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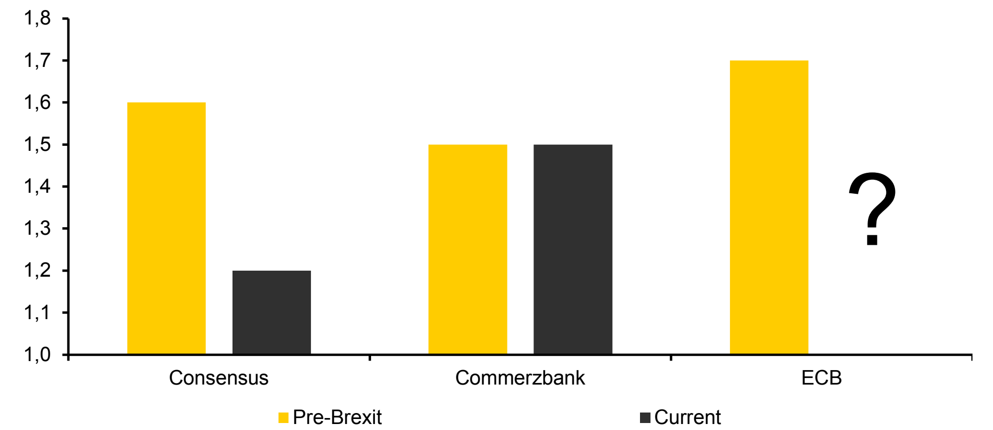
Week in Focus

2 September 2016

ECB Council meeting: Dr Draghi to extend the therapy

Eleven weeks after the Brexit referendum, the ECB should by now have gathered enough information for a reassessment of the situation. It may well lower its projections for growth and core inflation somewhat. In this case, it is also quite possible that the council will decide next week to extend its bond buying programme beyond March 2017. It would then presumably also ease the current restriction which requires it to buy only those bonds with yields above the deposit rate. **Page 2**

How sharply will the ECB cut projections because of Brexit?
2017 growth forecasts, in per cent



Source: Consensus Forecast, ECB, Commerzbank Research

The **Week in Focus** in 100 seconds
Please follow this link for video summary.

Fed: When hawks cackle …

Fed leaders have recently demonstrated that they stand united and key policymakers are trying to keep the option of a rate hike open for September. However, data will remain decisive and today's employment report should play an important role, but we maintain that December is the most likely time for the next rate hike. **Page 5**

Outlook for the week of 5 September to 9 September 2016

Economic data: German manufacturing is likely to have started the third quarter with a decline in output, and orders in July are unlikely to signal any improvement on the horizon. In the USA, the non-manufacturing PMI probably dipped in August but should continue to signal solid growth in the service sector. **Page 8**

Bond market: Unless there is a big positive surprise in today's US payrolls, 10y Bund yields will likely keep trading in a tight -0.1%-0% band, although next week's ECB QE update may test the upper yield boundary. **Page 11**

FX market: The US employment report is the key event for FX markets in the days ahead. But given market scepticism regarding the Fed's medium-term strategy, the dollar is unlikely to react much, even if the report surprises to the upside. **Page 12**

Equity market: German companies continue to feel the pinch from weaker global growth. In order to maintain or further raise their earnings margins, they can be expected to continue with additional restructuring and to consider take-overs and joint ventures. Investors are advised to overweight companies with stronger earnings momentum. **Page 13**

Commodity market: Oil prices should retreat a little next week as fresh forecasts by the US Energy Information Administration are likely to fuel concern about renewed market oversupply, although downside is likely to be limited by the upcoming meeting of oil producers at the end of the month. **Page 14**

Chief economist:
Dr Jörg Krämer
+49 69 136 23650
joerg.kraemer@commerzbank.com

Editor:
Peter Dixon
+44 20 7475 4806
peter.dixon@commerzbank.com

For important disclosure information please see pages 17 and 18.

Dr Michael Schubert
Tel. +49 69 136 23700

ECB Council meeting: Dr Draghi to extend the therapy

Eleven weeks after the Brexit referendum, the ECB should by now have gathered enough information for a reassessment of the situation. It may well lower its projections for growth and core inflation somewhat. In this case, it is also quite possible that the council will decide next week to extend its bond buying programme beyond March 2017. It would then presumably also ease the current restriction which requires it to buy only those bonds with yields above the deposit rate.

How sharply will the ECB cut projections due to Brexit?

At the last meeting in July, ECB president Draghi said that it was still too early to estimate the impact of Brexit on euro monetary policy: "…when we have more information, including new staff projections, we will be in a better position to reassess the underlying macroeconomic conditions, the most likely paths of inflation and growth". Draghi left no doubt that the ECB council would act if need be.

Eleven weeks after the Brexit referendum, the ECB should now feel confident enough to make a judgement and consider Brexit in its projections. But how sharply will it cut its projections as a result? In the past, ECB growth projections have not differed much from the consensus forecast. But the consensus for 2017 has dropped significantly, from 1.6% to 1.2% since the Brexit vote (and the publication of the last ECB projection), meaning it is now half a percentage point below the current ECB projection of 1.7%.[1] A fifth of survey participants now predict a growth rate of 1% or lower. If the ECB lowers its projections on a similar scale, it would very likely follow its words with action, and further loosen monetary policy.

That said, most projections were lowered directly after the Brexit vote when many feared a global uncertainty shock. These fears have largely dissipated in the meantime, suggesting that the ECB will reduce its growth projection for the coming year only moderately from 1.7% to 1.5% (see table 1). What's more, the second quarter looks likely to have exceeded the ECB's expectations. With such a small correction to expectations, the ECB is likely to decide against major steps, such as another cut in the deposit rate – including the introduction of allowances – or even against any extension of monthly purchase volumes.

Concerns about inflation and expectations …

This does not mean that the ECB council will not at least discuss further measures on Thursday. The accounts of the last meeting showed again that the ECB is somewhat concerned that there is no sign yet of an upward trend in the core inflation rate, which the central bank had hoped for. And the latest figure for the core rate published on Wednesday, which showed a figure of just 0.8% in August – which will not be included in the new projections – is unlikely to have reduced the worry lines of council members.

The persistently low level of market-based inflation expectations is another cause for concern according to the ECB accounts. The five-year inflation expectation five years ahead was lately at 1.3%, which is 0.2 percentage points lower than at the beginning of 2015, when the ECB announced its large-scale bond buying programme (chart 1, page 3). While this could also be a consequence of ECB bond purchases (see box, page 3), it is still quite open at present whether such considerations will play any role at all in the in-depth discussion on inflation expectations, announced in the July minutes, at the meeting on Thursday.

TABLE 1: **ECB set to revise projections downwards slightly**
Commerzbank forecasts for September projections of ECB experts, June projections of Eurosystem experts in brackets

	2016	2017	2018
Growth	1.6 (1.6)	1.5 (1.7)	1.7 (1.7)
Inflation	0.2 (0.2)	1.3 (1.3)	1.6 (1.6)
Core rate	0.9 (1.0)	1.1 (1.2)	1.5 (1.6)

Source: ECB, Commerzbank Research

[1] Consensus Economics, August 2016 survey.

Box: Low inflation expectations despite or because of QE?

At the press conference in July, ECB president Draghi explained very low inflation expectations by "technical factors": After the Brexit referendum, nominal bonds were in high demand and their yields hence fell more sharply than the yields of inflation-linked bonds. Consequently, inflation expectations calculated on the basis of these yields also dropped.

However, expectations have already been much lower since the spring – i.e. before the Brexit vote – than would have been expected based on the previous close correlation with our index for global risk perception or US inflation expectation (charts 1 and 2). In the spring, the ECB increased its bond buying programme and has been purchasing more in the long-term segment ever since (chart 3, page 4). This correlation suggests that ECB bond purchases in particular have pushed down longer-term inflation expectations over time. This would also explain why the downward pressure on expectations continues today although the fears of an uncertainty shock due to Brexit have largely vanished.

