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The Shifting Balance

Global Strategy Outlook

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Key Views for Global Markets Q4 2014

Global Outlook

The market is gearing up for a divergent shift in global central bank policies with the Fed and the BoE shifting towards a tightening stance and the ECB and BoJ driving further aggressive reflationary policies. The expectation of this shift in policy and the uncertainty associated with it, will drive a moderate increase in volatility, especially in global Currency markets and, to some degree, in risky assets especially Emerging Markets (EM), at least for the near term.

The expectation that Fed policy rates will rise in 2015, coupled with the imminent end of QE will continue to drive the dollar higher and US curve flatter. As we saw in the 1990s when Japan and Europe struggled and Emerging Markets were in financial crisis, the US dollar and US Treasuries were safe haven assets, US equities outperformed on a strong US economy, whilst inflation fell and bond yields remained low. There are a number of similarities today with the US re-emerging as a growth leader in a world of softer growth and low inflation – Europe and Japan are struggling with weak growth and low inflation and the emerging world is being constrained by weak commodities, tight money and deteriorating growth – in this environment the US dollar's strength will continue to grow, especially also given Japan's and the ECB's reflationary policies. This in turn will have a number of consequences:

1. Drive down commodity prices.
2. Drive up currency volatility particularly in the USD pairs.
3. Put pressure on those EM countries that are grappling with growing deficits and rising inflation. This will drive EM volatility higher initially in currency and local rates markets, however, we expect a full feed through into EM risk premia in hard currency EM sovereign and EM Credit markets as well as EM Equities.
4. Create a deflationary and an implicit monetary tightening effect on the US economy which will drive down inflation expectations (lower breakevens) and moderately drive up US real yields which could potentially delay the Fed's much expected rate hikes in 2015.
5. Help in the reflation of Europe and Japan through a weaker euro and yen relative to the dollar.

The associated rise in US real yields and bear flattening of the UST curve will drive some volatility in risky assets as we have already seen in US HY. The key question is to what degree will the rise in volatility be? Whilst an end of QE should be associated with a rise in volatility, we see no shrinkage in the Fed's balance sheet in 2015 given that the first main wave of maturities will be in 2016. However, in spite of the zero stock effect on the market, the flow effect will be significantly reduced, and this will not be helped by the slow take up of the ECBs first TLTRO. Hence, the reduced flow effect, at least in Q4, could be a precursor to higher volatility as the ongoing dampening effect of the Central Banks' asset purchases, is reduced. However, **the degree of volatility will be somewhat limited in Developed Markets risky assets and more focussed in Currency markets and EM.**

One needs to bear in mind that both the ECB's and BOJ's balance sheets are set to grow in 2015 which should offset the Fed's and BoE's lack of contribution to the flow effect. Not only will this support European and Japanese risky assets but this will keep a lid on any spike in volatility we may experience in Q4 2014. We expect the rise in US real yields to be moderate as the appreciation in the US dollar should constrain monetary conditions. This will be supportive for Developed Markets risky assets, at least for the medium term.

We do not see much pressure on term premia in nominal rates given the little to no inflation and wage pressure. Furthermore, the global financial system is still under deleveraging pressure and global savings outweigh investment, which continues to be bullish for bonds. Furthermore, any EM volatility will drive the flight to quality trade increasing demand for USD and developed market assets, especially risk free assets. In addition, in order to boost exports and add more stimulus, the Chinese may well lower bank lending rates further and buy more US Treasuries to weaken the strong trade weighted RMB. **Overall, we remain constructive on US and European government bonds.**

In spite of the supportive backdrop of low US nominal yields and the wall of CB liquidity, which has fuelled the search for yield that has supported EM assets, we see the rise in the US dollar, the drop in commodity prices and the ongoing drop in demand from China as key factors for EM underperformance. We also see China growth weakening further: housing-market travails, overcapacity, slower credit growth and weak imports all point to a further slowdown in China growth. These domestic issues are compounded by the combined devaluation impact of the euro and yen on exports. So far the recent stimulus effects appear to be having only short-term benefits. All this does not bode well for EM exporters who are heavily dependent on Chinese demand. Moreover if US real yields rise further the attractiveness of EM real yield pickup will certainly look less appealing given the deteriorating risk profile of EM countries. **Overall, we are negative on EM assets and currencies.**

With the recent sell-off in US HY many investors are wondering if this is the beginning of a major risk-off trade, especially given the rise in real yields and bear flattening of the UST curve, with expectations that the Fed will be hiking rates sooner than later. US HY current all-in-yield levels are unattractive from an investment standpoint, especially in an environment where the front-end of the US curve bear flattens. Given that HY investors are total return based, this has driven some outflows in HY mutual funds and ETFs. This, coupled with the record issuance we have seen ($40bn of HY issuance expected) has led to a significant level of indigestion and spread volatility. We do not expect this to continue in any significant manner as whilst HY will be prone to corrections given lofty valuations we do not expect to see a significant deterioration in credit quality and a marked rise in defaults in 2015. Yes HY corporates are levering up and we see debt growth starting to outpace profit growth, but debt levels are not at unsustainable levels relative to profits. **We do not see a sustained sell-off in US HY or for US credit overall. In fact, with the long end of the Treasury curve remaining stable at current levels we expect long duration IG credit to be well bid for Q4 2014. Furthermore, once the market has absorbed the latest wave of HY issuance we expect HY spreads to tighten especially given the fact that US HY is now trading close to the wides of the year (c.450bp). Given where we are from a valuation perspective, and where corporates are in the releveraging part of the credit cycle, we expect low positive excess returns overall in credit.**

Global Equity markets, ex EM, will continue to be in the bull phase given the broad level of liquidity and the improving growth story in the US. US stocks look overbought in light of QE coming to an end, where the implicit QE effect which supported share buybacks should wane and the rise in the dollar should dampen corporate profitability. Global-orientated cyclical or commodity companies should come under pressure here on the back of the stronger dollar and weaker commodity prices. That said, with improving US growth expectations US corporates are continuing to invest in M&A and capex, albeit now that they are releveraging. **Overall, this should be positive for domestic US stocks and US commodity importers.**

In Europe and Japan the expectation of further reflationary policies by the ECB and BoJ should continue to give support to European and Japanese equity markets. Moreover, the ongoing weakening in the euro and yen will continue to help earnings of the exporters and provide ongoing support to both equity markets. In Japan, whilst the correlation between USDJPY and Japanese equity indices remains positive the lack of labour market slack means that the correlation may drop over time with further yen devaluation. The only equity market where we see more downside is in EM equities where the higher dollar and weaker EM growth outlooks will act as a drag. **The rotation out of EM equities will in turn support US, European and Japanese equities.**

For Q4 this backdrop remains:

- Positive USD.
- Negative for JPY, EUR, AUD and EM currencies of commodity export countries versus the USD.
- Supportive for Developed Markets risky assets in general: equities, corporate and financial bonds and loans.
- Positive for European assets: peripheral sovereigns, financial and corporate bonds, core and semi-core euro government bonds, domestic European equities (especially French, Italian and Spanish equities), IG and HY credit, real estate, ABS, CLOs, loans.
- Positive for domestic US equities (large/mid-caps).
- Negative for global-orientated and commodity based stocks.
- Positive for US IG credit especially longer duration bonds.
- Neutral for US High Yield (HY) – short term downside.
- Mildly negative for short-to-mid dated Treasuries, supportive for longer dated Treasuries.
- Mildly negative (further drop) for inflation breakevens, moderately negative (further rise) for US real yields.
- Positive for Japanese equities, real estate.
- Negative for longer dated JGB's 10yrs and out.
- Negative for EM equities.
- Negative for EM credit and hard currency and local currency sovereigns debt.

On a broad scale we expect volatility to be moderately elevated in Q4 with a notable rise in FX and EM volatility. EM market valuations remain compressed and carry is no longer enough to compensate for the rise in volatility. Year to date, EM FX carry performance has been wiped out by the recent devaluations. In Developed Markets especially in credit and equities, idiosyncratic risk can have a marked effect on portfolio performance given the low return profiles. The technical backdrop for markets is getting weaker. Secondary market liquidity continues to reduce. Furthermore, as banks go into year-end risk appetite by market makers will reduce. In case of a risk-off scenario the current backdrop could result in larger losses.

US

Persistent labour market slack and weak wage growth will continue to dominate Treasury valuations where inflation pressure remains subdued which in turn will keep the Fed policy dovish for now. Furthermore, the impact of the current dollar strength could well delay the Fed from hiking rates in 2015, given the implicit monetary tightening effect. Clearly the extent of the dollar rally and pace of employment and wage growth will define the Fed's path. In terms of employment, what is key is labour market participation, if this increases it will maintain the slack in the labour market thus keeping wage inflation muted and bond yields range bound. Moreover, the US is re-emerging as a growth leader in a world where growth and inflation is softer and Europe and Japan are in reflation mode – this environment is good for the US dollar and US assets, moreover it will also keep Treasury yields range bound. As a result our view for Q4 on US assets is:

- **USD** – we expect the dollar to continue to strengthen on the expectation that US growth continues to improve relative to a weakening global growth backdrop.

- **US Treasuries** – *Nominal rates*: We expect a moderate bearish bias to front end US Treasury yields with 2-5y rates rising on the back of expected Fed hikes in 2015. Stronger growth and employment numbers will be key for this. We expect 10y and longer dated Treasury yields to be capped or moderately higher from current levels. The equilibrium level for the 5y5y rate should be close to the long term potential nominal GDP of 3.85%, the current 5y5y rate is at 3.39%, 46bp below the equilibrium level. *Real rates*: the stronger dollar and lower commodity prices should lower inflation expectations keeping inflation breakevens low. On the back of this and the fact the QE is coming to an end we expect real rates to rise modestly.

- **US Treasury Curve** – we expect the curve to stay flat and trade in a range bound fashion where 2s5s and 5s10s could flatten further, depending on payrolls and employment numbers.

- **US Equities** – the current weakness of the consumer on the back low real wages and limited wealth gain will drag on small cap companies. We expect outperformance of large to mid-cap domestic orientated companies that are less impacted by the stronger dollar and those commodity importers who will benefit both from the stronger dollar and lower commodity prices. Global-orientated cyclical and commodity companies should come under further pressure here as the dollar strengthens.

- **US Credit** – the recent sell-off in US HY driven by the combination of record issuance and a rise in short term yields should create better entry point to buy the asset class. Whilst US corporates are releveraging their balance sheets we do not expect a significant rise in defaults in 2015. US Investment Grade credit will continue to be supported. Long duration credit will continue to outperform on the back of a stable flat treasury curve. We expect modest positive excess returns in IG credit.

Europe

The latest round of measures by the ECB to improve inflation expectations and help reflate the economy are having some effects especially in terms of the weaker euro, lower Bund, semi core and peripheral yields and a somewhat improved loan supply. Moreover, in the lead up to the AQR and Stress Tests banks have been aggressively recapitalising. This, in combination with the ECB's ABS and Covered Bond Programme should help free up regulatory capital to improve banks ability to lend. The latest Loan Officer survey has shown a marked improvement in demand for loans and as such the steps that the ECB has put in place should start to open the credit channel, which is key for European growth. Furthermore, through the LTROs and now the TLTRO the liquidity channel is also open and is operating. So far a lot of small things have improved namely: lower deficits, weaker currency, more loans approved in the background which on a step by step basis is all positive for Europe. Moreover, the ECB seems committed to keeping the ZIRP (Zero/Negative Interest Rate Policy), the liquidity channels and now the credit channels open for some time and it seems that Mr Draghi will do more if needs be. As a result our view for Q4 on European assets is:

- **Bund Yields** - we expect the front end (0-5y) to remain flat on the back of the ECB's ZIRP. In the absence of any further ECB intervention, ongoing demand for yield will keep 10y Bund yields well bid, with 10y Bund yields trading in the 1% sub level. Without any change in inflation expectations or any further ECB policy actions 30y yields will also trade lower.

- **Peripheral Sovereigns** – with a weaker euro, lower funding costs, improving M3 and bank lending numbers, the introduction of the conditional and unconditional TLTROs we expect peripheral sovereigns such as Italy, Spain and Portugal to continue to outperform versus Bunds with spreads slowly compressing to 90, 105 and 140bp respectively.

- **Euro** – the ECB's reflationary policy has successfully started to drive the euro lower (5.5% devaluation on a trade weighted basis) and with Mr Draghi's commitment to do more if inflation expectations do not rise we expect the euro to continue to weaken. We are expecting EURUSD to reach 1.22 by year end.

- **European Banks** - we continue to favour European banks. Banks have largely been recapitalising ahead of the AQR. We do not expect any major negative fallout from the Stress Tests other than a few banks being asked to recapitalise further. Furthermore, the new TLTROs (even if it is smaller than the LTROs for peripheral banks) create very attractive senior funding out to 4 years. As such we will see more long dated (5-10y) senior issuance from European banks. Now that S&P has downgraded the sub debt of European banks we see value across the capital structure. The cost of equity continues to improve and relative to the slow improvement of Return On Equity creates a very positive picture for European banks.

- **European Equities** – European equities have lagged on the back of the fallout from the Russian sanctions. That said, the weaker euro and the ongoing reflationary stance by the ECB will be supportive for European Equities. Furthermore, European Equities provide an attractive earnings yield of 8% versus the US at 7%. Versus EM equities European equities provide a far better risk reward profile (0.8 one year Sharp ratio for European Equities versus 0.2 for EM equities). Post the AQR we expect banks stocks to push higher. Moreover, in the latest Loan Officer survey the demand for loans by SMEs and corporates is picking up. This bodes well for small cap companies especially in light of the ECB's effort to free up bank capital to assist lending, which in turn should slow NPL growth. Of all the equity markets we see the most upside in European equities over the next 12 months.

- **European Credit** – the backdrop for European credit remains constructive, for both IG and HY. Lower European government bond yields, improving European peripherals and further accommodative policy by the ECB all point to lower spreads and steep CDS curves. We continue to see upside for European bank paper especially post the S&P downgrades and AQR/Stress Tests. As we mentioned in the last *Global Strategy Outlook* we expect more M&A activity in European HY. Idiosyncratic risk is on the rise and current valuations do not compensate for large single name losses such as Phones 4U – name selection is key to performance overall. Institutions that have Turkish and Eastern European/Russian exposure could also come under renewed pressure and further spikes in risk aversion. In summary, we favour Financials, Corporate Hybrids, single B credits, Leveraged Loans and European peripheral corporates (that have low EM exposure).

UK

UK growth is continuing to improve and is expected to reach 3% for 2014 and moderate slightly in 2015. Furthermore, consumer confidence has now risen to pre-crisis levels, investment is strong and unemployment continues to drop, supporting consumption. As with the US and Europe inflation remains benign, that said spare capacity in the economy is eroding and thus, we are of the view that the BoE will start its tightening cycle February 2015. As a result our view for Q4 on UK assets is:

- **Gilts** – the strong growth backdrop will continue to drive gilt yields higher into year end, with 10y gilts expected to be around 2.75% at by end 2014. Moreover, we are of the view that the Gilt/Bund spread will continue to widen to a target of 160bp. Apart from a short term 5s30s steepening driven by long dated issuance we expect 5s30s to flatten going into 2015, in keeping with our BoE rate hike call in Q1 2015.

- **UK equities** – given the international exposure of many large cap names in the FTSE we expect some weakness to feed through from ongoing derisking in EM, poorer revenues by companies that are exposed to weakening EM growth, deteriorating EM central bank liquidity and weak commodity prices. Furthermore, idiosyncratic risk events driven by M&A, poor governance issues (e.g. Tesco, Co-operative Group) and ongoing banking regulation will limit UK equity upside. For performance we recommend buying domestic corporates selectively.

- **GBP** – GBP could strengthen further on the back of stronger UK growth and expected rate hikes, especially versus EUR, JPY and CHF. We expect GBP to trade flat versus USD into year end.

- **UK Credit** – As with US credit and European credit, Sterling credit should remain supported here. The current yield differential of 2.55% versus euro credit makes Sterling credit very attractive on an all in yield basis. That said, a lot of this is because Sterling is very long dated. However, given our view that the long end of the Gilt curve will flatten going into 2015, this is very supportive of long date sterling credit. Idiosyncratic risk remains very dominant in UK credit especially in HY and we continue to expect UK M&A to gain momentum especially in Retail, Construction and Building Supplies sectors. Given where valuations are, careful name selection, to avoid the pit-holes, will be paramount to positive return performance.

Japan

Whilst the yen has weakened and nominal interest rates are kept in check by the BoJ's significant JGB-buying operations, Japanese exports have not revived, slack in the economy is disappearing full employment is approaching and consumer spending power has been considerably weakened especially due to the VAT hike and yen imported inflation. The Japanese public will not support further erosion of their spending power. Prime Minister Shinzo Abe will therefore have to adopt more fiscal stimulus, to help growth. This will not be enough, in our opinion, and as such the BoJ will have to ramp-up purchases of JGB's in 2015 especially at the long end as rising inflation expectations will put pressure on the long end of the curve. As a result our view for Q4 on Japanese assets is:

- **JGBs** – we expect JGB yields to trend upwards gradually as the yen weakens with 10y JGB yields at 0.7% by year-end. The short end of the curve will remain stable and yields could even fall to 5bp for 2y paper. On the back of raised inflation expectations we expect long dated yields to rise and the long end of the curve to remain steep - 20s30s. Once 30y yields rise above the 1.7% mark however, we expect to see buying from life insurance companies return, thus limiting the long end steepening somewhat.

- **JPY** – pressure on the BoJ to ramp up monetary stimulus will increase going into 2015, this will result in more downside pressure on JPY. Furthermore, greater Japanese demand for foreign assets are expected to pick up and will exert more pressure on the yen. The shift in GPIF's allocation away from JGBs could result in more buying of foreign assets beside Japanese equities, thus further weakening the yen. We expect USDJPY to reach 114 by year end.

- **Japanese Equities** - we expect Japanese equities to rise along with the weakening of JPY. However, over time we expect the positive correlation of Japanese equities and the USDJPY to weaken as the limited onshore capacity will mean that the positive currency impact on revenues for domestic orientated companies will weaken. Only large companies with an external presence will benefit as they focus predominantly offshore. The reduction in GPIF's portfolio weight to domestic bonds should mean an increase in demand for Japanese equities, which should be very supportive in the short to medium term. Barring any further major weakening of JPY, we expect the Nikkei 225 to finish the year at 16000.

Emerging Markets

The stronger dollar and weaker commodity prices does not bode well for EM countries, especially those commodity producers and those countries that are very dollar based in their trade. The bear flattening of the front end of the US Treasury curve and rise in US real yields is not good for EM banks particularly those in Latam, Asia and the Middle East. In addition, the slowdown in China growth and reduction in commodity imports will drive down EM growth and put further pressure on those countries grappling with growing twin deficits. EM currency volatility has risen and will rise further especially versus the dollar. This in turn will put pressure on the those central banks to tighten policy further in countries with high external funding needs and those struggling with inflation, namely Turkey, South Africa, Indonesia, Brazil and India. That said commodity importers like India should benefit in this climate. In addition, Asian block countries are also coming under competitive pressure due to the weaker JPY especially South Korea and China. CEEMEA countries are the least vulnerable to the higher dollar as a lot of their trade is euro or ruble based. Clearly the reflationary stance by the ECB can only benefit them driving down their financing costs as yields compress. That said, the offsetting factor is the ongoing sanctions with Russia, which will put pressure on their trade balance especially in countries like Poland.

- **EM FX** – we expect further EM currency weakness versus the dollar. Furthermore, currencies of countries with large external funding needs and large dollar exposure will come under increased pressure. Conversely, countries like South Korea could well intervene to stop their currency appreciating versus JPY to keep competitiveness. Overall, FX volatility is on the rise and will stay elevated for some time.

- **EM Equities** – we expect EM equities to come under more pressure with the rise in the dollar, fall in commodity markets and weakening growth picture. The fall will be led by commodity producers, energy companies and banks. Whilst the yield pickup is very enticing, Volatility Adjusted Returns are not as attractive as that offered by European equities, for example. Furthermore with weakening economic prospects for some EM countries their Corporate and Financial sectors remain very vulnerable from an earnings and credit quality standpoint.

- **EM Sovereigns** – we expect sovereign risk premia to rise especially for those commodity and energy exporting countries and for those countries with large external funding dynamics (e.g. Brazil, Venezuela, Chile, Peru, the Middle East, South Africa, Turkey and sub-Saharan Africa).

- **EM Corporates and Financials** - we do see default risk rising and credit rating deterioration for the Corporate and Financial sectors in countries where economic fundaments continue to weaken. Unlike sovereigns, many EM companies thrived off the abundant global liquidity and China led growth without balance sheet repair and healthy liability management. In the less sophisticated companies the sudden weakening of local currencies could result in FX losses where hedges were not fully or properly implemented. The combination of growth deterioration and tight monetary policies in Brazil, Turkey and South Africa will drive NPLs higher, putting pressure on bank balance sheets. Those institutions with large hard currency debt profiles will come under pressure if local currencies depreciate further.

Key Trades Across Asset Classes for Q4

Global Rates

- **US: position for the approach of rate hikes via weighted bullet-vs-barbell positions (e.g. long belly of correlation-weighted 3s4s5s) or vs. 6m expiry 2s5s conditional bear flattener.**

  These trades will perform as the first Fed rate hike draws nearer, but do not suffer from the punishing negative carry that outright shorts or curve flatteners do.

- **EUR: sovereign spreads - Long 3y Spain and Italy vs. Germany (Target 30bp and 40bp respectively).**

  We prefer to express the view that peripheral spreads will gradually tighten vs. Germany in shorter maturities, as these offer better risk/reward than in longer maturities where the volatility-adjusted carry of periphery has already converged to that of the core.

- **EUR: rates - conditional 3y expiry 5s30s conditional bear steepener. Entry ATMF versus ATMF+2 (+91bp). Carry +1bp/mth.**

  This trade expresses the view that the front-end of the curve will be anchored for several years by ultra-low ECB policy whether or not the ECB eventually moves to large-scale asset purchases. However, if and when, the ECB does decide on large-scale asset purchases, long-dated yields will rise driven by revived long-term inflation expectations.

- **UK: 5/30y Gilt steepener (Target 150bp).**

  The Gilt curve looks too flat versus both the level of 10y yields and the shape of the money market curve.

- **Cross-market: Long 10y EUR vs. 10y US and UK (Target 175bp and 170bp respectively).**

  Continuing economic and policy divergence between the euro area and the US and UK means that 10y spreads (already wide by historical standards) will widen still further.

Credit

- **Directional HY Trade (Buy Short Term US High Yield Debt; SJNK or HYS ETF).**

  Short term (1y-3y) HY bonds have cheapened significantly since mid-July. This has been driven by significant outflows in the HY market and the front-end has been impacted dis-proportionately. We think that HY markets will perform later in the year and this will cause short end HY debt to outperform. Short term debt is yielding 5.5% and has a duration of 2.5 which implies that short term HY spreads would have to widen by 200bp (approximately) to breakeven. We are not expecting that scenario for US HY over this time horizon given our balanced outlook on the asset class and better growth outlook for the US economy.

- **Relative Value Trade (US HY Basis Trade).**

  The US HY basis (as represented from Long HYG ETF, Short CDX HY Index and Short 5Y Treasuries) is currently trading at -70bp. Cash HY has underperformed synthetic High Yield over last two months. We recommend investors to enter this trade once the basis reaches -80bp or lower.

- **Series 22 iTraxx Main Flatteners (updated for Series 22).**

  On the back of the recent roll the move wider and steeper in the 3y to 5yr part of the Series 22 curve, makes it attractive to put on duration weight flatteners. With the reasonably constructive backdrop for credit, we recommend Main flatteners to take advantage of the new curves. A 3s5s flattener in the ratio of 1.59 is the best choice for carry and roll down potential, for a given notional of 5 year (€5.11k of combined carry and roll down for €10mn notional of 5 year over 3 months).

