Taking a step back

25 July 2017
Month in Review

Yellen indicates that Fed may not need to hike rates much more
CNBC, July 12, 2017

China’s economy beats outlook, grows 6.9% in Q2
Market Watch, July 16, 2017

US inflation decline is too persistent to ignore
FT, July 16, 2017

Hawkish Central Bankers Spark a Debate About the End of Easy Money
Bloomberg, July 06, 2017

Bank of Canada joins the Fed in hiking interest rates
ForexPromos, July 14, 2017

ECB Tapering Decision May Take Until October
Bloomberg, July 21, 2017

Euro hits nearly two-year high after Draghi comments; dollar tumbles
Market Watch, July 20, 2017

Wall Street at new highs as tech breaches dot-com era record
CNBC, July 12, 2017

Low Vol Leads To Big EM Inflows
Value Walk, June 26, 2017

Health Care Overhaul Collapses as Two Republican Senators Defect
NYT, June 26, 2017

France wants hardest Brexit, says City envoy to EU
FT, July 16, 2017

UK Brexit bill talks hit impasse
FT, July 19, 2017

An OPEC Country Breaks Ranks and Increases Oil Output
Bloomberg, July 18, 2017

IMF says global recovery on firmer footing
Daily Mail, July 23, 2017
The House View, 25 July 2017
Taking a step back

As markets enter into the summer lull, it is useful to take a step back. The global economy is in better shape than it has been in several years. This has allowed other central banks to follow the Fed and gradually start their exit journey, a process that is a historic challenge given the unprecedented level of monetary accommodation. But with inflation still below target, a key part of the normalisation puzzle is still missing.

Although labour market tightness has not yet fed to wages, and hence to inflation, we expect it will. Core inflation should move higher over the medium-term in the US and Europe, supporting further monetary tightening and a normalisation of yield curves. While no policy change is expected by the Fed on 26-July, an announcement to begin phasing out its balance sheet reinvestment is likely in September and we expect another rate hike in December. As for the ECB, rate hikes are still far off, and we expect the central bank to announce another QE extension and tapering in October.

Our global macro outlook is little changed this year. We expect growth to rebound from the slowest pace post-crisis in 2016, though relative to consensus we are more positive on the US and more bearish on Japan. In China, we continue to expect a gradual deceleration, but see upside risks to growth in the second half of the year.

We are generally constructive on risk assets, expecting material upside to US equities in the next 18 months and positive but more balanced performance in EM. There are signs the dollar has peaked, but we do not expect a material devaluation yet. We are more positive on the euro, seeing upside versus the dollar and sterling. We expect yield curves to normalise gradually, but there is risk of a more sudden upward shift, depending on the path of core inflation.

David Folkerts-Landau, Group Chief Economist
Synchronised global growth, but stubbornly low inflation is helping to keep central bank hawkishness in check

**Economic outlook**
- Global growth to rise to 3.6% in 2017 (from 3.1%) and pick up further to 3.7% in 2018. Most synchronised growth environment in last six years
- US economy to accelerate: forecast 2.5% growth on average in 2017-18. Limited fiscal stimulus expected; risk of recession remains low
- Eurozone above-trend growth to continue: 1.9% in 2017, 1.6% in 2018. Reduction in political risk supports growth; euro strength not expected to weigh materially
- EM: growth to pickup to 4.7% in 2017, 4.9% in 2018. China growth beat expectations; upside risk in H2-17

**Central bank watch**
- Fed: announcement on balance sheet policy in September; next rate hike in December, 3 more in 2018
- ECB: slowly progressing toward exit. Next move QE extension at slower pace, announced by year-end
- BoJ: no change expected in target short rate or yield curve control policy for much of this year
- BoE: expect to stay on hold; risk of a one-off rate hike over next 12 months but not the start of a hiking cycle
- PBoC: baseline is no benchmark interest rate hike in 2017-18 but chance of one in 2018 rising
- EM: low inflation allows EM to continue easing (most of LatAm, parts of EMEA) or wait before tightening (Asia)

