Year Ahead 2016: Volatility Resurrection

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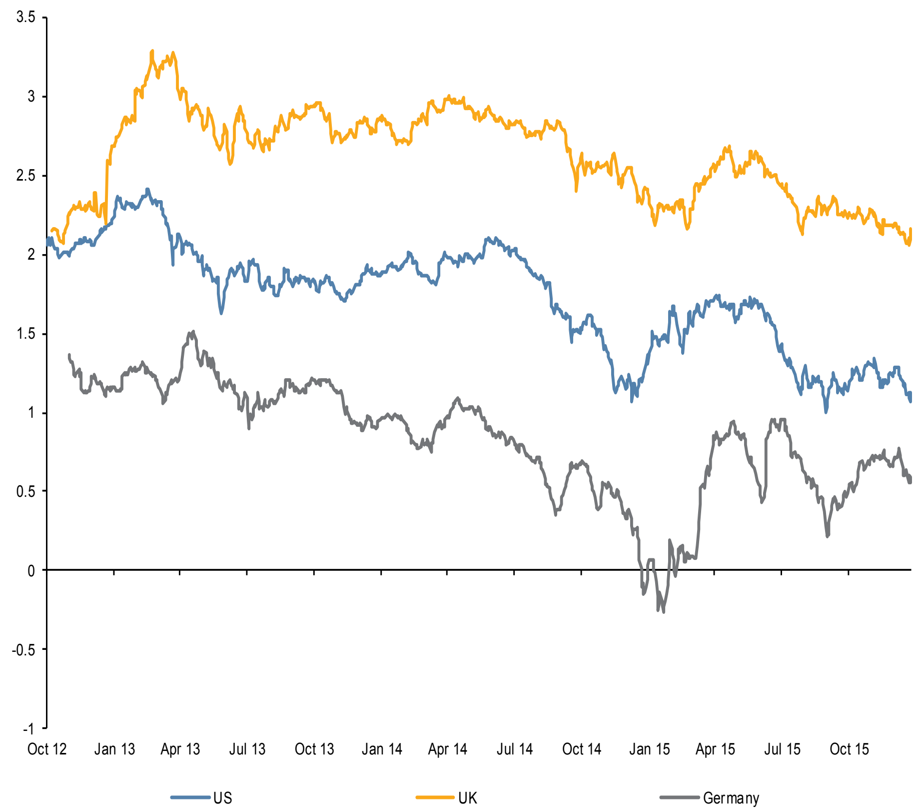
Important disclosures can be found at the end of this presentation.

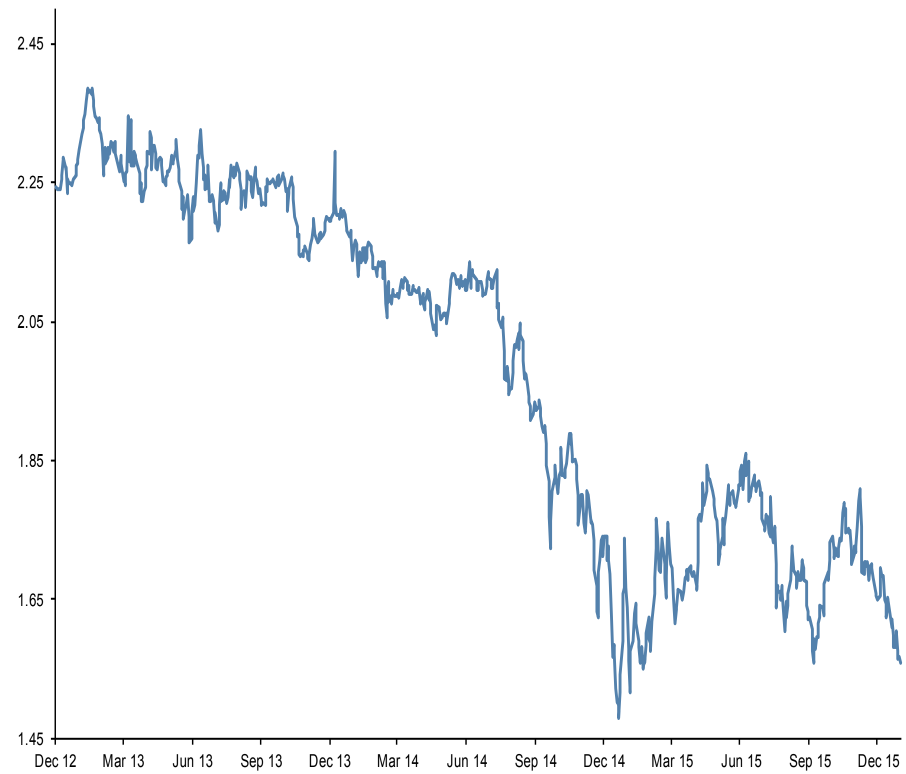
Inflation targeting central banks won't give up on their mandate. Inflation expectations are fragile

