PICTET
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-9%	Drop in largest investment banks' trading revenues in 2015 **Page 2**
2.5%	Our expectation for US GDP growth (quarter on quarter annualised) in the third quarter **Page 4**
+20.2%	Year-on-year rise in infrastructure investment in China in August **Page 5**
+1.7%	Rise (in USD) in MSCI Asia (ex Japan) Index in September **Page 7**
240%	Ratio of Japanese public debt to GDP **Page 9**
1.7%	Our year-end forecast for the US 10-year T-bond **Page 10**
579 tonnes	Demand for gold-backed ETFs in the first half of 2016 **Page 11**
USD275 bn	Infrastructure spending programme over five years proposed by Hillary Clinton **Page 12**

Ahead of US elections, regulatory and central bank distortions continue to sway markets

October 2016

Perspectives

EDITORIAL OUTLOOK

Regulatory changes are creating dislocations on markets

Cesar Perez Ruiz,
Chief Investment Officer

Regulatory change is making banks safer, but is also creating major dislocations–so is arguably making financial markets less safe overall. Since the financial crisis of 2008-09, regulation of banks has become much tougher–notably with the Volcker rule barring banks from certain types of proprietary trading, and new requirements, such as those encompassed by the Basel III rules, for banks to hold more capital. As a result, banks have reduced their trading activities. FICC trading revenues (fixed income, currencies and commodities) at the world's 12 largest investment banks fell by 9% in 2015 to USD70 bn, down from USD109 bn five years earlier[1].

A significant pending change that is already having an impact on markets is reform by the Securities and Exchange Commission (SEC) of regulation governing US money market funds, a USD2.7 trn market that is a key source of dollar funding. The reform, due to take effect on 14 October, is intended to safeguard the sector from the kind of shock that it experienced following the collapse of Lehman Brothers, and takes the US in the direction of Europe on rules for money market funds.

First, prime funds (which invest in a range of assets) will now have to make public net asset values based on the current value of their assets. In other words, prices will fluctuate according to market conditions, and will now be able to fall as well as to rise.

Second, funds can now impose gates (limits on withdrawals): specifically, a fee of 2% on redemptions if fund assets that can be liquidated within a week drop below 30%, or 1% if they fall below 10%. Funds also have the option to put a 10-day bar on withdrawals when the 30% threshold is surpassed.

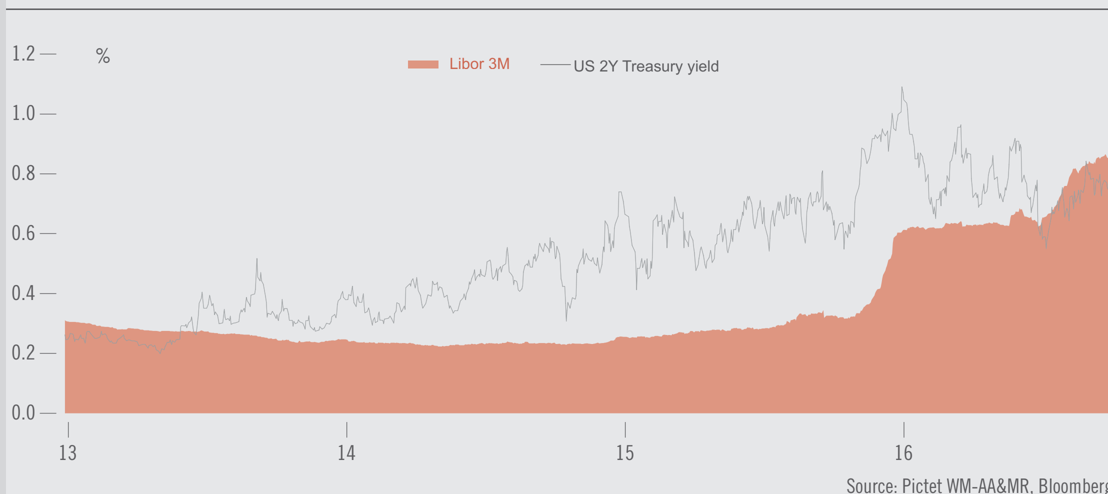
As a result, investors are shifting from prime funds into government funds (those limited to government bonds), in order to avoid the higher risks created for investments in prime funds by the regulatory changes. If 3-month Libor is yielding 85 basis points, to get an equivalent yield on a government bond, you need to move to the 2.5 year, while from 6-month Libor the switch would be to 5-year Treasuries.

Over USD700 bn has already moved from prime to government funds–and government fund holdings surpassed those of prime funds for the first time in March. This money is unlikely to shift back unless spreads change significantly so that the extra yield offered by prime funds is sufficient to offset the disadvantages created by the new rules.

This change is creating a dislocation between Libor and short-term Treasury yields–with Libor rates, unusually, rising above 2-year Treasury rates. Initially,

[1] *http://www.reuters.com/article/us-banks-investment-trading-idUSKCN0VV007*

LIBOR 3-MONTHS AND 2-YEAR US TREASURY YIELD



Source: Pictet WM-AA&MR, Bloomberg

this was interpreted by the markets as a sign of a rise in overall risk aversion, but in fact it appears to be a technical issue.

One result is tighter financial conditions–which is something the Fed will be watching. Interest rates on short-term borrowing by banks, corporates and local governments have risen. This supports the case for the Fed not raising interest rates aggressively, since financial conditions are already tightening, and is in line with our view that Fed rate rises will be only gradual (we continue to forecast a 25bp rise in December, followed by just two more such increases in 2017).

Another result should be to benefit bank profitability, since banks can take advantage of the steepening of the yield curve–indeed, a relatively flat yield curve has been a major factor weighing on bank stocks. This is another factor supporting our preference for US over European bank stocks–in addition to the generally greater difficulties faced by European banks, including a negative-interest-rate environment and weaker balance sheets.

Of more immediate interest to us, the changes may also create an investment opportunity. We had already reduced our holdings of US Treasuries, and we are now exploring ways to benefit from this change to regulation of money-market funds through investments around Libor. Buying Libor instruments would allow us to shift some duration risk.

In a world of higher correlation among asset classes, and also more stringent regulation, it becomes even more important to exploit the inefficiencies that we believe exist in markets. We need to remain disciplined in our approach, but also try to benefit from these dislocations.

Central bank divergence needs to be watched

The resilience of the euro area economy three months after the Brexit vote and improving momentum in China are heartening, but divergence in central banks' monetary policies is becoming an issue.

