

Perspectives

Investment Strategy — *pages 3-5*

Dealing with disruption

Investment Strategy Highlights

A regime change in equity returns

Regional Focus — *pages 6-7*

Trump fiscal easing hopes fizzle out

The ECB can manage euro strength

Asset Focus — *pages 8-15*

Euro and US bonds go their separate ways

Emerging-market assets retain strong momentum

Developed equities look for a second wind

Trends & Themes — *pages 16-18*

Responsible investing

The case for buying protection



Deceptive calm

Even though central bankers are turning less dovish, low volatility has remained the hallmark of equity markets, while bond markets have continued to behave themselves. But things are stirring beneath the placid surface.

ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT FORECASTS (AT 15 SEPTEMBER 2017)*

INTEREST RATES (IN %)	CURRENT	DECEMBER 2017E	DECEMBER 2018
Switzerland - short	-0.75	-0.75	-0.50
Switzerland - 10 year	-0.05	0.20	0.50
Euro area - Refi rate	0.00	0.00	0.00
Euro area - Deposit rate	-0.40	-0.40	-0.25
Germany - 10 year	0.43	0.70	1.00
France - 10 year	0.71	1.00	1.50
Italy - 10 year	2.08	2.60	2.90
Spain - 10 year	1.61	1.80	2.30
US - Fed rate (mid range)	1.13	1.38	1.63
US - 10 year	2.20	2.50	2.50
UK - Repo rate	0.25	0.25	0.25
UK - 10 year	1.31	1.40	1.70
Japan - Overnight	-0.10	-0.10	-0.10
Japan - 10 year	0.03	0.00	0.30
CREDIT SPREADS (IN BP)*	CURRENT	DECEMBER 2017E	DECEMBER 2018
European IG	99	130	135
European HY	264	330	360
US IG	109	120	125
US HY	364	440	460
EM Corporates (USD)	252	300	300
EM Sovereign (USD)	268	350	350
* Bloomberg Barclays indices			
GDP GROWTH RATES	CURRENT (YOY)	DECEMBER 2017E	2018E
US	2.2% (Q2 17)	2.2%	1.7%
Euro area	2.3% (Q2 17)	2.1%	1.7%
UK	1.7% (Q2 17)	1.5%	1.0%
Suisse	0.3% (Q2 17)	0.8%	1.7%
Japan	1.4% (Q2 17)	1.9%	1.2%
China	6.9% (Q2 17)	6.8%	6.3%
CONSUMER PRICE INFLATION	CURRENT (YOY)	DECEMBER 2017E	2018E
US (core PCE)	1.4% (Jul 17)	1.6%	1.8%
Euro area (headline CPI)	1.5% (Aug 17)	1.5%	1.2%
UK (headline CPI)	2.6% (Jul 17)	2.8%	2.3%
Switzerland (headline CPI)	0.5% (Aug 17)	0.5%	1.0%
Japan (core CPI)	0.5% (Jul 17)	0.3%	0.8%
China (core CPI)	2.1% (Jul 17)	2.2%	2.3%

*Past performances or forecasts are not per se a reliable indicator of future performance.

Content completed on 19 September 2017.

Editor: Isidore Ryan

Design: Stéphane Bob, Forth Studio

Printed on FSC-certified paper.

DEALING WITH DISRUPTION



CESAR PEREZ RUIZ

Chief Investment Officer
Pictet Wealth Management

“Currencies have been providing an escape valve for pressure that would otherwise be building up on markets more broadly.”

There seems to be plenty to worry investors at present. Perhaps most importantly, geopolitical risk remains high. North Korea continues to press ahead with its nuclear programme in defiance of US threats, and while we still see a military conflict as unlikely, there is a danger of miscalculation, as well as of upsetting the key US-China relationship. The Trump administration continues to be worryingly dysfunctional and unpredictable, and there is a risk that President Trump, lacking any major legislative achievements, will try to bolster his falling popularity with his base by resorting to protectionist measures.

In France, President Emmanuel Macron's popularity has also declined, although this should not be a major concern for markets as long as he delivers on reform (and the current push on labour market reform looks promising). And time is running out for the Brexit negotiations, with barely a year left to reach agreement on the terms of the UK's withdrawal from the EU in order to allow for ratification by March 2019 and avoid the UK leaving without a deal. (We think a transition period that includes continued single market access will likely be agreed, but risks are high.)

In addition, natural disaster risk is increasing because of climate change. Major hurricanes have been creating some uncertainty in short-term US data—although the damage to US economic performance from such events tends to be very limited.

Despite these concerns, equity markets remain calm. Index volatility is still at historically low levels, with the VIX (implied volatility on the S&P 500) at around 10. But this apparent calm is deceptive. Some trends suggest that underlying volatility is already starting to increase.

Currencies are proving to be the weakest link. Large reversals in the dollar against other major currencies, and in the Swiss franc against the euro, for instance, have been major headaches for investors this year. In a sign of the stress on foreign exchange markets, their implied volatility has diverged from that of fixed income since around July whereas the two tend under normal circumstances to move broadly in sync. Currencies appear to be providing an escape valve for pressure that would otherwise be building up on markets more broadly.

Moreover, although equity volatility remains low at an index level, sector dispersion is significant. For instance, on the S&P500, sector performances have varied widely year to date between technology stocks, up by around 30%, to oil and gas, down by some 15% (in US dollars). Disruptive innovation and M&A are creating further ructions within sectors, epitomised by the pressure Amazon is starting to put on food retailers after its purchase of Whole Foods.

We nevertheless expect equity markets to remain well anchored as long as economic growth and earnings growth are healthy (our baseline scenario for the rest of 2017 and 2018) and as long as that there is a lack of strongly compelling alternatives.

That said, we do expect headline volatility to rise. Low headline volatility over recent years is explained in large part by central banks' highly supportive policies. However, these are now beginning to be unwound, starting with the Fed, which confirmed at its September meeting that it would start unwinding its balance sheet in October. We also expect the ECB to start tapering its asset purchase programme in 2018.

It therefore remains important to be well hedged against geopolitical risk. There are two main ways to do this: through gold, or by buying protection for equity allocations. Since we remain constructive on equities, and since we think gold's rise this year is largely down to dollar weakening, we have been buying protection for our equity allocation in discretionary portfolios.

Investment Strategy Highlights

An overview of Pictet Wealth Management's stance on asset classes.*

ASSET STANCE

- There are two ways to hedge geopolitical risk: buying gold or buying protection for portfolios. We prefer the latter, to take advantage of current low volatility and because gold's gains so far this year reflect the depreciation of the dollar.
- We remain constructive on developed-market equities, particularly the euro area and Japan. We are neutral on the US, underweight UK and selective in Swiss equities.
- Low volatility and higher dividend yields make a case for 'equities as the new bonds'. But that could change as central banks gradually withdraw their supportive policies, and we are keeping protection for the downside.
- Low correlations and a pick-up in disruptive M&A mean a good environment for active management.
- Emerging-market local-currency bonds continue to look tempting. Any short-term pullback could be a chance to buy this asset class.

COMMODITIES

- We see the current equilibrium oil price at USD55/b, and our scenario is for it to remain around this level over the next 12 months.

EQUITIES

- Equities are likely to mark a pause until a new catalyst emerges.
- As we move through the remainder of 2017, markets will increasingly focus on the earnings outlook for 2018; we expect mid-single-digit earnings growth next year, still good but less so than in 2017.

CURRENCIES

- We still expect a modest rebound in the USD in the final months of 2017, given extreme negative positioning. But our new estimate for the EUR/USD rate for end-2018 is 1.24, compared with a level of 1.19 at end-August.

FIXED INCOME

- We have revised our year-end target for the US Treasury yield from 2.8-3% to 2.5%. As we still expect yields to rise, we will stay underweight core sovereign bonds and short duration.
- Despite high prices, we continue to prefer

OUR CURRENT ASSET CLASS STANCE*

	STANCE					MONTHLY CHANGE**
	Very bearish	Bearish	Neutral	Bullish	Very bullish	
CASH/CURRENCY						
USD (vs EM and G10 currencies)						
EUR (vs USD)						
CHF (trade-weighted index)						◀
DEVELOPED MARKET EQUITIES						
US						◀
Euro area						
Europe						
Japan						
EMERGING MARKET EQUITIES						
Asia						
Latam						
SOVEREIGN BONDS						
US						
Euro periphery						
Core Euro						
USD EM						
Local currency EM						
CORPORATE BONDS						
US high yield						
US investment grade						
EUR high yield						
EUR investment grade						
Hard currency EM						
GOLD						
HEDGE FUNDS						
PRIVATE EQUITY						
REAL ESTATE						

*At 8 September 2017.

