

Perspectives

INVESTING IN 2019

The lessons from last year

Last year was difficult for investors to navigate. Visibility is low, but one should not be systematically negative on prospects – *pages 3-6*

Withstanding volatility

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Elections in India and a slowing economy in China set the scene for equities in both countries – *pages 12-13*

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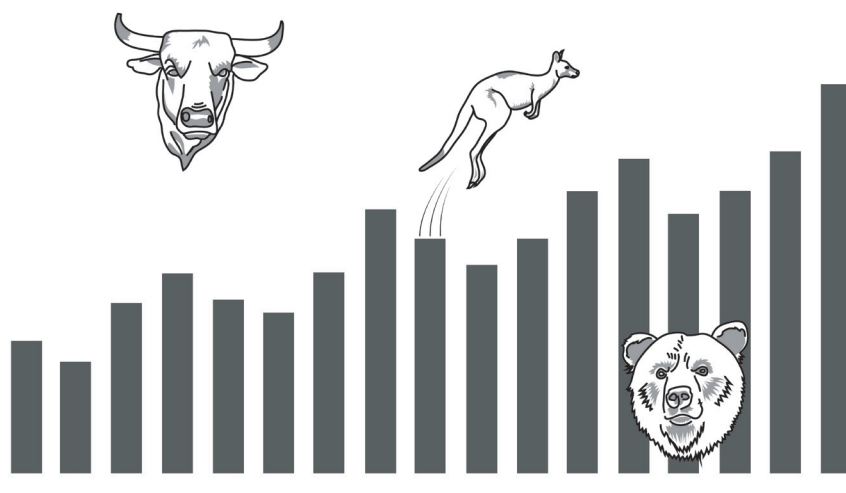
After a difficult year for credit, the focus is on quality. Emerging-market paper is worth examining – *page 16*

Currencies

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Responsible investing

Sustainable and socially responsible investing is no longer niche and here to stay – *pages 20-21*



“The Three Amigos”

We could well see more volatility spikes this year, with bulls and bears alternately marking out their territory. This represents an opportunity for investors agile enough to fast-changing conditions, like kangaroos.

ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT FORECASTS (AT 15 JANUARY 2019)*

EQUITIES INDEXES	CURRENT	DEC 2018	DEC 2019 E
S&P 500	2 610	2 507	2 700
Stoxx 600	349	338	351
Euro Stoxx	338	328	347
CAC 40	4 786	4 731	4 950
DAX 30	10 892	10 559	11 400
MSCI Italy	53	51	55
IBEX 35	8 850	8 540	9 050
MSCI EM (USD)	1 005	966	1 050
MSCI China (HKD)	75	71	76
MSCI India (INR)	1 267	1 263	1 362
TOPIX	1 543	1 494	1 600
SMI	8 825	8 429	9 000
INTEREST RATES (IN %)	CURRENT	DEC 2018	DEC 2019 E
Switzerland - Deposit rate	-0.75	-0.75	-0.50
Switzerland - 10 year	-0.16	-0.25	0.30
Euro area - Refi rate	0.00	0.00	0.25
Euro area - Deposit rate	-0.40	-0.40	0.00
Germany - 10 year	0.21	0.24	0.60
France - 10 year	0.62	0.71	1.20
Italy - 10 year	2.87	2.74	3.40
Spain - 10 year	1.39	1.42	2.00
US - Fed rate (mid range)	2.38	2.38	2.88
US - 10 year	2.71	2.68	3.40
UK - Repo rate	0.75	0.75	1.00
UK - 10 year	1.26	1.28	1.70
Japan - Deposit rate	-0.10	-0.10	-0.10
Japan - 10 year	0.01	0.00	0.25
EM sovereign (local currency)*	6.61	6.86	7.50
*JP Morgan indices			
CREDIT SPREADS (IN BP)*	CURRENT	DEC 2018	DEC 2019 E
European IG	159	154	150
European HY	486	506	500
US IG	154	159	155
US HY	455	533	500
EM Corporates (USD)**	342	362	375
* Bank of America Merrill Lynch indices, ** JP Morgan indices			
FOREIGN EXCHANGE	CURRENT	DEC 2018	DEC 2019 E
EUR/USD	1.14	1.15	1.22
EUR/CHF	1.13	1.13	1.15
USD/CHF	0.99	0.98	0.94
GBP/USD	1.29	1.28	1.37
USD/JPY	109	110	102
COMMODITIES	CURRENT	DEC 2018	DEC 2019 E
Gold	1290	1283	1280
Oil (WTI)	52	45	61
GDP GROWTH RATES	CURRENT	DEC 2018 E	DEC 2019 E
US	3.0%	3.0%	2.4%
Euro area	1.7%	1.9%	1.6%
UK	1.5%	1.3%	1.4%
Switzerland	2.4%	2.6%	1.7%
Japan	1.3%	0.7%	1.0%
China	6.8%	6.6%	6.1%
World	3.9%	3.7%	3.5%
CONSUMER PRICE INFLATION	CURRENT	DEC 2018 E	DEC 2019 E
US (core PCE)	2.0%	1.9%	2.4%
Euro area (headline HICP)	1.6%	1.7%	1.4%
UK (headline CPI)	2.5%	2.5%	2.3%
Switzerland (headline CPI)	0.9%	1.0%	1.1%
Japan (core CPI)	0.9%	0.9%	1.1%
China (headline CPI)	1.8%	2.2%	2.5%
World (headline HICP)	4.0%	3.5%	3.6%

Source: Pictet WM - AA&MR, Bloomberg, Factset, Eikon, AA&MR

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

THE “THREE AMIGOS” MARKETS OF 2019



CÉSAR PÉREZ RUIZ

Head of Investments and CIO
Pictet Wealth Management

**“We should not be afraid
of volatility.”**

2018 was a year of contradictions and global desynchronisation, and while what lies ahead is far from clear, the key to understanding what could happen in 2019 lies in understanding what happened in markets in 2018.

Global growth in 2018 was healthy and earnings were bolstered by US tax cuts. However, most asset classes suffered against a backdrop of rising US rates and a host of trade and geopolitical issues. Indeed, the number of asset classes in positive territory at the end of the year was the lowest in over four decades. Correlations broke down, challenging traditional portfolio diversification. Hedge funds, which typically perform well when volatility spikes, failed to do so too as a result.

Inflation is on the rise, particularly in emerging markets. Central banks are becoming less predictable and remain desynchronised. With the US at full employment and an unemployment rate at the lowest level in decades, our central scenario still sees the Fed raising rates twice in 2019, although with high risk of that going down, depending on how financial conditions develop.

We do not foresee a recession in 2019, but the growth of real GDP and blue-chip nominal earnings is decelerating. Political risk significantly impacted markets in 2018, and with ongoing trade tensions, Brexit and European Parliament elections, it will continue to play a major role in markets this year. However, we expect EBIT (earnings before interest and taxes) margins to remain stable. We are avoiding increasingly leveraged smaller companies but do not expect an earnings recession overall. Capex drove growth in 2018, but given global growth deceleration, we expect lower capex in 2019.

In this uncertain environment, we favour companies with structural growth drivers and pricing power as well as low leverage. And as rates move higher, we prefer dividend growers to dividend earners. We are neutral US Treasuries and increasingly cautious about the prospects for credit.

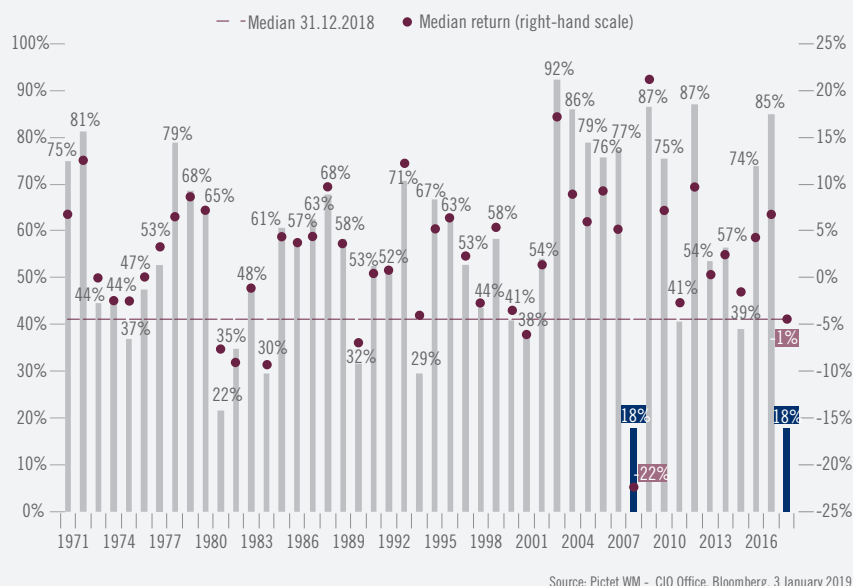
After a tough year, we think emerging-market equities will come back in favour, particularly in Asia. Signs are emerging that a long period of underperformance is coming to an end, as valuations start to look more attractive in light of earnings potential. The weaker USD that we expect in 2019 should offer further support. Fundamental growth drivers are strong in some Asian economies, with India and Vietnam particularly well positioned to withstand the potential effects of rising protectionism and trade disruption. Uncertainty-driven risk remains elevated. For that reason, we have placed the lowest probability to our scenario in years, at 55%. The two biggest risks to our scenario in our view are that the Fed kills the cycle through quantitative tightening and heightened geopolitical risks in the wake of US Defence Chief Jim Mattis’s resignation.

