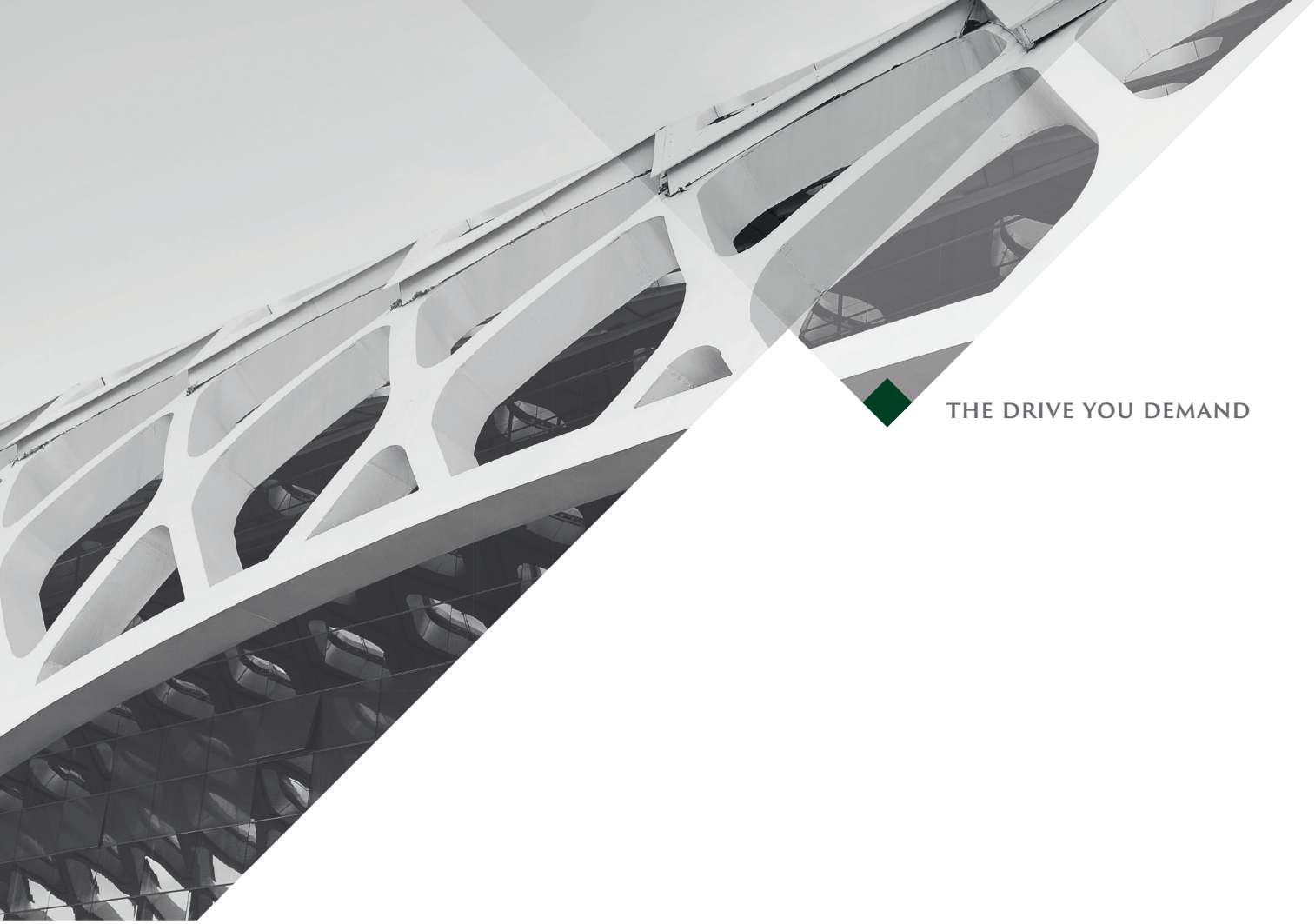


THE DRIVE YOU DEMAND

INVESTMENT OUTLOOK
Q3 2017

July 2017 | Global Investment Committee

UBP

UNION BANCAIRE PRIVÉE

EXECUTIVE SUMMARY

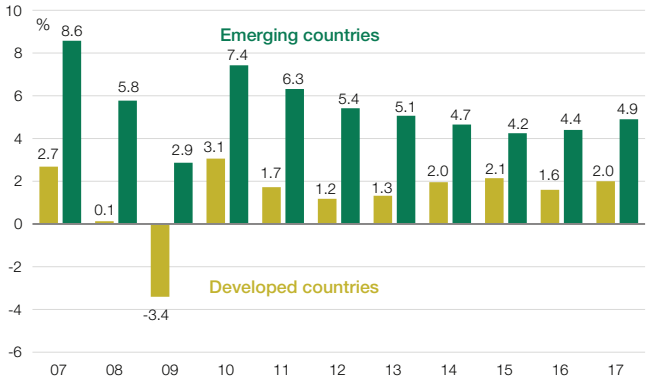
- *Global growth remains strong, despite political and geopolitical uncertainties.*
- *The outlook for the eurozone is improving, supported by prospects of reforms in France, a pro-cyclical policy in Germany and a renewed European political project.*
- *US growth should stay on a 2–2.5% trend, and there is no recession in sight.*
- *Deflation is not a threat for next year, as inflation is expected to stabilise at around 2% in developed countries, after temporarily slowing in Q2.*
- *A new monetary regime will dominate in the coming years, as central banks progressively put an end to their ultra-accommodative strategies.*
- *Our asset allocation continues to favour equities. Sustained global earnings growth should support equities in the second half of the year but elevated valuations suggest that returns will probably be more modest than in the first half.*
- *Given the particularly high valuations in the US, we prefer non-US equities in Europe, Japan, and Asian emerging markets. Technology and banking are our preferred sectors.*
- *Global bonds should adjust to the tighter monetary regime and the end of cheap money. Floating-rate notes and non-directional bond strategies should benefit from rising interest rates and an increase in the volatility of the bond markets.*
- *With expensive valuations in both equities and bonds, increasing performance dispersion between regions and sectors should allow hedge fund strategies to bring diversification benefits to portfolios.*

Positive outlook despite political risks

