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Q 03 / 2018

Quarterly Investment Review and Outlook

Quarterly Report – Q03/2018

At a glance

Review – 2nd Quarter of 2018

1. **EPS Expansion**
   - Global GDP growth has remained solid, despite mounting political risks.
   - Germany's Ifo index reporting for the 2nd Quarter of 2018 unexpectedly rebounded, retracing half of its H1 drop.
   - US consumer confidence, although it was already elevated, kept increasing.
   - All this is in line with 3% real GDP growth at the global level (US: ~3%; Europe: ~2%) and an H1 slowdown (oil, euro, weather, trade fears, etc.)

2. **List of ongoing concerns**
   - **Trade tensions**: Trade war rhetoric continues to affect both sides of the Pacific. A fully fledged trade tension, with custom controls and taxes levied, would reduce the global GDP by around 0.5% to 0.75% per annum.
   - **Italy**: Unorthodox budget proposals (and the increase in the deficit beyond the 3% threshold) are of concern. We believe that the market attributes too much risk to this factor.
   - **EM weakness**: Turkey, Argentina, and Venezuela have imposed austerity measures on themselves. We expect that this process is not self-resolving; more broadly speaking, all EM markets will be affected. In particular, stress will increase due to external deficits covered by dollar financings, a disruptive dollar strength and a reduction in global liquidity.
   - **Brexit fears:** Fueled by recent UK officials' pessimistic comments, a hard Brexit is now to be expected. Costs: about 2% of the GDP for the UK and about 1.5% for The EU

3. **Valuation**
   - **Equity valuations:**
     a) On one hand, we do have ongoing publication of solid EPS figures in the US (mainly fueled by share buybacks and strong repatriation flows). Similar results may be seen for companies in Europe and in Japan, but there is no artificial impetus (which makes them less attractive).
     b) The risk premium for EM and Peripheral EU market continues to increase, leading to a significant compression of earnings multiples.
     c) EU equities have the best risk/reward opportunity, but Brexit concerns are a major concern for this upside potential to materialize.

4. **Central Bank actions**
   - **ECB:** the last ECB meeting was a non-event, with guidance as to the QE and interest rates remaining unchanged.
   - **FED:** The FED did increase the reference rate by 25bp in September, thereby confirming that it will keep on the track of policy normalization. There is one more rates hike to be expected by December. Finally, it could remove the reference "accommodative" in its policy stance.

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Key concerns

This is an ongoing register, and we have currently identified at least 8 known potential sources of risk that could impact the market in 2018 and beyond. Each risk is classified with a probability of occurrence ratio (POR); possible consequences are updated as and when they appear.

Breakdown in US industrial activity: POR < 5%

Possible consequences:
- Renewed US stock market consolidation
- EUR appreciates strongly
- Yield curve steepening

Sharp rise in commodity prices, and in particular, energy: POR < 5%

Possible consequences:
- EUR GDP underperformance
- General risk-off by investors
- Yield curve flattening

Revival of the Philips curve (core inflation up): POR < 10%

Possible consequences:
- Term premiums up
- Yield curve steepening
- Debt (government, corporate, and private) sustainability issues

Re-introduction of a custom tariff/trade war: POR > 75%,

Possible consequences:
- Disruption of industrial activities around the globe
- Higher prices for consumer staples
- Stock market corrections (based on lower EPS expectations)

Increase in HY credit spread and increase in default rates: POR < 5%

Possible consequences:
- US stocks down
- Wider credit spreads for HG issues
- Volatility up

Downturn in Chinese economic activity: POR < 5%

Possible consequences:
- Emerging market downturn
- Commodity prices down
- Forced liquidation of US Treasury, accompanied by a weak USD

Unexpected increase in US public deficit, increase in twin deficit: POR < 5%

Possible consequences:
- Term premiums up
- US downgrade
- Weak USD

Investment recommendations by type

1. **Equities:**

Short-term view: - Neutral

Medium-term view:

- **Main:** Strongly positive on new technologies that are enabling the 4th economic revolution (robotics, automation, artificial intelligence, and augmented reality). Additionally, we have a strong view on specialty retailers and non-US oil service companies as shale oil is topping out.
- **EM:** Valuations are particularly attractive at their current level; a major factor which is often ignored is the fact that Asian populations benefit from pro-future thinking governments and a very supportive framework.

2. **Bonds:**

Short-term view: - Negative

Medium-term view:

- **HG:** Risk/return characteristics are not attractive, despite recent improvements.
- **TB:** Holding US Treasuries is an effective way to stabilize a portfolio during times of greater uncertainty (macro and political).
- **HG**: EM Bonds offer an attractive entry points, as the yield pick-up covers for most of the expected short-term vulnerabilities.

3. **Credit:**

Short-term view: - Neutral because of rich valuation

Medium-term view: - Strong overweight in corporate via short-dated investment grade bonds.

4. **Metals:**

Short-term view: - Neutral because of stronger USD

Medium-term view: - Neutral to negative: With political and monetary risks expected to dissipate over time, precious metals are expected to lose their status of refuge asset class.

4. Commodities:

Short-term view:	-	Neutral because of stronger USD
Medium-term view:	-	Should inflation pick up in an unexpected manner, commodities prices would best reflect the adjusted conditions.

5. Structured solutions:

Short-term view:	-	**Proxy-Strategies**: In times of uncertainty, exploiting equity market volatility by means of conditional capital guaranteed structures appears to be an attractive opportunity, as compared to both fixed-income and equity markets.
Medium-term view:	-	**Secular Trends:** Strong secular trends such as IIoT go far beyond our everyday lives. IIoT has already started reorganizing the way products and services are managed, not only in delivery to end consumers, but also in how they are handled inside an existing supply-chain. Progress in high-performance computing and big data analyses, as well as the availability of new low-energy consumption sensors, has put IIOT at the tipping point, moving beyond where previously, human intelligence was required. Structured solutions around this topic may be done upon request.
	-	**Market Neutral:** Longer-term investors might consider market neutral strategies. Dispersion Strategies are non-directional investment opportunities aimed at capturing the absolute performance difference of an underlying equity universe.

Investment recommendations by theme

1. US Technology:

Short-term view:
- Momentum and revisions continue to be strong.

Medium-term view:
- Most developed stock markets are close to the upper end of their 10Y range.
- On average, the US looks expensive; however, pockets of good value and growth do continue to exist (e.g., IT, Oil Related Service and Equipment).
- Japan and the EM are among the cheapest markets vs. their 10Y metrics.

2. Energy/Oil services:

Short-term view:
- This sector is highly correlated to headline news and geopolitical events.

