

Subject: Epstein Views Update 12/12 [I]  
From: Tazia Smith <[REDACTED]>  
Date: Wed, 18 Dec 2013 11:55:42 -0500  
To: Paul Morris <[REDACTED]>  
Cc: Vahe Stepanian <[REDACTED]>

Classification: For internal use only

Not do anything in FX/significant positioning before FOMC decision

Bullish japanese equities, short yen

hence buy of DXJ

open to a basket of single names but does not want yen exposure. suggested a quanto'd basket and he is open to it (we had that priced and quanto is not pricing well. still reviewing - now adding a fx return component to present)

Bullish Euro

Bearish Latin America

Sold latam mutual fund

Does not like Brazil (evaluating BRL step-up notes that are underwater)

Does not like Mexico, yet said he was open to revisiting DepoPlus

European equities - still long basket of single names

I suggested a Eurostoxx hedge just to protect some of those gains and he liked that idea...operationally we are not set up for equity derivatives with CB&S, working with them to onboard as seamlessly as possible (I know JE would be irritated by this) before I show this pricing. Given cash levels + DB view still bullish europe, we could price a twin win note as a 'buffer' overlay solution without giving upside participation.

Reminded him about DAG (DB Ag ETF, suggested taking that gain and buying back in ~6mos)

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From: Paul Morris/db/-  
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To: [REDACTED]  
[REDACTED]

Date: 12/18/2013 11:16  
AM

Subject: Re: Fw: Into  
FOMC...

hi did u get some of his views when u last spoke? high level is good, thx

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From: Tazia Smith/db/-  
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To: Paul  
Morris,

Cc: [REDACTED]  
[REDACTED]

Date: 12/18/2013 10:15  
AM

Subject: Fw: Into  
FOMC...

PM - JE does not like firm views so we do not send him commentary like the below. Harry is on our distribution list (requested to be), however.

----- Forwarded by Tazia Smith/db/dbcom on 12/18/2013 10:14 AM -----

From: Tazia Smith/db/-  
dbcom

To:

Cc: [REDACTED]  
[REDACTED]

Date: 12/18/2013 10:14  
AM

Subject: Into

FOMC...

Good Morning -

Ahead of today's FOMC announcement at 2pm, please see DB Global Markets' Chief Economist, Peter Hooper expectations (ie. \$5-15bn of tapering, skewed toward Treasuries + dovish commentary) below. Please take a look through Hopper's quick pros/cons, which outline the knife-edge decision on hand. He shows that each input (unemployment, GDP growth, asset valuations, Bernanke's succession, etc) is only very marginally signalling to taper, or not to taper. Inflation is an exception to that as Hooper points out "Core PCE inflation is now uncomfortably low;" a factor reinforced by yesterday's benign CPI data.

Also included here is a replay of yesterday morning's client call, "Positioning ahead of the FOMC" with Dan Orlando (US Government Trading) and Oleg Melentyev (US Credit Strategy). Note that the traders' view is that QE tapering does not happen today due, in part, to the low/inline CPI data as well as supply-uptake concerns.

1 Week REPLAY:



As you know, DB House Outlook for 2014 continues to favor developed markets equities (highlighting Germany, as well as upside in the US and Japan) and is above consensus on expectations Chinese GDP growth (+8.6%).

DB Global Market Strategist, Keith Parker, pointed out last week that flows into equities have been hedged. DB Global Markets Research comments that positioning in EM is less extended than it was in May, thus a taper should not lead to as a dramatic of a pull-back across EM risk (equities, debt, and FX). See note attached.

Please contact us with follow-ups,

Tazia, Joe, Vahe & Jay

[attachment "Investor Flows - Pent Up Demand 12.9.13.pdf" deleted by Paul Morris/db/dbcom]

----- Forwarded by Tazia Smith/db/dbcom on 12/17/2013 06:58 PM -----

From: [REDACTED]  
[REDACTED]

To:

Date: 12/17/2013 06:06  
AM

Subject: Fed note: What will the Fed do at the December FOMC meeting?  
(Peter Hooper)

Fed note: What will the Fed do at the December FOMC meeting?

In brief, in a very close call, we think the Fed will taper light (\$5-15 bn, skewed towards Treasuries). We also think that the taper, if it does come, will be accompanied by a dovish statement that reinforces the low for long message on policy rates. In what follows, we first review the various arguments for and against a December taper. We then provide our "top ten" list of ways the Fed could reinforce the low for long message.

