EDMOND DE ROTHSCHILD

PRIVATE BANKING

INVESTMENT STRATEGY

April 2017

KEY POINTS

The financial markets took a break in March.

The economic environment remains buoyant for equities.

We are continuing to underweight bonds.

The financial markets are not expecting a lot of volatility.

EDITORIAL

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THE OIL PRICE IS ROLLING OVER, CERTAIN CURRENCIES SUCH AS THE BRITISH POUND AND JAPANESE YEN ARE STRENGTHENING COUNTER-TREND, AND SECTOR AND GEOGRAPHIC ROTATIONS OFFER RELATIVE VALUE OPPORTUNITIES.

The journey ahead for both Donald Trump and Theresa May will be arduous, drawn-out and most probably rather lonely, as the former tries to deliver his much-hyped tax reforms and the latter triggers Article 50, attempting to divorce the U.K. from Europe, whilst remaining on friendly speaking (trading) terms. Therefore what better musical reference to use this month than "The Long and Winding Road" initially recorded back in 1969 by the Beatles and also covered by two other musical geniuses, George Benson and George Michael.

The recent failure by the Trump administration to reform Obamacare has at least temporarily taken some of the froth out of the markets, which as recently as a couple of weeks ago appeared to be in danger of a "melt-up" scenario with prices reaching levels many strategists had penned in for their year-end targets. However, concerns about a "melt-down," courtesy of this policy initiative set-back, seem to be overdone, as Trump will relentlessly continue to drive his pro (USA) business agenda and shift his focus to the arguably more important subject of tax reform. There is still a chance that Obamacare implodes anyway, which would allow Trump to use the "I told you so" rhetoric he would clearly love to. Moreover, central banks on both sides of the Atlantic remain ready and willing to adopt a flexible approach to monetary stimulus should a pause in economic growth be observed courtesy of a delay in fiscal reflationary stimulus.

Understandably, most financial commentary is centered around the major equity and bond markets, however to focus solely on these would be to ignore risk, signals and miss opportunities. The oil price is rolling over, certain currencies such as the British Pound and Japanese Yen are strengthening counter-trend, and sector and geographic rotations offer relative value opportunities. It is therefore vital to spend time and consideration on these and other aspects to guard against after-the-event analysis and regrets. After all, as one of our Hedge Fund friends said recently: "there is a reason why the windscreen is 1,000 times the size of the rear-view mirror."

INVESTMENT CONVICTIONS

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT
Asset Classes We prefer equities over bonds.	BONDS	CASH ALTERNATIVE INVESTMENTS	EQUITIES
Bonds We keep our fixed income allocation well diversified across fixed income segments, and prefer credit to duration.	SOVEREIGN	CORPORATE INVESTMENT GRADE EMERGING	HIGH YIELD OTHERS
Equities - Regions	UNITED KINGDOM	EUROPE SWITZERLAND JAPAN EMERGING	USA
Equities - Sectors We prefer the Information Technology sector, and underweight Utilities and Telecommunications.	CONSUMER STAPLES UTILITIES TELECOMS	CONSUMER DISCRETIONARY ENERGY FINANCIALS	INDUSTRIALS MATERIALS HEALTHCARE IT

MACROECONOMICS

RATE HIKE, WITH MORE TO FOLLOW

HIGHLIGHTS

- ☑ The Fed raised its rates in March and left its growth forecasts unchanged.
- ☑ Several members are considering gradually scaling back the Fed's balance sheet.