- **Dated Sub Insurance offers best ratings adjusted spread pickup across all sectors in Investment Grade.**

  Sub Insurance pays extra (80bp relative to Bank Sub) because of the illiquidity but given the well capitalised nature of the insurance sector and no writedown feature in the instruments (unlike bank AT1, which are also junk rated mostly) we like dated Insurance Subs. There is no need to extend from dated to perpetuals in Insurance as the extra pickup is not much given the duration. Our favourites are UQA, ACHMEA and ALVGR.

FX

- **Short EURGBP – Target 0.76.**

  We expect the UK economy to continue to grow strongly in 2014 causing markets to price in higher yields, especially relative to the eurozone. We forecast the BoE to lead the tightening cycle within the G5 with its first rate hike coming in February 2015. EURGBP is closely correlated with the short-end yield differential. In addition, the GBP remains very cheap according to our BNP Paribas FEER[1] model.

- **Short EURUSD – Target 1.22.**

  The August Jackson Hole speeches by Fed Chair Janet Yellen and ECB president Mario Draghi emphasised the divergence in monetary policies, accelerating the fall in EURUSD. This pair is increasingly linked to real yield differentials that should continue to shift in the USD's direction. Support to the EUR from portfolio flows peaked earlier this year and such flows should weigh on the EUR as it is increasingly used as a funding currency.

- **Long USDJPY – Target 114.**

  As the USD rebounds in 2014, we forecast it to make its largest gains against the currencies with the loosest monetary policy. The BoJ is likely to ensure that policy is loosest in Japan and that JGB yields remain low. Japanese investors are increasingly purchasing foreign assets and the anticipated reform of the government pension investment fund should encourage further outflows.

- **RKOs attractive for USD bulls.**

  USD risk-reversals, although much lower than the levels seen during May 2013's 'taper tantrum', when adjusted by the level of base vols, strongly favour a rise in the USD. Positioning Long the USD via RKOs looks attractive, especially given the flattening of vol surfaces and high risk-reversals relative to base vols.

[1] BNPP FEER (fundamental equilibrium exchange rate) is the value of an exchange rate when an economy is operating with an internal balance (ie, output in line with potential output, full employment and inflation in line with the central bank's target) and a sustainable current account balance.

Emerging Markets

- **Long 3m INRIDR; NDF ref 197, Target 205, Stop Loss 194.5.**

  INR is benefiting from a revival of FDI commitments – the first real positive for the "Modification" trade, and also from the sharp drop in gold and oil prices. IDR, in contrast, continues to face headwinds from lower commodity prices, and more recently, some disappointing political developments that has dampened our expectation of hard hitting reforms.

- **Short USDMXN spot ref 13.45, Target 13.15, Stop Loss 13.60.**

  The USD rally looks overstretched vs. MXN. We factor in the higher risk premium on EM assets, and the systematic component of USD strength in the performance of MXN – but still find that the squeeze in USDMXN is driven by technical factors rather than fundamentals. We believe the MXN can snap back sharply if USD strength stalls.

- **Pay 1y2y FWD ZAR at 7.60% Target 8%, Stop Loss 7.45% or Pay 5y ZAR 7.60% Target 8%, Stop Loss 7.45%.**

  Tapering in the US is almost concluded, which implies a slower pace of inflows to EM. Countries with high inflation and large C/A deficit may require larger risk premia in this environment. For now ZAR interest rates are lagging behind FX weakness but with large funding requirements, this is unlikely to be sustained. Interest rates in the front end need to rise to rebalance the risk of currency depreciation.

- **In Latam, switch into Brazil Banbra'22 from Caixbr' 22 in banks.**

  Pickup 8bp in z-spread (98th percentile rank). It compares favourably to Banbra'20 and Banbra'17 trading 40bp and 60bp tighter than Caixbr'19 and Caixbr'17 respectively. In our view, Banco do Brasil offers a safer business risk profile. The ongoing deterioration of the macroeconomic outlook in Brazil is likely to result in an increase in non-performing loans. Caixa is more exposed to an asset quality deterioration risk given its aggressive loan portfolio growth in the past couple of years (+35% pa) with a shift in the mix towards new and riskier segments. Banco do Brasil's loan expansion, although also aggressive, has been slower than Caixa's (19% pa) and, more importantly, accompanied by a focus on safer segments. The difference in strategy has already resulted in a divergence in the quality of operating results with, for example, Caixa's NPL 90d deteriorating +0.5pp yoy to 2.8% in Q2 while Banco do Brasil's NPL 90d have been roughly stable at 2.0%. We expect this divergence to continue.

- **In CEEMEA, we recommend switching from VIP 7.5043% '22 into VIP 8.25% '16.**

  We see Vimpelcom's spreads in the short end of the curve offering sufficient cushion in the face of geopolitical risks in Russia and rising UST yields, as consumer spending on mobiles in Russia also looks resilient against a backdrop of falling commodity prices. The current flatness of this curve is not reflective of the company's improved maturity profile post-Wind refinancing earlier this year nor by its good liquidity and recently adopted strategy to deleverage to 2.4x net debt/EBITDA by the end of this year from 2.6x reported in June 2014 (a target we expect the company to deliver). For more cautious investors, a switch may be the most appropriate strategy given the natural hedge embedded into the flatness of Vimplecom's curve, which we do not expect to invert any further.

- **In Asia, we favour exiting CITPAC bonds in favour of wider names in the BBB+ or A-/BBB+ Chinese SOE space, such as the AMCs and China's properties names.**

  We think the CITIC/CITPAC curve is rich, offering little UST cushion and likely to remain unprofitable. The lion's share of new CITIC Ltd's profit contribution is from China CITIC Bank (over 80% assets and 70% profits, 2013 figures), and it is unlikely that CITPAC will be able to raise more cash from CITIC Bank by increasing its dividend payout. The bank itself has relatively strong asset growth. With a CET1 of around 8.7%, ROE in the high teens but asset growth in the mid-20%, there is a good chance that CITIC Bank itself would also need to raise its capital via external sources. The company does not sound optimistic about an increase in production, and lack of earnings growth is therefore likely. This will probably mean a return to the market for financing in the coming year to fund existing debt and capex.

Equities

- **Long European financial stocks - SX7E.**

  We are very constructive on European bank stocks where the cost of capital continues to improve as well as return on capital. We expect that, through the rest of the year and into 2015, investors will slowly recognise the existence of a lower-for-longer risk-free yield environment in Europe and a lower equity risk premium for European banks which contribute to the up to 45% upside to banks' equity valuations. This potential has not yet been fully recognised by the market. Selling downside volatility (selling puts on SX7E) is another way to express this view.

- **Position with upside leverage and low downside risk for two more years of SPX gains.**

  The strength of the currency and rising yields are headwinds for equities but will only serve to limit the positive momentum from further earnings growth and valuation expansion. The US economic and equity market outperformance combined with a rising USD could be a very appealing combination for global investors in economies with weak/volatile GDP and underperforming equity markets. The flows could become self-perpetuating.

  As US equity upside skews are flat and downside skews are steep, the following trade can be implemented.

  Buy 2x Dec-16 SPX 2000-2250 call spread for up to 25% upside for a 12.5% rally over two years (and outperform delta-1 investment up to SPX 2500). Fund this by selling 1x the Dec-16 SPX 1900 put option. Risk: The investor will make losses if the SPX is below 1900 at the December 2016 expiry.

Robert McAdie

G10 Rates

Near-term headwinds

G10 Rates: Near-term headwinds

- **In 2015, we expect policy rates to start to be raised slowly in the US and the UK, whereas the BoJ and ECB will continue their asset purchase and liquidity-provision programmes.**
- **Hence, we expect yield curves to bear flatten in the US and the UK and to bear steepen in core Europe and Japan. Generally, the rise in core yields will be modest. Peripheral European sovereign spreads should remain near current levels.**
- **During the balance of 2014, however, financial markets will face three significant headwinds: much lower incremental liquidity provision than they have been used to; falling market inflation expectations; and higher US real yields.**
- **These headwinds threaten to cause countertrend moves before the end of 2014, particularly where positioning is heavy. We therefore see near-term risks to our central case forecasts of flatter curves and slightly tighter peripheral spreads in the form of a near-term bull steepening of the US curve and a widening of peripheral spreads in Europe. We recommend moderating positioning accordingly.**
- **The inflation market merits special attention, as the winding down of the Fed's quantitative easing has resulted in a sharp rise in real yields and a smaller fall in breakeven inflation expectations, with knock-on effects and implications across financial markets.**

Bear flattening in the US and the UK, bear steepening in Europe and Japan in 2015

We forecast a gradual rise in yields and a tightening of peripheral spreads in the medium term

In 2015, we expect policy rates to start to be raised slowly in the US and the UK, whereas the BoJ and ECB will continue their asset purchase and liquidity-provision programmes. So we expect yield curves to bear flatten in 2015 in the US and the UK and to bear steepen in core Europe and Japan. Generally, we forecast the rise in core yields to be moderate (Table 1).

Our forecasts are not far from the market-implied forwards (except in Japan – see below), which

Table 1: BNP Paribas rate forecasts versus forwards

As of Sep-14		At end 2014				At end 2015			
US	**Spot**	**Dec-14 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**	**Dec-15 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**
3m OIS	0.09	0.09	0.10	1	1	0.85	0.58	76	-27
2y	0.54	0.77	0.70	24	-7	1.77	1.75	123	-2
5y	1.76	1.93	2.00	17	7	2.55	2.65	79	10
10y	2.52	2.62	2.90	10	28	2.96	3.25	44	29
30y	3.23	3.28	3.55	5	27	3.46	3.70	23	24
GER	**Spot**	**Dec-14 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**	**Dec-15 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**
3m OIS	-0.04	-0.04	-0.07	0	-3	-0.06	-0.08	-2	-2
2y	-0.07	-0.07	-0.10	0	-3	-0.01	-0.05	6	-4
5y	0.17	0.21	0.20	4	-1	0.43	0.50	26	7
10y	0.96	1.05	1.15	9	10	1.32	1.50	35	18
30y	1.89	1.90	2.10	1	20	2.00	2.50	11	50
UK	**Spot**	**Dec-14 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**	**Dec-15 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**
3m OIS	0.45	0.54	0.47	8	-7	1.25	1.61	80	36
2y	0.84	1.06	1.00	22	-6	1.84	1.90	100	6
5y	1.80	1.94	2.10	15	16	2.33	2.68	53	35
10y	2.44	2.54	2.75	10	21	2.84	3.20	40	36
30y	3.07	3.12	3.50	5	38	3.25	3.80	18	55
JGB	**Spot**	**Dec-14 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**	**Dec-15 Fwd**	**BNPP**	**Fwd - Spot**	**BNPP - Fwd**
3m OIS	0.06	0.06	0.10	0	4	0.06	0.10	0	4
2y	0.06	0.07	0.10	1	2	0.11	0.30	5	19
5y	0.18	0.20	0.25	2	5	0.26	1.00	8	74
10y	0.53	0.57	0.70	4	13	0.71	2.00	18	129
30y	1.62	1.64	1.80	2	16	1.72	2.70	11	98

Source: BNP Paribas

implies that there will be considerable room to trade from both the long- and short-duration side during the course of the next four to five quarters.

As a result of the continued divergence of their economic trends and policy settings, we expect the divergence between euro core rates and their US and UK equivalents to persist, with 10y cross-market spreads widening still further, to around three standard deviations away from their average of the past 15 years (Table 2).

In euro area sovereigns, we expect core spreads to vacillate in a tight range and non-core to narrow further given, on the one hand, the absence of a full ECB programme of government bond purchases and, on the other, the possibility that such a programme eventuates.

Table 2: BNP Paribas cross-country spread forecasts (bp)

Cross-Market Spreads						Implied Z-score		
US vs. GER	**Spot**	**Dec-14 Fwd**	**BNPP**	**Dec-15 Fwd**	**BNPP**	Spot	BNPP Dec-14	BNPP Dec-15
2y	60	84	80	177	180	0.7	0.9	2.0
10y	156	156	175	164	175	2.5	2.9	2.9
US vs. UK	**Spot**	**Dec-14 Fwd**	**BNPP**	**Dec-15 Fwd**	**BNPP**			
2y	-30	-29	-30	-8	-15	0.6	0.6	0.7
10y	8	8	15	12	5	0.6	0.8	0.6
UK vs. GER	**Spot**	**Dec-14 Fwd**	**BNPP**	**Dec-15 Fwd**	**BNPP**			
2y	90	113	110	185	195	0.1	0.4	1.5
10y	148	148	160	152	170	2.6	3.0	3.2

Source: BNP Paribas

Heading into the end of 2014, however, we see a significant risk of near-term countertrend moves, caused by the confluence of three significant headwinds:

Increased risk of countertrend moves during Q4 2014

1. Incremental liquidity provision will decline into the year end, as the Fed finally stops buying new bonds for the first time since 2012 and with the ECB's TLTRO and asset purchase programmes likely to get off to something of a slow start.

2. Real yields are rising in the US. This makes sense, given that the Fed is strongly signalling that it wants to start raising the Fed funds rate next year. But if negative real yields are a foundation of the 'portfolio balance channel', this could call carry trades – such as owning peripheral European sovereigns – into question.

3. Market inflation expectations are falling, led by the EUR 5y5y breakeven inflation rate but also spreading to the US and the UK – which may cause markets to reassess the likely pace and extent of Fed and Bank of England rate rises.

Because central banks are responsible for these headwinds, central banks should also be able to lean against any excessive market dislocations, we believe. But, in the meantime, there is room for market jitters into the year end.

We therefore see significant near-term risks to our central case forecasts of flatter curves and slightly tighter peripheral spreads. These risks could well take the form of a near-term bull steepening of the US curve and a widening of peripheral spreads in Europe. We recommend moderating positioning accordingly: we have taken profit on our more bearish US front-end trades and prefer to express our peripheral views through a Spain-Italy 10y spread widener, keeping our longs in peripherals versus core bonds concentrated in shorter maturities.

Rise in real yields is likely to persist through 2015

Looking further ahead, the end of Fed QE should result in a steadily-rising level of real yields across the curve. As the Fed raises its nominal policy rate towards the inflation rate, the 'real anchor' – which we define as the difference between 1y OIS and the one-year CPI rate will move towards zero. And on the basis of past relationships, this should increase the 10y real yield to around 1.5% – the highest level since the onset of the financial crisis. In one way, this rise in real yields is encouraging, as it represents a normalisation of market real rates. But it poses a threat to valuations of other assets – especially if the rise in real yields is not matched by stronger economic growth. The outlook for real yields is discussed more extensively in the inflation section, below.

Europe

Risk of a fall in liquidity is not priced in

The risk of a tightening of liquidity in coming months is not priced in

The policy rate corridor is now consistent with a negative eonia, but the ECB has signalled that the rate-cutting cycle is over. Against this backdrop, liquidity conditions will drive rate levels. The likely evolution of liquidity until February is inconsistent with OIS rates well below zero. Indeed, after the ECB's first targeted longer-term refinancing operation (TLTRO) on 18 September provided EUR 82.6bn of liquidity, there is little chance of demand at the second TLTRO (to be held in December) being much above EUR 250bn. Meanwhile, a further EUR 322bn will be repaid on 3y LTROs by the end of February. As a result, and as Chart 1 shows, there is a high risk of decline in liquidity – albeit a temporary drop – in the next five months. This risk is not priced in.

Banks will have alternative sources of funding. The ECB's MRO and 3-month LTROs will prevent banks from searching for liquidity in money markets. The ECB's asset purchase programmes (asset backed securities purchase programme and new covered bond purchase programme), due to start in October, may also limit the decline of liquidity. But the programmes look unlikely to be large enough to keep liquidity at the current level or higher until February. Volatility in rates may increase as the level of excess liquidity declines.

ECB policy to keep the short end very flat for a while

The second wave of TLTROs (the level of which will depend on banks' net lending to the economy) and the ECB's asset purchases will inflate its balance sheet next year. In addition, the ECB's maintenance of its zero rate policy at least until 2017 means liquidity will remain high next year and the curve should be flat, at least up to the 5y area.

5s30s curve to be directional with 30y yields

Given the expected persistence of the ECB's zero interest rate policy, we expect the curve out to the 5y to stay very flat. With 0-5y yields locked down, the steepness of the curve beyond the 5y sector is very directional with the level of the 30y yield. Hence, we recommend a 5s30s conditional bear steeepener, which should benefit if and when the ECB finally revives medium-term inflation expectations but will otherwise remain out of the money. Excess liquidity and the improvement of banks' balance sheets will also support a tightening of the Bund/swap spread.

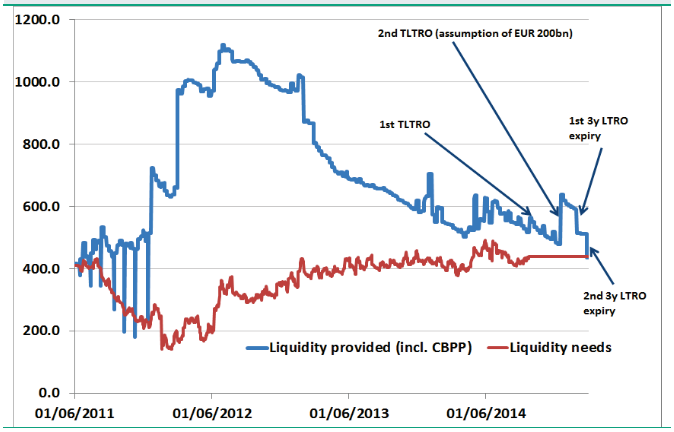
Trades

- **Receive EUR 1y fwd 2y/5y. Entry +43bp. Target +20bp. Carry +1bp/mth. Stop +50bp.**
- **Conditional 3y expiry 5s30s bear steepener. Entry ATMF versus ATMF+2 (+91bp). Carry +1bp/mth.**
- **Sell the Bund ASW: Entry 21.3bp, target 13-15bp with a stop-loss at 25bp.**

Peripherals

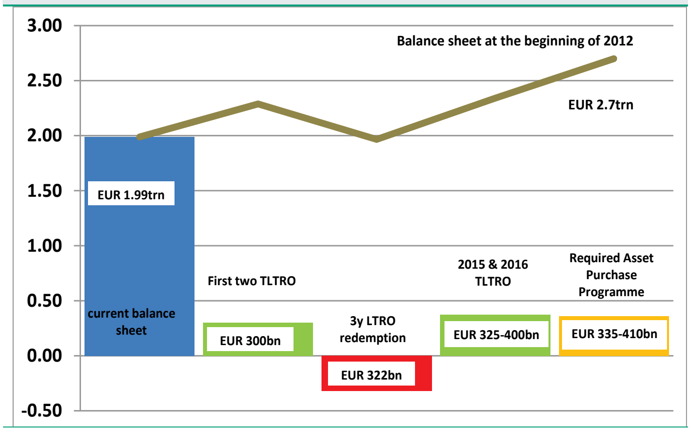
We expect a further modest narrowing of peripheral spreads in Q4 2014, with Spain outperforming Italy. We forecast 10y Italian and Spanish spreads to Germany to tighten slightly over the next three months (Table 3).

Chart 1: Risk of tighter liquidity conditions ahead



Source: Bloomberg, BNP Paribas

Chart 2: ECB's balance sheet targets are ambitious



Source: Reuters EcoWin Pro, BNP Paribas

Table 3: BNP Paribas Italian and Spanish end-period yield and spread forecasts*

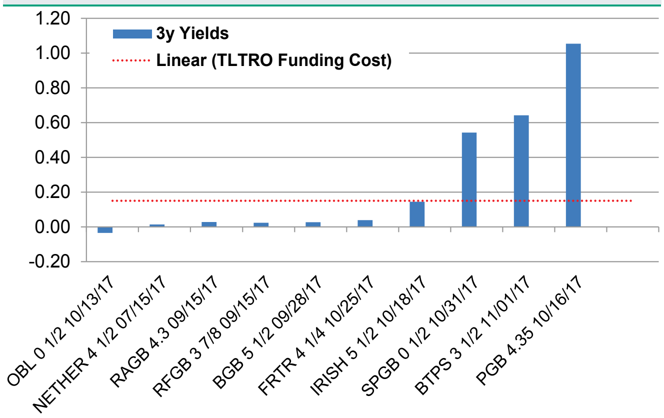
10y Yields (%)	Current	Q4 14	Q1 15	Q2 15	Q3 15	Q4 15
Germany	0.93	1.15	1.20	1.30	1.40	1.50
Italy	2.33	2.45	2.50	2.50	2.50	2.50
Spain	2.11	2.20	2.20	2.25	2.30	2.40
10y Spreads to Bund (%)	**Current**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**
Italy	1.40	1.30	1.30	1.20	1.10	1.00
Spain	1.19	1.05	1.00	0.95	0.90	0.90

Source: BNP Paribas **Current rates as at 3 October*

In Q4 2014 we expect the main features of the peripherals market to include:

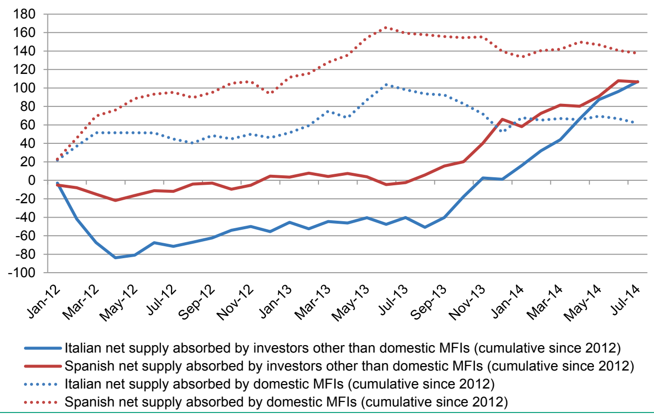
- The provision of a strong backstop by the ECB which has confirmed that its target is to increase its balance sheet by at least EUR 700bn. Should the TLTROs and the ABS and CB purchase programmes fail to achieve this, the chances of a broad-based sovereign asset purchase programme would increase, supporting 10y Italian and Spanish bonds.
- The short end of peripheral curves will be supported by the fact that all other core and semi-core paper are at or close to negative yields, while carry trades in short-dated peripherals remain profitable as their yield exceeds the TLTRO funding rate (Chart 3).
- Peripherals have managed to borrow at very favourable terms in 2014, lengthening the average maturity of their debt and lowering their average funding costs. This improves the sustainability of the countries' debt positions, counterbalancing the effect of anaemic growth in nominal GDP.
- Investors other than domestic monetary financial institutions (MFIs) have purchased most of the net supply of peripheral debt to date in 2014 (Chart 4). Indeed, domestic MFIs were net sellers of domestic debt from July 2013 to July 2014. Non-resident investors have returned to peripheral markets and their total holdings remain much lower (in terms of the share of the debt outstanding) than before the onset of the financial crisis.

Chart 3: 3-year EGB yields versus TLTRO funding cost



Source: BNP Paribas

Chart 4: Net supply absorbed by domestic MFIs vs others



Source: BNP Paribas

We forecast 10y Italian and Spanish spreads to Germany of 130bp and 105bp, respectively, by the year end. These levels are wider than our 100bp target when we expected ECB quantitative easing. However, they are tighter than our revised 150bp target after the June ECB meeting. This reflects our view that while a QE programme – which would be the quickest way to increase the ECB's balance sheet to the targeted level – has not been adopted, the ECB now has more mechanisms and commitments in place to support liquidity than it had in June.

Trades

- **Long 10y SPGB/BTP spread. Current -17bp. Target -30bp. Stop -10bp.**
- **Long 3y SPA/GER spread. Current 58bp. Target 30bp. Stop 70bp.**
- **Long 3y ITA/GER spread. Current 68bp. Target 40bp. Stop 80bp.**

US

A new beginning leaves timing key

With the Fed ever more hawkish and seemingly on a predetermined path to the end of QE, the markets face a new beginning. The key issues are the exact timing of Fed rate hikes and the aggressiveness of the policy tightening. As a result, we have focused on timing our various front-end views in the 2-5y part of the curve and in the long end in terms of the Fed's tightening timeline and current market expectations. Investor demand also plays a significant role in our expectation that the sell-off at the long end will be smaller than that seen at the short end. We have also examined barbell combinations versus bullet trades to position for our view, as the former allow us to extract a better carry or roll-down profile while tracking the performance of a specific point on the curve.

