February 2015

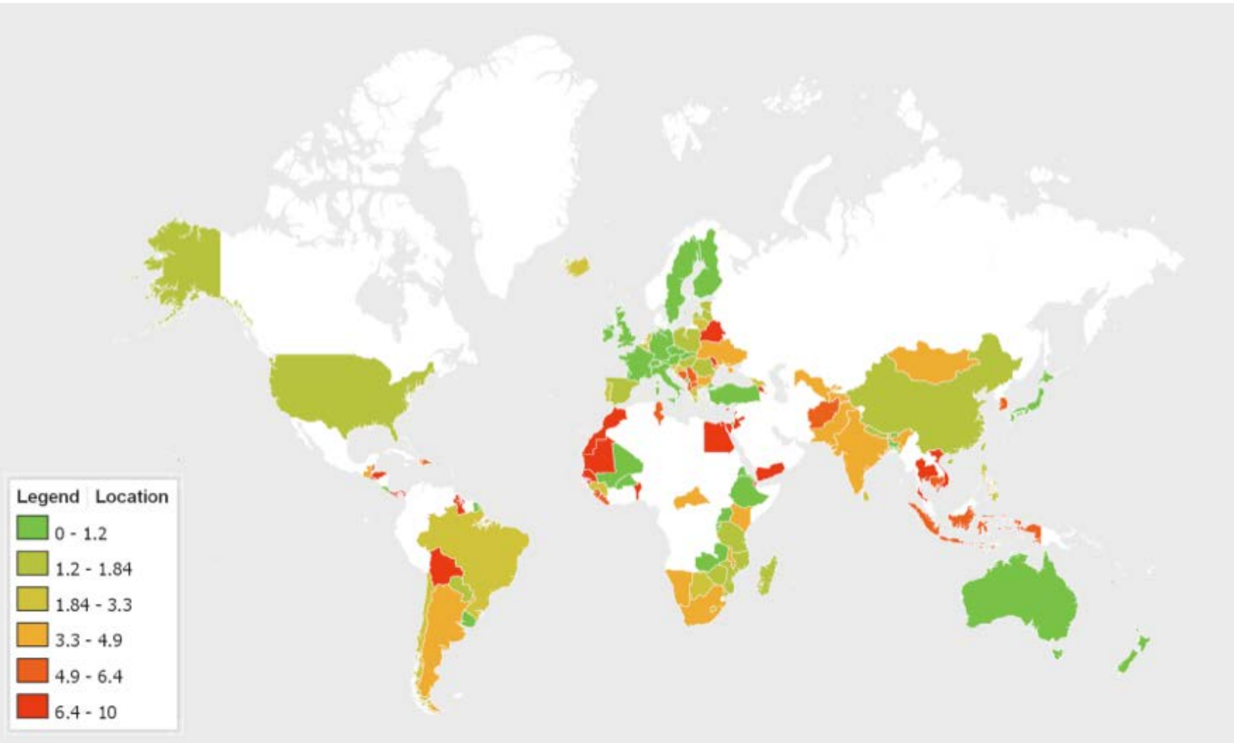
Monthly Update

ETF Securities Research and Roubini Global Economics

Winners and Losers

- Our focus this month is on what the tumbling oil prices imply for our key theme of growth and monetary policy divergence, particularly in light of the European Central Bank's decision to add sovereign bonds to its quantitative easing (QE).
- The global economy is dealing with the biggest oil supply glut since the mid-1980s, and financial markets continue to sort the winners from the losers.
- In our view, lower oil prices are not a zero-sum game. Although the main impact is a transfer of wealth from producers to consumers; they are a net positive for the global economy, supporting growth, reducing inflation, improving importers' external balances and giving space for global central banks to ease.
- **What to watch this month:** Riksbank meeting (Feb 12) to monitor Sweden's response to the European Central Bank's quantitative easing; deadline for Greek package (Feb 28) for clarity on the eurozone debt situation; U.S. employment (Feb 6) CPI (Feb 26) for clarity on the Fed's rate path.

