Global equities

CIO View

• We have a positive view on equities.
• US economic growth is underpinned by solid fundamentals, and we expect support for corporate profits in the coming quarters. Eurozone earnings are also well supported by low refinancing costs and robust demand.
• Risks to global equities remain, notably in the emerging markets, where the risk of a China hard landing, or more pronounced slowdown in other EM country, could cause equities to suffer. We also continue to monitor the health of the US economy.

Drivers

• US corporate profits: As the drawbacks that arose from the strong dollar and lower oil prices wane, we expect US profit growth to resume in the second half of the year. Valuations are close to long-term averages, meaning earnings growth should aid equity prices.
• Eurozone earnings: Eurozone companies benefit from low refinancing costs and broadening domestic demand. Solid revenue growth and gradually rising net profit margins should boost company profits at a mid-single digit rate this year.
• ECB policy: Low European inflation data led the ECB to accelerate its QE program and cut deposit rates to -0.4%. Extra liquidity should ultimately support equities.

Risks

• China hard landing risk: China is still undergoing a major economic adjustment. A "hard landing," driven by a sharp downturn in property and manufacturing, remains a risk, and would hurt equities.
• US growth slowdown risk: A deceleration in the world’s largest economy would dent global demand, and the accompanying dollar weakness could negatively affect other equity markets exposed to dollar revenues.
• Emerging market growth: Weak growth in the emerging markets is already holding back corporate earnings, such that we hold a negative view on EM equities. A more severe downturn would likely cause global equity prices to fall.

Positive scenario

• A synchronized acceleration in developed market growth and a
My House View

turnaround in the emerging markets lead to the S&P 500 trading at 2,300 and the Eurostoxx 50 index reaching 375.

Negative scenario
- Some combination of a global recession, tighter financial conditions and a severe slowdown in China ensues. The S&P 500 falls to 1,750 and the Eurostoxx50 to 270.

Underexposed statement
- Equities are a key driver of long-term portfolio growth, and we hold a positive view on them. Market declines since the start of the year may have left some investors under-allocated to the asset class.

In-line statement
- Investors with in-line allocations should hold their positions and await volatility before rebalancing. Our preferred markets are the US and Eurozone. We have a negative view on emerging markets.

Overexposed statement
- Overexposed investors could experience a sharp drawdown in the event of a China hard landing, US recession or EM slowdown. The recent rally should be used as an opportunity to reduce holdings.

Positive idea
- US
- Eurozone
- Energy
- Healthcare
- Technology

Our preferred markets within global equities are the US and the Eurozone. We expect support for US corporate profits in the coming quarters. Eurozone earnings are also well supported by low refinancing costs and robust demand.

By sector, energy is an attractive "value play" that should benefit from improving free cash flows and higher oil prices as of 2H16. We like technology because of its strong cash generation and the ongoing IT enterprise spending. And healthcare is rated most preferred because of steady earnings growth. We see little chance of a meaningful change in US drug prices.

Negative idea
- EM
- Consumer staples
- Materials
- Telecoms

Our least preferred market within global equities is emerging markets. The consensus expectation for EM earnings growth of 9% over the coming 12 months is far too high in our view.

By sector, we are cautious on consumer staples, mainly because of high valuations and only modest earnings growth. Materials and utilities are rated least preferred because of weak commodity prices for the former and mediocre earnings growth for the latter. Our cautious stance on telecoms stems from intense pricing pressures in the US market. In Europe, earnings momentum is resilient but valuations are stretched, reflecting M&A activity.
US equities

CIO View

- We have a positive outlook on US equities over a six-month investment horizon.
- US consumer fundamentals appear to be on a solid footing, we expect profit growth to improve in the second half of the year and the Fed has signalled only a gradual path of interest rate hikes.
- Risks include a renewed slump in oil prices, a sharp slowdown in China or a continuation of the recent uptick in US inflation.

Drivers

- Favorable US indicators: There have been signs of stabilization in the manufacturing sector, and trends in the much larger US consumer and services segments remain supportive. This provides a favorable backdrop for US equities.
- US corporate profits: As the drawbacks that arose from the strong dollar and lower oil prices wane, we expect profit growth to resume in the second half of the year. Valuations are close to long-term averages, meaning earnings growth should aid equity prices.
- Fed policy: The Fed remains accommodative, sustaining market confidence. Policy is loose among trading partners too. China should see its growth stabilize thanks to policy support, and the Eurozone should experience greater growth due to loose ECB policy.

Risks

- US inflation: Investors should note that core inflation has been rising recently. An acceleration of this trend could bring forward market expectations of rate hikes, lead bond yields higher, tighten financial conditions, lower consumption growth and hurt US equities.
- China hard landing: China is still undergoing a major economic adjustment. A “hard landing” due to a sharp downturn in property and manufacturing would cause global risky assets, including US equities, to suffer.
- Oil prices: Oil has been a key driver of US equities this year. Oil remains oversupplied and we expect prices to decline in the coming months. This could weigh on energy sector earnings and capex.

Positive scenario

- Robust developed market growth, continued low inflation and an EM turnaround boost growth, profits and markets. The S&P 500 tops 2,300.

Negative scenario

- Tighter financial conditions, lower oil prices and an EM slowdown hurt earnings and sentiment. The S&P 500 trades at 1,750.

Underexposed statement

- Some exposure to the world’s largest equity market is usually warranted. US economic resilience and recovering profits are reasons for under-allocated investors to rebalance.

In-line statement

- Investors with in-line exposure can optimize sector exposure by allocating toward growth-oriented sectors and away from
interest rate-sensitive ones.

