
Perspectives

INVESTING IN 2018

Who will blink first?

While fundamentals remain sound and the US fiscal boost could sustain equities, a big question mark hangs over central banks if inflation picks up sharply – *pages 3 and 5*

Facing ‘known unknowns’

Identifying key risks to better guard against them – *page 6*

The earnings outlook

Trump’s tax cuts will be a game changer for US equities. Expected earnings in Japan and the euro area also look healthy against the backdrop of continuing economic growth – *pages 7-12*

Separating the wheat from the chaff

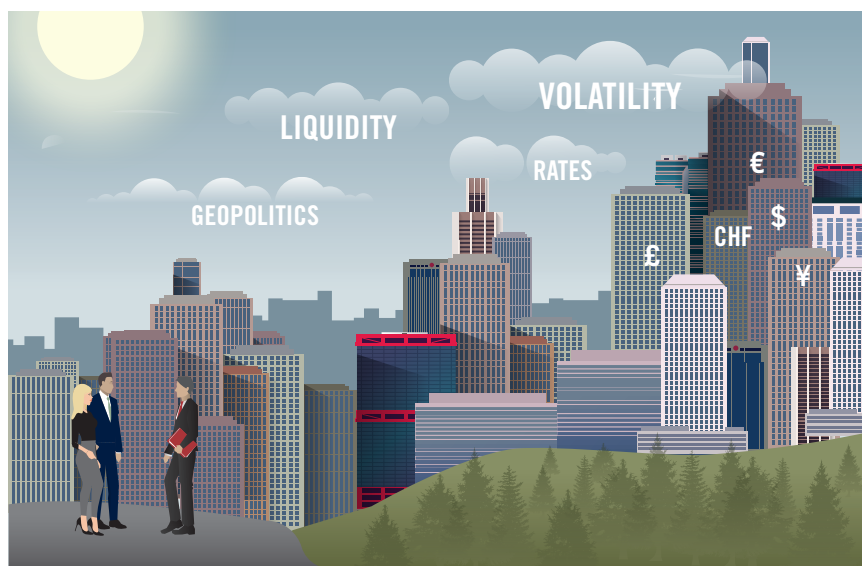
More than ever, rich valuations and changes in the economic cycle mean divergence in the prospects for different equity sectors – *pages 14-16*

Credits: still room to perform

After the odd scare in 2017, quality corporates and select emerging-market debt continue to hold their attraction – *pages 18-19*

Generating alpha

Hedge funds could come into their own with renewed volatility and price dispersion – *pages 20-21*



After an exceptional year...

2017 was an exceptional vintage for risk assets that will be hard for 2018 to repeat. But the environment could become increasingly favourable for active management as challenges rise and volatility increases.

ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT FORECASTS (AT 9 JANUARY 2018)*

INTEREST RATES (IN %)	CURRENT	DEC 2017	DEC 2018
Switzerland – short	-0.75	-0.75	-0.50
Switzerland – 10 year	-0.09	-0.15	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	0.43	0.90
France – 10 year	0.79	0.79	1.40
Italy – 10 year	1.98	2.02	2.50
Spain – 10 year	1.48	1.57	2.20
US – Fed rate (mid range)	1.38	1.38	1.88
US – 10 year	2.48	2.41	2.60
UK – Repo rate	0.50	0.50	0.75
UK – 10 year	1.24	1.19	1.60
Japan – Overnight	-0.10	-0.10	-0.10
Japan – 10 year	0.06	0.05	0.25
CREDIT SPREADS (IN BP)*	CURRENT	DEC 2017	DEC 2018
European IG	83	87	110
European HY	264	279	270
US IG	97	99	120
US HY	335	363	430
EM Corporates (USD)**	273	282	310
EM Sovereign (USD)**	273	286	320
# Bank of America Merrill Lynch indices			
FOREIGN EXCHANGE	CURRENT	DEC 2017	DEC 2018
EUR/USD	1.20	1.20	1.24
EUR/CHF	1.17	1.17	1.16
USD/CHF	0.98	0.97	0.94
GBP/USD	1.36	1.35	1.37
USD/JPY	113	113	115
COMMODITIES	CURRENT	DEC 2017	DEC 2018
Gold	1320	1302	1370
Oil (WTI)	62	58	55
GDP GROWTH RATES	CURRENT (YOY)	2017E	2018E
US	2.3%	2.3%	2.0%
Euro area	2.6%	2.3%	2.3%
UK	1.5%	1.4%	1.0%
Suisse	1.2%	1.0%	2.0%
Japan	2.1%	1.8%	1.3%
China	6.8%	6.8%	6.3%
CONSUMER PRICE INFLATION	CURRENT (YOY)	2017E	2018E
US (core PCE)	1.5%	1.5%	1.8%
Euro area (headline HICP)	1.4%	1.5%	1.5%
UK (headline CPI)	3.0%	2.7%	2.3%
Switzerland (headline CPI)	0.8%	0.5%	1.0%
Japan (core CPI)	0.9%	0.5%	1.0%
China (headline CPI)	1.7%	1.6%	2.5%
E = estimate.			

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

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WHO WILL BLINK FIRST IF INFLATION PICKS UP?



CESAR PEREZ RUIZ

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Pictet Wealth Management

“There is even less scope for things to go wrong this year.”

Last year was a remarkable one for markets, and this year also looks very promising for risk assets. Momentum behind economic and earnings growth remains good, all the more so with US tax cuts. The big difference with 2017 is that volatility is bound to pick up, with occasional spikes, for two main reasons. First, central banks are starting to pull money out of the system and, second, investors have unwisely lowered their defences and started to capitulate to the rally. This leaves even less scope for things to go wrong.

In that context, these are the key themes we see for 2018 in terms of positioning:

- **Stay positive on equities.** It should be another good year for developed market equities. Broad economic momentum is likely to favour Value over Growth stocks. Financials and beneficiaries of US tax cuts should outperform. A still-supportive Bank of Japan (at a time when other main central banks are tightening policy) bodes well for Japanese equities, which are one of our strongest convictions.
- **Be short duration on sovereign bonds.** A key question for 2018 is how long inflation will stay weak. We expect yields on core sovereign bonds to rise in the US, as the Fed continues its tightening cycle, and in Europe, as growth stays strong and the European Central Bank (ECB) tapers.
- **Prefer quality in credit.** With interest rates set to rise gradually, we would stay close to quality in credit, and when seeking more yield think it is better to give up liquidity than increase risk. We favour investment grade, but unlike in 2017, we have become cautious on high yield given tight spreads and risk profile, and prefer, selectively, emerging market debt.
- **Favour alternative investments.** Higher volatility and lower correlations between assets will continue to create opportunities for active managers and hedge funds, as will a continued resurgence in M&A activity as corporate confidence improves. Private equity should keep its illiquidity premium over public equities.
- **Diversify away from the dollar.** The US dollar's long bull-run is likely over, given strong growth outside of the US and weak domestic inflationary pressures. We are looking to diversify away from the dollar in portfolios, where appropriate, and with ECB policy normalisation under way, the euro looks a particularly attractive alternative.
- **Take advantage of volatility spikes.** Volatility should be seen as an opportunity for trading to boost returns. The prospect of higher volatility, and less caution among investors, also supports keeping risk mitigation positions in portfolios.

So far, so good. But what could go wrong? Geopolitics is an obvious risk. We managed to avoid an ‘accident’ in 2017, but geopolitical risk again looms large for 2018. North Korea and the Middle East continue to pose risks, and we also think there is a high chance of populist moves by Trump ahead of the mid-term elections, possibly on trade (NAFTA and US-China trade relations are in the spotlight).

Another big question is what central banks will do if inflation picks up more sharply. Capacity constraints have already emerged in Japan, and output gaps have closed in both the US and Europe. With the US stimulating the economy at a time of low unemployment, tax cuts could have a stronger impact on growth than the current consensus anticipates. All this could leave central banks behind the curve and force them to tighten policy more aggressively. Markets look too complacent about this, and mere hints of more rapid central bank tightening led to significant wobbles on bond markets in the first half of January. So this is one to watch, including for any spillover into equity markets.

On balance though, strong fundamentals should mean another year when it pays to stay invested, while being more tactical, which is what we are doing. We wish you all the best for a successful and prosperous 2018.

Investment Strategy Highlights

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

ASSET STANCE

- › Economic and earnings growth continue to offer good momentum and the possibility of upside surprises for 2018, so we remain overweight developed market (DM) equities.
- › However, uncertainties over other key aspects of the outlook mean that investors may be unwise to lower their defences. We are keeping tail risk mitigation in portfolios.
- › Emerging market (EM) equities should continue to perform in 2018, but we remain prudent about low earnings momentum in some sectors.
- › Declining intra-index correlations and rising volatility will favour active management and stock-picking in 2018.

CURRENCIES

- › We continue to expect a gradual weakening of the dollar in 2018, and estimate an EUR/USD rate of 1.24 for end-2018.

EQUITIES

- › We are bullish on DM equities, in the US, the euro area and Japan. But elevated valuations mean a highly selective approach is needed.
- › We favour value over growth stocks for 2018. Sectors we like include industrials and financials.
- › We are neutral on tech stocks. But while some high-profile tech stocks with an earnings deficit look overbought, good cash generation means we do not expect a tech bust.

FIXED INCOME

- › US 10-year Treasuries' yield could be 2.60% by end-2018, up from 2.41% at end-2017. Our end-2018 target for 10-year German Bunds is 0.90%, up from 0.43% at end-2017.
- › As we expect yields to rise, we would stay underweight core sovereign bonds and short duration.
- › We continue to see opportunities in credit. However, as interest rates could rise gradually, we would focus on quality. We favour investment grade, but are cautious on high yield given tight spreads and risk profile, and prefer, selectively, emerging market debt.

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					
Switzerland					
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					

COMMODITIES

- › Our base scenario is still for the equilibrium oil price to remain at around USD55-USD58 for WTI in the coming months. However, risks are to the upside.

