PICTET
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<2%
Long-run annual GDP growth potential of the US
Page 2

1.5%
Our forecast for real GDP growth in the euro area this year
Page 4

+26%
Rise in Chinese car sales in September compared to same month in 2015
Page 5

+13.9%
Upward revision in 2017 earnings estimates for European basic resources stocks
Page 6

+17%
Rebound in Japan's Topix equity index since June (in yen)
Page 7

-3.3%
Central bank forecast for change in Brazil's real GDP this year
Page 8

+50 bp
Rise in 10-year UK gilt yields in October
Page 10

-2.9%
Fall in gold prices in October (in US dollars)
Page 11

Lacklustre growth means new approaches to monetary policy are coming to the fore along with fiscal measures

November 2016

Perspectives

EDITORIAL OUTLOOK

New economic policies needed

More constructive economic policies would help central banks and governments out of their current dilemma.

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

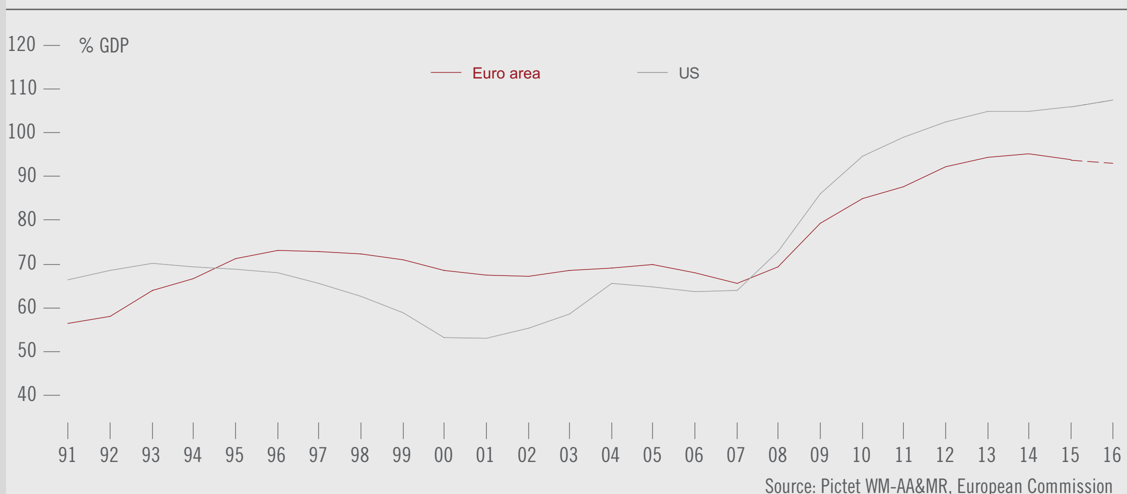
The direction of economic policy is undoubtedly at the crux of economic and financial-market prospects for 2017 and beyond and is becoming all the more important as the monetary policies adopted by all the world's main central banks are showing signs of running out of steam. Alas, governments in the US, Europe and Japan had to massively increase their debt burden in the wake of the financial crisis to stave off the risk of a full-blown economic depression. Between 2008 and 2015, the government debt-to-GDP ratio in a number of developed countries rose from 60% to over 100%. This has acted as an important constraint on their ability to introduce more traditional Keynesian budget policies. Consequently, the support to economies from government policies is only slightly positive at best.

There is general consensus among economists about the numerous challenges that governments in the developed world will face in the coming years. These tend to revolve around the need to remove the risk of a deflationary spiral and to anchor growth at a higher, sustainable level than at present, while also reducing income and wealth inequalities. Official estimates suggest that the potential real GDP growth of developed countries has declined in recent years and is now little more than 2% per annum in the US, 1% in Europe, and possibly close to zero in Japan.

The main problem is that in the last two and half decades, traditional Keynesian budget policies have failed to restore a virtuous economic growth cycle. It is unlikely the infrastructure spending packages envisaged by the two candidates in this year's US presidential elections will be enough to close the gap between the current level of economic activity and where it should be based on historical trends.

An efficient budget policy requires a fiscal multiplier effect higher than 1, meaning that each unit of government spending has to generate more than one additional unit of economic activity. Fiscal multipliers also function in the other direction. If fiscal multipliers are small, countries can cut spending faster or raise more in taxes without much short-term damage. Getting the fiscal multiplier effect wrong (and even the International Monetary Fund admits it underestimated this fiscal multiplier) can help explain both the dramatic increase in indebtedness in developed states since 2008 and the short-term damage to growth caused by over-zealous austerity programmes.

Three main reasons explain the ineffectiveness of the old Keynesian recipes. First, the openness of modern economies and the tendency for some government spending to leak into the external sector through imports diminish the multiplier effect. Second, infrastructure spending tends to be less effective than productive investment by the private sector. Third, the theory of 'Ricardian equivalence', put



forward by economist Robert Barro in the mid-1970s, suggests that budget deficits create an anticipation of future tax hikes, pushing households to save rather than to spend any additional revenue generated by extra government spending.

Different economic policies will surely be necessary to meet the challenges that governments face, especially as the results of those implemented for several years now have hardly been conclusive. But along with the build-up in government debt, there are two other major obstacles to adopting more growth-friendly economic policies.

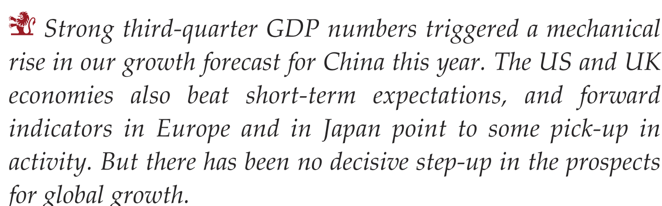
The first of these is conceptual. In order to take the lead after years of central bank-engineered quantitative easing, governments and their economic advisors need to come up with new theoretical models that are sufficiently robust to convince central bankers of the merits of a different approach to monetary policy. This subject is discussed at length later in this issue of *Perspectives*. But, in a nutshell, is not easy to see any conceptual framework acceptable to central bankers ready for adoption in the short term.

The second hurdle that fresh economic policies face is political in nature. Budgetary policy has turned out to be a damp squib in terms of supporting sustainable growth and spending since 2008. Proof of this is the tendency for growth to slow each time governments try to rein in public spending. Of course, the intervention of central banks and governments was vital to preventing a depression at the height of the financial crisis. But once this goal had been achieved, fiscal policies should have been introduced that aimed at reviving productive investment and capacity, which ultimately offer the only real hope for creating sustainable growth and jobs.

