EDMOND DE ROTHSCHILD

PRIVATE BANKING

INVESTMENT STRATEGY

December 2016

KEY POINTS

The outlook for US economic growth is improving.

Reduction in the allocation to bonds in favour of equities.

The developments of the US dollar should be monitored.

Political uncertainties will continue to create volatility and opportunities.

EDITORIAL

by Craig Lewis
Head of Investments
International Private Banking

Well, what a difference a day truly makes! As Donald Trump begins assembling his team to attempt to make "America great again" and prepares for his inauguration as the 45th US president on the 20th January, the unexpected is starting to become the expected. Back in November 1979, Pink Floyd released the protest song, "Another Brick in the Wall". Almost 40 years later populist protests are changing the face of politics and real "protectionist" walls could soon start being built. As one of my colleagues told me recently, before the elections many people took Trump literally but not seriously. After the elections, there is no doubt that Trump should be taken seriously, although perhaps not so literally. It seems the "Mexican wall" may have already been downgraded to a partial fence.

REVIEWING AND ADJUSTING YOUR INVESTMENT PORTFOLIO NOW, TO MAKE SURE IT'S IN THE BEST SHAPE POSSIBLE, TO PROTECT AND GROW YOUR CAPITAL, IS LIKELY TO SERVE YOU WELL.

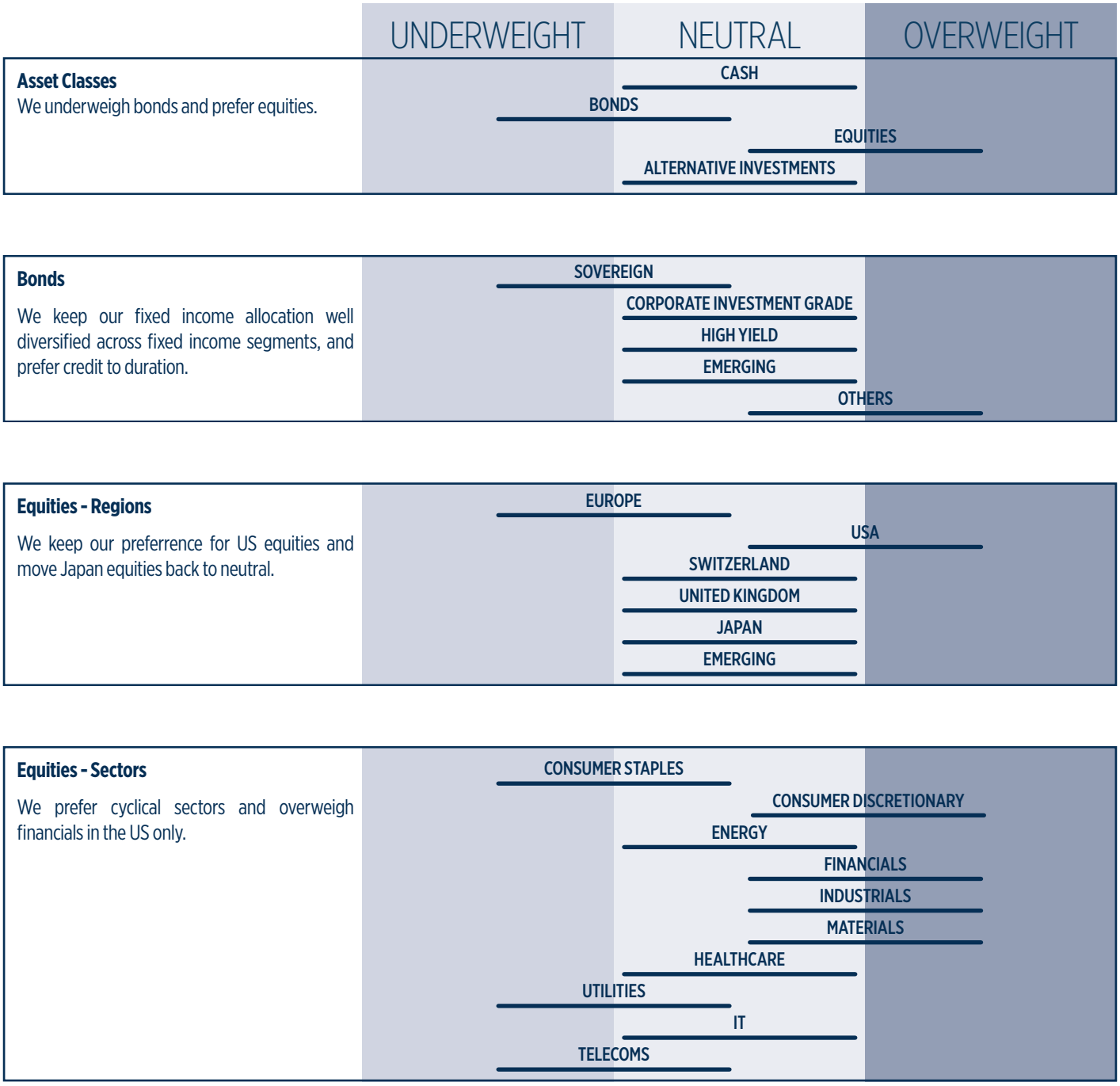
Apart from an initial few hours of panic as the election result was becoming clear; the markets are now making a series of common bets, even before Trump officially receives the keys to the Whitehouse. The US dollar has strengthened, US Treasury yields have increased, and US equities, in particular Financials and Industrials, have outperformed, all on the belief that Trump will deliver significant fiscal stimulus, decrease regulation and protect US companies. However, whilst a shot of adrenalin (or Botox!), may have been delivered to the US economic patient, it is far from certain which promises will be ratified, what the long term effects will be, and how the rest of the world reacts.

