Has the European Project Come to an End?

March 23, 2017

LEGAL

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QA@HEDGEYE.COM

TO BE ANSWERED AT THE END OF THE CALL

OUTLINE & SUMMARY

1. **ECB & EU:** conflicted ECB and persistent EU political risk; economic prospects within region are set to remain highly fragmented at the country level

2. **Netherlands Election Results:** limited political risk with centrist coalition formation underway; excellent economic prospects

3. **France Election Preview:** underestimated risk of a Le Pen victory and 'Frexit'; negative economic prospects

4. **Germany Election Preview:** limited political risk on a coin-flip election between Chancellor Merkel and SPD leader Martin Schulz; excellent economic prospects

5. **Brexit Update:** uncertainty of Brexit result heightens political risk; mixed economic prospects with risk asymmetrically skewed to the upside

EUROPE: A CONFUSED MARKETING MESSAGE

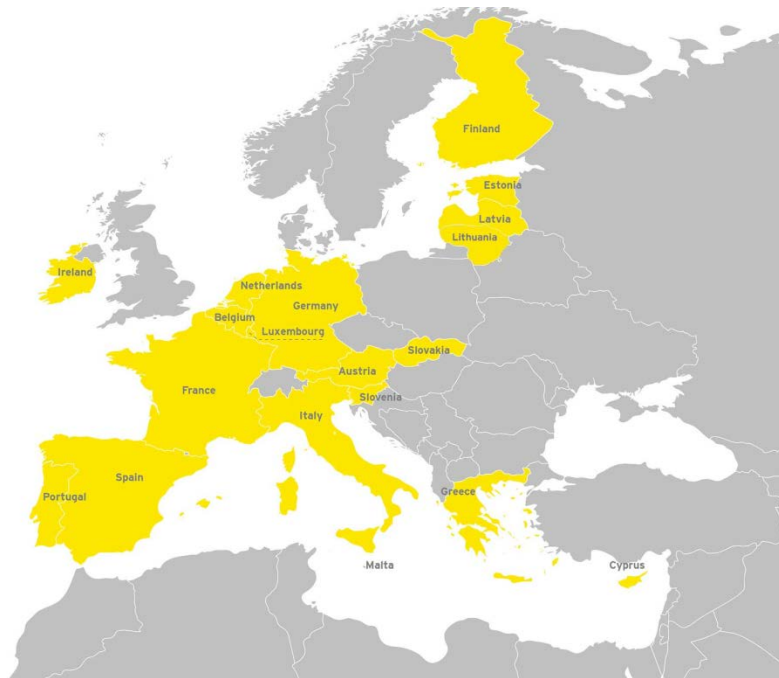**THE STRUGGLES TO CARVE OUT A EUROPEAN IDENTITY...**

"Who do I call if I want to speak to Europe?"
-Henry Kissinger

PRICE STABILITY, AND UNILATERAL MONETARY POLICY FOR 18 UNEVEN, DISPARATE ECONOMIES IS A FLAWED STRUCTURE. BUT DOES IT HAVE LEGS?

ECB POLICY SQUABBLING IS BUBBLING

HAWKS VS DOVES (MARCH 2017)

ECB President Draghi - From ECB Presser (March 9, 2017):

- Does NOT anticipate another interest rate cut, but said monetary condition need to be maintained to ensure inflation continues to pick-up.
- Said ECB stands ready to increase asset purchase program if needed.

Bundesbank President and ECB Member Jens Weidmann
- Suggests the ECB should slowly start to retreat from its easy-money policies, specifically the ECB should remove its pledge to boost stimulus again if the economic outlook darkens.

Austrian Central Bank President and ECB member Ewald Nowotny
- Said the Fed's model of finishing bond purchases before hiking rates may not transfer well to Europe.
- He said interest rates wouldn't have to be increased simultaneously or to the same extent, adding that the ECB could also raise deposit rate earlier than prime rate.

ECB Member and Chief Economist of ECB Peter Praet
- Said very substantial stimulus was still needed as underlying inflation remained subdued.

As of the 3rd week of March, Eurozone money markets are pricing in an 80% chance that the ECB could lift its deposit rate at its December 2017 meeting, vs 60% change the week prior following comments from ECB's Nowotny.
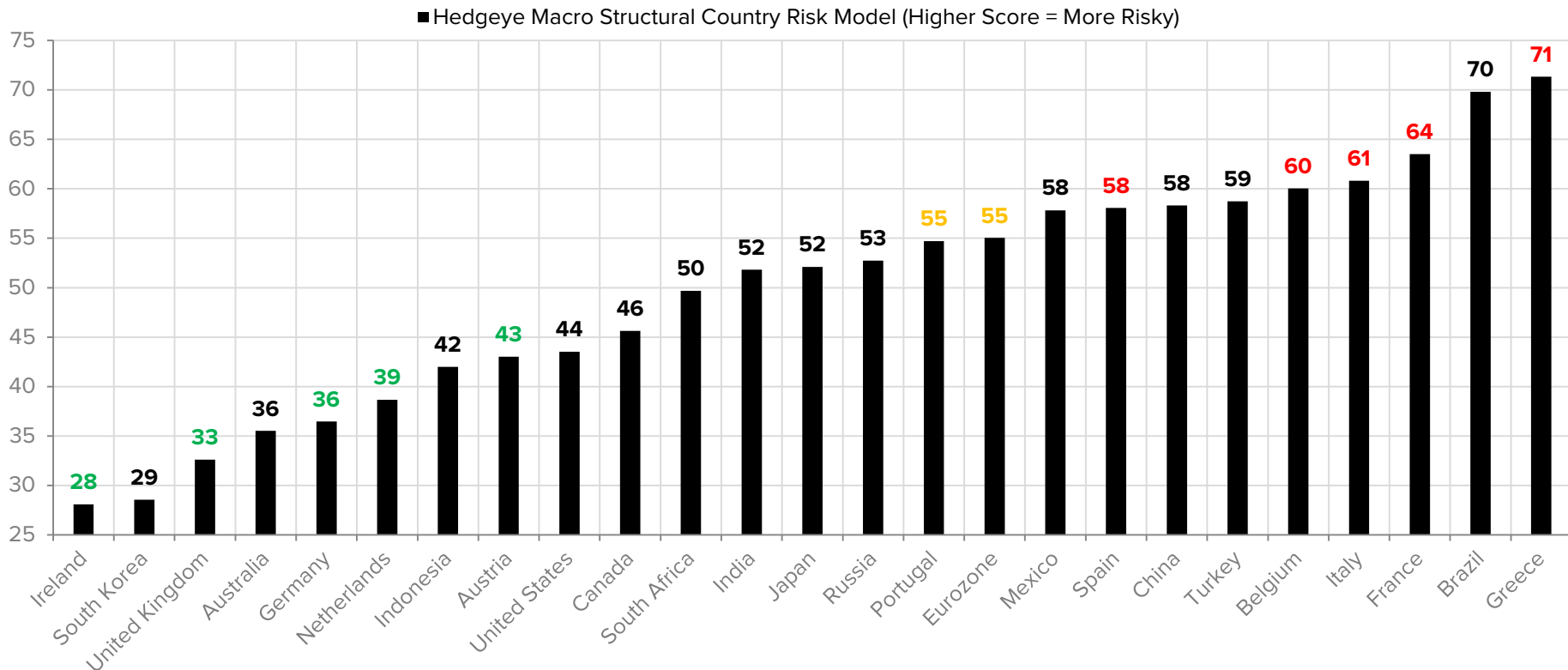
COUNTRIES REMAIN DIVIDED ON POLICY...

POLITICAL RISK IS HEIGHTENING. A MOVE TOWARDS PROTECTIONISM SUGGESTS EUROBONDS (AS A PATH FORWARD FOR THE REGION) ARE NOT A VIABLE SOLUTION TO ALL OF EUROPE'S FUNDING NEEDS. RISKS ARE PRICED AT A COUNTRY LEVEL.

... AND ON A VARIETY OF KEY METRICS

FORMER SECRETARY OF STATE HENRY KISSINGER FAMOUSLY SAID, "WHO DO I CALL IF I WANT TO SPEAK TO EUROPE?" TO THIS DAY, EUROPE REMAINS AS FRAGMENTED AS EVER IN ECONOMIC AND POLITICAL RISK TERMS.

■ Hedgeye Macro Structural Country Risk Model (Higher Score = More Risky)

Country	Score
Ireland	28
South Korea	29
United Kingdom	33
Australia	36
Germany	36
Netherlands	39
Indonesia	42
Austria	43
United States	44
Canada	46
South Africa	50
India	52
Japan	52
Russia	53
Portugal	55
Eurozone	55
Mexico	58
Spain	58
China	58
Turkey	59
Belgium	60
Italy	61
France	64
Brazil	70
Greece	71

QUANTIFY COUNTRY-LEVEL ECONOMIC AND POLITICAL RISK USING OUR PROPRIETARY STRUCTURAL RISK MODEL.

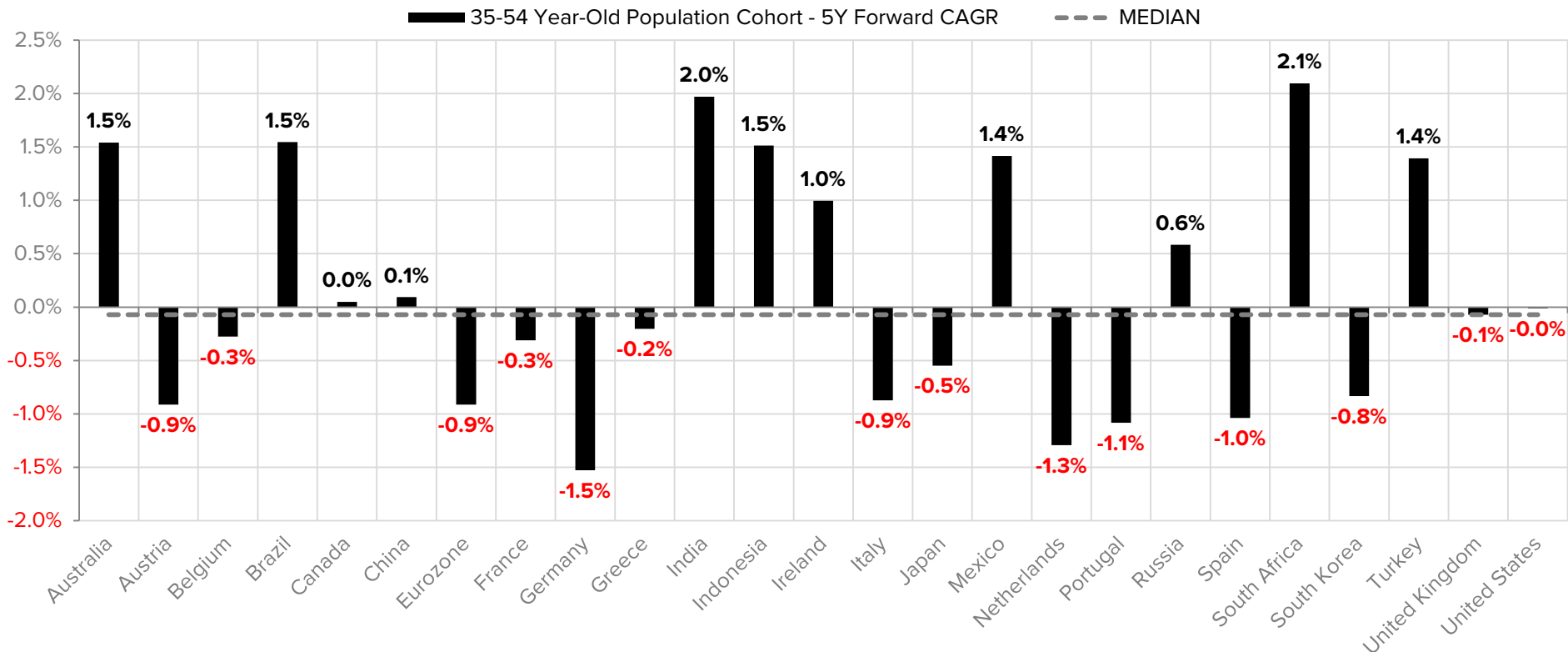|	Pillar I: Demographic Risk		Pillar II: Fiscal Policy Risk		Pillar III: Economic Cycle Risk		Pillar IV: Populism Risk		Pillar V: Competitiveness Risk	
	5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population)	35-54 Year-Old Population Cohort - 5Y Forward CAGR	Debt as a % of Nominal GDP	Central Gov't Budget Balance as a % of Nominal GDP	Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y)	Debt Service Ratio Gap (Z-Score, Trailing 10Y)	GINI Coefficient	Misery Index (Unemployment Rate + Headline Inflation Rate)	World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better)	All-In Effective Corporate Tax Rate
Australia	25%	1.5%	41%	-1.5%	2.2	-0.0	34.9	7.2%	15	48%
Austria	30%	-0.9%	85%	-0.7%	-0.1	-	30.5	8.2%	19	52%
Belgium	31%	-0.3%	106%	-2.9%	1.5	1.1	27.6	10.9%	42	59%
Brazil	15%	1.5%	78%	-9.7%	0.6	2.0	51.5	17.4%	123	68%
Canada	29%	0.0%	92%	-0.1%	2.1	2.4	33.7	9.0%	22	21%
China	17%	0.1%	46%	-3.4%	1.8	1.5	42.2	4.8%	78	68%
Eurozone	35%	-0.9%	92%	-1.8%	-0.0	-0.7	-	11.7%	33	44%
France	34%	-0.3%	97%	-3.2%	1.4	0.4	33.1	11.4%	29	63%
Germany	35%	-1.5%	68%	0.7%	-1.1	-1.3	30.1	8.2%	17	49%
Greece	33%	-0.2%	183%	-4.9%	0.2	-	36.7	24.5%	61	51%
India	10%	2.0%	68%	-3.7%	0.6	0.1	35.2	10.8%	130	61%
Indonesia	10%	1.5%	27%	-1.9%	1.3	1.5	39.5	9.4%	91	31%
Ireland	23%	1.0%	75%	-1.6%	-0.3	-	32.5	7.4%	18	26%
Italy	36%	-0.9%	133%	-2.4%	-0.5	-2.2	35.2	13.4%	50	62%
Japan	50%	-0.5%	250%	-5.7%	-1.3	-1.2	32.1	3.5%	34	49%
Mexico	12%	1.4%	56%	-2.6%	2.3	2.8	48.2	8.4%	47	52%
Netherlands	32%	-1.3%	64%	-0.9%	-0.5	0.2	28.0	7.0%	28	40%
Portugal	36%	-1.1%	128%	-3.6%	-1.6	-2.1	36.0	12.1%	25	40%
Russia	24%	0.6%	17%	-3.9%	1.4	0.9	41.6	10.0%	40	47%
Spain	32%	-1.0%	100%	-5.1%	-2.2	-1.7	35.9	21.7%	32	49%
South Africa	10%	2.1%	52%	-4.1%	0.0	-0.2	63.4	32.8%	74	29%
South Korea	23%	-0.8%	39%	0.5%	1.4	-1.3	-	5.5%	5	33%
Turkey	29%	1.4%	32%	-3.1%	1.5	1.8	40.2	22.3%	69	41%
United Kingdom	30%	-0.1%	89%	-2.9%	-1.1	-1.1	32.6	7.1%	7	31%
United States	27%	-0.0%	108%	-3.1%	-0.6	-0.7	41.1	7.4%	8	44%
MEDIAN	**29%**	**-0.1%**	**78%**	**-2.9%**	**0.2**	**0.0**	**35.2**	**9.4%**	**33**	**48%**

DEMOGRAPHIC RISK: AGING

EMPIRICAL EVIDENCE SHOWS THAT POPULATION AGING IS INVERSELY CORRELATED TO TREND RATES OF REAL GDP GROWTH AND INFLATION.

Legend: ■ 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population) — — MEDIAN

Data values by country:
- Australia: 25%
- Austria: 30%
- Belgium: 31%
- Brazil: 15%
- Canada: 29%
- China: 17%
- Eurozone: 35%
- France: 34%
- Germany: 35%
- Greece: 33%
- India: 10%
- Indonesia: 10%
- Ireland: 23%
- Italy: 36%
- Japan: 50%
- Mexico: 12%
- Netherlands: 32%
- Portugal: 36%
- Russia: 24%
- Spain: 32%
- South Africa: 10%
- South Korea: 23%
- Turkey: 29%
- United Kingdom: 30%
- United States: 27%

DEMOGRAPHIC RISK: POPULATION GROWTH

POPULATION GROWTH IS A CRUCIAL FACTOR IN PROJECTING ECONOMIC OUTPUT – ESPECIALLY IN THE CORE CONSUMPTION DEMOGRAPHIC COHORT OF 35-54 YEAR-OLDS.

Legend: ▬ 35-54 Year-Old Population Cohort - 5Y Forward CAGR — — — MEDIAN

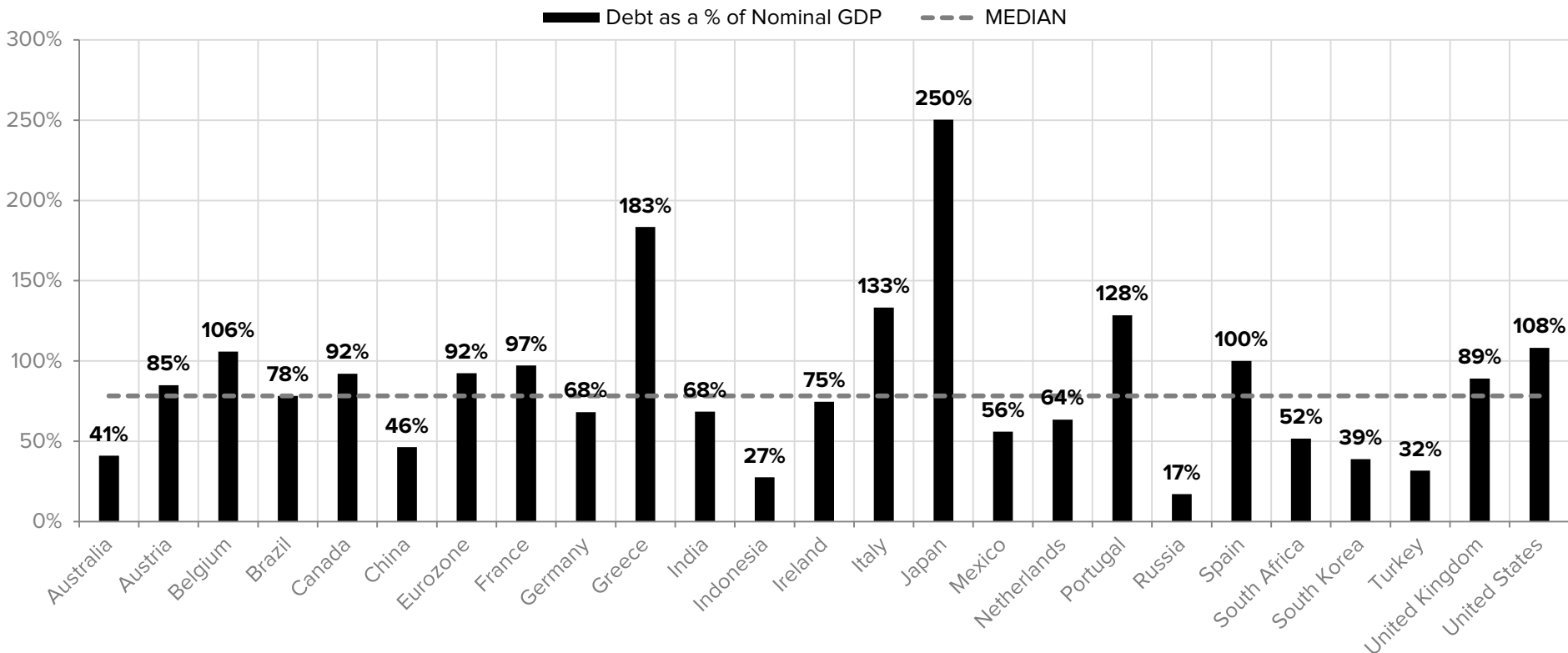| Country	35-54 Year-Old Population Cohort - 5Y Forward CAGR
Australia	1.5%
Austria	-0.9%
Belgium	-0.3%
Brazil	1.5%
Canada	0.0%
China	0.1%
Eurozone	-0.9%
France	-0.3%
Germany	-1.5%
Greece	-0.2%
India	2.0%
Indonesia	1.5%
Ireland	1.0%
Italy	-0.9%
Japan	-0.5%
Mexico	1.4%
Netherlands	-1.3%
Portugal	-1.1%
Russia	0.6%
Spain	-1.0%
South Africa	2.1%
South Korea	-0.8%
Turkey	1.4%
United Kingdom	-0.1%
United States	-0.0%

WHY DO 35-54 YEAR-OLDS MATTER?

BECAUSE ACCORDING TO BOTH EMPIRICAL EVIDENCE AND LIFE-CYCLE ECONOMICS THEORY, THIS IS THE WORLD'S CORE END CONSUMPTION DEMAND DEMOGRAPHIC.
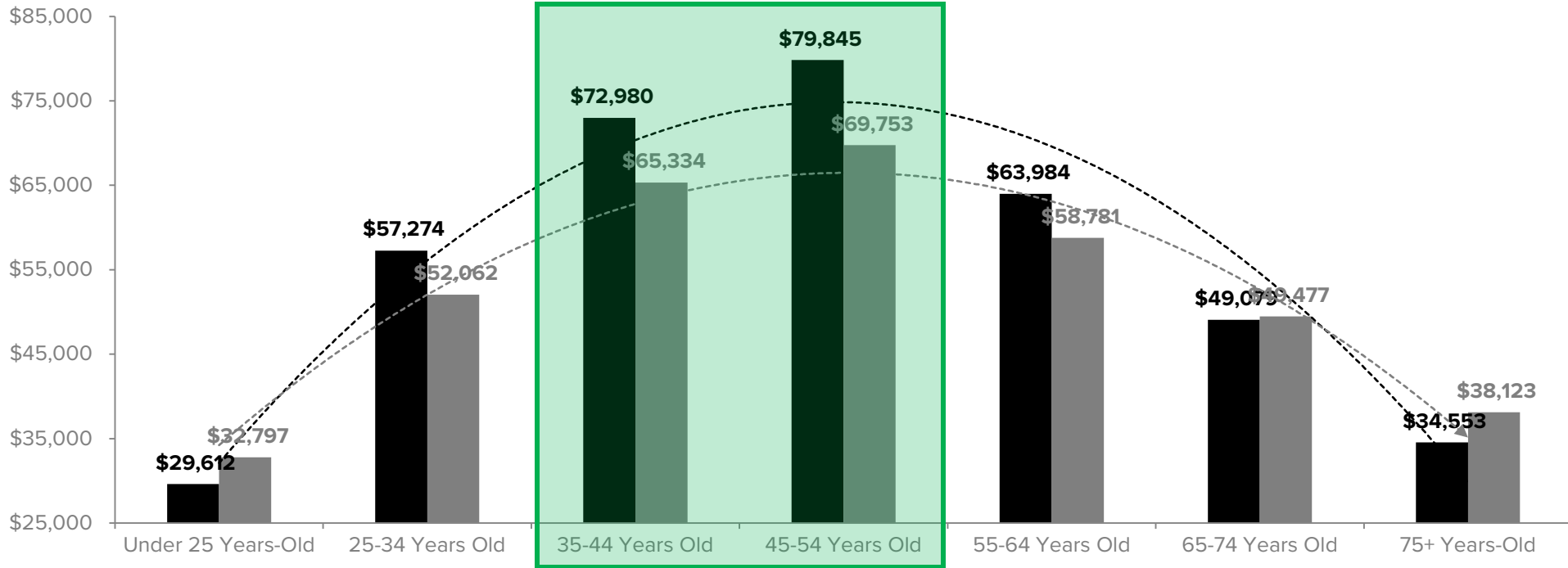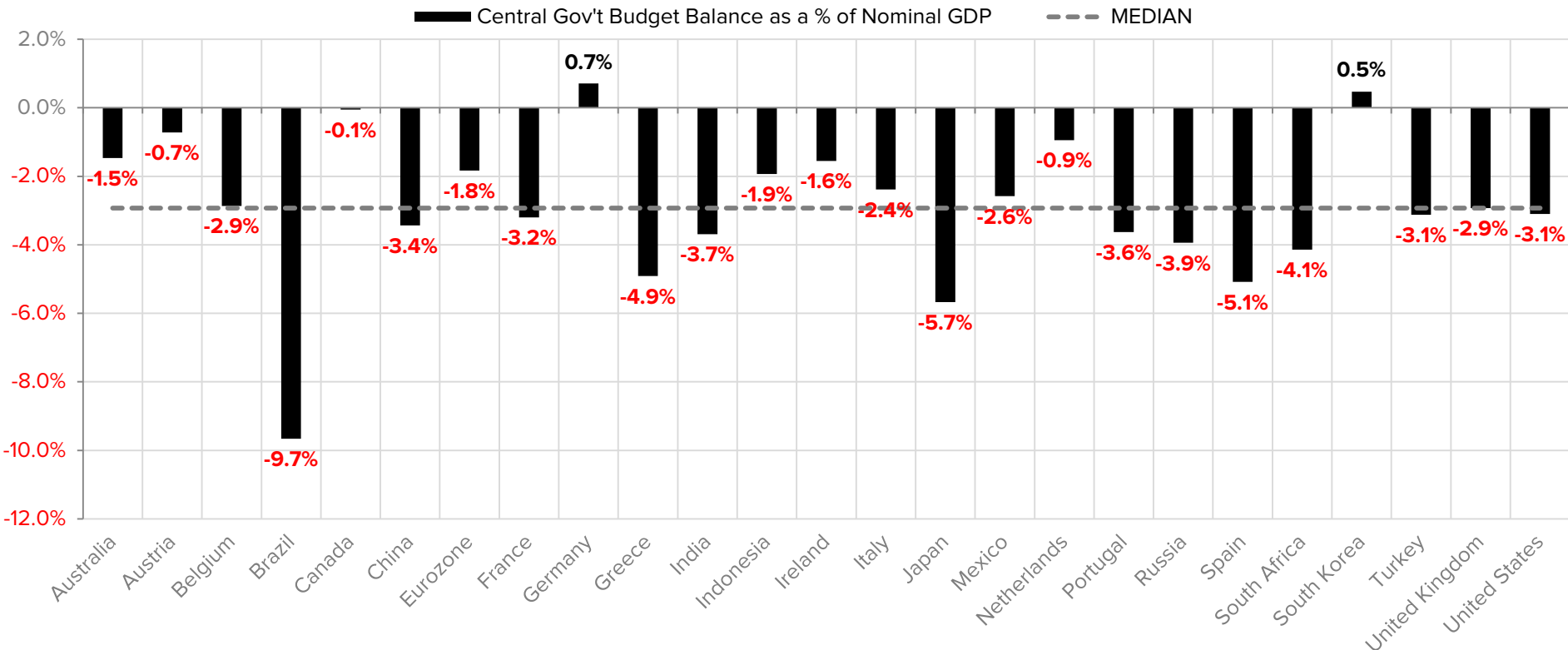
FISCAL POLICY RISK: SOVEREIGN DEBT

