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THE **EUROZONE** IN 2016

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A maturing recovery in the EZ: Stable GDP growth and higher inflation

* **Real GDP growth has been stable at 1.6% year-over-year in recent quarters, and we think this pace will be sustained in 2016**. Survey data and narrow money growth continue to tell a story of a firm and stable cyclical recovery in the Eurozone. In addition, the ECB likely will err on the side of caution in adding further support if inflation or growth falters, and looser fiscal policy in Germany will also help.

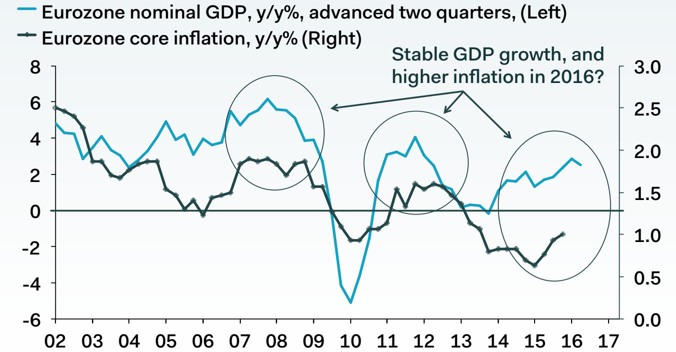
* **Global headwinds have intensified, but the economy looks resilient for now**. Investors used to talk about the risk of a Eurozone accident derailing global growth, but the tables have turned. Unless we see signs of a slowdown in domestic demand, we are optimistic the euro area economy can weather global headwinds from higher U.S. rates, fiscal tightening in the U.K., and slow growth in emerging markets.

* **Weakening consumers' spending is the biggest cyclical risk in the short run.** Household consumption has accounted for two-thirds of Eurozone GDP growth in the past two years, and a slowdown would be a big hit to the economy, given the lackluster investment picture. We see few signs of a downturn in consumer sentiment, however, indicating consumers' spending should hold up, at least in the early part of the year.

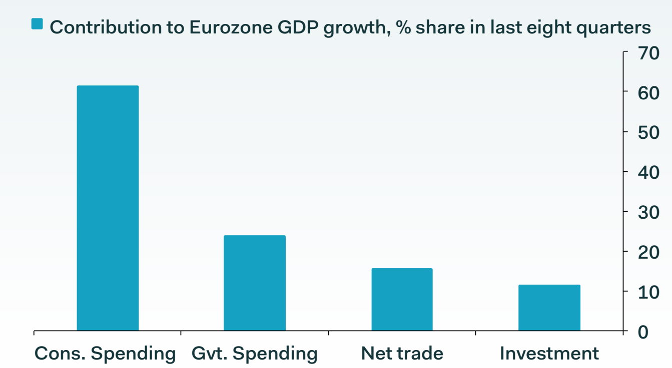
* **A revival in construction could help boost investment spending in 2016.** The sector has been moribund since the financial crisis, but leading indicators suggest a cyclical upturn is under way. Capital expenditures in the building sector accounts for 50% of total investment in the Eurozone, and even a modest upturn would lift quarterly investment rates significantly this year.

* **A further decline in oil prices could prompt the ECB to do more, but this is not our base case.** Core inflation is one of the most long-lagging indicators in the Eurozone, and we think its slow recovery will continue this year. This likely will offset volatility in headline inflation, and we doubt the central bank will be forced to ease further, given the already very loose policy stance.

THE BUSINESS CYCLE LIKELY WILL MATURE FURTHER IN 2016...



...BUT CAN INVESMENT MAKE GROWTH MORE BALANCED?



THE **EUROZONE** IN 2016

* **The markets' assumptions for inflation this year, based on inflation swaps and long-term benchmark yields, look too low to us.** Bond markets are focused on deflation risks, but macroeconomic data are telling a story of higher inflation ahead. We think long-term benchmark 10-year yields are too low at 0.6%, and also believe one-to-three year inflation implied by swaps are mispriced.

* **Eurozone equities will continue to enjoy support from QE, and should return 15% in local currency terms.** Higher earnings and modest multiple expansion should help equities in the euro area outperform the global benchmark this year. But a lot of good news and monetary easing are already priced in, and the stock market in Europe will not be immune to higher rates in the U.S; expect higher volatility.

