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Q 03 / 2017

Quarterly Investment Review and Outlook

Quarterly Report – Q03/2017

At a glance

The message of the quarter: The Federal Reserve passed another milestone toward normalizing monetary policy, unveiling plans to trim its USD 4.5trn balance sheet starting October 2017 and hinting at a further rate rise this year. Equity markets shrugged off the news as this course of action was largely expected.

Preview of the 4th quarter, 2017

Global

- Based on still easing financial conditions, the US cycle can extend further
- Growth in the Eurozone continues to power ahead, but limitations are starting to appear
- Based on low energy input prices, the economies in LATAM are in an early stage recovery situation

Liquidity

- With the FED announcement of September 20, 2017, the market now expects one more interest rate hike in December of 2017, and 3 hikes in 2018
- Cyclical inflation (spikes) could appear, but there is no reason at present for this to translate into a secular trend
- 10-Year US yields to stay within a target range of 2.7%

FX

- In Europe, economic indices to reach maturity by end of 2017, while in the US these same indicators start to bottom out during the 4th quarter of 2017
- Rate differential to play in favor of short-lived USD appreciation
- The ECB tip-toeing is expected to result in some weakness to the EURO

Politics

- Europe: Despite uncertainties caused by the Italian elections, as well as possible ramifications from the independence referendum in Catalonia, some institutional progress is expected in 2018
- US: After a very weak start, the Trump administration starts to deliver in 2018
- Brexit: The coming quarter is expected to be flashpoint of the exit talks

Outlook

The global economic cycle is now entering the last phase. While a small deceleration may occur, we expect this last phase of the present economic cycle to last until the beginning of 2020/2022. This prolonged period of end-cycle can be explained by still abundant liquidity, no secular inflation concerns, and continued low and stable interest costs for corporations.

Corporate credit tightening is the main risk in this maturing cycle. This tightening can occur in two ways: a) by means of increased market volatility, which in turn increases the equity risk premium, and b) in a direct increase of corporate financing costs, which in turn generates lower capex and less job creation. Both symptoms will ultimately lead to an economic slowdown.

Based on a recent OECD analysis, financial momentum continues to be supportive for global markets. In fact, markets are at their highest since 2003. We can conclude from this that there is no recession in sight for the time being.

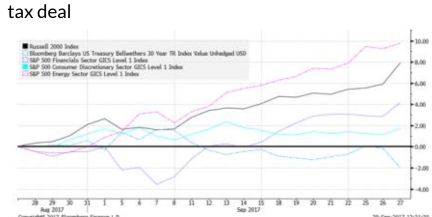
Global growth outlook still compelling

%annual growth	2016	2017e		2018e	
	Exane	Exane	Consensus**	Exane	Consensus**
World*	**3.1**	**3.6**	**3.6**	**3.7**	**3.7**
United States	1.5	2.2	2.1	2.4 ↑	2.4
Japan	1.0	1.4	1.4	0.7	1.1
South Korea	2.8	2.5	2.8 ↑	2.4	2.6
Euro Area*	**1.7**	**2.1**	**2.0** ↑	**1.8**	**1.8** ↑
Germany	1.8	2.1 ↑	1.8 ↑	1.7	1.8 ↑
France	1.1	1.7	1.6 ↑	1.6	1.6
Italy	0.9	1.4 ↑	1.2 ↑	1.2 ↑	1.0
Spain	3.2	3.4	3.1 ↑	2.5	2.6 ↑
United Kingdom	1.8	1.6	1.6	1.3	1.4
Central & Eastern Europe*	**3.0**	**3.5** ↑	**3.9** ↑	**3.0**	**3.3**
Poland	2.8	3.8 ↑	3.8 ↑	3.2	3.4
Hungary	2.0	3.5 ↑	3.7 ↓	2.9	3.3
Turkey	2.9	3.5 ↑	4.3 ↑	3.1	3.5
Russia	-0.2	1.5	1.5	1.3	1.7
Latin America*	**-1.0**	**1.4**	**1.6**	**2.1** ↑	**2.4**
Argentina	-2.3	2.6	2.8	2.6	2.8
Brazil	-3.6	0.4	0.4	1.8 ↑	2.1
Mexico	2.3	2.2 ↑	2.1 ↑	2.4 ↑	2.2
Emerging Asia*	**6.4**	**6.5**	**6.5**	**6.5**	**6.4**
China	6.7	6.7	6.6	6.5	6.3
India	6.8	7.3	7.3	7.5	7.6
Indonesia	5.0	5.3	5.2	5.3	5.4
Middle East & North Africa	3.8	2.3	n/a	3.2	n/a
Developed countries*	**1.7**	**2.1**	**2.0**	**1.9**	**2.0**
Emerging countries*	**4.1**	**4.6**	**4.6**	**4.8**	**4.9**

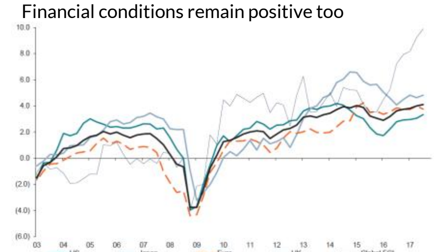
** Forecasts using IMF weights* ↑ / ↓ *upgrade / downgrade*

*** from most recent Consensus Forecasts (Jul/Aug 2017)*

Potential beneficiaries of the Trump Administration tax deal



Financial conditions remain positive too



Source: OECD, Exane BNP Paribas estimates

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Transformative technology (Economy 4.0) for industries

Industrial robots that teach each other to make processes more efficient, assembly lines capable of taking orders directly from customers, machines that schedule their own maintenance…these are not futuristic visions, but present-day examples of a new, data-driven approach to manufacturing that arguably represents the most significant transformation of industry since the Industrial Revolution.

Industry 4.0, as this transformation is known, capitalizes on the potential of connected technologies and the Internet of Things to link various aspects of the production process. Automation, data sharing and data analysis are taking manufacturing to new heights of efficiency and productivity, and driving the development of innovative new products and services. But like any major shift, this change needs to be approached carefully, underpinned by solid planning and the right solutions and partners.