Growth indicators remain largely positive, but doubts persist

Positive growth surprises in the UK, the US and China have brought some marginal improvements, but global growth is still lacking momentum.

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



Strong third-quarter GDP numbers triggered a mechanical rise in our growth forecast for China this year. The US and UK economies also beat short-term expectations, and forward indicators in Europe and in Japan point to some pick-up in activity. But there has been no decisive step-up in the prospects for global growth.

After a disappointing second quarter, GDP growth in the US picked up considerably in the third. The likely winner of the presidential election, Hillary Clinton has promised extra fiscal spending to deal with America's creaking infrastructure, which should help overall growth. Fiscal stimulus is likewise becoming the order of the day in Japan, the UK and China. We can also expect one more throw of the dice from the European Central Bank in the form of an extension and enlargement of its quantitative easing programme in December.

But recent improvements in large economies remain marginal. While China continues to make the transition toward an economy more based on domestic demand, we expect growth to fall to 6.2% next year. With the surprisingly strong Q3 bounce in the US likely to prove temporary, we have not changed our forecasts for the US for 2016 or 2017, with growth looking likely to remain well below the levels seen at this stage in previous cycles. Fiscal stimulus will take time to kick in and the boost to growth could prove quite modest. With the end of electioneering in the US, the focus will return again to the issue of low productivity and Fed rate rises.

In Europe, tensions surrounding the Italian constitutional referendum on 4 December are likely to be eclipsed by the start of Brexit negotiations early next year, which will cast a pall over the UK's prospects. Next year will also see important elections in France, Germany and the Netherlands. And growth in the euro area remains fragile, as can be seen in low inflation and the lack of momentum in credit demand.

Everywhere, central banks are facing important credibility tests, none more so than the Bank of Japan which has been administering increasingly exotic monetary medicine. All in all, while recent upside data surprises are welcome, they do not signal a decisive upward shift in growth momentum, which remains modest.

US: strong Q3 GDP largely due to temporary surge in food exports

US GDP grew by a strong 2.9% q-o-q annualised in Q3, above consensus expectations of 2.6%. However, consumer spending disappointed somewhat and growth in final domestic demand actually decelerated from 2.4% in Q2 to 1.4% in Q3. Growth in Q3 was mainly due to inventory re-building and very strong growth in exports (+10.0%), on the back of a surge in soybean exports that will probably prove temporary. Although exports are likely to fall back in Q4, financial conditions in the US remain supportive, fundamentals for consumer spending and the housing sector are positive, and investment in the oil sector should recover. We therefore remain reasonably sanguine on US growth. Our yearly average forecasts that US GDP will grow by 1.5% in 2016 and 2.0% in 2017 remain unchanged. However, due to a likely pull-back in soybean exports, we are cutting our growth forecasts for Q4 2016 from 2.0% q-o-q annualised to 1.5%.

So far this year, core PCE inflation has moved sideways. We continue to believe that it will only pick up modestly over the coming months. Our forecast that it will reach 1.9% y-o-y by year end remains unchanged and our early forecast for December 2017 is 2.1%. We continue to expect the Fed to raise rates by 25 basis points in December, with two additional 25bp hikes to follow in 2017.

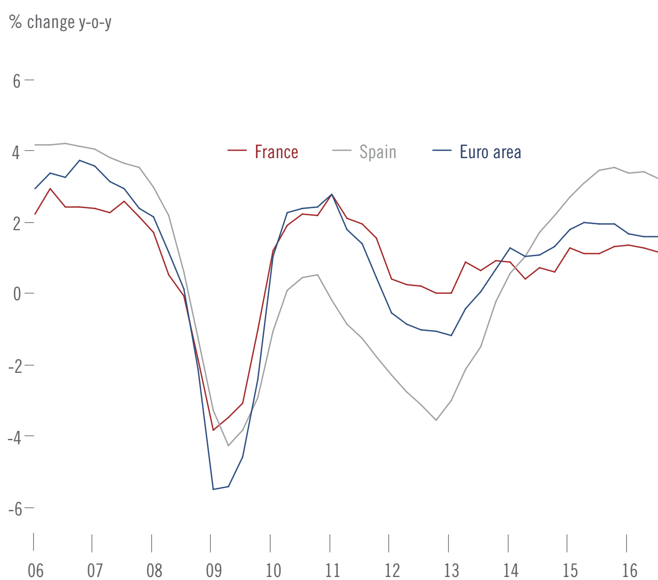
"While recent upside data surprises are welcome, they do not signal a decisive upward shift in global growth momentum, which remains modest."

Euro area: risks broadly balanced

The latest business surveys have been consistent with a solid start to Q4. The main forward-looking indicators suggested that GDP growth is likely to gain momentum in the months ahead, especially (but not only) in Germany. By contrast, bank credit data for the euro area have been pretty disappointing. The credit impulse weakened significantly in Q3, suggesting that domestic demand is at risk of slowing as we move into 2017. Of itself, this poses a significant downside risk to our GDP forecast for the euro area. The question is to what extent stronger cyclical momentum and a (modest) boost from net exports will offset a weaker credit cycle. On a brighter note, European non-financial corporations are sitting on large cash piles and investment spending has become less dependent on bank credit, at least for large companies.

For the moment, 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 broadly balanced, in

REAL GDP GROWTH IN FRANCE, SPAIN AND THE EURO AREA, Q1 2006 TO Q3 2016



Source: Pictet WM - AA&MR, Eurostat

our view. After the formation of a government in Spain following 10 months of political deadlock, the political focus is now shifting to the constitutional referendum in Italy, with the exact consequences of a 'No' vote to the government-backed proposals for Senate reform largely unclear.

Meanwhile, euro area inflation has remained subdued despite positive base effects stemming from energy prices (which should gather pace over the coming months). The key concern for the ECB, however, remains the lack of momentum in core prices. We still expect the next ECB staff forecasts (to be published in early December) to legitimise additional monetary action in the form of a six-month extension of quantitative easing to September 2017, with the pace of asset purchases maintained at the current rate of EUR80 bn per month.

China: near-term stabilisation in growth

Recent data releases have confirmed that the Chinese economy has stabilised for now. GDP rose by 6.7% in real terms year-on-year (y-o-y) in Q3, the same pace as in the first half of 2016. China is almost certainly on track to meet the government's growth target of 6.5-7% this year.

