EDMOND DE ROTHSCHILD

PRIVATE BANKING

INVESTMENT STRATEGY

February 2017

KEY POINTS

We are further strengthening our net exposure to equities.

Globally, the outlook for economic growth is encouraging.

Risk perception among participants is low in view of expectations for volatility.

Donald Trump is determined to take action.

EDITORIAL

by Craig Lewis
Head of Investments
International Private Banking

IT IS UNLIKELY TO BE ALL ABOUT TRUMP IN THE COMING YEARS, AND IT'S XI JINGPING, THE CHINESE PRESIDENT, WHO WE SHOULD BE LISTENING TO AND WATCHING.

If Rihanna were to launch her hit «What's my name?» this year, you would be forgiven for thinking that the title of the song was commissioned by the new US president, to remind those yet unaware, that «Trump» is a name that will be hard to forget and/or avoid.

Whilst almost all headlines seem to reference Trump and his protectionist policies to «make America great again», we are reminded by our Chief Group Economist, Mathilde Lemoine, that it is unlikely to be all about Trump in the coming years, and it's Xi Jingping, the Chinese president, who we should be listening to and watching. For it is likely that China and her policies could ultimately overshadow Trump and significantly impact global growth. As we celebrate the Chinese New Year, we can perhaps rely on the Chinese Rooster to wake-up the global economy as its planned economy and commodity consumption drive growth, not just in China, but across the world.

As many equity markets record new highs and the Dow climbs above the magic 20,000 level, it is all too easy to get carried away with optimism. Yet it's at these times that we need to refocus, and continually make sure we are not being led astray by numerology or complacency.

Over the following pages our investment specialists, strategists and economists will share with you the results of their analysis and their insights. We hope you find their guidance and conclusions both interesting and helpful in managing your financial investments.

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 We have reduced our allocation to UK equities.	UNITED KINGDOM	EUROPE SWITZERLAND JAPAN EMERGING	USA
Equities - Sectors We prefer cyclical sectors and overweight financials, industrials, IT and materials.	CONSUMER STAPLES UTILITIES TELECOMS	CONSUMER DISCRETIONARY ENERGY HEALTHCARE	FINANCIALS INDUSTRIALS MATERIALS IT

MACROECONOMICS

ENCOURAGING OUTLOOK

HIGHLIGHTS

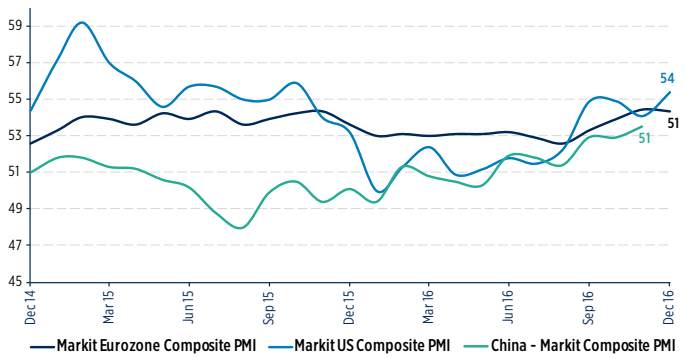
- ☑ D. Trump is determined to implement his programme.
- ☑ The outlook for growth is encouraging.
- ☑ The pound sterling will remain under pressure. Brexit is Brexit.

Donald Trump in the spotlight
Since taking office on 20 January, D. Trump has already signed more than 18 decrees or memoranda. More specifically, he has withdrawn from the Trans-Pacific Partnership, relaunched the Dakota and Keystone XL oil pipeline projects, introduced a hiring freeze for federal workers, restricted access to American territory for people from seven Muslim countries and even signed a decree against Obamacare. All this highlights his determination to implement his programme quickly and gives his initial plans more credibility. The probability of his promises being applied is therefore higher, reinforcing the positive market sentiment. However, D. Trump has not yet made any announcements concerning issues with potentially significant economic impacts such as the infrastructure improvement programme, the review of the tax system and the repatriation of funds held by American businesses abroad. In our opinion, the uncertainty is just as high as the expectations. In this climate, the changes in the US dollar need to be monitored more closely than ever.