Should ECB bond purchases indeed be responsible for low long-term inflation expectations and the ECB partly loosens the extent to which purchases are tied to the deposit facility rate, as we expect, the yield curve would likely steepen somewhat again and inflation expectations derived from yields would rise again.

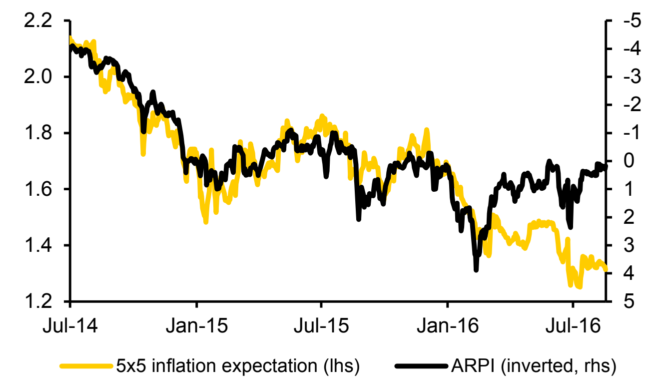
… argue for extension of QE

Given the unfavourable development of the core rate and inflation expectations, the ECB is unlikely to end its bond purchases in March 2017. Experience from the US suggests that the markets would interpret any announcement by the ECB to reduce its monthly purchases as a signal of monetary policy tightening, which the ECB probably wants to avoid.

But will the ECB announce the extension as soon as next Thursday? ECB vice president Constancio declared some weeks ago that the council would announce its decision no later than the last meeting of the year on 8 December in order to reduce market uncertainty about whether it will make purchases beyond March 2017. As the ECB normally couples its more important decisions, which would include the official extension of QE, with the publication of new projections, next week's meeting and the one in December are possible dates for such an announcement.

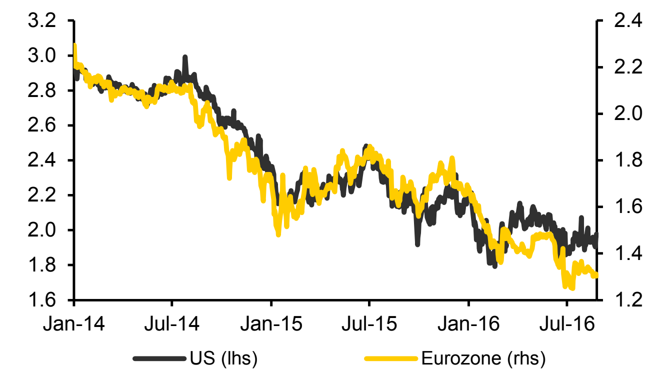
The decisive factor in choosing between these two dates is likely to be whether the ECB still believes that the core rate will start to pick up. If this is the case, the decision on an extension of QE could be deferred for a few months. In our view, it is more likely that even the moderate downward revision of the projections that we anticipate, together with the current trend in the core rate and inflation expectations should be enough for the ECB to realise that their targets will be achieved later than thought. We therefore expect an extension of QE at the meeting next Thursday.

CHART 1: **Inflation expectations decouple from ARPI² …**
Five-year inflation-linked forward swap rate five years ahead in the euro zone, global risk perception (ARPI²)



Source: Bloomberg, Commerzbank Research

CHART 2: **… and from US inflation expectations**
Five-year inflation-linked forward swap rate five years ahead, USA and euro zone



Source: Bloomberg, Commerzbank Research

Will the ECB buy bonds with yields below the deposit rate?

However, as Bunds in particular risk becoming more scarce in this case, the central bank will probably adjust the technical parameters of its programme at the same time. The ECB is unlikely to buy fewer Bunds and more bonds of other member states or lift the issue-based ceiling of 33%, as it otherwise risks being accused of monetary state financing. Even ECB executive board members have stressed on a few occasions that these limits were necessary to ensure that the ECB is acting within its mandate and is observing legal boundaries.[2]

It is more likely that the ECB will also buy government bonds whose yields are below the deposit rate in future, as suggested by the fact that there is currently a shortage of German bonds, mainly because bonds with a maturity of up to seven years are yielding less than the deposit rate.

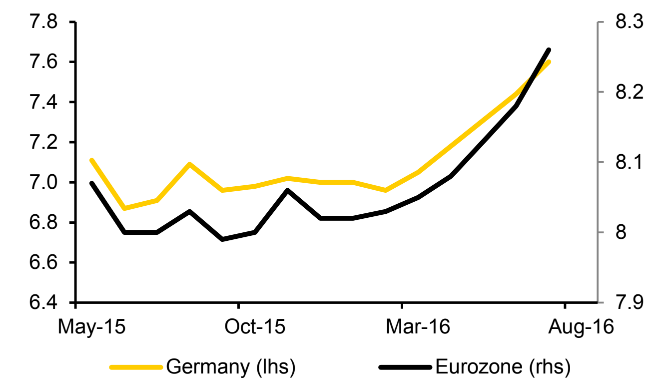
Even so, the ECB is unlikely to get rid of the deposit rate tie completely, as this has helped to make the yield curve even flatter this year because purchases have focused on longer maturities. The ECB welcomes this and will not wish the curve to become much steeper by abolishing the tie. It could therefore stipulate, for example, that the *average* yield of purchases by each national central bank over the month must be above the deposit facility rate. The Bundesbank, for example, could then buy some, but not too many, short-term German bonds. Loosening the tie in this way would presumably allow the yields of ten-year Bunds to rise only moderately while the extension of QE – widely expected on the market – would have practically no effect on Bund yields.

It also seems possible that the ECB could raise the issue limit for government bond purchases from currently 33% to 50% for example. This appears less problematic from a legal perspective as long as it only applies to bonds without collective action clauses (CACs).[3] However, our calculations indicate that this would relieve the shortage of bonds only to a small degree – unlike removing the tie to the deposit rate (chart 4).[4]

Depo rate cut and allowances in December

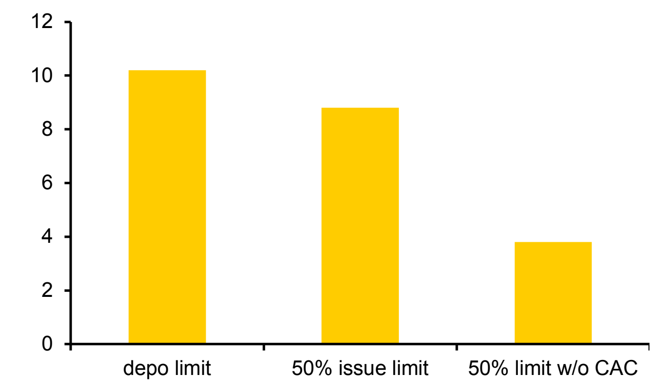
The extension of QE, which we expect to be decided on Thursday, will probably be followed by a further depo rate cut in December. After all, core inflation and inflation expectations are set to disappoint further in the months to come. The doves on the ECB council who want to help highly-indebted countries by loose monetary policy will thus possibly find a majority for another rate cut and the introduction of allowances.

CHART 3: **ECB buying more at the long end recently**
Weighted average remaining maturity of government bond purchases in years



Source: ECB, Commerzbank Research

CHART 4: **Abandoning deposit facility rate tie is much more effective**
Estimated additional time scale for German public-sector bond purchases in months if the deposit rate ties are removed or the issue limit is raised from 33% to 50%



Source: ECB, Bloomberg, Commerzbank Research

[2] "Brexit: the ECB's weapons", *Economic Insight,* 8 July 2016.
[3] The ECB wants to avoid the case in which it can achieve a blocking minority under the terms of contractual collective action clauses in the event of restructurings as it does not want to get into a situation where it has to reject restructuring due to the prohibition of monetary state financing.
[4] See "Changing the rules, or the game!", *Ahead of the Curve,* 7 July 2016.

Bernd Weidensteiner
Tel. +49 69 136 24527

Fed: When hawks cackle …

Both at the Jackson Hole symposium and thereafter, the Fed's leaders demonstrated that they stand united. The key policymakers are trying to keep open the option of a rate hike at the next meeting. The relevance of the data to monetary policy was again emphasised, and today's employment report in particular should play an important role. However, we still believe December is the more likely meeting for the next rate hike by the Fed.