As in the previous recovery, the rise in fixed-asset investment (FAI) has played a crucial role, particularly in the property sector. The stimulus measures that have been introduced since late last year have led to a surge in housing prices and triggered a round of panic purchases by the Chinese middle class, especially in the first-tier and some second-tier cities. Taking advantage of the market boom, real estate developers have accelerated construction, which boosted property investment growth to 6% y-o-y in Q3 2016 from 1% at the end of 2015. Many heavy industries, from steel and glass makers to construction machinery, have also seen a notable rebound in activity.

However, FAI's momentum, especially that related to the housing, probably won't last. Our analysis suggests a structural oversupply of housing since 2013, especially in the lower-tier cities. In addition, some local governments have re-introduced measures to curb rising housing prices over concerns of a property bubble. As a result, FAI growth will likely drop again as we enter 2017.

Outside of FAI, other parts of the economy have shown some encouraging signs of transition. Growth in services continues to outpace growth in the broader economy, and service industries now account for 52% of Chinese GDP, up from only 42% a decade ago. Household consumption remains resilient. The growth in retail sales stabilized at over 10% y-o-y in Q3, with automobile sales rising 26% in September 2016 compared to a year earlier.

Inflation is gradually moving higher in China. The producer price index (PPI), which gauges the price of industrial products, saw positive y-o-y change in September for the first time in over four years. The consumer price index is also gradually improving as core inflation edged higher in Q3, but is still comfortably below the government's target. This positive trend will likely persist in Q4 2016 and extend into 2017, which will help improve corporate revenues and the ability of companies to service debts.

All in all, the latest data have confirmed the near-term stabilisation of the Chinese economy and caused a mechanical upward revision in our 2016 GDP forecast to 6.7% from 6.5%. With concerns for growth fading in the short term at least, the government's focus may shift more towards structural reforms. However, given the imbalances in the economy, the pace of China's expansion is still likely to trend downward and we are keeping for now our forecast of 6.2% GDP growth for China in 2017.

Government bonds prove vulnerable

Relatively upbeat earnings, the stabilisation of commodity prices, some improvement in the macroeconomic picture and (perhaps especially) continuing central bank support have been helping some equities, but bond markets have started to wobble.

Christophe Donay, Jacques Henry, Luc Luyet and Alexandre Tavazzi

FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 31.10.2016

		Index	Since 31.12.2015	Previous month
US equities*	USD	S&P 500	5.9%	-1.8%
European equities*	EUR	Stoxx Europe 600	-4.2%	-1.0%
Emerging-market equities*	USD	MSCI Emerging Markets	16.6%	0.2%
US government bonds*	USD	ML Treasury Master	5.3%	-0.2%
US investment grade*	USD	ML Corp Master	8.2%	-0.8%
US high yield*	USD	ML US High Yield Master II	15.7%	0.3%
Hedge funds	USD	Credit Suisse Tremont Index Global**	0.1%	0.1%
Commodities	USD	Reuters Commodities Index	5.8%	0.0%
Gold	USD	Gold Troy Ounce	20.4%	-2.9%

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

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

October was marked by a noticeable rise in long-term interest rates in response to signs inflation might be returning and the era of ultra-loose monetary policies may soon end.

Gilt yields rose significantly in October as a weak currency fed into inflation in the UK, the Fed seemed ever more likely to hike rates in December, while in the euro area rumours circulated that the ECB was preparing the ground for tapering of its asset-buying programme.

The recent tension in fixed rates remains mild by historic standards and, even allowing for higher commodity prices, we are not expecting any substantial increase in inflation rates any time soon. But the negative interest rate paid on some government bonds in Europe and Japan has made them particularly vulnerable to changes in sentiment—all the more so given that investors have been increasing duration in their search for yield. Government bond exposure has become expensive, and the risk of a flare-up in the bond market cannot be ignored. The rise in long-term yields is helping to justify our decision to shorten duration positioning and to seek tactical opportunities in the money market.

At the same time, recent yield steepening is positive for bank margins, a development that is particularly welcome in Europe. Indeed, concerns about European banks seem to be fading for the moment, helped by relatively solid third-quarter earnings. Banking was among the best-performing sectors on US and European equity indexes in October along with a number of cyclical sectors. The poor performance of gold is a further sign that, whatever the concerns about the bond market, financial stress is fading.

Other factors continue to suggest equities might still have some potential. While valuations are not cheap, earnings growth is expected to improve markedly in developed markets. And investors are still more defensively positioned than bullish signals might warrant, with a recent Bank of America/Merrill Lynch survey showing that the average cash balance held by global fund managers recently reached its highest level in 15 years. We remain relatively upbeat about equities, and we see some justification for shifting away from defensive sectors to undervalued cyclical ones, including select financials.

Equities: logical consequences

The investment landscape has changed since this summer. As mentioned last month, the recovery in commodity and energy prices has enabled emerging markets and cyclical sectors to take over equity-market leadership. The recent rise in long-term bond yields is allowing the very lowly valued financial sector to join in the recovery as steeper yield curves are seen as positive for financials' profitability. As markets tend to anticipate actual events, it is worth noting that upward revisions in expected earnings for this year have been strongest for banks on the S&P500 and for basic resources on the Stoxx Europe 600. Estimates of 2017 earnings for basic resources were revised up by 0.8% in the US and by 13.9% in Europe in October.

Thus, the Q3 earnings season has helped validate market optimism surrounding the cyclical and financial sectors, where valuations are lower than for general indices. The price-to-book ratios for MSCI US and MSCI Europe banks currently stand at around 1.0x and 0.8x, respectively. The corresponding numbers for the US and European energy sectors are 2.0x and 1.1x, respectively. These numbers compare with 2.7x for the overall MSCI US and 1.7x for the MSCI Europe indices. Thus, the most undervalued sectors are benefitting from the cyclical improvement, allowing Value-style investments to perform the best. We are keeping a positive attitude towards equity markets. But we recognise that the US elections and the Italian

referendum in December could spark volatility and are keeping protection in place in our portfolios.

A shift in stock/bond correlation

In the month of October, the S&P 500 returned -1.8% and the Stoxx Europe 600 -1.0%, compared with 10-year US Treasuries' -1.8% and 10-year German Bunds' -2.5% (all gross total returns in local currency). Over the past 15 years, there has generally been a negative one-year correlation between equities and bonds, explaining the benefits of diversifying between the two main assets. The last time the correlation between equities and bonds moved into positive territory was in 2013, when a Fed announcement that it was tapering its asset purchases led to a sell-off of both equities and bonds. But it may be too early to say there has been a wholesale reversal in long-standing correlation trends. While sovereign bonds had a bad month, some equity indices had strong returns in October, including the TOPIX (+5.1% in yen), the MSCI Latin America Index (10.0% in USD), and the MSCI Emerging Europe (+4.2% in EUR).

