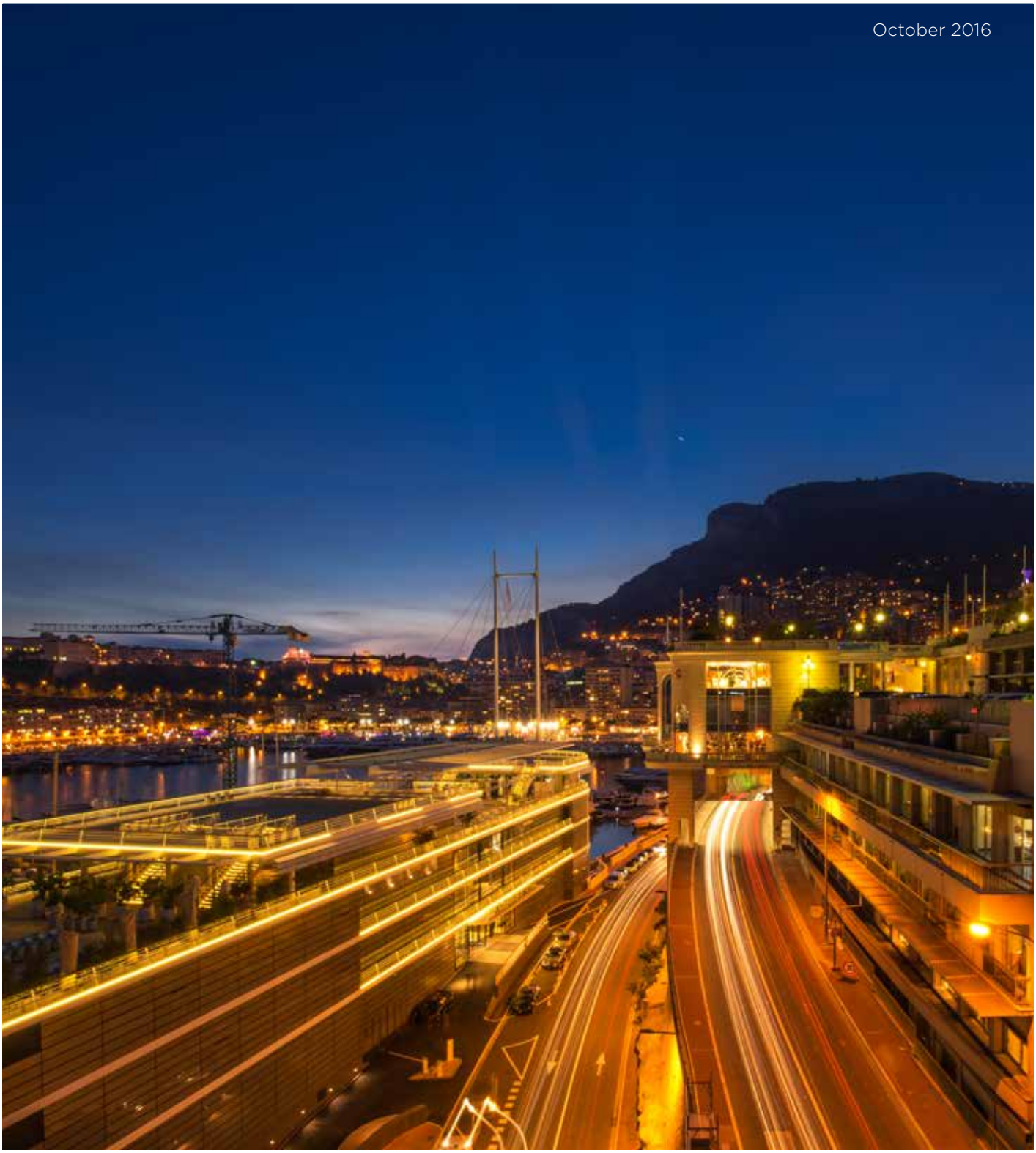
EDMOND DE ROTHSCHILD

PRIVATE BANKING

INVESTMENT STRATEGY

October 2016



KEY POINTS

Financial markets continue to be heavily influenced by central banks, particularly by those in Japan and the US.

Our investment scenario remains cautious and focuses on balanced allocation.

We are taking a constructive and tactical approach to action as we approach the next results season.

The Fed rate hike cycle will be slower than expected and will limit the potential rise in the US dollar.

EDITORIAL

by Craig Lewis
Head of Investments
International Private Banking

In 1981, Adam and the Ants, an English new wave band, hit number one in the UK music charts with their song and demand to "Stand and Deliver". 35 years later it is fair to say that many of the world's main central banks are asking their governments to "Stand and deliver - Your money or your life" in terms of delivering expansionary fiscal policy to their lacklustre economies, and pick up the baton from monetary policy. However, whilst it's easy to demand, it is much harder to deliver, with coordinated (pan-country/regional) fiscal policies almost an impossibility to implement in practice. There is also the question as to how such expansion will be funded as well as the difficulty of predicting the unintended consequences, not just of future fiscal policy, but of its combination with the unorthodox monetary policies currently in use. The job of central bankers and finance ministers has never been easy but it is likely to become a lot tougher going forward.

