GLOBAL MARKETS OUTLOOK 2017

January 2017

Mark your calendars: Fiscal Policy, Political Risk, Reflation, Steeper G3 curves, Chinese economic risk…

The macroeconomic backdrop remains somewhat satisfactory in 2017, with no worrying signals so far despite the late stage of both the economic cycle and the bull market, technically, at its 8th year. In the US, the President-elect has bolstered optimism about growth with his promises of USD 1tn fiscal spending, corporate tax cuts, and deregulation. This was helped as well by stronger momentum in economic data in H2 2016. We believe recessionary risks are very limited at the moment.
Growth is also under way globally, with signs of pickup in Europe and Japan, as well as fading recessions in some EM countries. Earnings growth in the US, Europe and Japan are expected at double-digit rates. In the UK, the Brexit overhang will not fade in 2017 as Article 50 is triggered and the positive effects of a weaker pound on tourism and exports should be dampened by a deterioration in business outlook. China should not be worrisome before fall when the 19th National Congress of the Communist Party will take place (every 5 years), with 5 out of 7 seats in the Politburo Standing Committee up for grabs. In the meantime, authorities have been trying to contain accelerating capital outflows triggered by higher U.S. yields.

We believe 2017 will be a year marked by higher yields, as monetary policy becomes less accommodative on higher inflation realizations, or risk-aversion driven yield tantrums.

Signs of **inflation** have already started to appear in several geographical regions, but price increases are currently due to base effects and higher commodity prices, rather than markedly increased demand (supply-based inflation). Red flags would be raised if inflation picks up on the demand front, as the Fed would be well behind the curve in raising rates, and would be forced into hiking much faster than the economy can handle. Currently, the Fed's median interest rate target for 2017 implies 3 rate hikes, as an expansionary fiscal policy would allow for higher rates. Looking at market implied rates, fixed income investors are positioned for only two hikes.

Financial conditions, which take into account levels of bond yields (-ve), US Dollar (-ve), equities (+ve), and credit spreads (-ve) have failed to worsen substantially on higher yields, as the equity rally shielded investor wealth. In 2017, they will remain a key indicator to watch as they are likely to dictate the Fed's behavior and affect EM performance.

Political risks are likely to occupy headlines in 2017. In spite of the spending spree that Trump is promising, the current fiscal backdrop in the US is already quite constraining, with debt/GDP at 73.6% and fiscal deficit at -3.1%, which would limit the size of the stimulus package. Also, other elements of his program, mainly his hard stance on **protectionism** (higher import tariffs), could hurt a global trade already in decline, and fuel more supply-side inflation in the U.S. Hence the first 100 days of his Presidency will be closely watched.
Across the pond, Europe will witness several important elections (the Netherlands, France, and Germany) that could further highlight voter dissatisfaction with the current political setting. Unexpected voting outcomes could hinder the currently supportive path of economic reforms.

	As of 12/30/2016	Net Px Chg in Q4 16 (%)	Net Px Chg in 2016 %
Equities			
MSCI WORLD	1,751.22	1.48	5.32
S&P 500 INDEX	2,238.83	3.25	9.54
NASDAQ COMPOSITE INDEX	5,383.12	1.34	7.50
Euro Stoxx 50 Pr	3,290.52	9.60	0.70
FTSE 100 INDEX	7,142.83	3.53	14.43
NIKKEI 225	19,114.37	16.20	0.42
MSCI EM	862.27	-4.56	8.58
HANG SENG CHINA ENT INDX	9,394.87	-1.95	-2.75
MSCI EM EASTERN EUROPE	146.73	13.62	32.97
MSCI EM LATIN AMERICA	2,340.65	-1.69	27.92
MSCI AC FAR EAST	119.55	-3.50	1.94
Fixed Income			
US Generic Govt 10 Year Yield	2.44	53.31	7.71
Germany Generic Govt 10Y Yield	0.21	-274.79	-66.93
BBG USD EM Sov	158.67	-4.15	9.90
BBG USD IG Corp	143.68	-2.95	5.94
BBG EUR IG Corp	137.51	-1.47	4.45
BBG USD HY Corp	169.79	1.55	17.41
BBG EUR HY Corp	173.15	1.66	8.66
BBG USD EM Corp	153.66	-1.59	11.60
Currencies			
DOLLAR INDEX SPOT	102.21	7.07	3.63
EUR-USD X-RATE	1.05	-6.39	-3.18
USD-CHF X-RATE	1.02	4.90	1.69
GBP-USD X-RATE	1.23	-4.87	-16.26
AUD-USD X-RATE	0.72	-5.95	-1.07
USD-TRY X-RATE	3.52	17.45	20.78
USD-BRL X-RATE	3.26	-0.22	-17.81
Commodities			
BBG Commodity	87.51	2.55	11.40
Oil (Brent)	56.82	15.82	52.41
Gold Spot $/Oz	1,147.50	-12.80	8.14
Silver Spot $/Oz	15.93	-16.93	15.02
Platinum Spot $/Oz	903.10	-12.09	1.30
Iron Ore 62% Fe S Dec16	79.75	55.43	117.30
LME ALUMINUM 3MO ($)	1,693.00	1.20	12.34
LME COPPER 3MO ($)	5,535.50	13.78	17.65
Henry Hub Natural Gas Spot Pri	3.68	29.70	59.23