The first half of 2017 was unusual in many ways. On the political front, after years of uncertainty, stability prevailed in continental Europe, as centrists pushed back the rising tide of populism in the Netherlands, Austria and, most recently, France. In contrast, the world cringed as the leading political power since the end of the Cold War stepped down from the global stage under its new president, Donald Trump, and instead engaged in domestic wrangling.

Though the second half of the year promises its share of political events – including the national party congress in China, German federal elections, potential Italian elections, the kick-off of Brexit negotiations, and the start of campaigning in the United States for the 2018 Congressional elections – just as in the first half, we expect economics and earnings to be the key drivers for markets.

Global GDP growth by main region



Source(s): IMF, UBP

Despite lingering political and geopolitical risks, the outlook remains positive and world growth should hold up, coming in at close to 3.6% in both 2017 and 2018. Although oil price volatility has surged recently, prospects in the main regions are still encouraging, with growth likely to rebound to 2% in developed countries and to near 5% in aggregate terms across emerging countries.

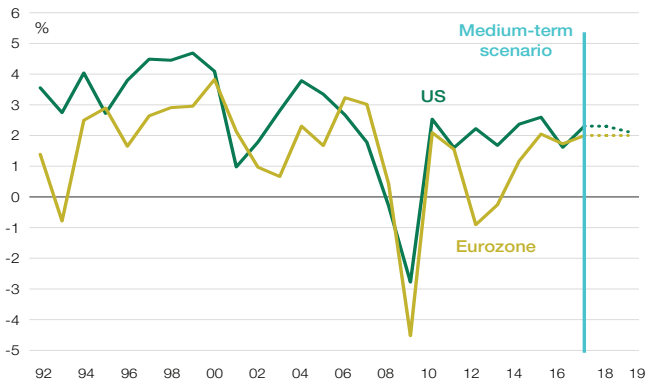
Prospect of a new deal for the eurozone

Though European growth data has been persistently surprising, the election of Emmanuel Macron has the potential, both in France and the broader eurozone, to step up the pace of activity and reform. His programme is based on liberal and pro-European reforms. If implemented, it should give a much-needed jolt to the French economy, whose growth has remained stuck on a 1% trend since the financial crisis, and it could also demonstrate to Europe that a French government is capable of far-reaching change.

