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World Outlook

Waiting for a US-led expansion

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Global Overview: Waiting for a US-led expansion

- When we last updated our view, we saw a substantial pick-up in US growth leading the global economy back toward trend growth over the year ahead. That view remains very much intact, though its realization has been delayed, we think predominantly by inclement weather. As heavy winter snows turn to spring rains, we find ourselves huddled waiting for data to take a substantial turn for the better.
- While we maintain our core view that global growth should pickup meaningfully over the next two years, we have marked down our forecasts relative to last quarter. Broad-based EM downgrades account entirely for these downward revisions. Most notably, we reduced our growth forecast for China in 2014 by 0.8pp. While we continue to look for the recovery in export growth observed in the second half of last year to continue through this year and into 2015, we now expect the government will use this as an opportunity to depress investment in heavy industry even more.
- Our expectations for a meaningful pickup in growth in the US economy are unchanged since we last updated our view, despite the recent spate of soft data. Much strengthened household balance sheets and much reduced fiscal drag are still there to drive the pickup. Thanks to very low inflation, the Fed is for now very much in a dovish stance. But, in response to a faster than anticipated decline in the unemployment rate and rising inflation ahead, we expect the FOMC to adjust its guidance later this year to indicate an initial rate hike during H1 2015. We see the Fed Funds rate reaching 1.50% by end 2015 and rising faster than the Fed currently projects thereafter.
- Europe is showing encouraging signs of resilience. The momentum has helped us raise our 2014 and 2015 GDP forecasts by 0.1pp, despite the downgrade to China and uncertainty with Ukraine. We remain cautious, however, and do not believe Europe has secured a self-sustaining resolution of the crisis yet. Our baseline expectation is that monetary policy is on hold but an asset purchasing policy is becoming a non-negligible risk.
- The outlook for Japan this year is one of volatility. We continue to expect growth will be well supported in the beginning of this year by the frontloading of expenditures ahead of the tax increase, followed by a sharp decline in GDP in Q2 as the tax hike takes effect. We expect it will be some months before policymakers will be able to judge whether the net effect of the tax hike has been to raise or lower inflation expectations. If they arrive at the latter judgment, a further easing of policy is possible later this year.
- We have also analyzed the linkage between US growth and that in the rest of the world via trade flows and found some evidence that US import demand may have become less sensitive to increases in US domestic demand. However, there is still a significant linkage: real imports from EMs and more globally have grown about in line with real domestic demand, whereas previously they had tended to grow more rapidly.
- Finally, we see both downside and upside risks to the global outlook, with the downside emanating more from Europe and China, and risks to our US forecast somewhat more balanced.

I. Introduction[1]

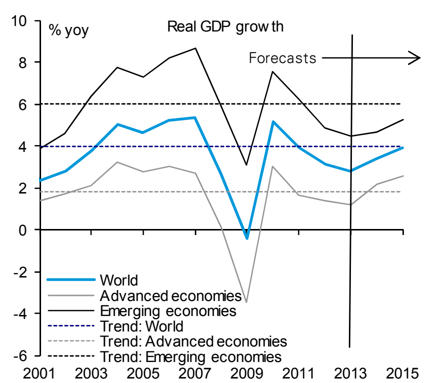
The past several years have been epitomized by a relatively synchronized stance for global monetary policy, in which the world's major central banks have pursued unconventional measures to provide additional stimulus in a world with near-zero interest rates. However, when we last updated our view in December, the Federal Reserve had taken a first step in the process of normalizing monetary policy as it began to reduce its pace of asset purchases. This decision by the Fed, which has had widespread implications for global financial markets, was supported by growing confidence in fundamentals in the US economy. At the same time, despite improving growth prospects in Europe and Japan, the ECB had surprised the market with a pre-emptive rate cut in the face of intensifying disinflationary pressures, a move that strengthened the credibility of ECB forward guidance, while the BoJ continued to expand its balance sheet at a rapid pace in order to raise inflation. This dichotomy between synchronized growth prospects and unsynchronized monetary policy and inflation in the major advanced economies is a key theme for the global economy and markets this year. Indeed, this storyline is the focus of our overview this quarter and is the common thread running throughout this publication. Our overview begins by discussing recent developments in the global economy and our baseline outlook through 2015. We then discuss this divergence in the stance of the world's major central banks in an environment with synchronized growth prospects but diverging inflation trends, as well as the implications of this synchronized growth outlook for prospects in EM economies. We also address the crucial question of whether synchronized growth in AE will provide significant external stimulus to EM economies, or whether EM growth has decoupled somewhat from these external forces. We conclude with summaries of our strategists' views on equities, rates, credit, mortgages, FX and commodities, and finally with some geopolitical analysis.

Economic outlook

Global growth outlook marked down, but core view of near-trend growth in 2015 remains intact

We continue to forecast a meaningful pickup in global growth over the next two years, with growth below trend in 2014 but rising to near trend rates in 2015 (Figure 1). This view is driven by expectations for above-trend growth in advanced economies (AEs) but below-trend growth in emerging market economies (EMs). Although our core view of growth rising toward trend over the next two years remains intact, developments since our last quarterly World Outlook publication have caused us to mark down global growth prospects over the next two years (Figure 2). We have reduced our global growth forecast for 2014 and 2015 by 0.3 and 0.1% points, respectively. A markdown of EM growth forecasts, which were reduced by 0.6 and 0.1% points in 2014 and 2015, respectively, accounts entirely for the downward revisions to global growth prospects. Perhaps most notably, we reduced our growth forecast for China in 2014 by 0.8% points.

Figure 1: Growth returning to trend



Source: IMF, Haver Analytics, Deutsche Bank Research

Our growth forecast for AEs, on the other hand, remains unaltered in the aggregate. Expectations for a meaningful pickup in growth in the US economy are unchanged since we last updated our view, despite the recent spate of soft

[1] The Authors are grateful to Stefan B. Schneider for his production editing of this report. We also wish to especially thank Manjuri Das, Siddhartha Chanda, Kuhumita Bhattacharya, Baqar Zaidi and Punit Kumar Jha, employees of Infosys Ltd., a third party provider to Deutsche Bank offshore research support services, for their assistance.

data. Moreover, a slight downgrade of our forecast for Japan is offset by a modest upward revision to our growth forecast for Europe.

Figure 2: Global GDP growth forecast & revision (% yoy)

	Forecast level Mar'14 WO			Revision since Dec'13 WO		
	2013	2014F	2015F	2013F	2014F	2015F
G7	1.3	2.3	2.8	0.0	0.0	0.1
US	1.9	3.2	3.8	0.1	0.0	0.0
Japan	1.5	0.4	1.4	-0.1	-0.3	0.1
EA	-0.4	1.1	1.5	0.0	0.1	0.1
EM Asia	5.9	6.4	6.7	-0.1	-0.5	-0.1
China	7.7	7.8	8.0	-0.1	-0.8	-0.2
India	3.9	5.5	6.0	-0.4	0.0	0.0
EMEA	2.3	2.0	3.2	0.1	-0.9	-0.3
Russia	1.3	0.6	2.2	-0.2	-1.8	-0.6
Latam	2.3	2.1	2.9	0.0	-0.5	-0.2
Brazil	2.3	1.7	1.7	0.1	-0.2	0.0
Advanced economies	1.2	2.2	2.6	0.1	0.0	0.0
EM economies	4.5	4.7	5.3	0.0	-0.6	-0.1
Global	2.8	3.4	3.9	0.0	-0.3	-0.1

Source: Deutsche Bank Research

US growth unrevised, still above potential

The recent soft patch in the data has been driven primarily by weather-related distortions in our view. We still see the underlying fundamentals for above-trend growth in the US economy very much intact. Accordingly, we continue to anticipate that real GDP growth will pick up in the US this year, as fiscal drag declines materially, the housing recovery continues, consumer spending strengthens, and business investment picks up amid greater certainty about the economic outlook. As a result, we have left our growth forecast for the US economy unrevised at 3.2% and 3.8% for 2014 and 2015, respectively. Under our outlook, growth will remain on a trajectory that should keep the Fed on track to at least reduce its pace of asset purchases by $10bn per meeting, ending outright purchases this fall. In addition, we anticipate that the unemployment rate will fall faster and wage/inflation pressures will rise a bit faster than the market and Fed currently anticipate. This should lead the FOMC effectively to adjust its guidance later this year, toward an initial rate hike during H1 2015. We also anticipate a somewhat faster ascent in rates thereafter than the Fed is signaling at this point.

A volatile outlook for Japan

There have been minor adjustments to our Japanese outlook since the beginning of the year reflecting mildly weaker growth in the second half of last year than was initially thought and as we reassess the implications of the April consumption tax increase. The net effect has been a reduction in 2013 and 2014 GDP growth rates of only a few percentage points and a similar increase in our forecast for 2015. We continue to expect growth will be well supported in the beginning of this year by the frontloading of expenditures ahead of the tax increase. This strength should be followed by a sharp decline in GDP in Q2 (-7%QoQ (saar)) as the tax hike takes effect. We think the government's supplementary budget – aimed at smoothing out the effect of the tax hike – will actually reinforce the rebound in activity in Q3. So we see 2014 as a year of tremendous volatility but with annual average GDP growth slowing to 0.4% from 1.5% last year. This cycle will likely be repeated, albeit less violently, in late 2015 with the next scheduled tax increase in October. With the tax hike coming much later in the year, GDP growth in 2015 is expected to average 1.4%, reinforcing the upward trend of growth in the US and EU economies next year.

Japan's inflation will be immediately affected by the tax increase, of course. We estimate that core inflation will rise more than 2pp with the tax hike to a y/y rate of 3.5% in Q2 from 1.3% currently, complicating matters for the Bank of Japan. Their monetary policy is intended to raise inflation expectations, but measuring inflation expectations will be very difficult in an environment of rising inflation but contracting activity. We expect it will be some months before policymakers will be able to judge whether the net effect of the tax hike has been to raise or lower inflation expectations. If they arrive at the latter judgment, then a further easing of policy is possible later this year.

Euro area growth revised up this year and next

Europe is showing encouraging signs of resilience. Banks are raising private funding and capital, funds have been flowing back to peripheral Europe securities and GDP is growing. Three quarters of domestic demand expansion in the Euro area is good news. The peripheral economies are growing too. The momentum has helped us raise our 2014 and 2015 GDP forecasts 0.1pp to 1.1% and 1.5% respectively despite the downgrade to China and the uncertainty with Ukraine. We remain cautious, however. We do not believe Europe has secured a self-sustaining resolution of the crisis yet. The combination of modest real growth and protracted low inflation means an outlook for nominal income growth that challenges public and private deleveraging, opening Europe to vulnerability in the event of an unanticipated shock. Ukraine has not become an economic crisis for Europe yet, but bears watching. Structural gaps remain and structural reforms are falling short of what is required for convincing resolution, both within countries and at a federal level. The ECB pledge in mid-2012 to do "whatever it takes" with the OMT was a key turning point. The recent German Constitutional Court ruling raises questions about OMT, but the market is more confident than it was that ECB QE could emerge if necessary to deal with a deflation problem. In our view, it will require a further deterioration in the outlook to bring asset purchasing firmly onto the ECB agenda. Our baseline expectation is that monetary policy is on hold with the ECB hoping global growth and a softer Euro (stronger dollar) helps the euro area muddle through, but asset purchasing/QE this year is becoming a non-negligible risk.

Emerging market growth outlook downgraded, especially for China

EM growth has disappointed broadly this year in response to weakening fundamentals, the shift in Fed policy, and idiosyncratic geopolitical/policy risks. As a result, we have marked down our growth forecast for EM economies by 0.6% points in 2014 and 0.1% points in 2015. These downgrades are relatively broad-based in 2014, with EM Asia, EMEA, and Latam forecasts reduced by 0.5, 0.9, and 0.5 pp respectively.

Despite the broad-based nature of our EM downward revisions, the most notable revision is undoubtedly to our outlook for China. Data so far this year in China are consistent with GDP growth of about 7.4% in Q1, well below what we had expected. We continue to look for the recovery in export growth observed in the second half of last year to continue through this year and into 2015 in line with our outlook for growth in the G3 economies. But we now expect the government will use this as an opportunity to depress investment in heavy industry even more. We think infrastructure and manufacturing investment will be well supported by global growth and the government's urbanization and other reform plans. But consolidation in mining, steel and other heavy industries will likely offset some of the external impulse. We therefore see less upside to growth this year than previously, forecasting GDP growth of 7.8% versus the 8.6% forecast we had in December. We see growth edging a little higher in 2015 to 8.0%.

The largest revisions to growth in other EM regions are mainly a consequence of country-specific factors. Chiefly among these, we have lowered our forecast for GDP growth in Russia by 1.8pp reflecting the heightened political uncertainty and the impact of sanctions. Elsewhere in emerging Europe the news recently has been rather more positive, although the potential for spillovers from Russia is a concern. Our Latin American growth forecasts have been lowered to reflect a weaker growth impulse from China and the need for more aggressive central bank tightening in Argentina, Brazil and Venezuela in response to persistent inflation and pressures on exchange rates. The biggest revision by far has been to Argentina, which we now see experiencing a GDP contraction of 2.1% this year following January's devaluation.

Growth outlook is above consensus

Our forecast for global growth is between consensus and the IMF in 2014. In 2015, our forecast is above consensus but in line with the IMF (Figure 3). While we anticipate that the global economy will expand at a 3.4% and 3.9% annual rate in 2014 and 2015, respectively, consensus expectations are closer to 3% than 4% over this period. In terms of US growth, we are about 1/2% point above consensus and IMF expectations in 2014, and nearly 1% point above these alternative forecasts in 2015. Our outlook for the EA, on the other hand, is very much in line with consensus and IMF expectations of growth around 1% in 2014 and 1.5% in 2015.

Figure 3: Consensus Forecasts GDP growth

		2013F	2014F	2015F
World	DB (Dec)	2.8	3.7	4.0
	DB (Mar)	2.8	3.4	3.9
	Bloomberg (Mar Survey)	2.1	2.8	3.1
	Consensus (Jan Survey)	2.4	3.1	N/A
	IMF (Jan)	3.0	3.7	3.9
US	DB (Dec)	1.8	3.2	3.8
	DB (Mar)	1.9	3.2	3.8
	Bloomberg (Mar Survey)	1.9	2.7	3.0
	Consensus (Jan Survey)	1.9	2.8	3.0
	IMF (Jan)	1.9	2.8	3.0
EA	DB (Dec)	-0.4	1.0	1.4
	DB (Mar)	-0.4	1.1	1.5
	Bloomberg (Mar Survey)	-0.5	1.1	1.5
	Consensus (Jan Survey)	-0.4	1.0	1.4
	IMF (Jan)	-0.4	1.0	1.4

Source: IMF, Consensus Economics, Bloomberg Finance LP, Deutsche Bank Research

Global inflation forecast unchanged in 2014 amid diverging underlying trends

Relative to December, we have left our global inflation forecast for 2014 unchanged and marked up our 2015 forecast for global inflation by a few tenths of a percent (Figure 4). This upward revision is concentrated in EM economies, where substantial currency depreciation has precipitated rising inflation pressures. We have also raised our inflation forecast for Japan in 2014 by 0.3% points. Conversely, we have reduced our inflation forecasts for the US and Euro area each by several tenths of a percent, as early inflation readings for this year indicate less inflation pressures than we anticipated when we updated our view last quarter. However, we continue to see inflation moving in different directions in these AEs, with inflation rising towards the Fed's 2% objective in the US but inflation falling in the Euro area relative to 2013.

Figure 4: Inflation forecast & revision (% yoy)

	Forecast level Mar'14 WO			Revision since Dec'13 WO		
	2013	2014F	2015F	2013F	2014F	2015F
G7	1.3	1.9	2.0	-0.1	-0.3	0.0
US	1.5	2.1	2.3	-0.1	-0.4	0.0
Japan	0.4	3.0	1.7	0.1	0.3	0.2
EA	1.4	0.8	1.3	0.0	-0.2	-0.1
EM Asia	4.1	3.4	4.0	0.7	-0.5	0.1
China	2.6	2.2	3.0	0.1	-1.3	-0.2
India	10.1	6.4	6.7	3.8	0.9	0.4
EMEA	4.9	5.1	5.0	0.1	0.6	0.3
Russia	6.8	6.2	4.9	0.1	1.0	0.2
Latam	8.9	12.4	11.3	-0.1	2.5	2.4
Brazil	5.9	6.0	5.5	-0.3	0.2	0.1
Advanced economies	1.4	1.8	1.9	0.0	-0.2	0.0
EM economies	5.1	5.3	5.4	0.4	0.3	0.4
Global	3.2	3.5	3.6	0.2	0.0	0.2

Source: Deutsche Bank Research

Synchronized growth, but unsynchronized policy

A defining characteristic of our forecast for 2014 is a synchronized pickup in growth in AEs but divergent trends in inflation and monetary policy stances. In the US, we forecast a meaningful pickup in growth in 2014 and 2015, with growth in both years well above potential growth rates. However, with inflation expected to be rising in the US but easing further in the Euro area, we see central banks in these two regions moving in different directions. The Fed is expected to finish winding down its QE purchases later this year and to begin raising rates around the middle of next year. For now, the Fed remains dovish—Chair Yellen's "six month" comment in her inaugural press conference was misread in our view. But we do expect the Fed to begin to give more hawkish signals before the end of this year. And good growth performance plus rising inflation should beget a somewhat faster pace of rate hikes down the road than is currently being advertised.

The ECB, while still very much in easing mode, frustrated our expectations for a modest easing of policy rates in recent months, suggesting the ECB sensitivity to projections of lower inflation is lower and the hurdle to further policy easing higher than we thought. But the ECB has a formal easing bias and strengthened the message in March by linking it to economic slack — the ECB wants the market to believe policy rates will remain accommodative for longer, even as the recovery plays out. The ECB presents this as "de facto loosening". Similarly, the ECB pushes the virtues of policy inactivity with the

AQR/EBA stress test — a successful test will improve the monetary transmission mechanism and the efficacy of unchanged but low (near zero) policy rates. With limited room for manoeuvre on standard policy rates, if downside risks materialize the ECB will have to reach for unconventional policy. Mario Draghi recently mentioned a trio of options: ABS purchases, targeted liquidity and QE. Bundesbank President Weidmann's recent more open comments on QE shows the institutional hurdles to the latter are declining, but QE still needs a trigger. ECB asset purchasing is not our baseline expectation — modest recovery is playing out, even in the periphery, and inflation is expected to start normalizing this year — but the credibility of the option has risen.

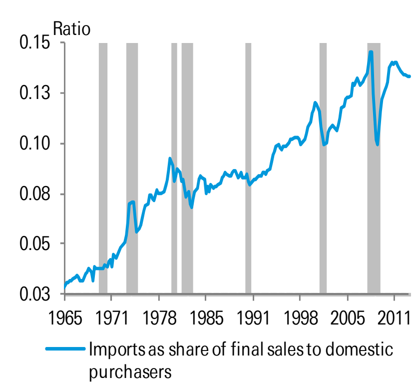
The Bank of Japan has not ruled out substantial additional balance sheet expansion if necessary to build on gains in inflation expectations it has achieved to date. But the volatile outlook for the economy will complicate the central bank's assessment of growth and inflation. Central to the question of whether additional stimulus is necessary, we think, is an assessment of whether the net effect of a tax-induced spike in inflation and decline in real GDP has been to raise or lower inflation expectations. We don't think this is a judgment policymakers will be able to make quickly. The decision is unlikely to be made until the Fall, in our view. However, if during the summer US bond yields are rising and perhaps especially if the ECB has decided in favour of QE as an option, the BoJ might choose to expand its asset purchase program to lock in low bond yields in Japan.

Is EM de-coupling from AE growth?

Our outlook anticipates a significant step up in growth in AEs while EM growth prospects have been downgraded. An interesting question arises from this view. To what extent should improving growth prospects in AEs support economic activity in EMs? Many have questioned recently the extent to which EM growth has become less sensitive to, or decoupled from, rising AE demand. This section analyzes this question. Because the US economy is the main engine of AE growth in our forecast, we focus on whether there is evidence that EM growth has, in fact, decoupled from US growth prospects.

This view of a lower sensitivity of EM growth to AE growth prospects is supported by the aggregate nominal trade data. Indeed, a notable downtrend is evident in the share of imports in US domestic demand over the past several years (Figure 5).[2] After rising rapidly during the decades prior to the global financial crisis, the import share of US domestic demand plummeted in response to the crisis, consistent with the sharp decline in world trade during this period. Following the end of the recession, as the US economy entered a recovery phase, the import share of US domestic demand rebounded strongly, reaching a level just shy of its pre-crisis peak. However, over the past two years, the nominal import share of US domestic demand has fallen gradually. This downward trend indicates that US imports have risen less than proportionally with US domestic demand and supports the view that import demand is becoming less sensitive to changes in US domestic demand.

Figure 5: Nominal import share of US demand has declined over past several years, reversing a long-term uptrend



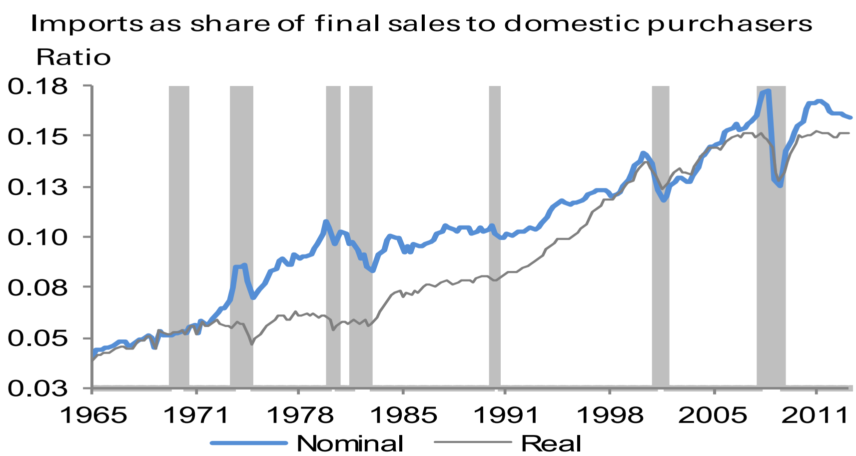
Source: BEA, Haver Analytics, Deutsche Bank Research

On the other hand, trade and demand data in real terms, which adjusts for relative price changes over time, tell a different story. Prior to the global financial crisis, the trends are similar for nominal and real import shares (Figure 6). The import share of US domestic demand in both nominal and real terms rose at a rapid pace between 1965 and the years leading up to the global financial crisis. However, in the post-crisis period, the share measured in

[2] In this section we define US domestic demand as GDP less net exports and change in private inventories.

real terms has leveled off and remained stable at or slightly above its pre-crisis peak levels, not declined as the nominal share has. The stability of the real import share suggests that, outside of the global financial crisis, real imports have risen about one-for-one with a rise in real domestic demand in the US in recent years.

Figure 6: Real import share of US demand has been steady recently



Source: BEA, Haver Analytics, Deutsche Bank Research

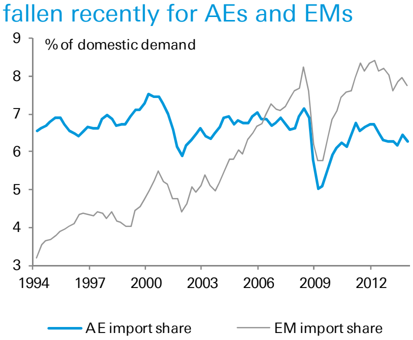
There are a couple important takeaways from these data. First, it appears that relative price changes have driven much of the recent decline in the US nominal import share. Some of this relative price movement reflects a decline in goods prices relative to prices of services globally. But it may also be the case that in order to maintain market share in the US, exporters in other countries have had to reduce their prices relative to trends in broader US prices. In other words, exporters to the US may have had to compete more in terms of prices than they have in the past.

The second key takeaway is that, even after accounting for relative price changes by focusing on the data in real terms, import demand has become somewhat less sensitive to rising US domestic demand, although this shift is less dramatic than suggested by the nominal data. For several decades leading up to the early 2000s, the import share trended upward, consistent with a greater than proportional rise in imports in response to an increase in US domestic demand. More recently, that sensitivity of imports to US domestic demand has diminished, as US imports have expanded roughly proportionately with domestic demand. Thus, the impetus from real domestic demand to real foreign exports to the US has diminished, but it is still significant, and noticeably more so than suggested by the nominal share data.

This analysis does not, thus far, provide insight into which countries or regions are driving these trends. Indeed, it could be that, although the real import share has leveled off, the EM share has declined while the AE share has risen, or vice versa. Have EM's been hit more than AE's in this regard? To address this question, we consider US import data disaggregated by region. The nominal import share for EMs rose substantially during the 1990s and early 2000s but have declined more recently, while that for AEs has declined recently after being relatively stable pre-crisis (Figure 7).

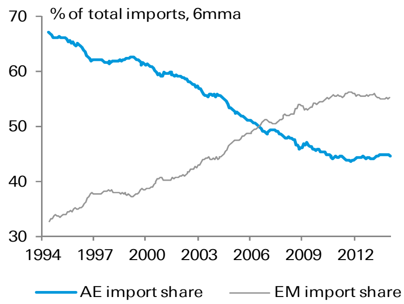
Another take on these data is to consider the relative shares of US imports originating from AEs versus EMs in total US imports (rather than in total domestic demand) (Figure 8). The share of imports coming from EMs trended up and that from AEs trended down until the past couple years. Since 2011, both of these shares have leveled off, suggesting that while EMs are no longer gaining US market share relative to AEs, they are also not losing market share.

Figure 7: Nominal import share has fallen recently for AEs and EMs



Source: Census Bureau, Haver Analytics, Deutsche Bank Research

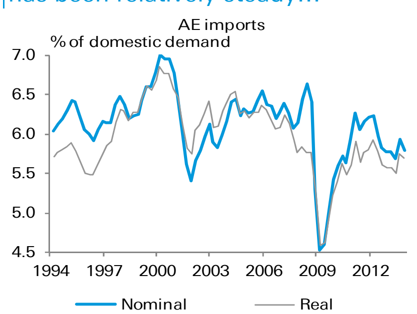
Figure 8: Share of US imports from EMs has been steady recently



Source: Census Bureau, Haver Analytics, Deutsche Bank Research

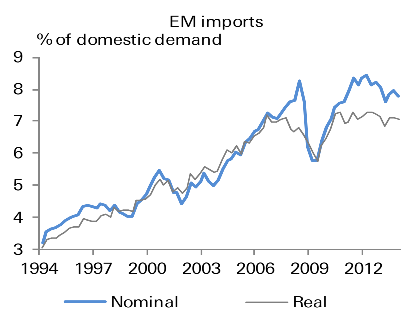
Evidence of recent stability in the share of US imports in domestic demand measured in real terms also holds up in the regionally disaggregated data. This is especially in the case of imports from EM (Figure 10), less so for AE (Figure 9).

Figure 9: Real import share for AEs has been relatively steady…



Source: Census Bureau, Haver Analytics, Deutsche Bank Research

Figure 10: …Similar for EM import share



Source: Census Bureau, Haver Analytics, Deutsche Bank Research

In sum, it does appear that the sensitivity of US import growth to US domestic demand has declined relative to pre-crisis values. However, this decline is overstated by the nominal data, suggesting that relative price movements explain much of the recent trend, and that exporters to the US may have had to compete more in price terms to maintain market share. Real import shares in US domestic demand have been relatively stable in recent years (post a period of crisis-induced volatility), a stability that is evident across regions, especially EMs. The stability of these shares indicates that imports from EMs have risen proportionally with US real domestic demand. This proportional relationship represents some decline in the impetus to EM exports from a pickup in US growth relative to earlier historical experience, but it is still a substantially positive impetus, far from a decoupling. Consequently, improving US growth prospects should provide significant external demand to EMs going forward.

Market forecasts/baseline strategy views

Global asset allocation: After the rebound

Our global asset allocation team highlights four key themes going into Q2: (1) a turn toward positive US data surprises; (2) a rise in inflation in the US and Europe this year; (3) short rates vulnerability to a re-pricing of the Fed; and (4) a catch up in rates and the dollar to the rebound in US data. As a result, they are overweight equities, underweight rates, and neutral credit, while they see EM de-rating nearing conclusion and a rise in the dollar from near the bottom of its multi-year uptrend channel.

US Equities: Constructive longer-term, but cautious near-term

Our US equity strategists maintain their year-end S&P 500 targets of 1850 and 2000 for 2014 and 2015, respectively, and forecast EPS of USD119 and USD125 over the next two years. However, they believe a 5%+ dip is likely in the near-term due to demanding valuations, weak Q1 EPS, continued tremors in EMs, and interest rate volatility. They identify several key risks, including downside risks to global growth acceleration, sharp rises in Treasury yields and the dollar, or a sharp decline in oil prices. In terms of sector preference, they prefer Tech and Financials, especially mega-caps still trading at low PEs, and encourage investors to tilt toward companies with strong dividend growth prospects.

European Equities: Capturing the response to EM weakness

Our European equity strategists maintain their Stoxx 600 year-end 2014 target of 375, based on an expectation of 12% EPS growth in 2014/15 and a target forward multiple of 13.5x. In their view, European equities are a global growth story, and they maintain a positive view on global growth despite recent EM concerns. In the near-term, however, headwinds to earnings expectations have emerged with recent Euro strength and downgrades to defensive sectors, but they look to re-engage more aggressively with the globally exposed companies in Europe. They continue to prefer domestic cyclical and financials; recommend overweights in banks, autos and construction; and remain underweight UK and positive Southern European equities.

