GLOBAL ECONOMICS & MARKETS

ANDBANK CORPORATE REVIEW
October 2017

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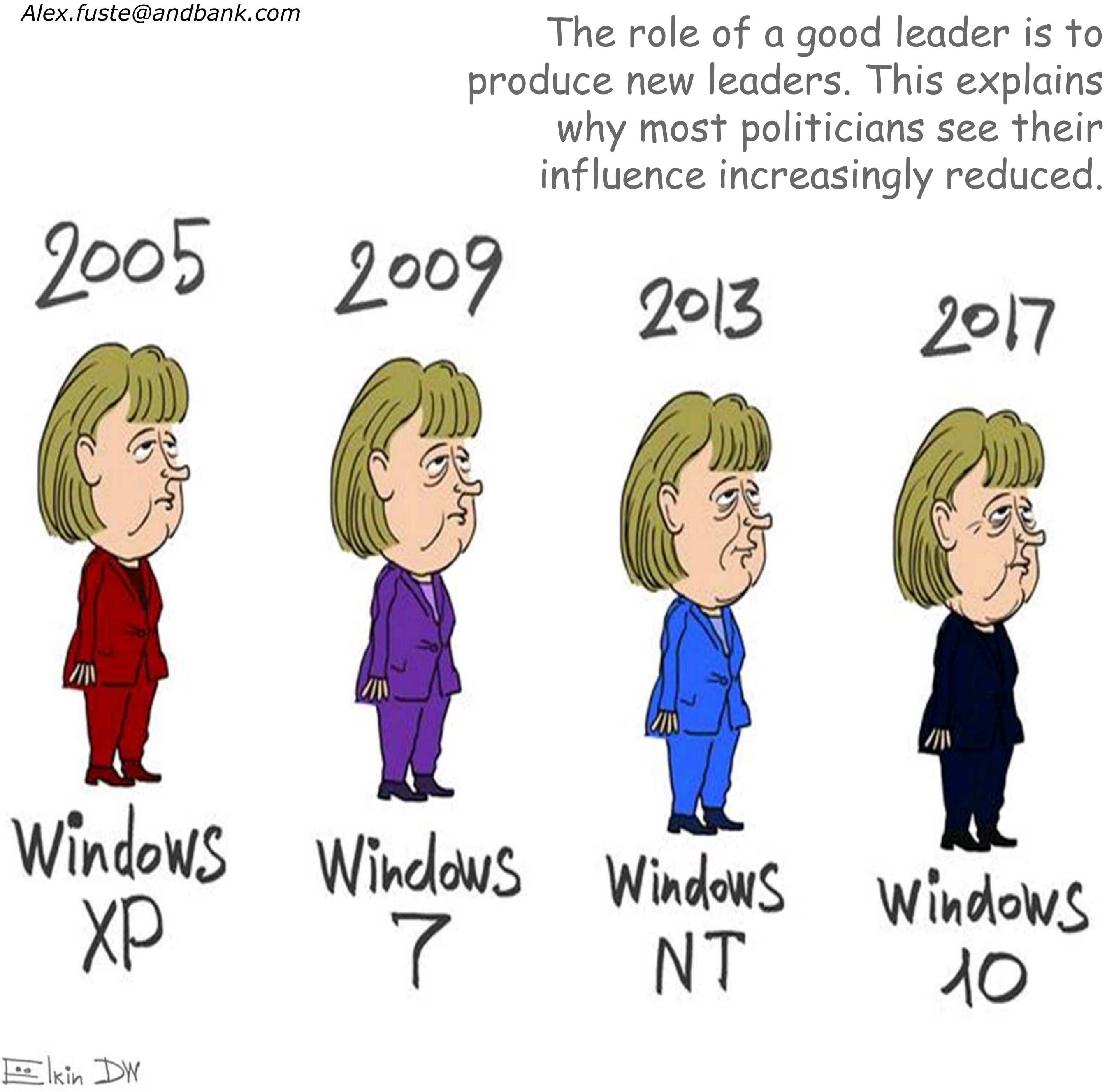


Contents

Executive Summary

USA - The Fed will start the balance-sheet runoff in October. It still expects one hike in the Fed funds rate this year, and three hikes in 2018. On the political front, Trump is on a bipartisan roll and while this certainly increases the possibilities for new steps in legislation and reforms, the truth is that no one knows how long his bipartisan kick will last or how successful he'll be. ***Equity S&P Index***: CAUTIOUS (EXPENSIVE). Target: 2,400. Exit point at 2,500. ***Bonds UST10y*** (EXPENSIVE). Entry point at 2.65%. ***Credit - CDXIG***: FAIR VALUE: target 55bp. ***CDX HY:*** FAIR VALUE. Target 323

Europe – ECB September statement clearly points to the October meeting (26th) as the date when the bulk of decisions to recalibrate current QE could be taken. Our central scenario is for an open-ended reduction to the Asset Purchase Program to start in 2018 (mainly due to technical reasons). A rate hike would only take place once tapering had ended (probably in 2019). ***Equity STXE600 Index***: FAIR VALUE. Exit point at 405. ***Bonds, European Govies:*** NEGATIVE. ***Corp. Credit:*** EXPENSIVE. Investment Grade entry point at 80bp (current 57pb). High Yield entry point at 350bp (current 255pb).

Spain - Economic growth may have peaked in the second quarter, with some economic indicators suggesting a slowdown in 3Q17. Nevertheless, the figures are still within our 3% GDP growth in 2017. ***Equity IBEX Index:*** NEUTRAL-POSITIVE. New central point (within our reasonable range) fixed at 10,271. Sell at 11,298. ***Fixed Income 10Y Govt. Bond:*** CAUTIOUS. We are keeping our year-end target at 1.9%.

China – China's GDP growth in 2017 will reach 6.8% (above the 6.5% target) though growth in Q4 will likely slowdown. ***Equity Shenzhen Composite Index:*** POSITIVE. Exit point at 2,078. ***Bonds 10Y Govie:*** POSITIVE, y/e target yield 2.9%. ***FX CNY:*** FAIR VALUE. Target at 6.75.

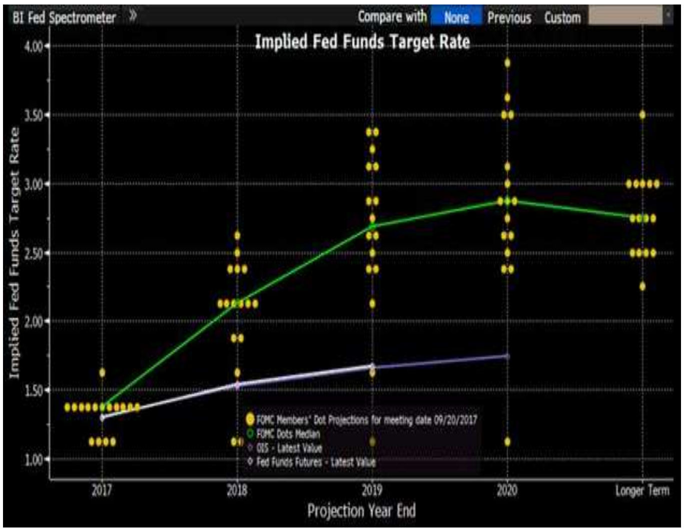
India – The introduction of the GST (India's biggest tax reform in 70 years) has heightened business uncertainty resulting in many firms failing to register for the new tax. Despite this, we see no risk of significant deterioration in India's credit metrics. ***Equity India Sensex Index:*** FAIR VALUE (HOLD). Fundamental price 29,958; Exit point at 32,953. ***Bonds 10Y Govie:*** : POSITIVE. Year-end yield target stable at 5.5%.

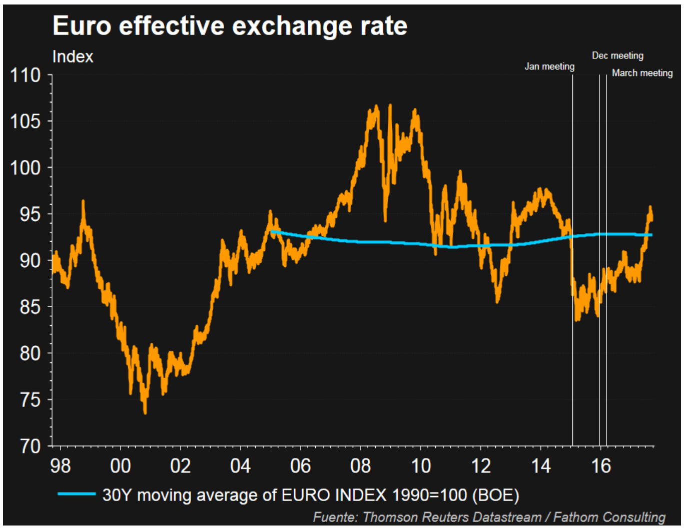
Japan – The BoJ is seen to keep its current pace of monetary easing until at least late 2018 as the pace of gains in consumer prices remain very slow. ***Equity Nikkei Index:*** CAUTIOUS (EXPENSIVE); Exit point at 19,528. ***Bonds 10Y Govie:*** NEGATIVE (EXPENSIVE). 10Y bond target 0%. FX JPY/USD: EXPENSIVE. USD-JPY fundamental target at 115.

LatAm – In Brazil, the president's political situation has improved. Labor reform bill, spending cap bill and the new long-term BNDES financing rate have been passed. ***Equity Brazil Bovespa Index:*** EXPENSIVE; Exit point at 72,000. ***Equity Mexico IPC Index:*** FAIR VALUE; Exit point at 52,000. ***Bonds:*** Brazilian 10Y Govies POSITIVE (Targets: 9.75% in Loc, 5.25% in USD). Local currency 10Y Mexican bonds POSITIVE (Target 7.0%), USD Mexican bonds NEGATIVE (Target 4.30%). Argentinian Global bonds in USD: NEUTRAL (Target yield 6%). FX targets: BRL 3.10, MXN 18.20, ARS 18.

Forex – The "USD Short" (mainly vs EUR) is still the most crowded position globally. In the absence of a political turnaround in the US that ends the political chaos inside the White House and within the GOP, technical analysis could still dominate and point to further USD depreciation. Fundamentally speaking (long-term view), our stable equilibrium target for the EUR/USD pair still favors the greenback (based on interest rate spreads, PPP, REER, monetary policy), although we have to admit that traditional valuation criteria are not proving useful in the short term. So Andbank's Investment Committee has decided to set the EUR/USD fundamental target for the next few months in the 1.10-1.15 range.

US: *A hawkish Fed expects a 25bp rate hike this year and three hikes in 2018. Balance sheet contraction in October.*





Fed rates and balance sheet normalization.

- **On-balance sheet normalization:** The Fed will start the balance-sheet runoff in October. The Fed's balance sheet now stands just shy of 25% of US GDP (well below the relative size of the ECB and BoJ balance sheet). The Fed will start with a monthly runoff cap of $10bn that rises by $10bn every quarter, reaching a $50bn monthly cap in October 2018. We estimate the process should end in 2021 with a final balance sheet of roughly $3 trillion (13% of GDP).
- This timeline allows the Fed to continue its tightening cycle, but may delay a third rate hike long enough to assess if recent weakness in core inflation is actually just temporary.
- **Fed rates:** The Federal Reserve said that it still sees the Fed funds rate at 1.4% by the end of 2017 (although our last Investment Committee was still not convinced of a third rate hike in December). The U.S. central bank maintained its 2018 projection of three hikes, saying it expects a benchmark rate of 2.1%. However, the Fed has slightly lowered its 2019 outlook for the Fed funds rate from its June projection. It now expects the benchmark rate to be 2.7% by the end of 2019 instead of the previously projected 2.9%, meaning two more hikes in 2019. The decision regarding the Fed funds rate and the start of the balance-sheet runoff in October was unanimous.

Macro: near-term risks appear roughly balanced

- **Growth outlook:** The Fed stated that "storm-related disruptions and rebuilding will affect economic activity in the near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term".
- The economy expanded at an annual rate of 2.1% in the first half. "The labor market has continued to strengthen" and economic activity "has been rising moderately so far this year", the Fed statement said. The FOMC repeated its language saying "near-term risks to the economic outlook appear roughly balanced".
- Recent retail sales came in below expectations, falling 0.2% MoM in August. In YoY terms, nominal retail sales growth declined to 3.2%, well below its January peak of 5.6%.
- Recent readings point to a greater likelihood of a meaningful drag on August economic activity from Hurricane Harvey, and given the possibility of sustained weakness in September due to Hurricane Irma, we now expect an even larger drag on growth in Q3. Consequently we are slightly reducing our tracking estimate for annual GDP to ~2%.
- **Inflation outlook:** While the storms will temporarily boost inflation due to higher prices for gasoline and other items, the Fed stated that "apart from that effect, inflation on a 12-month basis is expected to remain somewhat below 2% in the near term but to stabilize around the committee's 2% objective over the medium term".

Politics & Reform agenda

- Trump is on a bipartisan roll of late. Elated by what he viewed as glowing press after his debt ceiling deal with Democratic leaders "Chuck and Nancy" last week, Trump wants to replicate that thrill of victory, which he believes Republicans have failed to deliver since his inauguration. Trump has complained in private that it's difficult to have any sort of relationship with Senate Republicans' Majority Leader Mitch McConnell. By contrast, Trump can relate to Democratic leaders Chuck Schumer and Nancy Pelosi, who talk more in non-Washington terms that he understands, according to people familiar with their meetings.
- No one knows how long his bipartisan kick will last or how successful he'll be. Closely connected to the debt ceiling is the outlook for fiscal policy in the US, notably the prospect for meaningful tax relief. The President was eager to collect tax proposals that could bring Democratic support.
- The prospect of a major tax overhaul has not increased despite Trump's "readiness" to aim for a bipartisan approach (compromise) to pass any bill in his agenda. However, on balance, meaningful tax relief still seems to be on the cards, even if it will fall short of the ambitious initial proposals. Any potential shortfall in the tax relief that will likely be granted to US taxpayers next year versus forecast assumptions made will need to be set against any extra government spending.