Bank Audi
Private Bank

Investment Strategy and Asset Class Review

- **Political policies are advantageous to equity markets in 2017**
- **Equities are core to any portfolio . Equities offer multiple opportunities in 2017.**
- **SP 500 targeted to rise by 7%, Nasdaq by 10% during the next 12 months.**
- **We favor both a tactical and thematic approach in 2017. We favor Tech, Financials and Materials.**
- **In Fixed Income, we use a selective approach to Credit and low duration bonds.**
- **The USD is expected to top by H1-17 against G3 (EUR, JPY, Commodity FX), but remains a buy on dips against some EM FX with imbalances such as TRY, CNY (Asia FX).**
- **The expected fixed income volatility should offer support to Gold, CHF and JPY as safe havens and portfolio diversification.**
- **Commodities for the most part, are expected to have bottomed in 2016, and should remain a buy on dips as inflation seeps in.**
- **Favor industrial metals in 1H-17, Oil in 2H-17, as well as uranium, lithium, graphite and bauxite as commodities pertaining to the alternative energy space.**

GLOBAL ASSET CLASSES	-	=	+
Equities			
Bonds			
Commodities			
Cash			
EQUITY REGIONS	**-**	**=**	**+**
US			
Europe			
Japan			
Emerging Markets			
FIXED INCOME	**-**	**=**	**+**
Sovereign			
Aggregate			
IG Corp			
High Yield			
Emerging Debt			
Convertibles			

The above table is meant as a reference.

EQUITIES

US equities remain the leaders of the post-GFC recovery. In 2016 again, they outperformed DM markets and given growth outlook, they are expected to participate in any equity rally that could take place this year. The recent market rotation has favored some sectors at the expense of the so-called yield-sensitive industries. Financials have rallied tremendously after years of regulatory-linked underperformance, while utilities, real estate, staples lost ground. Rotation is expected to continue as long as the base scenario remains that of a fiscal expansion in the US.

This is why our approach this year to equity markets is via themes:

(1) **Financials** as many tailwinds are in favor of further upside (higher yields, higher growth, deregulation, little sensitivity to strong USD, possibility of higher capital returns to shareholders), yet valuations seem a bit stretched for now. We would wait for a multiple contraction either via a market correction or earnings revisions – which haven't completely materialized.

(2) **Materials** are also compelling despite the 2016 rebound, yet to be tackled on a selective basis as the sector is too diversified. **Favor infrastructure-linked companies as well as the ones that would benefit from protectionism.**

(3) **Tech** as we believe the entry point is currently attractive given the recent pullback. Some quality names with decent growth remain a core holding in an equity portfolio.

Some other themes that also look attractive:

(4) **Healthcare,** given their heavy underperformance, high cash position, and attractive valuation that could give room for multiple expansion. US companies can benefit from tax inversion-linked cash repatriation, while the risks of pricing pressure look somewhat priced in. The main risks remain strong competitiveness (stringent FDA approval processes, patent cliffs with the rise of generics and biosimilars).

(5) **Consumer Discretionary** (excluding the luxury segment) is a compelling value play as well, that can benefit from stronger growth.

(6) **Small caps** are also poised to benefit from stronger growth, and are generally more immune to strong US dollar – noting that attention to be paid to leverage given higher yield expectations which could affect access to financing.

