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4.4%
Annual return from a 60/40 portfolio over the next decade according to our in-house model
Page 2

2.5%
Our expectation for US GDP growth in the third quarter
Page 4

+12%
The rise of the Stoxx Europe 600 equity index in July-August
Page 6

+0.2%
Headline annual inflation in the euro area in July and August
Page 6

+500%
Rise in consumer price inflation expected this year in Venezuela
Page 8

1.7%
Our two-month forecast for the US 10-year T-bond yield
Page 10

-3.1%
Decline in gold price during August
Page 11

50
India's target place in Ease of Doing Business Index, up from 142 in 2014
Page 12

A quiet summer helped risk assets to regain traction, but important political and economic issues are fast looming into view

September 2016

Perspectives

EDITORIAL OUTLOOK

Private equity to the rescue

Christophe Donay,
Head of Asset Allocation and Macroeconomic Research,
Chief Strategist

Positive returns on assets are becoming a rare commodity. Historical analysis suggests that a portfolio split between 60% US equities and 40% US Treasury bonds could expect to earn an average total return of 7.6% annually since 1800[1]. But the financial crisis of 2007-08 and the extraordinary measures introduced to combat it have changed the landscape for investing. Now, in an age of comparatively low growth and low inflation, our in-house models are showing that, all things being equal, expected returns for the same 60/40 portfolio over the next decade will be little more than 4.4% per annum. Even adjusted for inflation, prospects for portfolio returns look far weaker than they did in the past.

How did we arrive at this situation? A major factor has been the dramatic fall in bond yields, pushed down by weak growth and flights to safety, and kept down by massive central bank buying of government bonds and successive cuts in base rates. But it is hard to see nominal interest rates declining further from where they are, which means their future return potential is limited. Should the yield on 10-year US Treasuries remain at 1.60%, which is where they were in summer 2016, then investors could expect a nominal annual return of the same order from this source. By comparison, Treasuries delivered an average annual return of 8.7% during the 30 years up to 2012. Even the gradual, shallow tightening of base rates that many market observers are expecting in the US would not change expected returns very much.

Low growth and an environment that remains broadly deflationary (linked to the deployment of new technologies, population ageing, the absence of labour-market pressures, etc) mean that expected returns from equities over the next decade could also be disappointing by historic standards. There is a growing realisation that loose monetary policy alone will not manage to reflate economies. And along with low inflation and growth, stretched valuations are also feeding into the deteriorating prospect for returns. Our models indicate that in the absence of an innovation shock, average total returns from US and European equities could be closer to 6% per annum than the 7.5% or so that the S&P 500 has delivered since 1800.

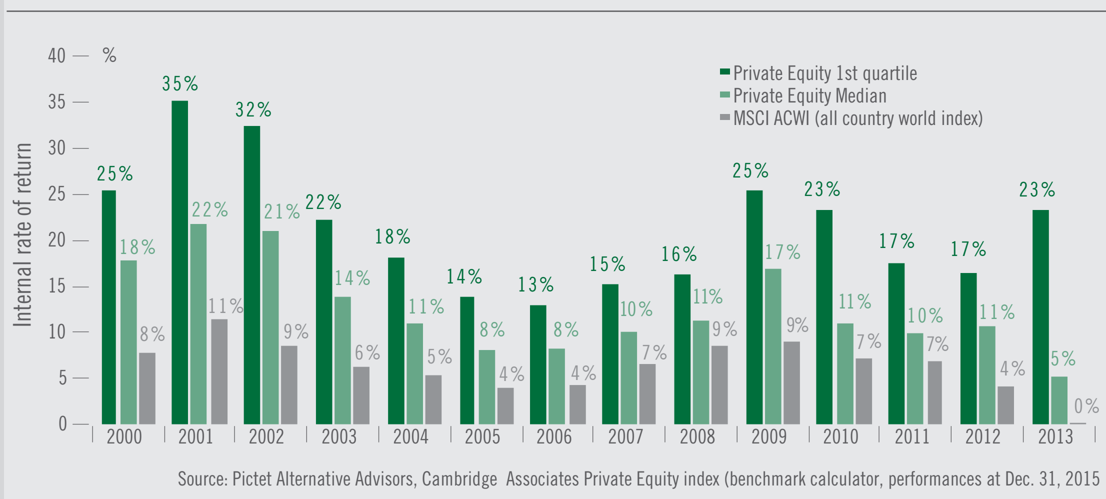
Not surprisingly given the relatively poor prospects for classic government bonds and equities, portfolio managers have been looking for alternatives, leading to renewed interest in high-yield and emerging-market bonds, as well as various, ever more complicated kinds of derivatives and real-estate vehicles.

In our view, one particularly interesting avenue is private equity. Our research suggests that private equity has consistently outperformed equities since the beginning of the century. Bearing in mind that past performance is no indication of future returns, and bearing in mind too that there is a significant illiquidity premium to pay (private equity investments are typically locked in for a period of 10 years or so), the result of our analysis is striking: any single vintage (the year when a private equity fund first invests) included on the Cambridge Associates Private Equity fund index has outperformed the MSCI World index by an average ratio of about 2:1 each year since the beginning of this century. This outperformance has been remarkably consistent (an exception is 2008, at the height of the financial crisis, when the ratio fell to 1.4:1).

Just as interestingly, our research indicates that the excess returns delivered by the top quartile of private equity funds of a given vintage have been on average up to three times higher than those of the MSCI World Index since the beginning of the century. Our models suggest that based on past trends, a traditional 60/40 portfolio that switched 15% of its allocation to private equity could lift its potential return from an annual average of 4% over the next decade to 6%.

[1] *Data supplied by Global Financial Data for the period 1800 to June 2015.*

PERFORMANCE OF PRIVATE EQUITY BY VINTAGE, 2000-2015



Source: Pictet Alternative Advisors, Cambridge Associates Private Equity index (benchmark calculator, performances at Dec. 31, 2015

The next question is why private equity has been offering such superior returns. Since 2008, private equity funds have clearly received a big boost from strengthening public equity and debt markets on the back of quantitative easing as well as the low yields offered by other forms of investment. Indeed, benefiting from depressed prices, private equity vintages launched at the height of the financial crisis have proven to be particularly successful in producing returns. But that does not explain their outperformance over the longer term. Some observers believe private equity capital can allow companies to take a longer-term view of strategy and restructuring compared to companies reliant on public markets, which come under more short-term pressures. Private equity partners' active involvement in the management of companies and their strategic orientation can also serve to create value. The best private-equity funds work hard to spruce up beaten-down or over-looked assets to extract value from them. Some academics also believe that the answer to private equity's outperformance is down to the ability of private-equity firms to buy low-beta (cash-generating and less volatile) stocks using leverage.

