Investment Strategy

January 2019


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CHRONOGRAPH
VACHERON CONSTANTIN
GENÈVE, DEPUIS 1755
Contact us : +41 22 580 1755
Vacheron Constantin Boutiques
Geneva • Lucerne • Zurich

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Graph sources: Bloomberg/BBGI Group

INTRODUCTION

Letter to Investors - Investment Climate

- Financial markets have finally given in to panic
- The yield curve has flattened, but not inverted
- The Fed is aware of this, and will adopt flexible policy
- Attractive valuations and new investment opportunities
- Risks remain, but opportunities carry the day

Three months ago, we spoke of rising risks and uncertainty. At the time, United States equity indices seemed unmoved by more uncertain economic prospects and at times extremely excessive valuations, particularly in technology segments and for digital assets. As such, the 4th quarter marked the end of six months of rises beginning in the 2nd quarter 2018, in what was a considerable resurgence of volatility on most equity markets. The correction was originally triggered by long rates rising above 3% as well as growing concerns regarding developments in American companies' profits. It was, however, short-lived and soon followed by a widespread price recovery thanks to hopes of the Sino-American conflict being resolved. But following the announcement on 30 November of a 90-day truce to allow American and Chinese negotiators to find common ground regarding trade relations between the two countries, a reversal of the yield curve abruptly revived fears in the financial markets. While the beginnings of a solution was finally emerging with regards to the main risk factor in the global economy thanks to a resumption of talks – already considered promising – between the two economic partners, a new risk factor suddenly arose, eclipsing the positive prospects of a possible resolution of the dispute.

The risk that the yield curve might reverse has become one of the main factors foreshadowing a recession in 2019. In a few short days, fear of an inversion of the yield curve spread like wildfire. This contributed significantly to the sharp fall across all asset classes on the financial markets, with a drop of nearly -8% on the US equity market in just four days. Fixed-yield investments were spared. This new source of concern did not only hit the American market, but also affected most financial markets and asset classes, in a wave of panic seldom seen for a month with an upward trend 80% of the time. As of mid-December, the investor sentiment, as measured by the American Association of Individual Investors, attested to this sharp change in risk perception, nearing its lowest level of optimism in the past twenty years at approximately 20% bullish. However, upon rational analysis of the situation, it must be noted that we were and are still a far cry from a real yield curve inversion. The economic outlook was still considered robust by the US Federal Reserve, in spite of a very slight decrease (0.1%) in GDP growth expectations for 2019 to +2.5%. FOMC members seem aware of market fears but remain convinced that the US economy is growing at a sustained pace. We can conclude that The Fed will stay mindful of not stoking further fears of excessive action that could trigger a growth shock.

In this climate, long rates benefited significantly from the ill-founded prospect of recession in December, as well as from the transfer between equities and bonds while stock markets were falling. Most yields slid 50 basis points in most countries. Although in the end growth prospects have turned out more favourable in the 4th quarter and at the start of this year, it is not unreasonable to surmise that the uncertainty which developed into a wave of panic could trigger further adjustment, this time benefitting "risky" assets and hindering rate markets.

It is interesting to note that consumer confidence continues to grow, and improved further in December, in a context which rather fosters anxiety. Neither the stock market fall, nor the government shut-down, nor the Sino-American crisis seems to have had an impact on household confidence. US households are no doubt focusing on the concrete factors currently attesting to the strength of the economy, and indeed they are buoyed by the excellent job market situation, rising wages, lower energy prices, falling inflation, as well as the tax cuts. All these factors contribute to increased purchasing power.

Thus, even if the market sell-off was widely covered by the media, consumers are influenced more by positive trends in their income. Private consumption will very likely be a key factor in GDP growth in Q1 2019.

We also believe that the two main sources of market risk -one the one hand, the excessive rise in Fed rates, and on the other, a trade war in March- should not materialise. As a consequence, the 1st quarter 2019 could be more rational than the previous quarter, and more positive for equity markets, real estate, and commodities. Prices have often fallen considerably over the past few weeks, often with more than -20% posted for the highest and lowest over the 4th quarter. As such, it is fitting to talk of a "flash" bear market for some indices of the S&P 500 (-20%), Nikkei 225 (-21%), Russel 2000 (-25%), and crude oil (-44%), whereas some others saw less eye-catching falls, such as the Eurostoxx (-15%), MSCI emerging markets (-11%), and the SMI (-10%). These corrections have helped financial assets' valuation levels; they now present interesting opportunities for repositioning in the absence of a recession. Fears of the rate curve inverting and the United States entering recession are overblown. Growth prospects remain favourable for 2019. Inflation is in hand and the Fed will remain flexible. We should see a long-term recovery of the upward trend on rates. We recommend reducing maturities and exposure to bonds, and repositioning on equity markets, real estate, and commodities.

Alain Freymond
Partner
CIO BBGI Group

Graph sources: Bloomberg/BBGI Group

BIG PICTURE

Key Convictions

- Growth prospects still intact
- The Fed and the ECB are in wait and see mode
- Rise in inflation and long rates
- Political uncertainty persists
- Investment opportunities

Growth prospects still positive

Global growth prospects have been jeopardised over the past few months, but they still remain broadly positive for 2019. The battle that the US president has waded into with his trade partners has indeed gradually affected many countries' growth forecasts for 2019, China first and foremost. Despite the truce agreed upon on 30th November and the ongoing negotiations since, uncertainty is lingering and will only dissipate when a solution is announced. Although the United States initially seemed immune to the effects of this confrontation, the latest developments on financial markets have served as a clear reminder that American multinationals can also suffer from changes in the business climate. We believe that a positive resolution to this conflict should soon be found, lifting the uncertainty that is weighing heavily on international economic prospects. In the United States, the trend remains robust and may not be affected to any great extent by this risk in the end. GDP growth should slow, while still hitting +2.5% in 2019. Front and centre stage, China will benefit from an agreement and will probably be able to maintain a high level of growth of more than +6%. The Eurozone, Germany, and Japan have been more severely affected by increasing uncertainty and trade tensions. Successful negotiations will put the risks and uncertainties regarding these issues into perspective and will increase the likelihood of +1.7% growth for the Eurozone, and +2% for Japan and Switzerland. Global GDP growth should slow but remain close to +4%.

The Fed and the ECB are in wait and see mode

The economic situations of the United States of America and the Eurozone are clearly very different, but both central banks should probably show great flexibility in how they run their respective monetary policies over the coming months. In the United States, the risk of the economy entering recession is very low, while the jobs market is posting its best performances for ten years and is propping up +2.5% growth forecasts. However, the Fed was forced to react to volatility on financial markets and the nearly -20% drop in prices, clearly underscoring both its confidence in the strength of the economy and its understanding of markets' concerns regarding the risk posed by key rates being increased too quickly. Having affirmed that it would pay particularly close attention to how risks develop, and that it is determined to implement an appropriate policy in a flexible manner, it implied that it would likely not take any action over the first half of the year. As regards the ECB, it will more than likely not be able to implement its policy within the deadlines set out either. The slowdown in Germany and risks of the economy weakening now seem sufficient to predict that there will be no rise in key rates before the 4th quarter, with inflation still being low. The ECB could intervene on a more ad-hoc basis and to a lesser degree if necessary, without fundamentally postponing its decision to put an end to liquidity injections as of January 2019.

Rise in inflation and long rates

Falling energy prices are currently acting as a brake on inflation. The fall in crude oil prices in October (-10.8%), November (-22%), and December (-10.8%) certainly had a significant impact on basic indices, growth of which was at zero in the United States and negative in the Eurozone in November. Indices excluding energy and food products moved up +0.2% over the month. The downward trend should continue in January, before the impact of any energy price recovery, which seems likely, can be taken into account. We believe that economic prospects should quickly reverse the crude oil price trend. First, inflationary risks appear moderate for the 1st quarter but expected inflation will likely increase gradually, driven in particular – as long anticipated – by wage increases (+3.2% in December), which should intensify in 2019. As such, we are expecting a rise on CPI indices, as well as on CPI indices excluding food and energy, reflecting the increase in wage pressure. The correction from 3.2% to 2.6% on ten-year US Treasury Bonds between November and December seems to be running out of steam. Long rates considerably benefited from an ill-founded recession scenario in December, as well as from the transfer between equities and bonds while stock markets were falling.

In this context, yields slid in the United States (-50 basis points), as well as in Germany (-40bp), the United Kingdom (-40 bp), France (-35 bp), Switzerland (-30 bp) and Japan (-15 bp). The improvement in the stock market climate will be damaging for rate markets- they will no longer enjoy the reinvestment of liquidities generated by selling assets or from fears of a recession. Long rates should gradually head back to 3% in the United States.

Political uncertainty persists

Regional economies started 2018 on a positive note. This should have been sustained and strengthened by positive developments in their various job markets. Consumption, the largest component of GDP in developed countries, should have been able to depend on robust forecasts, backed up by a rise in purchase power and by domestic demand. Although this did happen, the effect was partially mitigated by the emergence of several sources of uncertainty and political risks which dragged confidence down and changed economic agents' forecasts. The main factor is of course the power struggle that the US president has foisted on his economic partners. Tensions between the United States and China remained high throughout 2018, and rose in the last quarter, to the point where they severely shook confidence. The stress caused by these high-risk negotiations is probably now subsiding. We believe that both parties must by now be aware of the need to quickly find common ground in order to avoid too much damage to their respective economies. However, the political risks will not evaporate once an agreement is announced, as seems likely.

Graph sources: Bloomberg/BBGI Group

In the United States, the swing in majority in the House of Representatives has changed the US president's position and foreshadows future political battles. The ongoing shutdown is another example of Donald Trump's governance style. He has engaged in another power struggle, the economic impact of which could be serious. Brexit remains a threat to the stability of Europe, which is also suffering from political pressures in France, Italy and Germany, the effects of which may already make themselves felt in the upcoming European elections in May. Political uncertainty is still very much on the agenda at the start of 2019.

Investment opportunities

Several months ago, we noted that, in spite of Trump's personal beliefs, US businesses were clearly not immune to the risks resulting from the trade war with China. The past several weeks have shown to what extent taking into account the risks of a global economic slowdown could also impact US equities. Even one of the most iconic stocks on the US market, Apple, was not able to avoid mentioning the risks related to this wrestling match weighing on its performance, which caused a downward revision of its outlook for 2019. In a letter to investors, Tim Cook noted that the economic environment in China had already impacted sales in Q4 2018, which could fall from the initially expected 91 billion to 'only' 84 billion. In this context, the fall in US share prices unsurprisingly and significantly reduced the valuation levels of S&P500 stocks.

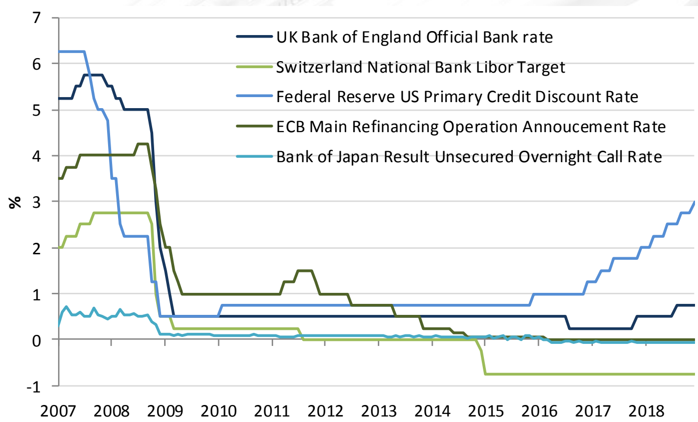
Valuations are now attractive at around 14x expected profits for 2019- -13% lower than the peak hit on 20th September. Technological shares have also undergone considerable decommitment and price drops (-23%), bringing valuation levels down by the same amount (19.2x) should profits remain consistent.

Indices representing the smallest assets have posted huge decommitments and even greater falls, for example the Russel 2000 index (20.5x) in the United States (-27%), the MSCI Small Cap Europe (-23%), and the MSCI Small Cap Switzerland Index (-34%). In terms of evaluating risk, the breadth of price corrections and the speed at which they took place affected the valuation, quantitative, technical and sentiment risk factors of our valuation models to a much greater extent. When the scores are adjusted, almost all markets are neck and neck, which points to a clear improvement in the "yield/risk" ratio.