Federal Reserve Board Chairwoman Janet Yellen set the tone in her Jackson Hole speech a week ago: In light of the solid trends in the labour market, the case for a rate hike has become stronger in recent months, she said. But she also pointed out that the Fed's decision depends on whether incoming data confirm the FOMC's view.

Her Vice Chairman Stanley Fischer was less ambiguous. Against the backdrop of the "very strong" employment reports of recent months, he was optimistic regarding the economy. He explicitly said that the August employment report, which is due out today, would influence the next interest rate decision. At the same time, he put the relevance of the current slow pace of GDP growth for Fed policy into perspective, pointing out that it is mainly attributable to weak productivity growth, which is difficult to control through monetary policy. Fischer also tried to dispel the impression that there are considerable differences of opinion at the top of the Fed – between Yellen, (New York Fed President) Dudley and Fischer himself. But this affirmation may be met with scepticism on the part of many watchers, because Fischer was positioned very strongly among the hawks of late and had given no reliable guidance regarding the Fed's course.

Atlanta Fed President Dennis Lockhart warned of attaching too much importance to the weak growth data for Q2. Lockhart showed himself open to a "serious discussion" about a rate hike at the meeting on 20/21 September, although he is not yet sure whether he would support such a move. Asked why, against the backdrop of the various risks, the Fed should not wait with another rate hike until it has actually reached its inflation target, he gave what he called a "classic answer": An appropriate monetary policy should act with a lead time of around one year – this was an obvious reference to the long and variable lags with which central bank measures take effect. These delays used to be an integral part of monetary policy analysis in the past but rather seem to have been forgotten recently. Observers with a longer memory can therefore take comfort in the fact that at least the Fed bears them in mind. Lockhart therefore does not believe that the Fed must reach its targets before "recalibrating" key rates at a higher level.

Boston Fed President Eric Rosengren pointed to the costs of very low interest rates over a long period. He is concerned about possible overheating in the commercial property market (the mortgage loans outstanding in this sector amount to around 3.6 trillion dollars, around one third of the mortgage loans for residential properties). The hunt for yield – which exposes investors to higher risk – was a danger in a low-rate environment, he said.

Once again, the hawks are dominating the debate. But this does not mean that a move in September is a foregone conclusion. Amongst FOMC members, there are roughly equal numbers of doves and hawks which want to win over those in the "centre" and Yellen and Dudley both stand in the centre. A strong August employment report could tip the scales towards the hawks. But we are sceptical whether the data will really allay all doubts. Indeed, payroll gains are likely to turn out noticeably lower than in June and July and, due to a negative calendar effect, wages are likely to rise less than broadly expected. The surprisingly weak outturn of the ISM index for manufacturing which was released yesterday also argues for waiting a little bit longer. The ISM dropped to 49.4 in August, the first sub-50 print in six months.

The Fed's communication campaign may therefore keep September alive as an option. But given the cautiousness the Fed has shown in recent months, and due to the fact that the hawks are louder but do not necessarily reflect the majority view of the FOMC, we still think the Fed is more likely to remain on hold until December.

Major publications from 26 August – 1 September 2016

Economic and Market Monitor: August/September 2016

In China investment shows an alarming picture. As state-owned enterprises are increasingly unable to finance investment out of retained earnings, they are raising increasing amounts of debt. China faces economically difficult years, even though the statistics authorities have reported surprisingly stable growth for the first half of the year.

In the US, economic growth in Q2 disappointed again at 1.1%. But there is still a good chance of stronger growth in the second half of the year. The intact economic upswing and approach of full employment suggest that the Federal Reserve will raise rates towards the end of the year.

In the euro zone, the economy followed up on the good start to 2016 with a fairly solid quarter-on-quarter growth rate of 0.4% in the second quarter. But core inflation (inflation excluding energy and food) still remains below 1% and is unlikely to rise as the ECB hopes. We expect the ECB to ease monetary policy again.

The DAX will likely pause for breath after the steep climb of recent weeks. Yields of ten-year Bunds should return to positive territory by the end of the year – mainly because the ECB will probably start to buy short-dated bonds even if their yield is lower than the deposit rate. The EUR-USD exchange rate will trend towards weakness in the coming months, and the days of large movements compared to 2014 are over for now. more

EM Briefing: India – Corporate bond reforms to circumvent clogged banks

RBI announced a series of measures to deepen the corporate bond and FX markets. This is to provide alternative sources of corporate financing, reduce reliance on a dysfunctional banking sector laden with bad loans, and improve the transmission of lower policy rates to the economy. The measures do not necessarily imply lower RBI rates anytime soon. Instead, the inflation profile will remain the key factor. For USDINR, we see RBI favouring stability rather than any particular rate. more

EM Briefing: China – Will the PBoC defend 6.70 again?

The odds of a Fed rate hike have risen after Yellen's speech in Jackson Hole. As one of the worst performers in Asia, CNY is again coming under pressure to weaken. However, we believe that the central bank will intervene to safeguard USD-CNY at 6.70, as it did in July. more

Commodity Spotlight Base Metals: Iron ore – excessive supply, overly expensive

Iron ore currently costs approximately $60 per tonne, a price level that is not justified in our opinion. After all, supply on the seaborne market is being further expanded, yet demand could decline in future. We therefore expect prices to fall and confirm our forecast of $49 per tonne by year-end. more

Commodity Spotlight Energy: Too much heat on the coal market

Prices on the global coal market have rallied very rapidly, due to a huge drop in coal output in China, by far the largest producer. The downturn meant a sharp rise in demand for imported coal. There is a risk, though, of Chinese supplies increasing again once government restrictions are relaxed, while at the same time domestic demand will steadily weaken. We therefore see the price rally as somewhat overdone, and expect prices to retreat once more, with the corresponding adverse effect on German electricity traded on the European Energy Exchange. more

FX Insight: ARPI² update – slightly lower uncertainty

Compared to last Wednesday, the ARPI² fell 0.1 index points. This was in particular due to lower commodity risks. A few days ago, the Iranian oil minister Zanganeh announced that he plans to attend the meeting of oil producers at the end of September in Algiers. Iran's absence at the Doha meeting in April had played a major role in the failure of the talks to reach agreement on a production cap. more

Preview – The week of 5 to 9 September 2016

Time	Region	Indicator	Period		Forecast	Survey	Last
Monday, 5 September 2016							
9:00	EUR	PMI services, final	Aug	sa	53.1	–	53.1 (p)
9:30	GBR	PMI services	Aug	sa	52.0	–	47.4
Tuesday, 6 September 2016							
5:30	AUS	Interest rate decision of the RBA		%	1.50	1.50	1.50
7:00	GER	Industrial orders	Jul	mom, sa	0.0	–	-0.4
				yoy	-0.8	–	-3.1
10:00	EUR	GDP, real (details)	Q2	qoq, sa	0.3	–	0.3 (p)
15:00	USA	ISM index (non-manufacturing)	Aug	sa	54.8	55.4	55.5
Wednesday, 7 September 2016							
• 7:00	GER	Industrial production	Jul	mom, sa	-1.0	–	0.8
				yoy	-1.0	–	0.5
8:30	SWE	Interest rate decision of the Riksbank		%	-0.50	–	-0.50
9:30	GBR	Industrial production	Jul	mom, sa	-0.2	–	0.1
15:00	CAN	Interest rate decision of the BoC		%	0.50	0.50	0.50
Thursday, 8 September 2016							
0:50	JPN	GDP, 2nd estimate	Q2	qoq	0.0	0.1	0.0 (p)
12:45	EUR	Interest rate decision of the ECB		%			
		Repo rate			0.00	–	0.00
		Depo rate			-0.40	–	-0.40
13:30	USA	Initial claims	Sep 3	k, sa	261	–	263
Friday, 9 September 2016							
2:30	CHN	CPI	Aug	yoy	1.7	1.7	1.8
7:00	GER	Exports	Jul	mom, sa	0.5	–	0.2
7:45	FRA	Industrial production	Jul	mom, sa	0.5	–	-0.8

*Source: Bloomberg. Commerzbank Economic Research; *Time BST (subtract 5 hours for EDST, add 1 hour for CEST). # = Possible release; mom/qoq/yoy: change to previous period in percent. AR = annual rate. sa = seasonal adjusted. wda = working days adjusted; • = data of highest importance for markets..*

Dr Ralph Solveen
Tel. +49 69 136 22322

Economic data preview:
Germany: Industry is holding back the economy

German manufacturing is likely to have started the third quarter with a decline in production. Although this is partly due to seasonal factors, the tendency in production is pointing downwards. What's more, orders in July are unlikely to signal a change for the better as only a substantial gain in always-volatile aircraft orders should have prevented a decline in order books. In the USA, the purchasing managers' index for the non-manufacturing sectors probably dipped in August but should continue to signal solid growth in the service sector.