Medium-term view:
- We expect the barrel price to remain range-bound for the next quarters. This provides a positive tailwind to energy companies, and in particular, to oil services companies.
- The sub-sector (oil field services) is taking advantage from capex backlog, so FCF should be excellent for the next 3 years.

3. Consumer Staples:

Short-term view:
- Consumer staples are mostly defensive stocks, so they are expected to hold up well when the market is expected to consolidate.

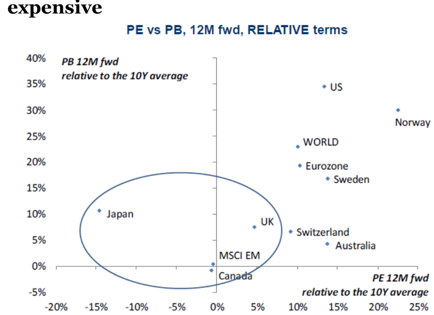
Medium-term view:
- Organic top-line growth is accelerating more than expected, while companies are passing on raw material inflation. Also, the combination of low interest rates and strong balance sheets provides a platform to engage in M&A. In Personal care, M&A remains a powerful trigger, while sales momentum is strong.

4. Economy 4.0

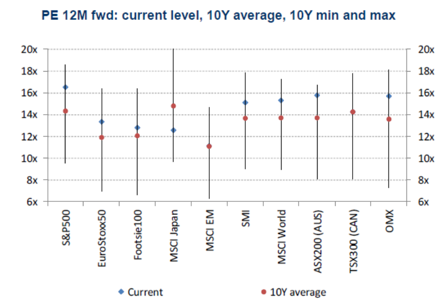
Short-term view:
- FANG stocks are vulnerable, due to regulatory threats.

Medium-term view:
- Investing in robotics and automation is participating in a long-term secular growth trend. However, product life cycles are short, and going forward, will become even shorter. We believe that these investment opportunities are authentic and without hype, and that they provide real upside potential for investors. IIOT translates into real and very immediate applications that improve industrial processes of any kind into higher productivity and better product quality, in addition to empowering end consumers.

Valuations: The US market looks rather expensive



Valuations: All markets rather toppish



Manufacturing 2025

Overview:

- This article develops how a transforming economy is creating opportunities.
- Start-ups are stepping up and creating opportunities by proactively implementing new ways of working within a) the financial sector, b) various industries and manufacturing bases, and c) technology itself.
- More than ever, our economies are converting to SaaS business models.
- Innovation-led development, beyond the traditional internet connection, is boosting the quality and value of patents.
- IIoT is leading a vast and deep Industrial Upgrading that goes beyond merely replacing an app; new job opportunities are being created.
- Sustainability is becoming key.

In the past few years, lowflation[1] was highly supportive for markets. That occurred on the back of accommodative central bank policies. As a result, unemployment and consumption have now reached levels that have not been seen for years in many countries. While the overall growth outlook is still solid, we do see some emerging concerns: a) consumer and business sentiments peaking, b) corporate profits holding steady, c) a soft approach regarding fully fledged capex undertakings, d) investors growing concerned about inflation risks, and e) the rising debt pile as compared to the GDP.

The case for taking a positive stance in the market.
Tackling the global debt pile is one of the most important tasks our economic and political leaders will need to address in the future. If left unaddressed, the ratio of GDP to Debt will weigh on future growth prospects. However, deleveraging the system is going to be a painful, drawn-out process.

Even so, there is an encouraging silver lining for investors. Companies in the private sector have a debt level that is far below the standard, if they have any debt at all. This is particularly true of consumer-led companies that are powering Economy 4.0, technology companies, and start-ups of any kind.

Obviously, this is good news, as it clearly shows where to seek future growth and investment returns. We assume that delivering the old economy will be an impossibility; therefore, falling in love with high expected returns, even ones that appear to be safeguarded and secure today, could prove to be an expensive deal.

A recent analysis published by UBS stipulates that new industry leaders are emerging in the following sectors: Healthcare, IT, Education, and Consumer Discretionary and Staples. This holds true for both developed markets and nearly developed markets, such as China. In fact, the Chinese economy passed a watershed moment in 2012 when the service sector overtook the manufacturing sector in terms of GDP contribution. This clearly confirms that a global economic rebalancing is underway.

The aforementioned change has further ramifications. As the average standard of living increases as a result of improving economic conditions, the demand for healthcare services will increase as well. According to WHO[2] data, healthcare-related expenditures increased in the following manner from 2005-2014 (see table on the right):

Country	CAGR for healthcare expenditure
Japan	1.2 %
UK	1.7 %
France	3.7 %
Germany	3.8 %
Americas	3.8 %
China	16.4 %

China is boosting spending on public healthcare services by passing reforms to promote private investments in healthcare and medical products. In turn, this will open up market opportunities for companies to enter a market with more than 1.3 billion potential customers. To illustrate the pick-up potential, one may consider the following analysis. As a percentage of GDP, healthcare-related spending ranges from 11% (Japan) to 17% (US) in developed nations; while in emerging countries, this number is far below 5%. In China, this percentage is rising relatively quickly, and is now around 5.5% of the GDP, up from 4.3% in 2010.

1 Lowflation refers to an inflation rate persistently below an official target rate
2 WHO = World Health Organization

The same development can be seen in the field of internet access. The push for e-commerce related activities is just about to begin. Statistics show that emerging market consumers are leading the way. For instance, in emerging market countries, close to 20% of retail sales are done through online channels, while in developed countries, this percentage has just about reached 12.4%. More importantly, the online access availability ratio (percentage of the population with online access) in emerging countries is around 54%, while in developed countries, this ratio is nearly 90%. Understanding these ratios is chief for identifying future growth opportunities.

Upgrading to automation

Upgrading the old economy will be a challenging opportunity for the global system. Specifically, it is expected to be a multi-pronged undertaking, comprising subsidies, tax rebates, and cheap loans, as well as retraining existing workforces to do more highly skilled jobs. The ultimate aim of this process is to convert low-value added and labor-intensive industries into fully fledged automated services. The eventual last step for some industries will consist in the closure of facilities in favor of new activities.

This is a long-term process and requires the supporting of new, clean, and sustainable industries. These new industries are not only opening up the new productivity channels, which are fully automated, but they are also expected to dedicate funding streams that provide financing for rising start-ups and companies that are truly engaged in Economy 4.0. Obviously, making products accessible to everybody lies at the heart of this global economy. Raising productivity is therefore a key element.

