Deutsche Bank
Research

Global

Cross-Discipline

Date
9 December 2014

Peter Hooper
Chief Economist
(+1) 212 250-7352
peter.hooper@db.com

Michael Spencer
Chief Economist
(+852) 2203 8303
michael.spencer@db.com

Mark Wall
Chief Economist
(+44) 20 754-52087
mark.wall@db.com

World Outlook 2015

Filling the tank before liftoff

Table of Contents

Global Overview: Filling the tank before liftoff

- Steady increases in the global supply of oil have reduced petroleum product prices to levels that are now modestly boosting the expansion of economic activity in many regions of the world. As oil prices recede further in the near term before trending gradually upward, we see global economic growth rising to a moderate 3.6% pace in 2015 and a bit further in 2016.
- In the US, where activity has been advancing at above-trend rates and the labor market has improved faster than expected, plentiful oil supplies should help keep this performance on track. On balance, the strengthening of the US labor market has supported our expectations that the Fed will begin to lift interest rates in June.
- The slow pace of recovery in core US price inflation, which has been restrained on the margin by the plunge in oil prices, means that the Fed can still be patient and allow momentum to build further in the real economy before taking off with rate increases at midyear on what we expect to be a relatively gradual path of ascent over the balance of 2015 and into 2016.
- We see growth in Europe and Japan picking up over the next two years—the former at relatively sluggish rates, and the latter to somewhat above trend rates. Economic slack and commodity disinflation will likely move inflation in the euro area low enough to cause the ECB to engage in "public QE" by the end of Q1. The BOJ will continue to push towards its 2% inflation goal, and we expect these developments to help weaken the euro and yen significantly further.
- Our global growth forecast has been marked down a few tenths since the September forecast, despite the surprising drop in oil prices, largely because of downward revisions in China, Russia, Brazil, and other EM economies. Most important is the downward revision to China, where we now see increased negative spillover from past overinvestment in property and the government focused on a more sustainable 7% rate of growth.
- We see global inflation moving sideways, with that in advanced economies rising, toward more desirable levels led by the US, Japan, and eventually the euro area. Emerging market inflation should recede toward more desirable levels, partly as a result of some policy-induced economic slowdowns and disinflationary commodity market pressures.
- The cross-currents of declining oil prices, ECB public QE, and Fed liftoff will add volatility to financial markets over the year ahead. Our equity strategists see the stock market affected less favorably than the overall economy by falling oil prices, as earnings projections have been marked down substantially in the energy sector. They also anticipate a pothole around the Fed's liftoff, but nevertheless see the S&P500 up modestly to 2150 by end-2015.
- The rates market too will face some tough sledding, with the 10-year Treasury yield expected to rise to 2.8% by a year from now. The drop in oil prices and Fed liftoff are expected to depress the US credit market, while lower oil prices give MBS a lift via improvements in household cash flow. Euro-area credit will be helped, though, by ECB action. The relative stances of central bank policies are expected to move the euro through 1.15 and the yen through 125 a year from now.

Introduction and Summary[1]

As 2014 draws to a close, investors find themselves having to digest an unanticipated but favorable commodity shock while they steel themselves for an increasingly likely Fed liftoff in the year ahead. Global markets have been rocked in recent weeks and months by a largely supply-driven plunge in oil prices. Analysts at the Fed and elsewhere have suggested that this development has potentially important implications for global growth and inflation. The effective wealth transfer from higher saving oil producers to lower saving oil consumers means a possibly significant net boost to global growth during 2015. At the same time, global inflation trends will be slowed and undesirable disinflation trends exacerbated, for a time. These inflation impacts in particular raise questions about central bank responses. Will these developments cause the Fed to delay (or even speed up) liftoff, will the ECB accelerate its expected move toward sovereign debt purchases, and will the BOJ raise its QE purchases yet another notch?

The immediate response of the rates market to the latest drop in oil prices following OPEC's recent failure to agree on production cuts suggested that investors expected the oil price decline to have lasting disinflationary effects and that central bank tightening would be delayed or easing prolonged. We maintain, to the contrary, that the negative impact on inflation will be temporary, limited primarily to headline (not core) inflation, and will have relatively little effect on central bank policy. Indeed, as we look beyond the next six months (during which the bulk of the oil shock effects on consumer price inflation will be felt), we see inflation pressures rising in important corners of the global economy. The US labor market, helped a bit by the boost from lower oil prices, will be tightening enough to induce significant further increases in wage pressures that have already shown tentative signs of emerging. Japan's underlying inflation should be making significant further progress toward the BOJ's 2% objective, and the ECB should have succeeded in engineering a turnaround (albeit a slow one) in that region's recent negative inflation trends with the help of a broad-based asset purchase programme, including sovereign QE. We expect this to be announced by end Q1 2015.

In what follows, we begin by analyzing sources of the recent plunge in oil prices and the prognosis for the oil market going forward. We then turn to a summary assessment of the outlook for growth, inflation, and monetary policy globally in each of the major regions of the world, with a special focus on the effects of the roughly 30% drop in our oil price assumption/projection since the September World Outlook. Finally, we review prospects for various global financial markets and how they have been influenced by the shift in oil prices based on the views of our market strategists, as well as how they are likely to be affected by the Fed's anticipated move towards rate hikes later this year.

Our analysis and projections suggest that the oil shock will prove to be a relatively mild one, with only limited net positive effects on global growth, and temporary reductions in headline, not core, inflation. We do not expect these effects to influence significantly the timing or magnitude of impending policy actions by the major central banks. As we enter a new year, attention will turn increasingly to the critically important liftoff to come. The US economy appears to be making enough progress to allow the Fed to begin raising rates, gently, around mid-2015, and to pursue a cautious ascent thereafter. This will be a seminal event for the markets—some disruption seems inevitable as tail expectations of zero rates in perpetuity are reined in. But overall, we expect the traditional key areas of vulnerability—emerging markets, risk assets -- to handle this adjustment reasonably well. The bump in the road should be no

[1] The Authors are grateful to Stefan B. Schneider for his production and editing of this report.

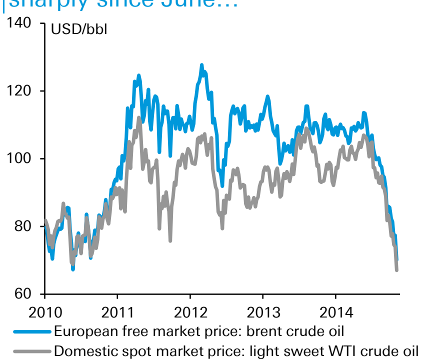
bigger than the taper tantrum, and quite possibly smaller given the adjustment that occurred in the wake of the announcement that new QE flow would be gradually terminated. In any event, the Fed has made it clear that the ascent in rates will be cautious initially and very much conditioned by how the markets and the economy are responding.

This baseline view is not without its risks and uncertainties. In the US, low oil prices and the stronger dollar could hit inflation and business investment more negatively than we assume, causing the Fed to delay liftoff. On the other hand, with the US labor market tightening briskly, wage and price inflation pressures could mount more rapidly, causing the Fed to tighten more aggressively, with attendant disruptions in financial markets. The risks in Europe next year rotate around sticky low inflation, the cohesiveness of the ECB Council as it responds with ever more controversial policies, tensions around the lack of progress on fiscal consolidation and structural reform, and a series of elections likely to show rising populism and anti-EU sentiment, including probably in Greece in Q1. In emerging markets, three key areas of uncertainty come to mind. Most important is the extent to which the recovery in US and European demand will be reflected in rising EM exports. Has export growth been restrained by structural factors or by uneven and unusually weak G3 growth? The second factor is political: the conflict in Ukraine has already exerted a strong negative impulse on EEMEA growth. Thirdly, we point again to the risks inherent in China's attempt to de-lever its economy without precipitating a collapse in property prices and growth.

Oil prices: Recent developments and prospects

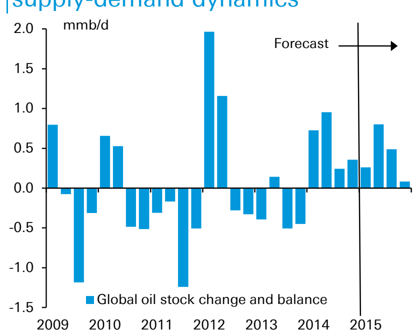
Since their recent peaks in June of this year, Brent and WTI oil prices have each fallen by almost 40%, recently reaching price levels not observed since 2009 and 2010 when the global economy was emerging from the global financial crisis (Figure 1). While downgrades to oil demand growth, particularly in the euro area and China, contributed to this sharp decline, the primary catalyst for this sell-off has been developments on the supply side of the market. Growth in oil supply, especially from non-OPEC sources, has sharply outpaced global oil demand growth (Figure 2). The softening of global GDP growth over the past year has contributed as well, though less importantly.

Figure 1: Oil prices have fallen sharply since June…



Source: FT, EIA/CME, Deutsche Bank Research

Figure 2: …As a result of changing supply-demand dynamics



Source: IEA, Deutsche Bank Research

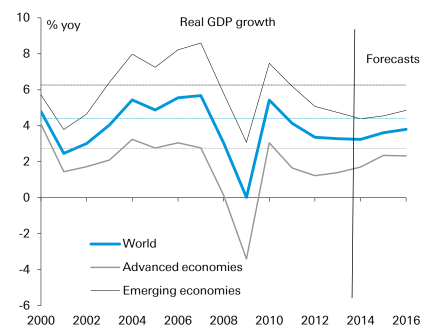
OPEC's recent decision to not adjust quota levels signals a continuation of these supply-demand imbalances into 2015 and possibly beyond, even as global growth is projected to turn up again. Absent a shift in these trends, expansion of non-OPEC oil supply is set to outstrip growth in global oil demand through 2015 and into 2016, resulting in the most severe mismatch between global oil supply and demand since the late 1990s. However, our commodity team finds that this outcome would push prices low enough (moving WTI below USD60) to trigger significant cuts in supply in the US and OPEC. Indeed, they expect OPEC to cut production by around 1.5mmbd in H1 2015 as prices move into the mid-60s, helping to tighten oil market fundamentals. At the same time, growth in the demand for oil should pick up in 2015 as global economic activity accelerates, albeit moderately, in line with our forecast. These dynamics suggest that while oil prices will likely remain low in the near-term, they should bottom in H1 2015 and rise gradually in H2 2015 and further out. In brief, we see WTI and Brent prices averaging USD67.5 and USD72.5 in 2015, respectively, and rising to USD79 and USD84 in 2017. These forecasts are down notably from our last World Outlook publication, when we forecasted WTI and Brent prices to average USD92.3 and USD103.3 in 2015. The implications of this shift in the energy price outlook for economic growth, central bank policies, financial markets, and especially prospects for inflation, are the focal point of this quarter's overview, and represent the common theme running throughout this document.

Economic outlook

Global economic activity to accelerate but remain below pre-crisis trends

Global growth is expected to bottom at a relatively subdued rate of 3.2% in 2014 and rise slowly over the next two years (Figure 3). This anticipated acceleration is broad-based, with growth rates rising in both the advanced and emerging market economy aggregates, although the pickup in advanced economy growth is more pronounced. The improvement in growth prospects is also broad-based within these aggregates, as economic activity is expected to accelerate across the G7, Asia (ex-Japan), and Latin America, with EEMEA the only notable region where growth is expected to fall in 2015. Within the advanced economies, growth is projected to rise by about 1 percentage point in the US and Japan next year – although the latter is relative to a sharp downward revision to growth in 2014, while economic activity in the euro area is expected to accelerate more gradually. The growth outlook in emerging market economies is more varied, with growth expected to fall in China and Russia in 2015, but rise sharply in India and Brazil, albeit from subdued growth rates this year.

Figure 3: Growth rebounding but remaining below trend



Source: IMF, Haver Analytics, Deutsche Bank Research
Note: Trends are based on pre-crisis average from 1999 to 2007.

The projected pickup in global growth is relatively modest and leaves the global economy expanding at below its elevated pre-crisis trend growth rate through 2016. We estimate that global potential growth has moved below its pre-crisis trend, especially for emerging economies. Advanced economy growth is expected to move above potential in 2015 and remain above potential in 2016, allowing for a meaningful reduction in slack in these economies (on average) over the next two years. Emerging market economies, on the other hand, are expected to recover to growth rates more in line with underlying trends that have been reduced by negative demographic trends in some key countries (most notably China).

Global and EM growth revised down since September WO

Despite the favorable movement in oil prices and their presumably net beneficial effects on economic activity, we have marked down our outlook for global growth since we last updated our view in September (Figure 4). This may be a testament to the relatively modest size of those net oil effects. In any event, we have reduced global growth by a few tenths of a percentage point in 2015 and 2016, relative to last quarter's forecasts. The downward revisions are driven entirely by markdowns to emerging market growth prospects, which were reduced by more than 1/2 percentage points over the next two years. These downgrades were broad-based across regions, with three of the BRICs, Russia, China, and Brazil (in that order) recording the largest and most important downward revisions. Conversely, our growth forecast for advanced economies in the aggregate is essentially unchanged since September, with modest revisions to growth in the US, Japan, and the euro area going in different directions and largely offsetting one another. We discuss the impact of oil price developments on the revisions to our outlook for each of the key regions (as well as any reinforcing or offsetting factors that contributed to forecast revisions) in more detail below.

Figure 4: Global GDP growth forecast & revision (% yoy)

	Forecast level Dec' 14 WO			Forecast change since Sep' 14 WO*		
	2014F	2015F	2016F	2014F	2015F	2016F
G7	1.8	2.5	2.4	-0.1	0.0	0.0
US	2.4	3.5	3.1	0.1	0.1	-0.1
Japan	0.5	1.4	1.6	-0.6	0.1	0.2
Euro area	0.8	1.0	1.3	0.0	-0.1	-0.1
Asia (ex-Japan)	6.0	6.2	6.1	-0.3	-0.7	-0.7
China	7.3	7.0	6.7	-0.5	-1.0	-1.3
India	5.5	6.5	6.5	0.0	0.0	0.0
EEMEA	2.3	1.9	2.5	0.4	-0.8	-0.4
Russia	0.5	-0.9	-0.4	0.0	-1.9	-1.8
Latin America	0.8	1.5	2.9	-0.2	-0.6	-0.1
Brazil	0.1	0.7	1.9	-0.2	-0.5	0.0
Advanced economies	1.7	2.4	2.3	0.0	0.0	0.0
EM economies	4.4	4.5	4.9	-0.2	-0.7	-0.6
Global	3.2	3.6	3.8	0.0	-0.3	-0.2

*Note: * September World Outlook forecast have been recalculated using IMF October WEO PPP weights; also Nigeria has been included (as part of EMEA) in the aggregation from this edition*
Source: Deutsche Bank Research

Global growth forecast consistent with IMF and Bloomberg

Our marked-down forecasts for global growth in 2015 and 2016 are in line with the latest forecasts from the IMF and Bloomberg (using similar aggregation methodologies) (Figure 5). However, these similarities mask a significant divergence in views within the G3. Indeed, our forecast for growth in the US economy in 2015 is about 0.5 percentage points above alternative forecasts from the IMF, Bloomberg, and Consensus Economics, while our expectations for US growth in 2016 are consistent with these alternative forecasts. Conversely, our forecasts for growth in the euro area are a few tenths below these alternatives each of the next two years.

Figure 5: Consensus forecast table, GDP growth, %

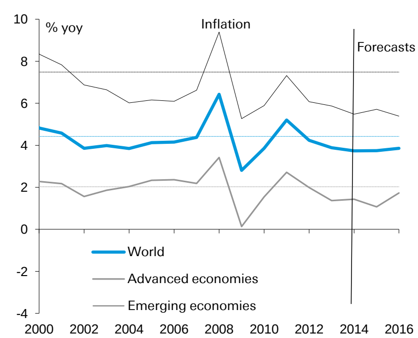
		2014F	2015F	2016F
Global	DB (Sep'14 WO)*	3.2	3.9	4.0
	DB (Current)	3.2	3.6	3.8
	Bloomberg (Nov Survey)	3.1	3.5	3.7
	Bloomberg (DB aggregation)**	3.2	3.6	3.8
	IMF (Oct)	3.3	3.8	4.0
	IMF (DB aggregation)	3.2	3.7	3.9
US	DB (Sep'14 WO)	2.3	3.4	3.1
	DB (Current)	2.4	3.5	3.1
	Bloomberg (Dec Survey)	2.2	3.0	2.9
	IMF (Oct)	2.2	3.1	3.0
	Consensus Economics (Oct Survey)	2.2	3.1	n.a.
Euroarea	DB (Sep'14 WO)	0.7	1.0	1.4
	DB (Current)	0.8	1.0	1.3
	Bloomberg (Dec Survey)	0.8	1.2	1.5
	IMF (Oct)	0.8	1.3	1.7
	Consensus Economics (Oct Survey)	0.8	1.2	n.a.

*Note: * September World Outlook forecast have been recalculated using IMF October WEO PPP weights. Also Nigeria has been included (as part of EMEA) in the aggregation from this edition. However, September forecast does not include Nigeria.*
*** Assuming DB's India GDP forecast for 2016 is consistent with Bloomberg consensus*
Source: IMF, Consensus Economics Inc, Bloomberg Finance LP, Deutsche Bank Research

Global inflation steady in 2015, rising in 2016

Despite concerns about the impact of falling energy prices on headline inflation in a global economy with already subdued inflation rates, our regional economists collectively see little change in global inflation over the year ahead, followed by a pickup in 2016. This global average behavior masks quite different trends across regions. In advanced economies, we see inflation declining noticeably further below desired levels in 2015 and then picking up significantly in 2016—in this case, oil price effects are clearly evident. However, in emerging market economies, imported inflation via depreciating currencies appears likely to more than offset the projected effects of lower oil prices, especially in Russia and Latin America. For emerging markets as a whole, we see a modest uptick in inflation in 2015, followed by some reversal in 2016.

Figure 6: Global inflation to rise modestly through 2016



Source: IMF, Haver Analytics, Deutsche Bank Research
Note: Trends are based on pre-crisis average from 1999 to 2007.

Figure 7: Inflation forecast & revision (% yoy)

% yoy	Forecast level Dec' 14 WO			Forecast change since Sep' 14 WO*		
	2014F	2015F	2016F	2014F	2015F	2016F
G7	1.6	1.2	1.8	-0.1	-0.7	-0.3
US	1.7	1.2	2.1	-0.1	-0.9	-0.2
Japan	2.9	1.4	1.0	0.1	-0.2	-0.8
Euro area	0.5	0.5	1.3	0.0	-0.6	-0.2
Asia (ex-Japan)	3.6	3.6	3.7	-0.1	-0.4	-0.3
China	2.2	2.6	3.0	0.0	-0.4	0.0
India	7.3	6.0	6.0	-0.4	-1.0	-1.0
EEMEA	6.0	6.7	6.0	0.4	1.3	1.0
Russia	7.7	8.9	7.2	0.4	2.7	1.4
Latin America	12.5	13.5	11.9	-0.6	1.2	0.8
Brazil	6.3	6.4	5.8	0.0	0.3	0.0
Advanced economies	1.4	1.1	1.7	-0.1	-0.7	-0.3
EM economies	5.5	5.7	5.4	0.1	0.3	0.2
Global	3.7	3.7	3.9	0.2	0.1	0.2

*Note: * September World Outlook forecast have been recalculated using IMF October WEO PPP weights; also Nigeria has been included (as part of EMEA) in the aggregation from this edition.*
Source: Deutsche Bank Research

US: advancing steadily toward liftoff with a mild boost from the oil market

Our baseline view on the US in 2015 is that the real economy will expand at a rate above 3%, supported by much improved household finances, and by a significant pickup in both business capital spending and homebuilding. The drop in oil prices is expected to support US growth in the near term as consumers enjoy a windfall gain at the gas pump. The $1 per gallon decline in gasoline prices that has occurred in recent months amounts to an effective income gain of roughly $1000 per household, or the equivalent of about 1% of total consumer spending. Assuming much of that gain is spent on other goods and services, real consumer spending should be boosted, especially in the current quarter and early in 2015. At the same time, the drop in oil prices represents a large loss of revenue to oil producers, depressing stocks in that sector and, over time, reducing investment spending in the oil industry. Part of this reduction in oil-related investment should be offset by increases in capital spending in other sectors that are stimulated by the near-term pickup in consumer spending. But we do expect some slowing in business fixed investment growth in H2 2015. Fiscal policy is assumed to have a neutral effect on the growth trajectory, and the external sector shifts from being a positive factor to a drag on growth.

With the dollar continuing to appreciate, and growth abroad picking up only relatively slowly, the risk is that the external drag on overall growth and capital spending in particular proves more powerful than our forecast has built in. Indeed, simulations with the Fed staff's model of the US economy suggest that over the next year or two, the negative impact on US GDP from the recent (and anticipated further) rise in the dollar could be significantly greater than the positive effect from the drop in oil prices.[2] Overall, our US economics team sees real GDP growth slowing over the forecast period, from around 4% in H2 2014 to 3.2% in H2 2015 and 3.0% in 2016. Absent the drag from the stronger dollar, growth could well be in the 3.5% - 4.0% range over the year ahead.

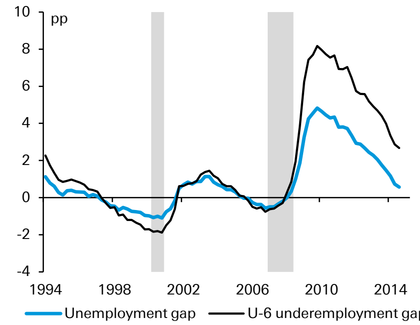
US GDP growth above 3% over the year ahead implies significant further tightening in the labor market. We expect the official unemployment rate (U3) to decline through current estimates of NAIRU early in H2 2015, and the broader measure of unemployment (U6) to be back near "full employment" levels by early 2016. These trends imply that recent early signs of upward pressure on wages will gain momentum during 2015. While the drop in oil prices will depress headline consumer price inflation to low levels in the months just ahead, core PCE inflation (excluding food and energy) should be little affected. The rise in the dollar will restrain core inflation at least modestly for a few quarters, and we expect core PCE inflation to rise only slowly through the course of 2015. Nevertheless, we expect modest increases in core inflation, more noticeable increases in wage inflation, and the continuing improvement in the labor market to be enough to get the Fed into action beginning to raise rates at mid-year. We see low risk that "liftoff" will occur sooner than June, and substantial risk that it will occur later, in September. We also expect, on our forecast (which is roughly consistent with the FOMC median forecast), that the Fed will pause a couple times in H2, ending the year at 1.0% as the upper bound of their target range. They should then move slightly more aggressively in 2016 as the labor market continues to tighten, ending the year at 2.5%.

Japan: inflation risks weighted to the upside

Prime Minister Abe's decision to postpone the second increase in the consumption tax from October 2015 to April 2017 removes an important obstacle to growth next year. Our growth forecasts for 2015 and 2016 have been revised up only 0.1% and 0.2% respectively but with the first tax increase having had a greater negative impact on growth than we'd expected, the delay in the second increase pushes out that risk to 2017.

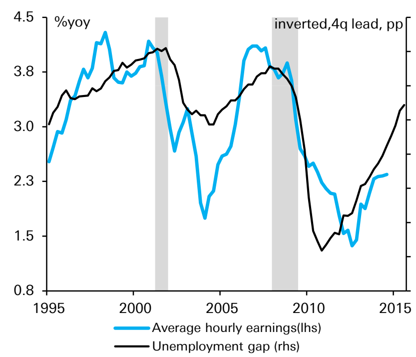
The oil price impact on Japan's economy is likely to be muted by a weakening currency. The 40% drop in the dollar price of oil since June has been accompanied by a 17% depreciation of the yen versus the dollar and cumulatively, retail prices for gasoline have fallen only about 6%. Fuels have a combined CPI weight of only 4%, so while there may yet be some pass-through still to be realized, the sequential decline in yen prices for fuels in the coming months may be quite small and the impact on inflation much smaller still. Of course, as elsewhere, there will be a sharp decline in prices on a YoY basis during the second quarter of next year, which will be reversed over the following months. Still, with an underlying headline inflation rate (ex-tax) today of only about 1%, this temporary effect could look quite large. But on balance, despite being entirely dependent upon oil imports – and having had to increase its oil consumption after having shut down its nuclear power plants – Japan is unlikely to benefit much from the prospective decline in prices if the yen continues to depreciate as we expect it will.

Figure 8: US labor market slack falling rapidly



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

Figure 9: Wages should rise further as labor market slack declines



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

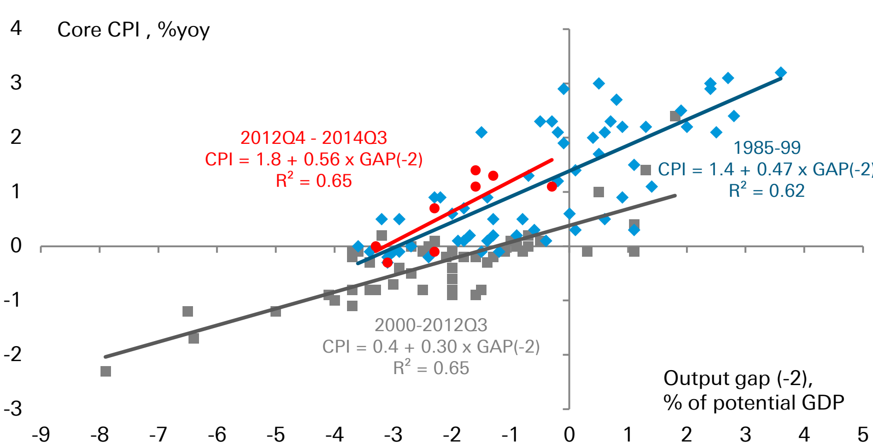
---

[2] As documented in our Global Economic Perspectives publication from November 14, 2014, simulations with the Fed's FRBUS model indicate that a sustained 10% appreciation of the dollar reduces real GDP growth by about 0.5%point for several years, whereas a 40% drop in oil prices raises growth by only about 0.1%. We find the latter result to be lower than our judgmental analysis would suggest, but even if it is off by a factor of two or three, the recent combination of strong dollar and weak oil prices is likely a net drag on the economy going forward.

Of more significance to the inflation outlook in Japan is our expectation of significantly above-potential growth through 2015-16. Against a government estimate of potential growth of about 0.6%, we see the economy growing 1.4% in 2015 and 1.6% in 2016. Of course, the starting point is now an output gap in the latest quarter of perhaps 2.8% of GDP. But our growth forecasts suggest that this output gap will gradually close over the next couple of years. Firms have over the past year been reporting increasingly tight labour market conditions – even after the consumption tax increase and subsequent decline in GDP -- and wage growth was at a six-year high in Q3. So we expect that the underlying inflation rate will decline over the coming couple of quarters in response to the recent recession in activity, but then rise steadily, although very slowly, from around mid-year through 2016. But we don't see consumer prices rising anywhere near 2% on an ex-tax basis. Instead, we think inflation rises to just 1% before the next consumption tax increase in April 2017.

But perhaps the risks around the inflation outlook, beyond the very near term, are growing to the upside. The analytical framework the BoJ has used to describe how QQE is supposed to work is the Phillips Curve, a relationship between unemployment (or the output gap) and inflation. The BoJ argued that rising inflation expectations would shift the Phillips Curve upwards, raising the equilibrium inflation rate. Extreme caution is necessary in evaluating macro data over only two years, but the very recent data seem to support their hypothesis. In common with the US and other advanced economies, Japan's Phillips Curve in the 2000s was flatter and lower than it had been during the late 1980s and 1990s. But the data over the past two years are clustered around a regression line much steeper and well above that of the previous 12 years (Figure 10). If so, then inflation may fall much more over the coming quarters than we expect, but then rise more quickly towards 2% than we forecast. Still, based on only two years' data we can only offer this as a risk to our forecast.

Figure 10: Japan's Phillips Curve shifting up?



Source: Haver Analytics and Deutsche Bank Research

Euro area: ECB under pressure to begin sovereign QE

We have added 0.2pp and 0.1pp to our euro area GDP growth forecasts for 2015 and 2016 as a result of our new, lower oil prices assumptions. This offsets the signs of weakness elsewhere in the economy — in particular investment spending and exports — leaving our GDP growth forecasts at 1.0% and 1.3% for 2015 and 2016 respectively (effectively unchanged compared to the last WO). Our concern with inflation, however, remains. At best, the euro area's large output gap will start to narrow only in 2016, maintaining disinflationary pressure. We expect headline HICP inflation to be 0.5% in 2015 (1.1% in the last WO), rising to 1.3%/1.7% in 2016/2017.

There is a chance inflation has a negative print in the next few months even if oil prices fall no further. Normally the central bank ought to look through the short-term impact of a positive supply shock on inflation. The danger is a further decline in inflation expectations. We do not believe that the modest growth benefits of lower oil prices alone will re-anchor inflation expectations. We continue to believe that the ECB will implement broad-based asset purchases including public QE by end Q1 2015.

Transition into sustainable recovery mode is conditional on successful QE, in our view. There are several potential drivers of recovery through 2015 and into 2016, from lower oil prices, the weaker euro and accelerating global growth to the Juncker investment plan and any confidence boost from implementation of structural reforms (e.g., in Italy). Unless the ECB re-anchors inflation expectations, the benefits of lower oil prices could be diverted into repaying still high levels of debt. Pushing the euro lower via QE will maximize the benefits of rising global growth. By injecting confidence into growth, the potential for the Juncker plan to spur private funds into infrastructure projects will increase, etc.

However, public QE — the purchasing of sovereign bonds — is controversial inside and outside the ECB. Skeptics are concerned about moral hazard. ECB President Draghi's patience is starting to wear thin. The impression from the latest press conference was that Draghi is willing to wait a little longer for the dissenters to be convinced of the need to act. Otherwise, he will accept a smaller majority to deliver sovereign QE. Implementing public QE with a smaller majority would risk undermining market confidence in the durability of the policy, weakening its transmission.