Will they taper in Dec? The key factors that will determine the outcome of that decision are as follows (we consider the arguments for and against a December taper in each case:

1. Economic conditions are the most important factor. The center of the committee (Bernanke, Yellen, and Dudley) have all stressed that taper will require an improving labor market, evidence of self sustaining economic growth, and inflation projected to return to desired level.

a. Labor market:

Pro taper: payroll employment gains have averaged more than 200k/month for the past 4 months and close to 200k (193k) since they embarked on QE3 September a year ago. The

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unemployment rate is down to 7%, the level Bernanke said would be consistent with ending QE, let alone beginning to taper.

Con: While payroll gains have been solid, the drop in the unemployment rate has been driven importantly by further declines in labor force participation. Some Fed folks are

no

doubt uncomfortable with how low labor force participation has moved. However, consistent with recent research

reported

by the Philly Fed, we find that the decline has been predominantly among people over age 55, suggesting they may be less likely to return to the labor market as economic conditions improve.

Bottom line: the labor market has improved enough (and

seems

to have enough momentum) to warrant a taper in December.

b. Growth:

Pro taper: GDP growth looks to have averaged above trend in H2, with consumer spending adding significantly (the recent November retail sales and manufacturing output reports were impressively positive). The outlook for 2014 remains bright with household balance sheets well repaired and fiscal drag set to be much smaller than it was this year. I do not expect any significant downward revision to the FOMC's economic projections for growth. Indeed, they may well mark down the projected path of the unemployment rate.

Con: Weakness in business investment spending, and more recent softness in capital goods orders augurs against the sort of self-sustaining economic recovery that the center

of

the FOMC has indicated they need to see to begin to taper. Homebuilding too has softened in the wake of the taper tantrum.

Bottom line: growth performance and prospects have strengthened just barely enough to warrant a December

taper.

c. Inflation.

Pro taper: The FOMC has been projecting inflation to return to 2% over the next several years. Long-term inflation expectations have been well anchored within their recent historical ranges; wage inflation has at least leveled off, and some indicators have been rising.

Con: Core PCE inflation is now uncomfortably low after trending down over the past two years. It declined again in

October, though those numbers may have been tainted by the government shutdown.

clearly

Bottom line: Recent inflation performance comes down

against a December taper, but that could change with an upside surprise to core CPI numbers for November tomorrow (Tuesday)—a reading of 0.2 to 0.3 would help).

Bottom line on overall economic conditions: slightly in favor of Dec. taper

2. Costs of QE (potential froth in credit markets, interference with markets, fiscal costs or possible losses in Fed net income down the road).

the

Pro taper: costs are rising, not declining, many/most on

to

FOMC would like to end the program, everything else equal. Fed folks have been saying for some time that they wanted

a

begin to taper by the end of the year, and this is why. While asset valuations do not look extreme, there has been

at

certain amount of reaching for yield, and if QE continues

this pace for much longer, valuations could become stretched.

Con: FOMC leadership has indicated that they do not see significant signs of financial instability associated with balance sheet expansion, they do not see markets malfunctioning, and they are not too concerned about fiscal issues down the road, given that the Fed is not likely to sell MBS or long-term Treasuries any time soon. This suggests that they would not be driven to taper in the near term by cost considerations.

Bottom line on costs: neutral on December taper

3. Fiscal uncertainties: this was a key factor behind the September surprise, but these uncertainties have now been largely resolved, with the budget deal currently in the works set to reduce fiscal drag in 2014 even further. Modest risk remains around debt ceiling, but a blowup seems quite unlikely in an election year.

Fiscal: Pro Dec. taper.

4. Communications strategy:

Several FOMC participants have advocated announcing an explicit schedule

for winding down QE with the initial taper. Doing so could push the bar for the initial taper somewhat higher and augur for delaying it a bit further so that they can be more confident they will not have to interrupt the exit process.

Communications: slight Con.

5. Market liquidity: Thin markets in second half of December, raise the possibility of an exaggerated negative price reaction, which could put a damper on confidence and on retail sales in the final days of the holiday shopping season.

Market liquidity: slight Con.

6. Leadership transition: Bernanke's term ends January 31. Would he want to be the one to deliver the important forward-looking message that would accompany the initial taper about the future course of policy at the press conference in January and then leave two days later? Bernanke could step down or step aside and let Yellen run the meeting and do the press conference. That could be a bit awkward, but it would also make Yellen's first move one that leads the Committee in a less dovish direction.

Leadership transition: neutral.

