Deutsche Bank
Research

European Equity Strategy

Market overview – September 2017

29 September 2017

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Market overview – September 2017

- **Macro:** Flash Euro area composite PMI new orders rebounded to a six-year high of 56.3 in September, up from 55.5 in August and consistent with Euro area GDP growth of 3%+ (slide 6). However, PMI momentum – the six-month change in the PMI and a key determinant of European equity market momentum – remains close to zero, having peaked at +4 points in February. We think the current level of the PMI is unlikely to be sustained, given that: (a) PMIs are consistent with GDP growth significantly above our economists' forecasts (2.2% for this year, 2.0% for 2018) and consensus (2.1% for 2017, 1.8% for 2018); and (b) the PMI has overshot the level suggested by the Euro area credit impulse, which, at 0.1% of GDP, is consistent with a PMI of 51. We expect the PMI to fade back to around 53 by year-end, consistent with our economists' growth projections. This would imply PMI momentum turning negative over the coming months. Yet, because of the slower-than-expected fade in macro momentum and a sharper-than-expected fall in the European political uncertainty index, our models now point to a flat market by year-end (with temporary upside to 400 on the Stoxx 600, or 4% above current levels; slide 7), before renewed weakness in response to negative PMI momentum in Q1 2018 (with a projected trough below 360 on the Stoxx 600). We expect to turn tactically positive on European equities on signs that PMI momentum is troughing, which is typically associated with a strong rebound (slide 9). Our current projections imply a trough in PMI momentum in early Q2 2018.
- **Valuations & earnings:** European equities are trading on 15.0x 12-month forward earnings. We expect P/Es to fade to 14.8x by year-end, as macro momentum softens and real bond yields rise in response to reduced central bank accommodation (slide 19). We raise our 2017 EPS growth estimate from 9% to 11%, on the back the recent strong macro data, but remain below consensus, at 13% (slide 16). Our forecasts imply a year-end level of the 12-month forward EPS for the Stoxx 600 of €25.9 (1% above current levels). Taken together, these projections point to mild upside risk to our long-standing Stoxx 600 year-end target of 375 (3% below current levels). Our year-end target for the EuroStoxx 50 is 3,400 (4% downside from current levels), for the DAX 12,400 (2% downside) and for the FTSE 100 7,500 (2% upside).
- **Sector & country allocation:** European cyclicals have outperformed defensives by 5% over the past month, overshooting the fair-value levels implied by our models. We remain overweight defensives relative to cyclicals, as we expect a fade in PMIs to weigh on cyclicals' performance over the coming months, with cyclicals' relative Shiller P/E already at a 10-year high (slides 85 – 87). Our main defensive overweights are pharma (slides 88 – 89) and food & beverage (slides 90 – 91). The expectation of fading PMI momentum also keeps us underweight banks (slides 92 – 93). We remain overweight energy (though our models points to reduced upside following the recent rally; slides 112 – 113). We have recently downgraded mining from benchmark to underweight, as the China credit impulse has started to roll over and our FX strategists see tactical upside for the USD (slides 94 – 95). Among country indices, we are overweight the UK (slides 135 – 138) and Germany (slides 96 – 98), while being underweight France (slide 142 – 144), Spain (slides 145 – 147) and Italy (slides 99 – 101).

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Market overview – September 2017

Market outlook 5

Neutral into year-end, but softening macro momentum is set to weigh in Q1 6

We project European EPS growth of 11% in 2017 15

We expect the European 12-month forward P/E at 14.8x by end-2017 19

Sentiment indicators have moderated from elevated levels 22

We remain cautious on the outlook for European equities relative to the US 25

DB cross-asset return forecasts 30

What are the risks? 31

Growth momentum has started to roll over 32

Rising real bond yields could weigh on multiples 33

Fixed income, FX & commodities outlook 35

Macro & structural issues 53

Key calls 84

Overweight defensives versus cyclicals, pharma, food & beverage; underweight banks and mining 85

Overweight Germany; underweight Italy 96

Sector allocation 102

Overweight: P&H goods, telecoms, real estate, energy, construction materials, media, food retail 106

Benchmark: chemicals, capital goods, autos, utilities 118

Underweight: general retail, insurance, consumer durables, tech, airlines 126

Country allocation 133

Styles & themes 148

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European Equity Strategy flashcard

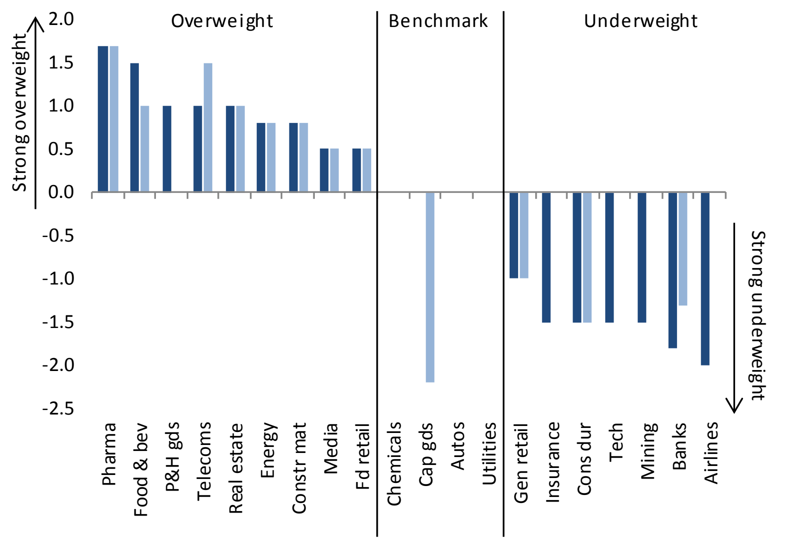
2017e target assumptions	Stoxx 600	EuroStoxx 50	DAX	FTSE 100
12m fwd EPS growth	11%			
Consensus	*13%*			
12m fwd P/E	14.8			
Current level	15.0			
Year-end target	375	3,400	12,400	7,500
Current level	386	3,557	12,705	7,323
Upside / downside	-2.9%	-4.4%	-2.4%	2.4%

Market outlook: We expect the Euro area composite PMI new orders to fade back to around 53 by year-end, consistent with our economists' growth projections. This would imply PMI momentum - the 6-month change in the PMI and a key determinant of European equity market momentum - turning negative over the coming months. Because of the slower-than-expected fade in macro momentum and sharper-than-expected fall in the European political uncertainty index, our models now point to a flat market by year-end (with temporary upside to 400 on the Stoxx 600), before renewed weakness in response to negative PMI momentum in Q1 2018 (with a projected trough below 360 on the Stoxx 600). Our current projections imply a trough in PMI momentum in early Q2 2018, which is typically associated with a strong rebound in equities.

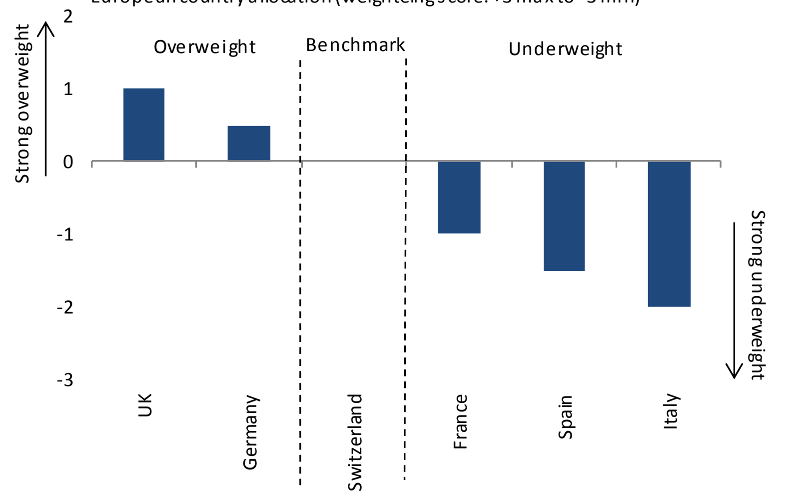
Top 5 trades	**Rationale**
Defensives (+) / cyclicals (-)	More downside when Euro area growth momentum fades
Pharma (+)	Should benefit from roll-over in Euro area growth momentum
Food & bev (+)	Benefits from weaker Euro area PMI momentum
Banks (-)	Downside risks to bond yields on a fade in growth momentum
Mining (-)	Downside as China macro starts to soften

Further recommendations	**Rationale**
Tech (-)	Not yet priced for a weaker dollar and softer US macro data
Construction materials (+)	Priced for an unduly pessimistic global growth scenario
Airlines (-)	Downside if oil rises and PMI momentum softens

European sector allocation (weighting score: +3 max to -3 min)



European country allocation (weighteing score: +3 max to -3 min)



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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Market outlook

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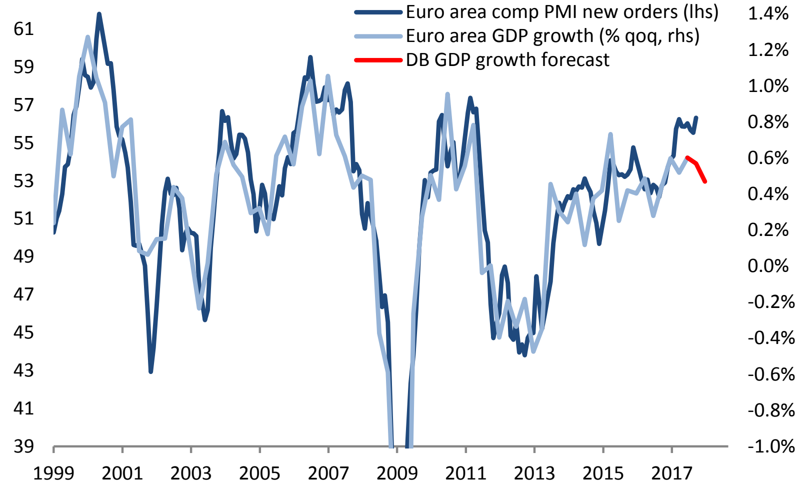
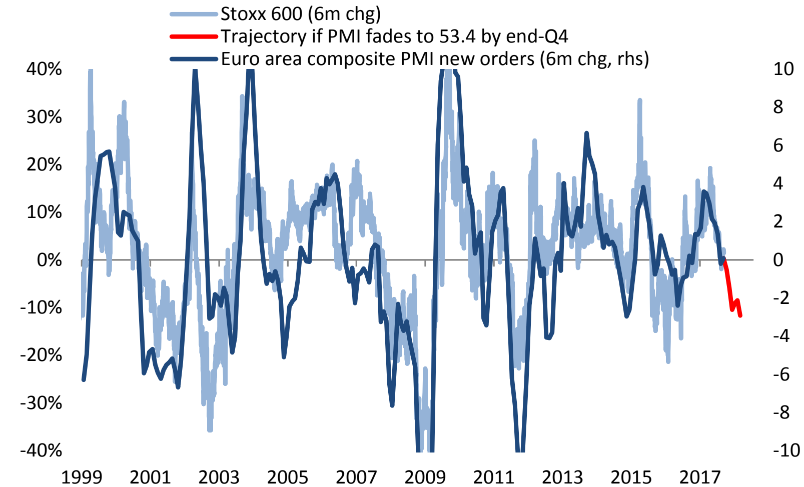
Neutral into year-end, but softening macro momentum is set to weigh in Q1

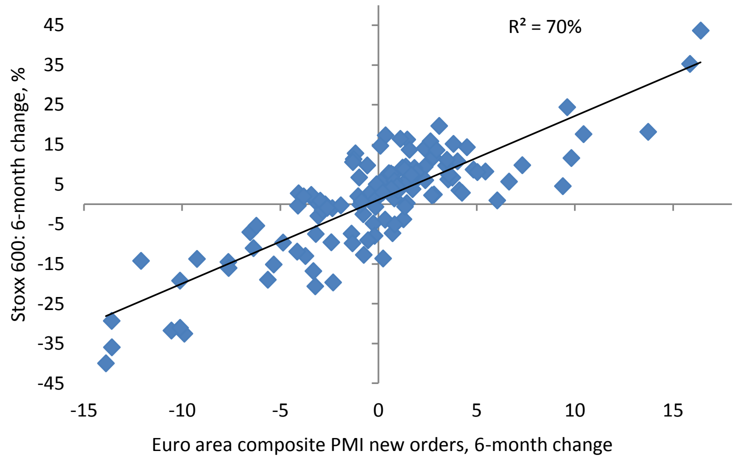
The Euro area flash composite PMI new orders rose +0.8pts in September to a level of 56.3 – the highest since April 2011 and consistent with Euro area GDP growth of 0.8% qoq (>3% annualised)



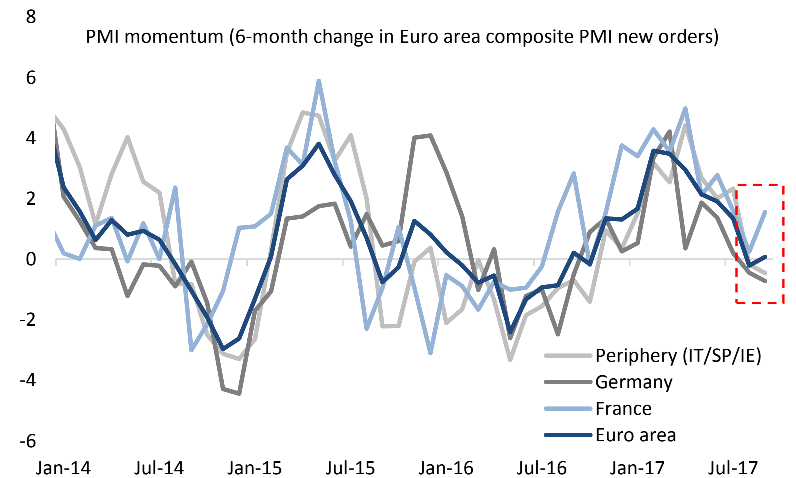
Euro area PMI momentum, a key driver of the European equity market, has risen back above 0, but our PMI forecast implies that it will turn negative over the coming months



Euro area PMI momentum explains around 70% of the variance in Stoxx 600 price momentum over the past decade



The slight improvement in PMI momentum in September was entirely driven by France, while PMI momentum in Germany and the periphery is negative



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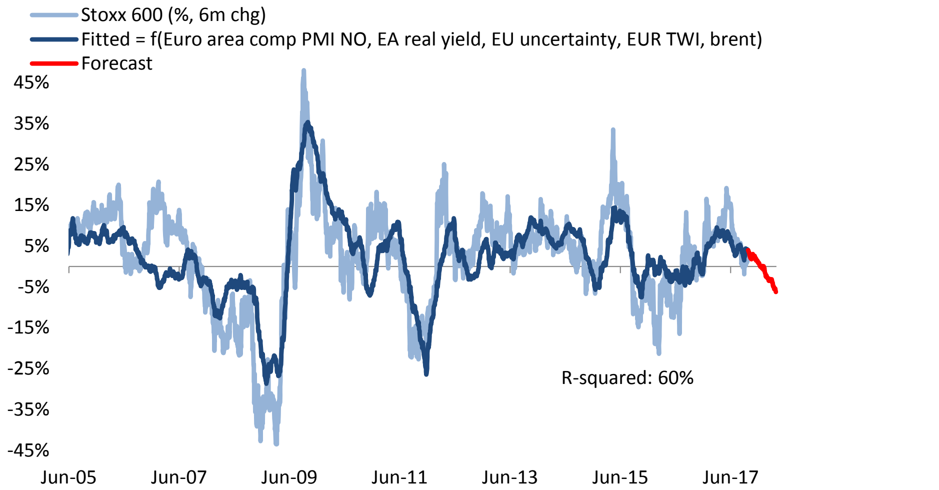
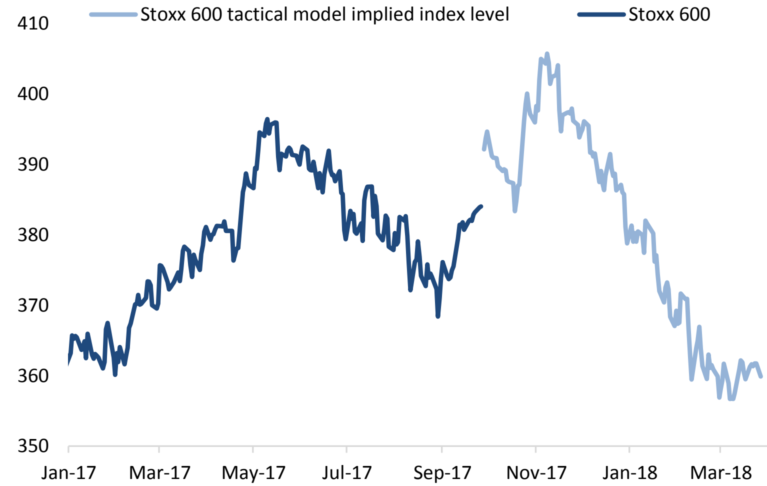
Neutral into year-end, but softening macro momentum is set to weigh in Q1

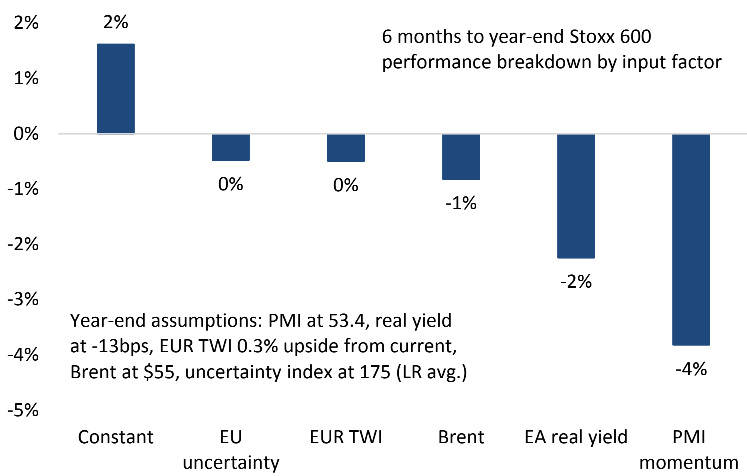
Our tactical Stoxx 600 model suggests the price momentum (i.e. 6-month change) for European equities will turn negative again over the coming months



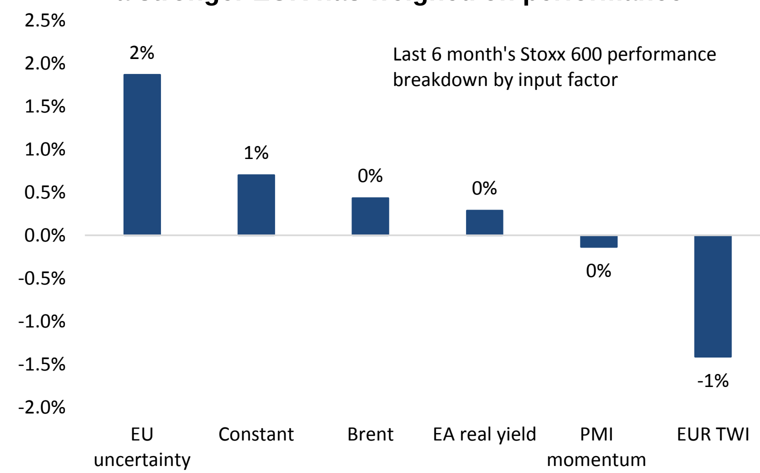
However, the model points to temporary upside for the Stoxx 600, before moving below 360 in Q1



We expect fading Euro area PMI momentum and rising real yields to weigh on European equity momentum over the *coming* six months



Our model suggests that over the *past* six months, European equities have been boosted largely by falling uncertainty, while a stronger EUR has weighed on performance



Source: Bloomberg Finance LP, Haver, Factset, Datastream, Deutsche Bank

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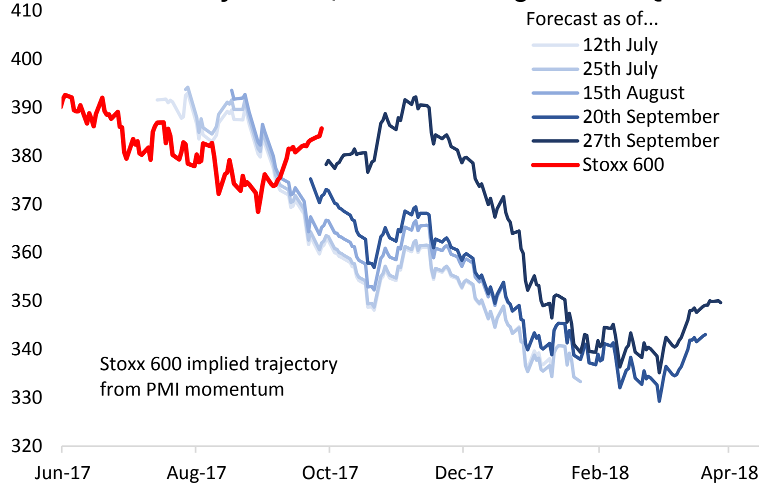
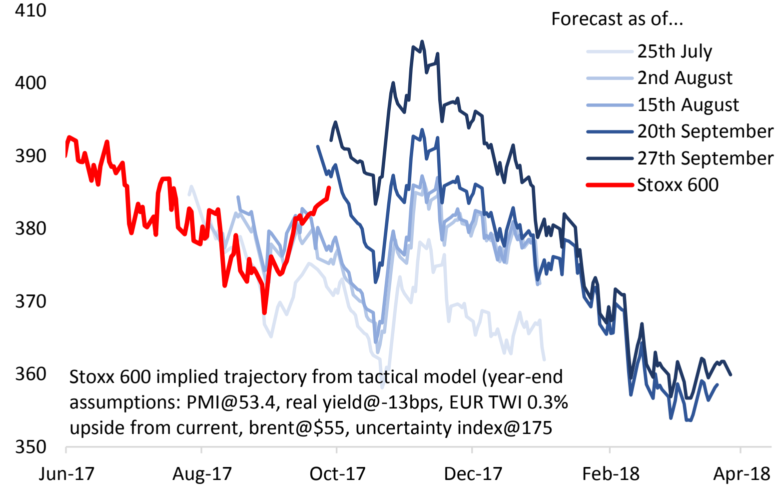
Neutral into year-end, but softening macro momentum is set to weigh in Q1

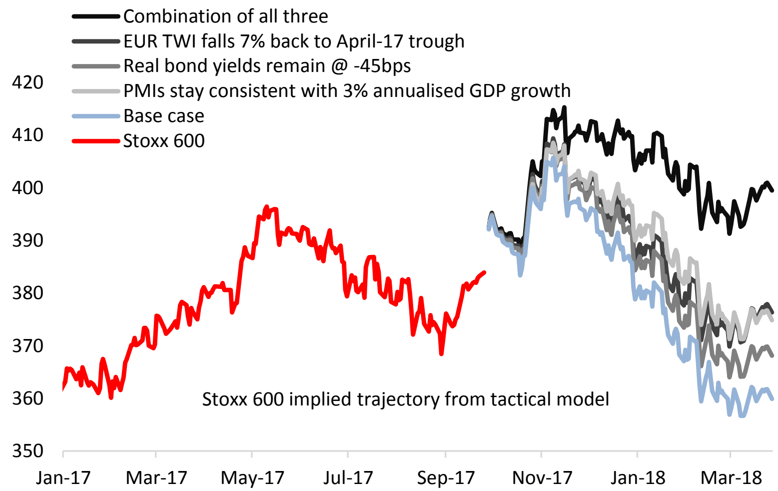
In response to the stronger-than-expected September PMI, our PMI momentum framework now suggests the market will be flat into year-end, before moving lower in Q1



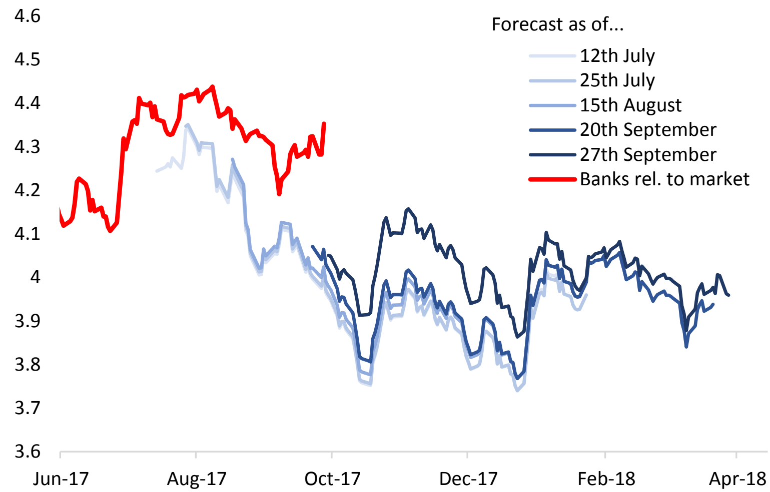
Our tactical Stoxx 600 model even suggests the Stoxx 600 could temporarily break above 400, before the drag from negative PMI momentum sets in



Scenario analysis: the market would be further boosted if the Euro is weaker than expected and the PMIs remain at current levels



Banks' relative performance is tracking above the PMI momentum-implied level, even taking into account the upward shift given the better September PMIs



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Neutral into year-end, but softening macro momentum is set to weigh in Q1

When Euro area PMI momentum peaks, European equities typically fall by around 20%, with banks underperforming by around 20%, cyclicals underperforming defensives by around 15% and bond yields falling by around 110bps

PMI momentum peak	Stoxx 600		Banks relative performance		Cyclicals relative to defensives		German 10y yields	
	Lead / lag (-) in months	Performance	Lead / lag (-) in months	Performance	Lead / lag (-) in months	Performance	Lead / lag (-) in months	Chg in yield (bps)
Jul-07	0.0	-12%	-0.7	-13%	0.1	-23%	0.2	-61
Mar-08	-2.0	-45%	-0.5	-47%	-2.0	-31%	-3.1	-176
Aug-09	-5.0	-9%	-0.4	-22%	-1.0	-4%	2.2	-164
Apr-11	-0.5	-24%	1.8	-28%	-0.4	-21%	0.1	-180
Mar-12	0.0	-14%	0.0	-15%	0.0	-12%	-0.1	-89
Sep-13	-0.1	-3%	-1.0	-4%	-0.5	-3%	0.1	-34
May-15	1.0	-27%	-1.3	-26%	-1.3	-11%	-1.0	-88
Mean	**-1.0**	**-19%**	**-0.3**	**-22%**	**-0.7**	**-15%**	**-0.2**	**-113**
Median	**-0.1**	**-14%**	**-0.5**	**-22%**	**-0.5**	**-12%**	**0.1**	**-89**

When Euro area PMI momentum troughs, European equities typically rebound by around 20%, with banks outperforming by around 20%, cyclicals outperforming defensives by around 15% and bond yields rising by around 65bps

PMI momentum trough	Stoxx 600		Banks relative performance		Cyclicals relative to defensives		German 10y yields	
	Lead / lag (-) in months	Performance	Lead / lag (-) in months	Performance	Lead / lag (-) in months	Performance	Lead / lag (-) in months	Chg in yield (bps)
Jan-08	-0.2	8%	-1.0	4%	-0.1	11%	-0.8	24
Feb-09	-1.0	25%	-0.7	56%	-0.2	25%	-0.6	81
Oct-10	4.6	25%	2.7	10%	0.4	10%	1.5	141
Oct-11	-1.3	24%	-2.7	17%	-0.3	21%	-0.8	54
Aug-12	2.3	12%	0.7	28%	1.5	15%	-0.5	33
Nov-14	0.9	34%	2.5	5%	0.4	10%	-5.0	64
May-16	-1.4	28%	-1.7	35%	-1.7	27%	-1.8	67
Mean	**0.6**	**22%**	**0.0**	**22%**	**0.0**	**17%**	**-1.1**	**66**
Median	**-0.2**	**25%**	**-0.7**	**17%**	**-0.1**	**15%**	**-0.8**	**64**

Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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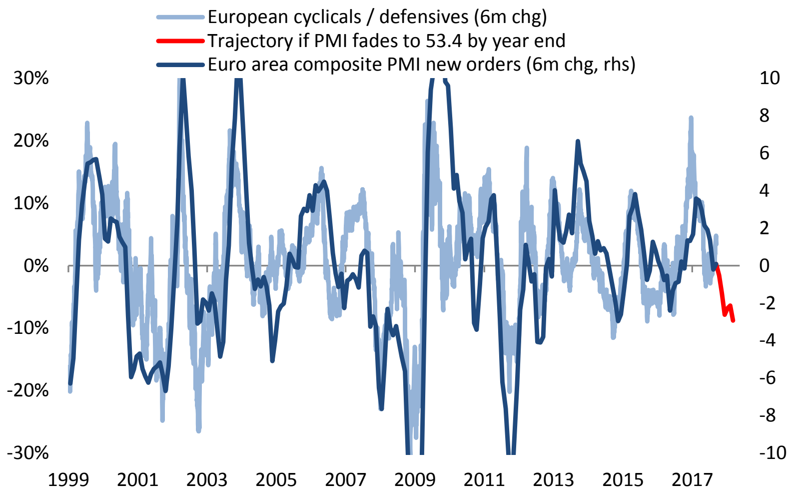
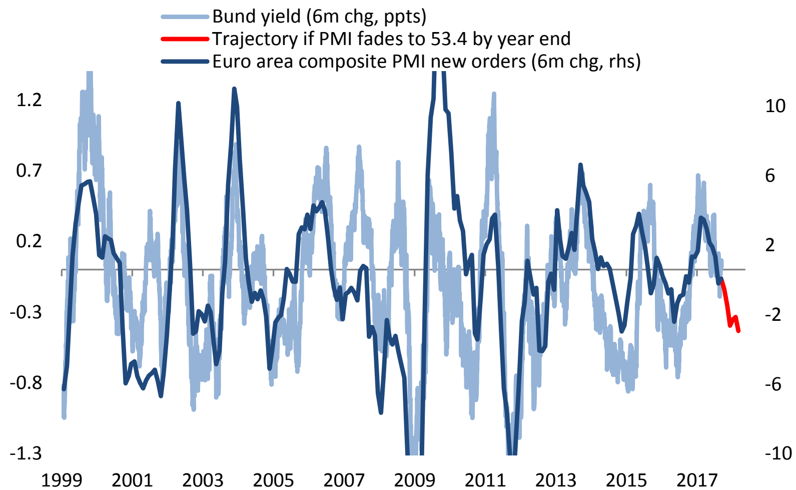
Neutral into year-end, but softening macro momentum is set to weigh in Q1

Weakening Euro area PMI momentum would be a negative for cyclicals versus defensives…



…and for the German bond yield



Our projected PMI scenario would be consistent with downside for bond yields, European equities, cyclicals vs defensives as well as banks, airlines, autos, Italy and Germany

	PMI	Correlation	Current level	Max implied level in 3-6 months time	Min implied level in 3-6 months time	Change from current to max implied	Change from current to min implied
10y US yields	Global	+	2.23	2.08	1.73	-0.15	-0.50
Bund yields	Euro area	+	0.41	0.32	-0.02	-0.09	-0.43
DAX	Euro area	+	12605	12421	11735	-1%	-7%
AC World	Global	+	555	523	505	-6%	-9%
European cyc / def	Euro area	+	76.0	71.5	67.3	-6%	-11%
SXXP	Euro area	+	384	355	335	-8%	-13%
Sector price relative to Europe							
Personal & HH goods	Global	-	32.5	37.0	34.9	14%	8%
Food & bev	Euro area	-	19.8	22.2	21.0	12%	6%
Real Estate	Euro area	-	11.1	12.2	11.7	9%	5%
Food retail	Euro area	-	4.0	4.4	4.0	10%	0%
Pharma	Global	-	10.0	10.7	10.2	7%	2%
Utilities	Euro area	-	7.2	7.7	7.2	8%	0%
Telecoms	Global	-	4.6	4.9	4.6	5%	0%
Cap goods	China	+	18.2	18.4	17.5	1%	-4%
Energy	Euro area	-	10.0	10.1	9.4	1%	-6%
Construction materials	China	+	9.3	9.4	8.7	1%	-7%
Consumer durables	Global	+	21.3	21.1	19.8	-1%	-7%
Chemicals	China	+	21.9	21.7	20.0	-1%	-9%
Airlines	Euro area	+	8.0	8.0	7.1	0%	-12%
Banks	Euro area	+	4.3	4.1	3.9	-4%	-9%
Autos	Euro area	+	12.7	11.9	10.6	-7%	-16%
Country price relative to Europe							
UK	Euro area	-	133.8	141.9	136.3	6%	2%
Switzerland	Euro area	-	76.7	80.1	78.0	4%	2%
Spain	Euro area	+	61.9	61.5	58.4	-1%	-6%
France	Euro area	+	119.7	117.1	113.7	-2%	-5%
Germany	Euro area	+	64.8	63.2	61.0	-3%	-6%
Italy	Euro area	+	48.3	43.4	41.0	-10%	-15%
Styles							
Value vs growth	Global	+	95.0	93.4	90.9	-2%	-4%
Small cap vs large cap	Euro area	+	47.8	48.2	46.5	1%	-3%

Assumptions: Euro area PMI to 53.4 (in line with DB GDP forecasts); China PMI to 49.4 from DB strategy model (credit impulse, RMB, global ex-CH PMI); global PMI to 53.1 (from EA PMI, China PMI and DB strategy US PMI model)

How to read this table: We project the price level over the next six months for each of the trades in the table on the basis of the historical correlation between their price momentum (i.e. 6-month change) and the PMI momentum (i.e. the 6-month change in the PMI) as well as our projections for the relevant PMIs (Euro area, China or global). The table shows the highest ("max implied") and the lowest ("min implied") price point for each trade in the time window between three months from now and six months from now as well as the implied price changes.

Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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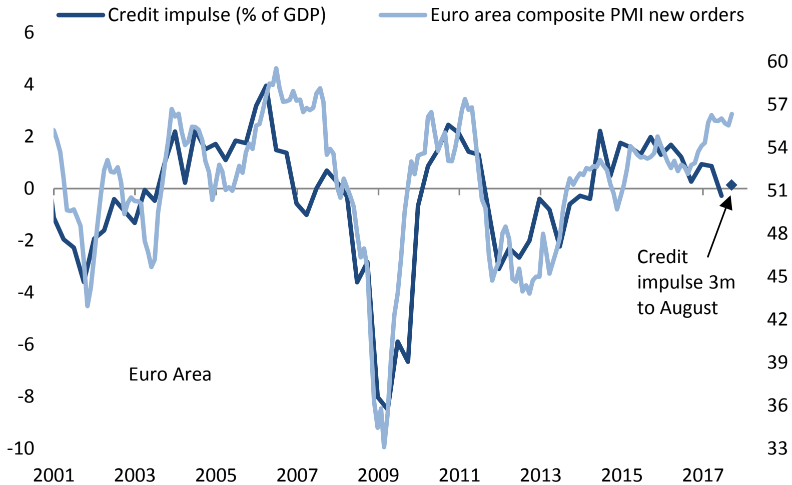
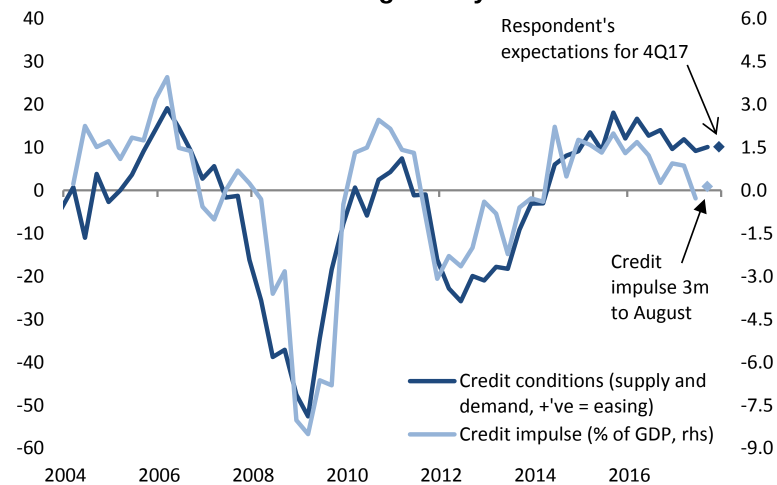
Neutral into year-end, but softening macro momentum is set to weigh in Q1

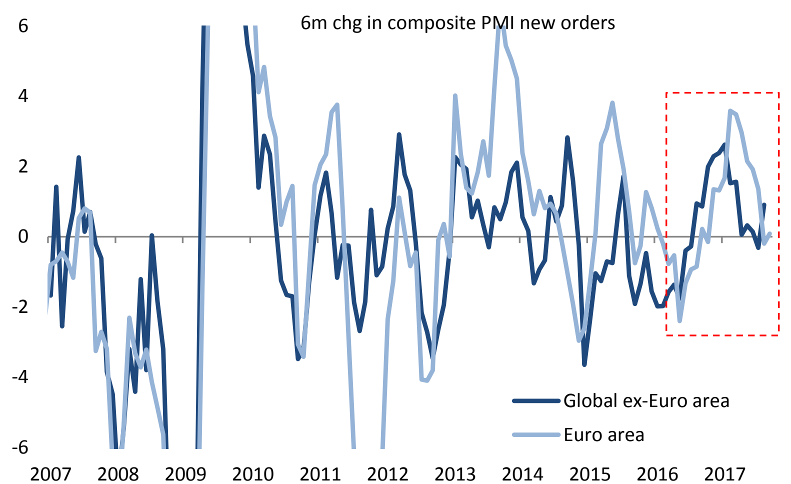
The Euro area credit impulse, at +0.1% of GDP in August, could improve in September to >1% of GDP thanks to a favourable base – but this is still consistent with a fade in the Euro area PMI to around 53



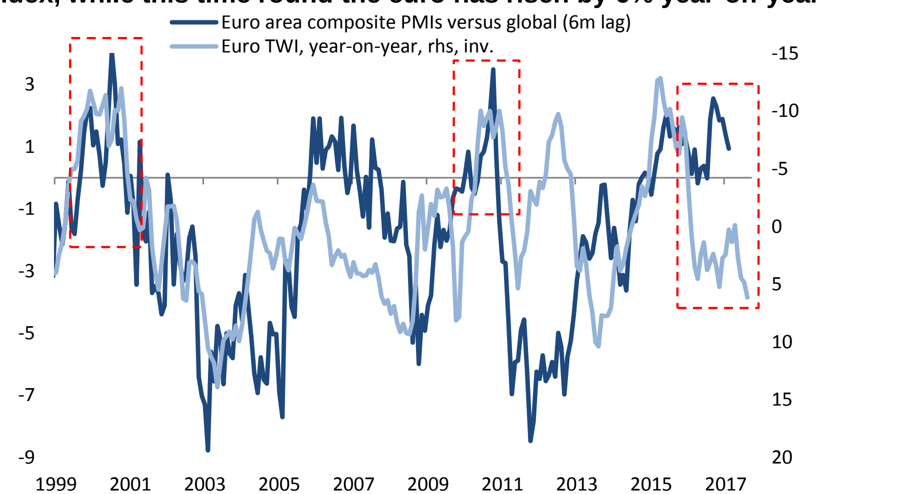
A rebound in the PMI to >1% of GDP in September would make it consistent with the message from the July ECB lending survey



The external recovery lent significant support to the Euro area in H2 2016, but this has faded



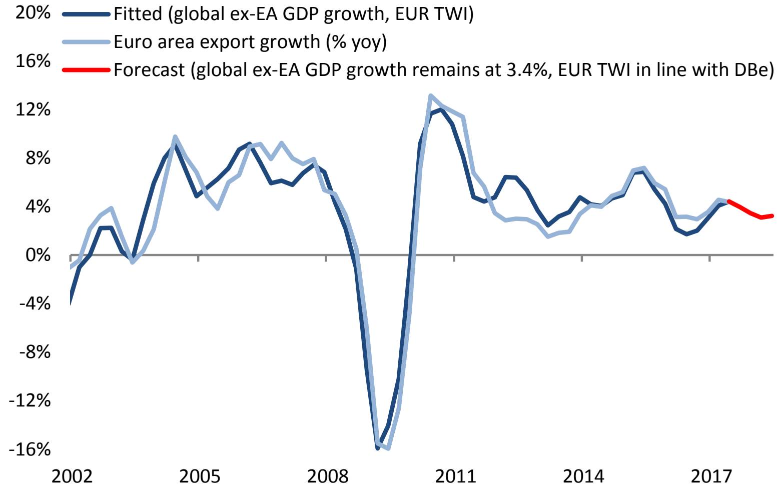
Relative Euro area PMIs are pulling back from a 20-year high – high relative Euro area PMIs in 2001 and 2011 were boosted by 10%+ falls in the euro trade-weighted index, while this time round the euro has risen by 6% year-on-year



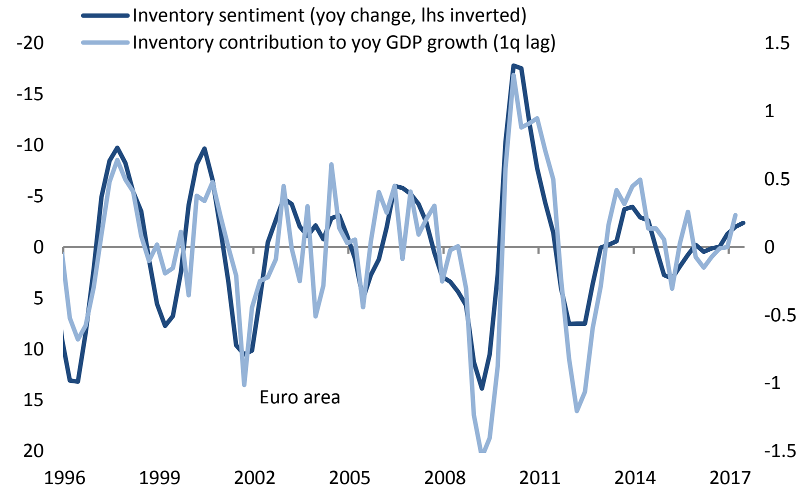
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Neutral into year-end, but softening macro momentum is set to weigh in Q1

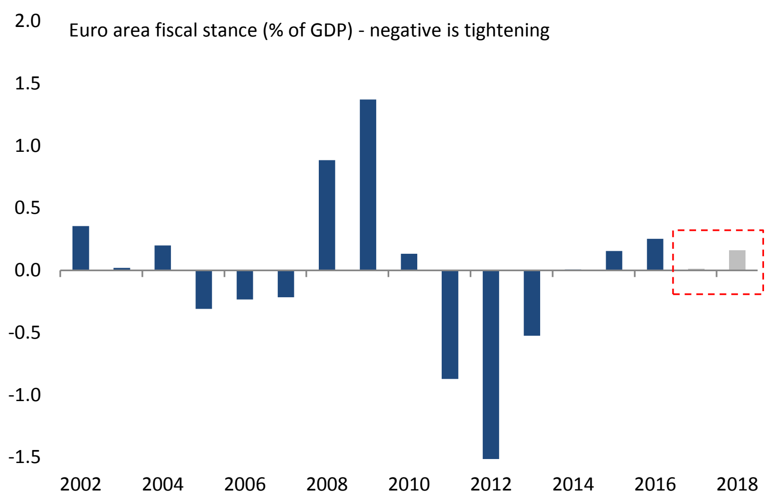
Even if global growth remains at current levels of around 3.4% yoy, Euro strength is set to weigh on Euro area export growth going forward, making it unlikely that Euro area GDP growth will accelerate to 3% yoy, as implied by PMIs



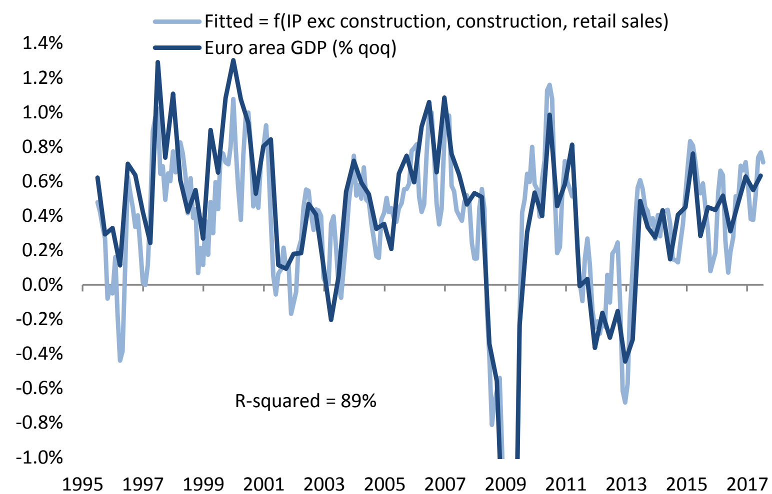
The contribution to year-on-year Euro area GDP growth from inventories is not set to increase, given lead indicators



Fiscal policy in the Euro area is set to be only mildly supportive this year, with little scope for larger-scale stimulus



In the near-term, the hard data appears to be corroborating the 0.7% qoq GDP growth rate implied by the PMI for Q3



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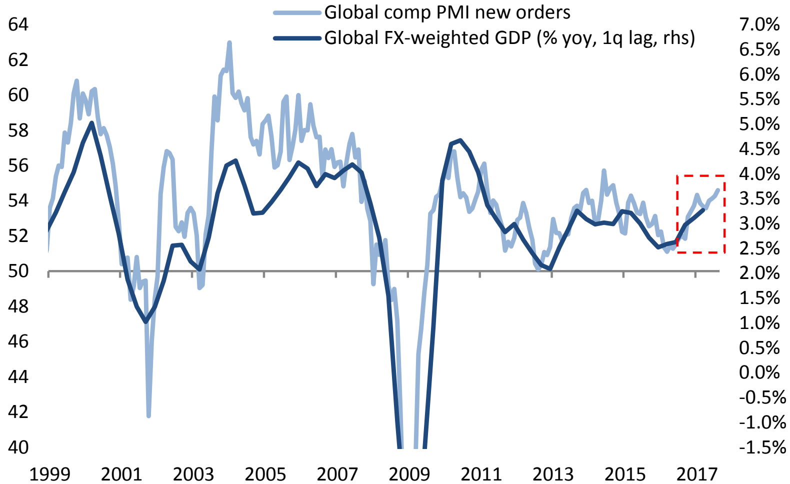
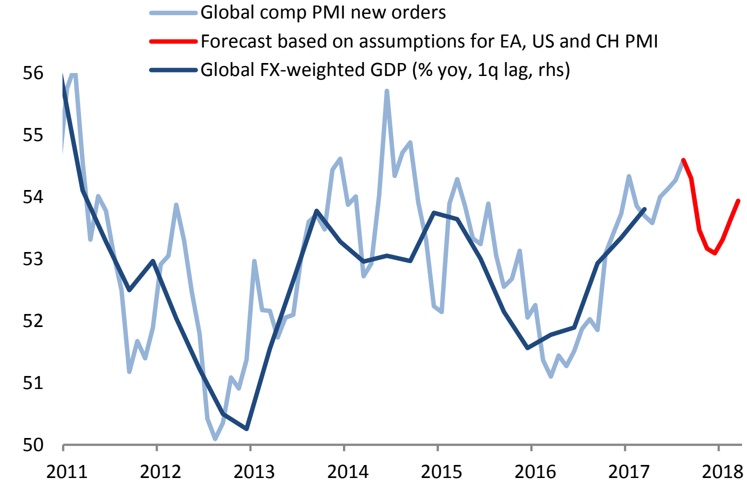
We see mild downside for the global PMI in the coming months

The global composite PMI new orders, at 54.6, is consistent with 2017 global GDP growth of 3.2% at market FX rates

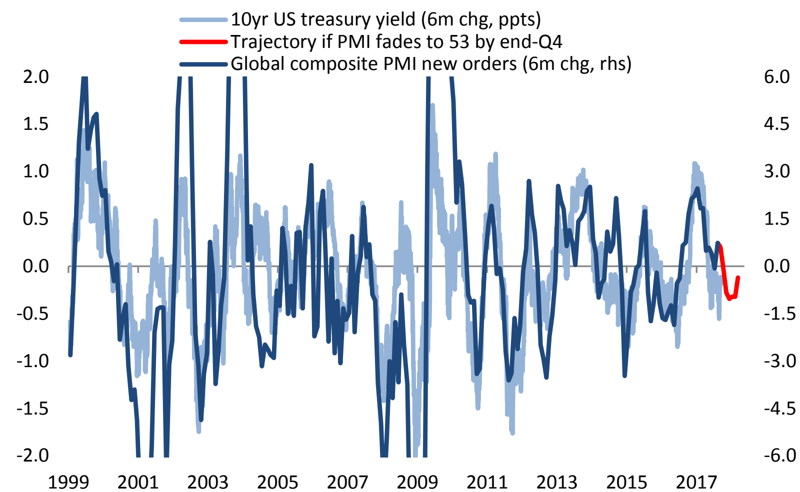


We project a decline in the global PMI drop to 53.1 by year-end given our assumptions for the Euro area, US and China PMIs



DB economists project global GDP growth at 3.2% this year, broadly in line with the Bloomberg consensus' forecast

Global PMI momentum (i.e. the six-month change in PMIs) has faded from +2.5 in February to +0.7, weighing on US bond yields

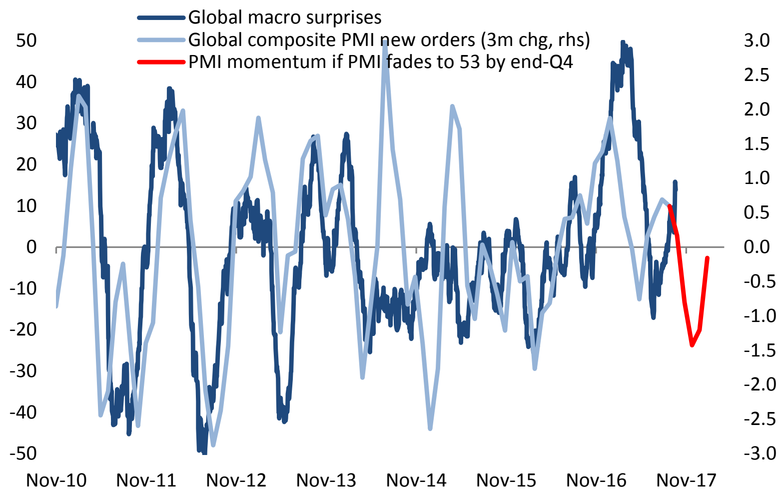


Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

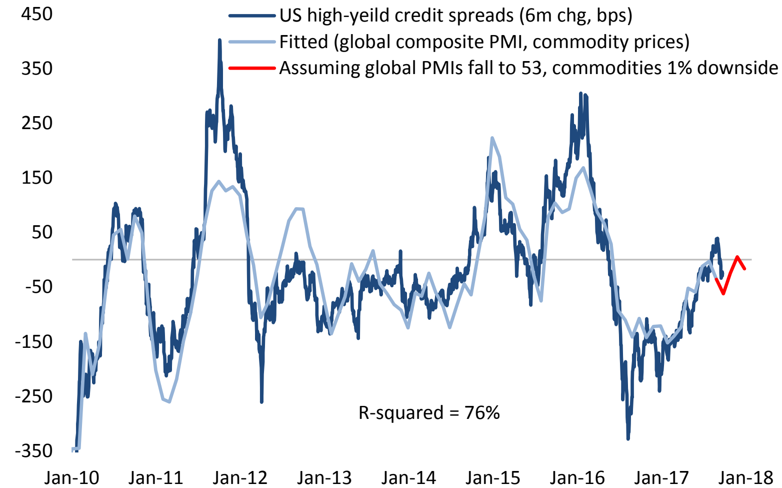
Sebastian Raedler +44-20754-18169; Wolf von Rotberg +44-20754-52801;
Thomas Pearce, CFA +44-20754-16568; Andreas Bruckner +44-20754-18171

We see mild downside for the global PMI in the coming months

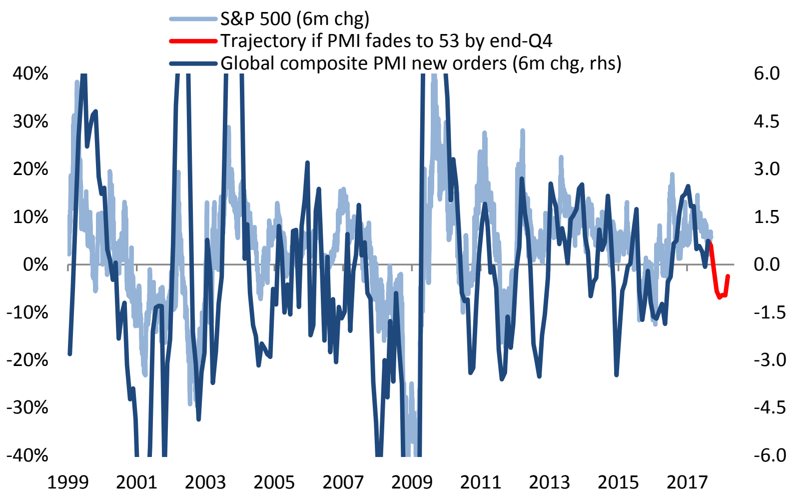
Our projections for the global PMI suggests a move into negative territory for global macro surprises over the coming months



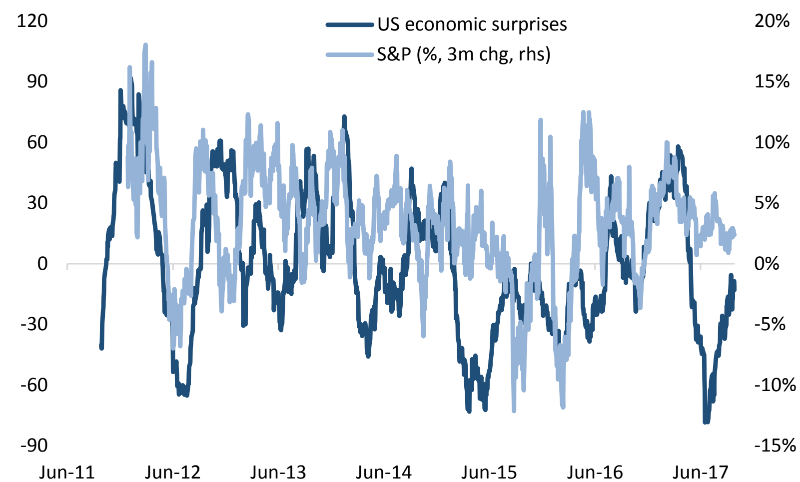
A fade in the global PMI combined with commodities falling slightly implies broadly flat credit spreads by year-end



A continued fade in global PMI momentum has the scope to weigh on US equity price momentum over the coming months



The S&P 500 has held up better than would have been suggested by negative US macro surprises



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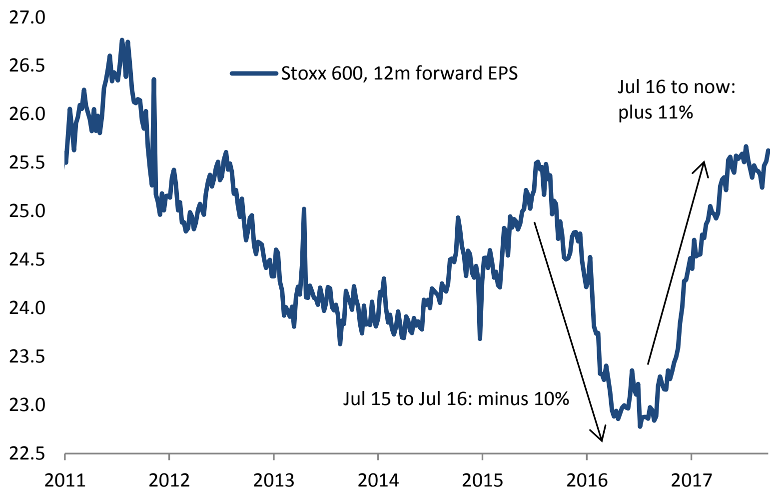
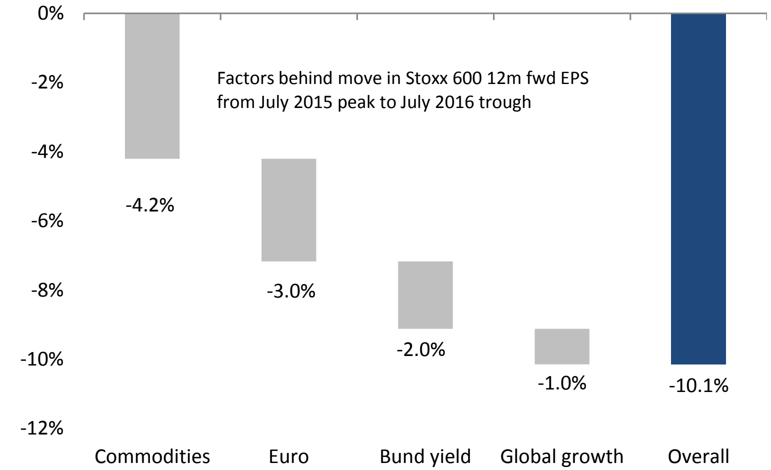
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We project European EPS growth of 11% in 2017

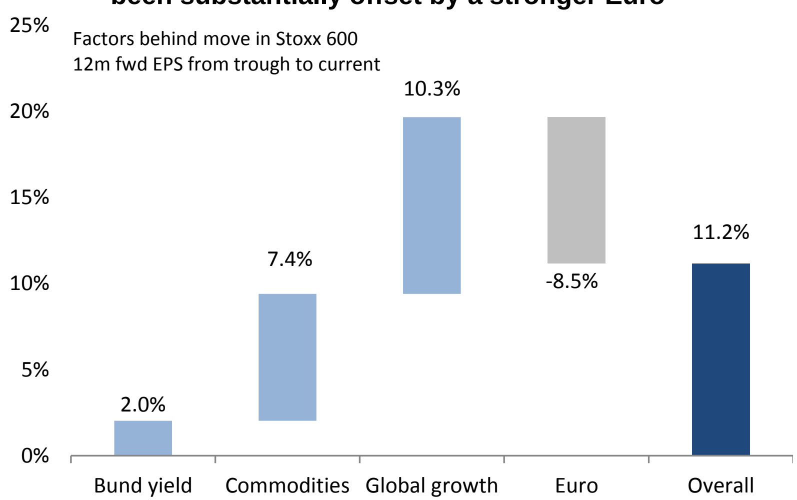
Stoxx 600 12-month forward EPS are up 12% from the trough – and have 1% upside to our end-year target of €25.9



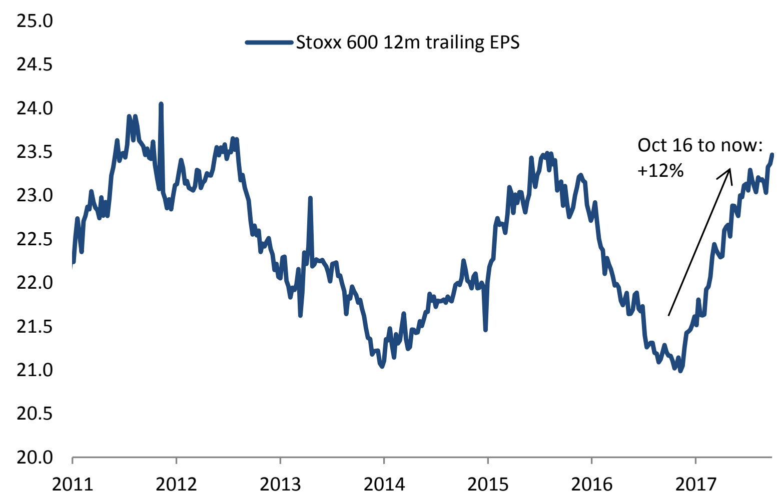
All key drivers of forward EPS were a drag during the 10% decline from mid-15 to mid-16, with weaker commodities and a stronger Euro accounting for most of the negative revisions



The improvement in forward EPS since mid-2016 due to a pick-up in global growth and rebound in commodities has been substantially offset by a stronger Euro



Stoxx 600 12-month trailing EPS is up 12% since the trough in October 2016



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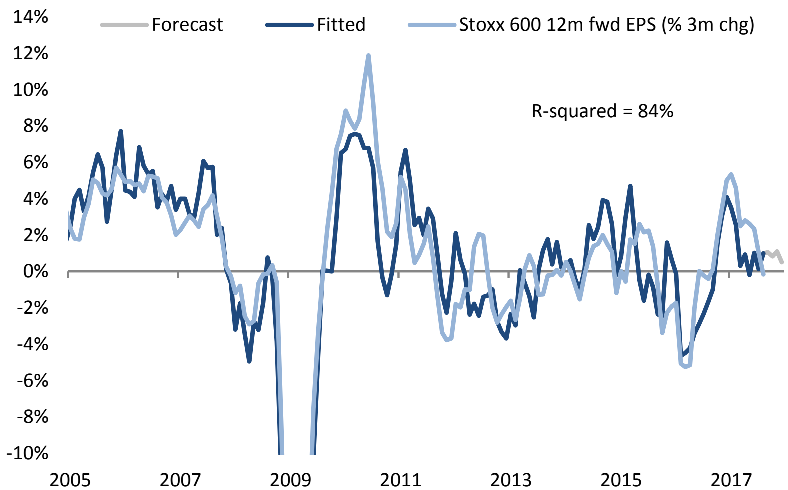
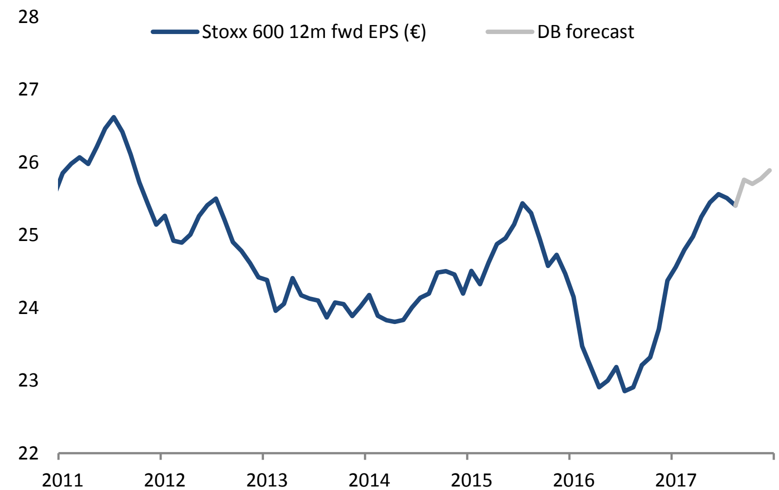
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We project European EPS growth of 11% in 2017

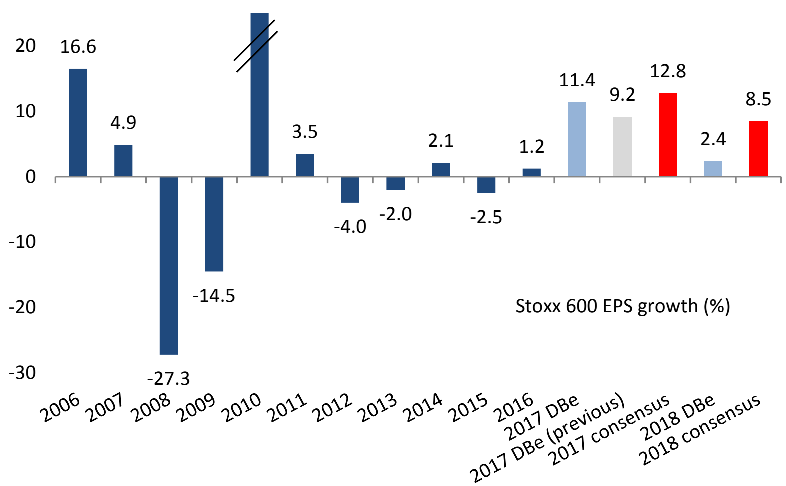
Our Stoxx 600 12m forward EPS model is based on global growth along with moves the Euro, bund yields and commodities



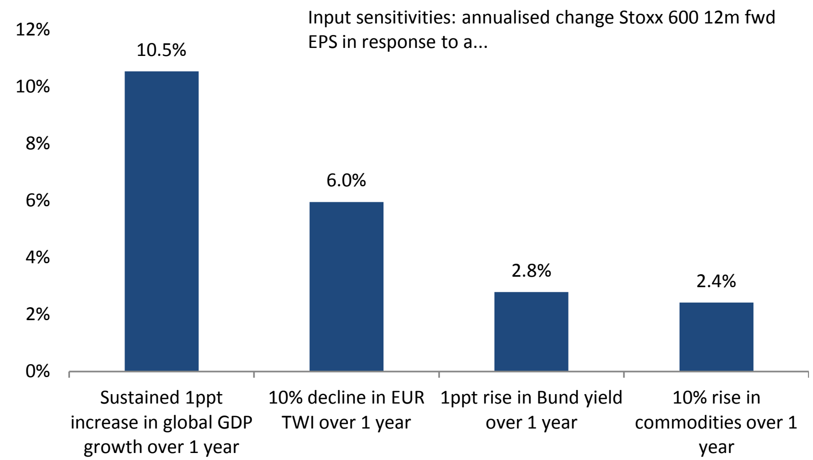
The Stoxx 600 12-month forward consensus EPS is up 11% since mid-2016 and we expect it to rise by a further 1% by year-end



Our projections are consistent with 2017 EPS growth of 11%, below bottom-up consensus expectations of around 13%



Our model explains moves in the European EPS as a function of global GDP growth, the euro, bond yields and commodity prices



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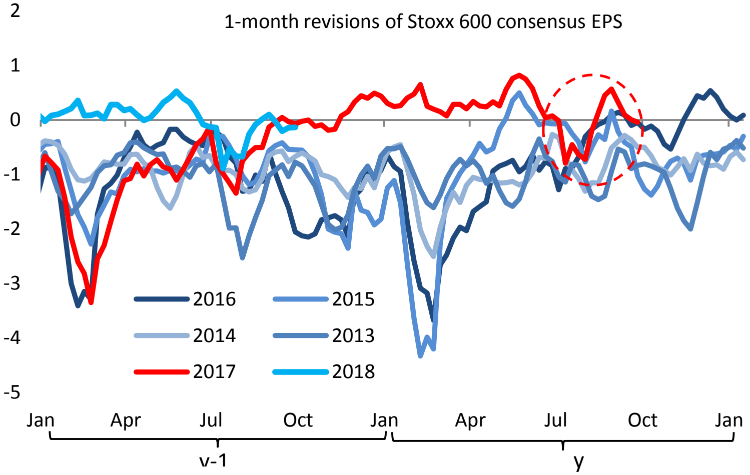
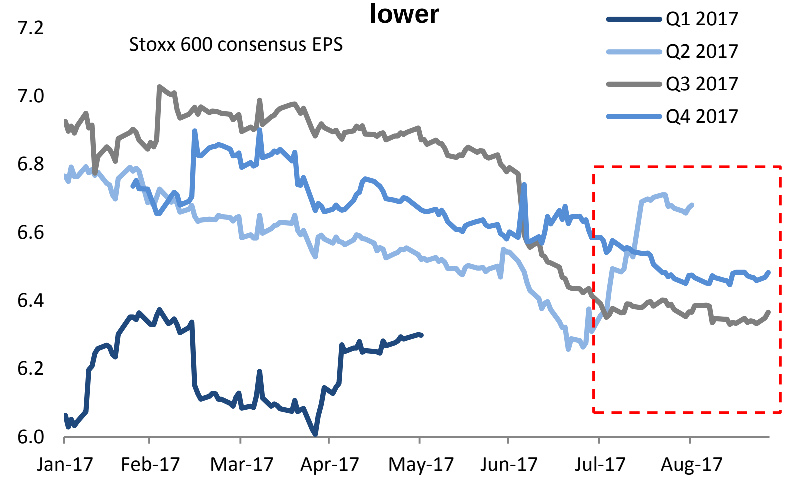
We project European EPS growth of 11% in 2017

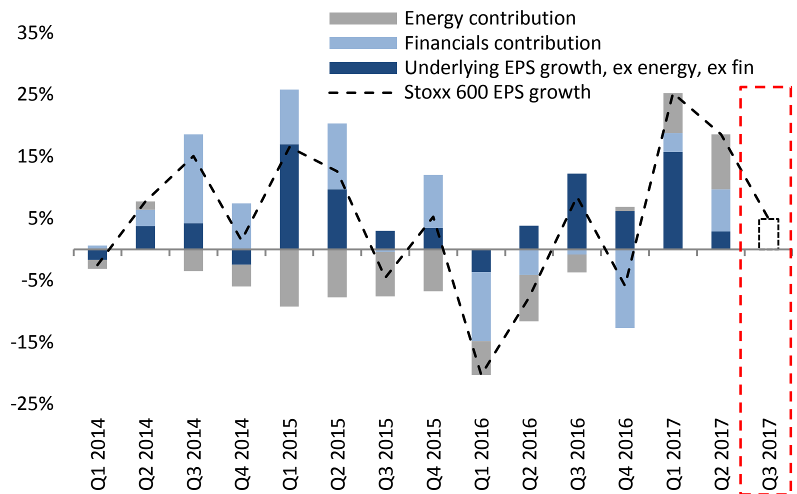
One-month revisions for 2017 EPS are close to zero after a brief recovery in July…



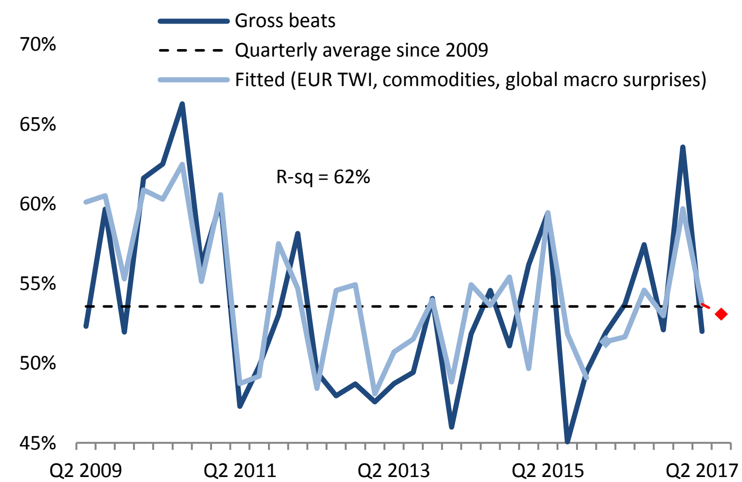
…which was driven by upward revisions to reported Q2 numbers, while Q3 has been flat and Q4 has continued to move lower



Expectations for Q3 are moderate with bottom-up consensus numbers suggesting EPS growth to drop to mid-single digit numbers – this is similar to underlying (ex-energy, ex-financials) growth in Q2



Beats dropped slightly below their 10-year average in Q2, with our model indicating further weakness in Q3, resulting from a stronger euro



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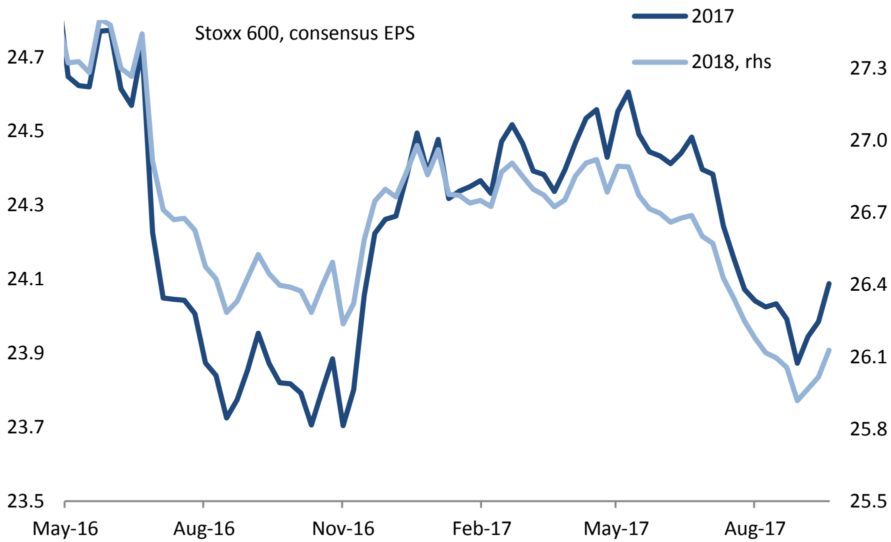
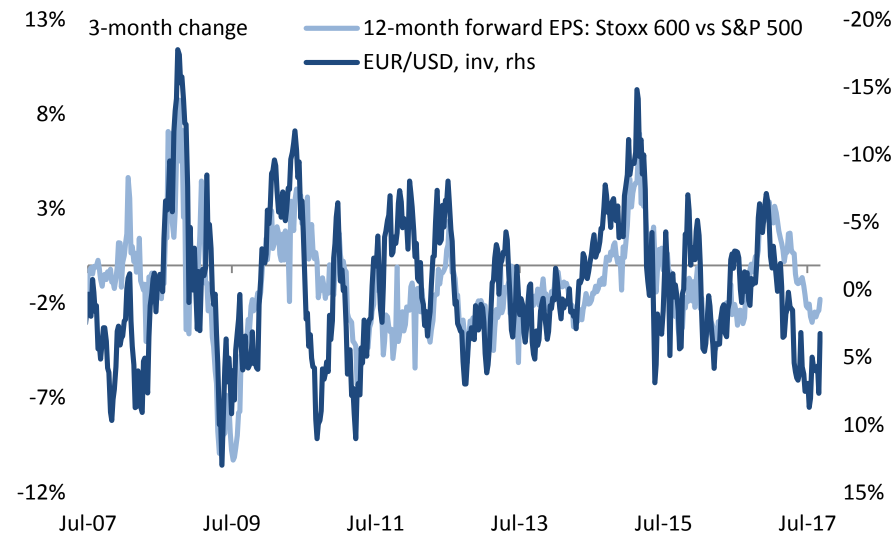
We project European EPS growth of 11% in 2017

2017 and 2018 consensus expectations for European EPS has started to rebound over the past 2 weeks in response to a slightly softer euro



European consensus earnings have dropped relative to those in the US in line with a stronger euro – before recovering slightly as the euro has started to weaken again



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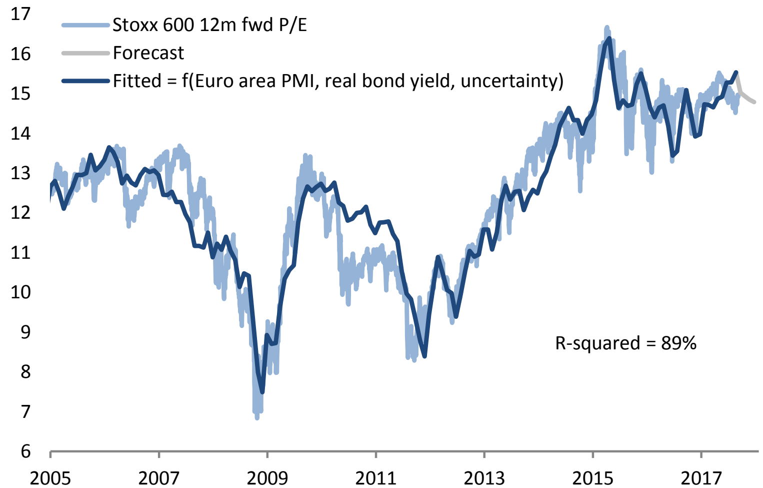
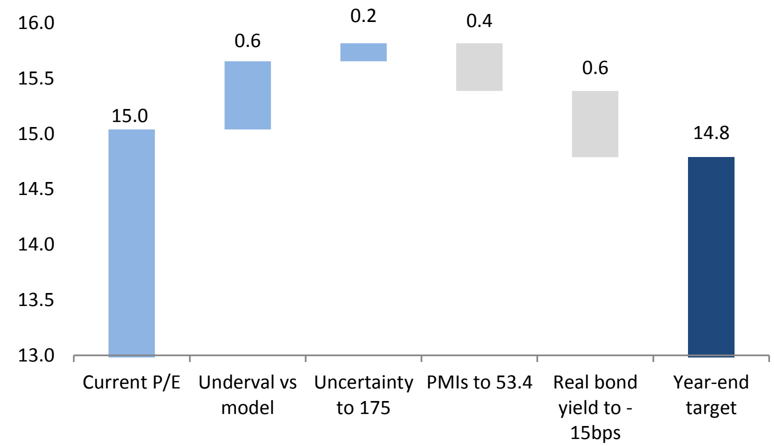
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We expect the European 12-month forward P/E at 14.8x by end-2017

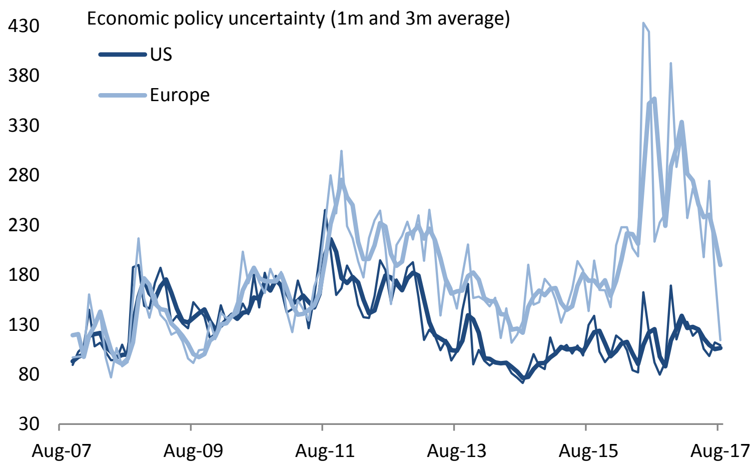
We expect the European 12-month forward P/E to end the year at 14.8x, slightly below the current 15.0x