** Three to six month horizon.

euro corporate credit over US, because of differences in the economic cycle, market complacency about Fed policy tightening, and our expectation that the ECB's tapering of its monthly asset purchases will be gradual.

- We expect US high yield spreads to widen, from 385 bp at the end of August to around 420 bp by the end of 2017.

ALTERNATIVES

- Conditions continue to favour hedge funds, notably long/short equity strategies.
- Valuations, competition and capital inflows remain high in private equity, but there are still good opportunities for attractive returns. China is becoming increasingly hard to ignore in this space.
- In real estate, investors should tread with caution, but look at distressed opportunities in retail, and at logistics (the main beneficiary of shifting retail trends).

NOTICE: This asset class stance is provided for illustrative purposes only. In general, asset allocations will differ among investors according, in particular, to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the asset allocation in this publication may not be suitable for all investors and shall not be used as the basis of an investment decision.



CHRISTOPHE DONAY

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

INVESTMENT STRATEGY

A regime change in equity returns

While earnings growth may stay at around 10% in the US, stretched valuations leave no room for disappointment.

In spite of all the political and geopolitical uncertainties that have arisen, volatility on equity markets has stayed at historically low levels. Up to September 15, there have been only four days this year when the S&P500 has dropped by more than 1%.

This apparent calm disguises the growing skepticism of investors. One can see this in the way stock indices have been performing. The election of a new US president who promised tax cuts, deregulation and large-scale infrastructure spending sent US stocks rocketing in the early months of 2017. In Europe, double-digit growth in earnings, starting from a low base, helped propel equity prices. But the mood has changed over the past six months. The 'Trump trade' has fizzled out as American politics shows alarming signs of dysfunctionality. The result is that annualised returns on the S&P500 between March 1 and September 15 was of the order of 7.5% (in US dollars), well down from about 50% between Trump's election

last November and end-February. A decline of this magnitude can legitimately be termed a regime change.

The economic backdrop still looks relatively favourable for the rest of this year and into the first half of 2018, even in the absence of a Trump stimulus. But we do see a decline in the rate of growth in the US in the second half (from around 2.2% to 1.7% annualised). This of itself will limit the potential for earnings growth, which we believe will remain at around 10% in the US. Such growth may be enough to sustain current above-historical-average valuations, but will limit the room for their further expansion. By contrast, European equities are unlikely to replicate earnings growth well north of 20% seen this year.

POLITICAL SURPRISES

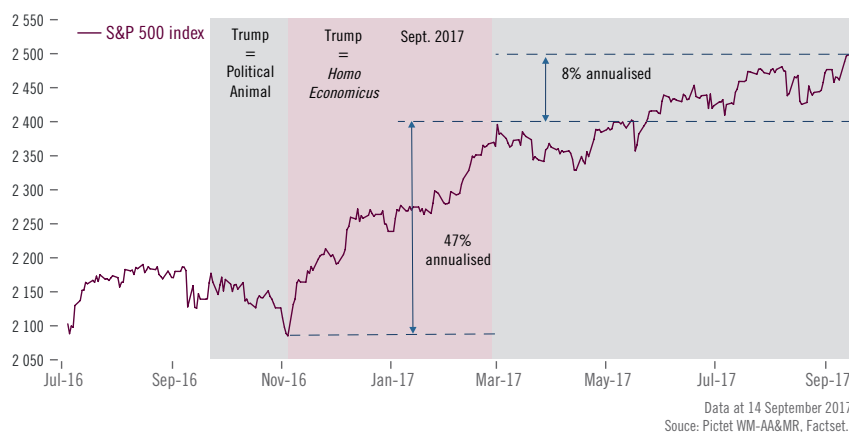
There is, of course, scope for positive surprises and for disappointments, with politics in the US capable of delivering either. We are not

at all confident that the Trump administration will prove capable of finding the political consensus needed to push through lasting tax cuts and reforms of the sort that would lift the fortunes of corporate US. We are skeptical that we will see any real supply-side boost from the current administration in the next couple of months. More worryingly, any further move to remove president Trump (whose administration is already looking shaky) could seriously de-stabilise financial markets. While supported so far by earnings growth, valuations are stretched, leaving no room for manoeuvre in the case of economic, political or geopolitical scares.

We conclude the US 10-year Treasury yield will rise to about 2.5% by the end of this year, but the scope for it to rise much beyond that by end-2018 will be limited by the drop in economic momentum and persistently low inflation. We believe we will remain in a low interest-rate environment, with nominal interest rates failing to go beyond 3.5% on either side of the Atlantic. While returns might be lower than in the past, government bonds will still serve as an important protection in portfolios, especially in view of the fraught political and geopolitical situation.

US dollar strength, another long-running theme, looks like it has ended. While the US dollar has recently looked oversold and short-term recoveries can be expected, a gently drifting US dollar (but not a full crisis) could continue to prove beneficial to emerging-market assets next year. ■

A REGIME CHANGE IN EQUITY RETURNS





THOMAS COSTERG

Senior US Economist
Pictet Wealth Management

REGIONAL FOCUS

Trump fiscal easing hopes fizzle out

As we approach the first anniversary of Donald Trump's election to the US presidency, belief that his tax reform promises will come to fruition have all but evaporated.

While Donald Trump's election brought major expectations for fiscal easing and supply side reforms, the track record of the Trump administration so far is meagre. As a result, we have recently taken out any fiscal easing (including infrastructure spending) from our baseline macro scenario for the US, with the result that our 2018 growth forecast has been cut to 1.7%, from 2.3%.

Fiscal easing would help in 2018, when we think some cyclical forces may dampen US growth. In particular, we worry about the recent slowdown in car sales, which we think will continue in 2018. We also expect a deceleration in private-sector construction. US oil production will probably moderate after this year's sharp rebound given the ongoing softness in oil prices, potentially affecting the manufacturing sector.

A major tenet of Trump's campaign platform was the promise to "drain the swamp" in Washington DC, a reference to the persistent underlying political gridlock and dysfunctional policy-making, particularly evident

during the Obama years. But gridlock has persisted, despite the fact that Republicans hold both Houses of Congress and the White House, at least on paper. The bottom line is that US policy-making's problems seem more deeply rooted than ever. The instability within Trump's White House itself only adds insult to injury. Indeed, various issues are making decision-making ever more complicated and sapping the Administration's energies.

DISTRACTIONS FROM TAX REFORM

The question of the government budget offers perhaps the best illustration of current problems and explains why the chances of major corporate tax reform have dimmed. In the wake of Hurricane Harvey in Texas, Congress expanded federal funding for local emergency operations, pairing it with a short-term extension of the federal budget until 8 December. But another budget extension risks taking attention away from the much more complex task of tax reform. In addition, the debate may be 'polluted' by several side

issues, ranging from immigration to a fresh push for health care reform and Trump's promise to build a wall along the US-Mexico border. And while many continue to agree that corporate tax reform, and lower tax rates, are needed, the devil in the detail. Without Democrats' support on which tax loophole(s) will be shut to 'fund' the tax cuts (and the omens are bad on this front), any cut in tax rates may only be short lived. The recent sharp increase in the budget deficit is further of bad news, as it limits the room for manoeuvre on tax cuts. Hurricane damage will make the deficit even worse. We are equally worried that Congress will shut down for legislative business altogether as attention turns to the mid-term elections next November.

The good news is that the US economy is taking the current political noise in its stride and we remain optimistic about near-term growth prospects. In fact, we have raised our 2017 growth forecast to 2.2% from 2.0%. Most indicators show solid underlying momentum, which is why we think the Fed will continue to hike rates gradually (by a quarter point in December and again in March), especially as financial conditions remain loose. But the picture in H2 2018 appears muddier from a cyclical perspective, and the lack of delivery by the Trump Administration could start to be felt first in business sentiment, and, ultimately, in growth statistics. ■

US NEW CAR SALES IN MILLIONS, (SEASONALLY ADJUSTED ANNUALISED RATE)



Source: Pictet WM-AA&MR, Thomson Reuters, August 2017



FREDERIK DUCROZET

Senior Europe Economist
Pictet Wealth Management

REGIONAL FOCUS

The ECB can manage euro strength

The euro's recent resurgence could have a relatively modest impact on growth and inflation, and the ECB could adapt its policy choices should it continue.

Just as the euro area recovery has gained momentum the recent sharp appreciation of the single currency is threatening to weigh on exports and inflation, delaying a return to the European Central Bank's (ECB) 2% inflation target. The euro strengthened against the US dollar and against a broad basket of 38 currencies, by 15% and 6%, respectively, from the start of this year to 11 September. The single currency is now much stronger than it was when the ECB announced quantitative easing in January 2015.

