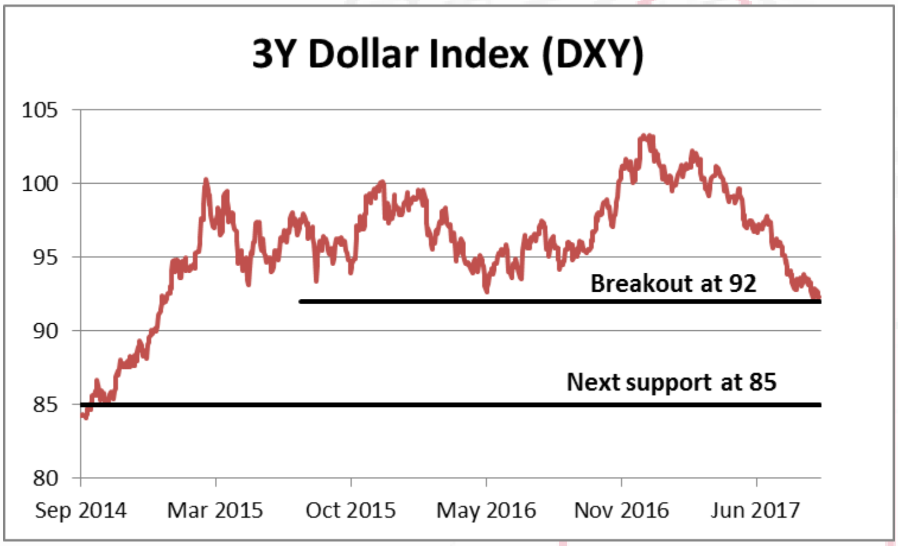
"Although FX markets leaned on the euro's side, we stick to our view that speculation on an early normalisation of ECB monetary policy is premature. Furthermore, with stronger inflation ahead, Fed funds rate hikes are likely to continue." Julius Baer

Review

Last month illustrated, again, that August is often a poor month for equities. Indices only just climbed into positive territory in the last 2 days, with ACWI up 40bps month on month and SPX up just 10bps, STOXX 50 off 80bps and Nikkei 225 -1.4%. Volatility picked-up as VIX spiked twice during the month to over 16, breaking the long stretch of complete calm after VIX fell to a record low earlier below 9 vs. long term average at 20.5. EM and AXJ are up 2.3% and 1.1% respectively, continuing their outperformance against DM equities. SPX was buffeted by shifts in politics and then by the impact of hurricane Harvey – notably on Energy stocks. STOXX and Nikkei were impacted by stronger EURO and JPY as USD slid to 2Y lows vs. EURO that tested 1.20 at one point. Q2 results, notably from Japan and PRC, are constructive for equities as have been latest global PMIs with August US ISM, EU's and PRC's PMIs all beating consensus handily.

FI markets traded within the YTD range although 10Y UST yield was close to testing YTD low of 2.10% before modestly climbing to 2.16% on Friday. Bund yield ended the month at 36bps from recent high closer to 50bps. FX was the most volatile asset class with the continued decline in USD's DXY to test, below key support at 92 briefly before modestly recovering to 92.80 on Friday. 'Safe haven' currencies, now including the EURO, are the main gainers but we also saw AUD test 80c and gains in several EM currencies with SGD strengthening through resistance at 1.3560. Gold, another 'safe haven', was the main gainer breaking briefly above $1,322 key resistance earlier in the month to a new YTD high and then regaining it at month-end. Oil again was moved on offsetting drivers from US shale oil production outlook vs. evidence Saudi Arabia was cutting back its production and exports. Harvey helped drive-up oil and gas prices last week with Brent above $52/brl. Base metals continued to climb higher with Copper testing 2Y-highs and Zinc at all-time-highs on firmer PRC import demand and robust global macro data.