German economic growth topped expectations in the second quarter, at 0.4% versus the previous quarter. This was not due to the industrial sector, where gross value added dropped slightly after a good start to the year, but solely to services, which picked up sharply, as in the previous quarter (see chart 5).

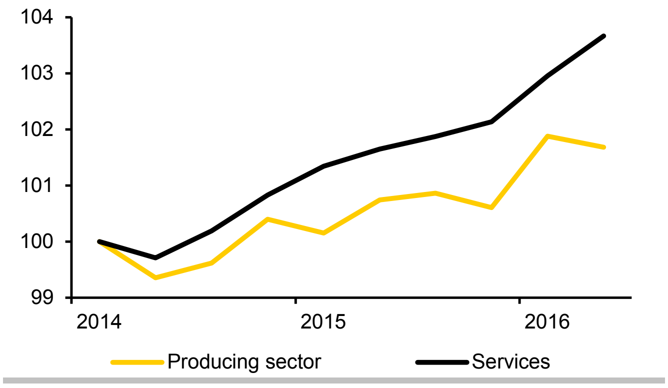
The July figures for manufacturing, due for publication in the coming week, should show that in this balance of forces remains unchanged for the time being; car production tumbled again in July according to the figures available from the German Automotive Industry Association (VDA) (and our seasonal adjustment) after the increase in the previous month. We consequently also expect a 1% loss in overall industrial production. This is partly still the result of the late timing of the Easter holidays, resulting in fewer holidays in June than on average in past years which boosted output in June. In July on the other hand, there were actually a few more holidays than usual across the (weighted) average of German federal states.

However, even without this short-term effect, the current trend for manufacturing is still downwards rather than upwards (chart 6). Our calculated trend based on order intake for industrial production took a downward turn in the spring, and the July order figures are unlikely to have made much difference. While we still expect stagnation at the July level, this should be due solely to a sharp rise in always-volatile aircraft orders, which likely profited from the Farnborough Airshow – a major trade event. Without this impact, orders likely fell.

USA: Non-manufacturing ISM no longer quite as strong

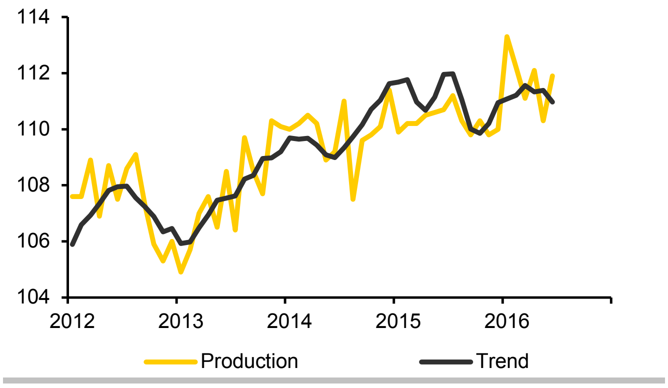
The US economy has been driven mainly by the service sector recently. Little should change in the third quarter, even if the respective ISM index for the non-manufacturing sectors is likely to have dropped from 55.5 to 54.8 in August (consensus 55.4), as suggested by the slight deterioration of the regional survey results. That said, this would still put the index at a solid level in the middle of the range year-to-date (52.9 to 56.5).

CHART 5: **Germany – production sector lagging behind**
Real gross value added, Index 2014Q1=100



Source: Global Insight, Commerzbank Research

CHART 6: **Germany – manufacturing turning downwards**
Manufacturing, Index 2010=100 and trend calculated on basis of order intake in past months



Source: Global Insight, Commerzbank Research

Central Bank Watch (1)

Fed

The discussion about the timing of the next rate hike currently dominates – in essence, it is all about the answer to the question "September or December?". But the longer-term outlook is more important. Chicago Fed President Charles Evans explained in a speech why we should expect key rates to remain low long-term. His most important argument is that for the time being the economy will probably grow only at a slow pace, which he attributes to demographic influences and low productivity growth. When economic growth is lower, the equilibrium real interest rate is also lower than in the past. Moreover, market interest rates are depressed by high demand for safe assets. Evans combines the arguments of "secular stagnation" with the thesis of a "savings glut". The result of his considerations is that the equilibrium key rate is also much lower than in the past. Therefore, the current stance of US monetary policy is less expansionary than classic rules (he obviously alluded to the Taylor rule) suggest. The risk of overshooting the 2% inflation target is therefore lower, and the risk of failing to reach it is higher. Whilst this does not preclude somewhat higher key rates, Evans clearly belongs to the camp of those who want to proceed with the utmost caution and favours remaining on hold in case of doubt.

Bernd Weidensteiner
+49 69 136 24527

CHART 7: **Expected interest rate for 3-month funds (USD)**

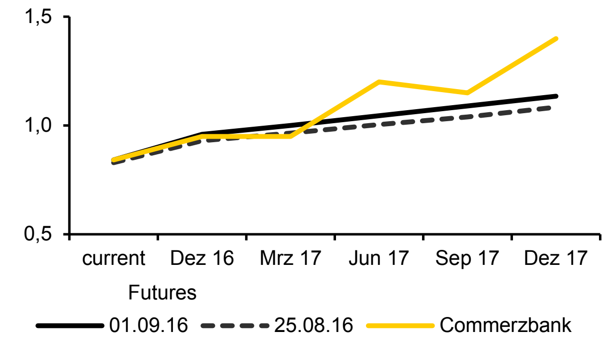


TABLE 2: **Consensus forecasts Fed funds rate (higher bound)**

	Q4 16	Q2 17	Q4 17
Consensus	0.75	1.00	1.25
High	1.00	2.00	2.25
Low	0.25	0.25	0.25
Commerzbank	0.75	1.00	1.25

Source: Bloomberg, Commerzbank Research

ECB

Comments by ECB's Villeroy suggest that at least without a simultaneous introduction of allowances, another rate cut is rather unlikely. "Negative interest rates are useful, but are just one tool among many others and have their limits," he asserted. "Bank profitability is a very hot issue," he said, before recalling that ECB president Draghi at his last press conference underlined the importance of ensuring that banks can continue to pass on the ECB's easy policies. Villeroy said that ECB policymakers are "carefully choosing" the appropriate tools.

Since the crisis began, governments have undertaken "a series of half-baked and half-hearted structural reforms ... That does not help supporting inflation expectations" ECB Executive Board member Coeuré complained. He warned the effect of monetary stimulus in such an environment could be weakened and come with increasing side-effects.

ECB president Draghi confirmed that possible purchases of Greek bonds under the ECB's purchase programme "would be examined at a later stage, taking into account the progress made in the analysis and reinforcement of Greece's debt sustainability". A precise timeline for the possible purchase of Greek bonds "cannot be specified at the current juncture", according to Draghi.

