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World Outlook 2016
Managing with less liquidity
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Global Overview: Managing with less liquidity

|| The long-awaited turn toward the normalization of US monetary policy should finally get under way next week, with the Fed set to raise rates for the first time since 2006. In the year ahead, we could also see signals that the monetary spigots in Europe will begin to close as well. While such indications are probably more than a year away in Japan, we do not expect the BoJ to add to its asset purchases. In a world that has been awash with central bank liquidity for most of the past decade, the central question for the year ahead is how the global economy and financial markets will react as the tap on that liquidity begins to tighten.

|| While the pivot away from this great monetary experiment is unprecedented and will not be without risks, we expect the world economy and financial markets to weather this turn in policy reasonably well. Supporting this adjustment is the expectation that major central banks -- and the Fed in particular -- will be moving far more cautiously than they have in the past as they withdraw accommodation.

|| The economic backdrop should allow for this gradual pace of policy normalization, at least initially. Global growth is expected to rebound gradually from the weakest growth rate since the financial crisis in 2015. Growth in advanced economies is projected to hold steady just shy of 2% over the next three years, with growth in the US slowing to near 2%, Europe's steady recovery continuing and Japan rebounding from disappointing growth this year.

|| The coming year should see growth in emerging market economies rebound, as the severe contractions in Russia and Brazil moderate and recent declines in export growth are expected to reverse, albeit weakly. Nonetheless, 2016 will be challenging for the emerging markets as falling commodity prices and still-weak global trade growth extend the recent experience with budgetary and balance of payments pressures. China is expected to continue its gradual deceleration, offering little respite to commodity producers.

|| Market interest rates should rise next year -- we see the 10-year Treasury yield ending the year at 2.5% with risks skewed to the upside -- as the market prices a tightening Fed. US credit spreads are likely to widen further as defaults rise moderately, but we do not see Fed hikes proving problematic for credit next year. The US dollar upswing should continue, though at a more modest pace. And we see equities remaining resilient and presenting some upside, as long as the rise in rates is limited and orderly.

|| The risks around our baseline view seem more numerous than in the past due to the unprecedented shift in monetary policy. The main downside is that the market adjustment to a tightening Fed is more adverse than we anticipate. A spike in yields could set off a significant re-pricing of

global

risk assets. This reaction would intensify if the Fed finds itself behind the curve as inflation rises from a tight labor market. Beyond the Fed, a sharper-than-expected slowdown in China next year would have obvious knock-on effects on commodities, global trade and emerging markets.

Meanwhile, intensified European political risk is also possible if differences

of opinion between countries on divisive themes like the refugee crisis spill over into other policy areas.

|| On the positive side, a surprising recovery in productivity growth in advanced economies, especially the US, would allow normalization to proceed very slowly and support a stronger recovery on the demand side of the economy. Risks are also skewed to the upside of our US economic outlook. The rebound in business fixed investment from a low base could be stronger than expected, especially with the peak impact from the drop in oil likely behind us, and the drag from a stronger dollar should begin to wane after mid-year.

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Introduction and Summary

Barring a significant negative economic or financial shock in the week ahead, the long-awaited turn toward the normalization of US monetary policy should finally get under way before the end of this year. The 25-basis-point fed funds

rate hike now widely anticipated at the Fed's December meeting would be the first such move since June 2006. In the year ahead, we could also see signals that the monetary spigots in Europe will begin to close as well. While such signals are probably more than a year away in Japan, we don't expect the BoJ to add to its asset purchases, implying a gradual easing of stimulus there.

In a

world that has been awash with central bank liquidity for most of the past decade, there is both great curiosity and great concern about how the global economy and financial markets will react as the tap is finally shut on that liquidity. This question is a central focus of our World Outlook for 2016.

The pivot away from this great monetary experiment is unprecedented and will not be without risks. However, we expect both the world economy and global financial markets to weather this turn in policy reasonably well, partly because

major central banks -- and the Fed in particular -- have made it abundantly clear that they will be moving far more cautiously than they have in the past as

they withdraw accommodation. Markets appear so far to have settled comfortably into the expectation that the Fed will be moving very slowly, expecting only about half the pace of hikes as the median Fed expectation, which is, in turn, about half the pace of historical Fed hiking cycles.

The economic backdrop should allow for this gradual pace of policy normalization, at least initially. Global growth has been slowed by significant

headwinds on both the demand side and the supply side of major economies.

While moderate consumer spending growth has increasingly been the principal driver of a sluggish recovery, capital spending has been very slow to

advance. A result of weak business investment has been that labor productivity growth has slowed to historically low rates in advanced economies. The inevitable slowing of China's economy to a more sustainable pace has also been a significant headwind to growth with dramatic implications for the world economy. China's slowdown has been a major factor underlying the weakening of commodity markets, trade flows, business investment, and manufacturing activity globally.

But the slow growth of supply--or decline in potential growth--has also meant that sluggish recoveries in demand have been able to achieve considerable progress in removing economic slack. The US and Japanese economies are already nearing full employment, and even Europe's labor market has shown gains. The progress to date in reducing unemployment will help, along with the stabilization of energy and other commodity prices, to push inflation higher

in the year ahead from recent extreme lows. The prospective pickup in wage and price inflation, as well as the continuing improvement in the labor

market,
is what is inducing the Fed to commence policy normalization. Spillovers from the Fed's move will help the ECB and the BoJ to achieve their inflation targets,
as prospective rate increases in the US further strengthen the dollar against the euro and the yen.
This raises the question of how far this policy divergence can go. Economic slack is declining enough to push Europe's core inflation close to its historical
average by end-2016. Stable and eventually rising commodity prices, supportive currency developments, and rising inflation expectations could lead
the ECB to start talking before year end about tapering in 2017. In this light,
the recent extension of its QE program, while disappointing to the markets, could prove to have been unnecessary. For the BoJ, any change in policy stance seems unlikely until well after the April 2017 consumption tax increase.

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But the changing market expectations for ECB and BoJ policy have the potential to induce another bout of market turbulence akin to the taper tantrum

of mid-2013, though likely with more limited implications for the global economy and financial markets.

While our baseline scenario sees a global economy that continues to grow at a moderate pace over the next two years, there are substantial risks on either side. On the down side, global financial markets could respond much more negatively to Fed normalization than we expect, with adverse repercussions for

household and business spending around the globe. The gap between the market's and the Fed's forecasts for interest rates suggests that this negative

response could result from an upward adjustment in market expectations towards the Fed, even without more aggressive tightening than the Fed currently envisions. A signal that the Fed will begin to wind down its reinvestment of securities could add to this turbulence. This downside risk would be exacerbated if there were a surprising resurgence of inflation pressures in the US as the unemployment rate moves below full employment. Such a development would likely prompt the Fed to adopt a significantly more rapid pace of normalization. A more aggressive Fed would, in turn, be negative

for risk assets with potentially strong depressing effects on aggregate demand.

A sharper-than-expected slowdown in China next year would have obvious knock-on effects on commodities, global trade and emerging markets. But on the positive side, it is possible that the recent poor performance of productivity

growth globally (especially in the US) has been an aberration, and that recent

technological advances could spur a surprising recovery. Faster supply-side growth would allow normalization to proceed very slowly and support a stronger recovery on the demand side of the economy. In addition, the risks to

our US outlook are skewed to the upside: the peak drag on business investment from the sharp drop in oil prices is likely behind us, and the drag

from net exports from the dollar surge is likely to dissipate beyond mid-year.

In what follows, we begin by presenting our baseline forecast for the global economy and financial markets, with an emphasis on 2016, but also a peek into 2017. We then provide a more detailed description of the outlook for the globe's major economic blocks. Next, we summarize our asset class views for the year ahead. We conclude by fleshing out the upside and downside risks to our baseline outlook in more detail.

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Global outlook

Disappointing global growth to pick up slightly next year

Growth in global economic activity is now projected to bottom this year and rise gradually toward trend by 2017, led primarily by an acceleration in emerging market economies. We expect global growth will have dipped to 3.1% in 2015, its slowest pace since the global financial crisis in 2009.

This

slowdown has been driven primarily by a deceleration in emerging market economies, where growth is expected to have fallen by more than one-half of a percentage point from 2014. The sharp contractions in Russia and Brazil are the main reason for this deceleration. Conversely, faster growth in the euro area and Japan implies a modest pickup in growth in advanced economies this year.

Over the next two years changes in the global growth outlook are likely to be driven entirely by fluctuations in emerging market growth. Next year growth is

projected to rise gradually, as the severe contractions in Russia and Brazil moderate. This should help boost emerging market growth by almost one-half of a percentage point, even with growth slowing further in China. But the emerging markets growth story is not simply a technical one: recent declines in export growth should reverse, albeit weakly, providing a more positive basis

for recovery than the 'less bad' Brazil and Russia outlooks. Growth in advanced

economies should remain stable at just below 2% in 2016, as a more-than-doubling

in growth in Japan and a slight pickup in the euro area offset

deceleration in the US. Further acceleration in global economic activity in 2017

is likely to be due to additional improvement in Russia and Brazil, while a pickup in India and stability in China would imply a modest acceleration in emerging Asia. Advanced economy growth is once again expected to remain just shy of 2% in 2017, despite a halving of growth in Japan.

Figure 2: Fluctuations in growth in emerging market

economies driving global growth dynamics over next two years

GDP growth, %

G7

US

Japan

Euro area

Asia (ex-Japan)

China

India

EEMEA

Russia

Latin America

Brazil

EM economies

Global

2014 2015F 2016F 2017F

1.8

1.7

2.4

-0.1

0.9

6.4

7.3

7.1

2.4

0.6

0.8

0.1

Advanced economies 1.7

4.6

3.4

Source: Deutsche Bank Research

1.9

2.4

0.7

1.5

6.1

7.0

7.3

1.0

-3.7

-0.8

-3.7

1.9

4.0

3.1

1.9

2.1

1.5

1.6

6.1

6.7

7.5

1.9

-0.7

-0.1

-2.4

1.9

4.4

3.3

2.1

0.8

1.5

6.3

6.7

7.8

2.5
0.5
2.2
1.0
1.8
4.9
3.6
1.5
1.6
2.8
0.4
3.4
2.0
6.7
6.0
7.8
CPI inflation, %
2014 2015F 2016F 2017F
0.3
0.2
0.8
0.1
2.4
1.4
4.9
8.7
15.6
9.0
0.3
5.6
3.4
1.5
1.9
0.7
0.9
2.9
1.8
5.4
6.7
9.2
8.5
1.4
5.9
4.0
2.1
2.3
2.1
1.6
2.9
1.8
5.0

5.9
7.1
12.5 15.2 18.8 19.4
6.3
6.2
1.3
5.3
3.6
2.0
5.7
4.2

Figure 1: Global growth to rise toward trend from its slowest pace since 2009

10
% yoy

-6
-4
-2
0
2
4
6
8

Real GDP growth
Forecasts
World
Advanced economies
Emerging economies

Note: Trend period: 1995:2017

Source: IMF, Haver Analytics LP, Deutsche Bank Research

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1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

2013
2014
2015
2016
2017

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Growth marked down broadly this year and next

Compared to our previous global update in June, growth has once again been marked down broadly for 2015 and 2016. Sharper-than-expected contractions in emerging market economies were the main downside surprise to our growth forecast for 2015. Projected growth in Russia has been marked down by 0.5 percentage points – after downward revisions earlier this year, while the forecast for Brazil has been reduced 2.3 percentage points since June. On the other hand, growth expectations for advanced economies were upgraded modestly, as upside surprises to growth in the US and the euro area more than offset disappointing growth in Japan.

Figure 3: Global growth projections revised down for 2015 and 2016

GDP forecast & revision (% yoy)

Forecast level

Current

G7

US

Japan

Euro area

Asia (ex-Japan)

China

India

EEMEA

Russia

Latin America

Brazil

Advanced economies

EM economies

Global

1.9

2.4

0.7

1.5

6.1

7.0

7.3

1.0

-3.7

-0.8

-3.7

1.9

4.0

3.1

1.9

2.1

1.5

1.6

6.1

6.7

7.5

1.9
-0.7
-0.1
-2.4
1.9
4.4
3.3
2.1
0.8
1.5
6.3
6.7
7.8
2.5
0.5
2.2
1.0
1.8
4.9
3.6

Forecast change since
June 15 W0 Update

2015F 2016F 2017F 2015F 2016F 2017F

1.8
0.1
0.3
-0.4
0.1
-0.2
0.0
-0.2
-0.2
-0.5
-1.0
-2.3
0.1
-0.3
-0.2
-0.5
-0.9
-0.3
0.0
-0.2
0.0
0.0
-0.3
-0.3
-2.0
-3.0
-0.4
-0.5

-0.4

Note: June 15 World Outlook update forecasts have been recalculated using IMF WEO October -15 PPP weights

Source: Deutsche Bank Research

The downward revision to expected global growth is more significant and broad-based for 2016. This growth is now expected to be 0.4 percentage points slower next year compared to our June forecasts, as advanced and emerging market economies were downgraded by similar amounts. Within advanced economies, the downward revision to US growth (-0.9 percentage points) is most severe. This downgrade is due mostly to the increased drag on net exports from greater-than-expected dollar appreciation, while reduced estimates of potential growth have also contributed. Expected growth in Japan was also revised down, though by a more modest 0.3 percentage points, while the growth outlook in the euro area is unchanged. Once again, Russia and Brazil represent the main downgrades to growth within emerging markets, while our outlook for a slight slowdown in China and pickup in India is unchanged.

DB's top-line global growth forecast roughly consistent with alternative projections

Our downgraded global growth forecast is about in line with outside alternatives from the IMF and Bloomberg through 2017. However, this consistency masks significant regional differences. In particular, while our US

growth forecasts are nearly one-half of a percentage point below alternative Deutsche Bank AG/London

Page 7

n.a

-0.7

-0.2

-0.1

n.a

0.0

-0.2

n.a

-0.8

n.a

-1.1

n.a

n.a

n.a

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forecasts for 2016 and 2017, our China growth forecasts are a few tenths above alternatives over this same timeframe. The Chinese government may clarify in the coming weeks its growth target for 2016, and forecasts for growth below 6.5% may be revised higher if, as seems likely, the government's target is at least that high. Meanwhile, our outlook for growth to

remain near 1.5% in the euro area is close to alternative forecasts from the IMF,

Bloomberg and Consensus Economics.

Figure 4: In-line global growth forecasts mask regional differences

Consensus Forecast table, GDP growth, %

Global

DB (Jun'15 W0)

DB (Current)

Bloomberg (Nov Survey)

Bloomberg (DB aggregation)

IMF (Oct'15)

IMF (DB aggregation)

US

DB (Jun'15 W0)

DB (Current)

Bloomberg (Nov Survey)

IMF (Oct'15)

Consensus Economics (Oct Survey)

Euro area DB (Jun'15 W0)

DB (Current)

Bloomberg (Nov Survey)

IMF (Oct'15)

Consensus Economics (Oct Survey)

China

DB (Jun'15 W0)

DB (Current)

Bloomberg (Nov Survey)

IMF (Oct'15)

Consensus Economics (Oct Survey)

2015F

3.3

3.1

3.0

3.0

3.1

3.0

2.2

2.4

2.5

2.6

2.5

1.4

1.5

1.5
1.5
1.5
7.0
7.0
6.9
6.8
n.a
2016F
3.8
3.3
3.4
3.4
3.6
3.4
3.0
2.1
2.5
2.8
2.6
1.6
1.6
1.7
1.6
1.7
6.7
6.7
6.5
6.3
n.a

Note: June 15 World Outlook update forecasts have been recalculated using
IMF WEO October -15 PPP weights
Source: Deutsche Bank Research, cited sources

2017F
n.a
3.6
3.4
3.7
3.8
3.6
2.8
2.1
2.5
2.8
2.5
1.6
1.5
1.8
1.7
1.6
6.7

6.7
6.3
6.0
n.a
Global inflation to accelerate after bottoming in 2015
Global inflation is projected to rebound strongly over the next two years after falling to its lowest level since the financial crisis. Both the decline and the anticipated rebound are driven primarily by the sharp decline in global commodity prices over the past 18 months and our expectation that prices will be roughly stable in the coming year. But inflation dynamics are varied across regions. In advanced economies, headline inflation fell about 1 percentage point this year, leaving price increases only a few tenths above deflationary territory. The sharp drop in headline inflation was driven by the 60% decline in oil prices since mid-2014. Meanwhile, inflation in Latin America and EMEA economies rose this year, due mostly to sharp currency depreciations. Weak currencies don't seem to have had the same effect in emerging Asia, though.

Figure 5: Global inflation to rebound strongly

10 % yoy
Inflation
Forecasts

8
6
4
2
0
-2
-4

World

Advanced economies

Emerging economies

Note: Trend period: 2000-:2017

Source: IMF, Haver Analytics LP, Deutsche Bank Research

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2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011

2012
2013
2014
2015
2016
2017

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Inflation is expected to rebound sharply in 2016 and rise modestly further in 2017. The initial acceleration is driven primarily by the stabilization of energy

price, removing what has been a considerable downward force on broad price indexes. Hence, the gap between headline and core inflation will close in the coming year. In addition, core inflation rates in the G3 economies have already

begun to rise gently, and our expectation is that even after the commodity price effect lifts headline inflation, the underlying rising trend in core inflation

will continue to push inflation higher. Advanced economy inflation is projected

to rise by 1 percentage point next year and 0.6 percentage points in 2017. On the other hand, inflation in emerging market economies – less influenced in most cases by energy prices -- is expected to rise modestly next year and remain stable in 2017. Upside risks to inflation from food prices are a concern-this

year has seen the most pronounced El Nino cycle on record and weather patterns may be equally disruptive next year. As yet, however, food prices globally are not showing any upward momentum.

Figure 7: Global inflation revised up led by emerging market economies

Inflation forecast & revision

% yoy

G7

US

Japan

Euro area

Asia (ex-Japan)

China

India

EEMEA

Russia

Latin America

Brazil

Advanced economies

EM economies

Global

Forecast level

Current

1.5

1.9

0.7

0.9

2.9

1.8

5.4

8.7

15.6

15.2

9.0
0.3
5.6
3.4
6.7
9.2
18.8
8.5
1.4
5.9
4.0
2.1
2.3
2.1
1.6
2.9
1.8
5.0
5.9
7.1
19.4
6.2
2.0
5.7
4.2

Forecast change since
June 15 WO Update

2015F	2016F	2017F	2015F	2016F	2017F
0.3					
0.2					
0.8					
0.1					
-0.1					
0.0					
-0.1					
-0.2					
2.4					
1.4					
4.9					
-0.2					
-0.2					
-0.2					
0.2					
0.4					
2.2					
0.5					
-0.1					
0.2					
0.1					
-0.5					
-0.6					

-0.3
-0.5
-0.6
-0.9
-0.3
1.0
2.2
6.2
2.6
-0.5
0.7
0.2

Note: June 15 World Outlook update forecasts have been recalculated using IMF WEO October -15 PPP weights

Source: Deutsche Bank Research

Our inflation forecasts have undergone significant revisions since the June update. Global inflation expectations have been revised up by 0.1 and 0.2 percentage points for 2015 and 2016. The impetus for this revision is higher inflation in emerging market economies resulting from greater-than-expected currency depreciation. This is most pronounced in Latin America, where forecast inflation has been revised up by 2.2 and 6.2 percentage points for 2015 and 2016, respectively. Inflation has been marked down broadly across advanced economies and emerging Asia, with forecasts falling by a few tenths for 2015 and by about one-half of a percentage point for next year.

n.a
-0.3
0.2
-0.1
n.a
-1.2
-0.5
n.a
0.3
n.a
1.2
n.a
n.a
n.a

Figure 6: G3 core inflation

%yoy

US (PCE)

-2.0
-1.5
-1.0
-0.5
0.0
0.5
1.0
1.5
2.0
2.5

3.0

2008 2009 2010 2011 2012 2013 2014 2015

Note: Japan "core core" inflation, net of the consumption tax increase.

Source: CEIC, Deutsche Bank Research

Euro area

Japan

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Regional detail

US outlook

US GDP growth is projected to have slowed to less than 2% in the second half of 2015, and we see it picking up slightly to just over 2% during 2016 and 2017.

The economy should be driven predominantly by a healthy expansion of consumer spending, plus some outsized gains in residential investment as the housing market continues to tighten. Business investment growth should remain relatively subdued, held back by, among other factors, a strengthening dollar, election-year uncertainties, subdued corporate earnings growth, and in

the longer term, tightening financial conditions. Output growth should be restrained substantially in the year ahead by the lagged depressing effects on

net exports of past substantial appreciation of the dollar and some further increases to come. That restraint should ease over time, but domestic demand growth should slow as the Fed's normalization of monetary policy progresses. And that slowing should help keep the labor market from overshooting too much.

The modest pace of GDP growth that we are projecting should be more than enough to effect ongoing tightening of the US labor market. With labor productivity growth and labor force growth both running at historically depressed rates, we estimate that potential GDP growth has slowed to around 1% currently, and is likely to rise only gradually as productivity and labor force

growth pick up over the period ahead. We see the unemployment rate falling into the mid-4% area over the next couple years, putting it noticeably below NAIRU, but not by enough to effect more than a gradual pickup in wage and price inflation. We see core PCE inflation returning to near 2% two years hence,

roughly in line with FOMC projections. However, our forecast for growth is a bit below consensus and the FOMC median projection, and we see the dollar rising more than the Fed is likely to have assumed. On a trade-weighted basis,

we expect the dollar to rise nearly 5% next year. While significant, this appreciation is a notable deceleration from the 20% rise in the trade-weighted

dollar since mid-2014. Accordingly, we expect the Fed to raise rates slightly less rapidly than anticipated in the most recent (September) FOMC median projection (a projection that could be revised down somewhat for the December FOMC meeting). At the same time, our projection for 100 bps of Fed rate hikes by the end of 2016 (including a 25 bp liftoff this month) and another

100 bps during 2017 is noticeably more than the market has been pricing. We also expect the Fed to taper the reinvestment of its maturing asset holdings and allow its balance sheet to begin to run off naturally after mid-2016.

Outlook for Europe

We expect euro area GDP growth to be broadly unchanged at 1.6% in 2016 and to slow in 2017. This reflects the shifting intensity of countervailing

headwinds and tailwinds. Global growth should rise, but less than we previously thought. Lower oil prices were a source of strong stimulus in 2015 and allowed private consumption to compensate for weaker net trade. However, we expect oil prices to be flat in 2016 and to rise about 10% in 2017

as supply constraints bite. Dual monetary and fiscal easing should help protect

euro area economic growth from the fading oil stimulus in 2016. With both monetary and fiscal policy likely to tighten modestly in 2017, economic growth

will be more exposed to the squeeze from higher oil prices. The net result is that we expect the average annualised rate of GDP growth to slow from 1.7% in 2016 to 1.4% in 2017.

The euro exchange rate is expected to fall about 5% in trade weighted terms in

2016, with EURUSD breaching parity. A partial normalisation of euro area rate markets is likely to cause some tightening of financial conditions later in the

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year. With productivity and potential growth running low, the output gap should gradually narrow even with these modest rates of GDP growth, and past euro depreciation starting to become more visible in inflation. Core inflation should be close to historical norms in H2 2016. By end 2016, the ECB's medium-term headline inflation projections should be at levels consistent with tapering starting to be discussed at the ECB and implemented in 2017; we see the first ECB policy rate hike only at the end of 2018. The risk

is that oil prices continue to decline in the near term and weigh on headline inflation. If this weakens medium-term inflation expectations, the late-2016 tapering risk should dissipate and the pressure for further ECB easing will grow.

The refugee crisis will remain a theme in Europe and fear of a repeat of the Paris terror attacks will linger. While refugee and security-related public spending is likely to lead to some relaxation in the fiscal stance in the year

ahead, we expect compliance with Europe's fiscal rules to improve into 2017. We expect euro area political uncertainty to rise as 2017 approaches. The refugee crisis has created frictions within and between countries, but the common threat to security highlighted by the attacks in Paris may unify Europe

and reduce the risk of local political events – including Greek debt relief negotiations, Portugal's minority government, Catalonia's independence bid and the UK's EU negotiations – from undermining area-wide stability in 2016. In our view, the unity won't last into 2017. The closer we get to the Dutch, French and German elections in 2017 – Italy may bring forward its election into 2017 too – the more political tensions are likely to build and impose a risk

premium on the recovery.

There is little basis to expect a strong non-cyclical euro area recovery either.

France may make some further modest progress on structural reforms in early 2016, but reform progress across the zone over the next couple of years is likely to remain slow.

UK economic growth appears set to slow over the next couple of years – but despite fiscal austerity, sterling currency strength and maybe some EU referendum-related uncertainty, GDP growth should be no worse than trend. We expect the robust labour market to keep private consumption growth well supported. Inflation base effects should push inflation up to close to the lower

bound of the Bank of England's inflation target range before mid-year. We continue to expect the Bank of England to raise policy rates for the first time in

this cycle in May. The EU referendum could be held as soon as late next year. According to opinion polls, the outcome looks closer than the last referendum in 1975 when 66% voted to remain in the EU.

Outlook for Japan

After what we view as a soft patch over the summer, due in part to unseasonable weather but also to a temporary pullback in capital investment,

we see the economy bouncing back strongly in Q4 and then returning to its underlying 1-1.5% trend during 2016. For an economy that has been repeatedly buffeted by shocks – some self-inflicted, most genuinely exogenous – we are conscious of the difficulty of making firm forecasts. But we do see Japan's economy as following an underlying growth rate well above its longrun potential and are therefore likely to continue to see the labour market tightening from what is already the lowest unemployment rate in 20 years. Household income growth, reflecting the combination of rising wage growth and employment, should remain at about 2-2.5%, providing the main driver of growth for the economy.

While headline inflation should rise through 2016 as the base effect on past oil

price declines drops out of the year-on-year comparison, we don't see it rising

beyond 1% until 2017. "Core core" inflation, excluding food and energy prices,

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has risen sharply in recent months and we expect this to continue for a few more

months, rising to above 1% in the first half of 2016. But with the lagged effects

of yen depreciation wearing off, we expect inflation to stabilize at about 1% rather than moving higher. This may induce the BoJ eventually to add to its asset

purchases, but our base case is that it would choose to continue the current level

of investments for longer rather than increase the scale of purchases. In any event, the risks likely remain tilted in the direction of any negative shock to

growth or inflation expectations leading to an augmentation of QE.

China and other emerging markets

The coming year will likely remain challenging for emerging markets as falling

commodity prices and weak global trade growth are likely to extend the recent experience with budgetary and balance-of-payments pressures and slow growth in many EM economies. We expect growth in China to slow further in the coming year to 6.7% from 7.0% in 2015 and 7.4% in 2014, offering little respite for commodity producers. This will probably force continued output cuts to close the supply-demand gap for resources. We think that by the end of 2016, this will have been achieved in the oil market, thanks to production cuts, especially in the US; but in most other commodity markets, balance should be restored only in 2017.

But the China forecast offers some hope in that the source of demand growth could shift at the margin back towards more commodity-intensive infrastructure and property investment. The 2017 forecast offers more encouragement for commodity exporters in the form of an end to the China slowdown – growth is expected to be maintained at 6.7% – perhaps allowing for the return to a positive cycle in commodity prices once supply cuts have been effected in 2016.

In the near term, we think maintaining the gentle downward glide path to growth in China will require more fiscal and monetary stimulus – we expect two more rate cuts, for example – but the recovery in the property market could remove some of the downward pressure on Chinese growth. The rate at which property prices are rising – and the stabilization of prices in more and

more smaller cities – combined with the rise in land sales revenues could be taken as indicators that property investment could be heading for a familiar boom following the 2014 ‘bust’. Our forecast is for a more restrained rebound,

however, as a large stock of unsold properties and slowing of rural-to-urban migration serve to limit developers’ enthusiasm to reinvest.

In India, we expect only a very modest pickup in activity and only late in our

forecast horizon. Banks and corporates will have to resolve a growing stock of

problem assets and stalled projects, a task that we don’t expect will be

completed quickly. The growth outlook, therefore, has a very gradual rise over the next two years. We are optimistic that the government's reform plans can, in the medium term, put India on a path towards much higher growth rates, but much hard work remains to be done in the meantime, including the implementation of tax, labour, land acquisition and investment reforms. For 2016, growth forecasts for Brazil and Russia offer only the prospect of a slowing pace of decline and eventual stabilization in activity, with growth expected to return in 2017. Given the size of these economies, this should be enough to boost regional growth forecasts. But a slower pace of recession is hardly cause for celebration. More encouragement comes in Argentina's likely adoption of more positive economic policies. The path to restoring investor confidence and market access will not be easy – likely involving a devaluation of the official exchange rate and a significant decline in government spending – but we have a fundamentally positive outlook for the Argentine economy at last, albeit again one that offers more growth potential in 2017 than in 2016.

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For most other emerging markets, a positive outlook requires an end to commodity price declines and also an end to the puzzling weakness in exports. In Figure 8, we plot the growth in real exports of goods and services in the major EM economies by region against US and EU combined GDP growth.

Aside from weighting EM countries by the size of their exports rather than GDP,

we have made one other notable change, adjusting Chinese exports for alleged over-invoicing in early 2013. This latter modification serves to highlight that the

decoupling of Asian exports from US and EU GDP growth is really a very recent phenomenon, emerging only in the last year. Growth in Emerging Europe exports has similarly decoupled from EU growth over the past year. Export growth in Latin America has been weak but reasonably closely aligned with US growth.

Many hypotheses have been proposed to explain the loss of export vitality, some of which we find unconvincing. "Onshoring" of manufacturing back to the US seems inconsistent with the weakness in US manufacturing output – particularly in information and communications technology, which is the mainstay of Asian exports to the US. Manufacturing output growth in the EU has followed a similar pattern to imports, implying again that domestic production doesn't seem to be rising at the expense of imports. Indeed, import

penetration into the US and European Union is not falling. While China has seen a loss of competitiveness in labour-intensive manufacturing, that has more than been offset by increasingly competitive higher-value industries. China now exports automobiles, high-speed trains and, soon, passenger jets; its share of global manufactured goods exports is rising today at about the same pace it was in the pre-crisis years.

With only about a year's data, it is hard to arrive at a convincing explanation,

but we think the following factors are important. First, slower growth in Chinese demand for commodity imports may have depressed overall export volumes among the commodity exporters. Second, those sectors that saw the greatest outward migration in production from advanced to emerging economies are now much more mature. Of particular importance, consumer electronics devices – mobile phones, laptops and tablets – are now ubiquitous in advanced economies and most emerging markets too. There simply doesn't need to be the growth in sales of such products since for most consumers the need simply is to replace worn-out devices. Third, as China moves up the value

chain, production networks may be shrinking. As Chinese suppliers become more proficient, it may require fewer imports of intermediate goods to produce

exports. And as multinationals in China focus more on serving the domestic market – now growing in USD terms as fast as the US market – they may be replacing more expensive imported components with locally sourced 'good enough' parts. Finally, the sharp depreciation of the euro in 2014 must surely

have played a role, as the weak euro has depressed the growth of imports

while stimulating exports in Europe.

Some of these influences depressing EM exports may become less of a constraint in the year ahead. The much slower pace of growth in the IT sector noted above likely reflects a temporary inventory depletion phase, which we think could end in the coming months with both production and imports rebounding. Even a mature sector like IT is likely still to see some growth as

long as the broader economy is growing. The euro is expected to depreciate, but less than it did in 2014. As the competitive advantage of China shifts to higher-value goods, carrying the rest of Asia with it even if to a lesser degree

than ten years ago, it is reasonable to expect export volume growth to recover.

This matters for the large number of small open economies in the EM universe, for which export growth has a highly significant influence on economic activity.

Even the modest recovery in export growth that we forecast for 2016 and 2017 will be enough, we think, to take GDP growth somewhat higher in most emerging economies.

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Figure 8: EM exports of goods and services vs. G2 GDP

Asia (lhs)

EMEA (lhs)

10

15

20

25

30

-20

-15

-10

-5

0

5

2005

2007

2009

2011

2013

2015

Note: Regional data weighted by 2014 nominal USD goods and services exports.

Source: Haver Analytics LP, Deutsche Bank Research

%yoy

Latam (lhs)

US&EU GDP (rhs)

%yoy

-6

-4

-2
0
2
4
6
8

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Given the challenges facing many EM economies, the coming year will likely see a marked divergence in monetary policy across the regions. In Latin America, despite a reasonably subdued growth backdrop, we expect central banks to raise interest rates in most countries and by almost as much as the Fed. In EMEA, we see rates going up in South Africa and Turkey and later in the year in Israel, but continuing to come down in Russia. In Asia, in sharp contrast to past Fed cycles, we expect only the Philippines will see rate hikes

in 2016. Instead, we expect central banks in China, India, Indonesia and Taiwan to cut rates. By implication, interest rate differentials in Asia should

move in favour of the US dollar, implying a risk of continued weakness in Asian currencies against the dollar. We expect most emerging market currencies to outperform the euro, though. Of particular note, we expect only about a 4.5% depreciation of the RMB against the USD, mostly late in the year as the PBOC cuts rates. The possibility that policymakers in China decide to move the exchange rate in a larger, discrete, devaluation is probably the greatest risk to the emerging markets currency outlook as that would likely trigger similar moves in other EM currencies. Partly for that reason – that it

wouldn't get much of a competitive advantage from a devaluation – we don't expect China to devalue the RMB.