Five Year Break-evens



Source: RBS, Bloomberg

Euro 5Y5Y Inflation swap



Source: RBS, Bloomberg

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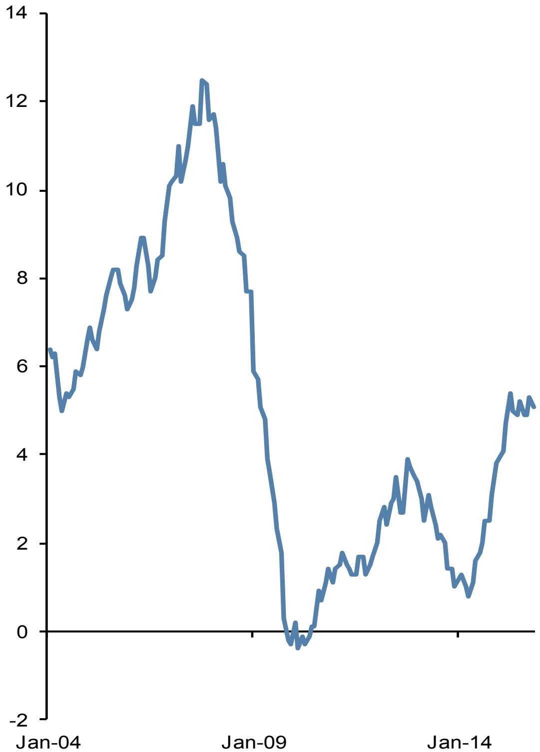
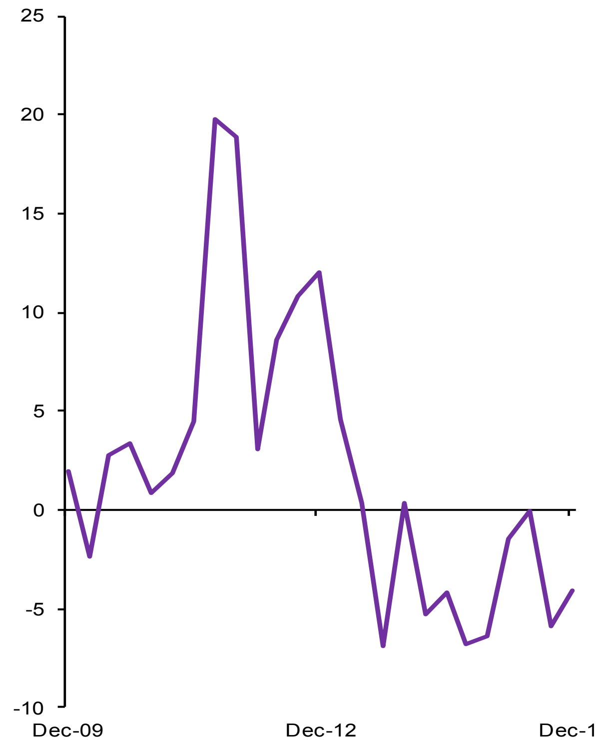
Euro zone money supply growth accelerates. But lending to business is weak and inflation is close to zero and hence far from target