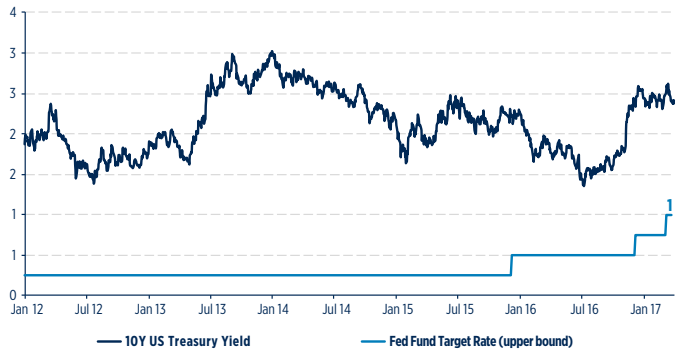
Fed in the spotlight

With no great surprise for the financial markets, which had assigned a probability of close to 100%, the Fed raised its Fed Funds rate to 1% at its meeting on 15 March. However, more surprisingly, the FOMC members did not change their outlook for economic growth or inflation, although some governors are starting to factor in the impact of the government's fiscal policy in their models. Which means that this virtually unanimous decision was not taken based on economic conditions, but rather market and political considerations. We believe that this increase is part of a plan to normalise rates, a dovish hike to some extent, rather than an attempt to "rein in" growth.

In terms of forecasts, we still expect the dollar's previous appreciation and the increase in rates to negatively impact the economy over the first half of 2017. Alongside this, the impacts of the fiscal stimulus plan on economic activity are not expected to be seen before the end of 2017. We are therefore maintaining our forecast for two Fed Fund hikes in 2017 and no significant appreciation for the US dollar. However, we acknowledge that the good economic figures reported recently (GDP growth for the last quarter of 2016, consumption, etc.) could strengthen activity levels in 2017, which would need us to revise our forecasts and require the Fed to adopt three rather than two rate hikes this year. Nevertheless, we can still see differences between the surveys and polls and the data for economic activity, which is encouraging us to leave our forecasts unchanged.

In line with its normalisation policy, several members of the Federal Reserve recently indicated that it was time to consider gradually scaling back the Fed's balance sheet. This quantitative tightening will be characterised by a reduction in the portfolio of securities held by the Fed, which is currently up to nearly $4470 billion. For reference, this amount has been kept stable since October 2014, with the Fed systematically reinvesting the amounts that mature in similar securities. By stopping its reinvestments, the Federal Reserve would automatically reduce the size of its portfolio. However, it is essential that this reduction takes place progressively and gradually in order to avoid destabilising the market for US Treasury bonds. If the stock of securities was reduced too quickly, this would result in monetary conditions tightening up again, which is not necessarily desired. In view of this, the Fed's communications will be very important in order to avoid giving out any incorrect signals to the market and triggering any unwanted volatility. This issue was seen previously when B. Bernanke announced a possible tapering in April 2013, which triggered a sharp surge in bond yields. In conclusion, we believe that discussions concerning the balance sheet will continue at the Fed's next meetings, but no action is expected until the first half of 2018, with a very gradual approach, based on low amounts.

QE Tapering in 2013 had Triggered Strong Reaction for US Treasury Yields
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



BOND MARKETS

REFLATION ON STANDBY IN THE US AND POLITICAL RISKS IN EUROPE

HIGHLIGHTS

- ☑ US: markets seem to have doubts over Donald Trump's ability to "reflate" the economy
- ☑ These doubts are benefiting emerging bonds thanks to the weaker dollar.
- ☑ Europe is still beset by political risks.

In the US, the Fed raised its short rates recently, triggering a fall in long rates. There seem to be growing doubts among investors concerning Donald Trump's ability to put in place the reflationary measures supposed to boost US growth. This analysis of reflation in the US, characterised by stable long rates and sluggish inflation expectations, could continue to be seen over the next few weeks.

Emerging markets have benefited from these doubts surrounding the Trump effect, supported by the weaker dollar in particular. Emerging bonds are expected to continue to see positive trends, while still offering attractive yields for investors.

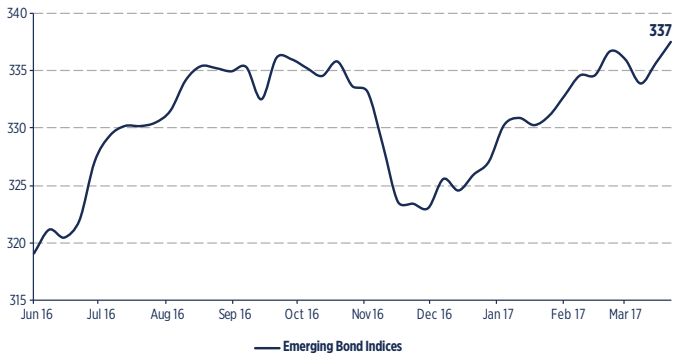
In the eurozone, bonds are reacting primarily to the political risks in Europe. The markets are focusing in particular on the French elections. The possibility of the anti-euro candidate being elected is keeping up pressure on prices for French bonds in particular, which are trading at a discount compared with German sovereign bonds. Peripheral bonds are also being affected by this uncertainty.