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

Seen as saviours from deflation and sluggish growth (or worse) or, increasingly, as instigators of dangerous asset-price bubbles through aggressive policy moves, central banks remain centre stage, but are progressively coming up with different responses to the challenges they face.

In September, the US Federal Reserve , European Central Bank, Bank of England and Bank of Japan all held policy meetings. In the event, the Fed left policy on hold at its September meeting, although we expect the Fed to raise rates by a quarter point in December. Yet faced by comparatively low growth and inflation expectations, it was noteworthy that the Fed revised down its median interest-rate projections. The UK economy has performed better than expected since the Brexit vote. But the potential for a significant slowdown, driven by big cuts in investments, looms over 2017, so while the BoE left its main policy rate unchanged in September, it hinted it will be lowered again by year's end. The euro area too seems to have weathered Brexit quite well. But, like the BoE, we expect the ECB to act soon to try to lift inflation expectations and alleviate the potential shortage of government bonds eligible for its asset-purchase scheme.

But the ECB is hardly likely to overhaul its policy approach as radically as the BoJ did in September. Instead of cutting policy rates further or expanding its asset-purchase programme by a set amount, the BoJ announced its intention to cap 10-year Japanese government bond yields at zero until inflation clearly exceeds 2%. In our view, this move is an admission of the buffers that the BoJ's existing quantitative easing scheme has come up against. By moving closer to a form of asset-price targeting, the BoJ has embarked on a new style of monetary policy making, one that potentially adds extra flexibility to the bank's approach by looking past the previous inflation-focused framework and focusing its attention more wholeheartedly on lifting growth. Will the BoJ succeed? A lot will depend on whether it is backed up by more aggressive fiscal policy. But after so many shifts in its monetary approach, the BoJ's credibility is on the line as never before. If the market considers the BoJ's zero-yield target is not credible, it will be tested.

More generally, the BoJ's moves are characteristic of monetary policies b that have become more desynchronized, less homogenous and less cooperative.

US: Fed hawkish for 2016, dovish for 2017

Following soft Q2 GDP numbers (+1.2% q-o-q annualised), US growth should pick up in Q3, on the back of an improvement in the pace of stockbuilding, soaring numbers of oil rigs in operation and more relaxed financial conditions. However, although job creation remained quite robust in July-August, ISM manufacturing and nonmanufacturing indices fell heavily in August and retail sales numbers were surprisingly weak. Nevertheless, we continue to expect GDP growth to rebound to 2.5% in Q3 and 2.0% in Q4. And our yearly GDP growth forecasts remain unchanged at 1.5% for 2016 and 2.0% for 2017.

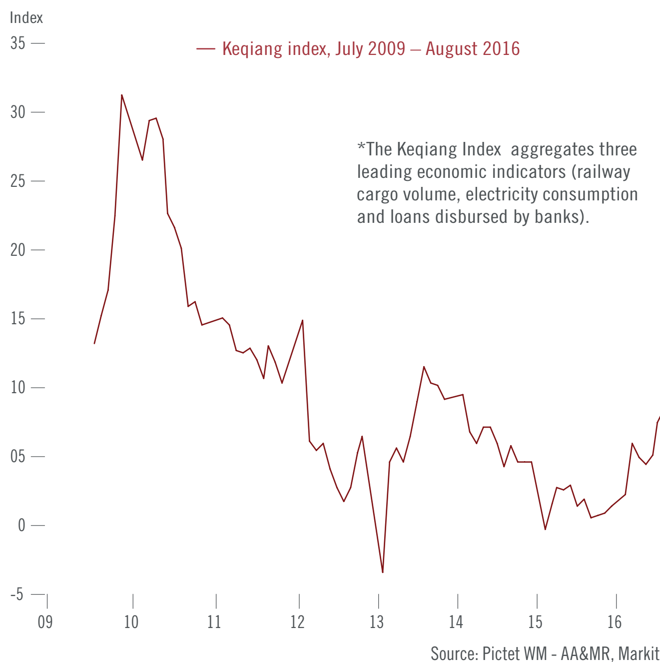
The Fed's Open Market Committee (FOMC) remained on hold at its September meeting, but appeared divided and hesitant. But it did adopt a more hawkish tone, at least for the short term. The Fed's policy makers reintroduced in their statement a sentence saying risks were roughly balanced and affirmed that the case for a hike has strengthened. Significantly as well, three voting members on the FOMC voted for an immediate hike. That was the first time in five years that three members dissented for the same reason. Moreover, 14 out of 17 FOMC members (82%) are still expecting one hike or more before this year is out. The Fed is clearly keeping a tightening bias and, in our view, the bar for not hiking in December is quite high. Therefore, we continue to believe the most likely scenario is that the FOMC will raise rates by a quarter point in December. But the Fed sounded more dovish for the medium term. The projections path for the Fed funds rate was revised down once again, including for the longer-run terminal rate. The Fed now expects 'only' two hikes in 2017 (instead of the three it forecasted back in June), in line with our own unchanged scenario for next year.

"After so many shifts in its monetary approach, the BoJ's credibility is on the line as never before."

Euro area: focus shifts back to politics

The latest euro area leading indicators continue to reflect the region's resilience, three months after the Brexit vote. There is little sign that domestic demand, which remains the main growth engine, is going to go into reverse any time soon, although recent hard data, such as credit flows, suggest that the pace of expansion is likely to soften somewhat. This might be compensated by improving foreign trade, perhaps via stronger demand from the US and China, as some forward-looking indicators suggest. As a result, we are maintaining our euro area GDP growth forecast unchanged at 1.5% for 2016 and 1.3% for 2017, with upside and downside risks still broadly balanced.

THE KEQIANG INDEX* SUGGESTS A PICK-UP IN ACTIVITY IN CHINA



Source: Pictet WM - AA&MR, Markit

In the months ahead, the focus will switch again to politics. The Italian constitutional referendum (to be held on 4 December) will likely be the last key political event in Europe this year. The vote has attracted mounting attention, predominately because of prime minister Matteo Renzi's pledge to resign in case of the referendum's rejection. At this stage, opinion polls suggest the outcome is still too close to call. However, even in the case of a no vote, early elections seem unlikely.

Meanwhile, inflation throughout the euro area has remained subdued despite a small positive base effect stemming from energy prices, which should gather pace over the coming months. However, core inflation (excluding food and energy) remains weak and most of the underlying prices indicators lack upward momentum. Consequently, we still believe that the European Central Bank will be forced to extend its asset-purchase programme beyond its soft deadline of March 2017 and that it will announce a number of technical changes to address bond scarcity at its December policy meeting.

