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JULIUS BAER NEXT GENERATION INVESTMENT THEMES

ARISING ASIA
DIGITAL DISRUPTION
ENERGY TRANSITION

FEEDING THE WORLD
SHIFTING LIFESTYLES

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Current prices
22 February 2017, unless specified otherwise
Dear Reader

For those looking for ultimate certainty, economics and financial markets are no place to find comfort. In fact, they are all about dealing with uncertainty. Investors are rewarded in the long run exactly for the fact that they are providing the first and second lines of defence by holding stocks or bonds in their portfolios and clinging to their positions – even while being outside their comfort zone.

‘At this point in time it is particularly difficult to come up with a decent forecast’ is a running joke in our trade. While things look amazingly easy in hindsight, the opposite holds true when facing things in the near and distant future. Yet even with our considerable experience the situation in the first few months of 2017 looks exceptionally challenging. This can be proven by objective statistics such as Economic Policy Uncertainty indices, which have been flagging 20+ year highs in uncertainty lately. Even more puzzling is that at the same time the positive surprises in the economy have jumped to five-year highs as well, leaving most investors ever more desperate. Will the uncertainty lead to extraordinary boom times ahead? Or is this just a flash in the pan before things take a major turn for the worse?

Finding the method to this madness is a major topic in this issue of Insights. We want to shed light on this presumed conundrum and provide you with guidance in these particularly uncertain times.

Christian Gattiker
Head of Research & Investment Solutions
Investment view: Page 6
• Never before have investors felt so uncertain about the direction of the global economy. Yet, the world economy has delivered more positive surprises lately than at any time over the last five years.
• The investment regime may be shifting from deflationary bust to inflationary boom and the investment stance should reflect this potential shift.

Technical analysis: Page 8
• Apple is trading at all-time highs – is it on track to reach USD1,000?
• Nasdaq 100 remains a core investment holding for investors.

Next Generation: Page 10
• Cybersecurity has become an essential part of IT spending for firms and governments, as they have to safeguard their growing digital assets from rising malicious threats.
• We recommend that investors take a diversified approach due to the sector’s considerable volatility, consolidation potential and technology risks.

Economics: Page 12
• According to the leading indicators the cyclical upturn in 2017 is gathering momentum and strength, particularly in the major advanced economies.
• US policy under Trump will most likely be highly reflationary, leading to more growth and inflation. The upcoming elections in the Netherlands, France and Germany could raise market volatility; however, constructive expectation is justified.

Currencies: Page 13
• Diverging policy between the US and the other major economies continues to be the overriding theme shaping the currency outlook this year. The new Trump administration’s rhetoric has created some hiccups for the USD rally.
• Policy issues are weighing on the outlook for the euro with anti-EU candidate Marine Le Pen most likely making it to the second round of the French presidential elections. The euro should regain its footing if Le Pen fails to win the second round.

Fixed income: Page 14
• Without the tailwinds of supportive monetary policy but with expectations of higher fiscal spending, inflation and growth in the developed world, credit-risky bonds have outperformed the more conservative segments of the bond market over the last year.
• We still prefer credit to duration risk but lower our rating on US high-yield and emerging market hard-currency bonds to Neutral after the strong tightening of spreads. We maintain our call for deeply subordinated debt of solid European banks.

Equities: Page 16
• For the first time in several years, the likelihood of equities achieving positive earnings growth has increased. However, current valuation levels limit their upside potential.
• Based on the relative attractiveness of equities compared with other asset classes, we advocate a balanced approach with a slightly cyclical bias when it comes to sector allocation.

Commodities: Page 18
• The reflation euphoria continues to prop commodities. The asset class is prone to a near-term setback as fundamentals are overhyped and the bullish sentiment is ripe for profit-taking.
• Oil prices should retreat as the shale revival undermines the oil producers’ supply deal. USD strength and rising interest rates should outweigh concerns over Trump’s policies and pressure gold.
GLOBAL BUSINESS CYCLE OVERVIEW

GROWTH (real GDP y/y, %)

<table>
<thead>
<tr>
<th>Average</th>
<th>2015</th>
<th>2016E</th>
<th>2017E</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>2.6</td>
<td>1.6</td>
<td>2.5</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.9</td>
<td>1.7</td>
<td>1.6</td>
</tr>
<tr>
<td>UK</td>
<td>2.2</td>
<td>2.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.8</td>
<td>1.4</td>
<td>1.6</td>
</tr>
<tr>
<td>Japan</td>
<td>1.3</td>
<td>1.0</td>
<td>1.1</td>
</tr>
<tr>
<td>China</td>
<td>6.9</td>
<td>6.7</td>
<td>6.5</td>
</tr>
<tr>
<td>World</td>
<td>3.3</td>
<td>3.1</td>
<td>3.5</td>
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</table>