WHILE THE DAYS OF SOVEREIGN DEBT CRISES IN ADVANCED ECONOMIES MAY BE BEHIND US, THAT DOESN'T MEAN HEAVILY INDEBTED NATIONS WON'T SEE THEIR GROWTH CHOKED OFF BY BLOATED PUBLIC SECTOR DEBT BURDENS.
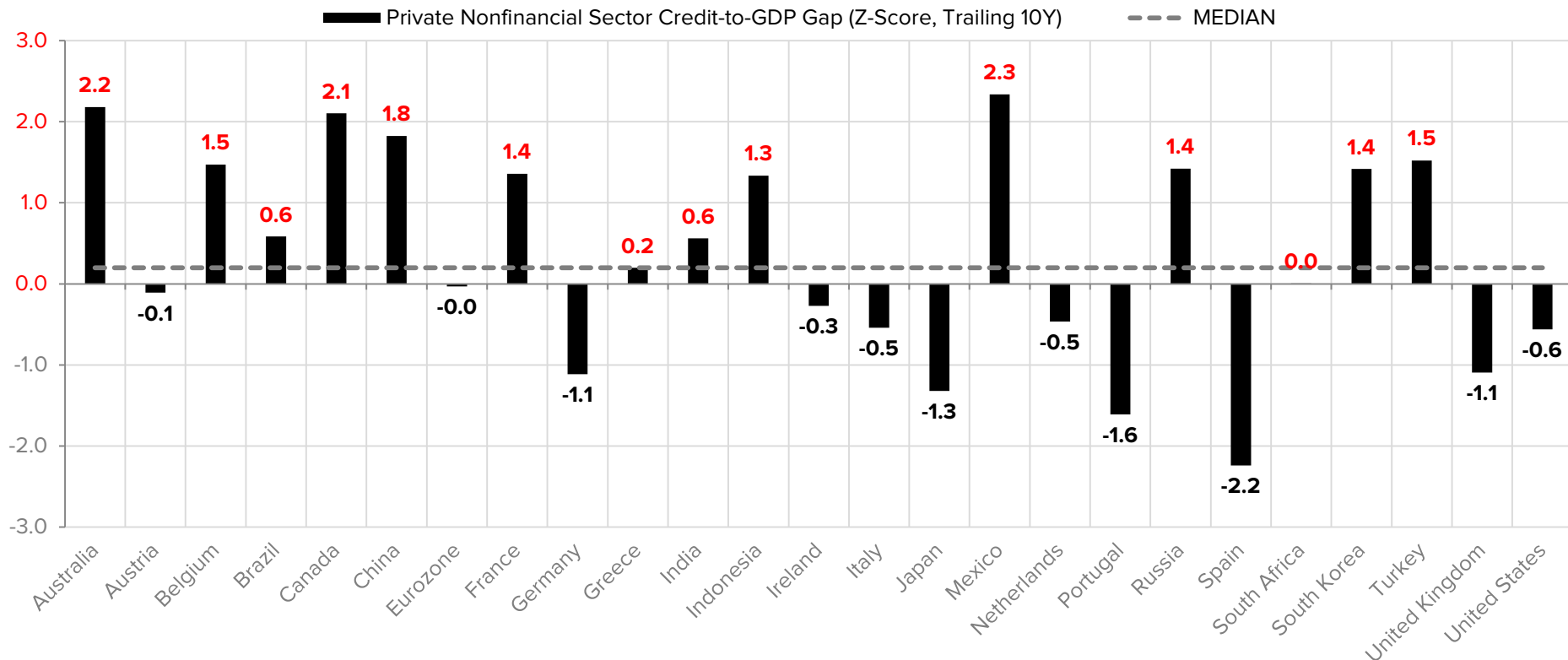

Legend: ■ Debt as a % of Nominal GDP --- MEDIAN

Country	Debt as a % of Nominal GDP
Australia	41%
Austria	85%
Belgium	106%
Brazil	78%
Canada	92%
China	46%
Eurozone	92%
France	97%
Germany	68%
Greece	183%
India	68%
Indonesia	27%
Ireland	75%
Italy	133%
Japan	250%
Mexico	56%
Netherlands	64%
Portugal	128%
Russia	17%
Spain	100%
South Africa	52%
South Korea	39%
Turkey	32%
United Kingdom	89%
United States	108%

FISCAL POLICY RISK: BUDGET BALANCES

COUNTRIES WITH DEEP, PERSISTENT BUDGET DEFICITS WILL SEE A MATERIALLY DIMINISHED ABILITY TO RESPOND TO FUTURE DOWNTURNS WITH COUNTERCYCLICAL FISCAL POLICIES.
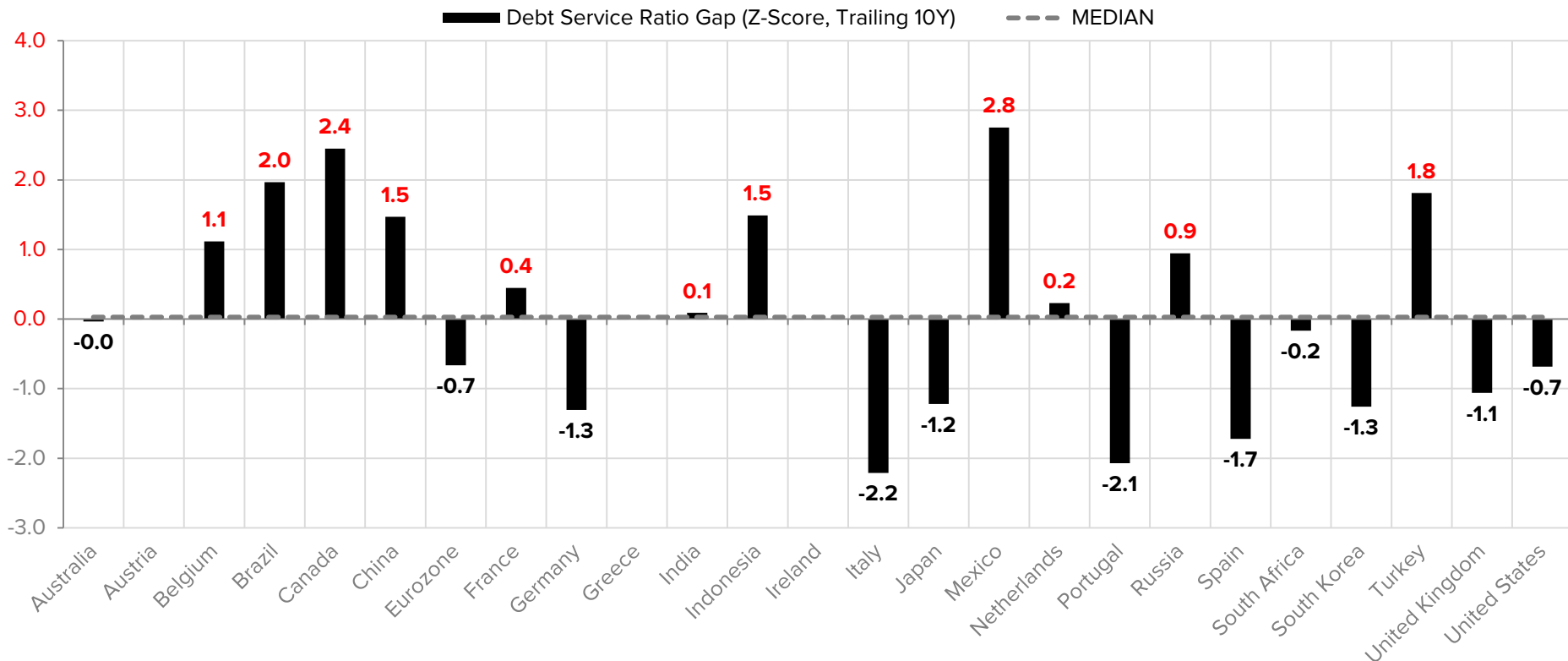

Legend: ▬ Central Gov't Budget Balance as a % of Nominal GDP   - - - MEDIAN

Data labels by country:
- Australia: -1.5%
- Austria: -0.7%
- Belgium: -2.9%
- Brazil: -9.7%
- Canada: -0.1%
- China: -3.4%
- Eurozone: -1.8%
- France: -3.2%
- Germany: 0.7%
- Greece: -4.9%
- India: -3.7%
- Indonesia: -1.9%
- Ireland: -1.6%
- Italy: -2.4%
- Japan: -5.7%
- Mexico: -2.6%
- Netherlands: -0.9%
- Portugal: -3.6%
- Russia: -3.9%
- Spain: -5.1%
- South Africa: -4.1%
- South Korea: 0.5%
- Turkey: -3.1%
- United Kingdom: -2.9%
- United States: -3.1%

ECONOMIC CYCLE RISK: SUPPLY OF CREDIT

EXCESS GROWTH IN THE RATIO OF PRIVATE SECTOR CREDIT TO THE BROADER ECONOMY HAS HISTORICALLY BEEN A HARBINGER OF RECESSION AS DELEVERAGING TENDS TO FOLLOW PEAK RATES OF ADVERSE SELECTION.
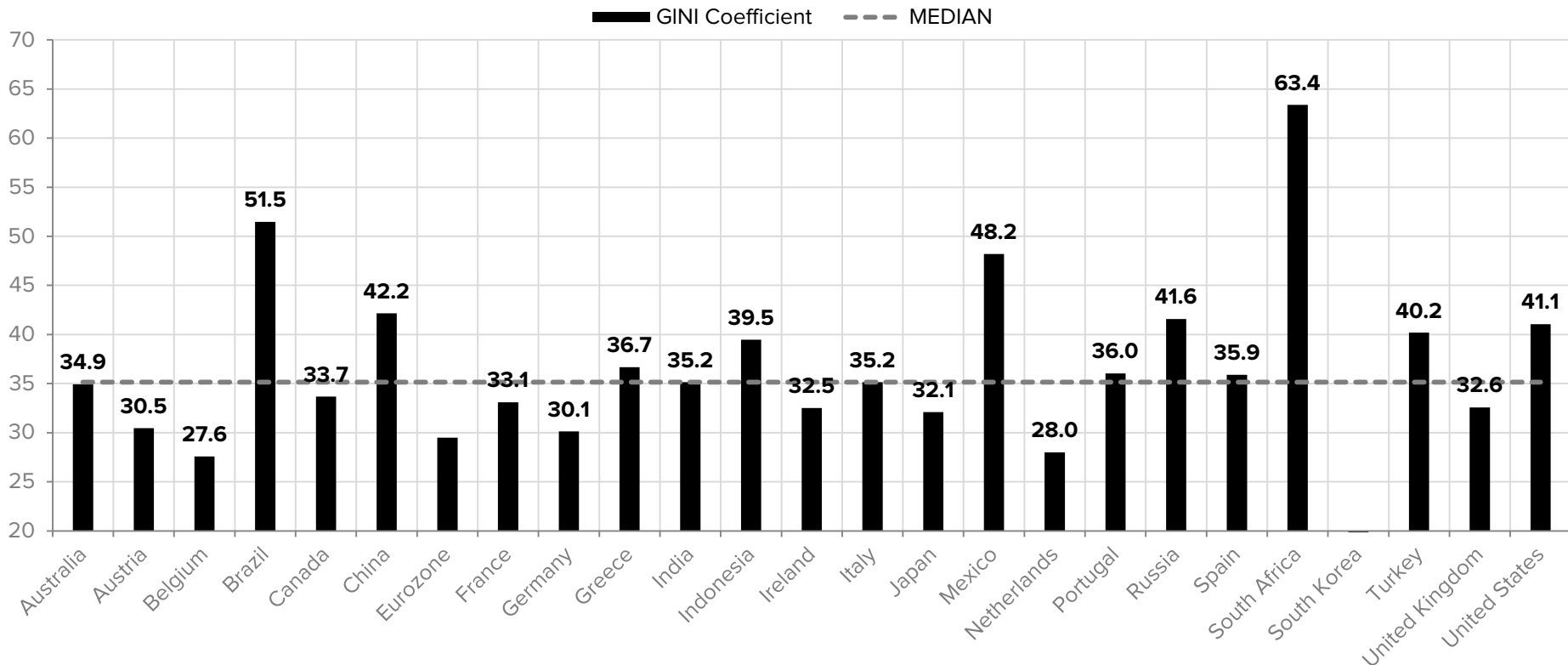
Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y) --- MEDIAN

Country	Value
Australia	2.2
Austria	-0.1
Belgium	1.5
Brazil	0.6
Canada	2.1
China	1.8
Eurozone	-0.0
France	1.4
Germany	-1.1
Greece	0.2
India	0.6
Indonesia	1.3
Ireland	-0.3
Italy	-0.5
Japan	-1.3
Mexico	2.3
Netherlands	-0.5
Portugal	-1.6
Russia	1.4
Spain	-2.2
South Africa	0.0
South Korea	1.4
Turkey	1.5
United Kingdom	-1.1
United States	-0.6

ECONOMIC CYCLE RISK: COST OF CREDIT

EXCESS GROWTH IN PRIVATE SECTOR DEBT SERVICE RATIOS HAVE HISTORICALLY PERPETUATED RECESSION-INDUCING RATES OF DELEVERAGING.
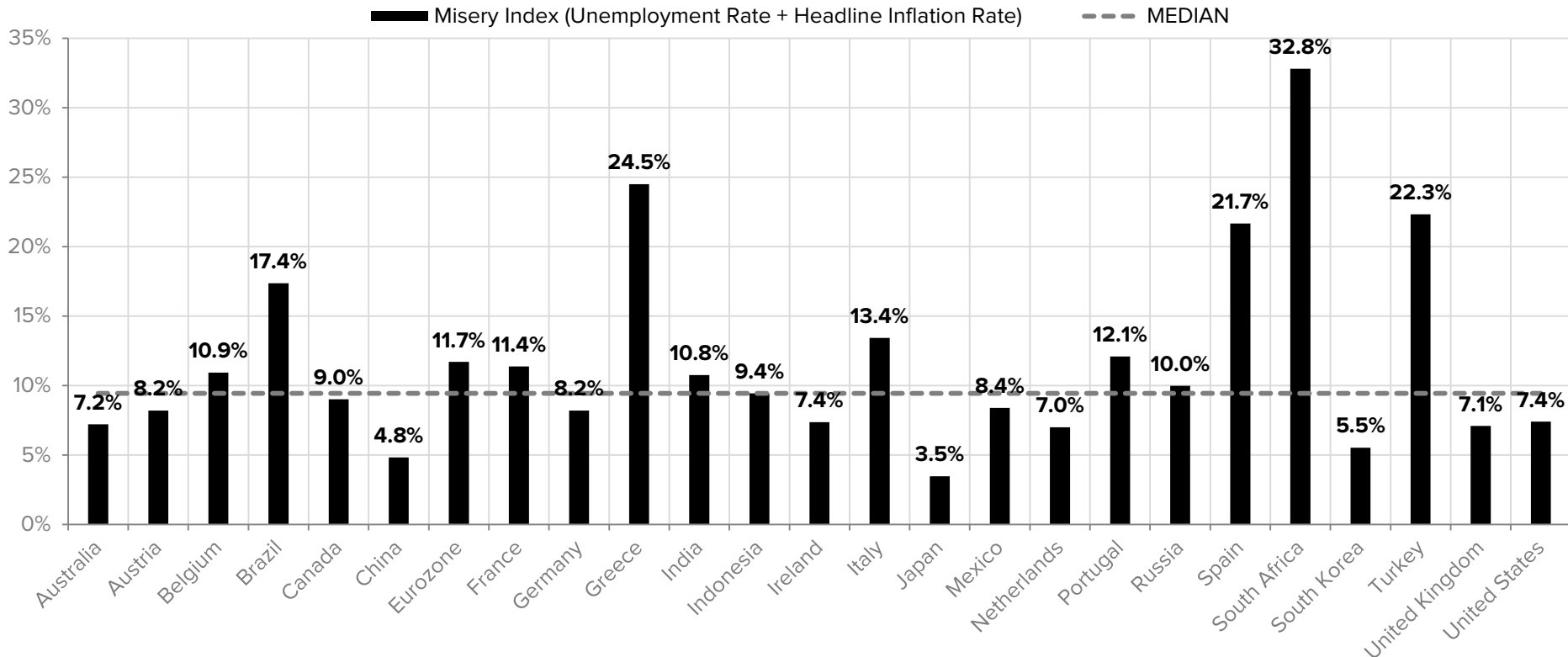

Legend: Debt Service Ratio Gap (Z-Score, Trailing 10Y) — MEDIAN

Country	Value
Australia	-0.0
Belgium	1.1
Brazil	2.0
Canada	2.4
China	1.5
Eurozone	-0.7
France	0.4
Germany	-1.3
India	0.1
Indonesia	1.5
Italy	-2.2
Japan	-1.2
Mexico	2.8
Netherlands	0.2
Portugal	-2.1
Russia	0.9
Spain	-1.7
South Africa	-0.2
South Korea	-1.3
Turkey	1.8
United Kingdom	-1.1
United States	-0.7

POPULISM RISK: INCOME INEQUALITY

RAMPANT INCOME INEQUALITY HAS BEEN SHOWN TO PERPETUATE BROAD-BASED DETERIORATION IN THE SOCIAL MOOD, AS WELL AS WIDESPREAD DEMANDS FOR THE GROWTH OF ENTITLEMENT SPENDING.

Legend: ▬ GINI Coefficient   - - - MEDIAN

Country	GINI Coefficient
Australia	34.9
Austria	30.5
Belgium	27.6
Brazil	51.5
Canada	33.7
China	42.2
Eurozone	(29.5)
France	33.1
Germany	30.1
Greece	36.7
India	35.2
Indonesia	39.5
Ireland	32.5
Italy	35.2
Japan	32.1
Mexico	48.2
Netherlands	28.0
Portugal	36.0
Russia	41.6
Spain	35.9
South Africa	63.4
South Korea	
Turkey	40.2
United Kingdom	32.6
United States	41.1

COMPETITIVENESS RISK: BUSINESS CONDITIONS

GOV'T REGULATIONS, BARRIERS TO ENTRY, LEGAL PROTECTIONS AND THE QUALITY OF ITS INFRASTRUCTURE ALL PLAY VITAL ROLES IN A COUNTRY'S ABILITY TO ATTRACT BOTH PORTFOLIO CAPITAL AND FOREIGN DIRECT INVESTMENT.
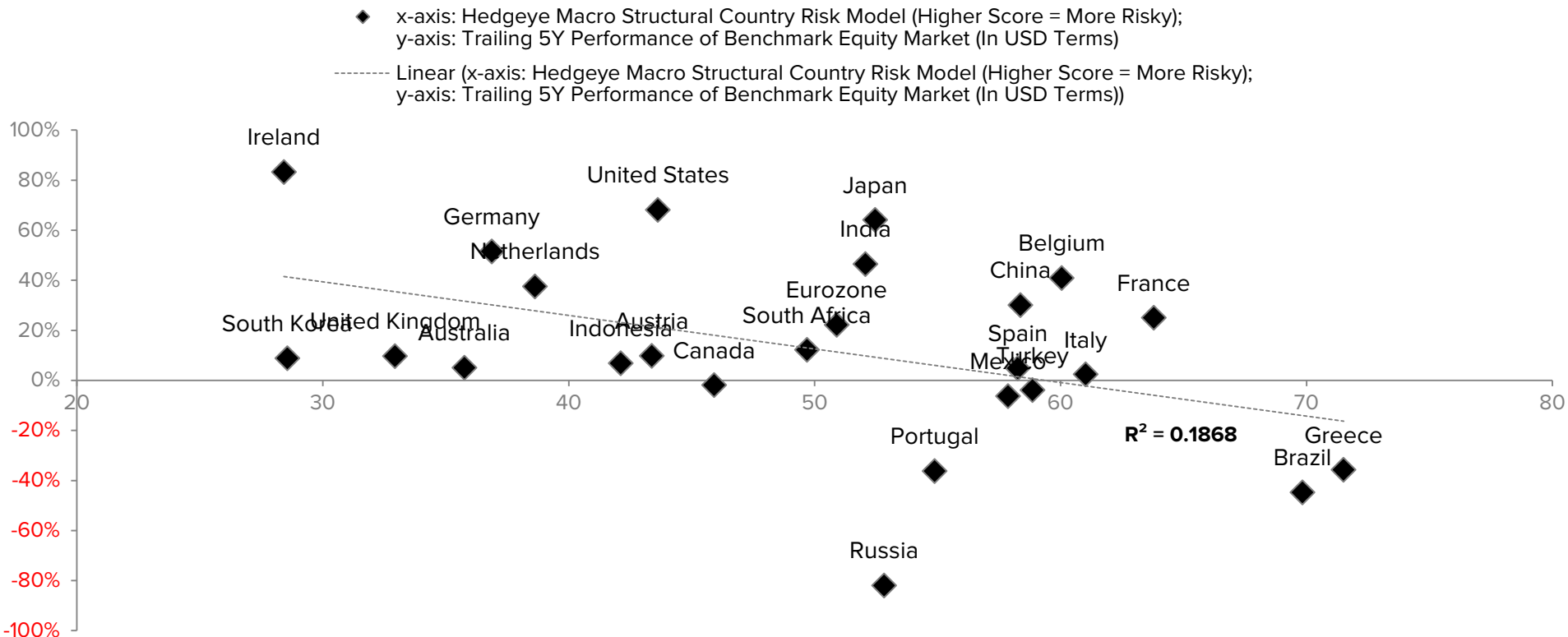
■ World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better)   - - - MEDIAN

Country	Value
Australia	15
Austria	19
Belgium	42
Brazil	123
Canada	22
China	78
Eurozone	33
France	29
Germany	17
Greece	61
India	130
Indonesia	91
Ireland	18
Italy	50
Japan	34
Mexico	47
Netherlands	28
Portugal	25
Russia	40
Spain	32
South Africa	74
South Korea	5
Turkey	69
United Kingdom	7
United States	8

COMPETITIVENESS RISK: CORPORATE TAXES

IN ADDITION TO THE AFOREMENTIONED FACTORS, CORPORATE TAX RATES PLAY AN OUTSIZED ROLE IN THE DIRECTION AND SUSTAINABILITY OF BUSINESS INVESTMENT IN MAJOR ECONOMIES.

Legend: ■ All-In Effective Corporate Tax Rate — — MEDIAN

Country	Rate
Australia	48%
Austria	52%
Belgium	59%
Brazil	68%
Canada	21%
China	68%
Eurozone	44%
France	63%
Germany	49%
Greece	51%
India	61%
Indonesia	31%
Ireland	26%
Italy	62%
Japan	49%
Mexico	52%
Netherlands	40%
Portugal	40%
Russia	47%
Spain	49%
South Africa	29%
South Korea	33%
Turkey	41%
United Kingdom	31%
United States	44%
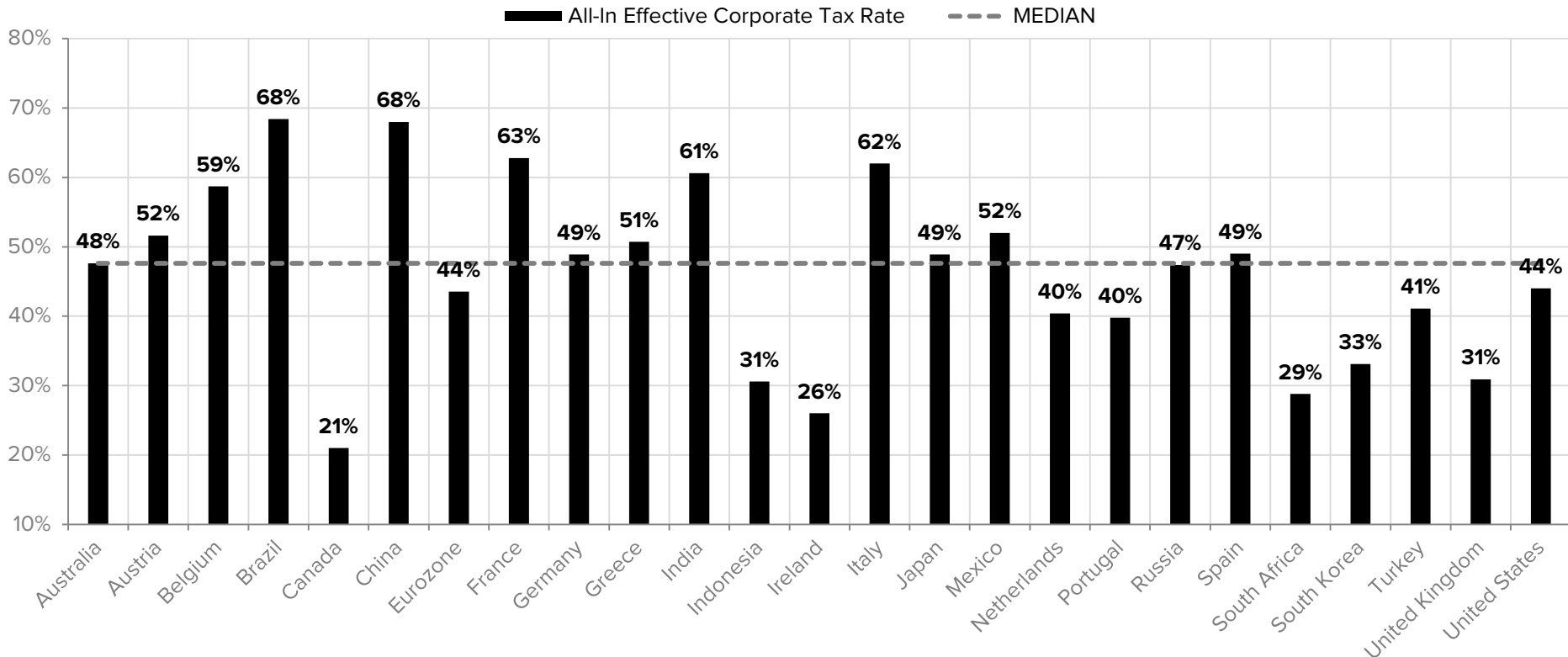
DOES THE MODEL WORK? YES

COUNTRIES WITH GREATER DEGREES OF STRUCTURAL ECONOMIC AND POLITICAL RISKS HAVE TENDED TO UNDERPERFORM OVER THE PAST FIVE YEARS AND WE EXPECT THIS RELATIONSHIP TO CONTINUE OVER THE LONG TERM.

◆ x-axis: Hedgeye Macro Structural Country Risk Model (Higher Score = More Risky);
y-axis: Trailing 5Y Performance of Benchmark Equity Market (In USD Terms)

------- Linear (x-axis: Hedgeye Macro Structural Country Risk Model (Higher Score = More Risky);
y-axis: Trailing 5Y Performance of Benchmark Equity Market (In USD Terms))

NEAR-TERM INEFFICIENCIES PERSIST, HOWEVER

EUROPE AS A WHOLE IS FAIRLY VALUED, BUT FRANCE, BELGIUM, ITALY, SPAIN AND PORTUGAL ARE CONSIDERABLY OVERVALUED RELATIVE TO GERMANY, THE NETHERLANDS AND THE U.K.

◆ x-axis: Hedgeye Macro Structural Country Risk Model (Higher Score = More Risky);
y-axis: Benchmark Equity Market Price-to-NTM-Earnings Ratio

-------- Linear (x-axis: Hedgeye Macro Structural Country Risk Model (Higher Score = More Risky);
y-axis: Benchmark Equity Market Price-to-NTM-Earnings Ratio)

$R^2 = 0.0467$
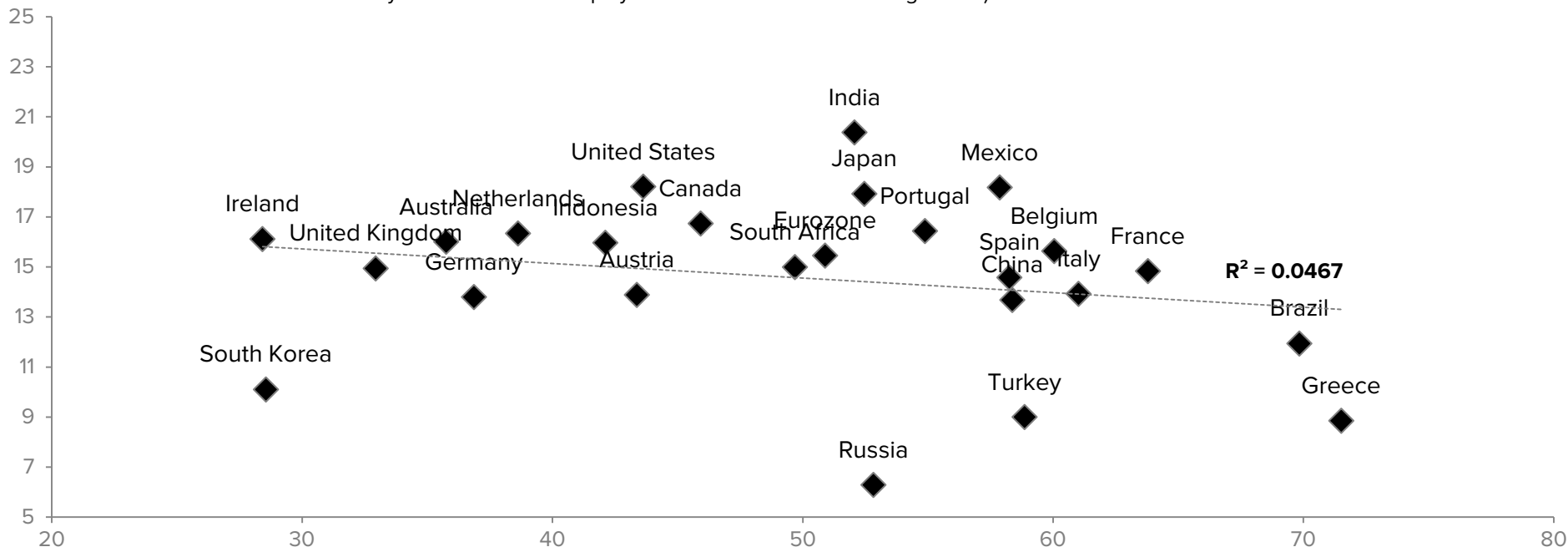
… ESPECIALLY IN THE CURRENCY MARKET

WHILE TYING ITS ROCK TO GERMANY AND THE NETHERLANDS HAS HELPED FRANCE, BELGIUM AND THE BROADER PERIPHERY PREVENT CURRENCY CRISES, IT HAS ALSO PREVENTED NECESSARY REFORMS IN THOSE ECONOMIES.