Summary of strategy views on the markets

Rates: Peak policy divergence

As the divergence between US and European monetary policy may have peaked, we believe that 2016 should see a partial convergence of US and European bond yields. Our end-year forecasts see the 10-year Bund around 1.1% and 10-year US Treasury at 2.5% (although our macro forecast—with the Fed on a slow but steady uptrend – may be consistent with a somewhat higher yield by end 2016). In Europe, absent an external shock, the market is likely to

focus in the second half of the year on the prospects of the ECB discussing (but not implementing) a tapering-off of asset purchases, while the front end should remain anchored. This should lead to steeper curves. In the US, the terminal rate priced by the market is arguably too low, and we see scope for the market to re-price this on the back of some improvement in historically low

productivity and a reduction in growth headwinds that have been suppressing the neutral rate. However, the pace of hikes next year looks closer to fair given

the lagged impact of the US dollar on core PCE inflation, which should limit the

scope of hikes in 2016.

Credit: US credit feels the pressure of high commodity exposure

US credit markets made a U-turn midway through 2015, as doubts began to surface with respect to issuer fundamentals and exposure to commodities and EM. Though current spread levels are more attractive than those prevailing just

a few months ago – both HY and IG are at 3- to 4-year wides – we expect the

push-and-pull to continue between those seeking more yield and those seeing signs of a cycle turn. However, we expect only a moderate rise in ex-energy defaults and continued pressure on HY spreads. Higher vulnerability of HY therefore makes IG credit a more attractive alternative, especially in light of

current levels. We recommend avoiding sectors exposed to the energy sector's capital expenditure declines, such as capital goods. Two to three hikes by the

Fed should not be problematic for credit. Fundamentals are better for European credit: debt accumulation has been nowhere near as aggressive as in the US market, and European credit has far less exposure to the energy and materials sectors. Overall, Europe is some way behind the US in terms of a deteriorating credit cycle, so we believe European credit can continue to outperform even if US credit widens further.

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US equity strategy: Still-low Treasury yields despite Fed hikes to boost S&P PE

Our S&P 500 targets are 2100 for 2015 end and 2250 for 2016 end, representing 5-10% upside. Health Care and Tech – which represent more than one-third of the S&P 500 – are why we are reasonably bullish for 2016, while Energy and Industrials remain a significant concern. Most of the rest of the market, both the S&P and the Russell 2000, seems fully valued except a few big Banks, Utilities, Airlines, and some of our specific stock picks. We do not

believe that a recession looms or that S&P profits will fall again in 2016. We

also do not expect the S&P will suffer a bear market or a sharp correction. But

there are a number of key risks for equities: any further dollar gains must be

slow, wage gains must be accompanied by better productivity, and the rise in yields as the Fed hikes must be gradual and contained.

European equity strategy: 7% upside in 2016E but beware of the risk of a nearterm correction

We see around 7% upside for the European equity market by end 2016, with a target of 410 for the Stoxx 600. European equities should benefit from stronger

EPS growth, low real bond yields, FX support from a further decline in the euro,

and relatively attractive valuations. Among sectors, we like European banks, where investor pessimism persists despite relative return on equity rising to a

seven-year high, and cyclicals, especially tech and auto. We are more cautious

on the outlook for the resource sectors and consumer staples, which are exposed to a further decline in commodity prices and an additional drop in emerging market exchange rates and rise in US bond yields. There is a risk of a

5-10% correction in the near term if an adverse reaction to Fed hikes leads to a substantial tightening in global financial conditions.

FX: Plenty of run left in the USD upswing

Following the historical 20% surge in the US dollar over the past year and a half (on a trade-weighted basis), we see the dollar upswing extending for at least another two years, though at a more modest pace. There are several unique circumstances with the current dollar upcycle, including that G10 central banks are not expected to follow the Fed's tightening impulse this time

around. How 2016 shapes up will be heavily influenced by whether the main macro driver is the Fed or China. If it is the Fed, US dollar gains are likely to be

slow and broad-based. Conversely, if the RMB again becomes a source of instability, US dollar gains should be heavily concentrated in commodity and

EM currencies. Our end-2016 forecasts are largely unchanged: EUR/USD at 0.90, USD/JPY at 128, and GBP/USD at 1.27.

Commodities: Supply adjustment is well underway for oil, not so for the metals

We expect OPEC will have engineered one of the sharpest historical declines in

US production by next year. While we expect that the first half of 2016 will remain oversupplied and risks remain to the downside during this period, the steady contraction of US supply along with trend rates of demand growth should lead to a more normalised market balance in 2017. However, the current recovery period for oil will likely be one of the slowest and most extended on record. We remain bearish on the outlook for gold as the Fed enters a tightening cycle and the US dollar appreciates further. Several factors

contribute to a difficult outlook for industrial metals: the barriers to exit for

many industrial metals are high, the industry still has not adjusted to structurally lower Chinese demand growth, and long gestation projects continue to add supply to the market. While supply cuts should gather momentum in 2016, we expect price stabilisation only in 2017 when markets should start to look more balanced.

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Asset allocation: 2016 Outlook: The Case for normalization

Our global asset allocation strategists discuss several key themes and catalysts

for the year ahead: First, rate normalization cycles have always been associated with significant price losses on 10-year Treasury securities.

Second,

although credit spreads tend to tighten with higher rates, the over-allocation to

credit – especially high grade – tends to keep credit vulnerable to rate hikes.

Third, the equity risk premium is at a 70-year high and should fall as rates rise,

providing some upside to equities. Fourth, although oil should continue to be pressured by a rising dollar, it now looks close to fair value. Fifth,

rising EM

growth and more favorable positioning should support EM once US rates reprice the Fed. As a result, our asset allocation is overweight equities in the US and Japan but neutral European equities and underweight EM; underweight bonds, cash and commodities; and long the dollar.

Geopolitics: The EU's geopolitical crisis eclipses its economic crisis

Our geopolitical strategist considers the implications of the accelerating external and internal geopolitical threats to the EU. The migration crisis, the

war in Syria, and tensions with Russia related to its association with the Ukraine are likely to push the economic disputes of the euro crisis to the back

burner and bring the geopolitical dimension – the original motivation for European unity – back to the forefront. The still-incomplete Union now has to develop policy through a security lens, as bringing stability to its surroundings

is vital to the stability of the EU.

Risks to the Outlook:

Downside risks

|| Fed exit tantrum. We have assumed that the market's reaction to Fed normalization will be relatively muted, partly because we assume the Fed will strive, initially at least, to ease its way gradually into the exit process.

Given the current gap between Fed expectations and market expectations, the reaction to the exit path we forecast, as well as to the tapering of reinvestment, could be substantially more negative than we envision. Ten-year yields could spike above the nearly 3% peak level reached during the taper tantrum in 2013. This shock could spill over into a sharp drop in risk asset values, with negative implications for consumer and business spending domestically, as well as major declines in emerging market and other risk assets abroad.

|| Inflation surge. The negative scenario we have just described would be

intensified substantially if the Fed proves to be significantly behind the curve and inflation pressures pick up more rapidly than expected, forcing the Fed to tighten policy a good deal more aggressively than now envisioned. This could easily happen if labor force participation continues to trend down, GDP growth picks up more in line with consensus expectations, and productivity growth remains depressed. Under these circumstances, unemployment could easily move below 4% over the year ahead, and wage inflation, which is already showing signs of stirring upward, could surge enough to influence longer-term inflation expectations and push up core price inflation substantially more than currently expected or desired.

|| European politics: Our baseline expectation is that the common threat to security highlighted by the recent terror attacks in Paris unifies Europe at least temporarily. This should prevent various national idiosyncratic events from undermining area-wide stability. The risk is that the differences of opinion between countries on divisive themes like the refugee crisis spill over into other policy areas, creating less beneficial outcomes to situations such as Greek debt relief talks, the minority government in Portugal, fiscal

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flexibility, the UK's EU membership negotiations, etc. We expect the fiscal crisis early warning indicators based on macro fundamentals to remain low and improve very modestly in 2016. The risk in the disunity scenario is that idiosyncratic national political risks materialise and amplify market concerns.

|| Managing rebalancing in China: We continue to see downside risks in China, especially from the external vantage. While the government may be committed to keeping growth from falling below 6.5%, the need to restructure commodity-intensive heavy industrial sectors, coupled with the weak property investment outlook, offers little support to commodity exporters who will have to continue to make cuts of their own. We see this challenge as being fraught with downside risks in China, as restructuring will inevitably lead to job losses, which we struggle to see being offset by hiring in other sectors. A rise in unemployment and consequent slowing of consumption growth could weaken neighbouring economies' exports to China.

Upside risks

|| Productivity rebound: We have assumed that business fixed investment remains subdued, helping to keep labor productivity growth depressed. But given recent technological advances, it might take only a relatively moderate increase in capital spending to reap a substantial rebound in productivity growth. Incentives to raise productivity will increase as the labor market continues to tighten, so our pessimism about investment growth may not be so well founded. In any event, a relatively quick return of the growth in US labor productivity for overall GDP from its near-zero level in recent years to a historically more normal level of 1.5-2% would mean the economy could grow at 2%-plus without tightening the labor market further, and allowing the Fed to normalize rates at an even slower than we are projecting. This would be a plus for the US and global economy.

|| Upside surprise to US growth: Our substantial markdown to US growth expectations has lowered the bar for an upside surprise next year. And there are reasons to view the risks to this outlook as skewed to the upside: fiscal headwinds have faded and there is potential for a stronger fiscal boost next year; the peak response of business investment to the sharp drop in oil prices is likely behind us; and the peak drag of the dollar on net exports should dissipate beyond mid-year. With the consumer expected to continue to show solid gains, especially as wages rise, and with housing market activity still well below normalized levels, we could see our first upward revision to US growth – relative to the start of the year – since the financial crisis.

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US: Dollar drag

|| On the back of weak manufacturing and international trade data, secondhalf 2015 real GDP growth is poised to rise by less than 2% as currentquarter output is projected to increase just 1.5%. This would result in 2015 growth of 2.0% (Q4/Q4), slightly below the 2.2% average annualized gain in economic output since the economy exited recession more than six years ago. More importantly, we expect 2016 real GDP growth to come in at only 2.2% (Q4/Q4), down 50 basis points from our previous estimate. This is due to a reassessment of the negative effects of the rising dollar and the possibility of further appreciation yet to come.

|| Nevertheless, with real potential GDP growth only around 1% due to slowing productivity growth, even a trend-like 2% GDP growth rate would likely be enough to put further downward pressure on the unemployment rate. Consequently, this should keep the Fed on track to raise interest rates, albeit at a very modest pace, as policymakers gain confidence that a tightening labor market will engender faster wage gains and a cyclical firming of inflation toward their 2% long-term goal.

|| The US factory sector is bearing the brunt of depressed global demand. The manufacturing ISM survey is in contraction territory, and the industrial production index is down from its cyclical peak in December 2014. Given that changes in the trade-weighted dollar tend to affect net exports with a substantial lag, the economy has yet to experience the full impact of the appreciating dollar. If the trade-weighted dollar remains at its current level or appreciates further, net exports could pose a more significant drag on US economic activity.

|| Based on the appreciation to date, we estimate the rise in the dollar is worth roughly 60 basis points of monetary tightening. The fact that the currency is doing some of the Fed's work for it is one reason why we expect the trajectory of interest rates to be mildly shallower than that implied by the FOMC's central-tendency forecasts. The strong dollar will also weigh on import prices, and hence consumer goods inflation. To be sure, there is a risk that the US dollar will rise substantially further because

the Fed is the only major central bank that is beginning to remove monetary accommodation. Other central banks, notably the ECB, are further easing monetary policy. Furthermore, the US factory sector is being hamstrung by a mini-inventory cycle that is also depressing output. This destocking will likely end next quarter. In the interim, the consumer looks set to continue to do the heavy lifting with respect to growth, but we expect spending to modestly slow over the course of next year because of the waning impact of the energy tax cut, a substantial portion of which appears to have been saved.

|| Additionally, we see only modest scope for non-residential investment to fill the void, as the uncertainty around global growth prospects and the outcome of the US Presidential Election may keep companies in a wait-and-see mode with respect to capital spending plans. While the drag from energy-related capital spending should dissipate in the coming quarters, it is not likely that we will see a meaningful boost to output growth from non-residential investment over the next several quarters.

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Figure 1: Macro-economic activity & inflation forecasts: US

Economic activity

2015

(% qoq, saar)

GDP

Private consumption

Investment (inc. inventories)

Gov't consumption

Exports

Imports

Contribution (pp): Stocks

Net trade

Industrial production

Unemployment rate, %

Prices & wages (% yoy)

CPI

Core CPI

Producer prices

Compensation per empl.

Productivity

Source: National authorities, Deutsche Bank Research

Q1

0.6

1.7

8.6

-0.1

-6.0

7.1

0.9

-1.9

n.a

5.6

-0.1

1.7

-3.3

1.8

0.6

Q2

3.9

3.6

5.0

2.6

5.1

3.0

0.0

0.2

n.a

5.4

0.0

1.8
-3.2
2.4
0.8
3.0
-0.3
1.7
0.9
2.1
-0.6
-0.2
n.a
5.2
0.1
1.8
-3.2
2.4
0.4
1.5
2.7
2.0
2.7
-1.3
1.4
-3.0
0.0
-1.2
-0.4
n.a
5.0
0.9
2.0
-1.2
2.6
1.3
6.4
1.6
-7.0
2.0
0.0
-1.2
n.a
4.9
2.1
2.0
2.2
3.3
2.0
2016
2.2
2.7

6.1
 1.6
 -5.0
 2.0
 0.0
 -1.0
 n.a
 4.8
 1.8
 1.9
 1.9
 4.0
 1.4
 2.1
 2.3
 6.3
 1.6
 -3.0
 3.0
 0.0
 -0.9
 n.a
 4.7
 2.0
 2.0
 2.5
 4.4
 1.3
 2.4
 2.2
 6.2
 1.6
 0.0
 3.0
 0.0
 -0.5
 n.a
 4.6
 2.0
 2.1
 2.5
 4.5
 1.3
 2015F 2016F 2017F
 Q3 Q4F Q1F Q2F Q3F Q4F % yoy % yoy % yoy
 2.1
 2.4
 3.1
 5.0
 0.8
 1.1

5.0
0.1
-0.6
0.0
5.3
0.2
1.8
-2.7
2.3
0.8
2.1
2.7
3.9
1.6
-3.3
1.9
-0.3
-0.7
3.0
4.8
1.9
2.0
2.3
4.1
1.5
2.1
2.1
4.5
1.6
0.9
3.6
0.0
-0.5
3.0
4.4
2.3
2.2
3.2
4.5
1.3

The Fed goes it alone. As US monetary policy diverges from that of its major trading partners in 2016, the dollar should continue to appreciate. As a result, we expect net exports to continue to drag meaningfully on economic activity. At the same time, the strong dollar will weigh further on import prices, likely suppressing consumer goods inflation through 2017. These projections are corroborated by simulations of the Federal Reserve Board's FRB/US macroeconomic model. Therefore, we have cut our 2016 real GDP growth forecast (Q4/Q4) to 2.2% from 2.7%. Additionally, we have lowered our 2016 core PCE inflation forecast (Q4/Q4) by two-tenths to 1.7%. For 2017, our

growth and core PCE inflation forecasts are similarly modest at 1.9% and 2.1%, respectively. Moreover, the effect of the appreciating dollar on growth and inflation should serve as a headwind to rate hikes. For this reason we expect only a cumulative 100 basis points (bps) of interest rate increases through yearend 2016, and 200 bps of hikes through 2017. These forecasts are slightly more conservative than the FOMC's most recent median projections, which call for policy rate increases of 125 bps and 250 bps through 2016 and 2017, respectively.

The Greenback goes gangbusters. Since July 2014, the inflation-adjusted broad trade-weighted dollar has appreciated 16%, among the largest moves on record. The dollar has gone from strength to strength because the US economy is arguably the healthiest of the major industrialized economies, and the Fed has consistently signaled its intention to raise interest rates this year.

Other central banks such as the BOJ and the ECB are at very different stages of the business cycle and are pursuing expansionary monetary policies to lift inflation.

What does FRB/US say? To gauge the implications of the strengthening dollar for monetary policy, we simulated a one-time, 16% shock to the real tradeweighted

dollar in the Fed's macroeconomic model of the US economy, often referred to as FRB/US. All else being equal, the simulated shock causes the real

output gap to widen by nearly -50 bps by yearend 2016 and more than -70 bps by yearend 2017. Even absent any additional shocks, the dollar drag will remain

substantial for about four years according to the FRB/US model. With the dollar

likely to remain firm, if not appreciate a bit further, it is possible that the dollar

drag might persist even longer than the FRB/US model presently projects.

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Figure 2: The real trade-weighted

dollar has appreciated sharply

Index

100

110

120

130

80

90

1980 1985 1990 1995 2000 2005 2010 2015

Source: FRB, Haver Analytics LP, Deutsche Bank Research

Real broad trade-weighted USD index

Figure 3: According to the FRB/US

model, dollar appreciation would

result in a large drag on output

Response of output gap

bps

10

-80
-70
-60
-50
-40
-30
-20
-10
0
0
2
4
6

8 10 12 14 16 18 20
Quarters after shock

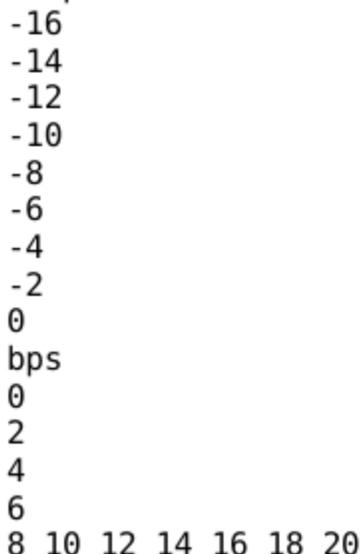
Source: FRB, Deutsche Bank Research
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The impact of the trade-weighted dollar on inflation is much more benign than the impact on growth. According to our FRB/US simulations, the recent dollar appreciation would subtract between one- and two-tenths from core PCE inflation over the next couple of years. This may not seem like much, but core inflation has been running significantly below the Fed's 2% target for the past three years. For inflation to rise toward that level, either dollar strength will have to reverse, or services prices will have to rise further, thereby offsetting the effect of the former on goods prices. Given our expectation of a further significant decline in the unemployment rate, services prices, which are dominated by the cost of labor and housing rents, should increase further. Since services account for roughly two-thirds of the core PCE deflator and goods the remaining one-third, acceleration in services prices could offset the deflationary impact of the strong dollar on goods prices. Our forecast assumes that services inflation will continue to accelerate, thus allowing policymakers to proceed with interest rate hikes, but at a very gradual pace relative to prior monetary tightening cycles. Inflation is expected to only gradually return to its 2% target over the next couple of years. The estimates of the FRB/US model are broadly consistent with our estimates of the impact of the appreciation of the dollar on the contribution of net exports in the GDP accounts.

1
Figure 4: According to the FRB/US model, dollar appreciation would result in a modest drag on inflation
Response of core inflation



Quarters after shock

Source: FRB, Deutsche Bank Research

Traditionally, changes in the trade-weighted dollar tend to impact net exports with a lag of approximately two years. When the dollar strengthens, net exports tend to weaken as US export prices become less competitive in the global marketplace and imported goods become relatively cheaper. In the process, domestic production and employment could suffer.

The manufacturing sector is most acutely impacted by the strength of the dollar. However, this weakness is being exacerbated by the excessive inventory building in the first three quarters of the year, which has left inventories elevated relative to demand. Hence, de-stocking is likely contributing to the slowdown in manufacturing output as well. While the inventory unwind should prove temporary, the lagged impact from the dollar will likely prevent a meaningful recovery in the manufacturing sector, which is

in contraction territory. It is noteworthy that the manufacturing ISM is highly

correlated with real GDP growth, even though the manufacturing sector accounts for only 12% of total economic output.

Watching the dot plot. The appreciation of the dollar is a key reason why the Fed trimmed its growth and inflation forecasts this year. A stronger dollar has

the same effect on growth and inflation as monetary tightening. Therefore, dollar strength will likely continue to be a meaningful headwind to rate hikes in

2016 and 2017, and possibly beyond. The Figure 8 below shows the FOMC's "dot plot" versus our forecasts and the latest futures market pricing. While the

fixed income market is nearly fully pricing a December rate hike, financial market participants expect a much shallower trajectory for the fed funds rate than what the Fed is currently projecting. If the Fed does not reduce its longerterm

forecasts of the fed funds rate, the ongoing divergence between what investors are expecting and the Fed is predicting could cause financial market

turbulence. Our own estimates of the path of interest rates are between those of the financial markets and monetary policymakers.

Figure 5: The expected drag from net exports due to dollar appreciation is meaningful

% yoy

10

15

-15

-10

-5

0

5

Real broad trade weighted USD (lhs)

Contribution of net exports in real GDP (rhs)

%, inverted

axis

2015 estimates

Correlation = 0.54

1980 1985 1990 1995 2000 2005 2010 2015

Source: FRB, BEA, Haver Analytics LP, Deutsche Bank Research

-2

-1

0

1

2

Figure 6: The manufacturing ISM and the new export orders series are both in contraction territory

ISM manufacturing

30.0

37.5

45.0

52.5

60.0

67.5

PMI composite index

Index

New export orders

Correlation = 0.62

1990

1995

2000

2005

2010

Source: ISM, Haver Analytics LP, Deutsche Bank Research

2015

1 Fed Vice Chair Fischer cited similar effects in a Jackson Hole speech earlier this year.

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The "energy tax cut" was saved. Our forecasts are predicated on the continuation of decent consumption growth, because there is little evidence pointing to a sustained increase in business fixed investment. Conceivably, the

latter could be boosted if oil prices rebound, thereby providing a lift to energy-related

capital expenditures. However, rising energy prices could dampen consumer spending as real incomes would compress. Essentially, there is asymmetry in consumer behavior, as falling energy costs do not really lift spending but rising energy costs hurt spending. Note that despite easy money, good job gains, rising net wealth and falling energy costs, the household savings rate has increased 110 bps over the last 12 months to 5.6%.²

As the

Fed attempts to push short-term rates higher, it is possible that households will

allocate more disposable income to savings. If consumers become more cautious about the economic outlook—the recent declines in consumer confidence bear watching—and spending is reined in, growth will slow to an even more underwhelming pace that leaves the economy vulnerable to an external shock, as there will be even less of a cushion between expansion and contraction. In this case, the Fed will likely pursue a much shallower path of

rate hikes than what it is presently assuming.

Despite our baseline expectation of just 2% economic growth, the unemployment rate is likely to continue to decline further. Our central forecast

assumes the rate will fall to 4.6% by yearend 2016, which is below the Fed's 4.9% median central tendency of the non-accelerating inflation rate of unemployment, also referred to as the NAIRU. The unemployment rate is then expected to move even lower in 2017. In turn, this should keep the Fed on a monetary-policy tightening track, as wage costs accelerate in response to tightening labor supply.

As always, there are risks to the economic and financial outlook. Arguably, there is greater uncertainty than in the recent past because of the notable divergence in global central bank policy. This makes the economic outlook much more tenuous than in recent years.

|| With respect to downside risks to growth, the recent dollar appreciation could continue to exert a larger-than-anticipated drag on the economy through the exports channel.

|| Beyond the possible further strengthening of the dollar, financial market conditions could tighten because of higher interest rates. As the Fed begins the process of interest rate normalization and contemplates the wind-down of its \$4.5 trillion balance sheet, a sudden spike in rates, similar to the 2013 "taper tantrum", could meaningfully dent housing activity (a current bright spot in the US economy) and engender an even weaker profile of investment spending.

|| With the economy nearly 6.5 years removed from recession, the business cycle is getting old in terms of years. While cycles do not die from old age but rather from imbalances built up in the system, downturns tend to be unexpected. The current cycle is longer than the 2001-07 episode and ranks as the fifth-longest in the last 150 years. It is hard to see the economy expanding for another six-plus years without a recession. In an environment of just 2% GDP growth, the economy is vulnerable to a negative exogenous shock, especially with little countercyclical policy available to the authorities—monetary policy is providing record stimulus and fiscal policy is paralyzed at the moment.

Figure 7: Underlying GDP growth has consistently reverted back to a sub-3% trend

% yoy

-6
-4
-2
0
2
4
6
8

Real GDP

Current business cycle

Average of last 9 cycles

-4 -2 0 2 4 6 8 10 12 14 16 18 20 22 24

"0" represents the recession end date

Source: BEA, Haver Analytics LP, Deutsche Bank Research

Figure 8: Our forecasts for rate hikes

are between those of the market and the Fed

-1
0
1
2
3
4
5

Minutes Sep-15

Sep-15 Median

DB Forecast

OIS

2015

2016

Source: Deutsche Bank Research

2017

2018

Longer Term

Figure 9: The unemployment rate

has fallen below the CBO's estimate

of the NAIRU

%

10

2

4

6

8

1990

1995

2000

2005

2010

2015

Source: BLS, CBO, Haver Analytics LP, Deutsche Bank Research

Unemployment rate vs NAIRU

Unemployment rate

NAIRU

2 "Oil prices and consumer spending: A crude relationship" US Economics Weekly November 20, 2015.

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Of course, there is always the possibility that growth surprises to the upside—although this is less likely because the economy has underperformed policymakers' expectations over the past half-dozen years. In terms of the upside risks to growth, the rapid appreciation of the dollar may already reflect the expected divergence of central bank policies. In turn, the pace of dollar appreciation may slow significantly over the coming quarters, and could even reverse, resulting in less drag on domestic production from the export sector than we currently assume.

Another potential upside risk is the labor market. As the job market continues to strengthen and the unemployment rate declines meaningfully further, wage and income growth may rise faster than expected, providing households with even more spending power than we envision. In this scenario, the pace of Fed rate hikes would be significantly faster than that implied by the current median FOMC projections.

The final upside risk pertains to inflation. The aforementioned potential for accelerating wage gains combined with a more dramatic recovery in energy prices relative to our projection—possibly due to either a stronger recovery in overseas growth or substantially less oil production—may push headline inflation more quickly back toward the Fed's 2% target. Relative to all of the aforementioned risks, this is perhaps the one that financial markets are least prepared for.

Figure 10: External balances & financial forecasts

Fiscal balance, % of GDP

Trade balance, USD bn

Trade balance, % of GDP

Current account, USD bn

Current account, % of GDP

Financial forecasts

Official

3M rate

USD per EUR

JPY per USD

USD per GBP

2014 2015F 2016F

-2.8

-508

-2.9

-390

-2.2

-2.4

-545

-3.0

-436

-2.4

0.13
0.46
1.09
123
1.51
-2.2
-664
-3.6
-531
-2.8
0.875
1.08
0.97
128
1.37
2017F
-2.1
-742
-3.8
-593
-3.1

Current Q1-2016 Q2-2016 Q4-2016

0.625

0.83

1.01

127

1.42

1.125

1.33

0.90

128

1.27

Source: Deutsche Bank Research as of December 07.

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Europe: Not a global engine

|| We expect euro area GDP growth to be broadly unchanged at 1.6% in 2016 and to slow in 2017. The global recovery will be less supportive than we previously thought. This year's stimulus from lower oil prices won't be repeated and probably reverses in 2017. Joint monetary and fiscal policy will help compensate in 2016 but not in 2017.

|| Broad financial conditions should start 2016 easy before tightening into year-end. The output gap will gradually narrow even with these modest rates of GDP growth and past euro depreciation is starting to become more visible in inflation. By end 2016, the ECB's medium-term headline inflation projections should be at levels consistent with a tapering discussion. While refugee and security-related public spending is likely to see fiscal policy relax next year, we expect compliance with fiscal rules to improve in 2017.

|| Political uncertainty is likely to rise into 2017. The refugee crisis has created frictions but the common threat to security may unify Europe and reduce the risk of local political events – Greek debt relief negotiations, Portugal's minority government, Catalonia's independence bid, the UK's EU negotiations – from undermined area-wide stability in 2016. The unity won't last into 2017. The closer we get to the Dutch, French and German elections in 2017 –Italy may bring forward its election into 2017 too – the more disharmonious the EU is likely to sound. This will weigh on structural reform, and market may take notice.

|| Despite fiscal austerity, a strong currency and maybe some EU referendum-related uncertainty, UK GDP growth will be no worse than trend in 2016, helped by robust private consumption. Inflation base effects will push inflation back up and we continue to see the Bank of England achieving rates lift-off in May. The referendum vote could be as soon as late next year. According to opinion polls, the outcome looks closer than the last referendum in 1975 when 66% voted to remain in the EU.

|| The EMEA region is a case of contrasting paths. CEE is characterized by decent growth with little or no inflation and scope to ease further if necessary. The economies elsewhere in EMEA are either experiencing recession or faltering growth but high inflation affords little if any room to provide offsetting policy support.

Figure 1: Macro-economic activity & inflation forecasts:

2015F 2016F 2017F

GDP (% yoy)

EU

Euro area

Germany

France

Italy
Spain
UK
Sweden
Denmark
Norway
Switzerland

1.8

1.5

1.7

1.1

0.7

3.2

2.4

3.2

1.6

1.4

1.0

1.9

1.6

1.9

1.4

1.4

2.8

2.5

2.7

1.7

1.4

1.2

Source: National authorities, Deutsche Bank Research

1.7

1.5

1.6

1.5

1.0

2.3

2.3

2.5

1.8

2.2

1.6

CPI (% yoy)

2015F 2016F 2017F

0.1

0.1

0.2

0.1

0.1

-0.6

0.0

0.0

0.5
 2.1
 -1.1
 1.0
 0.9
 1.2
 0.8
 0.8
 0.7
 1.1
 1.0
 1.4
 2.4
 -0.4
 1.7
 1.6
 1.7
 1.3
 1.5
 1.6
 1.9
 1.9
 1.8
 2.3
 0.3
 EEMEA
 Poland
 Hungary
 Czech Republic
 Romania
 Russia
 Ukraine
 Kazakhstan
 Israel
 Turkey
 South Africa
 GDP (% yoy)
 2015F 2016F 2017F
 1.0
 3.4
 2.7
 4.5
 3.7
 1.9
 3.5
 2.4
 2.7
 4.0
 -3.7
 -9.7
 1.5

2.4
2.9
1.3
-0.7
3.0
2.0
2.8
3.1
1.1
2.5
3.5
3.3
3.2
3.0
0.5
3.0
3.6
3.5
3.5
1.3
CPI (% yoy)
2015F 2016F 2017F
6.7
1.1
2.1
1.6
8.7
-0.9
0.0
0.4
-0.6
15.6
48.7
6.4
-0.5
7.6
4.6
-0.2
9.2
15.3
14.2
0.8
7.8
6.4
5.9
1.7
2.7
2.0
2.6
7.1
9.3

6.5

1.2

7.5

6.5

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Euro area

Modest growth to continue in 2016, slow in 2017

Our forecast for euro area GDP growth in 2016 remains unchanged at 1.6%. A modest pick-up in global growth should help as should the benefits of easier monetary and fiscal policy, including a weaker currency. Compared to our previous forecasts, policy easing has increased in volume. This is balanced by

less external support than we were expecting earlier. Political and geopolitical

risk may weigh too. The net impact is we see a little less growth in exports, private consumption and investment in 2016, a little more from government consumption but overall GDP growth broadly unchanged at 1.6%.

Our expectation is that euro area GDP growth will decelerate in 2017 to 1.5%.

Full-year GDP growth masks the true extent of the slowdown: average annualized rates of growth should slow from 1.7% in 2016 to 1.4% in 2017.

Global growth should accelerate into 2017, but we expect headwinds from rising oil prices, the euro exchange rate, fiscal policy and political uncertainty.

Euro area and global GDP growth are normally highly correlated. Disappointing external growth was masked in 2015 by much lower-than-expected oil prices. Global growth is expected to accelerate modestly in 2016, but less than we expected in our last quarterly review. The ratio of global trade to global GDP

growth has also deteriorated further. We expect the euro exchange rate to depreciate over the next year thanks to the ECB's monetary policy stance but to be no weaker than we were previously assuming.

Lower oil prices helped private consumption compensate for disappointing net trade in 2015. Employment was a little better than expected, compensation growth was weaker, but a lower deflator (lower oil prices) pushed real private

consumption growth higher. Real PCE growth will probably slow in 2016. Base effects will push the deflator up while small improvements in employment and wages, a looser fiscal stance and a decline in savings (low interest rates, robust

confidence) should limit the deceleration in PCE growth. 2017 will likely be more difficult for private consumption as oil prices are expected to rise 10% in

dollar terms and the fiscal rules are expected to bite again.

Figure 2: As the lower oil price effect

fades in 2016, real compensation growth should deteriorate, dragging

on private consumption

% yoy

-2.5

-2.0

-1.5

-1.0

-0.5

0.0

0.5
1.0
1.5
2.0
2.5
3.0
3.5
4.0

2012
2013

PCE deflator
Compensation per employee
Employment
Real total compensation

2014
2015

Source: Deutsche Bank Research , Eurostat

2016
2017

Figure 3: Investment spending
recovery has flattened
EA non-construction investment spending (lhs)
German mfg orders from EA ex heavy transport (rhs)

10
15
20
-20
-15
-10
-5

0
5

% yoy
%yoy

10
20
30

correlation, orders
lagged 1 qtr: 0.88

2004
2006
2008
2010
2012
2014

Source: Deutsche Bank Research , Eurostat, Haver Analytics LP

-40
-30
-20
-10
0

Figure 4: Macro-economic activity & inflation forecasts: Euro area

Economic activity

2015

(% qoq, saar)

GDP

Private consumption

Investment

Gov't consumption

Exports

Imports

Contribution (pp): Stocks

Net trade

Industrial production

Unemployment rate, %

Prices & wages (% yoy)

HICP

Core inflation

Producer prices

Compensation per empl.