GDP = gross domestic product

INFLATION (CPI y/y, %)

<table>
<thead>
<tr>
<th>Average</th>
<th>2015</th>
<th>2016E</th>
<th>2017E</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>0.1</td>
<td>1.3</td>
<td>2.4</td>
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<tr>
<td>Eurozone</td>
<td>0.0</td>
<td>0.2</td>
<td>0.18</td>
</tr>
<tr>
<td>UK</td>
<td>0.1</td>
<td>0.6</td>
<td>0.18</td>
</tr>
<tr>
<td>Switzerland</td>
<td>-1.1</td>
<td>-0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Japan</td>
<td>0.8</td>
<td>-0.1</td>
<td>0.5</td>
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<tr>
<td>China</td>
<td>1.4</td>
<td>2.0</td>
<td>2.0</td>
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<tr>
<td>World</td>
<td>2.8</td>
<td>2.9</td>
<td>3.2</td>
</tr>
</tbody>
</table>

CPI = consumer price index

CENTRAL BANK RATES (%, p.a.)

<table>
<thead>
<tr>
<th>Year-end</th>
<th>2015</th>
<th>2016</th>
<th>2017E</th>
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<tr>
<td>USA</td>
<td>0.50</td>
<td>0.75</td>
<td>1.50</td>
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<tr>
<td>Eurozone</td>
<td>0.05</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>UK</td>
<td>0.50</td>
<td>0.25</td>
<td>0.25</td>
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<tr>
<td>Switzerland</td>
<td>-0.75</td>
<td>-0.75</td>
<td>-0.75</td>
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<tr>
<td>Japan</td>
<td>0.10</td>
<td>-0.10</td>
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</table>

E = Estimate

10-YEAR GOVERNMENT BOND YIELDS (%, p.a.)

<table>
<thead>
<tr>
<th>Year-end</th>
<th>2015</th>
<th>2016</th>
<th>2017E</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>2.24</td>
<td>2.49</td>
<td>2.65</td>
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<tr>
<td>Eurozone</td>
<td>0.60</td>
<td>0.20</td>
<td>0.45</td>
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<tr>
<td>UK</td>
<td>1.88</td>
<td>1.39</td>
<td>1.20</td>
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<tr>
<td>Switzerland</td>
<td>-0.18</td>
<td>-0.13</td>
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<tr>
<td>Japan</td>
<td>0.30</td>
<td>0.06</td>
<td>0.00</td>
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ASSET CLASS VIEW

<table>
<thead>
<tr>
<th>View</th>
<th>Asset class</th>
<th>Risk category</th>
<th>Focus on ...</th>
<th>Avoid ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>→ Cash</td>
<td></td>
<td>Conservative</td>
<td>Treasury inflation-protected securities (TIPS)</td>
<td>Core European government bonds</td>
</tr>
<tr>
<td>↑ Bonds</td>
<td></td>
<td>Quality</td>
<td>EUR high-grade bonds</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Opportunistic</td>
<td>Deeply subordinated debt of solid European banks, Asia’s real estate, European peripheral debt</td>
<td></td>
</tr>
<tr>
<td>↑ Equities</td>
<td></td>
<td>Speculative</td>
<td>Selected USD high-yield issuers, selected local-currency exposure</td>
<td></td>
</tr>
<tr>
<td>↑ Commodities</td>
<td></td>
<td>Conservative</td>
<td>Healthcare</td>
<td>Consumer staples, utilities; US dividend growers, US large caps</td>
</tr>
<tr>
<td>↑ Currencies</td>
<td>Thematic Next Generation (cross-asset class)</td>
<td>Medium (cross-asset class)</td>
<td>Chile, Hong Kong, Japan; energy, information technology, consumer discretionary, financials; European small caps, US small caps, European high dividend</td>
<td>Singapore, South Africa; industrials, real estate; European large caps</td>
</tr>
<tr>
<td>→ Currencies</td>
<td></td>
<td>Opportunistic</td>
<td>China, India, Philippines, Poland, Vietnam</td>
<td>Turkey</td>
</tr>
<tr>
<td>↑ Next Generation</td>
<td></td>
<td>Speculative</td>
<td>Industrial metals, iron ore, oil, silver, soybeans</td>
<td>JPY, TRY, HUF, KRW</td>
</tr>
</tbody>
</table>

Vietnam: Julius Baer makes no offering in local markets; Philippines: For residents of the Philippines, investments into the local market are bound by legal restrictions.