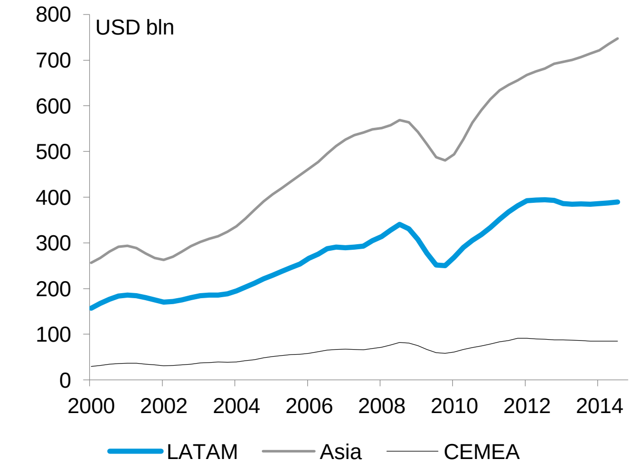
Emerging market economies: slowing growth despite the G3 revival

Since the September Outlook report, 2015 growth forecasts for almost all EM economies have come down. Overall EM growth has been lowered by 0.2% in 2014 and about 0.7% in 2015/16 mainly due to a significant re-think on China. The Chinese authorities have successfully stabilized growth at about 7.5% over the past three years, but our expectation now is that they will guide growth down over the coming years. Hence, while the 2014 forecast has been reduced by only 0.5%, by 2016 our new forecast is 1.3% lower than it was in September. The other major development since September has been the worsening of the Ukraine conflict, which has led to sharp downward revisions to the growth forecasts for both Ukraine and Russia. GDP growth in Russia is now expected to be about 1.9% lower in 2015-16 than previously forecast and the Ukraine growth forecast for 2015 has been cut by 5%.

Beyond these two changes, however, the tendency has been for EM growth forecasts to be reduced due to disappointing performance of exports to the advanced economies and the drag on commodity exporters of further declines in commodity prices. There are many possible reasons for the weakness in exports[3] but the fact is that while US imports from emerging Asia are growing at a reasonable pace -- although not as fast as they were in the pre-crisis years -- imports from Latin America and the CEMEA countries (even excluding the oil exporters) are stagnant in dollar terms. And Euro area imports from all three emerging market regions are falling in dollar or euro terms.

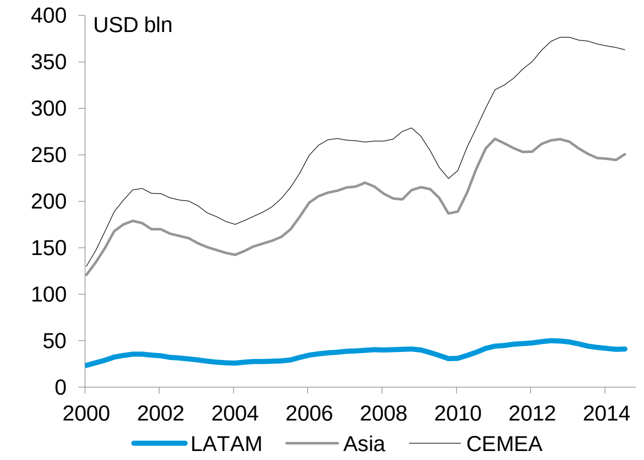
[3] See Peters, Heiko and Stefan Schneider, "Sluggish global trade: cyclical or structural?" in *Global Economic Perspectives*, Nov 25, 2014. The authors suggest that global trade growth has been depressed relative to global GDP growth because of a slowing of supply chain evolution and a slowdown in trade liberalization. Trade flows had been artificially boosted in the early to mid-2000s because China was quickly integrating itself into the global economy, a special factor that is no longer relevant.

Figure 11: US imports from emerging markets



Source: Deutsche Bank Research

Figure 12: Euro area imports from emerging markets



Source: Deutsche Bank Research

Since September, the changes to the US and Euro Area growth forecasts have been small and essentially offsetting. Combined US and Euro area growth is expected to be comparable to these economies' pre-crisis growth rate of about 2.4% next year and only slightly slower in 2016 as Fed rate hikes start to bite. But we are less confident that this will drive EM export growth materially higher, especially for commodity exporters. But even for many manufactured goods exporters the outlook for exports is more muted than it was before.

The subdued export growth in most EM economies gives rise to a temptation to give free rein to the exchange rate as the primary shock absorber. EM currencies have depreciated significantly in recent months triggered in part by the diverging policy outlooks among the G3 central banks. With the ECB and BoJ embarking on renewed monetary easing and the Fed talking up chances of rate hikes next year, a strong dollar fever has gripped foreign exchange markets. EEMEA economies' ties to the euro and the desire to protect export competitiveness in Asia as the yen depreciates anew have contributed to the downward pressure on EM currencies. While we are confident that the majority of EM central banks have large enough foreign exchange reserves to prevent a full-blown crisis, the growing influence of foreign investors in local currency bond markets is an important new risk for policymakers to consider. In Indonesia and Malaysia, for example, foreign investments in local currency government bonds are more than one-third the value of foreign exchange reserves.

While the decline in export growth probably accounts for most of the slowdown in EM growth, domestic factors have played a role as well.[4] In some countries, supply bottlenecks – Brazil, India and South Africa perhaps most prominently – have been a constraint on growth. In others, the withdrawal of monetary or fiscal stimulus has exerted a drag on growth that was supposed to have been offset by more robust export growth.

Lower commodity prices appear, on average, to have been a negative for emerging economies. Commodity exporters, especially Russia, Kazakhstan, Nigeria, South Africa and Venezuela, have been very badly affected by an adverse terms of trade shock with falling oil and minerals prices. But the consumers in emerging markets haven't benefitted much from the lower energy prices. To a great extent this is because, as we observed in the

[4] For a more complete discussion of the role of domestic and external factors impinging on EM growth, see "Stress Testing EM," in the *EM Monthly*, December 4, 2014.

September World Outlook report, lower USD prices for oil and other commodities are offset by depreciating EM currencies. Indeed, in almost half the EM economies we follow, it may be that a 10% nominal exchange rate depreciation would more than offset the deflationary impact of a 30% decline in crude oil prices.[5] And strikingly, despite the fact that oil and food prices in global markets have been falling over the past six months, since September our inflation forecasts have generally been revised up as EM currencies have depreciated. Russia and Argentina have, not surprisingly, seen the most dramatic increases in expected inflation, but inflation forecasts have been revised up in most EEMEA and Latin American economies.

Asia stands somewhat apart in this respect, with inflation forecasts coming down in most countries. Indonesia's inflation rate has been revised up because previously we had not assumed that oil subsidies would be cut. And it is in Asia that we see the most upside risk to inflation. While in the other regions, inflation is expected to decline in 2016, we see modest upside to inflation in Asia. In China, for example, food prices in 2014 have been unusually low; a bounce back in 2015 could take inflation much higher. A key upside risk stems from the need for fiscal reform – as has been the case in India, Indonesia and Malaysia subsidy cuts in China would have an immediate impact on inflation.

The fiscal consequences of lower commodity prices vary greatly across economies. While depreciating currencies may help insulate government finances – for example in Russia – the lower oil prices have been a boon to countries that subsidize oil consumption. India, Indonesia and Malaysia, for example, have been able to sharply reduce their oil subsidy costs – eliminating subsidies altogether in India and Malaysia – at significant fiscal savings. Some of this may be reallocated to infrastructure or social expenditures, but there will likely be a net decrease in the government deficit.

The monetary policy outlook for emerging markets is very mixed in this environment of disappointing external demand growth, rapidly moving commodity prices and exchange rates and important domestic idiosyncracies. While the Fed's policy has historically been an important driver of the EM policy outlook, the fact that the BoJ and ECB are adopting more aggressively stimulative policies confuses the EM outlook considerably. We see only eight EM central banks raising rates over the coming year – Brazil, Indonesia, Malaysia, Mexico, Peru, the Philippines, South Africa and Ukraine – and six central banks cutting rates – China, Chile, India, South Korea, Turkey and Vietnam.

Market strategy views

Global Asset Allocation: 7 questions and trades for 2015

Our Global Asset Allocation team considers 7 key questions heading into 2015 and discusses their implications for positioning. In their view: (1) the next US recession is at least 3 years away; (2) equities and HY remain cheap to drivers; (3) low bond yields reflect low market expectations of monetary policy, not low inflation or growth; (4) the great rotation was delayed by the fall in rates, but the over-allocation to bonds and under-allocation to equities remains; (5) rates and equities can both move higher if the former is driven by higher real rates; (6) oil prices have fallen due to global growth and increased supply, but primarily because of the stronger dollar; and (7) EM equity de-rating is not yet complete. They remain overweight equities, underweight bonds with HY over HG, underweight cash and commodities, and long the US dollar.

[5] See Spencer, Michael, "Commodity prices and EM inflation," in *Global Economic Perspectives*, Nov 1, 2014.

US Equities: Better time for consumer ahead, tougher time for producers

Our US equity strategists expect mid-single digit S&P 500 gains in 2015 with ~3% EPS growth and no PE expansion from today's ~17.5x PE. They have cut their 2015E S&P EPS by USD5 to USD121 on plunging oil prices, the stronger dollar and the growth challenges abroad, but maintain their 2015 and 2016 year end S&P 500 price targets at 2150 and 2300, respectively. They think it is important for WTI oil to stay above USD60 on average and Euro above USD1.10 to avoid a profit recession in 2015 even if US GDP growth is 3%+. They are overweight secular growth sectors Health Care and Tech and prefer Financials over Energy. They are also overweight utilities as their preferred bond substitute, and prefer Consumer Discretionary Retailers over Industrial Capital Goods.

Rates: Refueling before liftoff

Our rates strategists expect bond yields to rise moderately ahead of the forwards in 2015 with year-end targets of 2.8% for 10Y UST and 1.1% for 10Y Bund. Ultimately, the behavior of core rates will be dictated by the evolution of the inflation outlook. In the US, although there is short-run risk of first re-visiting the recent lows in yields, the market is now pricing a neutral rate around 2.50-2.75% vs. 4-4.25% a year ago and the inflation risk premium is at historical lows. Relative to current pricing, the balance of risks is tilted towards the market pricing a terminal rate above 3.25% rather than below 2% and a partial normalization of the bond risk premium, but this could be tempered by supply/demand factors. In Europe, the 5Y sector should perform well and peripheral spreads should tighten further. The risks are tilted towards inflation staying low and the ECB QE exacerbating supply/demand imbalances which would keep Bund yields lower throughout the year. From a valuation perspective, government bond QE should benefit the front-end of the euro curve and the long-end of peripheral bond markets. From a flow perspective, 5Y5Y core real rate could also benefit despite rich valuations.

European Credit: Waiting for the ECB

Our European credit strategists think the potential announcement of a broader asset purchase program by the ECB should benefit European credit even if they jump straight to government bond purchases. They like EUR HY in Q1 as fundamentals remain broadly supportive and it has limited exposure to energy companies, while other sectors of the economy could potentially benefit from lower oil prices. Specifically, they prefer EUR Single-Bs. There may be opportunities to pick up extra yield in USD IG over EUR IG, although potential negative pressures from the energy sector could mean that there will be a more attractive entry point. The relative actions of the ECB and Fed could also provide justification for a better entry point into USD IG credit, since the journey may be volatile if a healthy US economy means US rate hikes.

US Credit: Unfamiliar places

Our US credit strategists consider the impact of lower oil prices on US credit markets, where the energy sector is the single largest sector in US HY and second largest in US IG. In their view, the weakest US shale oil producers could enter a zone of distress if oil prices remain below USD55 for at least a few months. Between oil showing few signs of bottoming, potential EM shocks, and the combination of distress and weight of energy in the US, they conclude that the path of least resistance for credit spreads is wider from here. They have marked their spread targets to 575bp in HY (+95bp) and 150bp in IG (+25bp). For the time being, the expectation of a potential near-term widening in HY brings them back to overweighting higher quality going into the next few months.

US MBS and Securitization: When oil and MBS mix

Our US MBS and securitization team considers the impact of falling oil prices on MBS. Improved consumer cash flow from lower gas prices should imply lower levels of mortgage delinquencies and help households save more toward a down payment on the margin, adding to MBS supply, while lower headline inflation likely shifts the risks toward a later Fed liftoff. The exceptions to the implications of lower energy prices might be in local mortgage markets with heavy employment in energy. The net impact is more predictable for relative value within MBS than between MBS and rates. An improving consumer balance sheet should be marginally bad for seasoned discounts through slower speeds and production coupons through better supply, but marginally good for premium MBS through sustained low short-term rates. Beyond energy, MBS looks likely to do well through Q1 2015 as net demand should easily absorb low net supply. The risk of wider spreads in MBS starts to build after March, as supply rebounds from seasonally-tempered levels.

FX: 30-30 vision

Our FX strategists reconsider the strong USD theme in light of 2014's moves. Although USD/JPY is now ~30% above their PPP measure, the conditions for an imminent turnaround are not present. Extreme yen valuations are likely to mean that yen slowly loses its starring role as the leading edge of a multi-year USD upswing, but still participates in USD strength. End of 2015 and 2016 forecasts have been revised to Y125 and Y130 respectively. For EUR/USD, the immediate impact of portfolio reallocation related to negative rates has likely taken place, and looking ahead, ECB QE in Q1 2015 has already been largely priced in. However, the portfolio displacement impact has hardly begun, and will remain a growing EUR negative factor. The EUR/USD end-2015 forecast remains at 1.15. The good news for the broader strong USD theme is that the market now only prices in a modest 125bps of Fed tightening through the end of 2016, leaving greater potential for US rates to finally contribute to USD strength in the year ahead. Other notable forecast changes include: AUD/USD end 2015 and end 2016 revised to AUD 0.78 and AUD 0.68, respectively.

Commodities: Oil markets in disarray

Our commodity strategists expect oil prices to remain weak throughout the next year, reflecting rapid non-OPEC supply growth and OPEC's reluctance to adjust quotas. Prospects for a price recovery will be based on whether price weakness triggers OPEC to cut production and/or more substantial downgrades to non-OPEC supply materialize. They view the USD65-70/bbl range for WTI as a key level at which US producers begin to constrain capital expenditures for future production growth. Other factors that could assist a price recovery are extreme cold this winter, a more aggressive programme of Chinese Strategic Petroleum Reserve building or positive global growth shocks. On the supply side, they view Libya and Iraq as the most likely candidates for oil supply losses. Their calculations suggest supply losses or positive demand surprises would need to exceed 1.2mmbd to strengthen oil market fundamentals. Oil prices trough in H1 2015 in their forecast, with WTI and Brent averaging USD70 and USD75 in Q4 2015, respectively.

Geopolitics: Ongoing alliance shifts

Our geopolitical strategist considers the strategic problems and openings of the great powers in the face of a US that is in a global strategic retreat. Most visible in the momentum to establish new alliances is Russia's approach toward China, including recent energy deals advantageous to China, which should over the long term attract Chinese capital and labor. In the Middle-East, the complete withdrawal of the US created the vacuum in Iraq that ISIL has filled but has strengthened the US's motivations for rapprochement with Iran. However, Saudi Arabia has opposed this development, and now seems to be playing the oil weapon. Their rationales for not cutting production include:

lower oil prices harm Russia, Iran, and higher cost producers, such as US shale, and may groom other cartel members to take a greater share of the supply cut quotas in the future. Finally, with troops winding down in Afghanistan, the opening of a vacuum will likely draw in serious attention from other large powers in the region: Iran, Russia, Pakistan, and India.

Peter Hooper, (1) 212 250 7352
Matthew Luzzetti, (1) 212 250 6161
Torsten Slok, (1) 212 250 2155
Michael Spencer, (852) 2203 8303
Mark Wall, (44) 20 754 52087

US: Is 2015 the year the Fed finally raises interest rates?

- The economy is expanding at an above-trend 3% annualized pace, and this is expected to continue through next year for several reasons. One, monetary policy will still be highly accommodative. Despite an expected 75 basis points (bps) of policy rate hikes to roughly 1%, real rates will likely still be negative. Two, government spending is no longer a drag on economic output. Instead, we are seeing modest gains in both federal and state/local expenditures. Three, total housing-related spending as a share of the economy is trending higher but remains depressed relative to its long-term average. Hence, there is ample scope for the housing sector to meaningfully boost overall economic output. Four, household balance sheets are in excellent financial health. This should support consumer spending and possibly allow for a decline in the personal savings rate. Five, the large decline in energy costs represents a significant tax cut for consumers and most businesses. In particular, our expectation of a sharp slowdown in the rate of headline inflation will lift real income, which will further buttress consumer spending.
- The unemployment rate, currently at 5.8%, has declined by a substantial 140 basis points (bps) over the last 12 months. If the labor market continues to generate approximately 230k jobs per month over the course of the next year, and if the labor force participation rate remains steady at 62.8%, two conservative assumptions in our view, the unemployment rate will average 4.9% in Q4 2015. At that point, wage inflation should begin to accelerate, because the labor market would be operating well above its full capacity. The Fed's estimate of the non-accelerating inflation rate of unemployment (NAIRU) is somewhere between 5.2% and 5.5%, and historically, wage growth has accelerated shortly after the unemployment rate has fallen below 6%. Consequently, if the unemployment rate breaches 5% next year, wage growth could rise meaningfully, and at the very least, should well-outpace headline inflation.
- Against this backdrop, monetary policymakers are projected to raise the fed funds rate by 25 bps next June. We expect this to be followed in the second half of the year with two more 25 bp rate hikes, thereby taking fed funds to 1.00% by yearend. In 2016, we expect monetary policymakers to continue to increase rates in relatively modest steps, finishing the year with a fed funds rate of 2.50%. Monetary policy is then projected to tighten further in 2017, when official interest rates are expected to approach their long run neutral level of around 3.50%. However, the ultimate pace and amount of monetary tightening will be determined by the performance of the economy and the response of the financial markets to interest rate normalization. If financial conditions do not meaningfully tighten in response to higher interest rates, then the Fed will have to hike rates significantly more than what is currently discounted.

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

Economic activity	2014				2015				2014F	2015F	2016F
(% qoq, saar)	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	-2.1	4.6	3.9	4.2	3.1	3.3	3.2	3.1	2.4	3.5	3.1
Private consumption	1.2	2.5	2.2	2.8	3.1	3.2	3.2	3.1	2.3	2.9	3.0
Investment (inc. inventories)	-6.9	19.1	5.1	9.5	4.7	7.9	6.6	6.2	5.9	7.4	6.2
Gov't consumption	-0.8	1.7	4.2	2.6	2.6	2.6	2.6	2.6	0.1	2.7	2.6
Exports	-9.2	11.0	4.9	2.3	2.0	2.0	2.5	3.0	3.1	3.1	3.3
Imports	2.2	11.3	-0.7	1.0	3.0	6.0	6.0	6.0	3.4	3.8	6.0
Contribution (pp): Stocks	-1.2	1.3	-0.1	0.1	-0.7	0.0	0.0	0.0	0.0	-0.1	0.0
Net trade	-1.6	-0.3	0.7	0.1	-0.2	-0.7	-0.6	-0.6	-0.1	-0.2	-0.5
Industrial production	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	4.1	4.5	3.9
Unemployment rate, %	6.7	6.2	6.1	5.8	5.6	5.4	5.2	4.9	6.2	5.3	4.8
Prices & wages (% yoy)											
CPI	1.4	2.1	1.8	1.4	1.1	0.8	1.2	1.8	1.7	1.2	2.1
Core CPI	1.6	1.9	1.8	1.7	1.8	1.9	2.1	2.3	1.8	2.0	2.4
Producer prices	1.6	2.8	2.4	1.5	0.5	0.2	0.8	2.2	2.1	0.9	2.9
Compensation per empl.	3.2	2.8	3.3	3.5	2.6	2.8	2.9	2.9	3.2	2.8	2.9
Productivity	0.7	1.3	0.9	0.4	1.9	1.5	1.3	1.3	0.8	1.5	1.3

Source: National authorities, Deutsche Bank Research

Underlying economic momentum is poised to carry over into 2015. The economy has averaged 4.1% annualized growth in four out of the last five quarters, and inflation-adjusted output is expected to expand at about the same pace in the current quarter. Although economic activity should decelerate somewhat next quarter, as some of the economy's recent strength was payback from the unprecedented weather-related decline in Q1 (-2.1%), year-over-year real GDP growth should accelerate to 3.9%. This should add to the general sense that the economy has finally reached a phase of sustainable expansion. It is worth noting that various measures of business and consumer confidence have risen significantly over the past year and have returned to pre-recession levels.

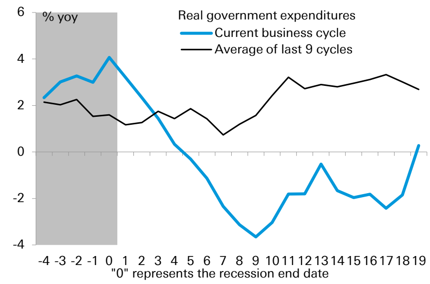
For the full year, 2015 real GDP growth is expected average slightly above 3%, which should be enough to push the unemployment rate below 5% by yearend. The recent decline in oil prices, if sustained, provides some upside risk to our consumption and hence GDP forecast which has been adjusted to show a more domestic tilt to growth than what we had previously projected: Consumption was marked up because of the likely improvement in household cash flow stemming from the collapse in oil prices. The degree of cash flow improvement will largely be a function of how long prices remain depressed. However, we did not raise our full year 2015 GDP forecast for a couple of reasons. One, we marked down our estimate of net exports, because of a stronger dollar and expectations of weaker overseas activity. Incidentally, these are two factors behind the recent plunge in oil prices. And two, lower oil prices will lead to slowing in energy-related investment, which we discuss in more detail below.

What is the impact of lower energy prices on the economy? Oil and gasoline prices are highly correlated—indeed, this is the case for the entire energy complex. However, in order to get a sense of how much household cash flow is likely to improve in response to lower energy costs, we need to look at the data over a four quarter period given that energy prices are extremely volatile and prone to large seasonal swings that often cancel themselves out over the course of a year. The high correlation between changes in gasoline prices and total household energy consumption is shown in the accompanying chart. As a rule of thumb, a one cent change in gasoline prices translates into a $1 billion change in household energy consumption. Thus, if the roughly 90 cent decline in gasoline prices since last spring is sustained over the next several quarters, household cash flow could improve by $90 billion over the next year.

While the effect on overall domestic activity is positive—we now see consumption growth running above 3% next year because of lower energy costs—there will be a modest offset from lower investment within the highly capital intensive energy industry. As the accompanying chart illustrates, oil and gas capex is highly correlated with oil prices. Importantly, the latter tends to lead the former by approximately two quarters, which makes sense because as prices rise, more expensive production becomes economically viable so firms invest in equipment to extract oil. The opposite happens when oil prices decline.

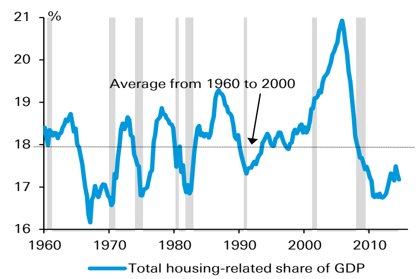
Given the lag between oil prices and capex spending, energy producers would have to anticipate a sustained downtrend in crude prices to meaningfully curtail investment. At around $70 per barrel, West Texas Intermediate crude oil prices are down roughly 30% compared to a year ago. If crude prices remain near current levels, given the aforementioned relationship between prices and energy-related capital expenditures, this would imply roughly a 20% year-over-

Figure 2: Government spending is finally a tailwind to growth



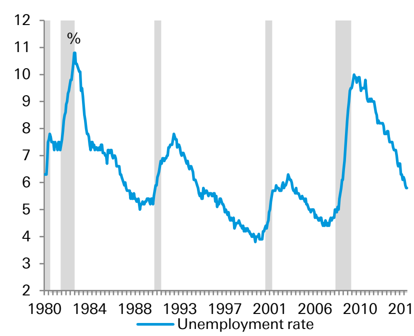
Source: BEA, Haver Analytics, Deutsche Bank Research

Figure 3: Housing has significant scope to boost overall economic output



Source: BEA, Haver Analytics, Deutsche Bank Research

Figure 4:The unemployment rate has declined at a record rate over the past year



Source: BLS, Haver Analytics, Deutsche Bank Research year decline in oil and gas capex. Since energy investment accounts for nearly 10% of total capex, which itself accounts for about 10% of total GDP, a 20% drop in the former would lower measured GDP growth by a couple of tenths next year. However, the outlook for capex in general remains upbeat.

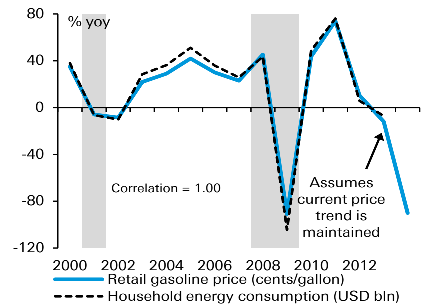
Outside of the energy sector, capacity constraints are clearly beginning to develop. For example, the capacity utilization rate of durable goods manufacturing is currently 77.3%. This is modestly above the average over the past 30 years (76.4%) when supply constraints have typically surfaced. As capacity utilization rises, companies will need to raise capital expenditures in order to keep pace with rising demand and depreciating equipment. This is one reason why the latest manufacturing ISM survey showed a record high reading in new orders. Thus, in aggregate, lower energy costs do not pose significant downside risk for business spending.

To the extent that lower oil prices partially reflect weaker overseas growth, US exports are likely to be softer than what we had previously assumed. To be sure, a stronger US dollar will also weigh on exports, which will become less competitive in the international marketplace. Furthermore, because imports will become cheaper, we may see an increase in their demand by consumers and producers. At the margin, this would negatively impact domestic production. The upshot is that net exports should present only a mild drag on economic activity next year. Additionally, since our underlying economic forecast has consistently called for above-trend growth and a declining unemployment rate, the overall 2015 GDP growth profile remains largely unchanged from our prior assumptions, although we altered the composition of output growth to reflect more domestic versus external demand.

Falling energy prices will depress headline inflation but this is unlikely to deter the Fed from raising interest rates. The drop in energy costs will weigh on headline consumer prices, which we expect to grow only slightly above 1% next year. This is well below the Fed's 2% target, and by itself, such modest levels of inflation would stay Fed tightening. Additionally, the sharp decline in energy costs has put downward pressure on inflation expectations. While the drop has been more noticeable for short-term inflation expectations, it is worth highlighting that long-term inflation expectations, as measured in the University of Michigan consumer sentiment survey, are at a multi-decade low of 2.6%. However, given our expectation of continued above-trend growth, which should cause further tightening in the labor market, we expect wage pressures to surface sometime next spring. We doubt the Fed would want to keep the policy rate at zero in such an environment, especially if GDP growth appears to have finally entered a virtuous, self-sustaining phase of the business cycle. Given the disproportionate share that labor has in the production process, rising compensation should eventually result in higher service costs, which are the dominant driver of core inflation.

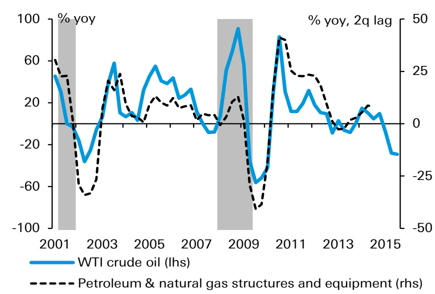
In the nearby table, we show the eight previous troughs in compensation growth alongside the corresponding unemployment rates. We exclude the mid-1970s period because compensation was elevated due to rampant inflation. Historically, labor compensation bottomed at an average growth rate of 3.3% and turned higher when the unemployment rate averaged 5.9%. In the current cycle, compensation troughed at zero and has been slow to recover. However, the fact the unemployment rate has fallen so rapidly—it is down 140 basis points over the last 12 months, which is the largest decline since the 12 months ending September 1984—wage inflation may soon trend higher. The fact that the quits rate is rising is encouraging.

Figure 5: Lower energy costs will result in a substantial boost to household cash flow



Source: EIA, BEA, Deutsche Bank Research

Figure 6:Lower oil prices point to weaker capex over the next few quarters



Source: EIA, BEA, Deutsche Bank Research

Figure 7:Compensation growth tends to accelerate when the unemployment rate falls below 6%

Date	Compensation per hour %	Unemployment Rate %
1949	2.9	6.0
1954	3.2	5.6
1964	3.1	5.2
1971	6.1	6.0
1984	4.3	7.5
1989	2.9	5.3
1994	1.2	6.1
2002	2.3	5.8
Average >	3.3	5.9

Source: BLS, Deutsche Bank Research

The quits rate, a key series on Fed Chair Yellen's dashboard of economic indicators, rose two tenths to 2.0% in September (the latest available data point). This represents a three-tenths improvement from September 2013 and is the highest reading in the series since April 2008 (2.1%). However, unlike 2008, when the quits rate was trending lower, the current trend is moving distinctly higher. Moreover, the current quits rate is only a tenth below its long-term average, which is an important leading indicator of labor costs. This is because a rising quits rate signals growing confidence in the labor market as these voluntary job leavers can presumably find meaningful employment elsewhere in the economy and ostensibly for higher pay.

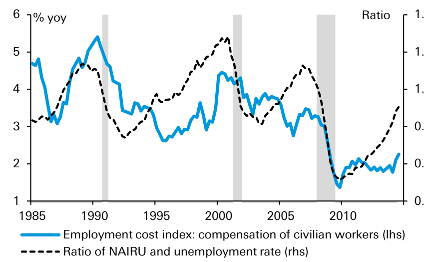
As illustrated in the accompanying chart, which compares the quits rate to the year-over-year increase in the employment cost index (ECI), a rising quits rate has historically been consistent with firming labor costs. For example, when the quits rate averaged 2.1% from 2000 to 2007, the ECI averaged annual growth of 3.6%. This is much faster than its current 2.3% year-over-year rate. To be sure, the unemployment rate averaged only 5.1% from 2000 to 2007, but the NAIRU was much lower back then. According to estimates by the non-partisan Congressional Budget Office (CBO), the NAIRU was 5% during this period.

If the economy continues to create jobs at the current pace of roughly 230k per month over the next year, the unemployment rate will decline substantially further from its current 5.8% level. Based on our calculations, trend job growth and a steady reading on the labor force participation rate means the unemployment rate will hit 4.7% by December of next year. This would be well below the Fed's and the CBO's estimate of the NAIRU. Consequently, we expect wage pressures to become meaningfully more pronounce in 2015.