Productivity

Source: National authorities, Deutsche Bank Research

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Q1

2.1

1.9

5.6

2.2

4.2

6.3

0.2

-0.7

0.9

11.2

-0.3

0.7

-2.9

1.4

0.4

1.4

1.5

-1.9

1.0

6.5

3.9

-0.5

1.3

1.9

11.0

0.2

0.8

-2.1

1.4
 0.7
 1.2
 1.6
 2.8
 0.4
 3.2
 5.3
 0.3
 1.4
 1.7
 2.0
 1.8
 4.5
 4.1
 -0.7
 2.0
 10.8
 0.1
 0.9
 -2.6
 1.4
 0.7
 -0.6
 0.3
 2.0
 10.7
 0.3
 1.0
 -2.5
 1.4
 0.5
 1.7
 1.7
 3.6
 1.2
 4.1
 5.3
 0.2
 2016
 2015F 2016F 2017F
 Q2 Q3F Q4F Q1F Q2F Q3F Q4F % yoy % yoy % yoy
 1.6
 1.7
 1.4
 3.2
 1.3
 4.1
 4.9
 0.2
 -0.3

1.8
10.6
0.9
1.2
-0.6
1.4
0.4
-0.2
1.8
10.4
0.6
1.2
-0.6
1.4
0.5
1.8
1.4
3.7
1.2
4.1
5.1
0.3
-0.3
1.6
10.3
1.0
1.3
0.5
1.5
0.6
1.8
1.4
3.4
0.8
4.1
4.5
0.2
0.0
1.6
10.2
1.3
1.4
1.4
1.5
0.6
1.5
1.8
2.0
1.2
4.7
5.1

-0.2
0.1
1.4
11.0
0.1
0.9
-2.5
1.5
0.6
1.6
2.8
1.2
4.2
4.8
-0.1
0.0
2.0
10.4
0.9
1.3
0.2
1.5
0.6
1.5
1.4
2.8
0.6
4.1
4.6
0.3
-0.2
2.3
10.0
1.6
1.5
1.6
1.6
0.6

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The investment spending recovery is losing momentum and turning volatile. Financing conditions should remain supportive – most visible to date in construction spending – but sluggish export demand and geopolitical risks will likely weigh. The euro area labour market has improved more rapidly than the historic Okun coefficient would have implied. This is consistent with weaker post-crisis productivity. Limited prospective returns may be dampening the investment recovery. The Juncker investment plan (European Fund for Strategic Investments or EFSI) will help to lean against this trend.

Sovereign QE began in early 2015. The principal transmission channel was a weaker exchange rate but the benefits were squeezed by the 7% appreciation of the euro trade-weighted index between March and September, reversing half the decline that preceded QE. This knocks 0.1% off 2016 GDP growth. There are also domestic transmission channels for QE. Real economy credit conditions have improved to pre-crisis levels. The average interest rate on bank

loans to the non-financial corporate sector has fallen 80bp from the peak. Lower interest rates supported asset prices and 2015 saw collateral values play

a role in easing lending standards for the first time since 2007.

Policy stance to benefit from joint monetary/fiscal policy push

Financial conditions remain close to the easiest levels of the cycle even after

the miscommunication ahead of the December ECB meeting that left the market disappointed with the outcome. What the ECB announced was nevertheless close to our original expectations. We have not changed the FX assumption underlying our economic forecasts that the euro falls by 5% in trade-weighted terms between 2015 and 2016.

The ECB appears confident its unconventional policies are working, for example, through the bank lending channel. There are challenges, however. First, it may prove difficult to accelerate the credit impulse in 2016. The credit

impulse is based on the second derivative of bank credit. The credit impulse improved in 2015 from the transition from deleveraging to credit expansion; for

some large countries like Spain, there was only a slower pace of deleveraging.

Maintaining the credit impulse at the same level in 2016 requires lending to accelerate. With high debt ratios in several countries, this will be challenging,

not least in Spain. Second, the ECB is concerned about the high level of NPLs and the slow pace of dealing with them. The flattening in the rate of GDP growth could raise banks' caution. The flattening yield curve will also reduce

banks' incentive to lend.

The euro area benefited more from a combined monetary/fiscal stimulus in 2015 than had been anticipated with the fiscal stance supportive of economic growth for the first time since 2010. This should continue in 2016. The bottomup

aggregation for the fiscal stance looks no stronger than 2015 but is

probably an underestimate (e.g., higher refugee and security-related public spending).

We do not believe the joint policy push will persist. We are concerned that the

Commission's flexibility on the fiscal rules will reverse. Our early warning indicator of fiscal crisis risk is below the levels it reached for the peripherals in

2009-2010. A moderate slippage in fiscal performance over the next year won't change this assessment; the fiscal risk sub-index should be no worse in 2016 than in 2014. Our concern is more that idiosyncratic national political risks materialise and amplify market concerns, for example, in Portugal (see below).

End 2016 could see the first ECB tapering discussion

If growth and inflation perform in line with our baseline forecasts, the measures announced by the ECB on 3 December ought to be the last major

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Figure 5: Unexpected 2015 euro appreciation dampens 2016 GDP

growth

Index

100

105

110

80

85

90

95

2012

2013

Actual

Current assumption

Source: Deutsche Bank Research , ECB

2014

2015

Euro trade-weighted index

Forecast

Difference

equivalent to

-0.1% off GDP

growth in

2016

2016

2017

Previous assumption

Figure 6: Financial conditions are

easy

0.0

0.2

0.4

0.6

0.8

1.0

1.2

Euro area narrow Financial Conditions

Index (market-based)

Rising means easier, falling means tighter

of standard deviations

20140101 20140618 20141203 20150520 20151104

Source: Deutsche Bank Research , Bloomberg Finance LP, Haver Analytics LP

Figure 7: Bottom-up fiscal stance estimates underestimating extent of fiscal easing in 2016

1.5

0.5

1

-0.5

0

-1.5

-1

-2

2007

2009

2011

2013

2015

Source: Deutsche Bank Research , European Commission

2017

Forecasts

'Fiscal Stance' (change in the structural primary budget balance), pp of GDP positive numbers are a tightening of the fiscal stance, negative numbers a loosening of the fiscal stance

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easing moves of the cycle. The outlook for economic recovery is not strong, but modestly above-trend economic growth means a gradual narrowing of the output gap and hence a gradual normalisation of core inflation. We expect that

roughly a year from now the ECB will have to think about whether to extend QE again or to taper in 2017. It may be slightly more marginal after what happened on 3 December, but the balance of probabilities suggests that a tapering discussion is likely to take place.

On current expectations, core inflation will have risen to within a couple of tenths of its historical average in H2 2016 and will be on course for a further

correction upwards in 2017 and 2018. The ECB has tended to announce new unconventional policy measures when the two-year ahead consensus headline inflation forecast is 1.6% or lower and tighten policy when it is 1.9% or higher.

If our forecasts for core and non-core inflation are correct – in particular our

expectation for rise in oil prices in 2017 – headline inflation ought to satisfy

the criterion for tightening policy.

Mario Draghi is likely to be cautious. A sustainable correction in inflation is the

objective – this means more than just reaching the inflation target for one year.

The ECB will be nervous of creating its own 'taper tantrum'. We expect the ECB to taper its QE purchases, meaning that purchases will continue after the current scheduled end date of March 2017 at a declining rate. A decision to taper is the first step towards exit and that is likely to result in a euro fixed

income market correction/normalisation later in 2016, tightening financial conditions. We see the first ECB policy rate hike only at the end of 2018.

The risk is that oil prices continue to decline in the near term and weigh on headline inflation. If this weakens medium-term inflation expectations, the late2016

tapering risk will dissipate and the pressure for further ECB easing will grow.

Political risks to rise into 2017

In Spain we think the tail risk of a radical party having a position of influence

within the new government is low. Beyond that, however, the euro area is dotted with potential risks. Portugal's minority Socialist government looks unlikely to survive a major test, particularly if it requires more austerity and

reform. The Catalan independence bid is a source of uncertainty. Ireland's outgoing coalition has a tailwind from strong GDP growth but is short of majority on current polls. Italy is the peripheral with the largest proportion of

votes going to eurosceptic and populist parties. The risk is that the 2018 Italian

election is brought forward one year. Opinion polls leave the UK referendum on EU membership – possibly in late 2016 – too close to call for now. The greatest political tests for Europe next year come from the refugee and terror crises. The conservative backlash in Germany against Merkel's initial welcoming is very gradually narrowing differences across countries on how best to address the refugee wave. The new terror dimension to the refugee crisis we believe will more likely than not lead Europe to a more unified stance.

Germany may be more willing to compromise on otherwise more divisive issues like Greece debt and fiscal easing to secure a better deal for refugees,

for example, or more funds to deal with the crisis 'at source'.

However, we do not expect any real progress on euro area integration – greater fiscal autonomy as a compromise for Catalonia would be the opposite of what a stronger euro area requires – nor do we expect the unified stance to last into 2017. The closer we get to the German, French and Dutch elections in 2017, the more disharmonious Europe is likely to sound.

Political

uncertainty will likely be another hurdle to growth in 2017 while elections create reasons for further delays to structural reforms.

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Figure 8: Balance of probabilities

points to initial ECB tapering

discussion in late 2016

1.0

1.2

1.4

1.6

1.8

2.0

2.2

%

Policy tends to tighten

above 1.9%

Probable area

of forecast

by H2 2016

Unconventional

policies implemented

below 1.6%

ECB Survey of Professional Forecasters

two-year ahead consensus headline

inflation forecast

2000 2002 2004 2006 2008 2010 2012 2014 2016

Source: Deutsche Bank Research , ECB

Figure 9: Fiscal risk get more worse

in 2016; it is political risk we need to

focus on

0.0

0.1

0.2

0.3
0.4
0.5
0.6
0.7
0.8
0.9
1.0

Early warning indicator - fiscal sub-index

Forecast

EA weighted avg

max

min

2005

2007

2009

2011

2013

2015

0.0 indicates none of the components are above the crisis threshold level, 1.0 indicators all are above the crisis threshold

Source: Deutsche Bank Research

Figure 10: Other indicators & financial forecasts: Euro area
2014

M3 growth, % yoy eop

Fiscal balance, % of GDP

Public debt, % of GDP

Trade balance, EUR bn

Trade balance, % of GDP

Current account, EUR bn

Current account, % of GDP

Financial forecasts

Official

3M rate

10Y yield

USD per EUR

JPY per EUR

GBP per EUR

3.7

-2.6

94.5

241.8

2.4

245.6

2.4

2015F

4.7

-2.2

94.6

328.0

3.2
308.0
3.0
0.05
2016F
5.5
-2.0
94.0
295.8
2.8
290.8
2.7
0.05
2017F
5.2
-1.6
92.8
256.3
2.3
251.3
2.3
Current Q1-2016 Q2-2016 Q4-2016

0.05
0.05
-0.11
0.69
1.09
134
0.72
-0.15
0.65
1.01
128
0.71
-0.15
0.80
0.97
124
0.71

Source: National authorities, Deutsche Bank Research, as of
December 07

-0.15
1.10
0.90
115
0.71

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Summing up

The net result of all these forces is that we see euro area GDP growth at 1.6%

in 2016, the mildest of accelerations on 2015 and consistent with our earlier views. However, the composition of growth has changed compared to earlier views. Export growth is expected to be a little slower, with indirect impacts on

investment and employment. Monetary and fiscal policy will try to fill the hole

left by the discontinuation of this year's oil stimulus. The biggest risk to growth

in 2016 is that the joint policy effort does not replace the fading oil stimulus.

We fear 2016 will mark the peak rate of growth in this recovery and GDP growth will be slower in 2017. Oil prices pose a significant threat in 2017.

Our commodity strategists expect oil prices to rise in 2017, for supply reasons, not

demand. The fiscal rules are likely to bite more in 2017 than 2016. If inflation is

rising, the ECB will probably not turn on the monetary spigot again either.

Structural reform has been very modest, meaning little expectation for a noncyclical

recovery. The onus will increasingly be on the global recovery to compensate. Given the repeated overestimation of global growth in recent years, a stronger global economy has a lot to prove.

Euro area inflation: Normalising

Euro area inflation should recover gradually over the coming quarters as (1) the

drag from lower commodity costs is assumed to progressively fade, (2) the weaker exchange rate is putting upward pressure on non-commodity import prices and (3) improving economic conditions and ECB support for expectations allow some normalisation in domestic inflation.

Point (1), above, is likely to mean that consumer energy inflation will rise quickly into 2016; under our assumptions, headline and core inflation are expected to converge by the end of 2016. Indirect effects via domestic production costs are however one factor working against a quick rise in underlying inflation.

(2) has been increasingly visible in some HICP components, with HICP durable goods inflation for example running at close to record highs in October. This should continue to exert some upward pressure on consumer prices through next year, especially on goods prices, but also on some services components, such as package holidays.

(3) Growth above trend and falling unemployment are expected to support margins and allow some rise in labour costs, while higher spot inflation and ECB policy should push up inflation expectations. In that context, domestic inflation is projected to rise, although only gradually. We see inflation close to

1% on average next year and around 1.6% in 2017.

UK: On course to a mid-year rate hike

The outlook remains for GDP growth to slow to trend over 2016 and 2017. In our view, government spending will slow due to ongoing austerity and we expect investment and exports to be held back by the EU referendum and a fragile external backdrop/strong currency, respectively. Growth will likely be weighted towards consumption. Inflation should rise and undermine purchasing power, but only slowly. We expect interest rates to rise too, and household finances are more highly geared than ever. However, the slowdown in private consumption growth should be more muted thanks to robust employment growth and the capacity for households to reduce the savings rate.

Figure 11: Headline and core inflation to correct upwards in 2016

-1.0

-0.5

0.0

0.5

1.0

1.5

2.0

2.5

3.0

3.5

% yoy

Euro Area HICP inflation

Forecast

Headline

Core (ex efat)

2010 2011 2012 2013 2014 2015 2016 2017

Source: Deutsche Bank Research , Eurostat

Figure 12: The inflation benefits of euro depreciation are materialising

1.5

2

0.5

1

-0.5

0

2000

2003

2006

2009

2012

Source: Deutsche Bank Research , ECB, Eurostat

2015

HICP core goods (NEIG) (lhs)

EUR trade-weighted, 18m lead (rhs)

% yoy

% yoy, inverted

-20

-15
-10
-5
0
5
10
15
20

Figure 13: Household confidence
points to inflation turning point
HICP, recreation & personal services (lhs)
Household confidence, financial situation (15m lead, rhs)

0
1
2
3
4
5
6
% yoy
% balance

10
-15
-10
-5
0
5

2001 2003 2005 2007 2009 2011 2013 2015 2017

Source: Deutsche Bank Research , Eurostat, European
Commission

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After remaining within a narrow band (0.1pp) of zero for most of this year, inflation looks set to rise with base effects likely to add 0.6-0.7% by February.

We expect CPI to average 1.1% in 2016 but it will probably still be shy of 1% at

the time of the May inflation report. Evidence of rising inflation will be important to the BoE when it comes to deciding to tighten policy, as will improved prospects for wages and economic growth generally. Some on the Monetary Policy Committee would no doubt feel uncomfortable raising rates at the same time as having to explain the downside miss to its inflation target, but we do not expect this to stop the Bank from hiking.

Should the Fed raise rates in December as we expect, then our call for the first

BoE move in May looks reasonable based on past experience. The Bank is not governed by US policy – but there are numerous reasons we think the MPC will follow suit with a lag: i) globalisation has meant increased synchronisation,

with both the BoE and Fed facing the same external conditions, ii) the UK is sandwiched between the tightening Fed and loosening ECB, iii) given the potential risks from a Fed move (particularly to EM), it seems reasonable for the BoE to wait given the UK's external sensitivity, and iv) in signaling the start

of a hiking cycle a Fed tightening could push the dollar higher leaving the pound weaker (note our bearish sterling forecasts) – giving the BoE more room to cut.

Figure 14: Macro-economic activity & inflation forecasts: UK

Economic activity

2015

(% qoq, saar)

GDP

Private consumption

Investment

Gov't consumption

Exports

Imports

Domestic demand

Contribution (pp): Stocks

Net trade

Industrial production

Unemployment rate, %

Prices & wages (% yoy)

CPI

Producer prices

Compensation per empl.

Productivity

Source: National authorities, Deutsche Bank Research

The timing of UK rate rises could be impacted by the EU referendum.

Currently the referendum bill is going through the upper house, where peers have amended the legislation which – if retained – would allow 16/17-yearolds

to vote. This is contentious, as younger voters are seen as more supportive of EU membership. Whether or not this amendment is upheld, allowing 16/17-year-olds to vote could delay the previously expected timing of the vote – either because of the time it takes to register the additional voters or because the bill goes back and forth before the elected Commons finally gets its way to drop the amendment. A pre-summer vote thus looks difficult (given the referendum cannot be held within four months of the bill being passed), with autumn more likely – if not into 2017. The Conservative Party's manifesto pledged a referendum before end 2017.

A delay raises the risk that inward investment is not merely deferred but diverted to other countries. This could be particularly disruptive to growth given that the UK has the largest stock of inward investment globally outside

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Figure 15: Other indicators & financial forecasts: UK

2014 2015F 2016F 2017F

M4 growth, %

Fiscal balance, % of GDP, FY

Trade balance, GBP bn

Trade balance, % of GDP

Current account, GBP bn

Current account, % of GDP

Financial forecasts

Official

3M rate

10Y yield

USD per GBP

GBP per EUR

-1.1

-4.9

-92.9

-5.1

0.4

-4.0

-6.6

-80.4

-4.3

0.50

0.58

1.90

1.42

0.71

2.6

-2.5

-6.8

-60.6

-3.1

0.75

0.84

2.00
1.37
0.71
3.5
-1.0
-123.7 -124.9 -133.4 -146.0
-6.8
-7.1
-60.0
-3.0
Current Q1-2016 Q2-2016 Q4-2016

0.50
0.57
1.93
1.51
0.72
1.00
1.12
2.40
1.27
0.71

Source: National authorities, Deutsche Bank Research, as of
December 07

Q1
1.5
3.1
6.3
4.4
-4.7
4.1
0.1
-0.6
1.6
5.5
0.1
-1.8
2.3
0.8
Q2
2.6
3.7
4.2
1.6
7.8
2.5 -10.4
-2.3
-1.3
1.4
2.4
5.6
0.0

-1.6
2.6
1.1
1.9
3.0
5.4
5.3
3.6
0.9
-1.5
0.8
5.3
0.0
-1.8
3.0
0.7
23.8
7.9
2.5
2.4
4.1
0.0
2.4
1.9
1.7
2.4
4.9
0.0
2.4
2.6
2.6
-0.1
0.0
0.8
5.3
0.1
-1.2
1.9
0.9
0.1
0.0
0.8
5.2
0.7
-0.1
2.4
1.7
2016
2.6
2.4
5.7

0.0
 2.0
 2.6
 2.8
 0.1
 -0.1
 0.8
 5.1
 1.0
 0.1
 2.3
 1.5
 2.5
 2.4
 5.7
 0.0
 2.0
 2.5
 2.7
 0.0
 -0.1
 0.8
 5.1
 1.1
 1.0
 2.5
 2.1
 2.5
 2.4
 5.7
 0.0
 2.0
 2.5
 2.6
 0.0
 -0.1
 0.8
 5.0
 1.5
 1.6
 3.0
 2.1
 2015F 2016F 2017F
 Q3 Q4F Q1F Q2F Q3F Q4F % yoy % yoy % yoy
 2.6
 2.4
 3.0
 3.9
 2.4
 3.5
 3.4

2.4
-0.9
-0.1
1.2
5.4
0.0
-1.6
2.4
0.9
2.5
2.6
5.1
0.8
2.7
4.0
2.8
0.2
-0.5
0.9
5.1
1.1
0.6
2.6
1.9
2.3
2.4
6.0
0.0
1.8
2.2
2.4
-0.2
-0.2
0.8
4.9
1.9
1.9
3.4
1.8

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of the US. The government needs to balance the competing objectives of a swift enough vote to retain investment, but allowing sufficient time for negotiations with Brussels.

EU membership renegotiations will begin at this month's European Council meeting. A deal seems more likely at the February Council meeting at the earliest. Mr Cameron's four themes for renegotiation are explored in our 27 November Focus Europe, but in short the key demands are: i) improving competitiveness by reducing red tape and deepening the Single Market – where work is already under way, ii) economic governance – ensuring that rules governing the euro area are not automatically imposed on the UK, iii) returning greater sovereignty to the UK – the 'Europe where necessary' philosophy, and most contentiously iv) constraining migration by use of the benefits system.

The vote looks likely to be closer than the last EU referendum in 1975 when the tally was 66% for remaining in. Polls have swung towards those favouring exit recently, with some even showing a majority wanting to leave. However, the average poll shows "In" slightly trumping "Out" (around 43% vs 40%). But similar to 1975, a government campaigning to remain in, supported by the opposition and the media in general, may well produce a vote to remain in the EU – albeit in modestly amended form. Still, we should expect a bumpy ride between now and then as some polls raise the risk of exit.

European politics: Testing times to continue into 2016

The environment for European policymakers has become even more challenging following the terrorist attacks in France in mid-November. Managing (and containing) the massive influx of refugees since the summer was already keeping many EU member states busy, above all Germany. The controversial decision on a quota for the redistribution of refugees and the lack

of full application of European rules has provided some evidence for the different interests and the respective understanding of solidarity on this topic.

Politics has started to move. Fuelled by the threat of terrorist attacks, a more coherent response to the refugee crisis should be felt in different policy areas.

Foreign and security policy will become more extensive including a stronger control of the EU's external borders and most likely a more conservative European response to the refugee crisis. In terms of fiscal monitoring, the fiscal framework in the euro area provides sufficient flexibility (to a reasonable

extent) should higher public spending related to foreign and security or asylum

policy drive budget deficits beyond the agreed trajectory up. The European Commission intends to provide a thorough assessment of member state budget plans in Q1/ 2016.

EU-28 relations with Russia might be reviewed as Russia is seen as an important partner in coping with the tensions in the Middle East and by extension the refugee crisis and the threat of terrorism. A number of the sanctions imposed in 2014 have been linked to a successful implementation of

the Minsk 2 agreement by the end of this year. The overall political environment – if not again deteriorating after the most recent events in Turkey and Ukraine – might work towards a re-assessment of parts of the sanctions over the course of 2016. The Netherlands will assume the EU Council Presidency in the first half of 2016.

One major topic will be re-negotiating the terms of British EU-membership. The Dutch are well positioned as a mediator in this complex process as they share some of the demands put forward by British PM Cameron but firmly support European integration. There is considerable political goodwill by the EU Deutsche Bank AG/London

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Figure 16: Huge influx of refugees in Europe*

100
200
300
400
500
600
700
800
900
0

2008 2009 2010 2011 2012 2013 2014 2015

*Schengen states, i.e. EU28 + Iceland, Liechtenstein, Norway and Switzerland

Sources: Eurostat, Deutsche Bank Research
eop, Thous.

monthly figures ,Thous.

application proceedings pending (lhs)

asylum applicants (rhs)

100
120
140
160
180
20
40
60
80
0

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partners to keep Britain in the EU. However, there is also a substantial risk that

the deal struck is not perceived as sufficient by the British public to vote in

favour of EU membership in the in/out referendum.

The Juncker Commission is following through on its promise to reduce the deluge of laws and to focus on clear priorities. One of them is improving and extending the single market. Proposals have been presented for the service sector as well as the digital economy. Another is the September Action Plan to

establish a Capital Markets Union by 2019. It seeks better integration of capital

markets to complement bank financing of the real economy in Europe, e.g., with less restrictive rules for securitisation. Aimed at unlocking investment in

Europe (additional EUR 315bn over the next three years) is the European Fund for Strategic Investment EFSI, which is up and running now. Finally, the Commission has tabled a proposal on the third pillar of the banking union, a pan-European deposit insurance scheme. The proposal envisages a gradual merging of national schemes starting in 2017 with a system of reinsurance and ending with a European backstop fund in 2024. Despite the longer phasing-in of the new system, Germany has already expressed its strong reservations regarding the Commission's initiative. Thus the time line appears to be more than ambitious.

EMEA: Contrasting paths

Growth in EMEA appears set to accelerate, to nearly double to 2% next year as Russia and Ukraine emerge from their deep recessions. Elsewhere, we expect growth to remain relatively stable or contract slightly.

We're not quite ready to call the end of the recession in Russia just yet but the

economy has shown clear signs of bottoming over the last few months. The recovery, however, is likely to be slow. Oil prices look set to remain low, likely

prompting the government to rein in spending over the coming year. Access to financing will remain difficult so long as sanctions are still in place.

Inflation is

falling and this will support a recovery in real incomes and confidence.

Overall,

however, we would expect the recovery to be hesitant, with the economy bouncing along a floor for the next year or so. This points to a contraction of

3.7% this year and a further 0.7% drop in 2016.

The longer-term outlook is barely less challenging. Poor productivity performance and a shrinking work force should cap potential growth to 1-2%. Structural reforms are needed to raise the economy's productive potential but these seem further away than ever as Russia has pursued a more inward-looking growth strategy following the deterioration in its relationship with the west.

The outlook for Russia is subject to significant risks, mostly associated

with the price of oil and geopolitics. But these risks are much more balanced, if not slightly skewed to the upside, than was the case heading into this year. The geopolitical landscape has shifted since last month's terrorist attacks in Paris, which have raised the prospect that Western leaders might soften their stance on sanctions in exchange for Russian support in targeting Islamic State forces in Syria. Whether this will prove to be the case is still far from clear. It will be difficult for the EU to start to remove sanctions as early as January (when they are set to expire) while progress in implementing the Minsk agreement remains so patently partial. But recent developments do make a reduction in sanctions at some point next year more rather than less likely. The economy has held up rather better in Turkey, the region's other geopolitical hotspot. After multiple elections over the last two years, the domestic political outlook became clearer when the AKP regained its overall

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Figure 17: EMEA: pickup in growth reflects fading recessions

EMEA
%
-4
-3
-2
-1
0
1
2
3
4
5
6
7

2009
2011
Source: Deutsche Bank Research
2013
2015F
2017F
EMEA excluding Russia and Ukraine

Figure 18: Russia recessions compared
-12
-10
-8
-6
-4
-2
0

%

Peak-to-trough drop in output

1998

2008-09

* estimated/forecast

Source: Deutsche Bank Research

2015 *

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majority in parliament last month. This should at least provide investors with a

bit more clarity, even as the risks emanating from its southern borders remain

acute. Against this backdrop, we think growth will remain positive albeit relatively mediocre at around 3% over the next year or so. Any upside will likely be capped by the need to further tighten monetary conditions to shore up

the lira and keep inflation in check as and when the Fed begins to normalize its

policy.

The economy in South Africa has been in the doldrums, growing by barely 1% this year. The year ahead is unlikely to be any better as declining profits weigh

on investment and household demand. The government will be unable to provide offsetting support as it will need to stick to its hard spending ceilings,

and possibly raise taxes, to stabilize the level of debt. Monetary policy will be

similarly pro-cyclical. Longstanding structural weaknesses have continued to weigh on the rand. The resulting upward pressure on prices may now be amplified by a severe drought. The central bank has already hiked rates a couple of times in the last few months and, like the Turkish central bank, will

likely to have to tighten further in the coming year in response to the Fed. Central Europe by contrast has been a relative island of stability over the past

year, growing by around 3.6%, the fastest pace since 2008. Public investment might weaken a little following the shift to a new EU budget envelope. Some transitory factors that supported growth this year will also fade, such as the

surge in inventories in the Czech Republic and the provision of refunds to holders of foreign currency mortgages in Hungary. Growth is thus set to slow this year, but only moderately, as the region's fundamentals remain generally healthy. The risks to the growth outlook are primarily external and, as ever, tied

to a slowdown in the Euro Area. An escalation of the VW crisis would also weigh on the region's prospects given the importance of the group in the region's manufacturing base. The outlook is particularly uncertain in Poland given the lack of clarity on the new government's fiscal policy stance and the

significant upcoming changes in the central bank's rate-setting monetary policy committee.

With domestic demand expected to remain strong and the sharp drop in oil prices in late 2014 now dropping out of the base, inflation should start to inch

higher in the coming quarters (except in Romania where another VAT cut will offset this). Food prices are also expected to climb as the impact of the earlier

drought starts to bite. Imported inflation, however, is expected to remain very subdued. This will likely limit the pace of any acceleration in inflation, which we expect to remain below target across the region in the first half of the year.

While we're not expecting any rate cuts, the benign outlook for inflation leaves

scope for some further loosening of monetary policy across the region in the near term if growth disappoints. In contrast to other emerging markets in the region, Central Europe is also less exposed to the Fed rate hiking cycle and should continue to benefit from the tailwinds provided by further ECB easing.

Figure 19: EMEA: two very different inflation stories

% yoy

10

-2

0

2

4

6

8

2014

Russia,

South

Africa, &

Turkey

CEE &

Israel

Inflation*

2015

* simple averages

Source: Deutsche Bank Research

2016

2017

Figure 20: CEE: growth set to remain robust

% yoy

-4

-3

-2

-1

0

1

2

3

4

5

6

7

Real GDP growth in Central Europe *

2005 2007 2009 2011 2013 2015F 2017F

* Simple average

Source: Deutsche Bank Research

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Japan: Return to steady recovery trend

|| We forecast the Japanese economy to return to underlying trend growth of real GDP at annualized 1.0-1.5% after a temporary soft patch in Q2 and Q3 2015.

|| We see low likelihood of meaningfully negative second-round effects from the global slowdown to domestic non-manufacturers despite an inevitable impact on the Japanese manufacturers.

A soft patch, not a recession

Real GDP shrank 0.2%qoq (annualized -0.8%) in Q3, the second consecutive negative contraction, but we do not think this means the economy has entered a

recession because of the large negative inventory contribution in Q3 growth and

the low accuracy of Japanese preliminary GDP estimate. Our Nowcast index (DBNCI) has been revised upward and is now trending gradually higher. We think the Japanese economy was in a soft patch in Q2 and Q3 but these instances were mild and transitory and should be followed by real final sales (GDP minus inventories) growth at an underlying trend of an annualized 1.0-1.5%.

Resiliency of non-manufacturing sector

Because the scale of the ongoing global economic slowdown from early 2015 is limited compared to the collapse of the IT bubble in 2000-2001 or the global

financial crisis of 2007-08, we forecast a low likelihood of meaningfully negative second-round effects from the global slowdown to domestic nonmanufacturers,

thus leading to a recession, despite an inevitable impact on the Japanese manufacturers.

Predicting an expansion in domestic demand (mainly private consumption)

Although we predict a return to an economic expansion with annualized growth of 1.0-1.5% from Q4 2015, this is likely to be driven not by exports but

rather by domestic demand (in particular private consumption). Nominal aggregate wages (= total cash earnings per person x number of employees) are maintaining growth of an annualized 2.0-2.5% and inflation is predicted to

converge at around 1%, so 1.0-1.5% growth in real aggregate wages is probably the underlying trend. Therefore, we think real private consumption could maintain annualized growth of 1.0-1.25%.

Figure 3: Macro-economic activity & inflation forecasts: Japan

Economic activity

2015

(% qoq, saar)

GDP

Private consumption

Investment

Gov't consumption

Exports
 Imports
 Contribution (pp):
 Private inventory
 Net trade
 Industrial production
 Unemployment rate, %
 Prices & wages (% yoy)
 CPI
 Core CPI
 Producer prices
 Compensation per empl.
 Productivity
 Source: National authorities, Deutsche Bank Research

Q1	
4.6	
1.7	
6.4	
1.1	
Q2	
-0.7	
-2.3	
-0.4	
2.6	
8.0	-16.1
7.8	-10.8
1.8	
0.2	
6.3	
3.5	
2.3	
2.0	
0.5	
0.6	
-1.9	
0.9	
-1.3	
-5.5	
3.3	
0.5	
0.5	
-2.2	
0.2	
1.3	
-0.8	
2.1	
-2.7	
1.2	
10.9	
7.1	
-1.9	

0.8
-5.2
3.4
0.1
0.8
-3.6
0.8
1.0
3.4
1.4
2.0
1.2
4.6
0.5
0.9
3.0
3.4
0.3
0.9
-2.8
1.3
1.2
-0.5
1.8
1.4
1.8
1.2
5.8
5.4
0.2
0.2
2.6
3.4
0.6
1.1
-0.9
1.9
1.1
2016
1.1
1.4
0.7
1.2
6.6
8.1
0.0
-0.1
3.0
3.4
0.5
1.1

-0.9
1.9
1.1
1.4
1.2
1.2
7.4
6.6
0.0
0.3
3.4
3.4
0.8
1.0
0.4
1.9
1.7
1.8
2.4
1.6
1.2
7.6
7.1

Figure 1: DBNCI turned to uptrend

29-Oct-15

19-Nov-15

-0.4
-0.2
0.0
0.2
0.4
0.6
0.8

Index

30-Nov-15

Jan-2014

Jul-2014

Jan-2015

Jul-2015

Note: Horizontal line shows -0.25 threshold for recessions.