**Key downside risks to our view**
- Low inflation signals deeper growth issues
- Trump disappointment: policies tilted to negatives, under-delivery vs. expectations, US growth doesn’t rise
- China financial instability: property bubble deflates; rising dollar, DM yields put pressure on outflows, RMB
- Political risk escalation in Europe derails recovery – Italy remains the key flash point
- De-globalisation: rise of anti-trade policies exacerbates anaemic global trade and sharply slows growth

Notes: H / M / L indicates estimated probability of risk (High, Medium, Low).
Strong performance for risk assets continues. ECB’s more hawkish tone impacting eurozone assets

Returns* per asset class in 2017

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 COB, 26 June 2017


Unwind of Trump foreign policy trades
Weighed down by stronger euro since Draghi’s Sintra speech
Performance supported by weaker pound
Strong performance this year: resilient to recent rise in rates
Sell-off in European rates following Draghi’s Sintra speech
Sterling supported by more hawkish BoE – but still weaker vs. euro
Signs of dollar top forming
Sharp drop in oil mostly a supply story. But prices stabilising
The global economy is in a better place than it has been in several years

Global economy is in a better place

Global growth
- World economy escaping 5 year low-to-no growth period
- Growth to rebound after bottoming in 2016 to slowest pace post-crisis

Broad-baseduptick
- Growth broad-based globally
- Most synchronised growth in last 6 years

Economic slack
- Economic slack falling
- Employment gap, output gap closing across major DM economies

Political risk
- Political event risk materially diminished
- Brexit and to a lesser extent Italy the notable exceptions

Global growth hasn’t been as synchronised globally for many years

Note: Diffusion index calculated as % of Composite PMIs above 50 (based on 8-18 countries)
Source: Haver Analytics, Markit, Deutsche Bank Research

Major developed economies have closed / are closing output gaps

Note: (*) The output gap is a measure of slack in an economy: it is the difference between output and potential output. A negative gap means the economy produces less than potential.
Source: Haver Analytics, OECD, Deutsche Bank Research
This has allowed central banks to start their exit process from ultra easy monetary policy

- The policy mix post-crisis saw monetary policy as “only game in town”, compensating for tight fiscal policy, tight (financial) regulation, lack of reform
- This unbalanced policy mix became exhausted
  - Declining marginal benefit of monetary easing
  - Calls for fiscal easing to counter rising inequality
  - Peak in regulatory tightening
- 2016 was a pivotal year for central banks’ stance
  - BoJ first to recognise negative side effects of aggressive monetary easing – yield curve control* introduced de-facto taper of QE
  - ECB followed with QE taper and other measures
  - Fed hiked rates three times since Dec-2016
  - In Jul-2017, Bank of Canada first G10 central bank to hike after the Fed
- The direction of travel is clearly a shift toward a tightening of monetary policy, albeit a gradual one
- The other policy levers are also likely to turn
  - Risk is for some form of fiscal easing, loosening of financial regulation

"As the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can [adjust policy] – not in order to tighten the policy stance, but to keep it broadly unchanged."
ECB President Mario Draghi, 27-Jun-2017

"Provided the data are still on track, I do think that beginning the process of withdrawing some of the incremental stimulus provided last August would be prudent moving into the second half of the year."
BoE Chief Economist Andy Haldane, 21-Jun-2017

"[T]he current outlook warrants today’s withdrawal of some of the monetary policy stimulus in the economy. Future adjustments to the target for the overnight rate will be guided by incoming data (…)."
BoE Chief Economist Andy Haldane, 21-Jun-2017

Policy mix becoming more balanced

<table>
<thead>
<tr>
<th>Policy mix</th>
<th>Post-crisis</th>
<th>Shift</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary policy</td>
<td>● ●</td>
<td>○ ●</td>
<td>Shift toward gradual tightening</td>
</tr>
<tr>
<td>Fiscal policy</td>
<td>● ●</td>
<td>○ ●</td>
<td>Risk of some fiscal easing</td>
</tr>
<tr>
<td>Financial regulation</td>
<td>● ●</td>
<td>○ ●</td>
<td>Past peak tightening</td>
</tr>
<tr>
<td>Structural reform</td>
<td>● ●</td>
<td>?</td>
<td>Some upside risk in France</td>
</tr>
</tbody>
</table>