December 2016 could yet have some surprises in store for financial markets as geopolitics (Italy Referendum 4th December), and Central Bank policy announcements (ECB 8th December & Fed 13th December) take center stage. After Italy's referendum rout, attention will now probably turn to what will likely be the most anticipated political vote of the first half of 2017: the French presidential elections. With François Fillon coming from nowhere to brush aside both Sarkozy and Juppé to claim the conservative presidential candidacy, a head-to-head with Marine Le Pen beckons. Pollsters believe it will be very difficult for Marine Le Pen to win though...

As we look to close out what has been an eventful 2016, our economists and investment specialists have put together their thoughts, insights and convictions for you to consider. 2017 is likely to be as challenging, if not more so, than 2016. Reviewing and adjusting your investment portfolio now, to make sure it's in the best shape possible, to protect and grow your capital, is likely to serve you well. Your Relationship Manager is on hand to advise and guide you.

I'd like to take this opportunity to wish all readers a peaceful holiday season with family and friends, and a prosperous and healthy 2017.

INVESTMENT CONVICTIONS



THE ECONOMISTS' EYE

THE RISE OF TRUMPONOMICS

HIGHLIGHTS

- ☑ Growth has re-accelerated as expected.
- ☑ The fiscal floodgates are being opened, often completely.
- ☑ Emerging countries are at the core of numerous pressures.

UNITED STATES

With support from a republican Congress, most of the tax cuts and a large part of the public, and particularly military, spending plans could be passed.
Initially, these proposals will stimulate GDP growth in 2017, which would be between 2% and 2.2%.
However, rising levels of inflation, debt, and therefore interest rates, could eventually drag down growth.
In practice, the rising dollar could affect exports, and rising long-term rates could affect residential real estate (Figure 1) and corporate investment.

EUROPE

In the euro zone, private sector growth is the strongest we have seen from year to date. The flash composite Purchasing Managers' Index (PMI) for November was at 54.1 - well above 50, which indicates expansion. Another positive factor, private sector credit, continues to accelerate gradually: 2.2% in October compared with 2.1% in September. In October, credit growth to non-financial businesses was 2.1% - its fastest rate since 2009 - and remained at 1.8% for households. These data support our forecast of a slight acceleration in the GDP growth rate to 0.4% QoQ in the final quarter of 2016, although it remained unchanged in the 3rd quarter (Figure 2).
So, at a time when Italy, the Netherlands, France and Germany are in a pre-electoral phase, the fiscal floodgates are being opened. The European Commission has recommended a fiscal expansion of 0.5% of GDP in 2017, ranging from +0.3% to +0.8% of GDP, in order to take account of specific national factors.

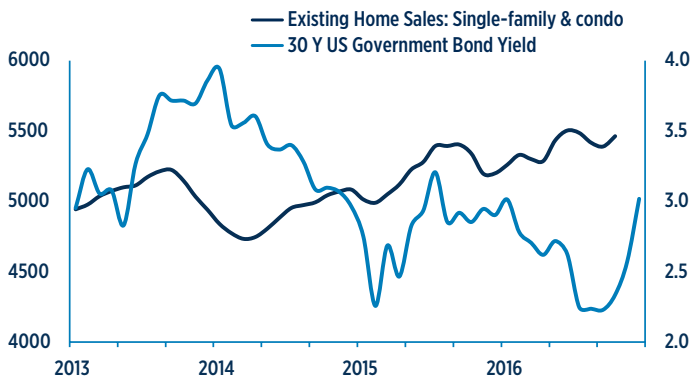
SWITZERLAND

Before the US elections, the SNB confirmed that it was prepared to intervene to counter a possible rise in the value of the franc. This rise in value has occurred.
In this context of a particularly strong Swiss franc, the SNB may therefore intervene, by resorting to foreign currency purchases rather than by key interest rate cut, as it did following the vote on Brexit. This preference for market intervention is reasonable, given the impact of negative rates on the financial sector, on savers and on pension funds.
If the Swiss franc were to settle permanently below 1.08, the SNB might be obliged to cut its key rate, because its interventions on foreign exchange markets would no longer be sufficient (Figure 3).