Financial Markets:

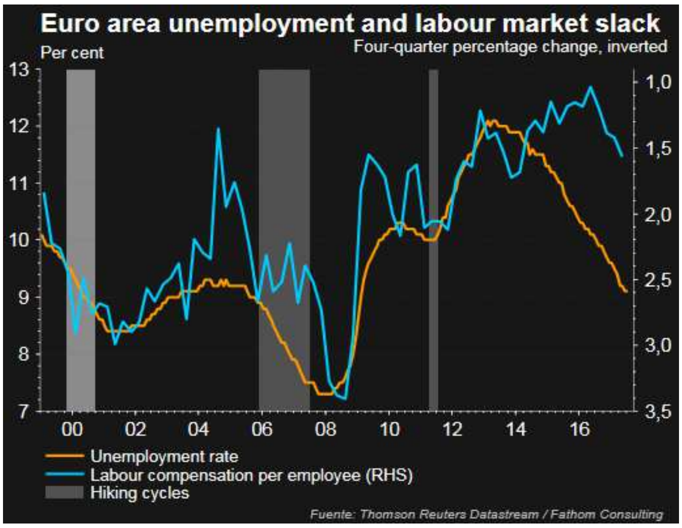
- **New! Equities (S&P):** ***CAUTIOUS (EXPENSIVE)***. We slightly revise upward the central point of our reasonable range for the S&P. The new central point is ~2,400. Exit point at ~2,500.
- **Bonds:** ***CAUTIOUS (EXPENSIVE)***. UST 10Y target (entry point) 2.65%.
- **Credit: CDX IG:** ***FAIR VALUE*** Target at 55bp. OW Fins, Tech and Autos. UW Retail and Healthcare.
- **Credit CDX HY:** ***FAIR VALUE*** Target 323. OW Fins, Tech, Media. UW: Materials, Energy and Retailers.

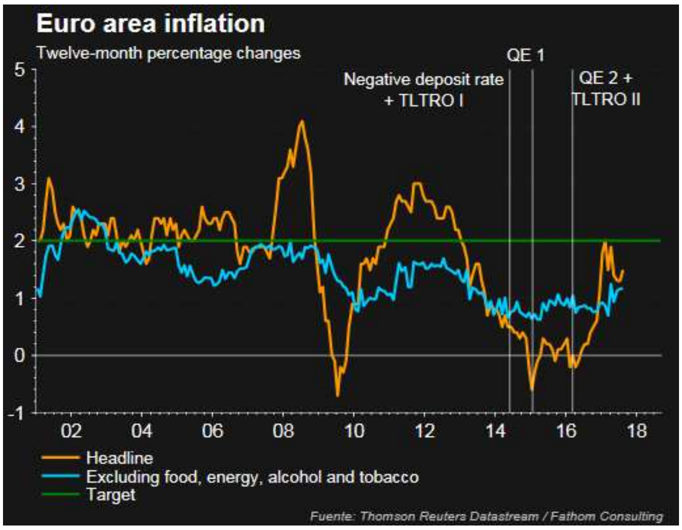
Europe: ECB delays stimulus decision until October

ESCENARIO MACRO BCE

		2017E	2018E	2019E
IPC	sep-17	1,5%	1,2% ↓	1,5% ↓
	jun-17	1,5%	1,3%	1,6%
	mar-17	1,7%	1,6%	1,7%
	dic-16	1,3%	1,5%	1,7%
	sep-16	1,2%	1,6%	
	jun-16	1,3%	1,6%	
	mar-16	1,3%	1,6%	
PIB real	sep-17	2,2% ↑	1,8%	1,7%
	jun-17	1,9%	1,8%	1,7%
	mar-17	1,8%	1,7%	1,6%
	dic-16	1,7%	1,6%	1,6%
	sep-16	1,6%	1,6%	
	jun-16	1,7%	1,7%	
	mar-16	1,7%	1,8%	

Fuente: BCE





ECB: QE recalibration is in the making / Bank of England: Hawkish

- As expected, September's statement clearly points to the October meeting (26th) as the date when the bulk of the decisions to recalibrate the current QE would be taken. Further details would follow suit, in December.
- Our central scenario is for an open-ended reduction in the Asset Purchase Program starting in 2018, which could initially extend over 6 months (9 months?), by reducing monthly purchases by €20bn per month at the beginning (from €60bn to €40bn per month), to be increased afterwards.
- A rate hike would only take place once tapering had ended (end of 2018 or 2019).
- Could the strong euro impact or affect the ECB's next steps? According to ECB officials, the recent euro appreciation has been a "source of uncertainty that requires monitoring". Regarding its possible implications for price stability, the ECB has downplayed the euro's role, stating that FX shifts currently have a lower impact on CPI/GDP from previous appreciation movements.
- In our opinion, a continued euro appreciation would increase the risk of slowing down the ECB normalization process.
- In the UK, the majority of BoE members see room for scaling back the monetary stimulus in the coming months. Forward rates already price in a 60% probability of a rate hike at the next meeting. Short term support for the pound, which should be moved in the mid term by the Brexit news flow.

Macro: robust growth but low inflation

- **GDP estimates continue to be revised upwards**, with the last ECB projections well ahead of the consensus for 2019 (1.7% vs 1.5% YoY). See the table.
- **Surveys support a bright outlook**, especially from the manufacturing PMIs (still on the rise), although admittedly the services PMI has decoupled and receded slightly.
- **As for inflation, August figures recovered both in general and core terms. Although levels remain subdued, inflation expectations have stabilized. Despite this stabilization,** ECB estimates were slightly trimmed, suggesting that price levels will remain far below the official target of 2% YoY in the foreseeable future. Draghi underlined the ECB's commitment: *"not resigned to low inflation"; "nothing will derail our will to get to the inflation goal"*.

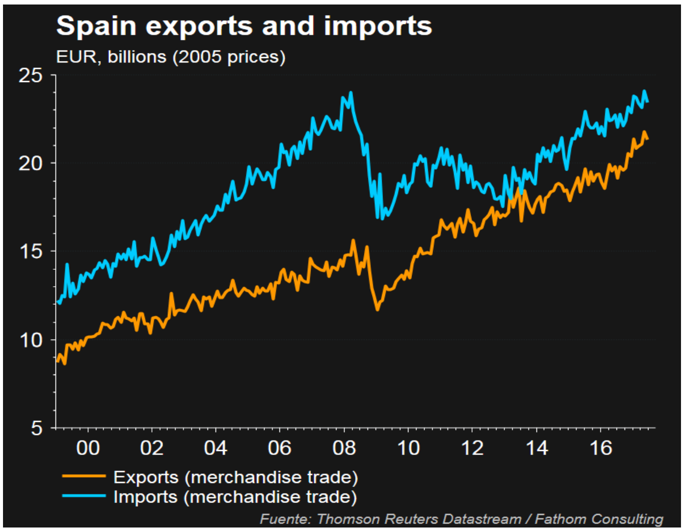
Politics: German elections could change the panorama in Europe

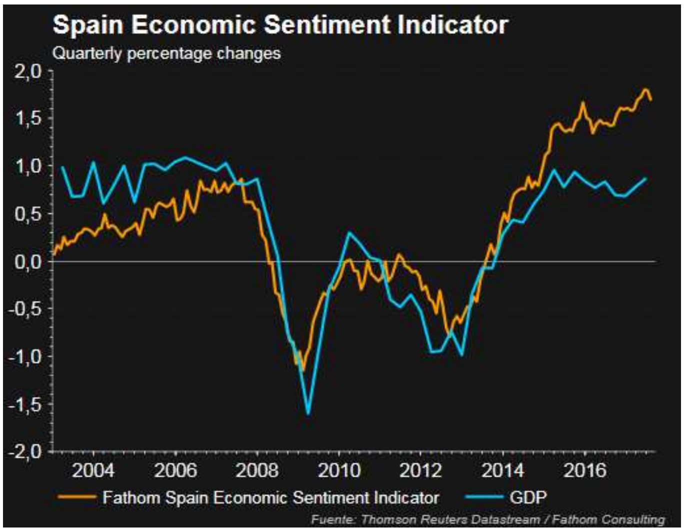
- A direct coalition of two forces (theoretically more stable) in Germany now seems impossible following the announcement of Schultz's SPD to go directly to the opposition and not form a coalition (I am told that the party leadership breathed quietly after the announcement). The reality then, brings us closer to a suboptimal solution in the form of a coalition with more participants, in some cases with antagonistic programs, and whose sum does not guarantee a comfortable majority.
- The possible (apparently only) coalition, already known as the "Jamaica Coalition", would group Merkel's CDU/CSU with the FDP and the liberal Greens. The irony is that while the liberals wanted to stop the march of European integration, the liberal Greens were apparently advocates of greater integration. The question is, which side will prevail? The Liberals will ask for the Ministry of Finance, while the Greens will probably demand the Ministry of Foreign Affairs. From a European integration perspective, the real situation leaves little room for doubt despite this apparent equilibrium of forces. The surge in the far right, fueled by deserters from Merkel's party, who has already said that she will work hard to bring them back, leads us to believe that there will be a certain amount of regression and a right turn in Merkel's policies. In theory that suggests less integration.
- A new and more conservative approach in policy, together with the presence of liberals in government, makes us to think that the new foreign policy focus could shift towards the consolidation of existing institutions, rather than the creation of new institutions or their transformation, in order to make integration progress.
- It is still too early to know how the European agenda could be affected. We do not want to anticipate events, or bet on a deterioration in the European agenda, but the electoral result in Germany is undoubtedly unfavorable to the European agenda.

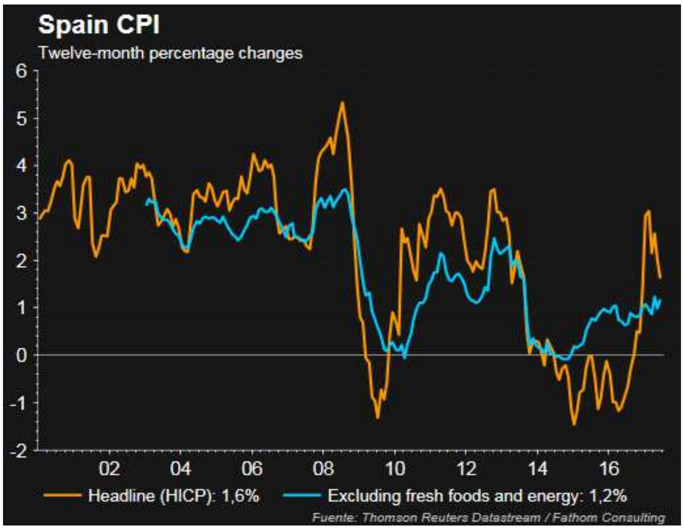
Financial Markets Outlook

- **Equity (STOX 600):** ***FAIR VALUE-POSIT***. Target 368. Sell at 405.
- **Bonds:** ***NEGATIVE***. Bund 0.70%, IT: 2.3%, SP 1.9%, IE 1.4%; PO (New!!): 2.6%.
- **Credit: Itraxx IG:** ***EXPENSIVE***. Target 80. **Itraxx Xover (HY):** ***EXPENSIVE***. Target 350.

Spain: Rate of economic growth peaked in the second quarter







Economic outlook

- New macroeconomic data released during the summer show that economic growth may have peaked in the second quarter. Economic indicators suggest a slowdown in GDP growth for 3Q17 (+0.7%), although the composite PMI is consistent with our 3% GDP growth in 2017 despite this recent weakness.
- While domestic demand remains the main contributor thanks to strong employment growth feeding demand, exports also seem to be pushing GDP growth, with the Exports-GDP ratio rising to 3.5% in the first quarter of 2017 from 2.2% in 2009.
- Several aspects reassure us about the short-term economic risks in this economy: The positive contribution of both domestic and external demand, the current account surplus, employment creation, and the continued deleveraging process in the private sector.
- Furthermore, Spanish growth now seems more balanced than in the recent past. Some reforms from previous years seem to have reshaped the economy, which now appears more robust to shocks and more able to benefit from the global recovery.
- Prices are indicating that our CPI target of 1.7% for year-end could prove accurate. The price rises that we have largely been forecasting for this year may well prove correct, with headline inflation falling to 1.6% YoY in August due to energy prices.
- Employment certainly represents a positive development, although most of this growth has been concentrated in low productivity sectors.

Fiscal & Deleveraging

- Spain's public deficit is expected to drop to −3.2% of GDP in 2017e and −2.2% in 2018e. This relative improvement is based on several factors: (1) Increase in revenues due to the favorable momentum on the economic front. (2) Repricing of public debt (10% cut in financial costs), and (3) Less use of the automatic stabilizers.

Banking & Reforms

- Asset quality improved markedly in 2Q17. The NPL ratio was 8.74% in May 2017, a figure that compares positively with the NPL ratio in May 2016 (9.84%) and December 2016 (9.11%). The coverage ratio has remained largely stable: 59.4% in May 2017 vs. 58.9% in December 2016. This ratio should improve further following Santander's acquisition of Popular and the capital increase just announced by Liberbank to boost its coverage ratio to 50% (from 40%)
- Deleveraging has been impressive. Since its 2010 peak, private sector debt has decreased by 50pp of GDP, equivalent to around €448 billion in nominal terms (€269 billion by corporates and €180 billion by households). Nonetheless, private sector debt should still be monitored closely as it is still higher than the euro area average.

