credit Suisse's total revenues, a portion of which are generated by Credit Suisse's investment banking activities

As of December 10, 2012 Analysts' stock rating are defined as follows:

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

Neutral (N) : The stock's total return is expected to be in line with the relevant benchmark* over the next 12 months.

Underperform (U) : The stock's total return is expected to underperform the relevant benchmark* over the next 12 months.

**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.*

Restricted (R) : In certain circumstances, Credit Suisse policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.

Volatility Indicator [V] : A stock is defined as volatile if the stock price has moved up or down by 20% or more in a month in at least 8 of the past 24 months or the analyst expects significant volatility going forward.

Analysts' sector weightings are distinct from analysts' stock ratings and are based on the analyst's expectations for the fundamentals and/or valuation of the sector* relative to the group's historic fundamentals and/or valuation:

Overweight : The analyst's expectation for the sector's fundamentals and/or valuation is favorable over the next 12 months.

Market Weight : The analyst's expectation for the sector's fundamentals and/or valuation is neutral over the next 12 months.

Underweight : The analyst's expectation for the sector's fundamentals and/or valuation is cautious over the next 12 months.

**An analyst's coverage sector consists of all companies covered by the analyst within the relevant sector. An analyst may cover multiple sectors.*

Credit Suisse's distribution of stock ratings (and banking clients) is:

Global Ratings Distribution

Rating	Versus universe (%)	Of which banking clients (%)
Outperform/Buy*	49%	(27% banking clients)
Neutral/Hold*	36%	(44% banking clients)
Underperform/Sell*	13%	(38% banking clients)
Restricted	2%	

**For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.*

Credit Suisse's policy is to update research reports as it deems appropriate, based on developments with the subject company, the sector or the market that may have a material impact on the research views or opinions stated herein.

Credit Suisse's policy is only to publish investment research that is impartial, independent, clear, fair and not misleading. For more detail please refer to Credit Suisse's Policies for Managing Conflicts of Interest in connection with Investment Research: http://www.csfb.com/research-and-analytics/disclaimer/managing_conflicts_disclaimer.html

Credit Suisse does not provide any tax advice. Any statement herein regarding any US federal tax is not intended or written to be used, and cannot be used, by any taxpayer for the purposes of avoiding any penalties.

See the Companies Mentioned section for full company names

The subject company (SGSN.VX, VOWG_p.DE, BHP.AX, HRMS.PA, BRBY.L, GSK.L, BASFn.DE, 1299.HK, VALE.N, ALFA.ST, 1398.HK, TATE.L, 3333.HK, BVI.PA, CFR.VX, BMWG.DE, FMG.AX, GLEN.L, EXO.L, RIO.L, PRTP.PA, LVMH.PA, CLF.N, 3968.HK, FCHA.MI, VWS.CO) currently is, or was during the 12-month period preceding the date of distribution of this report, a client of Credit Suisse.

Credit Suisse provided investment banking services to the subject company (SGSN.VX, VOWG_p.DE, GSK.L, 1299.HK, VALE.N, 1398.HK, 3333.HK, BVI.PA, BMWG.DE, GLEN.L, EXO.L, RIO.L, CLF.N, 3968.HK, FCHA.MI) within the past 12 months.

Credit Suisse provided non-investment banking services to the subject company (1398.HK, RIO.L, 3968.HK) within the past 12 months

Credit Suisse has managed or co-managed a public offering of securities for the subject company (SGSN.VX, VOWG_p.DE, GSK.L, 1398.HK, 3333.HK, BMWG.DE, GLEN.L, EXO.L, CLF.N, 3968.HK, FCHA.MI) within the past 12 months.

Credit Suisse has received investment banking related compensation from the subject company (SGSN.VX, VOWG_p.DE, GSK.L, 1299.HK, VALE.N, 1398.HK, 3333.HK, BVI.PA, BMWG.DE, GLEN.L, EXO.L, RIO.L, CLF.N, 3968.HK, FCHA.MI) within the past 12 months

Credit Suisse expects to receive or intends to seek investment banking related compensation from the subject company (SGSN.VX, VOWG_p.DE, BHP.AX, BRBY.L, GSK.L, BASFn.DE, 1299.HK, VALE.N, 0762.HK, ALFA.ST, 1398.HK, TATE.L, 600519.SS, 0175.HK, 3333.HK, BVI.PA, BMWG.DE, FMG.AX, GLEN.L, EXO.L, RIO.L, PRTP.PA, LVMH.PA, CLF.N, 3968.HK, FCHA.MI, VWS.CO, ANTO.L) within the next 3 months.

