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20%	The percentage of total income controlled by the richest 1% of Americans **Page 3**
1.5%	Our forecast for euro area growth this year, down from 1.8% as a result of the Brexit vote **Page 4**
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Brexit vote leads to changes in scenarios. Quantitative strategy to the fore in the search for investment returns.

July 2016

Perspectives

EDITORIAL OUTLOOK

Brexit highlights dangers of political polarisation

César Pérez Ruiz,
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The UK's vote to quit the European Union (EU) shook markets in late June and revealed a sharply divided country. The main transmission mechanism to the rest of Europe is political. Eurosceptics in other EU countries have taken encouragement from the Brexit vote, with populist parties in France, Italy and the Netherlands calling for their own votes on EU membership. And while the EU27 are likely to take a tough line with the UK to discourage other countries from going down the same road, there is clearly a risk that Brexit is followed by further fragmentation of the EU.

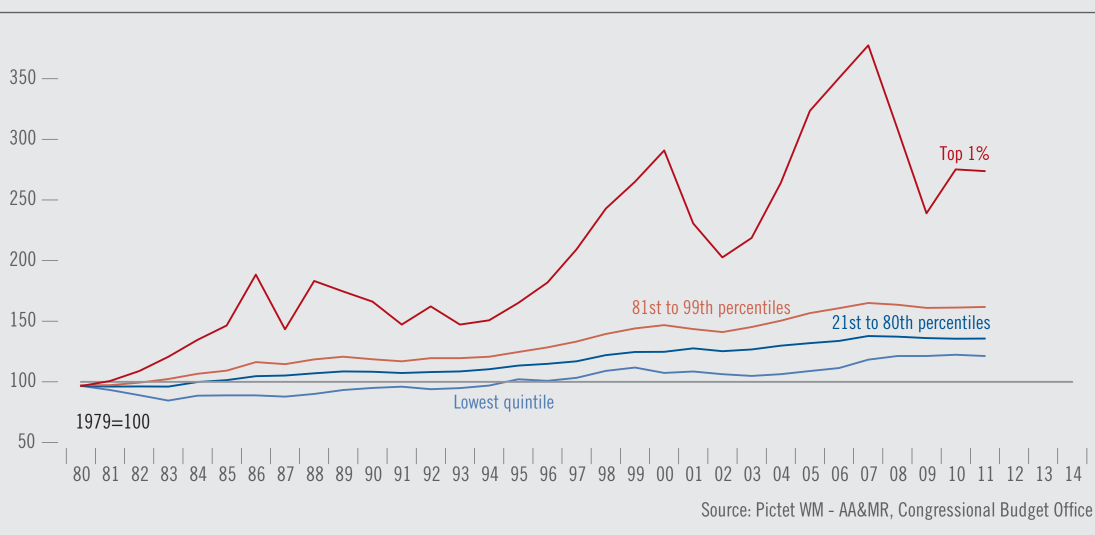
It is important to understand how we have arrived at such a crisis. There are, of course, many reasons (political, historic, institutional). But along with opposition to uncontrolled immigration, one common underlying theme in the rise in populism throughout the western world is inequality, and the idea that the rich are getting richer while incomes among the poor stagnate. There is some evidence that this is the case. Economists Thomas Piketty and Emmanuel Saez have calculated that the richest 1% of American population accounted for 10% of total income at the end of the 1970s, but 20% in 2013. At the same time, figures point to, at best, a stagnation in median incomes in the US since the end of the last century.

Are things much better in Europe? Figures published by the French statistical agency INSEE show, for example, that the median income in France fell by 1.1% between 2008 and 2013, while the income of the 10% households with the lowest incomes fell by 3.5%. It is thus no surprise to learn that the areas in England (although not in Scotland) with the lowest median incomes were the ones most solidly in favour of Brexit, while those with the highest median incomes voted equally firmly to stay in the EU.

Before important elections in France and Germany next year, Austria and Italy will be the next test grounds for the rise of populism. Prime minister Matteo Renzi has promised to stand down if the referendum in October that he called on electoral reform and the abolition of the elected upper house of parliament fails to pass. On 1 July, Austria's highest court annulled the results of the May presidential election, meaning it will have to be re-run (likely in early autumn). The US presidential election in November also poses concerns, with the demagogic Donald Trump drawing on similar anti-establishment sentiments to those that animated the Brexit campaign.

But the Brexit vote could equally prove a high-water mark for populism, given the sense of foreboding now hanging over the British economy. Indeed, the message from the 26 June re-run of the Spanish general election is that populism is not necessarily gaining momentum. The governing Partido Popular actually increased the number of seats it won compared with the inconclusive December election, while the populist Podemos formation stagnated.

Come what may, the current environment of severely reduced political visibility is making investment decisions more difficult. We do not know what path the UK will take. The British seem in no hurry to apply the now-famous 'Article 50' of the European Treaty, which would formally start the process for the UK to leave the EU. Visibility would be improved if it became clear that Brexit was not going to happen after all, or if, by contrast, we quickly saw a precise timetable for the UK's exit from the EU and the outlines of its future relationship



with the EU. But that will require leadership. Among other things, it will depend on who the next British prime minister is and on how successful he/she is in holding the Conservative Party together and avoiding a fresh general election. We will monitor the unfolding political developments closely to see if they significantly impact our macro scenario and will trade accordingly. We already took advantage of the spike in volatility following the Brexit vote to take some profits within the put options that we added to portfolios in May.

This is much more of a UK and European crisis than a global one: the UK accounts for just 4% of global GDP. Brexit is undermining, but not derailing, the EU's growth prospects—we have cut our GDP growth forecast for the euro area in 2016 from 1.8% to 1.5%. Growth in the US, which is much less affected by Brexit and has better demographics than Europe, will hold up better. But the problems related to inequality are far from being resolved there either. During much of the current economic cycle, productivity growth has been very low in the US, just as in Europe, thus explaining the weak rise in wages in recent years and contributing to the feeling among many people that they are being left behind by economic recovery. Such a development can make the easy solutions proposed by populists look appealing.

Some far-reaching solutions to the problems linked to inequality are being put forward. A proposal that the state pay a universal living allowance garnered 24% support in a referendum in Switzerland in June, for example. We will likely see similar initiatives in northern Europe in the coming years.

