Switching into a higher gear
Month in Review

Trump wins presidency, defeats Clinton in historic election upset
Bloomberg, 5-Nov-2016

Final Polls Show Renzi's Referendum Heading for Defeat in Italy
Bloomberg, 18-Nov-2016

Wall Street extends record streak, Dow breaks 19,000 for first time
Reuters, 22-Nov-2016

Best Trump Rally Bets: Deregulation Trades in Financials, Small Caps
ValueWalk, 23-Nov-2016

TSY/Bund Spread Widest in 26 Years
Market Pulse, 17-Nov-2016

The Market Is Betting Trump Will Bring Higher Inflation and Interest Rates

Market Perceives December Rate Hike As A Done Deal
The Huffington Post, 21-Nov-2016

U.K.: Not Leading the Fiscal Charge
WSJ, 23-Nov-2016

Japan eyes only modest spending rise, diverging from Trump's promise of stimulus
Reuters, 25-Nov-2016

Investors Make Bullish Bet on Trump, and an Era of Tax Cuts and Spending
NY Times, 21-Nov-2016

Angela Merkel to stand for fourth term as chancellor in 2017
theguardian, 20-Nov-2016

'Trader Tantrum' Sparks Biggest Ever Emerging Market Bond Outflows As Dollar Soars
Zerohedge, 22-Nov-2016

Bank of Japan Reacts Strongly to Surging Bond Yields
ETF Daily News, 17-Nov-2016

Dollar Hits 13-Year High
WSJ, 16-Nov-2016

Francois Fillon set for face-off with Marine Le Pen after winning French presidential primaries
The Telegraph, 27-Nov-2016

Euro's Sharp Drop Fuels Speculation Over Dollar Parity
WSJ, 18-Nov-2016

More stimulus rumored after China replaces finance chief
The China Post, 28-Nov-2016

Bank stocks have gotten pricey, thanks to the Trump rally
Business Insider, 23-Nov-2016

ECB to keep stimulus tap running as bond-buying program likely to be extended, Draghi says
Financial Post, 21-Nov-2016

Greece wants to conclude EU/IMF review but cannot accept 'irrational' demands – Tsipras
Cyprus Mail, 23-Nov-2016

Deutsche Bank Research
thehouseview@list.db.com     http://houseview.research.db.com
The House View – 29 November 2016
Trump’s win may have opened a new chapter for the US. The shift toward a more balanced mix of easy monetary and fiscal policy and looser regulation is expected to jumpstart the economy, ending years of low growth and inflation. Faster US growth would also have positive spillovers to the rest of the world.

Risks remain that some of these growth-friendly policies are not implemented or have unexpected effects. But the biggest threat to growth is a possible protectionist turn, which would further depress already anaemic global trade.

Any political spillover in Europe would also be negative. The first risk event is Italy’s Senate referendum on 4-December. Polls suggest the vote will fail, and if it does, PM Renzi will likely resign. The sell-off in Italian assets indicates that this outcome is being priced, but as long as immediate elections and a eurosceptic government are possible, market stress can build further. Elections in the Netherlands, France and Germany next year will ensure that political risk remains a source of volatility.

In the coming weeks we will see the last ECB and Fed decisions of 2016. In Europe, taper talk is premature, and we expect a six month extension of QE. In the US, a rate hike in December is all but a done deal.

Markets have so far focused on the positives of Trump’s policies, with the dollar strengthening, rates selling off and equities rising, reaching all-time highs in the US. Several of these trends should continue in the coming months: the rates sell-off has some further room to run and the dollar should strengthen further, with the euro reaching parity next year and further weakness expected in sterling and yen.

David Folkerts-Landau, Group Chief Economist
More bullish on US outlook following Trump win. But European politics remain a key potential headwind in year ahead

Economic outlook

- Much more bullish on US growth following Trump win. Marked up forecasts for 2017 (2.3%), with acceleration coming mostly in H2, and 2018 (3.5%).
- Eurozone growth to remain subdued. Faster US helps but with lag. Headwinds from credit, Brexit, politics to keep growth muted in 2017 (1.1%) and 2018 (1.4%).
- EM outlook also subdued. Expect pick-up in LatAm, CEEMEA, but spillover from US initially likely negative.