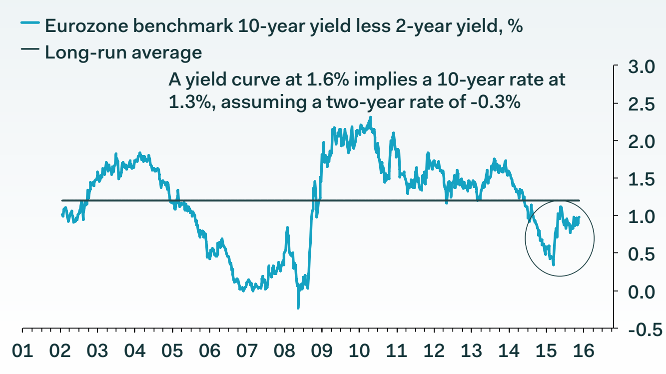
* **Negative interest rates, QE and a current account surplus means the Eurozone will remain a source of excess liquidity to global capital markets**. A dovish ECB won't completely negate the adverse impact of higher U.S. rates but carry trades funded in euros likely will remain a key theme this year. We think the current account surplus will be stable at about 3% of GDP, with the income balance offering support to offset a modestly weaker trade surplus.

* **GDP growth in Germany will be better and more balanced in 2016.** We expect a slight acceleration in GDP growth to 1.6% year-over-year from 1.4%—our current forecast—in 2015. Consumers' spending likely will lose momentum slightly, but investment—especially in construction—and government spending will give offsetting support. We also expect a positive contribution from net trade as imports fall amid stable exports.

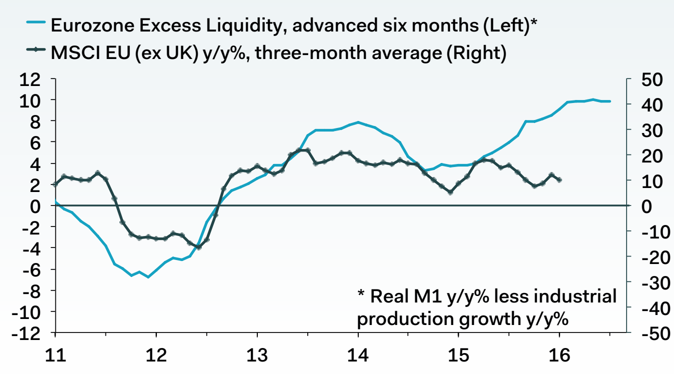
* **French GDP growth likely will accelerate slightly to 1.2% year-over-year from 1.0% in 2015.** Q4 data likely will be tainted by the Paris terrorist attacks, but the hit will be temporary, and we think the economy pick up as the year progresses. Structural challenges remain significantly, but survey data and real M1 growth suggest the recovery will continue.

* **Spain's economy will slow this year.** Real GDP growth in Spain likely will come in at about 3.0% year-over-year in 2015, but should slow to about 1.5%-to-2.0% in 2016, as manufacturing investment weakens. The uncertainty election outcome raises short term risk that firms will postpone adding staff and investment projects, but consumers' spending likely will remain strong.

WE THINK THE CURVE CAN STEEPEN FURTHER IN 2016...



...AND EQUITIES SHOULD DO WELL FOR INVESTORS TOO



Forecast summary:

Economic Activity (y/y%)	2014	2015	2016	2017	2018
Eurozone GDP	0.9	1.6	1.6	1.0	0.8
Contribution of Household Consumption	0.4	0.8	0.6	0.4	0.1
Contribution of Government Consumption	0.1	0.3	0.4	0.2	0.2
Contribution of Investment	0.2	0.2	0.5	0.4	0.3
Contribution of Net trade	0.1	0.3	0.1	0.1	0.2
Germany GDP	1.5	1.6	1.8	1.3	0.9
France GDP	0.2	1.2	1.2	0.8	0.6
Italy GDP	-0.1	1.2	1.2	0.8	0.4
Spain GDP	1.6	3.0	2.0	1.2	0.6
Labor Market and Prices					
Eurozone unemployment (end of year)	11.4	10.7	10.4	10.4	10.2
Eurozone CPI y/y% (end of year)	0.0	0.2	1.6	1.7	1.4
Eurozone labour productivity growth y/y%	0.8	0.9	0.8	0.7	0.7
Other					
Eurozone current account, % GDP	2.5	3.0	3.0	2.3	2.3
Eurozone budget deficit, % GDP	-2.8	-2.6	-2.9	-3.0	-3.2
Government debt, % GDP	92.0	95.0	97.0	99.0	101
ECB refi rate, Q4 average	0.05	0.05	0.05	0.05	0.05
10-year benchmark rate, Q4 average	0.7	0.4	1.3	1.0	0.8
Eurostoxx, Q4 average	3170	3300	3950	3800	3650