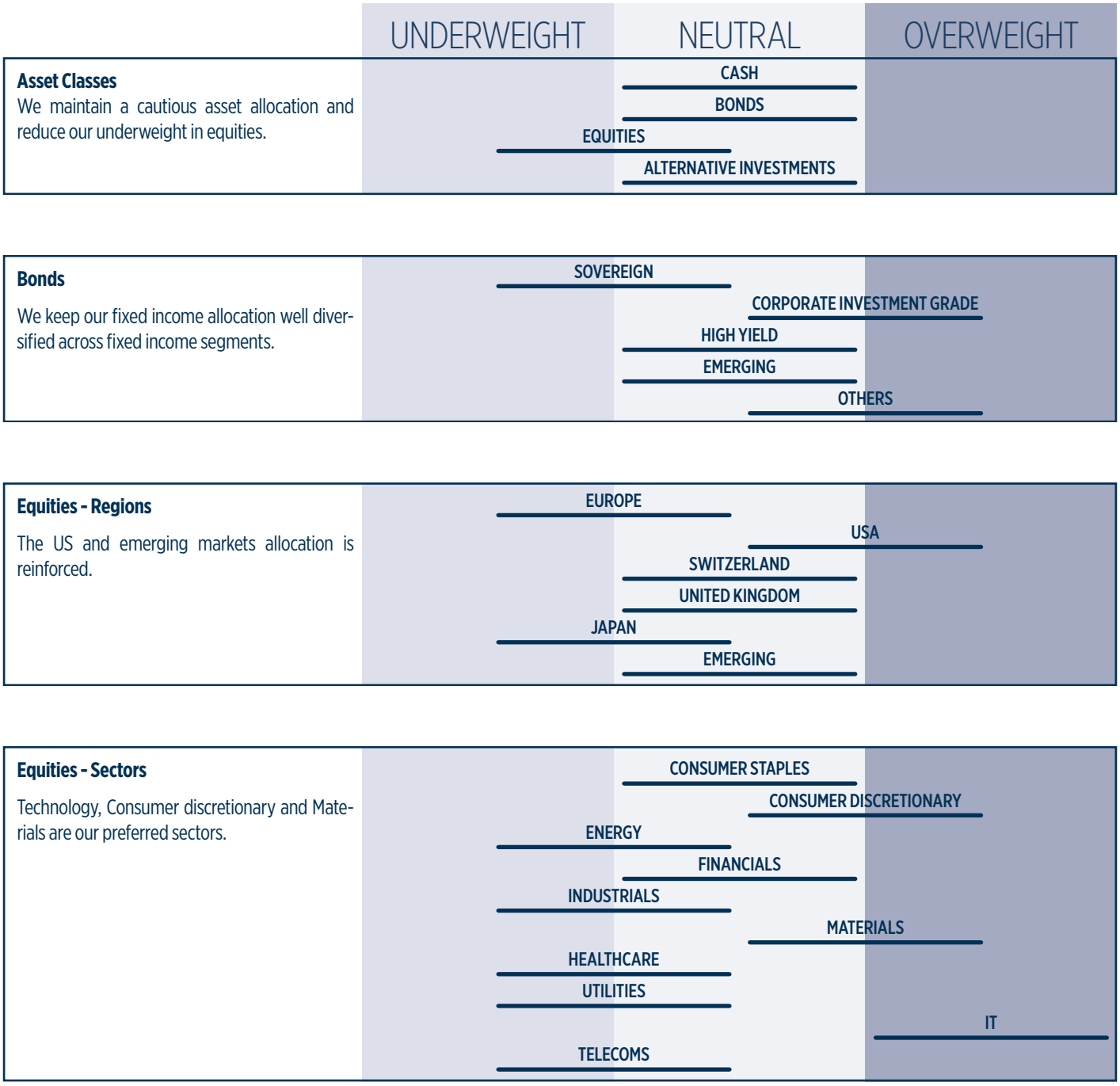
"SMART DIVERSIFICATION" IS AND WILL BE A KEY FACTOR FOR PROTECTING AND GROWING INVESTMENT PORTFOLIOS.

For now though, financial markets in general appear to be giving policy-makers the benefit of the doubt, as equity markets continue to make gains and bond and currency market volatility remains subdued. However, this may reflect the 'hunt for yield' and search for positive returns rather than faith in central banks and politicians. Our job is to continually reassess and challenge prevailing thinking and our portfolio positioning, particularly focusing on our economic analysis, the health of the companies we are ultimately investing in, as well as understanding sentiment and risks. Although we are deeply concerned about lacklustre economic and earnings growth and believe we are towards the end of the investment cycle, we cannot ignore shorter-term dynamics completely. We therefore remain invested in risk assets but retain a strong desire to ensure our portfolios and advice are positioned to withstand and adapt to changes in sentiment, policy, and fundamentals.

Diversification, or rather "Smart Diversification", is and will be a key factor for protecting and growing investment portfolios, especially in an environment where positive correlations between major asset classes have increased. It is more important than ever to delve deeper into asset classes and sub-asset classes to ensure we uncover the most appropriate exposures, which in combination give stability to an investment portfolio. We sense a heightened risk that today's markets are transitioning through an important inflection point which may mean that what worked well in the past may work less well in the future. This applies equally to monetary and fiscal policy, politics and geopolitics, and regulations.

Over the following pages, and together with our special additional publication "Autumn Insights", we have focused on identifying particular themes and exposures within asset classes that are likely to provide value on both a standalone basis as well as within a portfolio context. As ever, we hope you find our analyses, insights and views both interesting and beneficial as we remain committed to serving your best interests.

