Deutsche Bank

Deutsche Bank Research: Themes in 2013

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Passion to Perform

Themes in 2013

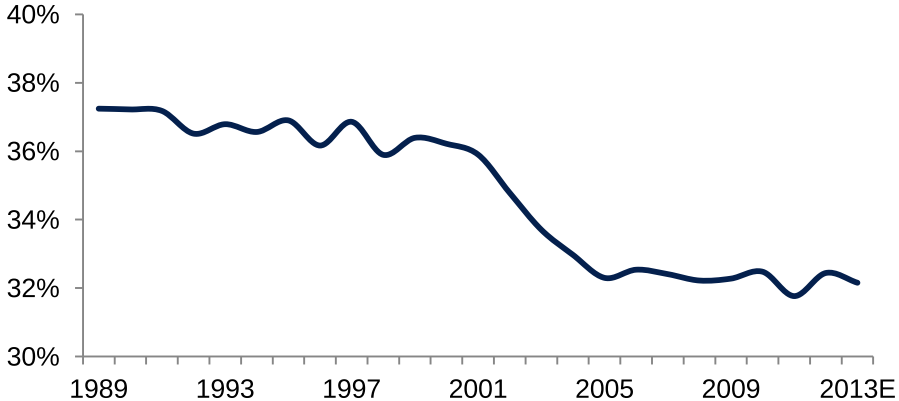
- In place of 'The House View' publication this month we close out the year by outlining twelve themes that could shape the global economy and markets in 2013. The themes are by no means exhaustive, and are designed to be thought-provoking rather than a summary of our forecasts (which will be covered by our outlook piece in January)
- Downside risks
  - **The state strikes back:** highly indebted governments become more interventionist and target corporate profits
  - **Bubble trouble:** a sell-off in core government bonds could leave investors nursing significant losses
  - **Sovereign risk - the next frontier:** France, Japan and the UK lose their safe-haven appeal
  - **Known unknowns:** things that we "know we don't know", such as natural disasters and geopolitics, remain a wild card
- Swing Factors
  - **Fiscal cliff-hanger:** fiscal cliff outcomes range from a recession to a growth spurt
  - **The Great Escape or QEternity:** will we get back to conventional monetary policy, or will we venture deeper into the unknown?
  - **United we stand:** will domestic politics in Europe hinder or help the path to crisis resolution?
  - **EM re-boot:** can emerging economies reform to deliver balanced growth in line with their full potential
- Upside risks
  - **The return of Equities:** investors return to equities amid a fall in risk aversion and rising confidence around global growth
  - **End of the oil super cycle:** the era of rising oil prices comes to an end
  - **Yankee bulls:** the US stages a stronger-than-expected recovery
  - **Crisis… what crisis?:** the Euro-crisis takes a back seat in 2013

The views in this publication are informed by Deutsche Bank's Global Strategy Group, which advises management and clients on broad market risks and global economic and financial developments. The views and forecasts of the group, which consists of senior research staff, may occasionally differ from those disseminated by their research colleagues

Editors: Raj Hindocha, Marcos Arana, Sahil Mahtani, Erin Urquhart

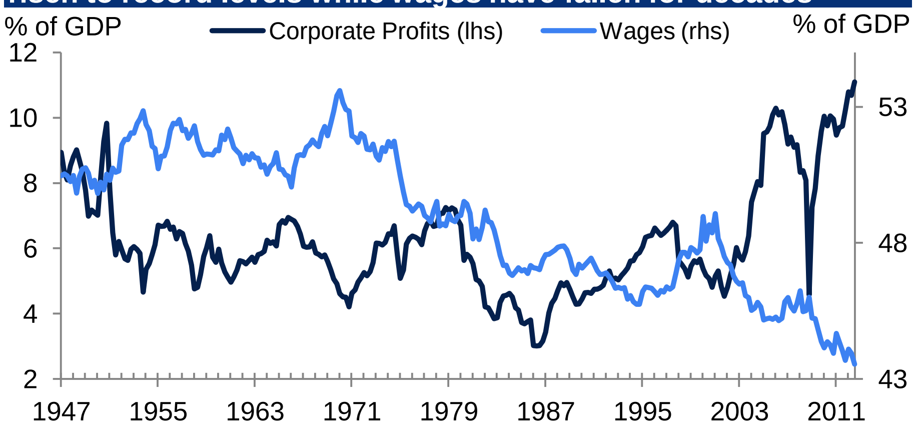
The state strikes back: indebted governments become more interventionist and target corporate profits

Effective global corporate tax rate: significant fall in tax levels over the past decade lend an argument to those calling for hikes



Source: Deutsche Bank Research

US corporate profits and wages as a share of GDP: profits have risen to record levels while wages have fallen for decades

