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SPECIAL EDITION 2017

Perspectives

US stocks eye Trump policy boost

Donald Trump's plans for a significant fiscal stimulus, as well as tax and regulatory reform have US execs salivating – *pages 4–6*

Reflation set to help Europe's banks

The sector went through a sombre period in 2016 and it still faces issues, but 2017 may be less challenging – *pages 6–7*

Equities: value strategies' day in the sun

Robust earnings dynamics and inflation expectations continue to support 'value' equities – *pages 8–9*

How high will euro area bond yields go?

Along with higher US rates, hints of ECB tapering will be on bond investors' minds – *pages 9–10*

Alternative investments reach a turning point

Reports of the death of the hedge fund industry are greatly exaggerated, and opportunities beckon in private equity – *pages 14–16*

What could go wrong?

Imagining how things could go haywire in Europe and China – *pages 16–18*

2017, the year of reflation

A modest rise in inflation expectations and an improved outlook for corporate earnings growth, together with a shift from monetary to fiscal stimulus will likely be important investment themes in 2017. In a word, reflation is in the offing. But any assessment of prospects for the world economy and financial markets cannot exclude the continued fallout from the Brexit vote and the actions of the Trump administration.

EDITORIAL

INVESTING IN A REFLATIONARY ENVIRONMENT

CESAR PEREZ RUIZ

Chief Investment Officer

Pictet Wealth Management

Our central scenario for 2017 is dominated by our expectation that inflation will re-appear as economic growth remains solid and upward pressure on producer prices re-emerges. Alongside reflation, we see three other key macro themes. First, a shift from monetary to fiscal stimulus, most notably in the US. Second, the return of corporate earnings growth, following four years of disappointment. Third, continued high political uncertainty, especially over the policies of the new Trump administration. Although political risk remains high, we do not expect anti-establishment, anti-EU parties to run governments in any EU country.

The following are some key views to keep in mind for investments:

Reflation to favour equities. Higher nominal GDP growth is likely to support better corporate earnings growth. This should favour equities over bonds.

The dollar probably wins again. We expect the Fed to raise interest rates twice in 2017, by 25bp each time. With Europe and Japan still in easing mode, and the yuan and emerging market (EM) currencies continuing to weaken, the US dollar should remain the strongest-performing major currency.

Value outperforms. Within equities, the reflationary trade should mean further outperformance by value and cyclicals, following the big leadership change seen on equity markets since July.

Sovereign bonds likely to suffer. Rising long-term rates probably mean an end to the 35-year bull market in sovereign bonds. In fact we expect nominal total returns on core sovereign bonds to be negative in 2017. However, better corporate profits will help credit markets. We favour short-duration corporate bonds and high yield, which are likely to perform best in an environment of rising sovereign yields and improving corporate profits.

Caution needed on EM. Generally, we still prefer to play emerging markets (EM) through developed markets, as EMs are still exposed to the slowdown in China, rising rates in the US and potential protectionist moves by Trump. But EM equites and local currency debt, which largely underperformed in the second half of 2016, may offer some tactical opportunities.

Things looking up for active managers. The end of the long bull market in sovereign bonds will make it even more important to look for new sources of diversification. A gradual rise in bond yields should make for a better environment for active managers, following a difficult year in2016, and alternatives.

Volatility spikes to persist. Finally, uncertainty over politics and policy means that volatility will likely continue to spike periodically. In this environment, we will continue to trade tactically in order to boost returns.

We are also keeping in mind alternative macroeconomic scenarios. A more upbeat one sees greater allowance for the expected supply-side stimulus in the US. In this event, US earnings expectations could continue to improve, helping boost equities and lowering corporate bond spreads, while a gradual rise in inflation is met by moderate rate rises. But in an alternative scenario, a Trump stimulus might prove too much for an economy already running at close to full employment, and quickly shows up in much higher inflation. This forces the Fed to raise rates faster than it might have, casting a shadow over the bond market. At the same time, the dollar strengthens to such a degree that the debts of some high-yield corporates and emerging-market sovereigns become a real concern.

We wish you every success in your investments in 2017.

CHRISTOPHE DONAY
Chief Strategist, Head of Asset Allocation & Macroeconomic Research
Pictet Wealth Management

MACRO VIEWPOINT

The innovation shock may not improve growth much

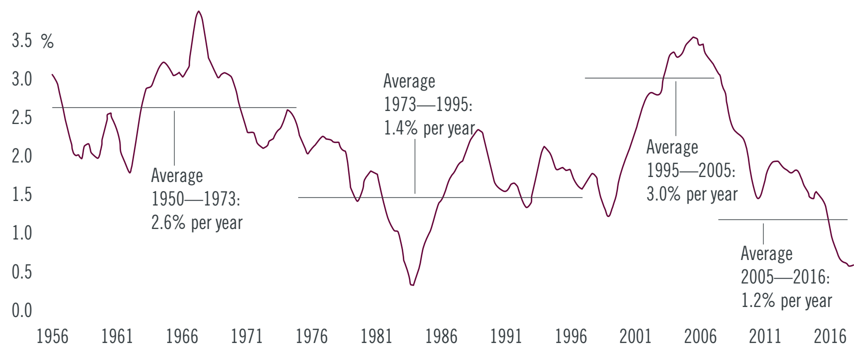
A potentially good year for risk assets cannot disguise secular shifts in the world economy.

This year could see important shifts in the investment landscape. Our central scenario for 2017 is set out in the previous article and was outlined in 'Topic of the Month' in the December issue of *Perspectives*. But one should not lose sight of trends over the next 10 years, which we believe will be marked by constant shifts in economic and policy regimes and, we believe, an innovation shock that is only beginning to be felt. This shock is to be seen across the board, whether it be in transport, life sciences, financial technology, energy, logistics or manu-facturing. Yet the truly transformative effects of this shock have still to be fully seen. Instead, over eight years after the collapse of Lehman Brothers, weak productivity growth is still trans-lating into sluggish economic growth, even as corporate profits as a percentage of GDP have climbed.

'Eight years after the Lehman collapse, weak productivity gains still mean sluggish economic growth'

Many explanations are given for this state of affairs, including the lingering effects of the financial crisis and disinflation, which has shown up in low or nonexistent wage growth. Automation is undoubtedly contributing to the downward pressure on wages, leading to displacement for broad swathes of the population and growing inequality. But we do not subscribe to the view that capitalist societies are facing some sort of secular stagnation. Productivity weakness in the past has frequently proved temporary and turned around unpredictably. Productivity growth actually picked up in the US in the late 1990s thanks to the appearance of the internet and new communications technology. And some believe that standard measures of productivity are failing to capture reality.

US NON-FARM SECTOR PRODUCTIVITY GROWTH, 1955–2016



*Annual growth rate in output per hour worked (5-year rolling average)

Source: Bureau for Labor Statistics, Pictet WM – AA&MR

Throughout history, productivity has tended to rise as the effects of innovation shocks spread – and as productivity has risen, so have real wages. In this regard, it is worth noting that hourly wages in the US grew at an annual 2.9% in December, the highest rate since 2009. As long as these gains in wages are accompanied by a rise in productivity, stronger wage growth could drive a boom in investment in innovation. In turn, in a kind of virtuous circle, this boom could serve as a catalyst for global productivity. Of course, the actual outcome may prove to be less straightforward. The innovation wave may well change humans' role in the production process – and in so doing could increase inequality even further.

The mixed, transformative effects of the innovation shock are already fully integrated into our 10-year expectations for growth and inflation along with other factors such as monetary policy and the changing role of emerging markets.

