



THE DRIVE YOU DEMAND

INVESTMENT OUTLOOK Q2 2017



EXECUTIVE SUMMARY

- ◆ *Synchronised and sustained global growth remains in place, despite political uncertainties*
- ◆ *The ECB should follow the Fed in adopting a more neutral policy stance in 2H2017*
- ◆ *Headline inflation is nearing 2% in major regions of the world though it should stabilise in the Eurozone in the months ahead*
- ◆ *US inflation risks remain tilted to the upside driven by wage growth and the potential for fiscal easing*
- ◆ *Hard currency EM debt compensates investors relatively well compared to other, richly valued DM fixed income alternatives*
- ◆ *Eurozone policy normalisation should bring increased interest rate volatility to the single currency area*
- ◆ *Elevated global equity valuations are driven primarily by historically high valuations in the US*
- ◆ *Non-US equities in Japan, EM and, to a lesser extent, Europe present better relative opportunities than US equities*
- ◆ *Eurozone markets currently underprice the prospect of a populist outcome in the French elections in coming weeks*
- ◆ *Alternative strategies including risk premia and market neutral strategies are increasingly attractive given elevated valuations across equities and fixed income*

GLOBAL ECONOMY

Sustained and synchronised growth

World growth continues on a positive trajectory in Q2, driven by the positive trend in place in the US, sustained activity in Asia and a more constructive outlook for the Eurozone. Growth looks to be sustained and synchronised across the main regions, thanks to firmer activity in the manufacturing sector and a positive trend in consumption.

US growth on trend, waiting for budgetary reforms

US growth should remain on a 2%-2.5% trend thanks to sustained consumption and high levels of business confidence in both manufacturing and service sectors. Fundamentals remain positive for consumers, as the economy is close to full employment and the housing market looks healthy. The positive surge in business sentiment over the past months should lead to a rebound in corporate investment in the coming quarters.

US: consumption underpinned by full employment



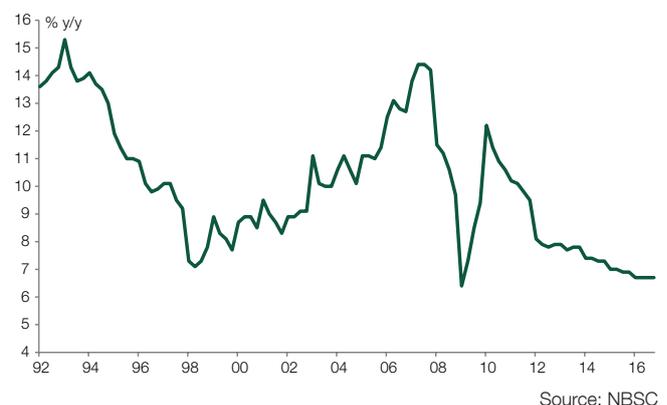
Budgetary policy is still expected to deliver reforms that could push activity higher. Nevertheless, despite the Republican majority in Congress and a new President in the White House, no agreement has been reached on the reform of Obamacare and decisions on fiscal measures have been delayed. The macro impact of lower taxes on household and corporates might only be seen in 2018.

As US growth seems already close to its potential, the risks associated with a strong fiscal stimulus are on the inflation side, with rising wage pressures and expanding fiscal and trade deficits. If the budgetary boost comes in lower than expected, US growth should remain on a 2%-2.5% trend, and overheating risks should be limited. The Fed should therefore continue gradually to normalise its policy, with two more rate hikes expected over the next quarters.

Emerging countries: exports and consumption as main drivers

Emerging countries offer a relatively stable outlook for the next quarters, despite fears of rising protectionism among developed countries. Growth has stabilised thanks to consumption and accommodative economic policy in past months. Moreover, momentum has turned positive in the manufacturing sector, and exports have performed better, particularly in Asia.