Timing of main market response to prospect of rate hikes is key

Turning first to Fed policy, BNP Paribas forecasts rate hikes to begin in Q2 2015 with this view supported by the strengthening of economic data to date, particularly the employment reports. The most stark gap between the current FOMC median rate projection and current market levels suggest a 60bp+ rise in 5y yields if the market were to adjust instantly to the FOMC median levels. We have highlighted many reasons in the past why we believe that this is unlikely to happen in the very near term, but why we think that a convergence between the two is inevitable in the long run. In the near term, the FOMC is likely to remain focused on employment, growth and inflation data, which may not be sufficient to force the market to move. Still, unless employment and inflation soften, the Fed will still hike sooner rather than later, initially putting the greatest pressure on the 5y part of the curve to adjust.

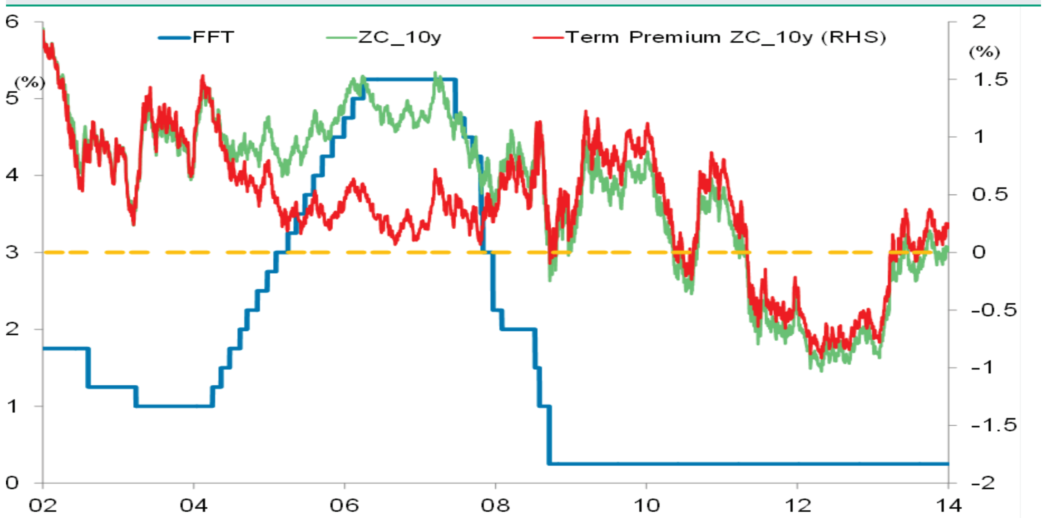
As we get to within six months of the first hike, pressure on the 2y part of the curve will also build, causing the curve to flatten. Thus, the timing of flatteners and steepeners will be critical. For now, we believe that the fact that the Fed didn't pull forward its hiking timeline at the latest FOMC meeting delayed the adjustment for the 2y, suggesting that the greatest pain for the 2y will come early next year, 3-6 months away from an imminent rate hike.

Investor demand to limit rise in yields at the long end of the curve

10y and 30y yields to rise less than 5y yields

At the back end of the curve, long-term considerations are likely to shape investor behaviour. One of the primary drivers of the long end, especially in the absence of inflation, is likely to be the term premium. With the risk of inflation falling further and the exit strategy by the Fed well-choreographed, the inflation risk premium and term premium built into the long end are likely to be modest (Chart 5), leading to a much flatter curve, particularly in light of the demand by some price-insensitive investors. Thus, while we forecast the 5y to sell off by nearly 85bp in the coming year, we forecast only a 50bp yield increase for the 30y part of the curve.

Chart 5: Term premium



Source: BNP Paribas

We favour curve flatteners

So who are the investors in longer maturities? While the latest data suggest that pension fund buying has been sizeable they also show that the buying could not have been solely responsible for the plunge in long-end yields thus far in 2014. Rather, we believe that significant hedge fund and foreign central bank buying also conspired to push longer duration yields down. As European yields fell, foreign investors seized the opportunity to earn relatively attractive returns in the US and added to their longer duration holdings. (For an analysis of the strong correlation between US and European long-end yields, see our article *EUR 5y/30y curve: A quantitative valuation model*) Therefore, we favour curve flatteners for the next two years with the exact timing of 5s30s flattening, for example, to be decided by the Fed's aggressiveness in hiking rates.

Sustainable positioning for higher rates

One of the greatest problems facing investors in the current rate-hiking cycle is that many of the trades that have been favoured historically have significant negative carry and rolldown. This occurs because investors must suffer more punitive carry and rolldown being short parts of the curve that are likely to rise the most in a rate-hiking scenario. We address this dilemma by creating correlation-weighted butterflies and option strategies to track the performance of a single point or yield spread while mitigating much of the negative carry.

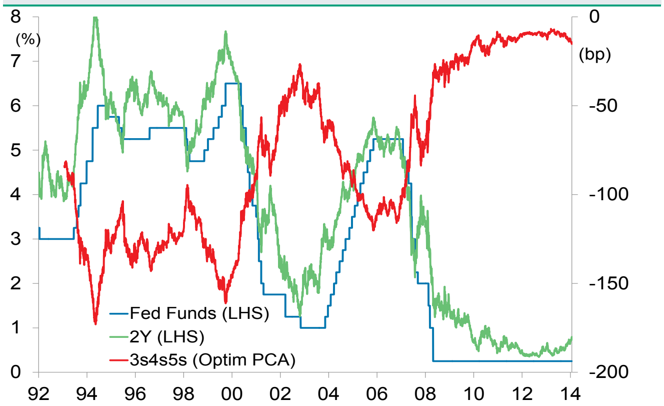
Trades

- **Receive 4y swap (1x) versus pay 3y swap (-0.80x) and pay 5y swap (-0.41x) DV01 weighted. Entry -15bp. Target -30bp. Carry plus rolldown: -4.6bp/3 months. Stop -10bp.** This weighted 3s4s5s trade tracks the performance of the 2y part of the curve very closely but has a lower amount of leverage as a trade-off to the reduced carry. It has an attractive entry point, currently 15bp, which is just off the peak of -7bp and is well off the 2006 low of -111bp (Chart 6). The correlation-weighted butterfly carries a beta of -0.2 to the 2y rate. Therefore, the rise of the 2y yield forecast in Table 1 would translate into a move of about 4bp for the optimised 3s4s5s butterfly.

- **Buy 4y UST 1.0 05/31/18 (1x) versus sell 3y UST (-0.80x) and sell 5y UST (-0.41x) DV01 weighted. Entry -16bp. Target -40bp. Carry plus rolldown -6.8bp/3 months. Stop -8bp.** This is the Treasury version of the above butterfly.

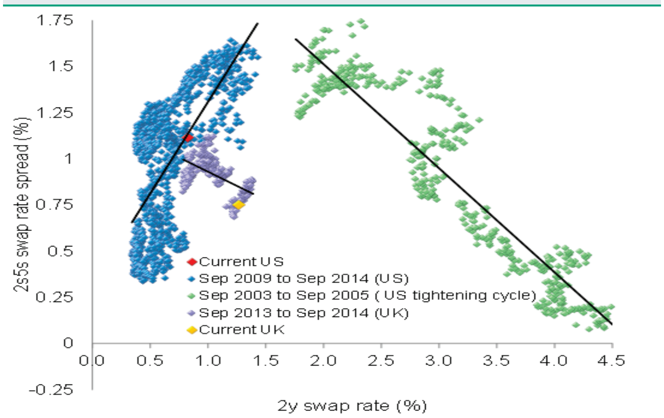
- **2s5s conditional flattener: Buy 6m2y atm payer (1x) and sell 6m5y atm + 9 payer (.41x). Entry = costless. Target 25bp. Carry plus rolldown -3bp/3 months. Stop -13bp.** This trade fits our flattening view at our preferred timing. Similar to the 3s4s5s trade, the conditional flattener does not suffer from punishing negative carry (there is zero carry at termination if the forward curve rolls to spot). The advantage over simply executing a 2s5s flattener is that the trade is entered at a strike spread of 107bp – 9bp better than the forward spread and only 6bp lower than the 2s5s spot spread. As the trade is entered in payer form, it is not exposed to bull steeping or any move to lower yields at termination. If we use the UK as an example, the trade is especially attractive because – as a tightening cycle approaches – 2s5s should shift its correlation to short-end rates and begin to flatten rather than steepen (Chart 7). Note that all levels are expressed as upfront basis points against the notional of the 6m2y leg.

Chart 6: 3s4s5s trade has reasonable entry level



Source: BNP Paribas

Chart 7: 2s5s begins to flatten as tightening approaches



Source: BNP Paribas

UK

Further normalisation of economic activity and policy to push Gilt yields up

10y Gilt yield to rise to 2.75% at the end of 2014 and 3.20% at the end of 2015

Our economists expect UK GDP growth to reach 3% in 2014 and to moderate only slightly in 2015 and 2016, with investment strong and consumption supported by the low level of unemployment. The CPI inflation rate is forecast to rise above the Bank of England's 2% target from late 2015 with core inflation rising and given the likely impact of higher wages. In terms of monetary policy, we expect the Bank of England to start quarterly 25bp rate hikes from February 2015. With the market pricing in a 60% probability of a 25bp hike in February, we highlight positive carry positions at the front end with a good risk-reward profile and a bearish (if any) directional exposure. Against a backdrop of reasonable global growth and monetary tightening in the US, we expect Gilt yields to rise going into the year end and through 2015. BNP Paribas forecasts the 10y Gilt yield at 2.75% at the end of 2014 and 3.20% at the end of 2015 (Chart 8).

Supply to steepen curve near term before it flattens again in 2015

At the front end, we recommend keeping positive carry positions with a good risk-reward profile including short£ Dec-15/Dec-17 steepeners and paying the 5y in the 2/5/10y GBP swap fly.

Net supply and a very flat curve support a steepening of the 5/30y Gilt curve until December

Further out along the curve, a rise in yields in response to the normalisation of economic trends and policy is typically accompanied by a flattening of the curve from the 5y point – as seen so far in 2014. The 5/10y and 10/30y segments look very flat versus both the yield level and the slope of the money market curve. In light of the flat or negative net supply in shorts and mediums, reasonable supply in longs and linkers and the current flatness of the curve, we see a one- to two-month window for holding 5/30y Gilt steepeners which carry positively, before re-considering structural flatteners at much better levels in 2015.

Spreads to be driven by monetary policy divergence

Stay long 10y Gilts versus Treasuries and short 5y Gilts versus Bunds

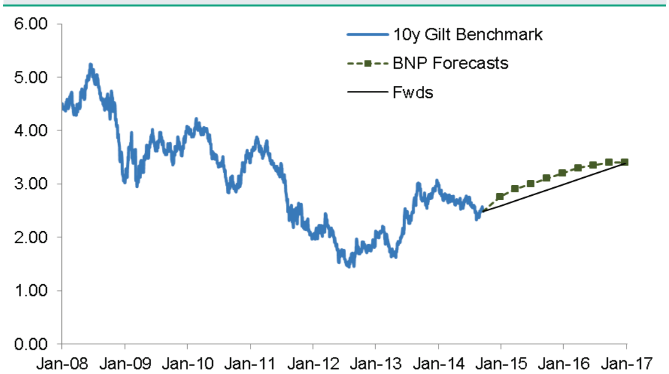
On spreads, we expect the BoE and Fed to both tighten monetary policy but a continued divergence of policy against the eurozone as weak growth and inflation cause the ECB to maintain its zero rate policy. While we expect the BoE to be the first to hike in Q1 2015 (with the Federal Reserve following in Q2), rate hikes may continue for longer in the US and the terminal rate may be higher, especially as the UK is more dependent on the eurozone and a has a lower effective policy rate due to high mortgage spreads. We stay long 10y Gilts versus Treasuries and short 5y Gilts versus Bunds, but our maturity preference may shift as rate hikes approach.

Ultra-long breakevens offer best value in Q4

We recommend buying 50y UKTi breakevens

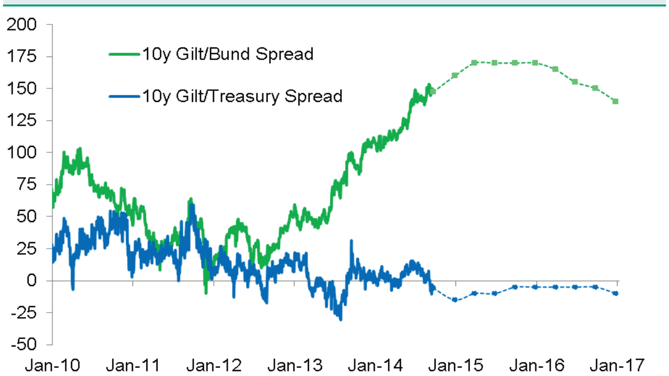
Inflation carry remains the best in the UK for the remainder of 2014 (1.2% versus flat or negative in the US, EUR and FRF markets) but this seems to be priced in at the front end. The UK inflation curve looked very flat versus the level of inflation breakevens but has already re-steepened rapidly. We see best value in ultra-long UKTi breakevens, which will benefit from ongoing liability-driven investment (LDI) activity, no supply in Q4 and a steeper nominal curve.

Chart 8: 10y Gilt yield and BNP Paribas forecasts (%)



Source: BNP Paribas

Chart 9: 10y Gilt/Tsy & Gilt/Bund spreads & forecasts

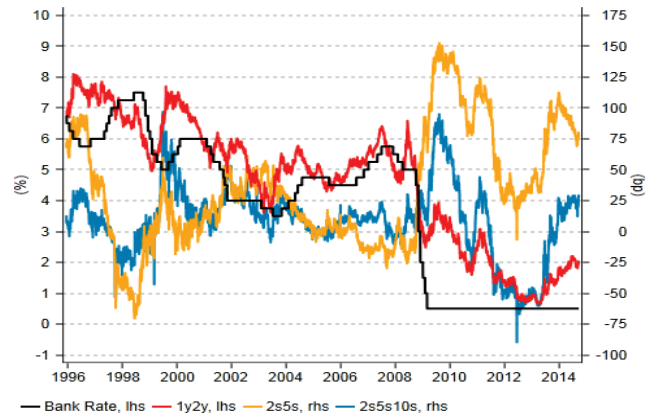


Source: BNP Paribas

Trades

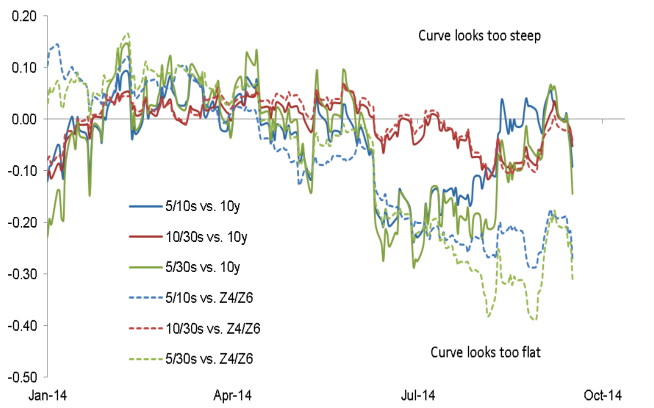
- **Front end: Dec-15/Dec-17 Short£ steepener at 104bp. Target 135bp. Carry/roll +5bp/month.** The red/blues curve is very flat versus short-end yields. Short£ steepeners are attractive, carry positively and perform if rate hikes are delayed or final rate is higher.
- **Front end: Sell 2/5/10y swap fly at 24bp. Target 50bp. Carry +2bp/month. Stop 16bp.** 1y2y and 2y2y rates look too low (with a terminal BoE Bank rate priced around 2.50%). Paying the 2/5/10y fly has a high correlation with shorting forwards with positive carry.
- **Curve: 5/30y Gilt steepener at 120bp. Target 150bp. Carry/roll +3bp/month.** The Gilt curve looks very flat versus both the level of 10y yields and the shape of the money market curve. Consider hedging against BoE-led flattening with Dec-14/Dec-16 steepener.
- **US/UK: Long 10y Gilt/Treasury spreads at +5bp. Target -15bp. Carry flat**. Position for a synchronisation of UK and US monetary policy in 10y but consider switching into 2y spreads in Q1 2015.
- **UK/EUR: Short 5y Gilt/Bund spreads at 163bp. Target 200bp. Carry -3bp/month**. Continued policy and economic normalisation in the UK versus ECB's zero rate policy.
- **Inflation: Long UKTi-60 breakeven at 3.32%. Target 3.45%. Carry +1bp/month**. Lack of ultra-long linker supply in Q4 and ongoing LDI should see cheap 50y UKTi breakevens rise.

Chart 10: Keep paying the 5y in the 2/5/10y swap fly



Source: Bloomberg, BNP Paribas

Chart 11: 5y+ Gilt curve too flat vs yields & money market



Source: BNP Paribas

Japan

Monetary policy outlook for 2015

The BoJ is unlikely to purchase additional TDBs from the market

Nominal interest rates continue to be kept in check by the BoJ's massive JGB-buying operations. We expect the central bank to maintain its quantitative and qualitative monetary easing (QQE) in 2015 following the sharp fall in GDP in Q2 2014 and as the government is set to announce before the end of this year that it will proceed with the planned October 2015 hike in the consumption tax rate from 8% to 10%. However, the method by which the BoJ expands the monetary base will probably need to be adjusted. This year, JGBs will account for JPY 50trn of the JPY 70trn increase in the monetary base while treasury discount bills (TDBs) will acount for much of the remaining JPY 20trn. However, supply-demand conditons in the TDB market have tightened to the point where the BoJ has been forced to buy at negative interest rates, making the current pace of TDB purchases unsustainable (Chart 12). The BoJ is due to release its semiannual *Outlook for Economic Activity and Prices* report on 31 October, and we expect it to also outline a plan for expanding the monetary base that involves maintaining its TDB holdings while increasing the supply of funds via JGB purchases, its loan support programme and other operations.

JGB yields to rise gradually in response to yen weakness and rise in US rates

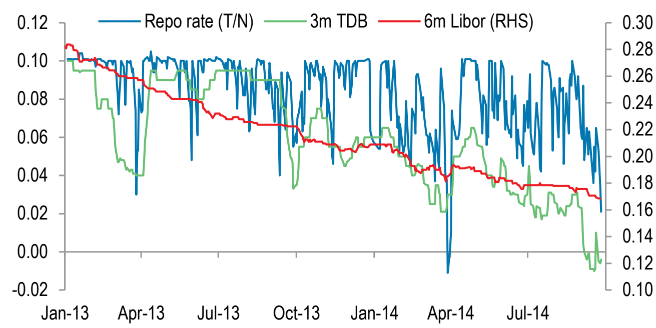
While JGB yields are likely to rise gradually, the short end could rally

Supply-demand conditions are thus likely to remain benign. Nevertheless, we expect JGB yields to trend upwards gradually as the yen weakens and overseas interest rates rise, with the 10y JGB yield likely to end 2014 around 0.7%. Japan's labour market is expected to achieve full employment in 2015 when upward pressure on wages should also push inflation rates up. JGB yields should rise sharply from current levels expecting the BoJ to start tapering. However, the BoJ's exit may be quite difficult and if nominal yields rise sharply to a level unsustainable for the government, the BoJ might be compelled to step in to prevent JGB yields rising above 2.0%. The short end of the curve will probably remain relatively firm, however, and yields could even fall to around 5bp in the 2y sector if the BoJ steps up its purchases by way of a substitute for TDBs.

Take profit on JGB 15s20s25s butterfly

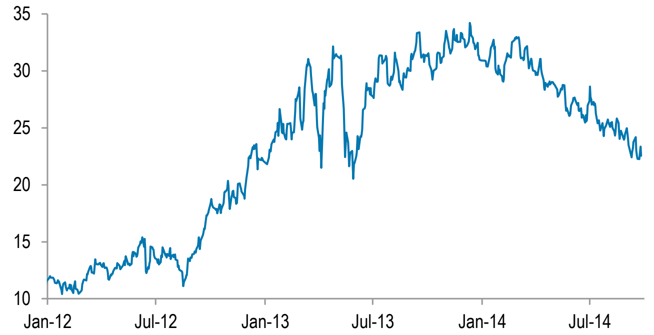
The 20y sector has outperformed since early this year as low interest rates have forced investors further out along the curve in search of carry. However, we expect to see at least a partial correction as yields start to rise gradually, particularly as carry has been eroded to less attractive levels. Financial institutions may look to lock in profits now that the second half of Japan's accounting year is under way, and while yields could fall temporarily if profits are taken out of the stock market (as in April), we would see that as a good opportunity to start unwinding long positins in the 20y. For example, we will be aiming to exit our long-recommended 15s20s25s butterfly trade before November (Chart 13).

Chart 12: TDB and repo rates (%)



Source: Bloomberg, BNP Paribas

Chart 13: JGB 15s20s25s butterfly (bp)



Source: BNP Paribas

30y sector's downside is limited

We expect to see renewed demand from life insurers in the 30y sector as yields rise. The steepening of the 20s30s curve since April has reflected the broader downtrend in yields as well as an increase in 30y issuance and adjustments to the BoJ's bond-buying operations, with lifers seemingly reluctant to buy after the 30y yield dropped below 1.7%. In light of this underperformance when yields were falling, we do not expect the 30y sector to be sold off heavily once yields start climbing.

Long-end asset swaps

Long 30y ASW near Libor-flat levels

20y and 30y asset swaps' correlation with the USDJPY exchange rate and equities has recently been weaker than we had expected, although yen weakness and rising stock prices have, of course, provided incentives to pay in swaps. The correlation with the US 30y swap rate has been somewhat stronger, however, and hence we continue to recommend being long ASW at the long end, with near Libor-flat levels offering a good entry level (Chart 14).

We see less reason to be long ASW in the medium- to long-term sector as JGBs are liable to cheapen as banks receive in swaps in order to control their duration, particularly if the uptake of the BoJ's loan support programme in December is as strong as we currently anticipate.

Volatility

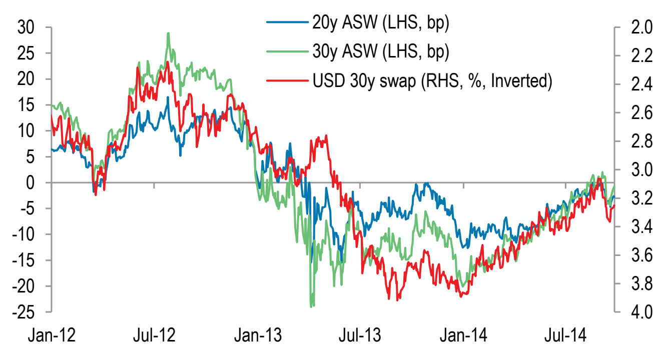
Enter a 3m10y payer spread

Volatilities for the gamma sector rebounded as the JGB curve bull flattened in August and remained relatively strong even as yields started rising in early September. However, volatilities for the vega sector bounced back only slightly earlier this month, with ultra-low yield levels seemingly continuing to provide an anchor.

Skew for the gamma sector had looked a little on the tight side earlier this year, but has steepened once again over the past month or so. As such, payer spreads offer a relatively cost-effective means of expressing our directional view. A 10y tail looks preferable to a 20y tail by virtue of its lower ATM volatility and steeper skew (Chart 15). Premiums are currently up only slightly from July (before volatility started rising) at around ¥0.30 for atm/atm+10bp and ¥0.20

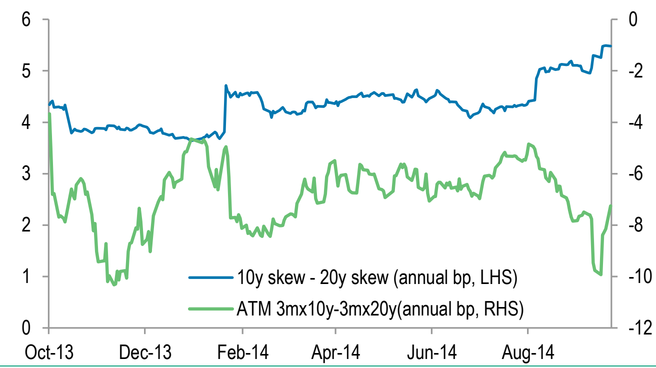
for atm+5bp/atm+15bp, while a ladder can be constructed slightly more cheaply by benefiting from skew. Options with expiries of up to around three months should be acceptable from a risk perspective as interest rates look unlikely to rise sharply during the period.