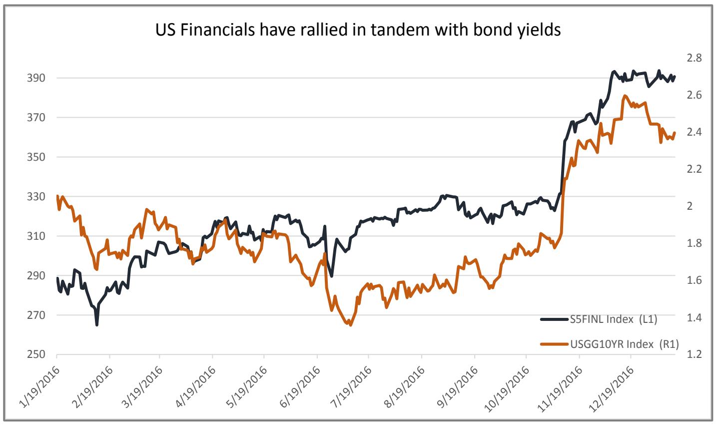
(7) **Logistics** as a way to get exposure to increased consumption and investments,

(8) **Defense** given the boost to come from fiscal spending.

In **Europe**, we remain opportunistic and favor investing in financials and quality European brands .

Japanese equities should be helped by continued support from the government and from a weaker yen.

As for **EM**, we would rather get exposure via EM-exposed DM names or commodity producers.



FIXED INCOME

Given renewed growth and inflation expectations in the US, diverging monetary policy between Central Banks and another year jam-packed with election risks, 2017 could very well be a year of choppy Fixed Income markets.

In this challenging environment, bond selection, relative value analysis and the ability to **stay nimble and proactive, rather than a passive long duration stand**, will remain key in order to achieve good performance.

We are therefore **keeping our overall short duration bias intact with a strong focus on credit selection.** Most analysts are now expecting 2-3 rate hikes in the US and an early tapering from the ECB which is helping shape steeper curves for most Developed Markets. For this,

G10 sovereign bonds lost their safe haven status with most managers ditching the traditional "buy and hold" strategy in favor of a more proactive one. The end of the lower-for-longer era is expected to weigh on Long duration and low beta bonds as investors adapt to this new environment.
In **Europe**, the busy political agenda coupled with expectation of tighter regulations on Financials is expected to create volatility driving spreads wider especially in Peripheral countries. **A possible shelter from the rising rate environment can be to remain light on duration and use strategies such as a bond ladder with maturities between 1 and 5 years of high spread double-B rated, DM corporate issuers**, and especially in the **US**, that stand to benefit from the new fiscal policy in the US.
In **EM,** it is still too early to jump in the full space given the new Trump administration, higher US rates, stronger US dollar, capital outflows from China, and timid growth revisions in the area.

Therefore, we will be **adopting a selective approach by focusing on commodity producers** which are expected to benefit from higher prices and on EM corporates benefiting from receding recessions such as **Brazil**, **India**, **Indonesia**, **Russia** and **some LATAM** countries.

FX

The combination of a Trump win, a Fed's hawkish-hike in December, and the announcement of an April dovish-taper by the ECB, pushed US dollar appreciation into higher gear in the November-December period. Indeed, after bottoming in May 2016 at 91.9, the Dollar index (DXY) recouped all losses incurred in 1H16, and managed to rise an extra 5% post-November 8th to 103.8.
Currently, markets and most economists are pricing 2 rate hikes in 2017, which translates into 10-Year yields around 2.4% and DXY near 102. Unless Trump policies in the first 100 days dampen prospects for higher growth, the US Dollar should mean revert around current levels. In 1Q17 however, **the global cyclical upturn should continue to justify buying the greenback on dips, especially against EUR, CHF and JPY in the short term**. Under the same context of global cyclical growth, EURJPY should perform well, while EURAUD is a sell on rallies.
In light **of 1H17 political risk in Europe, EURSEK remains a sell on rallies, while EURGBP is prone to 300bp moves around 0.86.**

As of 2H17, we prefer to start holding EUR, JPY, CHF and gold, as well as oil linked-FX (NOK,RUB) versus the US Dollar, as we expect trade tensions with China, as well as a potential steepening of European and Japanese yields versus the U.S.

Trade tensions with China can be played by **going short the high beta pair AUDJPY on rallies or via a 6-month long put structure**.

