INVESTMENT OUTLOOK
DEFLATIONARY BOOM MARKETS

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GREECE: THREE SCENARIOS
We foresee three separate and to some extent independent scenarios:
1. Technical default, alone
2. Technical default leading to ‘Grexit’, alone
3. Technical default leading to ‘Grexit’, leading to panic/contagion across global markets

BUNDS MARKET RIOT
When the frequency of policy shifts increases, so it is the likelihood of policy mistakes
Over the next months, we expect Global Markets to be erratic, volatile and potentially chaotic

MEDIUM TERM VIEW:
DEFLATIONARY BOOM MARKETS
Our bearish view for global economies, and especially so for Europe and Japan, entails that the strenuous battle against die-hard deflation will force the hand of Central Bankers into monetary printing, driving up further bonds and equities

LONG TERM VIEW:
DEFLATIONARY BUST?
If there is no normalization of growth rates, just sluggish GDP growth, deflationary trends may prevail, over-indebtedness may go uncured, unemployment may remain high in Europe. Central Banks will continue pumping liquidity and fuel bubble, until their arsenal runs thin.
EUR break-out likely.

CONCEPTUAL FRAMEWORK TO OUR VIEW:
SECULAR STAGNATION
Structural deflation is the backbone of the macro outlook we endorsed for the last few years. Here below we will try to characterize our conceptual framework on Secular Stagnation and Structural Deflation a bit better.

CRYSTAL BALL
Our Target Levels for S&P, Nikkei, Eurostoxx, Fed Fund Rates, US Treasuries, Bunds, BTPs, WTI, Gold, USD, JPY, EUR, CNH, Inflation, spreads

Note: Please click on the title of each chapter to access the section of interest directly
GREECE: THREE SCENARIOS
GREEK REFERENDUM, A PYRRHIC VICTORY

A VICTORY LEADING TO UNCERTAINTY

"Another such victory and we are undone."
— King Pyrrhus of Epirus in the Battle of Asculum, his second Pyrrhic Victory against the Romans.

Source: Google Images
NO ONE IS INNOCENT!

GREEK GDP COLLAPSED ~ 25% IN 7 YEARS

NO ONE IS INNOCENT!

GREECE REAL GDP vs IMF PROJECTION, 2009=100

GREECE REAL GDP vs IMF PROJECTION, 2009=100

GREECE REAL GDP 2008-2014 vs US GDP DURING THE GREAT RECESSION

Source: Fasanara Research, Bloomberg

AUSTERITY FAILED, MONETARY POLICY LATE IN THE GAME

WORSE THAN GREAT DEPRESSION
WHAT TO EXPECT FROM HERE

THREE SEPARATE SCENARIOS

WE DISTINGUISH THE THREE SCENARIOS WE SEE PLAYING OUT GOING FORWARD. SUCH SCENARIOS ARE DEPENDENT (SCENARIO 2 AND 3 ASSUME SCENARIO 1 HAS TAKEN PLACE), BUT NOT CONSEQUENTIAL (SCENARIO 1 DOES NOT IMPLY SCENARIO 2 NOR 3, NOR 2 IMPLIES 3)

<table>
<thead>
<tr>
<th>TECHNICAL DEFAULT</th>
<th>‘GREXIT’</th>
<th>PANIC/CONTAGION ACROSS GLOBAL MARKETS</th>
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- **NOT NECESSARILY A TECHNICAL DEFAULT LEADS TO A GREXIT.** 
  This has not occurred yet, as Greece’s failure to pay back maturing loans to IMF only puts them in arrears on a bilateral loans (does not automatically trigger cross default clauses). The first technical default may occur on July 10th on TBills, or July 20th on ECB maturing debt.

- A Default surely leads to increased capital controls, deposits freeze and IOUs being issued. But not necessarily an exit from the currency union.

- **NOT NECESSARILY A GREXIT LEADS TO FINANCIAL PANIC AND CONTAGION ACROSS GLOBAL BOND AND EQUITY MARKETS.**

- Surely, a period of volatility opens up, but not necessarily a durable one. After all, the ECB prints Eur 60bn per month. Markets may determine that that is enough (helped by inevitable ECB’s bold statements in the process), and decide to sidestep durable panic/contagion. In 2001:
  - the ‘surprise effect’ had an impact
  - the non-existence of European financial institutions designed to deal with such intra-union pandemics also played a role
  - the reluctance of the ECB to assume the role of lender of last resort was crucial in letting the crisis unravel back then (the much celebrated Weidman/German Constitutional Court’s fierce opposition to QE/deficits monetization left us prematurely and mysteriously)

- **THIS IS TO SAY THAT THE THIRD SCENARIO IS THE ONLY WHICH CAN BE CLEARLY CATEGORIZED AS NEGATIVE FOR GLOBAL MARKETS.**

- In some respect, the first scenario of a technical default is potentially a favourable one, and preferable to a muddle-through situation where the can is kicked down the road further and uncertainty remains. A technical default (where not only debt but also wages/pensions go unpaid in Euro denomination) could potentially tip over the current government in Greece and could therefore lead to a best-case scenario
ECB unlikely to withdraw ELA until July 20th

NO AGREEMENT

11TH HOUR AGREEMENT

Vague promise of debt haircut (as opposed to rescheduling) in exchange for vague structural reforms and solid radio silence

California-style IOU’s to pay pensions & public wages

GRACCIDNET: BANK CASUALTY/BAIL IN

Greek Parliament to pass law for IOUs to become Legal Tender

“GREIN”

GREXIT

ECB’s LIKELY REACTION

✓ QE UNCHANGED
✓ DEFLATIONARY EVENT / RATES LOWER FOR LONGER
✓ FULL IMPLEMENTATION OF PROGRAMME

✓ ECB’s QE UPSIZED (or reoriented in peripheral Europe)
✓ OMT
✓ “WHATEVER IT TAKES” / SHOW OF FORCE

WHAT TO EXPECT FROM HERE

HOW THE GREEK SAGA MAY EVOLVE
BUNDS MARKET RIOT
SEISMIC ACTIVITY PERSISTS

LAST BUT NOT LEAST... BUND RATES EXPLOSION

- ECB QE: 60bn EUR per month, capped at -20bps yield
- US 10yr TREASURY DROP 30bps intra-day in Oct14
- OIL PRICE DROP from $107 in Jun14 to $45 in Mar15
- MAS debased SGD at Unexpected Policy Meeting
- CB of CANADA CUT RATES from 1% to 0.75%
- YEN DEBASEMENT by 15% in few weeks in Nov14
- EUR lost -25% vs USD between May14 and Mar15
- EU FORWARD INFLATION YIELD IMPLOSION
- SNB UNEXPECTEDLY REMOVED 1.20 EUR floor
- BUND RATES IMPLOSION from 180 to 5 bps in 1 year
- DENMARK CB CUT RATES FOUR TIMES in 15 DAYS
- BUND MARKET RIOT: rates moving from 5bps to 105bps
- RUSSIA CB CUT RATES multiple times and then raised them

Source: Google Images
BUND MARKET RIOT

DRAMATIC SHOCK IN THE FIXED INCOME WORLD

- The 10yr Bund moved from 0.05% yield to above 1% in a rapid shift
- Remindful of Taper Tantrum in 2013 and VaR shock on JGBs in 2003

10yr GERMAN BUND YIELD

Source: Bloomberg
A RECENT PRECURSOR FOR BUNDS

JAPANESE GOVIES ANTICIPATING THE MOVE?

- The 10yr Japanese bond yield spiked ~30bps in January, a precursor of what then happened in Bunds

10yr JAPANESE GOVERNMENT BOND YIELD

Source: Bloomberg
WHAT ABOUT THE US?