It is interesting to see how industries and nations are preparing for this broad move. We do observe many different initiatives, most of them including AI, VR, and MR in some form. According to the IFR (International Federation of Robotics), Chinese manufacturers are upgrading at the fastest pace; they already overtook the US and Japan in 2016, in terms of numbers of AI-Assisted units operated.

The analysis goes one step further and gives input regarding where to find future enablers. Chinese companies are rapidly acquiring know-how, competences, and qualifications to push the industrial use of robots and automation to the next level. It is expected that in China, the use of robots and AI-assisted production systems will increase about 3.7 times in the period from 2015 to 2020. During the same period, the number of AI-assisted systems will remain constant in developed countries such as Japan and the US.

As outlined above, upgrading to Economy 4.0 does not just consist of replacing an old-economy unit with a new-economy unit which is fully automated, and which is able to interact in many ways with the community. It is more about training the next generation in the most appropriate manner to successfully master the challenge of implementing and making Economy 4.0 sustainable. Therefore, ramping up our existing way of training Generation Z is probably as important as anything else. Emphasizing schooling on legal training in humanities, and in the social services at the expense of providing a strong STEM[3] education doesn't bode well for the next generation's ability to take Economy 4.0 to the next level. The WEF (World Economic Forum) has compiled the following data: Provided the present system maintains the *status quo*, by 2030, China will produce about 48 Million STEM graduates; this is more than 37% of all STEM graduates on the globe. More importantly, according to the former president of Google China, about 43% of all AI scientists are of Chinese origin.

Investment opportunities

IIoT related investment opportunities are vast; it is key to understand how industries will deploy services and applications for broader use. Focusing on old-style economies that are trying to catch up with modern times is likely a lost cause. Even so, investors will continue to gravitate toward the "comfort zone" of traditional investments. However, the apparent security of sticking to what has worked in the past is an illusion.

Companies like Baidu, Tencent, and Alibaba have grown because there were a number of factors which played in sync. We strongly believe that this will also be the case for IIoT and any Next Generation type of business. The roll-out of 5G-enabled networks and applications is about to be launched, and this is probably the final link that will propel opportunities forward.

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3 Science, Technology, Engineering, and Mathematics

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The most promising opportunities are presently found in activities such as collecting information that has become part of a bigger universe. The subsequent step is data analysis and its economic use. The tables below show mostly activities related to collecting and analyzing.

Sub-Sector	Sub-Segment	Activity
Hardware	Input Devices	Sensors and trackers
		Voice recognition
		Cameras & lenses
	VR Engine	Memory
		Processors
		Image Generation
		Display
	Output	Audio 3D
		Graphics
		Haptics
Software	Cloud-Management Systems	Platforms
		VR Modeling Tools
		VR Development Tools
		Database Management Tools/Applications

A non-exhaustive list of companies related to AI, AR, VR, and MR, segmented by product and process:

Devices	Processors and Graphics	Sensors, Cameras, Geolocalization	Sensors, Cameras, Geolocalization
Alphabet (Google Glass, etc.)	Micro-Star Intern.	Silicon Motion Technologies	Take-Two Interactive Software
	AsusTek Computer	Himax Technologies	Dassault Systems
Microsoft (HoloLens)	St Microelectronics	Faro Technologies	Activision Blizzard
Samsung (Gear VR)	Micron Technology	Largan Precision	Electronic Arts
Facebook (Oculus)	Texas Instruments	Universal Display	Square Enix
Sony (PSVR)	Nintendo Co, Ltd.	Logitech Intern.	Immersion
HTC (Vive)	Qualcomm	Alps Electric	Autodesk
Razer, Inc.	SK Hynix	3D Systems	Nintendo
Lenovo	Toshiba	LG Display	VMware
	Nvidia	Plantronics	Capcom
	AMD	Realtek	Ubisoft
	Intel	Garmin	Imax
		Canon	PTC
		GoPro	
		Nidec	
		Nikon	
		Zeiss	

The impact of trade tensions and other concerns on Manufacturing 2025

During the past quarters, headlines have crystallized more and more around trade tensions and protectionism. It is estimated that a fully fledged trade war will reduce the global GDP between 0.5% and 0.8%. In contrast, a hard Brexit will reduce the UK GDP by 2% and the EU GDP by 1.5%!

Given this analysis, trade tensions are not truly a threat to global growth. Rather, the difficulty will be that industries have to plan more in terms of timing; the just-in-time factory process model will no longer work as smoothly as it has in the past, because of multiple custom processes. Remember that today, a fully fledged car factory has only enough on-site stock to maintain a full-speed production process of fewer than 18 hours.

Despite trade tensions, Brexit, and uncertainties in Latin America, global economies are on a good footing to withstand such difficulties. More importantly, if necessary, central bankers have some headroom to provide adequate and targeted support for industries. One final note in closing: being the president of a nation is a temporary function; provided the system in place is not corrupt, a leader will lose potency at some point, probably even while the leader is in power. The good thing about all this is that we have now learned what not to do while trying to make things better.

What are our preferences?

Key takeaways for the last quarter of 2018

General:

1. Interest rates on the rise in developed markets
2. US-driven economic cycle to continue (based on tax deal and share buybacks fully supportive)
3. QE to be reduced to the lowest possible level in G-7 nations
4. Inflation likely to stay below expected levels
5. Possible trade war initiated by the US administration, destroying confidence in the established system
   - Should the US levy 25% tariffs on all imports from China, 2019 EPS expectations for the S&P500 would have to be cut by ~10%. Against this backdrop, it will be difficult for global equities to post positive returns next year; even so, 2020 EPS expectations are very optimistic. Margins should be drained by rising unit labor costs, and share buybacks should be reduced to a marginal level.

Americas:

6. One more interest rate increase in 2018 and at least three in 2019
7. Tightening financial conditions and drag on the economy could lead the FED to reverse the intended course of action
8. US Equities appear to be expensive; share buybacks generate a kind of self-entertained value appreciation of around 10-12% per annum. For 2019, we expect that companies will reduce share buyback in general and concentrate more on organic growth!
9. Trade-related market correction is expected to be short-lived
10. The energy sector appears to be under-invested for the wrong reasons. FANG stocks have captured most investors' attention; yet based on FCF, they are truly overpriced and some downside pressure should be expected. On the other hand, oil field services companies do generate substantial FCF and they are priced at the same level as 2 years ago when they didn't generate any FCF!

Asia:

11. Quality over quantity! This is supported by higher local consumption
12. China to continue to surprise to the positive
13. Asian market are resilient vis-à-vis a trade war; with reforms taking shape, financial market de-leveraging, and more constructive growth, the region is expected to surmount the trade war related set-back.