"Political uncertainties are likely to remain a feature of the coming months and should continue to weigh on the GBP."

Current environment benefits Japan

Japan has been lagging other equity markets so far this year, with the Topix recording a -8.1% return in yen in the 10 months to end October, compared with +4.0% for the MSCI World in USD. Yet in October, the Topix made up part of the performance gap with a total return of +5.3% in yen, thanks in part to a 4% drop in the value of the yen against the US dollar during the month. Since June 2016, the TOPIX index has rebounded by almost 17% while the yen has remained in a range of 100-106 to the US dollar. The rebound of the Topix is in line with a massive improvement in Japanese earnings revisions, which bottomed in June. Despite weak top line growth, the latest reporting season shows that Japanese companies have managed to increase their margins. A continuation of this trend will be key for their prospects next year.

Sterling badly hit

Sterling has been heavily influenced by politics since the statement by British Prime Minister Theresa May on 2 October that the UK would trigger Article 50 (the official legal notification of the UK's wish to leave the EU) "no later than the end of March". As the UK government seems to want to prioritise immigration control over an eventual free trade agreement with the EU, prospects for a 'hard' Brexit have grown, hurting sterling significantly. Political uncertainties are likely to remain a feature of the coming months and should continue to weigh on the GBP. Additionally, although UK growth has thus far been resilient, most of the Brexit fallout is likely to materialise in H1 2017, notably through a decline in private investment spending. Consequently, sterling is likely to remain weak in the next few months.

Towards an OPEC deal

Following the preliminary agreement announced at an informal meeting in Algiers at the end of September, the odds favour a credible oil production deal at the formal OPEC meeting in Vienna on 30 November. Failure to finalise the deal sketched out in Algiers would severely damage OPEC's credibility and remove a significant support for oil prices. Indeed, without an agreement, Brent oil prices would face significant downwards pressures that could bring them back below USD40 per barrel, something OPEC would definitely want to avoid.

Torpid

The world economy has still not returned to the growth levels seen before the financial crisis. With some notable exceptions, economic growth remains torpid. The IMF forecasts global GDP growth of 3.1% this year, rising to 3.4% in 2017. By comparison, global GDP rose by 5.2% in 2007[1]. According to the IMF, the global recovery remains "weak and precarious"[2], echoing the OECD's view that the world economy is stuck in a "low growth trap"[3].

2.2%

According to preliminary estimates, GDP in the UK rose by 0.5% in volume terms in the third quarter, down from 0.7% in the second[11], as services, which constitute almost 80% of GDP, continued to expand. Compared to the same three months of 2015, UK GDP rose by 2.3% in Q3. **The latest figures have mechanically pushed our 2016 GDP growth forecast up to 2.0% from 1.3% immediately after the Brexit vote and our 2017 forecast to 1.1% (from 0.9%).**

2.9%

Real GDP growth in the US topped expectations in the third quarter, coming in at an annualised quarter-on-quarter rate of 2.9%[7]. This was a sharp rise from the 1.4% recorded in the second quarter. Although household consumption figures were disappointing, we remain relatively sanguine on US growth, forecasting that **US GDP will grow by 1.5% in 2016 as a whole and 2.0% in 2017.**

-3.3%

Brazil's central bank believes that the country's real GDP (adjusted for price changes) will shrink again in 2016, by 3.3%, having already declined by 3.8% in 2015. **But there is an air of confidence that Brazil's recovery will start in the last quarter of 2016.** Real GDP shrank 3.8% year-on-year in the second quarter, down from 5.4% in the first[8].

3.2%

Spain's economy grew by 0.7% quarter on quarter in Q3 2016 and by 3.2% compared to the same period last year[9]. **Robust economic momentum means the Bank of Spain expects full-year GDP growth of 3.2% in Spain in 2016**[10]. But with euro depreciation and falling oil prices becoming less of a factor in year-on-year forecasts, it expects growth to decline to 2.3% in 2017.

1 IMF World Economic Outlook, April 2008 - https://www.imf.org/external/pubs/ft/weo/2008/01/pdf/text.pdf
2 IMF World Economic Outlook update, October 2016 - http://www.imf.org/external/pubs/ft/weo/2016/02/index.htm
3 OECD, 1 June 2016 - http://www.oecd.org/economy/global-economy-stuck-in-low-growth-trap-policymakers-need-to-act-to-keep-promises.htm
4 Singapore Ministry of Trade and Industry, 14 October 2016 - http://www.singstat.gov.sg/docs/default-source/default-document-library/news/press_releases/advgdp3q2016.pdf
5 Australian Bureau of Statistics, 7 September 2016 - http://www.abs.gov.au/ausstats/abs@.nsf/mf/5206.0?opendocument&ref=HPKI
6 National Bureau of Statistics of China, 19 October 2016 - http://www.stats.gov.cn/english/PressRelease/201610/t20161019_1411211.html
7 Bureau of Economic Analysis, 28 October 2016 - http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm

South Korean GDP growth slowed to a year-on-year rate of 2.7% in the three months to end September, compared to 3.3% in the previous quarter[12], reflecting the woes of large corporations such as Hyundai, Samsung and Hanjin Shipping. In spite of uncertainties regarding the outlook for exports and domestic consumption alike, the Bank of Korea expects full-year growth of 2.7% this year, compared with 2.6% in 2015.

0.7%

Japan's economy expanded by a quarter-on-quarter rate of 0.2% and by a better-than-estimated 0.7% annualised rate in the April-June quarter according to revised data, which showed that private demand was stronger than earlier reported[13]. However, **momentum in Japan remains weak, and growth was well below the 2.1% annualised rate seen in the first quarter.**

3.3%

Australia's GDP grew 3.3% in the year to June, the fastest pace in four years, helped by public investment[5]. According to the newly-installed governor of the Reserve Bank of Australia, Philip Lowe, the Australian economy was "adjusting reasonably well" to the unwinding of the mining investment boom.

6.7%

China's economy expanded by 6.7% in the third quarter, for the third consecutive quarter[6]. While there is some skepticism about official figures, recent data have gone some way to allaying fears of a renewed slowdown in China, as a jump in property sales feeds through to industrial output and consumption. **We expect the Chinese economy to grow by 6.7% this year and 6.2% in 2017**.

0.6%

The Singaporean economy grew 0.6% year-on-year in the third quarter, much slower than the 2% rate seen in the second quarter[4]. This was the slowest rate since 2009, reinforcing fears that the Southeast Asian financial hub has been hit hard by the global slowdown and changes in Chinese growth patterns.

