



global weekly

Investment
Communication
8 January 2016

Happy New Year?

Events in China took center stage, as market interventions and currency devaluation caused reverberations in financial markets around the world.

So far, 2016 has had a poor start. This week, a brutal sell-off in Chinese equity markets was initially triggered by weaker-than-expected Chinese manufacturing data and by uncertainty regarding new and expiring stock market regulations. The move was accelerated, however, by the weaker fixing of the Chinese yuan by the central bank, which sparked fears of more substantial weakness of the yuan to come.

The yuan had already grabbed attention in August, when Chinese authorities allowed it to devalue. The currency is now managed via a basket of currencies, instead of being pegged to the US dollar. The new manner of managing the yuan better reflects China's trading position. But removing the link to the dollar has invited speculation that a weaker yuan is a government policy to support the economy.

The recent market wobbles have not affected our view on China or global growth. We expect the Chinese economy to grow by a healthy 6.5% in 2016. The impact on developed economies is expected to be limited. The US and Europe will continue on a path of self-sustained recovery that is supported by domestic demand.

Equity markets update

Global equity markets have had a historically bad start to the year. The concerns which set this drop in motion are the same as in 2015: slower than expected Chinese growth, oil prices continuing to fall and worries over the Chinese yuan. Trading in Chinese equities was halted twice this week, which is exceptional.

The severe movements in Chinese markets can be explained by two facts: market participants are mainly private entities or investors (instead of institutional, which is the case in more developed markets) and behaviour can therefore be more driven by emotions than fundamentals. In addition, the situation has been exacerbated by poor communication by Chinese authorities and the "circuit breakers" and other

Equity index performance

	Value	One week change (%)	Year-to-date (%)
MSCI ACWI	377.9	-5.4	-5.4
S&P 500	1943.1	-4.9	-4.9
AEX Index	417.7	-5.5	-5.5
EuroStoxx 50	3081.8	-5.7	-5.7
DAX Index	9996.4	-7.0	-7.0
Nikkei 225	17698.0	-7.0	-7.0
Hang Seng Index	20453.7	-5.8	-5.8

Important rating changes (RL=Recommended List; NR=not rated)

Company	From	To
Yahoo!	Hold	Buy
Glencore	Sell	Hold
LVMH Moët	Hold	Buy
American Express	Buy	Hold
Visa	Hold	Buy

Government bond yields

	Yield (%)	One week (bp)	One year (bp)
US Treasuries 2-year	0.988	-6.2	38.1
German Bunds 2-year	-0.393	-4.4	-28.7
Japan 2-year	-0.024	-1.0	0.3
US Treasuries 10-year	2.183	-8.7	16.5
German Bunds 10-year	0.542	-8.6	3.3
Japan 10-year	0.218	-4.2	-7.0

Spreads

Index	Spread (bp)	One week (bp)	One year (bp)
CDX NA IG	96.07	7.63	27.23
iTraxx Euro 5-year	82.21	5.16	20.68
JPM EMBI+	424.88	14.77	5.23

Performance data as of Friday, 8 January

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interventions that were seen this week. All of this added to an already worrisome market climate.

The traditional safe havens, utilities, consumer staples and telecom outperformed the MSCI World Index over the week, while the materials and energy sectors underperformed. The energy sector was under pressure after oil prices declined below 2008 levels. This decline was initiated by growing tensions between Saudi Arabia and Iran in combination with further growth in oil production in Russia and questions whether the OPEC is too divided to be able to influence future oil prices.

Integrated oil and gas companies, such as Royal Dutch Shell and Total, remain committed to their dividend policies, but there is growing concern whether this commitment may be too ambitious given current market conditions. It is likely that further reduction in investments may be necessary for these companies to maintain their dividend policies.

On a stock level, there were bright spots in the week. Online TV services company Netflix soared after the announcement that it had expanded services to 130 more countries. With this expansion, the company is the first to provide global service, although China is still missing. Netflix is, however, in talks with the Chinese government and local partners to expand in China.