Europe:

14. Italy shatters European recovery, but we believe concerns are overstated. A new draft budget plan will be submitted to the Commission by October 15, 2018. The market is probably missing the event.
15. Late cyclicals are expected to perform best in the current economic cycle
16. Consumer Staples are the most defensive opportunities; while they might suffer from rising interest rates, their downside risk is limited.
17. A high M&A is expected in the Food and Personal Care sector; organic sales are solid, while at the same time high input prices are most overturned to consumers. Momentum in these sub-sectors is strong.

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Sector Analysis

Basic Materials

Materials stocks have sold off on trade related concerns, despite solid FCF and strong 2nd quarter EPS growth. Although the sector has a solid outlook, the near term outlook is limited, as economic activities are expected to remain stable. EU-based companies should benefit from solid US growth but weakening conditions in emerging markets. Increased protectionism remains the immediate key concern for all companies around the globe, but hopefully this concern will dissipate over time.

Several sub-sectors have experienced different outcomes. For example, strong global economic growth and industrial activity have led to a rebound in growth in the industrial gas industry. On the other side, the chemical sector has experienced a strong pickup in the Ethan price, thereby depressing output margins. That trend is expected to continue into 2019. Somewhat slower economic growth has hurt the container and packaging sub-sector. Based on ongoing trade tensions and potential industrial re-orientations, this sub-sector is expected to consolidate further in the future.

Investment opportunities:

Based on strong demand for gas products and an accommodative monetary policy, we expect that this sub-sector will outperform the larger market well into 2019. At present, the companies we like include EMN, DWP, and APD

Consumer Staples

The US consumer staples index has underperformed the broader market this year, with a negative total return of (3.4%) versus the S&P 500's +10.6% (as of September 25th). This reflects fears of heightened competition, potential disruption from Amazon, mixed earnings results, and higher interest rates. In Europe, consumer staples companies provided mixed quarterly updates as well. Organic sales growth continues to be driven by emerging markets (which are weakening, but still very high), but pricing power is relatively low at present, by historical standards.

One can expect the 4th quarter to provide better input for investors. EPS growth is expected to accelerate on the back of better organic sales, margin expansion, and efficiency programs. M&A activities may occur, but should be limited given that the sector is already now relatively well consolidated.

We are, however, strongly positive on companies that truly engage in niche online activities. This structural shift will positively impact growth opportunities and ultimately, generate FCF and EPS growth. Particular attention should be given to the following sectors:

- Companies with high exposure to emerging markets, which should benefit from good economic momentum;
- Companies with efficiency improvement, online strategies, and synergy potential, which offer better earnings growth; and
- Tobacco companies, which offer attractive dividend yields owing to their highly cash-generative business models.

Investment opportunities:

Given the overall competitive outlook for the sector, investors should seek companies with strong balance sheets, low financing costs, and a strong focus on products and services. Because of the high absolute valuation and limited upside potential, high yield dividend stocks are at risk; companies to consider include AD, ABI, BAT, NESN, EL, MO, and PM.

Key figures for Europe:

Target values:

Present fair value (DJStoxx600):	380
E12 months value (DJStoxx600):	425
Upside potential:	+11.8%

Key economic ratios:

P/E 2018 (E):	14.4
P/E 2019 (E):	13.0
Div. Yield 2018:	3.4
Div. Yield 2019:	3.7

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
- Amadeus

High competitiveness:
- Siemens
- Daimler
- Gemalto
- Richemont
- Swatch

Sustainable dividends:
- ABN-Amro
- Imperial Tobacco
- Altria
- Philip Morris

Technology

During the past few years, technology disruption has gathered significant momentum as trends like e-commerce, FinTech and automation have been dislocating many incumbent players across major markets. Despite strong recent growth, in our view, technology disruption is only in its early stages. With technology penetration across many traditional industries still only in the single-digits or teens at best, we believe that technology disruption still has significant headroom to continue.

Growth-based investors should maintain their exposure to the sector through a diversified list of disruptors and enablers. Among disruptors, we like platform companies with network effects in industries such as internet and software. Among enablers, we like companies that are exposed to trends like cloud, Big Data, and artificial intelligence (AI).

In particular, we would like to draw investors' attention to IIoT (industrial internet of things), also called EIoT (enterprise internet of things). This is a relatively new development; thoughts about IIoT respectively EIoT comes first in a recent survey undertaken by McKenzie. 98% of respondents reported that their companies already include specific AI-supported initiatives on their roadmap. Most initiatives center around enabling new business models; creating new, more efficient products; and providing services that enable a better SaaS.

These activities normally generate a shift to cloud-based computing, increased security, and IT consulting to manage the transition to the cloud. These activities are part of a strong secular trend, and we stay invested even while valuations appear to be expensive.

Investment opportunities:

Against this backdrop of tariff-driven uncertainty, IT spending remains robust. Industry analyst Gartner expects IT spending (data center + enterprise software + devices + IT services) to grow 7.5% this year, versus 5.5% last year. Software is expected to see the strongest growth, at nearly 9%.

We therefore remain constructive on software companies that are either "cloud native" or that provide tools to manage the transition to the cloud. Select services companies should benefit from increased consulting demands for cloud and digital strategies. Our present preference goes to ASML, IBM, Nvidia, Salesforce, Tencent, and Visa.

Telecommunications

This sector includes mobile phone companies, internet service providers, and cable and satellite companies.

The telecom market's structure is rapidly changing. In the past, this sector enjoyed constant share price appreciation and regular dividend increases. In contrast, today's competition is stiff, and consumers benefit from an oversupply; consequently, prices are declining. Significantly, the introduction of 5G comes with a huge cost-load that cannot quickly be recouped. Its near-monopolistic landline control is long gone, and this has fundamentally transformed what was once a defensive sector into a highly cyclical one.

We continue to see deteriorating fundamentals across the sector, due to stiff competition, the expensive roll-out of 5G, and rising capital costs.

Investment opportunities:

Large-scale equipment upgrades are a frequently recurring case for the telecom sector. For operators with insufficient subscribers, it will ultimately result in negative cash-flows. Finally, we note that from a purely technical point of view, the telecom sector will experience a reshuffling, from which a new Media sector will emerge.

Given these factors and until more light is shed on the matter, we prefer to remain on the sidelines; customers seeking active exposure should focus their attention on ATT, Centurylink, Drillisch, and KPN.