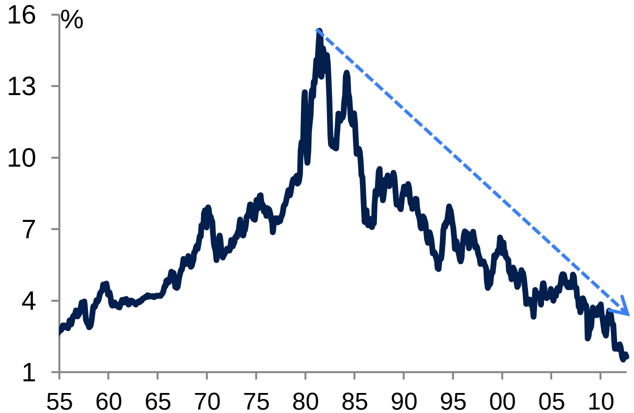


Source: FRED, US DOC, BEA, Deutsche Bank Research

- **Corporates are in good shape,** facing **lower tax rates** while **profits and cash are at record highs**
- **Conversely, labour's share** of the pie (wages / GDP) has **declined steadily since the 1970's**
- **Governments**, in a difficult fiscal position, may **target corporate / private wealth** for economic or social reasons
  - **Tax reform**, e.g., US may tax foreign profits when earned (not repatriated), Italy raises property tax
  - **Nationalisation**, e.g., of natural resources or corporates in Latin America, French government threat to nationalise ArcelorMittal plant
  - **Influence strategy**, e.g., French government opposition to Peugeot restructuring plan / layoffs
  - **Rising social pressure**, e.g., Starbucks UK offers to pay more corporation tax amid public pressure
  - **Pressure on home-bias**, e.g., pressure on European banks to support domestic sovereign
  - **Nearshoring**, e.g., Apple to manufacture Macs in the US for the first time since 90s as CEO says "we do have a responsibility to create jobs"
  - **Currency wars**, e.g., countries compete to weaken their currencies to promote export growth

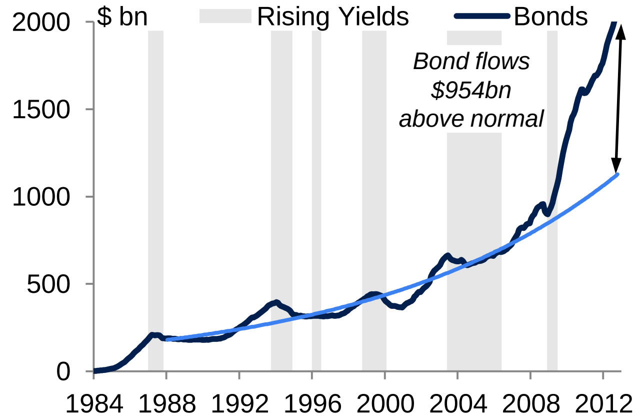
Bubble trouble: a sell-off core government bonds could leave investors nursing significant losses

US 10 year bond yields: 30-year secular bull market in bonds has seen yields steadily fall



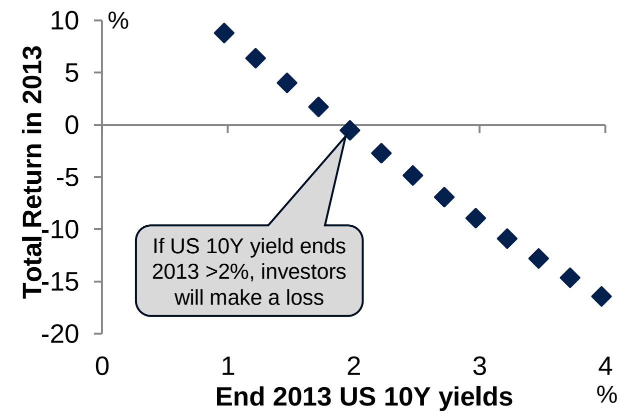
Source: FRB, Haver Analytics Deutsche Bank Research

Since the crisis, inflows into all bonds have surged way above trend-rates



Source: Deutsche Bank Research

End-2013 Total Return scenarios for investors in US 10Y bonds



Source: Bloomberg Finance LP, Deutsche Bank Research

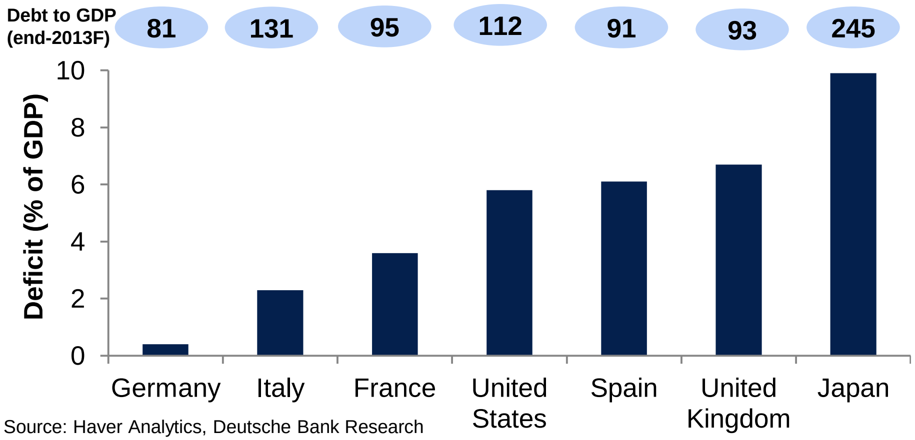
- Core government **bond yields have fallen steadily since the 1980's**
  - UK, US, German 10Y yields all hit record lows in 2012
  - 10Y German and US **real yields** (after inflation) were **negative all year** i.e., investors willing to lose money in real terms
  - Negative short-term **nominal yields** e.g., Germany, Switzerland (i.e., investors willing to pay governments to lend to them)

- Since the crisis, **flows into bonds have surged;** several **triggers could reverse this trend**
  - **Negative ratings action** and / or investor concern over high debt
  - **Reduction in risk aversion**
  - **Buyers strike** as investors shun low yielding bonds or see central banks as behind the curve
  - **Economic recovery** triggers the end of central bank bond purchases

