PICTET
1805

2.0%	Our forecast for yearly average growth in the US in 2017 **Page 4**
6.2%	Our expectation for Chinese GDP growth in 2017 **Page 5**
17.0x	Price-earnings ratio for S&P500-quoted companies at end November **Page 6**
-4.0%	Total return for US 10-year T-bonds in November **Page 7**
27.1%	Official rate of unemployment in South Africa in third quarter **Page 8**
43 bp	Rise in yield on US dollar investment-grade corporate bonds in November **Page 10**
-8.1%	Fall in gold prices in November (in USD) **Page 11**
2 x 25 bp	In-house expectation for Fed rate hikes in 2017 (two 25 basis point rises) **Page 13**

From deflation to reflation: our central scenario sees cyclical regime shift in the world economy next year

December 2016

Perspectives

EDITORIAL OUTLOOK

Trump policies a new factor in growth outlook

Cesar Perez Ruiz
Chief Investment Officer,
Pictet Wealth Management

Almost a month after Donald Trump's victory in the US presidential elections, many questions remain about his intentions. So far, there has been a mixture of appointees from the Republican mainstream and others that are considered less mainstream. But at time of writing, the complexion of Trump's economic team remained unknown.

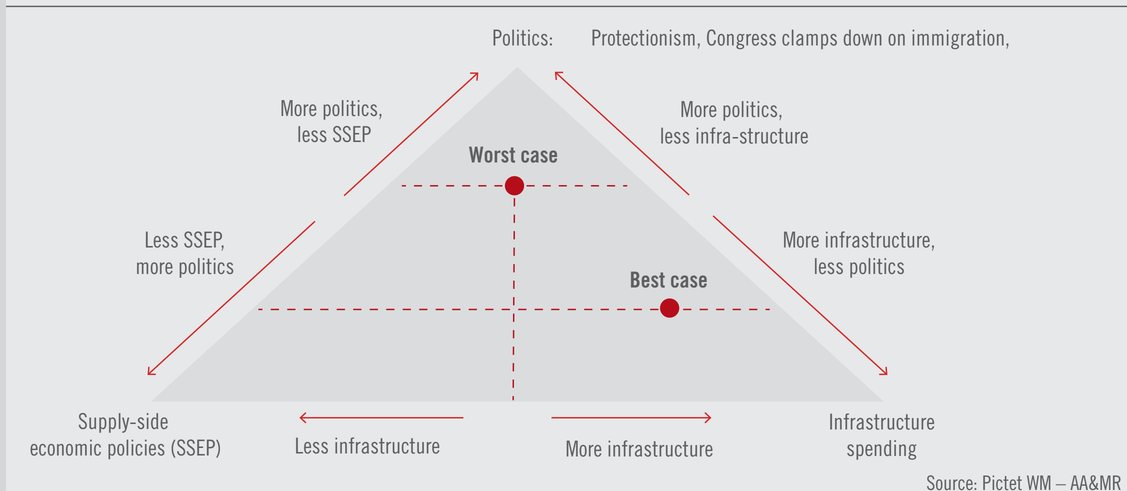
We have been of the view that president Trump would be somewhat different than candidate Trump. Faced with the reality of power and the checks and balances built into the American system of government, many of Trump's most remarked-upon proposals would have to be toned down. These proposals have included slapping stiff tariffs on Chinese imports, building a wall between the US and Mexico and dismantling Obamacare.

The first signal that candidate Trump's campaign rhetoric might remain just that came from his conciliatory victory speech on 9 November. But the speech was also noticeably vague on his policy priorities as president. Based on the positions he took during the presidential campaign, he could lean more towards protectionism or more toward fiscal stimulus. Neither priority is, superficially at least, in contradiction with an 'America First' approach to economic policy that was the hallmark of his campaign. But policies that heavily favour protectionism would have a very different effect on financial markets than ones that give priority to fiscal stimulus.

A wish to satisfy the different constituencies who voted for him means that a Trump administration's policies could fall somewhere between the two. Already, the president-elect has rejected the Trans-Pacific Partnership, a Barack Obama-sponsored trade pact with Japan and 10 other countries together accounting for 40% of the world economy and the same fate surely awaits a similar trade pact with Europe, the Transatlantic Trade and Investment Partnership. But it remains to be seen how much further Trump goes down this road. Ending the two-decades-old North American Free Trade Agreement with Canada and Mexico (NAFTA) would be destructive and cause more problems than it solves, as would the imposition of high trade tariffs.

The benefits of a robust fiscal stimulus package seem far more obvious. Trump has promised a large-scale infrastructure spending plan as well as extra defence spending, together with cuts to personal and corporate taxes. And some artisans of Ronald Reagan's strong supply-driven economic programme at the beginning of the 1980s have been prominent among Trump's advisors. These factors explain why our base case is that a Trump presidency will turn out to be growth friendly (at least for the US), with the first effects of fiscal stimulus beginning to be felt toward the end of 2017 before having a fuller impact in 2018. A faster-growing US economy is likely to help nations who export to the US as well—as long as any gains are not cancelled out by obtuse trade policies under the new Trump administration.

It may be that Trump's fiscal plans turn out to be less than the markets would like to see, with even a Republican-dominated Congress balking at a fiscal package that digs too deep a hole in the public accounts. Fiscal stimulus means more spending, which may be good for equities and bad for bonds. The sharp climb in Treasury bond yields since Trump's victory



has been especially helpful to the stocks of banks, which stand to benefit from improved margins as bond spreads widen. The US banking sector has also benefited from Trump's promise to cut regulation. Trump's businessman impulse to slash regulations could help other sectors as well. But fiscal stimulus at a time of full employment also holds out the risk of over-heating and a faster increase in policy rates than is currently being factored in.

Ahead of the US elections, we decided to rotate part of our bond allocation out of US Treasury bonds and into German Bunds, and part of our equity allocation from world defensives into world value. Although Bunds offer only a token positive yield, the strong rise in US yields since the presidential election has justified our decision to move half of our US 10-year T-bond holdings in euro and CHF accounts into Bunds. Along with outperforming T-bonds since the US elections, Bunds stand to be a net beneficiary of further expansion of ECB bond buying. Similarly, a decision to move one third of our tactical portfolios from defensives to 'value' during the summer proved justified as the rise in equity markets since then has been led by cyclical sectors such as energy and by 'value' stocks, while defensives have trailed.

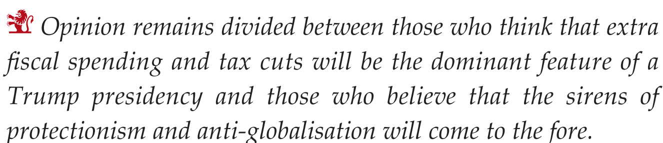
Faced with a rising US dollar, higher US Treasury yields and the prospect that the US becomes less open to trade, emerging-market assets and currencies have been suffering in the face of what is being called a 'Trump tantrum', with foreigners pulling money out of emerging markets. The large volume of dollar-denominated debt in some emerging markets makes them especially vulnerable to a sustained rise in the US currency.