One major step will be the reform of the labour market, due next September, which should give the economy more flexibility and open the door to other significant measures. But some of those (such as a corporate tax cut and a revision of labour costs) face a major fiscal constraint, as France's budget deficit to GDP is above 3%, which means they will probably have to be delayed until next year so that France can bring that deficit back below the 3% target and be credible among other EU governments. Macron obviously has an ambitious programme for the eurozone (a joint budget, an investment plan and a new political project), which has been welcomed by Angela Merkel, who has signalled that Germany will be open to discussions after its September elections.

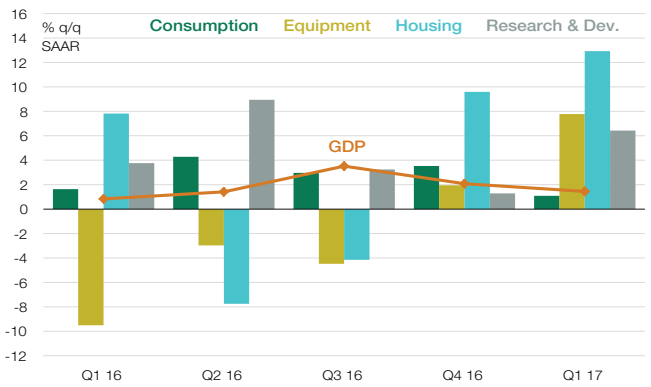
The German chancellor has reform plans of her own: her electoral programme focuses on significant tax cuts for families (up to EUR 30 billion) and public spending is already increasing, in a departure from the widely criticised fiscal austerity of recent years.

US & eurozone GDP growth



Source(s): UBP, IMF

US GDP, consumption and capex



Source(s): BEA, UBP

The combination of French reforms and increased German spending gives the European political project a new lease of life and could lift the eurozone's economic growth to a higher medium-term trajectory (2–2.5%), closer to the US trend, making the region less dependent on the rest of the world. If European integration is taken yet further, the prospect of a federal budget (on some specific items initially) would rebalance the policy mix and reduce the influence of central bank action.

In the UK, both the economic and the political outlook have darkened. After the snap elections in June, the loss of the Conservatives' majority in parliament has weakened prime minister Theresa May, who has been forced to strike a confidence-and-supply deal with the Democratic Unionist Party. Meanwhile, domestic economic activity is flagging and there is no immediate prospect of renewed budgetary or monetary stimuli. As Brexit negotiations kick off, the EU has the upper hand and has been able to impose its own agenda. This will make it difficult for Theresa May to strike separate new trade deals in parallel with the Brexit talks, as originally planned. Added to this, the debate on a soft-versus-hard Brexit has come back to the fore, generating more volatility and uncertainty around sterling.

In the US, though it appears increasingly unlikely that the Trump administration will be able to successfully pass new tax legislation in 2017, a recovery from the seasonally slow first quarter should keep the US growth rate in the 2–2.5% range for the rest of the year. Fundamentals remain strong for consumers and sentiment is still positive even though none of the promised tax cuts have materialised: the economy is close to full employment and wages could grow more than expected in the next quarters (due to mounting signs of a labour shortage), house prices are still rising faster than inflation, and wealth effects are supporting consumers. Besides volatility in the manufacturing sector and fiscal uncertainty that could potentially impact investment, consumption should continue to drive US growth.

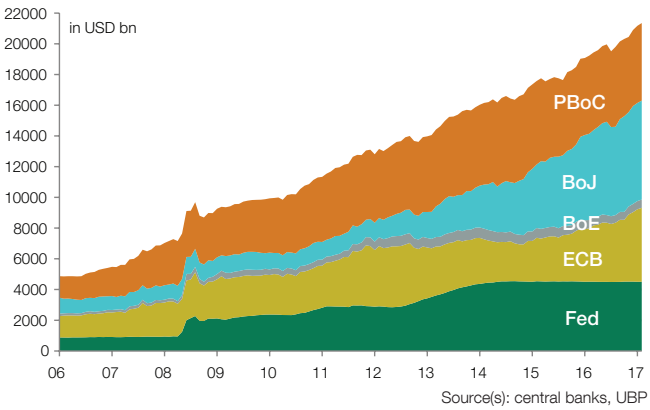
As it heads into its national party congress in the autumn, China's growth should carry on stabilising just below 7% ahead of more significant reforms and policy initiatives planned for 2018. The challenge for the current government, and the requirement for Xi Jinping to consolidate his power, is to preserve a stable economic environment, to promote long-term growth projects, and to prevent any potential threat to financial stability due to the spread of non-performing loans and shadow banking.