◆ x-axis: Hedgeye Macro Structural Country Risk Model (Higher Score = More Risky); y-axis: Real 3M Deposit Rate

------- Linear (x-axis: Hedgeye Macro Structural Country Risk Model (Higher Score = More Risky); y-axis: Real 3M Deposit Rate)

$R^2 = 0.0416$
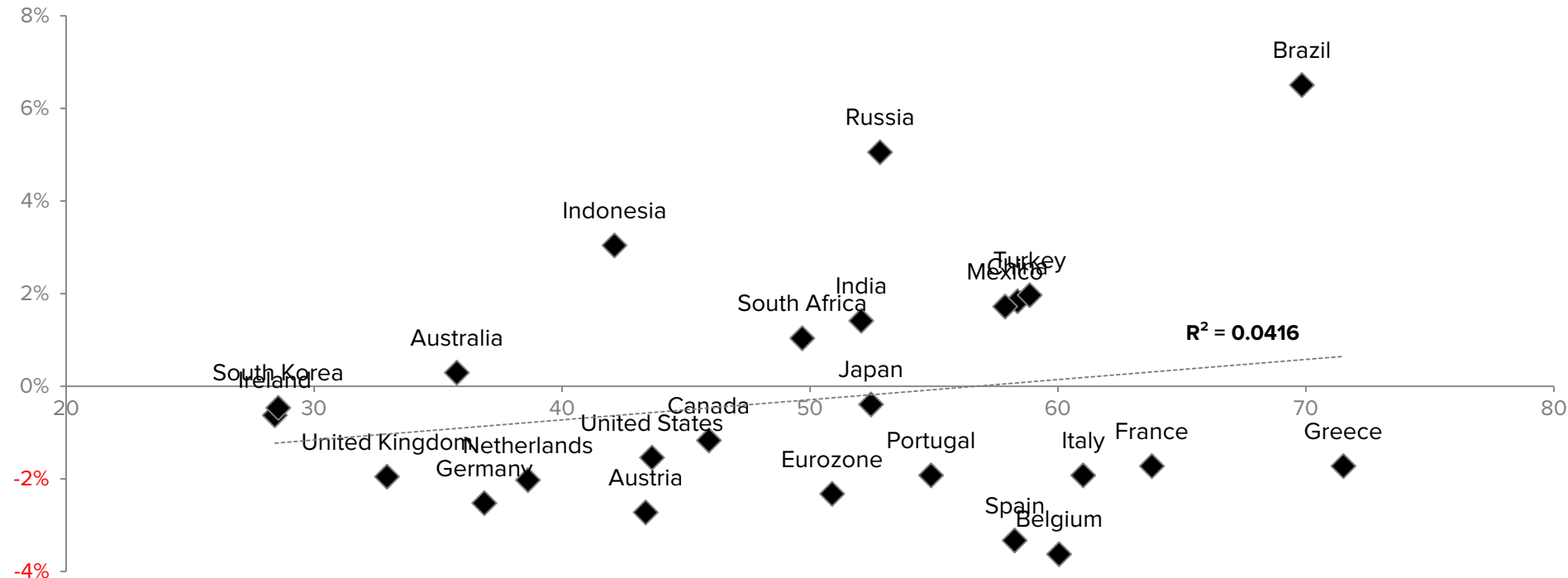
THE EUROZONE SCREENS POORLY WITH RESPECT TO HOW WE QUANTIFY DEMOGRAPHIC RISK.

◆ x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR

- - - - Linear (x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR)

$R^2 = 0.5948$
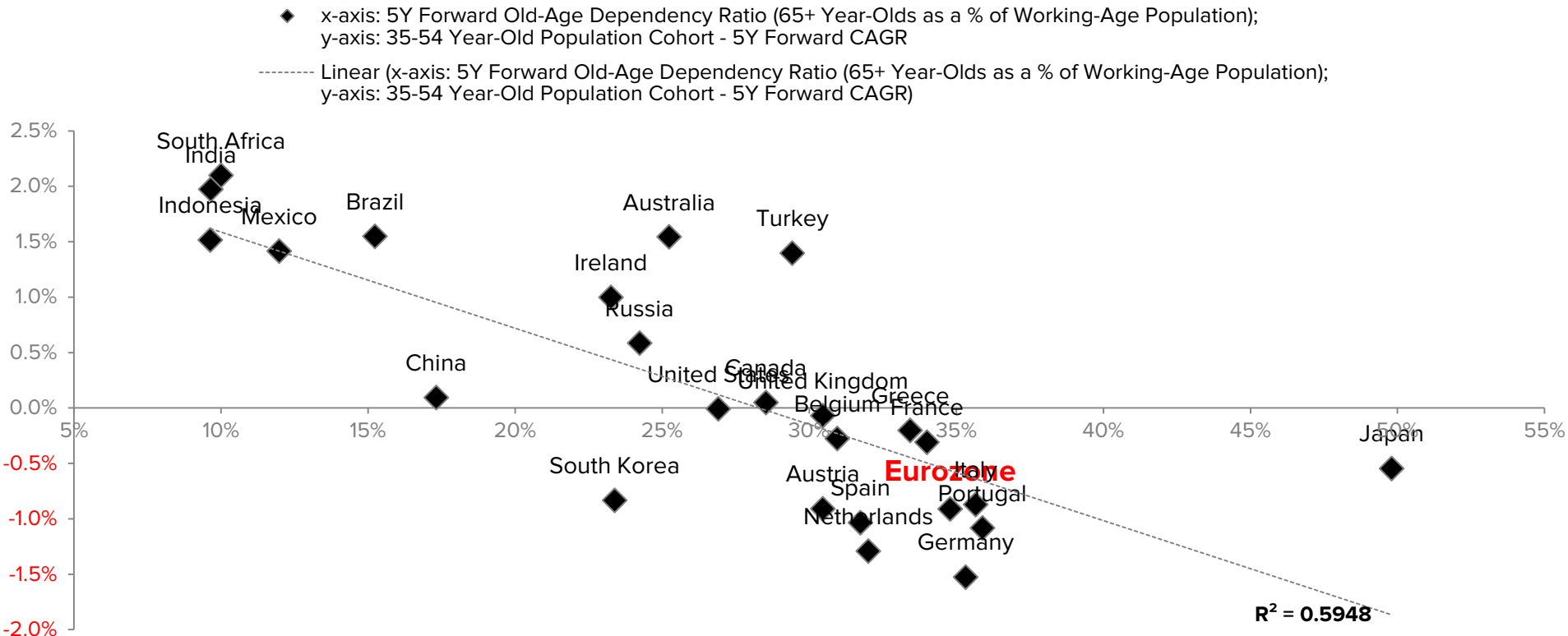
PILLAR II: FISCAL POLICY RISK

THE EUROZONE SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF ADVERSE FISCAL POLICY.

◆ x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP

- - - - - Linear (x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP)

$R^2 = 0.1078$
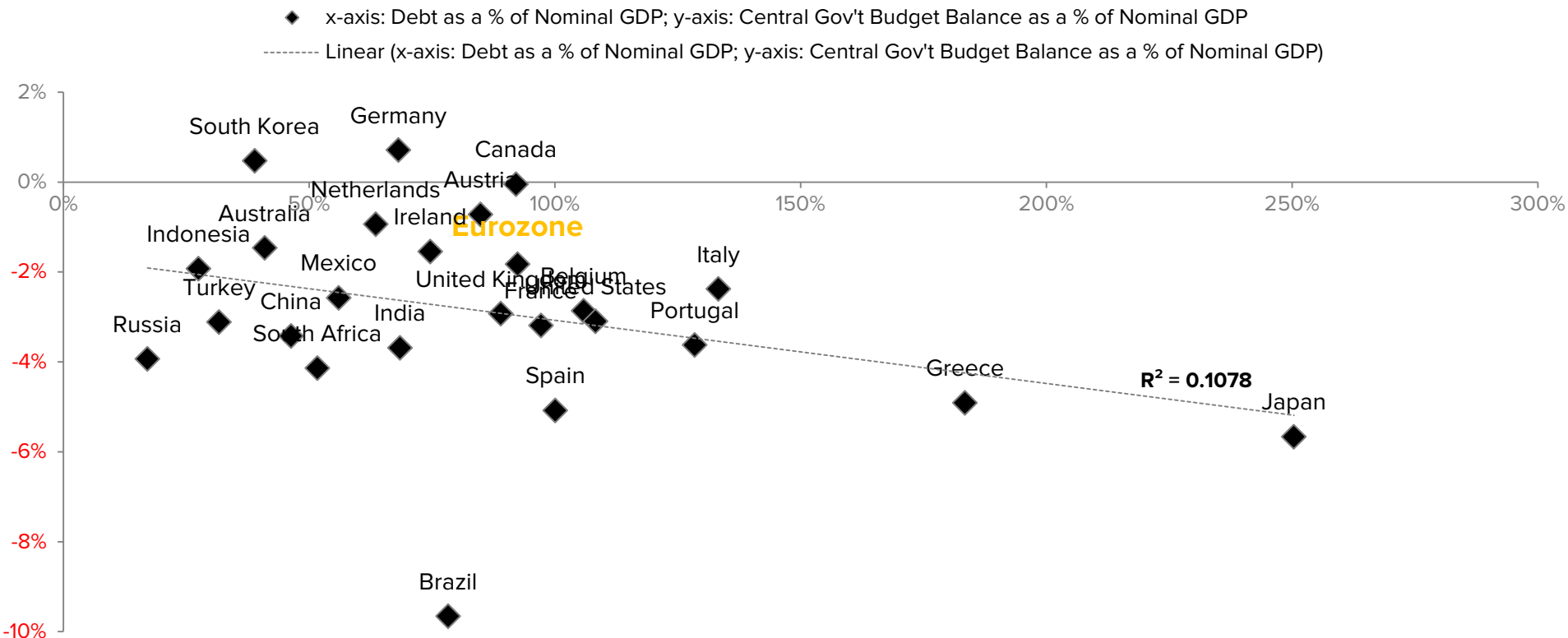
PILLAR III: ECONOMIC CYCLE RISK

THE EUROZONE SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RECESSION.

x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio

------- Linear (x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio)

$R^2 = 0.6269$
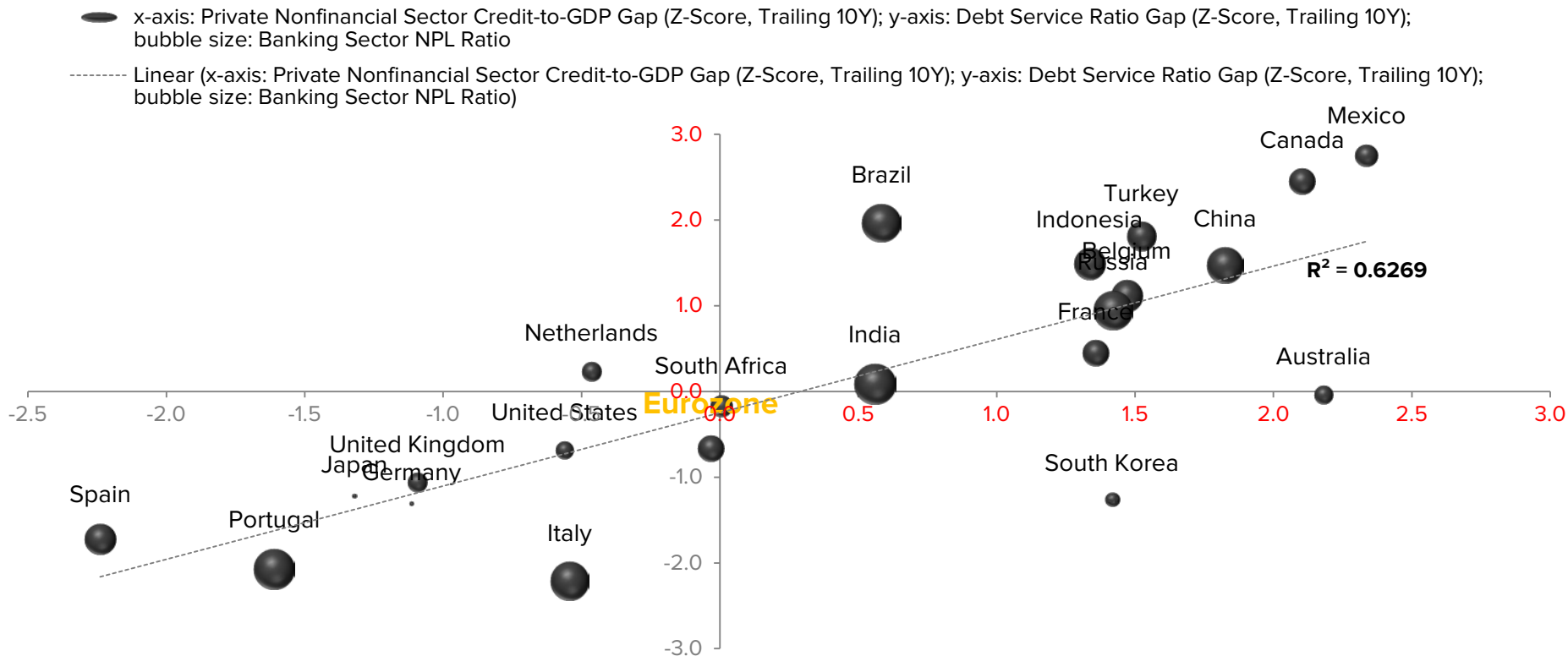
PILLAR IV: POPULISM RISK

THE EUROZONE SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RISING POPULISM.

◆ x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate)

----- Linear (x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate))

$R^2 = 0.3246$

South Africa
Greece
Spain
Turkey
Brazil
Italy
Eurozone
Portugal
Belgium
France
India
Germany Austria
Canada
Indonesia
Russia
Netherlands United Kingdom Ireland Australia
United States
Mexico
Japan
China
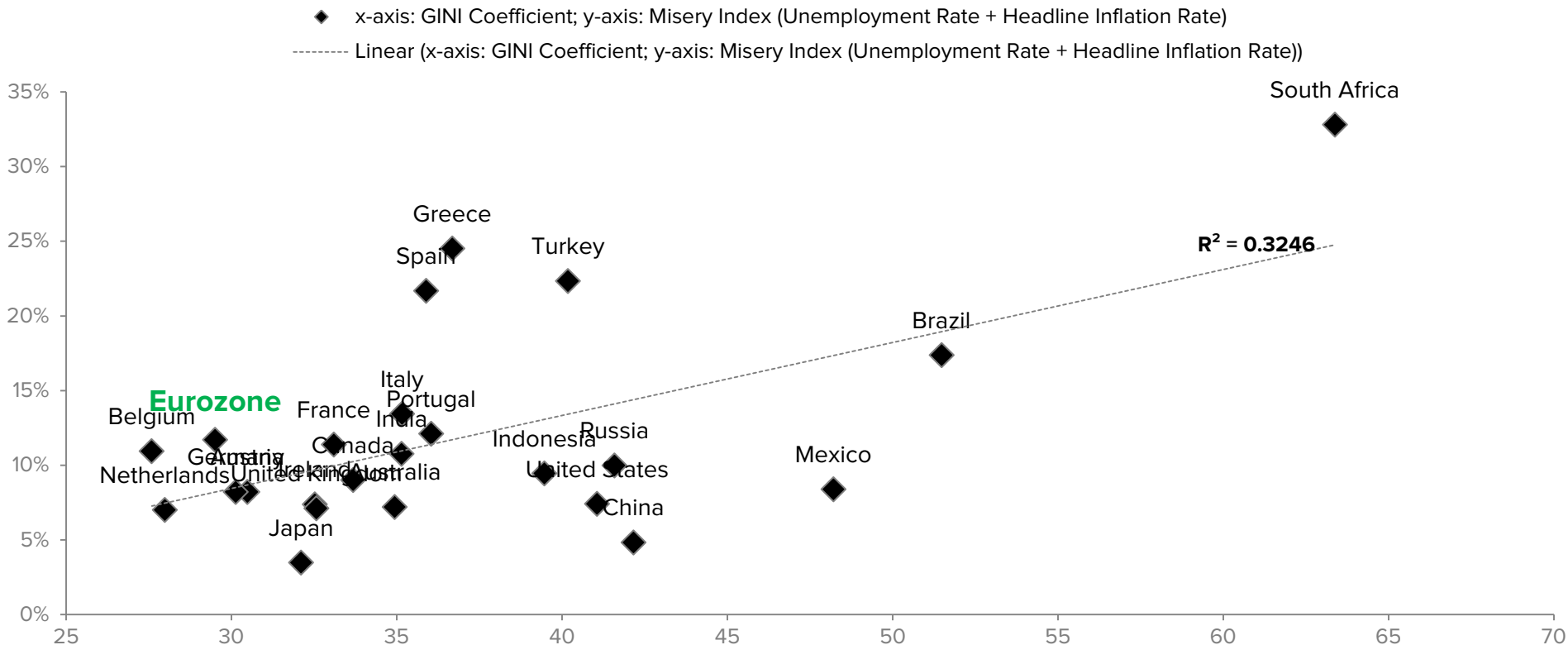
PILLAR V: COMPETITIVENESS RISK

THE EUROZONE SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF CAPITAL FLIGHT, UNDERINVESTMENT, MALINVESTMENT OR SOME COMBINATION OF THE THREE.

◆ x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate

------- Linear (x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate)

$R^2 = 0.1745$

Data points labeled: China, Brazil, India, France, Italy, Belgium, Mexico, Austria, Germany, Australia, Spain, Japan, Russia, United States, Eurozone, Greece, Netherlands, Portugal, Turkey, South Korea, United Kingdom, South Africa, Indonesia, Ireland, Canada
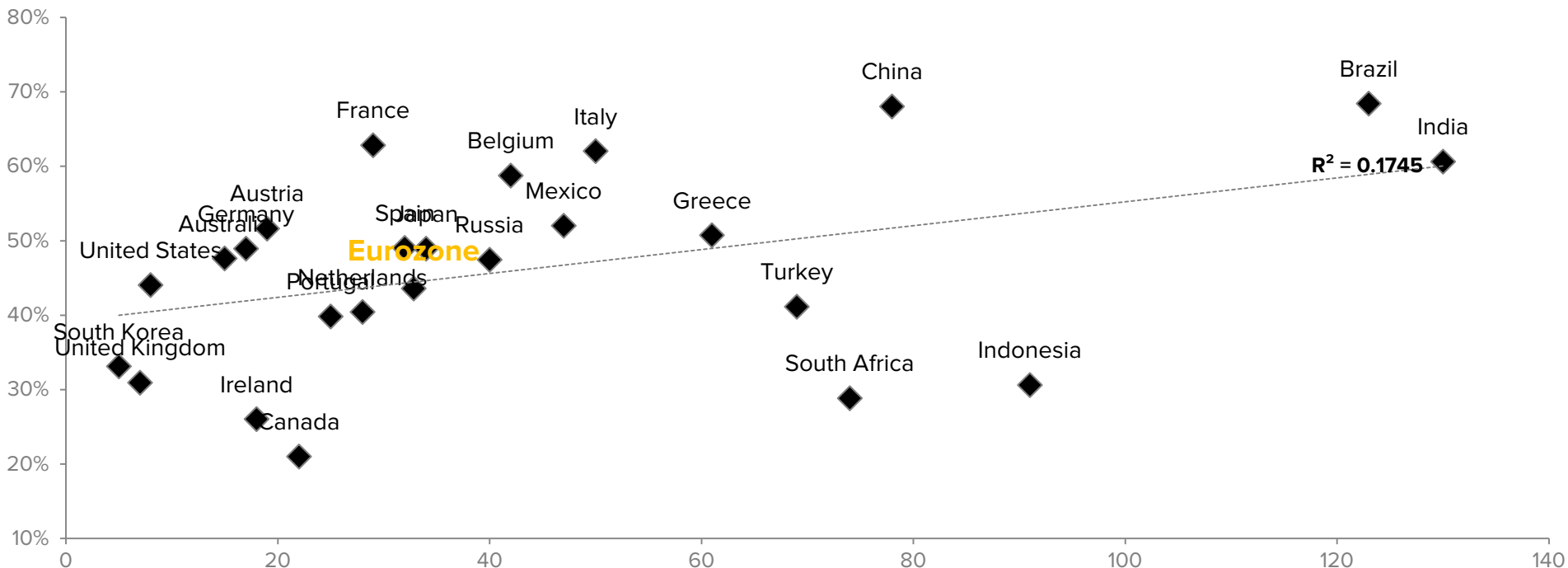
EUROZONE GIP MODEL

EUROZONE	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	Hedgeye Macro GIP Model		
Real GDP QoQ	0.2%	0.3%	0.2%	0.4%	0.4%	0.8%	0.4%	0.3%	0.5%	0.5%	0.3%	0.4%	0.4%	GIP = Growth/Inflation/Policy		
Real GDP YoY	0.7%	1.3%	1.0%	1.1%	1.3%	1.8%	2.0%	1.9%	2.0%	1.7%	1.6%	1.8%	1.7%	Full-year Estimates	2016E	2017E
2Y Average	-0.2%	0.1%	0.3%	0.6%	1.0%	1.6%	1.5%	1.5%	1.7%	1.8%	1.8%	1.9%	1.9%	Hedgeye Predictive Tracking Algorithm	1.7%	0.9%
3Y Average	0.0%	-0.1%	-0.1%	0.1%	0.3%	0.6%	0.9%	1.0%	1.3%	1.6%	1.5%	1.6%	1.7%	Bloomberg Consensus Estimate	1.7%	1.6%
Percentile (T10Y)	36%	44%	38%	44%	49%	59%	64%	62%	64%	56%	56%	62%	59%	Central Bank Forecast	1.7%	1.6%
CPI YoY	0.8%	0.7%	0.6%	0.4%	0.2%	-0.3%	0.2%	0.1%	0.1%	0.0%	-0.1%	0.3%	0.7%	Full-year Estimates	2016E	2017E
2Y Average	1.6%	1.3%	1.0%	0.9%	0.5%	0.2%	0.4%	0.2%	0.2%	-0.2%	0.1%	0.2%	0.4%	Hedgeye Predictive Tracking Algorithm	0.2%	1.7%
3Y Average	2.0%	1.7%	1.5%	1.4%	1.1%	0.7%	0.7%	0.6%	0.4%	0.1%	0.2%	0.2%	0.3%	Bloomberg Consensus Estimate	0.2%	1.7%
Percentile (T10Y)	8%	8%	8%	5%	3%	3%	5%	5%	8%	5%	5%	23%	36%	Central Bank Forecast	0.2%	1.7%

QUAD #1
Growth Accelerating as Inflation Decelerates
Policy Response: NEUTRAL

QUAD #2:
Growth Accelerating as Inflation Accelerates
Policy Response: HAWKISH

QUAD #4:
Growth Slowing as Inflation Decelerates
Policy Response: DOVISH

QUAD #3:
Growth Slowing as Inflation Accelerates
Policy Response: IN-A-BOX

y-axis: Sequential Delta of YoY Real GDP Growth (bps)

x-axis: Sequential Delta of YoY Headline CPI (bps)

Data Source: Bloomberg

© Hedgeye Risk Management

1Q17 marks the start of a challenging year for broader Eurozone growth in rate-of-change terms. That, coupled with a likely reversal in headline inflation that should trend through year-end, means investors are increasingly offsides with regards to how dovish Draghi should be as we progress through the year.

Key High Frequency Growth and Inflation Indicators: Eurozone
(Values Shown as a Percentile of the Respective Trailing 10Y Sample)

Legend: ■ 4Q16 Average ■ 1Q17 Average ■ 12MMA ■ 3MMA ■ Previous Value ■ Latest Value

Chart categories and latest values:
- Household Consumption YoY % Change = 1.2% (JAN) — 61%
- Industrial Production YoY % Change = 0.6% (JAN) — 44%
- Exports YoY % Change = 13.1% (JAN) — 83%
- Composite PMI = 55.6 (FEB) — 100%
- Benchmark Consumer Confidence Index = -6.2 (FEB) — 87%
- Benchmark Business Confidence Index = 25.6 (MAR) — 61%
- CPI YoY % Change = 2% (FEB) — 66%
- Core CPI YoY % Change = 0.9% (FEB) — 21%
- PPI YoY % Change = 3.5% (JAN) — 72%

Data Source: Bloomberg.   © Hedgeye Risk Management

Key Financial Market Indicators	Percentile (10Y)	5Y Change	3Y Change	2Y Change	18M Change	1Y Change	YTD Change	6M Change	3M Change	2M Change	1M Change	1W Change	1D Change
Benchmark Equity Market = 374.77	89%	41.1%	14.3%	-6.5%	8.0%	10.2%	3.7%	8.5%	4.1%	3.8%	0.5%	-0.8%	0.2%
Policy Rate = -0.4%	0%	-65bps	-40bps	-20bps	-20bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps
1Y OIS Spread vs. Policy Rate = -32bps	49%	32bps	-25bps	-15bps	-10bps	7bps	3bps	7bps	2bps	3bps	4bps	0bps	0bps
2Y Sovereign Debt Yield = -0.75%	2%	-98bps	-96bps	-53bps	-50bps	-26bps	1bps	-8bps	4bps	-7bps	15bps	4bps	2bps
10Y Sovereign Debt Yield = 0.4%	13%	-146bps	-123bps	18bps	-20bps	21bps	19bps	48bps	18bps	4bps	17bps	-5bps	-1bps
10Y-2Y Sovereign Debt Yield Spread = 115bps	43%	-48bps	-27bps	71bps	30bps	47bps	18bps	56bps	15bps	11bps	1bps	-9bps	-2bps
LT Breakeven Rate (5Y5Y or 10Y) = 1.62%	10%	-70bps	-47bps	-11bps	-1bps	19bps	-12bps	27bps	-9bps	-15bps	-12bps	-8bps	-1bps
FX Rate vs. USD = 1.0783	5%	-18.7%	-21.8%	-1.5%	-3.6%	-3.6%	2.5%	-4.0%	3.1%	0.2%	1.9%	0.1%	-0.1%

GROWTH: Trending higher across the preponderance of key high-frequency indicators, but the now-trending breakdown in consumption growth is concerning for the outlook.

INFLATION: Headline CPI continues to trend higher at an elevated rate of +2%, but core inflation remains range-bound at +/- 1%.

POLICY: While both the OIS and FX markets have responded to hawkish rhetoric out of various members of the ECB, the trending breakdown in inflation expectations is confirming of our #Quad4 view in 2Q17 and 3Q17.

THE POLITICAL CALENDAR IS UNDERWAY

CHANGING OF THE GUARD?

Netherlands Election – March 15, 2017

France Election – April 23, 2017 (Round 1)
                            May 7, 2017 (Round 2)

Germany Election –September 24, 2017

WHAT THE DUTCH ELECTION TELLS US?

SHOWDOWN - GEERT WILDERS VS PM MARK RUTTE. AND THE POPULIST LOST!

THE MAIN CANDIDATES

Geert Wilders of the Dutch Freedom Party (PVV)

- Wilders garnered huge headlines campaigning on an anti-Islam platform behind his openly xenophobic views.
- Central to his campaign is a pledge to remove the Netherlands from the Eurozone.
- A huge supporter of President Trump and the Brexit camp.

Current Prime Minister Mark Rutte of the People's Party for Freedom and Democracy (VVD) aka Liberals

- Rutte has been Prime Minister since 2010, and leads a coalition between his Liberals and the Labor Party (PvdA).
- Under Rutte's rule the country witnessed increasing waves of nationalism, in part, as response to the war in Syria that increased immigration patterns to Western Europe, including Holland.
- Ahead of the election Rutte highlighted March 15th as an opportunity for the Dutch to send a signal to the world that it's possible to "stop the trend" of rising populism sweeping western democracies.