We can be reasonably sure that 2019 will bring the return of a more standard volatility regime, with intermittent spikes, which we do not believe is necessarily a bad thing. As the bear and bull make their cameos in markets, we should not be afraid of volatility. Volatility offers opportunities for tactical investors who are agile and flexible enough to adapt to fast-changing conditions, like the kangaroo. Bearing this in mind, we face 2019 prepared to dance with the market’s “three amigos” – the bear, the bull and the kangaroo.

In a nutshell

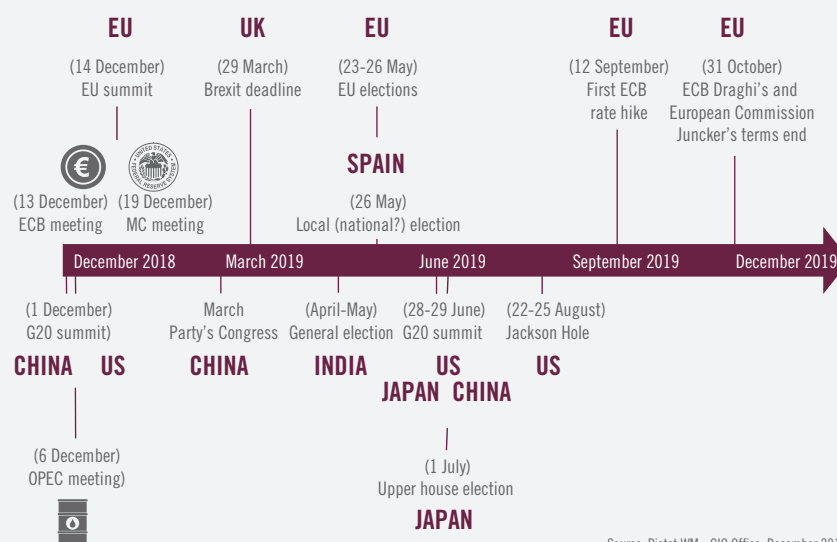
Charts of note

CHART 1: PROPORTION OF ASSET CLASSES REPORTING POSITIVE TOTAL RETURNS BY YEAR (IN USD)



Last year was on a par with 2008 for having such a low proportion of asset classes recording a positive total return. However, with a median return of -4%, asset classes fared better than in 2008.

CHART 2: 2019 TIMELINE OF KEY EVENTS



In a year when the policy and political focus will be largely on Europe, the March 29 deadline for the UK's exit from the European Union will be a particular headline. European Parliament elections in May and moves by the European Central Bank (ECB) to normalise policy will also keep markets occupied.

Source: Pictet WM - CIO Office, December 2018

**CHRISTOPHE DONAY**

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

A year rich in lessons

Following a poor year for most asset classes, “nimbleness” will likely be the watchword for investors in 2019 as volatility stages a comeback and growth slows.

Rich in lessons for investors, 2018 contained elements of the best as well as the worst. On the positive side, we had the best global growth in a decade, inflation remained in a “sweet spot” (neither too hot nor too cold) and corporate earnings rose at a healthy pace (by an extraordinary 23% in the case of S&P 500 companies, thanks to the Trump tax cuts). By contrast, with the exception of 2008, never has a smaller percentage of asset classes turned in a negative performance since 1970 (*see charts on facing page*).

The turn away from expansionary monetary policies, the rise of populism and the related rise in geopolitical tensions all contributed to a disappointing 2018 for risk assets. Unconvinced by strong fundamentals, investors asked for higher risk premiums, and price earnings ratios fell by around 20% in developed and emerging markets alike.

Worryingly, some of the same factors could remain in play in 2019. In Europe alone, the European Central Bank has ended its net asset purchases, while European Parliament elections in May will take place against the backdrop of budgetary disputes involving Italy and the UK’s exit from the EU. The road ahead for Sino-US trade relations remains unpredictable. On top of this, growth momentum is slipping (we think world growth will drop from 3.7% to 3.5% this year), full employment in the US and elsewhere points to higher inflation, and central banks will continue to gradually remove liquidity from markets as they seek to ‘normalise’ policy. On the corporate side, profit growth will be much lower than

in 2018 (around 6% in Europe and the US for the full year, according to our baseline scenario), and market volatility is likely to be higher than for much of last year.

Fundamentally, we believe that the jolts markets suffered in 2018 could be the expression of a transition towards a new market and economic regime, one marked by increasing inflation pressures, more subdued growth in the US and Europe and in some previous growth champions (including China), less ample liquidity and periodic upsurges in volatility. All this means a ‘regime change’ for equity valuations as well, which could remain stuck below the high levels reached between 2016 and early 2018.

“The jolts markets received in 2018 mark a transition towards a new market and economic regime.”

But it is too easy to adopt a systematically negative bias on prospects. On the political front in particular, positive outcomes could be just as likely as negative ones. The slowdown and pause in rate hikes in the US, plus signs that the Fed will slow the pace of balance-sheet reduction could provide traction to risk assets in the months ahead. Trade negotiations between China and the US could gain some traction, for example. The fiscal stimulus being introduced by China and some European countries could help growth perk up again. In other words, the watchword in 2019 will very likely be “nimbleness” (on the downside as

well as the upside), with investors that show tactical agility better placed to rise to the challenge of a fast-changing market environment than those that do not. Even heightened volatility can play into the hands of investors flexible enough to seize the opportunities it presents.

Yet the fact remains that visibility has rarely been as low as it is now. Whereas for the past 10 years we have assigned a 70-75% probability to our core scenario, we are only able to assign a 55% probability to our core macro scenario for 2019, which includes a continuation of festering trade disputes, a fudged Brexit, two Fed rate hikes (but with a risk of one) and the avoidance of a major escalation in geopolitical tensions. We see a 35% probability of a much more negative outcome, and a 10% probability of a more positive one.

All these considerations mean we have become more active in our tactical approach and have been adapting our strategic asset allocation. We have an underweight stance on credit (both investment grade and high yield) and, within a neutral stance on equities, we prefer dividend growers and high-quality stocks with growth visibility. The relatively uninspiring prospects for 60/40 portfolios (60% equities, 40% bonds) also mean we have moved more decisively to include private assets in our strategic allocation. ■



ALEXANDRE TAVAZZI

Global Strategist
Pictet Wealth Management

INVESTMENT INSIGHTS

Looking back, looking forward

The outlook is hazy for risk assets this year, but there are some grounds for measured optimism.

The market environment was challenging in 2018, with only 18% of asset classes reporting positive returns as contraction in valuations more than outweighed healthy earnings growth. In short, markets were unwilling to pay high prices for earnings.

Three things are worthy of note. First, there was a change in the monetary environment last year, with the US Federal Reserve (Fed) increasing interest rates and the European Central Bank (ECB)'s moves towards ending its asset purchases. Second, 2018 brought to an end a long 10-year cycle of positive returns. Third, as volatility spiked at various points in 2018, the worst strategy to be in was leveraged passive investment. In such an environment, investing in short-dated US Treasuries and money-market investments delivered the best returns for US dollar investors, of the order of 3%. Particularly noteworthy was the performance of credit, which was on a par with its plunge in 2011, at the height of the European sovereign debt crisis. Significantly, as the year wore on, investor willingness to "buy the dip" faded as outflows in the asset class reached crisis levels, particularly for high yield.

The end of 2018 was marked by a lack of market depth that amplified price movements. In part because of stringent regulations, banks were unwilling to provide short-term funding in repo markets. This led to a year-end liquidity squeeze and contributed to a significant tightening of financial conditions. As market sentiment soured, the sectors that did best were the most rate-dependent ones, with the view that the Fed would soon have to cut rates again.

The outlook for 2019 is hazy. Earnings growth expectations for 2019 have been dropping. Some stabilisation of expectations might be required to reassure markets. It will also be important to see how corporate margins fare. Corporate profits' share of US GDP have expanded since the financial crisis, while employee compensation has stagnated (*see chart*). With the labour market so tight, can US companies continue to rack up strong record margins, or will labour take a bigger share (bad for earnings, but good for consumer spending)?

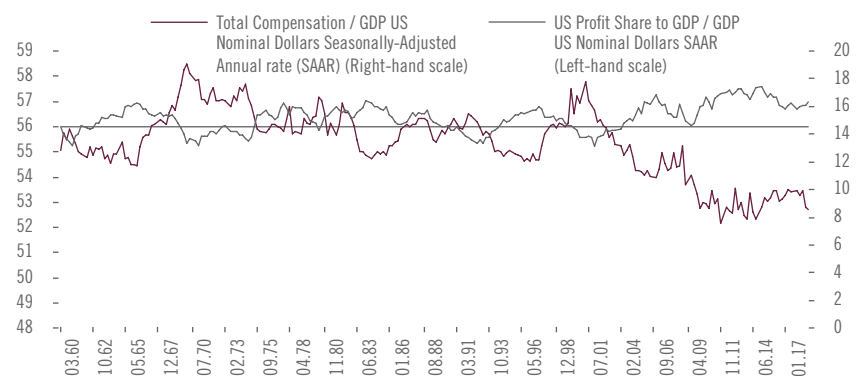
Measured optimism

Policy uncertainty will continue to shape markets. First and foremost, after Fed chairman Jerome Powell's recent comment that the Fed could be 'patient' on rate rises (one reason behind the equity market rebound in the early days of 2019), participants want to know what precisely are the US Federal Reserve's intentions for monetary policy. Along with developments

in US-China trade relations, the looming Brexit deadline on 29 March and European Parliament elections at end-May, market participants will want to see the success of China's response to economic slowdown, as well as the ability of the ECB to carry through its plans for policy normalisation and transition to a new ECB president to replace Mario Draghi.