INVESTMENT CONVICTIONS



MACRO OVERVIEW

CENTRAL BANKS AT THE CORE OF FINANCIAL MARKETS

HIGHLIGHTS

- ☑ Central banks reiterated their concerns about GDP growth, but stock markets took heart from their dovish tone.
- ☑ The Bank of Japan will put in place a new monetary framework "QQE with Yield Curve Control", to achieve the price stability target of 2%. The European Central Bank could eventually take the same approach as well.

The central banks have again expressed their concern over GDP growth. The Fed kept its benchmark rate at 0.50%, while the Bank of Japan took a step forward by proposing a new monetary framework.

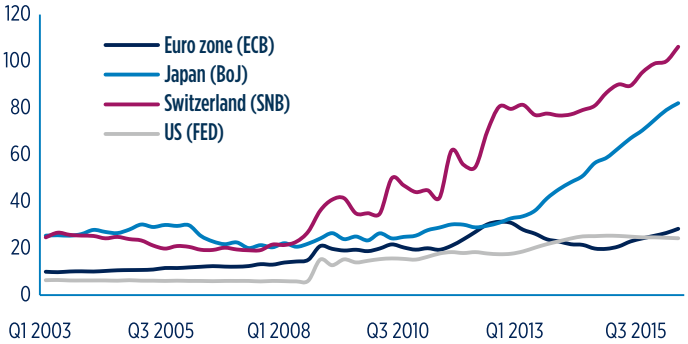
As we expected, the Federal Reserve kept the Fed funds rate at 0.50%, while hinting even more at a rate hike in December. The Fed's post-meeting statement noted that arguments in favour of monetary tightening had gained ground, thus striking a tone similar to that of Mrs. Yellen's comments at the Jackson Hole press conference on 26 August. Most members of the Federal Open Market Committee (FOMC) still expect a rate hike before the end of the year, as seen in their new projections.

That said, the FOMC members again reduced the number of rate hikes they expect and their projection of the long-term Fed funds rate. They only expect two increases in 2017 (versus three before) and believe that the long-term Fed funds rate will reach 2.875% (versus 3.00% before). They are even more pessimistic about long-term US GDP growth, which they now estimate at 1.8% instead of 2.0%.

- We still expect the Fed funds rate to be raised in December 2016. In its statement, the Fed confirmed its intention to raise its benchmark rate before the end of the year, although its decision will remain data-dependent.
- In our view, and as forecast by the FOMC members, the Fed funds rate is likely to be raised two more times in 2017, bringing it to 1.25%.
- This rate-hike cycle should be more gradual than expected, however, and this will limit upward pressure on the dollar.

The Bank of Japan (BoJ) kept its deposit rate at -0.1% and noted that it would continue buying "about" 80 trillion yen per year in assets. But it also announced that it would set a yield-curve control to keep 10-year government bond (JGB) yields at around 0%. Its aim is thus to "artificially" steepen the Japanese sovereign yield curve in order to support profits in the financial sector. This means that the BoJ intends to keep its quantitative easing policy and negative deposit rate in place for the foreseeable future while preventing the 10-year yield from entering negative territory out of concern for the financial sector.

Central banks cumulative balance sheets as a % of GDP
Sources: Thomson Reuters Datastream / National central Banks, Edmond de Rothschild.



- The BoJ has thus demonstrated that central banks can always go further and that they have the tools they need to influence bond yields regardless of maturity.
- The BoJ has introduced a new monetary policy framework "QQE with Yield Curve Control" that could also be used by the European Central Bank.
- Negative interest rates are set to last. In noting its desire for inflation to surpass and remain above 2.0%, the BoJ confirmed its intention to continue its current monetary policy longer than planned. Its yield-curve target should allow it to keep a negative deposit rate without causing excessive damage to financial institutions.
- Although investors welcomed these announcements, which lifted financial shares, distrust of the BoJ could return. We still have our doubts that this policy will push up inflation expectations. Renewed concerns about the effectiveness of its strategy would push up the yen against the dollar and weigh on the Nikkei index.

The ECB will closely observe the financial consequences of this new monetary approach, especially in view of the Eurozone's ongoing struggles. The September flash PMI composite index dropped slightly, from 52.9 in August to 52.6 in September, its lowest level since the start of 2015. We still expect economic activity to edge upward before the end of the year on the back of increased mortgage lending and growing public spending. But this may not be enough for the ECB to reach its inflation target.

ECONOMIC FOCUS

CONSUMER SPENDING SHOULD LOSE STEAM

HIGHLIGHTS

- ☑ Consumer spending could continue to grow in 2017, albeit at a slower pace.
- ☑ Household disposable income is likely to be buoyed by wage growth, which should outpace inflation.
- ☑ Our forecasts could be revised after the results of the presidential elections.

GDP growth in the USA has historically been driven by consumer spending, whose share of GDP has risen from 60% in the 1950s to around 70% today. Despite this trend, consumer spending growth – like GDP growth – has slackened. It slipped from a record 3.2% in 2015 to 2.6% so far in 2016 and could slow even further in 2017. It is nevertheless likely to be one of the only components supporting US GDP growth.