[8] Instituto Brasileiro de Geografia e Estatística, 31 August 2016 - http://www.ibge.gov.br/home/mapa_site/mapa_site.php#indicadores
[9] Instituto Nacional de Estadística, 28 October 2016- http://www.ine.es/prensa/cntr0316a.pdf
[10] Banco de España, 29 September 2016- http://www.bde.es/bde/en/secciones/prensa/Agenda/Boletin_Economi_3113dadbbfb6751.html
[11] Office of National Statistics, 30 Sept., 2016 - https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/quarterlynationalaccounts/quarter2aprtojune2016
[12] Bank of Korea, 25 October 2016 - http://www.bok.or.kr/contents/total/eng/boardView.action?boardBean.brdid=19443&boardBean.rnum=4&menuNaviId=1959&boardBean.menuid=1959&board-Bean.cPage=1&boardBean.categorycd=0&boardBean.sdt=&boardBean.edt=&boardBean.searchColumn=&boardBean.searchValue=
[13] Japan Cabinet Office, 8 September 2016 - http://www.esri.cao.go.jp/en/sna/data/sokuhou/files/2016/qe162_2/gdemenuea.html

Markets grow choppier

Given a perceptible rise in benchmark bond yields, markets proved choppier than before in October, while higher interest rates and dollar strength hit precious metals. But in a month marked by some limited profit taking, banks continued to outperform, helped by yield-curve steepening.

Equities

Profit taking

Sector rotation within indices.

In October, the S&P500 (-1.8%* return) and the Stoxx Europe 600 (-1%*) suffered from profit taking. The Japanese market rose by 5%*, helped by its exposure to other economies and its cyclical characteristics. Emerging markets rose by 0.25% in US dollars in October. The rise in commodity prices we mentioned last month impacted sovereign bond markets and resulted in a steepening of yield curves. This enabled financials, especially banks, to perform strongly. The MSCI Europe Banks Index was the best performing sector index in Europe, with a monthly return of 8.7%*, while their US and Japanese counterparts rose by 4.5%* and 8.8%*, respectively. These strong performances were also helped by Q3 earnings for banks that were higher than expectations.

Post the Brexit referendum, the investment environment has become more positive for cyclical companies, as commodity prices have recovered, while the recent move in bond yields on top of better earnings is facilitating a global recovery in financial stocks. Thus, the most undervalued sectors (cyclicals and financials) have started to move higher, allowing Value-style investments to outperform Growth. As the pricing environment continues to improve, the 2017 estimated earnings growth rate (around 12% in the US, 13% in Europe and 9% in Japan) looks quite likely to be achieved. We thus think that equity markets still have upside potential, but we are keeping some protection in place ahead of the upcoming US elections and Italian referendum.

** Total return in local currency.*

Bonds

A negative month for sovereigns

Sovereign yields rose as higher inflation and less monetary easing were priced in.

Long-term developed market sovereign bonds yields rose strongly in October, as markets anticipated less monetary accommodation and higher inflation. The move was most impressive in 10-year UK gilts (+50 bp to 1.25%) and 10-year German Bunds (+28 bp to 0.16%). The ECB is widely expected to extend its QE programme beyond March 2017, but rumours circulated of a reduction in the pace of purchases and a change in technicalities that could reduce the amount purchased at the long end of the German curve and lead to higher long-term yields. For our part, we anticipate the ECB will announce an extension of QE in December, with asset purchases maintained at their current pace of EUR80 bn per month. We also expect an increase of the issuer limit and larger deviations from capital keys for the ECB's asset purchases, which could push the 10-year Bund yield up towards 0.3% by year end (higher than the 0.08% previously anticipated).

The 10-year US Treasury yield rose 23 bp to 1.83% in October due to a rise in inflation expectations and the growing probability of a December Fed rate hike, but also the belief in some quarters that, the Fed may be ready to slacken the pace of hiking in 2017 to let inflation and the economy accelerate further. We have revised our year-end target for US 10-year Treasury yields from 1.7% to 2%.

Corporate bonds

High yield outperforms

Rising core sovereign yields dragged investment grade bonds yields in their wake, but spreads tightened for high yield.

Investment grade (IG) corporate bonds posted a negative performance* (-0.8% in USD) in October, with the knock-on effect of higher core sovereign yields only partially compensated for by spread tightening. The US IG yield reached 3% for the first time since the Brexit referendum in June, while its euro counterpart reached 0.8% (still lower than before the referendum thanks to the ECB's purchases of corporate debt).

In the high-yield (HY) space, spreads tightened significantly (-6 bp for US HY and -40 bp for euro HY) in October. US HY returned +0.3%. A rise in the oil price due to a possible OPEC output cut led to a significant tightening of spreads in the energy and metals & mining sectors. Euro HY's performance was stronger (+0.9%) thanks to steeper sovereign yield curves and Q3 bank results that were above (low) expectations. The results of vulnerable banks such as Deutsche Bank surprised by their resilience.

In emerging markets, sovereign bond yields rose more in hard currency (USD) (+25 bp for the JPM EMBI) than in local currency (+18 bp for JPM GBI-EM) due to the rise in US Treasury yields and the worry caused by USD appreciation.

** All credit data are based on Bank of America Merrill Lynch indices.*

Hedge funds

The end of the (QE) world as we know it ?

The world is gearing up for monetary policy normalisation. Will this prove a more favourable environment for hedge fund strategies?

Contemplating the state of the hedge fund industry today, two questions spring to mind: Why have hedge funds been performing below their historical average? Is this the 'new normal' or can we expect a rebound?

In our efforts to find an answer to the first question, we've been struck by one thing in particular. The five-year rolling annualised performance of some of the most established global macro managers was in the region of 15% or more until a few years back. Today returns are half that, if not less. The reason for this is, in our view, linked to quantitative easing. QE has been distorting markets, with indiscriminate buying of financial assets, zero or negative interest rate policies, talk of helicopter money, etc. Implementing hedge fund strategies under these conditions has proved challenging as market forces are being trumped by central bank policies.

So what happens now? Our analysis of hedge fund performances under rising rates regimes finds that when central banks are returning to conventional policies and interest rates are rising, hedge funds tend to outperform in both the short and long term. So while past performance is not a predictor of future success, there is some cause for optimism about the future of hedge funds post-QE.

Precious metals

Bad month for precious metals

October was not kind to precious metals investors as gold, silver, platinum and palladium all saw significant declines.