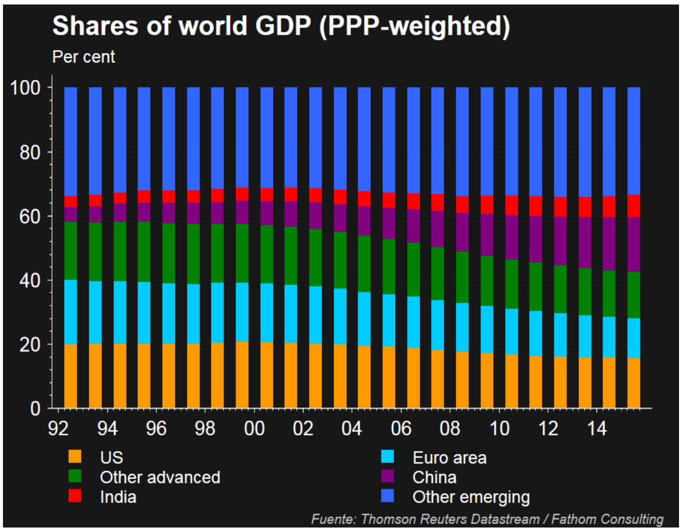
Politics

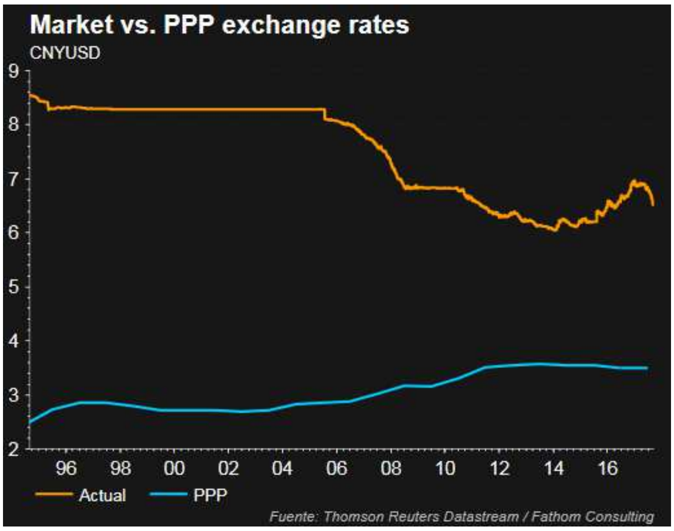
- Perhaps the only gray spot that presents this market today is the unrest that stems from political uncertainty in the country. An uncertainty that has leaked into economic affairs (though not irreversibly) in the sense that the 2018 budget negotiation has become trickier than the previous year, following the position of the PNV which has withheld its support for the moment, generating uncertainty around key aspects such as deficit reductions, reduction in taxes or the much needed greater reforms.

Financial Markets:

- **New! Equities (Ibex): *NEUTRAL-POSITIVE***. New central point (within our reasonable range) fixed at 10,271. Sell at 11,298. Our revised central point stems from an update in our sales and margins forecasts, reflecting last quarter results and guidance from Spanish companies. On the one hand we are downgrading our sales growth target to 3.5% due to the disappointing second quarter sales (Telefónica, Inditex, etc.), the new euro level and lower overseas growth expectations. On the other hand, we have upgraded our profit margin target to 8.5% (from 8.3%) following impressive Q2 figures (companies delivered a profit margin of 8.9%).
- ***Fixed Income - 10Y Govt Bond: CAUTIOUS***. We maintain our fundamental (entry point) target at 1.9%.

China: Financial deleveraging remains underway





FX management

- The surge in the yuan has blindsided traders and potentially complicates China's efforts to manage a slowdown in growth while deepening its ties to global markets. Traders attribute the yuan's strength to US dollar softening and to the PBoC's tighter controls over the yuan (which have reduced expectations of a weaker yuan and prompted companies that had been hoarding dollars to convert them into local currency). Authorities suggest that yuan management should continue, with methods that have proved effective at keeping the currency stable.

Macro Front

- Auto sales growth could wane: Vehicle sales rose 5.3% YoY in August compared to a 6.2% increase in July.
- Exports +5.5% YoY (+7.2% previously). Imports +13.3% YoY (+11%)
- Outstanding loans +13.2% YoY (stable)
- CPI: +1.8% YoY in August (vs +1.8% prior month)

Outlook

- China's GDP growth in 2017 will reach 6.8% (above the 6.5% target) though growth in Q4 will likely slow down.
- China's entrepreneur confidence index at highest since 2012 (5K survey)
- The significant stimulus program implemented in 2016 by President Xi Jinping's in a rush to deliver decent GDP growth in the run up to the 19th Party Congress will start to fade in 2018, leading to less impressive growth in China and globally.

Fiscal (deleveraging process of the real economy is being completed)

- Macro-prudential approach: Some Chinese media have begun reporting the success of the financial deleveraging, arguing that interbank borrowing has been reduced significantly leading to balance sheet contraction at some large joint-stock banks (where new liabilities fell sharply in H1). The report also highlighted a decline in the number of new wealth management products, and a deceleration in M2 growth, which fell to 9.4% in June, the slowest rate on record. The tightening process is more or less completed. Both Xi and Premier Li Keqiang stressed the importance of "deleveraging" the real economy.
- August fiscal spending +2.9% YoY (vs 5.4% in July)
- The Financial Work Conference (FWC) is a big deal, held only once every five years. It has a history of making decisions that have a major impact in determining the structure and development of China's financial sector At this latest FWC, the focus was on: (1) Stronger financial regulation and (2) Further centralizing China's financial regulatory framework, bringing the four regulators under a single committee, which should reduce turf wars and cut regulatory arbitrage.

Geopolitics: Major Chinese banks suspending North Korean transactions.

- Kyodo reported Chinese state banks have started suspending transactions through accounts held by North Koreans. The banks have yet to freeze the accounts, meaning that North Koreans can still withdraw money, but they are now prevented from making deposits.

Reforms

- Investments abroad: Chinese companies face obstacles in their offshore pursuits. According to Dealogic, Chinese firms have announced $113bn in cross-border deals this year, down almost a third from the same period a year earlier. Moreover, there have been 86 announced Chinese deals worth $9.9bn in the US so far in 2017, down from 118 deals worth $33bn in the same period last year.

Corporate

- Banking: CBRC reported the NPL ratio of Chinese commercial banks was 1.86% with banks' total assets at CNY239T ($37T). The provision coverage was 175.1% and the capital adequacy ratio stood at 13.2%.
- Profit margins among the 500 biggest companies are low (4.42%) but Q3 corporate guidance remains robust, with more than 77% of firms predicting positive YoY profit growth, while 15% of them anticipated increases of more than 100%. Companies continue to see recovering demand and rising prices.
- IT industry prospers: The Ministry of Industry Technology reported that revenues of the major IT and Internet companies reached CNY17T ($2.6tn) in 2016, 1.55 times the total in 2012, equivalent to an average annual growth rate of 11.6% over the period.

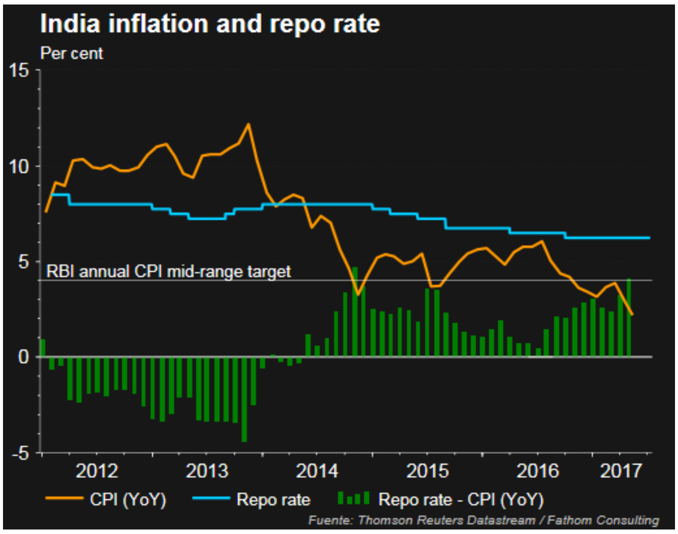
Bitcoins

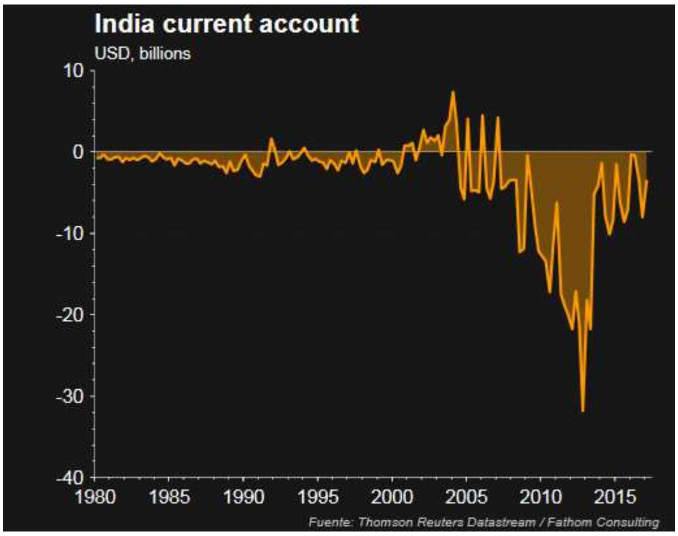
- The PBoC has led a draft of instructions that would ban Chinese platforms from providing virtual currency trading services. Officials from PBoC, banks and regulatory bodies considered the options for months but ultimately came to a consensus to shut down virtual currency exchanges.

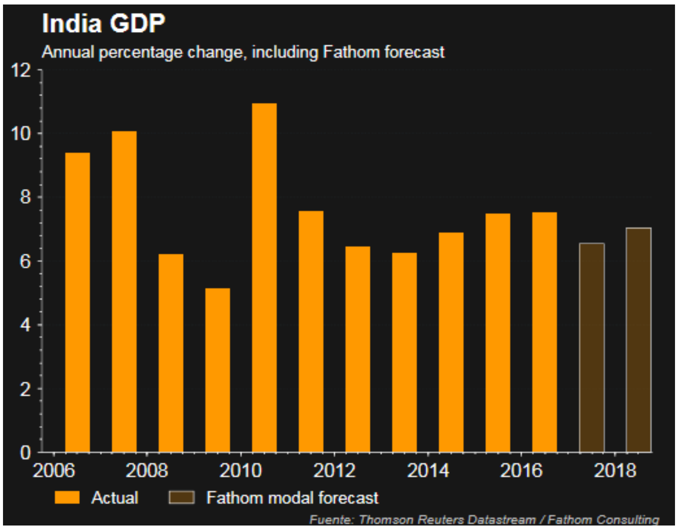
Financial Markets

- **Equity (Shanghai): *FAIR VALUE*.** Exit point: 3,387
- **Equity (Shenzhen): *POSITIVE*.** Exit point: 2,078
- **Bonds: *POSITIVE*.** 10Y bond target 2.9%
- **FX (RMB): *FAIR VALUE*.** USD-CNY target at 6.75

India: Fiscal Reform (GST) implementation gives rise to some chaos







Fiscal Reform (GST) implementation gave rise to some chaos

- The introduction of the GST, billed as India's biggest tax reform in 70 years, has heightened business uncertainty resulting in many firms failing to register for the new tax.
- Some market participants are worried that India could be forced to cut spending on key infrastructures such as railways and highways as lower-than-expected tax collections have upset the government's budget calculations.
- Tax receipts were about $7.8 billion in July - a little over half the monthly target - mostly because millions of firms failed to comply with the new Goods and Services Tax (GST) system that harmonizes all state and federal sales taxes but is still a work in progress.
- The finance minister of the northern state of Punjab told Reuters that the new tax was launched in a "hurry resulting in a lot of chaos".

Outlook

- India's GDP growth slowed to 5.7% for the April-June quarter from 7.9% a year earlier, a slowdown also partly blamed on the introduction of the GST, and there is a widespread perception that economic growth could take a further hit if public spending were to be slashed due to lower tax collections.
- However, we are still optimistic that receipts from personal and corporate income tax will slightly overshoot the target of 9.8 trillion rupees ($152.8 billion) for the whole year, partly due to a crackdown on tax evaders, and GST collections may pick up in the coming months.
- The finance ministry said tax receipts were expected to improve as problems related to the new GST system and the technology underpinning it were tackled. In his annual budget, finance minister Jaitley had forecast 17% growth in tax collections
- We therefore see no risk of significant deterioration in India's' credit metrics, and the target for the fiscal deficit (3.2% of GDP) can still be met.
- This is an abnormal year. A shortfall in tax and non-tax revenue could result in a GDP slowdown. Additionally, the economy is still recovering from Modi's move to withdraw 86% of high value banknotes as part of a fight against political corruption.

Poor external figures over the summer weigh on the Rupee

- India's goods exports rose 5.7% to $23.82 billion in August from the previous month, the first rise in five months, but the trade deficit widened to $11.64 billion from $11.45 billion in July. The current account deficit also widened to $14.3 billion, or 2.4% of gross domestic product, in April-June from $3.4 billion or 0.6% of GDP in January-March.

Reforms: Market regulation.

- India's capital markets regulator has decided to allow Infrastructure Investment Trusts and REIT Trusts to raise debt capital by issuing debt securities, in a bid to facilitate growth of such funds.

Reforms aimed at achieving the New Defense Procurement procedure

- To boost domestic R&D (starting with defense) and turn India into a manufacturing power, the government has: (1) Raised the cap on foreign investment in the defense industry from 26% to 49%, (2) Streamlined the licensing process for defense contracts, and (3) Simplified the industry's tax structure. Good news for Tata Power, BEML, Larsen & Toubro and Bharat Electronics. The goal is to produce in India, source in India and export from India.
- Whether India can make the step up to building its own modern defense industry is another matter. No one knows how quickly the government will move. It could be decades before India can substitute indigenous for foreign technology.

Equity market: India's NSE index hits record high

- NSE index hit an all-time high this month, joining a rally in Asian shares, with banks, diversified conglomerates and automobile firms leading the gains.
- There is a feel-good factor as there could be more spending (public).