But there may still be room for more 'traditional' ways of tackling the problem of low growth and stagnation that has encouraged the rise of populism in its various forms. After years of austerity in the western world, more could undoubtedly be done to modernise education, to encourage entrepreneurship and innovation, and to raise capital spending (both in the public and private sector). If Europe is to achieve a turnaround in the trend towards populism, the lack of income growth among lower-earning segments needs to be addressed.

UK vote brings uncertainty, but no systemic risk as yet

The Brexit vote on 23 June caused turmoil on financial markets. But central banks stand ready to curb tensions and the Chinese and US economies, with little exposure to the UK, continue to fare comparatively well.

Christophe Donay, Bernard Lambert, Nadia Gharbi, Frederik Ducrozet and Dong Chen

Although Brexit has led us to pare our UK and European growth forecasts, this is not a 'Lehman moment' redux.

Understandably, June was dominated by the Brexit referendum in the UK. Markets took a sharp dive after it became clear that British voters had decided to leave the European Union, while the political consequences continue to unfold. As a result we have downgraded our growth forecast this year for the UK from 1.8% to 1.3%. We believe that UK inflation will rise by 0.9% instead of 0.7%, as sterling weakness pushes up imported inflation. But we are of the opinion that the full consequences of Brexit will only become fully apparent in 2017, when we now expect the UK economy will grow by only 0.9%, well down from our previous estimate of 2.2%. We believe foreign investment into the UK will come to a standstill as the situation pans out, and that consumer spending will also take a hit. The European Union will also feel the effects of Brexit. Instead of growth of 1.7% in 2017, we now think the EU will rise by 1.3%.

But Brexit is far from being the kind of systemic risk that almost brought down the global financial system in 2008. And given that the UK economy only accounts for 2% of the world economy, we think the Brexit vote will only have a slight impact globally, although it does cause an extra drag on already relatively lackluster global growth (we now expect world GDP growth of the order of 3% this year and next rather than 3.2%). Brexit should barely register with the US economy, which we still see growing by 1.8% this year and 2% in 2017.

Yet Brexit will probably mean lasting upward pressure on US financial conditions, leading the Fed to become even more cautious than before about rate tightening. And Brexit has pushed up the value of the yen, making further Bank of Japan intervention to stabilise the currency even more likely. Indeed, we expect all the world's main central banks will intervene to steady nerves in the weeks ahead (another reason we believe Brexit is not the equivalent of a 'Lehman moment'), whether through yet more liquidity injections, further forms of monetary easing, or currency buying.

BREXIT: CHANGES IN PICTET'S BASELINE SCENARIO FOR GROWTH AND INFLATION

	UK		Euro area	
	Before Brexit	After Brexit	Before Brexit	After Brexit
		REAL GDP		
2016	1.8%	1.3%	1.8%	1.5%
2017	2.2%	0.9%	1.7%	1.3%
		INFLATION		
2016	0.7%	0.9%	0.3%	0.1%
2017	1.7%	1.9%	1.3%	1.1%

Source: Pictet WM - AA&MR

US economy should remain relatively immune to Brexit shock

Following the Brexit vote, fears of a US economic downturn have resurfaced, and Fed funds futures moved dramatically in consequence. By 29 June, the market was actually pricing a 10-15% probability of a Fed rate cut by September. However, we are not overly worried. The UK absorbs less than 4% of US exports and the EU countries around 18%, equivalent to 2.3% of US GDP. Even a sharp slowdown in the EU would only have a marginal direct impact on US economic growth. Admittedly, through the transmission channel of tighter monetary and financial conditions, the negative implications for the US economy could potentially be quite sizeable. Fortunately, the tightening in US financial conditions has been fairly modest so far. From 23 June (just before the Brexit referendum results were announced) to 29 June, the real trade-weighted US dollar appreciated by around 2.0%. But its level remained below what was recorded on average in Q1. And there was only a modest tightening of US monetary and financial conditions overall.

"In spite of the uncertainties, we remain relatively comfortable with our US economic forecasts for the moment"

Nevertheless, with a deterioration in the European economic outlook and quite possibly some policy response from European central banks, upward pressure on US financial conditions will probably prove to be a lasting phenomenon. In this new environment, the Fed will probably act even more cautiously than we thought before. We still expect a 25bp hike in rates this year, but most probably in December instead of September. And for 2017, we have cut our forecasts from three quarter-point hikes to two. The current uncertainties are placing downside risks on US growth and inflation. But in view of the latest data releases, we actually remain relatively comfortable with our

US economic forecasts for the moment. We continue to forecast US GDP growth to average 1.8% in 2016 and 2.0% next year. Our inflation forecasts also remain unchanged. We continue to expect core PCE inflation to end this year at 1.9% y-o-y and at 2.2% in 2017.

Politicians and the ECB to determine the fate of the euro area

We have revised our economic forecasts for the euro area following the Brexit vote, lowering our GDP growth forecast for the next couple of years to 1.5% in 2016 and 1.3% in 2017. Focusing on the direct impact through trade and financial linkages, our in-house macro-econometric model points to a net drag on activity similar to that mentioned by the ECB (around 0.50% over the next three years). Downside risks dominate, in our view, including the risk of political contagion to other member states, depending on the shape a future deal (if any) between the UK and the EU takes, as well as single-country factors. In Spain, a centre-right minority government seems more likely on balance after the 26 June general election, but a third round of elections cannot be ruled out. In Italy, PM Renzi has threatened to step down should his constitutional reforms be rejected by voters in October. The latest polls point to a very tight outcome, while the Italian banking sector remains fragile, to say the least.

In the end, the most favourable scenario for European financial markets would consist of a new push towards European integration and, possibly, some targeted fiscal measures. But we suspect there will not be much political appetite for any grand initiative ahead of the general elections in France, Germany and the Netherlands next year. This could change in a situation of severe financial stress.

Ultimately, the ECB is likely to respond to signs that financial conditions are tightening and activity data weakening. We expect ECB intervention will be verbal initially before it moves formally to extend QE beyond its soft deadline of March 2017, and announces an increase in issuer limits and, possibly, a broadening of the universe for asset purchases or a limited deviation from capital keys. Looser TLTRO conditions are also likely in the event of sustained pressure on the banking sector.