Household disposable income up despite the recent rise in oil prices

Retail sales continue to grow by around 3% per year, and consumer confidence remains solid. Yet growth in consumer spending will depend on the following variables:
1. real disposable personal income, which may be affected by real wage growth and by tax changes following the elections,
2. inflation, which can reduce household purchasing power, and
3. fluctuating oil prices, which can influence consumer buying behaviour and the level of household savings.

Household personal income breaks down as follows: 71.8% gross wages, 18.6% property income (dividends, interest, rent), 9.6% social benefits (net of contributions). And on average, the tax levied on this income is 12.2%. Each of these subcategories can affect consumer buying decisions and, ultimately, GDP growth.

- When it comes to wages, opposing forces are at work. Wages are pushed upward by factors including full employment, the high number of job openings and the mismatch between the labour market's needs and the skills on offer. But at the same time, wage growth is held in check by a levelling off in the labour force participation rate and declining productivity, which erodes margins.
- Net household wealth affects buying decisions. First, rising property and financial markets feed consumer confidence. Second, when the markets are trending upward, households' borrowing capacity increases as the value of their collateral rises (e.g. real estate). Household lending has expanded by 1.6% since the start of the year, and banks' lending conditions to households are generally accommodative. Only auto loan conditions have tightened; banks are much more cautious now following several quarters of strong growth in auto lending (+11.2% in 2015), driven in part by a catch-up effect following the crisis. The default rate edged upward to 3.5% in Q2 2016, and interest rates are also up slightly.
- Tax rates will depend on who the next president will be. Donald Trump has proposed income tax cuts across the board, which would boost consumer spending in the short term. But the Republican candidate has little support within his party, and his proposal would have trouble getting through Congress. Hillary Clinton's tax plan would not affect consumer spending because it would only raise the taxes on the wealthiest, whose spending behaviour would change little.
- Household savings grew when oil prices fell in 2014 and 2015. Savings levels have gone down in recent months, however, reaching 5.7% of disposable income in July 2016. This limits consumers' ability to ramp up their spending.

Inflation is expected to accelerate in the next few months, and this will have a bearing on consumer purchasing power.

- Inflation should reach 2% by the end of the year for two main reasons: first, stable oil prices will affect year-on-year price increases (through the base effect); second, the dollar has been relatively

stable so far this year, and this has reduced downward pressure on import prices and thus on inflation. Under this scenario of rising prices, real interest rates may decline on the one hand, which would boost household borrowing and spending, but on the other hand real wages could also drop, which would undermine consumer purchasing power.

› Despite higher inflation, the wage-price spiral could have trouble kicking in. In effect, rising inflation will have more to do with stable oil prices than with GDP growth. This means that productive inputs will simply be more expensive and drive up production costs. Assuming that companies are price-takers, which means that domestic demand is not high enough for companies to set their prices, their margins may narrow and wages may struggle to increase significantly. Prices may therefore increase at a faster rate than wages for a short time.

Fluctuating oil prices could continue to influence household consumption behaviour. For example, every household saved an average of USD 115 in 2014, USD 790 in 2015 and USD 180 up to now in 2016 (USD 1,085 in total) thanks to lower oil prices. All of this money may not have been spent, but household savings grew and expanded American households' safety cushion.

Conclusion: consumer spending should continue to grow, but at a slower pace

› At the beginning of 2016, consumer spending increased by an average of 2.55% year-on-year. We expect it to expand a bit more slowly in 2017, between 2.10% and 2.40%. It will nevertheless remain the main driver of US GDP growth (annual GDP growth would have been around -0.4% in the first semester without this component).

› There are several factors behind this expected slowdown: slowly accelerating wages, declining savings, inflation (which is eroding household purchasing power), and stabilising oil prices. Consumer spending will also be directly affected by tax changes the new US president seeks to implement in 2017.

Because consumer spending should remain a key driver, we don't expect a recession in the USA in 2017.

BOND MARKETS

CENTRAL BANKS STILL DECISIVE FOR BOND MARKETS

HIGHLIGHTS

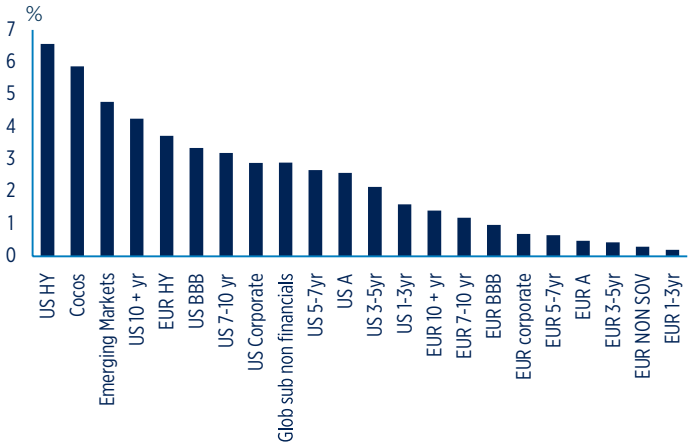
- ☑ The US Federal Reserve is maintaining its key interest rates in a context of strongly diverging central bank policies
- ☑ The Bank of Japan has decided to directly control the rates curve and is aiming for a 10-year rate of 0%.