Central bank watch

- ECB: expect 6 month QE extension in December. Too early for ECB to taper, given core inflation still low.
- BoJ: easing bias. Limited rate cuts possible. Monetary base expansion likely to slow.
- BoE: neutral stance, with risks slightly skewed to easing – but further rate cut no longer our baseline.
- PBoC: return to easing with rate cut in H1-2017.
- EM: generally on hold, with few exceptions (e.g., tightening in Turkey).

Key downside risks to our view

- Political risk escalation, banking stress in Europe that derails recovery – Italy a key risk.
- China hard landing: sharp contraction that drags down global growth, possibly due to deflating property bubble.
- Deglobalisation: rise of anti-trade policies exacerbates already anaemic global trade and sharply slows growth.

Notes: H / M / L indicates estimated probability of risk (High, Medium, Low).
(*) Sharp deceleration in growth, e.g., growth falling below 5%.
(**) Non-performing loans.
Trump’s election has been the key driver for markets – leading to dollar and DM equities rally, and core rates and EM sell-off

2016 YTD and since US election on 8-November

Note: (*) Total return accounts for both income (interest or dividends) and capital appreciation. (**) FX, Commodities are spot returns.

Source: Bloomberg Finance LP, Deutsche Bank Research. As of 28 November 2016
Donald Trump’s unexpected election in the US has triggered a reassessment of the US and global macro outlook

- Past the election surprise, the focus has shifted to the macroeconomic implications of Trump’s policies
- This has triggered a positive reassessment of the US and global macro outlook
- The view centres on the expectation of a shift toward a more balanced policy mix
  - Monetary policy “only game in town” post-crisis – ultra easy monetary policy compensated for tight fiscal policy, tight regulation, lack of reform
  - Fiscal stimulus, regulatory easing welcome at a time when monetary easing seen as exhausted
- The US is the first to take this step
  - Only major country planning material fiscal easing (infrastructure spending, tax cuts)
- Similar response elsewhere unlikely for now, but the pendulum is shifting in this direction
  - UK: only marginal relaxation of austerity, but new fiscal flexibility rules and corporate tax cuts
  - EU: likely to use flexible approach toward existing fiscal rules
  - China: some fiscal easing likely in 2017

Policy mix: Trump’s fiscal plan to be the first shift toward a more balanced policy mix

<table>
<thead>
<tr>
<th>Monetary policy</th>
<th>Fiscal policy</th>
<th>Financial regulation</th>
<th>Structural reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ultra easy, has compensated for tightness elsewhere</td>
<td>Large stimulus planned</td>
<td>Possible easing</td>
<td>Prospects unclear</td>
</tr>
</tbody>
</table>

More relevant in Europe

Trump proposes a material increase in the fiscal deficit

Fiscal balance, % of GDP

Source: CBO, CRFB, Haver Analytics, Deutsche Bank Research. Note: deficit projection under Trump assumes growth and tax revenues will follow the CBO's estimates. We expect both series to outperform these estimates. As a result, the change in the deficit is likely to be less drastic than shown above.
This reassessment of the outlook brings about the expectation of higher inflation as growth accelerates

- The reassessment of the macro outlook is based on the expectation of the start of a regime shift
  - Normalisation away from years of low growth, low inflation and low interest rates
- The US election reinforced a process that started earlier, underpinned by green shoots in inflation...
  - US inflation on a broad uptrend, with further upside risk from fiscal stimulus
  - European inflation stable at low level, but expected to rise, albeit slowly
- ...as well as signals from central banks that the policy stance was shifting away from lower rates
  - ECB, BoJ acknowledged limits of more rate cuts
  - Fed eager to resume rate hikes
    ...Likely gradual through 2017 but faster pace expected in 2018
- There remain risks to this assessment
  - Much depends on the success of Trump's administration to sustainably lift US growth