**Overexposed statement**
- Overexposed investors should be conscious of the risks, including higher US inflation or a China hard landing, and diversify across regions or asset classes.

**Positive idea**
- Technology
- Consumer discretionary
- Healthcare
- Energy

Within US equities our most preferred sectors include technology, consumer discretionary and healthcare for their strong relative growth prospects. The probability of higher oil prices over the next year and low valuations drive our energy sector overweight.

**Negative idea**
- Utilities
- Consumer staples
- Telecoms

We are cautious on utilities, consumer staples and telecoms, which would be hit in the event of an increase in US interest rates or bond yields.

**Eurozone equities**

**CIO View**
- We have a positive outlook on Eurozone equities over a six-month investment horizon.
- Corporate earnings are improving thanks to gradually rising margins and higher revenue. Ongoing monetary easing assists continued economic recovery. Leading economic indicators have stabilized.
- Risks include a slowdown in global growth, rally in the euro, or renewed flare-up of the Eurozone crisis.

**Drivers**
- *Eurozone growth:* The domestic recovery has been resilient thanks to improving employment. Consumer demand is holding up well. Leading indicators point to continued growth in the service sector and a moderate expansion in manufacturing.
- *Eurozone earnings:* Eurozone companies benefit from low refinancing costs and broadening domestic demand. Solid revenue growth and gradually rising net profit margins should boost company profits at a mid-single digit rate this year.
- *ECB policy:* The ECB’s monetary policy has led to a decline in the rate at which companies borrow from banks, supporting profitability. Increased lending volumes should also aid growth.

**Risks**
- *US recession risk:* Should Eurozone growth remain solid alongside signs of weakness in the US economy, the euro could rally against the US dollar, damaging Eurozone earnings.
- *China hard landing risk:* Eurozone equities only derive 6-8% of revenues from China. But a hard landing, potentially stemming from a sharp downturn in property and manufacturing, would hurt Eurozone equities.
- *Eurozone crisis risk:* A renewed flare-up of the Eurozone crisis,
with questions over Greece's status in the euro, or continued Spanish political uncertainty could lead bond yields to rise and Eurozone equities to fall.

**Positive scenario**
- Stronger global economic growth boosts revenues and earnings. The Eurostoxx 50 index trades at 375.

**Negative scenario**
- A slowdown in global growth, along with a renewed Eurozone crisis, sends the Eurostoxx 50 index down to 270, with falls only mitigated by ECB action.

**Underexposed statement**
- Volatility in Eurozone equity markets may have left some investors out of line with long-term allocations. Decent economic and earnings growth and accommodative ECB policy are reasons to consider rebalancing.

**In-line statement**
- Investors with in-line exposure can rotate toward the low-valued financials and energy sectors, and away from more highly valued consumer staples. We also dislike materials and utilities.

**Overexposed statement**
- Overexposed investors should be conscious of the risks, including a rally in the euro, a hard landing in China or renewed flare-up of the Eurozone crisis.

**Positive idea**
- Energy
- Financials
- Healthcare
- Technology

Our most preferred sectors within Eurozone equities are financials, energy, healthcare and technology (IT). Market concerns about bank capital ratios are overdone, in our view. Distressed valuations offer re-rating potential. Energy is also a "value" play that should benefit from higher oil prices in 2H16. Healthcare promises steady earnings growth. Eurozone IT offers a combination of promising growth (software), self-help and higher capex.

**Negative idea**
- Consumer staples
- Materials
- Utilities

Our least preferred sectors are commodity-related plays, including materials and utilities. Consumer staples are least preferred mainly because of high valuations.

**UK equities**

**CIO View**
- We are neutral on UK equities.
- Corporate earnings growth is improving thanks to gradually rising margins and higher revenue. Ongoing monetary easing assists the chances of a continued economic recovery. Leading economic indicators have stabilized.
- Risks include a slowdown in global growth, a rally in the euro or
a renewed flare-up of the Eurozone crisis.

Drivers

- **GBP weakness**: The GBP has slid about 7% against both the USD and the EUR in the past six months. This has removed the currency headwind from the FTSE 100, and earnings could benefit as the year progresses.

- **Oil prices**: The crude oil price, since its mid-February rise, is now up by about 10% this year. This should aid energy sector earnings, which has a 13% weighting in the UK stock market.

- **UK valuations**: The FTSE 100 trades at a trailing P/E of about 16.0, a slight discount to other developed market equity P/Es. Meanwhile, it trades at a 12-month forward P/E of about 15.5x.

Risks

- **Emerging market growth**: China accounts for about 10-15% of FTSE 100 revenues, and emerging markets about 25-35%. Slower emerging market economic growth and the currency depreciation in those markets are hurting some earnings.

- **Brexit risk**: A Brexit would likely affect domestic stocks the most, along with companies with large exports to Europe. The index as a whole would be more immune, given that only 25% of UK equity revenues are domestic.

- **Oil prices** have been an important leading indicator of UK earnings per share in recent months. A renewed decline in oil prices would likely affect profits and equity values negatively.

Positive scenario

- Faster global growth and higher commodity prices boost earnings growth in commodity and energy sectors. The FTSE100 moves to 6,750.

Negative scenario

- Slower global growth, along with a renewed Eurozone crisis, sends the Eurostoxx 50 index down to 270, with falls only mitigated by ECB action.

Underexposed statement

- Investors underweight in the UK should consider the market’s defensive qualities in the context of their portfolio. The currently weak pound, attractive valuations and recovering oil prices are reasons to rebalance.

