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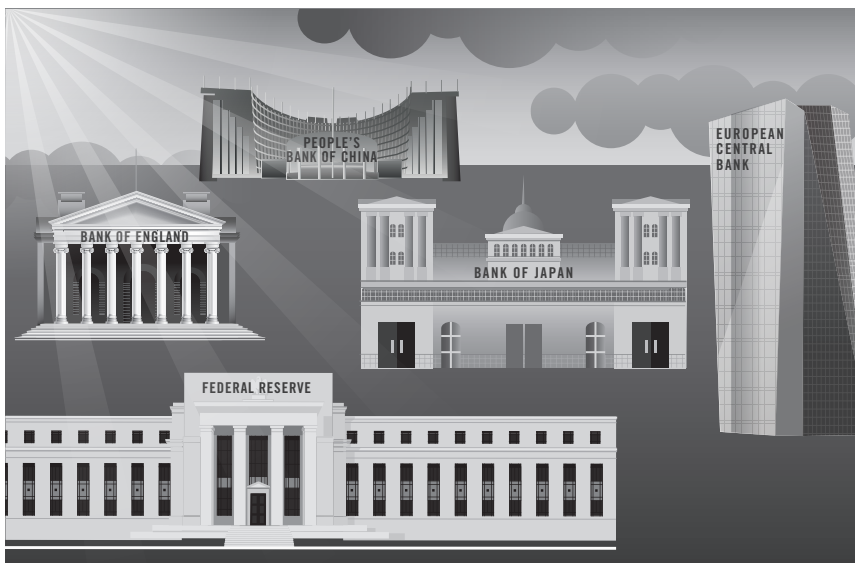
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Dollar cycle grinds to a halt

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Fresh opportunities for hedge funds



Doing nicely

The upturn in growth, benign central banks and improving fundamentals have all ensured that investors in most risk assets have reaped a rich bounty in 2017 so far. How long will the good times last?

ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT FORECASTS (AT 9 NOVEMBER 2017)*

INTEREST RATES (IN %)	CURRENT	DECEMBER 2017E	DECEMBER 2018E
Switzerland - short	-0.75	-0.75	-0.50
Switzerland - 10 year	-0.03	0.20	0.40
Euro area - Refi rate	0.00	0.00	0.00
Euro area - Deposit rate	-0.40	-0.40	-0.40
Germany - 10 year	0.43	0.70	0.90
France - 10 year	0.84	1.00	1.40
Italy - 10 year	2.01	2.30	2.60
Spain - 10 year	1.63	2.00	2.20
US - Fed rate (mid range)	1.13	1.38	1.88
US - 10 year	2.37	2.50	2.60
UK - Repo rate	0.25	0.50	0.75
UK - 10 year	1.31	1.40	1.60
Japan - Overnight	-0.10	-0.10	-0.10
Japan - 10 year	0.07	0.00	0.25
CREDIT SPREADS (IN BP)#	CURRENT	DECEMBER 2017E	DECEMBER 2018E
European IG	92	100	120
European HY	233	250	285
US IG	100	110	130
US HY	338	380	405
EM Corporates (USD)	275	300	340
EM Sovereign (USD)	280	310	350
# Bank of America Merrill Lynch indices			
FOREIGN EXCHANGE	CURRENT	DECEMBER 2017E	DECEMBER 2018E
EUR/USD	1.17	1.15	1.24
EUR/CHF	1.16	1.13	1.16
USD/CHF	0.99	0.98	0.94
GBP/USD	1.32	1.32	1.37
USD/JPY	113	115	115
COMMODITIES	CURRENT	DECEMBER 2017E	DECEMBER 2018E
Gold	1282	1250	1370
Oil (WTI)	52	48	50
GDP GROWTH RATES	CURRENT (YOY)	2017E	2018E
US	2.3%	2.3%	2.0%
Euro area	2.5%	2.1%	1.7%
UK	1.5%	1.4%	1.0%
Suisse	0.4%	0.8%	1.7%
Japan	1.4%	1.6%	1.2%
China	6.8%	6.8%	6.3%
CONSUMER PRICE INFLATION	CURRENT (YOY)	2017E	2018E
US (core PCE)	1.3%	1.5%	1.8%
Euro area (headline HICP)	1.4%	1.5%	1.3%
UK (headline CPI)	3.0%	2.7%	2.3%
Switzerland (headline CPI)	0.7%	0.5%	0.9%
Japan (core CPI)	0.7%	0.4%	1.1%
China (core CPI)	2.3%	2.2%	2.2%
E = estimate.			

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

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STILL IN A SWEET SPOT



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“We think solid fundamentals mean equities still have room to run”

With the end of 2017 approaching, it is time to review how markets have fared this year. In line with our core scenario, it has generally been a risk-on environment, and, barring late surprises, most asset classes are set to finish in positive territory.

It has been another good year for equities, supported by economic momentum, earnings growth, and continued central bank dovishness (in mid-November, the MSCI World was up 16% year-to-date in US dollars). As a result, our decision to stay overweight developed-market equities has proved the right call. We have particularly favoured euro area and Japanese equities. Euro area stocks benefited from the euro area's broad-based economic rebound and the waning of political risk in the EU as the year progressed (most notably with the defeat of far-right Marine Le Pen in France's presidential election in May), notwithstanding the worrying deadlock in the Brexit talks (we were rightly underweight UK stocks) and the recent crisis over Catalonia. Abenomics and very loose monetary policy have been good for the Japanese economy and equities, and prime minister Shinzo Abe's re-election in a snap election in October promises more of the same.

We were neutral on US equities, which also proved well advised. The surge in business and investor optimism that followed Trump's election in November 2016 gradually petered out as the year progressed amid political dysfunctionality in Washington DC and a lack of progress on tax reform—although the US economy remains robust regardless.

Within fixed income, we preferred corporate credit, and benefitted from the gradual compression of spreads during the year. But spreads now look tight, and we have taken some profits on high yield in the second half of the year. Perhaps the biggest surprise has been the failure of US Treasury yields to rise this year (at around 2.3% in mid-November, the 10-year rate was actually down slightly from January). This is because inflation has remained unusually subdued for this stage of the economic cycle—probably reflecting structural changes in the economy. Sovereign yields did pick up a little in Europe, where we were underweight European government bonds.

Emerging-market assets also generally had a strong year, as China's growth remained robust, commodity prices rebounded in the second half, US fiscal stimulus failed to materialise and Fed tightening proved very gradual. We have been playing emerging markets through hard-currency debt; beyond this it proved hard to find a time to buy in to these markets tactically, but we think there are good opportunities.

It was a good year for active management, as we predicted. Most hedge fund strategies did well as correlations among asset classes fell, and a surge in M&A activity on the back of improving corporate confidence also provided opportunities.

Nonetheless, there have been signs of stress, notably in currency markets. The dollar's unexpected weakening proved a headache for many investors, and its recent rebound now looks largely played out. Volatility has remained at historically low levels, but with geopolitical risk on the rise we thought it advisable for most of the year to mitigate some of the downside risk to portfolios through put options on equities or call options on gold.

Next year currently looks set to be a case of more of the same, at least in the first half. After nine years, the rally in developed-market equities is maturing and valuations are high, although we think solid fundamentals mean equities still have room to run. So we will be staying long equities. The gradual withdrawal of liquidity support by central banks is worth watching—although Trump's choice of Jerome Powell to replace Janet Yellen at the Fed fits with our view that policies will generally remain dovish. Political risk will remain in the headlines: among other things, the Middle East and North Korea remain concerns and elections in Mexico and Brazil could bring surprises. We will be keeping a close eye on volatility, which could well pick up from current low levels.

Investment Strategy Highlights

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

ASSET STANCE

- › We remain constructive on equities, which are being underpinned in particular by robust earnings growth.
- › However, there are signs of pressure, especially in forex markets, and occasional spikes in volatility are likely, notably as a result of geopolitical risk. It is worth considering risk mitigation for portfolios – put options on equity indices are one way to protect some of the downside.
- › US tax cuts could provide a significant boost to 2018 earnings growth and US equities, but the legislative process is likely to dilute and delay the plans that have been outlined.
- › Low correlations and a pick-up in disruptive M&A mean a good environment for active management.