Source: Deutsche Bank Research

Figure 2: Rising nominal wages

Nominal aggregate wages, 3mma

Nominal wage index per-capita, 3mma

Employment index

100
105
110
115
90
95

2000
 2003
 2006
 2009
 Source: MHLW, Deutsche Bank Research
 2012
 2015
 Index, CY 2010=100, sa
 2015F 2016F 2017F
 Q3 Q4F Q1F Q2F Q3F Q4F % yoy % yoy % yoy
 1.6
 0.7
 -0.6
 0.0
 1.4
 3.3
 0.7
 -0.4
 0.3
 4.1
 3.4
 1.0
 1.0
 1.3
 1.7
 1.0
 0.3
 0.5
 -0.9
 3.4
 0.8
 1.1
 -2.0
 0.7
 0.4
 1.5
 1.3
 0.8
 1.3
 5.1
 4.1
 -0.1
 0.3
 1.4
 3.4
 0.7
 1.0
 0.0
 1.9
 1.2
 0.8

-0.2

1.0

1.2

6.9

4.7

-0.1

0.5

1.7

3.3

2.1

1.9

2.6

1.8

0.5

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Little hope for an export recovery

We do not carry high hopes for exports to recover due to Japan-specific factors (continued outward foreign direct investment, low price elasticity for

luxury goods exports, an exclusion of Japanese manufacturers from the global supply chain since the Great East Japan Earthquake) as well as a global factor,

namely the shift to a closed economy regime (disappearance of growth frontiers: decline in benefits of international trade).

CPI inflation to converge at around 1%

The level of CPI excluding energy clearly turned around in H1 2013 after 15 years of declines up to 2012, and has maintained an upward trend of around 1% annualized since then. Deflation has clearly ended, mainly as the result of

QE that started at a cautious pace under former-BoJ Governor Shirakawa in 2012. There is an argument that inflation will slow from now on due to a stable

JPY exchange rate and a weak rise in wages; however, the fact that the Japanese economy is moving from the flat section on the Phillips curve to the steeper section indicates that an economic expansion will have larger impact on inflation than before. This regime shift should fully offset possible drags on

inflation from a stable JPY exchange rate and slow wage growth.

Not predicting additional monetary easing

Based on the facts that the BoJ at present is promising an almost open-ended easing with no set limit on the timeline and that the scale of the monetary base

increase is an annual JPY80trn (16% of GDP), an overwhelming scale compared to other countries, we forecast monetary policy is likely to maintain

the current easing stance (no more rounds of easing). Were the BoJ to enact additional monetary easing reluctantly, we believe this would only occur in the

case of a sharp slowdown in the global economy, JPY appreciation, and a slump in share prices.

Japanese economy almost reaches its new steady state

We have reiterated several times that the new steady state of the Japanese economy since the introduction of QQE in April 2013 is 2% nominal GDP growth, 1% CPI inflation, 1% 10-year JGB yield, and 5% M2 growth. The Japanese economy has been in the transition process and seems to be very close to this new steady state.

Figure 7: Other indicators & financial forecasts

2014

M2 growth, %

Fiscal balance, % of GDP

Public debt, % of GDP

Trade balance, USD bn

Trade balance, % of GDP

Current account, USD bn

Current account, % of GDP

Financial forecasts

Official

3M rate

10Y yield

JPY per USD

JPY per EUR

3.4

-5.9

213.6

-99.8

-2.2

24.9

0.5

2015F

3.8

-5.4

211.6

-9.3

-0.2

137.0

3.3

0.10

0.15

0.40

127

128

Figure 4 : Export volume of major countries

Total (38 countries)

Germany

Japan

100

120

140

160

40

60

80

2002

2005

2008

2011

2014

Note: Total includes EU 28 countries, US, Japan, Canada, Brazil, Mexico, China, Hong Kong, Korea, Taiwan and Singapore. China is included from January 2005.

Source: Haver Analytics LP, Deutsche Bank Research

Index, CY 2010=100

US

China

Figure 5 : Consumer price index

101

103

105

107

109

97

99

1995

2000

2005

Note: Excluding the consumption tax hike effect

Sources: MIC, Deutsche Bank Research

2010

2015

Overall

Overall, excluding fresh food

Overall, excluding food and energy

Overall, excluding fresh food and energy

Index, CY 2010=100, sa

2016F

4.8

-4.5

210.5

-22.6

-0.5

152.4

3.6

0.10

0.15

0.45

128

124

2017F

5.1

-3.4

208.4

-23.5

-0.5

168.8

3.9

Current Q1-2016 Q2-2016 Q4-2016

0.10

0.17

0.32

123

134

0.10

0.15

0.55

128

115

Source: National statistics, Deutsche Bank Research, as of December 07

Note: DB forecast from Q4 2015.

Source: Cabinet Office, METI, Nikkei NEEDS, Deutsche Bank
Research

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Figure 6 : Nominal GDP and
industrial production

Industrial production (lhs)

100

105

110

115

120

65

70

75

80

85

90

95

2001 2003 2005 2007 2009 2011 2013 2015 2017 2019

Index, CY2010=100, sa

Forecast

Nominal GDP (rhs)

JPY trn, sa

450

460

470

480

490

500

510

520

530

540

550

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China: Rising challenges to trigger further policy easing

China's economy had a tough year in 2015. 2016 will likely be even more challenging. The current round of policy easing may help to boost growth in Q4 2015 and Q1 2016, but it will exacerbate overcapacity and raise leverage, both are damaging in the long term. In mid-2016 the government may face a policy dilemma again. Downside pressure on growth may resurface, and pressure the government into further policy easing.

Growth will likely stabilize in 2016Q1

The economic difficulty that troubled China for most of 2015 may be arrested temporarily in Q1. The difficulty in 2015 was to some extent due to a large fiscal contraction caused by the decline of land sales revenue in H1. Land auctions have rebounded strongly since mid-2015 because of policy easing (Figure 1). As growth of land sale revenue usually lags growth of land auctions

by 1-2 quarters, the fiscal revenue has improved in Q4 2015 and should rebound further in Q1 2016. This will likely help GDP growth to pick up in Q4 and Q1.

Investment is still the channel to boost growth, in our view. Higher land sales

in Q3 2015 indicate the weak property investment may finally show some signs of stabilization in Q4 and Q1. Growth of infrastructure investment may pick up again as land sales help boost fiscal revenue. Property and infrastructure combined account for almost half of investment in China. Hence we expect investment growth may pick up modestly in Q4 2015 and Q1 2016.

Challenges may rise beyond 2016Q1

The rebound of land sales was driven primarily by policy easing rather than economic fundamentals. The property sector remains in an oversupplied condition, as indicated by a rising level of inventory (Figure 2). This round of

rebound in land sales helps to address economic and fiscal pressure in the short term, but will exacerbate the oversupply problem in the property sector.

The policy easing since mid-2015 also led to another undesirable outcome – acceleration of leverage buildup. The growth of credit stock as measured by the total social financial picked up in Q3 to 12.5% yoy from 11.9% in Q2. Based on our estimate this is the first time it rebounded since 2014Q4. The rising leverage in the economy imposes financial risks. The authorities are clearly aware of this, but decided to focus on the short-term growth concern in

H2 2015.

Given the undesirable side effects of policy easing, we believe the government

may switch to a neutral policy stance in Q4 2015 once growth shows signs of stabilization. We expect the effect of policy easing will run out of steam in H1

and growth will then face downward pressure again.

Labor market dynamics may drive the policy outlook

The key macro uncertainty in 2016 lies in the labor market. In spite of expectation of slower growth beyond Q1, the prospect of unemployment is

unclear. The best indicator in the market about labor condition is the ratio of job vacancies to job seekers. This ratio dropped in H1 as growth slowed, which is intuitive as it suggested weak labor demand. But it surprisingly rebounded in Q3. Moreover the ratio has been above 1 for 20 consecutive quarters (Figure 3).

This suggests the job market does not show signs of rising unemployment despite of the slower growth.

Figure 2: Rising housing inventory

Floor space for sale

500

550

600

650

700

Mln sq metres

Figure 1: Land sales and local

government land sales revenue

% yoy

20

40

60

80

-60

-40

-20

0

Sep-2013 Mar-2014 Sep-2014 Mar-2015 Sep-2015

Source: CREIS, Ministry of Finance, Deutsche Bank Research

SouFun land sales, value

Local government land sales revenue

Feb-2014

Jul-2014 Dec-2014 May-2015 Oct-2015

Source: WIND, Deutsche Bank Research

Figure 3: Job vacancies to job

seekers ratio

1.00

1.02

1.04

1.06

1.08

1.10

1.12

1.14

1.16

Job vacancies to job seekers ratio

Source: WIND, Deutsche Bank Research

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Dec-10
Mar-11
Jun-11
Sep-11
Dec-11
Mar-12
Jun-12
Sep-12
Dec-12
Mar-13
Jun-13
Sep-13
Dec-13
Mar-14
Jun-14
Sep-14
Dec-14
Mar-15
Jun-15
Sep-15

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We understand why the labor market has been resilient, but we do not have full confidence it will stay so in 2016. The stable labor market reflects three

factors. The labor force is shrinking, hence less pressure to supply side. The

demand side has been boosted by a robust service sector, which helps to absorb labor from the weak industrial sector. Moreover, the government managed to prevent large scale layoffs so far, despite the growth slowdown. This delays job destruction.

The labor market outlook is uncertain because the delayed job shedding may occur in 2016. The government started to send signals recently that it would tolerate more bankruptcy. Premier Li Keqiang mentioned the risk imposed by "zombie companies" on the economy in a State Council meeting in November. The lack of government intervention in the recent Shanshui cement bond default may also indicate the subtle change in government's thinking. The government recently mentioned the importance of managing the supply side of the economy, which suggests it may finally address the overcapacity problem more seriously.

We believe it is the right policy to allow some "zombie companies" to go bankrupt. It will help improve the efficiency of the economy and avoid building

up of bad loans down the road. The impact on the labor market in the short term is difficult to forecast. We assume as a baseline case that there will be

some signs of rising unemployment in the economy. In such a scenario we believe the government will respond by cutting interest rates twice in H2 2016,

and expand fiscal spending.

There is room for policy easing in 2016, but with caveats

The government has the capacity to ease policies. On the monetary front, the reserve requirement ratio is still quite high (Figure 4). We expect 4 RRR cuts in

2016. The one-year deposit rate is currently at 1.5%. With inflation relatively

low, the PBoC can cut the benchmark interest rates if downward pressure on growth intensifies. On the fiscal front, total government debt is around 39.6%

of GDP, not including the RMB8.6 trillion debt of local government financing vehicles, which has been recognized by the central government. This is lower than the level in major developed economies.

Further policy easing clearly has its costs. The leverage ratio of the economy

will likely rise further and imposes higher financial risks. Loosening of monetary policy may delay the resolution of "zombie companies" and overcapacity problem further. The benefit of short-term growth stabilization will come with pains in the longer term, and the tradeoff is becoming increasingly unfavorable. There is room for easing in 2016, but this may come with a hefty price.

SDR inclusion is structurally positive

The SDR inclusion of the RMB on November 30 is a structurally positive development for China (Figure 5). The most significant macro implication is on reform outlook. The progress of structural reforms has been slow. There is doubt among investors about whether China is truly committed to market-oriented reforms. Such doubt heightened in the summer after what happened in the equity market. The SDR inclusion may work as a catalyst to boost the momentum of reforms in China. It indicates that the authorities are keen to integrate China's economy further with the global economy, which may help better align China's domestic market operations with international best practices.

The size of capital inflows in the short term may not be high, as the SDR inclusion itself will only begin effective Oct 1 2016. But China has opened its fixed income and foreign exchange markets to foreign central banks and Deutsche Bank AG/London

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Figure 6: Deutsche Bank forecasts:

China

(% yoy, unless stated)

Real GDP growth

CPI inflation, pavg.

Current account balance, % of GDP

USD/CNY, eop

Fiscal balance, % of GDP

Government debt, % of GDP

1-year deposit rate, %

M2 growth

7.3

2.0

3.1

6.1

-1.8

37.1

2.75

12.3

7.0

1.4

3.3

6.4

-3.2

39.6

1.50

13.6

Source: National authorities, Deutsche Bank Research

2.8

6.7

-3.5

40.0

1.00

12.7

Figure 4: Reserve requirement ratio

12
16
20
24
8

2007 2008 2009 2010 2011 2012 2013 2014 2015

Source: PBoC, Deutsche Bank Research

%

Reserve requirement ratio for large financial institutions

Figure 5: SDR basket

%

100
20
40
60
80
0

2005

2010

Source: IMF, Deutsche Bank Research

2016

11

11

34

USD EUR RMB GBP JPY

9.4

11.3

37.4

8.33

8.09

30.93

10.92

44

41.9

41.73

2014 2015F 2016F 2017F

6.7

1.8

6.7

1.8

2.5

6.7

-3.5

40.5

1.00

12.4

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sovereign wealth funds this year. We expect these institutions will start investing in 2016. Some argue that the market expectation of RMB depreciation may jeopardize the inflows. We do not think this is the key constraint, as central banks hold Euro and Yen assets despite these currencies

also facing depreciation expectations. In our minds, the key constraint is that

the domestic market is not ready for foreign reserve managers yet.

Infrastructure needs to be established, liquidity condition needs to improve, and rules need to be revised to facilitate trading. This will take time, but we

have no doubt it is doable.

We maintain our view that the Chinese government will not allow sharp RMB depreciation in the rest of the year. As the market expectation for a December

rate hike heightens, RMB depreciation would cause high volatility in the financial market, which is damaging to China's economy. We believe the PBoC may want to wait for the Fed to hike rate first and see how risks in the emerging markets evolve, before it takes the next move on the exchange rate.

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Asia (ex Japan): Triple troubles

At first glance, Asia's ongoing economic slowdown could be explained away in cyclical terms that could bottom next year. After all, the hangover from the global financial crisis of 2008-09 persists and global economic recovery is uneven. With appropriate policy support, the recovery could gain strength, and

it appears that 2016 may well be the year of strong fiscal spending in many parts of the world. The recent commodity bust may turn out to be temporary, with only short-lived impact on investment. G2 economies could continue to get stronger and re-emerge as a source of vigorous exports demand for Asia. China's cyclical measures to deal with overcapacity and financial system stress

could pave the way for healthier growth.

Even if some of these favorable developments were to transpire, Asia may find the economic environment in 2016 and 2017 to be about the same as the last couple of years. There may be further slowing of China, but India and Indonesia could see growth accelerate, Malaysia and the Philippines could maintain trend growth, and the rest of Asia could see less disappointment.

Indeed, our forecast for the next two years assumes such a path. We see China settling at sub-7% growth in an orderly manner, while by 2017 India's growth should head past 7.5% and Indonesia should go back to 5%. 2-3% growth may be the norm for many other Asian economies, but given the challenging nature of the cycle, that ought to be an acceptable outturn. The key assumption in these forecasts is that financial sector risks are managed and economic spillovers from a slowing China are contained.

But there are some major fault lines in this somewhat innocuous narrative. Deeper examination of the region's economic dynamic however reveals a series of headwinds that transcend the cycle. In this piece, we go over three key headwinds – aging, stagnant trade, and rising debt – that could get in the

way of growth and prosperity in the coming years. There are enough savings and safeguards in place in the region to mitigate risks of an outright crisis owing to these headwinds; a more likely scenario however is a gradual erosion of potential GDP growth rate, worsening of public finances, and a general decline in sentiment about the region's prospects.

Aging

Considerable attention has been paid in recent years to China's rapid aging. Indeed, recent news on the relaxation of the long-standing one-child policy reflects the seriousness with which the Chinese authorities are considering the

aging problem. Beyond China, a number of Asian Tiger economies are undergoing an aging process that will last decades. Aging is problematic for a variety of reasons. As the number of elderly rises, the labor force shrinks, reducing not just the availability of workers but also the output, incomes, and

taxes generated by those workers. As a result, potential GDP growth declines, the fiscal position worsens (as transfers to dependents rise and tax collection

from the shrinking pool of workers declines), and overall economic vitality dissipates. The decline in potential GDP growth along with a rise in the share of dependents also has adverse implications for savings, debt sustainability, and financial markets.

Can't public policy arrest this problem? While we welcome China's latest initiative, we find that aging is very difficult to reverse. Singapore is a case in

point. Faced with declining fertility and the prospect of rapid aging, the authorities have introduced wide-ranging measures to encourage families to have more children. These measures include longer leave for parents, tax incentives, and a more generous social safety net. But so far, the track record

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Figure 2: Regional growth

momentum continues to be weak

z score

-1.2

-1.0

-0.8

-0.6

-0.4

-0.2

0.0

Oct-13 Feb-14 Jun-14 Oct-14 Feb-15 Jun-15 Oct-15

Note: Regional z-score is GDP-weighted, derived as a composite of country-by-country-scores of monthly indicators of domestic demand (.e.g. retail sales, imports, credit growth, and industrial production). Data is from 1995 to present.

Source: CEIC, Deutsche Bank Research

MMI

Figure 1: Deutsche Bank forecasts:

Emerging Asia

(% yoy, unless stated)

Real GDP growth

Private consumption

Investment

Government consumption

Exports

Imports

CPI

CA balance, % of GDP

Asia ex. China and India

Real GDP growth

CPI

6.1

6.5

5.7

6.1

6.7

6.3
-1.5
-6.1
2.4
2.6
4.1
3.4
3.6
2.2

Source: National authorities, Deutsche Bank Research

4.2
5.3
2.9
2.1
3.8
2.9
16.9 17.6 18.7
4.3
1.7
3.4
2.4
2014 2015F 2016F 2017F
6.4
6.7
5.2
6.3
6.9
6.7
5.7
5.9
7.5
2.9
1.8
4.2
3.3

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has been disappointing, with Singaporeans by and large choosing to keep family size small. We think that the Chinese authorities will also find that once

set in practice, the culture and social attitude in keeping family size small is

very difficult to reverse. Opening up to more immigration could reduce the headwind to aging, but that comes with its own set of political sensitivities and

social implications. We reckon that most aging societies in Asia will have to accept the phenomenon and deal with recalibrating public finance, social safety net, and the service sector to take this into account.

Not all economies in Asia are facing down the barrel of inexorable aging.

India,

Indonesia, and the Philippines, with 1.5bn people among them, should have favorable demographics dynamic for decades to come. This could create the potential of redistribution of growth, with the aging economies passing on the

mantle of high growth to the relatively young ones. With the right investment policies, the latter economies could become that hub of regional manufacturing and demand. These economies also look set to maintain comfortable growth and interest rate differential to keep debt sustainable.

All

three are blessed with large populations and a favorable domestic demand dynamic that could generate satisfactory growth.

Having a young population is no guarantee of high growth though. Not only do the governments need to put in place the requisite infrastructure and employment opportunities for the emerging workforce, they also need to ensure social stability that can often be challenged if population grows too fast.

Trade stagnation

Asia's success as a region owes much to its dynamic export sector. Over the past five decades, starting with Japan, followed by the Tiger economies, and then by China, Asian producers have supplied the bulk of manufactured goods consumed globally. A cost-competitive and educated workforce, businessfriendly

policies, and efficient infrastructure have combined to give global leadership to Asia. But maintaining global market share and manufacturing leadership is one thing, continuing to grow with trade is turning out to be an

altogether different challenge. Even as US growth has picked up, Europe has bottomed, and consumers worldwide have been benefitting from low energy prices (akin to a tax cut), Asia's exporters have had a torrid year.

So far this year, all key Asian emerging market economies have reported negative exports growth. Whether they are commodity or electronics exporters, large or small economies, those that rely on China versus those that rely on G2

demand, the underperformance is across-the-board. Given the sharp drop in global commodity prices and the slowdown in China's investment cycle, it is easy to understand why commodity exporters like Indonesia and Malaysia will

likely report such poor exports earnings. But the weakness among electronics producers seems counterintuitive. Surveys of purchasing managers in the US and EU show a much better environment presently for new orders than they have been in the past, say in 2013. Still, Asian exports are substantially weaker.

Indeed, the tight historical relationship between Asian exports and lagged values of US and EU PMI has broken down over the past few years. Indeed, this breakdown in relationship can be seen not just with aggregate data, but with country-by-country analysis. The G2 cycle should have been much more supportive of Asian exports than has been the case.

Our conjecture is that the recent bout of poor trade data reflects structural factors that will hold back exports (and export related investment) for years to

come. The recovery in the US and EU is atypical, characterized by poor wage growth, low quality jobs, and greater service sector orientation than the past.

Also, the aging dynamic in both regions is changing the pattern of consumption (and imports) profoundly. Furthermore, contrary to press reports

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Figure 3: Deutsche Bank forecasts

(% yoy, unless stated)

China

GDP

CPI

CA bal., % GDP

Fiscal bal., % GDP

Hong Kong GDP

CPI

CA bal., % GDP

Fiscal bal., % GDP

India

GDP

CPI

CA bal., % GDP

Fiscal bal., % GDP

Indonesia GDP

CPI

CA bal., % GDP

Fiscal bal., % GDP

Malaysia GDP

CPI

CA bal., % GDP

Fiscal bal., % GDP

Philippines GDP

CPI

CA bal., % GDP

Fiscal bal., % GDP

Singapore GDP

CPI

CA bal., % GDP

Fiscal bal., % GDP
Korea
GDP
CPI
CA bal., % GDP
Fiscal bal., % GDP
Sri Lanka GDP
CPI
CA bal., % GDP
Fiscal bal., % GDP
Taiwan
GDP
CPI
CA bal., % GDP
Fiscal bal. % GDP
Thailand GDP
CPI
CA bal., % GDP
Fiscal bal., % GDP
Vietnam
GDP
CPI
CA bal., % GDP
Fiscal bal. % GDP
Source: Deutsche Bank Research
7.0
1.4
3.3
1.8
2.8
-3.2
2.5
3.1
0.6
2.4
7.3
4.9
-1.3
-3.9
4.5
6.4
-2.2
-2.3
4.6
2.0
2.5
-3.2
6.0
1.4
2.6
-1.5

2.5
-0.4
20.2
2.6
2.6
0.7
8.9
-0.3
5.5
1.0
-1.6
-6.0
1.0
-0.3
15.6
-1.6
2.5
-0.9
3.8
-2.0
6.5
0.8
-1.6
-5.7
-3.5
3.0
4.4
2.0
1.3
7.5
5.4
-1.6
-3.8
4.5
4.8
-2.0
-2.3
4.2
2.7
3.0
-3.1
6.0
3.0
1.1
-1.6
2.5
1.2
19.4
3.3
2.8
1.6

7.3
-0.2
6.0
4.5
-1.4
-6.0
2.4
1.1
14.0
-1.8
2.5
0.9
2.7
-2.1
6.7
5.0
-2.9
-5.0
2015F 2016F 2017F
6.7
6.7
1.8
2.5
-3.5
4.0
3.8
2.4
1.8
7.8
5.0
-2.0
-3.7
5.0
5.2
-1.8
-2.2
5.0
2.6
3.3
-2.9
5.8
3.1
1.2
-1.8
2.5
1.8
17.8
3.1
3.0
2.1
7.2

0.1
7.0
5.0
-1.5
-5.5
2.7
1.6
12.7
-1.7
2.5
1.7
2.9
-2.2
7.0
5.8
-3.1
-5.0

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of trade liberalization, trade restrictions have risen sharply among the G-20 in

recent years, as per UNCTAD data. We don't think any of these drags are going away. Therefore, Asian exporters may well have to settle for a new normal of anemic exports growth. Within the region, there are some additional challenges, starting with China's import substitution drive (which has hurt intermediate and capital goods exports from Japan, Taiwan, and Korea), rising cost of production (Singapore and Thailand), and failure to move up the value chain (Taiwan and Thailand).

For aspiring economies like India and Indonesia, these developments are disappointing. The prevalence of regional excess capacity and weak G2 demand for Asian exports will make it particularly hard for these economies to

join the club of major export-oriented manufacturers. They will do better relying on manufacturing to satisfy domestic demand, in our view.

Debt

The rise in regional debt, especially in China, is under a great deal of focus,

evidenced by a plethora of reports issued by multilateral agencies. Taking advantage of years of strong growth, favorable investor sentiment, relatively low rates, ample liquidity, expectations of stable currency, and supportive fiscal and financial sector policies, Asian borrowers have accumulated substantial debt in recent years. But the optimistic projections associated with

these borrowings have turned out to be mostly wrong. Both nominal and real growth rates have slowed, pushing down ROE, real rates have turned out to be high owing to sharp disinflation or deflation, and for those with foreign currency borrowing, expectations of stable currency have been off by a large margin due to the strong USD cycle. For those in the commodity sector, the risks are the greatest due to the combination of sharp revenue declines and soaring cost of servicing foreign currency debt.

In addition to corporates, Asian households have amassed sizable debt in recent years, with Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand characterized by burdens amounting to over 60% of GDP. China's reported household debt figures are lower (slightly below 40% of GDP), but strikingly, its households have added more than 20% of GDP worth of debt in the past five years. Gross debt figures for wealthy economies like Singapore, South Korea, and Taiwan may be less alarming due to households' strong asset position, but for the rest of the cohort the high debt level can act as a

major deterrent to the credit cycle and consumption outlook. High household debt may not be a source of systemic risk in the near term, but could readily become a chronic drag to growth. Unlike corporations, households don't have particularly orderly routes to restructuring debt. Hence firm level defaults and

restructuring could form the headlines in the coming year, but the household debt burden that lies side-by-side could well be a bigger source of long-term headwind to the economy.

Conclusion

|| Against this background, Asian policy makers need to recognize the nearterm risk of deflation, debt, and trade dependency, and the medium-term risk of aging and lower potential growth. Aggressive demand generating policy in the immediate future and well thought-out structural policies to address aging and competitiveness are needed. The previously successful model of growing fast as a global beta is unlikely to be replicable for most Asian economies. The key is to recognize the challenges mentioned here and strive for a more domestically (and perhaps regionally) sustainable growth model

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Latin America: Still adjusting to low commodity prices

Latin America's economic growth has continued to surprise on the downside. External demand has remained weak, commodity prices low, and investment depressed. This together with a disorderly fiscal adjustment in Brazil and tighter economic restrictions in Venezuela and Argentina finally pushed the regional economy into recession in 2015. Further adjustment is likely to maintain negative growth in 2016, and a final recovery might need to wait until 2017, when we project 2.1% growth, close to the new medium-term pace of the region.

Further exchange rate depreciation is expected to help through the ongoing adjustment process, but some large countries like Brazil, Venezuela, Colombia, and Peru do need to see a bigger correction in their current account deficits. Weaker currencies and depressed economic activity will create a growing policy dilemma in the region, but are unlikely to put at risk anti-inflationary commitment among Latin American Central Bankers.

Lower public and external indebtedness than in the past should buffer Latin America from a likely rate and USD shock in 2016 and 2017, but debt dynamics are becoming fragile in Brazil while liquidity constraints might warrant a debt re-profiling in Venezuela. Different than in the past, private sector debt does not pose a financing risk, but might be another toll preventing a rapid investment rebound. Within such a mediocre backdrop, Argentina's election brings great hope for significant policy improvement.

Economic adjustment to continue in 2016

Economic performance has continued surprising on the downside, forcing new forecasts revisions. We now estimate 2015 to be a year characterized by economic recession. Furthermore, we project negative growth to remain during 2016, based on continued weak external demand, low commodity prices, a disorderly fiscal adjustment in Brazil, and tighter economic restrictions being the case in Venezuela.

The region is still suffering from a challenging external backdrop but also from

the hangover from the last commodity bonanza. Commodity prices have been falling since late 2011 but some of them have simply tumbled since mid-2014. More importantly, according to future markets, commodity prices are expected to remain weak through much of 2016. Changes to commodity prices in the last three years have greatly harmed countries like Venezuela, Chile, Colombia

and Peru, with accumulated income losses since 2012 of 8.0% of GDP, 4.5%, 4.0%, and 2.3%, respectively.

Weaker economies have also exacerbated increasing public sector deficits, best reflected by the chaotic fiscal adjustment Brazil has been trying to introduce since the presidential re-election in late 2014. The need to compensate for weaker public sector revenues in the case of Mexico and Colombia is noteworthy too, adding further drags to weak economies.

Mexico's relative small dependence on commodities plus its strong link with

US trade makes it the country with a faster recovery prospect nonetheless. FX weakening is part of the adjustment but more might be needed ahead. In tandem with weaker commodity prices, regional currencies have been depreciating steadily in the last couple of years, representing changes in real exchange rates in the 15-30% range, with Brazil, Colombia, and Chile in the upper bound of the spectrum, and Peru and Mexico in the lower. This has obviously helped to improve competitiveness in the region, but it has been certainly not enough. As noted, unit labor costs were very high to start with, as well as domestic absorption. This somehow is reflected in incomplete current account adjustments in countries like Colombia, Brazil, and Peru. The latter is likely to maintain pressure on these currencies but at the same time be an additional tow for investment pickup.

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Figure 1: Current account adjustment still taking place (%GDP)

Brazil

% GDP

-9

-7

-5

-3

-1

1

3

5

2006

2008

2010

2012

Source: IMF, Haver Analytics LP , Deutsche Bank Research

2014

Colombia

Peru

Chile

Mexico

Figure 2: Deutsche Bank forecasts:

Latin America

(% yoy, unless stated)

Real GDP growth

Private consumption

Investment

Exports, USD bn

Imports, USD bn

CPI

Industrial production

Unemployment, %

Fiscal balance, % of GDP

CA balance, % of GDP

-2.5

-0.8

-0.7

-5.7

-0.1

-0.5

-2.7

2014 2015F 2016F 2017F

0.8

1.2

2.2

2.0

-3.0

934.1 824.8 843.1 881.0

907.8 820.4 822.5 858.7

12.5 15.2 18.8 19.4

-1.3

5.7

-3.2

6.5

-5.2

-2.8

-7.2

-3.0

Source: National authorities, Deutsche Bank Research

0.2

7.6

-5.9

-2.5

2.3

7.7

-5.0

-2.4

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Countries' recent investment performances also allow us to identify the most challenging macroeconomic outlooks in the region, led again by Brazil and Argentina, but including also the special case of Chile. In the latter, the combination of worsening external backdrop and controversial reforms has badly affected confidence and investment, but this effect should be partly temporary in nature, as policy uncertainties are expected to fade, and macro policy is actively helping the recovery in confidence and growth.

The suboptimal investment performance is also a good indicator of the need for a second round of reforms in the region. Unfortunately Mexico has been the only country to show a clear determination to push for reforms in a couple

of specific areas, particularly in the energy sector. By contrast, in Argentina,

Brazil, and in particular in Venezuela, there has been an increasing intervention

of some form of state capitalism, with expanding governments, increasing trade protectionism, and economic controls. This appears to explain the observed characteristics of the recent slowdown in the region, particularly visible in the industrial sector, and in countries reporting significant increases

in unit labor costs, typical of a middle income malaise.

In this regard, recent presidential elections in Argentina provide room for hope.

The new administration is expected to introduce corrective policies for existing

macro-imbances, while bringing Argentina back to international markets after a likely resolution of the pending holdouts case. Similarly, a mid-term election in Venezuela could bring a more balanced policy making, although the risk of a power vacuum should not be disregarded. By contrast, ongoing political instability in Brazil is likely to remain a big burden for fiscal adjustment

and economic performance at least in 2016. A warranted fiscal adjustment has been announced, and steps are being taken to reestablish much needed policy credibility, but President Rousseff's conviction and power to support these policies remain major question marks.

Low external debt is a plus but fiscal dynamics could worsen fast

The last several years of ultra-low global interest rates have been a bonus for

emerging countries and a likely rise in US rates has the potential to create further turbulence in capital flows. Similarly, the recent decline in commodity

prices might prove too strong a test to external balances in producer countries.

However, low levels of hard currency debt, with Brazil, Chile, Peru, and Mexico

being actually creditors of the world economy, provide an exceptional buffer this time around. Expectations for slow-motion rate normalization in the US are

another blessing for emerging economies in this cycle.

This notwithstanding, public debt dynamics show that countries like Brazil, Venezuela, and Colombia might face significant increases in their debt levels if they fail to reduce their large primary deficits. Furthermore, at current oil prices, external conditions in Venezuela remain unsustainable, as a low level of reserves barely covers the projected balance of payment deficit of a single year under the status quo. Besides, a public debt restructuring appears difficult to avoid, with the government being harshly constrained politically by a protracted recession with inflation.

Gustavo Cañonero, (1) 212 250 7530

Figure 3: Public debt dynamics

turning fragile for some countries

Source: IMF, Deutsche Bank Research

Figure 4: Deutsche Bank forecasts:

(% yoy, unless stated)

Argentina GDP

CPI

Brazil

Chile

-1.5

0.1 -3.7 -2.4

6.3

9.0

1.9

4.4

2.1

4.4

3.0

4.9

2.3

2.5

Peru

2.8

3.5

2014 2015F 2016F 2017F

1.0 -0.1

3.9

38.6 27.9 37.3 23.6

CA bal., % GDP -1.7 -2.3 -2.4 -2.3

GDP

CPI

8.5

2.2

3.6

2.8

6.0

2.7

3.1

3.4
 3.8
 CA bal., % GDP -4.3 -3.5 -1.8 -1.9
 GDP
 CPI
 Colombia GDP
 CPI
 Mexico GDP
 CPI
 CA bal., % GDP -1.2 -0.7 -1.3 -0.9
 4.6
 2.9
 CA bal., % GDP -5.2 -6.2 -5.9 -5.1
 2.3
 4.0
 CA bal., % GDP -2.3 -2.5 -2.7 -2.9
 GDP
 CPI
 2.4
 3.2
 Venezuela GDP
 CPI
 1.0
 6.2
 2.7
 3.5
 3.2
 3.5
 3.2
 3.4
 4.2
 3.3
 CA bal., % GDP -4.0 -3.6 -3.3 -2.5
 -3.4 -9.7 -7.6 -3.2
 62.0 120.0 175.0 250.0
 4.6 -0.3 -0.9
 CA bal., % GDP
 Source: National authorities, Deutsche Bank Research
 0.2
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Bond Market Strategy: Peak policy divergence

|| The divergence between US and European monetary policy may have peaked. Our year-end forecasts have 10Y Bund at 1.1% and 10Y UST at 2.50%.

|| In Europe, absent an external shock, the market is likely to focus in H2 on the prospects of the ECB discussing (but not implementing) taper. The curve should steepen as the front-end should remain anchored.

|| In the US, the terminal rate priced by the market is arguably too low. However, the hikes priced for 2016 appear close to fair given the downside risks to core PCE due to the lagged impact of the USD.

|| There are several key risks to this outlook: the policy response in China, oil prices, fiscal and regulatory policies, the US credit cycle and (geo) political risks.