Note: (*) BoJ introduced YCC in Sep-2016. By targeting a 10-yield level, BoJ introduced flexibility in the amounts of QE purchases
The Fed, ECB and to a lesser extent BoE are now on an exit path

<table>
<thead>
<tr>
<th></th>
<th>Federal Reserve</th>
<th>European Central Bank</th>
<th>Bank of England</th>
<th>Bank of Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macro backdrop</strong></td>
<td>Strong macro backdrop, growth above trend</td>
<td>Strong macro backdrop, growth above trend</td>
<td>Economy slowing – FX-led real income shock weigts on growth</td>
<td>Economy slowing down into 2018</td>
</tr>
<tr>
<td></td>
<td>At full employment, output gap nearly closed</td>
<td>Employment gap, output gap closing steadily</td>
<td>Close to full employment</td>
<td>Inflation low and well below target</td>
</tr>
<tr>
<td><strong>Key challenge</strong></td>
<td>Falling inflation weakens case for faster pace of hikes</td>
<td>Euro strength</td>
<td>Conflicting goals: higher inflation, weak sterling warrant higher rates, but this threatens growth</td>
<td>Inflation not rising despite massive BoJ stimulus</td>
</tr>
<tr>
<td></td>
<td>Market reluctant to price Fed rate hike guidance</td>
<td>Inflation rise not yet self-sustaining</td>
<td>Impact of Brexit talks</td>
<td>Counter-cyclical nature of Yield Curve Control*</td>
</tr>
<tr>
<td><strong>Policy stance</strong></td>
<td>Committed to gradual exit – burden of proof for deviating from plan is high</td>
<td>Slow and gradual exit</td>
<td>On hold despite more hawkish rhetoric in recent months</td>
<td>On hold, talk of exit not justified at present</td>
</tr>
<tr>
<td></td>
<td>As economy improves, view current policy as increasingly easy</td>
<td></td>
<td></td>
<td>Dovish turn in board as two members terms end</td>
</tr>
<tr>
<td><strong>What we expect</strong></td>
<td>Sep-17: announcement of tapering of balance sheet reinvestments</td>
<td>Oct-17: 6-month QE extension, at €40bn/mth</td>
<td>Base case is no policy move through end-2018</td>
<td>BoJ not under pressure for urgent action</td>
</tr>
<tr>
<td></td>
<td>Dec-17: rate hike</td>
<td>Mid-18: deposit rate hike</td>
<td>Risk of a one-off 25bp hike in next 6-12 months – but not a start of a hiking cycle</td>
<td>No change expected in target short rate or YCC in 2017</td>
</tr>
<tr>
<td></td>
<td>2018: three hikes</td>
<td>H2-18: likely QE extension at lower pace</td>
<td>Mid-19: start of hikes</td>
<td></td>
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<td></td>
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</tr>
</tbody>
</table>

Note: (*) BoJ introduced YCC in Sep-2016. Rather than maintaining a commitment to a JPY amount of QE purchases, the BoJ started targeting a 10-year yield around zero. The policy has a countercyclical nature: the more inflation normalises and yields rise, the more bonds the BoJ will purchase, thus easing when not needed; the opposite also holds true.
We need to remember that the policy normalisation process is a historic challenge given how accommodative monetary policy is

- Monetary policy easing since the crisis is the largest and longest monetary expansion in modern history
  - Policy rates cut to all-time lows
  - Central bank balance sheets bloated by QE – all-time high assets of USD15tn for main DM CBs
  - ECB, BoJ continuing with their QE purchases for the foreseeable future
  - Constitutes unprecedented monetary policy experiment

- The normalisation process itself will also be an unprecedented monetary policy experiment
  - No template in history for the scope of unwinding that needs to take place
  - Policy remains far from normal, even as the macro normalisation is well underway and in some cases almost complete

Central banks are sitting on trillions of dollars of assets accumulated since the crisis – with the ECB and BoJ continuing to add