- **A sell off in bonds in 2013 could leave investors nursing heavy losses**
  - A rise in US 10Y yields to 3%, equates to a total return of -9%
  - A rise to 4% (average since 2000), equates to a total return of -16%
  - To replicate the 2012 YTD performance (~3%), yields would need to fall to 1.57% (from 1.77 now)
- **A sell off would result in mark-to-market losses for bond mutual funds**, which rise and fall to reflect the market value of the bonds within it

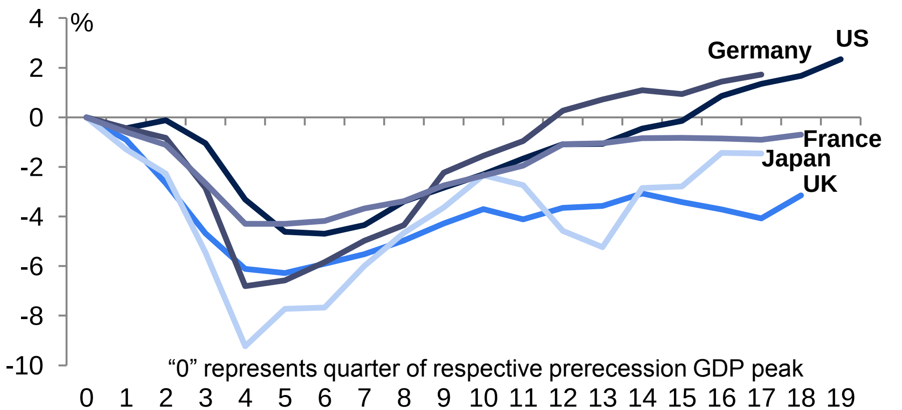
Sovereign risk - the next frontier: France, Japan and the UK lose their safe-haven appeal

Japan, the UK and France are in poor fiscal shape…



Source: Haver Analytics, Deutsche Bank Research

…while real GDP levels remain well below pre-crisis levels



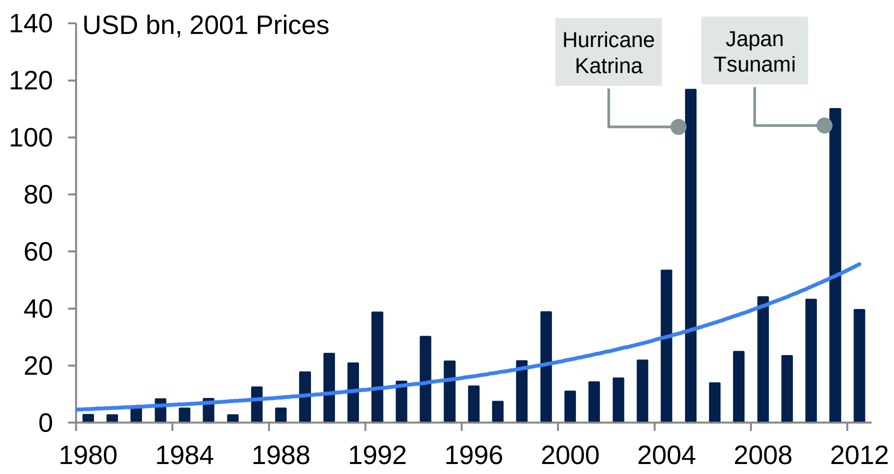
Source: Haver Analytics, Deutsche Bank Research

- **France, the UK and Japan have worrying fiscal metrics combined with very weak recoveries**
  - Public debt will rise to 245% of GDP in Japan and above 90% in the UK and France in 2013
  - Deficit consolidation has been limited in France and the UK, while Japan's deficit is rising
  - GDP in France, the UK and Japan is below its pre-crisis level and will remain so until 2014
- **These conditions have led rating agencies to lower their risk assessments**
  - France has lost 2 of 3 AAA-ratings in 2012
  - UK AAA-downgrade likely in 2013
  - Japan has been downgraded by all three agencies
- **Sovereign debt markets face revaluation risks**
  - Central banks in Japan and UK may have to step up purchases significantly to keep yields low
  - Successful reforms in the periphery could weaken France's relative position as a safe haven
- **The US is less likely to come under pressure**
  - Growth is positive; private sector is deleveraging
  - But, a negative outcome to debt reduction negotiations could weaken sentiment

Known unknowns: things that we "know we don't know[1]", such as natural disasters and geopolitics, remain a wild card