Next-generation manufacturing

The term Industry 4.0 was originally coined in Germany to describe a national policy of promoting computerization in factories. However, its definition has broadened beyond the simple automation of routine tasks to encompass far more ambitious concepts. Industry 4.0 envisions truly "smart" production facilities. In these facilities, connected sensors, devices and machines are in constant communication, generating, collecting and analyzing massive quantities of data in real time. This data can then be used to fuel insights and business decisions—decisions that, in many cases, machines are capable of making themselves.

In the past, the concept of "just in time" drove the delivery of raw materials to a production facility. In contrast, IIoT (Industrial Internet of Things) now enables manufacturers to create substantial gains on the sell-side. For example, GM currently runs its business with over 100,000 cars standing idle somewhere in a parking lot. The average idle time for a car (all car companies) is in excess of 3 months. In fact, some of these cars will never be driven by a customer because the company miss-anticipated sales. Now, consider the efficiency gains a manufacturer can achieve by reducing this idle time and by only producing cars that will sell. Obviously, some benefits will be one-off items, but the majority will be ongoing like better resources management and that will be increasing the company efficiency most. This manufacturing example is just a fraction of the potential benefits of IIoT.

The productivity gains that Industry 4.0 promises to unlock have prompted many countries to see it as a path to revitalizing the manufacturing sector. Consider the following facts:

- Germany is investing 200 million Euros into Industry 4.0 research
- Industry 4.0 technologies are at the core of China's "Made in China 2025" manufacturing strategy
- In the United States, businesses, academia and government agencies have joined forces to form the Smart Manufacturing Leadership Coalition.

The focus and resources being poured into Industry 4.0 development bode well for many more advances in the years ahead.

Putting the pieces together

Given the wide range of ideas and technologies grouped under the Industry 4.0 umbrella, many companies may be wondering how it can be applied to their own production processes, and where to begin. In fact, several Industry 4.0 building blocks can be adopted relatively quickly and easily to provide a platform for more intelligent manufacturing, and to realize rapid returns on investment by increasing efficiency and lowering expenses.

The Industrial Internet of Things (IIoT): The IIoT comprises the connected devices that enable consistent real-time communication between people, production lines and other segments of an industrial business, dramatically improving the speed and efficacy of facility management. This communication needs to take place on secure, robust and rapid networks. The standard for exchanging IOT occurs through narrowband, also called (NB-IoT), a network standard optimized for industrial settings.

When machines and other factory equipment are given the ability to communicate, machines can coordinate and configure themselves to handle a wide range of requests, enabling highly customized just-in-time production based on customer preferences. This ultimately will lead to lower production prices, faster product delivery, and a higher degree of personalized product range. In other words, the industry is moving away from the mass-production business model.

Real-world applications

Cloud architecture: Cloud-based platforms provide the vast computing resources and storage capacity needed to support real-time collaboration and to process and analyze the massive quantities of data that define the Industry 4.0 environment. This Big Data provides a foundation for the automation of key processes and anticipatory decision-making.

Robotics: The use of robots is not new; the industry started using robotic technologies in the early fifties. However, for such machines to operate intelligently, they must be equipped with advanced sensors and wireless technologies that enable constant communication (M2M) and control (H2M). Newly developed technologies allow for the use of next-generation 5G network-based industrial solutions.

By adopting and combining these technologies, enterprises can create a fully networked production environment and address some of the biggest issues impacting the manufacturing process. One such issue is downtime. That is, due to unanticipated breakdowns and the need to maintain and replace parts on the assembly line, production facilities typically operate at only around 60 percent of peak capacity and effectiveness, meaning time and resources are constantly going to waste.

Through the IIoT, it is possible for firms to realize predictive maintenance whereby machines monitor and report their own status and provide advance warnings of the need for a new part or upgrade, and identify issues on the assembly line before they occur. Because this servicing can be planned in advance, effective downtime will be reduced to a few hours or less, whereas in the past the downtime was generally in excess of several hours, if not days. This ultimately brings companies closer to achieving their full production potential.

Conscious about the challenges

There is no denying the benefits of Industry 4.0, but embracing it involves substantial changes across the enterprise, and implementations need be mapped out. According to some studies, more than 50% of current companies are expected to fail to successfully transform their business to an “Economy 4.0” status.

That ratio sounds alarming, but based on the more recent history, real figures still appear to be on the low side. It is therefore important for investors to recognize early fast-changing trends so that adjustments in the actual asset allocation can be made in time.

Software, key enabler of IIoT, is becoming ever cheaper,

Outlook 2017/2018

1. **Highly positive foundation for a risk-on model**
   - We continue to believe that under current conditions, risk-on strategies are poised to outperform market-neutral and defensive strategies.
2. **Fading conviction in proxy trades**
   - In recent years, expansive central bank policy and low interest rates have supported markets. Stock winners and losers nevertheless emerged. With central bank policy expected to tighten gradually, the so-called “bond proxies” could suffer, while financials could benefit.
3. **Markets could easily see a 5-10% decline**
   - Any correction may be considered a healthy technical adjustment.
4. **Infrastructure spending**
   - We continue to believe that there is the need and the political support for increased infrastructure spending in many countries. While infrastructure spending-related companies have performed well recently, we estimate that this trend is not over yet by far. Still, it will be more difficult to crystallize potential outperformers, as short-term triggers are already fully priced in.
5. **S&P 500 faces key resistance around 2600**
   - Because of solid fundamentals, a strong conviction call on US equities is being maintained. However, as the economic cycle advances, it is opportune to enter protective strategies that will enhance performance developments during periods of uncertainty.

The next three months

Cyclical stocks are by definition tied to the economic cycle—some early to the cycle, others later. Led by the US, the current global economic cycle is entering into the last up-leg. Consequently, investors should focus on stocks that benefit from the latter stages of the cycle rather than those that are at or past their industries' cyclical peaks.

The current economic cycle enters in the last up-leg.