China: short-term upside surprises possible, but our medium-term view remains unchanged

After a weak start to the second half of the year, recent macro data from China have shown rising economic momentum, led by a rebound in fixed-asset investment (FAI) in the property and infrastructure sectors.

The year-over-year (y-o-y) growth in FAI rose to 8.2% in August from 3.9% the previous month, reaching its highest reading since April 2016. The growth in infrastructure investment rose to 20.2% y-o-y in August, compared with 16.4% the previous month, and growth in property investment rose to 6.2% from 1.4%.

The strengthening of FAI has led to a notable rebound in various indicators, such as power generation and rail freight, while demand for industrial commodities also rose in recent months. In volume terms, China's imports of crude oil jumped by 23.5% y-o-y in August (vs. an average of 14.6% in May through July) and imports of iron ore rose by 18.3% (vs. an average of 11.3% in May through July). With rising demand, the prices of various industrial commodities in China have increased sharply in the past few months.

In our view, the stronger-than-expected performance of the Chinese economy lately has been due to: 1) reconstruction following serious flooding that affected large parts of southern China this summer; 2) the government's strong fiscal support for infrastructure projects; and 3) a property boom that has extended beyond first-tier cities. A gradual recovery in global demand may also have helped China's manufacturing sector through stronger exports. With further evidence pointing to rising momentum, we believe it highly probable that the Chinese economy will surprise on the upside in the next three to six months, with GDP growth coming in above 6.5% over H2 2016.

However, our medium-term view of prospects for the Chinese economy remains largely unchanged. We expect growth will slow again next year as FAI resumes its downward trajectory. In our view, the recent surge in property price across China is not supported by market fundamentals and it has raised serious concerns among the Chinese policy makers, resulting in several major cities re-introducing property-buying restrictions lifted only a year ago. As the property market loses steam and the government sticks to reform policies designed to cut industrial overcapacity, we expect China's growth to decline towards 6.2% in 2017.

Spikes in volatility plead for investor alertness

In the coming weeks, the third-quarter earnings season, central bank actions, and trends in oil prices are likely to determine the direction of most asset classes.

Christophe Donay, Jacques Henry, Luc Luyet and Alexandre Tavazzi

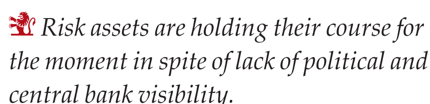
FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 30.09.2016

		Index	Since 31.12.2015	Previous month
US equities*	USD	S&P 500	7.8%	0.0%
European equities*	EUR	Stoxx Europe 600	-3.3%	-0.1%
Emerging-market equities*	USD	MSCI Emerging Markets	16.4%	1.3%
US government bonds*	USD	ML Treasury Master	5.3%	-0.2%
US investment grade*	USD	ML Corp Master	9.1%	-0.3%
US high yield*	USD	ML US High Yield Master II	15.3%	0.6%
Hedge funds	USD	Credit Suisse Tremont Index Global**	0.0%	0.5%
Commodities	USD	Reuters Commodities Index	5.8%	3.4%
Gold	USD	Gold Troy Ounce	24.0%	0.5%

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

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



Risk assets are holding their course for the moment in spite of lack of political and central bank visibility.

In spite of some short-term dips, risk assets remained generally unruffled by market events in September. The calm that characterized the summer months was prolonged a little further. But market calm is not an excuse for complacency. There are, in fact, several reasons for investors to remain alert in the coming weeks and months. The lack of coordination among major central banks is one of these. The Bank of Japan (BoJ), European Central Bank (ECB) and US Federal Reserve (Fed) are all now working under different styles of monetary policy, with the latter about to raise rates, the ECB ploughing on with its quantitative-easing strategy and the BoJ embarking on yield-curve control. The divergence in central bank policies make it difficult to assess their direction and overall impact, leading to a lack of visibility for markets. Politics are a further potential source of volatility, with presidential and congressional elections in the US in early November, the lack of government stability in Spain and a constitutional referendum in Italy on December 4.

Yet equities still seem comparatively attractive for the moment. Current valuations look relatively elevated, but more reasonable on the basis of forward earnings forecasts. Along with decent, if unspectacular, US growth, the Fed maintains a fair measure of credibility with investors, explaining why we have been relatively comfortable about being long US assets. But question marks over the credibility of central bank, and the limits of their actions, have appeared in Europe and Japan. We are therefore increasingly alert to the potential that market expectations for monetary policy may be disappointed. In addition, problems in the European banking sector have not gone away. The high-levels of nonperforming loans in the Italian banking system are well documented, but in recent weeks the capital problems of even once-mighty Deutsche Bank have also been hitting the headlines.

Although an opportunity to trade options, the risk of a rise in volatility—whether because of market factors, politics, or the lack of central bank visibility—pleads for a wide diversification of equity exposure. In spite of low yields, these same factors explain why we continue to hold core sovereign bonds as a way of protecting portfolios. The lack of visibility also has implications for credit markets, which up to now have benefited from central bank buying of corporate debt, as well as the recent improvement in bank credits.

Equities: a crucial Q3 earnings season

During the last two quarters, earnings published in both the US and Europe have been above expectations. With the benefit of hindsight, Q1 marked a bottom in terms of earnings disappointments. Coincidentally, that quarter corresponded to the trough in industrial metal prices and energy prices. The Bloomberg Industrial Metals Index has progressed by 20% from its January lows while oil prices have gained more than 80%. These improvements are at the heart of the strong performances recorded so far this year by the MSCI EM index (+13.7% in USD to end-September), the MSCI US energy index (+15%) and MSCI Europe materials index (+14%). Thus, sectors where earnings growth disappointed the most in 2014, 2015 and 2016 (together with financials) have started to show positive revisions.

The coming Q3 earnings season will be important as investors start to look into 2017. As we have often mentioned on these pages, current valuations are at the high end of their historical range. Any acceleration in earnings growth may enable equity markets to move higher. In Europe, the 12-month forward EBIT margin recently bottomed at 10% and now stands at 11.%. In the US, EBIT margins have rebounded from 14.8% in February to the current level of about 15.2%. US and European

companies are thus able to generate more earnings from the same sales amount. Investors are likely to scrutinise the coming Q3 numbers to see this trend confirmed. If it is, equity markets should have more upside potential.

