



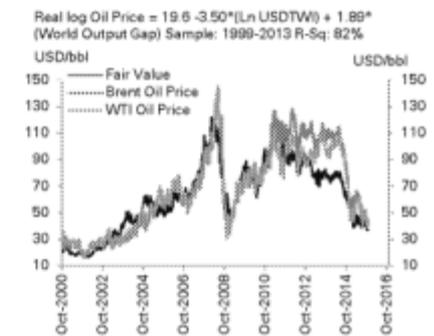
The ghosts of EM crises past: equity over-allocation to EM has been completely unwound; EM FX to have overshot the relative growth slowdown; waiting for the Fed. Past EM crises occurred when US dollar up cycles (3/4 of the way through) coincided with US rate hiking cycles. Key difference now is that EM FX has already depreciated. EM growth normalization explains well the underperformance of EM equities and fall of EM FX. EM absolute growth is now back to the middle of its historical range while relative growth is still a bit high. In terms of allocations, the equity over allocation to EM has been completely unwound. Bond allocations are lower but the potential for more downside on a broader unwind of fixed income over allocations remains. EM FX has overshot. We would look to go long EM once US rates re-price for the rate hiking cycle.

Asset allocation and trades:

Overweight equities; underweight bonds, cash and commodities, long the dollar

- Within equities, we would overweight the US and Japan, neutral Europe, underweight EM (until Fed re-pricing).
- Expect mid-cycle price gains for US equities (+13%) on solid demand-supply, strong underlying earnings growth as dollar drag recedes, valuations slightly below fair value; similar appreciation in Europe but higher risk as the largest consensus overweight and relative valuations at the expensive end; more in Japan (+18%) as steep valuation discount dissipates; less in EM (6%) as relative growth slows further and higher US rates and dollar pressures spreads.
- We look for higher 10y yields (+75bps) as markets gradually move toward pricing in Fed's path of rate normalization. A higher terminal rate and risk premium could mean additional pressure in the future. We are underweight duration and prefer HY over HG for larger spread compression as rates rise.
- Trades:
  - The Fed to move faster: steepeners at the short end (EDZ7 – EDZ6)
  - It's all about inflation: Short Euribor Dec 2018 futures
  - Equity recoveries from 10%+ corrections are strong: Long S&P 500 March 2016 risk reversals
  - As rates catch up to the dollar: Long Financials short Energy
  - Excessive defensive premium to erode: short Consumer Staples
  - Long US-centric dollar beneficiary stocks
  - Stay short copper: supply to add to overvaluation pressure.

Figure 13: Oil near fair value



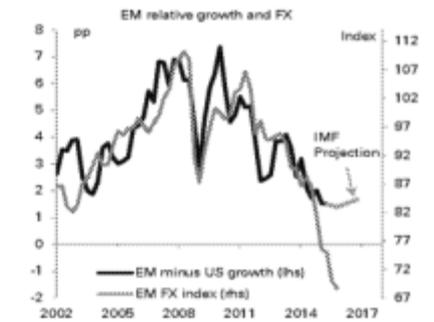
Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 14: EM equity over allocation has been reversed



Source: EPFR Global, Deutsche Bank Research

Figure 15: EM FX has overshot



Source: National statistical organizations, Deutsche Bank Research

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