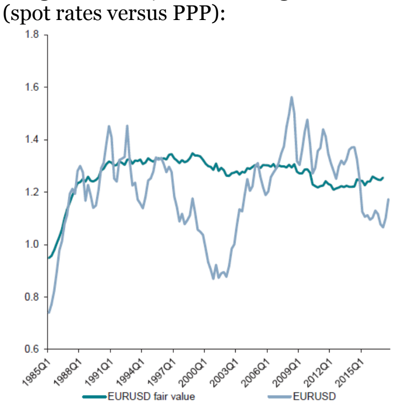
- Led by the US, the global economic cycle remains robust
- Due to monetary policy issues, Europe is lagging the US cycle by about 2½ to 3 years; therefore, European based companies will most likely not meet performance expectations for 2017. With the framework rarely being as positive as it has been for 2017, the question is: When and under what conditions can European stocks perform? According to fundamental analysis, we note that European companies are much less aggressively managed, and—more importantly—less leveraged than US companies. This is one of the key factors in their constant underperformance. Nevertheless, we believe that the European stocks should be part of a global equity portfolio. As a reminder, European companies have the highest degree of geographical diversification. Therefore, they are key beneficiaries of a global recovery.

Which companies are poised to benefit from the present economic situation?

- Activities that typically benefit early in the economic cycle include those involved in the initial stages of creating a product or service. These companies are commonly referred to as early-cyclicals.
- Activities exposed to the latter part of the cycle include those that benefit from corporate capital expenditure (capex). Companies operating here are called late cyclicals.
- Based on the above definitions:
  - North America: Late cyclicals
  - Europe: Mid to late cyclicals.

Market appears to be fairly priced, i.e. no excess’

Long-term USD/EUR exchange rate (spot rates versus PPP):



Earnings revisions up in Europe versus flat in the US:

Modern schizophrenia by Central Bankers?

In the wake of the 2008 GFC[1], the UK and US household sectors went through a heavy and long de-leveraging process. The dominant source of household credit in both countries is via mortgages, the growth of which has only recently recovered into the low single digits (around 3%). However, the problem now lies in unsecured credit, the growth of which has exploded to above 10% in both countries.

We have previously raised concerns about household credit growth and the net savings balance of US and UK households. In both countries, the net household savings balance is negative and economic growth is mostly dependent on consumption, while in other developed countries, economic growth is the result of innovation. In addition, there is a 3rd category of developed countries in which innovation takes place but doesn't translate into economic growth or consumption!

We do not believe this debt time bomb is specific to any country. We are in a QE (increase CB balance with the aim to fuel the world economy) and exercise in a zero interest rate world (cheap debt financing), where central banks are effectively force-feeding debt down borrowers' throats. They did this in 2003-2007 and they are doing it again. Most of the liquidity merely spins around financial markets. In the US, corporations are highly leveraged. If the current growth cycle is not prolonged by any means, it could well be that we are facing a corporate credit bubble in the US by 2019/2020. In the UK, another heavyweight country where economic activities shifted from the 2nd to the 3rd sector in the recent decade, a consumer credit bubble is close to bursting.

The fact that such excess situations occur again and again is not new; in fact, this is not of particular concern today. The concern is rather about the reaction and the anticipatory steps taken by the governors and central bankers to avoid these situations. The reaction of the BoE regarding a potential credit bubble is bizarre, if not hallucinatory.

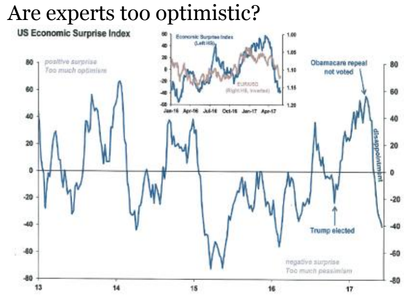
In a memorandum addressed to UK Banks, the Governor of the BoE warned institutions that they should not forget about the past lending practices. Subsequently he increased the bank capital requirements on consumer loans.

But as Ed Conway from Sky News points out, at the same time it is warning of a consumer credit bubble, the BoE has increased its program of lending to banks at preferential rates to increase bank lending in areas such as consumer credit.

Such a hollow cautionary statement regarding consumer credit is therefore made to look ridiculous, and takes BoE monetary policy to a new level of schizophrenia. When interest rates are excessively low, both borrowers and lenders are prone to making ill-advised decisions. But by ignoring their own role in creating debt misery for millions, central banks can only deal with their own cognitive dissonance by blaming someone else.

US deficits:

Are experts too optimistic?



[1] GFC = Global Financial Crisis

The Big Picture for the shift from Europe to the US

For European markets, there is still some meat left on the bone, but not much. The macro environment in Europe still appears to be highly supportive for equities, but we doubt that there is much room for more appreciation. Valuations are not stretched, cyclical indicators are not showing any weakness, and the ECB is not showing any change of course. Still, the market does not move, and European investors look tepid and appear to be busy with different matters.

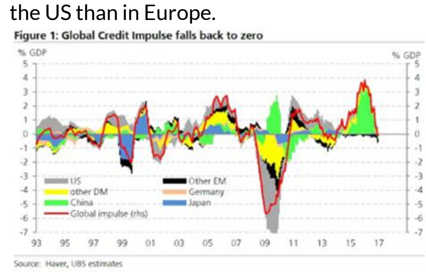
As it could turn out, markets may get relatively quickly disappointed with the European stock market performances. Because they are lackluster for the last 12 months, our preference goes again to the US equity market at the expense of Eurozone equities. In Europe, markets were supported for the last 3 years by a pollyannic macro environment, but there was little-to-no actual performance delivery. At the same time, US equities have performed extremely well and by now, the market has somehow digested the asymmetric risk/rewards profile that built up as a result of ongoing share buyback programs.