POLL TRENDS PROVED ACCURATE

IN FACT, POLLS SHOWED A TUMBLING OF SUPPORT FOR WILDERS PVV PARTY SINCE THE BEGINNING OF THE YEAR (BLUE LINE)

Peil.nl - Ontwikkeling politieke voorkeur sinds september 2013
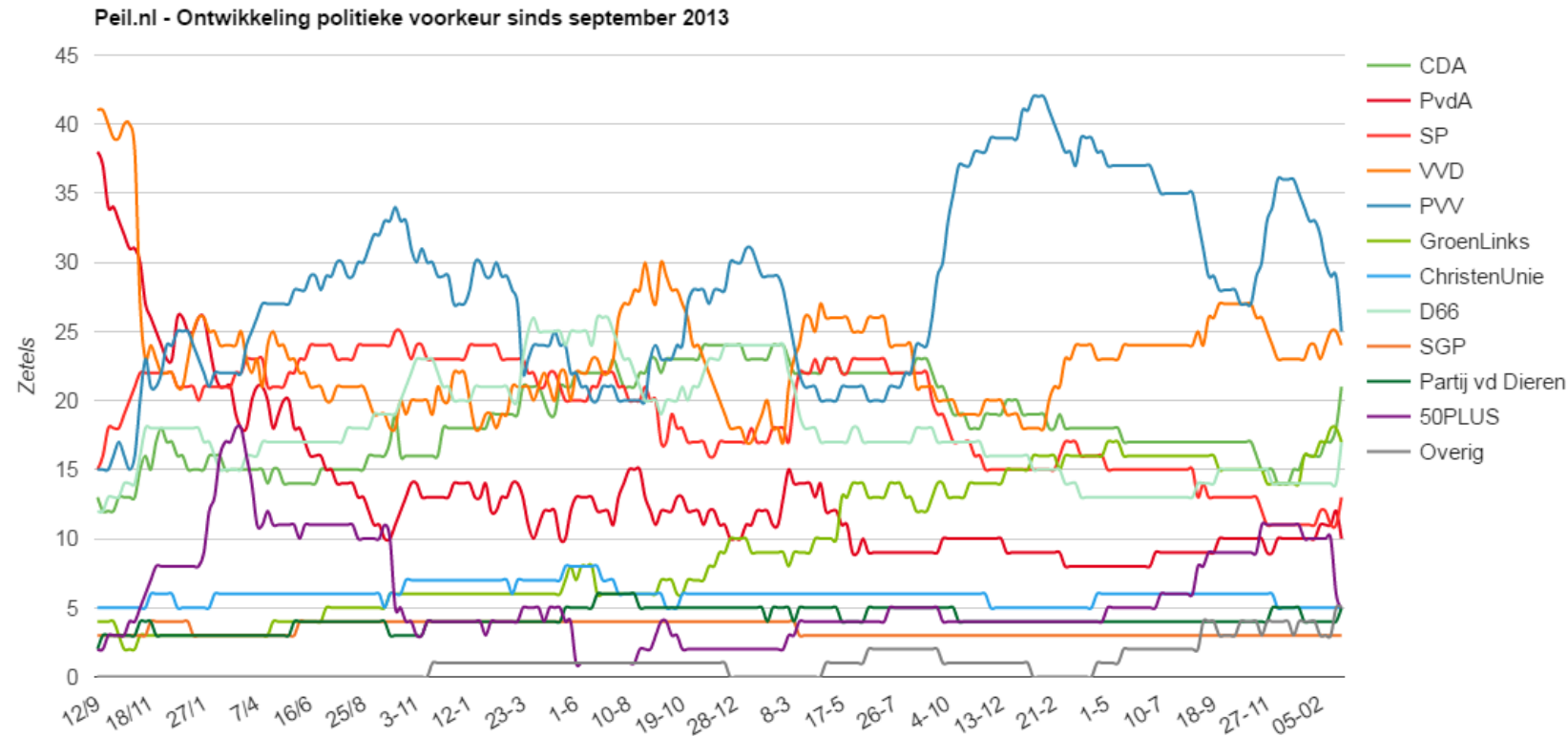
RUTTE WINS, NO NEXIT, WHAT ABOUT FREXIT?

RESULTS: AND THE POLLS WERE RIGHT.... STRONG POPULIST SUPPORT, BUT FAR FROM A MAJORITY... COALITION BUILD FROM RUTTE'S VVD PARTY UNDERWAY. NO NEXIT !!!

Dutch general election results 2017 | Parliament seats per party

● VVD ● PvdA ● PVV ● SP ● CDA ● D66 ● Other

31   19   19   16

9   14   19
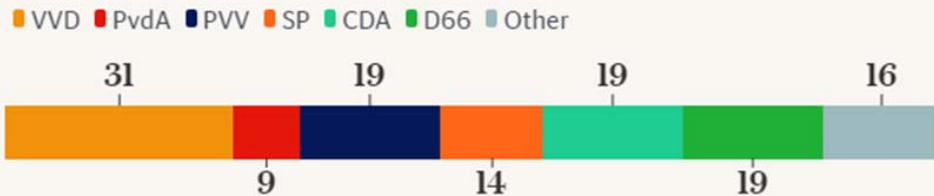
The parties
VVD - People's Party for Freedom and Democracy
PvdA - Labour Party
PVV - Party for Freedom
SP - Socialist Party
CDA - Christian Democratic Appeal
D66 - Democrats 66

Other
CU - Christian Union, 5 seats
GL - GreenLeft, 4 seats
SGP - Reformed Political Party, 3 seats
PvdD - Party for the Animals, 2 seats
50PLUS - 50PLUS, 2 seats

Rutte's Coalition Build is Underway.

Preference towards: Liberal and Centre-right parties (D66 and Christian Democratic Appeal).

House of Parliament = 150 seats.

76 seats needed to form a majority.

PILLAR I: DEMOGRAPHIC RISK

THE NETHERLANDS SCREENS POORLY WITH RESPECT TO HOW WE QUANTIFY DEMOGRAPHIC RISK.

◆ x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR

------ Linear (x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR)

$R^2 = 0.5948$
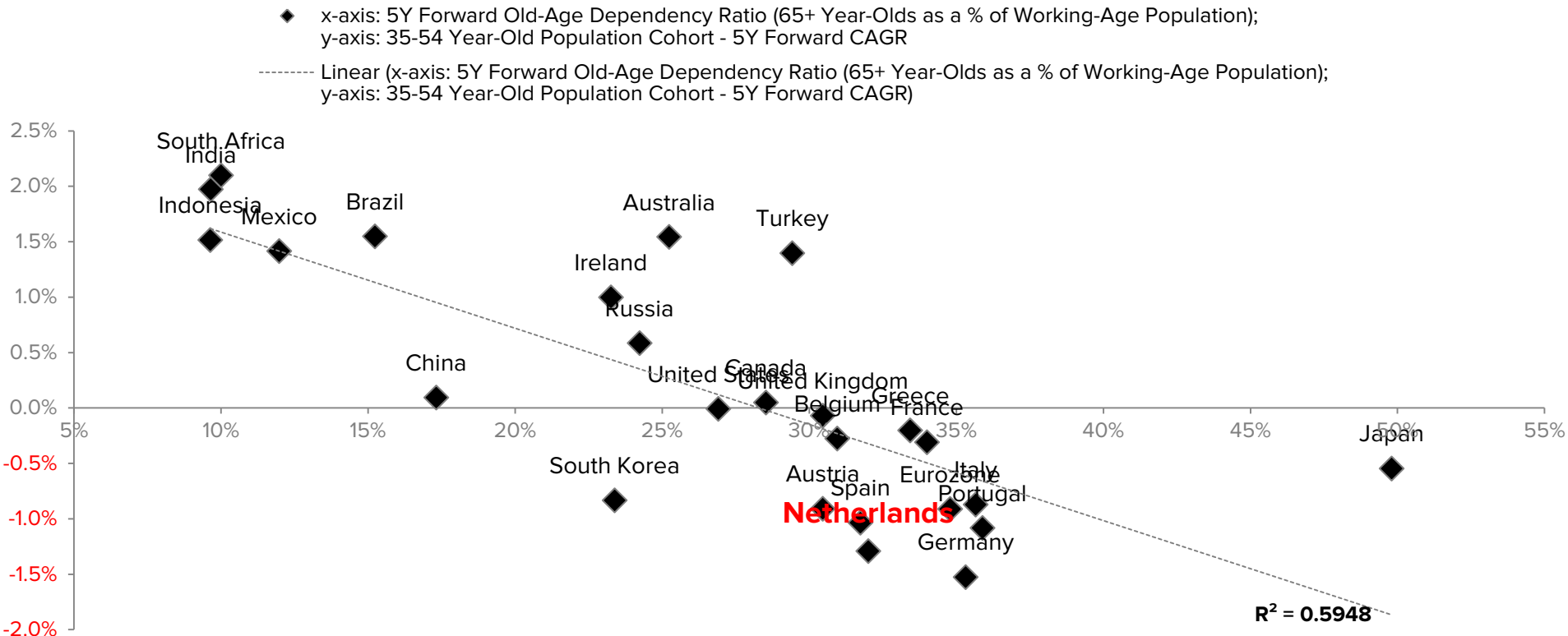
PILLAR II: FISCAL POLICY RISK

THE NETHERLANDS SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF ADVERSE FISCAL POLICY.

◆ x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP

------- Linear (x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP)

R² = 0.1078
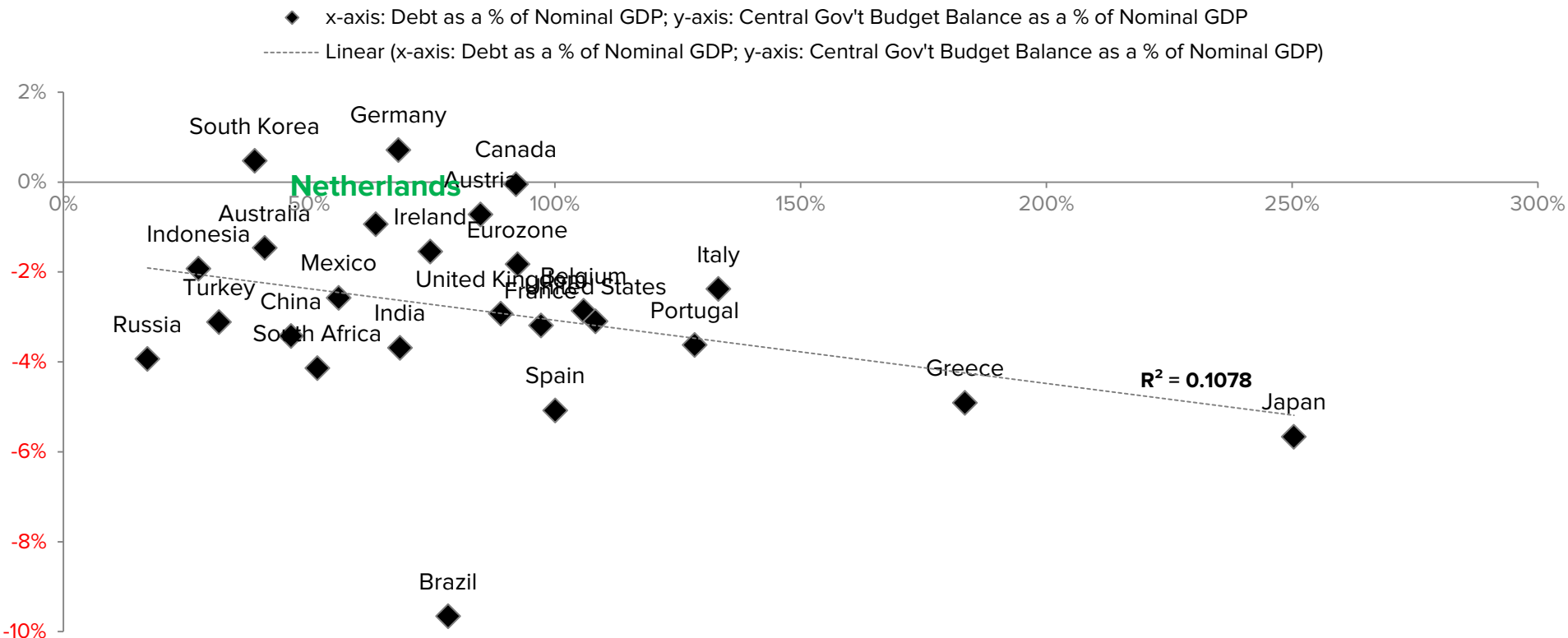
PILLAR III: ECONOMIC CYCLE RISK

THE NETHERLANDS SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RECESSION.

x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio

Linear (x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio)
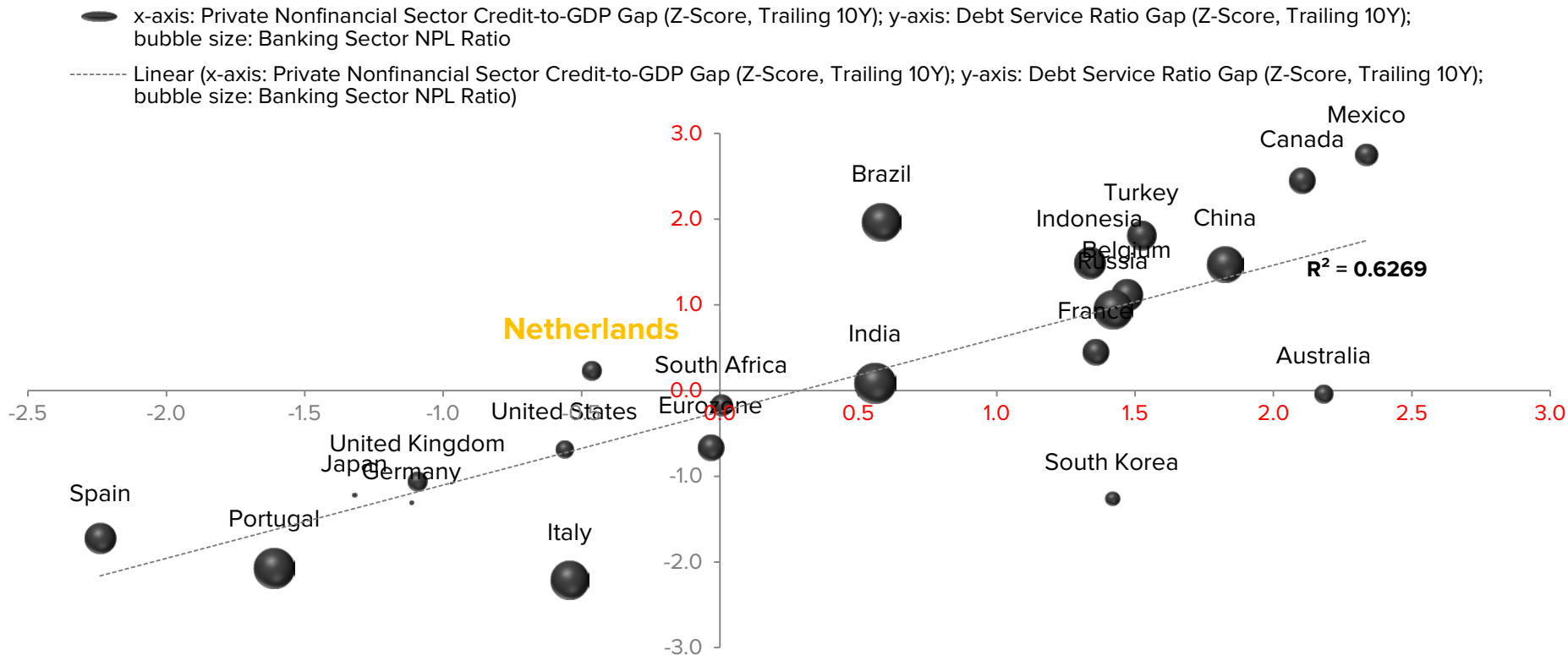
PILLAR IV: POPULISM RISK

THE NETHERLANDS SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RISING POPULISM.

◆ x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate)

------- Linear (x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate))

R² = 0.3246

South Africa
Greece
Spain
Turkey
Brazil
Italy
Portugal
France
India
Belgium
Eurozone
Germany
Austria
Canada
Netherlands
United Kingdom
Ireland
Australia
Indonesia
Russia
United States
Mexico
China
Japan
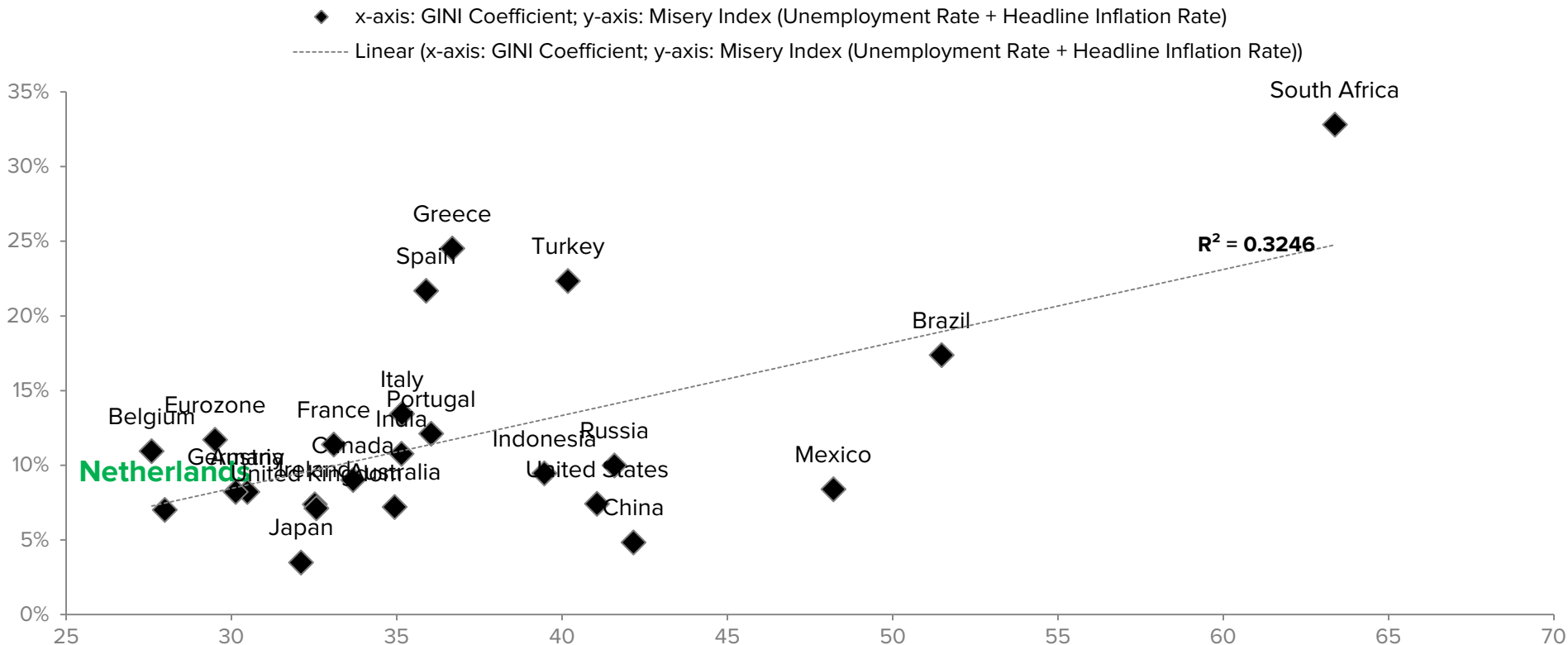
PILLAR V: COMPETITIVENESS RISK

THE NETHERLANDS SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF CAPITAL FLIGHT, UNDERINVESTMENT, MALINVESTMENT OR SOME COMBINATION OF THE THREE.

◆ x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate

------- Linear (x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate)

$R^2 = 0.1745$
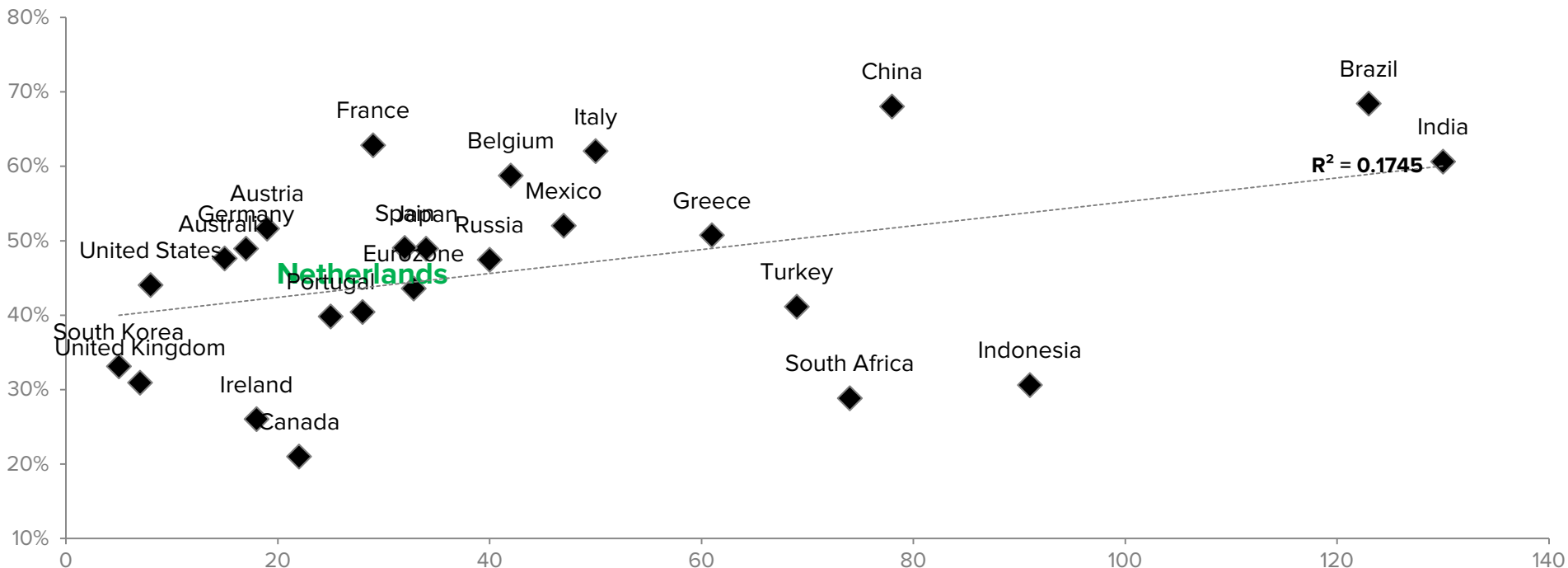
NETHERLANDS GIP MODEL

NETHERLANDS	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	Hedgeye Macro GIP Model		
Real GDP QoQ	0.6%	-0.2%	0.5%	0.4%	1.1%	0.6%	0.1%	0.2%	0.3%	0.7%	0.7%	0.8%	0.5%	GIP = Growth/Inflation/Policy		
Real GDP YoY	1.6%	0.6%	1.6%	1.6%	1.9%	2.6%	1.9%	2.0%	1.4%	1.5%	2.3%	2.4%	2.3%	Full-year Estimates	2016E	2017E
2Y Average	0.3%	-0.5%	0.2%	0.8%	1.8%	1.6%	1.8%	1.8%	1.7%	2.1%	2.1%	2.2%	1.9%	Hedgeye Predictive Tracking Algorithm	2.1%	2.2%
3Y Average	0.2%	-0.8%	-0.3%	0.1%	0.8%	0.6%	0.8%	1.2%	1.6%	1.6%	1.9%	2.0%	1.9%	Bloomberg Consensus Estimate	2.1%	1.8%
Percentile (T10Y)	46%	36%	46%	46%	59%	67%	56%	62%	41%	46%	74%	77%	74%	Central Bank Forecast	2.1%	2.1%
CPI YoY	1.6%	1.1%	1.0%	0.9%	0.9%	0.2%	0.9%	0.7%	0.6%	0.6%	0.0%	0.0%	0.7%	Full-year Estimates	2016E	2017E
2Y Average	2.2%	2.0%	1.9%	1.9%	1.3%	0.6%	0.9%	0.8%	0.8%	0.4%	0.4%	0.4%	0.7%	Hedgeye Predictive Tracking Algorithm	0.3%	1.7%
3Y Average	2.3%	2.2%	2.0%	2.0%	1.8%	1.4%	1.5%	1.5%	1.1%	0.6%	0.6%	0.6%	0.7%	Bloomberg Consensus Estimate	0.1%	1.3%
Percentile (T10Y)	41%	13%	10%	8%	8%	0%	8%	5%	5%	5%	0%	3%	15%	Central Bank Forecast	0.1%	0.9%
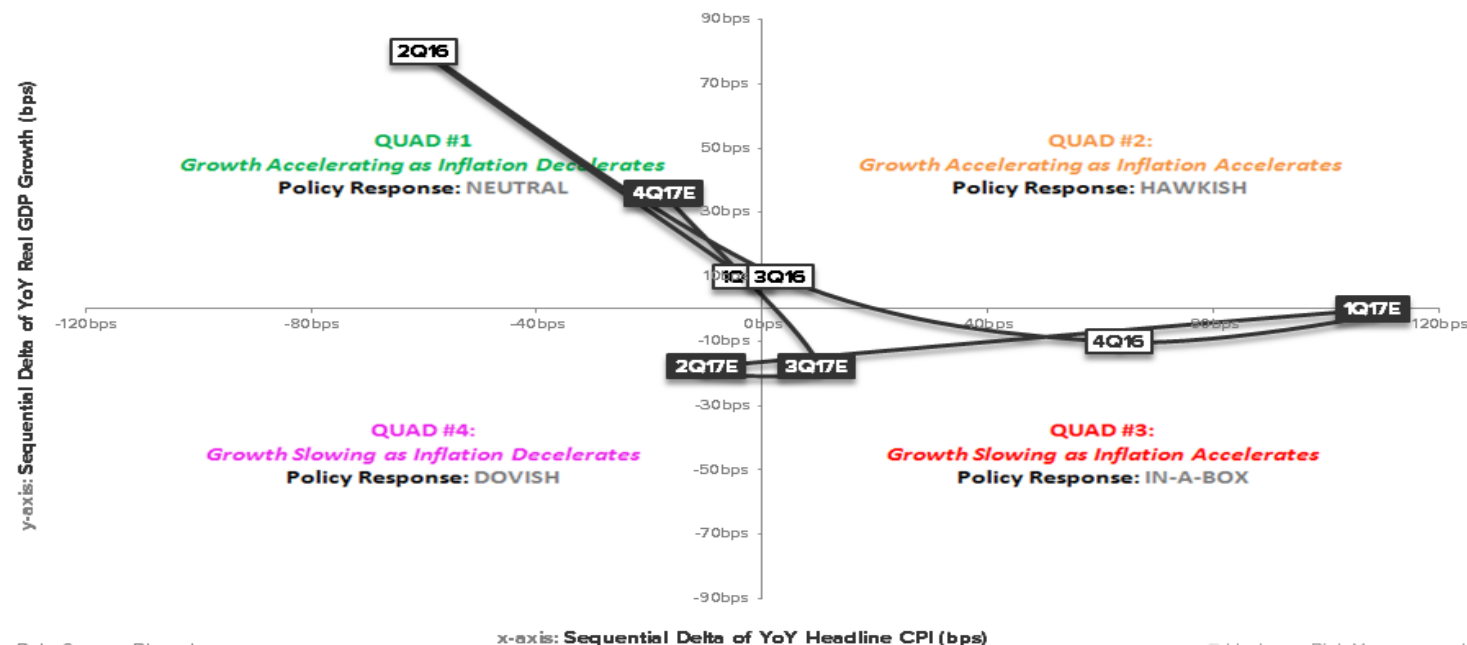
Headline inflation should peak in 1Q17, but then remain range-bound through year-end. Growth is likely to resume its gradual decline off of its 3Q16 cycle-peak over the next two quarters, contributing to the broader slowdown seen across the currency bloc.

Data Source: Bloomberg

© Hedgeye Risk Management

NETHERLANDS ECONOMIC SUMMARY

Key High Frequency Growth and Inflation Indicators: Netherlands
(Values Shown as a Percentile of the Respective Trailing 10Y Sample)

■ 4Q16 Average ■ 1Q17 Average ■ 12MMA ■ 3MMA ■ Previous Value ■ Latest Value
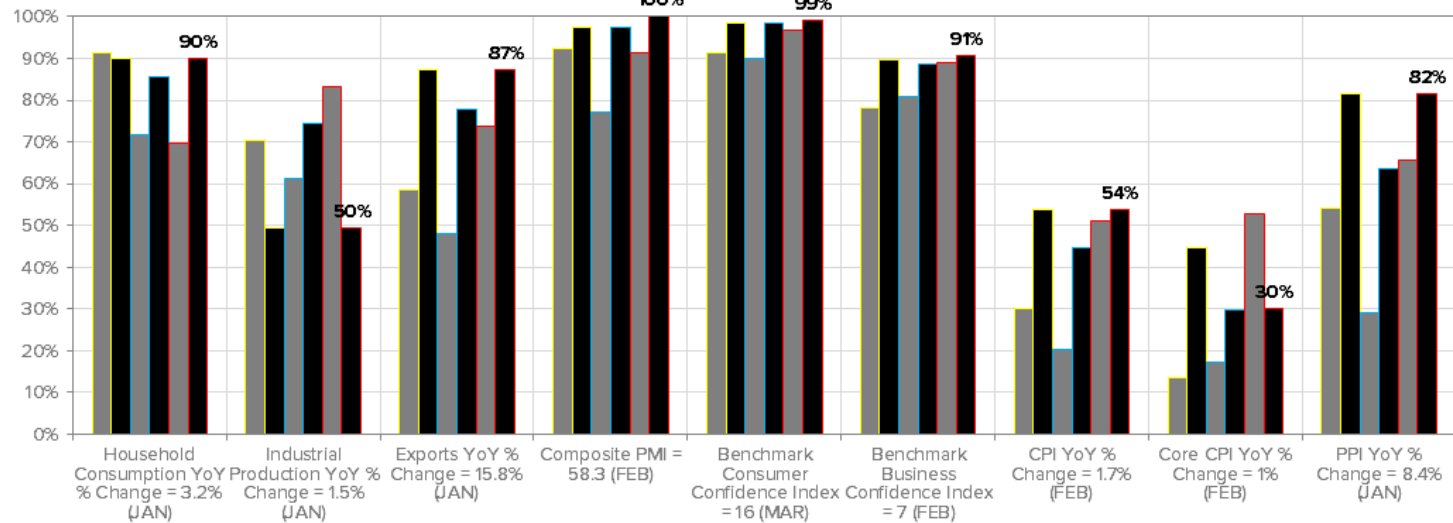
Data Source: Bloomberg.