INVESTMENT IDEAS: EQUITIES

<table>
<thead>
<tr>
<th>Topic</th>
<th>Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Swiss dividends</td>
<td>LafargeHolcim, Lonza, Mobimo</td>
</tr>
<tr>
<td>Overweight insurance</td>
<td>AXA, Munich Re, Swiss Life.</td>
</tr>
<tr>
<td>Overweight Philippines</td>
<td>Bank of the Philippine Islands, Metrobank, Universal Robina</td>
</tr>
</tbody>
</table>

For further information about the mentioned companies, please refer to page 17 or the respective Baer Insight Equity/Fixed Income Fact Sheet. Please note that these publications may have a different distribution scope.

Source of all tables and graphs: Julius Baer
Never before have investors felt so uncertain about the direction of the global economy. Yet, the world economy has delivered more positive surprises lately than at any time over the last five years. The investment regime may be shifting from deflationary bust to inflationary boom and the investment stance should reflect this potential shift.

**TERM OF THE MONTH:**
Economic Policy Uncertainty Index

The Global Economic Policy Uncertainty (GEPU) index runs from January 1997 to the present. The GEPU Index is a national income-weighted average of national EPU indices for 18 countries: Australia, Brazil, Canada, Chile, China, France, Germany, India, Ireland, Italy, Japan, Netherlands, Russia, South Korea, Spain, Sweden, the United Kingdom, and the United States. Each national EPU index reflects the relative frequency of own-country newspaper articles that contain a trio of terms pertaining to the economy (E), policy (P) and uncertainty (U). In other words, each monthly national EPU index value is proportional to the share of own-country newspaper articles that discuss economic policy uncertainty in that month.

Source: Economic Policy Uncertainty (EPU), Julius Baer

The ‘uncertainty vs surprise’ conundrum

The global economy is truly entering an age of uncertainty, particularly since the US presidential elections in November 2016. While it is a truism to say that the future is fraught with great uncertainty, we can rely on hard statistical facts to explain that ‘this time is different’. In fact compared to the availability of data over the past 20-odd years, the Global Economic Policy Uncertainty index (see term of the month) is now at all-time highs (see chart 1). So at no point in time since the Clinton administration were the public more puzzled about what lies ahead in terms of economic policies. Yet amazingly, economic surprise indices jumped over the last few weeks to levels not seen over the past five years (see chart 2). These indices measure how many net positive data points are reported in the world. In a nutshell, there is more uncertainty than ever before (which is bad) but incoming economic data is better compared to the past five years (which is good). This conundrum, however, does not help comfort global investors as the explanation does not seem straightforward. Are there two separate issues, i.e. there is high uncertainty and at the same time we are experiencing a completely unconnected global recovery, which is by coincidence happening at the same time? Or is the high uncertainty just a harbinger of a new investment regime that is gaining traction?

Political risks can also turn into opportunities.

**Chart 1: Economic policy uncertainty (EPU) skyrocketing**

![Chart](https://example.com/chart.png)

Source: Bloomberg Finance L.P., Julius Baer
The benefit of the doubt for an inflationary boom

Hopefully, we will be able to give definite answers to these tricky questions at some stage. Perhaps by 2020 – by then, we will have the full growth and inflation backdrop for the decade. In the meantime, however, investors will face the problem of having to make investment decisions while not knowing the answers. Given the size and scope of recent signals from the real economy and the economic stimulus in the pipeline, we are leaning towards giving the current situation the benefit of the doubt, i.e. that the world is undergoing a transition from deflationary bust to inflationary boom (see chart 3).

The gorilla in the room – elections

For most investors political uncertainty abounds as the US economic policies have to become clearer and the outcome of European elections in the Netherlands, France and Germany is still quite open. Not to mention what is happening behind the scenes in China. Yet, let us not forget that uncertainty is not a one-way street. Political risks can turn into opportunities as well.

One step at a time

Given the highly uncertain backdrop and particularly with European elections on the agenda, we do not think that investors should be overly bold at this juncture. Instead, they should stay invested and if they have not done so yet, take one step at a time. This means they should add some inflation linkers to a conservative fixed-income portfolio, and some European subordinated bank debt to high-octane bond positions. The same applies for equities where conservative investors should buy healthcare names for the long term given their valuation discount. On the other hand, risk-oriented investors can add cyclical and interest-rate-sensitive exposure, such as energy stocks, information technology or insurance names.

Chart 3: From deflationary bust to inflationary boom?