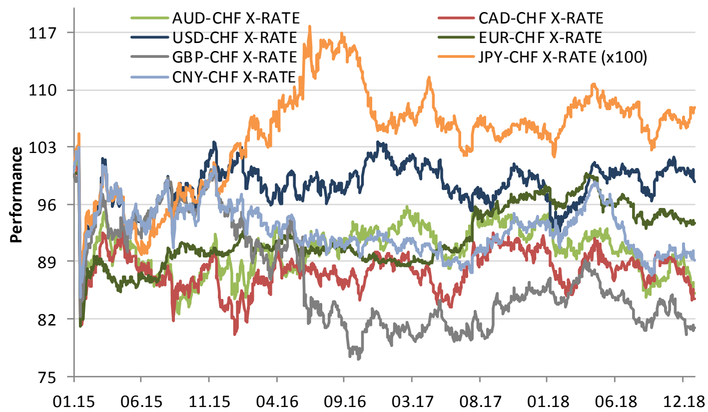
The Swiss market's current PE of 13.9x expected profits for 2019 is slightly above that of the Eurozone (11.9x), but comes in under the Nikkei 225 (14.7x) and the S&P 500. We believe that these valuation levels are attractive in the economic context of growth without recession. However, keep in mind that analysts have not yet significantly reduced their earnings expectations for 2019. Careful attention should thus be paid to the real valuation of the market over the next several months, in particular if it starts trending upward and once again approaches the 2,900 mark. In light of more favourable yield/risk ratios, we recommend increasing exposure to equities as 2019 gets underway.

With no clear slowdown in global growth in 2019, we believe that prospects are favourable for equities, particularly for small and medium capitalisations, which were more severely affected by recent volatility. Prospects should also favour real estate investments and commodities. Risks of recession are receding, which will particularly benefit crude oil and gas prices. Industrial metals, which were badly affected by prospects of a slowdown in China, should also draw significant benefit from this change in prospects.

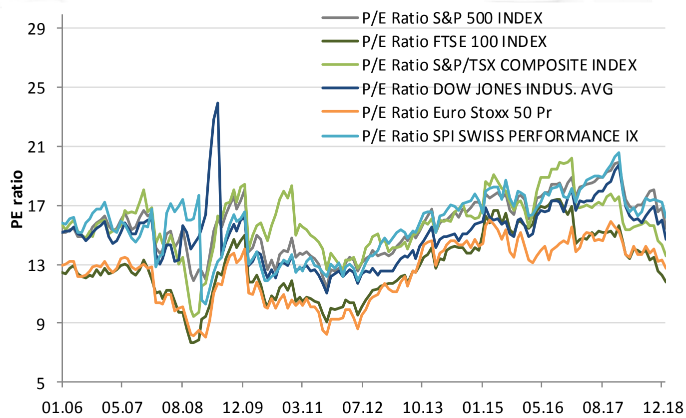
Central Bank rate (EUR, CHF, GBP, USD, JPY)



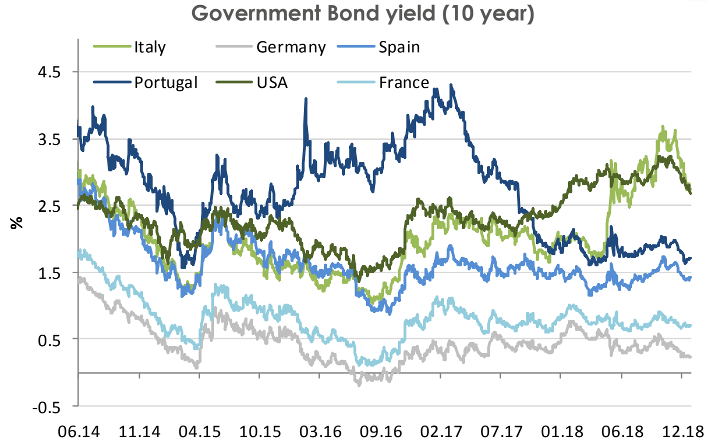
7 Major currencies against CHF (Normalized at 100)



Price/Earning Ratios in developed Markets



Government Bond yield (10 year)



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Global Outlook

- Clearly no recession in the US
- Slowdown continues in the euro area
- UK GDP paralysed by Brexit
- Uncertainty continues to dominate in Japan
- Temporary deceleration in Switzerland

Clearly no recession in the US

In 2018, the US economy created 2.6 million new jobs, that is, 400,000 more than in 2017. The job market continues to strengthen and could be a key factor with regard to both consumption and inflation. While the latter is considered to be close to the Fed's target rate, we think it may rise above 2% once energy prices react to the change in perception regarding the global economy. The risks of recession were overblown over the past few weeks and temporarily had a very negative effect on fuel prices, which will likely benefit very quickly from a normalisation of growth forecasts, driving an increase of the CPI. In a relatively fraught environment, consumer confidence nevertheless continues to grow, further improving in December. Neither the stock market fall, nor the government shut-down, nor the Sino-American crisis seem to have impacted household confidence. US households are no doubt focusing on the concrete factors currently attesting to the strength of the economy, and indeed they are buoyed by the excellent job market situation, rising wages, lower energy prices, falling inflation, as well as the tax cuts. All these factors contribute to increased purchasing power. Thus, even if the market sell-off was widely covered by the media, consumers are influenced more by positive trends in their income. Private consumption will very likely be a key factor in GDP growth in Q1 2019.

As we have mentioned numerous times, the main risk factor for the US economy is more than ever generated by the US president himself. The truce has not yet produced tangible results likely to dispel the uncertainty still casting a shadow on the markets. An increasing number of US multinationals, moreover, are concerned regarding the potential effects of this conflict on their results. The earnings outlook for 2019 is starting to be more severely impacted in certain sectors, while the US trade deficit is sinking further into the red.

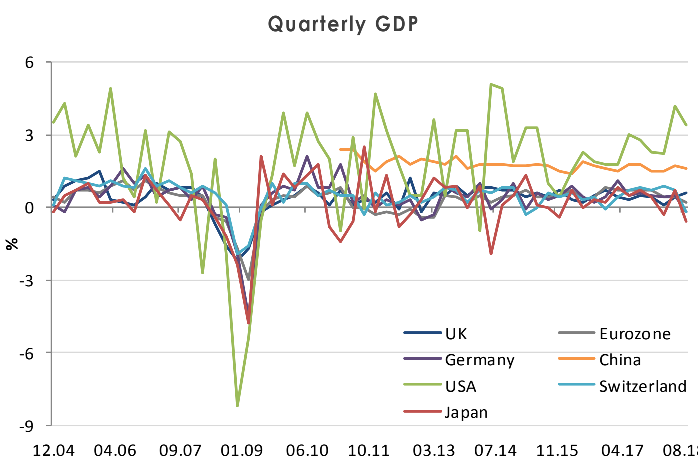
An agreement between the two superpowers will logically be reached before the loss of momentum threatening both economies actually materialises. The growth outlook for the US is still of around +2.5% in 2019.

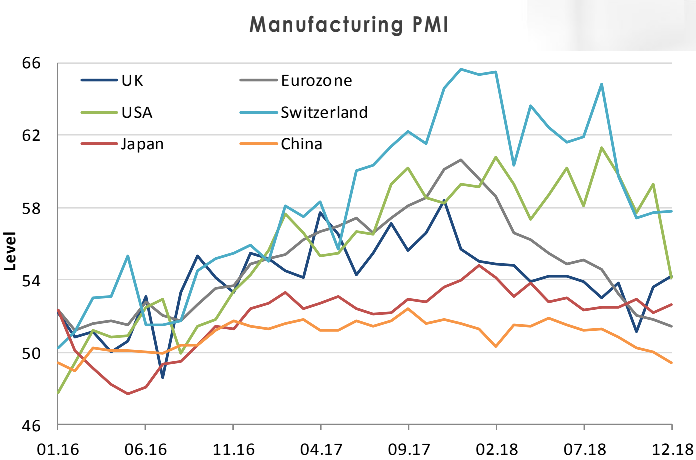
Slowdown continues in the euro area

The outlook remains uncertain for the euro area as a whole given the likelihood of a sharp slowdown in Q4. GDP growth had already dropped from +0.4% in Q2 to only +0.2% in Q3, bringing the Eurozone's yoy GDP growth down to +1.7%. Contrary to expectations the growth rate thus dropped below its recent trend. The -0.2% contraction of the German economy in Q3 was the main contributor to this decline.

The German auto sector in particular seems to have been one of the main factors contributing to the slowdown. The euro's correction of close to -10% from 1.24 to 1.14 against the dollar in Q2 did nothing to support European exports over the last few months. Foreign demand was thus more affected by the tariffs issue and the uncertainty related to the risks of a trade war than by the depreciation of the euro. However, most observers still expect the European economy to achieve a growth rate of +2% in 2018 and +1.6% in 2019, despite Germany's mediocre recent performance.

The risk of recession in Europe thus remains limited and is only of around 20%, barely more than in the US (15%). But the situation in Germany does not seem to be showing any clear signs of improvement in particular with regard to industrial activity, which portends a rather disappointing economic performance in Q4 for the Eurozone's largest economy as well as a difficult start to 2019. Forecasts for the Eurozone thus remain shrouded in uncertainty, as noted in our previous analyses.





Graph sources: Bloomberg/BBGI Group

The latest industrial production figures for Germany for November (-1.9%) were unexpected and suggest that the sector contracted for the third month in a row. These results constitute the sector's worst quarterly performance of the current economic cycle and are unfortunately not limited to the auto sector.

However, they could be offset by a stronger performance of the services sector and consumption (retail sales were up +1.4% in November), as household confidence remains stable. Nevertheless, the economy continues to falter in Germany, increasing forecasting risks for the beginning of 2019 for the euro area as a whole, even though the situation in some other countries is more positive. The ECB does not seem to be unduly concerned with regard to these developments for now. The bank notes that the Eurozone's economy continues to behave in line with expectations, highlighting the positive trends in the job market and their likely impact on wages and inflation. However, the ECB did slightly reduce its growth outlook to +1.7% for 2019 (real GDP) and to +1.6% for inflation.

UK GDP paralysed by Brexit

Just a few weeks from the Brexit deadline, the British economy remains dominated by rising uncertainty, which is unsurprisingly eating into the confidence of economic actors. While Q3 GDP was up +0.6% or +1.5% yoy, figures for the past months suggest an increasingly clear loss of momentum as the year draws to a close. The three-month growth rate at the end of October was only +0.4% due to a much weaker month of October (+0.1%). The somewhat better performance of the service sector (+0.2%) helped avoid economic stagnation, as most majors sectors were showing declining activity. The manufacturing sector contracted by -0.9% in October (-1% yoy), slightly more than industrial production, which was down -0.6% (-0.8% yoy). In spite of a weak pound, exports (+0.8%) did not grow sufficiently to make a positive contribution, while the trade balance (-11.9 billion pounds) deteriorated following a revision of the initial figures, due to the rising cost of imports (+3.5%). The services balance (8.6 billion) helped decrease the overall trade deficit to 3.3 billion pounds. Just a few months from the deadline for the UK, the British economy remains plagued by uncertainty. The slowdown is increasingly significant and is likely to worsen, if leading indicators are to be believed.

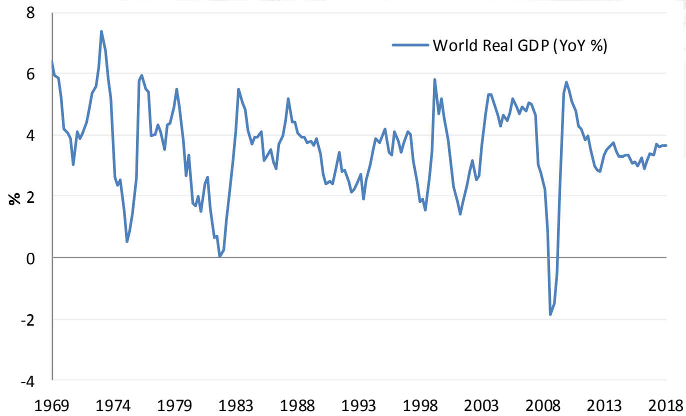
The services PMI dropped from 56 in December 2016 to 50.4 in November, close to the growth threshold, its lowest level since June 2016, pointing to growing concern as the deadline nears. The manufacturing PMI ticked up slightly to 50.7, helping the composite index remain above the 50-point threshold. GDP growth in Q4 could be limited to +0.1%. The UK economy's growth prospects thus diminished further, confirming that an upswing at the end of the year or in Q1 2019 seems unlikely.