Chart 14: Long-end ASWs and US swap rate



Source: BNP Paribas

Chart 15: 3m10y and 3m20y payer



Source: BNP Paribas

Trades

- **Take profit on a long JGB 15s20s25s butterfly (JL110/JL148/JX30) at 20bp or before November.**
- **Go long 30y ASW at Libor-flat levels.**
- **Enter a 3m10y atm+5bp/atm+15bp payer spread at ¥0.20.**

Inflation

US real and nominal yields to rise gradually, with TIPS exhibiting a high beta

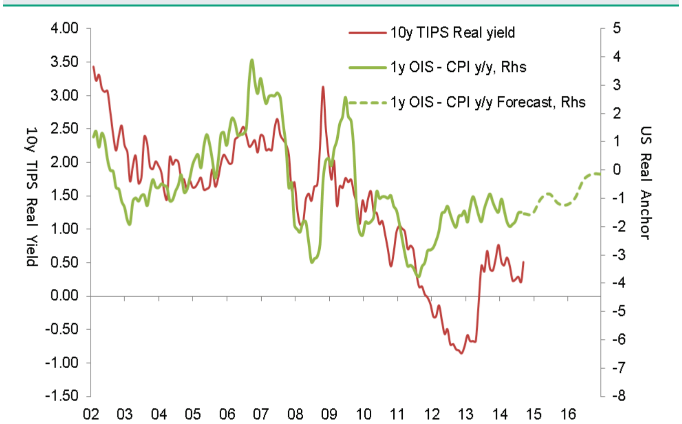
The rise in 10y TIPS yields is consistent with a normalisation in policy rates

Long 5y5y US CPI forward

Low and negative real rates have been central to the broad rally in asset markets since the financial crisis. The sharp rise in 10y TIPS real yields (40bp) over the past month is concerning as it was accompanied by a simultaneous 20bp drop in 10y breakevens (now below 2.00%). Using the real anchor (1y OIS – CPI y/y rate) to model 10y US real rates since 2002 by assuming short-term real policy rates propagate down the curve, we expect a real anchor of 0% at the end of 2016 (Fed funds rate at 2% and CPI rate of 2% y/y). This would imply a 10y TIPS real yield of 1.50%, based on the relationship since 2002 (Chart 16). With a forecast of 3.50% on 10y Treasuries at end-2016, this would see 10y TIPS exhibiting a high beta (around 1) with breakevens averaging 2.00%. The low observed real/nominal yield beta in the QE-driven sell-off should reverse with higher yields at the end of QE and probable start of US rate hikes.

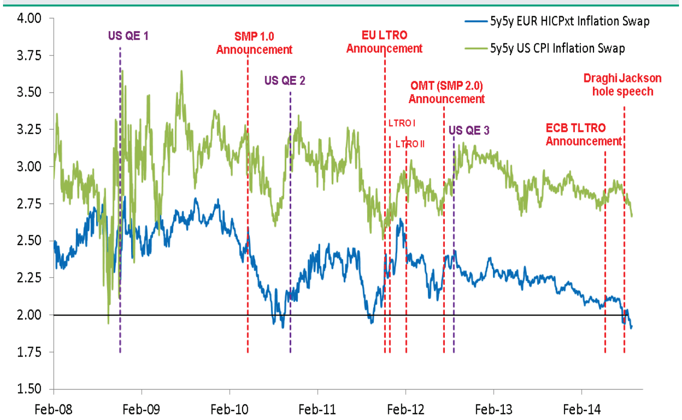
The main risk to our central scenario is that further downside surprises in US inflation could see inflation expectations become unanchored, changing the likely path of US rates. However, we find the US 5y5y inflation swap forward too low below 2.65% – close to crisis levels – and have put on a long position; we target a 20bp+ widening towards its average at 2.90%.

Chart 16: 10y TIPS real yield vs US real anchor & forecast



Source: Bloomberg, BNP Paribas

Chart 17: 5y5y EUR & US inflation swap forwards



Source: Reuters EcoWin Pro, BNP Paribas

European disinflation risks persist

Keep short 5y5y EURxt inflation forward

Long 10y US/EUR breakeven spreads

Despite their June and September actions, the ECB have not done enough to avoid disinflation. In our view, the ECB will not embark on sovereign bond purchases without further weakness in growth, inflation and lower inflation expectations. We keep our strategic short 5y5y EUR HICPxt position which is 10bp+ in profit and carries by +15bp/year and set a new target at 1.80%. We keep our long 10y TIPS/OATei breakeven spread and expect the spread to widen by 15bp+. Curve-wise, we expect the 5/10y segment of the inflation curve to re-steepen as it looks too flat versus the low level of breakevens in core linkers (and swaps).

Carry and inflation forecasts versus swap market pricing

Seasonals remain flattish in the eurozone and French inflation markets in the next few months, but are negative in the US and quite positive in the UK. As Table 4 shows, and despite the recent recovery at the front end, 1y and 2y EUR and FRF inflation look around 10-20bp cheap versus our economists' inflation forecasts. Meanwhile, front-end US inflation still looks slightly rich, while the 1y and 2y RPI look around 50bp cheap (as usual). With the oil price fall (15% on crude in USD terms) still being passed through to national CPIs, the front end will remain volatile in response to fixing releases.

Trades

- **EUR: Keep 2y zero coupon 0% floors on HICPxt at 8 cents. Target 20 cents. Stay short 5y5y EUR HICPxt forward at 2.02%. Target 1.80%. Carry/roll: +15bp/year**. ECB zero rate policy to keep rates and breakevens low. Position for disinflation risk.
- **EUR: OATei-18/-24 BE steepener at 28bp. Target 40bp. Stop 23bp. Carry variable**. The 5/10y inflation curve looks 10-20bp too flat versus the level of breakeven.
- **USD: Long 5y5y US breakevens at 267bp. Target 290bp. Roll -0.5bp/month.** Buy US inflation at near-crisis levels while 5y5y forward avoids TIPSs' negative carry.
- **UK: Long UKTi-60 breakeven at 3.32%. Target 3.45%. Carry +1bp/month.** Lack of ultra-long linker supply in Q4 and ongoing LDI should see cheap 50y UKTi breakevens rise
- **US/EUR: Long TIPS Jul-23 vs OATei-24 BE at 85bp. Target 100bp. Stop 75bp. Carry variable.** The level of breakevens is not justified in the US, but could fall further in EUR.

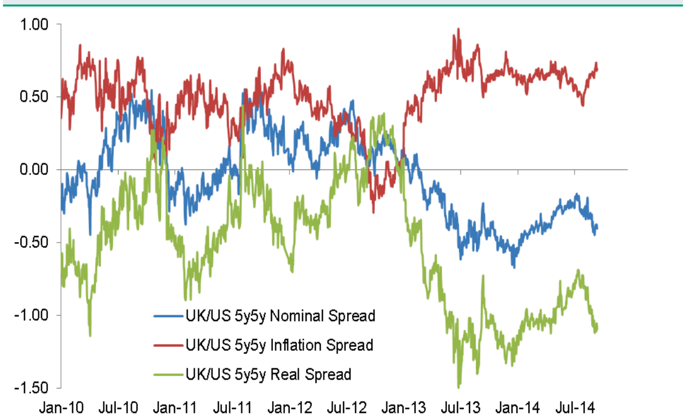
G10 IR Strategy Team

Table 4: Swap market versus BNPP inflation forecasts

1y 25-Sep-14	USD y/y Inflation	EUR y/y Inflation	FRF y/y Inflation	GBP y/y Inflation
BNPP CPI Forecasts	1.34%	0.76%	1.00%	3.40%
1y ZC Inf Swap (BBG)	1.44%	0.57%	0.82%	2.86%
Potential (vs. BBG)	-0.10%	0.19%	0.18%	0.54%
2y 25-Sep-14	**USD** y/y Inflation	**EUR** y/y Inflation	**FRF** y/y Inflation	**GBP** y/y Inflation
BNPP CPI Forecasts	1.57%	0.94%	0.99%	3.58%
2y ZC Inf Swap (BBG)	1.67%	0.70%	0.86%	2.93%
Potential (vs. BBG)	-0.10%	0.24%	0.13%	0.65%
1y1y 25-Sep-14	**USD** y/y Inflation	**EUR** y/y Inflation	**FRF** y/y Inflation	**GBP** y/y Inflation
BNPP CPI Forecasts	1.78%	1.12%	0.96%	3.64%
1y1y ZC Inf Swap (BBG)	1.90%	0.83%	0.90%	3.00%
Potential (vs. BBG)	-0.12%	0.29%	0.06%	0.64%

Source: Bloomberg, BNP Paribas

Chart 18: UK/US 5y5y real, nominal & inflation spreads



Source: BNP Paribas

G10 FX

Policy divergence gains traction

G10 FX: Policy divergence gains traction

- **We expect policy divergence to remain a key driver of FX rates.**
- **We were early to call for broad USD strength and, after a slow start, this trend is becoming firmly entrenched.**
- **Moderate positioning in FX markets suggests current market moves can continue.**
- **We have revised up our USD forecasts in tandem with our economists' quarterly review of the macroeconomic outlook.**
- **We forecast the EUR, JPY and CHF to underperform the rest of the G10 bloc.**

USD appreciation to be strongest against the low yielders

The USD has begun to appreciate supported by front-end yields

There has been a sharp turnaround in the major FX markets since our June edition of *Global Strategy Outlook*. USD moves have become more closely correlated with the US's yield advantage again and the currency has begun to appreciate as US front-end yields have risen. The USD has risen against all major currencies over the past three months with the rise accompanied by an increase in investor exposure to the G10 FX markets. Our BNP Paribas FX positioning analysis suggests that risk taking in the major currencies has rebounded strongly after falling to a three-year low in late June. Nevertheless, our analysis does not show investor positioning to be stretched which, in turn, suggests that recent trends have a significant ability to extend if the fundamentals pan out as we expect.

We have raised our USD forecasts and lowered our JPY forecasts

In tandem with our economists' quarterly review of their macroeconomic forecasts, we have adjusted our quarterly G10 FX projections. As part of this exercise, we have used our cyclical equilibrium exchange rate framework and our economists' latest macroeconomic projections. The resultant changes to our FX forecasts are outlined in Table 1 below and generally reflect a stronger USD and weaker EUR and JPY than previously assumed.

Policy divergence remains key

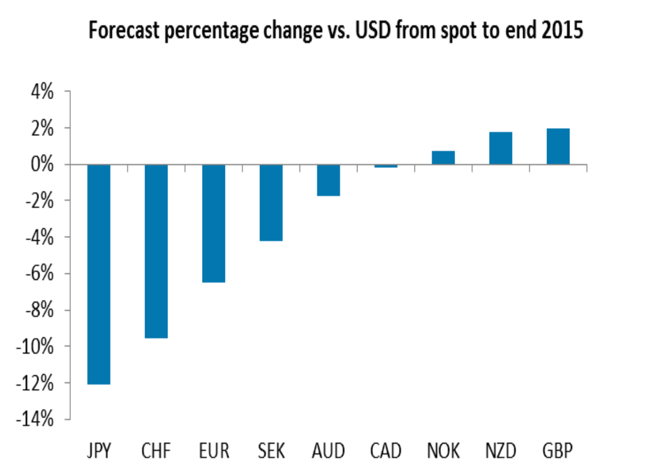
In our 2014 year-ahead preview published December 2013, we forecast policy divergence to be an increasingly important driver of G10 FX rates. With the ECB having eased policy sharply this year and likely to do more ahead, even as the Fed and Bank of England move towards rate hikes, the impact of policy divergence is likely to increase. However, with our bullish GBP and USD calls becoming consensus views in the market, the focus is likely to shift towards identifying leaders and laggards among USD pairs and GBP crosses. The USD and GBP are unlikely to appreciate evenly against all G10 currencies – some currencies will lose more ground than others and we expect to see increased interest in positioning for such moves in crosses as the policy divergence theme matures.

Table 1: Updated BNP Paribas FX forecasts

	Spot*	End 2014 old	End 2014 new	End 2015 old	End 2015 new
EURUSD	1.25	1.32	1.25↓	1.26	1.18↓
USDJPY	109	110	112↑	124	124
EURCHF	1.21	1.24	1.22↓	1.25	1.25
GBPUSD	1.60	1.74	1.64↓	1.75	1.64↓
USDCAD	1.12	1.10	1.12↑	1.12	1.12
AUDUSD	0.87	0.92	0.89↓	0.90	0.86↓
NZDUSD	0.78	0.86	0.82↓	0.80	0.80
USDCHF	0.96	0.94	0.98↑	0.99	1.06↑
EURJPY	137	145	140↓	156	146↓
EURSEK	9.10	8.90	9.15↑	8.70	8.90↑
EURNOK	8.17	7.80	8.00↑	7.50	7.60↑
EURGBP	0.78	0.76	0.76	0.72	0.72

Source: BNP Paribas *Spot rates as at 3 October

Chart 1: JPY, EUR and CHF to underperform*



Source: BNP Paribas *Spot rates as at 3 October

EUR, CHF and JPY are funding currencies …

Chart 1 shows the percentage changes we now expect for each G10 currency against the USD by the end of 2015. We forecast USD appreciation to be strongest against the EUR, JPY and CHF. We expect the USD's rise against currencies in the commodity bloc to be more modest and for Cable to be fairly stable and even rise slightly over the period. This forecast profile suggests EUR-, CHF- and JPY-funded trades into higher-yielding currencies will be successful on a trend basis, and we think global market participants and domestic investors in the eurozone, Switzerland and Japan will increasingly look to exploit these strategies.

… with their central banks keeping policy loose

A key relative-value consideration over the coming year will be the extent to which markets move to price in domestic central bank tightening, offsetting the effects on currencies of a rise in US front-end rates. As Chart 2 below shows, G10 currencies can be broken down into three categories: 1) currencies backed by central banks which are likely to hike rates soon; 2) currencies backed by central banks that are expected to hike late in 2015 or early in 2016; and 3) currencies where there is no scope for rate hikes to be priced in. Those in the third category are likely to be the preferred funding currencies for risk trades – we can expect these currencies to weaken during periods of healthy risk appetite but recover ground quickly during periods of market stress.

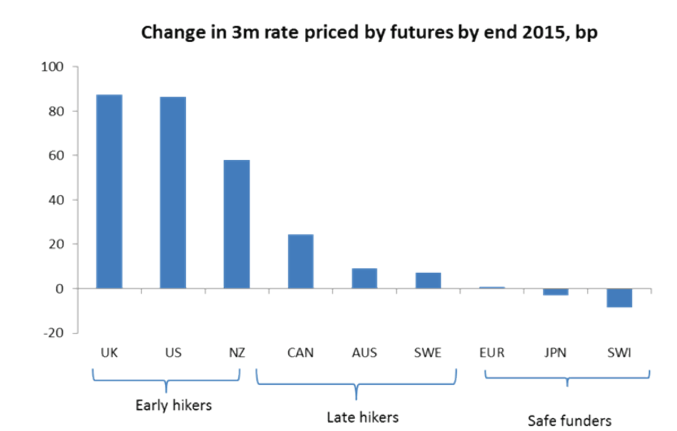
Higher yielding currencies suffer if US long end sells off

The nature of the interest rate adjustment in the US will also be an important determinant of relative performances across the G10 bloc. Between May and September 2013, US long-end rates rose sharply as markets priced in an end to the Fed's quantitative easing. As Chart 3 below shows, the G10 currencies that were the worst hit during this period were those that had been on the receiving end of substantial bond purchases during the bullish bond market of the previous six years. In contrast, 2014 has been characterised by a gradual rise in front-end rates as market expectations of a hike in the Fed funds rate have increased. Long-end yields have largely been stable or lower for most of this adjustment, before rising recently. The USD has gained ground against low-yielding currencies, but the recent bear flattening of the curve has been much less damaging for the bond-sensitive commodity bloc and EM currencies than 2013's bear steepening episode. We expect a gradual upward adjustment in the Fed funds rate in 2015 to be accompanied by continued bear flattening; the adjustment at the long end of the curve should be gradual and we do not expect the 10-year rate to exceed 3.25% at the end of 2015.

Trading implications

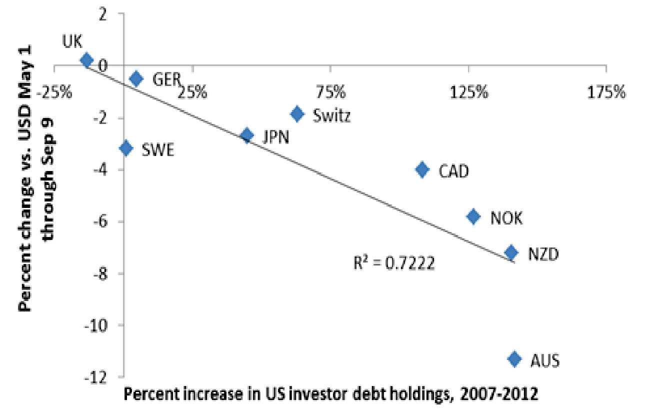
- Continue to go long the USD and GBP opportunistically versus the EUR, JPY and CHF.
- Continue to fund long positions in the EM and commodity bloc via the EUR and JPY during periods when risk appetite is stable and the adjustment at the long end of the US curve is gradual.
- Explore long positions among the 'late hikers', particularly when macroeconomic dynamics are shifting. Again, the EUR, JPY and CHF will be preferred funders for these trades.

Chart 2: EUR, JPY and CHF are 'safe' funders



Source: Bloomberg, BNP Paribas

Chart 3: Bond bull market favourites were hard hit during the taper crisis



Source: US Treasury, Bloomberg, BNP Paribas

Trades

- **Short EURGBP – target 0.76**
  We expect the UK economy to continue to grow strongly in 2014 causing markets to price in higher yields, especially relative to the eurozone. We forecast the BoE to lead the tightening cycle within the G5 with its first rate hike coming in February 2015. EURGBP is closely correlated with the short-end yield differential. In addition, the GBP remains very cheap according to our BNP Paribas FEER[1] model.

- **Short EURUSD – target 1.22**
  The August Jackson Hole speeches by Fed chair Janet Yellen and ECB president Mario Draghi emphasised the divergence in monetary policies, accelerating the fall in EURUSD. This pair is increasingly linked to real yield differentials that should continue to shift in the USD's direction (Chart 4). Support to the EUR from portfolio flows peaked earlier this year and such flows should weigh on the EUR as it is increasingly used as a funding currency.

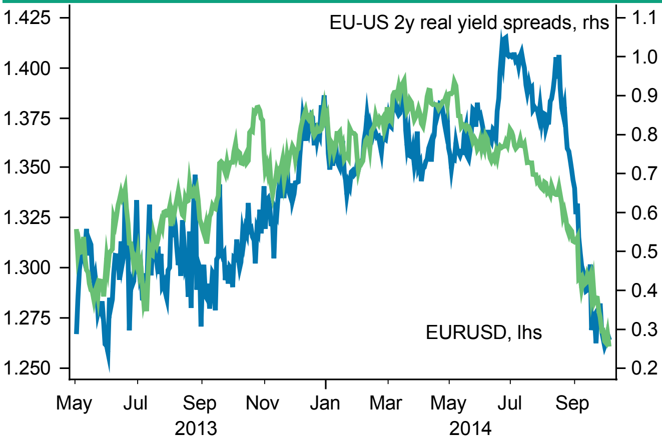
- **Long USDJPY – target 114**
  As the USD rebounds in 2014, we forecast it to make its largest gains against the currencies with the loosest monetary policy. The BoJ is likely to ensure that policy is loosest in Japan and that JGB yields remain low. Japanese investors are increasingly purchasing foreign assets and the anticipated reform of the government pension investment fund should encourage further outflows.

- **RKOs attractive for USD bulls**
  USD risk-reversals, although much lower than the levels seen during May 2013's 'taper tantrum', when adjusted by the level of base vols, strongly favour a rise in the USD. Positioning long the USD via RKOs looks attractive, especially given the flattening of vol surfaces and high risk-reversals relative to base vols.

Steven Saywell, Global Head of FX Strategy

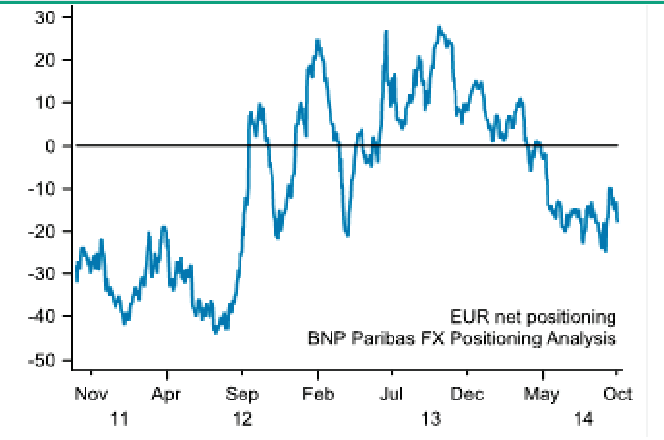
Daniel Katzive, Head of FX Strategy, North America

Chart 4: EURUSD is increasingly closely correlated to real yield spread



Source: Macrobond, BNP Paribas

Chart 5: EUR short positioning is not at an extreme level



Source: Macrobond, BNP Paribas

[1] BNPP FEER (fundamental equilibrium exchange rate) is the value of an exchange rate when an economy is operating with an internal balance (ie, output in line with potential output, full employment and inflation in line with the central bank's target) and a sustainable current account balance.