Source: International Monetary Fund, Datastream, HCWE Worldwide Economics, Julius Baer

Christian Gattiker, CFA, CAIA
Apple at USD1,000?
Apple has risen to a new all-time high on a total-return basis, surpassing the peaks reached back in March 2015. What a drought – after 89 weeks, Apple is finally back at new all-time highs. One might be concerned since the stock is also the largest-capitalised stock in the world. Nevertheless, intuition can be misleading. Historically, Apple has done quite well after long periods of drought. Over a three-month period, it managed to rise 12%, and even 30% over a six-month period. Taking into account the historic six-month performance, Apple’s stock should rise to USD170 per share. Some of our readers might remember that Apple had a stock split of 1:6 in 2014. Consequently, if we multiply today’s split-adjusted target price (USD170) by a stock split factor of 6, we get USD 1,020. In other words, if the stock split had not taken place in 2014, Apple could potentially reach USD 1,000 per share. We thus recommend that investors retain their holdings in Apple.

Is it only Apple?
One might be tempted to dismiss Apple since the stock or company does not behave like other stocks. Nevertheless, in the current bull market, we would urge investors to go one step further and put the Nasdaq 100 to the test one more time. Looking at a long-term chart of the Nasdaq 100 (chart 2), we can see that the Nasdaq 100 is trading at all-time highs. At the same time, the long-term momentum buy signal, which has been in place since July 2016, remains. Thus, we continue to be bullish on the Nasdaq 100.

Buying at the peak?
Of course investors are frightened when looking at chart 2, which shows that the Nasdaq 100 is trading at all-time highs. Are we going to buy technology stocks like we did in March 2000 and watch them melt away? Of course we might check the performance since then, which stands at 8% or 0.46% p.a. It becomes more obvious if we compare the Nasdaq 100 to other assets such as 7 to 10-year US Treasury bonds. As seen on chart 3, the Nasdaq 100 / US Treasury ratio is trading 50% below its 2000 peak. Secondly, we see that long-term momentum is in favour of the Nasdaq 100 and against US Treasury bonds.
When you don’t trust bonds – test it with gold
Investors might be reluctant to place any trust in a comparison using US government bonds as a benchmark. They might worry that with all the quantitative easing around the globe, US Treasuries are mispriced. In this case, we can only compare the underlying asset with the Swiss franc or gold, as both of these assets are not and cannot be subject to printing.

As seen on chart 4, the Nasdaq 100 / gold ratio is still trading below its 23% retracement from its peak in the year 2000. Nevertheless, long-term momentum is bottoming and the odds are increasing that the Nasdaq 100 / gold ratio will finally be able to break through the resistance at the 23% retracement. Thus, we can summarise that the Nasdaq 100 is currently supported by the advance in Apple’s stock as well as the relative performance vs. bonds and gold. Therefore, we recommend that investors hold the Nasdaq 100 as a core holding in their portfolios.

Secular bull markets are born in pessimism.

Secular bull markets are born in pessimism.
Cybersecurity is one of the top global risks today. Cybercrime costs the global economy USD 445 billion annually. We believe cybersecurity has become an essential part of IT spending for firms and governments, as they have to safeguard their growing digital assets from rising malicious threats. We still see it as an attractive growth area but would recommend a diversified approach.

Cyber risk ranks among the top global risks
Cybersecurity has become a top concern among corporate executives and national leaders. Events such as the hacking of the US Democratic National Committee, and also multiple high-profile data breaches over the last few years (e.g. Target, Sony, Home Depot, Yahoo, etc.), have raised a whole new set of issues. Furthermore, the pace of malware growth has been accelerating over the past few years. The average time it takes to detect these attacks can be several hundred days, and lack of rapid discovery could significantly hurt the corporate earnings and reputation of the affected enterprise. A study by Allianz estimates that cybercrime costs the global economy USD 445 billion annually.

Cybersecurity is a top spending priority
The mitigation needs for cyber risk led to a spending boom for IT security in 2014–2015, with growth accelerating from 2.5% in 2013 to 9% in 2015. The rise in spending lifted all boats, but the consequence was a deceleration of growth in 2016. Now, we think we are seeing a growth stabilisation. Cybersecurity spending is estimated to grow at a lower but steadier rate of 7.5% a year through 2020E, to reach USD 114 billion: still more than twice the rate of overall IT spending. Over the near term, several third-party research surveys highlight that security software ranks as top priority for CIOs (chief information officers).

Cybersecurity spending is estimated to reach USD 114 billion by 2020.