Low volatility favouring risky assets

Despite some fluctuations in volatility in September, trading, as suggested by our models, remains stuck in a low-volatility regime,. At the end of September, the VIX stood at 14 and the VSTOXX at 20, despite the recent stress around Deutsche Bank. This environment proved to be supportive for risky assets in September, especially for equities. Indeed, emerging-market equities enjoyed their highest monthly returns (the MSCI Asia (ex Japan) returned +1.7% in USD and the MSCI Eastern Europe +1.5%). This environment could remain intact until year's end, in our view. Standard correlation between developed equity markets and 10-year sovereign bonds remained largely negative in September, with a slight decrease in the performance of the S&P 500 and Stoxx Europe 600 versus a slight increase in the performance of 10-year US T-bonds and 10-year German bunds.

BoJ supportive of equities

The decision by the Bank of Japan (BoJ) at its September policy meeting not to cut further the deposit rate supported Japanese banks, which by the end of the month were trading close to the top of their range since January. Foreign investors have kept selling Japanese equities, but BoJ buying through ETFs at an annual pace of USD30 bn has more than compensated for this trend. The BoJ in September amended this purchase programme to limit distortions on highly priced stocks and will in the future buy around 70% of TOPIX ETFs. The correlation between the TOPIX and the Yen/USD rate has been declining since July. In September, the TOPIX returned 0.3% in local currency despite a mild 1% strengthening of the yen. The short-term positive trend for Japanese equities has further to go, but earnings are key for the longer term. Downwards revisions to earnings have been curbed for the moment, but the 9.3% expected growth for 2017 depends on a weaker yen.

Politics impacting currencies

A number of political events are likely to impact FX markets in the next months. US elections should have a muted, though positive, impact on the USD, as both presidential candidates are in favour of some form of fiscal stimulus. In the UK, political uncertainties about the nature of its Brexit deal with the European Union are likely to weigh on the growth outlook, and hence on the GBP. In the euro area, the Italian constitutional referendum in early December could result in a political crisis, weakening the euro.

Finally, the Bank of Japan is trying to lift inflation expectations in order to push real interest rates down—a task that will prove very challenging for the BoJ on its own. A deeper coordination of fiscal and monetary policies and/or bolder structural reforms in Japan will likely be needed to bring real rates down in any meaningful way and thus make the yen unattractive.

Few details on oil output freeze

At an informal meeting in Algiers at end September, OPEC agreed to cut oil output to 32.5-33.0 million barrels per day. Although details and country-level production quotas will only be determined at an official OPEC meeting in Vienna in late November, the Algiers agreement is a short-term positive for oil producers and should strengthen the floor for oil prices. In the longer term, the agreement opens the way for a rebound in US shale production, suggesting that the outlook for global oil supply has tilted to the upside.

Government debt: emerging markets do better

Public debt in developed countries exploded during the financial and sovereign debt crises, rising from 53% of GDP in 2007 to almost 80% by end-2012, according to the International Monetary Fund (IMF)[1]. While showing signs of stabilising in some rich countries since then, public debt levels have recently been rising (albeit often from low levels) in major commodity-dependent countries, as governments there attempt to plug gaps left by sharp drops in the price of commodities such as oil.

71%

The Maastricht Treaty of 1992 committed future euro area members to "maintaining sound fiscal policies, with debt limited to 60% of GDP and annual deficits no greater than 3% of GDP". But **neither of the currency bloc's two main economies, France and Germany, are close to fulfilling the debt-to-GDP criteria**. Germany's debt-to-GDP ratio stood at 71% at the end of the first quarter[6].

106%

The US's gross public debt, including external debt, stood at 106% of GDP at the end of 2015, according to the IMF[2]. **This ratio increased rapidly during the financial crisis of 2008-2010. By way of comparison, the public debt-to-GDP ratio stood at 34% in 1974.**

69.5%

As Brazil's economic and political problems have deepened, so its public debt has risen. Having managed to keep government debt at slightly over 50% of GDP in the first four years of this decade, a large budget gap meant that gross general government debt relative to GDP has shot up since 2014, reaching 69.5% in July 2016[9].

17%

Long considered one of the more successful sub-Saharan countries, **Moody's reaffirmed Botswana's A2 issuer rating and stable outlook in September, citing its "large fiscal reserves and very low debt levels".** Diamond-rich Botswana's government debt-to-GDP ratio stands at 17%[11].

1 «When Should Public Debt Be Reduced,» IMF discussion paper, June 2015 http://www.imf.org/external/pubs/ft/sdn/2015/sdn1510.pdf
2 International Monetary Fund, World Economic Outlook, April 2016, p. 180 http://www.imf.org/external/pubs/ft/weo/2016/01/pdf/text.pdf
3 Eurostat, 22 July 2016 http://ec.europa.eu/eurostat/documents/2995521/7573561/2-22072016-AP-EN.pdf/16cdaec5-3f1c-4cab-a8cf-954b917e04a9
4 Fitch Ratings, 13 June 2016 https://www.fitchratings.com/site/pr/1005944
5 Eurostat, General government gross debt by Member State, September 2016 http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina230&plugin=1

At 135% at the end of the first quarter, Italy's gross government debt relative to GDP was the second highest in the euro area after Greece's. **The Italian ratio was higher than the 133% figure at the end of 2015 as Brussels granted the government extra spending flexibility** in a bid to kick-start a long-stagnating economy.

45%

China's gross government debt-to-GDP ratio has grown in recent years, but was still a manageable 45% in the first quarter of 2016[7]. Yet **this figure does not capture large volumes of local government debt classified as corporate borrowing**. The pace of increase in China's 'total credit outstanding' has become a source of concern, having risen from 148% of GDP at end 2007 to around 255% at the end of the first quarter[8] of 2016.

240%

Japan is the world's most indebted country, with a gross public debt that is over 240% of GDP according to the IMF. In April, ratings agency Fitch cut Japan's credit rating, and then the outlook for this rating from stable to negative in June, fearing that the country's public debts could rise beyond the 247% peak the agency had previously been forecasting for 2020[4].

14.7%

Saudi Arabia still has ample financial resources, but the coffers have stopped swelling as last year's big drop in oil prices continues to bite. With the authorities having to spend more to prop up the economy, ratings agency Fitch expects Saudi Arabia's debt-to-GDP ratio to grow to 14.7% this year, compared with 1.6% in 2014[10].