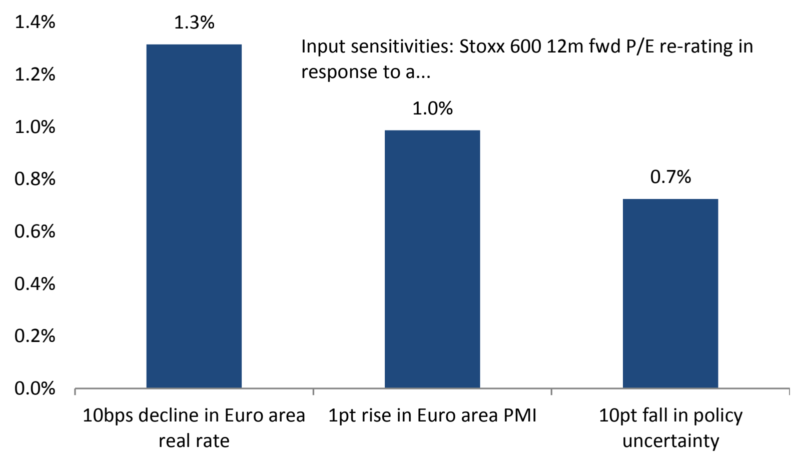
We expect lower PMIs and higher real bond yields to weigh on European multiples, partly offset by lower macro uncertainty



The European macro uncertainty index has fallen sharply over the past months – and we see marginally further downside (from 190 to 175) into year-end



Our model explains around 90% of the variance in the European P/E over the past decade on the basis of real rates, PMIs and political uncertainty



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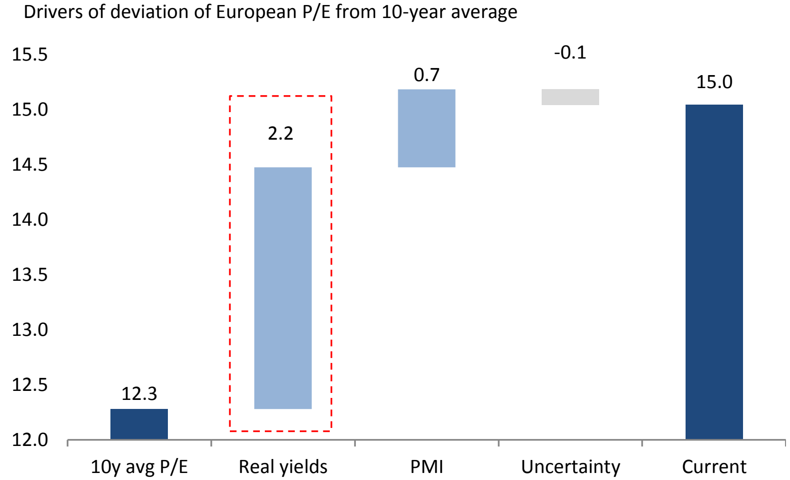
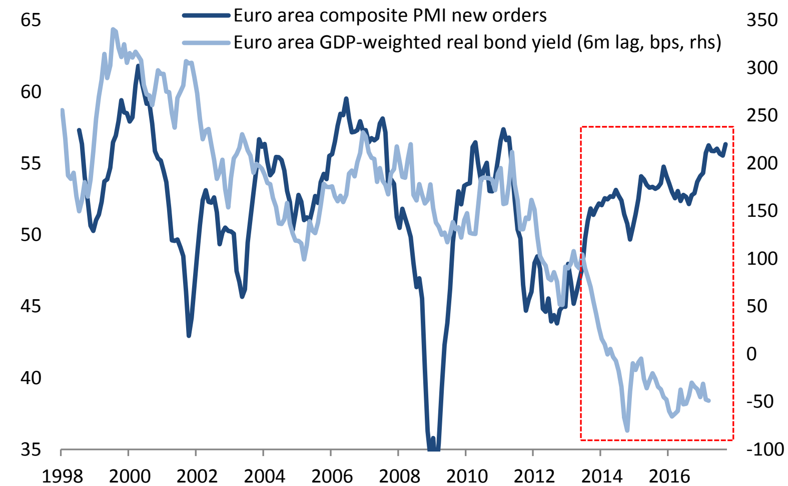
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We expect the European 12-month forward P/E at 14.8x by end-2017

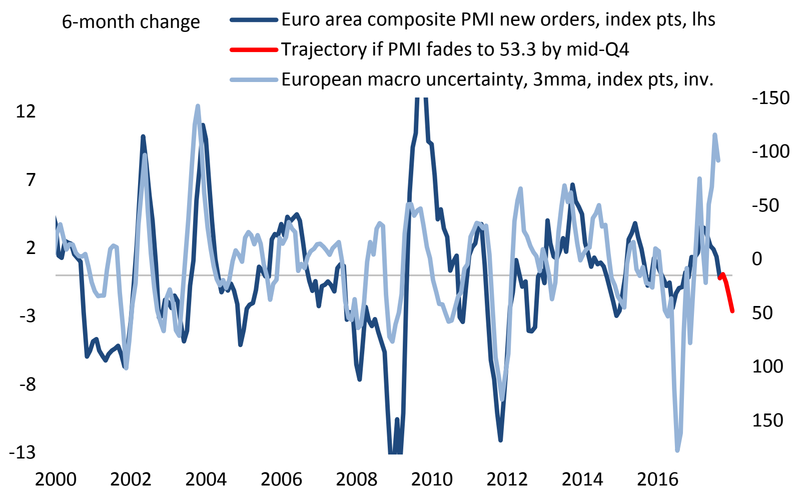
European 12-month forward P/Es are already >20% above their 10-year average, driven by extremely low real bond yields



Over the last 4 years, equity valuations have benefitted from a goldilocks scenario of extraordinarily low real bond yields relative to growth, allowing multiples to rise close to a 10-year high



There is a risk that that weakening Euro area PMI momentum pushes up European macro uncertainty over the coming months



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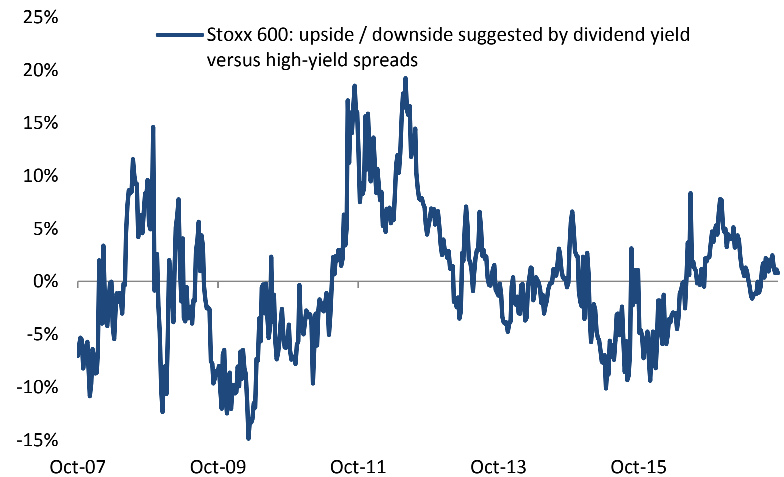
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

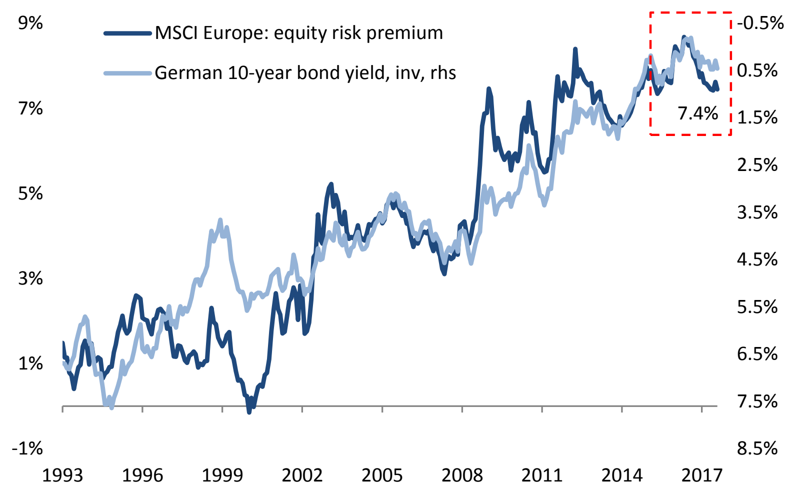
We expect the European 12-month forward P/E at 14.8x by end-2017

The European dividend yield tends to track the US high-yield credit spread – and has fallen to 3.3% as spreads have tightened

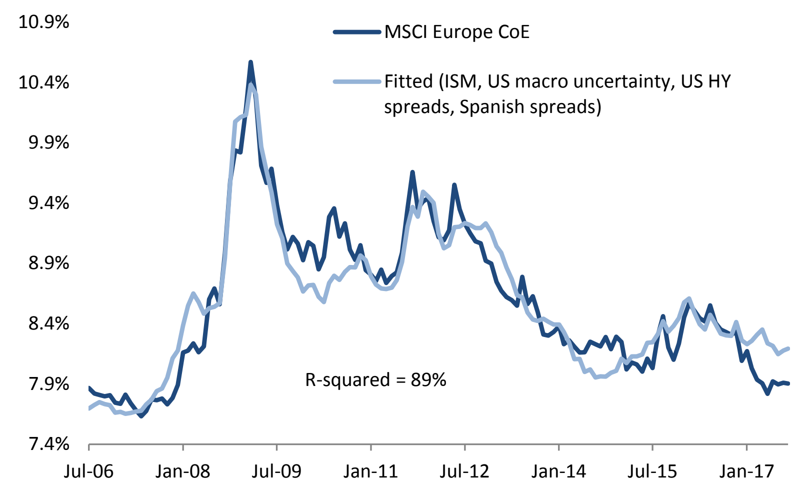
High-yield credit spreads suggest that the European dividend yield (and, hence, the European equity market) are broadly fair-value



The European equity risk premium (ERP), at 7.4%, has fallen from its all-time high of 8.7% in mid-2016 – and is now below the levels suggested by bond yields



The implied European cost of equity (CoE), at 7.9%, is 30 basis points below the level implied by our fair-value model



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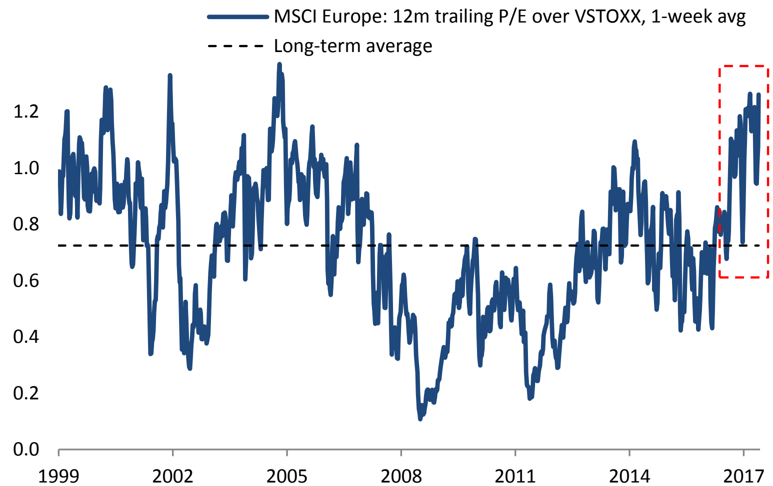
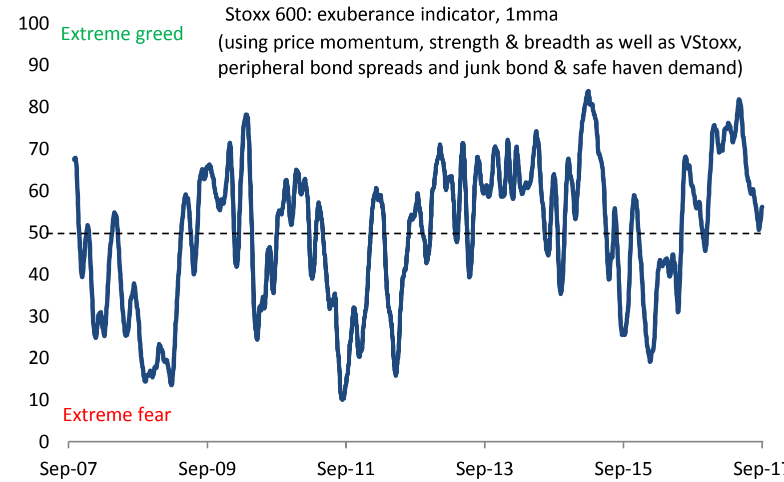
Sentiment indicators have moderated from elevated levels

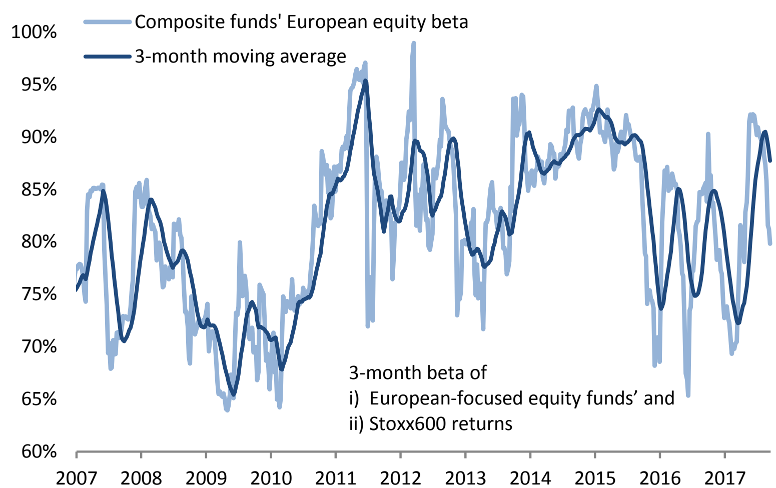
The European equity complacency indicator (P/E over VSTOXX) remains at an elevated level



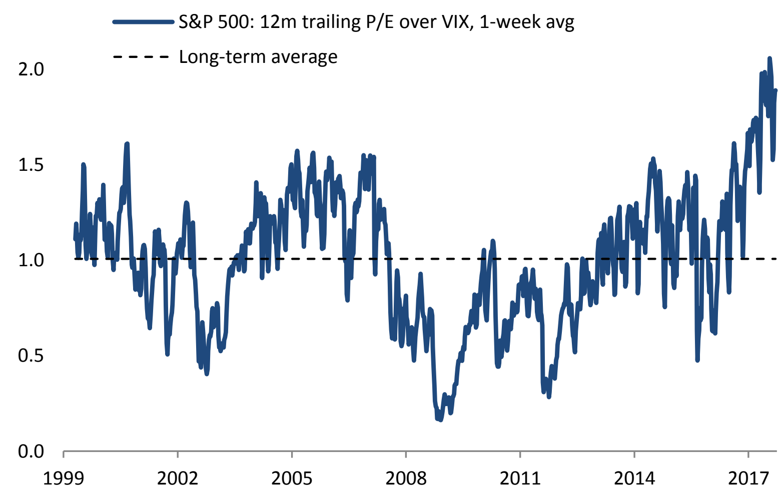
Yet, our European exuberance indicator has recently movde lower after hitting a 10-year high earlier this year



Our investor positioning proxy for Europe has now rolled over from its bullish 2.5-year high it had reached over the past six months



The US complacency indicator (P/E divided by VIX) has fallen slightly over the past month, but remains at elevated levels



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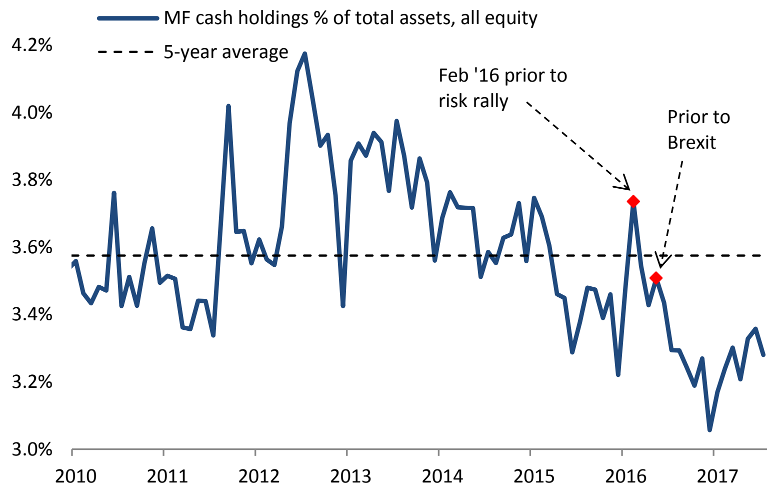
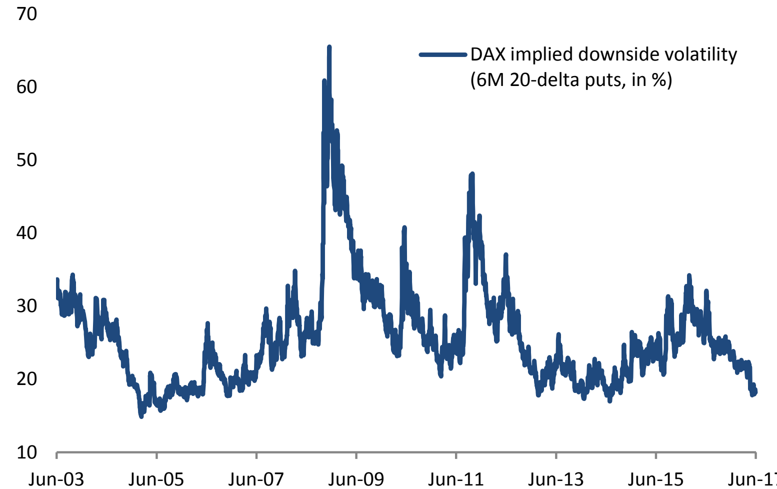
Sentiment indicators have moderated from elevated levels

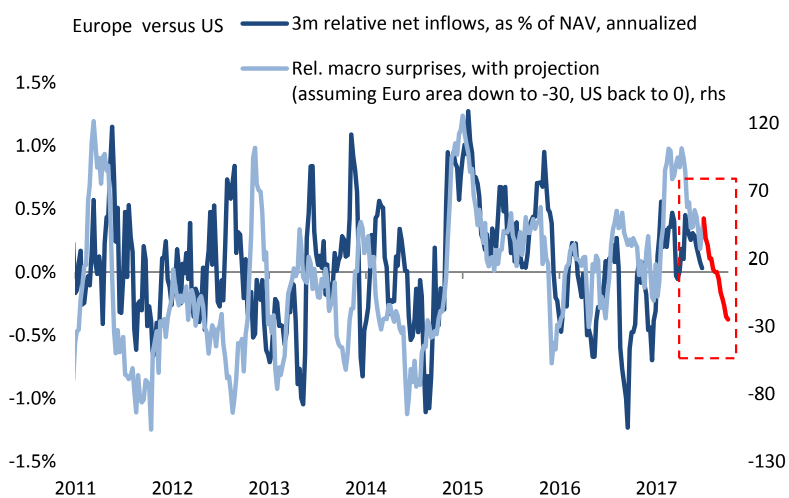
US equity mutual fund cash holdings remain close to a six-year low



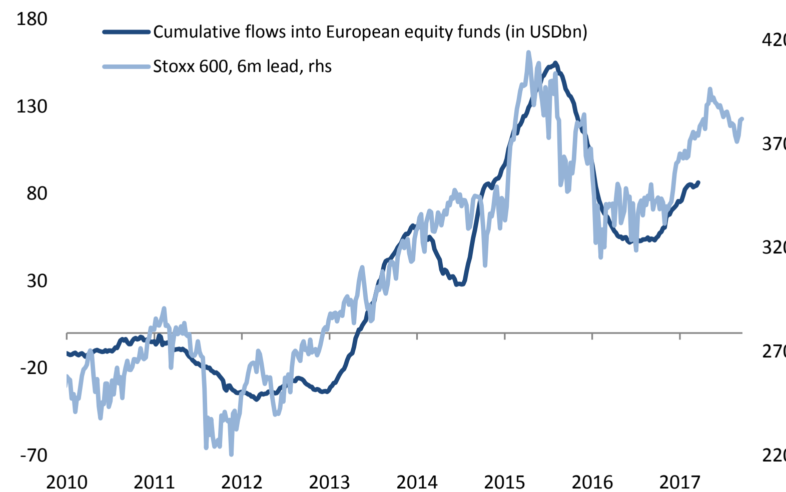
DAX downside protection is close to record lows



If macro surprises rebound in the US, but fade in the Euro area, this would be negative for European funds flows relative to US flows



European fund flows are likely to pick up – but they tend to *lag* equity market performance by six months (i.e. have little predictive power)



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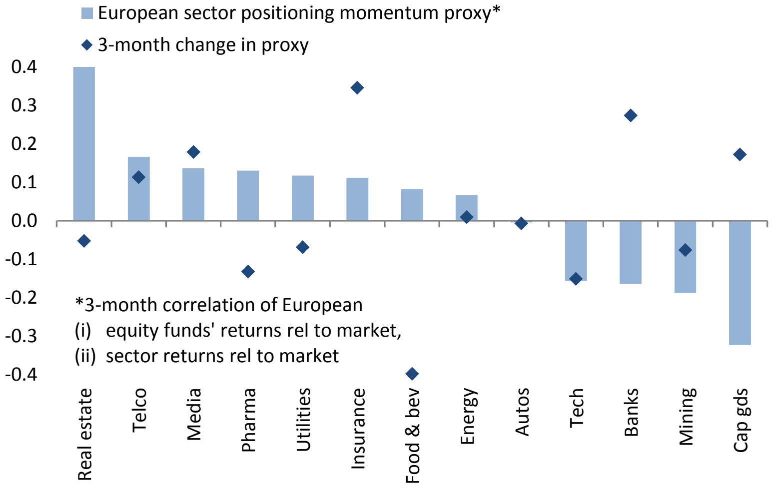
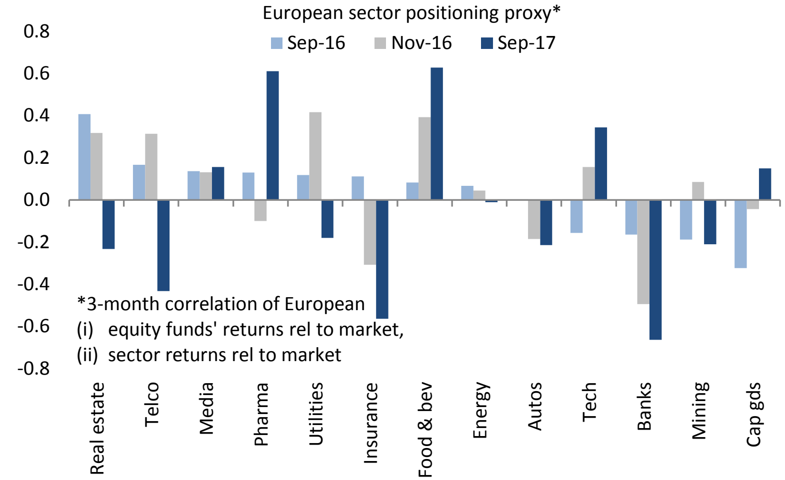
Sentiment indicators have moderated from elevated levels

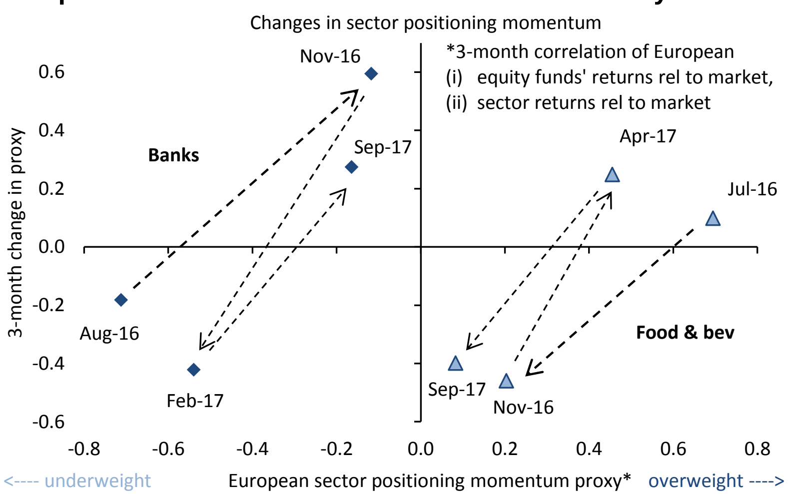
Insurance, banks and capital goods have seen the strongest increase in investor positioning over the past three months, while food & beverage, tech, and pharma have seen the deepest cuts



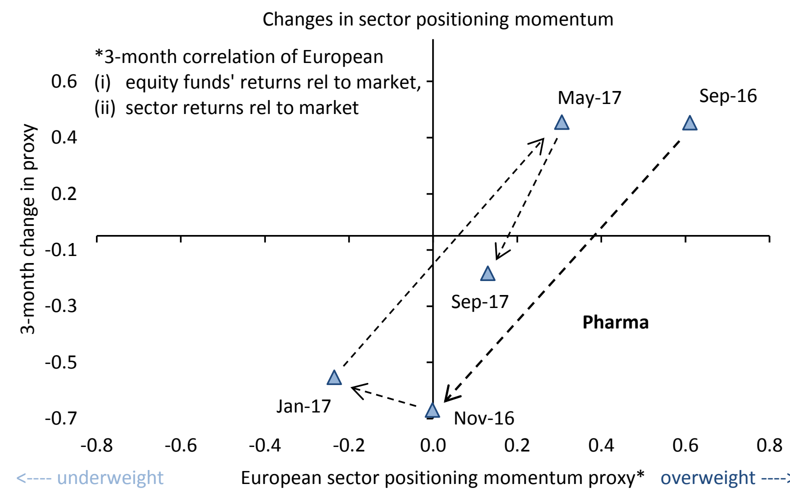
Over the past twelve months, investors have most notably shifted positions in real estate, telcos, insurance and utilities (from overweight to underweight) and in capital goods and tech (from underweight to overweight)



Our positioning proxy suggest investors are still slightly underweight banks and slightly overweight food & beverage, but have reduced both positions back to the level from November last year



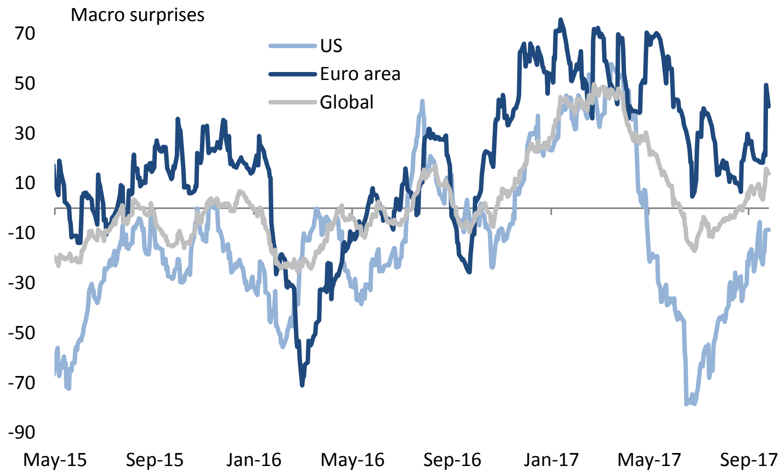
At the turn of the year, investors cut pharma from overweight to underweight, but are now slightly overweight once more



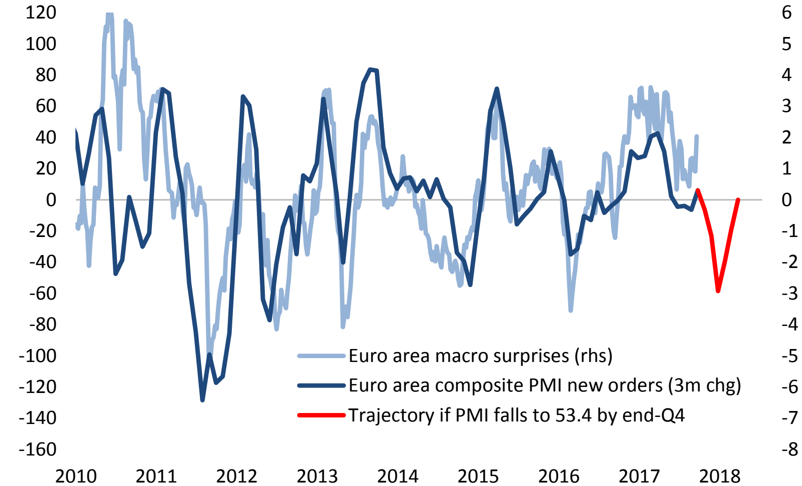
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We remain cautious on the outlook for European relative to US equities

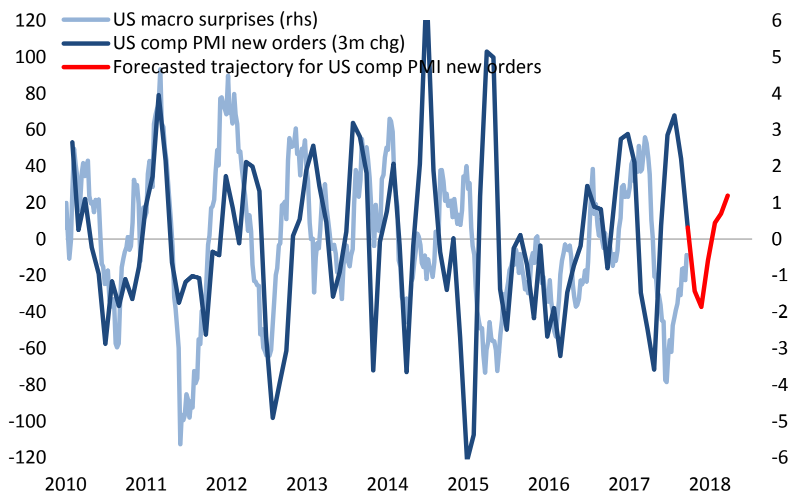
Euro area macro surprises have recently rebounded, helping to lift global surprises back into positive territory



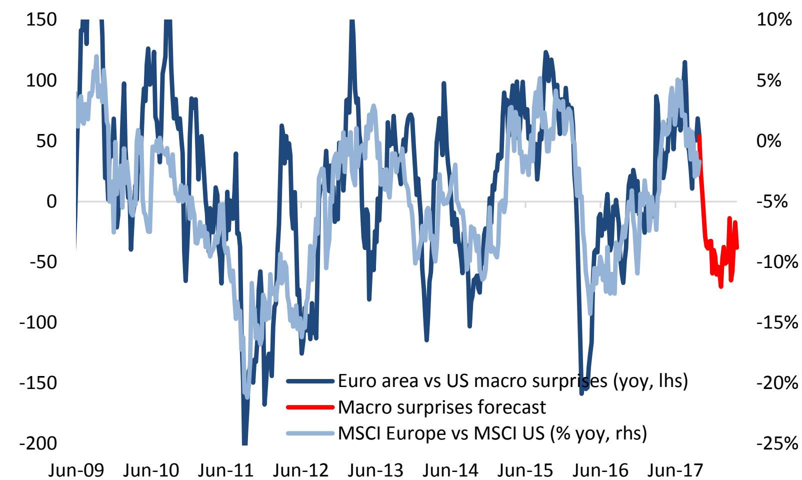
We expect the 3-month change in PMIs to turn negative over the coming months, implying Euro area macro surprises should turn negative as well



US macro surprises should also remain negative in the near-term if our forecasts for the US composite PMI new orders are correct



The implied drop in relative Euro area macro surprises is consistent with around 10% underperformance of European versus US equities



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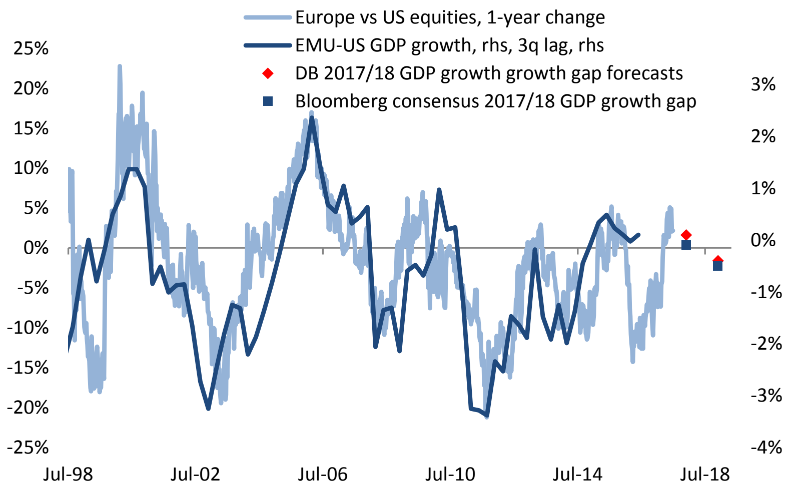
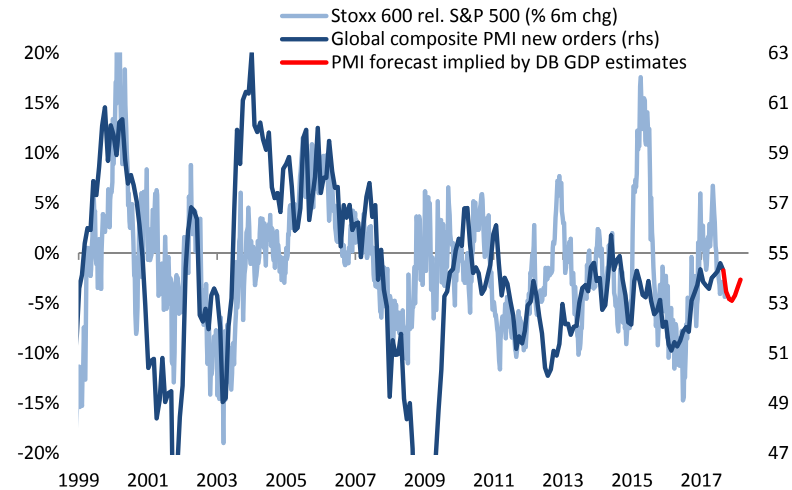
We remain cautious on the outlook for European relative to US equities

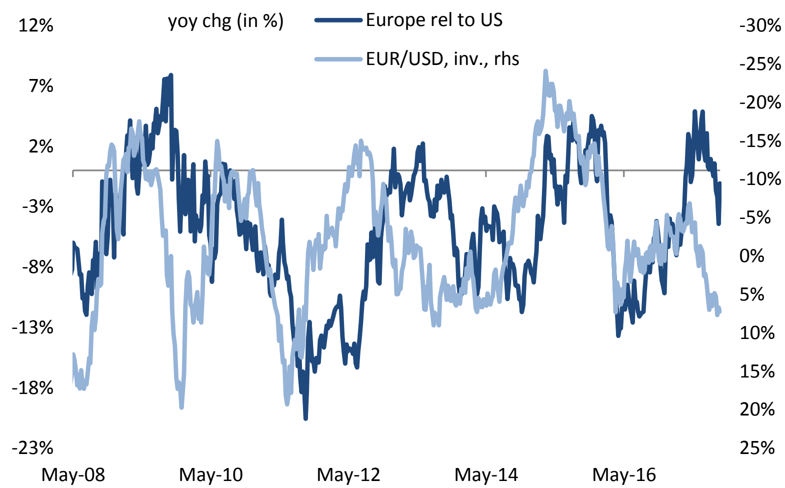
Relative GDP growth forecasts point to continued underperformance of Europe versus US equities



European equities tend to outperform the US when global composite PMI new orders are above 55 (consistent with global GDP growth at 3.7% in market FX terms vs DB expectations of 3.2%)



European equities typically underperform in periods of EUR strength – but have recently held up better than the FX trajectory would have suggested



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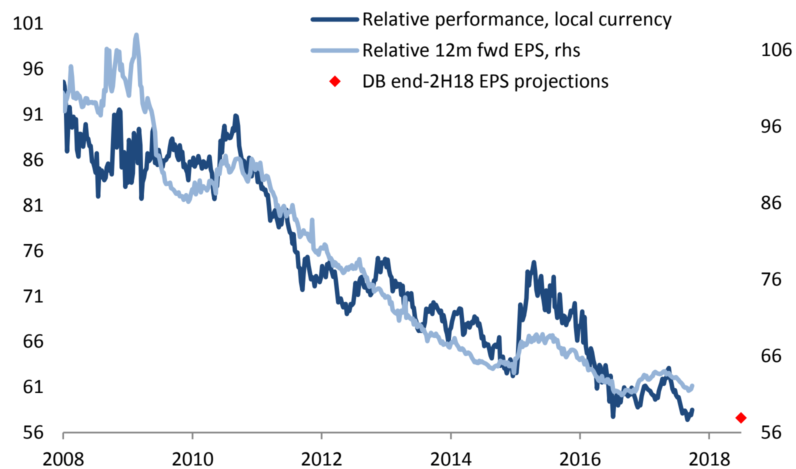
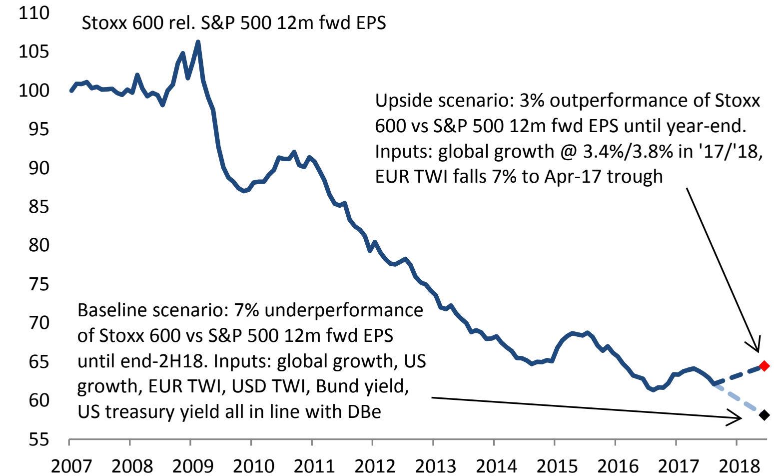
We remain cautious on the outlook for European relative to US equities

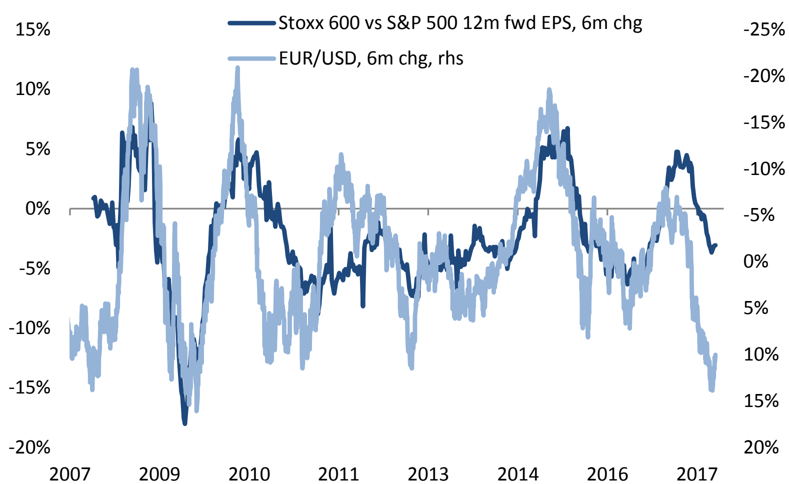
Europe has underperformed the US by over 40% since 2007 as relative EPS have declined by nearly 40% - we see further marginal downside for relative EPS by end-2H18



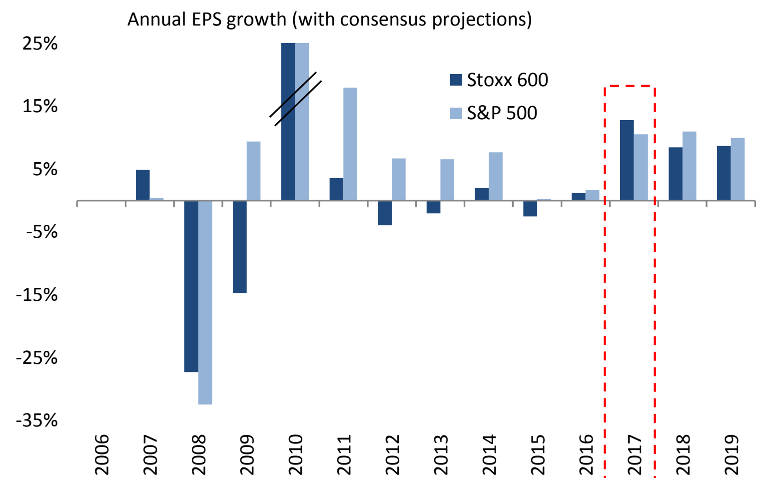
What would it take for Europe forward EPS to rise relative to those in the US? Much stronger global growth and a fall back to this year's trough for the Euro



The recent rise in the EUR/USD points to downside risk for European EPS relative to those in the US



Consensus growth projections for relative European EPS growth are more optimistic than we are, projecting 13% in Europe versus 11% in the US for 2017



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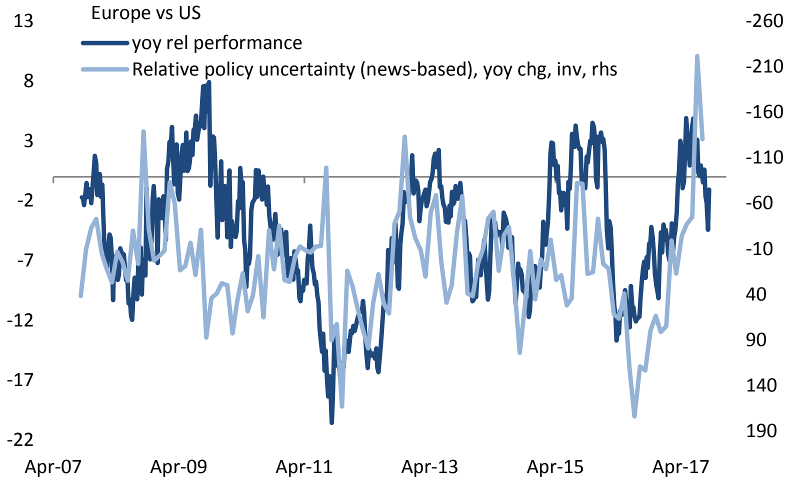
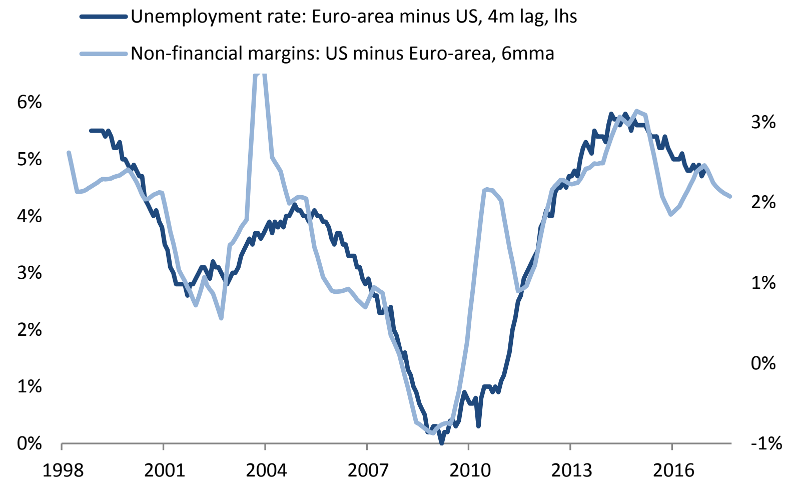
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We remain cautious on the outlook for European relative to US equities

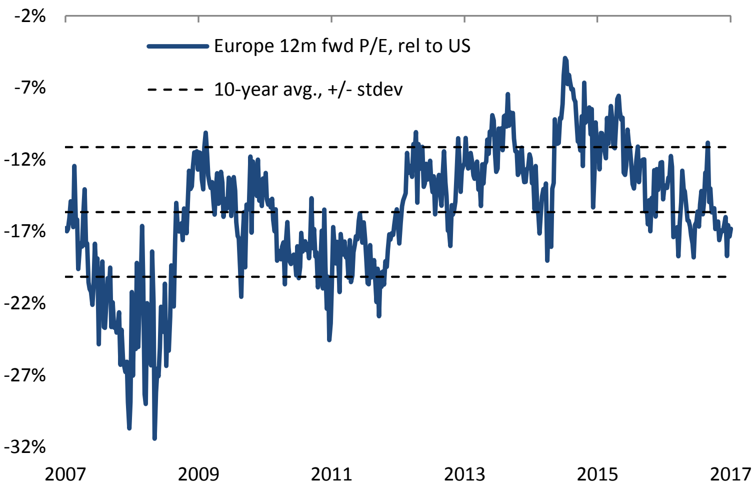
The decline in relative European macro uncertainty could provide support for European equities' relative performance



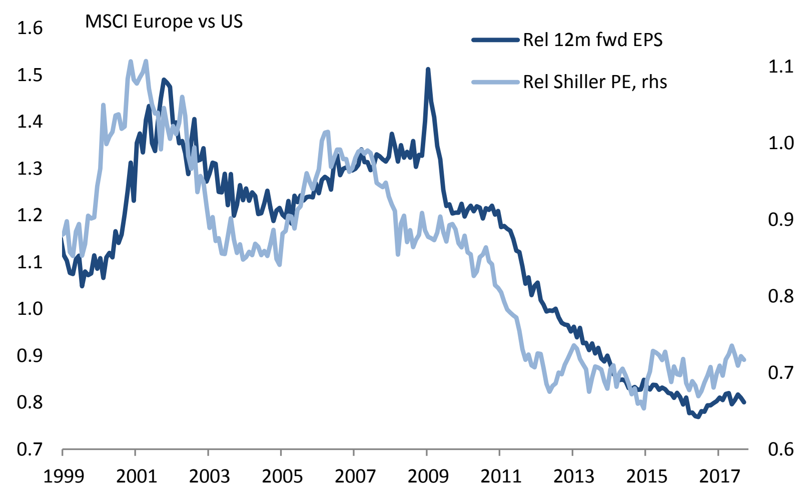
Non-financial margins in the US remain close to a 20-year high relative to those in the Euro area given the more advanced economic recovery in the US



European equities are trading at a 17% P/E discount to the US, close to its 10-year average



Europe's discount on Shiller P/E (as well as relative P/B) is still close to a record low, but that will likely only change when relative EPS start to rebound



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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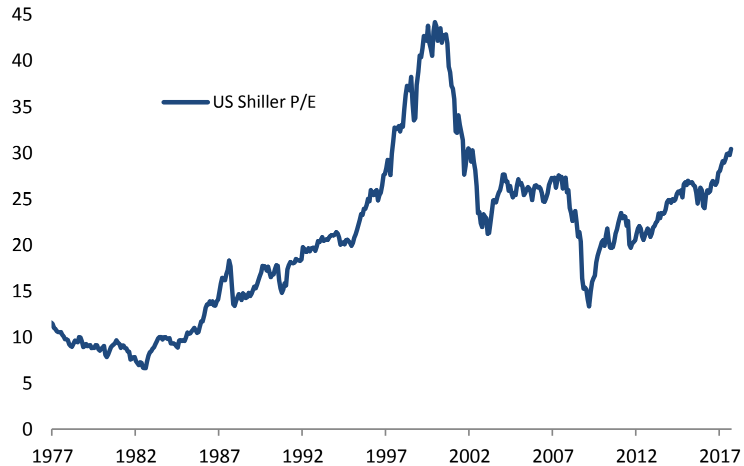
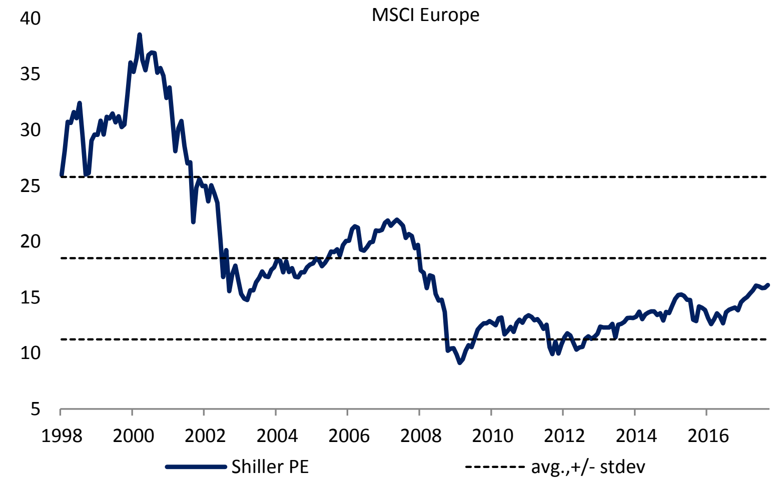
We remain cautious on the outlook for European relative to US equities

The US Shiller P/E, at 30.4x, is already at a 15-year high



The European Shiller P/E, at 16.1x, is at the highest level since 2008, but remains below its 20-year average



US market cap to GDP, at 135%, has only been higher 2% of the time since the early 1970s

Euro area market cap to GDP, at 62%, is at a post-crisis high

Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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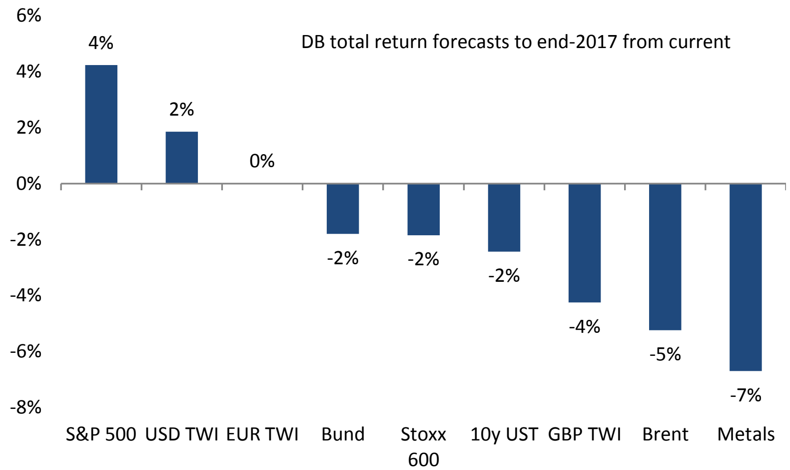
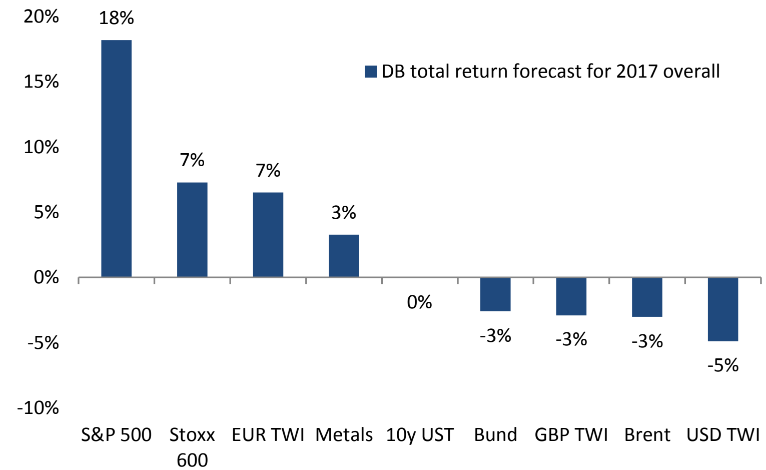
DB cross-asset return forecasts

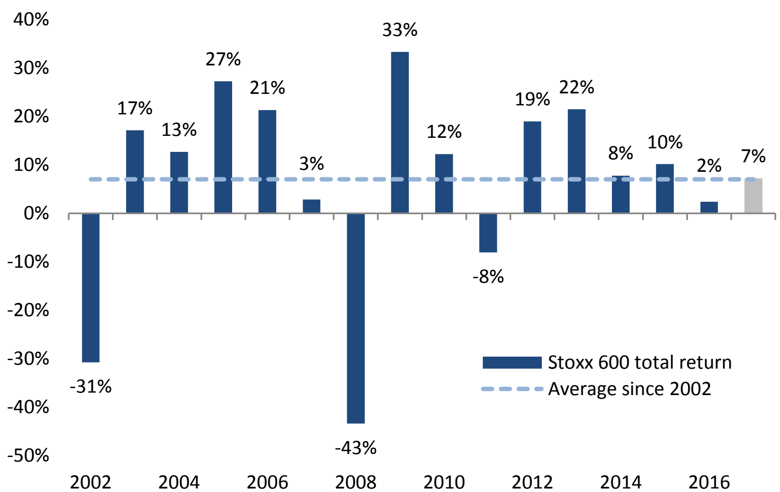
Until the end of the year, DB analysts' forecasts imply 4% upside for US equities and 2% upside for the USD TWI



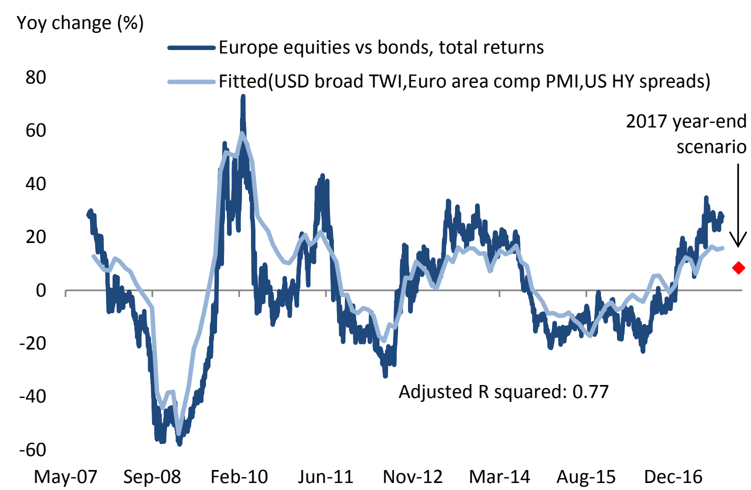
For 2017 overall, the S&P 500 is expected to return 18%



We think the total return index for the Stoxx 600 be flat until year-end, implying returns for the whole year at 7% (in line with the average annual return since 2002)



Our top-down model of European equity versus bond returns points to 8% excess return for equities in 2017



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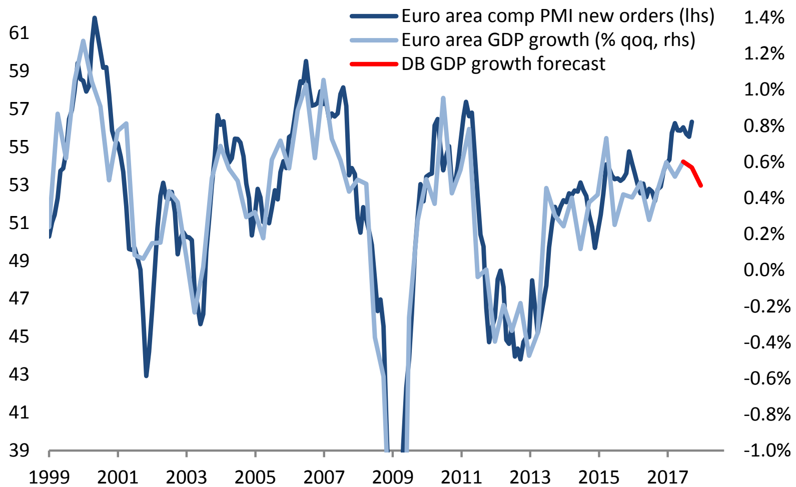
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

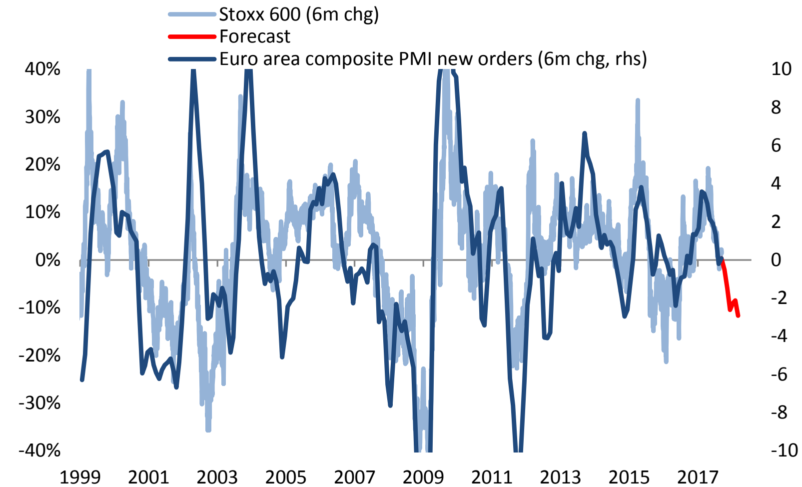
What are the risks?

What are the risks? 1) Growth momentum has started to roll over

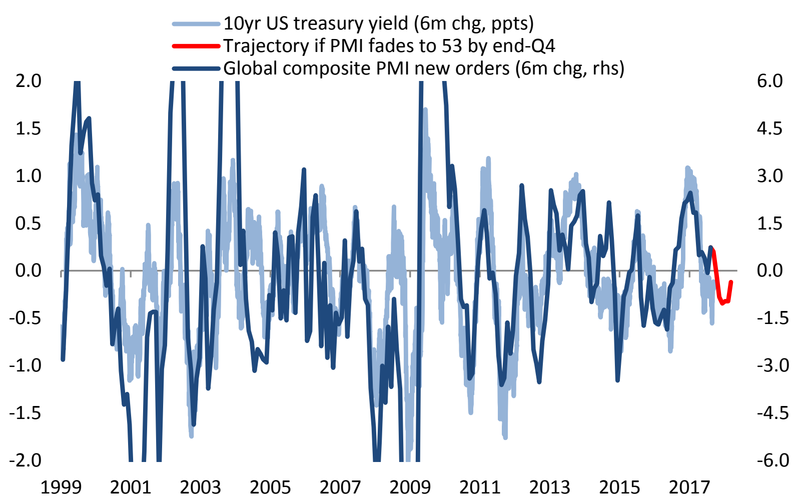
The Euro area PMI, at 56.3, is consistent with GDP growth of just over 0.8% qoq, or >3% annualized – we target a level of 53.4 by end-Q4, consistent with our economists' Q4 GDP growth forecast of 0.5%



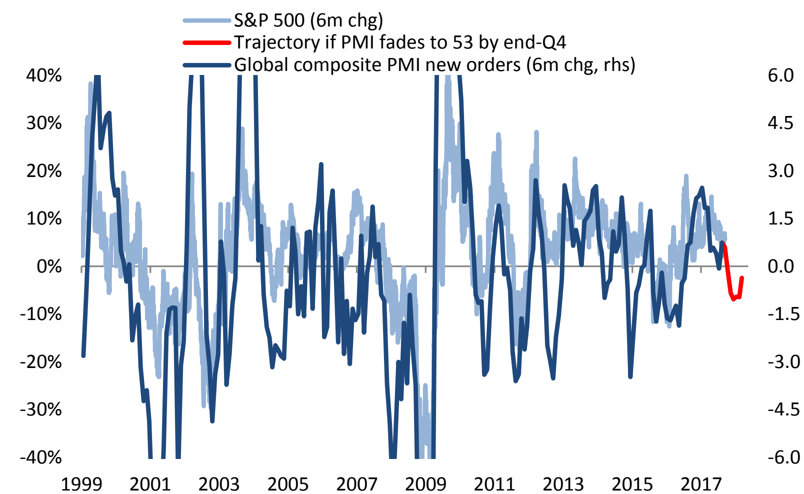
Euro area PMI momentum is a key driver for European equity momentum, and if the PMI does fade to 53.4, this would imply downside for the market over the coming months



Global PMI momentum (i.e. the six-month change in PMIs) has faded from +2.5 in February to +0.7, weighing on US bond yields



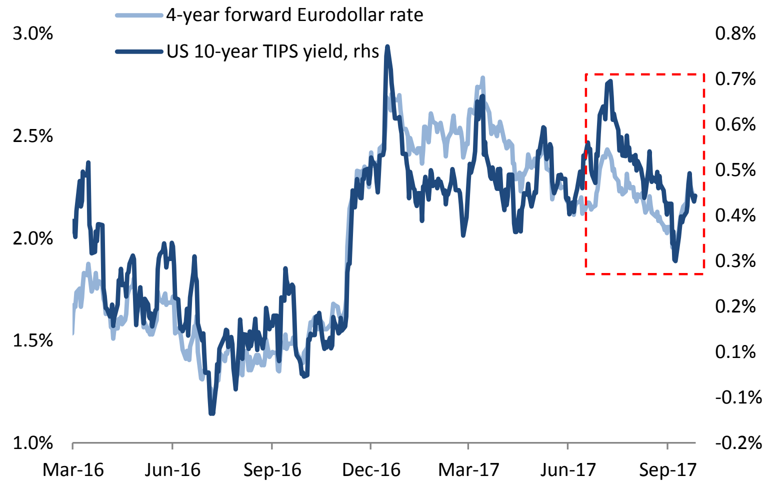
A continued fade in global PMI momentum has the scope to weigh on US equity price momentum over the coming months



Source: Bloomberg Finance LP, Datastream, Deutsche Bank

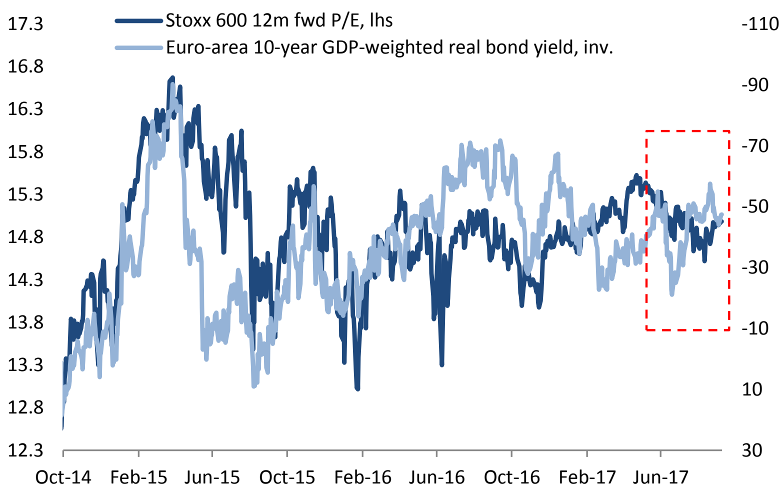
What are the risks? 2) Rising real bond yields are set to weigh on multiples

Fed expectations have been moving higher in recent weeks, putting upward pressure on US real bond yields

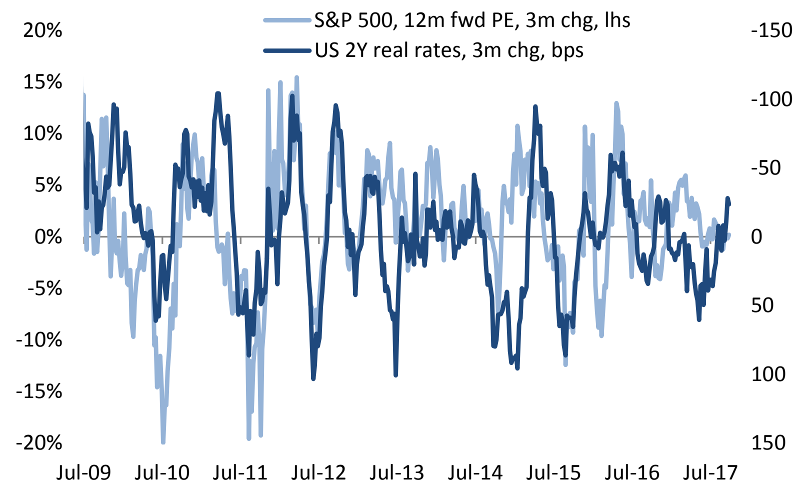


The relationship with the global PMI suggests that the market-implied terminal Fed fund rate should be >50bps higher

Higher real bond yields normally means lower P/Es - Euro area real bond yields have risen by around 16bps since the start of the year and should keep rising if the ECB withdraws accommodation in H2



Rising US real bond yields tend to be associated with lower US equity multiples



Source: Datastream, Haver, Deutsche Bank

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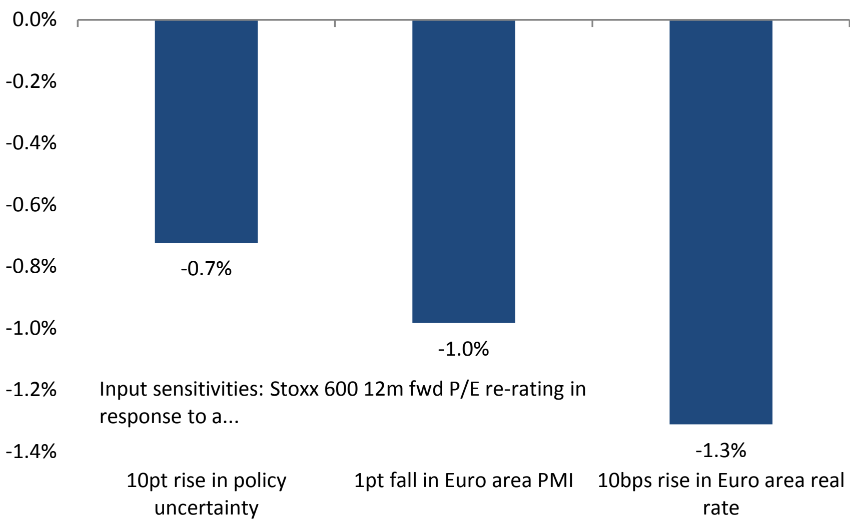
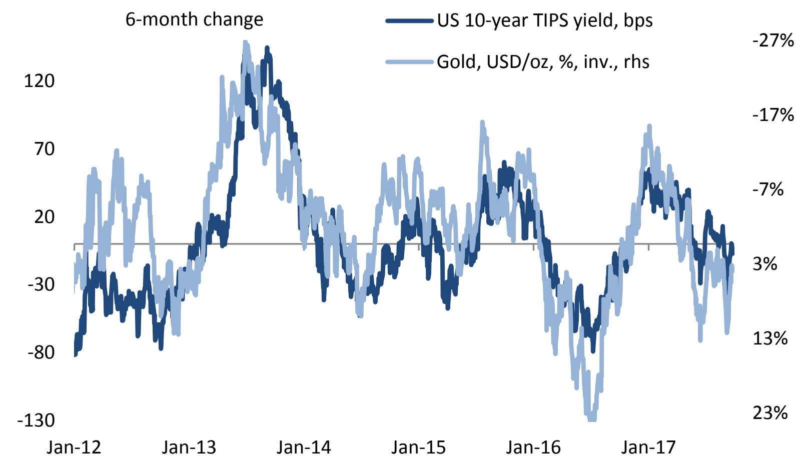
What are the risks? 2) Rising real bond yields are set to weigh on multiples

Our 12m fwd P/E model suggests that every 10bps rise in the real bond yield takes 1.3% off European P/Es



Rising US real bond yields are typically associated with a lower gold price



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Fixed income, FX & commodities outlook

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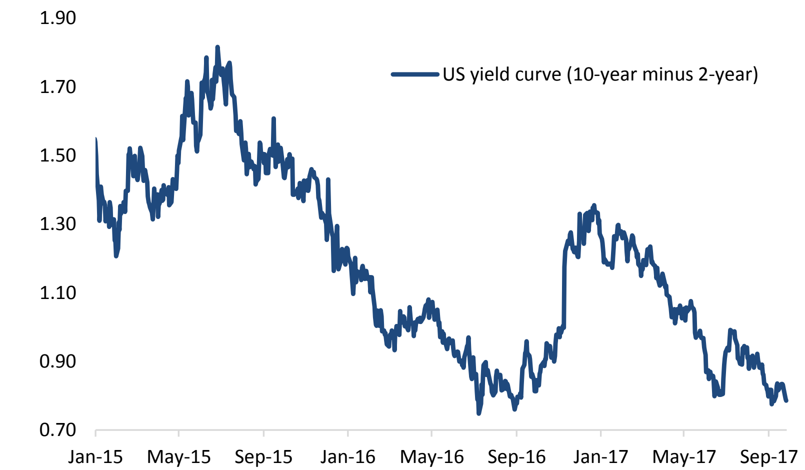
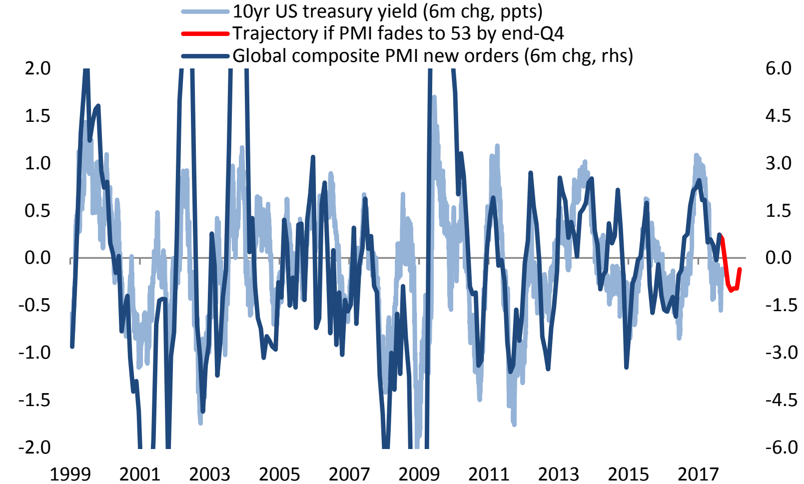
Bond yields: fading growth momentum versus central bank tightening

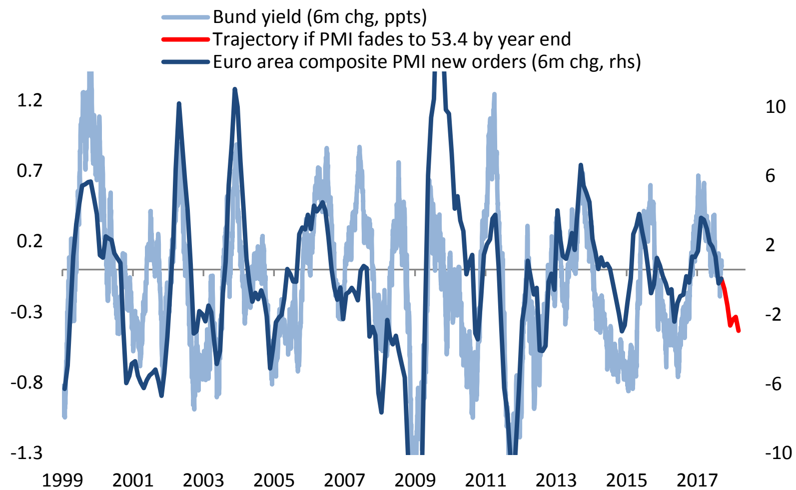
The US yield curve (10y – 2y) is now only around 5bps above its mid-2016 trough



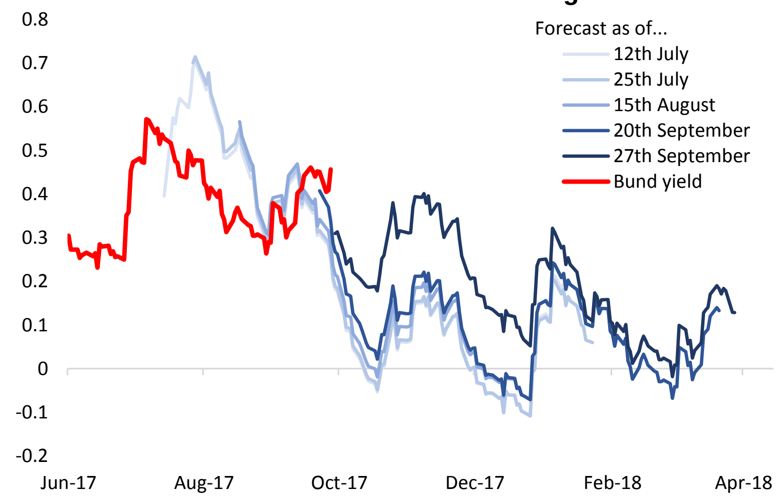
US bond yields appear to have undershot global PMI momentum in the near-term, but could face further downside versus current levels around year-end if our PMI forecasts are correct



We expect Euro area PMI momentum to turn negative again, which typically weighs on German bond yields



Bond yields have been tracking the course suggested by PMI momentum – and our projections for PMIs point to moderate downside over the coming months



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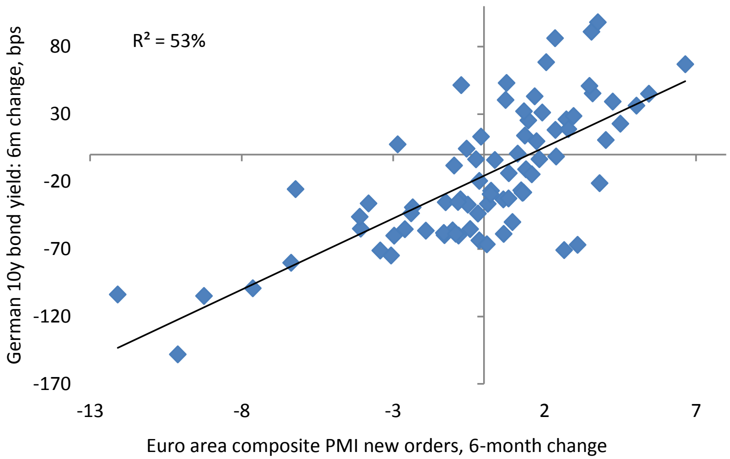
Bond yields: fading growth momentum versus central bank tightening

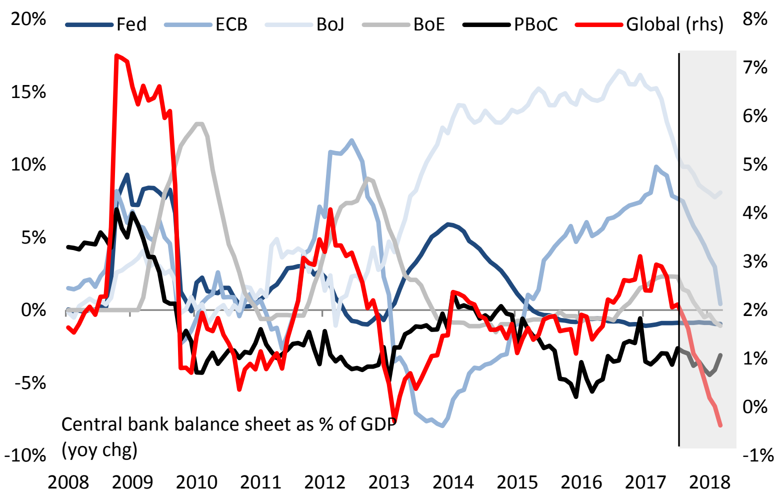
Euro area PMI momentum explains around 55% of the variance in German bond yield momentum since 2010



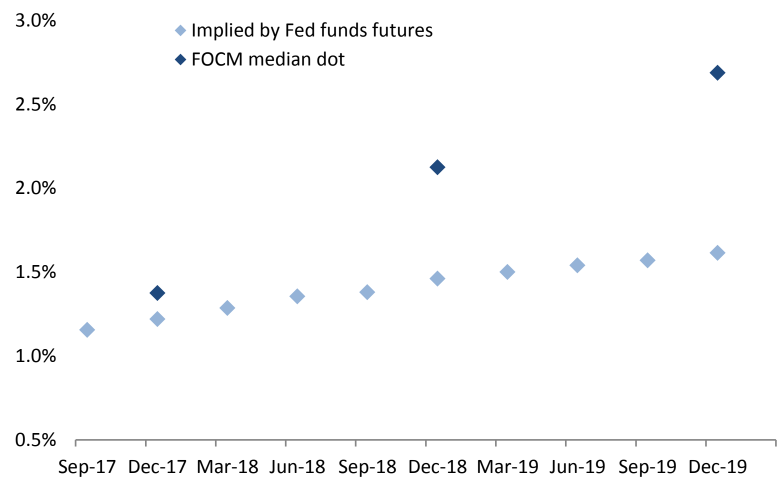
During past periods of falling Euro area PMI, bond yields have typically fallen by around 90bps

	German 10y yield fall back period		
PMI peak	Lead / lag (-) in months	Duration (months)	Chg in yield (bps)
Oct-99	-0.1	0.8	-58
Apr-02	0.6	11.3	-147
Nov-03	-0.5	3.7	-63
May-06	-1.6	2.6	-48
Jul-07	0.2	2.0	-61
Mar-08	-3.1	6.2	-176
Aug-09	2.2	14.6	-164
Apr-11	0.1	5.3	-180
Mar-12	-0.1	2.3	-89
Sep-13	0.1	0.6	-34
May-15	-1.0	9.8	-88
Mean	**-0.3**	**5.4**	**-101**
Median	**-0.1**	**3.7**	**-88**

On the positive side, global QE is set to fade, which should help to de-compress the term premium



The Fed seems to be underpriced: the Fed itself expects four more hikes by end-2018, while the market only expects just over 1 hike



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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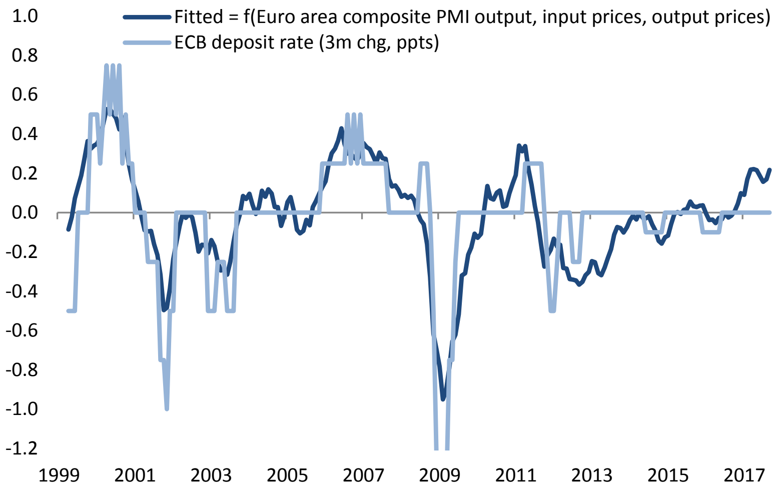
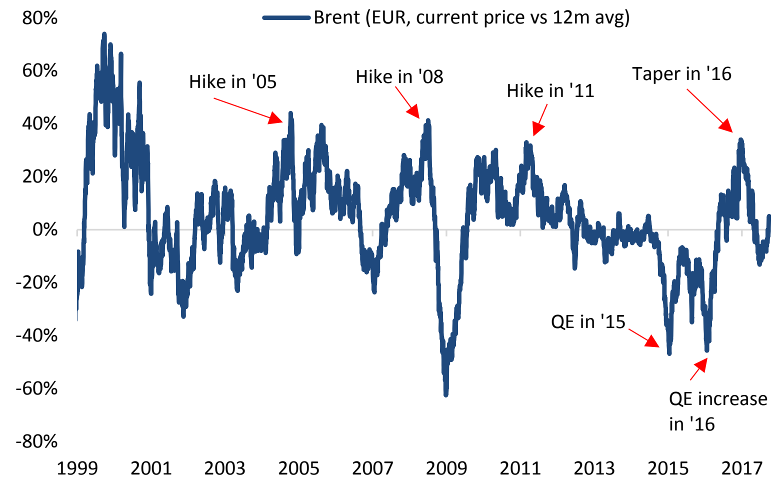
Bond yields: fading growth momentum versus central bank tightening