In-line statement

- Investors with in-line exposure can rotate toward the low-valued financials and energy sectors, and away from more highly valued consumer staples. We also dislike materials and utilities.

Overexposed statement

- Overexposed investors should be conscious of their vulnerability to commodity-related sectors, which add portfolio risk and can offset the index’s defensive nature.

Positive idea

- UK value
- UK dividend growth
- Companies with US exposure

Value as a style of investing relates to investing in companies with intrinsic value. Value tends to outperform as bond yields rise.

UK dividend growth: At this point in the economic cycle, we believe that
the best total returns (price appreciation + dividend income) in a dividend strategy will come from companies that offer not only a decent dividend yield but also dividend growth. Given the relatively low UK government bond yields, the yield on dividends still looks attractive. Dividends are key to UK equity market total returns.

The best way to avoid Brexit risk, we believe, is to buy companies with a high exposure to the US. This provides a currency benefit from the stronger USD sales into the weaker GBP reporting currency, and avoids companies at risk from any associated UK or European economic slowdown.

Negative idea
- Brexit risk
- Mid caps
- UK financials
- House builders
- Utilities
- UK exporters

Areas of the UK equity market most at risk in the event of a Brexit in our view are: domestically exposed segments such as the FTSE 250 (mid caps); UK financials; house builders; utilities; and UK exporters. A Scottish exit from the UK becomes a risk should the UK vote to leave the EU. We think the stock of companies with significant sales in Scotland might also underperform the broader UK market.

Swiss equities

CIO View
- We are neutral on Swiss equities.
  - A still-strong Swiss franc is making life difficult for companies producing domestically. Swiss companies delivered robust sales growth of 3-4% in local currencies last year, but suffered from marked currency losses for the third straight year.
  - The currency headwind should start to ease in the months ahead, and improving Eurozone economic growth and low oil prices should undergird the market.

Drivers
- Eurozone growth: Swiss companies generate more than one-third of their operating profits from Western Europe, and cyclical and financial stocks can be expected to perform well in an environment of improving Eurozone economic growth.
- Oil prices: Swiss equity earnings receive a boost from lower oil prices as the well-represented consumer sector benefits from greater disposable income and lower raw material costs. The Swiss exchange no longer lists any companies in the energy sector.
- Low interest rates: In a low interest rate environment, dividend-paying stocks appeal as a means of generating income.

Risks
- Strong Swiss franc: Because the CHF remains strong, companies focusing on Swiss production still face volume growth challenges and pricing pressure when selling domestically or exporting due to tough foreign price competition.
- Emerging market growth: Swiss companies are globally diversified and generate just under one-third of their profits from emerging markets. Swiss stocks are therefore vulnerable to foreign demand and currency movements.
My House View

Positive scenario
- Improving Eurozone economic growth boosts Swiss cyclical and financials, whose earnings rise by 5%. The SMI reaches 9,000.

Negative scenario
- A slowdown in global growth affects Swiss corporate profits, which are only partly protected by a less-cyclical profile. The SMI falls to 7,000.

Underexposed statement
- Investors underexposed to the market should consider the merits of a market which is defensive and exposed to a wide range of revenue sources. Improving Eurozone growth and low oil prices support the market.

In-line statement
- Investors with in-line exposure could consider rotating allocations toward high-quality dividend payers and mid-caps, two of our preferred areas within Swiss equities.

Overexposed statement
- Overexposed investors should be conscious of the market’s high sensitivity to the Swiss franc and its defensive nature, which can leave it behind in a global recovery.

Positive idea
- Within Switzerland, we favor high-quality dividend payers and mid-caps. Quality dividend payers are attractive given the current low interest rates. Mid-caps offer strong balance sheets at a low valuation premium.

Negative idea
- We are relatively more cautious on the large-caps within Switzerland. The overall price-to-earnings ratio for Swiss equities is fair to expensive, and earnings growth is weaker among large caps than among mid-caps.

Japanese equities

CIO View
- We are neutral on Japanese equities.
- Their valuation is lower than the historical average, and we expect the yen to weaken somewhat in the coming months.
- Given the yen’s recent strength, the slower earnings and the uncertainty about the outlook for the Chinese economy, we believe the shares are fairly valued.

Drivers
- Bank of Japan policy: Negative deposit rates have failed to weaken the JPY against the USD. But the bank might expand its monetary stimulus measures if inflation data, wage negotiations and/or the growth outlook disappoint significantly in the next six months.
- Japanese earnings: Reduced corporate tax rates, the end of one-time write-offs of asset values at large Japanese companies and possible future weakness in the yen mean that earnings should be relatively solid in FY 2016.
- Japanese fiscal policy: We think Prime Minister Shinzo Abe may postpone a planned VAT hike, leading to political stability and reducing risks of a slowdown. It would likely be welcomed by Japanese equities.
Risks

- **Strong yen**: The yen has been seen as a safe haven amid global uncertainty and has strengthened by about 7% this year. This is likely to weigh on Japanese earnings in the near term.
- **Japanese growth**: Sentiment in the manufacturing sector deteriorated and is now pointing to a moderate contraction; exports and imports have retreated compared to a year ago. As the Japanese equity market is strongly geared to cyclical sectors, it is quite sensitive to economic growth.
- **China hard landing risk**: Uncertainty about the growth outlook for China has weighed on sentiment for Japan, given the close trade relationship between the two.

Positive scenario

- Greater global and domestic demand and a weaker yen boost earnings by around 10%, and the Topix tops 1,600.

