

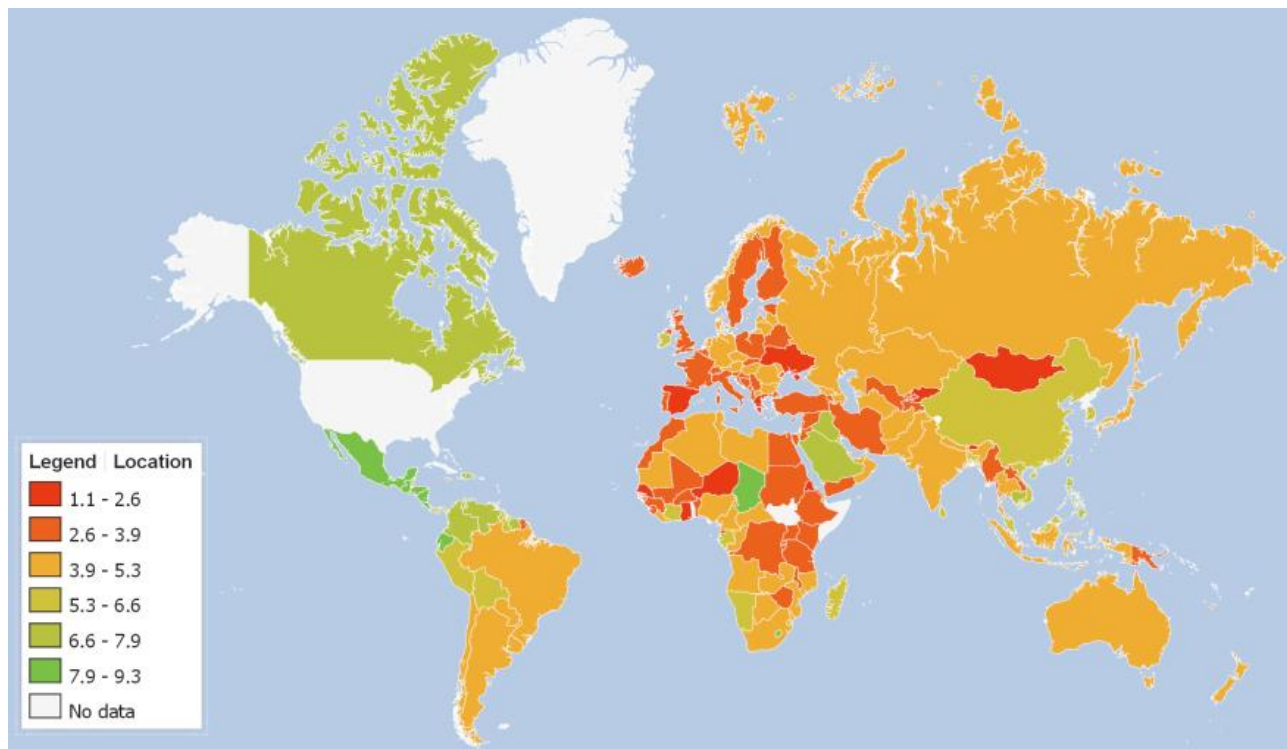
Monthly Update

ETF Securities Research and Roubini Global Economics

To Hike or Not to Hike

- The attention of investors is dominated by EM turbulence and speculation about the Federal Reserve's tightening cycle. Our view on the most likely timing of the Fed's first rate hike has moved from September to December. Given current turbulence and market volatility there is a risk of further delay into early 2016 but the speed and duration of hikes after the first rate rise in nine years is still more important than the initial lift off. Persistent disinflationary pressures have made a delay until December increasingly probable, while a slower-than-normal "normalization" path after the first hike is a near certainty.
- This is a key element of the theme of monetary policy divergence we established in January. The first hike and messaging will set the tone for the longer normalization cycle. The Fed seems likely to be followed in tightening by the Bank of England, even as other key central banks (in Europe and Japan) ease further.
- **What to watch this month:** Fed policy meeting (September 17), to see whether Janet Yellen and co. take the plunge or delay until December, or even into 2016; in emerging markets, Brazil's central bank meets (September 1-2) to decide if the 14.25% interest rate will be enough to quell inflation; in Mexico, we expect Banxico to parrot the U.S. with a hike to 3.25% on September 21, if the Fed surprises markets.

Heatmap: Sensitivity to Fed Policy (0 = vulnerable, 10 = resilient)



Source: Roubini Global Economics. Note: Scores are from Roubini Country Insights' Fed Normalization Indicator, which is a blend of a country's ability to benefit from U.S. demand and its vulnerability to external financing shocks.

Key Theme: Policy Divergence and the Fed's 'Lift-Off'

Investors' attention is dominated by speculation about the Fed's tightening cycle. Our view is that "lift-off" will happen in December with persistent disinflation keeping a delay until Spring 2016 possible. Keep in mind that the speed and duration of hikes after lift-off is more important.