At Pictet Wealth Management, our market scenarios for 2017 have been built around two basic themes seen as coming progressively to the fore. The first is the increasing prominence of fiscal policies in place of monetary policies that have run out of steam before economic growth has been put on a firm footing. The other is the expected rise in corporate earnings in the developed world for the first time in two years. But Donald Trump's victory now adds an extra dimension to our scenarios—that of the unpredictability of a populist who has never held political office and whose economic ideas still need fleshing out.

US provides positive momentum to global economy

We believe fiscal stimulus will boost the US economy in the second half of 2017. We foresee no major growth upsets in either Europe or China and we expect that rises in inflation will be contained.

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



Opinion remains divided between those who think that extra fiscal spending and tax cuts will be the dominant feature of a Trump presidency and those who believe that the sirens of protectionism and anti-globalisation will come to the fore.

As discussed elsewhere in these pages, we lean toward the belief that president Trump's plans will start to give a boost to US growth in the latter half of 2017. Positive momentum in the US economy is building (the annualised 3Q GDP growth rate has been revised up to 3.2%) could spill over into the wider global economy—as long as it is not overtaken by a hardline US stance on trade policy.

In China, the improvement in growth momentum already seen in the third quarter has extended into the current one, causing us to raise our full-year GDP growth forecast for 2016 from 6.5% to 6.7%. Although we expect China's growth to fall next year, we still believe it will be robust (above 6%). The Japanese economy is also showing some signs of life, with third-quarter GDP growth far higher than consensus forecasts. In particular, Japanese exporters are benefiting from a renewed decline in the value of the yen against the dollar—a trend we expect will continue next year.

The picture remains somewhat mixed in Europe. The UK is facing a substantial slowdown as Brexit fears start (finally) to take their toll, and the euro area has a fretful series of popular votes ahead. The Italian referendum of 4 December will be followed in the first half of 2017 by elections in the Netherlands and France. But forward indicators point to a pick-up in business activity in most of the euro area, and while inflation remains weak, signs are emerging that Europe too will partake in the global trend toward reflation.

US growth slower in H1 2017, but stronger in H2

Economic data published recently have been mixed in the US. On the back of a sharp reversal in soybean exports, GDP growth could fall from 3.2% in Q3 to 1.5% in Q4. However, this would still give a robust 2.3% average growth rate for H2. We are basically working on two opposing hypotheses. According to the first, baseline hypothesis, although Congress is likely to water down Trump's budgetary proposals, we still expect a substantial fiscal stimulus programme that will raise GDP by 0.5-1.0% in the US over 2017 and 2018. However, the positive impact of this programme should only start to be felt in late 2017. The second hypothesis takes into account the possibility of a marked increase in trade protectionism. However, our best guess is that the effects of potential trade and immigration measures will have a very limited impact on growth and inflation, at least next year. Complicating our analysis is the rapid tightening of monetary conditions (with the dollar and long-term rates moving higher since the presidential election). This tightening, equivalent to increase of more than 75 basis points in short-term rates by the end of November, could weigh on growth in H1 2017. We forecast that growth will slow to some 1.7% on average in H1 2017, before picking-up to 2.4% in H2 as fiscal stimulus kicks in. On a yearly average basis, we continue to forecast that growth will accelerate from 1.5% in 2016 to 2.0% next year.

"We see an extremely low chance of a nationalist, anti-EU party winning a major election next year"

Core PCE inflation has remained relatively stable over the past nine months or so. Although labour market slack continues to diminish and wage increases are picking up, the increase in core PCE inflation in the US should be modest in 2017 given dollar appreciation and low global inflation. We forecast a y-o-y core PCE inflation rate of 2.1% by the end of 2017 (1.7% currently). The Fed will most likely hike the Fed funds rate by 25 bps in December. Faced with a marked tightening in monetary conditions and no more than a modest pick-up in core inflation, the Fed will act very carefully. We forecast it will hike rates by 25 bps twice next year.

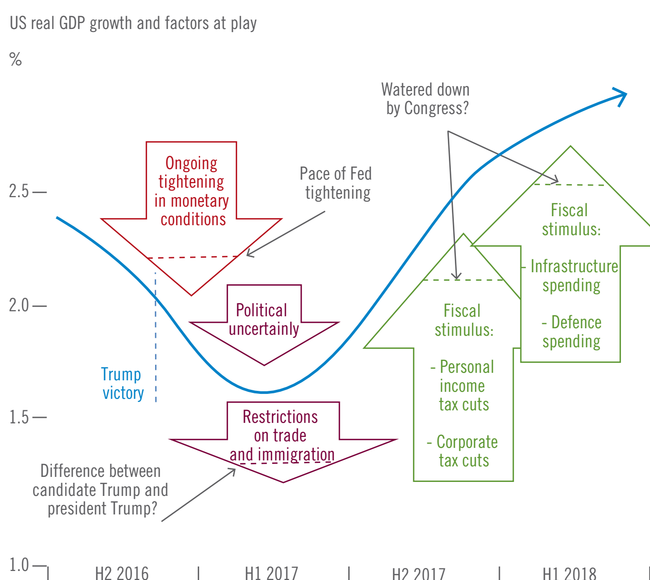
Risks evenly balanced for European growth

Our baseline scenario foresees no significant acceleration in euro area GDP growth in 2017, but a broadly steady pace of economic expansion. In other words, the slowdown in annual GDP growth we forecast, from 1.6% in 2016 to 1.3% in 2017, is purely the result of a lower carryover into next year. Moreover, we see risks as broadly balanced, with both upside and downside potential for growth relative to our baseline.

On the one hand, domestic demand is expected to remain the main engine of growth in the euro area, supported by improving labour market, healthy real income growth and loose monetary conditions. Fiscal policy is likely to turn more supportive although it will remain sub-optimal and unevenly distributed, with surplus countries unlikely to make full use of their fiscal room to manoeuvre barring a

FACTORING IN PRESIDENT TRUMP: A SLOWDOWN IN US GROWTH IN H1 2017 FOLLOWED BY STRONGER GROWTH IN H2

US real GDP growth and factors at play



Source: Pictet WM - AA&MR, Datastream

severe slowdown. Exports are likely to turn more supportive too, although global economic and political uncertainty should remain a drag on aggregate demand. On the other hand, 2017 will bring a series of big political tests, with three major elections in the Netherlands, France and Germany. Notwithstanding a rise in the populist vote, we see an extremely low chance of a nationalist, anti-EU party winning a major election next year or holding a legally binding referendum on EU/EMU membership.

