
H2O Update on EM markets

London – August 24, 2015



Markets are challenging the “Fed put” in an environment of China/emerging market crisis.

Our long-term bearish view on EM markets since mid- 2013 partially protected us from the risk-off environment since last Wednesday.

Our positive performance coming from short EM FX, short commodity FX, short MSCI EM did not absorb the negative technical sell-off on our long European equities, long Italian BTPs, long USD and short US-5y Treasuries.

We are now expecting a further slump in EM markets and yet a rebound of other risk-on strategies including European equities to which global investors are much less exposed (in particular following the Greek crisis) and which should quickly benefit from the indirect ECB QE protection and from the fall in commodity prices.

Liquidity has been poor for a while as we said many times. Now the challenge is to see big risk parity funds experiencing significant redemptions in the wake of very negative returns two or three standard deviations below their weekly average drawdowns. It could lead to renewed market gaps on credit and emerging markets.

The asset allocation conundrum could unfold in two phases:

- The equity put is removed triggering flight to quality (we are in this sequence as markets acknowledge the Fed hike in September or December);
- The put is removed across the entire yield spectrum and correlation traps will take place in bond markets triggering solid bear flattening, and credit underperformance continuation.

Part of the market reaction seems to be following the template of last October in the wake of another round of oil price weakness. From this perspective, the fall in DM equity markets should be a buying opportunity as soon as capitulation occurs, probably by early September. We would expect lower oil prices will eventually constitute a positive shock for world growth through the consumer, though initially the negative impact on producers dominates asset prices. In any case, growth would be reallocated from commodity producers towards commodity importers, so world growth would be fine but its regional composition would shift dramatically. This disinflationary boom should be positive for DM equities, so the question should not be whether, but when to buy them.

Part of the recent market move is related to China’s decision to let its currency depreciate, in the context of already faltering growth. Although the CNY depreciation has been modest, this policy decision gives credit to the new regime of weak growth in China and Asia in general. It also opens the door to more competition for currency depreciation within the region. More specifically, USD-pegged Asian currencies are likely to come under a lot of pressure as the USD appreciates, the CNY depreciates and the Fed eventually hike rates.

The recent downward move in EM equities is most likely the beginning of a bearish trend similar to that of 1997 and 1998. Note that EM has 2 business cycles to cleanse in the current recession, as there was no cleansing during the 2008 GFC in EM when looking at the uninterrupted upward trend in leverage in most EM countries. Hence, current recessionary forces have a long way to go before investors will be in a position to look again at profitable investments in EM assets.

Due to the lack of leverage in global banks, systemic risk and worldwide contagion across markets is unlikely. However, tighter financial regulation also means a structurally poorer market liquidity. This calls for more frequent episodes of volatility spike. These episodes can be seen as the quantum jumps through which the new growth regime (DM vs EM, commodity consumer vs. producers, tighter USD funding) is recognized step by step. Although all risky assets are initially affected, some are because of positioning (as EMU equities and the euro last week) while others are because of worsening fundamentals (EM assets, commodity currencies). Unlike the second group which is following a well-established downward trend, the first group is bound to recover as soon as volatility comes off.

Finally, for investors, the Fed is converging towards a policy dilemma whereby the put (it is always keen to offer in the face of short-term uncertainty) becomes increasingly incompatible with the need to begin normalizing its policy now that the unemployment rate is close to 5%. EM assets and US Treasuries are the most exposed to this dilemma, although DM equities would also have to factor in a greater uncertainty. In that regard, a short position on 5-year US Treasuries might oddly enough offer the best protection for H2O strategies. We are maintaining our strategy on the Fed (long USD, flattening of the US yield curve, short US small and mid-caps) as portfolio construction mitigates the timing challenge and tactical management offers an objective diversification component.

Issued in London on August 24, 2015.

H2o Asset Management LLP, 10 Old Burlington Street, London W1S 3AG, United Kingdom, Management Company n°529105 FCA

H2o AM LLP is authorized and regulated by the Financial Conduct Authority.

This document (and any attachments thereto) is confidential and for use only by the intended recipient. Access by others is unauthorized. Its content should not be relied upon and no liability or responsibility is accepted by us (H2o AM LLP) or associated companies), without subsequent written confirmation of its contents, signed by an authorized signatory. If you are not the intended recipient, please notify us promptly and delete all copies and note any disclosure, copying, distribution or any action taken or omitted to be taken in reliance on the information it contains is prohibited and may be unlawful. This message is provided for information purposes and should not be construed as a solicitation or offer to buy or sell any securities or related financial instruments.

Company Name & Business Office: H2o AM LLP, 2nd floor, 10 Old Burlington Street, London W1S 3AG. Company Number OC356207.

H2o AM LLP, 2nd floor, 10 Old Burlington Street, London W1S 3AG. United Kingdom Management Company n°529105 FCA.

Additional notes

Outside the United States, this communication is for information only and is intended for investment service providers or other Professional Clients. This material may not be distributed, published, or reproduced, in whole or in part. Although Natixis Global Asset Management believes the information provided in this material to be reliable, it does not guarantee the accuracy, adequacy or completeness of such information.

The analyses and opinions referenced herein represent the subjective views of the author as referenced, are as of the date indicated and are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material.