Rates: Divergences

Our rates strategists view the emergent story in 2014 as one of divergences – growth vs. potential; the front end vs. the long end; the Fed vs. ECB. They expect the front end and long end in the US to follow different narratives in the short run: the front end responding to less dovish Fed rhetoric, but the long end pricing still low inflation and potential growth impediments. If all goes well, rates should continue their upward drift, with the 10y Treasury reaching at least 3.25%, with an upside of 3.5% by 2014 year end. In the short run, however, they see scope for a dip in yields led by longer forward rates. In Europe, they expect the ECB to keep the front end of the euro curve stable, but rate normalization in the US could drag intermediates and longer maturities somewhat higher. They see short-run risks tilted to the downside, as EM underperformance has historically presaged slowing global output momentum, falling inflation, and peak G3 yields

Credit: Still positive Q2, getting more worried about H2

Our credit strategists, taking a more bearish stance, are getting more worried about H2 2014 based on a view that the Fed and ECB have been less willing to pursue additional accommodation than they previously expected and that the hurdle for central banks to offer more liquidity has been raised. In their view, liquidity is far more important than growth at this stage. As a result, they have slightly increased some year-end spread level targets. They remain positive on

Q2, as a weather-related rebound in US data should drive confidence in the near-term. They note that China constitutes the biggest threat to a decent quarter for risk in Q2.

US MBS and Securitization: For MBS, a tale of two yield curves

Our US MBS and securitization strategists note that last week's FOMC meeting put the front end of the yield curve in play and essentially created two yield curves – the first 5-years and in and another further out. This changes the interest rate proposition for MBS. Simple duration should matter progressively less for MBS, and yield curve exposure should matter more. Managing rate exposure has to entail moving measurement and hedging from one point on the curve to multiple. Fortunately, the solution is straightforward in their view: measure the partial duration of the position or portfolio to the 2-, 5-, 10- and longer parts of the yield curve and, potentially, hedge the partial exposures. It adds complexity, but it offsets risk.

FX: 2014 Outlook

Our FX strategists think that Yellen's testimony last week marks the beginning of the end for US rates carry trades and USD funding for FX carry. In an environment with continued Fed normalization, it is difficult to see carry trades on the short-end part of the US curve doing well. The Euro is now exceptionally attractive both in terms of spot FX and the funding level of yields. For EM FX, a more hawkish Fed outlook means the near-term focus is back on currencies with external vulnerabilities. But EM FX should trade less as a group. In China, CNY is no longer the best carry trade and should weaken with levels such as 6.30 or more possible over the course of this year. While many are focusing on where the CNY fix will set in coming days and weeks, the more interesting thing to monitor, in their view, is whether actual volatility will rise.

Commodities: A tentative revival

Our commodity strategists note that commodities have overtaken benchmark fixed income returns as the best performing asset class on an excess returns basis so far this year and that this rebound has become more broad-based over the past few weeks. Industrial metals, which have been affected by sluggish Chinese growth, have been the only sector to post negative returns. In their view, it is questionable the extent to which the factors that have benefited commodities can be sustained over the medium-term. A rebound in US data, a rise in real long-term real yields, and a move lower in EURUSD all pose risks to precious metals. Recent divergent performance in energy markets has been affected by the weather. They view crude oil, diesel, natural gas, palladium, aluminium, nickel and grains as the markets of most interest related to concerns over Russia and Ukraine.

Geopolitics: Russia has more problems than just Ukraine

Our geopolitical strategist considers the recent events in Russia and Ukraine in a broader context. From Russia's point of view, the price of not acting in Ukraine was to risk the prospect of its own continued disintegration. This high price helps explain Russia's apparent indifference to the potentially large economic costs of mounting Western sanctions and the direct economic cost of supporting the population in the annexed Crimea. But the risk to Russia of going much farther in Ukraine would be high. Taking the eastern part of the Ukraine would be more problematic and could lead to civil war. For this reason, it appears easier from the Russian perspective to let events unfold in hopes that prospective difficulties in controlling the zone from Kiev might help mold the evolution of the new Ukrainian government in a more conciliatory direction.

Risk

We see key risks to the global economy having shifted more fully from the US back to Europe and Asia (notably China) over the past year.

The risks in Western Europe are generally skewed to the downside. Growth expectations have been modestly upgraded compared to the last WO. Germany has shown better than expected momentum and expectations are rising for additional fiscal push in Italy (e.g., clearance of public sector arrears). The UK recovery also has upside potential and could help support demand on the continent. But Ukraine is a new event. We estimate it would require an 8-9% decline in Russian GDP to knock 0.5% off German GDP. This is on a par with the impact on Russian GDP of the Rouble crisis in 1998. Economic sanctions triggered by Ukraine/Crimea could take Europe towards this scenario. We have not factored any impact into our baseline forecasts yet. Bank deleveraging will be a theme this year on account of the AQR/EBA stress test, although the credit impulse dynamics mean the risks to growth are skewed more to next year rather than this year.

Inflation in the Euro area is low. With the exception of a brief period of negative headline inflation in 2009, headline and core are about as low as they have ever been in the ECB era but at a time when the room for manoeuvre with standard monetary policy has never been as limited. We expect inflation to slowly normalize — on average, headline inflation is forecast to be 0.8%, 1.3% and 1.6% in 2014, 2015 and 2016. Vulnerability to shock is high, particularly this year. Concerning are signs that survey- and market-based measures of inflation expectations are weakening. A dis-anchoring of inflation expectations could quickly compound itself. Markets have shrugged off the German Constitutional Court concerns about OMT, seeing QE as more justifiable should deflation become a genuine threat. As weak as the outlook for inflation is, the ECB has been unmoved so far. Forecasts need to be downgraded and expectations weaken further to elicit an ECB response. Risks are tilted in this direction. The ECB staff expectation of 1.0% inflation in 2014 already feels too optimistic, for example. Should our view on the US recovery prove too optimistic and the dollar soften further, the Euro exchange rate could be a trigger for ECB easing.

Politics has been a constant source of uncertainty through the euro crisis. There are a small number of key events this year. One is the European Parliamentary elections at the end of May. There is expected to be a significant increase in seats won by populists and Euro/EU-sceptic parties. We don't see this having ramifications for the European Parliament, where the traditional centre-right and centre-left party groupings will remain dominant. But there could be ramifications in some countries. One is Greece where the radical left-wing Syriza party is polling in the lead. If anything, however, it is such fears that will likely ensure that the EU delivers some debt relief for Greece. The implicit integration would be good news for European markets. Other countries to watch include France and Italy where support for populists and alternative parties could frustrate attempts at structural reform. In Spain, the central government and all the major national parties are blocking a Catalan referendum on independence, but this does not preclude an early regional election as a proxy vote adding to concerns about political disunity at a time when political integration is an important plank of crisis resolution.

Among the emerging markets, the key risks currently emanate from Russia and the tensions in Eastern Europe. We have already taken the growth forecast for Russia down sharply, but if Russia were seen to be targeting other territories for annexation this could become a pan-European (indeed, global) shock to sentiment and growth. China's transition to a more marketdetermined cost and allocation of capital presents another risk of potentially global consequence. The key question is whether a liquidity crisis is caused either by the reallocation of credit away from state owned enterprises or of household savings out of or within the 'shadow' financial system. Reform necessarily means a loss of control over intermediation and therefore heightened systemic risk. Lastly, we expect this spring to see a return to a rising yield environment in the US. While in some EMs fundamentals have improved since last summer's 'taper tantrum' in a way that should mitigate the impact of higher US yields – India's current account deficit has fallen by half, for example – others are not materially better off than they were last summer and therefore remain exposed to a withdrawal of fixed income investments.

Finally, we see risks both ways for the US economy. It is possible that the bounce in US growth will be even greater than our above-consensus view as the headwinds of inclement weather and fiscal drag melt away. It is equally possible that the weather is masking more deep-seated (but less evident) factors that may have been holding back consumer and business spending as well as housing activity in recent months. Looking further down the road, we expect the Fed will err on the side of caution as it moves towards tightening. But slack in labor markets may have diminished appreciably already and both wage and price inflation pressures and an unmooring of inflation expectations could emerge at a pace that forces a more aggressive Fed exit. In an environment of some potentially substantial but thus far invisible financial sector froth, this is a mix that could induce a temporary but significant setback to ongoing recovery in the US and global economies.

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US: Faster growth and less labor slack will nudge inflation higher later this year

- Over the past year, the US economy has demonstrated a significant acceleration. From a near-stall in late 2012 (due to Hurricane Sandy), GDP growth in year-on-year terms has accelerated from 1.3% at the start of last year to 2.6% at year-end. We expect this trend to continue over the course of 2014, which will result in the longest sustained period of above-trend growth in the post-recession period. In turn, this will have significant implications for both employment and inflation. This acceleration is due to a combination of improving domestic economic drivers and significantly reduced fiscal drag. In fact, fiscal constriction has masked a meaningful improvement in private sector output growth, as real GDP ex-government grew 3.8% last year (4.7% in H2).
- The drivers of output growth in the near and medium term will continue to shift toward domestic sources, including faster consumer spending—in particular for services, continued recovery in the housing sector and a pickup in business investment. Exports also appear poised to contribute to growth in the short term, although this is more of a wildcard in the longer term if the dollar strengthens appreciably. Moreover, in addition to less fiscal drag, state and local government spending is on the cusp of finally turning up following an extended, post-recession contraction.
- A sustained period of above-trend growth will result in a faster pace of hiring and hence significant further decline in the unemployment rate. In fact, we project the unemployment rate to approach 6.1% by year-end—consistent with the bottom end of the Fed's central tendency forecast range, which was again lowered at the last meeting. As the unemployment rate approaches (and falls below) NAIRU, wage pressures will become more apparent in the economy. Rising wage inflation will initially be a welcome development for policymakers, as it will support income growth and consumer spending. However, it will ultimately translate into greater consumer inflation, particularly in the service sector.
- The hurdle is high for the Fed to deviate from its $10 billion per meeting glide path of reducing asset purchases. As such, the final reduction in purchases should be announced in early Q4. The Fed will continue to signal the onset of rate increases in H1 2015 through forward guidance emphasizing undesirably low inflation and excessive labor market slack. We expect the Fed Funds rate to be 1.50% at the end of 2015 and 3.50% at the end of 2016.

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

Economic activity	2013				2014				2013	2014F	2015F
(% qoq, saar)	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	1.1	2.5	4.1	2.6	3.1	3.2	3.5	3.7	1.9	3.2	3.8
Private consumption	2.3	1.8	2.0	3.3	2.3	2.6	2.5	2.6	2.0	2.5	2.8
Investment (inc. inventories)	4.7	9.2	17.2	2.5	3.6	5.6	9.6	8.6	5.4	6.8	8.9
Gov't consumption	-4.2	-0.4	0.4	-5.2	3.5	2.9	2.9	3.6	-2.2	1.0	3.5
Exports	-1.3	8.0	3.9	9.5	5.0	6.0	6.0	6.0	2.7	6.2	5.4
Imports	0.6	6.9	2.4	1.5	2.0	5.0	7.0	6.0	1.4	3.7	6.1
Contribution (pp): Stocks	0.9	0.4	1.5	-0.1	-0.7	-0.6	0.0	-0.1	0.2	-0.1	-0.1
Net trade	-0.3	-0.1	0.1	0.9	0.3	0.0	-0.3	-0.1	0.1	0.2	-0.2
Industrial production									2.6	4.1	5.4
Unemployment rate, %	7.7	7.5	7.2	7.0	6.5	6.4	6.3	6.1	7.4	6.3	5.9
Prices & wages (% yoy)											
CPI	1.7	1.4	1.5	1.2	1.5	2.1	2.3	2.6	1.5	2.1	2.3
Core CPI	1.9	1.7	1.7	1.7	1.7	1.9	2.0	2.2	1.8	2.0	2.4
Producer prices	1.4	1.6	1.2	0.7	1.4	2.7	3.0	3.8	1.2	3.6	3.3
Compensation per empl.	1.7	1.8	1.9	0.3	2.4	2.5	2.9	2.9	1.4	2.7	2.9
Productivity	-1.8	1.8	3.5	1.8	1.3	1.3	1.3	1.3	0.5	1.7	1.3

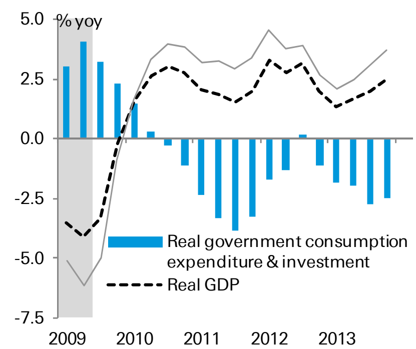
Source: National authorities, Deutsche Bank Research

New Fed Chair, same old (low inflation) problem Janet Yellen's first FOMC meeting and ensuing press conference revealed increasing confidence among policymakers that the pace of growth in the economy and recovery in the labor market had not meaningfully deteriorated; instead, they attributed recent data weakness to inclement weather in December, January and February. Policymakers maintained confidence in their medium-term economic outlook, as evidenced by only minor tweaks to their real GDP forecasts in the Summary of Economic Projections; although they did lower their unemployment rate projections for the next three years. However, policymakers continue to fret still-too-low consumer inflation. Fed members generally believe that inflation will move back toward their objective over the medium-term, but in the interim they are concerned about economic damage inflicted by persistently below-target inflation—particularly with respect to real interest rates and debt burdens. Even though the FOMC's official communiqué showed little change in its assessment of economic conditions, the histogram of interest rate expectations suggested a slightly more hawkish evolution among policymakers. The "dot plot", as described by Ms. Yellen, pointed to an earlier onset of interest rate increases and a slightly faster pace thereafter. Whether or not this interest rate profile comes to fruition will depend on the timing and magnitude of the rebound in consumer inflation as growth accelerates and labor conditions improve.

Over the course of last year, policymakers' inflation forecasts for year-end 2014 drifted steadily lower, likely due in part to the fact that measured inflation continued to decelerate. The core PCE deflator, which is the favored inflation metric among monetary policymakers, has lost traction over the past two years. It peaked at 2.0% in March 2012, decelerated to 1.5% in January of last year and slipped further still to 1.1% in January 2014. The FOMC's central tendency range for 2014 headline inflation slipped from 1.5% to 2.0% in March of last year to 1.5% to 1.6% in the latest projections. Similarly, forecasted core inflation slipped from a range of 1.7% to 2.0% down to a lesser 1.4% to 1.6% over the same period. Clearly, policymakers have resigned themselves to more muted price pressures—all while the actual decline in the unemployment rate exceeded their expectations and their growth projections generally panned out. In the following analysis, we address the major undercurrents influencing core inflation. We utilize data from the consumer price index (CPI), because it is timelier and not subject to revision; however, since the core CPI and core PCE deflator are highly correlated, the overall conclusions are broadly similar.

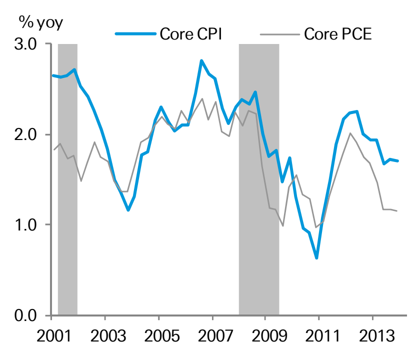
There is very little inflation in the goods-producing sector. The overall low level of consumer inflation is misleading, because it is not indicative of the underlying health of the economy. In general, weak price pressures typically reflect weak demand. However, this is not the case at present. As the latest CPI data demonstrate, there is an ongoing and stark divergence between the inflation trends for goods and services. For example, core goods inflation slipped to a new, post-recession low of -0.4% year-on-year in February. Meanwhile, core service inflation—at 2.3%—is only slightly below its post-recession peak of 2.6%. The weakness in goods prices is not the result of tepid demand, as reflected in real goods consumption growth of 3.8% in H2 2013. Rather, consumer goods deflation is the result of three key trends, which are not directly linked to the strength of consumer demand: One, muted energy prices; two, muted input prices in the supply chain; and three, falling import prices, which are largely attributable to a stronger dollar. With respect to the first point, CPI energy was in negative territory in Q4 (-2.3%), in large part due to falling prices for motor fuels (-5.7%). Despite a temporary spike in utility demand due to below-average temperatures, overall energy prices remained depressed through February. With respect to the second point above regarding soft input prices on a broader spectrum, the producer price index shows very limited upstream price pressures in the production pipeline. The stages-of-processing data show unprocessed nonfood materials less energy down -3.3%

Figure 2: Fiscal drag has masked a significant improvement in private sector output growth



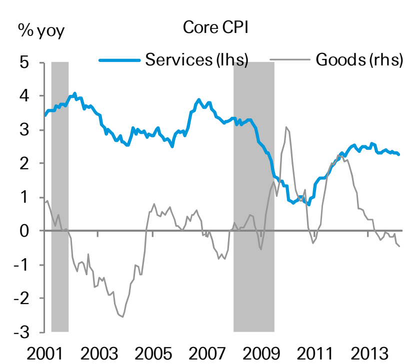
Source: BEA, Haver Analytics, Deutsche Bank Research

Figure 3 Major metrics of core inflation have been decelerating over the past several quarters



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

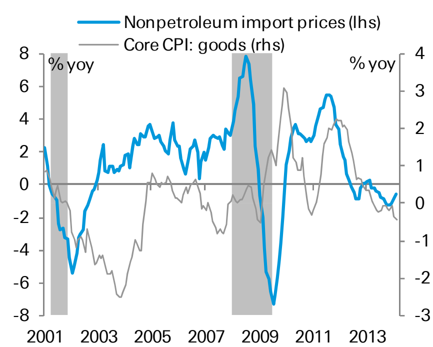
Figure 4 The core inflation undercurrents show two very different trends



Source: BLS, Haver Analytics, Deutsche Bank Research year-on-year, while processed goods for intermediate demand are effectively stagnant (-0.1% year-on-year) and final demand for goods is up just +0.6%. While extreme swings in the earlier stages of production typically do not translate into such large moves in the later stages, they do tend to accurately foreshadow the general trend. As such, weak “upstream” pressures at present likely foreshadow very little upward drift in prices for finished consumer goods in the near term. Of course, limited price pressures in the production pipeline are in part due to currency market trends—the third factor cited above. The ongoing appreciation of the dollar, which is largely a function of improving economic fundamentals fostering expectations of higher interest rates, is resulting in lower import prices. The broad index of the trade-weighted dollar appreciated +3.7% in February relative to year-ago levels (compared to +1.5% and +2.4% in Q3 and Q4 of last year, respectively). Dollar appreciation has accelerated over the past three quarters, while at the same time import price weakness also intensified. Non-petroleum import prices declined by -0.9% in Q3 2013, -1.2% in Q4 2013 and they continue to fall in the current quarter. The recent import price weakness is the most severe since 2009, when import demand was still in a recession-induced swoon. As a result, the acceleration of core inflation which we project for this year will largely hinge upon the service sector—but it is important to note that outright deflation in consumer goods prices is not a reflection of weak demand.

Service inflation: Hot and getting hotter Despite weak price pressures for consumer goods, core service inflation has further room to rise. The core service category can be broken down into two main components—rent of shelter and other services excluding rents and energy. The latter includes subcategories such as medical care, education and other personal services. With respect to shelter inflation, we have found the rental vacancy rate (a measure of supply) and household income growth (a driver of demand) to be the dominant factors. The rental vacancy rate has steadily declined since the end of 2009 and currently stands at a 13-year low (8.2%). Personal income growth metrics have been choppy in recent months—in part due to recent weather distortions and tax changes at the start of last year. Nonetheless, income appears to be muddling along somewhat faster than the rate of inflation of late, which in turn should support discretionary spending. In fact, one measure of the income trend—household withholding tax receipts—has shown a marked acceleration since the start of the year. Tax receipts are useful, because they are reported in a timely manner and are not subject to revision. The tax receipt trend is significant, because it corroborates our broader view that many components of the economy which have been impeded by bad weather are poised to bounce back significantly in the near term. Distortions aside, personal income growth is due to accelerate later this year as the pace of hiring increases and wage pressures intensify in an environment of reduced labor market slack. The trend in shelter inflation is critical, because it comprises a substantial share of both the CPI and PCE deflator. Shelter inflation has witnessed a pronounced acceleration over the past three years, rising from +0.8% in Q1 2011 to +2.0 in Q1 2012, +2.2% in Q1 2013 and +2.6% as last reported (according to the CPI). Our modeling anticipates further acceleration to +2.8% through year-end. Shelter inflation is unlikely to moderate until builders alleviate the supply shortage for both rental units and new homes for sale.

Figure 5: A stronger dollar “imports” disinflation



Source: BLS, Haver Analytics, Deutsche Bank Research

The non-shelter core service inflation categories are also showing broad-based price pressures, as evidenced by the following results (as of February): medical services (+2.4%), transportation (+1.4%), recreation (+1.7%), education/communication (+1.6%) and other personal services (+1.9%). It is noteworthy that there is substantial breadth to the underlying core service inflation trend. As of last quarter, non-shelter core service inflation was up +2.3%—and it was only slightly lower in the current quarter (1.9%). We do not expect the recently observed deceleration to endure based on our modeling. While somewhat more difficult to forecast than shelter or goods inflation, we have found the non-shelter core service inflation categories to be most sensitive to a range of labor market metrics, such as the unemployment rate, unit labor costs and the employment cost index. It is not surprising that these metrics are among the most useful forecasting tools for non-shelter service inflation—because labor costs are typically the largest expense in service-providing industries. (Incidentally, this is commonly true in the goods-producing sector, as well.) Given our constructive outlook for the labor market—which includes falling unemployment, rising wages and increasing average hourly earnings—we expect non-rent core service inflation to reaccelerate toward 2.9% by year-end (or about 100 bps above current levels).

Our analysis yields three main conclusions: One, core goods prices are not likely to materially contribute to consumer price pressures in the near term; two, shelter costs will continue to be one of the dominant drivers of core inflation—in fact, look for further acceleration in this category given tight vacancy rates; and, three, non-shelter core service inflation, which hit a slight soft-patch at year-end, is due to pickup as labor slack is further reduced. The combination of these three trends will result in higher core inflation in 2014 and beyond. Importantly, the underlying drivers of the inflation trend in both the core PCE deflator and the core CPI are the same, although modest differences in index composition will yield slightly different results. Our forecasts yield a 50 basis point acceleration in the core CPI from 1.7% in Q4 2013 to 2.2% at the end of this year. If we re-weight these forecasts according to the core PCE deflator, it yields a lesser 40 bps acceleration from 1.1% to 1.5%. Inflation is poised to rise, what will be the Fed's policy response?

An acceleration of core inflation in 2014 would be consistent with the historical relationship between GDP growth and core inflation—particularly considering that growth finally crossed above-trend in Q2 of last year. Given the usual six-quarter lag, higher inflation pressures should become more clearly present in the second half of this year—although based on our forecast, price pressures will not return to policymakers' comfort zone of 2.0% to 2.5% until 2015. Even so, as firmer inflation and lower unemployment become more apparent later this year—particularly if growth is above 3% and wage pressures are building—policymakers will feel confident that inflation will reach their targeted range in 2015. Hence, they will continue navigating toward their projected initial rate hike sometime by the middle of next year.

- The major risks to the economic outlook have shifted as growth has become more domestically oriented. As such, our growth forecast is most vulnerable to a sustained period of depressed hiring and income growth, which could result from a shock to private sector confidence.
- Our inflation forecast is largely hinges upon wage pressures. Therefore, if labor inflation evolves either faster or slower than we anticipate, due to a shift in NAIRU or a growth surprise—consumer inflation could similarly deviate from our projected path.
- Policymakers could face a significant challenge with respect to forward rates guidance—particularly after shifting away from qualitative thresholds—because less explicit guidance will provide market participants with sufficient vagueness to challenge the timetable of the policy exit.

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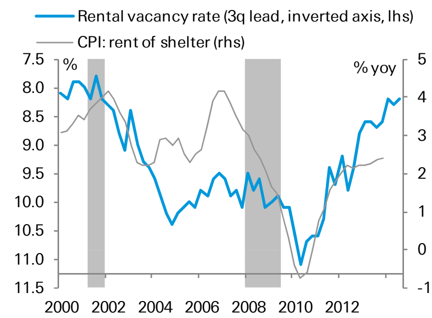
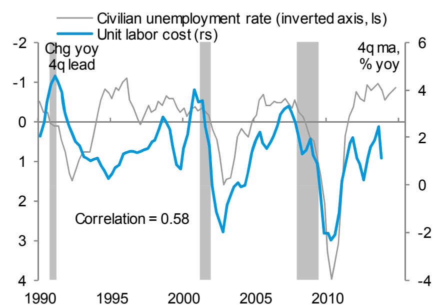
Figure 6: Shelter inflation has been, and will continue to be, a major driver of core inflation



Source: Census, BLS, Haver Analytics, Deutsche Bank Research

Figure 7 Tighter labor market conditions will create wage pressures—and ultimately greater consumer price pressures



Source: BLS, FRB, Haver Analytics, Deutsche Bank Research

Figure 8: External balances & financial forecasts: US

		2013F	2014F	2015F
Fiscal balance, % of GDP		-3.8	-2.9	-2.5
Trade balance, USD bn		-472	-423	-464
Trade balance, % of GDP		-2.5	-2.4	-2.5
Current account, USD bn		-379	-398	-438
Current account, % of GDP		-2.3	-2.3	-2.3
Financial forecasts	Current	Q2-2014	Q3-2014	Q1-2015
Official	0.13	0.13	0.13	0.25
3M rate	0.23	0.35	0.35	0.35
USD per EUR	1.37	1.32	1.29	1.21
JPY per USD	102	109	112	117
USD per GBP	1.66	1.61	1.59	1.52

Source: National authorities, Deutsche Bank Research, as of March 28

Europe: Appearances can be deceptive

- Euro area markets are demonstrating encouraging resilience despite heavy deleveraging, stress test uncertainty and events like the German Constitutional Court's preliminary negative ruling on the OMT, which we think dealt it a potentially fatal blow. Resilience may reflect several factors, from the economic recovery, reversing fragmentation and perhaps a belief in the market that if necessary to address a deflationary shock the ECB could always engage in QE. Optimists see some potential for a virtuous cycle of voluntarily recapitalized banks, low funding costs and rising credit supply. We are more hesitant and fear some market complacency.

- Growth is a source of vulnerability. Our GDP forecasts are broadly unchanged relative to the last World Outlook (1.1% in 2014, 1.5% in 2015), but there remain sizeable uncertainties, from the Ukraine crisis to the AQR/EBA and its impact on credit growth. If growth disappoints expectations — whether this year or next — we fear markets will refocus on structural imbalances, of which there are still many.

- Nominal growth is a risk too. Euro area inflation is low — forecasts for 2014 and 2015 are a tenth or two lower than the last WO — and contrary to our expectations, the ECB has been, and we fear will remain, constrained to respond. The easy options are not commensurate with the risks while the more effective options are more difficult to implement. The ECB is hoping for the best. With luck, the global economy helps the recovery while Fed progress towards the monetary turning point lifts the dollar and takes the pressure off the Euro. The risk is markets view the ECB as "all talk and no action" and inflation expectations become dis-anchored. We believe the ECB is increasingly prepared for QE, if needed.

- In the UK loose policy has gained traction and we have revised up our 2014 growth view. But we see that giving way to a moderation by year-end. Higher interest rate expectations, austerity and sterling provide some of the reasons. Upside risks, alternatively, stem from housing (London is booming) and the possibility we have underestimated the impact of current policy support. With stronger growth we have brought forward our rate hike view by six months to May 2015 — immediately following the election. A halt in the recovery or a more sizable inflation undershoot than expected are risks for delayed normalisation.

- The Ukraine crisis escalated dramatically in recent weeks and is far from resolved. There is an economic element to the crisis, not least for Ukraine which has been heading down an unsustainable path for years with a fixed and overvalued FX rate and large external and fiscal imbalances. Debt is not unsustainable and we think the economic crisis can be resolved without notional haircuts on Ukraine Eurobonds. Elsewhere in Emerging Europe the news over the quarter has been more encouraging.

Figure 1: Macro-economic activity & inflation forecasts:

	GDP (%yoy)			CPI (%yoy)		
	2013	2014F	2015F	2013	2014F	2015F
EU	0.1	1.5	1.7	1.5	0.9	1.4
Euroarea	-0.4	1.1	1.5	1.4	0.8	1.3
Germany	0.4	1.5	2.0	1.6	1.1	1.7
France	0.3	1.0	1.4	1.0	1.0	1.1
Italy	-1.8	0.6	1.1	1.3	0.7	1.2
Spain	-1.2	0.7	1.5	1.5	0.5	1.1
UK	1.8	2.9	2.2	2.6	1.6	1.8
Sweden	1.5	2.7	3.0	0.0	0.5	1.8
Denmark	0.4	1.4	1.5	0.8	1.4	1.8
Norway	2.1	2.5	2.6	2.1	1.9	2.1
Switzerland	2.0	1.8	2.0	-0.2	0.4	0.8

	GDP (%yoy)			CPI (%yoy)		
	2013	2014F	2015F	2013	2014F	2015F
EMEA	2.3	2.0	3.2	4.9	5.1	5.0
Poland	1.6	3.0	3.9	0.9	1.7	2.3
Hungary	1.1	1.9	2.0	1.7	0.5	2.3
Czech Republic	-0.9	2.0	2.5	1.4	1.1	2.0
Romania	3.5	2.8	3.2	4.0	2.0	3.3
Russia	1.3	0.6	2.2	6.8	6.2	4.9
Ukraine	0.0	-4.9	2.5	-0.3	2.8	5.8
Kazakhstan	6.0	4.8	5.2	5.8	5.1	6.3
Israel	3.3	3.7	4.2	1.5	1.6	2.2
Turkey	4.0	2.2	3.8	7.5	8.1	7.8
South Africa	1.9	2.7	3.5	5.8	6.0	5.6

Source: National authorities, Deutsche Bank Research

Euro Area: Signs of resilience…

Euro area markets are showing encouraging resilience. Banks deleveraged by record volumes in Q4 2013. Having become the new marginal buyers of sovereign debt with the help of ECB policies like 3Y LTROs, the fact that markets did not experience systemic disruption in Q4 suggests new buyers are emerging. Despite lingering uncertainty around the ECB AQR/EBA stress tests such as the macro assumptions and the backstops and bail-in rules, European bank equity and bank debt markets are remarkably healthy. Peripheral sovereign markets have also been unperturbed by the German Constitutional Court's preliminary — and negative — judgement on the OMT, which we think dealt it a potentially fatal blow.