There are reasons for measured optimism. Far fewer stocks were trading above their 200-day moving average at the start of 2019 than one year before. Based on 12-month forward price-equity ratios, valuations are much lower than in early January 2019, just before the first market jolt of the year. Sentiment is also much less buoyant than at the beginning of 2018. Finally, having sold off earlier, emerging markets have been closing their performance gap with developed markets. As 2018 was such a wretched year for emerging markets overall, base effects could mean 2019 is much kinder to them. ■

THE KEY TO US EARNINGS



Source: Pictet WM - CIO Office, Bloomberg, January 2019



EMMANUEL ETCHART
Advisory FX & Precious Metals
Pictet Wealth Management



ADRIEN MANSET
Advisory Derivatives
& Structured Products,
Pictet Wealth Management

“Rather than the storm that rocks the boat, we see volatility more like wind in the sails”

ASSET CLASS FOCUS

Harnessing volatility in your portfolio across economic cycles

Market volatility can present investment opportunities across all phases of the economic cycle. Depending on the investment objectives and time horizons, solutions are available to use volatility to the investor's advantage.

For some, rising volatility is a symbol of chaos. For us, volatility represents something different. Rather than the storm that rocks the boat, we see volatility as wind in the sails; harnessing that wind can position your boat to safely reach the shore.

Across each phase of the economic cycle, the proactive investor can review his or her portfolio to best position it for the market characteristics that mark each phase. We advocate considering a further step by taking into account solutions that specifically use volatility towards meeting investment goals.

In the early part of the cycle, opportunities abound and derivatives can be used for replication and leverage in order to maximise returns. In the mid-cycle that follows, momentum remains but is limited and derivatives can be used to monetise what remains of it, commonly through volatility carry strategies that create asymmetric return profiles.

As we move into late-cycle territory, as we are now, the timing is perfect to review your portfolio and assess your capacity to withstand the increased

market volatility. Derivatives can be used to adapt the risk-return profile and apply tactical protection. And finally in a recession, market dislocation presents opportunities to buy undervalued securities, restructure the less performing strategies and position your portfolio to prepare for the recovery to follow.

In our view, the key step after positioning a volatility-linked solution along the cycle is in fitting it to the portfolio. This is usually done through two axes detailed in the chart below: time horizon and whether the solution requires selling volatility or purchasing it. In the prevailing volatility regime, we can find opportunities to sell short-term volatility and monetise it in order to increase yield with a risk-adjusted solution. However, the market also offers opportunities to purchase longer-dated volatility, supporting the case for an arbitrage towards capital protected notes, for example. With careful consideration and the right expertise, opportunities can be found to meet your portfolio objectives throughout the economic cycle. ■

VOLATILITY – SELECTING THE RIGHT INSTRUMENT

		STRATEGIC, MEDIUM TO LONG TERM			
LOW VOLATILITY BUY IT	Alternatives to direct holdings Long or Concentrated Equity Positions Capital Protected Notes Cash Extraction Synthetic Forwards	Volatility Carry Alternative to EUR / CHF deposits Fixed Income profile with an Equity Conversion Risk Composite Forwards		HIGH VOLATILITY SELL IT	
	Protection & Overlay Buy protection Buy cheap premium Relative spreads	Volatility Selling Tactical Option Strategies Digital payoffs Dual Currency Investment			
		TACTICAL, SHORT TERM			

Source: Pictet WM - Advisory, January 2019



ZSOLT KOHALMI

Global Head of Real Estate
Pictet Alternative Advisors SA

REAL ASSETS

Truffle hunting

Real estate offers the prospect of attractive long-term risk-adjusted returns to a large extent decorrelated from gyrations of the mainstream stock markets. But as Zsolt Kohalmi explains, a well-trained nose is needed to reveal the opportunities out there.

What are the fundamental reasons for investors to consider direct real estate investing at the current time?

The first reason making real estate investing particularly appealing in today's environment is that the market can offer interesting entry points at times of volatility in the property sector. Where some asset owners see reason for concern and decide to exit certain markets at all costs, we see a hidden opportunity to benefit from attractive below-market entry pricing driven by non-rational decisions to sell.

The second reason is real estate's ability to generate market-independent returns. Especially in times when stocks trade sideways, real estate is a valuable source of diversification thanks to its low correlation to traditional asset classes. In effect, real estate can deliver compelling risk-adjusted returns irrespective of market moves and across cycles, as its performance is driven mainly by two components: current income of 3-7% cash-on-cash annually, and alpha generation through active asset management.

Today we are probably at a turning point in real estate investing. With capitalisation rates (net operating income divided by current market value) having compressed, pushing up the prices of assets, value-creation strategies are ever more compelling. Value-add can be created through improving a real estate asset from a bricks and mortar perspective, or by improving the asset's use and operational efficiency, i.e. "sweating" the asset more. For instance, adapting an office space to address the changing needs of modern tech companies or reducing a building's energy consumption. Private real estate benefits from the luxury of time: its long-term investment horizon allows for intrinsic value creation independent of market swings.

A last reason to consider investing in real estate is downside protection. Tangible assets retain a residual value over time – the "bricks & mortar" component. Even in times of volatility, property will maintain a latent value, and even more so if the quality of the asset and the location are good.

Moreover, real estate serves as an inflation hedge (albeit imperfect), as rents tend to be indexed against consumer price inflation.

You also believe that the European context is particularly favourable for real estate...

We still have low interest rates in Europe, with the current spread of property yields over 10-year government bonds near all-time highs. This makes European real estate particularly attractive compared to other asset classes. While an increase in interest rates could weigh on property yields, we believe it would take a hike of at least 150 basis points before there is any real move in capitalisation (cap) rates. Given the current political instability in Europe, we do not expect to see that anytime soon.

Meanwhile, the underlying fundamentals are supportive. One important factor in Europe's favour is that, except pockets like Dublin, London and key German cities, there has been limited rental growth in Europe overall since 2008. In the aftermath of the global financial crisis, there has been an unwillingness to lend or to invest in development projects. Hence, compared with the US, there has been little new construction of new real estate in Europe or renewal of existing stock during the past decade. So now, as economies recover, with unemployment falling, demand has been outstripping supply in many locations. In Europe overall, office occupancy has reached 93%, and in some places around 95%, which makes office availability a structural issue. There is presently a positive imbalance between demand and supply,

CHART 1: EU UNEMPLOYMENT VS OFFICE OCCUPANCY

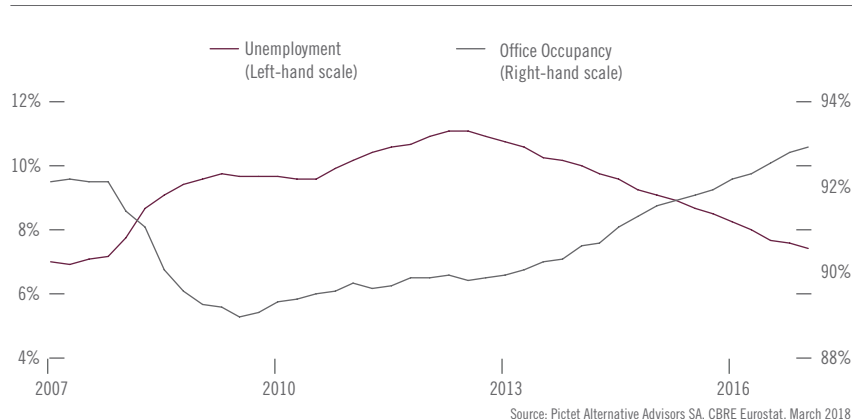
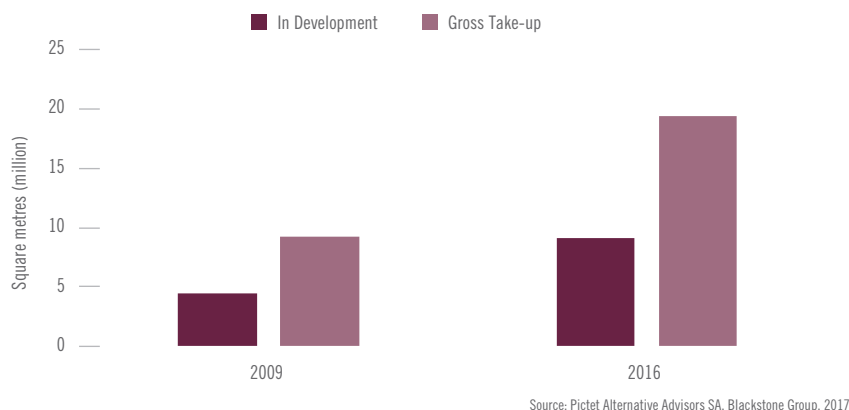


CHART 2: SUPPLY/DEMAND IMBALANCE IN EUROPEAN LOGISTICS



meaning there is significant scope for rental growth in some markets. Then there is the question of what size and type of offices one builds to meet the changing needs.