Growth has stabilised in China



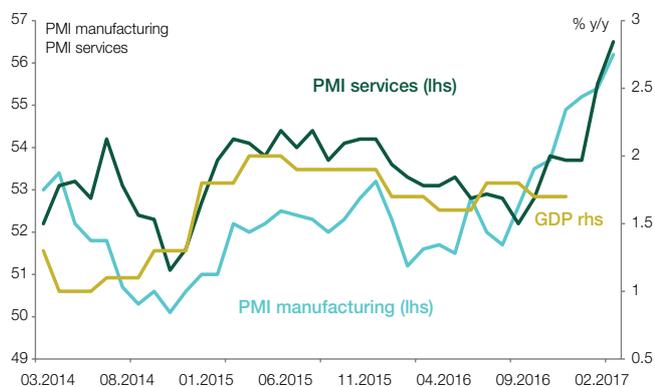
Growth in China should stabilise around 6.5%, thanks to a strong consumer economy and global investment. After the Xi Jinping-Trump meeting, fears of a 'cold war' on trade and currency between the two major economies have reduced. In the meantime, China continues to tighten its monetary policy, aiming to clean up the banking sector, prevent any further bubble in the property market and stabilise capital flows.

Among emerging markets, Asia continues to offer the most attractive outlook, thanks to China and India. The economic situation in Brazil and Russia has improved slightly but commodity price volatility and political instability act to slow down the exit from recession. Moreover, the latest geopolitical developments in the Middle East have reduced the probability of seeing any easing of sanctions against Russia.

Eurozone: improving outlook despite major political uncertainties

The outlook on the Eurozone has improved over the past months. Business sentiment has rebounded in both the manufacturing and service sectors, and consumer confidence has also improved, underpinned by an improving trend in the labour market. A rebound in capex is expected to follow from firmer global demand. The German economy remains the leader, thanks to solid domestic demand, a low unemployment rate and rising fiscal and external surpluses.

Eurozone: rising business confidence points towards firmer GDP growth



Sources: Markit, Eurostat

Growth in France and Italy has improved, but the situation remains fragile. The French Presidential election has exposed rising uncertainties as anti-EU parties (Marine Le Pen – extreme right party, and Jean-Luc Mélenchon – left/extreme left party) have gained in recent polls. If any risk of a 'Frexit' seems low based on latest polls, the outcome from both presidential (April/May) and legislative elections (June) offers only limited visibility on future economic policy.

Inflation in the Eurozone has rebounded significantly in Q1-17, thanks to higher oil prices and it should perform in a 1.5%-2% y/y range. Core inflation is still low (close to 1% y/y) but deflationary pressures have finally been removed. ECB policy has turned less aggressive as purchases of bonds have

been reduced in Q2 (from EUR 80 bn to EUR 60 bn); its communication is expected to be markedly less dovish in the next quarter and its policy is expected to be more neutral next year, as growth and inflation should normalise.

ASSET ALLOCATION

Transitioning exposure within asset classes

The strong and synchronised global growth backdrop supports elevated valuations in equities as well as tight spreads in credit, though it remains at odds with the low real yields seen across government bond markets around the world.

As such, while credit fundamentals are showing few signs of stress, we continue to favour equities over bonds as the prospect of rising interest rate volatility creates a challenging return environment for fixed income.

We have taken the opportunity to transition some of our directional equity positions towards partially capital protected exposure, recognising the still elevated political and geopolitical risks facing markets in the months ahead.

Being aware of elevated valuations across regions and major asset classes, we see alternatives as increasingly important, both as a risk mitigation tool as well as a driver to returns looking ahead.

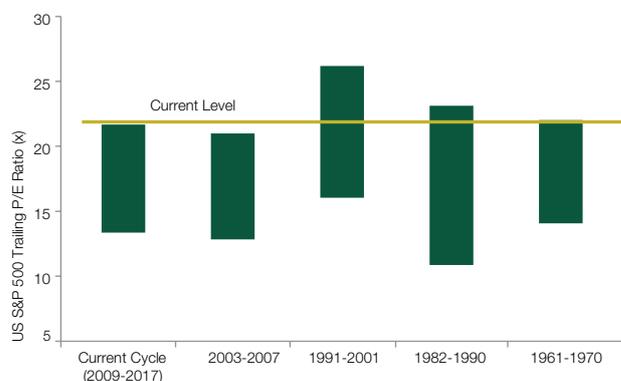
EQUITIES

Focus on non-US equities

With global equities rising 7% in 1Q2017, valuations appear somewhat high on a historical basis. However, the bulk of this overvaluation is due to elevated multiples in the US, where at 22x trailing earnings, valuations have only been at such a level during the tech bubble of 2000-01.