Chinese policy makers ease off the gas pedal

While many uncertainties still remain, the direct impact of Brexit on China's real economy is likely to be limited, as the UK accounts for only 2.5% of China's total exports and slightly over 1% of imports. Beside the trade channel, one also needs to pay attention to possible financial contagion through currency and capital flows. But, so far, the impact of Brexit on emerging Asia, China included, has been fairly modest. The recent round of depreciation of the yuan against a basket of trading partners' currencies didn't trigger any financial turmoil similar to late last year. Capital outflows from China have dropped quite significantly in recent months, indicating that moves to tighten capital controls are having an effect and that investors are gradually adapting to the new exchange rate regime.

Following a sharp deceleration of growth last year, the Chinese authorities stepped up stimulus. Now there are signs that the policy makers have eased off the gas pedal again. The rise of bank lending has clearly slowed. In the first two months of Q2, new bank loans dropped at an annual rate of 4.2%, in contrast to the 25.5% increase in Q1. The changes in total social financing, a more comprehensive measure of credit creation, are even more dramatic. As credit growth has slowed down, so has economic activity. The year-on-year growth in fixed-asset investment declined to 7.4% in May after staying above 10% for four consecutive months. Property investment has also started to lose momentum.

We expect monetary policies to remain prudent for the rest of the year, leaving fiscal policies to play a bigger role in supporting growth. This year's government budget proposed a fiscal deficit equivalent to 3% of GDP, compared to 2.4% in 2015. If we include additional local government bond issuance, lending through policy banks and the increase in land sales, the effective fiscal deficit could be about 10% of GDP.

All in all, we expect the Chinese economy to continue to muddle through for the rest of the year with the help of policy support. We are thus maintaining our 6.5% forecast for real GDP growth in 2016.

Brexit unknowns emphasise the need to stay nimble

The Brexit referendum has opened up a period of uncertainty for risk markets. In such an environment, core bonds play their traditional protective role, while the US dollar and yen have come under upward pressure.

Christophe Donay, Jacques Henry, Luc Luyet and Alexandre Tavazzi

FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 30.06.2016

		Index	Since 31.12.2015	Previous month
US equities*	USD	S&P 500	3.8%	0.3%
European equities*	EUR	Stoxx Europe 600	-7.4%	-4.8%
Emerging-market equities*	USD	MSCI Emerging Markets	6.6%	4.1%
US government bonds*	USD	ML Treasury Master	5.7%	2.3%
US investment grade*	USD	ML Corp Master	7.6%	2.2%
US high yield*	USD	ML US High Yield Master II	9.3%	1.1%
Hedge funds	USD	Credit Suisse Tremont Index Global**	-1.5%	0.4%
Commodities	USD	Reuters Commodities Index	9.3%	3.4%
Gold	USD	Gold Troy Ounce	24.4%	8.8%

Sources: Pictet WM - AA&MR, Datastream, Bloomberg

** Dividends/coupons reinvested ** End-May 2016*

Brexit poses many questions for strategists. With much depending on the evolving political situation in Europe, portfolio diversification takes on a new importance.

Time to hunker down

Market strategists face a protracted period of reduced visibility following the 23 June Brexit referendum in the UK. The immediate impact of the Brexiteers' victory was not slow in coming. Risk assets of all sorts sold off immediately – particularly European equities and high yield bonds as well as euro area periphery bonds—before hints of central bank action helped them stage a comeback. Safe-haven assets such as long-dated US Treasuries and Bunds, the yen, physical gold and the Swiss franc all made short-term gains as a result of Brexit volatility.

But one should not forget there is a world beyond the European Union. The bonds and currencies of emerging markets outside Europe have reacted relatively calmly to the results of the Brexit referendum. We expect its impact on global growth to be slight. And in Europe itself, there are signs that after the initial shock, risk assets may stabilize for a while as market participants take a harder look at the form that Brexit takes. But where they go from there remains an open question, and one that only the politicians can answer.

Of course, visibility would be improved if it became clear that through some adept political manoeuvring, the UK's departure from the European Union does not go through after all. Risk assets could be expected to react positively to such a development. But if, as all sides are adamant will actually happen, the UK ends up departing from the EU, then markets will focus on the form of that departure. Risk assets would be hit particularly hard if there were a 'hard' exit, leaving the UK with no preferential access for its exports to the EU. Without being ecstatic, risk assets might react less negatively should we see a 'soft' exit, with some preferential access to the EU for UK exports in return for some notable concessions.

But we simply don't know which one of these scenarios will pan out. It is not even clear that a 'happy end' in the form of continued British membership of the EU would trigger 'risk-on' moves of a durable sort, as markets would soon turn back their attention to factors that were already weighing them down before the referendum (lack of earnings and economic growth momentum etc...). In short, our view is that market participants will simply have to hunker down until the smoke clears. We don't know yet how long this will be. In such conditions, portfolio diversification takes on a new meaning, involving a constant search for types of assets that are both liquid but as decorrelated as possible from the greatest sources of risk so as to ensure that portfolios are ready to withstand further political shocks.

Equities: no time to think

The result of the Brexit referendum has opened a period of uncertainty for equity markets. Prior to the vote, market valuations had reached levels close to their previous peaks (almost 18x in the US and 16x in Europe), and had thus become vulnerable to bad news. Financial markets were quick to choose between Brexit's winners and losers. Among the former, one finds large UK companies that should benefit from a very competitive currency (the pound lost 9% in June against the USD) and their international exposure. The MSCI UK Large Cap index returned +7.9% in June in sterling, while the Small Caps index (which depends on the domestic economy) lost 6.8%.

Markets have taken a negative stance on peripheral euro area economies and their financial sectors. Greek, Italian and Spanish banks pulled the main banking sector index 17% lower on the month. Thus, in the absence of any clear political process, broad index performances mask a very polarised reality.