Economy Seems *Just* Strong Enough

In the absence of short-term tail risks flaring up, the focus of investors is on the start and pace of the gradual policy-tightening cycle in the U.S., amidst a spike in volatility.

Compelling arguments can be made for and against "lift-off" on September 17 versus a delay, but we think the balance of risks no longer favours September. The Fed will make its decision based on US economic conditions. Although an upturn in activity data and solid job gains would appear to justify a rate hike in September that data predate recent market turmoil. Therefore, the most prudent path is to delay and see if recent turbulence damages the U.S. economic outlook.

Risks of a Delay Have Risen Considerably

The statement after the July Fed policy meeting left all options open, despite the upgraded growth outlook and increased worries about *low* inflation.

In Q2, U.S. GDP growth came in at 2.3% q/q annualized, accompanied by a notable upward revision to Q1. All in all, revised data shows a slower pace of expansion, lower unit labor costs (around 0.4% lower y/y in Q1), and that slack remains.

Although the pace of job gains has moved back above 200,000 per month, the housing market continues to report decent activity and credit growth has accelerated (in the context of still-restrictive credit conditions), disinflationary pressures will likely persist in the near term as wage growth is slow, the dollar is strong and oil and commodity prices have retreated again.

For this reason, it is highly possible that the Fed will delay beyond September. That will reinforce the caution of the Bank of England, which we see postponing its own tightening cycle into early 2016 for domestic reasons, despite hawkish rhetoric from a few members of the monetary policy committee.

Divergence could be postponed, but only temporarily. Once hikes begin, market attention will shift to the pace and duration of tightening. Due to the fragility of growth and burden of private debt, hikes will be slow and careful, and will probably end at a lower point than past cycles, with growth at a poorer level too. The European Central Bank and the Bank of Japan will probably need to ease more, in contrast.

Few Others Can Go Back to 'Normal'

In emerging markets, we see a distinction between:

- 1) Countries that are Europe-linked (for example, those in Central and Eastern Europe) and can thus afford to maintain accommodative policy or are surplus countries

(such as East Asian countries, which are trying, if anything, to weaken their currencies); and

- 2) Commodity-producing, trade deficit countries, where rates will have to rise (such as South Africa) or remain high (Brazil, Russia, Colombia, India and Indonesia), and where currency pressures are also negative, but less welcome.

Finally, China's decision to alter its exchange rate regime remains opaque, but we do not think it presages a "currency war", and the People's Bank of China has ammunition to control the exchange rate in the short term—if it wants to.

Figure 2: U.S. Economic Outlook Brightens

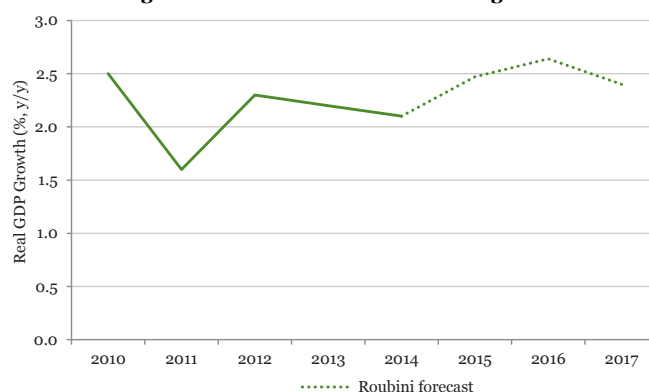
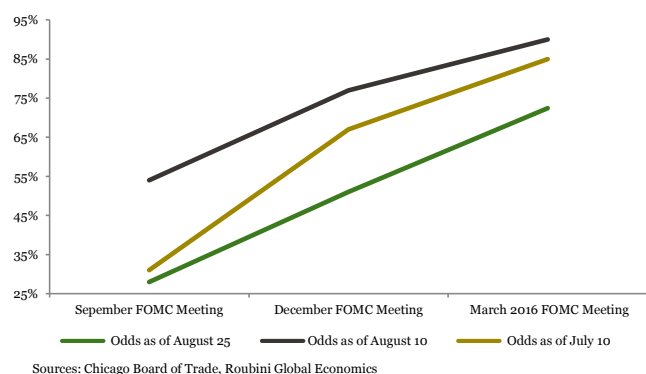


Figure 3: Changing Odds of 25-bp Fed Rate Hike, as Reflected in Fed Funds Futures



What to Watch

- **Inflation.** Signs of inflation ticking up will increase the pressure on the Fed to hike, but low inflation may not lead to a delay if it is seen as temporary.
- **The hiking path.** If the Fed does hike in September, a second hike in December would not automatically follow, especially in the face of material concerns about market illiquidity

Asset-Class Implications: Fixed Income

Developed Markets

Pockets of uncertainty, such as the moves in China's FX and equity markets and the continuing issues around Greece, despite the agreement on the third bailout, will keep U.S. Treasuries attractive for risk-averse investors.

