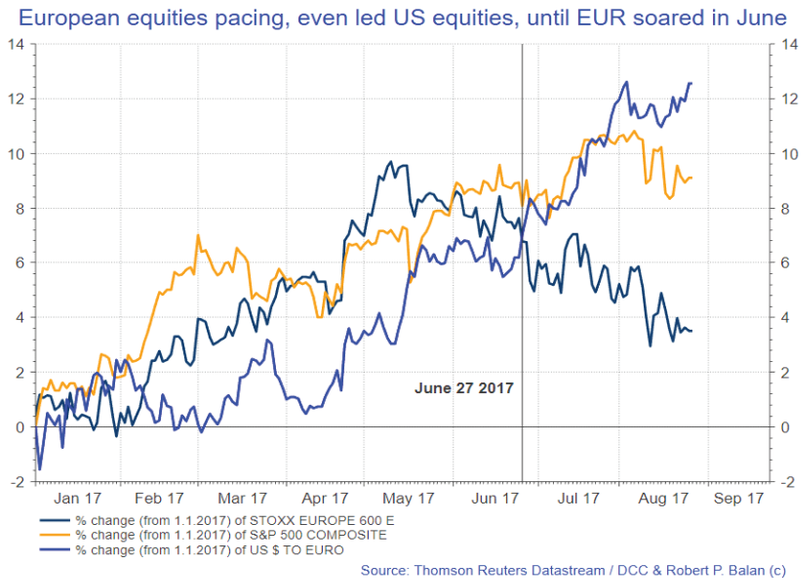
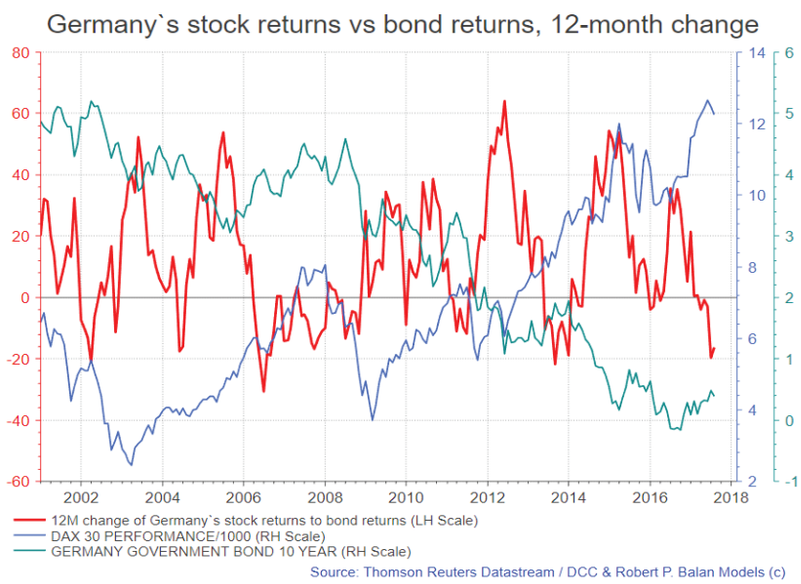
32 / EUR/USD, EU stock markets are hostages to the inflation data, as the ECB waits for further developments

Eurozone equities were competitive with, and even led US equity valuations during H1 2017, until the EUR soared in June after Mr. Mario Draghi`s uncharacteristic "Sintra" verbal gaffe, which pushed the common currency sharply higher, and EU equities started to spiral lower ***(see first graph on this page)***. The impact of the EUR will continue to be a major bugaboo for EU equities, as the ECB looks to balance its footing – given the uncertainty of the current path of inflation and growth in the common market. A recent Ifo survey showed a third monthly slide in investor confidence in Germany. The wavering in sentiment comes even as economic data shows the exporting nation is on track for its strongest growth since 2011 – German angst can be pinned largely on the rapid appreciation of the euro.