ALTERNATIVES

- › Our outlook for hedge funds remains positive, as monetary and political developments should work in favour of most strategies. We especially like long/short equity, relative value and merger arbitrage strategies.
- › Despite high prices, we continue to see opportunities in private equity, which we expect to maintain its illiquidity premium to public equities.
- › Uncertainty and high valuations pose challenges for real estate in 2018. However, niche opportunities are set to remain in vogue.

*At 8 January 2018.

** 12-month horizon.

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**

Head of Asset Allocation &
Macroeconomic Research
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The US fiscal boost should sustain the equity rally

The picture still looks rosy for the global economy and corporate earnings, but keep an eye on inflation (and bond yields).

From a macroeconomic viewpoint, the new year is starting on an upbeat note, with world growth becoming steadily more broad based. Our in-house models show real global GDP growing by over 4% this year, just as in 2017, while never have so few countries been in recession or deflation since the financial crisis a decade ago.

With strong growth will come higher inflationary pressures. Our forecast is for inflation in advanced economies to rise closer to 2% in 2018. Although it has not been functioning as theory suggests it should for some time, we might even see a revival of the 'Phillips Curve', with the drop in unemployment finally leading to a jump in the price index, especially if there is a boost in the corporate investment cycle.

Yet many of the world's major central banks have begun to tighten monetary policy or at least have begun to sound more hawkish. One could even say that policy communication is synchronised. And yet a look at futures suggests that market participants are still not anticipating the risks involved. Significantly, in the US, Fed Opening Market Committee members' forecasts for policy rates for end-2018 are still higher than Fed futures.

It may also be the case that the impact of the Trump tax reforms, passed in December, has not yet been properly assessed. Many forecasters still believe the reforms will provide only a modest boost to US growth. We are not so sure; the cuts could well shift the trajectory for growth and inflation this year and next, especially if productive investment picks up.

We have long called for fiscal stimulus to take over from central banks to help sustain the current growth cycle. The US has taken the lead, with the fiscal boost announced at the end of last year coming at the right time, just as the momentum provided by monetary policy is turning into a monetary drag.

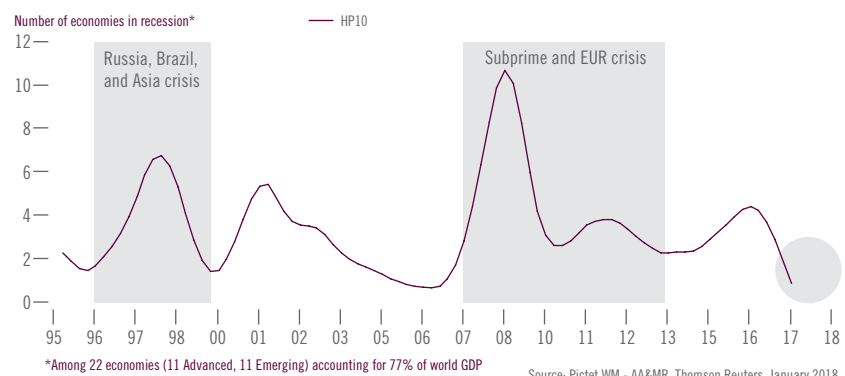
The tax cuts in the US this year are likely to have both direct and indirect effects. The direct effect will be on corporate profits. Estimated earnings in 2018 for US corporates are being feverishly adjusted upwards, and could be double what was being expected before the tax package was passed. Indirectly, the tax cuts could result in a pick-up in corporate investment and help extend the current upward phase in the economic cycle, however long it already is. More investment in a tight jobs market could finally push up wage inflation and re-establish the Phillips Curve, meaning an increase in inflation more broadly.

The situation in Europe is slightly different. The strong pick-up in the

European economy was one of last year's most pleasant surprises, with GDP growth recently surpassing the level in the US. Large-scale fiscal stimulus of the kind seen on the other side of Atlantic has been slower in coming—although important corporate tax cuts are in the offing in France and increased government spending on infrastructure has been at the heart of recent talks to form a coalition government in Germany. Greater efforts will be needed in this direction as the European Central Bank moves to 'normalise' its policies.

All in all, in a context of strong economic growth and corporate earnings globally, equities could well continue to be main source of positive returns for investors in 2018. The upward risk to inflation diminishes further the attractiveness of government bonds. Nevertheless, US Treasuries remain a source of diversification and should help protect portfolios in cases of unexpected shocks and higher volatility. ■

NUMBER OF ECONOMIES IN RECESSION, JANUARY 2018





ALEXANDRE TAVAZZI

Global Strategist
Pictet Wealth Management

INVESTMENT STRATEGY

‘Known unknowns’: key risks for 2018

Although we remain upbeat about prospects for risk assets, there are plenty of reasons for caution.

The biggest risks that we see to the outlook for risk assets in 2018 fall into three broad categories: geopolitical shocks, higher rates and liquidity shortages. This is not to say we are excessively gloomy. In fact, we see considerable upside risk to our baseline scenario from the potential for faster-than-expected economic growth, especially following US tax cuts. Our overweight in developed market equities means we are already well positioned to benefit from such a scenario. But in a climate that still appears, on balance, highly supportive of equities, it makes sense to look at what could go wrong.

Of course, these are only the risks that we know about. Along with the “known unknowns”, there are also “unknown unknowns”: in other words, the biggest shocks to markets often come from unexpected directions. But identifying the key risks that we are aware of at least means that investors can guard against them.

Geopolitical shock. The current geopolitical climate is the most dangerous since the end of the Cold War. The waning of US hegemony and challenges to the global political order from the likes of China and Russia, together with the rise of populism and illiberal authoritarianism, have created a highly uncertain environment. Risks are compounded by the volatile temperament of the current occupant of the White House. In this context, although 2017 managed to pass without a major ‘accident’, our baseline scenario for 2018 again factors in occasional, short-term spikes in volatility on geopolitical tensions, but there is a risk that a geopolitical crisis escalates to a point where it seriously undermines

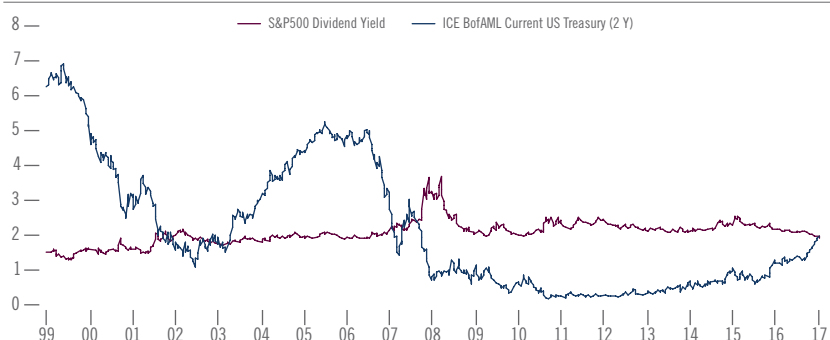
the economic outlook and triggers a full-blown market sell-off. Possible candidates include a direct conflict involving Iran and Saudi Arabia and/or the US that sends oil prices soaring. Among others are a major escalation of the North Korean nuclear crisis and a trade war between the US and China and the collapse of NAFTA.

Surprises on rates. Supportive central bank policies have played an important role in suppressing volatility and supporting asset prices in recent years. We expect these policies to start to be withdrawn in 2018, but only gradually. We think there will be three or four rate rises from the US Federal Reserve this year, but none from the Bank of Japan or the European Central Bank—although the latter will be tightening policy by tapering quantitative easing. But there is a risk that a resurgence of inflation forces central banks into faster tightening. Investors seem to be ignoring this risk (in early January, markets were only pricing slightly more than two Fed quarter-point rate rises this year), while bond moves in early 2018 suggest that even hints of increased central bank hawkishness

have the potential to destabilise markets. Equity valuations would likely contract, all the more so that they have they have reached their highest quartile over the past 20 years and that even in terms of dividends, they have become relatively less attractive (see chart).

Liquidity shortages. With MIFID II regulations being implemented in 2018, market liquidity could decline temporarily, particularly for assets traded by market-makers (bonds, forex). Even a short-term shortage of liquidity could trigger a negative exogenous shock that forces investors to sell equities (which are more easily tradable) to reduce portfolio risks, regardless of fundamentals. This is a relatively low-probability risk, but could have a high impact. Moreover, one needs to monitor the rapid growth of passive investing. Assets under management for passive funds are projected to reach USD5.3trn this year, just shy of active funds’ USD5.8trn. But passive funds have not yet been seriously tested by a liquidity crunch, and it is unclear how they would react. ■

TWO YEAR TREASURIES NOW OFFER SAME YIELD AS EQUITIES



Source: Pictet WM AA&MR, Factset, January 2018



THOMAS COSTERG

Senior US Economist
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REGIONAL FOCUS

The stars align for the US economy

The Trump tax cuts come on top of a number of other positive drivers that augur well for the US economy in 2018, although underlying blemishes and fragilities remain.

The recently enacted US tax cuts provide a further boost to an already long list of favourable factors for US growth in 2018: rising domestic oil production, still-loose financial conditions and strong external demand. The stars are almost perfectly aligned. Some critics of the tax cuts say they precisely add one star too many and increase the risk of ‘overheating’ of the US economy, especially given the already-tight labour market. While this risk is something indeed worth monitoring, we still think the Goldilocks economy will persist in 2018 – still not too hot to cause a sharp spike in inflation, and not too cold to fall into recession either.

One crucial aspect, particularly regarding investment, is that the US is starting from a low base. There is still much room to add capacity. Private domestic investment (net of depreciation) averaged only 3.6% of GDP in 2017, versus 6.2% on average between 1980 and 2007. The question is whether US firms will eventually open their purses in 2018 and spend on capex after years of stinginess. Years of very low interest rates seem to have had only a modest impact on investment, to the disappointment of many Federal Reserve officials who believe in textbook macroeconomic models. Tax cuts are equivalent to further lowering corporates’ cost of capital. Will that finally persuade US companies to invest?