Outlook for growth still encouraging
In the last quarter of 2016, US GDP growth accelerated to 1.9% year-on-year. The upturn in commodity prices, the build-up of stocks and the levels of fixed capital investment have made a positive contribution to growth and supported private consumption, although this came in weaker than the previous two quarters. However, the strong dollar has affected exports, as expected. In China, growth reached 6.8% in the final quarter of 2016, giving 6.7% for the year. While this figure is in line with Beijing's target, it is important to note that borrowing pushed up debt to 264% of GDP, compared with 247% at the end of 2015. The direction set by D. Trump for trade relations between the world's top two economies could impact international trade and economic growth for both countries. Having said that, Purchasing Managers' Index figures have continued to build on their positive trend that began mid-2016, confirming our growth scenarios.

Brexit is Brexit
Prime Minister Theresa May wants to maintain her schedule for the UK's exit from the European Union, despite the high court ruling that parliament needed to be consulted on this first. Mrs May still seems to prefer a "hard" Brexit, based on limited negotiations with the EU. There is an increased risk of British institutions losing their European financial passport and clearing houses relocating to the eurozone. Some banks have already published estimates for the number of jobs that might be transferred to Frankfurt for instance. The pound sterling looks very likely to remain under pressure.

Composite PMI Indices Follow a General Upward Trend
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



BOND MARKETS

VOLATILE... AS EXPECTED

HIGHLIGHTS

- ☑ Bonds were particularly volatile in January.
- ☑ We are continuing to reduce our government bond allocation.
- ☑ And we are increasing our exposure to high yield bonds.

January confirmed the fears that we reported last year: the fixed-income market will be volatile. US 10-year rates have fluctuated by 25 bp since the start of 2017. This volatility is clearly linked to Donald Trump taking office and investor uncertainty concerning the impacts of his economic policy.

However, we are still cautious in terms of bond investors faced with the improvement in the economic environment in the US and more generally around the world. This phase in the economic cycle is not favourable for bonds in general and fixed-rate sovereigns in particular. We have therefore continued to scale back our exposure to government bonds, while maintaining significant exposure to inflation-linked bonds. Our objective is to minimise, where possible, the duration risk, which translates into a loss of value for fixed-rate bond assets when interest rates rise.

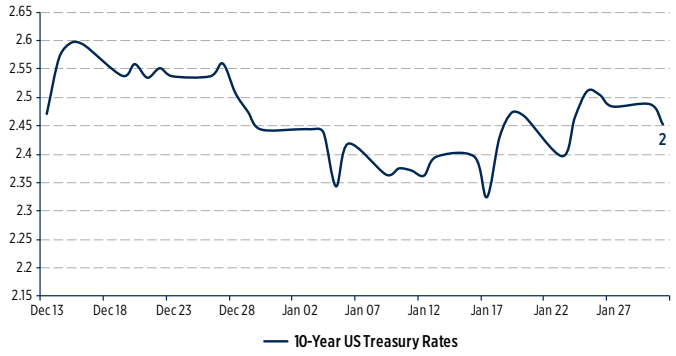
We still prefer bonds whose interest rates are indexed against money market rates. If the central banks adopt less accommodating policies, this would push up yields for this bond class.

Faced with the weak level of yields on good quality corporate bonds following the European Central Bank's purchase programme, we have reduced our exposure to investment grade corporate bonds in Europe.

We have also focused on high yield corporate bonds. In an improving economic environment, the reduction in default rates is enabling them to deliver substantial yields.

Our bond portfolios are therefore cautiously positioned, reflecting a moderately positive view of the economy

Evolution of 10-Year US Treasury Rates since 13/12/2016
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



EQUITY MARKETS

CONTINUED GROWTH: TO BE OR NOT TO BE... CYCLICAL

HIGHLIGHTS

- ☑ Acceleration in economic momentum and profit cycle confirmed.
- ☑ More than ever, it is time to focus on procyclical market segments, with technology as a key component.