Yet, we would argue that this time is different and that a strong euro will have limited macroeconomic effects. As ECB Executive Board member Benoît Coeuré put it in a recent speech, the key question is whether the exchange rate adjustment is endogenous. If the currency is appreciating for good reasons, then the relative improvement in domestic demand should mitigate, or even offset, the drag on growth and inflation. We think this is largely the case, consistent with our view of a long-term equilibrium value for the EUR/USD above 1.20.

The impact of a stronger euro on exports has to be seen against the backdrop of a synchronised pick up in global growth, a domestic-based euro area recovery, and diminishing FX pass-through effects due to structural change, including more tightly integrated global supply chains. Classic macroeconomic models suggest a permanent 10% appreciation of the trade-weighted euro would shave 1 to 1.5 percentage points (pp) from cumulative GDP growth over the next two to three years. But more recent empirical studies and ECB staff projections point

to the impact being less severe. Using these projections, the recent run-up in the euro would cost up to 0.3pp of lost GDP growth over two years. While no one honestly knows exactly to what extent FX pass-through has declined, it is accepted that the pain threshold varies significantly from one country to the other, with a higher threshold in the most competitive countries like Germany and lower in more vulnerable ones like Italy.

A DECLINE IN PASS-THROUGH

The same is true for inflation, although some of the FX effects are arguably easier to quantify given their mechanical effect on energy costs labelled in dollars. At the other end of the spectrum, prices for a wide range of domestic-based services are largely insensitive to currency fluctuations. This leaves non-energy industrial goods as the most FX-sensitive category in core consumer prices, accounting for 26% of the total HICP index.

All in all, classic models suggest a 10% currency appreciation dents inflation by a cumulative 1pp or so over the medium term (some ECB models point

to up to 2pp). But studies by the ECB point to a decline in the pass-through rate, consistent with the 'Draghi rule' that a 10% currency appreciation translates into a 0.45pp drag on inflation over two years. This suggests that recent euro appreciation would reduce inflation by a more manageable 0.2pp in 2019, in line with ECB staff revisions in September.

There is no escaping the fact that a stronger euro will complicate normalisation of the ECB's monetary stance—but it should not derail its broad strategy. Recent comments by top ECB officials suggest that the currency pain threshold has not been hit yet. Should further sustained euro appreciation translating into an "unwarranted tightening" of financial conditions and even lower inflation projections, we would expect the ECB to look at a 'slower for longer' reduction in asset purchases alongside technical changes aimed at mitigating the bond scarcity issues catching up on the bank's asset purchase programme. ■

THE EURO INDEX (THE EURO AGAINST A TRADE-WEIGHTED BASKET OF 38 CURRENCIES)



Source: Pictet WM-AA&MR, European Central Bank, September 2017

**LAURÉLINE CHATELAIN**Fixed Income Strategist
Pictet Wealth Management

Euro and US bonds go their separate ways

Growth, inflation and monetary policy all point to continued divergence in government bond markets next year.

Unlike last year, when the 10-year US Treasury (T-note) yield rose and the German Bund equivalents fell, US yields have fallen so far in 2017, while Bund yields have risen. From January 1 to September 8 2017, the T-note yield fell 39bp (to 2.1%), whereas the Bund yield rose 10bp (to 0.3%). We think divergence is likely to continue in 2018 when we expect the T-note 10-year US Treasury yield to remain stable at low levels, whereas its German counterpart should rise.

In our start-of-the-year scenario for 2017, we identified three macro-economic factors liable to influence yields – inflation, monetary and fiscal policy – leading us to forecast a rise in the T-note yield to 2.8%-3% and the German Bund to 0.7% by the end of the year. In the event, political gridlock in Washington has forced us to abandon our expectations for a fiscal stimulus in the US while weakness in core personal consumption expenditure (PCE) inflation means it is set to come in well below the Fed's target of 2%, contrary to our expectations. Hence, we have revised down our year-end target for the US Treasury yield to 2.5% from 2.8%-3%. By contrast, our initial forecast remains unchanged for the Bund yield as the euro area economy has been performing broadly in line with our expectations.

Looking forward, we anticipate that divergence between European and US bond yields will continue, with no strong catalyst for T-bond yields to rise much beyond 2.5% by the end of next year. However, we believe the 10-year Bund yield could rise to about 1% by end-2018 (see chart). We have slightly modified the three main factors we see as likely to influence yields. We

now believe these will be inflation, monetary policy and growth (rather than fiscal policy).

CORE INFLATION STILL BELOW TARGET

Core inflation should rise by the end of next year in the US and in the euro area, but we expect it to remain below the Fed and the European Central Bank's (ECB) targets of close to 2%. Considering that the two economies are at different stages in the economic cycle, below-target core inflation in the US would be the sign that the US economic cycle is maturing, with full employment failing to spark inflationary pressures. By contrast, we expect inflationary pressures to grow in the euro area in the coming year, a signal that the European recovery remains robust.

ECONOMIC GROWTH MOVING IN THE EURO AREA'S FAVOUR

We expect US real growth to pick up from 1.5% in 2016 to 2.2% in 2017. However, cracks are starting to appear in economic data, leading us to conclude that the US economic cycle

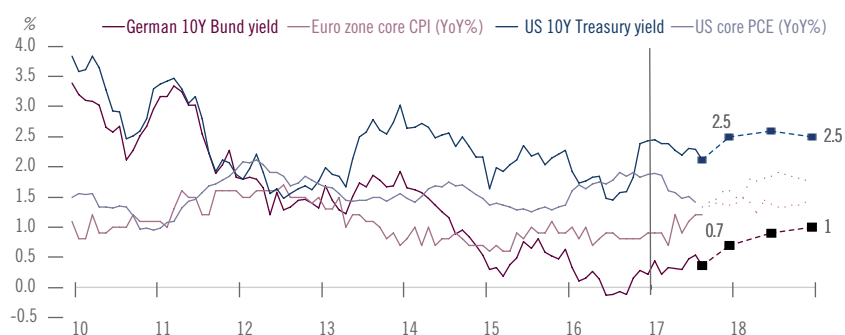
is maturing and that growth is set to slow down to a rate closer to its long-run potential. Hence, we expect GDP growth of 1.7% next year (down from 2.3% in our previous estimates), meaning that the US Treasury yield curve should continue to flatten, with short-term rates rising more than long-term ones.

By contrast, we expect that real economic growth in the euro area will continue to run well above its long-run potential of about 1%. In fact, we expect GDP growth of 1.9% in 2017 and 1.7% in 2018. This robust growth should put upward pressure on the 10-year German Bund yield, with the yield curve steepening in anticipation of ECB rate hikes in the following years.

MONETARY POLICY: THE FED AND ECB REVERSE ROLES

Due to below-target inflation and falling economic growth, the Fed will probably be more constrained in raising rates in 2018 than it currently anticipates. We expect only two additional hikes in this cycle — one in December 2017, the other in March

10-YEAR BOND YIELDS AND INFLATION, INCLUDING PWM FORECASTS



Data at 8 September 2017
Source: Pictet WM-AA&MR, Factset.

2018 — after which the Fed could call a halt, having probably reached a Fed fund rate level consistent with the economy's potential. However, the Fed's balance-sheet reduction, to start this quarter, will gradually accelerate and is due to reach a cruising speed of -USD50 bn a month.

We expect core inflation in the euro area to reach around 1.3% (y-o-y) in 2018. Such levels have not been observed since 2012 and could encourage the ECB to taper its QE. We think the ECB could reduce its monthly asset purchases to EUR40 bn a month in H1 2018 (from a current rate of EUR60 bn) and then gradually end purchases entirely by the end of 2018. Moreover, it could hike the deposit rate from -0.4% to -0.25% in 2018 as part of its efforts

to unwind extraordinary post-financial crisis measures. This means that the ECB could turn relatively more hawkish than the Fed, moving slowly towards rate-hikes in 2019 whereas the Fed remains on hold.

All in all, our macroeconomic scenario leads us to expect a divergence in direction between T-bond and German Bund yields in 2018, with the former remaining stable and the latter continuing to rise. However, both remain classic safe-haven assets and in the case of an equity sell-off due to either political turmoil or recession fears, Bund and T-bond yields alike would fall. Instead, we anticipate a rise in the 10-year US Treasury yield towards 2.5% by the end of 2018. This forecast is underpinned by our fair

value model, which is based on the long-term relationship between the T-bond, the neutral interest rate, the long-term inflation expectations and the size of the Fed's balance sheet. The fair value obtained through this methodology has been working as an attractor for the US 10-year Treasury yield, around which it gravitates, and shows the T-bond remaining stable at 2.1% in 2018. We believe the rise in European yields will be relatively steeper, with the 10-year Bund yield reaching 1% by the end of 2018. ■



LUC LUYET

Currencies Strategist
Pictet Wealth Management

ASSET FOCUS

Currency shifts may ease

These are interesting times for forex, with some significant changes in exchange rates. Here we present our views of the road ahead for some major currencies.