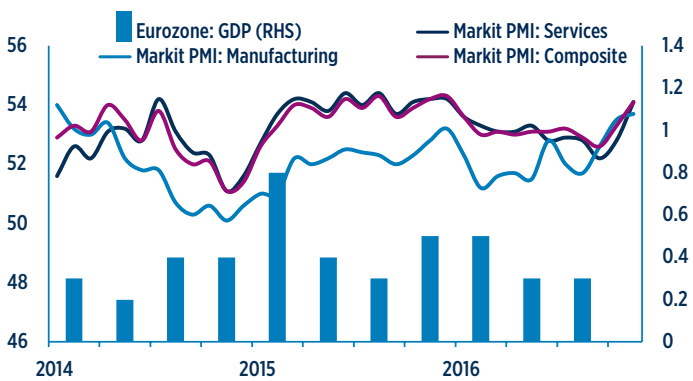
JAPAN

For the yen, cyclical factors will again become dominant, provided that the fiscal stimulus package announced this summer and the new monetary policy adopted in September turn out to be effective in

1 | Existing Home Sales & 30-Year Yield
Sources: Thomsom Reuters Datastream/ Edmond de Rothschild (Suisse) S.A.



2 | PMIs mark acceleration in Q4 2016 GDP growth
Sources: Thomsom Reuters Datastream/ Edmond de Rothschild (Suisse) S.A.

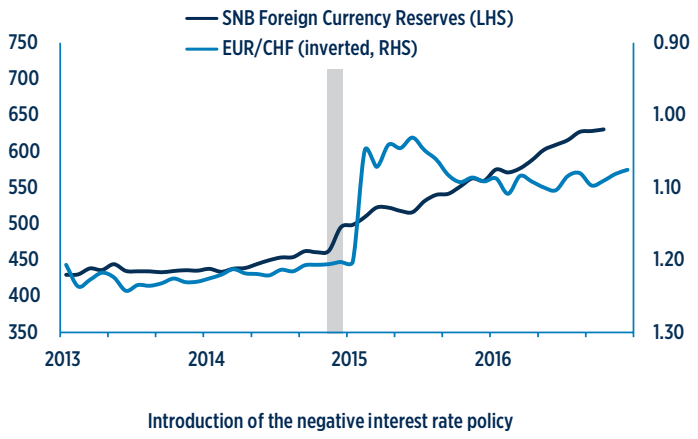


supporting growth and increasing inflation. The Bank of Japan, however, no longer believes that its super monetary policy is compatible with control of the yield curve. The Board has postponed by one year (i.e. to 2018) the point at which inflation is expected to reach its target of 2%.

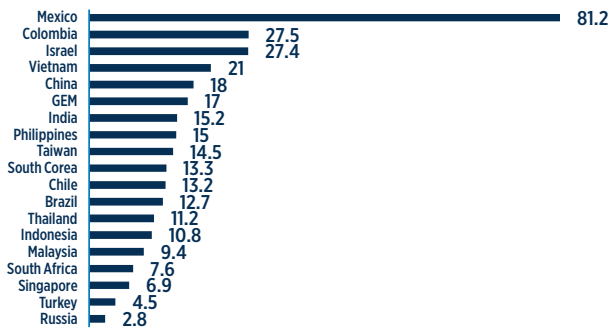
EMERGING COUNTRIES

Assuming he develops his international policy as proposed in his campaign, the election of Donald Trump may have severe repercussions on emerging markets.
The main source of contagion would be international trade, given the strong integration of emerging economies in global value chains.
Globally, strong US protectionism would place in the firing line those countries with the strongest trading links with the US, such as Mexico, China, South Korea and Taiwan. According to the UN, the domestic added value derived from global trade represents 28% of the emerging world's GDP, compared with 18% for developed countries. In relative terms, emerging Asia would be most affected, because of its greater integration in global value chains: foreign added value accounts for 30% of exports from this region, compared with 14% for South America and 13% for the economies of the former Soviet bloc.
Even though this strongly protectionist scenario cannot be ignored, it still seems highly improbable. Legal actions by American companies hit by the rising cost of their imports and the threat of reprisals by partners of the US may lead to a trade war which would not be in the interest of the parties concerned. Furthermore, given the high penetration of certain goods of Chinese or Mexican origin in the United States, it would be difficult to find substitutes for them in the short or medium term.
The middle way would be to lodge complaints about China's unfair trade practices to the WTO. The manufacturing subsidies to certain exporters and the dumping practices in certain industrial sectors would then be targeted. This method of operating between the two countries would not be new. Of the 37 trade disputes against China since 2004, 19 were brought by the United States.
The use of protectionist measures against Mexico and China, more reasonable than the imposition of 35% and 45% tariff barriers, therefore seems to be a credible scenario for Mr Trump. The result would nonetheless be an environment of increased uncertainty towards emerging country trade, which is likely to increase investor aversion to risk assets from this region. In theory, the change of channel would serve as an adjustment variable. In this configuration, the currencies of economies with significant current account deficits and the weakest fundamentals would be rendered more vulnerable. The recent resurgence of political risk in some large emerging economies is also a negative factor. The currencies of South Africa, Turkey or Brazil could be particularly affected.
Finally, the application of strong protectionist measures would have the result of pushing up inflation, forcing the Fed to accelerate the increase in its key rates. Such an environment is traditionally a source of volatility for emerging countries.