The good news is that ‘animal spirits’ seem to be stirring at last, and corporate managers may well believe that demand is around the corner, giving the greenlight to their investment plans. Recent survey data has been very positive for consumers and corporations alike. That bodes well for investment

growth in 2018. And also, in the longer term, for productivity growth, which has been soggy lately, depressed further by recent under-investment.

The tax cuts, and particularly the sharp drop in the corporate statutory tax rate to 21%, from 35% from January 2018, are not the only locomotive of US growth. While often overlooked, domestic oil production is on a tear, and Texas, the second state by GDP after California, is seeing especially solid economic momentum. Recent rises in global oil prices are a further impetus for solid growth of the US oil sector in 2018 – and of connected activities such as petrochemicals, metals manufacturing and transportation. At the time of writing, weekly US oil production was nearing 9.8 million barrels per day, compared with roughly 5.0mb/d 10 years ago. Of course, the risk, is that if global oil prices were to plummet again, they could destabilise the US economy.

There are a few blemishes in an otherwise favourable US growth picture. Household incomes—needed to sustain consumption in the medium term—are still not accelerating. The recent sound holiday shopping

season was mostly due to consumers’ recourse to credit card debt rather than accelerating incomes. The saving rate has plummeted to the lowest since November 2007. (Still, we think wages could tick higher.) The fraught political climate in the US is a further element of fragility.

A paramount focus in 2018 will be the ongoing monetary policy ‘normalisation’ and the level of long-term interest rates. The Fed has made clear (most recently at its December meeting) that it will voluntarily remain “behind the curve” while it measures the impact of the tax cuts. In other words, it will not accelerate its plans for rate hikes, with Fed officials foreseeing three quarter-point increases in 2018. This prudent view is further supported by persistently low inflation. However, the Fed’s plans for slow normalisation is vulnerable to a sudden return of price pressures. This would lead to calls for faster rate hikes, potentially upsetting the almost perfect alignment of economic conditions. Still, we think the Fed will only play a supporting role in 2018, while the fundamentals of the US economy grab the limelight. At last, some will say. ■

THE US UNEMPLOYMENT RATE (CLOSE TO 4%) IS AT ITS LOWEST LEVEL SINCE 2000



Source: Bureau of Labor Statistics, January 2018



JACQUES HENRY

Senior Cross-Asset Strategist
Pictet Wealth Management

REGIONAL FOCUS

A game changer for US earnings

The lowering of the statutory corporate tax rate will boost earnings growth, benefiting a broad range of sectors.

The statutory corporate tax rate in the US is set to drop from 35% to 21% from January 2018, and will undoubtedly be a game changer for US earnings growth.

With the exception of real estate, all US sectors will benefit from the fiscal boost, even the technology sector, which prior to passing of the tax cuts in late December was facing an effective 2018 expected tax rate of 23% (compared to 29% for S&P500 companies as a whole).

Ahead of the bill's passage, consensus S&P500 earnings growth expectations stood at 11.8% for 2018 and 10.2% for 2019. Expected earnings growth rate could now more than double, benefitting all sectors, and had already reached 15% by mid-January. The strongest impact is expected to be on the financial sector, which should see its earnings growth almost treble.

In our central equity market scenario for 2017 (prepared in November 2016), we factored in stable

valuation multiples in both the US and in Europe. This relationship between price and earnings did indeed hold steady until the end of August when a regime shift occurred in the US, as tax reform discussions started again. Since then, the 12-month forward price-earnings (PE) ratio of the S&P500 has increased by 0.8x, i.e. adding 4.5% to US equity returns. Cyclical have been the major beneficiaries of the rerating, as well as financials, but to a slightly smaller extent.

The concentration of earnings growth in a handful of sectors has become a major issue for equity markets of both sides of the Atlantic. On average, 5-10% of S&P500 stocks achieve 80% of the index's annual earnings growth, explaining why stock-picking has become a major issue for investors. Indeed, serial growers in US technology are behind most of 2018's expected earnings growth. So far, this ranking has not been challenged by the tax reform.

Our 2018 scenario for US equity markets, drawn up before the passage of tax cuts, was based on the premise that high valuations offered little upside potential, so that our expectations for total returns matched those for earnings growth. But the increasing prospect of tax cuts led to an expansion in multiples as 2017 drew to a close. The US fiscal reform, by boosting earnings growth, provides further upside risk to our US equity scenario. ■

CHART 1: ANALYSTS INCREASINGLY FACTORING US TAX REFORM INTO THEIR EXPECTATIONS

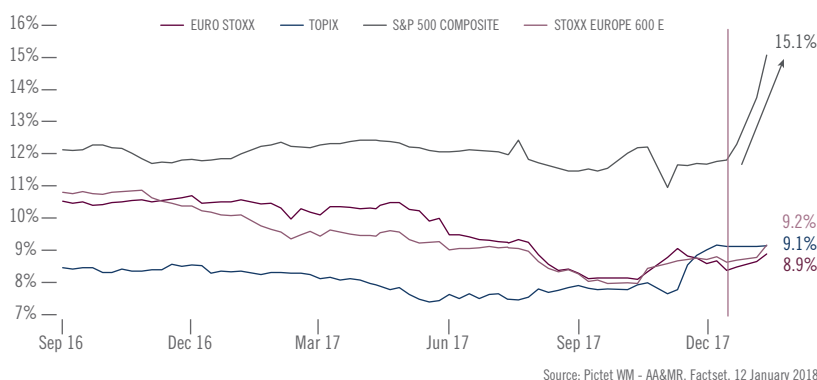
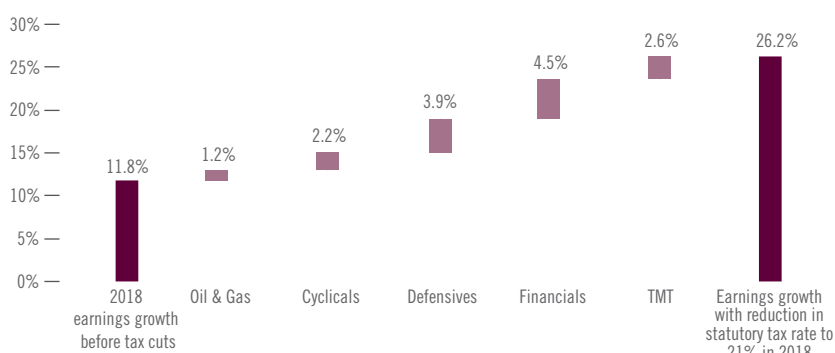


CHART 2: 2018 EARNINGS GROWTH EXPECTATIONS IN US ACROSS SECTORS POST TAX CUTS





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REGIONAL FOCUS

Banking on a virtuous cycle in the euro area

Euro area growth looks resilient and is set to be supported by increasing corporate lending.

The euro area ended 2017 on a very strong note, with most economic indicators close to levels not seen since the early 2000s. Taking account of such strong momentum, as well as carryover effects and upward revisions to past data, we forecast euro area annual GDP growth of 2.3% in 2018, similar to 2017.

Strong growth should gradually push inflation higher, but we still expect the ECB to maintain a cautious approach to policy normalisation, with the first hike in policy rates only coming in 2019. The political picture looks less fraught than last year. Although we expect the situation in Catalonia and the upcoming election in Italy to cause some localised volatility, the kind of systemic risk that a win by the National Front in France last year would have caused should be avoided.

Our central forecast continues to reflect a gradual slowdown in the quarterly pace of growth, to around 2% year-on-year by end-2018, due to less favourable tailwinds (the acceleration of global growth in 2017) and the appearance of some modest headwinds (tighter financial conditions linked to the gradual tapering of the ECB's asset purchases and the euro's strength, although we expect this strengthening to moderate in 2018). We also recognise that some euro area economies are growing well beyond their long-term potential, resulting in a fast erosion of spare capacity, especially in Germany.

Nonetheless, this European expansion looks robust. Its most important feature is the high-quality composition of growth, which has become increasingly

EURO AREA CORPORATE LENDING: € BN MONTHLY FLOWS, 3-MONTH MOVING AVERAGE (ADJUSTED FOR SECURITISATION)



broad-based, synchronised across countries and sectors, self-sustained and resilient to external shocks.

In particular, credit-fuelled investment spending is helping the euro area business cycle, leading to even more self-sustained job creation and consumption. In turn, improved quality of growth should provide greater visibility to investors.

STRONG BACKDROP FOR CAPITAL SPENDING

Capital expenditure already picked up meaningfully in 2017. The acceleration has been mainly driven by the construction sector and is now a key source of strengthening domestic demand. As construction activity is still 19% below its pre-crisis (2008) level, it has further room to improve since the sector's expansion cycles tend to last longer than the upward phase of economic cycles. Machinery and equipment investment should also strengthen.

Supportive factors include reduced political risks, good corporate profits and cash flows, as well as an improving credit impulse. In

short, credit supply is no longer a constraint and credit demand improved further in H2 2017. Annual growth in euro area bank loans to non-financial corporations edged progressively higher in 2017, to reach close to 3% annualised in November, with the use of internal sources of finance likely explaining why credit growth has not picked up even faster despite favourable market conditions.

The latest credit flows and bank lending surveys signal a strengthening upturn in the euro area credit cycle, with small and medium-sized companies also benefiting from easier access to credit. Bank lending tends to lag nominal GDP growth, indicating upside risks in the first half of 2018. Of particular note, banks have started to increase long-term loans in the last months of 2017, adding to positive potential in terms of investment spending and hiring. ■



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REGIONAL FOCUS

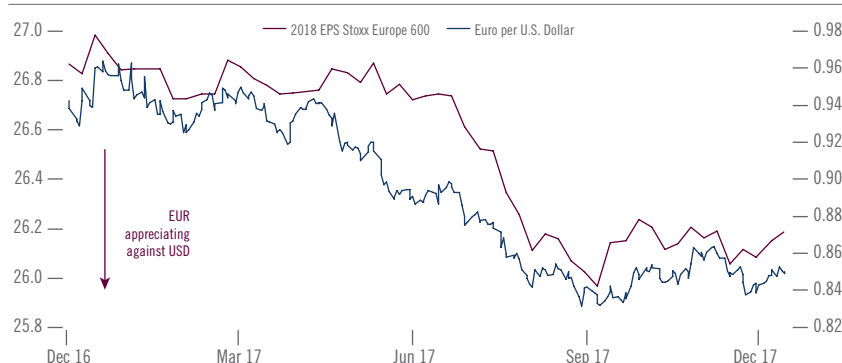
European equities offer a significant discount

At the start of 2018, European equities were trading at a valuation discount to their US peers. But economic momentum in the euro area means the former could deliver double-digit total returns this year.