Recent changes in the main macro and microeconomic parameters have been fully aligned with our core investment guidelines for equities. Economic momentum is accelerating, particularly in terms of its industrial component, and the numerous investment-based fiscal stimulus programmes that are expected to be rolled out will further strengthen this trend.

While external shocks create short and medium-term distortions, value creation (returns on investment exceeding the average cost of capital) and businesses' ability to make profits are still the primary reasons for being shareholders in companies.

From this perspective, the changes that are underway represent supporting factors for the markets. The tentative signs of a turnaround in the profit cycle seen in the third quarter were confirmed in the fourth quarter, and the (large) majority of reports have exceeded expectations, particularly in the US (75%) and Japan (73%). In addition, profit growth is exceeding revenue growth across the board, which means that growth is being combined with higher margins, resulting from the in-depth restructuring operations from the past few years and the benefits of the operational leverage effect.

Illustrating the growing credibility of this recent trend, for the first time in a long time, the estimates for 2017 were revised upwards last month for all the main stock markets!

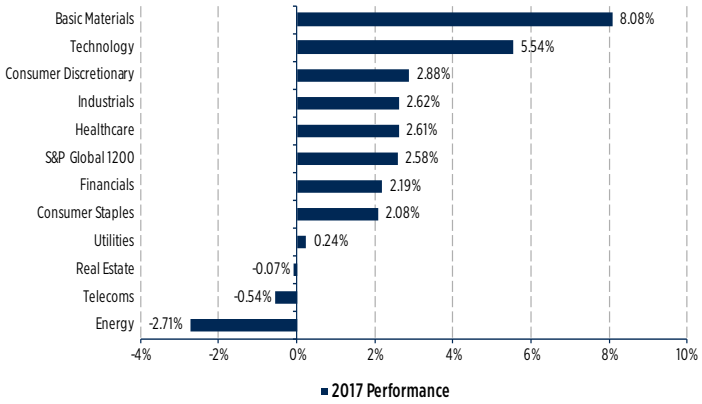
As a result, valuation multiples (which were previously the market's Achilles heel) are embarking on a healthy and logical contraction, reflecting the upturn in margins and profits in the market's cyclical segments.

A "reflationary" growth scenario is still central to our global asset allocation and our positioning on the stock markets.

From a perspective factoring in risk management as well as potential gains, our investment committees always prefer:

- Industrialised countries over emerging countries
- The United States over Europe
- Cyclical segments over defensive segments
- SMEs over major multinationals
- Value profiles over growth profiles.

S&P Global 1200: 2017 Sectoral Performance
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



Summary of Q4-2016 S&P 500 and Stoxx 600 Results
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

Q4-16 Results	S&P500	Stoxx600	Topix
% Published	48.0 %	23.0 %	43.0 %
Revenue (year/year)			
Index	4.0 %	5.0 %	-1.0 %
Ex-Financials	3.0 %	4.0 %	-2.0 %
Ex-Energy	4.0%	4.0%	-1.0%
% Below Estimate	52.0 %	64.0 %	48.0 %
Revenue (year/year)			
Index	6.0 %	7.0 %	10.0 %
Ex-Financials	5.0 %	7.0 %	12.0 %
Ex-Energy	6.0%	9.0%	10.0%
% Below Estimate	76.0 %	53.0 %	73.0 %

COMMODITIES

SUPPLY-SIDE TRENDS ARE JUST AS IMPORTANT AS CHANGES IN DEMAND

HIGHLIGHTS

- ☑ Industrial metals are emerging from five years of bearish trends and look set to continue progressing.
- ☑ Gold is primarily retaining its benefits for risk diversification.
- ☑ Oil is expected to reach balanced levels.