Natural Disasters

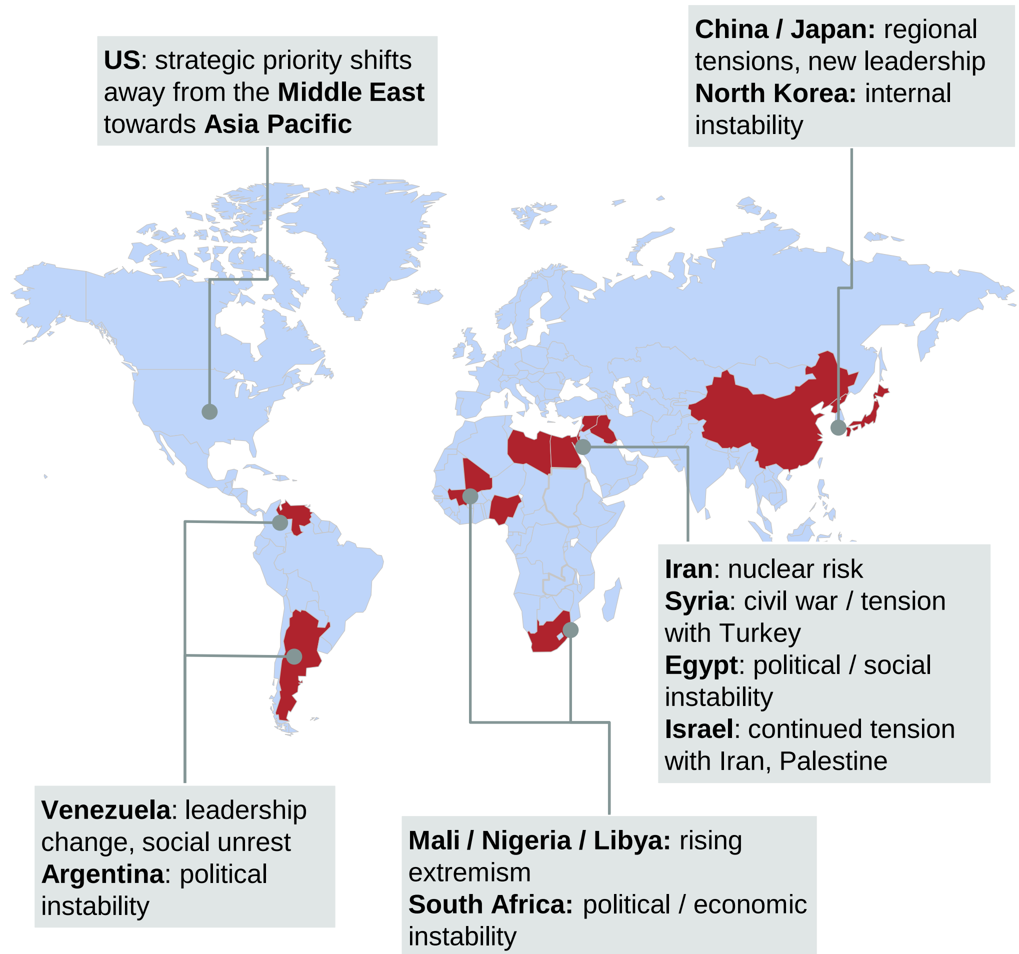
Insured real losses from natural disasters: losses are on the rise although can fluctuate wildly from year-to-year



Source: Swiss Re, Munich Re, Deutsche Bank Research

- **Insured losses from natural disasters have risen eight-fold** in economic terms since the 1980's
  - Freak weather events are **occurring more often** than can be explained by natural variability alone
  - **Rising urbanisation**, which increases the concentration of wealth and people, **exacerbates the impact** of such events
  - **Losses can fluctuate wildly** from year to year

Geopolitical hot-spots in 2013



[1] Former US Defence Secretary Donald Rumsfeld, February 12 2002

Fiscal cliff-hanger: fiscal cliff outcomes range from a recession to a growth spurt

December	Q1 2013	Economic and financial impact**
Option 1: Go over the cliff ▪ Political gridlock prevents agreement to avoid the cliff before 2-Jan* ▪ No agreement on long-term debt sustainability	**Meltdown** ▪ December 31 deadline breached ▪ Fiscal cliff (USD 650bn in spending cuts / tax rises) kicks-in on 2-Jan ▪ Q1 negotiations stall, no mitigation	▪ **S&P target:** 1200 ▪ **2013 GDP:** -2%
	Retroactive agreement ▪ December 31 deadline breached ▪ Fiscal cliff kicks-in on 2-Jan ▪ Congress agrees to reverse some of the measures with retroactive effect	
Option 2: Cliff delayed ▪ Temporary extensions agreed, only some cuts / tax hikes allowed ▪ Can happen with or without agreement on framework for long-term debt sustainability	**Delay, discuss, fail to resolve** ▪ Fiscal cliff mostly avoided ▪ Discussions continue in 2013 ▪ Gridlock persists, Congress fails to agree long-term tax and entitlement reform ▪ Likely to see serious US debt downgrade	▪ **S&P target:** 1450 ▪ **2013 GDP:** 1%
	Delay, discuss and agree (base case) ▪ Fiscal cliff mostly avoided ▪ Discussions continue in Jan/Feb ▪ Credible framework for long-term fiscal overhaul reached	▪ **S&P target:** 1500 ▪ **2013 GDP:** 2%
Option 3: Grand Bargain ▪ Cliff avoided ▪ Agreement on principles for debt reduction, details worked out in 2013	**Compromise reached** ▪ Congress irons out details ▪ US debt put on downward trajectory, with a comprehensive tax and entitlement reform	▪ **S&P target:** 1600 ▪ **2013 GDP:** >3%

(*) First working day of 2013; (**) 6-12m S&P outlook

The Great Escape or QEternity : will we get back to conventional monetary policy, or will we venture deeper into the unknown?