A REPLICA OF THE GERMAN SITUATION

- Shockwaves were sent across bond markets in the US, with the US 10yr Treasury yield reaching 2.50% and well above 3% for the US 30yr Treasury yield.

10yr & 30yr US TREASURY YIELD

Source: Bloomberg
ITALIAN YIELDS FOLLOWED SUIT

THE MOVE IN THE BTPs WAS EXACERBATED BY THE GREEK SITUATION

- Massive impact also on the European bond market, with yields reaching pre-ECB’s QE levels – both on peripheral European yields and spreads

10yr ITALIAN BTP YIELD

10yr ITALIAN BTP vs. FRENCH OAT YIELD

Source: Bloomberg
SEISMIC ACTIVITY PERSISTS

CROSS-ASSET CORRELATION KICKS IN DURING MARKET SELL-OFFS

- The brutal move on Bunds, a 10-sigma event when measured against deceptively low levels of (daily realized) volatility, is confirmation of the dislocated markets we live within, and joins the list of numerous other recent schizophrenic episodes and sudden bouts of volatility, what we described in the past as ‘SEISMIC MARKETS’

- One more confirmation of fat-tailed distributions (as opposed to normally-distributed), exhibiting a tendency for outliers: low-probability high-impact events do occur (statistician David Hand would say 'must occur'), deep excursions from the central value do happen, and when they do their magnitude is great. What we failed to see this time around is another connotation of today’s markets we must account for: a bias for CoVaR to spike at times, sky-high cross-asset correlation to kick-in, especially in downside scenarios for markets, pushing an idiosyncratic risk into a systemic one

Source: Fasanara Research, Bloomberg
WHY THAT HAPPENED TO BUNDS?

CONCURRING FACTORS

In justification of the move in Bunds, we can (uselessly ex post) think of a few concurring factors:

1. All too obviously, liquidity-induced markets are prone to asset bubbles, but also prone to recurring volatility shocks. THIN LIQUIDITY, LOW INVENTORIES, ABUNDANT LEVERAGE, on stretched valuations when not outright asset bubbles, around crowded positioning on consensus trades, have all contributed to this move on government bonds. Unexpected losses on the part of the portfolio that should be the least volatile (risk parity funds in primis), have triggered stops and unwinds, which fed on the sell-off. Margin calls on excessive leverage created then overcompensation to the downside, and overshooting. Admittedly, a textbook reaction to asset bubbles in overleveraged markets.

2. Additionally, the move was fuelled by some seeing ECB’s policies being successful in REIGNITING SOME FORM OF INFLATION EXPECTATIONS, as reflected by economic releases surprising to the upside (although in minimal fashion), a stronger Euro, and the 5y5y forward inflation swaps moving ~30bps higher from the lows reached in January. Investors expecting that would call it ‘normalization of markets’, and reversion to the mean of a pre-Lehman economic environment. We do not see it as sustainable and durable, but it surely took place this time around and played a role.

3. Also, outside of Europe, the move was helped by somehow HIGHER EMERGING MARKETS’ EQUITIES AND CURRENCIES (especially equities), somehow HIGHER COMMODITY MARKETS (oil in primis, rebounding at some point 40% from the lows, but also copper and iron ore, in turn driven by some expectations of liquidity injections in China, where Shibor rates halves from 4% to 2%, at a time when a Chinese competitive devaluations seems to be in the bucket list of many traders).
REFLATION OR FAKE SIGNAL?

INFLATION EXPECTATIONS TICKING HIGHER

5y5y FORWARD INFLATION SWAP

Source: Bloomberg

Greece  Bunds Market Riot  Deflationary Boom Markets  Deflationary Bust  Deflationary Trends  Crystal Ball
REFLATION OR FAKE SIGNAL?

MAIN COMMODITIES INDEXES TICKING UP

- Main commodities indexes rebounded in April and May – though the trend is already fading away

Source: Bloomberg
REFLATION OR FAKE SIGNAL?

THE SAME GOES FOR EMERGING MARKETS

EMERGING MARKETS EQUITY AND FX INDEXES

MSCI EMERGING MARKETS INDEX

~ +11.6%

MSCI EMERGING MARKETS CURRENCY INDEX

~ +3%

Greece Bunds Market Riot Deflationary Boom Markets Deflationary Bust Deflationary Trends Crystal Ball

Source: Bloomberg
IDIOSYNCRATIC MOVE IN RATES

FX AND EQUITY DID NOT FOLLOW

- Bund movement as IDIOSYNCRATIC, for it was not validated by other asset classes all around it, be it equities or FX.
- Although with some volatility in their path, both the FTSE MIB and the EUR/USD have traded range-bound, sticking to the levels they both were around March.

TWO CLEAR EXAMPLES OF RANGE-BOUND PRICE ACTION

Source: Bloomberg
BONDS ACTING LIKE EQUITIES

THE GERMAN CASE

- The nature of the dislocation is detectable in EQUITY MARKETS BEHAVING LIKE BOND MARKETS, WHILE BOND MARKETS BEHAVE LIKE EQUITY MARKETS

- Whilst Bunds were losing 20% of their value, in equity market-type volatility (or even private equity market-type volatility, nowadays), the DAX index was losing approx. 7% from its peak, a bond market-type volatility. In a way, in the last few months, a good allocation to equities would have helped hedge the downfall in the bond markets, paradoxically
BONDS ACTING LIKE EQUITIES

THE ITALIAN CASE

- FTSE Mib, the Italian stock market, has stayed close to the highs of the last several years, while Italian government bonds were sent off trading close to the lows, both in absolute terms and relative to Bunds/OATs, as low as seen only before the ECB launched QE operations.
BONDS ACTING LIKE EQUITIES

THE US CASE

S&P & US 10yr TREASURIES COMPARATIVE CHART

Source: Bloomberg
MEDIUM TERM vs. LONG TERM VIEW: ALL UP FIRST, ALL DOWN LATER
OUR VIEW IN A NUTSHELL

NOMINAL UPSIDE POTENTIAL...

IN THE SHORT TO MEDIUM TERM, WE EXPECT EUROPEAN BOND AND EQUITY PRICES TO RISE SIGNIFICANTLY AS EUROPEAN AUTHORITIES AND THE ECB STEP UP THEIR EFFORTS TO SAVE THE SAVABLE

...BEFORE IMPLOSION

Long Term

- IN THE LONG TERM, WE THINK THE EUR CURRENCY EXPERIMENT MAY LIKELY IMPLODE
- AT CURRENT RATES, THE STRUCTURE OF EUROPE IS BOTH INSTABLE AND UNSUSTAINABLE

Source: Google Images
SHORT/MEDIUM TERM: DEFLATIONARY BOOM MARKETS
In the medium term, our forecast is for a vicious cycle:

- **BATTLE AGAINST DIE-HARD DEFLATION**
- **“DEFLATIONARY BOOM” MARKET ENVIRONMENT**

**WEAK ECONOMIC ENVIRONMENT**

**BEARISH VIEW FOR GLOBAL ECONOMIES**

**MONETARY PRINTING**

Such a loop and, most importantly, such ‘deflationary boom’ market environment is to last for the foreseeable future.

However, this might be the case only until they go closer to run out of ammunition, over the next few years.