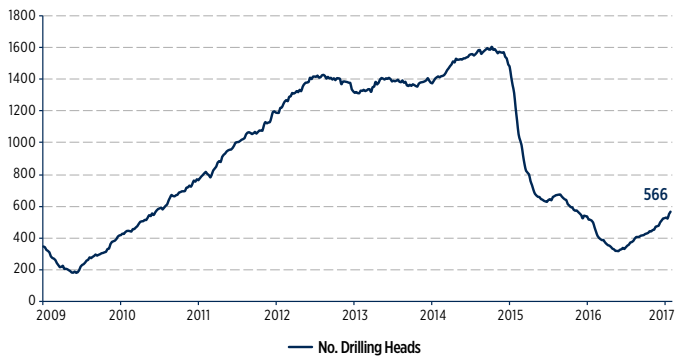
Industrial metals have emerged from a bearish trend that dated back to 2011! The credibility and sustainability of this trend reversal depend on the combination of a positive change in the general environment for demand (acceleration of global growth's industrial components) and a moderation of supply growth, linked to the drastic cuts in investment in the last three years, the gradual exhaustion of ageing production sites and the optimisation of the portfolio of productive assets (closure of sites with insufficient or zero profitability). This "economic Darwinism" also applies today for China, which produces one fifth of all industrial metals.

While its trends are not genuinely bullish, gold prices are picking up again and this metal is retaining its risk diversification value for building a balanced portfolio. Caught between the negative impact of rising interest rates and a stronger dollar than last year and the positive impact represented by (geo)political risks and uncertainties, the $1,200-$1,300 range seems credible for the coming months.

Lastly, oil prices have continued to trend up, alongside the effective implementation of the production cuts announced by the OPEC members and certain other countries (including Russia). A bullish surge to $60 per barrel is possible in this context and this season. However, we believe it is too early to anticipate any significant move away (scale and duration) from the $50-$60 range. This is the "fault" of the very high responsiveness of US production, which is expected to prevent a surge in prices. This is confirmed with the 80% increase in the number of wellheads in operation since activity levels reached a low point mid-2016.

Evolution of LMEX (basic materials) over 5-years
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

Number of Active Drilling Heads in the US Since 2009
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



ASSET ALLOCATION

DIRECTIONAL

HIGHLIGHTS

- ☑ We are switching part of our directional hedge fund allocation to equities.
- ☑ We are closing our tactical allocation to UK equities.
- ☑ We are maintaining our preference for US over European equities.

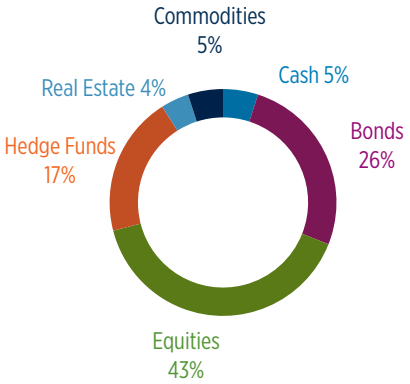
January confirmed our asset allocation. First of all, our bond positioning is paying off, because credit instruments have outperformed government bonds since the start of the year, while short maturity bonds are suffering less than securities with longer maturities. In terms of equities, January's performance figures also fully justify our conviction concerning this asset class. However, the good surprise has been emerging markets, which have delivered significantly higher returns than other regions. US equities have also performed well, benefiting from investor optimism faced with US economic growth.

The market environment has continued to be buoyant for the equities market, encouraging us to maintain our overweighting on equities for February. Expectations for volatility in the short term are low and highlight the general optimism. However, it cannot be said that investors are being complacent, considering the flows on the options markets. Demand for put options to protect portfolios has increased, showing that the downside risks are being identified. Unless something unexpected happens, we believe there is little chance of the scenario from the first quarter of 2016 being repeated. Fundamentally, we can also see that expectations for profit growth are being revised upwards, in line with our scenario for an end to the profit recession, helped by leading economic indicators that are encouraging globally. We should therefore continue to focus on cyclical securities and equities should be overweighted. In terms of our geographical allocation, we are maintaining our preference for US equities, but our tactical exposure to UK equities has been reduced to zero. With the prospect of a Brexit moving into its implementation phase, we believe that the outperformance by UK equities compared with their European peers is a thing of the past. The sector and geographical allocation will be decisive in 2017.