Credit Suisse has received compensation for products and services other than investment banking services from the subject company (1398.HK, RIO.L, 3968.HK) within the past 12 months

As of the end of the preceding month, Credit Suisse beneficially own 1% or more of a class of common equity securities of (SGSN.VX, BRBY.L, BASFn.DE, LXSG.DE, ITRK.L, 1398.HK, TATE.L, CFR.VX, 2601.HK, BOSSn.DE, 3968.HK, KAZ.L, BOL.ST).

Credit Suisse has a material conflict of interest with the subject company (SGSN.VX) . Credit Suisse AG is acting as an agent in relation to the company's announced share buy-back program.

Credit Suisse has a material conflict of interest with the subject company (1299.HK) . Jack So (IB in HK) is an Independent Non-Exec Director of AIA (previously was a Non-Executive Director).

Credit Suisse has a material conflict of interest with the subject company (RIO.AX) . Credit Suisse is acting as advisor to Imerys on the proposed acquisition of the Luzenac Talc Group from Rio Tinto.

For other important disclosures concerning companies featured in this report, including price charts, please visit the website at https://rave.credit-suisse.com/disclosures or call +1 (877) 291-2683.

Important Regional Disclosures

Singapore recipients should contact Credit Suisse AG, Singapore Branch for any matters arising from this research report.

The analyst(s) involved in the preparation of this report have not visited the material operations of the subject company (2208.HK, UHR.VX, SGSN.VX, VOWG_p.DE, PEUP.PA, 0941.HK, BHP.AX, HRMS.PA, BRBY.L, SKFb.ST, GSK.L, BASFn.DE, 1299.HK, LXSG.DE, VALE.N, 0762.HK, KIOJ.J, ALFA.ST, ITRK.L, 1398.HK, RENA.PA, TATE.L, 600519.SS, KNEBV.HE, 0175.HK, 3333.HK, BVI.PA, CFR.VX, 2601.HK, SAND.ST, ATCOa.ST, BMWG.DE, FMG.AX, BOSSn.DE, GLEN.L, EXO.L, SFER.MI, RIO.L, PRTP.PA, LVMH.PA, CLF.N, DAIGn.DE, 3968.HK, FCHA.MI, VWS.CO, RIO.AX, ANTO.L, KAZ.L, BOL.ST, VED.L, AAL.L) within the past 12 months

Restrictions on certain Canadian securities are indicated by the following abbreviations: NVS--Non-Voting shares; RVS--Restricted Voting Shares; SVS--Subordinate Voting Shares.

Individuals receiving this report from a Canadian investment dealer that is not affiliated with Credit Suisse should be advised that this report may not contain regulatory disclosures the non-affiliated Canadian investment dealer would be required to make if this were its own report.

For Credit Suisse Securities (Canada), Inc.'s policies and procedures regarding the dissemination of equity research, please visit https://www.credit-suisse.com/sites/disclaimers-ib/en/canada-research-policy.html.

Credit Suisse Securities (Europe) Limited (Credit Suisse) acts as broker to (EXO.L, RIO.L).

The following disclosed European company/ies have estimates that comply with IFRS: (SGSN.VX, VOWG_p.DE, PEUP.PA, SKFb.ST, BASFn.DE, LXSG.DE, ALFA.ST, ITRK.L, RENA.PA, TATE.L, SAND.ST, ATCOa.ST, BMWG.DE, BOSSn.DE, RIO.L, PRTP.PA, DAIGn.DE, FCHA.MI, RIO.AX, ANTO.L, KAZ.L, VED.L, AAL.L).

Credit Suisse has acted as lead manager or syndicate member in a public offering of securities for the subject company (SGSN.VX, VOWG_p.DE, GSK.L, BASFn.DE, 1299.HK, 1398.HK, 3333.HK, BVI.PA, 2601.HK, BMWG.DE, GLEN.L, EXO.L, RIO.L, CLF.N, 3968.HK, FCHA.MI, RIO.AX, AAL.L) within the past 3 years.