3 | The SNB will intervene to avoid a strong appreciation of CHF
Sources: Thomsom Reuters Datastream/ Edmond de Rothschild (Suisse) S.A.



4 | Share of exports from emerging countries to the US
Sources: Thomsom Reuters Datastream/ Edmond de Rothschild (Suisse) S.A.



BOND MARKETS

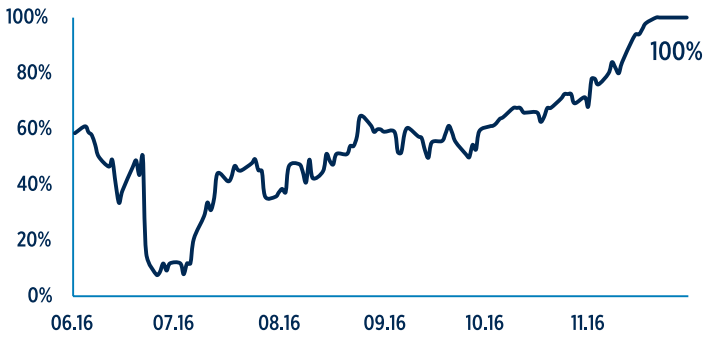
VOLATILITY ON THE HORIZON FOR BOND MARKETS

HIGHLIGHTS

- ☑ Investors seem convinced that rates would remain high.
- ☑ In this context, we are reducing the duration (i.e. interest rate sensitivity) of our portfolios.
- ☑ And we maintain our preference for credit.

The sharp fall in bond markets following the US election supports our investment beliefs concerning bonds: continue to maintain the low duration of our bond portfolios.
The election of Donald Trump, and the hopes (or fears?) raised by possible tax measures, have led to a sharp rise in inflation expectations, and therefore to an upward adjustment in various government rates. This was followed by a strong and rapid steepening of the yield curve.
Our tactical positioning and the diversification of the bond component of our portfolios have enabled us to cushion the impact of these negative market developments. However, we continue to make changes in our bond component allocation to render our portfolio even more resilient in this environment of high bond volatility.
As such, we will take advantage of the lull on the fixed-income market to reduce our exposure to government bonds by continuing to favour inflation-indexed bonds.
Fixed rate debt issued by blue chip companies has not escaped this downward trend. Within the bond segment, we continue to favour floating rate securities issued in dollars. We maintain our exposure to subordinated hybrid securities of companies, whether financial or not, in Europe and the US. Corporate hybrid debt continues to offer attractive valuations in a market where the European Central Bank is buying senior debt. Subordinated financial debt also benefits from the improved balance sheets of banks and insurance companies and from the protection of bondholders by the regulatory authorities.
As regards high yield bonds, our exposure to loans has held up particularly well in recent weeks. The floating rate structure of this type of debt has delivered on its promises. We maintain our current exposure, which we are prepared to increase if necessary. The objective is to stabilise the portfolio by giving it positive sensitivity to a rise in rates.
We remain alert to developments in emerging markets. The sharp rise in the dollar, combined with the protectionist rhetoric of the American president-elect, is holding back emerging bonds. Furthermore, the election of Donald Trump has led to a significant withdrawal of capital from this asset class, resulting in often exaggerated declines. We remain ready to seize potential opportunities in these markets.

Possible FED interest rate hike in December
Source: Bloomberg



EQUITY MARKETS

THE MARKETS GRAPPLE WITH HIGH ANXIETY

HIGHLIGHTS

- ☑ A "reflationary" growth scenario is good for equities.
- ☑ Uncertainty is here to stay, so let's return to corporate fundamentals, which are improving.
- ☑ Favour the US and the cyclical and Value sectors of the list.

