THE DRIVE YOU DEMAND

INVESTMENT OUTLOOK

Q2 2016

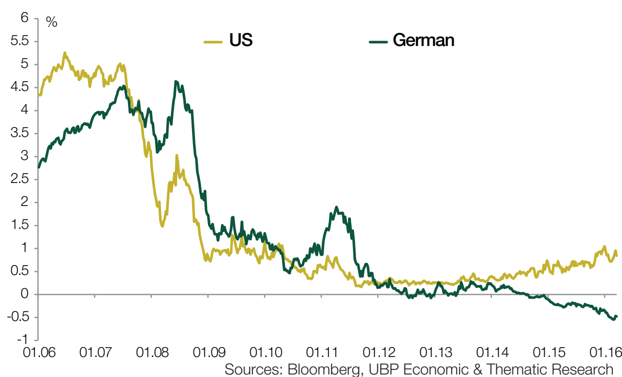
Union Bancaire Privée

Central banks: more aggressive, but no more credible

Equity markets have rebounded more than 15% from their February lows, but there are still signs of tension and global economic forecasts have been downgraded. Eight years after the financial crisis, markets and economies remain heavily dependent on monetary policy.

Lower interest rates and liquidity injections stimulated the US economy in the aftermath of 2008, but the same measures in Europe and Japan are struggling to deliver any sustained boost to activity. As a result, the ECB and BoJ have adopted increasingly unorthodox measures, using negative interest rates and buying private-sector non-financial bonds. Even more noteworthy is the fact that some eurozone central bank officials are no longer ruling out helicopter money, i.e. distributing banknotes directly to households, in the hope of driving inflation higher.

US and German 2-year bond yields



Sources: Bloomberg, UBP Economic & Thematic Research

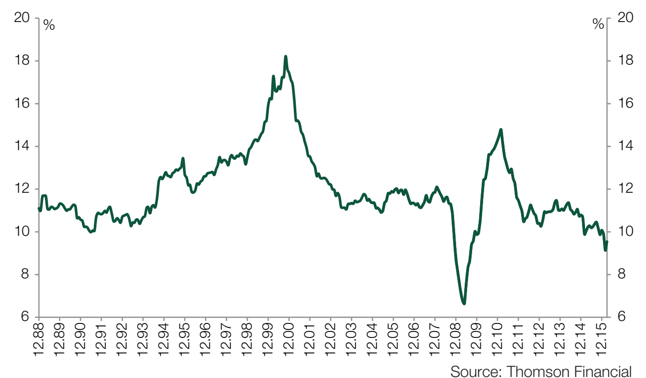
Such a proposal, which runs counter to both the ECB's mandate and monetary theory, shows the limited effect of monetary policy measures in isolation, and could destroy confidence in fiat money without stimulating activity. Although central-bank decisions are giving short-term reassurance to the markets by buying time, the solutions are unlikely to be effective over a sustained period and their medium-term credibility is under threat.

Even with very low interest rates, the debt burden on developed countries is too great and hampering their recovery. Growth in developed countries is now expected to be less than 2% in 2016, despite repeated help from central banks. Furthermore, fiscal policies are not expansionary and are unable to support final demand. Nevertheless, recession and widespread deflation should be avoided.

A new phase, less beneficial for shareholders, is taking shape in the financial markets

Despite the recent rally, the financial markets remain fragile. Yield curves have flattened due to central-bank action, and inflation expectations are still very low. Lower yields on assets and the introduction of negative interest rates are hurting bank profits, especially in core eurozone countries. There is the threat of current-account deposits being taxed, and European banks are in no rush to lend, particularly given the ongoing capital constraints on their balance sheets. Investors are being forced to reconsider banks' medium-term earnings prospects, and it is likely that banks will have to raise fresh capital. Although Mario Draghi has been outwardly confident about the improvement in European banks' balance sheets, the process is not over and non-performing loans remain a drag on the banking sector, particularly in Italy, as the legacy of the last super-debt cycle continues. Monetary stimulus is becoming a double-edged sword, with banks being used as a transmission mechanism. However, banks are not benefiting from this, or less so than before, and their profitability is continuing to fall, deterring them from lending.