During the coming weeks, analysts will adapt their estimates to the new environment (lower European

growth, lower GBP and lower long-term rates). Excluding the UK, the Stoxx Europe 600 PER declines from 16x to 15.6x and its EPS growth rate improves from 2.5% to 5.6%. However, given the current uncertainties, investors are unlikely to take those numbers at face value, but rather continue to observe political and, especially, central bank decisions. One needs to remain nimble in times like these.

US Treasuries protecting portfolios

Core sovereign bonds' role in protecting portfolios in times of financial market turmoil has not vanished despite low interest rates. In June, 10-year US Treasuries returned 3.3%, outperforming 10-year German Bunds, which returned 2.6%. Even, 10-year Japanese bonds returned 1.3% (all performances in local currency). At times of heightened risk, the longer the duration, the better: over the month, 30-year US Treasuries returned 7.1%, while 30-year German Bunds returned 11.9%. Gold showed similar behavior, rising by 8.8% in June. Protective assets posted stellar returns over the first half of 2016 as a whole, with gold returning 24.4% and 30-year bonds in the US and Germany returning 16.3% and 29.6%, respectively.

Japan suffering from a strong yen

The tight correlation between the yen/USD exchange rate and the TOPIX continued to hold in June. As a result, the TOPIX underperformed massively over the month, posting a 9.6% decrease on a total return basis compared with -4.8% for the Stoxx Europe 600 and a slight 0.3% increase for the S&P 500 (all returns in local currency). The drop in the TOPIX was largely due to currency effects as, in USD terms, the TOPIX decreased by 'only' 2.3%. The yen had hit 102 against USD by the end of June, i.e. a further 8% strengthening over the month, with half of this appreciation following the Brexit vote as investors fled to safe havens, which include the yen. The yen's current level is a source of concern as most analysts and companies have used 105 as their basic assumption to forecast 2016 earnings. In June, analysts revised down their 2016 earnings forecasts by 2.2% for the TOPIX index. This adverse trend could go further without a reversal in the FX market, jeopardizing the 15% earnings growth forecast for this year.

The Fed to remain cautious

After the poor US labour market data for May, the14-15 June Federal Open Market Committee meeting was a non-event. Following Brexit, it is likely that the Fed will continue to wait longer before raising rates. However, the improvement in US data we are expecting makes a rate hike in December relatively likely – although this was definitely not being priced in by the market at end June. Meanwhile, the Chinese yuan has continued to depreciate against a trade-weighted basket of currencies (the drop is estimated at -5.9% since the start of the year), regardless of the performance of the US dollar. This contrasts with the People's Bank of China's assertion that it wants to keep the yuan more or less stable against its currency basket but indicates where the Chinese authorities would like to see the yuan going. As such, there are several factors supporting US dollar strength.

Dark clouds over oil demand

Last month, we highlighted the increasingly volatile nature of oil supply given structurally higher levels of outage. Now, in June going into July, the rise in uncertainties following the UK's Brexit vote poses a risk to global oil demand. Coupled with our scenario for a stronger US dollar in the coming months and the numerous long oil positions held by market participants, the likelihood of a temporary correction in oil prices has significantly increased.

Improvements in current-account balances across many countries

Thanks to the drop in oil prices in particular, the current accounts of many commodity-importing countries have improved. This is especially important for emerging markets, for which a healthy current-account balance is seen as helping to boost foreign exchange reserves and improving their ability to withstand capital market volatility—from an increase in US interest rates, for example. By contrast, Germany's substantial current-account surplus is blamed for reducing demand across Europe and adding to deflationary pressures.

7%

The UK's current-account deficit hit a record £32.7 bn (equivalent to 7.2% of GDP) in the last quarter of 2015, up from £20.1 bn in the previous quarter, according to the Office for National Statistics. While figures for the first three months of 2016 show a noticeable improvement in the UK's trade balance (the deficit fell to 6.9% of GDP), the country has persistently run a current-account deficit over the past 15 years.

+9.9%

According to the Commerce Department, **the US current-account deficit jumped by 9.9% in Q1 2016, to USD124.7 bn, its highest level in over seven years,** as goods exports fell and investment from abroad declined. The current-account deficit in Q1 was equivalent to 2.7% of US GDP, well below the record high of 6.3% reached in Q4 2005.

USD412 mn

In April, Brazil recorded its first current-account surplus in seven years. The surplus was the equivalent of USD412 mn, compared with a deficit of USD857 mn the previous month and a deficit of USD6 bn in April 2015. This improvement reflects a sharp decline in the demand for imports in recession-hit Brazil and the boost to exports given by the sagging value of the Brazilian real.

-USD2.96 bn

Turkey's current-account deficit narrowed for a ninth consecutive month in April, to USD2.96bn in April from USD3.86 bn a year earlier. This improvement was entirely due to the drop in imported energy prices; excluding gold and energy, the balance has not improved in the past year. **Turkey's current-account deficit declined from 9.6% of GDP in 2011 to 4.5% at the end of 2015.**

€25.6 bn

Germany's trade balance hit €25.6 bn in April, up from €21.8bn a year earlier, as exports rose 3.8% over the 12-month period, while imports remained virtually unchanged. **In 2015, Germany's current account climbed to a controversially high 8.8% of GDP**, according to European Commission figures.

USD48.1 bn

China's current-account surplus slipped from a preliminary USD85.3 bn in Q4 2015 to USD48.1 bn in Q1 2016. **China's current account reached a record high of USD1,331 bn in 4Q 2008, but has generally been declining since then as a percentage of GDP** (2.7% in 2015 compared with 9.3% in 2008) as policy makers concentrate on building up the domestic economy.

7.7%

Figures released in June showed that Korea's current-account surplus from trade with the sluggish Chinese and the US economies dropped almost 20% compared with a year before. Nonetheless, **Korea has run overall current-account surpluses throughout this decade: in 2015, it rose to USD105.9 bn (7.7% of GDP)** thanks to the fall in global energy prices.

2.9%

Japan posted a current-account surplus for the 22nd consecutive month in April. The surplus (¥1.88 trn, USD17.9 bn) was 42% higher than a year earlier. Japan's surplus came to 2.9% of GDP in 2015, its highest level since 2010, helped by the fall in commodity prices.