As of the end of the preceding month, Credit Suisse beneficially owned the following percentages of the voting rights of the subject companies: 1.0% or more of UHR.VX

As of the date of this report, Credit Suisse acts as a market maker or liquidity provider in the equities securities that are the subject of this report.

Principal is not guaranteed in the case of equities because equity prices are variable.

Commission is the commission rate or the amount agreed with a customer when setting up an account or at any time after that.

To the extent this is a report authored in whole or in part by a non-U.S. analyst and is made available in the U.S., the following are important disclosures regarding any non-U.S. analyst contributors: The non-U.S. research analysts listed below (if any) are not registered/qualified as research analysts with FINRA. The non-U.S. research analysts listed below may not be associated persons of CSSU and therefore may not be subject to the NASD Rule 2711 and NYSE Rule 472 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

Credit Suisse Securities (Europe) Limited Andrew Garthwaite ; Marina Pronina ; Robert Griffiths ; Yiagos Alexopoulos ; Nicolas Wylenzek ; Alex Hymers

Important MSCI Disclosures

The MSCI sourced information is the exclusive property of Morgan Stanley Capital International Inc. (MSCI). Without prior written permission of MSCI, this information and any other MSCI intellectual property may not be reproduced, re-disseminated or used to create and financial products, including any indices. This information is provided on an "as is" basis. The user assumes the entire risk of any use made of this information. MSCI, its affiliates and any third party involved in, or related to, computing or compiling the information hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. MSCI, Morgan Stanley Capital International and the MSCI indexes are services marks of MSCI and its affiliates.

The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of Morgan Stanley Capital International Inc. and Standard & Poor's. GICS is a service mark of MSCI and S&P and has been licensed for use by Credit Suisse.

Important Credit Suisse HOLT Disclosures

With respect to the analysis in this report based on the Credit Suisse HOLT methodology, Credit Suisse certifies that (1) the views expressed in this report accurately reflect the Credit Suisse HOLT methodology and (2) no part of the Firm's compensation was, is, or will be directly related to the specific views disclosed in this report.

The Credit Suisse HOLT methodology does not assign ratings to a security. It is an analytical tool that involves use of a set of proprietary quantitative algorithms and warranted value calculations, collectively called the Credit Suisse HOLT valuation model, that are consistently applied to all the companies included in its database. Third-party data (including consensus earnings estimates) are systematically translated into a number of default algorithms available in the Credit Suisse HOLT valuation model. The source financial statement, pricing, and earnings data provided by outside data vendors are subject to quality control and may also be adjusted to more closely measure the underlying economics of firm performance. The adjustments provide consistency when analyzing a single company across time, or analyzing multiple companies across industries or national borders. The default scenario that is produced by the Credit Suisse HOLT valuation model establishes the baseline valuation for a security, and a user then may adjust the default variables to produce alternative scenarios, any of which could occur.

Additional information about the Credit Suisse HOLT methodology is available on request.

The Credit Suisse HOLT methodology does not assign a price target to a security. The default scenario that is produced by the Credit Suisse HOLT valuation model establishes a warranted price for a security, and as the third-party data are updated, the warranted price may also change. The default variable may also be adjusted to produce alternative warranted prices, any of which could occur.

CFROI®, HOLT, HOLTfolio, ValueSearch, AggreGator, Signal Flag and "Powered by HOLT" are trademarks or service marks or registered trademarks or registered service marks of Credit Suisse or its affiliates in the United States and other countries. HOLT is a corporate performance and valuation advisory service of Credit Suisse.

For Credit Suisse disclosure information on other companies mentioned in this report, please visit the website at https://rave.credit-suisse.com/disclosures or call +1 (877) 291-2683.