In what areas do you think direct real estate investing can create value in Europe?

Europe is not as advanced in the economic cycle as the US, and base rates have not risen yet, meaning the opportunities for value creation in Europe are immense, whether in terms of refurbishment, building additional space or turning smaller assets into portfolios for institutional investors. Overall, institutionalisation—the running of real estate assets by professional managers—is still at an early stage in Europe (under 5% of private rented accommodation in the UK is managed professionally, for example).

Demographic trends are reshaping the way we use real estate today, leading to new opportunities in the sector. For example, household formation is evolving: millennials today are contributing to the growth in single households as opposed to family ones; while when it comes to home ownership, they prefer to rent rather than buy. These trends will increasingly be felt in many European markets, giving rise to a need for modern, for-rent homes designed for single young professionals. At the other end of the spectrum, there is a growing need for specialised senior housing stock to accommodate Europe's ageing population, as well as student housing to host increasing numbers of inbound international students.

In the office sector, the flexible workspace model is still at a nascent stage in continental Europe when compared to the US. As European technological hubs are emerging, there is an interesting opportunity to modernise the Old World's office stock for tech occupiers. In retail, growth in new logistic hubs has trailed the shift in consumption patterns. Traditional retail, suffering in the US because of overbuild, is still growing in parts of Europe. Instore sales are growing in some locations, and well-sited shopping centres, perhaps with some repurposing, still hold potential.

“Demographic trends are reshaping the way we use real estate today, leading to new opportunities in the sector.”

Are there any particular markets in Europe grabbing your attention?

Some markets in Europe (Ireland and Spain, for example) are red hot and we expect short-term volatility, especially as economic growth starts to waver. But irrespective of our macro view, there are micro opportunities given how opaque real estate is. We are engaged in a ‘truffle hunt’, meaning that we are looking for deals that allow for “better than market” risk-adjusted returns. But that requires a well-trained nose in the form of origination capacity—in

other words people based in local markets who can dig up off-market transactions.

Can technology and governance trends also be vectors of growth in direct real estate?

Real estate is one of the last industries to be disrupted by tech innovation. But proptech, a set of cross-industry technologies that is changing the way we research, rent, buy and manage property, is set to have a significant impact. Take the example of energy consumption: today, proptech solutions are allowing for an in-depth analysis of real estate assets' environmental performance, making it possible for asset managers to become efficient, responsible investors. And when it comes to ESG (environmental, social and governance) investing, what differentiates real estate from other asset classes is that a responsible investment approach has an immediately tangible and measurable impact on the social well-being of the property's tenants and surrounding communities.

With direct real estate investing very much in vogue, what more can Pictet bring to the table that its rivals can't?

While direct real estate is a new initiative, Pictet has been investing in real estate since 2007. Our real estate team has decades of experience and has handled about USD30 billion in real estate transactions in the past eight years. What places us in a uniquely favourable position in real estate is our on-the-ground presence that allows us to go ‘truffle hunting’. Pictet has offices in 18 gateway cities in Europe, including 6 with dedicated real estate investment professionals. This allows us to really know and understand the peculiarities of each individual market, while many other direct real estate teams work almost exclusively out of London. ■

**JACQUES HENRY**

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**GREGORY KUNZ**

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Low expected equity returns lend defensive tilt to allocation

Against the backdrop of uncertainty and falling earnings growth expectations, we favour companies with structural growth drivers and pricing power as well as low leverage. And as rates move higher, we prefer dividend growers to dividend earners.

Over the long run, earnings growth has fuelled equity performance. However, in 2019, it is expected to provide little support. The global economy was strong in 2017 and 2018, with nominal GDP growth well above potential. However, this growth is expected to slow in 2019. Based on our estimate of the elasticity of earnings growth to nominal GDP, we should see US earnings growth of close to 9% in 2019. Nevertheless, owing to two main micro drivers, we believe this figure may be out of reach.

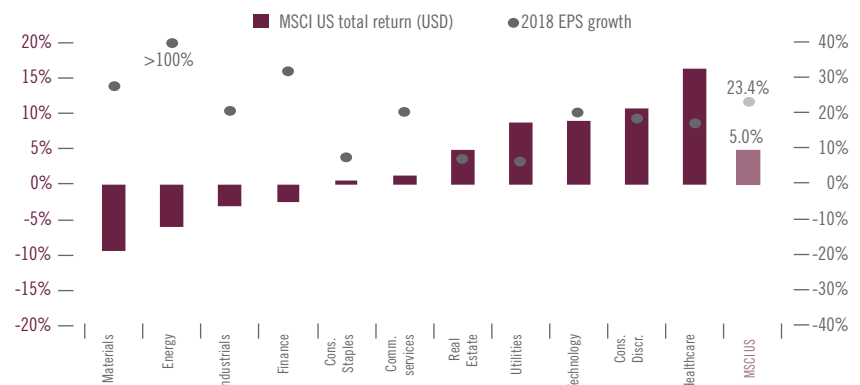
First, the oil price collapse in Q4 18 poses a downside risk to US GDP growth, given that the US has become a major oil exporter in recent years. Oil also accounts for a significant share of earnings growth among the S&P 500 and the Stoxx Europe 600 companies. The oil and gas sector contributes 0.4% out of the 7% consensus earnings growth expected for 2019 in the US and Europe, which is at risk of further downside revisions.

Second, with last year's US tax cuts behind us, the base effect looks challenging, especially in the US, where 2018 earnings growth is expected to come in at around 24%, after an outstanding Q3 18 with growth above 27%.

Taking these two micro drivers into consideration, in 2019, single-digit earnings growth appears most likely. Based on our estimates, we expect 5% earnings growth in the US and Europe, rather than the 9% suggested by our elasticity of earnings growth to nominal GDP model.

The strong derating of equity valuations we witnessed in 2018 came on the back of rising investor uncertainty driven by global trade tensions and geopolitical risks. Elevated levels of uncertainty tend to drive volatility higher and equity valuations lower as investors require a higher risk premium in order to invest, as witnessed in December. As factors weighing on valuation have not vanished, there is still a risk that market valuations have not reached a trough.

CHART 1: SOLID EARNINGS PER SHARE (EPS) GROWTH NOT ENOUGH TO PUSH 2018 TOTAL RETURNS HIGHER IN THE US...



Source: Pictet WM, Bloomberg, 2018

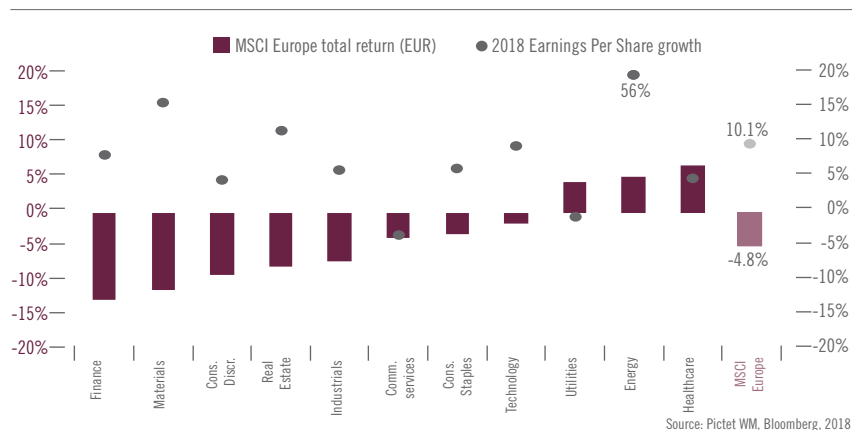
Currently, the chief supporting factor for equity total returns is dividend yield, which is close to 4% in Europe and over 2% in the US. In addition to dividends, share buybacks have also been supportive in the US, after the 2018 US tax reform incentivised companies to repatriate cash, which was then used to buy back shares. Looking ahead, a 2% US buy back yield would be consistent with historical standards, as US companies tend to return around 100% of their net income to shareholders through a combination of dividends and buybacks. Following this hypothesis would make the total cash returned to shareholders similar in the US and Europe. Overall, we expect single-digit returns for developed equities in 2019.

Nine years after the Global Financial Crisis, the equities investment landscape becomes increasingly challenging to navigate. This year, we think emerging-market equities will come back in favour, particularly Chinese and Indian equities. Beyond this regional view, we take a bottom-up approach by company type for 2019. As earnings growth and markets lose momentum, dividends will account for an even larger portion of equity total returns this year. With these factors in mind, we have identified three themes for companies we favour for investment in 2019: companies with earnings visibility and pricing power, dividend growers and structural growers.

Earnings visibility with pricing power

We expect a slowdown in corporate earnings growth driven by a deceleration in global growth, cost pressures and trade tensions in 2019. In this environment, sectors and companies with pricing power should be able to pass through cost increases incurred. Mounting cost pressure, be it from labour, raw materials or tariffs, will likely impair operating leverage, earnings and cash flow generation. Therefore, the ability to price comes as a natural hedge, and we would favour sectors with high and growing gross profit with low volatility profiles. These companies can be found in such sectors and industries as pharmaceuticals, life sciences, luxury and

CHART 2: ...OR IN EUROPE



beverages. The healthcare sector, with over 50% gross margin, looks particularly attractive, with segments like biotech, pharmaceuticals and life science showing the strongest margin profile. Meanwhile, metals and mining and building equipment are likely best avoided.