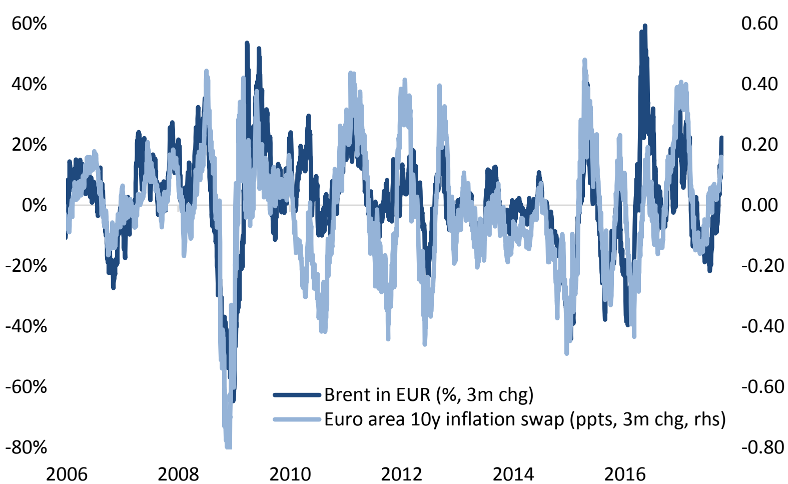
Strong Euro area lead indicators suggest the ECB is set to turn more hawkish over the coming months



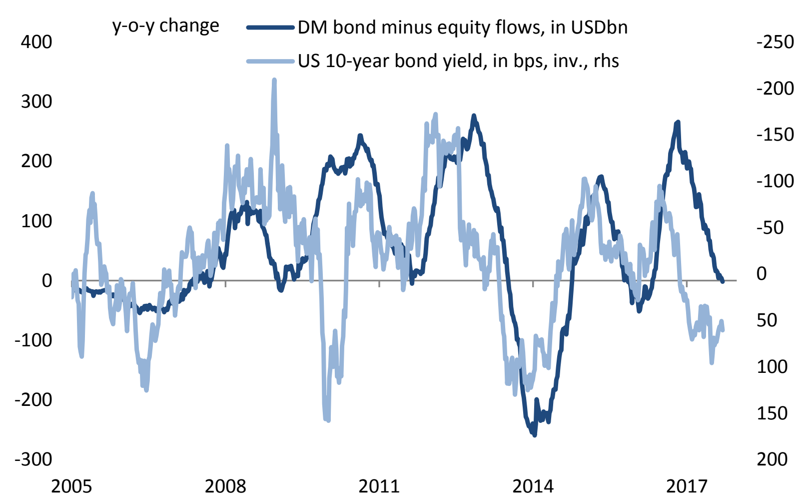
The ECB has historically been more likely to tighten policy in periods of rising oil prices



Over the past couple of weeks, European bond yields have benefitted from a stronger oil price and a weakening euro



The current level of the US 10-year bond yield suggests flow momentum out of DM bond funds and into DM equity funds has further to go



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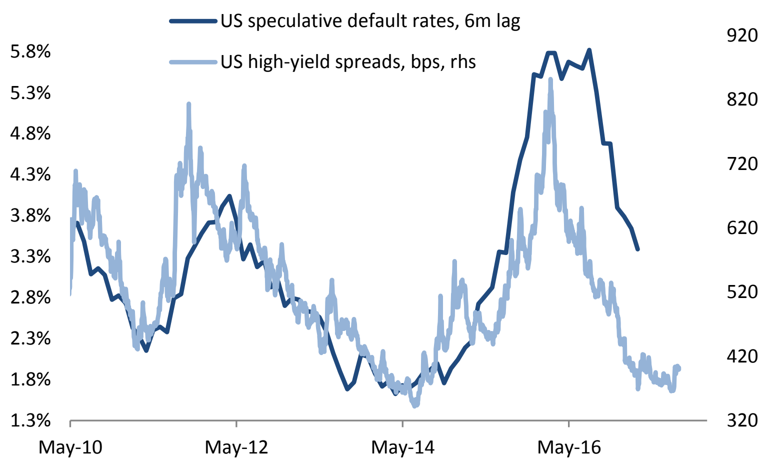
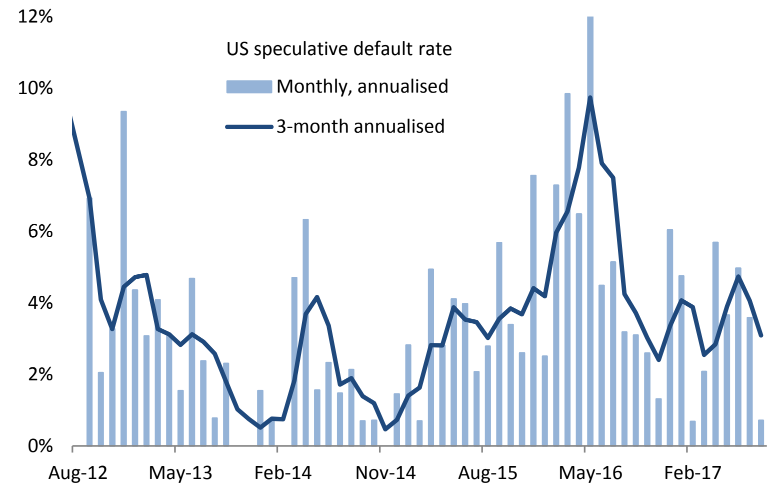
US yield-credit spreads: close to trough levels, but our models suggest little upside

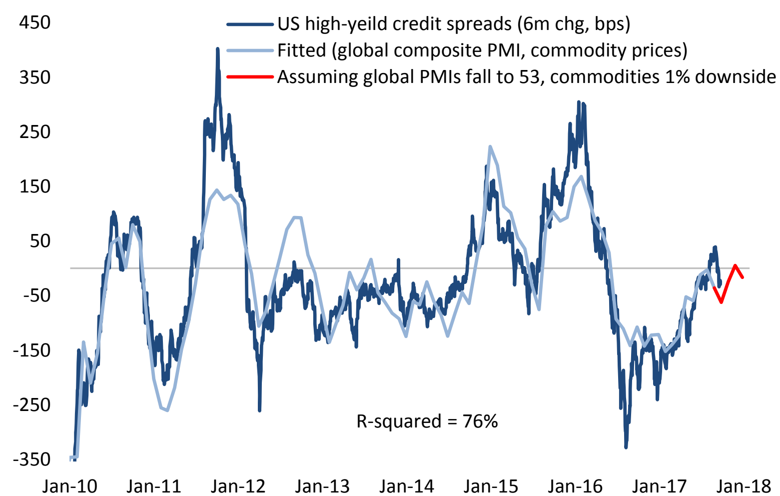
US high-yield spreads are priced for the default rate to decline from around 3.5% to below 2%



The 3-month annualised default rate currently around 3%



Our US high-yield credit spread model (based on commodity prices and global PMIs) suggest broadly flat spreads over the coming months



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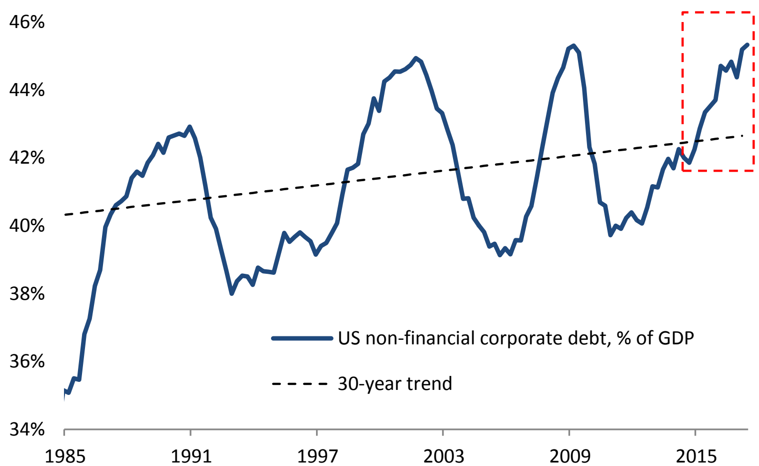
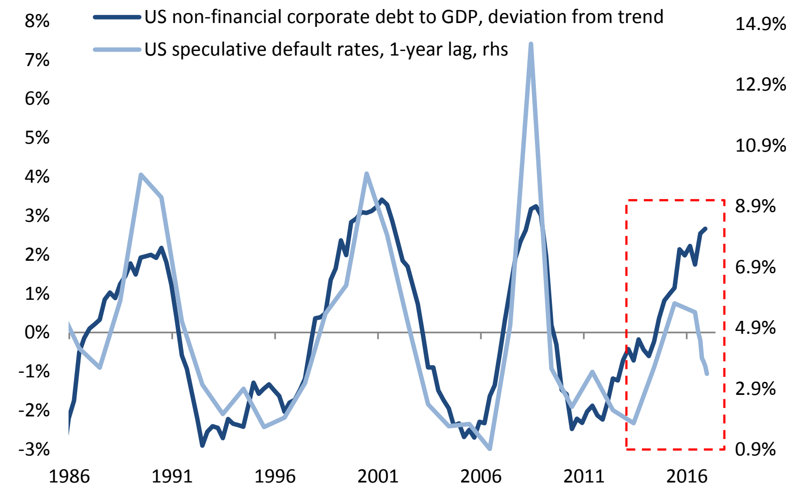
US yield-credit spreads: close to trough levels, but our models suggest little upside

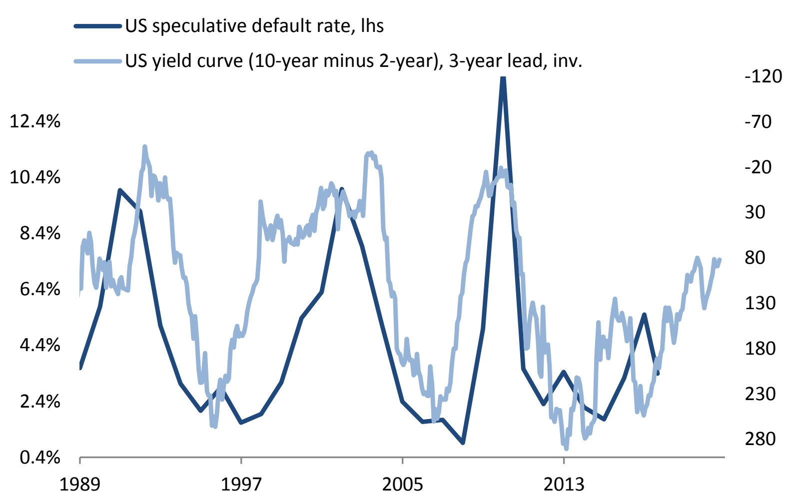
Monetary policy is being tightened against the backdrop of corporate debt to GDP close to an all-time high



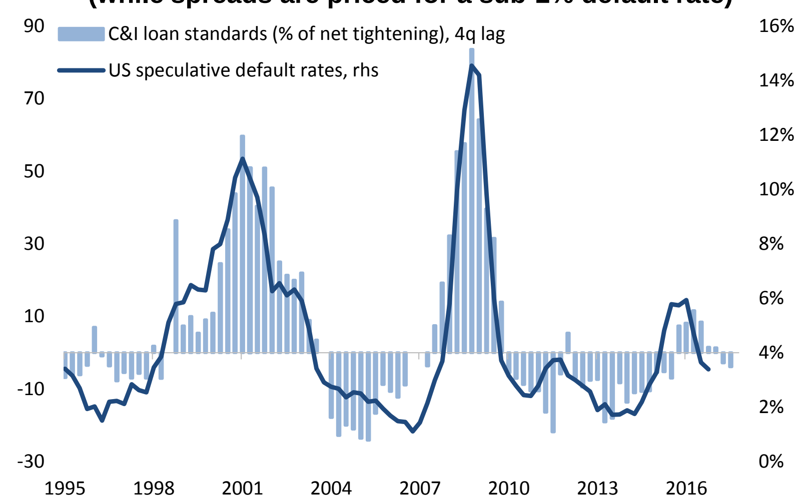
In the past, defaults have tended to rise when US corporate debt to GDP has risen above trend



The shape of the US yield curve points to upside risk for the US default rate



US bank lending standards point to a default rate of just over 3% (while spreads are priced for a sub-2% default rate)



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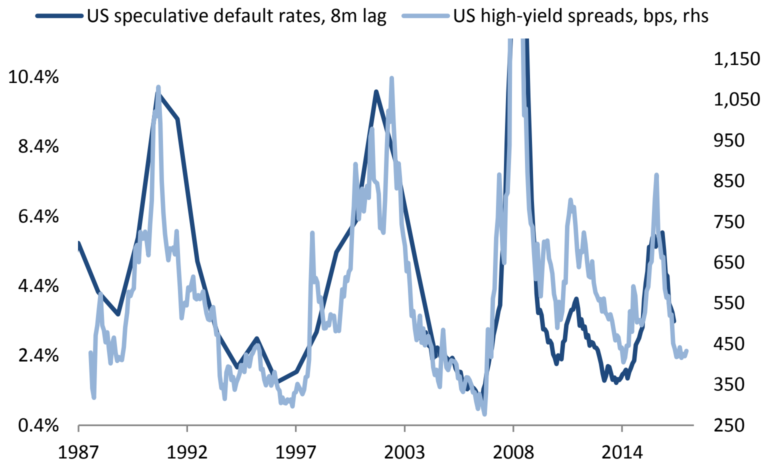
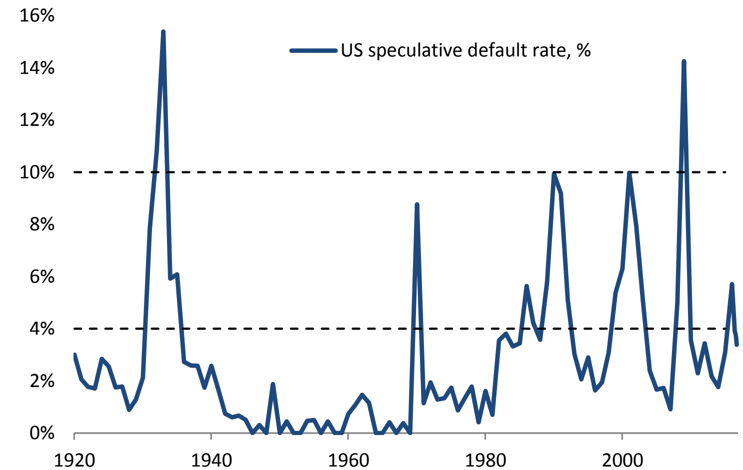
US yield-credit spreads: close to trough levels, but our models suggest little upside

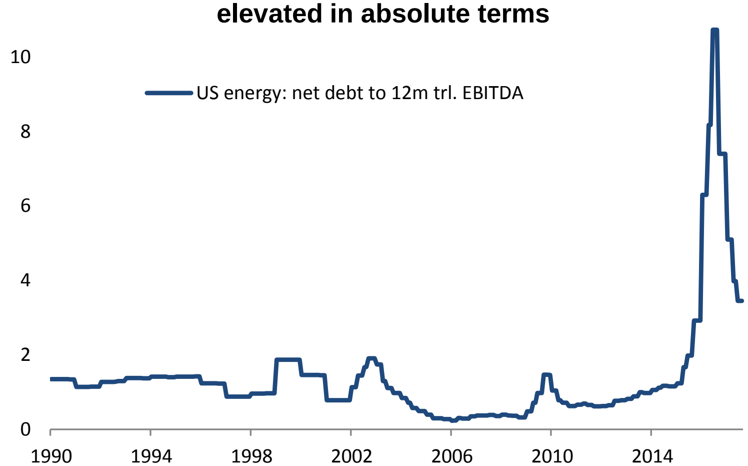
US high-yield spreads, at around 400bps, are priced for default rates close to historical trough levels



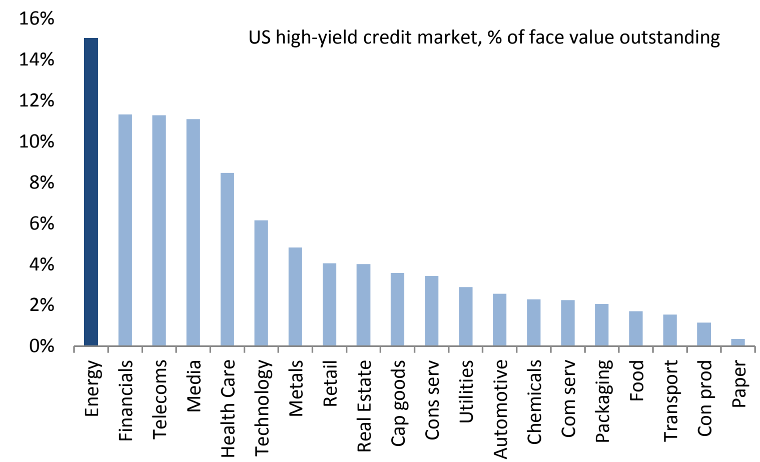
Over the past 100 years, when the US speculative default rate has risen above 4%, it has typically kept rising to 9% - 10%



US energy leverage has dropped sharply but remains elevated in absolute terms



Energy is the largest sector in the US HY market, at 15% of face value outstanding



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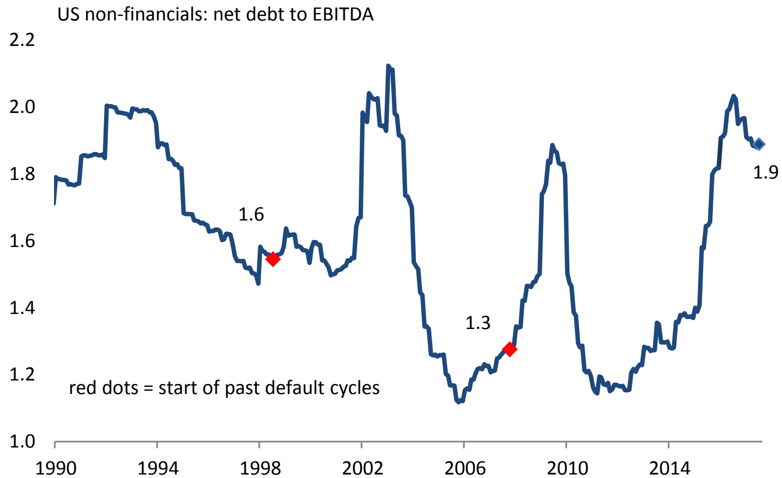
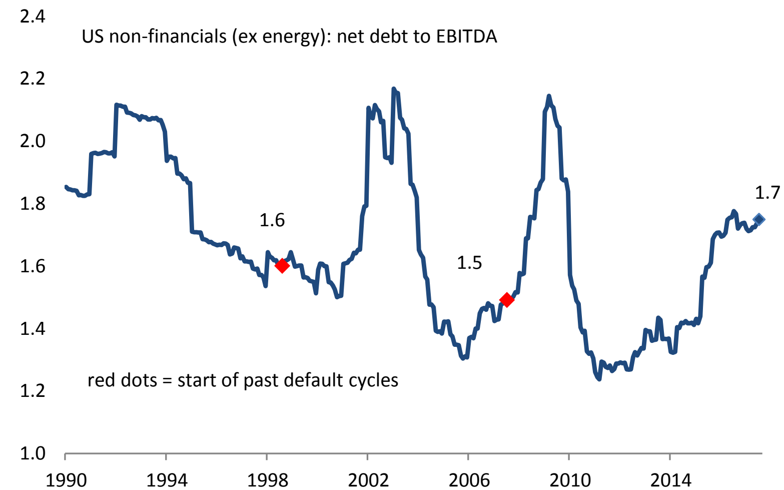
US yield-credit spreads: close to trough levels, but our models suggest little upside

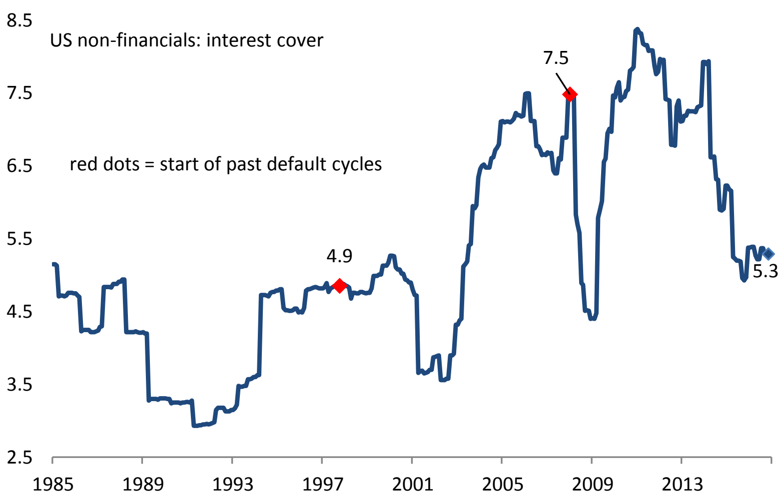
The US net debt to EBITDA ratio has risen to 1.9x, compared to 1.6x and 1.3x at the start of past default cycles



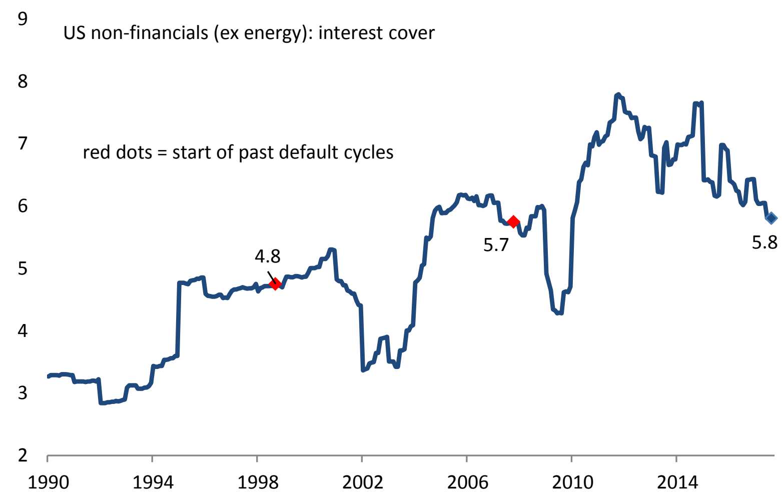
Even ex energy, US corporate leverage is slightly above the level were it stood at the start of past default cycles



Yet, US interest cover is close to a five-year low – and is below the levels at which it was at the start of the last default cycle



Ex energy, the interest cover is in line with levels at the start of the last default cycle



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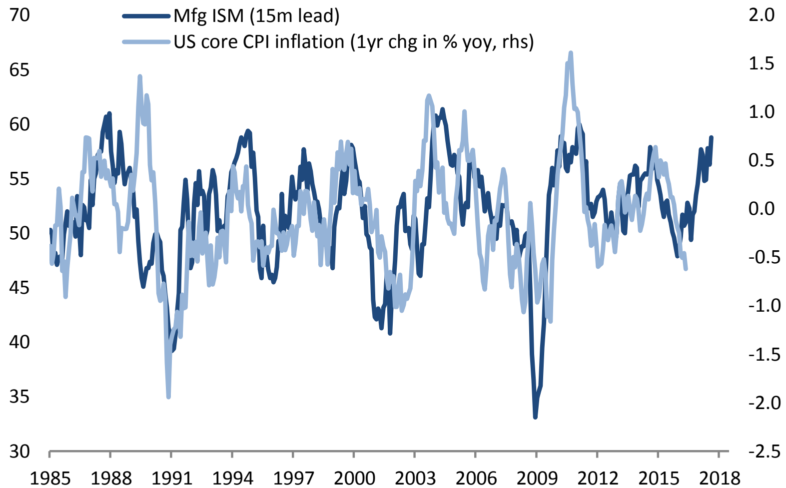
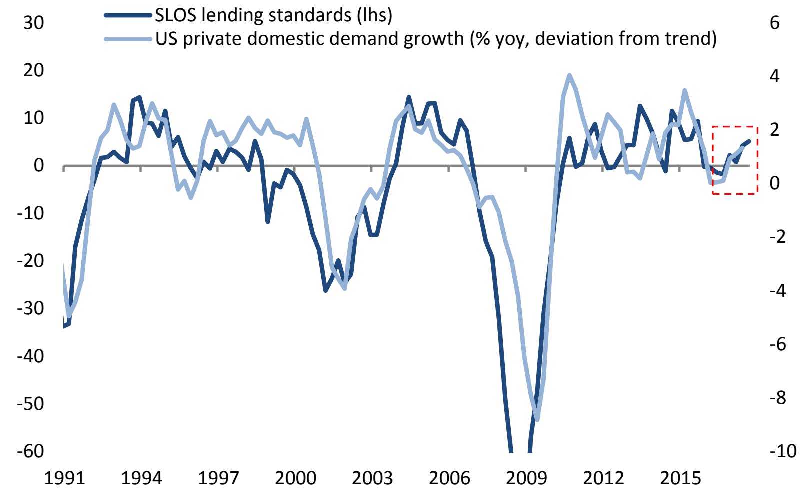
Our FX strategists see tactical USD upside by year-end

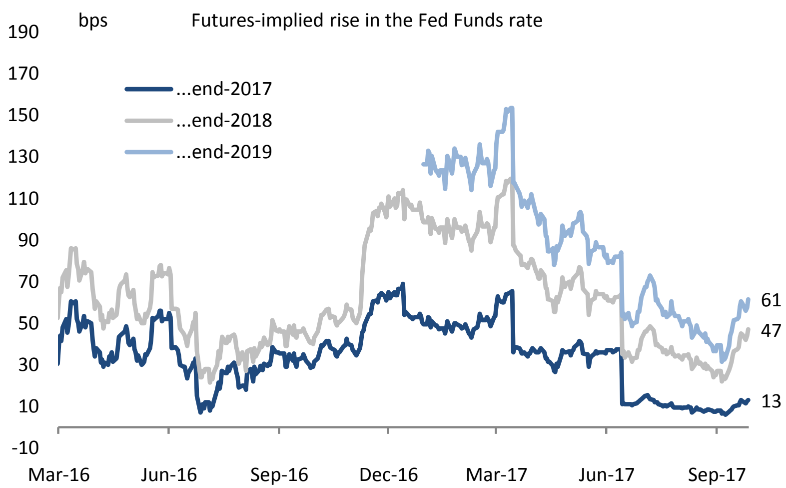
Core CPI should recover to just over 2% by year-end given the recovery in the manufacturing ISM over the past year



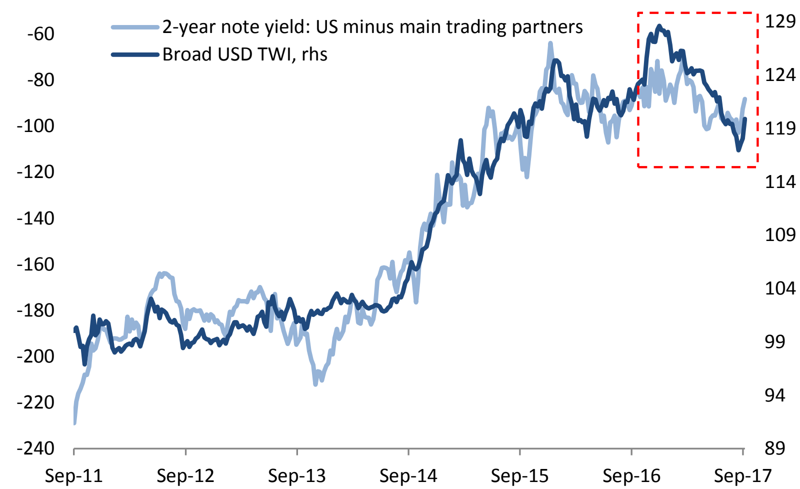
Credit dynamics point to some acceleration in private demand growth for the US



A Fed hike is only half-priced by the market (DB expects a hike in Dec) – and the market is still only priced for little more than two hikes by end-2019



The recent hawkish turn in Fed expectations has put upward pressure on the US 2yr note yield, the 2yr note yield differential and the USD



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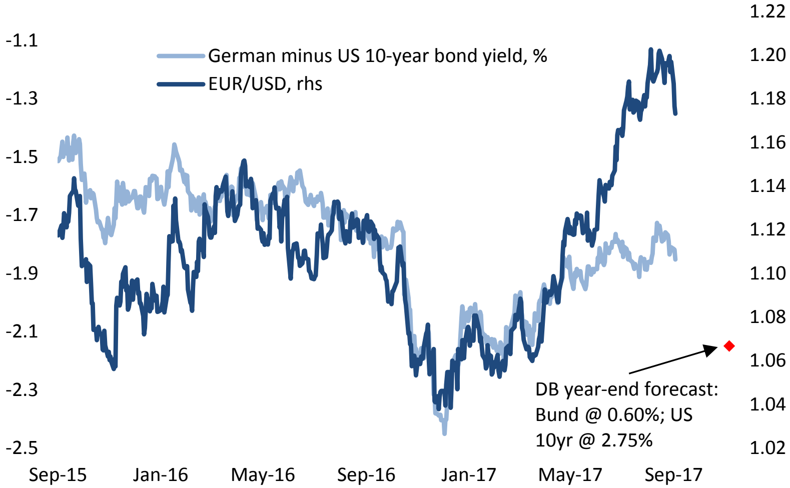
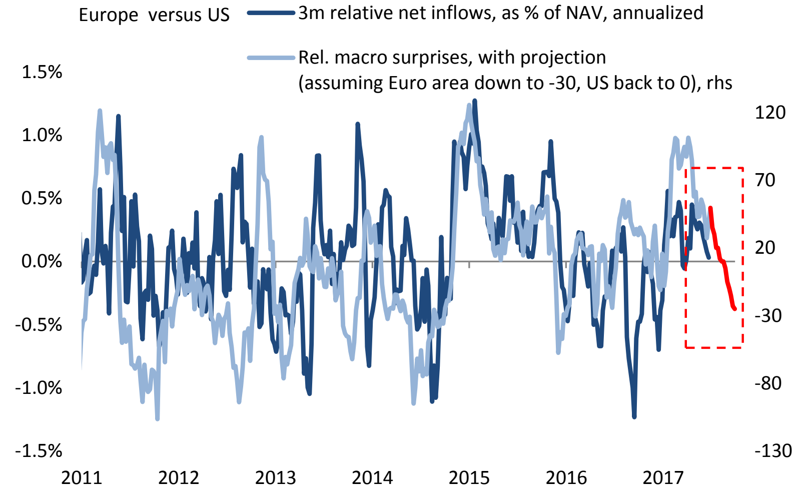
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Our FX strategists see tactical USD upside by year-end

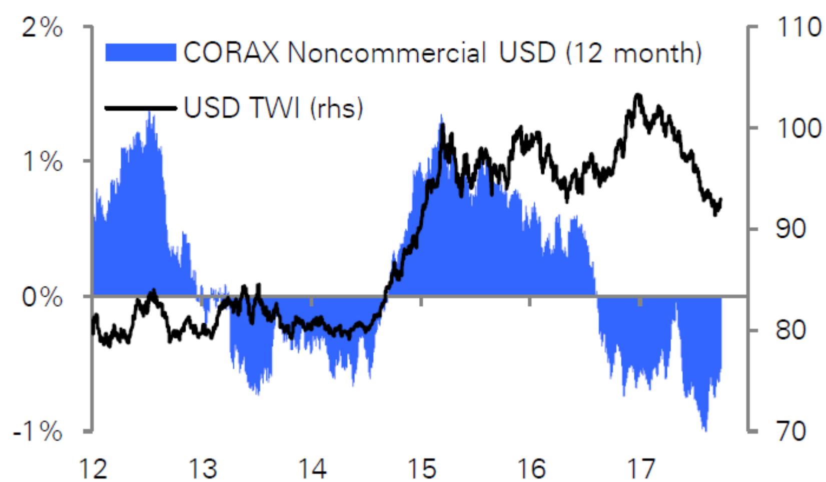
EUR/USD, having looked very stretched relative to 10yr yield differentials, is beginning to fall back



Our FX strategists argue that the euro has benefitted from inflows into European equity funds, but our projections for relative macro surprises point to a swing of relative equity flows from Europe to the US



USD positioning (12m rolling) is remains short



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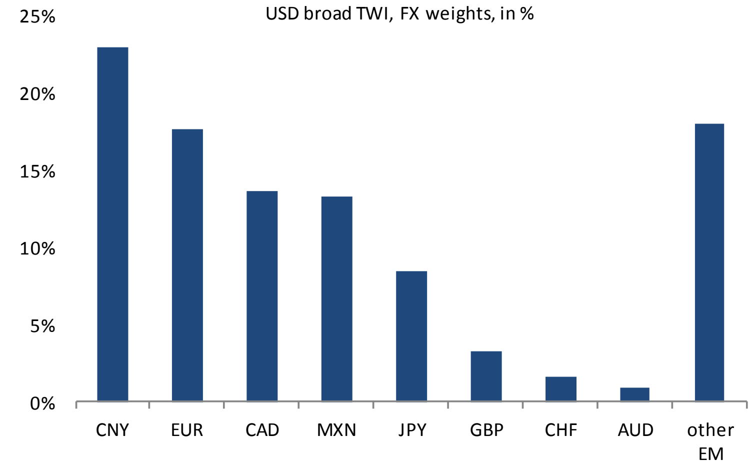
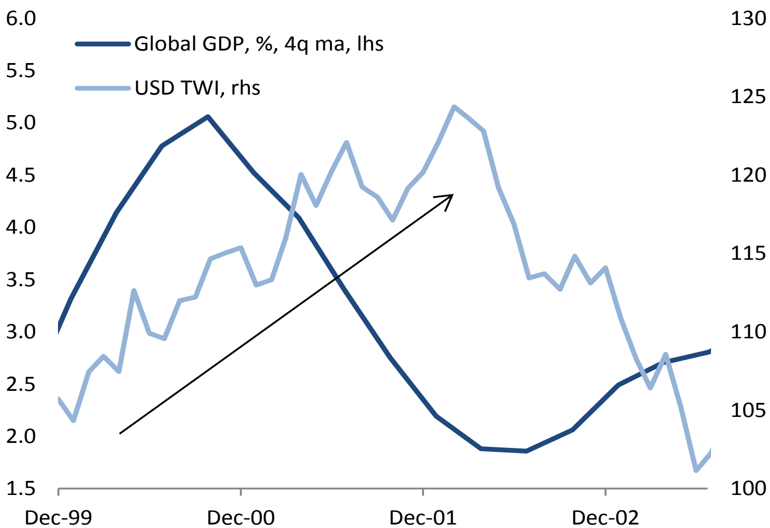
Our FX strategists see tactical USD upside by year-end

Over time, rate differentials are likely to move to imply RMB depreciation, with Fed hikes unlikely to be matched by the PBoC given high Chinese debt levels

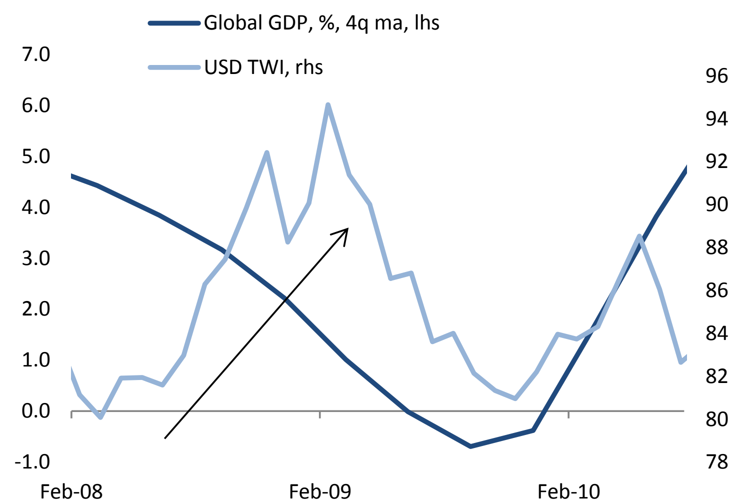
The CNY accounts for the more than 20% of the broad USD TWI basket



The USD rose by 18% during the 2001 recession...



... and by 19% during the 2009 recession



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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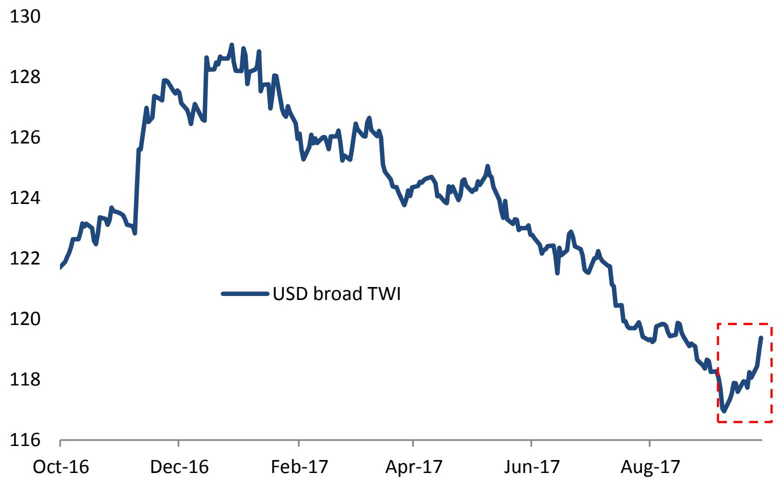
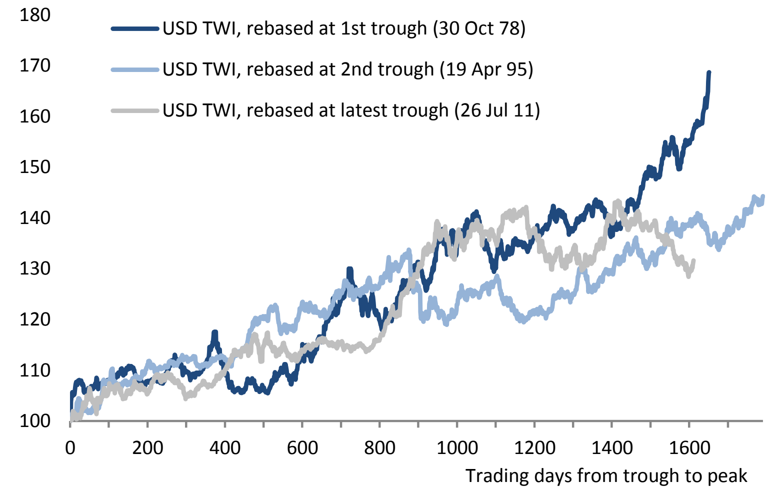
Our FX strategists see tactical USD upside by year-end

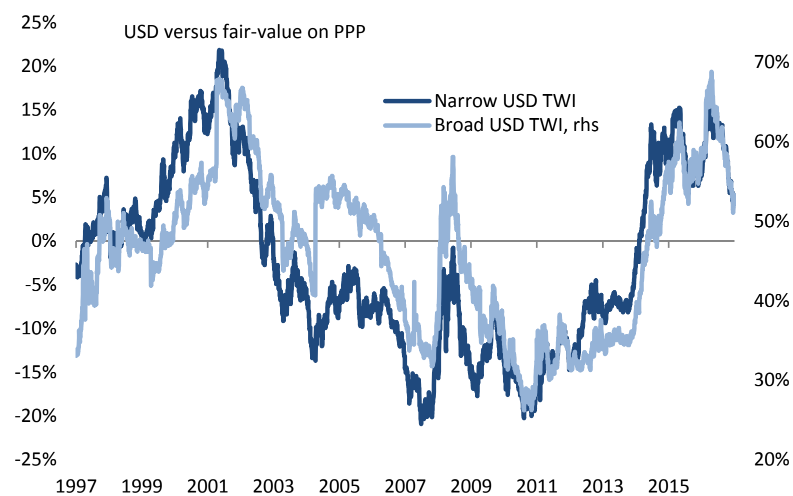
After falling over 9% since the start of the year, the broad USD trade-weighted index has recovered 2% since early September



However, our FX strategists believe that, structurally, we have seen the peak in the post-2011 USD bull market, which has seen the USD rise by ~40%



The USD TWI only now only looks marginally stretched relative to fair-value on PPP



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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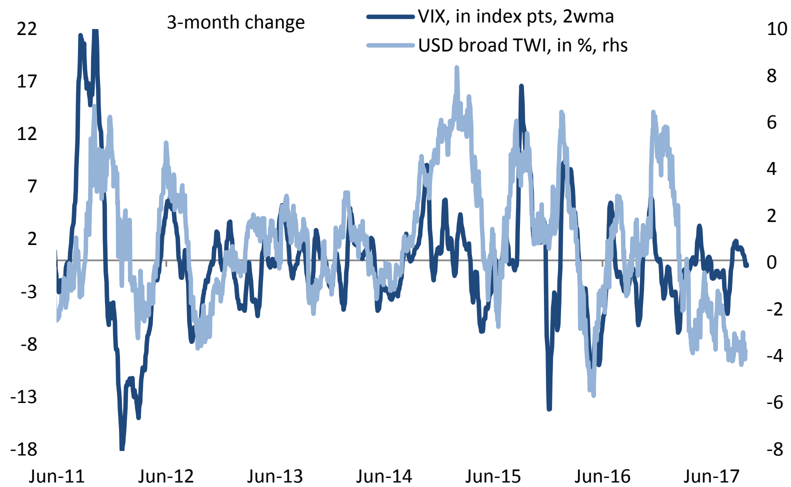
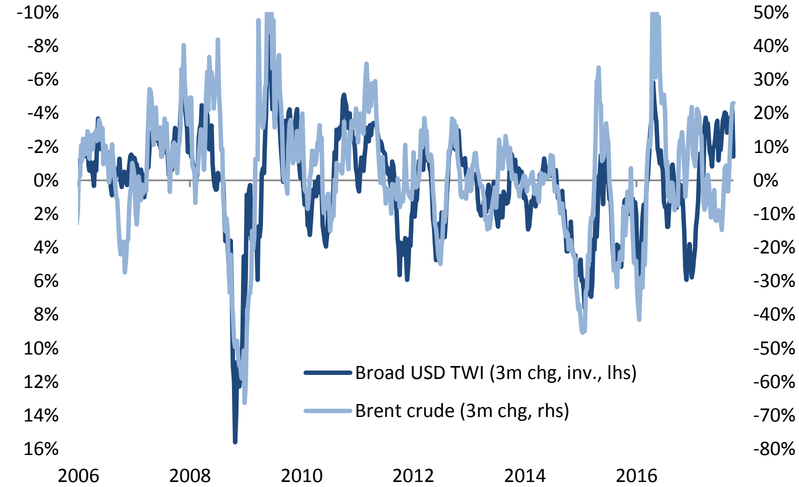
What would be the implications of a stronger dollar?

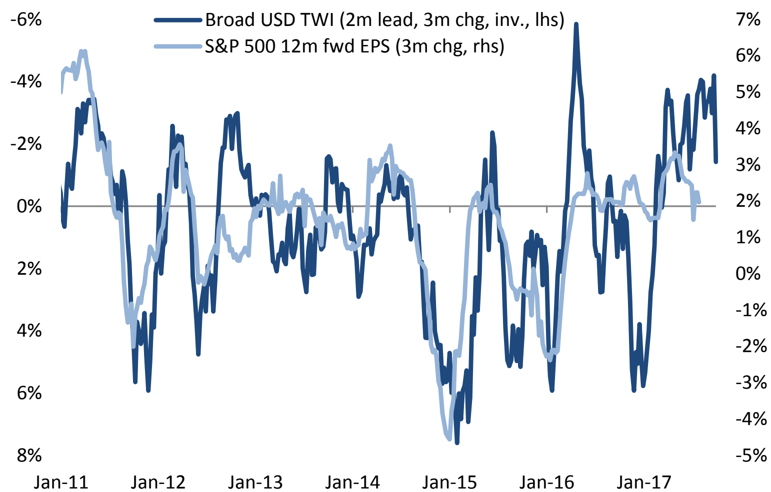
US dollar strength is associated with higher volatility…



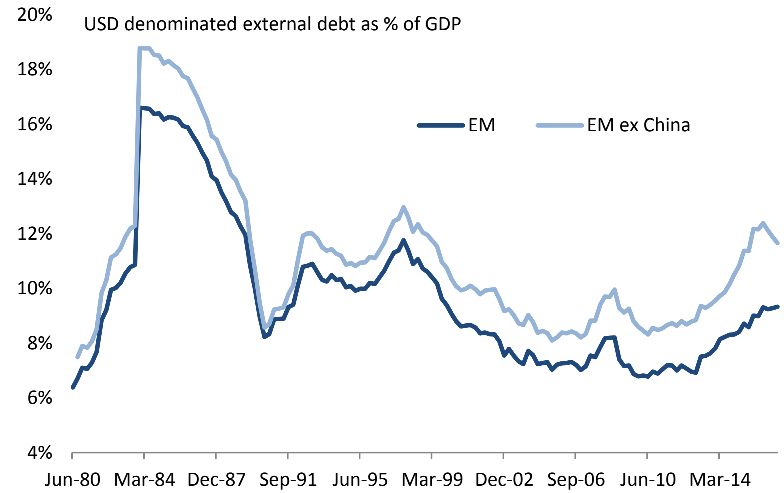
… and lower commodity prices



USD strength should weigh on US corporate profit growth



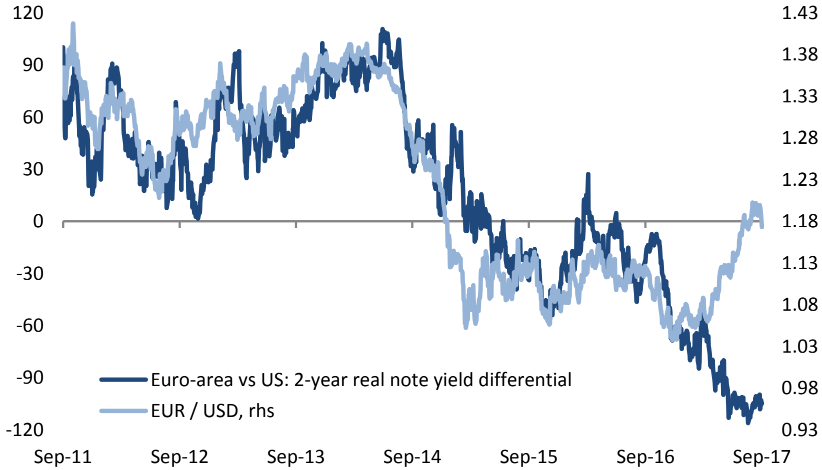
EM (ex China) USD-denominated external debt as a proportion of GDP, at 12%, is close to the highest level since 1998



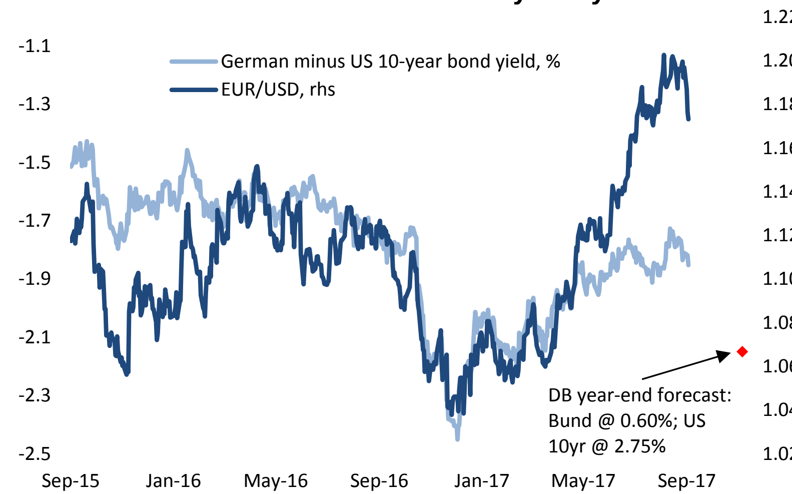
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Has the euro overshot?

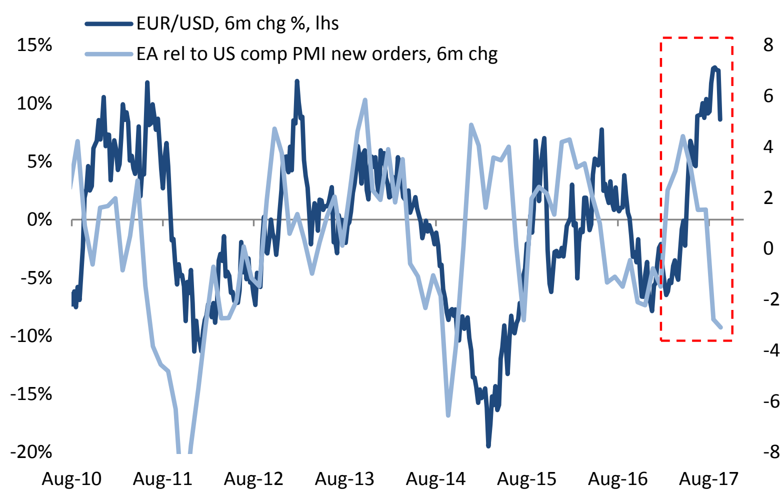
The EUR/USD typically moves in line with short-term rate interest rate differentials – but the relationship has broken down recently



The EUR/USD now trades significantly above the level implied by relative bond yields – and our rates strategists expect US bond yields rise relative to those in Germany into year-end



EUR/USD typically strengthens in periods of rising Euro area PMIs relative to those in the US – this relationship points to downside risks for EUR/USD over the coming months



On the positive side, the EUR is still around 10% cheap against the USD on PPP

Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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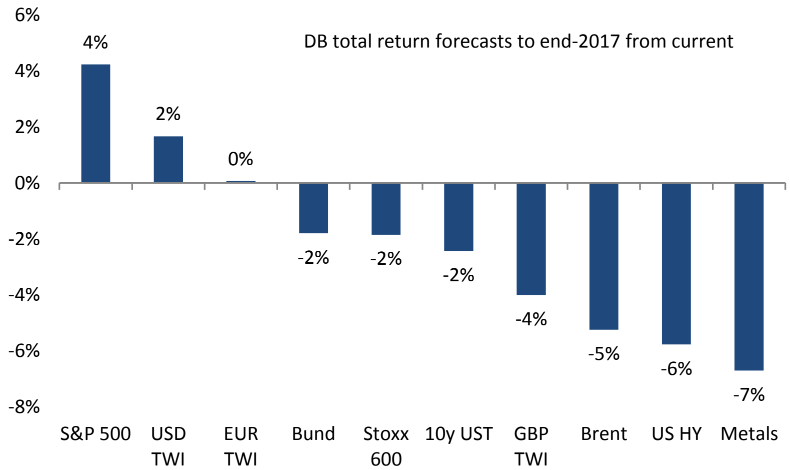
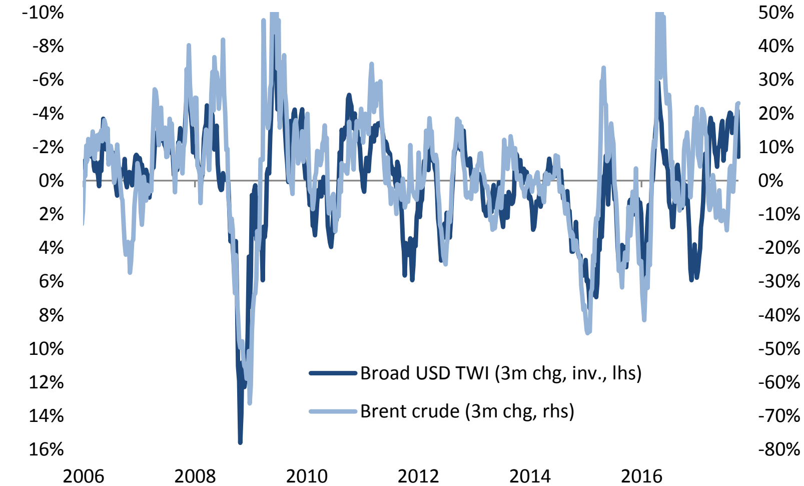
Commodities: renewed downside for oil and copper as the USD strengthens

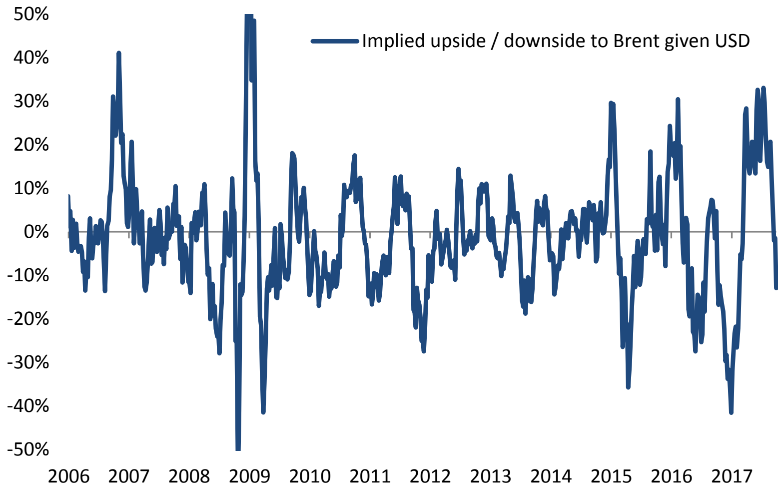
DB's commodity analysts are forecasting 5% downside for Brent by year-end



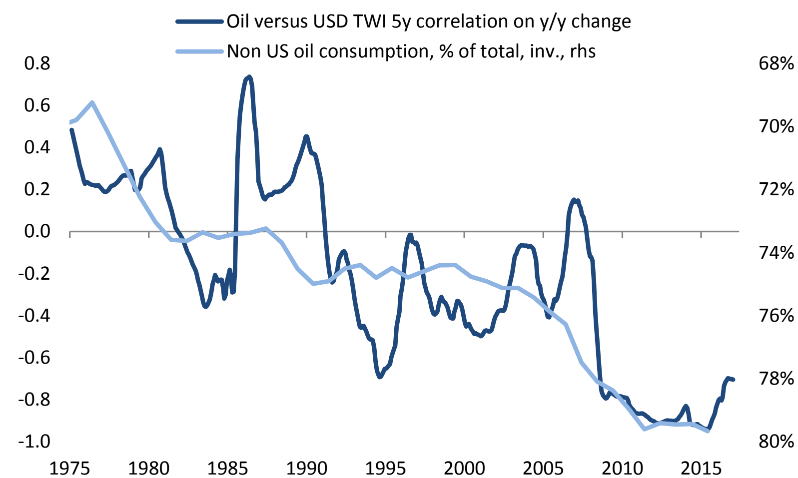
The broad USD trade-weighted index has risen by 2% since early September…



…and combined with the sharp rally in Brent that we have seen, there is now downside suggested by this relationship



The correlation between oil and USD has strengthened alongside the rise in non-US oil consumption



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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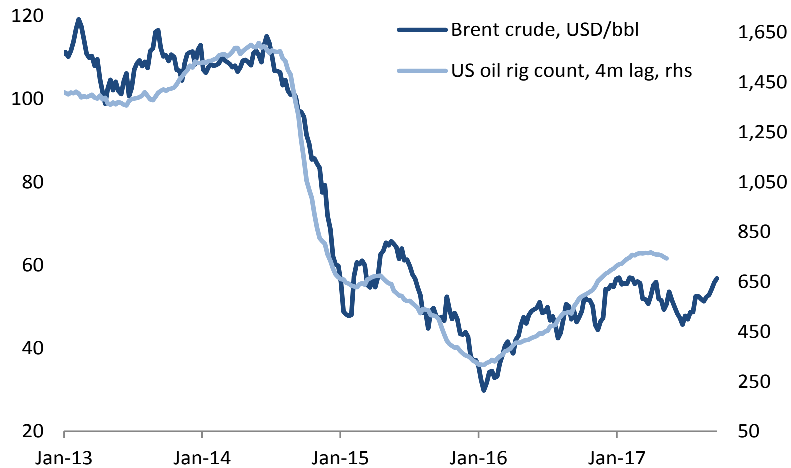
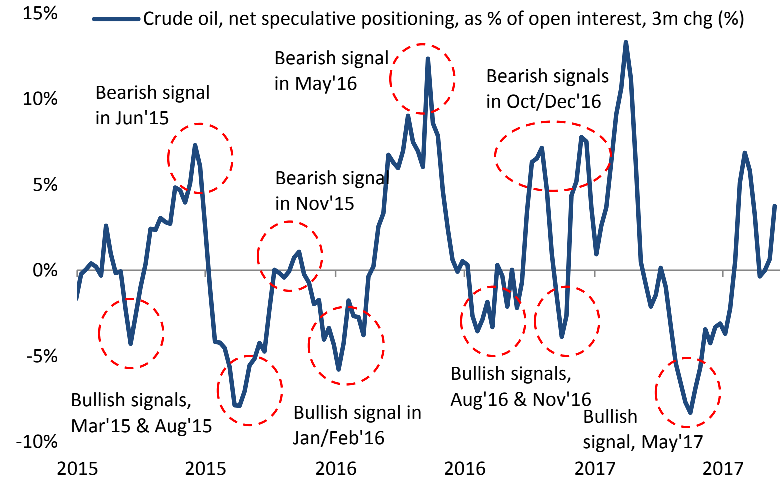
Commodities: renewed downside for oil and copper as the USD strengthens

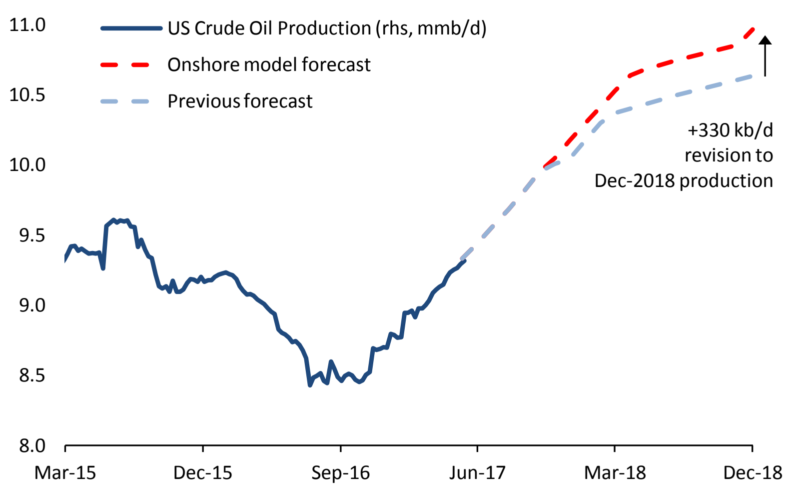
Despite the rebound, the level of the oil price still points to some mild downside for the US rig count



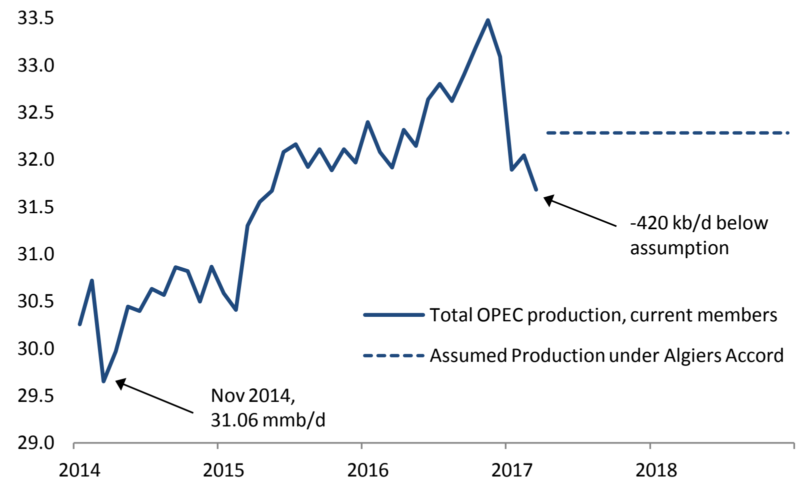
Oil speculative positions have rebounded over the last couple of months



US shale oil production has been stronger than expected …



… but this has been offset by OPEC producing below expectations



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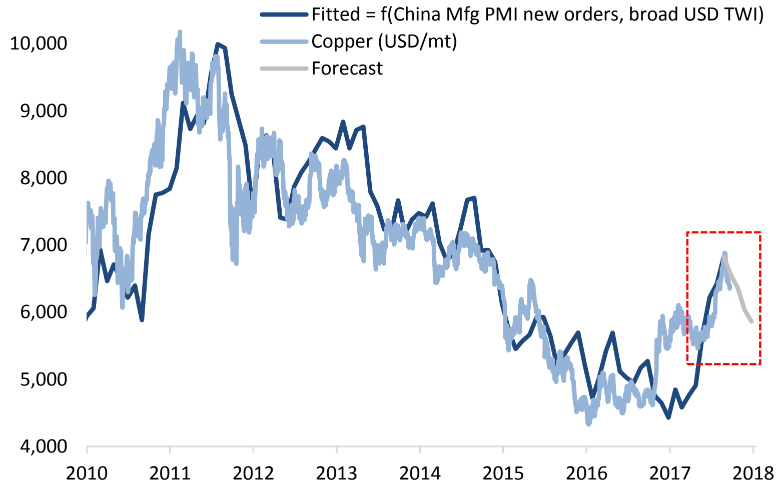
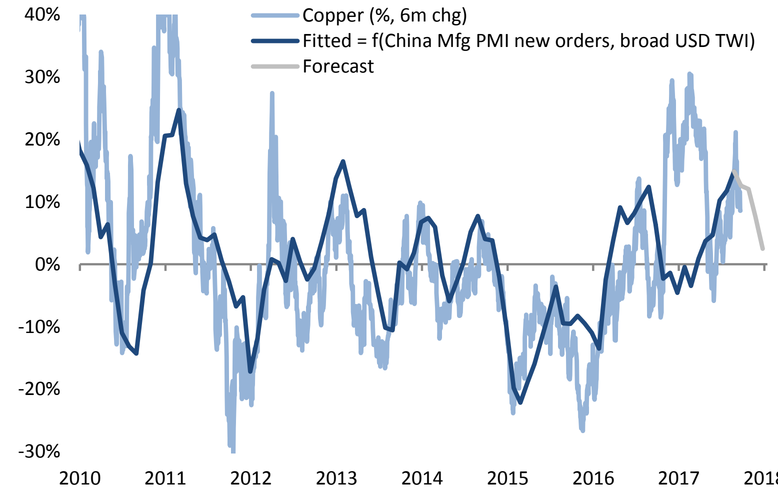
Commodities: renewed downside for oil and copper as the USD strengthens

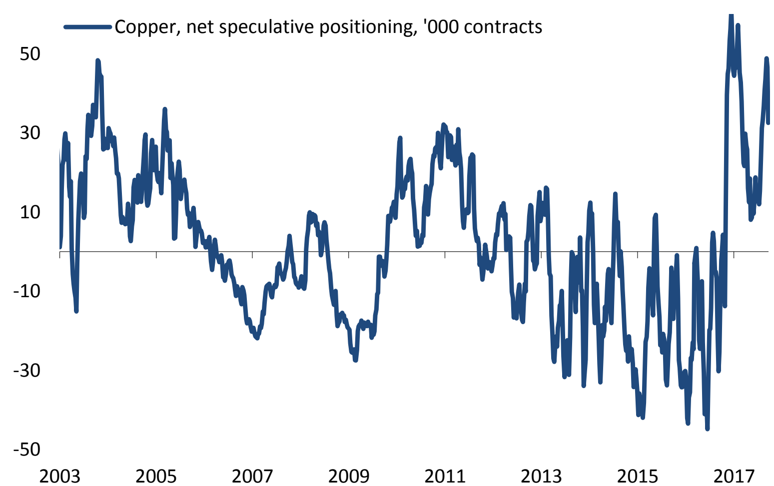
Our copper model now points to around 8% downside for the copper price by year-end



Our model explains moves in copper as a function of moves in the China PMI and broad USD, with the only notable decoupling occurring around the time of the 2016 US election



Net speculative copper positions remain elevated



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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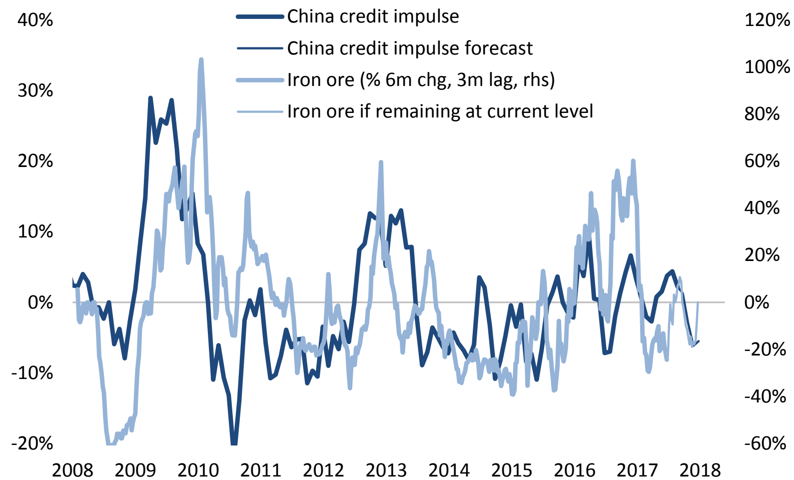
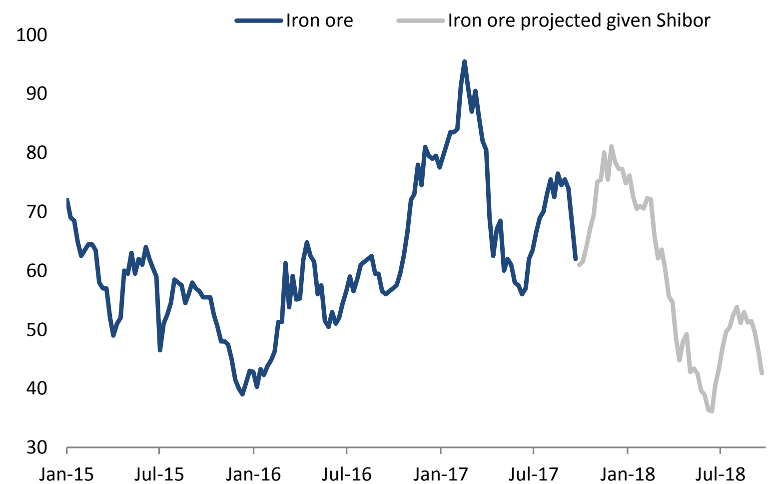
Commodities: renewed downside for oil and copper as the USD strengthens

The pullback iron ore in September has been to a level that is consistent with our expectations for the China credit impulse



Iron ore also displays a decent relationship with developments in SHIBOR with a 1-year lag

SHIBOR suggests near-term upside but with risks of a sharp fall through Q1/Q2



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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Macro

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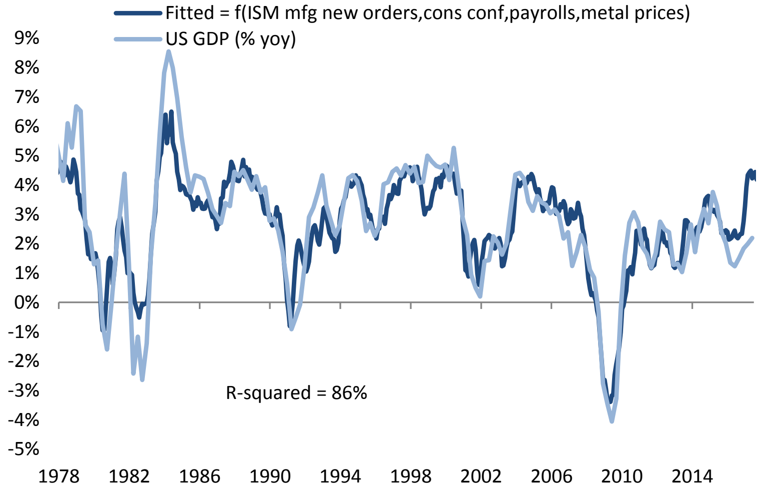
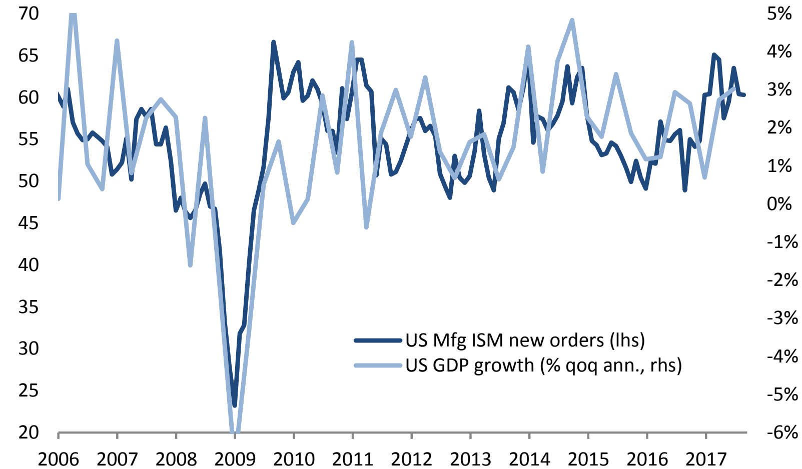
US: GDP growth at 2.5% to 3%, but low productivity growth caps upside

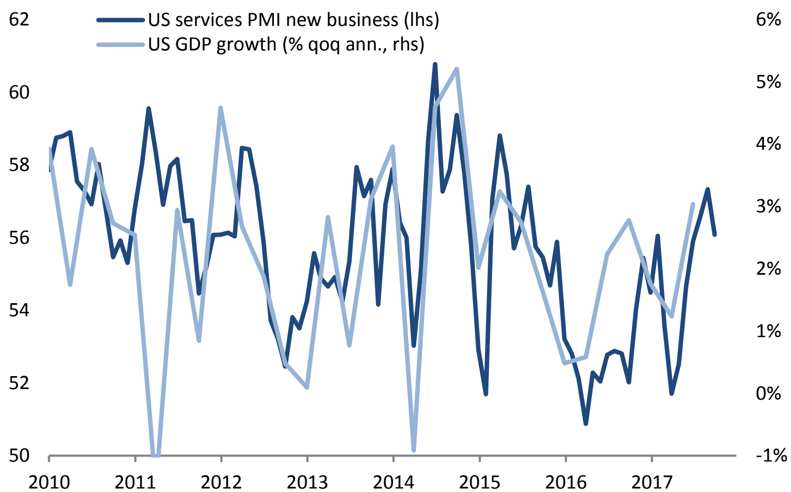
Our survey model still suggests that GDP should be running at around 4% yoy as consumer confidence and NFIB surveys remain high – actual growth has been 2.0 / 2.2% yoy in Q1/2 however



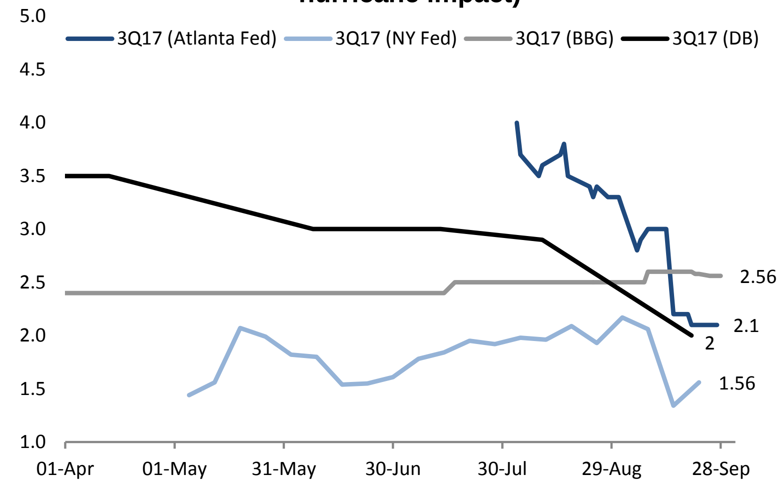
August's Mfg ISM new orders is consistent with 2.9% qoq annualised in Q3



August's services PMI new business is consistent with 2.5% qoq annualised in Q3



Monthly business surveys seem optimistic relative to a range of Q3 forecasts (with DB having downgraded on the back of the hurricane impact)



Source: Bloomberg Finance LP, Datastream, Deutsche Bank

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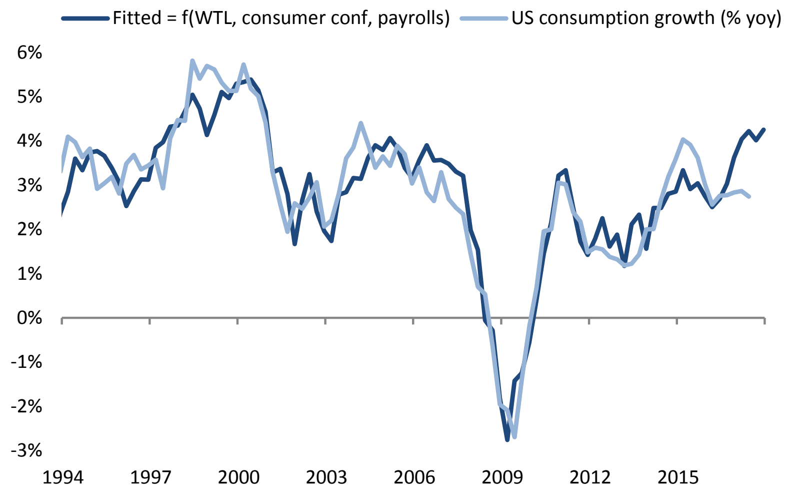
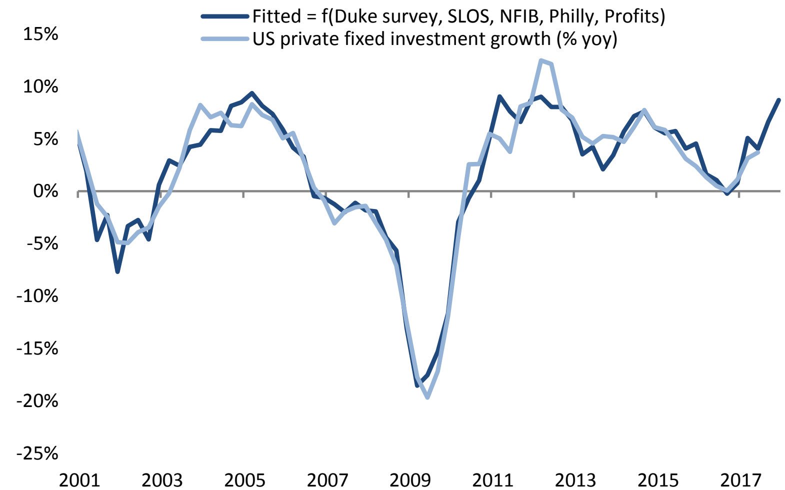
US: GDP growth at 2.5% to 3%, but low productivity growth caps upside

Our consumption growth model points to upside from current levels, but has been too optimistic recently

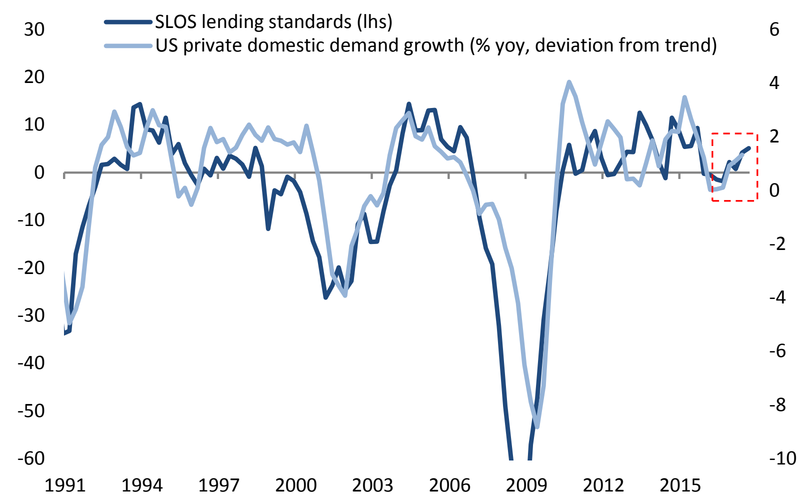


Our private fixed investment growth model points to some further acceleration from 3.5-4.0% yoy up to 8-9% yoy



If Q3 inventory build comes in line with the indication from ISM inventories, then this would add >2% to the qoq annualised growth rate

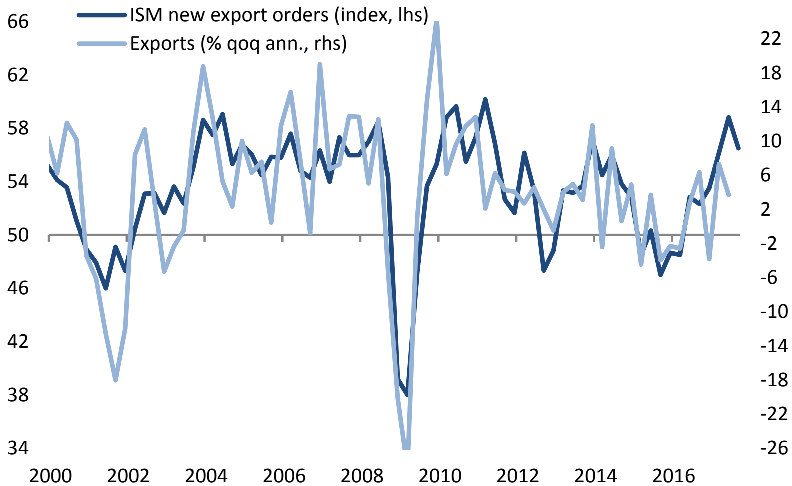
The catch-all indicator for private demand from the Fed survey points to some further acceleration to 3% yoy from 2.8% in Q2