COMMODITIES

- › While a temporary surge in oil prices is possible, for instance on geopolitical risk, we see limited upward pressure based on fundamentals. We estimate an equilibrium price over the next 12 months of USD55–58 per barrel for WTI, close to current levels.

CURRENCIES

- › We see limited further downside for the EUR against the USD. We continue to expect a gradual weakening of the dollar in 2018, and estimate an EUR/USD rate of USD1.24 for end-2018.

EQUITIES

- › October was another good month for equities, and we remain generally bullish on euro area and Japanese equities. We are more neutral on richly valued US equities, although that would change if there are positive surprises on tax reform.
- › We are neutral on tech stocks, bullish on prospects for financials and materials in both Europe and the US, and have moved to a more bullish stance on industrials and energy in Europe.

FIXED INCOME

- › US 10-year Treasuries should yield around 2.6% by end-2018. Our end-2017 target for 10-year German Bunds is 0.70%, and we expect a further gradual increase in 2018. As we still expect yields to rise, we

OUR CURRENT ASSET CLASS STANCE*

	STANCE				
	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 9 November 2017.

** Three to six month horizon.

would stay underweight core sovereign bonds and short duration.

- › We continue to see opportunities in credit. However, tight spreads on high yield leave little room for disappointment. Spreads are also tight on investment grade, but this is compensated by the carry, which remains reasonable.

ALTERNATIVES

- › Our outlook for Hedge Funds remains positive, as monetary and political developments should work in favour of most strategies.
- › Valuations, competition and capital inflows remain high in Private Equity, but there are still good opportunities for attractive returns.
- › We continue to see value in real estate investing.

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

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Head of Asset Allocation &
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INVESTMENT STRATEGY

Slow policy ‘normalisation’ should not endanger risk assets

With inflation still below target, the limits of monetary policy were plain to see in 2017. While we await the emergence of new monetary styles able to deal with the new challenges we face, central bank caution could help ensure that risk assets have further to run.

The varied policies of the world’s main central banks remained desynchronised and non-cooperative this year, as they have been for some time. The Bank of Japan continues to buy government bonds to ensure that government bond yields remain at zero, whereas, by contrast, the US Federal Reserve has embarked on balance-sheet reduction. The Bank of England has just raised interest rates, but the European Central Bank looks unlikely to follow suit until sometime in 2019, according to our analysis.

Yet central banks would all like to give themselves room to ‘normalise’ policy to deal with the next recession – preferably without impacting growth or upending financial markets.

But here, their room for manoeuvre is limited. This is because central bank policy has not been enough to generate sufficient levels of growth and inflation to warrant anything more than a very cautious approach to policy normalisation. In the US the current expansionary cycle is the weakest

(in magnitude if not in length) since World War Two. According to one estimate, US GDP is USD 3 trillion below where it would be if growth had been as strong as in the 1980s.

Anyway, what does ‘normalisation’ mean in the current circumstances? If one applies the ‘Taylor rule’—which looks at employment, inflation and growth to determine where ‘real’ (inflation adjusted) interest rates should be—the idea that central banks might be able to reduce their balance sheets to pre-financial crisis levels anytime soon looks far-fetched.

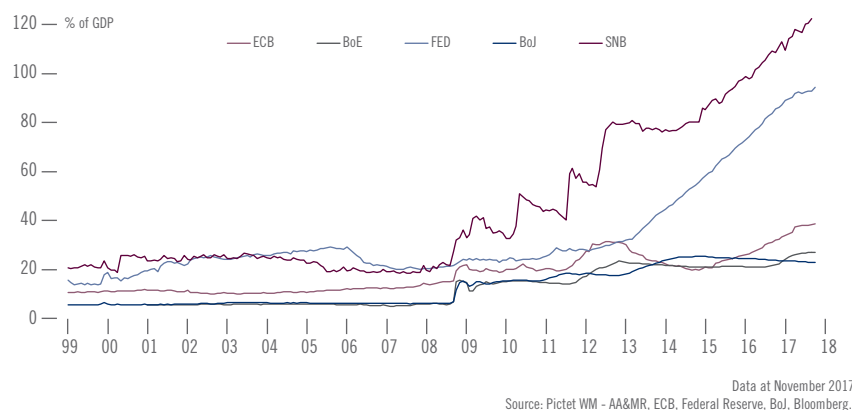
If central banks’ policies seem to have hit a buffer, it may be because their policy framework is inadequate for the challenges that arise from rampant globalisation and successive waves of technological innovation. In other words, the time has come for a new vision of monetary policy, one that looks beyond crisis management and quantitative easing, which has drawn more on the technical skills of central bankers than on their grasp of

the long-term issues facing the world. This new vision would aim to foster an environment that makes markets and economies durably more resilient to crises and would probably require a new ‘style’ of monetary policy—one that involves anything from setting flexible inflation targets to defining asset-price targets and fixing goals for nominal GDP. It would probably also need to broaden the scope of policy further, to encompass a series of macroprudential features.

As we wait for new thinking to take hold, we find ourselves in a situation where the least policy mistake by central banks could have serious consequences for risk assets that have reached stretched valuations, such as equities and non-investment grade bonds. But a significant market correction is not our central scenario at present, as we expect central banks to maintain a very patient and prudent approach to unwinding the loose policy measures of recent years. In short, policy normalisation will, we think, take a backseat to the wish to avoid depressing asset markets to a degree that risks destabilising the economic cycle.

This means that long-term interest rates could remain lower for longer than some observers have been expecting. US 10-year Treasury bond yields for instance, could remain stuck in a range of 2.5-3.0% next year, even with nominal GDP growth of 3.5-4%). But this caution should provide support for risk assets. Already helped by earnings growth, the bull market for equities seen this year could continue for a while yet. ■

ADVANCED ECONOMIES: THE GROWTH IN CENTRAL BANKS’ BALANCE SHEETS





THOMAS COSTERG

Senior US economist
Pictet Wealth Management

REGIONAL FOCUS

Trump presidency – Stuck in a sand bunker

Trump's divisiveness and political isolation, added to structural deficiencies in the US political system, is a medium-term risk for the US economy.

While on the campaign trail, Donald Trump promised to break the Washington DC logjam. Building on his business executive credentials, magnified by his appearance on reality TV show 'The Apprentice', he was the one, he said, that would make sure things get done. The reality one year later, with Trump now in the White House, is that political gridlock is as bad as ever, even though the Republican Party controls both the executive and legislative branches of government. The Trump Administration's legislative successes have been meagre.

There are several possible reasons for this. The first may be that Donald Trump is not cut from the same cloth as mainstream Republicans. To understand his presidential victory, one should look back to the 1992 presidential election, in our view. That year saw the eruption of a third-party candidate, Ross Perot, a business magnate who ran a particularly vehement campaign against NAFTA and job offshoring and took 19% of the votes. In a way, the Trump 2016 election triumph resulted from a successful synthesis of Perot and George H.W. Bush, the US president in 1989-1993. Trump's promise to renegotiate NAFTA, and to adopt a more muscular approach to trade policy particularly in relation to China and Mexico, drew particular support in the once-Democratic manufacturing rust-belt states. At the same time, his commitment to large across-the-board tax cuts went down well with the so-called 'country club Republicans'. Voter fatigue after Democrat Barack Obama's two-term presidency and some mixed feelings about Hillary Clinton's personality did the rest.

The problem is that what looks a clever synthesis on paper looks quite troublesome in the current political landscape, which is characterised by extreme polarisation, fueled by the rise of social media and big money. Mainstream Republicans in Congress doubt Trump's credentials and his Republican values. Trust between Congress and Trump is sorely lacking. Some Republicans wonder about Trump's idea to turn the Republicans into the party of the "American worker" and of the "forgotten men and women", as he put it in several speeches. Having already come under sharp pressure from the Tea Party movement in recent years, Trump's populist push is nudging the Republican Party further to the brink.

That Trump seems to lack a clear vision and strategy for the US is a second possible reason for the current impasse. His political decisions so far show a significant lack of consistency. His Administration seems to be flying blind, perhaps because it includes several political novices, like Trump's son-in-law Jared Kushner. What Trumpism stands for remains unclear.