0.1%

India's current-account balance swung from a USD7.1 bn deficit in the last quarter of 2015 to USD0.3 billion in the first quarter of 2016 (0.1% of GDP). However, this improvement risks being eroded by a 40% bound in oil prices this year. India last reported a current-account surplus in the first quarter of 2007.

Markets grapple with the fallout from UK vote

While equity markets staged a revival at the end of the month, the UK's Brexit referendum caused a jump in volatility, both before and after the actual vote. Safe-haven assets such as core government bonds, physical gold and currencies such as the yen, the Swiss franc and the US dollar all pushed higher in June.

Equities

The 'B' Word

Markets adapt to a new reality.

The result of the UK Brexit referendum caught markets by surprise. The amplitude of market moves in the following days was exceptional and was reflected in the monthly returns for June. Thus, in local currency, the Stoxx Europe 600 had a total return of -4.8%, while the S&P500 managed to rise by +0.26%. The performances of the Italian (-9.5%), Spanish (-9.1%) and Greek (-15%) markets is a clear indication that the key Brexit challenge is further EU integration. Investors sold bank stocks, perceived as fragile in a world of ultra-low bond yields and renewed European tensions. The Stoxx Europe 600 Banks index corrected by 17.6% in euros.

Thanks to a 9% decline in the GBP, the FTSE100 index rose by 4.7% (in GBP) in June. A weak currency is a clear advantage for the index constituents, 87% of whose sales are generated outside of the UK. The MSCI Emerging Markets index returned 4% on the month, reflecting the 4% rise in commodity prices. European volatility rose and reached 39.9% before closing the month at 26%. In the US, the VIX index reached a high of 25% and closed June at 15%.

Macroeconomic forecasts will adapt to the new reality, and so will earnings forecasts. At 15.5x and 17.9x respectively at the start of July, European and US multiples remain close to their previous peaks. Valuation levels will remain uncertain until estimates reflect the new reality. A period of uncertainty has just started.

Bonds

Safety flight into US Treasuries

Safe-haven government bonds outperform peripheral equivalents amid heightened uncertainty.

The British vote in favour of Brexit caused a rush to safety on financial markets. In this risk-off environment, safe-haven bonds such as US Treasuries and German Bunds posted a positive performance over June as a whole— up to 12.7% in the case of the 30Y German Bund. The US 10Y Treasury yield fell 38bp to 1.47% in the days after the Brexit referendum, and the 10Y Bund yield fell into negative territory, reaching -0.13%.

The fear that Brexit would lead to an implosion of the European Union (EU) led to a widening of 20bp for 10Y Italian and Portuguese government bonds over Bunds in June. Spanish government bond spreads experienced only moderate widening thanks to a relatively market-friendly result at the general elections of 26 June. However, political uncertainty should keep weighing on the performance of peripheral bonds, which could experience spread widening over the summer. For the recent underperformance of peripheral bonds versus Germany to reverse, the following improvements are needed: A resolution of the non-performing loans issues facing Italian banks, the passing of the Italian government's referendum on constitutional reforms in October, and the formation of a stable centre-right minority government in Spain. Until then, yields on safe-haven bonds like US Treasuries and German Bunds should stay low and offer investors an effective protection, for volatility is not at an end.

Corporate bonds

Brexit hitting euro credit

*Brexit has led to the underperformance of euro credit relative to USD credit.**

At the end of June, Brexit caused turmoil on financial markets, leading to the underperformance of high yield (HY), the riskiest segment in credit. Over the month as a whole, Euro HY underperformed its US counterpart in terms of total return (-0.3% vs +1.1%), as Europe has greater exposure to the banking sector (22% in euro HY vs 5% for its USD peer) and to British companies (11% in euro HY vs 3% in USD), which were both worrying investors at the end of June. More worryingly still, Italian financials account for 45% of debt in the euro financial HY space. Italian banks have been underperforming their peers due to a very high non-performing loan ratio of 12%. Overall, European banks have suffered from the flattening of the German yield curve (as longer-term rates have come down) and from an anticipated slowdown of the European economy due to Brexit.

The investment grade (IG) segment of the corporate market benefited from the fall in government bond yields, with the USD IG yield falling 27 bp to 2.9%. USD IG also outperformed euro IG in terms of total return, posting 2.2% against 1.0% for the euro index. Driven by European politics, financial markets could remain volatile this summer, with USD credit outperforming its euro counterpart. Euro HY could keep underperforming as long as financial perspectives do not brighten for European banks.

** Data are based on Bank of America Merrill Lynch indices.*

Hedge funds

Resilient amid post-Brexit haze

As Britain voted to leave the European Union, hedge fund managers remained resilient and provided protection on the downside.

Ahead of the Brexit referendum, hedge fund managers to a large extent went into risk-off mode, as the weeks leading up to the referendum saw opinion polls shift between forecasting a win for 'remain' to a win for 'leave' and back again. While markets and bookmakers just before the poll pointed towards a 'remain' win, Brexit was regarded as a potential tail event. Given the binary outcome – managers treaded cautiously and did not engage significant risk in their portfolios. According to the first performance indicators, it seems that the majority of managers in the hedge fund space did not suffer excessive losses beyond strategy expectations after it was announced the 'leave' side had won. In fact, Global Macro, CTA and Relative Value managers generally navigated the increased market volatility with success, adopting tactical positioning. Of note, trend-following CTA managers, positioned long fixed income and long US dollar, posted substantial gains on average on the day of the referendum results (24 June). Global Macro managers took advantage of FX weakness and marked up modest gains, while Relative Value managers with long volatility / long convexity profiles were also positive. Fundamental-driven equity and credit managers, on the other hand, were hurt by the turbulence but the drawdowns reported were smaller in scale than the markets'.

Precious metals

Supported by uncertainties

The uncertainties linked to Brexit supported safe haven demand for precious metals.

The performance of precious metals in June was significantly influenced by the UK referendum on the EU. Indeed, the close result that was being predicted boosted safe-haven demand for gold and silver even before the Brexit results. The UK's decision to leave the EU suggests that uncertainties are likely to persist for an extended period of time, further supporting demand for gold and silver.