The change of allocation this month is linked to our positioning on alternative funds. With our balanced mandates, hedge funds perform two roles in our portfolios. On the one hand, directional strategies aim to provide positive asymmetry for returns and lower volatility than their "equity long-only" equivalents. These directional strategies are less of a factor in market fluctuations and can be seen as a conservative substitute for equities. On the other hand, non-directional alternative strategies, such as arbitrage, offer stable returns, often with low correlation. Less volatile, they are often described as a substitute for bonds that have low sensitivity to interest rate fluctuations and are therefore perfectly well-suited to an environment with rising interest rates. In view of this, we are maintaining our allocation on non-directional alternative strategies. However, our overweighting on equities requires a more direct positioning on this asset class. We are therefore partially scaling back our exposure to directional hedge funds in favour of equities.

Our recommended asset allocation is focused more on growth, increasing our net exposure to equities. On the other hand, we are maintaining our defensive positioning on bond segments, with a low duration.

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	43.0%
Europe	11.0%
North America	20.5%
United Kingdom	0.0%
Switzerland	2.0%
Japan	3.5%
Emerging markets	5.0%

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

INVESTMENT DECISIONS

Bonds ↔

Equities ↗

Directional Hedge funds ↘

UK equities ↘

Liquid assets
We are keeping an average level of liquid assets in our portfolios. With interest rates low, and even negative in the short term, the level of liquid assets in the portfolios is exclusively for tactical needs.

Bonds
We are keeping our allocation unchanged within balanced portfolios, in which bonds aim to reduce and diversify risks. From a purely bond perspective, we are increasing the weighting of high yield bonds at the expense of government and corporate bonds. We have a preference for US and European high yield bonds.

Equities
We are increasing our equities exposure. With the outlook for profit growth and the encouraging economic data, particularly in the US, we are overweighting this asset class. However, our tactical allocation with UK equities has been closed.

Hedge funds
Our allocation for directional hedge funds is being scaled back in favour of equities. The aim is to make our portfolios more directional. Our weighting on non-directional strategies, also viewed as a substitute for bonds, remains unchanged.

Gold
This precious metal's weighting is being kept at its target level within our portfolios. Gold's recent performance was primarily linked to changes in the US dollar rather than inflation. The expected upswing in inflation is encouraging us to keep a significant weighting within our portfolios.

US dollar
We are maintaining a low weighting for the US dollar in our portfolios as a base currency compared with the euro and Swiss franc. If the greenback weakens further, this could encourage us to tactically increase our weighting in the future. Based on current levels, and in line with our medium-term forecasts, we estimate that the strengthening of the dollar offers limited potential for returns compared with its contribution to risk.

RISK MANAGEMENT

COMPLACENCY?

HIGHLIGHTS

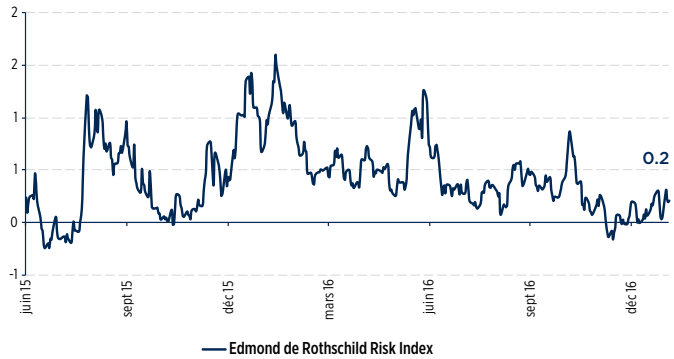
- ☑ The EdR Risk Indicator is at a typical level for calm financial markets.
- ☑ Implied volatility levels for equities remain low.