As regards price dynamics, we expect headline inflation to peak at close to 1.5% in H1 2017, helped by energy-related base effects, before moderating in the second half of the year. Downside risks to core inflation, which we forecast to average 1.1% in 2017, are the main reason why we expect the ECB to maintain a very loose monetary stance while it tries to regain flexibility in terms of the parameters of its asset purchase programme.

China: steady momentum extended into Q4

Recent data releases indicate that the Chinese economy has stabilised in Q4. The growth in fixed-asset investment has picked up moderately, led by property while the growth in infrastructure and manufacturing investment eased slightly in October. Retail sales showed some softness, growing 10% y-o-y in October, compared to 10.7% in September, largely due to slower growth in auto sales.

China's producer price index (PPI) rose by a further 1.2% y-o-y in October, having moved out of negative territory in September. The rebound in global commodity prices and the deprecation of the renminbi will likely push up PPI further in the coming quarters. In addition, the surge in China's property prices this year may feed into prices for non-tradable items such as services, which, in turn, should push up the consumer price index as well. All in all, reflation is underway in China.

Rising inflation has helped boost China's nominal GDP growth. In Q3, China's nominal GDP rose by 7.8% compared to the same period last year, the highest reading since Q3 2014. Consistent with the improvement in nominal GDP, the profitability of the Chinese corporates has been recovering, especially in the industrial sector.

As it becomes clearer that the economy is on track to meet the government's growth target of 6.5-7% this year, policies have shifted from boosting growth to controlling risks. Many local governments have moved to rein in runaway housing prices. Credit growth, including household mortgage loans, has started to ease in recent months. The People's Bank of China will likely maintain a neutral policy stance for the rest of the year. While it will continue to maintain accommodative liquidity conditions, more emphasis will be put on restraining the risk of asset bubbles, in particular in the housing sector.

To summarise, the Chinese economy continues to show signs of stabilising. The data available so far are consistent with our forecast of 6.7% growth in China's real GDP for 2016. Looking ahead, we don't think the current growth momentum is sustainable in the medium term, especially in the area of property investment and related heavy industries. As a result, we expect China's growth rate to decline moderately to 6.2% in 2017. However, inflation may keep moving higher in the next few quarters while remaining below the government's target of about 3%. Higher prices will likely provide continued support to the corporate sector ahead.

'Trump trades' take hold

One of our key investment themes for 2017 is the turn towards fiscal policy and away from monetary policy to sustain growth, with Donald Trump's election promising to accelerate this trend. But we are also aware some trends may be overbought.

Christophe Donay, Jacques Henry, Luc Luyet and Alexandre Tavazzi

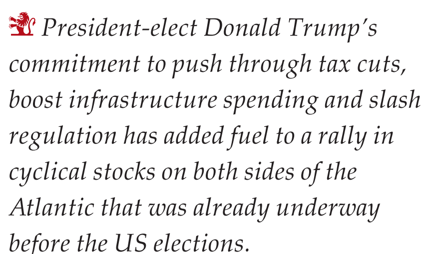
FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 30.11.2016

		Index	Since 31.12.2015	Previous month
US equities*	USD	S&P 500	9.8%	3.7%
European equities*	EUR	Stoxx Europe 600	-3.2%	1.1%
Emerging-market equities*	USD	MSCI Emerging Markets	11.3%	-4.6%
US government bonds*	USD	ML Treasury Master	1.3%	-2.7%
US investment grade*	USD	ML Corp Master	5.3%	-2.7%
US high yield*	USD	ML US High Yield Master II	15.2%	-0.4%
Hedge funds	USD	Credit Suisse Tremont Index Global**	-0.1%	-0.2%
Commodities	USD	Reuters Commodities Index	7.5%	1.6%
Gold	USD	Gold Troy Ounce	10.5%	-7.9%

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

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



President-elect Donald Trump's commitment to push through tax cuts, boost infrastructure spending and slash regulation has added fuel to a rally in cyclical stocks on both sides of the Atlantic that was already underway before the US elections.

Energy and basic resource-related stocks have done well as have banks, buoyed by the widening of yield spreads. Defensive stocks, especially bond proxies that pay a steady dividend, have not fared so well. These stocks are often to be found in sectors such as utilities, pharmaceuticals and consumer staples. But with the Dow Jones Industrial Average breaking through 19,000 in late November, it may be legitimate to wonder how far further recent trends have to go, at least in the near term. We have done well from the reorientation of our portfolios from defensives towards cyclicals. But while further rebalancing may be justified, cyclicals' outperformance could call for some caution for now.

It may be also be appropriate to wonder how far further the drop in Treasury prices can go in the short term, given our expectation that US growth will dip in the first half of 2017 (hurt by a strong dollar and rising long rates) given that core inflation pressures remain mild and given that Fed tightening (we expect two 25 bp rate hikes in 2017) is already being priced in.

While equity volatility remains low, it has risen for fixed income since Trump's election. The two asset classes are responding to different narratives. While equities remain focused on prospects of higher US growth, fixed income is focused on burgeoning inflation. Inflation trades still have room to play out: either fixed income volatility will decline if inflation concerns lessen, or fixed-income volatility will eventually spill over into equities as well. While we see price pressures remaining modest in the near term, should president Trump's spending and tax plans gain traction at a time when the US is running at full capacity, we could see inflation rising in the US. Then, the 35-year-old rally in US Treasuries would be truly over and question marks would arise about Treasuries' status as an instrument to protect portfolios.

Equities: outperformance accelerates

We commented last month how the investment landscape has changed since the summer, with cyclical sectors taking the lead together with financials. The least one can say is that the US election results have accelerated this trend. Anticipating a pro-growth Trump administration, developed equity indices rallied in November, led by US small caps (+12%) and Japan (+5.5%). Sector wise, the rebalancing from defensive to cyclical sectors progressed further.

Moreover, the rise in raw material prices is feeding through to higher longer-term inflation expectations and a steepening of yield curves, which is creating a better environment for banking stocks in all markets. US banks now trade at a price-to-book ratio of 1.14x while their counterparts in the euro area and Japan still trade at a discount to book (of 0.75x and 0.63x, respectively). Banks' profitability is penalised by negative interest rates in both Japan and the euro area.

For investors, it is hard to know which markets to favour in 2017. Based on valuations alone, Europe (14.2x PER) and Japan (14.5x) are cheaper than the US (17.0x), but potential fiscal spending, lower taxation and possible capital repatriation in the US will be a difficult combination to beat. We expect markets to trade on Trump's promises, at least until he officially becomes the 45th president in late January.