US dollar. The US dollar has suffered heavily from the weakness in US inflation since the start of the year and from the inability of the Trump administration to assemble a working majority in Congress. Looking forward, we believe core PCE inflation is likely to remain below the Fed's 2% target, reducing the Fed's leverage to raise rates just as US economic momentum is likely to slow and the likelihood of a meaningful fiscal boost has evaporated. Consequently, the two pillars supporting the US dollar since the second half of 2011, namely superior growth and monetary policy, are unlikely to do so going forward. The US dollar is therefore likely to weaken further in 2018, although at a more gradual pace than in 2017. Its equilibrium value based on purchasing power parity is

seen at around USD1.22 per EUR, not far off its early-September market rate of USD1.20. The significant divergence of the EUR/USD from what is implied by rate differentials should also limit the downside potential of the US dollar.

Euro. Contrary to the US dollar, sentiment surrounding the euro has improved immensely. European political uncertainty has faded markedly, the economic recovery has broadened and the European Central Bank (ECB) is preparing to normalise monetary policy as the inflation outlook improves. Despite a significant appreciation in the euro trade-weighted index since the start of the year (by more than 5% by the end of August), the ECB is not yet overly concerned about the FX pass-through (see

article on page 7). That being said, further strengthening would likely constitute an important speed bump along the path to normalisation by leading to an unwarranted tightening of financial conditions and lowering the inflation outlook. This eventuality and the recent disconnect between the recent currency moves and rate differentials should limit the euro's upside potential.

Sterling. While most countries are concerned about muted inflationary pressures, the Bank of England (BoE) has a different problem. Given the sharp depreciation of sterling following last year's Brexit referendum, headline inflation has risen beyond the BoE's target of 2%. But, as in other countries,

“Further downside risk in sterling looks limited”

domestic inflation remains weak due to a lack of wage growth. The result is an environment of low growth, given the squeeze on consumers’ real income, and high inflation. The macro background is therefore not ideal for a rate hike, let alone for a full tightening cycle. Although political uncertainty on the nature of Brexit will continue to feed volatility, the fact that sterling is fundamentally undervalued and the BoE’s low tolerance for a weak currency (as highlighted by the hawkish signals it gave after its 14 September policy meeting) suggest that further downside risk in sterling is limited.

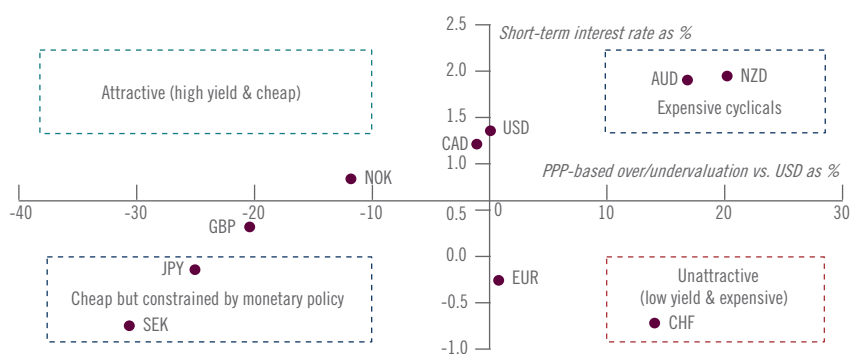
Yen. Rate differentials also point to Japanese yen weakness as the Bank of Japan (BoJ) looks set to remain fully committed to its yield-curve control (YCC) framework, keeping 10-year interest rates at very low levels. Unfortunately for the BoJ, nominal rates, especially in the US, have failed to rise given muted inflationary pressure. Furthermore, high geopolitical tensions have somewhat hurt risk appetite, pushing the yen higher. Although the slowdown in US activity is likely to curb upward pressure on long-term nominal rates, should geopolitical tensions over North Korea fall short of a full-blown crisis, then rate differentials favour downward pressure on the yen, especially as inflation in Japan is nowhere near the BOJ’s 2% target.

Swiss franc. Inflation should also remain low in Switzerland. However, the Swiss National Bank’s mandate

(SNB) to ensure price stability is less ambitious than the BoJ’s. As in Japan, exports are a critical part of the Swiss economy. But contrary to Japan, the Swiss franc has been significantly overvalued in the past few years, leading the SNB to adopt a very accommodative monetary policy. However, the SNB has become concerned by the massive increase in its balance sheet, caused by sustained market intervention to curb the Swiss franc’s strength and by the potential unwanted consequences of highly negative short-term interest rate. Given the significant improvements in the euro area, the overvalued and negative-yielding franc has lost some of its attractiveness. The recent significant depreciation of the Swiss currency coupled with ECB normalisation should also lead to a less accommodative SNB, thus relieving some of the downward pressure on the franc.

Swedish krona. Among other major currencies, the Swedish krona currently looks the most attractive. The macro background is positive: Swedish growth is robust and inflation has recently surprised to the upside. As the currency is extremely undervalued, the Riksbank might soon be persuaded to release its tight grip on it. The probable replacement at the start of next year of the Riksbank’s current very dovish governor could accelerate the shift towards a less accommodative monetary stance. However, as exports are key for the Swedish economy, the Riksbank is unlikely to stand idle should the krona appreciate too rapidly. ■

G10 CURRENCIES: VALUATIONS BASED ON FUNDAMENTALS VS. SHORT-TERM INTEREST RATES



Data at 11 September 2017
Source: Pictet WM-AA&MR, Thomson Reuters



JACQUES HENRY

Senior Cross-Asset Allocation Strategist
Pictet Wealth Management

ASSET FOCUS

Emerging-market assets retain strong momentum

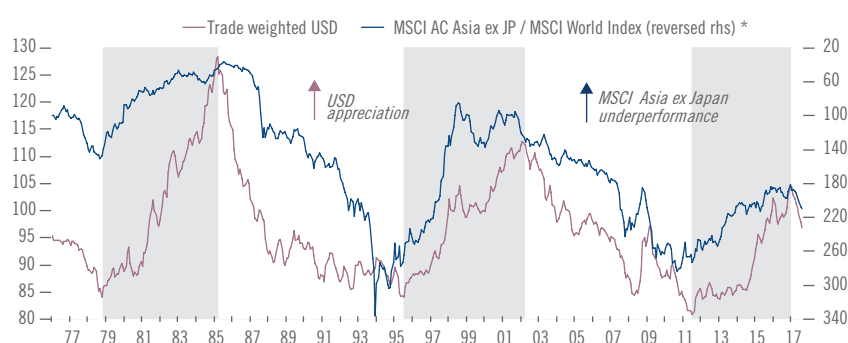
A backdrop of improving fundamentals and dollar weakness means the prospects for many countries remains supportive.

Currencies. EM currencies are particularly sensitive to trends in the US dollar and US real rates. The health of the global trade environment is also a key factor in the performance of many emerging market (EM) currencies dependent on commodities. Chinese activity has a significant influence on the global trade outlook. In the event, the significant weakness in the US dollar since the start of the year (the US dollar index was down almost 10% in the first eight months of 2017), the lack of any upward pressure on US real rates and strong Chinese activity have formed a particularly supportive environment for emerging currencies.

The US dollar is likely to weaken further next year given our expectation that US growth will moderate and that the Fed will only raise rates once in 2018. Coupled with low upward pressure on US real rates, the global environment should favour currencies of emerging markets where the economic backdrop remains favourable, in spite of a deceleration in growth in China. European currencies like the Czech koruna, should continue to benefit from their relatively robust growth prospects, while high-yielding currencies with healthy external buffers such as the Russian rouble and the Indonesian rupiah also remain attractive.

Equities. EM equities have outperformed other equity markets and all major asset classes this year. Total returns from the MSCI EM index rose 23.2% from 1 January to 8 September, 2017 in US dollars. The increase has been even higher in Asia ex Japan (27.3%). Earnings, valuations and currency rates have been the most important drivers of those returns and are

TRADE-WEIGHTED US DOLLAR AND THE MSCI AC ASIA EX JAPAN/MSCI WORLD INDEX



Data at 11 September 2017
Source: Pictet Wealth Management-AA&MR, Factset.

expected to remain so for the next 18 months. Earnings growth in Asia ex Japan is currently expected to be close to 23%, with further growth of 11.3% in 2018. Earnings growth of this level is well above that expected for developed markets (DM). And EM valuations are cheaper, offering a 20% discount in terms of 12-month forward earnings relative to DM, even excluding tech and financial stocks that account for half of the EM space. Unlike DM, some further rerating of EM equities could boost expected returns. Last but not least, our forecast for further slight weakening of the USD should provide further support to EM equities.