Chart 1: Corporates are constantly under attack

<table>
<thead>
<tr>
<th>Type</th>
<th>0</th>
<th>25</th>
<th>50</th>
<th>75</th>
<th>100</th>
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</thead>
<tbody>
<tr>
<td>Virus, worms, trojans</td>
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<td></td>
<td></td>
<td></td>
<td>100</td>
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<td>Malware</td>
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<td>Web-based attacks</td>
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<td>Botnets</td>
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<td>66</td>
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<td>Phishing</td>
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</tr>
<tr>
<td>Malicious code</td>
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<td>52</td>
</tr>
<tr>
<td>Malicious insiders</td>
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<td></td>
<td></td>
<td>43</td>
</tr>
<tr>
<td>Denial-of-service attack</td>
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<td></td>
<td></td>
<td></td>
<td>36</td>
</tr>
<tr>
<td>Stolen devices</td>
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<td></td>
<td></td>
<td></td>
<td>36</td>
</tr>
</tbody>
</table>

Share of US companies experiencing cyberattacks by type (%, 2015)

Note: August 2015 survey
Source: Ponemon Institute, Wall Street Journal, Julius Baer
Factors driving secular growth in cybersecurity
We see three factors driving growth in IT security going forward, such as: 1) cloud computing, 2) growing complexity and impact of cyberattacks due to increased connectivity (mobility, Internet of Things, etc.), and 3) new regulation and public spending initiatives.

Chart 2: US federal cybersecurity budget is expected to rise

Cloud is both a risk and an opportunity
On the one hand, we believe that public cloud usage will significantly increase, and as such also the need for security solutions. On the other hand, the tail risk is that cloud vendors may capture the demand for cybersecurity services from dedicated cybersecurity companies, with solutions fully contained within their cloud offering, as a part of the cybersecurity market transitions to public cloud providers.

We recommend taking a diversified approach due to considerable volatility and technology risks.

Investment conclusion
Over the longer term, we believe the most attractive areas of security will be those that offer tools and services to help improve the manageability of security architectures. We therefore believe we will likely see increased acquisitions going forward. Furthermore, the cybersecurity industry is far from reaching maturity. Many new companies with new approaches and technologies are constantly emerging, leading to a highly fragmented sector ranging from network, identity and access management, to endpoint security and solutions. We therefore recommend that investors take a diversified approach due to considerable volatility, consolidation potential and technology risks, as the industry is in a constant arms race between cyberattackers and cyberdefenders.

Fabiano Vallesi
ECONOMICS

GLOBAL UPTURN TO CONTINUE AGAINST POLITICAL BACKDROP

According to the leading indicators the cyclical upturn in 2017 is gathering momentum and strength, particularly in the major advanced economies. US policy under Trump will most likely be highly reflationary, leading to more growth and inflation. The upcoming elections in the Netherlands, France and Germany could raise market volatility; however, constructive expectation is justified.

Strengthening global economic upturn in 2017...

The latest surveys of key leading indicators, such as the purchasing managers’ indices (PMIs), continue to signal a strengthening and broadening cyclical upturn in 2017, particularly in the major advanced economies. However, a remarkably lasting divergence in relative cyclical strength remains between the advanced and most major emerging economies. An abating investment boom in the latter and a peak in globalisation of value-adding activities have led to considerably slower global growth and global trade since 2014. Barring political risks, 2017 should nevertheless offer an improving backdrop for corporate earnings.

… but populist politics are major wild cards

The Trump presidency, with corporate tax cuts, infrastructure spending and protectionism, should accelerate supply constraints and raise US growth and inflation. This is our baseline scenario, to which we attach a probability of 85%. However, in our “unguided missile” scenario, to which we allot a probability of 15%, we could see lower US growth and even higher inflation due to direct presidential interference in corporate activities, regardless of any consequences, including reprisals from affected US trading partners.

Chart 1: Global purchasing manager’s indices (PMIs) surging ahead

Source: JP Morgan, Datastream, Julius Baer

Chart 2: US scenarios for the Trump presidency

Source: Julius Baer

Containment of the populists would positively stimulate financial markets.

The 2017 elections in the Netherlands, France and Germany will trigger market volatility, as the populists are expected to gain ground. France’s presidential elections will most likely be the focus: French far-right National Front leader Marine Le Pen will most likely win the majority of the votes in the first round of the presidential run-off on 23 April, but lose in the decisive second round on 7 May. All three countries have very high EU and euro approval rates, so we expect no exits to occur. Containment of the populists would positively stimulate financial markets.