Negative scenario

- Sputtery global and domestic growth and a stronger yen cause earnings disappointments. The Topix drops to 1,150.

Underexposed statement

- Those underinvested in Japan could regard the market’s recent weakness as an opportunity to enter it – we expect policy announcements to support it in the months ahead.

In-line statement

- Investors with in-line exposure could consider rotating toward companies engaged in share buybacks, and away from REITs.

Overexposed statement

- Overexposed investors should be aware of the highly cyclical nature of the market and its dependence on sometimes volatile global demand, and consider rebalancing.

Positive idea

- We prefer companies with share buyback potential. The BoJ’s recently introduced negative interest rate policy and the country’s corporate governance code encourage share buybacks.

Negative idea

- We are particularly cautious on Japanese REITs, mainly due to high valuations. Their 35% price/NAV premium is now near the 2007 peak, and we see their outperformance being capped by new office space supply increases in 2017-2018.

EM equities

CIO View

- We are negative on EM equities.
- We are cautious on earnings growth and note that many economic variables indicate contraction. The risk of a China hard landing remains.
- For investors with a long time horizon, valuations may be considered favorable, and a weaker dollar and higher commodity prices could help near-term performance.

Drivers

- Favorable valuation: The MSCI EM index is trading at a 13.4x trailing P/E, about a 20% discount to developed markets.
A weaker US dollar: The recent EM rally has, in part, been driven by the relative weakness in the dollar and accommodative statements from the Fed. A dovish Fed could help EM more.

Higher commodity prices have boosted emerging markets of late. A continued rebound would ease the pressure on commodity exporters in the region.

Risks

- **EM earnings growth**: Consensus expects 12-month earnings growth of about 9% over the coming 12 months. We are more cautious and expect about 0-5% earnings growth.
- **EM growth**: EM manufacturing PMIs have stabilized but are still below 50, indicating contraction. Exports remain in contractionary territory. This is not a favorable backdrop for EM equities.
- **China hard landing risk**: Uncertainty about the growth outlook for China has weighed on EM sentiment, given that China is an important source of end demand for many EM countries.

Positive scenario

- The global economic outlook improves, boosting EM earnings growth and investor confidence. MSCI EM rises to 875, assuming 7% earnings growth on a trailing P/E multiple of 13x.

Negative scenario

- EM prospects are hit by deteriorating global growth or a sharp deceleration in the Chinese economy. Earnings decline considerably and the MSCI EM trades at 650.

Underexposed statement

- Investors underexposed to emerging markets should consider current valuations as a potentially attractive entry point for longer term strategic holdings. The weaker dollar and higher commodity prices are easing near-term pressures.

In-line statement

- Investors with in-line exposure should carefully consider country allocations, given the heterogeneous nature of EM. We currently prefer China and Turkey to Mexico, Thailand and Taiwan.

Overexposed statement

- Overexposed investors should consider the variety of near-term downside risks, including weak earnings growth, uncertainty over China and idiosyncratic issues in major markets. Global diversification is key.

Positive idea

- China
- Turkey
- High quality dividend yielders

Our most preferred equity markets are China and Turkey. In China, valuations already reflect a lot of the growth and macro fears. We believe the country is likely to adopt further monetary and fiscal stimulus measures, which could lift multiples. Fading China tail-risk concerns will improve sentiment for the overall market.

We like Turkey due to its attractive valuation, resilient earnings and macroeconomic growth.

In an environment of low global interest rates, we think a basket of defensive stocks with high dividend yields, earnings growth and
superior ROE should outperform other emerging markets.

**Negative idea**
- Mexico
- Taiwan
- Thailand

Our least preferred markets are Mexico, Thailand and Taiwan. In Mexico, we think the market is overly optimistic on earnings and will likely de-rate as it is trading at expensive valuations. Thai macro fundamentals, especially with regard to industrial production, have been weak. Taiwan’s earnings upside is limited, and we expect further political risks and difficulties for the tech sector.

**Global bonds**

**CIO View**
- We recommend a neutral duration stance within bonds.
- Fixed income is likely to receive support from loose ECB monetary policy, and a still-accommodative stance from the Fed. Decent economic growth should aid riskier credits.
- Overall returns are likely to be muted, in particular for the safest credits, given extremely low yields. Volatile commodity prices will affect the asset class.

**Drivers**
- **ECB policy**: Poor European inflation data led the ECB to accelerate its QE program, cut deposit rates to -0.4% and assist banks with a targeted long-term refinancing operation. These steps will support bond prices across the credit spectrum.
- **Fed policy**: In spite of improving US economic data, the Fed has kept its accommodative stance, sustaining market confidence in US-denominated bonds. Sharp interest rate hikes seem unlikely.

**Risks**
- **US inflation**: US core inflation has been rising recently. An acceleration of this trend could bring forward market expectations of rate hikes and lead bond yields higher.
- **Bond valuations**: Given the low starting yields, returns across the fixed income spectrum are likely to be less than in previous decades.

**Positive scenario**
- Growth continues to approve thanks to ongoing accommodative central bank policy. Low rates limit benchmark yield rises while credit spreads compress.

**Negative scenario**
- Inflation rises but is not accompanied by growth. Benchmark yields climb and funds flow out of risky credit funds.

**Underexposed statement**
- Many fixed income asset classes have historically low yields. But bonds remain an important part of most portfolios, offering stability and diversification. Investors underexposed to them can take advantage of the broad range of options to best fulfill portfolio requirements.