In recent years, bond markets have continued to be dominated by rumours of central bank intentions, followed by their actions and pronouncements. It all started with the European Central Bank (ECB) meeting. Investors were fearful that the ECB in particular, as well as other central banks, had become less accommodating. Also fuelling the fear were various statements and efforts by members of the Fed headed up by its Chair Janet Yellen. Against this back-drop, the rumour that the Bank of Japan (BoJ) wanted to steepen the country's rate curve to help Japanese banks, was explosive and led to a decline in all bond market segments. US 10-year rates rose more than 20 bps in less than a week and High Yield indices, for example, lost more than 1% over the same period. The German 10-year rate registered positive for the first time in three months.

The BoJ surprised with its decision to allow the rate curve to steepen by controlling it directly, going as far as to set a target level for Japanese 10-year rates at: 0%. This forceful and sudden announcement, followed by the Fed's decision to maintain its key rates, seemed to reassure bond investors about central banks' intentions, namely to continue to maintain the system via an ongoing accommodating monetary policy. The immediate effect was a renewed rally in bond assets across all segments. The «search for yield» strategy still has a good future ahead of it.

Nonetheless, the sharp divergence seen in the Fed vote suggests that it may indeed hike rates before the end of the year. This would encourage bond investment in the US, widening the spread between US and European bond yields.

Yield (to maturity) accross global fixed income markets
Source: Bloomberg



EQUITY MARKETS

AN END-OF-YEAR RALLY WILL BE CYCLICAL OR NOT AT ALL

HIGHLIGHTS

- ☑ Rebound for better correction?
- ☑ The credibility of the Central Banks governs investor confidence.
- ☑ A (tactical) end-of-year rally gains credibility.

The weight of words!

Although the latest economic figures were weaker than expected in the principal economies (excluding China), **central bankers,** in this case those in Japan and the US, have been careful not act on them but have, it seems, been able to **find the right words** to reassure investors over the expected improvement in economic conditions in the months ahead or, at least, over their desire and their capacity to take appropriate action to achieve their goals (at last).

The **BoJ** reaffirmed its intent to continue its QE, while strengthening the qualitative side. To do so, it is setting a goal for managing the overall yield curve, with a target of 0% for 10-year maturities and effectively endorsing negative short-term rates (-10 basis points) that are to go no lower. This is until inflation has reached at least 2%.

As for the **Fed,** it has not surprised the markets but it has convinced them that it will be vigilant but cautious and that it is still critical to wait. Even though the central bank recognised that US economic conditions are no longer worrying, it is still going to wait, certainly until December. Moreover, in revising its US economic growth forecast from +2.0% to +1.8% (due to low productivity), it also lowered the long-term equilibrium rate from 3.0% to 2.8% and its expectations of a rise in Fed Funds from three to two in 2017. Remember that in the previous three cycles of rate rises, the markets remained in good shape with the Fed just supporting economic improvement without kindling runaway inflation.

The Central Banks are thus enjoying a resurgence of confidence that is bolstering the investment climate which is, for the time being, somewhat calmer as witnessed by the continuing positive flow of funds into emerging markets.

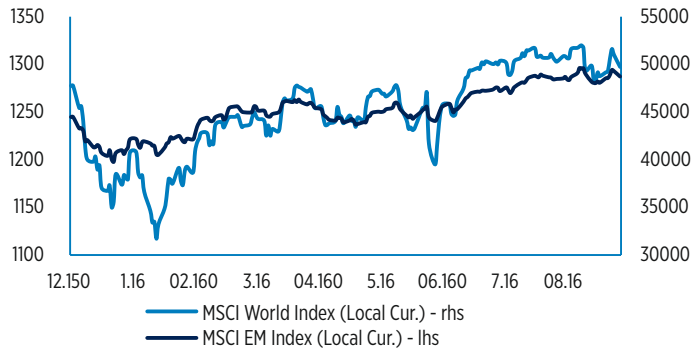
The hypothesis of an **end-of-year rally,** a frequent occurrence in recent years, **is thus gaining credibility** – to the extent that many are counting on fiscal overspend (or at least announcements of it) to support monetary policy measures.

Such a rally will thus be tactical (cash and announcement effects) rather than fundamental (valuations and political uncertainties).

It will also be cyclical (economic reacceleration or additional stimulus measures) or not at all!

Tactically, we are reducing our underweight in equities, and increasing our exposure, to the discretionary-consumption and technology sectors (particularly in the United States) on the one hand, and to emerging markets (principally Asian) on the other.

MSCI World (including emerging market) in local currencies
Source: Bloomberg



COMMODITIES

WHERE DO THEY FIT IN PORTFOLIOS?

HIGHLIGHTS

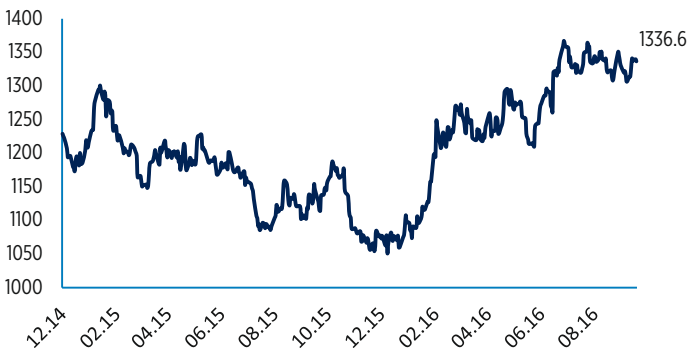
- ☑ Gold retains its diversification role.
- ☑ Base oil prices remain volatile between $40 and $50.
- ☑ Scope of rebound in industrial metals is widening.