In the US policy remains far from normal even as unemployment and inflation are very close to the Fed’s targets

Note: zero means at target and normal policy
Source: Haver Analytics, Deutsche Bank Research
The missing link has been inflation

- Inflation still below target in major DMs despite stronger macro backdrop
  - US core inflation slowed recently, ~0.5pp below target
  - Eurozone core inflation higher but still below target
  - Japan core inflation falling
- Persistent inflation shortfall is:
  - Leading to a down drift in inflation expectations
  - Raising questions about link between inflation, slack
  - Challenging central bank credibility to deliver inflation
- Medium-term inflation view largely unchanged: core inflation should move sustainably higher
  - Uptrend to continue in Europe
  - Most likely in 2018 in US
  - Labour market tightness will feed into wages and inflation
The current regime of low inflation and inflation expectations in the US has interesting parallels to the 1960s and 80s

- Today’s low inflation regime despite low unemployment has interesting historical parallels
- Similar to 1980s: oil price plunge contributed to low inflation expectations and “pricing out” of high inflation risk
- Similar to first half of 1960s: core inflation stuck below 2% despite unemployment near 4%
- Some unique aspects led to inflation surge in second half of 60s
  - Large jump in fiscal spending
  - Medicare, Medicaid introduction boosted medical inflation
  - Fed did not tighten enough
- For current episode, suggests:
  - Should not expect replay of magnitude of 60s surge
  - But higher realized inflation and low unemployment could lift inflation expectations

Similar oil price plunge in mid-1980s

![Graph showing oil price plunge in mid-1980s](source: EIA/CME, Haver Analytics, Deutsche Bank Research)

Risk of high inflation outcomes was priced out (e.g., consumer inflation expectations)

![Graph showing high inflation outcomes](source: UMICH, Haver Analytics, Deutsche Bank Research)

Fiscal spending jumped ahead of inflation in 1960s

![Graph showing fiscal spending growth](source: OMB, BLS, Haver Analytics, Deutsche Bank Research)
We have a positive macro outlook, and expect a rebound in global growth from the slowest pace since the crisis in 2016.

<table>
<thead>
<tr>
<th>Country</th>
<th>Big picture</th>
<th>Rationale</th>
</tr>
</thead>
</table>
| US | More bullish than consensus | ▪ Stronger growth led by capex on deregulation, elevated business confidence, better global momentum  
▪ Only limited fiscal stimulus expected. Significant tax cuts or spending increases an upside risk  
▪ But growth will remain low by historic standards |
| Eurozone | Positive outlook | ▪ Highest growth in years. Above-trend pace to continue  
▪ Reduction in political risk supports growth  
▪ Euro strength not to weigh materially  
▪ Growth uptick remains cyclical, raising questions as to how long it can last |
| UK | Growth to slow down | ▪ Consumption to suffer from drop in consumers’ real disposable income – high inflation, subdued wage growth, high leverage  
▪ Brexit uncertainty to weigh on business spend  
▪ Weaker sterling not feeding through to exports |
| China | Upside risks this year | ▪ Big picture, gradual growth slowdown continues  
▪ But export recovery has propped up growth recently – see upside risks into year-end  
▪ High level of debt the key concern |
| EM | Benign macro backdrop | ▪ Growth revised up marginally, especially in Asia  
▪ Momentum eased somewhat but still strong; robust DM growth a positive pull factor  
▪ Vulnerabilities pose localised not systemic risks |

Real GDP growth* (%yoy)