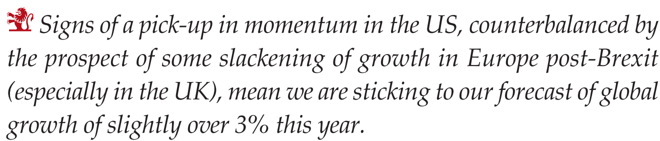
Of course, private equity is not immune from changing market conditions. There were mark downs across a range of industries at the beginning of this year (notably in energy and in sectors connected to emerging markets), but as markets have generally rebounded since then and as the search for yield has become ever more intense, there are reports that private-equity funds are having to pay higher prices for investments and that, as a result, it has become more difficult to identify opportunities with true value-added potential. The coming rise in interest rates in the US while also affect private-equity firms that rely on leverage. It is therefore particularly important to understand the capital growth drivers behind private-equity strategies and to be capable of spotting top-performing managers.

Yet the fact remains that private equity investments have demonstrated superior risk/return characteristics over the past three decades. Returns surpass those of public equity markets, with top-quartile funds usually generating consistently strong multiples on invested capital that compensate investors for the long-term nature of such investments. It is therefore no surprise that private equity is increasingly becoming a standard feature of large portfolios.

Large economies pulling through, but difficult issues are coming to the fore

Summer proved to be relatively serene for major economies, with signs the US economy is regaining momentum and Brexit causing limited disruption (so far). But the world economy remains stuck in low gear.

Christophe Donay, Bernard Lambert, Frederik Ducrozet and Dong Chen



Signs of a pick-up in momentum in the US, counterbalanced by the prospect of some slackening of growth in Europe post-Brexit (especially in the UK), mean we are sticking to our forecast of global growth of slightly over 3% this year.

A host of figures showing a healthy economy (including wage and employment growth) are pointing to a significant pick-up in growth in the US after a disappointing first half and we believe US growth this year will be of the order of 1.5%. Data released in early August suggested a sluggish start to the second half for the Chinese economy, but monetary and fiscal support should help maintain GDP growth at around 6.5% this year. Fiscal stimulus has also become the order of the day in Japan, where the government announced a sizable budgetary package at the end of July, although its near-term impact is likely to be limited. The Japanese economy served up a worse-than-expected performance in the second quarter, growing at a miserly annualised rate of 0.2%.

The euro area would also seem to be on an even keel. Growth slowed in the second quarter as expected, but leading indicators show that activity continues to expand, so that we believe real GDP growth in the euro area will reach 1.5% this year. The impact of the Brexit vote of 23 June seems limited for the moment; far from weakening, following a brief post-referendum swoon the euro has actually strengthened in recent weeks--not only against sterling, but also against the US dollar. And despite the dire predictions for the UK following the Brexit vote, employment and retail sales figures there continued to plough ahead in July. Consumer and business surveys indicate the worst may be yet to come, but Bank of England intervention and expansionary budgetary measures could well soften the blow.

But like Japan, the skies above Europe are not entirely clear. There are still a number of downside risks (political as well as economic) that offset the upswing we are seeing in the US. Resilience in the face of Brexit does not mean that political and economic issues have gone away. While growth remains low and uneven, there is still no consensus on the need for fiscal stimulus even as the limits of monetary policy become more apparent. Italy will likely be firmly in focus, given the country's long-running economic decline, the fragility of its banking sector, and an autumn constitutional referendum on which prime minister Matteo Renzi has staked his government's credibility.

Noticeable rebound in US economic growth likely

At 1.1% quarter-on-quarter annualised, US GDP growth was surprisingly soft in the second quarter. Moreover, as the previous quarters were revised down noticeably, it now appears that growth settled at a meagre 1.2% in the second quarter of 2016 compared to the same quarter of 2015. However, consumer spending was very strong in Q2 and final demand grew healthily, the main reason behind the weak GDP number being a sharply negative contribution from stock building. Inventories actually fell in Q2, a very rare outcome outside of recessions, and usually followed by a sharp reversal in stock building. Financial conditions have eased back markedly over the past few months, exports are recovering modestly and the collapse in investment in the oil sector is ending. Data released so far for July and August are consistent with our belief that the US is picking up momentum. We expect GDP growth to rebound to 2.5% in Q3 and 2.0% in Q4. Nevertheless, after taking into account the softness registered in the first half, we have had to cut our yearly GDP growth forecast for 2016 from 1.8% to 1.5%. Our forecast for 2017 remains unchanged at 2.0%.

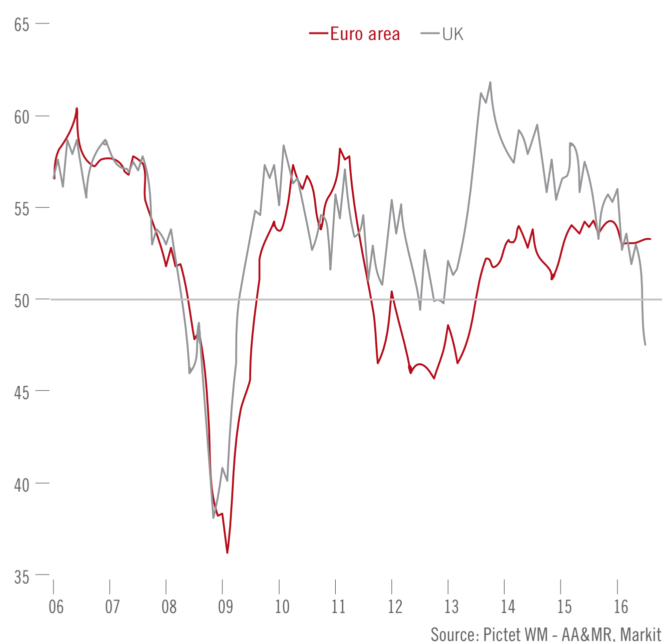
Recent remarks from Federal Reserve (Fed) members—notably from Chairwoman Yellen and Vice Chairman Fischer—suggest that the Fed is more confident about the economic outlook and less worried about downside risks, and that it would like to hike rates sometime in the near future. However, inflation and inflation expectations remain subdued. July's core PCE inflation remained unchanged at 1.6% for the fifth month in a row. And although wage increases have picked up somewhat, they remain relatively low. As a result, we continue to believe that the most likely scenario is that the Fed will wait until December before acting although the possibility of a hike in September has certainly risen following the latest Fed comments. For 2017, we continue to forecast two quarter-point hikes.

Euro area: cyclically resilient but structurally challenged

In the last couple of months, high-frequency macro data have remained broadly consistent with our post-Brexit forecasts, which foresee euro area GDP growth of 1.5% in 2016 and 1.3% in 2017. However, the balance of risks has improved on the back of surprisingly resilient business surveys and credit data, in particular. Some caution is warranted as both Brexit negotiations and unresolved issues in the banking sector, particularly in Italy, may still have delayed consequences for broader financial conditions and activity in the euro area. In addition, an elevated political risk premium in Italy and in Spain is likely to act as a drag on investment at some point.