LOWER RETURNS EXPECTED

We conclude that as the effects of the financial crisis fade, we will see a gradual 'normalisation' of inflation and growth across most countries over the coming years, which we believe will find a new equilibrium. Lingering fears of deflation or

even disinflation may be put to rest although inflation will remain low by historical standards. Assuming that the effect on overall economic growth of the innovation shock proves relatively modest, our central scenario for the next 10 years is that real GDP growth will average 2.25% annually in the US, 1.25% in the euro area and 4.5% in China (well below the 8.6% annual rate it recorded in 2008–2015).*

Our observations of changing macro-economic dynamics feeds into our expected return calculations across a variety of asset classes. Overall, the returns that can be expected from developed-market equities over the next 10 years will be over a third lower than average of the past 46 years, while our estimates are that total annual returns from government bonds over the next 10 years will be just a quarter of what they were on average since the beginning of the bull market in bonds in 1981. Fortunately, there are also other ways to compensate for the decline in expected returns in the classic asset classes. This involves seeking out alternative assets – but at the price of relatively low liquidity. ■

*Our in-depth findings are included in the latest issue of *Horizon*', published in January 2017.

EQUITIES

US equities: animal spirits are back to the fore

In an interview, Frank Bigler, head of equity investment research at Pictet Wealth Management, spells out the prospects for US equities under the new Trump administration.

FRANK BIGLER
Head of Equity Investment Research
Pictet Wealth Management

WITH DONALD TRUMP AS US PRESIDENT AND WITH BOTH HOUSES OF CONGRESS CONTROLLED BY THE REPUBLICANS, WHAT CAN BE EXPECTED TO DRIVE US EQUITY MARKETS IN THE YEAR AHEAD?

There are three main topics driving US equities at the moment. First, belief in a substantial expansion in infrastructure spending; second, expectations for tax cuts; and third, the meaning of tax reforms for corporate activities.

On the first point, our view is that while a government drive to increase infrastructure spending seems to be on the cards (Trump's transition team has pledged to spend USD550 billion on infrastructure), the number of quoted US companies that will benefit is relatively small. Among infrastructure providers, the main beneficiaries stand to be those with purely domestic revenue streams, such as cement and gravel producers, where the supply and demand is only affected by national factors. As a consequence, even for steel and engineering companies that are exposed to global trends, the benefits may not be so clear cut. For a start, any increase in income in the US may be counterbalanced by hits to international business caused by the rise of the US dollar. Trump's plans to increase defence spending are also worth noting.

As for Trump's tax cuts and reforms, everything is still very much up in the air. Between Trump's ambitious plans and Congress's wish to limit the deterioration in public finances, we believe that some sort of middle path will be found. At least initially, a cut in personal taxes will likely have a bigger impact on smaller and medium-sized companies exclusively focused on the domestic market rather than S&P 500 companies with more international exposure. Perhaps the most direct benefits would be for retailers, and higher disposal income should help drive an already-healthy home-building sector. But it could be a couple of quarters before the effects of household tax cuts are felt on corporate balance sheets.

The third big theme for corporate America are proposed changes to corporate taxation, in particular Trump's intent to encourage US corporations to repatriate the vast profits they hold abroad in places like Ireland to avoid a statutory corporate

USD550 billion

Size of Trump's infrastructure pledge

tax rate of 35%. The Trump administration's stated aim is that companies will use any tax holiday on repatriated profits to reinvest and revitalise growth. But we think the potential for greater investment in many sectors is pretty small. For companies in mature sectors, including industrial conglomerates like General Electric, the opportunities for organic growth in the US are limited. In addition, multinationals remain engaged in efforts to shorten their supply chains, meaning that production is located closer to regional end markets.

Other sectors such as IT and biopharma are already cash rich, so a tax holiday may not necessarily mean any great changes in their plans to invest in the US. Instead, with the five largest US pharma companies alone estimated to hold about USD250 billion in cash overseas, according to our calculations, a repatriation of foreign profits could well spur an increase in M&A in some sectors. We could also see companies use repatriated money for share buy backs or for dividend increases.

ALONG WITH THE EXPECTATIONS AROUND A TRUMP PRESIDENCY, THERE ARE ALSO SOME RISKS, NOTABLY WHEN IT COMES TO TRADE POLICIES…

Trump rhetoric on trade and tariffs is undoubtedly alarming, and is rankling countries like China and Mexico. He has already buried the Trans-Pacific Partnership and the European equivalent, the Transatlantic Trade and Investment Partnership, will probably go the same way. But there are actually few sectors in the US that would benefit from greater protectionism. Those that might – steel, coal production – are already moribund, and stand to contribute little to future economic growth. Other sectors such as car production often have assembly plants in countries like Mexico, and will suffer if tariff barriers go up. These sectors also have a large dependence on immigrant labour, which may also be curtailed under Trump. But a clampdown on immigration might just accelerate the trend toward automation rather than create huge numbers of new jobs in the US. Silicon Valley would also be concerned about any broad-brush attempt to curb immigration. But along with the dichotomy between rhetoric and what protectionism can achieve, contradictions can be seen at another level, notably between Trump's own deal-making instincts and an administration that, alongside some noted protectionists, he has packed with dyed-in-the-wool capitalist businessmen and bankers.

IN VIEW OF WHAT YOU ARE SAYING, DO YOU THINK MARKETS RISK GETTING AHEAD OF THEMSELVES?

Worries about what Trump might do on the trade front are undoubtedly being 'trumped' at the moment by what can only be called a re-emergence of 'animal spirits' among corporate leaders. This is because, along with tax cuts and extra government spending, there is a feeling that the general ramping up of regulations over the past eight years will finally start to moderate. This is particularly noticeable in sectors like financials and energy. The signals sent by appointing climate-change contrarian Myron Ebell as head of the Environmental Protection Agency and Goldman Sachs executive Steven Mnuchin as Treasury secretary are major contributors to the aforementioned 'animal spirits'.

> 'One risk is that inflation rises much faster than market participants expect'

Likewise, the nomination of Rex Tillerson, CEO of Exxon Mobil, as secretary of state suggests a shift in the focus of America's international relations away from strictly political considerations to one that takes better account of businesses' concerns. And while this will be music to the ear of the oil industry, the implications for American corporations at large could be very positive and contribute to renewed appetite for deploying capital and investing in growth.

That said, there are clearly risks. One is that inflation rises much faster than market participants are factoring in, forcing the Fed to raise rates faster than anybody is anticipating. We already have full employment in the US, and there are some signs of burgeoning wage growth. What I find slightly worrying is that a whole new generation of participants has arrived on the scene since the financial crisis who have no experience of inflation or its effects. The last time that CPI inflation briefly topped 5% in the US was in 2008. The best parallel I can think of is how the warnings of analysts who had gone through the sharp down cycle in oil from the mid-1980s to the mid-1990s were forgotten as oil marched steadily upward during the late 2000s and again between 2009 and 2014. In short, there is a risk that people forget the past.

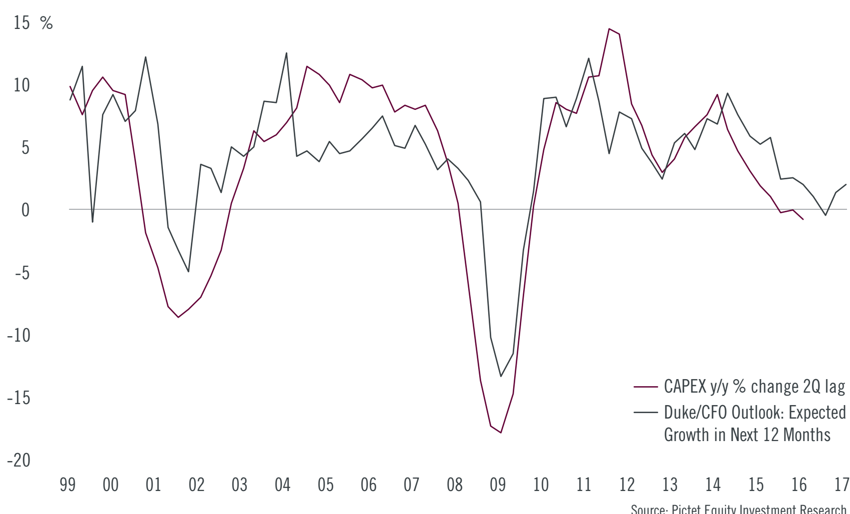
S&P 500: 12-MONTH FORWARD P/E RATIO, 1995–2016

Source: PWM Equity Research, Bloomberg

There are also plenty of corporations that have taken on debt at low interest rates to engage in buy backs. They could be hurt in the long term, especially if the size and pace of rate increases are greater than they are prepared for. And one has to wonder whether current valuations are sustainable. The 12-month forward price-earnings ratio on the S&P 500 was running at around 17x at the beginning of 2017 – pretty high by historic standards. For the moment, these valuations are being justified by the expected pick up in earnings, and I don't see price-earnings ratios reaching the levels seen during the dotcom bubble, which would really indicate an asset bubble.