© Hedgeye Risk Management

GROWTH: Trending higher across the preponderance of key high-frequency indicators. Although historically elevated soft data readings suggest this may be as good as it gets (for now) for reported growth.

INFLATION: Headline CPI is trending higher and mirroring the melt-up in producer prices. Like the rest of the Eurozone, core inflation readings remain structurally challenged.

POLICY: Short-term rates markets are somewhat mirroring the breakdown in inflation expectations, portending a dovish pivot out of the ECB.

Key Financial Market Indicators	Percentile (10Y)	5Y Change	3Y Change	2Y Change	18M Change	1Y Change	YTD Change	6M Change	3M Change	2M Change	1M Change	1W Change	1D Change
Benchmark Equity Market = 510.07	94%	56.4%	30.3%	2.5%	21.7%	15.0%	5.6%	12.2%	5.6%	5.7%	2.5%	-0.9%	0.1%
Policy Rate = -0.4%	0%	-65bps	-40bps	-20bps	-20bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps
1Y OIS Spread vs. Policy Rate = -32bps	49%	32bps	-25bps	-15bps	-10bps	7bps	3bps	7bps	2bps	3bps	4bps	0bps	0bps
2Y Sovereign Debt Yield = -0.73%	1%	-111bps	-102bps	-57bps	-50bps	-25bps	1bps	-10bps	-4bps	-11bps	6bps	4bps	-1bps
10Y Sovereign Debt Yield = 0.64%	14%	-181bps	-120bps	32bps	-14bps	22bps	28bps	60bps	27bps	16bps	9bps	-6bps	-2bps
10Y-2Y Sovereign Debt Yield Spread = 137bps	44%	-70bps	-18bps	89bps	36bps	46bps	27bps	71bps	31bps	27bps	3bps	-10bps	-1bps
LT Breakeven Rate (5Y5Y or 10Y) = 1.62%	10%	-70bps	-47bps	-11bps	-1bps	19bps	-12bps	27bps	-9bps	-15bps	-12bps	-8bps	-1bps
FX Rate vs. USD = 1.0783	5%	-18.7%	-21.8%	-1.5%	-3.6%	-3.6%	2.5%	-4.0%	3.1%	0.2%	1.9%	0.1%	-0.1%

MEET THE MAIN CANDIDATES

Jean-Luc Melenchon
La France Insoumise

Benoit Hamon
Socialist

Emmanuel Macron
En Marche

Francois Fillon
Republican

Marine Le Pen
National Front

- In February 2017 he received the backing of France's Communist Party for his candidacy. [age: 65]

- Melenchon says the means of production, trade and consumption must be changed, and cites climate change as one of his concerns, saying "This is a tremendous opportunity to loose the bonds that paralyze us today."

- Calls for France to leave European treaties (euroskeptic), saying the EU's economic liberalism has sapped its ability to deliver democratic change.

- He left the Socialist Party in November 2008 to found the Left Party with French deputy Marc Dolez.

- He joined the Left Front electoral federation and got elected to the European Parliament in 2009, where he still serves.

- Melenchon made an unsuccessful bid for the French presidency in 2012; received 11% of the votes or 4th place.

BENOIT HAMON, THE SOCIALISTS

- Former Education Minister Benoit Hamon been called the "French Bernie Sanders". [age: 49]

- The left-winger shot to the center stage after his decisive win in the first round of France's Socialist party primary, beating the favorite Manuel Valls.

- Hamon's Programs:
  - a universal monthly payment for all French citizens, regardless of income.
  - wants to legalize cannabis,
  - to tax the wealth created by robots
  - ditch the labor law passed last year that made it easier to hire and fire

- The income plan outlined would be put into effect in 3 stages:
  - 1.) the current minimum welfare payment for France's poorest would be increased by 10% to €600 a month
  - 2.) The payments would then be extended to all those from 18-25 years old
  - 3.) The program would be rolled out to all French citizens sometime after 2022, with the monthly payment increased to €750 a month

EMMANUEL MACRON, EN MARCHE (ONWARDS)

- Formerly an investment banker, Macron worked as economic adviser to President Francois Hollande before taking up the post of economy minister in 2014. [age: 39]

- In April 2016 he set up En Marche, which he describes as "neither left nor right" and resigned from Hollande's government on August 30, 2016 in order to launch his presidential bid.

- He has never been elected an MP - and has never stood for election.

- A europhile, he has a reputation with his "Macron Law", a controversial reform bill that allowed shops to open more often on Sundays and deregulated some sectors of industry.

- For much of France's business community Macron seen as a breath of fresh air, with a list of pro-business policies aimed at boosting economic growth.

- Macron describes France as "blocked by corporatism" (large interest groups).

- He is an economic liberal and pro-business, who has backed ending France's 35-hour week for younger workers, but is on the left on social issues.

- He has backed deregulation in certain French industries and greater checks on politicians' powers.

THE FILLON AFFAIR....

- Fillon convincingly defeated party rivals Nicolas Sarkozy and Alain Juppe, but then promptly became embroiled in a scandal beginning in late January 2017.   [age: 62]

- Summoned to appear before an investigating judge following claims in the media that his wife was paid for parliamentary work she did not carry out.

- Fillon has refused to step aside for another candidate, stating instead that he was the victim of a "political assassination" and alleging that the timing of the investigation was part of a plot to deny voters the opportunity to vote for a center-right president.

- Campaigning on radical plans for economic belt-tightening include cutting half a million public sector jobs, lengthen work week from 35 to 39 hours, increase retirement age to 65, and remove the wealth tax (ISF).

- He wants to add immigration quotas, strip jihadists returning from the wars in Iraq or Syria of their French nationality and require parents in receipt of social allowances to agree to a "parental responsibility contract".

- On foreign policy, Fillon wants to lift EU sanctions on Russia and help Syrian President Bashar al-Assad defeat ISIS.

- "You don't leave the euro and the protection afforded by the European Central Bank ... for an adventure ... that would ruin borrowers and savers alike."

- Le Pen took over leadership of the National Front (FN) from her father in January 2011. Trained as a lawyer. [age: 48]

- Campaign Proposals (slogan - "Made in France"):

  - Slashing legal immigration from 200,000 to 10,000 entries per year
  - Deporting illegal immigrants
  - Prioritizing French citizens for jobs and housing
  - Holding a referendum on exiting the EU and euro
  - Calls for reintroducing the franc
  - Increasing police numbers and powers, and creating 40,000 new prison

- She was elected to the European Parliament in 2004 and remains an MEP, representing North-West France.

- After taking over leadership from her father in 2011, she distanced herself from him politically. She denounced him for suggesting that the Nazi gas chambers were "a detail of history".

- She came third in presidential polls in 2012.

TWO ROUNDS LIKELY:

Presidential Election Process
How France elects its head of state

First–round results → **Second–round results** → **Inauguration**

Anyone who meets the constitutional requirements can run. If a candidate gets more than 50 percent of the vote, he or she is elected. If no one wins a majority, the two candidates who received the most votes move on to a second round.
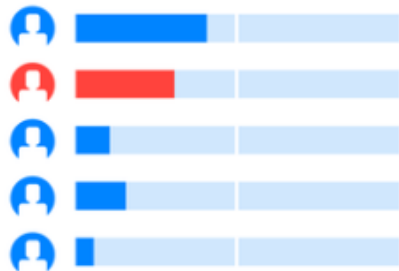
The final two candidates compete in a runoff. The candidate with the most votes wins.
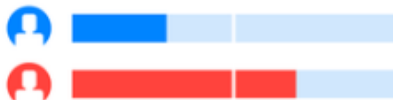
The winner is inaugurated about 10 days after the second round. The president takes office before the parliament is elected.

New President

Source: French constitution, 1962 legislation

Bloomberg

HISTORY IS MIXED...

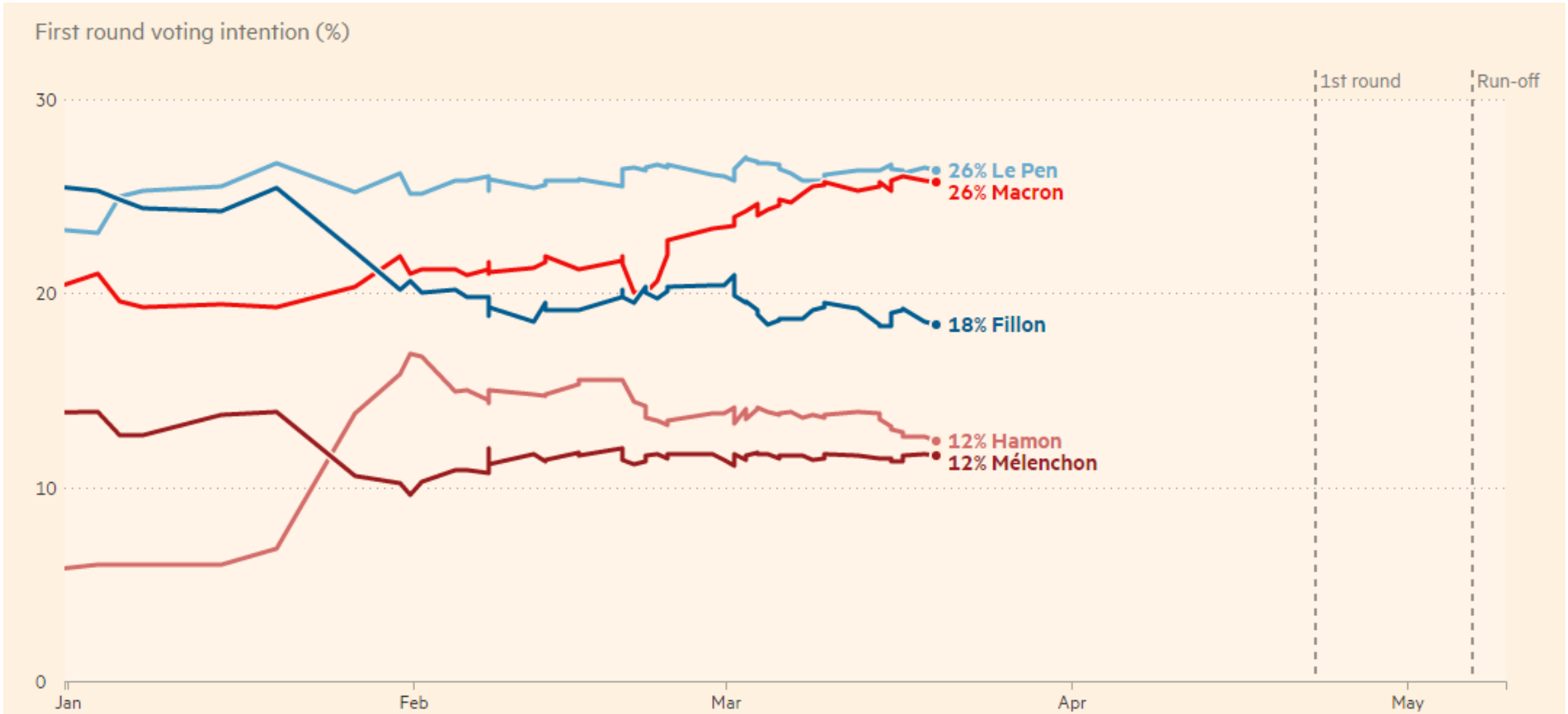In the 8 elections since the system was implemented in 1965, the first-round winner became the president 5 times.

- In 1974, 1981 and 1995, the candidate who placed second came back to win.

~40% French voters are undecided...

WHO IS LEADING IN NATIONAL OPINION POLLS?

A LATE JANUARY FILLON SCANDAL PULLED HIS SUPPORT LOWER, TO MACRON'S BENEFIT. CAN FILLON REBOUND? NO CANDIDATE IS CLOSE TO 50% MAJORITY
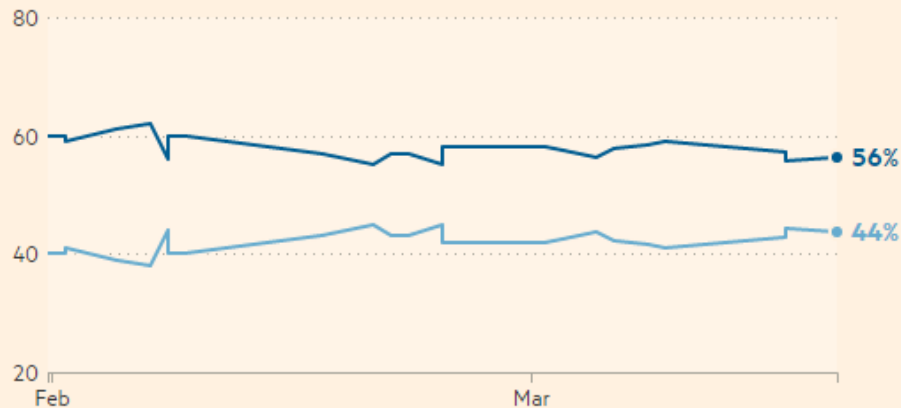
First round voting intention (%)

30

1st round   Run-off

26% Le Pen
26% Macron

20

18% Fillon

12% Hamon
12% Mélenchon

10

0

Jan   Feb   Mar   Apr   May

POLLS OF 2ND ROUND RUNOFF SHOW…

HAMON (SOCIALIST) AND MELENCHON (THE LEFT) FAILED TO AGREE ON AN ALLIANCE, RULING THEM OUT OF A PATH TO THE 2ND ROUND

Le Pen vs Macron
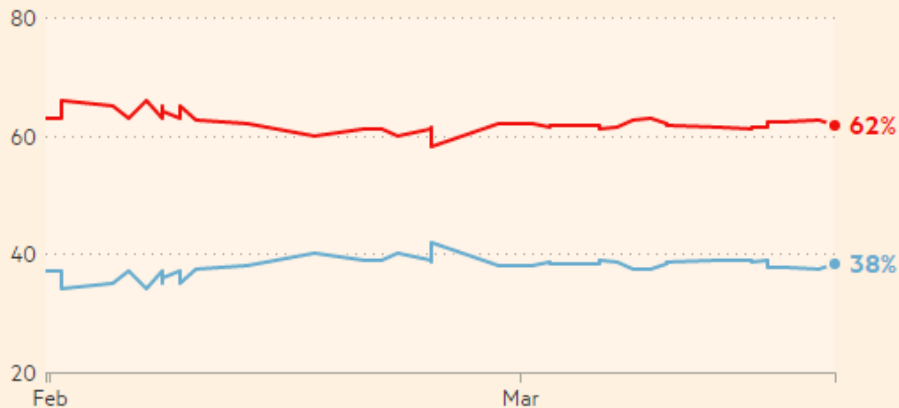
Le Pen vs Fillon

SD

- Macron won the 1st TV debate on March 20th, according to **Elabe** snap poll:

    → Macron 29%; Melenchon 20%; Le Pen & Fillon 19% each; and Hamon 11%.

- A separate **OpinionWay** poll showed → Macron 24%; Fillon and Le Pen 19% each; and Melenchon 15%; and Hamon 10%.

- 2 more TV debates (tbd) scheduled ahead of April 23rd 1st round vote.

- Pollster Ifop's data show that more than 80% of Le Pen's supporters say that they would definitely vote for her in the first round.

- By contrast, less than 49% of Macron's backers were certain that they would vote for him.

LE PEN, LIKE TRUMP

IN LE PEN'S WORDS… POPULIST MOVEMENT UNDERESTIMATED?

- <u>Le Pen says Trump's victory boosts her chances of winning because it "makes the French realize that what the people want, they can get, if they mobilize themselves."</u>

- "So it's a sign of hope for those who cannot bear wild globalization. They cannot bear the political life led by the elites."

- <u>"I feel less isolated today because of the multi-polar world defended by Donald Trump but also by Theresa May and Vladimir Putin."</u>

- "<u>I am opposed to a multicultural France</u>, I think that those who have a different culture and who arrive in France have to submit themselves to French culture. Like the old saying:

  __'When in Rome, do as the Romans do.'__

  I think that in France we should do like the French people."

DO POLLS REFLECT TRUE LE PEN SUPPORT?

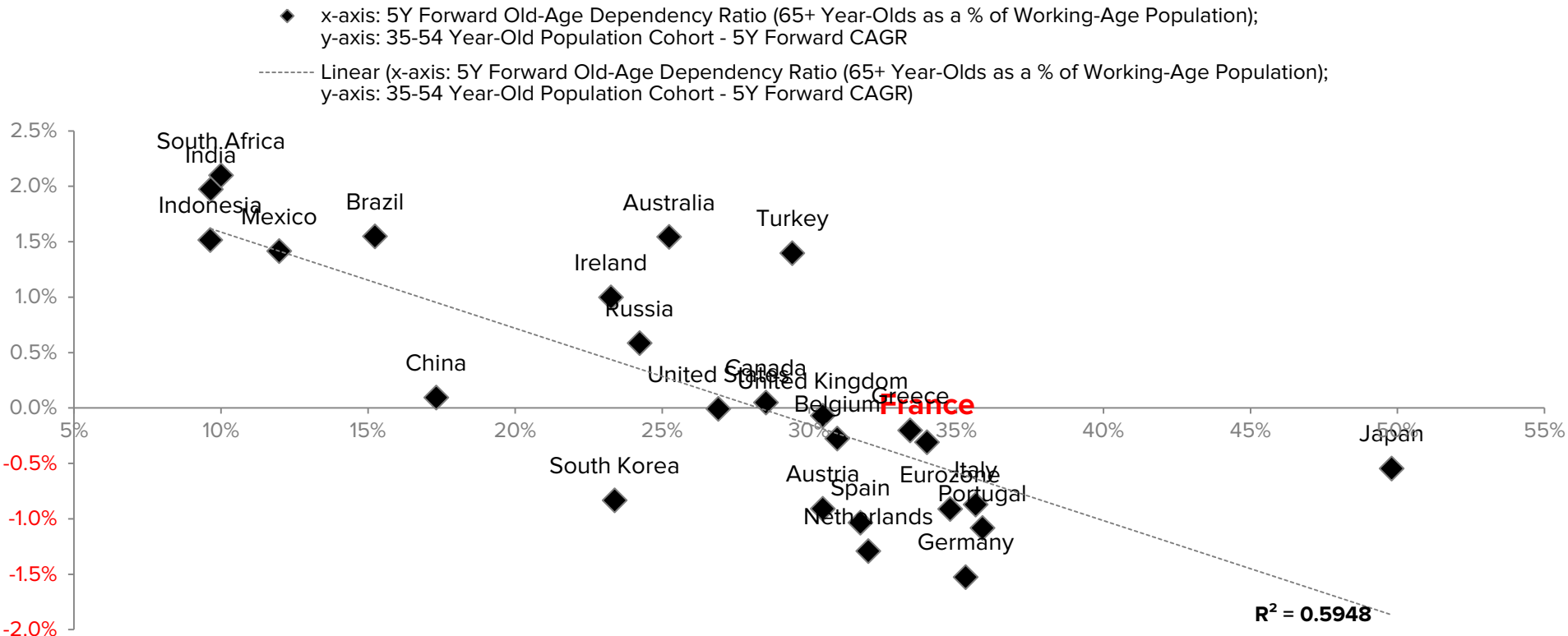**UNDERESTIMATING LE PEN AND WHAT'S THE DOWNSIDE RISK?**

- A Le Pen Victory stands to usher in a prolonged period of uncertainty around France's position IN or OUT of the Euro.

    - A series of votes (like Brexit) to take place
    - Long runway for voting and conversion (debt default vs new currency repayment?)
    - Downside risk in EUR/USD around "uncertainty", and
    - Perceived Domino Risk =

If France exits, Eurozone entity as we know it
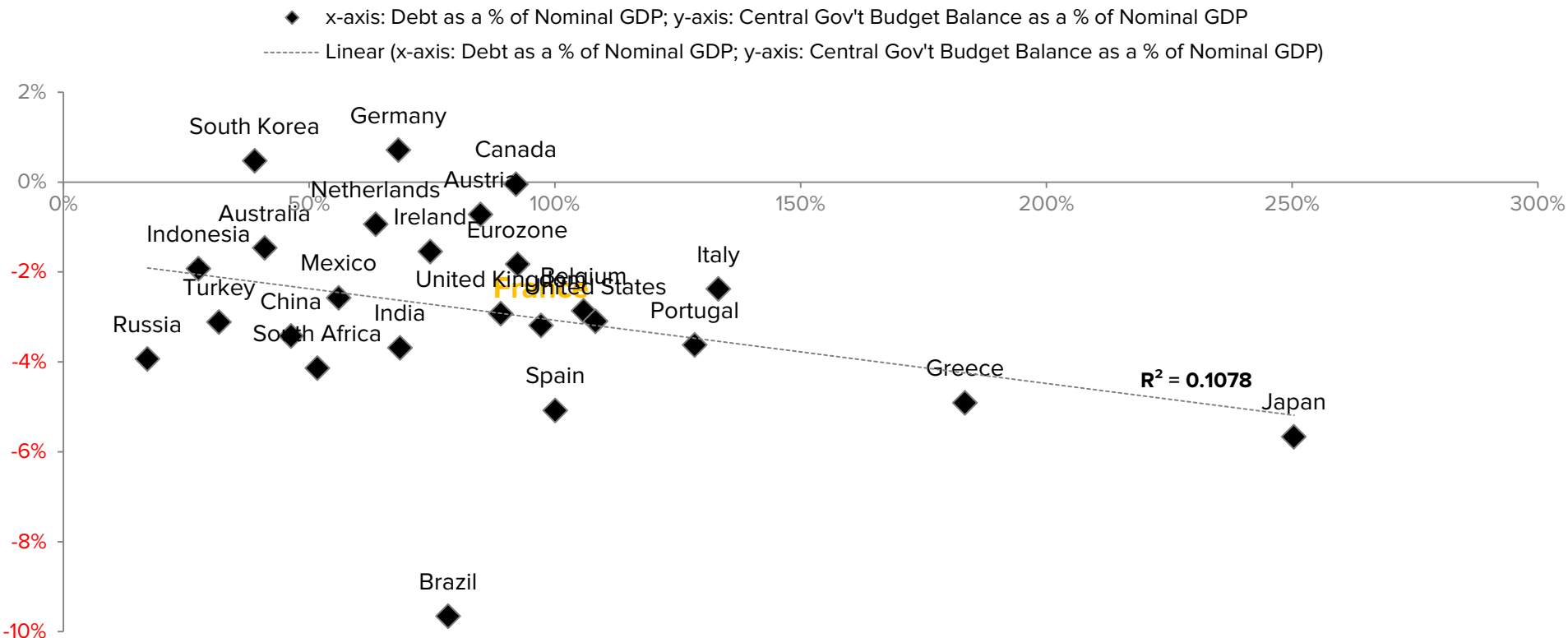*is defunct!*

FRANCE SCREENS POORLY WITH RESPECT TO HOW WE QUANTIFY DEMOGRAPHIC RISK.

◆ x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR

- - - - Linear (x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
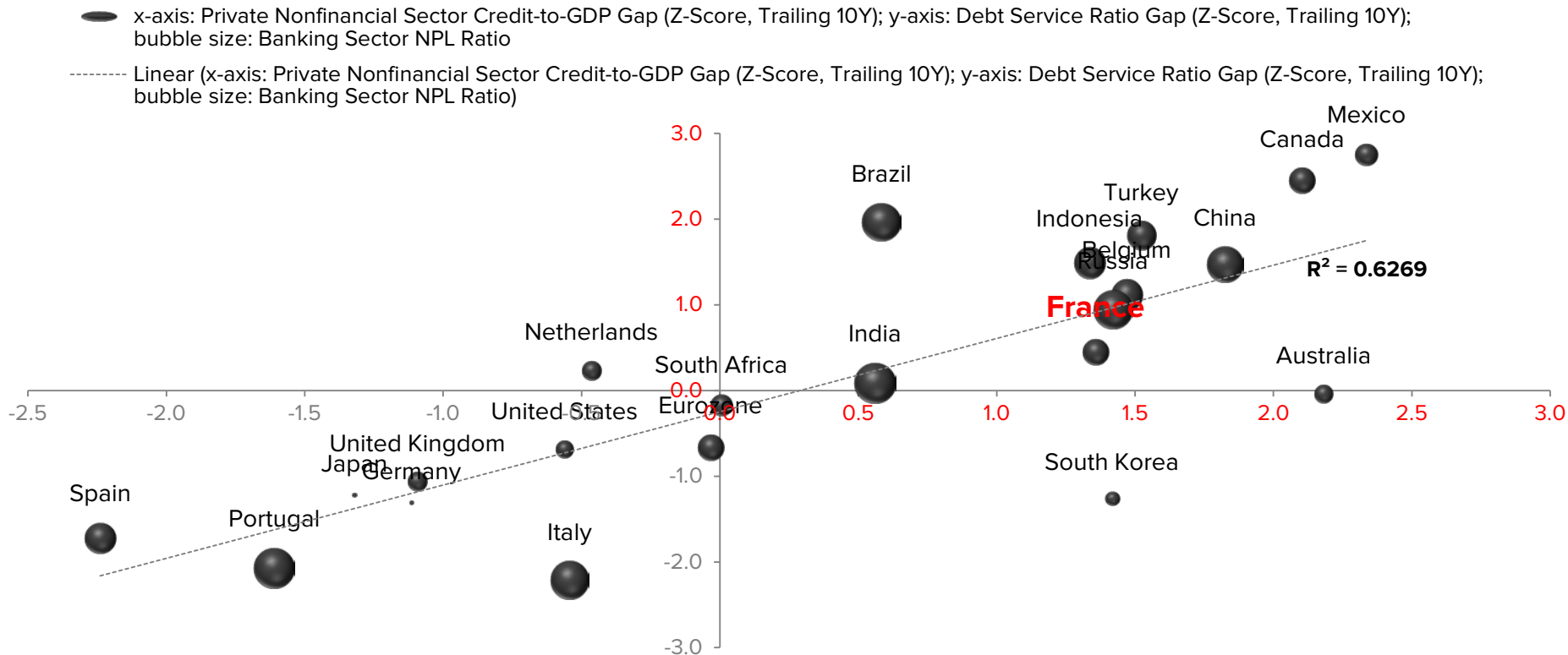y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR)

$R^2 = 0.5948$

PILLAR II: FISCAL POLICY RISK

FRANCE SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF ADVERSE FISCAL POLICY.

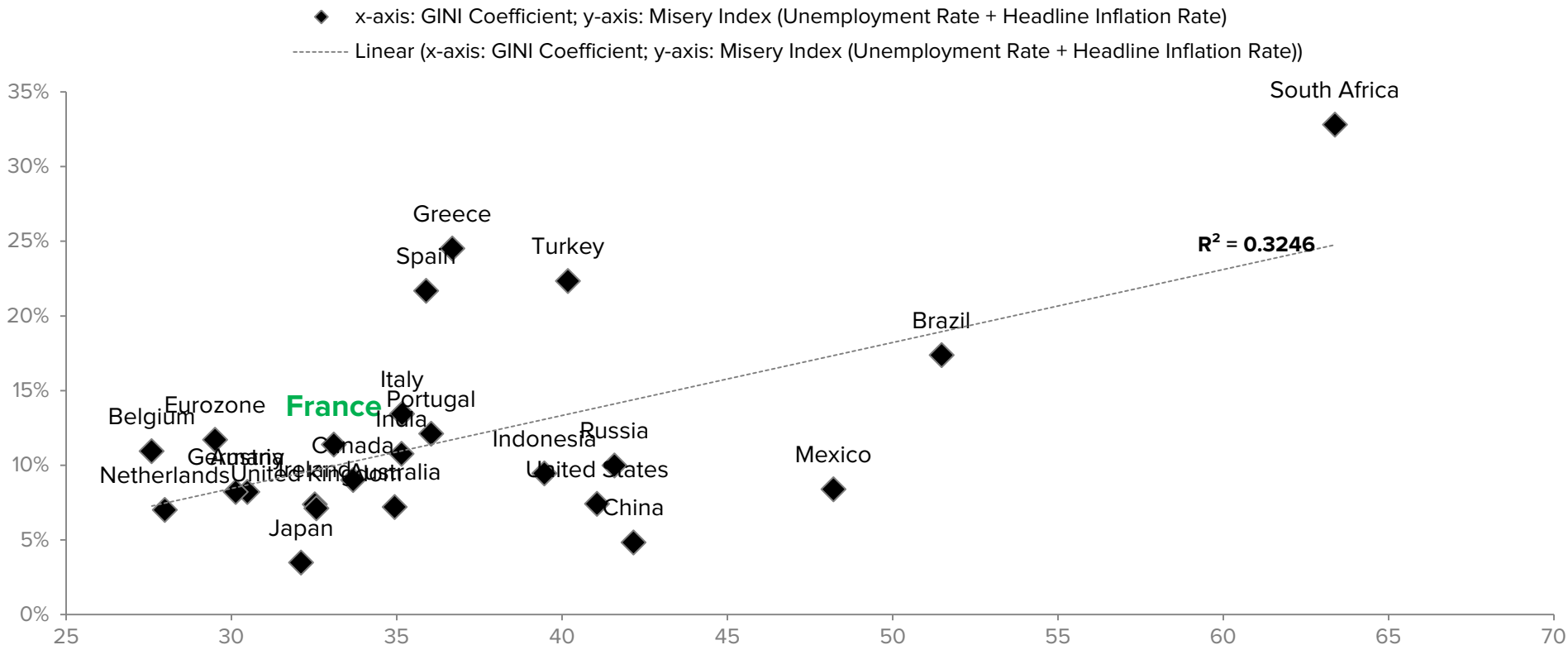◆ x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP

------ Linear (x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP)

R² = 0.1078

FRANCE SCREENS POORLY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RECESSION.