No change (in the fundamentals or market) for **gold,** which indeed is what we expect from this asset for diversifying the structure of portfolios. Certainly, the prospect of a hike in interest rates in the United States is not, in itself, a favourable development for the price of gold, but it will be more gradual than previously thought (in size and timing). It is also worth taking into account, on the one hand, the probable extension of monetary policies in Europe and Japan and, on the other, the many political and geopolitical uncertainties in the months ahead – not to mention the stressful episodes affecting the financial sector, like the meltdown at Deutsche Bank. It is therefore wise to hold on to some prudent diversification in gold!

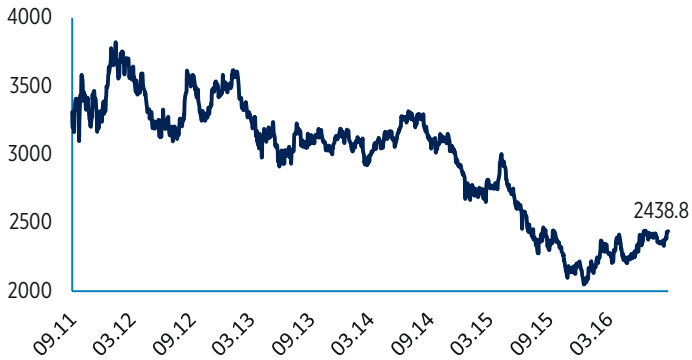
A possible agreement between the main **oil**-producing countries, whether OPEC members or not, has shaken up the financial world in recent weeks. But the many statements by interested parties, against a backdrop of deep political and military rivalry, is fuelling strong volatility. We still believe that the need to adapt for long-term survival will prevail in the end. But for that to happen, the production of each of the main protagonists will need to have reached a level considered acceptable to support putting a freeze on the situation. This is very likely already the case for the Saudis and the Russians. It is probably still too early for the Iranians. The Algiers Agreement is therefore having for the time being, an impact that is more political and symbolic than operational. Ultimately, the shifting convictions surrounding this thorny issue will fuel volatility within the $40–$50 range, which seems clearly established.

Industrial metals (LMEX index: aluminium, copper, zinc, nickel, tin and lead) continue to form a shock absorber since the start of the year, while remaining on a downward trend over the past five years (see chart). This movement reflects the rationalisation of production on profitability criteria. But it is important to note, now, that the situation is also recovering in iron ore and metallurgical coal. Almost two thirds of the demand for these two components of steel depend on the Chinese market, while, in that market, the authorities are taking action to reduce loss-making and heavily polluting overcapacity. This is a significant development when the first signs of shaky demand are also appearing in that country. Let's not forget, either, the potential stimulus plans for (infrastructure) investment that many mature or emerging countries may adopt. While remaining selective and opportunistic, it is certainly wise not to be entirely absent from the sector.

Evolution on the ounce price on the last 12 months (US$ / Ounce)
Source: Bloomberg



LMEX index over 5 years (six Industrial metals)
Source: Bloomberg



CONSTRUCTIVE ASSET ALLOCATION

HIGHLIGHTS

- ☑ Accommodating monetary policies support equities and credit.
- ☑ We are more constructive on US and emerging market equities...
- ☑ ...but maintain a stable risk level and diversified portfolios.

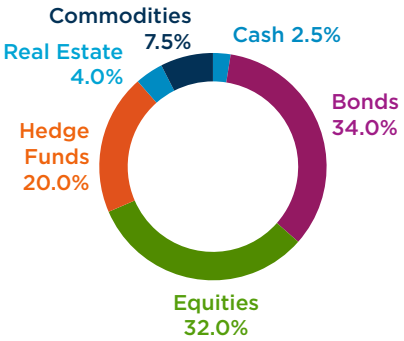
The central banks continue to take centre stage. Interpretations of monetary policy announcements and statements are positively influencing general market sentiment toward financial assets in general. Against that backdrop, the recent decisions by the Fed and the Bank of Japan show no significant departure from the accommodating policies that have prevailed to date. No change of tack then, and the theme «lower for longer» remains the order of the day. From that point of view, the market environment is positive for so-called risky assets such as equities and credit.

But the market is distrustful, as we are too, and is questioning the efficacy of unconventional policies. The message from monetary policymakers is also becoming less categorical, and some of them are hinting, explicitly or not, that they expect government to help them stimulate economic growth. We are thinking in particular of fiscal policies and public expenditure programmes that are often mentioned but are not yet announced and far from being implemented. Announcement effects in pre-election periods? It's possible, but as far as we're concerned the market believing in them is enough for short-term effects to be felt in the form of a rise in inflationary expectations and the steepening of interest rate curves. Indeed, interest rates had already begun moving upwards prior to the Bank of Japan and Fed meetings, before then returning to normal. We also see that the 6-month LIBOR interbank dollar rate is now higher than 5-year Treasury Note rates. We can legitimately wonder whether it is worth taking on non-interest-bearing time risk. Preference for short rates could increase the risk of interest rates rising. We are consequently reducing interest rate sensitivity in our portfolios by favouring short-duration credit instruments and reinforcing floating-rate instruments. Dovish pronouncements by the US central bank and expectations of key rates rising more slowly than expected have also kept the dollar stable, even weak. It is a significant factor for our gold allocations and emerging market allocations which have a degree of negative sensitivity to a strengthening dollar.