Our call on US equities is mainly based on the very low level of confidence versus the US administration. We strongly believe that the Trump Administration can finally deliver a wind of change, and this hypothetical situation makes US corporations more attractive than the Eurozone market, where one has to deal with more complex situation. These situations include:

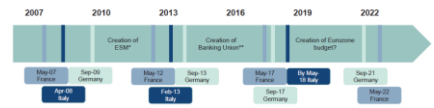
- Uncertainties ahead of the Italian general election as a source of volatility
- Independence referendum in Catalonia, which could trigger another EU crisis because the European parliament has acted unprofessionally and incompetently
- French equity market, which is subject to the supply side reforms (although the law was signed by the President, its benefits will most only likely be visible in 3 to 4 years—too distant for the average citizen)
- European exporters unpreparedness versus the sudden USD devaluation

Given the above, we are more bullish on the US market, where will develop our investment ideas around Hedged Low Volatility Strategies and on strong secular growth trends such as Companies with High-Value Add. These companies operate mainly in relation with the 4th economic revolution.

Lacking credit impulse is more "productive" in the US than in Europe.

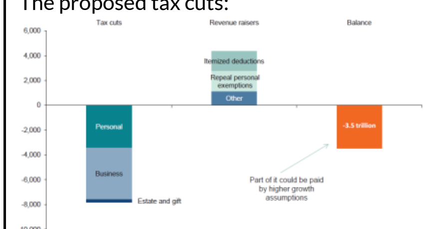


Timeline for European politics: a rather slow and complicated process:



The reshuffle of the Trump Administration:

The proposed tax cuts:



What are our preferences?

Key takeaways for 2017/2108

General:

1. Interest rates on the rise in developed markets
2. US-driven economic revival; US economy has decelerated because of unrealistic political goals. As of now, expectations have fallen to the lowest possible level; any kind of achievement can translate into a new kind of euphoria.
3. Monetary policy tightening to start in Q4/2017 in the US, most probably followed by Europe in 2020
4. Cyclical inflation will most likely appear late 2017 and to follow through into 2018
5. Worldwide industrial overcapacity is slowly being absorbed, which will ultimately lead to a structural inflation trend starting by 2019/2020.
6. Concerns around North Korea will remain in place, but no real escalation is expected due to Chinese interests.

Americas:

7. US interest rates to initially rise to above 2.7%
8. Tightening financial conditions and drag on the economy could lead the FED to reverse the intended course of action.
9. US Equities are expensive, but still on a positive trajectory because of ongoing share buyback programs.
10. 2017 GDP growth to accelerate to 2.4%, up from 1.5% in 2016
11. USD regains short-term attractiveness, followed by a further decline towards 1.25/1.30 (EUR/USD).

Asia:

12. China's excess industrial capacities have been reduced on the back of newly implemented anti-pollution laws.
13. China's growth stability to prevail over reforms
14. Chinese leverage has experienced the fastest rate of expansion
15. Chinese public debt-to-GDP at 83% by 2020. When local governments financing vehicles and other off-budget activities are included, this ratio augments to over 150%.

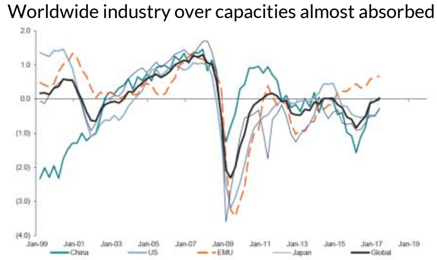
Europe:

16. Financing conditions stabilized at the level of mid-2016, which supports domestic consumer confidence.
17. Eurozone GDP growth appears to be capped because of sudden Euro strength and a possible tightening stance by the ECB.
18. France and Italy are under pressure to deliver on the fiscal side. Italy to surprise positively, while a no-outcome is to be expected in France.
19. Across the continent, labor market conditions look better for now.

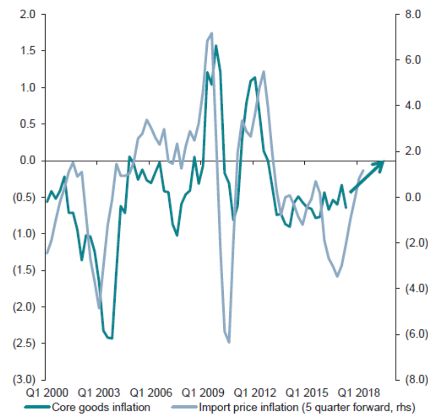
Binary outcomes:

20. EM countries stand at different positions in their economic cycle. Can LATAM surprise to the positive?
21. The paradox of the lasting economic cycle could lead to corporate credit bubble in the US. How is it happening and when will it materialize?
22. With the reshuffling of the Trump administration, there appears to be more order in the House of Republicans. The Trump administration and Republicans may finally start delivering against the now very low expectations. Expect market rallies as a consequence.

Worldwide industry over capacities almost absorbed

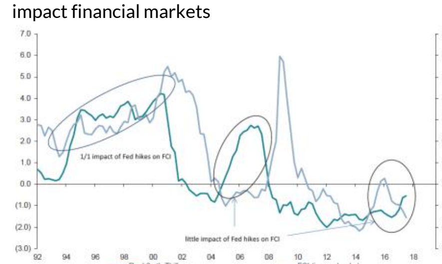


Starting 1028, present lower import prices will translate into lower inflation pressure



Emerging Markets are at different in place in their economic cycle

No reason to panic, tightening by FED does not really impact financial markets



Sector Analysis

Basic Materials

Investor sentiment towards the material sector shifted dramatically in 2016. Better economic fundamentals triggered earnings upgrades; subsequently, commodity prices started to increase as well. Today, rising inflation expectations are positive for commodity-focused stocks, but negative for price-sensitive consumer chemicals.

The sector should continue to benefit from solid growth in China, elimination of overcapacities on the back of newly introduced anti-pollution rules, and a globally higher nominal GDP. Disappointing performance so far this year is to some extent due to the very strong gains made by the sector in 2016. In general, valuations are not particularly attractive by historical measures, although they are not excessive.

We remain cautious regarding the chemical sub-sector. Second quarter earnings continued some of the trends from first quarter, namely volume growth and positive pricing in upstream divisions. Raising input prices strongly impacted downstream operators, and upstream operators were impacted by outages. While valuations have pulled back, the earnings outlook appears to be overestimated, given the circumstances.