We see the resilience stemming from several factors. First, the Euro area economy has been recovering. GDP growth has been positive since Q2 2013. On average so far, growth has been above expectations. The growth is in peripherals as well as core countries, and is in domestic demand as well as trade. Unemployment has stopped rising, and employment growth was positive in Q4 for the first time this cycle. Soft data for Q1 implies growth is continuing in early 2014. The situation in Ukraine is a potential dampener relative to expectations, but steady recovery has nonetheless impressed investors who thought GDP could not grow due to fiscal retrenchment and private debt deleveraging. The reality may be that improved economic and financial market confidence, supported by OMT, has caused fiscal multipliers to decline. Moreover, as we have long argued with the credit impulse, slower deleveraging is all that is required for GDP to grow.

Second, financial fragmentation is easing. This is another benefit of the credibility of the ECB's OMT commitment (to do "whatever it takes"). Private funds fled the peripherals to the tune of hundreds of billions of Euro in the 12 months before mid-2012. The OMT was the turning point. Hedge funds might have had the early mover advantage, but with the perceived tail-risk in the Euro area falling, other investors are increasingly willing to rebuild their exposure to the peripherals. This was demonstrated by the very successful sovereign debt auctions for Spain, Portugal and Ireland at the start of 2014. Investors may be going through a process of structurally rebuilding exposures, easing funding constraints.

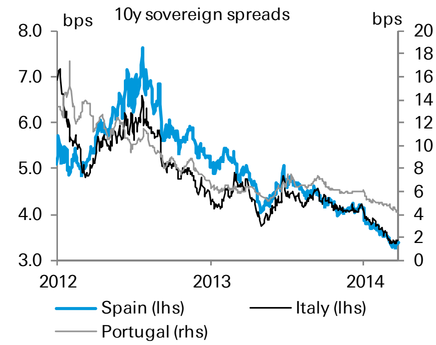
There is likely to be a third factor too, namely a perception of ECB QE should the situation demand it. Mario Draghi has promoted the notion this year that ECB QE is not impossible or illegal despite the GCC opposition to OMT. The market probably still trusts the "whatever it takes" mantra, believing implicitly that GDP-weighted bond purchasing to deal with deflation has displaced the OMT bilateral support for a country in crisis. In short, GCC hurdles to OMT matter less.

…but beware complacency

In a perfect world, this configuration could beget a virtuous cycle of recapitalized banks, low funding costs and financeable economic growth. This could yield time for underlying structural imbalances to be worked off and for politicians to build out closer Euro area integration.

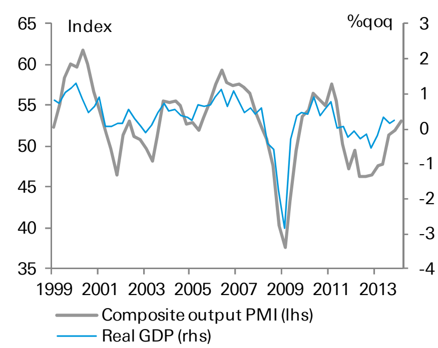
We are not convinced such self-reinforcing forces are entrenched. We fear some complacency in Euro markets and the factors that could trigger some market re-assessment. Growth is one factor. We forecast 1.1% GDP growth in 2014, not much different from consensus. The turnaround from a 0.4% contraction in GDP in 2013 is due primarily to diminishing negatives – slower fiscal consolidation and slower private deleveraging. To keep the growth impulse going in 2015 — we expect 1.5% — genuine drivers have to emerge. It is possible fiscal multipliers continue to normalize, but this requires the bank

Figure 2: As tail risk dissipates, sovereign spreads decline



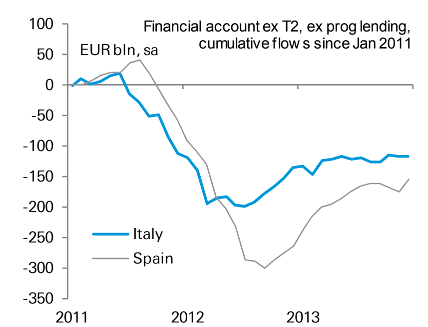
Source: Haver Analytics, Deutsche Bank Research

Figure 3: Soft and hard data confirm the recession ended in early 2013



Source: Deutsche Bank Research

Figure 4: Private finance is flowing back into the peripherals



Source: Deutsche Bank Research

lending channel to normalize. Bank capital may have improved — our banks analysts expect European Core Equity Tier 1 (CET1) to be almost 11% this year. Implying banks ought to be carrying a capital buffer into the AQR/EBA stress test — but business lending margins are back to cycle wides. This may signal banks' concern over nominal income growth ahead. We do not need private credit to grow this year to achieve c.1% GDP growth, but without private credit growth in 2015, GDP growth will be more difficult to achieve — for example, expectations for investment spending growth imply corporate sector access to credit. Add to this the new negative factor for 2014 – the situation in Ukraine — and growth expectations might have reached their peak for now. Europe needs the global economy to compensate — four tenths of growth this year and next year come from net trade — but even here there are questions marks, particularly from EM.

Crisis in the Ukraine could impair the European recovery

We have not explicitly revised our growth expectations because of the situation in Ukraine. It is a downside risk. There are three main channels through which the ongoing crisis in Ukraine could impact the economy in the rest of the world. First, non-resident financial institutions could be affected if, in retaliation against sanctions, Russia decided to embark on asset grabbing, or if the credit worthiness of Russian assets materially declined as a consequence of an escalating crisis. Second, world trade could be affected by a drop in Russian imports, either as a consequence of some trading bans, or more likely through the contraction in Russian demand stemming from a sudden stop in external financial flows. Third, in retaliation against sanctions, disruptions in Russian supply could impair economic activity in the countries which are dependent on Russian energy. These channels are naturally mutually reinforcing (e.g. a drop in the Russian supply of energy would reduce import growth and credit worthiness in Russia).

On all these counts, the European Union would come firmly first among those negatively impacted. However, to get into a territory where European growth would be materially impacted, an extreme scenario would need to be contemplated, with a deep recession in Russia – similar to what was seen at the time of the Ruble crisis in 1998 - and large spillover to the Eastern part of the European Union. More than such a dramatic scenario, our main concern actually is that the Ukrainian crisis creates a diffuse sense of uncertainty in Europe, adding to the question marks hanging on the emerging markets in general and China in particular, as well as to the difficulties to make sense of the recent dataflow in the US to create a "wait-and-see attitude" which would be detrimental to the ongoing subdued recovery in the Euro area.

If growth were to disappoint expectations — whether this year or next year — we fear markets will refocus on the structural imbalances in Europe. We see the structural primary budget balance at 1.9% of GDP in 2014, the highest since 2000. But Spain will still be running a deficit and Ireland might be barely positive. Greece, Italy, Ireland, Portugal and Spain might each be running current account surpluses, but structural CA balances remain negative, especially in Greece. Unemployment rates remain very high and persisting credit constraints could force firms to constrain employment and pay, adding to deflation risks. France and Italy concern us in this regard. The lower average rate of inflation in the Euro area also means that the competitive rebalancing between member states is more likely to entail absolute deflation in the weak peripherals. This risks stoking debt-deflation spirals.

Figure 5: % of EU goods exports destined for Russia

Country	Exports
Austria	2.5
Belgium	1.6
Bulgaria	2.7
Cyprus	0.7
Czech Republic	3.1
Denmark	1.9
Estonia	10.7
Finland	9.9
France	2.1
Germany	3.1
Greece	1.7
Hungary	3.0
Ireland	0.7
Italy	2.6
Latvia	11.5
Lithuania	18.9
Luxembourg	1.1
Malta	0.7
Netherlands	1.3
Poland	5.5
Portugal	0.7
Romania	2.3
Slovakia	4.2
Slovenia	3.5
Spain	1.3
Sweden	2.0
UK	1.8
EU27	2.7

Source: Deutsche Bank Research

Figure 6: Macro-economic activity & inflation forecasts: Euro area

Economic activity	2013				2014				2013	2014F	2015F
(% qoq, saar)	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	-0.9	1.3	0.6	1.1	1.2	1.2	1.5	1.2	-0.4	1.1	1.5
Private consumption	-0.4	0.6	0.5	0.6	0.4	0.4	0.8	0.8	-0.5	0.5	0.8
Investment	-6.4	0.6	2.3	4.3	2.0	0.8	2.4	2.8	-2.8	2.3	3.4
Gov't consumption	1.1	-0.1	1.5	-1.0	-0.4	-0.4	-0.4	-0.8	0.3	-0.3	-0.7
Exports	-3.7	9.7	0.1	4.9	3.2	4.9	4.9	4.5	1.3	4.1	5.3
Imports	-4.5	6.9	3.9	1.6	2.8	4.9	4.9	4.5	0.1	3.7	5.1
Contribution (pp): Stocks	0.1	-0.6	1.2	-1.3	0.4	0.7	0.4	0.1	-0.2	0.1	0.2
Net trade	0.2	1.5	-1.5	1.6	0.3	0.2	0.2	0.2	0.5	0.4	0.4
Industrial production	1.5	2.8	-0.2	1.8	1.3	1.3	1.7	1.2	-0.7	1.3	1.8
Unemployment rate, %	10.4	10.5	10.7	10.7	12.0	12.1	12.0	12.0	12.1	12.0	11.8
Prices & wages (% yoy)											
HICP	1.9	1.4	1.3	0.8	0.7	0.8	0.7	1.0	1.4	0.8	1.3
Core inflation	1.4	1.1	1.1	0.8	0.8	1.0	1.0	1.1	1.1	1.0	1.2
Producer prices	1.2	-0.1	-0.6	-1.1	-1.4	-0.2	0.1	0.8	-0.2	-0.1	1.5
Compensation per empl.	1.7	1.6	1.7	1.4	1.3	1.2	1.2	1.3	1.6	1.2	1.5
Productivity	-0.1	0.4	0.6	1.0	1.1	1.0	1.3	1.3	0.5	1.2	1.1

Source: National authorities, Deutsche Bank Research

ECB taking risk with low inflation

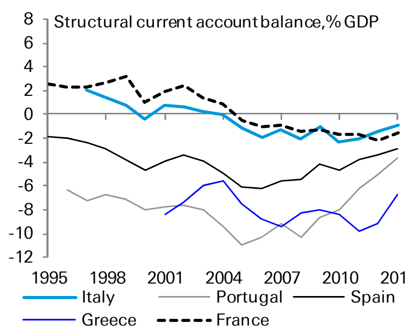
Another factor restraining our optimism is low inflation and the ECB incapacity to respond. A formal bias to ease remains in place, but the lesson we have learned from February and March — we incorrectly anticipated policy easing — is that the hurdle to easier policy is higher than we thought. 'Easy' policy options like a refi rate cut or ending SMP sterilization are unlikely to yield much stimulus so the Council feels disinclined to deliver. More significant policy options, like ABS, FLS and QE, are either not under the full control of the ECB (e.g., ABS requires legislative and regulatory changes) or are controversial (e.g., QE) and therefore require a considerable deterioration in the outlook to bring them more meaningfully into consideration.

Our sense is the ECB remains divided internally, with many of the Executive Board members dovish and eager for policy easing but failing so far to gain majority support from the Governing Council. The division makes verbal policy making easier than actual policy making — the best example being the negative deposit rate. The risk is that markets will over time conclude that the ECB is constrained to "talk, not act". With the ECB staff forecasting HICP inflation below target for the next 3 years, we believe the ECB is risking a dis-anchoring of inflation expectations. There is some evidence to support this. Real interest rates may already be rising, threatening the nascent recovery.

A case can be made for greater monetary policy insurance. We agree that inflation is probably at or about the low for the cycle (see discussion below), but the buffer against negative inflation and deflation is about as narrow as it has ever been at a time when standard policy has the least amount of room for manoeuvre that it has ever had. Were there to be an unanticipated shock, the ECB could quickly end up behind the deflation curve. The combination of disinflation in normally volatile food and energy prices and deflation in peripheral countries rather than core — interpreted as good deflation rather than bad — has emboldened the majority on the ECB to accept this risk.

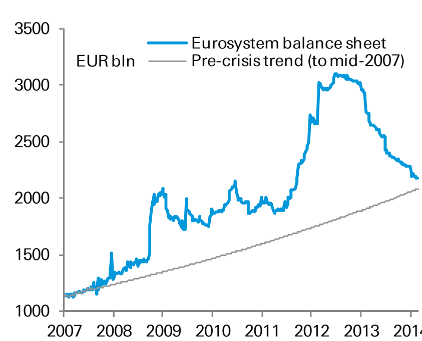
Our baseline for the ECB is no further policy rate cuts and no asset purchasing (first rate hike not before 2016). But there are risks. Jens Weidmann's recent comments on QE drew a lot of attention. The heart of his message is that the Bundesbank is intellectually ready to contemplate QE. This in itself is an important stepping stone. This means that should the need arise, the political or "theological" hurdles to QE should not be overstated. The level of insurance we have from the Eurosystem is high, if things turn sour. This does not mean

Figure 7: Structural current account deficits remain



Source: Deutsche Bank Research

Figure 8: ECB balance sheet has contracted nearly E1tr since mid-12



Source: Deutsche Bank Research

that QE can at this stage be a baseline expectation, but asset purchasing of some form is definitely a non-negligible risk this year. We can fairly easily see the central bank being dragged into QE, rather than enthusiastically and pre-emptively embracing it.

Potential triggers for ECB easing are: inflation expectations, particularly if the gradual upward trajectory in the staff forecasts for 2014-2016 were to flatten/invert; the Euro exchange rate has already been highlighted by Draghi as "increasingly relevant" to price stability, and in a scenario of weaker global demand, perceptions of a constrained ECB could squeeze the Euro higher; and renewed tensions in the periphery, particular in light of a less potent OMT.

Political risk: Never far away

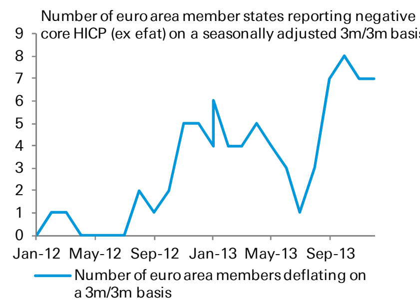
There is also politics, a perennial source of uncertainty. There are idiosyncratic risks, such as Renzi and Hollande's capacity for successful structural reforms in Italy and France and the Catalan independence question in Spain. In May the European Parliamentary elections are set to see a marked rise in the number of seats held by populist and anti-Euro/EU parties. The ramifications of the European Parliamentary elections might be felt more at a national level than in Brussels. For example, were Syriza to beat the New Democracy party in Greece, it could unsettle markets. Chances are there will be a general election in Greece by February 2015 and a Syriza-led government might not be out of the question. Following a half year of hiatus, Athens has just concluded a programme review with the Troika. The deal allows Athens to finance a small stimulus, financed by an earlier than expected primary surplus. This and a signal of EU willingness to discuss debt relief in August could yet win PM Samaras sufficient support to retain power.

Optimism is growing and Greek yields have fallen sharply. 'OSI lite' is likely – margin compression and maturity extension on official sector loans, though agreement may wait until after a general election. This could be enough to allow Greece to re-open the sovereign market this year. Alongside the "clean exit" by Ireland in December and probably also by Portugal in May — assuming peripheral sovereign markets remain open — this would be a notable success for Greece and the EU. But there is still a long way to go to get public and private debt back to pre-crisis levels. In the absence of clearer debt mutualisation, the Euro area will remain vulnerable to setbacks. Exiting the orbit of this crisis remains difficult.

Euro Inflation

After falling strongly through Q4 2013, inflation has started to stabilise in recent months, with headline inflation in a 0.73% y/y to 0.86% y/y range between October and February. The drivers behind the 2013 disinflation include weaker EM growth, lower commodity prices , a stronger currency—the food and energy contribution to inflation has fallen from 1.3pp in Q4 2012 to 0 in February—subdued domestic demand, structural economic adjustments in some countries as well as a diminishing contribution from administered prices and indirect taxation. Looking forward, the pull from these factors should progressively fade and we would see inflation moving broadly sideways in the coming months, before edging higher into and through 2015, while remaining well below the ECB target. Core inflation should be supported by a stabilisation in the government contribution, fading downward pressure from some imported goods as well as by better demand on the back of an improving economy. Food inflation could continue to ease until the summer on account of past declines in commodity prices and unusually high seasonal food prices in spring 2013, but recent increases in world agricultural prices have led to upward revisions to consumer food price forecasts into 2015. Finally, assuming oil prices in line with market pricing, energy inflation is expected to stay negative on average this year, and rise only marginally next. Recent

Figure 9: Rising incidence of countries deflating



Source: Deutsche Bank Research

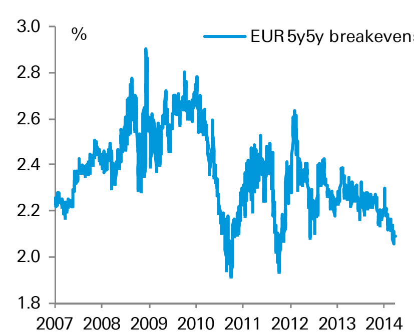
Figure 10: Debt-deflation spirals are not theoretical

Contribution of GDP deflator to changes in private debt-to-GDP ratio

	Greece	Ireland	Italy	Port.	Spain
2007	-2.2	-4.9	-1.9	-5.5	-6.2
2008	-4.3	3.4	-2.9	-4.1	-5.4
2009	-2.6	8.0	-2.7	-2.5	-1.9
2010	-2.6	7.8	-1.2	-1.6	0.2
2011	-1.1	2.1	-1.0	-1.2	-0.3
2012	-0.2	-2.6	-2.3	0.6	0.1
2013ytd	2.2	-2.8	-2.0	-1.7	-1.1

Source: Deutsche Bank Research

Figure 11: Market-implied breakeven inflation rates are declining



Source: Deutsche Bank Research

declines in wholesale petrol prices (in Euro terms) have led to downward revisions to Q2 HICP forecasts and are the main reason why we see inflation below ECB staff forecasts this year. Weaker EM growth, a stronger currency and the possibility of a prolonged period of low spot inflation pulling inflation expectations lower are downside risks to inflation forecasts.

Italian politics

Italy's new PM, Matteo Renzi, the fourth in 2 ½ years, will be supported by the same fragile majority of the previous government. That has not stopped him from adding to the already ambitious institutional reforms a commitment to boost economic growth. Indeed, Italy's key issue is lack of growth. After a modest recovery in GDP over the next few years as the output gap closes, we see Italy's potential GDP tending to zero without economic reforms versus slightly above 1% in Spain, Germany and France.

The first proposed institutional reform is a new electoral law to boost future government stability. But its effectiveness has been de facto linked to the constitutional reform curbing the influence of the Senate. The latter is a lengthy, uncertain process but also one that would improve future efficiency of the decision-making process. The last constitutional reform should also improve the country's institutional framework by reallocation transport and energy policies to the central government.

In terms of economic reforms, although we see PM Renzi moving in the right direction, he is taking the path most convenient for electoral rather than economic purposes.

Renzi announced an 0.8% of GDP cut in Italy's tax wedge. However, he directed the cuts mainly to income taxes rather boosting competitiveness via lower corporate taxes. This means that the net benefit to the economy will be dampened by higher imports and no boost to exports. We see a +0.2pp cumulative modest impact on 2014-2015 GDP. Another slightly smaller boost to short-term GDP should come from a modest expansion of the ongoing 3% of GDP programme to repay arrears of the public administration.

In 2014, the proposed economic reforms will lower the primary surplus but the fiscal deficit should remain below 3% of GDP thanks to the lower sovereign yields.

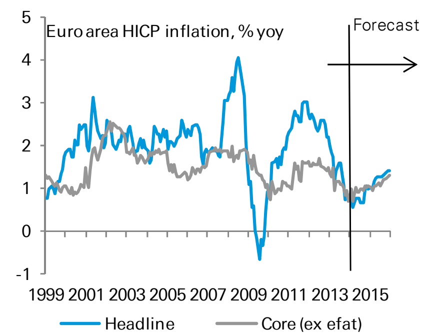
In the long term, the above cut in the tax wedge, structurally funded via lower public current expenditures, could have a small impact on potential GDP growth (0.1pp). But a larger reduction will be necessary to boost GDP and competitiveness – a technically feasible development given the target public expenditure reduction in 2015 and 2016.

The risk is that the government does not fully implement the spending cuts or dissipates them opting for a wide range of minor policies aimed at boosting political support. We also see downside risk to exports due to Italy's ongoing competitiveness gap and risks from an escalation of the tensions between Ukraine and Russia. But, as always, the key issue for Italy is the ability of the government to fully implement proposed reforms.

Spanish referendum

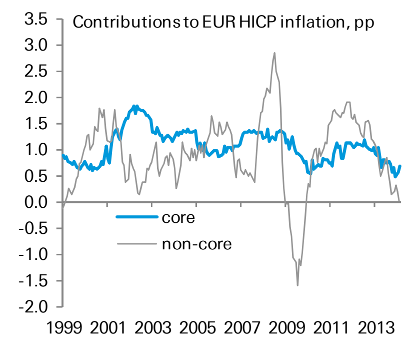
Market views on the country have spectacularly improved and Spain is no longer a "risk generator" in most investors' eyes. We generally concur, but we still think some stress in 2014 could come from the political realm. Indeed, there is still not clear roadmap to deal with Catalonia's push for independence.

Figure 12: Inflation at or about the cyclical low



Source: Deutsche Bank Research

Figure 13: Most of the disinflation due to non-core items



Source: Deutsche Bank Research

Figure 14: Other indicators & financial forecasts: Euro area

	2012	2013F	2014F	2015F
M3 growth, % yoy eop	3.5	1.0	0.8	2.7
Fiscal balance, % of GDP	-3.7	-3.0	-2.5	-2.1
Public debt, % of GDP	92.6	95.5	96.2	95.2
Trade balance, EUR bn	79.7	153.8	173.4	166.8
Trade balance, % of GDP	0.8	1.6	1.8	1.6
Current account, EUR bn	126.2	216.6	234.0	213.7
Current account, % of GDP	1.3	2.3	2.4	2.1
Financial forecasts	Current	Q2-2014	Q3-2014	Q1-2015
Official	0.25	0.25	0.25	0.25
3M rate	0.31	0.35	0.38	0.40
10Y yield	1.54	1.85	2.05	2.35
USD per EUR	1.37	1.32	1.29	1.21
JPY per EUR	140	144	144	141.57
GBP per EUR	0.83	0.82	0.81	0.80

Source: Deutsche Bank Research, as of March 28

The Catalan government's petition for the right to organise a referendum on their sovereignty was rejected broadly by the central government. In addition, Spain's constitutional court, as expected, ruled Catalonia's request unconstitutional, since popular sovereignty cannot be divided and resides firmly in the entire population of Spain.

The CC kept a door open, noting that the Catalan people are entitled to "a right to decide", but that their "aspirations" have to find an outlet which would be consistent with Spain's constitutional order. Agreement between the Socialists and PP, who would likely take different tracks, is difficult to imagine. In any case, revising the constitution is cumbersome in Spain, involving a parliamentary procedure, a referendum and possibly new general elections. We are not optimistic on this avenue, at least in the near future.

Meanwhile, in Catalonia, the chief of the government has stated his intention to "go ahead with the process" after the CC ruling, without explicitly stating his willingness to organize a referendum no matter what.

A similar issue arose in the Basque Country in 2008, when a referendum planned by the regional nationalist government was stopped by the Constitutional Court. However, at the time the Basque government had given itself quite some wiggle room - keeping the questions put to referendum very vague, not using the word "independence" - while Catalonia's nationalists will now have a hard time climbing down from their current tough stance. A split of the coalition, and early regional elections, may be unavoidable.

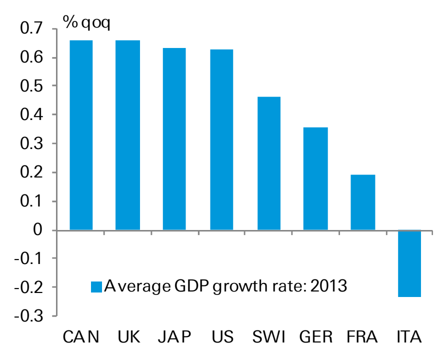
The potential for some unrest towards the end of this year, and additional strained relationship on sharing the burden of the fiscal adjustment, is high in our view. There is no clear, "harmonious" path we can discern at this stage.

UK: Strong growth not built to last

The UK has grown faster than any other G7 economy over the past year, albeit from a low base. Annualised growth has averaged 3% since last spring - slower than the 15 year run-up to the credit crisis but a solid performance nonetheless relative to what had gone before. Domestic policy support coming from low interest rates, a bloated central bank balance sheet, the Funding for Lending Scheme (FLS) and Help to Buy appears to be finally gaining traction with the ECB's (as yet unused) Outright Monetary Transactions having taken the risk of Euro break up off the table.

We expect the recovery to continue, at similar rates in the first half of 2014 to that seen at the end of last year before slowing to something more sustainable thereafter. The fact that the business surveys have held up well suggests a slightly stronger rate of growth for this year than we had originally expected - we have thus upped our view from 2.7% to 2.9%. Moreover, it is easy to see how this could be even stronger in the event that the Bank of England is right in expecting the national statistics office to revise up past estimates of growth (revisions to tend to be pro-cyclical). As for next year, we expect growth to migrate towards its long run average rate of just over 2%.

Figure 15: UK enjoys strongest growth in G7



Source: Deutsche Bank Research

There are a number of reasons for this view of moderating growth, ranging from market expectations of higher rates and their impact on highly-sensitive households to weak real wages, sterling's rise over the past year, the need for further fiscal consolidation (confirmed in the recent 2014 Budget) and the fact growth over the very long-run has been far less than what we have seen of late. Global political uncertainties, including most recently that of Russia/Ukraine, provide further cause to be cautious.

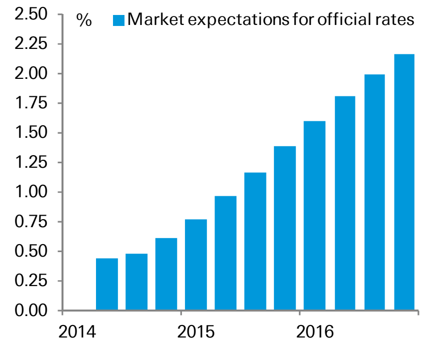
While these downside factors have been taken into account in our central forecasts, we should not ignore the upside risks to our growth profile going forward. These include the possibility that we have underestimated the impact of the sizable policy support that has been put in place over recent years; the strength of the housing market recovery; the chance that business investment grows more quickly than we currently expect (note the BoE sees double digit growth rates in the coming few years); and the possibility that in the event global risks dissipate the world economy - and thereby UK export demand - may find itself in a far stronger position.

Still, in expecting stronger growth it seems reasonable to bring forward our view of the first rate rise from the Bank of England. We had previously thought that the Bank would wait until the end of 2015 before starting to take back monetary accommodation, but recent communications from the MPC suggest it could be earlier. We have therefore brought forward our view to May 2015 (note that the meeting is scheduled for immediately after the general election), with the Bank expected to deliver two 25bps hikes by the end of next year taking policy rates to 1%. Looking further ahead we see rates ending 2016 at 2%, then 2.5% at the end of 2017 and 3% by 2018. As the Governor has argued, this is a gradual tightening consistent with terminal rates being lower than in the past.

What could prevent the MPC from beginning the process of policy normalisation as soon as May next year? Clearly a halt in the recovery could be sufficient, as could more intense disinflation. On this latter issue, CPI inflation has fallen to just below the 2% target and is likely to continue to head down on account of: sterling's appreciation over the past year, benign upstream price pressures, sub-2% unit labour cost growth, the existence of a margin of spare capacity (however large that may be), lower inflation expectations and the trend towards lower inflation among the UK's competitor countries. A more sizable or persistent undershoot of the target (we see inflation temporarily falling to 1.5% by end-2015 before heading back up to 2% the following year) could provide room for the MPC to be even more cautious in the tightening phase.