- With respect to risks, the biggest downside risk to our economic forecast is further deterioration of growth prospects outside the US, which may result in a greater drag from net exports. This situation would also likely imply a stronger US dollar, and thus potentially even lower energy costs. In turn, this would further weigh on headline inflation and inflation expectations, possibly delaying the timing of monetary policy tightening out until September or beyond. It is highly unlikely that the Fed would begin raising rates next October, when there is no scheduled press conference, or in December when financial markets are notoriously illiquid, and policymakers risk an outsized response in asset prices. Another risk to the Fed rate call is inflation: If labor cost pressures are slow to materialize and if core inflation remains depressed, the Fed may delay the timing of the rate hiking cycle even if economic activity turns out be stronger, which is a risk we discuss below.
- With respect to upside risks, the dramatic fall in energy prices may stoke a larger-than-anticipated gain in consumer spending, and hence even stronger GDP growth than what we are currently projecting. In this scenario, the labor market would likely tighten substantially, stoking a more rapid pace of wage inflation. In turn, financial markets would need to re-evaluate both the timing of the liftoff of the fed funds rate as well as the cumulative amount of monetary policy tightening the Fed will undertake. With the bond market already pricing a meaningfully more benign trajectory for interest rates than what the FOMC currently projects, this could cause considerable volatility in the Treasury market.

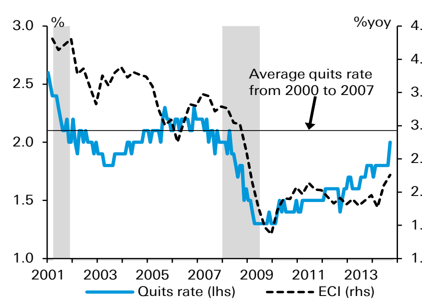
Joseph A. LaVorgna, (1) 212 250 7329
Brett Ryan, (1) 212 250 6294

Figure 8:Wage pressures should firm as the labor market approaches the NAIRU



Source: BLS, CBO, Deutsche Bank Research

Figure 9:A rising quits rate has historically coincided with firming labor costs



Source: BLS, Deutsche Bank Research

Figure 10: External balances & financial forecasts

	2013	2014F	2015F	2016F
Fiscal balance, % of GDP	-4.0	-2.9	-2.5	-2.9
Trade balance, USD bn	-476	-519	-555	-658
Trade balance, % of GDP	-2.8	-3.0	-3.0	-3.4
Current account, USD bn	-400	-441	-472	-559
Current account, % of GDP	-2.4	-2.5	-2.6	-2.9
Financial forecasts	Current	Q1-2015	Q2-2015	Q4-2015
Official	0.13	0.25	0.50	1.00
3M rate	0.24	0.35	0.75	1.35
USD per EUR	1.23	1.22	1.20	1.15
JPY per USD	120	121	121	125
USD per GBP	1.57	1.61	1.60	1.58

Source: National authorities, Deutsche Bank Research, as of December 08

Europe: ECB under pressure to begin sovereign QE

- For the euro area, we split the outlook between the challenges of the first few quarters of 2015 and the potential for a more positive outcome beyond that. The key to the transition is successful ECB QE and the stabilization of inflation expectations. We continue to expect the ECB to implement broad-based asset purchases including public QE in Q1 2015, probably March.
- OPEC's decision to allow oil prices to fall creates a positive growth impact for the euro area, but only enough to broadly balance the weakness we had observed in investment and exports since the last WO. Our GDP growth forecasts are broadly unchanged at 1.0% in 2015 and 1.3% in 2016.
- Our concern with low inflation remains. At best, the output gap will only start to narrow in 2016. Negative inflation is possible in the next few months. Without QE, inflation expectations will remain weak. With QE, we expect inflation to rise to 1.7% in 2017, close to target.
- Transition into sustainable recovery mode is conditional on successful QE. The euro area will benefit from cheaper oil and avoid debt-deflation dynamics if inflation expectations correct higher. Pushing the euro lower via QE will maximize the benefits of rising global growth. By injecting confidence into growth, the potential for the Juncker plan will increase, etc.
- Expectations have been put back for the timing of the Bank of England's first tightening of the cycle. We recently moved our view out from February to August next year. Two factors in particular have been responsible for this: the weakness in the euro area and the outlook for UK price and wage inflation.
- The UK election provides plenty of event risk for markets: a Conservative majority would raise fears of an EU in/out referendum; Labour would introduce a mansion tax, higher top rate of income tax and less austerity; while the lack of an overall majority for either of the two major parties could lead to fraught coalition negotiations.
- The sharp drop in oil prices has had strongly differing effects on the emerging markets in the region, providing relief to those with large energy import bills but adding significantly to the challenges being faced by Russia and other large oil producers in the region.

Figure 1: Macro-economic activity & inflation forecasts:

	GDP (% yoy)			CPI (% yoy)				GDP (% yoy)			CPI (% yoy)		
	2014F	2015F	2016F	2014F	2015F	2016F		2014F	2015F	2016F	2014F	2015F	2016F
EU	1.3	1.3	1.6	0.6	1.1	1.5	EEMEA	2.3	1.9	2.5	6.0	6.7	6.0
Euro area	0.8	1.0	1.3	0.5	0.5	1.3	Poland	3.3	3.3	3.5	0.1	0.9	1.7
Germany	1.4	1.0	1.2	0.8	1.0	1.5	Hungary	3.4	2.4	2.3	-0.1	1.9	3.1
France	0.4	0.9	1.4	0.6	0.5	1.2	Czech Republic	2.4	2.5	2.7	0.4	1.5	1.9
Italy	-0.4	0.3	0.9	0.2	0.4	1.1	Romania	2.5	2.9	3.0	1.2	2.2	2.6
Spain	1.3	1.9	1.8	-0.2	0.4	1.4	Russia	0.5	-0.9	-0.4	7.7	8.9	7.2
UK	3.0	2.5	2.3	1.5	1.3	1.8	Ukraine	-6.9	-4.5	1.5	11.9	18.6	9.8
Sweden	1.9	2.3	2.8	-0.2	0.5	1.5	Kazakhstan	3.9	2.1	2.6	6.8	8.4	8.3
Denmark	0.9	1.7	1.8	0.6	1.0	1.5	Israel	2.4	2.9	3.2	0.5	0.8	2.0
Norway	2.2	2.4	2.5	2.0	2.0	2.0	Turkey	3.0	3.2	3.5	8.9	6.8	7.3
Switzerland	1.7	1.8	2.0	0.1	0.4	0.8	South Africa	1.4	2.6	3.2	6.1	4.6	5.6

Source: National authorities, Deutsche Bank Research

Euro area: In need of successful QE

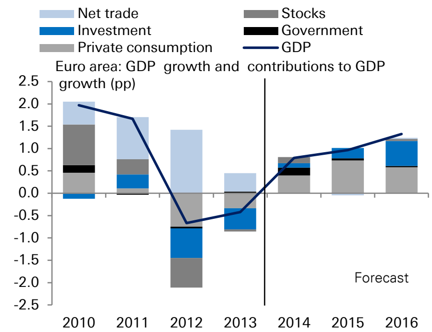
OPEC's recent decision not to cut supply has caused us to reduce significantly our oil price assumptions. As a result, we have added 0.2pp and 0.1pp to our GDP growth forecasts for 2015 and 2016. This offsets the signs of weakness elsewhere in the economy, leaving our forecasts at 1.0% and 1.3% respectively (effectively unchanged relative to the last WO). Our concern with inflation, however, remains. At best, the large output gap will start to narrow only in 2016, maintaining disinflationary forces. We expect headline HICP inflation to be 0.5% in 2015 (1.1% in the last WO), rising to 1.3%/1.7% in 2016/2017.

There is a chance inflation has a negative print within the next few months even if oil prices fall no further. Normally the central bank ought to look through the short-term impact of a positive supply shock on inflation. The danger is inflation expectations. We do not believe that the modest growth benefits of lower oil prices alone will re-anchor inflation expectations. We continue to believe that the ECB will implement broad-based asset purchases including public QE by end Q1 2015.

Transition into recovery mode is conditional on successful QE, in our view. There are several potential drivers of recovery through 2015 and into 2016, from lower oil prices, the weaker euro and accelerating global growth to the Juncker investment plan and any confidence boost from implementation of structural reforms. Unless the ECB re-anchors inflation expectations, the benefits of lower oil prices could be reduced. Pushing the euro lower via QE will maximize the benefits of rising global growth. By injecting confidence into growth, the potential for the Juncker plan will increase, etc.

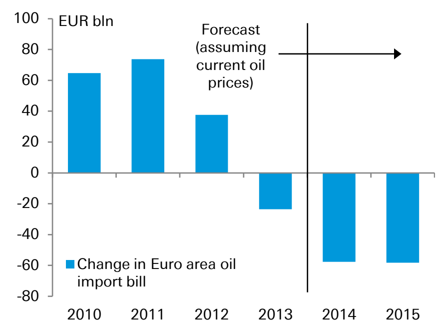
However, public QE — the purchasing of sovereign bonds — is controversial inside and outside the ECB. Skeptics are concerned about moral hazard. ECB President Draghi's patience is starting to wear thin. The impression from the latest press conference was that Draghi is willing to wait a little longer for the dissenters to be convinced of the need to act. Otherwise, he will accept a smaller majority to deliver sovereign QE. Implementing public QE with a smaller majority would risk undermining market confidence in the durability of the policy, weakening its transmission.

Figure 2: A very modest recovery, output gap starting to close at best in 2016



Source: Deutsche Bank Research, Eurostat

Figure 3: Another large drop in euro area oil import bill expected in 2015



Source: Deutsche Bank Research , ECB

Lower oil prices should help growth, re-anchoring inflation expectations is key

Growth in the euro area in 2015 will be determined in part by the outcome of a contest between oil and debt. We are reducing our crude oil (Brent) assumptions for 2015 and 2016 from roughly $90/pb to c.$75/pb. This should be positive for growth. We believe the elasticity of euro area growth with respect to a $10 decline in oil is about 0.2pp after one year.

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

Economic activity	2014				2015				2014F	2015F	2016F
(% qoq, saar)	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	1.2	0.3	0.6	0.3	1.2	1.5	1.2	1.3	0.8	1.0	1.3
Private consumption	0.8	1.1	1.1	1.2	1.6	1.6	1.1	1.1	0.7	1.3	1.1
Investment	1.0	-3.7	0.4	0.6	2.0	1.8	2.4	2.2	0.5	1.2	2.8
Gov't consumption	2.6	0.9	0.8	-0.5	0.1	0.4	0.2	0.3	0.8	0.2	0.1
Exports	1.0	5.2	2.3	2.1	4.1	3.6	4.0	4.5	3.2	3.5	4.7
Imports	2.4	5.1	3.7	2.8	4.5	3.6	4.2	4.6	3.6	3.9	4.9
Contribution (pp): Stocks	0.5	0.1	0.3	-0.2	-0.1	0.0	0.1	0.1	0.1	0.0	0.0
Net trade	-0.5	0.2	-0.5	-0.2	0.0	0.1	0.1	0.1	0.0	0.0	0.0
Industrial production	0.7	-0.2	0.7	0.2	0.9	1.9	2.0	2.0	0.6	0.7	1.6
Unemployment rate, %	11.7	11.6	11.5	11.6	11.6	11.7	11.7	11.6	11.6	11.6	11.5
Prices & wages (% yoy)											
HICP	0.7	0.6	0.4	0.2	0.1	0.4	0.5	0.9	0.5	0.5	1.3
Core inflation	0.8	0.8	0.8	0.7	0.7	0.8	0.9	1.0	0.8	0.9	1.2
Producer prices	-1.6	-1.1	-1.4	-2.3	-2.3	-1.5	-1.0	0.6	-1.6	-1.0	1.5
Compensation per empl.	1.8	1.6	1.3	1.4	1.2	1.1	1.0	0.9	1.5	1.1	1.3
Productivity	1.0	0.4	0.3	0.1	0.3	0.9	1.1	1.4	0.3	0.9	0.9

Source: National authorities, Deutsche Bank Research

At the same time, inflation expectations are positively correlated with oil prices. The positive case for 2015 is oil prices stabilise at their current level, energy price inflation bottoms out and HICP inflation remains out of negative territory. In this scenario inflation expectations re-anchor in 2015 and the euro area avoids a debt-deflation dynamic. Debt-deflation begins not when inflation is negative but when it is below levels expected when the debt was taken out.

The risk scenario is if inflation expectations do not stabilise, for example, if second round effects from lower oil prices weigh on core inflation and wages. The risk of debt-deflation dynamics would increase. This would divert some of the cash-flow benefits of lower oil prices into deleveraging. The risk is non-negligible. Euro area member states representing almost 45% of area-wide GDP currently have private debt-to-GDP ratios above 160% of GDP, the Commission's threshold for "excessive" imbalances, and a core HICP inflation rate below 1%. The group includes France, Spain and the Netherlands.

In short, the extent to which the euro area benefits from lower oil prices will depend on whether or not inflation expectations correct higher. Avoiding this inflation expectations tipping point into the downward pull of debt-deflation will be how we judge the early success of ECB QE policy.

Public QE is necessary

We changed our call on the ECB in the last WO. We changed from seeing private QE as sufficient to believing the public QE was necessary. Public QE won't solve the euro area growth malaise. That is the prerogative of structural policy. Private QE might well be a better policy for the bank-based euro area financial system, but the ECB does not have the risk appetite to take enough credit risk to provide capital relief to banks. In order to meet the legal primary mandate of price stability, the ECB intends to expand its balance sheet EUR 1 trillion and the only credible way to do so, in our view, is via the purchasing of euro area sovereign debt.

The ECB's legal mandate is medium-term price stability, defined as inflation "below but close to 2%" in the medium term. In our view, the ECB is behind the curve. The 5-year ahead inflation expectation series in the ECB Survey of Professional Forecasters (SPF) fell to 1.80% in Q4, taking it back to the lowest since 2001. We expect the ECB to announce a broad-based asset purchase programme including sovereign QE in Q1 2015. We think the most likely timing is 5 March, but it a close call. If the second TLTRO is disappointing, the QE announcement could come on 22 January. In our view, ECB President Draghi is willing to accept a smaller majority in order to deliver QE.

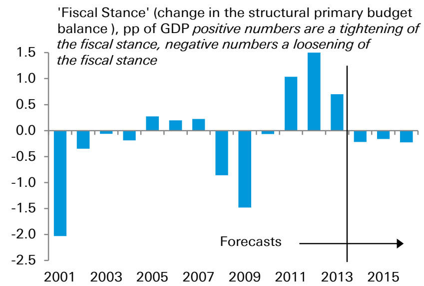
Based on historic elasticities, a EUR 1 trillion expansion of the ECB balance sheet ought to weaken the euro trade weighted index 10%. The TWI has dropped 5% already and we expect another 5% decline over the next year. That is equivalent to EUR/USD weakening c.10% to 1.15. Assuming historic elasticities, this would add 0.2-0.3pp to HICP inflation in 2017, raising it to 1.7%, close to the ECB target. The risk is that historic elasticities are too high.

Solving the euro area policy quandary

We see the low point of the economic cycle in Q4 2014. Assuming the ECB enacts a resolute QE programme by end Q1 2015 and succeeds in anchoring inflation expectations and minimizing second round effects from low inflation, the euro area could benefit more from the direct impact of lower oil prices and a weaker euro exchange rate.

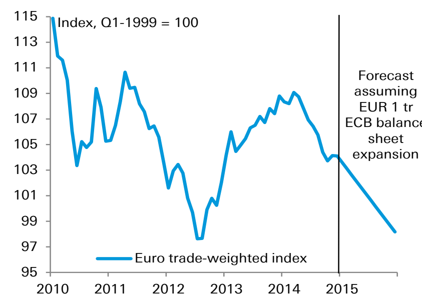
Maximising the potential to move to more positive recovery trajectory depends on the ECB having the freedom to ease the monetary policy stance unhindered by political concerns. This is not beyond Europe. It requires the political will to

Figure 5: Fiscal stance is broadly neutral



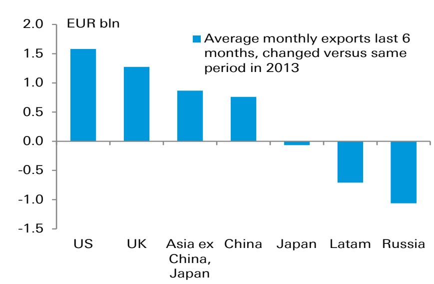
Source: Deutsche Bank Research , European Commission

Figure 6: Euro trade weighted index to fall another 5% in 2015



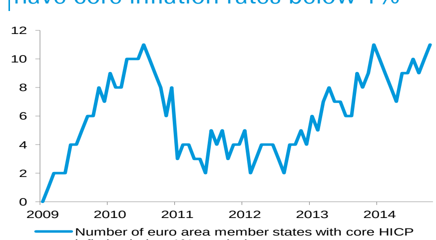
Source: Deutsche Bank Research , ECB

Figure 7: Russia and Latam have dragged on exports



Source: Deutsche Bank Research , Eurostat

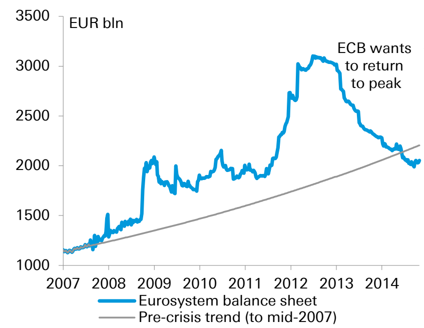
Figure 8: 11 of 18 member states have core inflation rates below 1%



Source: Deutsche Bank Research , Eurostat solve the euro area's policy quandary: the ECB needs to ease policy without having to control the moral hazard concerns; fiscal sustainability needs to be achieved without self-defeating austerity; and structural reforms need to be delivered in a way that avoids adding domestic political costs. There is a way, via the euro area's new policy coordination framework, to free up the ECB to ease policy within being constrained by moral hazard concerns.

The solution requires Europe to focus on growth. This is achievable without changing the ECB mandate or loosening the fiscal rules. First, the maximum room for fiscal manoeuvre 'within the rules' needs to be granted to member states like France and Italy, for example, in exchange for structural reforms. Second, Macro Imbalance Procedures (MIPs) need to be accelerated to hold countries to time-bound, country-specific reforms. It was Europe's political and institutional will that markets underestimated in 2010-2012. There is a risk in 2015 that the various elections (Greece, Portugal, Finland and Spain) signal rising populism, a lack of trust in the EU and a higher hurdle to ever closer union. If Chancellor Merkel secures stronger reform pledges in exchange for budget leniency from Paris and Rome by March, the ECB hawks will have less reason to object to QE on moral hazard grounds. With sufficient political will, Merkel could protect the credibility of the Stability and Growth Pact, the MIP and the ECB.

Figure 9: ECB intends to grow the balance sheet towards 2012 levels

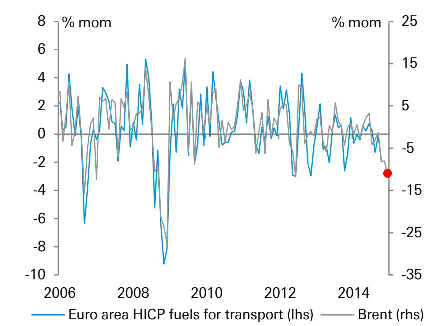


Source: Deutsche Bank Research , ECB

Low inflation is a concern

The sharp decline in oil prices since the September World Outlook has led to further significant downward revisions to euro area inflation forecasts. Oil-related energy prices have declined in every month since August, and a further fall is expected in December, so that the cumulative July-December price decline could exceed 10%; this will have subtracted about 0.6% from headline HICP over this period. Assuming crude prices in line with current market pricing, consumer energy prices could be expected to be a significant drag on headline inflation on average next year—subtracting about 0.4pp, which compares to an average contribution of about +0.5pp since 1999.

Figure 10: Crude oil prices are pushing HICP inflation lower

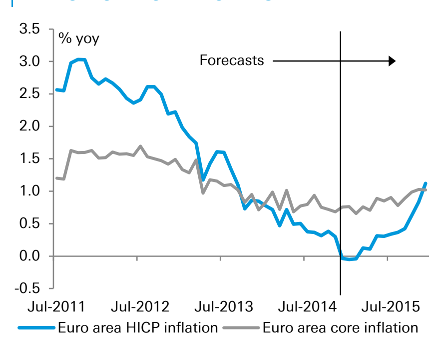


Source: Deutsche Bank Research , Eurostat

Food inflation had started to rise on the back of some normalisation of unprocessed food prices, but seems to have stalled again in November. We expect further increases from next spring, but the recovery is projected to remain muted given the weakness in agricultural prices this year; we see processed food inflation (excluding alcohol and tobacco) turning negative in the coming months.

Core inflation has moved broadly sideways in a 0.7%-1.0% range since Q4 2013, and has been weaker than expected since September, staying close to the bottom of that range while some increases were expected. Indirect effects from commodity weakness (as well as past FX strength), somewhat weaker than expected economic activity as well as possibly some downward adjustment in inflation expectations may have played a role. These factors have also led to some downward revisions to forecasts. Better economic conditions and a weaker exchange rate are still expected to lead to some recovery in core inflation through next year, but the projected profile is very flat, reaching 1.0% only at the end of 2015.

Figure 11: HICP could fall below zero in the next few months



Source: Deutsche Bank Research , Eurostat

On balance, we see headline inflation falling to 0% or slightly below in the coming months. With oil prices at current levels, inflation could stay close to 0 through most of H1, before rising in H2 on the back of somewhat higher core and food inflation and base effects from energy. On average inflation would stay below 0.5% in 2015 under these assumptions, before rising above 1% again in 2016.

Germany: Converging with the (low) average

The German economy has slowed precipitously during 2014. Simple models based on business surveys point to qoq GDP growth of around ¼% in Q4, unfortunately this is the amount by which these models over-predicted growth in the last 2 quarters. Moreover, the downward momentum of these surveys – notwithstanding the small spike in the November ifo – highlights the risk that we could see a negative GDP print during the winter-half.

In 2015 private consumption will remain the mainstay of growth. Domestic demand will also receive impulses from construction investment but to a smaller extent. Employment should expand by almost ½%, although the negative consequences of the minimum wage will cause job growth to taper off towards year-end. The introduction of the minimum wage of EUR 8.50 per hour, which will boost the wages of some 4m employees by around one third, might even provide some upside for Q1 consumption. However, we expect wage settlements in 2015 (with the IG Metall round the most important one starting in mid-January) to drift towards 2% compared to slightly above 3% in 2014. This will be the result of the sluggish demand trend in the manufacturing sector.

According to the PMI, new orders have been falling for the last 3 months, in November the order backlog index dropped by 2.4 points to 48.5. Sluggish internal and external demand has together with geo-political uncertainties – to which Germany is particularly exposed – resulted in a wait-and-see approach with regard to capex. After slumping by 2.3% (qoq) in Q3 we do not expect investment in machinery & equipment to rebound before Q2 2015. The expected depreciation of the Euro against the USD (accounting for 13.5%of the trade-weighted index) will support German exports, but the Yen's 30% depreciation during the last 2 years (weight 6%) presents a noticeable counterbalance.

In addition, German exports with their strong focus on capital goods are suffering from ongoing weak global investment activity and the structural changes in global trade which hit global value chains – so far one of Germany's comparative advantages – in particular. Net-exports should therefore not contribute to 2015 GDP growth. The introduction of the minimum wage might cause a slight increase in core inflation. Still, because of the strong oil price decline headline inflation is expected to remain at around 1%, with the risks tilted to the downside.

European Politics - in search for growth

At a European level, the economic debate is focused on a convincing growth strategy given the euro area's lackluster recovery. Following broad demands for an investment initiative the new EU Commission President Juncker has just unveiled its plans. The Commission proposes to set up a European Fund for Strategic Investments (EFSI), to better use existing resources to attract private investment in projects by providing, e.g., first-loss protection. The plan falls short of (unrealistic) expectations and is unlikely to be a game-changer in economic terms. Making better use of existing EU funds could be an advantage in itself and together with adequate incentives for private investors' participation in infrastructure projects as well as a better regulatory and administrative environment for doing business the initiative could contribute to improve growth conditions in Europe.

The EU leaders' summit on December 18/19 will decide on the final details of this new fund. This is likely to come in a package that also allows France and Italy to make further use of the flexibility of the stability and growth pact, i.e. extending the path for meeting the fiscal criteria in return for a firm commitment for structural reforms.

Figure 12: The pace of fiscal consolidation has slowed

	General government balance		
%GDP	2014F	2015F	2016F
Germany	0.1	-0.5	-0.7
France	-4.4	-4.2	-3.9
Italy	-3.0	-2.8	-2.7
Spain	-5.6	-4.5	-3.8
Netherlands	-2.5	-2.0	-1.9
Belgium	-2.8	-2.8	-2.5
Austria	-3.0	-1.9	-1.2
Finland	-2.8	-2.6	-2.0
Portugal	-4.7	-3.5	-3.3
Greece	-1.3	0.5	1.9
Ireland	-3.6	-2.9	-2.8
Euro area	-2.6	-2.5	-2.3

Source: Deutsche Bank Research

Going forward, the year 2015 will likely be dominated by political risks and the repercussions of national elections on integration politics. In terms of elections, in all countries where they take place populist parties are on the rise and tend to question the relationship with the EU. This will be the case in particular in the UK. The election in May will be the starting point for a re-negotiation of the UK-EU relations leading up to the referendum in 2017. This process will raise a number of practical questions and will overshadow also the "normal business" of policy making in the EU.

In Greece, political and financial risks are becoming increasingly intertwined, with the range of potential outcomes broad and unpredictable. Most notably, a potential change in government with a more adversarial agenda vis-à-vis the euro area is a distinct possibility. Just like Greece was the thin end of the wedge for the euro area financial crisis in 2010, next year could mark a new phase of tension where the prevailing policy consensus is more seriously challenged by a government that was itself born out of the aftermath of the crisis.

In Spain, recent alleged widespread corruption for awarding public contracts and alleged fraudulent use of credit cards by politicians have negatively affected Rajoy's People's Party and also the moderately left-wing PSOE. This is benefiting the newly formed anti-establishment Podemos party. The risk ahead of the 2015 general election is a more fragmented Parliament which could partly hinder government effectiveness. The Spanish economic recovery remains one of the few bright spots in the euro area, but the political situation is likely to remain a source of material uncertainty over 2015.

The legal opinion delivered by the ECJ on the OMT and the subsequent ruling of the GCC will provide uncertainties to the market as it will influence the design of the ECB's public QE. Further down the road, the economic sanctions implemented in the context of the Ukraine crisis will expire automatically in July. This will lead to controversial discussions and political noise as extending the agreed sanctions or a changed embargo package needs the unanimous decision by all 28 EU members.

UK: The election is looming

The UK's economic recovery has continued into the second half of the year at a solid pace, with growth running at an annual rate of 3%. However, we expect growth to slow in 2015 to 2.5% — still respectable but more sustainable than the rapid pace we have become used to over the past year. The components of third quarter GDP raised some questions about its sustainability, however. In particular, business investment fell (though how much we can read into this is debatable given its typical volatility), government spending was up noticeably (unlikely to continue given austerity), higher inventories present downside risks to production going forward, and the combination of a weak euro area and rising domestic consumption point to a continued drag from net exports.

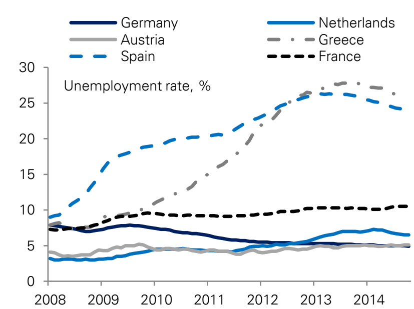
Expectations have been put back for the first monetary tightening. Indeed, we recently moved our own view out from February to August next year. Two factors in particular have been responsible for this – the global (and especially European) macroeconomic backdrop, and the outlook for price and wage inflation. On the first issue, the euro area is the UK's largest trading partner, the destination for close to 45% of UK exports. Net exports are likely to struggle on account of the combination of a weaker euro area and a stronger GBP/EUR exchange rate – up over 10% since summer 2013.

Figure 13: Public debt remains high

	Gross government debt		
%GDP	2014F	2015F	2016F
Germany	74.0	72.4	70.6
France	97.1	99.5	100.3
Italy	132.4	134.0	133.3
Spain	98.1	100.9	102.3
Netherlands	70.3	70.4	69.5
Belgium	105.7	106.7	106.8
Austria	88.0	88.1	86.8
Finland	59.7	62.6	64.5
Portugal	128.8	126.4	124.9
Greece	174.0	164.6	157.7
Ireland	110.6	108.9	106.2
Euro area	94.9	95.3	94.6

Source: Deutsche Bank Research

Figure 14: Despite GDP growth, Spanish unemployment remains very high



Source: Deutsche Bank Research , Eurostat

Figure 15: Other indicators & financial forecasts: Euro area

	2013	2014F	2015F	2016F
M3 growth, % yoy eop	1.0	3.1	3.8	5.6
Fiscal balance, % of GDP	-2.9	-2.6	-2.5	-2.3
Public debt, % of GDP	93.2	94.9	95.3	94.7
Trade balance, EUR bn	168.3	212.9	214.2	204.2
Trade balance, % of GDP	1.7	2.1	2.1	1.9
Current account, EUR bn	197.4	237.9	229.2	209.2
Current account, % of GDP	2.0	2.4	2.2	2.0
Financial forecasts	Current	Q1-2015	Q2-2015	Q4-2015
Official	0.05	0.05	0.05	0.05
3M rate	0.08	0.10	0.05	0.05
10Y yield	0.79	0.70	0.80	1.10
USD per EUR	1.23	1.22	1.20	1.15
JPY per EUR	148	148	145	144
GBP per EUR	0.79	0.76	0.75	0.73

Source: National authorities, Deutsche Bank Research, as of December 08

Second, past weakness in real wages has been a factor in delaying rate rises – though the evidence is slowly building to suggest that the outlook here is improving. Indeed, while annual rates of wage growth remain low (not much above the 1% mark), much of this reflects weakness around the turn of the year (2013/14). Looking at more recent trends, the annualised rate of growth of private sector regular pay over the last six months has picked up sharply to 3.75% - well above the rate of inflation. This is a result of the labour market being tighter than it was, though the Bank of England still believes there is some slack left.