Consumer Discretionaries

Overall, the macroeconomic backdrop for consumers is more favorable, and financial conditions are also supportive for increased consumer spending. The stock market is nearing record highs, and home prices are steadily rising, providing a boost to household budgets. There are also some negatives, such as increasing household indebtedness in many countries, and political uncertainty. Last but not least, private equity investors' withdrawing of assets from passive orientated investment vehicles to proceed with DIY strategies demonstrates that private individuals have excessive confidence in the system.

Recent numbers don't support this observation. For example, rolling 12-month automobile sales in the US are at 16.9 million units (steady for five consecutive months- but 17.6 million vehicle sales (annualized) are forecasted, showing that the consumer sentiment is uncommon. Consider the following:

a) Wage growth should translate into car sales
b) The average car age is increasing, now in excess of 11 years
c) Consumer credit facilities are increasing (normal at this stage in the economic cycle), yet the number of loans with negative equity is increasing disproportionally

It is therefore opportune that we have a neutral stance on the automobile and components sub-sector. We believe that industry-wide ramifications such as the move to electric cars, further automation and use of robots (IIoT), will create sector-wide disruptions. While this process will probably roll out over the next 5 to 10 years, the highly cyclical sub-sector of automobile and components is the most exposed sub-sector to any change in sentiment.

Finally, we note that the consumer discretionary sector is one stock class that could gain most in the event the Trump Administration pushes ahead with the tax deal.

Energy

Energy companies have shown clear progress on cost savings, efficiency gains and investment discipline in the first half of 2017, earning the rewards of two difficult years (2015 and 2016). In our view, integrated oil and gas producers, which are paying generous dividends, offer the lowest risk.

In the US, Hurricane Harvey has impacted almost all oil and gas operations in the southern fields. The potential implications are vast, especially as capacity rebuild-up will take more time than starting from scratch, and companies like Pioneer, Apache, Anadarko, and EOG are already suffering from low output prices.

Key figures for Europe:

Target values:

Present fair value (DJStoxx600): 385
E12 month's value (DJStoxx600): 425
Upside potential: +10.4%

Key economic ratios:

P/E 2017 (E):	15.3
P/E 2018 (E):	14.05
EPS Growth 2017 (E):	26.0%
EPS Growth 2018 (E):	10.0%
Div. Yield 2017:	3.1
Div. Yield 2018:	3.4

Most likely next short-term move:

DJStoxx600	flat/down
DJStoxx50	flat/down
SMI	flat/down
DAX	flat/down

Key names to look at:

Strong intellectual property:
- Roche
- Novartis
- BNP Paribas

High competitiveness:
- Siemens
- Daimler

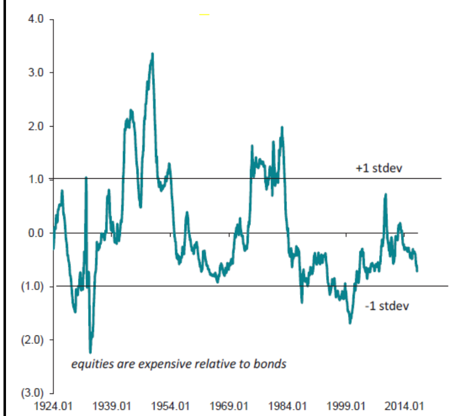
Sustainable dividends:
- Crédit Agricole
- Imperial Tobacco
- Altria
- Philip Morris

A shift to gas in the Permian basin?

A recent analysis made public that more gas than oil was produced in the region in Q2/2017. Worries intensified when some producers acknowledged a potentially "gassier" production profile in the future. The higher gas-output-ratio (GOR) suggests two distinct developments:

a) Each oil well experiences the same exploitations cycles; oil first, then some kind of mixture, and finally, mainly gas. The use of new technologies increased the accessibility and production of gas, while oil recovery projections and production remained unchanged.
b) In a more or less lean and alike production universe, quarterly production results should merely change! However, because of aging installations, serious operating problems required a facility shutdown for several weeks. Although the facility is operational again, analysis did not account for this incident and one should therefore expect that the GOR will not become more volatile in future.

The US-Equity market is overpriced!



Technology

Despite a weak start to the 2nd quarter earnings season, global tech results gathered momentum, with more than 80% of companies beating consensus estimates on both revenues and earnings. Positive revisions to consensus figures are supportive for the global medium growth outlook, which means the sector is once again rerated against the broader market. While earnings growth continues to be above average, the sector's mid-single-digit premium is still below the historical average premium of 15–20%. The additional driver of our positive view–i.e. cash distribution–remains intact as tech companies continue to generate record cash flows. This bodes well for both share buybacks and dividends.

Globally, 75% of DRAM, 45% of NAND Flash, 95% of OLED panels, and 35% of LCD panels– all used in smartphones, PCs, servers and TVs – are manufactured in South Korea. With North Korea risks fading, the sector focus is again on fundamentals.

The epicenter of the industry's attention is IIOT (Industrial Internet of Things). Clearly, the secular growth trend around this concept has just begun. Technology-based disruption will impact industrial processes, developments, and customer-facing activities. All of this will occur on the back of a fast-growing tech ecosystem that will interconnect M2M and M2H.

In Asia alone, technological innovations will disrupt local corporate revenues by USD 500–750 billion (low to mid single-digit percentages), from 2018 to 2020. Key beneficiaries include both global and Asian internet companies and technology enablers in semiconductors and other component industries.

Consumer Staples

The broad business disruption trend for Consumer Staples is still in the making. With the new model, companies are poised to rapidly change their business model and to gain a large market share relatively quickly. Although valuations look attractive, Consumer Staples have not performed well on a year-to-date basis. This reflects investors sidelining because of increased competition, an unclear future due to disruptions, an inadequate business model, and a lack of management experience in the field.

The sector's average valuations are cheap compared to long-term figures. Investors with a higher degree of risk appetite should focus on drivers such as industry consolidation, restructuring and cost-cutting measures, as well as on sub-sectors and businesses that could appear to be immune versus disruption (tobacco, health, and wellness).

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Financial Services

Based on improving macroeconomics, rising interest rates, consumer satisfaction, and a better regulatory backdrop expected over the next 12 months, financial services and, in particular, banks are expected to do well. Despite underperformance of US Financials relative to the S&P 500 year-to-date, the solid backdrop as well as positive optionality around potential tax cuts should support outperformance over the Q4 2017-2018 period.