Uncertainty continues to dominate in Japan

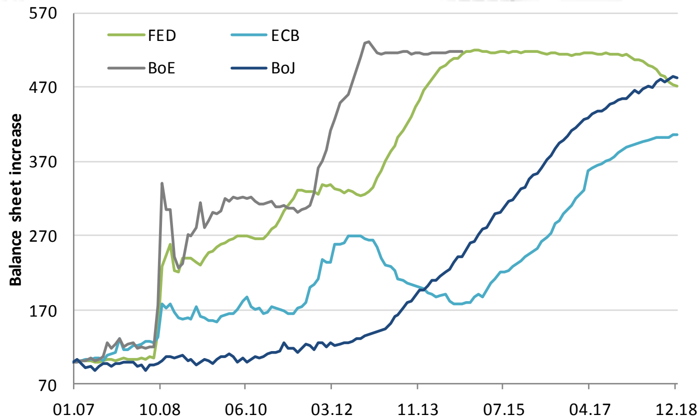
Given the significant instability of Japan's economic performance, several months ago already we questioned the sustainability of the country's remarkable growth rate of +0.7% in Q2 (+3% annualised), the fastest growth rate posted since 2016. We predicted that GDP growth was unlikely to maintain this pace, in particular in the context of intensifying risks of trade tensions and a decrease of economic activity in Asia.

Nevertheless, the growth shock caused surprise when the revision of growth figures, first published in November, showed that GDP had contracted by -0.6%, i.e. more than expected. In fact, it was the sharpest contraction since 2014. Unfortunately, these results confirmed the instability of Japan's economic performance over the past quarters. Q3 results thus almost completely wiped out the exceptional performance generated in Q2, leaving little opportunity for the situation to reverse significantly for 2018 in Q4. The Japanese economy thus contracted more sharply, essentially due to a steep drop in corporate spending. Natural disasters that hit Japan also played a role in this phenomenon and can in fact explain the contraction, which was the strongest of the decade.

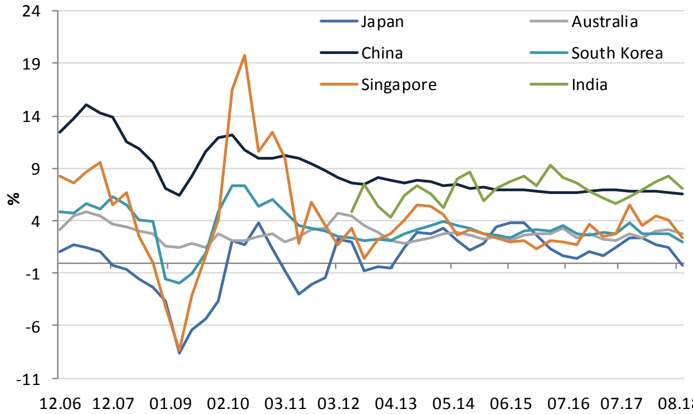
World Real GDP Growth



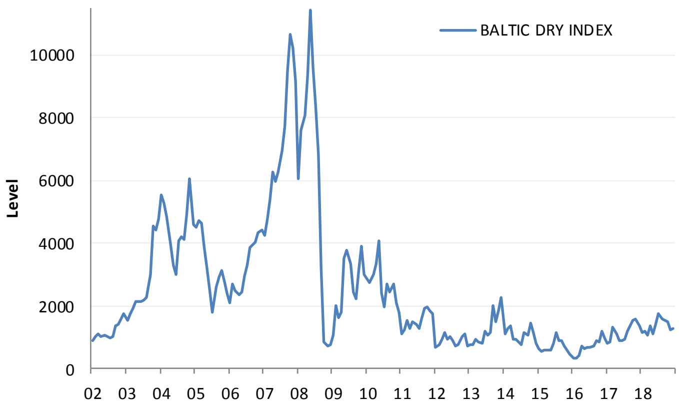
Balance sheet increase



GDP Growth rates in Asia



Baltic Dry Index



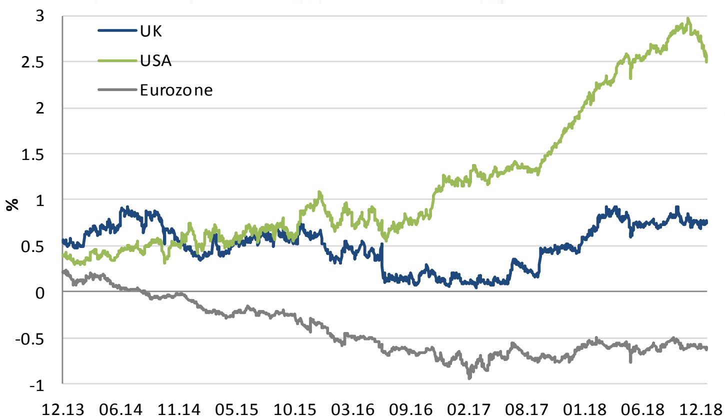
Graph sources: Bloomberg/BBGI Group

The risks of a trade war continue to constitute the main threat to Japanese growth, in particular given that the yen is likely to continue to stabilise over the next few months. Indeed, the monetary factor remains one of the key elements with regard to generating more positive growth. Uncertainty continues to weigh on leading indicators as 2018 comes to a close. Business leaders sentiment is still not significantly improving in Japan, as in most countries. The wrestling match initiated by the US president remains the key factor of uncertainty in Japan as well, in spite of the truce negotiated on 30 November. The stabilisation of the yen after a correction of approximately -10%, although favourable to large Japanese export companies, does not seem sufficient to allay the concerns of purchasing managers, who still prefer to remain cautious given the persisting risks of a major trade war. The Japanese economy, which was booming in Q2, suddenly and unexpectedly contracted (-2.5% yoy), thus confirming the hesitancy seen in surveys. The PMI indices have been stabilising for several months but are still not showing clear signs of an upturn following the steady decline seen in the first half of the year. In November, the manufacturing PMI improved slightly (52.2) over October (51.8); even so, it did not point to any upturn in the industrial sector over the next few months. When industrial production came in at +2.9% for October it was thus a positive surprise, however, it was followed by a -1.1% contraction in November, raising doubts regarding the prospect of a recovery on the back of a bleak third quarter. The composite index remained at 52.4, still close to its 2017 lows, bolstered by the more positive trend in the services PMI, which posted a heartening Increase in October and stabilised at 52.3 in November. The Chinese slowdown is affecting Japanese economic momentum. In 2019, Japanese GDP is expected to post moderate growth below +2%.

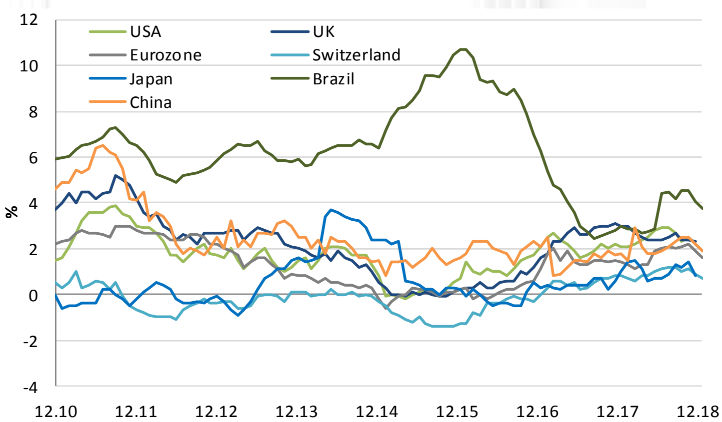
Temporary deceleration in Switzerland

Switzerland's real GDP contracted by -0.2% in Q3, despite growing by an extraordinary and promising +0.7% in the previous quarter. Swiss GDP growth thus decreased from +3.4% to only +2.4% yoy, effectively putting an end to six consecutive quarters of economic expansion. The strong growth phase was thus interrupted in real terms even though Switzerland's quarterly nominal GDP grew very slightly from CHF 172.8 to 173 billion in September. The economic shock of Q3 is calling into question expectations for 2018 and 2019. SECO experts displayed notable optimism when they revised their outlook for 2018 and 2019 significantly upward to +2.9% and +2.4%, respectively. At the time it was not unreasonable to anticipate that economic trends prevailing just before the summer, sustained by strong global economic conditions, would persist, enabling the Swiss economy to achieve growth of up to +3% over the year. As for us, we noted that this exceptional momentum would likely slacken over the next several quarters, without fundamentally calling into question the year-end trend driven by a combination of positive dynamics in industry, consumption, investment and exports. Q3 results obviously challenge these expectations. In our main scenario, we now expect that less favourable global economic conditions, in particular the economic slowdown in Germany, could have a negative impact on Switzerland's foreign trade over the next few months. The recent stabilisation of the Swiss franc against the euro at 1.13 since mid-August as well as the relative stability of the dollar, unchanged over the past seven months and close to parity, are unlikely to penalise the competitiveness of Swiss exports and consequently of the country's foreign trade. In this context, we are revising our outlook for Swiss GDP, which is unlikely to progress by more than +2.5% in 2018 and +2% in 2019.

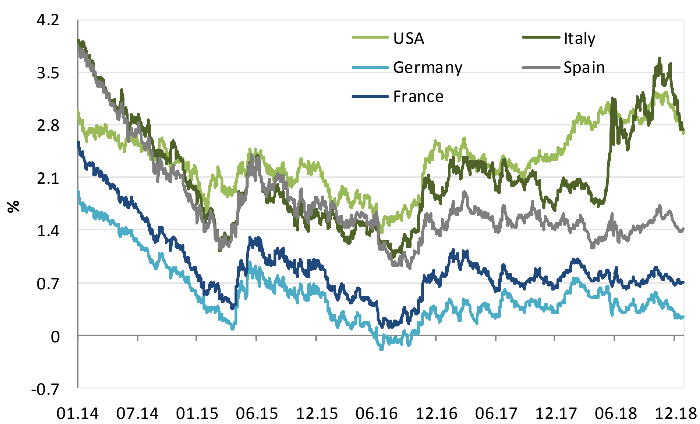
2-year Government Bond yield



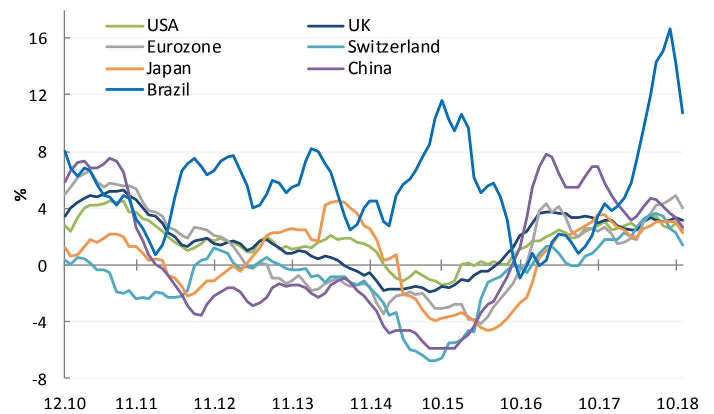
Inflation - CPI Indices



10-year Government Bond yield



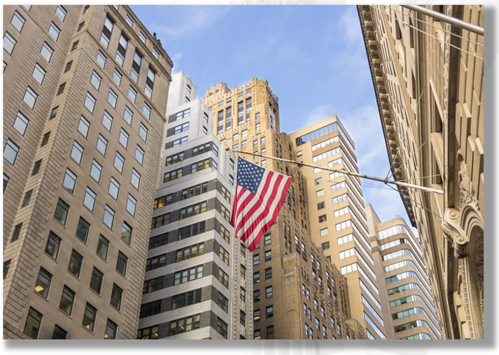
Inflation - PPI Indices



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

United States



- Federal Reserve stays the course in spite of market jitters
- Job market will vindicate the Fed
- GDP will benefit from a favourable consumption climate in Q1
- Donald Trump's strategy is far from beneficial for the US
- Inflation and long-term rates stabilise
- As only 20% of investors are optimistic, it is time to be contrarian on equities

Federal Reserve stays the course in spite of market jitters

The FOMC's last meeting of the year took place in a particularly challenging political and economic context, amidst threats of a government shutdown, the Sino-American crisis, the stock market plunge, and the bursting of the speculative bubble on a number of tech stocks, to name but a few. Just weeks away from the end of the year, the Fed's options were limited, as it had to endeavour not to further distress investors who were already jittery and liable to scare themselves further and depress the price of almost all financial assets even more upon the slightest increase in uncertainty or signs confirming their fear of an impending recession.

FOMC members had to carefully assess the economic situation as well as the risks of a collapse in investor confidence to avoid another market panic. Indeed, the investment climate had already sharply deteriorated after the 0.25% rate hike implemented in September, obliterating all stock market gains for the past year. The stabilisation of share prices in November remained fragile and was likely to be upset in the event of disappointing news.