**WE BELIEVE THAT MONETARY AUTHORITIES ARE BEHIND THE CURVE AND THAT GLOBAL STRUCTURAL DEFLATIONARY TRENDS AT WORK WILL FORCE THEIR ACTIONS**

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**Greece**
**Bunds Market Riot**
**Deflationary Boom Markets**
**Deflationary Bust**
**Deflationary Trends**
**Crystal Ball**
**Deflationary Boom Markets**

**Market Reaction**

**ECB Policies**

1. Rates Lowering
   - Recent Bund weakness to maybe last a bit more but then fade away
   - Bunds reaching to new lows on yields (5yr Bund in negative territory, 10yr Bund close to zero)

2. Credit Spread Narrowing
   - Inflation forward rates remaining low or moving lower, commodities staying weak or weakening from here, China staying the course of a stable CNH

3. Yields Plummetsing
   - Spreads between European government bonds to tighten back to pre-ECB’s QE levels, and then eventually reach new lows
   - The ECB announced front-loading of QE activities for the summer period, with the pretext of avoiding summer illiquidity. What if there is no volatility arising from Greece and such a tsunami of liquidity hits the shores? What happens then to rates and spreads?

4. Equities Melting-up
   - European equities to move into new highs, melting up further
   - Recent schizophrenic bond markets might have pushed few more bond investors away into the nearby riskier asset class. If not only bonds offer negative, zero or zero-like returns, but also they present private equity market-type volatility, at times, then what is the point in being invested in them for the bulk of one’s portfolio. Let them go freely into the coffers of the ECB and Co., and help inflate equities into bubble territory (which is not the case yet in Europe, differently than in the US)

5. Interest Rate Curve Flattening

6. Risk Premia Imploding

**Source:** Google Images
EQUITIES MELTING-UP EVENTUALLY, GREECE A SPEED BUMP

DAX TECHNICALLY POISED FOR UPSIDE

Source: Bloomberg
EQUITIES MELTING-UP EVENTUALLY, GREECE A SPEED BUMP

DAX BACK TO RECORD CHEAP

DAX P/E RELATIVE TO MSCI EUROPE

Source: IBES
EQUITIES MELTING-UP EVENTUALLY, GREECE A SPEED BUMP

FTSEMIB AIMING AT 30,000 AND BEYOND

Source: Bloomberg

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YIELDS PLUMMETING

QE EFFECTS TO BE MAGNIFIED

- It is estimated that >60% of 2015 European government Bonds issuance was covered in the first months of 2015
- European net bond issuance (after QE) will be negative over the next two months (-€72bn in July and -€24bn in August)
- QE EFFECTS COULD BE FELT MUCH MORE in 3Q15 and 4Q15 due to negative net issuance post QE purchases

Source: Bloomberg
JAPANESE MARKET STILL VERY ATTRACTION

FEW REASONS

- Similarly to our views on European Equities, we deem Japanese Equities as being:

CHEAP ON VALUATIONS

High P/Ers and low prospective returns, but fat dividend yields when compared to shallow bond yields and a low bar for investors’ expectations

CHEAP AGAINST THE BACKDROP OF EXCESS LIQUIDITY

Induced by Central Bank, but also by macro-(im)prudential policies forcing the hand of a $2trn pension fund industry – led by GPIF – or the hand of retail – think of PAYE schemes, estimated impact being $0.8trn in 5 years

NOT SO CHEAP AGAINST ECONOMIC ACTIVITY, BUT THAT IS A POSITIVE, ESSENTIAL TO OUR VIEWS

A truly accelerating economy would jeopardize Central Banks’ policies and withdraw liquidity. Critically, we have a BEARISH VIEW OF THE ECONOMY, especially so in Europe and Japan, as we believe that ‘secular stagnation’ theories have merit (explained in further details later in this Outlook). Differently than in Europe, in Japan you also get the added value of policy decisionism (Abe has an all-in approach, in stark contrast to the dysfunctional/muddle-through European policymaking), fiscal expansion (VAT hike delayed vs miscalculated austerity overkill inducing structural reform fatigue)

Greece

Bunds Market Riot

Deflationary Boom Markets

Deflationary Bust

Deflationary Trends

Crystal Ball
JAPANESE MARKET STILL VERY ATTRACTIVE

NEW HIGHS IN SIGHT?

- JAPANESE EQUITIES TO SET NEW HIGHS and we continue looking for a purely nominal rally. Nominal as opposed to real, when adjusted for currency fluctuations.
  
  Nominal and not real, when compared to a deteriorating economy. Elusive returns, but returns nevertheless

- We had a target on the Nikkei at 20,000 two years ago. Now we are there but we kept our longs for the time being, anticipating new highs

Source: Bloomberg
JAPANESE MARKET STILL VERY ATTRACTIVE

MELTUP TO LAST FOR A LITTLE LONGER... UNTIL 25,000?

Source: Bloomberg
LONG TERM: DEFLATIONARY BUST
**QE**s **COMPARISON**

**MANY BULLETS ARE BEING USED BY CBs TO SUSTAIN THE ECONOMY**

In the past six years, the FED:
- Went from cutting rates to zero rates
- QE1 in 2008 (upped in 2009)
- QE2 in 2010
- QE3 in 2012
- Operation Twist
- All sort of other tools – US Treasury’s preference shares, TARP, CPP, P-PIP, etc.

The ECB:
- Went from cutting rates to moving rates to zero...
- …to bringing rates into negative territory
- MRO
- LTRO I
- LTRO II
- SMP
- OMT
- T-LTROS
- ABS Purchases
- **QE1**

- In Europe, there might as well be an ECB’s QE2 and a QE3 in front of us, if recent history is any guide
- That can easily fill the next few years, while superficial but timidly improving GDP/inflation/unemployment numbers make mainstream agents baptize it as successful policymaking

**Source: Google Images**
CBs’ MUNITION ARSENAL DRYING UP

WE THINK WE ARE PAST 70% OF TOTAL AMMO AVAILABLE

- ECB’s measures
- FED’s measures

CENTRAL BANKS MUNITION ARSENAL

- QE1 in 2008
- QE2 in 2010
- QE3 in 2012
- Operation Twist

FED cutting rates to zero

- QE2
- QE3

Other tools (e.g. US Treasury’s preference shares, TARP, CPP, P-PIP)

FED bringing rates to zero and then into negative territory

MRO, change collateral rules, cut reserve requirements, etc.

LTRO I

LTRO II

SMP, end SMP sterilisation

OMT

T-LTROs

ABS Purchase

Forward guidance

FX intervention? Others?

Source: Google Images
CBs’ MUNITION ARSENAL DRYING UP

CENTRAL BANKS’ INDUCED BUBBLE SET TO BURST

- AT SOME POINT, THOUGH, WE EXPECT A CHANGE IN REGIME, ONCE CENTRAL BANKS RUN DRY OF AMMUNITION, AND THINGS MAY THEN UNRAVEL

- If we are right about the global economy...
  - There will be no normalization of growth rates, just sluggish GDP growth
  - Deflationary trends may prevail
  - Over-indebtedness may go uncured
  - Un-employment may remain high in Europe

- Against such backdrop, CENTRAL BANKS WILL CONTINUE PUMPING LIQUIDITY AND FUELLING THE BUBBLE, until their arsenal is running thin (which is still not the case today), at which point political regime changes may possibly provoke an unplug

- In Europe, a dissolution of the currency peg (EUR break-out) would then be a genuine option

- The famous quote “do not fight Central Banks” is permutated into “DO NOT FIGHT CENTRAL BANKS AS YET”. There will be a time for that. There will be a time where market forces are more in line with residual Central Bank forces left over
AND IN THE LONG TERM...