At the time of writing these lines, America's new president has already signed more than 18 decrees or memoranda. The markets, just like the media, have welcomed or rejected these decisions. In Europe, the political landscape for 2017 is gradually starting to take shape, with the main parties electing their champions and surveys becoming more frequent. Brokers are also starting to issue different scenarios for assessing the impacts of the elections or Donald Trump's potential decisions. However, despite these uncertainties, the financial markets remain calm. Interest rates have stabilised, share prices are seeing limited fluctuations, gold prices are evolving in line with the US dollar and oil prices are fluctuating above the $50 mark. Even more symptomatic, the indexes for implied volatility are close to their lowest levels from the US to Europe and Hong Kong. The market expects to see only moderate changes in financial assets, which is most often a sign of a bull market. Nevertheless, from potential renegotiations of free trade agreements to protectionist measures and geopolitical tensions, there seem to be enough factors to justify including a risk premium in prices... Could financial players have become complacent?

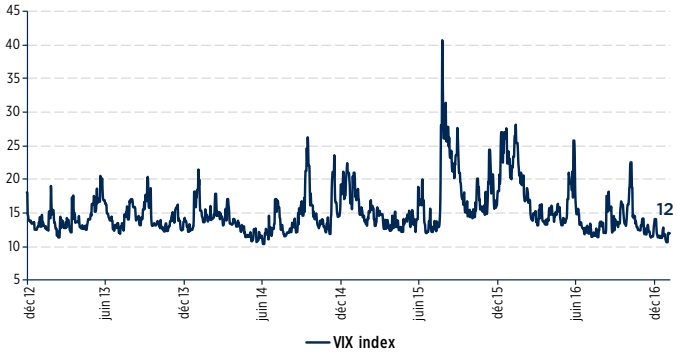
Certain elements lead us to believe that investors are being more cautious than we might believe at first sight. Firstly, while volatility expectations are consistently low for the short term, more normal levels can be seen beyond the first 100 days of the new presidency. Illustrating this, US implied volatility levels climb from 12% to nearly 18% at six months. On the options markets, demand for index puts has increased in terms of both volumes and prices in relation to call options. While the baseline scenario is still optimistic, measures for protection against bad surprises seem to have been put in place. Optimistic but cautious are the terms that come to mind to characterise the financial markets.

Our risk indicator shows a low stress level on a historical comparison, although with a slight increase recently. From a low of nearly zero at the start of the month, the level of market risk has risen to around 0.22 at the time of writing these lines. This confirms our impression of calm markets favouring growth assets such as equities. However, it is moving away from levels that could indicate a sense of complacency and has started to incorporate slightly more the uncertainties that have been mentioned so often.

The Edmond de Rothschild Risk Index Level is Close to its Historical Average and Keeps Increasing
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

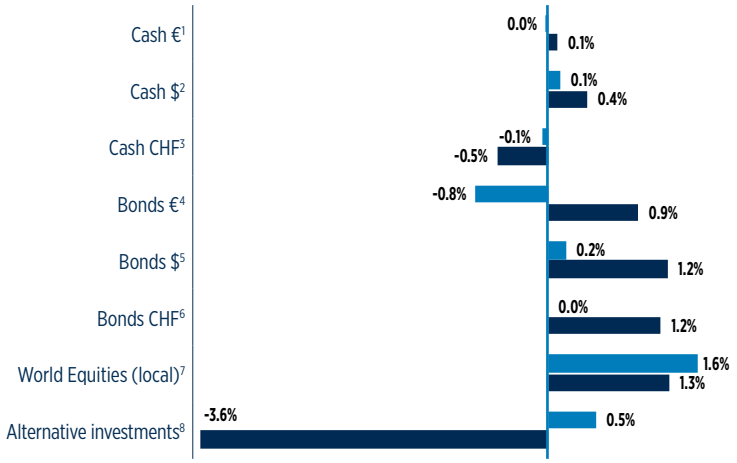


Implied VIX Volatility Indices Remain at Extremely Low Levels
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.