176%

Greece's already-huge government debt mountain grew to 176% of GDP in the first quarter of 2016 from 170.5% a year before[5]. **In spite of preferential interest rates granted by its European creditors, there have been widespread calls for debt relief for Greece.**

[6] *Eurostat, 22 July 2016 http://ec.europa.eu/eurostat/documents/2995521/7573561/2-22072016-AP-EN.pdf/16cdaec5-3f1c-4cab-a8cf-954b917e04a9*
[7] *Bank of International Settlements, 16 September 2016 http://stats.bis.org/statx/srs/table/f3.1*
[8] *bid. http://www.bis.org/statistics/tables_f.pdf*
[9] *Banco Central do Brasil, 14 September 2016 http://www.bcb.gov.br/pt-br/#!/busca/gross%20government%20debt%20GDP*
[10] *Fitch Ratings, 1 September 2016 https://www.fitchratings.com/site/pr/1011101*
[11] *Moody's Investor Service, 13 September 2016 https://www.moodys.com/research/Moodys-Botswanas-rating-balances-large-fiscal-reserves-and-low-debt--PR_354994*

An Indian summer for risk assets

Equity markets turned in another positive performance in September, while hedge funds also ended the third quarter on a high note. In spite of radical Bank of Japan action, yen strength remains an issue for Japanese risk assets, and the short-term outlook for gold prices looks uncertain.

Equities

Continuing to shine

Positive returns for EM and Asia.

After a strong August, equity market performances were positive again in September. The MSCI World total return was 0.6% (in USD). The largest contributor to equity performance was Japan, with the Topix making a total return of 1.3% (also in USD). In its last meeting, the Bank of Japan decided to leave base rates unchanged, which allowed the banking sector to rebound. In the US, the S&P500 remained unchanged, while the Stoxx 600 declined by 0.1%. Emerging markets continued their positive performance from August. The MSCI EM registered a total USD of 1.3% in USD, helped by a 1.7% return in Asia ex-Japan and a 1.5% return in EM Europe. The recovery in global raw materials and the recent rise in oil prices (helped by an OPEC production agreement) clearly helped emerging countries' performance.

Volatility remained low, at a monthly average of 14.2% in the US and 19.8% in Europe. To be sure, political events and (to a lesser extent) economic ones have led to spikes in volatility, but they have tended to be short term.

The coming earnings season will be quite important as earnings in the last two quarters have been better than expected. A further improvement in the earnings cycle would increase investors' confidence and alleviate current concerns about high valuations. For 2017, price-earnings ratios currently stand at 16.3x in the US, 14.4x in Europe and 12.9x in Japan.

Bonds

Core yields remain low

Central bank dovishness leads to low core sovereign bond yields.

The Fed signalled that it anticipated a slower pace of rate hikes from 2017 onwards than before, but that it would probably still hike once in 2016. The 10-year US Treasury yield stabilised at 1.59% in September, although it spiked to 1.73% before the September Fed meeting. The 10-year Bund yield fell during the month, by 5bp, to -0.12%, continuing to be distorted by the ECB's quantitative easing (QE). The surprise came from the Bank of Japan (BoJ), which introduced yield-curve control, anchoring the 10-year JGB yield around 0%. This asset-price targeting measure could further accommodate BoJ's monetary policy if inflation expectations do rise, lowering real yields.

In peripheral euro area countries, spreads on Spanish 10-year bonds versus German Bunds tightened after regional elections and the resignation of resignation of the socialist party leader were seen as increasing the possibility that the centre right will finally manage to form a minority government. By contrast, spreads on Italian and Portuguese bonds widened. DBRS, the last agency to maintain an investment-grade rating on Portugal's sovereign debt, will review that rating on October 21. A downgrade would exclude Portugal from the ECB's QE scheme. We maintain our year-end yield target of 1.7% for the 10-year US Treasury and 0.08% for the 10-year Bund. We also expect Spanish government bonds to continue to outperform Italian equivalents.

Corporate bonds

Euro high yield in the red

Due to higher bank exposure, euro high yield underperformed US dollar high yield.

BOFAML* US dollar high yield was the only credit segment to perform well in September (+0.5%) thanks to a 9% rebound in the oil price and a dovish Federal Reserve. Credit spreads fell 13bp in September, whereas they rose 30bp for euro high yield. The latter returned -0.5%, mainly due to its important exposure to the banking sector. The USD14 bn fine US justice imposed on Deutsche Bank created some stress, as the fine could impede the latter's capacity to pay the coupon on its Tier-1 contingent convertible bonds (cocos, a type of subordinated debt), reminding investors of some of the risks that these instruments carry. Coupons don't have to be paid if the distributable amount is insufficient and cocos are converted into equity or written down if Tier-1 capital falls below regulatory levels. Fears regarding banks' ability to pay coco coupons have led to widening of the CDS spread on Europe's weakest banks.

Total returns from investment-grade credits were slightly down over the month, with a widening of credit spreads in US dollar (+4bp) and euro (+8bp), but yields were unchanged. Credit fundamentals remain weak and we anticipate by year-end a slight widening of credit spreads and a rise in yields, in line with our scenario for higher core sovereign yields.

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

Hedge funds

A positive quarter overall

The third quarter was mostly upbeat for hedge fund strategies, especially for equity and credit strategies.

The quarter got off to a good start for hedge fund strategies, as Brexit-induced fears did not materialise. Tactical traders navigated the Brexit vote of 23 June successfully despite low risk levels in portfolios. July was profitable for Long/Short Equity as well and managers started to rebuild their exposures. Range-bound markets mid-quarter were also beneficial for the strategy, as the environment proved conducive to stock-picking. However, this low volatility regime coupled with trend reversals, proved more challenging for CTA managers, who suffered on their long fixed-income, long gold and short energy positions. On the credit front, robust markets with strong inflows fuelled Event Driven, Distressed and Relative Value managers' performance. Distressed debt managers saw a positive outcome for long-running stories such as the restructuring of Caesar's Entertainment and TXU Energy, while other energy-related names added to returns on the back of rising oil prices.

But while Event Driven managers' special situation books enjoyed a strong quarter, it was more of a mixed bag for M&A strategies given volatility around deals like SAB/Anheuser Busch and the US antitrust action against health insurance deals such as Humana/Aetna.

Precious metals

Gold could disappoint in short term

The surge in gold investment demand in the first half raises risk of disappointment among investors.

Demand for gold-backed ETFs reached 579.2 tonnes in the first half of 2016. This compares with total demand of less than 620 tonnes from mid-2013 to end-2015. The surge in demand stemmed mostly from concerns over the global economy, the decision by UK voters to leave the European Union, the Fed's persistent caution, and the ever more accommodating stance of other central banks.

Looking forward, the US growth outlook is likely to remain robust while the Chinese economy is unlikely to weaken significantly in the coming months. Furthermore, following the September Fed meeting, a December rate hike looks to be on the cards. Finally, although the US elections could lead to some short-term uncertainties, both presidential candidates are pushing for growth-friendly budgetary policies (especially Trump) that could strengthen the US growth outlook somewhat.