<table>
<thead>
<tr>
<th>Country</th>
<th>2016</th>
<th>2017-18</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>3.7</td>
<td>4.8</td>
</tr>
<tr>
<td>EM</td>
<td>2.0</td>
<td>4.8</td>
</tr>
<tr>
<td>DM</td>
<td>2.5</td>
<td>4.8</td>
</tr>
<tr>
<td>US</td>
<td>1.4</td>
<td>2.5</td>
</tr>
<tr>
<td>UK</td>
<td>1.7</td>
<td>2.0</td>
</tr>
<tr>
<td>Germany</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.7</td>
<td>2.0</td>
</tr>
<tr>
<td>France</td>
<td>1.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Italy</td>
<td>1.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Japan</td>
<td>1.0</td>
<td>2.0</td>
</tr>
<tr>
<td>India</td>
<td>6.5</td>
<td>6.5</td>
</tr>
<tr>
<td>China</td>
<td>1.4</td>
<td>6.5</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.8</td>
<td>6.5</td>
</tr>
<tr>
<td>Russia</td>
<td>1.8</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Note: Arrows denote change from 2016 to 2017-18 average
Source: Deutsche Bank Research
In China, growth has been better than expected and we see upside risk in the second half of the year

- China is in a phase of managed deceleration as the economy rebalances away from investment, exports
  - Services accounts for more than 50% of GDP, from under 40% back in 2000
- Amid this gradual slowdown, growth remained stronger than expected in the first half of the year
- In the second half there are 2 main risks to watch...
  - Slowdown in property and land markets
  - Over-tightening of financial regulation
- ...But on both these fronts, we have a positive view, and see upside risk to our growth forecasts
  - Property sales and new housing starts both rebounded strongly in June
  - A new Committee for Financial Stability and Development will support economic growth
- Big picture, high and rising debt levels are the main concern – but authorities are trying to address this
  - Issue particularly at state-owned enterprises and local governments
  - Credit growth remains higher than GDP growth, but at a lower rate than in 2016
With the notable exception of Brexit, political risk is now greatly diminished in Europe

- 2017 was to be a year fraught with political risk especially in Europe
- At the half-year mark, our base case of political risk not escalating is playing out
  - Underperformance of right-wing eurosceptics in France and Netherlands
  - Most market-friendly outcome to French elections
  - Latent risk but no disruption in Italy, Spain
- While political risk events remain in H2-2017, the same pattern of no escalation should prevail
- UK and Brexit negotiations the key exception, though expected
- Concern over Italy likely to rise toward year-end and into 2018

2017 European political calendar

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2017 European political calendar

- Netherlands general election
  - Right-wing, eurosceptic PVV party underperformed vs. expectations
  - Government formation ongoing
- France elections
  - Most market-friendly result
  - President Macron has absolute Parliament majority
  - Positive outlook for reform in France, for EU / eurozone
- UK early election
  - Increased political uncertainty
  - Brexit outcome now more binary: higher risk of "crash Brexit", but also higher risk of more benign "softer Brexit"
- Germany federal election
  - Next government coalition at stake
  - Little overall risk, limited to fine tuning of domestic policy
- Austria election
  - Right-wing FPO losing ground in polls since end-2016
  - Likely to finish 2nd or 3rd largest but may join coalition with mainstream parties
- Italy election
  - Political uncertainty to continue
  - Collapse of electoral reform means 2017 election is unlikely
  - Eurosceptic government in 2018 possible but unlikely

Note: (*) Eurosceptic Five Star Movement underperformed in most recent elections
### Summary of market views