But while I don't see a stock-market crash around the corner, it wouldn't take much to see short-term pullbacks in market prices of the order of 5–10% if assumptions about, say, Obamacare repeal or tax reform turn out to be ill founded. In any case, the market needs to catch its breath and it will likely do this once it has made a more realistic assessment of what a Trump administration means.

THE RE-EMERGENCE OF ANIMAL SPIRITS: CAPITAL SPENDING INTENTIONS IN THE US



Source: Pictet Equity Investment Research

THERE IS ALSO AN ELEMENT OF THE 'PAIN TRADE' BEHIND MARKETS' UPWARD MOVEMENT…

Undoubtedly, most market participants were caught flat-footed by Trump's presidential victory and have been playing catch up ever since. This sets up the market for great lurches forward followed by pull-backs. But the overall direction of the market is still up, in our view, and any pull-back would be taken as an opportunity to exploit. That is what makes option trading interesting as a way both to protect portfolios against bouts of volatility and to quickly exploit that volatility for tactical trades. ■

YANN GOFFINET
Senior Financial Analyst
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EQUITIES

Reflation set to help banks

Higher interest rates will be good for the European banking sector.

The market performance of European banks in 2016 was a tale of two halves. In the first half, banks were the worst-performing sector on the Stoxx Europe 600 index. This was a period during which the ECB embarked on a new quantitative easing (QE) scheme and the British decided to leave the EU in the Brexit referendum, both factors contributing to ever-lower interest rates throughout Europe.

But in the second half of the year, banks recovered most of their first-half underperformance as bond yields rose from their July lows on both sides of the Atlantic, in line with improved economic data. In the US, the recovery in bond yields has been further boosted by the election of Donald Trump.

> 'Banks recovered most of their first-half underperformance as bond yields rose'

There was a high correlation between the European banks' relative performance and inflation expectations during 2016 (*see chart*). An equally good

correlation could be shown between European banks' relative performance and US bond yields.

BANKS DO WELL IN A REFLATIONARY ENVIRONMENT….

Imagine a simplified world with interest rates of 3.5%, while retail banks pay 2% for client deposits. In this world, banks pocket the 1.5% difference as part of their net interest margins. But in a different scenario, where interest rates drop below 1.5%, as banks are reluctant to charge customers for depositing money at the bank, their margins on deposits start to shrink. Should base rates turn negative, then banks are potentially facing negative deposit margins. This is the situation in which European banks found themselves in 2016, especially after the ECB slashed its own deposit facility rate to – 0.40% in March.

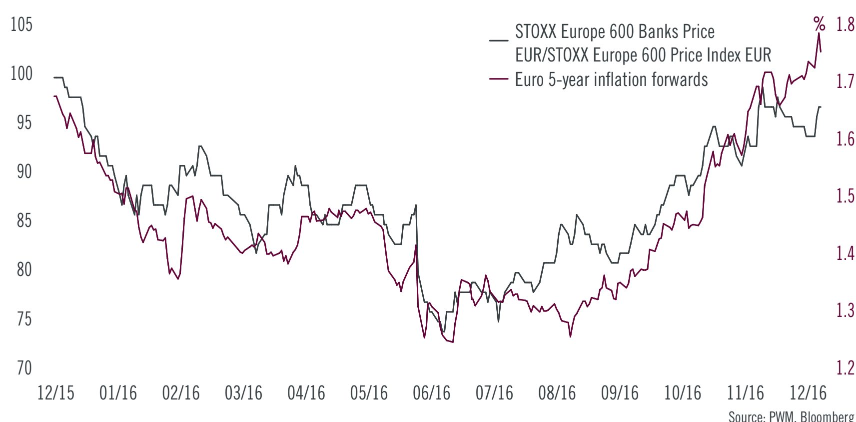
> 'With negative rates and flat yield curves, banks cannot cover their costs and make double-digits returns at the same time'

On the lending side, margins have held up better. However, euro area banks have generally been unable to offset lower deposit margins through rising loan margins (unlike banks in Sweden and Switzerland). The flattening of the yield curve that has accompanied the ECB's QE has further dented bank margins. Given that banks' assets are of longer duration than their liabilities (loans tend to be of longer maturity than deposits), a flattening of the yield curve leads to less interest revenue.

5%

Average ROE of European banks

THE CORRELATION BETWEEN THE RELATIVE PERFORMANCE OF EUROPEAN BANKS AND INFLATION EXPECTATIONS



Source: PWM, Bloomberg

In combination with rising capital requirements since the financial crisis, this pressure on net interest income, which remains euro area banks' main source of revenues (about 60%) has led to low returns on equity (ROE). The average ROE in the European banking sector stood at about 5% in 2015/16. This compares with an average ROE for Stoxx Europe 600 companies of 12.5%. Put another way, with negative rates and flat yield curves, banks cannot cover the cost of their infrastructure (IT, branches, staff) and make double-digit returns at the same time.

…BUT THE EASY REFLATIONARY TRADES ARE DONE

Hence, the turn in interest rates and inflation expectations during the second half of 2016 came as a relief for European banks, putting to rest some of the worst fears about future profits. From a valuation standpoint, the price-earnings multiple at which banks trade relative to the overall equity market moved from 0.6x in summer 2016 back up to its historic average of above 0.8x in a matter of a few months.

The speed of banks' recent re-rating suggests that most of the easy reflation trade may have happened already. Even if the re-rating proceeds and banks' relative P/E multiples move higher than their long-term average, a wave of earnings upgrades may be needed to support the performance of the European banking sector from here on (so far, earnings have simply bottomed out after a long period of decline).

The coming months will clarify if the optimism on growth and interest rates, particularly evident since the election of Donald Trump, is justified. Still, global interest rates may well have seen a low in 2016, so that the environment for banks going forward may steadily become less challenging and normalise. Such a development would justify selectively increasing portfolios' exposure to banks. Banks with exposure to the US, the market that is driving the upturn in interest rates, may remain attractive – at least as long as the ECB continues with its QE programme. ■

Inflation expectations favour 'value' equities

'Value' equity strategies performed well in the latter half of 2016. This trend seems set to continue this year.

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WILHELM SISSENER
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Last year was one of contrasts in financial markets. Fears of disinflation remained the overriding theme in the first half. This meant that relatively safe equities characterised by low price volatility outperformed inexpensive, but higher-risk, stocks (i.e. 'value' stocks). Early July saw a regime shift, caused by much better-than expected US employment data and a reassessment of the economic consequences of the UK's Brexit vote. This enabled inflation expectations to re-emerge to dominate market sentiment. According to our measures, since this regime shift, US value equities have significantly outperformed low-volatility equivalents and the S&P 500 benchmark, by 31% and 21% in USD, respectively.*

There are as many value indices as index providers. For a clear-cut reading of market trends, we at Pictet Wealth Management have developed our own US 'value' index, taking into account the most recent academic research. This index is currently heavily overweight financials (mostly banks) and oil & gas stocks relative to the S&P 500 benchmark, while it is most underweight healthcare.