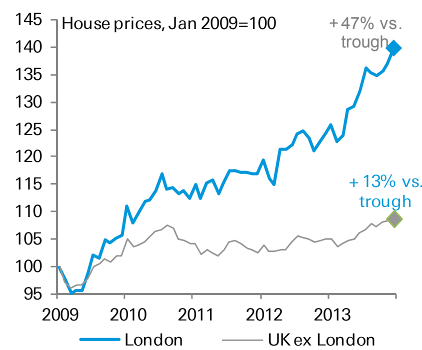
A final issue we would like to touch on here relates to the housing market. Regional prices have generally remained below their pre-recession peaks, and while these markets have remained relatively subdued low rates, rising employment and Help to Buy should support activity and prices going forward. National affordability measures are in line with their very long-run averages, which may not be as comforting as it appears given that interest rates are at exceptionally low levels - even small moves higher in Bank Rate could mean a rapid deterioration in affordability.

Figure 16: DB slightly later than market for first hike



Source: Deutsche Bank Research

Figure 17: London housing boom - risks in both directions



Source: Deutsche Bank Research

Figure 18: Macro-economic activity & inflation forecasts: UK

Economic activity	2013				2014				2013	2014F	2015F
(% qoq, saar)	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	1.6	3.0	3.4	2.9	3.3	2.8	2.3	2.0	1.8	2.9	2.2
Private consumption	4.8	-0.8	4.6	0.5	1.2	1.6	1.6	1.6	2.3	1.5	1.9
Investment	2.1	16.4	6.9	10.0	8.2	9.1	10.4	10.0	-0.5	9.4	8.3
Gov't consumption	-3.0	7.4	2.3	1.3	0.8	0.4	0.0	-0.4	0.9	1.2	-0.5
Exports	0.0	13.2	-10.7	1.7	2.0	1.6	1.6	2.0	0.8	0.8	2.4
Imports	-9.2	12.6	3.0	-3.6	0.8	2.8	2.3	2.0	0.4	1.6	2.2
Domestic demand	-0.9	3.1	8.1	1.2	0.4	3.2	2.5	2.0	1.9	2.5	2.1
Contribution (pp): Stocks	-3.8	0.2	3.7	-0.7	-1.7	0.8	0.0	-0.4	0.3	0.0	-0.2
Net trade	3.2	0.0	-4.5	1.7	0.4	-0.4	-0.2	0.0	0.1	-0.3	0.0
Industrial production	2.1	2.5	2.1	2.1	3.2	2.4	2.0	2.0	-0.3	2.5	2.0
Unemployment rate, %	7.8	7.8	7.6	7.2	7.0	6.8	6.7	6.6	7.6	6.8	6.5
Prices & wages (% yoy)											
CPI	2.8	2.7	2.7	2.1	1.7	1.8	1.6	1.5	2.6	1.6	1.8
Producer prices	1.6	1.3	1.5	0.9	0.7	0.9	0.9	1.7	1.3	1.0	1.9
Compensation per empl.	0.6	2.2	0.8	1.2	2.4	1.1	2.6	2.9	1.2	2.3	3.0
Productivity	-0.7	1.0	0.7	1.5	1.1	0.9	1.1	1.4	0.6	1.1	1.6

Source: National authorities, Deutsche Bank Research

London housing remains a market unto itself - prices in the capital are up 20% from their previous peak in 2008 (almost 50% from their trough in early 2009) and the market shows little signs of slowing. The boom appears to have been driven by overseas demand, with London seen as a 'safe haven' and sterling still far weaker than it was pre-crisis (making prices affordable to global cash-rich investors). Macro-prudential policies which target domestic lending are unlikely to be useful in tackling such an asset price surge. The biggest risks to the boom unravelling in our view are a) easing global uncertainties (reducing London's safe haven appeal), b) rising sterling, c) a swifter removal of easy global monetary conditions.

Elections for the European Parliament

The elections for the European Parliament (EP) from 22-25 of May will result in an unprecedented share for parties with a decidedly EU-critical agenda. The largest anti-EU parties include the French Front National, the Dutch PVV, and the UK Independence Party. However, the parties commonly referred to as “euro-sceptic” are very heterogeneous. In addition to populists from the political right (Front National and PVV), there are also neo-fascists from Hungary and Greece, the German anti-Euro party AfD, and far-left-wing groups such as Syriza from Greece.

Even though a combined share for euro-sceptics of around 20% is not unrealistic, the direct consequences will be limited. Ideological differences will prevent many of these parties from seeking a close cooperation. In addition, the large pro-European factions - the European People’s Party (EPP), the Party of European Socialists (PES), the Alliance of Liberals and Democrats for Europe (ALDE), and the European Green Party - will retain a comfortable majority. Finally, the EP is influential only in certain policy areas. Fundamental decisions related to the euro crisis management will continue to be negotiated by the member states in the European Council and the Eurogroup.

After the EP election, a new EU Commission will be appointed. The best chances for the position as President of the Commission have Martin Schulz, the candidate of the PES, and Jean Claude Juncker who is running under the EPP. In recent polls, both groups are estimated to garner between 26-30% of the vote. While it seems likely that the candidate of the largest parliamentary group will be chosen to lead the new Commission, it is also possible that a compromise candidate will emerge from the EU Council consultations who can concurrently ensure the full backing of the EP.

Also the successors of Herman Van Rompuy as President of the European Council and of Catherine Ashton as High Representative for Foreign Affairs will

Figure 19: Other indicators & financial forecasts: UK

	2012	2013F	2014F	2015F
M4 growth, %	-3.8	1.1	2.0	5.0
Fiscal balance, % of GDP, FY	-5.1	-5.8	-4.7	-3.8
Trade balance, GBP bn	-108.7	-107.8	-109.3	-112.9
Trade balance, % of GDP	-6.9	-6.7	-6.4	-6.3
Current account, GBP bn	-58.5	-58.2	-45.6	-46.4
Current account, % of GDP	-3.7	-3.6	-2.7	-2.6
Financial forecasts	Current	Q2-2014	Q3-2014	Q1-2015
Official	0.50	0.50	0.50	0.50
3M rate	0.52	0.52	0.52	0.52
10Y yield	2.68	2.90	3.00	3.30
USD per GBP	1.66	1.61	1.59	1.52
GBP per EUR	0.83	0.82	0.81	0.80

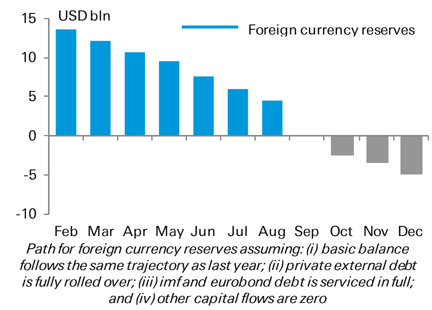
Source: Deutsche Bank Research, as of March 28 be chosen. In addition, the Eurogroup may get a full-time president when the term of the Dutch Finance minister Dijsselbloem expires in mid-2015. This idea, initially agreed to by France and Germany, was also subsequently endorsed by the Italian government.

Russia and the Ukraine crisis

The crisis in Ukraine has escalated dramatically in the last few weeks and is far from being resolved. The territorial integrity of the country is in question following the disputed incorporation of Crimea into the Russian Federation. The EU and United States have implemented sanctions in the form of visa restrictions and asset freezes targeted at individuals and, in the case of US sanctions, one Russian bank. Both the EU and US have indicated that they are prepared to implement more significant economic sanctions if the crisis is not satisfactorily resolved, most likely financial sanctions targeted at specific companies and institutions. Russia has responded by imposing visa bans on a number of US officials and legislators.

There is of course an economic element to this crisis, not least for Ukraine and Russia, but also in terms of the broader implications for other markets. Ukraine itself had been heading down unsustainable path for a number of years, maintaining a fixed and overvalued exchange rate and running up large external and fiscal imbalances. It was already facing an economic crisis, which recent events have only exacerbated. With very limited reserves and substantial external debt service obligations, it urgently needs external financial assistance. The EU and US have already indicated their willingness to provide significant financial support, which will most likely be disbursed alongside an IMF program.

Figure 20: Ukraine reserves



Source: Deutsche Bank Research

Though difficult, the economic situation in Ukraine is not unmanageable. Public debt could easily increase from 40% to over 60% of GDP due to further currency weakness, recession, fiscal imbalances, and borrowing for balance of payments needs. Unlike the situation in Greece prior to its debt restructuring, however, Ukraine's debt is not at levels that begin to stress sustainability. With a combination of external support and domestic adjustment, we think the economic crisis can be resolved without the need for forced restructuring involving significant notional haircuts for holders of Ukrainian Eurobonds. The latter would make little material difference to the success of a program as most official support would be going towards boosting reserves and financing the fiscal deficit rather than servicing this debt[3].

Leaving aside its importance as a transit route for Russian gas exports to Europe, Ukraine itself is too small to seriously impact other economies directly. Its problems were also well known and are not being viewed by markets as symptomatic of broader systemic weaknesses in EM. Even Russia's economic and financial links with Ukraine are relatively moderate. Ukraine accounts for about 5% of Russian exports, which is roughly 1% of GDP. Russian banks have increased their exposure in Ukraine in recent years as western banks have reduced theirs. The direct exposure of Russian banks (mostly the state-owned ones) is estimated at about USD 30bn, which is about 2% of their total assets. Indirect exposure, e.g. through lending to Russian oligarchs who have extensive business interests in Ukraine, could be somewhat greater. As for western European banks, since the global financial crisis, they have halved their exposure to about USD 25bn.

The economic damage to Russia stems rather from its own involvement in the crisis rather than its direct exposure to Ukraine. Pressure on the rouble

[3] For a deeper discussion of these issues, see our Special Report, "Bailing Out Ukraine".

prompted the central bank to intervene (selling USD23bn in March of its USD 500bn of reserves) and hike rates by 150bps to 7.0% to support the currency. Higher capital outflows, the reduced availability of external finance, weaker confidence, tighter domestic liquidity conditions, and higher inflation will all weigh on economic activity. We have accordingly revised down our forecast for growth in Russia to 0.6% from 2.4%. Given Europe's reliance on Russian energy and other economic ties, aggressive economic sanctions will likely be held in reserve as a last resort. But the fear of such sanctions has already curtailed financing for some corporates and dampened sentiment accordingly.

Unlike Ukraine, Russia is large enough to matter for other markets. It is important principally as an energy provider (mostly to Europe): it is the world's third largest oil producer (after the US and Saudi Arabia) and second largest producer of natural gas. Any disruption to these energy supplies would be damaging for Europe but even more so for Russia itself. Oil and gas revenues account for almost half of Federal government revenues and about two-thirds of exports. While the government balance sheet is relatively strong (foreign reserves are high, public debt is less than 15% of GDP, and the government has about 4% of GDP in accumulated oil savings), the economy is weak and it would be unable to withstand a sustained suspension of these supplies (especially if the state also need to provide support to Russian companies hit by sanctions).

Figure 21: Export exposure to Russia

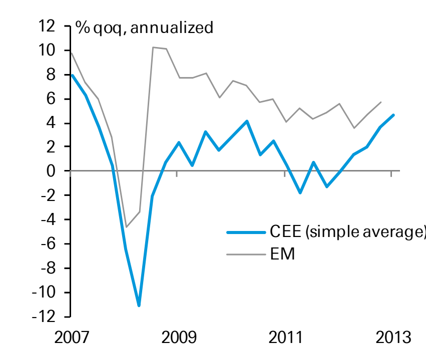
Source: Deutsche Bank Research

Aside from its importance as an energy supplier, however, Russia's economic importance should not be overstated. It is a relatively closed economy (imports account for only 20% of GDP). Beyond its immediate CIS hinterland, it is an important market mainly for the Baltic countries, where exports to Russia account for about 9% of GDP, and to a lesser extent Finland and some countries in central and south-eastern Europe, where exports to Russia account for 2-3% of GDP (chart). Sharply lower growth in Russia is therefore likely to weigh on activity in these countries.

Emerging Europe

Elsewhere in emerging Europe, the news over the past few months has been somewhat more encouraging. In Central Europe, after a protracted period of economic stagnation, confidence is returning and recoveries across the region are gathering pace. The heavy lifting of fiscal austerity is mostly done. The pace of deleveraging in the private sector is easing. Inflation is low and spare capacity still significant, which should give central banks some breathing space before monetary conditions need to be tightened. External vulnerabilities have been much reduced since the last crisis, leaving the region less exposed than other EMs to Fed tapering. Currency adjustment during the EM sell off has been modest but the region appears to be relatively competitive and well placed to take advantage of strengthening external demand[4].

Figure 22: CEE growth relative to EM



Source: Deutsche Bank Research

Further afield, large external imbalances in South Africa and Turkey have begun to correct and recent monetary policy tightening has also helped to stabilize markets. The near-term growth outlook in both cases, however, remains lackluster despite strengthening external demand. Both also have important upcoming elections, which could create uncertainty, especially in Turkey where the political atmosphere remains charged.

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[4] See also, "Central Europe: A Good EM Story".

Japan: Steady expansions with temporary halt

- The Japanese economy remains on a 1.5-2.0% stable real GDP growth path in 2014-2015, with transitory disturbances by two VAT hikes.
- The VAT hike-led dislocation of demand could be large enough to surprise the financial market (real GDP growth [saar] at 2.4% in Q1 2014 and -7.0% in Q2) but we believe it subsides quickly.
- The effects of aggressive monetary easing should gradually spread to both consumption and capital investment.

Heading for new (and better) steady state

We maintain our view that the economy is heading for a new steady state over the next 3-5 years: 2% nominal GDP growth, 1% CPI inflation, 1% 10-year JGB yield and 5% M2 growth. A higher nominal GDP growth than long-term rates alleviates the government debt dynamics and induces a virtuous circle between economic activity and asset prices.

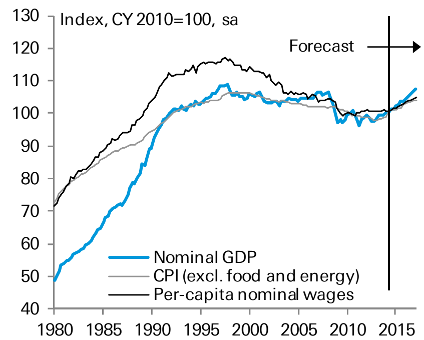
Virtuous circle to unfold in domestic activity

Improvement of economic activity in 2013 including the determinants of wages (corporate profitability, output gap, inflation) is sufficient to deliver 2% growth of nominal aggregate wages for 2014 onward. This should allow the economy to harvest the second-stage effect of monetary easing i.e. consumption growth led by the recovery in wages and employment. Recovery in capital investment, the third-stage effect of monetary easing, has already started but remains anemic, mainly led by non-manufacturers and small companies. This situation could improve in late 2014 when the VAT hike shock proves transitory and the businesses gain more confidence into the Japanese economy, including manufacturers and large companies, with some pick-up in investment growth.

CPI inflation to peak in H1 2014

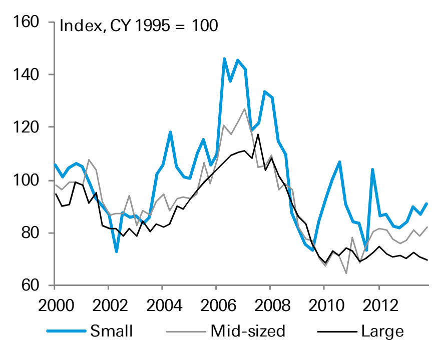
CPI inflation, excluding fresh food and consumption tax effects, is likely to peak at 1.4% yoy in H1 2014 and stay at around 1.0% thereafter, due to smaller contributions from JPY depreciation and narrowing output gap on inflation in 2014 and 2015 than in 2013. Missing a 2% inflation target, however, is not necessarily a setback for monetary policy, as economic expansion and normalization of economic activity continues.

Figure 1: Nominal GDP and prices set to recover



Note: Data for Q1 2014 onward are DB forecast. CPI includes effects of consumption tax.
Source: Cabinet Office, MIC, Deutsche Bank Research.

Figure 2: Capital investment by size of companies



Notes: Small (paid-in capital of JPY10-100 mn), mid-sized (JPY100mn-1bn), large (JPY1bn or above)
Source: MoF, Deutsche Bank Research

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

Economic activity	2013				2014				2013	2014F	2015F
(% qoq, saar)	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	4.5	4.1	0.9	0.7	2.4	-7.0	4.7	1.3	1.5	0.4	1.4
Private consumption	4.2	2.6	0.8	1.6	6.1	-15.1	5.7	1.2	1.9	-0.2	0.3
Investment	0.9	9.0	8.4	6.2	-2.3	-6.0	-1.8	-0.4	2.4	0.7	-0.5
Gov't consumption	2.6	3.5	1.0	1.9	1.0	1.6	1.6	1.2	2.2	1.5	1.3
Exports	17.8	12.2	-2.7	1.7	10.7	4.7	9.0	9.2	1.6	5.9	9.2
Imports	4.5	7.2	10.1	14.7	10.8	-9.1	4.3	4.9	3.3	5.9	3.9
Contribution (pp):											
Private inventory	-0.5	-0.6	0.4	0.1	-1.1	1.1	0.6	-0.4	-0.3	0.0	0.1
Net trade	-0.8	1.9	0.9	-1.8	-1.7	0.1	2.2	0.8	-0.2	0.1	0.9
Industrial production	-6.5	-3.0	1.9	5.8	8.9	5.7	4.7	3.8	-0.6	5.7	3.4
Unemployment rate, %	4.2	4.0	4.0	3.9	3.8	3.8	3.8	3.7	4.0	3.8	3.6
Prices & wages (% yoy)											
CPI	-0.6	-0.3	0.9	1.4	1.7	3.8	3.4	3.1	0.4	3.0	1.7
Core CPI	-0.4	0.0	0.7	1.1	1.4	3.5	3.2	3.1	-0.2	2.1	1.4
Producer prices	-0.3	0.7	2.2	2.5	2.0	4.6	4.1	4.0	1.3	3.7	2.6
Compensation per empl.	-0.4	0.2	-0.2	0.4	0.5	1.1	1.7	1.6	0.0	1.3	1.6
Productivity	3.2	1.2	2.2	2.0	-0.6	-1.0	-0.9	0.1	2.1	-0.6	1.0

Source: National authorities, Deutsche Bank Research

Additional monetary easing in Q4 2014

The likelihood of an imminent monetary easing (say, in Q2) is dissipating. We forecast the next easing action in Q4, which could include not only a commitment to expand the monetary base (albeit at a slower pace than the current JPY60-70trn a year) throughout 2015 but also a possible alteration of their goal, in the form of a broader band of inflation (2%±1%), a lower band (1.5%±0.5%), an open-ended easing (dropping the two-year deadline), or adopting price 'level' targeting.

Current account surplus to expand again

We expect the trade deficit to peak in Q1 thanks to the restraint on imports from the VAT hike and the fading J-curve effect. The pace of the contraction of the deficit, however, should be slow because of exporters' discount pricing and persistently high mineral fuel imports (6% of GDP). In a medium term, Abenomics should induce a higher private financial surplus (by rapid profit recovery and modest investment recovery) and a lower fiscal deficit (by revenue recovery and fiscal adjustments). We forecast the fiscal balance to improve by around 4% of GDP from 2013 to 2016. From an identity of the saving-investment balance in each sector, this combination leads to an expansion of the current account surplus.

Monetary policy can temporarily substitute for growth strategy

Among the three arrows of Abenomics, aggressive monetary easing is the most important and effective, leaving the other two (flexible fiscal policy and growth strategy) almost irrelevant in the short run. We believe that monetary easing can temporarily substitute for a growth strategy by stimulating aggregate demand, which in turn induces demand for capital and labor, reinforcing the supply side of the economy and leading to higher potential growth. A large part of the growth strategy will ultimately come from microeconomic deregulation measures, which take a long time to be implemented and their macroeconomic effects are hard to verify.

Risks to economic forecast

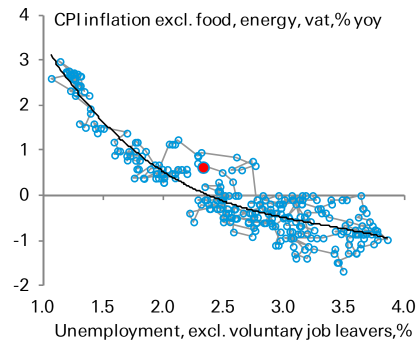
1) A protracted negative payback after the VAT hike; 2) lax fiscal policy; 3) no further JPY depreciation; 4) slower global growth.

Figure 4: Other indicators & financial forecasts

	2012	2013F	2014F	2015F
M2 growth, %	2.5	3.6	4.6	5.0
Fiscal balance, % of GDP	-9.1	-9.2	-7.2	-5.6
Public debt, % of GDP	210.4	212.8	215.4	214.7
Trade balance, USD bn	-49.5	-89.1	-82.3	-42.9
Trade balance, % of GDP	-0.8	-1.8	-1.8	-0.9
Current account, USD bn	62.9	34.7	35.2	81.2
Current account, % of GDP	1.1	0.7	0.8	1.8
Financial forecasts	Current	Q2-2014	Q3-2014	Q1-2015
Official	0.10	0.10	0.10	0.10
3M rate	0.21	0.20	0.20	0.20
10Y yield	0.63	0.60	0.70	0.80
JPY per USD	102.2	109.0	112.0	117.0
JPY per EUR	140.4	143.9	143.9	141.6

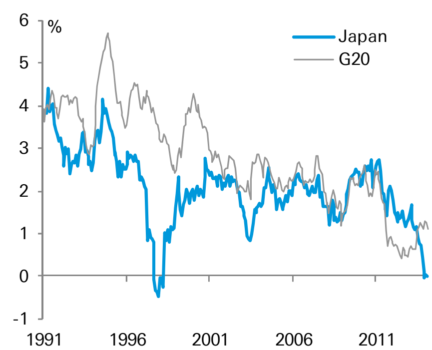
Source: Deutsche Bank Research, as of March 280

Figure 5 : Phillips curve in Japan



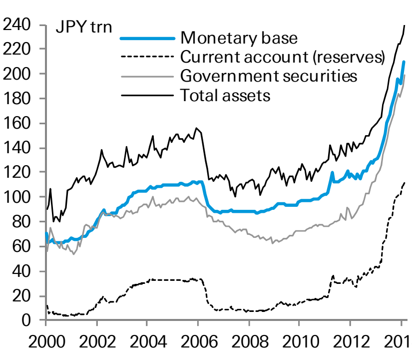
Note: A large filled marker represents January 2014.
Source: MIC, Deutsche Bank Research

Figure 6 : Declining real long-term rate in Japan



Note: CPI inflation excluding energy and fresh food. Global real interest rate is the weighted average using PPP-based GDP in 2010. Real interest rate = 10-year government bond yield - core CPI inflation.
Source: Haver Analytics, Datastream, Deutsche Bank Research

Figure 7 : BoJ's balance sheet



Source: BoJ, Deutsche Bank Research

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Asia (ex Japan): China concerns are heightened; exports upside right around the corner

- The first quarter of 2014 has offered mixed signals for Asia. Between Lunar New Year-induced drag to regional activities, pollution-related factory shutdowns in China, and adverse weather causing a dip in consumer demand in the US, data flow thus far suggests pockets of weakness in the region, particularly in the economies dependent heavily on exports.
- Since latest US data suggests that the economy is making up for lost activity during the winter storms and EU data is mostly constructive, we remain confident that Asia's exports are soon to rebound, which would likely offset the negatives to growth in the early part of the quarter.
- The outlook for 2014 has one dark cloud; which is China. The prevailing negative sentiment in the market will be alleviated only after China puts together a string of positive data surprises, an outcome that could be a few months away, in our view. Latest dataflow has prompted us to revise down the 2014 growth forecast to 7.8%. We have however not changed our view on the upside to exports, which should minimize negative spill-over to the rest of the region (barring commodity exporters)
- India and Indonesia have seen a sharp reversal of sentiment and dataflow so far this year, but we remain more optimistic about the prospect of the former than the latter.

Overview

Recent dataflow from the US suggests that weather had a tangible effect on activities in late-2013 and early-2014, but the drag could well be short-lived and a sizeable payback may be around the corner. Wage data suggests personal income continues to post healthy gains, which ought to support consumption once the weather-related negatives disappear from the data. The dataflow from the Euro area is also looking promising. We are particularly encouraged by the improvement in the EC economic sentiment index and retail sales, which point to some upside risk to the area's Q1 GDP outlook.

Figure 1: Deutsche Bank forecasts: Emerging Asia

(% yoy, unless stated)	2012	2013F	2014F	2015F
Real GDP growth	6.1	5.9	6.4	6.7
- Private consumption	6.8	5.5	6.1	6.6
- Investment	5.7	6.0	6.0	6.8
- Government consumption	7.0	6.0	5.3	5.4
- Exports	3.7	5.8	10.2	11.2
- Imports	5.1	5.6	8.5	10.4
Industrial production	5.9	5.9	7.5	7.3
CPI	4.3	4.1	3.4	4.0
CA balance, % of GDP	1.3	1.6	1.7	1.4
Asia ex. China and India				
Real GDP growth	4.1	4.0	4.5	4.7
CPI	3.3	2.6	3.4	3.8

Source: National authorities, Deutsche Bank Research

These are important developments for our Asia view, which continues to hinge on a strong pick-up in external demand this year. Between weather-related issues in the US and Lunar New Year related drag here in Asia, the dataflow so far has not been particularly promising, but a positive payback looks likely. Recent reversal in the long-dollar and short-treasury positions, even if likely to be short-lived, has supported Asia's emerging economies as the much feared EM to DM flow has tapered for the time being. While we are sure that US rates risk will impact Asia's financial markets again as data improves, the silver lining is that this will only take place when the outlook for external demand improves further.

Besides mixed readings from US data, sentiments have not been helped by the unrest in Ukraine/Crimea, political uncertainty in Thailand and Turkey, and financial sector stress in Argentina. Looming bigger than these negative developments, however, has been the dark cloud of uncertainty over China. Lack of clarity about the direction of liquidity, policy induced volatility in the FX market, manifestation of event risk in the shadow banking system and credit markets, poor PMI readings, and worse-than-expected exports data have combined to create heightened concerns, most acutely reflected in the price of equities and some commodities.

Regionally, with the exception of Thailand, domestic sentiments have been ranging from neutral to positive, with sharp rebound in India and Indonesia in expectations of market friendly election outcomes later this year. Overall, inflation in the region is tame, liquidity still ample, and exchange rates have been stable lately. If trade data from February/March onward begin to improve across the board, Asia will find its footing again, in our view. There is a lot of negative news on EM these days; for Asia's exports oriented economies, a much-needed boost could however be just around the corner.

Country focus

- Concern about China has risen, understandable given its large economic footprint and long-standing track record of stability. Indeed, Q1 growth could surprise to the downside given the prevailing weakness in manufacturing activity (due partly to suspension of production at coal-burning factories). Taking into account the developments so far this year, we are revising down our 2014 GDP forecast to 7.8%. We see relatively stable consumption growth and improving exports ahead but investment weakness will likely persist. Proceedings from the recent National People's Congress indicates that fiscal policy may be slightly more expansionary in 2H14 than we had expected, while monetary policy will likely remain largely unchanged. On reforms, healthcare, internet and the environment will likely receive strong government support. SOE reforms and deregulation will likely advance aggressively in the year ahead.
- India is enjoying a bout of stability and positive dataflow that seemed dear just a few months ago. Balance of payments pressures have dissipated, rupee has been rallying on the back of a near-surge in portfolio flows, and inflation has been easing steadily. Markets are also rallying in expectations of a reform-friendly mandate in the April/May Parliamentary elections. We remain of the view that regardless of the nature of the coalition that leads India from this summer onward, the reforms put in motion in recent years will continue, especially in the areas of fuel price adjustment, FDI liberalization, project clearance, and disinvestment.
- Indonesia has also experienced respite from FX market pressure and inflation lately, although we see that relief as temporary, with overheating a lingering concern and resurgence in imports likely to materialize soon. Markets are encouraged by the prospect of Joko Widodo becoming the next President, but little is known about his views on economic reforms.
- South Korea seems to be undergoing a soft patch lately, but like China, we see a revival around the corner, led by exports. We are encouraged by the recently announced three-year economic innovation plan, which envisages a series of regulatory reform and restructuring measures aimed at promoting investment and boosting potential GDP growth.
- Thailand has seen its growth momentum slow, but not come to a halt, in recent quarters. We have cause for cautious optimism as the political situation may be heading toward some sort of resolution, with a tourism and exports-driven recovery also in the making.
- Malaysia and the Philippines appear to be on a strong footing, with buoyant domestic demand and exports gathering pace. We however have reasons to believe that the Philippine's current account surplus may be overstated due to widespread under-invoicing of imports, which may explain the peso's seemingly surprising weakness since last year.
- Singapore just passed its budget, once again devoting considerable resources to address its medium-term challenges: productivity, social welfare, and relief from rising cost of living. As signs of partner country demand revival gather, the economy seems poised to have one more year of 3%+ growth.