Dividend growers

Because we expect marginal multiple expansion (if at all) this year, we prefer stocks whose future performance is backed by tangible dividends rather than relying on earnings growth expectations. With this in mind, we prefer stocks whose future performance is backed by tangible dividends rather than relying on earnings growth expectations. Among dividend yielders, we look for companies with strong track records of dividend growth and solid balance sheets because we believe they are less likely to cut dividends should the earnings or macro outlook deteriorate. As history has shown, companies that are able to sustainably grow their dividend have healthily outperformed the broader market as well as the highest yielders, highlighting the importance of cash generation and allocation. Here as well, healthcare and some consumer staples segments look particularly attractive, as stable business models drive recurrent cash flow generation. Among dividend growers, we would mention the (very) high free cash flow margin of 20% generated by some of the large US tech companies, which should be sustainable, should we avoid a recessionary scenario.

Structural growers

Considering the various risks and uncertainties weighing on the macro cycle, we favour companies with desynchronised growth. Companies that are developing and delivering innovative products and services that generate structural growth have seen little change in fundamentals, while cyclical companies face the risk of being exposed to negative earnings revisions at this point of the cycle. The trends that we currently look at within this theme include e-commerce, cloud services, and population ageing. These companies can provide better protection in a global slowdown by playing the “future consumer” in a context of shifting demographics and new ways of living. We would be selectively exposed to industrials through the automation, security and safety of supply chains

Given a likely more volatile macro background and slower global growth, these three themes should favour a more defensive investment approach, as potential rises for well-established business models and quality earnings compounders to become attractive investments once more. This would stand in contrast to the past two years, when an exceptional growth environment boosted investor risk appetite and drove capital to stocks whose earnings generation proved to be volatile and at times secondary. This is not to say that we should chase after companies with well-known corporate moats, but at this time of the cycle it seems reasonable to put a greater emphasis on sector and company fundamentals. ■



JULIEN HOLTZ

Emerging Markets Strategist
Pictet Wealth Management

ASSET CLASS FOCUS

A tale of two countries

China and India face distinct challenges in 2019, with implications for their respective stock markets.

Equity investors are often reminded that one does not buy an economy, but companies. A closer look at transmission mechanisms from macroeconomic conditions to market movements is therefore critical to successful investing, especially in emerging markets (EM), where stable relationships can be hard to come by.

Granted, both China and India exhibit superior growth within the EM space – albeit with diverging momentums. However, there is no guarantee that corporate earnings growth (which is a significant driver of stock prices over the long term) should follow the same trend.

By definition, nominal GDP correlates better with sales than earnings, which are distorted by a myriad of idiosyncratic factors (productivity, investments, financing structure, etc.). In addition, indices used by investors to assess equity markets may, by construction, provide a biased view. This is especially the case in China, where a mosaic of share classes has sparked a proliferation of indices with varying compositions.

The gap between nominal GDP and earnings growth can thus be significant. While the Indian economy grew on average by 13% per year between 2009 and 2017, Indian equities grew by 7.1%. In China, earnings of offshore and onshore equities respectively grew by 5.2% and 7.5% annually, while the average annual GDP growth was 11.1% over the same period.

Change is rarely linear. Annualised performances can therefore hide sequences of strongly heterogeneous sub-regimes of growth and inflation.

Earnings growth, in turn, does not systematically translate into market performance.

Strong divergences in valuation ratios such as price-to-earnings (P/E) across markets, sectors and companies, as well as their volatility over time, are a stark reminder that there is more to stock returns than corporate earnings. Geopolitics, monetary and fiscal policy, investor expectations, inflation, interest rates, credit conditions and liquidity are all reflected in market prices through valuation ratios.

Indian and Chinese equity markets again provide a clear illustration of this phenomenon. Between 2009 and 2017, 12-month forward P/E ratios expanded by 85% for Indian equities, 58% for Chinese offshore equities, and only 16% for Chinese onshore equities.

All in all, Indian equities returned 16.3% to investors annually (in local currency terms) over nine years, well above nominal GDP growth, whereas Chinese offshore and onshore equities returned 11.5% and 11.3%, respectively,

in line with the country's economic expansion (*see chart 1*).

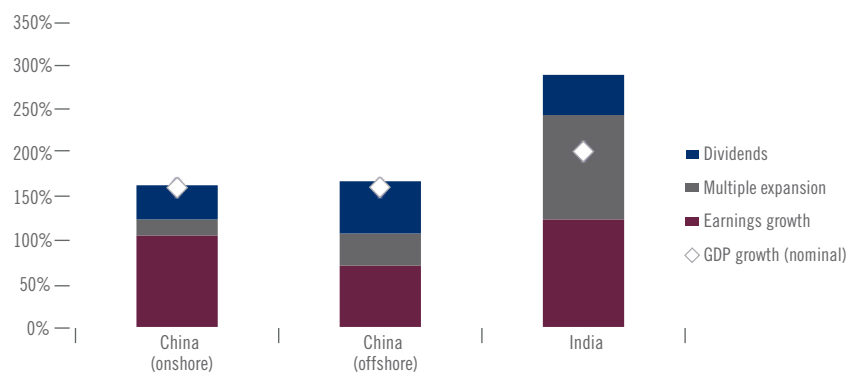
Accounting for changes in foreign exchange significantly reduces the performance gap, however. In USD terms, Chinese equities returned around 12% and Indian equities 13% annually.

What should we expect in 2019?

2018 proved a dreadful year for EM equities in general. China was particularly hard hit in this regard as onshore indices dropped by 25% in RMB terms. This was mainly driven by a stark multiple contraction (-30% to 9.4x) on the back of increasing trade tensions with the US and slowing domestic growth.

India, on the other hand, was better able to weather turbulence: the MSCI India returned a flat performance in INR (-9% in USD). The de-rating of Indian equities was indeed limited compared to Chinese equities (-5% to 17.9x) and compensated by earnings growth.

CHART 1: BREAKDOWN OF EQUITY PERFORMANCE (2009-2017) & COMPARISON TO GDP GROWTH



Source: Pictet WM - AA&MR, Factset, January 2019

Chinese and Indian equities thus enter 2019 with contrasting situations. The former corrected sharply in 2018 and are among the least favoured within EM funds. The latter exhibit historically rich valuations and are currently favoured by investors (see chart 2).

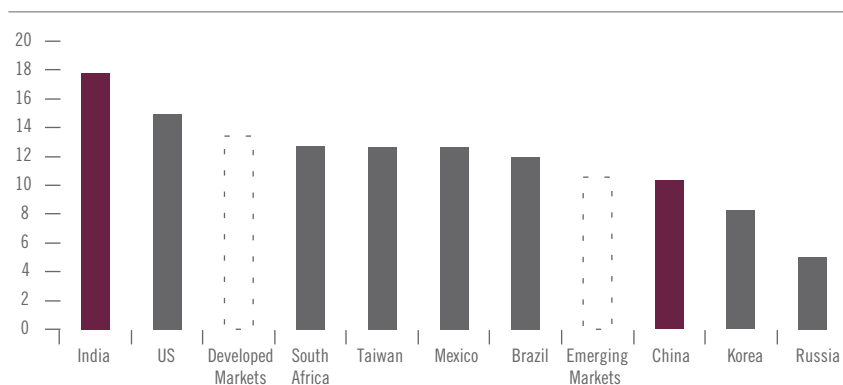
Financial markets can become fixated on certain issues, especially in times of stress. In this regard, 2019 should prove no exception, with investors' attention focusing on a specific set of political and economic aspects.

China: fighting a perfect storm

In China, the continuation of trade tensions (and their potential mutation into broader US/China tension) as well as the government response to the current economic slowdown will be key. Both aspects weighed heavily on stock prices in 2018, creating a "perfect storm" for the Chinese government to manage.

- Tariffs initiated by President Trump served as the catalyst for last year's underperformance of EM equities relative to developed markets. Although this would likely reverse should tensions ease – recent events seem to indicate a limited deal is achievable in the coming months –, some disagreements appear deeply rooted and may well persist through 2019. We consequently do not expect much tailwind for valuations from this front.
- A real upside could instead come from policymakers. Avoiding an economic hard landing remains a top priority for Chinese authorities, motivating the sharp deleveraging campaign of the past two years. However, as debt is necessary for the economy to grow, and the effectiveness of monetary measures is fading, the government is likely to step up in place of the private sector via fiscal and budgetary stimuli. With a government debt below 50% of GDP (vs around 100% for advanced economies), it can certainly afford to do so. Although it is still too early for Chinese authorities to reveal what cards are in their deck, their ability to prop up growth and reverse market sentiment should not be underestimated.

CHART 2: 12-MONTH FORWARD PRICE-TO-EARNINGS RATIOS FOR SELECT EQUITY MARKETS



Source: Pictet WM - AA&MR, Factset, January 2019

India: politics, politics and politics

The Indian economy is relatively isolated from trade tensions and should benefit from recent structural reforms. Furthermore, earnings are expected to recover sharply after several years of lacklustre growth, led by financials as they contended with a clean-up pushed by the Reserve Bank of India. We therefore see politics as the driving force in Indian markets in 2019.