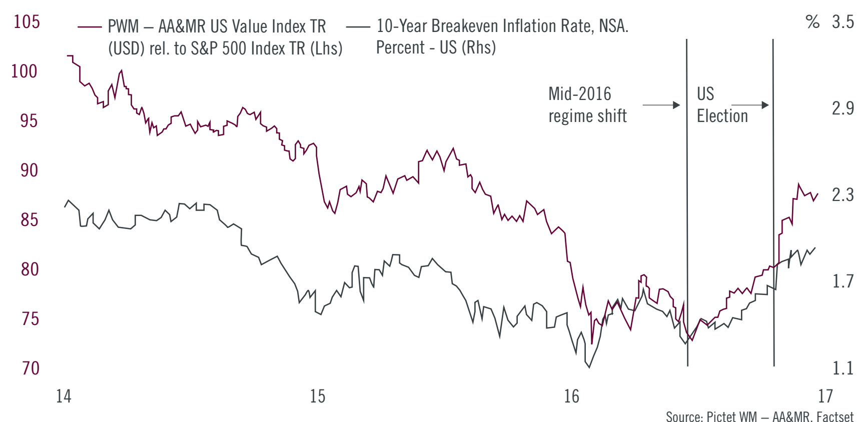
The risk factor driving value stocks is alive and well – namely, the resurgence in long-term inflation expectations, which has helped long-term interest rates rise. The 10-year US Treasury yield increased from a low of 1.36% in July to almost 2.4% in early January 2017. We expect yields to rise towards 3% by year end. This will raise banks' net interest margins, helping the case for strong earnings growth in the sector.

> 'US value equities have significantly outperformed low-vol equivalents and the S&P 500'

The recovery in oil prices, from under USD30 per barrel in February 2016 to over USD50 in early January, should help oil & gas sector profits to recover. As we expect oil prices to average around USD55 per barrel in 2017, energy companies' profits will benefit from a strong base effect this year.

*Total returns from 5 July 2016 to 5 January 2017

THE 10-YEAR US BREAKEVEN INFLATION RATE: A SIGNIFICANT RISK FACTOR DRIVING 'VALUE' EQUITIES



Source: Pictet WM – AA&MR, Factset

Consequently, contrary to the continuous slashing of earnings expectations of recent years and anaemic growth in earnings in 2015 and 2016, we expect earnings growth overall to recover in 2017. We believe growth could easily reach 7–8% in developed markets and 10% in emerging markets. Financials should account for around 15% of the earnings growth of S&P500 companies and 25% of Stoxx Europe 600, while the oil & gas sector is likely to account for around 30% of total earnings growth in the US and almost 20% in Europe.

'Inflation expectations are a significant risk factor driving US value-style equities'

The scenario for robust earnings dynamics, which is underpinning the ongoing reflation trade and helping 'value' equities in particular, has strengthened in the aftermath of the US elections in November.

Taking the 10-year US breakeven inflation rate as a proxy, trends in inflation expectations favour 'value' (*see chart*). Inflation expectations are a significant risk factor driving US value-style equities relative to the S&P 500.

All things considered, our expectations for earnings growth remain extremely cautious and provide room for positive surprises in 2017. One could come from Donald Trump's economic programme if it has a sensible supply-side element. His tax reform proposals and a large infrastructure spending plan would help sustain nominal GDP growth and market sentiment. A straightforward simulation shows that cutting the corporate tax rate in the US to 15% from the current level of 35% could result in double-digit earnings growth in 2017 and 2018. While not part of our core scenario, this is certainly something to monitor in 2017.

Plans for increased US public spending support a continued rise in 10-year inflation expectations. If expectations were to increase towards the historical average of 2.2% from around 2.0% at present, then there is the potential for the market price of 'value' equities to even rise by double digits this year, according to our calculations. The value trade is therefore still in play, driven by still-inexpensive equities in sectors that are sensitive to rising inflation expectations. ■

BONDS

ECB tapering will be on investors' minds

Along with the approach of bond purchase tapering, euro area bonds will be influenced by rate normalisation in the US and a packed political agenda.

LAURÉLINE CHATELAIN
Fixed Income Strategist
Pictet Wealth Management

In December 2016, the ECB decided to extend its quantitative easing (QE) programme until at least December of this year, but at a reduced rate of Eur60 bn per month from April on, compared with the current EUR80 bn. In addition, the ECB broadly hinted that it would start contemplating tapering of its monthly purchases in the second half of 2017.

With the taper tantrum of 2013 after the Fed indicated it stood ready to downsize its own bond purchases still fresh in memories, forecasting the path of ECB tapering will be essential for bond investors to avoid surprises. Core inflation will be a key focus. In the event, we think core inflation would have to consistently overshoot the ECB staff's median projection of 1.1% year-on-year in 2017 before the ECB would draw up any definitive plans for exiting QE. In fact, we believe the ECB will want to remain cautious to avoid the spill-over effects of a renewed fall in inflation expectations. Based on our forecasts that headline inflation will only reach 1.5% on average in 2017 and 1.3% in 2018, we expect the ECB will lean against any overly hawkish shifts, only ending its monthly asset purchases at end 2018 at the earliest.

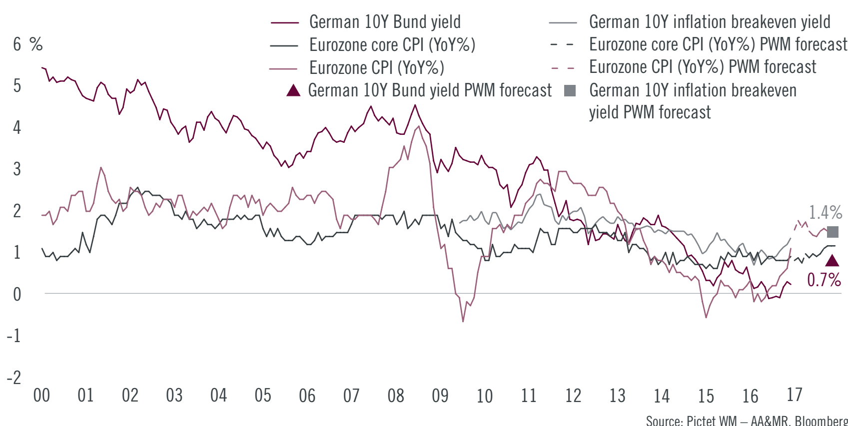
However, the market's focus on inflation data could result in higher bond market volatility. This data can be jumpy and should be impacted by positive base effects in Q1 2017, which will fade as the year progresses.

The recent spike in headline inflation, if prolonged, could put some pressure on the ECB eventually, although the bank's Governing Council is likely to continue to resist (German) politicians arguing for tighter policy. Moreover, the euro area bond market remains highly integrated globally and the actions of the world's other main central banks are also important for forecasting euro area bond yields. For example, the 10-year German Bund yield is almost perfectly correlated with its US Treasury peer.

In line with market forecasts, we expect two 25bp hikes from the Fed in 2017. However, if the core PCE price index moves persistently higher than the 2.1% year-on-year rate expected for end-2017, the Fed could ramp up the pace of rate hikes. A more hawkish Fed would probably put upward pressure on Treasury yields, especially on short maturities, leading to a flattening of the yield curve. This would have repercussions for euro area sovereign bonds. As things stand, we expect the benchmark 10-year US Treasury yield to reach 3% by the end of 2017 (up from 2.36% on Jan. 5), potentially spiking higher during the year if the US Congress agrees to a substantial fiscal stimulus. On the other hand, we are not expecting any policy surprises from either the Bank of England or the Bank of Japan. The former's ability to support slackening domestic demand will be held back by rising imported inflation, while thelatter will be forced to pursue QE as inflation remains persistently below target.