Euro M3 Money Supply Growth



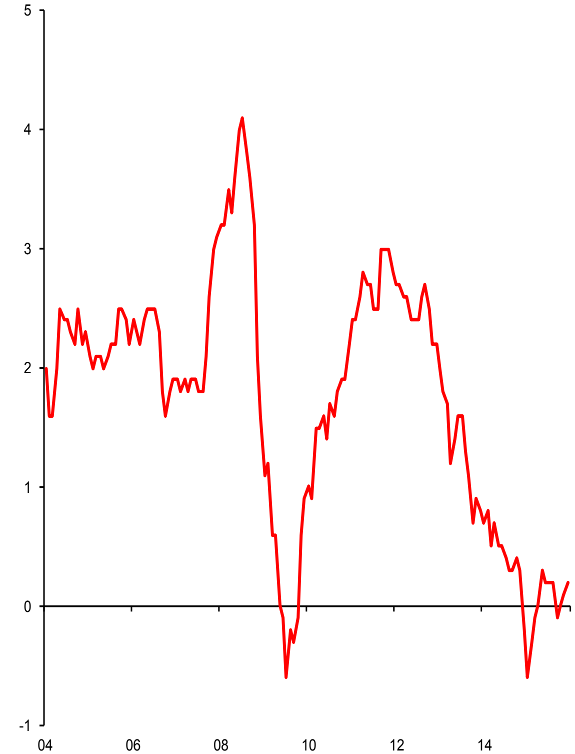
Source: RBS, Bloomberg

Expected change in lending to Business Survey



Source: RBS, Bloomberg

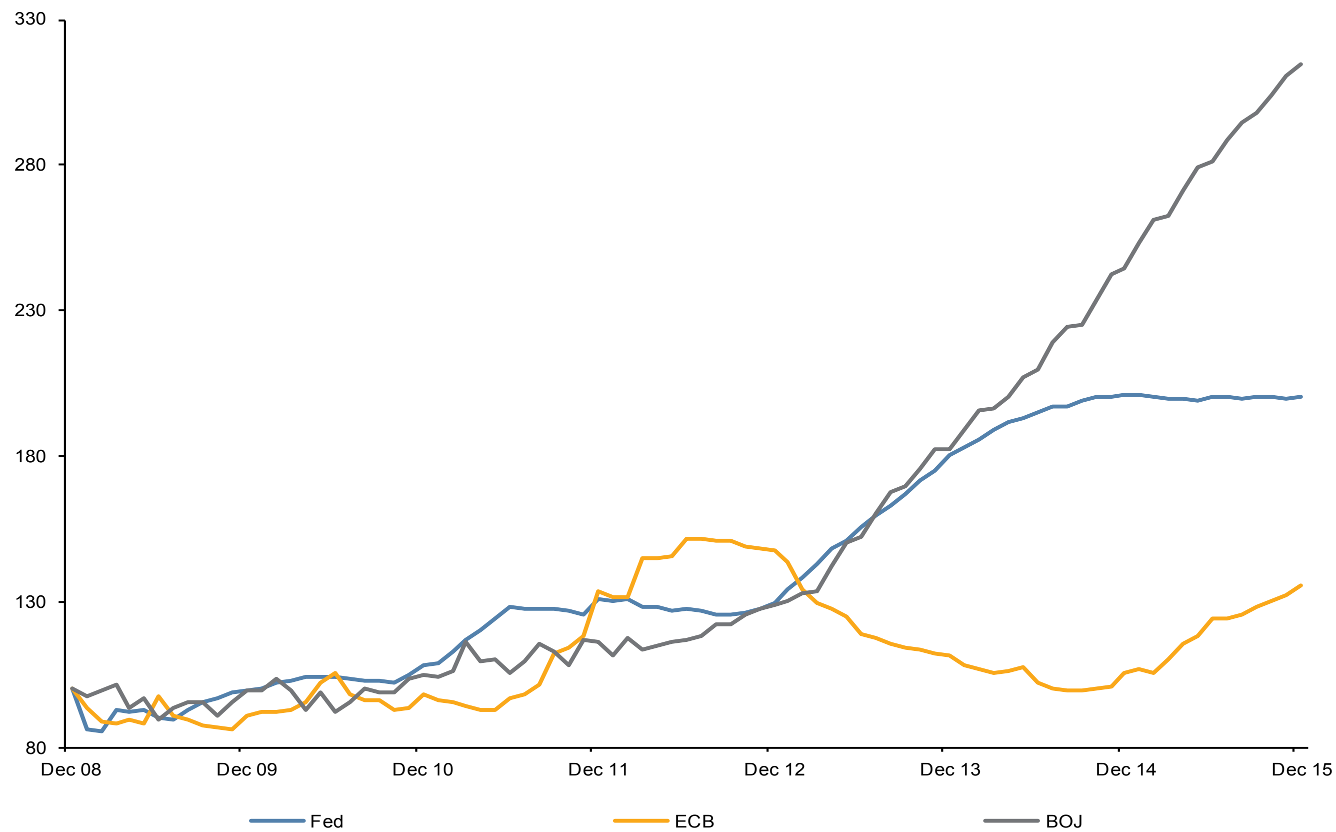
Euro HICP inflation



Source: RBS, Bloomberg