Our central equity market scenario for 2017 (prepared in November 2016) foresaw stable valuation multiples in both the US and in Europe. But since August, when meaningful tax reforms in the US started to become a distinct possibility, the 12-month forward price-earnings (PE) ratio for S&P500 companies has increased by 0.8 point (to reach 17.8x), whereas it has remained unchanged for Stoxx Europe 600 firms (around 15x). PE levels in Europe have historically been lower than in the US. On average, 1.3-1.5x of this gap can be explained by differences in the sectoral composition of the S&P500 and Stoxx Europe 600. The main one is in the technology sector, as giant US tech companies have no equivalent in Europe. Technology accounts for 20.4% of the S&P500, but only 4.3% of the Stoxx Europe 600. However, sector bias does not explain all of the current gap in valuations. At a time when equity markets in general are richly valued, European equities offer a significant discount to US equities, especially for investors scared by the levels of valuation reached in the US.

Through much of 2017, revisions to projected earnings for European equities were driven by the euro's appreciation against the USD. The single currency rose by almost 13% in the first eight months of 2017, leading 2018 earnings expectations for the Stoxx Europe 600 index to be revised down by 3%. But from September 2017, just as US fiscal reform discussions got underway in earnest, and until early November, the US dollar recouped some of its strength. Euro area earnings have largely evolved in line with

THE EFFECT OF A RESURGENT EURO ON EUROPEAN EARNINGS IN 2017



Source: Pictet WM-AA&MR, Factset, January 2018

FX moves since September. With FX headwinds gradually vanishing, 2018 earnings for European stocks should look more robust.

POSITIVE ECONOMIC MOMENTUM

Despite the effects of currency movements, 2017 sales growth in the US and Europe should be roughly similar (5.7% for the S&P500 and 5.8% for the Stoxx Europe 600). Indeed, even if earnings growth for the Stoxx Europe index (excluding financials) remained stable in H2 17, the growth rate for euro area cyclicals was revised up thanks to higher top-line sales growth, which moved up from 4.2% to 5.5%. This has been helped by a strengthening euro area economy. Supportive economic momentum should persist in 2018 and prove supportive of top-line growth that is currently a bit shy of 3.8% for 2018, with growth seen as especially modest for cyclicals.

A slowdown in the euro's gains and economic momentum should make it possible for European equities to achieve 2018 earnings

growth closer to 10% compared to late-December expectations of 8.8%. Assuming no PE expansion and a dividend yield still above 3%, total returns for European equities should reach double digits. ■

10%

2018 European earnings growth could move closer to 10%



DONG CHEN

Senior Asia Economist
Pictet Wealth Management

REGIONAL FOCUS

Abenomics will continue to push Japan forward

Prolonged monetary stimulus and economic reform are likely to continue to boost Japan Inc. this year.

The Japanese economy has not looked so good in over a decade, with the quarterly Tankan survey of business conditions and sentiment strengthening to an 11-year high in Q4 2017. The economy may have expanded by 1.8% in 2017, up from 0.9% in the previous year. In 2018, the growth rate may moderate slightly to 1.3%, but, again, with positive growth in each quarter. If realised, this would mark 12 consecutive quarters of growth, the longest period of expansion for Japan since 1986.

In 2018, the strengthening global economy will likely continue to help Japanese exporters. In the first 10 months of 2017, Japanese exports grew by 12% year-over-year (y-o-y), the highest since 2010. As the synchronised expansion of the world's major economies is set to continue in 2018, we expect Japanese exporters to extend their stellar performance into the new year, especially as the yen will likely stay on the weak side.

Domestic demand is also picking up. Consumer confidence is at its highest in more than four years. Household living expenditures rose by 1.7% y-o-y in real terms in November 2017, compared to a drop of 1.7% in 2016. Rising consumption has been partly driven by income growth, which is still modest but slowly building up.

Capacity constraints are becoming more evident, especially in services. However, the acute labour shortage hasn't led to much wage growth or inflation pressure so far. After five years of unprecedented monetary easing, core inflation in Japan (all consumer price index items excluding fresh food) remains

below 1%, less than half the Bank of Japan's (BoJ) 2% target. One reason is that both workers and management in Japanese companies place priority on the long-term stability of employment over wage increases. While this has led to minimal job cuts and wage reductions in economic downturns, it also means wage growth tends to be sluggish when the economy picks up. In addition, Japanese companies are increasing their spending on labour-saving technologies to cushion rising labour costs, which has so far enabled many of them to avoid hiking prices for their products.

ABENOMICS LIVES ON

In the absence of any significant inflation pressure in the foreseeable future, the BoJ decided to keep its monetary policy unchanged at its latest policy meeting in December. We expect the BoJ to keep monetary easing largely intact throughout 2018, although the amount of Japanese government bond (JGB) purchases required to keep the yield curve under control has been reduced.

Prime Minister Shinzo Abe and his Liberal Democratic Party reaped a landslide victory in the snap election in October, which gave him a fresh four-year mandate. Hence, Abenomics will live on, with its policy stimulus and structural reforms. Since Abe came to office in 2013, the administration has introduced a series of policy measures to improve corporate governance, reduce corporate tax and encourage women to join the labour force (with notable success on the last score, *see chart*).

In December 2017, the Japanese parliament approved another round of corporate tax cuts that will slash the standard rate to about 20% from 30%, but only for companies that raise wages aggressively and boost domestic capital spending. While not comparable in breadth to the latest US tax reform, it is another step in the right direction. Abe's reforms have been largely under-appreciated but they have already had a positive impact on the economy as well as on the market and can be counted on to continue to do so. ■

JAPANESE WOMEN'S LABOUR PARTICIPATION RATE (JAN 1975-NOV 2017, 3-MONTH MOVING AVERAGE)





JACQUES HENRY

Senior Cross-Asset Strategist
Pictet Wealth Management

Things are looking up for Japanese equities

Helped by central bank intervention, Japanese equities stormed back in 2017 and are set to post attractive returns this year.

In 2017, Japan's TOPIX index posted a stellar return of 22.2% (in yen), not so far from the MSCI Emerging Markets' 31.0% (in USD).

Such a performance is all the more outstanding when one considers the 7% decline in the Topix between mid-March and mid-April, at a time when Japanese equities were already lagging all other major equity markets. What has changed and what should we expect in 2018?

Since the collapse of the Japanese asset price bubble in 1991-1992, the ups and downs of the Japanese equity market can be largely explained by the behaviour of foreign investors. This factor is still important, but has lost some traction since the Bank of Japan (BoJ) started a massive quantitative easing (QE) programme in 2013. Since then, fluctuations in the value of the yen have turned out to be the main factor behind the TOPIX's performance. One of the side effects of QE was to drive the yen lower. This boosted earnings, as Japanese blue chips are either big exporters or have significant foreign exposure. Stronger earnings led to stronger equities. All this worked

well until 2016, when renewed weakening of Japanese equity markets triggered a bold monetary policy response from the BoJ.

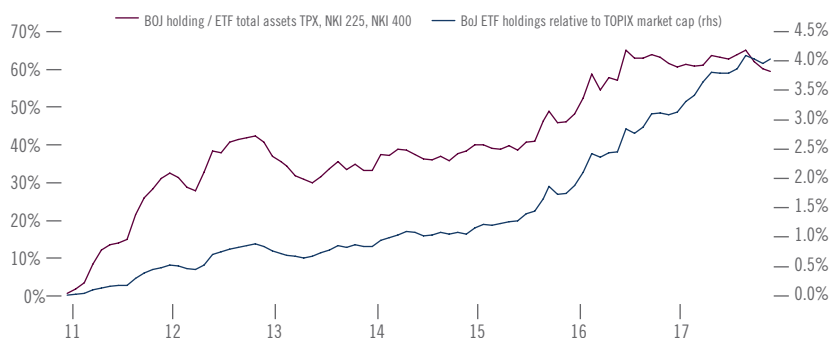
“The TOPIX's strong performance in 2017 can largely be explained by BoJ policy”

In September 2016, the BoJ announced it would double its direct purchases of Japanese equities to JPY600 trn (around USD53 bn) on an annual basis. Via ETFs, the BoJ has been purchasing on three major Japanese equity benchmarks—the TOPIX, Nikkei 225 and JPX-Nikkei 400. This has turned the BoJ into a major shareholder of some mid-caps on the Nikkei, which (like the Dow Jones) is one of the few indices that is price rather than free-float weighted. As the yen traded sideways against the US dollar in 2017, the TOPIX's performance can largely be explained by BoJ policy (the BoJ has been on track to meet its annual purchase target since July 2017).

The mandate of the current BoJ governor, Haruhiko Kuroda, ends in March. But with the legislative elections of last October clearing the way for prime minister Shinzo Abe to remain prime minister for the next four years, it seems likely at this stage that either Kuroda's mandate will be extended or that another dovish governor will be appointed in his place. The Japanese equity market is different from others in terms of internal dynamics, as the BoJ is the sole major central bank intervening directly on equity markets. The BoJ started tapering its purchases of Japanese government bonds in late 2016, but its equity ETF purchases remain intact. However, given the recent performance of Japanese equities, the share of equity ETFs owned by the BoJ shrunk from 65% of total Japanese market capitalisation in August to around 60% in November. The BoJ currently owns around 4% of the Topix's market capital, a figure that has remained stable in recent months.