A DISRUPTIVE SCENARIO TO ARISE

- At some point though, as the arsenal gets emptier, several months or few years from now, one will have to look around, analytically, and if

1. GDP IS STILL SHALLOW
2. DEBT IS STILL HIGH AND HAS GROWN SOME MORE
3. INFLATION IS STILL ZERO / NEGATIVE (TAKING DEBT RATIOS HIGHER WITH IT)
4. UNEMPLOYMENT IS STILL AWFULLY HIGH

POLITICAL INSTABILITY

BOND YIELDS RISING IN NO INFLATION / GROWTH AS RISK GETS REPRICED

EQUITIES GIVING BACK FICTITIOUS GAINS ALL TOO QUICKLY
EUR BREAK-UP SCENARIO

QUOTE FROM OUR DEC 2013 OUTLOOK

• “The fact that the fear of destruction, either in the form of widespread unemployment, GDP contraction or civil unrest, is preventing the EUR currency peg from being dismantled, must delay the final extinction of the currency, until such same destruction is to happen anyway, under the squeeze of the currency peg itself”

• If history is any guide, three conditions were met in past currency crisis and emerging market crisis:
  ✓ AN OVER-VALUED CURRENCY (read, the EUR to countries like Italy and Spain),
  ✓ OVER-INDEBTEDNESS, as a share of GDP or the productive economy (rephrased, too much debt and no growth against it)
  ✓ CURRENT ACCOUNT DEFICIT

BY ANY OBJECTIVE CRITERIA, ALL THREE LEVERS ARE MET FOR CERTAIN COUNTRIES IN SOUTHERN EUROPE, MAKING THE CASE FOR A RESHAPING OF THE EUR-FIXED CURRENCY REGIME A GENUINE ONE

IN ADVANCED ECONOMIES THE READJUSTMENT MAY BE SLOWER TO OCCUR THAN IN EMERGING ECONOMIES, BUT IT MAY STILL DO OCCUR OVER TIME, INCLUDING A CURRENCY-DRIVEN ONE
THREE PROBLEMS WITH EUROPE
A MORE IN-DEPTH ANALYSIS

1. DYSFUNCTIONAL POLITICS
   - GREECE FIASCO
   - SEPTEMBER 1992 ERM’s FIASCO
   - GREECE DOMINATED 90 MEETINGS OF EUROPEAN MINISTERS SINCE 2010

2. ERRONEOUS POLICY MAKING
   - RELYING ONLY ON MONETARY POLICY, FISCAL CONTRACTION / AUSTERITY

3. GLOBAL DEFLATIONARY TRENDS AT PLAY
   - ITALY CASE STUDY
   - DEFLATIONARY TRENDS SECTION [HERE]
EU FIASCO – DÉJÀ VU?

IS IT REALLY DIFFERENT THIS TIME AROUND?

"The Germans have totally undermined the pound", John Major raged on Black Wednesday. The man he blamed was Helmut Schlesinger, president of Germany's Bundesbank, whose loose talk the day before, casting doubt on the ability of the ERM to stay together, precipitated the final attack that sank the pound. In truth his comments acted only as a catalyst for the markets' loss of faith in the British government's ability to maintain the pound's minimum ERM rate.
FIND THE ODD (IF ANY)

COINCIDENCE OR REALITY?

EU PARLIAMENT IN STRASBOURG

Head Office of the European Parliament including a hemicycle of 750 seats, 1233 offices for the members of Parliament, 18 commission halls of 50 to 350 seats, catering centre and services. The architecture is a metaphor of the European Culture ongoing and its history, and of the democratic institutions carrying it.

The edifice expresses the foundations of the Western civilization: Classicism and Baroque, from Galileo’s to Kepler’s ellipse, the transition from a central geometrical structure (Galileo) to the anamorphosis (Borromini) and the ellipse (Kepler, Gongora), showing the constant motion expressing the evolution of the institutions, evolving from central power to a democratic organization.

Deflationary Boom Markets

Greece

Bunds Market Riot

Deflationary Boom Markets

Deflationary Bust

Deflationary Trends

Crystal Ball

Pieter Bruegel the Elder painting

Source: Google Images
"Interestingly, some euro finance ministers disagreed and criticised not only our text but also the text of the institutions”
Yanis Varoufakis

Greece dominates 90 meetings of European ministers since 2010. How is that for leadership?
EUROPE’S WOES

ERRORNEOUS POLICY MAKING

REAL ISSUE: DEFICIENT AGGREGATE DEMAND

- At times of deficient aggregate demand, MONETARY EXPANSION, WITHOUT FISCAL EXPANSION AND REDISTRIBUTION POLICIES, IS INEFFECTIVE IN THE LONG RUN
- Surely circuit breaks are avoided, but it cannot do much about reigniting a growth / inflation cycle

WRONG REMEDY: AUSTERITY

- As Europe's obsession for AUSTERITY IMPEDES A FISCAL EXPANSION TO JOIN MONETARY EXPANSION, the chances of success of European policymaking must be lower, against the same conceptual framework they advocate to (monetary printing alone will not kick off escape velocity; fiscal overkill will induce structural reforms fatigue, as opposed to force structural reforms). Purely relying on the private sector is insufficient.
- As demographics are a paramount factor, it should be noted that FISCAL POLICY ONLY CAN AFFECT DEMOGRAPHICS, NOT MONETARY POLICY

We never know we are right, we can only know if we are proven wrong, we can be temporarily right until falsification comes, one failed test is enough to falsify, but no amount of confirming evidence is sufficient to verify. (Soros)
GREECE IS IN GOOD COMPANY

OTHER EXAMPLES OF THE EU SAGA

Finland: real GDP is 10% lower than before the crisis

Economic decline is visible in Denmark, in the Netherlands, etc

Spain: unemployment rate at 23%, real income per capita still 7% lower than before crisis.

Portugal: real income per capita still lower 6% than before crisis

Italy: GDP is 10% lower than before the crisis, Industrial Production is 25% lower than before the crisis

Source: Fasanara Research, Google Images
THE CASE STUDY OF ITALY

ZERO INFLATION LIKE A DEATH PENALTY

Despite austerity and a primary surplus of ca. 2% of GDP, debt/GDP is worsening and dangerously approaching 140% on the back of zero inflation and stagnating GDP

- GDP cannot run at past glory days, as credit acceleration is well past its peak and its marginal effectiveness... making inflation key
- As a country, for the debt/GDP ratio to improve, primary budget balances have to exceed the difference between real GDP growth and real interest rates on public debt
- For the same amount of shallow GDP growth, if inflation is zero or negative, real rates rise and debt/GDP worsens

- Italy would need a primary surplus of ~8% if it wanted to stabilize its debt/GDP at zero inflation
- Trying that would be suicidal, as deflation would worsen
- Which it would lead to more austerity and more contractionary policies to cause further internal devaluation, more declines in unit labour costs, more salary cuts, more unemployment, less consumer spending and less corporate investments

AS A RESULT, ZERO INFLATION IS LIKE A DEATH PENALTY FOR DEBT-LADEN COUNTRIES, LIKE ITALY

IT FOLLOWS THAT DEFLATION IS A GAME CHANGER FOR EUROPEAN POLICYMAKING, FORCING BOLD ACTION

Source: Google Images
THE CASE STUDY OF ITALY

EXCESS SOVEREIGN DEBT

- Italian debt to GDP ratio is currently close to the levels seen during WW1 and WW2
- The resolution of this era of excess debt and financial repression can bring nothing else but volatility in the financial markets

ITALIAN GOVERNMENT DEBT AS % OF NOMINAL GDP SINCE 1900

Source: BAML
THE IMPACT OF PRICE STABILITY IN THE EU


- European authorities can blame peripheral European countries for years of reckless budgets, as much as Europe periphery can blame EU authorities for allowing inflation to reach the zero bound...thus making anything now left in the control of said countries totally irrelevant

- It should also be noted that Germany’s current account surplus is to blame as much and more than France’s deficit on GDP. Indeed, imbalances on both sides are regulated by European rules. Here then, Germany surplus at over 8% of GDP exceeds threshold for EU sanctions (EU macroeconomic imbalance procedure sets it at 6%) more than 4% France deficits exceed deficit parameters (3%)

---

- DEFLATION IS A GAME CHANGER AND FORCED THE ECB INTO ACTION, TO BE INCREASED GOING FORWARD AS IT IS TOO LITTLE TOO LATE, IN AN ATTEMPT TO AVOID:
  - FULLY-FLEDGED DEBT CRISIS,
  - A LONG PERIOD OF JAPAN-STYLE DEPRESSION, AND
  - AN IMPLOSION OF THE EUR FIXED CURRENCY REGIME

- If the ECB is to avoid defaults and debt restructurings in Europe, it must engineer financial repression and debt monetization
- One way to achieve that is engineering negative real rates

Source: Google Images
RISKS TO OUR LONG-TERM VIEWS

WHAT CAN POSSIBLY PROVE US WRONG?