As a result, we see sovereign yields in G4 countries remaining lower than would usually be warranted at this stage of the business cycle, despite the upward pressure exerted by the forthcoming Fed and Bank of England policy-rate normalization cycles.

That said, term premiums are depressed, offering investors not much yield to compensate for the risk.

We still expect the 10-year U.S. Treasury and 10-year German bund yields to end 2015 at 2.5% and 0.5%, respectively.

The UK 10y yield, meanwhile, will likely continue to track its U.S. counterpart along a lower trajectory (a spread of around 30 bps) and we see the 10y Japanese government bond yield at 0.5% at year-end.

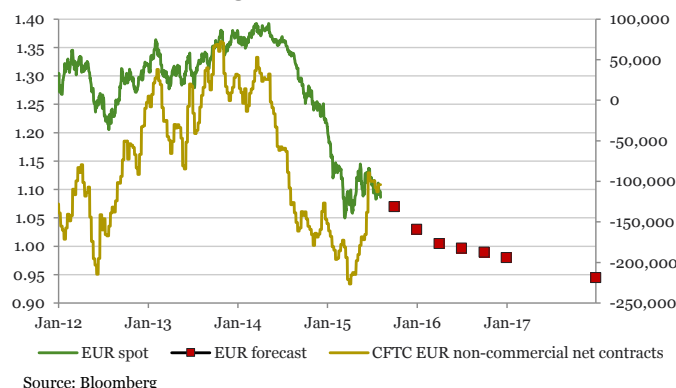
Emerging Markets

Emerging-market external debt spreads (409 bps) will probably widen further, but the likely slow pace of rate hikes in the U.S. suggests the correction will not be sharp.

However, high foreign-exchange reserves have begun to decline, in some cases at a worrisome pace.

Brazil, Colombia, Malaysia and some oil exporters will likely underperform the EMBIG index, and we think corporates will probably face more pressure, ending their outperformance (some from highly stressed levels) versus sovereigns.

Figure 4: EUR's Dead Cat Bounce, Driven by a Reduction in Positioning, Is Now in the Rearview Mirror



Asset-Class Implications: Equities

U.S. Equity

Along with many other observers, we argued that the Fed's 2013-14 tapering of its quantitative easing program did not amount to monetary tightening and would not have a negative impact on the S&P 500's performance, which it did not.

However, tapering did appear to have a negative impact by increasing the perceived risks associated with weak balance sheets. Other factors (growth, value, carry, momentum and volatility) may have offset the impact of higher balance-sheet risk on the overall market.

With Fed rate hikes approaching, this experience warrants a cautious stance toward the equity market, especially as other risk factors may no longer provide as much cushion. Although we hold a tepid baseline view of U.S. equity, the prospect of a slow rate-hiking cycle provides some comfort, and there are upside risks for earnings as well as a robust M&A cycle.

Should hikes inflame concerns over corporate balance-sheet quality, tech and discretionary stocks would be fairly robust and telecom and utilities would be most vulnerable.

These calls are in line with our view that tighter Fed policy is likely to pressure high-yielding defensives.

Rest of the World Equities

From a regional perspective, markets with high levels of foreign ownership tend to have higher beta to U.S. balance-sheet vulnerability. Turkey, Mexico, Chile and Malaysia look most exposed, but Taiwan, India and Japan seem resilient.

Eurozone equities have benefited from the temporary resolution of the Greek crisis, but the lack of a sustainable structural upswing in Europe (which would translate in higher earnings and dividends) will likely constrain performance, although the European Central Bank's liquidity currently supports valuations.

We remain neutral on emerging-market equities overall, as the grim growth outlook offsets the attractive valuations.

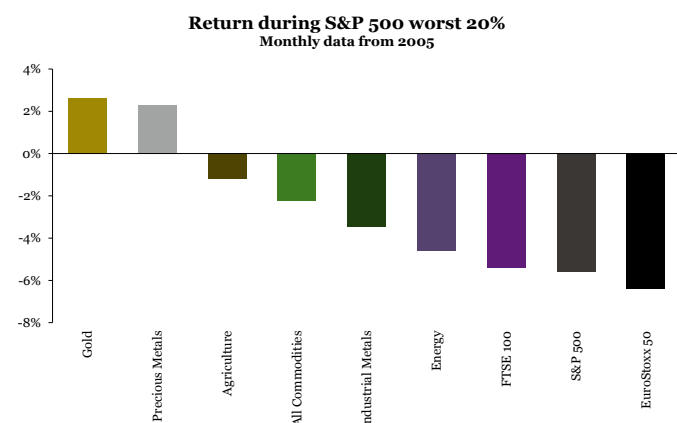
Figure 5: Less Risk of Financial Instability and Capital Inflows in Russia



Asset Class Implications: Commodities

Uncertainty around China's currency policy, dovishness from recent Federal Reserve communications and a rout in global equity markets have rekindled interest in gold, traditionally the first port of call in times of market stress.