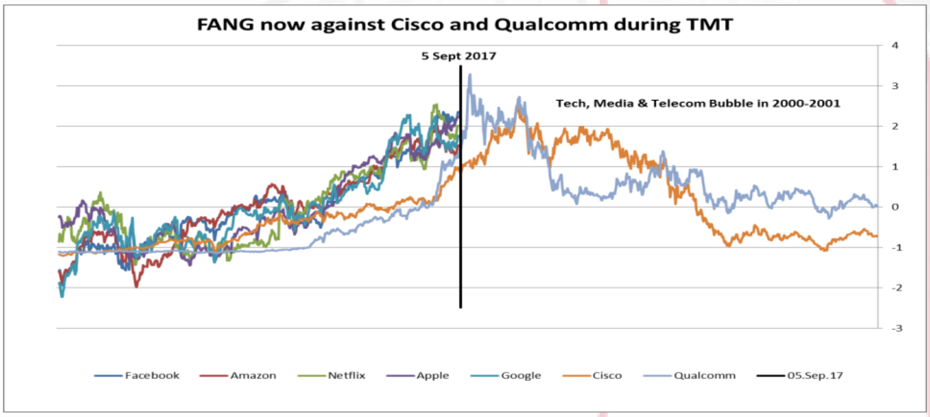
Outlook

N. Korea-related geopolitical risks may create temporary spikes in risk-off behaviour, as on Monday. However, our base case is neither USA nor N. Korea want to trigger military action. It is clear too that PRC is 'leaning' on Kim Jong-Un more than ever. One argument is that since Kim has demonstrated N. Korea can detonate a hydrogen bomb, he has achieved his strategic position and will be more open to negotiating from a better position of strength that might see tensions subside. We remain in the camp that military conflict is a 20% possibility and to construct portfolios around this binary outcome is problematic. However it supports our current high cash weighting, along with a holding in gold, and reduced equity weighting, making us quite defensive.

Investors are bi-polar around US fiscal reforms, having excitedly pushed up equities, after Trump's victory, we highlighted at the time as being overly optimistic vs. now effectively discounting nothing will happen. We believe there is a decent chance Trump and a GOP-controlled Congress can win enough support for a more moderate tax reform Bill before YE17 that would have material implications for asset classes and equity sectors as we saw in Q4CY16. Hurricane Harvey has altered the political narrative around lifting the debt ceiling and the budget hugely reducing the risk of a government shutdown.

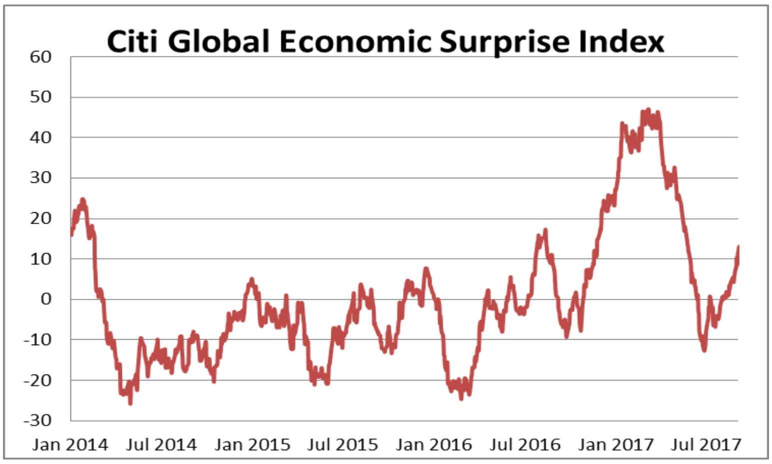
The US IT and social media giants – Apple, Facebook, Google, Amazon & others like Qualcomm - face some major risks ahead. The first being a rewriting of rules to regulate them such that they pay much more in tax, face anti-trust constraints as well as level the playing field for offline and smaller online rivals. It is highly likely the future will be a lot harsher for these IT giants, and that the advantages they have had in building disruptive businesses to established structures will now reverse as they are viewed as established businesses with 'unfair' advantages. Another huge risk lies in US IT companies with large exposures to PRC. The concern is they get caught in a trade-related crossfire, and understandably so as PRC has 'stolen' much of its IT intellectual property (IP). It is likely in US's wider interest to control and restrict the usage and sale of IP overseas.