Sectorally, we continue to see opportunities in US technology. While in healthcare, one of our favourite sectors, the absence of healthcare reform in the US is potentially a headwind to a more sustained re-rating of earnings power in the sector. In the near term, however, we retain positions in the sector expecting continued outperformance in the months ahead.

US Equities: Elevated valuations leave returns reliant on Earnings



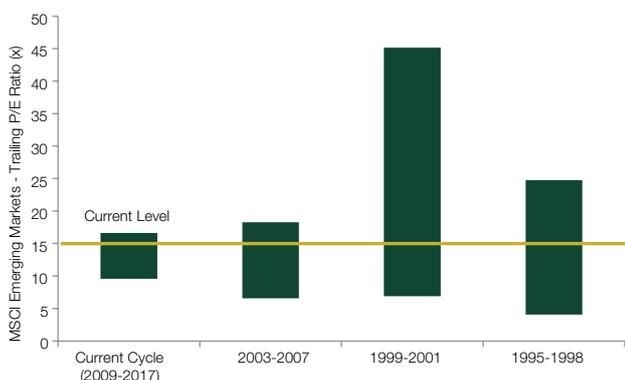
Sources: UBP, Bloomberg Finance L.P.

In Emerging Markets, valuations remain short of the cyclical highs seen in the 2003-07 global expansion. With earnings upgrades continuing apace and the strong USD headwind fading in EM, we see further upside looking ahead. Economic and earnings momentum in Asia has resulted in a pivot in our preferences towards the Asian EM region.

In Japan, a pause in the strength of the Japanese yen looks to be the key hurdle to reverse the disappointing year-to-date performance in Japanese equities. With the valuation story intact and earnings and economic momentum remaining strong, we believe the long-term value proposition offered by Japan remains an opportunity for patient investors.

Admittedly, corporate returns generation (ROEs) remains near cyclical lows in both the EM and Japanese markets, suggesting the next leg to global equity returns will be driven by a continuation in the upside surprises to earnings seen year-to-date, especially among corporates outside of the US, where such announcements are less meaningfully priced.

EM Equities: Valuations peaks remain short of previous cyclical expansions



Sources: UBP, Bloomberg Finance L.P.

We have become less negative on Eurozone equities in light of the robust recovery in the single currency area. While valuations, especially versus the US remain fair to modestly cheap, we see more meaningful prospects of earnings surprises as the primary driver to returns on the continent.

That said, the 8% rally in Eurozone equities since January suggests that the prospect of a populist outcome in the upcoming French elections is still relatively poorly priced in Eurozone equities.

As a result, we have taken the opportunity to tilt our European equity exposure towards partially capital protected positions through the French election season, allowing us to maintain exposure to the ongoing cyclical recovery while protecting against near-term risks surrounding the political landscape in Europe.

FIXED INCOME

Interest rate volatility to spread to the Eurozone

With the ECB expected first to change its communication emphasis over the summer followed by a move to 'taper' its quantitative easing programme moving into 2018, investors should expect the 'one-way' trend in Eurozone rates to transition to increasingly 'two-way' volatility, much as seen in the post-2013 period following the end of the US quantitative easing programme in 2013.

Like the US in 2012, with real German yields sitting near historical lows, we expect the beginnings of a transition away from ECB President Mario Draghi's 'whatever it takes' policy regime to result in the start of a normalisation in the real interest rates environment within the single currency area in the years ahead.

Normalisation in German Real Yields: Rising Interest Rate Volatility Ahead



Sources: UBP, Bloomberg Finance L.P.

Such a transition in regimes suggests that government bonds and also, in light of tight spreads, euro-area credit markets may see the 'coupon plus' that has characterised returns in the asset classes give way to 'coupon minus' return profiles looking ahead.

With historically low yields in the market combined with increasing prospects of volatility greater than seen in recent years, we see the unattractive risk-reward profile plaguing USD fixed income markets spreading to EUR fixed income markets looking ahead.

Emerging market bonds, with spreads still near historical averages, present one of the few, relatively attractive return profiles compared to the broader fixed income universe, both in USD and EUR.