BNP Paribas end-period FX forecasts*

USD Bloc	Spot	Q4 '14	Q1 '15	Q2 '15	Q3 '15	Q4 '15	Q1 '16	Q2 '16	Q3 '16
EURUSD	*1.25*	1.25	1.23	1.22	1.20	1.18	1.17	1.17	1.16
USDJPY	*109*	112	115	118	121	124	125	126	127
USDCHF	*0.96*	0.98	1.00	1.02	1.03	1.06	1.08	1.09	1.10
GBPUSD	*1.60*	1.64	1.64	1.65	1.64	1.64	1.65	1.67	1.68
USDCAD	*1.12*	1.12	1.12	1.12	1.12	1.12	1.10	1.08	1.08
AUDUSD	*0.87*	0.89	0.88	0.87	0.86	0.86	0.90	0.90	0.91
NZDUSD	*0.78*	0.82	0.82	0.81	0.81	0.80	0.80	0.80	0.80
USDSEK	*7.26*	7.32	7.40	7.38	7.33	7.54	7.44	7.35	7.41
USDNOK	*6.52*	6.40	6.42	6.48	6.42	6.44	6.41	6.32	6.38

EUR Bloc	*Spot*	Q4 '14	Q1 '15	Q2 '15	Q3 '15	Q4 '15	Q1 '16	Q2 '16	Q3 '16
EURJPY	*137*	140	141	144	145	146	146	147	147
EURGBP	*0.78*	0.76	0.75	0.74	0.73	0.72	0.71	0.70	0.69
EURCHF	*1.21*	1.22	1.23	1.24	1.24	1.25	1.26	1.28	1.28
EURSEK	*9.11*	9.15	9.10	9.00	8.80	8.90	8.70	8.60	8.60
EURNOK	*8.17*	8.00	7.90	7.90	7.70	7.60	7.50	7.40	7.40
EURDKK	*7.44*	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46

CEEMEA	*Spot*	Q4 '14	Q1 '15	Q2 '15	Q3 '15	Q4 '15	Q1 '16	Q2 '16	Q3 '16
USDPLN	*3.34*	3.36	3.37	3.28	3.29	3.39	3.44	3.46	3.52
EURCZK	*27.5*	27.0	27.0	27.0	27.0	27.0	27.0	27.0	27.0
EURHUF	*309*	318	305	295	295	295	295	295	295
USDZAR	*11.30*	10.95	10.50	11.00	11.20	11.50	11.00	11.00	11.00
USDTRY	*2.30*	2.15	2.17	2.20	2.22	2.22	2.23	2.25	2.25
EURRON	*4.41*	4.50	4.50	4.45	4.40	4.45	4.41	4.38	4.34
USDRUB	*39.90*	38.47	39.78	40.95	42.57	43.48	43.66	43.66	43.84
EURPLN	*4.20*	4.20	4.15	4.00	3.95	4.00	4.03	4.05	4.08
USDILS	*3.70*	3.65	3.80	3.80	3.80	3.80	3.80	3.80	3.80
USDUAH	*13.00*	13.5	14.0	15.0	15.5	16.0	16.0	16.0	16.0
EURRSD	*119*	122	112	115	115	115	115	115	115

Asia Bloc	*Spot*	Q4 '14	Q1 '15	Q2 '15	Q3 '15	Q4 '15	Q1 '16	Q2 '16	Q3 '16
USDSGD	*1.30*	1.27	1.28	1.30	1.30	1.32	1.33	1.33	1.34
USDMYR	*3.30*	3.25	3.25	3.30	3.30	3.40	3.42	3.44	3.45
USDIDR	*12178*	12000	12000	12250	12500	12500	12600	12700	12800
USDTHB	*32.60*	32.50	33.00	33.00	33.30	33.50	33.50	33.75	34.00
USDPHP	*44.80*	44.50	45.00	45.00	45.00	45.00	45.10	45.20	45.40
USDHKD	*7.80*	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80
USDRMB	*6.10*	6.10	6.08	6.12	6.10	6.05	6.03	5.95	6.98
USDTWD	*30.40*	29.80	29.70	29.70	29.60	29.50	29.50	29.60	29.70
USDKRW	*1062*	1000	1000	980	980	975	980	985	990
USDINR	*61.60*	60.00	61.00	62.00	63.00	63.00	63.20	63.30	63.50
USDVND	*21280*	21300	21300	21300	21600	21600	21600	21600	21600

LATAM Bloc	*Spot*	Q4 '14	Q1 '15	Q2 '15	Q3 '15	Q4 '15	Q1 '16	Q2 '16	Q3 '16
USDARS	*8.40*	10.75	12.50	12.75	13.50	15.00	16.02	17.04	18.05
USDBRL	*2.50*	2.21	2.25	2.30	2.33	2.36	2.38	2.40	2.42
USDCLP	*599*	580	575	575	570	565	566	567	568
USDMXN	*13.50*	12.95	12.90	12.90	12.85	12.85	12.88	12.91	12.94
USDCOP	*2013*	1980	1997	2015	2023	2030	2034	2037	2041
USDVEF	*6.30*	13.80	13.80	13.80	25.60	25.60	25.60	25.60	25.60
USDPEN	*2.90*	2.88	2.90	2.90	2.90	2.90	2.91	2.91	2.92

Others	Spot	Q4 '14	Q1 '15	Q2 '15	Q3 '15	Q4 '15	Q1 '16	Q2 '16	Q3 '16
USD Index	*86.50*	86.65	87.92	88.63	89.85	91.25	91.59	91.38	91.93

Source: BNP Paribas **Spot rates as at 3 October 2014*

Equities

Proceed, with caution

Equities: Proceed, with caution

- **We remain bullish on equities and continue to believe that this bull market may last a further three years. However, increased caution is warranted. Caution, as our analysis suggests equity volatility has reached a low and may trend upwards. Caution, because US equities no longer embed a buffer against rising yields. Caution, as the ECB may be making a policy mistake. Caution, because the credit cycle is turning.**
- **While our equity performance targets are similar globally, we have greatest confidence in our forecasts for US equities and believe that investment risks are lower in the US than elsewhere. We expect US equities to rise by up to 50% by the end of 2017 and volatility to remain low. We therefore expect US equities' Sharpe ratio to be the best of global equity markets and to rise above that of US high yield bonds. One concern is that the risks related to equity investment may steadily increase as the credit cycle turns.**
- **The main cause of our concern of a turn in the credit cycle is the start of an increase in financial leverage. While leverage can rise a lot further before being a significant risk to equities, low absolute corporate bond yields are vulnerable to rising sovereign yields. While carry remains somewhat attractive, we believe the risk and volatility of corporate bonds will come more into question. However, more financial leverage and weaker bond markets may be positive for the S&P 500 over the next year or two as companies will be leveraging profits and investors should continue reallocating toward equities.**
- **European banks: A rise in this sector remains one of our main views. We are patiently waiting for two catalysts – the release of the bank stress test results and the ECB's TLTROs. We expect that, through the rest of the year and into 2015, investors will slowly recognise the existence of a lower-for-longer risk-free yield environment in Europe and a lower equity risk premium for European banks which contribute to the up to 45% upside to banks' equity valuations.**

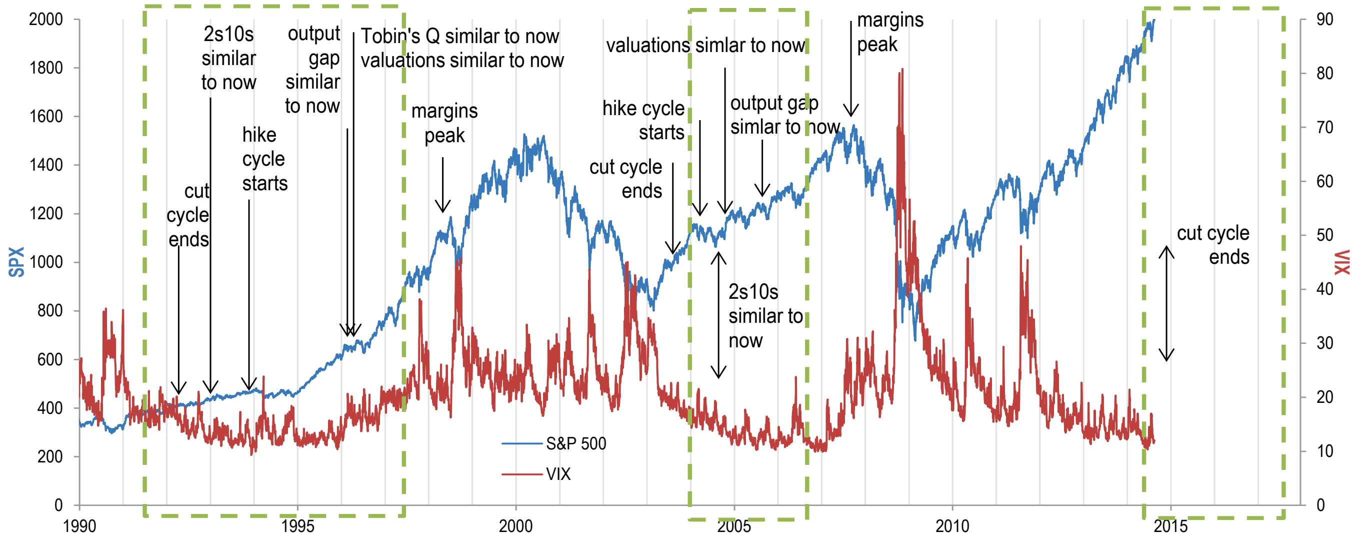
Proceed for three more years, with caution

Market cycle may last another three years

In June's edition of *Global Outlook Strategy*, we argued that this market cycle may only be slightly more than half-way complete. No single factor has a particularly good record at timing the cycle within a few years but most of those often cited reflect mid-cycle dynamics (Chart 1).

Our preferred measure for timing the market cycle is the business cycle and a good predictor of this is the output gap. We would argue that the output gap reflects other relevant factors and

Chart 1: Similarities to current business cycle variables during previous market cycles. Green boxes are 'mid-cycles'

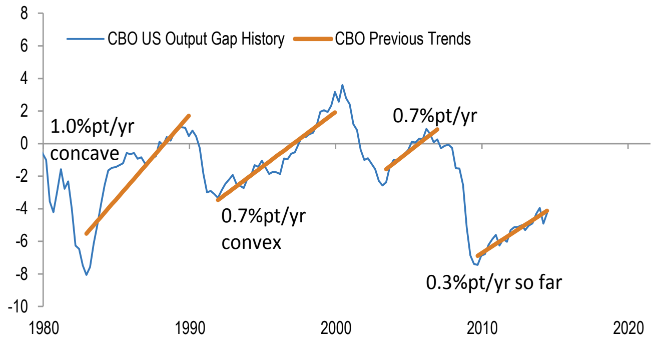


Source: Bloomberg, BNP Paribas

best matches the notion of an economic cycle from boom to bust. It also possesses useful statistical properties such as stationarity. It shows similar historical recovery trends from recessions and it peaks at similar levels over time. The output gap is perhaps particularly important in the current cycle due to the very high excess capacity in labour markets.

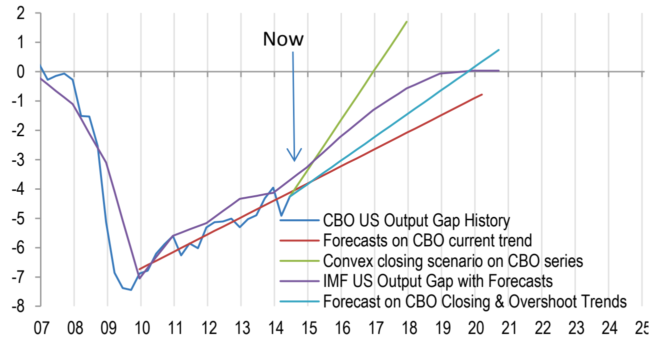
Our analysis of the US output gap suggests that we might only be slightly over half-way through a long and slow business and market cycle as the current gap is estimated still to be larger than the trough of the previous two recessions (Chart 2). A variety of forecast paths for the closure of the gap (Chart 3) suggest there could be a bull market through to the end of 2017.

Chart 2: Previous closing trends in the output gap



Source: CBO, BNP Paribas

Chart 3: US output gap forecasts (% of GDP)



Source: CBO, IMF, BNP Paribas

Market could rally further 25-50%

Using estimates of growth, inflation, revenue growth, margin expansion, buyback accretion and multiple expansion, we have developed targets for the SPX, SX5E and EEM to the end of 2017 (Table 1). The lower and upper estimates suggest this bull market still has 25-50% to run. While performances across these indices are expected to be fairly similar, the volatility estimates and probability we ascribe to each scenario suggest the best Sharpe ratio remains on investments in US equities.

Table 1: End 2017 index targets under different scenarios

		Stable growth, inflation & margins **S&P 500** **SPX**	Liquidity neutral & Margin Rebound **Euro Stoxx 50** **SX5E**	Liquidity neutral & ROE Rebound **GEMs** **EEM**
Economy	Real GDP Growth	2.4%	1.3%	4.0%
	Rate of inflation	1.9%	1.3%	3.5%
	Nominal GDP	4.3%	2.6%	7.5%
	Revenue Beta to GDP	1.5	1.6	0.8
Income Statement	Revenue Growth	6.5%	4.2%	6.0%
	Margin Expansion	0.0%	4.0%	2.0%
	Net Buyback Accretion	1.5%	1.0%	-1.0%
	EPS Growth	**8.0%**	**9.2%**	**7.0%**
Market	Multiple Expansion (Lower Bound)	0.0%	-1.5%	-1.0%
	Multiple Expansion (Upper Bound)	5.5%	5.0%	5.0%
	Lower Annualised Performance	**8.0%**	**7.7%**	**6.0%**
	Upper Annualised Performance	**13.5%**	**14.2%**	**12.0%**
	Investment Horizon	3.2	3.2	3.2
	Lower Point-to-Point Performance	28%	27%	20%
	Upper Point-to-Point Performance	50%	53%	44%
	Average	39%	40%	32%
	Current Index Level	1972	3223	41.5
	Lower Target	**2519**	**4082**	**50**
	Upper Target	**2953**	**4924**	**60**
Risk	Vol	11	17	17
	Probability	50%	35%	30%
	Sharpe Lower	0.7	0.5	0.4
	Sharpe upper	1.2	0.8	0.7

Source: BNP Paribas. Data as at 1 October, 2014

Volatility is likely to trend upwards

The risk of investing in equities is increasing

A three-year target of a rise of 25-50% must embed a great deal of uncertainty. That is why we have examined the fundamental drivers of volatility. Our conclusion is that these drivers have reached a low and may trend upwards such that the risk associated with investing in equities is increasing.

Table 2 summarises our analysis. Firstly, it separates the fundamental drivers of baseline volatility (the volatility experienced on any 'no news' day) and the behavioural or leverage drivers of spike volatility (the volatility experienced during short bursts of catalyst-driven market activity).

Table 2: Fundamental volatility framework

"Baseline" fundamental volatility	Mechanism of impact	Jun 06	Jun 10	Jun 14	Forecast Dec 17	Implication for volatility Current	Implication for volatility Trend
GDP Volatility	"Central planning" targets the muting of nominal GDP volatility. Mid-cycle dynamics in play	0.8%	1.6%	1.3%	1.3%	Low	Neutral
Revenue Volatility	Globalisation provided diversification of revenue benefits. Peak diversification?	**2.6%**	**6.6%**	**1.4%**	**1.4%**	Low	Neutral
Operating Leverage	Outsourcing of fixed costs and high margins make for low operational leverage	2.4	1.3	1.3	1.4	Low	Neutral
Financial Leverage	High profit and low debt levels suggest low volatility but downtrend in fin. lev. finished?	0.8	2.3	1.1	1.5	Low	Increasing
Net income Volatility	**Quarterly data annualised**	**5.3%**	**28.3%**	**3.3%**	**4.7%**	**Low**	**Increasing**

"Spike" volatility equity volatility	Mechanism of impact	Implication for volatility Current	Implication for volatility Trend
Market structure	Demand for ETFs (inc. bonds), risk factor investing (inc. shorting) and low-vol strategies	Low	Declining
Buybacks	High, but few signals of a decline soon as yield differentials still favourable	Low	Neutral
Equity valuations	Elevated but on-average not extreme. Parts of the market vulnerable (small caps, tech)	Neutral	Increasing
Investor leverage	High and increasing but effects often temporary	High	Increasing

Source: BNP Paribas

Research has found that a variety of macro and fundamental factors can help explain both baseline and spike volatility and we forecast several of these. In essence, baseline volatility is driven by:

- **GDP volatility:** In particular, nominal GDP volatility. While there is a very weak link between real economic growth and corporate profits, there is a causal chain through a company's income statement. On this factor, central banks and governments are increasingly focussing on limiting volatility in nominal GDP.
- **Revenue volatility:** As discussed above, low nominal GDP volatility implies low revenue volatility. The continued diversification of revenue as a result of globalisation should also contribute to low revenue volatility.
- **Operational leverage:** A company's mix of variable and fixed costs has a significant impact on how much revenue volatility will contribute to EBITDA volatility. Here too, globalisation has structurally changed the sensitivity of large, developed market companies to revenue volatility. For example, the significant fixed costs of large manufacturing plants and workforces are now predominantly in emerging markets.
- **Financial leverage:** Corporate financial leverage has been decreasing for several decades and is currently very low. Buybacks have stabilised the downtrend but, until recently, much of the buyback activity was cash-flow funded. As we see more aggressive debt funded buybacks and acquisitions, we expect to see financial leverage rise, potentially increasing baseline volatility.

The outlook for spike volatility is less benign. We consider the following factors to be relevant:

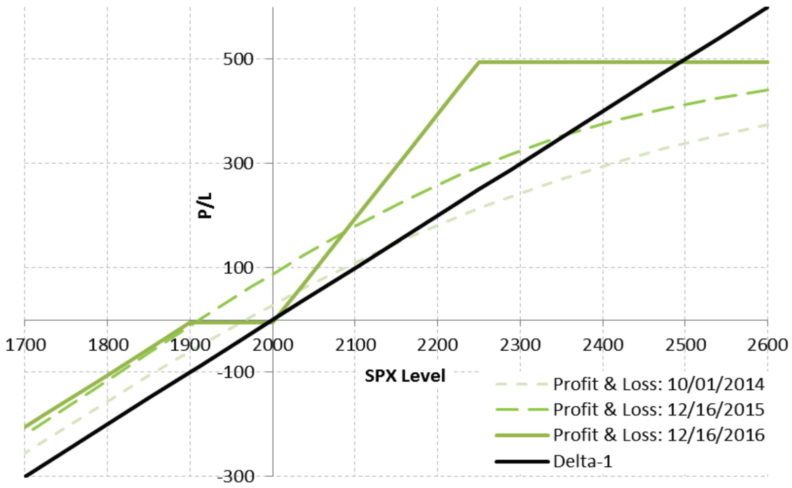
- **Market structure:** Investors globally are intensely focussed on a variety of strategies that serve to reduce the potential for spike volatility. Investor demand has been for low volatility assets such as bond ETFs, quality/low vol equities and long/short strategies. In the absence of fundamental shocks, investor behaviour has lessened the chance of spike volatility.
- **Buybacks:** We expect these to continue to help keep the potential for spike volatility low in the US by remaining a strong bid to the stock market (USD 400-500bn per year).
- **Equity valuations:** When investors believe they own an overvalued asset, their reaction to news is likely to create a greater chance of spike volatility. US equities are currently moving above fair value and further valuation expansion will contribute to more significant spike volatility when there are catalysts.
- **Investor leverage:** Low volatility and low return environments encourage risk taking with investment leverage. However, that also means catalysts cause a more significant reaction from investors. While we believe investors are invested in lower risk strategies than in previous cycles, they are beginning to use quite a lot of leverage. As the cycle progresses we expect this to increase and the potential for spike volatility to rise significantly.

Trade

- **Position with upside leverage and low downside risk for two more years of SPX gains**
  Buy 2x the Dec-16 SPX 2000-2250 call spread for up to 25% upside for a 12.5% rally over two years (and outperform delta-1 investment up to SPX 2500). Fund this by selling 1x the Dec-16 SPX 1900 put option.

Risk: The investor will make losses if the SPX is below 1900 at the December 2016 expiry.

Chart 4: SPX ratio bull collar trade payoff profile



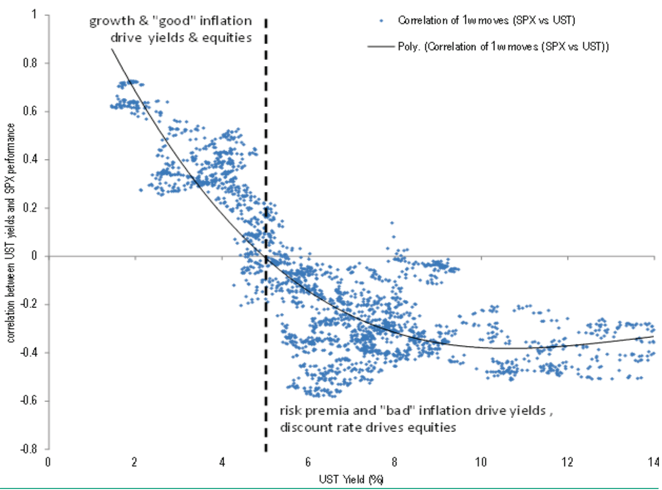
Source: BNP Paribas

Proceed, with increasing yield caution

In the US market, lower yields have been accompanied by a greater correlation between equities and yields (Chart 5). At low absolute yield levels, rising yields suggest growth is improving (good for equities) while falling yields mean markets fear deflation (bad for equities).

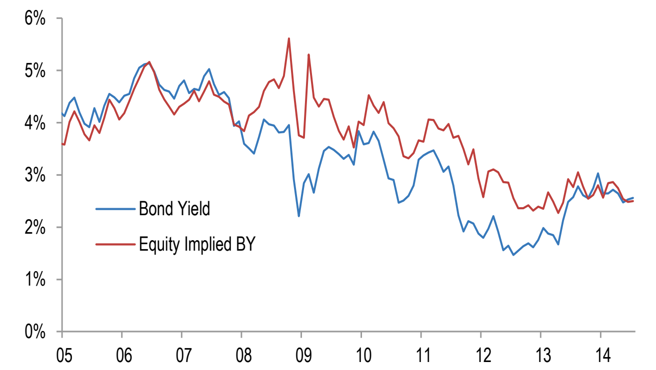
However, if we assume a constant and fair equity risk premium for equities, the ‘buffer’ to rising yields that equity investors had accounted for in valuations has now declined to zero (Chart 6). This means that, from this point, rising US sovereign yields must be offset by further improvements in growth expectations, otherwise the valuation of equities will become more expensive (or prices will decline to compensate).

Chart 5: UST-equity correlation versus UST yields



Source: Bloomberg, BNP Paribas

Chart 6: Equities accurately reflect current bond yields (BY)



Source: Bloomberg, BNP Paribas

US versus Europe

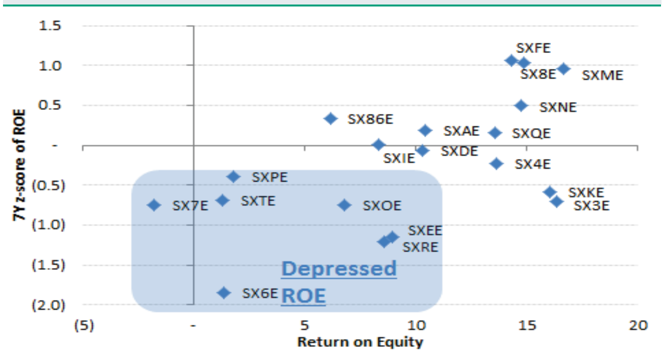
While we forecast the Sharpe ratio for US equities to be superior over the next three years, deciding a short-term preference for equity investment in the US or Europe has become rather tricky. European valuations on many equity specific measures appear to have moved above US valuations. In contrast, ERP and relative valuations to local bond yields suggest Europe is more appealing. However, Japan is a cautionary lesson showing that low bond yields don't mean equities reflect relative value if yields are low due to the threat of deflation.

Hence, the case for Europe over the US must be made by making a case for earnings growth to rebound. The current low level of profit margins provides a lot of operational leverage should companies be able to generate some revenue growth. European companies have global exposure and should benefit from the EUR's current weakness. However, significant weakness in local markets is limiting the improvement in revenues.

Analysts remain hopeful though. 2014 European EPS growth estimates are still forecasting a rebound in 2014 and 2015, despite the weak economic growth environment in Europe.

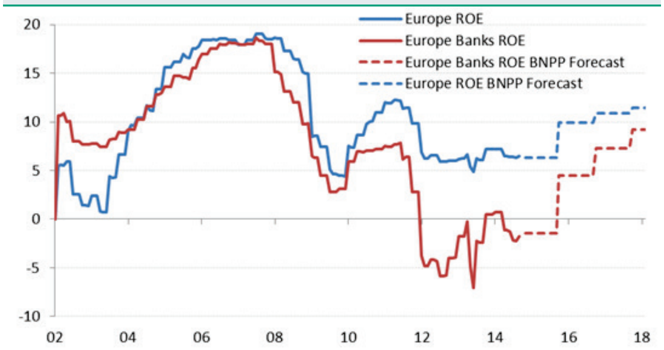
What will really drive an improvement in aggregate earnings in Europe will be a recovery in some of the sectors where ROE is still very depressed. Chart 7 shows these while Chart 8 shows one of the main areas of concern and potential improvement – European banks.

Chart 7: ROE remains depressed in pockets of Europe



Source: Bloomberg, BNP Paribas

Chart 8: Europe ex-banks ROE consensus has stabilised

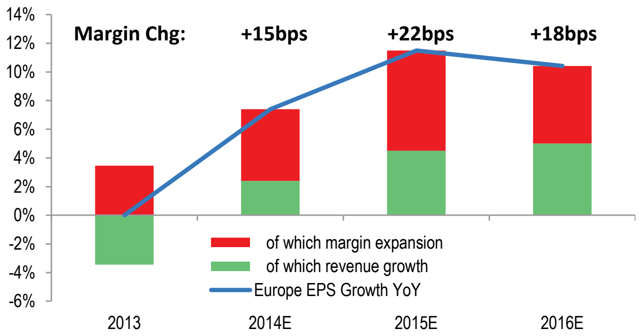


Source: Bloomberg, BNP Paribas

The estimate of European earnings growth of more than 10% for the next three years is roughly equally split between margin expansion and revenue growth. It is the margin expansion that investors are most concerned about given recent weakness. Table 3 shows current and forward ROE estimates and the weighting of each sector in the index. It highlights that we expect 53%

of the improvement in European ROE in the next twelve months to come from a near 7% improvement in the ROE of European banks (from -1.8% to +4.9%). These ROE levels are 'below the line' which means a downtrend in the amount of extraordinary costs (fines etc) will provide a significant contribution to this improvement.