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Figure 2: Deutsche Bank forecasts

(% yoy, unless stated)		2013F	2014F	2015F
China	GDP	7.7	7.8	8.0
	CPI	2.6	2.2	3.0
	CA bal., % GDP	2.0	2.2	2.3
	Fiscal bal., % GDP	-2.0	-2.0	-1.5
Hongkong	GDP	2.9	4.2	4.5
	CPI	4.3	3.5	3.2
	CA bal., % GDP	-0.9	3.7	2.8
	Fiscal bal., % GDP	0.6	2.6	3.4
India	GDP	3.9	5.5	6.0
	CPI	10.1	6.4	6.7
	CA bal., % GDP	-2.6	-2.5	-3.0
	Fiscal bal., % GDP	-4.6	-4.5	-4.2
Indonesia	GDP	5.8	5.2	5.5
	CPI	4.0	6.4	6.4
	CA bal., % GDP	-3.3	-3.0	-2.7
	Fiscal bal., % GDP	-2.2	-2.4	-2.6
Malaysia	GDP	4.7	5.5	5.6
	CPI	2.1	3.1	2.9
	CA bal., % GDP	3.8	4.3	5.5
	Fiscal bal., % GDP	-3.9	-3.8	-3.4
Philippines	GDP	7.2	6.8	6.8
	CPI	2.9	4.3	3.8
	CA bal., % GDP	5.4	4.8	3.4
	Fiscal bal., % GDP	-1.4	-2.4	-2.2
Singapore	GDP	4.1	3.5	4.5
	CPI	2.4	2.5	3.5
	CA bal., % GDP	14.7	15.5	14.5
	Fiscal bal., % GDP	7.3	6.9	6.8
Korea	GDP	2.8	3.9	3.6
	CPI	1.3	1.9	2.8
	CA bal., % GDP	5.9	4.1	2.8
	Fiscal bal., % GDP	-0.7	-0.1	0.1
Sri Lanka	GDP	7.3	7.5	7.5
	CPI	6.9	5.5	7.1
	CA bal., % GDP	-2.1	-1.9	-2.0
	Fiscal bal., % GDP	-5.8	-5.5	-5.0
Taiwan	GDP	2.2	3.7	3.4
	CPI	0.8	0.9	1.2
	CA bal., % GDP	11.2	10.2	9.1
	Fiscal bal. % GDP	-2.3	-1.5	-0.8
Thailand	GDP	2.9	3.5	4.5
	CPI	2.2	2.9	2.3
	CA bal., % GDP	0.1	1.0	0.3
	Fiscal bal., % GDP	-3.0	-3.2	-3.3
Vietnam	GDP	5.4	5.8	6.3
	CPI	6.6	7.0	9.8
	CA bal., % GDP	3.2	2.0	-3.1
	Fiscal bal. % GDP	-6.0	-6.2	-5.5

Source: National authorities, Deutsche Bank Research

Latin America: Uneven and challenging outlook

- Latin America's challenging macro environment has been further complicated but lackluster Chinese growth and its effect on commodity prices. Indeed, after a tough adjustment to this new reality in 2013, regional GDP growth is now expected to be even lower in 2014, at 2.1% down from 2.6% forecasted in December. Despite this dull outlook, we continue to believe Latin America is unlikely to witness any major economic setback, let alone financing stress as the level of external debt remains too low to create problems.
- Absent positive external shocks, performance will continue relay on the quality of policies during the boom years and/or the proper reaction to new conditions. As expected, economies driven by consumption in the last few years are facing the greatest growth challenges, but some positive recent policy responses in Brazil, Argentina, and Venezuela might help moderate these countries´ vulnerabilities at the cost of a worse short term performance. Others, like Colombia, and Peru, that balanced domestic demand growth while maintaining macro prudence are actually performing better than initially expected. Chile is the outlier in this "solid" group, as a demanding new government agenda is negatively affecting investment.
- As noted, the current global backdrop imposes a premium on reforms and recent efforts on the structural front in Mexico are noteworthy, making it the promising regional story. Growth so far has been elusive for Mexico, too, but its economy is expected to start benefiting from its strong manufacturing links with the US. We could also see brighter days in Argentina if elections in late-2015 lead to a change of policies as we expect.

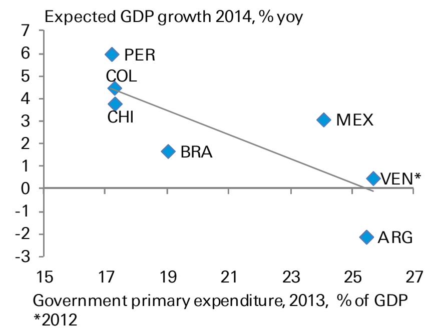
Elusive growth fostering more reactive policies

This year expected headwinds for Latin American, including the end of the super commodity cycle, increasing financing costs, and the beginning of a strong dollar cycle, have been exacerbated by lackluster economic growth in China. Such an external backdrop together with the quality of past policies would be the most critical factor shaping economic performance ahead. This basically implies further differentiation among regional markets.

Economic performance so far this year has been worse than expected. On average, we expect regional growth to be 2.1% in 2014, down from 2.6% forecasted in our last quarterly, or even lower than the poor 2.3% recorded in 2013. Economic growth expectations for 2015 have also been revised downwards from 3.1% to 2.9%. Part of this is related to the need of some countries to tighten economic policies in response to a more unfavorable external environment, as has been the case in Argentina, Brazil, and Venezuela to some extent. Part of the on-going adjustments regarding domestic absorption and the exchange rates are expected to help maintain stability in the external accounts, with an average current account deficit remaining in the order of 2.4% of GDP, still mostly financed by foreign direct investment flows.

As expected, the external headwinds for the region have been exacerbated by still high exchange rates and production costs, significantly eroding competitiveness. This new impediment for growth is most severe in countries that failed to promote sizeable investment growth, relying instead on consumption booms. The chart on this page shows the relationship between expected growth and the size of public sector primary spending. In Latin America, those countries pursuing consumption led growth utilized the public sector as their main policy device. Essentially, external constrains have become more of a problem for consumption led growth cases, forcing a bigger adjustment than in other countries.

Figure 1: Growth and the size of the public sector



Source: Haver Analytics, Deutsche Bank Research

Figure 2: Deutsche Bank forecasts: Latin America

(% yoy, unless stated)	2012	2013F	2014F	2015F
Real GDP growth	2.8	2.3	2.1	2.9
- Private consumption	4.4	3.5	2.6	3.3
- Investment	1.9	3.4	2.2	4.3
- Exports, USD bn	977.0	992.2	1028.8	1072.9
- Imports, USD bn	890.6	937.2	961.5	1012.0
Inflation	8.1	8.9	12.4	11.3
Industrial production	0.6	1.3	1.9	2.9
Unemployment, %	6.2	6.0	6.1	6.1
Fiscal balance, % of GDP	-3.2	-3.5	-4.0	-3.8
CA balance, % of GDP	-1.6	-2.5	-2.4	-2.3

Source: National authorities, Deutsche Bank Research

The necessity of Argentina to devalue its exchange rate in January and the implied negative income effect, exacerbated by the lack of complementary measures to contain inflation expectation, has pushed the economy into recession this year, something not fully anticipated in our December outlook. This however has probably helped avert a more stressful situation down the road. But a more permanent change in policies and the outlook might need to wait until the October 2015 general elections. With vast relatively unexploited natural resources and an economy that is basically unleveraged, there are reasons to be optimistic about the medium-term.

In Brazil, a persistent inflation problem, partly fueled by a too long consumption-led growth, also warranted tighter monetary policy than initially anticipated and a contingent adjustment in the fiscal stance, to achieve sustainable low inflation but which is impairing performance in the short term. Low investment, among the lowest in EM at less than 20% of GDP, is Brazil´s constraint to faster non-inflationary growth. The presidential election in October 2014 provides an opportunity for a major political change but despite poor economic performance the administration remains relatively popular and is likely to renew its mandate for another 4 years.

Similarly economic difficulties in Venezuela have been amplified in the last quarter. After years of increased state intervention in the economy financed by high oil prices and debt, the country now finds itself saddled with excessive regulation, inefficient state companies, and a rigid exchange rate regime. But this has resulted in increasing rationing of basic goods and growing social demands for a change. The government´s reaction has been to search for a new exchange rate regime that promises a more efficient distribution of hard currency resources and an important improvement in the fiscal situation. But President Maduro not only still needs to deliver such a change, but is also facing growing social discontent, which might create a new source of instability.

The increasing need for reforms

As discussed, with the region facing a less favorable external backdrop, there will be a premium on reforms. In this regards, recent efforts on the structural front in Mexico are noteworthy. A new administration has already delivered labor market, financial, fiscal, and energy reforms. The new regime for the energy sector could be fundamental for a significant increase in private investment in Mexico's abundant natural resources, long been banned by the country´s constitution. Together with a pick-up in US activity this should support stronger growth in Mexico.

Although reform achievements were not uniform in the region, there is basically no major country where past external vulnerabilities have not been addressed. As a result, the region remains relatively unleveraged with respect to external financing sources. Indeed, external debt services in terms of available international reserves are at their all-time lows. With around1.5% they are also relatively low relative to GDP (2012). In addition, FDI remains the most important source of external financing. Although, we do expect the foreign investment appetite to decrease, this should simply be reflected in a slower pace of investment and growth rather than in the balance of payments or financial stress. As noted, Latin America will face the prospects of tightening global financial conditions without fearing the typical balance of payment crisis of the past. However the next few years might represent a growth challenge for some of the largest countries in the region.

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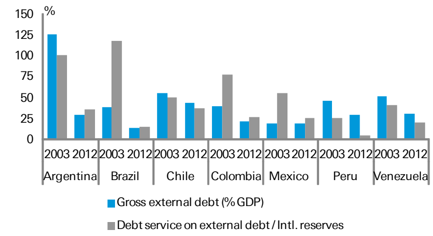
Figure 3: Lower external vulnerabilities



Source: National authorities, Deutsche Bank Research

Figure 4: Deutsche Bank forecasts:

(% yoy, unless stated)		2012	2013F	2014F	2015F
Argentina	GDP	1.2	2.4	-2.1	1.9
	CPI	24.0	24.9	39.8	29.4
	CA bal., % GDP	0.0	-1.1	0.1	0.4
Brazil	GDP	1.0	2.3	1.7	1.7
	CPI	5.8	5.9	6.0	5.5
	CA bal., % GDP	-2.4	-3.6	-3.5	-3.5
Chile	GDP	5.6	4.1	3.8	4.1
	CPI	3.0	1.9	3.5	3.0
	CA bal., % GDP	-3.5	-3.2	-3.7	-3.3
Colombia	GDP	4.2	4.3	4.5	4.3
	CPI	3.2	2.0	2.7	3.3
	CA bal., % GDP	-3.2	-2.6	-2.8	-3.0
Mexico	GDP	3.8	1.1	3.1	3.7
	CPI	4.1	3.8	4.0	3.8
	CA bal., % GDP	-1.2	-1.8	-2.1	-2.2
Peru	GDP	6.3	5.2	6.0	6.5
	CPI	3.7	2.5	2.7	2.9
	CA bal., % GDP	-3.1	-5.0	-4.8	-4.5
Venezuela	GDP	5.6	1.5	0.5	3.5
	CPI	23.8	40.0	65.0	70.0
	CA bal., % GDP	3.7	1.6	1.8	2.6

Source: National authorities, Deutsche Bank Research

Global Asset Allocation: After the rebound

- We highlight 4 themes going into Q2: negative US data surprises, in our view the core driver of the cross asset pull back in Q1, turning positive; an inflation reset likely sooner rather than later; short rates vulnerable; a catch back up of disparate pricing across asset classes to the rebound in data.
- Asset allocation. So far the rebound in equities and credit is in line with the turn up in the data, while rates lagged and the dollar is furthest behind. We are overweight equities where we expect the recent breakout to sustain on improving macro data, clean positioning, high short interest and a low hurdle for Q1 earnings. Underweight rates, where a reset of the inflation trajectory as idiosyncratic factors unwind and consequent re-pricing of Fed expectations should see short rates and rates vol. go higher. Neutral credit, underweight low spread product, HY over HG. We see the ongoing EM multi-year de-rating closer to being done but not quite there yet, though short positioning is tactically supportive. The Fed's reaffirmation of rates normalization should see the dollar continue to bounce from near the bottom of its multi-year uptrend channel.
- Trades. Cheap upside in equities as vol. remains low; risk reversals as the market remains focused on the downside; playing the data upside through rate sensitivities (long basket DBUSRTUP short DBUSRTDN); Eurodollar June 17 the sweet spot for playing a repricing of Fed expectations; long 5y vs 2y breakeven inflation rates; long US banks/short gold.

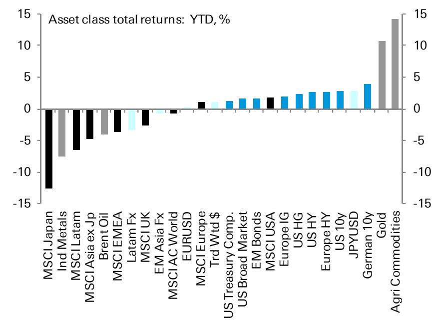
We highlight 4 themes going into Q2:

US data surprises, in our view the core driver of the cross asset pull back in Q1, turning positive. The move down in the S&P 500 and the US 10y was closely correlated with that in our US macro data surprise index, which in our view reflected the unusually cold weather (The 2014 Growth Pang, February 25 2014). Attention also focused on EM, but performance did not deviate notably from the multi-year underperformance trend. As big negative surprises moved out of the index, consensus expectations fell gradually and some data has begun to snap back, our data surprise index has moved sharply back into positive territory. A typical data surprise cycle suggests 6-8 weeks of positive surprises. Presently, consensus expectations are being revised up only very modestly, keeping the hurdle rate low for positive data surprises.

Inflation reset likely sooner rather than later. The underlying drivers continue to point to a turn up in core inflation in the US and in Europe. The medium term drivers of services inflation (75% of core) in the US and core inflation in Europe are unemployment and in Europe also the change in unemployment. In both the US and Europe, core inflation has been running below levels implied by the medium term drivers. In the US the overall disconnect due to idiosyncratic factors at 50 bps is at past extremes, levels from which it has tended to revert and holds the potential for a significant inflection up in core inflation. With a typical reversion of idiosyncratic factors unwinding taking 12 months, a partial unwind could lift core inflation above 2% by year end.

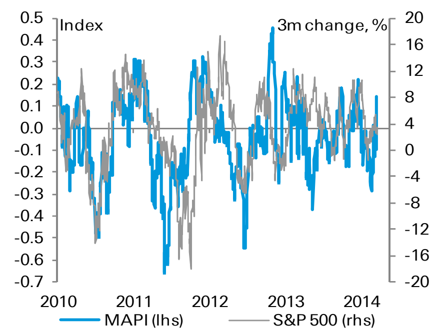
Short rates vulnerable. Last week's FOMC saw modestly more hawkish forward rates guidance. But by any standard, guidance remains very late and slow, predicated on an implicit strong view that inflation will rise only very gradually back up to 2%, by end-2016. Historically, when unemployment has fallen to the natural rate, the Fed was done with most if not all of its hiking cycle. On the trend of the last 4 years, unemployment should fall to the natural rate by March 2016, with recent observations suggesting some risk of getting there earlier. The Fed's guidance for this point in the cycle is for policy rates of only 1.25% versus their estimate of a neutral policy rate of 4%. With market

Figure 1: Cross asset returns in 2014



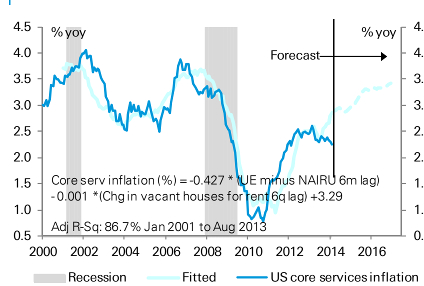
Source: Haver Analytics , Bloomberg Finance LP, Factset, Deutsche Bank Research

Figure 2: US data surprises turn up



Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 3: Inflation reset sooner in US



Source: BLS, Haver Analytics , Deutsche Bank pricing around the Fed's guidance, a reset of expectations for the inflation trajectory leaves the shorter end of the rates curve vulnerable to a significant re-pricing. In Europe, with the recovery projected to be slow and unemployment to fall very gradually, the pickup in core inflation will continue to reduce the probability of the ECB doing QE but should not see a significant re-pricing (Although the increase in core inflation implied by the model is above the forecast of our European economists).

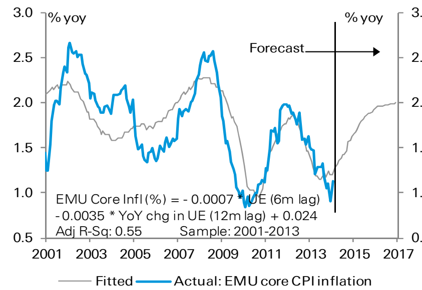
Convergence of disparate pricing across asset classes to the rebound in data. The rebound in equities and credit is in line with the turn up in the data, while rates lagged and the dollar is furthest behind. The rebound in equities, though before the sharp bounce in data surprises, has been in line with it (Equities Rally Amid Position Unwinds, February 17 2014). Both HG and HY credit spreads tightened in sync with equities since the early February bottom. Since mid-2012, the S&P 500 and the US 10y have traded together, with deviations from time to time closing by the 10y moving back into line with levels suggested by equities. Indeed the initial sell down in the S&P 500 and the 10y yield were in line with each other. Since the bottom though, rates have moved up by much less, with the S&P 500 and our data surprise index pointing to the 10y at a little over 3% versus current levels of 2.74%. Finally, the US dollar began to weaken as data surprises turned negative in late January and did not bounce notably until last week's FOMC.

Asset allocation views

- Equities breakout to sustain with US data and demand-supply supportive; overweight US (dependable growth) and Japan (leveraged upside). Assuming a typical macro data and surprise cycle, our top-down model of the S&P 500 points to mid-single digit upside (S&P 1950) early in Q2. Our demand-supply framework points to slightly higher levels assuming short covering ($45b), net buybacks ($100b) and continuing inflows ($35b).[5] We stay overweight US equities given solid growth and the highest total yield. We stay overweight Japan which is now trading at the lowest relative P/E in over ten years on tax hike concerns but should notably outperform if the Yen weakens on higher US rates and global growth picks up.
- Rates re-pricing of inflation trajectory and Fed expectations to take rates and vol higher. The selloff in the 5y yield on the FOMC brought short-rate pricing in line with Fed guidance. Rates beyond the 5y were essentially unchanged as the 5y5y has hugged the 4% terminal rate guidance since January. So there is basically a zero risk premium on Fed guidance in the bond market, while positive data surprises raise the risk that the inflation reset happens sooner, forcing rate hike expectations earlier and steeper. We expect bond volatility to rise with inflation as it has historically, which would in turn likely raise the bond risk premium above that of expected short rates.
- Reduce credit exposure in low spread product, stay overweight HY. Credit spreads have historically tracked bond volatility, grinding tighter when low vol encourages carry trades. Spreads are modestly above the level implied by the Move index, providing a cushion. But we see another bout of bond volatility on rising inflation concerns as a risk to high grade spreads where the cushion is low and recent large issuance an overhang. HY spreads remain attractive particularly as growth picks up and issuance is down YTD.

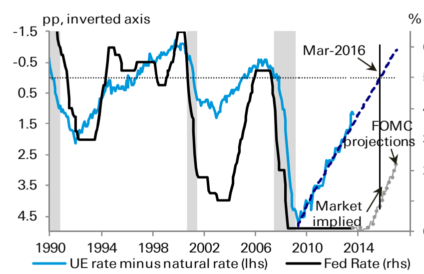
[5] The two model-based projections on the S&P 500 outlook over the near-term differ from the view expressed by US equity strategists, who see e.g. demanding valuations and weak Q1 EPS weighing over the near-term.

Figure 4: Inflation upside in Europe



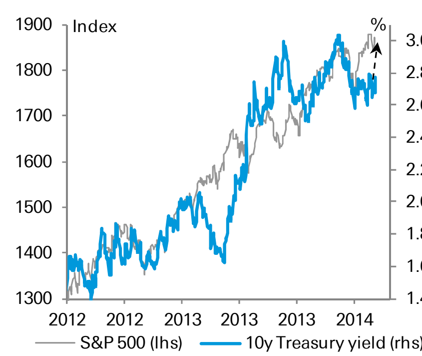
Source: Haver Analytics , Eurostat, Deutsche Bank Research

Figure 5: Short rates vulnerable



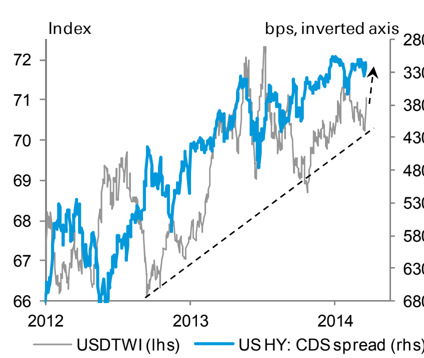
Source: FOMC, BLS, Bloomberg Finance LP, Deutsche Bank Research

Figure 6: S&P up with data, rates lag



Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 7: USD furthest behind



Source: Bloomberg Finance LP, Deutsche Bank Research

- EM derating closer to being done but not there yet; short covering providing support. EM equities have been consistently underperforming since late 2010 as relative multiples have de-rated compared to the US. EM currencies have followed the downtrend with EM bonds underperforming only really in 2013. Despite notable EM risks hitting markets in Q1 (Argentina, Venezuela, Turkey, China, Ukraine), EM underperformance was in-line with the trend; there was no broad-based selloff, suggesting that covering of short positions which were near extremes provided support. The key driver of the EM de-rating is the narrowing of the EM-DM growth differential, which is now at 2.8% and 80bps from the top of its 0-2% historical range (1975 to 2002). EM equity valuations are in line with our fair value estimates with geopolitical risks the likely catalyst for the de-rating overshooting. Recent tightening of rates and credit in many EM countries is likely to slow growth further with a lag. So we stay underweight EM assets and at this late stage of the EM cycle where central banks are tightening we prefer EM currencies over equities and bonds.

- Dollar rebounding from near bottom of multi-year up-channel; increase underweight in precious metals. The USD has been rising in a trend channel since bottoming in 2011 and weakness since late January took the dollar toward the bottom of its band. Improving US data and rising US short rates should take the dollar up toward the middle of the band. Rising US growth, rates and the dollar is worst for gold which has outperformed through each market phase this year making it vulnerable to an unwind.

Trades

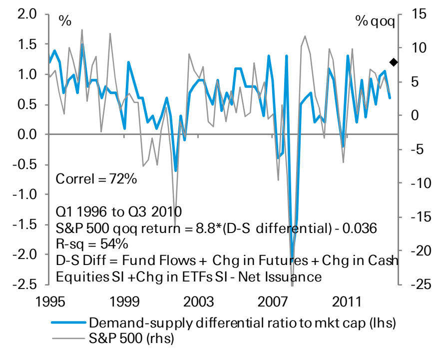
- Cheap upside calls in equities; market focused on downside. With vols low S&P 500 calls are cheap (2m 5% OTM 9.8%, 23rd percentile), providing leverage to near-term upside as investors lack conviction. With the market more focused on the downside and skew still high, we recommend risk reversals as well (2m 5% skew 81st percentile).

- DBUSRTUP over DBUSRTDN to play data upside through rate sensitivities. At the stock level, we go long our DBUSRTUP basket (stocks with highest betas to 10y) and short DBUSRTDN (negative beta to 10y); relative performance of the baskets has closely followed the 10y YTD.

- Eurodollar June 17 sweet spot for playing a re-pricing of Fed expectations. Should inflation pick up, the market is likely to price in earlier and faster rate hikes, back at least to what was priced before the no-taper Sept FOMC. June 2017 Eurodollar futures yield 2.8% currently compared to 3.2% then, the largest reset across the Eurodollar futures curve. June 2017 Eurodollar futures are furthest from normalized levels assuming a typical rate hiking cycle of 2 years (vs. current market pricing near 6 years), and thus the most yield upside if Fed expectations reset on higher inflation.

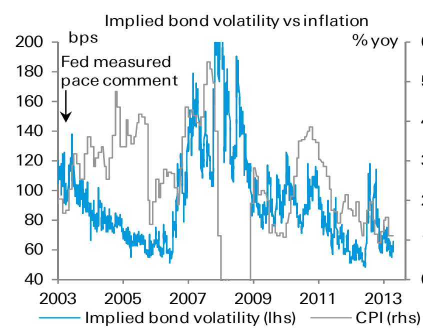
- Long 5y versus 2y breakeven inflation. We had been long 2y breakeven inflation since late last year. We now suggest switching to a long in 5y breakevens with the 2y near our estimate of fair value (2.1%) and core likely to rise more than headline as services inflation resets higher and energy prices moderate. With the 5y breakeven rate only 15 bps higher than the 2y, we see much greater upside on a re-pricing of the core inflation trajectory. For a relative value trade, we recommend being long the 5y breakeven inflation rate and short the 2y, as the spread follows the difference between core and headline which we expect to rise.

Figure 8: S&P demand-supply



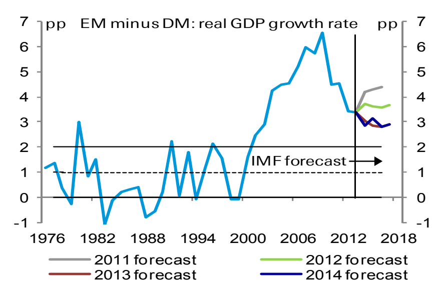
Source: CFTC, NYSE, Haver Analytics, Bloomberg Finance LP, Compustat, Deutsche Bank Research

Figure 9: Bond vol. rises with inflation



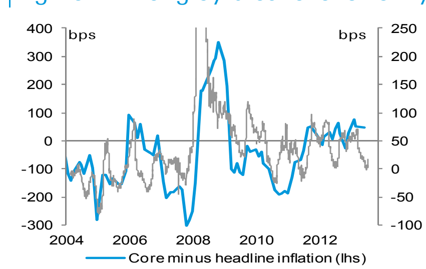
Source: BLS, Bloomberg Finance LP, Haver, Deutsche Bank Research

Figure 10: EM growth de-rating



Source: IMF, Haver Analytics , Deutsche Bank Research

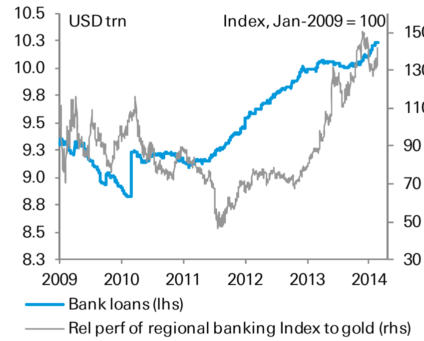
Figure 11: Long 5y breakevens vs. 2y



Source: Bloomberg Finance LP, Deutsche Bank Research

- Long US banks short gold. Gold prices are 24% above our fair value estimate based on the USD, global slack, money supply and central bank buying. We see gold weakening as growth fears and geopolitical fears dissipate. US regional banks (KRE ETF) on the other hand are best placed to benefit from rising US short rates as well as the recent pick up in loan growth. Relative performance historically has indeed tracked the 5y as well as loans. This cross asset trade capitalizes on a number of key multi-year trends: US rate normalization, USD up cycle, commodity underperformance cycle, US housing and durables rebound, rising Financials payouts.

Figure 12: Long banks short gold



Source Deutsche Bank Research

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US Equity Strategy: Constructive longer-term, but cautious near-term

- S&P 500 targets remain 1850 for 2014 year-end and 2000 for 2015 year-end. Our S&P EPS forecasts are unchanged: 2014F USD119 and 2015F USD125.
- We think a 5%+ dip is likely in the near-term on: 1) demanding valuations, 2) weak Q1 EPS, which will place a greater burden on the rest of the year to achieve healthy growth, 3) continued tremors likely in EM economies, 4) volatility in future Fed Funds rate expectations and Treasury bond yields that likely reverberates in currencies, commodities and fair PE estimates. Modest gains should be achieved late this year and better in 2015 as clarity on the longer-term outlook for interest rates and EM improves.
- At 17x trailing EPS (18x ex. mega-caps), the market is priced for sustained high profit margins and healthy EPS growth. The debate is no longer about the recovery's durability or normalized earnings, but rather how much growth will accelerate and how low interest rates can stay. For strong near-term gains, the market must assume margins stay high and interest rates stay low for a long time. We are confident that margins stay high and EPS growth accelerates to a healthy pace, but we are uncertain for how long and to what degree interest rates stay below historical norms. Further PE expansion is justified if rates rise but plateau below historical norms.
- Our sector strategy is to prefer Tech and Financials, especially mega-caps still trading at low PEs. We encourage investors to tilt toward companies with strong dividend growth prospects to stay ahead in a rising rate environment.

Goldilocks global economy required for attractive S&P 12-month upside

Key drivers of S&P performance this year and next are US interest rates and China growth. The outlook for US interest rates will influence the PE and the outlook for China growth will influence EPS. In order for the S&P to reach 2000 in 12-months (16x fwd 2015E EPS) or up 7%, we think the US must accelerate, but not so much that it causes a spike in yields, and China decelerate (EM in general), but not so much that it undermines commodity prices and capex. How these trends interact will remain uncertain at least through summer.

Until there is greater visibility on the timing and pace of Fed Funds rate hikes interest rate volatility across the curve is likely to stay elevated and limit further PE expansion. A significant risk is that the US accelerates more than the consensus view, leaving little labor slack, causing a more rapid ascent in yields that strengthens the dollar and weighs on commodity prices. This scenario coupled with EM economies struggling to maintain good growth is a threat.

Uncertainty around the pace at which China slows and to what secular growth rate it settles into is the main investor debate on growth. China is 1/6th of World GDP but is expected to generate 1/3rd of World GDP growth in 2014. Healthy China is key for healthy EM and S&P profits. We estimate that ~10% of S&P sales and ~15% of S&P profits are directly from EM, but when indirect exposures that are very sensitive to EM like commodity prices, US exports and capex are included profit exposure is 2x as much. Despite credit pressures in China, we believe China growth will stay healthy, even if slower than the past, and stay supportive of healthy demand for consumption oriented commodities and global capital goods.