In EM, **as long as the Chinese economy holds up and until the Politburo's 19th National Congress in 4Q17**, we prefer to buy commodity exporting **EM FX (BRL, RUB, ARS)** whenever the dollar index or DXY appreciates towards the 103-105 level, as well as receding drag from economies and higher commodity prices. The combination of domestic bonds (sovereign/supranational) along with long FX positions would be a good way to earn carry.

COMMODITIES

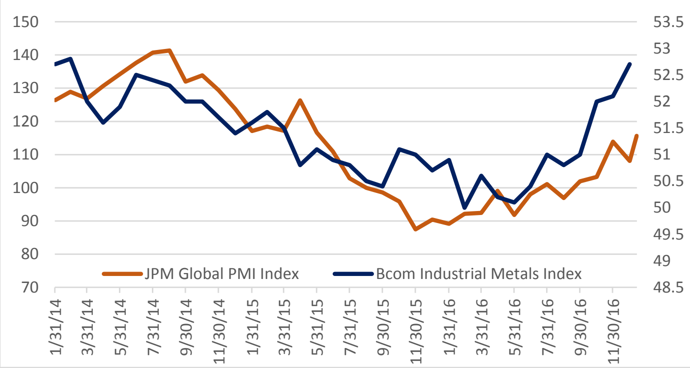
The same fundamentals that drove the decline of commodities since 2011 are those pushing them higher today, after bottoming out for most in 2016.
Thanks to a mix of corporate bankruptcies and natural production declines stretching over the past two years, as well as unplanned output cuts (Canada, Nigeria, Libya, etc.) and a global pact to cut production in 2016, oil is currently trading above the 50$-threshold.

Markets are ready to punish OPEC and non-OPEC participants if they do not abide by their pledge, but in the short term, higher production in the U.S., as well as near record inventories are keep a lid on oil prices. Looking at positioning, investors are reluctant to add shorts on oil via futures and options. This suggests that any reversal due to evidence of higher production or lower-than-anticipated cuts, could drive oil below 45$/bl.

Natural gas seems to have bottomed in 2016 after the warmest El-Nino weather pattern in decades hit the U.S., high inventory levels and slow coal-to-gas industrial conversion pushed prices below breakeven for many producers. However, with **(1)** the return of a somewhat normal winter, **(2)** the still declining production declining as rig counts fail to pick up, and **(3)** increasing export/pipeline demand of 7bcf/d, inventories have recently retraced below the 5-year seasonal average, which is lending support to the price. The futures curve is currently flat until May 2017, which lends credibility to a 3.5$/mmbtu average in 2017 for natural gas. Looking at the longer term, Oil and Gas majors have been heavily approving investment decisions in natural gas, which suggests a shift from oil to natural gas.

The higher real yield environment in light of a combination of a solid U.S. economic growth and 300bn p.a. in US and Chinese infrastructure spending, pushed industrial metal prices 20% higher since November. Demand-driven price rallies in industrial metals look unlikely as China seems to be replenishing its inventories (record imports in December 16). However, inflation appear to be returning, not only due to base effects, but also in light of protectionist measures in DM and lower production rates in China. This supply driven inflation if carefully maintained, would help increase mining revenues in China and prevent further waves of bankruptcies and unemployment. We therefore prefer to buy industrial metals on dips rather than on current highs, and prefer metals with ongoing supply constraints such as Zinc, and seasonal constraints such as Copper in March-May and July-December.

Higher inflation supports manufacturing activity



In 2H16, gold suffered a major blow both on the financial and physical demand fronts due to **(1)** Trump risk-on rally: unwinding of long positions as hedges v. equities, **(2)** Fed turning more optimistic in their forecasts, **(3)** Weakest demand on record due to India's demonetization scheme ahead of Diwali season and China's fight against capital outflows, **(4)** EM central banks dumping gold holdings as they fight against outflows (Turkey, …) , **(5)** Increased demand for Bitcoin as a safe haven. In 2017, given that we -and markets- are positioned for 2 rate hikes, current 10-year yield levels of roughly 2.4% ought to be an equilibrium level. This implies a mean-reverting gold around 1,190-1,200$/Oz. We like buying dips more than selling rallies (uncovered) as geopolitical risks continue to rise and demonetization effects in India fade, lending a hand to seasonal physical demand as of July.