Trump's decision to nominate Jerome Powell as Federal Reserve Chair is the perfect embodiment of a 'non choice': faces change, but policies do not (Powell can be expected to adopt a broadly similar approach to policy as that of his predecessor, Janet Yellen). And many of Trump's political decisions have raised eyebrows, for instance his criticism of the FBI and the firing of the agency's director James Comey. Another surprise has been the controversial nomination of former Republican congressman Scott Garrett to head the Export Import Bank, even though Garrett has long advocated its closing.

The 'Twitter risk' and a seemingly poor understanding of the legislative process is a further problematic aspect of President Trump's *modus operandi*. Trump's constant tweeting and eagerness to ad lib on different matters is a significant disruption to the normal legislative process in Congress. Trump's approach is making current efforts to reform the tax code particularly difficult, a reform already facing an uphill struggle given unified opposition by Democrats, who accuse

TRUMP FAVOURABLE POLL AVERAGE (RCP), AVERAGE OF DAILY DATA



Source: Real Clear Politics, November 2017

Trump of cutting taxes mostly for the rich. Trump's *ad hominem* attacks against several Republican senators on Twitter risk imperiling tax cut objectives, given that there is only a slim Republican majority in Congress, particularly in the Senate (52-48).

PROSPECTS FOR TAX REFORM

What may save tax reform is anxiety among Republicans about arriving before voters in next year's mid-term elections empty handed. Their worries are made all the more acute by mounting fears of a mini populist rebellion led by right-wing firebrand Steve Bannon, who has promised ample funding for his preferred candidates. When it comes to adding up the votes to secure a Trump tax deal, there is no margin for error in Congress, and much room for accident. All things told, we think it is possible some moderate and temporary tax cuts will be enacted in Q1 2018.

The good news is that the US economy is advancing at a decent clip on auto pilot, and can digest ongoing political gridlock. There is close to full employment, US corporates are churning out cash (even with the current elevated tax rates), interest rates are low, and financial market volatility is limited. The near-term macro outlook remains robust, as shown by ongoing rises in job openings. The recent rise in oil prices is a further boon to the domestic energy sector, and rising drilling activity (a key backbone of the US economy now) should continue to boost the manufacturing sector. As long as Texas does fine, the US should be good. The risk of recession remains low, especially as financial conditions are very loose.

The decidedly patchy record of the Trump Administration may simply be revelatory of much deeper structural problems with the US political

system, particularly when it comes to rising polarisation and rising tensions both between and within the two traditional parties. That may matter should growth momentum slow. Gridlock in Washington could mean the response to the next downturn is slower than usual, and any recession could be deeper as a result. There will be a time when interest rates will be much higher than now, leading to painful budget decisions that could have been avoided. More worryingly, ongoing political stasis could strengthen the appeal of political extremes on both sides of the political spectrum; the risk is that Congress could gradually turn populist, harming business confidence. Despite the current calm at the macro level, the US political picture continues to be a source of potential fragility for the US and global economy in the medium term. ■



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REGIONAL FOCUS

Euro area: the year the force awakened

Having looked threatened by Brexit and the rise of populism, this year actually saw a significant upturn in the euro area's fortunes.



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Europe Economist
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After a tumultuous 2016 marked by the Brexit vote, the rejection of Italy's constitutional referendum and rising support for populist parties in several countries, 2017 will likely be remembered as the year when the euro area turned the corner. None of the "exit" risks materialised – on the contrary, Brexit seemed to give a boost to European unity and cohesion. Meanwhile, economic growth kept on surpassing expectations, with the euro area on track to grow at its fastest pace in a decade this year. Importantly, the latest leg of a robust and broad-based recovery is being increasingly driven

by laggard countries such as France and Italy. Growth quality is improving, with accelerating job creation and investment spending.

To be sure, politics have dominated the outlook this year, with three major elections in the euro area. The Dutch general election in March, and the risk of a fragmented parliament, was the first political test Europe had to face. In the event, the ruling centre-right VVD managed to remain the biggest party but after the Eurosceptic PVV party came second, it took more than 200 days to reach a deal on a fragile four-party coalition government.

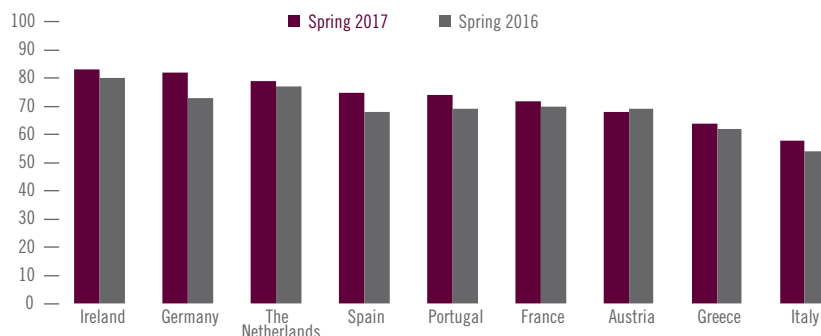
Even though the spectre of a eurosceptic party leading the country has vanished, the new coalition is likely to take a tough line on euro area reform compared to previous administrations.

In France, the young leader of a new centrist party, Emmanuel Macron was elected president in May on a pro-business, pro-reform, pro-European platform, beating the Eurosceptic far-right candidate and generating a wave of enthusiasm and hope at home and abroad. Time will tell whether Macron manages to achieve all his ambitious goals at home and abroad, but the French election marked a clear turning point for Europe, removing a major tail risk from the outlook.

During the summer, on the back of diminishing political uncertainty and a robust euro area recovery, the Swiss franc marked its biggest unforced depreciation against the euro since the Swiss National Bank floor was abandoned in January 2015. In the meantime, the Greek treasury sold EUR3bn worth of five-year notes, its first bond sale in five years. The Board of Directors of the European Stability Mechanism (ESM) approved the supplemental Memorandum of Understanding of Greece, and released EUR8.5bn in new loans in return for pension and tax reforms. Moreover, the European Union hinted at additional debt relief in the form of maturity extension.

In September, Germany's general elections brought some surprises. The results were particularly disappointing for the social-democrats, with the SPD dropping to a historical low of 20.4% of the votes. Chancellor Angela Merkel's conservative CDU and its sister party, the CSU, underperformed too, with only 32.8%. The biggest surprise was the strong third place of the far-right, eurosceptic AfD with 13.0%, although all the small parties did better than predicted by the polls. Negotiations to form a 'Jamaica' coalition between the CDU, the liberal FDP and Greens finally broke down on 19 November when the FDP walked away. At time of writing, new elections could not be excluded, save another twist in the situation. This is an even more challenging background for Macron to push his proposals for European integration.

PUBLIC SUPPORT FOR EUROPEAN ECONOMIC AND MONETARY UNION, INCLUDING THE EURO



Source: Eurobarometer, November 2017

October was marked by unprecedented tensions between the Spanish central government and Catalonia. After the regional Catalan Parliament voted on a unilateral declaration of independence (DUI), Prime Minister Mariano Rajoy called a snap election in Catalonia for 21 December, which will be key to how the situation develops. In the meantime, in Italy, the lower and upper houses agreed on a new electoral law, one of the missing elements in any assessment of prospects for next year's general election. The new law harmonises the voting system for both houses of parliament, favouring parties entering pre-election coalitions at the expense of the populist Five Star Movement, which has always ruled out alliances. Last but not least, in Austria, the centre-right People's Party (ÖVP) of 31-year-old Foreign Minister Sebastian Kurz won the general elections and is expected to form a coalition government with the far-right (FPÖ).

THE ECB CONTINUES ITS SUPPORT

The ECB has long been accompanying the recovery, and the decision it made in October to extend its Quantitative Easing (QE) programme by nine months, albeit at a reduced monthly pace of EUR30bn, was consistent with ongoing support to financial markets and the economy. The ECB also reiterated its commitment to keep policy rates at present levels until "well past" the end of net asset purchases, while the reinvestment of bond proceeds will continue "for an extended period of time" after the end of QE. The trade-off between growth and inflation looks much more difficult in the UK where, in early November, the Bank

of England delivered a 25bp rate hike, tightening its monetary stance for the first time in over 10 years.

