ZURICH

31st August 2015

The week gone by

Global **equities** (in euro terms) have seen significant volatility in the last few weeks on the back of Chinese economic growth concerns and a lack of liquidity. Despite heavy falls on Monday, markets managed to end the week in positive territory helped by a cut in Chinese interest rates and a rally in energy prices. Investors continue to focus on the timing of upcoming US interest rate rises – there is now a 37% chance of lift off in September although some commentators have pushed out the date to March 2016. Euro currency weakness has significantly enhanced returns for eurozone investors in 2015 (see table below), and this was again the case last week. Equities remain better value relative to other asset classes on a yield basis.

The global index (in euro terms) was up by 1.4% last week giving a total return year-to-date of plus 5.6%. Technically, the Index has fallen well below the critical 200-day moving average and, despite the rally during the second half of last week, is now 4% below this mark. There was a mixed bag of returns for the major equity **markets** in local currency terms last week ranging from plus 2.2% in Ireland to minus 3.6% in Hong Kong. Ireland has been performing well on the back of strong earnings' results. The key US market was up 0.9%.

Eurozone **bond** prices fell by 1.2% last week reacting to the rally in equities. Bonds, however, have been performing well recently in reaction to Chinese growth worries. Overall, eurozone bonds have given a return of minus 0.1% year-to-date and prices remain well-off their mid-April peaks. The German 10-year bond yield rose from 0.56% to 0.74% last week; it had hit an all-time-low of 0.06% in April. Equivalent US yields rose from 2.04% to 2.18%. **Commodity** prices in general were up by 3.0% (in dollar terms) last week, supported by a 11% rally in oil prices, but are down 14.3% so far in 2015.

	Index	1 Week Return 21.08.15 to 28.08.15		Year to Date Return 31.12.14 to 28.08.15	
		Local Currency %	Euro %	Local Currency %	Euro %
Global (euro)	FTSE World (total return)	1.4%	1.4 %	5.6%	5.6 %
US	S&P 500	0.9%	2.5%	-3.4%	4.5 %
Europe	FT/S&P Europe Ex. U.K.	1.2%	1.2%	6.9%	6.9%
Ireland	ISEQ	2.2%	2.2%	20.8%	20.8%
UK	FTSE 100	1.0%	0.5%	-4.8%	1.7%
Japan	Topix	-1.5%	0.5%	10.1%	17.6%
Hong Kong	Hang Seng	-3.6%	-2.0%	-8.4%	-0.9%
Australia	S&P/ASX 200	1.0%	0.0%	-2.7%	-7.7%
Bonds	Merrill Lynch Euro over 5 year	-1.2%	-1.2%	-0.1%	-0.1%

The week ahead

- In the US August employment report (Friday), non-farm payrolls are expected to increase 218k (last: 215k) and for the unemployment rate to remain constant at 5.3%. It is likely that the August Chicago PMI index (Monday) will rise marginally to 54.8 (last: 54.7).
- At the ECB interest rate announcement (Thursday) it is expected that President Draghi will maintain an accommodative stance.
- In the UK, it is forecast that August manufacturing PMI (Tuesday) will remain constant at 51.9.

Global Outlook

Emerging Markets

- Emerging market growth fears have been central to the turbulence seen in markets during August. Emerging market currencies have depreciated substantially against the G4 (Eurozone, Japan, UK & US) whilst global oil prices and G4 bond yields have been falling. A demand boost from the US and China would be the catalyst to help emerging markets recover but with the recent activity data in China being a disappointment; concerns have become heightened. The US and other developed markets are posting solid growth numbers (as seen in positive revisions to Q2 GDP estimates last week). However, economic growth in the major developed economies is driven in a large part by services; thus having limited impact on emerging markets.
- Emerging market private sector debt levels remain high (JPMorgan estimate levels at around 130% of GDP). The risk of disruptive de-leveraging (with local Governments having limited capacity to offset any adverse shock to private sector credit supply), combined with FX headwinds, reduced growth expectations, and reduced pricing power for goods and commodities leaves emerging markets in a difficult position.