There are many uncertainties (which is hardly news) and most of them are political in nature.
Investors are therefore returning to the fundamentals of investment in equities: the earnings power of companies, and the profitable employment of their capital and cash flows.
From this perspective then, all systems seem to be on the go. Barring distortions caused by the energy sector, earnings growth reached +6% in the US and +2% in Europe. More interestingly, earnings growth now exceeds income growth, revealing a widening of margins resulting from restructuring during the crisis and from operational leverage. The movement is gaining traction, as evidenced by the upward revisions of estimates for the commodities, financials (US) and discretionary consumer sectors.
The global economic upturn, coupled with monetary policies which are still accommodative (compared to the past) and with probable fiscal initiatives (public spending and tax cuts) lead us to believe that a "reflationary" growth scenario may develop, pushing indexes (moderately) higher and, more importantly, amplifying pro-cyclical rotation.
We are now overweight in equities, favouring:

- The United States
- Within Europe, Germany
- At the sectoral level, cyclical and Value sectors of the list

Could Italian voters upset this constructive scenario?
Luckily this time the polls had it right. The "no" to the Italian referendum does not come as a surprise for the financial markets. Bond spreads, bank CDSs and stock market performance could thus be reversed, especially as the ECB already shows signs that it could adjust its action to counter possible risks.
Even with a 'no' vote in the referendum, there is no systemic connection which would make this sequence of events lead to an Italeave:
A 'no' vote in the referendum will not call for early elections.
In a spirit of "change with continuity", a member of the government could be asked to become Prime Minister; for example, Pier Carlo Padoan, the Minister of Economy and Finance since 2014.
An exit from Europe, or the euro, would require an amendment to the constitution, i.e. a two-thirds majority both in the Senate and in Parliament.
Lastly, transparency and political stability have never been a transalpine trait. Since World War II, Italy has had 63 governments, often short-lived with an average life expectancy of less than fourteen months.

No need to panic, but a constructive scenario remains central to our positioning.

Q3 results in a snapshot
Source: Bloomberg

Indexes	Growth Y/Y		Ex-energy
	Revenues	Earning per share	**Earning per share**
S&P 500	3%	3%	**6%**
Stoxx600	-1%	0%	**2%**
Topix	-8%	-1%	**-3%**

COMMODITIES

FOCUS ON CYCLICAL COMPONENTS

HIGHLIGHTS

- ☑ While we increase the risk-on bias in our portfolios, gold is losing its tactical attraction.
- ☑ Industrial metals benefit from our macroeconomic scenario.
- ☑ With or without the OPEC agreement, oil is confirming a sustainable base between USD 40 and 52.

Gold remains under pressure, and has lost nearly USD 150 since the American election under the combined effect of a net rise in the dollar and bond yields, while an increase in Fed Funds in December is virtually certain. In the short term, significant technical and psychological vehicles have been broken, hence the one-third reduction in our tactical allocation, while overall, we are increasing the Risk-On and cyclical bias of our portfolios.

The informal talks and the dithering of the major oil producing countries (OPEC members, or not) betray divergent geopolitical interests, while the economic reality of their public finances is expected to push them towards an agreement.

In any case, the American production of shale oil, a technology which enables rapid responses to price fluctuations, is today (and in the short/medium term) the main supply adjustment factor. Indeed, considerations linked either to a possible agreement within OPEC, or to failure of the negotiations in progress, are more likely to produce sudden movements within a well-established range (USD 40 - 52), than impose a new trend range in the coming months. Remember also that, historically, many producers, have a strong tendency not to act in accordance with their commitments.

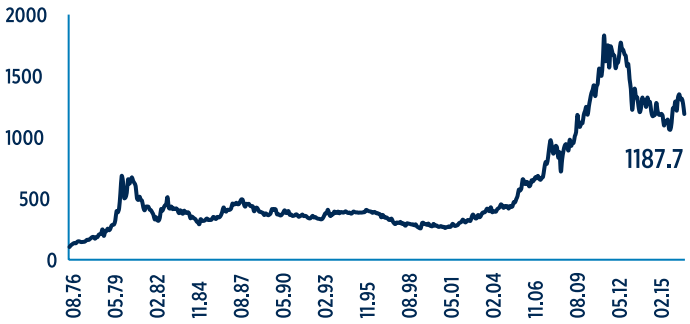
The rebound in industrial metals is growing and spreading. Copper, which had previously remained slightly subdued, has in turn exploded. The six metals represented in the LMEX index are now moving decidedly upwards, while iron ore and metallurgical coal also continue their uptrend. The downtrend of the past five years has been broken!

On the supply side, producers, under pressure from plummeting prices and shrinking balance sheets, have had to streamline their production purely on the basis of economic criteria and of the planned depletion of major sites.

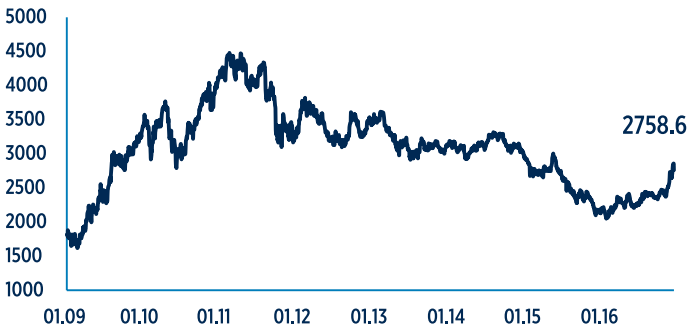
On the demand side, an economic recovery with a strong industrial component is taking the place of necessary restocking. Moreover, the prospect of stimulus plans broadly backed by infrastructure spending is taking shape in many countries.