The increasing odds that we will see a Fed rate hike in December, coupled with over-optimism among gold investors, led to a sharp decline in gold prices at the beginning of October. This decline was echoed by all other precious metals. Gold and silver quickly made up some of their losses, but platinum continued its decline until the middle of the month before rebounding sharply, while there was no meaningful recovery in palladium prices at all. Overall, gold prices fell 2.9% in October (in US dollars), silver by 6.6%, platinum by 4.4%, and palladium by 13.8%. The expected Fed hike in December and related US dollar strength are likely to weigh further on precious metals. However, major central banks are likely to keep real rates low in order to support investment recovery, so the scope for a further significant decline in gold seems limited. Palladium, after its recent sharp decline, is more attractive given its significant exposure to global car sales, which should remain supportive. We remain cautious on platinum as diesel car sales as a share of the total should continue to decline.

Currencies

USD back in favour

The US dollar appreciated significantly in October, as highlighted by the 3.1% and 1.5% gains in the USD index and the USD broad index, respectively.

There are several reasons for recent USD appreciation. One is the higher odds that we will see a 'hard' Brexit, which has led to a sharp depreciation of sterling. Another is rising market rates expectations of a Fed rate increase in December. The PBoC's willingness to let the renminbi depreciate further against the USD is another. Finally, rising long-term yields have weighed on the Japanese yen (as the 10-year rate is now capped by the BoJ at close to 0%) and on low-yielding currencies elsewhere in Asia where the outlook for inflation is relatively weak.

Looking forward, sterling is likely to remain weak as the bulk of the fallout from the Brexit vote has yet to materialise. Furthermore, with US market rate expectations still very dovish for 2017 compared to our scenario of two hikes and with the ECB set to extend QE until at least September 2017, the EUR/USD rate is likely to remain under pressure. Meanwhile, some improvements in the Japanese inflation outlook should lower real rates and make the yen less attractive. Finally, the PBoC is likely to continue to favour gradual renminbi deprecation against the USD. All these factors suggest that the USD should remain strong in the coming months.

The world is ready for a change in monetary policy style

Monetary policy style differs between central banks and varies according to circumstances, creating global policy desynchronisation. In the bid to help tepid global growth, approaches to monetary policy are not set in stone.

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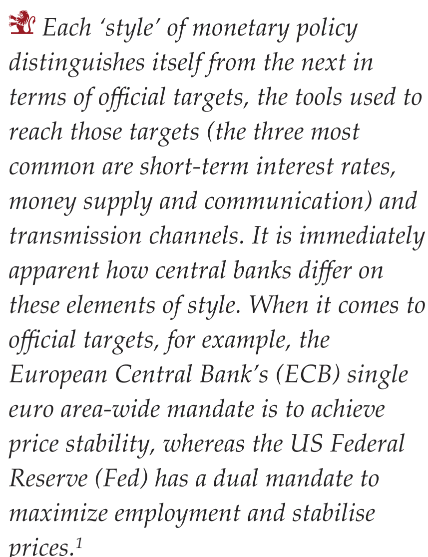


Each 'style' of monetary policy distinguishes itself from the next in terms of official targets, the tools used to reach those targets (the three most common are short-term interest rates, money supply and communication) and transmission channels. It is immediately apparent how central banks differ on these elements of style. When it comes to official targets, for example, the European Central Bank's (ECB) single euro area-wide mandate is to achieve price stability, whereas the US Federal Reserve (Fed) has a dual mandate to maximize employment and stabilise prices.[1]

The Fed alone has overhauled its style of policy making four times over the past five decades *(see box)* but, in general, central-bank policy has converged towards a form of inflation targeting since the early 1990s. The Reserve Bank of New Zealand was the first to officially adopt inflation targeting back in 1990. It was followed over the following two decades by central banks in countries as diverse as Australia, Sweden Brazil and Poland. Armed with a mandate to achieve price stability from its birth in 1998, the ECB quantified its medium-term inflation target as below but close to 2% in 2003. As for the Fed, in 2012, the bank's chairman Ben Bernanke, worried by disinflation, reiterated the Fed's commitment to achieving 2% inflation.

Between 1982 and 2008, inflation targeting seemed to work well for central banks, and was deemed to have been behind the significant fall in volatility between the highs and lows of the business cycle between the mid-1980s and 2007 (the so-called 'Great Moderation').

Criticism of existing policies

But the subprime crisis and its aftermath has called into question existing approaches to monetary policy. Eight years after the height of the financial crisis, economic activity is still below its long-term trend and inflation below target rates. Major economies would seem to be stuck in a liquidity trap, with successive injections of cash by central banks into the banking system and cuts to interest rates failing to stimulate inflation and spending.

The criticism of the current style of monetary policy has four main strands.

First, the huge increase in central bank balance sheets is taken as proof of just how dysfunctional monetary policy has become. Central bank assets have typically grown five fold since 2008. The Bank of Japan's (BoJ) balance sheet is equivalent to over 90% of Japan's GDP, while the Swiss National Bank's represents some 110% of Switzerland's.

Second, while real economic growth became more stable during the Great Moderation (roughly from the mid-1980s to 2007) and inflation declined, in the background some economic fundamentals were deteriorating and there was a worrying growth in debt leverage. Contrary to the Great Moderation mantra, capitalist economies actually seem to have become more unstable from one cycle to the next. There have been three major booms-and-busts so far this century, each time linked to an excessive build-up of debt, and each time ending up in a recession more pronounced than the one before. The first was a direct consequence of the dotcom bubble of the late 1990s as technology, media and telecoms companies scrambled for positioning at the dawn of the internet age.

In 2008, the subprime mortgage crisis, initially confined to the US, turned into a global crisis. This was an even more serious episode than the dotcom crash of 2001, because this time the whole global banking system was brought to the verge of collapse. At the heart of the 2008 crisis was an excess build-up of debt by US households. The latest crunch was the 2010 euro crisis. This was an

Fed policy regime shifts

At the beginning of the 1970s, at a time of wide fluctuations in currencies before the eventual breakdown of fixed-exchange rates, the Fed focused on maintaining stability by targeting the price of bank reserves. Then, in the late 1970s, when inflation was rampant, it turned its attention to controlling money supply. The Fed finally managed to tame inflation, with core average consumer price inflation falling from over 13% in 1980 to 2-3% in the mid-1990s. Then, in 1999, in the face of criticism that a more explicit target would hurt policy flexibility, the Fed said it had a "desired" target range for inflation of below but close to 2%, as measured by the personal consumption expenditures price index. Finally, in November 2008, as the US financial system faced meltdown, the Fed announced it would purchase up to USD600 billion in agency mortgage-backed securities and agency debt and lowered overnight interest to zero to help ease money supply. This was the start of quantitative easing, involving a massive expansion of the Fed's balance sheet.