In the euro area itself, anticipation of ECB tapering could lead to a strong rise in Bund yields, as ECB buying pressure subsides. This would enable the bond market to reprice government bonds in line with signs of resilient economic growth and accelerating inflation in Germany and, to a certain extent, in the euro area as a whole. The benchmark 10-year Bund yield could rise to 0.7% by the end of 2017 (up from 0.25% in early January), spiking higher if inflation accelerates more than anticipated. In this scenario, spreads on peripheral bonds over Bunds would widen, particularly in economies such as Italy and Portugal, where the market might again focus on debt sustainability. With important elections due in France, the Netherlands, Italy and Germany this year, political uncertainties could also trigger higher volatility. Any changes in countries' fiscal and economic policies would soon turn up in sovereign bond yields. ■

10-YEAR GERMAN BUND YIELD & EURO AREA INFLATION



Source: Pictet WM – AA&MR, Bloomberg

BONDS

Cometh the hour, cometh the unconstrained bond fund

After years of treading water, unconstrained (or absolute return) bond funds are poised to come into their own again as we enter a period of moderate reflation.

MUSSIE KIDANE
Head of fund and manager selection
Pictet Wealth Management

Record low interest rates and the prospects of a pending normalisation of monetary policy have spawned significant interest in unconstrained bond funds as investor's quest for higher yield and capital protection. Despite periodic bouts of volatility, global bond indices have risen by almost 20% over the last five years. Unconstrained bond funds have lagged, delivering a 6% return on average over the same period. As a result, many investors are understandably disappointed by the relative performance of unconstrained bond strategies. Beyond the simple

arithmetic, is investors' frustration justified? What are or should be the basis for assessing these non-traditional strategies? Unconstrained bond funds are flexible, non-traditional fixed-income strategies that invest in global sovereign bonds, credit, mortgage or asset backed securities and currencies. These all-weather products are designed to offer most of the conventional benefits of bond investing (consistent income, liquidity and diversification) but with the opportunity to mitigate downside risk to a greater degree than is reasonably possible in traditional bond investment approaches.

Unconstrained bond funds can be expected to underperform traditional strategies during bond bull markets and outperform them during bear markets by better preserving invested capital on the downside. The return figures during the last five years, which proved to be very positive for traditional government bonds and less so for unconstrained funds, are thus consistent with historical trends.

As such, the charge against unconstrained bond funds is unjustified: these products have proven to be more than a marketing gimmick. However, in our opinion, there is a fundamental misunderstanding and mis-selling of these strategies as the holy grail of bond investing. Unconstrained bond strategies target the dual (and at times diverging) objective of significant income generation and capital preservation. The constant tradeoff between risk-on and risk-off trades that these strategies have to constantly juggle with to meet this dual objective precludes them from competing with benchmarked bond strategies, especially in bull markets. Investors can hardly enhance the safety of their investments without giving away some meaningful upside in the process.

'The blanket accusations against unconstrained bond funds are unjustified'

We therefore believe that the blanket accusations against unconstrained bond funds are empirically unjustified. Since these products are designed to be different from benchmarked bond funds, their return streams are likely to differ as well. Furthermore, given the highly diversified range of assets in which unconstrained funds invest, the performance dispersion is oftentimes significant. As illustrated in the table above, the average return difference between the 5% best-performing unconstrained bond funds and the 5% worst performing is 11%, 13% and 22% over the last one, three and five years respectively.

'Unconstrained funds are likely to deliver superior performance when rates are rising gradually'

When analysing the results of absolute return funds, it is important to take into account first the return objective and the associated risk level, and second the investment horizon required to achieve the stated objective. As the table shows, more than 30% of fund managers in the un constrained bond category have delivered positive returns over one, three and five years. The obvious conclusion that we can draw is a rigorous and systematic manager selection approach distinguishes winning fund managers from the rest.

Unconstrained, or absolute return, bond funds are likely to deliver better relative performance in a gradually rising interest rate environment, such as in the US at present. Should the recent trend of higher bond yields (in US and in Europe) persist through 2017 and beyond, these products will be well positioned to outperform traditional bond strategies. ■

ABSOLUTE RETURN BOND FUNDS

% TOTAL RETURN AS OF 31.12.2017

	YTD	1 YEAR	3 YEARS	5 YEARS
Top 5%	4.8	2.9	6.8	14.2
Top 25%	2.8	0.2	1.7	10.7
Universe Median	0.0	-1.0	-0.2	5.7
Bottom 25%	-1.1	-2.6	-3.3	2.3
Bottom 5%	-3.3	-7.5	-5.8	-1.0

Source: MPI, Lipper fund data base

11%

1-year performance gap between best and worst funds

Is the link between oil and the US dollar weakening?

The breakdown in the historic link between oil prices and the dollar at the end of 2016 could persist this year.

LUC LUYET
Currency Strategist
Pictet Wealth Management

MALIK ZETCHI
Financial Analyst
Pictet Wealth Management

Over the years, a well-established link has been forged between the price of oil and the US dollar, with dollar strength tending to be negative for oil, and vice versa. This is because a strong USD usually erodes oil production costs and therefore enhances supply. A stronger USD also makes oil imports more expensive in other currencies, hence depressing demand. Consequently, USD appreciation tends to favour oil supply over oil demand, leading to downward pressure on the oil price. The reverse is true when the USD depreciates.

The past three years have tended to confirm this well-established link between weak oil prices and a strong dollar. There have been two key drivers behind the maintenance of this structural linkage. First, since the Fed announced in 2013 that it would begin to 'taper' its monthly asset purchases, Fed policy divergence from the accommodative monetary policies of other important central banks has supported a stronger US dollar. Second, OPEC, led by Saudi Arabia, has allowed oil oversupply to swell in order to drive high-cost non-OPEC producers (notably the US) out of the market. OPEC strategy to prioritise market share over oil market stabilisation has weighed on the oil price.

However, the final weeks of 2016 saw two key events, leading to a dramatic change of behaviour between the oil market and for the US dollar.

The first was Donald Trump's win in the US presidential election. A Republican-dominated Congress is seen as likely to approve a sizeable fiscal stimulus package. The prospect of fiscal stimulus has brightened the US growth outlook and boosted the US dollar.

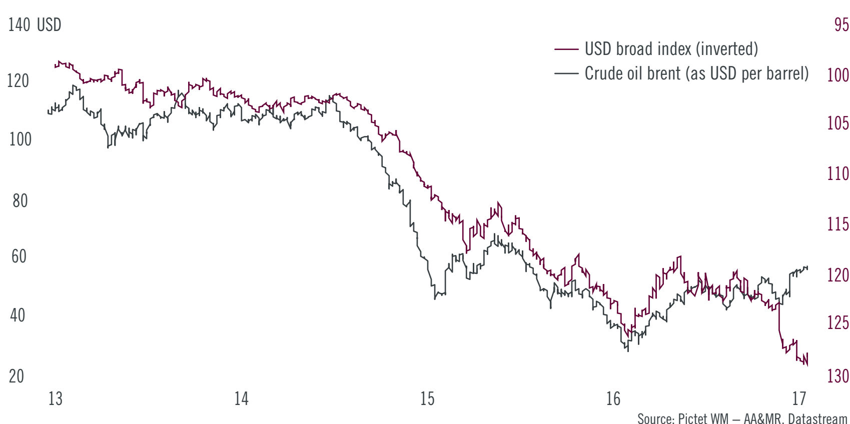
The second key event was the OPEC agreement in November to cut oil production. This deal is decisive not only because it firmly establishes a floor for oil prices, but also because it brings back confidence in an industry that has been through an unprecedented downturn over the past three years. To feed demand for oil that continues to grow, investments are needed and higher oil prices were definitely required, underlining the importance of the November deal.

Putting the two events together, Trump's victory has led to a significant appreciation of the US dollar, while at the same time the OPEC deal has lifted the oil price.

POSITIVE PROSPECTS FOR OIL PRICES AND THE USD

Trump's growth-friendly policies could start to boost growth in the second half of 2017. Furthermore, the Fed is expected to further raise rates given healthy growth and reduced slack in the US labour market. Overall, the US policy mix should prove supportive of the greenback in 2017.