Stock/bond correlation still negative

The negative correlation between equity and bond returns in place for more than 15 years held firm in November again, with a 3.7% return for the S&P 500 (in US dollars) and a -4.0% return for 10-year T-bonds. On average, those two asset classes do not show such a strong negative correlation, and the current correlation regime does not exclude periods where both equities and bonds sell off simultaneously (as happened in October). Such synchronised movements should not last for too long going forward, providing inflation remains contained. Our analysis suggests that US core inflation would need to shoot up to around 3.8% before we see positive correlation, whereas current expectations for the next few years range from 2.2% to 2.4%.

Weak yen and strong Japanese equities

In November, the yen depreciated against the USD by 7.4% while the TOPIX index posted the best monthly return of any major equity index, rising 5.5% (in local currency). This illustrates the still-strong correlation between FX and equity returns. The TOPIX was still down 3.1% and the yen was still 6% higher against the USD in the 11 months to end-November. The US elections were a trigger for a further 10-year T-bond yield increase at a time when the Bank of Japan's yield curve control (with a 0% target for 10-year maturities) has made the yen less attractive. A weaker yen is positive for Japanese earnings. Indeed, 2017 earnings were revised up in November after negative revisions in October. On top of its yield curve controls, the BoJ is still buying Japanese equities through ETFs, which is contributing to inflows into Japanese stocks.

Trump makes the USD great again

The US elections have broadly benefited the US dollar. Indeed, with the Republicans controlling Congress, Donald Trump's plans for meaningful fiscal stimulus are likely to find traction. The expected boost to the US economy should support further Fed rate hikes in 2017 and 2018. Furthermore, president-elect Trump has been, thus far, much more moderate than candidate Trump when it comes to protectionism. This explains why risk appetite has remained strong, allowing the US dollar to appreciate against defensive currencies like the Swiss franc. Overall, fundamentals after the US elections are supportive of further USD appreciation. However, the US dollar started its current structural upwards cycle in July 2011. The previous two long cycles lasted roughly six and a half years apiece, meaning that the current cycle is reaching maturity.

OPEC agrees to first oil supply cut since 2008

At a formal meeting in Vienna on 30 November, OPEC found an agreement to cut oil production by about 1.2 million barrels a day for six months starting in January. This marks a shift in the oil cartel's strategy back towards stabilising the oil market. Indeed, with the return of Nigerian and Libyan production, a lack of agreement among OPEC members to curtail oil production would have likely led to a significant decline in the oil price. Although this agreement is positive for the oil price in the short term, it may lead to US producers increasing their own output in response to higher prices, thus limiting the upside potential.

Unemployment

According to the International Labour Organization (ILO)[1], the unemployment rate in developed economies decreased from 7.1% in 2014 to 6.7% in 2015. In most cases, however, improvements were insufficient to eliminate the jobs gap that emerged in the wake of the global financial crisis. Moreover, says the ILO, the employment outlook has been weakening in emerging economies, notably in Brazil, China and oil-producing countries, with 2.3 million jobless added to the global tally in 2016.

4.8%

The Office for National Statistics (ONS)[5] announced that the unemployment rate in the UK stood at 4.8% in the three months to end September, its lowest level since the same period in 2005. **The ONS also reported that the number of people in jobs in the UK (31.8 million) remains at a record high.** Nonetheless, the Bank of England has been forecasting a rise in unemployment as the uncertainties surrounding Brexit begin to bite.

4.6%

The official US unemployment rate dropped to 4.6% in November, bringing it below what the Fed considers to be full employment and well below the 10.2% rate recorded six years before. The U6 measure (a wider gauge of unemployment) declined from 9.5% in October to 9.3% in November, after having remained stable over several months.

11.8%

Amid the worst economic downturn since the 1930s, **Brazilian unemployment has risen substantially since early 2013.** Data show the 11.8% unemployment rate recorded in the three months to end September unchanged from the three months to August[9]. Real earnings were 2.1% lower than in the three months to end-September 2015, when the unemployment rate was 8.9%.

19.2%

Spain's joblessness rate fell to 19.3% (seasonally adjusted)[2] in October, compared with a high of over 26% at the beginning of 2013. Spain's unemployment rate has been the highest in Europe outside Greece since the European sovereign debt crisis put an end to a building boom. Youth unemployment remains a scourge, standing at 43.6% at end October, according to Eurostat.

1 *International Labour Organization, 19 January 2016 - http://www.ilo.ch/global/research/global-reports/weso/2016/WCMS_443480/lang--en/index.htm*
2 *Eurostat, 1 December 2016 - http://ec.europa.eu/eurostat/documents/2995521/7752348/3-01122016-AP-EN.pdf/5f785386-b824-4b65-a09d-99d8bed9958a*
3 *Ibid.*
4 *Bundesagentur für Arbeit, 2 November 2016 - https://www.arbeitsagentur.de/web/content/DE/Detail/index.htm?dfContentId=L6019022DSTBAI818146*
5 *Office for National Statistics, 16 Nov. 2016 - https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/november2016*

6.0%

Unemployment in Germany dropped to 6% in October[4], its lowest level since reunification in 1990. Eurostat, using different criteria, recorded a 4.1% seasonally adjusted rate in September. Germany's steadily tighter labour market (in spite of a surge in immigration) has fed into fears of overheating and complicated the debate over how Germany should spend its budget surplus.

4.0%

Premier Li Keqiang said at China's annual parliament in March that China would create over 10 million new jobs in 2016, enough to hold the urban unemployment rate below 4.5%. This target looks set to be achieved, for China's urban unemployment rate stood at 4.04% at end September, according to official data[8]. This rate has remained constant over several quarters, but the real joblessness rate is probably higher (and more volatile).

3.0%

The unemployment rate in Japan has been dropping since mid-2009, and stood at 3% in October[6]. The job-to-applicant ratio has also continued to rise, with 1.43 openings per applicant in October[7], the highest reading since August 1991. But a tight labour market has not translated into wage growth (cash income rose just 0.1% in August year on year), probably because many of the jobs generated are low-paying, part-time ones.

23.4%

Greece has the unenviable record for unemployment in Europe. According to Eurostat, the seasonally adjusted rate stood at 23.4% in October[3]. Credit flowed freely in Greece before its sovereign debt crisis, helping to push unemployment down as low as 7.5% in mid-2007. Youth unemployment stood at 46.5% at end-August 2016.

27.1%

The official unemployment rate in South Africa rose to 27.1% in the third quarter of 2016 compared to 25.5% a year earlier, while the employment rate fell by 0.7%[10]. In absolute terms, the number of people unemployed rose by over half a million in the space of the three months to end-March, while those in employment fell by over 350,000 (the highest number ever on record).