References in this report to Credit Suisse include all of the subsidiaries and affiliates of Credit Suisse operating under its investment banking division. For more information on our structure, please use the following link: https://www.credit-suisse.com/who_we_are/en/ This report may contain material that is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Credit Suisse AG or its affiliates ("CS") to any registration or licensing requirement within such jurisdiction. All material presented in this report, unless specifically indicated otherwise, is under copyright to CS. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of CS. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of CS or its affiliates. The information, tools and material presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. CS may not have taken any steps to ensure that the securities referred to in this report are suitable for any particular investor. CS will not treat recipients of this report as its customers by virtue of their receiving this report. The investments and services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about such investments or investment services. Nothing in this report constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. CS does not advise on the tax consequences of investments and you are advised to contact an independent tax adviser. Please note in particular that the bases and levels of taxation may change. Information and opinions presented in this report have been obtained or derived from sources believed by CS to be reliable, but CS makes no representation as to their accuracy or completeness. CS accepts no liability for loss arising from the use of the material presented in this report, except that this exclusion of liability does not apply to the extent that such liability arises under specific statutes or regulations applicable to CS. This report is not to be relied upon in substitution for the exercise of independent judgment. CS may have issued, and may in the future issue, other communications that are inconsistent with, and reach different conclusions from, the information presented in this report. Those communications reflect the different assumptions, views and analytical methods of the analysts who prepared them and CS is under no obligation to ensure that such other communications are brought to the attention of any recipient of this report. Some investments referred to in this report will be offered solely by a single entity and in the case of some investments solely by CS, or an associate of CS or CS may be the only market maker in such investments. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this report reflect a judgment at its original date of publication by CS and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as well as rise. The value of securities and financial instruments is subject to exchange rate fluctuation that may have a positive or adverse effect on the price or income of such securities or financial instruments. Investors in securities such as ADR's, the values of which are influenced by currency volatility, effectively assume this risk. Structured securities are complex instruments, typically involve a high degree of risk and are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. The market value of any structured security may be affected by changes in economic, financial and political factors (including, but not limited to, spot and forward interest and exchange rates), time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Any investor interested in purchasing a structured product should conduct their own investigation and analysis of the product and consult with their own professional advisers as to the risks involved in making such a purchase. Some investments discussed in this report may have a high level of volatility. High volatility investments may experience sudden and large falls in their value causing losses when that investment is realised. Those losses may equal your original investment. Indeed, in the case of some investments the potential losses may exceed the amount of initial investment and, in such circumstances, you may be required to pay more money to support those losses. Income yields from investments may fluctuate and, in consequence, initial capital paid to make the investment may be used as part of that income yield. Some investments may not be readily realisable and it may be difficult to sell or realise those investments, similarly it may prove difficult for you to obtain reliable information about the value, or risks, to which such an investment is exposed. This report may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the report refers to website material of CS, CS has not reviewed any such site and takes no responsibility for the content contained therein. Such address or hyperlink (including addresses or hyperlinks to CS's own website material) is provided solely for your convenience and information and the content of any such website does not in any way form part of this document. Accessing such website or following such link through this report or CS's website shall be at your own risk. This report is issued and distributed in Europe (except Switzerland) by Credit Suisse Securities (Europe) Limited, One Cabot Square, London E14 4QJ, England, which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This report is being distributed in Germany by Credit Suisse Securities (Europe) Limited Niederlassung Frankfurt am Main regulated by the Bundesanstalt fuer Finanzdienstleistungsaufsicht ("BaFin"). This report is being distributed in the United States and Canada by Credit Suisse Securities (USA) LLC; in Switzerland by Credit Suisse AG; in Brazil by Banco de Investimentos Credit Suisse (Brasil) S.A or its affiliates; in Mexico by Banco Credit Suisse (México), S.A. (transactions related to the securities mentioned in this report will only be effected in compliance with applicable regulation); in Japan by Credit Suisse Securities (Japan) Limited, Financial Instruments Firm, Director-General of Kanto Local Finance Bureau (*Kinsho*) No. 66, a member of Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association; elsewhere in Asia/ Pacific by whichever of the following is the appropriately authorised entity in the relevant jurisdiction: Credit Suisse (Hong Kong) Limited, Credit Suisse Equities (Australia) Limited, Credit Suisse Securities (Thailand) Limited, regulated by the Office of the Securities and Exchange Commission, Thailand, having registered address at 990 Abdulrahim