Although the European Central Bank is continuing to flood the European bond market with liquidity, the markets are expected to start showing concerns about a potential monetary policy tightening.

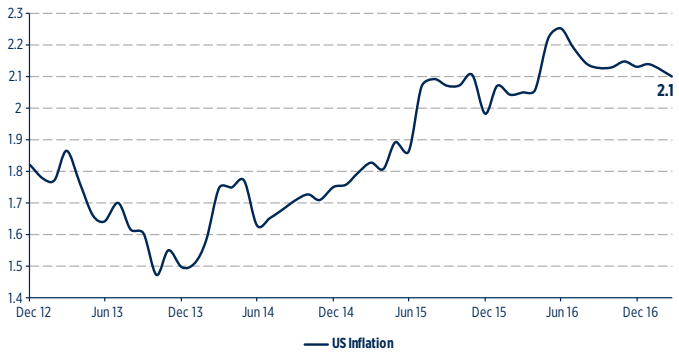
In this context, we are selling our entire exposure to inflation-indexed bonds. We are also maintaining our exposure to emerging market bonds. Despite the solid performance achieved since November last year, and the risks relating to the various protectionist measures that could be rolled out by the US president, the risk-adjusted yield still seems attractive. The downturn affecting high yield bonds in general and oil-related bonds in particular in the past few weeks has attracted our attention. But not enough to encourage us to invest. In a rate hike environment, we are maintaining our preference for senior loans. We are steering clear of European sovereign bonds, because we believe their risk-return profile is very negatively asymmetrical.

In conclusion, recent market developments have confirmed the relevance of the strategy adopted for our portfolios over the past few months, with a preference for credit risk over duration risk.

Evolution of Emerging Markets Bond Indices
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



Evolution of US 5 Year, 5 Year Forward Inflation Rate
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



EQUITY MARKETS

UNCERTAIN WATERS, BUT A POSITIVE CURRENT

HIGHLIGHTS

- ☑ Corporate economy is supporting bullish trends.
- ☑ Trends are being regularly disrupted by politics.
- ☑ United States' relative appeal is now over.
- ☑ Sector performances are varying in line with changes in the yield curve.

With the political uncertainty surrounding the programmes that will be chosen (Europe) or effectively deployed (USA), these are uncertain times for investors. But **the underlying current is still positive!**

Ultimately, in a low-rate environment with an economic recovery, the main reason to position ourselves on the stock markets is still the corporate economy's dynamic development. And from this perspective, the news is good and even better than expected.

From the US to Europe and even Japan and emerging countries, the full benefits of the reacceleration of the earnings cycle are being seen. Across the board, revenues are picking up, margins are strengthening and profits are growing more quickly than sales (see left-hand table below). In the US, profits and margins are already at record levels, so comparisons are more difficult. However, this phenomenon is taking shape and therefore much more spectacular in other major regions.

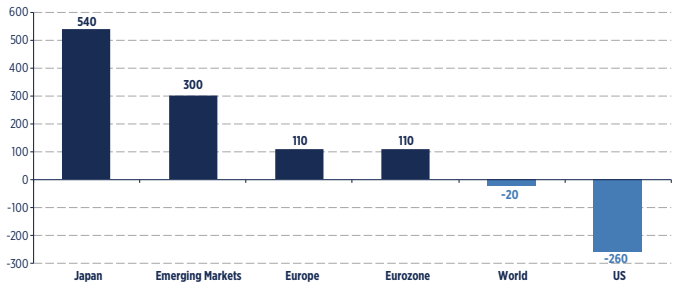
Valuation-related considerations are moving in the same direction, in both absolute terms, and in relation to expected profit growth for this year (right-hand table below): more growth at lower prices outside the US! A geographical rebalancing is therefore expected.