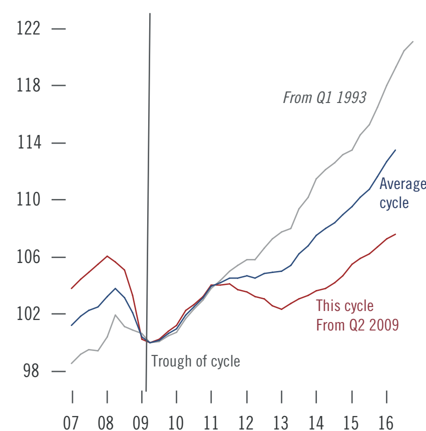
[1] *Following the enactment of the Full Employment and Balanced Growth Act of 1978, the Fed actually has the legislated goal to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".*

entirely new phenomenon, centered on sovereign debt.

If the effectiveness of central banks' policies is increasingly questioned, they are not running out of ammunition to implement them. Since 2008, the world's main central banks have used a vast array of transmission channels: currency weakening to reboot exports; reflation of asset prices to boost confidence; a clean-up of banks' balance sheets to boost the credit cycle. But, ultimately, all these measures have failed as economic growth remains subdued. Indeed, the belief that countries have become trapped in suboptimal growth and that developed economies, especially in Europe, look set to complete a 'lost decade' of subpar growth *(see graph)* since the financial crisis forms the third strand of criticism of monetary policy.

The fourth major strand of criticism is centred on the realisation that low inflation is of itself not enough to guarantee economic stability and an optimal rate of growth. In fact, it has become apparent that the dangers inherent in a low inflation rate outweigh its advantages. To the extent that low price rises are a reflection of deflationary pressures, they carry a risk for economic wellbeing as a whole.

THE EURO AREA'S SUBPAR GROWTH CYCLE



Source: Pictet WM - AA&MR, Eurostat

New policy alternatives

With all these criticisms in mind, new, alternative styles of policy making have been floated. Three of the most plausible involve the targeting of asset prices, the targeting of nominal GDP (NGDP), and the setting of a flexible inflation target.

Asset price targeting. Arguably, the BoJ partially and indirectly adopted asset-price targeting in September when it announced its intention to purchase sufficient Japanese government bonds (JGBs) to ensure that 10-year bond yields remain at about zero. This might be considered a form of 'incomplete' asset-price targeting. Could other central banks more openly assume responsibility for ensuring the stability of asset prices as well as price stability? Once one accepts the basic justification for such a radical move—to ensure central banks can act more effectively to avoid the boom-bust phenomena described above—at what level of asset prices should central banks intervene? Each time credit growth exceeds nominal GDP growth, debt is building up. Should central banks draw up a target for credit growth, with a specific target by sector? Alas, theoretical research still does not provide a clear answer to these questions and there is no set measure for deciding when an asset class is entering bubble territory. Consequently, in spite of its appeal, asset-price targeting is not quite ready to become the next monetary-policy style among central banks.

NGDP targeting. The sluggish recovery of developed-world economics has helped monetary-policy style gain traction. Considering that a repetition of the Great Depression and the Great Recession is not only undesirable but also avoidable, so-called 'market monetarists' want central banks to help maximise GDP growth and at the same time keep volatility as low and at stable as possible. Central banks, they argue, should sustain pro-active monetary policies by all means available, including quantitative easing, until the target level of nominal GDP is achieved. Central banks should be transparent about their goal for aggregate demand growth and companies and households need to be convinced that central banks are serious about achieving that goal. In this style of monetary policy, inflation and

Crisis	Date	Excessively leveraged parties	Asset class most directly affected
TMT crash	2001-2002	TMT companies	US and European equities
Subprime crisis	2008-2009	US households	US housing market
Euro crisis	2010-2012	Greek, Spanish, Portuguese sovereign debt	Peripheral euro area sovereign bonds

As measured by the S&P500 and Stoxx Euro 600 indices

interest-rate targets are not ends in themselves and the famous Taylor rule of monetary policy of limited use.

Flexible inflation targeting. With the International Monetary Fund drawing attention to its potential for tackling low growth, flexible inflation targeting stands the best chance of becoming the template for future monetary policy in the developed world. In essence, this style of policy making involves accepting price rises above the official inflation target for a limited length of time. The main risk is the impact on the bond market. Already, many argue that heavy central bank intervention over the past eight years has disrupted natural market mechanisms and excessively stimulated the sovereign bond market. As a result, 10-year Treasuries present an asymmetrical risk for investors.

Under this scenario, hikes in base rates, coupled with accelerating US growth, could lead to a substantial rise in US long-bond yields.

It is worth recalling that in summer 1994, Alan Blinder, who had recently joined the Federal Open Market Committee, remarked that the Fed was obliged to intervene whenever unemployment was high. At that time, the US was close to full employment, with an unemployment rate of 6.1%. Blinder's remarks were taken as signaling that the Fed wanted to push unemployment below even its structural rate, which investors felt could trigger an inflationary spiral. The result was the 1994 bond market crash. Today, if the Fed were to announce that it was ready to accept inflation above its 2% target, the risk is it draws attention to the extent it has fallen behind the curve, based on the latest price data. Who knows how bond markets might react once the realisation sunk in that long-term US interest rates are well below their 'natural' level (which should mirror nominal growth, defined as GDP growth plus inflation).

Conclusion

Monetary policies will be a key risk factor for bond and equity markets in 2017. Central banks have to reassure investors about their capacity to adapt monetary policy style according to economic circumstances. Over the medium term, their credibility could be threatened if they fail to convince market participants of the effectiveness of their policies and the significance of their impact on the economic cycle.

Over the longer term, whether fresh styles of monetary policy will help real economics or not, the questions raised by the consequences of the huge build-up in central bank assets remains. But there is at least a growing acceptance that central banks should be able to use their swollen balance sheets to implement whatever new style of policy making emerges. Yet, whatever monetary policy style emerges, it will not be a magic wand that saves developed economies from their "lost decade". Monetary policy still needs to work in tandem with budget policy to be fully effective. Alas, the jury is still out on this score, with politicians not entirely prepared to push through appropriate fiscal measures to underpin growth *(see editorial).*

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Benchmark bond yields rise

Long-term benchmark bond yields rose in October, with 10-year yields climbing out of negative territory in the euro area. High-yield and emerging-market debt remain this year's star performers in the fixed-income space, while energy and materials stocks are in the lead in global equities.