Still, at this stage, most indicators continue to point to an ongoing expansion in domestic demand in Q3, while the contribution of foreign trade to growth has become positive

COMPOSITE PMIS FOR UK (TO JULY 2016) AND EURO AREA (TO AUGUST 2016)



Source: Pictet WM - AA&MR, Markit

again and a pick-up in growth in the US may help at the margin. Interestingly, our forecasts point to a (limited) 're-convergence' across the larger euro area countries as GDP growth looks set to rebound in France and Italy, the two laggards in the current cycle with the greatest potential for catch-up.

"Resilience in the face of Brexit does not mean that political and economic issues have gone away."

Notwithstanding positive data surprises, the outlook for inflation remains challenging despite all the ECB's efforts. True, headline inflation has started to rise, to 0.2% in July and August compared with 0.1% in June, but underlying consumer prices lack momentum. As reported by Eurostat, core in August HICP inflation excluding energy, food, alcohol and tobacco fell back to the bottom of the 0.8-1.0% range it is has been stuck in since quantitative easing (QE) started in March 2015. The ECB is sounding increasingly concerned over subdued core prices and wage dynamics. We expect further downward revisions to core inflation forecasts from ECB staff in the next few quarters, paving the way for an extension in QE by year end along with a loosening in the parameters applied to the ECB's asset purchases.

China remains on course for 6.5% growth

Macro data in the last couple of months generally pointed to a softening in China's growth momentum, as expected. Fixed-asset investment slowed down significantly in July as construction weakened, a reversal of the rebound that began in late 2015. We expect fixed-asset investment to decline further in the months ahead as the property market continues to lose steam.

After a slow start, the government seems to be becoming more serious about cutting overcapacity in heavy industry, with an acceleration in capacity reductions in the coal-mining and steel-making industries. Stricter enforcement of capacity controls will likely pose more headwinds to near-term growth, although it should bring benefits to the Chinese economy in the medium and long term. Inflation has largely remained stable, in line with tame food prices, but an improvement in producer prices as a result of a rebound in global commodity prices has benefited industrial profits.

The central bank has clearly eased off on monetary stimulus, with a decline in the growth of new bank lending compared to the same period last year, especially those to non-financial corporates. A similar pattern can be observed for total social financing, a more comprehensive measure of credit creation in the economy. However, it's worth noting that China's household sector, which historically has never borrowed heavily, has been levering up rather quickly as a result of the recent spike in property prices. Bank loans to households surpassed those to non-financial corporates in the three months to end July— a rare phenomenon, previously only seen for short periods in 2007 and 2009. But while the average loan-to-value ratio for properties sold rose from less than 40% in 2013 to nearly 80% in Q2 2016, we still do not believe this will lead to any imminent financial risks. However, the rise in household indebtedness, combined with the fairly stable inflation outlook, will likely limit further monetary easing in the near future.

On the fiscal policy front, we expect continued government support for infrastructure investment to provide some cushion to economic slowdown. The increase in local governments' quota for specialised government bonds to Rmb300 billion this year from Rmb100 billion in 2015 provides additional resources for infrastructure construction. All in all, we continue to expect China to grow by about 6.5% this year. In spite of gradual reforms, however, important structural issues remain.

Equities regain their lustre, fixed-income prospects less clear

With risk back on, emerging-market equities, US high yield bonds and hedge funds have all returned to favour among investors, while precious metals have faded.

Christophe Donay, Jacques Henry, Luc Luyet and Alexandre Tavazzi

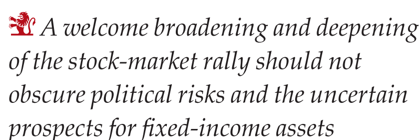
FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 31.08.2016

		Index	Since 31.12.2015	Previous month
US equities*	USD	S&P 500	7.8%	0.1%
European equities*	EUR	Stoxx Europe 600	-3.2%	0.8%
Emerging-market equities*	USD	MSCI Emerging Markets	14.8%	2.5%
US government bonds*	USD	ML Treasury Master	5.5%	-0.6%
US investment grade*	USD	ML Corp Master	9.4%	0.3%
US high yield*	USD	ML US High Yield Master II	14.6%	2.2%
Hedge funds	USD	Credit Suisse Tremont Index Global**	-0.5%	1.1%
Commodities	USD	Reuters Commodities Index	2.3%	-0.4%
Gold	USD	Gold Troy Ounce	23.1%	-3.1%

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

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



A welcome broadening and deepening of the stock-market rally should not obscure political risks and the uncertain prospects for fixed-income assets

The summer months were mostly positive for risk assets, with major US stock indices reaching record highs. Equities quickly brushed off Brexit to push close to new highs, helped by generally firm economic data in Europe and the US and by the upturn in the fortunes of commodity producers. Even financials--on the ropes earlier this year--started to shine again. The upturn in optimism has resulted in sector rotation, with cyclicals outperforming more defensive stocks. Valuations are high, particularly in the US, and there is room for disappointment if earnings do not meet expectations. But excepting Japanese equities (penalised by a strong yen), the upturn in oil prices, ongoing bank restructuring in Europe, and stabilisation or some improvement in global growth plead in favour of equities. At the same time, we cannot ignore ongoing political risks: along with a highly-charged US presidential election, these include continuing uncertainty surrounding Brexit and instability in countries such as Italy and Spain.

The MSCI Emerging Markets index has been outperforming the MSCI World, thanks in part to strong foreign inflows and a relatively benign vision of US rate hikes. Here too, some caution may be merited as the Fed becomes more hawkish. However, bar the odd blip, emerging market bonds and currencies performed well throughout the summer months. Early-year turbulence in Chinese markets has faded, helped by large doses of budgetary and monetary intervention.

Although they still have a role in well-diversified portfolios and have continued to perform, long-dated bonds remain vulnerable to any unexpected fall-out from tightening of US base rates. Bond yields have turned negative across longer durations in many places. Even for benchmark US Treasuries, risks will rise if, as we suspect, current inflation expectations turn out to be excessively low. Corporate credit has performed well in the current low-yielding environment, but it is questionable how much longer the credit rally can continue. The European Central Bank continues to exert a considerable grip on European credit through its purchase programme, but how far more it can squeeze the market before somebody gets hurt is not clear.

How much fiscal authorities will spend in a bid to keep growth and inflation humming along in the global economy is also increasingly an issue for market participants. Faced with low yields and the risks attached to government bonds, as well as the high valuations attached to public equities, we are looking at the potential of private equity to diversify sources of return (*see editorial*).

Equities: cyclical sectors improve

During August, all major equity indices rose, the US ones reaching new highs.