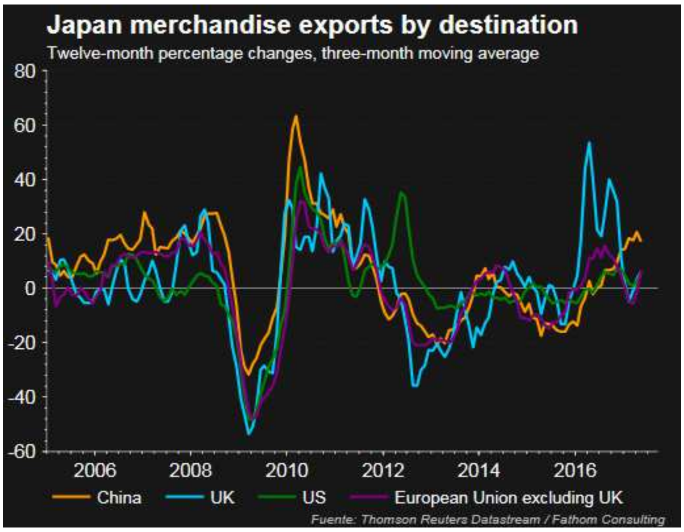
Bond Market

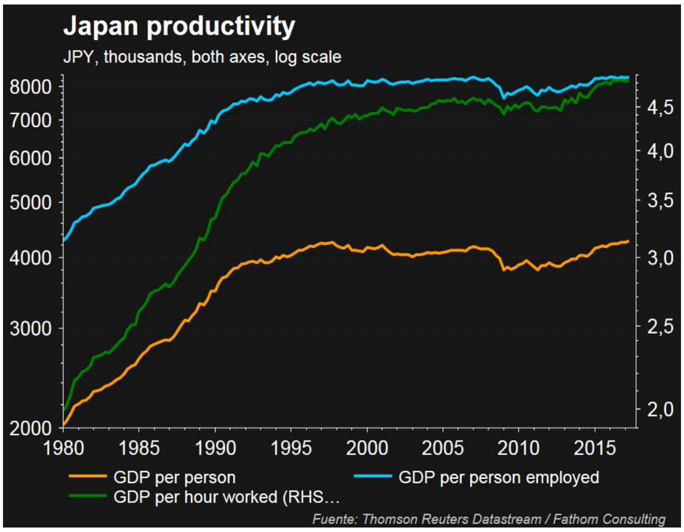
- Indian government bonds fell last month after a faster-than-expected rise in August inflation marred expectations of an interest rate cut in the near future.
- The country's retail inflation quickened to a five-month high of 3.36% on year in August. The nation's Monetary Policy Committee cut the policy repo rate last month by 25 basis points to a near-seven-year low, as expected, but maintained a neutral stance and flagged inflation risks.

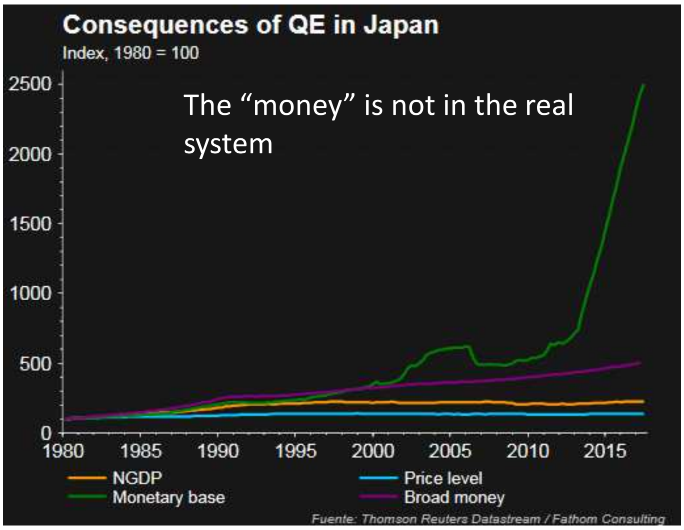
Financial Markets

- **Equity (Sensex): *FAIR VALUE***. Fundamental price 29,958. Exit point at 32,954
- **Bonds: *POSITIVE***. 10Y bond target at 5.5% (from 5.7%)
- **FX: *FAIR VALUE***

Japan: Most analysts think BoJ will keep current pace of monetary easing "at least" until late 2019







Geopolitics

- North Korea fired a ballistic missile over the Japanese archipelago on Friday, the second such launch within a month and just one week after North Korea threatened to use nuclear weapon to 'sink' Japan. The US Pacific Command said in its initial assessment that the missile was an intermediate-range ballistic missile, while Prime Minister Shinzo Abe called for an emergency UN Security Council meeting.

Monetary policy

- Lenders embracing central bank's interest-free loans: The Nikkei reported a Bank of Japan program providing no-interest funds to eligible commercial banks is gaining traction, with ~¥3T ($27.1B) in new loans set to be issued to private-sector lenders on Friday. This will lift the total balance of the program's lending to banks, both national and regional, to roughly 38T yen - up 40% over the past year.
- **Contradictory policies?** On the one hand, the BoJ has supplanted foreigners as the biggest buyer of Japanese equities, with Investment Trusts Association of Japan data showing the outstanding balance of investment trusts ballooning to ¥102T in August, hitting a fresh record amid ongoing BoJ ETF purchases. On the other hand, Financial Services Agency (FSA) officials have recently been talking to regional banks (motivated to boost returns in a zero rate environment) to gauge whether they have the knowledge and the ability to handle trading in a risky investment environment. The FSA has told them to strengthen their risk management processes amid doubts about the capacity of some lenders.

Macro & micro front

- (-/+) Tankan sentiment index for manufacturers fell 2 points to 27 in September, reflecting uncertainty on elevated regional tensions with North Korea. (+) However, Tankan index for the service sector rose 5 points to 34 marking the best reading since June 2015, led by retailers and information and communications firms.
- (+) Q3 MoF large firm business survey index +5.1 vs (2.0)
- (-) July final industrial production (0.8%) MoM vs preliminary (0.8%)
- (+) July core machinery orders +8.0% MoM vs consensus +4.8%.
- (=) July tertiary sector activity index +0.1% MoM vs consensus +0.1% and (0.2%) in prior month.
- GDP forecast: The Cabinet Office left its FY17 GDP growth forecast unchanged at 1.5%. FY18 growth is estimated at 1.4%.

Domestic Politics

- LDP struggles for consensus on amending constitution. The ruling Liberal Democratic Party has resumed talks on amending the constitution's war-renouncing Article 9, aiming to submit a proposal to parliament this fall, but opinions remain sharply divided within the party and beyond. Prime Minister Abe wants simply to add a reference to Japan's Self-Defense Forces to Article 9 and leave the article's existing language as is, though other LDP members have objected.

Fiscal & Monetary

- Japan seen adopting extra budget, despite no apparent need: A Reuters poll showed 22 out of 35 analysts expect the government to compile an extra budget for FY17 even though 31 respondents saw there is no need given the strength of Japanese and global economies. The poll also showed that most analysts believe the BoJ will keep the current rate of monetary easing until at least late next year as the pace of gains in consumer prices remains very slow.

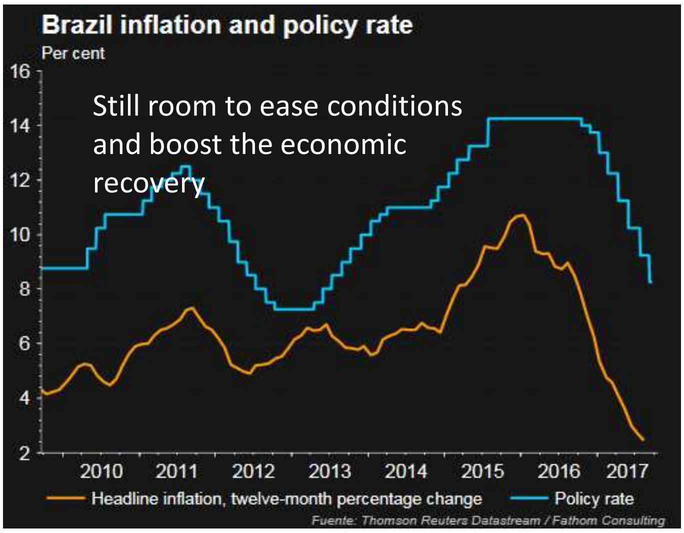
Japanese equity market seen in perspective

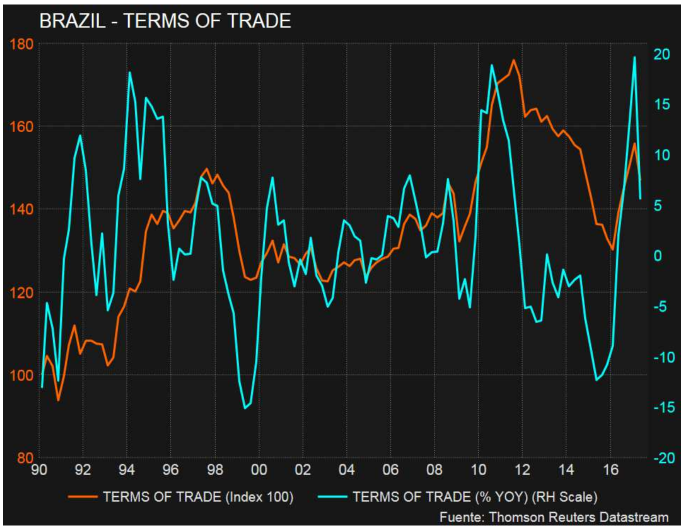
- The Nikkei recently discussed in a report how share prices on the Tokyo Stock Exchange have rebounded slightly since late 2012, in part due to Prime Minister Abe's reflationary policies, but the report stresses that the long-term trend in Japan since the end of the last century has been lackluster. It noted the Nikkei 225 is up only about 40% over that period, far behind the NASDAQ, which is up 160%, and Germany's DAX, which has climbed 90%. Why such underperformance? Could it continue? In the report, it was argued that a lack of momentum has been evident within its most valuable companies, particularly tech companies, which Japan has fewer of compared to the US and Europe.
- Electric-car stocks enjoy great momentum: Signs that China may join the UK and France in phasing out sales of fossil-fuel-burning automobiles sent share prices soaring for manufacturers of electric cars and their components, propelled by hopes that heavy demand for greener vehicles is close at hand. Notable related moves included Panasonic, Sumitomo, Titan Kogyo and Nidec.

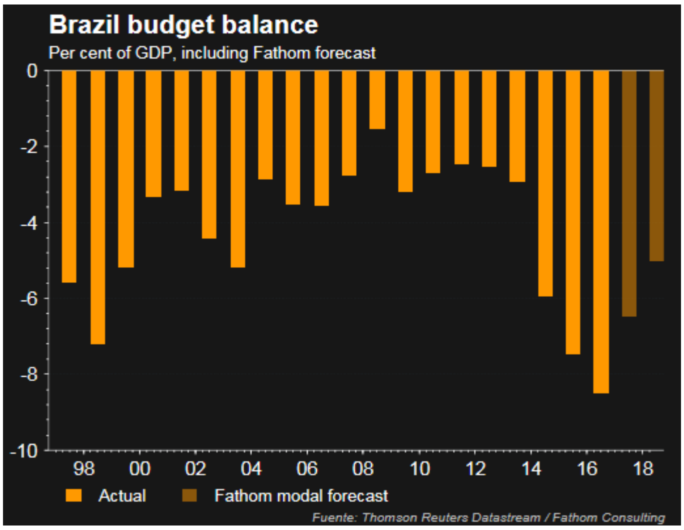
Financial Markets

- **Equity** (Nikkei 225): ***NEGATIVE (EXPENSIVE)***. Exit point at 19,528.
- **Bonds: *NEGATIVE (EXPENSIVE)***. 10Y bond target 0%.
- **FX: *EXPENSIVE***. USD-JPY fundamental target at 115.

Brazil: GDP growth accelerates despite the political uncertainty







Politics

- **Temer's current situation:** Over the last weeks, the president's political situation has improved, considering the damage imposed by the JBS plea bargain deal in mid-May. Temer has survived the Supreme Electoral Court trial in June and the initial charge of passive corruption in August, repealing it in Congress. The government's next move will focus on a second charge by the General Attorney, on the crimes of obstruction of justice and criminal conspiracy. In a turnaround in the case, audios have been discovered with indications that the JBS whistleblowers (Batista and Saud) were hiding information from Justice, which repealed the deal and led them to prison. Although this doesn't annul the evidence on Temer, it weakens the case in Congress even further. In the end, we believe the president will have the 172 votes necessary to repeal these charges once again. The political class has very little incentive to dismiss Temer, given the upcoming electoral period and the fact that he is in a position to take the fall for unpopular measures, amidst an economic recovery.
- **What are the risks ahead?** Even though the president's political situation has improved, there are still loose ends that could potentially inflict further damage. Antonio Palocci, former finance minister in Lula's administration, is negotiating a plea bargain deal, which could implicate not only the main players in the PT ("Workers' Party"), but also in the financial sector. Another risk is the incarceration of Geddel Vieira Lima, a former minister of Michel Temer and Dilma Rousseff, after the discovery of BRL 51 million in cash. Geddel could negotiate a plea bargain deal with the potential involvement of Temer and allies. A third risk is another charge from the General Attorney on criminal conspiracy practices, dating from at least 2006, implicating key PMDB figures such as Michel Temer, Eduardo Cunha, Eliseu Padilha and Moreira Franco. The impact of such risks are still uncertain, but they are potentially big.

Structural Reforms:

- Structural reforms status: The Labor Reform bill, the Spending Cap bill and the new long-term BNDES financing rate ("TLP") have been approved.
- The Labor Reform bill was finally approved in the Senate (by a wide margin of 50 votes in favor and 26 against). The few changes proposed do not impact the productivity gains expected from the original bill.
- The Social Security reform is still lacking a formal schedule since recent developments in Congress (initial charge on Temer) have delayed the discussion on the pensions bill. Nevertheless, we believe that there will be a vote on the bill in the Lower House in late October/early November, even if initially diluted (it can be subsequently adjusted by Ordinary Laws). If we are right, it could proceed to the Senate by next May, before the start of the electoral schedule, when congressmen pursue their own agendas seeking reelection.