In terms of equities, we are maintaining our defensive position, although tactically reducing our underweighting. Our expectations of profit growth in the next results season suggest that the US market is heading for new highs. The same goes for the emerging markets, where profits growth is rebounding somewhat, sustained by a stable dollar and firming commodities prices. Conversely, we are assigning a risk premium to European markets due to uncertainties over the next elections, Brexit, the Italian referendum, and stresses such as those the banking sector is currently experiencing.

All in all, our asset allocation is tactically more constructive, despite our continuing expectations of a drawn-out economic cycle. The accommodating policies of the central banks are lengthening this cycle. We therefore favour diversifying the sources of risk in portfolios and remain cautiously positioned.

Balanced allocation



Bonds	37.0%
Sovereign bonds	8.0%
Corporate bonds	16.0%
Emerging bonds	4.0%
High yield bonds	4.0%
Convertible bonds	5.0%

Equities	28.0%
Europe	8.0%
North America	11.0%
United Kingdom	2.0%
Switzerland	2.0%
Japan	2.0%
Emerging Markets	3.0%

Source: Edmond de Rothschild (Suisse) S.A.

INVESTMENT DECISIONS

DIVERSIFICATION AND CAUTION

US equities ↗

Emerging market equities ↗

Sovereign bonds ↘

Corporate investment grade bonds ↘

Gold ↔

Bonds:
We are reducing portfolio interest rate risk by reducing bond weighting. To do so, we are realizing profits on primarily European corporate fixed income instruments as well as on the portion in government bonds. The exposure to peripheral European countries has been reduced, while exposure to the inflation theme has been maintained. We continue to diversity our interest rate risk by selecting floating-rate short-maturity securities, or alternatives such as loans or CAT bonds for example.

Equities:
The underweighting that has prevailed in recent months has been reduced by increasing US and emerging market equities. Regarding sector exposure, we prefer consumer-driven sectors, as well as securities associated with the technology and infrastructure sectors. The stabilisation of the dollar and the recovery in commodities prices are supporting emerging countries.

Hedge funds:
Hedge funds are an important part of our asset allocation and contribute to its robustness. We continue to favour more defensive strategies such as relative value arbitrage. Although hedge funds in general are going through a difficult period, the spread in performance between the strongest managers and the less strong is wider than ever. Fund selection remains the key factor in alternative management.

Commodities:
Gold prices have been only slightly affected by interest rate volatility, and have remained in the $1310–$1350 range. We are maintaining our allocation in this precious metal.

RISK MANAGEMENT

DIVERSIFICATION IS NOT WINNING

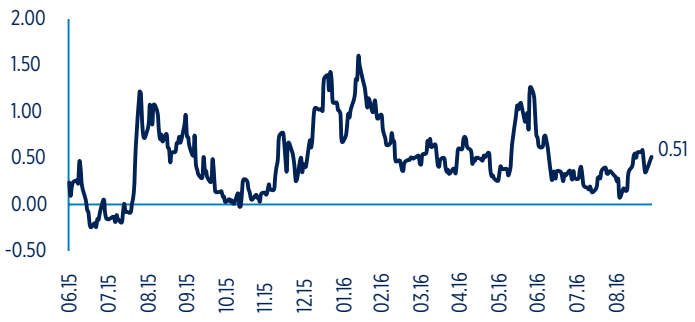
HIGHLIGHTS

- ☑ Risk diversification is variable.
- ☑ Correlation between equities and bonds is increasing.
- ☑ Interest rate risk must be managed.

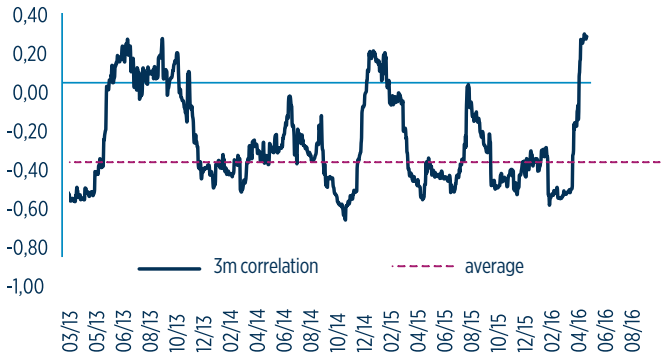
Portfolio construction is as much an art as a science. In general, and in line with our investment philosophy, we strive to build a robust portfolio that can benefit from multiple sources of return that are not very interdependent. Take, for instance, the two major asset classes, equities and bonds, or commodities and listed real estate securities. Asynchronous price movements in these assets reduce portfolio volatility by combining them appropriately. This is where the scientific side takes over, as optimisation techniques can find the best combination offering the best risk/return ratio. In such an ideal world, the correlation between asset classes is constant and the effects of diversification are known in advance. But in practice, these correlations alter over time reflecting changes in the macroeconomic environment, investor preferences, and financial crises. It is therefore critical to pay particular attention to correlations, as changes can result in our portfolio diversifying risks poorly or not at all. In a «perfect storm», correlations become positive and losses accumulate, the very opposite of the sought-after robust portfolio!