- Main risks to our long-term view are not to be forgotten and can be summarised as per below:

1. FAST RISING GDP
2. RISING INFLATION
3. RISING PRODUCTIVITY RATES
4. RISING WORKING POPULATION
5. DECLINING INDEBTEDNESS
6. DISRUPTIVE TECHNOLOGICAL BREAKTHROUGH INNOVATION
7. LIQUIDITY CRUNCH

- Should we see any of these elements emerging in global economies, and do so in a DURABLE FASHION (and especially so in Europe and Japan, the preferred spots of our asset allocation and where we have been the most active in the last couple years), we stand ready to change our views and throw overboard our current portfolio positioning.

...VERITAS FILIA TEMPORIS – Truth is the Daughter of Time
(Aulus Gellius, Noctes Atticae Liber XII - 11,7)

Source: Google Images
LIQUIDITY CRUNCH

IS LIQUIDITY RISK MISPRICED?

Risk parity is an asset allocation framework that seeks to ALLOCATE SAME MARKET RISK TO EACH ASSET and then LEVERS THE PORTFOLIO in order to reach a target portfolio volatility.

This means that in dollar terms, the portfolio is very OW low volatility assets, i.e. fixed income, and that those positions are leveraged. The collapse in rate volatility relative to equity volatility since the start of QE means that the leverage in fixed income positions has increased markedly over the past few years.

As the MOVE Index now moves markedly HIGHER, we may see OVER-SHOOTING in market sell-off on rising rates. Volatility-induced sell-offs.

MOVE INDEX – MERRIL LYNCH OPTION VOLATILITY ESTIMATE

**ENTRANCE WITH NO EXIT**

US Credit mutual fund assets vs dealer inventory ($bn, IG+HY)

Source: Bloomberg, Haver Analytics, Citi Research

Source: Bloomberg

~ +78%
LIQUIDITY CRUNCH

IS LIQUIDITY RISK MISPRICED?

Net free credit is a measure of cash available in margin accounts to meet potential margin calls.

This measure is currently at extreme levels and, in case of a market sell-off, investors will be forced to sell some positions, CRUSHING MARKETS’ LIQUIDITY AND EXACERBATING THE CORRECTION

Source: BAML
DEFLATIONARY TRENDS
SECULAR STAGNATION

CONCEPTUAL FRAMEWORK

THE CURRENT DEPRESSED ECONOMY, WITH ITS LOW INFLATION, LOW GDP GROWTH RATES, LOW POTENTIAL GDP GROWTH, LOW WORKING POPULATION GROWTH RATES AND LOW INTEREST RATES, IS NOT A CONSEQUENCE OF THE GLOBAL FINANCIAL CRISIS AND THE LEHMAN MOMENT, BUT RATHER THE RESULT OF MORE STRUCTURAL FORCES THAT HAVE BEEN AT PLAY FOR DECADES

- SHALLOW GLOBAL AGGREGATE DEMAND IS MASSIVELY VISIBLE:
  - Declining GDP and declining GDP potential – the output gap is narrowing as a consequence of a drop of estimation over potential
  - Declining Commodity prices (falling prices & falling volumes) – across functional commodities like Iron Ore, Mr Copper, non functional like Silver, Gold and Dry hire rates
  - Oil – driven by geopolitics
  - Interest Rates at multi-centuries lows, Inflation rates at lowest levels since WWII
  - Demographics play a big role as they affect long-term anti-cyclical growth
  - Money Multiplier and Velocity of Money drifting lower since decades – marginal effectiveness of new lending structurally declining
  - Low demand for loans, low Capex, low loan supply on low expected returns

- Global financial crisis / Lehman-moment was an accident on the road to deflation as opposed to a catalyst for it; it was maybe just an accelerator
  - It is vividly noticeable that in the years going into the GFC, from 2003 to 2008, despite what we would today admit being bubbles levels of credit expansion and real estate expansion, definitive and unsustainable manias, GDP growth was not impressive but rather just fine. During those boom years, despite an unprecedentedly over-leveraged private sector, GDP growth was un-impressive, while inflation risks were subdued

- A few further comments:
  - Are low interest rates a consequence of high savings rates, exceeding investment rates, change in savings/investments propensity structural? If so, this is bad for productivity. Also it compresses bank margins and disincentives bank lending
  - Expectations of deflation would drive real rates higher – this is bad for dealing with debt overhang and causes redistribution from debtors to creditors
  - Financial repression faces headwinds and so does debt overhang and its grim grip on the economy – the long-term deleveraging cycle is therefore lengthened
  - Rentiers benefited over productive forces in the economy, despite rates at zero. Capital gains in excess of fair value substituted income stream lead to inequality, lack of productivity, lower propensity to invest and lower aggregate demand (in this respect Oil drop > QE)
  - At times of deficient aggregate demand, monetary expansion is ineffective in absence of fiscal expansion / redistribution policies. Only fiscal policy can affect demographics
  - Disinflation is often ignored as it is believed to be sticky on the downside. This is a problem in itself. ECB predicts 2015-2016 inflation to jump 1.5%, while the largest ever jump in last 30 years was 1.3% (from 2009 to 2010 when oil went from $34 to $80)
DEPRESSED ECONOMY

DEPRESSED ECONOMY

DEFICIENT GLOBAL AGGREGATE DEMAND

LOW GDP GROWTH RATES

LOW INFLATION

LOW POTENTIAL GDP GROWTH

LOW FUNCTIONAL COMMODITY PRICES
(FALLING PRICES AND DECELERATING VOLUMES)

Oil is the most visible one. Admittedly, it has lately been manipulated by supply-side effects driven by geopolitics, more than anything else. However, its inability to materially rise during Arab Springs is informative. Medium-term, oil is under pressure due to additional supply generated by technological advances, alternative energies getting cheaper and the global drive for energy efficiency. Longer-term, oil is one technological breakthrough away from extinction (e.g. batteries). A matter of when, not if.
SECULAR STAGNATION

DIAGNOSIS, PROGNOSIS and THERAPY

PROBLEM: DEFICIENT AGGREGATE GLOBAL DEMAND

UNDERGOING ATTEMPTED REMEDY

✓ Cut rates to discourage savings \(\rightarrow\) ASSET BUBBLE
✓ Boost consumer borrowing & spending
✓ Fictional feeling of recovery \(\rightarrow\) BUBBLE POPS

IN EUROPE...

ISSUES

× Not even bubble price activities – levels below pre-QE
× Dysfunctional politics, lack of confidence

ALTERNATIVE REMEDY

✓ Deficit monetization + deficit spending
✓ Government borrowing, create debt, bought by CB
✓ Government absorbs excess savings
✓ Government implements demand-boosting investments (e.g. infrastructure)

ISSUES

× Europe not doing any of it, no fiscal expansion, relying on private sector EU
× EU animal spirits, really?