Global equity markets, ex-Europe, have been resilient over the rest of summer, but some cracks have appeared, with the MSCI World down 1.5% so far in the 3rd week of August. The global index has been led down by weakness in the US, but other major equity markets. e.g., eurozone, further contributed to the wobble. The German DAX has been more resilient, but it too succumbed to the onslaught of a resurgent EUR. Stock-to-bond ratios can provide a good perspective of what is happening. Trailing 12-month stock-to-bond returns in Germany have been rolling over since Q1 2017. In Germany, the performance of the DAX 30 is now a significant 8% decline on a three-month basis ***(see 2nd graph on this page)***. This should be amusing in light of earlier consensus expectations that eurozone equities would beat their peers, especially the US, during the entire year. A similar deterioration of stock-to-bond ratios is going on all over the developed world – which suggests further downside for equities relative to fixed income. This fits our thesis that we should see one more fall in global long-term bond yields, which should clear the deck, ahead of a future, new rate regime.

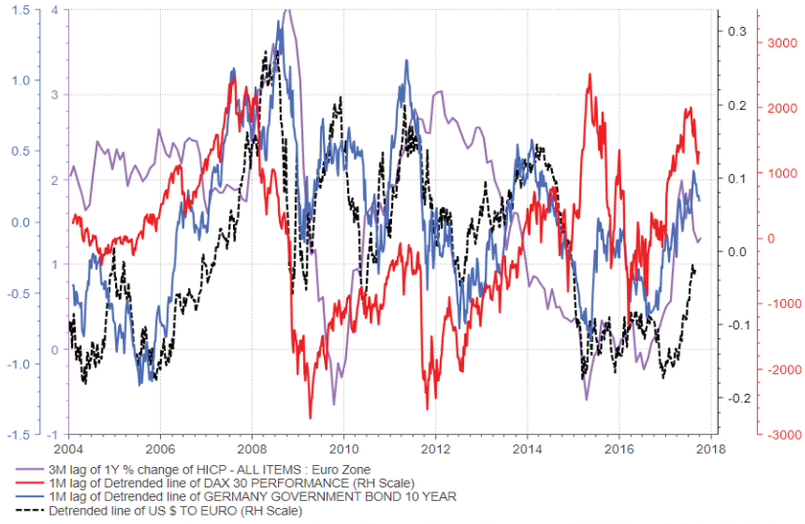
Equities and credit tend to price in the economic news ahead of the hard data. But sometimes, a lagging indicator will take the front-seat. In the case of the eurozone, that lagging, but singularly important number, is the EU-wide HICP. This piece of information is generally perceived as one of the factors that could impact the decision of the ECB whether or not to lift stimulus at some point. It has come as an irony that after the injection of massive global, systemic liquidity, rising inflation and the expected corresponding rise in bond yields, have become positive factors for equity markets. And the opposite produces the inverse effect *(see first graph on next page)*. This is not hard to fathom, as a reflationary process (typified by uptick in inflation, expected or actual, along with rise in rates) follows any decision to curtail stimulus, on the grounds that it is no longer needed, and that the danger has gone by.

A return to a low-inflation regime may therefore be devastating to the EU stock markets, in our opinion. We expect the DAX and other European equities to continue falling as consequence of a failing inflation impulse (***as can be seen in the 1st graph on this page)***. There has been a burst of extreme euphoria during the first half of the year, as inflation measures soared (proxy: the Citi Inflation Surprise Index), along with sharply higher inflation expectations. But alas, the surge peaked, and the Citi inflation index (CIS) is now deflating as fast as it expanded. **Looks like the global disinflation impulse may still have some life left in it – and now we understand why German bond returns have been outperforming Dax returns, as the CIS peaked and fell everywhere in the developed world *(see 2nd graph on this page).***

The Citi Inflation Surprise Index literally collapsed after soaring for the most of 2017. The disinflation pulse, as shown by the chart above, is by no means limited to the Eurozone, so there is a global scope to the forthcoming decline in inflationary pressure. Even as we limit our illustrations and discussion to conditions obtaining in the eurozone, the lesson has a bearing to US and Japan discussions as well.