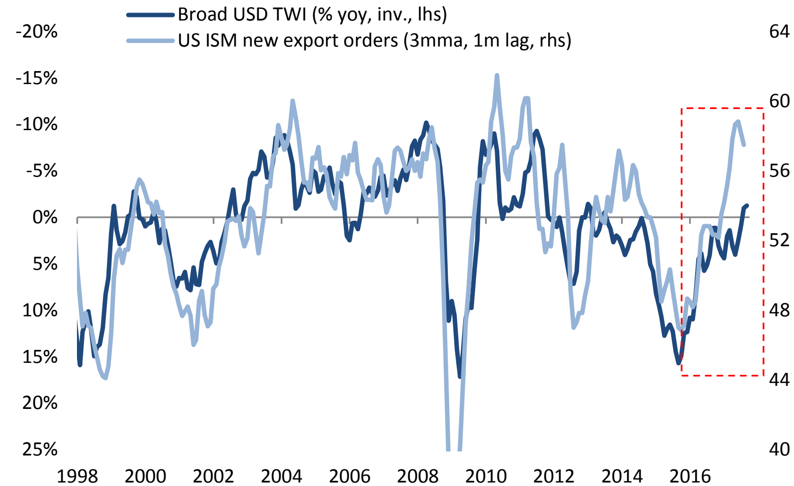
Source: Bloomberg Finance LP, Datastream, Deutsche Bank

US: GDP growth at 2.5% to 3%, but low productivity growth caps upside

July/August ISM Mfg new export orders is consistent with an acceleration in export growth…

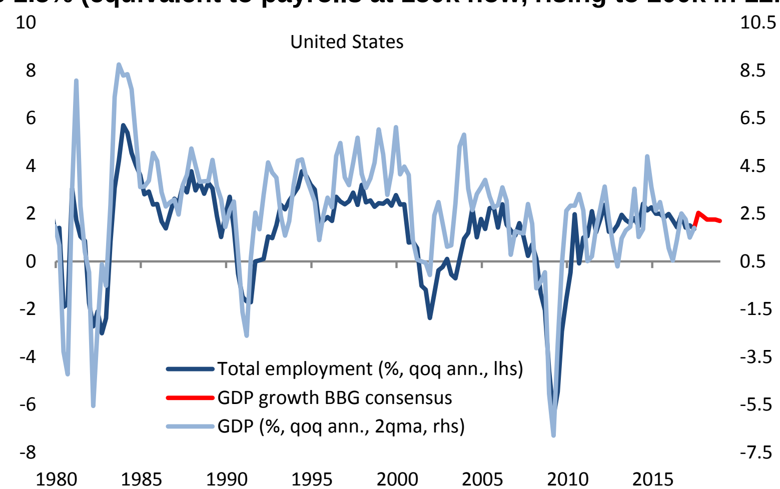


…but the ISM new export orders seem to have overshot USD TWI depreciation and appear to be fading



Productivity growth appears stuck at around 0.5% annualized

If productivity growth doesn't pick up, then in order to maintain the 2% annualized average growth rate seen since 2010, employment growth will have to be 1.5% (equivalent to payrolls at 150k now, rising to 200k in 12m time)



Source: Bloomberg Finance LP, Datastream, Deutsche Bank

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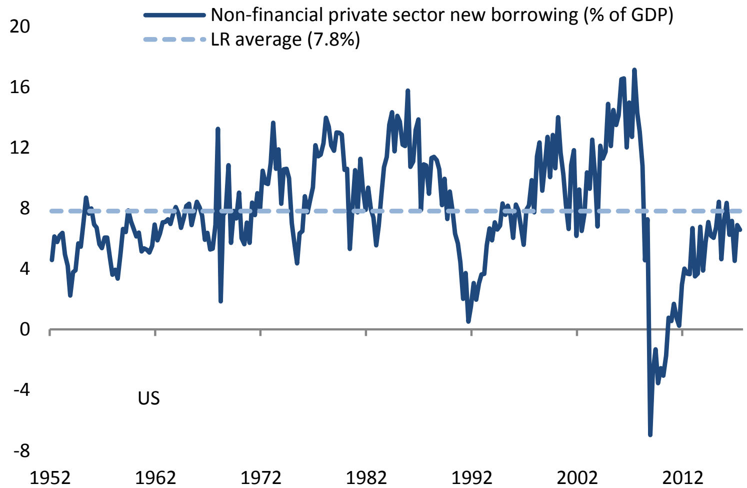
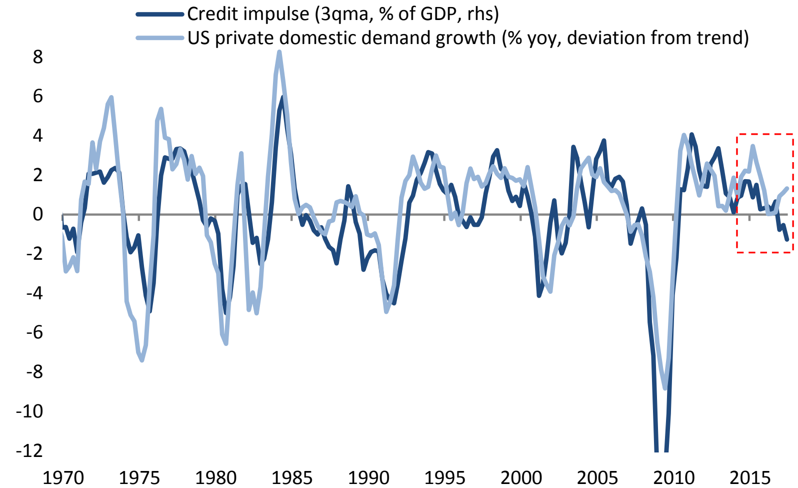
US: GDP growth at 2.5% to 3%, but low productivity growth caps upside

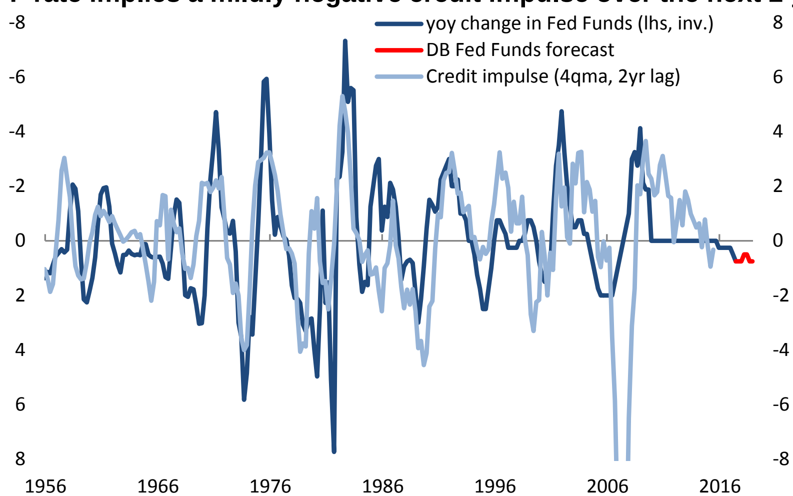
US new borrowing has been softening below long-run average levels…



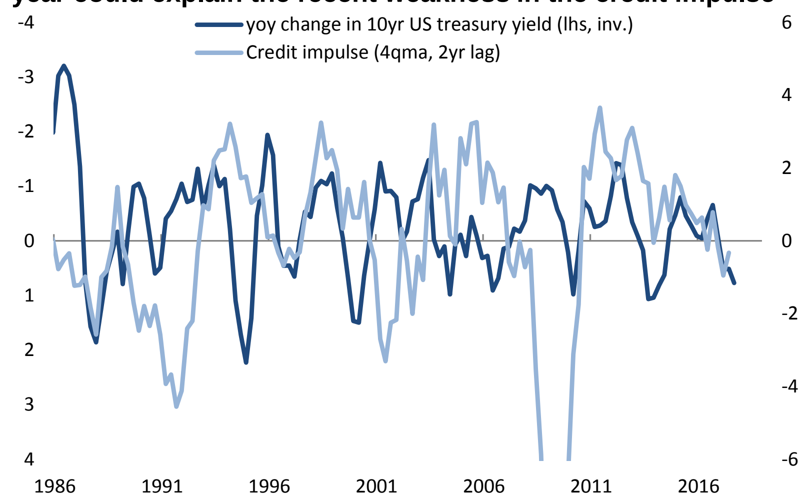
…this has translated into a negative credit impulse over recent quarters



The credit impulse has been slightly more negative than the move in the Fed Funds rate would have implied – DB's projected path for the FF rate implies a mildly negative credit impulse over the next 2 years



The relationship between the credit impulse and moves in longer term US rates has picked up post-crisis – and the move up in rates over the past year could explain the recent weakness in the credit impulse



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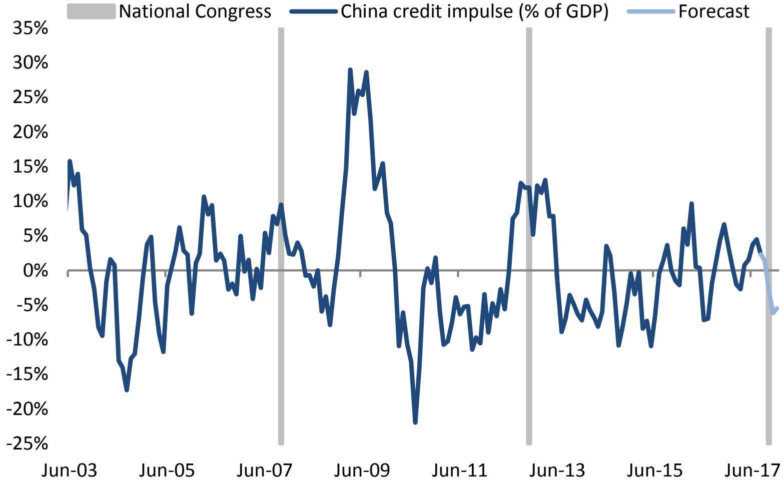
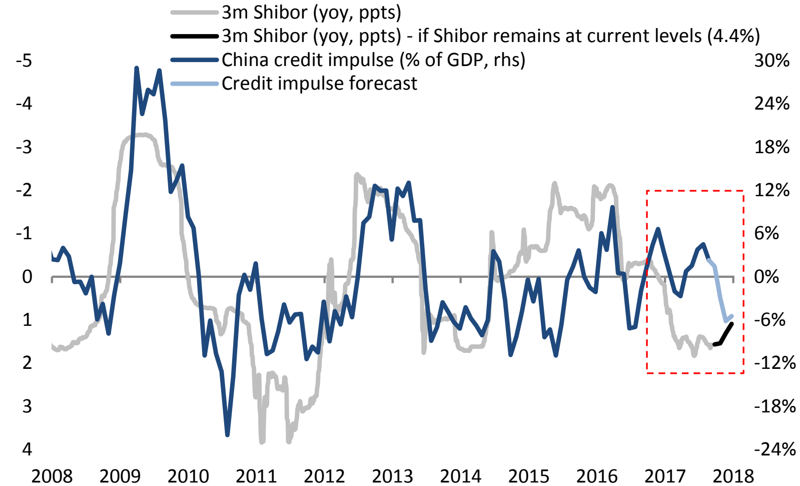
Source: Bloomberg Finance LP, Datastream, Deutsche Bank

China: downside for growth momentum as the credit impulse rolls over

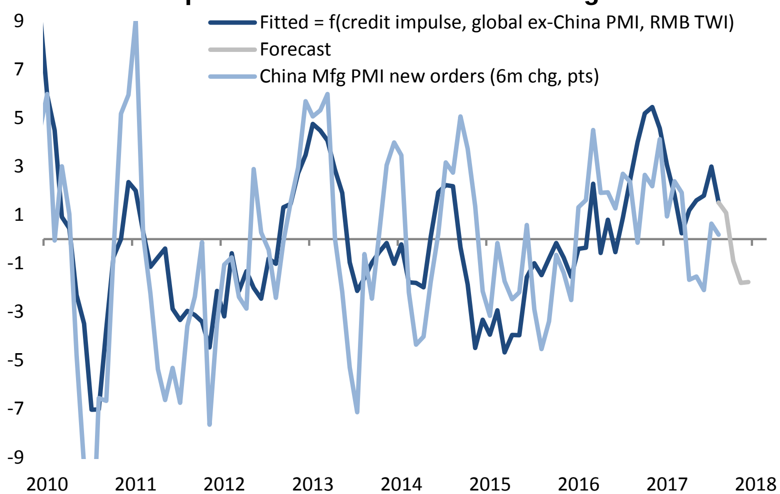
We expect the China credit impulse to fall to -6% of GDP by mid-Q4 (-3% of GDP on average for the rest of the year), based on the government's TSF growth target of 12% for this year



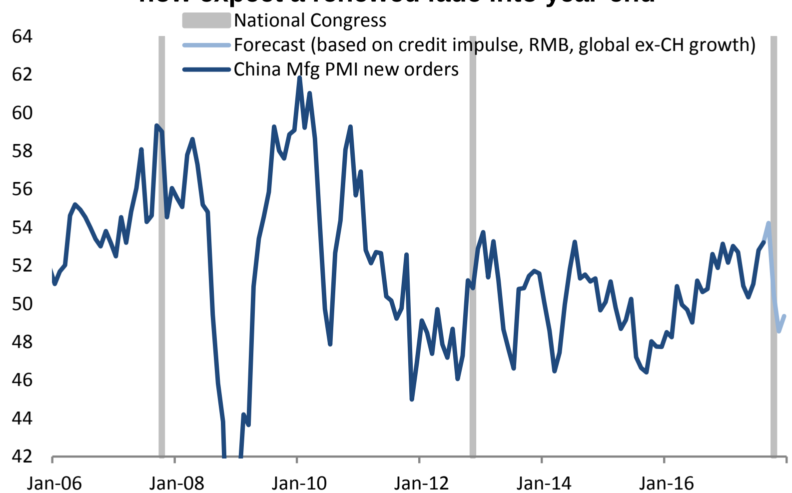
This forecast for the credit impulse is consistent with the move suggested by the moves in SHIBOR



We expect China manufacturing PMIs to fall over the coming months, on the back of a renewed fade in the China credit impulse and the recent RMB strength



The Chinese manufacturing PMI saw some recovery after hitting an 11-month low in May, as our model had projected – yet, we now expect a renewed fade into year-end



Source: BIS, PBC, CNBS, Haver, Bloomberg Finance LP, Deutsche Bank

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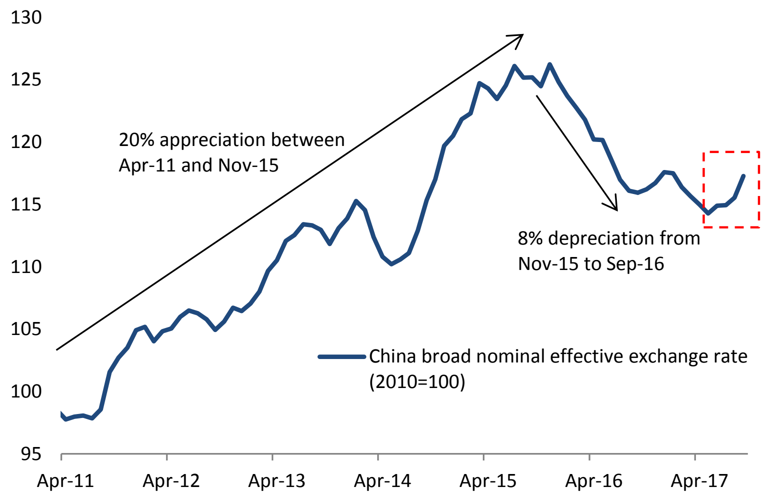
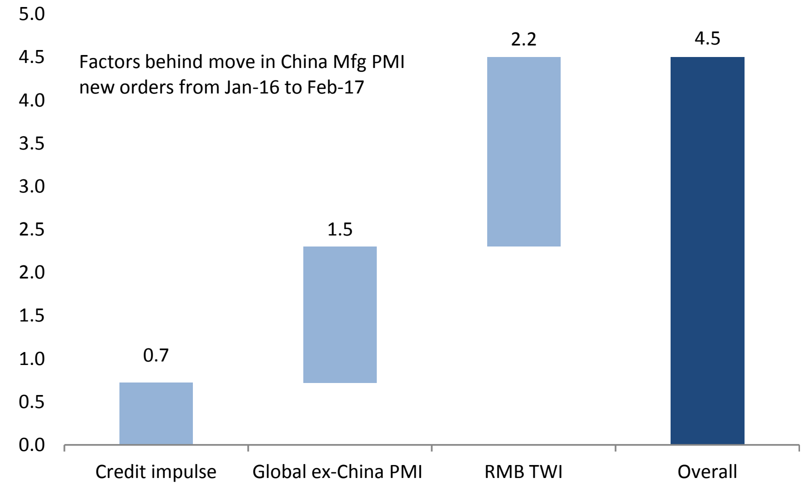
China: downside for growth momentum as the credit impulse rolls over

The RMB has been strengthening over the past few months – a negative for the PMI, according to our model



Our China PMI model suggests the falling RMB played a key role in boosting the China Mfg PMI in 2016



A weaker RMB has allowed Chinese export growth to rebound

Source: BIS, PBC, CNBS, Haver, Bloomberg Finance LP, Deutsche Bank

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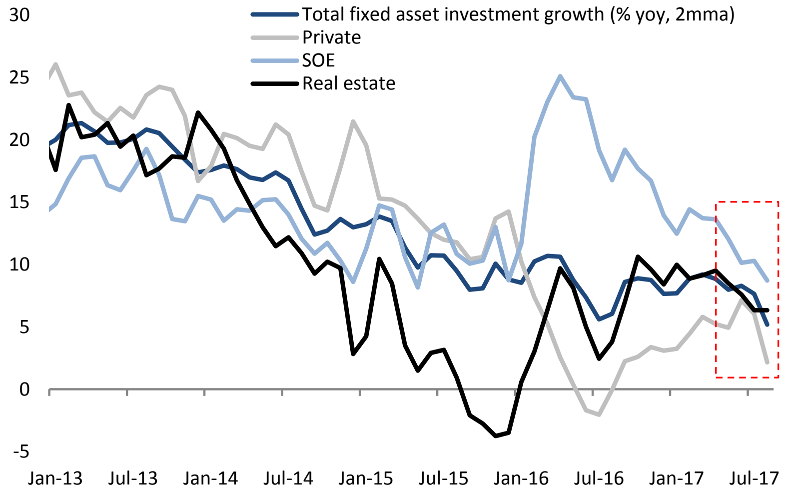
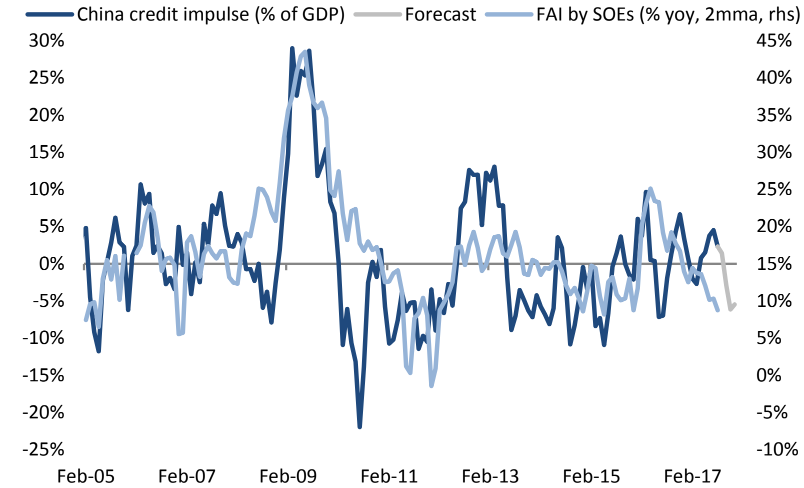
China: downside for growth momentum as the credit impulse rolls over

FAI growth weakened significantly in August to 5.2% yoy (2mma), now below the low seen in mid-2016

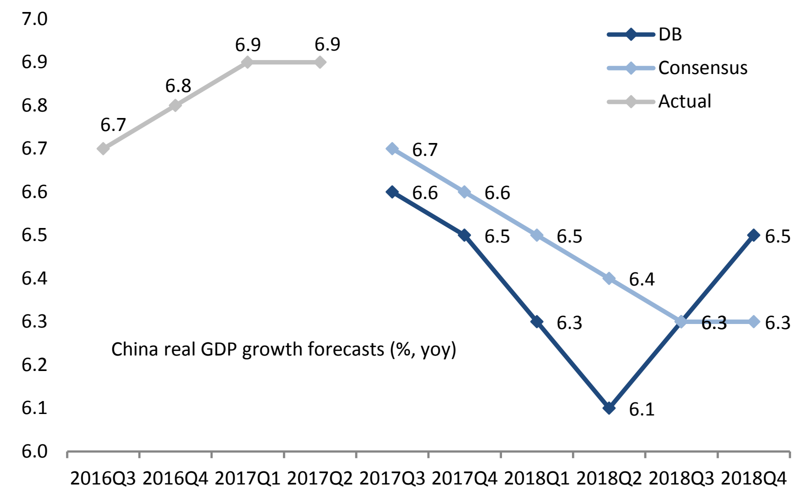


The weakness in SOE's FAI growth (35% of overall FAI) has been surprising relative to the current level of the credit impulse



FAI growth has displayed a strong relationship with GDP growth since the crisis and now points to a sharp slow-down in Q3

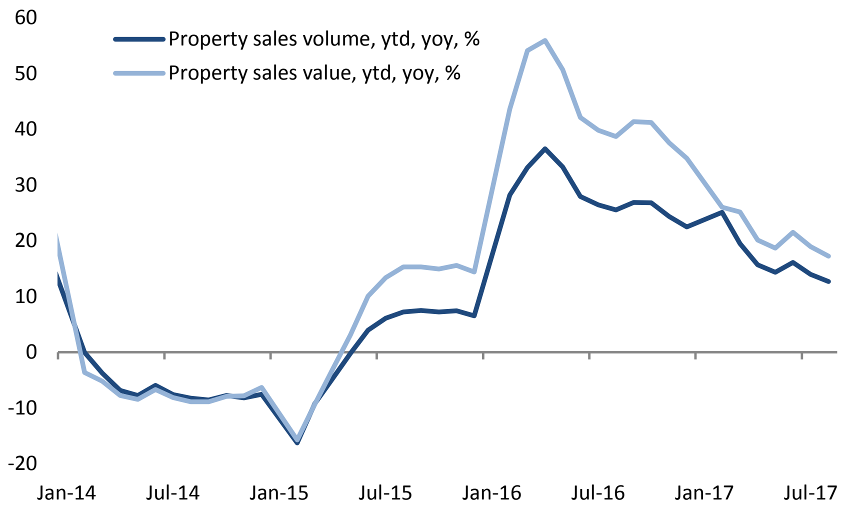
Our economists expect a sustained slowing in Chinese growth through to Q2 2018

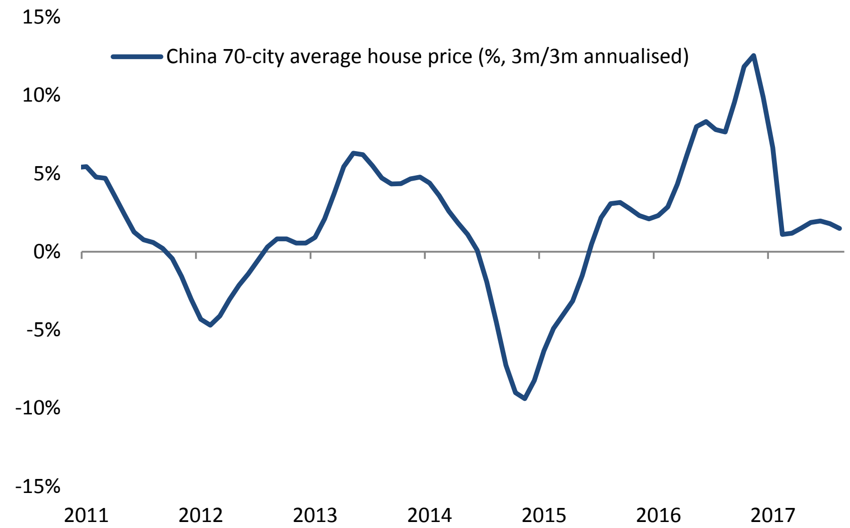


Source: BIS, PBC, CNBS, Haver, Bloomberg Finance LP, Deutsche Bank

China: downside for growth momentum as the credit impulse rolls over

Momentum in China's housing market has slowed from high levels

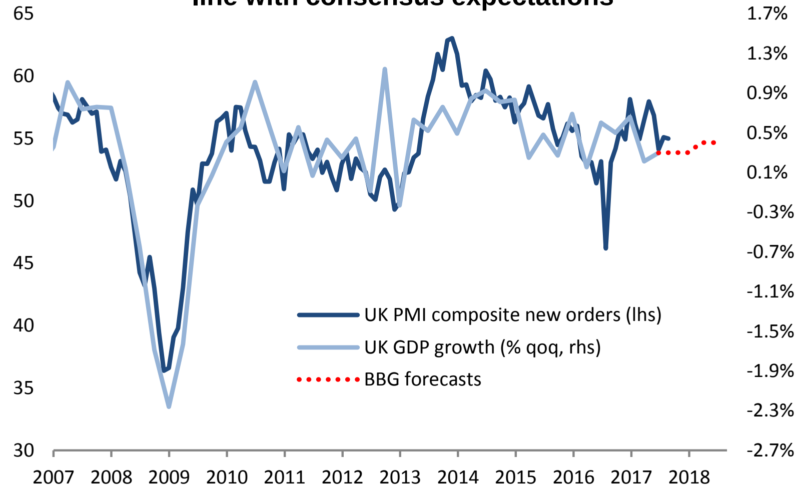




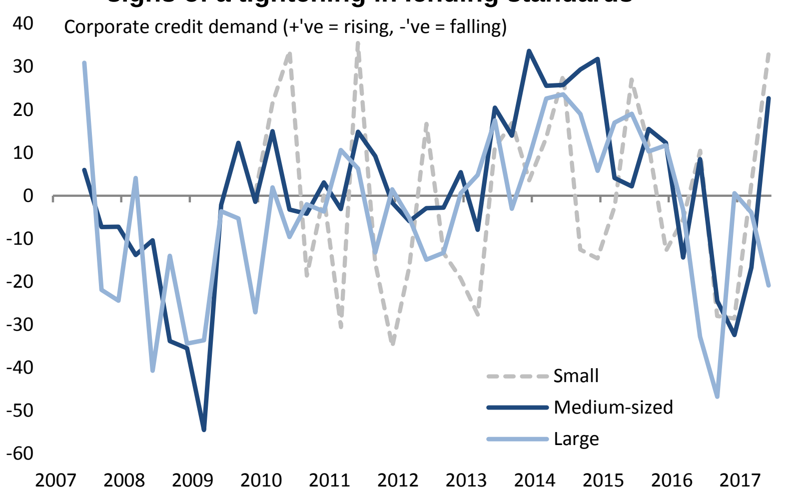
Source: BIS, PBC, CNBS, Haver, Bloomberg Finance LP, Deutsche Bank

UK: downside risks to consumer spending

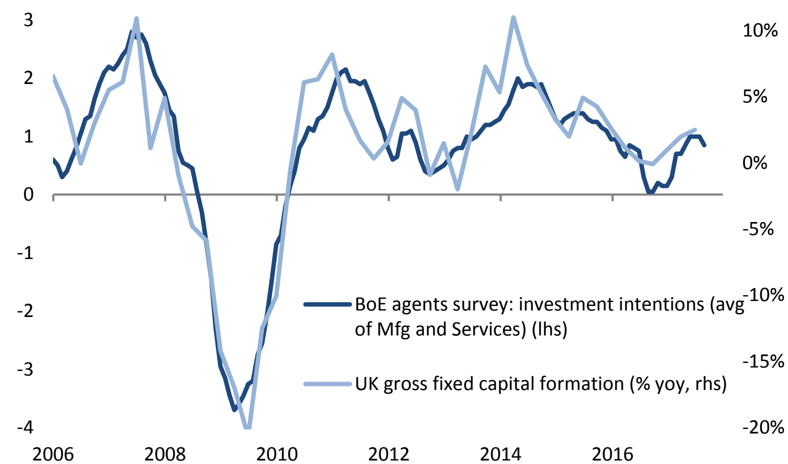
The composite PMI new orders has stabilised around 54 over the past 4 months, consistent with 0.3% qoq GDP growth – broadly in line with consensus expectations



An area of key concern given Brexit uncertainty has been business investment – yet, credit demand is recovering, while there are no signs of a tightening in lending standards



The BoE's survey on investment intentions appears to be peaking at levels consistent with slightly positive investment growth



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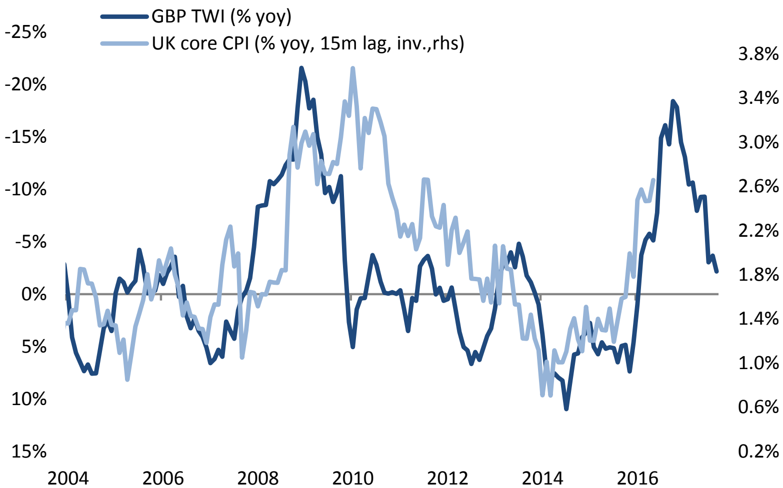
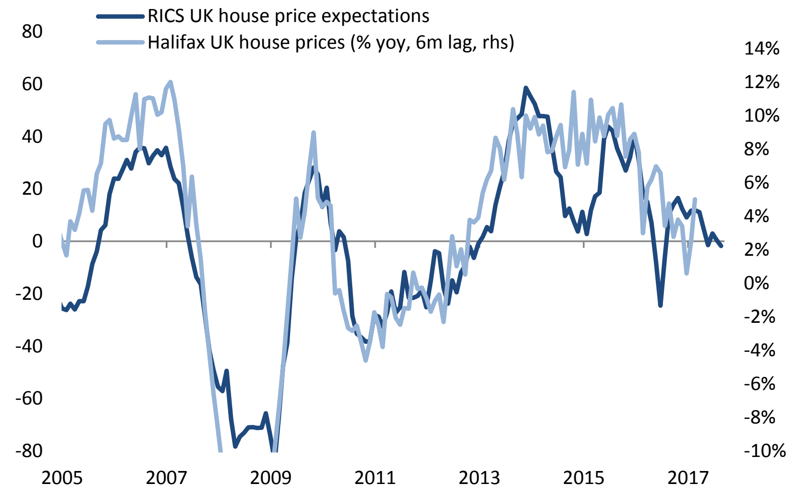
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

UK: downside risks to consumer spending

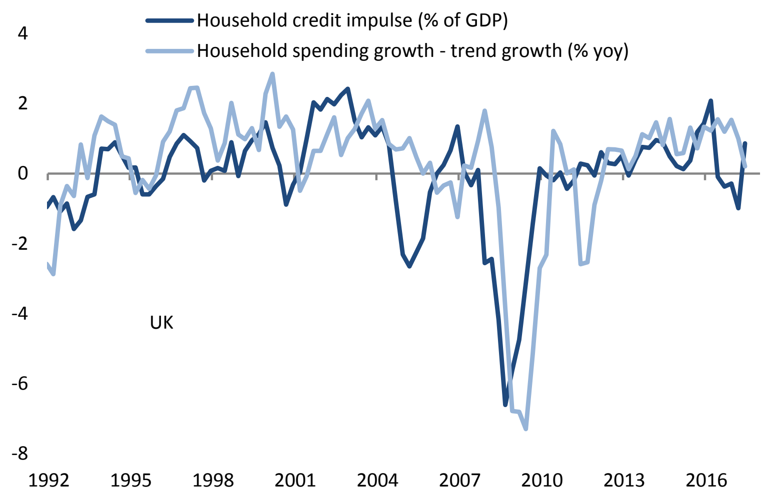
Inflation pressure is set to intensify, given past GBP weakness, weighing on real disposable income



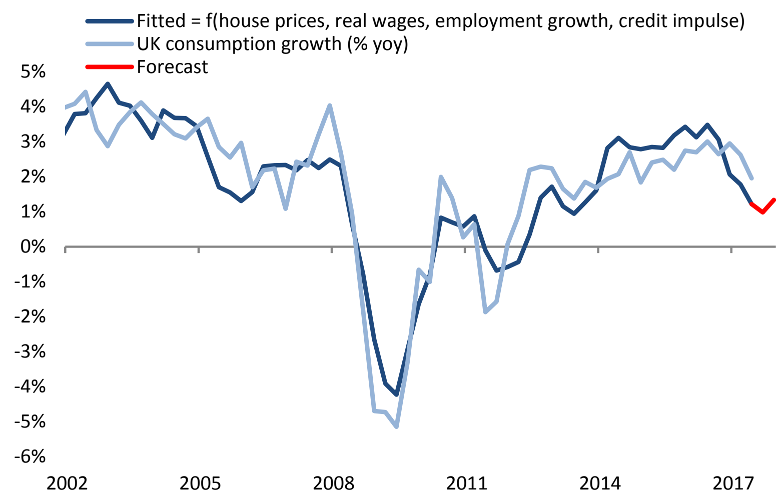
Growth in UK house prices appears set for some slight slowing, according to the latest RICS survey



The UK credit impulse has rebounded – and is now consistent with household spending growth remaining at current levels



Rising inflation and slowing real wage growth, along with slowing employment and house price growth is set to further weigh on consumption growth after a sharp slowing in Q2



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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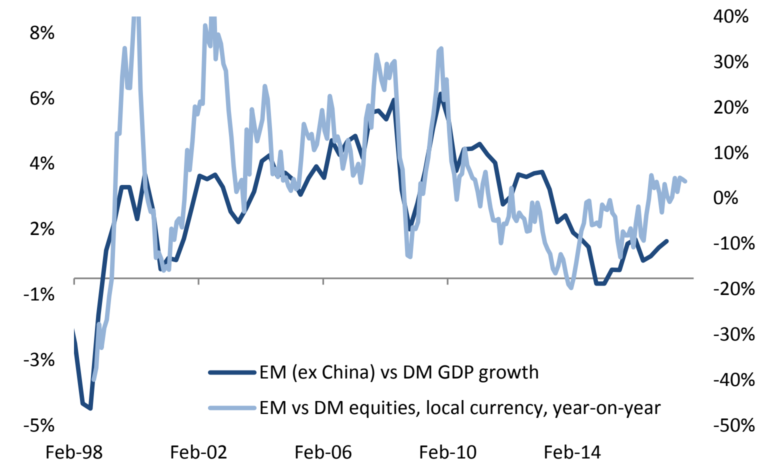
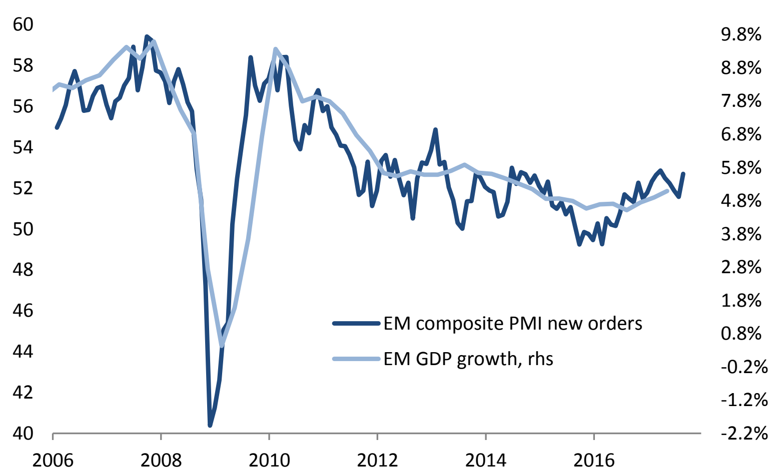
Has the EM growth cycle turned?

Will relative EM growth accelerate in line with stronger metal prices?

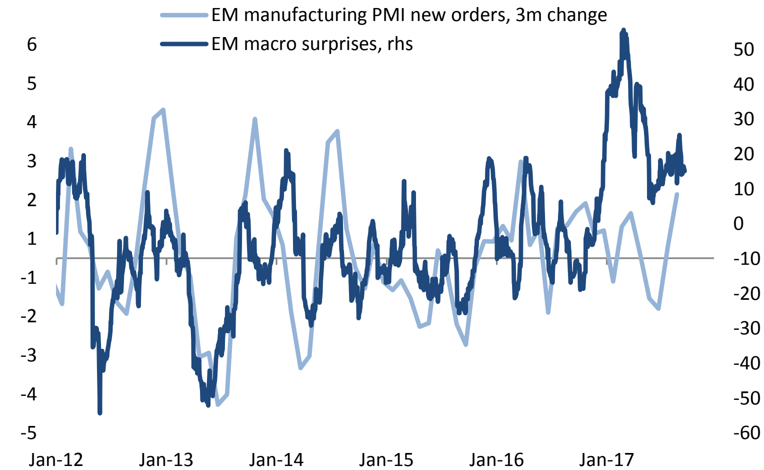
EM equities have performed in line with DM equities over the past year – consistent with a further acceleration in relative GDP growth



EM PMIs are consistent with a slight acceleration in EM GDP growth from current levels



EM macro surprises remain positive, helped but the recent improvement in the PMIs



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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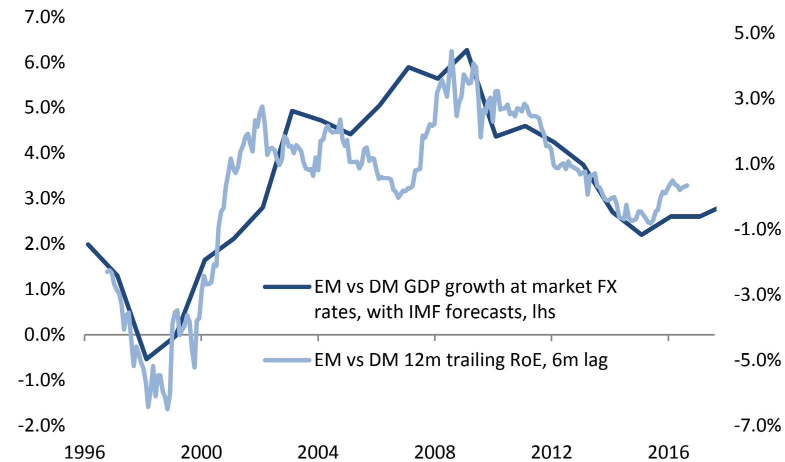
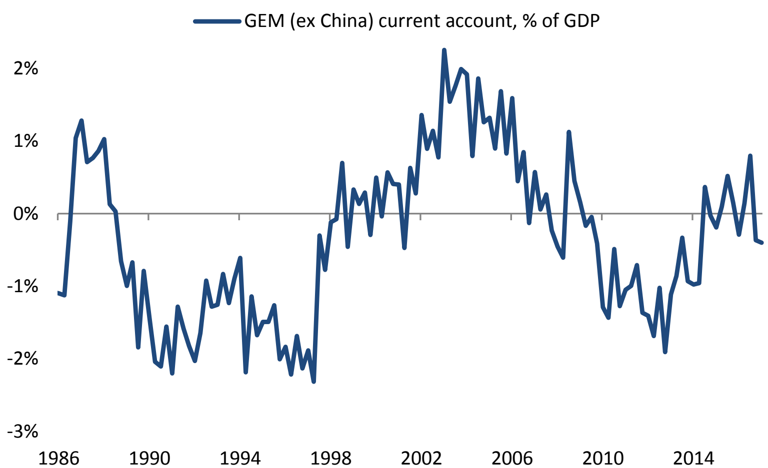
Has the EM growth cycle turned?

EM (ex China) GDP growth tends to follow China's GDP growth with a one-quarter lag and has been rebounding while China's growth remains stable

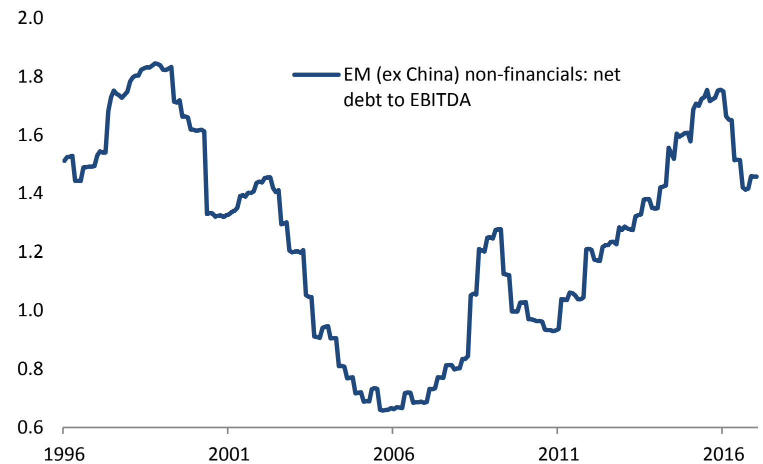
EM's relative RoE tends to track relative EM GDP growth



EM (ex China)'s current account is only in very slight deficit, pointing to reduced external vulnerability



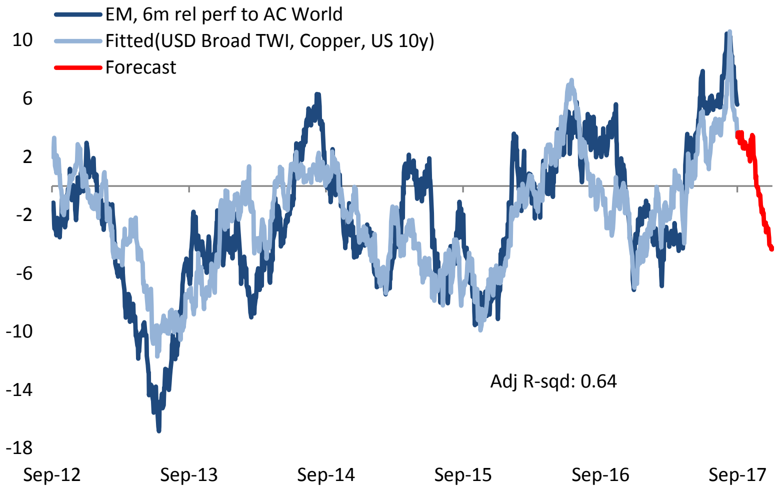
At 1.4x, EM (ex China) non-financial net debt to EBITDA has fallen from its peak at 1.7x in mid-2016



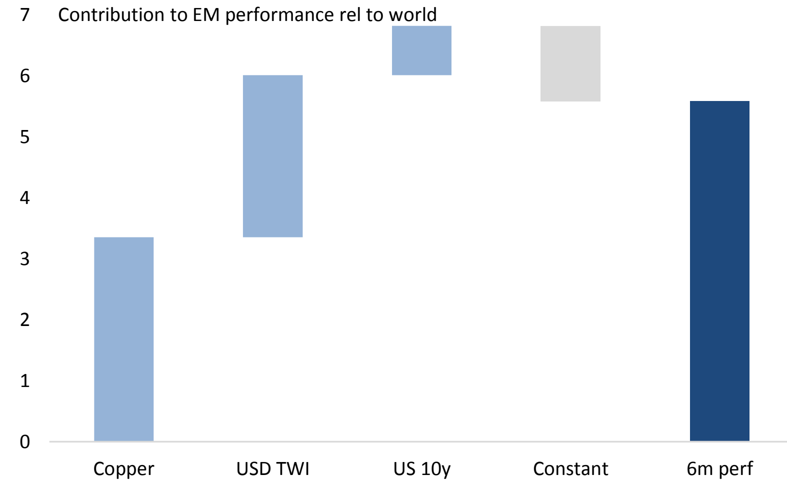
Source: Bloomberg Finance LP, EPFR Global, Haver, Datastream, Deutsche Bank

Has the EM growth cycle turned?

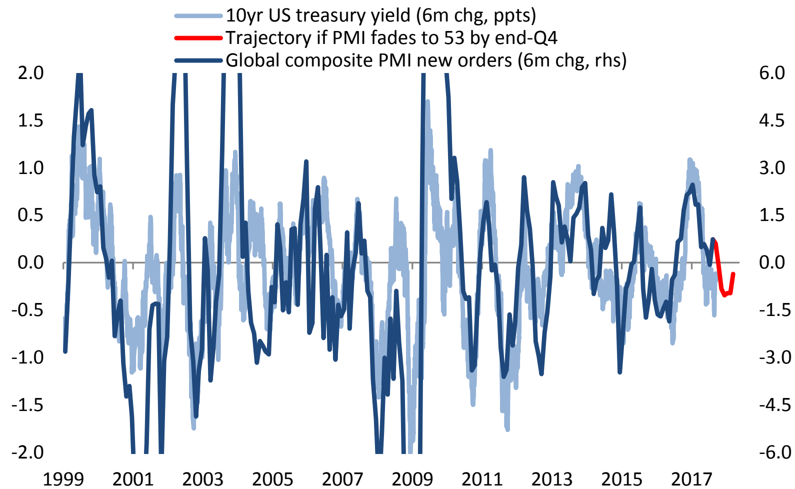
EM equities have outperformed global equities by c.6% over the past 6 months…



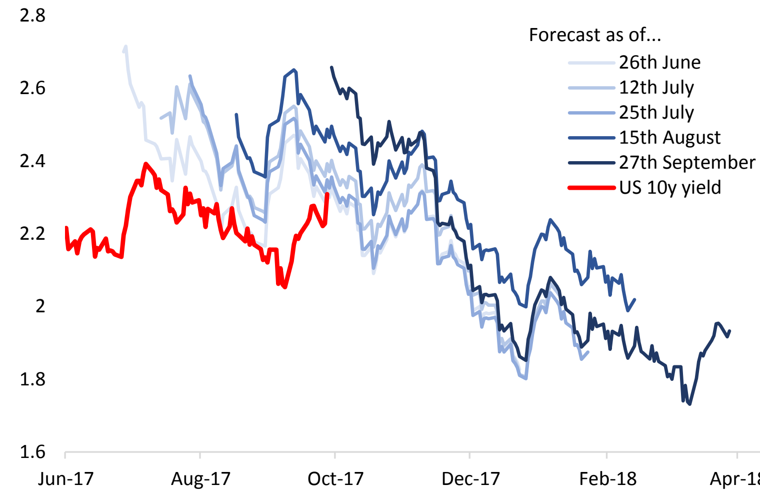
…benefitting from a combination of rising copper prices, falling bond yields and a weaker USD



Yet, with our expectation of downside for copper and weaker USD TWI, this presents downside risks for EM's relative performance – US bond yields have also undershot global PMI momentum…



…suggesting little support for EM relative performance from falling yields for now, though the downside potential for US yields increases around the year-end if our PMI projections are correct



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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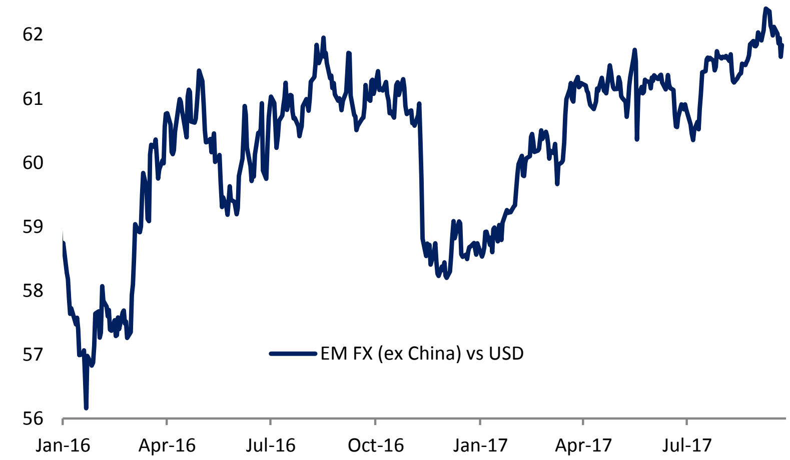
Has the EM growth cycle turned?

EM (ex China)'s real effective exchange rate has risen by 11% since February 2016

EM FX has pulled back recently, but is still up by 4% against the USD since early 2017



EM (ex China) sovereign spreads are around post-crisis lows

Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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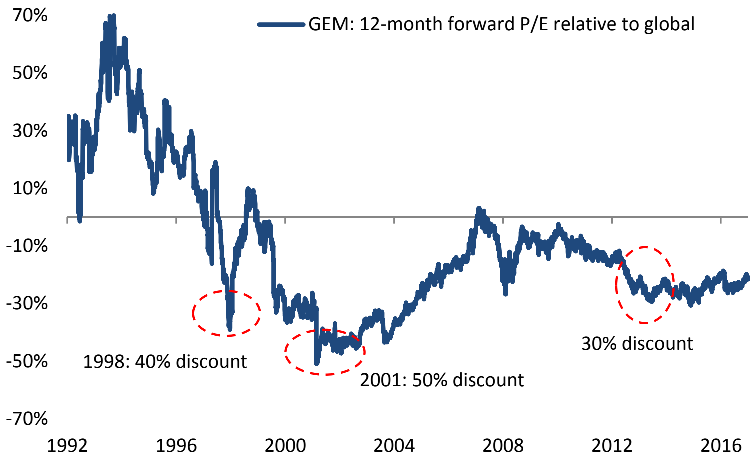
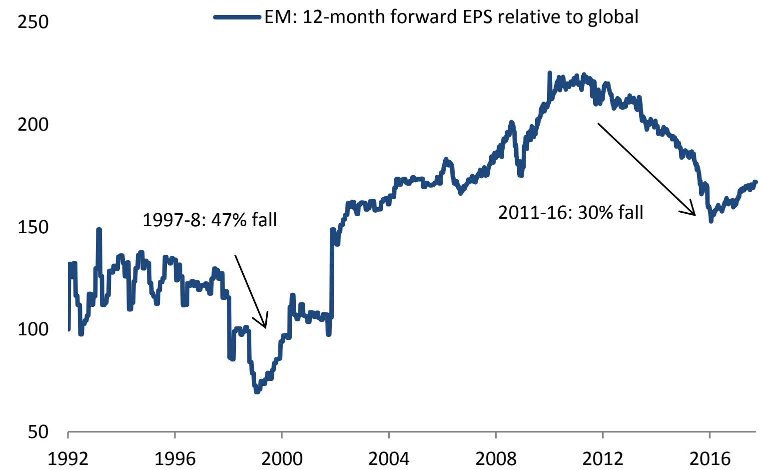
Has the EM growth cycle turned?

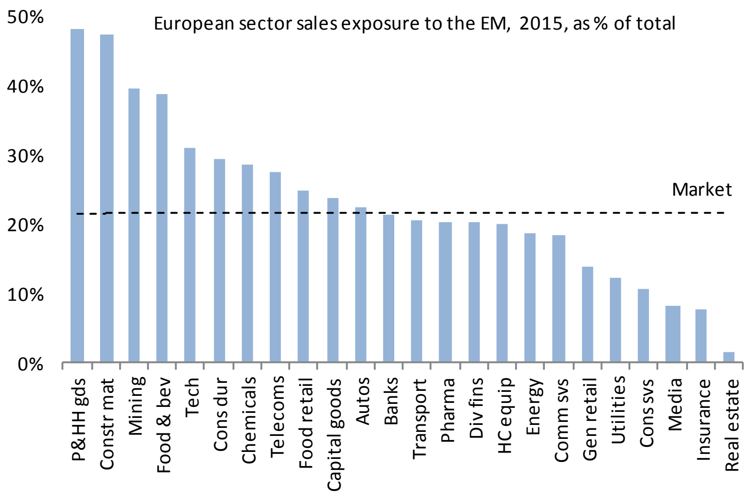
EM equities are trading on a 20% P/E discount to DM equities, after troughing at 30% discount in 2015 (compared to a 50% discount in 2001)



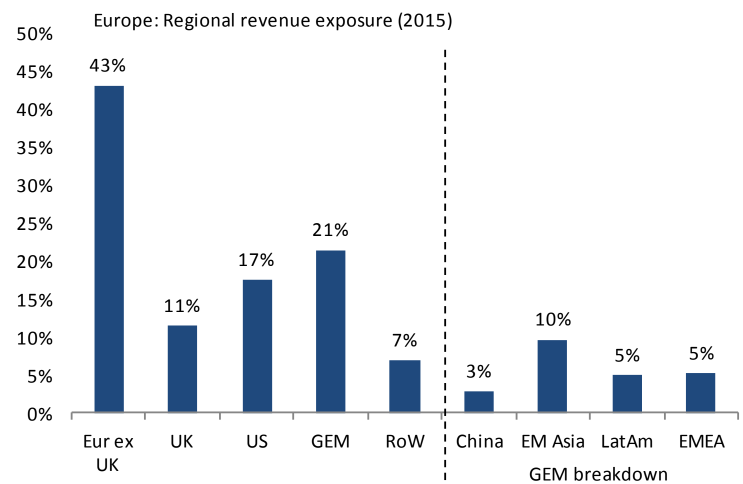
EM's relative 12-month forward EPS has risen by 13% since January 2016 – after falling by 30% over the previous five years



Around 40% of European staples, construction materials and mining revenues come from emerging markets versus ~20% for the market overall



European companies generated 54% of their 2015 revenues in Developed Europe, ~20% in the Emerging Markets and 18% in the US



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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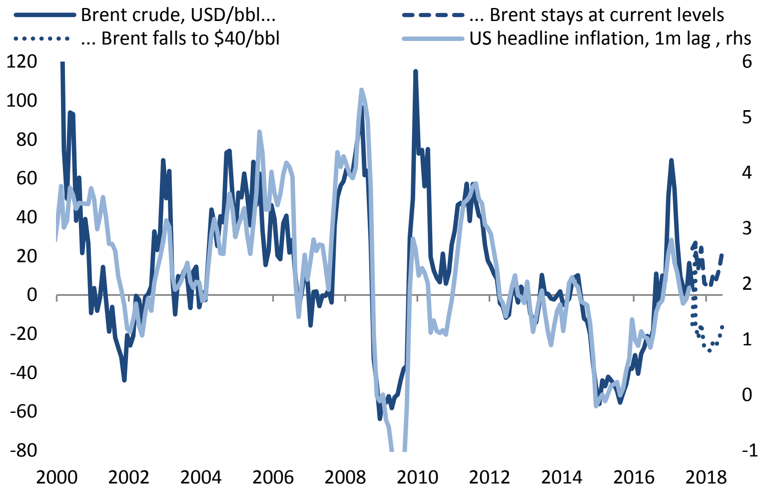
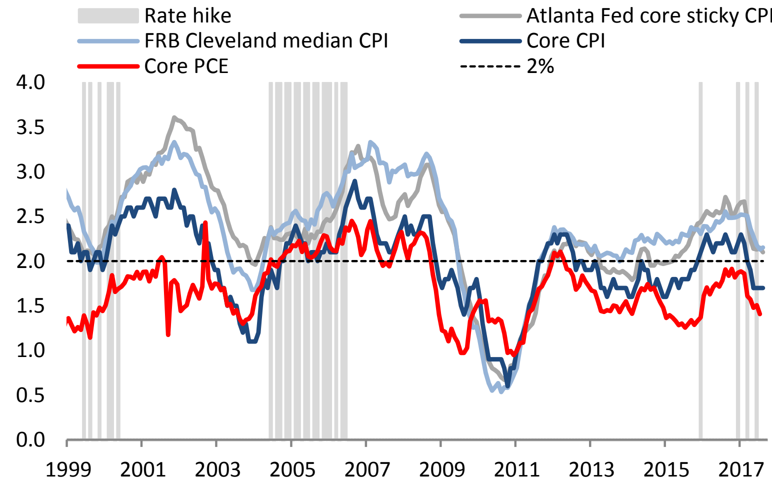
US core inflation is likely to have bottomed

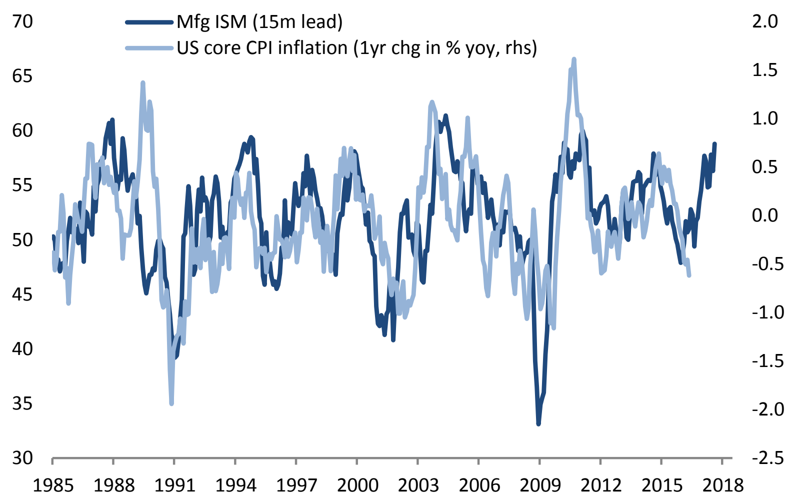
US headline inflation has recovered from 1.6% in June to 1.9% currently, and if oil prices stay around current levels, is set to rise above 2%



Most measures of core inflation in the US have moved lower but appear to be stabilising



Core CPI should recover to just over 2% by year-end, given the recovery in the manufacturing ISM over the past year



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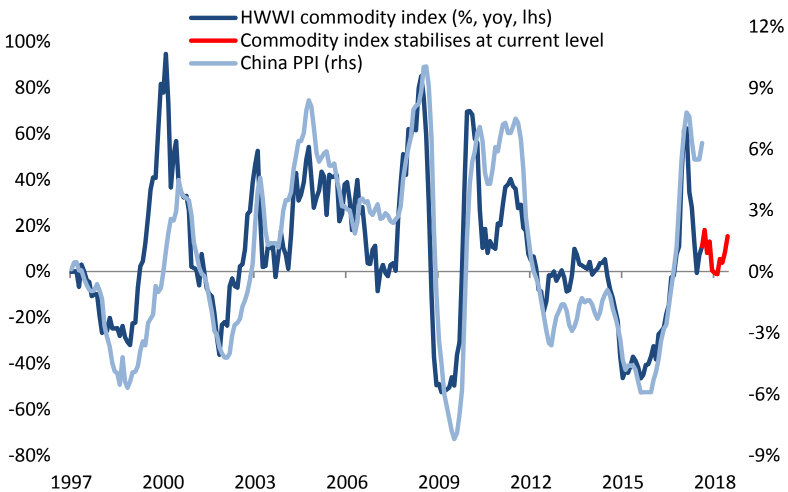
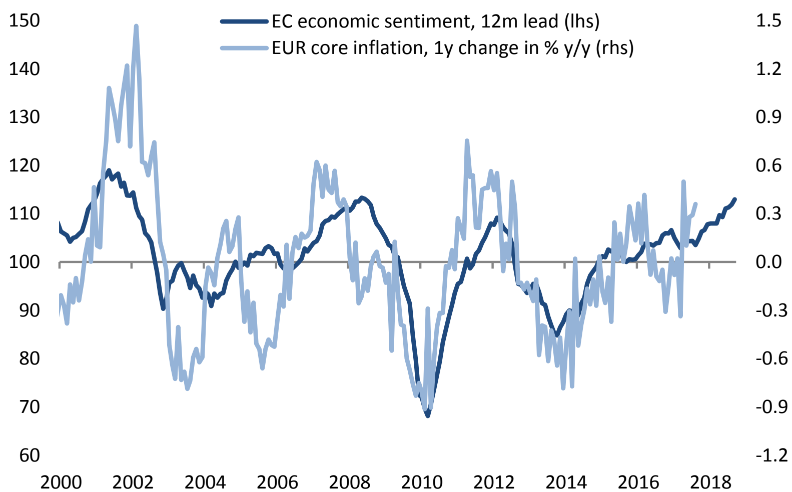
Lead indicators still point to downside for Chinese PPI inflation

Moves in commodity prices continue to point to downside to China PPI inflation, but for now it appears supported, potentially by efforts to cut capacity

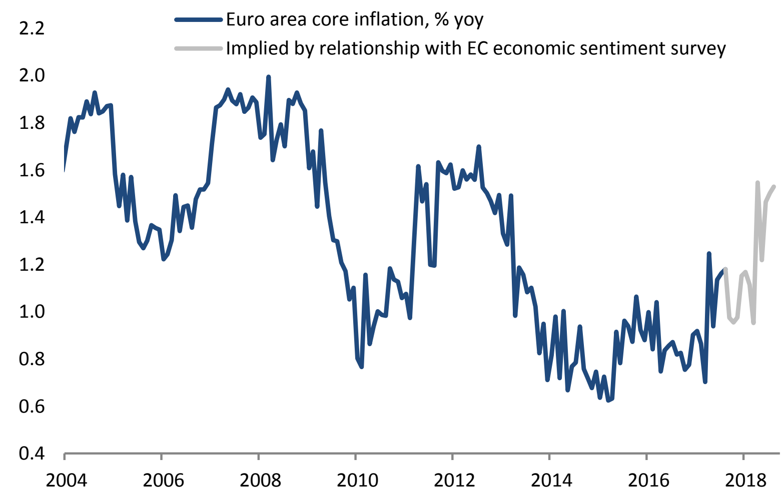


The downside for China PPI based on PMI output prices is reduced after recovery in PMI output prices over the past months

Strength in the EC economic sentiment is consistent with upside for Euro area core inflation…



… implying a rise in core inflation to around 1.5% over the coming months



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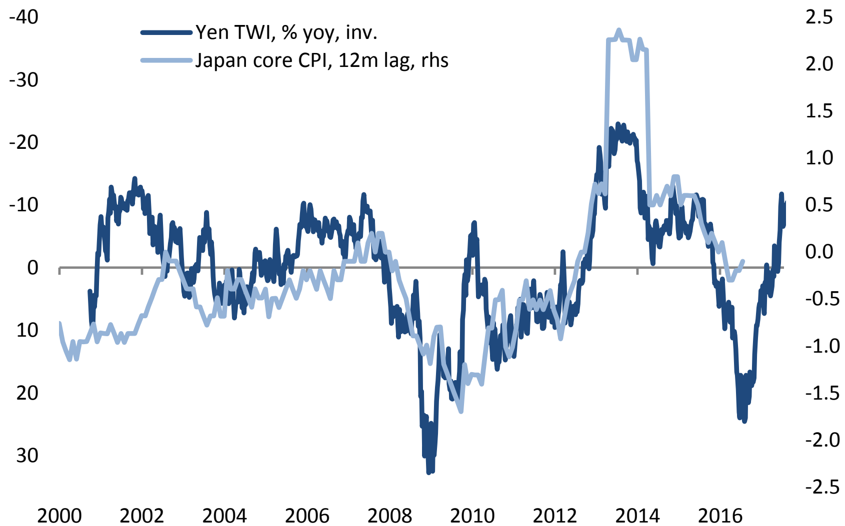
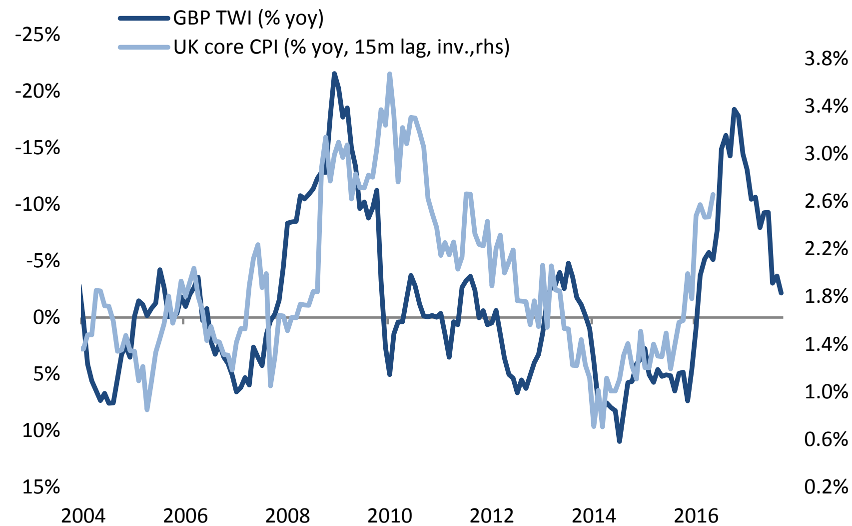
See downside for Japan inflation and upside for UK inflation, given FX moves

There are near-term downside risks to inflation in Japan on the back of earlier Yen strength



UK core inflation is set to rise as a lagged effect of a weaker GBP over the past year



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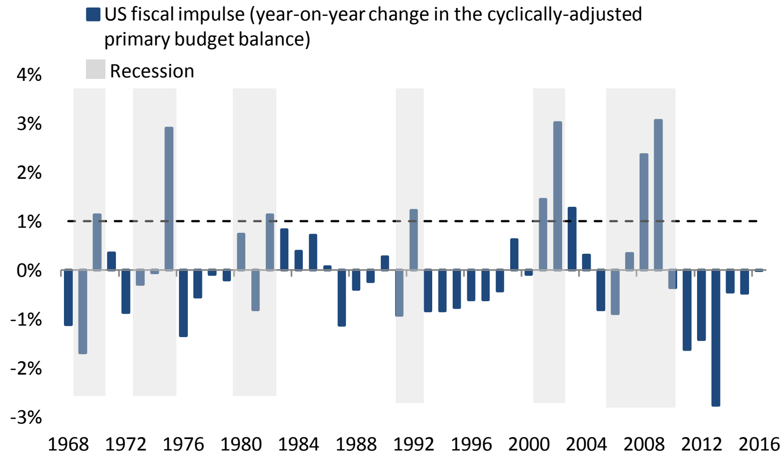
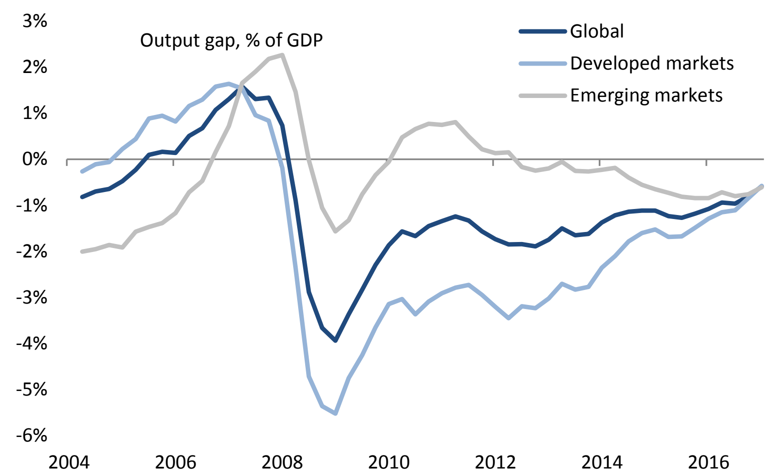
The shift from monetary easing to fiscal stimulus

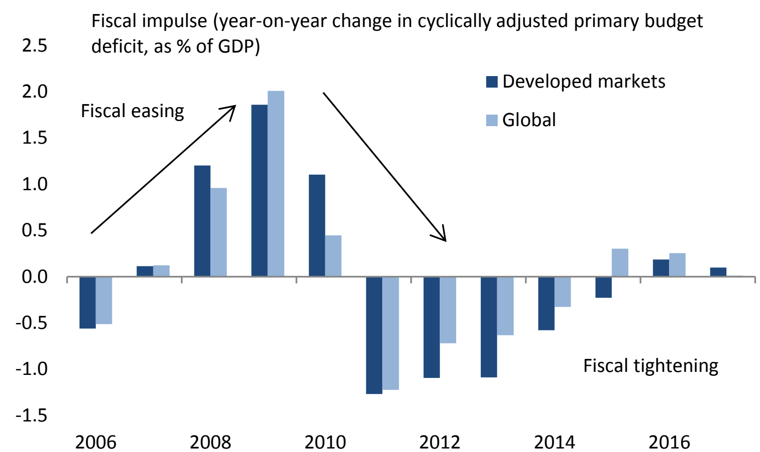
Over the past 50 years, meaningful fiscal stimulus in the US (>1% of GDP) has only been implemented once the economy was already in recession



Five years of easy monetary and tight fiscal policy has failed to close the global output gap



During the period of intense fiscal stimulus – between 2008 and 2010 – the global output gap halved, from 4% to 2% of GDP



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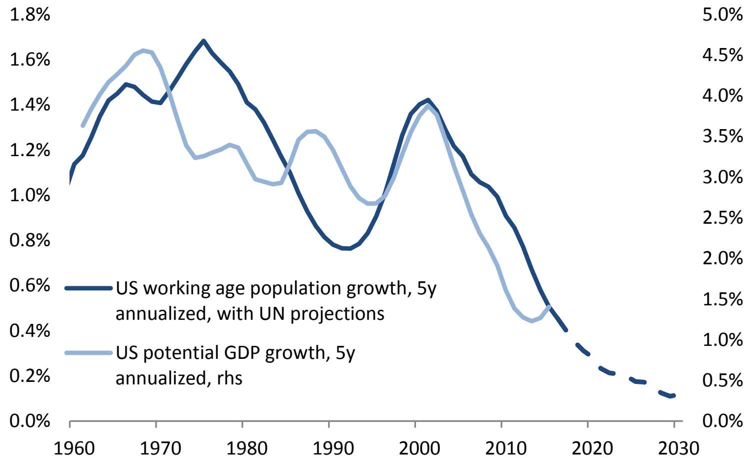
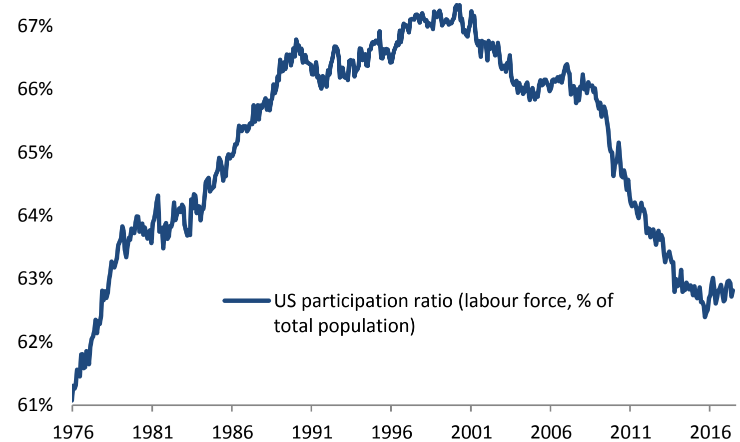
Structural issues

1) US growth hampered by weak productivity and potential growth challenges

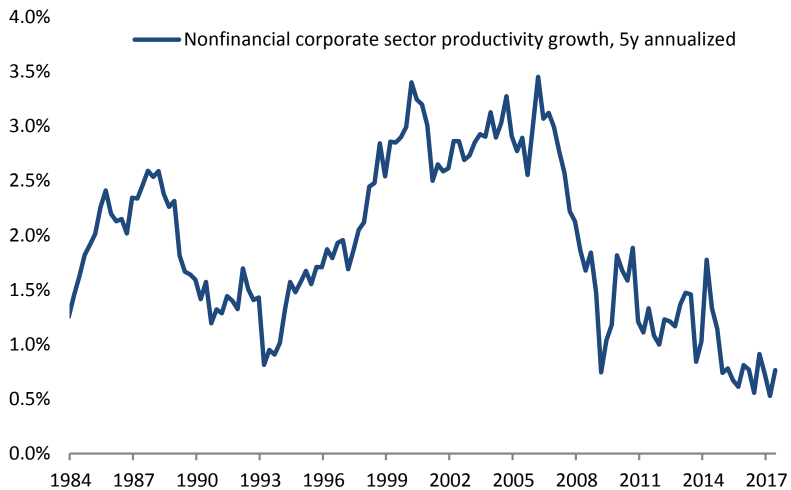
US working age population growth has slowed from 1.5% in 2000 to 0.5% now, and is set to fall to 0% by 2039, according to UN projections

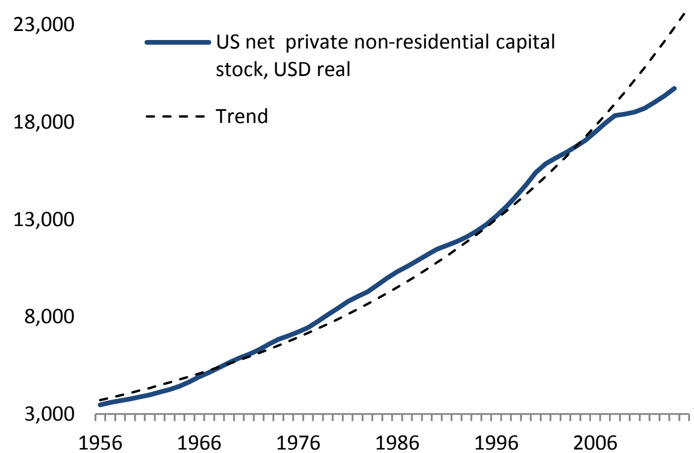


The US participation ratio, at around 63%, is close to a 40-year low and is set to fall further as the proportion of those aged 65+ in the total population increases from 14% now to 21% in 2030



5-year productivity growth, at 0.5-1.0%, is around the lowest level in at least 30 years, partly because of population aging (old workers have higher productivity, but lower productivity growth), partly because of weak demand and partly because of underinvestment in the capital stock (now some 14% below the long-run trend)





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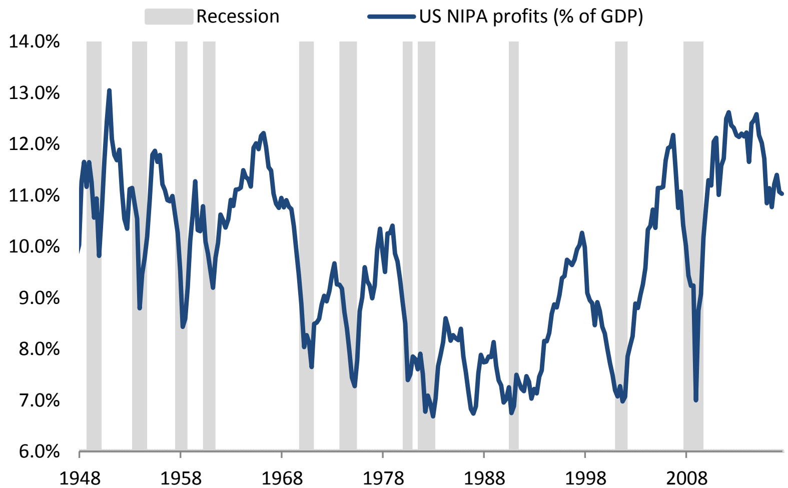
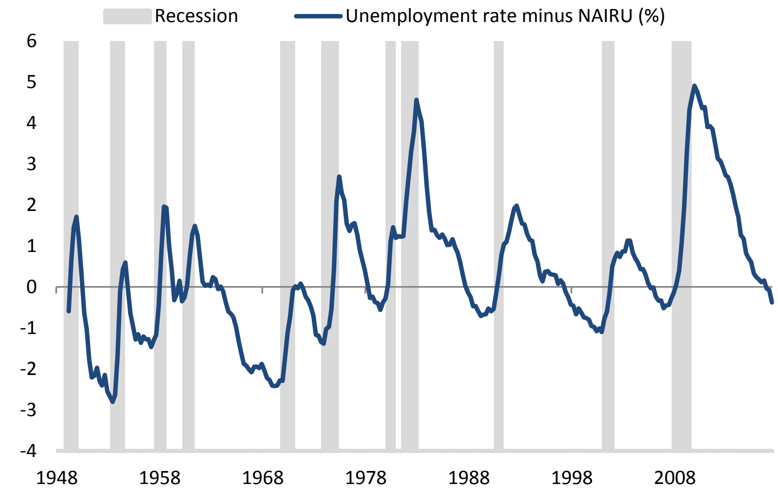
Source: Bloomberg Finance LP, Datastream, Deutsche Bank

2) The US looks late-cycle

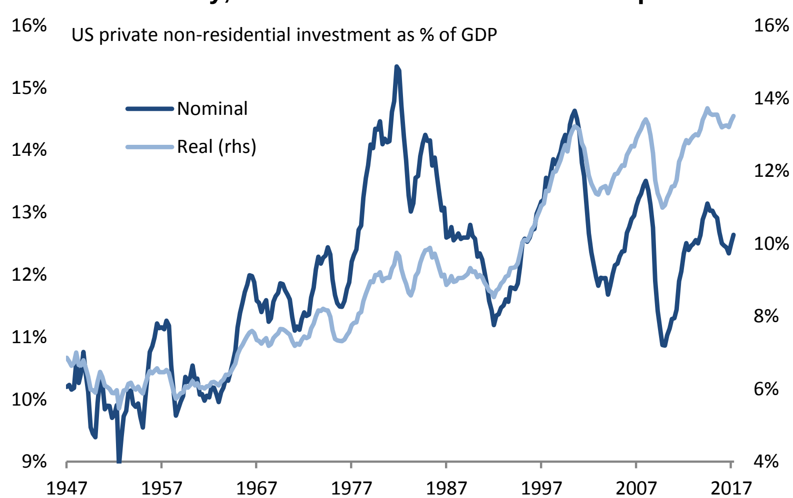
US corporate margins, at 11% are still close to the highs over the past 70 years



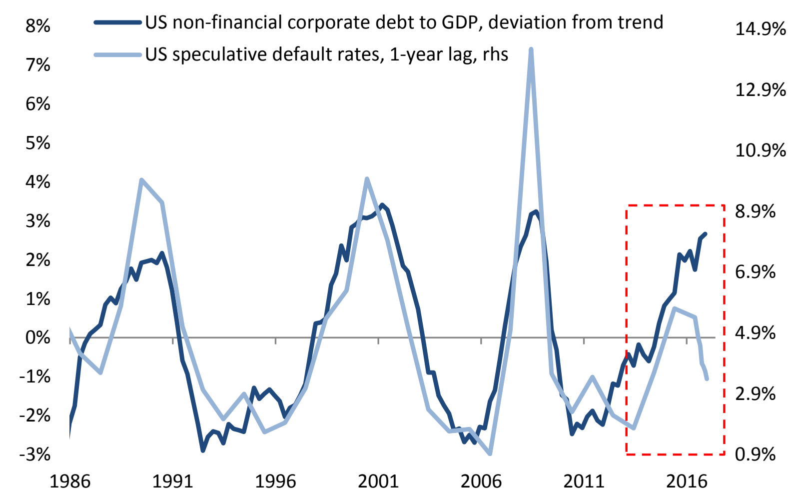
Unemployment is moving below the NAIRU – a pre-condition for most recessions in the past



Although investment as a % of nominal GDP is low relative to history, on a real basis it is close to the peak



Corporate debt to GDP 3 percentage points above trend points to an underlying default rate of around 7%



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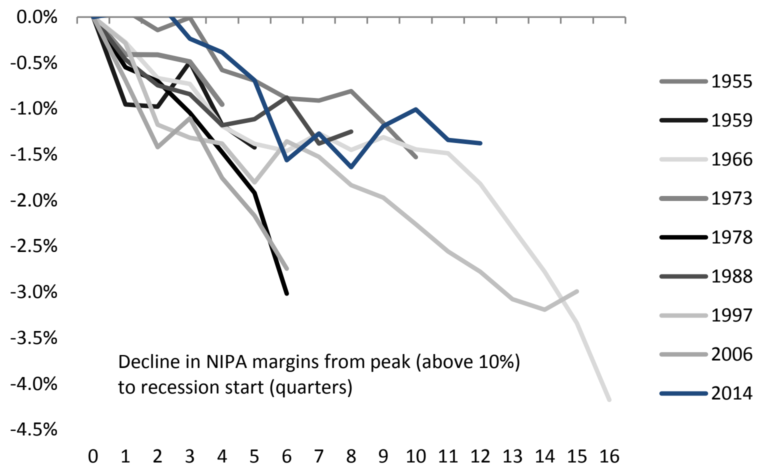
2) The US looks late-cycle

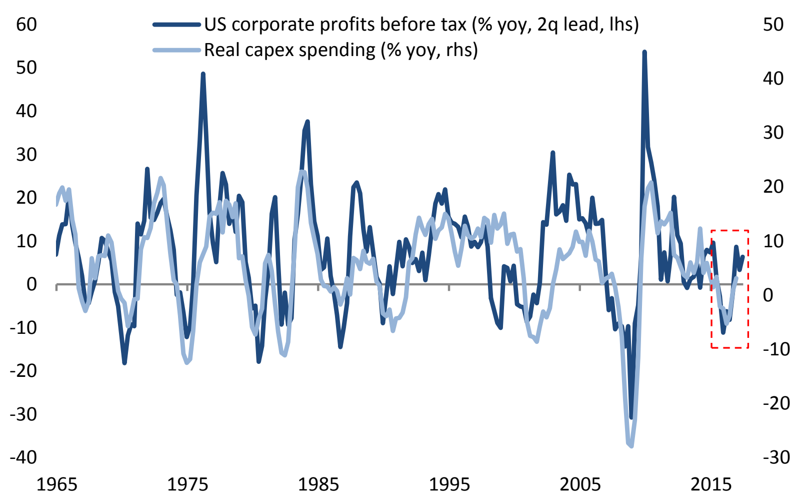
Over the past sixty years, corporate margins have on average peaked eight quarters before the onset of a recession



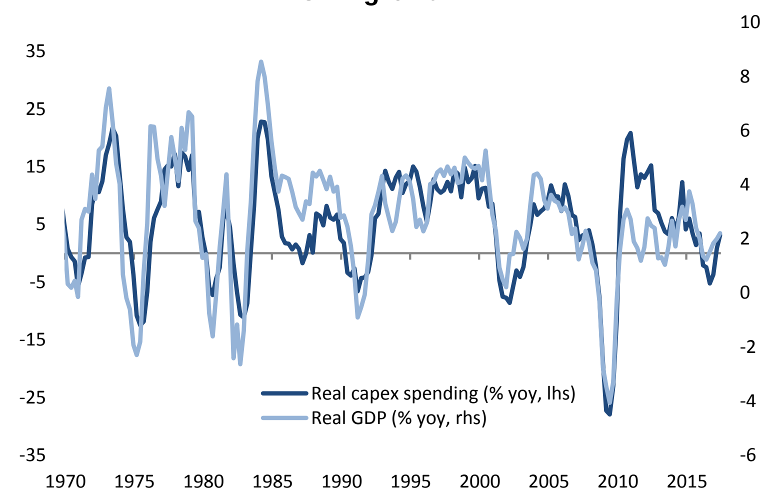
Declining corporate margins have frequently preceded a recession

US corporate margin declines (NIPA profits to GDP)			
Margin peak	Recession start	Margin decline to recession start Quarters	%
Q1 1955	Q3 1957	9	1.6%
Q2 1959	Q2 1960	4	1.2%
Q1 1966	Q4 1969	15	3.3%
Q1 1973	Q4 1973	3	0.5%
Q4 1978	Q1 1980	5	1.9%
Q1 1984	No recession		
Q4 1988	Q3 1990	7	1.4%
Q3 1997	Q1 2001	14	3.2%
Q3 2006	Q4 2007	5	2.2%
Average		**8**	**1.9%**
Q2 2014		12	1.4%

Corporate profits typically lead investment by 2 quarters...