All in all, the European economy has performed significantly better than expected this year. Although we forecast a gradual slowdown in GDP growth from 2.1% in 2017 to slightly below 2% in 2018, the quality of growth should continue to improve. Alongside the waning of political risk, this provides greater visibility to investors. ■

2.1%

Our forecast for euro area growth in 2017



DONG CHEN

Senior Asia Economist
Pictet Wealth Management

REGIONAL FOCUS

Abenomics, five years on

While inflation remains low, we judge Abenomics to have been a success, with a pick-up in growth and more progress on structural reforms than is sometimes realised.

Abenomics has been with us for nearly five years, since Shinzo Abe became prime minister of Japan in early 2013. It comprises three key elements (also known as the “three arrows”) – monetary easing, fiscal stimulus and structural reforms. The central aim has been to re-shape expectations about the Japanese economy through a radical shift in policy regimes.

In our view, Abenomics has largely been successful in what it was intended to achieve in the past five years. It has had quite a positive impact on the Japanese economy and capital markets, although it has been slow to alter low inflation expectations.

The improvement in the Japanese economy over the past five years has been significant. Compared to December 2012 when Abe was first elected, Japanese nominal GDP has risen by nearly 11%, reaching JPY546 trillion (annualised) by Q2 2017. While it may still be hard for Abe to achieve his goal of JPY600 trillion of nominal GDP by

2020 unless inflation picks up quite significantly from here, 11% growth nevertheless is quite an achievement, given the economy had shrunk by 4.6% in the previous decade.

Japan’s labour market is on fire. Total employment has increased by 4.6% since the end of 2012, despite the fact that Japan’s working-age population has been falling since 1993. The unemployment rate was 2.8% in September 2017, 1.5 percentage points lower than in December 2012 and the lowest in more than two decades. There are 50% more job openings than the number of job seekers. Although the average wage has not risen much yet, the aggregate compensation of employees has increased by 8.6%.

Due to the Bank of Japan’s (BoJ) unprecedented monetary easing programme, the yen has depreciated significantly, down by over 30% against the US dollar and 19.8% in trade-weighted terms since end-2012. Exporters clearly have benefited from the weaker currency. Combined with

a strengthening global economy, currency weakness helped boost Japanese exports by 25% between Q3 2012 and Q3 2017.

Improving corporate earnings, combined with the BoJ’s equity ETF purchase programme, have fed into solid equity market performance. The Nikkei 225 index rose by 120% (in yen) between December 2012 and 8 November 2017, and the Topix rose by 111% over the same period.

The only major setback for Abenomics so far has been inflation (or rather the lack of it). Core consumer price inflation (CPI, excluding fresh food) was 0.7% year-over-year (y-o-y) in September 2017, far below the 2% target set by the BoJ. Excluding energy prices, underlying inflation was only 0.2%. Granted, core CPI of 0.7% is much better than deflation (at the end of 2012, Japanese inflation stood at -0.2% y-o-y), but the stubbornly low inflation rate just shows how difficult it can be to change deeply entrenched expectations.

ABENOMICS: SOME MEASURES OF SUCCESS

	Dec-12	Latest*	Change (%)
Nominal GDP (JPY trillion)	492.8	545.8	10.8
Numbers in employment (million)	62.6	65.5	4.6
Aggregate employee compensation (JPY trillion)	252.4	274.0	8.6
Unemployment rate (%)	4.3	2.8	-1.5
Female labour force participation (%)	48.2	51.3	3.1
USD/JPY rate	86.5	113.9	31.6

* USD/JPY rate at 8 November, 2017; nominal GDP and compensation of employees at end-September 2017; employment, unemployment, and female labour participation rates at 30 September 2017. Source: Bloomberg.

STRUCTURAL REFORMS UNDER-APPRECIATED

One common perception about Abenomics is that the third arrow, namely structural reforms, has never been fired. We disagree.

Since Abe came to office, the administration actually has introduced quite a few policy changes on both the economic and social fronts, the positive impact of which is gradually showing up. Below is a brief overview of some major reform themes since 2012.

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Managing Director
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REGIONAL FOCUS

Asian equities can no longer be ignored

With a return of close to 38% in the first 10 months of 2017 (in USD), the MSCI AC Asia (ex Japan) symbolises the strong comeback of Asian stocks this year. David Gaud, PWM's chief investment officer in Asia, argues that the time has come to invest directly in Asian corporates.

Many investors (and their advisors) continue to believe the way to approach Asia is through western companies that have exposure to the region. But you advocate direct investments...

In spite of healthy economic growth in Asia outside Japan, investors often continue to have a jaundiced view of Asian companies and sectors—whether because they don't look particularly profitable or because there are governance issues, or because share prices are too volatile. But I think the profound changes in the corporate environment mean it is time to consider a direct approach to Asia outside Japan. That is not to pretend all is rosy in the garden, but there is a strong case for an active, selective approach to an extremely dynamic corporate scene.

Two fundamental changes are worth signaling. It is true that returns from invested capital (ROIC) over the cost of capital have swung wildly over the past 25 years in Asia, but there are signs that the bottom of the cycle was reached last year and that invested

capital is being increasingly used effectively, with companies better able to turn capital into profits and to capture the region's strong growth.

Having declined for a couple of years up to 2013, growth in earnings per share in China has increased rapidly. Earnings growth for Chinese equity indices now well exceeds Chinese GDP (which we expect this year to be around 6.8%), and China is increasingly at the cutting edge in areas like fintech, electric cars etc...

In addition, companies have been able to increase their profitability while facing substantially higher lending costs than in the West, where interest rates have been kept down by central bank largesse. Obviously, state-owned enterprises in China benefit from special conditions, but for private companies around Asia, interest rates are of the order of 7%.

To put it simply, I would argue that with economic growth maturing in Asia, it is now less about volume, market share gains and capacity expansion at all costs and more about

profitability, sustainable free cash-flows and better operating leverage. The supply-side reforms in China are helping very much in this direction.

The performance of Asian equity indices has long been dominated by tech, where you can find total annual returns of the order of 10-20%, but evidence of healthy returns is broadening to a much wider range of sectors, from telecoms to banks, utilities and consumer staples, where price-earnings ratios remain lower than in Europe and the US—an important argument for including Asian equities in any portfolio diversification strategy.

Even if far from our central scenario, a major spike in the US dollar, of the sort we saw last year, poses a risk for the performance of Asian equities. But such a risk is not new, and domestic investors are increasingly convinced there are better things to do with their money than park it in 10-year Treasuries. Analysis shows that as domestic economies grow and local stock markets become more liquid, currency fluctuations are playing a steadily decreasing role in Asian equity markets, although there is a great variation from one market to the next.

CHART 1: ASIA (EX JAPAN): –RETURNS ON INVESTED CAPITAL (ROIC) VERSUS WEIGHTED AVERAGE COST OF CAPITAL (WACC)



Source: Worldscope, Factset, November 2017

So which countries do you prefer at the moment?

China obviously remains the region's economic motor and the reinforcement of Xi Jinping's authority likely to herald a continuation of the restructuring of Chinese industry, including supply-side reforms that have taken out a lot of overcapacity in the steel and coal industries. Consolidation of the banking industry is also well underway. The result is that the return on capital in these sectors

has improved. Real estate is likely to be the next area to be cleaned up. The need to expand electricity generation means that even traditional sectors facing more stringent environmental standards such as coal still have potential. All in all, the road is clear for the continued growth of Chinese companies focused on the country's increasingly robust domestic economy.

It is easier to focus on a single region than to try to capture the sheer vastness of China, where national statistics hide a lot of different realities, so one major theme we are exploring is the planned development of the Greater Bay Area encompassing Hong Kong, Macau and southern Guangdong. If things go to plan (annual growth there is projected to be around 8% per annum in 2020-2050), this region will have an economy bigger than that of greater Tokyo, the Bay Area around San Francisco and greater New York by 2030.

“Asian corporates have been able to increase profitability while facing substantially higher lending costs than in the West.”

Elsewhere, we continue to like Indonesia. The country is benefiting from the strengthening of the global economic cycle and favourable demographics and is now rated investment grade by all the main international ratings agencies. We continue to see opportunities in Thailand and Singapore, and the Philippines are starting to attract our attention. Taiwan is a good place for stock picking and corporate governance standards there are high.