- General elections are due to take place in April or May for the 17th Lok Sabha (lower house), and will decide the next Prime Minister of India. A victory by the ruling BJP party would provide political stability and facilitate the continuation of gradual structural reforms. Nonetheless, a stable government might prove even more critical for markets than which party ends up governing (BJP or the rival Congress party).
- Furthermore, the combination of recent losses by the BJP in three key states' local elections and the appointment of a more dovish governor at the helm of the RBI strongly raised the likelihood of more accommodative policies, both monetary and fiscal, in the run-up to the elections. This in turn decreases the risk of missing earnings expectations.

The risk of a hung parliament aside, our base case relies on solid and steady earnings growth in 2019, more than compensating for a moderate normalisation of valuation ratios.

Diversification is the only free lunch.

One can hardly paint a pristine bullish outlook for EM assets in a rate-hiking environment in which markets increasingly seek early end-of-cycle signals. As such, some diversification is necessary; hence our current positioning on China and India's contrasting equity markets.

Not all is gloom for EM in 2019, however. A potential pause in the Fed's hiking cycle and a weaker US dollar may benefit EM as a whole, while persisting low oil prices would be a net positive for both China and India. Overall, we believe both markets have the potential to yield a total return close to 10% in 2019 (in local currency terms). ■

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

What signals are being sent by the US yield curve?

The declining spread between shorter- and longer-term Treasury yields is being seen as a harbinger of slower growth. But distortions have been caused by Fed monetary policy and traditional correlations are being tested.

**JACQUES HENRY**Senior Cross-Asset Strategist
Pictet Wealth Management

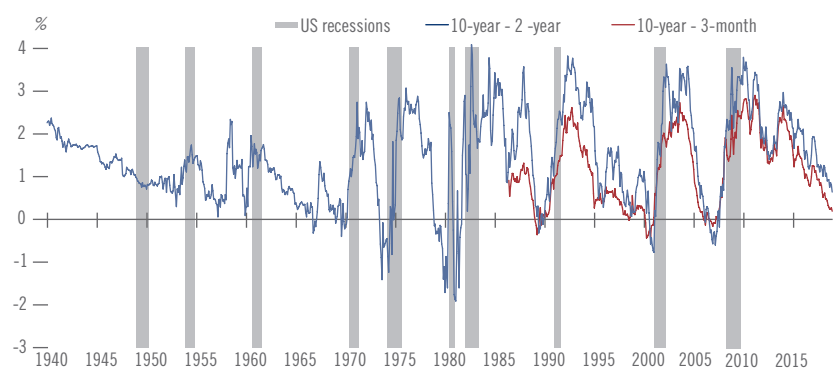
The recent flattening of the US Treasury yield curve has rattled investors. This is because, historically, an inversion of the slope of the yield curve has signalled an impending economic recession (see chart 1). The immediate cause for inversion usually lies with the Federal Reserve's (Fed) rate hiking cycles, given the cooling effect rising interest rates have on the US economy.

The yield curve is impacted by monetary policy

However, the widespread use of quantitative easing (QE) by central banks around the world has distorted the signal being sent by yield curve movements and kept them low by historical standards. Indeed, through its massive purchases of US Treasuries in the aftermath of the financial crisis, the Fed has contributed to a flattening of the yield curve by pushing down the US Treasury term premium (i.e. difference between the yield investors receive for holding a long-term bond and a shorter-term bond) since 2010. The Fed's quantitative tightening since 2017 (i.e. the passive reduction

of its balance sheet) along with President Trump's December 2017 tax cuts led investors to expect a revival of the term premium. Indeed, both events should have increased the number of long-term US Treasuries available to private investors, pushing prices down and yields up. But in the event, the term premium has remained stubbornly negative since 2017 for three reasons. First, historically, rate hiking cycles have usually led to yield curve inversion, because investors start anticipating that rates will be cut again as recession risks rise. Second, the US Treasury Department has been taking advantage of low short-term yields to increase issuance of mostly short-term bonds, also relieving pressure on longer-term rates. Third, the Fed holds only about 11% of all 10-year and 30-year US Treasuries outstanding, meaning that its balance-sheet reduction has limited impact on these parts of the yield curve. All in all, paltry increases in the long-term Treasuries available to private investors together with expectations that the contractionary effects of the Fed's hikes will exceed the benefits of fiscal

CHART 1: US YIELD CURVE SLOPES AND US ECONOMIC RECESSIONS



Source: Pictet WM - AA&MR, Factset, Global Financial Data, December 2018

stimulus on economic growth have limited the rise in long-term Treasury yields and pushed the US yield curve dangerously close to inversion.

We expect the US yield curve to invert in 2019 as the Fed stops its hiking cycle due to weakening US growth. The main hope for renewed steepening resides in an acceleration in inflation and robust economic growth in 2019. Indeed, fears that inflation pressures were building did lead to a steepening at the beginning of 2018.

The yield curve as a measure of economic health

The yield curve is negatively correlated with the output gap, which measures the difference between gross domestic product (GDP) and long-term average (potential) GDP. Usually, a steep yield curve is an indication of remaining slack in the economy, whereas a flat yield curve indicates an economy operating at close to potential. This long-term relationship, stretching back to the 1960s, has strengthened further over the last 30 years.

Moreover, recessions are more likely to occur when inflation is accelerating, as it is another indication of an economy close to potential. In 1966, 1977 and 1998, yield curve inversion in the US provided false recession signals because inflation was either muted or trending downwards.

A simple model consisting of three main variables has been developed to forecast an economic recession: the yield curve slope, the interest rate on US commercial paper and the Conference Board leading index. A yield curve inversion of -100 basis points (in other words, the two-year yield 1% higher than the 10-year one) at the end of 2019 would not necessarily be enough to materially increase the probability of a recession by Q1 2020. For this probability to rise above 50% would require the US 90-day commercial paper rate to climb from 2.9% at the end of 2018 to above 5%, and a Conference Board Leading Economic Index of -4 by the end of 2019.

The protection status of core sovereign bonds

10-year core sovereign bonds have a dual function: as well as protecting portfolios, they are meant to generate

CHART 2: ONE-YEAR US EQUITY-BOND CORRELATION AND THE US TWO-YEAR YIELD



a return for investors, like any other asset.

The cornerstone of diversification in a balanced portfolio is the combination of assets with low-to-negative correlations in order to smooth its volatility. Therefore, it is worth paying attention to the US sovereign bond-equity correlation, which historically has often been low or negative. It turns out that this correlation tends to increase when the US yield curve flattens, highlighting how challenging the current environment is from a diversification point of view. Moreover, US bond-equity correlation is closely linked to the US two-year Treasury yield, which is highly dependent on the Fed's monetary policy (see chart 2).

The protection offered by 10-year US Treasuries often comes to the fore when risk increases, because equities tend to sell off in such circumstances whereas core sovereign bonds post a positive return as their yields go down. This inverse relationship between the performance of bonds and equities has held true for two-thirds of the time over the past 200 years, and for nearly 90% of the time since 2000. In 2018, this relationship was challenged, as US Treasuries delivered negative returns when equity markets sold off in February, and again at the beginning of the equity market correction in October. Yet the long-term relationship has not entirely broken down, because from early October to 20 December, the S&P 500 posted a 15% loss, whereas 10-year US Treasuries posted a 3.2% gain (total returns in US dollars).

In 2018, a traditional 60/40 US equities-to-bonds portfolio would have posted a small loss. The last time this happened was during the global financial crisis in 2008 and 2009. A risk-parity portfolio of equities and bonds (involving an optimal asset allocation between S&P 500 and 10-year US Treasuries according to volatility levels) would have led to similar losses. Yet in December, risk-parity strategies performed a bit better, thanks to low equity exposure (around 25%) and the positive return of US sovereign bonds. Historically, a risk-parity approach outperforms a 60/40 portfolio before a recession and in the early part of a recession.

The yield curve and banking industry returns

Traditionally, returns from bank stocks relative to the broader equity market have tended to be positively correlated with interest rates. But in 2018, US banks underperformed the broader equity market, despite rising rates, until the third quarter, breaking the correlation with the 10-year US Treasury yield. A similar event occurred in 2013. Overall, since 2017, the slope of the yield curve has decoupled from the returns for bank equities.

A flattening yield curve is not supportive of bank lending activity. Following their recent underperformance, US bank valuations are starting to look attractive, but have not yet reached an extreme valuation level relative to other sectors. ■

**LAURÉLINE CHATELAIN**Fixed Income Strategist
Pictet Wealth Management**RODOLPHE RANOUIL**Head of Fixed Income Research
Pictet Wealth Management

The rise in US corporate leverage triggered fears that a slowdown in profit growth and higher interest rates could precipitate the end of the credit cycle. In Europe, euro credit spreads renewed their ascent following the global equities sell-off late last year, rising in tandem with US spreads. EM companies score better on fundamental metrics, as they have been reducing leverage faster. EM spreads were hit particularly hard throughout most of the year, due to US dollar appreciation against most EM currencies and the deceleration in trade volume growth amid US-China trade tensions and Chinese economic softening, all of which pushed spreads wider. Counterintuitively, the sell-off in late 2018 has had a limited impact on EM spreads, proving that between more robust fundamentals and faltering US dollar strength, EM companies could be positioned to better weather a further slowdown in global economic activity in 2019.