Some improvements in underlying market fundamentals also appeared and should last beyond 2016. The global pricing environment is improving thanks to rising commodity and oil prices, which meant that Q2 earnings in cyclical sectors surprised positively and the upward revision in earnings estimates meant they outperformed broad indices in August. There was also an increase in the number of stocks participating to the rebound in the S&P 500 (+9%) and Stoxx600 (+12%) in the two months to end August. This improvement was accompanied by a big decline in volatility (from 25% in June to 11% in August), indicating that investors have less need for protection.

Current expectations of 13% earnings growth in the US and Europe look credible to us as cyclical sectors, which have been the source of multiple downward revisions since 2014, should now contribute positively. Moreover, the expected contributions to earnings growth are

well spread among sectors, limiting potential disappointments. Thus, for the first time since 2014, earnings growth could well be above 10% in 2017. The corresponding valuation levels (16.4x for the S&P500 and 14.5x for the Eurostoxx600) appear more reasonable in this light. In short, developed equity markets may still have upside potential, but are still subject to spurts of volatility.

FX influence different in EM and DM indices

Japan and the UK have posted starkly opposite local-currency returns, with a 13% decrease for the TOPIX and a 12% increase for the FTSE100 in the first eight months of 2016. Those movements are in line with significant currency movements, as the yen has appreciated by 16.3% over the same period while the pound has depreciated 11%, mainly since the June Brexit vote. DM equity markets are usually negatively correlated with FX, but this year the negative correlation has been unusually pronounced. The transmission mechanism is mainly through earnings, as those indices that combine a strong global exposure and weak currency receive a boost from the earnings of listed companies repatriated from abroad. This was the cornerstone of the TOPIX's strong performance in 2013-2015. This is quite different from the behaviour of emerging markets and developed markets closely linked to commodities. Here, the YTD increase in commodity prices has been supportive for both currencies and equities, but the return dispersion is somewhat wider.

BoJ buying Japanese equities

Japanese equities have posted the worst YTD return among major equity markets with a 13% decline in the first eight months of 2016. Yet the TOPIX has bounced back 6.8% over the past two months alone, while the exchange rate has remained fairly stable at around 102 yen per USD. Earnings momentum remains weak, as 2016 and 2017 earnings expectations were revised down in August by 1.4% and 1.0%, respectively. But even expected earnings growth for next year of 10.2% (based on top-line growth of 3%) looks challenging in the current FX environment. Two factors can explain the recent resilience of Japanese equities. First, investors are expecting bold new Bank of Japan (BoJ) measures to weaken the currency at its September policy meeting. Second, the BoJ has become the main buyer of Japanese equities, holding half of Japanese equities ETFs, which account for around 5% of the TOPIX's market capitalisation.

BoJ to keep fighting deflationary forces

The 21 September could be a very eventful day for forex markets as both the Fed and BoJ hold monetary-policy meetings on that date. However, whereas the Fed is looking to raise rates before year's end (most likely in December), the BoJ may ease policy further after a comprehensive assessment of the impact of its bold monetary programmes up to now.

Given that inflation remains well below the BoJ's 2% target (CPI ex fresh food was -0.5% y-o-y in July), given that the pool of eligible Japanese bonds it is looking to buy is rapidly shrinking, and given that the success of negative rates remains questionable, it will be an interesting meeting. We continue to expect that the BoJ will maintain its resolve to bring inflation back to its target at the "earliest time possible", favouring further easing measures such as deeper negative rates. However, we remain sceptical on the practical effects of extending existing policies and expect that, ultimately, bolder actions will be required. Hopefully for the Japanese economy, the persistent divergence in monetary policies between the US and Japan will at least favour a mild appreciation of the USD vis-à-vis the JPY in the coming months.

Renewed talk of output freeze

Oil prices remain supported by prospects of the market moving into deficit (demand exceeding supply), thanks to robust global demand and declining non-OPEC output. Given that Brexit has proved to have had a muted impact on global oil demand thus far, supply dynamics are likely to be the key driver for oil prices in the coming months. But although an agreement on an output freeze at end-September is more likely than it was in April (when it was last mooted), the fact that Russian and Saudi output is close to historical highs should mitigate any positive impact on prices of such a freeze.

The inflation conundrum

In spite of ever-more radical policy loosening by central banks, inflation remains notable by its absence in most industrialised countries. Stable or improving growth, tightening labour markets, and low productivity gains that should push up core inflation in large industrialised economies are being offset by disinflation from abroad. But some commodity-importing emerging markets, India among them, appear to be in an inflation 'sweet spot', with falls in inflation contributing to gains in real GDP and affording central banks extra policy flexibility.

+0.2%

The euro area harmonised index of consumer prices (HICP) rose to an annual rate of 0.2% in July[6] and again in August (according to Flash estimates). The all-item HICP is therefore at the same level as one year before, but higher than the -0.2% recorded in April 2016. **Excluding energy, the annual HICP in July was 1.0% and an estimated 0.9% in August.**

2.2%

US core consumer price inflation (CPI, excluding food and energy) slipped to a year-on-year rate of 2.2% in July, from 2.3% in June[2] . Prices including energy and food were up 0.8% in July from a year earlier, also a slower rate than in June. **Inflation in the US has lagged strong job growth, although some observers believe that rises in average hourly earnings and firmer US growth will put upward pressure on prices.**

c. 500%

The International Monetary Fund said it expected consumer prices in Venezuela to rise by 480% this year and (assuming there are still goods to buy) to over 1,600% in 2017[3], but **a tweet based on leaked monthly data say annualized inflation rate has already reached 1,000%[4].** The central bank estimated annual consumer price inflation was a modest 181% in 2015[5] .

+40%

Argentinian consumer prices rose at a month-over-month rate of 2.0% in July, well down from 3.1% in June[8] and 4.2% in May. The May figures were the first from a revamped INDEC after a "statistical emergency" was declared in December 2015. A previous government is accused of having manipulated INDEC data to downplay price rises. A **central bank poll of analysts still expects annual price increases to top 40% this year before dipping below 20% in 2017.**

1 Australian Bureau of Statistics, 27 July 2016 http://www.abs.gov.au/ausstats/abs%40.nsf/mediareleasesbyCatalogue/902A92E190C24630CA2573220079CCD9?OpenDocument
2 Bureau of Labor Statistics, 16 August 2016 http://www.bls.gov/news.release/pdf/cpi.pdf
3 International Monetary Fund, April 2016 http://www.imf.org/external/country/VEN/index.htm
4 Francisco J. Monaldi, https://twitter.com/fmonaldi
5 Banco central de Venezuela, 18 February 2016 http://www.bcv.org.ve/Upload/Comunicados/aviso180216.pdf
6 Eurostat, 29 July 2016 http://ec.europa.eu/eurostat/documents/2995521/7572517/2-29072016-BP- EN.pdf/a93ad3a1-5ff4-4310-a01c-2a439e090c85

-1.1%

Month-on-month inflation was -0.4% in Switzerland in July. The year-on-year rate was -0.2%. Average annual inflation was -1.1% in 2015[11]. **The last time Swiss inflation was positive was…in 2011, when it reached 0.2%.** Consumer confidence and retail sales figures have also been negative.