ECB has more room for more easing, probably in March

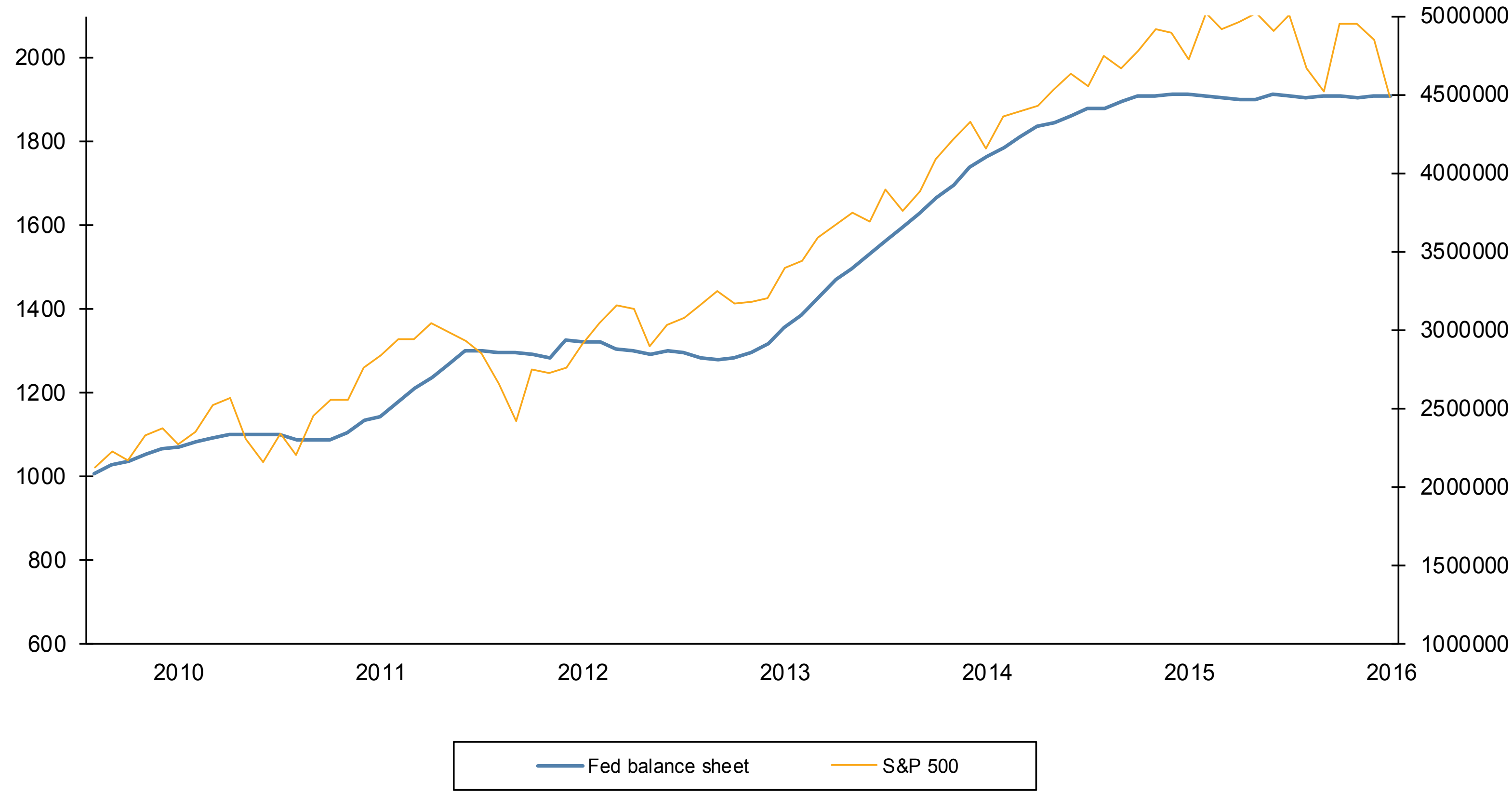
ECB, Fed and Bank of Japan balance sheet size,
Dec 2008 = 100



Source: IIF, Datastream, national sources

To paraphrase Ben Bernanke post crisis: ‘My job is to make equities go up’. He did that. But what now?