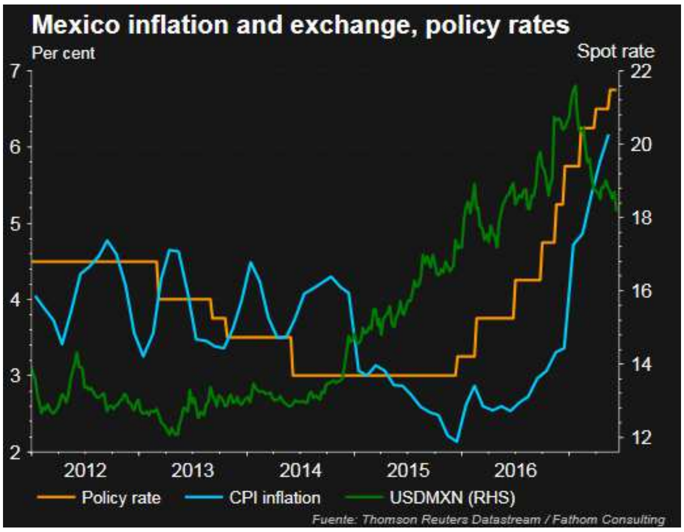
Economics

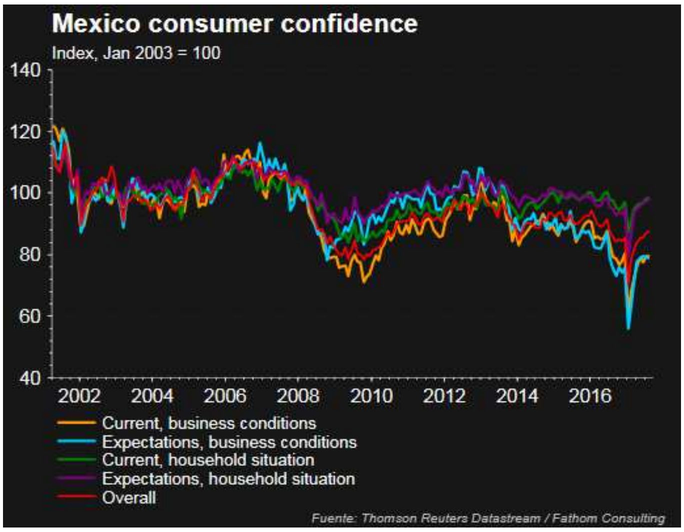
- Better than expected economic activity: GDP grew by 0.20% in 2Q17, relative to Q1. Strong results from domestic consumption and retail sales, but weak numbers from fixed capital investment. Another economic activity figure, the Central Bank's IBC-Br index, shows that the economy expanded by 0.41% in July (relative to June), driven by industrial production, and 1.41% in 12 months.
- Still low inflation: IPCA in August rose by 0.19% (+2.46% in 12 months), on yet another lower than expected figure. Important to highlight that food prices exert a huge downward impact, falling by 5.4% in 2017. We believe that inflation will remain low in the short term, given a still high unemployment rate and idle industrial capacity.
- Micro agenda moving forward: As part of an effort to boost revenues, the government has released a plan to privatize or award public assets and infrastructure to the private sector. These include airports in Sao Paulo, energy distribution plants from Eletrobras and the paper money printing company, Casa da Moeda.

Financial Markets:

- **New! Equities (Ibovespa):** ***EXPENSIVE***. **Central point of our fundamental target range 68,500. Exit point 72,000**. Even having adjusted our year-end PE target, the Ibovespa has already surpassed our exit point for year-end (72,000 points). Moreover, we expected that level to be reached only after the approval of all structural reforms planned by the government. On a risk-adjusted basis, we prefer high duration federal government bonds rather than equities..
- **Government Bonds:** ***POSITIVE***. 10Y bond Loc target 9.75%. 10Y bond in USD target 5.25%.
- **New! Foreign Exchange:** ***FAIR VALUE.*** New target BRL/USD at 3.1 (from 3.2).

Mexico: Any change resulting from NAFTA talks is likely to be gradual and neutral





BANXICO

- Banxico's rise cycle seems to have come to a halt. Analysts' forecasts for the next interest rate movement, range around a 25bp cut but this will only take place in the 2nd quarter of next year.

Macro Front: GDP & Inflation

- The central bank has adjusted its growth forecasts to between 2%-2.5% for this year and between 2-3% for 2018.
- Banxico suggests that at 6.66% inflation in August, price changes may now have peaked.
- In its monthly inflation report, the central bank projected a downward trend for inflation starting in September or October this year. This could bring inflation below the long-term goal of 3% +/-1% by the end of 2018.
- S&P and Fitch changed Mexico's sovereign grade outlook from negative to stable anticipating a better-than-expected outcome for NAFTA and recognizing Mexico's public finance consolidation.

NAFTA negotiations

- U.S. negotiators have told Canada and Mexico they expect to table full details of the Trump Administration's demands regarding the North American Free Trade Agreement in a bid to cut a deal by year end. Canada is preparing for the third round as the talks move to Ottawa. Foreign Minister Chrystia Freeland will spend Friday in an intensive series of consultations in Toronto ahead of the negotiations.
- We believe that any change is likely to be gradual. US corporations, particularly automakers, would be at substantial risk of supply chain disruptions. The 'lobby' of American farmers would also oppose.
- Two-thirds of the 38 banks and institutions responding to the survey expect the outcome of the renegotiation to be largely neutral.
- The changes are likely to encompass dispute settlement mechanisms, labor and environmental standards, protections for supply management and rules of origin, among other areas, and the greatest impact could be on the automotive and agricultural industries. Our guess is that the bulk of the negotiations will relate to the "Rules of Origin". These determine if a product is eligible for free trade. One of the main rules is Value Added Content (or Regional Value Content), which in turn is divided into two groups: Product Specific or Wide Regime. The latter contains "*De minimis*" rules (that stipulate the maximum portion of external materials in one product) and the "Accumulation rule" (that allows imported products to be treated as if they were domestic). These rules are very flexible and the negotiation will probably come from this side.

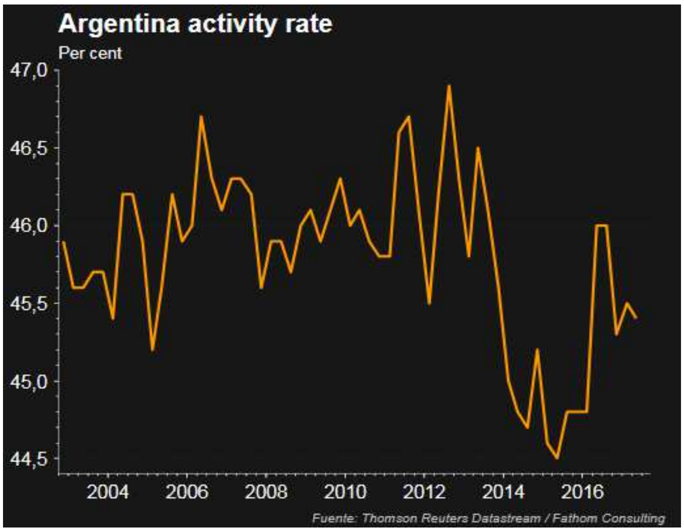
Public Finances

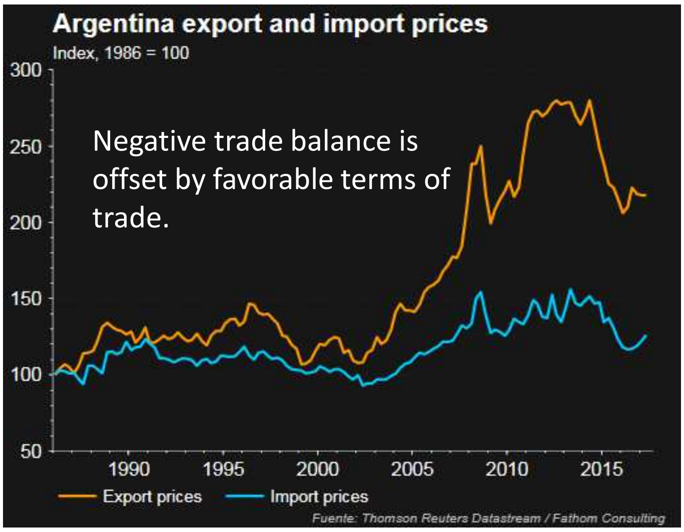
- Fiscal budget and primary surplus in July showed a 2% reduction in public expenditure and a 7.2% increase in revenues on a 12 month basis.
- Finance ministry has published its macroeconomic and public finance forecasts for 2018 budget. The main indicators are a projected 2-3% economic growth, 3.0% inflation, 18.10 exchange rate (in a 2.4% US GDP growth scenario).

Financial Markets

- **Equities (IPC Gral): *FAIR VALUE***. Fundamental central point: 51,000 points; Exit point: 52,000 points. Despite numerous recent geopolitical events, Mexican stocks are holding up well in a favorable global environment, with recent upward revisions for emerging markets that have had a positive impact on Mexico's IPC index. The index managed to break the psychological 50,000 level and it would not be surprising if it reaches the 53,500 mark (the target for this year's close by the more optimistic brokers). Measured in dollars, the IPC index is now at its highest level since November 2015, being the best performing index among emerging markets (30%). We recommend a slight reduction in exposure to this market.
- **Bonds: *MIXED***. 10Y bond Loc target 7.0%. 10Y bond in USD target 4.35%. We expect a flatter yield curve due to stable inflation expectations and a low growth scenario. We expect the M10-T10 spread to be around 450-475 bp. We are predicting one more rate hike by the Fed and no more movements on the Mexican rate scene. For the US denominated 10Y bond we forecast a 150-180 spread against the US T-bond.
- **NEW! FX: *CAUTIOUS***. Target 18.20. MXN appreciation dynamics have weakened and the Mexican currency has been trading in the 17.50-18.00 range. The possibility of a moderate pace of rate hikes by the Fed, together with Banxico's aim to try and break the rate hike cycle, have weighed on the MXN. In the longer term, fewer risks associated with the NAFTA negotiations put MXN in a stronger position against USD.

Argentina: Primary elections bring relief to the government





- The previous government used monetary issuance to cover fiscal gap. After holdouts issue was resolved, the current government changed the source of financing and tapped international debt markets to cover fiscal needs until it can implement the reforms needed to fix fiscal problems. Two aspects are key for this plan to succeed: Low leverage offering a good starting point (Debt to GDP @53.8% and External Debt to GDP @31.7%) and government legitimacy, to be tested in mid-term elections.

Latest developments:

- On August 13th, Argentina had its primary elections in which candidates were chosen for October 22nd mid-term election that will renew half of the lower chamber and one third of the Senate. Expectations were that the government's party would perform well at a national level but lose by a 3-4% margin in Buenos Aires Province where it competes with former president Cristina Fernandez de Kirchner. The results showed that the government not only performed well nationally, but also lost by just 0.21% in BA Province. These better than expected results set the scene for a good performance by the government in October. This mid-term election is important for 2 reasons: firstly because it is the first election after Macri's victory in December 2015 (he won with a newly formed coalition, Cambiemos) and secondly, because it confirms that the average voter agrees with the reforms being implemented in the country so far.

Macro Front

- **Economic Activity:** GDP 0.3% YoY in June according to EMEA proxy for GDP growth. This reading points to 1.6% growth in the first 6 months of the year led by construction and fisheries. Economic growth continued across almost all sectors, with 14 out of 15 posting YoY growth. Growth in the manufacturing and retail sectors was especially notable, which posted positive figures for the first time this year. We keep our target of 2.75% Real GDP growth for 2017.

Fiscal

- **Fiscal**: Cumulative primary fiscal deficit of 1.70% for the first 7 months of the year. This reading represents just 40% of the government's target for the entire year (4.2% primary deficit). The reasons behind this strong performance in public finances are various: (1) 0.30% of tax amnesty extraordinary collections, and (2) Zero capital spending in the first part of the year. Increases in social transfers and capital expenditure are expected to rise in the months ahead, which will probably lead to poorer fiscal figures. In general, we believe that the government will hit its official target by year-end.

Prices

- August inflation reading of 1.4% MoM (1.7% in July). YTD inflation running at 14.4%, already exceeding the lower threshold of the government's target range (12–17%). However, the last four months have shown a deceleration in the inflation path compared to the first months of the year (1.40% vs 2.2% MoM). Central bank maintains its hawkish stance focused on getting inflation into target range.
- Current reference rate stands at 26.25% (last time it moved was in April, with a 150bp hike). CB stated that it intends to bring monthly inflation down to 1% MoM by year-end. Remember that in order to hit the government's target, inflation needs to average 0.65% between September and December, which is why we think the target will not be met and expect the inflation rate to close 2017 around 21%. Median estimations point to 22% inflation at year-end.

Financial Markets:

- **New! Bonds: *NEUTRAL***. Target Govt Bond 10Y USD: 6% (from7%). Spreads widened before the primary (PASO) elections but narrowed more intensely following the election results. Chances of a good election result in October have increased considerably, and thus there is a strong case that these levels are here to stay and that spreads could reach new lows. If the government gets good results in the election, the focus will be on reforms, and market participants will wait for progress on this matter.
- **New! FX: *NEUTRAL***. 1H17 was extremely stable for ARS, however a combination of factors have caused the currency to depreciate 14% (from 15.60 to 17.80) in the last few months: Brazilian political turmoil starting in May, MSCI's decision not to upgrade Argentina to Emerging Market in June, CFK candidacy for the senate in June, and the fact that producers are selling less than expected despite a great harvest. After the government's strong electoral results in August, the peso appreciated but below pre-PASO levels. A government win in October should be positive for ARS but we continue to think that any depreciation should be adjusted more to inflation. We raise our year-end target for ARS/USD to 18.00 (a 13% depreciation for the year). This is a lower loss than that implied by the inflation spread, but we think aspects such as big USD inflows (tax amnesty) could favor the ARS.