Conventional

Unorthodox

Monetary Policy

Increasingly Unorthodox

Central bank policies	Fed	ECB	BoE	BoJ
▪ **Adjust policy interest rates in line with mandate**, i.e., inflation, or inflation and unemployment	✓	✓	✓	✓
▪ **Liquidity Provision**				
– **Emergency liquidity** provision for banks	✓	✓	✓	
– **Term funding** for banks (e.g., ECB LTRO, UK funding for lending)		✓	✓	
▪ **Asset purchases**				
– **Credit easing**, i.e., buying specific securities to repair credit channel e.g., ECB (SMP, OMT, covered bonds), Fed (MBS) – *note that ECB's sovereign purchases also stabilise sovereign bond markets*	✓	✓	✓	✓
– **Quantitative easing**, i.e., supporting asset prices, boosting liquidity, lowering rates, to support economy	✓		✓	✓
▪ **Verbal guidance, conditional targets**, e.g., Fed commitment to keep rates low until late 2015 or "at least as long as the unemployment rate remains above 6.5%"	✓			
▪ **Negative interest rates** on central bank deposits to incentivise lending to the economy	?	?		
▪ **Change / modify mandate**				
– **Temporarily raise inflation target** to lower real rates and reduce debt burdens			?	?
– **Set target for nominal GDP**				
▪ **Outright debt monetisation**				
– **Soft measures**: transfer interest payments from bond purchases back to government		✓	✓	
– **Cancelling debt**: central banks 'write-off' government debt on their balance sheet				

? = speculated

The Great Escape

- Halt asset purchases
- Withdraw liquidity
- Raise interest rates

QEternity

- More asset purchases
- Greater policy experimentation

A key risk is that over-stimulus fuels dangerous asset price bubbles

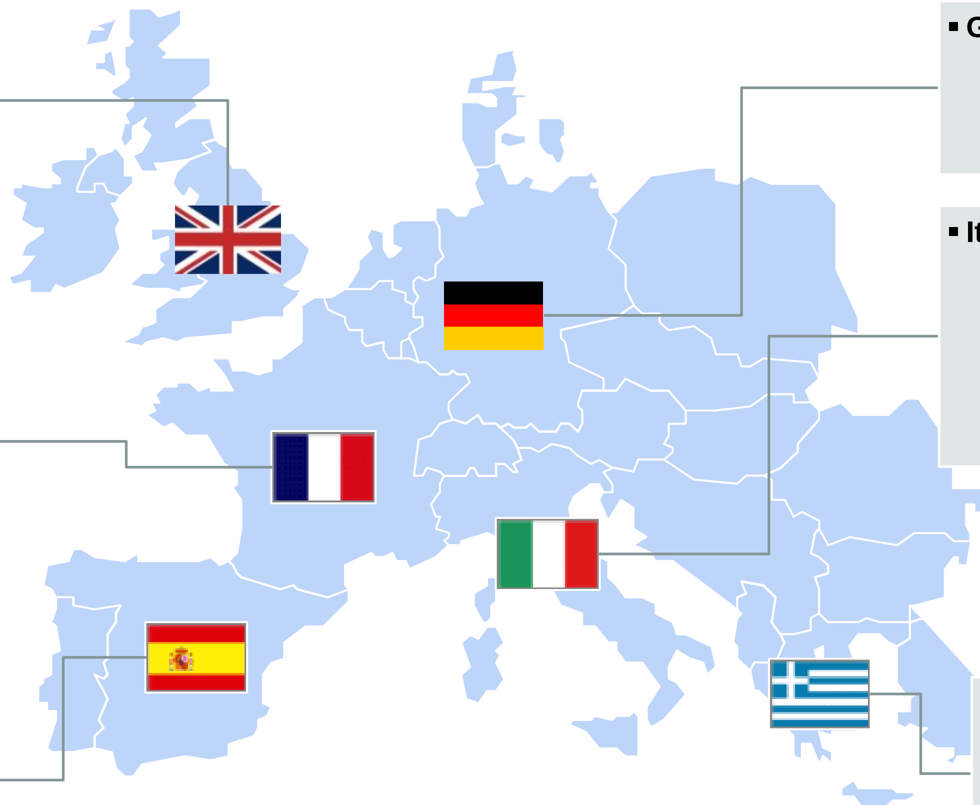
United we stand: will domestic politics in Europe hinder or help the path to crisis resolution?

Domestic politics: what to watch in 2013

- **Increasing Euro-scepticism**
  - Ongoing tension with EU partners
  - Threat of referendum on EU exit?

- **Government under pressure**
  - Government torn between serving left-wing of socialist party and pushing ahead with much-needed structural reforms

- **Tension between central government and regions**
  - Slippage on budget deficits
  - Opposition to austerity
  - Separatist threat from Catalonia



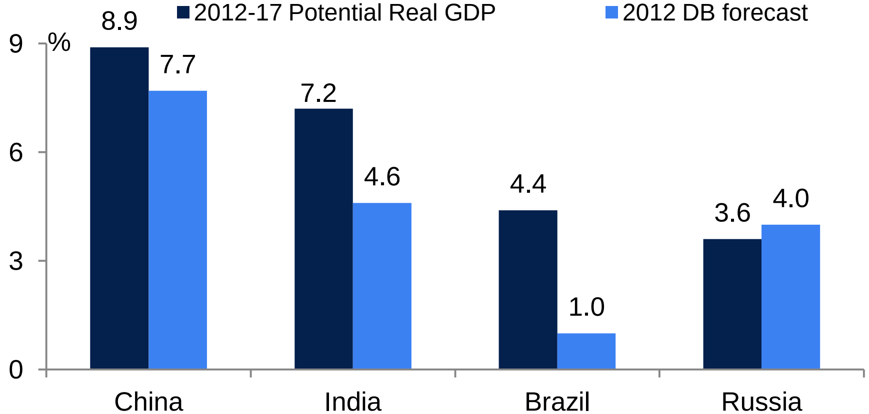
- **German elections** in autumn 2013
  - Could shift focus away from European crisis resolution to domestic issues

- **Italian elections** in Q1 2013
  - Implementation of structural reforms is essential
  - Political uncertainty / government stability -- a pre-requisite for European aid