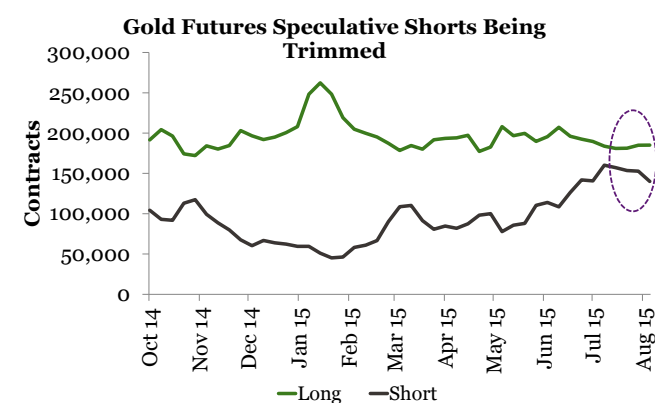
Gold has historically performed well during equity market downturns. Taking the worst 20% of S&P 500's monthly performance since 2005, we see that gold on average has performed positively. On average gold has outperformed major equity markets by at least 8% in those months.



Although gold started to show signs of strengthening during the early stages of the Greek financial saga, the ever-presence of an 11th-hour deal led to fear-fatigue and under-pricing of the risk that a worst-case scenario would materialise. Gold appeared to have lost its haven status.

However, recent uncertainty around China's currency policy and violent gyrations in global equity markets has driven interest in the hard asset once again. With the European Central Bank and Bank of Japan firmly in easing mode, fears of currency debasement have not subsided, another source of investor support.

Speculative shorts in the futures market, although elevated, have been trimmed and flows into gold exchange traded products have turned positive once again. With fear overriding greed, gold's role as an insurance asset is likely to be reinstated.

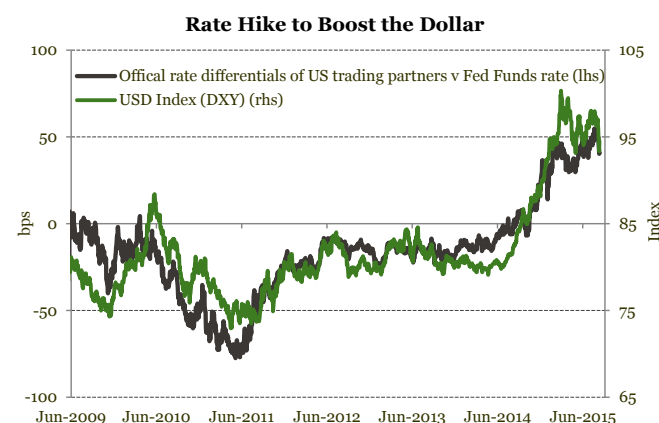


Asset-Class Implications: Foreign Exchange

We feel that the recent US dollar weakness is transitory.

Investors believe that a softer Chinese economic environment is likely to dull the recovery of the US economy. Moreover, the market appears to believe that Chinese economic volatility will have a significant impact on the Federal Reserve's projections for the US jobs market and the outlook for inflation. As a result, investors are paring back expectations for a rate hike in the US, and that is weighing on the USD, benefitting the Euro. We think that the Federal Reserve is more concerned about the domestic economy and that the current Chinese slowdown is only an issue at the margin.

We do not expect a hard landing in China and feel that policy stimulus will continue to assist the growth and development path. On the global economic front not much has changed and that is especially true for the US economy. We feel that current levels for the US Dollar are attractive and that after its recent setback, the USD will continue its ascent against the Euro and most other G10 currencies.



Much of the recent market volatility has stemmed from the Peoples Bank of China (PBOC) raising its central parity rate and the more significant policy change to set the new Renminbi fixing rate at the previous day's closing spot CNY rate. The PBOC's move allows greater exchange rate flexibility and transparency of CNY pricing in its ongoing reform of the Renminbi.

We feel that currency reforms will continue and that the knee jerk market reaction will fade. Most markets, particularly commodities and commodity currencies, should begin to stabilise.

We expect that as investors begin to see the volatility moderate that currencies like the Canadian dollar and the Norwegian Krone will begin to post gains, especially if the oil market begins to experience support at depressed price levels

While historically defensive currencies like the CHF and JPY have gained as investors have unwound higher risk appetite currency trades, we feel that this is unlikely to be sustained.

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