Bonds. EM fixed income has performed well year to date, with total returns of around 10% (as of 8 September, 2017) for the three main segments, US dollar-denominated sovereign and corporate debt and sovereign debt in local currency.

The depreciation of the US dollar and strong Chinese growth have pushed EM hard-currency sovereign and corporate spreads over US Treasuries to historically low levels. Over

the next 18 months, moderation in the Chinese and US economies could contribute to a slight widening of EM spreads as further slight US dollar depreciation should not be sufficient to drag spreads down to new historic lows. By contrast, our expectation that the 10-year US Treasury yield will rise towards 2.5% (from 2.1% at 8 September, 2017) by end-2018 could push up the yield of hard-currency EM bonds. Nonetheless, the high coupons the latter offer should compensate and ensure a decent total return of around 3%.

In spite of our expectation for further dollar weakness next year, investors should remain selective when it comes to local currency debt. But EM countries where moderate inflation allows central banks to remain accommodative, where growth is solid and where the political environment is relatively stable should benefit from lower yields and appreciating currencies, providing investors with positive total returns in the coming 18 months. ■



FRANK BIGLER

Head of Equity and Credit Research
Pictet Wealth Management

“Markets believe the remaining upside in equities is limited”

ASSET FOCUS

Equities are looking for a second wind

The strong equity gains of early 2017 have petered out, in spite of buoyant earnings. Some sectors should fare better than others, but a new catalyst is needed to push market indices much higher.

Despite a very strong earnings season, we recently moved from a positive to a neutral position on five out of the 10 main sectors we cover in the US and six out of 10 in Europe. We remain positive on financials on both sides of the Atlantic—because of prospects of ECB tapering in Europe and because of potential deregulation in the US. We are also positive on materials in the US and Europe since 2018 price forecasts are still lower than the spot price for most metals (*see article on next page*).

While we are negative on prospects for European healthcare, which has fewer growth-sector characteristics, we are positive on prospects for the same sector in the US for three main reasons. First, fears of a cap on US drug prices have turned out to be unfounded. Second, valuations still offer a discount to the broader market. Third, 2Q results showed an acceleration in upwards earnings and sales surprises. US healthcare companies also stand to benefit from any moves to reform tax repatriation rules. We are negative on the consumer sectors in the US and in Europe, as top-line growth in both places is being challenged by the lack of pricing power and sluggish volumes (*see article on US consumer sector on page 14*). The dramatic changes induced by the e-commerce continue to make it a difficult sector call.

In contrast with the US, among the better-performing sectors on the MSCI Europe since the beginning of this year have been industrials, materials and financials, which is consistent with the strong economic backdrop in the euro area. In contrast, the best sectors in the S&P 500 have been information technology,

health care and utilities, while all other sectors underperformed the index. The energy sector has been the most notable laggard on both sides of the Atlantic.

The second quarter of 2017 was one of the strongest earnings seasons for US and European equities since the financial crisis. The S&P 500 saw 73% of companies beat earnings guidance, while aggregate EPS growth for the index was a healthy 10.2%. Despite healthy earnings, over July and August, the S&P500 rose just 2% in US dollar terms. In Europe, the earnings numbers were equally strong, and yet the Stoxx Europe 600 declined by 1.5% in euro terms. Such modest index performances are in a sharp contrast with the first-quarter earnings season, when markets responded much more positively to upbeat earnings data. The muted reaction this time round reflects the belief that remaining upside in equities remains limited amid lack of guidance on 2018 earnings.

PROJECTIONS FOR EARNINGS GROWTH

Indeed, following the Q2 earnings season, we have updated our company financial models. Despite the strong reports and the generally positive tone adopted by company managements, we have only been able to apply modest upward adjustments to our expectations for full-year earnings. The lack of meaningful upward revisions to our models means we have limited expected returns for individual stocks. While 12-month forward price-to-earnings for the S&P 500 remained at an elevated 17.4x in early September, consensus revisions have also been modest, indicating

that much of the positive momentum from the last two reporting seasons had already been priced into the full-year market expectations.

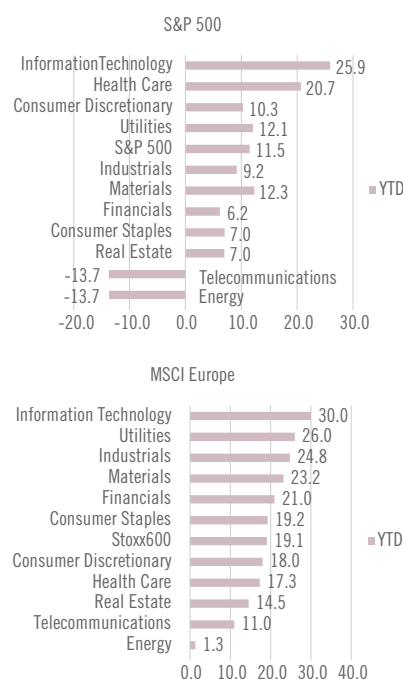
DRIVERS OF SHORT-TERM POSITIONING

We see four drivers for earnings estimates that could affect our sector positioning in the coming months. First, inflation expectations remain low. While not so long ago there were still concerns that the Fed would fall behind the curve as Trumponomics boosted the American economy, no such boost has occurred. The lack of fiscal stimulus coupled with subdued oil prices lead us to think that there are now few industries in the US that can command pricing power. The change in sector leadership from companies liable to benefit from the reflation trade to those known for innovation (i.e. growth stocks), very much reflects this new market posture. ECB and Fed policy meetings in September could well trigger short-term shifts in market positioning

and lead to sector rotation. Second, the euro's continued strength is impacting business fundamentals, notably for large international players. Again we think that short-term currency fluctuations have led to aggressive market positioning. Third, in October, companies will start providing earnings guidance for 2018. With bottom-line growth in 2018 currently expected to be in the region of 8% in Europe and 11% in the US, we see potential for adjustments, notably in relation to currency moves.

Finally, expectations are now low concerning the Trump administration's ability to repeal or reform key regulations. We no longer expect any meaningful breakthrough on this front, but we think the market can still be wrong-footed by any kind of political breakthrough. While hopes have faded, we will be closely monitoring any progress on US tax reforms in the months ahead. ■

EQUITIES: % TOTAL RETURNS BY SECTOR, 1 JAN. - 14 SEPT. 2017*



Data at 14 September 2017
* in US dollars for the S&P500, in euros for the Euro Stoxx 600.
Source: Pictet Wealth Management Equity Research, Bloomberg.

BACKDROP REMAINS ATTRACTIVE FOR MINING & METAL

Malik Zetchi, Commodities Sector Analyst, Pictet Wealth Management

Having weathered six years of falling or stagnant commodity prices, the metals & mining industry seems to be well down the road of redemption. Just 18 months ago, balance sheet stress and dividend cuts were the order of the day. But global mining companies have been dealing with their problems, rationalizing their operations. The top three companies, accounting for 60% of the seaborne iron ore market, have reined back on their ambitions for expansion, while the world's top copper company has also been cutting output to prop up prices.

China's environmental aspirations definitely have positive implications for commodity prices, with vast supply-side reforms in the steel industry for instance resulting in almost 200 million tons of China's installed capacity in the process of being shut down, 15% of the total. By early September, iron ore prices were trading comfortably above their 2016 lows at around USD 75/t, while copper was up 20% year to date.

Downside buffers

In spite of these developments, market expectations for a sustainable improvement in the commodities cycle remain fairly modest. Consensus metal prices forecasts for

2018 are well below current spot levels, -30% lower in the case of iron, 17% in the case of copper and 40% in the case of metallurgical coal. Metals & mining valuations are still reasonable, with the sector trading at a 12-month forward price/earnings (P/E) ratio of 13.3x, just slightly above the historical average. Should commodities prices hold unto their recent gains, valuations would become highly attractive, with a 14% free cash flow yield translating into a forward P/E ratio of about 8x, for example. While the price remains volatile, commodities do not need to rise from here to drive earnings higher for next year and companies still have downside valuation buffers.