Equity Markets

▪ GLOBAL EQUITY INDICES - FUNDAMENTAL ASSESSMENT

Index	Net Margin 2016	Andbank's Sales growth 2017	Sales per Share 2017	Andbank's Net Margin 2017	EPS 2017	EPS Growth 2017	Current PE (forward) E[EPS 2017]	Anbank's PE estimate 2017	INDEX CURRENT PRICE	2017 Central Point (Fundam range)	2017 E[Perf] to Centr. Point	2017 Exit Point	E[Perf] to Exit point
USA S&P 500	10,3%	10,0%	1.276	10,0%	128	7,2%	19,67	18,81	2.510	2.400	-4,4%	2.520	0,4%
Europe STXE 600	6,9%	3,7%	313	7,6%	24	14,6%	16,25	15,50	386	368	-4,6%	405	4,9%
Spain IBEX 35	7,3%	3,5%	7.648	8,5%	650	20,6%	15,82	15,80	10.287	10.271	-0,2%	11.298	9,8%
Mexico IPC GRAL	7,4%	7,0%	33.048	7,1%	2.356	2,9%	21,28	21,65	50.137	51.003	1,7%	52.278	4,3%
Brazil BOVESPA	7,6%	5,5%	53.915	7,7%	4.151	6,4%	17,72	16,50	73.567	68.499	-6,9%	71.924	-2,2%
Japan NIKKEI 225	5,1%	2,5%	19.981	5,2%	1.039	4,4%	19,59	17,90	20.356	18.599	-8,6%	19.529	-4,1%
China SSE Comp.	8,5%	7,5%	2.689	8,0%	215	1,1%	15,57	15,00	3.349	3.226	-3,7%	3.388	1,1%
China Shenzhen Comp	8,2%	8,5%	890	7,8%	69	2,8%	28,63	28,50	1.988	1.979	-0,5%	2.078	4,5%
Hong Kong HANG SENG	14,8%	3,0%	12.535	14,5%	1.818	0,6%	15,17	12,50	27.568	22.720	-17,6%	24.992	-9,3%
India SENSEX	10,5%	11,0%	15.851	10,5%	1.664	10,7%	18,93	18,00	31.498	29.958	-4,9%	32.954	4,6%
MSCI EM ASIA (MXMS)	12,6%	7,5%	407	12,6%	51	7,4%	10,49	8,75	538	449	-16,6%	494	-8,2%

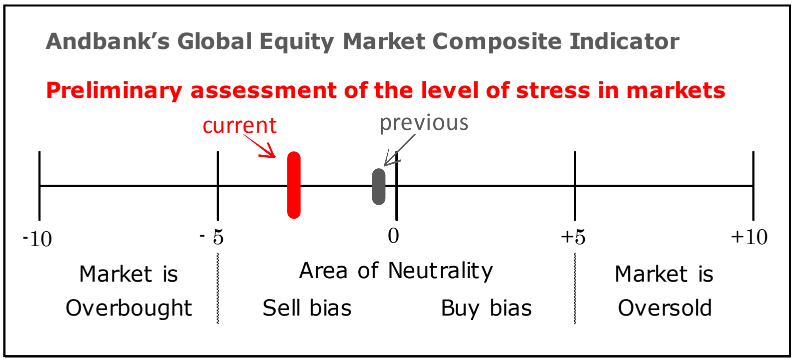
UPWARD REVISION DOWNWARD REVISION

ANDBANK ESTIMATES

▪ RISK-OFF PROBABILITY: Short-term view

Andbank's Global Equity Market Composite Indicator (Breakdown)

	Previous Month	Current Month
Buy signals	4	2
Positive Bias	4	2
Neutral	4	4
Negative Bias	5	8
Sell signals	5	6
FINAL VALUATION	-0,7	-3,2



Andbank GEM Composite Indictor: Our stance for equity indices in developed markets worsens this month and maintains a sell bias. Our broad index has moved from -0.7 last month to -3.2 (in a -10/+10 range), settling in an area that suggests that the market is overbought. We have therefore removed the "slightly overbought" assessment from our statement and replaced it by a clearer "overbought".
Positioning indicators: In aggregate, these indicators show a mixed picture, with hedge funds and speculators showing cautious positioning (underweight) while classical asset allocators still remain exposed to the equity market with a certain intensity (in relation to historical patterns).
Flows: According to Datastream, flows towards equity markets lost momentum in September ($-3.3bn in US and $-5.2 in Europe), while we have seen inflows into MM instruments globally ($+102bn) and fixed income instruments ($+63.8bn). This lack of momentum in equity inflows could last, since flows have not been particularly aggressive.

▪ TECHNICAL ANALISYS: Trending view 1/3 months. Supports & Resistances

- **S&P:** ***BULLISH / BULLISH***. Supports 1&3 month at 2405. Resistance 1&3 month at 2538/2573
- **STOXX600:** ***BULLISH / BULLISH***. Supports 1&3 month 376/368. Resistance 393/404
- **IBEX:** ***SIDEWAYS-BULLISH***. Supports 1&3 month at 10,000. Resistance 10,758/11,184
- **€/$:** ***BULLISH / BULLISH*** Supports 1&3 month at 1.1661. Resistance 1.2168/1.2397
- **Oil:** ***BULLISH / BULLISH*** . Supports 1&3 month at 45.41/42.06. Resistance 1&3 month at 52.2/55.2
- **Gold:** ***SIDEWAYS/SIDEWAYS-BULLISH***. Supports 1&3 month at 1263/1251. Resist 1&3 months at 1375
- **US Treasury:** ***SIDEWAYS BEARISH*** Supports 1&3 month 2.02/1.97. Resist 1&3 months at 2.42

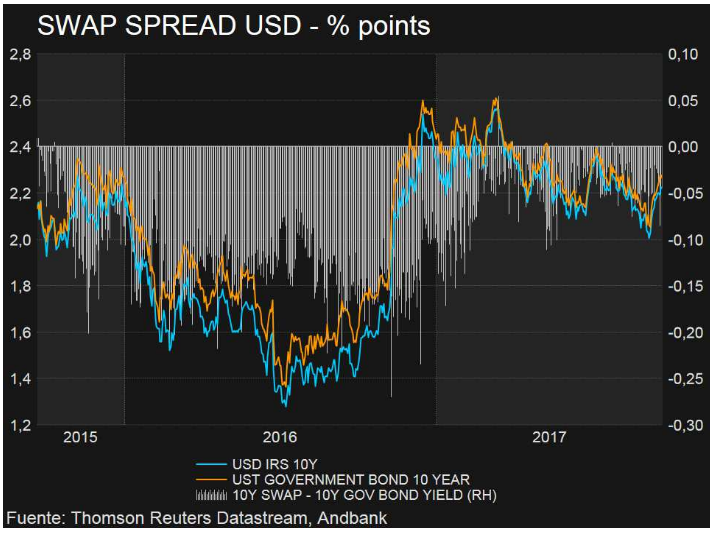
Fixed Income – Core Country Bonds:

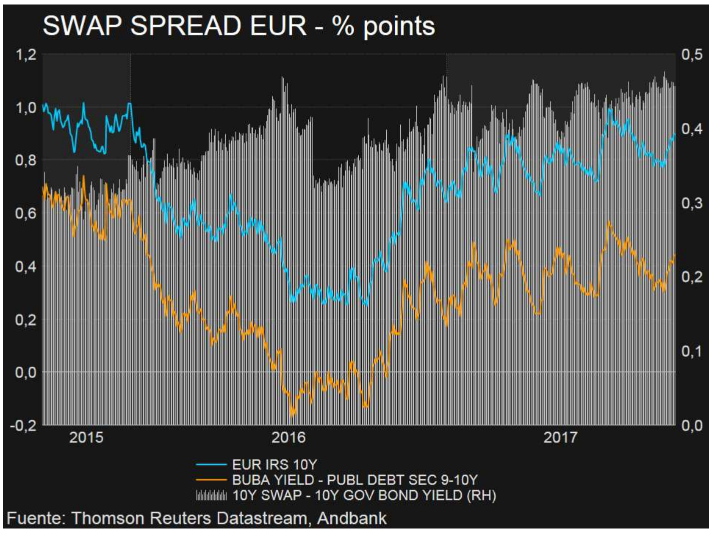
❑ UST 10Y BOND: Floor 1.85%, Ceiling 3.2%. Fundamental Target 2.65%

1. **Swap spread:** The swap spread declined to -4 bp (from -2 bp last month). For this spread to normalize towards the +15 bp area, with our long-term CPI expectations (reflected in the swap rate) anchored in the 2.0% area, the 10Y UST yield would have to move towards **1.85%**.
2. **Slope:** The slope of the US yield curve flattened to 82 bps (from 96 bps). With the short-end normalizing towards 1.4%-1.5% (today at 1.44%), to reach the 10Y average slope (of 178 bp) the 10Y UST yield could go to **3.2%**.
3. **Real yield:** A good entry point in the 10Y UST would be when real yield hits 1%. Given our CPI forecast of 2%, the UST yield would have to rise to **3%** to become a "BUY".

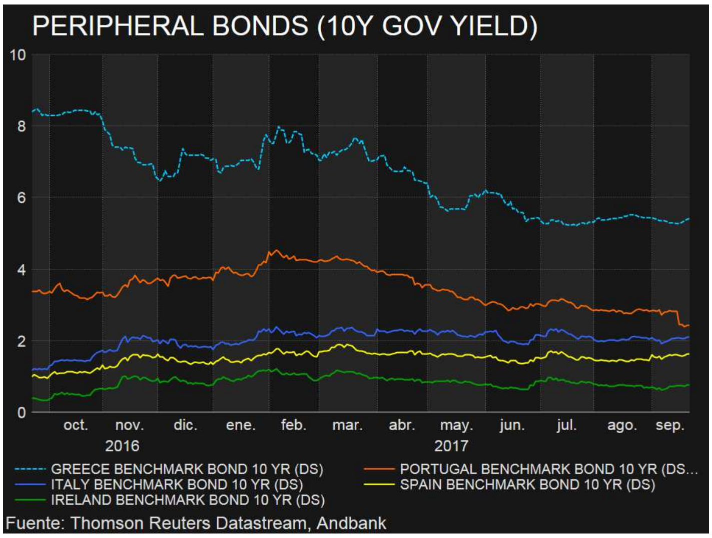
❑ BUND 10Y BOND: Ceiling 0.95%. Fundamental target 0.70%

1. **Swap Spread:** The swap spread upticked to 46 bp (from 44 bp last month). For the swap spread to normalize towards its long-term average of 35 bp, with our long-term CPI expectations (reflected in the swap rate and anchored in the 1.25% area), the Bund yield would have to move towards **0.90%** (entry point).
2. **Slope:** The slope of the EUR curve steepened significantly during the summer to 116 bp (from 97 bp). If the short end "normalizes" in the -0.25% area (today at -0.72%), to reach the 10Y average yield curve slope (126 bp), the Bund yield would have to go to **1.01%**.





Fixed Income – Peripheral Bonds



❑ *10Y Government Bond yield targets*

- **Spain:** 1.90%
- **Italy:** 2.30%
- **New! Portugal:** 2.60% (from 3.00%)
- **Ireland:** 1.40%
- **Greece:** 7.50%

Fixed Income – EM Govies. Why so calm?

The not-so-known negative factors:

1. The flurry of hawkish comments from developed world central bank officials threatens to call time on the EM rally. If the rise in developed market bond yields persists, investors face the risk that liquidity will recede and emerging market bond yields will rise steeply too (as developed market bonds sold off last week, investors in the largest US dollar denominated emerging market bond ETF withdrew more than US$800m—the biggest outflow in the fund's history).
2. The emerging markets have US$280bn of US dollar-denominated debt due to mature by the end of 2018. That is considerably more than the US$200bn raised by emerging market borrowers in new issues over the past 12 months. Clearing this "maturity hurdle" in an environment of rising yields will be challenging to say the least.

The not-so-known positive factors:

1. As developed market yields rise on the back of improved growth prospects, the resulting rise in demand for emerging market exports will boost corporate margins in the emerging world.
2. The new normal for structural growth rates in developed economies is settling well below previous levels. This means that developed world yields may well prove to be capped.
3. The new intervention "playbook" used by central banks to defend their currency: "Sell USD exposure through Non-deliverable Forward Contracts settled in Local Currency". The advantages are clear: (1) Standard forward contracts do not immediately affect the value of FX reserves. (2) The buyers of fw USD exposure are local branches of international banks (interested in paring loses). To hedge this higher forward exposure, they sell USD against local currency in the spot market, resulting in a *de facto* outsourcing of the central bank's open market operations. (3) These commercial banks benefit from higher o/n rates or any increase in o/n rates resulting from a fall in the currency. Further depreciation in the local currency results in a loss in their spot trade but a gain in their forward position. (4) The central bank can withstand downward FX pressures while satisfying demand for its USD held as FX reserves. (5) But this strategy is not a magic bullet. If depreciation persists, forward contracts must be rolled over, with the CB making a loss each time. However, the strategy is aimed at buying time for fundamental structural reforms.

Our Rule of Thumb:

To date, our rule of thumb for EM bonds has been "buy" when the following two conditions are met:

1. The US Treasury bond is cheap or at fair value.
2. Real yields in EM bonds are 150 bp above the real yield of the UST bond.

Is the UST cheap or at fair value?

✓ Historically, a good entry point in the 10Y UST has been when real yields are 1.75%. Given the "new normal" of ZIRPs, a good entry point in the 10Y UST bond could be **when the real yield is 1%.** Given our 2017 target for US CPI of **2%**, a theoretical fair value (entry point) should be with nominal yields at **3%**. **Therefore the first condition is not met.** With a longer-term view, our expected average inflation is around 1.5%-2%, meaning that a good entry point in UST could be 2.5%-3%.