Indeed, as surprising as it may seem, barely a few days after the release (28 Nov.) of Q3 growth data (+3.5%), the fear of a recession spread like wildfire. A number of less reliable statistics and excessive fear of a yield curve inversion supposedly signalling an impending recession were enough to stir up further panic and trigger a sell-off that slashed another -10% off the main equity indices over the first two weeks of the month.

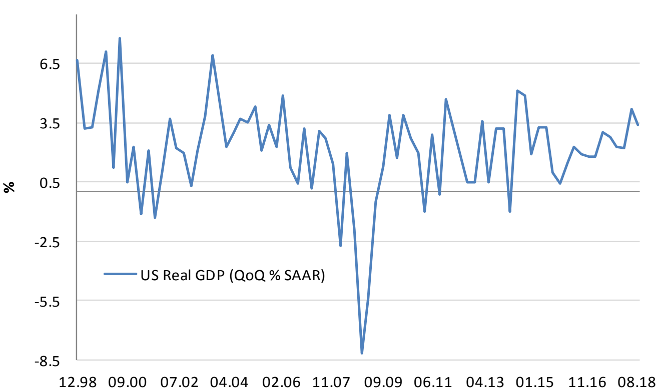
The Fed's commentary (19 Dec.) in connection with the widely anticipated 0.25% rate hike to 2.5% seemed particularly measured, however, and apt to calm investor jitters. Indeed, there was essentially no change in the evaluation of economic conditions that could have led to fears of a sharp slowdown in 2019. Thus, the economic outlook was still considered robust, in spite of a very slight decrease (0.1%) in GDP growth expectations for 2019 to +2.5%.

FOMC members seem aware of market fears but remain convinced that the US economy is growing at a sustained pace. We believe the Fed will exhibit a large degree of flexibility in conducting monetary policy. The drop in the dot plots indicates that risks tied to international political factors have been taken into account, suggesting heightened caution with regard to raising rates in 2019.

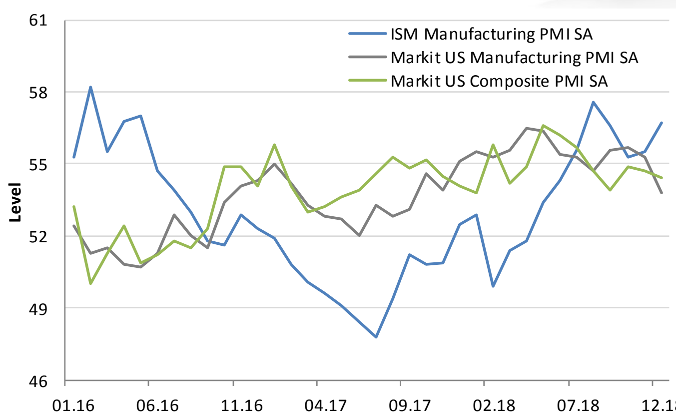
According to the Fed, the Fed funds rate should thus be 2.4% by the end of 2018, 3.1% by the end of 2019, and 3.4% in 2020. We believe that for now the FOMC is going down the path of implementing two rate hikes in 2019, the first of which is unlikely to occur in H1. The Fed will stay mindful of not stoking further fears of excessive action that could trigger a growth shock.

In our view, current economic conditions continue to benefit from a combination of positive factors that will bolster GDP growth. Consumption in particular will likely be boosted by increasingly significant developments in the job market and by the very sharp decline in energy prices in the last quarter.

Quarterly US Real GDP Growth

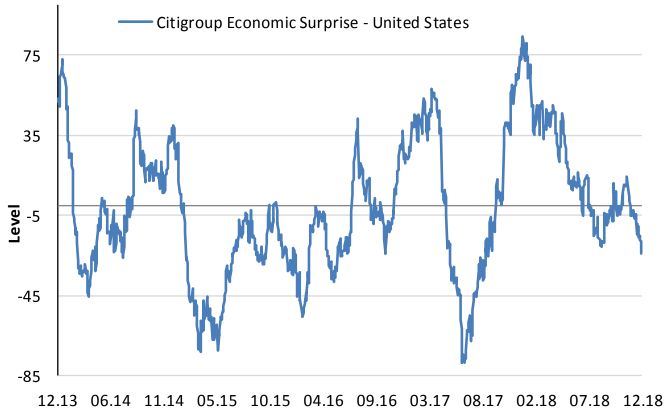


PMI Indices

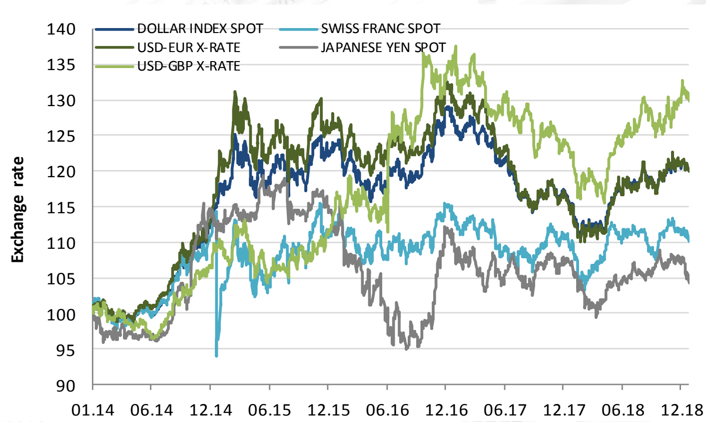


Graph sources: Bloomberg/BBGI Group

Citigroup economic surprise index USA



Dollar trade-weighted index and currencies



Job market will vindicate the Fed

The drop in the dot plots in a robust economic context gives the Fed substantially more wiggle room. In 2019, inflation is likely to guide its actions. For now, there is no significant change in the outlook on inflation. The decrease in energy and fuel prices should reduce the risk that price indices will rise above the Fed's target.

However, the job market continues to strengthen and could be a key factor with regard to both consumption and inflation. While the latter is considered to be close to the Fed's target rate, we think it may rise above 2% once energy prices react to the change in perception regarding the global economy.

The risks of recession were overblown over the past few weeks and temporarily had a very negative effect on fuel prices, which will likely benefit very quickly from a normalisation of growth forecasts, driving an increase of the CPI.

With regard to the job market, the latest statistics published showed very strong momentum. In December, job creation was the strongest since the beginning of the current economic cycle. With the creation of 312,000 new jobs, the US economy was displaying its vigour at the very same time as the stock market panic was spreading based on fears of a possible recession in 2019.

The number of people employed in the US thus grew to 150,263,000, exceeding for the first time ever the 150 million mark.

At the same time, October and November data were revised upward, showing solid employment growth in excess of 250,000 new jobs per month over the last quarter – a paradoxical situation given the Investment climate of the past few weeks.

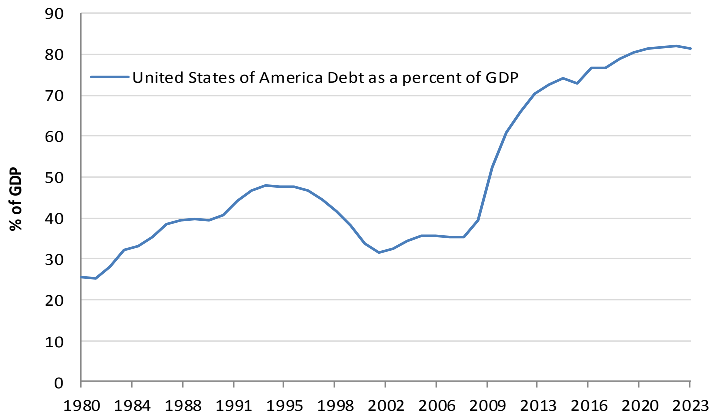
The Fed will also be keen to note the positive trend in hourly wages, whose growth rate of 3.2% in December was the fastest since April 2009. The slight increase in the unemployment rate from 3.7% to 3.9% is not a negative factor in light of the increase in the labour force participation rate of the US population seen in December.

Indeed, the participation rate (63.1%) passed the 63% mark, showing that the strength of the economy is attracting new participants who had not been in the market until now.

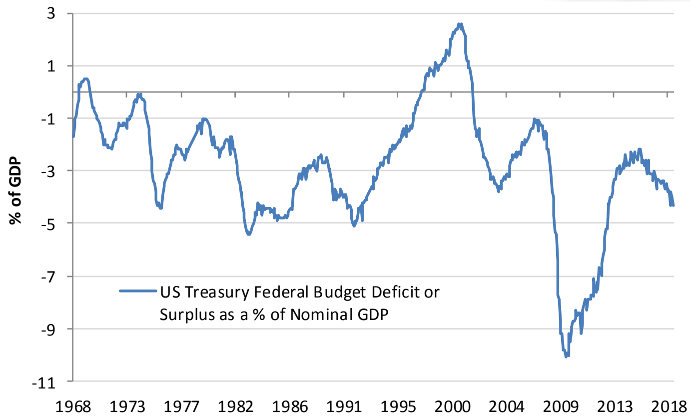
In 2018, the US economy created 2.6 million new jobs, that is, 400,000 more than in 2017.

The Fed was certainly correct in anticipating robust economic growth and not giving in to pressure from those who wanted a rate cut claiming a yield curve inversion that potentially signalled an impending economic recession.

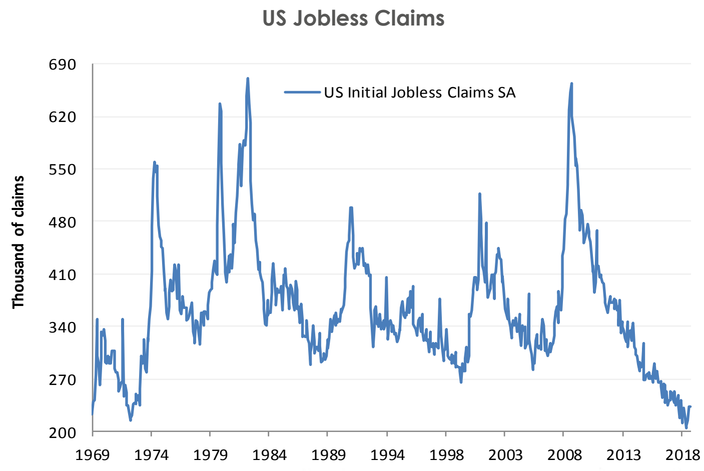
Debt (% GDP)

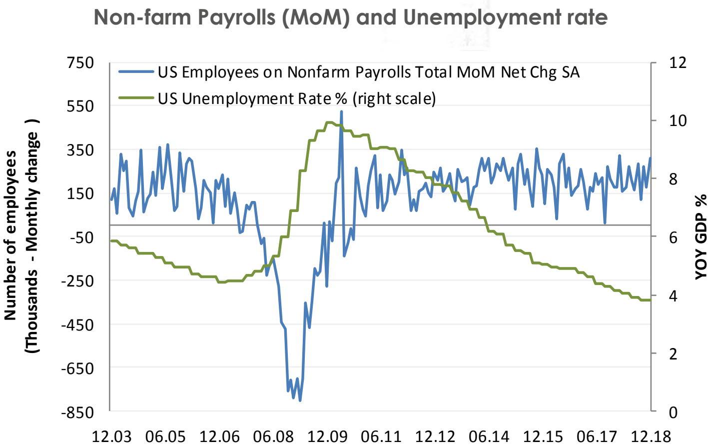


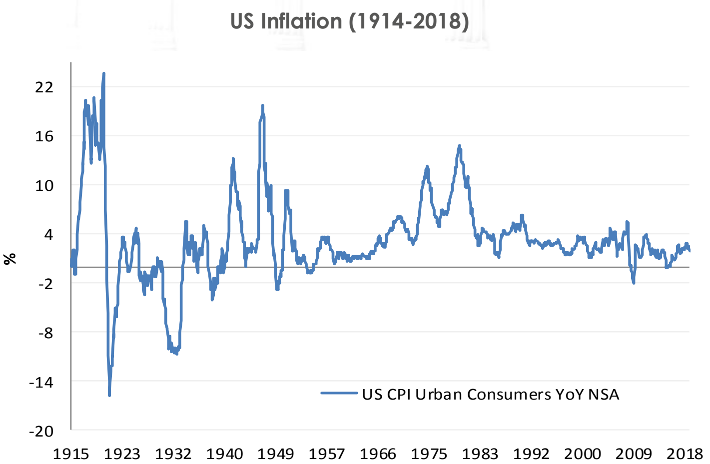
Deficit/Surplus

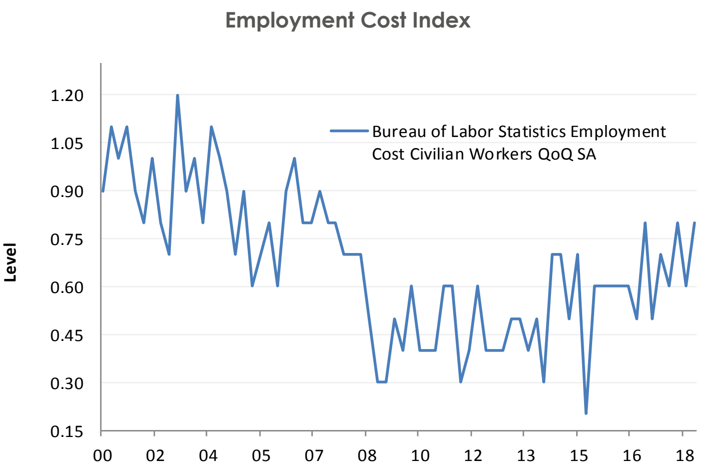


Graph sources: Bloomberg/BBGI Group









Graph sources: Bloomberg/BBGI Group

Leading indicators are now pointing to increasing concerns

Leading indicators remained positive for the manufacturing sector until November, before dropping sharply from 59.3 to 54.1 in December.