The earnings season starts next week. Companies in our universe, such as Alcoa, CSX, JP Morgan Chase and Intel, will present their fourth-quarter numbers. Despite the turmoil seen in markets, we expect overall company earnings to be in line with expectations.

Bond markets update

Where equity markets were spooked by the worries about China, oil prices and other challenges this week, fixed income markets remained relatively sanguine. Interest rates barely moved on either side of the Atlantic, and credit spreads remained volatile but little changed.

What worried bond investors this week though was the news and events around the new bail-in clause for senior bondholders of bank debt. In the aftermath of the credit crisis of 2008-2009, when some banks were saved by governments, it was decided that senior bondholders would also have to take some of the burden when a bank failed. Under new EU regulation that took effect on 1 January 2016, national governments were required to draft this legislation and be responsible for its execution.

This new setup was put to the test in Portugal this week. Last

year, Portugal divided Banco Espirito Santo, previously the nation's largest lender, into a "good" bank and a "bad" bank. In November, the ECB stress test found a EUR 1.4 billion hole in the balance sheet of the good bank. Over the weekend, five bonds that were previously assigned to the good bank were re-allocated to the bad bank. On Monday, these bonds fell by 80%. The removal from the good bank's balance sheet, however, plugged the hole.

What was strange though, is that these bonds ranked "pari-passu" with 47 other bonds of Espirito Santo that remained with the good bank. Pari-passu means that they should be treated equally and not receive preferential treatment. This equal treatment is tantamount to the functioning of the bond market. Investors will think twice of lending to banks when regulatory decisions in a restructuring can disregard bond legislation.

In another story this week, we saw the French government come up with an entirely new resolution framework, where they introduced "junior senior debt." This new type of debt will rank between senior debt, and subordinated debt (that will be bailed-in first). It thus seems that the French government is moving to protect senior bank bonds, as they will not be subordinated to other senior liabilities by law.

In 2016, it is clear that buying bank bonds has become a lot more complicated.

Currency outlook

The ultimate safe haven in currency markets, the Japanese yen, has profited from the recent turmoil in currency markets. The yen outperformed the US dollar by more than 2% this week, with the USD/JPY dropping below 118. We do not rule out that further strength in the yen will trigger intervention by the Bank of Japan. The US dollar was the runner up, appreciating versus most other emerging and major currencies. We expect sentiment in currency markets to calm down and investors to refocus on monetary policy divergence. We therefore expect the EUR/USD to decline to below parity this year and the USD/JPY to rally to 135.

Asset allocation

Our current asset allocation reflects an overweight allocation to equities (profiles 2 to 5) and commodities (profiles 2 to 6) and a strong underweight in bonds (profiles 1 to 5), with no bond allocation in profile 6. Real estate, which is strongly correlated to equities, is underweight (profiles 2 to 5), but overweight in profile 6. There is no real estate allocation in profile 1. Hedge funds are now overweight in all profiles to

mitigate risks. Cash is overweight in profiles 1, 2, 3 and 4 and underweight in profiles 5 and 6.

Published this week

Depreciation of the Chinese currency triggers market woe (7 January 2016)

Since the beginning of the year, equity markets have suffered, triggered by troubles in China. Earlier this week, disappointing industrial data generated market volatility. But today, the further depreciation of the Chinese yuan is the source of concern.

Bond Markets Monthly: 2016 - a year of central bank wrestling?

December heralded some expected and unexpected news for bond investors, which has set the scene for 2016. Just when market focus was directed at impending policy changes by the European Central Bank (ECB) and the US Federal Reserve, the credit market was shaken by the closing of the Third Avenue hedge fund, which invested in bonds with very low ratings. The ECB's policy announcement disappointed markets, while the Fed delivered as expected. The net result was that the ECB

and the Fed moved in opposite directions in December, and the divergence between their monetary policies increased.

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