+1.8%

China's CPI advanced at a rate of 1.8% year on year in July, down from 1.9% in June and 2.3%[10] in April. **Consumer price increases therefore remain well below the government's 3% inflation target for 2016 and point to anemic economic growth.**

-0.4%

Japan's nationwide consumer price index (less fresh food) fell by 0.5% year on year in July[9], the fifth straight month of declines. Prices excluding food and energy were up a mere 0.3% compared to a year earlier, showing that consumption trends remain weak. **The spectre of deflation still looms, and the Bank of Japan remains far from achieving its inflation target of 2%.**

+6.1%

Consumer prices in India accelerated in July, to a year-on-year rate of 6.1% from 5.8% in June[7]. Food inflation rose to 8.4% in July. Thanks to the drop in energy prices and the efforts of the Reserve Bank of India, **CPI has declined substantially since early 2013, when it topped 12%, but the latest figures are still above the RBI's target of 5% inflation** by March 2017.

+1.5%

Australian core price inflation (ex energy and food prices) came in at a year-on-year of 1.5%[1] in the quarter ended 30 June, well below the Reserve Bank of Australia's (RBA) target of 2-3%. In an attempt to lift sluggish price growth and help the economy, the RBA cut base interest rates to a record low of 1.5% on August 2.

[7] Ministry of Statistics and Programme Implementation (MOSPI), 12 July 2016 http://mospi.nic.in/Mospi_New/upload/cpi_pr_12aug16f.pdf
[8] INDEC, 12 August 2016 http://www.indec.gov.ar/uploads/informesdeprensa/ipc_08_16.pdf
[9] Japan Statistics Bureau, 26 August 2016 http://www.stat.go.jp/english/data/cpi/1581.htm
[10] National Bureau of Statistics, 8 August 2016 http://www.stats.gov.cn/english/PressRelease/201608/t20160809_1386544.html
[11] Federal Statistical Office, 8 August 2016 http://www.bfs.admin.ch/bfs/portal/en/index/news/medienmitteilungen.html?pressID=11023
[12] Secretariat for Economic Affairs (SECO), 4 August 2016 http://www.bfs.admin.ch/bfs/portal/en/index/news/medienmitteilungen.html?pressID=11023

The lazy, glorious days of summer

Any worries about Brexit faded during summer, allowing an array of risk assets to shine. Equities have benefited from improvements in earnings and corporate debt benefited from the hunt for yield. The main losers from the improvement in sentiment have been precious metals.

Equities

No Brexit blues

Improving fundamentals and better earnings.

Equity markets quickly forgot the Brexit shock to concentrate on the improvements in market fundamentals that appeared during August. The MSCI World Index reported a total return of 0.1% over the month in US dollars, while the MSCI EM index returned 2.5%. Among emerging markets, China and Hong Kong performed the best with returns of 7.3% and 5.2%, respectively. In developed markets, Europe (+0.8%) was slightly ahead of the US market (+0.1%) in local currency terms, thanks to the German (+2.5%) and the UK (+1.7%) markets. The Topix rose by 0.5% in local currency during August. Thus, markets were quick to rebound after the UK referendum of 23 June as it became clearer that the vote for Brexit would not impact the global economy. The very high volatility recorded right after the referendum quickly declined to levels last seen in 2014 (11.3% in the US at the end of August and 20% in Europe).

Second-quarter results published during August justified optimism as US and European companies' earnings were ahead of expectations by 1.8% and 8.7%, respectively. Cyclicals and financials posted positive surprises for the second quarter in a row, allowing upwards revisions for the whole year and an improvement in profit margins. Despite these improvements, 2016 valuations remained on the high side at end August, at 18.6x for the S&P500, 16.4x for the Stoxx 600 and 13.9x for the Topix. Based on 2017 estimates, valuations appear more reasonable, at 16.4x in the US, 14.5x in Europe and 12.6x in Japan.

Bonds

Risk-on mood benefits Spain & Italy

Higher yields on core sovereign bonds help peripheral bonds outperform.

As Brexit fears have eased, safe-haven government bonds—with the exception of United Kingdom gilts, which have benefited from Bank of England quantitative easing (QE)—have underperformed Italian and Spanish bonds. In line with our scenario, the 10-year US Treasury yield rose 13bp in August to 1.58%, as market expectations of another US Federal Reserve hike in December increased to 61%. We believe the gradual shift upward should continue, with the yield reaching 1.7% in the coming two months.

As the European Central Bank (ECB) remains in easing mode, the 10-year German Bund yield has remained in negative territory (-0.07% at end August). We do not expect the ECB to act in September but rather in December, when it may announce a six-month extension to QE and a change in its parameters as it runs out of German bonds to buy. For this reason, the 10-year Bund yield could rise slightly, to 0.08% in the next two months.

Italian and Spanish bonds rallied in August, with spreads over Bunds tightening by about 7bp. Idiosyncratic risks remain elevated. In Italy, these include a constitutional referendum this autumn and banks' non-performing loans problems, and in Spain, the lack of a government. However, a small chance that a minority centre-right government will be formed and strong economic growth means we have a favourable bias towards Spain.

Corporate bonds

High yield outperforming

High yield outpaces investment grade thanks to renewed risk appetite.

High yield posted a strong performance in August, with the BofAML* US dollar index returning 2.3% and its equivalent for the euro 1.7%, thanks to investors' risk-on mood. Spreads versus sovereign bonds tightened spectacularly as yields kept falling, tumbling below 4% for euro high yield. The outperformance of US dollar high yield was due to the rebound in oil prices. In euro, the energy effect was more subdued but the financial sector contributed positively. However, due to the non-performing loans (NPL) issues facing Italian banks and worries regarding the banking sector's profitability in general, credit default swaps on euro high yield financial subordinated debt remain elevated and volatile, illustrating market fears. For this reason, as long as the NPL problem is unsolved, US dollar high yield should keep outperforming its euro counterpart—although a resumption of the US Federal Reserve's hiking cycle could reverse this tendency.

US dollar and euro indices of investment-grade bonds were flat in August, with yields slightly higher in the US due to rising US Treasury yields. However, corporate bonds served as buffer against this rise, as spreads have tightened. Even if credit has already performed strongly year to date, spreads over sovereign bonds remain attractive for now in a low-yielding environment.

* *BofAML (Bank of America Merrill Lynch) performances are posted in total return.*

Hedge funds

What's in store for equity hedge strategies?

Equity hedge managers had a tough first half, but have been recouping losses.