Two reasons to patiently wait for a dip now through summer

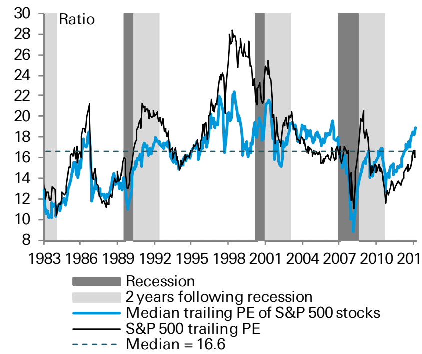
Elevated PEs and shifting Fed policy tend to bring above normal volatility, usually causing more than one 5%+ dip during the year. Twelve mid-cycle years since 1960 saw multiple 5%+ dips during the year and five saw flat gains for the year (1978, 1984, 1987, 1994 and 2005).

The S&P trailing PE at 17x and the forward PE at 15.8x are 5-10% above their average since 1960. The median S&P trailing PE at 18.9x is 10-15% higher than its average since 1983 and has entered into its late 1990s range. In the late 1990s, PE expansion was led by the Tech sector and mega-caps. Right now, PE expansion is being led by non mega-caps and sectors outside of Tech, Financials and Energy. In the late 1990s, it was excitement about extremely strong long-term growth prospects at Tech and still depressed EPS at most Industrials, Energy and Materials companies that supported the high PEs. Now, it appears that the expectation for secularly lower interest rates supports PEs.

We find these PEs fair but full until there is more clarity on the health of emerging markets and how interest rates react to stronger US growth and more normal monetary policy; including QE's end and overnight rate normalization. 2014 EPS revisions continue to remain negative and while weather is a good excuse, it is unlikely that managers will give strong guidance during reporting and thus it will be difficult to discern the true trend in sales and EPS growth until Q2 reporting in late July and early August.

Our DPS forecasts are: 2014F USD 41.00 and 2015F USD 46.50 as the dividend payout increases to 34% and 37% respectively from 32% currently. We expect another year of strong dividend growth, healthy capex growth, and flat net dollars spent on buybacks but sustained at high levels. We think strong dividend growth stocks (Tech, Banks) outperform high share buyback stocks (Consumer) in 2014.

Figure 1: S&P PE is elevated vs. history

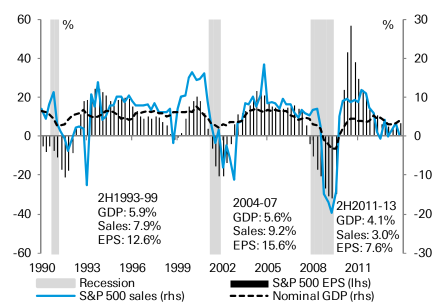


Source: Deutsche Bank Research

S&P sales and EPS trend of the last 2 cycles are difficult acts to follow

After two slow years we expect S&P sales and EPS growth to improve in 2014, but it is unlikely to accelerate to the rates of the last two cycles. Initial recovery in the last two cycles was soft, but by mid-cycle (2 years after recession end: 1993-99 and 2004-07) nominal GDP growth of 5-6% was healthy and S&P sales growth of 7-10% was very strong. Tech related capex in the 1990s and EM related capex in the 2000s (exports, commodities) lifted mid-cycle average S&P sales growth to 1.5x nominal GDP growth. Since H2 2011, average S&P sales growth was only 3% and less than nominal GDP growth of 4.1%. A moderate pick up in capex and exports to about 5%, as we expect, should bring S&P sales growth equal to nominal GDP growth. Our 2014E EPS of $119, up 8% y/y, is better than 5-6% growth of the last two years (4% ex. Financials), but significantly lower than the low to mid teens EPS growth of the last two cycles.

Figure 2: US nominal GDP and S&P 500 sales and EPS growth (yoy)



Source: Deutsche Bank Research

Risks to our view: Global acceleration fails to materialize, a surge in treasury yields and dollar or a sharp decline in oil prices

- Faltering of global growth, investment and trade emanating from emerging economies. In this regard, we keep a careful eye on China, commodity prices and exports.
- Stronger than expected climb in yields, as this would likely strengthen the dollar and weigh on commodity prices, exports and US investment, as well as limit intrinsic value based S&P PE upside.

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European Equities Strategy: Capturing the response to EM weakness

- We remain positive on European equities and maintain our Stoxx 600 end-14 target of 375. We continue to be pro-domestic cyclicals, pro-financials, pro-value and pro-Eurostoxx we originally initiated in October 2012. We remain underweight UK and positive Southern European equities.
- Our target of 375 is driven by i) an expectation of 12% EPS growth in 2014/15, and ii) a target forward multiple of 13.5x (vs. 13.7x currently). The multiple is justified in being above-trend because earnings are so depressed and interest rates have fallen sharply.
- Despite the concerns around EM circling, the demand indicators as they stand today show a global economy looking healthy, and we remain relaxed on the outlook for global growth given our assessment from a credit impulse perspective.
- With this outlook we are on standby to re-engage more aggressively with the globally exposed companies in Europe. On our estimates they have underperformed domestic stocks in Europe by 15% over the last 12 months.
- High dividend yield continues to outperform. We would attribute this to the recovery in the Euro area economy and how this has given rise to stability in dividends. This also represents a short duration strategy.

Global growth and European earnings

Despite the concerns around EM circling, the demand indicators as they stand today show a global economy looking healthy. Our key global indicator, the global manufacturing PMI rose to 53.3 in February, a 34-month high, which suggests that the better global growth rates seen in H2 2013 can be maintained, and even improve (Figure 1).

In addition, consensus forecasts for economic growth are also being revised higher. The average Bloomberg consensus forecast across the US, the Euro area and China for 2014 bottomed in Q4 of last year at 3.67% and has risen to 3.83% currently.

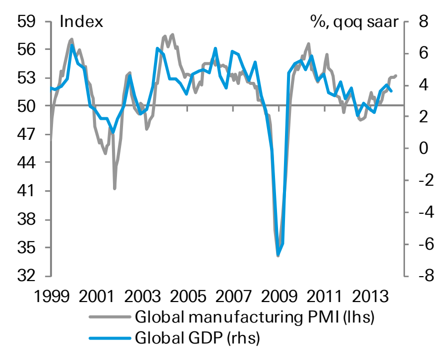
The relevance of this for European equities is that European earnings are a global growth story. Since the start of 2012 there have been persistent downgrades to global GDP growth, which have acted as a significant drag to European earnings expectations. With these forecasts now showing signs of a turn, a stabilisation in earnings expectations should be forthcoming.

In the near term however, additional headwinds to earnings expectations have emerged with the strength in the Euro and downgrades that defensive sectors continue to see, which is not typical. The earnings revisions of defensive sectors tend to be stable with the change normally being felt across cyclicals. When we directly put cyclicals and defensives up against each other on relative earnings momentum (Figure 2), it is cyclicals that are positive and defensives that are firmly negative.

European equities – capturing the response to EM weakness

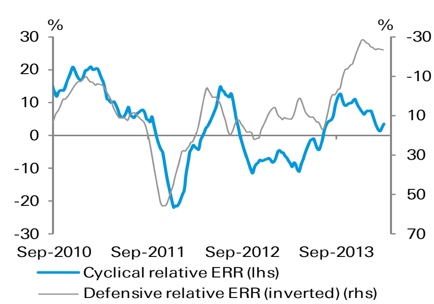
We remain comfortable on the outlook for global growth given our assessment from a credit impulse perspective. The credit impulse is the year over year change in the flow of new borrowing, and we believe that this is the correct credit variable to relate to spending growth, rather than credit growth.

Figure 1: Global manufacturing PMI and global GDP growth



Source: ECB, Deutsche Bank Research

Figure 2: Cyclicals vs. defensive ERR



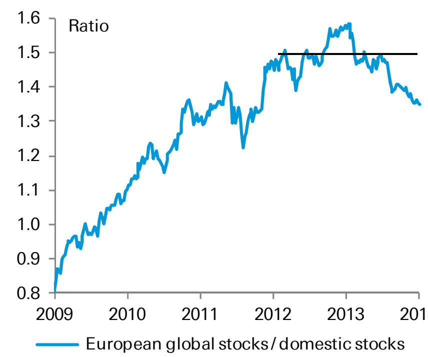
Note: ERR = Earnings Revisions Ratio = #upgrades to 12m fwd EPS #downgrades as % of total # est. Changes
Source: Deutsche Bank Research , IBES

Through the lens of the credit impulse, we see demand growth supported by a positive credit impulse in both the US and the Euro area in 2014, potentially making it the first year since 2010 to see a positive credit impulse in both the major developed market regions. This should do a lot to support EM growth.

Additionally, from a credit impulse perspective we see growth in EM ex-China as well supported. Credit growth has already been falling in this region for over two years and the credit impulse has already been in negative territory. Furthermore, growth has already adjusted down to levels consistent with the negative credit impulse. In order to see a significant deterioration in growth from current levels, we would need to see credit growth start to fall more aggressively than it is doing currently.

With this outlook we are on standby to re-engage more aggressively with the globally exposed companies in Europe. On our estimates they have underperformed domestic stocks in Europe by 15% over the last 12 months (Figure 3). Other signs of weakness in global stocks within European equities can be found when looking at the DAX, which is sitting at a significant discount to Europe (8%), while the premium the Swedish market has commanded over Europe has narrowed to 2009 levels.

Figure 3: Global exposure / Domestic exposure



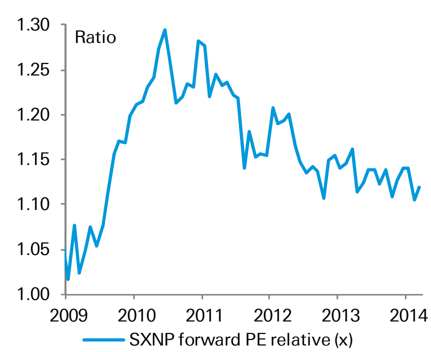
Source: Datastream, Deutsche Bank Research

We would also contend that EM weakness has had a wide range of impacts. To our minds it has played a role in driving a wedge between the performances of sectors and stocks that previously were well correlated. We have seen an increase in the dispersion of returns.

We can see this within the cyclical and defensive groupings. Pharma has been well liked amongst investors for a while, and we have noticed this getting stronger over the last 6 months probably as people have become less enamoured with food & beverages (due in large part to its EM exposure). With many investors having a strict adherence to 'quality', Pharma has been seen as the best alternative to staples.

Between the cyclicals we are now seeing quite a divergence in performance between the more global industrial sector and the more domestic sectors. As a consequence of this underperformance, the PE relative of industrials has fallen back to levels last seen in 2009 (Figure 4). We recommended an overweight stance on industrial goods & services.

Figure 4: Stoxx 600 industrials forward PE relative



Source: IBES, Datastream, Deutsche Bank Research

Whilst we recognise the significant moves already seen from globally exposed stocks in Europe, and are encouraged by the conclusions for global growth from a credit impulse perspective, we still believe it is too early to make a full preference for global stocks. In the meantime, we continue to believe there is better visibility across domestic exposure and a greater scope for upside economic surprise from the Euro area as credit growth starts to recover from negative rates of growth, giving a positive credit impulse. We recommend overweights in banks, autos and construction.

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Rates Outlook: Divergences

- The emergent story in 2014 is one of divergences – growth and potential, the front end and the long end, the Fed and the ECB.
- In the US, we expect the front end and long end to follow different narratives in the short run: the front end responding to less dovish Fed rhetoric and iterating on the timing of a first rate hike, but the long end pricing still low inflation and potential growth impediments from the external environment.
- If all goes well, rates should continue their upward drift, with the 10y Treasury reaching 3.25% by 2014 year end. In the short run however we see scope for a dip in yields led by longer forward rates.
- We expect the ECB to keep the front end of the Euro curve stable. However, ongoing rate normalization in the US could drag intermediates and longer maturities somewhat higher.
- We see the short run risks tilted to the downside. Historically EM underperformance has presaged slowing global output momentum, falling inflation, and peak G3 yields. Industrial metals remain in negative territory y/y. Chinese growth has disappointed.

The market narrative thus far in 2014, and likely for the foreseeable future, is one of divergences: growth and potential, the front end and long end, the Fed and the ECB. Perhaps the most determinative one for the market's trajectory is at its root the divergence of growth from potential in the US.

We think a strong case can be made that potential growth in the US and indeed in most major industrialized economies has fallen, and perhaps durably due to secular and slow moving demographic factors. The employment/population ratio has stagnated as labor force participation has declined, most notably in younger age cohorts. As a result the work force is older and less productive, and the economic speed limit might well be lower.

The obvious relevance is the magnitude of the output gap for any level of real activity, given lower potential. If all goes well and the economy accelerates, inflation is likely to rise and the Fed will be obliged to begin rate hikes. On the other hand, lower trend productivity and wage growth may have flattened the Phillips curve, and inflation may be slow to respond to falling unemployment.

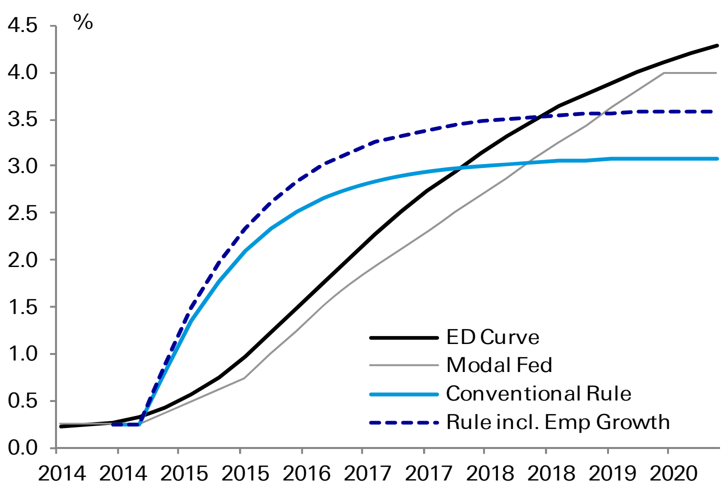
This is essentially the key to the resolution of the current low rate, steep curve environment. We have argued the current pricing paradigm is "slow and high", meaning the market is priced for rates hikes to begin slowly or late, and to rise to the conventional level of 4% or indeed higher if inflation looks to have the bit in its teeth. Either way, the curve transitions into flattening mode. The issue is whether that flattening is done bearishly or bullishly.

Given lower potential growth, we have argued that the more likely scenarios are "fast and low" – hikes begin sooner due to resurgent inflation, but need not rise as high – or "slow and low", meaning the flatter Phillips curve makes inflation slow to rise and rates need not rise to their (lower) equilibrium level.

Perhaps the key point is that lower potential growth also implies lower equilibrium interest rates. We have illustrated this in the context of a modified policy rule that incorporates employment growth in addition to the conventional explanatory variables, namely the output gap and inflation gap.

At full employment, target inflation, and 0.9% employment growth such a rule suggests that the terminal short rate in the US should be 3%. Market forward rates continue to rise in the back years, again suggestive of a more conventional terminal rate level of 4%.

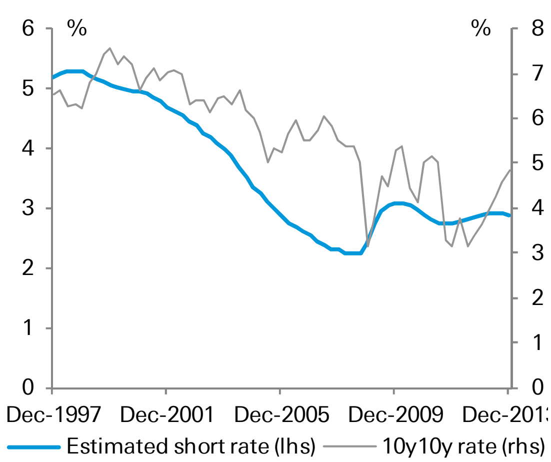
Figure 1:The importance of employment growth – Fed, market, and model short rate projections



Source: Deutsche Bank Research

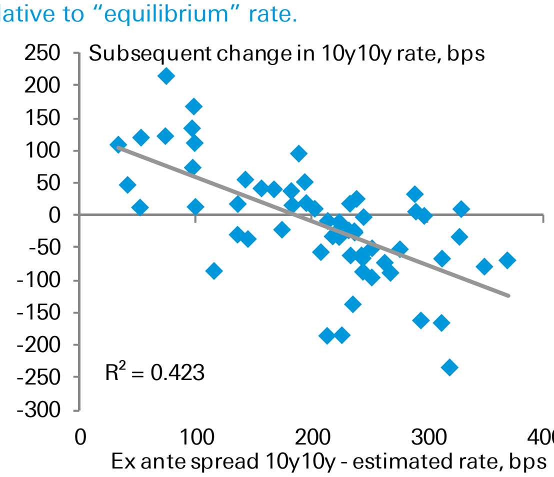
From a somewhat different perspective, one can illustrate that the freely estimated short rate (i.e. the intercept) from a conventional policy rule began to fall early in the last decade, and post crisis has leveled off at just under 3%. In the context of market behavior, this is relevant because that long run "equilibrium" rate should exert some magnetic pull on longer forward rates. Indeed, one can illustrate that if the forwards depart from the equilibrium level at any given point in time, then they tend to fall in the following period.

Figure 2: Model short rate and market 10y10y rate



Source: Deutsche Bank Research

Figure 3: Long forwards tend to decline when high relative to "equilibrium" rate.



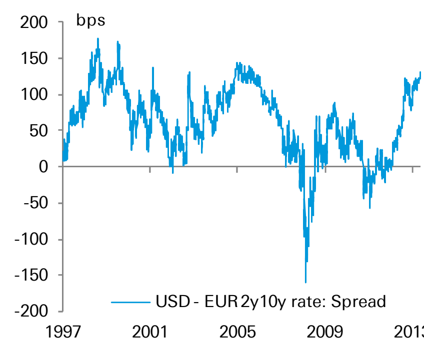
Source: Deutsche Bank Research

In the short run, given weaker Chinese growth, low industrial metals prices, sluggish growth and low inflation in Europe, and uncertainty over the magnitude of adjustment necessary in EM, we see ongoing risks that the 5y5y rate continues to fall. In spot space this pulls 10y Treasuries lower toward 2.5% by mid-year, before steady growth as envisaged by our economists allows yields to continue their upward climb, ending the year at 3.25%.

Another key issue in the US has been Fed guidance. All else equal, qualitative guidance and a broad set of relevant criteria for a potential rate hike should increase uncertainty and hence risk premia in the front end of the curve. Of course much of this happened following the March FOMC. We'd expect this increased risk premium to persist, absent more forceful dovish guidance from the Fed chair, which was notably absent in her first appearance as the Chairperson.

One historically glaring divergence in the market is in USD and EUR yields, driven of course by the different stances of the Fed and ECB. We think the ECB is somewhat constrained with regard to policy options. Easing measures that are easy to implement (e.g. halting sterilization of the SMP) would have limited impact. The solutions which would have an impact – large scale private sector purchases or government bond purchases – are either technically or politically problematic. The potential efficacy of negative deposit rates is unclear, though policymakers seem to have become more comfortable with that potential option. vLTROs appear to be contrary to the immediate objectives of the ECB.

Figure 4: USD – EUR 2y10y rate



Source: Deutsche Bank Research

Many intermediate yields in the US are at or near decade-high spreads to their European counterparts. These spreads are of course symptomatic of market concerns that the ECB has not acted forcefully enough to prevent further declines in inflation, while the Fed risks being behind the curve and at any rate is likely to begin tightening policy in the next 1-2 years. We note that it is not immediately obvious that both of these conditions are likely to persist simultaneously.

While the ECB is likely to successfully keep short end rates low, we see potential for higher yields in the US to pull along the intermediate and longer sectors of the EUR curve. We favor short positions in the belly of the EUR curve via paying 5y5y versus the US or UK, paying the belly of 5s10s30s fly versus the US, or paying the belly of the 2s5s10s butterfly, 2y forward.

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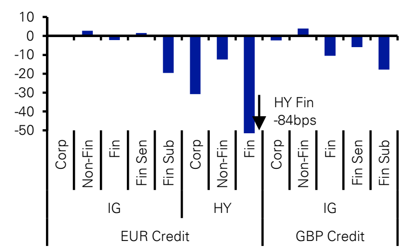
Credit Strategy: Still positive Q2, getting more worried about H2

Our 2014 view published in early December 2013 in our outlook ("The Bubble-Taper Tightrope") was that after a volatile but ultimately positive H1, 2014 would be a good year based on our assumption that central bank liquidity would remain very high. It seems that we were too dovish on our outlook for central bank liquidity with the Fed now talking confidently about possible rate rises in H1 2015 and the ECB not finding it easy to follow through from their pre-emptive rate cut in November 2013.

Our biggest concern for financial markets now that Q1 is nearly behind us is not so much that it's been a difficult quarter for many assets globally, but that it seems the hurdle for central banks to offer more liquidity has been raised. We're now a bit more worried about H2 than we were at the start of the year. We previously thought H2 would see the ECB conduct QE (or a similar scheme) and that the Fed may slow down the pace of tapering.

It seems that the message from the Fed has increasingly been that barring a significant negative shock to the economy which would lead them to notably lower their outlook for employment and inflation, the taper is set to continue. We thought they may pay more attention to sluggish global growth, low current inflation and any possible issues in EM but it seems that their sensitivity to these issues is lower than we previously thought. Indeed as seen from this week's FOMC, they are clearly getting more confident that they'll be able to raise rates in H1 2015. As such we're starting to get a bit more worried about H2 2014 than we were because towards the end of this period the FED could be out of QE again and we could be facing up to the first rate rise within a few months of the end of the year. The worry for markets earlier in H2 is that it does seem that the S&P 500 (and risk generally) has led moves in the Fed balance sheet by around 3 months since 2009.

Figure 1: YTD spread change (bps)



Source: Deutsche Bank Research

It's hard to find an explanatory variable that better correlates with the rise in equities since 2009 than the expansion of the Fed balance sheet. Figure 2then shows US and European credit performance, alongside the S&P500, in the expansion and brief contraction stages of QE since 2009. The grey shaded rows are where QE has paused and the balance sheet has fallen. Equities and credit have generally had a much more difficult time in these periods.

Figure 2: Alternating periods of QE on/QE off and risk on/risk off

Federal Reserve B/S ($bn)			Price Change	Spread Change (bps)			
Period	Change	Period	S&P 500	CDX IG	CDX HY	ITX Main	ITX Xover
15 Sep 08-23 Dec 08	1,388	19 Jun 08-26 Sep 08	-9.7%	48	166	27	106
23 Dec 08-11 Aug 09	-320	26 Sep 08-15 May 09	-27.2%	-5	373	18	207
11 Aug 09-25 May 10	363	15 May 09-26 Feb 10	25.1%	-65	-583	-49	-333
25 May 10-23 Nov 10	-37	26 Feb 10-27 Aug 10	-3.6%	20	19	33	62
23 Nov 10-19 Jul 11	564	27 Aug 10-22 Apr 11	25.6%	-18	-150	-19	-162
19 Jul 11-02 Oct 12	-76	22 Apr 11-06 Jul 12	1.3%	20	150	73	320
02 Oct 12-	1,375	06 Jul 12-	37.2%	-48	-266	-101	-432

Source: Bloomberg Finance LP, Deutsche Bank Research

Clearly such a correlation won't always hold but there is no evidence yet in this post crisis world that markets are able to continue to be buoyant without such liquidity. Given that the correlation seems to work best with a 3-month lag, risk assets might start to price in a peak in the Fed's balance sheet by early H2. As such we're getting a bit more nervous about markets from this point. As a minimum there might now need to be a set-back in the second half to force central banks into a return to more dovish behaviour. Those of a bullish persuasion might argue that if the US economy is managing to meet consensus and Fed expectations in H2, then the end of QE won't matter. However we'd stress that in the 5 year 'mega' equity market rally, the historically very weak economic recovery has had little to do with performance. So we'd argue that liquidity is far more important than growth at this stage.

Outlook for Q2

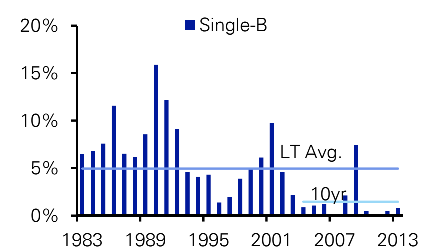
We're a bit more relaxed about Q2 as there should be a weather related rebound in US data which even if it isn't sustained in H2, drives confidence over the next few weeks and months. As we go to print it seems that the situation in the Ukraine is not escalating at pace although this is clearly one to watch. China probably constitutes the biggest risk to a decent Q2 for risk and it does seem that cracks that many of us have felt have been present for a while are starting to widen. For now China has the resources to continue to intervene in its economy but we wonder how long this can continue. Watch the policy response to the slowdown in Q2 and watch for any contagion from what now seems to be an inevitable pick up in onshore corporate defaults.

Credit remains fairly low beta – even the high beta part

The technical strength of credit has certainly been evident in Q1, with high beta performing very well in spite of it being a risk off period for many global equity markets. Even in periods where equities (and CDS) have sold off, sellers of cash credit have generally been hard to find.

We've discussed at length over the last couple of years that defaults in the developed world corporate bond markets are at extreme lows, and have been now for a decade. There is no obvious reason why this changes in the near-term as demand / available liquidity for fixed income and corporate bonds remains very high. As discussed above its interesting that Chinese corporates are starting to see defaults. One would have to say that Western corporates are in far better shape than those in the Chinese market but the contagion is one to watch.

Figure 3: Single-B default rates



Source: Moody's ,Deutsche Bank Research

Valuations

Apart from the fact that Sub Financials and HY have tightened further over the last three months, valuations elsewhere across the credit space are broadly unchanged from when we published our Outlook. In Figure 4 we update a table from our outlook where we show where spreads are in the EUR and GBP credit markets. The final column shows the percentage of time spent below current levels. So 100 would mean that an index was at all time wides and a value of zero would indicate all-time tights.

As was the case at the start of 2014, no sub sector of the EUR and GBP markets is yet in its lowest quartile relative to its own history (back to 1999 for IG and 2003 for HY). Sub Financials whilst tightening in Q1 remain broadly just above their long-term average from a spread point of view. HY remains the most expensive part of the universe on this measure and whilst BBs are getting close to entering their lowest quartile relative to history for now they remain just outside of it.

So HY is getting more stretched but in a world of high demand and low defaults it seems investors will still have a preference to chase yield in any period of quiet macro activity. As we discussed at the top there's now a fair chance that the macro environment will get more challenging in H2 as market anticipates the end of QE. However Q2 looks set to see some stability as geo-political risk eases and US data improves.

Figure 4: EUR and GBP credit benchmark spreads relative to long-term wides, tights, medians and averages

	EUR credit						GBP credit					
	Current	Average	Median	Wide	Tight	Percent Time at Current or Tighter	Current	Average	Median	Wide	Tight	Percent Time at Current or Tighter
Non Fin IG All	109	121	116	389	43	44%	135	152	146	392	79	38%
Non Fin AA	69	65	65	197	14	58%	74	92	91	202	43	33%
Non Fin A	84	96	91	330	31	39%	118	132	127	332	64	39%
Non Fin BAA	135	168	158	545	59	38%	164	197	182	570	95	32%
Fin Sen	99	106	67	426	19	58%	110	158	118	635	57	41%
Fin Sub	231	275	111	1,693	41	60%	258	303	210	1,452	74	60%
Fin Bank Sen	97	99	58	391	17	60%	103	134	89	494	45	56%
Fin Bank LT2	204	211	107	1,013	29	62%	196	223	155	759	62	59%
Fin Bank T1	293	558	387	4,810	63	43%	332	414	310	2,641	81	52%
Non Fin HY BB	279	427	361	1,401	142	27%						
Non Fin HY B	496	724	613	2,461	236	31%						
Non Fin HY CCC	969	1,367	1,153	6,159	318	39%						

Note: EUR and GBP IG based on data since 1999, EUR HY based on data since 2003.
Source: Deutsche Bank Research

Credit spread forecasts

We're not making too many changes to our forecasts but we've slightly increased some year-end spread level targets to acknowledge our concerns that H2 might not be as good as we previously felt. A big factor as to whether we eventually predict wider spreads in H2 is likely to be based on what we see happening to central bank policy as we go into and through H2. At the moment our base case is that there is a wobble in H2 but that central banks eventually respond. The difference between the view now and that at the start of the year is that we initially didn't think central banks would need prompting to be highly accommodative. With the Fed continuing to taper regardless, and with the ECB's reticence towards easing further we now feel they may need a push. There's a good chance markets give them such a push in H2. Fortunately the technicals and fundamentals in credit remain firm enough that credit should remain a low beta asset class to any volatility for the foreseeable future. The lighter shaded areas represent a move tighter in our spread forecasts, the darker shaded areas represent a move wider.