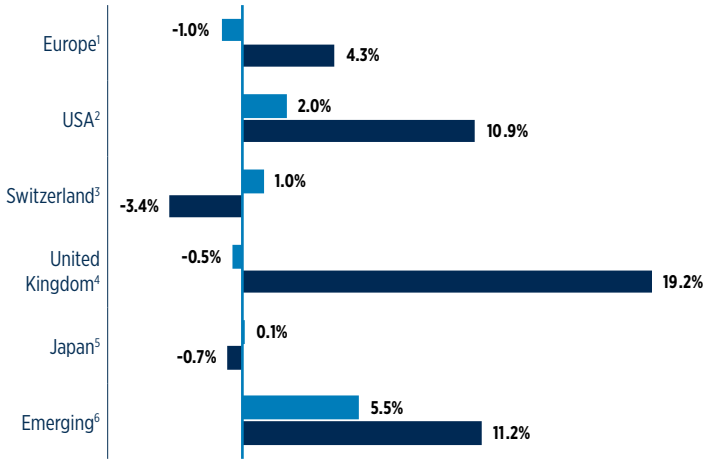
MARKET PERFORMANCES

Asset classes



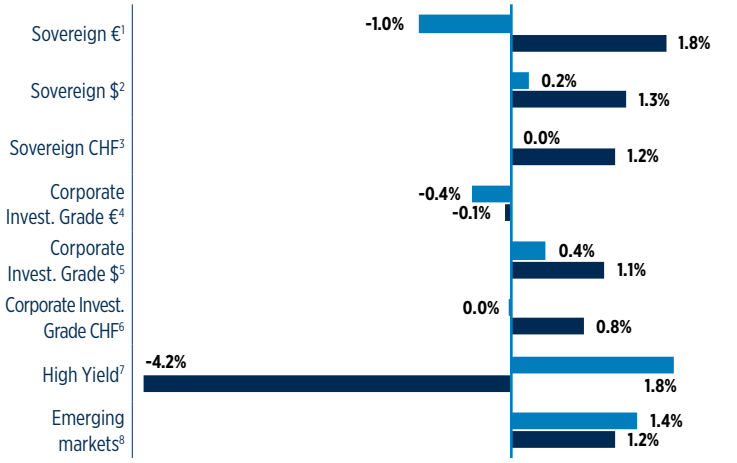
1: J.P. Morgan Cash Index Euro Currency 3 Month | 2: J.P. Morgan Cash Index USD 3 Month | 3: J.P. Morgan Cash Index CHF 3 Month | 4: BofA Merrill Lynch 1-10 Year Euro Broad Market Index | 5: BofA Merrill Lynch 1-10 Year US Broad Market Index | 6: Swiss Bond Index (SBI) AAA-BBB 1-10 Total Return | 7: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

Equities



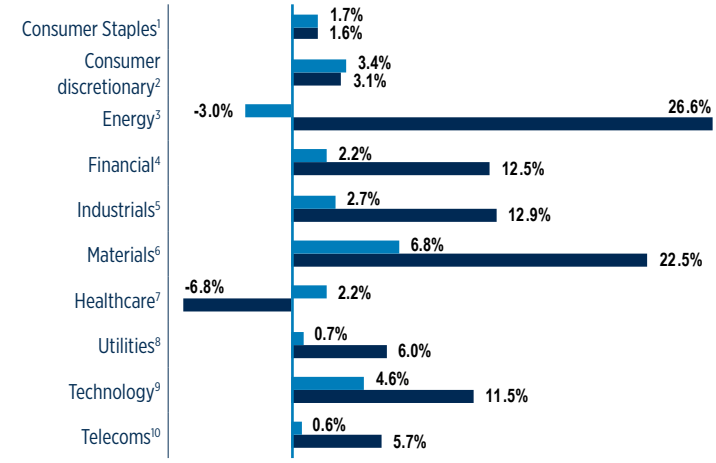
1: MSCI Daily TR Net EMU Local | 2: MSCI Daily TR Net USA Local | 3: MSCI Daily TR Net Switzerland Local | 4: MSCI Daily TR Net UK Local | 5: MSCI Daily TR Net Japan Local | 6: MSCI Daily TR Net Emerging Markets USD.

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 (31/01/2017) ■ 2016
Sources: Bloomberg, Edmond de Rothschild (Suisse) S.A.

The following persons contributed to this issue:

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