The first half of 2016 was among the most challenging semesters ever for equity hedge managers. Choppy market moves and a series of rotations in risk factors were the main culprits of underperformance, which was almost indiscriminate across portfolios regardless of style, geographical focus or sector bias. Most strategies, with the notable exception of trading-focused ones, struggled in a period when stock price movements were disconnected from companies' fundamentals, especially around the time of earning releases. Besides acute reversals in momentum and sector leadership, hedge funds' most long-held stocks, as tracked by the GS VIP basket, had reported a record 11 months of underperformance vs. the S&P500 by June 30. The basket of stocks most shorted by hedge funds outperformed longs over the same period. Nevertheless, around mid-summer the market backdrop started to look more supportive for equity hedge strategies as equity risk factors seemed to normalise. Whereas markets still seem to be lacking clear trends or directionality, improving market conditions in the US may be the catalyst for more rate hikes before year's end. A hike, or even shifting expectations around rate increases, could create new trading opportunities for equity hedge managers. In the meantime, managers are positioning themselves cautiously, seeking to deploy capital opportunistically.

Precious metals

Taking a breather

After performing strongly in June-July, precious metal prices have stalled.

The rise in precious metals in June and July as a consequence of uncertainties linked to Brexit lost some momentum in August. More precisely, gold gained 11.2% in June-July, but lost -3.1% in August. The respective performances were 27.1% and -8.3% for silver (confirming its behaviour as a magnifier of gold's performance), 17.3% and -8.4% for platinum, and 29.8% and -5.3% for palladium. The latter's outperformance was due notably to the metal's significant exposure to car sales in China, which have been particularly strong recently.

Looking forward, given our scenario for a resumption of the Fed's tightening cycle in December, US interest rates will likely be less supportive for precious metals. Coupled with a strengthening of the US dollar, the odds of seeing a continuation of the current price correction seem fairly elevated. Among precious metals, we continue to prefer palladium given supply-demand issues and given its exposure to car sales in the US and China, which are expected to remain strong. A potential pullback in palladium's price would provide more attractive entry points than at present, as its recent stellar performance and our US rate hike scenario suggest a poor short-term risk-reward ratio.

Currencies

Carry or value?

Despite the persistent search for higher yields, value strategies have tended to perform better than carry strategies thus far this year.

The relative low volatility thus far this year, helped by central banks' accommodating monetary policies, has favoured the search for yield. As a result, among G10 currencies, carry strategies based on buying high-yielding currencies through the sale of low-yielding currencies have thus far provided a positive performance. However, it is interesting to note that value strategies, based on buying the cheapest currencies and selling the most expensive ones, have actually performed better. The rationale supporting value strategies is that with central banks close to the limits of what they can do, especially in terms of policy rates, the forces pushing misaligned currencies to revert to their long-term fundamental value are to the fore again. Unfortunately, these two strategies tend to be mutually exclusive as cheap currencies like the Japanese yen or the Swedish krona have low yields, whereas high-yielding currencies like the Australian and New Zealand dollar are expensive. The Norwegian krone seems to be the best compromise. It has a decent positive yield (around 1.09% on 3-month deposits) and is undervalued (-17.3% vis-à-vis the USD), which ultimately makes it very attractive.

TOPIC OF THE MONTH – EMERGING ASIA

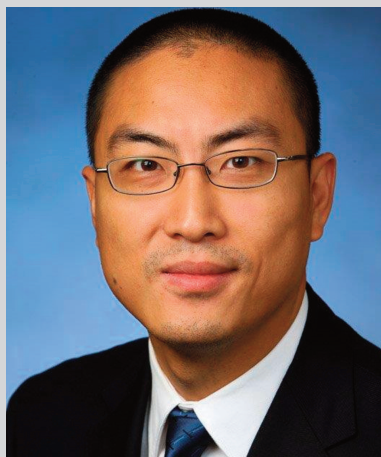
As China slows, India and Indonesia are economic bright spots

In a climate marked by sluggish global growth, India and Indonesia, two of the largest economies in Asia, have embarked on ambitious reforms that could well boost sustainable GDP growth.

Broad emerging markets (EMs) have been out of favour among global investors in recent times. EM Asia is no exception. Investors are especially concerned about the slowdown in China, the slump in commodity prices and expected Fed rate hikes. Yet, two large economies in EM Asia, India and Indonesia, may still be able to deliver superior economic performance. The key to our bullish views lies in improving macro conditions as a result of structural reforms.

Two large countries with great potential

Bright demographic picture. The first thing to note is that India and Indonesia have the world's second and fourth largest populations (1.3 billion and 258 million respectively in 2015) and an extremely positive demographic structure. The relative youth of their populations means that for decades to come, India and Indonesia will continue to have an abundant supply of labour—although we recognise finding jobs for the expanding work force will be a substantial challenge. By contrast, China's labour force has already peaked. China's labour costs are more than double the level seen in India and Indonesia, making the latter more attractive for labour-intensive manufacturing and services.



Dong Chen,
Senior Asia Economist,
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Plenty of room for development. According to the World Bank, India and Indonesia's GDP per capita (on the basis of purchasing-power parity, PPP) ranked 123 and 96, respectively, out of 183 countries in 2015. In both countries, there is plenty of room to improve infrastructure and technology, for example, to boost productivity growth, particularly in India. In areas like energy, transportation and telecommunications, India still lags behind China, in many cases by a large margin.

While China is often criticised for over-investment, India clearly hasn't invested enough. With a small capital stock to start with, additional investment could generate substantial marginal returns, with a potentially huge positive impact on efficiency enhancement and productivity growth.

Structural reforms to unleash growth

Throughout history, India and Indonesia have also had their lot of disappointment. Protectionist and populist policies, poor infrastructure, and lack of efficiency are the common factors that have held the two countries back from reaching their full potential.

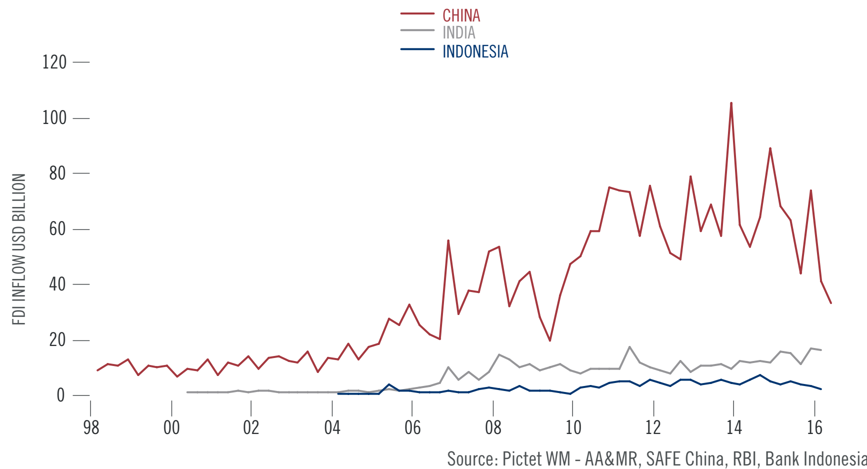
However, 2014 may prove to have been a watershed for both countries. In May of that year, Narendra Modi became Indian prime minister and in July, Joko Widodo (popularly known as Jokowi) was elected as Indonesian president. Both have strong reform agendas.