ALTERNATIVE REMEDY

✓ Process is self-regulating
✓ Excess savings go abroad in reach of better returns
✓ Capital outflows weaken currency \(\rightarrow\) rising import demand from abroad

ISSUES

× China: saving instead of spending, investing in Treasuries to boost their exports \(\rightarrow\) China glut
× Europe: demand drain, negative inflation, Japan-like trap

Source: Google Images

Deflationary Trends
DEPRESSED ECONOMY

FOCUS ON SOME DRIVERS

1. FALLING WORKING POPULATION / FALLING PRODUCTIVITY RATES

Demographics affect long-term anti-cyclical growth. An ageing population is much of a global issue (including China), although it is clearly more visible in countries like Japan, Italy and Germany. In Japan in particular, the depressed economy of the 90s owed much to the combination of falling fertility rates (from 1.8 children per woman from 1980 to 1.4 from 2010) and increased life expectancy. That, coupled with Japan’s stance over no immigration, no women at work, no job cuts and no wages cut, helped fuel 24 years of depressed economy (Japan’s ‘lost decades’). Undoubtedly, a falling working population played a big role.

2. OVER-INDEBTEDNESS

As inflation moved lower, debt ratios went higher for most large economies globally (except perhaps for today’s austerity stakhanovites in Germany). Debt diverts resources away from productive investments into sterile debt service. Even at minimal interest rates, such diversion is material. Over-indebtedness constrains the wings of productivity and growth from opening up.

3. DIMINISHING EFFECTS OF MONETARY PRINTING AND THE CREDIT CYCLE

This is visible when looking at the 40-year chart of ‘Money Multiplier’ (how many $ of commercial bank money for any $ of Central Bank money, how many $ of money supply for any $ of monetary base, the famous $ lent to the real economy) and ‘Velocity of Money’ (how many $ of GDP produced for any $ of loans extended to the real economy). The end of the Bretton Woods System triggered by Nixon’s New Economic Policy in August 1971, unleashed the full power of the fractional-reserve banking system, and the beauty of credit expansion and its multiplier effect on growth and productivity. Has the credit-based expansion now run into some kind of a dead end? Has it permanently gone into exhaustion mode, or are there ways to reigniting the virtuous cycle? The impossibility of exponential growth in a finite environment makes us propend to think it cannot.

4. TECHNOLOGICAL ADVANCES

Striking difference to past occurrence of secular stagnation. When Alvin Hansen in 1938 referred for the first time to ‘secular stagnation’ he enlisted ‘low technological advances’ as a key driver. Today, in contrast, we believe we are in the middle of a technological revolution (Google, Apple, Amazon, 3D printing etc.), reshaping the world we live within. However, incidentally, such technological revolutions calls for

- Shredding jobs (Nike employed 106k less people in 2013 due to automation, WhatsApp was a 50-employee company when it was valued as much as Nokia, an employee- and plants-rich company)
- Reducing unit production costs to levels where one can live almost without working or working less (even sequencing the human genome used to cost $ 2.5bn in 1990, it now costs $ 750 to be produced)
- Increasing income inequality and further concentrating wealth into elites, while reducing the economy’s capital intensity

Less labour, but also less capital. Less investments needed.
How to Interpret Low Interest Rates?

**Low Interest Rates**
Engineered by Central Banks to combat deflationary trends and stimulate growth.

**Increased ‘Savings Propensity’**
Low interest rates may reflect high savings rates, and savings rates exceeding investment rates. If there is any structural change in the propensity to save over investing, that would bode badly for productivity.

**Compressed Bank Margins**
Low interest rates to be the cause also of the compression of bank margins, therefore somehow de-incentivizing bank lending, thus leading to low loan supply.

**Low Rates Still Too High, Impeding Recovery**
Rates are low by historical standards, trading at multi-centuries lows. They might be low against the Taylor rule, but not low enough against the Wicksellian natural rate. If inflation is to be sub-zero for long, nominal rates are surely too high.

**Low Demand for Loans, Low Capex**
Low rates may also be consequent upon low Capex on the back of low expected returns. In this respect, they are a reflection of stagnation, not just a policy response to it.

**Damaged Rentiers Pushed into Riskier Asset Classes, Including Investments in the Real Economy**
Central Banks policies have inflated financial assets to a level where those rentiers have vastly profited.

**Financial Engineering**
Low interest rates divert attention from real economy into financial engineering (e.g., M&A, buybacks).

Greece | Bunds Market Riot | Deflationary Boom Markets | Deflationary Bust | Deflationary Trends | Crystal Ball
SECULAR STAGNATION

A (PRE)HISTORICAL POINT OF VIEW

INTEREST RATES IN THE PAST 5000 YEARS

Source: BAML
SECULAR STAGNATION IN EUROPE

LOCAL PROBLEMS ON TOP OF GLOBAL ONES

FISCAL POLICY TIGHTENING
- Austerity Targeting
- Internal Devaluation is itself a form of Deflation

ECB’s CONTRACTING BALANCE SHEET
- 2 years of contraction, 1tn EUR since 2012

HIGHER EUR
- It reached 1.3990 against USD in May ’14

EUROPEAN ENDOGENOUS FACTORS

THE AMAZON EFFECT
WEAKER USD THAN OTHERWISE ON ZIRP POLICIES
WEAKER THAN POTENTIAL GROWTH
SLACK IN LABOUR MARKET
LOW ENERGY PRICES

DEMOCRAPHICS
WEAK AGGREGATE DEMAND
CHINA SLOWING DOWN
JPY DEVALUATION EXPORTING DEFLATION
OIL PRICE IMPLODING
OVER-INDEBTEDNESS

GLOBAL STRUCTURAL TRENDS / EXOGENOUS FACTORS

Greece
Bunds Market Riot
Deflationary Boom Markets
Deflationary Bust
Deflationary Trends
Crystal Ball
EUROPEAN DEFLATION IS A STRUCTURAL ISSUE

FROM OUR 9TH JUNE 2014 OUTLOOK

BACK IN JUNE WE STATED THAT EUROPE LOOKED LIKE JAPAN IN EARLY ‘90s:

- In the presence of deflation the debate over austerity, fiscal balances, spending cuts, return to competitiveness loses relevance ... in fact, debt ratios deteriorate at zero inflation
- We approach deflation in Europe as a structural issue which will likely affect markets dynamics for a long time
- Europe is entangled in secular stagnation, which has just started to translate in deflation terms, helped by a flawed fixed currency regime
- We also like to compare Europe to what Japan looked like in the early ‘90s. in fact, similarly to japan then, Europe today presents unmistakable connotations, including:

1. **HIGH LEVEL OF INDEBTEDNESS**
   Drawing resources away from productive investments into sterile debt service

2. **OVERVALUED CURRENCY**
   Especially to peripheral European countries (30% overvalued against D-Mark, 40%+ overvalued against the rest of the world). Peripheral Europe is experiencing a currency crisis as if they borrowed in foreign hard currency

3. **INACTIVE CENTRAL BANK**

4. **FALLING WORKING POPULATION**

5. **FALLING PRODUCTIVITY RATES**

Source: Google Images

Deflationary Boom Markets  Deflationary Bust  Deflationary Trends

Crystal Ball
EUROPEAN DEFLATION IS A STRUCTURAL ISSUE

FROM OUR 9TH JUNE 2014 OUTLOOK

- WE CAN NOW SAY, INSTEAD, THAT EUROPE IS WORSE THAN JAPAN IN THE EARLY 90s

- Japan has never experienced as low a level of GDP and Employment during its ‘two lost decades’

- Decisionism in Japan under Abe stands in stark contrast against dysfunctional politics / ineffective policymaking in Europe

- Fiscal expansion in Japan (VAT delayed, as of late) compares with fiscal tightening / austerity in Europe. Monetary policy without fiscal policy does little to incentivise a virtuous cycle of growth/inflation, cannot even avoid debt ratios from worsening further

- Structural reforms fatigue, on the back of austerity overkill. Speed of adjustment to blame, while it triggered political extremism

- Europe is trapped in the wrong currency, especially so for uncompetitive countries in peripheral Europe

Source: Google Images
SECULAR STAGNATION

PRESENTED WITH CHARTS

FEDERAL RESERVE MONETARY BASE SINCE 1959

US CPI SINCE 1920 (7-year mvg avg)

US NOMINAL GDP GROWTH SINCE 1953 (7-year mvg avg)

Source: Fasanara Research, Bloomberg
SECULAR STAGNATION

GLOBAL STRUCTURAL TRENDS

BALTIC DRY INDEX – 2007 to date

IRON ORE SPOT PRICE INDEX – 2010 to date

COPPER FUTURES – 2010 to date

Source: Bloomberg

Greece  Bunds Market Riot  Deflationary Boom Markets  Deflationary Bust  Deflationary Trends  Crystal Ball
SECULAR STAGNATION

BAD DEMOGRAPHICS: POPULATION GROWTH TRENDS

- The old-age dependency ratio (calculated as population aged 65+ per 100 population aged 15-64) is clearly increasing in developed markets.
- The figures are particularly shocking in Japan, where this ratio tripled in the last 20 years.
- European countries also seem to follow the same path as Japan.