Energy

Whilst energy stocks have started to rise with the price of oil, oil services have been lagging since the beginning of the year. We are convinced that they are now going to outperform strongly, following the first upgrades coming from Morgan Stanley and Wells Fargo or Carnegie. Upstream companies and Sovereign countries have announced massive increases in their exploration programs over the last two weeks, as they realize that their oil reserves are quickly shrinking. Equinor and the like will invest over USD 100bn in the North Sea by 2026, and Saudi Arabia has announced a capex of USD 133bn by 2026. A survey of over 85 oil companies by Fearnleys shows an increase in E&P budgets of +6% this year and +16% next year. Next November, we will see the full impact of the oil embargo, with Iran plummeting from 2.3m barrels a day in May to 1m barrels a day by year's end (they are already at 1.7m and have reduced their production from 4.6m barrels a day to 3.9m in August). Saudi Arabia, the only country with little spare capacity (less than 1m barrels a day), is unlikely to be a short-term game changer, despite Donald Trump's tweets to the contrary.

For the first time since 2014, day oil platform maintenance rates are globally up, and the number of contracts is on the rise. Transocean was up 24% over the last two weeks, on back of an upgrade by Morgan Stanley and Wells Fargo. For the first time in years in this region, RIG ontracted one harsh environment rig in northern Canada at over $300k/day, and Seadrill signed up two rigs with the same contract size.

Companies are again investing in offshore projects. Subsea 7 is expected to see its EBITDA margin increase to 20% by the end of 2019 vs. 16% today. It trades at 3.5 times the EV/EBITDA 2020 vs. a historical level of 5.5 times. Petrofac and John Wood are in the same boat. Lamprell and Nabors should benefit from the capex increase in Saudi Arabia. Subsea 7 projects the number of subsea trees to be installed next year at 450 vs. 220 in 2018 and 160 in 2017. Techip FMC is also strong in this segment.

Overall, economic conditions are good. We are therefore not concerned that an eventual recession will significantly impact the offer/demand ratio; however, a recession will not eliminate the previous investment gap.

Based on OECD statistics between 2008 and 2016, annual crude oil production has increased by 1.25% to its current level of about 4TToE, or approximately 100 million barrels per day. At the same time, demand increased by about the same amount. However, there has been a shift in consumption—EM countries now consume about 58% of the total production, while 10 years ago, they absorbed about 40%.

More importantly, consumption is split as follows: Gasoline, 44%; Heating Oil and Diesel Fuel, 19%; Other Products, 15%; Jet Fuel, 8%; Propane, 6%; Residual Fuel Oil (powering factories, fueling large ships, and making electricity), 5%; Asphalt, 3%.

People will likely drive and fly for pleasure a little less during periods of recession. Therefore, while end-consumer demand will slightly lower during periods of recessions, we expect the industrial demand to be relatively constant despite adverse economic conditions. This is very much the visibility we like to have for an opportune investment case.

Investment opportunities:

Rising demand and limited supply means that oil prices are likely to continue to increase. Demand from EM, as shown above, is increasing in tandem with their improving standard of living.

Periods of under-investment in exploration will ultimately reduce output capacities; in other words, the price of oil will remain high. This, in turn, will benefit oil field service companies that can generate better FCF.

With such positive industry momentum, we expect strong stock performance for: SLB, Transocean, SBM Offshore, Petrobras, and Santos (not an exclusive list).

Key figures for USA:

Target values:

Present fair value S&P 500:	2925
E12 months value S&P 500:	2950
Upside potential:	+0.8%

Key economic ratios:

P/E 2018 (E):	18.1
P/E 2019 (E):	16.4
Div. Yield 2018:	1.8
Div. Yield 2019:	2.0

Most likely next short term move:

S&P 500	down
Nasdaq	down

Key names to look at:

Strong intellectual property
- VISA
- Mastercard

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

Financials:
- VISA

Financial Services

Europe: Despite solid reported earnings, the Eurozone banking sector has lagged the market. This has occurred as expectations for an interest rate hike have faded in recent months amid concerns over exposure to Turkey and the resurgence of the Italian debt issue (but which we believe is overstated). We see no short-term trigger for sector outperformance; rather, we believe sustained higher earnings will only come once with actual interest rates hikes are done, which should materialize in 2020 at the earliest.

The ECB announced that it will keep interest rates on hold at least through the summer. As a result, bond yields are unlikely to rise meaningfully this year, which is a drag on bank profitability.

We think that this year's expectations for reported earnings will be met, particularly because we expect credit quality to continuously improve and enable lower credit-related provisions. However, investors do not usually pay for provisioning beats, as they are considered low-quality earnings. Banks valuations look attractive relative to non-financials, but this reflects mediocre profitability.

On the upside, we believe that current valuations do not discount the earnings benefits of a fully positive yield curve. Bank earnings are highly sensitive to interest rates. All things being equal, for an average bank's valuation, a 1% interest rate increase may be expected to increase the achievable profit by 35%. Nevertheless, we advise selectivity in investing in Eurozone Bank; there is a preference for institutions from key countries over those from the peripheral market, the former having better earnings visibility.

The US earnings growth outlook remains healthy, driven by solid US consumer spending, secular growth drivers in tech, steady gains in US manufacturing activity, higher oil prices (which support the energy sector), and surging capital spending. These factors are all very favorable for financials.

The outlook for US banks remains good; statistics show that lending standards and capital spending intentions are expected to remain very supportive throughout 2019. Structural factors, such as industry consolidation and a secular decline in tax rates, support higher-than-average profit margins. Also, profit margins at the corporate level typically only decline when the economy enters a recession. Finally, the prospect of higher wages is unlikely to crimp profitability. Labor cost inflation is very good for the financial sector, as higher consumer income is usually quickly leveraged into fast consumer lending. In turn, this is positive for the financial sector (bank, lenders, and credit card companies).

Investment opportunities:

Most of the expected upside for US Banks has been achieved in the last 12 months. However, in Europe, there is still much headroom available, especially for lenders for the continental market. Peripheral operators and banks with strong exposure to LATAM should be avoided until more clarity is provided regarding Brazil (election outcome).

We like institutions that are expected to be less affected by an eventual recession. Therefore, we focus on end-consumer service providers like lenders, credit card companies and the like. Some of them operate worldwide, which makes them even more attractive, as they are less impacted by regional developments. Our key picks: V, MA, PYPL, and ING.

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Consumer Discretionaries

US: Hurricanes are typically negative events for Consumer Discretionaries. This is particularly true for retailers, as stores are forced to close; additionally, those that sell discretionary products are unlikely to recoup lost sales after the fact (because attention shifts from discretionary items to staples). However, there are some exceptions to this negative impact; home improvement retailers, for example, are big beneficiaries. These companies benefit from cleanup and rebuilding after the storm; in addition, they see a big lift in sales prior to the event, as consumers prepare themselves by purchasing generators and materials to board up windows. Depending on the degree of storm damage, the post-storm sales lift could last for several quarters.