Oaktree Capital's Howard Marks raises very real questions as to whether the 'FANG's had become another investment mania as with 'Nifty Fifty' in '60s, oil stocks in '70s & TMT bubble in late '90s. In these cases, investors became irrational in believing these businesses had found the elixir to growth. Marks notes the huge inflows into passive ETFs add risks for investors in FANGs as the inflows have clearly helped push up share prices of larger caps. However, this can work equally in reverse and could result in a 'vicious cycle' as disillusionment over the business fundamentals is made worse by ETFs being forced to dump their largest holdings.



US Equities - Review

- US equities struggled through August but at least closed slightly up vs. a typical decline of -1.4%. Growth-related sectors outperformed with N'DAQ up 1.3% but Financials -2% and Russell 2,000 small caps -1.4% fell as 'value' suffered.
- Macro data was mixed with stronger consumer survey data. ISM Manufacturing at 6M-high and solid exports but Non-Farm Payroll (NFP) 'missed' at 156,000 vs. consensus at 180,000 and wage growth was flat at 2.5%.
- Yellen was deliberately silent, at Jackson Hole, on monetary policy but the 'uber-complacent' FI markets interpreted her silence as being 'dovish', sinking USD, UST yields and pushing FED Futures probability of a Fed hike Dec. below 50%.
- The main story was Trump's renewed focus on fiscal reforms in a speech last Wednesday with evidence that key GOP Congressional leadership are crafting a deal with the Goldman Sachs alumni duo, Cohn and Mnuchin.

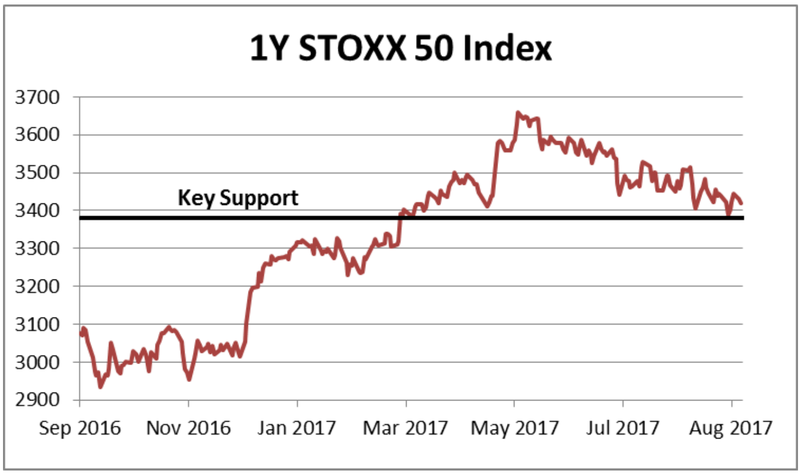


US Equities- Outlook

- US GDP was revised up to 3% for Q2 on stronger consumption and private sector fixed asset investments (FAI) offset in part by weaker public spending. We expect US GDP growth, wages and inflation will accelerate in H2 (vs. slowing growth in EU).
- We expect the Fed to announce it will start gradually unwinding its QE-inflated $4.4trillion balance sheet this month. This might equate to less than $500bn in Y1. Financial conditions have eased substantially YTD but it is likely QE has dampened UST 10Y yields by as much as 50-60bps. We do not think Fed's unwind will alter its intention to gradually increase interest rates.
- Sentiment is overly pessimistic and policy gridlock could endure all year. GOP is aware of mid-terms in Nov. '18 and will be desperate to score some legislative wins. There is the makings of a bipartisan deal on tax reforms and infrastructure spending via an alliance of moderate GOP Congressional members and parts of the Democrat party and Trump is all about deal-making