OLD-AGE DEPENDENCY RATIO IN G6 COUNTRIES

Source: UN, Credit Suisse
EMERGING COUNTRIES vs DEVELOPED COUNTRIES POPULATION FORECAST

- Between now and 2099, population in EM is forecasted to grow by 3,600,000,000 (or 62%)
- In contrast, population in DM will grow by only 32,000,000 (or 3%)
- By 2099 almost 90% of the world is estimated to live in an Emerging Market

Source: BAML
SECULAR STAGNATION

BAD DEMOGRAPHICS: POPULATION GROWTH TRENDS

WORKING AGE POPULATION GROWTH 2013 - 2038

- Growth of the working age population is a key input for long-term potential economic growth

- In the next 25 years, the working age population is set to shrink in countries such as Germany, Japan, Korea, Italy and China

- By contrast, the working age population of India, Indonesia, Mexico, Australia and Turkey among others is set to grow
SECULAR STAGNATION

THE AMAZON EFFECT

- Technology keeps on innovating, improving productivity, reducing costs and labour force
- For instance, the number of connected devices was 500 millions in 2003, will be 7.2 billion in 2015 and will increase to 50 billion (6 devices per person) by 2020
- ROBOTICS & TECH ADVANCES ARE SHEDDING JOBS WHILE DEPRESSING INPUT PRICES. Nokia is worth as much as WhatsApp. Nike employed 106k fewer workers in 2013 due to automation. Cost of sequencing human genome dropped from 2.5bn in 1990 to 750$ in 2014.

COST PER GENOME, 2001 - 2014

GROWTH OF WORLD POPULATION AND THE HISTORY OF TECHNOLOGY SINCE 9000BC

Source: NHGRI Genome Sequencing Programme
SECULAR STAGNATION

O V E R - I N D E B T E D N E S S

- Ageing population & rapid technological changes are coinciding with extremely high levels of public sector debt
- High level of debt is one of the defining feature of the current economic and financial landscape
SECULAR STAGNATION

OVER-INDEBTEDNESS

- No real deleveraging has occurred since the latest financial crisis
- US total market debt owed is currently $59 trillion (327% of GDP) and it has largely outpaced GDP growth in the last 25 years

US NOMINAL GDP AND TOTAL CREDIT MARKET OWED SINCE 1952

Source: BAML
SECULAR STAGNATION

MONETARY BASE EXPANSION VS. MONEY MULTIPLIER AND VELOCITY OF MONEY COLLAPSE

- BmV = PY, (where B = the monetary base, m = the money multiplier, V = velocity of money), PY is nominal GDP

- The money multiplier is a measure of the maximum amount of commercial bank money (money in the economy) that can be created by a given unit of central bank money, i.e., the total amount of loans that commercial banks extend/create

- The velocity of money is a measurement of the amount of economic activity associated with a given money supply, i.e., total Gross Domestic Product (GDP) divided by the Money Supply
  
  This measurement also shows a marked slowdown in the amount of activity in the U.S. economy for the given amount of M2 money supply, i.e., increasingly more money is chasing the same level of output

VELOCITY OF M₂ MONEY STOCK (M₂V)

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M₁ MONEY MULTIPLIER (MULT)

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Shaded areas in both charts indicate the latest financial crisis

Source: Fasanara Research, Bloomberg

Fasanara Capital Limited
SECULAR STAGNATION

DEBT VIGILANTES GONE MISSING

RELATIONSHIP BETWEEN DEBT LEVELS AND BORROWING COSTS

ITALIAN 10yr GOVERNMENT BOND YIELDS

Source: Fasanara Research, Bloomberg

Source: BAML, Global Financial Data, Bloomberg

Greece
Bunds Market Riot
Deflationary Boom Markets
Deflationary Bust
Deflationary Trends
Crystal Ball
SECULAR TRENDS

US 10yr TREASURY’S MULTI-YEAR DOWNTREND

Source: Bloomberg
SECULAR TRENDS

US 30yr TREASURY’S MULTI-YEAR DOWNTREND

Source: Bloomberg
PORTFOLIO CONSTRUCTION
**Fasanara’s Manifesto**

**How We Approach Decorrelation / Diversification**

**Defining Elements of Today’s Markets**

- **Low Volatility**
  - Owing to Central Banks’ Activism

- **High Cross-Asset Correlation**
  - Especially to the downside

- **Seismic Activity**
  - Calm above the storm

**Asymmetric Profiles Available**
- Markets offer access to non-linear payoffs

**Opportunistic Behaviour a Must**
- Roaming across asset classes in pursuing the cheapest way to implement the view

**Asymmetric Profiles Needed**
- Monetary Policy Experimentation means uncharted territory, need for convexity / long gamma