Though inflation-linked bonds increasingly price in a more normalised inflation scenario, with the broader fixed income universe appearing to richly price even an attractive outcome in the global economy, relative value in duration hedged, inflation-linked strategies remains intact.

Against this backdrop, we prefer active management to capitalise upon the expected pick-up in interest rate volatility via non-directional strategies within fixed income.

ALTERNATIVE STRATEGIES

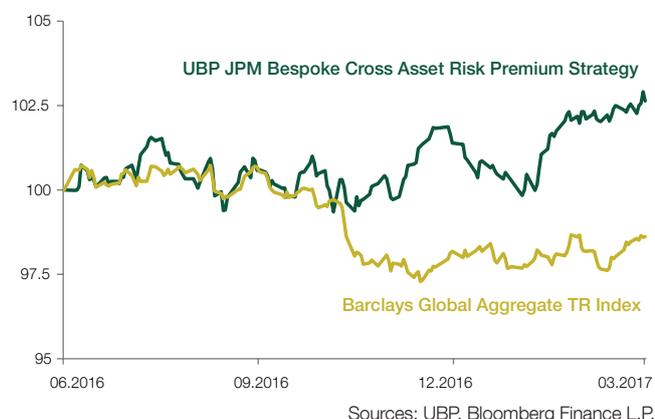
Protecting against rising interest rates AND equity volatility

Complementing an active, non-directional tilt to our fixed income exposure, we believe that alternative strategies are set to take up part of the role that fixed income strategies have historically served in portfolios – providing a cushion against rising volatility in markets.

In the environment ahead, however, the prospect of rising volatility facing investors will likely be found not only in the traditional equity markets, but, as noted above, increasingly across USD and EUR fixed income markets.

As a result, we see risk premia strategies as an increasingly important vehicle given the now two-way risks facing broader fixed income strategies looking ahead.

Risk Premia Strategies: Protecting Portfolios against Rising Interest Rate Volatility



Moreover, in light of elevated valuations seen across many asset classes, we view market neutral strategies as offering valuable protection against periodic spikes in volatility looking forward.

With gold performing well in 2017, the fundamental case for the yellow metal is weaker than in late-2016, perhaps requiring a more tactical approach. However, with the political uncertainty of Europe now giving way to the policy instability following the US President's legislative stumbles in his first 100 days in office as well as his first major foreign policy challenges in Syria and North Korea, we believe gold remains as a reasonably priced protection in the face of elevated geopolitical uncertainty.

FOREIGN EXCHANGE

Expect more selective US dollar strength ahead

We believe the US dollar bull market that has been in place since 2011 is increasingly mature and nearing its end. Indeed, on a real effective exchange rate basis, the US dollar is now only weaker than it was during the post-World War II Bretton Woods system and at the time of its strength in the early-1980s which culminated in the Plaza Accord to depreciate it against the Japanese Yen and German Deutschmark.

US Dollar: Bull market reaching maturity



As a result, while we do expect further US dollar strength in the months ahead, we suspect that any such movement may come against a much narrower set of currency pairs than seen in recent years.

In particular, with our expectation that the European Central Bank is set to begin adjusting its communications ahead of tapering its Quantitative Easing policy, we believe US dollar strength against the euro and to a lesser extent against the Swiss franc should be nearing an end.

As a result, in EUR and CHF strategies, we are seeking opportunities to close our long USD bias in portfolios. However, with EURUSD strongly anticipating the prospect of tapering by the ECB and short positioning by speculators near the lowest level since the Eurozone crisis, we believe short EURUSD positions remain an attractive hedge against unexpected outcomes in the French elections.

Against the Japanese yen, where we expect the Bank of Japan to maintain its anchor on long-term rates while the US Federal Reserve continues its tightening policies looking ahead, we expect year-to-date yen strength to reverse in favour of a renewed weakening in the yen.

However, the sustained weakness in cable (GBPUSD) since 2014 should transition to episodes of volatility as the UK begins more direct negotiations around its exit from the European Union. With sterling near its weakest levels on a real effective basis in the post-war period, we suspect that, as clarity emerges on the final settlement between the UK and the EU, a more durable bottom in sterling/cable should be achievable.

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