Place, 27th Floor, Unit 2701, Rama IV Road, Silom, Bangrak, Bangkok 10500, Thailand, Tel. +66 2614 6000, Credit Suisse Securities (Malaysia) Sdn Bhd, Credit Suisse AG, Singapore Branch, Credit Suisse Securities (India) Private Limited (CIN no. U67120MH1996PTC104392) regulated by the Securities and Exchange Board of India (registration Nos. INB230970637; INF230970637; INB010970631; INF010970631), having registered address at 9th Floor, Ceejay House, Dr.A.B. Road, Worli, Mumbai - 18, India, T- +91-22 6777 3777, Credit Suisse Securities (Europe) Limited, Seoul Branch, Credit Suisse AG, Taipei Securities Branch, PT Credit Suisse Securities Indonesia, Credit Suisse Securities (Philippines) Inc., and elsewhere in the world by the relevant authorised affiliate of the above. Research on Taiwanese securities produced by Credit Suisse AG, Taipei Securities Branch has been prepared by a registered Senior Business Person. Research provided to residents of Malaysia is authorised by the Head of Research for Credit Suisse Securities (Malaysia) Sdn Bhd, to whom they should direct any queries on +603 2723 2020. This report has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (each as defined under the Financial Advisers Regulations) only, and is also distributed by Credit Suisse AG, Singapore branch to overseas investors (as defined under the Financial Advisers Regulations). By virtue of your status as an institutional investor, accredited investor, expert investor or overseas investor, Credit Suisse AG, Singapore branch is exempted from complying with certain compliance requirements under the Financial Advisers Act, Chapter 110 of Singapore (the "FAA"), the Financial Advisers Regulations and the relevant Notices and Guidelines issued thereunder, in respect of any financial advisory service which Credit Suisse AG, Singapore branch may provide to you. This information is being distributed by Credit Suisse AG, Dubai Branch, duly licensed and regulated by the Dubai Financial Services Authority (DFSA), and is directed at Professional Clients or Market Counterparties only, as defined by the DFSA. The financial products or financial services to which the information relates will only be made available to a client who meets the regulatory criteria to be a Professional Client or Market Counterparty only, as defined by the DFSA, and is not intended for any other person. This research may not conform to Canadian disclosure requirements. In jurisdictions where CS is not already registered or licensed to trade in securities, transactions will only be effected in accordance with applicable securities legislation, which will vary from jurisdiction to jurisdiction and may require that the trade be made in accordance with applicable exemptions from registration or licensing requirements. Non-U.S. customers wishing to effect a transaction should contact a CS entity in their local jurisdiction unless governing law permits otherwise. U.S. customers wishing to effect a transaction should do so only by contacting a representative at Credit Suisse Securities (USA) LLC in the U.S. Please note that this research was originally prepared and issued by CS for distribution to their market professional and institutional investor customers. Recipients who are not market professional or institutional investor customers of CS should seek the advice of their independent financial advisor prior to taking any investment decision based on this report or for any necessary explanation of its contents. This research may relate to investments or services of a person outside of the UK or to other matters which are not authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority or in respect of which the protections of the Prudential Regulation Authority and Financial Conduct Authority for private customers and/or the UK compensation scheme may not be available, and further details as to where this may be the case are available upon request in respect of this report. CS may provide various services to US municipal entities or obligated persons ("municipalities"), including suggesting individual transactions or trades and entering into such transactions. Any services CS provides to municipalities are not viewed as "advice" within the meaning of Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. CS is providing any such services and related information solely on an arm's length basis and not as an advisor or fiduciary to the municipality. In connection with the provision of the any such services, there is no agreement, direct or indirect, between any municipality (including the officials, management, employees or agents thereof) and CS for CS to provide advice to the municipality. Municipalities should consult with their financial, accounting and legal advisors regarding any such services provided by CS. In addition, CS is not acting for direct or indirect compensation to solicit the municipality on behalf of an unaffiliated broker, dealer, municipal securities dealer, municipal advisor, or investment adviser for the purpose of obtaining or retaining an engagement by the municipality for or in connection with Municipal Financial Products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of the municipality. If this report is being distributed by a financial institution other than Credit Suisse AG, or its affiliates, that financial institution is solely responsible for distribution. Clients of that institution should contact that institution to effect a transaction in the securities mentioned in this report or require further information. This report does not constitute investment advice by Credit Suisse to the clients of the distributing financial institution, and neither Credit Suisse AG, its affiliates, and their respective officers, directors and employees accept any liability whatsoever for any direct or consequential loss arising from their use of this report or its content. Principal is not guaranteed. Commission is the commission rate or the amount agreed with a customer when setting up an account or at any time after that.

Investment principal on bonds can be eroded depending on sale price or market price. In addition, there are bonds on which investment principal can be eroded due to changes in redemption amounts. Care is required when investing in such instruments.

When you purchase non-listed Japanese fixed income securities (Japanese government bonds, Japanese municipal bonds, Japanese government guaranteed bonds, Japanese corporate bonds) from CS as a seller, you will be requested to pay the purchase price only.