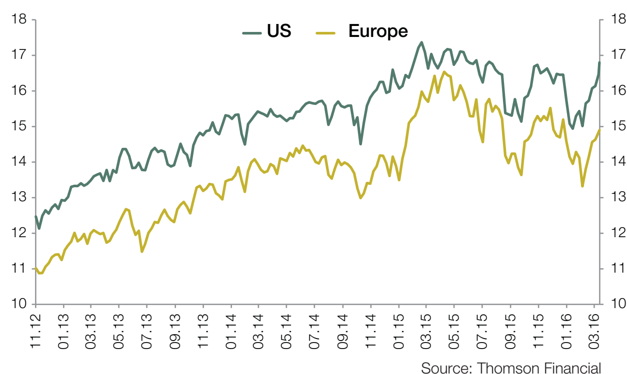
MSCI AC World: bottom-up consensus on long-term earnings growth



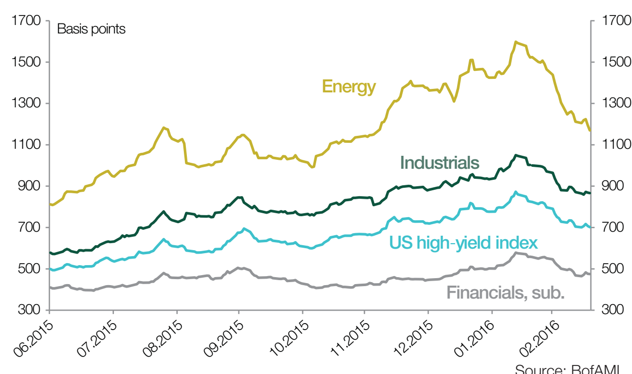
Source: Thomson Financial

Given the banking sector's importance to the economy, along with weak nominal growth more generally, investors should be prepared to lower their medium-term corporate earnings growth outlook. Earnings are likely to grow 3-5% per year in the current environment, well below the historic average. Lower commodity costs, moderate wage growth and a gradual increase in financial leverage in the last few years have enabled US companies to maintain their margins at historically high levels, and margins have also improved in Europe and Japan. But those positive factors are now likely to fade, dragging down earnings.

12-month forward PER: Europe & US



USD high-yield spreads by sector



As a result, the steady rise in valuations that took place until 2014 cannot continue. Earnings downgrades picked up in early 2016, and the market rally has taken valuations above their end-2015 levels. Multiples look stretched given the modest earnings growth outlook, in spite of very low interest rates. As a result, the upside in equity markets appears to be limited, and we are likely to see a succession of rallies and corrections in the next few quarters, together with occasional bouts of volatility and ongoing geographic and sector rotation. The bull market in place since 2009 seems to be coming to an end.

Asset allocation: reduce beta in diversified portfolios

The financial cycle that is currently taking shape is less favourable for shareholders than the period between 2010 and 2014. Valuations and earnings prospects mean that investors should be more cautious about equities, and should favour strategies based on yield rather than on beta. That means more credit risk and less equity risk.

Equity markets remain fragile and turbulence could resume because of weak growth, low visibility, a very busy political timetable – with elections in Spain, the referendum in the UK and the US electoral campaign – along with the terrorist threat in Europe and doubts about the effectiveness of monetary policy. In addition, the recent stabilisation in the oil price is tentative in our view, because there remains excess supply in the oil market while demand is only growing at a moderate pace. In equity markets, growth stocks struggle in this kind of environment, and we are gradually shifting portfolios towards value stocks.

We advise focusing on yield, including strategies involving high-yield bonds. Credit appears to be the most attractive segment of the bond market, given that government bonds are yielding very little, especially in Europe. Investments in government bonds are only justified for portfolio-building purposes. Yields on corporate bonds and the foreign debt of emerging countries are attractive in our view. Credit spreads rose to excessive levels in February, particularly in the US, and the resulting risk premium is attractive given the likelihood that the US will avoid recession and that emerging markets will gradually stabilise.

We also recommend products and assets that add convexity to diversified portfolios. Volatility may give rise to opportunities in certain sectors and stocks, and some hedge fund strategies should benefit from the current market environment and from the rotation within themes and sectors.

Jean-Sylvain Perrig
Chief Investment Officer

Patrice Gautry
Chief Economist

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Union Bancaire Privée, UBP SA
Rue du Rhône 96-98 | PO box 1320 | 1211 Geneva 1, Switzerland
T +41 58 819 21 11 | E ubp@ubp.com | www.ubp.com

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