There are, of course, two ways to achieve rising real wages – either through stronger nominal wage growth or lower inflation. It turns out that real wages are being supported by both, with CPI inflation expected to fall further in the near-term to below the 1% threshold. BoE Governor Carney would, as a result, be required to write an open letter to the Chancellor to explain the miss. There are many reasons to think that inflation could remain low for some time – including weak unit labour cost growth, falling factory gate prices, past increases in sterling, the existence of spare capacity, falling inflation expectations, weak global inflation pressures and declining energy prices. It may well prove difficult for the Bank to justify rate rises as long as this disinflationary environment persists – which is why we have pushed out our view of the first hike to the second half of 2015. At this point, we would expect to see inflation heading slowly back up again, some improvement in the prospects for the euro area, and UK GDP settled in to a decent (albeit slower) trend.

The general election of May 7 will provide the political focus for the first half of next year. Recent polls have put the opposition Labour Party modestly ahead of the coalition Conservatives, which if maintained would yield them a small majority. However, the polls have been trending away from the opposition and towards the incumbent for the past year and a half now. Rising real wages should benefit the Conservatives but disappointing fiscal numbers (income tax receipts have failed to impress, thus extending the period of fiscal tightening throughout the next parliament) and risks of Europe's weak growth spilling over into the UK could yet reverse this trend. The election provides plenty of event risk for the markets: a Conservative majority would raise the spectre of an EU in/out referendum (with potential knock-on effects for inward investment); Labour would introduce a mansion tax, higher top rate of income tax and less austerity; while the lack of an overall majority for either of the two major parties could lead to fraught coalition negotiations – the risks for this have risen on account of the current junior coalition partner (the Liberal Democrats) polling badly and the UK Independence Party gaining significant support.

Figure 16: Other indicators & financial forecasts: UK

	2013	2014F	2015F	2016F
M4 growth, %	1.9	-2.0	5.2	4.9
Fiscal balance, % of GDP, FY	-5.6	-4.9	-3.9	-2.0
Trade balance, GBP bn	-110.2	-112.7	-116.8	-120.5
Trade balance, % of GDP	-6.4	-6.4	-6.6	-6.5
Current account, GBP bn	-72.4	-88.0	-70.6	-64.8
Current account, % of GDP	-4.2	-5.0	-4.0	-3.5
Financial forecasts	**Current**	**Q1-2015**	**Q2-2015**	**Q4-2015**
Official	0.50	0.50	0.50	1.00
3M rate	0.56	0.55	0.68	1.25
10Y yield	2.02	2.10	2.20	2.50
USD per GBP	1.57	1.61	1.60	1.58
GBP per EUR	0.79	0.76	0.75	0.73

Source: National authorities, Deutsche Bank Research, as of December 08

Figure 17: Macro-economic activity & inflation forecasts: UK

Economic activity	2014				2015				2014F	2015F	2016F
(% qoq, saar)	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	3.0	3.7	2.8	2.6	2.3	2.3	2.1	2.1	3.0	2.5	2.3
Private consumption	2.7	2.4	3.2	2.8	2.8	2.4	2.0	2.0	2.2	2.6	2.3
Investment	9.8	5.1	4.0	6.1	6.1	5.7	5.7	5.7	7.6	5.6	5.5
Gov't consumption	-1.1	3.9	4.5	0.0	0.0	0.0	0.0	0.0	1.5	0.8	-0.5
Exports	-1.4	-1.7	-1.6	0.0	0.8	1.6	1.6	1.6	-1.7	0.5	1.9
Imports	-7.9	-1.1	5.5	1.4	2.3	2.3	2.1	2.1	-0.9	2.3	2.2
Domestic demand	0.7	3.9	4.9	1.9	2.8	2.5	2.2	2.2	3.1	2.8	2.3
Contribution (pp): Stocks	-2.3	0.7	1.4	-0.9	0.0	0.0	0.0	0.0	0.3	0.0	0.0
Net trade	2.2	-0.2	-2.2	-0.5	-0.5	-0.3	-0.2	-0.2	-0.2	-0.6	-0.1
Industrial production	3.7	0.8	0.8	2.0	2.0	2.0	2.0	1.6	2.3	1.8	1.7
Unemployment rate, %	6.8	6.3	6.0	5.9	5.8	5.8	5.7	5.7	6.2	5.8	5.6
Prices & wages (% yoy)											
CPI	1.7	1.7	1.5	1.1	1.0	1.2	1.3	1.6	1.5	1.3	1.8
Producer prices	0.6	0.4	-0.3	-0.5	-0.5	-0.1	0.7	1.7	0.1	0.4	1.9
Compensation per empl.	1.9	-0.1	0.9	1.5	2.2	2.3	3.1	3.0	1.0	2.7	3.0
Productivity	0.6	0.7	0.7	1.2	1.7	1.7	1.8	1.7	0.8	1.8	1.8

Source: National authorities, Deutsche Bank Research

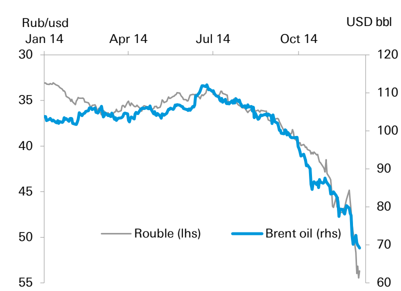
EMEA: Lower oil having strongly differing effects across countries

The sharp drop in oil prices has had strongly differing effects on the emerging markets in the region, providing relief to those with large energy import bills but adding significantly to the challenges being faced by Russia and other large oil producers in the region.

In Russia, while growth has decelerated only moderately to 0.8% yoy over the first three quarters of the year, underlying momentum has faded more sharply than this. In sequential terms, growth was flat in the third quarter and will likely turn negative in the current quarter. With little sign of a breakthrough in the crisis in Ukraine, sanctions look set to remain in place until at least mid-2015 when EU countries would need to approve their renewal. The resulting squeeze in access to external financing has pushed up the cost of domestic financing and forced some companies to delever.

The last thing that Russia needed against this backdrop was a drop in the price of oil which, alongside natural gas, accounts for almost half of government revenues and two-thirds of exports. Facing intense pressure on the rouble, the Central Bank of Russia (CBR) elected to protect its reserves and let the currency float, a process that it has been gradually building towards in any case. At the time of writing, the rouble had fallen by 40% since mid-year. While this will protect the local currency value of Russia's oil revenues and thus minimize the damage to the budget, it will add to the pressure on inflation, which has already accelerated to 9%. The CBR has also had to hike interest rates by 400bps so far this year to 9.5%, but may well need to do more to keep inflation in check and safeguard financial stability.

Figure 18: Oil price fall triggers collapse in Russian rouble



Source: Bloomberg Finance LP, Deutsche Bank Research

The degree of dollarization in the economy has been much reduced in recent years following the gradual introduction of greater exchange rate flexibility and successful efforts to bring down inflation. Russian companies will face difficulty in rolling their maturing external obligations, though at USD 112bn over the next two years, these are relatively manageable when compared with foreign reserves of USD 420bn. The biggest risk could come from large scale deposit withdrawals and conversion into hard currency, which would add to the squeeze on the economy.

All in all, we still think that letting the rouble float was the right thing to do. Nevertheless, the backdrop for the Russian economy is an extremely challenging one. We think it is about to enter a protracted recession, albeit a relatively shallow one by historical standards, with output contracting by 0.9% in 2015 and 0.4% in 2016.

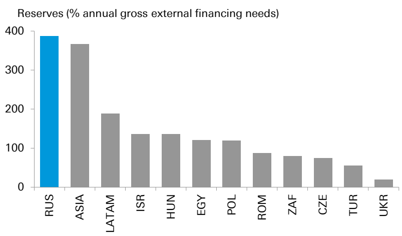
At the other end of the spectrum, one of the biggest beneficiaries of the drop in the price of crude has been Turkey, where oil imports account for about 7% of GDP. The reduction in energy prices will provide significant relief, helping to further reduce one of the largest current account deficits in EM. It will also contribute to a much needed reduction in inflation from elevated levels, which will likely pave the way for the Central Bank of Turkey (CBT) to deliver modest rate cuts early next year. We have nevertheless left our growth forecasts for Turkey more or less unchanged at 3.25-3.50% for the next couple of years as we think the tailwinds from cheaper energy prices will be largely offset by weaker demand from the Middle East and Russia, two of its main trading partners. We also think the drop in inflation will prove mostly temporary and that the CBT will need to reverse its rates cuts towards the end of next year once the Fed has begun its tightening cycle.

Central Europe meanwhile has continued to perform admirably, delivering growth of 3% on average over the last year and a half. Stronger domestic demand has helped to offset much of the impact of softer activity in the euro area and the crisis in Russia and Ukraine. We view this as a dividend from years of painful deleveraging, following which private credit growth has begun to recover, fiscal stances have returned to neutral, and external imbalances have been corrected.

The region is also a net energy importer so cheaper oil prices will help to sustain growth rates at around these levels for the next couple of years. In the near term, it will add to deflationary pressure, which has seen headline inflation rates turn negative recently in Poland and Hungary. Central banks in the region have so far interpreted this pressure are largely exogenous, reflecting the lower price of food and energy, and imported deflation from the euro area. Given the strength of domestic demand, it has been something that policymakers have been prepared to look through. There is scope, therefore, for central banks in the region to cut rates further if necessary should growth start to flag and/or deflationary pressure start to infect their domestic economies.

Finally, the picture in South Africa is a somewhat mixed one. It will also benefit from lower oil prices. In particular, it will help to ease the dilemma facing the South African Reserve Bank, which has had to gradually hike rates to keep inflation in check despite an anemic outlook for growth. It may now be able to get away without hiking rates at all next year. On the other hand, the change in the composition of demand in China and the associated weakness of other non-oil commodity prices is a potential drag on the South African economy. Moreover, elections earlier this year have done little to kick start the structural reform process. Infrastructure bottlenecks are being addressed only slowly and there has been little progress in improving labor

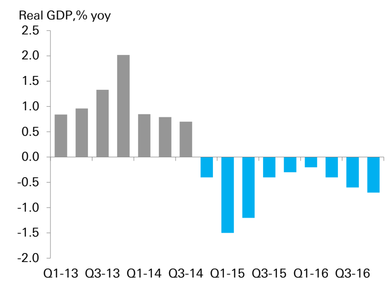
Figure 19: Russian reserves still high by EM standards



Figures for asia and latam are regional medians. gross external financing needs defined as current account defict plus maturing

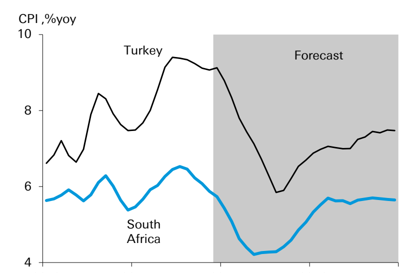
Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 20:Russian economy poised to enter protracted recession



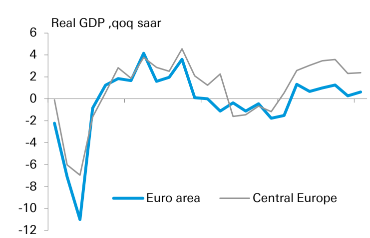
Source: National statistics, Deutsche Bank Research

Figure 21: Inflation relief from lower oil prices likely to be temporary



Source: National statistics, Deutsche Bank Research

Figure 22: Central Europe decouples



Central europe is the average for czech republic, hungary, and

Source: Haver Analytics, National statistics, Deutsche Bank Research relations. Growth has repeatedly disappointed on the back of this. While we do anticipate an acceleration in growth over the next couple of years, it is likely to be a muted one by past standards.

Mark Wall, (44) 20 7545 2087
Markus Heider, (44) 20 7545 2167
Stefan Schneider, (49) 69 910 31790
Barbara Boettcher, (49) 69 910 31787
George Buckley, (44) 20 7545 137
Robert Burgess, (44) 20 7547 1930

Japan: Steady recovery trend intact after April VAT hike

- The Japanese economy is on a 1.5% stable growth path in 2015-2016, led by balanced contributions from domestic and external demand.
- GDP growth is likely to remain above long-term interest rates, which underpins a virtuous circle between economic activity and asset prices.

Acceleration in activity in Q4 before entering stable growth path in 2015

The 1.9% (saar) contraction in Q3 GDP growth was led by a -2.2pp contribution from inventories, suggesting an end to inventory adjustment by Q3 and a boost in activity in Q4. Many economic indicators pointed to a pick-up in August and September, including consumer durables shipment, autos and housing that were hit the most by the April VAT hike. As such, we now forecast acceleration in activity in Q4 before moving to a stable growth path in 2015. Economic growth in 2015-2016 should be characterized by broadening the base of the investment recovery and steady private consumption growth, on the back of continued aggressive monetary easing, a rise in the opportunity cost of investment in financial assets (vs. investment in real assets), corporate earnings recovery, and a steady rise in wages. A delay in the second VAT hike (from 8% to 10%) to April 2017 would help stabilize economic growth profile even at the expense of slower improvement in the fiscal balance. Nominal GDP levels could come back to the historical high (in Q4 1997) sometime in 2017.

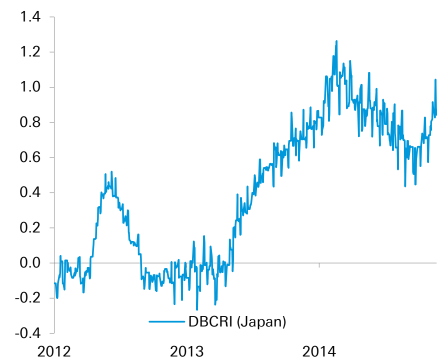
Continued improvement in labor market

We maintain our view of 2.0-2.5% growth in nominal aggregate wages in 2014-16 on the back of a recovery in profits, a narrowing output gap and rising prices. The composition of the wage growth should shift from employment to per-capita wages, from part-time to full-time employment, and from a rise in bonuses to monthly salary. These changes are already under way.

CPI inflation likely to stabilize at 1%

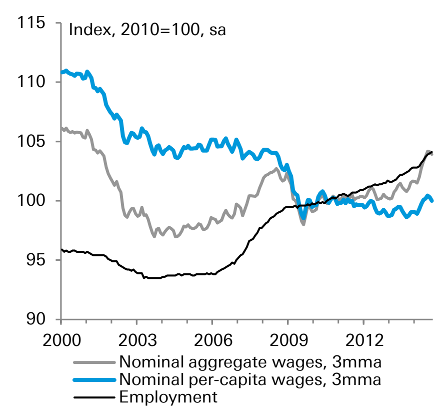
CPI inflation, excluding fresh food and VAT effects, is likely to stabilize at around 1% in 2015-2016. A better prospect for the output gap, JPY depreciation and falling oil prices seem to offset each other. Reaching 2% CPI inflation requires the unemployment rate to fall to a 2.5-2.8% range. With a rising labor participation going forward, the decline in unemployment of this magnitude seems unlikely to achieve within 2015-2016.

Figure 1: Composite realization index turning up in Japan



Note: Standardized various economic indicators.
Source: Deutsche Bank Research.

Figure 2: Rising nominal wages



Source: MHLW, Deutsche Bank Research

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

Economic activity	2014				2015				2014F	2015F	2016F
(% qoq, saar)	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP	6.7	-7.3	-1.6	5.3	2.2	1.4	1.3	1.5	0.5	1.4	1.6
Private consumption	9.1	-18.6	1.5	5.1	1.6	1.2	1.2	1.2	-0.8	0.7	1.4
Investment	20.2	-16.7	-2.1	4.7	1.6	0.5	0.5	0.9	3.9	0.0	1.0
Gov't consumption	-0.9	-0.2	1.3	1.2	1.2	1.2	1.2	1.2	0.3	1.1	1.2
Exports	28.2	-1.9	5.3	9.8	7.3	7.7	6.8	7.6	8.0	6.9	7.4
Imports	27.3	-19.9	3.1	8.9	6.0	6.0	6.2	6.1	7.2	4.3	6.5
Contribution (pp):											
Private inventory	-1.7	4.2	-2.2	0.7	0.4	0.0	0.0	0.0	0.1	0.2	0.1
Net trade	-2.0	0.4	3.0	0.4	0.3	0.3	0.4	0.2	0.2	0.5	0.3
Industrial production	12.2	-14.4	-7.5	8.2	3.0	3.0	3.0	3.0	2.1	1.4	3.2
Unemployment rate, %	3.6	3.6	3.6	3.6	3.5	3.4	3.4	3.4	3.6	3.4	3.2
Prices & wages (% yoy)											
CPI	1.5	3.6	3.4	3.0	3.1	1.0	0.7	0.8	2.9	1.4	1.0
Core CPI	1.3	3.4	3.1	2.8	2.8	0.6	0.6	0.8	1.8	1.1	0.9
Producer prices	2.0	4.3	4.0	2.6	1.6	-1.5	-1.6	-0.1	3.2	-0.4	1.2
Compensation per empl.	0.0	0.9	0.8	0.6	0.5	0.5	0.5	0.5	1.0	1.7	1.7
Productivity	1.3	-0.4	-1.7	0.6	-1.7	1.2	1.7	0.9	-0.1	0.5	0.9

Source: National authorities, Deutsche Bank Research

JPY exchange rate and trade balance

While the recovery in export volumes is disappointing, the relationship between the volume-based trade balance (excl. fuel imports) and JPY exchange rate shows a 10% JPY depreciation leads to a 20-40bp improvement of the real trade balance/GDP ratio in two years. The actual improvement in the real trade balance so far is 110bp with a 30% JPY depreciation, in line with the estimate. We forecast a re-expansion of the current account surplus due to slow narrowing of the trade deficit and an expanding income surplus.

Fiscal deficit to continue a narrowing trend

The fiscal deficit should remain on a narrowing trend, albeit at a slower pace, due to the delay in the second VAT hike. The revenue loss from this delay would be around JPY4trn a year (0.8% of GDP). An introduction of a preferential low VAT rate is likely to be introduced in April 2017 to basic necessities, as a teaser. Japan's fiscal deficit is roughly half cyclical and half structural. The improvement in the structural deficit cannot be achieved by an economic expansion alone. A few more rounds of the VAT hike and a few other changes in the social security are needed to deliver a primary surplus. That said, the QQE and resulting economic expansion have started healing the debt problem by easing the debt dynamics and stabilizing net government debt.

Monetary policy to maintain aggressive easing

We forecast the BoJ to maintain its aggressive monetary base expansion at JPY80trn a year throughout 2015 and possibly in 2016 as well. The following are potential risks for in 2015-2016: 1) a switch to an open-ended 2% inflation target (already implicitly done), 2) an introduction of price-level targeting, 3) a large-scale purchase of ABS/MBS by encouraging the private sector to package existing loans, and 4) a slower pace of the monetary base expansion. Changing/missing the 2% inflation target may be disappointing to the financial markets but is not necessarily a setback for monetary policy, as long as the economic expansion continues.

Risks: 1) Another delay in the VAT hike beyond April 2017, 2) less coordination between the government and the BoJ, 3) inability to restrain entitlement spending (social security), 4) more government involvement/discretion in growth strategy implementation.

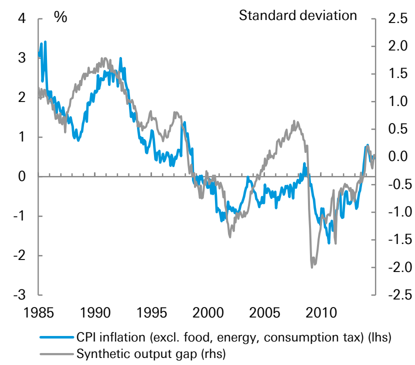
Figure 7: Other indicators & financial forecasts

	2013	2014F	2015F	2016F
M2 growth, %	3.6	3.3	4.4	5.1
Fiscal balance, % of GDP	-9.1	-7.2	-6.4	-5.4
Public debt, % of GDP	212.9	214.8	214.7	213.9
Trade balance, USD bn	-89.4	-97.0	-45.0	-33.4
Trade balance, % of GDP	-1.8	-2.1	-1.1	-0.8
Current account, USD bn	34.1	16.4	78.3	99.6
Current account, % of GDP	0.7	0.4	1.9	2.4
Financial forecasts	**Current**	**Q1-2015**	**Q2-2015**	**Q4-2015**
Official	0.10	0.10	0.10	0.10
3M rate	0.20	0.15	0.15	0.15
10Y yield	0.42	0.55	0.55	0.65
JPY per USD	119.8	121.0	121.0	125.0
JPY per EUR	148.1	147.6	145.2	143.8

Source: Deutsche Bank Research, as of December 08

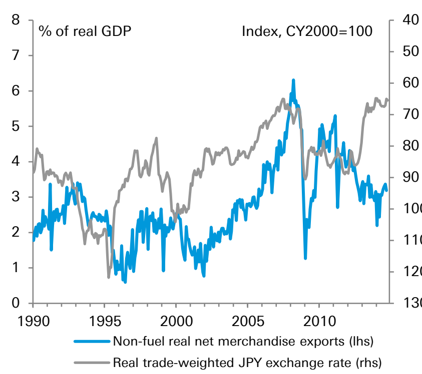
Mikihiro Matsuoka, (81) 3 5156 6768

Figure 4 : Output gap vs. CPI inflation



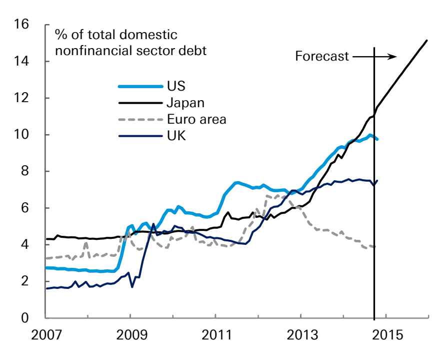
Note: Synthetic output gap = 0.35 x standardized capacity utilization - 0.65 x standardized cyclical unemployment rate. Cyclical unemployment rate = (Unemployment - voluntary job leavers) / labor force.
Source: MIC, METI, Deutsche Bank Research

Figure 5 : Real trade balance vs. JPY exchange rate



Source: Haver Analytics, BoJ, MoF, Cabinet Office, Deutsche Bank Research

Figure 6 : Monetary base in G4



Note: Japan assumes JPY6.67trn monthly rise (JPY80trn annual rise) in monetary base.
Source: BoJ, Federal Reserve, Haver Analytics, Deutsche Bank Research

Asia (ex Japan): Tailwind from the US, shadow from China

Overview

Asia will enter 2015 with multi-directional winds blowing in the global economic landscape. Our GDP forecasts, on aggregate, show the region growing only marginally faster (6.2%) than this year (6.0%) as a result. There will be tailwind to trade from continued improvement in the US economy, but anemic growth in the EU and slowing momentum in China will neutralize much of the upside, in our view. Many Asian countries will have strong domestic narratives next year, with India and Indonesia hoping to enjoy some dividend from strong fiscal, monetary, and structural measures of recent years, as well as goodwill from investors with respect to their new governments. Thailand would attempt to transition back to democracy, prior to which the military regime would make efforts to boost investment and growth. China will have a number of dominating themes, including improving governance, dealing with the property market slowdown and associated fallout, boosting social security to support consumption, and continuing with financial market liberalization.

While many domestic narratives will be compelling, external developments will be impacting the outlook profoundly. Below we highlight some areas that will influence Asia's economies:

Figure 1: Deutsche Bank forecasts: Emerging Asia

(% yoy, unless stated)	2013	2014F	2015F	2016F
Real GDP growth	6.1	6.0	6.2	6.1
Private consumption	5.8	6.2	6.2	6.2
Investment	6.0	4.8	5.9	6.3
Government consumption	6.3	6.2	6.2	6.7
Exports	5.7	5.0	6.1	6.7
Imports	4.2	2.7	5.0	6.0
CPI	4.5	3.6	3.6	3.7
CA balance, % of GDP	1.4	2.4	2.5	2.3
Asia ex. China and India				
Real GDP growth	4.4	4.1	4.5	4.6
CPI	3.5	3.4	3.6	3.4

Source: National authorities, Deutsche Bank Research

Slowing China

Given China's scale and rapid and non-volatile growth in recent decades, a prolonged soft patch there could catch the region's economies and businesses by surprise. Asia's trade exposure to China is considerable for both final demand and intermediate goods. Financial linkages have deepened too in recent years with the region's investors taking on Chinese equity and debt in great quantities. Any disorderly development there could have wide ripples on the region's economies and financial markets.

Stagnating Europe

Given that the GDP of the Eurozone rivals that of the US sharply below-trend growth there remains a big drag to Asia's exports demand. While weak growth in Europe is not a new development, the associated risks could readily spill over to Asia, including various unintended consequences of aggressive monetary policy easing, debt and currency market volatility, and potential disruption of financial and credit flows.

Commodity price correction

Given that most economies in Asia are importers of energy, ongoing correction in commodity prices bodes well for the region's current account and inflation outlook. This is welcome news particularly for deficit economies like India and Indonesia. Malaysia, in contrast, stands to lose as it is a major commodity exporter. Also, to the extent that weak commodity prices reflect demand malaise in China and EU, this development cuts both ways for region's outlook.

Faltering global trade

UN data show that global trade in value terms has been stagnant since 2012 while in volume terms the stagnation goes back to 2011. Slowing G3 growth and rise in trade protectionism have driven this trend, which is unlikely to change in the near term. Given that Asian economies rely heavily on trade, the loss of momentum in global trade could turn out to be a major headwind to growth in the near and medium term.

Fed policy normalization and QE in EU/Japan

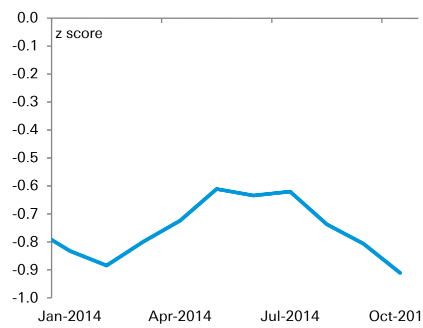
It would be remarkable if Fed policy normalization proceeds without creating any disruption to global markets next year. At the very least, the ongoing USD rally in anticipation of the Fed move will likely continue, putting pressure on regional FX. At the same time, likely continuation of aggressive unconventional monetary policy in EU and Japan will create additional complication for regional exchange rates. South Korean won, for instance, would have to find a balance between giving in to the USD rally vs. strengthening against the Japanese yen (the latter development would hurt its exporters).

Country views

China

We expect the economy to decelerate from 7.3% in 2014 to 6.9% yoy in 2015H1, dragged by weak property investment. The government responded to the potential risks with a rate cut on Nov 21, and we expect two more rate cuts and two RRR cuts in 2015. Contingent on the policy actions, we see risks to outlook balanced. Upside risk comes from service sector exports amid regional trade cooperation and mainland opening up. Lagged effects of the monetary policy easing cycle, together with more expansionary fiscal policy, will pull up GDP growth to 7.2% in 2015H2, in our view.

Figure 2: Regional growth momentum continues to weaken



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

Hong Kong

Growth could head toward 3% next year on stronger external demand (mainly the US) and associated stronger local consumption. However, this outlook faces downside risks including domestic uncertainty, faster-than-expected China deceleration, and slower-than-perceived EU recovery.

India

Actual data show an economy still treading sideways, but sharply rising consumer and business sentiment bode well for the cycle. An investment recovery and re-acceleration in consumption seem likely in the coming year. Little progress on structural areas has been made by the new government so far, but tangible movement on tax, FDI, and mining could be around the corner. A risk is that drag from non-performing investments and loans could delay the recovery, calling into question lofty asset market valuations. Also, market volatility around Fed rates normalization could cause debt service difficulties for India's corporate sector, which has borrowed in USD heavily in recent years.

Indonesia

Commodity sector headwind and some degree of fiscal/monetary tightness will likely keep growth below trend in 2015, but the ongoing macro adjustments could set the ground for stronger fundamentals and sustained economic performance ahead. Still, next year could be challenging for the economy, with the exchange rate at risk of coming under pressure if the current account does not improve in the aftermath of the fuel price hike. There are also concerns that President Widodo's reform agenda could be undermined by a fractious and antagonistic parliament.

Malaysia

The economy will be tested as fiscal consolidation advances while commodity prices decline. A period of depreciating currency and higher borrowing costs could compound the challenge. Deceleration in domestic demand together with anemic exports revenues due to falling oil prices could drag growth below 5% in 2015, reversing this year's rebound.

Philippines

Accelerated public spending ahead of the 2016 elections, sustained remittance inflows, robust expansion of the IT-BPO industry, and lower commodity prices could help the economy grow by at least 6.5% in the next two years. Power supply shortfall could however disrupt domestic activity.

Singapore

Another year of 3% real growth could be in store in 2015 if the drag from slowing China and EU is countered by rising orders from the US. Inflation risks are likely to all but dissipate, allowing the MAS to letting the NEER to flatten or depreciate.

South Korea

We expect a modest improvement in GDP growth, to 3.6% in 2015, vs. 3.4% in 2014, while the government embarks on productivity-enhancing reform measures. Sustained weakness of the won however could pose risks to capital flows.

Sri Lanka

We expect 7.5% real GDP growth rate in this and next year, with mid single-digit inflation and stable fiscal metrics. The upcoming Presidential elections in January 2015 and possible interest rate hikes by the US Federal Reserve sometime next year are two event risks which could potentially cause increased volatility in financial markets.

Taiwan

Growth to hover around mid-3% over the next couple of years, but for sustained strong growth the authorities need to take growth-enhancing reform measures. The TWD weakness poses a risk to foreign investment in onshore securities. However, the threat to financial stability is limited by Taiwan's large foreign assets.

Thailand

Growth may bottom out early next year, but our forecast of 3.5% rise in real GDP is subject to many domestic and external risks. Lack of inflation pressure will allow BoT to stay on the sidelines for the duration of the year, although rate cuts could be entertained if real rates are seen to be rising long before growth recovery is assured. There are many risks to the outlook, however. Exports and tourism could remain in doldrums if the political situation does not improve.

Vietnam

The authorities' target of 6.2% growth and below 5% inflation is achievable, but sustained delay in structural reform risks Vietnam's potential.