Special caution is warranted for BBB-rated issuers (just above high

Plenty of reasons to focus on quality and even more to start looking at EM

2018 proved a difficult year for credits globally, as spreads moved wider in both the developed market (DM) and emerging-market (EM) space. However, the reasons behind the decompression across the two markets differ.

yield), as a turn in the US credit cycle usually brings about a wave of credit rating downgrades and defaults. The rating category now represents a significantly larger proportion of both the investment-grade and the high-yield indices in EUR and USD than it did 10 years ago.

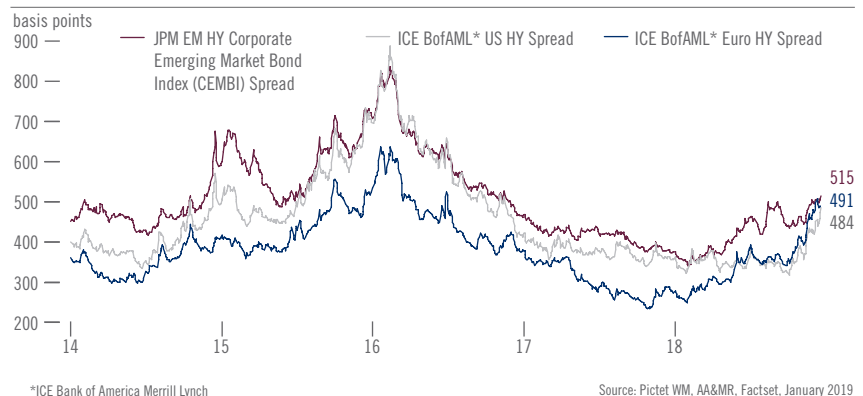
That is an effect of companies adjusting their financial policies against a backdrop of low interest rates and readily available credit. At this point in the cycle and with the resurgence of volatility, we now need to distinguish between the core and the fringe BBB-rated issuers. The core are substantial businesses that are financially equipped to release cash flows in restructuring conditions. The fringe are typically companies that were attracted to issuing debt by the low rate conditions prevailing at the time. Furthermore, within the core BBB-rated space, one has to distinguish between issuers that are still using the debt markets to enhance shareholder pay-outs and those that have started rolling out de-leveraging

programmes. That last category is our preferred segment of the credit market.

Selectiveness will also be key in EM credit. We focus on geographic areas with limited political risk and issuers that have strong fundamentals, as measured by their deleveraging momentum and business profile stability. The diverging stories of Mexico and Brazil last autumn provided a flavour of what to expect this year in terms of political risk impact. Similarly, we prefer issuers based in Kazakhstan to their Russian sector peers, given the running risk of additional US sanctions on Russia.

Taking stock of the more difficult environment we expect in 2019 for credit, we have turned underweight on DM credit, favouring quality in the credit space and companies with deleveraging programmes and solid earnings capabilities. We remain neutral on EM corporates but pay special attention to regional stories and emphasise the selection of robust companies with a deleveraging tilt. ■

EM AND DM (HIGH YIELD) CREDIT SPREADS WIDEN





HEINRICH MERZ

Head of Hedge Funds
Pictet Alternative Advisors SA

ASSET CLASS FOCUS

Building robust portfolios for volatile markets

In 2019, we expect a turn in the economic cycle to drive market uncertainty higher. Which hedge fund strategies are likely to work in such an environment?

The unfolding global environment is providing the potential for greater dispersion across underlying asset markets, while temporary liquidity-driven dislocations as well as plentiful corporate actions will drive arbitrage opportunities. In this context, we believe that market-neutral equity, relative value, and discretionary macro strategies will be the most rewarding in 2019.

Late-cycle market dynamics have historically benefitted discretionary macro managers. The dynamics likely to prevail this time around are, we believe, likely to be less clear-cut and transparent than in prior turns in the economic cycle, given the range of issues currently unsettling markets. As a result, our preference is for managers focused on tactical trading and those active in areas likely to see extensive dislocations, such as emerging markets.

We also remain aware that markets, particularly in the US, will begin to lose two pillars of support: stock buybacks and the impetus provided by the December 2017 tax cuts. As a result, we continue to avoid long-biased strategies, especially those active in the less liquid credit space (although we stand ready to increase allocations substantially should opportunities arise).

Equity hedged. Equity long/short, broadly defined, will face a challenging 2019. The potential top-down hazards are many. Despite a relatively robust underlying global economy and ongoing innovation, market volatility will strain portfolio management. Equity long/short managers will need to be able to insulate their portfolios from a series of macro-geopolitical risks while remaining true to their investment processes. By contrast, we are bullish on the prospects for **market-neutral strategies**. We believe that managers accustomed to running low net exposures and balanced factor risk will be less side-tracked than other equity hedge fund managers. Those with strong shorting skills will find increasing opportunity. Managers with either short-term (one-to-two months) or long-term (18 months to three years) horizons face a lower probability of being shaken out of positions than those with intermediate horizons.

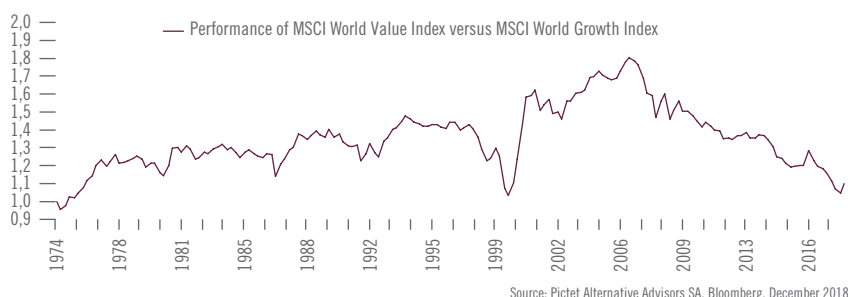
We believe that market leadership will broaden, providing greater opportunities for value-focused managers that have long suffered from the effects of quantitative easing (*see chart*).

Relative value. Relative value managers represent an attractive investment proposition given expectations for elevated levels of volatility across asset classes, as well as divergence between and greater dispersion within asset classes. We expect multi-strategy managers to capture a greater number of tactical investment opportunities given their ability to move quickly during periods of dislocation.

Within relative value, we see specific opportunities in **fixed-income and volatility arbitrage**. Volatility arbitrage managers should benefit from higher volatility and a reduced participant pool (investment banks have largely exited this space). The environment for fixed-income arbitrage remains attractive in light of the US Federal Reserve's balance-sheet reduction and the end of the European Central Bank's net asset purchases. We remain cautious about the use of leverage within this strategy.

Macro. Macro managers enter 2019 with a tactical mindset. The broad outlook and positioning of macro managers has turned markedly bearish (for credit in particular) and risk averse. While we are neutral macro overall, within this area we favour fundamental and trading strategies. Managers expect disturbances and discontinuities (and hence opportunities) as the year progresses. In contrast to current positioning, we expect Discretionary Macro managers, particularly those with opportunistic and tactical trading teams, to react swiftly to potential market regime changes. We also favour those managers with proven capability in trade implementation via derivatives. ■

VALUE SUFFERS RELATIVE TO GROWTH UNDER QUANTITATIVE EASING



**LUC LUYET**

Currencies Strategist
Pictet Wealth Management

2019 currency outlook

In 2019, the outlook for currencies will likely be clouded by political uncertainty. At the same time, global growth moderation also appears rather likely, with China's economy slowing and the US tax cut effects fading.

As a result, the global environment should prove supportive of currencies such as the Japanese yen and the Swiss franc. More precisely, the extreme undervaluation of the yen and reduced scope of its use as a funding currency should more than offset the negative impact of an unfavourable rate differential.

Similarly, lingering European political uncertainty should weigh on capital flows out of Switzerland. As such, the Swiss structural current account surplus should continue to favour a strong franc, despite an unsupportive rate differential.

The external environment in 2019 could remain challenging for emerging market (EM) currencies, although to a lesser extent than in 2018. On the one hand, the likely moderation in global economic growth and the festering trade dispute between the US and China could weigh on risk appetite and hence, on capital inflows to EM countries. On the other hand, the Fed is likely to end its tightening cycle, which should weigh on the US dollar and keep a lid on US rates.

We expect a rebound in oil prices during the winter season, followed by some weakness due to an unsupportive oil supply/demand balance in the second half of 2019. This sequence would suggest a year of two halves for oil-sensitive currencies such as the **Norwegian krone** or the **Canadian dollar**.

A resynchronisation of the US economy with the current global trend and the end of the Federal Reserve's tightening cycle suggest that the two key drivers of **US dollar** strength in 2018 should weaken in 2019. With that, we believe that the US dollar should gradually depreciate in 2019.

Overall, it is difficult to single out EM currencies as particularly attractive (undervalued and offering decent real rates, with strong external buffers and low idiosyncratic risks). In our opinion, the **Brazilian real** comes close, but will be highly dependent on the fate of much-needed social security reforms.



The **euro**, which behaves like an anti-US dollar, should therefore gradually appreciate. More expansionary fiscal policy and the drop in energy prices should provide some tailwinds to growth. The expected abatement of political uncertainties should also prove supportive of the euro. This is also backed by euro-area GDP growth, which should stay above trend, alongside ongoing monetary normalisation by the European Central Bank.

Political uncertainties will likely remain a theme for EM currencies overall in 2019 and particularly for the **Russian rouble and Mexican peso**.