⬤ x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio

------- Linear (x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio)

PILLAR IV: POPULISM RISK

FRANCE SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RISING POPULISM.

◆ x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate)

------ Linear (x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate))

$R^2 = 0.3246$

PILLAR V: COMPETITIVENESS RISK

FRANCE SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF CAPITAL FLIGHT, UNDERINVESTMENT, MALINVESTMENT OR SOME COMBINATION OF THE THREE.

◆ x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate

------- Linear (x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate)
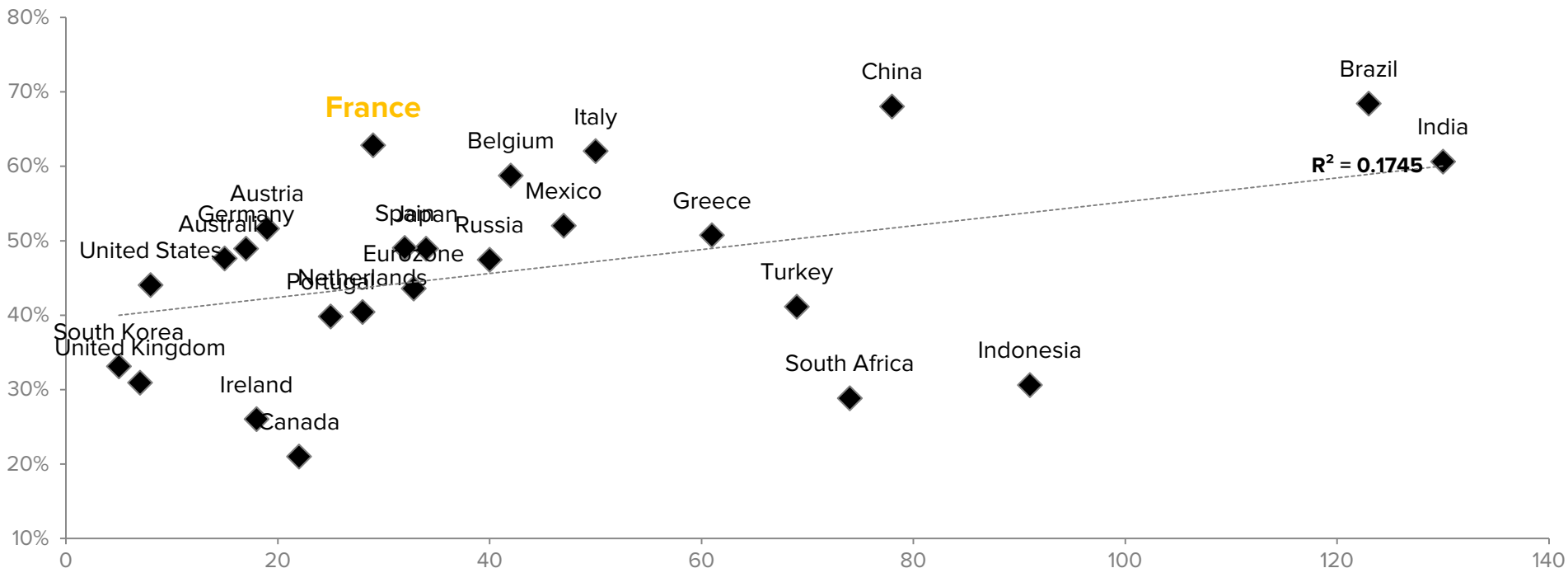
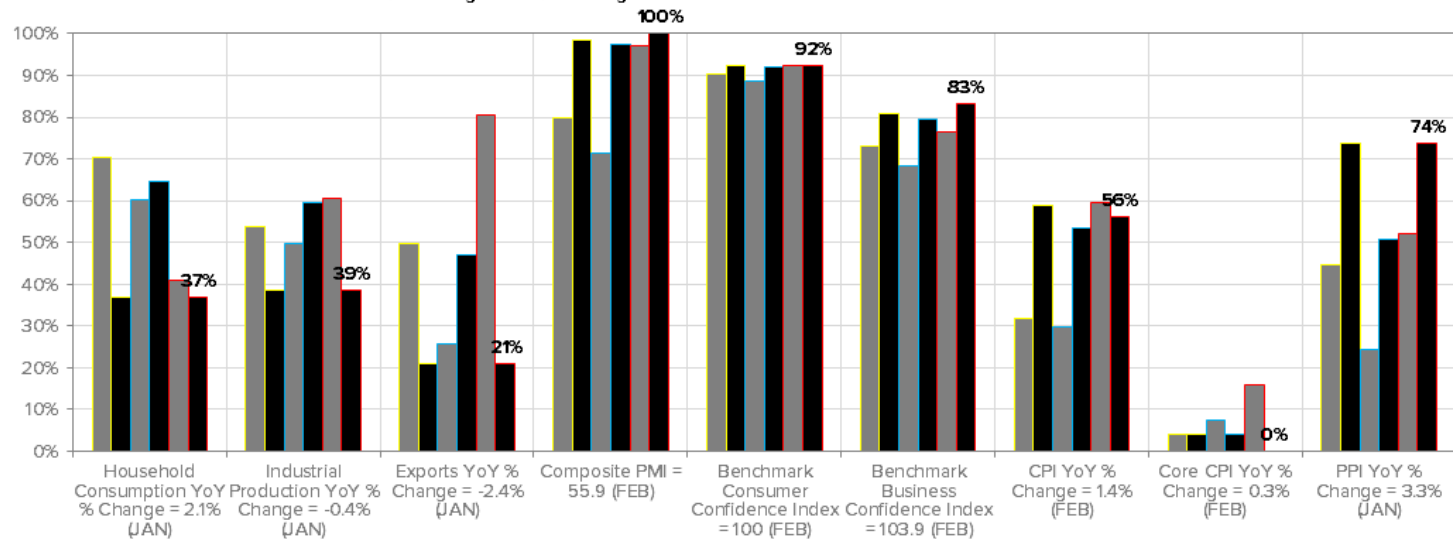| FRANCE	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	Hedgeye Macro GIP Model		
Real GDP QoQ	0.2%	0.0%	0.2%	0.4%	0.1%	0.6%	0.0%	0.3%	0.2%	0.7%	-0.1%	0.2%	0.4%	GIP = Growth/Inflation/Policy		
Real GDP YoY	0.9%	0.9%	0.4%	0.7%	0.6%	1.3%	1.2%	1.1%	1.2%	1.2%	1.1%	1.0%	1.2%	Full-year Estimates	2016E	2017E
2Y Average	0.5%	0.5%	0.7%	0.7%	0.8%	1.1%	0.8%	0.9%	0.9%	1.3%	1.2%	1.1%	1.2%	Hedgeye Predictive Tracking Algorithm	1.1%	0.9%
3Y Average	0.8%	0.4%	0.5%	0.5%	0.5%	0.7%	0.8%	0.8%	0.9%	1.1%	0.9%	0.9%	1.0%	Bloomberg Consensus Estimate	1.1%	1.3%
Percentile (T10Y)	33%	33%	26%	33%	31%	51%	49%	49%	51%	51%	49%	49%	56%	Central Bank Forecast	1.2%	1.4%
CPI YoY	0.7%	0.7%	0.6%	0.4%	0.3%	-0.3%	0.2%	0.1%	0.1%	0.0%	0.0%	0.3%	0.5%	Full-year Estimates	2016E	2017E
2Y Average	1.1%	0.9%	0.7%	0.7%	0.5%	0.2%	0.4%	0.2%	0.2%	-0.2%	0.1%	0.2%	0.3%	Hedgeye Predictive Tracking Algorithm	0.2%	1.0%
3Y Average	1.5%	1.4%	1.1%	1.1%	0.8%	0.5%	0.6%	0.5%	0.4%	0.1%	0.3%	0.2%	0.3%	Bloomberg Consensus Estimate	0.3%	1.4%
Percentile (T10Y)	10%	13%	8%	8%	5%	3%	8%	8%	10%	8%	10%	21%	31%	Central Bank Forecast	0.3%	1.5%
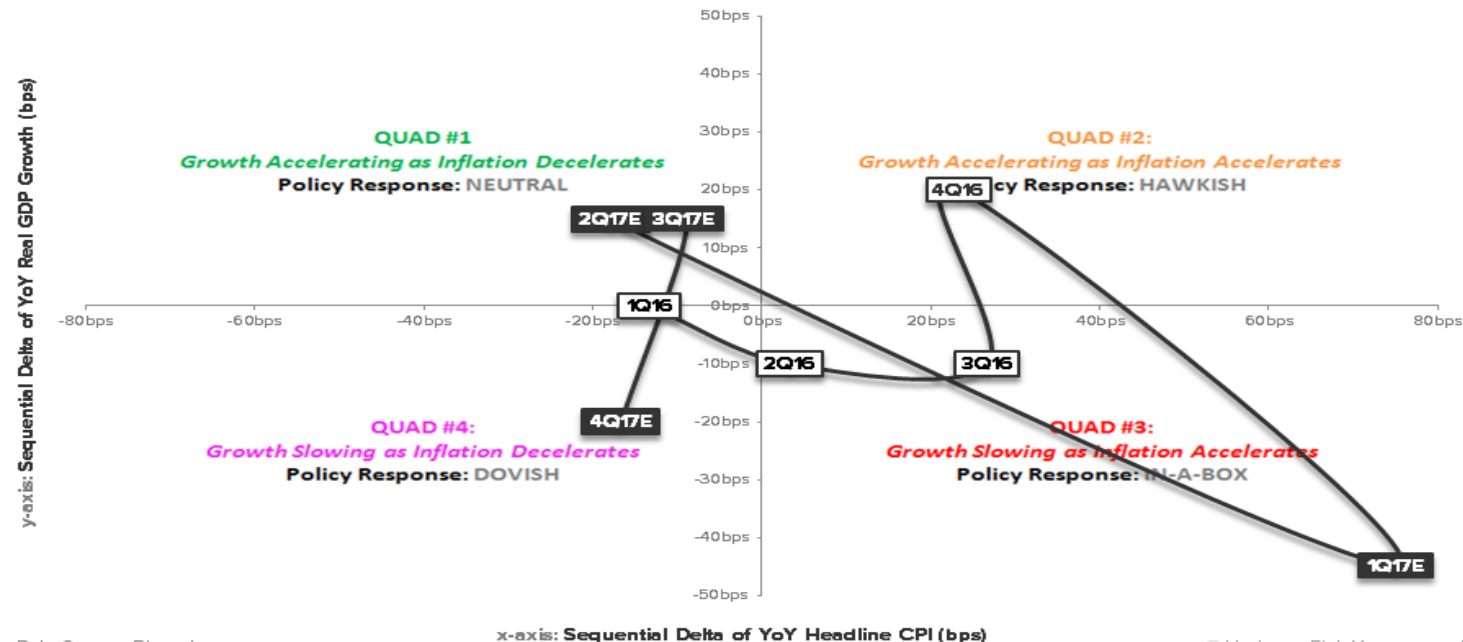
While French growth appears to have negatively inflected here in 1Q17, receding base effects suggests the damage is done for now. Like many developed economies across Europe and abroad, headline inflation is likely to peak here in Q1, which means France is likely to experience a couple quarters of #Quad1 over the next ~6 months.

Data Source: Bloomberg

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Key High Frequency Growth and Inflation Indicators: France
(Values Shown as a Percentile of the Respective Trailing 10Y Sample)

Legend: ■ 4Q16 Average ■ 1Q17 Average ■ 12MMA ■ 3MMA ■ Previous Value ■ Latest Value

Data Source: Bloomberg.

© Hedgeye Risk Management

Key Financial Market Indicators	Percentile (10Y)	5Y Change	3Y Change	2Y Change	18M Change	1Y Change	YTD Change	6M Change	3M Change	2M Change	1M Change	1W Change	1D Change
Benchmark Equity Market = 4998.03	88%	43.8%	15.3%	-1.1%	12.8%	13.0%	2.8%	11.3%	3.3%	3.7%	2.2%	-0.3%	0.1%
Policy Rate = -0.4%	0%	-65bps	-40bps	-20bps	-20bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps
1Y OIS Spread vs. Policy Rate = -32bps	49%	32bps	-25bps	-15bps	-10bps	7bps	3bps	7bps	2bps	3bps	4bps	0bps	0bps
2Y Sovereign Debt Yield = -0.46%	7%	-93bps	-76bps	-33bps	-28bps	-4bps	19bps	14bps	19bps	7bps	0bps	-2bps	-1bps
10Y Sovereign Debt Yield = 1.01%	20%	-194bps	-115bps	52bps	3bps	46bps	32bps	79bps	31bps	15bps	2bps	-8bps	-4bps
10Y-2Y Sovereign Debt Yield Spread = 147bps	43%	-101bps	-39bps	85bps	31bps	50bps	13bps	65bps	12bps	8bps	2bps	-7bps	-3bps
LT Breakeven Rate (5Y5Y or 10Y) = 1.18%	22%	-56bps	-22bps	-11bps	7bps	22bps	-8bps	22bps	-1bps	-12bps	-4bps	-7bps	-1bps
FX Rate vs. USD = 1.0783	5%	-18.7%	-21.8%	-1.5%	-3.6%	-3.6%	2.5%	-4.0%	3.1%	0.2%	1.9%	0.1%	-0.1%

GROWTH: Trending higher across the preponderance of key high-frequency indicators, but the nascent breakdown in French hard data is confirming of our #Quad3 outlook for 1Q17.

INFLATION: Headline CPI is trending higher and mirroring the recovery in producer prices. Core inflation, however, remains as structurally challenged as anywhere else in the currency bloc.

POLICY: Short-term rates markets have yet to materially respond to the trending reversal in French inflation expectations, but are likely to do so in the coming weeks.

MEET THE MAIN CANDIDATES

CHANCELLOR ANGELA MERKEL (CHRISTIAN DEMOCRATIC UNION: CDU & CSU) VS MARTIN SCHULZ (SOCIAL DEMOCRATS: SPD)

WHO IS MARTIN SCHULZ?

HE'S NOT A FAMILIAR FACE IN BERLIN BUT IN BRUSSELS

- Schulz was born in the West Rhineland. [age: 61]

- Referred to as a "Man of the People".

- Dropped out of high school and trained as a bookseller.

- Proficient in six languages.

- Political career began in 1987 as mayor of Würselen, near Aachen, a post he held for 11 years.

- Since 1994 he has been a member of the European parliament.

- Head of the SPD MEPs since 2000.

- In 2012 elected President of the European Parliament.

- In 2012 he received the Nobel peace prize on behalf of the EU.

"Wilders failed to win the Dutch elections. I am relieved, but we need to continue to fight for an open and free Europe."

WHO IS CHANCELLOR ANGELA MERKEL?

A FAMILIAR FACE IN GERMANY – SEEKS 4TH TERM AS CHANCELLOR

- Merkel was born in Hamburg, raised in East Germany. [age: 62]

- Affectionately referred to as "Mutti" or "Mommy".

- A former research scientist with a doctorate in physical chemistry;
- speaks Russian.

- Entered politics after fall of the Berlin Wall in 1989. 1990 elected to the Bundestag in first election after reunification.

- 1991 – Chancellor Helmut Kohl appoints her to his cabinet as Minister of Women and Young People; in 1994 named Minister of the Environment, Nature Conservation and Nuclear Safety. In 1998 becomes general secretary of the Christian Democratic Union.

- 2005 – becomes 1st woman chancellor of Germany, the 1st chancellor born after World War II, and the 1st from (raised) the former East Germany.

- 2009 – is reelected chancellor of Germany. 2015 – TIME magazine Person of the Year.

POLLS ARE NECK-AND-NECK

ONLY SLIGHT ADVANTAGE TO MARTIN SCHULZ'S SPD (COLORED RED) VS CHANCELLOR MERKEL'S CDU (COLORED BLACK) IN RECENT WEEKS

Polling firm [hide] ⬍	Fieldwork date ⬍	Sample size ⬍	TO ⬍	CDU	SPD	DIE LiNKE.	GRÜNE	FDP	AfD	Other	Lead
Civey	19–21 Mar 2017	5,030	?	32.2	33.1	7.6	6.7	6.1	10.0	4.3	0.9
INSA	17–20 Mar 2017	1,933	?	31	32	8.5	6.5	6.5	11.5	4	1
Emnid	9–15 Mar 2017	1,832	?	33	32	8	8	5	9	5	1
INSA	10–13 Mar 2017	2,051	?	31	31	8.5	6.5	7	11.5	4.5	Tie
Civey	8–10 Mar 2017	5,017	?	33.5	31.4	7.1	6.8	6.7	10.3	4.2	2.1
Forsa	6–10 Mar 2017	2,505	76	33	32	7	7	6	9	6	1
Forschungsgruppe Wahlen	7–9 Mar 2017	1,212	?	34	32	8	7	5	9	5	2
Infratest dimap	6–8 Mar 2017	1,502	?	32	31	8	8	6	11	4	1
Emnid	2–8 Mar 2017	1,882	?	33	33	8	7	6	8	5	Tie
INSA	3–6 Mar 2017	2,022	?	30.5	31.5	8.5	6.5	7.5	11	4.5	1
Ipsos	3–6 Mar 2017	1,058	?	33	29	9	8	6	11	4	4
Civey	2–6 Mar 2017	5,006	?	33.6	31.2	7.6	6.7	7.0	9.4	4.5	2.4

51% SPELLS A MAJORITY; MERKEL FATIGUE?

CDU/CSU – Angela Merkel is in her 12th year as Chancellor, running for her 4th term. Merkel Fatigue? Maybe! Her party has been plagued by mismanagement of immigration flow, criticized for freely opening up the German borders WITHOUT defined quotas and resettlement strategies & policies.

Coalition Options:

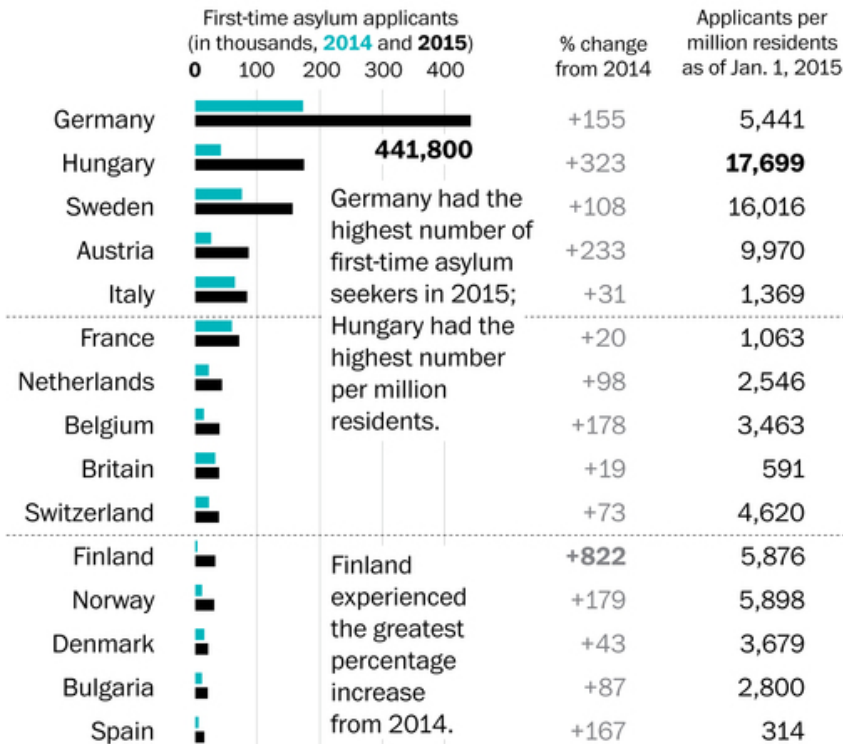**Black-Red?** → CDU/CSU + Social Democrats (SPD) = current 'Grand Coalition'

Black-Gold? → CDU/CSU + Free Democrats (FDP)

Black-Green? → CDU/CSU + Greens

IMMIGRANT ISSUES MERKEL'S DOWNFALL?

IMPACT OF IMMIGRATION INFLUX IN 2015 (FROM SYRIA AND OTHER EMBATTLED COUNTRIES)

First-time asylum applicants (in thousands, 2014 and 2015)	% change from 2014	Applicants per million residents as of Jan. 1, 2015
Germany	+155	5,441
Hungary — 441,800	+323	**17,699**
Sweden	+108	16,016
Austria	+233	9,970
Italy	+31	1,369
France	+20	1,063
Netherlands	+98	2,546
Belgium	+178	3,463
Britain	+19	591
Switzerland	+73	4,620
Finland	**+822**	5,876
Norway	+179	5,898
Denmark	+43	3,679
Bulgaria	+87	2,800
Spain	+167	314

Germany had the highest number of first-time asylum seekers in 2015; Hungary had the highest number per million residents.

Finland experienced the greatest percentage increase from 2014.

- Up to 1 Million refugees entered Germany in 2015, but fewer than 500,000 applied for protection due to delays.

- Germany by land size is ~ the size of the state of Montana.

SPD PLATFORM & COALITION

SPD HAS A 154 YEAR HISTORY… SCHULZ RIDING LIFT OF ALTERNATIVE TO MERKEL

SPD - campaigns for workers' rights and called for greater investment in education and health care.

Coalition Options:

Red-**Red**-**Green**? → SPD + far-left Die Linke + the Greens.
- Or without The Linke? The Linke rejects NATO and wants to raise the top income tax rate to 75% - ideas at odds with the SPD.

Red-**Black?** → SPD + Merkel's Conservatives (CDU/CSU).

RISE OF ALTERNATIVE FOR GERMANY (AFD)?
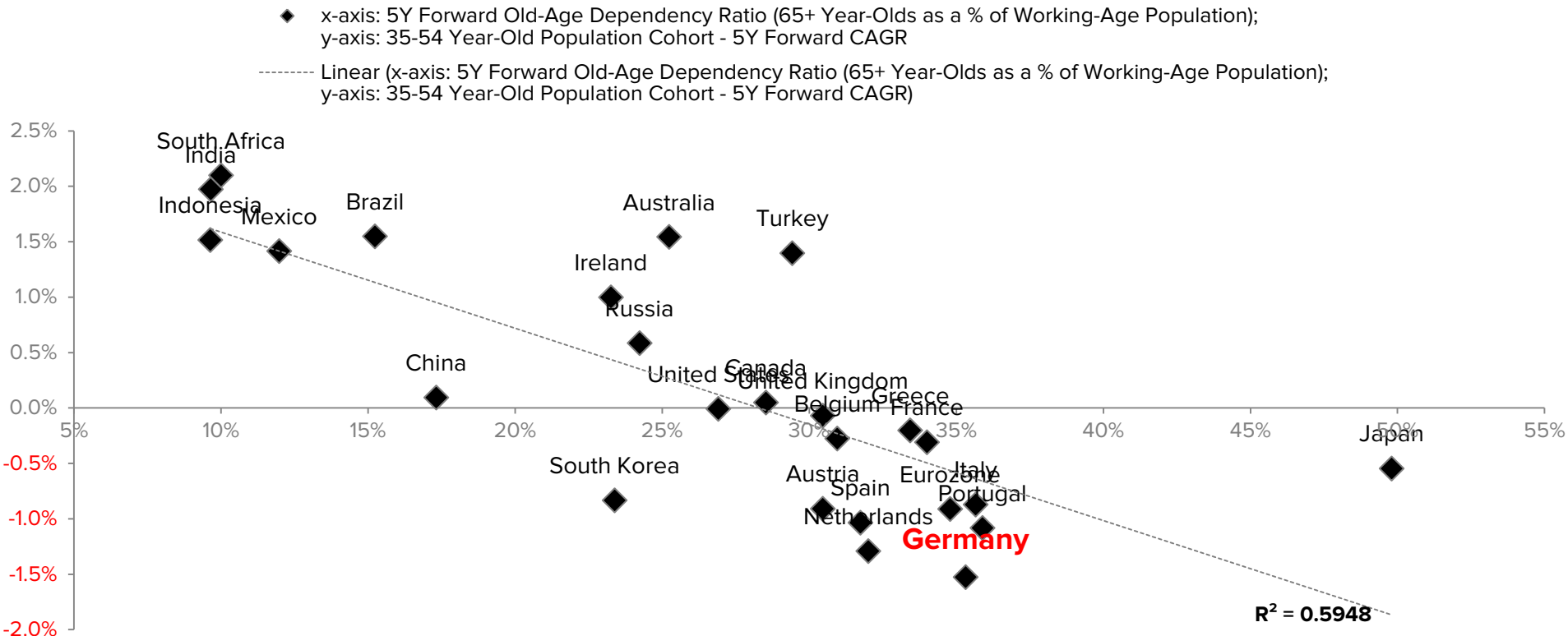

- **AfD Party Platform** –
  - Founded in 2013, led by Frauke Petry
  - Strong anti-immigration message
  - Soft Euroskeptic - supportive of EU with power shifted to national level
  - Critical of further EU integration
  - Opposition to bailouts of EU member states
  - Defender of traditional family (anti abortion; anti gay)
  - Critics have accused individual members of promoting neo-Nazi ideas.

- The AfD won 4.7% of the votes in the 2013 Federal Election (just shy of the 5% need to sit in the Bundestag) and has gained representation in 10 of the 16 German States.

- Currently polls between 8-15% popular vote.

- **Note: None of the established parties are willing to cooperated with the AfD,** but could be an opposition force in the Bundestag if the party captures at least 5% of the vote.
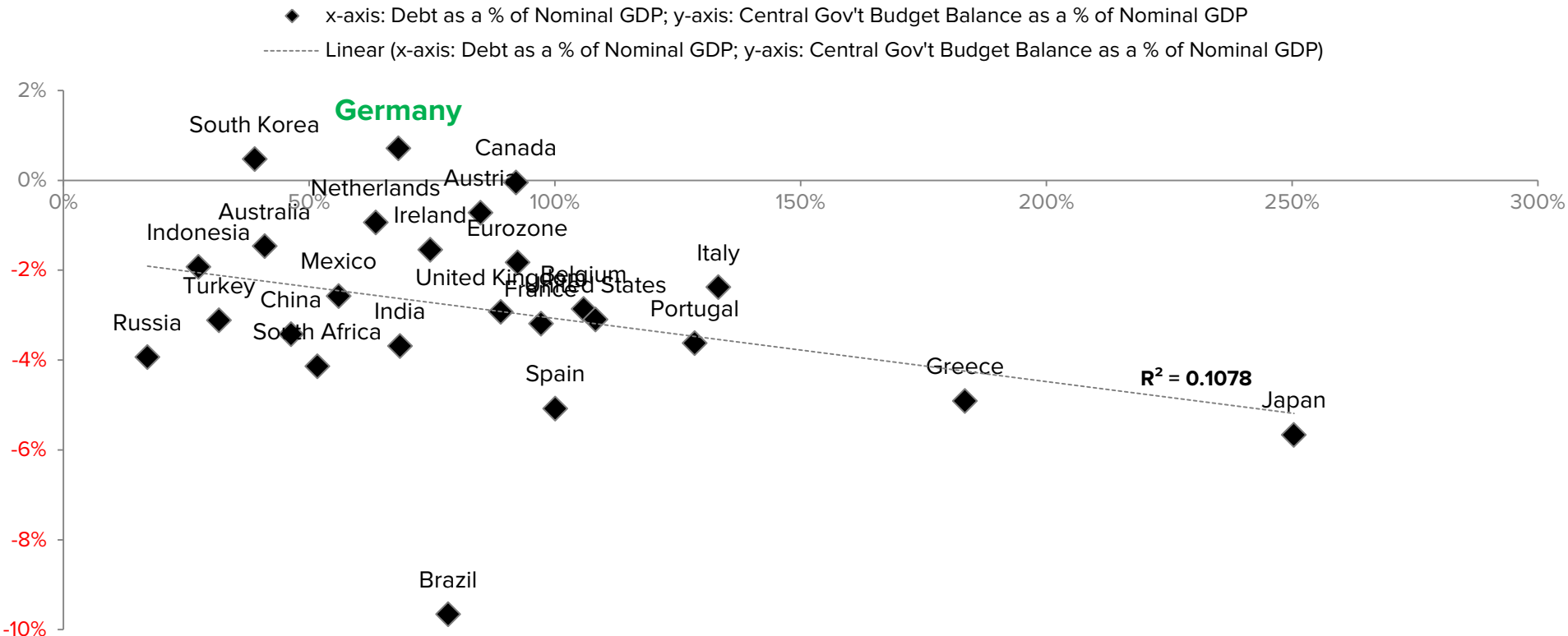
GERMANY SCREENS POORLY WITH RESPECT TO HOW WE QUANTIFY DEMOGRAPHIC RISK.