Indeed, the ISM manufacturing index currently seems to be indicating persisting uncertainty tied to the absence of resolution of trade tensions between Washington and Beijing. The chain of production of manufactured goods now seems to be increasingly impacted by the risks involved in current policy.

The December dip is the largest decrease since October 2008. The new orders segment tumbled from 62.1 to 51.1, but the employment indices continue to be solid, suggesting that, in spite of a likely slowdown in production, businesses remain confident and ready to expand their teams.

The services indicator has stabilised since September, closing the year at 54.4. Most indicators continue to point to further economic expansion though likely at a slower pace.

GDP will benefit from a favourable consumption climate in Q1

In a relatively fraught environment, consumer confidence nevertheless continues to grow, further improving in December. Neither the stock market fall, nor the government shut-down, nor the Sino-American crisis seem to have impacted household confidence.

US households are no doubt focusing on the concrete factors currently attesting to the strength of the economy, and indeed they are buoyed by the excellent job market situation, rising wages, lower energy prices, falling inflation, as well as the tax cuts. All these factors contribute to increased purchasing power.

Thus, even if the market sell-off was widely covered by the media, consumers are influenced more by positive trends in their income. Private consumption will very likely be a key factor in GDP growth in Q1 2019.

Donald Trump's strategy is far from beneficial for the US

As we have mentioned numerous times, the main risk factor for the US economy is more than ever generated by the US president himself. The truce has not yet produced tangible results likely to dispel the uncertainty still casting a shadow on the markets. An increasing number of US multinationals, moreover, are concerned regarding the potential effects of this conflict on their results.

The earnings outlook for 2019 is starting to be more severely impacted in certain sectors, while the US trade deficit is sinking further into the red. An agreement between the two superpowers will logically be reached before the loss of momentum threatening both economies actually materialises.

Inflation and long-term rates stabilise

Falling energy prices are currently acting as a brake on inflation. However, we anticipate that a positive economic outlook should quickly reverse the downward trend in fuel prices.

First, inflationary risks appear moderate, but expected inflation will likely increase gradually, driven in particular – as long anticipated – by wage increases (+3.2% in December), which should intensify in 2019.

With regard to long-term rates, the correction from 3.2% to 2.6% seen in November and December appears to be petering out. It is unlikely that it will further benefit from the reinvestment of liquidity generated by the sell-off and from the fears of recession. Long-term rates will likely gradually increase back to 3%.

Limited prospects for the dollar

The dollar is still benefitting from attractive yield spreads against most currencies. In 2019, these spreads will likely be hit by rising interest rates in the Eurozone and other developed and emerging countries. We continue to expect the dollar/Swiss franc exchange rate to trend upward, potentially reaching 1 to 1.05 francs. The US currency will likely once again lose its attractiveness, very gradually, against the euro and emerging currencies assuming the stock market climate improves.

As only 20% of investors are optimistic, it is time to be contrarian

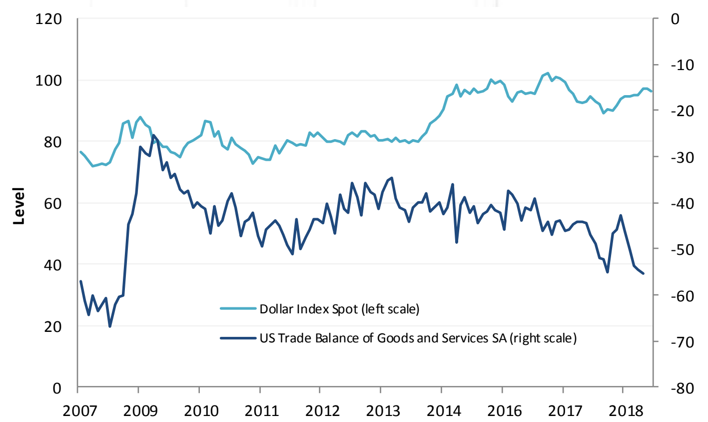
Several months ago, we noted that, in spite of Trump's personal beliefs, US businesses were clearly not immune to the risks resulting from the trade war with China. The past several weeks have shown to what extent taking into account the risks of a global economic slowdown could also impact US equities.

Even one of the most iconic stocks on the US market, Apple, was not able to avoid mentioning the risks related to this wrestling match weighing on its performance, which caused a downward revision of its outlook for 2019. In a letter to investors, Tim Cook noted that the economic environment in China had already impacted sales in Q4 2018, which could fall from the initially expected 91 billion to 'only' 84 billion.

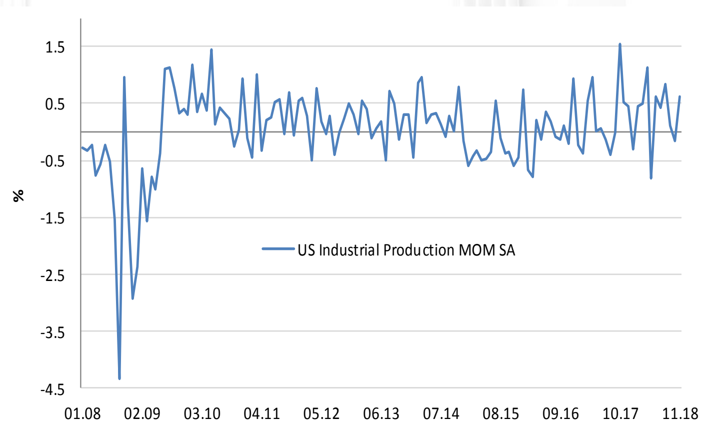
In this context, the fall in US share prices unsurprisingly and significantly reduced the valuation levels of S&P500 stocks. At around 14x 2019 expected earnings and -13% lower than the high reached on 20 September, valuation levels are attractive.

However, keep in mind that analysts have not yet significantly reduced their earnings expectations for 2019. Careful attention should thus be paid to the real valuation of the market over the next several months, in particular if it starts trending upward and once again approaches the 2,900 mark.

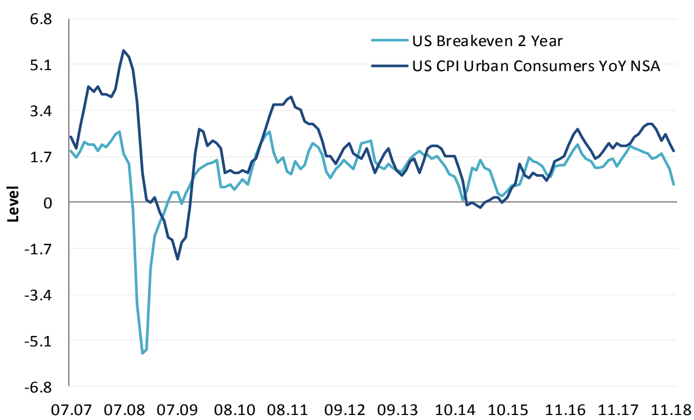
US Trade Balance of Goods and Services



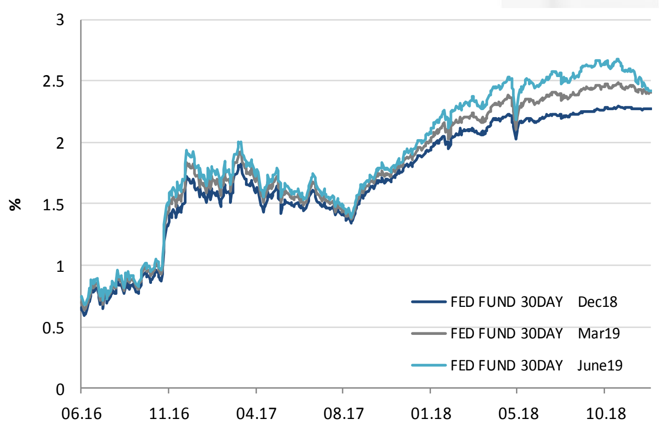
US Industrial Production



US Expected Inflation and CPI

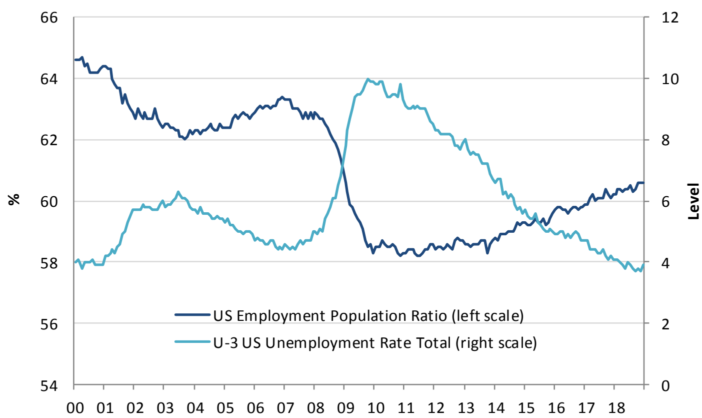


Fed Funds Futures

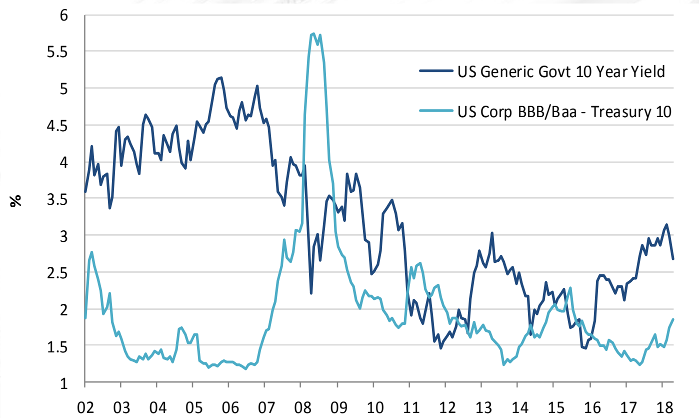


Graph sources: Bloomberg/BBGI Group

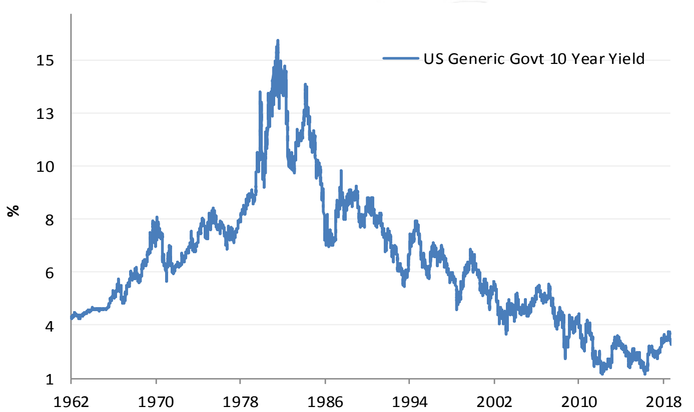
US Unemployment rate and Employment Population Ratio