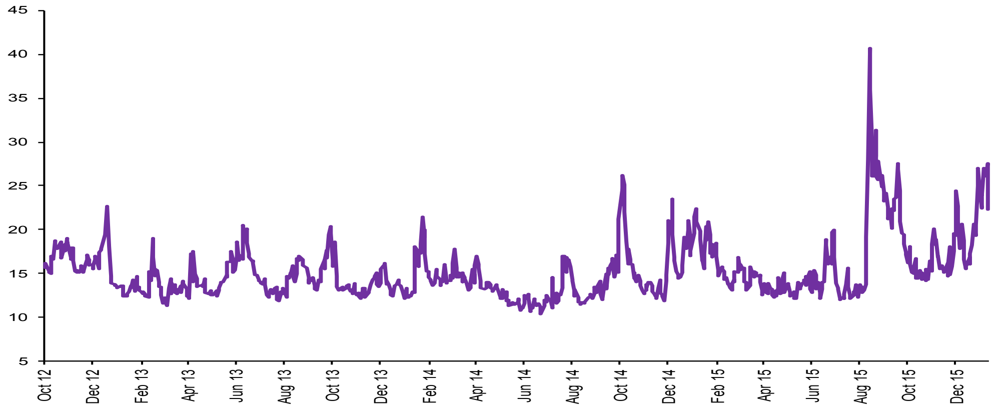
Fed balance sheet and S&P 500



Source: RBS, Bloomberg

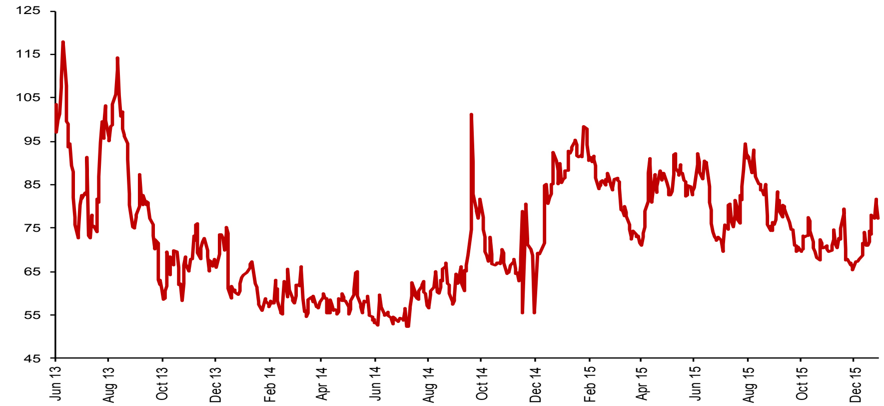
We may be exiting the world of crushed volatility and entering a world of Volatility Resurrection

VIX Index, 2012-



Source: Bloomberg

MOVE Index, 2013-

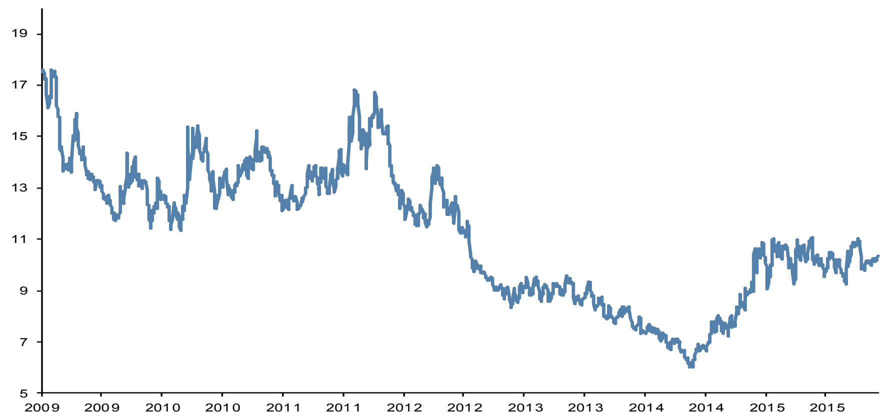


Source: Bloomberg

Majors FX Vol Index, 1992-

Source: Bloomberg

EURUSD 1Y ATM, 2008-



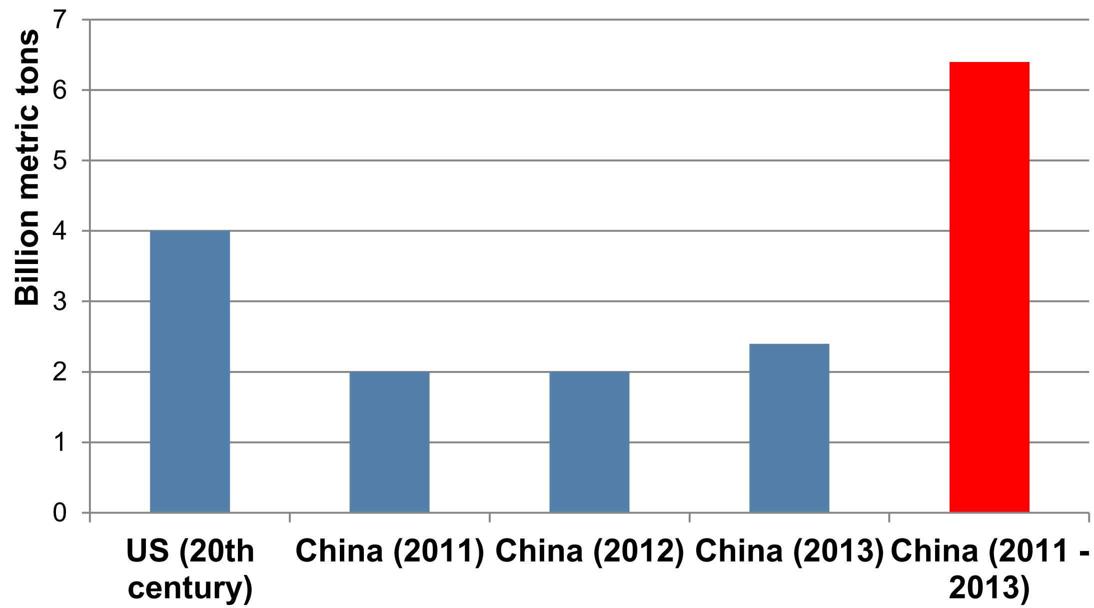
Source: Bloomberg

The astonishing 'stat' of the year … China poured more concrete in three years from 2010 than the US did in the whole of the 20th century

"Any discussion has to start with China, which poured more concrete between 2010 and 2013 than the US did in the entire 20th century. A reading of the recent history of investment-driven economies — whether in Japan before the oil shock of the 1970s and 1980s or the Asian tigers in the late 1990s — tells us that growth does not fall off gently."