EU Equities – Review

- STOXX 50 peaked late May on Macron enthusiasm and has underperformed SPX since. On a YTD basis, it hits a 4M-low last month and briefly fell below a key technical support. The strong EURO is certainly one factor, hitting large cap exporters which are well represented in the index. STOXX Q2 earnings were the most disappointing globally as it barely met consensus.
- FTSE results Q2 showed +20% YoY growth, mostly from gains off a weaker GBP. However macro data disappointed and still no obvious unity on a negotiating position on BREXIT despite Labour's 'soft' commitment.
- Macro data in continental EU remains robust at a high absolute level with August PMIs out last week surprising to the upside and hope that the strong Euro is not yet impacting activity. Strength is more in manufacturing than services and in S. EU (Italy especially. picked-up along with Spain vs. slight weakness from Germany & Holland) than core-EU.
- Macron's 'honeymoon' period is over with his popularity plunging to 36% after a number of blunders, demonstrating his real support base is around this level. Merkel cautiously supported Macron's suggested EU integration reforms.

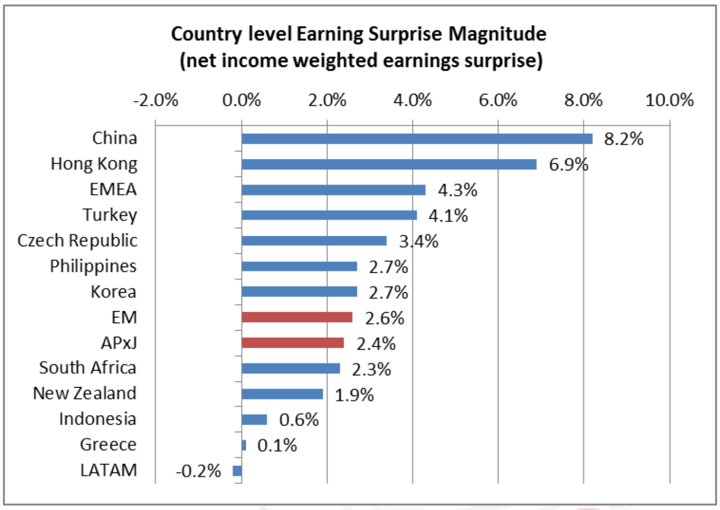


EU Equities – Outlook

- Euro's moves will continue to be a key variable but our base case is its rise against USD is overdone and as greater realism takes over on the divergent monetary policies between the Fed and ECB, this might help STOXX. We continue to expect domestic demand geared sectors, small and medium enterprises (SMEs) and financials to out-perform with financials benefitting from re-leveraging, falling non-performing loans (NPLs) and stronger loan growth.
- FTSE earnings growth, according to UBS, will slow from +19% FY17E to 7% as GBP depreciation gains fall out yet BREXIT-related negatives on domestic demand impact sectors geared to the local economy as banks.
- We think markets have become complacent about the underlying political risks in EU, not least from the Italian election as recent polls suggesting a majority of Italian votes support anti-Euro parties. However, there is a more positive narrative potentially being a closer Franco-German unity driving EU integration, assuming Merkel wins this month, that addresses some of the key structural flaws although HSBC's detailed analysis of this was dubious of real progress.
- UK government's negotiating stance remains opaque – not least to EU's lead negotiator – but it appears it is moving slowly towards a 'softer' option and the need for a transitional deal on trade.

APAC AND EM Equities – Review

- Nikkei 225 cracked last week and fell below key 20,000 support level to 19,500 as JPY gained towards YTD high of 108.80 despite delivering the best earnings growth globally of any DM equity market of +30% YoY. Abe seems to have survived a tricky patch politically helped by no obvious opponent in, or outside, the LDP.
- PRC Q2 results so far are a key positive surprise for AXJ equities as, with over 60% reported so far, A-shares earnings are up 24% YoY. Even more positive is the evidence, finally, that the drag from its SOEs might be inflecting with several large SOEs as Petrochina, China Mobile and large 5 banks beating consensus as well as, in some cases, paying out substantially more in dividends.
- N. Korea clearly is an existential threat to S. Korea, and to Japan, so it is no surprise both KOSPI and KRW were volatile last month as tension waxed and waned. Several sell-side houses are turning more positive on Thailand's SET that has lagged the region the most except for Philippines's PSEI, although THB is up 8% vs. USD YTD, as its economy picks up and earnings are seen to improve.
- Political risks remain high around Brazil's President, Temer, but he survived an impeachment vote of sorts and BOVESPA optimists remain hopeful that meaningful pension reforms will be passed by YE17 with a key vote later this month.