Peak policy divergence

The end of 2015 was marked by the unusual combination of the Fed likely to tighten policy, while the ECB delivered additional easing (albeit below heightened expectations). There should be some partial policy convergence in 2016. Absent an external shock, conditions could be in place for the ECB to discuss (but not implement) tapering its asset purchase programme in the second half of the year. In the US, the market is close to pricing secular stagnation leaving room for an upward repricing of the terminal rate.

However,

the pace of rate hikes priced in 2016 looks close to fair given the lagged impact of the USD and commodity prices on core PCE. As a result, we expect yields to remain close to or even below the forwards initially before repricing

higher later in the year as (a) the market focuses on the reassessment of the ECB's policy, (b) the factors driving the downside pressures on Core PCE in the

US dissipate and (c) the Fed potentially opens the door for a tapering of its reinvestment policy.

ECB: From QE quasi-infinity to taper tantrum

The final ECB meeting of 2015 disappointed overly hyped market expectations but nonetheless added more stimulus. Is this last round of ECB easing just one

of many more to come as Europe is turning Japanese? A Japanese-type outcome can be defined as a situation in which private sector deleveraging is slow and is not accommodated by a more aggressive policy response. As a result, the credit impulse (i.e. the pace of deleveraging) never reverses and domestic demand remains under pressure. Ultimately, the economy converges to a situation in which the output gap widens, inflation is negative and real rates are too high. None of that is happening in Europe. In fact, on most of

the key metrics, Europe resembles more the US with a ~3-year lag than Japan in the 1990s. Indeed, as can be seen below³, Europe went through a two-step deleveraging process, but ultimately credit growth turned negative and the pace of deleveraging peaked mid-2013 three years after the US (see Figure 1) To accommodate the deleveraging process, the ECB engineered negative 10Y real rates in 2015 vs. 2012 for the Fed (see Figure 2.) Moreover, ECB policy also led to a more aggressive currency devaluation of more than 15% in real effective terms in 2015 vs. less than 10% achieved for the USD in early 2011 (see Figure 3).

³ In the analysis we compare in event time the behavior of key financial and economic variables in the US and Europe during this crisis and Japan in the 1990s. The reference time $t=0$ is defined as the peak in credit growth (Q4-07 for the US and Europe and Q1-90 for Japan).

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Figure 1: Europe more resembles the US with a 3Y lag when considering credit...

Japan

Euro area

Rolling 4Q private sector borrowing, % of GDP

(MFI loans to the private sector for the euro area)

10

15

20

25

30

-5

0

5

-10 -6 -2

2

6 10 14 18 22 26 30 34

No. of quarters from peak: Japan Q1-90, Euro area and US Q4-07

Vertical lines indicate the peak in deleveraging in US and EA

Source: : Haver Analytics LP, Bloomberg Finance LP, ECB, Federal

Reserve, Bank of Japan, Deutsche Bank Research

US

-1.0

0.0

1.0

2.0

3.0

4.0

5.0

6.0

Figure 2: ...and long term real rate

dynamics

Japan

Euro area

US

Long term real rate (10Y rate- GDP deflator) , %

100

110

120

130

140

150

Temporary impact of

the 1997 VAT hike

-20 -16 -12 -8 -4 0 4 8 12 16 20 24 28 32

No. of quarters from peak: Japan Q1-90, Euro area and US Q4-07

Vertical lines indicate the peaks in easing for long term real rates

Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg

Finance LP, ECB, Federal Reserve, Bank of Japan, Eurostat, BEA, CA0

Similarly, the output gap has mirrored the dynamics of credit, as the unemployment rate peaked mid-2013 in the euro area vs. late 2009 in the US. At the same time, the GDP deflator has remained around 1% in Europe and is at a similar level to the US. Thus, unlike Japan, the European economy is in a situation in which the deleveraging of the private sector is complete, the output gap is declining, the GDP deflator is positive, real rates are negative and the currency is cheap.

If Europe is ~3 years behind the US, the latest round of ECB easing would mirror the QE3/4 easing of the Fed at the end of 2012. Even though the incremental easing appears modest, the monthly pace of purchases in Europe was already exceeding (duration adjusted and as % of GDP) the pace of QE infinity. Also, this simple analogy would suggest that sometime in the second half of 2016, the focus will turn to when the ECB could indicate a tapering of its purchases. This conclusion is backed up by the evolution of the output gap.

If the unemployment rate declines in 2016 at the same pace as it did in 2015, it will be close to 10% in Q4-16, i.e. about 3% above the pre-crisis level. When both the Fed pre-announced tapering in 2013, and the ECB hiked in 2011, the unemployment rate was at similar levels relative to pre-crisis (see Figure 4).

Also, by the end of next year, our economists expect core inflation to be in a 1.25-1.45% range, only about 0.2% lower than the pre-crisis average (see Figure 5).

Figure 4: End of 2016, the unemployment rate should be at the level at which the Fed pre-announced tapering mid 2013

Japan

-1

0

1

2

3

4

5

6

Unemployment rate (0,% t=0)

Euro area

US

-16 -12 -8 -4 0 4 8 12 16 20 24 28 32 36

No. of quarters from trough: Japan Q1-90, Euro area and US Q4-07

Source: Deutsche Bank Research, Haver Analytics LP, Eurostat, BEA, BLS, CA0, MIC

0.5

0.7

0.9
1.1
1.3
1.5
1.7
1.9
2.1
2.3
2.5

Figure 5: Core inflation in Europe should be close to its pre-crisis average by the end of 2016

Core HICP

%yoy

Forecasts

Pre-crisis average

80

90

-20 -16 -12 -8 -4 0 4 8 12 16 20 24 28 32

No. of quarters from peak: Japan Q1-90, Euro area and US Q4-07

Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg Finance LP, ECB, Federal Reserve, Bank of Japan, eurostat, BEA, CAO

Figure 3: Europe benefits from a sharper currency depreciation than the US a few years ago

Japan

Euro area

REER (100 at t=0)

US

1997 1999 2001 2003 2005 2007 2009 2011 2013 2015

Source: Deutsche Bank Research, Haver Analytics LP, Eurostat

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From a market perspective, a potential tapering discussion will help support a

partial normalization of core euro rates sometime next year. The timing of the

repricing could depend on several factors, including the risk from EM countries

and oil prices, which we discuss below. From a pure domestic perspective though, the dynamics of inflation and the unemployment rate would suggest a repricing in the second half of the year.

Fed: Irregular tightening

Now that a December hike seems likely, the market shifted its focus on the pace and terminal rate of this hiking cycle. It is now generally accepted that

the rate cycle will be shallower than the most recent tightening cycles.

Currently the market is pricing that the neutral real rate (estimated as 4Y1Y OIS

minus 2%) will remain close to zero. One side of the argument for low neutral real rates is a structurally lower level of productivity (the secular stagnation

argument). Productivity has indeed been close to historical lows during this recovery. However, the uptick in real wages since the trough of the recession would suggest that there could be some upside to productivity from these levels. This would be particularly the case if wages do follow the leading indicators, which suggest some improvement towards 2.5% yoy on a nominal basis (around 1% in real terms based on current core PCE forecasts).

Figure 6: Productivity at historical low levels, but the

improvement in real wages suggests some upside risks

Real output per hour, 12q MA (lhs)

0.0

0.5

1.0

1.5

2.0

2.5

3.0

3.5

4.0

4.5

% yoy

Real wage growth, 8q ahead (rhs)

% yoy

-0.5

0.0

0.5

1.0

1.5

2.0

2.5

3.0

85
91
97
03
09
15

Source: Deutsche Bank Research, Haver Analytics LP, BLS, BEA, NBER

Source: Deutsche Bank Research, Haver Analytics LP, BLS
Others (including the Fed) argue that real rates have been low because of headwinds, namely tight fiscal policy, tighter regulation and credit supply, weaker demand for credit due to balance sheet repair and general macro uncertainty (fiscal cliff, Europe, China etc...). For Chair Yellen, we expect the normalization of policy will be driven not by an increase in GDP growth, but rather by the fact that the neutral real rate will drift up. The improvement in lending conditions and the marginally more supportive fiscal policy would also argue for some upside risks for the neutral rate. Irrespective of which side proves to be correct (within our own research team, the views are mixed), given that the market is de-facto pricing secular stagnation, the risks are to the upside in yields.

Figure 7: There is scope for a limited normalization of

wages
% yoy
1.25
1.50
1.75
2.00
2.25
2.50
2.75
3.00
3.25
3.50
3.75

Implied by Quits and Part Time
ECI (% yoy)

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Sep-2001
Sep-2003
Sep-2005
Sep-2007
Sep-2009
Sep-2011
Sep-2013
Sep-2015

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Figure 8: Improvement in credit conditions would support some improvement in the short-term neutral real rate

Neutral real rate implied by Fed Laubach/Williams model (lhs)

-1.2

-0.8

-0.4

0.0

0.4

0.8

1.2

1.6

2.0

2.4

2.8

3.2

3.6

4.0

SL0 cumulative supply conditions and demand conditions for mortgages (rhs)

%

100

200

300

400

-700

-600

-500

-400

-300

-200

-100

0

Figure 9: Easier fiscal policy should also support some improvement in the short-term neutral real rate

-1.5

-1.0

-0.5

0.0

0.5

1.0

1.5

2.0

2.5

3.0

3.5

4.0

4.5

5.0

5.5

Source: Deutsche Bank Research, Haver Analytics LP, Federal Reserve

93 94 95 96 98 99 00 01 03 04 05 06 08 09 10 11 13 14 15

Neutral rate from Laubach Williams model

US fiscal drag (CBO estimate, rhs)

Source: Deutsche Bank Research, Haver Analytics LP, Federal Reserve, CBO

Even if the risks are geared towards a higher terminal rate, the pace of tightening may be uneven at least initially. On the one hand, there is scope for

an upward surprise to the forthcoming ECI wage data. On the other hand, we continue to see downside risks to the FOMC's core PCE projections for next year, primarily on the back of the lagged impact of the USD strength and commodity weakness on core goods PCE inflation.

Figure 10: DB core PCE projections below FOMC

projections at the end of 2016

Core PCE

0.6

0.8

1.0

1.2

1.4

1.6

1.8

2.0

2.2

2.4

2.6

% yoy

DB forecasts, Nov-15 to Dec-16

2016 FOMC projection

for core PCE at 1.7

-5

-4

-3

-2

-1

0

1

2

3

4

5

2006

2008

2010

2012

2014

Source: Deutsche Bank Research, Bloomberg Finance LP, Haver Analytics LP,

FOMC

2016

Source: Deutsche Bank Research, BLS, Federal Reserve, Haver Analytics LP

As the gap between the market and the dovish centre of the committee and our economists' expectations (three hikes for 2016) is relatively small, it is difficult to argue for a much faster pace of rate hikes for next year.

However,

once the downside risks to inflation are reflected in the FOMC forecasts (presumably sometime in H1), there is a case for rebuilding some risk premium in the curve further out. This would be exacerbated if the Fed initiates its tapering of reinvestment in H2 as expected by our economists. This repricing would also coincide with the market focusing on potential tapering signals from the ECB.

Figure 11: Downside risks to core PCE are due to expected weakness in core goods on the back of the temporary impact of USD strength

Core goods inflation (lhs)

% yoy

USD TWI, 20 months lead (rhs)

% yoy

-40

-30

-20

-10

0

10

20

30

40

-3.0

-2.5

-2.0

-1.5

-1.0

-0.5

0.0

0.5

1.0

1.5

2.0

2.5

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Jun-93

Sep-94

Dec-95

Mar-97

Jun-98

Sep-99

Dec-00

Mar-02

Jun-03

Sep-04

Dec-05
Mar-07
Jun-08
Sep-09
Dec-10
Mar-12
Jun-13
Sep-14
Dec-15
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017

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Back-end and swap spreads convergence

The rationale outlined above would be consistent with a possible underperformance of the European back-end relative to the US. This macro assessment is supported by valuation arguments. Long-term valuation arguments which ignore flow effects such as QE suggest a significant richness of 5Y5Y rates in Europe relative to the US. Accounting for flows, the relative richness is less clear. The corollary however is that any pricing out of flow effect should lead to an underperformance of European fixed income in the long end of the curve. At the same time, the structural drivers of the cheapness of swap spreads in the US are likely to become more prominent in Europe. This should also lead to a relative cheapening of the long end of the German curve vs. USTs.

Figure 12: 5Y5Y adjusted risk premium (which ignores flow effects) indicate some scope for underperformance of European fixed income

-3.0
-2.5
-2.0
-1.5
-1.0
-0.5
0.0
0.5
1.0
1.5
2.0
2.5
3.0
%
%

US vs. Germany spread of adjusted 5Y5Y BRP (lhs)
Subsequent 1Y chge in USD vs EUR 5Y5Y spread (rhs)

-3.0
-2.5
-2.0
-1.5
-1.0
-0.5
0.0
0.5
1.0
1.5
2.0
2.5
3.0

1991199319951997199920012003200520072009201120132015

Source: Deutsche Bank Research, Bloomberg Finance LP, Federal Reserve, ECB,

Consensus Economics

Figure 13: Swap spreads have diverged significantly in the US vs. Germany (cheapening of long UST bonds)

bps
10
-80
-70
-60
-50
-40
-30
-20
-10
0

Dec-2009 Dec-2010 Dec-2011 Dec-2012 Dec-2013 Dec-2014 Dec-2015

Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg Finance LP, , Federal Reserve, ECB

Spread between UST 30Y ASW and German 30Y ASW

Key risks to the outlook:

As always, there are important risks to this outlook. These include external risks such as China and the dynamics of oil prices, but also domestic risks such as a change in the fiscal policy outlook, political risks in Europe or a turn

in the US credit cycle. We summarise the key risks below.

China: We argued earlier this year that China rather than Europe was the main disinflationary source at the global level. In contrast to Europe, credit growth

remains relatively high, long-term real rates are above 4%, the GDP deflator is

in negative territory and the currency has appreciated close to 30% and is now

overvalued on some metrics. Our economists are positive on the short-term outlook for growth and China's ability/desire to maintain a relatively stable currency. However, they also recognize the secular decline in growth. Putting it all together, China could continue to exert background disinflationary pressures, but without creating a significant financial shock. Relative to this

scenario, the risks would come from a more aggressive adjustment and/or policy response. For instance, a more aggressive devaluation would increase the disinflationary pressures that would be exported to the rest of the world,

while enabling a rebuild of FX reserves. Both factors would contribute to a flattening of the curve and would likely lead to more dovish ECB and Fed. Conversely, a more aggressive domestic easing (fiscal and monetary policy) while maintaining the currency stable is likely to reduce disinflationary forces

while at the same time putting more pressure on FX reserves. Both factors would lead to steeper core curves.

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Figure 14: Chinese REER dynamics tend to more closely mirror the Japanese experience

Japan

100

110

120

130

140

150

80

90

-20 -16 -12 -8 -4

0

4

8 12 16 20 24 28 32

No. of quarters from peak: Japan Q1-90, Euro area and US Q4-07, China Q4-09

Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg Finance LP,

BIS, Bank of Japan,

Federal Reserve, ECB, PBoC, CNBS, Eurostat, BEA

Euro area

REER (100 at t=0)

US

China

%

-1

0

1

2

3

4

5

6

-20 -16 -12 -8 -4

0

4

Figure 15: Long-term real rates have also increased thanks to a falling deflator

Japan (lhs)

Euro area (lhs)

US (lhs)

Long term real rate (10Y rate- GDP deflator)

China (rhs)

%

Temporary Impact of the

1997 VAT hike

8 12 16 20 24 28 32

No. of quarters from peak: Japan Q1-90, Euro area and US Q4-07, China Q1-09

Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg Finance LP,

BIS, Bank of Japan,

Federal Reserve, ECB, PBoC, CNBS, Eurostat, BEA

Oil: Oil prices are exerting a significant impact on global bond markets.

First,

there is an obvious and very strong correlation between oil prices and the inflation risk premium and the term premium. Second, the ECB has now introduced a strong link between oil prices and monetary policy. The ECB is primarily concerned about a disanchoring of inflation expectations, i.e. the risk

that persistently low spot inflation feeds into inflation expectations. In that

respect, the ECB is less focused on why spot inflation is low (supply or demand factors, temporary or permanent) and inclined to react if spot inflation

remains too low for too long. Given that spot inflation is itself largely determined by oil prices, there is an obvious link between the latter and the ECB's policy decisions. Our oil strategists see potential downside risks to oil

prices in the short term, but are more positive for the medium-term outlook from a supply/demand perspective. The turn in oil prices, when it occurs, is likely to signal both a normalization of the term premium in bond markets and underperformance of European fixed income. Conversely, continued decline in oil prices would delay any prospects of an ECB tapering and further slow the pace of rate hikes in the US.

Fiscal and regulatory policies: The past few years have been marked by a policy

mix which was relying on monetary policy to (over?) compensate for tighter fiscal and regulatory policies. While the regulatory pressures remain strong, there has been a shift in the fiscal outlook. Indeed, not only have fiscal policies

in Europe and the US turned neutral, but there are arguably some upside risks over the next couple of years. In the US, the latest budget agreement has incorporated a small fiscal stimulus. The upcoming presidential election could

also open the way for a more constructive dynamics between Congress and the Presidency. In Europe, the refugee crisis and the renewed focus on security

will also skew the risks towards more fiscal easing, above and beyond what is recognized in the EC's forecasts. The loosening of fiscal policy is likely to be

relatively limited in the short term. However, from a medium-term perspective,

a shift in fiscal policy would be an important driver behind a reassessment of

monetary policy both in the US and Europe.

US credit cycle: Under some metrics, the US credit cycle is already quite mature. Credit growth as percentage of GDP has recently averaged 7.5%, in the range seen in the late 1990s (6-10%) prior to the 04-07 credit bubble (1015%).

From this perspective, there are no signs of excess in aggregate, but no clear room for improvement either. Given the significant cumulative accumulation of inflows into specialized credit bond funds over the last few

years, there is a clear risk that the policy tightening leads to an unwind of these inflows, which would put pressure on credit spreads and in turn could lead to a decline in credit growth. This could prompt the Fed to slow the tightening process and in an extreme scenario reverse it.

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-6

-4

-2

0

2

4

6

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Figure 16: Private sector credit growth back to pre-credit bubble levels

Net borrowing of the non-financial private sector

10
15
20
-10
-5
0
5

1974 1978 1982 1986 1990 1994 1998 2002 2006 2010 2014

Source: Deutsche Bank Research, Haver Analytics LP, Federal Reserve, BEA
% of GDP, saar

Figure 17: Cumulative inflows into US funds since the Euro area debt crisis

-20%
-10%
0%
10%
20%
30%
40%
50%
60%
70%
80%

US IG

US Equities

US Govt bonds

US High Yield

US MM

Jun-2010 Jun-2011 Jun-2012 Jun-2013 Jun-2014 Jun-2015

Source: Deutsche Bank Research, EPFR

(Geo) Politics: The Middle East will likely remain, directly or indirectly, an

important source of (geo) political risk. One direct effect would be via the rebuilding of risk premium in the oil market (with the associated implications

on inflation and bond markets). An indirect political risk would manifest itself

in terms of the debate around the handling of the refugee crisis, with associated implications on border controls and by extension the functioning of

the single market. This could support anti-EU sentiment in general and be particularly relevant in the UK ahead of the EU referendum.

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US Credit Strategy: US credit feels the pressure of high commodity exposure

US credit markets have made a U-turn midway through 2015, as doubts began to surface with respect to issuer fundamentals, exposure to commodities and EM, and more recently even certain developed market names. The cavalier attitude that energy sector problems will remain contained has also seen defectors as oil prices set new lows during the course of the year and bonds came under even more pressure. At the same time, the expected pickup in consumer spending still takes time to materialize.

The US credit market reflects a much more realistic view of a potential for rising credit losses from here, with spreads in both HY and IG being at 3- to 4year

wides. Naturally, we like these levels better than those prevailing just a few months ago, and unless those credit losses start materializing soon, the market could be positioned for a strong rebound. Evidence we look at suggests that this is not the most likely outcome just yet, however.

At the core of our view is that the epicenter of this cycle will be in commodities

and EM. These areas continued to show few signs of imminent turnaround at the time of this writing. A McKinsey study earlier this year estimated total of

new debt created since 2007 at \$50trln, capturing all global sovereigns, corporates, and consumers. Much of it was raised with a belief in the commodity super-cycle. Today, we know that such a belief was wrong, and so it would only be logical to assume that meaningful debt write-downs are inevitable. The question really is whether they remain limited to commodity/-EM

areas, or spill over to a wider set of sectors.

We see three primary risks to the upside from here. The first one, least predictable but most relevant, is the Chinese economy turning the corner. The second, somewhat evident, is equities continuing to diverge in the face of commodity meltdown. The third, perhaps the most obvious, is more stimulus from central banks, at least outside the US. We discuss each of these in greater detail in our full year-ahead publication to be released soon. That they

are listed here as risks, and not base case, gives readers a preview as to our

assessment of their probabilities.

Overall, we expect the push-and-pull to continue, with those seeking more yield and those seeing signs of a cycle turn. We expect variable degrees of success to be claimed by each side at different points over the course of 2016.

We find ourselves believing in moderate increases in ex-energy defaults to 3.2% next year, up from 1.9% today, and a continued pressure on HY spreads, where USD DM ex-energy index could widen by about 100bp.

Higher vulnerability of HY makes IG a more attractive alternative, in our eyes,

especially in light of its current levels; we expect IG to widen only by about

10bps from here, or well inside of a normal 1:4 relationship to HY. European credit should remain better bid than the US, and loans should continue to quietly outperform HY, just like both of them did in 2015. We are not viewing 2-3 hikes by the Fed as being problematic to credit. In our opinion, their ability to hike multiple times would be proof that credit tightening concerns were overblown. Also critical to our positive outlook on IG is the continued demand for 'safe yield' from overseas investors, particularly those in Asia. Non-U.S. investors absorbed roughly one-third of the net supply of U.S. issuer bonds in 2015 in a great rotation to developed-market debt markets, in flows that appeared to favor financial bonds, single-A corporates and 5-year and 30-year paper. The laggard, 10-year BBBs, look cheap on a relative basis and we like owning these bonds outright or through 2s10s flatteners.

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The energy and materials sectors trade historically cheap to trailing fundamentals, although their prospects are tied heavily to the willingness of management teams to pare back bloated capital spending budgets that now run at double the rate of EBITDA. We recommend avoiding sectors exposed to the energy sector's coming capital expenditure declines, such as capital goods.

Trends in non-financial issuer quality outside the energy sector are also worrisome, leading us to revise our view on the relative performance of senior

US bank paper, which we think can now trade to spread parity with quality and duration-matched non-financials.

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European Credit Strategy: To follow the US or march to its own beat?

Credit markets do have a late cycle feel about them but it will likely make a big difference to performance over the next 12 months if this cycle ends in 2016 or extends until at least 2017.

Fundamentals – US deteriorating, Europe steadier but past peak

As Oleg Melentyev has alluded to in his US section, US credit quality has deteriorated. However Europe credit quality remains much more stable.

Figure 1: US IG total and net leverage

Total Leverage

0.7

0.9

1.1

1.3

1.5

1.7

1.9

2.1

2.3

2.5

Net (floored at \$0)

Net Leverage

ex-Energy/Metals

Figure 2: US HY total and net leverage

Total Leverage

ex Energy/Mining

2.5

3.0

3.5

4.0

4.5

5.0

5.5

6.0

6.5

2006 2007 2008 2009 2011 2012 2013 2014

2006 2007 2008 2009 2010 2011 2012 2013 2014 2015

Source: Deutsche Bank Research

Source: Deutsche Bank Research

In Europe there are sign that earnings have been drifting lower but debt accumulation has been nowhere near as aggressive as in the US market thus helping the ratios. European credit has far less exposure to the Energy and Materials sectors, which has helped create some of the divergence.

Figure 3: Euro IG (left) and HY (right) credit fundamentals

1.0

1.2

1.4

1.6
1.8
2.0
2.2
2000
2002
Net Debt/EBITDA (LHS)
EBITDA/Interest (RHS)
10
11
12
6
7
8
9
2004
2006
2008
2010
2012
2014
2.0
2.5
3.0
3.5
4.0
4.5
2005

Source: Deutsche Bank Research, Bloomberg Finance LP

Another reason for diverging fundamentals has been corporate activity. US M&A has risen much more sharply than in Europe. For share buybacks the divergence between the US and Europe is even more extreme. Europe has actually seen less in buybacks in 2015 than what was seen over the past decade whereas the US volume remains historically high even if not quite reaching peak levels.

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Net Debt/EBITDA
EBITDA/Interest
Net Leverage

2007
2009
2011
2013
2015

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Figure 4: US and European M&A activity (left) and share buybacks (right)

1,000

1,500

2,000

2,500

500

0

US Acquirer WE Acquirer

100

200

300

400

500

600

700

0

US (S&P 500)

Europe (Stoxx 600)

Data for 2015 up to the end of November

Source: Deutsche Bank Research.

Overall these charts show that Europe is some way behind the US in terms of a deteriorating credit cycle. As such even if US credit widens further, it's possible that European credit can continue to outperform. We would be mildly bullish European credit and would be more aggressive if we saw some stabilization in the US credit market.

Valuations

Credit spreads globally are all wider than their 50th

percentile observation

through history with most rating bands having been tighter 60-80% of the time.

Figure 5: Spread percentile rank – Current vs. YE 2013 and 2014

Wide Spread

EUR Non-Fin HY B (13yrs)

USD Fin Sen (17yrs)

EUR Non-Fin HY CCC (13yrs)

GBP Fin Sen (17yrs)

EUR Non-Fin HY BB (13yrs)

EUR Non-Fin BBB (16yrs)

GBP Non-Fin BBB (17yrs)

USD Non-Fin A (17yrs)

GBP Fin Sub (17yrs)

EUR Fin Sub (17yrs)

USD Fin Sub (17yrs)

EUR Fin Sen (17yrs)

USD Non-Fin BBB (17yrs)

GBP Non-Fin AA (17yrs)

USD Non-Fin AA (17yrs)

USD Corp HY BB (16yrs)

GBP Non-Fin A (17yrs)

USD Corp HY CCC (13yrs)

EUR Non-Fin AA (17yrs)

USD Corp HY B (16yrs)

EUR Non-Fin A (17yrs)

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

Current Rank

Source: Deutsche Bank Research, Mark-it Group

The only caveat to this analysis is that the widest 10-15% of observations usually sees credit spreads gap wider as a recession hits. We are very close to

the edge of pricing in a mild recession in global credit spreads. If we avoid it in

2016, spreads look very attractive but given that we're probably late cycle in

the US there are risks at this stage to trying to eke out carry for another 12

months. On balance we're mildly bullish European credit due to being less late

cycle than the US and due to valuations.

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Rank (31 Dec 2014)

Rank (31 Dec 2013)

Tight Spread

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2003

2004

2005

2006

2007

2008

2009

2010

2011

2012

2013

2014

2015

01/01/2001

01/01/2002

01/01/2003

01/01/2004

01/01/2005

01/01/2006

01/01/2007

01/01/2008

01/01/2009

01/01/2010

01/01/2011

01/01/2012

01/01/2013
01/01/2014
01/01/2015

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US Equity Strategy: Still-low treasury yields despite Fed hikes to boost S&P PE – Heavy tilts to Health Care & Tech

|| We recently cut 2016E S&P EPS by \$3 to \$125 on revised assumptions of even lower oil prices and a stronger dollar, but this is still about 5% EPS growth from 2015. We believe an 18x trailing PE is fair provided the climb in Treasury yields is moderate as the Fed hikes. Thus, S&P PE expansion should provide an additional few percent upside. Our S&P targets are 2100 for 2015 end and 2250 for 2016 end or up 5-10%.

|| 2015E S&P EPS is \$119, up 0.5% despite sales down 4%, buoyed by net margins climbing to a record high and about 1.5% share shrink. Ex. Energy & Financials, as much less y/y litigation expense at Banks, 2015 S&P EPS was up 6% or 10% ex. 4% FX drag. Growth led by Health Care and big consumer oriented Tech firms. We expect growth to slow at these two S&P segments, but remain key growth drivers.

|| 2016E S&P EPS of \$125 is up 5% on 4% sales growth, flat margins and 1% share shrink. Sales should turn positive in 2016 as commodity and currency drags diminish and sales better connects with US GDP. We assume WTI oil averages \$55/bbl in 2016 and that DXY averages 100 with euro at \$1.05 within DXY. This is a 1.5% FX drag to sales vs. 4% in 2015. If euro is \$0.95 then drag is 2.5%, if DXY is 110 then 4%.

|| Sales growth and PE should be the main drivers of performance in 2016. But few sectors offer both strong sales growth and sizable PE upside. Health Care does and should outperform in 2016 on sales-driven superior EPS growth and a higher PE. Health Care is the biggest and fastestgrowing part of US consumer spending. We're excited about the supply of life-enhancing products and the demographic 'destiny' of greater demand. Health Care is cheaper than the S&P, which is very unusual, despite a superior growth profile, balance sheets and less cyclicity. The political risks seem rather exaggerated beyond Managed Care.

|| Our 2250 S&P target or 18x trailing 2016E S&P EPS is a PE 10-15% above history and highest on S&P EPS post a cyclical recovery other than the late 1990s. But we believe it's fair given persistently low long-term real interest rates. If Fed Funds and 10yr Treasury yields rise slowly and plateau around 2% and 3.0-3.5% (10yr TIPS yield <1.5%) in late 2017, then an 18x trailing PE looks fair on normalized S&P EPS – about 15x for Financials & Energy and 20x aggregate profits of other sectors. This assumes a fair real return on long-term S&P investment of 5.5%. A fair PE is 1/real CoE when future real EPS growth + dividend yield equals the real CoE.

|| Health Care and Tech are why we are bullish on the S&P 500 for 2016. Energy and Industrials worry us a great deal. Most of the rest of the market, both the S&P and the Russell 2000, seem fully valued except a few big Banks, Utilities, Airlines, and some of our specific stock picks.

Fortunately, Health Care and Tech represent 35% of the S&P 500. These two sectors dominate Growth style indices and have been outperformers since 2012. We advise sticking with sector and style strength and tilting heavily toward Health Care and Tech, about 45% of a US equity portfolio, with a material allocation to Utilities of about 5%.

|| We do not think current conditions represent early cycle Fed hiking and we suggest that investors throw out their early-cycle playbooks. However, we also do not believe that a recession looms or that S&P profits will fall again

in 2016 or that the S&P will suffer a bear market or a sharp correction. That said, here are five warnings signs to monitor of the cycle or the stock market being in jeopardy of rolling:

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Figure 2: Earnings weights of Tech & Health Care vs. Energy & Financials

10
15
20
25
30
35
40
45
0
5

Tech + Health Care

Energy + Financials

Source: Deutsche Bank Research, Compustat, S&P

%

Earnings weights of Tech & Health Care vs. Energy & Financials

S&P EPS estimates & targets:

2015E S&P EPS: \$119

2015 end S&P target: 2100

2016E S&P EPS: \$125

2016 end S&P target: 2250

Figure 1: S&P 500 Trailing PE and implied ERP

10
15
20
25
30
35
0
5

Recession

Implied ERP (rhs)

Avg ERP ex 1975-82 = 3.5%

Trailing PE (lhs)

Avg ERP = 4%
Avg PE = 15.9
Red dot shows implied ERP on 10yr TIPS yield of 1.5% instead of
0.28% currently
Source: Deutsche Bank Research, IBES, S&P
Overstated EPS from
inflation distortions
Low offered ERP
contributes to crash
Long-term growth
optimism
Return to
normal

0%
2%
4%
6%
8%
10%
12%
Page 53
1985
1988
1991
1994
1997
2000
2003
2006
2009
2012
2015
1960
1963
1966
1969
1972
1975
1978
1981
1984
1987
1990
1993
1996
1999
2002
2005
2008
2011
2014

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1. Dollar: Dollar strength challenged GDP and especially S&P EPS and performance all of 2015. It is important that any further dollar gains be very slow and not materially exceed 5% in 2016 from DXY ~100 levels.

2. Unemployment and Unit Labor Costs: If unemployment falls quickly from 5.0% today despite still-slow growth, on less participation, then Fed hikes might exceed our 1% expectation at 2016 end. It's important that unit labor costs don't jump over 2%. Higher wage growth is great if funded by better productivity, but if unit labor costs approach 3%, Treasury yields could jump over 3% even if US growth stays slow.

3. Yield Curve: Historically, a flat or inverted curve is very cautionary. The

curve remains steep, but with exceptionally low Fed Funds rates. If 10yr yields fall well under 2% as Fed hikes we'd likely be concerned.

4. Credit costs: Conditions at high yield credit markets are concerning, but we are encouraged by very low loan losses at banks.

5. Fiscal conditions: US fiscal conditions are healthy, but politically driven

tax hikes or government disruptions or broad spending cuts are a risk.

Key to 2016 S&P upside: Good S&P sales growth resumes with yields still low 2015 was a lost year of S&P EPS growth owing to exceptional headwinds from the surge in the dollar and collapse in oil prices as well as weak manufacturing,

capex and exports. However, growth was strong at Health Care, parts of Tech and Consumer Discretionary, albeit disappointing at many Retailers given macro tailwinds. Ex. Energy, Financials, Health Care and AAPL, AMZN, GOOG, S&P EPS growth is about 2.5% in 2015. Less currency drag and good growth from Health Care and most of Tech should bring 5% S&P EPS growth in 2016.