US core inflation is grinding steadily upward; Eurozone inflation is low but expected to rise, albeit slowly

The increase in long-term inflation expectations accelerated after the US election
The main reason to be optimistic about US growth is a material fiscal stimulus package that should help lift business spending

- A unified Republican government increases the chances that Trump will deliver his pro-growth plan
  - Lower income, capital gains and corporate taxes
  - Rollback of business regulations
  - Increase in defense and infrastructure spending
- As a result, we have raised our real GDP growth forecasts to 2.3% in 2017 and 3.5% in 2018 (from 1.7% and 1.9% respectively)
  - Peak impact expected in H2 2017 and H1 2018
- A key driver will be increase in business spending
  - Scope for substantial acceleration as capex has been very weak in this cycle
  - Increase in capital stock would help stabilise or reverse the downtrend in productivity growth
  - Consumption to improve more modestly as there is little pent-up consumer demand
- Labor gains to improve, with unemployment rate possibly dropping to 4% by 2018 (from 4.9% now)
- Inflation to remain contained in near-term by dollar strength due to improved growth prospects
But not all of Trump’s programme is positive. The success will depend on what gets implemented – and uncertainty here is high.

### Overview of Trump’s policies

<table>
<thead>
<tr>
<th>Policy area</th>
<th>Proposal</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal deficit</td>
<td>▪ Substantial stimulus, of around 2-3% of GDP</td>
<td>▪ Potential game changer for growth</td>
</tr>
<tr>
<td></td>
<td>▪ Infrastructure and tax cuts, financed via deficit</td>
<td>▪ Higher deficits risk raising debt to GDP – but acceptable if growth does accelerate</td>
</tr>
<tr>
<td></td>
<td>▪ Corporate: slash tax rate*, one-off offer to repatriate foreign profits at 10%, move from worldwide to territorial tax</td>
<td>▪ Congress could water it down</td>
</tr>
<tr>
<td></td>
<td>▪ Personal: cut top rate, repeal estate tax</td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td>▪ Reduce regulatory burden, repeal parts of Dodd-Frank</td>
<td>▪ Ease credit supply constraints, helping support growth</td>
</tr>
<tr>
<td>Finance</td>
<td>▪ Critical of QE / low interest rates policy, supports Fed audit</td>
<td>▪ Challenges to Fed independence would be negative</td>
</tr>
<tr>
<td></td>
<td>▪ Chair Yellen likely to be replaced in 2018</td>
<td></td>
</tr>
<tr>
<td>Fed</td>
<td>▪ Protectionist stance: introduce tariffs / duties</td>
<td>▪ Material blow to globalisation</td>
</tr>
<tr>
<td></td>
<td>▪ Tough on China: 45% tariffs, label as FX manipulator</td>
<td>▪ Major threat for global economy</td>
</tr>
<tr>
<td>Foreign policy</td>
<td>▪ Renegotiate NAFTA, reject TPP, unlikely to support T-TIP**</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ Isolationist stance</td>
<td>▪ Challenge to US-led liberal world order that has prevailed for last 70 years</td>
</tr>
<tr>
<td></td>
<td>▪ Swing toward Russia, criticism of NATO, China</td>
<td></td>
</tr>
<tr>
<td>Trade</td>
<td>▪ Tough stance on immigration: build Mexico wall, end birthright citizenship</td>
<td>▪ Very negative at face value, though likely to be watered down</td>
</tr>
<tr>
<td>Immigration</td>
<td>▪ Repeal Obamacare</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ Minimum wage determined at state / local level</td>
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<tr>
<td></td>
<td>▪ Scale back climate change regulation</td>
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</tr>
</tbody>
</table>

Note: (*) From 35% to 15%; (**) Trans Pacific Partnership and Transatlantic Trade and Investment Partnership; (#) High frequency trading
Major concerns include the threat of protectionism, the potential drag from a strong dollar on the US economy, and EM