Heatmap: High 'Oil Intensity' Separates Winners From Losers Among Importers as Crude Plunges (0 = weak; 10 = strong)



Source: Roubini Global Economics

Note: The Oil Intensity of Importers metric measures how much energy a country uses to produce a unit of GDP, calculated as the volume of oil consumed in a country divided by constant GDP.

Key Macro Theme: Decoupling and Monetary Policy Divergence

Changes in oil prices are not a zero-sum game. Developed-market producers appear best positioned to weather the price slump at a country level, and emerging-market net oil-consuming countries will see bigger boosts to growth than their developed-market counterparts.

Fallout From Great Oil Shock

Changes in oil prices are not a zero-sum game and a simple transfer of wealth from producers to consumers; rather, they are a net positive for the global economy.

That is not to say that the adjustment to lower oil prices will be smooth: Cashflow and credit deterioration will occur in oil producers both big and small, in net oil-exporting and net oil-importing economies (with domestic oil-production sectors), and across sovereign and corporate markets.

Oil Slump Rewards Over-Consumers…

When it comes to the regional "winners" and "losers," developed-market producers appear best positioned to weather the price slump at a country level, and emerging-market net oil-consuming countries will see bigger boosts to growth than their developed-market counterparts.

For producers, those most at risk of a slump and financial distress are countries with high fiscal needs, limited adjustment capacity, poor business environments and elevated political risk, particularly in Venezuela and sanctions-constrained Russia.

We see currency adjustment in other more flexible economies (such as Mexico and Colombia) as helping with necessary macro adjustments, reducing the need for fiscal cuts.

For net consumers, the greater the oil intensity of the economy, the more it stands to benefit from the price decline, which is the key reason why emerging markets will receive a bigger boost to growth than developed-market consumers.

…and Intensifies Deflation Pressures, Which Central Banks Must Counteract

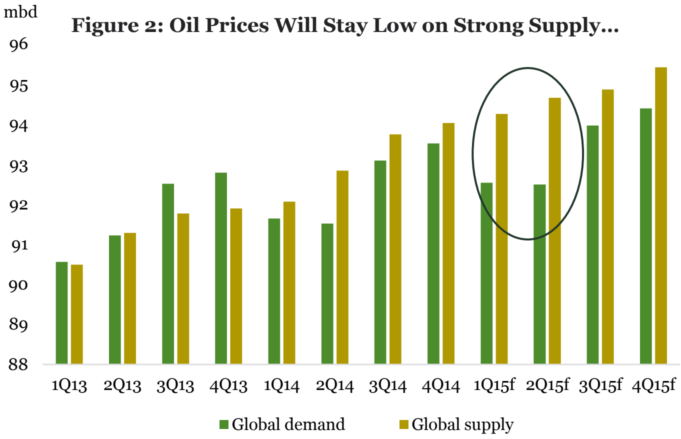
The added deflationary pressure from the oil price slump, and fear of de-anchoring inflation expectations and wages, led to one of the busiest months since the "Lehman" days for monetary activism.

Most notably, the European Central Bank finally overcame its unfounded fears and institutional dysfunction to launch a large sovereign QE program. And the Bank of Japan's own easing program will remain at full throttle.

Meanwhile, the Swiss National Bank caught markets off guard as it reneged on its currency floor; this is a policy mistake, but its experimentation with deeply negative interest rates is remarkable. Interest in gold has increased on the back of these developments.