This provides quite an interesting backdrop for investing in the metals & mining space. At this point in the cycle, we tend to favour companies that clearly intend to return the large amounts of cash they are accumulating to shareholders without targeting a specific commodity price. Companies' strategies for growth are not uppermost in investors' minds for now. ■



MARIANNE JOHNSON

Consumer Sector Analyst
Pictet Wealth Management

ASSET FOCUS

Light and shade in the US consumer sector

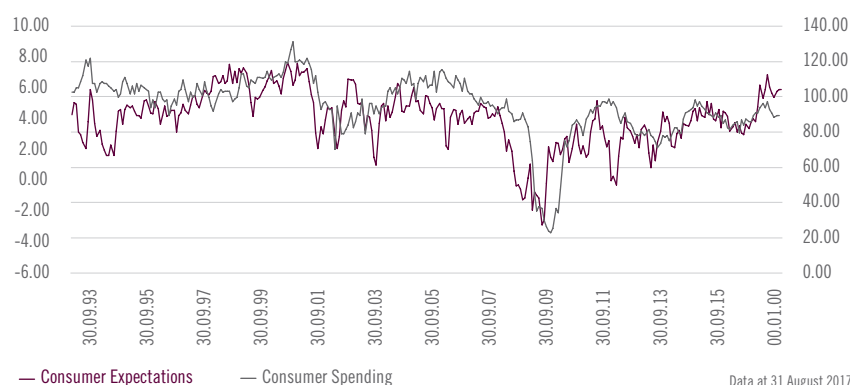
While the US economy is continuing to grow, structural undercurrents mean that some parts of the consumer sector are likely to fare better than others.

In general, US consumer stocks beat Q2 earnings expectations, but several well-respected and normally consistent discretionary names came up short in terms of guidance. This is probably a bigger reason than the Amazon threat why the market performance of high-multiple US names has sagged of late. There are fewer places to hide in US consumer discretionary than in Europe and valuations are still not back to levels liable to unlock investor interest. This year we are also seeing a divergence between healthy consumer spending and sentiment reports and most consumer company earnings, which have traditionally been positively correlated. A structural shift to e-commerce and so-called 'experience spending' are the main reasons for this, meaning investors need to be increasingly selective.

Developments in the US have led us to shift our stance on the US consumer sector relative to the forecast we made at the beginning of this year. The *early-year 'Trump trade'* has unwound given lack of follow through on president Trump's policy proposals, especially for cutting taxes and creating jobs. The Border Adjustment Tax proposal also appears to be off the agenda. As a result, US wage growth has been flaccid, and the lack of inflation has resulted in a weaker dollar. Our previous leaning towards US-centric names has thus switched to exposure to emerging markets showing improvements in their economic fundamentals.

We expect momentum to remain strong for the next 12-18 months in longer-term investment themes such as *channel shift* (from physical retail to

US CONSUMER CONFIDENCE EXPECTATIONS VS CONSUMER SPENDING



Data at 31 August 2017
Source: The Conference Board, Bureau of Economic Analysis.

e-commerce). *Household durables* are another major investment theme, thanks to strong household formation, especially among Millennials. However, the 'active lifestyles' trend is showing signs of weakening, causing pressure another theme, *health & wellness*.

We continue to like home improvement retailers for several reasons. We appear to be in the middle of the housing cycle, not the end. Rising rates could take a while to impact home improvement spending given favourable housing demand/ supply and affordability metrics as well as healthy consumer balance sheets. US home prices continue to rise. We don't view the push by mega-internet operators into heavy bulk items as problematic in the current cycle, since the main home improvement retailers have several lines of defence, including a high percentage of pro sales, sophisticated supply chains and leading omni-channel capabilities. Hurricane damage in the southern US will also give a short-term boost to same-store sales.

As a beta play, we still like US auto suppliers, whose valuations remain undemanding. Global auto demand remains healthy/stable and well ahead of investor expectations. Rising production with higher content has been driving supplier revenue and EPS beats.

Industry disruption means we are cautious about US media. Big US media companies are accelerating initiatives to deliver content to consumers via the internet. But there are strategic risks involved and earnings downgrades in the next 2-3 years cannot be excluded.

We remain selective regarding US staples. Competition is increasing for large players as millennials demand less standardised products. We continue to like self-help stories that display a positive mix of products, M&A synergies, and the ability to save costs. And we like those agile enough to use their balance sheets to buy growth. Given the tailwind of a weak USD, we look favourably on consumer staples companies with exposure to emerging-market growth. ■

**RODOLPHE RANOUIL**

Head of Fixed Income Research
Pictet Wealth Management

Summer wobbles are a sign of unease in corporate credit

After a period of remarkable buoyancy, deep undercurrents mean that risks are rising in some parts of the credit market.

Credit markets have had an eventful summer, caught between rising geopolitical risks, a strong earnings season and sustained primary supply. By early September, credit spreads were close to their tightest levels this year, which are incidentally also the tightest levels over benchmark government bonds since the start of the 2007 asset-backed securities crisis.

Arguably, the world has moved on since then and the picture for credit is now significantly different. Nevertheless, current tight spreads raise our sense of caution, as there is very little room for shock absorption. Indeed, we find it surprising how little spreads have reacted to the recent escalation of risk in North Asia, which reveals just how strong demand patterns are for corporate paper.

Issuers are benefitting from this, with a plethora of jumbo deals coming to market this summer. Even excluding these transactions, primary markets have been very active. There are seasonal factors at play here, but the intensity suggests that issuers are keen to use the current window to raise cheap funding ahead of the expected announcements on QE by the ECB and a possible rate hike by the Fed later this year.

What we see on the horizon leads us to play it close to home, with a potential glut of issuance combined with rising geopolitical risks and the ECB's willingness to reduce its monthly asset purchases all providing the background for wider spreads before year's end. In addition, while corporate results have been very strong so far this year, it will prove difficult to beat recent profit growth figures over the next few quarters.

STILL POSITIVE ON BANK CREDITS, BUT CAUTIOUS ON US AUTOS

Our view on bank senior paper and subordinated debt remains positive – particularly for European banks, which are in the process of rebuilding their capital buffers. Nonetheless, current tight spreads on subordinated bank debt and the high-beta nature of these instruments are making us increasingly cautious. Insurers' senior and subordinated bonds continue to offer value in our view as does high-quality corporate hybrid paper.

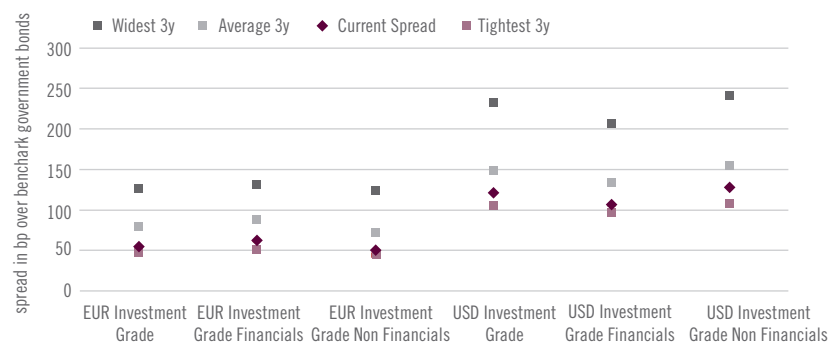
Our 'rising stars' tactical plays have borne fruit too, particularly in metals & mining. We continue to see performance potential for issuers in this sector, which have not had their spreads pushed down by ECB actions. For the same reason, but also for yield pick-up, we see value in US investment-grade corporates at this juncture as well as in select emerging-market corporates.

The key foreseeable risk for non-financial corporate bonds is the anticipated reduction in the pace of ECB monthly purchases, which could turn

out to be the 'elephant in the room' for European credit markets. Our view is that corporate bonds liable for purchase under the ECB's corporate sector purchase programme (CSPP) are highly vulnerable to a European-style 'taper tantrum' – particularly the ones with longer durations. In addition, the low-coupon bonds issued in recent years offer insignificant carry protection to compensate for wider spreads.

Separately, US autos are an increasing source of worry. Car sales for August were not reassuring, coming in 4.4% lower than a year earlier. We have to go back to February 2014 for a lower monthly number. If this trend continues, significant risks could arise in this sector, in our view. Some of these risks have already materialised in the form of a decline in second-hand car prices (down 10% from a peak in 2014) that is likely to be aggravated by the end of lease contracts, which have helped support sales over the past three years. ■

SPREAD VARIATIONS FOR CORPORATE CREDIT*



Data at 5 September 2017
Source: Pictet Fixed Income Research, Bank of America Merrill Lynch.



MARIANNE JOHNSON

Responsible for sustainability
Pictet Wealth Management

TRENDS & THEMES

Not just about altruism

‘Responsible investing’ aims to capture the growing awareness of all the responsibility that everybody feels toward the society and environment in which we live. **Marianne Johnson**, responsible for sustainability at Pictet Wealth Management (PWM) Equity Research, outlines PWM’s new initiatives in this direction.

PWM has just announced a major initiative in the area of responsible investing. What is the thinking behind this move?

PWM has *de facto* been incorporating environmental, social and governance (ESG) metrics in its approach to investments for a long time. Thanks to Pictet Asset Management, Pictet is already ranked highly in terms of its sustainable investment offering and is recognised for its all-round expertise in the field of durable development. Now the time has come to make PWM’s approach equally systematic.