Contrasting sector performances between the US and Europe or Japan. In line with the past few weeks, and for the coming months, relative performance levels for the different sectors will vary from one region to another. The differentiating factor is linked to changes in the yield curve!

In the US, the capping of 10-year rates at around 2.5% and the gradual upswing in short rates have led to a flattening of the curve, reflecting the economic cycle's growing maturity. This highlights a less conventional breakdown of performance levels than the split between cyclical and defensive. For instance, sectors with high debt levels (and high dividends) are looking more positive (public utilities, telecoms or real estate). At the other end of the scale, the appeal of banks, largely dependent on loan activities and interest spreads, is fading. So it is time to adopt a more nuanced positioning.

On the other hand, a slight increase in long rates is still expected for Europe and Japan, but with monetary policies remaining extremely accommodating. In other words, a steepening of the curve and the corresponding reflationary stock market positionings are still on the agenda. We will therefore focus on financials, primary materials or industrial stocks.

Earnings Growth: Evolution of Consensus since 01/01/2017
Sources: JP Morgan, Edmond de Rothschild (Suisse) S.A.



Valuation of the Main Geographic Areas
Sources: IBES, JP Morgan, Edmond de Rothschild (Suisse) S.A.

	2017 P/E X	2017 Growth %	P/E vs. Growth Ratio X
US	18.2	10.2	1.78
Europe	14.4	12.7	1.13
Japan	14.5	13.4	1.08
Emerging Countries	12.0	16.7	0.72

COMMODITIES

INDUSTRIAL METALS ARE LEADING THE FIELD

HIGHLIGHTS

- ☑ Industrial metals have moved into a new bull market.
- ☑ Gold is diversifying risk and palladium is shining bright.
- ☑ Oil is still expected to see an average range of $50-$55 for the year.

A movement is strong and sustainable when it is based on multiple sources of support! This is the case for the majority of **industrial metals.**

- Global economic recovery, driven by industrial activities.
- Gradual resumption of investment.
- Probable increase in dedicated budgets for infrastructure spending (US and Europe).
- Slowdown in supply-side growth after three years of drastic investment cuts and extensive work to rationalise production assets.
- Social and political tensions affecting production (South Africa, Chile, Indonesia, etc.).

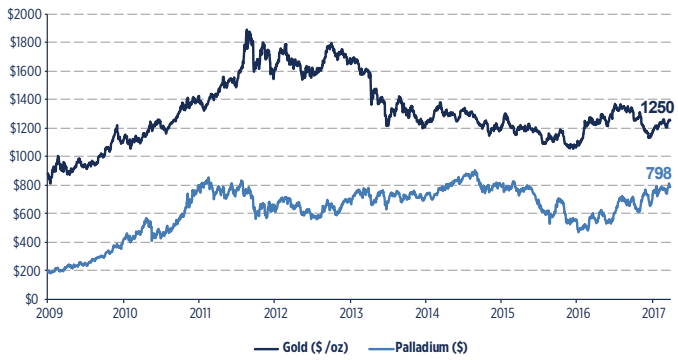
As shown on the right-hand chart below for copper and nickel, these multiple trends are gradually paving the way for a return to a supply-side shortfall compared with demand, a reduction in surplus stock and, ultimately, an increase in prices. In this area, there is still some way to go.

Gold. Here, we can only repeat what we said last month, with our position confirmed by the reality seen virtually each day: gold has retained its benefits for diversifying risk when building portfolios! On the one hand, the (geo) political uncertainty, and on the other, the (moderate) increase expected in rates and the dollar support the idea of a status quo, ranging from $1,200 to $1,300.