Dr Michael Schubert
+49 69 136 23700

CHART 8: **Expected interest rate for 3-month funds (EUR)**

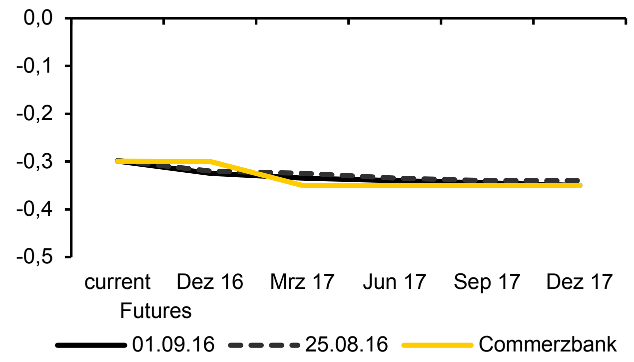


TABLE 3: **Consensus forecasts ECB minimum bid rate**

	Q4 16	Q2 17	Q4 17
Consensus	0.00	0.00	0.00
High	0.00	0.00	0.00
Low	-0.10	-0.25	-0.25
Commerzbank	0.00	0.00	0.00

Source: Reuters, Bloomberg, Commerzbank Research

Central Bank Watch (2)

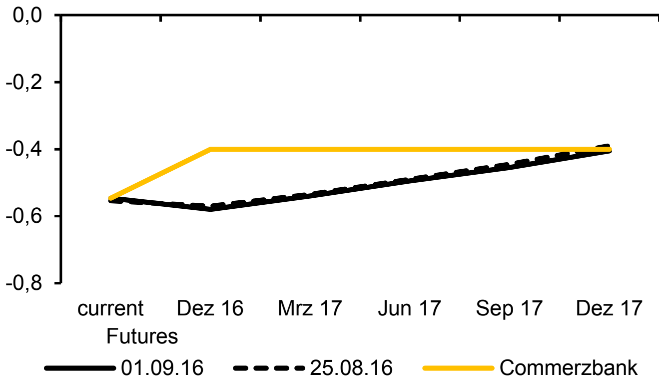
Riksbank (Sweden)

The Riksbank is set to leave its key interest rate unchanged at -0.5% next week. Its statements on asset purchases and its future interest rate policy will be more interesting. In July, the Riksbank sat tight but in view of rising – but still too low – inflation signalled that it is still ready to take further measures should the inflation outlook be at risk. It has lowered its growth and inflation projections slightly for 2017 and 2018 and also its interest rate path. It also extended its mandate for intervention on the currency market from January and decided to continue bond purchases up to the end of 2016.

Although the inflation rate has picked up in recent months, it has been very volatile. At the same time, the ECB is likely to signal next week that it will extend its asset purchases beyond March 2017. This entails a risk that the Riksbank will increase its asset purchases by a small amount next week as a preventative measure against the krona appreciating. If the krona is too strong, it will be more difficult to achieve the inflation target. The discussion about the inflation target could be very significant this time as hints by central bank chief Stefan Ingves have led to increasing speculation that the Riksbank could introduce a target range around its inflation target of 2%. This would signal to the market that the central bank is indeed ultimately planning to make its monetary policy less expansionary.

Antje Praefcke
+49 69 136 43834

CHART 9: **Expected interest rate for 3-month funds (SEK)**



Source: Bloomberg, Commerzbank Research

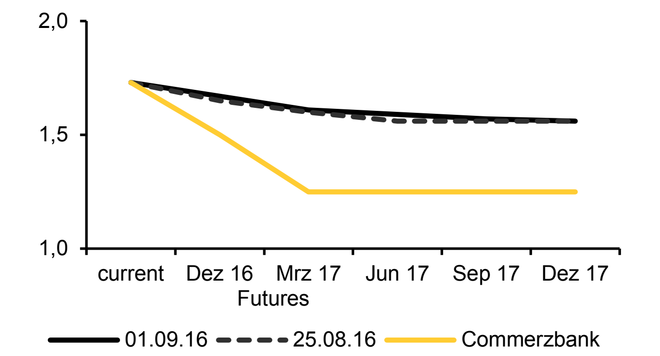
RBA (Australia)

In August, the Australian central bank (RBA) lowered its key interest rate by 25 basis points in a surprise move which was aimed primarily at reigning in the AUD appreciation in place since spring. After all, economic performance had been fairly favourable recently. While the low level of commodity prices continues to weigh on investment in the important mining sector, the outlook has brightened on the back of the latest recovery on commodity markets. Moreover, the labour market keeps recovering. It is only inflation that is too low by the RBA's standards. The trimmed mean, its preferred measure (adjusted for outliers) stood at 1% in the second quarter, i.e. again below its 2-3% target range. Low inflation is likely to be the main reason why current RBA strength is a thorn in the RBA's side as it puts pressure on import prices and therefore also on consumer prices.

We expect the AUD to depreciate against the USD on a sustainable basis only once markets believe in a quicker tightening cycle from the Fed, which will only be the case around the start of next year. The RBA will therefore remain in easing mode for now. We do not expect it to cut its key interest rate further at next week's meeting as it will likely wait for the Fed. However, it will probably keep the door wide open for another move.

Thu Lan Nguyen
+49 69 136 82878

CHART 10: **Interest rate expectations (AUD)**



Source: Bloomberg, Commerzbank Research

Markus Koch
Tel. +49 69 136 87685

Bond market preview:
Guided by data

Markets are eagerly waiting for the pivotal US labour market report to be released today, followed by at best tier-2 data on next week's agenda. Unless there is a big positive surprise in US payrolls, 10y Bund yields will likely keep trading in a tight -0.1%-0% band. Adding the ECB's pending QE policy update next Thursday to the equation may test the upper yield boundary. We suggest reducing Bund duration ahead of the meeting.

TABLE 4: **Weekly outlook for yields and curves**

	Bunds	US Treasuries
Yield (10 years)	sideways	Modestly higher
Curve (2 - 10 years)	neutral	neutral

Source: Commerzbank Research

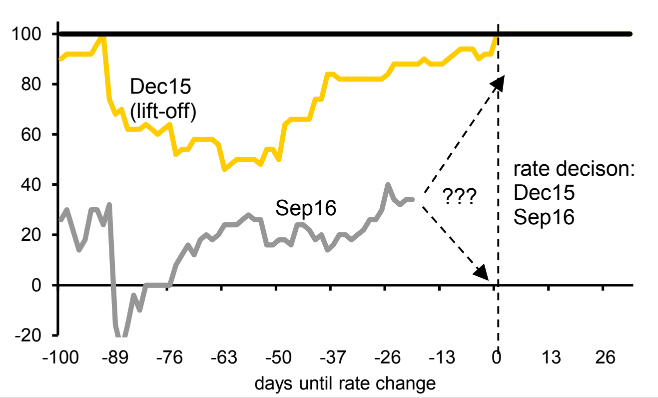
Outlook for the Bund future, 5 September to 9 September	
Economy	→
Inflation	↑
Monetary policy	↓
Trend	→
Supply	↑
Risk aversion	→

Prior to the tier-2 macro data due out next week (see page 9), the pending US labour market report could prove a game changer across interest rates curves. As the data are widely considered pivotal in the context of policy calls voiced by leading Fed members of late, last week's volatility spree in 10y Bund (yields) may resurface as early as this afternoon. What is different this time around are implied probabilities for a Fed funds hike at the 21 September FOMC meeting (derived from Fed funds future). Contrary to the readings of 80%+ observed in the run-up to the December 2015 decision, the odds for a near-term rate hike are currently priced at only 32% (see chart 11). To unravel the policy conundrum rather soon, payrolls would have to show readings of 250k+ to trigger a more sustained bearish tone - thereby also rattling US curve valuations. However, with payrolls forecast to come in way below 200k, the respective uncertainty will likely persist also into Q4.

Going forward to next week, a revamp of the ECB's QE plan is due out – likely to address an extension of bond purchases and/or lifting restrictions (see p.2). In sum, we do not expect Bunds to leave the well-established -0.1%-0% band (chart 12), but 10y yields may well test the upper boundary as a result. The outlook for EGBs is barely affected by supply, featuring merely c. €7.5bn in net issuance. Only in the week after next could a noticeable switch in the sign from slightly positive to negative lend some support to EGBs.