Consequently, gold prices could find it hard to move much higher, perhaps leading to disappointment among investors with a short-term time horizon. But in the longer term, the low-yield environment in developed countries and increasing interest in inflation-overshooting policies among central banks should support gold investment demand.

Currencies

Persistent upward pressure on yen likely

The impact of the Bank of Japan's new policy framework depends mostly on drivers outside its reach.

On 21 September, the Bank of Japan (BoJ) introduced a new monetary policy framework that relies on control of the yield curve. This involves fixing not only the short-term policy interest rate, currently at -0.1%, but also maintaining the 10-year government bond yield at its current level of around 0%.

The new framework is unlikely to weaken the Japanese yen (JPY). Indeed, the bar for additional easing by the BoJ remains high as its existing negative interest rate policy is tending to have a negative impact on financial institutions, which ultimately weighs on the velocity of money. Furthermore, the BoJ is no longer constrained to precise increases in the monetary base (previously set at JPY80 trn a year), which could open the way for a gradual tapering of its asset purchases.

Still, as currencies tend to be significantly influenced by the real interest rate (the nominal rate minus inflation), the impact of inflation expectations on the JPY is likely to increase even further. The BoJ's new 'inflation-overshooting commitment' is an attempt to lift inflation expectations, but this could be hard to achieve given an observed inflation rate that is far below its 2% target. Unless fiscal policies play a greater role in boosting growth, the JPY is likely to remain strong. But at least the BoJ's new policy framework seems to favour a deeper coordination between fiscal and monetary policies.

Next president's policies likely to be more growth friendly

The upcoming US presidential and congressional elections are full of uncertainties. Although, at time of writing, a Hillary Clinton victory still seemed the more likely scenario, a triumph by Donald Trump remains a real possibility. In both cases, we should end up with a slightly more growth-supportive budgetary policy. But should Trump win and should the Republicans keep a majority in both houses of Congress, the outcome could be a more markedly expansionary shift in fiscal policy.

The US presidential election will take place on 8 November. Although Hillary Clinton remains ahead of Donald Trump in opinion polls, the gap was shrinking as we write (mid-September). Therefore, the result of the presidential election is far from a done deal. Both candidates have very low popular approval ratings, and although Clinton currently is still favourite to win, she finds herself in a fragile situation. Health problems and/or renewed abuse of power allegations could damage her candidacy, while Donald Trump might succeed in reassuring electors by looking more "presidential". The chances of a Trump victory are far from nil. What are the two candidates' main policy proposals? Which ones are actually likely to be implemented? What impact will the upcoming elections have on the economy and on financial markets?

The first thing to say is that the elections in November are not only about choosing the next president. Congressional elections will also be held, for all 435 voting-member seats in the House of Representatives and for 34 of the 100 seats in the Senate. This is important, as real – and lasting – changes in policies usually require Congressional approval. This is particularly true for budgetary matters, less so for trade questions.

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The current US president, the Democrat Barack Obama, faces a House of Representatives and Senate that both have Republican majorities, which has been a significant factor in prolonged political gridlock in the US. Will this situation be resolved in November?

Of the 34 seats up for grabs in the Senate election, 24 are currently held by the Republicans. The Democrats only need a net gain of four seats to reach a majority (five if Trumps wins the presidency). This seems quite achievable. Actually, we believe the most likely scenario is that the Senate majority will go to the party that wins the White House. For the House of Representatives, the Democrats require a net gain of 30 seats to reach a majority. Polls currently suggest they should gain 4, with a tight race for a further 16 seats. The Democrats' chances of winning a majority in the House therefore seem slim. The most likely outcome is still that the Republicans will retain their majority in the House.

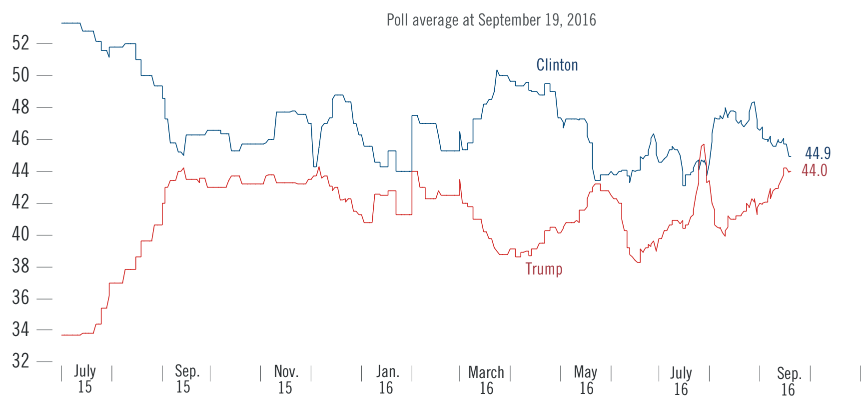
The two presidential candidates have very different policy ideas on many themes such as immigration, the environment, financial regulation, healthcare, social security, and supervision of the Fed, to name just a few (*see table*). Although all these subjects have their importance, we will focus here on the two that are the most important for the future course of the US economy, namely fiscal and trade policy.

Both Clinton and Trump favour expansionary fiscal policies

Both candidates have made proposals that would boost government spending in general and expenditures on infrastructure in particular. Clinton has proposed USD275 bn in infrastructure spending over five years, with leverage (in the form of loans, loan guarantees etc..) potentially raising this amount to USD500 bn. Trump has been less specific so far, but seems to be going for something even bigger. While both candidates at least agree on the need for more infrastructure spending, on the taxation side, the candidates' proposals show wide divergence when it comes to how this spending should be funded. Clinton has proposed that some of her infrastructure programme be financed by higher taxes on business. Although she has not been very precise on this subject, higher revenues could come notably from the foreign profits of US multinationals, which are currently untaxed as long as they are not repatriated. She has also proposed raising taxes on high-income earners. For his part, Trump has basically suggested financing infrastructure spending through government borrowing. Moreover, he envisages cutting the top corporate tax rate from 35% to 15% and the top individual tax rate from 39.6% to 33%.

Actually, it seems some important artisans of supply-side economics and advisers of Ronald Reagan back in the 1980s have been contributing to Donald Trump's fiscal programme. There is indeed an interesting parallel between Trump proposals and 'Reaganomics'. Some

PRESIDENTIAL PREFERENCE: CLINTON VS TRUMP



Source: Pictet WM - AA&MR, RealClearPolitics.com

commentators are even nicknaming the Republican candidate "Ronald Trump". Of course, even if Trump were elected, it's far from certain that Congress would accept policies that could raise the federal debt substantially. However, Congressmen are probably more open to 'deficit spending' than they were, given that the federal deficit has fallen, from 9.8% of GDP in fiscal year 2009 to 2.5% in 2015.