United States

- Last week saw the S&P 500 drop to 1867; a level not seen since October 2014 and approximately 12% from its 2015 high made back in May. From this low, there has been a rebound of around 6%. The key question is whether last week's low marked *the* low or just *a* low remains, as the index is still below the key technical resistance level of 2000. Utilities were the worst performing stock sector of the week as the 10 year bond yield moved from its near 2% level up to 2.2%; mainly driven by moving expectations surrounding the timing of the Fed initiating interest rate hikes. The timing of this Fed liftoff remains one of the most discussed and debated topics amongst investors.
- Domestically, macro data doesn't show any material sign of deterioration with unemployment low, the housing market recovering steadily, and consumers' benefitting from low gas and potential wage hikes as labor force slack erodes. A recovery in the housing sector remains integral to continued economic strength and figures for demand, supply, affordability & credit accessibility currently all support a rejuvenation of the housing cycle. However Residential investment still languishes at 3% of GDP vs. the longer term average of approximately 5%. When analysing the economic data with the volatility of US equity indices of late, the movement appears to be an index price correction and does not reflect expectations for an economic recession in the US.

Euro Area, Europe & UK

- August data for the Eurozone showed robust manufacturing survey numbers coupled with an improvement in consumer confidence. Although exports up to June 2015 have been robust, the recent devaluation of the Renminbi and the strengthening of the Euro is a meaningful headwind. Given the export-driven growth model of the Eurozone, this may create downside risk to Euro Area GDP growth. For example it is estimated that a 200bp slowdown in China (with a fixed exchange rate) could lead to approx. 10-15bp decline in Euro Area growth. The ECB meeting minutes highlighted the fragility of the euro Area recovery, weak inflation and, despite an incrementally more optimistic tone, still see the balance of risks to the downside. Commodity prices, the emerging market slowdown and exchange rate developments will shape the inflation outlook for the region.
- The Greek Parliament approved the third bail out from the Troika with the support of 222 MPs. Risk around Greece has not waned given;
    - Weakening position of the government, the announcement of a new political movement by the leader of Syriza's leftist platform and the very high probability of a party split and snap election.
    - Execution of the bailout program terms will be challenging in itself
    - Banks recapitalisation process will also be a tough process.
- Inflation in the UK showed a pick up recently, but the Bank of England are unlikely to shift their stance on rates, as low commodity prices (including the continued slide in Oil) should see inflation continue to trend lower in the near term whilst wage growth is decelerating. Although the Monetary Policy Committee has been focused on domestic data (wage growth, inflation) they are drawn towards external risks also, such as currency and real interest rate levels. Monetary conditions have tightened in the last two years due to the strengthening currency and higher real interest rates (as inflation remained low, exacerbated by oil price weakness). A rebound in inflation would mean lower real interest rates and help to offset some of the monetary tightness. However the BoE are unlikely to tighten any time soon given weak inflation and a strong GBP. A slowdown in the Chinese economy is a headwind, which further supports the case for no hike.

Central Bank Watch:

- It appears that the G4 Central Bank policies are being affected by EM growth concerns and financial market developments. The heightened risk awareness could point to them taking a somewhat more dovish policy stance for a little longer than previously expected.
- In the US, expectations for a rate rise have been pushed out beyond September. Although many believe early 2016 is likely, the consensus is still for a move prior to year end. The trajectory of hikes is more important than the timing of the first move and the path of hikes will be gradual.
- Earlier in 2014, the ECB announced an open ended Quantitative Easing program. The ECB will commence buying €60bn of private and public sector securities every month to end-September 2016 at least. The ECB may also increase the size of the program or bring forward some buying activity depending on economic data and inflation.
- The MPC have not changed their stance of late and remain focused on labour force slack.
- Japanese monetary policy is expected to remain loose for some time to come. The BoJ cut its FY15 GDP and FY15-17 CPI forecasts, but said its price target remain achievable. Inflation still remains well below 2% target at present.

Positioning

- Zurich Life funds are overweight in equities and underweight bonds versus the manager average.
- Zurich Life funds favor Irish and Spanish over German and Belgian bonds.
- In equities, we are:
    - Underweight UK, North America
    - Neutral Asia ex Japan
    - Overweight Ireland, Europe ex UK and Japan

  (All the above are relative to the manager average)
- Sector weights (at aggregate level) are: underweight energy and utilities, and overweight consumer goods and industrials.

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