With a 15.2x forward price-earnings (PE) ratio, the TOPIX is just as expensive as the Stoxx Europe 600, but still cheaper than the S&P500. The outlook for Japanese earnings still looks pretty strong, as they are expected to grow 9.1% in 2018. With a dividend yield close to 2% and assuming valuation levels remain constant, the TOPIX is on track to post a double-digit return in 2018. ■

THE BOJ'S PURCHASES OF ETFs SINCE 2011



Source: Pictet WM-AA&MR, Factset, January 2018



DAVID GAUD

Chief Investment Officer Asia
Pictet Wealth Management

REGIONAL FOCUS

Emerging markets: it's Value stocks' turn

Growth stocks, often dynamic Asian tech companies, grabbed the limelight in 2017, but their undervalued (and underappreciated) Value rivals may be about to stage a comeback.

Growth was the best-performing segment of global emerging markets (GEM) in 2017. Earnings-revision types of stocks, largely cyclical, came second best and Value came third, ahead of Defensives. But as we expect global momentum to strengthen further this year, we believe the recovery in earnings should spread more widely beyond Growth and become particularly positive for Value stocks.

Growth stocks have tended to drive the performance of emerging market (EM) equity indices in recent years, particularly in Asia, home to many fast-growing tech companies. The dynamism of Asian Growth stocks—stocks which command a premium because of their potential for superior capital gains (but often pay little by way of dividends)—has overshadowed Value stocks, often large, more established companies in sectors such as finance and energy that trade below book value or what metrics suggest the stock is worth.

The performance of Growth-style stocks up to now has come against a backdrop of prolonged foreign investor caution toward emerging markets in general. But emerging markets roared back in 2017 (the MSCI Emerging Market Index rose about 38% in US dollar terms last year and the MSCI AC Asia (ex Japan) by 42%), in tandem with a pick-up in economic performance.

As economic growth turns out to be better shared among sectors, investors are expected to become more price conscious and gradually more reluctant to pay huge premiums on Growth stocks. This is all the more so as Value stocks still have plenty of upside potential: the recovery in GEM Value stocks so far been the slowest of

any of the four last recovery cycles (*see chart*), even though Value stocks tend to outperform when economic growth is accelerating and abundant. Within Value, we find several sectors that are important to the EM universe: banks, insurers, real estate, consumer durables & apparel, energy and materials.

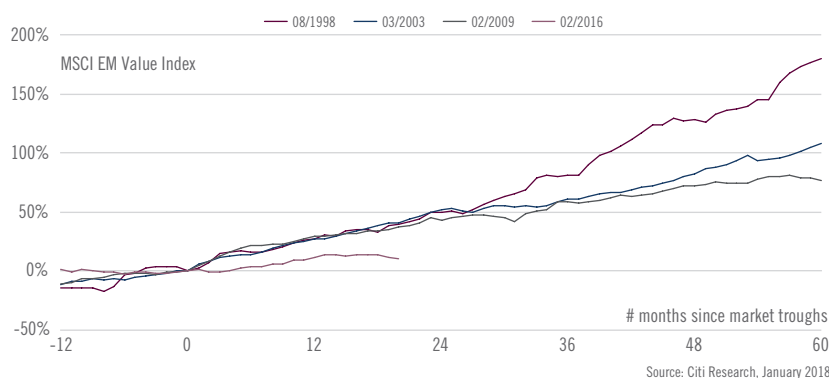
The Growth vs. Value debate is of particular interest in China, where investors who focus mainly on high-profile tech companies could be overlooking the often spectacular evolution of some so-called 'old economy' companies. There, one sees auto companies unafraid to engage in state-of-the-art robotisation or to launch new-energy vehicles. Chinese property developers are looking at exploiting 'big data' to improve services to clients, while traditional life insurers (with valuations to match) have been adding leading-edge internet expertise. In short, companies that are considered 'old economy' may turn into something much interesting—and they are cheap. This is happening most particularly in China because the present central government has the

means and intent to support such massive shifts.

We are keenly aware of the risks that GEMs face, including political instability in some countries. We are also taking heed of the comments by outgoing People's Bank of China chairman Zhou Xiaochuan, that China risks facing a 'Minsky moment' as a result of excessive financial leverage (although we consider such a 'moment' unlikely in the short term). Currency fluctuations also continue to dictate prospects for EM stocks to some extent.

And yet, excellent value, healthy growth prospects, a recovering banking sector and increasingly sophisticated and diversified financial markets suggest that emerging markets may be increasingly able to withstand pressure over the long term. However, if one wants to avoid the risk associated with richly valued Growth and Cyclical stocks whose earnings do no more than match GDP and inflation growth, EM Value stocks (however defined) with often lower beta are worth a second look. ■

EM VALUE STILL PERFORMING LESS WELL THAN DURING PREVIOUS RECOVERY CYCLES





GREGORY KUNZ

Head of Equity Research
Pictet Wealth Management

ASSET FOCUS

Equity sectors: separating the wheat from the chaff

Conditions are ripe for developed-market equities to prolong their recent performance a while longer. But valuations are high across many sectors, meaning a selective approach is needed.

Equity markets were strong in 2017, supported by factors such as an acceleration in global growth and moderate inflation, a tide of M&A deals and, most recently, fiscal reforms in the US. But valuations are high, making it critical to assess sector fundamentals to achieve the most appropriate positioning in 2018. With economies growing strongly, little sign of inflation, and decent earnings growth expected the stars remain aligned for developed-market equities. Growth should remain robust across leading economies, with the potential for upside surprises. Inflation should pick up modestly, but is unlikely to surge. This environment should support continued good earnings growth in a variety of sectors.

Careful normalisation of policy in the US and Europe and good economic momentum should continue to offer support to equities.

REASONS FOR OPTIMISM, REASONS FOR CAUTION

US tax cuts should lead to a substantial rise in earnings growth for US corporates in 2018 (*see article page 8*), while the improvement in sustainable growth in Europe bodes well for stocks there as well. All in all, the momentum behind hard macro data is improving investors' visibility on corporate profit growth in developed markets.

US tax cuts could also be a decisive catalyst for rotation to value-oriented domestic companies in the US that pay higher effective tax rates now than growth ones. The potential for increased corporate investment and for M&A will likely boost the potential for active management

in a range of sectors. The slippage in intra-index correlations to close to three-year lows also offers renewed opportunities for stock-picking and active management.

Yet we also remain aware stocks have become expensive, based on forward price/earnings ratios, and while corporate tax cuts in the US (but also Japan) are boosting earnings estimates, there is no room for disappointment. The rise in official interest rates could impinge on equities' performance. And questions remain about how passive investments will react if we see a significant upturn in volatility (an environment much more suited to active management).

“While tax cuts are boosting earnings estimates, there is no room for disappointment”

Below is a brief overview of our assessment of prospects in the main European and US equity sectors in 2018.

We are constructive on **industrials**. The business environment for 2018 remains solid and should favour fixed-asset investments, especially in developed markets. As the cycle matures, investors should pick companies exposed to the best end-markets (oil & gas, mining, aerospace & defence, non-residential construction, automation), those that offer transformation stories, or those benefiting from structural growth drivers.

We are also positive on **US and European banking stocks** in 2018. In the US, the combination of rising interest rates, tax reform, and looser regulation should give a boost

to banks' profitability. In Europe, the refined Basel agreement reached in December is the last piece of re-regulation post crisis. The debate on the European Central Bank's next moves on monetary policy is likely to be revived in 2018.

In **consumer discretionary**, we expect disruption to continue. Favoured subsectors include home repair and remodel as Millennials come of age, and also leading brands and e-Commerce share gainers.

The outlook for **luxury** remains positive on Chinese middle class expansion, but we would be selective as valuations are at post-crisis highs.

Contrary to the consumer discretionary sector, fundamentals for global **consumer staples** in 2018 look brighter. After a difficult 2017, organic sales growth should improve to 3-4%, driven by improving emerging market economies, higher inflation in developed markets (which should support pricing), and a shift towards products better aligned with consumer needs, which should support volumes.

In **healthcare**, large pharma and biotech companies face questions about their ability to grow after 2020 and M&A is needed to complement existing portfolios. US medtech, life science and health services enjoy superior earnings growth visibility but trade at a premium over both the S&P500 and their own history. Managed Care Organizations look relatively attractive, as we see room for further valuation expansion in addition to upside to consensus estimates.

In the **technology** sector, 2017 was marked by good performance as much as it was marked by rising multiples. With price-earnings ratios having increased

from around 12x to 19x between 2012 and 2017, we are now at a point where valuations are becoming an issue, and we believe a focus on sustainable and robust earnings growth is the best option.

In 2017, the **energy** sector's performance was significantly impacted by a reset in crude oil prices expectations, both short and longer term, on the back of the US shale market disruption. As we move into 2018, signs are emerging of a better investing environment.

There is also light at the end of the tunnel for the **metal & mining** sector. Companies have come a long way down the redemption path; they are emerging in far better financial shape than before and are strategically sounder. We want to be part of this rerating story that is shaping up in 2018. Three sectors (industrials, financials and consumer staples) deserve a closer look, either because of our positive stance on them, or because we have moved recently from a negative to a neutral stance (consumer staples).

1. INDUSTRIALS

Fernand Pacicca, Senior Investment Manager, Pictet Wealth Management

The business environment for 2018 remains solid and should favour fixed-asset investments, especially in developed markets. With low interest rates and strong European economic momentum, the outlook for European industrial companies is good. Backlogs of work are increasing (*see chart 1*) and so are delivery times. US companies will benefit from a resilient economy, but the need for capacity expansion is less pronounced; goods are processed and delivered more rapidly than in Europe. That said, the enactment of tax cuts could give impetus

to the capex cycle. We remain prudent about Chinese industrials due to our below-consensus economic growth outlook for their domestic market and low earnings momentum.

The rise in oil prices should help the recovery of process-related investments continue. The outlook for non-residential construction is also looking up, as the US, Europe and Asia all need to invest in infrastructure. In Asia, the most interesting end-markets are rail equipment and heavy-duty trucks.