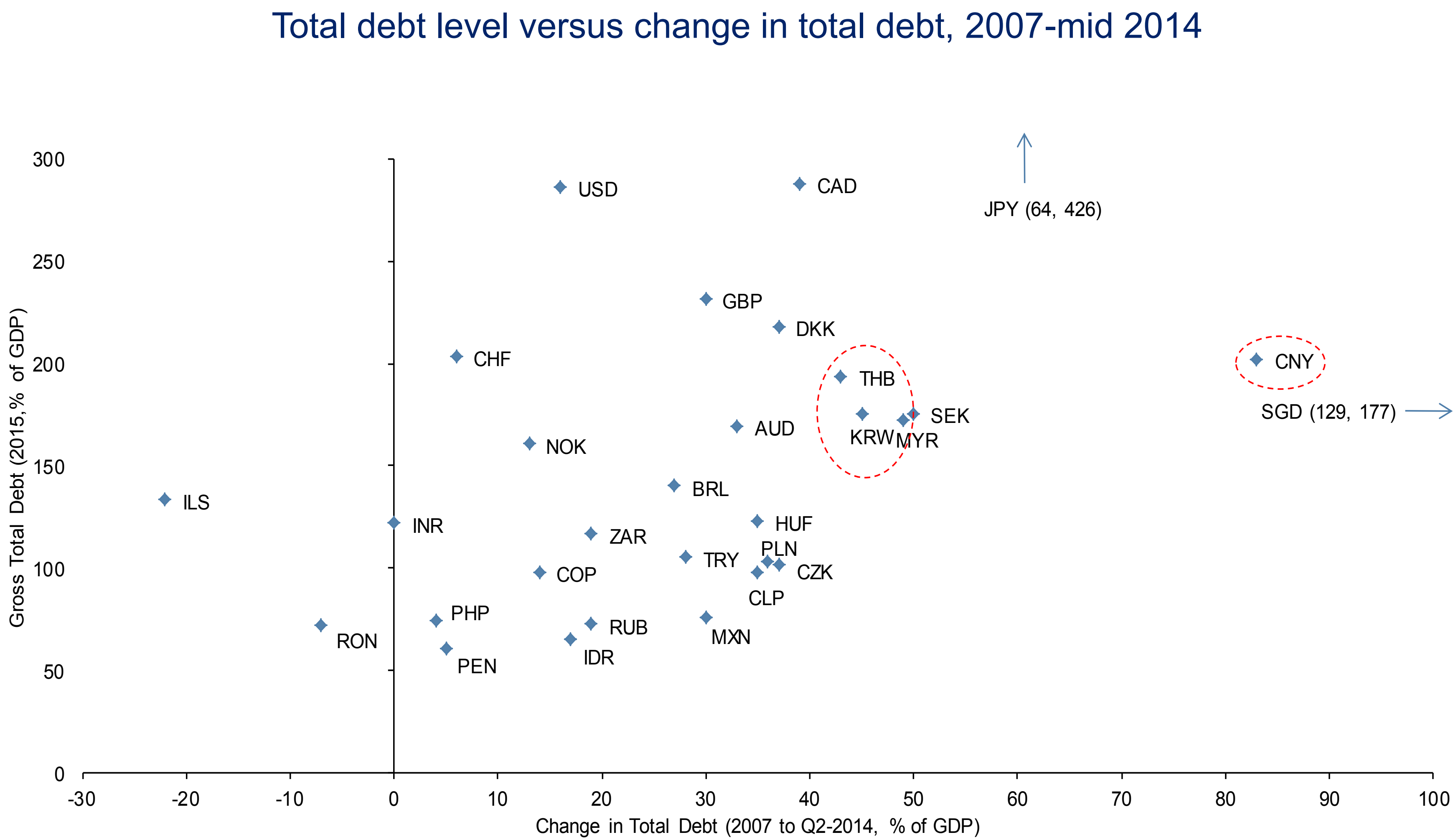
Lawrence Summers, FT, October 7th 2015

Cement consumption:
China in the years 2011-2013
versus US in the whole of the 20th century