- **Government stability** as impact of austerity and weak economy continues
- **Social unrest**, rise in anti euro / anti Europe rhetoric

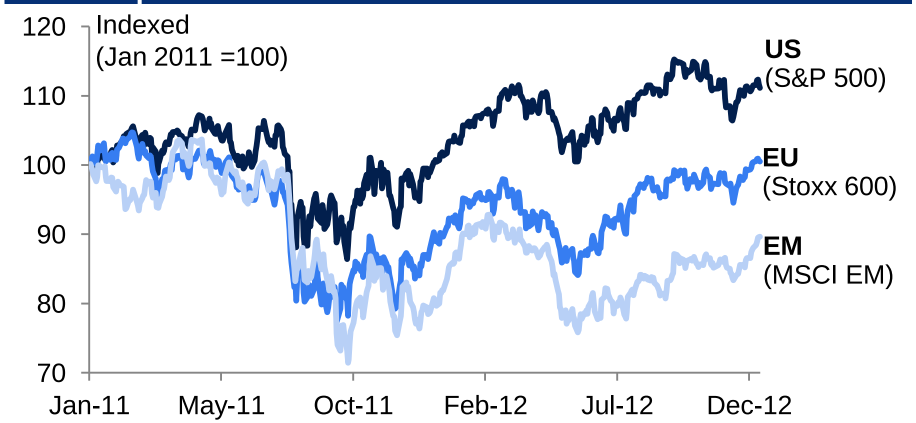
EM re-boot: can emerging economies reform to deliver balanced growth in line with their full potential?

Most BRIC countries are growing well-below their potential levels



Source: OECD, Deutsche Bank Research

Equities performance: EM equities have underperformed the US and Europe



Source: Bloomberg Finance LP, Deutsche Bank Research

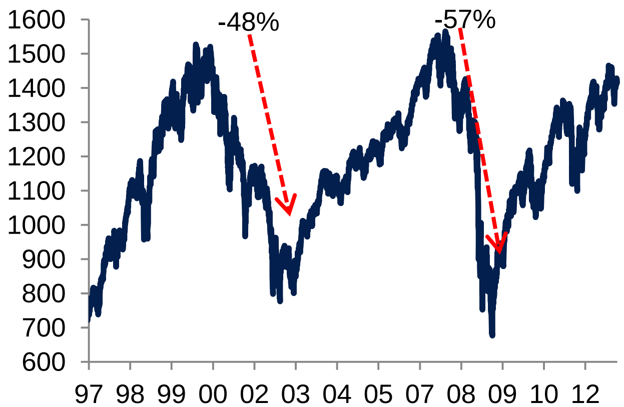
- **Major EMs are performing below potential**
  - Of the BRICs, only Russia is performing above potential output
  - India, Brazil and China, have estimated output gaps anywhere from 1% to 3%

- **Not all EMs face the same challenges**
  - In **India**, **supply-side issues** (e.g. power cuts, high regulation) are limiting growth.
  - In **China**, there is a **need to boost household consumption** and **lower investment spending**
  - In **Brazil**, **structural reforms** could boost competitiveness (Brazil ranks126/183 in the ease of doing business, according to World Bank)
  - In **Russia**, **diversification away from** an **oil & gas**-based growth model will require **structural reforms** to foster rule of law and privatisation

- **Until politically difficult reforms are enacted, EM equities will continue to under-perform**
  - Real earnings in EM equities today are 5% below 2006 and 19% below 2007 levels

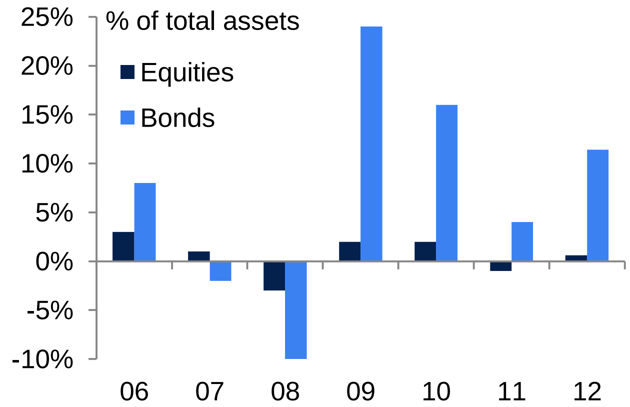
The return of Equities: investors return to equities amid a fall in risk aversion and rising confidence around global growth

US S&P 500: two of the largest market crashes ever are in recent memory



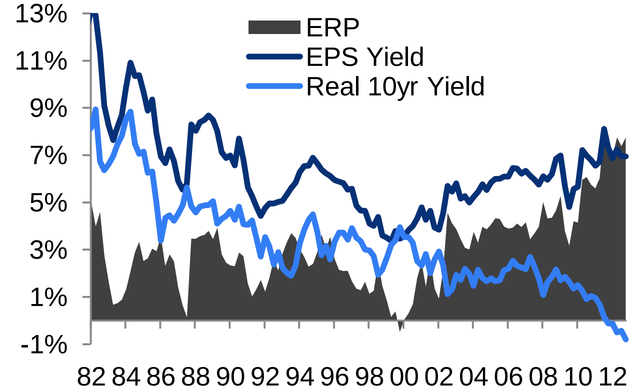
Source: Bloomberg Finance LP, Deutsche Bank Research

Global equity and bond fund flows



Source: Deutsche Bank Research

The ERP* is over 700bps: EPS yield of ~7.0% - 10yr TIPS yields are negative



Source: Bloomberg Finance LP, Deutsche Bank Research
*The ERP is the difference between the real 10 year yield and the earnings yield (EPS/P) priced in the equity market.