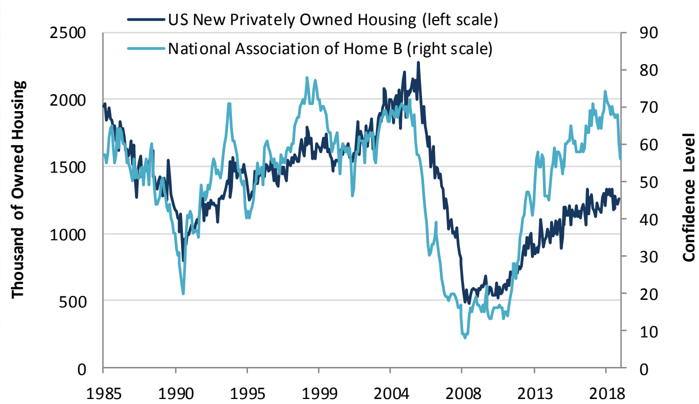
Yield spread Us Treasury - BBB 10 year



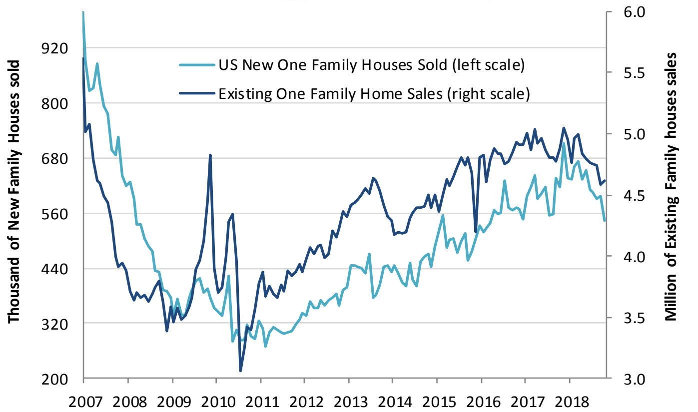
US Government Bonds 10 year yield



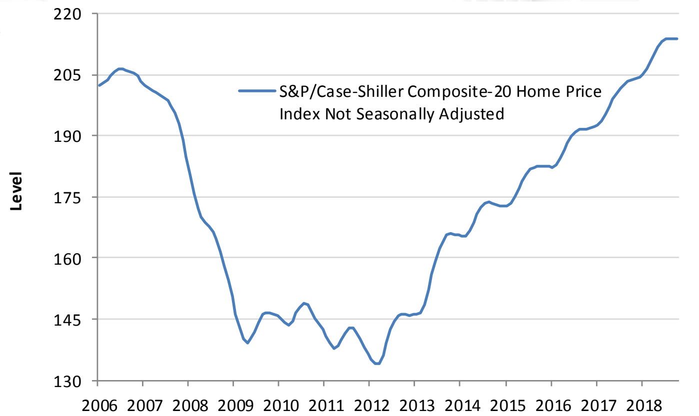
US New Privately Owned Housing and NAHB USA



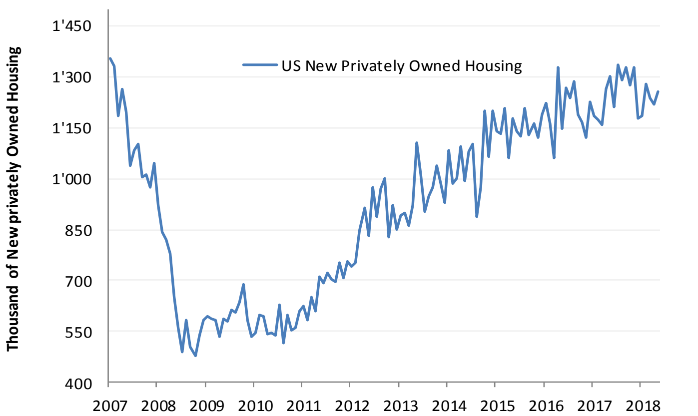
Sale of US New and Existing Family Houses



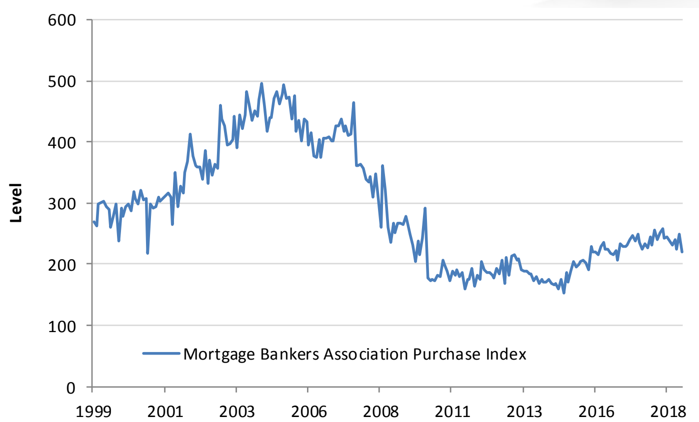
Real Estate Prices - S&P Case-Shiller Index



Housing Starts



New Mortgage Applications - MBA



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Switzerland

- Euphoria gives way to bewilderment
- Downward revision of the growth outlook for Swiss GDP
- Surprise collapse of economic momentum in Q3
- Leading indicators still uncertain
- Yield curve remains normal

Euphoria gives way to bewilderment

The State Secretariat for Economic Affairs (SECO) released Swiss growth figures, which shocked everyone and highlighted the collapse of the incredible economic momentum of Q2 2018. Indeed, Switzerland's real GDP contracted by -0.2% in Q3, despite growing by an extraordinary and promising +0.7% in the previous quarter. Swiss GDP growth thus decreased from +3.4% to only +2.4% yoy, effectively putting an end to six consecutive quarters of economic expansion. The strong growth phase was thus interrupted in real terms even though Switzerland's quarterly nominal GDP grew very slightly from CHF 172.8 to 173 billion in September.

These surprising results are concerning for several reasons, and in particular because they indicate, for this quarter at least, a stronger dependence on the German economy than was previously thought to exist. Switzerland thus followed in the wake of the pronounced economic slowdown in Germany (-0.2%) and other European countries in the same period.

The Swiss economy, which posted a growth rate well above both historical trends and the growth rate of the Eurozone in Q2, was ultimately significantly impacted by developments in the Eurozone. This episode is thus a reminder, if we needed it, of the country's special situation with regard to its regional partners.

Downward revision of the growth outlook for Swiss GDP

The economic shock of Q3 is calling into question expectations for 2018 and 2019. SECO experts displayed notable optimism when they revised their outlook for 2018 and 2019 significantly upward to +2.9% and +2.4%, respectively.

At the time it was not unreasonable to anticipate that economic trends prevailing just before the summer, sustained by strong global economic conditions, would persist, enabling the Swiss economy to achieve growth of up to +3% over the year. As for us, we noted that this exceptional momentum would likely slacken over the next several quarters, without fundamentally calling into question the year-end trend driven by a combination of positive dynamics in industry, consumption, investment and exports.

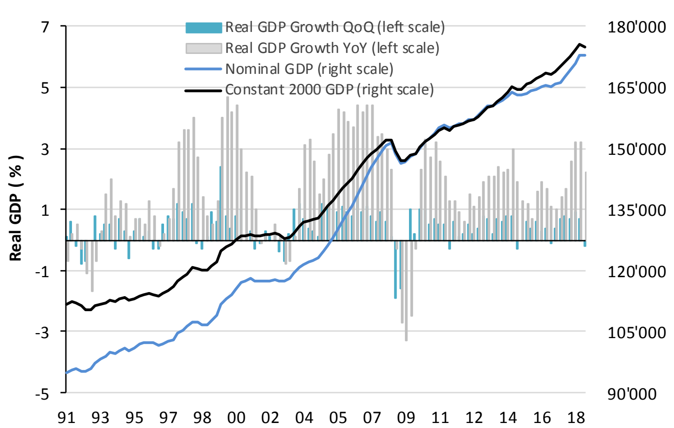
Q3 results obviously challenge these expectations. In our main scenario, we now expect that less favourable global economic conditions, in particular the economic slowdown in Germany, could have a negative impact on Switzerland's foreign trade over the next few months. The recent stabilisation of the Swiss franc against the euro at 1.13 since mid-August as well as the relative stability of the dollar, unchanged over the past seven months and close to parity, are unlikely to penalise the competitiveness of Swiss exports and consequently of the country's foreign trade.

In this context, we are revising our outlook for Swiss GDP, which is unlikely to progress by more than +2.5% in 2018 and +2% in 2019.

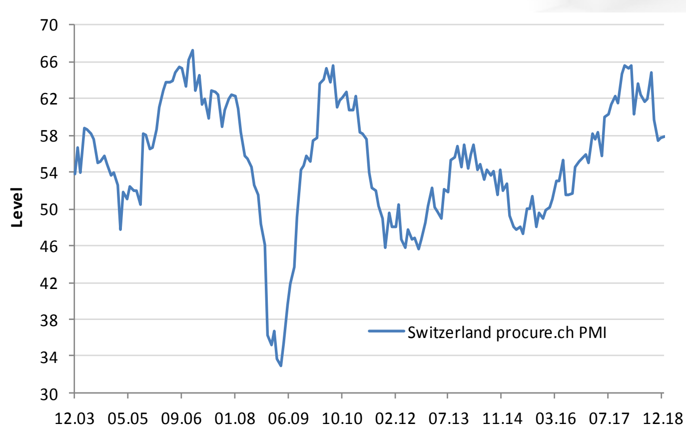
Surprise collapse of economic momentum in Q3

To everyone's surprise, Switzerland's real GDP unexpectedly contracted by -0.2% in Q3, bringing GDP growth to +2.4% yoy. This slump occurred following excellent results in Q2 (+0.7%) and is surprising in terms of its relative magnitude, as economists' consensus anticipated growth of +0.4% over the quarter and +2.9% yoy. This is the first contraction since the -0.1% drop in Q4 2016. Thus, it interrupts six consecutive quarters of growth exceeding +0.4%. These developments are synchronous with the sharp slowdown in Europe and in Germany in particular.

Nominal GDP - Nominal and Real GDP Growth rate

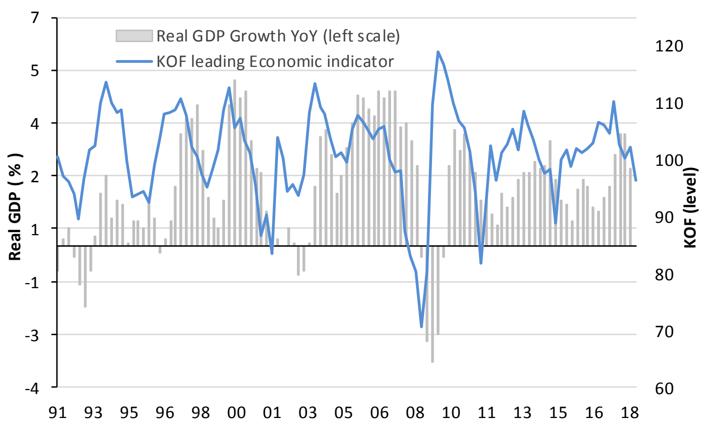


Swiss Purchasing Manager Index (PMI)

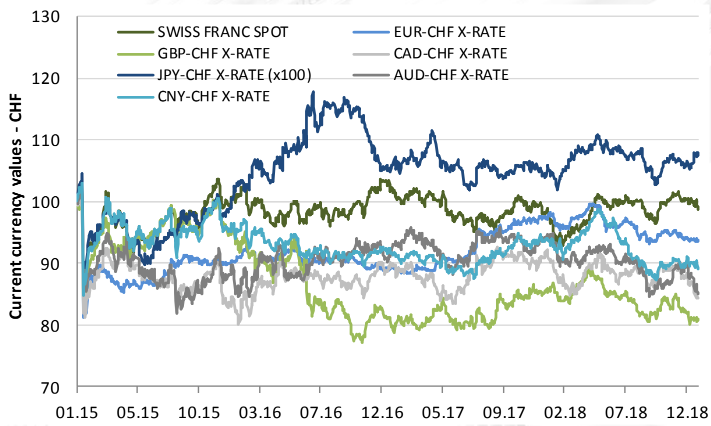


Graph sources: Bloomberg/BBGI Group

Real GDP Growth YoY - KOF leading economic indicator



CHF Exchange rate (Normalized at 100)



The manufacturing industry declined by -0.6% after increasing by +1.5% in the previous quarter, which could be considered a stabilisation at a relatively high level, given the strong momentum seen previously. A particularly dry summer weighed on hydroelectric power plant output, and the energy sector thus posted a drop of -2.2%.

Total merchandise exports fell by -4.2%, also contributing overall to poor GDP performance. With regard to services, retail and wholesale trade value added fell by -1%, as did that of the financial sector (-1.1%). Only the corporate services (+0.7%) and healthcare (+0.5%) sectors contributed positively. The consumption climate remained relatively gloomy; indeed, households increased spending only very marginally (+0.1%).