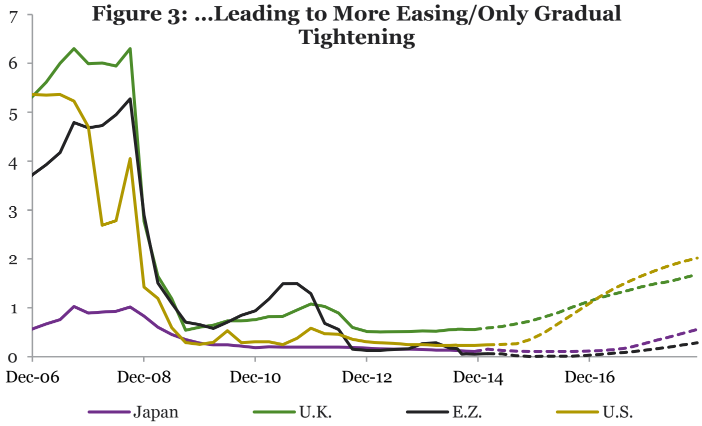
Central banks in Norway, Canada, Russia, India, Turkey and others have rushed to cut rates, while the Bank of England and Federal Reserve have indicated they are very comfortable at zero, for now. Slow and careful rate hikes in the two developed-market outperformers remain a Q3 prospect, with risks of delay.

Figure 2: Oil Prices Will Stay Low on Strong Supply…



Source: Bloomberg, Roubini Global Economics

Figure 3: …Leading to More Easing/Only Gradual Tightening



Source: Bloomberg, Roubini Global Economics

What to Watch

- **Signs of supply adjustment,** most likely in the U.S., as lower prices defer new investment and production growth slows. A stabilization of oil prices could allow for better discrimination across credits.

Asset-Class Implications: Fixed Income

Rates

The theme of central banks reversing course (with the associated reputational risks) gained steam as central banks from India to Canada began easing cycles.

Negative rates are becoming prevalent in Europe, as deflation risks rise along with the chances of the eurozone breaking up, after the Swiss National Bank abandoned its intervention policy. Yields are negative out to 10 years, but rates below -1% are probably unsustainable.

In contrast, the theme of divergence is still alive; the coming Federal Reserve rate hikes means the U.S. 10y will trade above 3% by end-2016, but yields can only surge if a return to zero interest rates becomes unlikely, and international headwinds including dollar strength can be overcome.

Quantitative easing from the European Central Bank and the Bank of Japan will keep German and Japanese government bond yields very low across the entire curve for the foreseeable future.

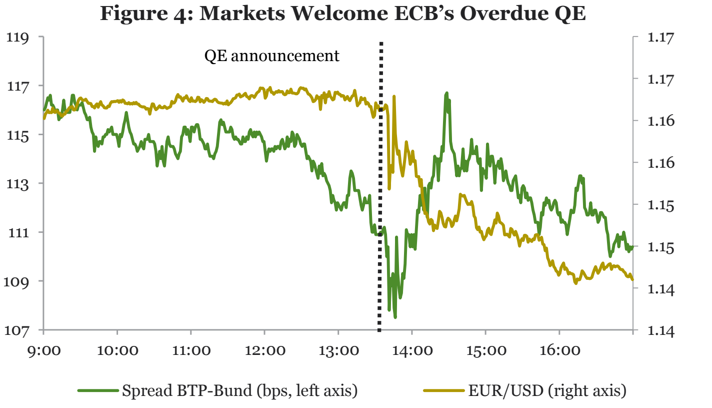
Credit

We do expect some defaults as a result of the oil price plunge, including in the U.S. high-yield space, among some frontier markets and among some small banks, enterprises and corporates in key oil exporters. Our baseline suggests these will not be systemic events, assuming oil prices bottom out and global monetary conditions remain dovish.

In U.S. high yield, we predict default rates will rise to around 10-20% by end-2016 for energy (where spreads are now around 1,000 bps), with the overall high-yield default rate cresting at a relatively low 3-5%. Nonetheless, the volatility means that yields of 7% are not a compelling risk-reward proposition.

Regarding emerging markets, softer inflation will keep most emerging-market central banks dovish, helping bonds, but leading to weaker currencies. Higher yields failed to compensate for spot depreciation in late 2014 and remain under 5%, providing little cushion, but emerging-market bonds at 6.3% look more attractive in the more accommodative environment.