Do real yields in EM bonds provide sufficient spread?

✓ A good entry point in EM bonds has been when EM real yields were 150bp above the real yield of the UST when the UST is at fair value. Assuming that the first condition is met, we should only buy those EM bonds with a real yield 1.5% above the real yield in the UST (that is, a 2.50% real yield).

		10 Year Yield Govies	CPI (y/y) Last reading	10 Year Yield Real	Projected change in Yield
EM ASIA	Indonesia	6,49%	3,82%	2,67%	-0,75%
	India	6,62%	3,36%	3,26%	-1,00%
	Philippines	4,66%	3,10%	1,56%	-0,50%
	China	3,60%	1,80%	1,80%	-0,50%
	Malaysia	3,91%	3,21%	0,70%	0,00%
	Thailand	2,23%	0,25%	1,98%	-0,50%
	Singapore	2,14%	0,56%	1,58%	-0,50%
	South Korea	2,28%	2,59%	-0,31%	1,00%
	Taiwan	1,03%	0,91%	0,12%	0,00%
EME	Turkey	10,68%	10,68%	0,00%	0,00%
	Russian Fed	7,58%	3,30%	4,28%	-1,00%
LATAM	Brazil	9,76%	1,73%	8,03%	-1,00%
	Mexico	6,81%	6,72%	0,09%	0,00%
	Colombia	6,63%	3,93%	2,70%	-0,75%
	Peru	5,59%	3,18%	2,41%	-0,75%

Commodities – Energy (Oil, WTI).

Fundamental target at $45. Buy at $30. Sell at $55.

Short term drivers for oil prices (news flow):

- **(-)** Andy Hall, the oil trader known to many as "God" and one of the best-known commodity dealers of the last three decades, said he decided to close his flagship hedge fund (Astenbeck Master Commodities Fund) amid a deteriorating outlook for prices next year. "The fact that OPEC has had to talk about further extending its production cuts is ultimately a sign of weakness, not of strength". "The medium-term outlook for oil still looks challenging with, if anything, balances for 2018 having deteriorated in recent weeks". Hall warned that U.S. shale firms would continue to flood the market: "With the WTI forward curve back above $50, shale operators will be able to profitably hedge incremental production for 2018".
- **(-?)** Norway's voters reelected Conservative PM Erna Solberg despite opposition from the country's Green Party (which had called for an end to Norwegian petroleum exploration). However, Solberg's party lacks a legislative majority and will require support from two green-minded, center-right allied parties (one of which wants strict limits on oil and gas exploration) in order to pass legislation.
- (-) Saudis to maintain Asian allocations despite output cuts. Saudi Arabia will supply full contracted volumes of crude to at least five north Asian term buyers in October. The allocations are in contrast to the steep cuts in the September allotment, suggesting that there is plenty of spare capacity.
- (-) Harvey and Irma will dent energy demand from consumers and refiners in affected regions, with the end result being to push millions more barrels of crude into oil caverns and floating tankers at a time when storage is already in heavy use. These factors will undermine efforts by global producers (such as OPEC and its allies) to rebalance the market by cutting output.
- (--) Saudis discuss output cuts extension with Venezuela and Kazakhstan. Russian energy minister says it is premature to extend global oil deal: Saudi Energy Minister Khalid al-Falih this weekend discussed with his Venezuelan and Kazakh counterparts the possible extension of OPEC's output-cut pact, which is currently set to expire at the end of March 2018. Non-OPEC Kazakhstan is aiming for a standalone deal with OPEC on restraining its crude production due to a need to crank up output at its Kashagan field. Venezuelan oil minister Del Pino said the ministers agreed to leave all options open and urged looking at exemptions previously granted to Nigeria and Libya.
- (-) China working on timetable to ban fossil-fuel autos: China will set a deadline for automakers to end sales of fossil-fuel-powered vehicles, becoming the largest market to do so, coming as part of a larger effort to cap carbon emissions by 2030 and help clean up smog-choked cities. While no date has been set as yet, one commentator noted he expects the implementation of a ban could be later than 2040, given the country's size.
- (-) Rosneft head says "oil rising on weaker dollar, not output pact": The chief executive at Rosneft, Russia's top energy company, said the main driver behind the recent rise in oil prices is a weaker dollar and not a global effort to curb output. He said the US is supporting shale producers through dollar depreciation. When asked if a global output pact should be extended, he said Saudi Arabia would likely make its decision based on its plans to list Saudi Aramco (Wow!).
- (+) Price of North Sea crude being held in floating storage has declined sharply since August, a sign that a long-awaited market rebalancing is gaining momentum. Two supertankers being used to store North Sea crude contain about 4M barrels of oil, down from closer to 10M barrels two weeks ago, in a sign that the whole market could be tightening up.

Structural drivers for oil point to low prices in the long run...

- **(-) Alternative energies picking up the baton:** Producers must bear in mind that the value of their reserves is no longer dictated by the price of oil and the quantity of their reserves, but rather by the amount of time for which they can pump before alternative energies render oil obsolete. In order to delay this deadline as long as possible, it is in producers' interests to keep the oil price low as long as possible (keeping the opportunity cost of alternative energy sources as high as possible).
- **(-) Growing environmental problems will gradually tighten legislation and production levels:** The value of producers' reserves depends on the amount of time they can pump at current levels before tougher environment-inspired regulation comes in. Saudi Arabia has between 60 to 70 years of proven oil reserves at current output, but with growing environmental problems that will likely continue to put big pressure on the market for fossil fuels over the coming decades. Riyadh's most serious risk is of sitting on a big chunk of "stranded reserves" that it can no longer extract and sell. Saudi Arabia (and other producers) therefore has a powerful incentive to monetize as much of its reserves as soon as possible by pumping as much oil as it can (if only to fund the construction of a less oil-dependent economy).
- **(-) The re-entry of Iran is a game changer** equivalent to a structural change in the global energy market. Iran insists that it must be allowed to step up its output from 3.6M to 4M bbl/day.
- **(-) OPEC's producers are no longer able to fix prices:** Back in the 1970s or the early 2000s, the exporters' cartel agreed to cut output and the approach worked well since it was easy to defend market share as the principal competition was among oil producers (in particular between Opec and non-Opec producers). That is not the case today. Today's biggest threat to any conventional oil producer comes from non-conventional producers and alternative energy sources. Energy cuts from conventional oil will easily be offset by a quick increase in shale oil production, which means that Opec producers are no longer able to fix prices.
- **(-) Shale producers to raise output heavily at $60 in oil price:** The IEA said that an oil price of $60 would be enough for many US shale companies to restart stalled production.

Commodities – *Precious (Gold)*

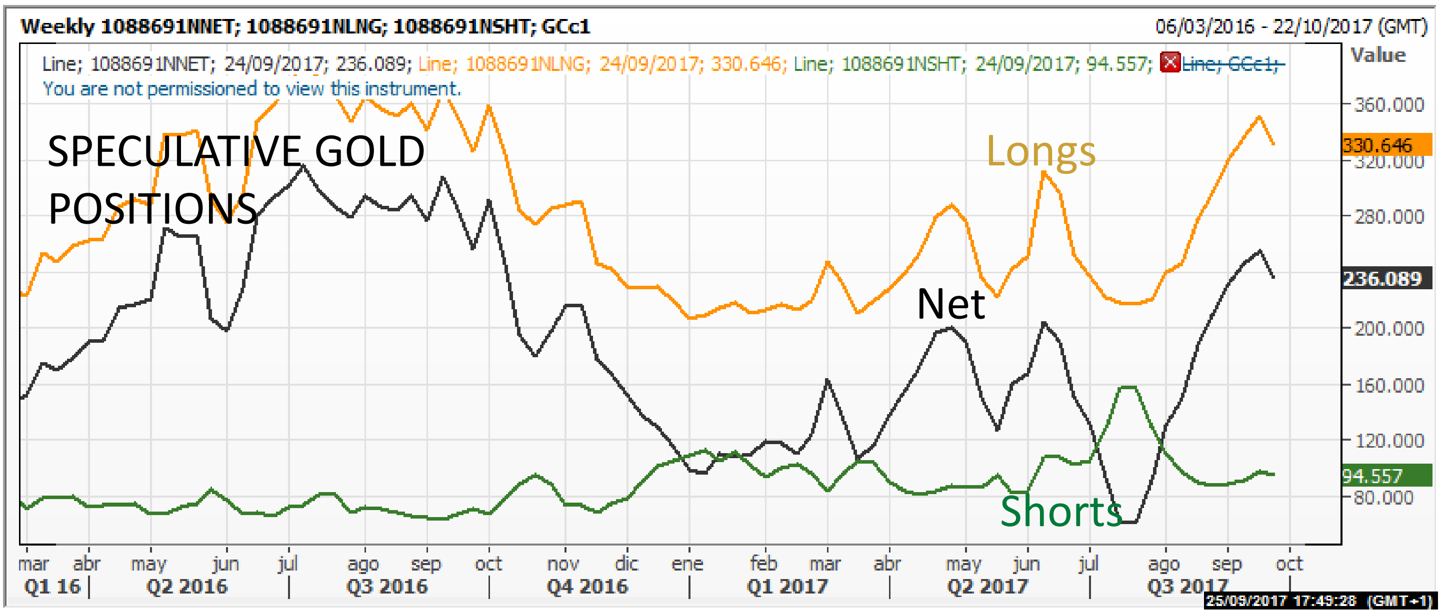
Fundamental price US$ 1,000/oz. Buy at US$ 900/oz. Sell above US$1,200.

Negative drivers:

1. **Gold in real terms.** In real terms, the gold price (calculated as the current nominal price divided by the US Implicit Price Deflator-Domestic as a proxy for the global deflator) rose to $1,145 (from $ 1,112 last month). In real terms gold continues to trade well above its 20-year average of $802. Given the global deflator (now at 1.1314), for the gold price to stay near its historical average in real terms, <u>the nominal price (or equilibrium price) must remain near **US$907**</u>.
2. **Gold in terms of Silver (Preference for Store of Value over Productive Assets):** This ratio has ticked UP to 76.4x (from 75.91x last month) and remains well above its 20-year average of 61.20, suggesting that <u>Gold is expensive (at least in terms of silver)</u>. For this ratio to reach its long term average level, assuming that silver is well priced, <u>then the Gold price should go to **$1,038 oz.**</u>
3. **Gold in terms of Oil (Gold / Oil):** This ratio ticked up in summer to 25.75x (from 25.67x last month) still well above its 20-year average of 14.90. Considering our fundamental long-term target for oil of US$45pbl (our central target), the price of gold must approach <u>**US$670** for this ratio to remain near its LT average level</u>.
4. **Gold in terms of the DJI (Dow Jones / Gold):** This ratio has moved to 17.24x (from 17.30x last month), still below its LT average of 20.19x. Given our central point (target price) for the DJI of 20,000, the price of gold must approach <u>**US$990** for this ratio to remain near its LT average</u>.
5. **Gold in terms of the S&P (Gold / S&P500 index):** This ratio rose to 0.518x (from 0.509x last month), but is still well below its LT average of 0.5859x. Given our target price (central point) for the S&P of $2,400 the price of gold must approach <u>**US$1,406** for this ratio to remain near its LT average</u>.
6. **Speculative Positioning:** CFTC-CEI 100oz Active Future non-commercial contracts: longs rose to 330k (from 217.2k). Shorts fell to 94.5k (from 157.1k) => Thus, <u>the net position rose sharply to +236k (from +60.1k)</u>, producing the largest long position since October 2016, suggesting that Gold is expensive.
7. **Financial liberalization in China.** Higher "quotas" each month in the QFII program are widening the investment alternatives for Chinese investors (historically focused on gold).

Positive drivers:

1. **Negative yields still make gold attractive.** The disadvantage of gold relative to fixed income instruments (gold does not offer a coupon) is now neutralized, with negative yields in a large number of global bonds, although the importance of this factor is diminishing as yields continue to rise.
2. **Relative size of gold:** The total value of gold in the world is circa US$6.9tn, a fairly small percentage (3.2%) of the total size of the financial cash markets (212tn). The daily volume traded on the LBMA and other gold marketplaces is around US$173bn (just 0.08% of the total in the financial markets).



Currencies – *Fundamental Targets*

- ***EUR/USD:* (NEW!) Mid-term target: 1.10-1.15**

Flows: Net notional in USD Global positioning plummeted during the summer and settled in negative territory to the tune of $-16.65bn (vs $-9.55bn two months ago) marking a new fresh low in global USD positioning. This is now well below its peak of +$28.7bn net longs seen in September 2016 and is showing a -2.1 sigma underweight on a 3-year z-score basis, which makes the "USD Short" the most crowded position globally. **This figure suggests that USD is now oversold.** Meanwhile, EUR positioning remains in a net long position, although it has recently reverted trend. Long contracts in EUR now total $9.41bn (much lower than the +$13.23bn two months ago). Despite this recent reversion in EUR positioning, current net long positions are still far greater compared to the -19bn net shorts seen last year (see table).

Drivers: In the absence of a political turnaround in the US, and with no firm steps to end the political chaos inside the White House (and within the GOP), **technical analysis will dominate**. According to our technical analysts, breaking through the 1.17 resistance level (which we thought would not be breached) fixes the new resistance at 1.20 (1 month) and 1.22 (3 months). However, recent outcomes in the German elections suggest a lack of momentum for the euro.