Reducing barriers to attract investment. In June 2016, the Indian government announced a new wave of major changes to its foreign direct investment (FDI) regime (the first wave was in November 2015). Under the new changes, foreign investors are allowed to take 100% ownership of Indian companies in a wide range of industries where a foreign presence used to be heavily restricted. According to Modi, liberalisation of the FDI regime will mean that foreign investment in most industries will automatically be approved.

Reforms of a similar nature have been implemented in Indonesia. In February 2016, the Jokowi government liberalised Indonesia's Negative Investment List. This policy change opened up 35 sectors to foreign participation, and restrictions were eliminated completely in certain industries.

FDI inflows to India and Indonesia still lag way behind those to China, but recent data have shown healthy growth in foreign investment to India. In 2015, FDI inflows to India amounted to USD55.6 bn, the highest in history and 54% higher than in 2013 (*see Chart 1*). FDI to Indonesia hasn't improved yet, but we believe Indonesia is well placed to benefit from the trend for more labour-

CHART 1: FDI TO CHINA, INDIA AND INDONESIA



Source: Pictet WM - AA&MR, SAFE China, RBI, Bank Indonesia

intensive manufacturing to move out of China to lower-cost locations.

Making doing business easier. The Modi government set a goal of boosting India's position in the World Bank's Ease Of Doing Business Index to 50, from 142 in 2014. To achieve that, the government has put much effort into streamlining procedures to obtain government approvals. As a result, there has been a noticeable increase in project starts since mid-2014 (*see Chart 2*).

In a similar spirit, the Indonesian government has introduced measures to reduce overlapping regulations, streamline government procedures and put in place tax incentives to support key sectors. Setting up a new business has also been made easier.

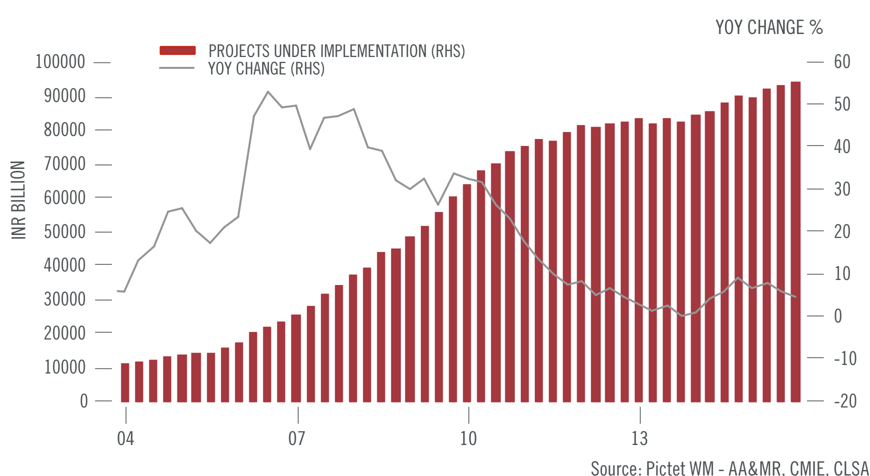
Strengthening fiscal positions to support infrastructure investment. Poor infrastructure is a common complaint among foreign investors in India and Indonesia. To address this issue, both countries have taken measures to strengthen their fiscal positions so as to provide more support to essential investment.

On the expenditure side, both the Indian and Indonesian governments have steered away from previous populist policies that resulted in large spending on inefficient subsidies. They have taken advantage of the slump in the global oil price to cut subsidies on fuel and other items.

On the revenue side, both governments have taken measures to improve the effectiveness of the tax system. In this regard, the most significant event was the parliamentary approval of a national goods and services tax (GST) in India at the beginning of August 2016. India's previous indirect tax system was plagued by multiple layers of levies, complex classifications issues, as well as differences in tax rates and administrative procedures from one Indian state to the next. To make things worse, taxes paid in one state were not recognized by the others. As a consequence, companies' distribution and logistics networks across state borders were often driven by tax optimisation considerations instead of economic factors. This has resulted in great economic inefficiency.

The new GST system (due to be rolled out in April 2017) aims to address these issues. By combining over a dozen central and local sales taxes, it greatly simplifies the indirect tax structure and reduces the potential for tax evasion. In addition, it creates a truly unified domestic market for India by eliminating geographical fragmentation. By enabling economies

CHART 2: PROJECTS APPROVED IN INDIA HAVE STARTED TO PICK UP SPEED



Source: Pictet WM - AA&MR, CMIE, CLSA

CHART 3: INDIA'S CURRENT ACCOUNT HAS IMPROVED SIGNIFICANTLY

Source: Pictet WM - AA&MR, RBI, Bank Indonesia

of scale, this reform will likely lead to stronger growth in trade and logistics, and at the same time expand the tax base.

With a strengthened fiscal position, we expect to see more government support for infrastructure investment in both India and Indonesia.

Improved external positions and lower inflation

India and Indonesia were among the 'Fragile Five' during the 'Taper Tantrum' of 2013 because of their deteriorating current accounts and vulnerabilities to capital outflows. Since then, however, there has been significant improvement in their current accounts, particularly in India (*see Chart 3*). India's average current account deficit has dropped to about 1% of GDP from 5% in mid-2013. In addition, India's FX reserves have risen 31% from their low point in September 2013.

Indonesia faces more headwinds in its current account as it is a net exporter of commodities. Nevertheless, it has managed to reduce its current account deficit from over 4% of its GDP in mid-2013 to about 2%. Like India, Indonesia's FX reserves have also increased notably, by 18% from their low in July 2013. A recent tax amnesty designed to encourage Indonesian residents to repatriate overseas assets will likely lead to more capital inflows in the near term. The additional tax revenue from this programme, potentially about USD12 bn through end-March 2017, will further strengthen the government's fiscal position.

The improved external positions of India and Indonesia, along with the reduced expectations for rate hikes by the Fed this year, have greatly alleviated investors' concerns. In addition, the slump in global commodity prices since 2014 has led to a sharp decline in inflation. With improved market sentiment and a benign inflation environment, the monetary authorities in both countries are now better positioned to support growth. In particular, we believe there is still room for rate cuts in India and Indonesia in the near term.

Conclusion

While many investors are still concerned about the broad EM space, and while vested interests and political risk remain factors in both places, we believe India and Indonesia could be two bright spots. With favourable demographics and reform-minded leaders, the growth outlook for the two economies is quite positive in the medium term, while accommodative monetary policies could boost growth in the near term. Although a change in statistical methodology has made comparisons with the past difficult, we expect India to be able to maintain GDP growth of over 7% per annum in the next three to five years, while Indonesia may see growth picking up gradually from about 5% currently to around 6% in the medium term. In a world where mediocre growth has become the norm, such performances are worthy of investors' attention.