Figure 4: Markets Welcome ECB's Overdue QE



Source: Bloomberg, Roubini Global Economics

Asset-Class Implications: Equities

Overall, we are neutral on global equities, and expect volatility spikes to occur with increasing frequency.

Developed Markets

With the energy sector accounting for the largest share of total S&P 500 capex, cash-flow pressures may force cutbacks in corporate spending—putting a significant dent in overall S&P 500 earnings growth. Analysts' earnings expectations have been marked down sharply, especially as large caps are the most exposed to global events.

Unattractive valuations, further energy-related pressure on earnings-per-share growth and fears of rising default rates in the energy sector leave the market extremely vulnerable should oil prices remain weak for longer than we anticipate.

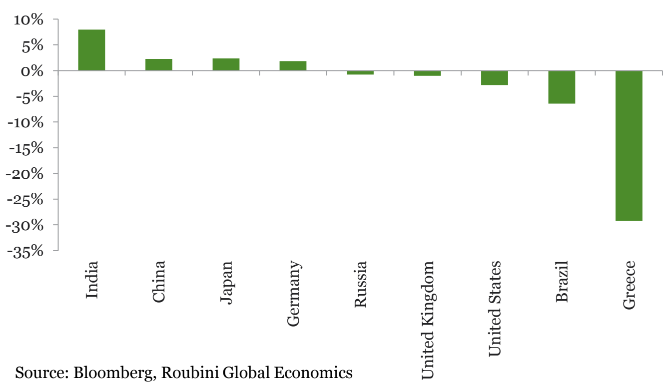
Consumer sectors, utilities, non-energy industrials and transport stocks all stand to benefit from lower costs.

On net, we expect the lower oil prices to be a positive for the equity market, although the overall gain might be modest given the energy sector's high share of capex spending in recent years and its footprint in the credit market.

Emerging Markets

Emerging-market equities look fairly valued compared with developed-market equities, and we prefer countries exposed to U.S. demand, with attractive valuations (Korea and, after the recent sell-off, Mexico).

Figure 5: Total Returns by Country Year-to-Date (USD terms)



Source: Bloomberg, Roubini Global Economics

Asset-Class Implications: Foreign Exchange

With deflationary and disinflationary pressures pushing central banks into an easing mode, the cries of currency wars will no doubt reemerge.

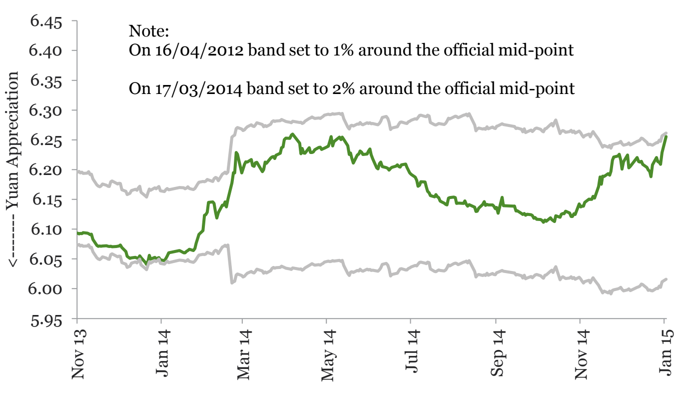
In anticipation of the ECB's bold QE programme, the Swiss National Bank abandoned its currency floor, sending the Swiss Franc to a record high against the Euro. Other casualties could be Danish Krone whose Peg to the Euro is under question. The Danish central bank has cut interest rates three times in the space of two weeks and has been reported to have spent as much as 100bn kroner in January defending its currency.

The most commodity-exposed developed countries, including Norway, Canada and Australia have seen their central banks act quickly, surprising the market and sending their currencies to multi-year lows.