This is no longer a bear market rally, but a new bull market justified by changes in fundamentals.

Gold Ounce/$ 40-year period
Source: Bloomberg



LMEX Index (Industrial Metals) since the end of the 2009 bear market
Source: Bloomberg

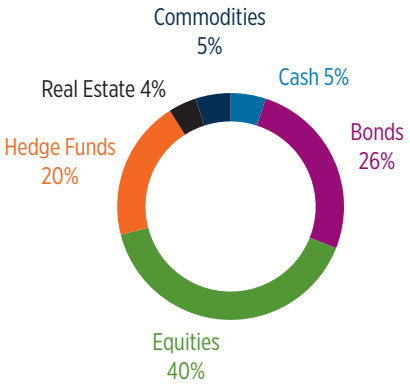


ASSET ALLOCATION

HIGHLIGHTS

- ☑ Our investment scenario prefers equities to bonds.
- ☑ We are monitoring developments in the US dollar, as abrupt strengthening would affect our scenario.
- ☑ Political uncertainties remain and may lead to volatility peaks in the coming weeks and months.

Balanced allocation



Bonds	26.0%
Sovereign bonds	6.0%
Corporate bonds	9.0%
Emerging bonds	4.0%
High yield bonds	4.0%
Convertible bonds	3.0%

Equities	40.0%
Europe	9.0%
North America	18.5%
United Kingdom	2.0%
Switzerland	2.0%
Japan	3.5%
Emerging markets	5.0%

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

Since the beginning of this quarter, statements by various government agencies and political leaders to boost fiscal policy have had the effect of pushing up inflation expectations and interest rates. This hesitant inflection point, which we observed in September, has turned into a significant movement following the election of Donald Trump as President of the United States of America. In the US, 10-year interest rates have rebounded dramatically, reaching the 2015 year-end levels of 2.35%. Meanwhile, German and Japanese government bond rates have returned to positive territory. These movements are occurring while economic fundamentals improve, suggesting more encouraging growth prospects in the United States. While the election of Donald Trump cannot itself be held responsible for recent developments, we note that financial markets want to believe in a more positive economic environment. Thus market dynamics seem to have changed and are, to say the least, prolonging the current economic cycle. That said, our optimism is tempered by the prevailing uncertainties which may cause current trends to change. Conversely, a reduction in these uncertainties could possibly lift sentiment higher, since many of these risks have already been priced into the markets. We will monitor changes in the US dollar, which influences emerging country assets as well as gold. Excessive strengthening of the dollar could have a negative impact on economic growth in America and limit rate hikes by the Fed.

As regards equities, the results recently announced by US companies show improved earnings and earnings growth, as well as weaker pressure on margins. Evaluations appear somewhat more favourable, in historic comparison, and the prospect of more favourable taxation makes US stocks more attractive, especially cyclical stocks. Although our preference is for US equities, fundamentals are also becoming more favourable in Japan, whilst in Europe they are at best nascent.

The "reflation" story, on the other hand, is raising headwinds for the bond segments. The steepening of yield curves shows that duration risk is very real. This is all the more true since we are starting with extremely low interest rates, and a rapid return to normal levels could be expensive. The risk of rate increases is now well recognised, and, as a result, our bond strategy has focused on credit and has gradually reduced interest rate sensitivity in our portfolios by favouring floating rate financial instruments, for example. Our allocation to government bonds remains low.

Our investment scenario for the coming months is therefore more constructive. We are positioning ourselves in favour of growth assets and are reducing assets which are, or are seen to be, sensitive to interest rates. Our asset allocation therefore favours equities over bonds.

INVESTMENT DECISIONS

Bonds ↘

Equities ↗

US Dollar ↔

Gold ↘

Cash ↗

Liquidity and Short term
We are increasing the allocation to liquidity in our base currency, firstly, to keep the level of risk in our portfolios under control, and secondly, to be able to seize future opportunities. Since financial markets face many political uncertainties and may be quite volatile, a liquidity component will enable us to seize opportunities when the market overreacts in the future.

Bonds
We are reducing our allocation to bonds in general because interest rate risk is currently very high. We advocate a defensive approach, favouring credit instruments with low duration, and floating rate instruments. We are also maintaining positions in inflation-linked bonds, which act as a hedge against interest rate risk.

Equities
Considering the growth outlook for profits and revenue, a positive market sentiment towards equities, and a more favourable momentum, we have decided to increase our exposure to equities, in order to make the best of an end-of-year rally. We favour US equities and the cyclical sectors. On the rebound, we are selling the themes and sectors which are suffering excessively from rising interest rates, such as high-dividend stocks or REITS.

Hedge Funds
Although hedge funds have, on average, performed below our expectations in 2016, we are maintaining our allocation to alternative investment strategies. The change in the market environment towards higher interest rates, in line with rising inflation expectations, should favour the hedge fund sector as a whole. However, this remains to be confirmed and will require an in-depth analysis at the beginning of next year.