Figure 5: 2014 Spread forecasts

			Spread Level (bps)		Spread Change (bps)		Spread Forecasts (bps)	
			Original Forecast Date (05 Dec 13)	Current	Since Original Forecast	YTD	Jun 14	Dec 14
Cash Market								
EUR	IG	Non-Fin	115	110	-5	5	105	100
		Fin Sen	108	100	-8	4	95	90
		Fin Sub	266	234	-32	-12	225	215
	HY	All	410	365	-45	-21	350	340
GBP	IG	Non-Fin	136	136	0	4	130	115
		Fin Sen	118	111	-7	-5	105	95
		Fin Sub	284	260	-23	-16	250	225
CDS Market								
Europe	iTraxx	Main	New Series	81			75	70
		Crossover	New Series	308			290	270
		Fin Sen	New Series	100			95	88
		Fin Sub	New Series	152			145	128

Note: Cash Market Spreads vs. Government Bonds. Highlighted cells indicate a forecast change.
Source: Deutsche Bank Research

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US MBS and Securitization Outlook: For MBS, a tale of two yield curves

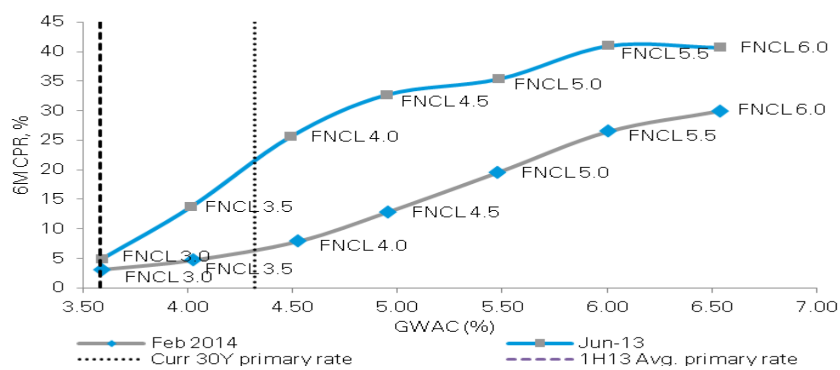
Last week's meeting of the FOMC put the front end of the yield curve in play, and even after the market adjustments that followed, yields on 5-year and shorter debt still stand to rise based on current Fed guidance and risk alone. As for the longer end of the curve, that has a lot less risk in it. And the combination creates an unusual situation for holders of MBS. We potentially have one yield curve 5-years and in and another further out.

A yield curve that pivots around the 5-year point changes the interest rate proposition for MBS. Simple duration should matter progressively less for MBS as the Fed makes its way out of QE and eventually starts to tighten, and yield curve exposure should matter more. Managing rate exposure has to entail moving measurement and hedging from one point on the curve to multiple. Portfolios that do not make the change end up with embedded yield curve trades – ones likely to move against them.

More about partial durations than prepayments

The partial durations of MBS should matter more in today's markets than they have in the past because of the relatively low sensitivity of total prepayments to rates. The 30-year mortgage rate available to consumers stood at 4.35% in mid-March, leaving 65% of outstanding 30-year MBS with less than 50 bp of incentive to refinance. Prepayment speeds over the last six months have ranged from 3.1 CPR in the average outstanding 30-year Fannie Mae 3.0% pool to 30 CPR in the average 6.0% (Figure 1). That is well below the range that existed as recently as June last year. Speeds in the heavily traded 30-year 3.5% through 4.5% pass-throughs are roughly a third of their pace last June. The bulk of MBS cash flows have spread out broadly along the curve.

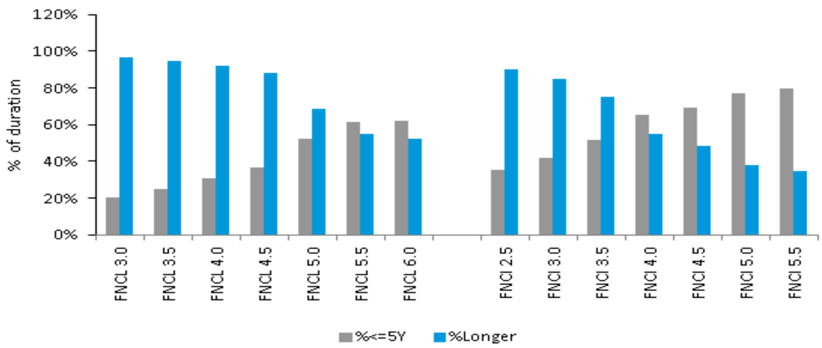
Figure 1: Slower prepayments, extended cash flows in MBS



Note: Data show 6-month CPRs for all outstanding FNCL pools with the indicated coupon as of Feb 2014 and June 2013.
Source: Deutsche Bank Research

To the extent that longer rates stay steady or only move up slowly, changes in shorter rates take on new importance through their impact on cash flow discounting. And MBS obviously have significantly different exposures (Figure 2). Exposures to the 5-year and shorter part of the yield curve in TBA 30-year Fannie Mae MBS range from 20% in 3.0% pass-throughs to more than 60% in 6.0%s. And exposures in the 15-year market range from 35% in 2.5% pools to nearly 80% in 5.5%s. Portfolios that measure or manage their positions with only 10-year rates could see their MBS move in price significantly without enough offset in their rate benchmark. Even measuring and managing with a blend of 5- and 10-year rates could misstate interest rate exposure.

Figure 2: Big differences in yield curve exposure across pass-throughs



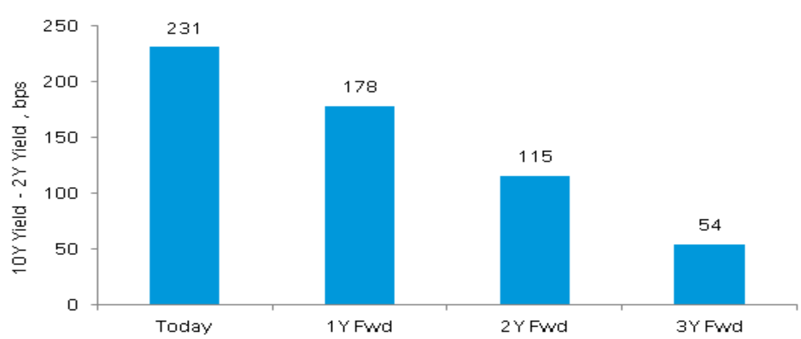
Note: Data show the percent of duration for each coupon that comes from the 5-year or shorter part of the yield curve and from the 7-year or longer part as of 24 Mar 2014.
Source: Deutsche Bank Research

Fortunately, the solution is straightforward: measure the partial duration of the position or portfolio to the 2-, 5-, 10- and longer parts of the yield curve and, potentially, hedge the partial exposures. It adds complexity, but it offsets risk. As one seasoned portfolio manager that we spoke to noted, no one with a portfolio of 2-, 5-, 10-year or longer corporate debt would hedge with a single point on the curve. That only happens in MBS.

More risk in shorter rates, less in longer

The complexity of hedging MBS partials is worth it for now because of the likelihood that the shorter and longer parts of the curve move at different rates. FOMC last week should have reminded us that the curve can flatten quickly.

Figure 3: Forwards have the yield curve flattening quickly



Source: Deutsche Bank Research

In the short run, Fed guidance and risk alone could push the front part of the yield curve up by another 10 bp to 20 bp. The FOMC's median projection from last week puts fed funds at 1% in December 2015 and 2% in December 2016, but fed funds futures still stand 10 bp to 20 bp below those levels. Add a risk premium for some of the uncertainty about the Fed's path over the next 18-to-30 months, and short rates look even richer.

In the long run, forward rates show the curve flattening significantly. The expected spread between 10- and 2-year Treasury yields drops from 231 bp today to 178 bp a year from now, 115 bp in early 2016 and 54 bp in early 2017 (Figure 3). Although forward rates may be understating the pace of flattening, the ultimately levels seem fair. That puts both 10- and 2-year rates in the neighborhood of 3% to 4%, reasonable given the likelihood of tame US inflation and real economic growth that may run a little slower than history alone would suggest.

Something special for MBS derivatives

For portfolios that traffic in MBS exotica, the yield curve exposure is even more interesting. For holders of inverse IO, for instance, a rise in rates led by the 5-year point on the curve poses a unique set of problems. The steepening of the 2-to-5-year part of the curve leads to a more rapid rise in forward LIBOR, shrinking the coupon on the IIO. At the same time, the flattening of the 5-to-10-year part of the curve leads to generally lower projected forward 10-year rates and, consequently, lower projected forward mortgage rates. The potential picture: less coupon and faster prepayment speeds, or Nightmare on Wall Street. For MBS derivatives books, it becomes especially important to measure and manage the partials.

The market has started to move

The market already shows signs of investors starting to hedge exposures to the short end of the yield curve, anecdotally including MBS investors. Repo rates on the short end of the Treasury curve have started to drop, a sign of increased interest in borrowing issues and selling them short. That’s a good sign. Although the vast majority of yield curve variation historically comes from parallel moves, Fed tightening historically has flattened the curve. The Fed gave fair warning last week. Hedging MBS with 10-year notes may not work well for long.

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FX Strategy: 2014 Outlook

- Yellen's testimony marks the beginning of the end for quantitative guidance, US rates carry trades and USD funding for FX carry
- For EM FX a more hawkish Fed outlook means the near-term focus is back on currencies with external vulnerabilities

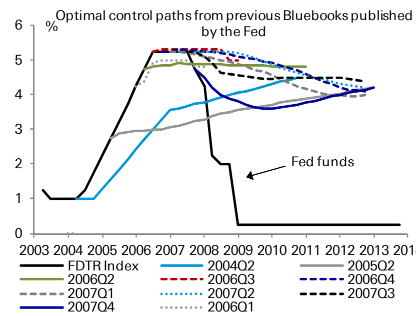
Forget March's upward revision to the FOMC rate dots. Instead, the meeting should be remembered for something more long-lasting: the beginning of the end of quantitative guidance. Implicitly, this happened by the Fed chair discouraging focus on the "dots". More explicitly, it happened by the Fed dropping the unemployment threshold with guidance now reverting to the Fed's dual mandate - as has been the case for the last three decades. At least the Bank of England provided some clarity on the size of the output gap and new level of "neutral funds" in last month's inflation report. Yesterday, the Fed effectively fully reverted to its pre-guidance regime: no dates, no data thresholds, just vague language. There should be two main implications of the March meeting:

- Normalization continues. Last year marked the beginning of the end of QE and therefore initiated the long process of Fed exit. This meeting takes us another step further onto that course by "unwinding" guidance, while also being notable for the first revision higher in rate projections. It is extremely difficult to see carry trades on the short-end part of the US curve doing well, even with the overnight sell-off post-meeting: the curve might be steep, but the Fed's reaction function is now even more uncertain, sensitivity to data should naturally keep rising, and volatility has likely reached a local low. Just look at the realized path of Fed funds versus the "optimal control" paths that the Fed was running in the 2004 rate hike cycle to get a sense of how benign rate pricing remains (figure 1).
- EUR should be the funding currency of choice. Just as US rates carry trades have become even more unattractive after the Fed meeting (note it was never really attractive in the first place, you would have lost money by being short US 5-yr since the beginning of the year), the same goes for dollar funding. Not only has the US curve meaningfully bear flattened (one of the strongest dollar bullish signals), but the Euro is now exceptionally attractive both in terms of spot FX and the funding level of yields: looking out to two years, there is a more than 60bps pick-up in yield by funding in Euro rather than the dollar.

So does this finally represent a turn in the dollar? As Yellen clearly pointed out in the press conference, it will depend on developments in the labour market and on inflation, meaning we are probably back [again] to a situation where the market collectively will focus on the positives in US data, while negatives will be largely dismissed. A Fed confident enough to continue tapering and revise higher their rate expectations, whilst at the same time still being some time away from actually hiking rates, sounds like an environment supportive of equities (if data is strong it will push markets higher, if data does not bounce back, it will only mean the Fed will postpone policy tightening further).

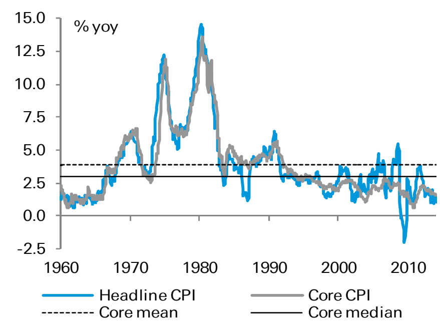
For EM FX a more hawkish Fed outlook means the near-term focus is back on currencies with external vulnerabilities, and what the market is looking for is evidence that the adjustment seen in this cycle has been sufficient for that to impact on the external balances. Hence expect C/A and trade balances to be closely monitored by the market, and until we get evidence of an actual improvement, further rate hikes will likely be required.

Figure 1: Optimal control paths



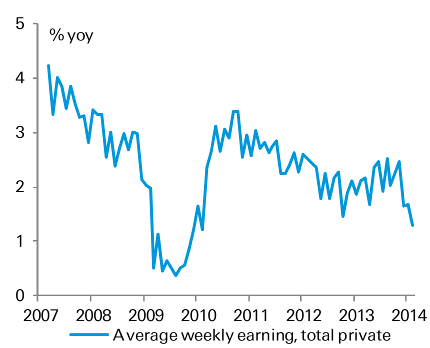
Source: EcoWin, Deutsche Bank Research

Figure 2: US headline and core CPI well below long-term median



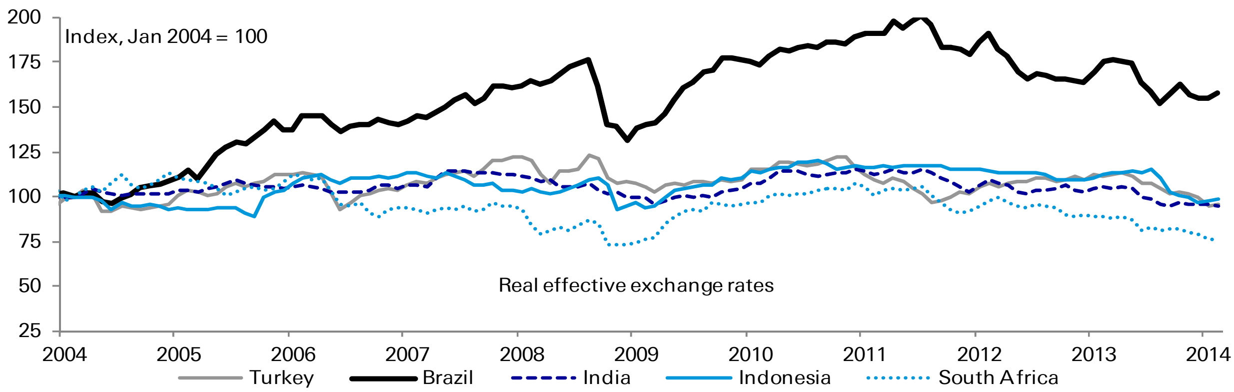
Source: EcoWin, Deutsche Bank Research

Figure 3: US wage growth key for the CPI outlook



Source: EcoWin, Deutsche Bank Research

Figure 4: Fragile Five real effective exchange rates (Jan 2004 = 100)



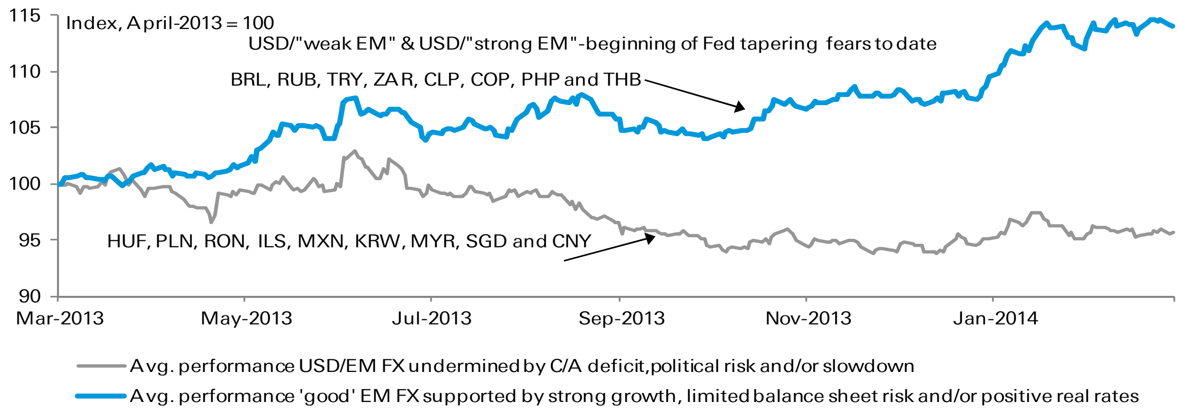
Source: BIS, Deutsche Bank Research

But, and as we have repeatedly argued over the past 12 months, EM FX should trade less as a group in an environment where growth continues to pick up, inflation in the developed world remains very subdued, and liquidity is not getting tighter, just somewhat less stimulative. While the positive EM stories certainly have been limited, there are huge differences in performance in EM FX since the Fed initially opened the door for tapering back in April/May of last year, when the perception of receding global liquidity and fears about a slowing China saw a real economic shift, not from EM to DM, but from commodity producers and/or "current account deficit" EM, towards fundamentally strong EM, where balance sheet [and political risk] is limited, where real exchange rates are competitive and where exporters therefore already are benefiting from stronger external demand and supply chain linkages to strong regional exporters.

Importantly, this is not just another theory/view but is already happening, and while on some days the FX market appears unconvinced, the reality is that PLN, HUF, RON, MXN, MYR, KRW, SGD and ILS are already in this limited but growing group of “strong” EM FX, while BRL, RUB, TRY, ZAR, CLP, COP, PHP and THB have remained weighed down by vulnerable external positions, political unrest and/or a continued economic slowdown. In an environment where we are back to month-to-month data watching, the diverging trend between “strong” and “weak” EM FX will just be further reinforced.

Finally we note that the CNY market does not appear positioned for the removal of Chinese state intervention in credit, rates and FX. If this happened the financial system would come under pressure and the economy would slow. In essence, the state intervention has been providing a credit subsidy, which when removed would have these impacts. It's for this reason that Chinese policymakers have not introduced a big band of liberalisation of markets, which is their stated long-term aim from last year's Plenum and the more recent NPC meetings. Instead, they are aiming to address each distortion in a start-stop manner to avoid any uncontrollable side-effects. The important angle, though, is that the current administration is resolute in introducing reforms. Last year the focus was corruption and interest rates and this year it seems to be FX - judging by the widening of the CNY band from +/-1% around the fix to +/-2% in mid-March. One could also add pollution to this year's target.

Figure 5: Strong vs. Weak EMFX theme set to continue as Fed hawkish bias persists



Source: Deutsche Bank Research

CNY no longer best carry trade

The widening in the band may signal that the Chinese authorities are no longer willing to assure the market of low volatility in the currency. Indeed, although carry in CNY or CNH is low in absolute terms, when adjusted for volatility, the carry has on occasion been the highest in the world. For much of 2012 and 2013, the volatility-adjusted carry for CNY or CNH was by far the highest in the world, easily surpassing that seen in the Brazilian real (see second chart). Entities both in China and outside China have even tried to capture this carry by disguising carry-related capital flows as trade flows through the over-invoicing of exports and using copper to finance trades. Over the past few months that has changed: shorter-term yields in China have fallen. Interestingly, volatility until very recently has been subdued. Moreover, there hasn't been much of a connection between band widening and subsequent increases in volatility. So while many are focusing on where the CNY fix will set in coming days and weeks, the more interesting thing to monitor is whether actual volatility will rise.

USD/CNY to 6.30?

But what cannot be denied as that CNY has been too strong compared to other EM surplus currencies - most of which reached a high against the dollar in early 2012 (see fourth chart). The extra-ordinarily high carry was no doubt a key factor that allowed CNY to march higher against the dollar. With that support gone, CNY should weaken with levels such as 6.30 or more possible over the course of this year.

What? Reserves may have costs?

Finally, many who believe in CNY appreciation find comfort in the $4 trillion FX reserves that China could deploy at will. Three things are worth bearing in mind when thinking about reserves. First, as a share of GDP, Chinese reserves are lower than both Singapore and Taiwan and not too far ahead of Korea's (see fifth chart). Second, during the 2008 crisis, Taiwan and Singapore's larger reserves didn't stop them weakening by 15% or during the 1997 crisis, them falling by 20%. Thirdly, using FX reserves to defend a currency would result in liquidity being drained from the domestic economy, and so an effective tightening of conditions. Therefore, it doesn't come without costs and so at some point as capital controls are lifted Chinese policymakers have to decide whether to target domestic interest rates or FX as both will no longer be possible.

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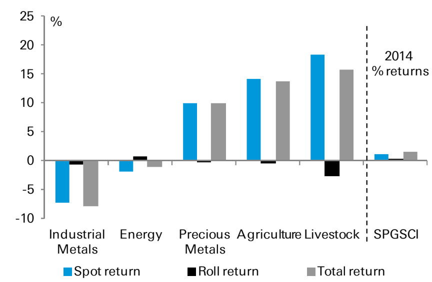
Commodities: A Tentative revival

- Commodities have overtaken benchmark fixed income returns to become the best performing asset class on an excess returns basis so far this year. Last month also witnessed US and European commodity ETPs enjoying their first inflows in over 12 months with most of these flows concentrated in the precious metals sector.
- The rebound in commodity returns has become more broad-based over the past few weeks. In terms of the five broad sectors, livestock, agriculture and precious metals have been the engine rooms of performance so far in 2014.
- However, it is questionable the extent to which the factors that have benefited these markets can be sustained over the medium term. For example, history shows that the duration of positive returns in the livestock sector has been brief. Indeed since 2001 the sector has posted negative annual returns 70% of the time.
- In precious metals, while gold price strength has accelerated since February, we view a rebound in US economic activity as posing a significant risk to the latest gold price recovery. In our view, a renewed rise in US long term real yields and a move lower in EURUSD pose the main risk to the gold price heading into the second quarter.
- Weather has played an important role in the divergent performance of energy markets so far this year with extreme cold weather in the US leading to a drawdown in heating oil inventories and pushing storage levels in the US natural gas market to precariously low levels.
- In contrast, a mild European winter has meant energy markets in this region have under-performed. However, like last year energy returns continue to trade broadly sideways and have consequently been agnostic to the events unfolding in the Ukraine.
- However, in this article we examine the potential hazard for commodity markets from an escalation in tensions between the West and the Russian Federation. We view crude oil, diesel, natural gas, palladium, aluminium, nickel and grains as the markets of most interest.
- So far this year, industrial metals have been the only commodity sector that has posted negative returns. The sector's weakness has been attributable to sluggish Chinese growth since beginning of the year alongside increasing fears of an unwinding in Chinese copper carry trade activity.
- However, market sentiment is slowly shifting on the expectation that China's government could loosen funding restrictions for property developers and speed up construction projects to support economic growth.

The crisis in Ukraine has introduced new event risk for commodity markets. When measured in terms of commodity trade flows, the Ukrainian economy is most sensitive to the energy sector since crude oil and US natural gas constitute around 13% of commodity net imports as a share of GDP, Figure 2. In contrast, agricultural exports account for less than 5% of GDP while metal exports comprised less than 2% of net exports between 2010 and 2012. Of the various commodity risks, we view the Ukraine's role in the natural gas market as the most relevant.

Figure 1: SPGSCI returns by sector & type



Source: Deutsche Bank Research (March 20 2014 data)

Figure 2: Net commodity exports as a % of GDP in Ukraine & Russia

	Ukraine	Russia
of which food/agriculture	**4.46%**	**-0.99%**
Live animals	-0.05%	-0.03%
Cotton	-0.02%	0.00%
Maize	0.11%	0.00%
Soya	-0.17%	-0.02%
Sugar	0.04%	0.00%
Wheat	-0.08%	-0.03%
Others	4.61%	-0.91%
of which metals	**1.55%**	**1.18%**
Crude fertilizers and crude minerals	0.17%	0.03%
Metalliferous ores and metal scrap	1.57%	0.19%
Non ferrous metals	-0.23%	0.96%
of which energy	**-12.98%**	**16.45%**
Coal, coke and briquettes	-0.78%	0.61%
Petroleum and petroleum products	-4.50%	13.55%
Gas, natural and manufactured	-7.96%	2.23%
Electric energy	0.26%	0.05%

Data refers to 2010-2012 average
Sources: IMF (negative figure implies net imports), Deutsche Bank Research ,

The threat of an interruption of European gas supplies imported from Russia via Ukraine has emerged for the first time since 2009, when gas shipments were halted as a result of contract disputes over import prices, transit fees and delayed payments. This time around, the situation is different as a result of the new Nord Stream pipeline and the seasonally high level of gas inventories in Europe on account of mild winter weather. Russia is responsible for supplying approximately 28% of European Union annual gas consumption. Of this imported quantity, roughly 80% was shipped via Ukraine in 2010, but this proportion has fallen to 53% since the commissioning of the Nord Stream pipeline which runs under the Baltic Sea.

Moreover an extremely mild European winter has meant that the region is enjoying a seasonally high level of gas inventories. While a complete halt of natural gas imports from Russia would still be an extremely disruptive event for the European gas network, the halt of Ukraine gas transit alone would have to last longer than in the past to be of equal importance.

In the event that G7 discussions turn to economic sanctions against Russia this may focus attention on palladium, nickel and aluminium as well as crude oil given the importance of Russian production, Figure 3. Last year Russia produced some 10.6mb/d or broadly 12% of the 90mb/d global oil market of which around 3.2mb/d were consumed internally. Quite aside from its position as a major oil exporter, Russia is also a major source of European oil products, most particularly diesel. Any disruption to this supply could therefore significantly impact global oil prices. For the time being, and in the absence of significant trade sanctions, oil markets have been relatively stable throughout the unfolding political crisis.

In terms of agriculture, the sector has been buoyed not only by a poor South American harvest, but, also from potential supply disruption risk from the Ukraine. This year Ukraine is set to become the world's 3rd largest exporter of corn and 6th largest exporter of wheat. The eastern provinces of Ukraine are among the key corn growing regions. Concerns of a disruption to planting which begins this month could begin to escalate if the current clampdown on the Crimean peninsula extends northwards. For the time being, attention is on the possible disruption of grain exports from Ukraine's Black Sea ports. However, the major grain terminals in the Ukraine are not in Crimea but in Odessa, Illichevsk and Yuzhne some 325km to the west.

In terms of gold, the market has enjoyed a powerful rally since the end of last year. However, since gold prices peaked in September 2011 and began its recent downtrend, it has been common to witness short term rallies. However, the common feature of these rallies is that they do not last for much longer than three months and that the degree of appreciation typically does not exceed 15%. As a result, one could argue that the recovery in the gold price since December last year is in danger of unraveling as we enter the second quarter in the event of a rebound in US economic activity, a renewed rise in US long term real yields and a long awaited turn in EURUSD.

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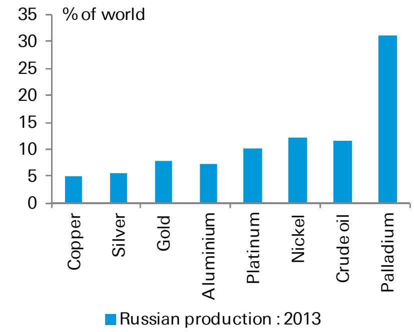
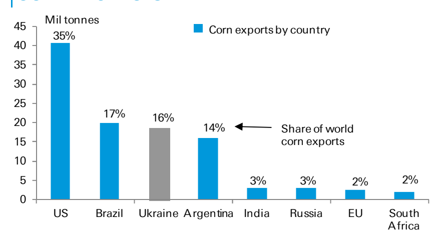
Figure 3: Russian production as a share of world production



Source: IEA, Brook Hunt, Deutsche Bank Research

Figure 4: Ukraine's role in global corn markets



Source: USDA, Deutsche Bank Research

Figure 5: DB oil price deck

	WTI (USD/bbl)	Brent (USD/bbl)
2012	94.2	111.7
2013	98.1	108.7
2014 Q1	98.3	108.0
2014 Q2	98.0	107.0
2014 Q3	96.0	106.0
2014 Q4	94.0	105.0
2014	96.6	106.5
2015	89.3	102.0
2016	85.0	98.0

Note: Figures are period average
Source: Deutsche Bank Research

Geopolitics: Russia has more problems than just Ukraine

During the Cold War, there were three major regions of conflict for the Western powers: Central and Eastern Europe, the Middle East, and East Asia. The settlements at the end of the Cold War effectively ended the great power conflicts in Europe and East Asia. The disintegration of the Soviet Union also paved the way for the West to establish a security cordon covering all the Sunni states from Morocco through Iraq, with the exception of Syria, systematically rolling up the old Soviet clients in Libya and Iraq via military action or political pressure. The less existential ideological conflict with Sunni jihadis after 2001 drew the West, at the peak of its post-Cold War expansion of influence, into Central Asia.

Of course, as always, there were still many potential conflicts to be managed—Iran's potential regional hegemony and its nuclear program, China's rapid rise to power alongside its desire to secure its nearby seas. Throughout this period, Russia could be characterized as an uncommitted power, cooperating in *de facto* or more formal alignments with its potential major adversaries in some dimensions while opposing in others. In other words, it has been advancing its interests. In questions of interest to the West, Russia has been cooperative over Afghanistan but supportive of Iran. But it sharply pushed back in 2007 against the attempt to expand NATO into Ukraine and Georgia, leading to the subsequent conflict in Georgia.

In the past five years, these three main outcomes of the post-Cold War settlement have begun to evaporate. The Arab Spring and its aftermath in North Africa, the abrupt US withdrawal from Iraq, and the Syrian civil war have essentially eradicated the West's laboriously constructed security cordon along the southern Mediterranean and Middle East. Perhaps a decade earlier than previously anticipated, China has begun its assertion of greater control over the East and South China Seas, which had been effectively dominated by the US for nearly seventy years.

And now, the sudden outburst of conflict in Ukraine has brought into question one of the bases of the post-Cold War settlement in Europe—populations might migrate, but there would be no forcible adjustments of international borders.