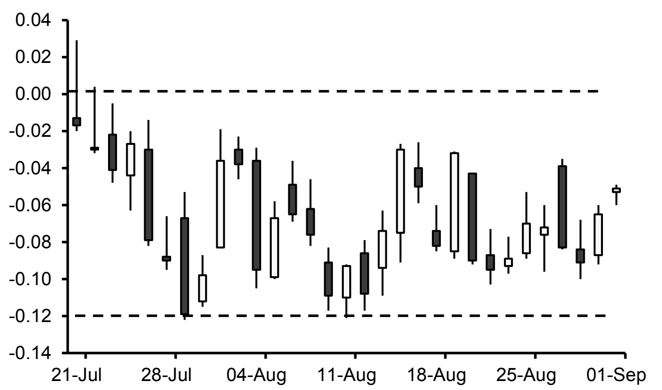
In the Iberian periphery, 10y Spanish and Portuguese government bonds are set to further underperform. Intriguingly, SPGs have been hit only modestly despite acting PM Rajoy failing to defeat parliamentary opposition by ten votes. For the 2nd vote, scheduled to take place this Friday, it will be a closer call, though, as a simple majority suffices to gain another mandate. Assuming another adverse outcome of the vote, Rajoy would be granted another 2-month period (ending late October) before parliament would be automatically dissolved and new elections are called for 25 December. In sum, we stick with our view to tactically reduce Spanish exposure given the ongoing political uncertainty, which undermines any reforms in Spain even further.

CHART 11: **D-day looming: markets doubt Fed move soon**
Historical implied probabilities for a Fed funds move (%)



Source: Bloomberg, Commerzbank Research

CHART 12: **What could drive Bund yields out of their range?**
10y Bund yields, in %



Source: Commerzbank Research

Ulrich Leuchtmann
Tel. +49 69 136 23393

FX market preview:
Reality check for the Jackson Hole chitchat

As a major driver of the Fed's rate decision at the upcoming meeting, the US employment report released this afternoon will be the key event for FX markets in the days ahead. Given the market's wide-spread scepticism surrounding the medium-term strategy of the Fed, the reaction of US exchange rates looks set to be limited, even if the employment report were to surprise to the upside.

TABLE 5: **Expected trading ranges for next week**

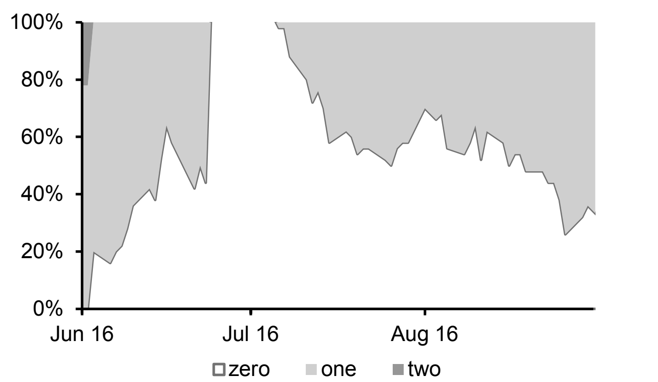
	Range	Trend		Range	Trend
EUR-USD	1.1025-1.1400	↗	EUR-GBP	0.8310-0.8550	↗
EUR-JPY	114.00-117.50	→	GBP-USD	1.3050-1.3500	↘
USD-JPY	101.00-105.25	↘	EUR-CHF	1.0850-1.1050	↘

Source: Commerzbank Research

All statements from Fed Chair Janet Yellen and Vice Chairman Stanley Fischer last weekend in Jackson Hole – pointing to one or possibly even two rate hikes by year-end – will go up in smoke, unless US economic data due to be published ahead of the FOMC meetings are sufficiently positive and the rest of the world is untroubled by major crises. "Data dependency" is the euphemism for this approach of the Fed. And this is why markets are not entirely convinced of what Yellen and Fischer said. Hence, the market still sees a probability of approximately one-third that the Fed will not raise rates at all by the end of the year (see chart 13), indicating that there is a highly sceptical minority. Small wonder. Even some FOMC members have come to the realisation that the FOMC has destroyed its credibility by persistently sending false signals for many years. A positive employment report, however, would be a much stronger indication of a rate increase than the statements of Yellen and Fischer. This would also provide a lift to the US dollar. Therefore, the employment report is so very important – despite the fact that it has not really been the US labour market which has recently kept the Fed from hiking rates.

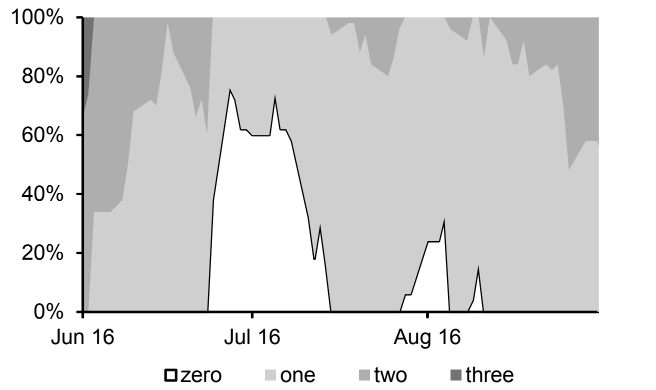
In the medium run, however, market participants should be cautious. Even a rate hike by year-end (or an employment report pointing in this direction) would not entirely dissolve scepticism about the medium- to long-term approach of the Fed. Even then, many would still have the impression that the Fed is extremely hesitant. Currently, the market is pricing in a 20% probability of one rate hike in 2016, followed by no hike in 2017 (chart 14 – compared with 48% for one increase in either year and 32% for no hike before 2017). Whether USD investments will carry an interest rate that is 25 basis points higher or lower makes little difference for USD exchange rates. Only if a rate hike were to signal that others are to follow would it leave a strong mark on FX markets. In our view, a positive figure this afternoon is likely to generate only a limited near-term USD reaction.

CHART 13**: Will there be one more US rate hike in 2016?**
Implied probability of the number of Fed rate increases by year-end 2016, based on Fed Funds futures



Source: CBoT, Commerzbank Research

CHART 14: **…and how many by year-end 2017?**
Implied probability of the number of Fed rate increases until year-end 2017, based on Fed Funds futures



Source: CBoT, Commerzbank Research

Markus Wallner
Tel. +49 69 136 21747

Equity market preview:
German companies battling weaker global economy

Once again, our Sector Conference Week showed how German companies are feeling the pinch from weaker global growth. In order nevertheless to maintain or further raise their earnings margins, they can be expected to press ahead with additional restructuring, and to consider the option of take-overs and joint ventures on account in part of lower financing costs. Investors are thus advised to overweight shares of companies with greater earnings momentum as a result of these measures and with a price-to-book ratio below their long-term average.

TABLE 6: **MDAX performance still positive over one-year horizon**

		Performance (%) since			Earnings 2016e Index points		Earnings 2016e Growth (%)		P/E 2016e	
	Index	31/07	30/06	31/12	current	31/12	current	31/12	current	31/12
DAX 30	10,593	2.5	9.4	-1.4	780.6	824.3	-0.8	4.3	13.6	13.0
MDAX	21,397	1.1	7.8	3.0	1169	1192	2.0	15.6	18.3	17.4
Euro Stoxx 50	3,023	1.1	5.5	-7.5	214.6	240.7	-1.5	5.5	14.1	13.6
S&P 500	2,171	-0.1	3.4	6.2	116.8	124.7	0.6	6.8	18.6	16.4