Taimur Baig (+65) 6423-8681

Figure 3: Deutsche Bank forecasts

(% yoy, unless stated)		2014F	2015F	2016F
China	GDP	7.3	7.0	6.7
	CPI	2.2	2.6	3.0
	CA bal., % GDP	3.1	3.4	3.3
	Fiscal bal., % GDP	-2.1	-2.5	-3.0
Hongkong	GDP	2.2	2.9	3.0
	CPI	4.2	3.5	3.2
	CA bal., % GDP	2.2	2.0	1.8
	Fiscal bal., % GDP	2.6	2.9	3.0
India	GDP	5.5	6.5	6.5
	CPI	7.3	6.0	6.0
	CA bal., % GDP	-1.4	-1.7	-1.7
	Fiscal bal., % GDP	-4.5	-4.0	-3.8
Indonesia	GDP	5.0	5.0	5.5
	CPI	6.4	7.4	5.1
	CA bal., % GDP	-2.6	-1.7	-1.2
	Fiscal bal., % GDP	-2.2	-1.7	-1.7
Malaysia	GDP	5.9	4.8	5.4
	CPI	3.1	4.0	3.7
	CA bal., % GDP	5.7	2.9	3.3
	Fiscal bal., % GDP	-3.5	-3.4	-2.8
Philippines	GDP	5.9	6.5	6.6
	CPI	4.3	3.5	3.8
	CA bal., % GDP	4.6	4.3	2.3
	Fiscal bal., % GDP	-1.8	-2.2	-2.4
Singapore	GDP	3.0	3.0	3.5
	CPI	1.0	0.5	1.5
	CA bal., % GDP	18.9	19.6	18.2
	Fiscal bal., % GDP	6.9	6.8	6.6
Korea	GDP	3.4	3.6	3.6
	CPI	1.3	1.7	2.1
	CA bal., % GDP	6.4	6.8	5.9
	Fiscal bal., % GDP	0.2	-0.5	-0.4
Sri Lanka	GDP	7.5	7.5	7.0
	CPI	3.3	4.0	6.0
	CA bal., % GDP	-2.9	-2.5	-2.0
	Fiscal bal., % GDP	-5.0	-5.0	-4.5
Taiwan	GDP	3.4	3.6	3.6
	CPI	1.2	0.7	0.9
	CA bal., % GDP	12.6	13.9	14.4
	Fiscal bal. % GDP	-2.0	-1.8	-1.5
Thailand	GDP	0.5	3.5	3.0
	CPI	1.9	0.5	2.1
	CA bal., % GDP	1.9	1.4	0.5
	Fiscal bal., % GDP	-2.8	-2.5	-2.0
Vietnam	GDP	5.8	6.2	6.2
	CPI	4.2	4.7	5.5
	CA bal., % GDP	4.3	3.5	0.0
	Fiscal bal. % GDP	-5.9	-5.3	-5.3

Source: Deutsche Bank Research

Latin America: Another challenging year ahead

- Latin America's economic growth has continued to surprise on the downside. External demand has been recovering, but terms of trade have received a new negative shock in the past couple of months. This together with some pending policy uncertainty is likely to further delay a much needed rebound in investment. Growth for 2014 is now projected at just 0.8%, while recovery in 2015 is set to be rather gradual. Growth is projected to reach 2.9% in 2016, closer to the new sustainable pace in the region.
- Weaker terms of trade are severely affecting investment demand, in particular in countries with still high labor costs. Fiscal expansion and overheating during the commodity bonanza seem to be directly related to worsening competitiveness. Unfortunately, a new form of state capitalism does not seem to be changing in a number of major regional economies, although recent policy decisions in Brazil, Argentina´s 2015 election, Mexico´s energy reform, and good policy continuing in Chile, Colombia and Peru remain good reasons for hope in the medium term.
- Low level of external indebtedness should buffer Latin American from a likely rate and external shock in 2015 and 2016, but debt dynamics are fragile in Venezuela, and international reserve coverage ratios might become too low in Venezuela, and Argentina.

Unfavorable external backdrop is likely to slow down the recovery ahead

We are finally projecting regional growth to be just 0.8% this year, from 1.0% estimated in September 2014 and 2.6% hoped for in December 2013. The recent correction in outlook has also affected forecasts for 2015, as we now project only 1.5% growth, from 3.1% in December 2013. It is worth noting that the latest forecasts acknowledge a new slowdown in consumption, expected this year to advance by only1.1% from 2.6% originally estimated. However, the downward revision in investment growth, closely related to persistent weakness in investment demand and worsening terms of trade in the last two months, is even more noticeable.

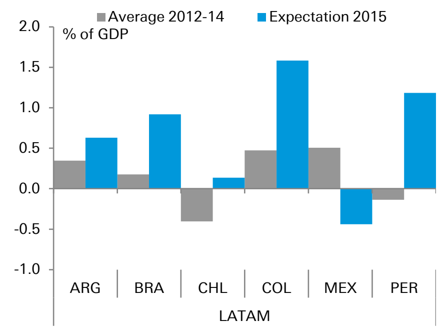
The region today is suffering from a challenging external backdrop but also from the hangover from the last commodity bonanza. Commodity prices have been falling since late 2011 with some of them having nose-dived since mid-year. More importantly, according to future markets, commodity prices are expected to remain weak through much of 2015 and 2016. Declining commodity prices in the last two years have greatly harmed countries like Chile, Peru, and Venezuela, with accumulated income loses since 2012 of 4.5% of GDP, 2.3%, and 1.1%, respectively.

If current price levels were to remain throughout 2015, the most vulnerable countries will be oil exporters. Indeed, current prices in 2015 would represent an income loss of almost 4% of annual GDP for Venezuela, and 1.5% for Colombia. Similarly, the continuation of current commodity prices could imply a revenue loss of around 2% of GDP for the fiscal accounts in Venezuela, or 1.3% for the Mexican treasury. As oil importers Argentina, Chile, and Peru could benefit from current relative prices as long they remain unchanged.

While supply side constraints warrant policy reforms not yet in the agenda

According to IMF calculations of trend growth, Latin American sustainable growth rates have moved from 3.5% average during the last decade to around 2.8% currently. Furthermore, this slowing trend is expected to continue in the years to come. The investment boom in the peak years and some policy driven overheating can certainly explain that path. Nevertheless, labor force growth in the region is now growing at half the pace in previous years, while

Figure 1: Income effect from recent commodity shock (% GDP)



Source: IMF, Haver Analytics, Deutsche Bank Research

Figure 2: Deutsche Bank forecasts: Latin America

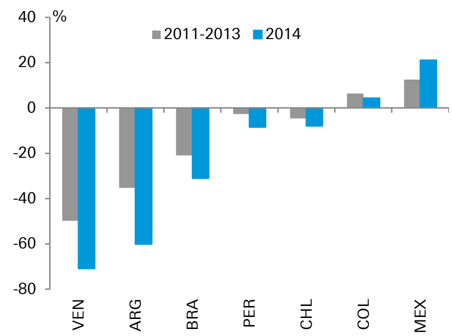
(% yoy, unless stated)	2013	2014F	2015F	2016F
Real GDP growth	2.5	0.8	1.5	2.9
Private consumption	3.6	1.1	1.4	3.5
Investment	2.3	-2.9	1.6	5.309
Exports, USD bn	969.2	933.3	909.2	951.4
Imports, USD bn	920.3	896.9	903.5	950.6
CPI	9.5	12.5	13.5	11.9
Industrial production	1.5	-0.7	1.6	3.4
Unemployment, %	6.0	5.7	6.0	5.9
Fiscal balance, % of GDP	-3.3	-4.5	-4.7	-3.6
CA balance, % of GDP	-2.5	-3.0	-3.0	-3.1

Source: National authorities, Deutsche Bank Research investment/GDP ratios have been contracting steady in many countries. For example, countries like Peru, Brazil, Chile, and Argentina have seen labor force growth slowdown from an average of 2.6% annual rate to 1.8%. Likewise, in the past capital formation accumulated at a pace of 2.8% above GDP to now expanding in line with GDP. This investment fall has been critical in countries like Brazil, Argentina, and Chile, while private sector investment in Venezuela has been negligible for a few years already.

The latter is a perfect indicator of the need for a second round of reforms in these economies. Unfortunately Mexico has been the only country to show clear determination to push for reforms in a couple of specific areas, particularly in the energy sector. On the contrary, in Argentina, Brazil, and Venezuela, in particular, there has been an increasing intervention of some form of state capitalism, with expanding governments, increasing trade protectionism, and economic controls. This appears to explain the observed characteristics of the recent slowdown in the region, particularly visible in the industrial sector, and in countries reporting significant increases in unit labor costs, typical of a middle income malaise.

In this regard, the recent election in Brazil and next year's presidential election in Argentina could represent a clear opportunity for a constructive change. In Brazil, partly forced by lackluster economic growth and a tight election result, re-elected President Rousseff appointed a new economic team suggesting a turnaround in the consumption-driven growth strategy of her first administration. A warranted fiscal adjustment has been announced, and steps are being taken to re-establish much needed policy credibility. The President´s conviction to support these policies, especially if the economy recovers more slowly than the government might expect, remains in doubt though. In Argentina, while there is no clear front runner in the polls, all the main candidates are thought to be supportive of policy reforms in one way or another. With little leverage in the economy, lack of investment for many years, and still abundant natural resources, Argentina has the potential for a rapid and significant turnaround as soon as polices change for the better.

Figure 3: Reduction in trend growth since 2004-2010



Source: IMF, Deutsche Bank Research

Stress testing the regional outlook to external shocks

There are a number of risks that EM in general and Latin America in particular might confront in the years ahead. The last several years of ultra-low global interest rates have been a bonus for public debt managers and a likely rise in US rates has the potential to create further turbulence in capital flows. Similarly, recent declines in commodity prices might challenge in producer countries' external balances.

Stress testing public sector debt dynamics shows that Venezuela might face significant increases in their debt levels if they failed to reduce their large primary deficits. However, others with more moderate primary deficit levels, including Mexico, could also face relatively large increases in debt. At the other end of the spectrum, some countries would see their debt levels continue to fall without much fiscal effort, notably Brazil, and Colombia.

The combined shock of higher rates, reduced capital inflows, and weak commodity prices could push international reserve coverage ratios to pretty low levels (well below 100%) in Venezuela, Argentina, and Chile. Needless to say, currencies are more exposed in these countries, and the authorities might have to allow further exchange rates weakening and/or tightening policy in the event of external shocks.

Figure 4: Deutsche Bank forecasts:

(% yoy, unless stated)		2013	2014F	2015F	2016F
Argentina	GDP	2.9	-1.5	-2.8	3.0
	CPI	25.3	38.6	38.6	26.1
	CA bal., % GDP	-1.4	-1.6	-0.9	-1.4
Brazil	GDP	2.5	0.1	0.7	1.9
	CPI	6.2	6.3	6.4	5.8
	CA bal., % GDP	-3.6	-4.2	-4.2	-4.2
Chile	GDP	4.2	1.6	2.6	3.2
	CPI	1.9	4.5	4.0	3.2
	CA bal., % GDP	-3.5	-1.9	-2.0	-2.8
Colombia	GDP	4.7	4.7	4.2	4.0
	CPI	2.0	2.8	3.2	2.7
	CA bal., % GDP	-3.4	-4.5	-4.9	-3.5
Mexico	GDP	1.1	2.1	3.4	3.7
	CPI	3.8	4.0	3.8	3.5
	CA bal., % GDP	-1.8	-2.3	-2.5	-2.7
Peru	GDP	5.8	2.7	5.5	5.0
	CPI	2.5	3.2	2.4	3.1
	CA bal., % GDP	-4.6	-5.1	-4.7	-4.7
Venezuela	GDP	1.3	-3.6	-2.0	2.0
	CPI	40.0	60.0	80.0	85.0
	CA bal., % GDP	2.2	1.6	0.4	0.6

Source: National authorities, Deutsche Bank Research

Gustavo Cañonero, (1) 212 250 7530

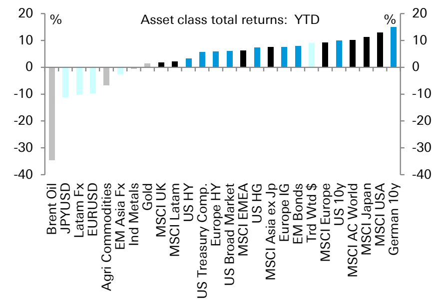
Global Asset Allocation: 7 questions and trades for 2015

Cross asset returns (and risks) are quintessentially tied to the economic and other cycles. With growth and risk assets already having rallied tremendously from the bottom (global equities 135%, S&P 500 200%), how should one position for 2015, which will mark the seventh year of the recovery since the global financial crisis? We first ask 7 key questions, the answers to which underpin our strategic view, then discuss our asset and regional allocation.

Seven questions and trades for 2015

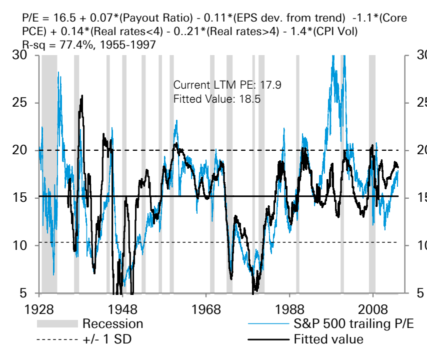
- How far along is the cycle? When will the next recession occur? 2014 marks the fourth year of near-trend global GDP growth and the consensus sees it rising only modestly above in 2015. With fiscal contractions in the US, Europe and Japan, it is a matter of arithmetic that private sector growth has been much stronger. Just as importantly, despite the variety of negative shocks and significant deceleration in faster growing EM, global growth has been relatively resilient remaining around trend. We see the global recovery as more like the uneven 1990s expansion rather than the unusually synchronized cycle of 2003-07, which was the longest since the early 1970s and reflected a variety of circumstantial factors. We see the US as still mid-cycle. All post-war recessions in the US were preceded by a rate hiking cycle and "induced" by the Fed. With the Fed planning to begin its hiking cycle in mid-2015 and a typical hiking cycle of 2 years, the next recession looks at least 3 years away.
- But have valuations of growth and risk assets already run full cycle? No, equities and HY still cheap to the drivers of valuation. The S&P 500 multiple is well explained by its traditional drivers (payout ratios, earning/normalized levels, inflation, real rates, and macro vol). While the multiple has been rising steadily over the last few years it is still short of fair value. Credit spreads in HG (+40 bps) and HY (+180 bps) remain well wide of previous cyclical tights. HY spreads incorporate a healthy risk premium (spreads less expected defaults with 30% recovery) of 3 pp at the upper end of the mid-cycle range historically (The Case For Credit Mid Cycle Not Froth, Jun 2014). *Stay long growth assets (equities, HY) and short recession assets (government bonds, HG, gold).*
- Why are bond yields so low? Not low inflation or low growth but low market expectations of monetary policy. While the US 10y breakeven inflation rate at 1.8% is lower than the Fed's inflation target and its long-run average, it is not particularly low. The low 10y yield reflects very low real rates which vary over the cycle but are not historically driven by short or long run growth expectations. Real rates are driven primarily (92%) by market expectations of Fed policy (What Is The 10y At 2.2% Telling Us? Oct 2014). Market expectations of Fed policy have fallen far below the Fed's guidance (175bps 3 years out). *Rate normalization will mean higher real rates: short 5y TIPS.*
- What happened to the great rotation? Rates fell. Rate normalization is the cyclical asset reallocation mechanism, historically leading to the covering of post-recession overweight bond and underweight equity positions. Each episode of higher rates over the last few years saw robust reallocations. As rates fell this year, money flowed back into bonds and inflows into equities ceased. The cumulative over-allocation to bonds remains $840bn and the under-allocation to equities $1.3trn. *Long regional banks/short REITs.*
- Do higher rates mean lower equities? Depends on the cause. Higher inflation means lower equities but higher real rates mean higher equities. Higher inflation has been consistently negative for US equity multiples historically (Do Higher Rates Mean Lower Equity Multiples? Sep 2014). Higher real rates by contrast have predominantly meant higher multiples. *Buy the bond-equity correlation on a pullback.*

Figure 1: Cross asset returns ytd



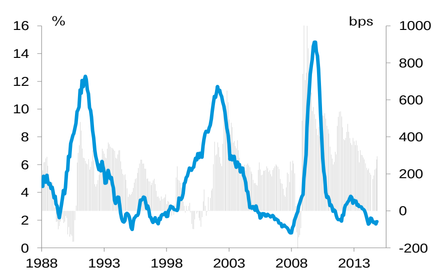
Source: Bloomberg Financial LP, Haver Analytics, Deutsche Bank Research

Figure 2: Equities still cheap



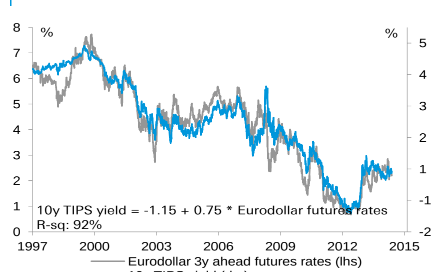
Source: BEA, BLS, Bloomberg Financial LP, Haver Analytics, Deutsche Bank Research

Figure 3: Healthy HY risk premium



Source: Moody's Analytics, Bloomberg Financial LP, Haver Analytics, Deutsche Bank Research

Figure 4: Fed expectations drive real rates



Source: Bloomberg Financial LP, Deutsche Bank Research

- Why have oil prices collapsed? Why are equities and commodities diverging? Perceptions of global growth and increased supply yes, but primarily the dollar. Across the Oil and Commodities complex historically, prices are well explained (average 82%) by global activity (slack) and the US dollar (Trading The Commodity Underperformance Cycle, April 2013). Since the dollar up cycle began in September 2011, commodities have been in a down-channel. The recent speeding up of the dollar up cycle, combined with record long speculative positioning in oil, saw sharp unwinds bringing oil prices more in line with fair value. We see the dollar up cycle as 3 years and 20% through a typical 6-7 year 40% cycle and having much further to run. *Long equities/short commodities; long industrial metals/short precious metals.*
- Is the EM de-rating done? Not yet. Four circumstantial factors drove the multi-year 2002-09 EM growth outperformance: slack after the late 1990s EM crises; dollar down cycle encouraged capital inflows and credit boom; dollar down-cycle meant rising oil and commodity prices benefitting EM exporters; interaction meant appreciating exchange rates which checked inflation and lengthened the cycle. Each of the four factors has gone into reverse and has further to run. Our baseline sees the EM growth spread reverting back into its historical range (When will EM Stop De-Rating, Oct 2013). *Long/short a basket of EM scored on valuation drivers.*

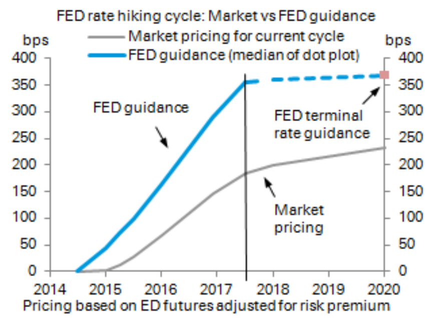
Asset allocation

We remain overweight equities; underweight bonds, HY over HG, underweight cash and commodities, long the US dollar. There are 2 key questions for asset allocation between bonds and equities in 2015. First, what kind of returns should one expect in equities after the strong returns of the last 6 years? With 3-5% corrections every 2-3 months typical for equities, do the returns justify the risk? We present five perspectives on prospective equity returns. Each argues for solid double digit returns and we discuss prospects for global equities. Second, why have market expectations of rates fallen so far below Fed guidance and how will this disconnect be resolved? Will Fed guidance move down to the market implying a gradual increase in long end rates? Or will the market re-price to the Fed's guidance in a disorderly manner?

Five perspectives on mid-cycle equity returns in the US:

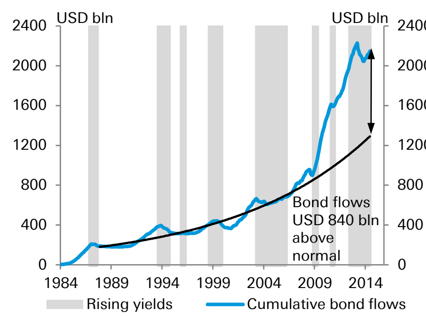
- The tight trend channel in place since June 2012 (17%). The S&P 500 has been rising in a clear trend channel with an 18.7% annual price appreciation with tight bands of ±4%. Obviously, a channel of such robust gains has to flatten or break eventually, and there is some evidence this has happened already, though only modestly to 16.7% since mid-2013.
- Our demand-supply framework for price appreciation (15%). The framework explains past quarterly returns for the S&P 500 well, including the big sell-down during the financial crisis, the subsequent consistently positive returns, and the magnitude of gains. At a fundamental level it justifies the trend up-channel (Equities Supply and Demand, November 2010). For 2015, a continuation of buybacks at the current pace, normal inflows into equities, allowing for some rise in short interest as concerns about the duration of the rally and valuation grow, together point to 15% price appreciation.

Figure 5: Market expectations have fallen far below the Fed's guidance



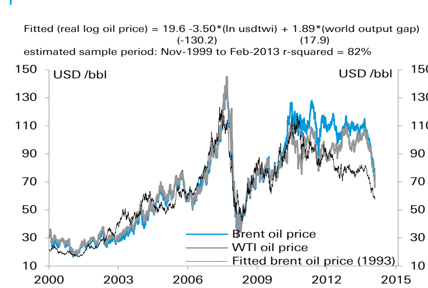
Source: Bloomberg Financial LP, Deutsche Bank Research

Figure 6: Large over allocation to bonds



Source: ICI, Haver Analytics, Deutsche Bank Research

Figure 7: Oil prices closer to fair value

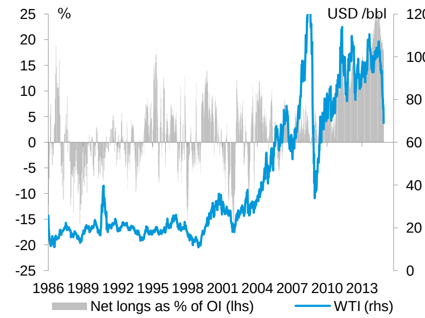


Source: Haver Analytics, Bloomberg Financial LP, Deutsche Bank Research

- Earnings growth and fair value multiple (13%). We see earnings growth in the US of 6.6% in 2015 as ex-FEM (Financials Energy and Materials) earnings growth continues at the solid and steady pace of the last 2 years of 9.5%, Financials earnings grow 10% on a pickup in loan growth and some rate normalization, while energy earnings fall 15% with oil prices remaining near current levels and Materials earnings are flat (After The Equity Rally: Where's The Value, November 2014). With the multiple having risen steadily toward fair value since the financial crisis, albeit with occasional interruptions in the face of shocks, a continued expansion to fair value by 1 multiple point would imply price appreciation of 5.6% in addition to earnings growth.
- Average historical returns excluding recession declines and post-recession rebound years (13%). Median S&P 500 annual total returns historically have been 15%. With a 2% dividend yield currently, that implies 13% price appreciation. The left hand side of the historical distribution of annual returns is dominated by recession declines. Similarly, the right hand side of the distribution is dominated by the sharp rebound in the first year of recovery from recession. Excluding both years, i.e. trimming both ends of the distribution, leaves the median return about unchanged.
- Cyclical macro growth and equities (12%). There is sufficient variation in the pattern of returns over the cycle historically to suggest that historical averages are unlikely to have much predictive content for 2015. What was common across cycles is that returns were correlated with macro growth as measured for example by the ISMs. So history argues equity returns will be driven by macro growth which is the broadest and simplest proxy driver for both equity discount rates (risk appetite) and earnings. With the US manufacturing ISM having averaged 55 since the recovery began and at 59 currently, conservatively assuming 56 implies 12% price appreciation in 2015.

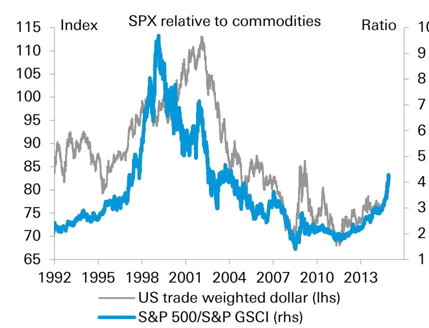
Global equity returns and regional allocation. In the US, the Euro area, Japan and EM Asia we expect earnings growth in the 6.5%-7.5% range, and therefore broadly a wash for relative performance. We expect significantly lower earnings growth in Latam of 4%. We expect multiples to expand in DM, to be broadly flat in EM. In the US, modest multiple expansion seems reasonable and likely with GDP growth continuing in the 3-4% range, solid steady ex-FEM earnings growth, dependable buybacks continuing at a robust pace and the dollar uptrend meaning a bigger share of global equity flows. We remain overweight. Japan is very cheap and we expect multiple expansions as growth picks up and significant outperformance over the US of 5% or more which keeps us overweight. We see Europe providing plenty of tactical trading opportunities over the coming year. But with earnings growth expected to be similar to the US and relative valuation currently in the middle of the historical range, risks to growth and pricing power keep us neutral for now. In EM, with the growth advantage over DM still having room to fall, we expect relative multiples to de-rate further by another 5%. Our baseline sees EM returns around earnings growth and we remain underweight (After The Rally Where's The Value, Nov 2014).

Figure 8: Speculative positioning in oil was very long



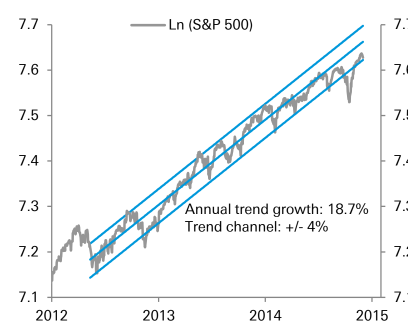
Source: Haver Analytics , Bloomberg Financial LP, Deutsche Bank Research

Figure 9: Long equities short commodities follow the dollar



Source: Haver Analytics , Deutsche Bank Research

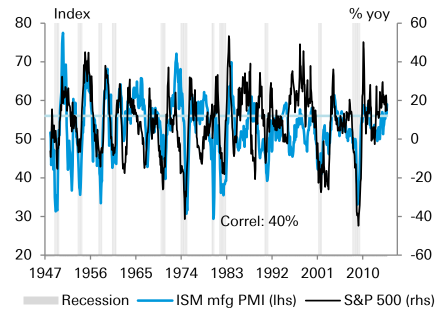
Figure 10: S&P 500 in tight trend channel since June 2012



Source: Haver Analytics , Deutsche Bank Research

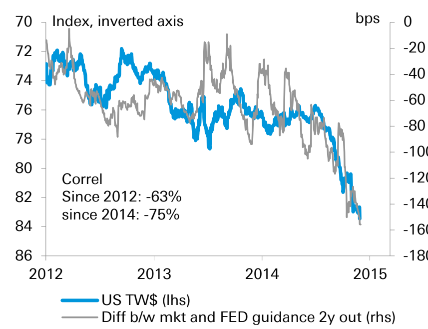
- **Why have market expectations of monetary policy fallen so far below the Fed's guidance? How will this disconnect be resolved?** Markets have historically tended to begin pricing hiking (or easing) cycles only a few months ahead of their actual start, then systematically underestimated the subsequent pace, so some of the current disconnect is in line with this behavior. But after being relatively closely aligned with Fed guidance in late 2013 and again in the spring of this year, market expectations have moved far below. This divergence has been correlated with the dollar's appreciation which in turn is a proxy for slower growth in the rest of the world and lower oil and commodity prices. In our view, the higher dollar will have a modest impact on core goods inflation and little impact on core services inflation. Our baseline sees both unemployment and inflation at the Fed's targets by next summer. The gradual rise in inflation thereafter is relatively benign. But given the long lag between monetary policy actions and their impact on the economy (1.5 years), we see risk management by the Fed requiring hikes much faster than market pricing. Any pickup in inflation would increase the likelihood of a disorderly re-pricing.

Figure 11: Equity returns correlated with the ISM



Source: ISM, Haver Analytics ,Deutsche Bank Research

Figure 12: Divergence of market from Fed guidance tied to the dollar



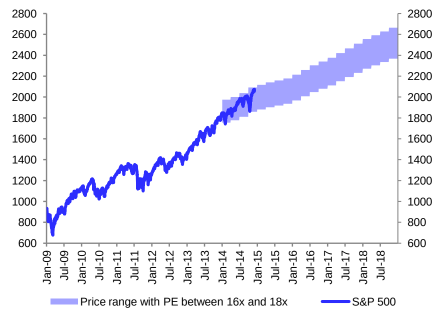
Source: FRB, Bloomberg Finance LP, Haver Analytics, Deutsche Bank Research

Binky Chadha, (1) 212 250 4776
Parag Thatte, (1) 212 250 6605
John Tierney, (1) 212 250 6795

US Equity Strategy: Better time for consumer ahead, tougher time for producers

- We have cut our 2015E S&P EPS by $5 to $121 since October on plunging oil prices, stronger dollar and the growth challenges abroad. We maintain our 2015 and 2016 year end S&P 500 price targets at 2150 and 2300.
- Our 2015E $121 EPS, ~3% growth, assumes: 1) 3% real US GDP growth in 2015 and at least 3% global growth; 2) US capex up 5% in 2015; 3) avg. oil prices of $65/$70 for WTI/Brent in 2015; 4) euro doesn't fall under $1.15 and 125 yen.
- PE rarely rises as the Fed hikes. We expect neither a surge in EPS nor a decline in the PE in 2015, as we consider EPS already at normal mid-cycle levels and the PE sustainable on lower interest rates than history.
- Our sector strategies: we are OW secular growth sectors Health Care and Tech. We prefer Financials over Energy and Financials is our preferred rate hike play. We also OW Utilities as our preferred bond substitute. And we prefer Consumer Discretionary Retailers over Industrial Capital Goods.
- We expect mid-single digit S&P 500 gain in 2015 with ~3% EPS growth and no PE expansion from today's ~17.5x PE. We think a fair trailing PE on mid-cycle normal S&P non-GAAP EPS is roughly 17.5x. We think it is important for WTI oil to stay above $60 on average and Euro above $1.10 to avoid a profit recession in 2015 even if US GDP is 3%+.