Preparing markets for a new global monetary regime

Since the financial crisis, central banks have run aggressive monetary policies, based on low or negative interest rates and asset-purchasing. Their balance sheets have expanded swiftly, accounting for an ever-higher proportion of GDP, and risk premia on risky assets as well as long-term interest rates have collapsed, boosting global asset prices.

World growth now appears to be on a solid trend as the main regions are maintaining their economies without the help of stimuli, and central banks should begin to tighten their policies in spite of inflation being temporarily low. As the US cycle has matured, the Fed has already begun a moderate rate-tightening cycle which will continue this year and next, and will probably simultaneously start a multi-year reduction of its balance sheet by ending the reinvestment of coupons on MBS and government bonds. Similarly, with declining unemployment and strengthening growth in the eurozone, the ECB will be following in the Fed's footsteps: we expect it to announce that it intends to end its QE programme in 2018, and probably also set a less negative deposit rate (currently at -0.40%). The Chinese central bank has already tightened its policy in a bid to curb the expansion of the housing bubble and increase banking-sector regulation. The Bank of England has also mentioned it could withdraw its monetary support, on the back of concerns of escalating inflation and a weak currency.

Central banks' balance sheets



Source(s): central banks, UBP

To reflect these moves, central banks have also significantly adjusted their communications in favour of a more neutral and even slightly hawkish tone, marking the end of a decade of abundant and cheap money. In the coming years, short-term rates will increase and global liquidity will probably retreat, leading to a tightening in financial conditions and a rise in the cost of capital. The withdrawal of central banks' backing will trigger a major shift as supply and demand on money and bond markets have been distorted by the central banks' asset buying, particularly in Europe, and as economies and markets alike will have to do without the safety nets the accommodative monetary policy had provided for so many years.

Non-US equities still ahead

With the rebound in US growth expectations and robust growth elsewhere in the world, we anticipate that global equities will continue to outpace global bonds between now and the end of the year. While equity returns should be more modest than the 12% generated in the first half of the year, absolute returns on bonds should face more headwinds in the months ahead. We also believe the outperformance of non-US equities over US ones will carry on, a trend that emerged in the second quarter of this year after several years of US dominance. And this trend reversal, in particular between Europe and the United States, should stay in place as the Merkel-Macron partnership matures.

Much like Japanese equities were boosted by the domestic reform momentum with new political leadership in 2012, continental European equities should benefit both from the new policies of Emmanuel Macron in France and from a newly emboldened German chancellor, Angela Merkel. With growth already strong in Europe, increased reform momentum might not only extend the economic cycle in the single-currency area, but also help raise earnings growth and returns across European companies. In contrast, the UK's negotiations with the European Union on Brexit should constrain UK equities, especially relative to their continental European peers.

Despite lagging behind in the first quarter of 2017, Japan continues to deliver earnings growth across its stable corporate sector. Unlike in the US and Europe, where companies have been rewarded by markets for meeting, and even beating, earnings expectations, Japanese corporates have seen their P/E multiples decline in recent years as investors question their sustainability. With growth coming from more proactive cost management, as well as from buybacks and increased dividends, Japanese equities look set to build upon their outperformance in the second half of 2017.

Attractive Japanese equity valuations

12-month forward PER: Japan equities relative to global equities

Source(s): Thomson Reuters, UBP

Surprisingly for many, emerging markets have led the way among equity investors since the beginning of the year, rising nearly 19% in that period alone. Though the valuation gap between emerging markets and their developed market peers has narrowed, it remains historically wide. Perhaps more importantly, the cyclical rebound in Chinese equities in the first half of the year (+26%) looks set to continue in the second, as China pivots its own policy regime towards its 'One Belt, One Road' programme of infrastructure building across Asia and Africa. Balance sheets at new China-sponsored financial institutions – the Asian Infrastructure Investment Bank and the new Silk Road Fund – should also lend support.