At PWM, approved equities lists already contain a strong element of ESG awareness—not least because over Pictet’s long history, we have been able to build up a store of knowledge into governance issues, for example. But up to now, there has not been an explicit set of reference tools at PWM to gauge the suitability of investing in a company from an ESG perspective.

Last year, we decided to make resources available to onboard external expertise and at the same time to leverage our own expertise to come up with

a deep, systematic approach to responsible investing. Basically, we are adding an extra layer of analysis to our traditional financial and strategic analysis of companies. We now have three agencies analysing stocks for us based on ESG criteria. Each has its own specialty. ISS is specialized in measuring corporate governance risks, CFRA looks closely at aggressive accounting practices, and Sustainalytics examines the behavior of companies from a social and environmental point of view. We use the company ratings they provide building blocks for our own analysis to come up with an aggregated ESG score. This ESG score and underlying ESG analysis forms part of our assessment of stocks liable to be included in or excluded from our investable universe.

“Investors are increasingly inquiring how we vote on governance issues”

A negative ESG score means a stock’s overall attraction as an investment is discounted. But a poor score on ESG does not automatically mean

exclusion from our approved stocks list, especially if evidence can be produced that the company’s dynamics are changing. If a stock still manages to stay on our list of approved equities, there will be analyst commentaries attached explaining the risk-return rationale for it being there.

Since ESG considerations were already part of Pictet’s process, isn’t there an element of gimmickry in this initiative?

Not at all. Adding a formal extra layer of analysis based on ESG criteria on top of our classic financial analysis should lead to better evaluation of the play-off between risks and returns. A properly gauged and timed investment in renewable technologies that would have seemed a far-fetched bet 15 years ago now would look like a sensible, rational—and potentially profitable—investment decision. Our own analysis shows that companies on our approved equities list in 2014 who were ‘best-in-class’ in terms of ESG were the best-performing stocks 30 months later. Consider that a church-owned investment fund in the UK that aims to reconcile Christian morality and mammon reportedly now ranks among the world’s best-performing endowment funds. So it is not simply a matter of altruism.

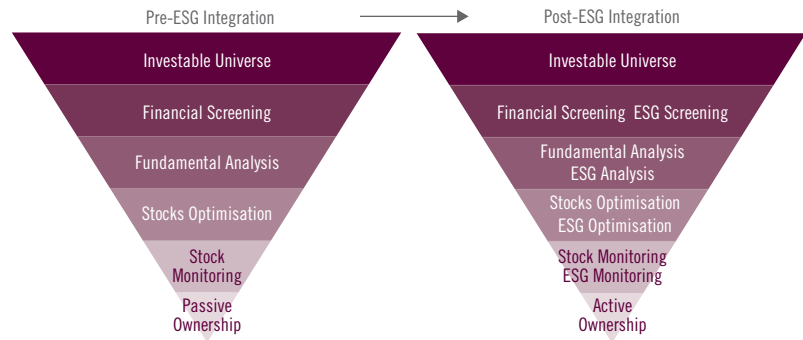
And one just has to look at the huge increase in shareholder activism in recent years, which as often as not has corporate governance at its heart. And the breath of this activism is broadening all the time, encompassing anything from the use of child labour in third-world countries to efforts to promote diversity and equal pay for men and women in western economies. Investors are

GROWTH OF SRI ASSETS BY REGION (IN BILLION), 2014-16

REGION	2014	2014	CAGR
EUROPE	\$ 10'775	\$ 12'040	5.7%
US	\$ 6'572	\$ 8'723	15.2%
CANADA	\$ 729	\$ 1'086	22.0%
AUSTRALIA/NZ	\$ 148	\$ 516	86.4%
ASIA X JAPAN	\$ 45	\$ 52	7.6%
JAPAN	\$ 7	\$ 474	724.0%
TOTAL	\$ 18'276	\$ 22'891	11.9%

Source: Global Sustainable Investment Alliance, 2016 Review

EXPECTED EVOLUTION OF PWM EQUITY RESEARCH PROCESS



Source: Pictet Wealth Management, September 2017

increasingly inquiring how we vote on governance issues at shareholder meetings, including matters like executive pay. This means that we are being tasked with becoming ever more active when managing the portfolios of clients anxious that we reflect their concerns.

There is a real demand for products that respond to ethical concerns, especially in the younger generation. A recent study by US Trust showed that 28% of millennial and 'Gen X' investors in the US already held ESG-type investments, and a further 57% were at least interested in doing so. Surveys show that young investors are at least as anxious that their investments are ethically sound as they are that they produce a positive return. Our job is to try to reconcile the two.

Responsible investing is not a niche. According to Global Sustainable Investment Alliance (GSIA), global socially responsible investing (SRI) assets totaled almost USD23 trillion at the end of 2016, and are growing at a rate of almost 12% per annum. And it is just as interesting for long-term investors like ourselves to note that investors are willing to give responsible investments more time to succeed than "traditional" investments—5.3 years instead of 3.2, according to one survey, with 82% of survey respondents saying they were prepared to stay invested in SRI investments longer than in non-SRI equivalents.

Is responsible investing a black-and-white issue when it comes to fund management?

Not necessarily, which means we have to offer a highly granular approach when it comes to proposing single stocks to investors.

Basically, one can imagine a 'responsible investing' process that starts with what is called "negative screening" that involves avoiding investments in industries and companies that do not meet established ESG criteria. For example, Pictet has long excluded heavy-weapon manufacturers from its list of investable companies. Other sectors such as mining, nuclear power, agribusiness and gambling also throw up a whole series of issues, with myriad companies that might score low in our ESG assessments. But we recognise that investors have varying notions of what constitutes an acceptable investment and that their tolerance for stocks that might set off ESG alarm bells also differs. For example, German investors might have a lower tolerance for nuclear energy stocks than investors in France, where nuclear power remains widely acceptable as a source of energy.

"Investors have varying notions of what constitutes an acceptable investment"

But once one moves beyond exclusion lists, one starts looking at "best-in-class" companies—investable companies that are financial solid and show a capacity for consistently providing value for shareholders while at the same time scoring highly on the basis of our ESG criteria. Using the ratings provided by our external partners and our own ESG and financial analysis, the result is an initial 'Best-in-Class ESG and Value Creators' list of investable stocks that is then integrated into our analysis grid. The next step is to step up our monitoring of our ESG investment and

coming up with tailor-made environmental and socially theme investment themes for clients.

What are some of the next steps in Pictet Wealth Management's ESG push?

An important step will be signing up to the United Nations Principles of Responsible Investing (PRI) charter in November. There are six basic principles to be respected in this charter with an annual audit to ensure that PWM adheres to them.

The rest of this year will see us the formal integration of external ESG inputs into our stock analysis and greater communication to our clients of what we are trying to do. We are also continuing to work closely with Pictet Asset Management to leverage its expertise, especially its experience in integrating sustainability issues into the investment process. ■



JACQUES ROULET

Senior Risk Manager
Pictet Wealth Management

TRENDS & THEMES

Buying protection against political risk is worth it

Protecting portfolios ahead of major political events means opening up to the possibility of adding derivatives.

Optimising the turnover of a tactical asset allocation over time is a complex task, as political events can have both transient and permanent effects on markets. Stacking a series of short-term transactions to time short-term market moves can quickly become inefficient as the timing has to be flawless. Furthermore, there is a risk that the costs rise beyond reason, eating into any potential gains.

An alternative to high turnover consists in tactically buying derivatives protection, which creates an asymmetrical return profile in portfolios. This involves purchasing options—instruments that confer the right, but not the obligation, to buy or sell financial instruments at a predetermined price. This is similar to subscribing to an insurance policy: you want to be compensated should the worst happen, but hope that your house will not burn down.

But there is no ‘one-size-fits all’ approach and a few conditions must be met to justify adding portfolio protection. As the price of options depends on the degree of variability of returns, options are affordable only when volatility is low. Also, the so-called ‘time value’ of options means they can become prohibitively expensive if one wants permanent protection.

So, in practice, instead of selling risky assets at times of heightened uncertainty, we prefer to spend a small amount on option premiums, thereby buying an insurance policy that will pay off only if the outcome is negative for the markets. This approach is well suited ahead of political events such as major elections or crucial votes whose binary outcomes have a high potential to shake markets.

BUYING PUTS ON RISKY ASSETS

There are two main approaches to protection. One involves purchasing a put (the right to sell at a predetermined price) on equities held in portfolios. At the time of writing in mid-September, we were invested in S&P 500 puts. Earlier this year, we held puts on high-yield bonds (actually implemented as an option on an interest-rate swap, called a ‘swaption’).

...OR CALLS ON ‘SAFE HAVEN’ ONES

The second approach is broader in scope, as protecting portfolios doesn’t have to be limited to assets owned. Thus, this year we have also been buying call options on gold (the right to buy at a predetermined price) as gold is considered a ‘safe haven’ asset (i.e. it rises when markets dive). In this case, the underlying asset does not have to be owned in the portfolio. Our gold options protected us well through a tense European electoral season earlier this year and we were able to sell them again almost at purchase price, as volatility had increased in the interim.