Figure 1: S&P 500 price range through 2018 assuming no recession



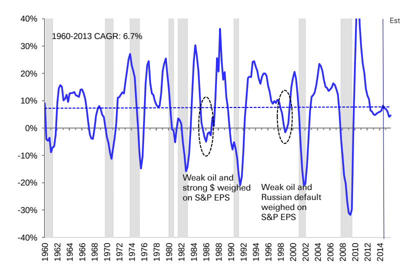
Source: S&P, Deutsche Bank

We cut EPS on lower oil prices. S&P is more of a producer than a consumer

The plunge in oil is concerning and is a net negative to S&P EPS, particularly for Energy, Industrials and Materials. We cut our 2014E EPS by $1 to $117.50 and our 2015E EPS by $5 to $121. We still expect 2015 EPS growth of ~3% as most macro data and company commentary do not suggest that global growth is careening. Europe is weak and hopes of improvement are policy dependent, but US growth remains healthy and consumption should stay strong on job gains and now cheaper oil. China and rest of EM is uncertain with what seems to be a controlled deceleration that isn't overly alarming, but is clearly weighing on commodities, materials and industrial goods' profits.

Our 2015E S&P EPS of $121 assumes 2015 avg. oil price of $65/$70 for WTI & Brent and euro doesn't fall below $1.15. Every $5/bbl lower oil price lowers energy earnings by 10% and S&P EPS by ~$1, net of benefits elsewhere. Since the S&P 500 is more of an oil producer than user, the ~30% decline in Energy sector profits that we expect next year, assuming oil at $65-$70/bbl, is too much of a hit for benefits at other sectors to fully offset. If oil price average ~$80/bbl next year then S&P EPS is likely $3 higher, all else the same.

Figure 2: Collapse in oil prices weighed on S&P EPS in 1985-86 and again in 1998

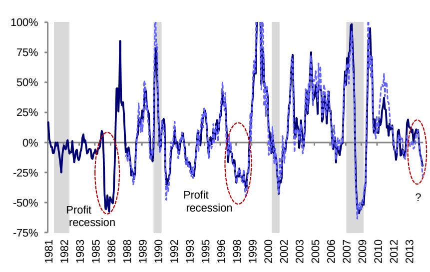


Source: S&P, I/B/E/S, Deutsche Bank Research

The S&P is global: 40% of total profits from abroad, 25% in foreign currencies

S&P 500 companies are among the largest and most successful multinationals in the world. We estimate that a third of S&P revenue and 40% of its net profits are earned abroad. This has been the case for at least 5 years and compares to 15-20% in the mid 1990s and likely 10-15% in the mid 1980s. Excluding Financials, Utilities and Telecom, slightly more than half of S&P profits are from abroad. While some foreign profits are earned in dollars, we estimate that roughly 25% of total S&P profits are earned in foreign currencies. Thus, we estimate that every 10% gain in the dollar vs. a trade weighted basket of currencies reduces S&P EPS by ~$2 or ~2% from FX translation.

Figure 3: A further slide in oil price will raise the risk of a profit recession in 2015

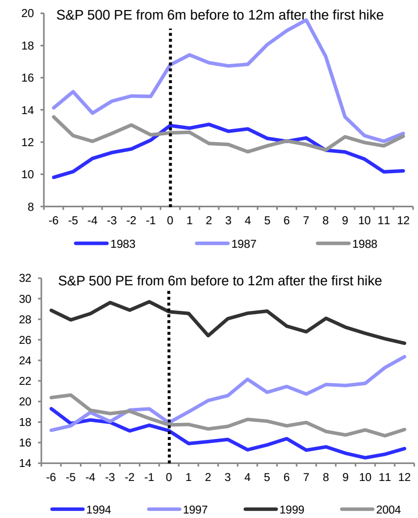


Source: EIA, Deutsche Bank

PE expansion is rare as the Fed hikes, but the usual decline is unlikely in 2015

The start of Fed hikes typically sees the S&P PE compress because hikes start 1-2 years after a recession when S&P EPS is still rebounding and PEs are still elevated. PE falls from above normal to normal. For next year, we expect neither a surge in EPS nor a decline in the PE as we consider EPS already at mid-cycle normal levels and the 17.5-18x PE on trailing EPS as sustainable. Our 2015E S&P EPS of $121 represents our estimate of mid-cycle normal earnings and includes a ~30% y/y decline in Energy sector profits. With this decline in Energy profits, we see S&P EPS and margins as sustainable with long-term EPS growth aligning with the nominal cost of equity less its dividend yield or roughly 5.5%. Given our outlook for 10yr treasury yields staying below 3.5% for the next several years, we think a fair trailing PE on mid-cycle normal S&P non-GAAP EPS is roughly 17.5x. This aggregate PE by sector is 14-15x for Financials & Energy and ~18.5x elsewhere. Our 2015 year end S&P 500 price target is 2150, which is 3-5% price upside plus a near 2% dividend yield.

Figure 4: S&P PE reactions around the first Fed rate hikes since 1983



Source: FRB, S&P, Deutsche Bank

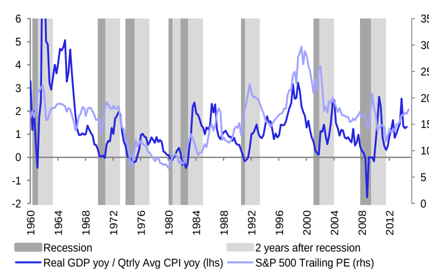
Sector strategies: OW Health Care and Tech, prefer retailers to capital goods

Health Care and Tech remain our most favored sectors. Sales growth has been strong at Health Care and improving at Tech in the last 2 quarters; their PEs are undemanding vs. other sectors; they have superior balance sheets and superior potential to increase payout. We prefer Consumer Discretionary Retailers to Industrial Capital Goods given that weak oil prices will weigh on S&P 500 capex growth and curb overall US capex acceleration in 2015, and soft commodity complex capex and US exports will be a big challenge to Industrial Capital Goods companies. We also OW Financials as our Fed rate hike play and Utilities as our preferred bond substitute.

Risks: Further slide in oil prices, much stronger US dollar, Europe recession, EM (China) hard landing, sharp rise in yields

- Further slide in oil prices after recent steep plunge could lead to profit recession in 2015. Profit declines outside of recessions are rare. Since 1960, there have been 10 instances when S&P trailing 4qtr EPS declined, of which only 3 were not during recessions (1967, 1985-86 and 1998). 1985-86 was caused by ~40% decline in year average oil prices coupled with a strong dollar and 1998 by ~30% decline in year average oil prices and the Russian default. An avg.WTI oil price below $60 could cause a profit recession in 2015.

Figure 5: Real GDP / Inflation ratio vs. S&P 500 trailing PE



Source: BLS, BEA, S&P, I/B/E/S, Deutsche Bank

David Bianco,(1) 212 250 8169
Ju Wang, (1) 212 250 7911
Winnie Nip (1) 212 250 8529

Rates Outlook: Refueling before liftoff

- We expect bond yields to rise moderately ahead of the forwards in 2015 with year-end targets of 2.8% for 10Y UST and 1.1% for 10Y Bund. In Europe, we also expect the 5Y sector to perform well and peripheral spreads to tighten further.
- More aggressive easing from the ECB and a turn in the inflation outlook are the key catalysts for this repricing. Until these conditions are met, the risk is that yields will first grind lower.

Refueling before liftoff

We expect bond yields to rise moderately ahead of the forwards in 2015 with year-end targets of 2.8% for 10Y UST and 1.1% for 10Y Bund. In Europe, we also expect the 5Y sector to perform well and peripheral spreads to tighten further. More aggressive easing from the ECB (which we expect in Q1) and a turn in the inflation outlook are the key catalysts for this repricing. Until these conditions are met, our US strategists see heightened short-run risks of first re-visiting the recent lows in yields. This would be particularly the case if the ECB disappoints, while positioning is vulnerable and risky assets are fully valued. In Europe, the risks are tilted towards inflation staying low and the ECB QE exacerbating supply/demand imbalances which would keep Bund yields lower throughout the year.

The combination of lower inflation, prospects of hikes in the US, more QE in Europe and Japan and supply/demand imbalances has resulted in a significant compression of long dated forwards and the bond risk premium globally. However, the measures of risk premium which were suggesting that the USD5Y5Y was too high at the end of 2013 are now implying that it is too low, even after adjusting for the lower inflation outlook. The market is now pricing a neutral rate around 2.50-2.75% vs. 4-4.25% a year ago, while Dudley estimates it to be between 3% and 4%. The inflation risk premium is at historical lows and there is a lack of differentiation in inflation expectations as evidenced by the fact that the USD-EUR 5Y5Y breakeven spread is around its historical average. Moreover, there is some evidence that long-term inflation expectations over-react to supply shocks via commodity prices, while their impact on domestic inflation is transient. From this perspective, relative to current pricing, the balance of risk is tilted towards the market pricing a terminal rate above 3.25% rather than below 2% and a partial normalization of the bond risk premium. However, this could be tempered by supply/demand factors (e.g. the ECB QE) which could keep the bond risk premium depressed by historical standards.

In the US, our economists expect growth to exceed 3% and the unemployment rate to decline below 5.0% in 2015. Key measures of labour market slack (Quits, Hires and Part-time) have improved in 2014 and are consistent with further normalization of wage inflation. By mid-2015, the Employment Cost Index (the Fed's favourite measure of wage inflation) should be close to levels at which the Fed initiated its tightening cycle in 2004. Core inflation is currently at a comparable level to Q3-2003. However, leading indicators of core inflation imply that it will only slowly drift up next year, while a stronger momentum was evident when the Fed hiked in June 2004. Despite the improvements in the labour market, the benign inflation outlook skews the risks towards a later rather than earlier liftoff relative to the current "mid-2015" Fed guidance. However, a delay of the Fed hikes for "good reasons" (inflation lower for longer due to supply factors) while wages are recovering should not lead to a further decline in the neutral rate or longer-term inflation expectations. If anything, the market should be pricing a higher terminal rate as the economy will be on an ever better footing by the time the first hike occurs.

In Europe, we expect the ECB to embark into large scale asset purchases in Q1 of next year. Further policy easing seems to be already reflected in core long-dated forward rates. EUR 5Y5Y real rates (in swaps) are at -25bp which is a level observed in the US during QE infinity and in Japan currently. EUR5Y5Y breakevens are at 1.80% which is low relative to history, but is not pricing policy failure. On the other hand, the front-end of the curve is pricing a relatively limited increase in excess liquidity. Also, 5Y5Y Italian spreads are above 200bp. Thus, from a valuation perspective, government bond QE should primarily benefit the front-end of the euro curve and the long-end of peripheral bond markets. From a flow perspective, 5Y5Y core real rates could also benefit despite rich valuations. Ultimately, the behavior of core rates will be dictated by the evolution of the inflation outlook. The downside surprise to core inflation over the last quarter has raised the risks around the inflation forecast. For this reason, we prefer to wait for evidence that the trough in inflation has been reached before positioning for a normalization of long dated forwards in core markets. Finally, the UK lies somewhere in between the eurozone and the US. Monetary policy will be more constrained than in the US by upcoming fiscal tightening, the election and developments in the eurozone, while inflation should provide some cover for the BoE. On the other hand, long dated forward rates are already quite low and the curves are too flat.

Since 2011, global growth has disappointed and inflation has declined, despite very aggressive monetary policy easing by the major central banks. There is a natural temptation to be skeptical about the outlook for 2015 given this recent experience. However, the last few years were also characterized by significant demand shocks: (a) fiscal tightening in the US, (b) fiscal tightening in Europe, (c) credit crisis in Europe, (d) unwind of the stimulus in China, (e) negative supply shock to commodity prices and (f) tighter regulation. Looking ahead, some of these demand shocks have faded. The peak in fiscal tightening in the US and the eurozone is behind us and Japan has delayed its VAT hike. The credit crisis in Europe has receded. Commodity prices have now suffered a positive supply shock which is a tailwind to growth both directly and via more supportive monetary policy. In short, the risks to the outlook should be more balanced than they have been in the past.

There are nonetheless important risks to consider. First, rising political (and geopolitical) risks in Europe could reintroduce a higher risk premium in peripheral markets. The immediate pressure is likely to arise from Greece whose probable new government is likely to lead to a breakdown of the negotiations with the Troika. Unlike 2010, the immediate contagion risks from Greece are limited. Most of the debt is held by the official sector and already serviced at quasi zero interest rates. However, the political contagion will remain a concern as there are elections in Spain, Portugal and Finland, in an environment where mainstream parties are generally underperforming. Second, the ECB's Governing Council may not be willing to cross the Rubicon of large scale asset purchases without more market pressure first. Third, the rebalancing of the Chinese economy could lead to a sharper slowdown than currently anticipated. This risk is mitigated by further policy easing (which is expected by our economists). Finally, growth in the US could materially disappoint as the credit dynamics in the US could slow down. This risk is mitigated by a healthy private sector balance sheet.

Francis Yared, (44) 20 7545 4017
Jerome Saragoussi, (33)144956408
Abhishek Singhania, (44) 20 7547 4458
Dominic Konstam, (1) 212 250 9753
Stuart Sparks, (1) 212 250 0332

European Credit Strategy: Waiting for the ECB

- The potential announcement of a broader asset purchase program by the ECB should in general benefit European fixed income assets including credit even if they jump straight to Government bond purchases.
- Credit yields are either at or have got close to their all-time lows in yield in 2014 and while spreads are in general tighter than their median they are not in their lowest quartile relative to history.
- Lower oil prices could put further near-term pressure on USD HY spreads led by the energy sector as rising defaults could potentially put a higher floor under spreads, even in a bullish scenario.
- We like EUR HY in Q1 as fundamentals remain broadly supportive and it has limited exposure to energy companies while other sectors of the economy could potentially benefit from the lower price of oil. EUR Single-Bs are our preference.
- There may be opportunities to pick up extra yield in USD IG over EUR IG although potential negative pressures from the energy sector could mean that there will be a more attractive entry point. The relative actions of the ECB and Fed could also provide justification for a better entry point into USD IG credit.

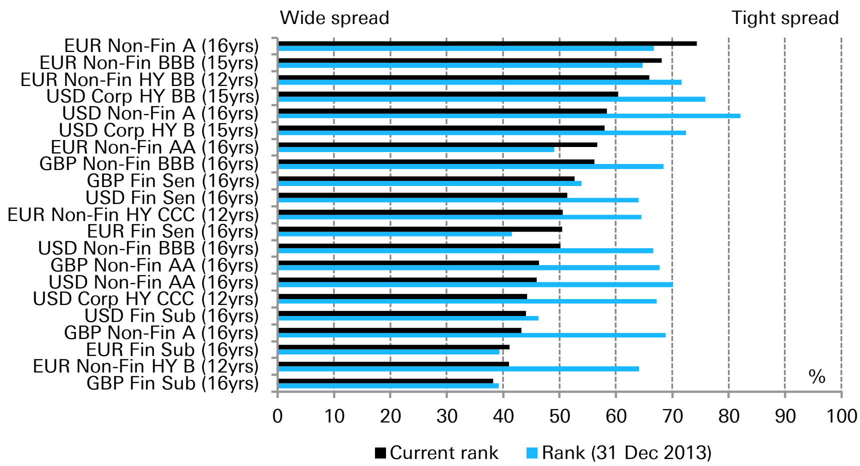
Waiting for the ECB

As discussed earlier in this document the house view is for the ECB to commence a broader asset purchase program by the end of Q1 2015. The broad based nature is aimed at reducing the political fall-out from just announcing Government bond purchases. So it is likely that qualifying IG corporate bonds will be eligible for purchase even if the ECB's target/goals will really only be met by Government bond purchases. Nevertheless the prospect of the ECB entering the corporate market will likely ensure performance from European credit into the end of Q1 2015. Even if the ECB just jump straight to Government bond purchases without wider inclusion, it should also lead to performance from other fixed income assets like credit.

Valuations

Although credit yields are either at or have got close to their all-time lows in yield in 2014, spreads are in general tighter than their median but not in their lowest quartile relative to history. As we highlighted earlier in 2014, a few indices on both sides of the Atlantic broke well inside their lowest quartile in history in H1 but as we end 2014 no rating band is in such territory. Figure 1 shows where each rating band within the iBoxx suite of indices is relative to its own history (number of years in brackets). This covers the EUR, GBP and USD markets, HY and IG and split between non-financials and financials. We also show where each index started 2014. Looking at the results, it would be hard pressed to say credit was at extremes in spread terms so there is scope for further performance.

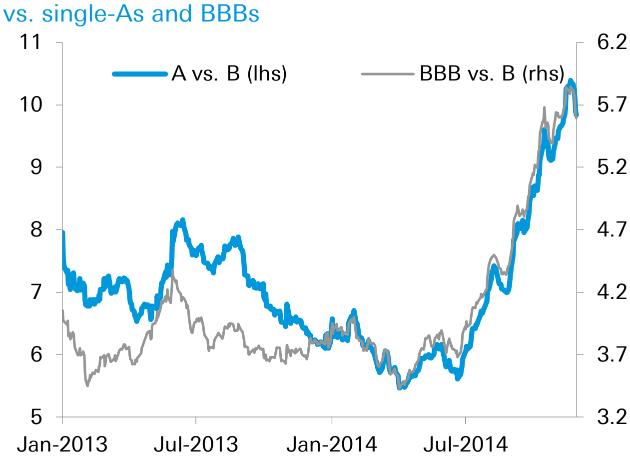
Figure 1: Current percentile vs. percentile at YE 2013 of iBoxx Index spreads



Source: Deutsche Bank Research, Markit

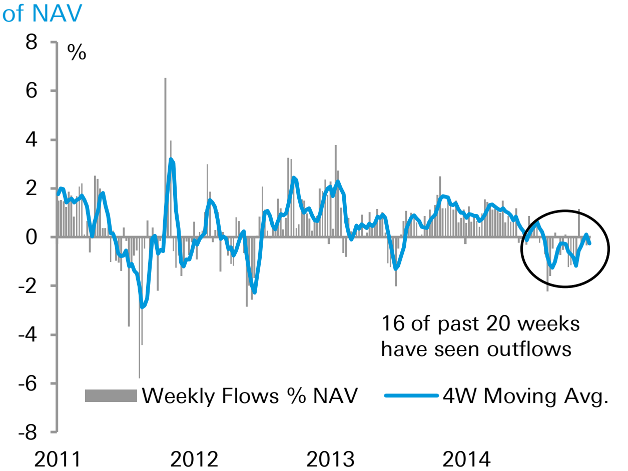
There have been some interesting valuation developments though in H2 2014. EUR IG has continued to grind tighter while EUR HY has had a poor half, especially Single-Bs and below (Figure 2). Outflows (Figure 3) and illiquidity are to blame. Any parts of the credit market that see outflows are likely going to see more weakness than in the past due to much lower street liquidity.

Figure 2: EUR iBoxx non-financial single-B spread ratio vs. single-As and BBBs



Source: Deutsche Bank Research, Markit

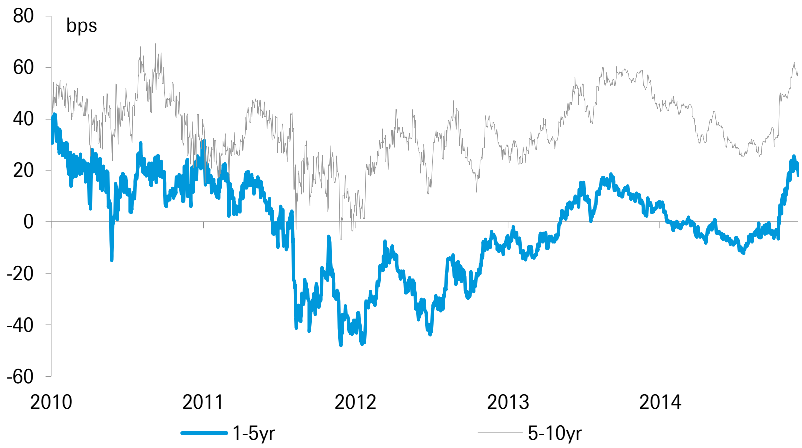
Figure 3: Western Europe HY fund flows as a percentage of NAV



Source: Deutsche Bank Research, EPFR

Also USD credit has widened during H2 due to 1) HY outflows, 2) a fully tapered FED and 3) credit quality concerns about the energy sector (the largest non-financial sector in IG and HY making up around 21% and 16% of the respective non-financial markets) after the drop in Oil.

Figure 4: USD-EUR non-financial benchmark spread difference by maturity buckets (bps)



Source: Deutsche Bank Research

Lower oil prices could put further pressure on USD HY spreads in the near-term led by the energy sector as it could lead to a rise in defaults that could potentially put a higher floor under spreads, even in a bullish scenario. However we like EUR HY in Q1 as fundamentals remain broadly supportive and it has limited exposure to energy companies with other sectors of the economy potentially benefitting from the lower price of oil. EUR Single-Bs are our preference.

In terms of USD vs. EUR IG credit, there do seem to be opportunities to pick up extra yield in USD IG. That said the potential negative pressures from the energy sector could mean that there will be a more attractive entry point into USD IG. It's also worth highlighting that the basis swap reduces these opportunities at current levels even if the optical pick-up looks attractive to some investors. However a big swing factor for the basis between USD and EUR credit is likely to be the respective monetary policies of the two central banks. The ECB is set to be supportive but the jury is still out on the Fed. Our base case is that international events prevent the Fed from being as hawkish as it wants which therefore keeps the central bank relatively supportive for credit, especially post the H2 2014 sell-off. However if you believe that the Fed will ignore international events and the near-term disinflationary impact of lower oil then this would provide another argument that there could be a better opportunity to own USD credit. Overall a healthy US economy will be good for USD credit but the journey may be volatile if it means US rate rises.

We suspect Q1 will be a positive quarter for EUR credit as it benefits from the actions of the ECB while continued energy sector pressures may weigh on USD credit spreads (both IG and HY). Fears of rate rises in the US from mid-year onwards (whether they materialize or not) will likely mean that USD credit has a more volatile year than EUR credit which is set to be sedated by the ECB.

Jim Reid, (44) 20 754 72943
Nick Burns, (44) 20 754 71970
Seb Barker, (44) 20 754 71344

US Credit Strategy: Unfamiliar places

- US credit markets are finding themselves in a difficult spot going into 2015. While divergent central bank policies still suggest there should continue to be a sustained bid for yield from global investors, recent dynamics in the energy sector present a risk to broader US credit benchmarks.
- The energy sector is the single largest sector in US HY, second-largest in US IG, and even third-largest in the S&P 500 (level 2 industries). Following a 37% drop in crude prices since June, bonds and equities of US energy producers came under significant pressure, while broad market benchmarks remain largely unaffected.
- We find this outcome puzzling given that there are few historical precedents of seeing one of the major sectors in the economy going into distress and not having a broader market impact. The most important argument here becomes, what are the net benefits and costs from this development to the US economy that has structurally changed due to energy revolution.
- Our earlier analysis, updated here, has shown that the weakest US shale producers could be entering a zone of deep distress at oil prices below $60/bbl, with the more recent data points suggesting that we could have an additional $5 of room before this happens. If prices were to stay sustainably below these levels for a few months/quarters, chances of a broad sector restructuring increase materially. This scenario would have repercussions for the timing of the overall HY default cycle.
- We are marking our spread targets to 575bp in HY (+95bp) and 150bp in IG (+25bp). Returns could be negative over the next few months.

Macro backdrop

The environment of slow global growth, coupled with divergent central bank policies, leaves investors with scarcity of safe yields, being pushed to lengthen duration or credit exposures to reach their return goals. This set of circumstances underpins a relatively subdued view from our rates team, forecasting only modest increases in longer segments of the US Treasury curve (+65bp in 5yr, +50bp in 10yr). This expectation provides perhaps the single most important factor working to support continued bid for credit, although it has its limitations, as we will discuss next.

On the other side, a 37% decline in the WTI oil price since late June raises a number of important questions on the ability of the US energy sector to seamlessly adjust to new realities. Our commodity strategists believe we could continue to see it going lower from here, following a recent OPEC decision to leave production targets unchanged. Our own analysis shows that such expectations find support in historical parallels to previous bear markets in oil. In addition, a deeper look at marginal costs of US shale producers and an assessment of their best strategy for survival suggests that overproduction could persist for some time.

A sustained drop in price beyond $60/bbl could put substantial pressure on the viability of many US shale producers, although it will take time to materialize, as in the short run many producers could maintain production levels taking only marginal costs into account. In other words, for as long as a barrel of oil sells for more than it takes to extract and transport it, without consideration of sunk costs on land and equipment, such producers could choose to maximize their volumes in order to narrow their revenue shortfalls. Structural changes in the US economy – with multiple sectors becoming beneficiaries of energy production as opposed to consumption – pose difficulties in making appropriate historical parallels.

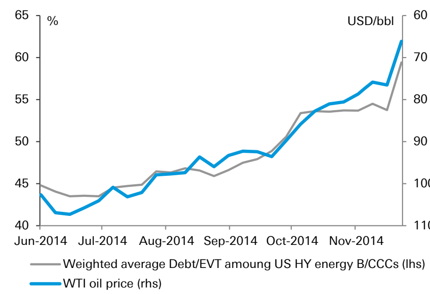
Some of the more obvious casualties could include capital goods and materials sectors, where suppliers of drilling equipment, pipes, storage containers, machinery, cement, water, and chemicals used in shale production are all likely to experience a negative impact. Further away from immediate suppliers to the energy complex are utilities, which have arguably also benefitted from years of incremental electricity production that was used to power all this new shale-related manufacturing, production, transportation, and refining activity.

Financials have seen their investment banking revenues supported by commissions from $550bn in new energy debt across USD IG, HY, and leveraged loan markets since early 2010. We believe these volumes are certain to be challenged. And while there are considerable benefits to consumer-discretionary parts of the economy from lower energy prices, one new factor that should be taken into consideration is that unemployment rates in shale-producing states is 4.0%, well below the national average.

Weakest HY energy issuers approaching a point of distress

We studied the impact of an oil price decline between late June and early November and a coincident deterioration in issuer debt-to-EV (D/EV) values to determine at what point a further drop in this commodity would push D/EVs to above 65% for the whole sample of US B/CCC energy issuers. The target of 65% D/EV came from our separate analysis of historical incidents of default, where we found that issuers bound for debt restructuring have started the last two years of their life with an average D/EV of 65%. We have also shown that issuers entering the 2008 cycle with D/EV of 65% or higher experienced a cumulative two-year default rate of 30%, well above the rest of the market. Given the recent trajectory in these metrics, we estimate the point of potential distress to be reached at around $55 WTI. Importantly, prices would have to remain depressed for a period of time to be fully reflected in cash flows. We estimate such a period to be measured in a few months.

Figure 1: Energy Bs/CCCs Debt/EV



Source: Deutsche Bank Research

Emerging market considerations

An additional wrinkle to this story is the enormous pressure experienced by EM oil-producing countries and companies. We are monitoring very carefully the developments around Venezuela and its national oil producer Petroleos de Venezuela (PDVSA), where the situation may be approaching a threshold, i.e. debt restructuring. Additionally, Russia came under significant pressure recently, with lower crude prices only adding to the earlier woes of sanctions imposed in response to its actions in Ukraine. Its largest state-owned enterprises (Gazprom, Rosneft, Sberbank, and Vnesheconombank) currently owe a combined $160bn in USD and EUR debt, with no ability to refinance it in the US or EU markets due to sanctions. Finally, Petrobras, the largest oil producer in Brazil, is trading inconsistently with its IG ratings. If downgraded to HY, this issuer would represent the largest fallen angel in history.

Valuations

One of the most interesting disconnects that we are currently witnessing on the valuation landscape is that broad market indexes – in equities and in credit – have largely ignored a bear market that has hit energy assets. The S&P 500 energy stocks are down 19% since their late-June highs, while the overall index is 5.8% higher, at all-time highs. In credit, energy bonds have widened by 50bp in IG and 310bp in HY, whereas non-energy bonds are wider by 20bp and 60bp, respectively. Taking into account that energy is the single-largest sector in all of HY, second-largest in IG, and third-largest in S&P500 (on a level 2 industry basis), this strikes us as an unusual outcome. Between oil showing few signs of bottoming yet, potential EM shocks, and the combination of distress and the weight of energy in the US, we conclude that the path of least resistance for credit spreads is wider from here.

We expect to be in a much better position to assess the a net effect of distress-in-energy vs benefit-to-consumer argument a few months from now, and it is possible in our minds to see an outcome where the latter argument prevails, and the market re-engages in a bullish move tighter in spreads. For the time being, however, this expectation of a potential near-term widening in HY brings us back to overweighting higher quality going into the next few months. In IG, we arrive at a 25bp widening forecast for DM USD IG (from 125bp today to 150). We generally maintain a positive stance on loans, following their decent YTD total return of +2.2% despite a persistent string of outflows since April. In our view, a positive correlation to wider spread in HY should be offset by tightening spreads into rising libor, as coupon floors disappear.

Oleg Melentyev, (1)212 250 6779
Dan Sorid, (1) 212 250 1407

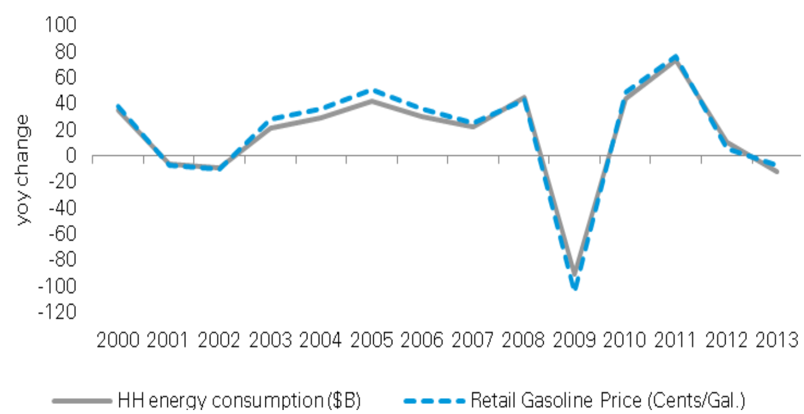
US MBS and Securitization Outlook: When oil and MBS mix

Although oil and MBS usually don't mix, the continuing drop in energy prices should have some impact on MBS in at least three ways: credit, MBS supply and rates. The combination has more implications for relative value within MBS than between MBS and rates, with premium MBS coming out a small winner.

Cash for consumers

The bad news for energy prices since June looks like good news for households if the lower prices hold, potentially taking nearly $110 billion out of the pocket of the energy business and putting into the pocket of consumers. US consumers tend to buy a fairly fixed amount of energy over modest intervals, as our colleague Joe Lavorgna pointed out in October, so changes in price translate almost directly into changes in disposable consumer cash. A $0.01 drop in the price of gas cuts energy spending by $1 billion, freeing up that cash either for saving or for spending on other things (Figure 1). With a $1 change in Brent historically leading to a $0.025 change in the price of gas at the pump, the drop in oil prices since June, if sustained, should free up nearly $110 billion for US consumers. To put that in a mortgage context, that's equivalent to 64% of all the interest that US consumers will pay next year on 30-year fixed-rate agency mortgages.