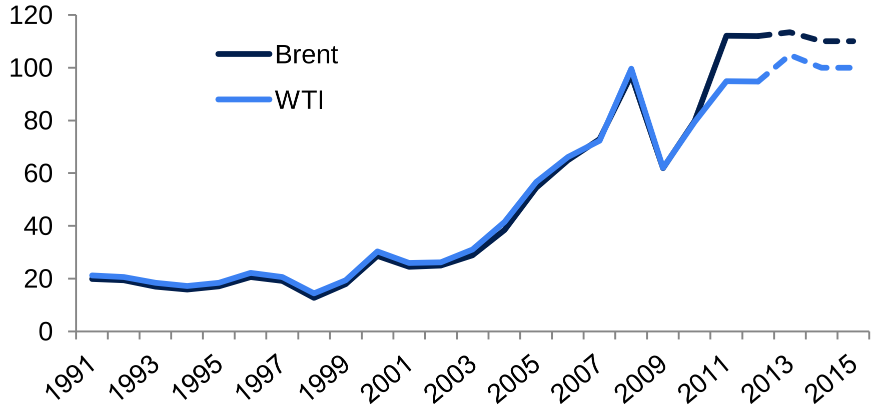
- Equity investors may be suffering from **'post-traumatic financial crisis stress disorder'**
- Two of the largest market adjustments since the Great Depression remain in recent memory
  - March 2000-July 2002 (S&P down 48%)
  - Oct 2007-Mar 2009 (S&P down 57%)

- **Since 2009, equity inflows have lagged bond inflows**
  - Bond funds have seen a cumulative 70% of inflows compared to only 3% for equities
- **Asset allocation has shifted dramatically in favour of bonds**
  - UK pension funds are holding more bonds than equities for the first time in 50 years

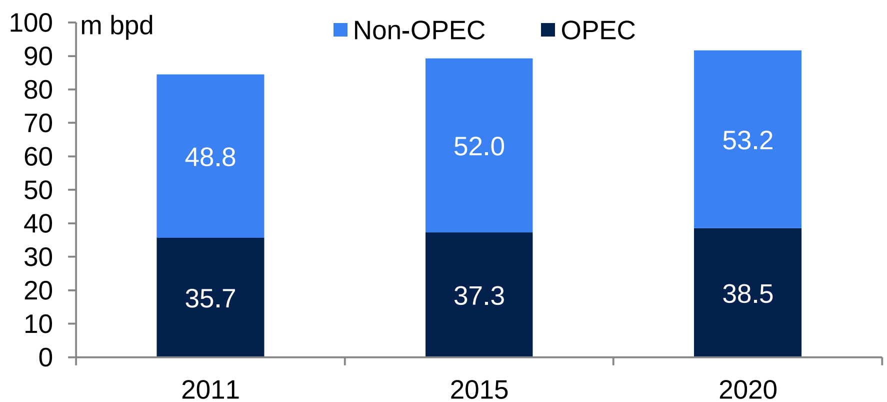
- **Equities cheap relative to bonds**
  - The **ERP** (Equity Risk Premium) is **at its highest multi-year level since the early 1980's**, a period that was followed by positive S&P gains
  - Suggests **investors continue to fear either a collapse in EPS** (sharp deflation) **or a surge in long-term real interest rates** (sharp inflation)

End of the oil super cycle: the era of rising oil prices comes to an end

Oil prices ($/bbl): the decade of rising oil prices could come to an end



Oil production (million barrels / day): non-OPEC is expected to contribute an increasing share of production

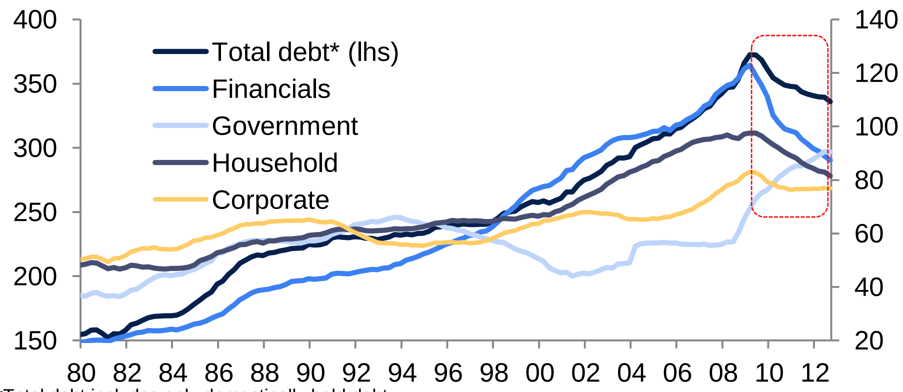


Source: IEA, Deutsche Bank Research

- **Oil prices have been rising steadily** since the end of the 1990s – with the notable exception of 2008-10
  - Trend has in 2012, with Brent oil flat for the year
- As incremental oil production increasingly comes from non-OPEC, the balance of power will start shifting
  - **Shale oil and gas to transform the US' energy position**, with the US set to overtake Saudi Arabia as the world's top oil producer by 2017
- **Shale oil / gas boom could cap oil prices** and reduce global inflationary pressure
- However a **significant fall in oil prices is unlikely**
  - Brent oil prices well below USD 100/bbl would make some production technologies uneconomic thereby cutting supply
  - Many key oil producers are reliant on high prices to finance their budgets and maintain political stability.