Increase in trade protectionism?
Both candidates have promised a tougher stance on trade policy. They both oppose the Trans-Pacific Partnership (TPP) and favour renegotiating the North American Free Trade Agreement (NAFTA). Trump has also promised to declare China a currency manipulator and called for high tariffs on goods sold by China or Mexico. Although more moderate, Clinton also seems willing to raise pressure on China. There is clearly a risk of a marked increase in trade protectionism whoever wins, and particularly if Trump is elected. This could lead to a reduction in US import growth, higher imported inflation and potential retaliation measures by trade partners, leading, in a worst-case scenario, to a full-blown trade war. However, we believe such an extreme scenario is highly unlikely.

We believe the TPP is unlikely to be ratified by Congress, that Transatlantic Trade and Investment Partnership (TTIP) negotiations will be curtailed, and that we will likely see some increase in import barriers. However, the presidential election's impact on trade in general and US growth in particular should remain fairly limited. There are good chances that a president Trump would end up being much more moderate than candidate Trump, and not only on trade policies.

Thematics	Presidential leeway	Clinton proposals	Trump proposals	Likely outcome Economic impact
Fiscal policy: Spending	Low	-Boost infrastructure spending by $275 bn over 5 years -Leverage this amount to $500 bn - Financed by taxes on higher-income individuals	- Boost infrastructure/military spending by an unspecified amount ($1,000bn?)	**Modest economic boost** More sizeable with Trump and a Rebublican Congress
Fiscal policy: Taxes	Low	- Comprehensive tax reform - Raise taxes on high income and capital gains - Strengthen rules preventing 'inversions', impose 'exit tax'	- Reduce the top corporate tax from 35% to 15% - Deter inversions by imposing a one-off 10% tax on offshore earnings	**Neutral if Clinton wins** **Noticeable boost to growth with Trump,** especially with a Republican Congress
Fiscal policy:	High	-In favour of free trade, but has turned more protectionist -Does not support the TPP in its current form -Renegotiate NAFTA	- Declare China a currency manipulator, impose high tariffs on China and Mexico - Scrap TPP, renegotiate NAFTA	**Some increase in trade protectionism, particulary with Trump** Not much economic impact in 2017-2018
Immigration:	Medium	-Broadly in favour of expanding immigration to the US -Reform legislation, easing access to citizenship for unauthorised immigrants	- Enforce immigration laws, secure borders - Hardline stance: would build a wall on the Mexican border and deport illegal immigrants	**Meaningful restrictions with Trump** May push long-term growth down, inflation up Not much economic impact in 2017
Federal Reserve:	Low	- Bring more diversity to the Fed	- In favour of Congress 'auditing' the Fed - Would not reappoint Fed Chair Yellen in Feb. 2018	No significant macro impact in 2017-2018
Regulation:	Low	- Wants the Dodd-Frank reforms to be strengthened - Support for reinstatment of the Glass-Seagall law	- Has called for an overhaul of Dodd-Frank - Support for reinstatement of the Glass-Steagull law	No significant macro impact in 2017-2018
Healthcare policy	Low	- Defends the ACA (Obamacare) and would seek to expand coverage - Crack down on prescription drug price increases	- Wants to repeal Obamacare - Replace it with reforms that follow 'market principles'	No significant macro impact in 2017-2018

The economic consequences of different election outcomes

The arrival of a new president together with potential changes in majorities in both houses of Congress, mean that several different political permutations are possible, each with diverse implications for the US economy. For example, a Clinton victory with a Democratic majority in both houses of Congress is possible. However, for the sake of simplicity, we will concentrate here on just two of the possible outcomes: first, the electoral scenario we consider the most likely, i.e. a Clinton victory with a Democratic majority in the Senate, but a Republican majority in the House of Representatives; and second, a Trump win with the Republicans retaining a majority in both houses of Congress. This latter scenario is not necessarily the second most likely—but nor can it be entirely discounted. At time of writing, betting markets saw a 30% chance of a Trump presidential win and a Republican-dominated Congress. Such an outcome would have the most wide-ranging implications for the US economy.

What will happen if our first, and probably most likely, electoral scenario becomes reality (a Clinton win combined with a divided Congress)? First, the fall in pre-election uncertainty would probably be slightly supportive for risk markets in the near term, depending on how high uncertainty had risen beforehand. But in the longer term, a divided government would probably mean a prolongation of the current political gridlock. Agreement might be found for an infrastructure programme and some tax-code revisions, but overall budgetary expansion would likely remain limited. On the trade front, neither the TPP nor the European equivalent, the TTIP, would be ratified, but a president Clinton would probably strive to avoid too much confrontation with the US's main trade partners. Overall, such an outcome is probably slightly supportive for the economy and fairly neutral for financial markets.

A Trump victory with the Republicans keeping their majority in both houses of Congress might be a different story. Trump has made some eye-catching promises, but it is still very unclear what he would really do if he became president. Therefore, if elected, uncertainty might actually increase, with worries about trade and immigration policies most in focus. So, under this alternative scenario, risk markets would suffer in the short term and there would be support for Treasuries and for the dollar (except against alternative safe-haven currencies like the euro and the yen). However, after a while, financial markets might come to realise that Trump and a Republican-dominated Congress heralds a return to supply-side economics and, potentially, a major shift in fiscal policy. This could lead to higher growth forecasts and interest rates. Higher growth would provide a more supportive environment for equities and the dollar in the medium term.

To conclude, whatever the outcome of the November elections, we should end up with at least slightly more growth-supportive budgetary policies and a government that is less keen on further trade liberalisation. However, the political agenda suggests that any budgetary boost following the elections is unlikely to impact economic growth before the second half of 2017 at the earliest.

At this stage, we are still in the realm of wild guesses rather than realistic forecasts when it comes to measuring the impact of the US elections. However, in our view, if Clinton wins but the Democrats fail to win a majority in the House of Representatives, the additional fiscal stimulus should be modest, of the order of 0.2 to 0.4 percentage points of GDP over 2017-2018. If Trump wins and the Republicans maintain their majorities in both houses of Congress, we could see a much more meaningful fiscal boost, equivalent to 0.5 to 1.0 percentage points of GDP over 2017-2018.