This year's hurricane season is significant; in some regions of the US, retail stores will remain closed for weeks. Retailers with the greatest hurricane exposure in 2018 include the following: AAP, DKS, HD, and Low.

Retail sales tax on online sales:
On 21 June 2018, the US Supreme Court (SCOTUS) ruled that state governments can compel retailers to collect and remit applicable sales taxes, regardless of whether they have a physical presence in the state. This decision clears the way for states to collect sales taxes on a greater array of online purchases. Consumer impact: Overall, we expect online prices to increase by the level of the tax rate, putting most online providers' prices on par with those of traditional brick-and-mortar stores; some larger items may become more expensive than in traditional stores. Even so, we don't believe that price equality will be a sufficiently compelling reason for consumers to return to traditional stores. After all, online providers have greater product diversity, and the speed of delivery at a reasonable cost offers sufficient impetus for consumers to stay loyal.

Europe: Despite increased stock price volatility, the luxury goods sector is still one of the star performers in Europe this year. Within the sector, performance remains highly divergent. This overall positive performance is due to a favorable environment of strong stock markets, rising house prices and a growing middle class, particularly in Asia. These factors are set to remain robust, but outlook for the remaining of 2018 and first half-year of 2019 has become tougher.

Fears about waning pricing power and lower numbers of new store openings are resulting in lower than expected medium-term growth rates. Innovation is likely to be at the forefront of efforts to improve the pricing mix. China continues to drive the industry's growth trajectory, something we expect to continue in the medium term. The watch market is also experiencing a healthy revival. Our preference is for companies with good organic growth opportunities or potential for successful restructuring and attractive valuations.

On back of a strong consumer confidence and decreasing unemployment rates, we see brilliant sector development. We expect the environment in Mainland Europe to remain supportive, while uncertainty surrounding UK general retailers should increase. Pre-Brexit, consumer confidence is still very high, and this is a surprise to us! However, we maintain that indices are likely to weaken upon the arrival of inflation, along with a worsening job market.

Finally, we note that e-commerce channels keep gaining market shares; as a result, European general retailers' earnings multiples have recently dropped, mainly due to high inventory levels. To address this issue, retailers are expected to roll out new online stores, which appear to be main growth drivers for the sector.

Investment opportunities:

Understanding the changing consumer spending paradigm is key! There are strong indications—among these, the recent retail sales report—that consumers and especially millennials have different spending habits now than they did prior to the Great Recession. Given this, we favor UUA, EL, NFLX, N, ADS, and ZAL, among others. Fixed income investors may also consider our new certificate, available under CH0408529433; it is a 2-year product with annual coupons of 7.56%, paid quarterly. Capital guarantee conditions apply for this product; the term-sheet may be downloaded here.

Key figures for Asia:

Target values:

Present fair value MXAPJ:	655
E12 months value MXAPJ:	700
Upside potential:	+6.8%

Key economic ratios:

P/E 2018 (E):	12.7
P/E 2019 (E):	11.4
Div. Yield 2018:	2.7
Div. Yield 2019:	2.9

Most likely next short term move:
MXAPJ down

Key names to look at:

- Tencent
- Alibaba

Industrials

For decades, many of the world's best companies have used their production systems as a source of a sustainable competitive advantage. What differentiates today's benchmark organizations, such as Danaher or Volkswagen?

Today, even the highest-performing companies can boost their performance still further. Such boosts are based on technology. Technology-driven opportunities come from data—specifically, the huge volumes of data on processes and performance generated by new generations of network-connected devices: the Industrial Internet of Things (IIoT). To capture opportunities, companies must revisit and reassess many of the processes and principles that have been successful for them in the past.

To boost performance, IIoT technologies should be utilized throughout the entire process. The more general move to digital tools that support operations, communication, analysis, and decision-making in every part of the modern organization, will not change the fundamental purpose of production systems. It will, however, transform the way they are built and run, offering improvements across four main dimensions: Connectivity, Speed, and Accessibility.

1. Connectivity

Traditional production systems embody a collection of separate tools that are bound together loosely by the rules governing their application—and most of those are still on paper. In the future, these will be digitized and automated, and the whole system will operate as a seamless, cohesive whole. Performance measurement and management will be based on precise data, and connectivity will support better fact-based decision-making.

2. Speed

Today's production systems are necessarily retrospective; in other words, the process will be adjusted only when it is too late. With the introduction of comprehensive, real-time data collection and analysis, production systems can become dramatically more responsive. Deviations from standards can immediately be flagged for action.

IIoT technologies will speed improvements in the production system itself, for instance, by automatically identifying performance gaps among plants or updating processes throughout the company whenever new best practices are identified.

3. Accessibility

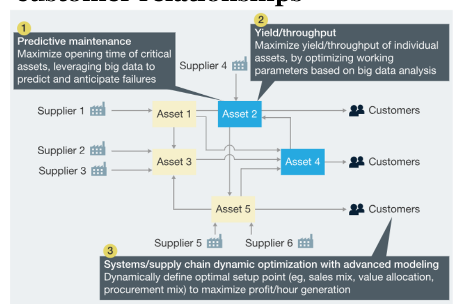
The roll-out of 5G will enable high accessibility to back-end data storage. At the same time and the throughout the entire process, users will have a predefined access route to consult, update, and use data. Implementing secure and tightly controlled applications will ultimately allow company to establish all sorts of benchmarks, internal and against its own competition.

Digital technologies will change the way an industrial process is mounted and executed; it will be a game-changer for many companies, most established companies can't overcome a sustainable change over time. IIoT will make available genuine transparency for all of us, consumers like employees at every level of a company – IIoT does not only help improve the production process and where most of the value is being created, it does also tell us how it is being done. Dashboards, mobile devices, and other applications will communicate to the entire company hierarchy how the organization is performing and where precisely value being contributed for investors.

How does this interlink with the real industrial application?

On the back of weak economic conditions industries normally adjust processes. According to the OECD, productivity growth for industrials in the EU fell from an average of 2.9 % p.a. (for the period 1996 to 2005) to 1.6 % p.a. (average of 2006 to 2015). We strongly believe that this low growth will persist for a prolonged period of time. Therefore, for EU industrials to stay competitive in a low growth environment, one of the possible ways of going forward is to integrate an even higher level of industrialization. European industrials will probably showcase how this can be done.

Advanced analytics maximize on customer relationships



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Who is adopting IIoT? The Early Bird Wins.