We are somewhat more negative on South Korea, where family-run chaebols control everything. Smaller companies' margins are all transferred to a dominant parent company, helping explain why Korean stocks trade at lower valuations than their global peers. But we note with interest that anti-trust watchdogs there are increasingly showing their teeth. India traditionally has had companies much better at creating value than elsewhere in Asia. But a consequence is that the market is relatively expensive at a time when the Indian

economy is going through noticeable upheaval. The need to recapitalise public banks could well expose high levels of debt leverage, resulting in a spike in credit defaults. At the same time, the introduction of the nationwide General Sales Tax is hurting consumption. In short, India remains a long-term favourite, but we see better prospects in China over the next 12 months.

In October, there was a brief, violent sell-off of Hong Kong shares when the Chinese central bank chief voiced fears that China might face a “Minsky moment”. What is your assessment?

Tighter reins over bank credit and the supply-side reforms being undertaken show that the Chinese authorities are acutely aware of the risk that a period of relative calm can quickly give way to instability. The control they have over lenders and borrowers facilitates the unwinding of leverage and has avoided a crash, so far at least. After the Party Congress in October, we think the deleveraging drive will continue. More fundamentally still, the huge enhancement in the financial metrics of many Chinese corporates should help them resist any market disruption. Improving corporate profitability, particularly in the industrial sector, is creating favourable conditions for some highly leveraged companies to reduce their debts.

And yet Chinese companies' continue to try to export capital...

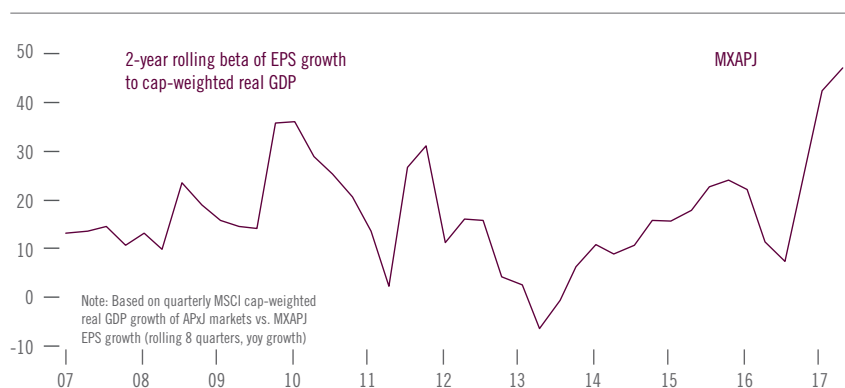
The Dalian Wanda conglomerate recently was at the receiving end of the Chinese authorities' efforts to clamp

down on debt-fueled foreign debts. The authorities frown on trophy acquisitions that deplete China's foreign exchange reserves, so that future acquisitions of European football clubs look like they're off limits. While China has embarked on major strategic initiatives like the One-Belt-One-Road Initiative, companies are clearly encouraged to invest at home. The Chinese are also conscious that Europe is a fortress, and that high-profile Chinese takeover attempts in certain sectors create considerable suspicion. But that will not stop smaller Chinese companies from continuing to invest abroad, often to acquire expertise in areas such as fintech.

But one cannot ignore growing geopolitical tensions, whether it is in the South China Sea or the Korean peninsula....

The rhetoric one hears is often for domestic consumption. Asian countries have shown far less propensity to engage in conflict than some western powers in recent decades. Asian countries are so closely interconnected commercially that outright war is hard to imagine. Just how far those linkages go can be seen in Beijing's offer to bail out Malaysia's beleaguered 1MDB state investment fund for close to one billion dollars. But China's assertion of its power on the Asian stage just as the US looks like it is pulling back is undoubtedly a major theme. ■

CHART 2: CHINESE CORPORATE PROFITS CATCH UP WITH GDP GROWTH



Source: Pictet Wealth Management, FactSet, November 2017



LUC LUYET

Currencies Strategist
Pictet Wealth Management

ASSET FOCUS

The end of the dollar's ascent

It is increasingly clear that the long-term trend of dollar strengthening clattered to a halt at the beginning of this year.

After an impressive performance at the end of 2016 following the US presidential elections and hopes of a pro-growth Trump administration, the first eight months of 2017 were particularly difficult for the greenback, with the US dollar index losing almost 10% during this period.

Indeed, the performance of the Trump administration since the inauguration of President Trump in January has raised major concerns about its ability to push its pro-growth agenda through Congress, notably meaningful tax reform. Furthermore, despite reduced slack in the US economy and very loose financial conditions, inflationary pressure has been particularly subdued so far this year, preventing the Fed from becoming too hawkish.

Our core scenario for growth, inflation and Fed funds rates for next year was revised down to take into account a lack of delivery from the Trump administration and the surprisingly low US core inflation rate. Meanwhile, the recovery in the rest of world has gathered momentum, which has led to rising expectations for monetary policy normalisation among major central banks. Consequently, growth differentials and monetary policy divergence, the main pillars of the US dollar's strength since 2011, have started to crumble. The fundamentally expensive valuation of the US dollar has magnified the negative impact, resulting in the greenback's significant depreciation against all G10 currencies in the first eight months of 2017.

In terms of our outlook for the US dollar, our less upbeat US macro scenario means the constructive

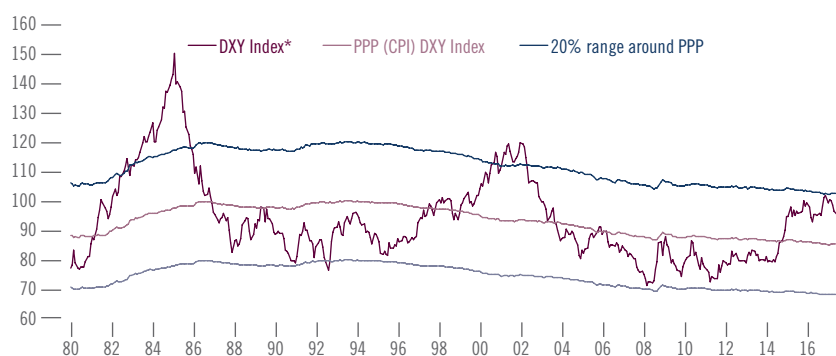
scenario that we had for the greenback at the beginning of this year has also been revised; while we thought the long-term upcycle for the US dollar, which started in July 2011, would come to an end around the beginning of 2018, we now believe it ended in January 2017.

Nonetheless, more supportive US data, monetary policy divergence and hopes of tax reform led to a rebound of the US dollar in September and October. Indeed, US economic indicators have been pointing to a strong growth outlook over the next few months, while both houses of Congress have passed a budget resolution that is a prerequisite for potential tax cuts. In the meantime, markets have revised up their expectations for additional Federal Reserve (Fed) rate hikes, while the European Central Bank (ECB) intends to progressively reduce its asset purchase programme and hinted that no rate hike is likely before the second half of 2019.

That being said, we do not see the growth differential and monetary policy divergence as being particularly

supportive of the US dollar going forward. Indeed, without a meaningful fiscal boost, our scenario is for a slow-down in economic momentum in the US in the second half of 2018 and we expect that muted inflationary pressure will limit the Fed's ability to raise rates in 2018. The nomination of Jerome Powell at the helm of the Fed is unlikely to lead to a change in the prudent monetary policy pursued by the current Fed Chair, Janet Yellen. True, other central banks, like the ECB, have signalled that they are in no hurry to raise rates. However, according to our base scenario of a gradual rise of inflation in the euro area, monetary policy dynamics could turn USD negative, with the Fed closer to the end of its tightening cycle while other central banks are still at the start of their normalisation process. Consequently, although the US dollar could stay strong in the short term given solid economic data, the longer-term outlook points to some gradual depreciation of the US dollar against the euro, compared to the November 8 level of USD1.16. ■

THE US DOLLAR INDEX (DXY) VERSUS PURCHASING POWER PARITY (PPP) 1980



* Measured with synthetic euro before January 1999.

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



LAURÉLINE CHATELAIN

Fixed Income Strategist
Pictet Wealth Management

ASSET FOCUS

What has happened to US Treasuries?

In spite of decent growth and Fed tightening, the 10-year yield has declined since the start of 2017. It is unlikely to rise much in 2018.