Even the Renminbi has depreciated within a whisker of its trading band, fuelling speculation that the band may have to be adjusted. The lack of movement in China's currency reserves indicates that it is market driven weakness rather than a People's Bank of China engineered move like the one we saw back in March 2014.

Disappointment over Q4 US GDP and indeed continued lack of inflationary pressure is likely to lead the US Fed to take its time raising rates. The US Dollar could shed some of its recent strength as the wait for rate hikes takes longer than many anticipate.

Figure 6: Yuan: -In Need of a Wider Band?



Source: ETF Securities, Bloomberg

Asset-Class Implications: Commodities

Energy

The weakness in oil prices has started to drive a cutback in non-OPEC production. According to Baker Hughes' rotary rig count, there was a 16% contraction in US rig counts in January 2015. In the past week WTI and Brent have rallied 10% and 13% respectively on the back of the apparent production cuts. We believe that OPEC countries will see these developments as a positive move and will motivate a cut in its June 2015 meeting.

Unlike conventional wells, which can produce relatively stable rates for a sustained period of time, shale oil and gas wells experience an initial burst of production in the first few years of their lives, followed by a sharp decline thereafter. We believe that the OPEC cartel will move with caution recognising that despite the recent reduction in rig counts, US production could easily rise once again. Saudi Arabia, the largest producer in the cartel is reluctant to give up market share and will wage the price war as long as it takes to reassert its market dominance. With little government debt its tolerance to run up deficits is extraordinarily high. Saudi Arabia can afford to be patient in this regard.

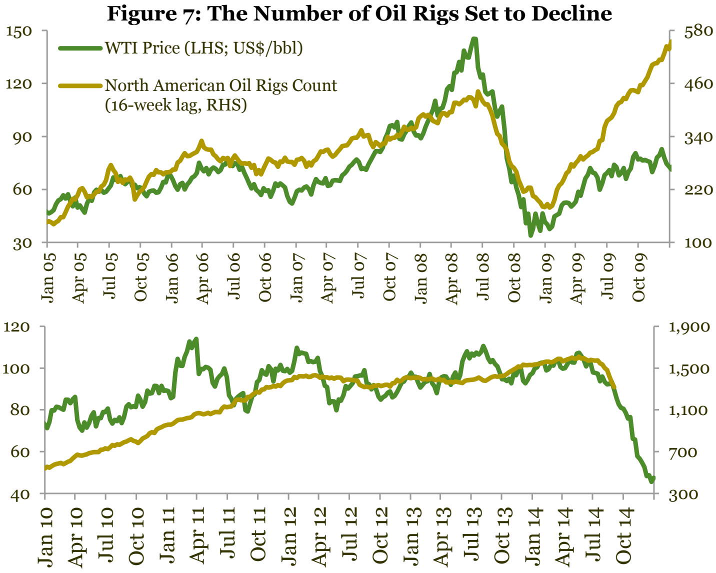
We see oil prices making a partial recovery but the outlook for oil will remain structurally weak and it is unlikely that prices will recover above US$100/bbl in the foreseeable future. Investment in non-traditional extraction will therefore remain subdued.

Precious Metals

Gold and silver have recently rallied as their store-of-value traits have come back into focus. Continued central bank balance – sheet expansion and a growing sense of uncertainty about policy moves and growth trajectories are likely to lift demand for the haven assets. As expectations for US real interest rate increases get pushed out, some of the weight on gold prices will ease.

India has lifted most of the gold import curbs it had in place in 2014, allowing for stronger gold consumption in 2015. Weakness in oil prices will reduce the pressure on India's current account deficit, helping the government avoid reintroducing the draconian and unpopular limits on gold imports.

Figure 7: The Number of Oil Rigs Set to Decline



Source: Bloomberg, Baker Hughes, ETF Securities

Important Information

ETF Securities (UK) Limited
3 Lombard Street
London
EC3V 9AA
United Kingdom

t +44 (0)207 448 4330
f +44 (0)207 448 4366
e infoUK@etfsecurities.com
w etfsecurities.com