APAC AND EM Equities – Outlook

- MS thinks the Nikkei could "explode" higher once JPY starts to weaken (forecast is 118 YE17) given it is the cheapest DM equity market at 14x PER FY17, has underperformed YTD other equity markets, FIIs are underweight significantly and has the best earnings growth and earnings revisions of any DM market. MS thinks improving corporate governance and likely rising share buy backs are being ignored by a slavish exaggeration of importance of JPY.
- Whilst the key political event in N.APAC will be the PRC five year leadership reshuffle, there is also a potentially very constructive inflection point in FY17 for the return on equity (ROE) of PRC equities with the hope that we might be on the cusp of genuine improvements in its large SOE sector that has weighed down ROE since GFC.
- India was a standout in AXJ with poor earnings and sizeable FY18 earnings downgrades that have likely not yet bottomed-out. Whilst we remain very optimistic about India's medium and longer term outlook, many of the short term catalysts have taken place and there is a risk of a correction given 'high-ish' valuations, deteriorating earnings and potential for INR weakness.

FIXED INCOME – Review

- Tepid inflation, geo-political tension and Yellen's silence contributed to UST 10Y yield falling to 2.12% last month, at the lower end of the 2.10-2.6% trading range as FI markets found ways to convince themselves of a more 'dovish' spin based on what Yellen did not say at Jackson Hole. Whilst views are polarised between those liking US High Yield (HY) Fixed Income (FI) for yield evidence is, within the massive fund inflows to US FI YTD, that real money favours IG.
- Bund yield fell back last month benefitting from its, and Euro's, 'safe' haven status whilst political concerns saw Italian 10Y sovereign spread widen out further.
- Emerging market FI yields held steady last month but inflows dropped sharply MoM.

FIXED INCOME – Outlook

- Views on the impact of Fed starting to unwind its balance sheet mostly downplay the risk that this could result in sharply higher yields going forward as argue financial conditions are much looser now than in 2016, that Fed will only unwind very gradually and that foreign demand for USTs appears to remain strong. A minority see this as being too complacent.
- The ECB faces a classic dilemma in that it is concerned if it were to 'taper', it might undo much of the good work its QE has done as it would likely send Euro sharply higher, impacting growth and STOXX as well as catalyse a FI sell-off. Debate is not if but when ECB moves to taper as early as Thursday's meeting or later in H1CY18.
- EM local currency debt (LCD) FI had some powerful proponents last month such as PIMCO that like its yield upside, see easing inflation in EM YTD and are constructive on EM currencies vs. USD as well as index changes that will increase the percentage weighting of EM FI overall – not least when PRC CNY FI is added to EM index later this year. We prefer EM equities to EM FI and are cautious on EM FX thus so on EM LCD.

FX – Review

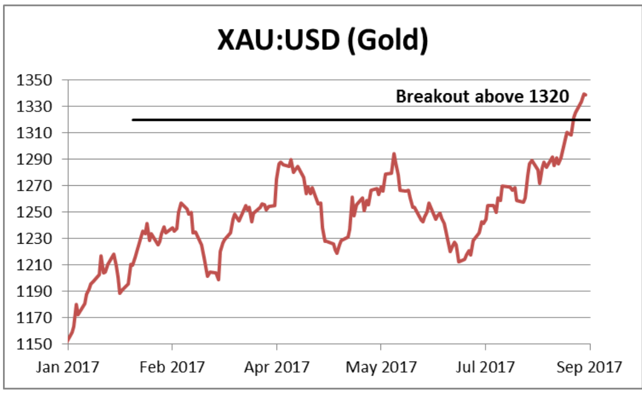
- Last month was again dominated by a sharp decline in the USD to test the bottom of its 3Y trading range on DXY of 92-1.05. Charts show there is little real support until 85, with stronger support at 83. However DXY recovered modestly from the lows to climb back above key support at 92.80 with several strategists coming out suggesting that Euro was overbought at 1.20 and that this level would weigh on ECB's decision on tapering.
- CNY gained towards 6.60 level and last month saw several previous CNY 'bears' capitulate and revise YE17/YE18 forecasts substantially stronger at 6.60 and 6.70 respectively as PRC FX reserves rose for 3rd month in a row and there was some success in slowing outbound direct investment (ODI).
- Industrial commodities price gains helped boost AUD to breakout from 72-78c range to test 80c whilst GBP continued its weakness, barely moving against an otherwise weak USD in 1.29-1.30 range as BREXIT concerns continued and fell sharply vs. EURO.