**In-line statement**
- Investors with in-line allocations should carefully monitor their
sub-asset class holdings. Fixed income has a broad range of risk categories, and we recommend holding a diversified set of them.

**Overexposed statement**
- Overexposed investors face the risk of higher inflation and of central banks raising rates sharply. Diversification into equities or alternatives could help mitigate it.

**Positive idea**
- European high yield
- US investment grade credit
- US senior loans
- Gold miners’ bonds

The yield pick-up of euro high yield over higher-rated bonds is attractive, with a yield to maturity that exceeds 5%. Corporate fundamentals are solid and default rates are expected to rise only moderately toward 2% in the next 12 months.

We believe that US senior loans are an attractive means of investing in the US high yield credit story. Their 7.8% yield make them potentially appealing to investors able to tolerate lower liquidity.

Gold miners’ bond yields are high compared to similarly rated bonds of other issuers. Industry fundamentals have improved, costs have declined, balance sheets are leaner and the strong 4Q15 earnings season heralds a profitable 2016 for the sector, in our view.

**Negative idea**
- High grade bonds
- 15 year + investment grade bonds

We are underweight high grade (HG) bonds relative to corporate bonds (IG & HY). For HG bonds in EUR and CHF, negative total returns are expected due primarily to a rate increase we see occurring that will be large enough to outweigh positive roll-down and carry. For HG bonds in USD, we expect muted, albeit positive total returns.

We remain cautious on IG bonds with maturities of 15 years and longer as they remain the most vulnerable to rate volatility and high supply at the long end of the curve.

**High grade bonds**

**CIO View**
- We have a negative outlook on HG bonds overall.
- Their return potential is low, given the low starting yields and the chance that they will rise in tandem with higher US inflation and a steadily improving European growth picture.
- That said, HG bonds remain an important portfolio diversifier that could benefit in the event of a China hard landing, renewed decline in oil prices or more policy easing.

**Drivers**
- **ECB policy**: Poor European inflation data led the ECB to accelerate its QE program and cut deposit rates to -0.4%. These steps will continue to support HG bond prices in the Eurozone and beyond.
- **Oil prices**: Global weakness in commodity prices has suppressed inflation, and we expect a renewed decline in oil prices in the
months ahead. This factor is likely to support HG bonds.

- **China hard landing risk** has created further worries about global overcapacity and deflation. These fears are contributing to lower inflation expectations, which support higher HG bond prices.

**Risks**

- **US inflation**: US core inflation has been rising recently. An acceleration of this trend could bring forward market expectations of rate hikes and lead bond yields higher.
- **Eurozone growth**: The Eurozone domestic recovery has been resilient thanks to improving employment. Consumer demand is holding up well. A stronger-than-expected recovery could lead markets to speculate that QE might end earlier than currently anticipated.
- **Bond valuations**: Given low starting yields and expected improvements in global economic data, we anticipate that HG bond returns will be low in the months ahead.

**Positive scenario**

- What’s negative for the global economy is positive for HG bonds. Stalling global growth, declining oil prices and concerns about China take Bund yields to 0.0-0.2% and Treasuries to 1.3-1.7%.

**Negative scenario**

- A scenario of improving global growth and rising inflation would be a negative scenario for HG bonds. Treasury yields rise as high as 2.5-2.9% and Bund yields go to 0.8-1.1%.

**Underexposed statement**

- Concerns about rising rates have caused many investors to flee HG bonds in recent years. But they remain an important portfolio diversifier and have consistently surprised positively.

**In-line statement**

- Within HG bonds, we believe USD HG boasts the highest return potential, while CHF HG has the lowest. We expect negative returns from EUR HG.

**Overexposed statement**

- Overexposed investors should consider the low return potential of the asset class, along with potential negative shocks that could materialize in the event of better-than-expected economic data.

**Positive idea**

- We believe that USD HG bonds have the highest return potential among HG bonds. Their credit spreads are expected to hold at current tight levels. The total return outlook will therefore rely on changes in the underlying Treasury curve. The HG index now offers a yield-to-maturity of 2.2%; we expect the overall performance to be flat over the next six months.

**Negative idea**

- We expect negative performance both from EUR and CHF HG bonds. The EUR HG index now offers a yield-to-maturity of 0.1%, with positive roll-down; we expect a negative overall performance in the next six months as rising yields offset the positive benefits of carry and roll-down. In CHF, the HG index now offers a yield-to-maturity of -0.2%, and we expect the overall performance to be negative over the next six months.
Corporate bonds

CIO View

- We have a positive outlook on USD corporate bonds with medium maturities.
- Return potential is low, given the low starting yields and the chance that they will rise in tandem with higher US inflation and a steadily improving European growth picture.
- Corporate bonds remain an important part of most portfolios. They deliver relatively stable returns through an economic cycle, given their exposure to a "rate" and "spread" component.

Drivers

- *Oil prices*: The recent oil price recovery has supported corporate bond prices, for US IG credit in particular, as fears of defaults in the energy sector have abated.
- *Global growth*: Receding fears of a global recession have supported the asset class in recent weeks. We believe global growth will remain stable and support corporate bonds in the months ahead.
- *ECB policy*: Its ultra-loose monetary policy is generating demand for IG credit and aiding the asset class.

Risks

- *Bond valuations*: The low starting yields, particularly in the Eurozone, make for an uninspiring outlook for returns.
- *Oil prices*: US IG credit is still exposed to volatile oil prices. We believe the oil market is still oversupplied, and a renewed price decline could affect US IG credit negatively.
- *Bond supply*: In the near term, the supply and demand backdrop can drive secondary market performance. We expect issuance to remain high this year.
- *US credit cycle*: It matured last year as leverage ratios rose and shareholder-friendly activities, such as M&As and dividend payouts, dominated CEO agendas. Investors in US IG should be wary of this trend.