Are we well diversified today? Historically, the correlation between bonds and equities has been negative. However, on certain occasions, this correlation has become positive leading to simultaneous losses. The chart below shows the correlation between US bonds and equities on a rolling basis calculated from daily returns over the past three months. In 2013, correlation increased sharply due to anticipation of Fed monetary policy changes, the «Taper Tantrum» resulting in a rise in interest rates. The same occurred in spring 2015 when correlations moved into positive territory in anticipation of the Fed hiking key rates in June 2015. In both cases, bond prices and equity prices rose and fell together. Interest rate risk thus affected bonds as well as equities. Today, we are seeing an unprecedented peak in volatility which is persisting despite the Fed's decision in September not to raise those rates. The risk of rates rising therefore must be taken seriously into account in our asset allocations in order to construct the most robust portfolios possible. Duly noted, the duration of the bond portion of portfolios was then reduced, supplemented by a reduction in US real estate income trusts (REIT) which are sensitive to both equity markets and interest rates. This is about risk management and building a prudent portfolio. Our investment scenario does not expect to see an immediate rise in interest rates, but should that happen, its impact would be stronger than expected due to the observed correlations. We are reducing this risk.

The level of risk of the EDR Risk Indicator is low compared to its historical levels, nevertheless remains positive
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

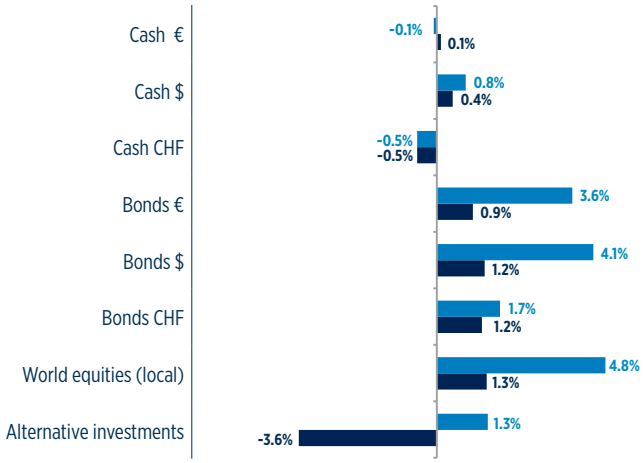


The correlation between American stocks and bonds has started to rise to become positive
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

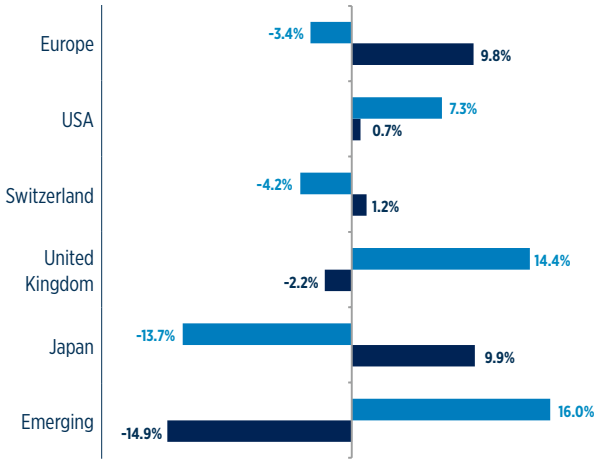


MARKET PERFORMANCES

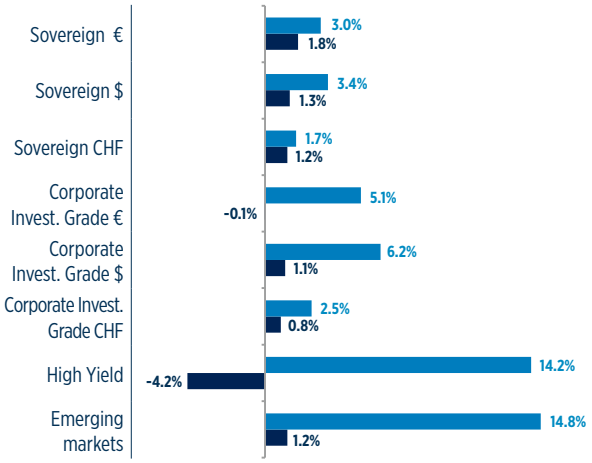
Asset classes



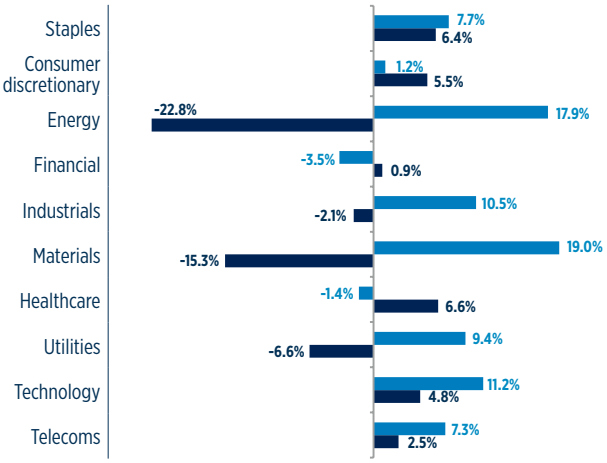
Equities



Bonds



Sectors



YTD (30/09/2016) 2015
Sources: Edmond de Rothschild (Suisse) S.A., Bloomberg

IMPORTANT LEGAL INFORMATION

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