ZURICH

14th September 2015

The week gone by

Global **equities** (in euro terms) have seen significant volatility in the last month or so on the back of economic growth concerns in China and the emerging markets. Last week, however, saw some stability return to markets. Investors continue to focus on the timing of the upcoming US interest rate rise – there is now a 30% chance of lift-off at this Thursday's FOMC meeting. Despite recent turmoil, equities remain well valued on a yield basis compared to cash and bonds while price/earnings multiples have contracted somewhat.

The global index (in euro terms) was up by 0.4% last week giving a total return year-to-date of plus 3.1%. Technically, the Index remains well below the critical 200-day moving average but is over 5% higher than the recent low on 24th August. All of the major equity **markets** were up in local currency terms last week ranging from 0.5% in Europe to 3.2% in Hong Kong. Returns to the eurozone investor were adversely affected last week by the strength of the euro currency.

Eurozone **bond** prices were unchanged last week. Bonds have been performing reasonably well recently in reaction to the Chinese growth worries. Overall, eurozone bonds have given a return of plus 0.4% year-to-date although prices remain well-off their mid-April peaks. The German 10-year bond yield fell from 0.67% to 0.65% last week; it had hit an all-time-low of 0.06% in April. Equivalent US yields rose from 2.12% to 2.19%. **Commodity** prices in general were flat (in dollar terms) last week and remain down by 14.5% so far in 2015.

	Index	1 Week Return 04.09.15 to 11.09.15		Year to Date Return 31.12.14 to 11.09.15	
		Local Currency %	Euro %	Local Currency %	Euro %
Global (euro)	FTSE World (total return)	0.4	0.4	3.1	3.1
US	S&P 500	2.1	0.4	-4.7	1.6
Europe	FT/S&P Europe Ex. U.K.	0.5	0.5	4.3	4.3
Ireland	ISEQ	2.1	2.1	23.4	23.4
UK	FTSE 100	1.2	1.3	-6.8	-1.5
Japan	Topix	2.5	-0.6	5.2	11.5
Hong Kong	Hang Seng	3.2	1.5	-8.9	-2.7
Australia	S&P/ASX 200	0.6	1.6	-6.3	-13.2
Bonds	Merrill Lynch Euro over 5 year	0.0	0.0	0.4	0.4

The week ahead

- In the US, at the September FOMC meeting (Thursday), it is generally expected that rates will remain on hold, with the Fed assessing downside risks to its outlook which have re-emerged in recent weeks. Any immediate increase in rates could destabilise markets further.
- Euro area final August headline and core inflation (Wednesday) to be confirmed at 0.2% year-on-year and 1.0% year-on-year, respectively.
- In the UK, it is expected that August CPI inflation (Tuesday) will print at 0.0% year-on-year (last: 0.1%).
- It is expected that Japanese policy will remain unchanged at the BoJ September monetary policy meeting (Thursday).

Global Outlook

Emerging Markets

- Emerging market growth fears have been central to the turbulence seen in markets recently. 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, whilst Brazil remains in recession. The US and other developed markets are posting solid growth numbers (as seen in positive revisions to Q2 GDP estimates recently). 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 (JPM estimate levels at around 130% of GDP). The risk of disruptive de-leveraging combined with FX headwinds, reduced growth expectations, reduced pricing power for goods and commodities leaves emerging markets in a difficult position.
- In China, increased fiscal and monetary easing measures are being instigated by policymakers but risks remain to the downside.

United States

- Last week the S&P 500 lost another 2% and the VIX Index (market estimate of future volatility) remains stubbornly high (>25). The key question that remains is whether we have seen *the* low or just *a* low. The S&P 500 index failed to even touch the key technical resistance level of 2000. With Financials, Utilities and Healthcare the worst performing sectors over both 1 week and 1 month timelines. Financials and Utilities were mainly hurt by moving expectations around the timing of the Fed initiating interest rate hikes, whilst Healthcare saw some profit taking; having been one of the strongest sectors year to date. Consumer staples and discretionary sectors have been the most resilient throughout the market volatility which speaks to the strength of the US consumer and domestic economic situation. Timing of Fed Lift off 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 labour force slack erodes. The August non-farm payroll report was robust, despite the lacklustre headline figure, and the positive revision suggests that some wage inflation is evident. 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

- The ECB recently revised down their outlook for real GDP growth for 2015, 16 and 17, primarily due to lower external demand owing to weaker growth in emerging markets. The Eurozone is one of the most exposed Developed Market regions to Emerging Markets; given its export-driven growth mode. The ECB is therefore more sensitive to inflation and currency dynamics and they have highlighted that risks to Euro Area growth remain on the downside. Although exports up to June 2015 have been robust, the recent devaluation of the Chinese Renminbi and strengthening of the Euro is a meaningful headwind. Commodity prices, the emerging market slowdown and exchange rate developments will shape the inflation outlook for the region.

- Given continued high structural unemployment and low potential output growth in the euro area, the ongoing cyclical recovery must be supported by effective structural policy reform in key member states, including product and labor market reforms and enhancing of the business environment. Loan growth has shown some improvement but the dynamics of loans to non-financial corporations remain subdued.

- Risk around Greece has not waned despite the approval of the third bailout by the Troika, 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.

- Robust private domestic demand is expected, despite the continuing fiscal consolidation and modest global growth and the near term outlook for inflation is muted given falling energy prices. The continued strength of the GBP is a drag on import prices and continues to contribute to inflation being low; ultimately posing further downside risks. Some wage growth is expected which should counterbalance the drag to inflation from oil and GBP appreciation.

- 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). Whilst the Monetary Policy Committee have been focused on domestic data (wage growth, inflation) they are drawn towards external risks, currency levels and real interest rate levels.

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, ECB announced an open ended Quantitative Easing program. The ECB will commence buying €60bn of private and public sector securities every month from March to end-September 2016 at least. The ECB may increase the size of the program or bring forward some buying depending on economic data and inflation data.
  - When the BoE does raise rates, they are expected to do so gradually and to a lower level than in recent cycles, given the likely persistence of the headwinds weighing on the economy.
  - 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
  - Neutral Asia ex Japan and North America
  - 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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