The fully integrated digital production systems as envisioned above do not yet exist in reality. However, there are a few sectors which have already made some quantum leaps. These include, for example, the oil and gas industry, which is rolling out industrial automation systems that can monitor the health of expensive capital assets in remote locations. These systems facilitate timely preventative maintenance by using sensor data, generating real-time performance information and providing an early warning of potential problems. In addition, auto makers already have production lines where hundreds of assembly-line robots are integrated with a central controller, business applications, and back-end systems. This technology helps companies to maximize uptime, improve productivity, and build multiple models (in any sequence), all without interrupting production.

Investment opportunities:

Ultimately, manufacturing transformations will be quicker to plan, thanks to the speed and flexibility of digital tools. Who is on the cutting edge?

Preferred companies are those with a combination of exposure to improving end-markets and favorable company-specific catalysts, such as cost-efficiency programs, restructuring, acquisitions, and new products with high value add. Therefore, primary attention should be given to themes such as e-commerce, energy efficiency, automation, and robotics. Names to look at in the US: BA, CAT, DE, FED, and UT; in Europe: Airbus, Sulzer, Rotork, and Fraport.

Healthcare

Given our expectation for the economy to remain on a solid footing outside of near-term trade jitters, healthcare fundamentals remain stable on both sides of the Atlantic, if a bit unexciting as compared to cyclicals. We expect European healthcare companies to generate low- to mid-single digit EPS growth in 2018. This is below the broader market, but is more robust compared to a risk scenario in which escalating trade tariffs lead to downgrades in other export-driven sectors.

The issue of US drug prices remains on the political agenda and may even grow in importance as mid-term elections approach. We still see few if any legislative changes likely to change current pricing dynamics, but we note that the President recently reiterated his intent to lower prices for consumers, even though earlier campaign rhetoric has led to little tangible change thus far. While US regulators are generally pro-industry, recent announcements suggest regulatory measures are increasingly likely. In commercial channels, we see signs of self-policing, and expect insurance companies and pharmacy benefit managers to continue pressuring US drug spend growth. We expect little concrete impact on European pharma and Medtech companies from Amazon's moves into the US healthcare distribution system.

Valuations are still below historical averages, and the sector looks attractive in the longer term, with good dividend growth and cover. While rising bond yields are usually a hurdle to the pharma's relative performance, we note its defensive features in a jittery market environment. M&A has picked up in the industry following the passage of US tax reform; we caution that not all earnings accretive deals are NPV-positive, and each should therefore be assessed on its own merits.

Looking ahead

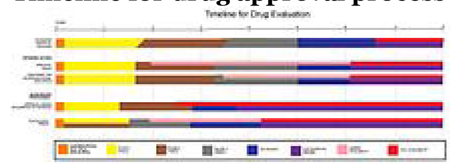
There is untapped opportunity arising for the healthcare industry to give itself a new impetus. After a weak start, wearables like fitness trackers that monitor personal health activities are gaining traction. Their use by US consumers has jumped from 9% in 2014 to over 30% in 2018. More than 80% of all consumers are willing to wear some application that can measure health data.

We see tremendous opportunity for both investors and the healthcare industry to be part of the key mechanisms through which healthcare providers can finally evolve beyond outdated practices and exceed service expectations. As adoption of new technologies is climbing, we will watch out for specific opportunities that offer an adequate risk/return profile.

Investment opportunities:

Healthcare companies typically offer consistent earnings growth, high returns on capital, and growing dividends for income-seeking investors. Pharma constitutes the core of our sector recommendations; we like companies where existing research pipelines, with clinical test at an early phase III level, can drive meaningful earnings momentum in foreseeable future. In medtech, we prefer companies with scope for self-help, given expensive valuations. Companies of interest: AstraZeneca, Bayer, Novartis, Novo Nordisk, Merck, Pfizer, Alexion, Celgene, Straumann.

Timeline for drug approval process



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Utilities

European utilities slightly outperformed European equities this year; this occurred on the back of lackluster performances by other sectors. More importantly, there are finally some positive news for investors from this sector: After two years of constant improvement of fundamentals, power producers benefited from rising wholesale power prices, a trend that is now expected to continue.

Higher power prices will improve the earnings trends of power producers and integrated utilities in the coming years. The sector is trading at a 2019E P/E of 13.2x, in line with the market. We think utilities are not expensive, but they're also not cheap. The dividend yield for utilities averages at 5.2%, so is still very attractive on an absolute level and compared to other sectors or bond yields. Moreover, we believe dividends should continue to rise. As the sector's visibility is improving, utilities are becoming increasingly opportune instruments for cash and bond proxy strategies.

US: The defensive characteristics of US utilities include stable earnings and dividends, mature business, strong balance sheets, and sales that are less sensitive to the progression of the economic cycle. These characteristics in utilities manifest themselves through stock price performance that is generally less volatile than the broader market—rising slower in expanding economies, and in theory, declining less in contracting economies.

As we have watched the performance of utilities stocks over the years, and because of a transforming business model in flux, we have kept absent from any active exposure. US Utilities are driven by the following fundamental drivers: a) capital spending, b) sales growth, and c) regulation.

Utilities are a strongly regulated operation, and on the back of this, investment returns can occur. Remember, Utilities are highly capital-intensive operations and if one were to apply the same rules that apply to the remaining industry, power prices would be much higher and more volatile. Regulations are there to maintain an artificial stability over time, for investors and customers alike.

As we are entering the 10th year of full economic expansion, there is a need for some investors to have a more defensive portfolio construction, which tends to outperform the market in periods of increased volatility or economic contraction. It is for this reason that we are adding a number of companies from the utilities sector to our investment universe.

Investment opportunities:

Record high temperatures were set this year around much of the world. As a consequence, we expect that political measures to reduce climate-damaging emissions will gain headway in many parts of the world. Thanks to falling costs, supportive politics and regulation, we believe that utilities—in particular, wind and solar—will increase capex to speed up the completion of the smart grid. Finally, we note that wind turbine manufacturers are benefiting from stabilizing selling prices, after a period of margin pressure. Our favorite names: Engie, Iberdrola, Nextera Energy Inc., RWE, Siemens Gamesa Renewable Energy, TPI Composites Inc., and Vestas Wind Systems

Foreign exchange

Currencies

The last six months in FX were rather uneasy ones, with the USD taking centre stage. There are a number of inputs from officials claiming that there are no inflation concerns, the FED is focusing on the stability of the financial system, etc. All of these comments were pro-USD, while plenty of short-term concerns (Turkey, Brexit, Italy, Sweden, yield curve tightening, elections, trade-war, etc.) drove a risk-off attitude.

We expect the short-term EUR/USD trading range to be between 1.15 to 1.20! The latter is clearly the upside limit for the time being, but we expect the FED to change direction at some point in the future, and then EUR/USD advance towards 1.35.