Positive scenario

- A Goldilocks, not-too-hot-and-not-too-cold global economy allows spreads to compress without benchmark yields rising sharply.

Negative scenario

- A sharp economic slowdown, along with a slump in oil prices, hurts US IG credit in particular.

Underexposed statement

- Corporate bonds, particularly in the US, offer attractive characteristics in the context of a portfolio. Exposure to a "credit spread" and a "benchmark rate" component keeps returns relatively stable through a cycle, and corporate bonds should be an important part of most portfolios.

In-line statement

- We recommend that investors take a medium-duration stance. We remain cautious on the long end of the curve given the high sensitivity to interest rates.

Overexposed statement

- Overexposed investors should consider the relatively low return potential of the asset class, the maturing US credit cycle and the
high primary market supply. Diversification to other asset classes or bond segments may be required.

**Positive idea**
- US investment grade credit
- Subordinated (hybrid) bonds
- Gold miners’ bonds

We overweight US IG credit with medium maturities. It offers a yield pickup over HG bonds and still provides some room for tighter spreads.

We also like selected subordinated (hybrid) bonds of high-quality non-financial issuers. We believe they offer yield gain over regular corporate bonds at only moderate additional risk.

**Gold miners’ bond** yields are high compared to similarly rated bonds of other issuers. Industry fundamentals have improved, costs have declined, balance sheets are leaner and the strong 4Q15 earnings season heralds a profitable 2016 for the sector, in our view.

**Negative idea**
- 15 year + investment grade bonds

We remain cautious on IG bonds with maturities of 15 years and longer as they remain the most vulnerable to rate volatility and high supply at the long end of the curve.

**European high yield bonds**

**CIO View**
- We have a positive outlook on European high yield bonds.
- We believe that valuations are attractive in the context of easy ECB policy and improving Eurozone economic growth.
- The key risks are greater uncertainty over the health of the Eurozone banking sector and a renewed slowdown in the emerging markets. Investors should also remain conscious that the asset class is less liquid than equities.

**Drivers**
- **HY valuations**: European HY bonds are pricing in a default rate of 3.5%, and their yield-to-maturity of 5.3% is attractive. We project a default rate of just 2%.
- **ECB policy**: The ECB’s ultra-loose monetary policy and its new TLTROs should reduce credit costs while limiting the worst effects of negative interest rate policy on the banking sector.
- **Eurozone growth**: The domestic recovery has been resilient, and leading indicators remain solidly in expansionary territory. This is a favorable backdrop for risky credit in Europe.

**Risks**
- **Eurozone recession risk**: A sharp drop in Eurozone economic growth would increase HY spreads and default risks. In the last episode of market stress in mid-2013, EUR HY spreads widened to ~570bps temporarily and reversed quickly. EUR and CHF HG would likely rally.
- **Eurozone financial sector risk**: Banks are the largest sector within European high yield (20% of the total), and concerns about the new European bail-in regime could weigh on smaller issuers.
- **Emerging market growth**: Rating downgrades raised the share of EM issuers in the index to 11%. This means that European HY credit is partly exposed to a renewed EM slowdown and
My House View

...idiosyncratic risks related to major issuers.

Positive scenario
- Gradual improvement in Eurozone growth enables spreads to compress to 350bps without benchmark yields rising sharply.

Negative scenario
- Concerns about the health of the Eurozone financial sector and a global economic slowdown cause spreads to widen to 1,200bps.

Underexposed statement
- European HY credit is a useful addition to portfolios for underexposed investors. It is pricing in an excessive default rate, and the latest ECB actions should enable spreads to tighten further.

In-line statement
- Investors with in-line allocations should continue to monitor the market closely in the months ahead for opportunities to add, or trim, positions as valuations shift.

Overexposed statement
- Overexposed investors should be wary of potential illiquidity in times of stress, and consider rebalancing toward other asset classes or regions.

Positive idea
- European leveraged loans

European leveraged loans, with their 6.0% yield and 623bps spread over EURIBOR, offer an alternative way of playing the European HY theme. Against the current backdrop of economic acceleration in the Eurozone, rising corporate earnings, very expansionary monetary policy and robust balance sheets, the default rate is expected to remain low.

Loans benefit from senior secured positioning, higher recovery rates, low price volatility and a favorable risk/return profile, in our view.

Negative idea
- Transportation
- Consumer services
- Capital goods

Within HY, we are cautious on the transportation sector, are becoming warier of the consumer services sector and foresee challenges for capital goods. Please refer to the HY bond list for the latest recommendations.

US high yield bonds

CIO View
- We are neutral on US high yield credit.
- The segment is exposed to the resilient US economy and recovering corporate profits, and should benefit from a still-accommodative Fed. Senior loans are an attractive alternative.
- A number of risks remain for US high yield, including a renewed decline in oil prices, a continued increase in US inflation and lower liquidity in the event of stress.

Drivers
- US economy: The manufacturing sector has shown signs of
stabilizing, and trends in the much-larger US consumer and services segments remain favorable for US HY.

- **US corporate profits:** As the drawbacks that arose from the strong dollar and lower oil prices wane, we expect US profit growth to resume in the second half of the year, boosting corporate fundamentals.

- **Fed policy:** Recent statements by its chair have suggested that the Fed will remain accommodative in the short term despite improving domestic conditions. This is helping to keep corporate funding costs low and aids US HY.