Contrary to many analysts' forecasts, the 10-year US Treasury yield (T-note) has failed to rise so far in 2017, standing at 2.32% on 8 November compared with 2.44% at the beginning of this year. In September, the lack of upward yield momentum led us to revise our own end-2017 forecast for the 10-year yield from 2.8-3% to 2.5%.

As the year comes to an end, trying to understand why the yield fell from its mid-December 2016 peak of 2.6% is key to assessing the US market environment. Three main macroeconomic factors liable to influence the T-note yield were taken into account when constructing our 2017 scenario: **Inflation**, **monetary** and **fiscal policy**. Reviewing each of these factors can help explain why the T-note yield has unexpectedly fallen.

Inflation. Core PCE (Personal Consumption Expenditures), the indicator tracked by the US Federal Reserve (Fed), fell from 1.6% in December 2016 to 1.3% in September 2017. In our baseline scenario, we expect core PCE to remain below the Fed's target of 2% for the rest of this year and next. Subdued inflation, in spite of recent rises in oil prices, has driven the 10-year inflation breakeven yield below 2% (this yield measures the expectations for inflation embodied in the nominal Treasury yield). According to our forecast, it should not rise much in 2018 either, unless core PCE accelerates above the Fed's 2% target.

Monetary policy. Market participants have been signalling that they do not expect the Fed to be able to continue its hiking cycle as aggressively as shown in its dot plots, which

foresees four more 25bp rate hikes by end-2018. In fact, having raised the Federal Funds rate twice in 2017 so far, the markets expect the Fed to raise it only twice more before the end of 2018, against three hikes in our scenario. The discrepancy stems from the markets' (and our own) anticipation that inflationary pressures will remain subdued for structural reasons, as the Fed is likely to fail to reach its 2% target on the core PCE.

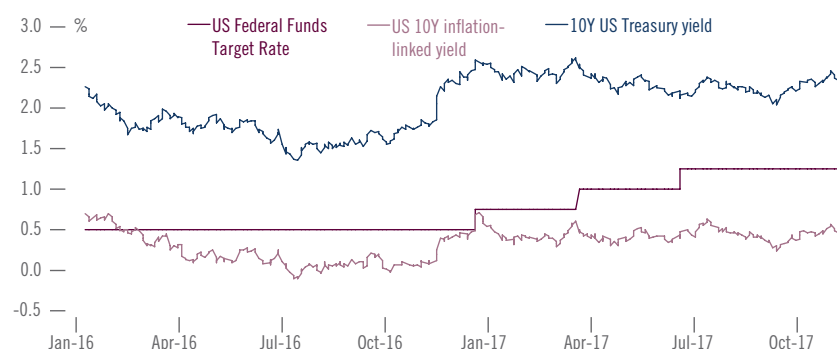
"Our central forecast is for the 10-year yield to rise only up to about 2.6% in 2018."

As the 10-year inflation-linked yield is strongly influenced by the direction of monetary policy, its yield jumped at each hike by the Fed since December 2016, but it has invariably fallen again as markets have cast doubt on the Fed's hiking cycle. At 8 November, the inflation-linked yield stood at 0.44%, lower than the peak of 0.7% reached in mid-December 2016 (see chart). We expect it to rise only moderately into 2018, supported

by additional rate hikes and reduced Fed purchases of US Treasuries as it shrinks its balance sheet.

Fiscal policy. The boost expected this year from fiscal policy has become ever more unlikely given stark political divisions even among Republicans themselves (as seen in the failure of the Obamacare overhaul). In the first two months of 2017, markets were expecting a significant fiscal reform from the Trump administration. But the likelihood of a permanent, Reagan-type reform that would provide a long-lasting boost to the US economy is no longer being factored in by markets. We now do not expect any tax reform this year, given that timing is short and that Congress remains divided on the matter, with some Republicans unwilling to increase the deficit. If, however, tax cuts do pass, we believe they will be limited in scope, boosting 2018 US GDP growth only slightly. Any boost would be welcomed, as the US economy seems to be close to full capacity and growth could slow, according to our central

TEN-YEAR US TREASURY YIELDS AND FEDERAL FUND TARGET RATE



Source: Pictet WM-AA&MR, Bloomberg, November 2017

forecast, from 2.3% in 2017 to 2% in 2018. But for much of this year, the disappointment with regards to fiscal policy has weighed on the T-note yield.

All in all, we expect the current macroeconomic environment to persist, with US inflation rising but remaining below the Fed's 2% target,

which should limit the Fed to three additional hikes. Fiscal policy could remain an unlikely joker in the pack in 2018. An analysis of the three macroeconomic factors outlined above justifies the failure of the 10-year US Treasury yield to rise this year. We expect it to move up to only 2.6% by the end of 2018. ■

1.3%

Core PCE inflation
in September



FRANK BIGLER

Head of Equity and Credit Research
Pictet Wealth Management

ASSET FOCUS

An impressive earnings recovery is driving equities

Equity markets produced strong returns over the first 10 months of this year. But in a strong year for stocks in general, some sectors have been doing better than others. There are still areas of opportunity.

The earnings backdrop has been very robust on both sides of the Atlantic and contributed meaningfully to returns in a period that saw little valuation expansion. The S&P 500 recorded an impressive 15% total return (in US dollars), with no major correction.

But what might appear a very strong and steady performance is actually more uneven when we look at it with more granularity. At a sector level, the deflation trade that emerged in November of 2016 on the back of Donald Trump's election win and that benefited cyclical sectors (basic materials, consumer cyclicals and financial services), ran out of steam within a couple of weeks. Technology and health care, both growth sectors, led the US market performance until early September. It is only in the last two months that the cyclical sectors have shown renewed strength. As of 31 October, the best-performing sector this year has been technology, followed by materials and health care. At the other end of the spectrum, we find telecommunications and energy.

In Europe, the Stoxx Europe 600 has had a more volatile year, with a 6% pull back over summer (in euros), but it was still up close to 10% in the first 10 months of 2017 overall. However, at a sector level, leadership has been more consistent than in the US through the course of the year, with the cyclical sectors outperforming most of the time, along with technology, the strongest sector (up 22% in euros). Industrials have been the second best-performing sector, followed by materials, with more than half of these performances realised over the past three months.

These strong returns are largely a function of an impressive earnings recovery. Earnings per share (EPS) growth reached 13.7% in the US and 29.8% in Europe in April, on the back of first-quarter results. These numbers were well ahead of expectations and helped to push the US market substantially higher. While equally strong second-quarter results helped support performance in Europe, in the US the market was held back by a lack of fresh catalysts and ongoing North Korea tensions.

3Q EARNINGS SHOW PROLONGED STRENGTH

The third-quarter earnings season was another strong one in the US. At time of writing, 74% of S&P500 companies that had reported had beaten consensus EPS forecasts, and 66% consensus sales forecasts. EPS and sales have been above the five-year averages across the last three quarterly earnings seasons.

We also note that expected year-on-year sales growth has moved up from 3% to over 6% since the start of the earnings season. This number is rather low but takes into account a negative contribution from the insurance sector, which is suffering from the impact of major hurricanes in the southern US in August and September. Stripping out the insurance sector, y-o-y sales growth in the third quarter would stand at more than 7%. In Europe, earnings and net income figures were equally strong. Robust earnings and the accommodative monetary environment are maintaining equity valuations at historically high levels, with 12-month forward price-earnings ratio of 18X and 15X in the US and Europe, respectively. But

they have been trading close to these levels for quite a long time already.

SECTORS THAT COULD SHINE

Technology has dramatically outperformed on both sides of the Atlantic. Earnings growth and multiple expansion have contributed to the sector's performance, with growth particularly strong for FAANG (the dominant five US technology stars) stocks. At this point, we find that technology valuations are demanding but not overstretched. The fundamentals remain very robust and growth figures should continue to outpace the rest of the market. Consequently, we think the tech sector can continue to exhibit high multiples and yet remain attractive from an investment point of view.

While the performance of technology, the quintessential growth sector, has been widely noted, it is interesting to see that materials, a pure cyclical sector, has been the second best-performing sector in the US) and the third best-performing one in Europe. Materials' strong returns are even more surprising as they are in a sharp contrast to the Energy sector's performance (down 9% in the US and flat in Europe).