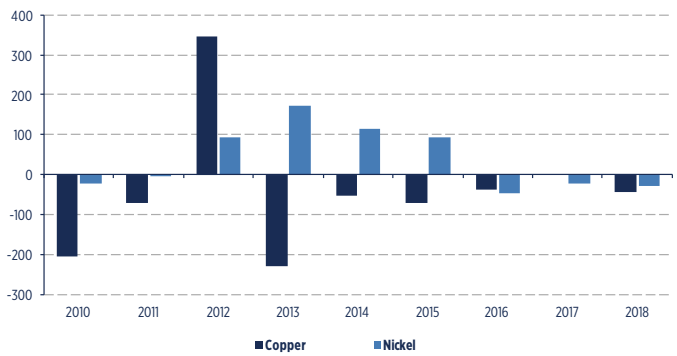
More anecdotal, due to limited possibilities for investment, **palladium** has achieved impressive growth (+80% since the start of 2016). Now that the disorderly liquidation of Russian stocks seems to be well and truly over, palladium stands out as a metal for all environments, with a role as a precious metal (jewellery) when the general mood is dominated by concerns and a role as an industrial metal (45% of demand generated by catalytic converters) when optimism prevails. These two roles are expected to continue supporting the trend for prices to rise over the coming months (see left-hand chart below).

Our **oil scenario** is being confirmed each month, ranging from $50 to $55 on average this year (with limited short-term fluctuations) and American production acting as the short-term regulator. While several producer countries are already calling for the latest production quotas to be maintained for the second half of the year, Saudi Arabia has stated several times that it does not want to take on the burden of reducing production on its own (thinly veiled reference to Russia), while highlighting that certain stakeholders who have not signed up to the agreement are playing too important a role. In this instance, they are referring to the US, where production is up to peak levels. The Saudis are making a lot of noise, no doubt so they can avoid having to take action.

Evolution of Gold and Palladium Prices since the end of the Equity Bear Market
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



Evolution between Offer/Demand of Copper and Nickel
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



ASSET ALLOCATION

EQUITIES FIRST

HIGHLIGHTS

- ☑ Market and economic conditions remain favourable for equities.
- ☑ We are rebalancing our geographical allocation outside the US.

Progress with performance on equities indices in developed countries has been held back, with negative or only slightly positive results for March. With regard to bonds, the Fed's key rate hike on 15 March is believed to have marked the start of a flattening of the yield curve, with the 10-year rate dropping nearly 0.3%, while short rates have fallen by less than 0.1%. Inflation expectations are also down, dropping back down below 2%. Are reflation, the upswing in economic growth, higher interest rates for the long term and an upturn in business profits no longer on the agenda?

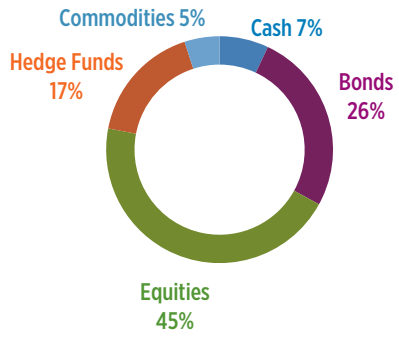
Firstly, we can see that this break in March follows a period of strong performance by equities and credit in general. As we wrote last month, it is normal and even desirable for markets to take a break. The disappointment following the failed attempt to reform Obamacare has ultimately made the market aware that the electoral promises will take time to be implemented and will be subject to fierce negotiations even within the Republican Party itself. The long-awaited tax reform is now on the agenda and could potentially have a bigger impact on the US economy and businesses than changes to the healthcare system. Having said that, if the tax reform does not go as far as suggested, this could lead to further disappointment and put US equities under pressure. The risk for US equities therefore seems slightly asymmetrical, with the newly elected president's pro-growth policy incorporated into prices.

Nevertheless, behind these political considerations, the business and economic fundamentals are still positive. Tactically, however, we believe that European, Japanese or emerging market equities have a relatively higher level of potential and should be given preference.