A third of S&P revenue and 40% of its profits are earned abroad. However, a substantial amount of Tech and Energy foreign earnings is still in dollars.

We estimate that roughly 25% of total S&P profits are earned in foreign currencies.

Thus, every 10% appreciation in the dollar vs. major currencies hits S&P EPS by 2.5% or \$3. In 2016, we see 1.5% or \$1.75 of S&P EPS drag or 2.5% drag at Tech and Industrials (including exports), roughly 2% at Staples and Health Care

and 1.5% at Consumer Discretionary. Yet Consumer Discretionary, Health Care and Tech should still deliver 5%+ sales growth. Only slight growth is likely at

Staples and Industrials, about 5% growth at Financials. Energy is a wildcard with 2016 earnings possibly -10% to +30%, but Energy is now a small contributor to total S&P EPS. S&P net margin likely flat with 1% share shrink.

Financial shock risk? Dominoes of dollar, oil, corporate credit and S&P 500 The S&P's 2015 broad-based revenue recession and flat non-GAAP S&P EPS has underscored a big risk despite the high likelihood of continued US growth.

We believe the worst of the profit recession is behind us for the S&P 500, but if

the dollar surges 10% or more from current levels (DXY 100 now) in early 2016 upon Fed hikes or other central bank actions, it could cause a sharp correction.

A surge in the dollar could cause commodity prices to stay this low or drop further, triggering further declines in high yield corporate bonds and flat to down S&P EPS through 1H16. If the Euro were to average \$0.95 in 2016 and DXY nearly 110 with oil prices near or below \$40/bbl most of next year, then 2016 S&P EPS would likely be about \$120 even with about 2.5% US GDP and 3% global GDP. If this were to occur, the S&P could revisit correction levels under 1900. We don't think this would tip the US economy into a full recession,

but it raises the risk and it is clearly not a good scenario for stocks.

Such a correction could be deep and long, even without a recession, if the Fed kept hiking despite these hits to markets owing to still-falling unemployment.

Figure 4: Strong dollar & weak oil

weigh on S&P EPS

Index

100

110

120

130

140

150

60

70

80

90

Recession

US Dollar Index USD TWI (lhs)

WTI Crude (rhs)

Source: Deutsche Bank Research, FRB, EIA/WSJ

Figure 3: 10yr real treasury yields

and inflation breakeven

10yr TIPS (lhs)

-1.0

-0.8

-0.6

-0.4

-0.2

0.0

0.2

0.4

0.6

0.8

1.0

%

10yr inflation breakeven (rhs)

%

1.1

1.3
1.5
1.7
1.9
2.1
2.3
2.5
2.7
2012
2013
2014

Source: Deutsche Bank Research, FRB

2015

USD/ bbl

100
120
140
20
40
60
80
0

Figure 5: Implied ERP vs Credit spread by sector

Implied equity risk premium , %

Attractive stocks vs bonds

Financials
Utilities
Health Care
Tech
Cons. Disc.
Cons. Staples
Energy

1.0
1.5
2.0

Credit spread, %

Source: Deutsche Bank Research, S&P, IBES

2.5
3.0

Industrials
Materials
Telecom

Offered Energy ERP if oil is \$65-70/bbl in 2016

2
3
4
5

6

7

8

9

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1973

1975

1977

1979

1981

1983

1985

1987

1989

1991

1993

1995

1997

1999

2001

2003

2005

2007

2009

2011

2013

2015

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We don't think this is likely, but it is a known and material risk. It is for this

reason, and also demanding valuations despite this risk, that we stay underweight

Energy, Industrials and Materials. We see little upside and lots of downside potential at these three highly global (EM), dollar- and commodity-sensitive

sectors. Whereas upside at Health Care and Tech is at least as good or most likely better with far less risk.

Figure 6: S&P 2016 EPS scenarios

Poor global growth (China ~5%)

A continued profit recession,

Foreign

Cons Disc

Cons Staples

Energy

Financials

Health Care

Industrials

Tech

Materials

Telecom

Utilities

S&P 500

per share

Avg oil price

Euro

Avg FF rate

US UE yr end

US GDP

Global GDP

Source: Deutsche Bank Research

Sales % Profits %

27%

28%

41%

18%

20%

36%

59%

49%

1%

6%

31%

FX A possible upside scenario

2015

2016

25%

28%

20%
15%
20%
35%
37%
40%
0%
6%
25%
115.5
85.5
45
218
154.5
115
225
30.3
33.5
33.4
1055.7
\$119
\$47
89
y/y 2016 EPS
128 10.8% 14.39
4.1% 10.01
6.75
60 33.3%
234
168
120
242
34.5
1142
\$128
\$60
1.10 1.10-1.15
0.2% 0.75%
5.0%
4.7%
2.5% 2.5-3%
3%
3.5%
34 12.2%
32.5 -3.0%
3.3%
7.3% 26.31
8.7% 18.89
4.3% 13.49
7.6% 27.21
3.82

3.65
3.88
8.2% 128.39
DB's base case for 2016 S&P EPS
2016
125
87.5
2015
115.5
85.5
45
218
154.5
115
225
30.3
33.5
33.4
1055.7
\$119
\$47
1.05
2.3%
52 15.6%
230
165
117
239
32.5
32.5
34.5
1115
\$125
\$55
1.05
0.2% 0.50%
5.0%
2.5% ~2.5%
3% ~3.0%
4.7%
y/y 2016 EPS
8.2% 14.05
9.84
5.85
5.5% 25.86
6.8% 18.55
1.7% 13.15
6.2% 26.87
7.3%
-3.0%
3.3%

5.6% 125.35
but decent US and global GDP growth
y/y 2016 EPS
2015
115.5
85.5
45
218
3.65
3.65
3.88
154.5
115
225
30.3
33.5
33.4
2016
125
85.5
230
161
232
34.5
8.2% 14.05
0.0%
30 -33.3%
9.61
3.37
5.5% 25.86
4.2% 18.10
105 -8.7% 11.80
3.1% 26.08
3.26
3.65
3.88
1055.7 1064.5
\$119
\$47
1.05
\$40
0.90
0.2% 0.50%
5.0%
4.7%
2.5% ~2.5%
3% ~3.0%
0.8% 119.68
\$120
29 -4.3%
32.5 -3.0%

3.3%
yet 2%+ US growth with low credit costs
Tight US labor mkt, Fed hikes >1% in 2016 Global recession and flat US GDP
y/y 2016 EPS
2015
115.5
85.5
45
218
154.5
115
225
30.3
33.5
33.4
1055.7
\$119
\$47
1.05
0.2%
5.0%
2016
122
85
233
160
225
5.6% 13.72
-0.6%
30 -33.3%
9.56
3.37
6.7% 26.16
3.6% 17.99
100 -13.0% 11.24
0.0% 25.30
2.92
3.60
3.82
26 -14.2%
-4.5%
1.8%
32
34
1046.7
\$118
\$40
0.90
1.2%
4.4%
2.5% 2.25%

3%
 2.5%
 -0.9% 117.68
 2015
 115.5
 85.5
 45
 218
 154.5
 115
 225
 30.3
 33.5
 33.4
 1055.7
 \$119
 \$47
 1.05
 2016
 y/y 2016 EPS
 110 -4.8% 12.37
 83 -2.9%
 20 -55.6%
 210 -3.7% 23.61
 2.3% 17.76
 158
 90 -21.7% 10.12
 210 -6.7% 23.61
 23 -24.1%
 30 -10.4%
 32.5 -2.7%
 966.5 -8.4% 108.66
 \$109
 \$35
 0.85
 0.2% 0.25%
 5.0%
 2.5%
 3%
 6.5%
 0.5%
 1.5%
 2.59
 3.37
 3.65
 9.33
 2.25

Figure 7: Our intrinsic valuation model
 S&P 500 Capitalized EPS Valuation
 Deutsche Bank's 2015E S&P 500 EPS
 DB's "normal 2015E" S&P 500 EPS

"Normal 2015E" EPS / 2015E EPS
 Accounting quality adjustment to pro forma EPS
 Normal 2015E S&P 500 EPS fair to capitalize
 Key principle: steady-state value = normal EPS / real CoE
 S&P 500 EPS Capitalization Valuation
 Normal EPS / (real CoE - (EM/payout) - EM):
 S&P 500 intrinsic value at 2015 start
 S&P 500 intrinsic value at 2015 end
 Implied fair fwd PE in early 2015 on 2015E \$119 EPS
 Implied fair trailing PE at 2015 end on 2015E \$119 EPS
 Normal EPS / (real CoE-value added EPS growth)
 S&P 500 Dividend Discount Model
 S&P 500 Long-term EPS & DPS Growth
 \$119 Deutsche Bank's 2015E S&P 500 DPS
 2015E dividend payout ratio
 \$122 DB's "normal 2015E" S&P 500 DPS
 103% Normal dividend payout ratio
 -\$12.00 EPS directed to net share repurchases
 Normal share repurchase payout ratio
 \$110 Total payout of S&P 500 EPS
 Total payout rate
 S&P 500 DPS Discount Model
 Normal DPS / (nominal CoE - DPS growth):
 2000 S&P 500 intrinsic value at 2015 start
 2109 S&P 500 intrinsic value at 2015 end
 16.8
 17.7
 Implied fair forward yield on 2015E DPS of \$41.0
 Implied fair trailing yield on 2015E DPS of \$41.0
 2000 DPS discount model using true DPS (all payout)
 \$41.00 Deutsche Bank's 2015E S&P 500 aggregate ROE
 34% 2014 end S&P 500 book value per share
 \$41.00 DB's "normal 2015E" S&P 500 aggregate ROE
 37%
 S&P 500 Cost of Equity & Fair Book Multiple
 15.9% Fair long-term nominal return on S&P 500 index
 \$750 Components of estimated fair S&P 500 return:
 14.7% + Long-term real risk free interest rate
 + Long-term fair S&P 500 equity risk premium*
 S&P 500 EPS retained for true reinvestment 39% = Long-term real S&P 500
 cost of equity
 \$26.50 Estimated ROE on reinvested S&P 500 EPS 7.50% + Long-term inflation
 forecast
 24% Economic margin (EM) or ROE-CoE
 \$67.50 Sources of long-term earnings growth:
 61% + Long-term inflation forecast
 0.00% = S&P 500 nominal cost of equity
 * S&P 500 ERP usually 300-400bps, w/ real CoE @ 5.5% - 6.5%
 2.00%
 + Fair return on true reinvestment
 + Value added return on true reinvestment

= Long-term earnings growth
 2000 + Growth from net share repurchases
 2109 = Long- term S&P 500 EPS/DPS growth
 2.05% + Fair normal dividend yield
 1.94% = Total shareholder return at constant PE
 2000
 Value added growth premium in fair value est.
 2.13% Fair S&P 500 Market Value and Book Value Multiple
 0.00% 2014 end S&P 500 book value per share
 4.13% Fair PB = Fair PE * normal aggregate ROE
 1.33% Fair PE = (ROE-g) / (real ROE*(real CoE-real g))
 5.45% Implied S&P 500 fair value of book at 2015 start
 2.05% Steady-state PB = normal agg. ROE / real CoE
 7.50% Confirmed by fair steady-state PE = 1 / real CoE
 0%
 \$750
 2.67
 18.2
 2000
 2.67
 18.2
 Normal 2015E economic profit per share \$68.75
 Sensitivity matrix of S&P fair value at 2015 yearend to normalized EPS and
 Real CoE
 S&P 500 EPS discount model 5 steps to value:
 1) Estimate normalized S&P 500 EPS
 2) Adjust normalized EPS for pro forma accounting quality
 3) Estimate a fair long-term real return on S&P 500 ownership (CoE)
 4) Capitalize normalized and accounting quality adj. EPS at real CoE
 5) Consider long-term potential for value added growth opportunities
 Real
 cost of
 equity
 5.00%
 5.25%
 5.50%
 5.75%
 6.00%
 \$118
 2227
 2124
 2031
 1945
 1867
 Normal 2015E S&P 500 EPS
 \$120
 2270
 2165
 2070
 1983
 1903

\$122
2313
2206
2109
2020
1939
\$125
2377
2267
2168
2077
1993
\$130
2484
2370
2265
2170
2083
\$135
2591
2472
2363
2264
2173
7.50%
1.50%
4.00%
5.50%
2.00%
7.50%

Source: Deutsche Bank Research
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Figure 8: S&P 500 Advised Sector and Industry Allocation (2014/15 PE based on DB US Equity Strategy top down sector and industry EPS estimates)

Market Advised

Weight (%)Weight (%)

Sector

2015 2016

PE PE

Biotechnology

Health Care Equipment & Supplies

14.5% 20.0% Health Care 17.1

16.1 Health Care Technology

Life Sciences Tools & Services

Pharmaceuticals

Over -

weight

21.2% 25.0%

Information

Technology

IT Services

17.4 16.3 Semiconductors

Software

Communications Equipment

Electronic Equipment

2.8% 5.0% Utilities

Electric Utilities

Gas Utilities

15.4

14.9

Independent Power Producers

Multi-Utilities

2.3% 2.5% Telecom 12.4 12.7 Telecommunication Services

Banks

Capital Markets

16.4% 16.5% Financials

13.7

13.0

Overweight

2015/16 PE

2015 2016

PE PE

14.4 12.9

21.6 20.3

27.8 24.1

19.1 18.4

17.7 16.9

Technology Hardware, Storage & Peripherals11.9 11.2

Internet Software & Services

30.0	26.7	
18.5	17.5	
16.9	16.3	
21.3	20.1	
12.3	11.8	
17.0	15.8	
14.6	14.3	
21.3	19.9	
10.5	9.5	
16.9	16.4	
12.4	12.7	
11.8	11.2	Consumer Finance
14.7	13.6	Diversified Financial Services
		Insurance
		REITs
		Real Estate Mgmt. & Development
		Thrifts & Mortgage Finance
		Equa lweight
		Consumer
		13.1%
		13.0%
		Discretionary
20.9	19.3	
		Auto Components
		Automobiles
		Distributors
		Household Durables
		Leisure Products
		Multiline Retail
		Specialty Retail
		Internet & Catalog Retail
		Media
		Food & Staples Retailing
9.7%	7.0%	
		Consumer
		Staples
21.0		
20.5		
		Airlines
		Under -
		weight
10.2%	5.0%	Industrials 16.4 16.1
7.3	8.3	Building Products
		Air Freight & Logistics
		Commercial Services & Supplies
		Professional Services
		Road & Rail
		Chemicals
3.0%	2.5%	Materials
17.7	16.5	
11.3	10.9	

20.4 18.8
 12.1 11.6
 18.5 17.8
 17.3 16.0
 33.2 11.6
 13.4 12.5 Diversified Consumer Services
 8.0 Hotels, Restaurants & Leisure
 8.4
 19.3 18.0 Textiles, Apparel & Luxury Goods
 16.4 14.6
 20.5 19.3
 15.3 14.3
 21.5 19.8
 81.5 65.2
 18.1 17.1
 18.1 17.5 Beverages
 Food Products
 Household Products
 Personal Products
 Tobacco
 23.9 22.3 Industrial Conglomerates
 18.1 17.0 Aerospace & Defense
 19.1 18.1 Construction & Engineering
 19.6 17.9 Electrical Equipment
 14.8 13.9 Machinery
 Trading Companies & Distributors
 17.1 16.3 Construction Materials
 Containers & Packaging
 Metals & Mining
 Paper & Forest Products
 6.9% 3.5%
 Energy
 27.5 23.8
 Aggregate PE of DB Industry allocations
 S&P 500 Index
 Source: Deutsche Bank Research, IBES
 Overweight
 15.6 14.8
 2049.62
 Equalweight
 17.6 16.6
 Energy Equipment & Services
 Oil, Gas & Consumable Fuels
 Underweight
 2015 & 2016 DB Strategy EPS 119.0 125.0 2015 & 2016 DB Strategy PE
 Bottom-up Cons. EPS
 118.4 128.1 Bottom-up Cons. PE
 22.8 22.6
 24.4 23.4
 20.4 19.8
 27.4 24.0

20.3 20.6

22.7 21.6

17.2 16.3

14.0 14.0

15.9 15.9

15.3 15.9

16.7 15.9

43.2 36.0

16.0 15.3

28.0 18.3

10.6 10.6

20.5 29.3

29.5 22.9

21.3 20.0

17.2 16.4

17.3 16.0

18.4 16.8

24.5 22.4

23.8 21.7

Equa lweight

2015 2016

PE

PE

Underweight

Health Care Providers & Services

2015 2016

PE

PE

16.3 15.5

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European Equity Strategy: 7% upside in 2016E but beware of the risk of a near-term correction

We see around 7% upside for the European equity market by end 2016, with a target of 410 for the Stoxx 600. We think European EPS overall will grow by 9% in 2016 (compared to consensus at 7%), with Euro-area EPS growth as the main driver, at 14% (compared to consensus at 8%). 12-month trailing P/Es, at 16.5x, are currently close to a 10-year high, but we see only moderate scope for de-rating, given the bias within the financial system for real bond yields

below equilibrium levels. We think Euro-area equities have scope to outperform US equities in 2016, on the back of stronger EPS growth (our US strategists project 5% EPS growth in 2016), more attractive valuations (the relative Shiller P/E is still close to a 20-year low) and FX support (our FX strategists expect the euro trade-weighted index to fall by 7% in 2016). We see

the risk of a 5% to 10% correction in the European equity market near term, as

global financial conditions tighten in response to the first Fed rate hike in nearly a decade.

Figure 1: The scope for a de-rating is limited by low real bond yields in Europe

Stoxx 600 12m trl P/E (lhs)

13.5

14.5

15.5

16.5

17.5

18.5

Euro-area 10-year GDP-weighted real

bond yield, inverted (rhs)

%

-100

-80

-60

-40

-20

0

20

40

Jun-14 Sep-14 Dec-14 Mar-15 Jun-15 Sep-15

Source: Deutsche Bank Research, Datastream, Bloomberg Finance LP

Figure 2: We expect 14% EPS growth in the Euro area in 2016, driven by a cyclical rebound in earnings

Euro area EPS growth US EPS growth

%

15

25

35

45

-35
-25
-15
-5
5

2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

DB

Source: Deutsche Bank Research, Datastream

Among sectors, we like European banks (the relative RoE has risen to a sevenyear

high despite investor pessimism about the sector's profitability outlook – but the relative P/B has not yet reflected this improvement) and cyclicals (tech

and autos, in particular). Pharma is our preferred defensive sector, given that

its high US exposure means it is a natural hedge in a correction scenario driven

by higher US rates and a stronger dollar. We are cautious on the outlook for the resource sectors (which would suffer if commodity prices fall further on the

back of a strong dollar) and consumer staples (which would be negatively affected by a further fall in emerging market exchange rates and a rise in US bond yields).

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Figure 3: Banks' P/B relative has not yet reacted to the improvement in relative RoEs

P/B relative (lhs)

%

-60

-50

-40

-30

-20

-10

European banks relative to the market

12m forward RoE relative (rhs)

%

-6

-5

-4

-3

-2

-1

0

1

100

120

140

160

180

200

220

80

2007

Source: Deutsche Bank Research, Datastream

2009

2011

Source: Deutsche Bank Research, Datastream

2013

2015

Figure 4: Consumer staples are priced for an implausible rates trajectory

European food & beverage, rel to the market (lhs)

US 10-year bond yields, inverted (rhs)

%

1.3

1.6

1.9

2.2

2.5

2.8

3.1

3.4

3.7

4.0

4.3

4.6

4.9

5.2

5.5

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Nov-05

Nov-07

Nov-09

Nov-11

Nov-13

Nov-15

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FX Strategy: Plenty of run left in the USD upswing

|| The multi-year strong USD cycle should extend for at least another two years, with a further 10% appreciation in the real broad USD TWI.

|| 2016 year-end forecasts are largely unchanged, with EUR/USD, USD/JPY and GBP/USD seen at 0.90, 128 and 1.27 respectively. We anticipate extremes in the likes of AUD/USD, NZD/USD and USD/CAD at 0.62, 0.53 and 1.40 respectively.

|| In macro terms, how 2016 shapes up will be heavily influenced by whether the main macro driver is the Fed or China. If the Fed is the driver, USD gains are seen as likely to be slow and broad-based, spread fairly evenly between G4, commodity FX and EM FX. If on the other hand, China, particularly China FX policy, becomes a source of instability, USD gains will likely be heavily concentrated in commodity and EM FX, while the G4 majors all outperform.

The USD continues to conform to the multi-year cycle big USD cycles of the past. Since the fall of Bretton Woods, big USD down cycles of 9-10 years have been followed by big USD upswings of 6-7 years. While all cycles are different,

the macro backdrop conforms to a view that we are about 2/3rds the way through the big USD up cycle, with the real broad index some 50 months into an upswing. In the same vein, the real Broad TWI has in past cycles largely retraced any prior cycle losses, and increased by 53% and 33% in the 1978 - 1985 and 1995 - 2002 upswings respectively. In the last downswing the USD real broad TWI fell by 28%. We expect that the USD will at a minimum fully retrace these losses, fitting with further real broad TWI gains in the order of

10%. In magnitude terms we are then also likely to be a little over 2/3rds the

way through the USD cycle, with USD gains henceforth likely to come at a slightly slower pace.

The main departure in this cycle relative to past cycles is that the USD gains

before the Fed starts hiking rates have been substantially larger than anything

we have seen in any fed hiking cycle. This front-loading of USD gains fits with

more modest USD gains to come.

It would however be premature to think that we are close to a USD top. This cycle is also likely to be unique in a couple of respects that are very positive for

the USD:

(1) In this cycle, at least for the coming year the Fed, and perhaps the BOE are

the only G10 Central Banks that are likely to tighten. This is in contrast to most

Fed tightening cycles, when many G10 Central Banks are typically tightening. In the last Fed tightening cycle, all G10 Central Banks tightened.

(ii) In addition, in this cycle many Central Banks are still leaning toward further

accommodation, including not least in encouraging their own currency weakness. The US is one of the few countries willing to tolerate currency strength.

iii) Some of the most important rate spreads for currencies, notably the 2yr US

Treasury - Bund yield spread are seen moving in favor of the USD for the next 5 years, if the respective forward curves prove correct. We expect that some of

the likely rate spread adjustment will also end up being front-loaded into the

next two years.

JPN

EU*

CHE

yes no

yes no

yes yes yes no

yes no

no

yes yes yes yes no

yes no

yes No, + easing

yes yes No, + easing

CAN yes yes yes yes yes No

GBR

yes yes No

AUD yes yes yes yes yes No

NZL** N/A N/A N/A yes yes yes No, + easing

SWE yes yes yes yes yes No

NOR yes yes yes no

6

Total 8

8

5

yes yes No, + easing

9

7

1

.*Bundesbank until 1992, ECB onwards.**data available from 1988 onwards Source: Deutsche Bank Research, Datastream

yes Maybe yes

Figure 1: USD real BROAD TWI performance during USD upward cycles

Cycle

Upswing

gain (%)

78-85
95-2002
2011
52.7
33.1
20.9
Prior cycle
loss (%)
-21.8
-34.0
-28.2

Source: Datastream, Deutsche Bank Research

Months of
upswing

78.0
83.0
50.0
Average
gain per
month
0.7
0.4
0.4

Figure 2: FX forecasts

Q1-16F Q2-16F Q4-16F 2015F

0.97
127
GBP/USD 1.42

128
1.37
0.90

128
1.27
2016F
EUR/USD 1.01
USD/JPY

1.05
125
1.47

Source: Datastream, Deutsche Bank Research

0.90
128
1.27

2017F
0.85
120
1.15

Figure 3: EUR/USD performance
months prior start of FED hike cycle

t-24
Median

Latest

-5%

-22%

t-12

-2%

-15%

Source: Datastream, Deutsche Bank Research

t-6

1%

-4%

t-3

-1%

-6%

Figure 4: G10 rate hike cycles

Figure 5: 2y US-German spread

forward curve

120

150

180

210

240

90

bps

Source: Datastream, Deutsche Bank Research

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Nov 76-May 81

Nov 82-Aug 84

Aug 86-May 89

Sep 92-Feb 95

Nov 98-May 00

Jun 03-Jun 06

2016

Curren

t

3MO

6MO

1YR

2YR

3YR

4YR

5YR

10YR

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(iv) Ongoing QE in Japan and the EUR area should remain a force encouraging a US yield curve bear flattening bias; that is the most favorable backdrop for

USD deposit and bond inflows.

The past year has shown an extraordinary divergence of over \$1 trillion between net inflows into US bond markets of over \$600bn, and a mirror image of similar scaled net outflows from EUR bond markets. We expect that this pattern will largely persist consistent with EUR/USD breaking below parity in H1 2016.

In contrast to these enormous portfolio flows, Japan largely sits on the sidelines, especially now that the GPIF portfolio reallocation is closing in on

completion.

Even if the yen does not quite conform to the past pattern of strengthening in

Fed tightening cycles, the yen should outperform almost all other currencies barring the USD in 2016, with a USD/JPY peak just shy of Y130. Extreme valuations remain a consideration in limiting yen losses, but will likely only

become more of a factor for EUR/USD on a break below 0.95.

In contrast to the yen that led the stronger USD cycle, the resilient G10 currencies should display some catch-up in 2016, as USD gains rotate into the GBP, and potentially the Swiss-franc as well. The pound in particular should suffer from a mix of fiscal contraction constraining the BOE tightening cycle,

making a C/A deficit of near 5% of GDP more difficult to finance, most especially in the face of 'Brexit' uncertainties.

In macro terms, how 2016 shapes up will be heavily influenced by whether the main macro driver is the Fed or China. If the Fed is the driver, USD gains are

seen as likely to be slow and broad-based, spread fairly evenly between G4, commodity FX and EM FX. If on the other hand, China, particularly China FX policy, becomes a source of instability, USD gains should be heavily concentrated in commodity and EM FX, while the G4 majors all outperform.

Historically, commodity and EMFX have tended to lag the majors at turning points, and this should also be apparent in this cycle when the USD eventually

turns. We anticipate extremes in the likes of AUD/USD, NZD/USD and USD/CAD at 0.60, 0.50 and 1.45 respectively.

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Figure 6: USD/JPY and USD/EUR performance depending of US yield curve

USD/JPY and USD/EUR performance depending of US yield curve

-25%

-20%

-15%

-10%
-5%
0%
5%
10%
15%
20%
Bear
Flatten
USD/EUR vs 10-2 yr yields
USD/JPY vs 10-2 yr yields
Twist
Flatten
Bull
Bear
Source: Datastream, Deutsche Bank Research
Bull
Twist

Flatten Steepen Steepen Steepen
Figure 7: Bond net flows -12m rolling
sum (in USDbn)
United States
Euro Area

200
400
600
800
-600
-400
-200
0
Sep-2013
Apr-2014
Nov-2014
Source: Datastream, Deutsche Bank Research

Jun-2015
USD bln
Japan
Figure 8: USD/JPY spot vs. PPP
20% Band
USD/JPY
115
165
215
265
315
65
Source: Datastream, Deutsche Bank Research

PPP USD/JPY
115
165

215
265
315
65
1973 1979 1985 1991 1997 2003 2009 2015
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Commodities: Supply adjustment is well underway for oil, not so for the metals

By next year, we expect that OPEC will have engineered one of the sharpest historical declines in US production. A modelled contraction of at least 650 kb/d would be comparable with the 600 kb/d fall in 1989 which occurred in the context of an extended supply slowdown beginning after prices fell in 1986.

Our modelling indicates that while the first half of next year will remain oversupplied and risks remain to the downside during this period, the steady contraction of US supply along with trend rates of demand growth will lead to a more normalised market balance in 2017.

We believe that the current recovery period in oil prices will be one of the slowest and most extended on record, owing partly to further growth in OPEC supply to 2017 when modelled OPEC production of 32.4 mmb/d matches our calculated call on OPEC (i.e., the volume required from OPEC to balance demand).

Oil at a Brent price of USD45/bbl is below the 2016 national budget breakeven level for all of the ten countries assessed by our EMEA macro team, and also below the breakevens for fourteen countries assessed by the IMF apart from Turkmenistan (with a breakeven of USD42.7/bbl).

However, budget breakevens may continue to fall as a result of coping strategies in the form of spending cuts and currency devaluation while government bond issuance and asset sales help to fund deficits, thus making another year of low prices survivable.

We maintain our bearish outlook for gold. We believe the first step in US policy normalisation will now more likely than not take place this month. Moreover, further tightening in 2016 is long overdue and a full pricing-in of this risk has yet to unfold. Additionally, further 6% strength in the tradeweighted

US dollar confirms the downside scenario for gold.

For industrial metals, the barriers to exit in many markets are high. These barriers range from the need to cover high fixed cost bases, take-or-pay supply contracts; pressure and incentives from governments to maintain employment and balance current accounts to a struggle for survival.

The metals industry still has to adjust to structurally lower Chinese demand

while long gestation projects continue to add tonnes to the market. While we see supply cuts gathering momentum in 2016, we only expect price stabilisation in 2017 when the markets start to look more balanced.

Oil fundamentals have bottomed; have prices?

Our view is that market balances have seen their weakest period and that a slow and steady process of US supply curtailment is well underway. We have already seen a 440 kb/d decline in the US since July, although this was preceded and overshadowed by an OPEC increase of 1,400 kb/d between November 2014 and June 2015.

Gradual improvement towards a more balanced market in 2017 is likely even with the onset of incremental Iranian exports next year. Further declines in the

US will offset the Iranian ramp-up, while underlying demand growth of 1.2 mmb/d will take up the slack of excess Saudi and Iraqi volumes.

Even if it is true that balances have seen the worst, market balances should remain weak for virtually the entire next year. Surpluses are most evident in the first half with an excess of +830 kb/d. Inventories will likely build once

again over this period while we model the second half surplus at +177 kb/d.

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Figure 2: Global crude oil balances

normalise in 2017E

OECD Stock Change (rhs)

Balance (rhs)

Global Oil Demand (lhs)

100

84

86

88

90

92

94

96

98

mm b/d

Surplus

Global Oil Supply (lhs)

mm b/d

Deficit

2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017

Sources: IEA, Deutsche Bank Research

-3.0

-2.0

-1.0

0.0

1.0

2.0

3.0

Figure 1: Oil price slumps compared

100

120

20

40

60

80

0

0 50 100 150 200 250 300 350 400 450

Number of trading days after the oil price peaked

Source: Bloomberg Finance LP, Deutsche Bank Research

Oil price peak

indexed at 100

2001

1990

1997

1985

2008

2014

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This is a time when markets are normally undersupplied and global inventories typically draw down, however, so a 'balanced' second half may still be regarded as bearish. Last year, OECD inventories rose over the second half, defying the typical profile, and they are on pace to do the same this year. While we believe any excursion of prices below the 2015 low would be shortlived,

some uncertainty arises from the fact that producer support in the form of shut-ins would be unlikely, in our view. First, operating expenses per barrel

of oil produced are quite low. We estimate that 1.92 mmb/d of global production becomes cash negative at a Brent price of USD30/bbl including 660 kb/d of low-volume stripper wells in the US. Second, producer shut-ins are unlikely to occur in this volume as there are myriad reasons to avoid the expenses of shutdown and eventual restart, such as the need to decommission older fields and the possibility of reservoir damage. The only scenario in which

we could more reliably expect such closures is if producers become convinced that long-term real oil prices will remain below USD30/bbl, which is unlikely in our view.

The US adjustment still has much further to go

The focus of expectations for supply contraction in 2016 continues to be centered on the US, although other non-OPEC producers and some OPEC producers such as Iraq may also begin to suffer declines at existing investment

levels. The susceptibility of US supply to contract is partly a result of a relatively short lag time between drilling and production, and also the responsiveness of the industry in which drilling contracts are relatively short,

lasting from six to twelve months. Thus far, drilling activity in the US has contracted by -66% from the peak, versus 26% in the remainder of non-OPEC and -14% among OPEC producers.

The decline so far of 440 kb/d will be extended over the coming months. A key assumption is that rig productivity growth will remain subdued in the major basins of the Bakken, Permian and Eagle Ford as the rate of contraction in drilling activity also slows. This is explained by the notion that a sharper rise in

productivity is only possible as activity falls materially. In this phase, producers

can selectively drill the most economic assets and exclude marginal plays, thereby raising the initial production rate from the average well. However, as

the decline in drilling activity flattens, this process of winnowing out the losers

is no longer possible to the same extent. We can observe the resulting slowdown in productivity gains beginning around August in the Permian, October in the Bakken, and in forecast figures for the Eagle Ford in December.

A second and more neutral assumption is that the level drilling activity

remains

constant going forward, despite an average decline of nine oil-directed rigs per week since September. We can think of the risks to our model as offsetting to some degree – if rigs do continue to decline, the production outlook would certainly deteriorate but would be helped by higher gains to rig productivity.

On these expectations then we find that a continued decline of US production in 2017 contributes to a more normal profile of first-half surplus followed by second-half deficit and the possibility of the first meaningful inventory draws.

With OPEC potential production in 2017 of 32.4 mmb/d matching the modelled “Call on OPEC”, this suggests that the market will recognise a need to stabilise and eventually raise the level of investment in supply both in the US and globally.