Existing growth drivers for global air traffic remain in place for 2018, especially in emerging markets.

“There is light at the end of the tunnel for the metal & mining sector”

With already chubby order books, aerospace companies can see 2018 through rose-tinted glasses. Freight should also continue to benefit from the expansion of e-commerce.

Finally, after several years of declining activity, mining equipment saw a solid step-up in growth in 2017 led by replacement demand. In the absence of big commodity price volatility, the recovery is expected to continue in 2018. Thanks to rising activity, companies will benefit from good pricing and operating leverage. Operating margins should thus continue to rise despite higher labour costs and investment in technology.

Digitalisation will still be a strong driver in industrials. It is also a way to raise barriers to entry and escape low-cost competition, although longer term industrial companies run the risk of cannibalisation.

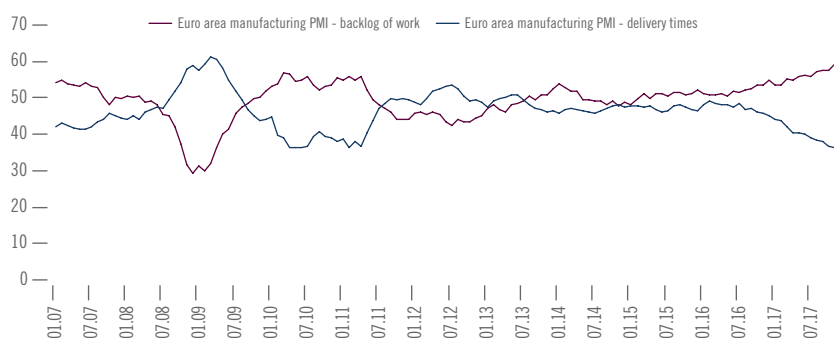
On both sides of the Atlantic, the capital goods sector is trading at less than one standard deviation above the long-term average in relative terms. This looks fair to us, as the sector benefits from several positive drivers.

2. FINANCIALS

Yann Goffinet, Senior Financial Analyst, Pictet Wealth Management.

A number of tailwinds will continue to be supportive for banks in the US, which is more advanced in the economic cycle than Europe (*see table next page*). First, interest rates are expected to go up

CHART 1: THE NEED TO INCREASE PRODUCTION CAPACITY IN EUROPE



Source: Pictet WM-AA&MR, Markit, December 2017

several times in 2018 and banks' net interest margins will continue to rise. Capital returns, through dividends and buy-backs, are another tailwind, with some banks already returning to shareholders more than 100% of the earnings they generate. Banking deregulation along with tax reform should further boost earnings. However, while still of little concern, normalising asset quality will be one headwind going forward.

In Europe, the finalisation of the new Basel agreement in December marks the end of the large-scale regulatory reforms engaged in since the financial crisis 10 years ago. Investors and bank managements now have a clear idea of the amount of capital that the industry will require. Furthermore, 2018 should see a revival of the debate around the interest rate outlook, while some drivers of recent earnings upgrades such as loan volumes and asset quality should remain supportive. As a consequence, capital returns should increase and the dividend yield may rise to about 4.5%. If it is lower in a year's time, it may be less because dividend expectations have proven over-optimistic again

and more because banks have re-rated. Against that, the elevated level of credit and equity markets, which boosted the sector's earnings in asset management in 2017, is perhaps the main risk to mention.

Sector performance in the US and Europe also remains tied to macro, as demonstrated by the correlation with bond yields. With the current improving economic environment, and with central banks reducing monetary stimulus (or reducing their balance sheets, as in the case of the Fed), bond yields are likely to rise, which should help banking sector outperformance.

3. CONSUMER STAPLES

Marianne Johnson, Financial Analyst, Pictet Wealth Management.

We have lately become more constructive on fundamentals for global consumer staples. After a difficult 2017, organic sales growth should improve to 3-4% in 2018, driven by: 1) an improving macro environment in emerging markets, benefitting multinationals with exposure there; 2) slightly higher inflation in developed markets, which

should support the pricing component of revenue growth; and 3) a shift in many companies' portfolios towards products and brands better aligned with consumer needs, which translate into higher volumes.

Profitability should continue to improve from ongoing cost optimisation programmes. Some have even given 2020 margin targets. We see room for further balance sheet deployment, be it for share buybacks or bolt-on acquisitions, as brand portfolios continue to be reassessed. All in all, we think global consumer staples can deliver 8-9% earnings per share (EPS) growth in 2018.

At end 2017, European staples were trading at a 12-month forward price-earnings (P/E) ratio of 19.5x, or a 29% market premium, which is in line with the 10-year average. US staples were trading at 21x P/E, 10% below their historic average. We acknowledge the negative correlation of staples with higher US interest rates, but downside should be marginal as the market already expects three rate hikes in 2018 (although we remain vigilant about the Fed turning more hawkish).

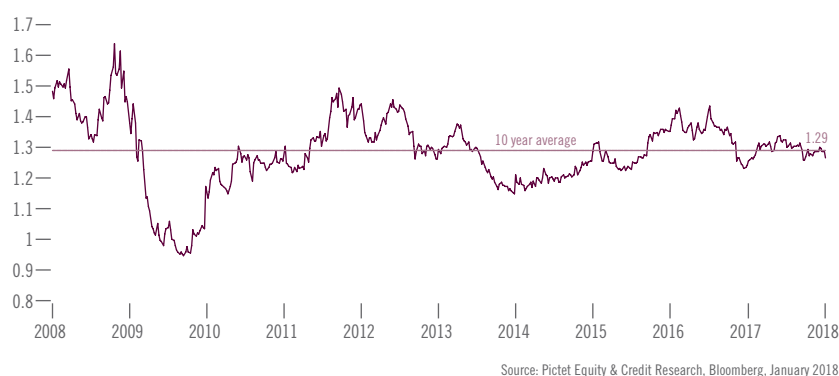
We like the beverages space as it still benefits from high barriers to entry, especially in spirits, but valuation may limit upside short term. We remain bullish about ingredient companies, which should continue to benefit from growing outsourcing as the speed of innovation is increasing. In the US, we prefer staples with international exposure, given certain emerging markets are showing green shoots, and the US dollar is unlikely to be the huge headwind it has been over the past four years. M&A candidates also remain an opportunity.

In Asia, premiumisation, healthy lifestyles, convenience and beauty are all powerful trends. Companies that capture one or more of these consumption trends are well-positioned to expand their positions. ■

EU/US BANKS OUTLOOK TURNING MORE POSITIVE FROM HERE

European banks		US banks	
Headwinds gone	<ul style="list-style-type: none"> › No more death threat to the eurozone › Capital increase done; deleveraging over 	Tailwinds	<ul style="list-style-type: none"> › Interest rates moving up › Capital return (total yield ~7%) with upside
Tailwinds	<ul style="list-style-type: none"> › Loan growth to still recover › Asset quality to continue to surprise positively › Improving outlook for capital returns 	Likely positive	<ul style="list-style-type: none"> › Regulation pendulum shift towards less regulation › Tax reform › Loan growth pick-up
Headwinds about to go	<ul style="list-style-type: none"> › Regulation soon finalised › Turn in interest rates outlook 	Headwinds	<ul style="list-style-type: none"> › Asset quality to normalise gradually (few pockets of excess)

CHART 2: EUROPEAN CONSUMER STAPLES P/E RELATIVE TO STOXX 600 P/E



19.5X

Forward P/E ratio for European consumer staple stocks



JEAN-DAMIEN MARIE

Head of Alternative Investment Solutions
Pictet Alternative Advisors

ASSET FOCUS

Alternatives: time to shine

The scene is set for investors to benefit from a range of alternative investments in 2018.

In 2018, alternative investments should continue to play an ever more crucial role in portfolios, especially if clients and asset managers alike prove eager to look for antidotes to the lacklustre return expectations for classic 60/40 equity/fixed income portfolios. At Pictet Alternative Advisors alone, alternative assets under management (including hedge funds, private equity and real estate) have grown, on average, 8.2% per year since 2008 and now total some USD 23bn.

In a context of mounting macro uncertainty, less liquid alternatives such as private real estate investments or venture capital and other forms of private equity may offer much more than just the potential for more palatable returns and the creation of lasting added value: they may also help protect portfolios. Monetary policies may not have done much to move the needle on inflation lately, but as the US implements tax cuts, deficits increase and inflation starts to pick up, investors may well be in need of a defensive allocation to assets that could offer protection against inflation, such as real estate. Real assets, including real estate, tend to have low correlations to traditional investments such as equities and bonds and stronger correlations to inflation, thus providing a potentially welcome defence for many portfolios.

Real estate. Macro uncertainty is exacerbated by the Brexit 'fog' hanging over London, one of the world's most active commercial real estate markets. Valuations in many primary cities are at historical highs

(see chart 1), yields have reached record lows and competition for transactions has grown substantially. With relatively little capital appreciation on the horizon in the immediate future, we might expect investors to focus on real estate strategies that seek to maximize income generation. Again, given the global economic backdrop, this income is more likely to be found in non-equity parts of the capital stack or through specialised opportunities that take advantage of long-term mega trends including urbanisation, ageing demographics, e-commerce and disruptive technologies that are changing the way properties are used or constructed.

"Niche real estate strategies could be worth a closer look"

Niche real estate segments have emerged such as: co-working/co-living spaces and student housing; residential units for senior citizens; and re-modelled high streets and

logistical hubs to suit new retail paradigms (online, omni-channel etc...). All this is to say that investors may be forgiven for looking bullish to real estate in 2018, whether as inflation protection or to generate income. Pictet has been avidly expanding its real estate activities in recent years, closing its first co-investment fund at the end of 2017 to complement a suite of private real estate debt and equity multi-manager funds.

Private equity. On the private equity front, 2018 may see more challenging times as unprecedented capital inflows and high prices (see chart 2), partially driven by low rates, have fuelled competition for private equity deals and pushed up valuations. Managers are under increasing pressure to rapidly implement significant transformation plans at their portfolio companies in order to meet return expectations. This means that many private equity investors may progressively broaden their horizons beyond traditional large-cap buyout deals.