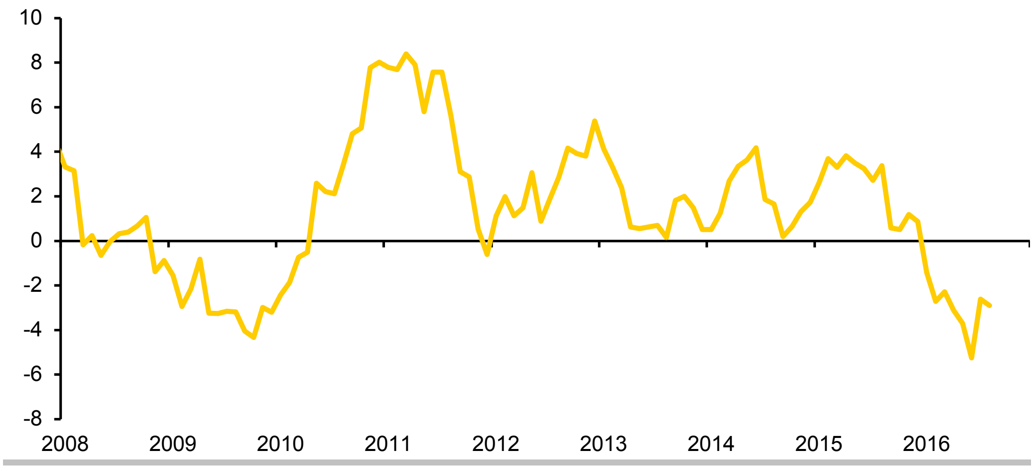
Source: Commerzbank Research, I/B/E/S

Germany's corporate sector continues to struggle against weaker global growth. Consequently, analysts expect a drop in DAX-listed companies' turnover of almost 3% over the next 12 months (see chart 14). In order to absorb the resulting pressure on earnings margins, many firms will probably carry out restructuring measures and opt increasingly for take-overs/joint ventures.

Businesses with high fixed costs in relation to their operating result could benefit the most from restructuring, and with most German companies personnel costs account for the lion's share. One example is Deutsche Lufthansa: here, a 1% cut in overall personnel costs would raise operating results by more than 5%.

We will probably be seeing more take-overs, too. Low corporate bond yields after all mean easier financing, and many companies have generous amounts of cash at their disposal. The total for all DAX companies currently amounts to around €156bn. In this favourable environment, however, there is a risk of take-overs or joint ventures occurring which prove too expensive and/or do not really strengthen a company's original business. These problems are particularly likely in the European banking and steel sectors.

CHART 15: **German companies battling weaker growth**
DAX ex financials: percentage change in turnover expectations year on year



Source: Datastream, Commerzbank Research

Barbara Lambrecht
Tel. +49 69 136 22295

Commodities market preview:
Cool down in every corner …

Oil prices should retreat a little more next week as fresh forecasts by the US Energy Information Administration EIA are likely to fuel concern about renewed market oversupply. The meeting of oil producers at the end of the month argues against big price losses though. Base metals should also become cheaper next week as China apparently imported a disappointingly small amount of copper in August. And last but not least, the nose-dive on the gold market could continue if an interest rate rise by the Federal Reserve becomes more likely in September.

TABLE 7: **Tendencies in important commodities**

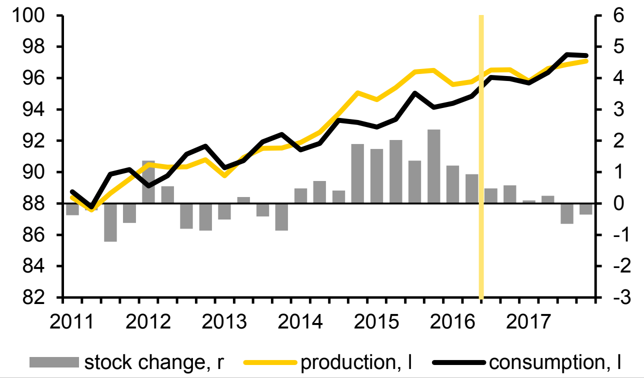
		Per cent change			Tendency	Commodity specific events
	1 Sep.	1 week	1 month	1 year	short-term	
Brent (USD per barrel)	47.1	-6.0	10.7	-5.8	↘	EIA (7.)
Copper (USD per tonne)	4635	0.1	-5.1	-8.6	↘	CHN: Trade balance Aug (8)
Gold (USD / troy ounce)	1306	-1.2	-3.5	14.6	↘	

Source: Bloomberg, Commerzbank Research

Rising US crude oil stocks and record-high OPEC production are increasing concerns about renewed oversupply on the oil market (see chart 16). New forecasts by the EIA next week are unlikely to ease these concerns. Already last month, the EIA raised its forecast for US production in the coming months. The quiet hurricane season so far could now prompt the EIA to trim its expectations of production losses in the Gulf of Mexico somewhat, even if September and October are two more “risky” months. At the same time, the EIA could present a slightly more pessimistic estimate of global oil demand. So far, it has expected daily demand next year to increase by 1.4 million barrels for the third year in a row, making it more optimistic than the two other energy agencies. Furthermore, should the Department of Energy’s weekly report show another rise in US crude stocks, prices should continue to retreat. That said, the price of Brent should not slide significantly below 45 USD per barrel because hopes of a production freeze should strengthen again ahead of the meeting of major oil producers in Algiers at the end of September, although we still maintain that this is (again) much ado about nothing.

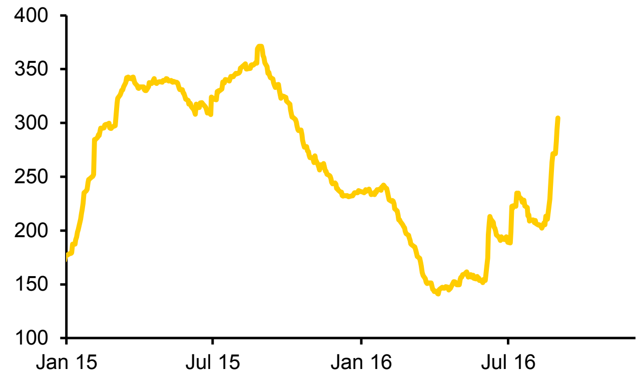
Autumn has come early on base metal markets: after the good summer, the mood has cooled. While the surprisingly strong Purchasing Managers’ Index in China has brought some relief recently, the correction should continue next week, as Chinese customs authorities are likely to report disappointingly low copper imports in August for the world’s biggest consumer by far. This is suggested by the sharp rise in LME copper stocks outside China (chart 17): In South Korea alone, almost 70,000 tons have been delivered into LME warehouses since mid-August. The apparent weak demand in China should continue to put pressure on the copper price in the short term before it should rise again in the long term on the back of tighter supply.

Chart 16: **Is there a risk of renewed surpluses on oil market?**
Million barrels a day, EIA forecasts from 2016Q3



Source: EIA, Commerzbank Research

Chart 17**: Huge rise in LME copper stocks**
Thousand tons



Source LME, Bloomberg, Commerzbank Research

Commerzbank forecasts

TABLE 8: **Growth and inflation**

	Real GDP (%)			Inflation rate (%)		
	2015	**2016**	**2017**	**2015**	**2016**	**2017**
USA	2.6	1.5	2.0	0.1	1.2	2.2
Japan	0.6	0.5	0.5	0.8	-0.2	0.7
Euro area	1.6	1.5	1.5	0.0	0.3	1.3
- Germany	1.7	1.8	1.3	0.2	0.5	1.9
- France	1.2	1.3	1.3	0.0	0.2	0.9
- Italy	0.6	0.8	1.0	0.0	0.1	1.1
- Spain	3.2	2.9	2.5	-0.4	-0.5	1.3
- Portugal	1.5	1.0	1.2	0.4	0.0	1.4
- Ireland	26.3*)	3.2	3.6	0.0	0.3	1.6
- Greece	-0.3	0.1	2.0	-1.0	0.5	1.5
United Kingdom	2.2	1.6	0.5	0.0	0.7	2.0
Switzerland	0.9	1.2	1.6	-1.1	-0.8	1.2
China	6.9	6.7	6.5	1.4	1.8	2.0
India	7.2	7.0	6.1	5.9	5.0	5.3
Brazil	-3.8	-3.6	0.8	9.0	9.0	6.0
Russia	-3.7	-1.0	1.3	15.6	8.0	7.0
World	3.0	2.8	3.1			

- The US economy has reduced its imbalances and seems to be growing at solid rates.
- Growth in China is decelerating due, among other things, to high private indebtedness and overcapacities across industries.
- The recovery in the euro zone will only continue at a slow pace.
- EMU has survived the sovereign debt crisis, but is gradually evolving into an "Italian-style monetary union".
- The German economy is experiencing a consumption-driven boom; below this glossy surface, however, its competitiveness is gradually eroding.
- High unemployment in most EMU countries is keeping inflation low for the time being.