Both industries are mostly driven by commodity prices and hence inflation expectations. But underlying industrial fundamentals differentiate them. Materials, especially metals and mining companies, have shown better discipline in their capital spending, thus maintaining a more favourable supply & demand equation than energy, where exploration and production companies continue

to invest in production capacity, especially in the US. It is also important to note that miners and most chemical companies actually benefit from a lower oil price as oil is a large part of their cost structure. We continue to have a positive outlook on materials as we believe that market expectations for growth are still too low for 2017 and 2018.

"We remain positive on cyclical stocks as far as year's end"

More recently, we have formed a positive view of the European energy sector. First, contrary to the US, the sector has started to show positive price momentum over the past two months. More precisely, we are positive on European integrated oil companies, whose free cash-flow generation is likely to remain positive on the back of capital expenditure discipline. The recent bounce in the oil price further supports their prospects. Consequently, the integrated oil companies' dividends are likely to be sustainable for the foreseeable future. In addition, we expect European stocks to benefit from the payout of annual dividends into the fourth quarter of 2017 and first quarter of next year.

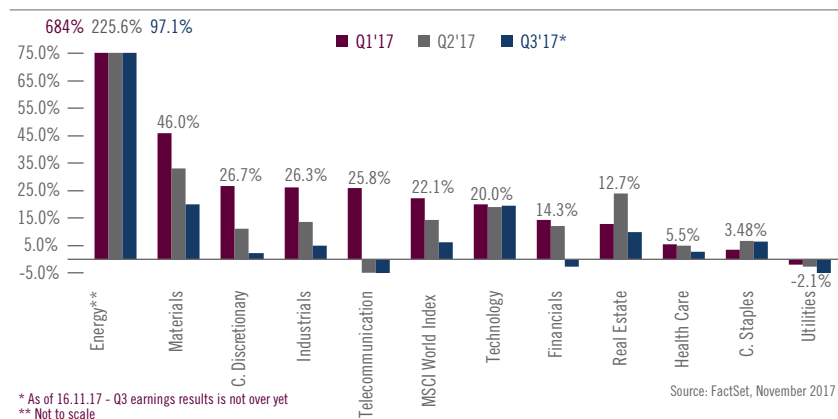
The health care sector has been a good performer in the US for most of 2017. However, performance has deteriorated in recent weeks on the back of weaker-than expected-earnings and renewed focus on the drug-pricing debate.

In the past couple of months we have noticed increased traction for cy-

clical sectors such as industrials and financials. This activity was prompted by the recent solid macroeconomic data and renewed expectations for tax reform in the US, which could translate into higher inflation and interest rates. The positive investment case is particularly strong for financials, with a more accommodative regulatory framework (in the US), improving earnings, as well as reasonable valuations support our positive view of banks. In addition, there has been a very strong correlation between interest rate movements and the banking sector's earnings performance.

To conclude, global economic growth still looking rosy and with corporate earnings still enough to support high valuations (even before potential tax cuts in the US), we want to maintain our equity positions. Without being bullish on developed-market equities overall, we remain positive on cyclical stocks as far as the end of this year. ■

MSCI WORLD INDEX-EARNINGS PER SHARE (EPS) GROWTH IN LAST THREE QUARTERS





MUSSIE KIDANE

Head of Fund & Manager Research
Pictet Wealth Management

ACTIVE MANAGEMENT

The numbers don't tell the whole story

High correlations, low return dispersion and skewed data have taken the sheen off active management in recent years. But with central banks normalising policy, it is coming into its own again.

It is a commonly accepted industry fact that the average actively managed mutual fund does not generate excess return net of fees. The logical consequence of this is that, in the absence of reliable manager selection capabilities, investors are better off buying the cheapest passively managed funds—hence investors' enthusiasm for passive investment vehicles such as ETFs in recent years. Nevertheless, it is worth looking closer at the underperformance of active management, identifying the reasons underpinning it and, most importantly, examining the potential for a turnaround in its fortunes.

Most headline news relative to active management performance depend on vendor data provided by the likes of Morningstar and Standard & Poor's that are heavily skewed toward products intended for retail investors. While this data reflects a significant portion of actively managed money, it does not represent it all. In fact, the portion of pension assets invested in segregated mandates and institutional pooled vehicles, while significant in size, is barely included in the data compiled by the fund research providers. Recent academic research¹ based on more complete datasets of equity and fixed-income strategies representing assets under management of USD18 trillion revealed that actively managed institutional accounts outperformed their strategy benchmarks by 86 basis points gross (42 bps net) in the US and global markets ex-US by 165 bps (107 bps net) per year on average between 2000 and 2012. One could therefore question whether it is fully correct to conclude that active managers do not add value net of fees given that the data usually referred to overemphasize a particu-

lar segment of the universe, namely easy-to-monitor retail mutual funds.

Another recent research paper² provides a persuasive explanation for active management's apparent underperformance. The research shows that active managers tend to outperform when dispersion of returns is high and correlation of returns is low, allowing managers to apply their unique insights to the investment process. The paper persuasively demonstrates that only in top quintile of return dispersion and bottom quintile of return correlation environments have active managers in aggregate beaten their respective benchmarks. Unfortunately for active managers, since 2007 macro factor risk has driven correlations to historically high levels.

The unconventional monetary policies unleashed by leading central banks on the wake of the Great Financial Crisis produced a rising tide that has lifted all boats. This in turn has made the job of active stock pickers difficult as fundamental corporate scores, which they base their bets on, have clearly taken the back seat. However, as central banks

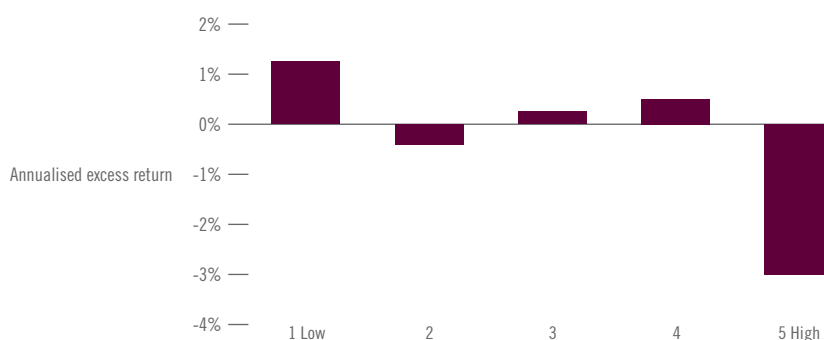
embark on normalisation of their monetary policies, the gap between winners and losers in stock markets is likely to widen from the depressed levels of recent years.

In conclusion, as the above-mentioned research paper remarks, *"in a world of low growth, return dispersion is likely to be higher, creating opportunities for active management. As a consequence, active managers are likely to have a greater opportunity to outperform in the future than they have in the past. The key to success lies in manager selection."* ■

¹ Gerakos, J. J., Linnainmaa, J. T., & Morse, A. (2016). *Asset managers: Institutional performance and smart betas* (November 2016)

² UBS Q-Series, *Active vs Passive: How will the world of investing evolve?* (June 2017)

PAIRWISE CORRELATION AND EXCESS RETURNS TO ACTIVE MANAGEMENT



Source: Dr Anna von Reinnitz (ANU), Factset, UBS Quant, November 2017



HEINRICH MERZ

Head of Hedge Funds
Pictet Alternative Advisors

ACTIVE MANAGEMENT

Alpha at the end of the QE tunnel

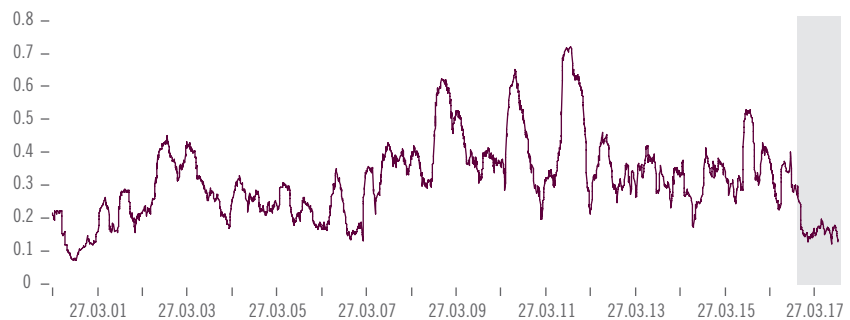
The performance of hedge funds has been bolstered in 2017 by the reversal of the tight market correlations of recent years. The unwinding of quantitative easing offers further opportunities for hedge funds to shine.