CONTINUED ON PAGE 21

CHART 1: REAL ESTATE MARKETS AT HISTORIC HIGHS



Base 100, September 2002.
Source: Pictet Alternative Advisors, NAREIT, Bloomberg, December 2017

**RODOLPHE RANOUIL**

Head of Fixed Income Research
Pictet Wealth Management

Still room for credits to perform

Having weathered the odd scare in 2017, fundamentals rather than central bank support will be critical for the continued performance of credit markets this year. So argues Rodolphe Ranouil.

After an excellent year for credit markets in 2017, what is your outlook for the year ahead?

The outlook for 2018 appears quite bright, and the market has so far shown it is able to deal with short-term bursts in volatility. We had two episodes of this in the second half of 2017, the first in August, when North Korean tensions flared, the second in November, when there was a spat of profit taking against a backdrop of low liquidity. This is often seen at the top of credit cycles, when leveraged issuers are tempted by the prospect of an end to loose financial conditions to gear up further. The result is that the market recoils at the drop in quality at the lower end of the credit spectrum, just as we saw in early November.

But the sell-off we saw in high yield was localised and posed no systemic risk. Flows remained fairly bid for investment-grade issues right throughout the mini-scare. The volatility was a secondary-market phenomenon that did not spill over into primary market, where issues continued to be oversubscribed. Overall, credit markets behaved quite well and the volatility proved short lived. Significantly, there was no widening of credit default swap (CDS) spreads for European banks and very limited rise in yields on subordinated debt.

The episodes of significant volatility in late 2017 should not disguise significant spread compression across the credit spectrum throughout most of the year—most noticeably in euro high yield. The widening of spreads in November represented a healthy correction that created new opportunities in this area and others.

In addition, the perception of peripheral risk has improved substantially. Who would have thought that Portugal's sovereign credit would be offering lower yields than Italy (a consequence of a December ratings upgrade), and even Greek debt was performing consistently well in the final months of 2017. In essence, we are seeing a recovery convergence in the euro zone that is leading to spread compression over Bunds. Once legislative elections are out of the way next spring, Italy could see similar spread tightening as other peripheral countries.

Yet the monetary backdrop is shifting, with the Fed raising rates and the ECB gradually curbing asset purchases...

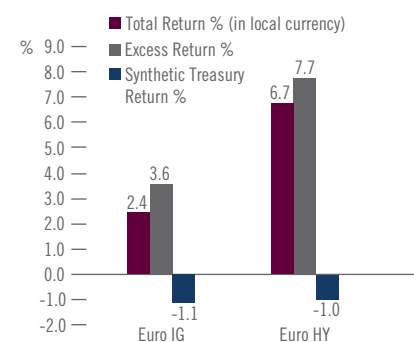
It seems improbable that the relative calm seen in financial markets overall can last, and challenges could mount as the year progresses. Credit professionals will likely exert more caution in 2018, showing much more conviction about the names they are buying rather than on simply finding extra yield. Yet we remain relatively sanguine.

The last time we had serious fallout from an abrupt drop in confidence was in late 1994, when the Mexican peso was suddenly devalued against the US dollar. There was another brief panic at the time of the 'taper tantrum' in late 2013, as markets' fears grew about the Fed's intentions to gradually reduce the money it was feeding into the economy. But that episode didn't last, and the Fed has become quite adept at signalling its intention to gradually reduce its balance sheet and

tighten monetary policy: as long as this remains the case, the credit market should be fine. Economic growth still has traction, default rates are low, liquidity is ample, corporate earnings growth is decent, and the tax cuts just voted through in the US should be good for investment-grade credits in particular, helping push asset values higher.

As for the ECB, it is beginning to prepare the ground for the withdrawal of post-crisis stimulus and we expect it to terminate quantitative easing by early 2019 at the latest. Yet it has decided to extend a reduced asset-purchase programme (EUR30 billion per month) to at least end-September 2018. Incidentally, while many think the ECB may devote a larger share of its asset purchases to corporate bonds to compensate for the dearth of sovereign equivalents, the situation is not that much better when it comes to corporate credits that meet the bank's criteria. Although gross issuance of investment-grade corporate bonds has boomed, net supply has been more modest (which has helped

CHART 1: 2017 PERFORMANCE OF EURO CORPORATE BONDS



Source: ICE Bank of America Merrill Lynch, 31 December 2017

support prices on existing bonds). In short, the ECB is likely to continue to offer some limited support to credit in 2018, but we think that fundamentals are likely to be far more important as well as themes like reflation.

What sectors are likely to thrive in these circumstances?

We remain bullish about financials—banks and (especially) insurers—and we continue to hold overweights in senior and subordinated debt alike. The default risk for select corporate hybrids is also fundamentally mispriced, we believe. The recovery in US oil & gas, as well as in the auto sector in Europe (but not in the US, where sales growth is faltering) are some of our other calls.

We also like “rising stars”—credits that offer attractive spreads rated at the upper end of the high-yield (“BB”) range and that have clear potential to become investment grade. We also see opportunities in fundamentally sound names, particularly in tech which, because they are not rated, offer a meaningful discount to the rest of market.

M&A is another great area of opportunity, given the volume of “jumbo deals” coming to market. A lot of the debt issued to fuel these deals are priced to sell, are very liquid, and come with the promise that the issuer will not come back to the market for a further two or three years.

Select hard-currency emerging-market corporates are also looking attractive—although any moves toward US trade protectionism will need to be monitored. We are also aware that valuations are high, particularly in areas such as US high yield. That is why we have reduced exposure to the lowest-quality parts of the credit spectrum. Our emphasis is on quality, even if that means sacrificing liquidity sometimes.

We believe it is appropriate to look at floating-rate notes, but we could be much more cautious on long-term paper.

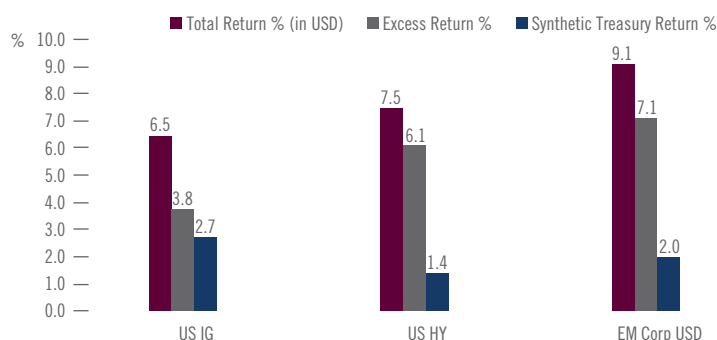
You paint a pretty idyllic picture of the credit market in 2018. What could go wrong?

In spite of healthy economic growth and ever-tighter labour markets, prices remain low. But a rush of inflation that triggers much more aggressive rate tightening than is currently being priced in could cause a lot of stress.

In a different vein, concerns about high corporate debt caused a spike in Chinese sovereign and corporate debt in November. We could certainly have repeat episodes in 2018, especially if the Chinese authorities continue to clamp down on excessive credit growth and shift the economy towards a more consumer-driven model and away from one based on heavy fixed investment. A lot of credits in the metal and mining market are fully valued and could well suffer as a result. You also have continued geopolitical tensions, elections in various countries

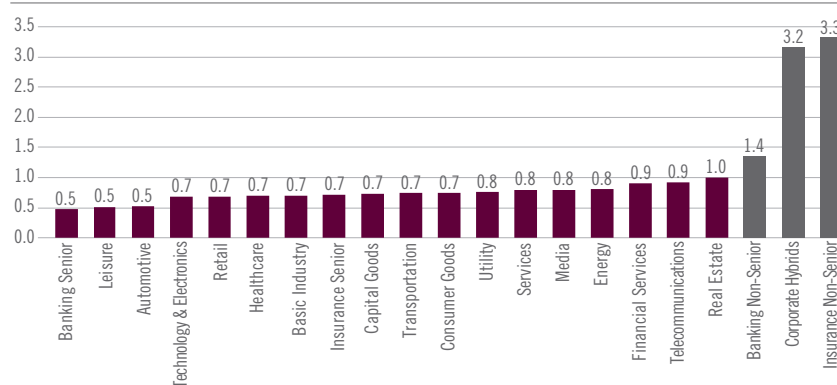
and Brexit-related risks that could impact key UK debt issuers. We think that the risk of a disorderly Brexit is currently not being properly priced by markets. ■

CHART 2: 2017 PERFORMANCE OF USD CORPORATE BONDS



Source: ICE Bank of America Merrill Lynch, 31 December

CHART 3: SECTOR YIELDS TO MATURITY IN EUR IG (IN %)



Source: ICE Bank of America Merrill Lynch, at 2 January 2017



HEINRICH MERZ

Head of Hedge Funds
Pictet Alternative Advisors

ASSET FOCUS

Volatility and dispersion to boost hedge funds

Some key opportunities for hedge-fund strategies to generate alpha are coming more clearly into focus.



ALEXANDRE RAMPA

Head of Hedge Funds
Customised Solutions
Pictet Alternative Advisors

A continued economic recovery in 2018 against a background of policy normalisation can be expected to boost volatility and dispersion within equity, currency and credit markets. In this context, we believe that key opportunities exist in fundamental Long/Short Equity, Relative Value and Event-Driven strategies, with a key focus on Europe, Asia and emerging markets.