◆ x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR

------ Linear (x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
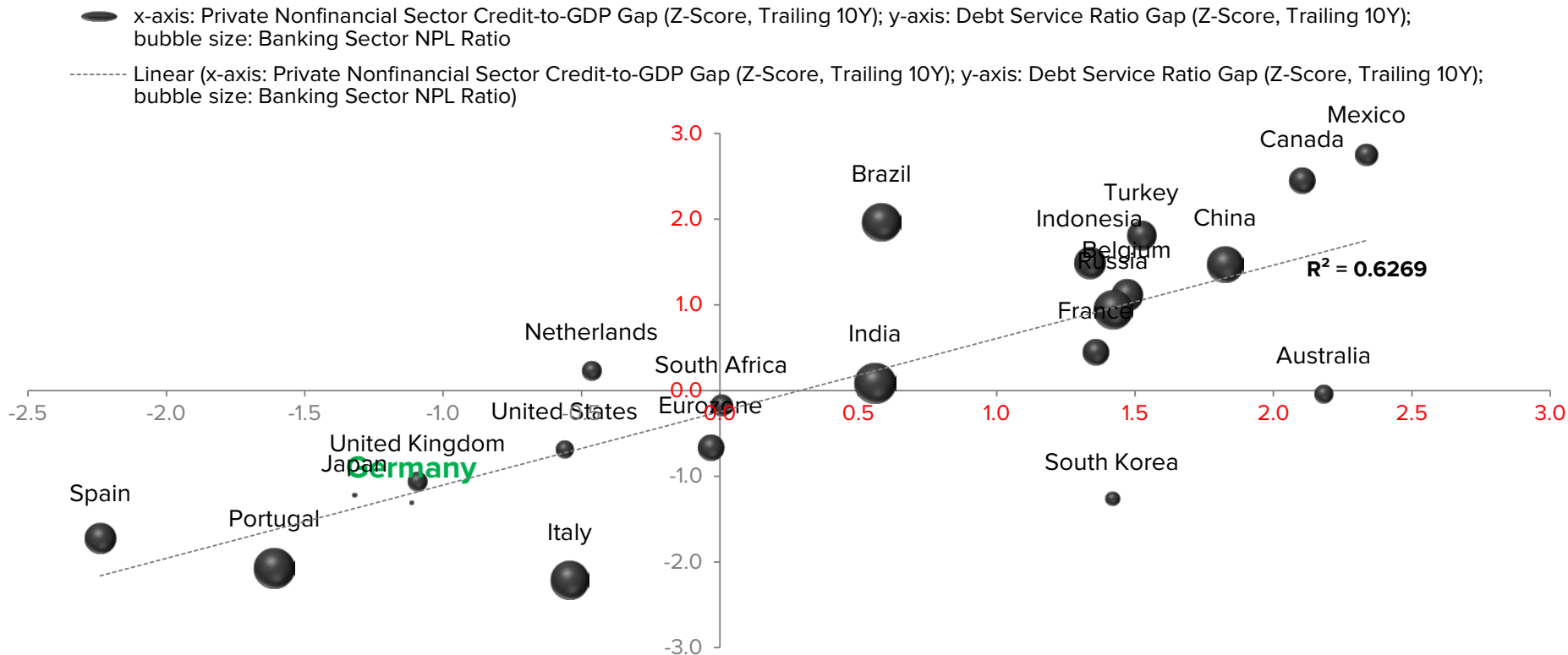y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR)

$R^2 = 0.5948$

PILLAR II: FISCAL POLICY RISK

GERMANY SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF ADVERSE FISCAL POLICY.

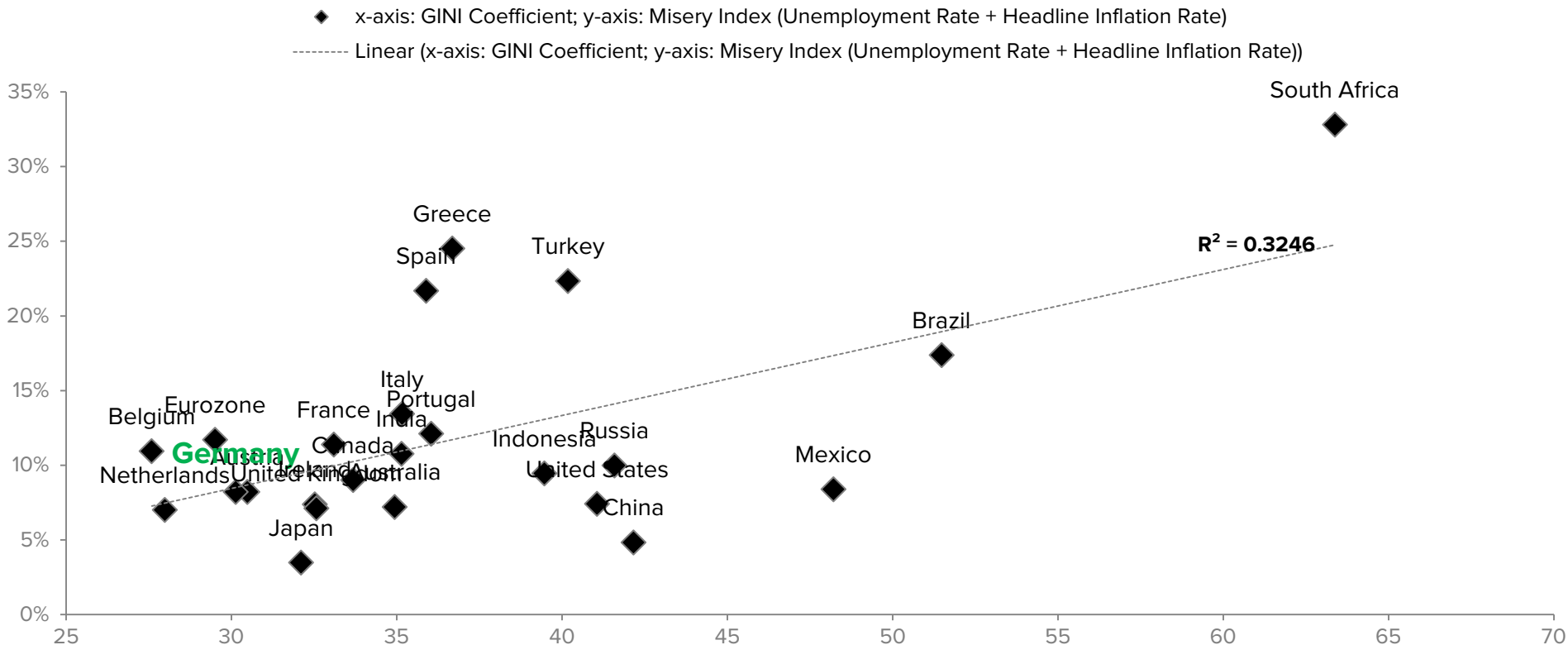◆ x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP

----- Linear (x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP)

R² = 0.1078

PILLAR III: ECONOMIC CYCLE RISK

GERMANY SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RECESSION.

● x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio

------ Linear (x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y); bubble size: Banking Sector NPL Ratio)

$R^2 = 0.6269$

PILLAR IV: POPULISM RISK

GERMANY SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RISING POPULISM.

◆ x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate)

------- Linear (x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate))

South Africa

Greece

Spain

Turkey

R² = 0.3246

Brazil

Italy
Portugal
Eurozone   France   India
Belgium   Russia
              Germany   Indonesia
Netherlands United Kingdom Australia United States   Mexico
                             Canada
Japan   China

PILLAR V: COMPETITIVENESS RISK

GERMANY SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF CAPITAL FLIGHT, UNDERINVESTMENT, MALINVESTMENT OR SOME COMBINATION OF THE THREE.

◆ x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate

------- Linear (x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate)
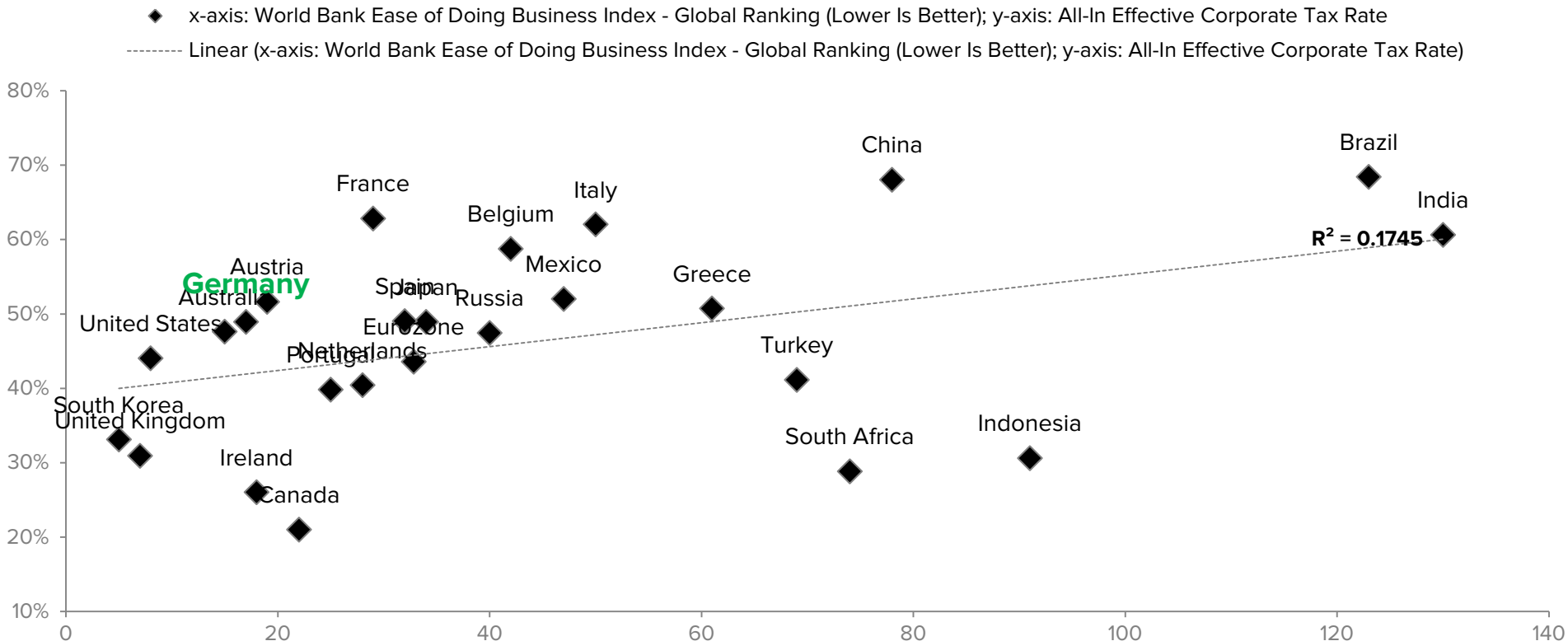
| GERMANY	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	Hedgeye Macro GIP Model		
Real GDP QoQ	0.4%	0.6%	-0.1%	0.3%	0.8%	0.2%	0.5%	0.2%	0.4%	0.7%	0.5%	0.1%	0.4%	GIP = Growth/Inflation/Policy		
Real GDP YoY	1.3%	2.4%	1.4%	1.1%	1.6%	1.2%	1.8%	1.7%	1.3%	1.9%	1.8%	1.7%	1.7%	Full-year Estimates	2016E	2017E
2Y Average	0.7%	1.0%	0.9%	0.8%	1.5%	1.8%	1.6%	1.4%	1.5%	1.6%	1.8%	1.7%	1.5%	Hedgeye Predictive Tracking Algorithm	1.8%	1.3%
3Y Average	1.3%	0.9%	0.8%	0.7%	1.0%	1.0%	1.2%	1.1%	1.4%	1.8%	1.7%	1.5%	1.5%	Bloomberg Consensus Estimate	1.9%	1.6%
Percentile (T10Y)	49%	62%	46%	41%	49%	38%	54%	46%	38%	56%	54%	49%	49%	Central Bank Forecast	1.9%	1.6%
CPI YoY	1.4%	1.0%	0.9%	0.8%	0.4%	-0.1%	0.4%	0.0%	0.2%	0.1%	-0.1%	0.4%	1.0%	Full-year Estimates	2016E	2017E
2Y Average	1.7%	1.4%	1.2%	1.2%	0.9%	0.5%	0.7%	0.4%	0.3%	0.0%	0.2%	0.2%	0.6%	Hedgeye Predictive Tracking Algorithm	0.4%	1.9%
3Y Average	2.0%	1.7%	1.5%	1.5%	1.3%	0.9%	0.9%	0.8%	0.7%	0.3%	0.4%	0.4%	0.6%	Bloomberg Consensus Estimate	0.5%	1.8%
Percentile (T10Y)	23%	13%	13%	8%	8%	3%	8%	5%	10%	8%	3%	21%	41%	Central Bank Forecast	0.4%	1.9%
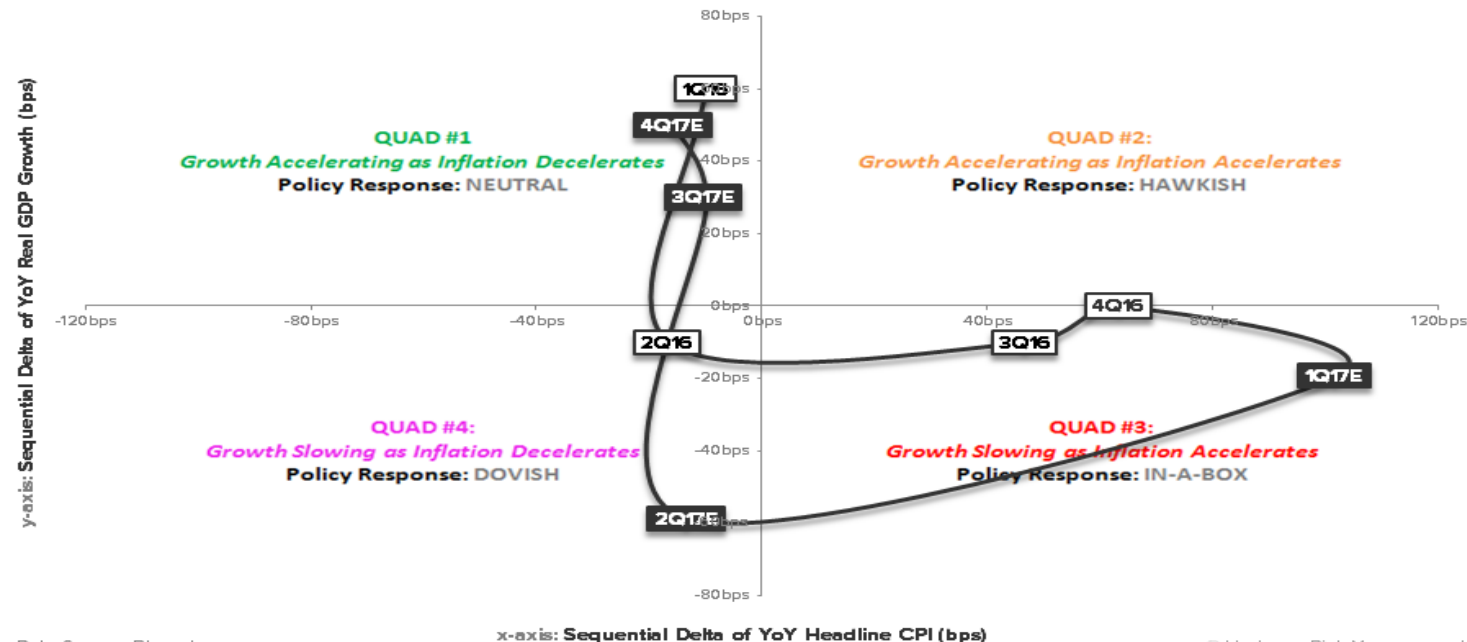
German growth has clearly inflected off of its 1Q16 cycle-peak and that trend looks set to continue here in 1H17. While base effects imply a positive inflection in 2H17, our model points to incremental deterioration in Q2. Like many developed economies across Europe and abroad, headline inflation is likely to peak here in Q1. Will the confluence of slowing/off-target inflation and #Quad4 quiet the hawkish camp within the ECB? It certainly should, at the margins.

Data Source: Bloomberg

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Key High Frequency Growth and Inflation Indicators: Germany (Values Shown as a Percentile of the Respective Trailing 10Y Sample)

Legend: 4Q16 Average, 1Q17 Average, 12MMA, 3MMA, Previous Value, Latest Value
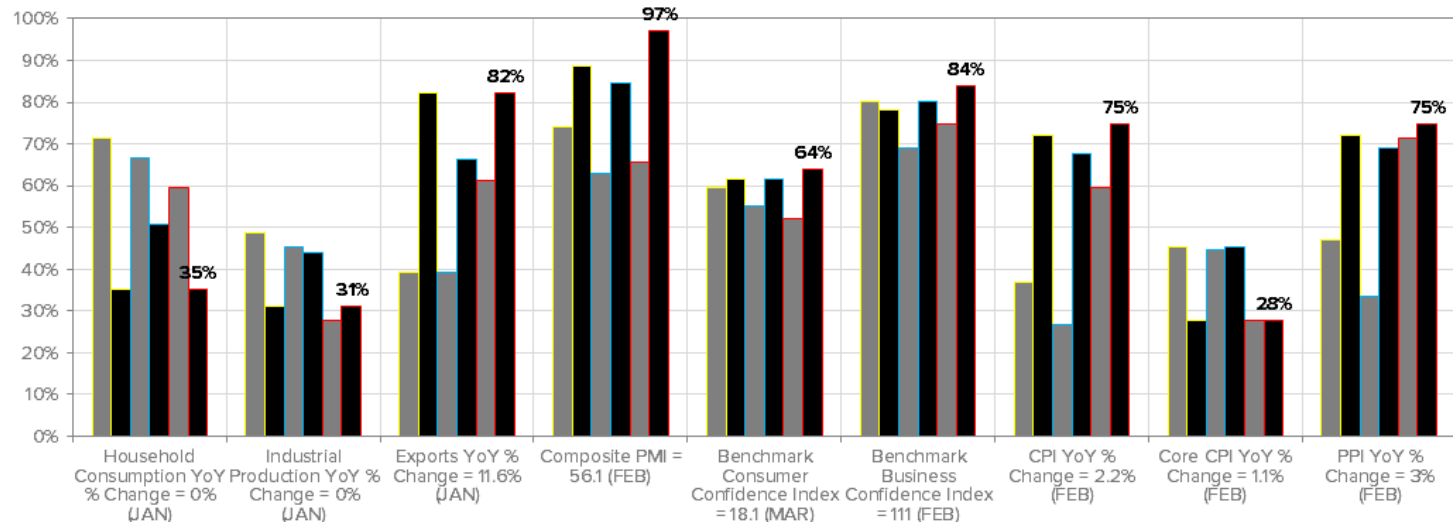
Data Source: Bloomberg. © Hedgeye Risk Management

GROWTH: Mixed at best, with a noteworthy divergence between the hard data – which is generally trending lower – and the soft data – which is generally trending higher. Germany is flirting with recession in two key sectors of its economy (i.e. household consumption and manufacturing).

INFLATION: Headline CPI is trending higher and mirroring the recovery in producer prices. Like the rest of the Eurozone, core inflation readings remain structurally challenged.

POLICY: Short-term rates markets have yet to materially respond to the nascent reversal in German inflation expectations, but are likely to do so in the coming weeks.

Key Financial Market Indicators	Percentile (10Y)	5Y Change	3Y Change	2Y Change	18M Change	1Y Change	YTD Change	6M Change	3M Change	2M Change	1M Change	1W Change	1D Change
Benchmark Equity Market = 11951.72	99%	70.8%	27.9%	0.5%	24.3%	19.2%	4.1%	12.5%	4.4%	3.5%	0.0%	-1.1%	0.4%
Policy Rate = -0.4%	0%	-65bps	-40bps	-20bps	-20bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps
1Y OIS Spread vs. Policy Rate = -32bps	50%	32bps	-25bps	-15bps	-10bps	7bps	3bps	7bps	2bps	3bps	4bps	0bps	0bps
2Y Sovereign Debt Yield = -0.75%	2%	-99bps	-96bps	-53bps	-50bps	-27bps	1bps	-8bps	3bps	-7bps	15bps	4bps	2bps
10Y Sovereign Debt Yield = 0.4%	13%	-147bps	-123bps	18bps	-20bps	21bps	19bps	48bps	18bps	4bps	17bps	-5bps	-1bps
10Y-2Y Sovereign Debt Yield Spread = 115bps	43%	-48bps	-27bps	71bps	30bps	47bps	18bps	56bps	15bps	11bps	1bps	-9bps	-2bps
LT Breakeven Rate (5Y5Y or 10Y) = 1.32%	22%	-49bps	-21bps	-8bps	16bps	36bps	5bps	35bps	8bps	0bps	-11bps	-9bps	-2bps
FX Rate vs. USD = 1.0783	5%	-18.7%	-21.8%	-1.5%	-3.6%	-3.6%	2.5%	-3.9%	3.1%	0.2%	1.9%	0.2%	-0.1%

BREXIT UPDATE

THERE'S A LOT OF NOISE AROUND BREXIT

BUT BREXIT IS A SERIOUS MATTER TO ESTABLISH BRITAIN'S NEW FOOTING...

"Brexit is arguably the biggest challenge since the Second World War"
–Former Chancellor of the Exchequer Alistair Darling
(11/2/16 on Bloomberg)

TIMELINE

June 2016 – Britain votes 52% to 48% to leave the EU.

July 2016 – Theresa May replaces David Cameron as UK Prime Minister.

November 2016 – Britain's High Court rules that Parliament must give its approval before the government can invoke Article 50 and negotiate an exit from the EU.

March 7, 2017 – The House of Lords voted by 366 to 268 in favor of an amendment to the EU 'Notification of Withdrawal Bill' calling for Parliament to be given a meaningful vote on the final exit deal negotiated with the EU.

March 29, 2017 – Date by which PM Theresa May signals Article 50 will be triggered – [on 3/16/17 the European Union 'Notification of Withdrawal Bill' received Royal Assent, providing the government with the power to trigger Article 50].

March 29, 2019 – Date by which Britain shall exit.

THE ART OF THE NEGOTIATION

FINDING THE BEST NEGOTIATING LEVER...

"But it is absolutely right at this stage that we do not set out every piece of our negotiating strategy, because that would be the best way to get the worst possible deal for Britain."

-PM Theresa May 11/23/16

EUROPE TO PLAY HARD BALL?

President of the European Commission Jean-Claude Juncker on March 19, 2017 <u>warned that the EU would not compromise on its demands for the UK to pay a Brexit divorce bill</u>, saying:

"Britain would have the choice to eat what's on the table or not come to the table at all."

Juncker added that the Commission's Brexit negotiator, Michel Barnier, has:

"Everything prepared down to the last detail," reportedly including an estimated Brexit bill and a demand for EU judges to oversee Britain's withdrawal.

→ EU reports suggest EU demands divorce bill as high as £50B, while May's cabinet wants the bill capped at £3B.

Further, Juncker said:
"The UK will need to prepare itself to be treated as a third country," while suggesting, ***<u>"The remaining member states will fall in love with each other again and renew their vows with the European Union... They will all see from Britain's example that leaving the EU is a bad idea."</u>***

OTHER VOICES FROM EUROPE

FEAR OF THE DOMINO EFFECT & BELIEF THAT THE POST WWII PEACE PROJECT PREVAILS

German Chancellor Merkel:
Says the EU could not divide its four freedoms – movement of goods, capital, people and services – to allow Britain to restrict immigration from the bloc while retaining tariff-free access to the market of almost 500 million people.

French President Hollande:
Says the UK must pay a "price" for leaving, because otherwise "we would jeopardize the fundamental principles of the EU" and "other countries would want to leave... to get the supposed advantages without the obligations."

European Council President Donald Tusk:
"The brutal truth is that Brexit will be a loss for all of us... If you ask me if there is any alternative to this bad scenario, I would like to tell you that yes, there is. And I think it is useless to speculate about 'soft Brexit'... In my opinion, the only real alternative to a 'hard Brexit' is 'no Brexit'."

EU TIMETABLE AND POSITIONING

European Council President Donald Tusk announced on March 21st that he will call a meeting of the EU-27 on **April 29ᵗʰ** to adopt the negotiating guidelines for Brexit talks.

Donald Tusk: *"Within 48 hours of the UK triggering Article 50, I will present the draft Brexit guidelines to the EU-27 member states."*

Dutch Finance Minister and President of the Eurogroup Jeroen Dijsselbloem said:

"May needs realism on the sequence of things, realism on the price it's going to cost, realism on the complexity and so the time needed, because up to now I've missed this very much from the UK government."

PM THERESA MAY'S GOALS

"Leaving the EU is not an end in itself. It is this generation's opportunity to shape a brighter future for our country... by getting the right deal for Britain abroad and a better deal for ordinary working people at home... to change the way our whole country works — and the people for whom it works — for ever."

-PM Theresa May in The Times Today, 3/17/17

"I want to give British companies the maximum freedom to trade with and operate in the Single Market, and let European businesses do the same here. But let me be clear: We are not leaving the European Union only to give up control of immigration again."

-Theresa May on October 2, 2016

SCOTLAND HANGS IN THE BALANCE….

Prime Minister Theresa May has told the Scottish National Party (SNP) that "now is not the time" to hold a second Scottish independence referendum, adding it would "make it more difficult for us to be able to get the right deal for Scotland, and the right deal for the UK [in Brexit negotiations]."

She continued, "I think it wouldn't be fair to the people of Scotland because they'd be asked to make a crucial decision without the necessary information, without knowing what the future partnership will be or what the alternative for an independent Scotland would look like."

Responding to May's comments, Scottish First Minister Nicola Sturgeon said:

"If the Prime Minister refuses to engage on the terms of a referendum before Brexit takes place then she is effectively trying to block the people of Scotland having a choice over their future. That would be a democratic outrage. It is for the Scottish Parliament not Downing Street to determine the timing of a referendum, and the decision of the Scottish Parliament must be respected."

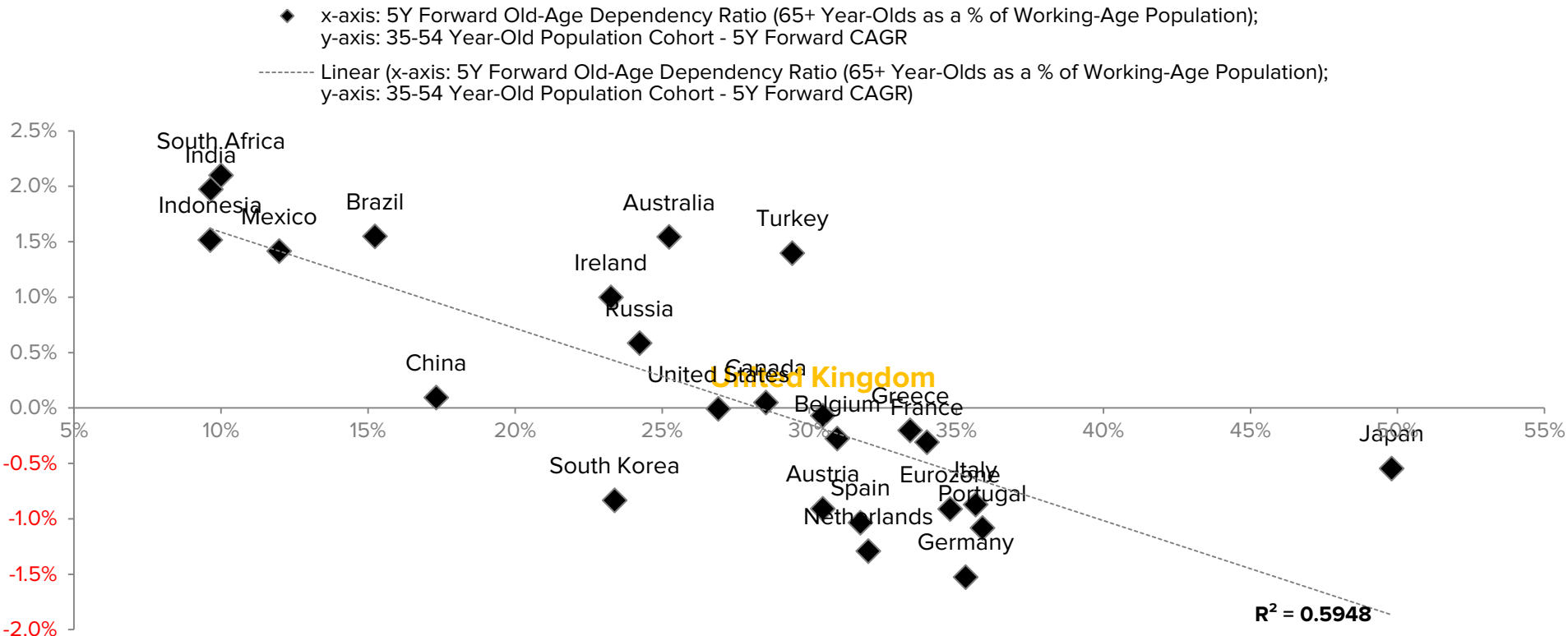# RISKS? UK FINANCIAL SECTOR BY THE NUMBERS

If (hard) Brexit...