<table>
<thead>
<tr>
<th>Asset class</th>
<th>View</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>Constructive US equities</td>
<td>Material upside over next 18 months, supported by double-digit earnings growth and synchronised global growth</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rising rates to encourage asset rotation from fixed income to equities</td>
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<tr>
<td></td>
<td>Europe vulnerable to turn in surprises</td>
<td>European equities have been supported by strong macro momentum</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Slumping macro data surprises could weigh, favour defensives over cycicals</td>
</tr>
<tr>
<td>Rates</td>
<td>Strategically bearish</td>
<td>Exit from easy monetary policy means rates should rise</td>
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<td></td>
<td></td>
<td>Normalisation process has had several false starts – stronger evidence of rising inflation needed for a decisive leg up in rates</td>
</tr>
<tr>
<td>FX</td>
<td>Dollar topping out</td>
<td>Dollar top may be forming in this mature bull cycle</td>
</tr>
<tr>
<td></td>
<td></td>
<td>But sharp devaluation unlikely</td>
</tr>
<tr>
<td></td>
<td>More positive on euro</td>
<td>Euro broke top of 2.5-year range of 1.05-1.15; expect move to 1.20 in 2018</td>
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<tr>
<td></td>
<td></td>
<td>Strength driven by better eurozone fundamentals. See move up vs. sterling</td>
</tr>
<tr>
<td>Credit</td>
<td>Constructive Europe</td>
<td>Performance more positive than expected but valuations stretched</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Risks weighted to downside but remain neutral, happy to earn carry for now</td>
</tr>
<tr>
<td></td>
<td>US HY resilient</td>
<td>Impressive performance as spreads tighten in a rising rate environment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Technicals weak however, with sizeable fund outflows in recent weeks</td>
</tr>
<tr>
<td>EM</td>
<td>Positive but more balanced</td>
<td>Strong EM performance in H1 to be followed by positive but more balanced performance in H2. Economic momentum easing but still stronger than DM</td>
</tr>
<tr>
<td>Commodities</td>
<td>Oil prices stabilising</td>
<td>Although global inventory remains high, demand growth is strong and US rig count may have reached a plateau in response to prices</td>
</tr>
<tr>
<td></td>
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<td>OPEC will begin monitoring exports as well as production</td>
</tr>
</tbody>
</table>
We remain constructive on US equities and see material upside over the next 18 months, on rapid earnings growth

- We remain constructive US equities and see material upside over the next 18 months
- Several factors will continue to support equities
  - Most synchronised global growth in 6 years, and expect it to strengthen further
  - Double-digit earnings growth in 2017-18
  - Stable valuations
  - Low risk of recession for the next year
- Contrary to common belief, rising rates are positive
  - Low rates are a tax on households, raise the savings rate and depress consumption
  - Unnaturally easy monetary policy with respect to inflation and GDP growth undermines confidence
  - Rising rates encourage asset reallocation out of fixed income and into equities
  - Correlation between rates and equities strongly positive for last 20 years
  - Equity risk premium still stands above 4% -- with ample room to fall in the event of higher real rates and higher equity prices
In FX, there are signs that a dollar “top” is forming, but conditions are not in place for a sharp devaluation

- Dollar has weakened by 10% this year – and there are signs of a dollar ‘top’ forming in this mature bull cycle (typically 6-7 years)

- In previous dollar tops (1985, 2002) the currency’s initial downward slide was sharp

- However, conditions are not in place for a sharp dollar devaluation this time around, at least not yet
  - Dollar tops are typically signalled by valuation extremes, but dollar hasn’t exceeded +20% overvaluation band
  - US current account is stable, owing to better energy balances – whereas generally it worsens by 1.5pp of GDP in the 2 years before a peak
  - Dollar interest rates are typically falling on G10 ranking tables in a dollar downcycle – this is not the case at the moment

[Graph showing USD trade-weighted index above fair value, but not at previous extremes]

Source: Bloomberg Finance LP, Deutsche Bank Research

US current account typically worsens ahead of dollar peaks, triggering overvaluation fears and intervention to weaken the dollar

[Graph showing US Current Account Balance as a % of GDP]

Source: Bloomberg Finance LP, Deutsche Bank Research

Elongated USD top with long EUR lead time, 7 Jul 2017
We are more positive on the euro, with upside to the dollar and sterling. We see yen weakening, but with risks on both sides

1 Euro at $1.20 by 2018
- We turned more positive on euro
- Currency has since broken the top of 2.5-year 1.05-1.15 range
- Short-end rate differentials now less of a driver for EURUSD rate
- Macron brings political upside to currency, i.e., France / Germany policy initiatives, fiscal stimulus
- Real money underweight euro

2 Bearish sterling versus Euro
- Limit to sterling downside vs. dollar as BoE uncomfortable with weak pound
- But currency uniquely exposed to earlier / faster ECB tightening
  - G10’s largest current account deficit, lowest real rates
- By end-2018 see sterling down 5%+ vs. euro, but only around 3% vs. dollar