Figure 3: An extended surplus in US commercial crude inventory

300
350
400
450
500
550
5Y Range
2015
2014
Forecast

Jan FebMar Apr May Jun Jul Aug Sep Oct Nov Dec
Sources: Bloomberg Finance LP, Deutsche Bank Research

Figure 4: Decline in US oil production has further to go

Actual rigs (lhs)
Production (rhs)

200
400
600
800
1000
1200
1400
0
2007 2008 2009 2011 2012 2014 2015 2016

Sources: Bloomberg Finance LP, Deutsche Bank Research

Rigs

Scenario (lhs)
Scenario (rhs)

kb/d
1000
2000

3000
4000
5000
6000
0

Figure 5: DB Oil price deck
WTI (USD/bbl) Brent (USD/bbl)

2015F
Q1 2016F
Q2 2016F
Q3 2016F
Q4 2016F
2016F
2017F
2018F
49.2
48.0
50.0
54.0
54.0
51.5
58.0
65.0

Figures are period averages
Source: Deutsche Bank Research

53.5
52.0
55.0
59.0
59.0
56.3
63.0
70.0

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Financial markets & gold

We maintain our bearish outlook for gold. Although Fed funds futures have priced in a normalisation of US policy at various points since 2009, we believe

the first step will now more likely than not take place this month.

Moreover, a

tightening cycle in US monetary policy is regarded as long overdue based on the Taylor rule, with a strong likelihood of further steps in the new year. While a 25 bps hike in December may have little impact for precious metals given the strength of market expectation, we also expect three more rate hikes

in 2016. If realised this would be a meaningful departure from the currently priced expectation and consequently, more negative for precious metals. We reference the impact to gold prices of the rise in market expectations of a December hike from 30% in October to more than 70% currently, Figure 6.

By the same token, a disappointment of the market expectation for the first rise in nominal US rates since 2006 would be positive for gold as we believe it

would have to be accompanied by either a systemic risk event, a sudden and dramatic deterioration in growth prospects, or else the shock that market participants have miscalculated in some other way.

Industrial metals: Supply rebalancing gains momentum

The barriers to exit in many metals markets are high. These barriers range from

the need to cover high fixed cost bases, take-or-pay supply contracts; pressure

and incentives from governments to maintain employment and balance current accounts to a struggle for survival. 2015 did however mark the start of the supply curtailments in response to low and falling prices. There are some differences between the oil and the metals markets however. In the case of oil,

demand was reasonably robust, and the oversupply was driven by a supply glut. In metals, the industry still has to adjust to structurally lower Chinese

demand while long gestation projects continue to add tonnes to the market.

We think the critical mass in this adjustment process will come in the latter half of 2016 for oil, but not so for the industrial metals. In the industrial metal

complex, it was only toward the end of 2015 that any significant capacity cuts

have been announced. Glencore has taken the industry lead in the base metals, with cuts of 500kt in mined zinc (c.3.5% of the market) and copper (c.2% of the market). In aluminium Alcoa announced cuts of 500kt (1% of global supply),

but we think more cuts from China is needed to be truly effective. More recently, Chinese smelters (copper ~200kt, zinc ~500kt and nickel ~120kt) announced a raft of cuts. These are partly in response to cuts by the miners in

our view however. The magnitude of these cuts is not sufficient to support

prices, except for potentially the Nickel market. In comparing the supply response during the global financial crisis, it was only when the cuts exceeded

10% of the market that prices started to find a floor. We see supply cuts gathering momentum in 2016, but the market will be wary of producers reversing their decision at the first sign of a price recovery. The adjustment

process this time round will be much slower than during the GFC, and we only expect a price stabilisation in 2017, when the markets should start to look more balanced.

The demand outlook for oil remains healthier than that of the industrial metals.

This statement deserves some clarification. In absolute terms the demand growth in many metals is likely to be higher than that of oil; however the rate

of growth in many metals is likely to be half the rate seen over the past five

years. Oil demand is likely to be only marginally lower over the next five years

due to the more price elastic response and the fact that oil demand growth is much less sensitive to the Chinese economic slowdown. The net result is that although we forecast metal demand growth to remain positive, producer and indeed market expectations are still too high in our view. The slowdown in

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Figure 6: Gold downside to result from US Fed normalisation

Index

85

90

95

100

105

Jul-2015

%

10

20

30

40

50

60

70

80

90

Aug-2015

Sep-2015

Oct-2015

Nov-2015

Dec-2015

Gold (indexed to 100, lhs inverse scale)

Silver (indexed to 100, lhs inverse scale)

Market-implied probability (0.25-0.5% Federal funds rate at 16-Dec-15 meeting) (rhs)

Sources: Bloomberg Finance LP, Deutsche Bank Research

Figure 7: Base metal production cuts as a percentage of the market

Volume cuts (lhs)

Percentage of market (rhs)

200

400

600

800

1000

1200

0

Copper

Nickel

Zinc Aluminium*

Note: *excluding Chinese capacity cuts as net additions far outweigh closures

Source: Deutsche Bank Research , Company Reports

Kt

%

10

12

0

2

4

6

8

Figure 8: Metal and oil demand growth forecasts

CAGR 2009 - 2014

0.0%

1.0%

2.0%

3.0%

4.0%

5.0%

6.0%

7.0%

8.0%

9.0%

CAGR 2015 - 2020E

2016E

Note: *excludes investment demand

Source: Deutsche Bank Research, Wood Mackenzie,

Platinum*

Aluminium

Nickel

Copper

Zinc

Lead
Iron ore
Oil

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Chinese metal demand is structural in our view, with over 60% of Chinese demand related to; infrastructure, property and industrial manufacturing. The remaining 40% is related to consumer demand.

Unfavourable demographics with an ageing working population is the main driver for slower metals demand in property related demand sectors. We forecast demand growth from the property sector to be essentially flat with lower "new" demand being offset by replacement demand as lower-quality buildings are upgraded. Metal demand from infrastructure is also likely to be low single digits, with many of the tier-1 and tier-2 cities close to being fully

developed, in our view. Infrastructure build in the lower tier cities offers some

upside as does the upgrading of some early infrastructure builds. However, the

jury is still out as to whether the more limited employment and social benefits

will entice the general population to relocate to these tier-3 cities. The overcapacity

in many basic industrial sectors such as mining, metal refining and processing, ship-building has led to a significant decline in capex. Basic industry is unlikely to be a driver of metals demand until the over capacity is

squeezed out of the market. Industries further down the value chain tend to be

more knowledge driven and less metal intensive, and any growth in these sectors is unlikely to offset the weakness in the basic industries. Demand growth in Auto's and white goods remains the bright spot for Chinese metals demand.

We forecast mid-single-digit demand growth with rising metals intensity per unit as higher specification models are purchased. The net result is flat to falling demand growth in steel and low single digit demand growth in the base metals.

Figure 10: Chinese copper demand by sector: demand is weighted towards FAI

Other

8%

Electronics

7%

Building/

Construction

21%

Figure 9: Falling Chinese FAI

10

20

30

40

-10

0

% change

Y/Y

FAI Manufacturing (Y/Y)

FAI Real Estate (Y/Y)

FAI infrastructure (Power/Water/Gas) (Y/Y)

Source: Deutsche Bank Research, Wind

Figure 11: Chinese copper demand growth by sector:

Demand growth remains positive, but structurally lower

10.0%

15.0%

20.0%

25.0%

White Goods

15%

0.0%

5.0%

2000 - 2005

Transportation

11%

Industrial

machinery &

equipment

11%

Source: Deutsche Bank Research

Electrical network

infrastructure

27%

Construction

Transportation

Total

2005 - 2010

2010 - 2014

Electrical network

White Goods

2014 - 2020E

Industrial Machinery

Electronics

Source: Deutsche Bank Research

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A cyclical rebound in off a low base

Although we think that much of the metal demand slowdown in China is structural, the cyclical weakness in the property market, weak land sales and continued anti-corruption investigations into some of the higher profile state

infrastructure companies has exacerbated the structural slowdown. We think that there is a reasonable probability of a modest cyclical rebound in demand for 2016. Property sales have improved off a low base, but as yet there has not

been a sustained pick-up in new starts. Land sales have improved, again off a low base, and this has resulted in a topping up of state coffers, which has allowed a re-acceleration in infrastructure spending. The end of anti-corruption

investigations will also allow some more freedom of action, especially at the local government level. Declining investment into manufacturing capacity will continue to be a drag on the sector, as over capacity results in falling capex.

Figure 12: Apparent crude steel

consumption versus floor space sold

China monthly floor space sold (lhs)

China monthly crude steel apparent consumption, (rhs)

15
30
45
60
75
90
-30
-15
0
%yoy, 6mma
%yoy, 6mma

16
24
32
40
48
-16
-8
0
8

Source: Deutsche Bank Research , WSA, CEIC

Figure 13: Chinese fiscal deposits versus fiscal expenditure

Figure 14: Non-financial sector capex growth rate yoy

% yoy,
3mma
-40%
-20%

0%
20%
40%
60%
80%

Fiscal deposit 10months backward (lhs)
Fiscal expenditure (rhs)

% ytd yoy,

3mma

After moved 10 months backward,
fiscal deposit becomes highly
correlated with fiscal expenditure.

0%

5%

10%

15%

20%

25%

30%

35%

40%

Jun-2002 Jun-2004 Jun-2006 Jun-2008 Jun-2010 Jun-2012 Jun-2014

12

15

18

21

24

27

30

-3

0

3

6

9

% yoy

Non-financials CAPEX growth rate (4-quarters moving average)

Source: Deutsche Bank Research, NBS

Source: Deutsche Bank Research, WIND

A crescendo of corporate activity

The mining sector is under severe stress, which we think will culminate in a flurry of corporate activity in 2016. The producers have continued to cut capex

and operating costs, with the help of falling producer currencies trying to outpace the fall in prices. We continue to see further capex declines and cost

cutting, but we believe the ability to cut much more is now limited.

Cashflows

and balance sheets remain under pressure. Dividends in all but a select few companies will be cut, asset sales are likely to accelerate and we expect to see

a rise in M&A. At the opposite end of the spectrum, we expect to see a few

companies in administration and the number of rights issues increasing over the course of the year, as companies look to repair balance sheets. The first wave of rights issues were seen in 2015 with the under pressure PGM producers Lonmin and Impala first out of the starting blocks. The crescendo of activity in the sector is likely to mark the bottom, and as long as the balance sheet repair process is accompanied by supply discipline, the outlook for the sector should improve towards the end of 2016.

Figure 15: spot metal prices versus marginal cost

%

-45
-40
-35
-30
-25
-20
-15
-10
-5

0

5

2015

2016e

Note: *incl. US Midwest premium, **at spot Pd, Rh and Rand, ***incl. sustaining capex, ****Seaborne market

Source: Deutsche Bank Research , Wood Mackenzie, Deutsche Bank AG/London

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Aluminium*

Copper AISC***

Nickel

Zinc

Iron ore

Met Coal****

Thermal Coal****

Platinum**

Gold AISC***

3Q04

1Q05

3Q05

1Q06

3Q06

1Q07

3Q07

1Q08

3Q08

1Q09

3Q09

1Q10

3Q10
1Q11
3Q11
1Q12
3Q12
1Q13
3Q13
1Q14
3Q14
1Q15
3Q15
Apr-08
Oct-08
Apr-09
Oct-09
Apr-10
Oct-10
Apr-11
Oct-11
Apr-12
Oct-12
Apr-13
Oct-13
Apr-14
Oct-14
Apr-15
Oct-15

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Figure 16: Large cap* miner net debt to EBITDA

Ratio

0.0

0.5

1.0

1.5

2.0

2.5

3.0

The cycle starts

to turn

The miners respond by
cutting capex and costs
which offsets commodity
price weakness

...the risk in 2016e is that
commodity prices continue
to weaken, . our base case
assumes some asset sales
for select producers.

...but not enough to offset the
speed of commodity price
declines in 2015

Figure 17: Glencore 1Y CDS spread

bps

200

400

600

800

1000

1200

0

2011

2012

2013

Base case

2014

2015E

2016E

Risk case

Note: *Mkt cap weighted BHPB, Rio, Barrick, Freeport, Alcoa, Norilsk, Alcoa,
Glencore, Southern

Copper, Anglo American and Vale

Source: Deutsche Bank Research, Company reports,

Source: Deutsche Bank Research, Bloomberg Finance LP

2017E

Glencore 1Y CDS spread

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Michael Hsueh, (44) 20 754 78015

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Dec-2014
Feb-2015
Apr-2015
Jun-2015
Aug-2015
Oct-2015

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Global Asset Allocation: The case for normalization

Key themes and catalysts for 2016:

After a record rise in the dollar, 2015 saw unusually negative US data surprises

that were second only to 2008. Five and a half of the first six months saw a prolonged and sustained period of negative surprises as the lagged impacts of the record rise in the dollar combined with a second severe winter and port strikes. Following a brief period of positive surprises, the August equity market

correction saw sentiment indicators fall sharply and another two months of negative surprises ensued. Macro data surprises were worse only in 2008.

2016 should see normal data surprise cycles, with a warmer winter an upside risk. The sharpest nine-month rise in the dollar against the major currencies was responsible directly for the sharp move down in manufacturing and indirectly through the collapse in oil prices on energy-related capex. The divergence between manufacturing and resilient services has been closely tied to the pace of dollar appreciation and should begin to anniversary out with the

former catching back up to the much larger latter sector.

Underlying (private) US growth has been much stronger than headline GDP growth rates and it has been resilient. Headline GDP growth in the US (2.0%) has been lowered by the shrinking government sector. With the peak in fiscal drag passed, we expect headline growth to lift towards private GDP growth (3.0%) if not higher given expenditure multipliers. The US recovery has also been resilient in the face of a variety of large shocks in recent years with, for

example, the labor market remaining in its 2.4% ar recovery channel.

Financial repression is reducing growth: rate normalization to raise incomes and

lower the savings rate. The traditional view that low rates represent stimulus

focuses on the cost of household (HH) liabilities, but the asset side is much bigger (Are Low Rates Raising The Savings Rate?, Oct 2015). Of \$100 trn of HH assets, cash alone is \$10 trn and lower rates mean lower interest income of \$360

bn (2% of GDP) before multipliers. Lowering the return on savings also raises the

savings rate (1 pp of GDP). Corporate cash holdings are 3x short-term debt so earnings should also rise with rates, especially for the Financials.

EM growth re-normalization is advanced: the question is whether it will be a soft or hard landing. The multi-year outperformance of EM during 2001-2010 represented a confluence of four circumstantial factors: slack following late 1990s crises; dollar down cycle encouraged capital inflows and credit boom; dollar down cycle meant oil and commodity up cycle; interaction meant appreciating exchange rates, which checked inflation and lengthened the cycle; each factor went into reverse in 2010-2011 and looks to have a little further to run. Our baseline view has been that the EM growth spread or advantage will revert to its historical range, and we are almost there (When Will EM Stop De-rating?, Oct 2013). While EM growth has been slowing since

the peak in 2010, the pace of deceleration slowed beginning in 2012 with the end of the European financial crisis. Our baseline view is that the pickup in developed markets growth, combined with the fact that EM FX has overshoot the decline in relative growth, will see a soft landing in EM.

The relatively typical global economic recovery continues at trend-like global

GDP growth rates. Despite the angst and narrative of how weak global growth has been, 2015 marked the fourth year running of trend-like global GDP growth. Using market exchange rate weights, growth has actually been rising since 2012 and should move at above trend next year. Asynchronous global recoveries are typical. We view the current global recovery as being like the 1990s when asynchronization was the norm; not like the unusually synchronized 2003-07 recovery, which was the exception.

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Fig. 1: Big neg. surprises this year...

Average Annual MAPI

-0.15

-0.10

-0.05

0.00

0.05

0.10

0.15

-0.15

-0.10

-0.05

0.00

0.05

0.10

0.15

Source: Bloomberg Finance LP, Deutsche Bank Research

Fig. 2: ... reflected dollar's rise

% yoy

-20

-15

-10

-5

0

5

10

15

20

1997

2001

2005

Recession

USD TWI, inverted axis (lhs)

Mfg minus Services PMI (rhs)

Index

pts

Flat

USD
Correl = -41%
2009
2013

-10
-8
-6
-4
-2
0
2
4
6
8

2017
Source: Markit, Bloomberg Finance LP, Deutsche Bank Research
Fig. 3: Pvt. vs. headline growth

Recession
Private
Index

102
107
112
117
122
127
97

Source: BEA, Deutsche Bank Research
Total
US Real GDP (Q1 2004 = 100)

3.0%
growth
2.0%
Govt
Index
-2.2%

102
107
112
117
122
127
97

Dec-03 Dec-05 Dec-07 Dec-09 Dec-11 Dec-13 Dec-15

Fig. 4: EM growth normalization
EM minus DM: Real GDP Growth (IMF data and
forecasts)

-1
0
1
2

3
4
5
6
7
% yoy
2011 forecast
2012 forecast
2013 forecast
2014 forecast
Consensus
2015 forecast

% yoy
2015
-1
0
1
2
3
4
5
6
7

Source: IMF, Deutsche Bank Research

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1976
1979
1982
1985
1988
1991
1994
1997
2000
2003
2006
2009
2012
2015
2018
2008
2015
2006
2004
2010
2011
2012
2001
2000
2003
2007

2013
2005
2014
2002
1998
2009
1999
1997

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The goods-services divide suggests the Fed and ECB are misdiagnosing underlying inflation: low goods inflation is a global phenomenon that reflects

the dollar up and commodity down cycles, which are accelerated by monetary policy divergence; services inflation is running much stronger and rising.

Core

goods inflation (25% weight in the US; 38% weight in Europe) consistently runs well below core services inflation. In the US, core goods inflation has been running slightly negative for three years, while core services a much stronger 2.5% for the last four years and recently moved to a new cycle high. In the Euro area, core goods inflation is running higher than in the US reflecting the depreciation of the euro, while core services has been moving up

and is running at 1.4%. Core goods inflation in the US is strongly correlated with import price inflation. Zero or slightly negative core goods inflation in the

US can also be thought of as foreign inflation less the dollar's appreciation.

Core services inflation in the US has moved up over the last three months and has a fair degree of catch up to do with the decline in unemployment relative to the NAIRU and rental vacancies.

The dollar up cycle should have 10% to go medium term, but speed breakers are now in place to slow the pace. The US trade-weighted dollar rose 23% during Jun 2014-Mar 2015, the fastest pace ever with about three years of appreciation in a typical dollar up cycle packed into nine months. The rapid appreciation erected two speed breakers which should slow the pace: lower core goods inflation prompted the Fed to push out rate guidance in April (marking a top in the dollar for next seven months); the drag on US growth and

earnings has seen a big reallocation (\$-150bn) out of US equities into Europe.

Historically turns in productivity are led by the dollar: typical lag implies we are

at the cusp. Historically, over the post-World War II period, productivity has

grown at a trend rate of 2.1% per year, with long multi-year cycles in the level

of productivity around this trend. The current level is near the bottom of the

trend channel, a level last seen in 1995. Incentives matter: the dollar looks to

have been an important driver of productivity historically. There has been a relatively strong correlation between the lagged level of the trade weighted dollar and productivity. The average lag looks to have been about three years.

Cyclical asset allocation: large over-allocation to fixed income at the expense

of equities persists. Around recessions, flows overweight bonds over equities.

Asset allocation re-normalizes around Fed hiking cycles. This time various QEs, calendar guidance and Twist prompted investors to put even more money into bonds long after the recession. Despite equity inflows resuming in 2013 (especially after the taper) cumulative overweight in bonds is still \$748bn and underweight in equities \$1.4 trn. Each episode of rising rates over the last five years saw robust reallocations from bonds to equities.

The cross asset rates minder:

Rate normalization cycles have long been associated with significant price losses on the 10y. Previous rate hiking cycles each saw long-lived capital losses on the 10y, averaging -11%. We estimate that a catch back up of market expectations to the Fed's guidance is worth +150bps in the 10y implying a significant potential re-pricing. The current divergence two years ahead is comparable with historical experience near turning points in rate cycles.

Figure 5: Trend like global growth

% yoy

-1

0

1

2

3

4

5

6

World real GDP growth (IMF data)

Average (3.6%)

% yoy

1990s asynchronous

global growth

2015

-1

0

1

2

3

4

5

6

Weights using PPP exchange rates

Source: IMF, Deutsche Bank Research

Figure 6: Dollar cycle has 10% to go

Index

100

110

120

130

60

70

80
90
1974
1982
1990
1998
2006
2014

Source: Bloomberg Finance LP, Deutsche Bank Research

Index

USDTWI

PPP Implied

20% Band

100

110

120

130

60

70

80

90

Figure 7: Dollar leads productivity

USD TWI (dev from PPP implied, 12q lead, lhs)

US Nonfarm Productivity (dev from trend) (rhs)

10

20

30

40

-30

-20

-10

0

%

%

10

Correl (since 1982): 51%

-10

-8

-6

-4

-2

0

2

4

6

8

Source: BLS, Deutsche Bank Research

Figure 8: Over allocation to bonds

Cumulative bond flows

Rising yields

400

800
1200
1600
2000
2400

0

USD bln

Bond flows

USD750bn

above normal

USD bln

400

800

1200

1600

2000

2400

0

Source: ICI, Deutsche Bank Research

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1984

1988

1992

1996

2000

2004

2008

2012

2016

1973

1977

1981

1985

1989

1993

1997

2001

2005

2009

2013

2017

1975

1979

1983

1987

1991

1995

1999

2003

2007

2011
2015
2019

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There is plenty of room for the terminal rate to go up and for the bond risk premium to turn positive. Starting in late 2012, the Fed began lowering its "long run" policy rate in sync with its forecast of lower long-run real GDP growth, from 2.5% to 2%, which corresponds to average headline GDP growth in this recovery. But with the drag from the government shrinking since early 2014 and private sector GDP growth running at 3%, underlying headline growth has already moved up to 2.4%. As the government sector begins to cease being a drag, headline real GDP growth should lift to 3% and the terminal rate to 4.5% ($3+2-0.5$). With the bond risk premium (BRP) an unprecedented negative through the Fed's calendar rate guidance, it turned positive around the taper but is back to around zero. We look at the BRP relative to the 10y as this normalizes for prevailing duration.

Historically, the

BRP ranged from 0% to 40% of the 10y yield, averaging 22%. That would be as additional 44 bps on the current 10y, about what the Fed seems to be assuming. The BRP has also been historically correlated with the US current account deficit as much of it was financed by the foreign official sector, which

bought Treasuries for Official Reserves. The present current account deficit points to 25% of the 10y yield, so similar (55bps) but slightly higher BRP. Credit spreads tighten with higher rates but over-allocations keep fixed income

vulnerable: HY over HG. It is generally assumed that higher rates mean wider credit spreads, i.e., that the beta of credit spreads to the 10y yield is positive;

the betas of both HG and HY spreads to the 10y have in fact always been negative (Credit After The Taper Reset, August 2013). HG has been the largest recipient of inflows in fixed income and with spread compression (beta less than 1) insufficient to offset the impact of higher rates, negative total returns

leave them vulnerable to outflows. HY much less so.

The equity risk premium is at a 70-year high; it is perfectly negatively correlated with the 10y yield. The equity risk premium (the equity discount rate

less Treasury yields) is a very hefty 8% (Cycles in the Equity Discount Rate and

Risk Premium, Apr 2015). Prior to this cycle, the last time it was this high was

in the 1950s post-World War II recovery period. It remains 3pp wider than it was pre-financial crisis. The equity risk premium has historically been strongly

negatively correlated with the 10y Treasury yield. With a beta around -1, a rise

in the 10y yield should see the equity risk premium shrink by a commensurate amount. Indeed a 3 percentage point rise in 10y yields that shrunk the equity risk premium by a commensurate amount in line with the historical pattern would take it back down only to where it was prior to the financial crisis, i.e.,

equities look to be priced for significantly higher yields and then some.

The dollar cycle is years ahead of the rates cycle. As US rate increases get closer and the ECB keeps rates on hold or even cuts further, rate differentials move in favor of the dollar; but the euro is two years ahead of rates and will therefore remain vulnerable to reversals. Positioning has been moving long the dollar. At 92% of April highs, there looks to be only modest room for the market to go longer. The next phase of the dollar up cycle looks to be closer to the typical 5% a year pace: (i) euro rates selloff has further to go; (ii) in the face of rapid dollar appreciation the Fed already pushed out rate hikes once marking a trough in the euro for the next six months and will likely do it again. Oil will continue to be pressured by a rising dollar but unlike 2014 it looks close to fair value. Across the oil and commodities complex, prices have been driven predominantly (average 81%) by global activity (slack) and the US dollar (Trading The Commodity Underperformance Cycle, Apr 2013). But as a practical matter, they have been driven almost entirely by the dollar and valuation, as global growth has varied little over the last few years. Oil prices are now close to fair value (Closing Our Short In Oil, Dec 2014) and risk-reward argues for being modestly underweight on a rising dollar. Industrial metals, especially Copper still looks expensive.

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Figure 9: Hiking cycles and 10Y

Fed Rate Cycles and 10y Treasury Price Changes

Hiking Cycle	Average	Median
1958-59	16	64
1961-66	26	37
1972-74	37	4
1976-80		
1980		
1983-84		
1994-95		
2004-06		

16
12
24
25
20
Fed
Rate at
Trough
0.5
0.5
3.5
4.8
9.5
8.5
3.0
1.0
Fed
Rate at
Peak
4.0
6.0
13.0
14.0
20.0
11.5
6.0
5.3
-3m to
+12m
return
-11.9
-1.9
-5.6
-0.9
-23.9
-10.2
-12.0
-1.5
-8.5
-7.9
Source: Bloomberg Finance LP, Deutsche Bank Research
10y treasury
price chg
during the
hiking cycle
-10.4
-9.6
-10.4
-23.1
-9.6
-12.5

-10.4

-3.1

-11.1

-10.4

Figure 10: Credit spreads and rates

bps

-2.00

-1.75

-1.50

-1.25

-1.00

-0.75

-0.50

-0.25

0.00

0.25

3m Beta of Corp Spreads to 10y

Rising yields

HG

bps

HY

-2.00

-1.75

-1.50

-1.25

-1.00

-0.75

-0.50

-0.25

0.00

0.25

Source: Factset, ML index, Deutsche Bank Research

Figure 11: Equity risk premium

negatively correlated with rates

%

0

2

4

6

8

10

12

14

10y yield, inverted axis (lhs)

Equity Risk Premium, over 10y (rhs)

pp

11

ERP (over 10y) = 10.48 -

0.874 * 10y yield

Adj R-Sq: 77.9%

Correl

Since 1933: -88%

Since 1980: -92%

1933 1947 1961 1975 1989 2003 2017

Source: Bloomberg Finance LP, Deutsche Bank Research

-3

-1

1

3

5

7

9

Figure 12: Euro is far ahead of rates

EURUSD

Fitted

1.0

1.1

1.2

1.3

1.4

1.5

1.6

At FOMC

exp of Fed

rates

At mkt

pricing

of Fed

$EURUSD = 1.35 + 0.06*(EUR-US\ 12m\ rate\ diff) + 0.014*(EMU\ PE\ (rel\ to\ US))$

R-sq = 52%; Smpl: 11/2004-5/2014

1.0

1.1

1.2

1.3

1.4

1.5

1.6

Source: Bloomberg Finance LP, Deutsche Bank Research

Page 69

2003

2005

2007

2009

2011

2013

2015

2017

1990

1992

1994

1996

1998
2000
2002
2004
2006
2008
2010
2012
2014
2016

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World Outlook 2016: Managing with less liquidity

The ghosts of EM crises past: equity over-allocation to EM has been completely unwound; EM FX to have overshoot 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 overshoot. 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
Real log Oil Price = $19.6 - 3.50 * (\text{Ln USDTWI}) + 1.89 * (\text{World Output Gap})$
Sample: 1999-2013 R-Sq: 82%

USD/bbl
110
130
150
10
30
50
70
90
Fair Value
Brent Oil Price
WTI Oil Price

USD/bbl
110
130
150
10
30
50
70
90

Source: Bloomberg Finance LP, Deutsche Bank Research
Figure 14: EM equity over allocation
has been reversed

100
200
300
400
500
600
700
-300
-200
-100
0

2004 2006 2008 2010 2012 2014 2016
Source: EPFR Global, Deutsche Bank Research
EM minus DM equity flows (Cumulative since 2004)

USD bln
USD bln
100
200
300
400
500
600

700
-300
-200
-100
0

Figure 15: EM FX has overshoot
EM relative growth and FX

-2
-1
0
1
2
3
4
5
6
7
8

2002

pp
Index
102
107
112
IMF

Projection

2005

EM minus US growth (lhs)
EM FX index (rhs)

2008

2011

67

72

77

82

87

92

97

2014

2017

Source: National statistical organizations, Deutsche Bank Research

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Oct-2000

Oct-2002

Oct-2004

Oct-2006

Oct-2008

Oct-2010
Oct-2012
Oct-2014
Oct-2016

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Geopolitics: The EU's geopolitical crisis eclipses its economic crisis

The EU is challenged to its south by the collapse of the security cordon built

laboriously over four decades along the southern Mediterranean and to its southeast by the collapse and sectarian civil wars of Syria and Iraq. Both of these

are the sources of the radical Islamist terror and the mass migrations that are

now threatening the EU's internal cohesion. To its east, it is challenged by Russia's response to its efforts to form an association with Ukraine.

The war in Syria is becoming an ever-greater can of worms. In addition to the mutually competing interests of the many factions battling the Assad regime and each other, four key outside countries and their coalition partners--

Russia,

France, the US, and Turkey--now have air forces in action also with mutually competing objectives, regardless of their formal coalition alignments. In response to the massacre in Paris, France has fully committed its most powerful conventional forces to this decade's "War on Terror". This sudden attack and response may help to cut through the knot of contradictions that have threatened the EU geopolitically and economically, for example by finally

dethroning the abrasive fiscal constraints via force majeure. More likely, in our

view: the EU will become even more absorbed in the conflicting tactics and strategies in Syria that have so tied up the other major participants.

The EU's basis is geopolitical

European unification has always been about geopolitics. The drive for European internal unity started as a geopolitical solution to end the intraEurope

warfare that arguably had continued since the fall of Rome--and it has evolved over 65 years at an accelerating pace. It began with the European Coal

and Steel Community, an accord between especially Germany and France on the allocation of these vital resources. Then in sequence came the European Economic Community, the Schengen Agreement, the European Community, and the European Union along with the euro area.

This political and institutional evolution has coincided with an historically long

peace in Western Europe. The geopolitical freeze imposed by US and Soviet occupation during the Cold War delivered the first 45 years of peace. But for the last 25 years, it has proceeded under its own momentum, albeit under the US security umbrella.

At its base, the euro itself initially was about internal geopolitics: German reunification in 1989 finally completed German's grand strategy in effect since

the Adenauer government. It could have created a thoroughly dominant Germany that once again might become overbearing and politically

destabilizing. The euro was the way to harness Germany to the interests of

the
larger Union to make its potential strength less threatening.
Aside from its economic aspects, the euro also was to be a device to
accelerate the arrival of the federal European state. Economists did then and
still do believe that a currency without an over-arching state would be
unstable.
But even this flaw strengthened the rationale for its creation: the euro
would
force the completion of unification. It would lock in members and compel
centralization of key financial decision-making and regulation. It was
“ Irreversible” and so therefore was the path to a super-state.
But the incomplete nature of the EU state system was the ultimate source of
the
euro economic and political crisis. A perceived unwillingness to do what it
took
via fiscal transfers to hold the system together has driven a not-quite
standard
balance-of-payments crisis from 2010 through 20012 and again in 2015.
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The existential crisis for the euro arose from the realization that the "irreversibility" of the system was simply an authoritative incantation and not a

well-underpinned objective reality. Even during 2010-2011 in a benign geopolitical environment, the perceived cost—both economic and geopolitical—to the system of a break-up was simply too great. So institutions were created and means were found via the bailout programs to hold the system together. But Greece stayed in depression, and this brought intra-EU politics to

a boil. The recently agreed third Greek Program forced Greece to stay in at least for the time being.

Good-bye to the geopolitical respite

Since the 2011-12 phase of the Greek and euro area crisis, Europe (and the US)

has lost control of the south shore of the Mediterranean. Iraq and Syria have disintegrated, the result of a major intensification of the Sunni-Shia conflict.

This was followed by the tightening of the Russia-Iran-Syria-Iraq alignment that threatens to surround the Sunni oil producers, underlined by last year's

spread of the war to Yemen. The EU's expansive effort to pull Ukraine into its

sphere has been resisted by Russian military force, and there is Russian pushback for the retaliatory sanctions along the length of its frontiers with the

EU.

All this is occurring at the moment of new US reluctance to put itself in the middle of these distant fights. Afghanistan is also crumbling as the US backs away from its post-9/11 advance into central Asia. Evidently, the US is consciously reducing the dependability of its generalized security umbrella or

at least creating that impression. This is consistent with former US Defense Secretary Robert Gates' 2011 valedictory warning: the lack of military funding

in most of the EU in accordance with NATO guidelines is leading to a decline of will to continue US support for NATO in the post-Cold War generation and the current administration.

Now huge waves of mass migration from Africa, the Middle East, and even Central Asia have beset the EU, and we believe they will not stop without direct and forceful EU intervention to stabilize these troubled regions.

This has

generated a bit more German dominance within the EU and added centrifugal tendencies in the eastern EU to those in the UK. Unilateral closing of frontiers

is undermining the Schengen Agreement, and the Eastern European members are nullifying the European Council's qualified majority mandate under the Lisbon Treaty to accept refugee quotas.