Shift in sentiment

Sentiment among investors in financial services stocks has recently been cautious and hesitant. This is mainly due to two factor: 1) Slower traction in Washington DC on policy actions that could spur macro-economic and business growth (i.e., tax reform and regulatory reform), and 2) Somewhat muted near-term financial performance across US Financials.

Near term guidance from some of the largest banks has been characterized by still slow loan growth that is consistent with the levels seen in the first half of 2017. Although we expect a little more strength in consumer loans, loan growth is still not at the robust level that was seen last year or was hoped for at this point in the cycle. Bank management recently pointed to headwinds from payoffs and pay downs as rates declined and demand from cash rich clients softened. Margins and net interest income are expected to be flattish-to-up slightly, as the small benefit from the June Fed rate increase has been mostly offset by some commercial deposit repricing and the flattening yield curve. We expect deposit betas (reflecting the extent to which market rate increases are passed on to depositors) will be a major topic of conversation during upcoming earnings calls.

Finally, we note that credit quality remains a concern. While institutions have made some provisions, we estimate that recent weather-related events will cause considerable damage to lenders. In the greater Houston area alone, about 800k cars need to be replaced, of which about 25% were on lease with insurance coverage, while most of the remaining were acquired through the traditional credit channel.

Industrials

In Europe, while key economic indicators such as PMI remain strong, stock markets no longer anticipate any major surprises, an expectation supported by a rather flattish reporting season. Increasingly, investors are taking a “travel and arrive” attitude, which consists of selling stocks that don’t deliver EPS upgrades. Under such circumstances, company valuations can potentially be corrected by up to one fifth!

For European industrials, the sudden Euro appreciation poses a headwind. Going forward, we believe that the broader European industrial sector is rather range-bound, but with ongoing strong fundamentals for specific operators offering high-end hardware applications related to IIOT[2]. Similar to Europe, in the US, the broader industrial market is toppish. Favorable conditions are company specific and catalysts include M&A, restructuring, new products, and a strong exposure to IIOT. It is therefore opportune to make trend-related investment analysis.

Key figures for USA:

Target values:
Present fair value S&P 500: 2520
E12 months value S&P 500: 2650
Upside potential: +5.1%

Key economic ratios:

P/E 2017 (E):	18.6
P/E 2018 (E):	16.6
EPS Growth 2017 (E):	10.0
EPS Growth 2018 (E):	12.2
Div. Yield 2017:	2.0
Div. Yield 2018:	2.2

Most likely next short-term move:

S&P 500	down
Nasdaq	down

Key names to look at:

Strong intellectual property
- VISA
- MasterCard
- Nvidia

Technology:
- Microsoft
- Micron Technology
- Nvidia
- Apple
- IBM

Financials:
- VISA

[2] IIOT = Industrial Internet of Things

Healthcare

With uncertainties regarding the US healthcare reform slowly disappearing, the sector's overhang is expected to disappear by the end of the 1st quarter of 2018. It can therefore expected that self-regulatory measure will prevail and that the US pharma market will continue to grow, albeit at a slower pace.

In the quarter of review, we noted some high-profile clinical data disappointments that led to an immediate share price correction. Such events are not company specific but rather have sub-sector wide ramifications, since there are always a number of companies making R&D on the same type of molecules, or pushing for research on the same types of treatments. It is therefore opportune to focus on product lines and their potential for success, and not merely on biotechnology.

The sector, both in the US and in Europe, offers attractive long-term fundamentals with attractive cash flows. Therefore, the major players can be seen as cash-substitutes.

Telecommunication

The telecommunication a sector is completing is multi-year-long healing process, with significant progress made in business reorganization, cost cutting, and infrastructure adjustments. The sector is now in progress of rolling out 4G, and is preparing for the launch of 5G. However, these two upgrades require relatively high investment capacities; as a result, only large players may be able to fully implement them in time. On the positive side, we recognize that the economic background is perfect for these upgrades; one can therefore expect that free cash flows should ultimately get a boost.

In the US, the telecommunication Service index has significantly underperformed the broader market. Despite ongoing lackluster business conditions, strong competition, rising debt costs, and unanswered sector standards, companies within this sector have started performing. However, we believe that this is a catch-up rally rather than a pattern that long-term investors should take for granted.

Utilities

Surprisingly, the Utility sector is keeping up with average market returns despite unfavorable conditions for the future, such as rising costs for debts, stronger competition from 3rd party power providers, and strongly rising infrastructure replacement costs.

The following is a summary of the reasons for the positive YTD performance of utility stocks:

a) Ongoing low interest rates help lock-in future financial engagement at low financial costs
b) From an investment point of view, because they are low volatility stocks, utility stocks were an excellent cash and bond-substitute
c) Restructuring benefits

Going forward, it is important for investors to focus on future-proof companies such as water utilities wherein competition is low and extremely high entry barriers for newcomers exist. All other utility sub-sectors will most like experience a more or less deep disruption, and we do believe that business conditions are not set for a positive outlook.

Key figures for Asia:

Target values:
Present fair value MXAPJ: 660
E12 months value MXAPJ: 735
Upside potential: +11.3 %
(figures as of 28.06.2017)

Key economic ratios:

P/E 2017 (E):	13.5
P/E 2018 (E):	12.3
EPS Growth 2017 (E):	20.0
EPS Growth 2018 (E):	11.0
Div. Yield 2016:	2.4
Div. Yield 2017:	2.6

Most likely next short-term move:
MXAPJ down

Key names to look at:

- Alibaba
- ASM Pacific Technology
- Tencent Holdings
- Ctrip International

Foreign exchange

Currencies

- USD: Support for the US dollar is likely to increase temporarily for the next few months, but this USD strength is counterproductive for the US economy!
- The temporary USD appreciation is expected to be FED-guided, because the latter ultimately wants to avoid a significant build-up of USD Carry trades, particularly on the back of a rather stressed credit market for US corporations.

Longer-term, why does the USD need to depreciate?