However, Brexit is mostly a European event and is unlikely to have significant effects on the world economy, notably on the US. True, Brexit should lead to more accommodating monetary policies, especially in Europe, but we continue to think that the Fed will raise rates this year on the back of improving US data. Furthermore, at end June net long gold positions (taking into account open interest) were at their highest levels since the start of this series in 1999. As such, the bullish sentiment surrounding gold seems too extreme, suggesting further short-term upside potential is limited.

But in the longer term, we acknowledge that Brexit will likely have persistent political consequences that should support safe-haven demand for gold.

Currencies

FX markets digest Brexit

June proved to be very stressful for investors as a result of the UK referendum.

Much of the long-term consequences of Brexit on the FX markets will depend on the political terms of the divorce between the UK and the EU, which could remain unknown for some time. The consequent rise in uncertainties does not bode well for risk appetite. As such, 'safe' currencies, mostly defined as belonging to countries with a positive current account, should perform well. Consequently, the Japanese yen and the Swiss franc should see further upward pressure, forcing their central banks to act. The Swiss National Bank has already announced it is intervening on the FX markets to curb the strengthening of the CHF, while the BoJ is likely to announce further easing measures in July.

The euro is in an interesting position as it is supported by an ever-increasing positive current account. However, Brexit will likely reduce the growth outlook for the euro area and heighten the risk of an eventual break-up. An Italian referendum in October and the French presidential election in April-May 2017 may also weigh on the euro's performance.

Although the US current account is negative, the US dollar is the reserve currency of the world and is therefore deemed safe. Coupled with improving US data, the US dollar remains attractive.

How the wind blows—anticipating changes in sources of return

Quantitative analysis can help anticipate potential sources of return, both in the short and long term. This article reviews various sources of returns and hints at the growing role of artificial intelligence in investment management.

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Investors are currently obsessed with low yields. Returns have plummeted as growth has slumped, while low inflation and low (even negative) interest rates are encouraging some parties to keep their money under the mattress. So, what has quantitative analysis to tell us about sources of return, past, present and future?

Scarcity, or the diamond-water paradox

The paradox of value, or the diamond-water paradox, is that although water (unlike diamonds) is essential for survival, limited supply means diamonds command higher prices. Supply drives the price of real assets, from precious metals and commodities to land. The supply of many commodities peaked in the final quarter of 2015, just as prices reached a trough. While the rebound in commodity prices will be interrupted by the next downturn, supply dynamics are currently foretelling a long-term bull market for

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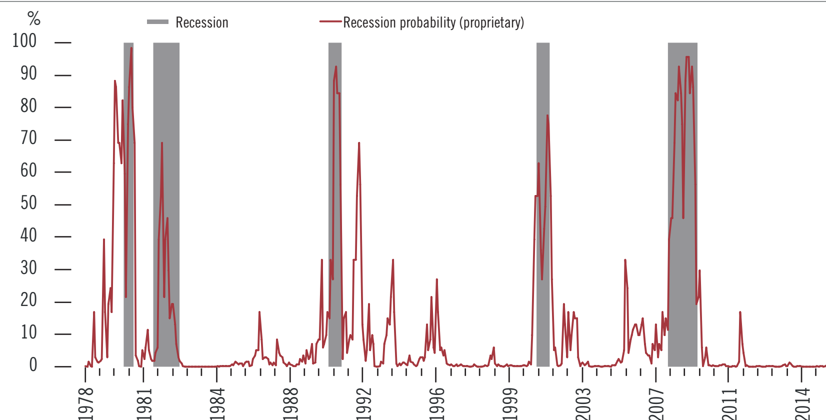
CHART 1: % PROBABILITY OF GLOBAL RECESSIONS, USING PROPRIETARY INDICATORS



Sources: NBER, Bloomberg, Datastream, Pictet WM-Quantitative Strategy

commodities. At the same time, a valuation gauge for property prices—the price-to-income ratio— suggests that property prices are presently undervalued in many peripheral parts of Europe and overvalued in several commodity-producing countries.

Time travel no longer pays

By discounting future cash flows to the present, or compounding current yields into the future, interest rates enable a form of time travel. The term premium (using the New York Fed's Adrian, Crump & Muench calculation) measures the additional yield buyers demand to hold 10-year paper instead of successive short-term notes. This premium has been positive for most of the past 50 years, but in mid-June stood at -0.52% for 10-year US Treasuries. Indeed, since the start of the year, the term premium has turned into a discount. So time travel no longer pays. There is currently no reward for immobilising funds in 10-year bonds instead of rolling over short-term notes for 10 years. For time travel (buying long-term bonds) to pay again, we need a pick-up in inflation— which usually occurs at this point of the economic cycle.

The subtle relationship between volatility and returns

Most of the time, the more volatile asset classes, like equities, generate better returns than less volatile assets like core government bonds. But during recessions (which are associated with equity bear markets), core government bonds produce higher returns. Arguably, some of the ingredients for a downturn are already present, but not to a sufficient degree to trigger an immediate recession. As an illustration, the Atlanta Fed's Wu-Xia Shadow Federal Funds rate—a model that integrates decades of historical data and takes account of recent quantitative easing measures to gain a more holistic measure of the impact of Fed policies—would in the past have had to go from its current level of 0.25% -0.50% to around 2.2% (which is 1.5%

above the 2-year rate) before a recession were triggered. The low probability of recession this analysis suggests should favour equities for now.

Higher-volatility asset classes generally reward investors by paying a higher return. But there is no compensation for high volatility within asset classes themselves. Quite the contrary: within the equities asset class, low volatility leads systematically to higher returns . Naturally enough, defensive (or less volatile) equities mainly outperform more cyclical peers during slowdowns. But over several complete economic cycles as well defensive equities outperform the broader market. This is because while the determinants of performance for all equities are similar, since defensive equities fall less during bear markets, there is more capital left for the compounding of returns.

Mean reversion–What goes up must come down

Observing that over the space of seven to 10 years deviations from fundamentals tend to correct, Benjamin Graham in his 1934 book, Security Analysis, pointed to one essential way to find undervalued companies. Thus, (and on the basis of Sidney Homer and Richard Sylla's magisterial A History of Interest Rates, interest rates are at their lowest level in 5000 years) government bonds have become highly overvalued after 35 years of strong performance, while emerging market equities and bonds are undervalued. Interestingly, mean reversion can also be observed over very short periods (see "The trend is your friend…").