...with investment growth being the key swing factor for GDP growth



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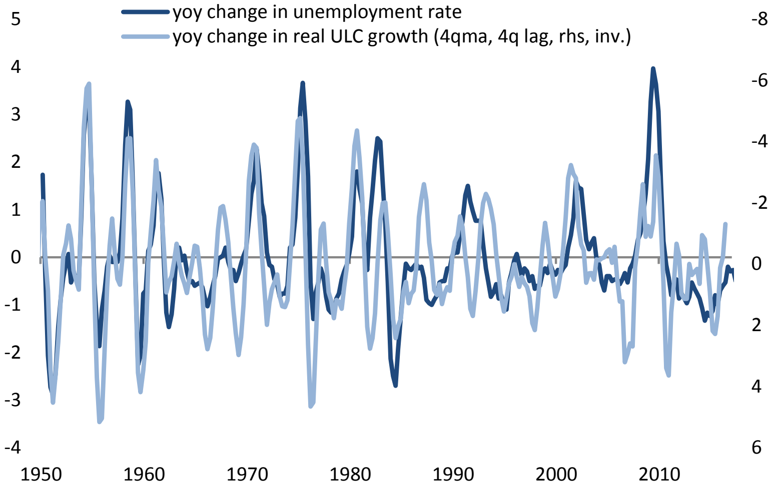
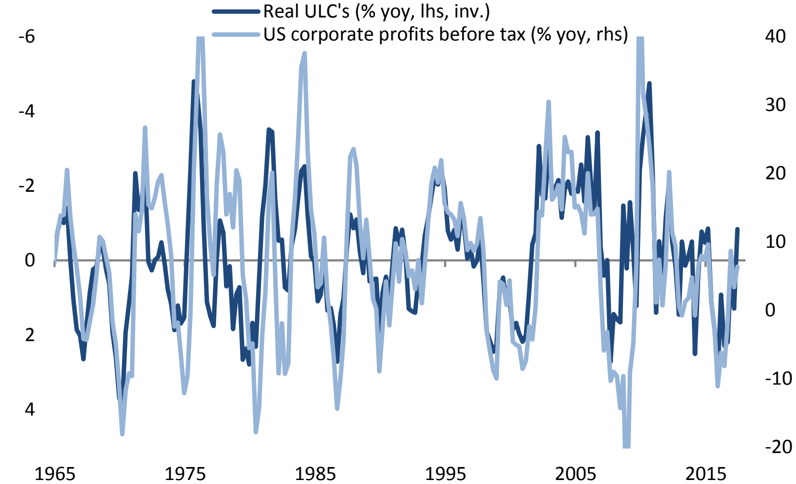
Source: Bloomberg Finance LP, Datastream, Deutsche Bank

2) The US looks late-cycle

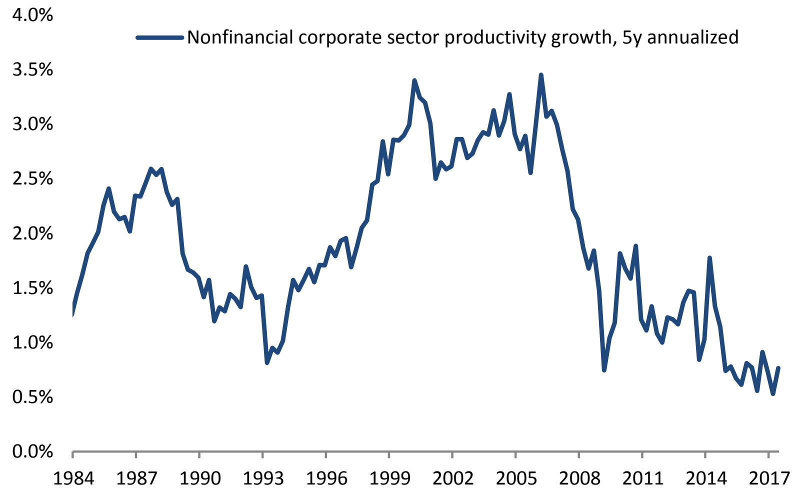
Falling unemployment is typically associated with rising unit-labour cost growth



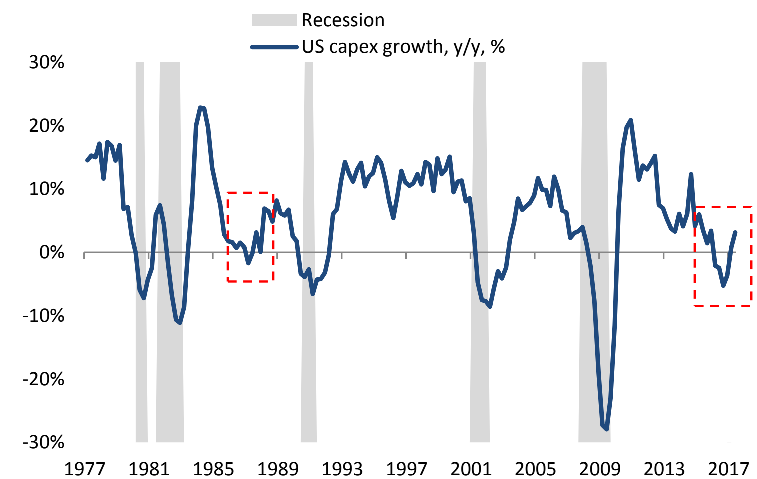
Rising unit-labour cost growth would present downside risks to the profit recovery



The weak trend in productivity growth raises the risk of elevated real unit labour cost growth and weaker corporate profit growth as wage growth normalises



In the past, when US capex growth was negative, the economy was typically already in recession (1987 & 2016 were the exceptions)



Source: Bloomberg Finance LP, Datastream, Deutsche Bank

2) The US looks late-cycle

During the past three US recessions equities have fallen sharply, with US outperforming and Europe and EM underperforming, bond yields have fallen, credit spreads have widened, commodities have declined and the USD TWI has strengthened, while the JPY has risen against the USD

Asset class performance during past US recessions

	Jul 1990 - Mar 1991	Mar 2001 - Nov 2001	Dec 2007 - Jun 2009	Average
MSCI Europe	-24%	-58%	-57%	-46%
MSCI AC World	-29%	-38%	-56%	-41%
Europe rel World	-32%	-35%	-34%	-34%
US rel World	30%	10%	11%	17%
EM rel World	-12%	-22%	-24%	-19%
Cyclicals vs defensives	-32%	-35%	-34%	-34%
US 10y bond yield	-127bps	-237bps	-316bps	-227bps
US HY spreads	421bps	281bps	1837bps	846bps
Brent crude	-59%	-54%	-76%	-63%
CRB metals index	-29%	-35%	-65%	-43%
Gold	20%	27%	85%	44%
USD TWI	12%	11%	21%	15%
JPY vs USD	22%	8%	29%	20%

Source: Bloomberg Finance LP, Datastream, Deutsche Bank

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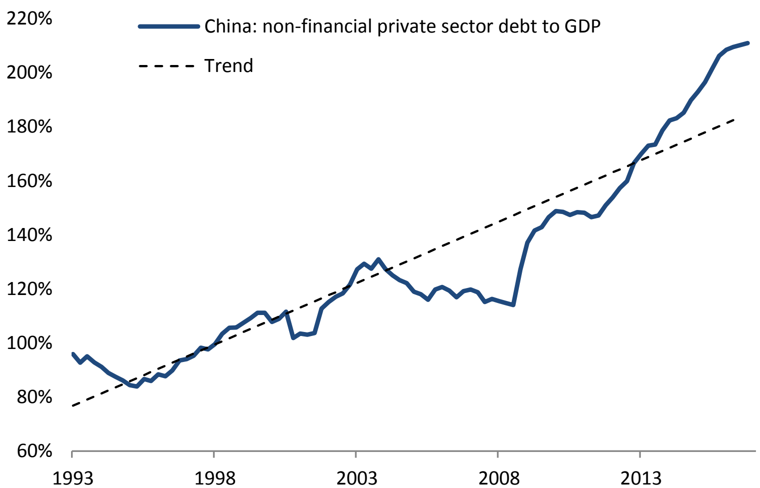
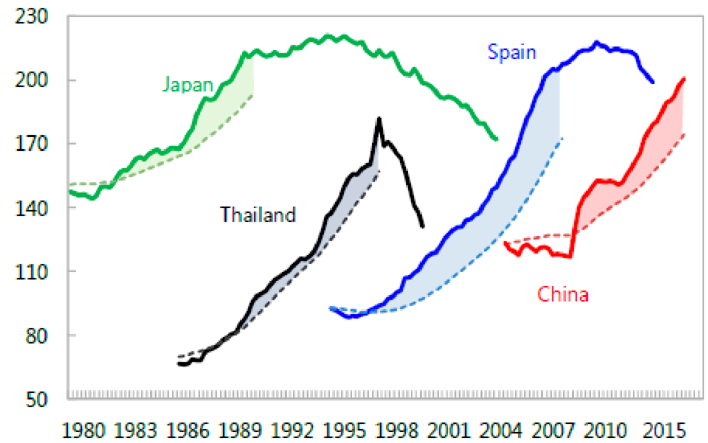
3) China's debt bubble

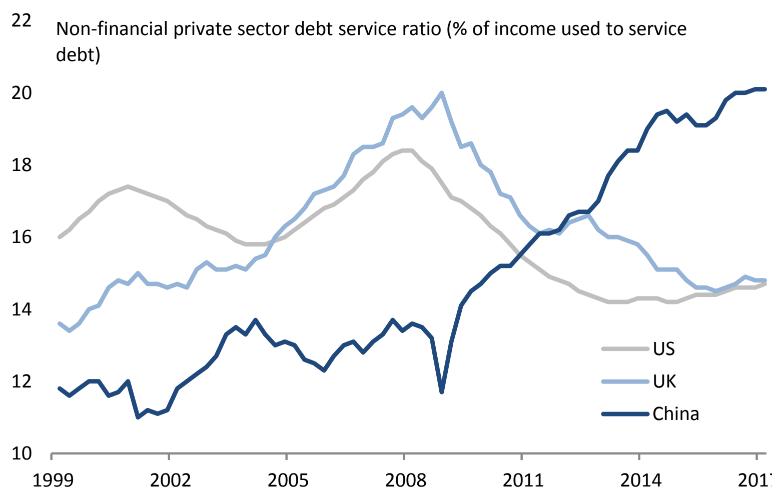
China's private sector debt to GDP is 30 percentage points above trend



The IMF has compared China's debt build-up with those preceding past debt crises



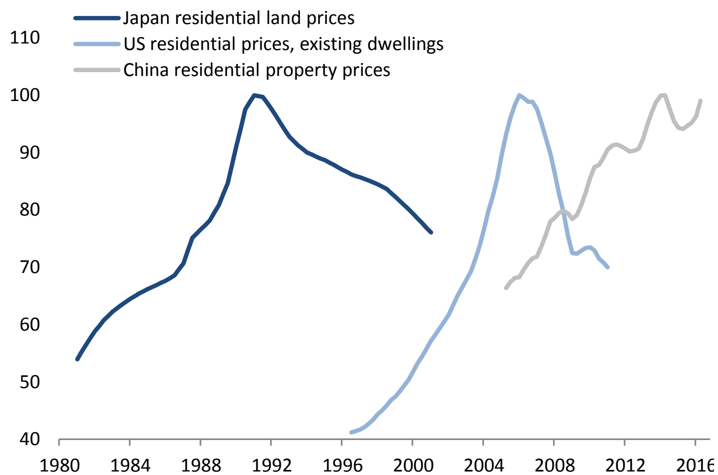
China's private sector debt service ratio is now notably above the level seen in the US pre-GFC



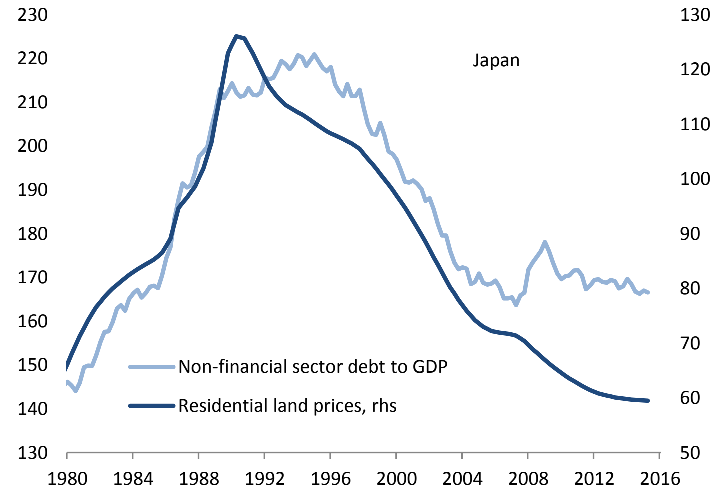
Source: Bloomberg Finance LP, Datastream, Deutsche Bank

3) China's debt bubble

Both Japan in the early 1990s and the US in 2007 were surplus countries and saw real estate prices pushed to high levels by unconstrained credit growth with much of the credit collateralized against real estate



Japanese land priced peaked in Q1 1991, precipitating sustained de-leveraging



China's NPL ratio is around the highs seen since 2009

Source: Bloomberg Finance LP, Datastream, Deutsche Bank

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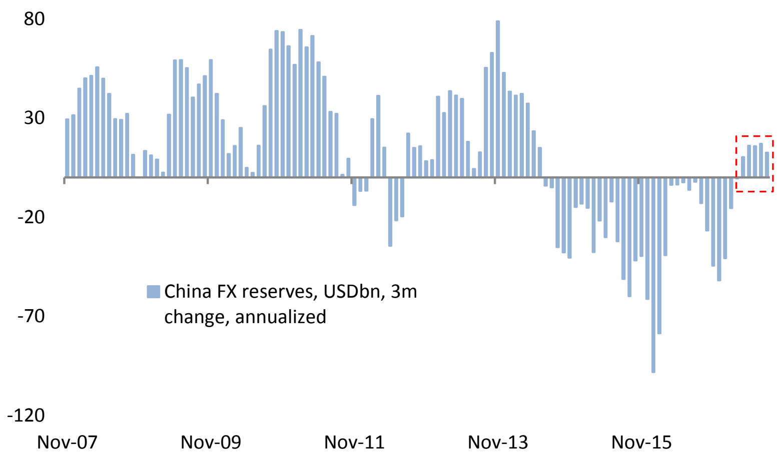
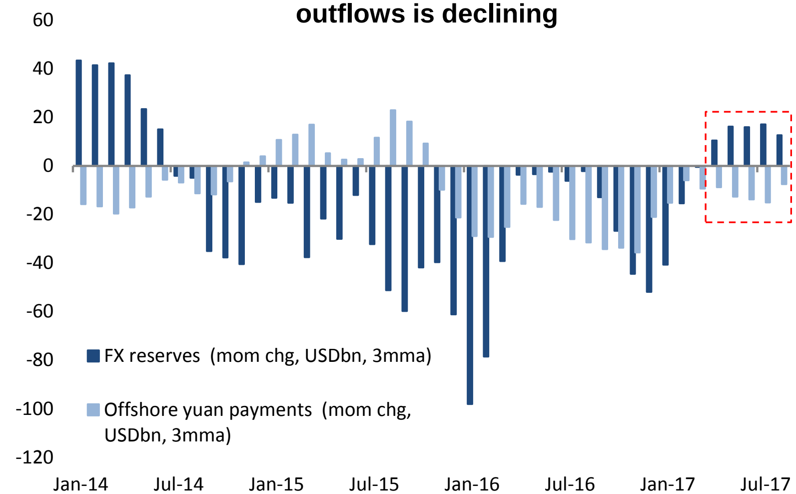
3) China's debt bubble

China has started to see capital inflows for the first time in 3 years

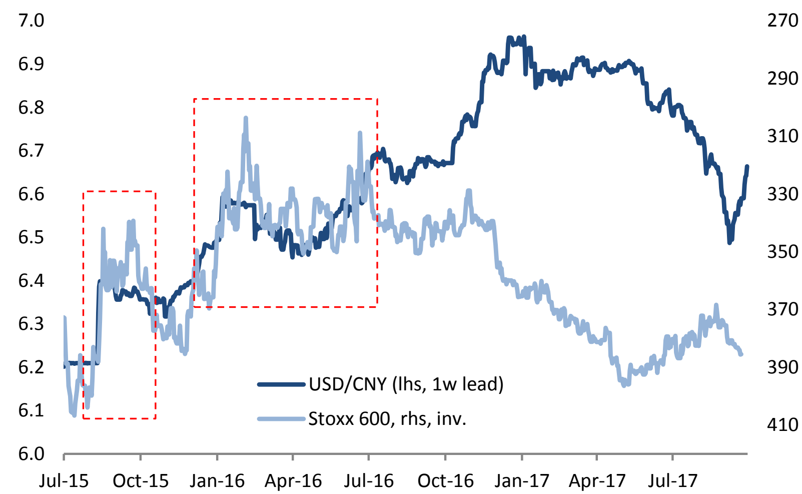


Yuan-denominated external flows are still negative (pointing to capital outflows), but the magnitude of outflows is declining



After a strong appreciation of CNY vs USD, rate differentials are pointing to little further upside

In 2015, episodes of sharp CNY depreciation were associated with falling equities



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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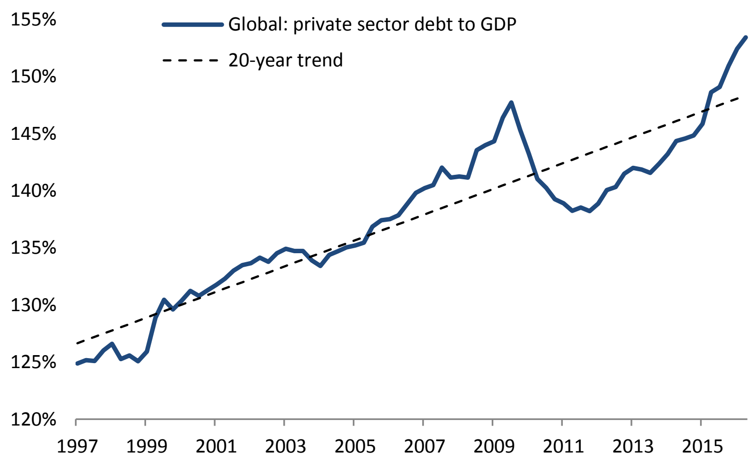
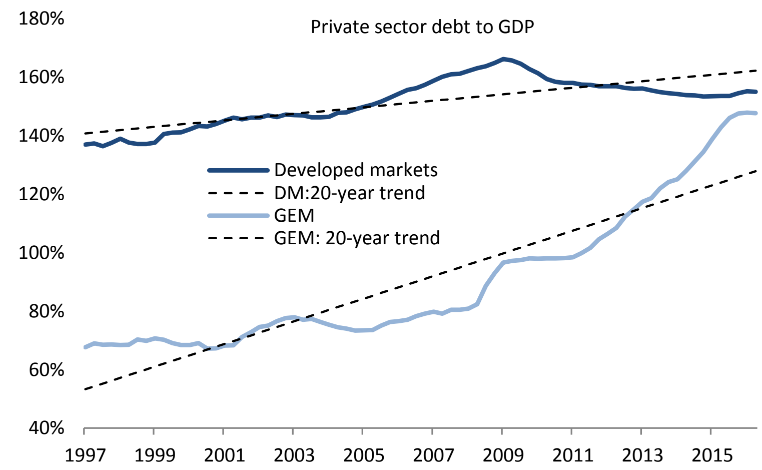
4) Global leverage remains high

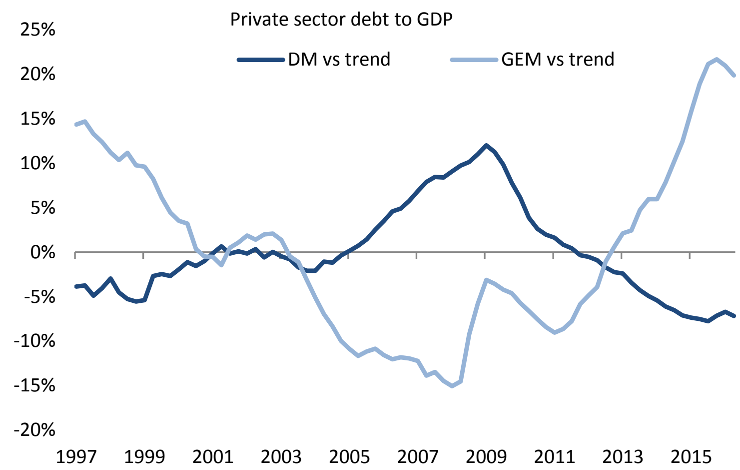
Global private sector debt to GDP is now above its long-run trend



Developed market private sector debt has fallen, while GEM private sector debt has risen over past years



Private sector debt imbalances have shifted from developed markets to GEM



Source: Bloomberg Finance LP, Datastream, Deutsche Bank

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Key calls

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Key calls:

SECTORS

1) **Overweight defensives versus cyclicals**

2) **Overweight pharma**

3) **Overweight food & beverage**

4) **Underweight banks**

5) **Underweight mining**

COUNTRIES

6) **Overweight Germany**

7) **Underweight Italy**

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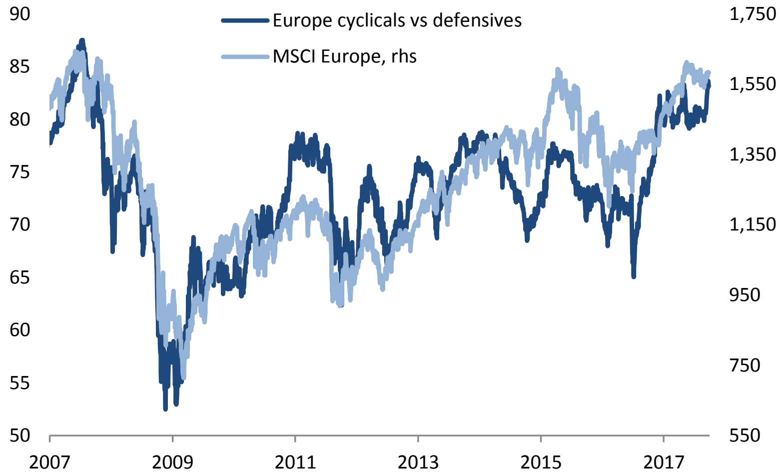
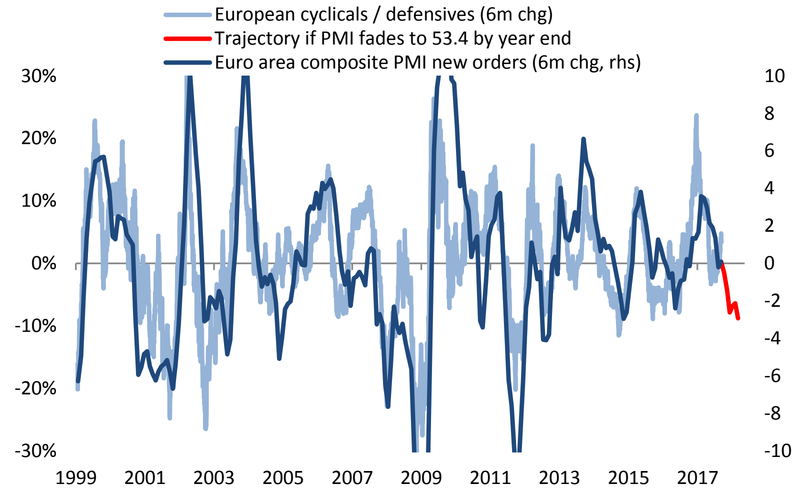
We expect cyclicals to underperform as PMI momentum fades

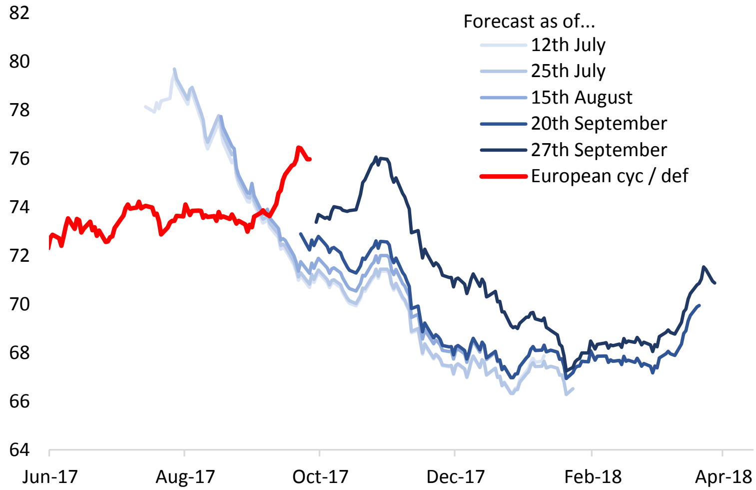
Since the end of August, cyclicals have outperformed defensives by around 5%, taking the price relative back to a 10-year high



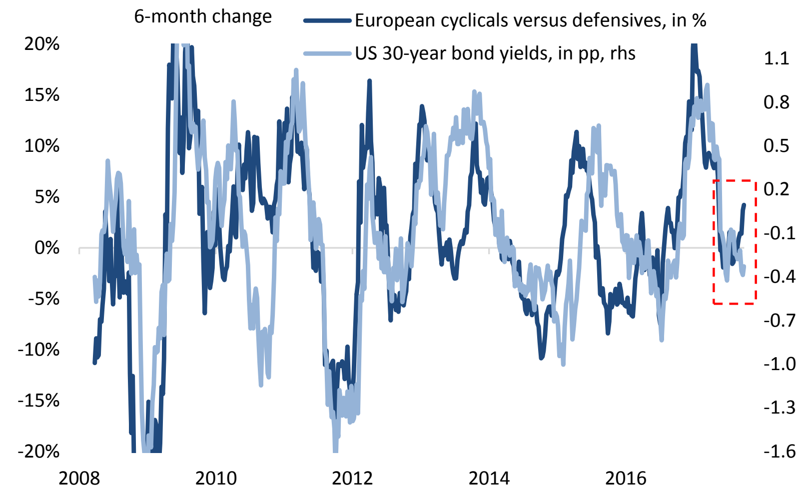
European cyclicals tend to underperform defensives when Euro area PMI momentum turns negative, as we expect it to



Cyclicals versus defensives have no upside implied by PMI momentum, even taking into account the recent strong September PMI



Cyclicals versus defensives has done better than the relationship with US bond yields would have suggested



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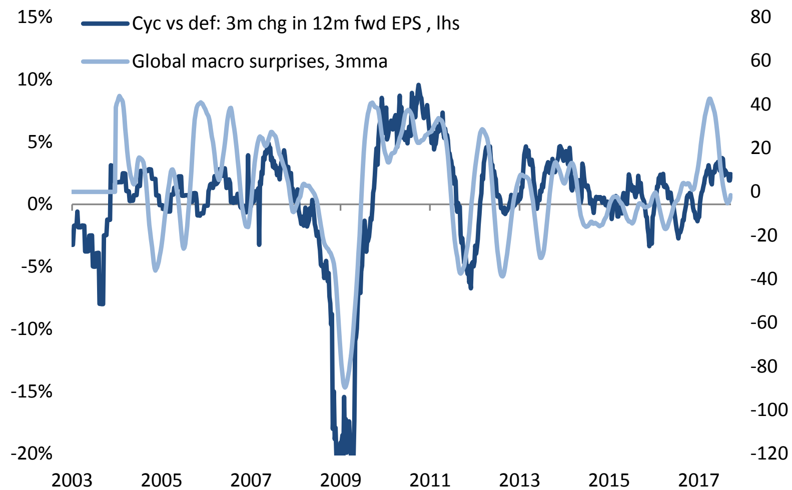
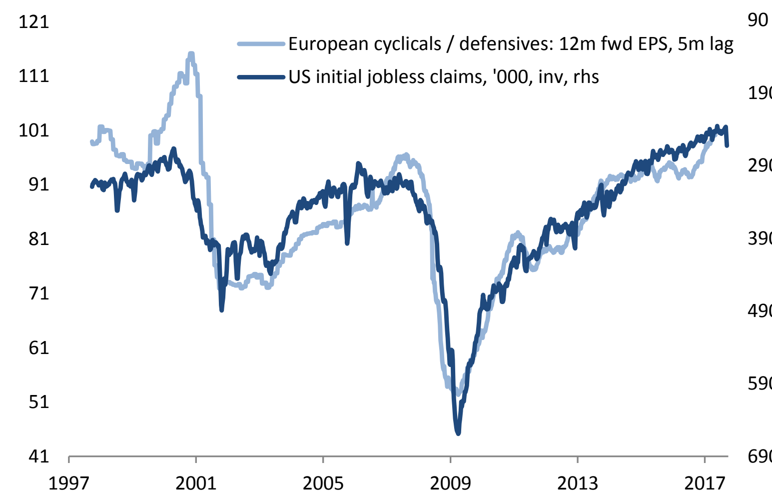
We expect cyclicals to underperform as PMI momentum fades

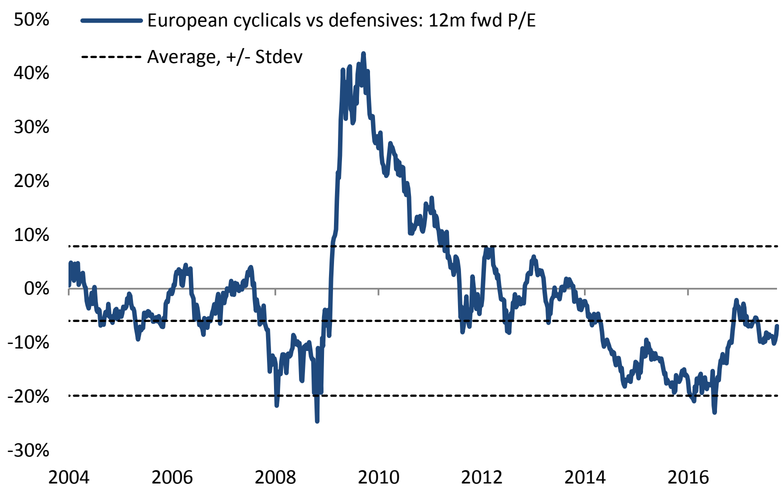
Cyclicals versus defensives earnings momentum tends to move in line with global macro surprises, which point to further downside



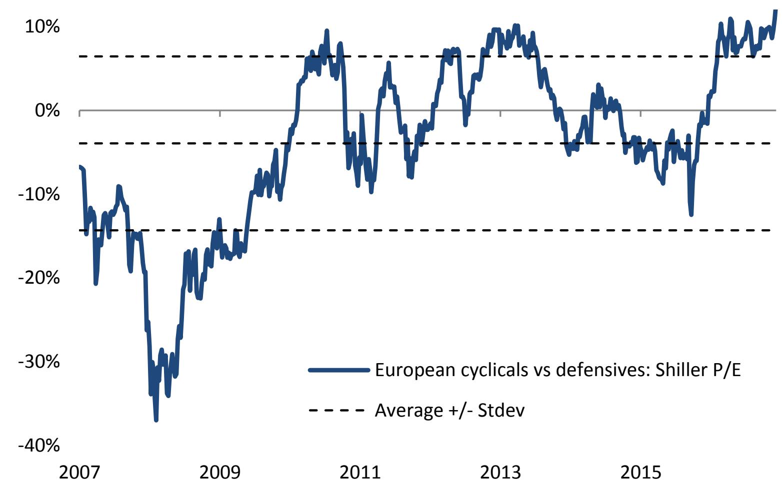
Relative EPS of European cyclicals versus defensives are already close to a 15-year high



The P/E of cyclicals versus defensives is only at average historic levels, but this metric has not been reliable in the past (e.g. cyclicals looked expensive in early 2009)



Cyclicals are trading on a 13% Shiller P/E premium relative to defensives, the highest level in at least ten years



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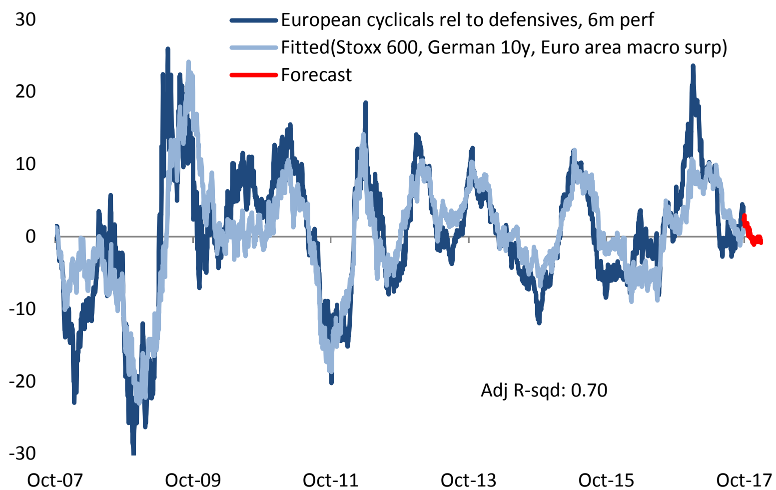
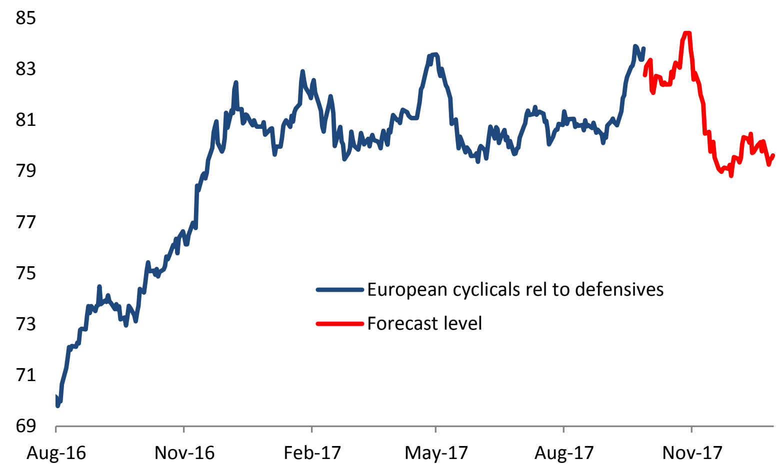
We expect cyclicals to underperform as PMI momentum fades

Our regression model explains European cyclicals versus defensives as a function of the Stoxx 600, German bond yields and Euro area macro surprises



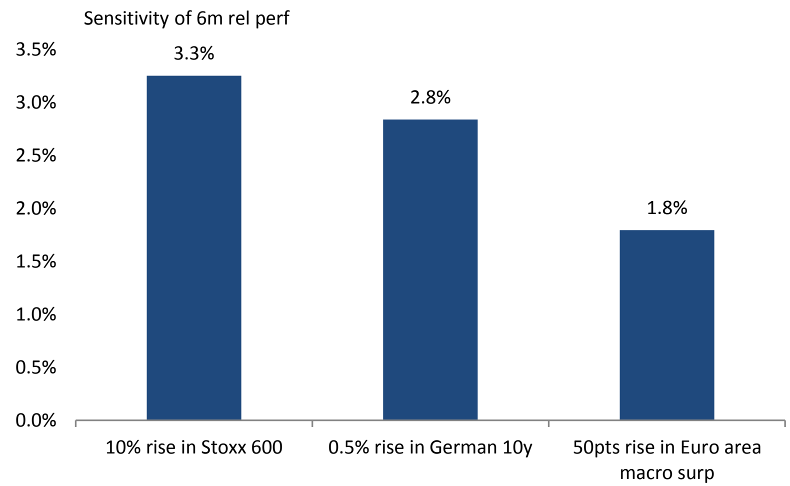
Our model suggests cyclicals versus defensives have overshot – and have downside over the coming months



Our strategists expect further upside for German bond yields, while we expect Euro area macro surprises to fall by year-end and the Stoxx 600 to be roughly in line with the current level

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Stoxx 600	386	375	-3%	*0.2%*
German 10-year bond yields	0.5%	0.6%	0.1%	*0.8%*
Euro area macro surprises	26	-50	-76pts	*-2.8%*
Constant				*1.0%*
6 month performance by year-end				*-0.9%*
Implied out/under-performance by year-end				**-5.0%**

Cyclicals tend to outperform defensives when the market rises, bond yields increase and Euro area macro surprises move higher



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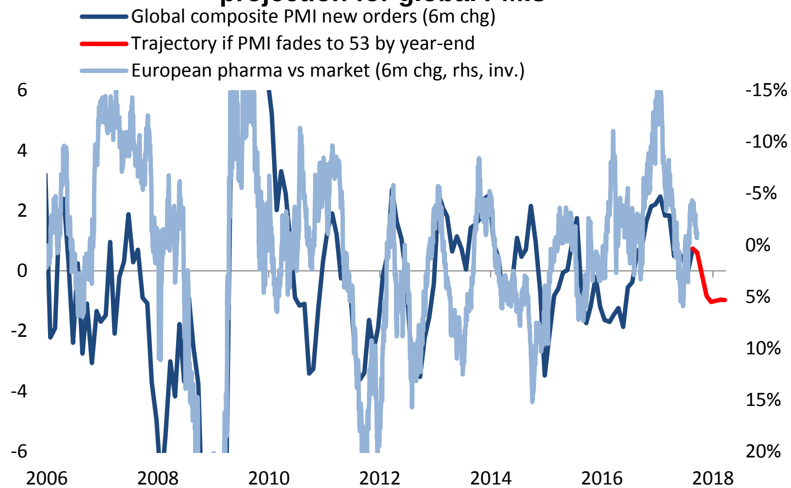
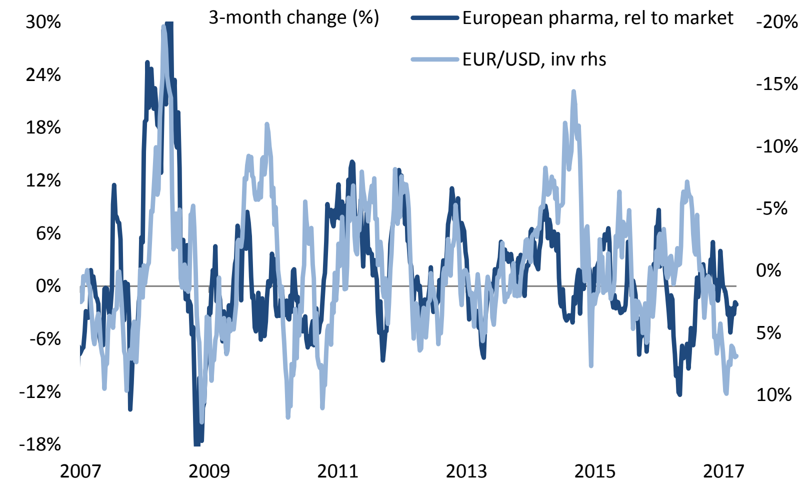
Pharma: should benefit from the roll-over in growth momentum

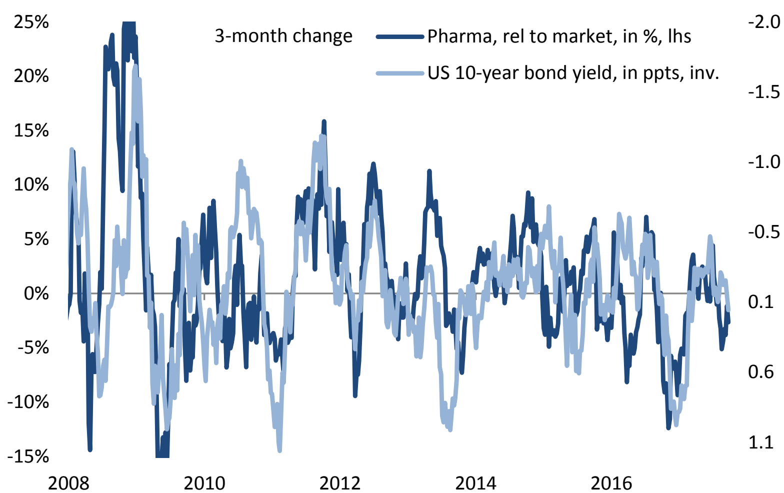
Pharma's relative performance tends to move inversely with global PMI momentum and has around 8% upside, given our projection for global PMIs



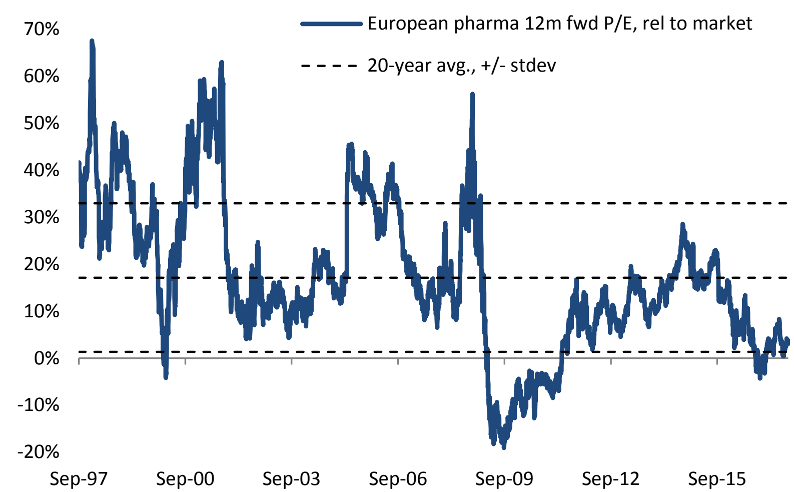
With ~40% of revenues coming from the US (vs ~20% for the market), pharma tends to outperform the market when the EUR/USD, falls as our FX strategist's expect



Pharma's relative price momentum typically moves in line with changes in US bond yields and could be vulnerable if yields continue rising



Pharma's P/E is trading close to that for the market, leaving the relative P/E around one standard deviation below its 20-year relative average



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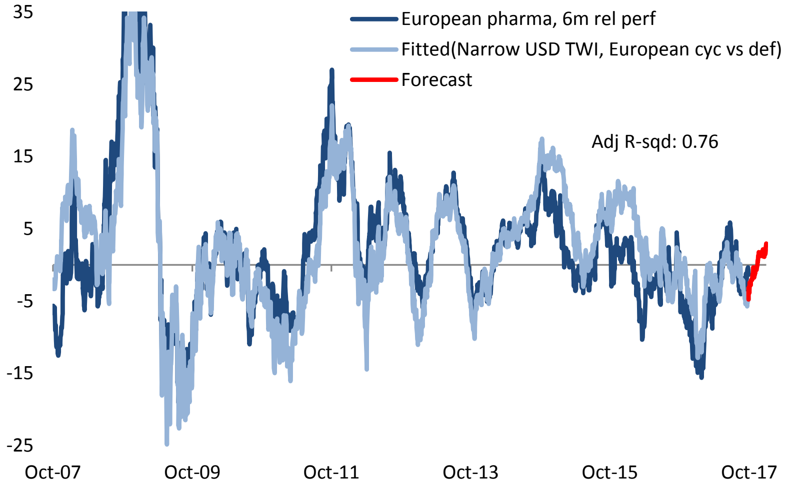
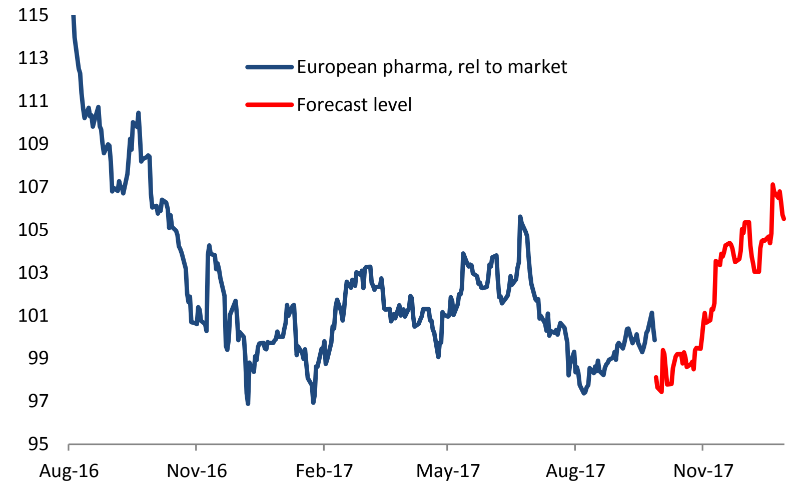
Pharma: should benefit from the roll-over in growth momentum

Our regression model explains European pharma's relative performance as a function of European cyclicals versus defensives and the US dollar



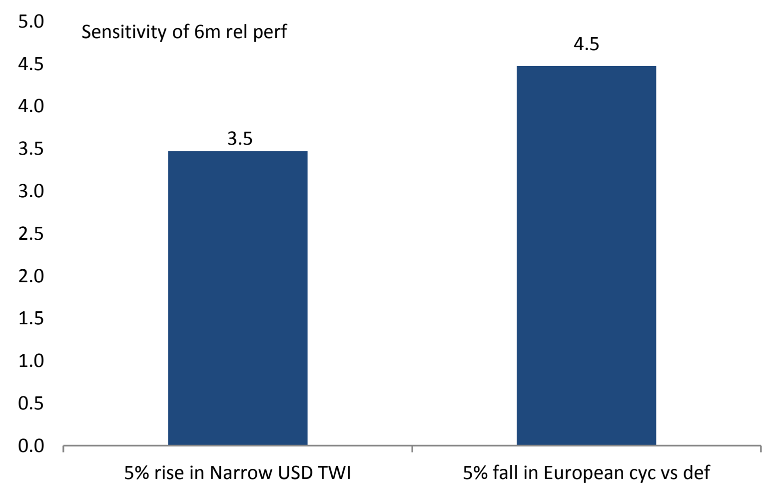
Our projected scenario points to around 6% upside for pharma's price relative by year-end



Our strategists expect the USD trade-weighted index to rise by year-end, while our model suggests defensives are set to outperform cyclicals

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Narrow USD TWI	99	102	2%	*-0.2%*
European cyc vs def	84	80	-5%	*0.8%*
Constant				*2.4%*
6 month performance by year-end				*2.9%*
Implied out/under-performance by year-end				**5.7%**

Pharma tends to outperform when European cyclicals outperform defensives underperform and the USD trade-weighted index rises



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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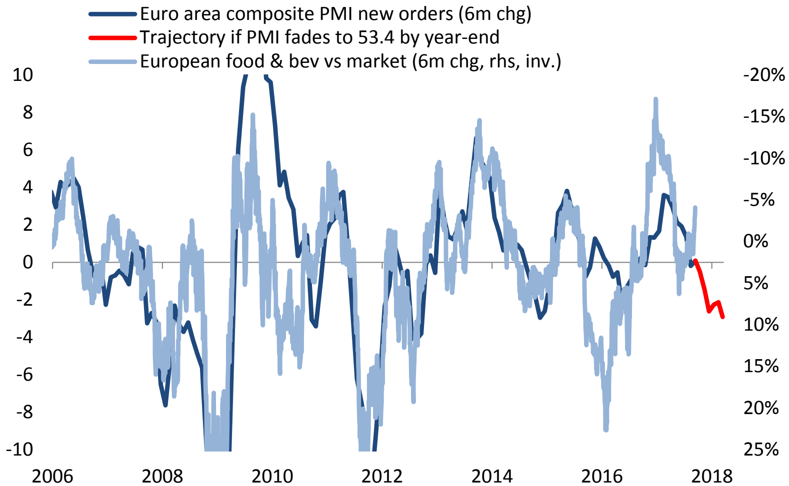
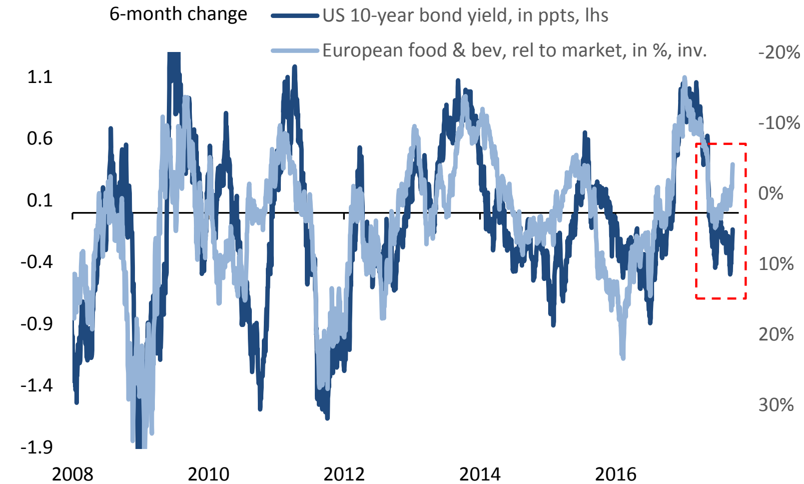
Food & beverage: upside if macro momentum softens

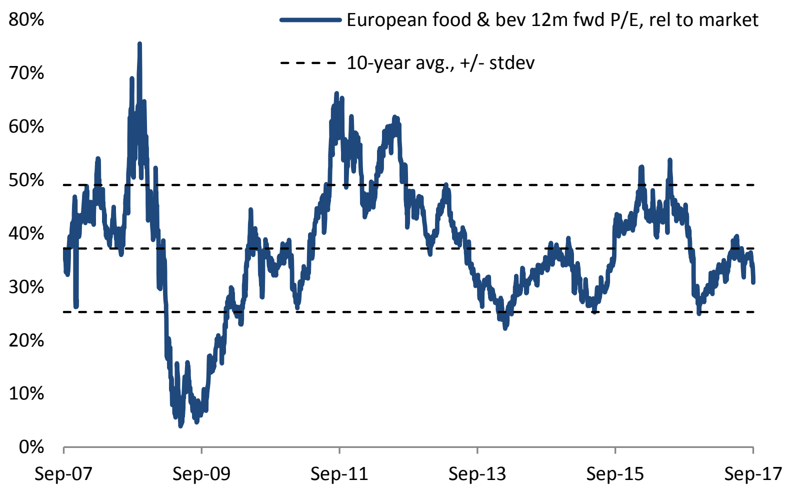
Food & beverage's relative performance tends to move inversely with Euro area PMI momentum and has around 10% upside, given our projection for PMIs



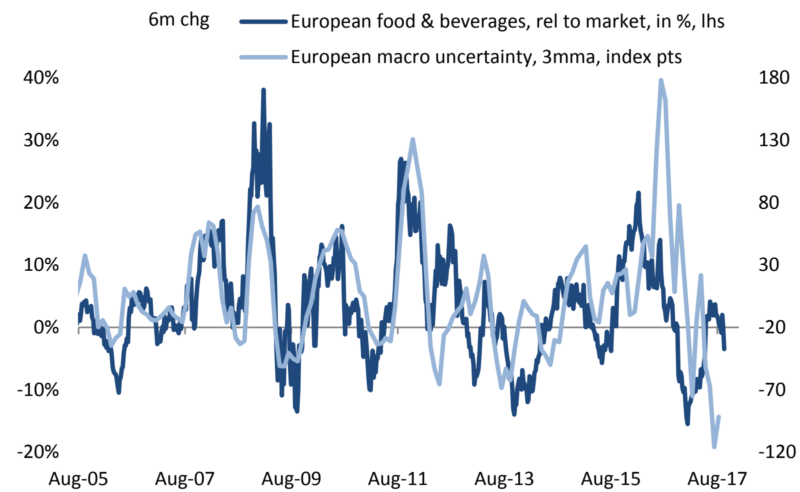
Food & beverage has underperformed more sharply than its relationship with US bond yields would have suggested



The sector's P/E premium, at 30%, is half a standard deviation below the 10-year average



On the downside, the recent fall in European macro uncertainty points to further downside for food & beverage



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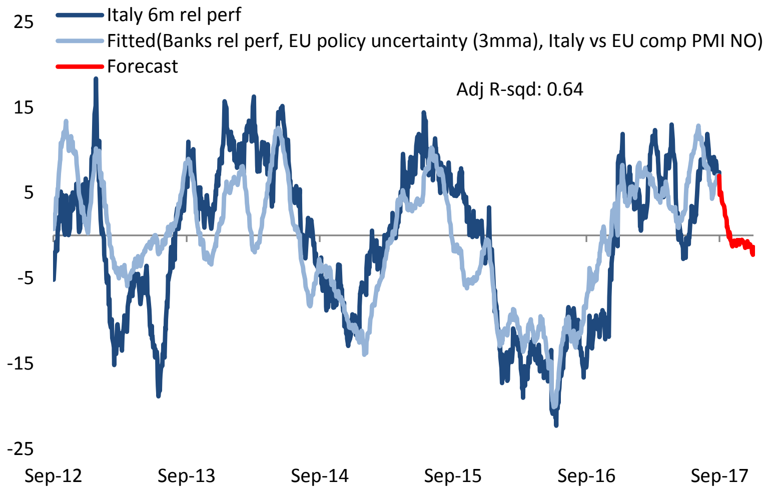
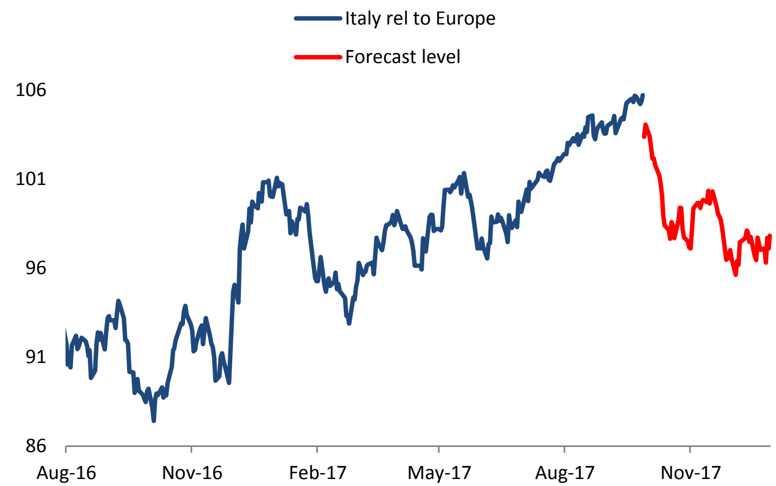
Italy: no longer cheap and vulnerable to a fade in PMI momentum

Our model, based on banks' relative performance, EU macro uncertainty & Italy vs. EU comp PMI new orders points to downside for Italy



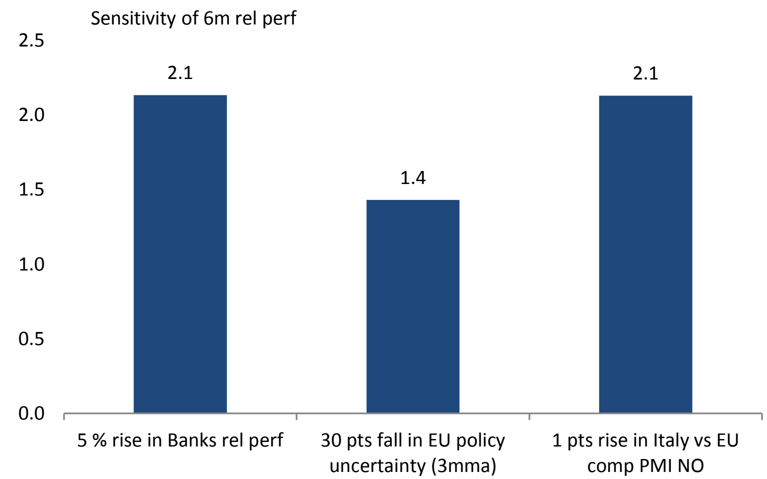
On level terms, our model is consistent with Italy underperforming by 8% until year-end



Based on our forecasts, banks will be a major drag on Italy's relative performance

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Banks rel perf	4.3	4.0	-6%	*-2.5%*
EU policy uncertainty (3mma)	190	175	-15pts	*3.1%*
Italy vs EU comp PMI NO	0.5pts	-0.1pts	-1pts	*-0.3%*
Constant				*-1.6%*
6 month performance by year-end				*-1.4%*
Implied out/under-performance by year-end				**-7.5%**

Italy tends to outperform in line with banks, when EU macro uncertainty falls and when Italy PMIs rise versus EU PMIs



Source: Bloomberg Finance LP, Haver, Factset, Datastream, Deutsche Bank

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Sectors

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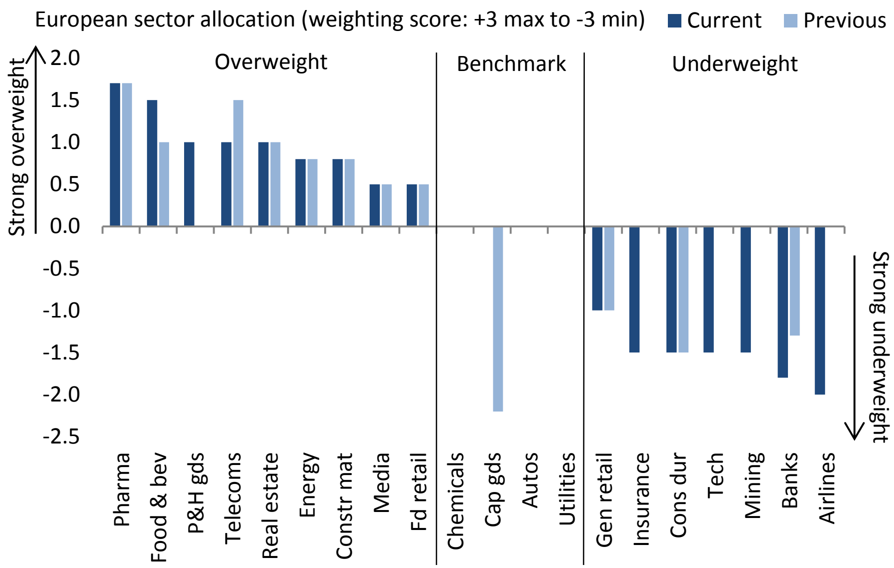
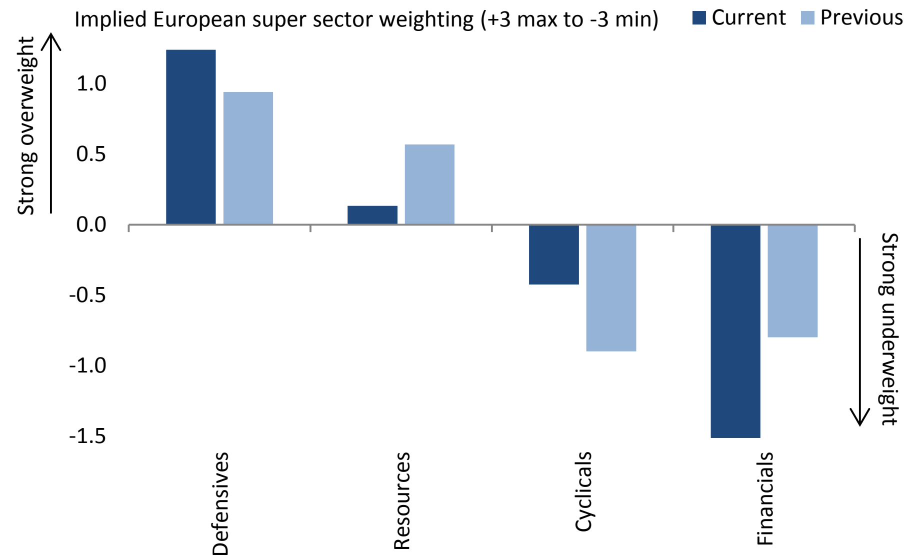
European sector allocation – overview

We are overweight pharma, food & beverage and energy, while being underweight mining, banks and airlines



We are overweight defensives and resources, while being underweight cyclicals and financials



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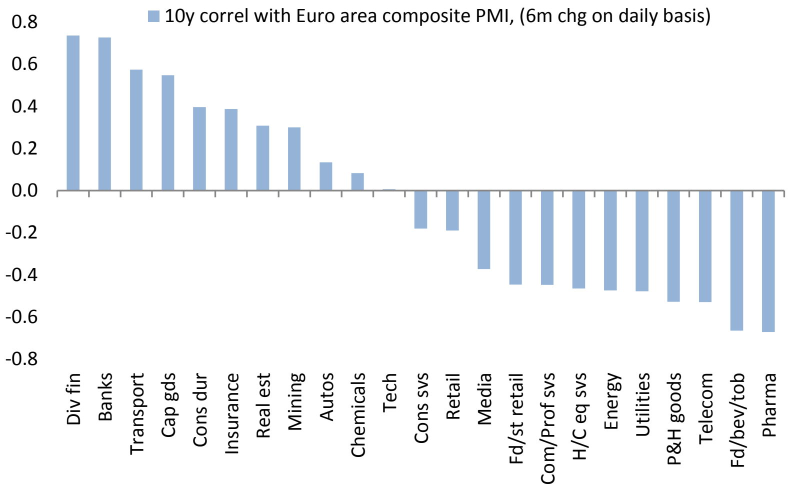
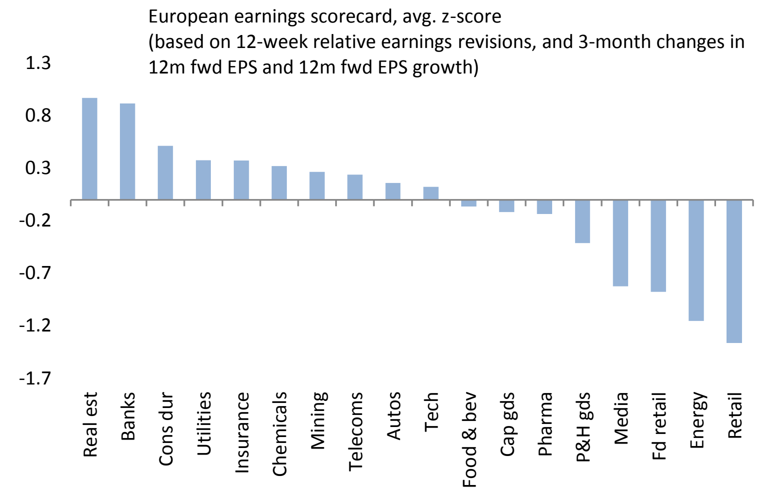
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

European sector scorecards

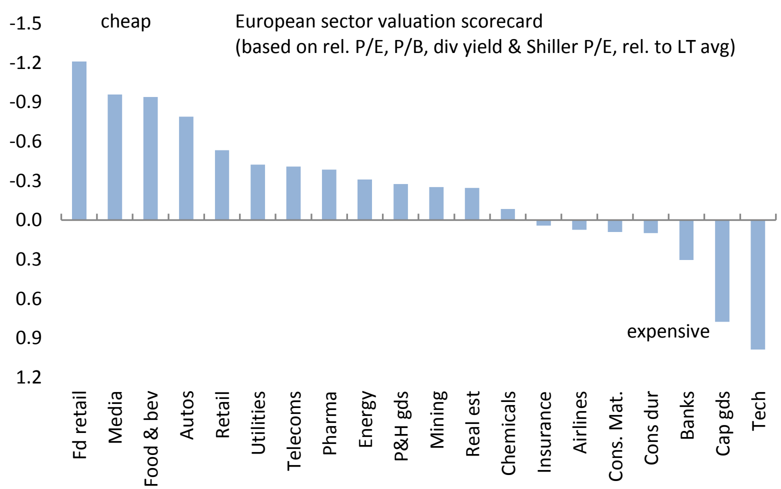
Financials tend to underperform when Euro area PMI momentum rolls over, while pharma and food & beverage benefit



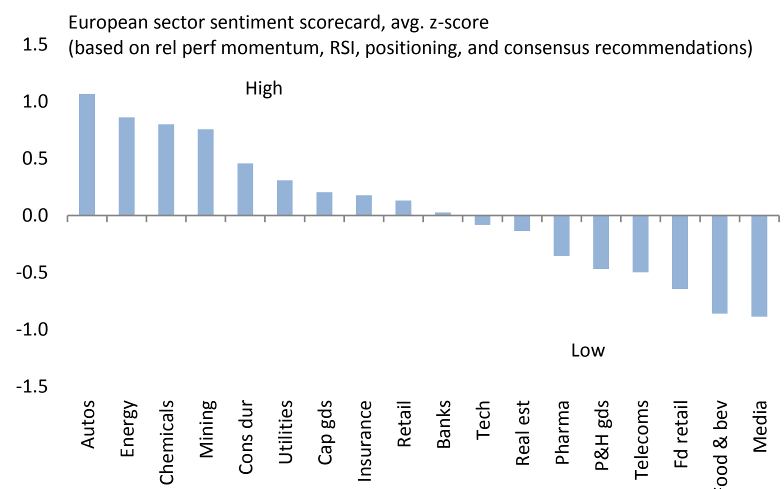
European sector earnings scorecard



European sector valuation scorecard



European sector sentiment scorecard



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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European sector allocation – overview

Our largest overweights are pharma, food & beverages and personal & household goods, while our largest underweights are airlines and banks

Rec.	European sector	Supersector	Weighting score (+3 max to -3 min)	Sector mcap (% of total)	Agg valuations (stdev from avg)	Macro drivers (sign of correlation)
Overweight	Pharma	Defensives	1.7	11%	-0.4	USD (+), US bond yields (-), Euro area growth momentum (-), European EPS growth (-)
	Food & bev	Defensives	1.5	9%	-0.9	Global growth momentum (-), Bond yields (-), EM FX (+), Macro uncertainty (+)
	P&H goods	Defensives	1.0	4%	-0.3	Global growth momentum (-), bond yields (-), US HY spreads (+), GBP/USD (-)
	Telecoms	Defensives	1.0	4%	-0.4	US HY spreads (+), Euro area rel US PMIs (+), Global growth momentum (-)
	Real estate	Financials	1.0	1%	-0.2	Euro area growth momentum (-), Euro area credit impulse (+), German bond yields (-)
	Energy	Resources	0.8	7%	-0.3	Oil (+), USD (-), GBP (-), Euro area growth momentum (-)
	Constr materials	Cyclicals	0.8	1%	0.1	Global growth momentum (+), Macro uncertainty (-), US HY spreads (-), EM FX (+), US infrastructure (+)
	Media	Cyclicals	0.5	2%	-1.0	USD (+), DM rel EM macro surprises (+), Euro area growth momentum (+)
	Food retail	Defensives	0.5	1%	-1.2	UK food inflation (+), UK consumer spending (+)
Benchmark	Chemicals	Cyclicals	0.0	4%	-0.1	EM growth momentum (+), Oil (+), USD (-)
	Capital goods	Cyclicals	0.0	10%	0.8	China growth momentum (+), China output prices (+), US inflation (+), EM FX (+)
	Autos	Cyclicals	0.0	3%	-0.8	Euro area growth momentum (+), CNY/EUR (+), European consumer confidence (+), Macro uncertainty (-)
	Utilities	Defensives	0.0	4%	-0.4	Bond yields (-), Euro area growth momentum (-), Electricity prices (+), Oil (+), US HY spreads (+)
Underweight	General retail	Cyclicals	-1.0	1%	-0.5	Euro area growth momentum (+), UK household finances (+), Euro (-), GBP (+)
	Insurance	Financials	-1.5	6%	0.0	Bond yields (+), Macro uncertainty (-), Cyclical versus defensives (+), EM rel perf (-)
	Cons durables	Cyclicals	-1.5	3%	0.1	Global growth momentum (+), US consumer confidence (+), EM FX (+), China retail sales (+)
	Technology	Cyclicals	-1.5	5%	1.0	USD (+), US consumer confidence (+), US macro surprises (+)
	Mining	Resources	-1.5	3%	-0.3	Metal prices (+), China credit impulse (+), USD (-), GBP (-), US real rates (-)
	Banks	Financials	-1.8	12%	0.3	Bond yields (+), Euro area growth momentum (+), Fed expectations (+), Macro uncertainty (-)
	Airlines	Cyclicals	-2.0	0%	0.1	Oil (-), EUR TWI (+), European consumer confidence (+), Macro uncertainty (-), USD (+)

Source: Deutsche Bank

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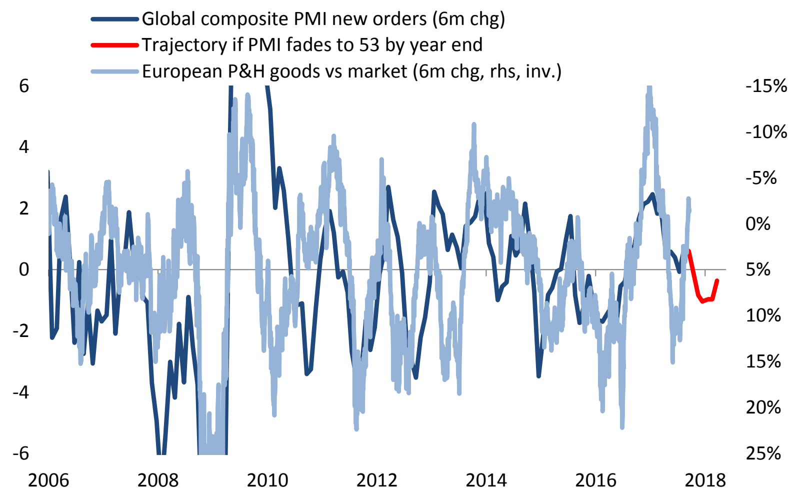
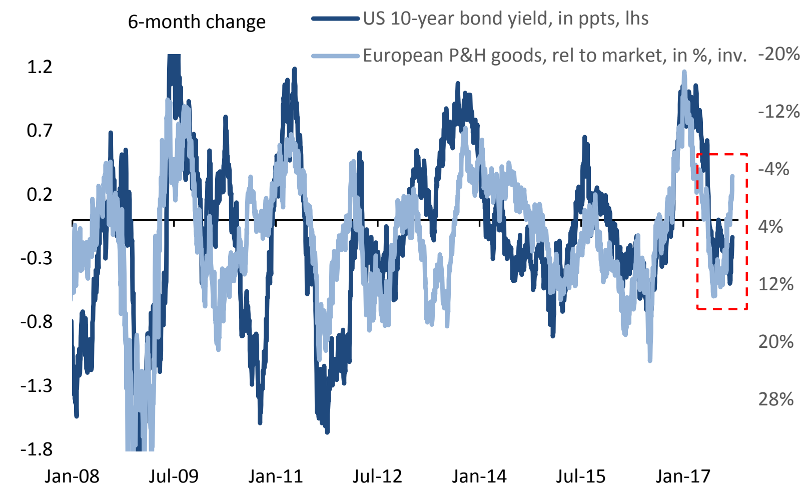
Personal & household goods: upside as growth momentum fades

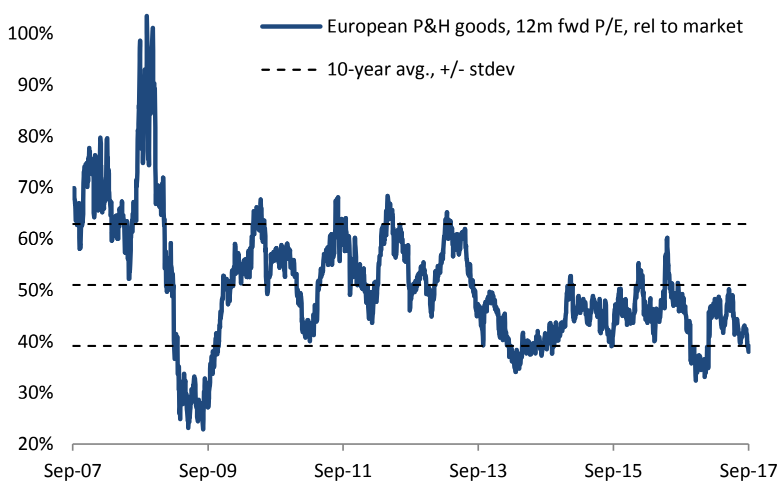
The relationship between P&G goods' relative price momentum and our expected fade in the global PMI momentum points to upside for the sector



The sector has underperformed more sharply than its relationship with US bond yields would have suggested



The sector's P/E relative, at a 38% premium, is one standard deviation below its 10-year average



P&H goods strongly outperformed the market earlier this year on the back of Kraft Heinz's take-over attempt of Unilever, but has now fallen behind

Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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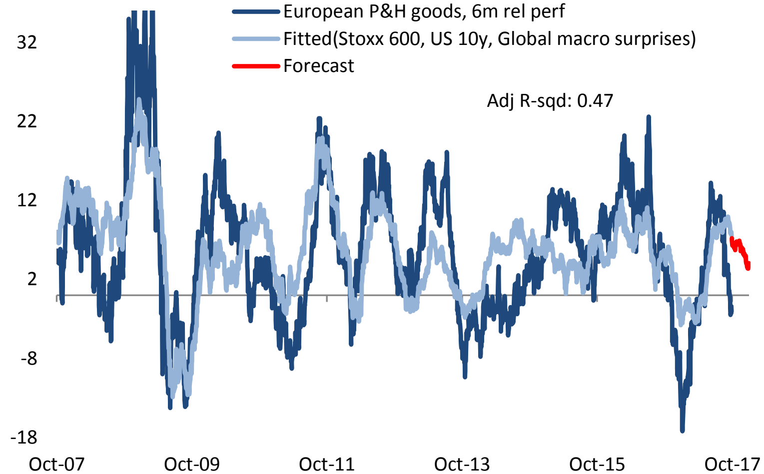
Personal & household goods: upside as growth momentum fades

Our regression model explains European personal & household goods' relative performance as a function of the Stoxx 600, US 10-year bond yields and global macro surprises

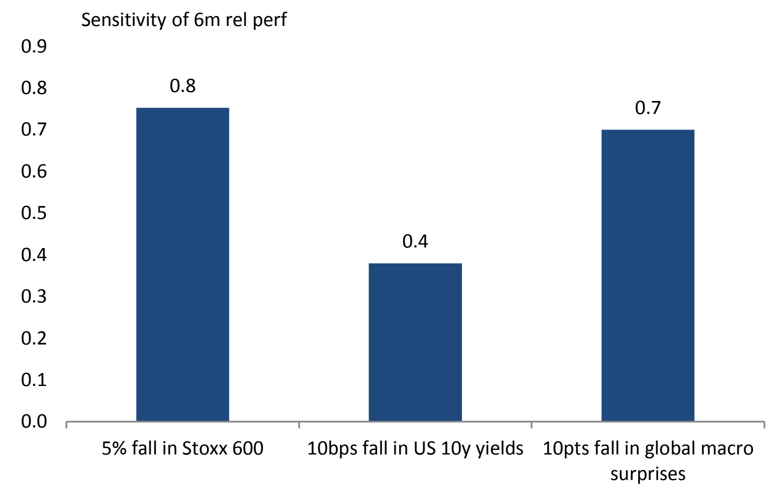


In level terms, our projected scenario for all input factors is consistent with personal & household goods outperforming by around 9% into year-end

We expect global macro surprises to fade until year-end and the Stoxx 600 to stay roughly at the current level, while our strategists expect the US 10-year bond yield to rise by 60 basis points

Model parameters	Level		Change	*Impact on 6m perf by yr-end*
	Current	Year-end forecast	Year-end vs current	
Stoxx 600	386	375	-3%	*0%*
US 10y yields	2.3%	2.8%	0.4%	*-2%*
Global macro surprises	12pts	-20pts	-32	*1%*
Constant				*5%*
6 month performance by year-end				*4%*
Implied out/under-performance by year-end				**9%**

Personal & household goods tend to outperform when European equities fall, US bond yields fall, and macro surprises fall



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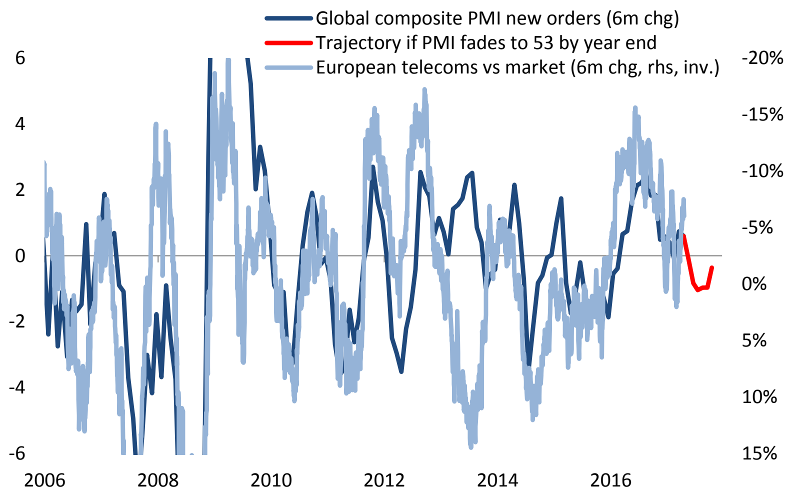
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Overweight

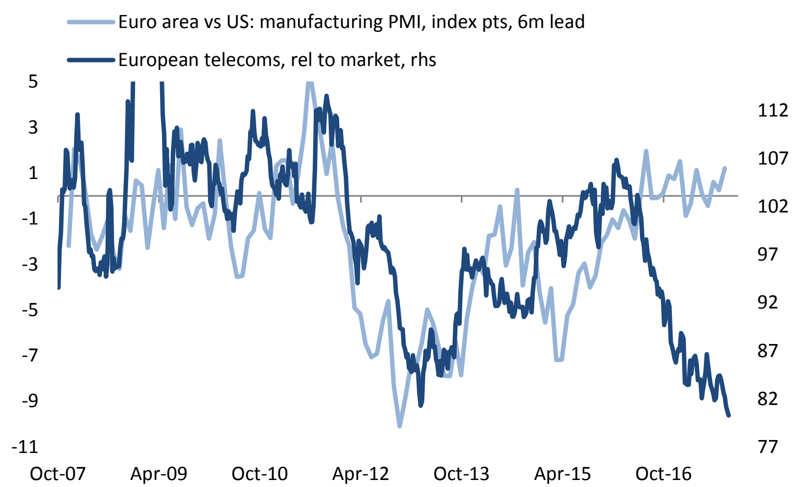
Telecoms: the fade in global macro momentum points to moderate upside

Telecoms have further upside given our expectations of a continued roll-over of global PMI momentum



Telecoms are already priced for US high-yield spreads to fall significantly further, while our credit model suggests spreads will stay flat

Telecoms are priced for Euro area versus US growth momentum to fall to Euro crisis levels – an unlikely scenario



Telecoms have underperformed the market by 12% over the past year, close to the peak year-on-year falls of 2010 and 2012

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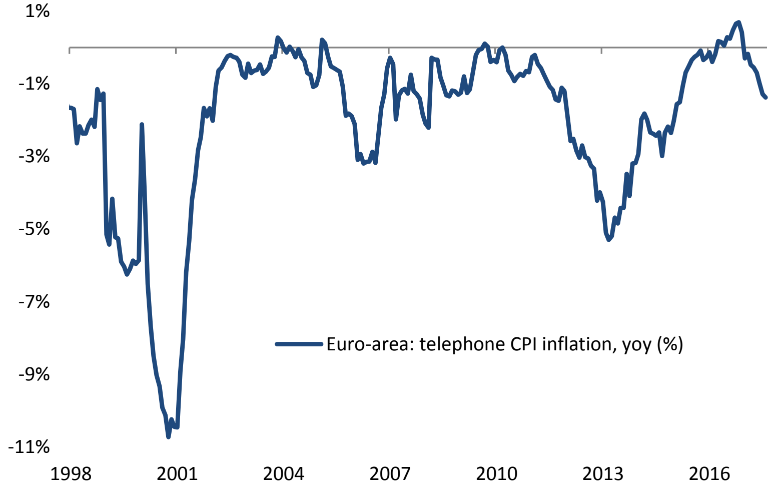
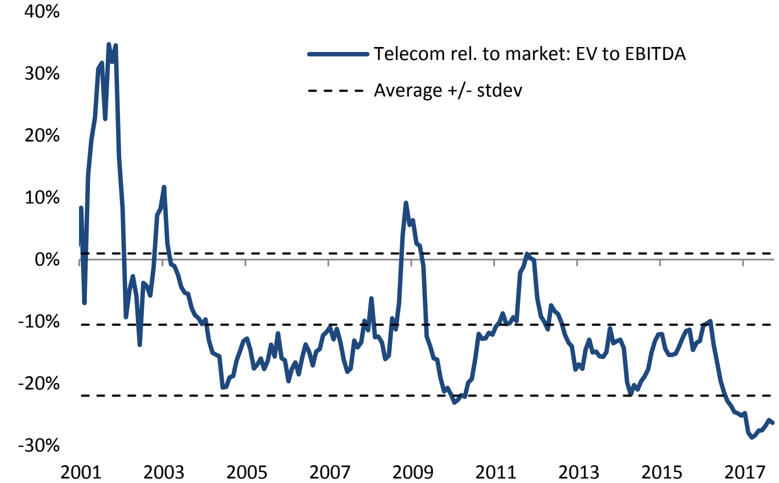
Telecoms: the fade in global macro momentum points to moderate upside

On the negative side, telecoms inflation has fallen back into negative territory after turning positive at the end of last year

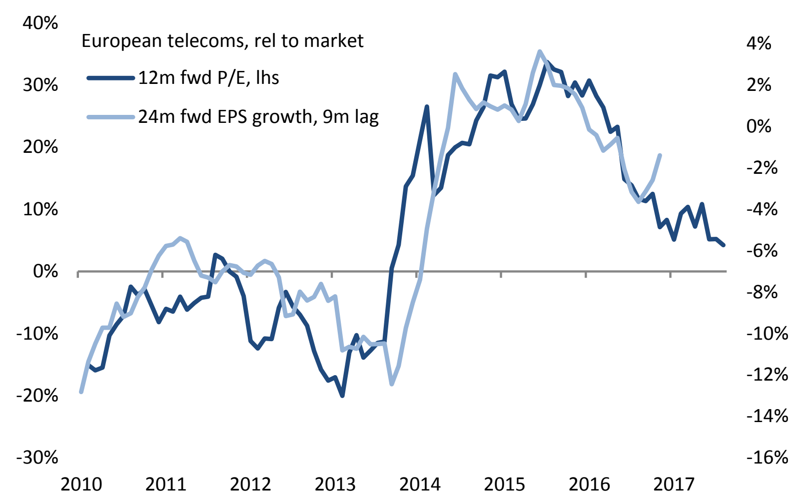


Relative EV to EBITDA for the sector has fallen to an all-time low



The relative P/E, at a 3% premium to the market, is at a 3.5-year low and below its 10-year average

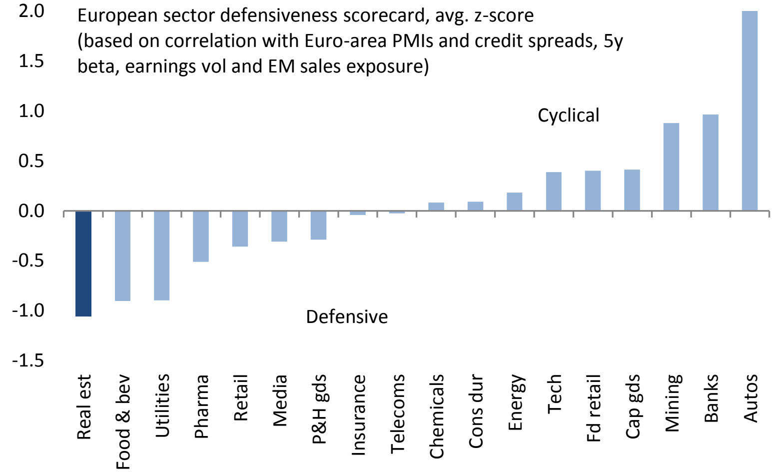
At current levels, the sector's relative P/E implies telecoms EPS growth some 600bps below that for the market over the coming two years



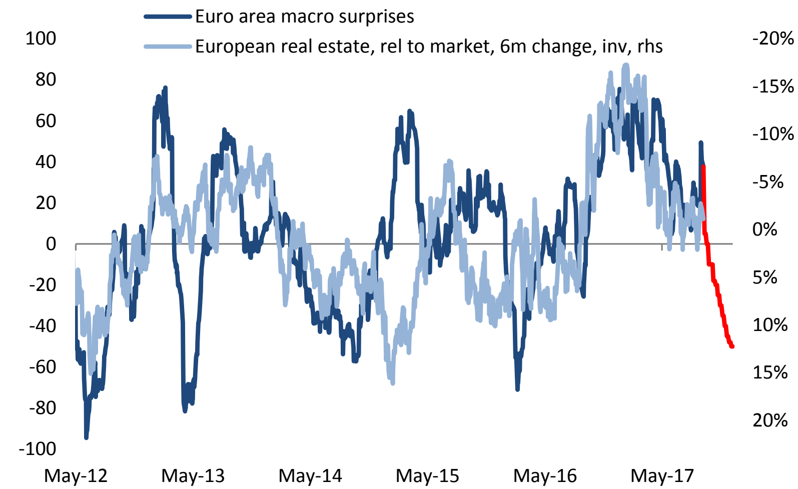
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Real estate: likely to benefit from a pull-back in Euro area macro surprises

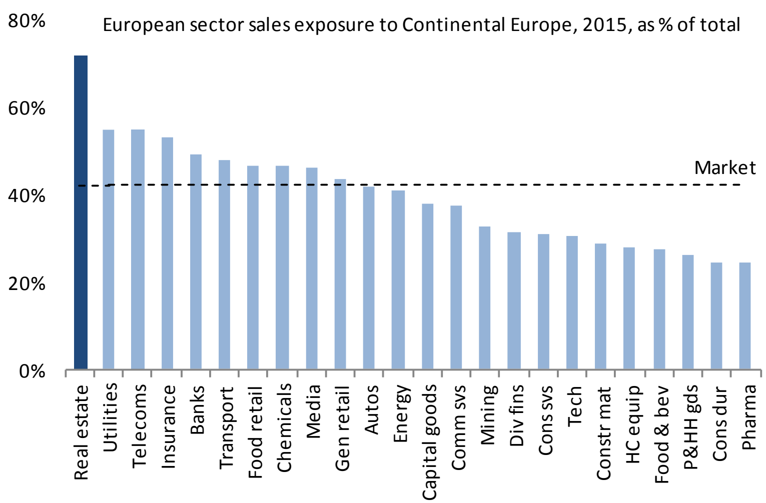
Real estate is the most defensive sector in Europe, according to our scorecard



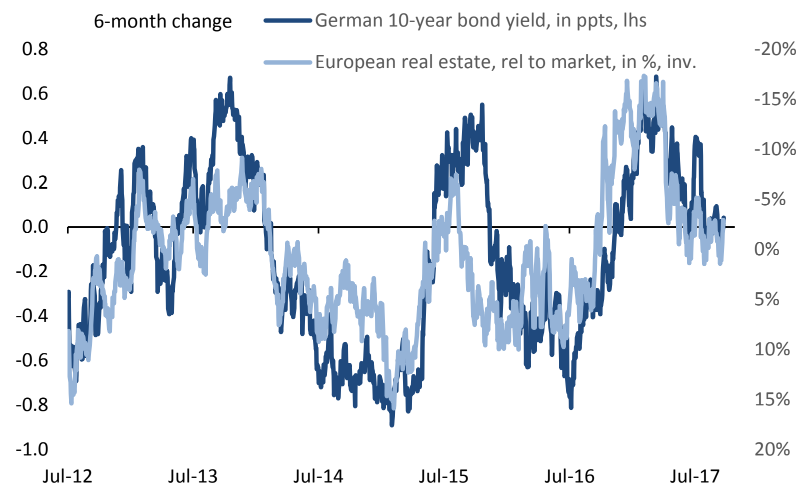
European real estate's relative price momentum has upside, given the roll-over in Euro area macro surprises, which we expect to continue



Real estate has the highest sales exposure to Continental Europe among all sectors



European real estate has benefitted from the fade in German bond yields, which we believe will continue to struggle as long as growth momentum is fading



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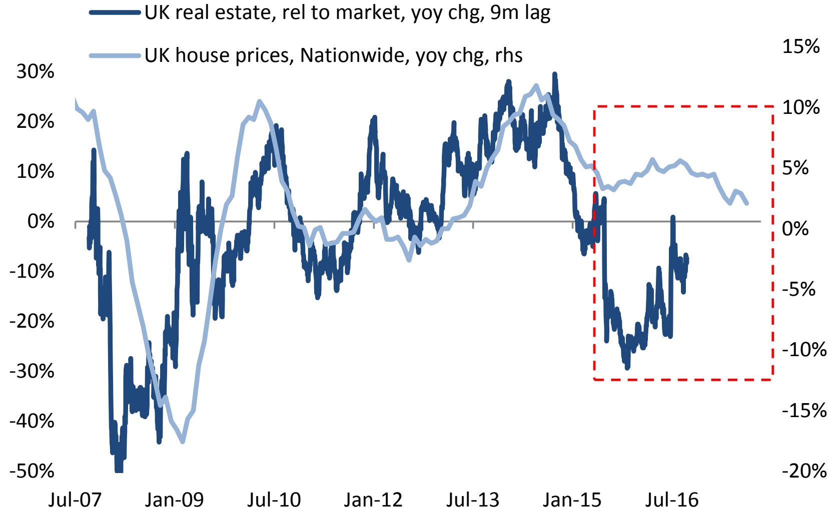
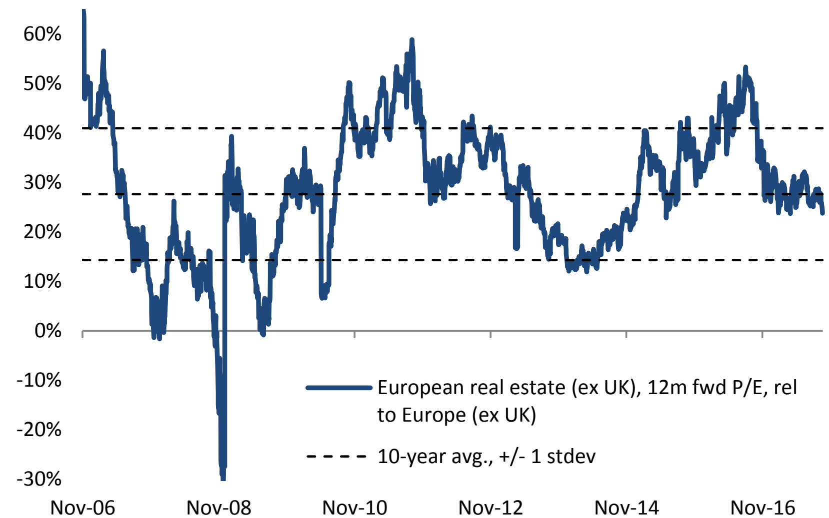
Real estate: likely to benefit from a pull-back in Euro area macro surprises

European real estate sector has 25% of sales coming from the UK, (second highest in the European market), but UK real estate companies seem already priced for house prices to fall sharply



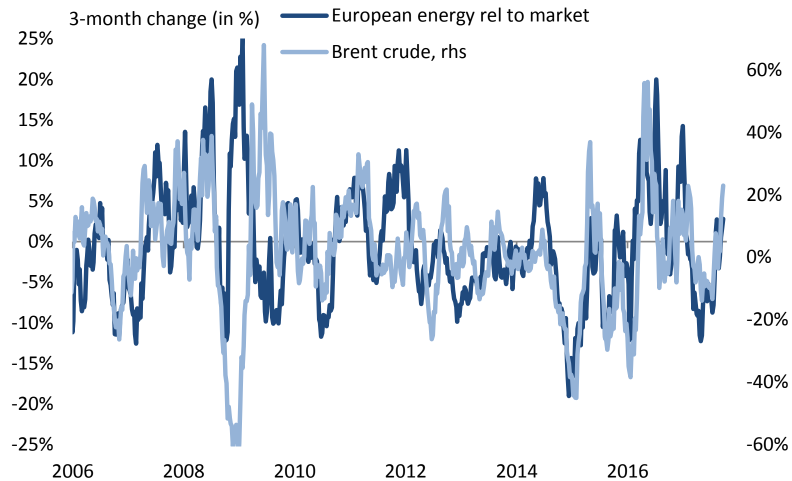
The 12-month forward P/E relative for European real estate (ex UK) has dropped back to its long-term average



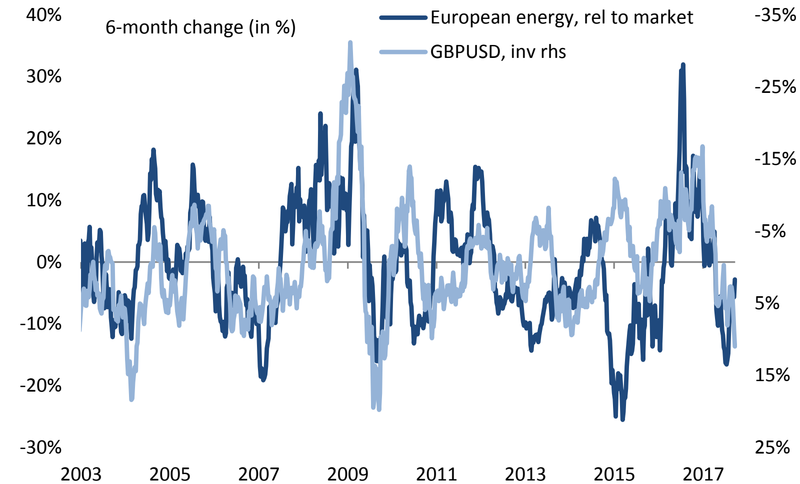
Source: Bloomberg Finance LP, Datastream, Deutsche Bank

Energy: reduced upside following the recent rally

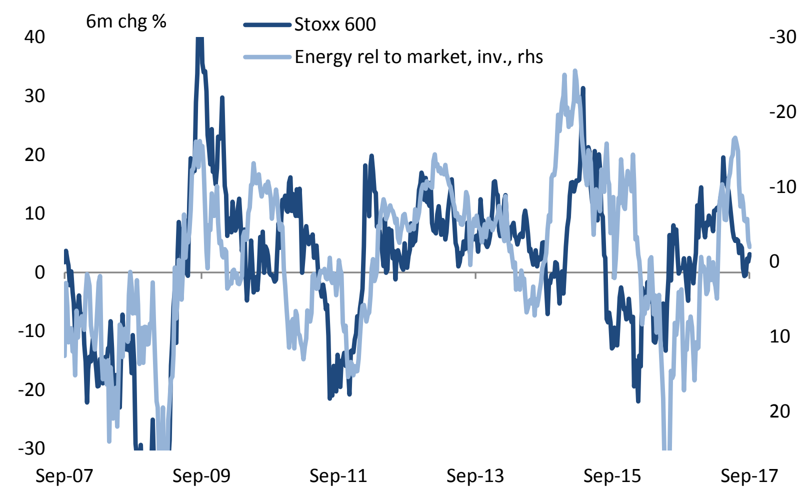
Energy's relative performance momentum has picked up on the back of rising oil price which still points to some further upside for the sector



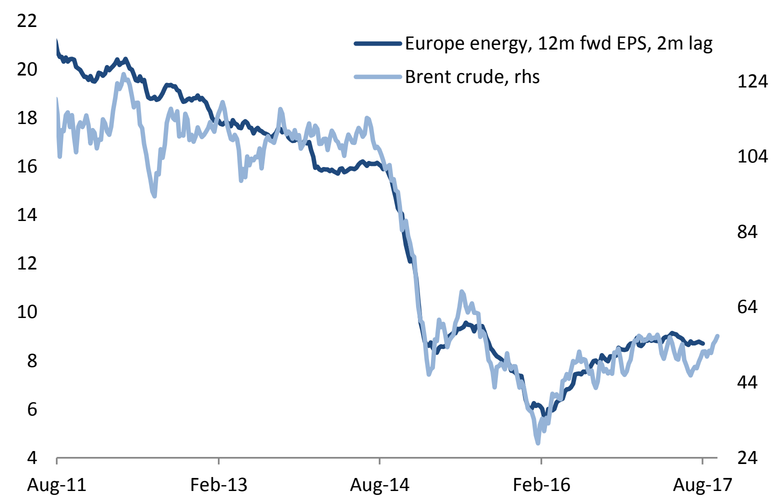
With 50% of energy market listed in the UK (compared to 30% for the market overall), energy's performance could benefit from renewed GBP weakness



Energy's relative performance has been helped by the pull-back in the European equity market – yet, we now expect the market to be flat into year-end



The current oil price suggests no further downside for consensus sector earnings



Source: Bloomberg Finance LP, Haver, Factset, Datastream, Deutsche Bank

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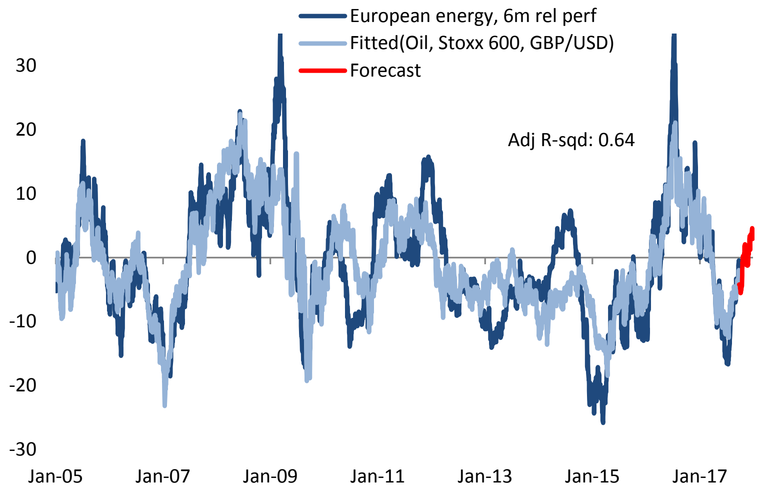
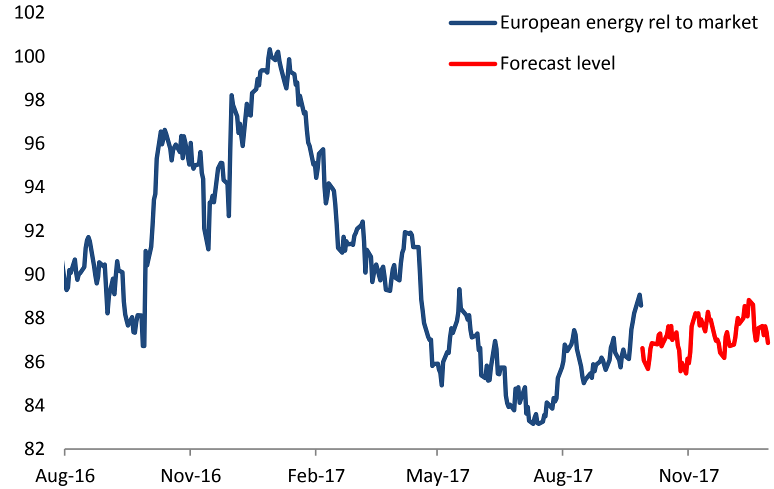
Energy: reduced upside following the recent rally

Our model explains energy's relative performance as a function of the oil price, the Stoxx 600 and GBP/USD



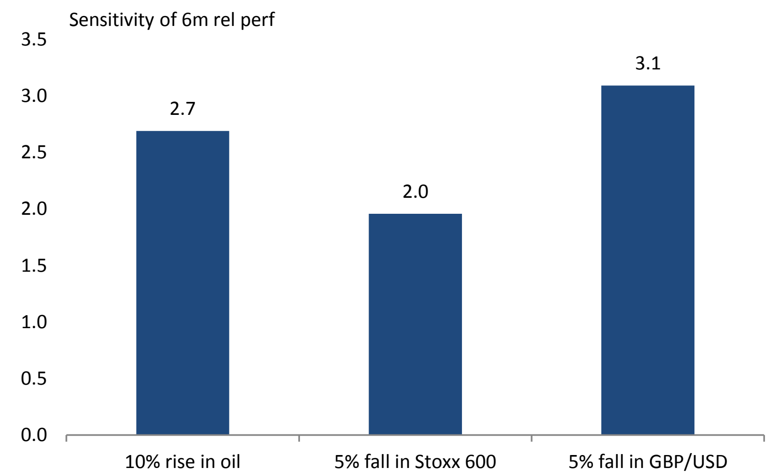
On level terms, our projected scenario for all input factors is now consistent with energy underperforming slightly into year-end



We expect Stoxx 600 to fall by 3%, while our strategists expect the oil price to fall by 5% & GBP/USD to drop by 4 % by year-end

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
oil	58	55	-5%	*5%*
Stoxx 600	386	375	-3%	*0%*
GBP/USD	1.34	1.29	-4%	*0%*
Constant				*-2%*
6 month performance by year-end				*3%*
Implied out/under-performance by year-end				**-1%**

Energy tends to outperform when the oil price rises, Stoxx 600 falls and GBP/USD falls



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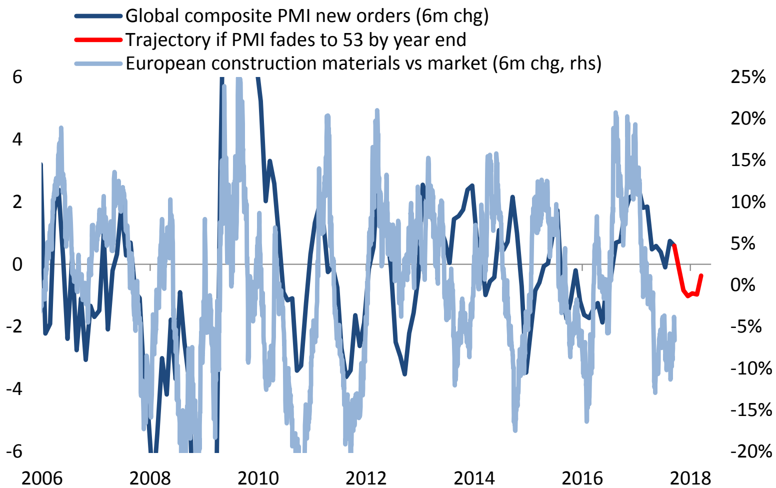
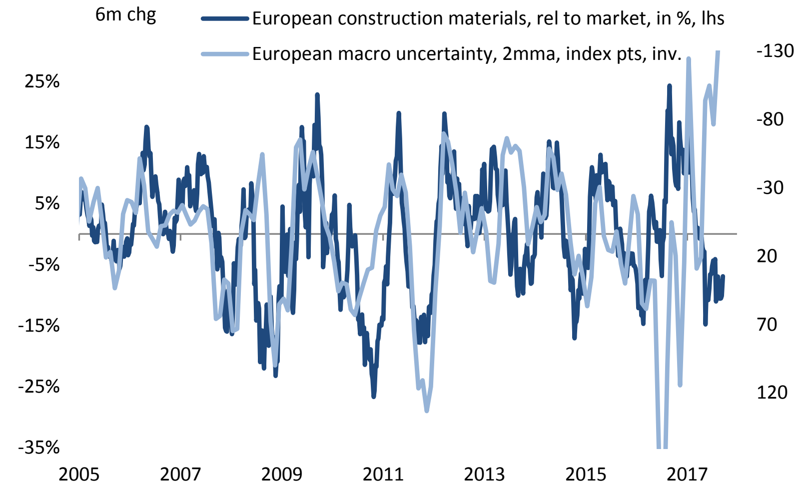
Construction materials: priced for an unduly pessimistic global growth scenario

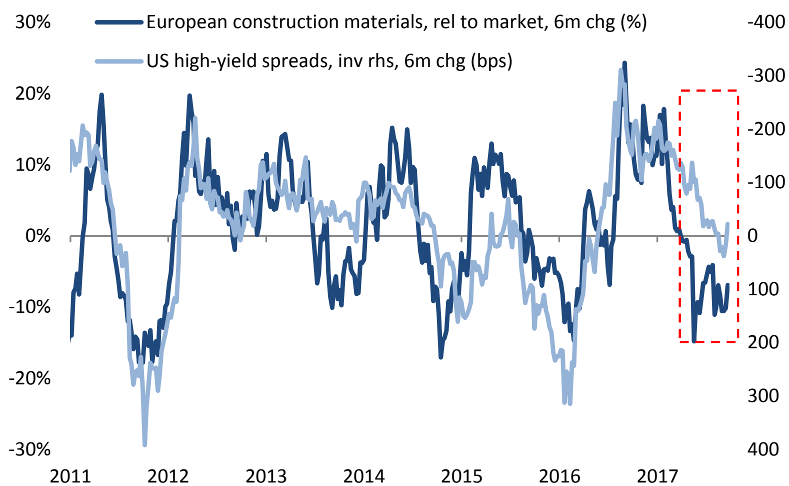
Construction materials are already priced for our envisaged slowdown in global growth momentum



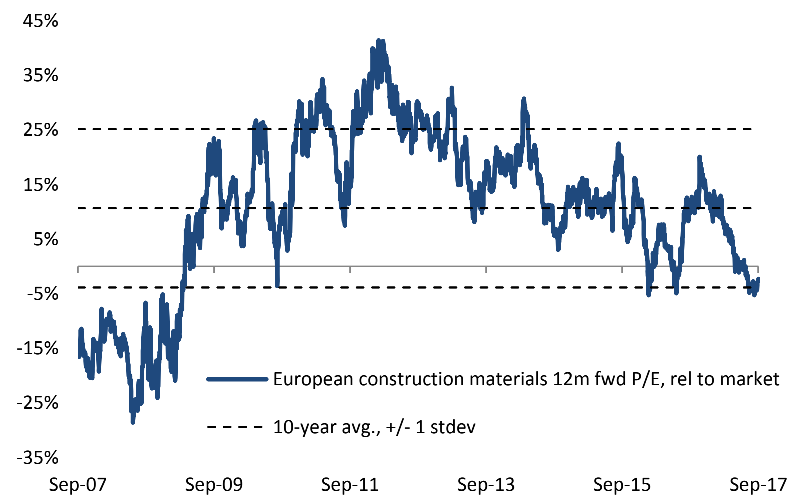
Construction materials should benefit from the recent drop in European macro uncertainty



The sector is discounting a further rise in US credit spreads, while our credit model suggest spreads are set to stay flat



Construction materials' relative P/E, at 3% discount to the market, is close to the lowest level since 2009



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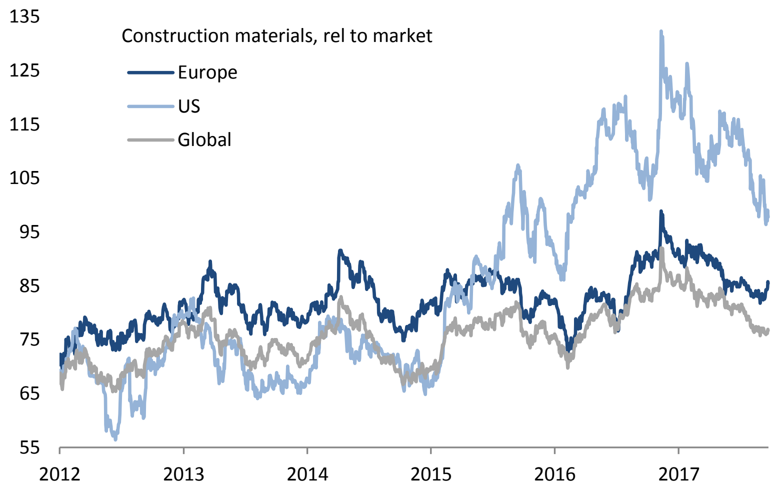
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

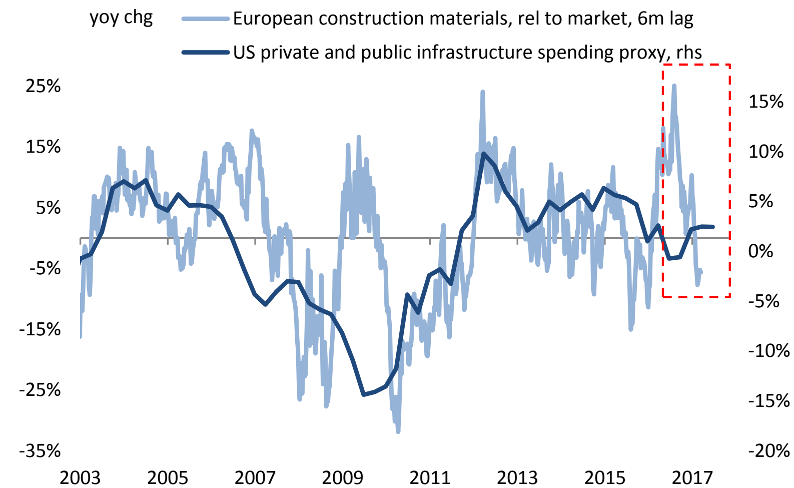
Overweight

Construction materials: priced for an unduly pessimistic global growth scenario

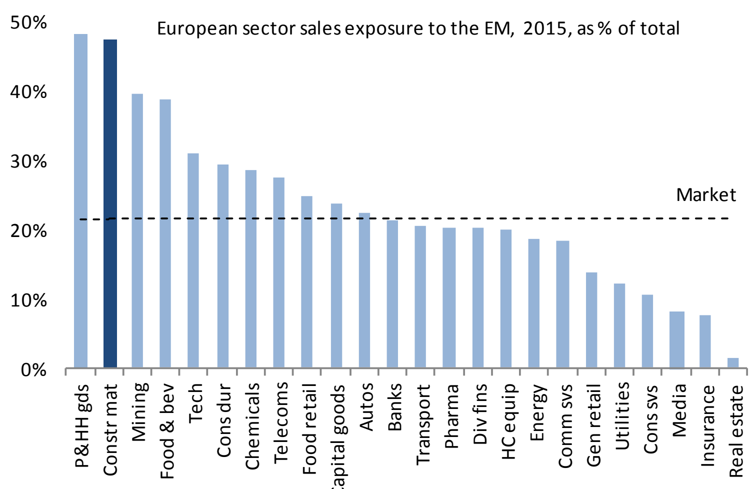
European peers have lagged the outperformance of US construction materials



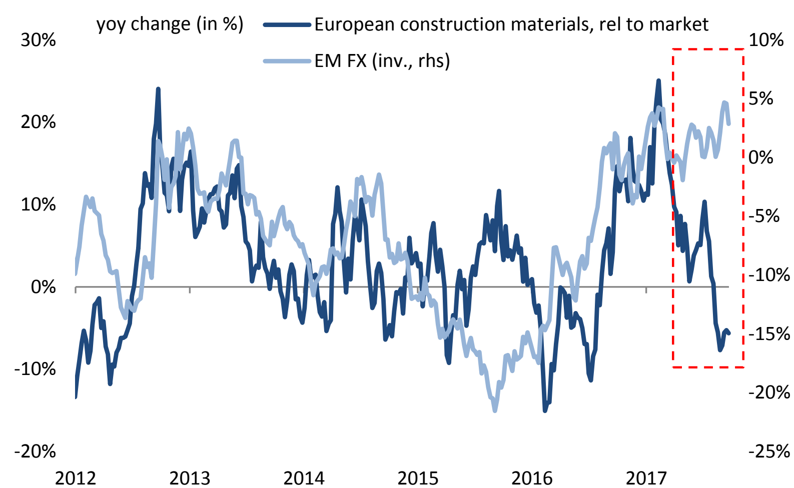
The sector is now priced for a fall in US infrastructure spending



Construction materials has the second highest EM exposure out of all sectors in Europe …



… but has underperformed despite a rebound in EM FX



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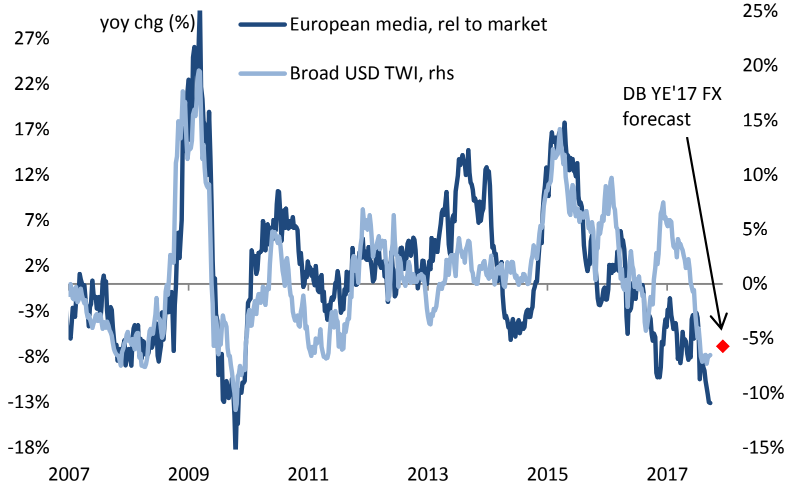
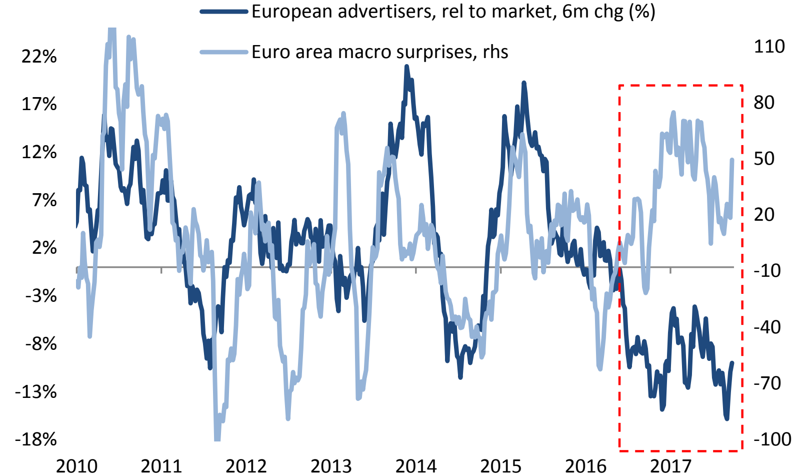
Media: should benefit from USD strength and EM weakness

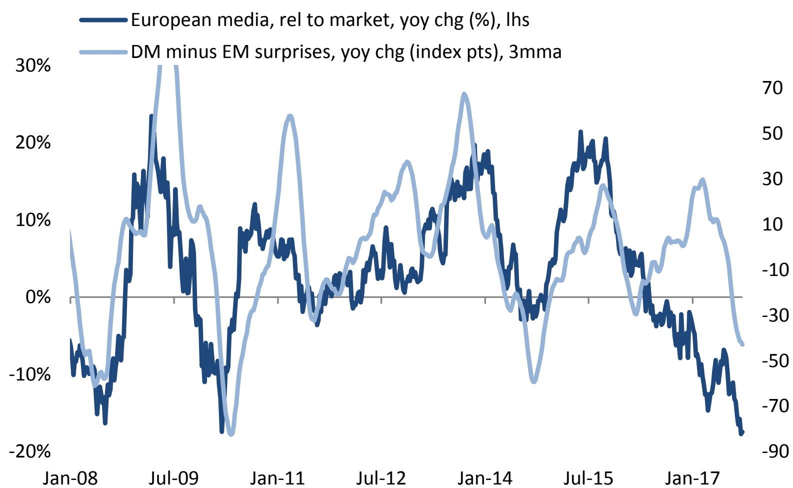
The European media sector should benefit if the dollar strengthens, as our FX strategists' expect it to



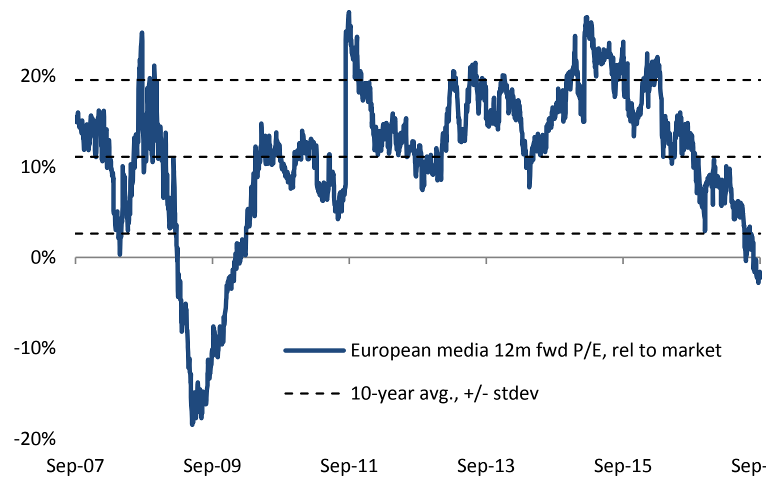
European advertisers have underperformed by around 10% over the past six months, significantly more than what would have been suggested by the move in Euro area macro surprises



Less than 10% of sector revenues come from emerging markets – and, as a consequence, media tends to benefit from DM strength relative to EM



The relative P/E for the sector has fallen to an eight-year low



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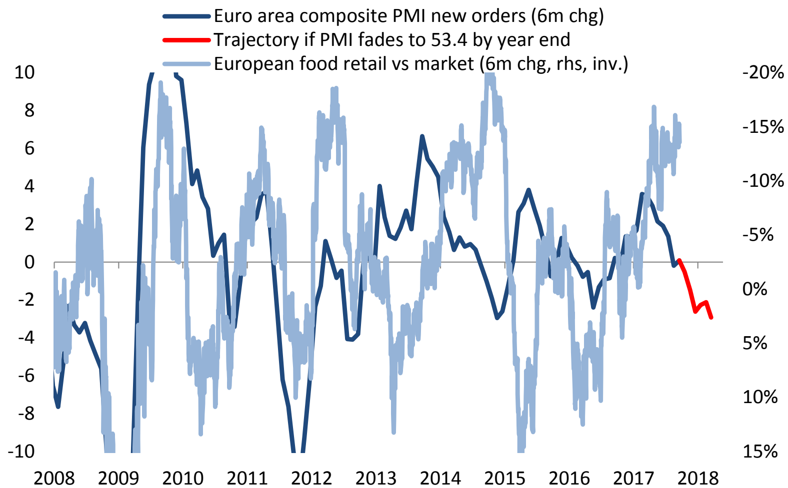
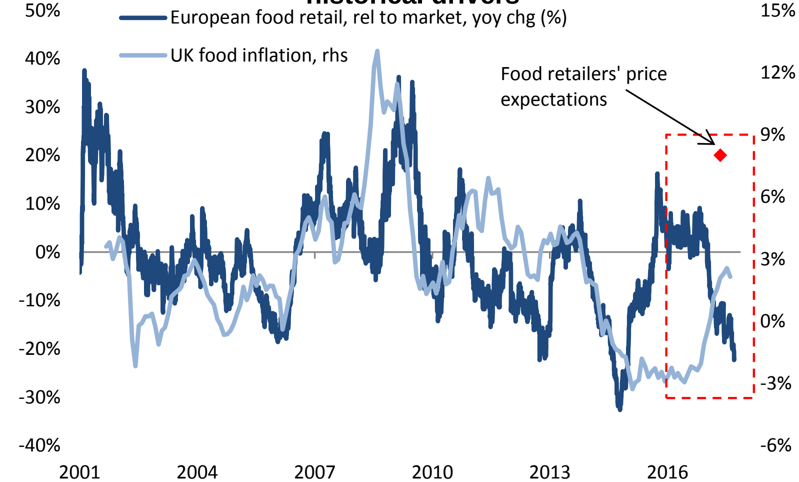
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Food retail: set to benefit from rising food inflation in the UK

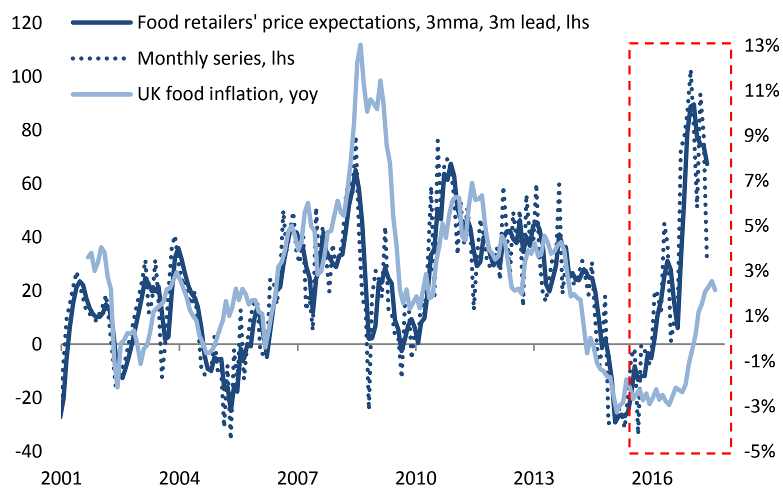
European food retail's relative price momentum has upside given our expectations of a continued roll-over of Euro area PMIs



Food retail's relative price momentum has dropped below the level suggested by current UK food inflation, one of the sectors' key historical drivers



UK food inflation has risen to 2.1% yoy in August, and industry expectations are pointing to further upside



Food retail's P/E relative is close to a three-year low and one standard deviation below the 10-year average

Source: Bloomberg Finance LP, Datastream, Haver, Deutsche Bank

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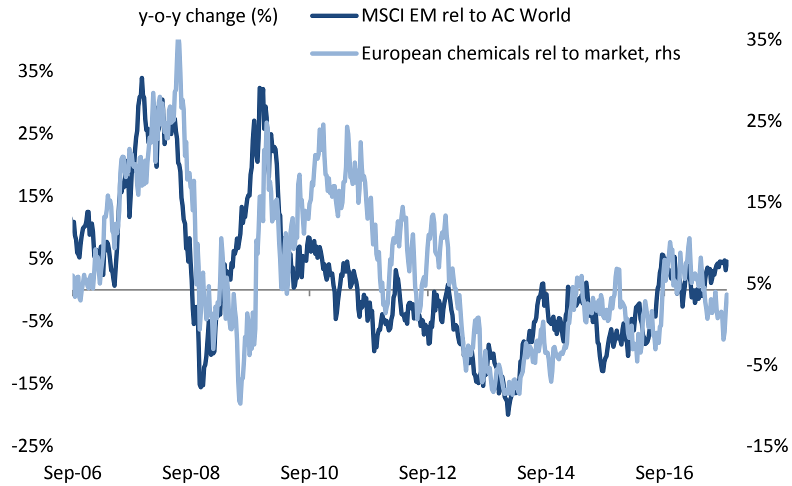
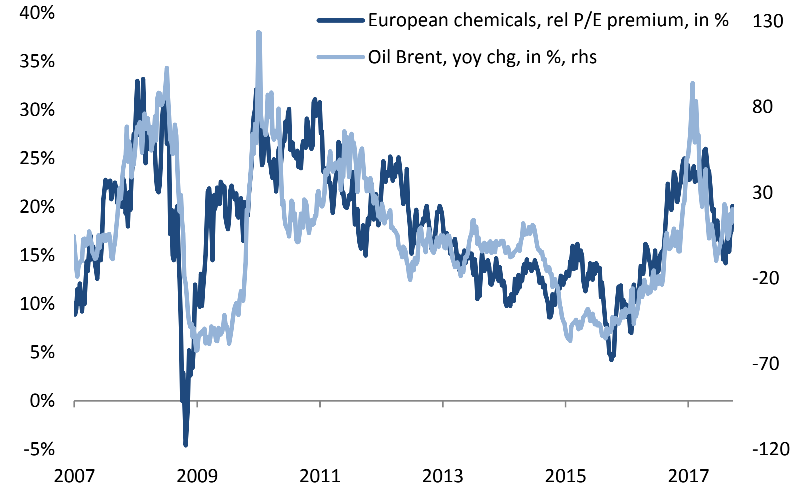
Chemicals: bottom-up conviction offsets diminished support from EM and oil

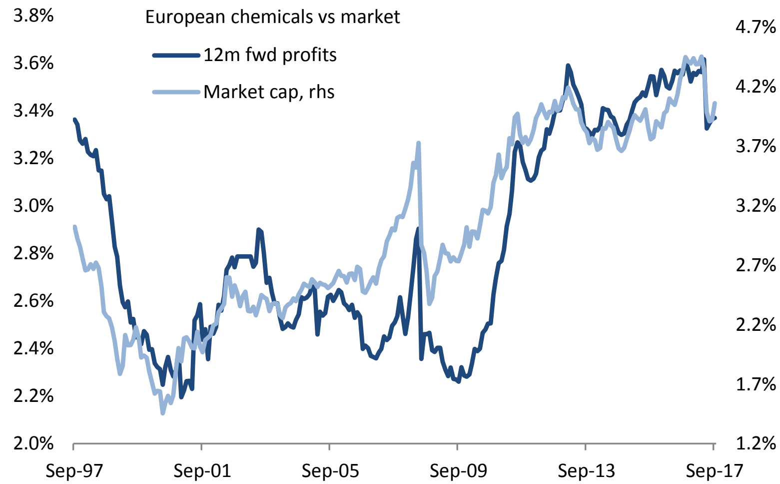
One third of sector revenues come from emerging markets, leading the sector to follow EM equities' relative performance, for which our model suggest downside until year-end



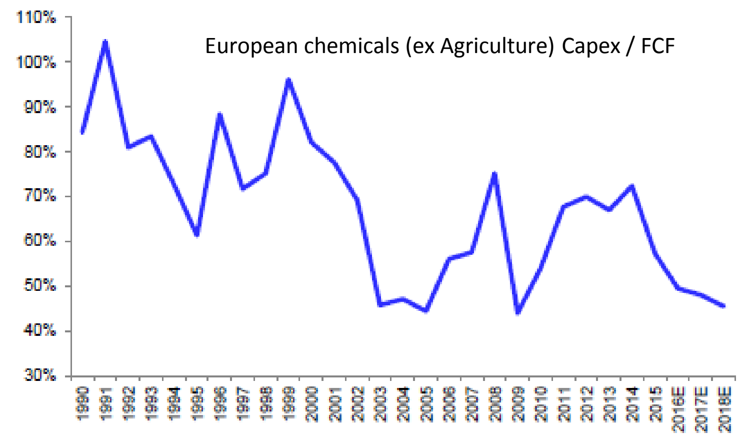
Chemicals' relative P/E rose in line with last year's strong increase in the oil price, the effect of which is now fading



Chemicals' relative earnings are still close to at an 18-year high, suggesting that further upside potential is limited



We expect the support from EM performance to fade, though bottom-up drivers (M&A, self-help, capacity discipline) should offset this



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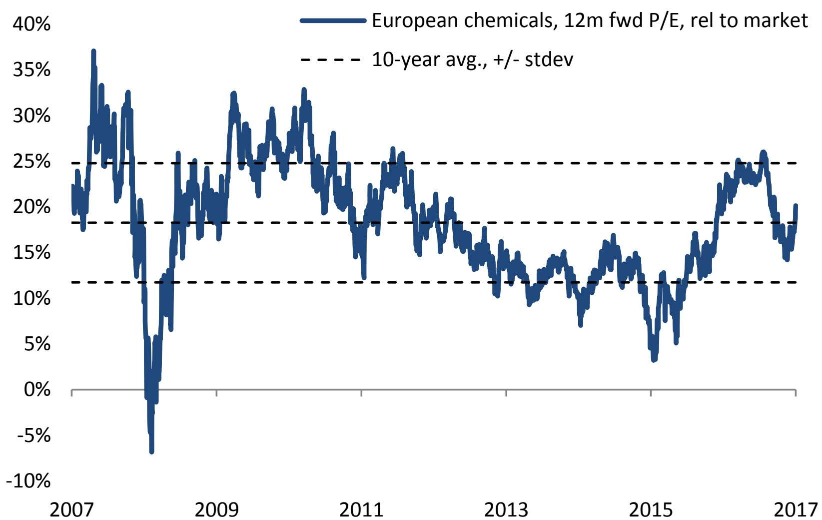
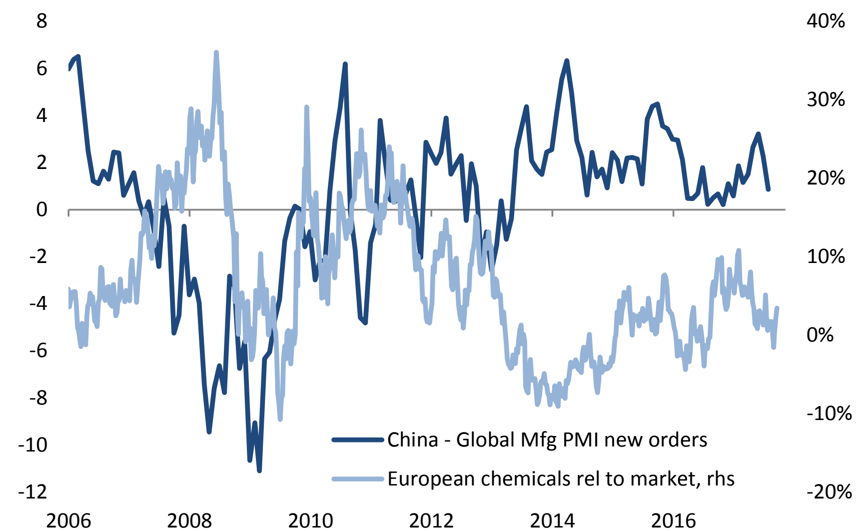
Chemicals: bottom-up conviction offsets diminished support from EM and oil

The sector's P/E premium is at 20%, slightly above its 10-year average



Although the sector is sometimes perceived as a China-specific play, there is no clear relationship of performance with China macro indicators



Source: Bloomberg Finance LP, Datastream, Deutsche Bank

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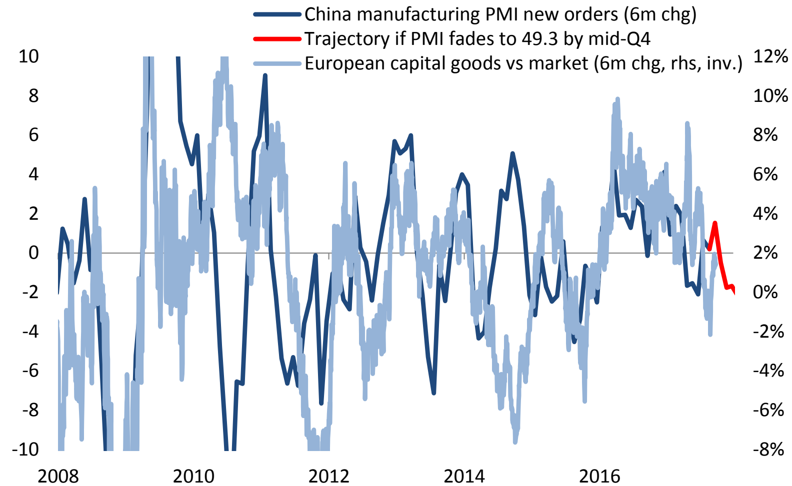
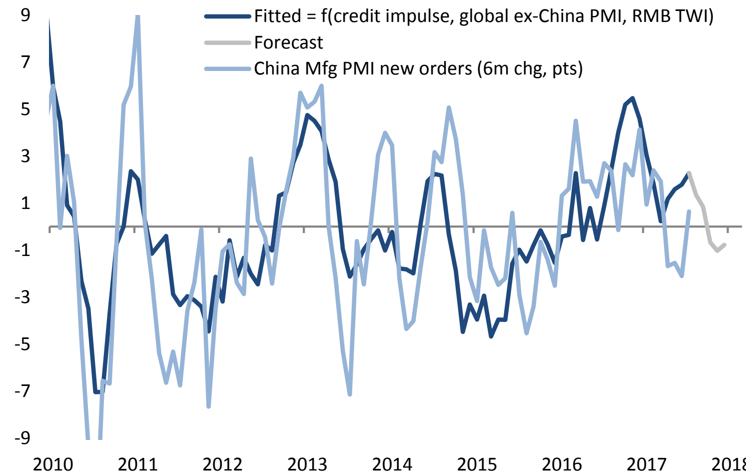
Capital goods: already priced for significant China macro weakness

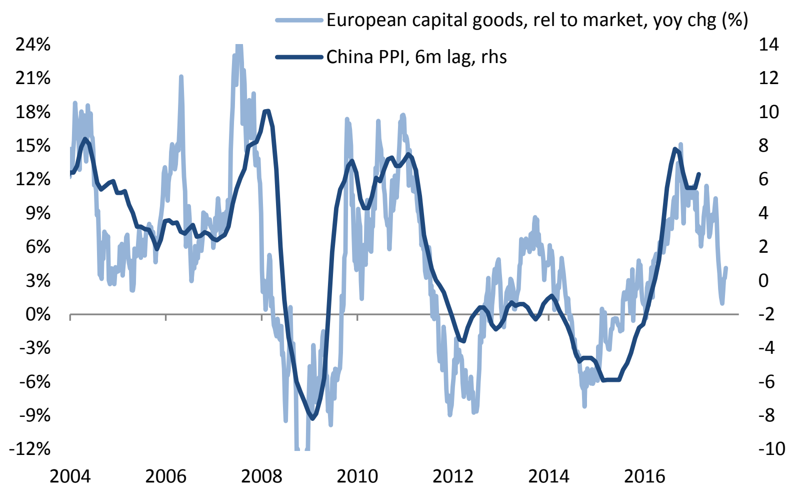
After capital goods' recent underperformance, the sector has no further downside despite our expected fade for China manufacturing PMIs



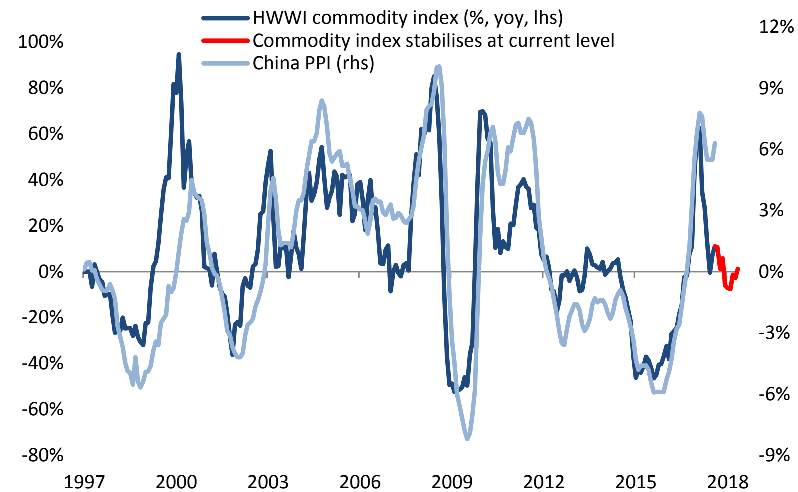
We expect China manufacturing PMIs to fall over the coming months, on the back of a renewed fade in the China credit impulse



Capital goods are already priced for Chinese PPI inflation to turn negative …



… while the current level of commodity prices implies that it will trough at around 0%



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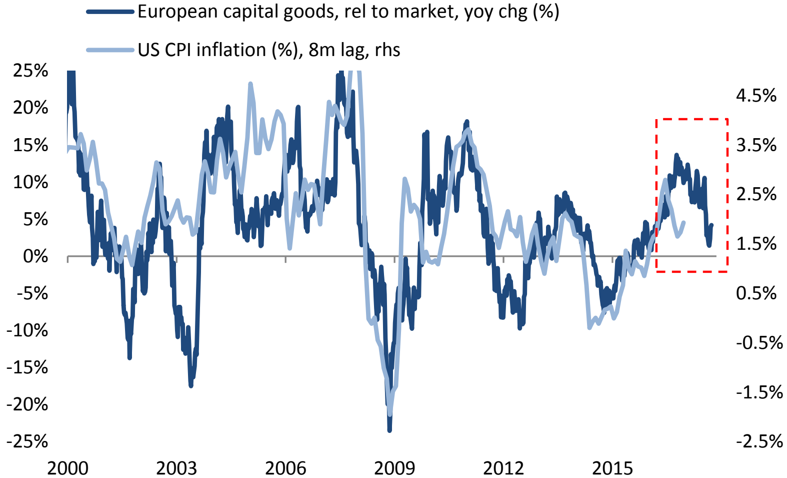
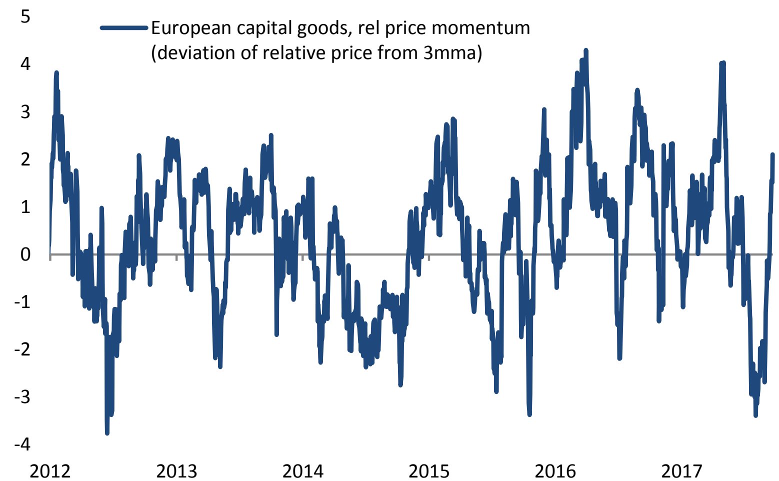
Capital goods: already priced for significant China macro weakness

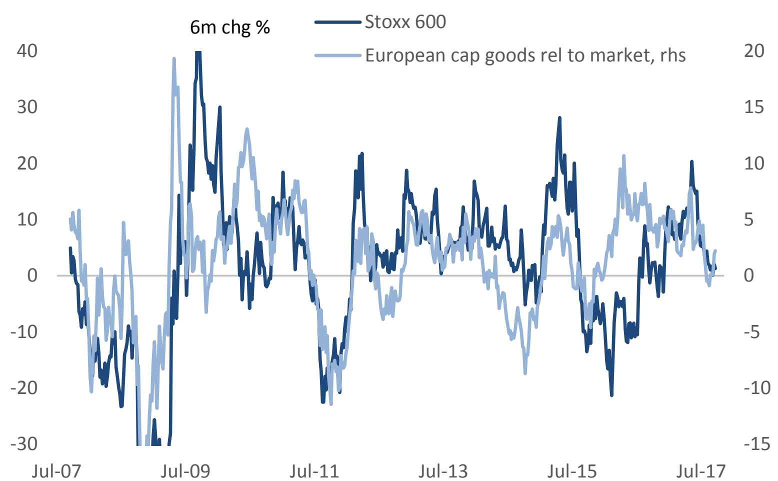
European capital goods are already priced for US CPI inflation to fall to 1.9%, while the recent improvement in the oil price points to ~2.5%



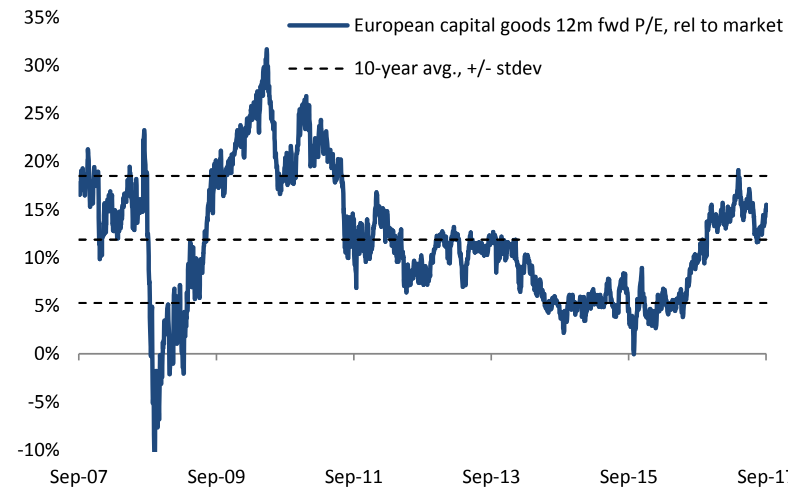
Capital goods' price momentum has rebounded from a 5-year low



Capital goods tend to underperform during periods of falling equity markets – but we now expect the market to be flat into year-end



Capital goods' relative P/E is half a standard deviation above its long term average



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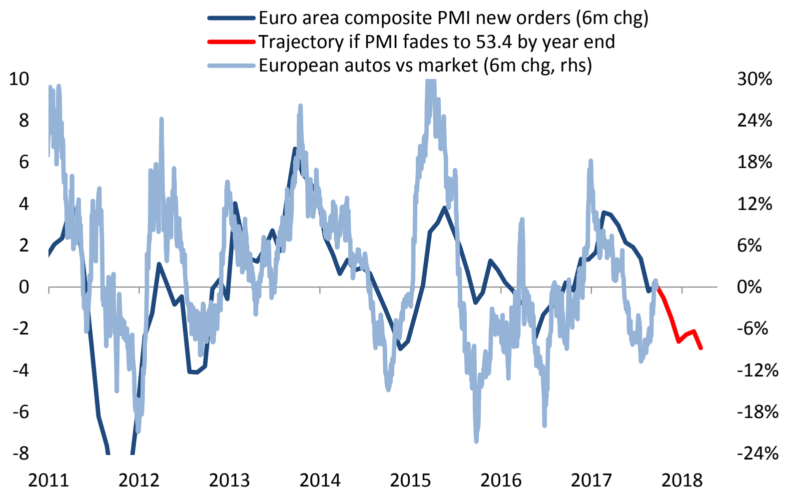
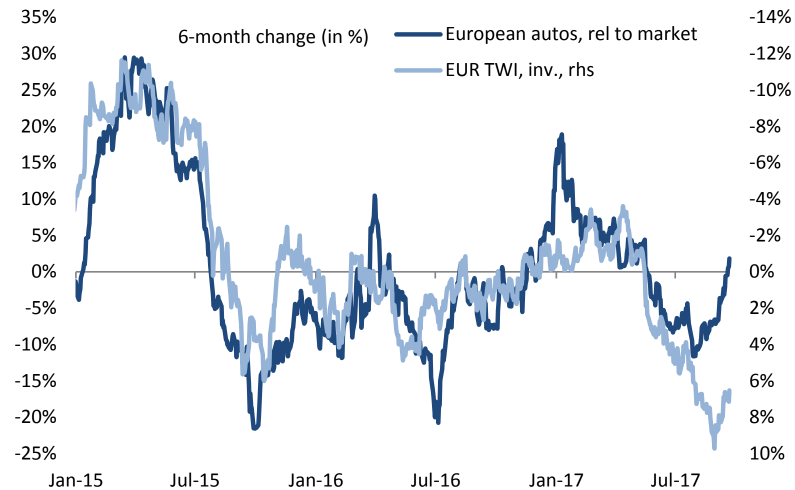
Autos: attractively valued, but weaker PMI momentum is set to weigh

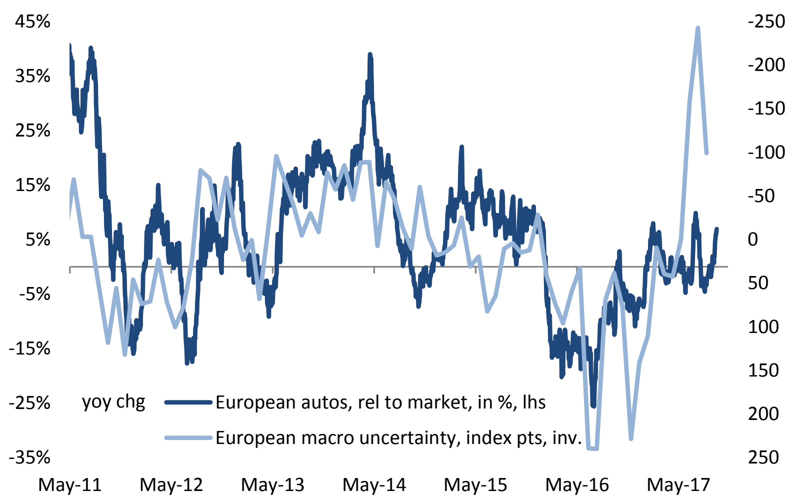
Our projection for fading Euro area PMI momentum still points to downside for autos' relative performance



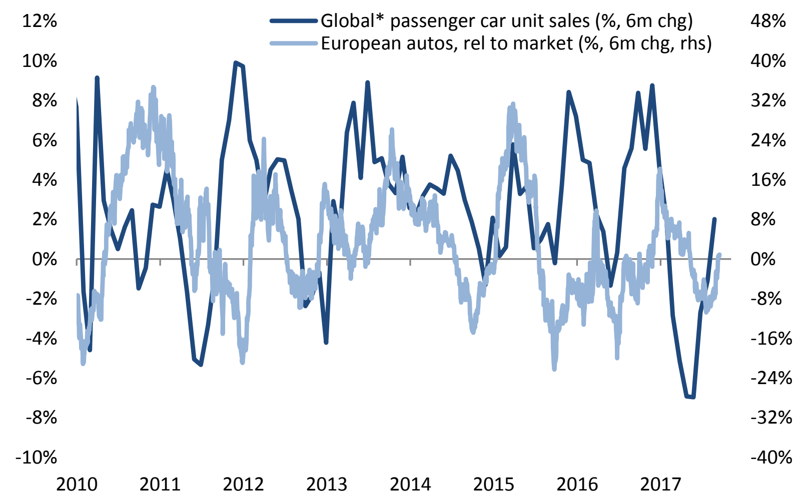
Autos' have managed to outperform despite the rise in the euro



On the positive side, the sector has not yet priced the recent decline in the European macro uncertainty indicator



Global car sales have recently rebounded, but there has historically only been a loose relationship with autos' performance



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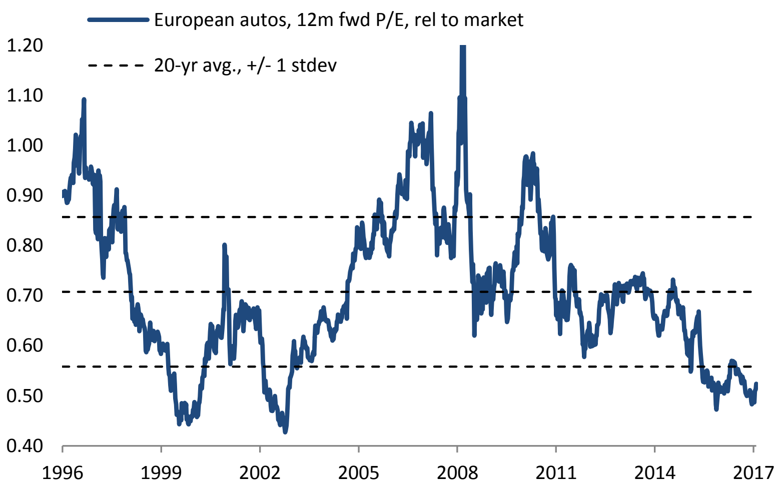
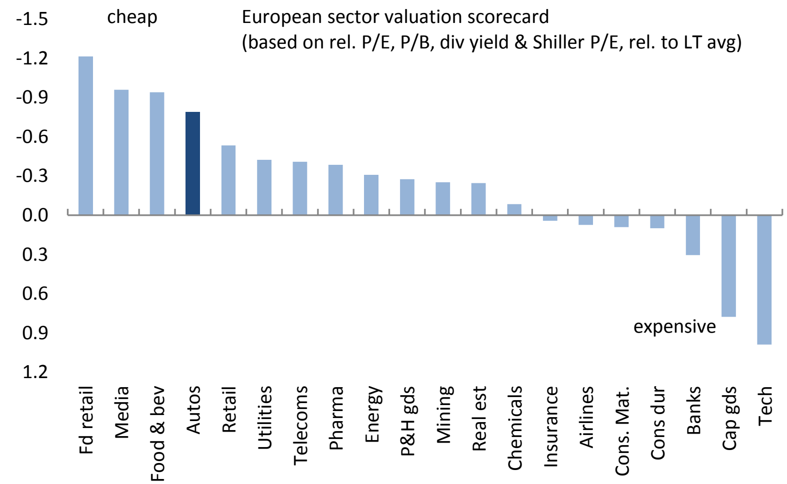
Autos: attractively valued, but weaker PMI momentum is set to weigh

Autos' valuations look attractive, with the relative P/E at a 14-year low…

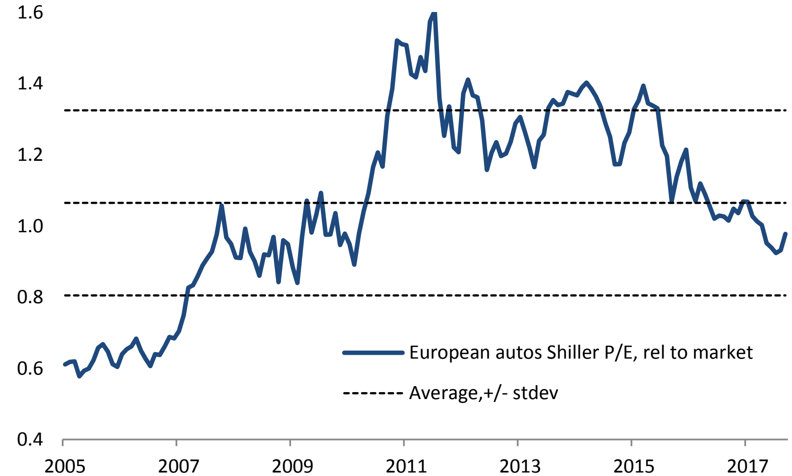


…making autos the fourth-cheapest sector on our valuation scorecard



Autos' share of market earnings have never been higher over the past 20 years

On relative Shiller P/Es (adjusting for the earnings cycle), autos are trade on a seven-year low