For added efficiency, call and put options can be bundled together into certificates that precisely match the asset

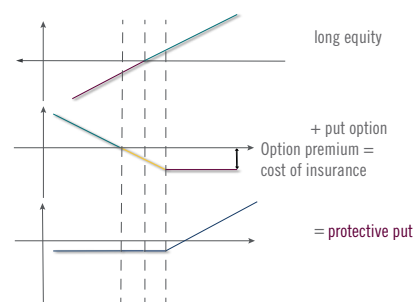
mix of portfolios. These certificates enable dynamic management of their content during their lifespan. They may incorporate up to 20% of cash, which can be deployed at a later stage depending on the state of markets.

In theory, option prices behave according to the famous Black-Scholes formula, based on a series of five parameters. In practice, options are most sensitive to the underlying instrument’s *market price* (delta in financial jargon) and its underlying volatility (gamma). So, with a tad of luck, it may be possible to sell back options after a while with limited or no loss *if the underlying instrument’s volatility increases*, even without negative price action on the underlying instrument.

For those unable or unwilling to buy options, we suggest considering the next-best thing, the so-called ‘delta replication’ approach. This consists in selling the underlying risky asset in proportions similar to the option’s immediate reaction to a price change. While not perfect, this approach provides a good proxy for options even if it requires adjustments whenever underlying prices or volatility moves significantly. ■

ADDING A PUT TO EQUITIES PROVIDES INSURANCE

1. The equity position wins when the market moves up and loses when it moves down.
2. The put has a cost and wins if the market moves down.
3. Putting the two together results in a **protective put** with limited downside but illimited upside.



Source: Pictet Wealth Management, September 2017

DISCLAIMERS

Distributors: Banque Pictet & Cie SA, Route des Acacias 60, 1211 Geneva 73, Switzerland and Pictet & Cie (Europe) SA, 15A, avenue J. F. Kennedy, L-1855 Luxembourg/B.P. 687 L-2016 Luxembourg.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

Pictet & Cie (Europe) SA is established in Luxembourg, authorized and regulated by the Luxembourg Financial Authority, Commission de Surveillance du Secteur Financier.

This marketing communication 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, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

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 Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. 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. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

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. Moreover, forecasts are not a reliable indicator of future performance. The content of this document can 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. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee 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 Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2017.

Distributors: Bank Pictet & Cie (Asia) Ltd ("BPCAL") in Singapore, 10 Marina Blvd #22-01 Tower 2, Marina Bay Financial Centre, Singapore 018983 and Pictet & Cie (Europe) S.A., Hong Kong branch ("Pictet HK branch") in Hong Kong. The registered address of Pictet HK branch is 9/F, Chater House, 8 Connaught Road Central, Hong Kong.

The information, tools and material presented in this document are provided for information purposes only and are not to be used or considered as an offer, an invitation to offer or solicitation to buy, sell or subscribe for any securities, commodities, derivatives, (in respect of Singapore only) futures, or other financial instruments (collectively referred to as "Investments") or to enter into any legal relations, nor as advice or recommendation with respect to any Investments. This document is intended for general circulation and it is not directed at any particular person. This document does not have regard to the specific investment objectives, financial situation and/or the particular needs of any recipient of this document. Investors should seek independent financial advice regarding the appropriateness of investing in any Investments or adopting any strategies discussed in this document, taking into account the specific investment objectives, financial situation or particular needs of the investor, before making a commitment to invest.

BPCAL/Pictet HK branch has not taken any steps to ensure that the Investments referred to in this document are suitable for any particular investor, and accepts no fiduciary duties to any investor in this regard. Furthermore, BPCAL/Pictet HK branch makes no representations and gives no advice concerning the appropriate accounting treatment or possible tax consequences of any Investment. Any investor interested in buying or making any Investment should conduct its own investigation and analysis of the Investment and consult with its own professional adviser(s) as to any Investment including the risks involved with transactions on such Investment.

This document is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any Investment mentioned in this document may fall as well rise. The market value may be affected by, amongst other things, changes in economic, financial, political factors, time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates of exchange may have a positive or adverse effect on the value, price or income of any Investment mentioned in this document. Accordingly, investors must be willing and able to, and effectively assume all risks and may receive back less than originally invested.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by BPCAL/Pictet HK branch regarding future performance.

This document does not constitute the investment policy of BPCAL/Pictet HK branch, or an investment recommendation, and merely contains the different assumptions, views and analytical methods of the analysts who prepared them. Furthermore, the information, opinions and estimates expressed herein reflect a judgment at its original date of publication and are subject to change without notice and without any obligation on BPCAL/Pictet HK branch to update any of them. BPCAL/Pictet HK branch may have issued or distributed other reports or documents that are inconsistent with, and reach different conclusions from, the information presented in this document.

While the information and opinions presented herein are believed to be from sources believed to be reliable, BPCAL/Pictet HK branch is not able to, and do not make any representation or warranty as to its accuracy or completeness. Accordingly, BPCAL/Pictet HK branch accepts no liability for loss arising from the use of or reliance on this document presented for information purposes only. BPCAL/Pictet HK branch reserves the right to act upon or use any of the information in this document at any time, including before its publication herein.

BPCAL/Pictet HK branch and its affiliates (or employees thereof) may or may not have long or short positions in, and buy or sell, or otherwise have interest in, any of the Investments mentioned herein, and may or may not have relationships with the issuers of or entities connected with Investments mentioned in this document. BPCAL/Pictet HK branch and their affiliates (or employees thereof) may act inconsistently with the information and/or opinions presented in this document.

The information used to prepare this document and/or any part of such information, may have been provided or circulated to employees and/or one or more clients of BPCAL/Pictet HK branch before this document was received by you and such information may have been acted upon by such recipients or by BPCAL/Pictet HK branch.

This document is provided solely for the information of the intended recipient only and should not be reproduced, published, circulated or disclosed in whole or in part to any other person without the prior written consent of BPCAL/Pictet HK branch.

Singapore

This document is not directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject BPCAL and any of its affiliates or related corporations to any prospectus or registration requirements.

BPCAL has obtained an exemption from the Monetary Authority of Singapore ("MAS") under section 100(2) of the Financial Advisers Act ("FAA") for the provision of financial advisory services to High Net Worth Individuals (as defined in the MAS Guidelines on Exemption for Specialised Units Serving High Net Worth Individuals FAA-G07) (the "Exemption") and is exempted from the requirements of sections 25, 27, 28 and 36 of the FAA, the MAS Notice on Recommendations on Investment Products (FAA-N16), MAS Notice on Appointment and Use of Introducers by Financial Advisers (FAA-N02), MAS Notice on Information to Clients and Product Information Disclosure (FAA-N03) and MAS Notice on Minimum Entry and Examination Requirements for Representatives of Licensed Financial Advisers and Exempt Financial Advisers (FAA-N13).

Please contact BPCAL in Singapore in respect of any matters arising from, or in connection with this document.

Hong Kong

This document is not directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet HK branch and any of its affiliates or related corporations to any prospectus or registration requirements.

Pictet & Cie (Europe) S.A. is incorporated in Luxembourg with limited liability. It is an authorized institution within the meaning of the Banking Ordinance and a registered institution (CE No.: AQ515) under the SFO carrying on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

Warning: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Please contact Pictet HK branch in Hong Kong in respect of any matters arising from, or in connection with this document.

Distributor: Pictet Bank & Trust Limited, where registered office is located at Building 1, Bayside Executive Park, West Bay Street & Blake Road, Nassau, New Providence, The Bahamas.

The document is not directed to, or intended for distribution or publication to or use by persons who are not Accredited Investors (as defined in the Securities Industry Regulations, 2012) and subject to the conditions set forth in the Securities Industry Regulations, 2012 or to any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet Bank & Trust Limited to any prospectus or registration requirements. Pictet Bank & Trust Limited is incorporated in The Bahamas with limited liability. It is a bank and trust company that is licensed in accordance with the Banks and Trust Companies' Regulation Act and is regulated by the Central Bank of The Bahamas. Additionally, Pictet Bank & Trust Limited is registered with the Securities Commission of The Bahamas as a Broker Dealer II and is approved to (i) Deal in Securities 1.(a) & (c); (ii) Arrange Deals in securities; (iii) Manage Securities; (iv) Advise on Securities.

Warning: The content of this document has not been reviewed by any regulatory authority in The Bahamas. You are, therefore, advised to exercise caution when processing the information contained herein. If you are in any doubt about any of the content of this document, you should obtain independent professional advice.