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Inflation to pick up next year

Among major currencies, the British pound is the one that has lost most ground this year, many of its losses occurring in the wake of the 23 June Brexit vote. The pound's decline is pushing up projected inflation. Indeed, while inflation remains weak throughout developed economies, we expect it to rise next year.

Data in charts and tables on this page are as of August 31, 2016

MAIN ECONOMIC INDICATORS

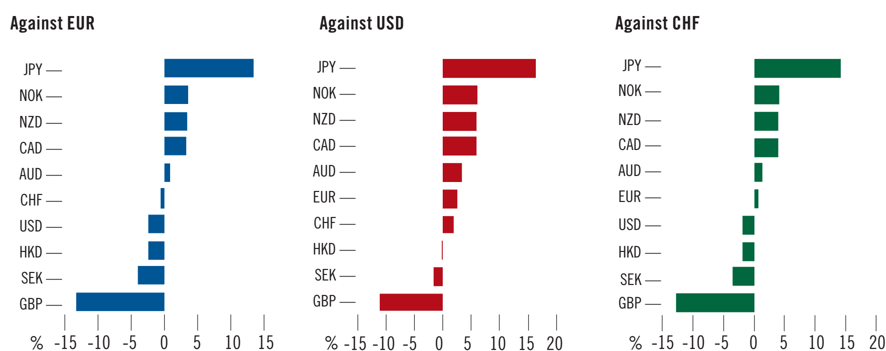
Pictet estimates – (consensus*)

GDP growth rates	2014	2015	2016E		2017E	
US	2.4%	2.6%	1.5%	(1.5%)	2.0%	(2.3%)
Euro area	0.9%	1.6%	1.5%	(1.5%)	1.3%	(1.2%)
Switzerland	1.9%	0.9%	0.9%	(1.0%)	1.5%	(1.4%)
UK	3.1%	2.2%	1.3%	(1.6%)	0.9%	(0.6%)
Japan	-0.1%	0.6%	0.6%	(0.5%)	0.5%	(0.8%)
China	7.3%	6.9%	6.5%	(6.5%)	6.2%	(6.3%)
Brazil	0.1%	-3.9%	-3.2%	(-3.2%)	0.7%	(1.0%)
Russia	0.5%	-3.3%	-0.8%	(-0.8%)	1.3%	(1.2%)

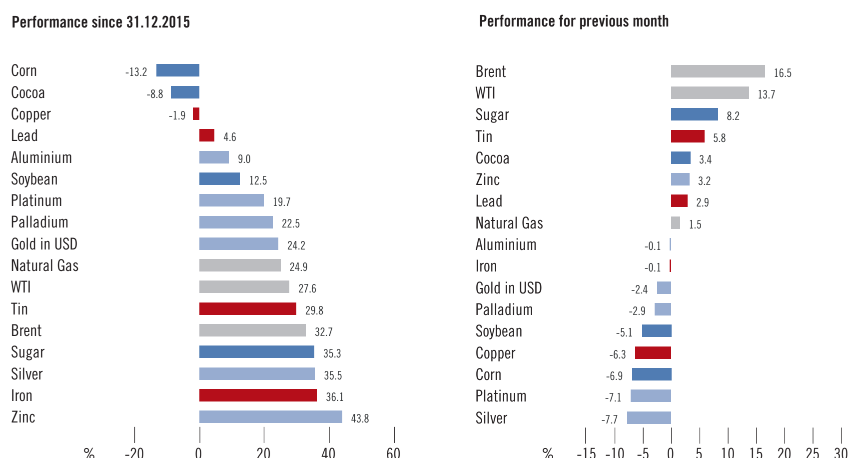
Inflation (CPI) Annual average, except year-end for Brazil	2014	2015	2016E		2017E	
US	1.6%	0.1%	1.3%	(1.2%)	2.4%	(2.3%)
Euro area	0.4%	0.0%	0.2%	(0.2%)	1.3%	(1.3%)
Switzerland	0.0%	-1.1%	-0.5%	(-0.4%)	0.3%	(0.2%)
UK	1.5%	0.0%	0.9%	(0.7%)	2.2%	(2.4%)
Japan	2.7%	0.8%	0.1%	(-0.1%)	1.1%	(0.6%)
China	2.0%	1.4%	2.2%	(1.5%)	1.8%	(1.7%)
Brazil	6.3%	9.0%	8.6%	(7.2%)	5.7%	(5.3%)
Russia	7.8%	15.5%	6.6%	(6.6%)	5.6%	(5.5%)

*Source: Consensus Economics Inc

EXCHANGE-RATE MOVEMENTS (SINCE 31.12.2015)



COMMODITIES

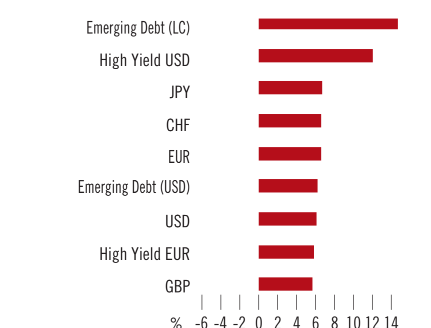


INTEREST RATES

	Short (3 months)	Long (10 years)
US	0.50%	1.6%
Euro area	0.0%	0.0%
Switzerland	-0.75%	-0.5%
UK	0.25%	0.6%
Japan	0.0%	-0.1%
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*	5.3%	2.3%	1.7%	16.9%
S&P 500*	7.7%	4.6%	4.0%	19.5%
MSCI Europe*	-0.6%	-3.4%	-4.0%	10.3%
Tokyo SE (Topix)*	1.5%	-1.4%	-2.0%	12.7%
MSCI Pacific ex. Japan*	7.3%	4.3%	3.6%	19.1%
SPI*	0.6%	-2.3%	-2.9%	11.6%
Nasdaq	3.1%	0.2%	-0.5%	14.4%
MSCI Em. Markets*	12.0%	8.8%	8.2%	24.4%
Russell 2000	7.4%	4.3%	3.7%	19.2%

* Reinvested dividends

SECTORS

Returns since 31.12.2015	US	Europe	World
Industrials	10.9%	4.2%	8.7%
IT	8.5%	1.0%	7.7%
Materials	12.0%	11.6%	16.1%
Telecommunications	15.1%	-14.6%	5.6%
Health care	0.7%	-9.3%	-2.1%
Energy	13.3%	8.2%	13.7%
Utilities	12.6%	-5.0%	6.0%
Finance	2.6%	-18.8%	-3.1%
Consumer staples	7.2%	2.4%	6.2%
Consumer discretionary	2.8%	-9.6%	0.1%

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