7. Bernanke legacy: Does Bernanke want to be remembered as the Chairman that blew up the Fed's balance sheet and then left? Alternatively, would he want to risk being remembered for scuttling the recovery by tapering prematurely? Probably not important in Bernanke's case—has striven to diminish the cult of the chairmanship.

Legacy: neutral.

As I add up the pros and cons for a December taper, this is a very close one; it is quite possible they have not made any decisions yet, and that the CPI inflation data on Tuesday could still tip the scale. At this point, I am now leaning slightly in favor of a December taper. This is not a consensus view, though I note that our US Economics team has been more consistently projecting a December taper.

If they do taper, I expect it to be a taper light, on the order of \$5 to \$15 bn (skewed more toward Treasuries than MBS). This would be accompanied by a statement that is relatively dovish--i.e., that reinforces the message that they expect rates to be held at very low levels for quite some time to come. There are a number of ways they could do this. Here is my top ten list of the things they could do in this regard, starting with the least likely and ending with the most likely:

10) Lower unemployment threshold from 6.5%. The October minutes and some Fed speak have suggested this is not likely—the 7.0 and even 6.5 numbers have created communication problems as it is. (likelihood: 15%)

9) Reduce interest on excess reserves. This got more support at the October

meeting, but my sense it is not a high probability. (25%)

8) Provide weak calendar forward guidance: for example, "we expect the first rate hike is at least one year away." Possible, but I do not expect the FOMC to revert to calendar-based guidance. (25%)

7) Add a specific inflation floor. There may be more support here, but still problematic. A floor of 1.5% does not say much, a floor of 2.0 would be too high for many members, and a floor of 1.75 would be shaving things pretty finely. (35%)

6) Lower their projections for the fed funds rate for the coming years. Marking down the endpoint for the fed funds path several years out (per #5 below) would allow them to revise down their interest rate forecasts for earlier periods as well. This could be a significant message, especially if they reduce their forecast for unemployment. (60%)

5) Lower their projections for the neutral level of the fed funds rate in the longer term based on downward revisions to potential growth estimates. (60%)

4) Point out (again) that their actions could be reversed if financial markets react negatively enough to put the economic expansion at serious risk. (75%)

3) Note that they are comfortable with the apparent success of their verbal guidance to date--that market expectations about the Fed funds rate do not look unreasonable. (80%)

2) Taper by only a modest amount initially. (85%)

1) Re-emphasize their existing forward guidance, i.e., that they might not begin to raise rates until unemployment is well below the 6.5 threshold, depending on what the overall picture in the labor market, growth, and inflation looks like. (90%)

In brief, a taper is likely to be accompanied by a statement and press conference that reinforces the low for long message, by reemphasizing what has already been said, as well as by reducing interest rate forecasts in the SEP.

Finally, in this light, it is interesting that Stanley Fischer has apparently become a leading candidate for Fed Vice Chairman. We strongly endorse his candidacy—he would be an excellent appointment all around. What is

interesting

is that he has publicly favored giving less, not more forward guidance. We do not see Fischer's views having a significant effect on the outcome of the December meeting if the Fed does decide to taper, but this is an issue that will bear watching in the future.

#### October FOMC

Information received since the Federal Open Market Committee met in September generally suggests that economic activity has continued to expand at a moderate pace. Indicators of labor market conditions have shown some further improvement, but the unemployment rate remains elevated. Available data suggest that household spending and business fixed investment advanced, while the recovery in the housing sector slowed somewhat in recent months. Fiscal policy is restraining economic growth. Apart from fluctuations due to changes in energy prices, inflation has been running below the Committee's longer-run objective, but longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic growth will pick up from its recent pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee sees the downside risks

to the outlook for the economy and the labor market as having diminished, on net, since last fall. The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, but it

anticipates that inflation will move back toward its objective over the medium term.

Taking into account the extent of federal fiscal retrenchment over the past year, the Committee sees the improvement in economic activity and labor market

conditions since it began its asset purchase program as consistent with growing underlying strength in the broader economy. However, the Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases. Accordingly, the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of \$40 billion per month and longer-term Treasury securities at a pace of \$45 billion per month. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling

over maturing Treasury securities at auction. Taken together, these actions should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more

accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

The Committee will closely monitor incoming information on economic and financial developments in coming months and will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. In judging when to moderate the pace of asset purchases, the Committee will, at its coming meetings, assess whether incoming information continues to support the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective. Asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's economic outlook as well as its assessment of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Charles L. Evans; Jerome H. Powell; Eric S. Rosengren; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action was Esther L. George, who was concerned that the continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations.

Peter Hooper

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