Janwillem Acket
“Weak USD” rhetoric of the Trump administration and scepticism that the Fed will hike rates three times this year have hindered the continuation of the USD rally. We firmly believe that strong economic indicators and rising price pressure in the US will spur rate-hiking expectations, allowing the widening interest-rate advantage to overrule any anti-USD rhetoric.

USD rally takes a breather
Diverging monetary and fiscal policy between the US and the other major economies continues to be the overriding theme shaping the currency outlook this year. The rhetoric of the new Trump administration has created some hiccups as of late. Both Donald Trump and Peter Navarro, head of the National Trade Council, are not greatly enamoured with the traditional “strong USD” policy. We acknowledge that the “weak USD” rhetoric could help curb the USD appreciation when positioning becomes excessive. With the USD rally taking a breather, bullish USD bets have retreated significantly. At the same time, we firmly believe that rhetoric alone will not be enough to overrule the advantage to the US of widening interest rates. Elevated policy uncertainty seems to be the chief argument for the persistent market scepticism that the Fed will actually hike interest rates three times this year. Strong economic indicators and rising wage and price pressure, however, support our view that the Fed will hike interest rates at least three times in 2017. This should drive the USD higher.

Chart 1: Implied US rate-hike probabilities and the USD

[Graph showing implied rate-hike probabilities and USD index]

Source: Bloomberg Finance L.P., Julius Baer

Policy issues are also shaping the outlook for the euro. The first round of the French presidential elections is fast approaching. Anti-EU candidate Marine Le Pen will most likely make it to the second round and polls show that she is still leading the presidential race. Until then, the euro will suffer and will only regain its footing if Marine Le Pen is defeated in the second round of the elections. We expect the ECB to become more receptive to a reduced asset-purchasing programme as soon as Europe overcomes this major policy threat and focuses on the positive economic situation.

Trump is not greatly enamoured with the traditional “strong USD” policy.

Chart 2: Polls for the second-round constellations in the French presidential elections

[Graph showing poll results]

Source: OpinionWay survey carried out between 7 and 9 February 2017, Julius Baer

David Kohl
FIXED INCOME

TAking a break in us high yield and emerging markets

Without the tailwinds of supportive monetary policy but with expectations of higher fiscal spending, inflation and growth in the developed world, credit-risky bonds have outperformed the more conservative segments of the bond market over the last year. We still prefer credit to duration risk but lower our rating on US high-yield and emerging market hard-currency bonds to Neutral after the strong tightening in spreads. We maintain our call for deeply subordinated debt of solid European banks.

Sticking to credit over duration risk has paid off
In an environment of rising core yields and improving global growth, our positioning on the bond market has reflected a strong tilt towards credit risk through an overweight stance on US high-yield (HY) bonds, emerging market (EM) hard-currency (HC) corporate bonds and deeply subordinated debt* of European banks with solid fundamentals. In 2016, these segments delivered some of the highest returns in years and they have started 2017 on a strong footing too.

Chart 1: Strong performance across the risky bond segments

Since early 2016, US HY bonds have delivered total returns of approximately 20%, EM hard-currency debt 11% and global contingent convertible (CoCo) bonds 6%.

Time to take a break in US high-yield and emerging market hard-currency bonds
As corporate fundamentals in emerging markets and the high-yield segments of the US bond market have improved as a result of higher commodities and better macroeconomic data, investors are becoming increasingly comfortable holding EM bonds. As a result, investors have witnessed a significant tightening of credit spreads extended across sovereign and corporate issuers in the developing world. To some extent, investors today are in the opposite situation compared to a year ago. Fundamentals may appear stable – in fact, they seem to keep getting better – but valuations are no longer attractive.

In order to assess where we stand in terms of expectation, risks and compensation, we compared the spreads against a series of factors such as default rates, commodity prices and leverage. For example, the valuation of US high-yield bonds already seems to anticipate that the default rates will decline substantially to the region of 4%. In other words, an even more pronounced decline should materialise to justify further compression in credit spreads.

Chart 2: US high-yield bonds anticipated a further decline in default rates

Source: Bloomberg Finance L.P., Julius Baer

Source: Barclays, Bank of America Merrill Lynch, JP Morgan, Julius Baer
Similarly, the risk-return trade-off in emerging market bonds has declined. Absolute credit spreads are still above the 2007 lows, which remains a common argument used by many investors who expect further tightening. While we think that further compression is possible, we note that absolute credit spreads do not account for the changes in corporate financial strength. When adjusting for leverage, credit spreads are actually at new lows.

US HY bonds are already reflecting a further decline in default rates.