[6] *Statistics Bureau, Ministry of Internal Affairs and Communications, 29 November, 2016 - http://www.stat.go.jp/english/data/roudou/results/month/index.htm*

[7] *Ministry of Health, Labour and Welfare, 29 November, 2016 - http://www.mhlw.go.jp/english/database/db-l/dl/g_workers_oct2016_01.pdf*

[8] *Ministry of Human Resources and Social Security, 25 October 2016 - http://english.gov.cn/state_council/ministries/2016/04/22/content_281475332873004.htm*

[9] *Instituto Brasileiro de Geografia e Estatistica, 27 October 2016 - http://saladeimprensa.ibge.gov.br/en/noticias.html?view=noticias&id=1&pagina=2&paginar=1&quantidade=10&busca=1*

[10] *Statistics South Africa, 22 November 2016 - http://www.statssa.gov.za/publications/P0211/P02113rdQuarter2016.pdf*

Trump victory boosts cyclical stocks, hurts Treasuries

The victory of Donald Trump in the US presidential election boosted the performance of cyclical stocks during November. Other risk assets also performed well ahead of an expected fiscal stimulus in the US. By contrast, safe-haven assets like gold and US Treasuries as well as defensive equities all underperformed.

Equities

The Trump effect

A further boost to cyclicals

The US elections delivered both a political and a market reaction surprise. Developed-market equities rallied on the back of Donald Trump's pro-growth programme, but emerging markets suffered from his threat to renegotiate trade agreements. The S&P500, Stoxx Europe 600 and Topix local currency total returns for November were +3.7%, +1.08% and +5.49%, respectively. The MSCI emerging markets' total return in USD was -4.6%.

Sector performances indicate that markets have started to discount the potential positive effects of Trump's fiscal spending and tax reduction plans. Cyclical sectors, which were already outperforming defensive ones, rallied strongly and financials followed suit thanks to steeper sovereign yield curves. Within the MSCI World index, banks returned 8.5% in November (in USD), followed by energy (+5.7%) and industrials (+3.7%). Trump and the Republicans' victory thus reinforced the outperformance of cyclical sectors that had commenced after the Brexit referendum in June. At the other end of the spectrum, utilities, consumer staples and telecoms declined by 6.1%, 5.1% and 2.5%, respectively, in November. Value-style investments further outperformed Growth equivalents.

As markets moved up without any substantial change in 2017earnings estimates, valuations rose further. The S&P500, Stoxx Euro 600 and Topix P/E ratio stood at 17.0x, 14.2x and 14.5x, respectively, at end November.

Sovereign bonds

Treasuries suffer

US Treasuries underperformed in November because of expectations for fiscal easing

Sovereign bonds posted negative total returns in November as yield curves bear steepened globally. The US 10-year Treasury underperformed its German equivalent, with a total return of -4% versus -1% in local currency. The 10-year Treasury yield rose 56bp to 2.4%, reaching its highest level since January, after Donald Trump's election ignited hopes for a large fiscal stimulus in the US. However, the upward move was much more subdued for the 10-year Bund and the JGB yield as their respective central banks remain in easing mode. We expect the European Central Bank to prolong QE at the same pace for six months beyond its current soft deadline and the Bank of Japan to maintain its 10-year yield target of around 0%. This should help JGBs and Bunds to continue to outperform US Treasuries in 2017.

Peripheral spreads widened by about 20bp in November as political uncertainty clouded prospects for risk assets, especially in Italy. The main issue remains the outcome of the Italian referendum on 4 December and its impact on the resolution of the non-performing loans problems of Italian banks.

US dollar-denominated emerging sovereign debt underperformed its local currency counterpart (-4.2% versus -1.9%), hit by the rise in US T-bond yields, but also by a rise in risk premiums as a result of the depreciation of emerging-market currencies against the US dollar.

Corporate bonds

USD investment grade trails behind

Strong tightening of spreads has helped US high yield to outperform other credit segments hurt by the rise in sovereign yields.

US dollar investment grade (USD IG) underperformed its counterpart in euro in November due to the strong rise in US Treasury yields. USD IG returned -2.7% versus -1%* for euro IG. The yield on USD IG rose 43bp during the month to reach 3.4% versus a yield of only 1% for the euro IG. However, USD IG spreads tightened slightly whereas euro IG widened 16bp, mainly due to the underperformance of some defensive sectors.

US dollar high yield (HY) outperformed its euro counterpart (-0.4% versus -0.9%) thanks to a stronger tightening of credit spreads in the former, which compensated for the rise in US Treasury yields. The OPEC agreement on November 30 led to significant tightening of spreads on oil-related HY bonds. By contrast, euro HY suffered due to its high exposure to financials, which were hurt by continued worries about the non-performing loans problem of Italian banks.

Credit could continue to perform poorly next year if sovereign bonds yields keep rising. However, a rebound in US growth could favour stronger tightening of US dollar HY spreads and compensate for the rise in US Treasury yields. However, HY valuations are high, warranting caution.

* *All credit data are based on Bank of America Merrill Lynch indices and are in local currency.*

Hedge funds

Hedging Trump

Trump's victory was a surprise to many. But in the hedge fund space, we are almost tempted to call the US elections a non-event.

Hedge fund managers adopted a cautious stance ahead of US election day on 8 November in light of increased political risk. Macro managers maintained a very tactical approach, reduced their gross exposure and implemented additional portfolio hedges. Equity-sensitive strategies, on the other hand, did not change their exposures. Interestingly, some tried to find adequate hedges but were unsuccessful given the uncertainty about the outcome of the vote. On election day itself, as the initial volatility abated, managers did not have the opportunity to monetise hedges.

Macro managers fared well in November, mostly thanks to the spike in long-term interest rates. Bullish emerging market positioning was the only pain point for managers with long EM credit & FX exposure. In long/short equity, performance varied depending on managers' sector bias as sector leadership reversed during November, with money chasing cyclicals and healthcare and leaving rate-sensitive sectors as well as some large tech names.

In the aftermath of the election, managers are cautious amid uncertainty around Trump's intentions vis-à-vis the US economy. Overall, managers expect more volatility moving forward, which should increase dispersion and pricing dislocations – an environment conducive to arbitrage trades.

Precious metals

Gold dragged down by Trump

His toning down of protectionist rhetoric and the improving US growth outlook were not kind to most precious metals in November.

Since the US elections, financial markets have mostly focused on the likelihood of fiscal stimulus in the US while dismissing the threats of protectionism aired by Mr Trump during his presidential campaign. Gold, the quintessential safe haven and unproductive asset, has been significantly penalised by this reflation theme (losing 8.1% in November), falling below the USD1200 per troy ounce threshold.

In 2017, more robust US growth, Fed tightening and a strong US dollar do not bode well for the yellow metal. However, low real rates and persistent political uncertainties could provide some support.

Overall, should Trump adopt a more moderate line on protectionism than before, we would expect silver to outperform gold as risk appetite continues to improve. However, should the new president move towards a tougher stance on trade, the hit to the global growth outlook and the negative impact on risk appetite could enable gold to outperform silver.