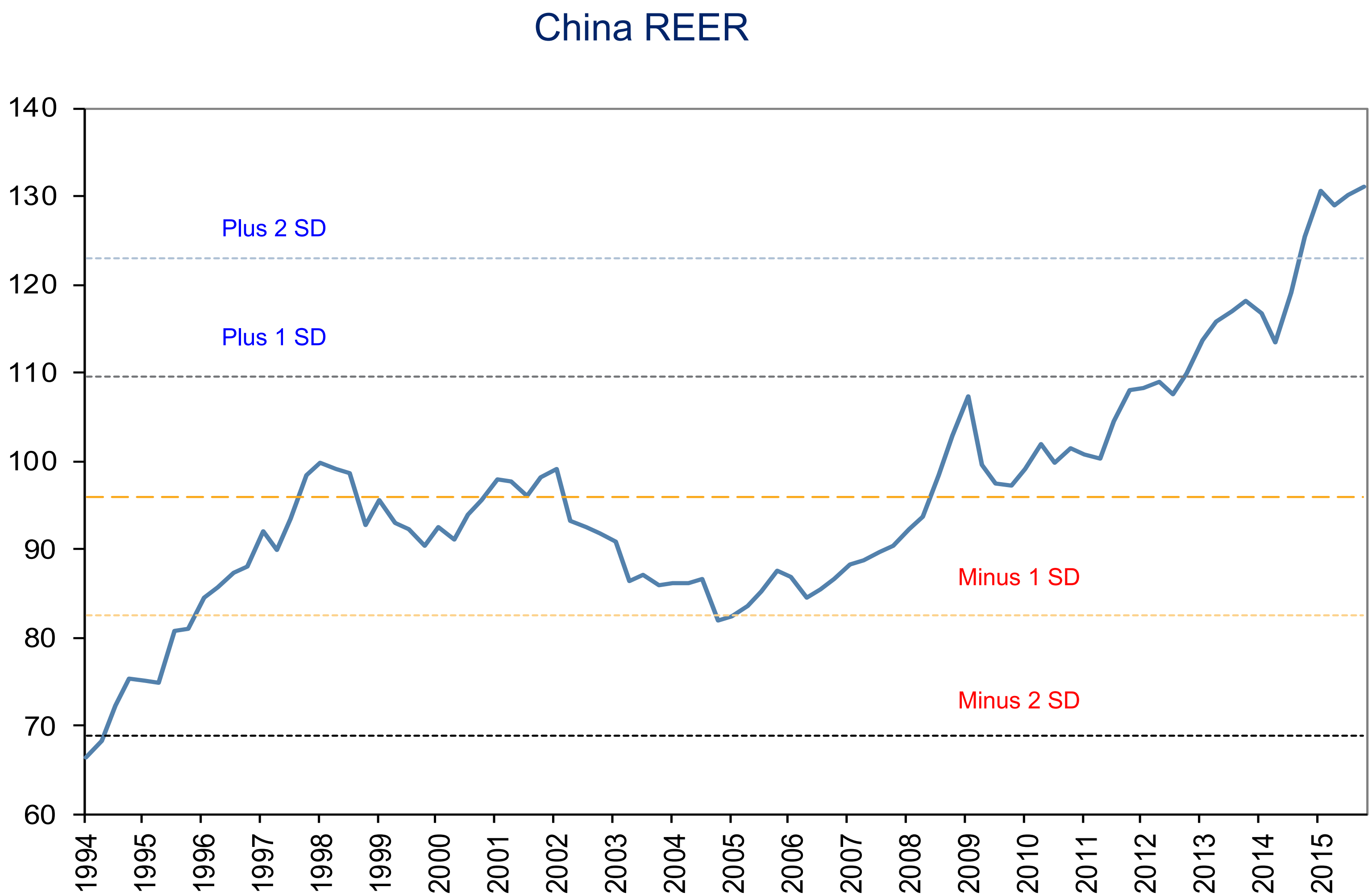
Source: RBS, US Geological Survey

China's <u>very</u> rapid build-up in total debt - in international context



Source: Bloomberg

In REER terms, renminbi has gone from very cheap to very expensive in 10 years. China needs to flex some mercantilist muscle. Weaker currency needed!



