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INVESTMENT OUTLOOK

Q3 2016

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Global growth outlook clouded by rising political uncertainties

The world growth outlook should remain modest in the second half of the year, despite the surge in risk after the UK's referendum on its EU membership.

Concern about a renewed US slowdown in early 2016 aggravated pressures in both Europe and Asia. This raised fresh concerns about the availability and effectiveness of future policy measures by central banks, as well as the political capability of fiscal agents in governments around the world.

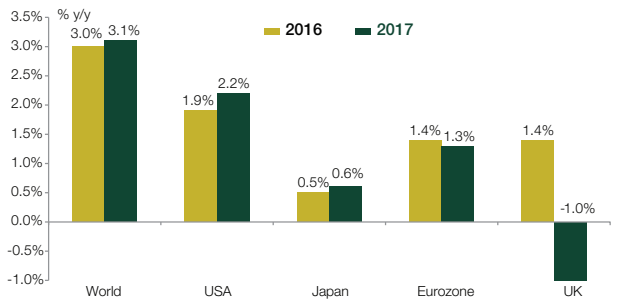
However, it was, once again, policymakers whose actions helped allay concerns, with the US Federal Reserve pausing its tightening cycle while the European Central Bank (ECB) expanded its purchases and announced its 'credit easing' programme in March. China's authorities also joined the fray with more traditional fiscal and monetary measures, and even the G20 weighed in, restraining members from using currency weaknesses to help their domestic economies.

Although central banks demonstrated their readiness to support growth momentum and carry out economic repairs where possible in H1 2016, the unexpected 'leave' vote in the UK now puts their inability to drive structural reform in the spotlight – a task left to reluctant politicians in Europe and, increasingly, around the world.

Politicians on the Continent will now have to take the lead in reshaping the European project. The UK's vote marks the start of a long period of uncertainty in Europe, heightening risks of the EU fragmenting. The lack of momentum on reforms since the eurozone crisis broke out, combined with the catalyst of the UK's leave vote, forms the key threat to the fragile global growth.

The direct economic damage from the UK's leave vote should weigh most heavily on the UK economy, while having only a moderate impact on that of the eurozone. Our expectations on world growth have barely changed in the aftermath of the vote, as we see limited impact on a steady recovery in the US and stability that has re-established itself in emerging economies.

World GDP



Source: UBP Economic & Thematic Research

Economic growth prospects for the year remain modest at 3%, with both developed and emerging economies' growth rates below historical levels. After a weak H1 2016, we expect a rebound in H2 thanks to firmer growth in the US, led by consumer spending supported by job creation.

The progressive eurozone recovery, helped by the ECB's supportive monetary policy, was expected to slow in H2 even without the uncertainty of the UK referendum's result. The H1 rebound was driven by more sustained consumption and corporate investment, but the trend is set to be moderate given rising uncertainties and lower exports to the UK. Thus, the growth outlook on the eurozone has been revised down slightly (1.4% expected in 2016; 1.3% in 2017).

The outlook for the UK is far more worrying, as confidence is set to fall dramatically after the vote and investment decisions will probably be delayed until more information is available on future agreements between the EU and UK. As a consequence, the UK economy may enter a recession in H2 2016 and in 2017 (-1% expected).

Concerns about the banking sector will increase due to the risk of a shrinking UK economy and a change in banking rules in Europe, at a time when worries about balance sheets still linger and a large amount of capital is needed to secure the sector.

Fears were similar in China in H1, where recent fiscal and monetary measures have stabilised growth prospects. However, like Italy, China is expected to begin to reform and restructure the non-performing loans on local banks' balance sheets, offsetting underlying growth momentum in the broader economy.

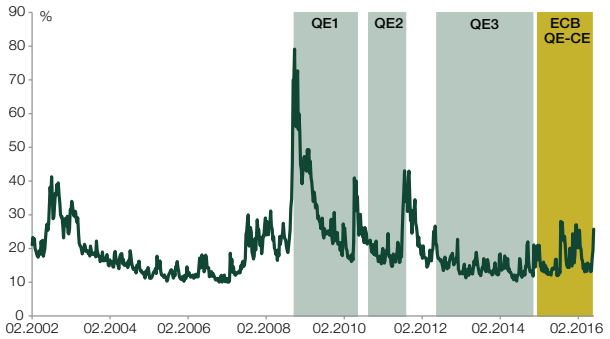
In Japan, the expected budgetary stimulus should sustain economic activity over the coming quarters, while the Bank of Japan should try to offset an unwelcome rise in the yen after the post-referendum fall in sterling. However, with limited momentum on Japan's labour and immigration reform agenda, its policymakers may need to turn to even more experimental tools in 2017 should growth momentum flag once again.

The economic outlook will remain heavily dependent on political developments, particularly in Europe. The upcoming elections in the Netherlands and referendum in Italy will be a test for anti-EU sentiment, and there have already been calls for referendums on the EU/eurozone in several countries (including Scotland, Austria, France and Germany). Government promises of further integration will probably not be enough to close the gap between citizens, the EU institutions and governments, leaving markets with the burden of periodically pricing in the increased risk of EU fragmentation.