Overall, we are comfortable with the corporate fundamentals in both segments of the bond market, but believe that valuations are already reflecting a great deal of good news already. Thus, we downgraded both segments to Neutral and await more attractive entry levels in the future or confirmation from macroeconomic data that the growth outlook is in line with currently priced-in expectation.

Alejandro Hardziej

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For the first time in several years, the likelihood of equities achieving positive earnings growth has increased. However, current valuation levels limit their upside potential. Based on the relative attractiveness of equities compared with bonds, we advocate a balanced approach with a slightly cyclical bias when it comes to sector allocation.

Expect rising earnings
For the first time in several years, the likelihood of global equities achieving positive earnings growth has increased. The first signs of a recovery are visible when we analyse the current earnings season: both European and US earnings are delivering surprisingly good performance. The factors supporting a more constructive view include an improving macroeconomic picture and normalising inflation levels. According to our earnings models, there should be 7% earnings growth in the US and even 9% in Europe. Nevertheless, the elevated valuation levels limit further upside potential of the equities. As a consequence, expectations for absolute returns remain in the single-digit region and these are still more attractive than other asset classes.

Chart 1: Earnings models point to positive growth potential in 2017
![Chart 1: Earnings models point to positive growth potential in 2017](source: Datastream, Julius Baer)

A balanced approach with a cyclical tilt
Despite this rather challenging situation we have noted that investors are becoming more risk-friendly again. With rising government bond yields, more risky assets have outperformed their less risky counterparts. A near-term consolidation thus becomes the likely outcome. However, we remain confident that the lows in bond yields are definitively behind us. As a consequence, we advocate a balanced approach with a slightly cyclical bias when it comes to sector allocation. Our last adjustment was the upgrade of insurance to Overweight. Overall, we recommend that investors manage their expectations but remain constructive on equities.

Rising earnings call for a slightly cyclical approach.

Chart 2: Cyclicals benefit from rising bond yields
![Chart 2: Cyclicals benefit from rising bond yields](source: Datastream, Julius Baer)

Christoph Riniker, CEFA
**OVERWEIGHT PHILIPPINES**

We aim to gain exposure to countries that are more shielded from a stronger USD, higher US interest rates and US and/or US-China trade frictions. The Philippines is one such country and we have upgraded it from Neutral to Overweight. GDP growth is intact and most revenues are generated domestically. The currency is back to credit-crisis levels seen in 2009 and it thus seems an opportune time to overweight the Philippines. The MSCI Philippines has been trading sideways over the last couple of years and has always bounced off an index level of 22. We target an upside potential of 10%.

Heinz Rüttimann, CAIA

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**OVERWEIGHT INSURANCE**

A generally more risk-friendly environment supports our view of a balanced but cyclically biased approach in terms of sector allocation. One of the sectors benefiting from a constructive macroeconomic backdrop and rising bond yields is financials. Since a number of risks remain (e.g. political uncertainty) that could impair equity performance, we currently prefer insurance to banks. Given the smaller outperformance of insurance over global equities over the last few months, the valuation also looks more appealing. Global insurance earnings should achieve double-digit growth in 2017.

Christoph Riniker, CEFA

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**DIVIDEND SEASON IN SWITZERLAND**

Swiss companies have the opportunity to distribute cash to their private shareholders in a tax-efficient way. While normal dividend payments are subject to 35% withholding tax deductions, capital repayments are free of taxes. Dividend strategies are currently popular in Switzerland because bond yield levels have been near the negative region for some time. As a consequence, even bond investors looking for yields are engaged in the equity segment. The distribution season in Switzerland will essentially start soon as most Swiss companies pay out dividends or distribute cash in March, April and May.

Christoph Riniker, CEFA
COMMODITIES

THE REFLATION EUPHORIA HAS LEGS

The reflation euphoria continues to prop commodities. The asset class is prone to a near-term setback as fundamentals are overhyped and the bullish sentiment is ripe for profit-taking. Oil prices should retreat as the shale revival undermines the oil producers’ supply deal. Dollar strength and rising interest rates should outweigh concerns over Trump’s policies and pressure gold.

Looming setback risks
Commodities have inched higher since the beginning of the year. A position in the popular Bloomberg Commodity index should have yielded around 2.5%. The economic backdrop indeed remains robust but the fundamentals increasingly look overhyped. The common denominator across the asset class is the reflation euphoria mirrored in the very bullish sentiment and hedge fund futures positions. Historically, such stretched positioning did not last long and was followed by profit-taking. We see short-term setback risks, expect a pick-up in roll headwinds, and thus maintain our Underweight recommendation.

The shale boom revives.