Chart 9: Operational leverage for European equities



Source: BNP Paribas

Table 3: Banks' ROE may account for most of EU improvement

Index	Name	Current ROE	12m Fwd ROE	ROE CHG	Weight	Contribution to SXXE ROE CHG
SX7E	Bnk	(1.76)	4.92	6.69	13.0%	53%
SX6E	Util	1.37	7.23	5.86	8.1%	21%
SXRE	Rtl	8.60	19.18	10.58	3.7%	8%
SX4E	Chem	13.67	17.78	4.11	6.6%	5%
SX3E	Fd&Bv	16.36	20.45	4.09	7.4%	4%
SXAE	Au&Pt	10.46	12.18	1.72	5.9%	4%
SXEE	Oil&G	8.97	10.65	1.67	5.9%	4%
SXTE	Tr&Ls	1.32	16.53	15.20	1.1%	3%
SXNE	Ig&S	14.78	16.19	1.40	11.2%	3%
SXIE	Ins	8.37	9.04	0.67	6.4%	2%
SXOE	Cn&Mt	6.81	8.78	1.97	3.2%	2%
SXDE	HeCr	9.96	12.16	2.20	4.8%	2%
SXPE	BsRs	1.84	3.45	1.60	1.3%	1%
SXQE	Pr&Ho	13.58	13.77	0.19	6.3%	0%
SX8E	Tech	14.91	15.02	0.12	4.8%	0%
SXFE	FnSv	10.78	10.27	(0.52)	1.0%	0%
SX86E	ReEs	6.20	5.85	(0.36)	1.4%	0%
SXME	Mda	16.69	8.53	(8.16)	3.0%	-4%
SXKE	Tel	16.24	10.58	(5.66)	4.8%	-7%
SXXE	Eurozone	6.48	7.28	0.80	100.0%	100%

Source: Bloomberg, BNP Paribas

European banks: Targeted policy leading to valuation drift

Banks have cut their risk significantly

Our thesis remains that investors have yet to recognise the huge de-risking of the European banking system that has already occurred. We believe risk reduction continues and that greater recognition of this over the next two years will lead to higher valuations for the sector.

Lower risk in banks should be reflected in a lower equity risk premium priced into the cost of equity (used to discount future cash flows). In addition, the huge fall in long-term European bond yields is contributing to a greatly reduced cost of equity that does not appear to be recognised or believed by (in particular) non-European based investors currently.

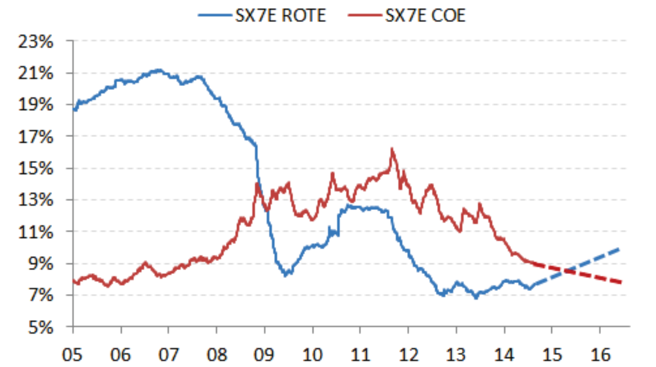
Chart 10 shows the history of the ROTE (return on tangible equity) and COE (cost of equity) of SX7E banks over the last decade and provides forecasts. While ROTE is currently low, it is already stable. As the list and size of potential fines decline, and as banks finish adapting to much higher capital and liquidity requirements, ROTE is expected to rise, albeit slowly and modestly.

Exane has provided a valuation model calibrated to current index levels for the SX7E below. It also shows a "blue sky" scenario to its forecasts assuming an improvement in ROTE to 11.5% and an increase in the long-term growth assumption. These alone could see 34% upside to their valuations for the sector.

Separately, we have taken current margin assumptions and a stable (lower than Exane) terminal growth assumption but assumed a lower cost of equity (current sovereign yields and a 1.1x beta) to produce a 'new COE regime' valuation that is 45% higher than current levels (Table 4).

We believe that there is a high probability that these valuation drivers will move in a favourable direction over the next two years and, given the magnitude of the impact on valuations, we believe this will cause a significant valuation drift for the SX7E. Finally, there are catalysts for investors' recognition of the potential value in EU banks. The stress test results to be released in October should give the large banks a clean bill of health and the ECB's targeted longer-term refinancing operations are a specific policy aimed at supporting banks' ability to deleverage and improve margins. Moreover, the level of detail likely to be published in the results of the bank stress tests will greatly increase transparency which we think will favour lower equity risk premia for these banks.

Chart 10: Eurozone banks' forward ROTE and COE



Source: BNP Paribas, Exane

Table 4: Impact of profitability metrics on sector valuation

	Current	'Blue sky'	New COE Regime
Net Interest Margin (%)	1.38%	1.48%	1.48%
Provisions to loans	0.83%	0.55%	0.55%
Cost-income ratio (%)	58.1%	57.1%	57.1%
ROTE (%)	**8.8%**	**11.5%**	**10.0%**
Growth rate	1%	2%	1%
COE	8.7%	9.4%	7.5%
Fair P/TE (x)	1.0	1.3	1.4
Fair value 2015e	521,777	696,784	751,511
Discounted back to 12m from now	507,615	676,338	733,708
Market cap today	505,604	505,604	505,604
Upside	**0%**	**34%**	**45%**

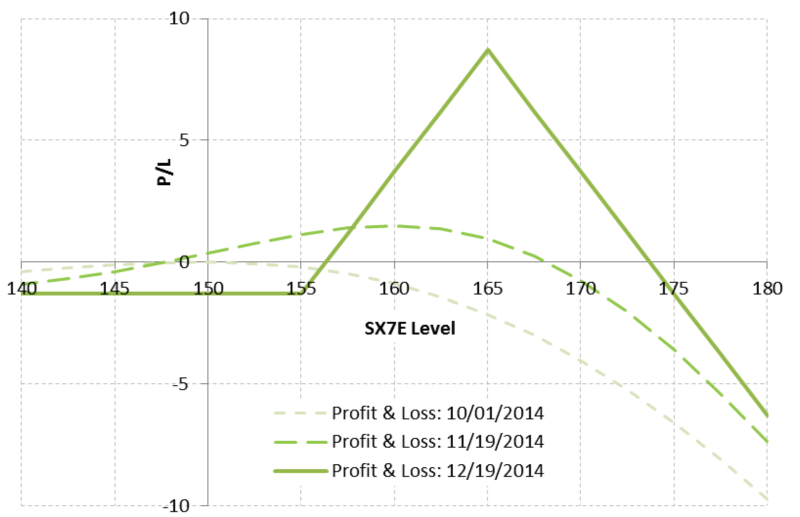
Source: BNP Paribas, Exane

Trade

- **Position for a short-term bounce in SX7E performance but a decline in volatility thereafter going into the year end.**
  Buy a Dec-14 155-165 1x2 call ratio on SX7E. This monetises a flat upside skew and elevated volatility versus our expectation. We think the SX7E will bounce 5-10% after the release of the results of the asset quality review but to then range trade into the year end. This strategy costs about 1.5 points for a potential 10 point profit.

Risk: The investor will make losses if the SX7E is below 155 or above 173.5 at the December 2014 expiry.

Chart 11: SX7E ratio call spread payoff profile



Source: BNP Paribas

Gerry Fowler, CFA

Global Credit

Waiting for ECB QE and Fed rate hikes

Global Credit: waiting for ECB QE and Fed rate hikes

As we write our outlook for credit over the next few months, the news about Bill Gross's departure from PIMCO is still being digested by the market. Will this news prove to be the case study for liquidity and concentration risks that many in the industry have highlighted over the past year as one potential unintended consequence of the new regulations? This coincides with a Blackrock publication entitled "*Corporate bond market structure: the time for reform is now*", which states "we believe the secondary trading environment for corporate bonds today is broken", arguing that this is hidden by low interest rates and QE and that it is breeding complacency. Additionally regulators are also considering new rules for large asset management firms and curbing some of their activities, as the 'too-big-to-fail' concerns have moved from banks to large asset managers. We have long argued that **the largest risk in the market is that of liquidity** as brokers are unable to hold too much inventory, which exacerbates any risk-off move. It will, perhaps, soon be tested and could be tested again in the future. One way to hedge for these low-probability high-impact events is via credit Options.

In the meantime, if we look over the next few months and assume no major market disruption linked to the above mentioned news, we have two key regions with very divergent drivers:

Eurozone: growth is stalling (albeit fundamentals are not deteriorating yet and in fact they are improving for banks), inflation is still falling, rates will remain low for a while, the € is weakening and the ECB is likely to embark on *proper* QE at some point (although the ECB's balance sheet will only really increase next year). Elsewhere in Europe, the sterling market has very different dynamics (UK growth, higher rates in 2015, sterling appreciation).

US: growth is picking up, inflation expectations are rising, the Fed is expected to begin interest rate hikes in Q2 2015 and the dollar is appreciating. Aside from the Hong Kong protests and Asian credit supply, the US rates and dollar appreciation are also key drivers for credit in **Asia**.

Overall, **we think the best opportunities are in £ IG, $ HY, € HY, € IG and $ IG, in that order**, for the following reasons:

£ IG: while the pressure on the BoE is increasing to hike rates earlier than expected due to the solid economic recovery, the flight to quality helped gilts in July/August which supported £ IG. The temporary blip in mid-September, where spreads saw a moderate correction, could not prevent £ IG from being the highest yielding asset class within credit in Q3, with 1.91% of total return. Looking forward to Q4 our bullish view on £ IG does not change; especially now as volatility drivers (mainly the Scottish independence vote) are out of the way. The current yield differential of 2.55% combined with a spread differential of 60bp between £ and € credit provides great carry and compression potential. We believe that £ credit should comfortably beat € credit in IG although we are becoming more constructive on pockets such as Corporate Hybrids as rates stabilise. While $ and € HY are likely to have better returns for Q4, we think that £ IG is more attractive on a risk-adjusted basis.

$ HY: while it may take some time for the market to digest recent West Coast developments, we believe US credit valuations will ultimately retrace much of the September sell-off over the coming months. Q3 volatility reflects investors' defensiveness tied to US Federal Reserve official comments about extended Leveraged Finance valuations and concerns about the outlook for global growth. A hefty new issuance pipeline also weighed on the secondary market. The HY index generated -2.0% total returns in Q3 and 3.2% YTD, with double Bs outperforming lower quality credits on a risk-adjusted basis. In line with basis underperformance globally, the CDX indices have actually widened less than their cash counterparts during the volatility in Q3 volatility, particularly on the HY side. Still, corporate fundamentals are stable and the appreciating dollar and decent yield versus other Fixed Income alternatives should attract global investors, especially with key segments of EM facing headwinds. Should the market rebound as expected, we would not be surprised to see spreads in the 425bp range, if not tighter, with the front-end outperforming longer duration paper. We believe that US HY should beat European HY given the substantial yield pickup (>1.7%) and relatively stronger position in the economic cycle.

€ HY: European HY suffered in Q3 from indigestion due to excess supply in July, headwinds from the US and some idiosyncratic bad news, all three leading to some outflows for the first time in a year. Despite that the Crossover ended Q3 as being the highest returning benchmark in credit comfortably beating European HY. European HY continues to be very delicate with idiosyncratic stories such as Phones 4U and Heckler combined with macro headwinds from US HY. However, given that current index yields are around c.4.5%, we believe that European HY will generate positive returns (unlike Q3) driven by carry and moderate spread compression due to the search for yield bid. Leveraged Loans had a good quarter as there were not many idiosyncratic moves like HY, a solid CLO bid and the asset class is naturally immune to any rates driven technical from the US. We believe that Loans will continue their good run in Q4 for precisely the same reasons as above and they could end up with returns similar to what we saw in Q3.

Between IG and HY, we prefer HY given recent underperformance and the compelling c.4.5% YTW at the index level. Within HY, we like Bs as they have underperformed relative to BBs, which had the safe haven bid. We would still recommend investors to avoid the CCC bucket given idiosyncratic risks with the sluggish European recovery.

On curves, given the recent sell-off, especially in cash, there is less incentive to push into longer duration as the liquid 5 year portion pays a lot more than 3 months ago. We would advise investors to stay in the belly rather than extend, especially in higher beta sectors like HY. There is also less rates upside in extending at current Bund levels.

In the CDS indices, we like the new Crossover (S22) given the significant curve pickup and the skew it will come in with. It needs to be remembered that on a total return basis the Crossover performed on a 1:5 basis vs. Main this year and we believe it will do another 1:4 at least (in total returns including carry), for Q4, given the roll dynamic.

€ IG: European credit had a wobbly Q3 with many extraneous factors moving spreads unlike the relatively smooth ride it had in H1 2014. It started with flare-ups in Russia and Ukraine, US rate hike worries, disappointing European data and the ECB not doing much. However it has largely ended well with the ECB announcing a purchase programme comprising ABS and covered bonds (size not yet known) and the Fed keeping the ‘considerable period’ language as of now. IG Cash continued to outperform CDS on a total return basis due to rates. Within IG sectors, we still recommend dated Sub Insurance, Corporate Hybrids over the next quarter. Within banks for Q4 we prefer bank senior to sub, primarily due to the issuance pressure in subs linked to evolving regulation such as Total Loss Absorbing Capacity (TLAC) and the leverage ratio. However, now that the S&P rating downgrades have taken place, we could see a short-term sub-senior compression. TLAC will not be clarified until the G20 meeting in Brisbane in mid-November, banks are in their closed period and so will not issue now, and the next positive catalyst for banks, especially peripheral banks, is the results of the AQR/Stress Tests to be published towards the end of October.

$ IG: cash spreads are fairly valued at present, in our view, although we prefer Financials versus Non-Financials given several sector-specific headwinds on the Industrial side. We forecast that IG corporate spreads will end the year around 100bp, approximately 11bp tighter than current levels. Q4 returns should be positive on both an excess and total return basis.

Key trade ideas

IG vs. HY CDX: once the CDX HY23/IG23 ratio reaches 5.7x, the HY/IG compression trade becomes attractive (Sell protection on HY23 and Buy protection on IG23).

Buy short dated US High Yield Cash; SJNK or HYS ETF: the US HY basis (as represented by Long HYG ETF Short CDX HY Index and Short 5y Treasuries) is currently trading at -70bp. Cash HY has underperformed synthetic HY over the last two months. We recommend entering this trade once the basis reaches -80bp or lower.

Flatteners: given the move wider and steeper on the roll, and the reasonably constructive backdrop we predict for credit, we recommend Main flatteners to take advantage of the new curves. Among the traded tenors 3y/5y flattener in the ratio of 1.59 provides the best carry and roll down potential for a given notional of 5 year (€5.11k for €10mn of 5 year over 3 months).

Options: Long iTraxx Main/Short SX5E in Options.

Top £ picks: HSBC and RBS senior, EDF, IMTLN, RWE, SGOFP, TELEFO, GKN, HTHROW and hybrids below.

Long $ IG picks: GM, BPCEGP, BACR, RABOBK, ISPIM, TSN, CAG, AA, DTV, FE and SABLN.

Top HY picks: US - ALLY, FNCIM, STLD and REYNOL. **Europe –** ARGID secured, BAKKA, BRAKES, WINDIM Unsecured, GALA and EIRCOM.

Long Corporate Hybrids: ENELIM € and £, VIEFP € and £, COFP €, TELEFO € 20 and £ 20, all SOLBBB €.

Long senior peripheral banks: MONTE, BPIM and POPSM.

Selective Longs in subs: Dated Sub Insurance offers best ratings adjusted spread pickup across all sectors in Investment Grade. It pays extra because of the illiquidity but given the well capitalised nature of the Insurance sector and no write down structures in the instruments (unlike bank AT1, which are also junk rated mostly) we like Dated Subs. Our favourites are UQA, ACHMEA and ALVGR

UCGIM T2s, which have suffered from both a downgrade to junk and the bank's exposure to Russia have upside. CMZB UT2 and legacy T1 from RBS and MONTE look attractive.

Key Shorts: US IG - NEM, T, SO, SPLS and BBBY. **US HY –** S and TMUS. **European Banks** – BARC Holdco senior, POPSM AT1 and BACR AT1. **European HY –** ALTICE International Unsecured and FOURSN.

Market technicals and performance forecasts

Europe

In European credit, 'duration' continued to lead high beta in Q3 in cash, with £ IG and € IG outperforming their shorter duration HY counterparts. The driver here was again (like H1) the continued rally in Bunds, with 5Y Bund yields going below 1% for the first time ever on the deflationary backdrop in Europe. For example, in € IG's 6.8% YTD total return, 4.7% has come from Bunds, which is almost 70%.

Table 1: Total returns in European Credit

	YTD Q3 TR	H1 TR	Q3 TR	Q4 TR	2014 TR
iTraxx Main	1.4%	1.3%	0.1%	0.6%	2.0%
iTraxx Crossover	6.8%	6.9%	-0.1%	2.8%	9.6%
iBoxx € IG	6.8%	5.0%	1.8%	1.1%	7.9%
iBoxx £ IG	7.6%	5.6%	2.0%	1.8%	9.4%
European HY (HPID)	5.4%	5.3%	-0.1%	2.1%	7.5%
European Loans (ELLI)	4.2%	2.9%	1.3%	1.5%	5.7%

Source: iBoxx, LCD, Ecowin, Markit, Bloomberg, BNP Paribas

Table 2: European credit issuance 2014 (€ bn equivalent)

	2014 YTD Iss.	2014 Iss. Forecast	YTD Iss./ Forecast	YTD Net Supply
Banks Senior	**213**	**220**	97%	**-44**
Banks Sub	**71**	**90**	79%	**36**
Covered Bonds	**93**	**120-140**	71%	**-75**
Insurance	**17**	**17-19**	94%	**9**
IG Non-Financials	**216**	**218-248**	93%	**42**
HY Non-Financials	**92**	**112**	82%	**56**
Leveraged Loans	**65**	**80**	81%	

Source: Dealogic, LCD, BNP Paribas

Technicals in IG credit continued to be supportive in Q3. As expected primary market activity was subdued during the summer months. Banks issued €40bn euro-equivalent of senior and €14bn of subordinated paper. AT1 issuance, which had seen a record pace in H1, was sidelined as geopolitical risks and the BES story worsened market conditions for issuers. AT1 issuance, however, came back in early September and we expect banks to continue to issue more AT1 and T2 in Q4. For senior paper we expect issuance to remain subdued as banks will take-up funding via TLTRO. IG Non-Financials issued €42bn euro-equivalent in Q3, remaining below the previous year's pace. Since most of the funding was already done in 2013, Non-Financial issuers reduced the use of primary market, despite the persistent low yield environment. Lack of investment opportunities kept capex low and corporates had no use for additional funding, unless there was some opportunistic M&A deal. This should not change in Q4 as the economic outlook in Europe remains benign. Therefore, we expect issuance in IG Non-Financials to largely match redemptions, generating small net supply.

In European Leveraged Finance, technicals were less supportive in Q3. The record supply of €10bn in July was only barely absorbed by the market. Combined with the first outflows of European High Yield funds since summer 2013, this oversupply led to some underperformance in the European HY market. Looking forward to Q4, we expect HY to do better, given the proactive accommodative policy change at the ECB. In terms of supply we expect another €25bn euro-equivalent for the rest of the year, which should bring full year supply to €112bn. The Leveraged Loan market has also shown strong primary market activity in Q3. However, in contrast to the HY market, the record supply was easily digested thanks to the strong comeback of the European CLO bid and lack of outflows. We expect another €16bn issuance in the last quarter of the year, which should be well absorbed, considering the significant pipeline in the CLO market.

US

Despite the record highs achieved by US equity markets recently, rising interest rates, corporate bond outflows, worries about secondary credit market liquidity and international concerns have made Q3 particularly challenging for US corporates. Preliminary September results show that IG cash credit has generated -74bp of excess returns and -0.1% of total returns in Q3, bringing YTD totals to 68bp and 5.6% respectively. BBBs and longer duration assets have outperformed single A's/above and the front end YTD, although higher quality assets and shorter duration bonds were better bid in Q3.

Table 3: Realised and Expected Total Return in US Credit

	Investment Grade			High Yield		
	Dec 2013	Sep 2014	Dec 2014 Est	Dec 2013	Sep 2014	Dec 2014 Est
Spread	113bp	111bp	100bp	414bp	489bp	425bp
Change in spread		-2bp	-11bp		+75bp	-63bp
		YTD	**Q4**		**YTD**	**Q4**
Excess Return		68bp	118bp		80bp	453bp
Total Return		5.6%	0.4%		3.2%	5.5%

Source: Yieldbook, BNP Paribas

In the US, September's robust IG primary calendar at the start of the month kept USD issuance only modestly below 2013's record pace. IG Financial issuance is up 14% in 2014, as banks have been aggressively tapping the capital markets to bolster capital positions ahead of upcoming regulatory reforms. European bank volumes are up 26% in 2014, while US bank volumes are up 27% over the same period. On the Non-Financial side the 14% decline in volumes was complicated by Verizon's jumbo transaction in September 2013, although activity is still somewhat slower than we had anticipated. Note that the 23% decline in European-domiciled dollar Non-Financial transactions reflects the relative attractiveness (for issuers) of issuing in €. HY supply has declined 9% in 2014 and 18% in Q3 which is in line with our expectations.

We see modest upside to our FY 2014 USD primary bond issuance forecast of c.$1.5trn due to: a) September volumes coming in at the higher end of our preliminary estimates; b) the pace of future interest rates is likely to be slower than what we envisaged in June, and c) a notable pullback in the calendar at the end of the month with the broader market wobbles. For Q4 we forecast supply of $140bn from IG Financials, $125bn for IG Non-Financials, and $90bn for HY.

Table 4: US credit issuance 2014 ($ bn)

Sector	2014 YTD	Q3 2014	Post crisis Q4 avg	2013 Q4	2014 Q4 forecast	2014 Total
IG Fin	462	134	85	110	140	602
IG Non-Fin	404	90	125	114	125	529
HY	266	74	78	79	90	356
Total US primary volumes	1,132	298	289	303	355	1,487

Source: Bloomberg, BNP Paribas

Asia

The softness in the commodities outlook, linked to the expectation of slower growth in China, has prompted trimming of risk. The commodity names that could be impacted are mostly in the Crossover HY area. Aside from US rates which are key to the Asian credit market, supply has been a significant driver recently. HY was impacted by upcoming significant AT1 supply by Chinese banks, expected in October. Protests in Hong Kong should also be monitored for any signs of deterioration. Single A credit in Asia is still our top pick, as it still offers value vs. US credit. The single A names we prefer are mainly the HK China names which can underperform in the short term if demonstrations gather pace and the situation deteriorates in Hong Kong. The trades that our Sector Specialists suggested: *Sell CITPAC* and *Sell KWG Property Holding curves* could be used to express this view. In addition, CITPAC is also iron-ore related.

Conclusion

Overall, going into the last quarter of 2014, we feel more constructive than we have over the last month. Most of the big volatility drivers are out of the way, even if one still has to monitor special situations closely. The Fed's steeper dot plot is known, the ECB announced a package which could be further added to if the December TLTRO disappoints or if the purchase programme does not have the desired impact. The results of the AQR/Stress Tests in late October should reassure the market and boost confidence. Supply is a concern in Fin Subs and in HY but if we only get what we forecast it should not derail European credit. Overall, we believe Q4 should feel better than Q3 for credit, particularly for assets that have lagged recently, such as US and European HY.

Still, rising volatility and mediocre liquidity may not be fully reflected in valuations as we head into the New Year, particularly given the potential for a Central Bank 'mistake' during 2015 that could reprice risky assets more broadly.