Palladium still seems the most attractive precious metal as it is exposed to the US economy through car sales. This explains its impressive performance in November, when it gained roughly 24% (in US dollars). As such, while we are keeping a positive bias to palladium, we acknowledge that some price consolidation is likely needed.

Currencies

A supercharged USD

The prospects of higher growth and interest rates after the US elections have led to a sharp appreciation of the US dollar.

Trump's win is likely to help further USD appreciation in 2017. At the same time, a mix of higher US growth and sustained inflationary pressures should make the Japanese yen particularly unattractive. The BoJ's move to cap the Japanese 10-year yield at around 0% should lead to further JPY depreciation in a higher-yielding environment.

The euro should remain supported by its large positive current account, while European political events are unlikely to cause a significant depreciation of the single currency. The prospect that the ECB will announce a timetable for the tapering of its monthly asset purchases in 2018 could support the euro in the second half of the year.

Sterling is the only big currency to have appreciated against the greenback after the US elections, suggesting that domestic concerns are more important than events elsewhere. But the expected slowdown in UK growth in the first half of 2017 and the likelihood of a hard Brexit could put renewed pressure on the GBP, despite its significant undervaluation.

Finally, the Swiss franc should remain strong in the months ahead given high political uncertainties around the globe. The Swiss National Bank will likely have to further expand its balance sheet to curb unwanted CHF appreciation.

2017: from deflation to reflation, from bonds to equities

Our central scenario for 2017 is marked by an upturn in price pressures that sparks a rise in nominal GDP growth and provides momentum for global reflation. However, we do not expect a significant acceleration in real global economic growth next year.

Cesar Perez Ruiz, Chief Investment Officer
Christophe Donay, chief strategist, head of Asset Allocation and Macroeconomic Research

Our central scenario expects price pressures to pick up next year, generating reflation momentum in the global economy. However, the pace of change will not be uniform. Major economies should remain desynchronised and we expect that fiscal and budget policies will remain non-cooperative. Nonetheless, after years of disinflation, and even deflation in countries like Japan, the global economy seems on the verge of a cyclical regime shift. This shift could impact major asset classes, favouring equities at the expense of bonds. Our central scenario foresees a continuation of the trend towards US dollar appreciation that started four years ago.

The economic outlook in 2017: our central scenario

In terms of monetary policy, we see substantial desynchronisation between the main central banks in developed economies. We see the Federal Reserve (Fed) moving gradually toward policy normalisation, with two 25 basis point hikes of the Fed funds rate during 2017. Core PCE inflation (the Fed's preferred measure) may break through 2% as a Trump administration fiscal stimulus equivalent to about 1% of GDP kicks in. But with wage growth still in check and a strong dollar, the risk of near-term 'overheating' of the US is not part of our central scenario. We expect average annual GDP growth of 2% in the US in 2017, up from 1.5% in 2016. While US GDP growth might falter in the first half, the Trump administration's fiscal stimulus plans will begin to feed into higher growth in the second half of the year.

In Europe too, inflation may be tilting upward. Our central scenario posits that fiscal stimulus will remain fitful in 2017, although targeted fiscal stimulus appears to be steadily gaining acceptance among European policy makers as a replacement for monetary policy, which has been losing its effectiveness. We maintain our forecast for euro area GDP growth of 1.6% in 2016 and 1.3% in 2017, although we recognise that governments now have extra fiscal space that could help growth and inflation. The European Central Bank (ECB) should remain dovish, extending its €80 billion-per-month asset-purchase programme beyond March to September 2017, given that underlying inflation should remain well under its 2% target. However, the ECB may make its forward guidance more explicit, with more precise indications of its plans for tapering asset purchases from 2018 on.

The Brexit vote in June 2016 has caused us to revise considerably our forecasts for the UK economy. Our central scenario sees a marked slowdown in real GDP growth from about 2.0% in 2016 to 1.1% in 2017 as a result of a decline in private investment spending and real incomes. Higher imported inflation is expected to limit the capacity for the Bank of England to ease policy rates much more to stimulate economic growth. At the same time, the resilience of the economy since June has created extra fiscal space for the UK government to intervene. Indeed, the Chancellor of the Exchequer's Autumn Statement in November set out plans for extra government borrowing and ditched a previous commitment to achieve a fiscal surplus by the end of the current parliament (2020).

In September, the Bank of Japan (BoJ) embarked on yield-curve control, akin to an unofficial and partial asset-price style of monetary policy, committing to purchase sufficient Japanese government bonds (JGBs) to ensure that 10-year yields remain at about zero. While we forecast that real GDP growth for 2017 will be the same as in 2016 (0.8%), there is the possibility of some moderate improvement in Japanese growth next year as the yen wilts against a resurgent dollar. While inflation is still well below the BoJ's target, it is rising, and deflationary pressures will gradually fade as the yen declines. Improving growth and inflation prospects could mean the BoJ has some room to taper its asset purchases, starting in the second quarter of 2017.

China remains in transition, with economic growth expected to continue to converge toward its structural growth rate potential of 4.5% per annum over the next few years. We expect full-year growth of 6.2% in 2017, down from 6.7% in 2016. Efforts to clamp down on property speculation are ongoing and will have an impact on fixed investment next year, but the Chinese authorities have sufficient budgetary and non-budgetary resources to ensure the economy remains on an even keel in 2017, with no hard landing. Producer prices have been rising in recent months, partly in response to rising commodity prices.

FACTORS THAT ENTER INTO OUR CENTRAL SCENARIO FOR 2017

RISK FACTORS	US	EURO AREA	UK	JAPAN	CHINA
INFLATION	Core inflation normalising (2%+) but no overheating. Wages in check	Headline below target in 2017-18, with downside risks to core (1.0-1.2%)	Large overshooting (3%+) due to imported inflation	Headline and core rising, but still well below target (0.3-0.5%)	Rising to 2%+, still below 3% target
MONETARY POLICY	Gradual normalisation (Two 25bp Fed hikes in 2017)	Still supportive, QE extended through 2017, tapering in 2018	BoE close to zero lower bound (no hike), creating fiscal space	Yield curve controls a challenge. Tapering possible in H2 2017	PBoC fairly neutral (stop & go), helped by currency depreciation
FISCAL POLICY	Fiscal stimulus of ~1.0% of GDP, kicking in in H2 2017	Small and uneven fiscal easing (~0.5%), with upside risks	Targeted stimulus in long-term consolidation trend	No major fiscal expansion beyond 2016 budget plans	Expansionary, with off-budget expenditures

Higher inflation (consumer as well as producer), together with renewed currency weakness, should help the global reflationary trend. Inflation could rise above 2% in China, but remain below the People's Bank of China's target of 3%, justifying the maintenance of low rates in 2017.