Source: BIS, Bloomberg

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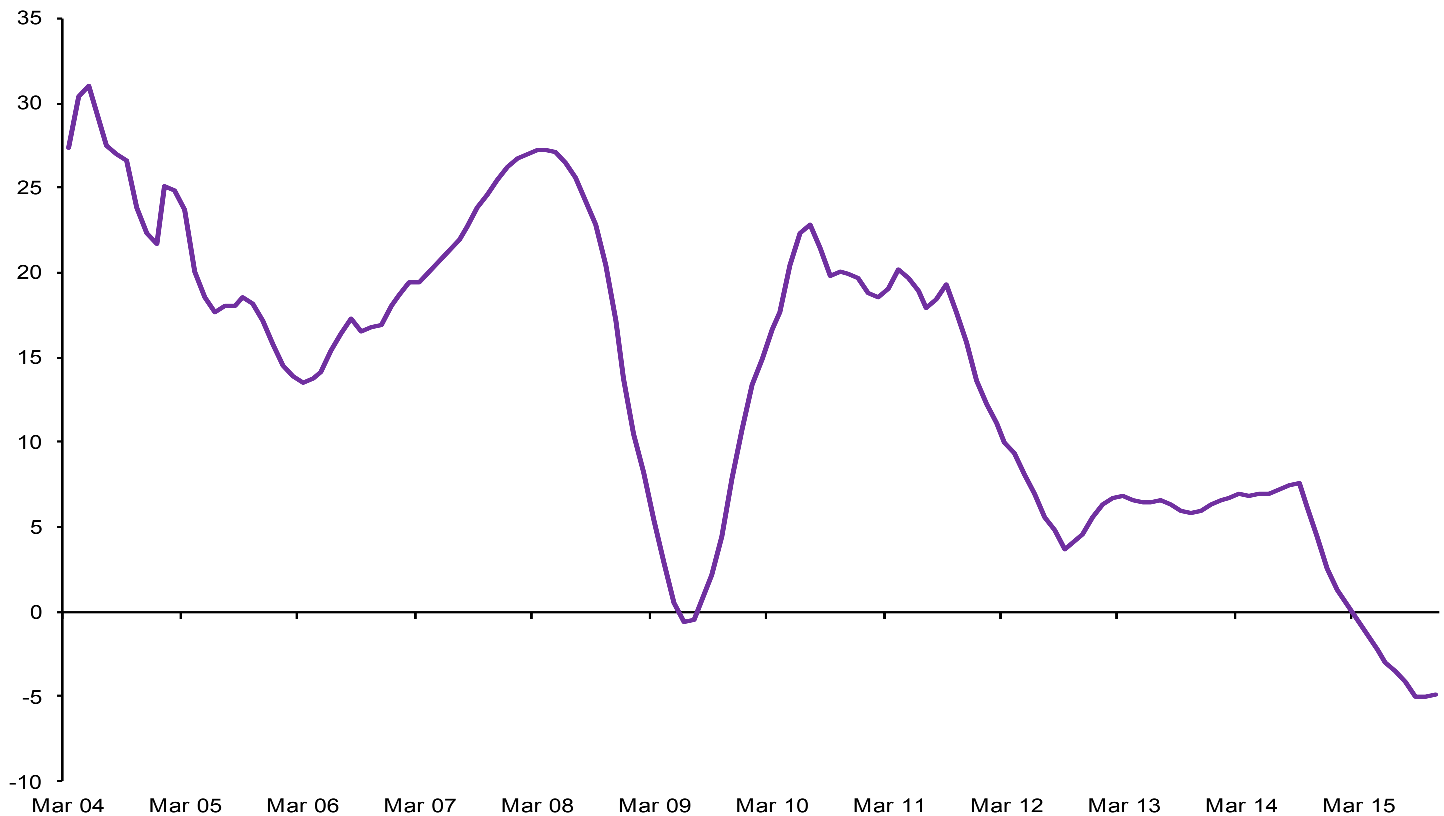
Volatility resurrection: Global FX reserves are shrinking as capital flees China and as Middle east and Russia reserves evaporate due to the energy price decline

Global foreign exchange reserves (change, % year/year)



Source: RBS, Bloomberg

Top Themes 2016

The Year Ahead in 250 words [November 24 2015]

Currency wars intensify in a mercantilist slugfest as world trade growth weakens. Over-capacity persists in global commodity, capital and consumer goods markets. Oil falls, dis-inflation grips and capex is moribund. Wage growth stays weak as economic returns accrue yet more to technology, less to labour. Hence, anti-austerity political populism steadily rises. Central banks of open economies try hardest to weaken their currency: export your deflation somewhere else before someone exports theirs to you! In Europe that means more negative policy rates and (for some) more direct intervention. China's competitiveness loss has been acute and the renminbi weakens as capital flight persists. But Bank of Japan, unable to buy ever more JGBs, concedes currency war leadership and the yen gains on crosses. The US economy trundles along and the Fed trundles with it, tightening absolutely little but relatively lots. Policy divergence lives as the most compelling FX directional theme in years and EUR/USD easily breaks parity. Sterling is cyclically resilient then (ultimately) structurally vulnerable as EU referendum cacophony builds. Global risk assets grind higher for a while as still-plentiful cash seeks a home. But macro liquidity skies darken on Fed liquidity withdrawal and falling global FX reserves. A stronger dollar lifts dollar debt servicing/repayment cost across EM and focus on relative reserve adequacy intensifies. Inflation in some emerging economies reflects extreme currency weakness, a most malevolent strain. Global market liquidity risks intensify and exit windows are narrow. Scepticism builds around inflation targets and around the central banks mandated to pursue them.

Source: RBS

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