The valuation gap in favour of EM equities justifies an overweight stance

Spread between developed and emerging markets 12-month forward PER (sector-adjusted*)

*EM PER is recomposed using DM sector weights

Source(s): Thomson Financial, UBP

Looking at sectors around the world, technology, having risen by nearly 18% year-to-date, saw its first substantial correction at the beginning of June. We are optimistic about the valuation outlook for that sector, especially in light of its earnings growth prospects. We expect that the unwinding of decidedly one-sided positions across global technology names will provide an opportunity for investors to add positions at attractive valuations in the coming months.

Technology stocks' valuation premium still modest given the solid earnings outlook

12m forward PER ratio of the technology sector relative to MSCI AC World

Source(s): Thomson Financial, UBP

In the banking sector, after a strong start to the year, falling long-term yields and weakening growth expectations in the United States weighed on banks' performances in the second quarter. As growth rebounds around the world in the second half of the year, together with a rising trend in government bond yields, we believe the cyclical recovery scenario for banks will come back into favour, providing an opportunity for financial sector investors in Europe, Japan and, to a lesser extent, the United States.

With global healthcare names rising by 16% in June, investors will have to rely increasingly on earnings growth to drive returns in the sector instead of the persistent re-rating that has rewarded investors so far this year. Though we are optimistic on the earnings outlook, the end of a P/E ratio expansion-led rally probably means increased caution is warranted in healthcare between now and the end of the year.

Despite the massive underperformance of energy companies since the start of the year, we believe that it is still too early to come back to the sector. With current oil prices, the risk of downward revisions to earnings estimates still appears very high, while dividends would be at risk if oil prices were to slide again.

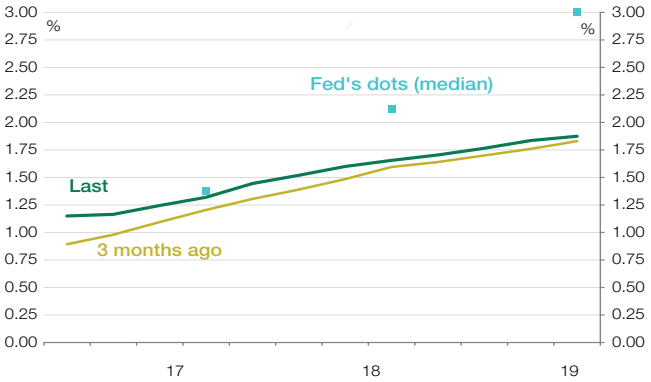
The current low-volatility environment gives investors the opportunity to buy relatively cheap downside protection as elevated valuations in equities make them particularly vulnerable to a potential spike in volatility. Unlike previous cycles where long-duration bonds could provide much of this protection, given the current level of government bond yields around the world and the upcoming stages in the normalisation process by central banks, we fear that fixed-income assets may no longer provide the same buffer as they used to.

Central banks' exit strategy should restore term premia and push real rates up

Fixed-income markets, which delivered a reasonable 4–5% total return in the first half of the year, will continue to be an area where risk management is critical.

The recent global central bank shift should materialise more distinctly in the second half of the year. In the US, the gap between the Fed's guidance and market pricing widened in the second quarter. While markets are assuming that subdued inflation will cause central banks to wind down their monetary stimulus even more slowly, despite tightening labour markets, we remain convinced that this single argument is not sufficient to call into question the Fed's rate-normalisation policy. We still believe that the market is underpricing the path of Fed rate hikes over the next 12 to 18 months, and that floating-rate notes should benefit from rising interest rates.

Mispricing of the path of Fed rate hikes

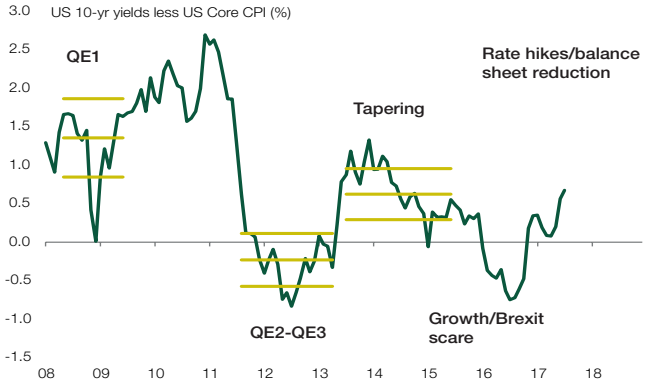


Source(s): Fed, CBT, UBP

After the summer months the monetary policy focus is likely to turn more towards the ECB and away from the Fed. Mario Draghi's speech in late June marked a potential turning point on rates and we expect this trend to continue.