1. Threat of protectionism

- Trump vowed to protect US jobs by erecting trade barriers, shifting from US' long-standing free-trade stance
- Position is negative for global trade
- Question is how strongly US embraces protectionism
  - Pledged withdrawal from TPP, tweaks to NAFTA manageable
  - More extreme action, e.g., WTO withdrawal or attacking China as currency manipulator, could be very negative

2. Impact of strong $ on US economy

- Stronger dollar reflects expectations of higher growth, inflation, rates – this is positive
- But there is concern that a strong dollar could weigh on US economy
  - Negative for trade, investment, manufacturing, corporate profits
  - Balancing forces should prevent excessive dollar appreciation
  - Dollar strength depends on Fed hikes, which depend on inflation and strength of economy

3. Impact on EM

- Stronger US growth positive for EM – but only with a lag. Barriers to trade diminish the positive spillover
- But negative impact of stronger dollar and higher rates is immediate
  - Effect on external debt service, creditworthiness, external accounts, risk assessment – and supply and demand of credit
- EM to suffer over next few quarters

Anti-trade tone appeals to Republican base

Impact of strong dollar

Impact on EM

Note: % saying “free trade has been a good thing for the US”
Source: Pew Research, Deutsche Bank Research

Note: Credit to private non-financial sector.
Source: BIS, Bloomberg Finance LP, Deutsche Bank Research

Hold the exuberance – 18-Nov-2016
Threats to trade come at a time when the world economy may be entering a period of deglobalisation

- The several decade-long rise of globalisation could be in retreat
  - Trade’s share of global GDP has peaked
  - Capital mobility has declined
  - Tariffs have risen and could rise further
- Undercurrent of anti-globalisation sentiment at centre of this trend
  - Evidenced in Brexit, Trump’s victory, rising support of eurosceptic parties in Europe
- Deglobalisation could have significant implications for global macro if it continues
  - Smaller trade imbalances, flows of capital and FDI
  - Dollar funding will become more constrained / expensive
  - Slower productivity growth and higher inflation with reduced specialisation

**World trade share of global GDP has peaked; do not take globalisation for granted**

```
% of GDP


WWI starts

WWI ends

2016 est.
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Source: Deutsche Bank Research

**Non-tariff impediments to trade have been on the rise**

```
% of products


Trade barriers

Anti-dumping

Countervailing duties (rhs)
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Source: IMF WEO Oct-2016, Deutsche Bank Research