**Where Does It Lead to in Terms of Portfolio Construction**

**Value Book**
- Long-Term holdings
- Infantry

**Hedging Book**
- Treasury of optionality
- Catapult

**Tactical Book**
- Intra-day trading
- Cavalry

*Source: Google Images*
FASANARA TRADE EXPLAINED

FEW VIDEO EXAMPLES ON OUR CORE IDEAS FROM ALPHA JOURNAL

1. LOOKING FOR CONVEXITY AND ASYMMETRIC PROFILES WITHIN PORTFOLIO

2. LONG LONG-DATED DIGITAL CALLS ON CNH VS USD

3. LONG SHORT-DATED ONE-TOUCHES PUTS ON JPY VS USD

4. LONG VANILLA LISTED CALLS ON OMX / SWEDISH EQUITY

5. LONG LONG-DATED EXOTIC CALLS ON NIKKEI

6. TAIL HEDGE ON THE BUXL / BUND CURVE

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CRYSTAL BALL

KEEP CALM AND
OH WHO ARE WE KIDDING
### Fasanara Expected Target Levels

<table>
<thead>
<tr>
<th></th>
<th>Spot (as of 07/07/2015)</th>
<th>2015 Fasanara Target</th>
<th>Key Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>2,070</td>
<td>2,100 – 2,200</td>
<td>Limited Upside, but overall positive on the S&amp;P More volatility than 2014</td>
</tr>
<tr>
<td>SX5E</td>
<td>3,335</td>
<td>3,600</td>
<td>Boosted by the ECB’s QE More volatile than in 2014</td>
</tr>
<tr>
<td>FTSE MIB</td>
<td>21,500</td>
<td>&gt; 25,000</td>
<td>Cheap on Valuations, Reallocation of capital flows Improved unemployment rates Remote possibility for snap election in Italy</td>
</tr>
<tr>
<td>NIKKEI</td>
<td>20,350</td>
<td>20,000</td>
<td>Currency debasement, regulation-driven flows and some genuine momentum improvement in corporate profitability</td>
</tr>
<tr>
<td>Athens Stock Exchange</td>
<td>800</td>
<td>20%+ up</td>
<td>Greece is a macro call, now more than before Debt forgiveness is a false issue, what matters is concession on primary surplus</td>
</tr>
<tr>
<td>Gold</td>
<td>1,165</td>
<td>&gt; 1,400</td>
<td>Upside risk, non-consensual</td>
</tr>
<tr>
<td>Brent Crude</td>
<td>57.00</td>
<td>&lt;$40</td>
<td>Possibly overshooting to below $30</td>
</tr>
<tr>
<td>BTP</td>
<td>2.28</td>
<td>~1%</td>
<td>Double push: Deflation + ECB’s QE</td>
</tr>
<tr>
<td>BTP/OAT</td>
<td>1.40</td>
<td>~0.6%</td>
<td></td>
</tr>
<tr>
<td>Bund</td>
<td>0.75</td>
<td>0% – negative</td>
<td>Even below Japanese JGBs</td>
</tr>
<tr>
<td>US 10YR Treasuries</td>
<td>2.20</td>
<td>1%</td>
<td>The best carry trade available globally Scarcity value: 50% of all gov’t bonds globally yield &lt;1% Global supply/demand for bonds in favour</td>
</tr>
<tr>
<td>US 30YR Treasuries</td>
<td>3.05</td>
<td>&lt;1.7%</td>
<td>Demand from national Central Banks of the Euro Area given the - 20bps cap of the ECB</td>
</tr>
<tr>
<td>AUD 10YR Goovies</td>
<td>2.85</td>
<td>&lt;2%</td>
<td></td>
</tr>
</tbody>
</table>
## Fasanara Expected Target Levels (cont’d)

<table>
<thead>
<tr>
<th>SPOT (as of 03/09/2015)</th>
<th>2015 Fasanara Target</th>
<th>Key Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UK 5Y5Y Inflation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.80</td>
<td>&lt;2.5%</td>
<td></td>
</tr>
<tr>
<td><strong>EUR 5Y5Y Inflation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.80</td>
<td>&lt;1%</td>
<td></td>
</tr>
<tr>
<td><strong>FED Fund Rates</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.12</td>
<td>0.5%</td>
<td><em>FED to slowly normalize rates amid current growth/job mix</em></td>
</tr>
<tr>
<td><strong>EUR/USD</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.095</td>
<td>&lt;1.05</td>
<td><em>Consensus</em></td>
</tr>
<tr>
<td><strong>USD/JPY</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 122.50                   | 130                  | *Currency debasement in progress*  
*Likely new injections upcoming* |
| **EUR/JPY**              |                      |           |
| 134.0                    | >145                 | *ECB will print $700bn this year, Japan is printing $800bn, for an economy which is less than 30% of Europe’s, while having 2x its inflation, a lower current account surplus* |
| **EUR/CHF**              |                      |           |
| 1.04                     | <0.95                | *SNB to fail again* |
| **USD/CAD**              |                      |           |
| 1.27                     | >1.30                | *Oil to show weakness again, Canada may experience deleverage of Real Estate bubble* |
| **USD/CNH**              |                      |           |
| 6.22                     | <6.20                | *Long term policy making a positive*  
*Debt service payments at 13% GDP non-consensual* |
THANK YOU FOR DIA LING IN!!

WE REMAIN AVAILABLE TO ANSWER ANY QUESTION YOU MIGHT HAVE

PLEASE FEEL FREE TO REACH OUT TO US BY WRITING AT: INVESTOR.RELATIONS@FASANARA.COM
Since September 2011, we have published Investment Outlooks and portfolio’s updates. Please find below links to our Research:

- June 1st 2015: Investment Outlook
- February 1st 2015: Investment Outlook
- December 1st 2014: Investment Outlook
- September 1st 2014: Investment Outlook
- June 9th 2014: Investment Outlook
- April 1st 2014: Investment Outlook
- February 10th 2014: Investment Outlook
- November 4th 2013: Investment Outlook
- October 7th 2013: Investment Outlook
- September 19th 2013: Investors Presentation
- September 3rd 2013: Investment Outlook
- June 28th 2013: Investment Outlook
- May 31st 2013: Investment Outlook
- May 3rd 2013: Investment Outlook
- April 5th 2013: Investment Outlook
- Portfolio Buckets as of 1Mar13: Value Book vs Hedging Book
- March 1st 2013: Investment Outlook
- February 1st 2013: Investment Outlook
- January 11th 2013: Investment Outlook
- December 17th 2012: Investment Outlook
- November 16th 2012: Investment Outlook
- October 26th 2012: Investment Outlook
- October 9th 2012: Investment Outlook
- September 14th 2012: Bi-Weekly Note
- July 27th 2012: Bi-Weekly Note
- July 13th 2012: Bi-Weekly Note
- May 2012: Investment Outlook
- April 13th 2012: Investment Outlook
- March 2nd 2012: Weekly Note

More 2012 reports available upon request.

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- Fasanara Investment Outlook | December 2014
- Fasanara Investment Outlook | September 2014
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- Fasanara Capital Themes & Big Trade Ideas | BANKING ON PHASE II OF ABENOMICS
- Fasanara Capital Themes & Big Trade Ideas | INVESTING & PROFITING FROM EUROPEAN DEFLATION
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16th Mar 2015: European rates to move even lower Video

8th Dec 2014: European bonds are not in a bubble Video

8th Dec 2014: Euro will be ‘dismantled’ in 3 years Video

26th Sep 2014: Was the US sell-off ‘quite normal’? Video

9th Jun 2014: ECB action to boost Greece and Italy Video

3rd April 2014: 30% Fall-off looming for S&P 500: Economist Video

6th Jan 2014: Markets’ overvaluation is a concern Video

20th Nov 2013: “Very cautious" on tapering and why he prefers European and Japanese equities over U.S. Video

Bloomberg

14th Oct 2013: Trading tactically around debt ceiling Video

3rd Oct 2013: Market was complacent about Italian risk Video

3rd Oct 2013: Markets will see 'Japan style' volatility Video

25th Sep 2013: Is the US heading for a correction? Video

5th Sep 2013: Expecting a Market Correction Video

12th Apr 2013: Is a Euro Zone Break-Up on the Way Video. Keep Gold Long Term, hedge for monetary madness Video

18th Feb 2013: Go Long Nikkei and Short Yen. Nikkei to 20,000 Video

28th Nov 2012: European Equities Will Jump Video

28th Nov 2012: Real Estate Outlook CNBC Interview 2

31st Aug 2012: How to hedge fatal scenarios Video

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• Fasanara examines investment opportunities thrown up by asymmetric profiles [Article] / Greek problems could be catalyst for major changes in Europe and world economies [Article]

• Fasanara Capital’s Take On Bunds Market Riot [Article]

• VaR shocks are ‘now inevitable’, says Fasanara Capital [Article]

• Fasanara Capital: Key Take Aways From Investment Outlook [Article]

• Global Markets To Be Erratic In 2015, Says Fasanara Capital [Article]

• The Big Picture: As central banks ease monetary policy, some expect more surprises [Article]

• Hedge Magazine - Issue 31 - The Art Issue [Article] (pag. 46-50)

• “Deflation In Europe Is Just Beginning”… And How To Trade It [Article]

• Greek Bond Offering Flies Despite Future Challenges [Article]

• Volatility Trading Intensifies as the VIX becomes a Trading Tool [Article]

• Fasanara Opportunities Fund Profiled [Article]

• The Big Picture: Japan is a catalyst for other economies [Article]

• Exclusive: Analysing the Great Rotation [Article]

• Rates, risks and the regulators - bad week for everyone except Norway? [Article]
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