But rather than causing growth to slow, higher bond yields will be a sign that economic prospects have improved everywhere and fears of deflation have faded. In the current context, we view the curve as excessively flat, considering fundamentals. We expect the shift in communications by global central banks towards a less dovish and more neutral stance to lead to a bearish steepening of the curve and higher real rates. In this context, we are retaining our short duration on portfolios.

Real rates should rebound



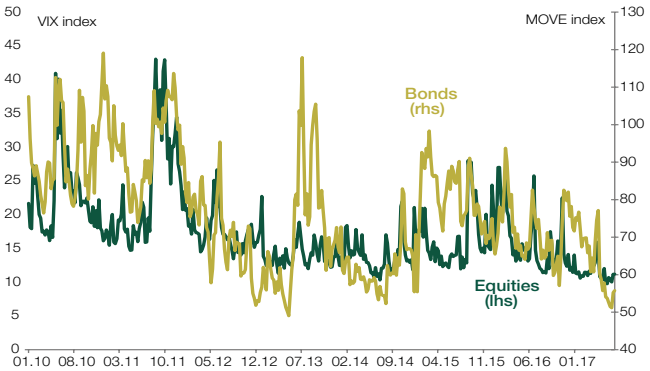
Source(s): Bloomberg Finance L.P., UBP

Credit investors are faced with historically low yield differentials compared with government bonds (spreads). Though corporate debt fundamentals remain strong, we feel that these spreads inadequately compensate investors for the prospect

of a rise in interest rate volatility. As a result, we have shifted towards non-directional bond strategies that can tactically capitalise on a shift in volatility.

MOVE index historically low

US implied volatility

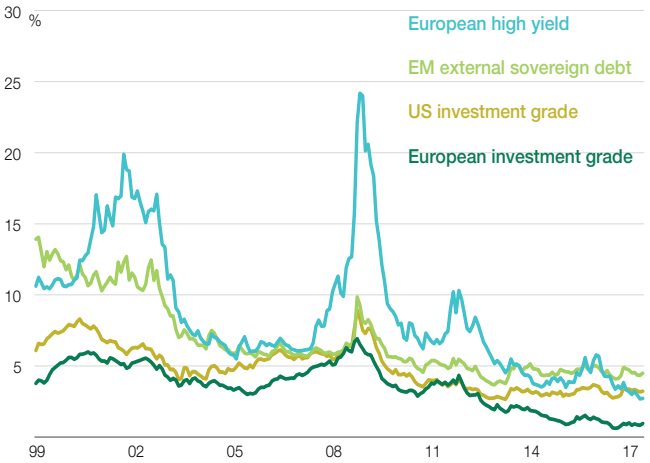


Source(s): Bloomberg Finance L.P., UBP

Within the fixed-income universe, it seems to us that emerging market debt is still one of the few areas where investors are being fairly compensated for both credit risk and the prospect of increased interest rate volatility. We continue to believe that active management with limited exposure to interest rate movements will be the key to preserving wealth in the fixed-income arena.

Attractive emerging market debt

Effective yield



Source(s): BofAML, UBP

As we are late in an already long economic cycle, investors will have to keep managing the risks of elevated valuations in many equity and bond markets around the world. In particular, the current market conditions and the potential impact of a higher-rate environment on investment portfolios have become a key concern. As a result, the attraction of hedge funds as an alternative to fixed income is a response to this potential sea change in the market, and we believe that hedge fund managers will have opportunities to exploit this.

We have thus increasingly been looking to hedge fund strategies to provide portfolios with diversification benefits. High valuations and wider performance dispersion across both regions and sectors should also play to the strengths of proactive hedge fund managers in the months ahead. As for gold, with the clear upside risk to real interest rates, the metal will be less appealing in terms of providing insurance against uncertainties in the months ahead.

Authors

Michaël Lok
Group Chief Investment Officer (CIO)
and Co-CEO Asset Management

Norman Villamin
Chief Investment Officer (CIO)
Private Banking

Patrice Gautry
Chief Economist

Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1, Switzerland
ubp@ubp.com | www.ubp.com