Additional US sanctions against Russia are likely, supporting a cautious stance on the Russian currency, despite elevated carry and the rouble's strong external buffers. In Mexico, some time will likely be needed for the market to fully discount uncertainties linked to President López Obrador's new administration, which suggests poor peso performance in the meantime.

Although weighed down by current account deficits, the **Indian rupee and Indonesian rupiah** have some attractive features. Their relatively closed economies mean the two countries are less exposed to the global cycle than other EMs and their statuses as net oil importers mean that they benefit from a decline in oil prices. Consequently, these currencies could prove attractive in the second half of 2019.

The direction for **Antipodean** currencies will likely depend on how the US-China trade dispute evolves and how it impacts the Chinese growth outlook. Interest-rate differentials do not favour outperformance of Antipodean currencies, as central banks are in no hurry to raise rates, especially in New Zealand.

Given a challenging external environment, we maintain a cautious stance on EM currencies with weak external buffers. In particular, the outlook for the **South African rand** looks rather poor. Indeed, weak GDP growth and renewed concerns about credit risks could further undermine the rand's prospects.



MARIE-LAURE SCHAUFELBERGER
Group Investment Stewardship
Pictet Group



TULLIO MUSSO
Chief Operating Officer,
Investment Platform
Pictet Wealth Management

PICTET AND THE FUTURE

Responsible Investing is here to stay

Responsible Investing has come a long way over a relatively short period of time and its growth rate is accelerating. As awareness of the topic grows, investors are discovering the superior financial returns in addition to the social and environmental benefits associated with this approach.

Responsible Investing for everyone

Responsible Investing comes in a wide variety of flavours, from Environmental, Social and Governance (ESG) integration, where these factors are included in traditional financial analysis, to impact investing, where meeting a goal with social benefits is prioritised ahead of financial returns, and everything in between. One thing these varieties share in common is the fundamental trend they are following, an accelerating growth trend that is here to stay.

To illustrate this and put it into context, we show here a timeline of critical events over the last decade that have defined this trend, starting with the 2006 launch of the United Nations-sponsored Principles for Responsible Investment (PRI). These six principles are presented as a voluntary and aspirational set of investment principles that offers a menu of possible actions for incorporating ESG issues into investment practice.

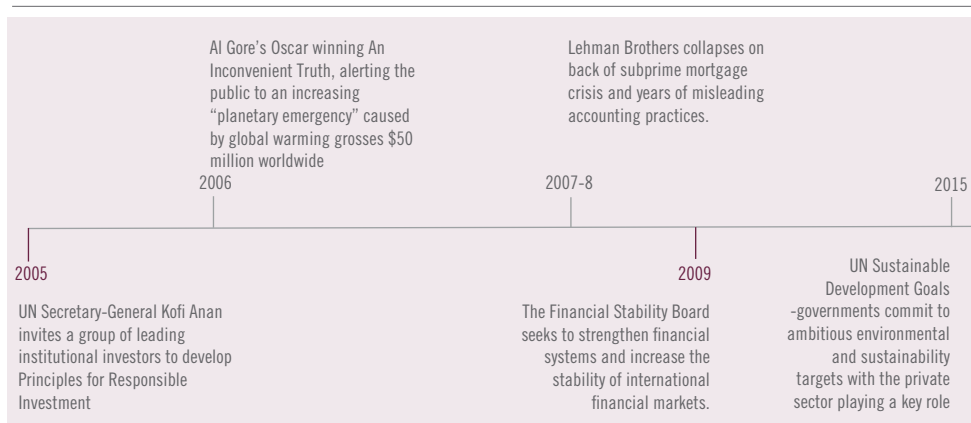
Since its launch, PRI has acquired over 1,800 signatories, with over USD 70 trillion in combined assets under management.

Regulatory implications and the opportunity they present

Last year, the EU published its action plan on financing sustainable growth with three objectives: 1/ to reorient capital flows towards sustainable investments; 2/ to manage financial risks stemming from ESG issues; and 3/ to foster transparency and long-termism in financial and economic activity. The institutionalisation of such initiatives makes them applicable to all players within the EU ecosystem, given the implication on legislation to follow. In 2018 alone, five legislative proposals were put forward that will have an impact on financial service players serving a European clientele.

Now there is an opportunity to be seized, because there are two sides to this coin. Failing to act will leave

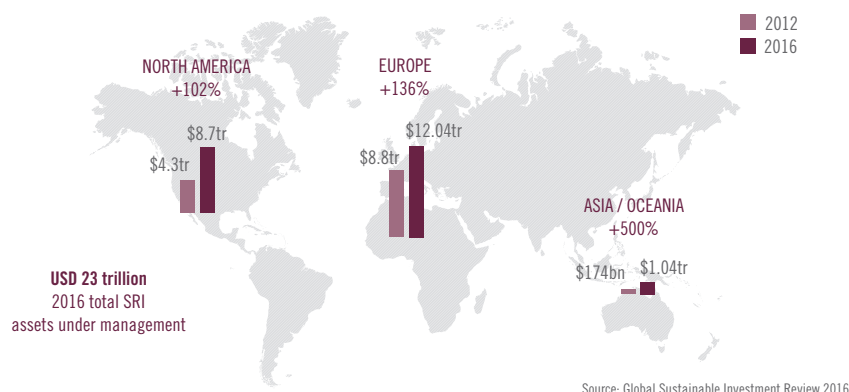
AN ACCELERATION OF ACTIVITY



1,800

Number of signatories to
UN-supported Principles for
Responsible Investment

GROWTH IN THE VALUE OF SUSTAINABLE INVESTMENTS



us exposed to a variety of risks, from regulatory-related ones to those associated with stranded assets (e.g. oil reserves in a future when government policy is targeted at staying below 2°C). However, taking action now can not only mitigate these risks, but even present a financial opportunity. This transition already in motion is the single biggest investment opportunity of the coming decades.

Drilling down to the industry level, let us take a look at shipping as an example. In 2005, the International Maritime Organization put a limit into effect on sulphur in fuel oil at 4.5%. This was lowered to 3.5% in 2008, and today the cap is 0.5% by 2020. Some large players within the shipping industry are setting themselves targets to go beyond this, to cut net carbon emissions to zero. These forward-looking industry leaders are seizing the opportunity presented to ensure they are still in the game in decades' time, while those who

fail to act now could face big surges in costs down the line or even bankruptcy as certain ships may become stranded assets. And stranded assets are not unique to the shipping industry, as each industry is threatened by its own specific version, defined as an asset that “loses economic value well ahead of its anticipated useful life”¹. Stranded assets are inherently costly but in many cases avoidable through long-term, forward-looking leadership and planning.

In 2015, the UN laid out a set of 17 Sustainable Development Goals (SDGs) to transform the world we live in by 2030. What they did not provide is a roadmap to transition towards these goals, which will require trillions of dollars in investment, from climate-friendly technological innovation to financing services that foster human wellbeing. While not all of these goals will present an equal investment opportunity, our role as wealth managers is to mine and

“Annual growth rates of ESG-labelled investments are out-pacing industry growth rates”

¹ Saltzman, D (2013) ‘Stranded Carbon Assets – why and how carbon risks should be incorporated in investment analysis’. Generation Foundation.

The Paris climate accords negotiated by 196 states with the goal of keeping the increase in global average temperature below 2 degrees.

2015

2015

The FSB launches Task Force on Climate-related Financial Disclosures to develop a set of voluntary, consistent climate-related financial risk disclosures used by companies for the purpose of investment.

Pictet, in cooperation with Swiss Sustainable Finance, spearheads an open letter to index providers, imploring them to exclude controversial weapons from mainstream indices.

2017

EU publishes action plan on financing sustainable growth; with 3 objectives.

2018

identify the best long-term sources of return for the individual or family, who may be seeking pure financial or a combination of social and financial returns.

Sustainable investments – where the investment flows are

With close to 12% annual growth, ESG-labelled investments are outpacing industry growth rates and now account for USD23tn in assets, globally. A continuation of this trend would imply that such ESG-labelled investments would account for half of total investments by 2020. This growth is in part driven by many institutional investors, which has driven asset managers to transition their product mix from mainstream to ESG-integration. In the future, the term Responsible Investing may disappear and simply be referred to as investing.

Indeed, Pictet is at the forefront of the wave moving in this direction. On the human rights level, in 2011, we adopted a controversial weapons exclusion for all of our actively managed portfolios. However, this did not address client assets in index-tracking passive strategies as our duty in those cases is to replicate the index in full.

To take action, Pictet, in cooperation with Swiss Sustainable Finance, spearheaded an open letter to index providers, engaging them to exclude controversial weapons from mainstream indices. By late 2018, we had secured the backing of over 80 Swiss and international asset owners and managers with combined assets of USD4.2tn.

Many Pictet clients are actively involved in philanthropy and charity work as a way of giving back and doing good. In fact, high-net-worth individuals, from Bill Gates to Warren Buffet, were the first to start pushing for a transition to a more sustainable and inclusive form of capitalism. It is their energy and quest for a legacy beyond financial returns that ultimately inspired and influenced institutional investors to start integrating these factors more broadly.

Our goal is to continue this conversation and accelerate our journey to a brighter future for people and planet, by promoting awareness that doing good can extend into financial portfolios as well. With the right momentum, it could kick-start a virtuous circle of asset allocation that delivers environmental, social and health benefits in addition to financial returns. ■

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