A number of factors could impair our core scenario. An alternative, more positive economic scenario posits major fiscal expansion in big economies, especially in the US. A much stronger-than-expected US supply-side economic policy could push US growth up to 3.0% by 2018, for example. Spurred on by rising asset prices, the (re-)emergence of animal spirits is another potential upside risk. On the other hand, important elections looming in Europe and continued uncertainties about the direction of the Trump administration regarding immigration and protectionism constitute important downside risks to our central scenario. And we cannot exclude that festering financial imbalances (including substantial dollar-denominated debts) will overwhelm some emerging economies, most notably China's.

Markets trends favour equities over bonds in 2017

Our central scenario for financial markets is dominated by our view that inflation will make a re-appearance next year as world growth picks up, pro-cyclical fiscal policies kick in and upward pressure on producer prices re-emerges. We see this environment as favourable for at least modest returns from developed-market equities. Valuations—as measured by forward price earnings—appear stretched relative to their historical average and have no significant room to expand further in a rising interest rate environment. But at the same time, growth in corporate earnings is showing signs of picking up again in the US and Europe for the first time in four years. Our central scenario is that the rise in long-term interest rates will not be enough to impair prospects for equities as long as the rate rises prove orderly. Having largely underperformed in the latter part of 2016, we think that emerging-market equities offer at least some tactical opportunities.

We believe that rising long-term rates will continue to impair the attractiveness of sovereign bonds *(see box)*. Indeed, expected nominal total returns for US Treasuries are negative in our central scenario for next year. We also see limited potential for further spread compression in the corporate bond space. Investment-grade corporate bonds in particular offer a slim yield buffer over Treasuries, limiting their potential in an environment of rising rates.

With the US economy strengthening and the Fed set to rate rises twice by 25 bps in 2017, we believe the stage is set for further US dollar strength next year (although the long-term trend for dollar appreciation is maturing). With no other major central banks looking to raise rates any time soon, monetary-policy divergences should further support the US dollar versus G10 and emerging-market currencies. By contrast, the BoJ's determination to cap bond yields means the Japanese yen should continue to weaken.

We also believe the climate will prove propitious for alternative assets. Our analysis of hedge fund

performance finds that when central banks are returning to conventional policies and interest rates are rising, hedge funds offer outperformance in both the short and long term.

As with our economic forecasts, we also take into account alternative scenarios for financial assets. A more upbeat scenario makes greater allowance for the expected supply-side stimulus in the US. In this event, US earnings expectations could continue to improve into 2018, helping boost emerging as well as developed-market equities. Improving expectations could also lead to renewed narrowing of corporate bond spreads. A darker scenario includes the possibility of an outbreak of 'bad' inflation, with an upturn in protectionism feeding into producer price pressures and hurting corporates' bottom lines. This would trigger a resurgence of volatility in equity markets from the current low levels and threaten already lofty valuations. In either alternative scenario, long-term rates would rise more quickly than they have been, exacerbating the 'Great Rotation' out of Treasuries.

A regime shift away from a 60/40 asset allocation

We expect the negative correlation between equities and bonds that is already beginning to reassert itself to persist in 2017. In view of different inflation expectations, we believe this negative correlation is likely to hold better in Europe than the US. The main threat to this scenario is a larger-than-expected spike in inflation, which could cause the equity/bond correlation to move back again from negative to positive. But, in general, in a rising interest-rate environment, the diversification and protection benefits offered by core sovereign bonds like US Treasuries are at risk. The long-predicted Great Rotation into equities and out of bonds may finally be upon us and may accelerate to the point where capital is sucked out of a bond market long considered one of the most liquid in the world.

As a consequence, the classic 60/40 portfolio (60% equities, 40% government bonds) may not prove to be the most appropriate allocation for a balanced portfolio. With inflation looming, fund managers may want to consider different approaches to asset allocation and open up to the potential offered by more illiquid assets such as private equity and real estate, for example.

In general, in a changing economic and market environment, wealth managers will have to remain active in their tactical asset allocation, which we believe holds out the possibility of improving the risk-reward ratio.

THE 'GREAT ROTATION': A REGIME SHIFT FOR FIXED INCOME

Some turning points for asset classes are easier to spot than others. One of the most obvious involves long-term US Treasury bonds. Donald Trump's election as president of the US has served to accelerate changes in bond performance already underway and to bring questions about the role of US Treasuries in a diversified portfolio even more sharply into focus.

Between 1982 (the beginning of the so-called 'Great Moderation', marked by a fall in the volatility of business cycle fluctuations) and the first tremors of the financial crisis in 2007, inflation fell from 14% to as low as 1%. US Treasuries produced an annual total return of the order of 9% per annum (in US dollars) during this time, with negative returns in just five of those 25 years.

But it is unlikely that bonds will deliver returns of the same magnitude in the years ahead. The reasons are quite simple. Either long-term interest rates stabilise around their current level and returns are in line with the coupon (around 2.3% for 10-year US Treasuries in late November) or, as many expect, inflation and economic growth move higher in the US, in which case interest rates could continue to rise until they approach the rate of nominal (unadjusted for inflation) GDP growth, estimated at around 4.5% on average in the US. In this case, assuming a return of 1.2% (the average total return our in-house models are currently expecting over the next decade), US Treasuries would end up destroying value. The only way the outlook for bond returns could improve is if there were sharp falls in long-term rates, to below 1%, which seems unlikely.

Contributors | Christophe Donay, Alexandre Tavazzi, Bernard Lambert, Dong Chen, Jean-Damien Marie, Jacques Henry, Luc Luyet, Nadia Gharbi, Lauréline Chatelain, Cesar Perez Ruiz **Editors** | Kalina Moore, Isidore Ryan | Content completed on 2th December 2016 | **Layout** | Production Multimédia Pictet **Paper** | Printed on FSC-Certified paper

Disclaimer | This document is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information and data contained in this document are provided for information purposes only; the Pictet Group is not liable for them nor do they constitute an offer, an invitation to buy, sell or subscribe to securities or other financial instruments.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The value and income of the securities or financial instruments mentioned in this document are based on rates from the customary sources of financial information and may fluctuate. The market value may vary on the basis of economic, financial or political changes, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance.

The content of this document is confidential and may only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. As such, the addressee of this document remains solely liable for any form of reproduction, copying, disclosure, modification and/or publication of the content of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

This document is issued by the Pictet Group. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2016.

US small caps salute Trump victory

November was a poor month for precious metals, reflecting a rise in risk appetite that could also be seen in the bond market. Ten year US bond yields rose strongly in November, from 1.8% to 2.4%. On the flip side, stock markets continued to rise, with the US small-cap index, the Russell 2000, responding especially well to Donald Trump's presidential victory.