Contrasting with our equities allocation, our bond exposure is still well below our benchmark levels. Although yield curves have stabilised in the US, we are still in a rate hike environment and this is not particularly positive for this asset class. This is particularly true in Europe, with encouraging economic growth indicators, where the market could bring forward its forecasts for the European Central Bank to adopt a less accommodating policy. We therefore prefer bonds with short durations and credit exposure rather than government bonds. More specifically, floating-rate instruments such as loans are to be given preference over high yield bonds in both the US and Europe. We are therefore maintaining a defensive strategy on the bond segment, with part in liquid assets in the reference currency for the accounts. In markets that lack direction, the currency risk can represent a significant additional risk, which we are not willing to take on. So we are keeping a marginal level of foreign currency exposure in our allocation grids.

In conclusion, the normalisation of economic conditions is still a key focus. The market environment is still favourable for measured risk-taking. Our preferred investment scenario favouring equities over bonds remains unchanged.

Balanced Allocation



Bonds	26.0%
Sovereign bonds	6.0%
Corporate bonds	7.0%
Emerging bonds	4.0%
High yield bonds	6.0%
Convertible bonds	3.0%

Equities	45.0%
Europe	11.0%
North America	20.5%
United Kingdom	0.0%
Switzerland	3.0%
Japan	4.5%
Emerging markets	6.0%

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

INVESTMENT DECISIONS

Equities ↔

Hedge funds ↔

Precious metals ↔

Currencies ↔

Bonds
We are maintaining our underweighting on the bond asset class overall. Our positioning is focused on low durations, mainly in Europe. We are increasing our exposure to credit, particularly high yield credit through loans, as well as corporate bonds from emerging countries.

Equities
Equities are still the driving force for our portfolios' performance. We are further strengthening our geographical diversification by increasing our allocation for Japanese equities and emerging markets at the expense of US equities.

Hedge funds
Funds of hedge funds have generally achieved positive performances since the start of 2017, following a difficult year in 2016. Non-directional strategies have continued to deliver stable, positive returns, with low volatility, and will be overweighted. The allocation remains unchanged.

Gold
The weighting for gold remains at its target level within our portfolios. It is a strategic asset within our portfolios thanks to its properties for diversifying equities risks, offering a safe haven, providing protection against unexpected or exaggerated increases in inflation.

US dollar
We are maintaining a low level of exposure to the US dollar. We are taking little risk with foreign currencies in our allocation.

RISK MANAGEMENT

MONETARY RISK

HIGHLIGHTS

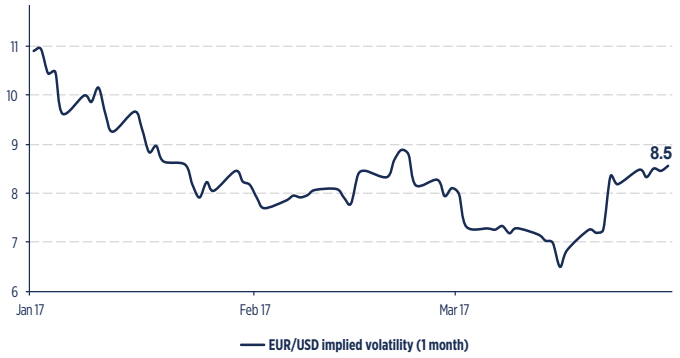
- ☑ The EdR Risk Indicator is close to zero.
- ☑ The currency risk must not be underestimated.

The currency risk must not be underestimated.
There are several ways of managing a portfolio's monetary exposure. For instance, it may be purely residual depending on the geographical allocation chosen. With this approach, we view the currency risk as an inherent feature of financial instruments and, ultimately, it is not managed. The asset allocation cannot be separated from the currency risk. For instance, in Swiss francs, the decision to invest in US equities must assess the benefits of both the shares themselves and the dollar-Swiss franc exchange rate. On the other hand, monetary exposure may be viewed as an asset class in its own right and therefore separated from other asset classes and actively managed. With this approach, we assess the merits of the various pairs of currencies and decide whether our monetary exposure needs to be hedged or not based on the risk and potential gains. In both cases, the monetary exposure's contribution to risk needs to be accurately measured. In a calm market environment with low volatility for the main asset classes, as today, the currency risk will represent a significant percentage of the portfolio's overall risk. Similarly, in a market without any real trends, changes in exchange rates can be the main sources of gains...or losses. We calculate that 20% exposure in foreign currencies can actually represent nearly 40% of the portfolio's total risk. Failing to recognise this risk can lead to major disappointments, even after choosing the right allocations or instruments! The US dollar's recent depreciation is a perfect example of this. Less than a month ago, the consensus was still that the acceleration in US growth automatically meant a stronger dollar. Its recent weakness will have taken many investors by surprise, at a time when the main classes were taking a break. The lack of a trend for the main asset classes highlights that foreign currency exposure needs to be carefully calibrated. From our perspective, we view currencies as a separate asset class and actively manage our exposure. This is primarily in US dollars and capped at around 5%.