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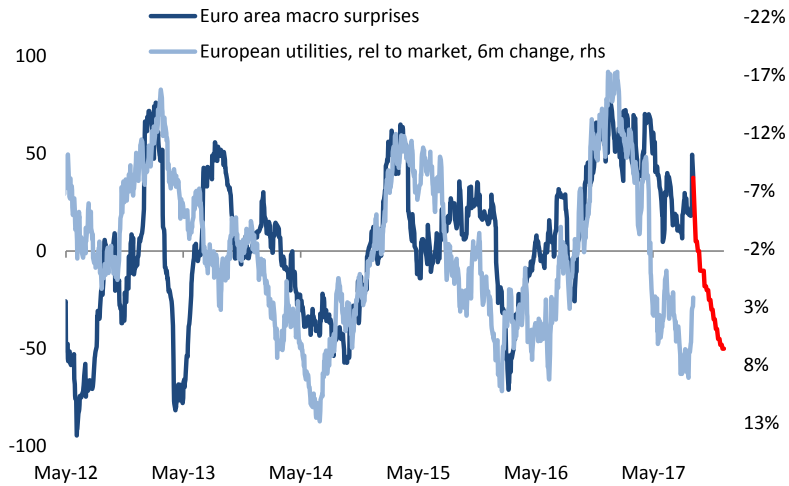
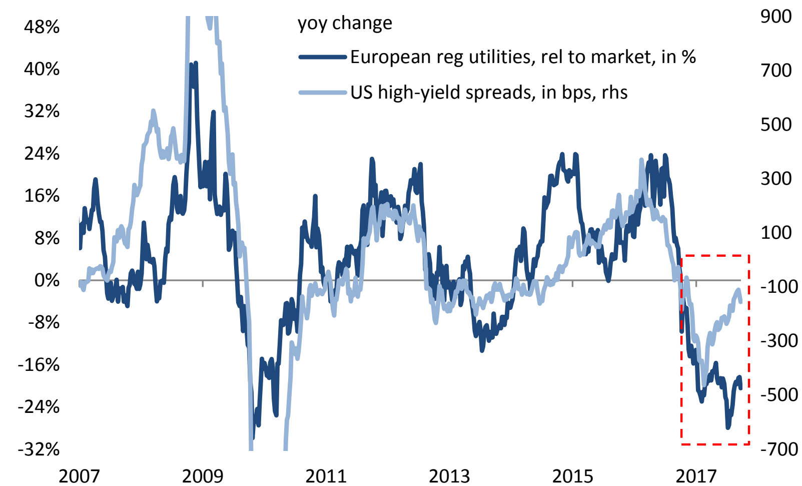
Utilities: already priced for weakening Euro area macro momentum

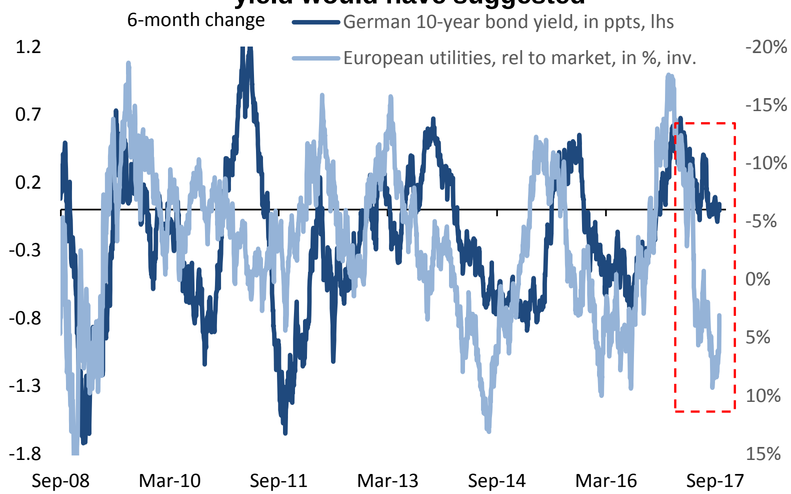
European utilities' relative performance is already priced for Euro area macro surprises to turn negative over the coming months



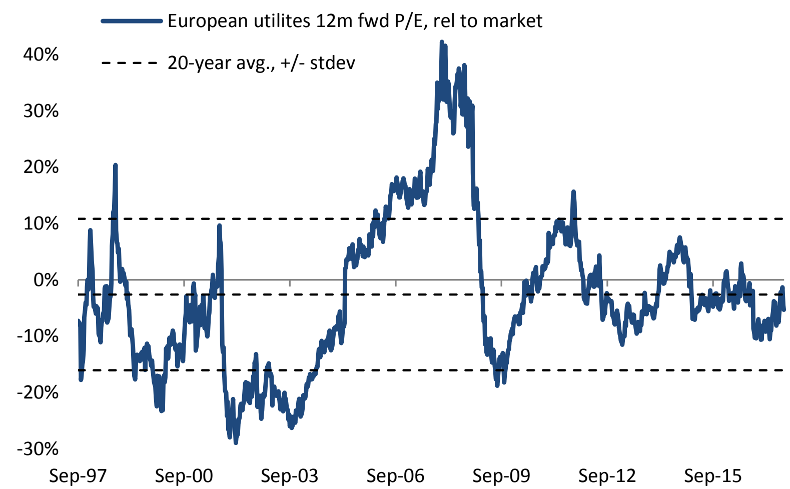
Regulated utilities (1/4 of sector market cap) are priced for a further sharp fall in US high-yield spreads, while our models project flat spreads



The sector tends to move inversely to bond yields, but has recently performed better than its relationship with the German 10-year bond yield would have suggested



Utilities' P/E is trading close to that for the market, leaving the relative P/E in line with the 10-year average



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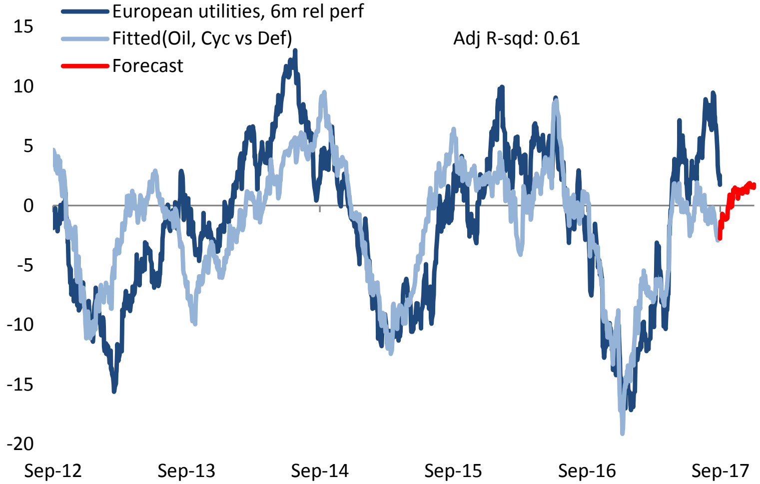
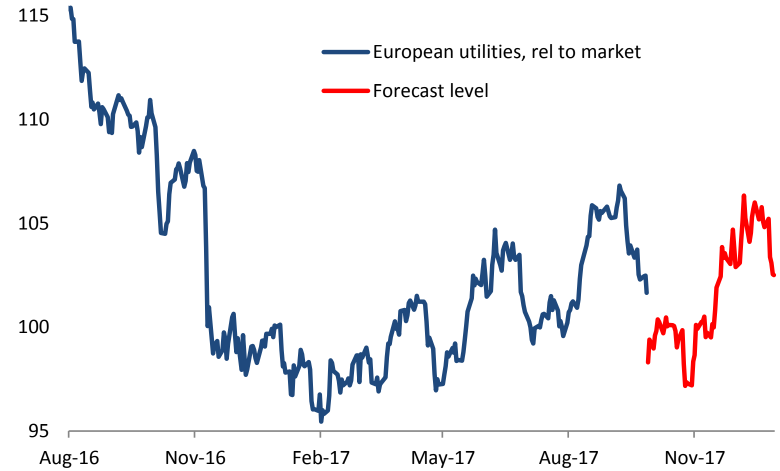
Utilities: already priced for weakening Euro area macro momentum

Our regression model explains European utilities' relative performance as a function of the oil price and European cyclicals versus defensives



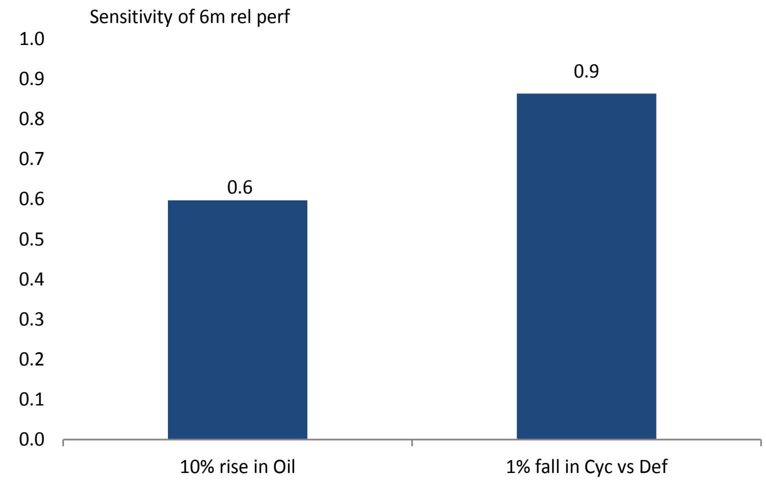
Our projected scenario for oil and European cyclicals vs defensives would be consistent with utilities outperforming around 1% by year-end



Our analysts expect 5% downside for the oil until year-end, while our model suggests defensives are set to outperform cyclicals

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Oil	58	55	-5%	*1.0%*
Cyc vs Def	84	80	-5%	*0.7%*
Constant				*0.0%*
6 month performance by year-end				*1.8%*
Implied out/under-performance by year-end				**0.8%**

European utilities tend to outperform when oil rises and when European cyclicals underperform defensives



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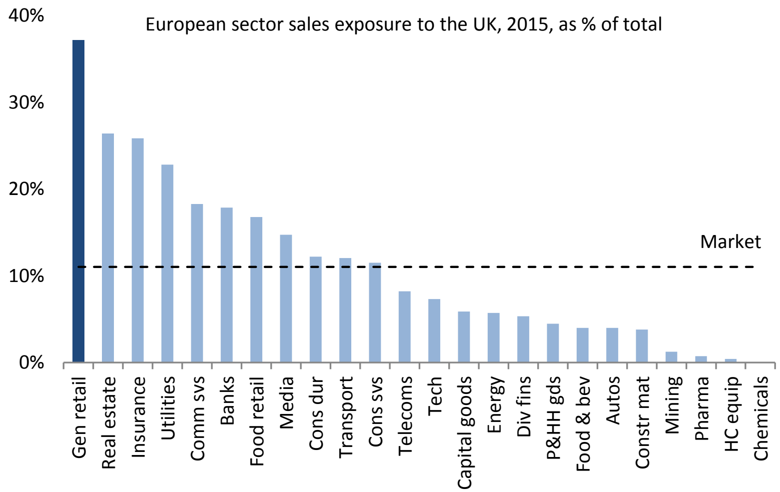
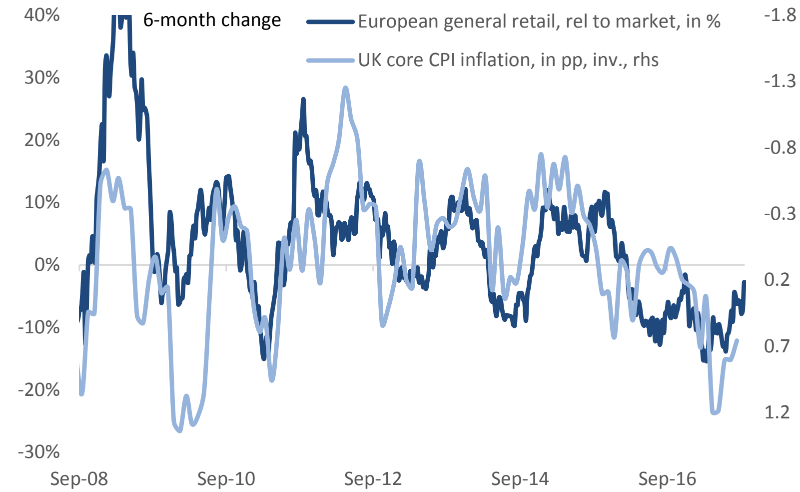
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

General retail: high UK exposure poses downside risk

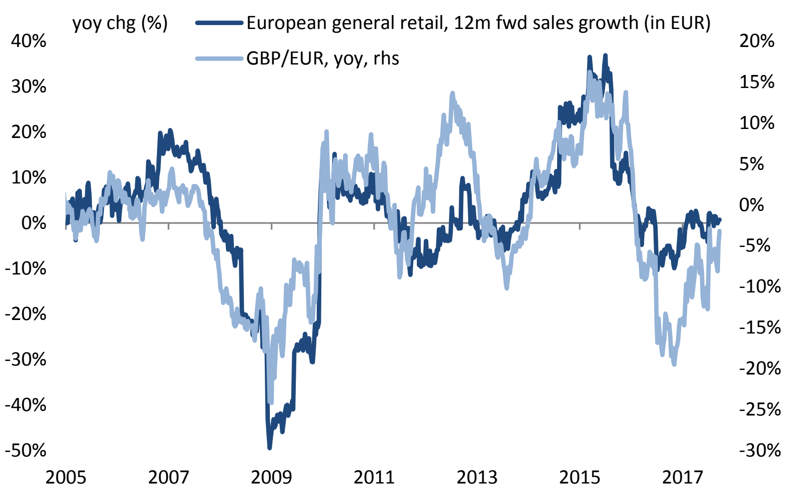
With more than 35%, European (non-food) retailers has the highest sales exposure to the UK among all sectors



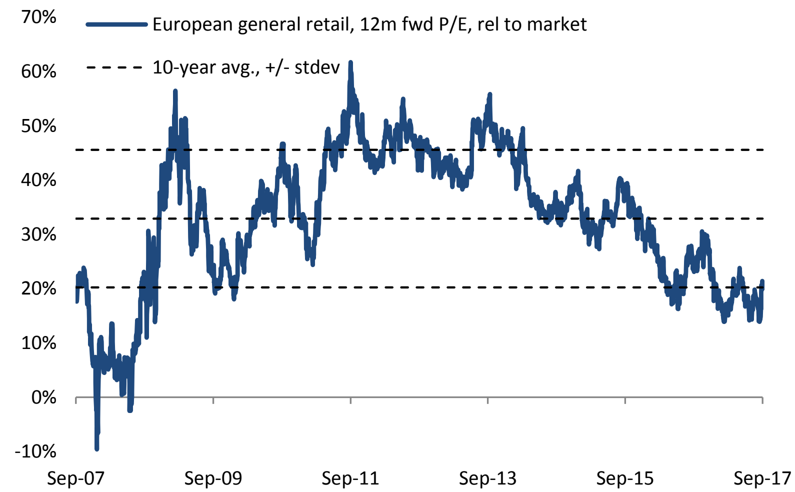
General retail's price momentum tends to move inversely to changes in UK core inflation, and the latter could see upside given past GBP weakness



Yet, after its recent rise, Sterling no longer points to downside for retail sales growth



Retail's large sales exposure to the UK makes it vulnerable to any slowing in UK household spending growth, reflected in relative P/Es close to an 8-year low



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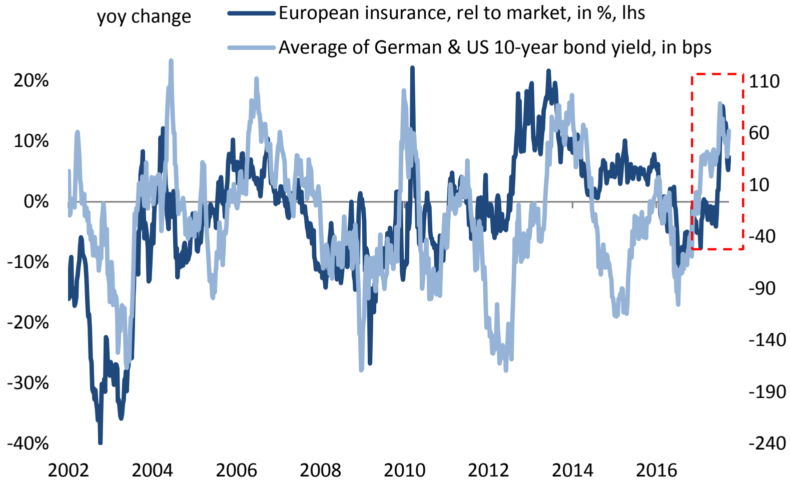
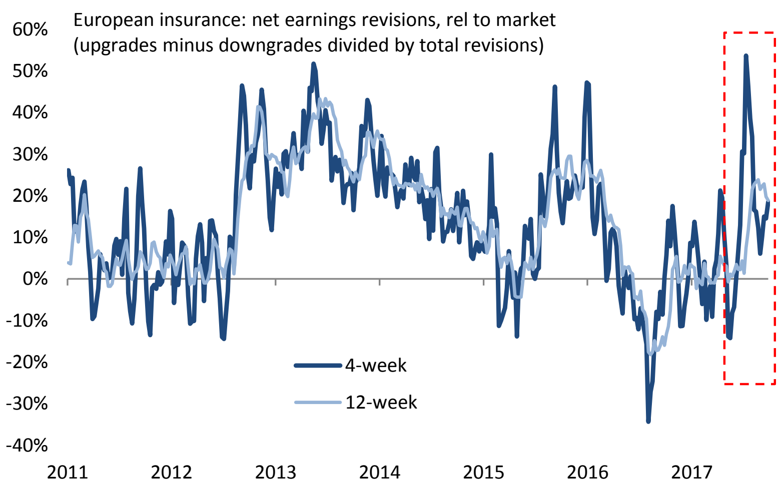
Insurance: fading growth momentum is set to weigh

Relative performance for European insurers has faded on the back of a turn in bond yield momentum, and we believe yields will likely struggle as long as growth momentum is fading

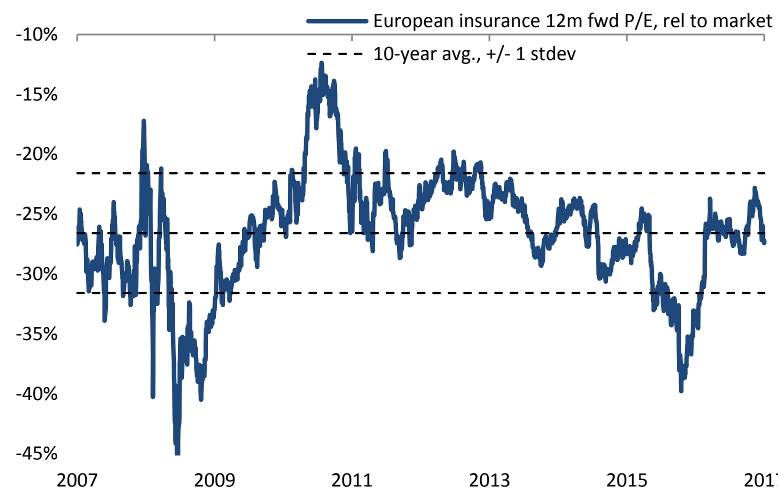


The price relative of insurance, a domestic sector, also to move inversely to the relative performance of emerging markets, but insurers have held up better than the recent EM rally would have suggested

Relative earnings revisions for the sector (defined as the ratio of upgrades to downgrades) have fallen sharply from a recent six-year high



Insurance is trading on a 27% P/E discount to the market, which leaves the relative P/E in line with its 10-year average



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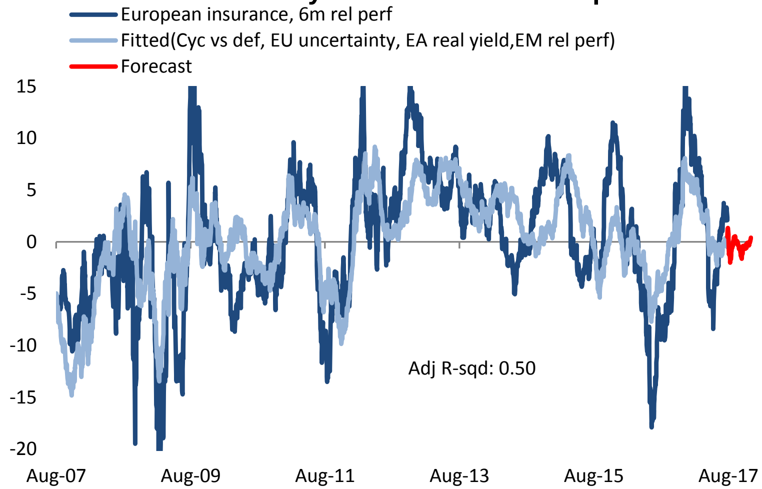
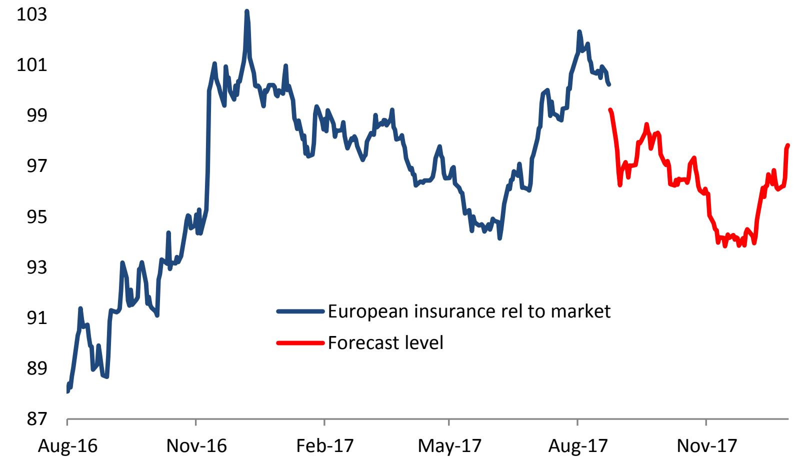
Insurance: fading growth momentum is set to weigh

Our regression model explains European insurance's relative performance as a function of European cyclicals versus defensives, EU macro uncertainty, Euro area real bond yields and EM relative performance



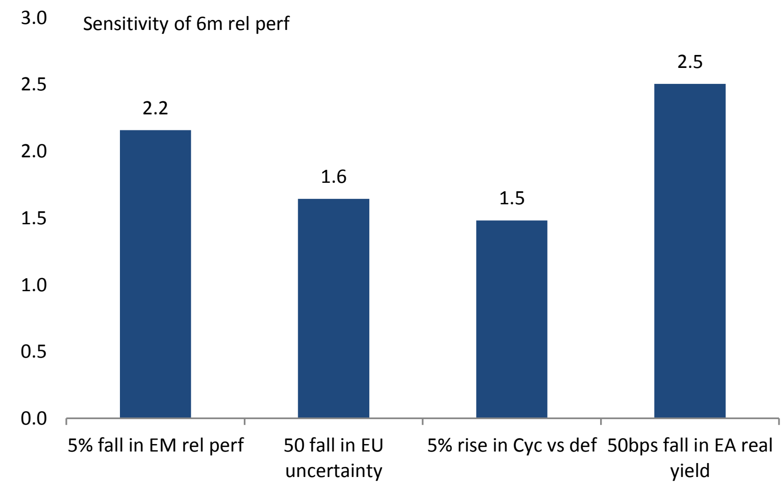
Our projected scenario points to around 2% downside for insurance's price relative by year-end



We expect defensives to outperform cyclicals, uncertainty to fall, real bond yields to rise and emerging markets to underperform relative to global

Model parameters	Level: Current	Level: Year-end forecast	Change Year-end vs current	*Impact on 6m perf by yr-end*
EM rel perf	109	101	-7%	*1.0%*
EU policy uncertainty (3mma)	190	175	-15	*1.6%*
Cyc vs def	84	80	-5%	*-1.3%*
EA real yield	-49	-14	36	*-1.5%*
Constant				*-0.1%*
6 month performance by year-end				*-0.3%*
Implied out/under-performance by year-end				**-2.0%**

Insurance tends to outperform when European cyclicals outperform defensives, uncertainty falls, real bond yields fall, and EM underperforms



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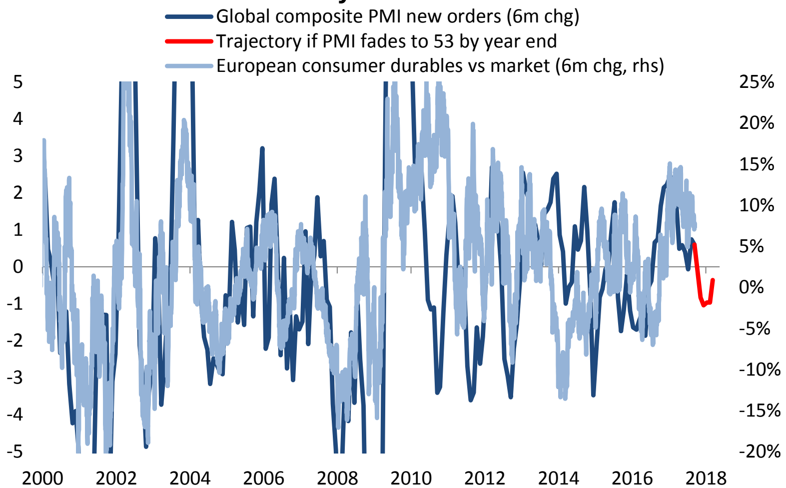
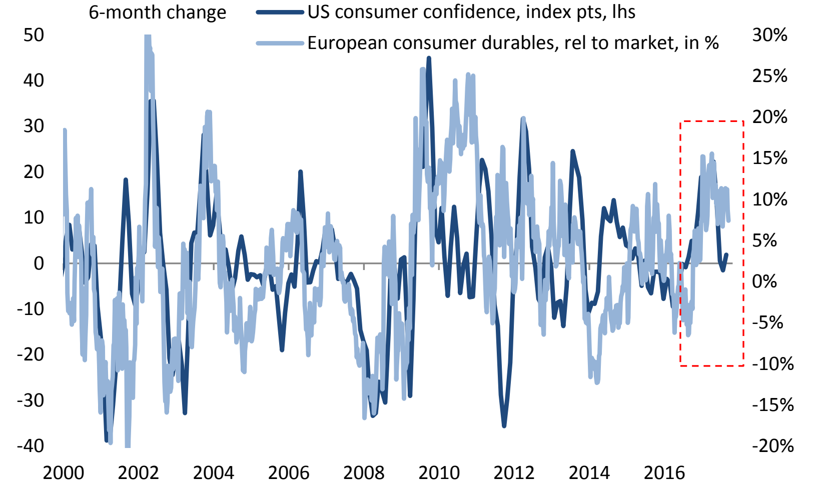
Consumer durables: not yet priced for fading global macro momentum

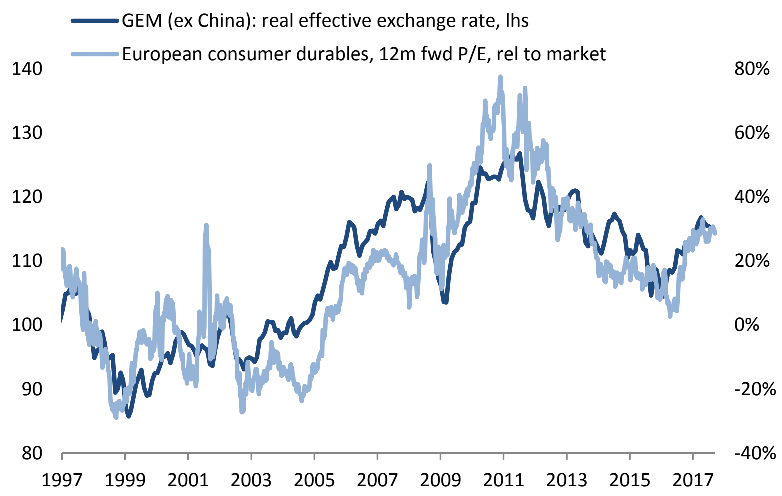
European consumer durables' relative price momentum has further downside given our expectation of fading global PMI momentum into year-end



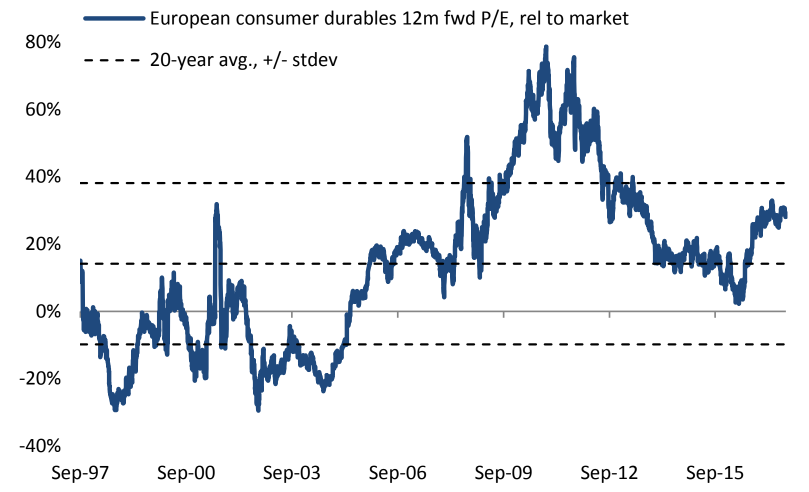
Consumer durables have outperformed in line with the post-election rebound in US consumer confidence to a 17-year high, but has yet to react to its recent fade



Consumer durables' relative P/E has risen on the back of strengthening EM FX, helped by a softer US dollar



The sector's P/E relative, at a 29% premium to the market, is close to one standard deviation above its long-term average



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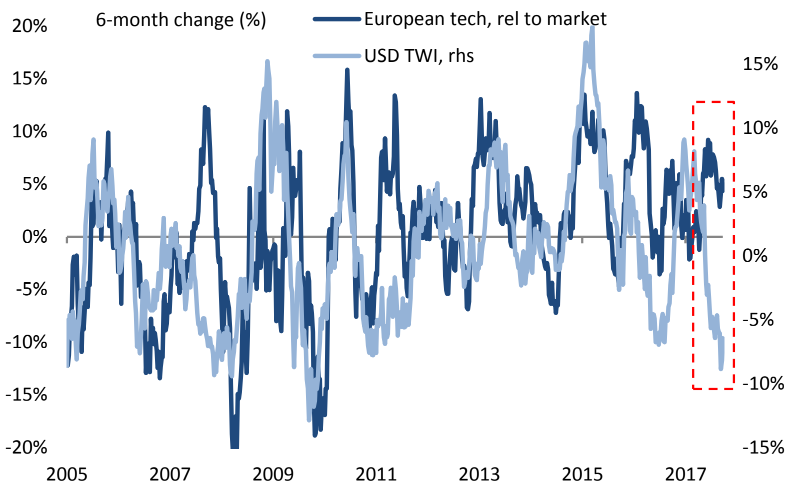
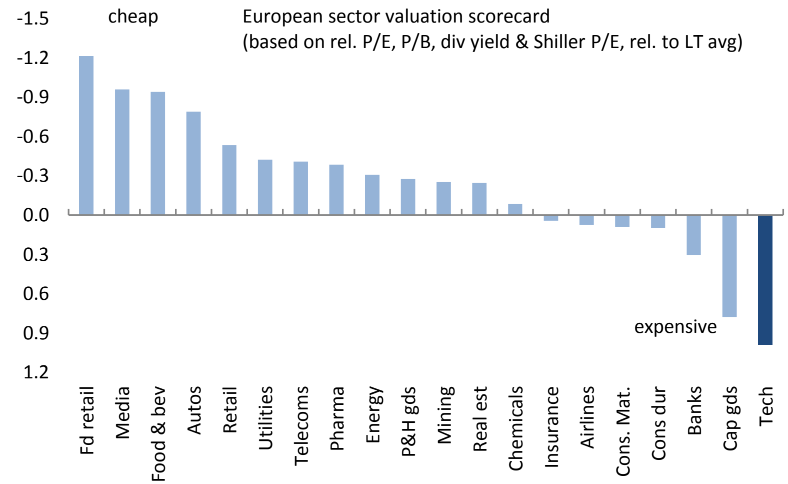
Tech: not yet priced for a weaker dollar and softer US macro data

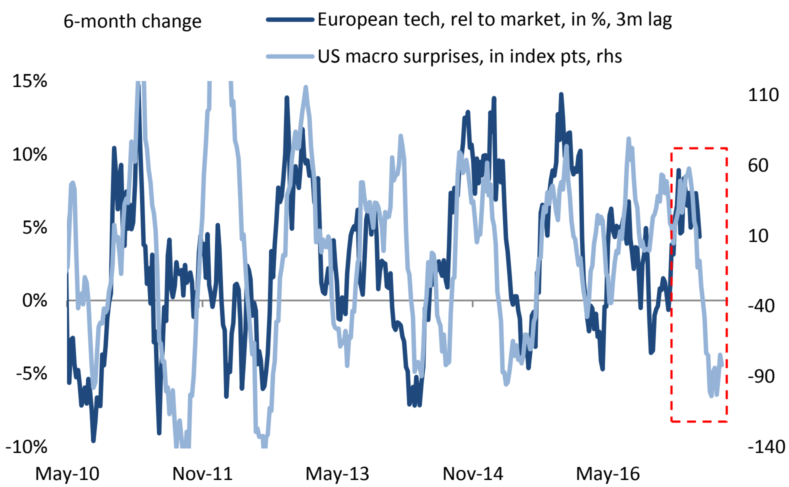
Tech's relative performance has not yet reacted to the recent USD weakness



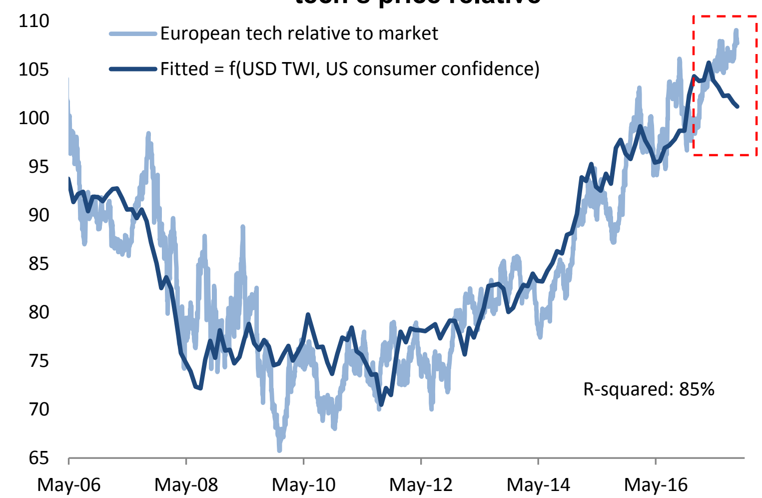
Tech ranks as the most expensive sector on our European sector valuation scorecard (because of an elevated relative Shiller P/E)



European tech's relative performance has yet to reflect the drop in US macro surprises



After the rally over the past months, our fair-value model (based on the USD and US consumer confidence) now points to 6% downside for tech's price relative



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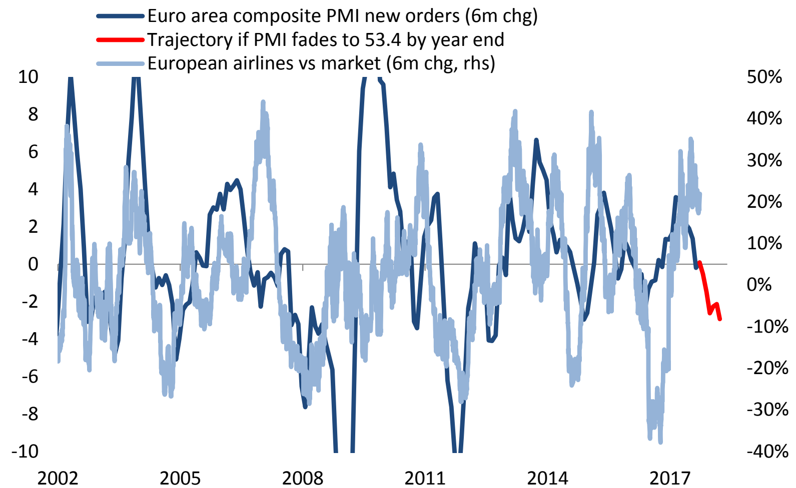
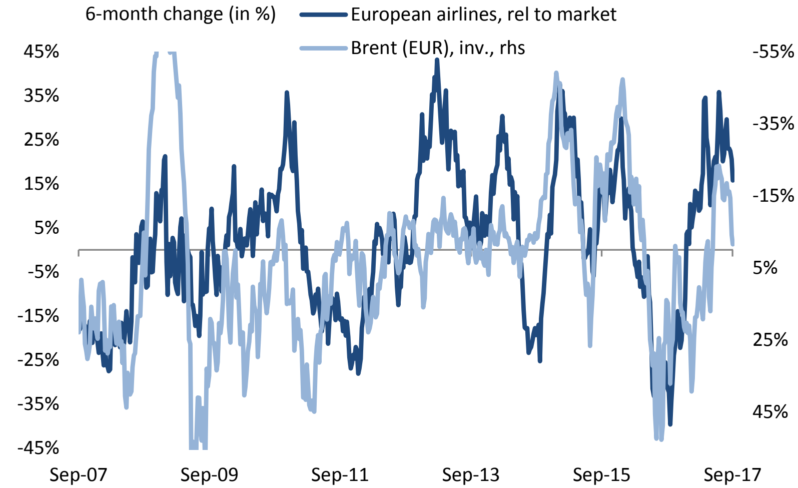
Airlines: downside in response to a stronger oil price and softer PMI momentum

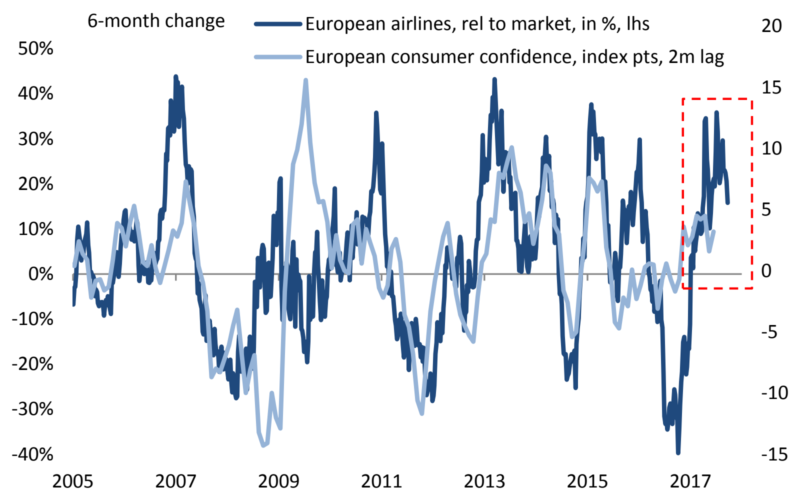
We expect Euro area PMI momentum to turn negative over the coming months, which would be consistent with airlines underperforming



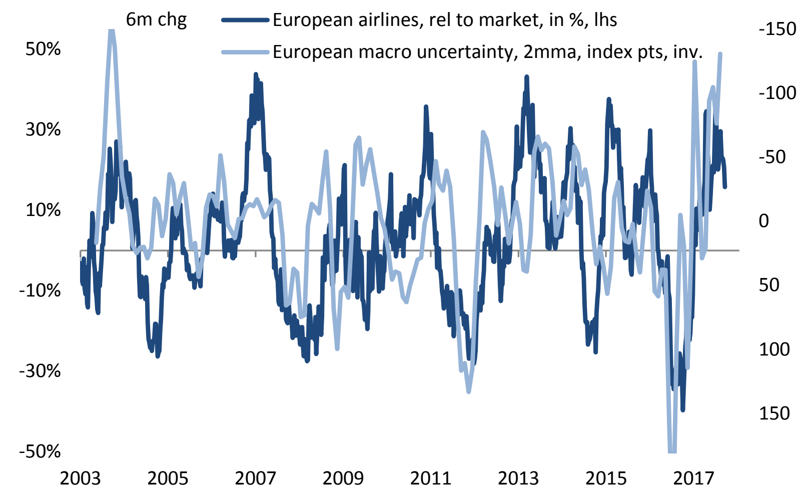
Airlines have yet to catch up with the latest rise in the oil price, which is typically a drag on the sector performance



European airlines are already priced for a further increase in European consumer confidence



On the positive side, the recent decline in European macro uncertainty would likely benefit airlines' relative performance



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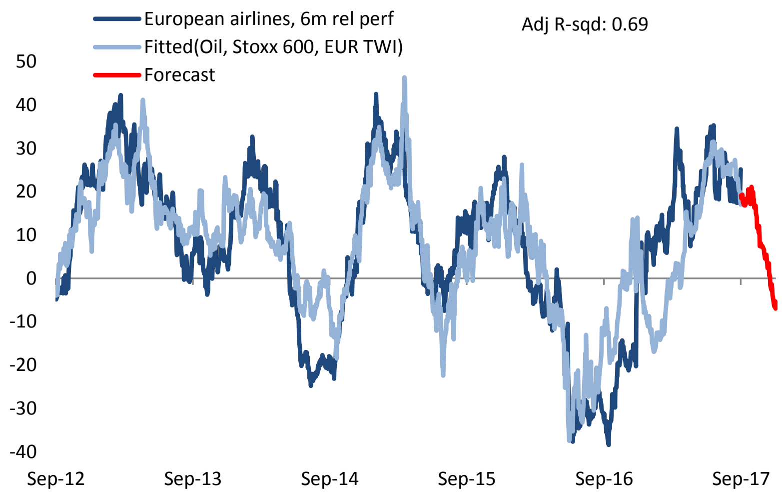
Airlines: downside in response to a stronger oil price and softer PMI momentum

Our regression model explains European airlines' relative performance as a function of the oil price, Stoxx 600 and the euro trade-weighted index

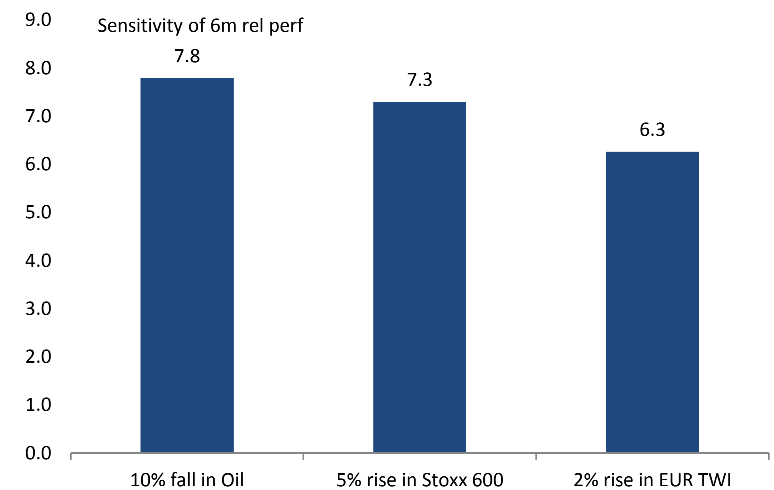


Our projected scenario for oil prices, Stoxx 600 and EUR TWI would be consistent with airlines underperforming by around 8% by year-end

Our analysts expect 6% further upside for the oil price and slight upside for the EUR TWI, while our Stoxx 600 target is roughly in line with the current level

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Oil	55	55	-1%	*-15%*
Stoxx 600	386	375	-3%	*1%*
EUR TWI	104	103	-1%	*10%*
Constant				*-3%*
6 month performance by year-end				*-7%*
Implied out/under-performance by year-end				**-8%**

Airlines tends to outperform when the oil price falls, market rises and euro strengthens



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Countries

Sebastian Raedler +44-20754-18169; Wolf von Rotberg +44-20754-52801;
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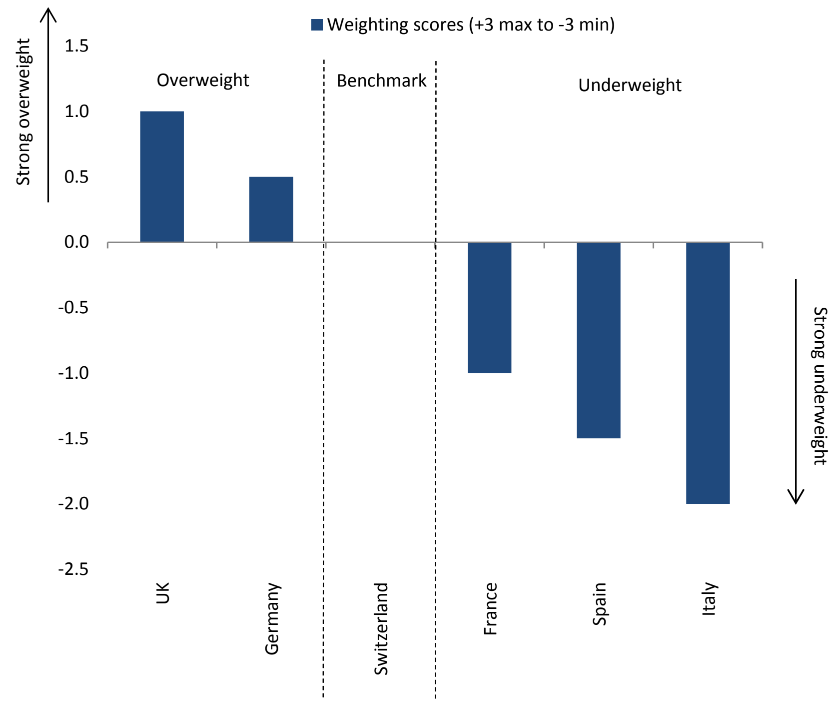
Country allocation: overweight Germany, underweight Italy

We are overweight the UK & Germany, underweight France, Italy & Spain and benchmark Switzerland

	Country	Index	Weighting score (+3 to -3)	Mcap (% of total)	Agg valuations (stdev from avg)	Index drivers (sign of correlation)
Overweights	**UK**	**FTSE 100**	1.0	34%	-1.1	GBP TWI (-), Stoxx 600 (-), Oil (+), Defensives (+), Macro momentum (-)
	Germany	**DAX**	0.5	18%	-0.4	EUR TWI (-), Cyclicals vs defensives (+), EM (+), Macro surprises (+), Volatility (-)
Benchmark	**Switzerland**	**SMI**	0.0	16%	-0.4	Pharma (+), CHF (-), Defensives (+), Volatility (+)
Underweights	**France**	**CAC 40**	-1.0	20%	1.2	Euro area rel PMI (+), Bund yield (+), EUR TWI (-), EM (-), Macro uncertainty (-), Macro surprises (+)
	Spain	**IBEX**	-1.5	7%	-0.1	Euro area PMI (+), Banks (+), USD broad TWI (-), Rates (+), Macro uncertainty (-), Spain spreads (-)
	Italy	**FTSE MIB**	-2.0	5%	0.4	Italy rel PMI (+), Banks (+), Rates (+), Macro uncertainty (-), Italy spreads (-)



Source: Bloomberg Finance LP, Haver, Factset, Datastream, Deutsche Bank

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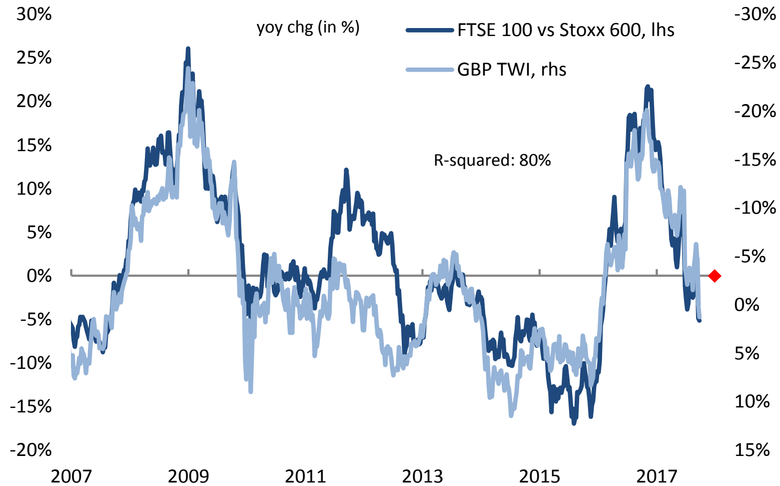
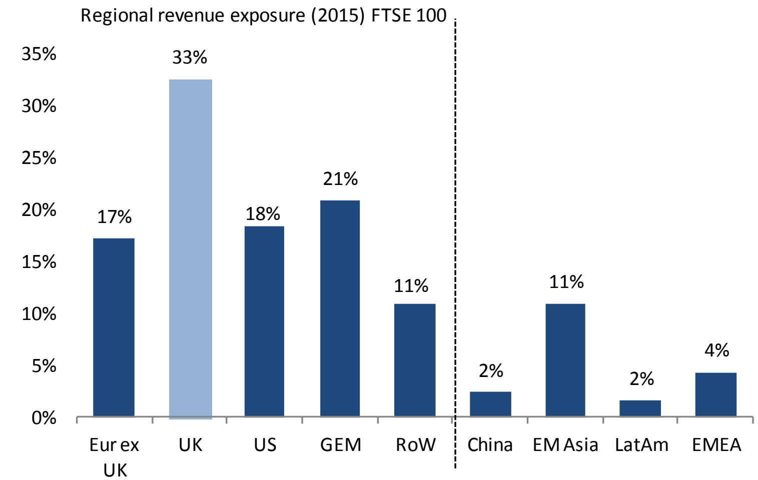
Overweight

UK: a defensive index supported by attractive valuations

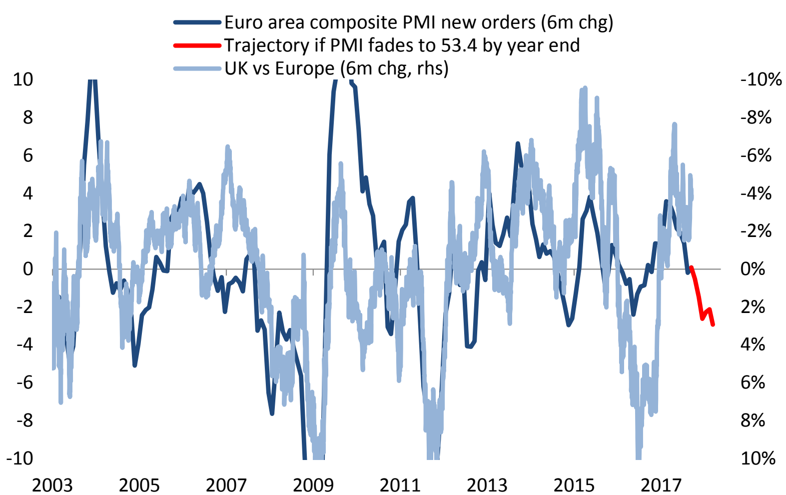
UK equities tend to outperform (in local currency terms) when the GBP weakens



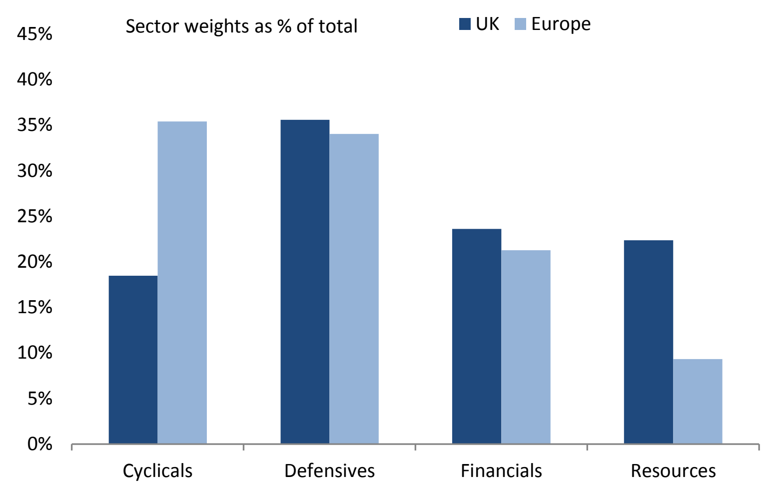
UK equities' high FX sensitivity derives from the high foreign revenue exposure, with around two thirds of sales from abroad



As a defensive index, the UK tends to outperform in periods of fading Euro area PMI momentum – and we expect PMI momentum to turn negative over the coming months



The UK has a small overweight in defensive sectors – and a large underweight in cyclical sectors



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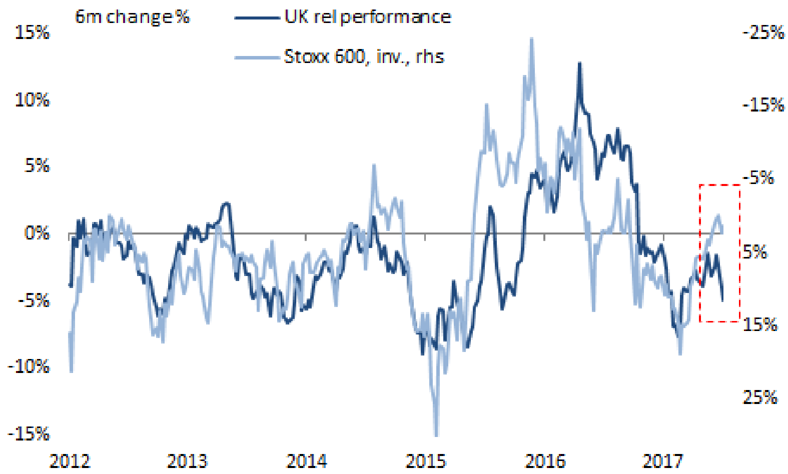
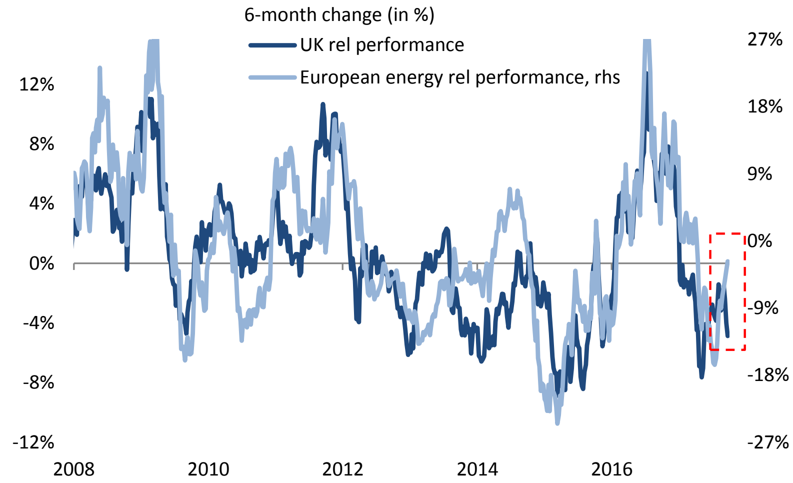
UK: a defensive index supported by attractive valuations

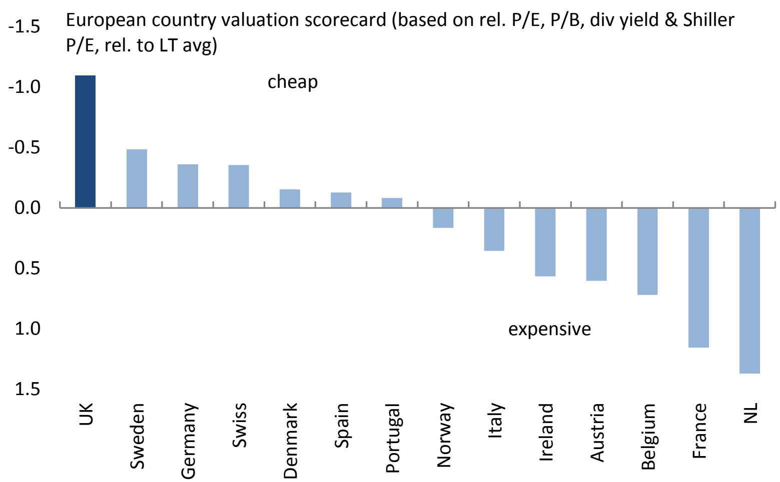
The UK's relative price performance tends to move inversely to European equities overall



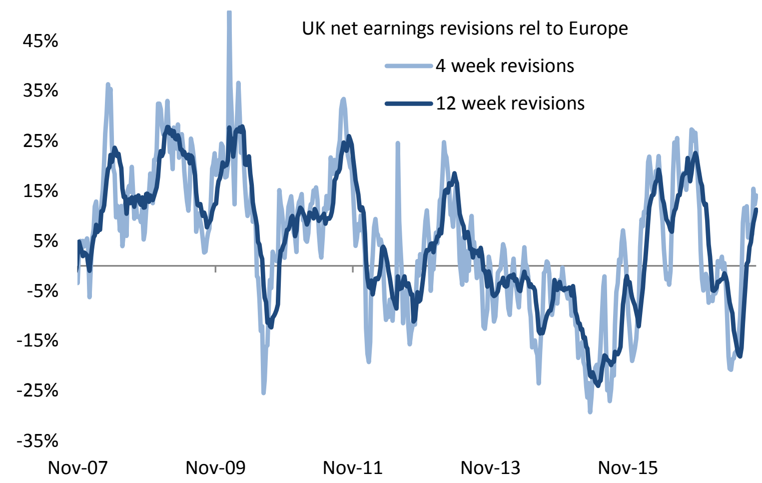
The UK's relative performance tends to move in line with energy, which is one of our sector overweights



The UK ranks as the cheapest market on our European country valuation scorecard



The UK's relative earnings revisions have recently turned positive again



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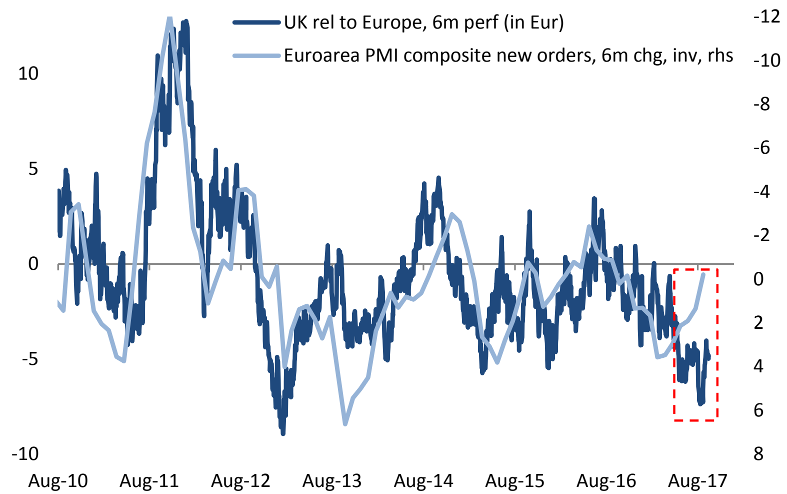
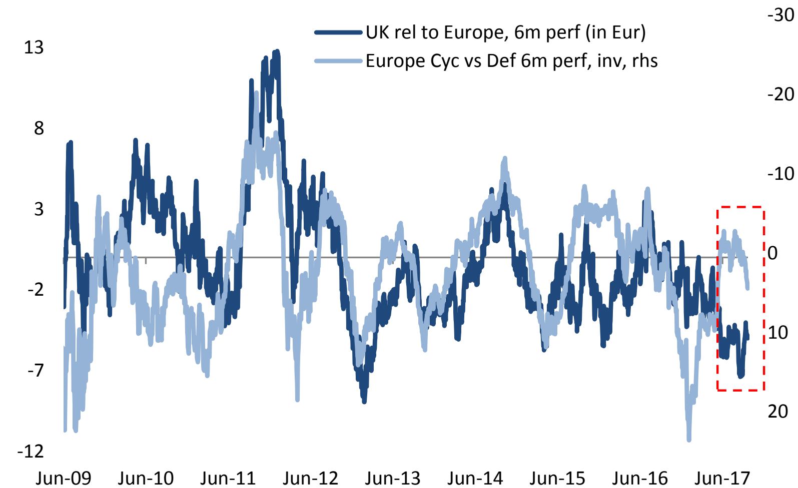
UK: a defensive index supported by attractive valuations

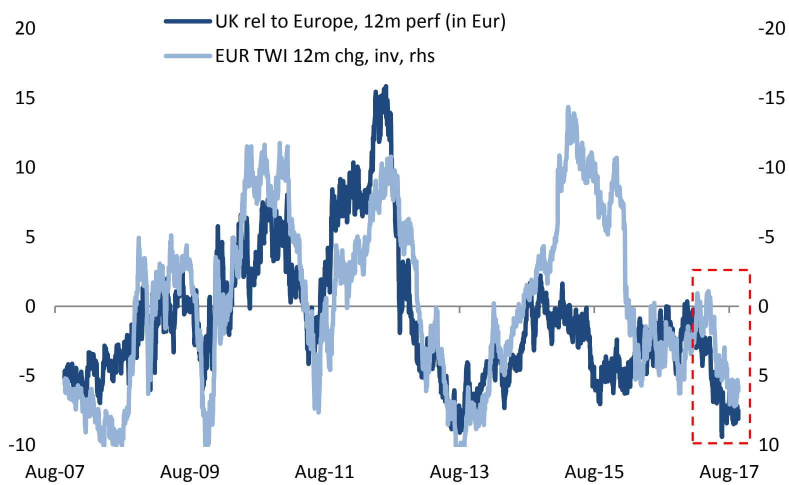
UK performance relative to Europe in EUR terms has not caught up with the fade in Euro area PMI momentum, which we expect to continue



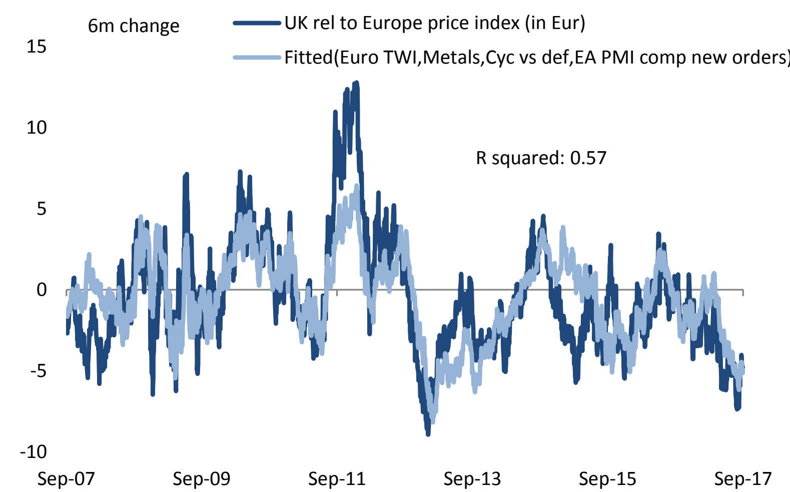
The UK's relative performance in EUR terms should benefit if European cyclicals start underperforming defensives, as we expect them to



The UK tends to underperform the European market in EUR terms when the EUR TWI rises



UK's relative performance in EUR term has been in line with our model (based on the Euro, metal prices, cyclicals over defensives and EA PMI)



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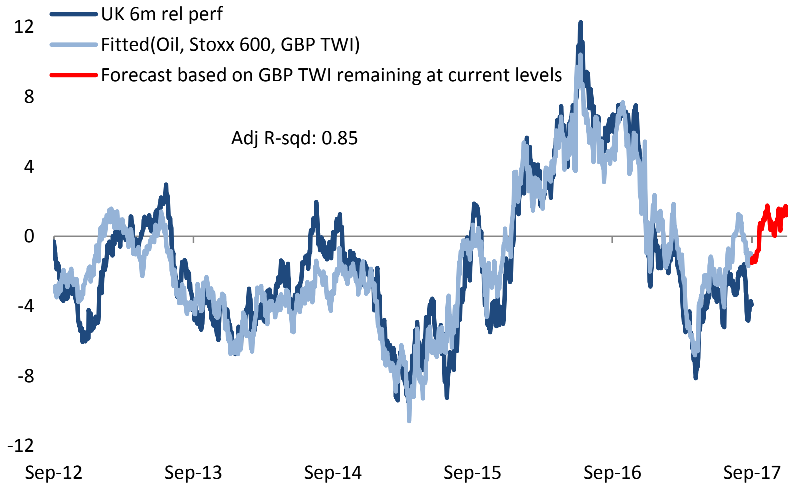
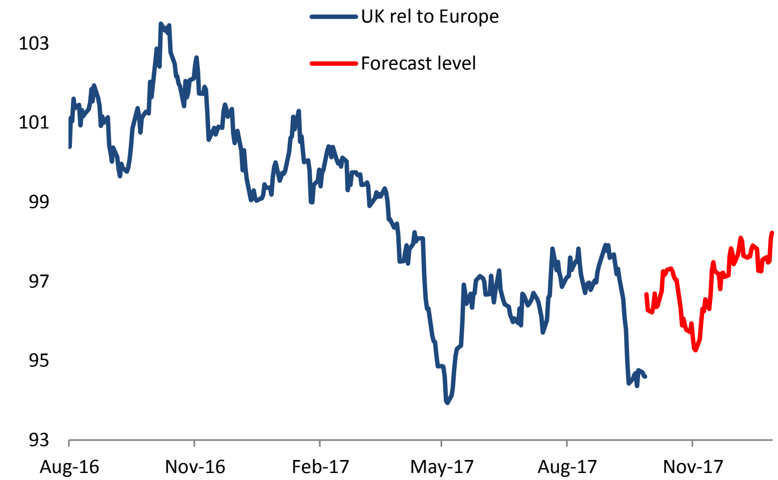
UK: a defensive index supported by attractive valuations

Our regression model, based on oil prices, the Stoxx 600 and the GBP trade-weighted index points to further upside for the UK



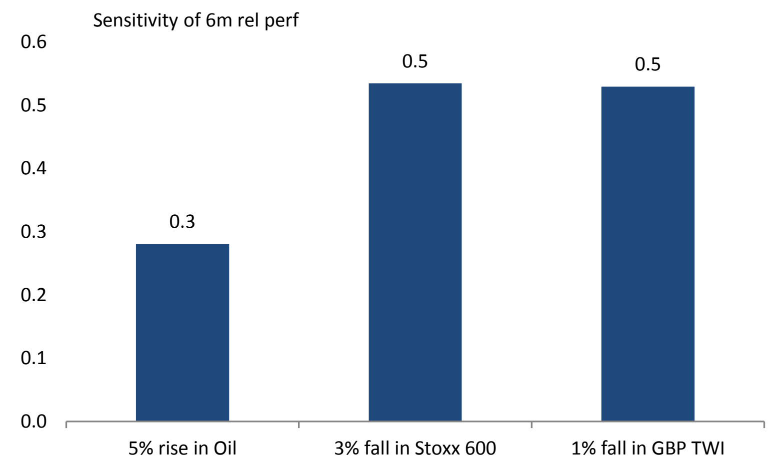
Our projected scenario for oil prices, Stoxx 600 and GBP TWI would be consistent for the UK outperforming by 4% by year-end



Our analysts expect slight further downside for the oil price and GBP TWI by year-end, while we expect mild downside for the Stoxx 600

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Oil	58	55	-5%	*0.9%*
Stoxx 600	386	375	-3%	*-0.1%*
GBP TWI	78	75	-4%	*1.4%*
Constant				*-0.7%*
6 month performance by year-end				*1.6%*
Implied out/under-performance by year-end				**3.8%**

The UK tends to outperform when sterling weakens, the oil price rises and European equities fall



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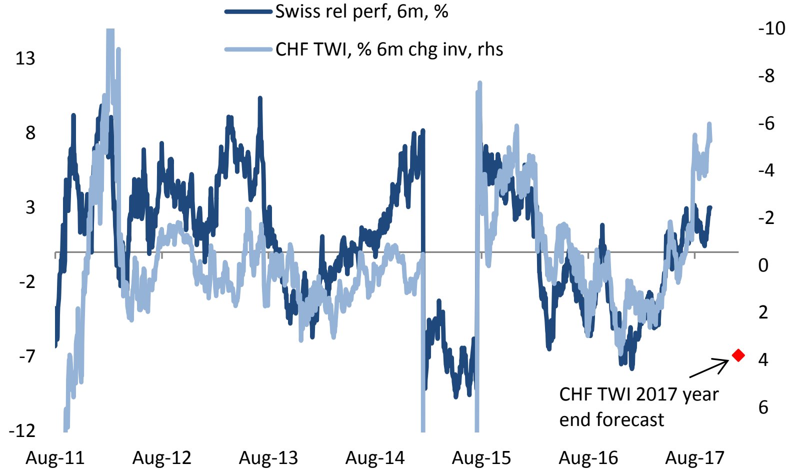
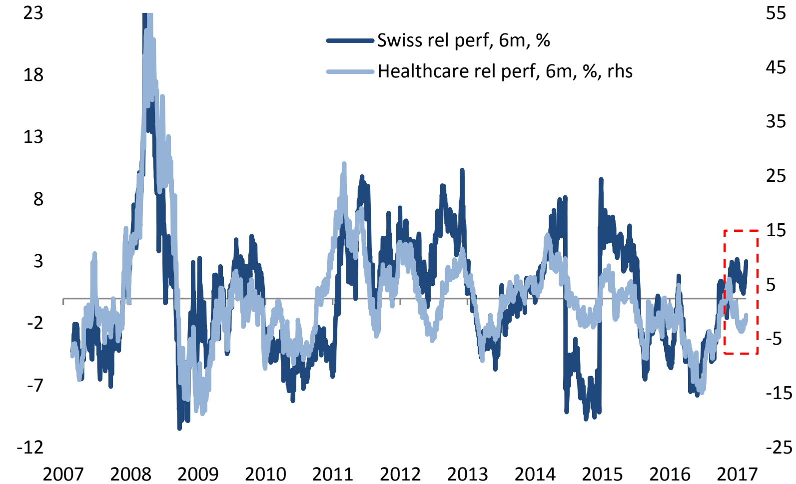
Switzerland: tailwind from pharma likely to be offset by Swiss franc strength

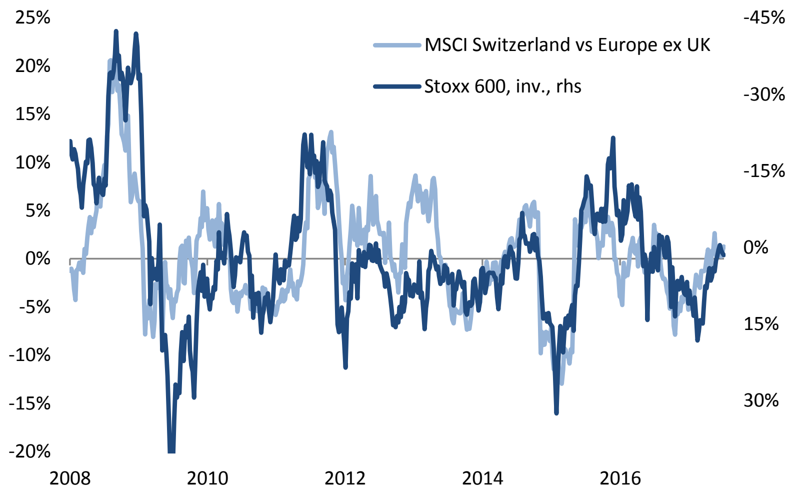
Switzerland has been among the best performing countries recently, outperforming by 3% over the past months, fuelled by a sharp depreciation in the CHF



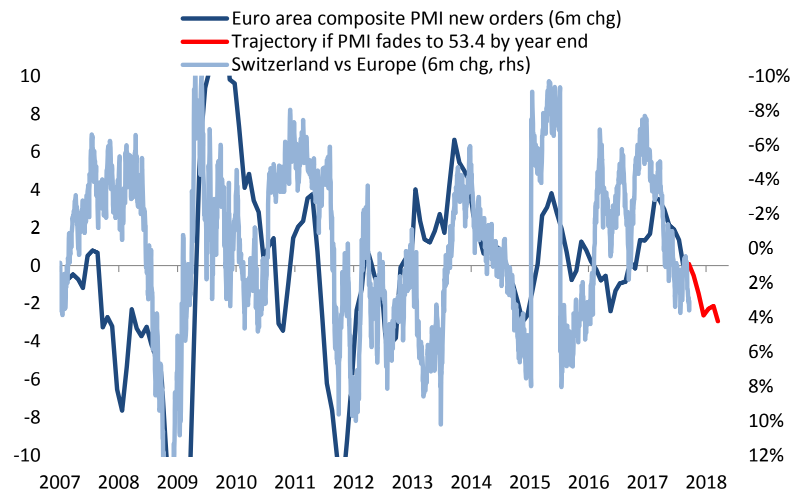
The index has outperformed despite the sharp fall in European healthcare, but we expect the latter to outperform into year-end



Switzerland has also benefitted from the recent pull-back in the European equity market, but we now except the market to be flat into year-end



We expect Euro area PMI momentum to turn negative over the coming months, though much of this is already reflected in Switzerland's relative performance



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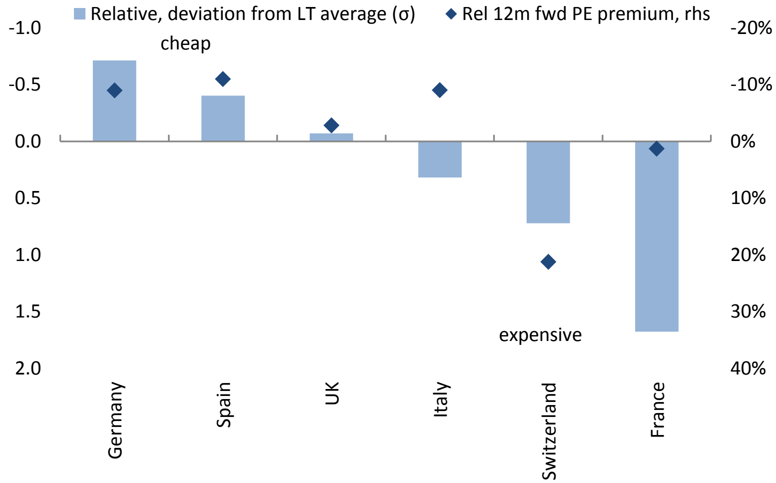
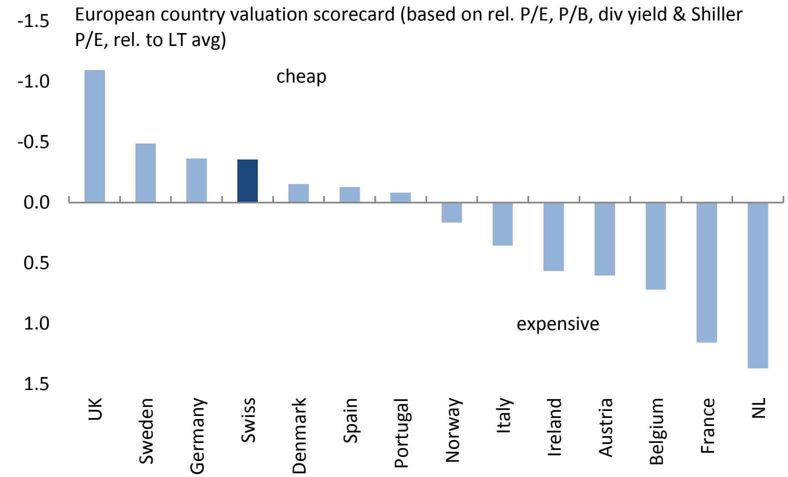
Switzerland: tailwind from pharma likely to be offset by Swiss franc strength

Although Switzerland's relative PE, which, at a 21% premium to the market, is the highest among all countries…

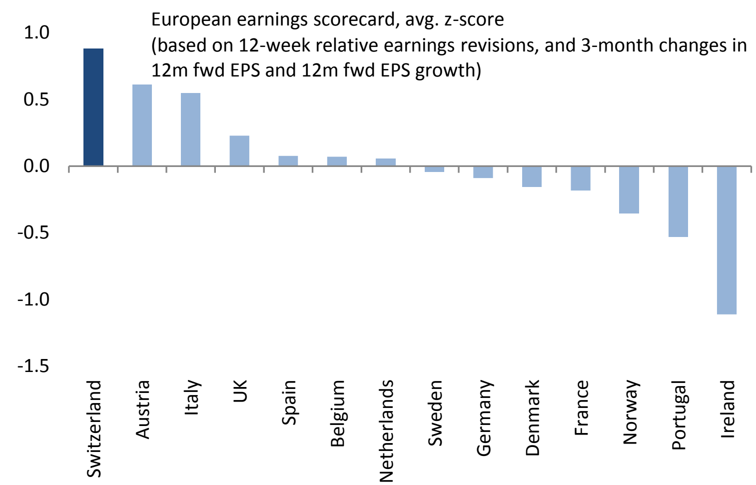


…this is offset by cheapness on other valuation metrics, which leaves Switzerland among the cheapest European indices on our valuation scorecard



The recent Swiss franc depreciation has driven Switzerland's 3-month relative earnings revisions back into positive territory for the first time since early 2016 …

… helping Switzerland rank top on our European country earnings momentum scorecard



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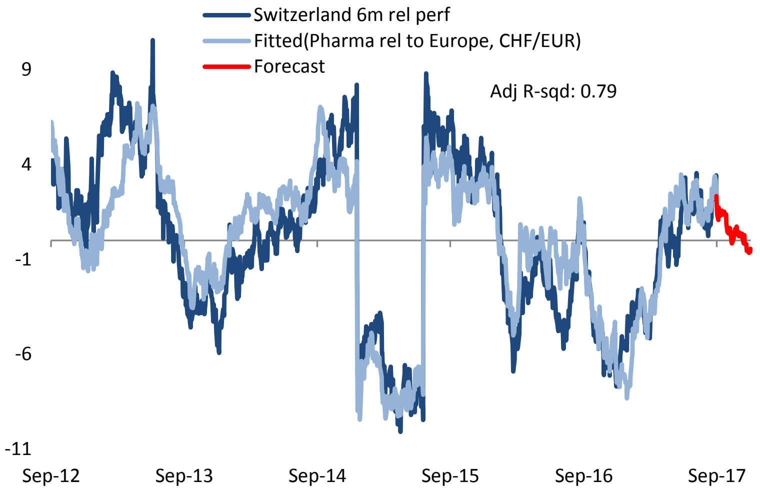
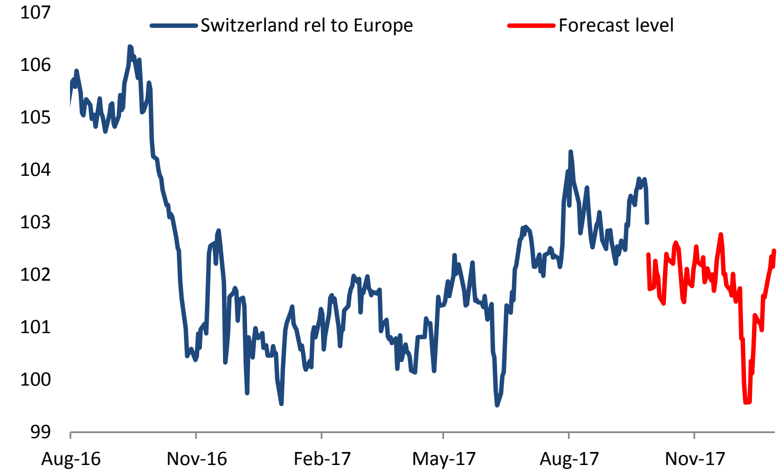
Switzerland: tailwind from pharma likely to be offset by Swiss franc strength