These accelerating external and internal threats will likely push the "petty" economic disputes of the euro crisis to the back burner and the geopolitical

dimension to the forefront. After the collapse of the Soviet Union, the unification of Germany, and the securing of oil in the Gulf War, external geopolitical threats to Europe disappeared for 20 years. In this geopolitical vacuum of a weak Russia, the EU took the opportunity to expand rapidly to the east while centralizing itself internally. The quasi-confederate European Community morphed into not quite a federal European Union, which morphed into a sort of Imperial Union showing interest in Ukraine. But now the geopolitical free ride is over. The US, at least until 2017, will likely not provide

much of an umbrella. And the still-incomplete Union now has to develop policy through a security lens.

The Eastern European states emerged from World War II with fairly uniform national populations and cultures due to the horrors and ethnic cleansings during and after the war. This is likewise partly true of the successor states to

the former Yugoslavia. They all signed on enthusiastically to the European project in expectation of sharing the bounty of European prosperity, governance institutions, culture, and democracy, with an added bit of

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protection from any future resurgence of Russia. These benefits were all delivered, but their national cultures are now threatened from the inside by the

unexpectedly accelerating progressive trends in European culture and even more by the requirement to absorb the extra-European culture of mass migration. This is bound to advance the power of nationalist forces that have always been skeptical of adhering too tightly to the European project. Bringing stability to its surroundings is vital to the stability of the EU. Otherwise, the migration crisis will continue to threaten its disintegration. To

enlist Russia to shift more weight against ISIS, as France wishes, a deal might

be done at Ukraine's expense and at the price of locking Russian bases in Syria and allowing the Assad regime to survive. However, to gain this tactical

enhancement, the EU and especially France would have to sacrifice strategic objectives in Ukraine and Syria. The alternative is to keep Russia at a distance

and to take punitive action against ISIS with more EU airpower, which would be about equal to the US and Russian air forces already there. The introduction

of the long-range S-400 missile defense system effectively makes Russia the air traffic controller in the region, so the air war now can be pursued only with

Russian assent. This is unlikely to shorten the Syrian civil war and may prolong

it. But showing it a continued hostile face incentivizes Russia to continue those

policies that collaterally have driven the refugee waves that threaten EU political cohesion.

Finally, Turkey, a main supporter of anti-Assad forces via logistical flows, is

the main refuge and transit point for refugees from the region. The EU is currently desperately negotiating with Turkey to plug the flow with offers of cash and visa-less travel for Turks to the EU. A strategic EU compromise with Russia that leaves the Assad regime in place might sacrifice any Turkish interest in stemming the refugee flow.

Any EU rapprochement with Russia would add yet more to the insecurity of the EU's eastern European members.

A can of worms, indeed.

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Key Economic Forecasts

Advanced economies

US

Japan

Euro area

Germany

France

Italy

Spain

Netherlands

Belgium

Austria

Finland

Greece

Portugal

Ireland

United Kingdom

Denmark

Norway

Sweden

Switzerland

Canada

Australia

New Zealand

EEMEA

Czech Republic

Egypt

Hungary

Israel

Kazakhstan

Nigeria

Poland

Romania

Russia

Saudi Arabia

South Africa

Turkey

Ukraine

United Arab Emirates

Asia (ex-Japan)

China

Hong Kong

India

Indonesia

Korea

Malaysia

Philippines

Singapore

Sri Lanka

Taiwan
Thailand
Vietnam
Latin America
Argentina
Brazil
Chile
Colombia
Mexico
Peru
Venezuela
G7
Advanced economies
EM economies
Global
2015F
2.4
0.7
1.5
1.7
1.1
0.7
3.2
1.9
1.4
0.8
0.1
-0.1
1.5
5.2
2.4
1.6
1.4
3.2
1.0
1.3
2.3
2.3
1.0
4.5
4.1
2.7
2.4
1.5
3.6
3.4
3.7
-3.7
3.3
1.3
2.9

-9.7
3.7
6.1
7.0
2.5
7.3
4.5
2.6
4.6
6.0
2.5
5.5
1.0
2.5
6.5
-0.8
1.0
-3.7
2.1
3.0
2.3
2.8
-9.7
1.9
1.9
4.0
3.1
GDP growth (% yoy)
2016F
2.1
1.5
1.6
1.9
1.4
1.4
2.8
1.4
1.3
1.4
0.8
-0.7
1.7
3.5
2.5
1.7
1.4
2.7
1.2
2.4
3.0
2.0

1.9
2.7
3.6
2.4
2.8
2.0
4.2
3.5
4.0
-0.7
1.4
1.1
3.1
3.0
3.0
6.1
6.7
3.0
7.5
4.5
2.8
4.2
6.0
2.5
6.0
2.4
2.5
6.7
-0.1
-0.1
-2.4
2.2
2.8
2.7
3.4
-7.6
1.9
1.9
4.4
3.3

Source: Deutsche Bank Research, National statistical authorities
2017F

2.1
0.8
1.5
1.6
1.5
1.0
2.3
1.3
1.2

1.4
1.0
1.8
1.5
3.0
2.3
1.8
2.2
2.5
1.6
2.6
3.4
2.5
2.5
3.2
4.0
3.3
3.5
3.6
5.0
3.5
3.0
0.5
1.6
1.3
3.5
3.0
2.7
6.3
6.7
4.0
7.8
5.0
3.0
5.0
5.8
2.5
7.0
2.7
2.5
7.0
2.2
3.9
1.0
2.7
3.2
3.2
4.2
-3.2
1.8
1.8

4.9
3.6
2015F
0.2
0.8
0.1
0.2
0.1
0.1
-0.6
0.3
0.6
0.8
-0.1
-1.0
0.6
0.0
0.0
0.5
2.1
0.0
-1.1
1.2
1.5
0.4
8.7
0.4
11.0
0.0
-0.5
6.4
9.0
-0.9
-0.6
15.6
2.2
4.6
7.6
48.7
4.2
2.4
1.4
3.1
4.9
6.4
0.7
2.0
1.4
-0.4
1.0
-0.3

-0.9

0.8

15.2

27.9

9.0

4.4

4.9

2.5

3.5

120.0

0.3

0.3

5.6

3.4

CPI inflation (% yoy)

2016F

1.9

0.7

0.9

1.2

0.8

0.8

0.7

1.0

1.7

1.7

0.9

1.0

1.1

1.5

1.1

1.4

2.4

1.0

-0.4

2.1

1.9

1.5

6.7

1.6

9.5

2.1

0.8

14.2

10.5

1.1

-0.2

9.2

2.3

6.4

7.8

15.3
2.9
2.9
1.8
4.4
5.4
4.8
1.6
2.7
3.0
1.2
4.5
1.1
0.9
5.0
18.8
37.3
8.5
3.6
6.0
3.1
3.8
175.0
1.5
1.4
5.9
4.0
2017F
2.3
2.1
1.6
1.7
1.3
1.5
1.6
1.6
1.8
1.9
1.3
1.1
1.5
2.0
1.9
1.8
2.3
1.9
0.3
2.3
2.2
1.8
5.9

2.0
9.0
2.7
1.2
6.5
9.5
1.7
2.6
7.1
2.9
6.5
7.5
9.3
3.3
2.9
1.8
3.8
5.0
5.2
2.1
2.6
3.1
1.8
5.0
1.6
1.7
5.8
19.4
23.6
6.2
3.5
3.5
3.4
3.3
250.0
2.1
2.0
5.7
4.2
Current Account (% of GDP)
2016F
2015F
-2.4
3.3
3.0
8.1
-0.1
2.1
1.5
11.0
-0.8

2.8
0.3
-0.5
1.1
5.0
-4.3
7.5
7.5
6.0
9.0
-3.3
-4.3
-4.1
-0.7
1.6
-3.9
3.1
3.6
-3.0
-2.2
-1.1
-0.7
4.3
-5.5
-4.3
-4.8
1.0
2.1
2.6
3.3
0.6
-1.3
-2.2
8.9
2.5
2.6
20.2
-1.6
15.6
3.8
-1.6
-3.0
-2.3
-3.5
-0.7
-6.2
-2.5
-3.6
-0.3
-2.8
3.6

2.7
7.8
-0.5
1.8
1.6
11.1
-0.5
3.1
0.4
0.5
1.2
4.5
-3.1
7.0
7.0
5.7
8.0
-2.6
-4.5
-5.0
-0.7
1.2
-4.4
3.3
3.0
-3.7
-1.8
-1.6
-1.1
5.0
-4.9
-3.8
-5.2
-1.8
2.5
2.1
2.8
2.0
-1.6
-2.0
7.3
3.0
1.1
19.4
-1.4
14.0
2.7
-2.9
-2.5
-2.4
-1.8

-1.3
-5.9
-2.7
-3.3
-0.9
2017F
-3.1
3.9
2.3
7.7
-0.6
1.8
1.4
11.1
-0.2
3.3
0.6
1.0
0.9
4.5
-3.0
6.5
6.5
5.5
8.0
-1.6
-4.1
-4.9
-0.4
0.7
-3.5
2.5
3.2
-1.9
-0.9
-1.8
-1.5
5.0
-3.2
-4.5
-5.1
-1.4
3.5
1.8
2.5
2.4
-2.0
-1.8
7.2
3.3
1.2

17.8
-1.5
12.7
2.9
-3.1
-2.4
-2.3
-1.9
-0.9
-5.1
-2.9
-2.5
0.2

Fiscal Balance (% of GDP)

2016F

2015F

-2.4
-5.4
-2.2
0.3
-3.9
-2.8
-4.3
-2.0
-2.7
-2.0
-3.4
-4.1
-3.0
-2.1
-4.0
-3.0
7.5
-1.5
0.0
0.1
-2.4
0.3
-5.5
-1.9
-11.5
-2.4
-2.8
-3.2
-2.7
-2.9
-1.2
-2.7
-19.7
-3.9
-1.6

-4.3
-4.0
-2.9
-3.2
2.4
-3.9
-2.3
-0.3
-3.2
-1.5
2.6
-6.0
-1.6
-2.0
-5.7
-7.2
-7.6
-9.5
-3.3
-3.0
-3.8
-2.6
-19.5
-2.2
-4.5
-2.0
0.0
-3.4
-2.4
-3.3
-1.9
-2.7
-1.6
-3.2
-3.0
-3.0
-1.5
-2.5
-2.5
7.0
-1.0
-0.5
-0.1
-2.3
0.7
-4.4
-1.4
-11.0
-2.2
-3.1
-0.2

-2.9
-2.9
-2.9
-2.1
-13.3
-3.5
-2.1
-4.0
-2.1
-3.1
-3.5
1.3
-3.8
-2.3
-0.2
-3.1
-1.6
3.3
-6.0
-1.8
-2.1
-5.0
-5.9
-6.1
-7.6
-3.2
-3.6
-3.3
-3.2
-15.8
2017F
-2.1
-3.4
-1.6
0.0
-2.9
-2.1
-2.6
-1.8
-2.3
-1.2
-3.1
-1.4
-2.8
-1.3
-1.0
-2.0
6.5
-0.5
-0.5
-0.2

-2.1
0.9
-3.6
-1.2
-9.7
-2.0
-2.9
0.1
-2.3
-2.7
-3.0
-1.6
-10.6
-3.4
-1.7
-3.5
0.3
-3.1
-3.5
1.8
-3.7
-2.2
0.1
-2.9
-1.8
3.1
-5.5
-1.7
-2.2
-5.0
-5.0
-4.3
-6.3
-2.5
-3.3
-3.0
-2.7
-15.0

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Key Economic Forecasts

QUARTERLY GDP

(% yoy)

US

Japan

Euro area

Germany

France

Italy

United Kingdom

Canada

Australia

EEMEA

Poland

Russia

South Africa

Turkey

Asia (ex-Japan)

China

India

Indonesia

Korea

Taiwan

Latin America

Argentina

Brazil

Mexico

G7

Advanced economies

EM economies

Global

Q1 2015 Q2 2015 Q3 2015 Q4 2015F Q1 2016F Q2 2016F Q3 2016F Q4 2016F Q1
2017F Q2 2017F Q3 2017F Q4 2017F

2.9

-0.8

1.2

1.1

0.9

0.1

2.7

2.1

2.1

0.2

3.6

-2.2

2.2

2.5

6.6

7.0

7.5
4.7
2.5
4.0
0.3
2.1
-1.6
2.1
1.8
1.9
4.8
3.4
2.7
1.0
1.5
1.6
1.1
0.6
2.4
1.1
1.9
-0.8
3.5
-4.6
1.3
3.8
6.3
7.0
7.0
4.7
2.2
0.6
-0.2
2.3
-2.6
2.2
2.0
2.0
4.4
3.3
2.2
1.1
1.6
1.7
1.2
0.8
2.3
1.2
2.5
-0.7
3.6

-4.1
1.0
3.1
6.4
6.9
7.4
4.7
2.6
-0.6
-1.2
0.0
-4.1
2.6
1.8
1.8
4.3
3.1

Source: Deutsche Bank Research, National statistical authorities.

*Note: All aggregates are calculated on the basis of countries mentioned in this table only.

2.0
1.6
1.5
1.5
1.3
1.2
2.1
0.8
2.8
-0.8
3.4
-3.8
0.6
2.7
6.5
7.2
7.1
4.4
3.0
0.2
-1.5
0.0
-4.6
2.4
1.8
1.8
4.3
3.1
2.4
0.9
1.4

1.6
1.0
1.2
2.4
1.8
2.7
-0.2
3.1
-2.4
0.6
1.9
6.4
7.0
7.5
4.0
2.9
1.0
-1.2
-0.1
-4.3
2.6
1.9
1.9
4.5
3.3
1.9
1.4
1.5
1.4
1.4
1.4
2.4
2.4
3.2
0.8
3.1
-0.4
1.3
1.6
6.4
6.8
7.6
4.1
3.0
2.6
-0.3
-0.2
-2.5
2.7
1.8
1.8

4.8
3.4
1.9
2.0
1.6
1.6
1.5
1.5
2.6
2.6
3.0
1.2
2.9
-0.4
1.4
3.3
6.4
6.6
7.6
4.8
2.5
3.4
0.6
0.0
-0.8
2.8
1.9
1.9
4.9
3.5
2.2
1.6
1.7
1.8
1.6
1.4
2.5
2.8
3.1
1.7
3.1
0.1
1.1
4.5
6.2
6.4
7.3
5.1
2.7
2.6
1.0

0.1
-0.1
2.9
2.0
2.0
4.9
3.6
2.2
1.8
1.7
1.8
1.6
1.2
2.4
2.7
3.1
1.8
3.3
0.4
1.1
4.1
6.2
6.5
7.3
4.7
2.9
2.5
1.9
3.9
0.6
3.0
2.0
2.0
5.1
3.7
2.1
0.2
1.6
2.0
1.5
1.0
2.3
2.7
3.3
1.7
3.1
0.5
1.2
3.3
6.5
6.7

7.7
4.7
2.9
2.6
2.2
3.9
1.0
3.1
1.8
1.8
5.3
3.7
2.1
0.5
1.5
1.8
1.4
0.9
2.2
2.7
3.5
1.6
3.2
0.6
1.4
2.8
6.5
6.7
7.9
4.9
3.2
2.8
2.4
3.9
1.3
3.2
1.8
1.8
5.3
3.7
1.9
0.7
1.4
1.7
1.5
0.9
2.1
2.4
3.7
1.6
2.9

0.7
1.7
2.4
6.7
6.7
8.4
5.7
3.1
3.0
2.6
3.9
1.6
3.3
1.7
1.7
5.5
3.7

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World Outlook 2016: Managing with less liquidity

Key Financial Forecasts

Interest Rates

US

Japan

Euro area

United Kingdom

Denmark

Norway

Sweden

Switzerland

Canada

Australia

New Zealand

EEMEA

Czech Republic

Hungary

Israel

Kazakhstan

Poland

Romania

Russia

South Africa

Turkey

Ukraine

Asia (ex-Japan)

China

Hong Kong

India

Indonesia

Korea

Malaysia

Philippines

Singapore

Sri Lanka

Taiwan

Thailand

Vietnam

Latin America

Argentina*

Brazil

Chile

Colombia

Mexico

Peru

Venezuela*

US

(End of Period)

3M rate

0.83

0.15
1.08
0.15
1.33
0.15
-0.11
0.57
-0.16
1.09
-0.29
-0.82
0.72
2.31
3.04
0.29
1.35
0.10
n.a
1.62
n.a
11.80
6.52
n.a
n.a
n.a
0.39
7.15
n.a
1.67
3.80
2.14
1.07
n.a
0.81
1.63
n.a
n.a
14.15
3.48
5.01
3.11
5.16
n.a
Exchange Rates (End of Period)
FX Rate (vs. US Dollar)
Japan
Euro area
United Kingdom
Denmark
Norway
Sweden

Switzerland
Canada
Australia
New Zealand
EEMEA
Czech Republic
Hungary
Israel
Kazakhstan
Poland
Romania
Russia
South Africa
Turkey
Ukraine
Asia (ex-Japan)
China
Hong Kong
India
Indonesia
Korea
Malaysia
Philippines
Singapore
Sri Lanka
Taiwan
Thailand
Vietnam
Latin America
Argentina
Brazil
Chile
Colombia
Mexico
Peru
Venezuela
123
1.09
1.51
6.84
8.53
8.52
1.00
1.34
0.73
0.67
24.8
287.4
3.86
307.1
3.96

4.12
67.8
14.4
2.88
23.73
6.40
7.75
66.84
13,833
1,167
4.22
47.2
1.40
143.2
32.82
35.91
22,425
9.73
3.10
702
3,149
16.68
3.37
6.30
127
1.01
1.42
7.39
8.91
8.74
1.13
1.38
0.66
0.56
26.8
312.9
3.97
311.7
4.14
4.36
64.4
14.6
3.07
23.45
6.40
7.75
67.50
13,850
1,200
4.58
47.9

1.42
144.0
33.50
36.60
22,800
13.50
4.00
710
3136
16.40
3.38
7.80
128
0.97
1.37
7.69
9.18
9.10
1.14
1.33
0.68
0.59
27.9
327.8
4.00
318.5
4.28
4.53
64.6
14.9
3.10
24.28
6.50
7.75
67.50
13,700
1,225
4.61
48.1
1.43
144.5
34.00
37.20
23,100
15.00
4.05
706
3183
16.30
3.42
9.75

128
0.90
1.27
8.29
Advanced economies Current Q1-2016 Q2-2016 Q4-2016 Current Q1-2016 Q2-2016
Q4-2016

1.09

134

FX Rate (vs. Euro)

1.01

10.80

9.72

1.28

1.40

0.62

0.53

28.9

355.6

4.00

329.8

4.56

4.88

66.0

15.4

3.18

25.00

6.70

7.75

68.00

13,500

1,240

4.30

47.0

1.45

145.0

35.00

37.50

23,500

17.30

4.20

710

3275

16.00

3.48

12.50

* High inflation regime and controls prevent to have a valid market reference.

Source: Deutsche Bank Research, Bloomberg Finance LP, Datastream; as of Dec

07

0.72

7.46

9.25
9.29
1.09
1.46
1.49
1.63
27.0
313.1
4.20
334.8
4.32
4.49
73.88
15.7
3.14
25.17
6.96
8.45
72.87
14,799
1,248
4.60
51.4
1.52
156.17
35.78
39.15
24,157
10.60
4.14
765
2,869
18.18
3.67
6.87
128
0.71
7.46
9.00
8.83
1.14
1.39
1.54
1.81
27.1
316.3
4.01
314.8
4.18
4.40
65.0

14.7
3.10
23.69
6.46
7.83
68.18
13,989
1,212
4.63
48.4
1.43
145.44
33.84
36.97
23,028
13.64
4.04
717
3,168
16.56
3.42
7.88
0.97
124
0.71
7.46
8.90
8.83
1.11
1.29
1.44
1.64
27.1
317.5
3.88
308.9
4.15
4.40
62.7
14.5
3.01
23.57
6.31
7.52
65.48
13,289
1,188
4.47
46.6
1.39
140.17

32.98
36.08
22,407
14.55
3.93
684
3,087
15.81
3.31
9.46
0.90
115
0.71
7.46
9.72
8.75
1.15
1.26
1.45
1.70
26.0
320.0
3.60
296.8
4.10
4.40
59.5
13.9
2.86
22.52
6.03
6.98
61.20
12,150
1,116
3.87
42.3
1.31
130.50
31.50
33.75
21,150
15.57
3.78
639
2,948
14.40
3.13
11.25
Current Q1-2016 Q2-2016 Q4-2016
123

134
186
18.0
14.5
14.5
123.5
92.1
90.4
83.1
5.0
0.4
31.0
FX Rate (vs. Yen)
127
128
181
17.2
14.3
14.5
112.4
92.0
83.6
70.9
4.7
0.4
30.7
128
124
175
16.6
13.9
14.1
112.3
96.2
86.5
75.7
4.6
0.4
29.9
128
115
162
15.4
11.9
13.2
100.0
91.4
79.5
67.7
4.4
0.4

28.1
-0.15
0.58
-0.20
1.30
-0.20
-0.80
0.55
2.13
2.67
0.30
1.35
0.10
n.a
1.70
n.a
11.00
6.70
n.a
n.a
n.a
0.90
6.90
n.a
1.60
3.74
1.97
1.10
n.a
0.68
1.80
n.a
n.a
14.25
3.77
6.44
4.75
5.92
n.a
-0.15
0.84
-0.20
1.30
-0.20
-0.80
0.60
2.13
2.67
0.30
1.35
0.10

n.a
1.70
n.a
10.50
6.80
n.a
n.a
n.a
1.15
6.80
n.a
1.60
3.74
3.22
1.20
n.a
0.68
1.90
n.a
n.a
14.25
3.77
6.51
5.25
6.22
n.a
-0.15
1.12
0.35
2.15
0.00
0.15
0.90
2.13
2.67
0.40
1.35
0.40
n.a
1.75
n.a
9.00
7.10
n.a
n.a
n.a
1.20
6.70
n.a
1.65
3.74

3.97
1.40
n.a
0.68
2.00
n.a
n.a
14.25
4.26
6.48
6.00
6.62
n.a
2.27
0.32
0.69
1.93
n.a
n.a
n.a
n.a
1.58
2.95
3.59
0.45
3.58
2.18
n.a
2.89
3.63
9.53
8.56
10.03
n.a
3.08
1.53
7.76
8.56
2.30
4.20
4.15
2.55
n.a
1.18
2.69
n.a
n.a
15.58
n.a
8.47
6.27

7.04
n.a
Advanced economies Current Q1-2016 Q2-2016 Q4-2016 Current Q1-2016 Q2-2016
Q4-2016
0.46
0.17
10Y rate
2.00
0.40
0.65
1.90
n.a
n.a
n.a
n.a
1.80
3.00
3.50
0.70
2.90
1.80
n.a
2.60
3.70
9.70
8.70
9.80
n.a
3.00
1.60
7.60
8.00
2.20
4.25
4.10
2.55
n.a
1.25
2.75
n.a
n.a
15.30
n.a
10.82
7.50
8.38
n.a
2.25
0.45
0.80
2.00

n.a
n.a
n.a
n.a
1.90
3.00
3.50
0.80
3.00
1.80
n.a
2.70
3.80
9.40
8.80
10.00
n.a
3.00
1.70
7.50
8.00
2.70
4.30
4.30
2.75
n.a
1.45
2.95
n.a
n.a
15.00
n.a
10.97
8.20
8.70
n.a
Official rate
2.50
0.55
1.10
2.40
n.a
n.a
n.a
n.a
2.55
3.00
3.50
1.00
3.30
2.00

n.a
2.75
4.00
8.50
9.20
10.30
n.a
3.20
1.80
7.50
8.50
2.75
4.40
4.50
2.90
n.a
1.70
3.10
n.a
n.a
14.00
n.a
11.17
9.00
9.17
n.a
Current Q1-2016 Q2-2016 Q4-2016
0.625
0.10
0.05
0.50
0.05
0.75
0.125
0.10
0.05
0.50
0.05
0.75
-0.35
-0.75
0.50
2.00
2.75
0.05
1.35
0.10
5.50
1.50
1.75
11.00

6.25
7.50
22.00
1.50
0.50
6.75
7.50
1.50
3.25
4.00
1.07
7.50
1.75
1.50
6.50
n.a
14.25
3.25
5.50
3.00
3.50
n.a
-0.35
-0.75
0.50
2.00
2.50
0.05
1.35
0.10
16.00
1.50
1.75
10.50
6.50
8.50
17.00
1.50
1.00
6.50
7.25
1.50
3.25
4.00
1.10
7.50
1.63
1.50
6.50
n.a
14.25

3.50
6.50
3.25
4.00
n.a
0.875
0.10
0.05
0.75
0.05
0.50
-0.35
-0.75
0.50
2.00
2.50
0.05
1.35
0.10
16.00
1.50
1.75
10.00
6.50
9.00
14.00
1.50
1.25
6.50
7.00
1.50
3.25
4.00
1.20
8.00
1.63
1.50
6.50
n.a
14.25
3.50
6.50
3.50
4.25
n.a
1.125
0.10
0.05
1.00
0.05
0.50

-0.35
-0.75
0.75
2.00
2.50
0.05
1.35
0.25
12.00
1.50
1.75
9.00
7.00
9.50
12.00
1.00
1.25
6.50
7.00
1.50
3.25
4.50
1.40
8.00
1.63
1.50
6.50
n.a
14.25
4.00
6.25
3.75
4.50
n.a
19.2
15.9
1.8
112.16
0.11
29.4
2.6
88.1
0.9
3.8
3.4
0.006
19.8
16.4
1.9
109.06
0.11

27.7
2.7
89.4
0.9
3.8
3.5
0.006
19.7
16.5
1.9
107.03
0.10
27.8
2.7
89.5
0.9
3.8
3.4
0.006
19.1
16.5
1.9
105.47
0.10
29.8
2.7
88.3
0.9
3.7
3.4
0.005

8 December 2015

World Outlook 2016: Managing with less liquidity

Long-term forecast

GDP growth,% yoy

2014 2015F 2016F 2017F 2018F 2019F 2020F

Advanced economies

US

Japan

Euro area

United Kingdom

Canada

Australia

EM economies

Russia

South Africa

China

India

Indonesia

Brazil

2.4

-0.1

0.9

2.9

2.5

2.6

0.6

1.5

7.3

7.1

5.0

0.1

2.4

0.7

1.5

2.4

1.3

2.3

-3.7

1.3

7.0

7.3

4.5

-3.7

2.1

1.5

1.6

2.5

2.4

3.0

-0.7

1.1

6.7
 7.5
 4.5
 -2.4
 2.1
 0.8
 1.5
 2.3
 2.6
 3.4
 0.5
 1.3
 6.7
 7.8
 5.0
 1.0
 2.1
 1.4
 1.4
 2.3
 2.2
 4.0
 1.2
 2.7
 6.5
 8.0
 6.0
 1.9
 GDP per head, % yoy
 2014 2015F 2016F 2017F 2018F 2019F 2020F
 Advanced economies
 US
 Japan
 Euro area
 United Kingdom
 Canada
 Australia
 EM economies
 Russia
 South Africa
 China
 India
 Indonesia
 Brazil
 1.6
 0.1
 0.6
 2.4
 1.4
 1.2
 -1.4

-0.1
6.8
5.7
3.8
-1.1
1.6
1.0
1.2
1.8
0.3
0.6
-3.8
-0.5
6.5
5.9
3.2
-4.5
1.3
1.8
1.2
1.9
1.4
1.6
-0.7
0.0
6.2
6.1
3.3
-3.2
1.3
1.2
1.0
1.7
1.7
2.0
0.6
0.3
6.2
6.4
3.8
0.3
1.3
1.9
0.9
1.7
1.3
2.5
1.3
1.7
6.0
6.6

4.3
 1.2
 Key official interest rate, % (eop)
 2014 2015F 2016F 2017F 2018F 2019F 2020F
 Advanced economies
 US
 Japan
 Euro area
 United Kingdom
 Canada
 Australia
 EM economies
 Russia
 South Africa
 China
 India
 Indonesia
 Brazil
 0.13
 0.10
 0.05
 0.50
 1.00
 2.50
 17.00
 5.75
 2.75
 8.00
 7.75
 11.75
 0.38
 0.10
 0.05
 0.50
 0.50
 2.00
 11.00
 6.25
 1.50
 6.75
 7.50
 14.25
 1.13
 0.10
 0.05
 1.00
 0.75
 2.00
 9.00
 7.00
 1.00

6.50
 7.00
 14.25
 2.13
 0.10
 0.05
 1.50
 2.00
 2.00
 8.50
 7.00
 1.00
 6.50
 7.00
 11.00
 2.88
 0.10
 0.25
 2.00
 3.50
 2.50
 8.00
 6.50
 1.00
 6.50
 7.00
 11.00
 FX rate vs. USD (eop)
 2014 2015F 2016F 2017F 2018F 2019F 2020F
 Advanced economies
 US
 Japan
 Euro area
 United Kingdom
 Canada
 Australia
 EM economies
 Russia
 South Africa
 China
 India
 Indonesia
 Brazil
 1.00
 1.00
 1.05
 1.47
 1.35
 0.69
 64.35
 14.30

6.40
67.00
3.90
1.00
0.90
1.27
1.40
0.62
66.04
15.40
6.70
68.00
4.20
1.00
0.85
1.15
1.40
0.60
64.74
15.70
6.70
69.00
4.37
1.00
1.00
1.27
1.30
0.65
60.39
13.20
6.70
69.00
4.53
1.00
1.10
1.34
1.20
0.70
59.15
12.80
6.70
70.00
4.69
1.00
120.64 125.00 128.00 120.00 110.00 105.00 100.00
1.21
1.56
1.16
0.82
56.26
11.58

6.10
63.33
Source: National Authorities, Deutsche Bank Research
1.15
1.40
1.20
0.70
60.35
13.30
6.70
70.00
12440 14000 13500 13000 12500 12000 12500
2.66
4.86
3.00
0.50
0.75
2.50
4.00
3.00
7.50
6.50
1.00
6.50
7.00
13.00
3.00
0.50
1.50
3.00
3.50
3.50
7.50
6.50
1.00
7.00
7.00
11.00
2.15
0.44
0.54
1.76
1.79
2.74
12.98
7.96
3.65
7.86
7.80
12.30
1.90

0.35
0.60
1.80
1.65
3.00
9.70
8.60
2.90
7.60
8.60
15.30
1.7
1.8
0.9
1.7
1.3
2.6
2.1
2.2
6.0
6.6
5.0
1.0
1.7
1.8
1.0
1.7
1.3
2.1
2.1
2.5
6.0
6.6
5.0
1.0
2.5
1.3
1.4
2.3
2.2
4.0
2.0
3.2
6.5
8.0
6.0
1.7
2.5
1.3
1.5
2.3

2.2
3.6
2.0
3.5
6.3
8.0
6.0
1.6
CPI inflation, % yoy
2014 2015F 2016F 2017F 2018F 2019F 2020F
1.6
2.8
0.4
1.5
1.9
2.5
7.8
6.1
2.0
6.7
6.4
6.3
0.2
0.8
0.1
0.0
1.2
1.5
15.6
4.6
1.4
4.9
6.4
9.0
1.9
0.7
0.9
1.1
2.1
1.9
9.2
6.4
1.8
5.4
4.8
8.5
2.3
2.1
1.6
1.9
2.3

2.2
7.1
6.5
1.8
5.0
5.2
6.2
2.3
1.4
1.9
2.0
2.0
2.5
5.5
5.3
2.1
5.0
6.0
5.0
Population growth, % yoy
2014 2015F 2016F 2017F 2018F 2019F 2020F
0.8
-0.2
0.3
0.6
1.1
1.4
2.1
1.6
0.5
1.4
1.2
1.2
0.8
-0.3
0.3
0.6
1.0
1.7
0.0
1.8
0.5
1.4
1.7
0.8
0.8
-0.4
0.4
0.6
1.0
1.4

0.0
1.1
0.5
1.4
1.8
0.8
0.8
-0.4
0.5
0.6
0.9
1.4
0.0
1.0
0.4
1.4
1.5
0.7
0.8
-0.5
0.5
0.6
0.9
1.4
-0.1
1.0
0.4
1.4
1.5
0.7

10Y bond yields (eop)
2014 2015F 2016F 2017F 2018F 2019F 2020F
2.50
0.55
1.10
2.40
2.55
3.00
8.50
9.20
3.20
7.50
8.50
14.00
2.75
0.50
1.50
2.80
4.00
3.00
8.00

9.30
3.30
7.50
8.50
12.05
3.00
0.60
1.80
3.20
5.50
3.00
7.50
9.00
3.50
7.80
8.00
11.77

FX rate vs. EUR (eop)

2014 2015F 2016F 2017F 2018F 2019F 2020F

1.21
1.05
1.00
0.71
1.42
1.52
67.74
15.05
6.72
70.35
4.10
0.90
1.00
0.71
1.40
1.48
68.30
14.06
7.43
76.89
3.22
1.26
1.45
59.50
13.87
6.03
61.20
3.78
0.85
1.00
0.74
1.19

1.42
54.86
13.31
5.70
58.65
3.71
1.00
1.00
0.79
1.30
1.54
60.39
13.20
6.70
69.00
4.53
1.10
1.00
0.82
1.32
1.57
65.00
14.07
7.37
77.00
1.15
146.70 131.25 115.20 102.00 110.00 115.50 115.00
1.00
0.78
1.00
0.82
1.38
1.64
69.37
15.29
7.71
80.50
15052 14700 12150 11050 12500 13200 14375
5.16
5.59
3.25
0.90
2.00
3.50
5.50
3.00
7.00
8.75
3.60
7.80
8.00

11.33
3.25
1.10
2.20
3.50
5.80
3.00
6.50
8.50
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7.80
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11.01
0.8
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1.4
-0.1
1.0
0.4
1.4
1.5
0.7
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-0.5
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1.9

2.0

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4.2

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2.1

5.0

6.0

5.5

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