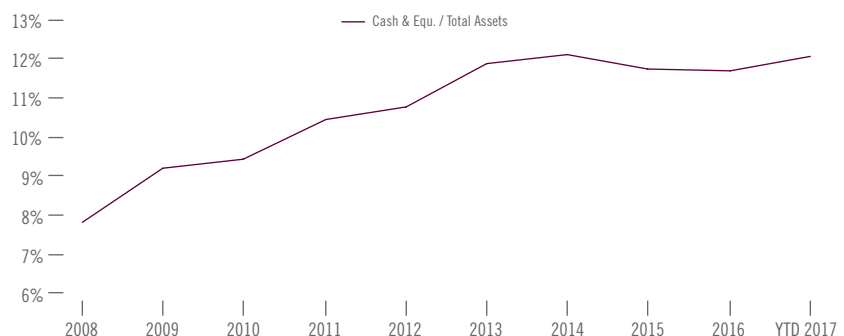
The last year has been a very fruitful one for our equity hedge strategies, both long and short, as the environment has become increasingly propitious for alpha generation (*see charts*). We believe improving financial conditions will allow earnings and corporate action to drive price dispersion, while the industry-specific momentum in growth equities opens opportunities in stock selection. In particular, while the tax overhaul in the US has been priced in at sector level, this is not the case at company level. We have identified and been profiting from corporate change and innovation cycles in different niche areas. Meanwhile, the largest beneficiaries of US tax reforms are expected

to be the consumer, utilities, materials, industrials, banks, health care and more domestic-oriented US businesses in general.

Our positive outlook on Relative Value is posited on the observation that this strategy usually does well when volatility and dispersion turn higher. We think that coordinated central bank ‘normalisation’ will boost rate volatility and we therefore favour fixed-income as well as volatility arbitrage strategies with multi-asset exposure in 2018. Higher dispersion among stocks should favour equity market neutral plays, just as an extended period of capital misallocation offers compelling opportunities in capital structure arbitrage. We are more cautious on credit arbitrage strategies, which might suffer from liquidity disruptions.

Activism and special situations will be an important way to gain alpha this year. We are therefore positive on Event-Driven plays (multi-strategy and merger arbitrage), which had a good 2017, with positive results across sub-strategies helped by M&A activity. We believe merger arbitrage

CHART 1: CASH ON BALANCE SHEETS IS SET TO DRIVE INCREASED CORPORATE ACTIONS



Source: Pictet Alternative Advisors, Bloomberg, November 2017

and 'special situations' (restructurings) should continue to benefit from a further upturn in corporate activity. US tax reforms should not only spur M&A, but also special dividends and buybacks. Life sciences, biotech and financial services are seen as focal points for prospective M&A deals.

We are neutral on Global Macro, but nimble trading-oriented macro strategies (and CTAs) could perform better this year. Global Macro had a disappointing 2017 because of the "reflation fade", but managers are generally sticking to their reflationary views. Energy trading opportunities are likely to be boosted by changing supply-demand dynamics and higher volatility, among other factors. Maintaining emerging-market exposure will also be important.

While we see the market rally extending further, the fragility of our base scenario has increased. Geopolitical risk is being poorly priced, and general uncertainty abounds. There is therefore the potential for dislocation and the probability of reversals, especially in thinly-traded assets. We

are particularly wary of managers exposed to a combination of illiquidity and crowding in the lower-rated credit space. We will also keep an eye on those with a narrow momentum-based focus on the equity space.

Legacy trades were an important driver of returns from classic Distressed strategies in 2017, but are expected to shrink, which means we have an underweight stance on this strategy. However, the seeds of an upturn in default rates are currently being sown through the

increased issuance of lower rated paper. Indeed, pockets of stress have started to surface in sectors like the telecom and media. Conscious of issues lurking around the corner such as limited liquidity, historically tight credit spreads, an approaching maturity wall and a higher proportion of covenant-light bonds, we believe managers in this space with an opportunistic approach and with emerging-market expertise could fare comparatively well. ■

CHART 2: CEO CONFIDENCE REACHING HISTORICAL RECORDS



Source: Pictet Alternative Advisors, Bloomberg, October 2017

CONTINUED FROM PAGE 17

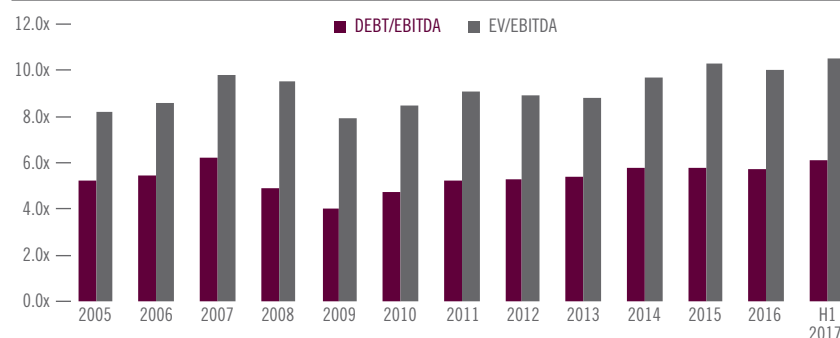
There is a wealth of opportunity in mid-market buyouts and growth equity plays, which are becoming ever more staple parts of mainstream private equity portfolios. Venture capital too is getting more attention from traditional private equity investors. Once the preserve of Silicon Valley, venture capital activity is now happening in Europe and Asia as well. A closer look at the possibilities offered by these trends may well be warranted. But even the most seasoned of buyout investors should be cautious: the venture capital ecosystem is very different from that of buyouts.

Hedge funds. Hedge fund investors are also optimistic about more liquid alternative investments this year. A generally positive outlook with a sustained global recovery coupled with monetary policy normalisation could boost volatility and

dispersion. Divergence in emerging markets is expected to increase due to factors such as rising commodity prices and the impact of Chinese economic policies. These elements may usher in an era of lower correlations, which typically offer greater opportunities to hedge fund managers, especially in short-term and relative-value trades.

All in all, macro trends are indicating that alternative investments are increasingly the corner stone of diversified portfolios. The versatile characteristics of many alternative asset classes, including lower correlations to traditional investments and the luxury of time to generate real returns, seem as though they will be especially appreciated in 2018. ■

CHART 2: AVERAGE DEBT AND ENTERPRISE VALUE (EV) -TO-EBITDA MULTIPLES: EBITDA > USD 50M



Source: Pictet Alternative Advisors, November 2017



LUC LUYET

Currencies Strategist
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ASSET FOCUS

Subdued expectations for the dollar

The long period of US dollar strengthening appears to be at an end. But the greenback's retreat could prove manageable in 2018.

The US dollar had a rough time through a large part of 2017. The greenback found itself exposed by the lack of proper economic steering from the White House, having rallied at the end of 2016 on hopes of a major fiscal boost after Trump's election in November. Furthermore, muted inflation raised doubts about the Fed's ability to continue tightening rates at the pace implied by the median of its projections for the Fed funds rate (i.e. the dot plot). These headwinds facing the US dollar were further magnified by the currency's stretched fundamental valuation at the start of 2017 (CPI-based purchasing power parity suggested the US dollar index was 20% overvalued), leaving almost no room for disappointment.

There were two main reasons for the strengthening of the US dollar in 2011-2016. One was US growth, with growth between the US and the rest of the world narrowing between 2011 and 2015. The second was monetary policy divergence, with the Fed looking to tighten monetary policy as soon as 2013 whereas other central banks were aiming to ease policy. But the improving global growth outlook, particularly in the euro area, and the fact that other central banks outside the US have already started or are looking to normalise their accommodative monetary policies now point to a less supportive environment for the US dollar going forward.

Consequently, the US dollar is likely to weaken in 2018 against the euro, although the magnitude of the depreciation of the US dollar index should be smaller than in 2017. The

first reason is that US growth is likely to be strong in 2018, thanks in part to the recently voted tax cuts. Furthermore, the Fed should remain in rate-hiking mode, making the US dollar one of the highest-yielding of any G10 currencies and hence rather attractive. Finally, the large fundamental overvaluation of the US dollar at the start of 2017 has already been reduced.

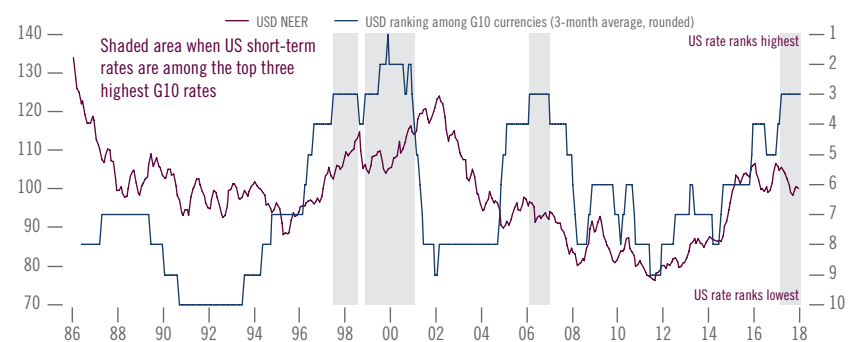
OPPORTUNITIES IN SCANDIES

Overall, the US dollar should remain relatively strong in the first half of 2018, at least against currencies sensitive to short-term interest rate differentials (like the Canadian dollar and British pound) or that are still weighed down by very accommodative monetary policies (like the Swiss franc and Japanese yen). However, the euro should continue to strengthen against the US dollar in 2018. Indeed, notwithstanding the strong growth momentum in the euro area and a less mature business cycle, the European Central Bank is likely to adjust its

forward guidance in the first half of 2018 in order to prepare markets for higher rates by 2019. Consequently, growth and monetary policy should remain favourable to the single currency. European currencies in open economies such as Sweden and Norway, should also see their currencies appreciate against the US dollar in the footsteps of the euro. This is especially the case in Sweden, where inflation has reached the Riksbank's target but monetary policy is still highly accommodative.

The Swiss franc should also benefit from a booming euro area, although this impact will be counterbalanced by capital outflows as the franc's defensive features are becoming less appealing. Overall, we do not see a significant depreciation of the Swiss franc, especially as the Swiss National Bank is likely to join the bandwagon of central banks by turning monetary policy slightly less accommodative as 2018 progresses on the back of improvements in global growth and reduced slack in the job market. ■

USD RANKS AS A HIGH YIELDER (THREE-MONTH INTEREST RATES) COMPARED WITH USD TRADE-WEIGHTED INDEX



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

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