The financial markets are not concerned.
The EdR Risk Indicator has moved back down close to zero, in line with its long-term historic average. The compilation of over 50 risk variables therefore reflects low levels of financial stress. This may seem somewhat paradoxical in the run-up to the French elections and at a time when Donald Trump's electoral promises seem to be losing a bit of momentum. Symptomatic of this environment, implied volatility levels for European equities are only high for the month of the French elections. In the following months, they will drop back down to normal maturity levels. Considering the narrowing of the yield spread between French and German government bonds, the European political risk is down. In the US, the disappointment following the failed attempt to reform Obamacare led to only a slight increase in volatility, up from 12% to 15%, before closing out March below 12% again. While these risk levels are favourable for current trends to continue, we are carefully watching out for potential surprises that could shake investors out of their complacency. We are monitoring the changes in the US dollar of course, but also the economic situation in China and prices for commodities, primarily oil.

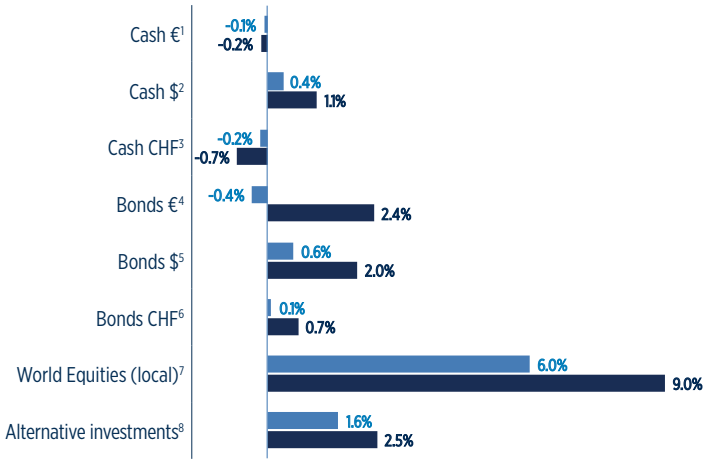
The Edmond de Rothschild Risk Index Remains Close to Equilibrium
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

EUR/USD 1-month Implied Volatily is Increasing
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