**Falling support for openness since early 2000s, and generally lower in the US**

```
%: Growing trade and business ties are a good thing…


US

Other country median
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Source: Pew, Deutsche Bank Research

**Number of new free trade agreements has been in decline**

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Number of free trade agreements signed

1980 1990 2000 2010

Source: WTO, IMF WEO Oct-2016, Deutsche Bank Research
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**Deglobalisation is here; what it means for global macro – 16-Nov-2016**

Another risk is political spillover in Europe – first and foremost in Italy

- Italy’s referendum on 4-Dec next political risk event
  - Senate reform intended to improve governability
  - Vote now partly about PM Renzi
- Opinion polls point to a No vote – negative as seen leading to new election, risk of 5SM# government
- While possible, this is only a tail risk
- A new interim government tasked with modifying electoral law before new elections is most likely
- While positive short-term, it poses medium term risk
  - Likely to lead to ineffectual governments, very limited reform progress
  - Low growth, bank concerns to remain
  - Italy to continue to underperform, boosting eurosceptic sentiment over time
- Immediate reaction to No vote likely negative as market reassesses risk of early election
  - Could lead to market pressure on Italian banks – any escalation could become systemic
  - Italian authorities will need to act swiftly and decisively if this is to be avoided

Note: Thicker lines denote most likely path. For a comprehensive analysis of the referendum see Italy’s referendum and beyond: a cross market view – 11-Nov-2016. (*) Proposal to narrow Senate role in favour of Lower House, reducing chance of political gridlock. (#) Eurosceptic Five Star Movement party
Beyond Italy, Trump’s win could further embolden nationalism in Europe – but current polls suggest the risk is relatively contained

1. Brexit uncertainty
   Polls suggest a 2017 election would give the government a much larger majority

- High Court ruling weakened government hand vs. Parliament
  - Still expect Art. 50 trigger in Q1-2017, Brexit vote to be honoured
- Early election in 2017 more likely
  - Government to gain stronger majority, more room for manoeuvre in EU negotiations
- Chances of interim deal before end-deal is agreed have risen

2. French elections (Apr/May-2017)
   Opinion polls suggest a Le Pen win next year is unlikely, but need to be taken with caution

- Concern of eurosceptic, far right government in France is rising
  - Le Pen unlikely to win presidency according to current polls...
  - All likely second round contenders would beat her
  - Hollande an exception, but unlikely to make it to run-off
- ...Yet outcome can’t be dismissed
  - Anti-immigration, protectionist narrative underpinned Brexit and Trump surprises

3. German elections (likely Sep-2017)
   Popularity of major parties has declined since 2013 election – another Grand Coalition likely

- Merkel will seek a fourth term
- Major parts of Merkel’s party favour coalition with Greens – but unclear if feasible
- Thus, another, but weaker, Grand Coalition appears likely
  - Coalition partners overall lost support vs. 2013 election result
- Regardless of exact composition of next coalition, looser fiscal policy is unlikely

In addition, Austria, Netherlands elections also carry risk of populist / eurosceptic governments
Stronger US growth should help eurozone growth prospects, but downside risks continue to dominate the outlook

- Eurozone growth remains slow but resilient at 1.2-1.5% despite recurring shocks
  - Upside to our forecast for Q4-2016
  - Growth expected to moderate to 1.1% in 2017
- A stronger US outlook should help eurozone growth but with limited impact in 2017
  - US is second most important destination for eurozone exports, behind the UK
  - US acceleration likely in H2-2017, but 1-2 quarter lag before this is felt in Europe
- But downside risks continue to dominate

Source: Eurostat, Deutsche Bank Research

- Packed calendar keeps political risk high
  - Uncertainty will weigh on growth, especially by deterring business spending
  - Risk of spillovers from Brexit, US election
- Softer domestic demand on weaker credit impulse
  - Though lending incentives could improve with better global growth, steeper curves
- Financial conditions becoming less supportive as rising rates outweighing euro depreciation
- More longer-term, structural issues of high debt, low growth, low competitiveness remain unresolved

Source: Deutsche Bank Research

Eurozone financial conditions drifting tighter