Yankee bulls: the US stages a stronger-than-expected recovery

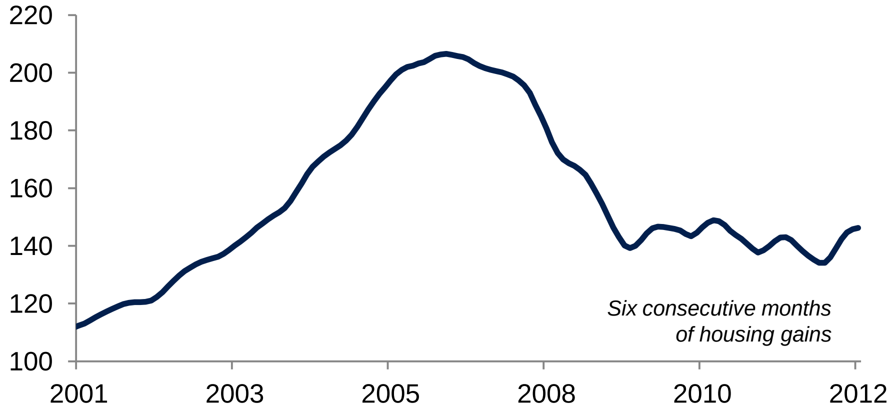
US debt (% of GDP): private sector deleveraging is well underway



*Total debt includes only domestically held debt

Source: FRB, Haver Analytics, Deutsche Bank Research

S&P Case-Shiller Home Price Index: prices are rising, and average prices are at mid-2003 levels



Source: Standard and Poor's Haver Analytics, Deutsche Bank Research

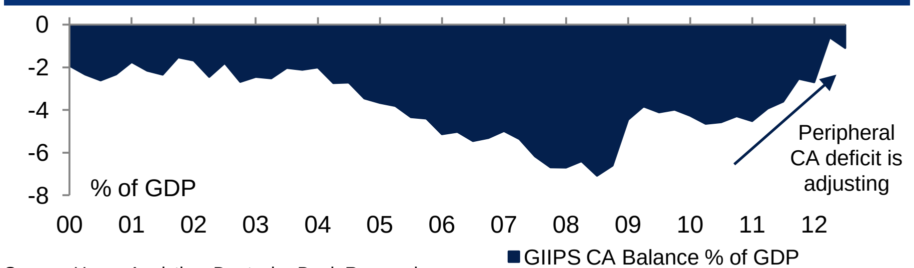
- **The US could stage a powerful recovery**
  - With banks recapitalised and an adjustment in the housing market, the economy has stabilised
  - Reduction in fiscal policy uncertainty will be supportive of growth in H2 2013
- **Deleveraging** is well underway
  - The US has been the fastest to reduce total leverage (public, financial, corporate and household)
- **Housing** sector now an upside risk
  - Housing inventories at lowest since 2002
  - Home prices have bottomed
- **Consumer spending** remains resilient
  - Household balance sheets improving thanks to deleveraging and higher house / equity prices
  - Labour market recovery supports spending
- **Manufacturing revival** driven by cheap energy costs due to shale oil and gas boom
  - US shale to give chemicals and manufacturing sectors competitive advantage

Crisis… what crisis?: the Euro-crisis takes a back seat in 2013

GIIPS 10Y government bond yields (GDP weighted): while still elevated, peripheral yields have tightened substantially

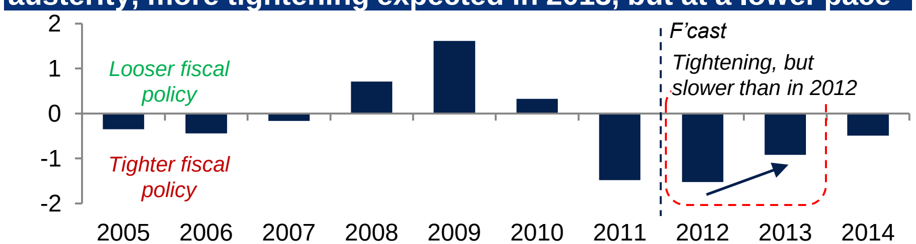
Source: Bloomberg Finanace LP, Haver Analytics Deutsche Bank Research

Current Account Balance: peripherals have reduced deficit



Source: Haver Analytics, Deutsche Bank Research

Eurozone fiscal stance* (% of GDP): 2012 may be the peak of austerity; more tightening expected in 2013, but at a lower pace



(*) Captures the discretionary tightening / easing of fiscal policy
Source: European Commission, Deutsche Bank Research

- The **euro crisis could well move out of market focus for 2013**
- **Overall context is improving**
  - Peripheral stress indicators (sovereign yields, CDS) have retreated
  - Macro adjustment underway, e.g., rebalancing of peripheral current account deficits
  - Fiscal austerity and credit contraction to continue in 2013 but at slower pace, but H2 2013 should see a return to growth
- **Region more resilient to shocks** with significant risk having transferred to the official sector
  - Greek debt held largely by official sector
  - LTRO's have enabled countries to better fund themselves domestically via their banks and ECB
- **Crisis containment to be the dominant strategy**
  - Leadership has shown commitment to preserve the euro (Greek exit avoided, OMT, LTRO)
  - German election in Autumn is set to avoid euro topics and keep lid on crisis during campaigns
- By end-2013, the state of the economy and progress at the country and institutional level will determine whether the euro-crisis regains centre stage

Appendix 1
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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.

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