CRUDE OIL PRICES, 2013–JANUARY 6, 2017 (USD PER BARREL)



Source: Pictet WM – AA&MR, Datastream

As for the outlook for the oil market, the progressive drawdown of global inventories should lead to a normalisation of the supply-demand balance and establish a new oil price range of around USD 55 per barrel on average during 2017, according to our scenario. While a bottom for oil prices seems to have been clearly established in early 2016, markets still do not know how high prices can rebound before they spark a supply response. US unconventional resources are likely to be the first to respond with higher supplies, but this should take a few quarters.This year will be critical for the industry to fully grasp the true potential of US unconventional resources and form an idea of how the next oil cycle will look like.

Although conditions for the oil industry are poised to improve, companies will continue to focus on doing 'more with less' and technology should remain disruptive in nature; this should put a natural ceiling on oil prices. Beyond the USD effect, we believe all the aforementioned factors will remain the fundamental drivers for medium-term oil prices.

Consequently, the change in the traditional behaviour pattern between oil prices and the US dollar seen at the end of 2016 could well continue into 2017. ■

QUANTITATIVE INVESTING

The rise of the quant investor

Tracing the growth (and limits) of quantitative investing.

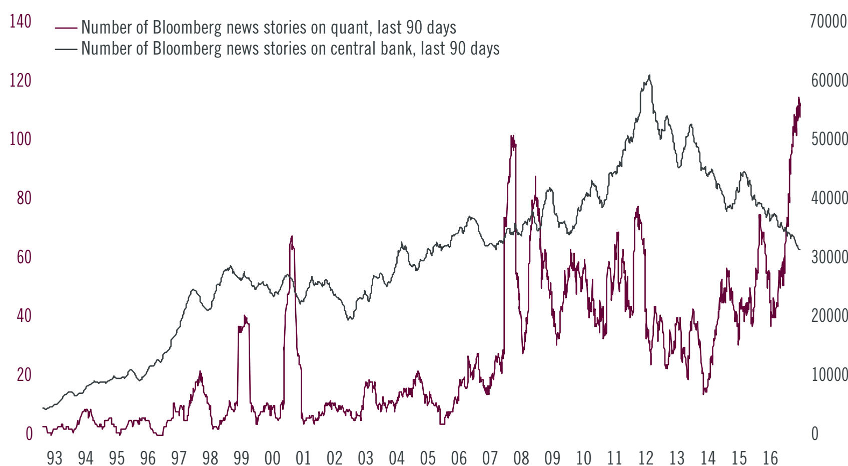
EDGAR VAN TUYLL VAN SEROOSKERKE
Chief Quantitative Strategist
Pictet Wealth Management

The huge rise in the interest in quants has two main facets. One is the exponential increase in financial technology (fintech), the other the tendency for people to focus on other potential market movers late in monetary cycles, when the effectiveness of central bank policy fades. Conversely, interest in quants declines in periods when monetary policy manages to lower expected returns by compressing their basic building block, interest rates and at the same time capping volatility. The loosening of monetary policy reduces opportunities for quants to add value by exploiting multi-month volatility and because it adds unwelcome 'noise' (in other words, much shorter-term price movements not soundly based on real information). But in time, the return of inflation, usually accompanied by an upturn in volatility and rate tightening, tends to favour quantitative investing again over market movements dictated by central banks.

The result of the rise of fintech has been outflows of money from actively managed mutual funds and hedge funds in parallel with huge new inflows into both index-linked funds (via ETFs) and absolute return funds based on quantitative strategies. Using quants, funds can be indexed against a number of different metrics. Indexation against variables other than market caps helps construct portfolios based on smart beta and indexation of hedge fund-like long/short strategies is used to produce funds built around alternative beta, while absolute return strategies help build CTA and systematic global macro hedge funds.

Absolute return strategies form naturally a part of private wealth management. Indeed, private clients were early adopters of hedge funds and private equity.

AS THE NUMBER OF BLOOMBERG STORIES CITING CENTRAL BANKS FALLS, THOSE MENTIONING QUANTS IS RISING



Source: PMW Quantitative Strategies, Bloomberg

At Pictet Wealth Management, we have developed two automated quant strategies that now have a combined track record of eight years. Both produce absolute returns by combining the results of our analysis of human behaviour with a systematic approach to global macro trends. Combining the two can help detect phenomena such as market bubbles and crashes. These phenomena have their parallels in nature (earthquakes, power outages, water freezing etc..) and are correlated with different stages of the economic cycle. In other words, bubbles inflate late in economic cycles and are often followed by market crashes, which tend to coincide with economic recessions.

THE FUTURE OF QUANTS

In an even more complex environment, characterised by multidimensional sources of information, machines can do better than humans – for instance, when it comes to taking decisions on and implementing very active switches between assets. But coming up with ground-breaking principles that can be applied to quant strategies requires human qualities of creativity and an 'outside the box' view that machines cannot currently replicate. Human communication skills are needed to show that alpha is a zero-sum game: in other words, for an investment strategy to create alpha over a certain period it must have difficult periods in return. The reward such a strategy produces is simply the premium earned by investors (including non-quant discretionary investors) for holding on to their investment through volatile periods compared to investors who are more jumpy.

When it comes to quants, extreme pessimism, just like extreme optimism, is unwarranted. Quant investing is not a black box (the biggest of these is the human brain) and it follows certain well-defined rules. As for super-intelligent computers, it is worth reminding oneself that some computers currently have as many 'digital neurons' as a rat's brain. While rats are remarkable creatures, they are probably not what you would want to manage your portfolio.

Quantitative investing is permanently evolving, like other technology-based industries: the quant model of five years ago is like the sports car of five years ago, still faster than most cars, but less fast (and less expensive) than the latest model. But even the model of 20 years ago will still go faster than a lot of more modern mass-produced cars and prove more durable. ■

ALTERNATIVE INVESTMENTS

i. The return of long/short & macro strategies

After a difficult year for many strategies, volatility in fixed income, the election of Donald Trump and a packed political agenda in Europe all offer renewed opportunities for hedge funds.

NICOLAS CAMPICHE
Chief Executive Officer
Pictet Alternative Advisors

Hedge fund managers welcomed 2017 with a fresh degree of confidence, and we believe reasonably so. Given the latest political developments in the US and Europe, it is clear that we are witnessing a regime change in the macro landscape. After a disappointing 2016, Trump's election may have reset the dynamics of the hedge fund industry. Hedge fund managers are sanguine about the opportunity set in the US in particular, fuelled by expectations about tax reforms, infrastructure spending, robust M&A activity and a gradual shift from monetary to fiscal policy.

In 2016, political instability weighed on the performance of macro managers', who mostly maintained low levels of risk and generally struggled to make money until November when the bond sell off enabled most managers to end the year in the black. On the CTA front, choppy markets and a series of trend reversals created an unfavourable environment, though the strategy proved its decorrelating benefits in a number of instances, including during the equity selloff at the beginning of 2016.

Trump's election in November revived the opportunity set for Tactical Trading strategies. Global Macro managers have been ramping up risk since, which generally indicates a high level of conviction. Consensus is that we are at the early stage of a broadly bear market for fixed income and inflation is expected to pick up in developed markets. The disconnect in volatility between equity and fixed income markets since the US elections – with rate

EQUITY MARKET VOLATILITY SPIKES IN 2016, AS MEASURED BY THE CBOE VVIX INDEX

Source: Bloomberg

volatility spiking as fixed income markets price in higher inflation, while equity volatility has dropped as equity markets discount positive earnings growth could create new investment opportunities for macro strategies. Elevated volatility in fixed income markets should increase dispersion and pricing dislocations, nurturing a conducive environment for arbitrage trades. That said, we remain aware of the risk of choppy price moves owing to government and central bank actions and we continue to favour managers who are nimble and able to adapt their exposures according to the market environment.