Fundamental Mid-term Target at 1.10-1.15: We think it unlikely that we will reach our original target of 1.05 this year (although it was reached in 1Q17), so we set a new preliminary mid-term target in the 1.10-1.15 range. Our structural view, still favorable to the dollar vs the euro, remains unchanged based on several factors: 1) Interest rate spread suggests that the EUR/USD should be around parity. See chart 2 on page 4. 2) In real terms, the euro is expensive at current levels to the tune of 5%, so no further drop in the greenback would be justified. 3) The recent appreciation of the euro will contribute to importing deflation, leading to a tightening in real monetary conditions and threatening the economic recovery in the Eurozone. 4) The Fed is much closer to real tightening by clearing its balance sheet and demonetizing its debt compared to the ECB, which will continue monetizing debt, albeit at a slower pace.

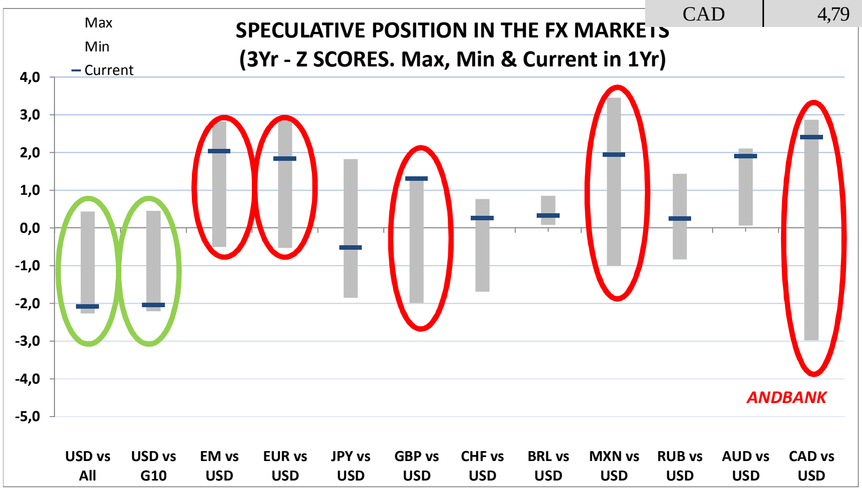
- ***JPY=* Target (115); *EUR/JPY:* Target (115).**

Several aspects suggest that JPY cannot continue to outperform: (1) With political shocks in Europe now allayed, investors are switching to Risk-on mode, meaning that safe haven flows into Japan are less likely now. (2) Real yield is lower in JGBs, and with the 10Y JGB controlled at 0%, there is little prospect that Japanese real yields will rise. (3) The BoJ has reiterated that it intends to stick to its ultra-loose monetary policy, at least until it hits the 2% inflation target (unachievable in the short-term). (4) Instead, the Fed is set to continue its rate-hiking path, which in turn will push up real yields in USD. (5) The prospect of the Fed paring back its balance sheet makes USD more attractive (or JPY less appealing). (6) JPY is no longer cheap in REER terms (it is expensive).

- ***GBP=* Target (0.83); *EUR/GBP:* Target (0.93)**
- ***CHF=* Target (0.95); *EUR/CHF:* Target (1.07)**
- ***MXN=* Target (18); *EUR/MXN:* Target (20.25)**
- ***BRL=* Target (3.1); *EUR/BRL:* Target (3.5)**
- ***ARS=* Target (18.0)**
- ***RUB:* NEUTRAL**
- ***AUD:* NEGATIVE**
- ***CAD:* NEGATIVE**
- ***CNY:* Target (6.75-6.80)**

Currency	Mkt Value of Net positions in the currency (Bn $)	Change vs last week in the currency (Bn $)	1-yr Max (Bn $)	1-yr Min (Bn $)	1-yr Avg (Bn $)	Current Z-score Z-score 3-yr
USD vs All	-16,65	-0,28	28,7	-16,6	9,3	**-2,08**
USD vs G10	-13,68	-1,21	28,4	-13,7	10,7	**-2,04**
EM	2,97	-0,93	3,9	-1,1	1,3	**2,03**
EUR	9,41	-3,46	14,3	-19,0	-1,2	**1,83**
JPY	-5,75	0,75	8,3	-14,2	-5,2	**-0,52**
GBP	-0,86	2,97	-0,9	-8,4	-4,7	**1,30**
CHF	-0,20	-0,03	0,9	-3,1	-1,4	**0,27**
BRL	0,35	-0,02	0,8	0,0	0,4	**0,32**
MXN	2,16	-1,14	3,3	-2,2	0,4	**1,94**
RUB	0,45	0,23	1,3	-0,3	0,5	**0,24**
AUD	5,81	0,75	6,0	-0,3	2,6	**1,90**
CAD	4,79	0,64	5,0	-7,3	-0,8	**2,40**

ANDBANK



3-year Z-Score:

$$\frac{\text{Current Position - 3 year average position}}{\text{3-year Standard Deviation}}$$

Values above +1 suggest positioning may be overbought

Values below -1 suggest positioning may be oversold

Market Outlook – Fundamental Expected Performance

Asset Class	Indices	Performance Last month	Performance YTD	Current Price 29/09/2017	Central Point (Fundam range)	Exp. Perf. To Central Point
Equity	USA - S&P 500	2,1%	12,1%	2.510	2400	-4,4%
	EUROPE - STOXX 600	4,1%	6,9%	386	368	-4,6%
	SPAIN - IBEX 35	0,4%	10,0%	10.285	10271	-0,1%
	MEXICO - MXSE IPC	-2,1%	9,8%	50.137	51003	1,7%
	BRAZIL - BOVESPA	3,8%	22,1%	73.567	68499	-6,9%
	JAPAN - NIKKEI 225	4,4%	6,5%	20.356	18599	-8,6%
	CHINA - SHANGHAI COMPOSITE	-0,4%	7,9%	3.349	3226	-3,7%
	CHINA - SHENZEN COMPOSITE	2,6%	1,0%	1.988	1979	-0,5%
	HONG KONG - HANG SENG	-1,9%	25,2%	27.554	22720	-17,5%
	INDIA - SENSEX	-0,5%	18,2%	31.482	29958	-4,8%
	MSCI EM ASIA	-1,2%	28,5%	538	449	-16,6%
Fixed Income Core countries	US Treasury 10 year Govie	-1,2%	2,9%	2,31	2,65	-0,4%
	UK 10 year Guilt	-2,5%	0,0%	1,35	1,50	0,2%
	German 10 year BUND	-0,7%	-1,8%	0,45	0,70	-1,6%
	Japanese 10 year Govie	-0,5%	-0,1%	0,06	0,00	0,5%
Fixed Income Peripheral	Spain - 10yr Gov bond	-1,0%	-0,7%	1,59	1,90	-0,9%
	Italy - 10yr Gov bond	-0,4%	-1,4%	2,15	2,30	0,9%
	Portugal - 10yr Gov bond	3,9%	13,8%	2,35	2,60	0,3%
	Ireland - 10yr Gov bond	-0,1%	0,9%	0,71	1,40	-4,8%
	Greece - 10yr Gov bond	-1,2%	15,7%	5,56	6,50	-2,0%
Fixed Income Credit	Credit EUR IG-Itraxx Europe	0,0%	0,6%	57,65	80	-0,6%
	Credit EUR HY-Itraxx Xover	-0,1%	2,8%	254,95	350	-2,3%
	Credit USD IG - CDX IG	0,1%	2,3%	56,50	55	0,7%
	Credit USD HY - CDX HY	0,6%	5,2%	315,82	323	1,1%
Fixed Income EM Europe (Loc)	Turkey - 10yr Gov bond	-2,0%	10,4%	10,68	10,00	16,1%
	Russia - 10yr Gov bond	2,3%	12,1%	7,58	7,00	12,2%
Fixed Income Asia (Local curncy)	Indonesia - 10yr Gov bond	2,0%	16,7%	6,49	6,50	6,4%
	India - 10yr Gov bond	-0,1%	4,0%	6,62	5,50	15,5%
	Philippines - 10yr Gov bond	0,8%	4,1%	4,66	4,25	7,9%
	China - 10yr Gov bond	0,7%	-2,5%	3,60	2,90	9,2%
	Malaysia - 10yr Gov bond	0,1%	5,5%	3,91	4,50	-0,8%
	Thailand - 10yr Gov bond	0,8%	4,6%	2,23	2,00	4,1%
	Singapore - 10yr Gov bond	-0,4%	4,4%	2,14	1,57	6,7%
	South Korea - 10yr Gov bond	-0,8%	-0,3%	2,28	2,50	0,5%
	Taiwan - 10yr Gov bond	0,0%	2,1%	1,03	1,00	1,2%
Fixed Income Latam	Mexico - 10yr Govie (Loc)	0,5%	10,3%	6,81	7,00	5,3%
	Mexico - 10yr Govie (usd)	0,4%	8,2%	3,62	4,30	-1,8%
	Brazil - 10yr Govie (Loc)	3,2%	22,0%	9,76	9,25	13,8%
	Brazil - 10yr Govie (usd)	-0,1%	12,0%	4,84	4,75	5,6%
	Argentina - 10yr Govie (usd)	0,3%	13,8%	5,71	6,00	3,4%
Commodities	CRY	3,5%	-4,9%	183,0	180,00	-1,6%
	Oil (WTI)	12,1%	-4,1%	51,5	45,00	-12,7%
	GOLD	-1,5%	11,9%	1.288,3	1.100	-14,6%
Fx	EUR/USD (price of 1 EUR)	-0,7%	12,2%	1,180	1,13	-4,6%
	GBP= (price of 1 USD)	-3,6%	-8,0%	0,75	0,83	11,3%
	EUR/GBP (price of 1 EUR)	-4,3%	3,3%	0,88	0,93	6,2%
	CHF= (price of 1 USD)	0,7%	-4,7%	0,97	0,95	-2,1%
	EUR/CHF (price of 1 EUR)	-0,1%	6,8%	1,14	1,07	-6,6%
	JPY= (price of 1 USD)	2,0%	-3,8%	112,42	115,00	2,3%
	EUR/JPY (price of 1 EUR)	1,2%	7,7%	132,59	129,38	-2,4%
	MXN= (price of 1 USD)	2,5%	-12,4%	18,15	18,00	-0,8%
	EUR/MXN (price of 1 EUR)	1,7%	-1,8%	21,41	20,25	-5,4%
	BRL= (price of 1 USD)	0,7%	-2,2%	3,18	3,10	-2,6%
	EUR/BRL (price of 1 EUR)	0,0%	9,7%	3,75	3,49	-7,1%
	ARS= (price of 1 USD)	0,8%	10,5%	17,53	18,00	2,7%
	CNY (price of 1 USD)	0,8%	-4,3%	6,65	6,75	1,6%

* *For Fixed Income instruments, the expected performance refers to a 12 month period*

Upward revision **Downward revision**

Monthly Global Asset & Currency Allocation Proposal

	Conservative		Moderate		Balanced		Growth	
Max Drawdown	< 5%		5%/15%		15%/30%		30%>	
Asset Class	Strategic (%)	Tactical (%)	Strategic (%)	Tactical (%)	Strategic (%)	Tactical (%)	Strategic (%)	Tactical (%)
Money Market	**15,0**	**23,0**	**10,0**	**16,8**	**5,0**	**11,5**	**5,0**	**6,8**
Fixed Income Short-Term	**25,0**	**33,7**	**15,0**	**22,2**	**5,0**	**10,1**	**0,0**	**3,4**
Fixed Income (L.T) OECD	**30,0**	**18,0**	**20,0**	**12,0**	**15,0**	**9,0**	**5,0**	**3,0**
US Gov & Municipals & Agencies		9,0		6,0		4,5		1,5
EU Gov & Municipals & Agencies		1,8		1,2		0,9		0,3
European Peripheral Risk		7,2		4,8		3,6		1,2
Credit (OCDE)	**20,0**	**15,0**	**20,0**	**15,0**	**15,0**	**11,3**	**5,0**	**3,8**
Investment Grade USD		4,5		4,5		3,4		1,1
High Yield Grade USD		7,5		7,5		5,6		1,9
Investment Grade EUR		0,8		0,8		0,6		0,2
High Yield Grade EUR		2,3		2,3		1,7		0,6
Fixed Income Emerging Markets	**5,0**	**5,5**	**7,5**	**8,3**	**10,0**	**11,0**	**15,0**	**16,5**
Latam Sovereign		1,7		2,5		3,3		5,0
Latam Credit		0,8		1,2		1,7		2,5
Asia Sovereign		1,7		2,5		3,3		5,0
Asia Credit		1,4		2,1		2,8		4,1
Equity OECD	**5,0**	**4,8**	**20,0**	**19,0**	**32,5**	**30,9**	**50,0**	**47,5**
US Equity		1,7		6,7		10,8		16,6
European Equity		3,1		12,4		20,1		30,9
Japan Equity		0,0		0,0		0,0		0,0
Equity Emerging	**0,0**	**0,0**	**5,0**	**5,0**	**10,0**	**10,0**	**10,0**	**10,0**
Asian Equity		0,0		3,5		7,0		7,0
Latam Equity		0,0		1,5		3,0		3,0
Commodities	**0,0**	**0,0**	**2,5**	**1,8**	**5,0**	**3,5**	**5,0**	**3,5**
Energy		0,0		0,4		0,7		0,7
Minerals & Metals		0,0		0,5		1,1		1,1
Precious		0,0		0,5		1,1		1,1
Agriculture		0,0		0,4		0,7		0,7
Alternative Investments	**0,0**	**0,0**	**0,0**	**0,0**	**2,5**	**2,8**	**5,0**	**5,5**
REITs		0,0		0,0		1,4		2,8
Alt.Energy (wind, solar, etc)		0,0		0,0		0,8		1,7
Market Neutral		0,0		0,0		0,6		1,1
Volatility		0,0		0,0		0,0		0,0

Currency Exposure (European investor perspective)				
EUR	94,5	90,5	86,7	77,8
USD	5,5	9,5	13,3	22,2

This recommended asset allocation table has been prepared by the Asset Allocation Committee (AAC), made up of the managers of the portfolio management departments and the product managers in each of the jurisdictions in which we operate. Likewise, the distribution of assets within each customer profile reflects the risk control requirements established by regulations.

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