We are getting close to the Brexit deal; however, if there is no proper Brexit deal, then there are substantial risks for the UK domestic market. At present, this is typically a binary outcome, and as investors, we try to stay absent from such market opportunities.

Energy/Commodities

Crude oil: Our base case scenario does not anticipate any major negative geopolitical event. Based on this, and with Iran and Venezuela off the list of exporting oil countries, the price of oil is set to increase. However, surplus capacity is no longer produced and managed by the US Shale Oil producer, but by Saudi Arabia and Russia. It is a fact that US shale oil producers work at a loss if the price per barrel falls below USD 65; it is also true that Saudi Arabia needs a barrel price in the region of USD 85 to balance out its State Budget. Therefore, the future barrel price will more than likely remain in between these target figures.

Target values in 3 months:

EUR/USD:	1.1250 - 1.1750
GBP/USD:	1.3000 - 1.3500
USD/CHF:	0.9750 - 1.00

Target values in 12 months:

EUR/USD:	1.20 - 1.25
GBP/USD:	1.30 - 1.35
USD/CHF:	1.00 - 1.05

Purchase power parities:

EUR/USD:	1.29
GBP/USD:	1.61
USD/CHF:	1.00
EUR/CHF:	1.21

Most likely next move:

EUR/USD	down
GBP/USD	down
USD/CHF	down

Target values in 3 months:

Oil:	$75 - $80
Gold:	$1,200

Target values in 12 months:

Oil:	$85 - $100
Gold:	$1,300

Upside potentials:

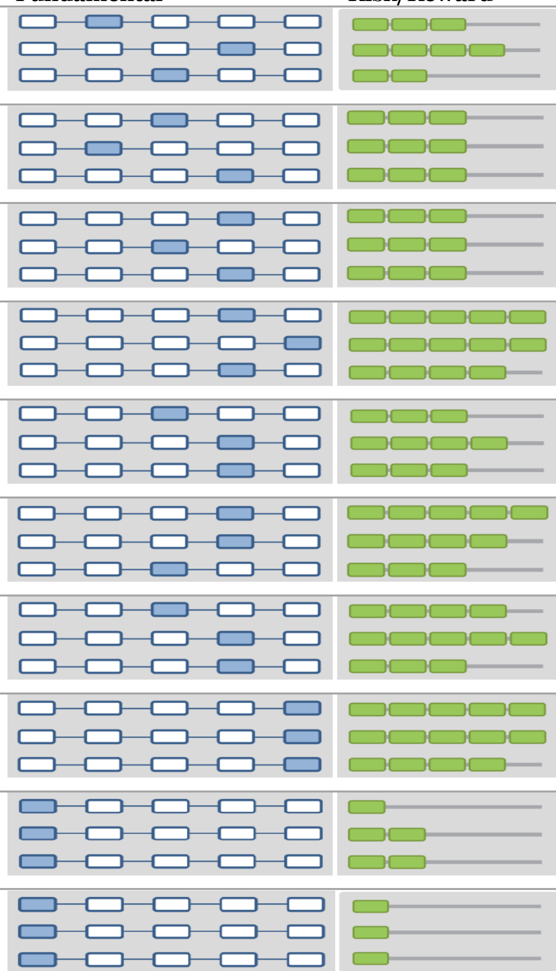
S&P GSCI	down
Oil	down
Gold	down

Next most likely move:

S&P GSCI	flat
Oil	flat
Gold	flat

Commodity related stocks:

Asset Allocation Preferences – October, 2018



Sector	Region	Fundamental	Risk/Reward	Investment case
Basic Materials	Americas Europe EM			The US administration-initiated trade war is not just a bluff, and its ramifications may extend well beyond general expectations. If it continues, the materials sector is expected to suffer most. However, we are still in the early stages and will keep monitoring progress.
Consumer Staples	Americas Europe EM			Improved ROI and ROE are the results of self-help strategies; these are leading to either a new cycle of M&A or to cash-return (share buy backs) strategies for investors. Sector is attractively valued.
Consumer Disc.	Americas Europe EM			Based on a bottom-up scenario, Consumer Discretionaries are the main beneficiaries of the US tax deal. This is because a lower tax rate will increase the purchasing power of consumers, while the low- to middle-classes have had the most significant wage-pickup in the last decade.
Energy	Americas Europe EM			Up- and down-stream operators remained very much disciplined in terms of developing new projects, and there is also an absolute drive for higher efficiency. At present, we do see higher FCF for oil field service companies, which benefit the most from past capex and equipment renewals. Most of the platforms in the western fields are no older than 7 years, therefore providing an excellent ROI.
Healthcare	Americas Europe EM			The sector suffers from relatively poor earnings dynamics and higher refinancing costs. After considerable underperformance for the past quarters, valuations have become more attractive. The healthcare sector will probably escape from any trade war sanctions. Investors should focus on healthcare service and technology companies, as they enjoy higher and more stable EBITDA ratios.
Financial Services	Americas Europe EM			Improving economic growth across the globe, driven largely by still-healthy US consumers, is set to provide a good backdrop for financial services stocks overall. The main beneficiaries can be found within the segment of diversified financials, as they benefit from the secular shift (online payments framework, which enables capital optimization potential).
Industrials	Americas Europe EM			Fundamentals are optimal for sector-based capex. The last reporting cycle has confirmed the sector's engagement in this sense. This does not come as a surprise, since the global recovery is well advanced and has, historically speaking, one of the highest synchronization levels. Still, we see subsectors where more potential exists, such as natural gas transformation and the general transportation sector.
IT	Americas Europe EM			This sector's companies recently experienced significant volatility; although the sector's key areas (e.g., IIOT, connectivity, etc.) remain fully intact, we nevertheless expect volatility to remain high. The sector is currently trading with a Fwd PE of close to 18. This is in line with average premiums over the past two decades. Software and service companies are our preferred play, as they take advantage of recurring revenues.
Telecom.	Americas Europe EM			Telecommunication is a capital-intensive business; therefore, the most recent underperformance can be attributed to rising interest rates and still stiff competition for new customers. Given that a new infrastructure deployment is in the works (upgrade to 5G), we would not expect the sector to suddenly start outperforming in a market-neutral environment.
Utilities	Americas Europe EM			Near-term attractiveness of the sector has changed. After two years of constant improvement of fundamentals, power producers benefited from rising wholesale power prices, a trend that is now expected to continue.

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Sources:
Analysis and comments: Bloomberg, Reuters, Natixis, UBS, BNP-Parisbas
Data and graphical items: Bloomberg, Reuters

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