**Risks**

- **Oil prices:** US HY, given the potential for defaults in the energy sector, has a high short-term correlation to the oil price. Another plunge in oil prices could raise the risk of energy-sector defaults and weigh on the asset class.

- **US inflation:** US core inflation has been rising recently. An acceleration of this trend could bring forward market expectations of rate hikes, and drive outflows from US HY funds.

- **US growth:** HY investors are exposed to US economic dynamics. Any slowdown would hurt corporate earnings growth, raise leverage ratios and increase default risks in US HY.

**Positive scenario**

- A gradual improvement in US growth compresses spreads to 500 bps without benchmark yields rising sharply.

**Negative scenario**

- A renewed decline in the oil price accompanies a broader US recession, causing spreads to rise to 1,100bps.

**Underexposed statement**

- Some investors may have sold out of US HY positions in recent months because of concerns about the energy sector. We believe a long-term strategic holding in US HY is important, and recommend that underexposed investors rebalance.

**In-line statement**

- Investors with in-line allocations to US HY bonds can maintain positions to benefit from US economic resilience, conscious of potential near-term volatility related to oil price moves.

**Overexposed statement**

- Overexposed investors should be wary of oil price moves and potential illiquidity in times of stress, and consider rebalancing toward other asset classes or regions.

**Positive idea**

- US senior loans

We believe that US senior loans are an attractive means of investing in the US HY credit story. Their 7.8% yield makes them potentially appealing to investors able to tolerate lower liquidity.

**Negative idea**

- Transportation
- Consumer services
- Capital goods

Within HY we are cautious on the transportation sector, are becoming warier on the consumer services sector and foresee challenges for capital
goods. Please refer to the high yield bond list for the latest recommendations.

**Emerging market bonds**

**CIO View**
- We are neutral on emerging market bonds denominated in USD.
- The segment is exposed to the resilient US economy and recovering corporate profits, and should benefit from a still-accommodative Fed. Senior loans are an attractive alternative.
- A number of risks remain for US HY, including a renewed decline in oil prices, a continued increase in US inflation and potentially lower liquidity in the event of stress.

**Drivers**
- *Oil prices*: The recent recovery in commodity prices has helped emerging markets. A continued rebound would ease the pressure on commodity exporters in the region.
- *EM bond valuations*: Although we expect further fundamental deterioration overall, many EM corporates have managed to cut operating and capital expenditures and put cash aside, alleviating short-term liquidity concerns. This means current spreads are broadly fair.

**Risks**
- *EM growth*: EM manufacturing PMIs have stabilized but are still below 50, indicating contraction. Exports remain in contractionary territory. This is not a favorable backdrop for EM bonds.
- *Oil prices*: Many EM issuers are commodity producers, and prolonged lower oil prices hurt them. The energy market remains oversupplied, and setbacks are likely before prices recover sustainably in 2H16.
- *EM credit ratings*: The negative credit rating cycle has not come to an end, and last month Moody’s placed a long list of oil-exporting EM sovereigns on review for downgrade.

**Positive scenario**
- Stronger-than-expected EM economic data, improved sentiment toward EM bonds and/or sustainable gains in commodity prices enable spreads to fall to 370bps, and corporate ones to narrow to 340bps.

**Negative scenario**
- Greater global risk aversion, deteriorating conditions in EM funding markets, weakening global growth prospects and lower commodity prices mean corporate spreads rise to 650bps, and sovereigns to 620bps.

**Underexposed statement**
- Emerging market bonds can play an important role in portfolios, providing diversification and additional return. Current spread levels are fair and can be seen as an opportunity to build strategic positions.

**In-line statement**
- Investors with in-line allocations to emerging market bonds maintain positions. Growth rates are not weak enough that we expect a significant increase in default rates.
Overexposed statement

- Investors overexposed to emerging market bonds should be wary of overexposure to moves in the oil price, and the current weak levels of emerging market growth and deteriorating credit ratings, and consider rebalancing toward other asset classes or regions.

Positive idea

- Russian USD corporate bonds
- Mexico USD sovereign bonds
- Argentina USD sovereign bonds
- Indonesia USD sovereign bonds

We still see attractive investment opportunities in select Russian corporate bonds from commodity exporters and banks with stronger fundamentals and/or state backing. Prolonged lower oil prices are credit negative for oil producers, but low breakeven oil prices and the depreciating ruble act as buffers.

In the sovereign space, Mexico enjoys a relatively solid fundamental backdrop. We recently turned more positive on Argentina as its newly elected president has moved to aggressively implement much-needed policy changes since his appointment. And the macro outlook for Indonesia is more positive as policymaking is visibly improving and growth shows tentative signs of stabilizing. Indonesian USD sovereign bonds are thus a good way to play this fundamental story.

Negative idea

- Russian USD sovereign bonds
- South African USD sovereign bonds
- Brazilian USD sovereign bonds
- Venezuelan sovereign bonds

We think valuations of Russian bonds look relatively expensive, despite the resilience of the credit. Further sovereign spread widening is likely in South Africa given weakening macro indicators. In LatAm, macro and political factors still warrant a cautious stance toward the Brazilian sovereign, but valuations reflect fundamental weaknesses. We continue to recommend avoiding Venezuelan sovereign bonds as we expect a credit event in the next 12-18 months.