Figure 1: As gasoline goes, so does household energy spending



Source: EIA, BEA, Haver Analytic, Deutsche Bank Research

Credit, supply and rates

The improved consumer cash flow should be a credit positive for all consumer debt, mortgages included. That should mean lower levels of 30-, 60- and 90-day mortgage delinquencies, an obvious plus for legacy private MBS and for agency credit risk transfer deals. For the agency MBS crowd, that should mean marginally lower levels of prepayments driven by the buyout of delinquent loans in seasoned conventional pools or in Ginnie Mae MBS.

The tumble in the price of energy also should add something to MBS supply. The direct boost to consumer cash flow should help households on the margin save more money toward a down payment and feel more comfortable servicing mortgage debt. The shift in prices and cash flow also has led our economists to revise up their projections for 2015 economic growth, with a stronger labor market also nudging up mortgage debt.

And last but not least, the drop in energy, likely sustained at least through the first half of next year, creates a deflationary force that should make the Fed cautious about raising rates too quickly. Headline inflation in the US should reflect the low energy prices with core trailing down slightly. FOMC governors Dudley and Fischer signaled recently that they would look past the likely drop in inflation and focus on economic growth and the labor market. Even though growth should tighten the labor market, low inflation should give the Fed room to keep rates low. That's an opportunity that the Fed is likely to take advantage of, especially given the Fed's concern about preserving financial stability as it tightens policy.

The only exceptions to the credit and supply implications of lower energy prices might be in local mortgage markets with heavy employment in energy. There the implications are flipped. Delinquencies rise. Demand for mortgage debt, and potentially the willingness of lenders to provide it, fall.

The net impact of this unusual mix of oil and MBS – better credit, marginally slower prepayments, a layer of new supply, sustained low financing rates – arguably is more predictable for relative value within MBS than for relative value between MBS and rates. For that basis, larger forces of supply and demand will matter. But within MBS, an improving consumer balance sheet should be marginally bad for seasoned discounts through slower speeds, marginally bad for production coupons through better supply, marginally good for premium MBS through sustained low short-term rates.

Beyond energy

MBS broadly looks likely to do well through the first quarter of 2015 when net supply should stay low and net demand should easily absorb the supply. The seasonal patterns in US housing should temper supply before it rebounds after March. At that point, the risk of wider spreads in MBS starts to build.

Steven Abrahams, (1) 212 250 3125
Chris Helwig, (1) 212 250 3033
Ian Carow, (1) 212 250 9370
Jeff Ryu, (1) 212 250 3984

FX Strategy: 30-30 vision

- Main forecast changes: USD/JPY end 2015 and end 2016 revised to Y125 and Y130 respectively (up 5 yen). AUD/USD end 2015 and end 2016 revised to AUD 0.78 and AUD 0.68 respectively.

Two months ago, our inaugural edition of the bi-monthly 'FX forecasts and valuation' publication was titled "long-term overshoot'. At the time USD/JPY was trading between Y107 and Y108, and our Y120 end 2015 was considered 'aggressive'. USD/JPY at Y107 was already straddling the fringes of the 20% band above PPP that has been a good indicator of valuation extremes, and eventual reversals. USD/JPY is now ~30% above our PPP measure, taking it to extremes not seen for over 30 years.

Does this scream imminent turnaround? No. The conditions for a turn require a change of regime that plays against the yen's role as the preeminent funder (more risk negative) and more specific to Japan, evidence from the export sector that the yen is cheap and that it is combining with cheap oil such that JPY FEER measures confirm BEER and PPP undervaluation signals. In the meantime, the extreme yen valuations are likely to mean that over the next 2 years the yen slowly loses its starring role, as the leading edge of a multi-year USD upswing, but still participates in USD strength. End of 2015 and 2016 forecasts have been revised to Y125 and Y130 respectively.

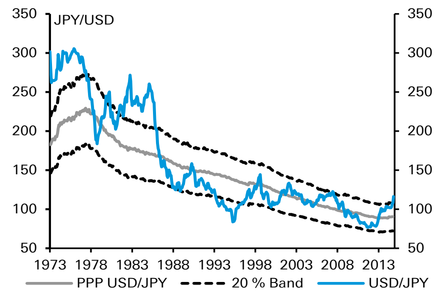
As fast as USD/JPY has accelerated to the upside in recent weeks, EUR/USD's downside momentum has shown a propensity to stall. The immediate impact of portfolio reallocation related to negative rates has likely taken place and looking ahead, ECB QE in Q1 2015 is already been largely priced in. The EUR then remains a conundrum for forecasters to the extent that it never seems to be quite as weak as 'the fundamentals' suggest. The large narrow basic balance surplus continues to act as a brake, in notable contrast to Japan's narrow basic balance deficit.

While the signal effect of ECB QE will not surprise, the portfolio displacement impact related to ECB balance sheet expansion has hardly begun, and will remain a prominent and growing EUR negative factor. The EUR/USD end of 2015 forecast then remains at 1.15.

As for the broader USD story, it continues to resemble some of the characteristics of the late 1990s inclusive of asset inflation versus commodities disinflation - encouraging of continued US economy outperformance versus almost all DM and EM countries in 2015.

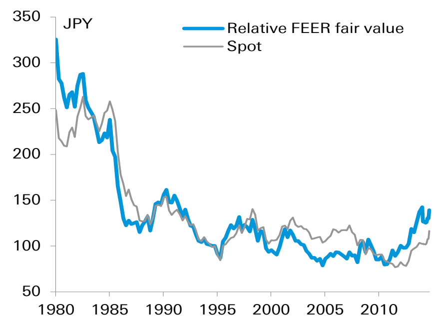
Terms of trade related trades allied to oil prices also largely explain most the relative value trades in the past two months, notably in the EM world. We anticipate that in the next two months before the next FX forecasts and valuations report, global risk appetite will remain resolute, largely buoyed by the benefits of softer energy prices, providing opportunities for tactical but not strategic carry trades.

Figure1: USD/JPY vs. PPP



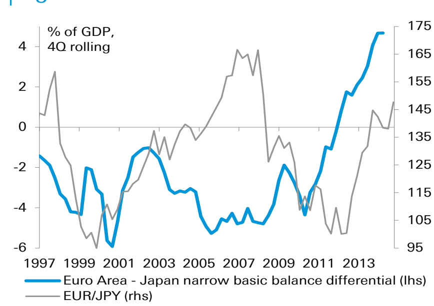
Source: Deutsche Bank Research

Figure 2: JPY FEER valuation



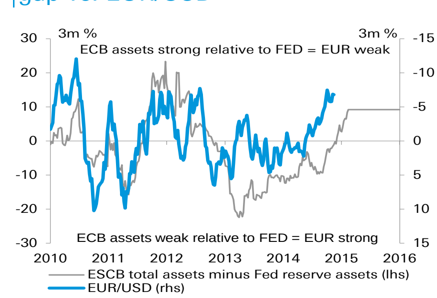
Source: Deutsche Bank Research

Figure 3: EUR-JPY NBB vs. FX



Source: EcoWin, Deutsche Bank Research

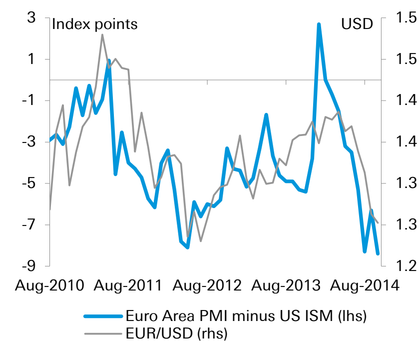
Figure 4: ECB – Fed assets growth gap vs. EUR/USD



Source: EcoWin, Deutsche Bank Research

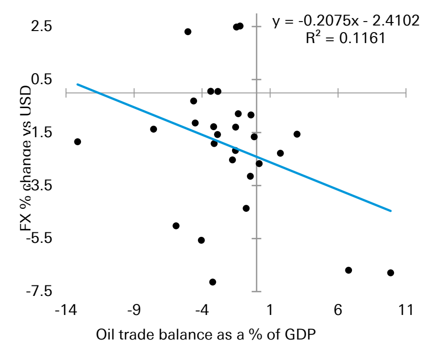
While the price action in 2015 has played out in many of the ways we predicted, it would be disingenuous to say the DB FX team has had it all our own way. Much more than we had expected of the USD gains in H2 2015 have relied on EUR weakness, led by negative rates, and JPY weakness induced by another bout of BOJ easing and augmented by the GPIF. The good news for USD bulls like ourselves is this: The market now only prices in a modest 125bps of Fed tightening through the end of 2016, over 50bps down from the start of the year. The slide in USD yields across the curve, has left far greater potential for US rates to finally contribute to USD strength in the year ahead. At a minimum, 2014 has been a year where the USD has proved that it can still rally when US risk appetite and stocks improve and US yields move lower. How far the USD has come in breaking old correlations, is one indication of how far it can go.

Figure 5: Euro Area – US PMI differential vs. EUR/USD



Source: EcoWin, Deutsche Bank Research

Figure 6: FX % change vs. USD since September 26 vs. oil trade balance



Source: EcoWin, Deutsche Bank Research

Alan Ruskin (1) 212-250-8646
Daniel Brehon (1) 212-250-7639

Commodities: Oil markets in disarray

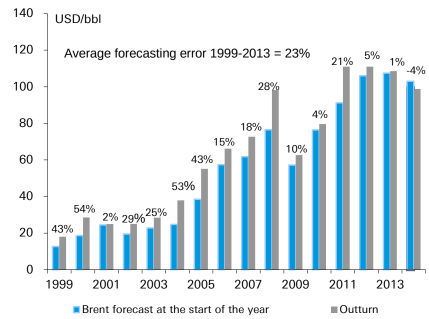
- Extreme oil price weakness this year reflects not just rapid non-OPEC supply growth, but OPEC's reluctance to play its customary role of withholding supply from the global market in times of oversupply. This has consequently thrown the oil market into disarray.
- We view the USD65-70/bbl range for WTI as a key level at which US producers begin to constrain capital expenditures for future production growth. However, even with revised oil supply expectations these still imply a surplus market in the first half of next year that, in the absence of OPEC action, will sustain oil price weakness.
- Indeed, on current trends the extent of the mismatch between global oil supply and demand in the first half of next year will be the largest since 1998 when crude oil prices fell by almost 30%.
- As a result, we expect oil prices will remain weak throughout next year. We expect prospects for a price recovery will be based on whether price weakness triggers OPEC to cut production and/or more substantial downgrades to non-OPEC supply.
- Other factors that could assist a price recovery in crude oil would be extreme cold this winter, a more aggressive programme of Chinese Strategic Petroleum Reserve building or positive growth shocks for example in the US, Europe or Asia.
- On the supply side, we would view Libya and Iraq as the most likely candidates for oil supply losses. However, on our calculations supply losses or positive demand surprises would need to be in excess of 1.2mmbd to have a chance of strengthening oil market fundamentals.
- Not surprisingly the implications of a sustained period of lower oil prices will be far reaching. The major EM winners will be Thailand, India and Chile where net petroleum imports account for over 5% of GDP. In contrast, Venezuela, Russia and Colombia will be the major losers from a current account perspective. From an equity standpoint, EMEA and Canada have the highest exposure by market capitalization to the energy sector.

OPEC's reluctance to play its customary role of withholding supply from the global market in times of oversupply has thrown the oil market into disarray. Not surprisingly, it has created substantial uncertainty over where prices may settle in the near term. Not only was the cartel's overall production allocation left unchanged, but there was also no commitment to tighten compliance with the 30mmb/d quota.

Given our assumption of an extended period of lower oil prices, we have reduced our expectations for US production growth from 950kb/d to 750kb/d yoy in 2015 (with 2016 growth marked down from 700kb/d to 450 kb/d yoy). However, one risk to this scenario is that US producers under sustained margin pressure may find ways of reducing costs, thus shifting the cost curve lower as has been the case in natural gas production. This would imply less of a curtailment in US tight oil production growth than we are assuming and with it a longer period for oil prices to stabilise.

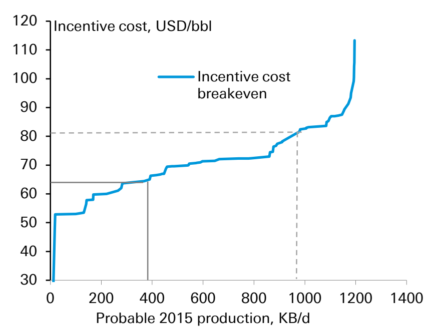
Even with reductions to the pace of US supply growth, the bearish fundamental outlook in the first half of next year is largely unchanged in the absence of OPEC production cuts. Indeed if we assume OPEC production remains close to current levels of 30.2mmb/d, then it implies the first half of next year will see the most oversupplied oil market since the same period in 1998, when oil prices fell by 28% yoy. However, the downgrades to US oil production growth will help to prevent a further deterioration of oil market fundamentals in 2016.

Figure 1: Consensus oil price forecasts versus outturns



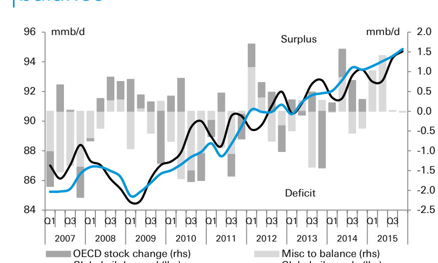
Source: Reuters, Deutsche Bank Research

Figure 2: US probable 2015 oil supply by breakeven



Breakeven calculations assume 10% IRR requirement
Sources: Wood Mackenzie Deutsche Bank Research

Figure 3: Global oil supply-demand balance



Source: IEA, Deutsche Bank Research

We expect this fundamental backdrop will sustain the pressure on OPEC to cut production either at their next meeting in June 2015 or before. We expect OPEC will eventually cut production by around 1.5mmbd and their action will eventually help to tighten oil market fundamentals. History suggests that when OPEC takes action, outside recessionary environments, it succeeds in stabilizing prices and it action typically raises crude oil prices by an average of 8.5% within three months of the quota reduction.

Other event risks that could help tighten oil market fundamentals would be a cold winter, aggressive SPR builds in China or supply disruptions in Libya, Iraq or elsewhere in the Middle East or beyond. However, given the oversupplied nature of the oil market heading into next year we believe positive demand/negative supply shocks will need to be of a significant magnitude to materially tighten oil market fundamentals. For example, armed incursions in Libya have led to supply losses of as much as 280 kb/d in November. However, this will be insufficient to affect oil market fundamentals significantly.

The impact on Russia from lower oil prices will also be worth watching closely. However, so far the decline in the oil price has been offset by the collapse in the rouble. As a result, we do not expect that Russian companies will reduce capex in rouble terms. Moreover for any new greenfield projects the Russian government is providing a tax incentive mechanism which guarantees that projects receive a 16.3% IRR. As a result we are not making any significant adjustments to Russian production levels which we expect will fall by around 250kbp by the end of the decade. More problematic may be the high cost ultra-deep water projects off West Africa and specifically Angola as well as Brazil.

Taking a step back from the supply and demand dynamic of the oil market, we attempt to estimate the fair value of oil relative to various indicators. We believe this may help to establish at what point the decline in the oil price can be considered excessive or even if the decline in the oil price has further to run. We examine at what level the oil price brings valuations back towards long run historical averages in real terms, relative to income, relative to physical and financial assets among others, Figure 4. This reveals that the potential steady state for Brent crude oil prices is around USD68.

Of these various indicators we view USD60 as a critical tipping point for crude oil producers. At this level it not only implies more significant curtailment in US oil production but the oil price at this level would start to trigger significant distress across the US High Yield energy sector. Indeed DB's US Credit Strategy team find that an oil price at this level would push debt/enterprise valuations among US energy B/CCC names to a level that would imply a 30% default rate for the whole segment. With the Fed beginning to tighten monetary policy this could prove to be a toxic environment.

From a current account perspective, the relative winners from the collapse in crude oil prices will be Thailand, South Korea, Chile and India. From an equity standpoint, EMEA and Canada have the highest exposure by market capitalization to the energy sector and would thus be the most exposed. From a commodity perspective the collapse in oil is not altering our timing of Fed tightening in the middle of the year so we are maintaining our bearish outlook for gold. Perhaps more concerning for the sector, is that palladium has now replaced gold in 2012 and crude oil in 2014 as the world's most overvalued commodity when measured in real terms, Figure 5. This may be easier to justify in a falling oil price environment given the positive boost to the global auto sector this might imply.

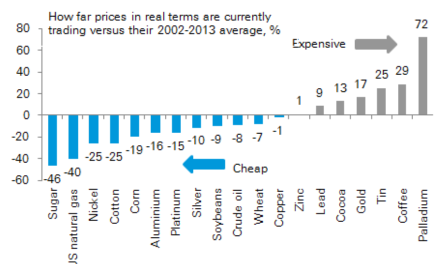
Michael Lewis, (44) 20 754 52166
Michael Hsueh, (44) 20 754 78015

Figure 4: Estimating the steady state for Brent crude oil prices against various indicators

Real terms (PPI)	USD53
Relative to income	USD53
Real terms (CPI)	USD54
Relative to copper	USD55
High Yield credit default*	USD60
As a share of world GDP	USD70
US tight oil incentive pric	USD70
Relative to gold	USD80
Relative to the S&P500	USD80
Versus the US dollar	USD80
GCC budget breakevens	USD89
Average	**USD68**

Levels for various indicators such as real terms and relative to income, bring valuations back towards their 1972-2013 average.
** Estimates are Brent with the exception of HY credit default, which is WTI. We assume existing WTI-Brent spread to calculate the average figure*
Source: Deutsche Bank Research (Commodities Weekly October 17, 2014

Figure 5: Valuing commodities in real terms



Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 6: DB Oil Price Deck

	WTI (USD/bbl)	Brent (USD/bbl)
Q4 2014F	77.0	80.0
2014F	94.0	100.3
Q1 2015F	65.0	70.0
Q2 2015F	65.0	70.0
Q3 2015F	70.0	75.0
Q4 2015F	70.0	75.0
2015F	67.5	72.5
2016F	72.0	77.0
2017F	79.0	84.0

Figures are period averages
Source: Deutsche Bank Research

Geopolitics: Ongoing alliance shifts

During the last year, we have discussed the strategic problems and openings of each of the great powers in the face of a US that is in global strategic retreat. Given its role as the currently most dissatisfied great power, Russia's moves in the Ukraine, its search for alliances to its east, the West's sanctions, and the rise of potentially closed blocs have attracted much of our attention as the most dynamic force. The proximate cause of many recent geopolitical events is the actual US withdrawals from territories it occupied or passivity in territories it had at least quasi-guaranteed. This was bound to attract numerous contending powers with an interest in the ultimate disposition of these territories. In turn, these forces will inevitably merge into new or evolving alliances:

1. …toward China

Most visible in the momentum to shift or establish new alliances is Russia's approach toward China. This has become concrete in energy deals advantageous to China, joint naval maneuvers in the Pacific and now in the Mediterranean, and increased potential arms sales. Over the long term, the energy deals should attract Chinese capital for pipeline construction and oil field development, and probably Chinese labor also. While embracing these moves, China has still kept some distance by signing an environmental deal with the US and by reducing tensions with neighbors in the South and East China Seas. With its confrontation with the West over Ukraine, Russia is more the supplicant in the approach to China, and China still has a strong economic interest to maintain good relations with the US.

2. …within the Middle-East

The complete withdrawal of the US at end-2011 created the vacuum in Iraq that ISIL has filled. The domestic political fallout of the rise of ISIL forced the US Administration to return 1500 troops to Iraq and to launch the bombing campaign, but the limited nature of the operation led to its being regarded as a political maneuver simply to get through the US mid-term elections. However, with the elections over, the Administration intends to send 1500 more troops and to allow them to engage in combat, presumably accompanying local forces as forward air controllers. Air attacks have blunted the offensive surge of ISIL but have not driven it back from its rapid conquests of last summer. The rise of ISIL has further strengthened the US Administration's motivations for rapprochement with Iran and led to tacit cooperation with Syria.

In turn, this has converted the impasse in the nuclear talks with Iran into more of a secondary nuisance to be papered over on the way to a larger deal. A larger deal would effectively end sanctions so that Iran could resume normal economic activity and rapidly develop its oil production. It would also permit much closer coordination against Sunni jihadist forces and possibly swing Iran away from Russia. The deadline in the talks has been postponed for a further seven months. This means that Iran can keep producing 5% enriched uranium but not a higher level of enrichment, and the limited relaxation of sanctions can continue. The talks are at an impasse over the number of centrifuges: the US wants no more than 4500, Iran wants no less than 10000. The difference determines the amount of time to breakout to a nuclear weapon, i.e. the amount of time required to enrich enough 5% enriched uranium to bomb grade. Along with this shift, the US Administration continues to distance itself from Israel.

Russia's role in the region is likewise ambivalent. It strongly supports the Assad government, its last client in the region from Soviet days and its toehold on the Mediterranean. This Syria policy aligns it with Iran, with which it also has export deals, specifically in building nuclear power reactors. However, it is against the proliferation of nuclear weapons to Iran and has been cooperative in the sanctions regime and a positive contributor to the negotiations. Moreover, if Iran were to escape the sanctions regime, this would undercut Russian oil as Iran develops its full potential.

Saudi Arabia has been adamantly opposed to the budding US rapprochement with Iran, its principal rival in the region. It has strongly supported the Syrian rebels. Now, however, it seems to be playing the oil weapon as it did just before the tanker war era of the last half of the 1980s. The rationales against cutting its supply are four-fold: first, it harms Iran with a 40% fall in the oil price that undoes any export revenue gains that Iran achieved with the relaxation of sanctions. Second, as in the case of any aggressive cartel, it punishes the higher cost new interlopers, notably US shale producers but also the marginal developments in the Arctic and deep water. Thus, future available supplies will be smaller, thereby preserving future market share although at the cost of a lower current price. Third, as in the past, it disciplines the other members of the cartel, perhaps grooming them to take a greater share of the supply cut quotas if the cartel can reconstitute itself in the future. Fourth, it cuts Russian export revenue from oil by 40% as of this date, thereby undercutting a key supporter of the Assad government and Iran. As a side effect from the West's perspective, this also steps up the economic pressure on Russia and makes further sanctions over Ukraine yet more effective.

Turkey has expanded trade relations with Russia to fill some of the gap left by Russia's trade sanctions against the EU. At the same time, Russia is a strong supporter of the Assad government in Syria, which Turkey opposes. It wants the US to add more weight in undermining the Assad regime at least by neutralizing Syrian air power, since US attacks on ISIL in Iraq and Syria have set back somewhat the forces arrayed against Assad. At the same time, the rapid rise of ISIL has seriously added to the flow of refugees across the border of Turkey.

United in opposition to the rise of Iran and the westward spread of its power, the Gulf States also seek the overthrow of the Assad government. Along with Turkey, the Gulf States have been the main supporters of the various Syrian rebel forces. However, they are now enlisted in the US sponsored coalition against ISIL, the most powerful of the rebel groups. Their ambivalence is reflected in their small contribution to the US air offensive relative to their own available forces.

3. …in Central Asia

As of end-November, there were about 16,000 US troops in Afghanistan, down from about 24,000 at end-September and a peak of about 100,000 two years ago. By end-December, about 10,000 US troops and 2,500 troops from other NATO countries will remain in an advisory capacity. Originally, complete withdrawal of this residual force had been programmed at end-2015. However, a recent change has shifted the final departure date to end-2016, and some troops will be allowed to engage in combat. Evidently, Iraq has taught the danger of leaving a vacuum too abruptly. Nevertheless, it is difficult to see how such a small force can hold much of the countryside since most of its strength will have to provide a protection force for headquarters and key transportation infrastructure to secure an exit route should the need suddenly arise. In addition to the Taliban already present and other Sunni sponsored jihadists, the opening of an Afghanistan vacuum will likely draw in serious attention from other large powers in the region: Iran, Russia, Pakistan, and India.

Peter Garber, (1) 904 520 5330

Key Economic Forecasts

	GDP growth (% yoy)			CPI inflation (% yoy)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
Advanced economies	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
US	2.4	3.5	3.1	1.7	1.2	2.1	-2.5	-2.6	-2.9	-2.9	-2.5	-2.9
Japan	0.5	1.4	1.6	2.9	1.4	1.0	0.4	1.9	2.4	-7.2	-6.4	-5.4
Euro area	0.8	1.0	1.3	0.5	0.5	1.3	2.4	2.2	2.0	-2.6	-2.5	-2.3
Germany	1.4	1.0	1.2	0.8	1.0	1.5	7.6	7.2	7.0	0.1	-0.5	-0.7
France	0.4	0.9	1.4	0.6	0.5	1.2	-1.8	-1.8	-1.5	-4.4	-4.2	-3.9
Italy	-0.4	0.3	0.9	0.2	0.4	1.1	1.6	1.8	1.6	-3.0	-2.8	-2.7
Spain	1.3	1.9	1.8	-0.2	0.4	1.4	0.4	0.6	0.9	-5.6	-4.5	-3.8
Netherlands	0.7	1.7	1.1	0.3	0.6	1.3	10.9	11.4	11.5	-2.5	-2.0	-1.9
Belgium	1.0	1.0	1.4	0.6	0.8	1.4	1.0	1.5	1.0	-2.8	-2.8	-2.5
Austria	0.4	0.8	1.5	1.4	1.2	1.7	1.5	1.8	2.4	-3.0	-1.9	-1.2
Finland	0.0	0.8	1.3	1.2	1.1	1.4	-1.3	-1.0	-0.6	-2.7	-2.3	-1.7
Greece	1.2	2.7	3.1	-1.3	-0.7	1.0	0.5	1.5	2.0	-1.3	0.5	1.9
Portugal	0.9	1.2	1.6	-0.2	0.7	1.3	0.5	0.8	1.0	-4.7	-3.5	-3.3
Ireland	4.0	3.3	3.2	0.3	0.6	1.6	4.5	5.5	6.0	-3.6	-2.9	-2.8
United Kingdom	3.0	2.5	2.3	1.5	1.3	1.8	-5.0	-4.0	-3.5	-4.9	-3.9	-2.0
Denmark	0.9	1.7	1.8	0.6	1.0	1.5	6.8	6.5	6.0	-1.0	-2.5	-2.0
Norway	2.2	2.4	2.5	2.0	2.0	2.0	10.5	10.0	9.5	10.0	9.5	9.0
Sweden	1.9	2.3	2.8	-0.2	0.5	1.5	5.9	5.3	4.8	-2.0	-1.5	-1.0
Switzerland	1.7	1.8	2.0	0.1	0.4	0.8	11.0	10.8	10.5	0.0	0.4	0.8
Canada	2.5	3.2	2.9	2.0	2.3	2.0	-2.0	-2.0	-1.7	-0.8	0.0	0.3
Australia	2.8	2.6	4.0	2.5	1.9	2.6	-2.9	-2.8	-2.1	-2.5	-1.5	-0.8
New Zealand	3.2	2.8	2.5	1.3	1.5	2.7	-3.5	-5.5	-4.7	-0.7	-0.1	0.4
EEMEA*	2.3	1.9	2.5	6.0	6.7	6.0	2.3	0.6	0.4	-1.7	-3.9	-3.4
Czech Republic	2.4	2.5	2.7	0.4	1.5	1.9	-1.0	-0.8	-0.6	-1.6	-2.1	-2.2
Egypt	2.2	3.7	3.8	10.1	12.0	9.0	-0.8	-1.6	-2.0	-12.7	-10.5	-9.5
Hungary	3.4	2.4	2.3	-0.1	1.9	3.1	3.8	3.7	3.6	-2.9	-2.7	-2.4
Israel	2.4	2.9	3.2	0.5	0.8	2.0	2.8	3.5	3.4	-3.0	-3.6	-3.1
Kazakhstan	3.9	2.1	2.6	6.8	8.4	8.3	2.0	2.1	1.6	5.3	2.4	1.9
Nigeria	6.0	4.8	5.7	8.6	10.0	9.0	2.7	0.1	1.2	-2.9	-4.2	-3.7
Poland	3.3	3.3	3.5	0.1	0.9	1.7	-2.6	-2.9	-3.1	-3.4	-2.9	-2.7
Romania	2.5	2.9	3.0	1.2	2.2	2.6	-1.2	-1.3	-1.3	-2.2	-2.5	-2.6
Russia	0.5	-0.9	-0.4	7.7	8.9	7.2	4.0	5.3	5.0	0.5	-1.4	-1.2
Saudi Arabia	4.3	2.8	3.5	2.9	3.2	3.4	12.2	-0.4	-0.7	-0.1	-11.2	-9.6
South Africa	1.4	2.6	3.2	6.1	4.6	5.6	-5.2	-4.2	-4.4	-4.2	-3.4	-2.5
Turkey	3.0	3.2	3.5	8.9	6.8	7.3	-5.2	-4.7	-5.0	-1.6	-1.8	-1.6
Ukraine	-6.9	-4.5	1.5	11.9	18.6	9.8	-3.5	-2.5	-2.0	-5.5	-4.5	-3.0
United Arab Emirates	3.5	3.5	3.8	2.2	2.5	3.0	12.3	3.9	2.8	4.9	-2.0	-1.1
Asia (ex-Japan)	6.0	6.2	6.1	3.6	3.6	3.7	2.4	2.5	2.3	-2.4	-2.5	-2.7
China	7.3	7.0	6.7	2.2	2.6	3.0	3.1	3.4	3.3	-2.1	-2.5	-3.0
Hong Kong	2.2	2.9	3.0	4.2	3.5	3.2	2.2	2.0	1.8	2.6	2.9	3.0
India	5.5	6.5	6.5	7.3	6.0	6.0	-1.4	-1.7	-1.7	-4.5	-4.0	-3.8
Indonesia	5.0	5.0	5.5	6.4	7.4	5.1	-2.6	-1.7	-1.2	-2.2	-1.7	-1.7
Korea	3.4	3.6	3.6	1.3	1.7	2.1	6.4	6.8	5.9	0.2	-0.5	-0.4
Malaysia	5.9	4.8	5.4	3.1	4.0	3.7	5.7	2.9	3.3	-3.5	-3.4	-2.8
Philippines	5.9	6.5	6.6	4.3	3.5	3.8	4.6	4.3	2.3	-1.8	-2.2	-2.4
Singapore	3.0	3.0	3.5	1.0	0.5	1.5	18.9	19.6	18.2	6.9	6.8	6.6
Sri Lanka	7.5	7.5	7.0	3.3	4.0	6.0	-2.9	-2.5	-2.0	-5.0	-5.0	-4.5
Taiwan	3.4	3.6	3.6	1.2	0.7	0.9	12.6	13.9	14.4	-2.0	-1.8	-1.5
Thailand	0.5	3.5	3.0	1.9	0.5	2.1	1.9	1.4	0.5	-2.8	-2.5	-2.0
Vietnam	5.8	6.2	6.2	4.2	4.7	5.5	4.3	3.5	0.0	-5.9	-5.3	-5.3
Latin America	0.8	1.5	2.9	12.5	13.5	11.9	-3.0	-3.0	-3.1	-4.5	-4.7	-3.6
Argentina	-1.5	-2.8	3.0	38.6	38.6	26.1	-1.6	-0.9	-1.4	-5.4	-5.8	-5.1
Brazil	0.1	0.7	1.9	6.3	6.4	5.8	-4.2	-4.2	-4.2	-5.1	-4.9	-3.7
Chile	1.6	2.6	3.2	4.5	4.0	3.2	-1.9	-2.0	-2.8	-1.9	-2.4	-1.7
Colombia	4.7	4.2	4.0	2.8	3.2	2.7	-4.5	-4.9	-3.5	-2.7	-3.0	-2.5
Mexico	2.1	3.4	3.7	4.0	3.8	3.5	-2.3	-2.5	-2.7	-4.2	-4.2	-3.5
Peru	2.7	5.5	5.0	3.2	2.4	3.1	-5.1	-4.7	-4.7	0.2	-0.1	0.6
Venezuela	-3.6	-2.0	2.0	60.0	80.0	85.0	1.6	0.4	0.6	-8.4	-11.4	-6.6
G7	1.8	2.5	2.4	1.6	1.2	1.8						
Advanced economies	1.7	2.4	2.3	1.4	1.1	1.7						
EM economies	4.4	4.5	4.9	5.5	5.7	5.4						
Global	3.2	3.6	3.8	3.7	3.7	3.9						