The public sector was not much more active, with public spending sliding back -0.1%. Capex also decreased by -2.2%. With regard to foreign trade, weak domestic demand naturally weighed on imports of goods and services (-1.6%).

A healthy job market and an employment rate at a 10-year low certainly contributed to the positive trend in consumption, whose +0.3% growth rate was nevertheless slightly below average. In sum, final domestic demand was slightly less robust, and capex was down slightly (-0.3%) following several quarters of sustained growth.

Swiss economy impacted by trade tensions between Beijing and Washington

We had been mentioning for several months that an intensification of global trade tensions was the main source of risk for the Swiss economy, even though order books seemed full, boosting the outlook for the manufacturing sector.

The uncertainty affecting the German auto sector over the past several months, in particular due to the introduction by the US of import taxes on vehicles made in Germany, ended up indirectly impacting Switzerland's industrial sector. The truce agreed upon by China and the US on 30 November came about at the right time, in our view, to avoid –if the two parties manage to come to an agreement– a negative impact on global growth prospects for 2019 and a particularly damaging intensification of uncertainty for financial markets at this point in the cycle.

Switzerland is not itself a target, but it is clearly feeling the indirect effects of the impact on other economies and its partners such as Germany. The German slowdown thus rather swiftly spread to Switzerland.

Leading indicators still uncertain

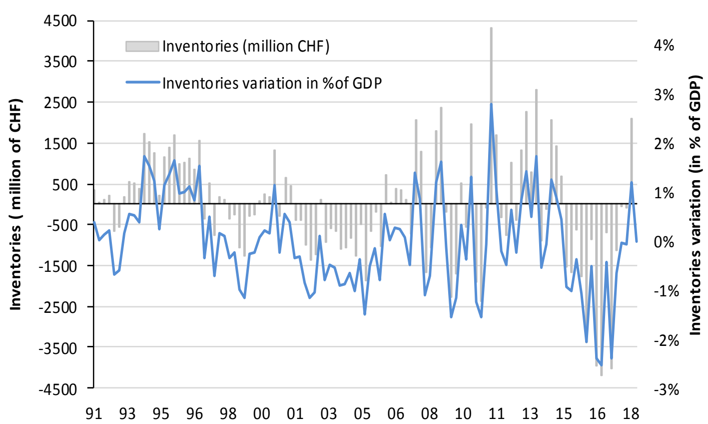
The KOF index continued to fall from its November 2017 high (110.3), which marked the highest degree of optimism since 2010, coming in at 99.1 in November, below the 100-point level. The trend does not seem to be reversing, just a few weeks shy of the end of the year.

As for the manufacturing PMI, which still indicated a healthy level of optimism in August, it also tumbled suddenly, dropping from 64.8, close to its 10-year high (65.6), to a mere 57.7 in November, a slight uptick from its October number.

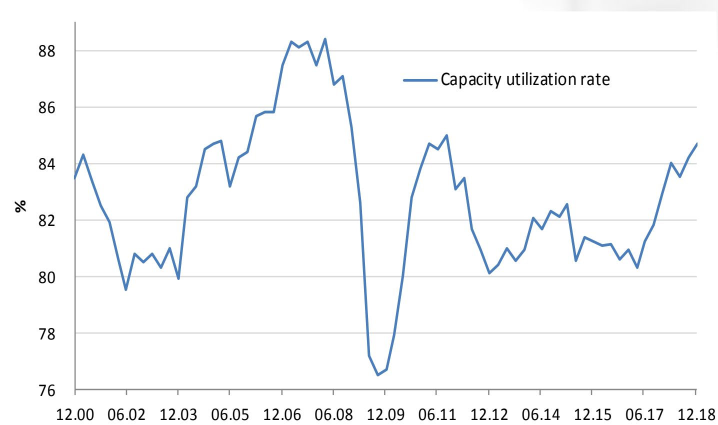
The services PMI also fell from 55.7 in October to 53.7 in November. In spite of these declines, the PMI indicators remain within the growth zone and continue to point to GDP growth in the +1.5% to +2% range in Switzerland.

The likely slowdown in economic activity and performance, indicated by slackening leading indicators, points to economic results inferior to those expected just a few months ago.

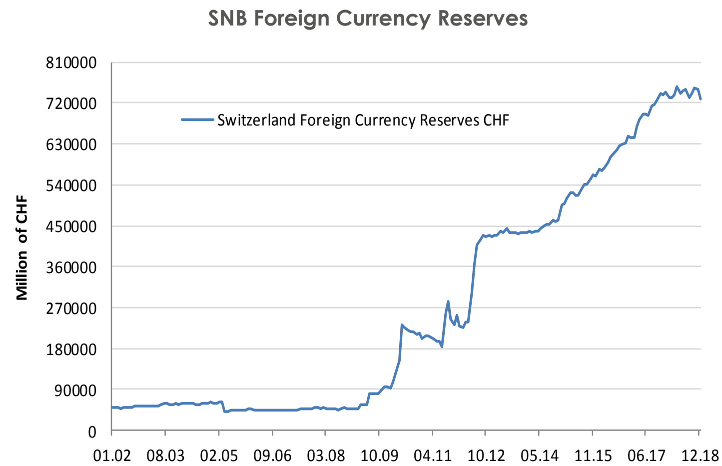
Inventories - variation in % of GDP

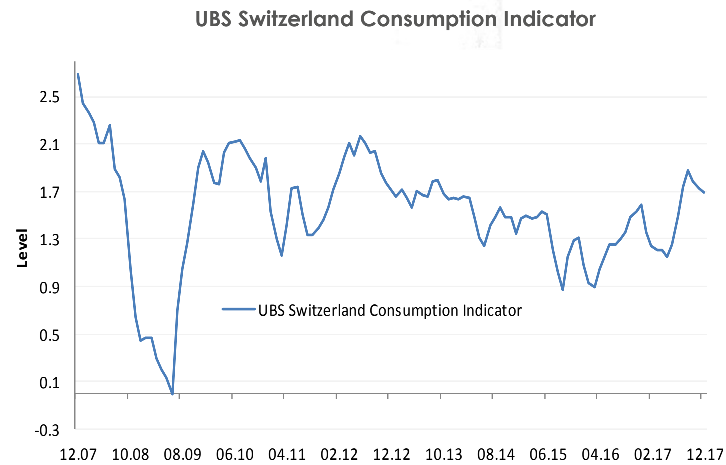


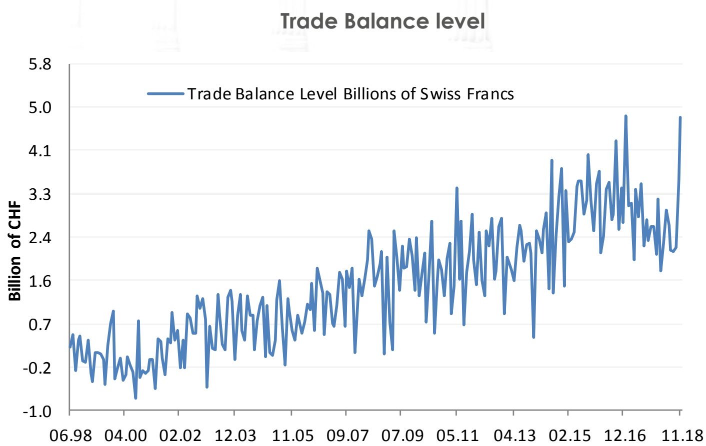
Capacity utilization rate

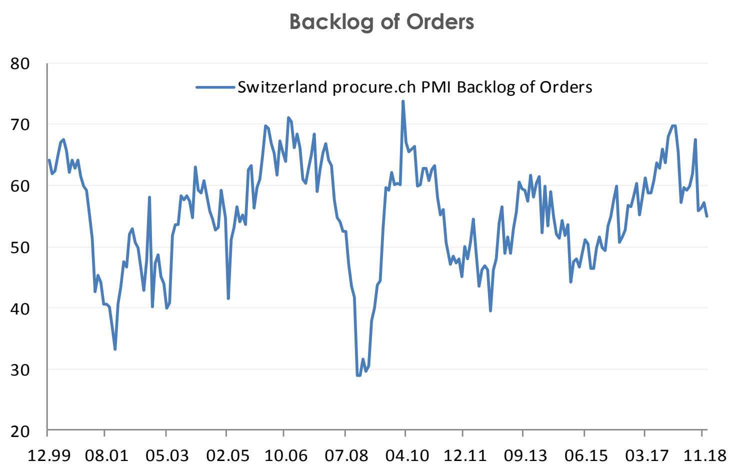


Graph sources: Bloomberg/BBGI Group









Graph sources: Bloomberg/BBGI Group

Consumption will likely bolster GDP

Growth in consumption was weak in Q3, failing to benefit from the record low unemployment rate (2.4%) over the past few months, probably due to the uninspiring increase in nominal wages. There was no major change in household confidence, but we think private consumption will likely continue to trend upward, bolstering GDP.

Public consumption expenditure will remain volatile in 2018, but the federal government's and cantons' budgets are rather solid, and the debt-to-GDP ratio (34%) is low by international standards, which gives the government some leeway to boost GDP through public spending, after the slight decrease noted.

Trade surplus increase in October

Since its January 2017 high, the monthly trade balance (2.13 in August) stabilised between CHF 2 and 3 billion, without showing any clear sign of resuming its upward trend. We were expecting that the improvement in global economic conditions and a weaker franc would finally lead to a boost in exports and an improvement in the trade balance.

The October results seem to point to such a trend, given the 3.75 billion surplus posted. In parallel, the performance of the watchmaking sector continued to improve with a nominal increase of +7.2% yoy in October.

Stabilisation of the Swiss franc

After the significant appreciation of the European currency to 1.20 in April, we were expecting a phase of consolidation of the exchange rate, which occurred amidst an uncertain political context in the Eurozone. The Swiss economy, which appeared stronger several months ago, fell into line with the Eurozone's.

The economic growth differential, which at the time clearly favoured the Swiss franc, is no longer significant. Any future phase of weakness of the franc will depend on the relative economic performance of and on the interest rate spread between the franc and the euro.

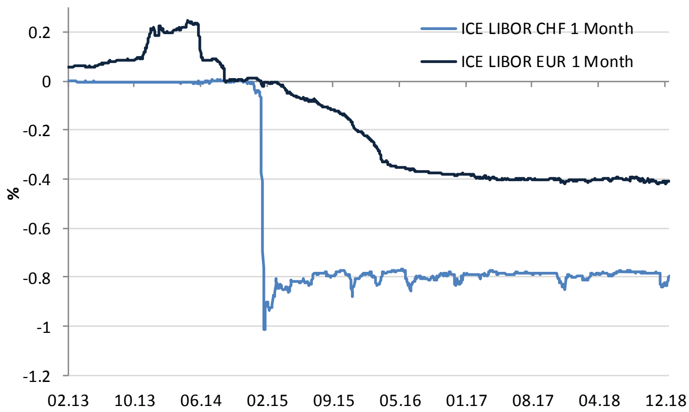
We continue to expect that the SNB will not raise rates as fast as the ECB. In the meantime, the exchange rate will likely stabilise between 1.12 and 1.17 against the euro.

Yield curve remains normal

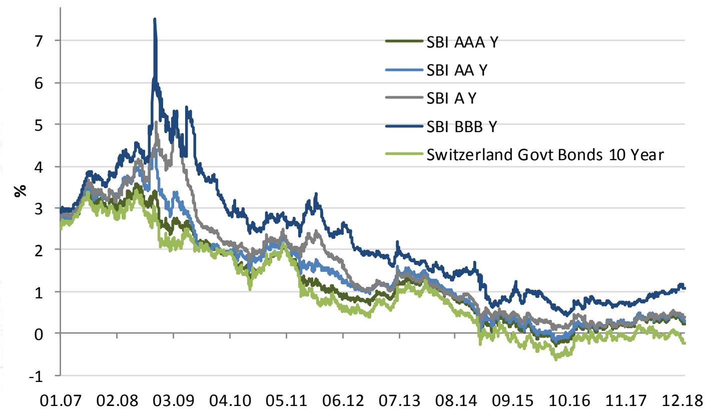
The normalisation of long-term interest rates in Switzerland started in summer 2016, but this initial adjustment phase rapidly stabilised at 0% with regard to 10-year Swiss government bond yields. The surprise slowdown of growth in the Eurozone and in Switzerland as well as the stabilisation of inflation in the latter at around 1% somewhat slowed the gradual upward trend in long-term rates. In order for the normalisation process to accelerate, economic statistics will have to improve in Switzerland as well as in the Eurozone.