Real Estate
Listed real estate in the US and Europe has suffered a lot in recent weeks because of its sensitivity to interest rates. Since the fundamentals in both the US and European real estate markets remain positive, we believe that the recent losses have been overdone. We maintain our allocation, but will adjust it on rebounds.

Commodities
We are making minor adjustments to our weighting in the yellow metal because of increased risks in the short term. Technically, because of the rise in the US dollar and in real interest rates, gold has lost some of the gains recorded so far this year. With the potential for a further fall of about 10%, down to the next vehicle level, we prefer to make a tactical reduction in our allocation. In the longer term, we maintain our positive view of this precious metal.

Currencies
We maintain our portfolios' exposure to the US dollar, but this is still historically low. Current economic fundamentals barely justify a significantly stronger dollar in the short term. That said, its momentum is such that we cannot exclude continued appreciation in the coming weeks, and therefore we maintain our exposure.

RISK MANAGEMENT

HIGHLIGHTS

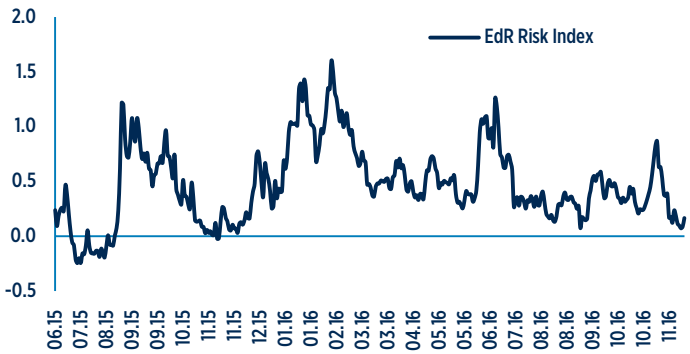
- ☑ Our Edmond de Rothschild Risk Indicator does not show a significant risk level, even given the known political uncertainties.
- ☑ Risks relating to the development of the US dollar and interest rates should be monitored.

According to our proprietary risk indicator, the overall level of risk in financial markets has fallen close to its historic average for the past 12 years. Market participants therefore do not seem particularly concerned about the predominantly political uncertainties of the coming months. As proof, the implied volatility index for US stocks (the most monitored "fear" factor) is back within the 12% to 14% range, after breaking through 22% just before the election of Donald Trump. The rise of populism, the questioning of austerity policies, the plans to increase public spending, to put the brakes on enhanced banking regulation, or to lower corporate tax rates are all factors which the markets perceive as positive. However, they are far from being implemented and political uncertainty remains. In the United States, the question is if, when and how will Republican promises be kept. In Europe, the political calendar is very busy throughout 2017: in France, Germany and the Netherlands, electoral promises will soon start influencing market sentiment. It is therefore probable that financial markets will again experience periods of volatility in 2017.

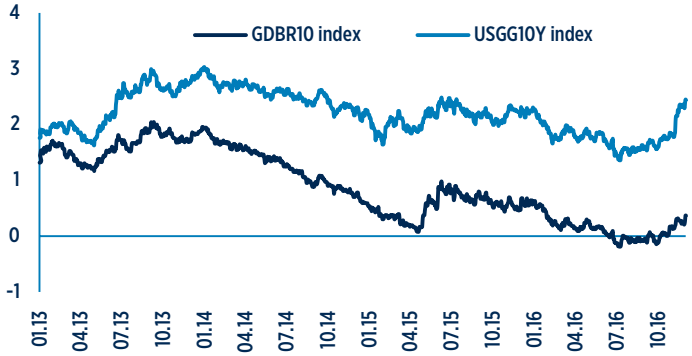
Apart from political risk, we think the strengthening of the US dollar and the rise in interest rates represent more significant risks to current optimism. Excessive strengthening of the greenback will have a monetary tightening effect in the US, but will also have an impact on emerging markets and commodities. The problem is to identify the level at which the Fed would need to re-assess its monetary policy and postpone the normalisation of its key rate. This would undoubtedly raise questions about the interest rate hikes we are seeing now. We will therefore keep a close eye on the developments of the US dollar!

The second risk we are following closely is the risk relating to interest rate hikes. Rates have, so far, been close to their historic lows and are still negative in Switzerland, and the yield curve has been flat, with short and long rates at similar levels. Often associated with an indication of low economic growth, the yield curve has recently begun to steepen following announcements of fiscal stimulus policies, rising inflation expectations, and better economic growth outlook. Most bond indexes have reacted, with, for example, the Bloomberg Barclays Global Aggregate Bond Index in November recording its biggest monthly loss since its inception in 1990. The major central banks' monetary policies have resulted in excessively low rates, and many analysts have commented on this environment as a "bond bubble" waiting to burst. Are we at the verge of the much-touted "Big Bond Bubble Burst"? We are not scaremongers and the bond markets are not in a state of crisis. It is, however, reasonable to wonder whether the bull market, which has lasted for more than 35 years, has not come to an end. So, for the sake of both prudence and conviction, we have reduced the bond risk in our portfolios.