Olivia Frieser, Mahesh Bhimalingam, Mark Howard, Ashish Jain, Klaus Plattner, Colleen Watson

Emerging Markets

A challenging Q4

EM: A challenging Q4

- **Q4 will pose significant challenges for EM and volatility in capital flows may increase as a result; a key risk for countries with large external funding needs.**
- **We are more cautious on EM as the market prices in an adjustment in US rates in response to the US economic recovery.**
- **In Latam, we continue to recommend a tactical stance as the flattening process in the US rates curve is at the initial stage. We favour receivers in the front-end of the Brazilian DI curve, the flattening on 2s5s TIIE in Mexico and a long CLPCOP.**
- **In CEEMEA we continue to receive Hungarian rates and pay rates in South Africa. We stay short the RUB**
- **In Asia, we think the MYR and IDR are the most vulnerable to Fed tightening and weak growth in China. By contrast, India stands out with its marked resilience, positive terms of trade surprise and improved growth momentum. We recommend being short MYR vs THB, long CNH vs SGD and long INR vs IDR.**
- **In the Sovereign and Credit space the pressure on EM bonds, particularly energy and commodity-sensitive credit, is likely to rise if USD and Treasury trends persist. Our trades are designed to provide protection from UST bear flattening and macroeconomic deterioration in commodity-reliant EM.**
- **In Latam, we favour moving into Brazil Banbra'22 from Caixbr' 22 in banks, given the former's higher spread cushion. Among commodity-sensitive names we like Sammin '22 vs Vale '22.**
- **In CEEMEA we see Vimpelcom's spreads offering sufficient cushion in the face of geopolitical risks in Russia and rising UST yields, not least given company's better maturity profile, good liquidity and prospects for deleveraging. We recommend switching from VIP 7.5043% '22 into VIP 8.25% '16 or buying VIP 8.25% '16 outright.In Asia, we think the CITIC/CITPAC cure is rich, offering little UST cushion and likely to remain unprofitable.**

EM FX and rates

EM face challenging Q4

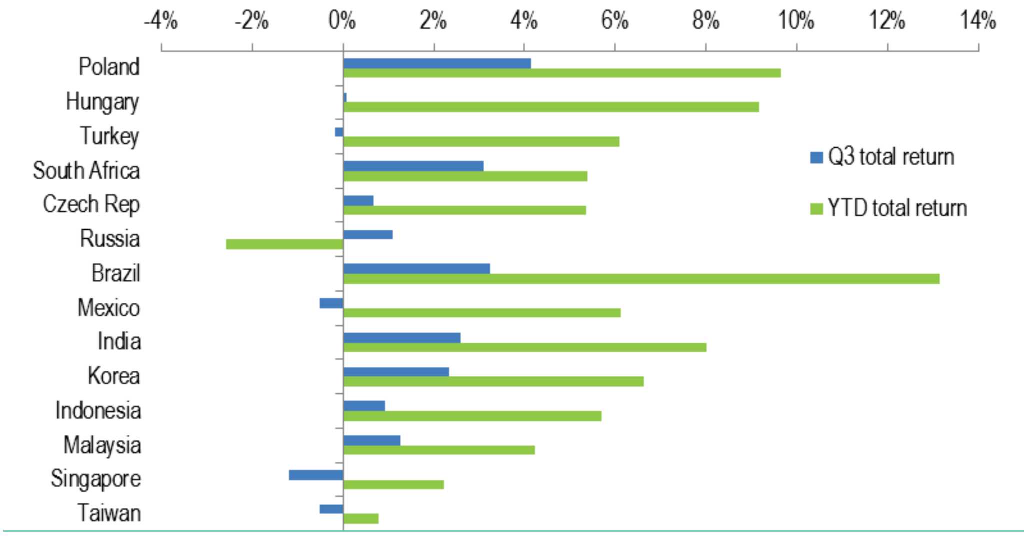
Volatility in capital flows to EM could increase…

We believe emerging markets face a very challenging Q4. The US quantitative easing programme (QE) is almost over and European QE is still uncertain. In addition, risk premia, which have been depressed relative to historical norms, only started to rebuild very recently. Finally, China's growth slowdown has intensified, depressing commodity prices and in the process amplifying the dispersion within EM (benefiting commodity importers like India and weighing on exporters like South Africa and Indonesia).

…a key risk for countries with large external funding needs

The combination of these three factors could generate volatility in capital flows to EM, which is a key risk for countries with large external funding needs. We are not turning negative on EM local fixed income as a result of subdued global growth prospects, but we are becoming more cautious as the market prices in an adjustment in US rates in response to the recovery in the US economy.

Chart 1: 5y local bonds total return FX unhedged slowed in Q3



Source: BNP Paribas

Weaker currencies, divergent interest rates

A strong USD could see EM outflow, but Japan and Europe are expanding their balance sheets

Historically, a strengthening dollar has caused outflows from EM. However, EM investors can take heart from the fact that, as the Fed's liquidity taps run dry, the BoJ will continue to expand its balance sheet and the ECB likewise. Faith in G3 central bank 'puts' is high, and not entirely unwarranted.

Latam will be most affected by Fed policy, and CEEMEA by the ECB

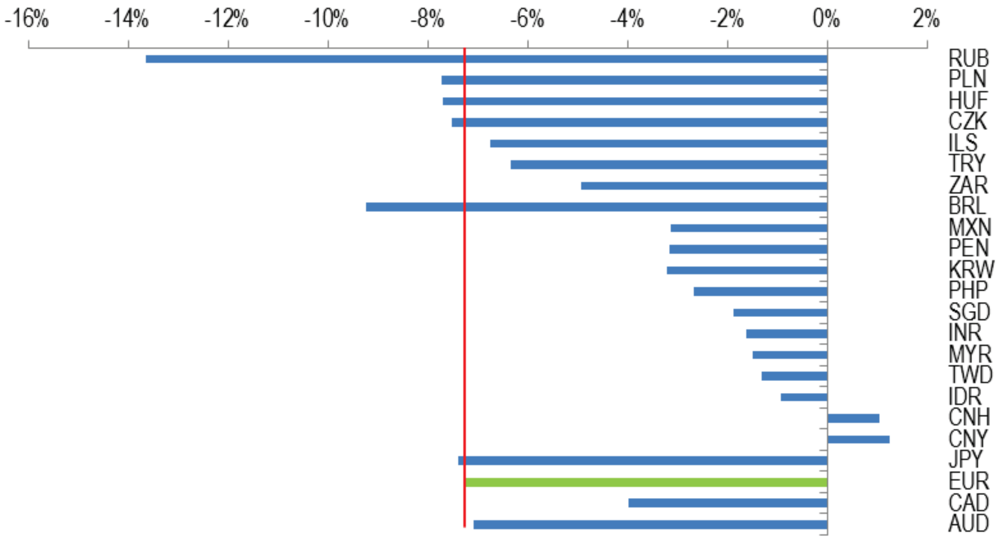
This implies that the currency story is not one of outright USD strength but one of growth and policy divergence within the G3 economies. Unfortunately, substituting the USD for the EUR or JPY funding may not be a seamless transition and, in any case, our analysis suggests the impact of Fed and ECB policies is not homogenous; normalisation of monetary policy by the Fed will have far greater impact on Latam, while ECB easing is likely to have the biggest impact on CEEMEA currencies.

Low inflation is now affecting EM, particularly China

With regards to EM rates, it's worth remembering that the reason for global central bank policy 'puts' is still low global inflation. Developed Market CPI breakevens remain subdued (close to zero in Japan and Europe) and this problem is now affecting a group of EM countries. Top of this list is China, whose own excess capacity issues are causing it to export deflation more widely. Some EM central banks are hitting the zero boundary and need to introduce non-conventional policy tools to sustain competitiveness: the Czech Republic, Poland, Korea and Israel fall into this camp, as does China, where the PBoC is forcefully avoiding the temptation of a weak currency but is forced to compensate by extraordinary easing measures on the domestic side. Consequently, rates should continue to press lower in these markets.

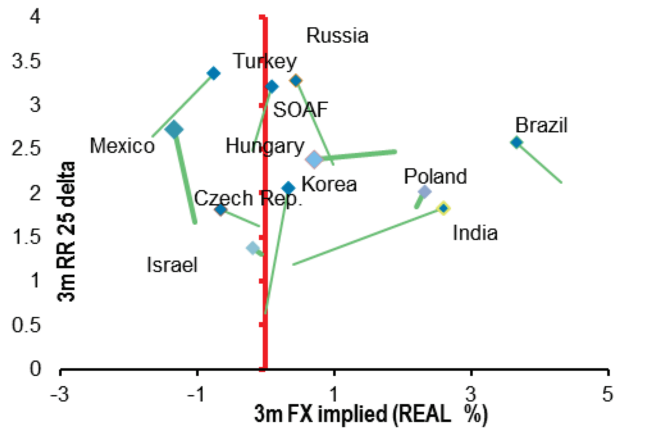
On the other hand, countries with high external financing have far less freedom to ease monetary policy. As Chart 3 highlights, the short term real interest rate differential remains low and, in many cases, real short term rates are negative or close to zero. The pressure will be high on Turkey, South Africa and Indonesia to push interest rates higher to prop up their currencies. The central banks of Brazil and India may be forced to disappoint on rate cut expectations. Mexican swaps look vulnerable due to high received positioning.

Chart 2: Q3 EM currency performance vs USD



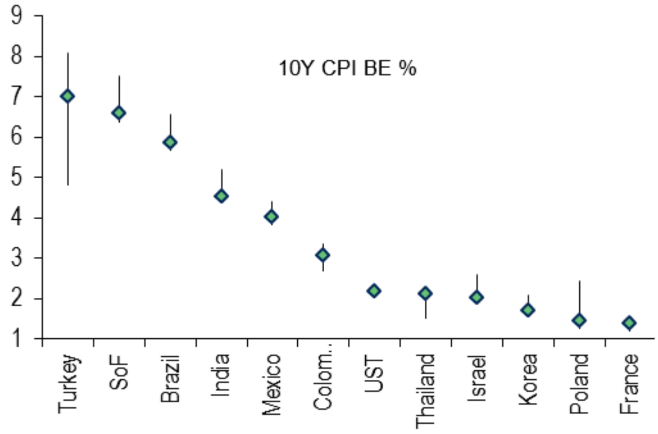
Source: BNP Paribas

Chart 3: Little differentiation in short term real rates



Source: Bloomberg, BNP Paribas

Chart 4: Significant differential in long term BE



Source: Bloomberg, BNP Paribas

Latam

Movement in long end of US interest rates curve crucial to Latam price action

The adjustment in the long end of the US interest rates curve, and its velocity, will be crucial to the dynamics of Latam asset price action. In this regard, the normalisation of premia and cost is at an initial stage so we continue to recommend a tactical stance; we prefer making the most of relative value and tactical trades to outright positions.

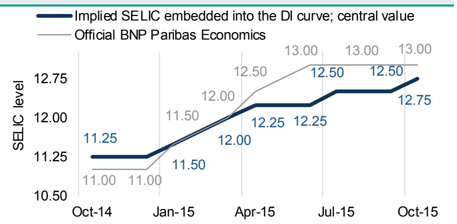
Volatility to edge higher in H2 2014

A sustained period of low volatility has created a false sense of security, distorting risk premia and in some cases creating asset overvaluation. This fall in volatility, combined with zero nominal rates (and negative real rates), has been the key driver of the risk taking mood and financial leverage. We assume a scenario of volatility slowly edging higher in H2 2014; this does not mean the market is going to enter a downward trend.

This publication is classified as non-objective research

Charts 5 & 6: What is priced in DI curve vs BNP Paribas scenario

Meeting/SELIC	11.00	11.25	11.50	11.75	12.00	12.25	12.50	12.75
October-14	46.2%	53.8%						
December-14	15.5%	48.8%	35.7%					
January-15		14.9%	47.4%	36.2%	1.5%			
March-15			10.0%	36.7%	39.9%	12.9%	0.5%	
April-15				8.4%	32.5%	39.4%	17.1%	2.4%
June-15				2.0%	14.1%	34.1%	34.1%	13.7%
July-15				1.2%	9.1%	25.8%	34.1%	22.2%
September-15			0.0%	1.2%	9.1%	25.8%	34.1%	22.1%
October-15				0.0%	1.2%	8.9%	25.5%	33.9%



Source: Bloomberg LLP, BNP Paribas

Trades

Brazil: Receive the front end of the DI curve – Apr-15 and Jan-16 – to benefit from a later-than-priced-in rate hike by the BCB.

- The political landscape remains centre stage. The presidential election is proving a very tight race and every poll is scrutinised by market participants.

- The first round on Sunday (5 October) showed an unexpected result, with Neves going into the run-off against incumbent candidate Rousseff. The uncertainty surrounding the outcome of this election has led to volatility in the market and the short end of curve has reacted accordingly, but is still pricing in a rate hike in December, which is earlier than our economic team forecasts (Charts 5 & 6 - note these forecasts are relatively aggressive).

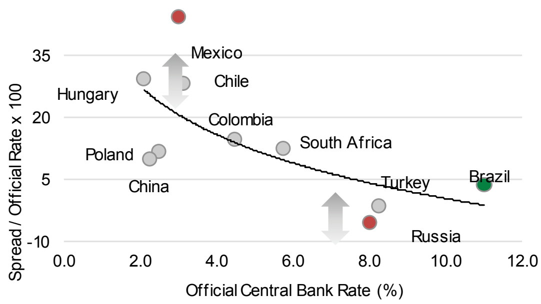
Mexico: We hold a flattener position on the 2s5s TIIE.

- Economic activity shows signs of recovery after a prolonged slowdown. With US activity firmly on track, we expect Mexico to benefit the most in the region. We will look for trade opportunities to position for the long MXN side as we did recently with a short EURMXN.

- On rates, the Mexican curve remains one of the steepest among its peers when adjusted by its base rate. The flattening process in the US rates curve is at an initial stage and we believe the Mexican curve won't be immune to that.

Charts 7 & 8: Mexico is the steepest curve among EM

	Spread	Ratio	Spread / Official Rate * 100
Brazil	42	1.04	3.82
Mexico	133	1.32	44.42
Colombia	65	1.14	14.44
Chile	89	1.27	28.25
Turkey	-12	0.99	-1.48
South Africa	71	1.10	12.35
Russia	-43	0.96	-5.38
Poland	29	1.15	11.76
China	22	1.07	9.78
Hungary	61	1.25	29.05



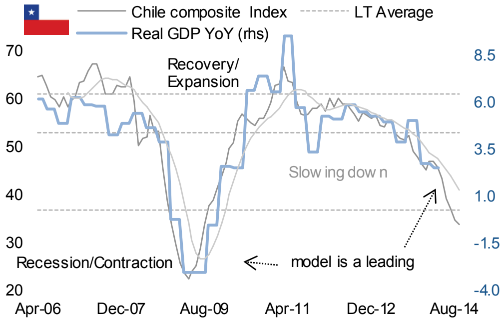
Source: Bloomberg LLP; BNP Paribas

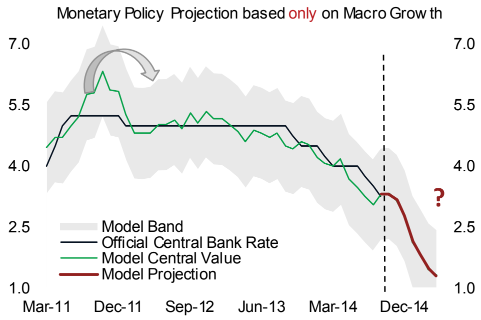
Chile and Colombia: We like the 5y CLPxCAM payer and long CLPCOP.

- The BCCh embarked on an easing cycle following a collapse in economic activity. The sharp rally in the front end of the CLPxCAM swap curve had a significant impact in the belly and long-end of the curve as well as on the CLP, both on an undershooting dynamic. As we approach the end of the easing cycle, we see these assets' prices converging back to fair value levels.

- In Colombia, after hiking rates by 125bp, BanRep kept rates on hold at the last meeting, in line with our economists' long-held call for a pause once rates reached 4.50%. With the rates outlook providing less of a support for the currency, and as portfolio inflows ease in the quarters ahead, we see potential for the COP to underperform the CLP.

Charts 9 & 10: Chilean economic activity has tumbled





Source: Bloomberg LLP; BNP Paribas

CEEMEA

CEEMEA would benefit from ECB QE but a delay will negatively affect TRY and ZAR

Close economic and financial ties to the eurozone means the region would benefit most from ECB QE. However, CEEMEA remains almost the most diversified region, and a delay in ECB QE will have significantly negative consequences for the TRY and the ZAR.

Trades

HUF: 5y5y fwd at 5% is good receiver. Short HUF FX with FX implied yield at 0.7% against the EUR.

- Monetary policy is already set for European QE. Bonds remain cheap vs swaps but Q4 supply will be negative, therefore ASW trades makes sense especially at the longer part of the curve.

TRY: We recommend owning USDTRY 1m RKO at 2.30, 2.40

- We expect Turkey to slow down next year to 3.5% yoy. Turkey will therefore be growing at similar pace to the US but with inflation close to 8% and real rates between 0%-1.5%.

- Without nominal depreciation, the real effective exchange rate would get close to alarming levels within two years, while with nominal depreciation, inflation will fall more slowly. Turkey monetary policy is therefore between a rock and a hard place. If European QE is not delivered relatively soon, the TRY may come under pressure again.

ZAR: We continue to recommend paying the 1y2y fwd or the 5y.

- As real rates cannot go much lower, monetary policy has reached its limit in supporting the economy. Inflation remains sticky whilst the carry roll down is less than that on the US curve. We continue to see the ZAR weakening.

RUB: We expect the gradual depreciation of the RUB to continue.

- The CBR will continue to smooth the trend, but with oil prices declining and fiscal deficit and capital outflows increasing, we do not expect the central bank to have much success.

Asia

End of Fed QE, Chinese slowdown and domestic policy influencing outlook for EM Asia

There are three main factors influencing the outlook for EM Asia. First, the impending end of Fed accommodation (which is only partly offset by the ECB and BoJ, in our view). Second, the continued slowdown in Chinese macro data, which influences both growth and the BoP outlook (via commodity prices) for the rest of Asia. And third, domestic policy dynamics, which create scope for differentiated responses to the external backdrop.

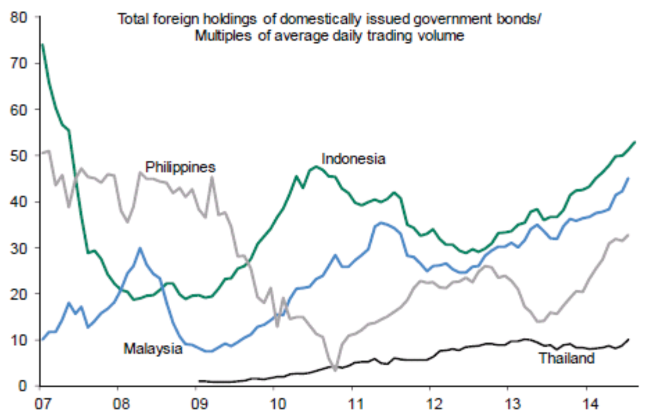
This is how we think it all fits together:

MYR and IDR will be the most vulnerable. With the persistent slide in commodity prices and falling demand from China, countries dependent on commodity exports will struggle. For Malaysia and Indonesia, commodity exports make up 30% and 50% of total exports respectively. In addition, these two countries remain overly dependent on portfolio flows.
Foreign bond ownership in Malaysia (MGS) and Indonesia currently stands at 46% and 37%, which is either near or above previous peaks. Much of the inflow into Malaysia and Indonesia to date has largely been below 3.25 and 11800 respectively. With USD/MYR and USD/IDR breaching these levels, investors who were unhedged are already underwater. In addition, the high ratio of foreign holdings to the average daily trading volume in both countries poses a liquidity risk – Chart 11 demonstrates the risk to the MYR and IDR.

PHP and THB will be less vulnerable. In contrast, the export baskets of the Philippines and Thailand are less linked to commodity prices. Bond markets are also less heavily owned by foreign investors. Foreign investors only take up 7% and 17% of RPGBs and THAIGBs respectively. Domestic monetary policy should also work to limit the loss of carry - the BSP appears to be stepping up its monetary tightening, while we expect the BoT to start hiking rates next year.

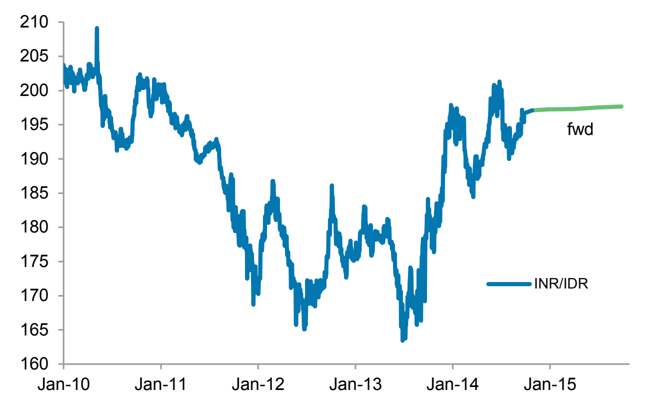
INR stands out as a clear beneficiary from the drop in oil and commodity prices. The current account deficit has narrowed sharply and solid net FDI inflows imply India is now less dependent on hot money inflows. The RBI has been steadily building up reserves and as a result, reserve adequacy indicators have improved – between September 2013 and March 2014 import cover increased to 7.8 months from 6.6 months and the ratio of short-term debt to reserves declined to 29.3% from 34.2%. Growth is also showing signs of bottoming and this would provide some support for equities. With S&P upgrading their outlook from negative to stable, this will provide a tailwind for INR bonds.

Chart 11: Liquidity risk in Malaysia and Indonesia



Source: Bloomberg, BNP Paribas

Chart 12: Buy 3m INR/IDR



Source: Bloomberg, BNP Paribas

KRW and CNH are policy plays. Left on its own, the won should strengthen due to strong BoP and lower oil prices. But the BoK is concerned about political pressure and will prevent won appreciation, in particular if the JPY continues to weaken. Falling commodity prices will keep a lid on inflation, and easing rhetoric from Finance Minister Hyun Oh-seok is unlikely to abate. Similarly, the CNH ought to weaken due to concerns about the macro slowdown, but the PBoC is running a strong currency policy. Fixings have remained in a range and the onshore spot is acting as an anchor to the CNH. As such, much of the easing will have to come via rates.

Trades

FX: We recommend selling MYR/THB, selling SGD/CNH and buying INR/IDR.

- Specifically, we continue to hold on to our short 1m MYR/THB position and would sell 3m SGD/CNH at current levels of 4.87, targeting 4.75 (2.5% return) with a stop at 4.94. We would also buy 3m INR/IDR at current levels of 197.3, targeting 205 (3.6% return) with a stop at 194.5.

Indonesia: We turn neutral on IDR bonds.

- We moved to an overweight stance in April 2014, expecting a range-bound market which supported carry trades. Although supply and fiscal reform prospects will support sentiment in the near term, the balance of risk is to the downside into year end. Fresh supply will hit in Q1 as the DMO usually frontloads issuance. The Fed's first rate hike, expected in Q2 15, will raise market volatility.
- Meanwhile the downside in yields is limited, with potential fuel price hikes boosting inflation and crowded positioning. Investors can also consider switching 10y holdings to the 5y as a defensive trade against sharp sell offs. The 5s10s curve has flattened to 14bps, from a 1y average of 40bp, and the 5y at 8.07% still offers attractive real yields.

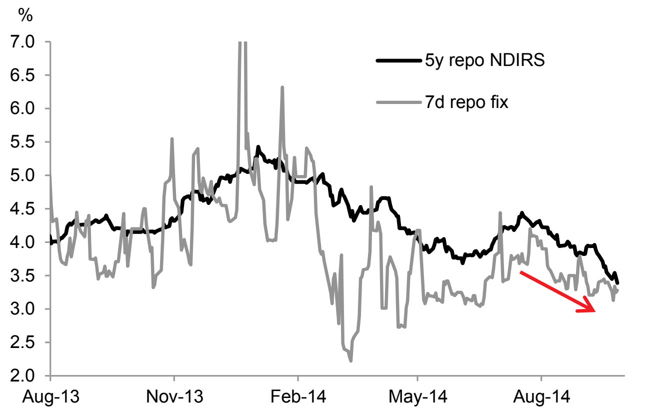
China: We like 5y receivers in CNY repo-NDIRS at 3.6% (current 3.45%), targeting 3.1% with a stop at 3.85%.