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

MAIN ECONOMIC INDICATORS

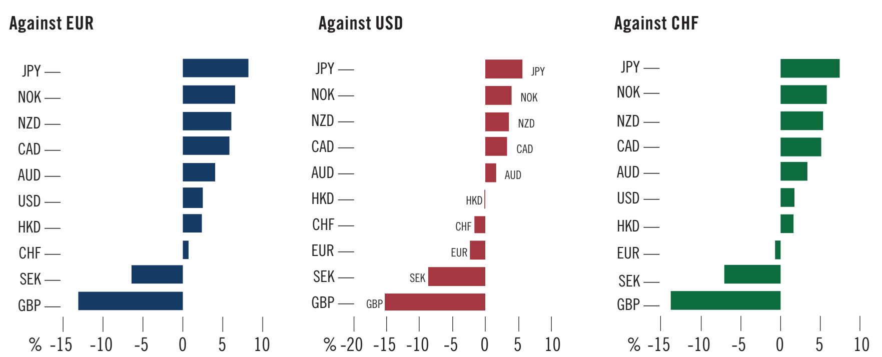
Pictet estimates – (consensus*)

GDP growth rates	2014	2015	2016E		2017E	
US	2.4%	2.6%	1.5%	(1.5%)	2.0%	(2.2%)
Euro area	0.9%	1.6%	1.6%	(1.6%)	1.3%	(1.3%)
Switzerland	2.0%	0.8%	1.5%	(1.5%)	1.4%	(1.5%)
UK	3.1%	2.2%	2.0%	(2.0%)	1.1%	(1.1%)
Japan	-0.1%	0.6%	0.8%	(0.6%)	0.8%	(0.9%)
China	7.3%	6.9%	6.7%	(6.7%)	6.2%	(6.4%)
Brazil	0.1%	-3.9%	-3.2%	(-3.3%)	1.0%	(1.2%)
Russia	0.5%	-3.3%	-0.7%	(-0.6%)	1.3%	(1.2%)

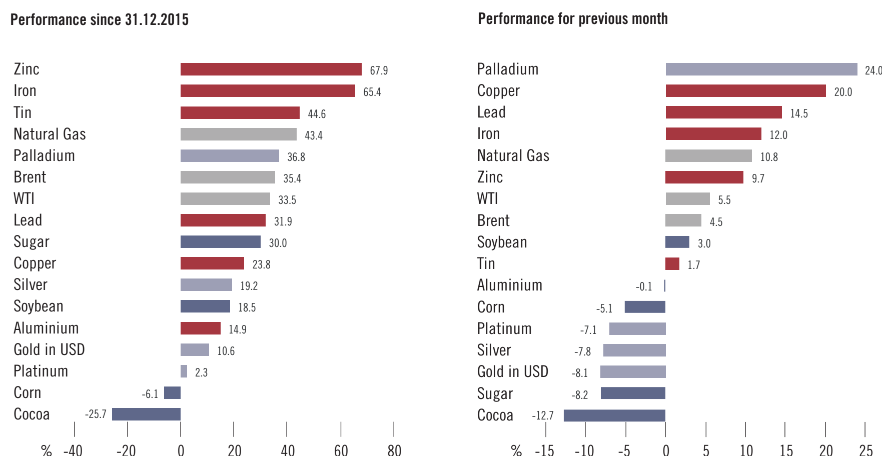
Inflation (CPI) Annual average, except year-end for Brazil	2014	2015	2016E		2017E	
US	1.6%	0.1%	1.4%	(1.2%)	2.4%	(2.3%)
Euro area	0.4%	0.0%	0.2%	(0.2%)	1.3%	(1.3%)
Switzerland	0.0%	-1.1%	-0.3%	(-0.4%)	0.4%	(0.3%)
UK	1.5%	0.0%	0.8%	(0.7%)	2.7%	(2.5%)
Japan	2.7%	0.8%	-0.3%	(-0.2%)	0.3%	(0.4%)
China	2.0%	1.4%	2.0%	(1.9%)	2.2%	(1.9%)
Brazil	6.3%	9.0%	8.0%	(6.9%)	5.4%	(5.1%)
Russia	7.8%	15.5%	6.5%	(6.1%)	5.5%	(5.1%)

*Source: Consensus Economics Inc

EXCHANGE-RATE MOVEMENTS (SINCE 31.12.2015)



COMMODITIES

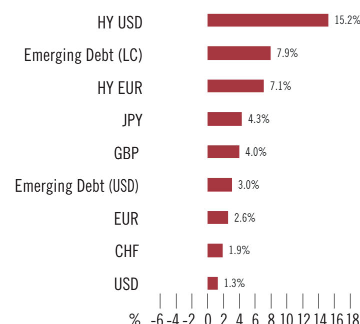


INTEREST RATES

	Short (3 months)	Long (10 years)
US	0.50%	2.4%
Euro area	0.0%	0.28%
Switzerland	-0.75%	-0.2%
UK	0.25%	1.42%
Japan	0.0%	0.0%
China	2.10% (1 year)	4.75% (5 years)
Brazil	14.0%	11.9%

BOND MARKETS

Returns since 31.12.2015



STOCK MARKETS

Returns since 31.12.2015

	USD	EUR	CHF	GBP
MSCI World*	5.6%	8.1%	7.5%	24.6%
S&P 500*	9.8%	12.4%	11.7%	29.5%
MSCI Europe*	-4.8%	-2.5%	-3.1%	12.3%
Tokyo SE (Topix)*	2.4%	4.8%	4.2%	20.7%
MSCI Pacific ex. Japan*	7.9%	10.5%	9.8%	27.3%
SPI*	-6.8%	-4.6%	-5.2%	9.9%
Nasdaq	6.3%	8.9%	8.2%	25.4%
MSCI Em. Markets*	11.3%	14.0%	13.2%	31.3%
Russell 2000	16.4%	19.2%	18.5%	37.3%

* Reinvested dividends

SECTORS

Returns since 31.12.2015	US	Europe	World
Industrials	15.9%	3.6%	9.9%
IT	10.2%	-2.8%	8.7%
Materials	13.9%	21.3%	18.4%
Telecommunications	9.9%	-21.4%	-3.3%
Health care	-5.0%	-16.1%	-9.6%
Energy	20.2%	14.0%	18.6%
Utilities	7.4%	-13.9%	-1.2%
Finance	15.7%	-10.0%	5.4%
Consumer staples	0.0%	-6.7%	-3.2%
Consumer discretionary	4.6%	-9.1%	0.2%

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

PERSP ANG 1216

PICTET
1805

Perspectives is also available to download.
Sign up to subscribe and keep up-to-date online
with our views on markets, the economy and
key underlying trends on the *Perspectives* website:
http://perspectives.pictet.com