A significant overvaluation of the USD versus the main currencies of the rest of the world is destructive to the US economy. Since the end of the Bretton Woods System, the USD has depreciated by about 5% on average per year. Through the offshore USD system, the global credit market was able to access cheap financing, which in turn fuelled the world economy. To maintain that trend, the USD has to become cheaper on an ongoing basis; the opposite development over a prolonged period of time would kill all EM markets and reverse DM's ever higher standards of life.

There are other reasons that indicate the USD needs to fall again:

- China has reduced its own reserves by USD 1 trillion and this trend is most likely just starting,
- Major Central Banks have become USD shy,
- Ever since GFC, the FED has underpinned the international level of confidence through its extensive monetary policy; investors are therefore increasingly reluctant to fund US deficits
- Rise of China trade: the Chinese economy is becoming more and more resilient towards past international dependency. This is supported by ever-growing local consumption, which makes the country less dependent on the USD.

Energy

In the aftermath of Hurricane Harvey, barrel prices have regained levels above USD 50-. The long-term trend is surely for higher energy prices. However, we believe that this price appreciation is more the result of capacity reductions and geopolitical situations. One such situation is the independence referendum in Kurdistan, which could diffuse additional tensions into a broader region already saddled with many difficulties.

From the operational side, we note that in the US, the number of active rigs has more than doubled since 2016. Therefore, the upstream section of the business appears to be secured. As a further key number, one could mention that in August 2017, the daily average output by Permian operators exceeded the total production of the smaller 8 OPEC countries. In other words, Permian operators now have the capacity to extract about 2.6 million barrels of oil per day, representing about ¼ of the total US consumption.

At this pace, the Permian production capacity will allow a full supply to all US refineries for the next 12 years. This is sufficient to keep oil prices at reasonable levels for consumers. Still, this luxury comes at a cost. Backed by a good economic outlook, drillers are eager to venture at any price from prime acreages to more complex formations. This has caused the average operational costs to increase by about 25% during the past two years. That kind of development could soon reach its peak, too; the current average cost to develop a new rig is about USD 6.75 million, while the net profit per rig has dropped to merely USD 500k!

Target values in 3 months:
EUR/USD: 1.100 - 1.1500
GBP/USD: 1.2500 - 1.3000
USD/CHF: 0.9750 - 1.00

Target values in 12 months:
EUR/USD: 1.20 - 1.25
GBP/USD: 1.15 - 1.20
USD/CHF: 1.00 - 1.05

Purchase power parities:
EUR/USD: 1.26
GBP/USD: 1.55
USD/CHF: 0.96
EUR/CHF: 1.21

Most likely next move:
EUR/USD: Down
GBP/USD: Down
USD/CHF: Down

Target values in 3 months:
Oil: $40-50
Gold: $1,250

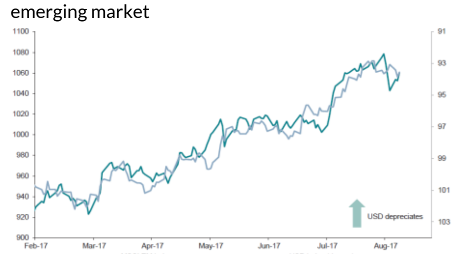
Target values in 12 months:
Oil: $60-65
Gold: $1,350

Upside potentials:
S&P GSCI: Down
Oil: Up
Gold: Up

Next most likely move:
S&P GSCI: Flat
Oil: Down
Gold: Down

Commodity related stocks:
- Vale
- BHP Billiton Plc
- Linde
- Rio Tinto Plc

A lower USD goes hand-in-hand with a well performing emerging market



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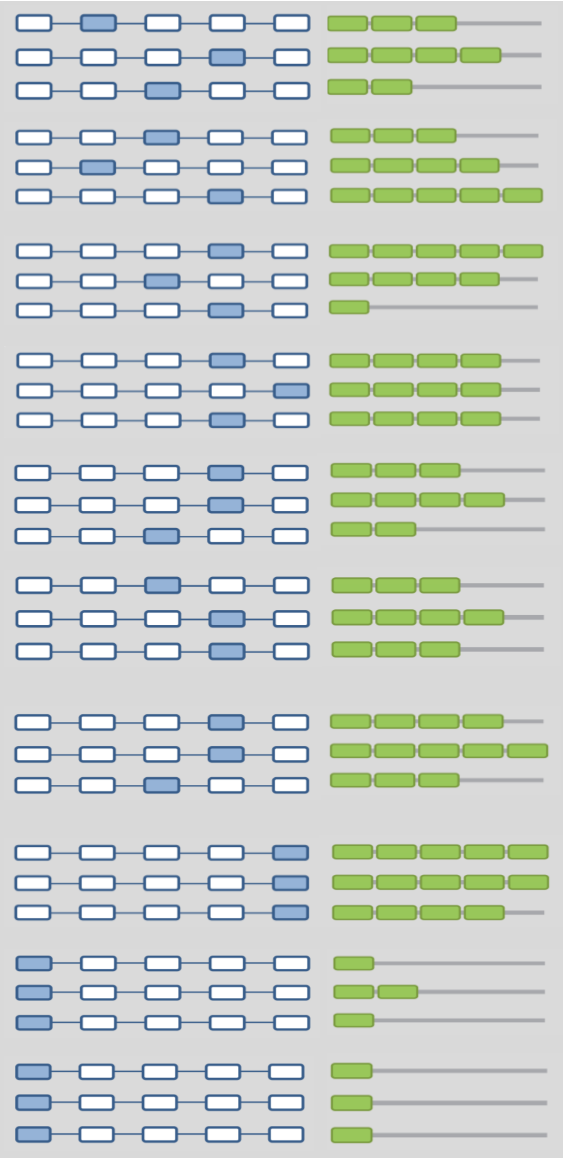
Asset Allocation Preferences – September 2017