- 7d repo fixings will remain low and any retracement in rates would represent a good opportunity to re-enter the trade.

Chart 13: Sell 3m SGD/CNH

Source: BNP Paribas

Chart 14: CNY rates on a downtrend



Source: BNP Paribas

EM Sovereign and Credit

Rising risk-aversion

EM bonds under pressure recently

As with higher-risk assets globally, EM bonds have come under pressure in recent weeks. This has particularly been the case for energy credits (sovereigns and corporates) as well as those most exposed to the flagging commodities cycle. Indeed, issuers underlying more than 65% of outstanding EM bonds have been subject to risks associated with the commodities rout or with front-end flattening on the UST curve. Credit risks associated with these will continue to come under greater investor scrutiny should dollar and Treasury trends persist, especially if Fed action results in curtailed financial markets liquidity.

Our EM selections are designed to provide protection from UST bear flattening and deterioration in the macro backdrop of various commodity-reliant EM economies: In Asia, we argue the CITIC/CITPAC curve is rich, offering little Treasury cushion and, given that it is a capex intensive business, likely to remain unprofitable. We would wait to see an improvement in its iron or project and resource segments. Among Latam banks, we favour moving into Brazil Banbra ’22 (which offers slightly higher spread cushion) from Caixbr ’22, which is more exposed to potential loan deterioration. Among commodity-sensitive names, we would favour Sammin ’22 versus Vale ’22 (helped by the greater resilience of iron ore pellet prices versus iron ore market). In CEEMEA, we see Vimpelcom’s spreads offering sufficient cushion, relative resistance in consumer spending in Russia and prospects of lower leverage. We recommend switching from VIP 7.5043% ‘22 into VIP 8.25% ‘16 to position for the flatness of the curve or buying VIP 8.25% ’16 outright.

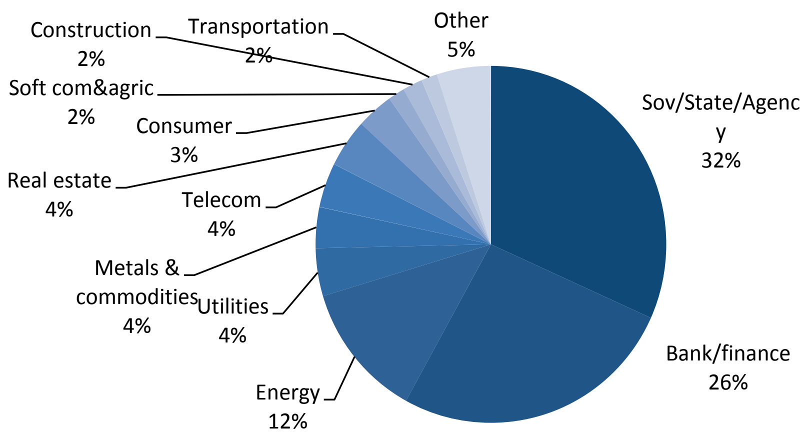
Flattening UST curve and risks to the EM bank sector

UST bear flattening will most impact EM bank bonds

We think further flattening pressure on the front end of the UST curve will impact EM bank bonds more severely than other sectors. Banks account for the largest corporate segment of hard currency debt outstanding and is second only to sovereigns in the overall EM picture (Chart 15). EM banks typically issue in US dollars (80%) and short tenors, with 60% of outstanding EM bank bonds maturing over a five year timeframe. This is especially the case in Asia, where the preponderance of bond issues will be especially susceptible to front-end Treasury flattening (Chart 16), and which accounts for 51% of EM bank bonds outstanding (Chart 17).

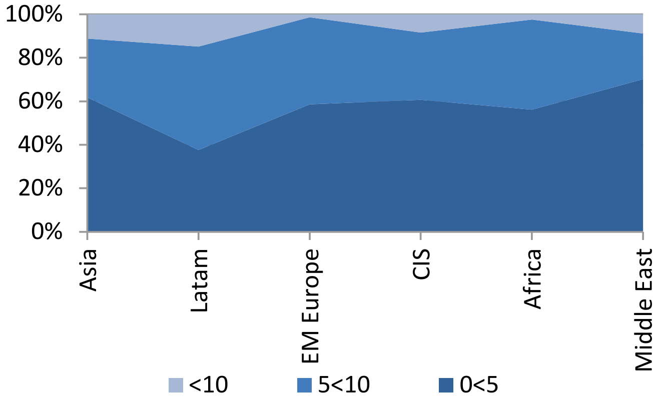
Although Asian banks are exposed to UST bear flattening due to the size of that market, the Middle East actually has a higher share of outstanding bank bonds which mature in the next five years (70%). Admittedly, most of these are of better credit quality than their Asian peers. While this may prove some comfort to investors on account of their better implied repayment capacity, it does mean that there is much less of a cushion (ie, lower spread levels to absorb a UST shock).

Chart 15: Outstanding EM bonds by sector (end Q3 14)



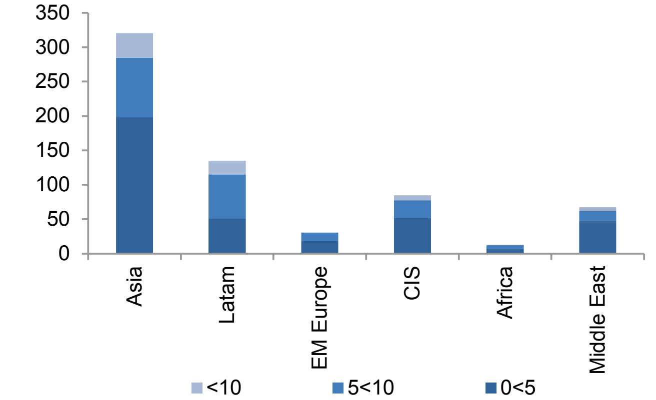
Source: BNP Paribas

Chart 16: EM USD bank bonds by tenor and region



Source: BNP Paribas

Chart 17: EM USD bank bonds outstanding USDbn

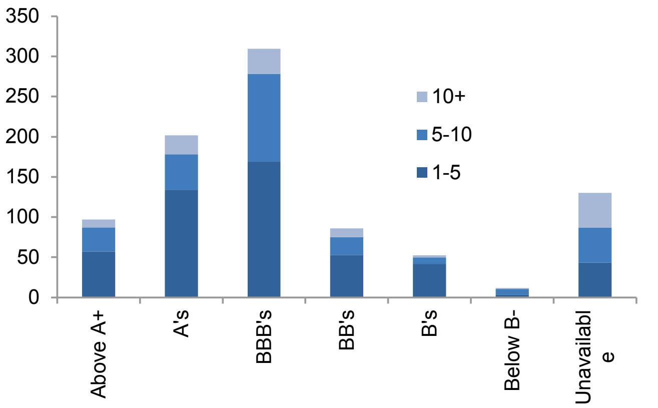


Source: BNP Paribas

EM bank sector poses a particular price – not credit – risk for investors

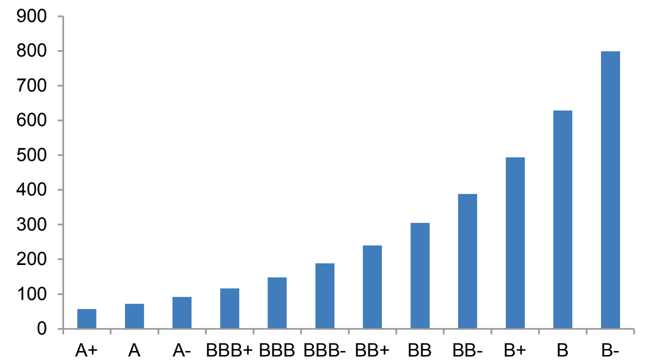
On this basis (Chart 18), the EM bank sector poses a particular price risk (as opposed to credit risk) for investors. Almost three quarters of EM bank debt is investment grade, with spreads providing investors with low levels of UST shock absorption potential (Chart 19). Fortunately, 40% of high grade EM Banks are rated BBB, where bonds have average spreads of 140bp. However, 60% of HG names give investors as little as 50bp (A+) to 90bp (A- names) of UST resistance potential.

Chart 18: Global EM bank bonds by rating and tenor (USDbn)



Source: BNP Paribas

Chart 19: Global EM 2-5 year bank bond spreads (bp)



Source: BNP Paribas

US dollar rally and falling commodities

Dollar rally removes hard currency commodity floor

The impact on market prices of excess supply in some commodity sectors (eg, copper and steel) and increased production in others (eg, shale oil) has been exacerbated by the reversal of US dollar direction. The dollar rally has removed one of the underpinnings that provided a floor for hard currency commodity prices.

Should the dollar rally have further legs, as BNP Paribas contends, we will likely see increased investor concerns regarding debt service among several sectors in the corporate arena (soft commodities and agriculture 2%; metals 4% and energy 12%).

Commodity-rich Latam particularly vulnerable

Commodity-rich Latam has proved especially vulnerably this quarter. Already, Venezuela's PDVSA has come under increased price downside with the PDVSA '22 bond price falling over 20% at its worst in Q3 14, and valuations implying a greater than 75% probability of default. In Brazil, falling prices for sugar have negatively impacted valuations of Grupo Virgolino de Oliveira with significantly reduced revenues sparking fears that the company will have insufficient cash to meet BRL 220m worth of debt servicing costs through H1 15.

EM sovereigns will not be permanently immune to the commodities rout, with over 50% of EM countries reliant on energy or other commodities exports (eg Brazil, Venezuela, Chile, Peru, Middle East, S Africa and sub-Saharan Africa). Our country selections have generally favoured credits more insulated from the current rout, with either higher dollar-based earnings, current account surpluses and comfortable reserve buffers.

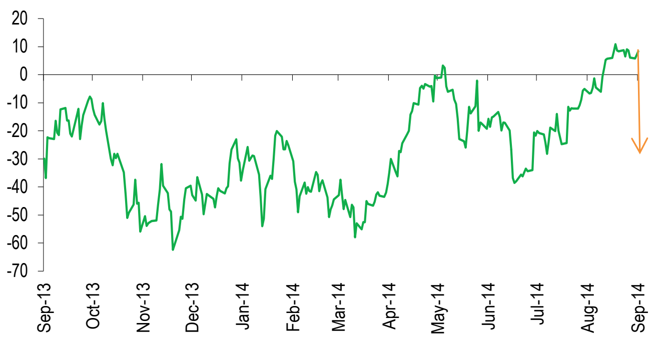
Latam

Trades

Brazilian state-owned banks: switch into Banbra'22 Snr out of Caixbr'22 Snr

- Pickup 8bp in z-spread (98th percentile rank). It compares favourably to Banbra'20 and Banbra'17 trading 40bp and 60bp tighter than Caixbr'19 and Caixbr'17 respectively. In our view, Banco do Brasil offers a safer business risk profile.
- Ongoing deterioration in Brazil's macroeconomic outlook (low GDP growth, high inflation, higher rates, gradually worsening job market) is likely to result in an increase in non-performing loans.
- We think this risk is considerably higher for Caixa, given its aggressive loan portfolio growth in the past couple of years (+35% pa) with a shift in mix towards new and riskier segments. Banco do Brasil's loan expansion, though also aggressive, has been slower than Caixa's (19% pa), and more importantly accompanied by an increased focus on safer segments.
- This difference in strategy has already resulted in a divergence in quality of operating results, with, for example, Caixa's NPL 90d deteriorating +0.5pp y/y to 2.8% in Q2, while Banco do Brasil's NPL 90d has been roughly stable at 2.0%. We expect this divergence to continue.

Chart 20: Z-spread difference Banbra'22 Snr - Caixbr'22 Snr



Source: BNP Paribas, Bloomberg

Table 1: Financial highlights (BRL MM)

	BANCO DO BRASIL			CAIXA		
	2Q14	1Q14	2Q13	2Q14	1Q14	2Q13
Financial margin	12,353	11,830	11,691	9,597	8,306	6,917
Allowance for loan losses	(4,570)	(4,187)	(4,219)	(3,951)	(2,478)	(2,241)
Fee and commission income	6,169	5,741	5,917	4,514	4,254	4,080
Net income	**3,002**	**2,436**	**2,634**	**1,879**	**1,510**	**1,830**
Loan portfolio	**718,754**	**699,251**	**638,628**	**552,108**	**519,793**	**431,298**
Loan portfolio growth y/y	*12.5%*	*18.0%*	*25.7%*	*28.0%*	*33.1%*	*42.5%*
NPL 90d (%)	**2.0**	**2.0**	**1.9**	**2.8**	**2.6**	**2.3**
ROAE (%)	**17.1**	**14**	**16.4**	**22.1**	**23.5**	**25.2**
Efficiency ratio (%)	42	45	43	57.9	59.5	61.1
Basel ratio (%)*	**14.4**	**13.8**	**15.9**	**14.4**	**13.7**	**14.7**
*Tier 1 (%)**	*10.3*	*9.9*	*10.3*	*12.1*	*11.3*	*7.4*
*CET 1(%)**	*8.4*	*7.8*	*8.8*	*12.1*	*6.7*	-

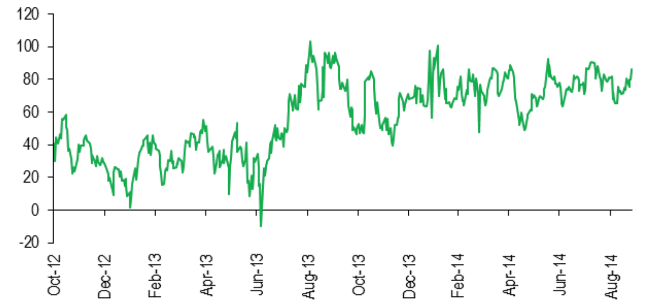
Source: BNP Paribas, Companies
(*) Est. pro-forma from recently announced conversion of hybrids into CET1:

Mining sector – switch into Sammin'22 out of Vale'22

- Samarco (NR/BBB-/BBB) is a 50/50 joint venture between Vale (Baa2/A-/BBB+) and BHP (A1/A+/A+) and is a leading, integrated, low cost iron ore pellets producer.
- The trade enables investors to pick up a generous 84bp in z-spread (90th percentile rank) and save USD8. In the current context, Samarco looks more attractive to us.
- The completion in March 2014 of its fourth pellet plant project which expanded its production capacity by 37% to 30.5mnt will support a gradual increase in sales volume and result in a reduction in capex. The company plans to invest BRL 1.3bn in FY 2014 (half of 2013's BRL 2.7bn programme and equivalent to less than 40% of annualised H1 2014 EBITDA). It compares to Vale's USD 14.75bn programme, equivalent to 90% of its annualised H1 2014 EBITDA.

- Iron ore pellet prices are expected to be more resilient thanks to more balanced demand and supply dynamics than on the iron ore market.
- Finally, Samarco's client base is more geographically diversified out of China (11% of sales vs 34% for Vale).

Chart 21: Z-spread difference Sammin'22 - Vale'22



Source: BNP Paribas, Bloomberg

Table 2: Financial highlights (BRL MM)

	VALE (USD MM)			SAMARCO (BRL MM)		
	2014 Q2	**2014 Q1**	**2013 Q2**	**2014 H1**	**2013 H2**	**2013 H1**
Net sales	9,902	9,503	11,032	3,589	3,860	3,345
Adj EBITDA	4,104	4,058	4,899	1,754	2,138	1,732
EBITDA Margin	**41%**	**43%**	**44%**	**49%**	**55%**	**52%**
Net Income	1,428	2,515	424	1,758	1,314	1,417
Short Term Debt	2,326	2,218	3,201	836	889	926
Long Term debt	35,055	34,858	26,480	8,441	8,091	5,931
Total Debt	37,381	37,076	29,681	9,276	8,979	6,856
Cash	7,065	7,182	6,256	1,257	555	470
Net Debt	30,316	29,894	23,425	8,019	8,425	6,387
Total Debt / EBITDA	1.8	1.7	1.6	2.4	2.3	2.1
Net Debt / EBITDA	**1.5**	**1.4**	**1.2**	**2.1**	**2.2**	**1.9**
Interest Coverage	4	4	8	9	11	30
Cash / ST debt	3.0	3.2	2.0	1.5	0.6	0.5

Source: BNP Paribas, Companies

CEEMEA

Trades

Vimpelcom (Ba3/BB/--; VIP): switch from VIP 7.5043% '22 into VIP 8.25% '16 or buy VIP 8.25% '16 outright.

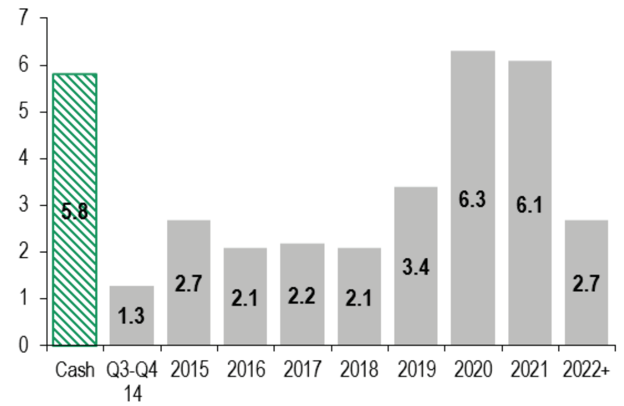
- We believe that most of the negative news is fully priced into VIP credit spreads. These include geopolitical risks stemming from the Russia-Ukraine conflict (telecoms are not sanctioned), the company's weak financial performance during the last few quarters and a loss of market share in a key Russian market due to capital underinvestment. VIP bonds are among the biggest underperformers in CEEMEA year to date among non-sanctioned issuers, in particular at the short end of the curve.
- Meanwhile, the positives are slow to price in. These include the company's recent strategy to deleverage to 2.4x net debt/EBITDA by the end of this year and to 2x in the next two years, from 2.6x reported in June 2014 (as calculated by the company and 3.1x as calculated by us). Consumer spending on mobiles in Russia looks resilient against a backdrop of falling commodity prices. Lastly, there remains a positive upside for Vimpelcom from potential in-market consolidation in Italy, should it lead to lower leverage. Vimpelcom's wide spread levels in absolute terms offer some cushion in the environment of rising UST yields.
- The current flatness of Vimpelcom's curve is not reflective of the company's improved maturity profile post-Wind refinancing. As of June 2014, Vimpelcom had USD 5.9bn in cash which covers its debt maturities for the next three years. We therefore recommend switching from VIP 7.5043% '22 into VIP 8.25% '16 and recommend buying VIP 8.25% '16 outright. In addition to the company's fundamentals, relative stabilisation of the Russia-Ukraine crisis is supportive as it is likely to result in a steepening of the curve in Russia Inc. from the front end of the curve.

Table 3: Vimpelcom's priority – to deleverage to 2.4x by end 2014 from 2.6x at Jun-14 (BNPP: 3.1x)

USDmn	LTM ended Jun-14	LTM ended Mar-14	2013
Revenues	21,328	21,979	22,546
EBITDA	7,651	8,000	8,260
EBITDA margin	36%	36%	37%
Net Income		-2,994	-2,625
Cash & equivalents	5,505	4,540	4,454
Total Assets		47,478	49,747
Total debt	29,022	27,393	26,802
Net debt	23,517	22,853	22,348
Interest Expense	2,234	2,084	-2,084
Operating Cash	6,002	6,245	6,351
Capex	-4,705	-4,239	-3,955
Free operating cash fl	1,297	2,006	2,396
Debt/ EBITDA	3.8x	3.4x	3.2x
Net debt/EBITDA	3.1x	2.9x	2.7x
EBITDA/Interest	3.4x	3.8x	4.0x

Source: BNP Paribas, Company reports

Chart 22: Vimpelcom's improved maturity profile – USD 5.8bn in cash covers maturities for the next 3 years (USD bn)



Source: BNP Paribas, Company reports

Asia

Trades

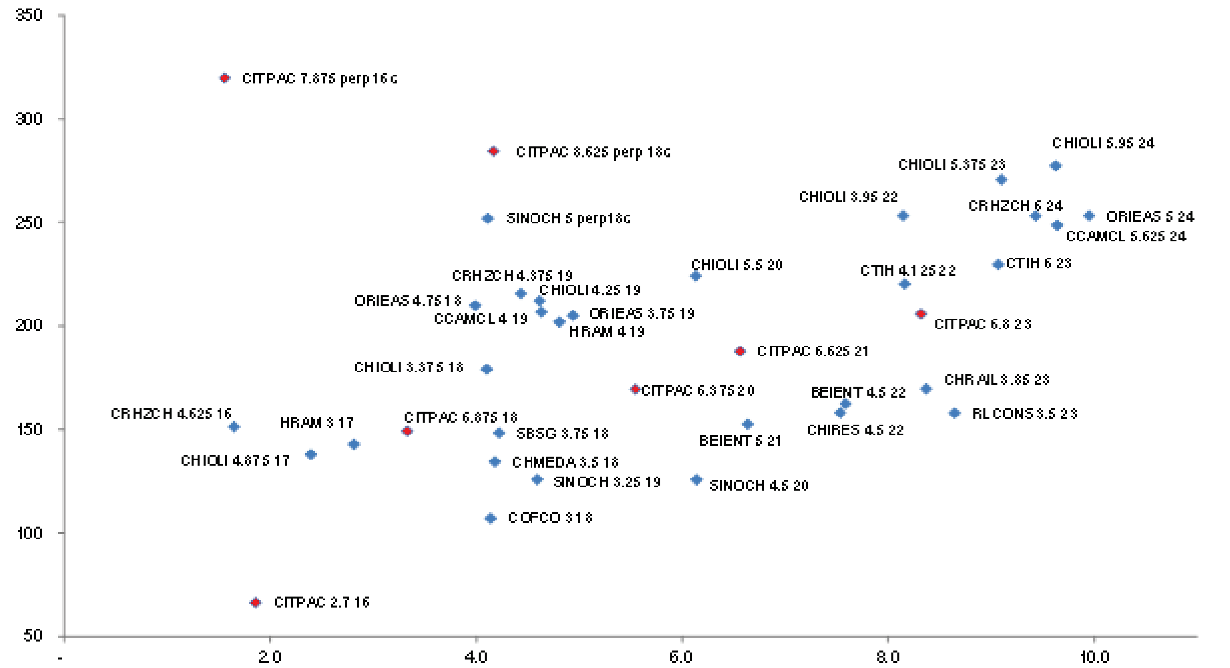
In Asia, we favour exiting CITPAC bonds in favour of wider names in the BBB+ or A-/BBB+ Chinese SOE space, such as the AMCs and the China properties names.

- We believe the valuation of CITPAC is too rich. Despite strong government support, none of its subsidiaries can be considered systemic. The lion's share of new CITIC Ltd currently comes from China CITIC Bank (over 80% assets and 70% profits, 2013 figures). It is unlikely that CITPAC could raise more cash from CITIC Bank by increasing its dividend payout. The bank itself has quite strong asset growth. With a CET1 of around 8.7%, ROE in high teens, but asset growth in the mid-20%, there is good chance that CITIC Bank itself could need to raise its capital via external sources too.

- The company has guided that the iron ore capex hump has passed, but it does not sound optimistic regarding the increase in production, with two production lines out of a total four still non-operational. A lack of growth in earnings (in the pro forma sense) is very likely, which means a return to the market for financing is also likely in the coming year in order to fund existing debt and capex. Its resource and energy segment, for the enlarged entity, is a capex-intensive area and has not been profitable for the past two years.

- As such, we prefer to compare CITPAC with wider names in the BBB+ or A-/BBB+ Chinese SOE space, such as the AMCs and property names until we have better clarity and see improvement in the performance of the iron ore project, its resource and segment.

Chart 23: CITPAC and Chinese SOE space



Source: BNP Paribas

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