The tensions in the oil market are growing. Compliance with the supply deal is surprisingly high, although Saudi Arabia shoulders most of the burden. Meanwhile, the shale boom is gathering momentum and undermines the Middle East’s efforts to tighten supplies. The soft fundamentals including growing US oil stocks and slowing demand growth will eventually unleash the unwinding of the stretched futures positions. Oil prices should retreat below USD 50 per barrel.

Optimism needs reality check
Tailwinds to commodities came from the early-year rally in metals prices, buoyed by growth optimism and supply concerns on the back of temporary mining disputes. However, hopes of massive infrastructure spending look misplaced and the prospects of softening global car sales from today’s subsidy inflated levels are dismissed. China’s old economy increasingly looks immune to further stimulus as the slowing growth in fixed asset investments suggests. Sentiment will get a reality check and the unwinding of futures long positions should pressure prices in the near term.

Chart 2: Gold and the US dollar

Norbert Rücker
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**APPENDIX**

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<tr>
<th>Rating</th>
<th>Description</th>
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<tbody>
<tr>
<td>Buy</td>
<td>Expected to outperform the MSCI regional industry group by at least 5% in the coming 9–12 months, unless otherwise stated.</td>
</tr>
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<td>Hold</td>
<td>Expected to perform in line (±5%) with the MSCI regional industry group in the coming 9–12 months, unless otherwise stated.</td>
</tr>
<tr>
<td>Reduce</td>
<td>Expected to underperform the MSCI regional industry group by at least 5% in the coming 9–12 months, unless otherwise stated.</td>
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**Strategy research**

Countries, sectors and investment styles are rated ‘overweight’, ‘neutral’ or ‘underweight’. These ratings are based on our expectations for relative performance versus regional and global benchmark indices.

<table>
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</table>

Equity investments are divided into three different risk segments. Risk here is defined as the historical five-year volatility based on monthly returns in CHF. Based on the data of all segments considered (developed markets, emerging markets, global sectors, investment styles) the following distinction is made:

- **Conservative**: Investments whose historical volatility is in the bottom quartile of the universe described above.
- **Medium**: Investments whose historical volatility is in the middle two quartiles of the universe described above.
- **Opportunist**: Investments whose historical volatility is in the top quartile of the universe described above.

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Risk categories for fixed income research

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**Credit rating definitions**

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<tr>
<th>Moody’s</th>
<th>Standard &amp; Poor’s</th>
<th>Fitch/IBCA</th>
<th>Credit rating definition</th>
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<tr>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
<td>Bonds rated Aaa are judged to be of the highest quality, with minimal credit risk.</td>
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<tr>
<td>Aa1</td>
<td>AA+</td>
<td>AA</td>
<td>Bonds rated Aa are judged to be of high quality and are subject to very low credit risk.</td>
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<tr>
<td>Aa2</td>
<td>AA</td>
<td>AA-</td>
<td>Bonds rated A are considered upper-medium grade and are subject to low credit risk.</td>
</tr>
<tr>
<td>Aa3</td>
<td>AA-</td>
<td></td>
<td>Bonds rated Aa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.</td>
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<tr>
<td>Baa1</td>
<td>BBB+</td>
<td>BBB</td>
<td>Bonds rated Baa are subject to speculative elements and are subject to substantial credit risk.</td>
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<tr>
<td>Baa2</td>
<td>BBB</td>
<td>BBB-</td>
<td>Bonds rated B are considered speculative and are subject to high credit risk.</td>
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<tr>
<td>Baa3</td>
<td>BBB-</td>
<td></td>
<td>Bonds rated Ca are judged to be of poor standing and are subject to very high credit risk.</td>
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<tr>
<td>Ba1</td>
<td>BB+</td>
<td>BB</td>
<td>Bonds rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.</td>
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<tr>
<td>Ba2</td>
<td>BB</td>
<td>BB-</td>
<td>Bonds rated C are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.</td>
</tr>
<tr>
<td>Ba3</td>
<td>BB-</td>
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Rating system for global technical analysis (absolute)

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<th>Rating</th>
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<tr>
<td>Buy</td>
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Rating system for global technical analysis (relative)

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<tr>
<td>Overweight</td>
<td>Expected to outperform its benchmark by at least 5% in the coming 3–12 months, unless otherwise stated.</td>
</tr>
<tr>
<td>Neutral</td>
<td>Expected to perform in line (±5%) against its benchmark in the coming 3–12 months, unless otherwise stated.</td>
</tr>
<tr>
<td>Underweight</td>
<td>Expected to underperform its benchmark by at least 5% in the coming 3–12 months, unless otherwise stated.</td>
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