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Stellar performances from EM debt and US high yield

Local-currency emerging-market debt and US high yield have put in stellar performances since the beginning of this year. In currencies, the British pound has continued to slide since the Brexit vote of 23 June, while the yen has risen strongly in spite of the Japanese authorities' efforts to weaken it.

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

MAIN ECONOMIC INDICATORS

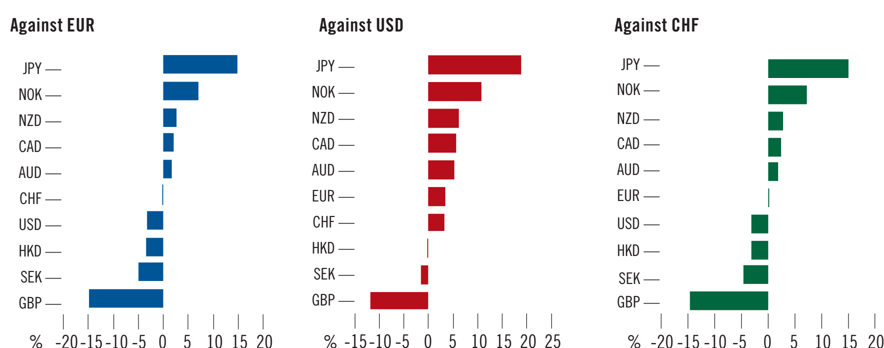
Pictet estimates – (consensus*)

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%	(1.3%)
Switzerland	1.9%	0.9%	1.5%	(1.2%)	1.3%	(1.3%)
UK	3.1%	2.2%	1.8%	(1.7%)	0.9%	(0.7%)
Japan	-0.1%	0.6%	0.6%	(0.6%)	0.6%	(0.8%)
China	7.3%	6.9%	6.5%	(6.6%)	6.2%	(6.3%)
Brazil	0.1%	-3.9%	-3.2%	(-3.2%)	0.8%	(1.1%)
Russia	0.5%	-3.3%	-0.7%	(-0.6%)	1.3%	(1.2%)

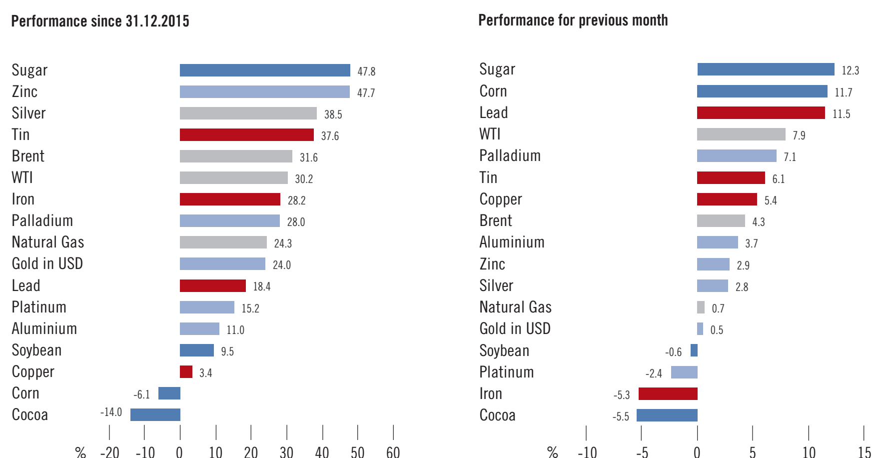
Inflation (CPI) Annual average, except year-end for Brazil	2014	2015	2016E		2017E	
US	1.6%	0.1%	1.3%	(1.2%)	2.4%	(2.2%)
Euro area	0.4%	0.0%	0.2%	(0.2%)	1.3%	(1.3%)
Switzerland	0.0%	-1.1%	-0.3%	(-0.4%)	0.4%	(0.3%)
UK	1.5%	0.0%	0.9%	(0.7%)	2.2%	(2.3%)
Japan	2.7%	0.8%	-0.3%	(-0.2%)	0.4%	(0.4%)
China	2.0%	1.4%	1.8%	(2.0%)	1.8%	(1.9%)
Brazil	6.3%	9.0%	8.8%	(7.3%)	5.5%	(5.3%)
Russia	7.8%	15.5%	6.8%	(6.3%)	5.6%	(5.4%)

*Source: Consensus Economics Inc

EXCHANGE-RATE MOVEMENTS (SINCE 31.12.2015)



COMMODITIES

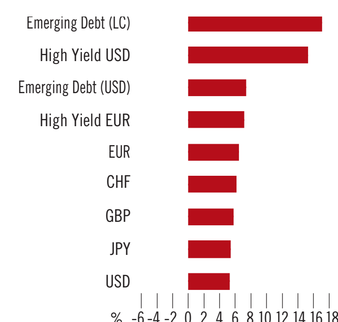


INTEREST RATES

	Short (3 months)	Long (10 years)
US	0.50%	1.6%
Euro area	0.0%	-0.1%
Switzerland	-0.75%	-0.6%
UK	0.25%	0.8%
Japan	0.0%	-0.1%
China	2.10% (1 year)	4.8% (5 years)
Brazil	14.25%	11.6%

BOND MARKETS

Returns since 31.12.2015



STOCK MARKETS

Returns since 31.12.2015

	USD	EUR	CHF	GBP
MSCI World*	6.1%	2.5%	2.7%	20.3%
S&P 500*	7.8%	4.2%	4.4%	22.4%
MSCI Europe*	0.6%	-2.8%	-2.6%	14.1%
Tokyo SE (Topix)*	3.7%	0.2%	0.4%	17.6%
MSCI Pacific ex. Japan*	12.8%	9.1%	9.2%	28.0%
SPI*	0.9%	-2.5%	-2.3%	14.5%
Nasdaq	6.1%	2.6%	2.7%	20.4%
MSCI Em. Markets*	16.4%	12.5%	12.7%	32.0%
Russell 2000	10.2%	6.5%	6.7%	25.0%

* Reinvested dividends

SECTORS

Returns since 31.12.2015	US	Europe	World
Industrials	10.0%	3.4%	8.7%
IT	11.0%	3.4%	10.2%
Materials	9.6%	14.4%	17.0%
Telecommunications	14.1%	-16.1%	4.7%
Health care	-0.1%	-11.6%	-2.8%
Energy	15.0%	7.2%	15.1%
Utilities	13.1%	-4.8%	7.0%
Finance	0.0%	-19.0%	-4.1%
Consumer staples	5.5%	2.1%	6.0%
Consumer discretionary	2.6%	-10.1%	-0.2%

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

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