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

MAIN ECONOMIC INDICATORS

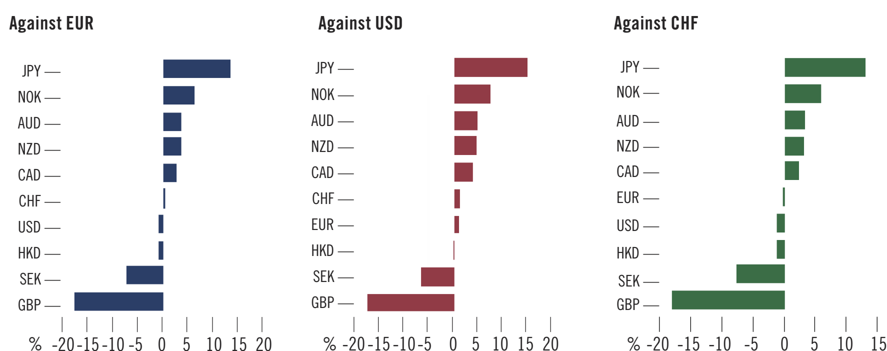
Pictet estimates – (consensus*)

GDP growth rates	2014	2015	2016E		2017E	
US	2.4%	2.6%	1.5%	(1.5%)	2.0%	(2.2%)
Euro area	0.9%	1.6%	1.5%	(1.6%)	1.3%	(1.3%)
Switzerland	2.0%	0.8%	1.5%	(1.5%)	1.3%	(1.4%)
UK	3.1%	2.2%	2.0%	(1.9%)	1.1%	(0.9%)
Japan	-0.1%	0.6%	0.6%	(0.6%)	0.6%	(0.9%)
China	7.3%	6.9%	6.7%	(6.6%)	6.2%	(6.3%)
Brazil	0.1%	-3.9%	-3.2%	(-3.2%)	1.0%	(1.1%)
Russia	0.5%	-3.3%	-0.7%	(-0.6%)	1.3%	(1.2%)

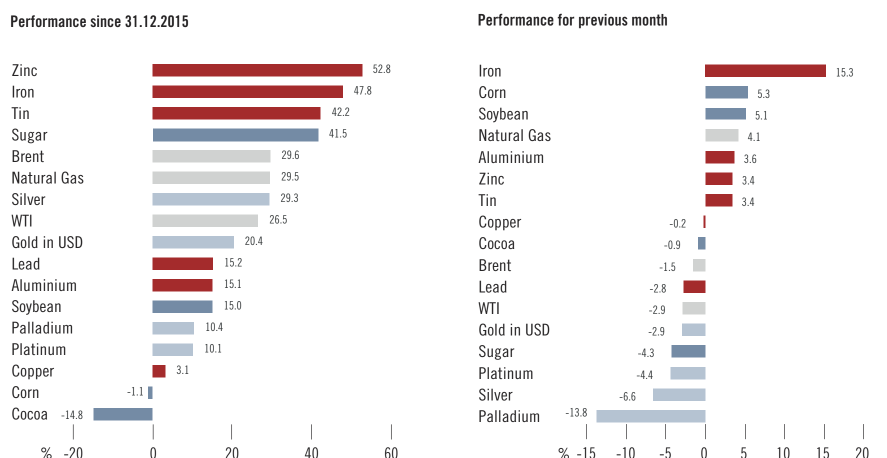
Inflation (CPI) Annual average, except year-end for Brazil	2014	2015	2016E		2017E	
US	1.6%	0.1%	1.4%	(1.2%)	2.4%	(2.3%)
Euro area	0.4%	0.0%	0.2%	(0.2%)	1.3%	(1.3%)
Switzerland	0.0%	-1.1%	-0.3%	(-0.4%)	0.4%	(0.3%)
UK	1.5%	0.0%	0.8%	(0.7%)	2.7%	(2.3%)
Japan	2.7%	0.8%	-0.3%	(-0.2%)	0.4%	(0.4%)
China	2.0%	1.4%	1.8%	(2.0%)	1.8%	(1.9%)
Brazil	6.3%	9.0%	8.0%	(7.1%)	5.4%	(5.2%)
Russia	7.8%	15.5%	6.5%	(6.3%)	5.5%	(5.3%)

*Source: Consensus Economics Inc

EXCHANGE-RATE MOVEMENTS (SINCE 31.12.2015)



COMMODITIES

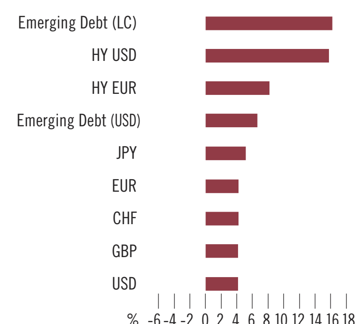


INTEREST RATES

	Short (3 months)	Long (10 years)
US	0.50%	1.8%
Euro area	0.0%	0.16%
Switzerland	-0.75%	-0.4%
UK	0.25%	1.25%
Japan	0.0%	0.0%
China	2.20% (1 year)	4.75% (5 years)
Brazil	14.0%	11.4%

BOND MARKETS

Returns since 31.12.2015



STOCK MARKETS

Returns since 31.12.2015	USD	EUR	CHF	GBP
MSCI World*	4.0%	3.1%	2.8%	25.6%
S&P 500*	5.9%	4.9%	4.6%	27.8%
MSCI Europe*	-2.7%	-3.6%	-3.9%	17.5%
Tokyo SE (Topix)*	5.2%	4.3%	3.9%	27.0%
MSCI Pacific ex. Japan*	11.1%	10.1%	9.8%	34.1%
SPI*	-4.5%	-5.4%	-5.7%	15.3%
Nasdaq	3.6%	2.7%	2.4%	25.1%
MSCI Em. Markets*	16.6%	15.6%	15.2%	40.8%
Russell 2000	4.9%	3.9%	3.6%	26.6%

* Reinvested dividends

SECTORS

Returns since 31.12.2015	US	Europe	World
Industrials	7.4%	1.3%	6.2%
IT	10.7%	-3.3%	9.5%
Materials	7.1%	16.4%	16.2%
Telecommunications	6.3%	-17.3%	-0.5%
Health care	-6.8%	-16.7%	-9.6%
Energy	11.5%	10.4%	12.9%
Utilities	14.0%	-7.4%	5.7%
Finance	2.0%	-14.1%	-2.0%
Consumer staples	4.5%	-3.2%	2.2%
Consumer discretionary	0.2%	-9.6%	-1.7%

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

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