Deteriorating risk-reward on equities vs. attractive carry opportunities

Against this backdrop, periodic bouts of volatility as seen in early 2016 should be common in the second half of the year. As a result, credit and carry strategies are our preferred core return drivers in diversified portfolios, with a focus on risk mitigation within equity allocations.

Fed & ECB QE and implied volatility

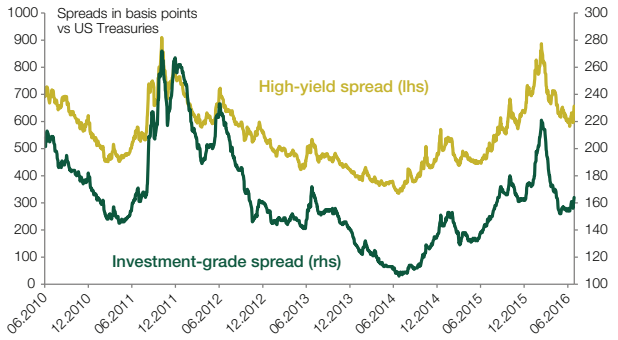


Sources: Bloomberg, UBP Economic & Thematic Research

Bond yields have fallen to levels close to those seen during the 2008 crisis. Yields on government markets continue to represent poor value for long-term investors, though we acknowledge the risk-mitigation benefits they might bring.

For USD-, EUR- and CHF-referenced investors, yields on dollar-denominated, investment-grade corporate debt are attractive given the yield pickup versus comparable government bonds. Oil prices are expected to stabilise with ongoing adjustments to US supply, and this should moderate risks in the high-yield sector, where risk premiums expanded sharply at the beginning of the year and more modestly recently in the aftermath of Brexit. We still believe that they are overpricing the magnitude of future default rate rises.

USD corporate credit spreads



Source: BofAML

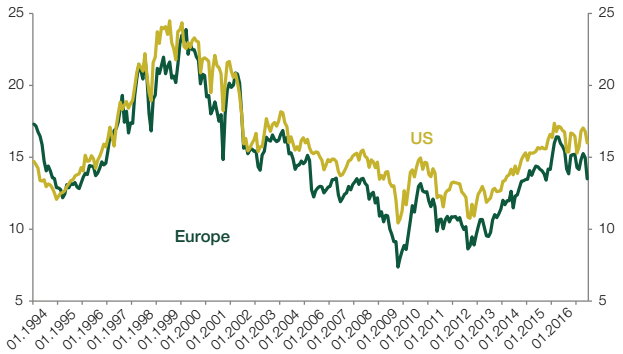
We see high-quality, USD sovereign and corporate emerging-market debt as still attractive in terms of capturing yield, as spreads remain elevated in spite of the stability we expect in emerging economies in coming quarters.

Unlike many credit markets, which overcompensate investors for the credit risks being assumed, equity markets in the West generally undercompensate investors for modest earnings prospects. The outlook on stocks has deteriorated, given still-high valuations and limited earnings growth, and we anticipate only very modest performances. In light of the generally unattractive risk-reward ratio in equities, we have oriented the portfolios towards value and low-volatility strategies in US equities, and towards dividend, volatility carry and value strategies in European equities.

Any improvement in earnings expectations should be modest given rising uncertainties on economies even if the removal of the commodity headwinds is confirmed going into H2 2016. Indeed, Q1 2016 earnings results in the US and Europe generally beat expectations and guidance was cautious but positive. Prospects on earnings growth have deteriorated in Europe on rising uncertainties, while in the US, margins could come under some pressure if labour market strength resumes in H2 2016, as we expect.

The limited benefit to investors of renewed modest earnings growth is expected to be offset by higher valuations in US and European equity markets. With P/E ratios at 17x 2016 earnings, the US market has returned to its highs in recent years, and the European market had reached 15x 2016 earnings before the correction resulting from the UK referendum; this suggests that a compression in P/E ratios is a likely risk facing equity investors in H2 2016 and probably in 2017.

12-month forward PER: Europe & US



Source: Thomson Financial

We are looking to a defensive sector bias in developed equities to support returns, with a focus on consumer staples and healthcare. To diversify our equity exposure we are looking to minimum-variance strategies to mitigate the impact of the expected periodic spikes in volatility. We have also increased the use of hedge funds to mitigate equity volatility. We expect macro, long/short and relative-value strategies to offer attractive risk-reward potential for investors.

In contrast, the headwinds that have plagued emerging markets appear to be increasingly well priced in, especially relative to the rising risks in developed markets. Large valuation discounts are now reaching historical extremes, despite the fact that emerging market corporates are generating returns

on equity that are now comparable to those generated by their Western counterparts. Moreover, with the new-found economic stability of emerging economies, the prospect of earnings deterioration that has plagued this asset class, especially when compared to developed markets, may be nearing an end.

Though our base scenario continues to call for a steady recovery of the global economy, the outcome of the UK referendum does not mitigate the risks of a fragmentation or a breakup of the EU/eurozone that policymakers appear ill-equipped to avert.

As a result, protection against a sharp weakening in EUR/USD exchange rate, as well as gold exposure and a healthy level of cash, should enable us to respond quickly to value opportunities in different asset classes, generated by high volatility triggered by rising political risks in the coming quarters.

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