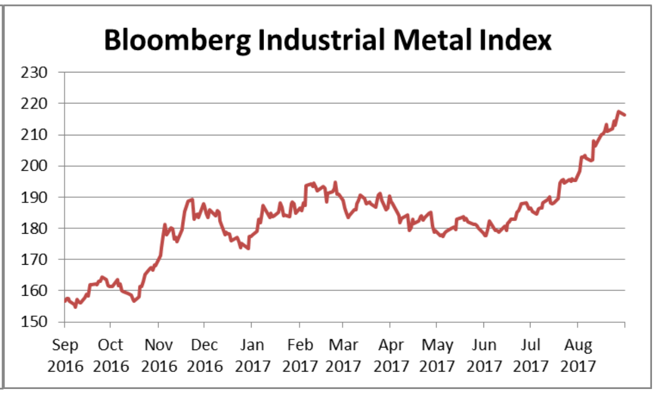
FX – Outlook

- Our base case is FX and FI markets are too pessimistic on US political gridlock, too complacent on EU's problems and ignore Fed's more hawkish and divergent monetary policy as compared to a still very accommodative ECB and dovish EM and APAC central banks. We believe USD will rebound towards 97 on DXY in rest of the year and remain puzzled how JPY is a 'safe haven' if there is risk of conflict with N. Korea. Policy progress by Trump would also be USD positive.
- The key for any recovery in GBP would be clarity that UK will opt for a 'soft' BREXIT negotiating position after German election result is known. Labour's policy commitment to a 'soft' option may help the Europhiles in the Tory party put pressure on the government whilst limiting the influence 'hardline' BREXITERS might have.
- In EM and AXJ YTD easing in inflation creates scope for some countries to ease monetary policy – notably Brazil, Russia, Mexico, Turkey, Indonesia and India - that implies weakness vs. USD. This supports EM hard currency FI than LCD.

COMMODITIES – Review

- Oil continues on its roller-coaster rise between the tramlines, for Brent oil price, of $45/brl at the low end and $55/brl at the higher end but Harvey boosted prices at the end of the month as Gulf of Mexico provides 25% of USD oil and gas and undertakes 10% of refining.
- Gold has proven resilient last month, testing YTD highs above key resistance at $1,320/Oz as it clearly was seen as the 'safe haven' asset.
- Enthusiasm over stronger PRC macro data – August official and CAIXIN PMIs both beat and new export orders hit a 10Y-high - and related strong commodity import volumes boosted base metals with 'Dr' Copper at a 2Y-high and Zinc at all-time-high.





COMMODITIES – Outlook

- Gold remains an important portfolio diversification in an increasingly risky and uncertain world where traditional FI no longer provides the 'safety hedge' We see it trading in a range of $1,100-$1,360/Oz but are trading sellers above $1,320/Oz and more so above $1,350 whilst buyers below $1,180.
- There is a case the oil price will remain around the $50/brl mark on Brent. At $50/brl or so 'big oil', such as SHELL, can generate free cash flow (FCF) to cover dividends and capex that suggests, with dividend yields at around 7%, Energy might be attractive after underperforming significantly this year

Source: Bloomberg, Morgan Stanley