The Edmond de Rothschild Risk Index is close its long-term average
Source: Bloomberg, Edmond de Rothschild

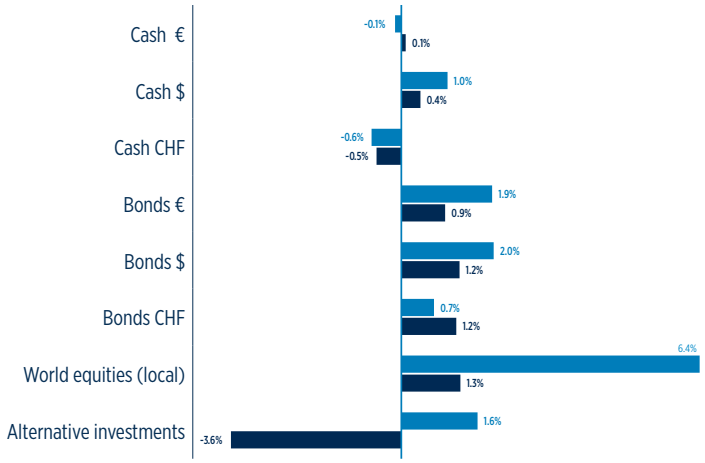


Strong increase in 10Y interest rates in the US and Germany
Source: Bloomberg, Edmond de Rothschild

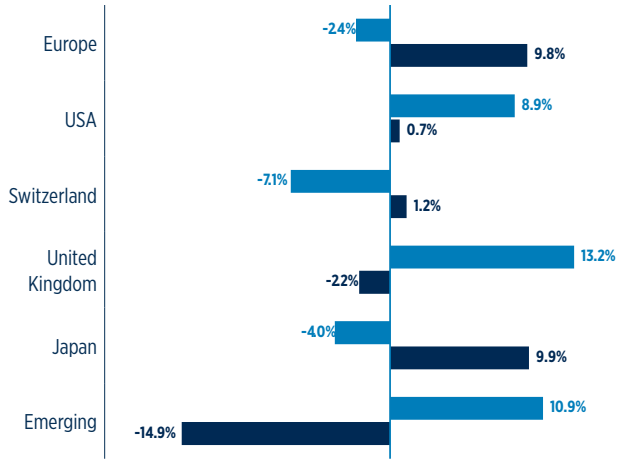


MARKET PERFORMANCES

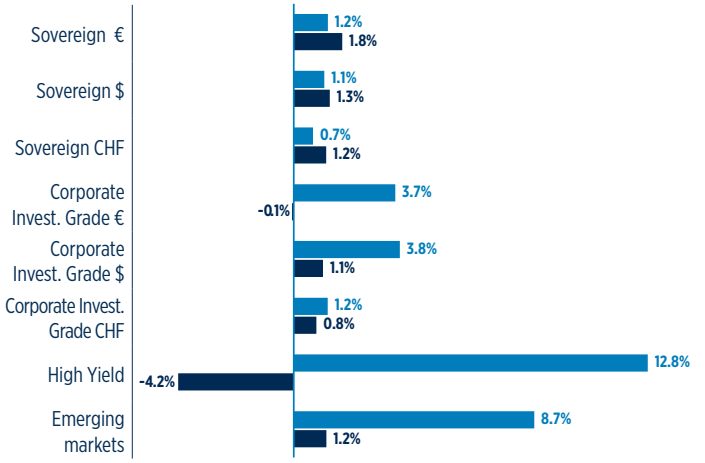
Asset classes



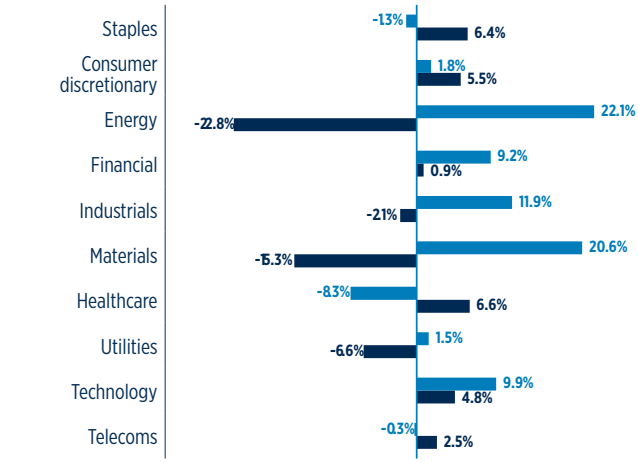
Equities



Bonds



Sectors



YTD (30/11/2016) ■2015
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

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Texts written on 5th December

IMPORTANT LEGAL INFORMATION

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