Source: Deutsche Bank Research, National statistical authorities
** Nigeria has been included (as part of EEMEA) in the aggregation from this edition.*

Key Economic Forecasts

QUARTERLY GDP	(% yoy)											
	Q1 2014	Q2 2014	Q3 2014	Q4 2014F	Q1 2015F	Q2 2015F	Q3 2015F	Q4 2015F	Q1 2016F	Q2 2016F	Q3 2016F	Q4 2016F
US	1.9	2.6	2.4	2.6	3.9	3.6	3.4	3.2	3.1	3.1	3.0	3.0
Japan	2.6	-0.1	-1.1	0.6	-0.5	1.8	2.5	1.6	1.6	1.6	1.7	1.7
Euro area	1.0	0.8	0.8	0.6	0.6	0.9	1.0	1.3	1.3	1.3	1.3	1.4
Germany	2.3	1.4	1.2	0.8	0.2	0.5	0.7	1.1	1.1	1.1	1.0	0.9
France	0.8	0.0	0.4	0.3	0.5	0.9	0.9	1.1	1.3	1.4	1.5	1.6
Italy	-0.3	-0.4	-0.5	-0.5	-0.3	0.2	0.6	0.9	1.0	1.0	0.9	0.8
United Kingdom	2.9	3.2	3.0	3.0	2.9	2.5	2.3	2.2	2.2	2.1	2.2	2.3
Canada	2.1	2.5	2.6	2.6	3.2	3.2	3.2	3.4	3.2	3.0	2.9	2.6
Australia	3.0	2.7	2.7	2.6	2.1	2.4	2.9	3.1	3.6	3.8	4.1	4.3
EEMEA	2.8	0.6	1.3	1.4	0.7	1.0	1.3	1.3	1.4	1.4	1.4	1.6
Poland	3.4	3.2	3.3	3.4	3.0	3.2	3.3	3.4	3.5	3.6	3.3	3.5
Russia	0.9	0.8	0.7	-0.4	-1.5	-1.2	-0.4	-0.3	-0.2	-0.4	-0.6	-0.7
South Africa	1.9	1.3	1.4	0.9	2.0	2.5	2.9	2.8	3.0	3.2	3.3	3.3
Turkey	7.4	-1.8	1.5	4.5	3.9	3.8	3.4	3.1	2.8	3.4	4.0	4.7
Asia (ex-Japan)	6.2	6.5	6.3	6.2	6.2	6.1	6.5	6.8	6.4	6.4	6.3	6.3
China	7.4	7.5	7.3	7.2	7.1	6.7	7.1	7.2	7.1	6.9	6.7	6.5
India	4.6	5.7	5.3	5.4	5.7	6.2	6.5	7.4	6.0	6.3	6.7	6.9
Indonesia	5.2	5.1	5.0	4.7	4.6	4.6	4.7	5.8	5.6	5.5	5.2	5.9
Korea	3.9	3.5	3.2	3.0	3.1	3.6	3.8	3.8	3.7	3.7	3.3	3.7
Taiwan	3.4	3.9	3.6	2.8	3.1	3.6	3.9	3.7	3.8	3.7	3.6	3.4
Latin America	1.6	-0.1	0.3	0.4	0.8	1.3	1.5	2.0	2.5	2.8	2.9	3.1
Argentina	-0.2	-1.5	-2.8	-3.0	-2.0	-2.0	-2.0	0.8	2.5	3.4	3.9	4.0
Brazil	1.9	-0.9	-0.2	-0.3	-0.1	0.7	1.0	1.1	1.6	1.9	2.0	2.2
Mexico	1.9	1.6	2.5	3.0	3.2	3.5	3.5	3.7	3.7	3.8	3.8	3.9
G7	1.9	1.8	1.5	1.8	2.3	2.5	2.6	2.4	2.4	2.4	2.3	2.3
Advanced economies	1.8	1.7	1.5	1.8	2.2	2.4	2.5	2.3	2.3	2.3	2.3	2.3
EM economies	5.0	4.6	4.7	4.6	4.6	4.7	5.0	5.3	5.1	5.2	5.1	5.2
Global	3.5	3.2	3.2	3.2	3.5	3.6	3.8	3.9	3.8	3.8	3.8	3.8

Source: Deutsche Bank Research, National statistical authorities.
**Note: All aggregates here are calculated on the basis countries mentioned in this table only.*

Key Financial Forecasts

Interest Rates (End of Period)

	3M rate				10Y rate				Official rate			
Advanced economies	Current	Q1-2015	Q2-2015	Q4-2015	Current	Q1-2015	Q2-2015	Q4-2015	Current	Q1-2015	Q2-2015	Q4-2015
US	0.24	0.35	0.75	1.35	2.30	2.45	2.60	2.80	0.13	0.25	0.50	1.00
Japan	0.20	0.15	0.15	0.15	0.42	0.55	0.55	0.65	0.10	0.10	0.10	0.10
Euro area	0.08	0.10	0.05	0.05	0.79	0.70	0.80	1.10	0.05	0.05	0.05	0.05
United Kingdom	0.56	0.55	0.68	1.25	2.02	2.10	2.20	2.50	0.50	0.50	0.50	1.00
Denmark	0.32	0.35	0.35	0.35	n.a.	n.a.	n.a.	n.a.	0.20	0.20	0.20	0.20
Norway	1.56	1.65	1.65	1.65	n.a.	n.a.	n.a.	n.a.	1.50	1.50	1.50	1.50
Sweden	0.11	0.25	0.25	0.25	n.a.	n.a.	n.a.	n.a.	0.00	0.00	0.00	0.00
Switzerland	0.00	0.02	0.02	0.02	n.a.	n.a.	n.a.	n.a.	0.00	0.00	0.00	0.00
Canada	0.92	0.98	1.23	2.00	1.96	2.23	2.40	3.50	1.00	1.00	1.25	2.00
Australia	2.86	2.63	2.38	2.13	3.04	3.50	3.75	4.00	2.50	2.50	2.25	2.00
New Zealand	3.88	3.67	3.67	4.17	3.85	4.25	4.50	4.50	3.50	3.50	3.50	4.00
EEMEA												
Czech Republic	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	0.05	0.05	0.05	0.05
Hungary	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	2.10	2.10	2.10	2.10
Israel	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	0.25	0.25	0.25	0.75
Kazakhstan	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	5.50	5.50	5.50	5.50
Poland	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	2.00	2.00	2.00	2.00
Romania	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	2.75	2.75	2.75	2.75
Russia	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	9.50	12.00	9.50	9.00
South Africa	6.07	6.10	6.10	6.15	7.81	7.70	7.80	8.20	5.75	5.75	5.75	6.00
Turkey	n.a	n.a	n.a	n.a	7.96	7.50	7.85	8.75	8.25	7.75	7.50	8.00
Ukraine	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	14.00	25.00	20.00	15.00
Asia (ex-Japan)												
China	n.a	n.a	n.a	n.a	3.80	3.50	3.40	3.70	2.75	2.75	2.50	2.25
Hong Kong	0.38	0.45	0.55	0.85	1.72	2.00	2.15	2.35	0.50	0.50	0.75	1.25
India	8.45	8.00	7.80	7.50	7.92	7.60	7.50	7.20	8.00	7.50	7.50	7.00
Indonesia	n.a	n.a	n.a	n.a	7.90	7.80	8.00	8.50	7.75	8.00	8.00	7.75
Korea	2.13	1.89	1.90	1.90	2.74	2.50	2.70	3.00	2.00	1.75	1.75	1.75
Malaysia	3.80	3.75	3.75	4.00	3.99	4.00	4.05	4.25	3.25	3.25	3.25	3.50
Philippines	1.42	1.82	2.12	2.72	3.70	3.80	4.00	4.50	4.00	4.00	4.25	4.50
Singapore	0.44	0.50	0.60	0.80	2.22	2.35	2.40	2.60	0.44	0.50	0.60	0.80
Sri Lanka	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	8.00	8.00	8.00	8.50
Taiwan	0.81	0.84	0.85	0.85	1.62	1.70	1.85	2.00	1.88	1.88	1.88	1.88
Thailand	2.17	2.25	2.25	2.45	2.96	3.00	3.00	3.20	2.00	2.00	2.00	2.00
Vietnam	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	6.50	6.00	6.00	6.00
Latin America												
Argentina	12.75	20.00	21.30	22.50	n.a	n.a	n.a	n.a	20.01	27.00	28.00	29.00
Brazil	11.65	12.20	12.00	11.80	12.10	12.50	12.20	11.70	11.75	12.50	12.50	12.50
Chile	3.00	3.25	3.00	3.00	4.42	n.a	n.a	n.a	3.00	2.75	2.75	2.75
Colombia	4.42	4.60	4.70	4.70	6.81	6.60	6.50	6.90	4.50	4.50	4.50	4.50
Mexico	2.84	3.40	3.50	4.50	6.00	6.00	6.25	7.00	3.00	3.00	3.00	4.00
Peru	4.66	4.64	4.89	5.14	5.28	4.80	5.00	5.50	3.50	3.50	3.75	4.00
Venezuela	14.82	17.00	17.00	20.00	n.a	n.a	n.a	n.a	14.50	16.00	16.50	17.00

Exchange Rates (End of Period)

	FX Rate (vs. US Dollar)				FX Rate (vs. Euro)				FX Rate (vs. Yen)			
Advanced economies	Current	Q1-2015	Q2-2015	Q4-2015	Current	Q1-2015	Q2-2015	Q4-2015	Current	Q1-2015	Q2-2015	Q4-2015
US					1.23	1.22	1.20	1.15	120	121	121	125
Japan	120	121	121	125	148	148	145	144				
Euro area	1.23	1.22	1.20	1.15					148	148	145	144
United Kingdom	1.57	1.61	1.60	1.58	0.79	0.76	0.75	0.73	189	195	192	198
Denmark	6.02	6.11	6.22	6.49	7.44	7.46	7.46	7.46	20.0	19.8	19.5	19.3
Norway	7.13	6.72	6.63	6.83	8.81	8.20	7.95	7.85	17.0	18.0	18.3	18.3
Sweden	7.51	7.34	7.42	7.61	9.28	8.95	8.90	8.75	16.1	16.5	16.3	16.4
Switzerland	0.97	1.01	1.03	1.09	1.20	1.23	1.24	1.25	123.9	120.0	117.5	114.7
Canada	1.14	1.15	1.17	1.20	1.41	1.40	1.40	1.38	106.2	105.2	103.4	104.2
Australia	0.84	0.83	0.81	0.78	1.48	1.46	1.48	1.47	101.0	100.4	98.4	97.7
New Zealand	0.78	0.78	0.75	0.70	1.59	1.56	1.60	1.64	93.6	94.4	90.8	87.5
EEMEA												
Czech Republic	22.4	22.5	22.9	23.9	27.6	27.5	27.5	27.5	5.4	5.4	5.3	5.2
Hungary	248.2	252.5	258.3	273.9	307.3	307.5	310.0	315.0	0.0	0.5	0.5	0.5
Israel	3.96	3.98	4.00	4.05	4.90	4.85	4.82	4.66				
Kazakhstan	181.4	220.0	217.8	213.5	224.2	268.4	261.4	245.5				
Poland	3.36	3.41	3.44	3.55	4.16	4.16	4.13	4.08	35.9	35.5	35.2	35.2
Romania	3.59	3.55	3.57	3.70	4.43	4.33	4.30	4.25				
Russia	53.1	47.5	48.5	47.5	65.65	57.9	58.4	54.6				
South Africa	11.2	11.4	11.3	11.0	13.9	13.9	13.6	12.6				
Turkey	2.24	2.27	2.26	2.30	2.77	2.77	2.72	2.64				
Ukraine	15.42	15.40	15.80	16.50	19.06	18.78	19.04	18.97				
Asia (ex-Japan)												
China	6.14	6.20	6.20	6.10	7.59	7.56	7.44	7.02	19.8	19.5	19.5	20.5
Hong Kong	7.75	7.78	7.80	7.80	9.58	9.49	9.36	8.97	15.7	15.6	15.5	16.0
India	61.85	62.50	63.00	64.00	76.46	76.25	75.60	73.60	2.0	1.9	1.9	2.0
Indonesia	12,296	12,300	12,450	12,250	15,409	15,006	14,940	14,088	101.92	0.01	0.01	0.01
Korea	1,116	1,120	1,150	1,170	1,326	1,366	1,380	1,346	0.11	0.11	0.11	0.11
Malaysia	3.27	3.41	3.44	3.45	4.28	4.16	4.13	3.97	34.7	35.5	35.2	36.2
Philippines	44.6	44.6	45.3	46.0	55.2	54.4	54.4	52.9	2.7	2.7	2.7	2.7
Singapore	1.31	1.33	1.35	1.35	1.62	1.62	1.62	1.55	91.8	91.0	89.6	92.6
Sri Lanka	131.0	131.5	131.7	132.0	161.96	160.43	157.99	151.79	0.9	0.9	0.9	0.9
Taiwan	31.19	31.50	32.00	32.50	38.56	38.43	38.40	37.38	3.9	3.8	3.8	3.8
Thailand	32.90	33.60	34.20	35.00	40.50	40.99	41.04	40.25	3.7	3.6	3.5	3.6
Vietnam	21,265	21,500	21,800	22,000	26,700	26,230	26,160	25,300	0.006	0.006	0.006	0.006
Latin America												
Argentina	8.55	9.10	9.52	10.25	10.57	11.10	11.42	11.79				
Brazil	2.58	2.55	2.60	2.75	3.19	3.11	3.12	3.16				
Chile	612	610	610	610	756	744	732	702				
Colombia	2,284	2200	2250	2358	2,560	2,684	2,700	2,712				
Mexico	14.30	13.70	13.50	13.90	17.68	16.71	16.20	15.99				
Peru	2.95	2.90	2.95	3.03	3.63	3.54	3.54	3.48				
Venezuela	6.29	6.30	6.30	15.00	7.74	7.69	7.56	17.25				

Source: Deutsche Bank Research, Bloomberg Finance LP, Datastream; as of Dec 08

Long-term forecast

	GDP growth,% yoy							CPI inflation, % yoy						
	2013	2014F	2015F	2016F	2017F	2018F	2019F	2013	2014F	2015F	2016F	2017F	2018F	2019F
Advanced economies														
US	2.2	2.4	3.5	3.1	2.8	2.7	2.5	1.5	1.7	1.2	2.1	2.6	2.3	2.3
Japan	1.5	0.5	1.4	1.6	1.0	1.3	1.3	0.4	2.9	1.4	1.0	1.9	1.0	1.0
Euro area	-0.4	0.8	1.0	1.3	1.6	1.7	1.7	1.4	0.5	0.5	1.3	1.7	1.8	1.9
United Kingdom	1.7	3.0	2.5	2.3	2.3	2.3	2.3	2.6	1.5	1.3	1.8	2.0	2.0	2.0
Canada	2.0	2.5	3.2	2.9	2.5	2.4	2.2	0.9	2.0	2.3	2.0	2.0	2.0	2.0
Australia	2.1	2.8	2.6	4.0	3.7	3.6	3.5	2.4	2.5	1.9	2.6	2.5	2.5	2.5
EM economies														
Russia	1.3	0.5	-0.9	-0.4	0.8	1.6	2.2	6.8	7.7	8.9	7.2	6.2	5.7	5.1
South Africa	1.9	1.4	2.6	3.2	2.8	3.3	3.5	5.8	6.1	4.6	5.6	5.4	5.3	5.3
China	7.7	7.3	7.0	6.7	6.7	6.5	6.5	2.6	2.2	2.6	3.0	3.0	3.0	3.0
India	4.7	5.5	6.5	6.5	7.0	7.0	7.5	10.1	7.3	6.0	6.0	6.0	6.0	6.0
Indonesia	5.8	5.0	5.0	5.5	5.5	6.0	6.0	6.4	6.4	7.4	5.1	5.5	6.0	6.0
Brazil	2.5	0.1	0.7	1.9	2.7	3.0	2.5	6.2	6.3	6.4	5.8	5.0	5.0	5.0

	GDP per head, % yoy							Population growth, % yoy						
	2013	2014F	2015F	2016F	2017F	2018F	2019F	2013	2014F	2015F	2016F	2017F	2018F	2019F
Advanced economies														
US	1.5	1.6	2.7	2.3	2.0	1.9	1.7	0.7	0.8	0.8	0.8	0.8	0.8	0.8
Japan	1.7	0.7	1.6	2.0	1.4	1.8	1.8	-0.2	-0.2	-0.3	-0.3	-0.4	-0.5	-0.5
Euro area	-0.6	0.5	0.7	0.9	1.1	1.2	1.2	0.2	0.3	0.3	0.4	0.5	0.5	0.5
United Kingdom	1.2	2.5	1.9	1.7	1.7	1.7	1.7	0.6	0.6	0.6	0.6	0.5	0.5	0.5
Canada	0.9	1.4	2.2	1.9	1.6	1.5	1.3	1.1	1.1	1.0	1.0	0.9	0.9	0.9
Australia	0.2	1.0	1.1	2.5	2.3	2.1	2.0	1.8	1.8	1.5	1.5	1.5	1.5	1.5
EM economies														
Russia	1.3	0.3	-1.0	-0.5	0.7	1.5	2.2	0.1	0.2	0.1	0.1	0.1	0.1	0.0
South Africa	0.5	0.4	1.7	2.1	1.8	2.3	2.5	1.4	1.0	0.9	1.1	1.0	1.0	1.0
China	7.1	6.8	6.5	6.2	6.2	6.0	6.0	0.5	0.4	0.5	0.5	0.5	0.5	0.5
India	3.3	4.1	5.1	5.1	5.6	5.6	6.1	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Indonesia	4.5	4.0	4.3	4.3	4.3	4.8	4.8	1.3	1.2	1.7	1.8	1.5	1.5	1.5
Brazil	1.3	-0.7	-0.1	1.1	1.9	2.2	1.7	1.1	0.8	0.8	0.8	0.8	0.8	0.8

	Key official interest rate, % (eop)							10Y bond yields (eop)						
	2013	2014F	2015F	2016F	2017F	2018F	2019F	2013	2014F	2015F	2016F	2017F	2018F	2019F
Advanced economies														
US	0.13	0.13	1.00	2.50	3.50	4.00	4.00	3.04	2.35	2.80	3.50	3.75	4.00	4.25
Japan	0.10	0.10	0.10	0.10	0.10	0.50	0.50	0.64	0.50	0.65	0.75	0.80	1.20	1.20
Euro area	0.25	0.05	0.05	0.05	0.50	1.50	2.50	1.93	0.70	1.10	1.60	2.00	2.25	2.50
United Kingdom	0.50	0.50	1.00	2.00	2.50	3.00	3.50	2.86	2.00	2.50	3.00	3.40	3.70	4.00
Canada	1.00	1.00	2.00	3.00	3.50	4.00	4.00	2.78	2.00	3.50	5.50	5.50	5.50	5.50
Australia	2.50	2.50	2.00	2.50	2.50	3.00	4.00	4.24	3.50	4.00	4.00	4.00	4.00	4.00
EM economies														
Russia	5.50	10.50	9.00	8.50	6.50	6.00	5.50	n.a	n.a	n.a	n.a	n.a	n.a	n.a
South Africa	5.00	5.75	6.00	6.50	6.50	7.00	7.50	8.27	7.66	8.20	8.50	8.50	8.50	8.80
China	3.00	2.75	2.25	2.25	2.50	2.75	3.00	4.63	3.55	3.70	n.a	n.a	n.a	n.a
India	7.75	8.00	7.00	7.00	7.00	7.00	7.00	8.82	8.02	7.20	7.20	7.20	n.a	n.a
Indonesia	7.50	8.00	7.75	7.00	7.00	7.00	7.00	8.45	7.70	8.50	8.00	8.00	8.00	n.a
Brazil	10.00	11.75	12.50	10.00	10.00	10.00	11.50	13.20	12.00	11.70	11.20	11.60	12.00	11.40

	FX rate vs. USD (eop)							FX rate vs. EUR (eop)						
	2013	2014F	2015F	2016F	2017F	2018F	2019F	2013	2014F	2015F	2016F	2017F	2018F	2019F
Advanced economies														
US	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.38	1.25	1.15	1.05	0.95	1.10	1.15
Japan	105.30	117.00	125.00	130.00	120.00	110.00	105.00	145	146	144	137	114	121	121
Euro area	1.38	1.25	1.15	1.05	0.95	1.10	1.15	1.00	1.00	1.00	1.00	1.00	1.00	1.00
United Kingdom	1.65	1.62	1.58	1.50	1.38	1.45	1.39	0.84	0.77	0.73	0.70	0.69	0.76	0.83
Canada	1.06	1.14	1.20	1.25	1.30	1.22	1.15	1.46	1.43	1.38	1.31	1.24	1.34	1.32
Australia	0.89	0.90	0.78	0.68	0.60	0.65	0.70	1.55	1.39	1.47	1.54	1.59	1.69	1.64
EM economies														
Russia	32.73	50.00	47.52	47.32	46.04	44.75	43.88	45.07	62.50	54.62	49.81	43.85	49.18	50.44
South Africa	10.49	11.00	11.00	10.50	11.14	11.80	12.43	14.44	13.75	12.64	11.05	10.61	12.97	14.29
China	6.10	6.15	6.10	6.10	6.00	6.00	6.00	8.39	7.69	7.02	6.41	5.70	6.60	6.90
India	61.90	62.00	64.00	65.00	66.00	65.50	65.00	85.23	77.50	73.60	68.25	62.70	72.05	74.75
Indonesia	12270	12200	12250	12750	13000	12500	12000	16895	15250	14088	13388	12350	13750	13800
Brazil	2.35	2.55	2.75	2.85	2.95	3.06	3.16	3.24	3.19	3.16	2.99	2.80	3.37	3.63

Source: National Authorities, Deutsche Bank Research

Contacts

Name	Coverage	Telephone	Email
David Folkerts-Landau	Global Head of Research	+44 20 754 55502	david.folkerts-landau@db.com
Marcel Cassard	Global Head, Macro and FI Research	+44 20 754 55507	marcel.cassard@db.com
Economics			
Peter Hooper	Global Economics	+1 212 250 7352	peter.hooper@db.com
Torsten Slok	Global Economics	+1 212 250 2155	torsten.slok@db.com
Joe LaVorgna	US Economist	+1 212 250 7329	joseph.lavorgna@db.com
Mark Wall	Europe Economics	+44 20 754 52087	mark.wall@db.com
Mikihiro Matsuoka	Japan Economics	+81 3 5156 6768	mikihiro.matsuoka@db.com
Michael Spencer	Asia Pacific Economics	+852 2203 8303	michael.spencer@db.com
Taimur Baig	Asia Economics	+65 6423 8681	taimur.baig@db.com
Gustavo Cañonero	Latam Economics	+1 212 250 7530	gustavo.canonero@db.com
Strategy			
Binky Chadha	Global Asset Allocation	+1 212 250 4776	bankim.chadha@db.com
Dominic Konstam	Rates Strategy	+1 212 250 9753	dominic.konstam@db.com
Francis Yared	Rates Strategy	+44 20 7545 4017	francis.yared@db.com
Jim Reid	Credit Strategy	+44 207 547 2943	jim.reid@db.com
Steven Abrahams	US MBS	+1 212 250 3125	steven.abrahams@db.com
David Bianco	US Equity Strategy	+1 212 250 8169	david.bianco@db.com
Oleg Melentyev	US Credit Strategy	+1212 250 6779	oleg.melentyey@db.com
Gareth Evans	European Equity Strategy	+44 20 7545 2762	gareth.evans@db.com
Bilal Hafeez	FX Strategy	+44 207 54 71489	bilal.hafeez@db.com
Michael Lewis	Commodities	+44 20 754 52166	michael.lewis@db.com
Peter Garber	Geopolitics	+1 904 520 5330	peter.garber@db.com

Appendix 1

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Peter Hooper/Michael Spencer/Mark Wall

Attribution

The Author of this report wishes to acknowledge the contributions made by Kuhumita Bhattacharya, Baqar Zaidi, Twisha Roy and by Punit Kumar Jha ,Ramakrishna Reddy, employees of Infosys Ltd., a third party provider to Deutsche bank offshore research support services.

Regulatory Disclosures

1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at https://gm.db.com/equities under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at http://gm.db.com.

3. Country-Specific Disclosures

Australia and New Zealand: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act and New Zealand Financial Advisors Act respectively.
Brazil: The views expressed above accurately reflect personal views of the authors about the subject company(ies) and its(their) securities, including in relation to Deutsche Bank. The compensation of the equity research analyst(s) is indirectly affected by revenues deriving from the business and financial transactions of Deutsche Bank. In cases where at least one Brazil based analyst (identified by a phone number starting with +55 country code) has taken part in the preparation of this research report, the Brazil based analyst whose name appears first assumes primary responsibility for its content from a Brazilian regulatory perspective and for its compliance with CVM Instruction # 483.
EU countries: Disclosures relating to our obligations under MiFiD can be found at http://www.globalmarkets.db.com/riskdisclosures.
Japan: Disclosures under the Financial Instruments and Exchange Law: Company name - Deutsche Securities Inc. Registration number - Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, Type II Financial Instruments Firms Association, The Financial Futures Association of Japan, Japan Investment Advisers Association. This report is not meant to solicit the purchase of specific financial instruments or related services. We may charge commissions and fees for certain categories of investment advice, products and services. Recommended investment strategies, products and services carry the risk of losses to principal and other losses as a result of changes in market and/or economic trends, and/or fluctuations in market value. Before deciding on the purchase of financial products and/or services, customers should carefully read the relevant disclosures, prospectuses and other documentation. "Moody's", "Standard & Poor's", and "Fitch" mentioned in this report are not registered credit rating agencies in Japan unless "Japan" or "Nippon" is specifically designated in the name of the entity.
Malaysia: Deutsche Bank AG and/or its affiliate(s) may maintain positions in the securities referred to herein and may from time to time offer those securities for purchase or may have an interest to purchase such securities. Deutsche Bank may engage in transactions in a manner inconsistent with the views discussed herein.
Qatar: Deutsche Bank AG in the Qatar Financial Centre (registered no. 00032) is regulated by the Qatar Financial Centre Regulatory Authority. Deutsche Bank AG - QFC Branch may only undertake the financial services activities that fall within the scope of its existing QFCRA license. Principal place of business in the QFC: Qatar Financial Centre, Tower, West Bay, Level 5, PO Box 14928, Doha, Qatar. This information has been distributed by Deutsche Bank AG. Related financial products or services are only available to Business Customers, as defined by the Qatar Financial Centre Regulatory Authority.
Russia: This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.
Kingdom of Saudi Arabia: Deutsche Securities Saudi Arabia LLC Company, (registered no. 07073-37) is regulated by the Capital Market Authority. Deutsche Securities Saudi Arabia may only undertake the financial services activities that fall within the scope of its existing CMA license. Principal place of business in Saudi Arabia: King Fahad Road, Al Olaya District, P.O. Box 301809, Faisaliah Tower - 17th Floor, 11372 Riyadh, Saudi Arabia.
United Arab Emirates: Deutsche Bank AG in the Dubai International Financial Centre (registered no. 00045) is regulated by the Dubai Financial Services Authority. Deutsche Bank AG - DIFC Branch may only undertake the financial services activities that fall within the scope of its existing DFSA license. Principal place of business in the DIFC: Dubai International Financial Centre, The Gate Village, Building 5, PO Box 504902, Dubai, U.A.E. This information has been distributed by Deutsche Bank AG. Related financial products or services are only available to Professional Clients, as defined by the Dubai Financial Services Authority.

Risks to Fixed Income Positions

Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates - these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.

David Folkerts-Landau
Group Chief Economist
Member of the Group Executive Committee

Raj Hindocha Global Chief Operating Officer Research	Marcel Cassard Global Head FICC Research & Global Macro Economics	Richard Smith and Steve Pollard Co-Global Heads Equity Research

Michael Spencer Regional Head Asia Pacific Research	Ralf Hoffmann Regional Head Deutsche Bank Research, Germany	Andreas Neubauer Regional Head Equity Research, Germany	Steve Pollard Regional Head Americas Research

International Locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

Global Disclaimer