- Britain's financial industry could lose up to 38 billion pounds ($48.34 billion) in revenue, according to a report by consultancy firm Oliver Wyman (commissioned by the main industry lobby group TheCityUK); and

- If finance firms lose the right to freely sell their services across Europe from the UK (known as *passporting*), 75,000 jobs may disappear (Britain's financial services sector employs about 1.1 million); and

- The government may lose up to 10 billion pounds in tax revenue, according to the report.

→ ~ 5,500 UK firms rely on corporate "passports" to conduct business across the EU from the UK.

→ The Financial Industry contributes ~ 8% of GDP.

RISKS CONTINUED...

- **Easier London Banking Exit?**

  - Reports that the ECB is likely to make it easier for banks that want to relocate their operations from London to the Eurozone after Brexit by temporarily waiving examination of financial models that big retail lenders and investment banks use. The source said any such decision by the ECB would be for practical reasons due to limited resources and would, aim to minimize disruption to European finance.

- **Takes longer than 2 years?** Complexity of trade agreements, including regulations and safety standards across the economy.

- **Costly?** Trade deals turn out to be more expensive.

PILLAR I: DEMOGRAPHIC RISK

THE U.K. SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY DEMOGRAPHIC RISK.

◆ x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR

- - - - Linear (x-axis: 5Y Forward Old-Age Dependency Ratio (65+ Year-Olds as a % of Working-Age Population);
y-axis: 35-54 Year-Old Population Cohort - 5Y Forward CAGR)
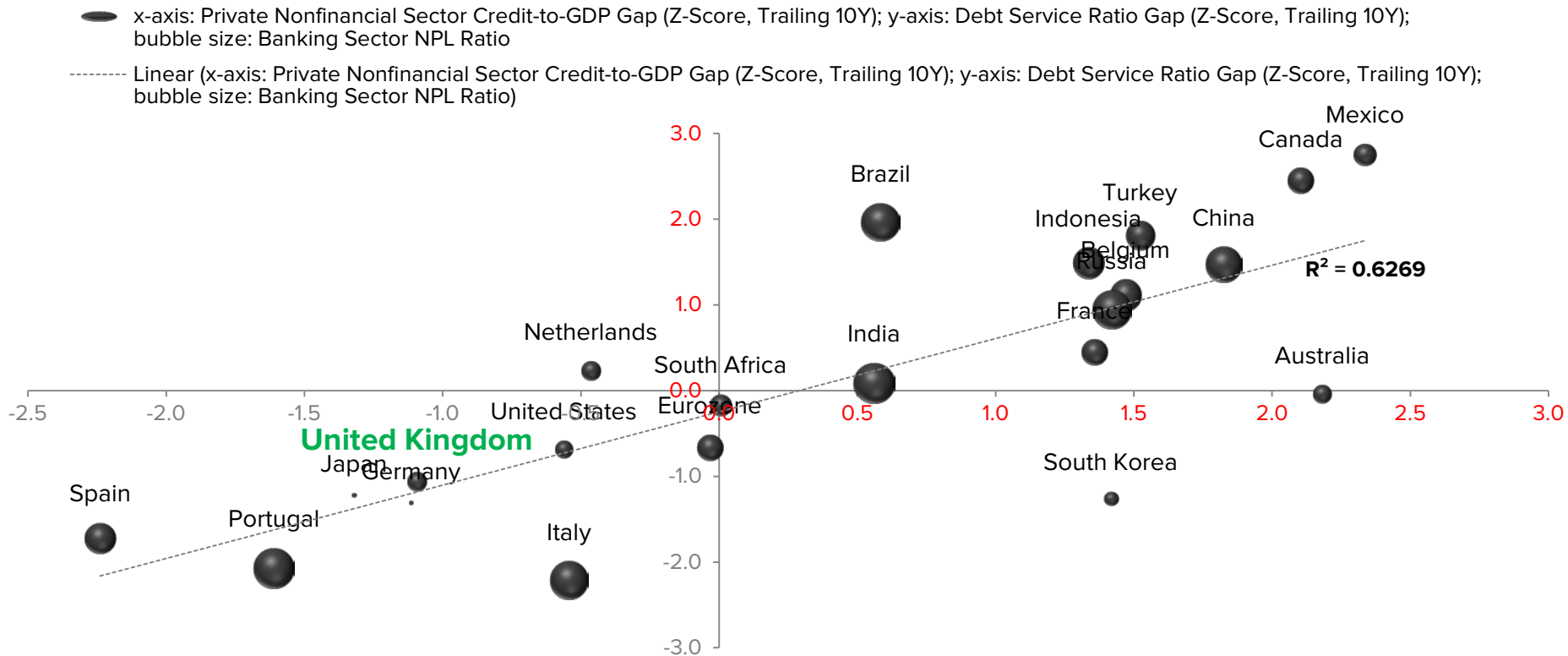
$R^2 = 0.5948$

PILLAR II: FISCAL POLICY RISK

THE U.K. SCREENS MODERATELY WITH RESPECT TO HOW WE QUANTIFY THE RISK OF ADVERSE FISCAL POLICY.

x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP

------- Linear (x-axis: Debt as a % of Nominal GDP; y-axis: Central Gov't Budget Balance as a % of Nominal GDP)

$R^2 = 0.1078$
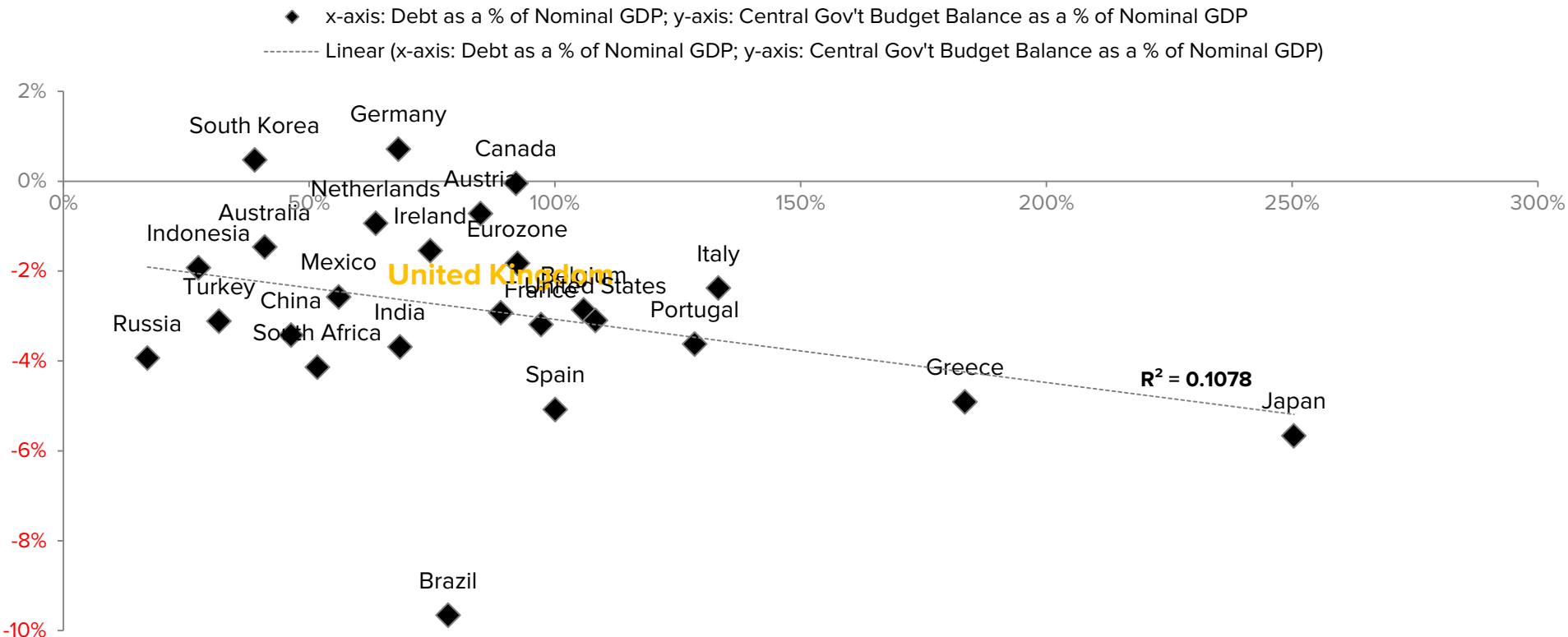
PILLAR III: ECONOMIC CYCLE RISK

THE U.K. SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RECESSION.

● x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y);
bubble size: Banking Sector NPL Ratio

------- Linear (x-axis: Private Nonfinancial Sector Credit-to-GDP Gap (Z-Score, Trailing 10Y); y-axis: Debt Service Ratio Gap (Z-Score, Trailing 10Y);
bubble size: Banking Sector NPL Ratio)

$R^2 = 0.6269$

PILLAR IV: POPULISM RISK

THE U.K. SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF RISING POPULISM.
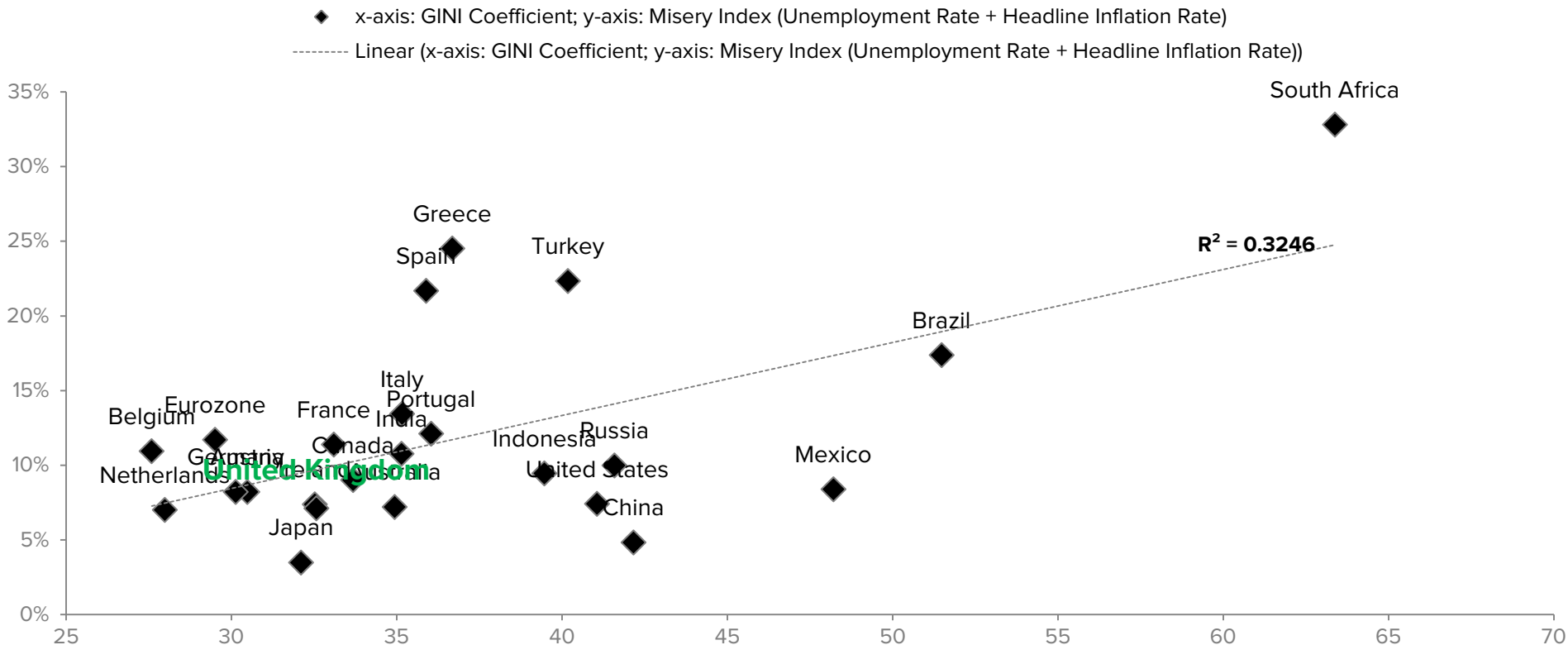
◆ x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate)

------- Linear (x-axis: GINI Coefficient; y-axis: Misery Index (Unemployment Rate + Headline Inflation Rate))

$R^2 = 0.3246$

THE U.K. SCREENS WELL WITH RESPECT TO HOW WE QUANTIFY THE RISK OF CAPITAL FLIGHT, UNDERINVESTMENT, MALINVESTMENT OR SOME COMBINATION OF THE THREE.

◆ x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate

------ Linear (x-axis: World Bank Ease of Doing Business Index - Global Ranking (Lower Is Better); y-axis: All-In Effective Corporate Tax Rate)
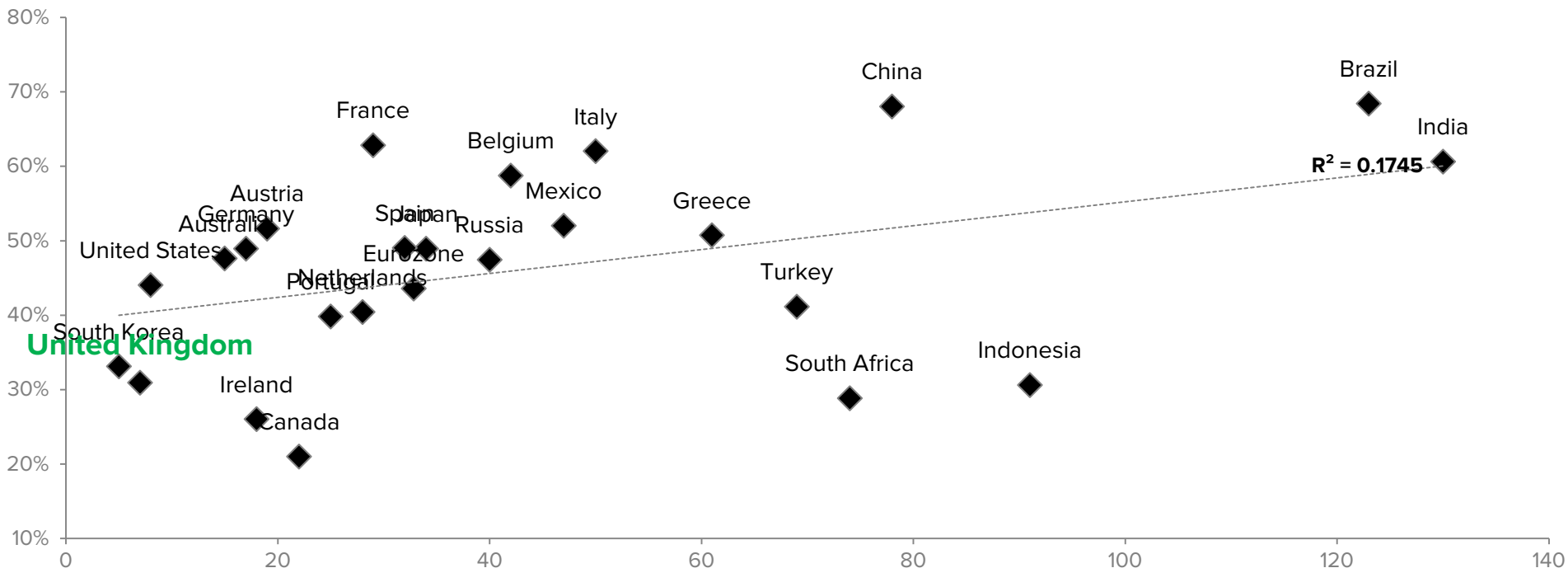
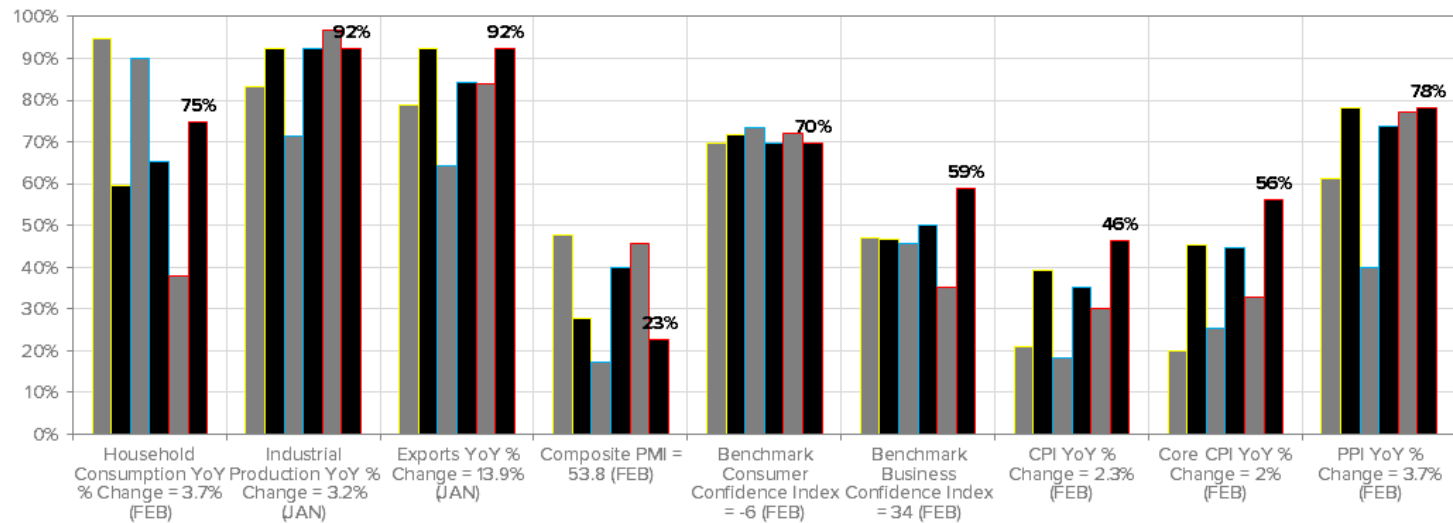| UNITED KINGDOM	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	Hedgeye Macro GIP Model		
Real GDP QoQ	0.5%	0.8%	0.9%	0.8%	0.8%	0.3%	0.5%	0.3%	0.7%	0.3%	0.6%	0.6%	0.7%	GIP = Growth/Inflation/Policy		
Real GDP YoY	2.4%	2.6%	3.1%	3.1%	3.5%	2.8%	2.4%	1.8%	1.7%	1.6%	1.7%	2.0%	2.0%	Full-year Estimates	2016E	2017E
2Y Average	1.9%	2.1%	2.6%	2.4%	3.0%	2.7%	2.8%	2.5%	2.6%	2.2%	2.1%	1.9%	1.9%	Hedgeye Predictive Tracking Algorithm	1.8%	2.0%
3Y Average	1.7%	1.8%	2.1%	2.2%	2.4%	2.3%	2.5%	2.2%	2.5%	2.3%	2.4%	2.3%	2.4%	Bloomberg Consensus Estimate	2.0%	1.7%
Percentile (T10Y)	72%	79%	87%	85%	95%	77%	64%	44%	41%	41%	44%	56%	54%	Central Bank Forecast	2.2%	2.0%
CPI YoY	2.1%	1.7%	1.7%	1.4%	0.9%	0.1%	0.0%	0.0%	0.1%	0.4%	0.4%	0.7%	1.2%	Full-year Estimates	2016E	2017E
2Y Average	2.4%	2.3%	2.2%	2.1%	1.5%	0.9%	0.9%	0.7%	0.5%	0.2%	0.2%	0.4%	0.7%	Hedgeye Predictive Tracking Algorithm	0.7%	2.0%
3Y Average	3.2%	2.7%	2.4%	2.2%	1.9%	1.5%	1.5%	1.4%	1.0%	0.7%	0.7%	0.7%	0.7%	Bloomberg Consensus Estimate	0.7%	2.6%
Percentile (T10Y)	23%	10%	8%	0%	0%	0%	0%	0%	5%	10%	10%	15%	21%	Central Bank Forecast	1.2%	2.7%
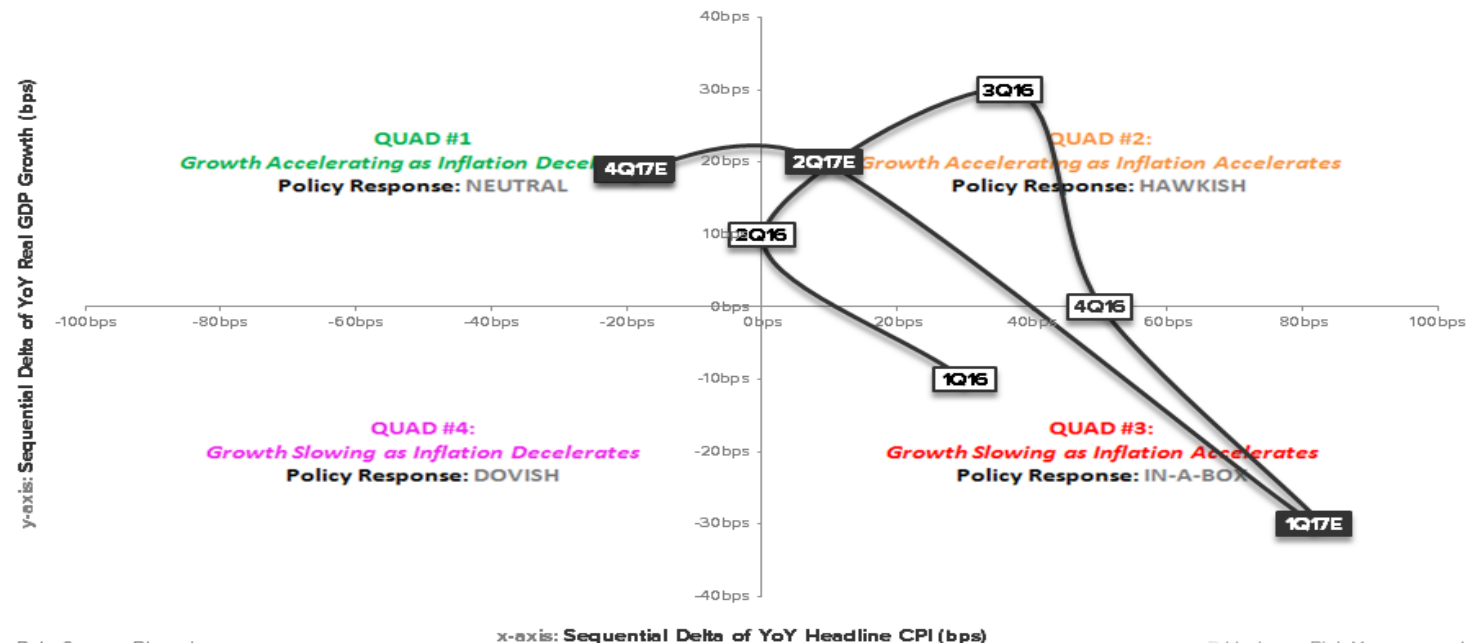
U.K. growth is finally doing what investor consensus and the mainstream media have long expected it to do following last summer's Brexit vote – i.e. slow – but whether or not that continues against shockingly easy base effects remains the million dollar question. Headline inflation should continue to accelerate through the second quarter, but our model points to a sustainable inflection beginning in 2H17.

Key High Frequency Growth and Inflation Indicators: United Kingdom
(Values Shown as a Percentile of the Respective Trailing 10Y Sample)

■ 4Q16 Average ■ 1Q17 Average ■ 12MMA ■ 3MMA ■ Previous Value ■ Latest Value

Data Source: Bloomberg.

© Hedgeye Risk Management

Key Financial Market Indicators	Percentile (10Y)	5Y Change	3Y Change	2Y Change	18M Change	1Y Change	YTD Change	6M Change	3M Change	2M Change	1M Change	1W Change	1D Change
Benchmark Equity Market = 3986.46	100%	31.1%	12.8%	5.0%	20.0%	17.1%	2.9%	6.0%	4.0%	2.7%	0.8%	-1.1%	0.1%
Policy Rate = 0.25%	0%	-25bps	-25bps	-25bps	-25bps	-25bps	0bps	0bps	0bps	0bps	0bps	0bps	0bps
1Y OIS Spread vs. Policy Rate = 3bps	59%	3bps	4bps	7bps	-1bps	10bps	5bps	14bps	3bps	1bps	4bps	2bps	1bps
2Y Sovereign Debt Yield = 0.14%	5%	-31bps	-53bps	-25bps	-44bps	-32bps	6bps	4bps	7bps	-1bps	6bps	6bps	3bps
10Y Sovereign Debt Yield = 1.18%	4%	-109bps	-157bps	-33bps	-61bps	-27bps	-6bps	45bps	-16bps	-19bps	3bps	-7bps	1bps
10Y-2Y Sovereign Debt Yield Spread = 104bps	22%	-79bps	-103bps	-8bps	-17bps	5bps	-11bps	41bps	-23bps	-17bps	-3bps	-13bps	-2bps
LT Breakeven Rate (5Y5Y or 10Y) = 3.46%	53%	9bps	-3bps	27bps	15bps	23bps	-6bps	26bps	-12bps	-8bps	-1bps	-9bps	-2bps
FX Rate vs. USD = 1.2494	3%	-21.3%	-24.2%	-16.4%	-18.0%	-11.5%	1.2%	-3.6%	1.7%	-0.3%	-0.5%	1.1%	0.1%

GROWTH: Consumption growth is now decidedly in free-fall and slowing more aggressively than the nascent inflection in consumer confidence would indicate. Conversely, business confidence continues to make new highs alongside historically elevated rates of manufacturing and export growth – the latter of which is growing +14% YoY. This two-speed U.K. economy will be difficult for investors to navigate – as if the Brexit process wasn't convoluted enough!

INFLATION: Trending higher across all key metrics. Above-target headline CPI and on-target core inflation create quite the policy conundrum for the BoE amid the breakdown in consumer spending.

POLICY: There's no person on earth I'd trade places with less than BoE Governor Mark Carney.

THEMATIC INVESTMENT CONCLUSIONS

INTERMEDIATE-TERM TREND (NEXT 2-3 QUARTERS)

- LONG Eurozone Minimum Vol./Dividend Plays
    - Pharma
    - Consumer Staples
    - Utilities
    - Telecom
    - REITS
- "RENT" France (EWQ)

- SHORT Euro (FXE)

LONG-TERM TAIL (NEXT 2-3 YEARS)

- LONG Germany (EWG; EWGS)
- LONG Netherlands (EWN)
- LONG U.K. (EWU; EWUS)
- LONG Ireland (EIRL)
- LONG Austria (EWO)
- SHORT Spain (EWP)
- SHORT Belgium (EWK)
- SHORT Italy (EWI)
- SHORT France (EWQ)
- SHORT Greece (GREK)

- LONG British Pound (GBP)
- SHORT Euro (FXE)

BETTING ON A CORRECTION IN EUROPEAN EQUITIES? GET IN LINE!

Volatility Premium Rankings TTM (Average Z-Score)

Average Z-Score: The avg. z-score aggregates the relative implied volatility premiums of 30D, 60D, 3Mth, and 6Mth windows for each ticker. A high z-score indicates implied volatility that is trading at a relative premium to realized trading ranges in each respective ticker over the given windows.

Ticker	Average Z-Score Ranking
IG Corporate Bonds	-1.69
Natural Gas ETF	-1.27
Silver ETF	-0.83
Muni-Bond ETF	-0.81
Mid-Term Treasuries ETF	-0.74
L-T Treasuries ETF	-0.56
Yen ETF	-0.33
Copper ETF	-0.32
Utilities ETF	-0.31
Powershares-Base Metals	-0.22
S&P 500 Index	1.60
Nikkei 225 Index	1.62
FTSE MIB Index	1.70
I-Shares China	1.85
Swiss Market Index	2.01
S&P ASX Index	2.12
German DAX Index	2.13
CAC 40 Index	2.21
FTSE 100 Index	2.21
Euro Stoxx 50 index	2.27

Average Z-Score Ranking

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