TABLE 1: ALTERNATING MARKET DARLINGS AND RECESSIONS, 1973-2016

1973-1975	Recession
1975-1980	Technology
1980-1982	Double recession
1982-1990	Japan
1990-1991	Recession
1991-2000	Technology
2001	Recession
2002-2007	Emerging markets
2007-2009	Recession
2009-2016	Technology

Sources: NBER, Bloomberg, Datastream, Pictet WM Quantitative Strategy

Size versus quality–No need to choose

Quality stocks, irrespective of their size, tend to do better over long periods. But quality (high and stable profitability and low debt) nowadays tends to be an attribute of larger technology companies that appear to aim to be the sole supplier of every conceivable product and service. Smaller, more nimble companies are often thought to offer better potential returns than larger ones—but they have had an exceptional run-up since 2000 and are now expensive relative to fundamentals.

Geography or innovation?

Over the past two centuries at least, expectations of fast growth have alternately been embodied by emerging markets (or, more generally, by geography-related themes) or technology (or by broad innovation-related themes). Emerging markets were at the forefront of the 2003-2007 bull market, while technology has taken the lead since the end of the last recession in 2009. Analysis of past patterns suggests that emerging markets will become the market darling again in a new economic cycle. But technology could continue to perform well in the next cycle as well, in light of the new industrial revolution that started around 2012, revolving around the internet of things, artificial intelligence and gene editing.

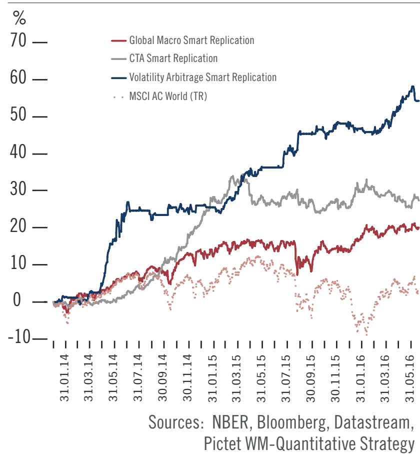
The trend is your friend, but it will bend

To the chagrin of 'active' managers, academic research supports claims that trend following (or momentum investing) is actually the strongest source of returns[1]. Many explanations for this have been proposed—one being the 'career risk' faced by active asset managers who fail to follow important investment trends.

Another approach to investing is to attempt to time the market by predicting turning points. 'Market timers' use events such as short-term market reversals to enter or exit trades. In a variation on this theme, asset allocators seize on leading indicators that turn before official

[1] *Dissecting Anomalies*, Eugene F. Fama and Kenneth R. French, Journal of Finance, vol. 63, no. 4, August 2008
Two Centuries of Trend Following, Y. Lempérière, C. Deremble, P. Seager, M. Potters, J. P. Bouchaud, Capital Fund Management, April 2014
A Century of Evidence on Trend-Following Investing, B. Hurst, Y. Ooi, L. Pedersen, AQR White Paper, September 2014
Two Centuries of Price Return Momentum, C. Geczy, M. Samonov, Financial Analysts Journal, Forthcoming

CHART 2: PERFORMANCE OF PROPRIETARY ALTERNATIVE STRATEGIES (IN US DOLLARS) SINCE 2013



Sources: NBER, Bloomberg, Datastream, Pictet WM-Quantitative Strategy

numbers do (anticipating instead of following trends). These leading indicators are the secret ingredient of some global macro hedge funds. Just to give a flavour, because oil prices have yet to double on a rolling 12-month basis, as they often do just before recessions, some fund managers believe the outlook is more favourable for equities than for bonds at the moment.

During volatile periods, both trend-following and market timing can increase the risk-adjusted returns of balanced portfolios, as calculated by the Sharpe ratio (excess returns over cash adjusted for volatility). This suggests that balanced mandates should include trend-following managed-futures (CTA), global macro, and rival alternative strategies.

Investors can sell volatility—for instance through much-in-vogue market-neutral equity strategies. The latter involve taking long positions in equities expected to increase in value and taking short positions in those expected to decline in relative terms. Carry strategies involve borrowing at low rates to invest at high rates, while another alternative strategy involves benefiting from the illiquidity premium paid by private-equity investments. Alternative strategies such as these can increase returns in bull markets, but may be more volatile during bear markets. Such strategies performed well in the past as long as equities kept rising. (Of note, our battery of indicators currently suggests equities should continue to do well for the moment).

Conclusion – machines as partners

Correlation effects mean a combination of the strategies cited in this article can produce higher risk-adjusted returns than any one of them taken alone. Portfolio weightings that deviate from weightings based simply on market capitalisation open up a world of opportunities, for instance by using leverage to build an optimal combination of assets with different volatilities (risk parity).

But to combine various sources of returns in a portfolio means developing a hybrid of IT, financial and macroeconomic analysis techniques. Over the years, Pictet has invested heavily in this area, building up the technology architecture that allows it to back-test and run any combination of strategies automatically. Beyond back testing, computers at Pictet are already running some portfolios automatically or finding patterns in financial markets (artificial intelligence) under the guidance of human experts. Computers can't (yet) think on their own. But there are already hints that computers together with human experts can find new sources of return quite different from the ones currently fraying the nerves of numerous investment professionals.

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Post-Brexit growth forecasts revised downwards

The UK's Brexit vote has caused us to revise downwards our growth forecasts for some economies this year and next. This is notably the case for the UK, where our forecast is well below consensus. Of note is the strong performance of the yen so far this year (to the chagrin of Japanese exporters) and of local-currency emerging debt.