*) This growth figure is not a typo.

TABLE 9: **Interest rates (end-of-quarter)**

	01.09.2016	**Q4 16**	**Q1 17**	**Q2 17**	**Q3 17**	**Q4 17**
USA						
Federal funds rate	0.50	0.75	0.75	1.00	1.00	1.25
3-months Libor	0.84	0.95	0.95	1.20	1.15	1.40
2 years*	0.81	1.00	1.10	1.30	1.40	1.60
5 years*	1.20	1.40	1.50	1.70	1.85	2.00
10 years*	1.59	1.65	1.75	1.90	2.00	2.10
Spread 10-2 years	79	65	65	60	60	50
Swap-Spread 10 years	-13	-10	-5	-5	-5	-5
Euro area						
Minimum bid rate	-0.40	-0.50	-0.50	-0.50	-0.50	-0.50
3-months Euribor	-0.30	-0.30	-0.35	-0.35	-0.35	-0.35
2 years*	-0.62	-0.70	-0.65	-0.60	-0.55	-0.50
5 years*	-0.49	-0.50	-0.50	-0.45	-0.35	-0.25
10 years*	-0.05	0.00	0.10	0.15	0.30	0.30
Spread 10-2 years	56	70	75	75	85	80
Swap-Spread 10 years	37	40	35	35	35	35
United Kingdom						
Bank Rate	0.25	0.10	0.10	0.10	0.10	0.10
3-months Libor	0.39	0.30	0.30	0.30	0.25	0.25
2 years*	0.13	0.15	0.15	0.15	0.15	0.20
10 years*	0.69	0.60	0.80	0.90	1.00	1.10

- The US economy approaching full employment suggests a rate hike is likely. However, after the meagre GDP growth in H1, the Fed seems set to be waiting for better data and delay its next hike until year-end.
- The gradual Fed's rate hikes will put only moderate upward pressure on US long-end yields. The curve is in for a flattening in the coming quarters, led by short-end rates rising somewhat more strongly than long-end rates.
- As euro zone core inflation should stay below ECB expectations, we forecast the ECB to once again loosen its monetary stance later in 2016.
- Ten-year Bund yields are likely to remain in negative territory over the coming months as the ECB bond purchase programme reinforces scarcity. As financial markets should stabilise and US yields rise gradually, we see moderately positive ten-year yields again only next year.
- Risk premiums of peripheral government bonds over Bunds are set to decline further in the medium term amid ECB measures.

TABLE 10: **Exchange rates (end-of-quarter)**

	01.09.2016	**Q4 16**	**Q1 17**	**Q2 17**	**Q3 17**	**Q4 17**
EUR/USD	1.11	1.08	1.06	1.05	1.04	1.04
USD/JPY	104	115	118	120	122	125
EUR/CHF	1.10	1.09	1.09	1.09	1.00	1.00
EUR/GBP	0.84	0.88	0.85	0.83	0.83	0.80
EUR/SEK	9.55	9.30	9.20	9.10	9.00	8.90
EUR/NOK	9.30	9.45	9.50	9.60	9.45	9.35
EUR/PLN	4.36	4.35	4.35	4.35	4.35	4.30
EUR/HUF	310	322	322	325	327	330
EUR/CZK	27.02	27.00	27.00	27.00	27.00	27.00
AUD/USD	0.75	0.76	0.74	0.74	0.73	0.73
NZD/USD	0.73	0.71	0.70	0.70	0.69	0.69
USD/CAD	1.31	1.32	1.32	1.28	1.24	1.20
USD/CNY	6.68	6.65	6.70	6.70	6.70	6.70

- Caused by Fed rate hikes that are not yet priced in by the market the US dollar should be able to gain moderately.
- The ECB's further monetary easing policy should – over time – be a burden for the euro.
- Sterling should suffer from Brexit uncertainty and easy BoE monetary policy in the short term, with potential to appreciate again once an amicable agreement between the EU and Britain is looming.
- In China's new, freer exchange rate system the country's macroeconomic weaknesses will have a bigger impact on the currency. Therefore we expect CNY to tend to depreciate against USD over the coming quarters.

*Source: Bloomberg. Commerzbank Economic Research; bold change on last week; * Treasuries, Bunds, Gilts*

Research contacts (E-Mail: firstname.surname@commerzbank.com)

Chief Economist
Dr Jörg Krämer
+49 69 136 23650

Economic Research

Dr Jörg Krämer (Head)
+49 69 136 23650

Dr Ralph Solveen (Deputy Head; Germany)
+49 69 136 22322

Dr Christoph Balz (USA. Fed)
+49 69 136 24889

Peter Dixon (UK. BoE). London
+44 20 7475 4806

Dr Michael Schubert (ECB)
+49 69 136 23700

Eckart Tuchtfeld (German economic policy)
+49 69 136 23888

Dr Marco Wagner (Germany, Italy)
+49 69 136 84335

Bernd Weidensteiner (USA, Fed)
+49 69 136 24527

Christoph Weil (Euro area, France, Switzerland)
+49 69 136 24041

Interest Rate & Credit Research

Christoph Rieger (Head)
+49 69 136 87664

Michael Leister (Head Rates)
+49 69 136 21264

Rainer Guntermann
+49 69 136 87506

Peggy Jäger
+49 69 136 87508

Markus Koch
+49 69 136 87685

David Schnautz
+44 20 7475 4756

Ted Packmohr
(Head Covered Bonds and Financials)
+49 69 136 87571

Marco Stoeckle
(Head Corporate Credit)
+49 69 136 82114

FX & EM Research

Ulrich Leuchtmann (Head)
+49 69 136 23393

Thu-Lan Nguyen (G10)
+49 69 136 82878

Antje Praefcke (G10)
+49 69 136 43834

Esther Reichelt (G10)
+49 69 136 41505

Peter Kinsella (Head of EM)
+44 20 7475 3959

Lutz Karpowitz (Dep. Head EM, CEE)
+49 69 136 42152

Elisabeth Andreae (LatAm)
+49 69 136 24052

Alexandra Bechtel (Projects)
+49 69 136 41250

Melanie Fischinger (LatAm)
+49 69 136 23245

Tatha Ghose (CEE)
+44 20 7475 8399

Charlie Lay (South Asia)
+65 63 110111

Hao Zhou (China)
+65 6311 0166

Commodity Research

Eugen Weinberg (Head)
+49 69 136 43417

Daniel Briesemann
+49 69 136 29158

Carsten Fritsch
+49 69 136 21006

Dr Michaela Kuhl
+49 69 136 29363

Barbara Lambrecht
+49 69 136 22295

Equity Markets Strategy

Christoph Dolleschal
(Deputy Head Research)
+49 69 136 21255

Andreas Hürkamp
+49 69 136 45925

Markus Wallner
+49 69 136 21747

Technical Analysis

Achim Matzke (Head)
+49 69 136 29138

Cross Asset Strategy

Dr Bernd Meyer (Head)
+49 69 136 87788

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Frankfurt	**London**	**New York**	**Singapore**	**Hong Kong**
Commerzbank AG	Commerzbank AG	Commerz Markets LLC	Commerzbank AG	Commerzbank AG
DLZ - Gebäude 2, Händlerhaus	PO BOX 52715	225 Liberty Street, 32nd floor,	71, Robinson Road, #12-01	15th Floor, Lee Garden One
Mainzer Landstraße 153	30 Gresham Street	New York,	Singapore 068895	33 Hysan Avenue,
60327 Frankfurt	London, EC2P 2XY	NY 10281-1050		Causeway Bay
				Hong Kong
Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000	Tel: +852 3988 0988