Sectors	Region	Fundamental attractiveness	Risk/Reward Opportunity	Investment case
Basic Materials	Americas Europe EM			Investor sentiment towards the material sector shifted dramatically in 2016. Better economic fundamentals triggered earnings upgrades; subsequently, commodity prices started to increase as well. Today, rising inflation expectations are positive for commodity-focused stocks, but negative for price-sensitive consumer chemicals. US Government's plans to spend up to $1 trillion on infrastructure is most likely not going to have any impact.
Consumer Staples	Americas Europe EM			The broad business disruption trend for Consumer Staples is still in the making. With the new model, companies are poised to rapidly change their business model and to gain a large market share relatively quickly. Although valuations look attractive, Consumer Staples have not performed well on a year-to-date basis. This reflects investors sidelining because of increased competition, an unclear future due to disruptions, an inadequate business model, and a lack of management experience in the field. The sector's average valuations are cheap compared to long-term figures. Investors with a higher degree of risk appetite should focus on drivers such as industry consolidation, restructuring and cost-cutting measures, as well as on sub-sectors and businesses that could appear to be immune versus disruption (tobacco, health, and wellness).
Consumer Discretionaries	Americas Europe EM			Overall, the macroeconomic backdrop for consumers is more favorable, and financial conditions are also supportive for increased consumer spending. The stock market is nearing record highs, and home prices are steadily rising, providing a boost to household budgets. There are also some negatives, such as increasing household indebtedness in many countries, and political uncertainty. Last but not least, private equity investors' withdrawing of assets from passive orientated investment vehicles to proceed with DIY strategies demonstrates that private individuals have excessive confidence in the system.
Energy	Americas Europe EM			Energy companies have shown clear progress on cost savings, efficiency gains and investment discipline in the first half of 2017, earning the rewards of two difficult years (2015 and 2016). In our view, integrated oil and gas producers, which are paying generous dividends, offer the lowest risk. In the US, Hurricane Harvey has impacted almost all oil and gas operations in the southern fields. The potential implications are vast, especially as capacity rebuild-up will take more time than starting from scratch, and companies like Pioneer, Apache, Anadarko, and EOG are already suffering from low output prices.
Financial Services	Americas Europe EM			Based on improving macroeconomics, rising interest rates, consumer satisfaction, and a better regulatory backdrop expected over the next 12 months, financial services and, in particular, banks are expected to do well. Despite underperformance of US Financials relative to the S&P 500 year-to-date, the solid backdrop as well as positive optionality around potential tax cuts should support outperformance over the Q4 2017-2018 period. Sentiment among investors in financial services stocks has recently been cautious and hesitant. This is mainly due to two factor: 1) Slower traction in Washington DC on policy actions that could spur macro-economic and business growth (i.e., tax reform and regulatory reform), and 2) Somewhat muted near-term financial performance across US Financials.
Healthcare	Americas Europe EM			With uncertainties regarding the US healthcare reform slowly disappearing, the sector's overhang is expected to disappear by the end of the 1st quarter of 2018. It can therefore expected that self-regulatory measure will prevail and that the US pharma market will continue to grow, albeit at a slower pace. In the quarter of review, we noted some high-profile clinical data disappointments that led to an immediate share price correction. Such events are not company specific but rather have sub-sector wide ramifications, since there are always a number of companies making R&D on the same type of molecules, or pushing for research on the same types of treatments. It is therefore opportune to focus on product lines and their potential for success, and not merely on biotechnology. The sector, both in the US and in Europe, offers attractive long-term fundamentals Therefore, the major players can be seen as cash-substitutes.
Industrials	Americas Europe EM			In Europe, while key economic indicators such as PMI remain strong, stock markets no longer anticipate any major surprises, an expectation supported by a rather flattish reporting season. Increasingly, investors are taking a "travel and arrive" attitude, which consists of selling stocks that don't deliver EPS upgrades. Under such circumstances, company valuations can potentially be corrected by up to one fifth! For European industrials, the sudden Euro appreciation poses a headwind. Going forward, we believe that the broader European industrial sector is rather range-bound, but with ongoing strong fundamentals for specific operators offering high-end hardware applications related to IIOT . Similar to Europe, in the US, the broader industrial market is toppish. Favorable conditions are company specific and catalysts include M&A, restructuring, new products, and a strong exposure to IIOT. It is therefore opportune to make trend-related investment analysis.
Information Technology (IT)	Americas Europe EM			Despite a weak start to the 2nd quarter earnings season, global tech results gathered momentum, with more than 80% of companies beating consensus estimates on both revenues and earnings. Positive revisions to consensus figures are supportive for the global medium growth outlook, which means the sector is once again rerated against the broader market. While earnings growth continues to be above average, the sector's mid-single-digit premium is still below the historical average premium of 15–20%. The additional driver of our positive view–i.e. cash distribution–remains intact as tech companies continue to generate record cash flows. This bodes well for both share buybacks and dividends.
Tele-communication	Americas Europe EM			The telecommunication a sector is completing is multi-year-long healing process, with significant progress made in business reorganization, cost cutting, and infrastructure adjustments. The sector is now in progress of rolling out 4G, and is preparing for the launch of 5G. However, these two upgrades require relatively high investment capacities; as a result, only large players may be able to fully implement them in time. On the positive side, we recognize that the economic background is perfect for these upgrades; one can therefore expect that free cash flows should ultimately get a boost
Utilities	Americas Europe EM			Surprisingly, the Utility sector is keeping up with average market returns despite unfavorable conditions for the future, such as rising costs for debts, stronger competition from 3rd party power providers, and strongly rising infrastructure replacement costs. The following is a summary of the reasons for the positive YTD performance of utility stocks: a) Ongoing low interest rates help lock-in future financial engagement at low financial costs, b) From an investment point of view, because they are low volatility stocks, utility stocks were an excellent cash and bond-substitute, c) Restructuring benefits. Going forward, it is important for investors to focus on future-proof companies such as water utilities wherein competition is low and extremely high entry barriers for newcomers exist. All other utility sub-sectors will most like experience a more or less deep disruption, and we do believe that business conditions are not set for a positive outlook.

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Sources:
Analysis and comments: Bloomberg, Reuters, various (specifically mentioned)
Data and graphical items: Bloomberg, Datastream, Dolefin, various (specifically mentioned)

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