Focus Europe: Economic growth and financial conditions – 18-Nov-2016
In China, the US election poses downside risks to trade and growth, raising odds of policy easing in 2017

- Recent data suggest China growth remains stable, helped by a credit-fuelled property sector boom
- But growth should slow as government continues to tighten credit and property market regulations to avoid a crisis
  - Growth expected to fall modestly to 6.5% in 2017 and further to 6% in 2018
- In response to slower growth, monetary and fiscal policies should once again ease in Q2-2017

- US election could impact China’s prospects
  - Potential for negative trade effect from disputes and possible tariffs
  - Higher odds of looser policy in 2017: rate cut, more fiscal stimulus to offset risk of softer trade
  - Looser policy raises risk of higher inflation, asset bubble, and eventual sharper growth slowdown
  - Likely more focus on enhancing global influence
- CNY weakness is not over: USDCNY to rise above 8 by end-2018, as outflow pressures persist

China property sector set to cool as credit growth slows and restrictions tightened

The Chinese fiscal deficit ratio generally saw sizeable expansion during previous ext crisis

Government debt: Chinese government still has ample room in fiscal capacity
Markets have clearly focused on the positive aspects of the US election, with equities soaring and core rates selling off.

DM equities have rallied, while EM equities have sold off.

US move led by cyclicals and sectors related to deregulation and infrastructure plans.

EM funds have witnessed record outflows in response to rising dollar and US rates.

US long-end yields have reached new highs for the year, as has the yield curve slope.

US credit spreads have continued their post-Brexit tightening.

DM equities have rallied, while EM equities have sold off.

Cumulative % change since 8 Nov

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<tr>
<td>US S&amp;P 500</td>
<td>EuroStoxx 600</td>
<td>MSCI EM</td>
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<tr>
<td>4%</td>
<td>2%</td>
<td>0%</td>
<td>-2%</td>
<td>-4%</td>
<td>-6%</td>
<td>-8%</td>
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Source: Bloomberg Finance LP, Deutsche Bank Research

…Contributing to a renewed bout of dollar appreciation…

% change vs. USD since 8-Nov

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<tr>
<td>Dollar index</td>
<td>GBP</td>
<td>CNY</td>
<td>EM FX</td>
<td>EUR</td>
<td>JPY</td>
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<tr>
<td>5.4%</td>
<td>0.3%</td>
<td>-1.8%</td>
<td>-3.2%</td>
<td>-3.7%</td>
<td>-6.3%</td>
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Source: Bloomberg Finance LP, Deutsche Bank Research

EM funds have witnessed record outflows in response to rising dollar and US rates.

% of AUM

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<tr>
<td>EM weekly flows</td>
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</tr>
<tr>
<td>2.0%</td>
<td>1.5%</td>
<td>1.0%</td>
<td>0.5%</td>
<td>0.0%</td>
<td>-0.5%</td>
<td>-1.0%</td>
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Source: EPFR, Deutsche Bank Research

EM funds have witnessed record outflows in response to rising dollar and US rates.

% change vs. USD since 8-Nov

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<td>-6.3%</td>
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Source: Bloomberg Finance LP, Deutsche Bank Research

US credit spreads have continued their post-Brexit tightening.

Cash credit spreads, bps

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<tr>
<td>USD HY</td>
<td>USD IG, rhs</td>
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<tr>
<td>650</td>
<td>600</td>
<td>550</td>
<td>500</td>
<td>450</td>
<td>400</td>
<td>350</td>
</tr>
</tbody>
</table>

Source: Bloomberg Finance LP, Deutsche Bank Research
## Summary of market views

<table>
<thead>
<tr>
<th>Asset</th>
<th>View</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Markets</td>
<td>Positive on US</td>
<td>Pro-growth policies and accommodative Fed to support US risk assets</td>
</tr>
<tr>
<td></td>
<td>Cautious on Europe and EM</td>
<td>Caution on Europe due to tepid fundamentals and political event risk</td>
</tr>
<tr>
<td></td>
<td></td>
<td>EM concerns due to outflows driven by increase in DM yields</td>
</tr>
<tr>
<td>Equities</td>
<td>Bullish US</td>
<td>US: equities at all-time highs, rally can extend further on expected tax cuts. Rotation into cyclicals</td>
</tr>
<tr>
<td></td>
<td>Europe: no upside into year-end</td>
<td>Europe: cautious given macro, political risk, possible bank stress and weakness in oil due to dollar appreciation</td>
</tr>
<tr>
<td>Rates</td>