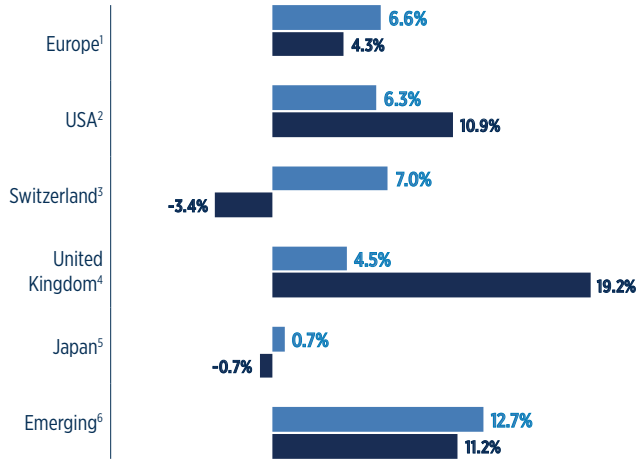
MARKET PERFORMANCES

Asset classes



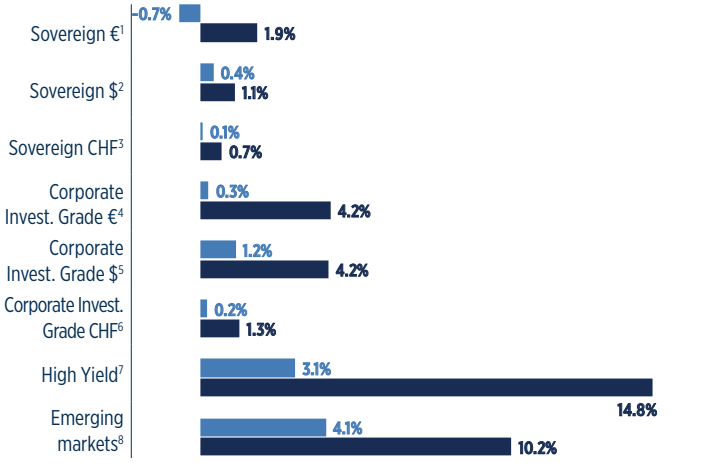
1: J.P. Morgan Cash Index Euro Currency 3 Month | 2: J.P. Morgan Cash Index USD 3 Month | 3: J.P. Morgan Cash Index CHF 3 Month | 4: BofA Merrill Lynch 1-10 Year Euro Broad Market Index | 5: BofA Merrill Lynch 1-10 Year US Broad Market Index | 6: Swiss Bond Index (SBI) AAA-BBB 1-10 Total Return | 7: MSCI AC World Daily TR Net Local | 8: Hedge Fund Research HFRX Global Hedge Fund Index.

Equities



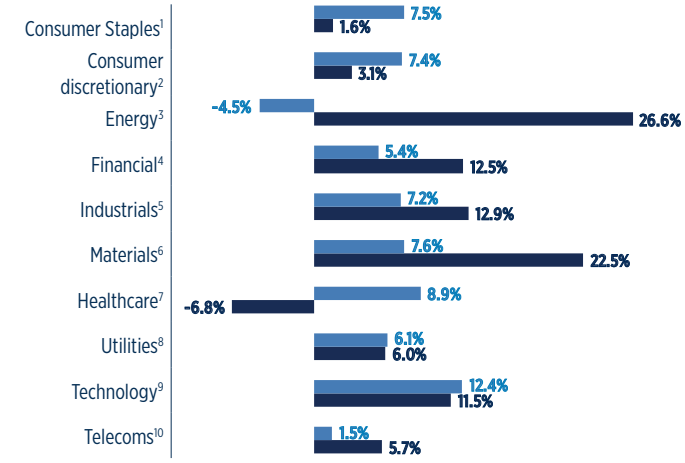
1: MSCI Daily TR Net EMU Local | 2: MSCI Daily TR Net USA Local | 3: MSCI Daily TR Net Switzerland Local | 4: MSCI Daily TR Net UK Local | 5: MSCI Daily TR Net Japan Local | 6: MSCI Daily TR Net Emerging Markets USD.

Bonds



1: EFFAS Bond Indices EURO GOVT 1-10 YRS TR | 2: EFFAS Bond INdices US Govt 1-10 YRY TR | 3: Swiss Bond Index (SBI) AAA-BBB 1-10 TR | 4: BofA Merrill Lynch 1-10 Year Euro Corporate TR Index | 5: BofA Merrill Lynch US Corp 1-10 Year TR | 6: Swiss Bond Index (SBI) A-BBB TR | 7: BofA Merrill Lynch Global High Yield Index | 8: J.P. Morgan EMBI Global Diversified Composite.

Sectors (world $)



1: MSCI Daily TR World Net Consumer Staples USD | 2: MSCI Daily TR World Net Consumer Discretionary USD | 3: MSCI World Energy Sector Net TR USD | 4: MSCI Daily TR World Net Financials Local | 5: MSCI Daily TR World Net Industrial USD | 6: MSCI Daily TR World Net Materials USD | 7: MSCI Daily TR World Net Health Care USD | 8: MSCI Daily TR World Net Utilities USD | 9: MSCI Daily TR World Net Information Technology USD | 10: MSCI Daily TR World Net Telecommunication Services Sector USD.

■ YTD (28/02/2017) ■ Previous year
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

The following persons contributed to this issue:

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Texts written on 31st March 2017

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