Key reasons for Russia's annexation of the Crimea have been well-reported. The multi-national Ukrainian state had, in effect, become a security buffer between the EU and Russia. Its succession of corrupt governments had stifled growth and had caused Ukraine to swing its geopolitical orientation back and forth from east to west. These gyrations led to stark final options by the end of 2013: either join the Russian-sponsored customs union or sign an association agreement with the EU. This is a major choice, both culturally and economically, and it split the population.

From Russia's perspective, Ukraine borders its own heartland, so its neutrality or eastward alignment is vital to Russia's security. Moreover, the naval base at Sevastopol its key to its strategy in the Mediterranean. Ukraine renewed Russia's long-term lease on its Crimea base in 2010 to an expiration date of 2042. But the sudden overthrow of the Yanukovych government by the Ukrainian-dominated forces in Kiev potentially threatened that deal (or at least renewals) and suggested that Ukraine was slipping out of its grasp. Russia acted to solidify the suddenly deteriorated security situation on its western frontier.

This was a security question, not an economic one, as indicated by Russia's seeming indifference to the potentially large economic costs of mounting Western sanctions and the direct economic cost of supporting the population in the annexed Crimea. There is also the perceived ideological motivation of restoring some of the Soviet Union's territorial extent and reintegrating its Russian-speaking population.

The Crimea was easy compared to Eastern Ukraine

With its narrow isthmus connecting it to the mainland and its overwhelmingly Russian-speaking population and large Russian military establishment, the Crimea is easy for Russia to take and control, without the need to devote large forces to prevent infiltration from Ukraine. Perhaps ten percent of the population is Tatar and twenty-five percent Ukrainian speakers, both loyal to Kiev; but these can likely be controlled by organizing local Russian militias, with Russian speakers constituting sixty percent of the population. The quick capitulation of loyal Ukraine military forces looks to be a *de facto* recognition of the futility of trying to resist the Russian occupation at this stage.

That the West is unwilling to make military threats over the Crimea itself also appears to be a *de facto* acknowledgement that it will be difficult to pry Russia out of the territory.

Also, the timing appeared right for Russia to make this move now. Much has been said about the EU's reluctance to push economic and financial sanctions very far because of its far greater economic interaction and energy dependency, but the US has also been relatively slow to ramp up the financial and economic pain to debilitating levels. This muted US response is not just a symptom of what many see as a vacillating US administration, which has been called out for presenting a window of opportunity for the annexation. It is for a good reason: we believe that over the next six to eight months at least, the US administration cannot risk a muscular confrontation with Russia. At the end of February, there were still 32,000 US troops and 50,000 overall NATO+US forces in Afghanistan, now scheduled to be withdrawn during the rest of 2014. With routes through Pakistan problematic and through Iran obviously closed, the US and NATO need (and have gotten, so far) Russian cooperation for ground supply and air corridors of retreat over the old Soviet Stans, the Caspian, the Caucasus, and Russia itself.

A larger strategic context

But these Russian moves are part of a larger, deteriorating geopolitical problem which likely explains why Russia appears willing to pay the economic price of expected sanctions, however debilitating a level they may reach. It apparently senses a need to stabilize and solidify its vital western borders, as it could soon see increased pressures in Central Asia and longer-term pressures in its far east as China rises in the neighborhood of a depopulated Siberia. The US/NATO intervention in Central Asia created a buffer and respite there for Russia during the last 12 years. With the US/NATO finally out of Afghanistan, this area could well become the scene for a contest between Sunni forces and Iran/Russia. In the event of a re-establishment of jihadist power in Afghanistan, Russian support for the old Soviet Stans would likely become more substantial and a long-term drain again, as they were in the late 1990s under Taliban pressure.

We suspect that from Russia's point of view, the price of not acting in Ukraine is to risk the prospect of its own continued disintegration. But the risk to Russia of going much farther in Ukraine would be high. Taking the eastern part of the Ukraine, with its long border and much smaller fraction of Russian speakers, would be more problematic and could lead to civil war, a drain that Russia would likely wish to avoid, especially since its military forces are small relative to the area they might have to pacify. It is far easier to simply continue to let events unfold in hopes that prospective difficulties in controlling the zone from Kiev might help mold the evolution of the new Ukrainian government in a more conciliatory direction.

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Key Economic Forecasts

	Growth of real GDP (% yoy)			Inflation, CPI (% yoy)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2013	2014F	2015F	2013	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
US	1.9	3.2	3.8	1.5	2.1	2.3	-2.3	-2.3	-2.3	-3.8	-2.9	-2.5
Japan	1.5	0.4	1.4	0.4	3.0	1.7	0.7	0.8	1.8	-9.2	-7.2	-5.6
Euroland	-0.4	1.1	1.5	1.4	0.8	1.3	2.3	2.4	2.1	-3.0	-2.5	-2.1
Germany	0.4	1.5	2.0	1.6	1.1	1.7	7.5	7.5	7.3	0.0	0.1	0.1
France	0.3	1.0	1.4	1.0	1.0	1.1	-1.7	-1.5	-1.3	-4.1	-3.6	-3.1
Italy	-1.8	0.6	1.1	1.3	0.7	1.2	0.8	1.2	1.2	-3.0	-2.9	-2.6
Spain	-1.2	0.7	1.5	1.5	0.5	1.1	0.7	2.1	2.5	-6.6	-5.8	-4.5
Netherlands	-0.8	0.9	1.4	2.6	0.5	1.2	10.3	10.5	11.0	-3.9	-3.1	-2.9
Belgium	0.2	1.4	1.6	1.2	1.1	1.5	-2.5	-2.0	-1.0	-2.7	-2.5	-2.6
Austria	0.4	1.4	1.8	2.1	1.5	1.7	3.0	3.6	3.7	-1.7	-2.8	-1.5
Finland	-1.4	0.3	1.4	2.2	1.6	1.8	-0.8	0.0	0.3	-2.0	-2.1	-1.6
Greece	-3.9	1.0	2.2	-0.9	-0.8	0.1	0.5	1.0	1.5	-13.1	-1.6	-0.9
Portugal	-1.4	1.4	1.1	0.4	0.3	0.9	0.5	1.0	2.0	-5.8	-4.2	-3.0
Ireland	-0.3	1.8	2.2	0.5	0.5	1.2	7.0	7.0	7.0	-7.2	-4.7	-2.6
United Kingdom	1.8	2.9	2.2	2.6	1.6	1.8	-3.6	-2.7	-2.6	-5.8	-4.7	-3.8
Denmark	0.4	1.4	1.5	0.8	1.4	1.8	7.2	6.5	6.5	0.0	-1.5	-2.0
Norway	2.1	2.5	2.6	2.1	1.9	2.1	10.6	11.5	11.5	7.6	9.5	10.5
Sweden	1.5	2.7	3.0	0.0	0.5	1.8	6.2	5.6	5.5	-3.6	-1.6	-0.8
Switzerland	2.0	1.8	2.0	-0.2	0.4	0.8	12.5	12.5	12.5	0.2	0.0	0.0
Canada	2.0	2.6	2.9	0.9	1.8	2.3	-3.0	-2.5	-1.9	-1.0	-0.8	-0.1
Australia	2.4	3.5	3.3	2.4	3.0	2.6	-2.9	-3.0	-2.7	-2.1	-2.3	-1.4
New Zealand	2.7	3.6	2.4	1.1	1.7	2.2	-3.4	-2.9	-5.3	-1.4	-0.1	0.8
EEMEA	2.3	2.0	3.2	4.9	5.1	5.0	0.7	0.5	0.0	-1.5	-1.1	-2.0
Czech Republic	-0.9	2.0	2.5	1.4	1.1	2.0	-0.6	-1.0	-1.4	-3.0	-2.8	-2.7
Egypt	2.1	3.0	4.2	6.9	9.9	10.4	-2.2	-0.4	-2.9	-14.7	-13.2	-14.3
Hungary	1.1	1.9	2.0	1.7	0.5	2.3	2.1	2.0	1.5	-2.5	-2.9	-2.7
Israel	3.3	3.7	4.2	1.5	1.6	2.2	2.5	2.0	2.6	-3.6	-3.0	-2.5
Kazakhstan	6.0	4.8	5.2	5.8	5.1	6.3	0.1	2.0	1.5	5.3	4.8	3.3
Poland	1.6	3.0	3.9	0.9	1.7	2.3	-1.5	-2.2	-1.9	-4.8	4.0	-3.1
Romania	3.5	2.8	3.2	4.0	2.0	3.3	-1.1	-2.0	-2.1	-2.5	-2.2	-1.9
Russia	1.3	0.6	2.2	6.8	6.2	4.9	1.5	2.0	1.6	-0.5	-0.6	-1.0
Saudi Arabia	3.8	4.4	4.1	3.8	3.6	3.5	17.4	8.7	6.7	7.4	2.5	2.0
South Africa	1.9	2.7	3.5	5.8	6.0	5.6	-6.0	-4.0	-3.9	-4.0	-4.0	-3.5
Turkey	4.0	2.2	3.8	7.5	8.1	7.8	-7.9	-5.9	-6.2	-2.1	-2.6	-2.6
Ukraine	0.0	-4.9	2.5	-0.3	2.8	5.8	-9.2	-5.9	-4.4	-4.5	-2.5	-2.2
United Arab Emirates	4.9	3.4	3.4	1.1	2.5	2.5	18.0	14.5	13.4	9.5	7.1	7.4
Asia (ex-Japan)	5.9	6.4	6.7	4.1	3.4	4.0	1.6	1.7	1.4	-2.4	-2.3	-2.0
China	7.7	7.8	8.0	2.6	2.2	3.0	2.0	2.2	2.3	-2.0	-2.0	-1.5
Hong Kong	2.9	4.2	4.5	4.3	3.5	3.2	-0.9	3.7	2.8	0.6	2.6	3.4
India	3.9	5.5	6.0	10.1	6.4	6.7	-2.6	-2.5	-3.0	-4.6	-4.5	-4.2
Indonesia	5.8	5.2	5.5	4.0	6.4	6.4	-3.3	-3.0	-2.7	-2.2	-2.4	-2.6
Korea	2.8	3.9	3.6	1.3	1.9	2.8	5.9	4.1	2.8	-0.7	-0.1	0.1
Malaysia	4.7	5.5	5.6	2.1	3.1	2.9	3.8	4.3	5.5	-3.9	-3.8	-3.4
Philippines	7.2	6.8	6.8	2.9	4.3	3.8	5.4	4.8	3.4	-1.4	-2.4	-2.2
Singapore	4.1	3.5	4.5	2.4	2.5	3.5	14.7	15.5	14.5	7.3	6.9	6.8
Sri Lanka	7.3	7.5	7.5	6.9	5.5	7.1	-2.1	-1.9	-2.0	-5.8	-5.5	-5.0
Taiwan	2.2	3.7	3.4	0.8	0.9	1.2	11.2	10.2	9.1	-2.3	-1.5	-0.8
Thailand	2.9	3.5	4.5	2.2	2.9	2.3	0.1	1.0	0.3	-3.0	-3.2	-3.3
Vietnam	5.4	5.8	6.3	6.6	7.0	9.8	3.2	2.0	-3.1	-6.0	-6.2	-5.5
Latin America	2.3	2.1	2.9	8.9	12.4	11.3	-2.5	-2.4	-2.3	-3.5	-4.0	-3.8
Argentina	2.4	-2.1	1.9	24.9	39.8	29.4	-1.1	0.1	0.4	-4.5	-4.8	-4.3
Brazil	2.3	1.7	1.7	5.9	6.0	5.5	-3.6	-3.5	-3.5	-3.2	-3.9	-3.5
Chile	4.1	3.8	4.1	1.9	3.5	3.0	-3.2	-3.7	-3.3	-0.6	-1.0	-0.8
Colombia	4.3	4.5	4.3	2.0	2.7	3.3	-2.6	-2.8	-3.0	-2.4	-2.3	-2.2
Mexico	1.1	3.1	3.7	3.8	4.0	3.8	-1.8	-2.1	-2.2	-2.9	-4.0	-3.6
Peru	5.2	6.0	6.5	2.5	2.7	2.9	-5.0	-4.8	-4.5	1.0	0.6	0.5
Venezuela	1.5	0.5	3.5	40.0	65.0	70.0	1.6	1.8	2.6	-14.3	-11.5	-13.5
G7	1.3	2.3	2.8	1.3	1.9	2.0						
Advanced economies	1.2	2.2	2.6	1.4	1.8	1.9						
EM economies	4.5	4.7	5.3	5.1	5.3	5.4						
Global	2.8	3.4	3.9	3.2	3.5	3.6						

QUARTERLY GDP	(% qoq annualised)											
	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014F	Q2 2014F	Q3 2014F	Q4 2014F	Q1 2015F	Q2 2015F	Q3 2015F	Q4 2015F
USA	1.1	2.5	4.1	2.6	3.1	3.2	3.5	3.7	3.8	4.0	4.0	4.0
Japan	4.5	4.1	0.9	0.7	2.4	-7.0	4.7	1.3	2.0	2.3	2.2	-2.7
Euroland	-0.9	1.3	0.6	1.1	1.2	1.2	1.5	1.2	1.6	1.6	1.7	2.0
Germany	0.0	2.9	1.3	1.5	2.0	1.0	1.4	1.6	2.0	1.7	1.6	1.9
France	-0.2	2.3	-0.2	1.2	0.7	1.2	1.8	1.3	1.2	1.2	1.5	1.5
Italy	-2.4	-1.1	-0.5	0.3	1.0	1.2	1.1	1.1	1.0	1.1	1.1	1.1
United Kingdom	1.6	3.0	3.4	2.9	3.3	2.8	2.3	2.0	2.1	2.4	2.0	2.3
Canada	2.9	2.2	2.7	2.9	1.9	2.8	3.6	3.2	2.0	2.9	3.1	3.2
G7	1.3	2.6	2.7	2.0	2.6	1.2	3.1	2.6	2.8	3.0	3.0	2.3

Source: Deutsche Bank Research, National Statistical Authorities

Interest Rates (End of Period)

	3M rate				10Y rate				Official rate			
	Current	Q2-2014	Q3-2014	Q1-2015	Current	Q2-2014	Q3-2014	Q1-2015	Current	Q2-2014	Q3-2014	Q1-2015
US	0.23	0.35	0.35	0.35	2.68	2.50	3.00	3.25	0.13	0.13	0.13	0.25
Japan	0.21	0.20	0.20	0.20	0.63	0.60	0.70	0.80	0.10	0.10	0.10	0.10
Euroland	0.31	0.35	0.38	0.40	1.54	1.85	2.05	2.35	0.25	0.25	0.25	0.25
United Kingdom	0.52	0.52	0.52	0.52	2.68	2.90	3.00	3.30	0.50	0.50	0.50	0.50
Denmark	0.30	0.40	0.45	0.55	1.57	1.90	2.10	2.45	0.20	0.20	0.20	0.30
Norway	1.71	1.75	1.85	2.05	2.87	3.10	3.20	3.30	1.50	1.50	1.50	1.50
Sweden	0.87	0.95	1.00	1.15	2.11	2.40	2.55	2.80	0.75	0.75	0.75	0.75
Switzerland	0.02	0.05	0.05	0.05	0.91	1.10	1.25	1.45	0.00	0.00	0.00	0.00
Canada	1.07	1.00	1.03	1.33	2.43	3.00	3.30	3.80	1.00	1.00	1.00	1.25
Australia	2.69	2.63	2.63	2.63	4.07	4.50	4.50	4.50	2.50	2.50	2.50	2.50
New Zealand	3.20	3.45	3.49	3.95	4.57	5.00	5.00	5.00	2.75	3.25	3.25	3.75

EM ECONOMIES OFFICIAL RATES

	Current	Q2-2014	Q3-2014	Q1-2015
EEMEA				
Czech Republic	0.05	0.05	0.05	0.05
Hungary	2.60	2.60	2.60	3.25
Israel	0.75	0.75	0.75	1.25
Kazakhstan	5.50	5.50	5.50	5.50
Poland	2.50	2.50	2.50	3.50
Romania	3.50	3.50	3.50	3.75
Russia	7.00	7.00	6.50	6.00
South Africa	5.50	6.00	6.00	6.00
Turkey	10.00	10.00	10.00	10.00
Ukraine	6.50	6.50	6.50	6.50
Asia (ex-Japan)				
China	3.00	3.00	3.00	3.00
Hong Kong	0.50	0.50	0.50	0.50
India	8.00	8.00	7.75	7.50
Indonesia	7.50	7.50	8.00	8.00
Korea	2.50	2.50	2.50	2.75
Malaysia	3.00	3.00	3.25	3.25
Philippines	5.50	5.75	6.00	6.25
Singapore	0.40	0.70	0.80	1.00
Sri Lanka	8.00	8.00	8.00	9.00
Taiwan	1.88	1.88	1.88	2.00
Thailand	2.00	2.00	2.00	2.50
Vietnam	6.50	7.00	7.00	8.00
Latin America				
Argentina	29.00	29.00	30.00	33.00
Brazil	10.75	11.00	11.00	11.50
Chile	4.00	4.00	4.00	4.50
Colombia	3.25	3.50	3.75	4.00
Mexico	3.50	3.50	3.50	4.25
Peru	4.00	4.00	4.25	4.50
Venezuela	20.60	25.00	25.00	20.00

Source: Deutsche Bank Research, Bloomberg Finance LP; as of March 28

Exchange Rates (End of Period)

	FX Rate (vs. US Dollar)				FX Rate (vs. Euro)				FX Rate (vs. Yen)			
	Current	Q2-2014	Q3-2014	Q1-2015	Current	Q2-2014	Q3-2014	Q1-2015	Current	Q2-2014	Q3-2014	Q1-2015
US					1.37	1.32	1.29	1.21	102	109	112	117
Japan	102	109	112	117	140	144	144	142				
Euroland	1.37	1.32	1.29	1.21					140	144	144	142
United Kingdom	1.66	1.61	1.59	1.52	0.83	0.82	0.81	0.80	170	175	178	178
Denmark	5.43	5.65	5.81	6.17	7.47	7.46	7.46	7.46	18.8	19.3	19.3	19.0
Norway	6.00	6.29	6.38	6.64	8.25	8.30	8.20	8.04	17.0	17.3	17.6	17.6
Sweden	6.47	6.59	6.67	6.90	8.90	8.70	8.58	8.35	15.8	16.5	16.8	17.0
Switzerland	0.89	0.95	0.98	1.05	1.22	1.25	1.26	1.27	115.1	115.1	114.2	111.5
Canada	1.10	1.15	1.17	1.20	1.51	1.52	1.50	1.45	92.8	94.8	95.7	97.5
Australia	0.93	0.87	0.86	0.82	1.48	1.52	1.49	1.48	94.7	94.8	96.3	95.9
New Zealand	0.87	0.81	0.80	0.77	1.58	1.63	1.62	1.58	88.8	88.3	89.0	89.5
EEMEA												
Czech Republic	19.9	20.5	21.0	22.3	27.4	27.0	27.0	27.0	5.1	5.3	5.3	5.2
Hungary	225.7	229.6	231.5	239.3	310.3	303.1	297.5	289.5	0.5	0.5	0.5	0.5
Israel	3.50	3.43	3.39	3.33	4.81	4.53	4.36	4.03				
Kazakhstan	182.1	156.7	175.0	185.0	250.2	206.8	224.9	223.9				
Poland	3.03	3.10	3.15	3.29	4.17	4.10	4.05	3.98	33.7	35.1	35.6	35.6
Romania	3.24	3.37	3.43	3.53	4.45	4.45	4.40	4.28				
Russia	35.7	36.8	36.6	35.0	49.09	48.6	47.0	42.4				
South Africa	10.6	11.5	11.0	10.2	14.6	15.2	14.1	12.3				
Turkey	2.19	2.35	2.30	2.35	3.01	3.10	2.96	2.84				
Ukraine	11.05	9.50	9.60	9.75	15.18	12.54	12.34	11.80				
Asia (ex-Japan)												
China	6.21	6.08	6.03	5.98	8.53	8.03	7.75	7.24	16.5	17.9	18.6	19.6
Hong Kong	7.76	7.78	7.80	7.78	10.66	10.27	10.02	9.41	13.2	14.0	14.4	15.0
India	60.12	62.10	61.00	61.97	82.63	81.97	78.39	74.98	1.7	1.8	1.8	1.9
Indonesia	11,384	11,500	11,600	11,800	15,647	15,180	14,906	14,278	0.01	0.01	0.01	0.01
Korea	1,069	1,085	1,070	1,065	1,470	1,432	1,375	1,289	0.10	0.10	0.10	0.11
Malaysia	3.27	3.32	3.33	3.21	4.50	4.38	4.27	3.88	31.2	32.8	33.7	36.5
Philippines	45.0	44.4	44.8	43.7	61.8	58.6	57.5	52.9	2.3	2.5	2.5	2.7
Singapore	1.26	1.28	1.28	1.29	1.73	1.69	1.64	1.56	80.9	85.2	87.5	90.7
Sri Lanka	130.6	130.3	130.3	130.0	179.52	172.00	167.44	157.30	0.8	0.8	0.9	0.9
Taiwan	30.50	29.90	29.80	29.65	41.92	39.47	38.29	35.88	3.4	3.6	3.8	3.9
Thailand	32.54	32.50	32.30	32.00	44.72	42.90	41.51	38.72	3.1	3.4	3.5	3.7
Vietnam	21,084	21,500	21,700	22,000	28,980	28,380	27,885	26,620	0.005	0.005	0.005	0.005
Latin America												
Argentina	8.00	8.84	9.30	10.60	11.00	11.67	11.95	12.83				
Brazil	2.26	2.45	2.50	2.50	3.10	3.23	3.21	3.03				
Chile	552	575	580	595	759	759	745	720				
Colombia	1,964	2070	2000	2020	2,700	2,732	2,570	2,444				
Mexico	13.08	13.00	12.95	12.88	17.98	17.16	16.64	15.58				
Peru	2.81	2.86	2.82	2.84	3.86	3.78	3.62	3.44				
Venezuela	6.29	6.30	6.30	9.30	8.65	8.32	8.10	11.25				

Source: Deutsche Bank Research, Bloomberg Finance LP, Datastream; as of March 28

Long-term Forecasts

	GDP growth, % yoy							CPI inflation, % yoy						
	2012	2013	2014F	2015F	2016F	2017F	2018F	2012	2013	2014F	2015F	2016F	2017F	2018F
Advanced economies														
US	2.8	1.9	3.2	3.8	3.0	2.8	2.7	2.1	1.5	2.1	2.3	2.5	2.6	2.3
Japan	1.4	1.5	0.4	1.4	1.2	1.3	1.3	-0.1	0.4	3.0	1.7	2.0	0.7	0.7
Euroland	-0.6	-0.4	1.1	1.5	1.5	1.6	1.7	2.5	1.4	0.8	1.3	1.6	1.8	1.9
United Kingdom	0.3	1.8	2.9	2.2	2.2	2.2	2.2	2.8	2.6	1.6	1.8	2.0	2.0	2.0
Canada	1.7	2.0	2.6	2.9	2.3	2.4	2.5	1.5	0.9	1.8	2.3	2.0	2.0	2.0
Australia	3.6	2.4	3.5	3.3	4.3	3.3	3.3	1.8	2.4	3.0	2.6	2.7	2.5	2.5
EM economies														
Russia	3.4	1.3	0.6	2.2	3.3	3.5	3.8	5.1	6.8	6.2	4.9	5.2	4.7	4.2
South Africa	2.5	1.9	2.7	3.5	3.9	3.7	3.5	5.7	5.8	6.0	5.6	5.0	5.0	5.0
China	7.7	7.7	7.8	8.0	8.0	7.5	7.5	2.6	2.6	2.2	3.0	3.0	3.0	3.0
India	5.1	3.9	5.5	6.0	6.5	7.0	7.0	9.7	10.1	6.4	6.7	7.0	7.0	7.0
Indonesia	6.2	5.8	5.2	5.5	5.5	5.5	6.0	5.4	4.0	6.4	6.4	6.0	6.0	6.0
Brazil	1.0	2.3	1.7	1.7	2.5	2.7	3.2	5.8	5.9	6.0	5.5	5.0	5.0	5.0

	GDP per head, % yoy							Population growth, % yoy						
	2012	2013	2014F	2015F	2016F	2017F	2018F	2012	2013	2014F	2015F	2016F	2017F	2018F
Advanced economies														
US	2.1	1.1	2.4	3.0	2.2	2.0	1.9	0.7	0.8	0.8	0.8	0.8	0.8	0.8
Japan	1.7	1.7	0.6	1.6	1.6	1.7	1.8	-0.2	-0.2	-0.2	-0.3	-0.3	-0.4	-0.5
Euroland	-0.9	-0.9	0.6	1.0	1.0	1.1	1.2	0.3	0.5	0.5	0.5	0.5	0.5	0.5
United Kingdom	-0.3	1.2	2.4	1.6	1.6	1.6	1.7	0.6	0.6	0.6	0.6	0.6	0.6	0.5
Canada	0.6	0.9	1.5	1.9	1.3	1.5	1.6	1.1	1.1	1.1	1.0	1.0	0.9	0.9
Australia	1.8	0.6	1.8	1.7	2.6	1.6	1.7	1.8	1.8	1.8	1.7	1.6	1.6	1.6
EM economies														
Russia	3.6	1.5	0.6	2.3	3.4	3.6	3.9	-0.2	-0.2	0.0	-0.1	-0.1	-0.1	-0.1
South Africa	1.4	0.6	1.7	2.5	2.9	2.7	2.5	1.2	1.3	1.0	1.0	1.0	1.0	1.0
China	7.2	7.2	7.3	7.6	7.5	7.0	7.0	0.5	0.5	0.5	0.4	0.5	0.5	0.5
India	3.6	2.4	4.0	4.5	5.0	5.5	5.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Indonesia	5.0	4.6	4.0	4.3	4.3	4.3	4.8	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Brazil	0.0	1.3	0.7	1.2	1.2	1.4	1.9	1.0	1.0	1.0	0.5	1.3	1.3	1.3

	Key official interest rate, % (eop)							10Y bond yields (eop)						
	2012	2013	2014F	2015F	2016F	2017F	2018F	2012	2013	2014F	2015F	2016F	2017F	2018F
Advanced economies														
US	0.13	0.13	0.13	1.50	3.50	4.50	4.50	1.76	3.04	3.25	3.35	3.50	3.50	3.50
Japan	0.10	0.10	0.10	0.10	0.10	0.50	0.75	0.75	0.64	0.70	0.90	1.10	1.20	1.40
Euroland	0.75	0.25	0.25	0.25	0.75	1.75	2.75	1.35	1.93	2.25	2.75	3.25	3.50	3.50
United Kingdom	0.50	0.50	0.50	1.00	2.00	2.50	3.00	1.82	2.86	3.10	3.75	4.00	4.25	4.50
Canada	1.00	1.00	1.00	2.50	3.75	4.00	4.00	1.80	2.78	3.60	4.50	5.50	5.50	5.50
Australia	3.00	2.50	2.50	2.50	3.00	4.00	5.00	3.27	4.24	4.50	4.50	4.50	4.50	4.50
EM economies														
Russia	5.50	5.50	6.00	6.00	5.25	6.00	6.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
South Africa	5.00	5.00	6.00	7.50	7.00	7.50	7.50	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
China	3.00	3.00	3.00	3.50	3.25	3.25	3.25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
India	8.00	7.75	7.50	8.00	8.00	8.00	8.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia	5.75	7.50	8.00	7.00	7.00	7.00	7.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Brazil	7.25	10.00	11.00	12.00	n.a	n.a	n.a	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

	FX rate vs. USD (eop)							FX rate vs. EUR (eop)						
	2012	2013	2014F	2015F	2016F	2017F	2018F	2012	2013	2014F	2015F	2016F	2017F	2018F
Advanced economies														
US	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.32	1.38	1.25	1.10	1.05	1.00	1.10
Japan	86.55	105.30	115.00	120.00	115.00	110.00	107.00	114	145	144	132	121	110	118
Euroland	1.32	1.38	1.25	1.10	1.05	1.00	1.10	1.00	1.00	1.00	1.00	1.00	1.00	1.00
United Kingdom	1.61	1.65	1.56	1.38	1.44	1.44	1.44	0.82	0.84	0.80	0.80	0.73	0.69	0.76
Canada	0.99	1.06	1.18	1.25	1.10	1.10	1.07	1.31	1.46	1.48	1.38	1.16	1.10	1.18
Australia	1.04	0.89	0.85	0.75	0.70	0.70	0.70	1.27	1.54	1.47	1.47	1.50	1.43	1.57
EM economies														
Russia	30.53	32.84	35.60	35.50	34.41	34.70	34.90	40.24	45.22	44.50	39.05	36.13	34.70	38.39
South Africa	8.50	10.49	10.50	9.30	10.00	10.70	11.40	11.21	14.44	13.13	10.23	10.50	10.70	12.54
China	6.29	6.10	6.00	5.90	5.82	5.75	5.70	8.29	8.39	7.50	6.49	6.11	5.75	6.27
India	54.78	61.90	61.00	63.00	65.00	66.00	65.50	72.21	85.23	76.25	69.30	68.25	66.00	72.05
Indonesia	9670	12270	11700	12000	11500	11000	11000	12747	16895	14625	13200	12075	11000	12100
Brazil	2.05	2.35	2.50	2.55	2.63	2.71	2.79	2.70	3.24	3.13	2.81	2.76	2.71	2.79

Source: National Authorities, Deutsche Bank Research

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Appendix 1

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