Data in charts and tables on this page are as of Juni 30, 2016

MAIN ECONOMIC INDICATORS

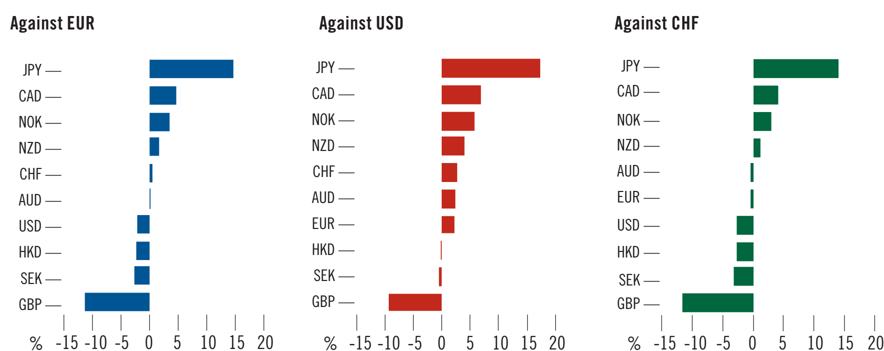
Pictet estimates – (consensus*)

GDP growth rates	2014	2015	2016E		2017E	
US	2.4%	2.4%	1.8%	(1.9%)	2.0%	(2.3%)
Euro area	0.9%	1.5%	1.5%	(1.6%)	1.3%	(1.6%)
Switzerland	1.9%	0.9%	0.9%	(1.1%)	1.5%	(1.5%)
UK	2.9%	2.3%	1.3%	(1.9%)	0.9%	(2.1%)
Japan	-0.1%	0.6%	0.6%	(0.5%)	0.5%	(0.9%)
China	7.3%	6.9%	6.5%	(6.4%)	6.2%	(6.2%)
Brazil	0.1%	-3.9%	-3.8%	(-3.7%)	0.9%	(0.7%)
Russia	0.5%	-3.3%	-1.6%	(-1.3%)	1.2%	(1.1%)

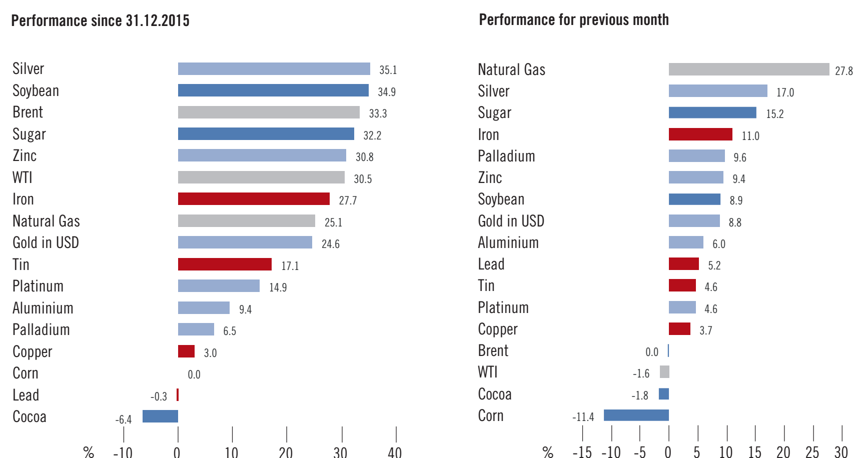
Inflation (IPC) Annual average, except year-end for Brazil	2014	2015	2016E		2017E	
US	1.6%	0.1%	1.4%	(1.3%)	2.4%	(2.3%)
Euro area	0.4%	0.0%	0.1%	(0.2%)	1.1%	(1.3%)
Switzerland	0.0%	-1.1%	-0.5%	(-0.6%)	0.3%	(0.2%)
UK	1.5%	0.0%	0.9%	(0.6%)	1.9%	(1.6%)
Japan	2.7%	0.8%	0.1%	(-0.1%)	1.1%	(0.9%)
China	2.0%	1.4%	2.2%	(1.5%)	1.8%	(1.7%)
Brazil	6.3%	9.0%	8.6%	(7.0%)	5.7%	(5.5%)
Russia	7.8%	15.5%	8.0%	(7.5%)	5.9%	(5.7%)

*Source: Consensus Economics Inc

EXCHANGE-RATE MOVEMENTS (SINCE 31.12.2015)



COMMODITIES

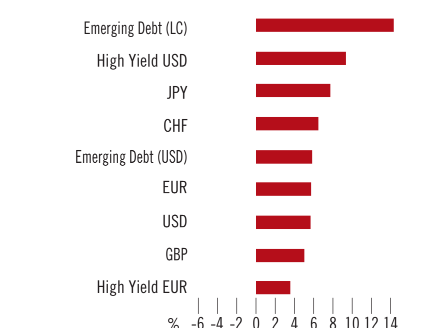


INTEREST RATES

	Short (3 months)	Long (10 years)
US	0.50%	1.5%
Euro area	0.00%	-0.1%
Switzerland	-0.75%	-0.6%
UK	0.5%	1.0%
Japan	0.0%	-0.2%
China	2.10% (1 year)	4.8% (5 years)
Brazil	14.25%	12.1%

BOND MARKETS

Returns since 31.12.2015



STOCK MARKETS

Returns since 31.12.2015	USD	EUR	CHF	GBP
MSCI World*	1.0%	-1.2%	-1.7%	11.4%
S&P 500*	3.8%	1.5%	1.1%	14.5%
MSCI Europe*	-4.6%	-6.7%	-7.2%	5.2%
Tokyo SE (Topix)*	-4.5%	-6.6%	-7.0%	5.3%
MSCI Pacific ex. Japan*	2.3%	0.1%	-0.4%	12.8%
SPI*	-2.2%	-4.3%	-4.8%	7.9%
Nasdaq	-3.3%	-5.4%	-5.9%	6.6%
MSCI Em. Markets*	6.6%	4.2%	3.7%	17.5%
Russell 2000	1.4%	-0.8%	-1.3%	11.8%

* Reinvested dividends

SECTORS

Returns since 31.12.2015	US	Europe	World
Industrials	6.4%	-4.3%	2.8%
IT	-1.3%	-10.5%	-2.2%
Materials	5.9%	1.0%	7.1%
Telecommunications	21.0%	-13.1%	8.1%
Health care	-1.1%	-7.4%	-2.6%
Energy	13.2%	12.6%	14.4%
Utilities	21.1%	-2.2%	11.6%
Finance	-4.1%	-25.7%	-9.7%
Consumer staples	8.9%	2.5%	7.1%
Consumer discretionary	-0.6%	-16.9%	-5.7%

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