<td>US: modest scope for further sell-off</td>
<td>US long-end rates have increased largely due to repricing of risk premium</td>
</tr>
<tr>
<td></td>
<td>Europe: Bund yields to rise due to inflation</td>
<td>Rates to continue to rise through mid-2017</td>
</tr>
<tr>
<td>FX</td>
<td>Bullish dollar</td>
<td>“Perfect storm” for dollar strength given likely fiscal stimulus, Fed rate hikes, ECB and BoJ QE, and supportive risk-asset cycle</td>
</tr>
<tr>
<td></td>
<td>Bearish euro</td>
<td>Euro close to breaking below long-standing range, to reach parity in 2017</td>
</tr>
<tr>
<td></td>
<td>Bearish sterling</td>
<td>Markets to re-focus on hard Brexit risks, weak sterling fundamentals</td>
</tr>
<tr>
<td></td>
<td>Bearish yen vs. USD</td>
<td>Forecasts revised due to sharp rise in US rates</td>
</tr>
<tr>
<td>Credit</td>
<td>Wider spreads in the US and Europe</td>
<td>Despite recent tightening, higher rates to push IG spreads wider; HY less so</td>
</tr>
<tr>
<td></td>
<td></td>
<td>IG and HY spreads to widen moderately in 2017, with elevated intra-year volatility due to policy uncertainty and political risk</td>
</tr>
<tr>
<td>EM</td>
<td>Pressure to continue</td>
<td>EM vulnerable to dollar strength due to substantial dollar-denominated debt</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Higher US rates have caused reversal of recent inflows</td>
</tr>
<tr>
<td></td>
<td></td>
<td>However, fundamentals stronger than they were during 2013 taper tantrum</td>
</tr>
</tbody>
</table>
Fed is set to raise rates in December; upside risk to rate expectations in coming years if Trump’s election brings faster growth

- With data supportive and financial conditions holding up well post-election, the Fed is expected to raise rates by 25bp at its December meeting
  - Supported by Fed commentary, including Yellen’s
  - Market now about fully pricing it
- Beyond the rates decision, focus will be on if the Fed’s forecasts react to the election surprise
  - Only modest changes likely as Fed waits for more clarity on fiscal policy outlook
  - Directionally, would expect higher growth, inflation and rates, and lower unemployment
- Upside risk to Fed’s expectations for rate hikes in coming years if growth picks up materially…
  - Fed expects only two rate hikes in 2017 and three in 2018
  - Faster inflation, lower unemployment, higher neutral rate could all warrant more increases
- …But risk unlikely to materialise before H2-2017
  - Inflation could moderate early in 2017
  - It will take time for fiscal, regulatory policies to pass and the economic impact to materialise
The ECB, meanwhile, is expected to announce a six-month QE extension at its 8-December meeting, amid a cautious outlook

- The ECB maintains an easing bias given a cautious view on the eurozone inflation outlook
  - Downside risks to growth remain (e.g., softening credit impulse, political uncertainty, rising oil)
  - Insufficient evidence that core inflation (0.8% yoy) will rise sustainably toward target
  - As Draghi noted, improvements to date (and expected) rely on ultra easy monetary policy

- No further cuts to the deposit rate expected
  - ECB has little urgency to weaken euro, especially given decline since the US election
  - Further cuts would hurt banks and potentially damage bank lending channel

- Instead, we expect a QE extension on 8-December
  - 6-month extension from 2017 March expected
  - A longer extension appears inappropriate at this stage given resilient macro data

- A combination of changes to QE parameters to deal with bond scarcity issues is also likely
  - Yield floor removal, issue limit increase most likely; capital keys change cannot be ruled out

---

**Downside risks to ECB’s inflation outlook remain, suggesting caution is appropriate**

<table>
<thead>
<tr>
<th>%yoy</th>
<th>Long-run average: 1.6%</th>
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<tr>
<td>Jan-16</td>
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<td>May-16</td>
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<td>Sep-16</td>
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</tr>
<tr>
<td>May-17</td>
<td>1.6</td>
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</table>

- Headline HICP
- DB forecast

Source: Haver Analytics, Deutsche Bank Research

**Bond scarcity remains an issue despite recent bond sell-off, with large share of bonds still trading below deposit rate floor**

Note: percent of debt trading below the deposit rate (~40bp) as of 28-Nov

Source: Bloomberg Finance LP, Deutsche Bank Research
Dollar strength due to fiscal stimulus to weigh on euro, yen and sterling; EUR/USD remains on track to reach parity next year

- “Perfect storm” for dollar strength