> 'A return to fundamentals will favour stock-pickers in the long/short equity space'

As far as equity-sensitive strategies are concerned, we believe the market environment will see a long-awaited return to fundamentals and hence favour stock-pickers in the long/short equity space.

Last year was not an easy one for long/short managers: despite generally good corporate earnings released during the first quarter, positions widely held by hedge funds and long-only mutual funds sold off heavily, while short positions rallied due to short-covering activity. Sector rotations and market volatility hurt managers in the first half of the year, but as the Brexit-fuelled upheaval abated, managers started rebuilding their gross exposures and slowly recouped earlier losses, especially as a number of sectors rebounded following Trump's win.

The November events seem to have redefined the market outlook, which is now evolving more favourably for long/short equity. First and foremost, a move away from a QE-driven market environment as interest rates increase should favour active management and shorting. In the US, amid a supportive domestic economic backdrop, correlation and dispersion indicators point towards a favourable stock-picking environment, while looser regulation may boost certain sectors such as healthcare and financials. In Europe, we would expect markets to remain volatile because of political events and lack of stability in the banking sector. Both regions can therefore offer attractive investment opportunities for both sides of hedge fund managers' books in our view, especially as long and short positioning seems to be less crowded and consensual already.

We are currently overweight long/short equity in our portfolio. Support for the strategy could come from equity markets' return to fundamentals, dispersion between sectors or factors, and technological disruptions due to secular trends. Potential headwinds however could lurk in Trump's policy implementation, high valuation levels and increased volatility due to multiple expansion/compression as market sentiment swings between thoughts of higher growth and fears that interest rate will rise too fast. We therefore aim to deploy capital cautiously in the long/short space and favour flexible generalists and sector specialists, able to exploit higher dispersion and volatility regimes. ■

ALTERNATIVE INVESTMENTS

ii. Private debt eyes up real estate finance

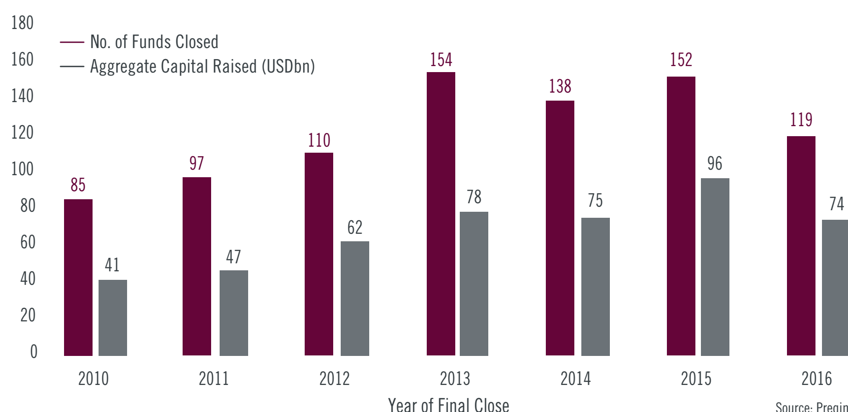
Amid concerns about illiquidity in some parts of the market, strategies focused on distressed debt and real estate lending could hold some opportunities.

After a record fundraising year in 2015, when almost USD100 billion was raised across private debt strategies, 2016 actually witnessed a slowdown, estimated to at approximately USD74 billion, according to data provider Preqin. Mezzanine funds attracted the most money closely followed by direct lending and distressed strategies (*see chart on next page*). That said, the highest number of vehicles in the market remain direct lending funds, highlighting the continued theme of scarcity of lending capital and disintermediation due to a flood of new regulations setting ever-stricter leverage and capital retention limits for traditional lenders (banks and insurance companies).

> 'Positions originating in the financial crisis still dominate the opportunity set'

We have witnessed many of the same stories at the most liquid end of the distressed space, with positions originating in the global financial crisis dominating the opportunity set (Icelandic banks, Lehman Brothers, Greece sovereign debt...). Economic growth remains slow, and we are likely late in the business cycle. Additionally, a record amount of the leveraged credit markets are controlled by daily liquidity vehicles at a time when

GLOBAL ANNUAL PRIVATE DEBT FUNDRAISING, 2010–2016



Source: Preqin

broker dealer inventories are at record lows and liquidity in these markets is extremely limited. This could prove a dangerous combination if high yield and leveraged loan investors decide they want their capital back in concert, causing trading prices to dislocate meaningfully from the fundamental performance of their underlying issuers. In addition, US corporate leverage is particularly high when compared to the periods immediately preceding the previous two downward turns in the economic cycle.

Interestingly, leverage is not only concentrated in the energy sector – more than 40% of bonds in almost every high yield sector exceeds 6x leverage. High yield debt issued by highly leveraged companies such as these has more than doubled since 2011. Historically, distressed managers have shown strong performances in a rising rate environment, when defaults typically increase. We continue to favour managers who have an ability to move around asset classes (from debt to post re-org equities) with long-term experience, strong sourcing capability and global geographical reach.

The opportunity we continue to find particularly interesting today is real estate lending. Debt originations are not keeping pace with maturities as liquidity continues to be insufficient due to scarcity of lenders. Total volume of new issued debt remains below pre-crisis level despite high Commercial Real Estate transactions volume. Thanks to a looming debt wall (around USD1.4 trn of commercial real estate debt is set to mature in 2016-19), the ingredients seem to be in place for real estate debt strategies to continue to be attractive into 2017. Shrinkage of debt also resulted in a global healthier equity/debt investment structure. The capital structure of a real estate investment offers debt providers an improved collateral cushion and higher yields (whole or subordinate loans) on an asset that has also had a fair value assessment.

We particularly like expert real estate lenders who can originate, arrange and sell loans on high-quality collateral. The appeal of this strategy stems from potentially regular income, rapid paybacks and capital appreciation associated with strong collateral. Prime opportunities are to be seen in mezzanine (the lowest, and therefore highest-risk debt tranches yield some of the highest coupons in the market, around 11% today) and in senior debt tranches (typically secured by a senior lien on the underlying property, currently yielding coupons in the 6% range). Investors may benefit from a range of sources of return, including upfront fees, current coupons, payment-in-kind and equity kickers. ■

WHAT IF...

...things go wrong in Europe?

Although there are some signs of economic momentum, 2017 will be a year of living dangerously in Europe.

NADIA GHARBI
Europe Economist
Pictet Wealth Management

Europe went through a tumultuous year in 2016 with the Brexit vote in the UK, the rejection of Italy's constitutional referendum, the rise in support for the far right in some countries and the consolidation of new forces outside the political mainstream. Political uncertainty as measured by the policy uncertainty index (*see chart on next page*) has reached record high levels.

In 2017, politics will remain a dominant topic in Europe, with at least three national elections in the euro area and the British vowing to open formal Brexit negotiations by the end of March.

National elections are scheduled to take place in the Netherlands, France and Germany this year and early elections are expected to be called

in Italy. Following the US elections in November and the Brexit vote last June, several commentators see the possibility of a 'populist wave' in the upcoming European elections, given similar concerns about globalisation, immigration, security and social exclusion have come to the fore on both sides of the Atlantic. While mainstream (coalition) governments are likely to prevail in most countries, risks of less market-friendly outcomes are non-negligible.

> 'Marine Le Pen becomes French president and decides to hold a referendum on EU membership'

Our low-probability, high-risk alternative scenario (not our central scenario) runs as follows:

Starting with the Netherlands, in the March parliamentary election, Dutch voters, galvanized by Donald Trump's victory, elect the Freedom Party led by Geert Wilders in an anti-immigration, anti-EU, anti-establishment vote. Then, the far-right candidate Marine Le Pen wins the French presidential election in May and quickly decides to hold a referendum on leaving the EU by the end of 2017. During the course of the year, the anti-establishment Five Star Movement comes to power in Italy amid weak growth and calls a (non-binding) referendum to exit the single currency. Finally, in the German elections in October, Angela Merkel fails to secure a fourth mandate.