A few years back, news that the Fed was reducing its balance sheet and considering rate rises would have prompted a severe market reaction. Today, as the ECB sets out plans for shrinking its own quantitative easing (QE) program, the calm on financial markets is striking, affording, we believe, new opportunities for hedge funds. In hindsight, three obvious trends stand out. First, backed by significant and sustained monetary stimulus, long-only assets have risen in unison over the past 10 years. To take two examples, the S&P500 index has returned +15% a year since its nadir in Q1 2009 and US high yield spreads have fallen well below their historic median, to between 350-400 bps today. Second, volatility has fallen year upon year. In early November, the VIX index of equity volatility stood at 9.4, close to the historic low set earlier in the year. Lastly, correlations—the degree to which assets move in unison—have, until recently, remained stubbornly high (*see chart*).

Together, these factors explain the headwinds faced by hedge funds up to now: profiting from picking winners and shorting losers relies on their existence in the first place. Low volatility combined with high correlation suppresses dispersion—the degree to which winners and losers diverge from their respective benchmark. Add in limited market exposure and higher human capital costs and it is unsurprising that hedge funds as a group have faced increased competition from passive long-only ETFs.

The key question, as the monetary tide gradually recedes is whether the future will mirror the past. For our part, we believe less QE translates to higher volatility, corrections of inefficiencies, the reversal of capital misallocations

AVERAGE S&P 500 STOCK CORRELATION



Source: Pictet Alternative Advisors, November 2017

and, concurrently, greater alpha. Indeed, despite continued low volatility, the performance of our managers over the last year reassures us that it does not take much policy normalisation for alpha to rebound strongly.

RESILIENCE TO TAIL RISKS

Below the current calm surface, we see a broad range of themes and investment strategies. Yes, in certain cases, performance continues to be driven by long exposure to well-known technology names (dominant US groups and Chinese e-commerce) against short positions in high-street retailers. In general, however, the drivers have broadened and deepened. Equity long/short managers are identifying and profiting from corporate change and innovation cycles in immuno-oncology, managed care, industrial cyclicals, consolidating transport industries and niche areas such as online gaming, to name but a few. Relative Value and Event Driven managers are converting their activist shareholder campaigns into portfolio performance across a range of (increasingly European) industries. Convertible as well as capital structure arbitrage strategies are benefiting from the translation of improved

corporate sentiment into corporate actions.

At a superficial level, markets are more resilient than before the financial crisis: banking leverage, for example, has been reduced, in part through regulation. At a granular level, however, several developments have increased systemic fragility. The rise of passive strategies (which simply mirror an index but provide no fundamental corrective mechanism) and risk-parity strategies (leveraging the least volatile asset index, only to try to sell it quickly should its volatility spike), the increased dominance of rapid-momentum trading algorithms, and the 'reach for yield' in less liquid corners of global credit markets could make a reversal more sudden than the build-up of these phenomena. Despite the opportunity cost, it is to control such tail-risks that we maintain allocations to macro and CTA strategies.

We firmly believe that a carefully selected group of managers, conducting deep fundamental due diligence and applying rigorous analytical methods, face a richer opportunity set and have the ability to differentiate themselves more clearly from their peers and competitors than ever before. ■

Corporate governance. Corporate governance has traditionally been a weak spot for Japanese companies. The lack of transparency, ubiquitous cross shareholdings, and the lack of protection for small shareholders are some of the common criticisms. To address these problems, the government published the Stewardship Code in early 2014 to encourage investors to use their voting rights to push companies to enhancing shareholder returns. The Corporate Governance Code, implemented in June 2014 as part of exchange listing requirements, seeks to make companies more transparent and responsive to shareholders. In 2012, only 17% of companies listed on the Tokyo Stock Exchange had at least two independent board directors. By 2016, this number had increased to 80%.

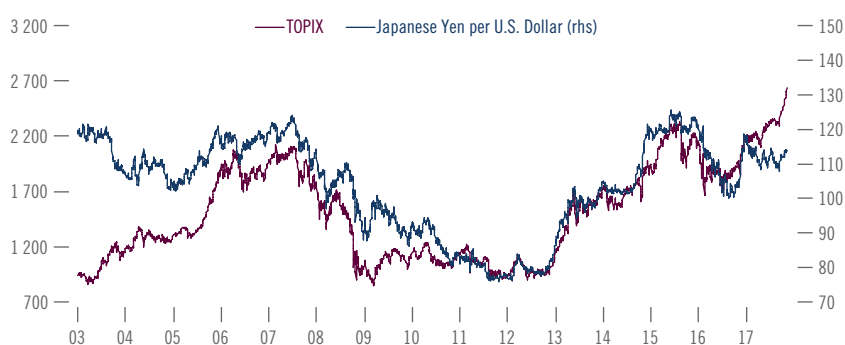
Tax. The corporate tax rate was reduced from 39.5% to 29.97% in fiscal year 2016 to enhance Japanese companies' competitiveness. The consumption tax was hiked from 5% to 8% in 2014, and is expected to be further increased to 10% in 2019. In addition, a taxpayer ID system, which assigns a unique 12-digit number to every registered resident in Japan, was introduced in 2016 to facilitate the collection of taxes. These measures will help achieve fiscal sustainability in the long term.

Womanomics. Japan's highly-educated women are the country's key hidden assets, as the female labour participation rate is very low by international standards. To encourage more women to join the labour force, the Japanese government created 191,000 new child daycare places in FY2013-2014, and plans to eliminate the waiting list for places entirely by end-2017, by when 400,000 new places are meant to be available. Also, maternity leave benefits for working women have been increased significantly and are now among the most generous of any developed country. In addition, the Corporate Governance Code requires Japanese companies to draw up gender diversity targets and action plans by April 2016. With these meas-

ures in place and the economy improving, the labour force participation rate for Japanese women rose by 3.2 percentage points to 51.4% between end-2012 and 30 September 2017

To conclude, in our view, Abenomics has broadly achieved what it was set up to do in the past five years. The impact on the Japanese economy and markets has been positive, and the various structural reforms that have been implemented will likely benefit Japan in the long term. The landslide victory of his Liberal Democratic Party in Lower House elections in October gives Abe a fresh mandate for another four years. As a result, we expect the key elements of Abenomics to stay in place for the foreseeable future. ■

TOPIX INDEX, JAN. 2010-6 NOV. 2017



Source: Pictet WM-AA&MR, Factset, November 2017

JAPANESE EQUITIES SHINE AGAIN

Japanese equities have taken off since the launch of Abenomics at the end of 2012, since when the Nikkei225 and Topix have risen by more than 150% (in yen terms). One important factor has been the drop in the value of the yen. The weak exchange rate has boosted the earnings of Japanese exporters, a significant part of the Japanese equity market, which have tended to outperform more domestically focused companies. But it is interesting to note that Japanese equities have continued to perform this year, although the trend toward yen weakness has eased considerably (the yen had declined by 2.9% against the US dollar year to date in early November). The Topix gained almost 19% (in yen) in the first 10 months of 2017, reaching its highest level since the stock market crash of 1989. No doubt, a central bank that has been hoovering up assets, including equities, as part of its massive quantitative easing programme has taken up from currency depreciation to boost stocks. Since September 2016, the Bank of Japan

(BoJ) has committed itself to buying USD6 trillion of Japanese equity exchange-traded funds per year. As a result, the BoJ already accounts for 4% of the Topix's market capitalization and close to 150% of inflows to the Japanese stock market over the past year.

Foreign investors remain wary of Japanese equities and until this year have generally been net sellers, in spite of strong performance. Although valuations are fairly demanding (forward price-earnings ratios are on a par with European indexes), Shinzo Abe's re-election in the October general election makes it likely that Abenomics, with all its market-friendly measures, and monetary policy stability will continue for some time to come. With Japan in the midst of its longest and strongest run of unbroken expansion since 2001, the earnings outlook for Japanese stocks looks good.

*Jacques Henry, Senior Cross-Asset Allocation Strategist,
Pictet Wealth Management*

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