3 Bidirectional risks to USDJPY
- With BoJ on hold, Fed tightening, we see a weaker yen with USDJPY up to 120 by end-2018
- But risks are high on both sides
  - Weaker yen if US inflation rises and Fed tightens faster
  - Stronger yen if Japan policy continuity is seen at risk
- Bidirectional risks mean implied USDJPY volatility is too low

Euro at last broke the top of a 2.5-year range

Trade balance close to record deficit

Bidirectional risk at odds with implied volatility close to 18-month lows
The normalisation of rates has had several false starts. Stronger evidence of rising inflation needed for a decisive leg up in rates

- For several years, ultra easy monetary policy, a tentative macro backdrop and a series of shocks have kept rates low by historical standards
- Since 2013 there have been several normalisation false starts – with rates rising sharply, led by the US
- In each of those cases the normalisation got interrupted and reversed, at least partially
- Rates appear low relative to growth, unemployment – but a sustained sell-off is unlikely without clear evidence of rising inflation

- We expect this rise in inflation to happen into 2018 – with central banks in turn getting more hawkish and supporting a sell-off in rates
  - Calling the exact timing is difficult
- Recent episodes have shown that the correction in rates can be sharp and material
  - Have seen several 80+ bp sell-offs in months – with moves of more than 100bp during 2013’s taper tantrum

Once it gains traction, the sell-off can be sharp and material

<table>
<thead>
<tr>
<th>bp sell-off, rounded*</th>
<th>UK</th>
<th>US</th>
<th>Germany</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taper tantrum (8 months)</td>
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<td>2015 (8 months)</td>
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<td>Post-Trump (2 months)</td>
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Source: Bloomberg Finance LP, Deutsche Bank Research

Rates normalisation process has had several false starts

Source: Bloomberg Finance LP, Deutsche Bank Research
A supportive macro backdrop helped EM perform strongly this year. The second half should be positive but less stellar.

- A very strong first half for EM assets fuelled by a supportive macro backdrop
  - USD weakness has been the main boost; EM FX +4% in H1, and still fundamentally undervalued
  - Low inflation allowing central banks to continue to ease (LatAm) or delay tightening (Asia)
  - Upward revisions to growth in Asia
- Performance in the second half will be less stellar, with more balanced returns under a range-bound USD, although EM macro will still outperform DM
  - Outflows during 2013’s Taper Tantrum were partly reversed in subsequent years
  - But positioning is structurally lighter than in 2013
  - We stay marketweight EM credit and focus on idiosyncratic factors for asset allocation
- Main risk to our call is a surge in risk aversion and dollar strength, i.e., a reversal of H1 tailwinds
  - However that would require a major repricing of growth, inflation, commodities or EU risks
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The House View range

- **The House View**
  - Monthly report
  - Summarises key financial and economic developments
  - Provides context on Deutsche Bank’s forecasts and outlook for economic growth, monetary policy and financial markets

- **Infographic**
  - A one-pager that tackles a current topic in a few charts and visuals

- **Special**
  - Ad-hoc in depth reports on major underlying topics affecting global economic growth and markets

- **Snapshot**
  - A handy two-page summary of Deutsche Bank Research macro and markets views

- **Macro Forecasts**
  - A summary of Deutsche Bank Markets Research macroeconomic, fixed income, foreign exchange and commodities forecasts
DB forecasts

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<th>Central Bank policy rate (%)</th>
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<th>Q4-18F</th>
<th>Q4-19F</th>
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<th>Key market metrics</th>
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<td>US 10Y yield (%)</td>
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<td>EUR 10Y yield (%)</td>
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<td>EUR/USD</td>
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<tr>
<td>USD/JPY</td>
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<td>S&amp;P 500</td>
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<tr>
<td>Stoxx 600</td>
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<td>375</td>
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<tr>
<td>Oil WTI (USD/bbl)</td>
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<td>Oil Brent (USD/bbl)</td>
<td>48.7</td>
<td>55.0</td>
<td>55.0</td>
<td>56.0</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

**ASIA**: China, HK, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Sri Lanka, Taiwan, Thailand, Vietnam

**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

The House View – 25 July 2017

Current prices as of 24-Jul-2017
Appendix 1
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