  - Large fiscal stimulus could accelerate Fed tightening given limited excess capacity
  - QE in Europe and Japan continues to drive demand for dollar-denominated assets
  - Risk-asset cycle supportive of fiscal stimulus
- EUR/USD should break below 1.05-1.15 range that held since early 2015, to reach parity next year
  - Forecasts unchanged but risks to the downside

- Given US policy changes and reversal of the Abe market rally, we are now bearish yen vs. dollar
  - Risk is yen reaches end-2017 forecast sooner
- Despite gains since High Court Article 50 judgment, we remain bearish sterling versus dollar and euro
  - Market to re-focus on hard Brexit without fiscal stimulus and negative current account dynamics
- US and European politics and US policy cycle to keep FX volatility elevated

### Latest DB FX forecasts

<table>
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<tr>
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<th>Spot</th>
<th>Year-end 2017</th>
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<td>EUR/GBP</td>
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Source: Deutsche Bank Research
Note: Spot as of 24th Nov close

### Euro trading near bottom of long-standing range, to reach parity in 2017

Source: Bloomberg Finance LP, Deutsche Bank Research

### We are now bearish yen vs. dollar given the increase in US yields

Source: Bloomberg Finance LP, Deutsche Bank Research
Change in growth, policy outlook has allowed US and Eurozone rates to reprice higher; sell-off to continue through 2017

- US long-end yields have increased sharply post election, e.g., 10Y yield up about 50 bps
  - Large rise in term premium: risk premium in long rates relative to expectations of short rates
  - Inflation and Fed rate hike expectations also up, but to lesser extent
- Foreign flows due to dollar strength and QE by ECB and BoJ limit magnitude of sell-off
  - 10Y yield to increase to 2.5% around mid-2017 and then return near current level by year-end

The increase in US long-end yields has been driven by normalization of term premium, which plummeted earlier this year

- Positive data momentum has been supportive of the repricing of European rates since the summer
  - Eurozone PMIs consistent with above-potential growth and thus improved core inflation
  - Oil price base effects to lift inflation expectations
  - 10Y yield up about 45bps since post-Brexit low, to rise further in 2017
- Sell-off possibly too fast (but not too far): there is a case for tactical risk reduction ahead of key events
  - E.g., Italian referendum, ECB meeting

The increase in US long-end yields has been driven by normalization of term premium, which plummeted earlier this year

In Europe, price components of surveys imply further upside to core inflation

Source: FRBNY, Haver Analytics, Deutsche Bank Research
Note: (*) The 10-year yield troughed for the year on 8 July.

Source: Deutsche Bank Research
Pressure on EM assets will continue, but expect improvement in coming quarters given stronger fundamentals vs. taper tantrum

1. EM are vulnerable to a sharp rise in the dollar, US rates...
   E.g., Fundamentals: EM corporates face a wall of (hard currency debt) maturities in the coming years

2. ...But fundamentals are stronger vs. 2013 taper tantrum
   Deutsche Bank aggregate macro vulnerability index shows significant reduction in EM vulnerability since 2013

E.g., Technicals: EM benefited from sustained inflows in the last several months, and we are starting to see a reversal

Bar a few exceptions, FX reserves cover is higher than in 2013

Note: Gross reserves used for Turkey. Source: Deutsche Bank Research
DB forecasts

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<th>GDP growth (%)</th>
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<td>US 10Y yield (%)</td>
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<td>EUR 10Y yield (%)</td>
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<td>Stoxx 600</td>
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<td>Oil WTI (USD/bbl)</td>
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<td>Oil Brent (USD/bbl)</td>
<td>48.1</td>
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* CPI (%) forecasts are period averages

CEEMEA: Czech Rep., Israel, Egypt, Hungary, Kazakhstan, Nigeria, Poland, Romania, Russia, Saudi Arabia, South Africa, Turkey, UAE and Ukraine

LATAM: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela

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DM: Australia, Canada, Denmark, Eurozone, Japan, New Zealand, Norway, Sweden, Switzerland, UK, US

Source: Deutsche Bank Research

Deutsche Bank Research thehouseview@list.db.com http://houseview.research.db.com

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