In the E.U. (outside of the U.K.): this material is provided by NGAM S.A. or one of its branch offices listed below. NGAM S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of NGAM S.A.: 2 rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. **France:** NGAM Distribution (n.509 471 173 RCS Paris). Registered office: 21 quai d'Austerlitz, 75013 Paris. **Italy:** NGAM S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. **Germany:** NGAM S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. **Netherlands:** NGAM, Nederlands filiaal (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. **Sweden:** Natixis NGAM, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. **Spain:** NGAM, Sucursal en España, authorised and supervised in relation to its activities in Spain by the CNMV. Registered office: Torre Colon II - Plaza Colon, 2 - 28046 Madrid, Spain.

In Switzerland: Provided to Qualified Investors by NGAM, Switzerland Sàrl. Registered office: Rue du Vieux Collège 10, 1204 Geneva, Switzerland.

In the U.K.: Approved for use by NGAM UK Limited, authorized and regulated by the Financial Conduct Authority (register no. 190258). Registered Office: NGAM UK Limited, Cannon Bridge House, 25 Dowgate Hill, London, EC4R 2YA.

In the DIFC: Distributed in and from the DIFC financial district to Professional Clients only by NGAM Middle East, a branch of NGAM UK Limited, which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Singapore: Provided by NGAM Singapore (name registration no. 5310272FD), a division of Natixis Asset Management Asia Limited, formerly known as Absolute Asia Asset Management Limited, to Institutional Investors and Accredited Investors for information only. Natixis Asset Management Asia Limited is authorized by the Monetary Authority of Singapore (Company registration No.199801044D) and holds a Capital Markets Services License to provide investment management services in Singapore. Address of NGAM Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre. Singapore 049315.

In Taiwan: This material is provided by NGAM Securities Investment Consulting Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C and a business development unit of Natixis Global Asset Management. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building II), R.O.C., license number 2012 FSC SICE No. 039, Tel. +886 2 2784 5777.

In Japan: Provided by Natixis Asset Management Japan Co., Registration No.: Director-General of the Kanto Local Financial Bureau (Kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 2-2-3 Uchisaiwaicho, Chiyoda-ku, Tokyo.

In Hong Kong: This document is issued by NGAM Hong Kong Limited and is provided solely for general information only and does not constitute a solicitation to buy or an offer to sell any financial products

or services. Certain information included in this material is based on information obtained from other sources considered reliable. However, NGAM Hong Kong Limited does not guarantee the accuracy of such information.

In Australia: This document is issued by NGAM Australia Limited ("NGAM AUST") (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only and does not constitute any offer or solicitation to buy or sell securities and no investment advice or recommendation. Investment involves risks. It may not be reproduced, distributed or published, in whole or in part, without the prior approval of NGAM AUST. Information herein is based on sources NGAM AUST believe to be accurate and reliable as at the date it was made. NGAM AUST reserve the right to revise any information herein at any time without notice.

In Latin America (outside Mexico and Uruguay): This material is provided by NGAM S.A.

In Mexico: This material is provided by NGAM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment advisor and is not regulated by the Comisión Nacional Bancaria y de Valores or any other Mexican authority. This material should not be considered an offer of securities or investment advice of any type and does not represent the performance of any regulated financial activities. Any products, services or investments referred to herein are rendered or offered in a jurisdiction other than Mexico. In order to request the products or services mentioned in these materials it will be necessary to contact Natixis Global Asset Management outside Mexican territory.

In Uruguay: This material is provided by NGAM Uruguay S.A. NGAM Uruguay S.A. is a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay ("CBU"). Please find the registration communication issued by the CBU at www.bcu.gub.uy. Registered office: WTC – Luis Alberto de Herrera 1248, Torre 3, Piso 4, Oficina 474, Montevideo, Uruguay, CP 11300.

The above referenced entities are business development units of Natixis Global Asset Management S.A., the holding company of a diverse line-up of specialized investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Global Asset Management conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions.

In Canada: NGAM Distribution, L.P. ("NGAM Distribution"), with its principal office located in Boston, MA, is not registered in Canada and any dealings with prospective clients or clients in Canada are in reliance upon an exemption from the dealer registration requirement in National Instrument 31 – 103 Registration Requirements, Exemptions and Ongoing Registrant Obligations. There may be difficulty enforcing legal rights against NGAM Distribution because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada. The agent for service of process in Alberta is Borden Ladner Gervais LLP (Jonathan Doll), located at Centennial Place, East Tower, 1900, 520 – 3rd Avenue SW, Calgary, Alberta T2P 0R3. The agent for service of process in British Columbia is Borden Ladner Gervais LLP (Jason Brooks), located at 1200 Waterfront Centre, 200 Burrard Street, P.O. Box 48600, Vancouver, BC V7X 1T2. The agent for service of process in Ontario is Borden Ladner Gervais LLP (John E. Hall), located at Scotia Plaza, 40 King St. W, Toronto, ON M5H 3Y4. The agent for service of process in Quebec is Borden Ladner Gervais LLP (Christian Faribault), located at 1000 de La Gauchetière St. W, Suite 900, Montreal, QC H3B 5H4.

In the United States: Furnished by NGAM Distribution L.P. 399 Boylston St. Boston, MA 02116. Natixis Global Asset Management consists of Natixis Global Asset Management, S.A., NGAM Distribution, L.P., NGAM Advisors, L.P., NGAM S.A., and NGAM S.A.'s business development units across the globe, each of which is an affiliate of Natixis Global Asset Management, S.A. The affiliated investment managers and distribution companies are each an affiliate of Natixis Global Asset Management, S.A.

This material should not be considered a solicitation to buy or an offer to sell any product or service to any person in any jurisdiction where such activity would be unlawful.