Meanwhile, in Greece, the absence of meaningful concessions on debt relief from the country's European creditors further erodes public support for the government of Alexis Tsipras, increasing the risk of an early general election in 2017. In Portugal, weak economic growth and fiscal slippage push the loss of its sole remaining investment-grade sovereign rating effectively excludes the country from the ECB's asset-purchase programme. In Spain, the minority government of Mariano Rajoy struggles to implement new reforms, and actually reverses some previously enacted. Moreover, political tensions between regional and national government increase, leading Catalonia to hold a referendum on independence. A victory by the separatists adds considerable uncertainty to an already fragile EU institutional framework.

Further north, Brexit-related uncertainty increases and unsettles Europe during the course of this year. In order to ensure she has a broader public mandate and a new parliament willing to push through her version of Brexit, UK prime minister Theresa May calls snap elections. This delays the process for triggering Article 50 beyond March and leads to a more anti-EU parliament, raising the chances of a 'hard' Brexit even further.

COUNTRIES TURN INWARD

As a consequence of the chances of a lengthy period of high political uncertainty, economic activity in Europe is damaged. Investment and consumption are dragged lower. No new reforms are implemented, further reducing Europe's medium-term growth potential. Sovereign bond yields increase, resurrecting debt sustainability concerns. Fiscally orthodox countries push for a more restrictive fiscal stance, further hurting growth potential. Following the victory of anti-immigration parties, internal border controls are revived, putting in danger one of the main pillars of European unity, the free movement of people. The trend towards more nationalism and less Europe is firmly established.

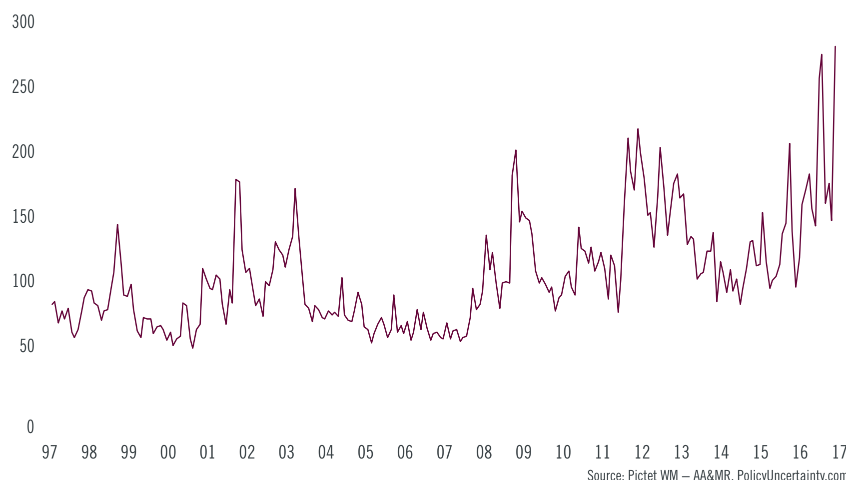
Last but not least, growing pressure on the Italian banking sector threatens to turn into yet another systemic crisis. The EUR20 billion bank bailout envelope made available proves to be insufficient to cover banks' capital needs and the interim Italian government struggles to find a solution. Tensions increase between Brussels and Rome, with the largest countries unlikely to make big concessions to Italy in an electoral year.

Thankfully, this disastrous scenario is unlikely to materialise. ■

EUR 20 billion

Italian bank bailout envelope

EUROPE – ECONOMIC POLICY UNCERTAINTY INDEX



Source: Pictet WM – AA&MR, PolicyUncertainty.com

...debts and Trump threaten China

While a sharp drop in China's growth to below 6% is not part of our core scenario in 2017, such a possibility cannot be ruled out as China faces increasing headwinds.

DONG CHEN
Senior Asia Economist
Pictet Wealth Management

The tremendous amount of debts that China has been accumulating since the global financial crisis remains the country's greatest near-term challenge. According to our estimate, China's debt-to-GDP ratio had risen to 261% by Q3 2016, from 145% at the end of 2008 (*see chart*). Almost half of these debts, or roughly Rmb86.8 trillion (USD12.6 trillion), are concentrated in the non-financial corporate sector, but the growth in indebtedness is faster in the financial and the household sectors. The rapid credit growth has been accompanied by various imbalances, including overcapacity in heavy industries, a property bubble and explosive growth in shadow banking.

The country's top leadership recently set out prudent and neutral monetary policy guidelines for 2017, with curbs on financial risks and asset bubbles seen as a priority. In parallel, measures have been introduced to cool down the property market, and the People's Bank of China (PBoC) has allowed the money market rate to rise to squeeze leverage in the bond market. In this context, the prospect of monetary easing by the PBoC in 2017 is slim.

Higher interest rates and slower credit growth will almost inevitably weigh on China's growth in 2017. The property bubble, further inflated in 2016 and will be increasingly hard to sustain as potential buyers remain on the sideline. A major correction in housing, not inconceivable in some Chinese cities, could be a serious drag on China's growth in 2017 as property construction slows down. In the worst-case scenario, a collapse in property prices could even lead to a financial crisis, given property's central role in credit creation in China.

THE TRUMP HEADACHE

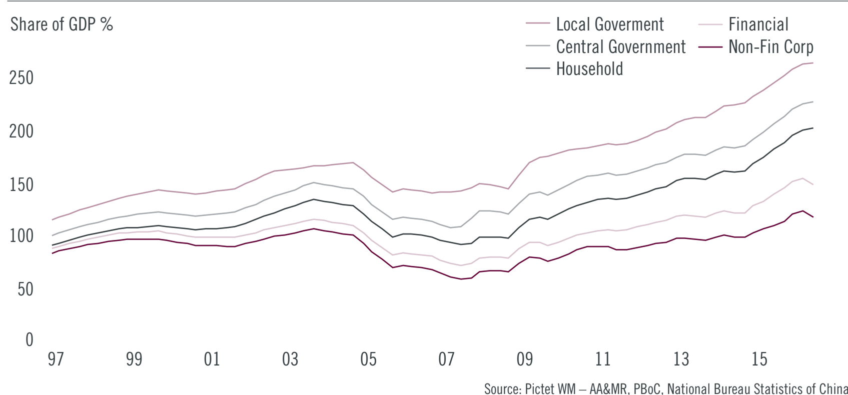
On the external front, China will likely face headwinds in 2017 due to the potential protectionist policies of the new Trump administration.

During his election campaign, Trump criticised China repeatedly, claiming its unfair trade policies were causing the loss of US manufacturing jobs. He has threatened to declare China a currency manipulator and to impose punitive tariffs on Chinese goods. Trump has nominated several members to his administration well known for their negative views on China's trade practices. Peter Navarro, the author of the book *Death by China: How America Lost Its Manufacturing Base*, was appointed head of the White House National Trade Council. Robert Lighthizer, an experienced lawyer who for a long time represented the US steel industry in trade litigation (including many cases against China), is to head the US Trade Representative Office. Given Trump's protectionist bias, we believe it is highly probable that the US will launch more anti-dumping cases against China and some China exports to the US may face steep tariffs.

In addition, Trump has signaled he may try to leverage sensitive issues such as Taiwan to force China to make more concessions on trade. His recent comments regarding Taiwan that challenge the 'one-China' policy signify a major deviation from the diplomatic framework established over four decades ago. Changes on the diplomatic front could have a negative impact on trade relations between the US and China, and, if handled badly, could fuel a rise in geopolitical tensions as well.

Thanks to strong control over the financial system, the Chinese authorities should be able to handle China's near-term debt problems, and the Trump administration may not implement all the protectionist policies threatened during the presidential election campaign due to political constraints. Yet we cannot dismiss the downside risks too lightly. We have to keep monitoring events in China and stand ready to position our portfolios as conditions dictate. ■

THE GROWTH IN CHINESE INDEBTEDNESS, 1996–Q3 2016



Source: Pictet WM – AA&MR, PBoC, National Bureau Statistics of China

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