Alternatives

CIO View

- We believe that hedge funds represent a crucial part of most well-balanced portfolios. HF managers have access to a broader range of investment strategies and instruments than most private investors or even long-only institutional investors do. Within our HF strategy, we reduced our allocation to equity hedge strategies to lower sensitivity to equity markets. We increased our allocation to macro/trading strategies to protect against downside risks.

Drivers

- Bond yields: In an environment where low yields will likely mean that bond returns are low, we expect hedge funds to provide an attractive alternative, with significantly higher returns and only moderately higher risk.
- Equity markets: We believe that equity markets will move higher this year. Hedge funds tend to be positively correlated to equity
markets while offering a source of return and relative stability in a portfolio.

- **M&A activity**: The M&A environment continues to look compelling given high corporate cash levels and elevated executive confidence. Equity event-driven strategies are looking at a fertile trading environment.

**Risks**

- **Market crash risk**: Hedge funds can suffer losses at times of major “risk-off” events in global markets, when asset prices fall and inter-asset correlations rise. We have seen a number of such episodes in recent months, and volatility can be expected to remain high.
- **Equity style rotation**: In recent years, hedge funds have underperformed when major trends reverse, for instance when momentum shifted from growth stocks to value or during the recent bounce-back in commodities.

**Positive scenario**

- Robust economies and equity markets boost the return contribution from market beta. This benefits equity-oriented strategies, including equity hedge and, to an extent, event-driven, most.

**Negative scenario**

- A sudden global risk-off phase ensues, with intra- and inter-asset correlations soaring.

**Underexposed statement**

- Investors with a limited allocation to hedge funds should consider the potential benefits of increasing their allocations. We believe that hedge funds can improve the return-to-risk characteristics of many portfolios.

**In-line statement**

- We think it’s important that investors seek a well-diversified portfolio of managers and styles. This should give them greater confidence in the long-run return prospects of their holdings.

**Overexposed statement**

- Overexposed investors should be aware that correlations with other asset classes can rise during periods of market stress. And individual managers are subject to a range of operational and investment risks.

**Positive idea**

- Navigating rising rates with hedge funds
- Exploring the benefits of equity event driven

Based on historical data, we find that most HF strategies are resilient to rising interest rates, while HG bonds performed poorly. Investors looking for an alternative to their HG bond exposure should consider a diversified HF portfolio characterized by a low directional exposure both to fixed income and equities.

The M&A environment continues to look compelling given high corporate cash levels and elevated executive confidence. Annualized deal spreads are attractive and hint at high rates of return for merger-arbitrage strategies and to a certain extent for special situations funds. We advise investors to focus on defensive low-beta managers.

**Negative idea**

- High beta managers
We recommend that investors concentrate on relatively defensive, low-beta managers and avoid high-beta strategies, which could subject them to risks from turbulent equity markets or other global risk-off events.

**Commodities**

**CIO View**
- We regard recent commodity price strength as premature and call for a renewed reversal into 2Q16. Most at risk in the short run are energy and base metals, which could fall 10-20%. Most commodity markets remain oversupplied, making their prices vulnerable to slowing Chinese growth. Near-term price weakness is also expected in precious metals. Agricultural commodities should largely trade flat.

**Drivers**
- **Geopolitical risk**: Key commodities such as gold and oil can be considered a partial hedge against geopolitical risks. Political instability in Venezuela or in the Middle East could lead to an oil supply outage, and higher prices.
- **US shale supply**: The path oil prices take will depend on cutbacks in non-OPEC supply. Capital expenditure cuts are slowly becoming visible, and a balanced market is our base case for year end. It should enable Brent oil prices to reach USD 55/bbl in 12 months.
- **US dollar**: Commodity prices are priced in dollars, and so recent US dollar weakness has had a positive impact. To the extent dollar weakness relates to dovish commentary from the Fed, it is also boosting the gold price.

**Risks**
- **Global oil supply**: The oil market is oversupplied by around 1-1.5mbpd, so prices need to stay low to force US shale-oil producers to cut investment and production. We expect Brent prices to fall to USD 30/bbl in 2Q.
- **Base metals supply**: Global demand growth for base metals should remain muted in 1H16, while the supply side is likely to capitalize on the recent price advances, precipitating a reversal in prices.
- **US inflation**: US core inflation has been rising recently. An acceleration of this trend could bring forward market expectations of rate hikes, and drive outflows from gold funds.

**Positive scenario**
- A combination of political instability, greater-than-expected shale cutbacks, growth surprises in China and a dovish Fed push gold to USD 1,450/oz and oil to USD 70/bbl.

**Negative scenario**
- An economic crisis in Asia that affects oil demand and gold jewelry purchases and more-resilient-than-expected US shale supply cause gold to fall to USD 1,000/oz and oil to USD 20/bbl.

**Underexposed statement**
- n/a

**In-line statement**
- We believe investors should hold no commodities in their long-term strategic asset allocations. The recent price rises have improved the long-term outlook for the asset class but do not justify long-term positions, in our view.
Overexposed statement

- Over the long run, commodities have offered limited, often negative, returns, yet have added considerable volatility to portfolios. We believe investors should hold no commodities in their long-term strategic asset allocations.

Positive idea

- Aluminium
- Cocoa

Our most preferred commodities at present are aluminium and cocoa. A high percentage of aluminium production is loss making, suggesting scope for production cutbacks.

Negative idea

- Copper
- Lead
- Soybeans
- Sugar

We are concerned that the recent recoveries in copper and lead prices could lead to a return of higher supply, and see price downside in these metals. Strong South American harvests suggest downside for soybeans, and sugar needs to work down high inventories. Recent support from the strength in the Brazilian real cannot be co counted on to continue.