The CIS index is also very useful in that it tends to lead changes in actual HICP inflation, and therefore the changes in the EU bond yields and the EUR currency (EUR/USD as proxy). The confluence of factors shown ***in the third graph of this page*** suggests the significant likelihood of a weaker EUR in the medium term. That would come as a relief to Mr. Draghi, who started the recent EUR rally in the first place. **The common currency remains below the middle of its 10-year range, but it has been up 12% against the dollar this year. Half of that of those gains started with Mr. Draghi's now infamous Sintra «hiccup» where what the ECB president probably thought was an insignificant comment**

With lower yields, weaker EUR, slower HICP inflation, the DAX falls

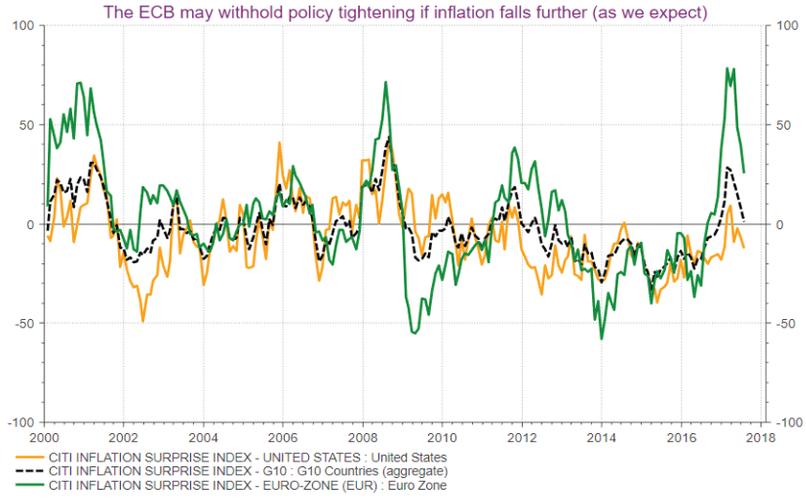


Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

CITI INFLATION SURPRISE INDEX -- EU vs US vs G10

EU inflation expectations are rapidly deflating (along with G10 and US expectations)

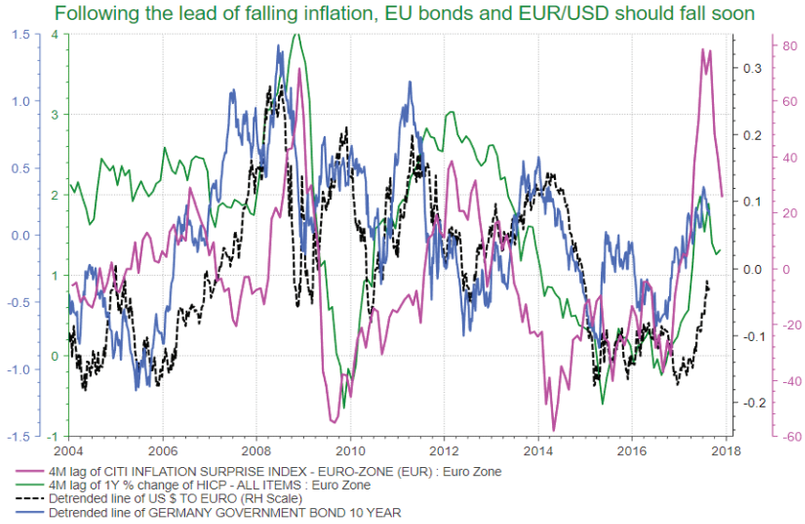
The ECB may withhold policy tightening if inflation falls further (as we expect)



Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

CIS Index tends to lead HICP inflation, bond yields and EUR by 1Q

Following the lead of falling inflation, EU bonds and EUR/USD should fall soon

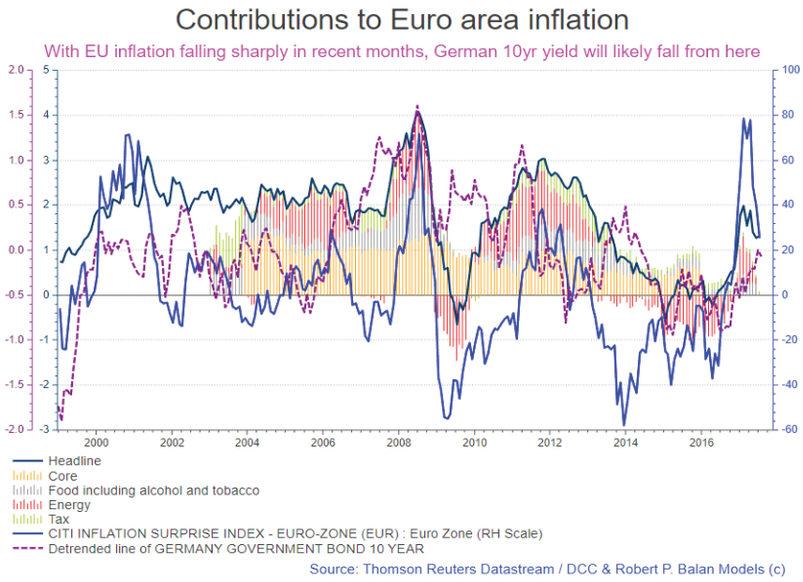


Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

about «transitory» inflation, ended up triggering a rates mini-tantrum across developed markets and a EUR surge. The currency further gained strength in July after reports indicated that Draghi would be speaking at Jackson Hole in August. The assumption -- very wrong as it turned out -- was that he would use his appearance in Wyoming to telegraph the ECB's next move.

Mr. Draghi had finally spoken at the Wyoming soiree on Friday. He spoke about openness of trade, commented that a global recovery is finally firming up, but made it clear that Europe`s recovery phase is at an earlier stage versus the US. During the Q&A session he also made clear that a significant degree of accommodation is still needed, QE has worked well, and ECB isn't there yet on inflation and must remain on guard. But it did not matter – the EUR rose more than 1% on Friday. The EUR strength also stemmed from even more indiscrete comments from US President Trump, blasting his fellow-Republicans for failure to pass his initiatives. In pushing the EUR up, we believe the market misread Mr. Draghi. A conservative but reasonable assumption, we believe the balance sheet will still expand by more than 400 bln euros by the middle of 2017. The ECB's extraordinary measures still include the minus 40 bp deposit rate. By the time, that deposit rate is no longer negative, how many times has the Fed raised its target rate? **Our read is that the ECB and Mr. Draghi are not in a hurry to tighten policy – and the Federal Reserve is.**

What provides a good backdrop which provides confidence for that belief is the fact that the elements which compose the EU HICP inflation measure have all become subdued in recent months – thus, we expect that the ECB will not tighten anytime soon. A stronger EUR is something Mr. Draghi instinctively does not want, a feeling that is shared by many in the ECB board (with the possible exception of the board member from Germany, Ms. Sabine Lautenschläger). The confluence of factors outlined above will also serve to push down the value of the common currency in the near-term.



However, the EUR will fight a rear-guard action, and no sharp de-rating is expected soon, as manufacturing continues to perform well. In Europe, the weakness in services in July was offset by the strength of manufacturing, leaving the over-all composite virtually unchanged at 55.8 (vs. 55.7). Manufacturing PMI rose to 57.4 from 56.6, matching the cyclical high seen in June. The service reading, which covers a larger part of the economy, slipped to 54.9 from 55.4. The index peaked in April at 56.4. Some key takeaways from the eurozone PMI: (1) the economy continues to operate at a strong level, but the momentum has moderated; (2) price components suggest that the decline in inflation since February may be moderating, as well and we cannot rule out a small bounce from here; (3) the euro's appreciation has so far not undermined export orders, where the sub-index rose to its best level in six years. We are sure that Mr. Mario Draghi and company would like to keep it that way.

Other activity and sentiment measures have deteriorated: morale among German investors deteriorated for a third consecutive month in August, according to survey data released earlier in the week. The ZEW research institute said its monthly survey showed its economic sentiment index fell to 10.0 from 17.5 points in the previous month. Economists had forecast a reading of 15. The economic sentiment indicator for the eurozone fell to 29.3 points this month from 35.6 in July. However, the indicator for the current economic situation in the eurozone climbed to its highest level since January 2008, rising to 38.4 points. Since November 2016, the indicator for the economic situation in the eurozone has been steadily increasing.

Most market participants believe that an adjustment in the European Central Bank's (ECB's) monetary-policy settings looks likely to be made soon. The argument was that it would be surprising if the central bank continued on its current highly accommodative course for much longer, considering the recent stronger-than-expected recovery in the eurozone economy. **But the ECB may opt to wait just a little longer, waiting for further development in the inflation front. That would tend to weaken the EUR, during a period which is considered a period for the US Dollar to "correct" some of its recent large losses. Moreover, a stronger EUR depresses import prices when inflation is still low, looping back to lower inflation even further, increasing the risk that the EUR rally brings about its own reversal.**