Our regression model, based on the CHF/EUR and the performance of the pharma sector points to…



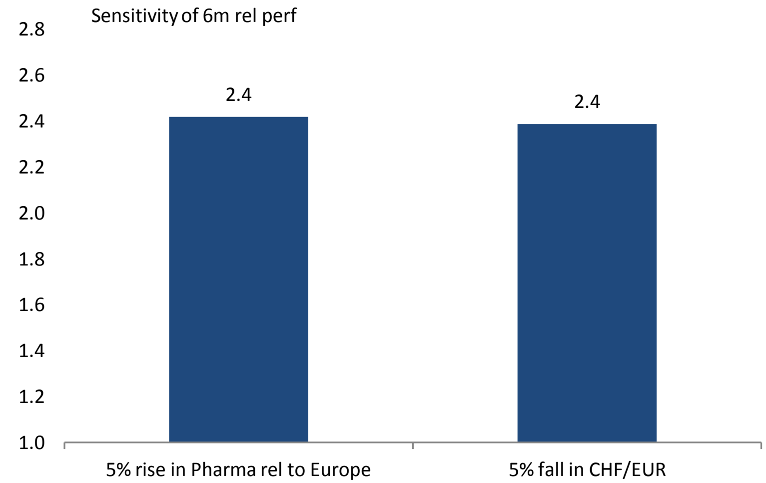
…no further upside for Switzerland versus Europe by year-end



Our model is based on 1) pharma, which we expect to outperform until year-end, and 2) CHF/EUR, which our FX strategists expect to appreciate by year-end

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Pharma rel to Europe	100	106	6%	*1.4%*
CHF/EUR	0.87	0.95	9%	*-1.9%*
Constant				*0.0%*
6m performance by year-end				*-0.4%*
Implied out/under-performance from current levels				**-0.5%**

Switzerland tends to outperform when pharma does well and the Swiss franc depreciates against the euro



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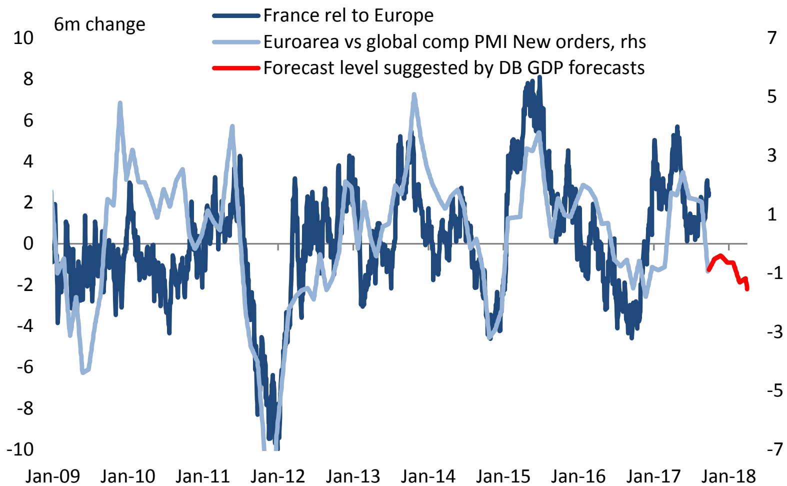
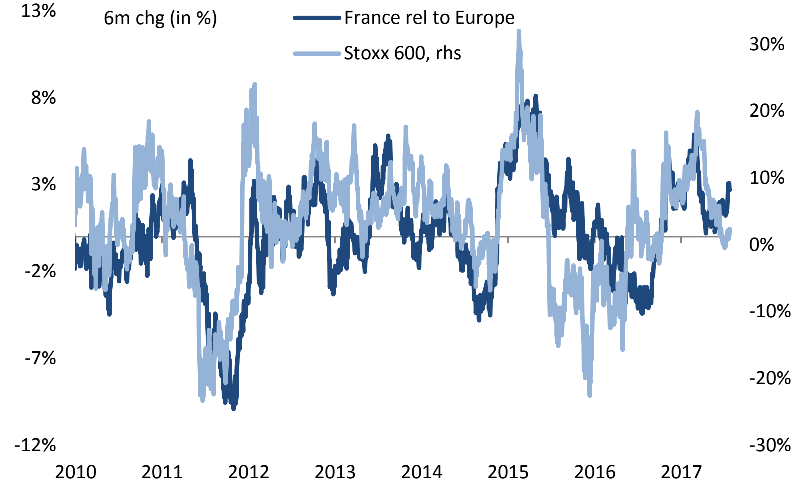
France: downside as growth momentum starts to fade

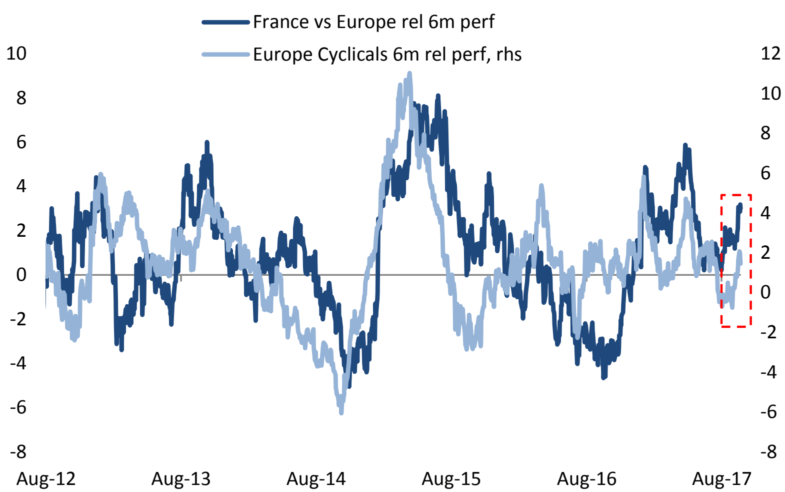
We expect relative Euro area PMIs to fade from their current elevated levels, which is likely to weigh on France's relative performance



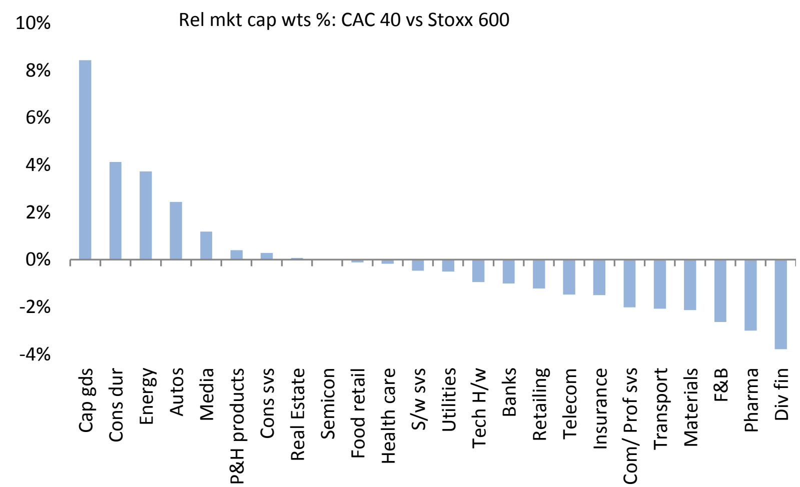
French equities have moved ahead of the level suggested by European equities' overall performance



France's relative price momentum has been better than its relationship with cyclicals versus defensives would have suggested



France is overweight capital goods and luxury goods, while being underweight pharma and food & beverage



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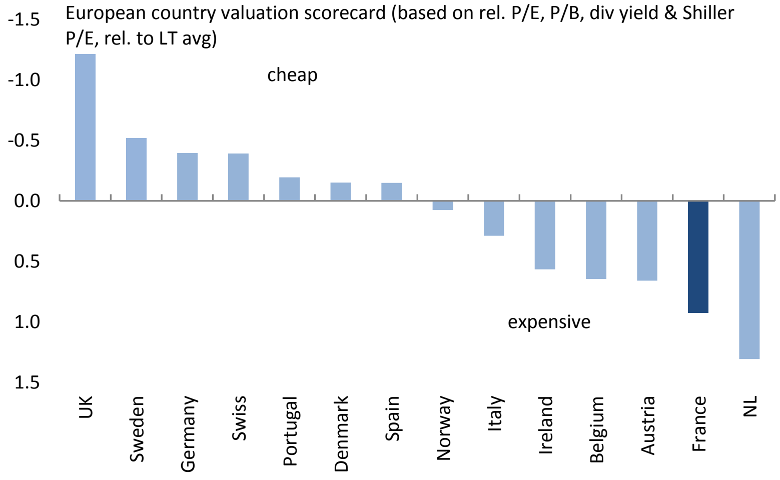
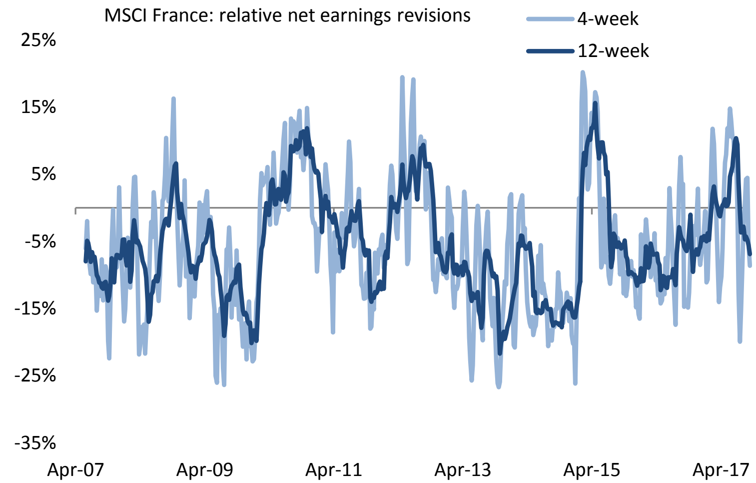
France: downside as growth momentum starts to fade

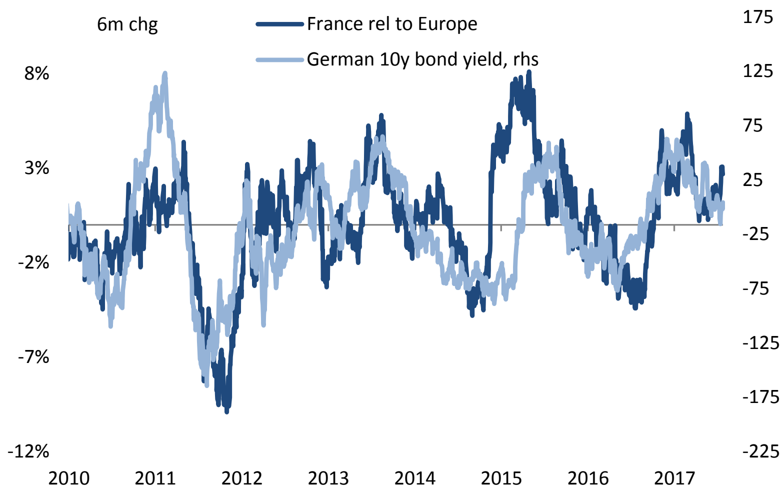
France is the most expensive country among major indices on our valuation scorecard



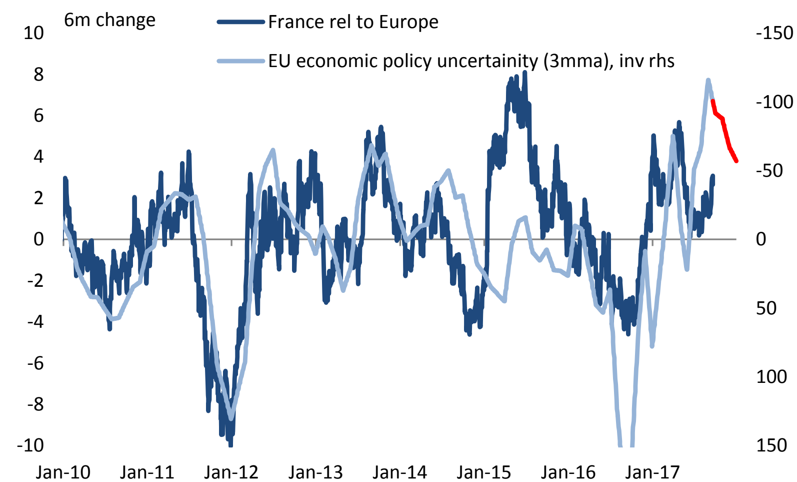
France's relative earnings revisions have turned negative again



On the upside, French equities could benefit if bond yields were to pick up (yet, we see a risk that fading PMI momentum weighs on yields)



France would also benefit from a continued fall in European macro uncertainty



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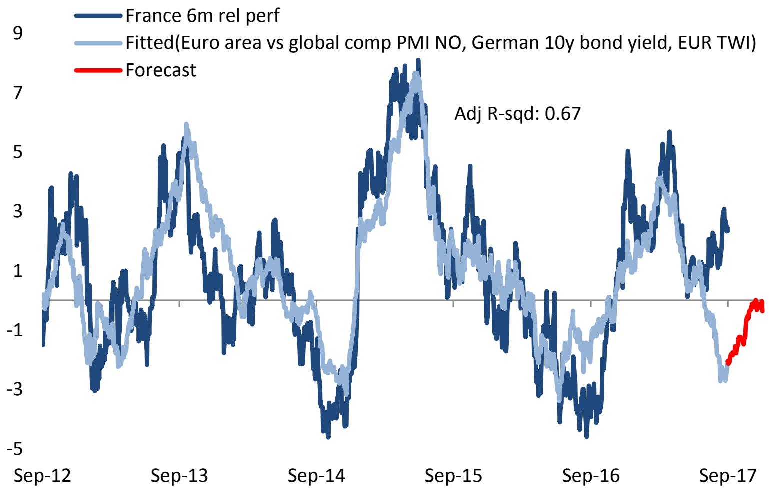
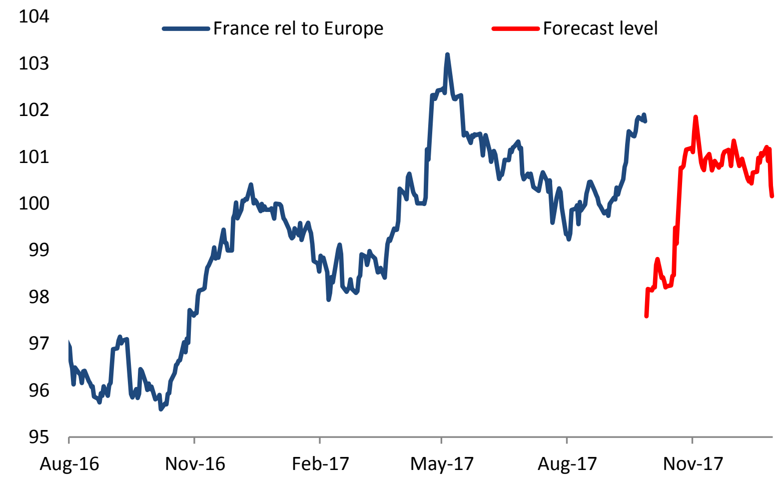
France: downside as growth momentum starts to fade

Our regression model, based on the Euro area PMI relative to global, the German 10-year bond yield and the Euro TWI points to downside for France



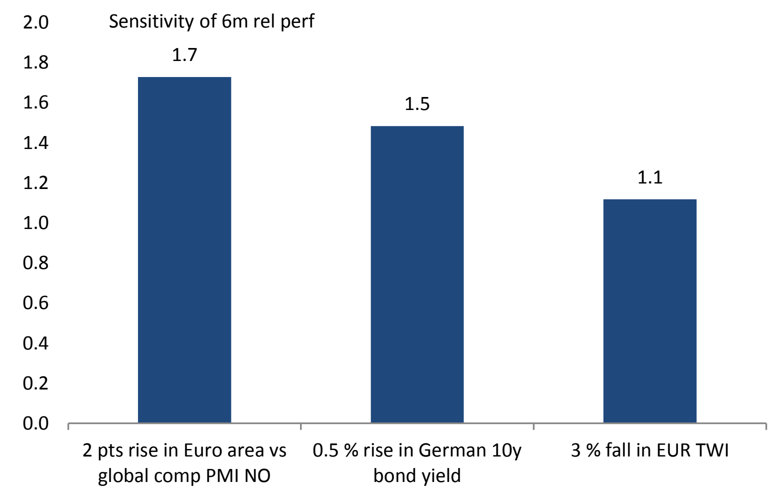
Our projected scenario for Euro area PMI relative to global, German 10-year bond yield and Euro TWI is consistent with a further 2% underperformance for France by year-end



We expect Euro area comp PMI to fade relative to global by year-end, while our strategists expect the German 10-year bond yield to rise by 13 basis points and the EUR TWI to remain at current levels

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Euro area vs global comp PMI NO	0.9pts	0.3pts	-1pts	*-0.6%*
German 10y bond yield	0.5%	0.6%	0.1%	*0.4%*
EUR TWI	102	103	0%	*-0.8%*
Constant				*0.6%*
6 month performance by year-end				*-0.4%*
Implied out/under-performance by year-end				**-1.6%**

France tends to outperform when Euro area PMI rise relative to global PMIs, the German bond yield rises and the euro falls



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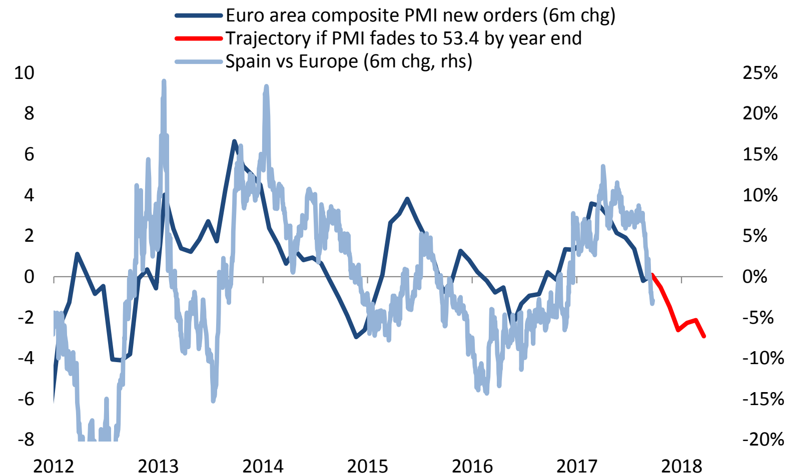
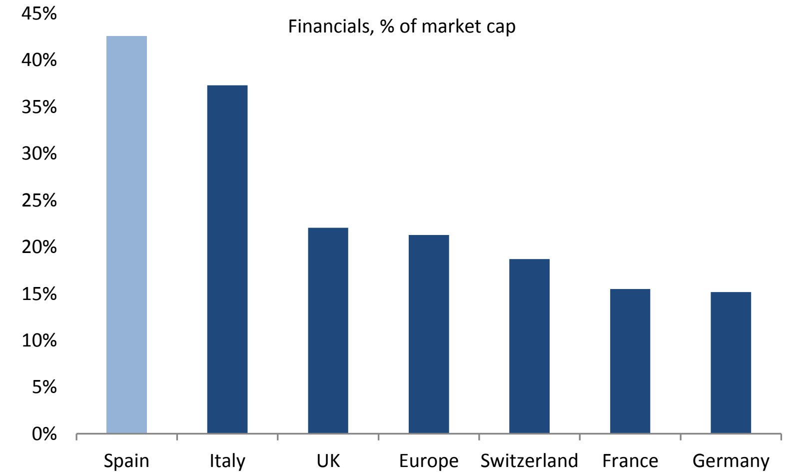
Spain: large financials weighting raises vulnerability to a fade in PMI momentum

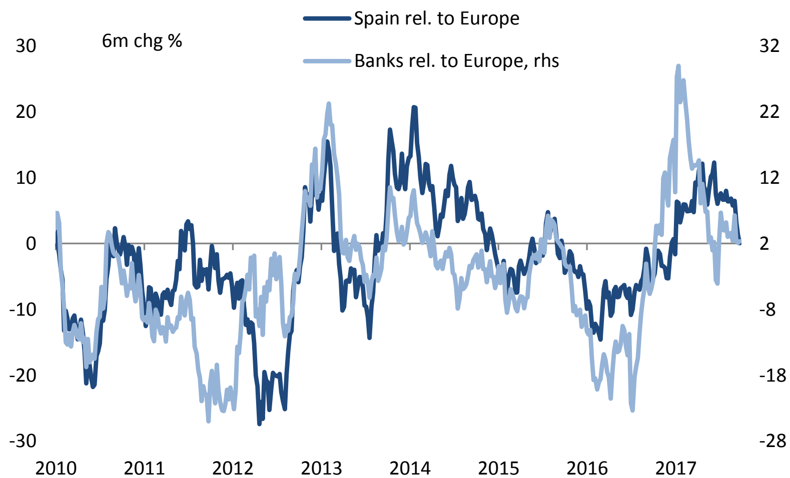
Spain has benefited from the rebound in Euro area PMI momentum earlier, which we expect to weaken over the coming quarters



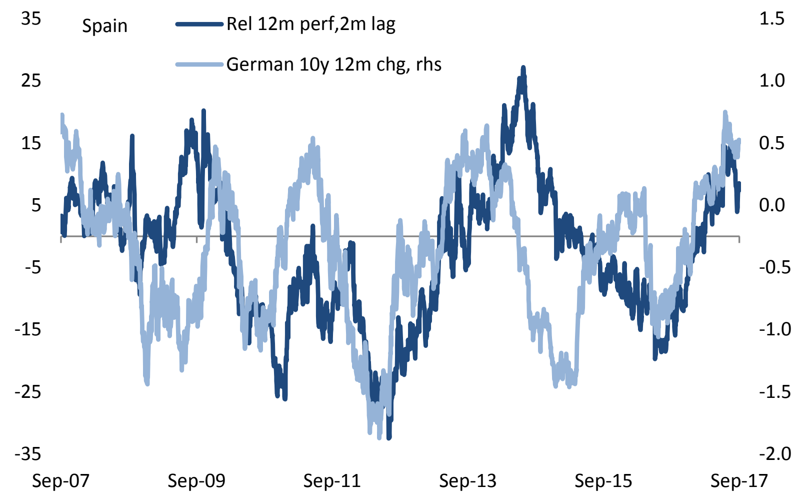
Spain is the European index with the highest weighting of financials



Spain's performance tends to suffer when banks underperform, as we expect them to over the coming months



Because of Spain's high weighting in financials, it tends to underperform when bond yields fall



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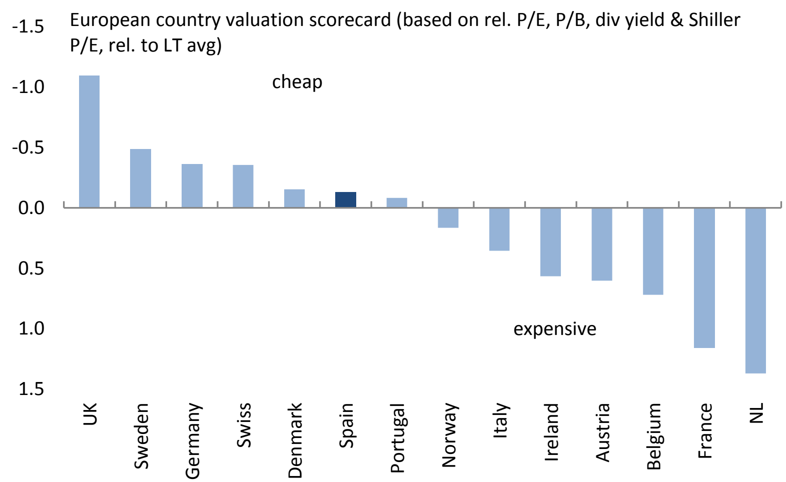
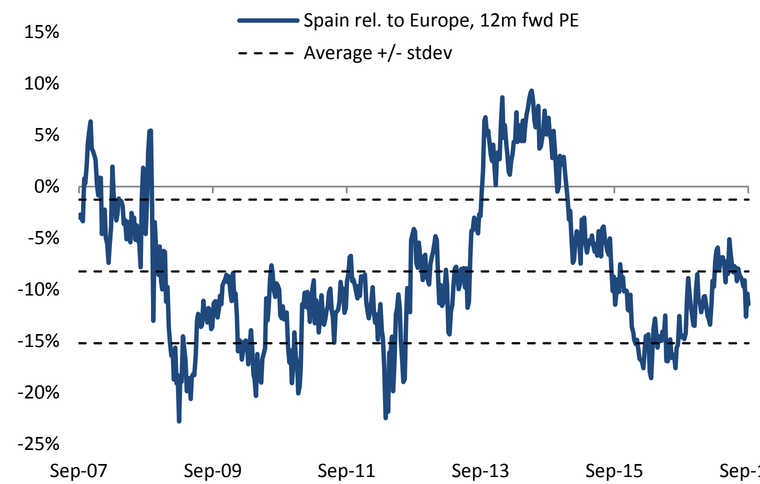
Source: Bloomberg Finance LP, Haver, Factset, Datastream, Deutsche Bank

Spain: large financials weighting raises vulnerability to a fade in PMI momentum

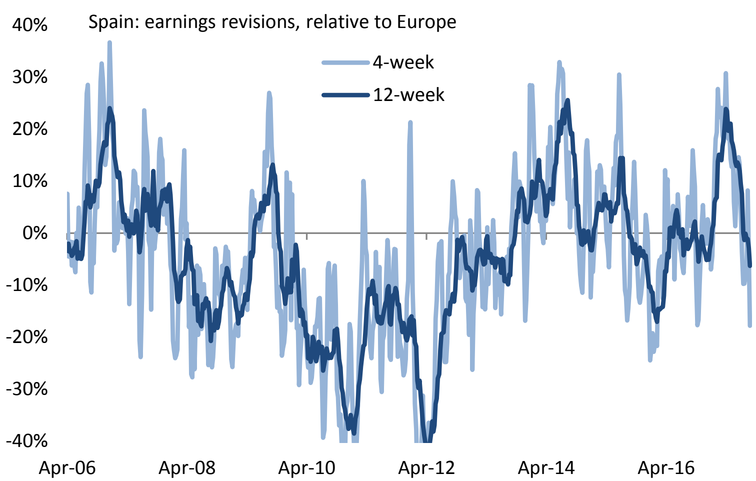
Spain is mid-ranking on our European valuation scorecard



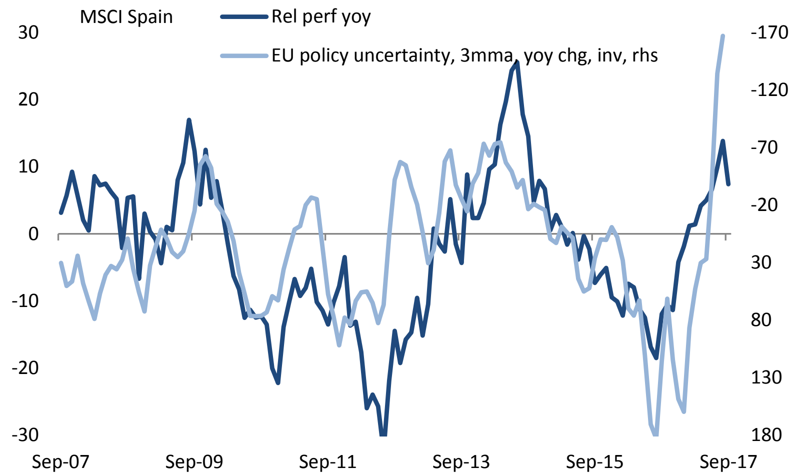
Spain's relative P/E is close to its 10-year average



Spain's relative earnings momentum, which was strongly positive earlier this year, has turned negative again



On the positive side, Spain could benefit from a further fall in European policy uncertainty



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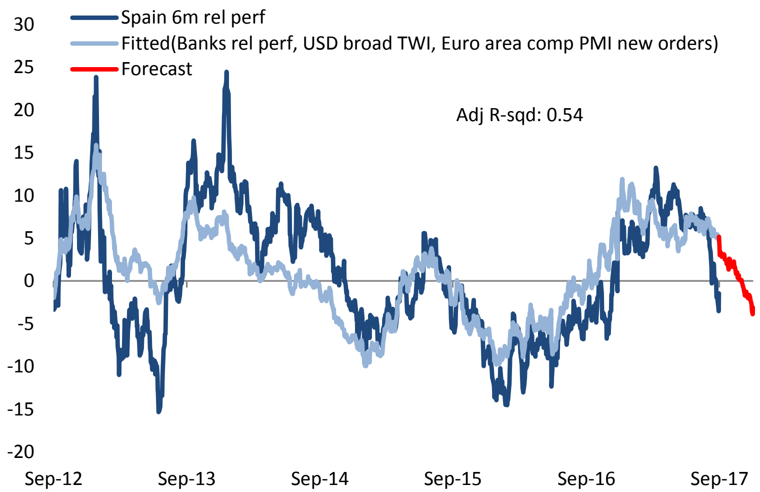
Underweight

Spain: large financials weighting raises vulnerability to a fade in PMI momentum

Our model, based on banks relative performance, Euro area PMIs and USD TWI suggests Spain's price momentum will turn negative over the coming months

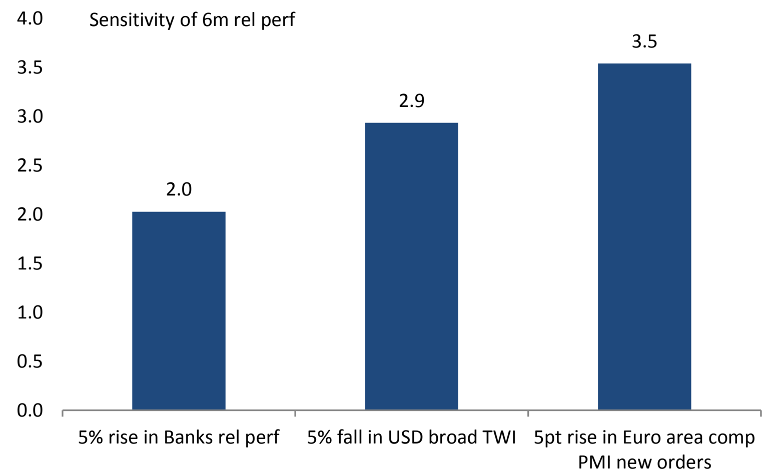


Our model points to around 1% downside for Spain by year-end

Projected downside for banks and a likely fade in Euro area PMI momentum are set to weigh on Spain's relative performance by year-end

Model parameters	Level: Current	Level: Year-end forecast	Change: Year-end vs current	*Impact on 6m perf by yr-end*
Banks rel perf	4.3	4.0	-5.6%	*-2.4%*
USD broad TWI	118	122	3.1%	*-0.1%*
Euro area comp PMI new orders	56	53	-3pts	*-1.8%*
Constant				*1.2%*
6 month performance by year-end				*-3.1%*
Implied out/under-performance by year-end				**-1.1%**

Spain tends to outperform when Euro area PMI momentum rises, banks outperform and the USD depreciates



Source: Bloomberg Finance LP, Haver, Factset, Datastream, Deutsche Bank

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Styles & themes

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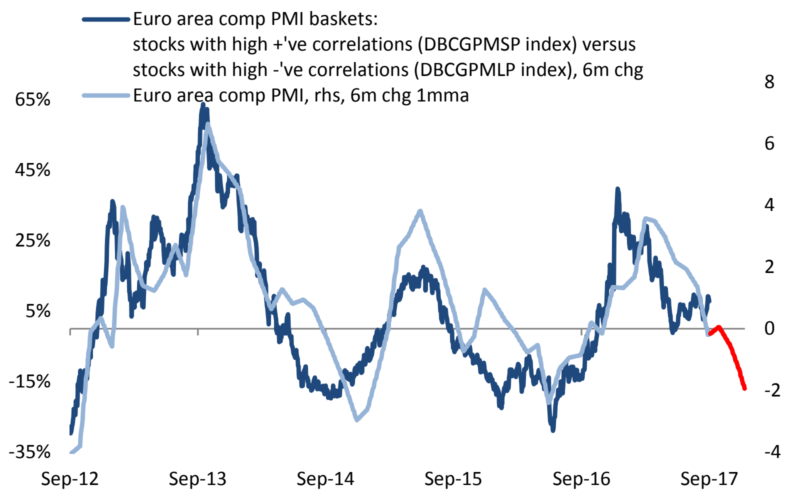
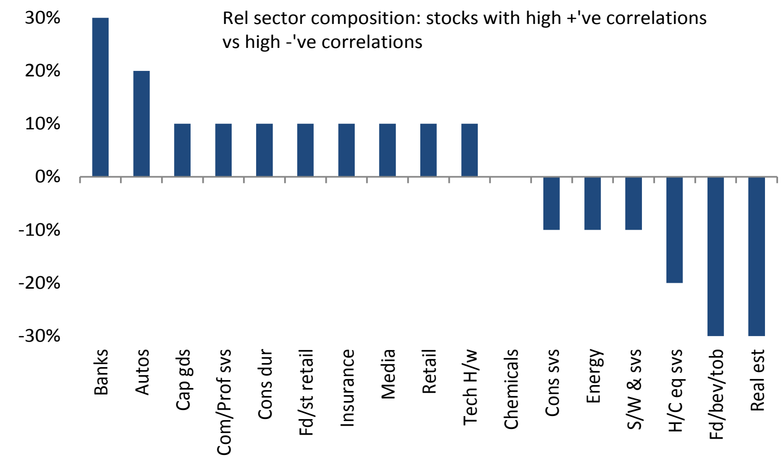
Baskets: European stocks most sensitive to swings in Euro area macro momentum

Our projected scenario implies that our basket of stocks with high positive correlations to Euro area PMI momentum is set to underperform our basket of stocks with high negative correlations to Euro area PMI momentum



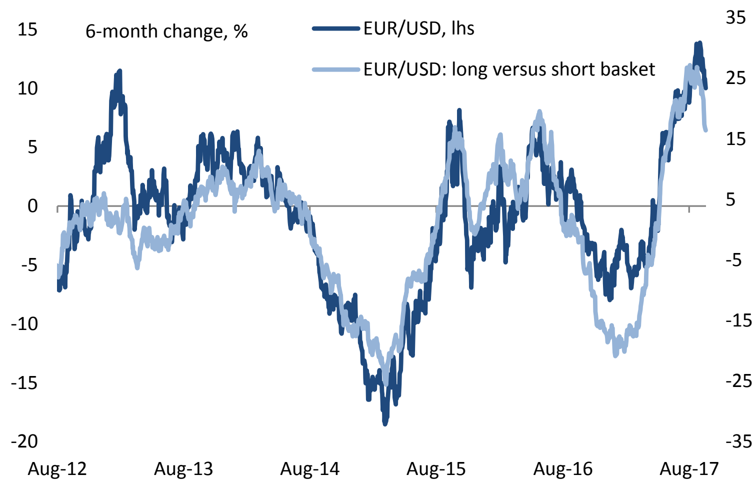
Our basket of stocks with high positive correlations to Euro area PMI momentum is overweight banks, while our basket of basket with high negative correlations to Euro area PMI momentum is overweight consumer staples and real estate – both baskets are equal-weighted



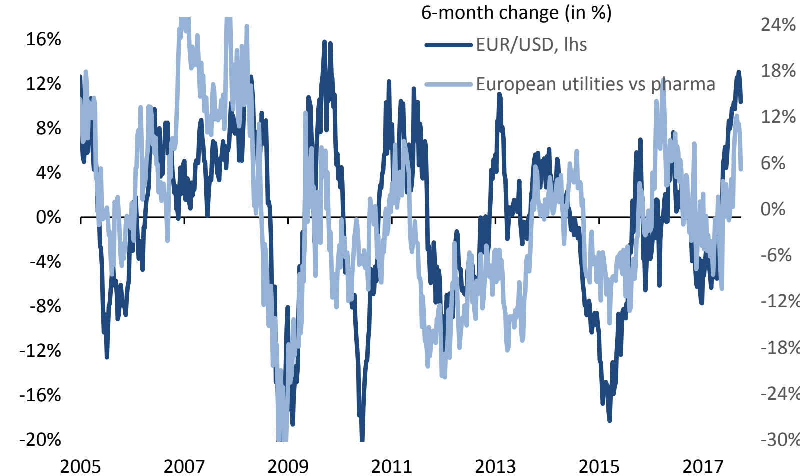
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Who would benefit from renewed EUR weakness?

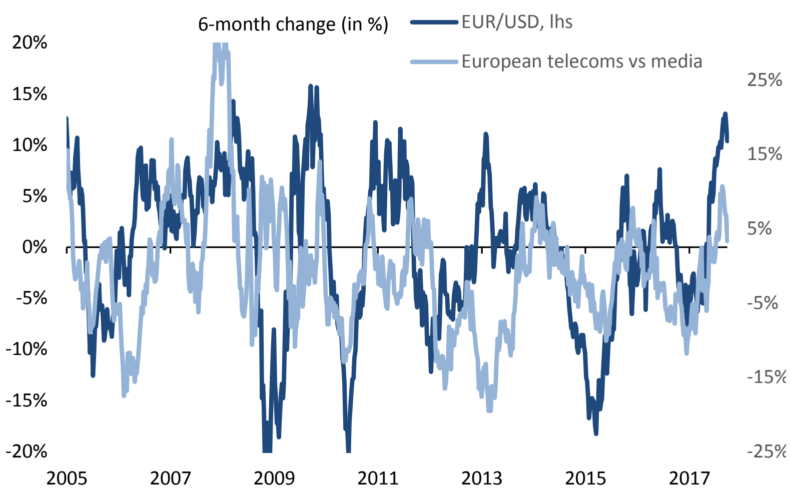
Our basket of stocks that benefit from EUR weakness should outperformed our basket of stocks that benefit from EUR strength – and have started to do so



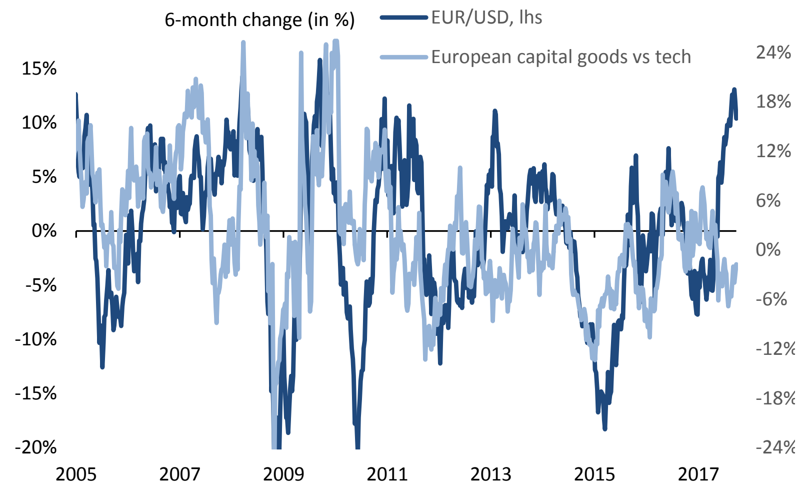
Euro weakness is typically associated with European pharma outperforming utilities



… as well as media outperforming telecoms



Tech versus capital goods also tends to move in line with the EUR/USD, but has been unresponsive to the recent euro strength



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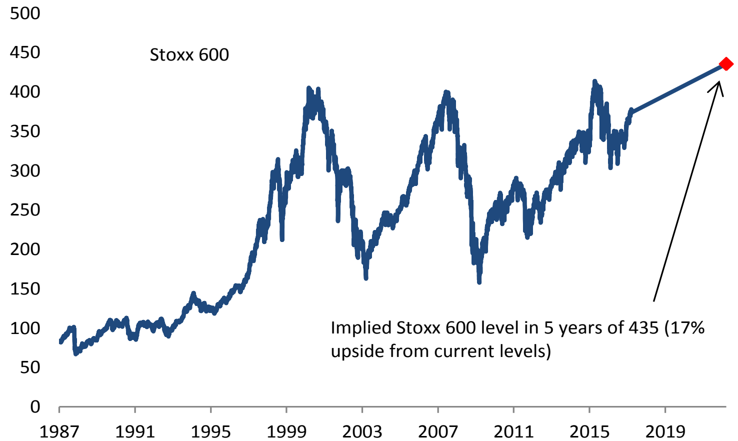
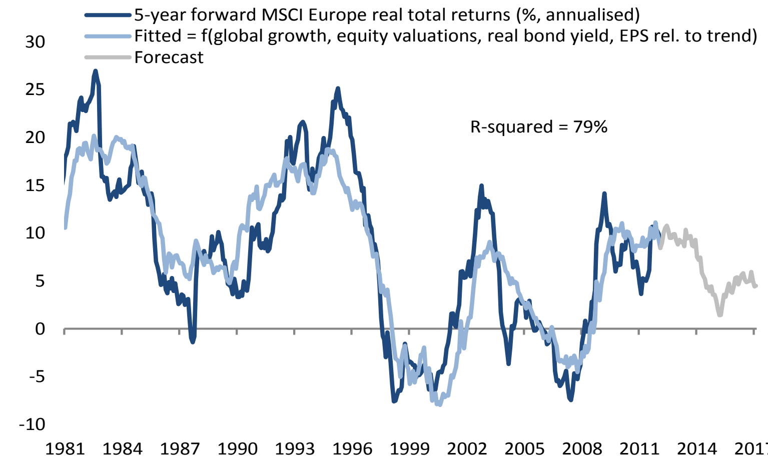
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We expect the Stoxx 600 to rise to 435 over the coming 5 years

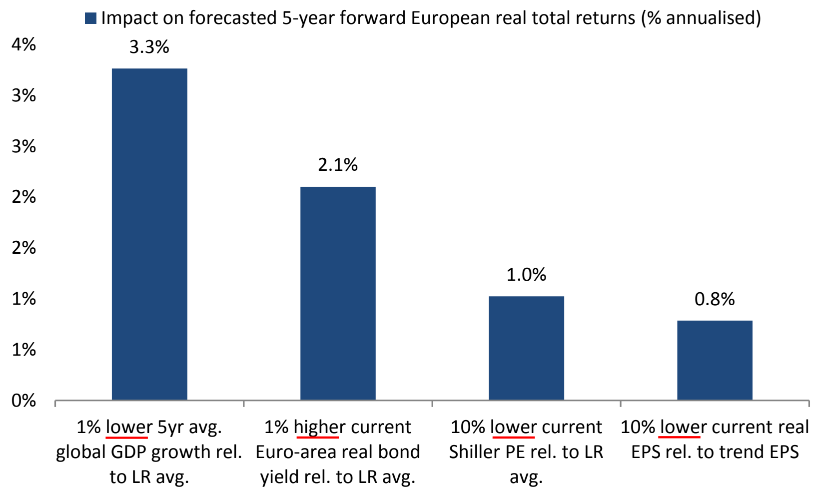
We expect a 3% annualized nominal price return which equates to a ~4.5% real total return (assuming 3.5% dividend yield and 2% inflation) - in-line with the 20yr average



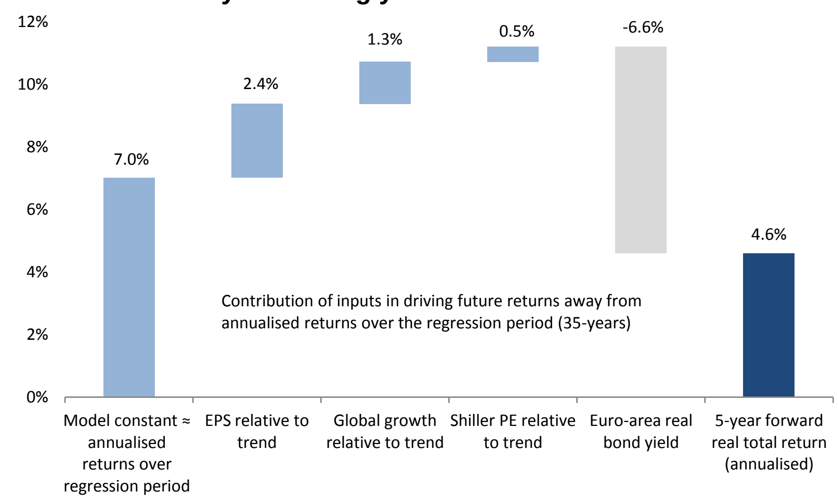
Our model is based on four observable (rather than forecast) input factors and explains around 80% of the variation in 5-year forward real annualized total returns for European equities since the early 1980s



High real bond yields, a low Shiller P/E, real EPS below trend and weak trailing GDP growth relative to the long-run norm are associated with stronger future returns, according to our model



Global growth, EPS re. trend and Shiller P/E all make positive contributions to our five-year forecast, while an extremely low real bond yield strongly reduces the forecast



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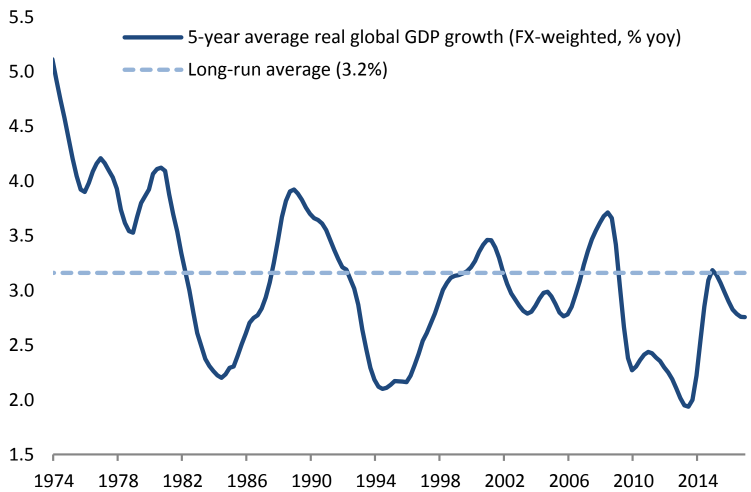
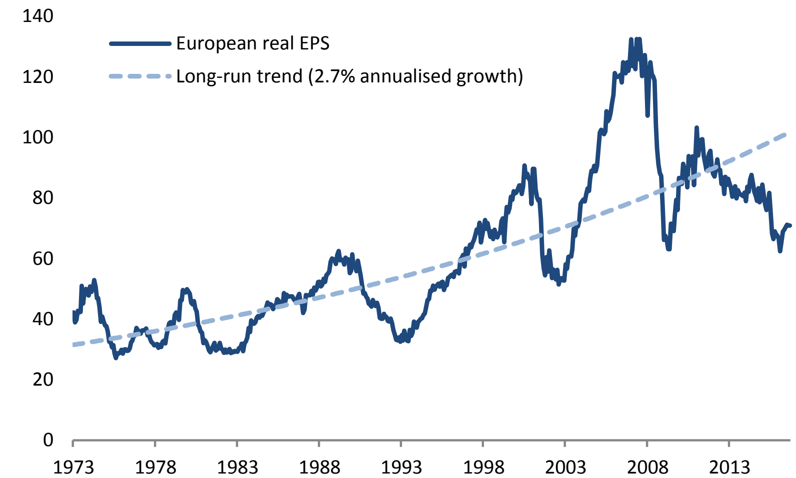
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

We expect the Stoxx 600 to rise to 435 over the coming 5 years

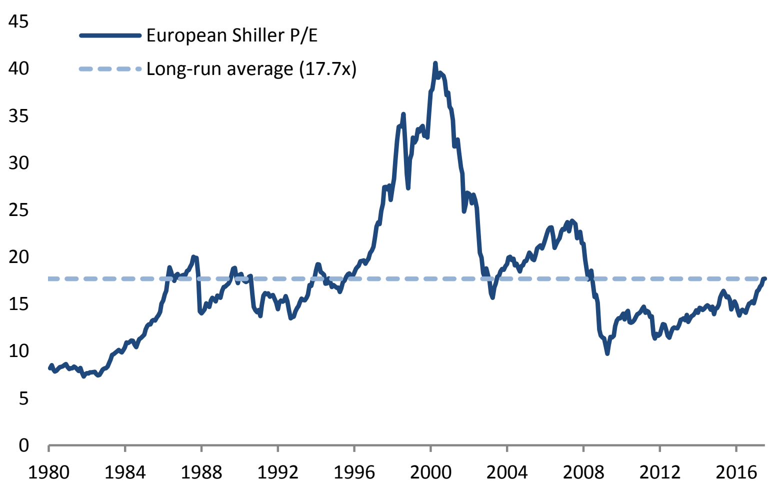
Real global GDP growth over the past 5 years, at 2.8%, is around 40bps below the long-run average of 3.2%



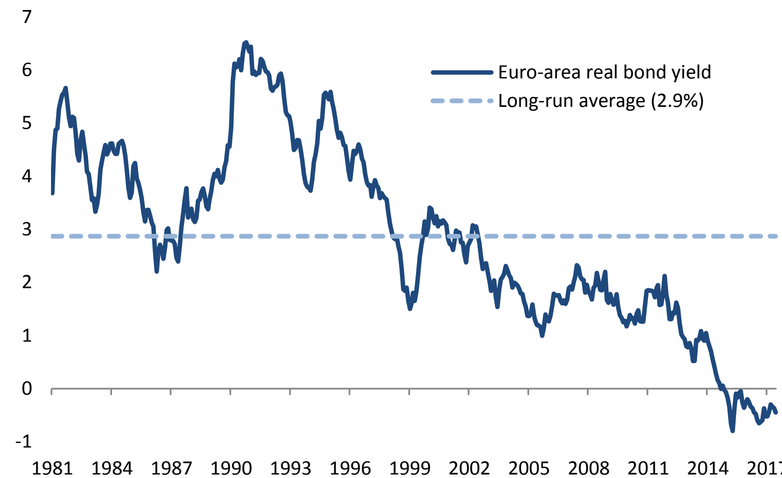
European real EPS is around 30% below the long-run trend



The Shiller P/E is now in line with the long-run average



Euro area real bond yields, at minus 20bps, are some 300bps below the long-run average



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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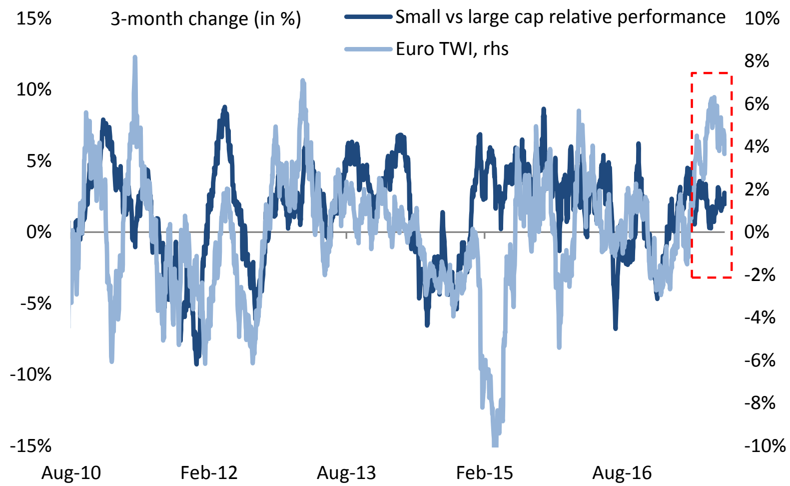
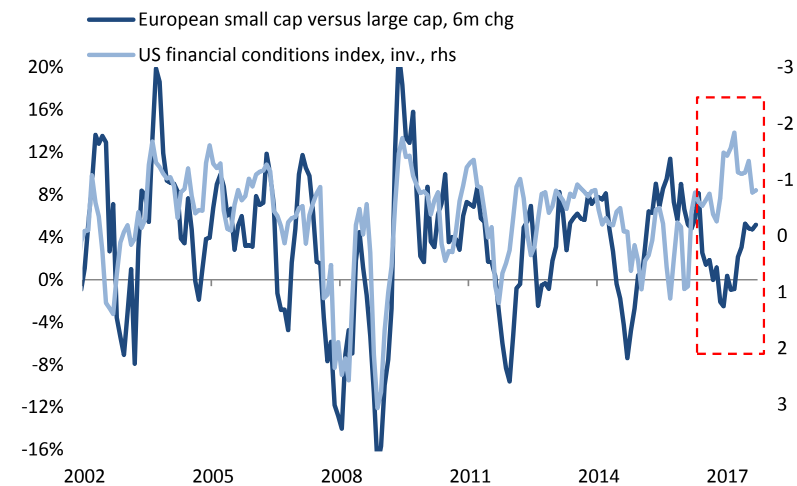
Overweight European small cap versus large cap

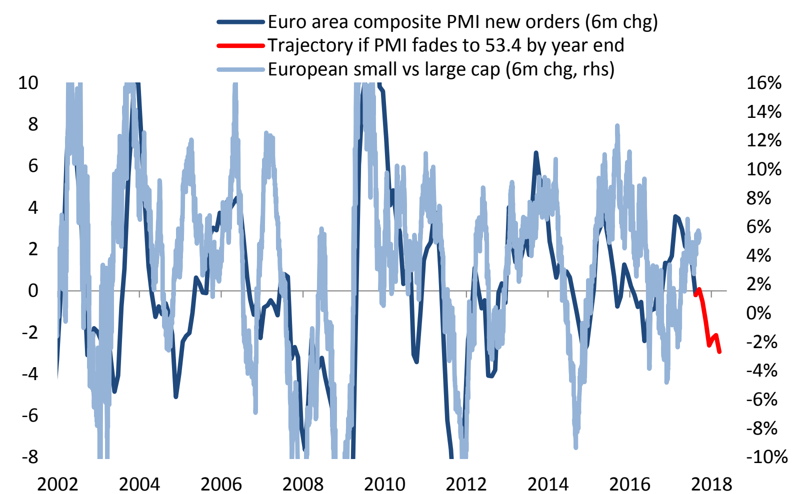
Small caps are more domestic (60% of revenues come from continental Europe vs 40% for large caps) but have lagged the recent period of EUR strength



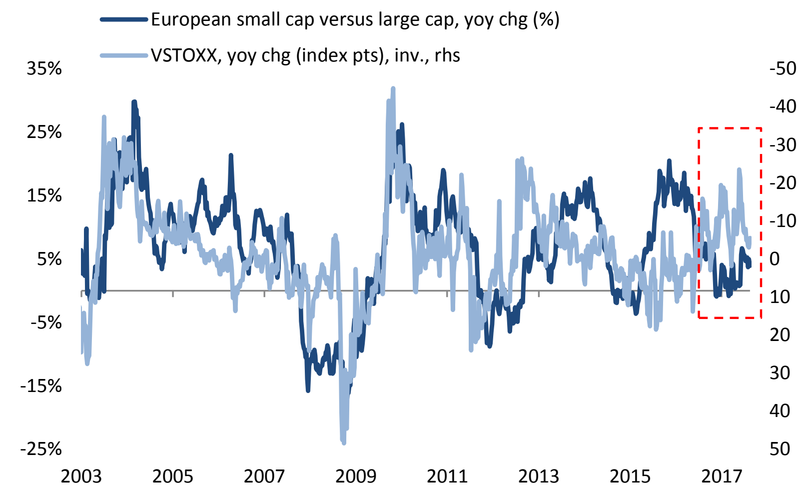
The current level of US financial conditions remains consistent with continued outperformance for small cap versus large cap



European small versus large cap tends to move in line with Euro area PMI momentum, which implies mild downside



European small caps would be vulnerable if volatility were to rise sharply



Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

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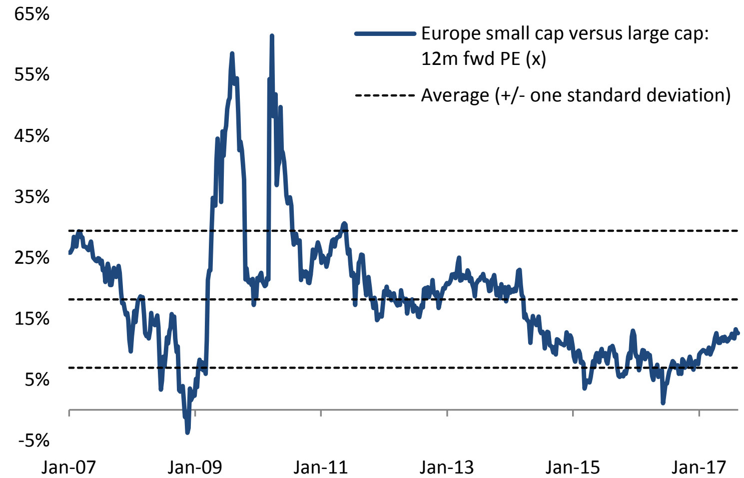
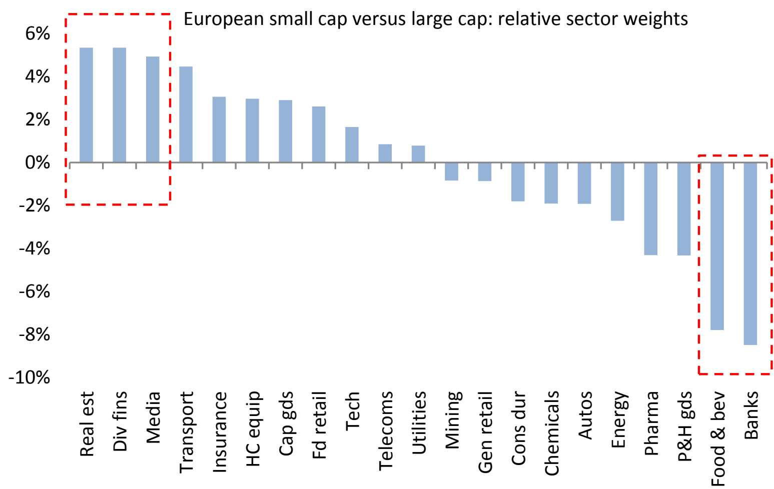
Overweight European small cap versus large cap

European small caps have outperformed large caps by more than 200% over the past 15 years, with times of crises being the only periods of reversal

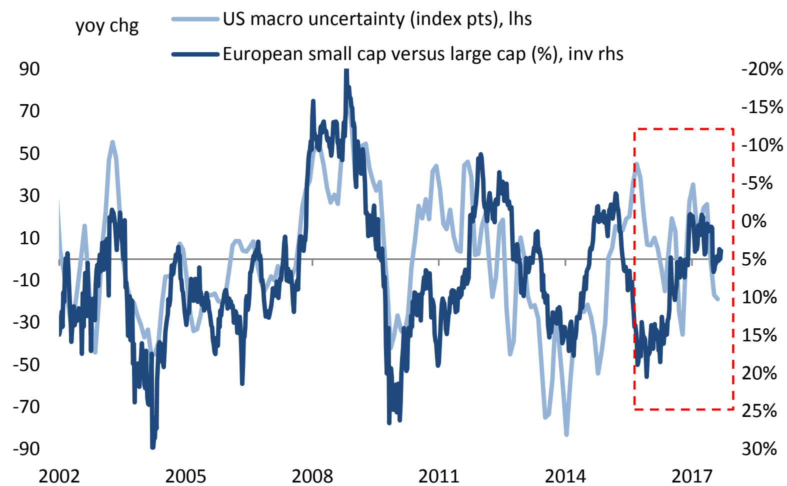
European small caps' relative P/Es, at a 13% premium to large caps, is half a standard deviation below the 10-year average



Small caps are overweight real estate and media, while being underweight food & beverage and banks



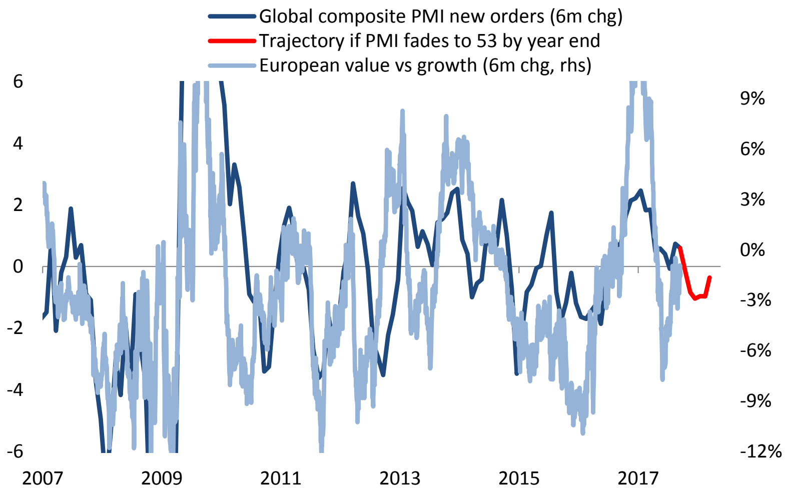
A sustained rise in US macro uncertainty would likely mean downside for small caps' relative performance



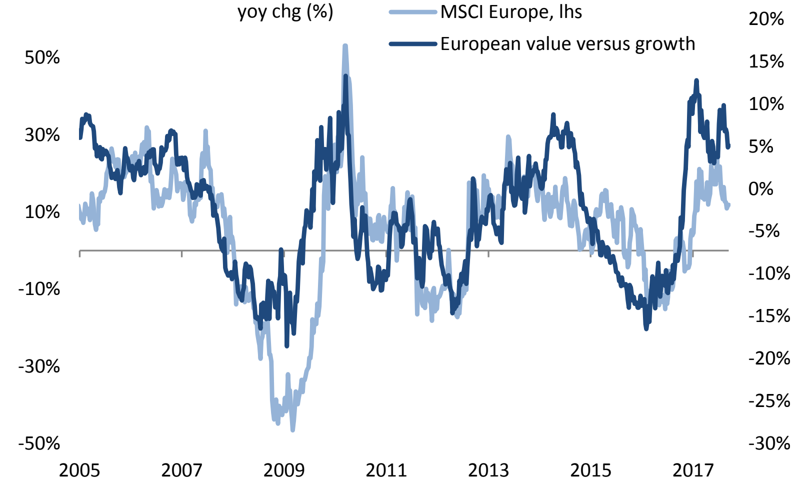
Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

Underweight value versus growth

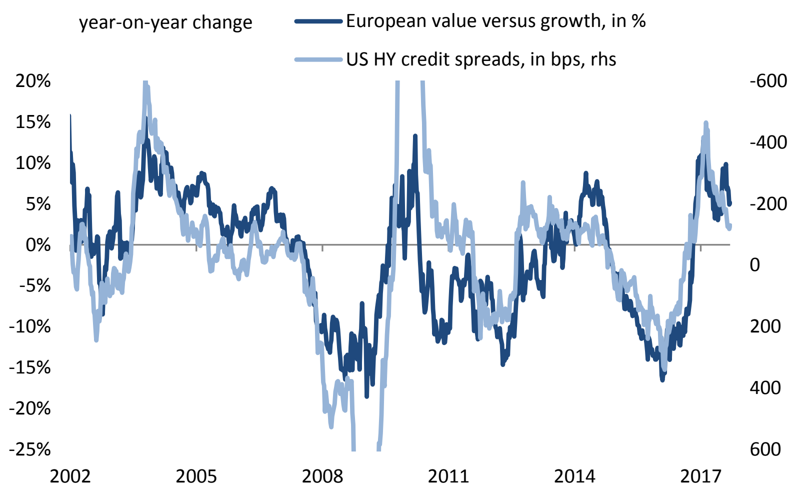
Value versus growth tends to move in line with PMI momentum and we see downside, given that we expect global PMI momentum to roll over



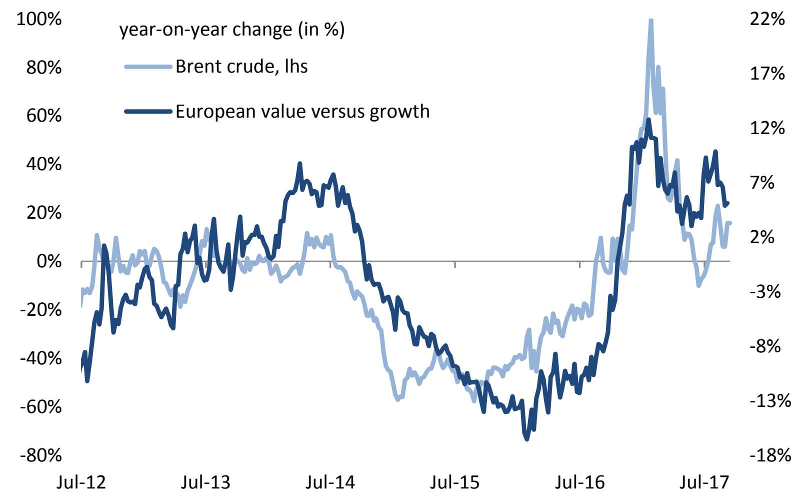
European value versus growth has done better than the overall market performance would have suggested



European value benefitted from the sharp tightening in high-yield spreads earlier this year, but our credit model suggests spreads will stay flat from here



Value stocks (via their energy component) typically perform well when oil prices rise, but oil has now overshot our analyst's year-end target



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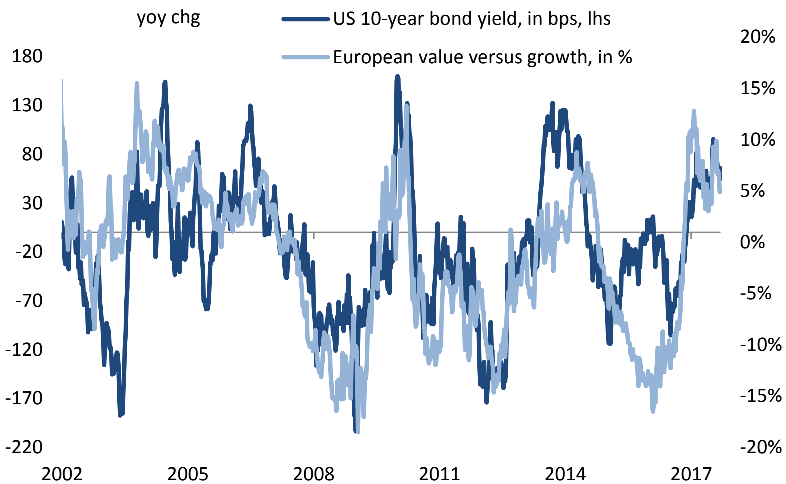
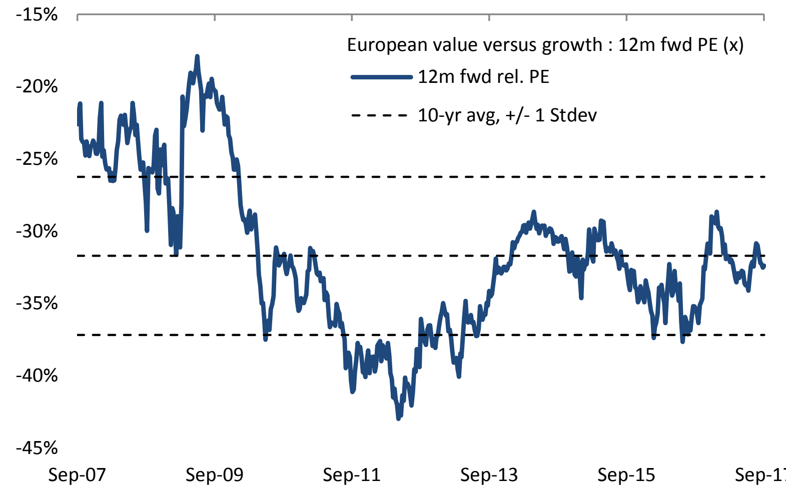
Underweight value versus growth

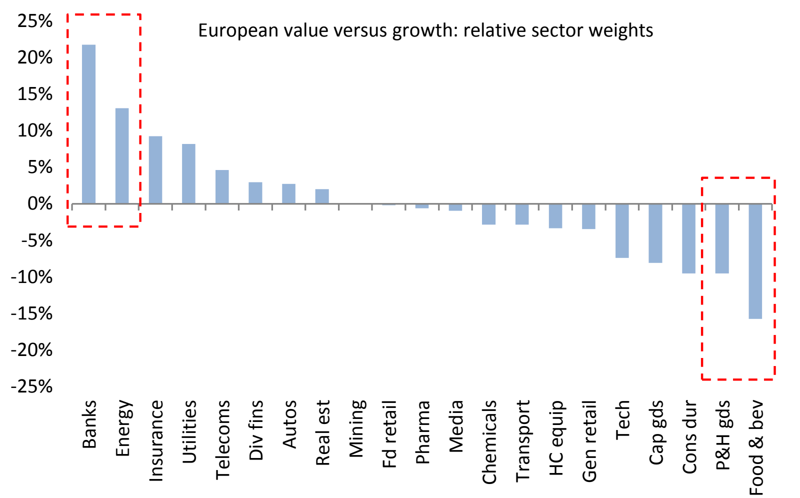
European value typically moves in line with changes in US bond yields and could benefit if yields continue rising



European value is trading on a 32% P/E discount to growth, which leaves the relative P/E in line with its 10-year average



Value stocks are overweight banks and energy, while being underweight food & beverage and personal & household goods

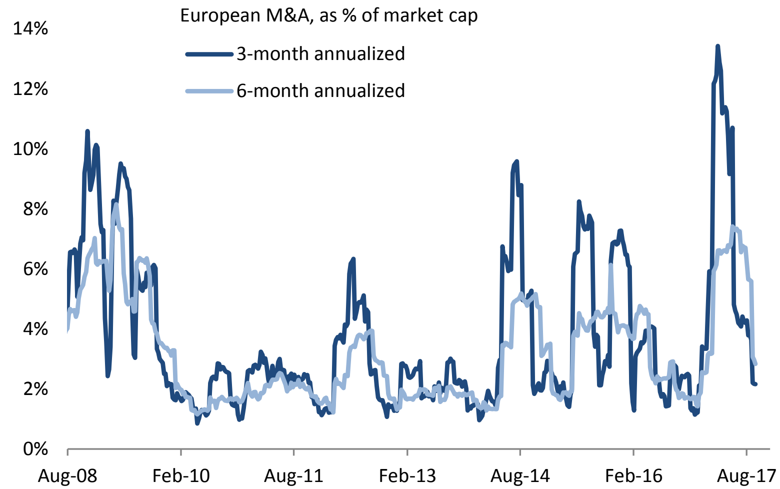


Source: Bloomberg Finance LP, Haver, Datastream, Deutsche Bank

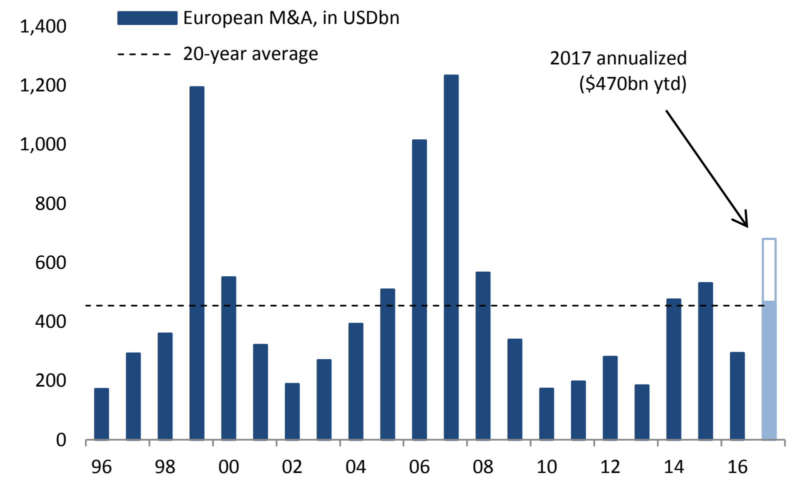
Can the pick-up in European M&A be sustained?

All M&A statistics in this report refer to deals in which the target company is European

Given subdued M&A activity over the past months, European M&A momentum has faded significantly after hitting a 10-year high in mid-March

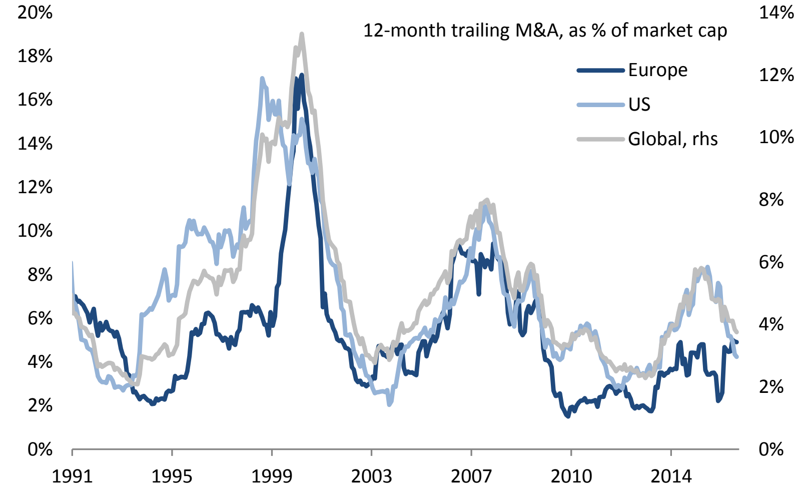


Year-to-date European M&A volumes have reached the 20-year average of $450 billion, and could rise to a new post-crisis high of $680 billion if the pace is maintained



12-month trailing M&A activity has risen to close to an 8-year high of 5% of market cap, but remains well below the 2008/09 M&A bonanza

Global 12-month trailing M&A activity has falling to a 2-year low at 3.8% of market cap (down from 6% in December last year)



Source: Dealogic, Datastream, Deutsche Bank

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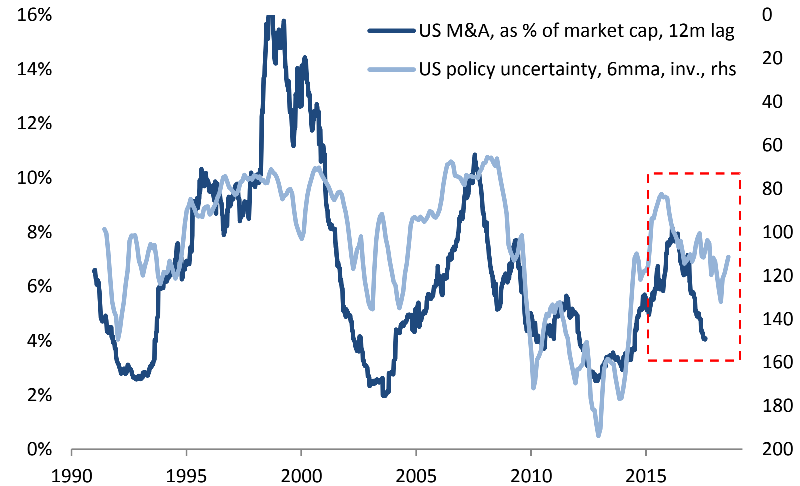
Can the pick-up in European M&A be sustained?

All M&A statistics in this report refer to deals in which the target company is European

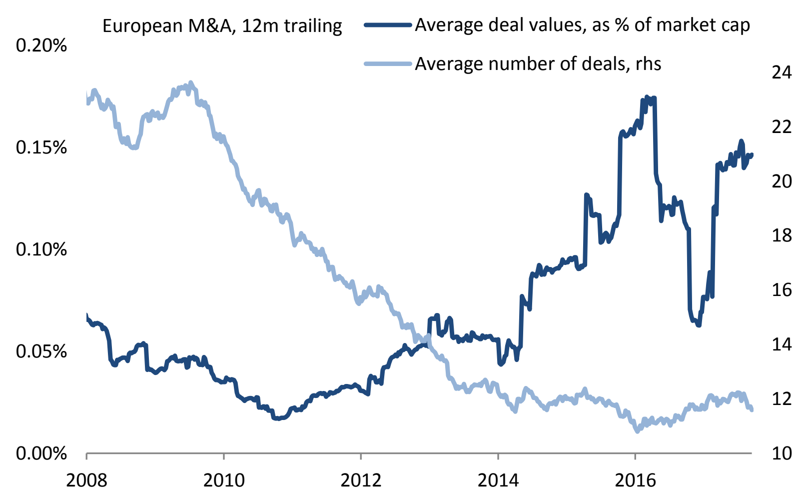
The fall in European macro uncertainty has helped European M&A activity to rise, but remains on levels inconsistent with a structural pick-up in M&A

Macro uncertainty also tends to be a key driver of the US M&A cycle, and points to upside for US M&A activity



The sharp rise in the Euro trade-weighted index should weigh on European M&A activity

Average deal values have picked up from a 2.5-year low, yet average deal numbers remain close to an all time low, pointing to weak foundations



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Source: Dealogic, Datastream, Haver, Deutsche Bank

The authors of this report wish to acknowledge the contributions made by
Ashutosh Rajgarhia, Mohan Rajkumar, **Rohit Mehboobani** and **Aditya Arora**.

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Appendix 1
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Rotberg, Wolf /Raedler, Sebastian /Pearce, Tom /Bruckner, Andreas

Equity Rating Key

Buy: Based on a current 12-month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield), we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total shareholder return, we recommend that investors sell the stock.

Hold: We take a neutral view on the stock 12 months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.

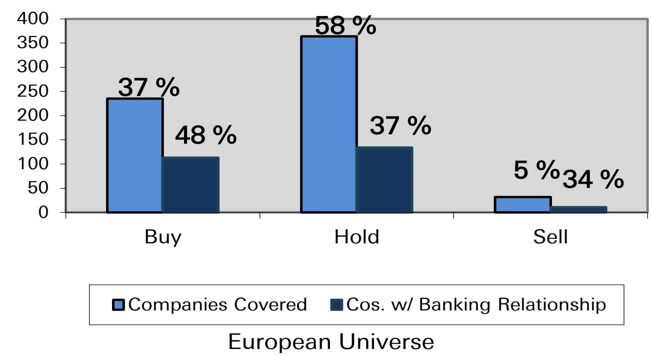
2. Ratings definitions prior to 27 January, 2007 were:

Buy: Expected total return (including dividends) of 10% or more over a 12-month period

Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period

Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity Rating Dispersion and Banking Relationships



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