The yield curve continues to steepen in a context where the SNB's monetary policy will likely remain stable in 2019. In this view, we believe that the upward trend of long-term rates in Switzerland will likely strengthen somewhat in 2019, if economic growth resumes in Europe. The planned termination of the ECB's bond purchasing programme could cause a few unpleasant surprises with regard to sovereign bond yields and increase the risk premium in relation to Swiss government bonds.

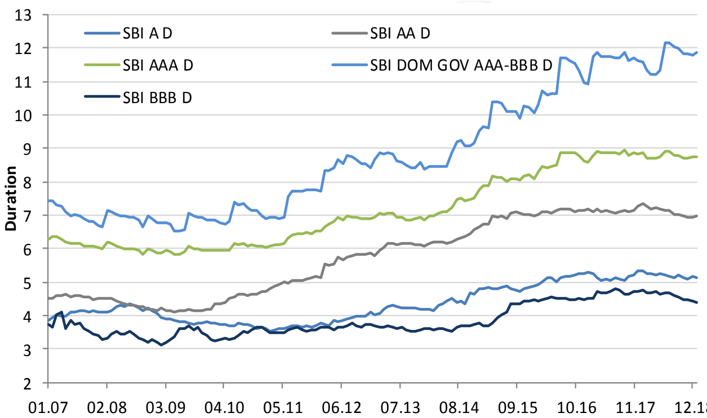
Libor spread rates 1 month



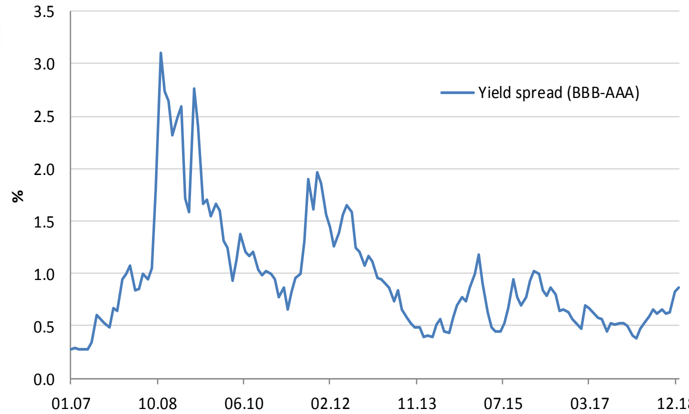
Yield (Government, AAA, AA, A, BBB)



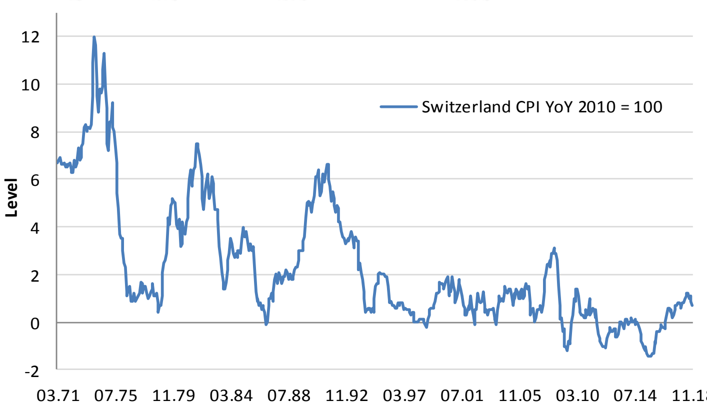
Duration of Swiss bonds



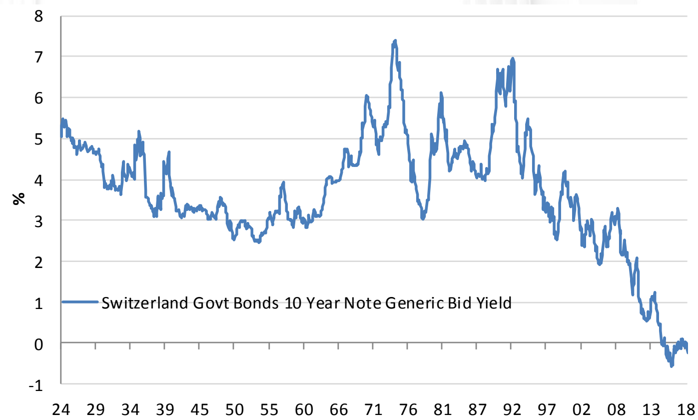
Yield spread



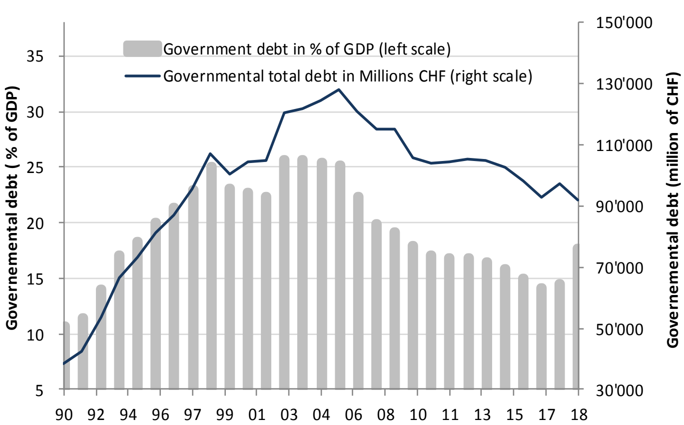
Inflation CPI



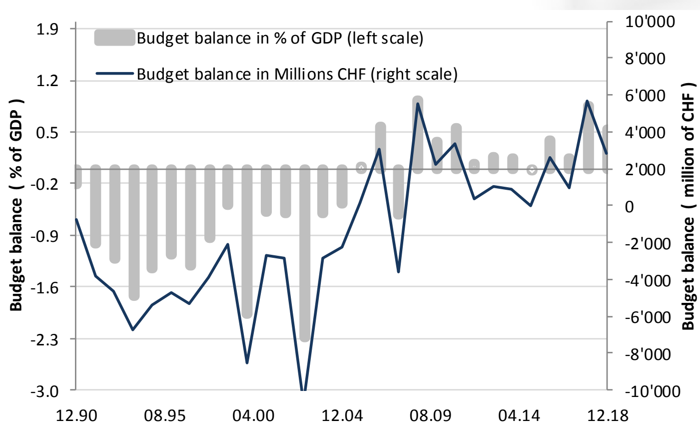
Government Bonds 10 year yield since 1924



Switzerland Government total debt



Switzerland Budget Balance



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Eurozone

- Slowdown in Europe is intensifying
- Leading indicators not optimistic
- Euro surprisingly stable
- ECB already in electoral mode?
- Outlook for euro fixed income markets in 2019?

Slowdown in Europe is intensifying

The outlook remains uncertain for the euro area as a whole given the likelihood of a sharp slowdown in Q4. GDP growth had already dropped from +0.4% in Q2 to only +0.2% in Q3, bringing the Eurozone's yoy GDP growth down to +1.7%. Contrary to expectations the growth rate thus dropped below its recent trend. The -0.2% contraction of the German economy in Q3 was the main contributor to this decline.

The German auto sector in particular seems to have been one of the main factors contributing to the slowdown. The euro's correction of close to -10% from 1.24 to 1.14 against the dollar in Q2 did nothing to support European exports over the last few months.

Foreign demand was thus more affected by the tariffs issue and the uncertainty related to the risks of a trade war than by the depreciation of the euro. However, most observers still expect the European economy to achieve a growth rate of +2% in 2018 and +1.6% in 2019, despite Germany's mediocre recent performance. The risk of recession in Europe thus remains limited and is only of around 20%, barely more than in the US (15%).

Legitimate concerns regarding German GDP

The situation in Germany does not seem to be showing any clear signs of improvement in particular with regard to industrial activity, which portends a rather disappointing economic performance in Q4 for the Eurozone's largest economy as well as a difficult start to 2019. Forecasts for the Eurozone thus remain shrouded in uncertainty, as noted in our previous analyses. The latest industrial production figures for Germany for November (-1.9%) were unexpected and suggest that the sector contracted for the third month in a row. These results constitute the sector's worst quarterly performance of the current economic cycle and are unfortunately not limited to the auto sector.

However, they could be offset by a stronger performance of the services sector and consumption (retail sales were up +1.4% in November), as household confidence remains stable. Nevertheless, the economy continues to falter in Germany, increasing forecasting risks for the beginning of 2019 for the euro area as a whole, even though the situation in some other countries is more positive.

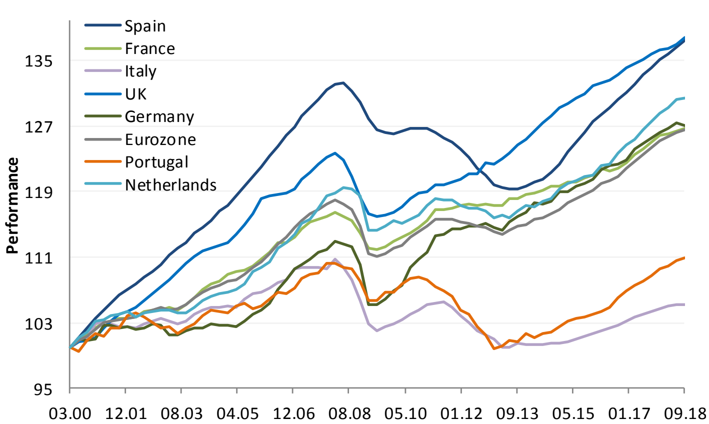
The ECB does not seem to be unduly concerned with regard to these developments for now. The bank notes that the Eurozone's economy continues to behave in line with expectations, highlighting the positive trends in the job market and their likely impact on wages and inflation. However, the ECB did slightly reduce its growth outlook to +1.7% for 2019 (real GDP) and to +1.6% for inflation.

Leading indicators not optimistic

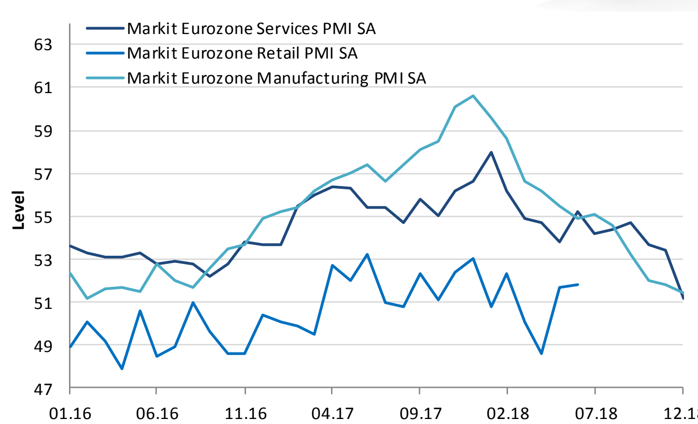
As Q4 came to a close, most leading indicators gave no concrete sign of picking up. The Eurozone unfortunately seems to be following the same trend that prevailed in the previous quarter. Indicators remain equivocal but are steadily deteriorating. Indeed, the Markit composite PMI index slid further in December to 51.1, well below the 58.8 high reached in January 2018, with both services (51.2) and manufacturing (51.4) falling back.

The Eurozone's economic performance is still closely tied to Germany's, which was still not showing any sign of recovery at year end. Germany's manufacturing PMI index fell from 63.3 at the beginning of the year to 51.5 in December 2018, in line with leading indicators overall, which closed the year on a downward trend at 51.6. The -1.9% decline in industrial output in November brings the sector's yoy contraction to -4.7%. Concerns are thus legitimate in regard to the health of both the German and the European economies.

GDP Growth - Eurozone

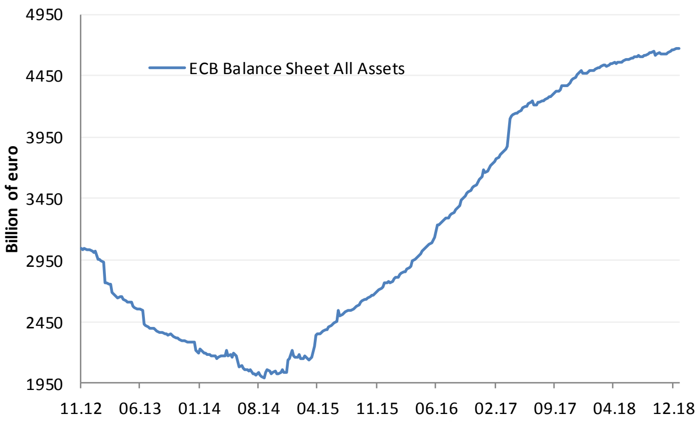


PMI (Manufacturing, Services and Retail) - Eurozone

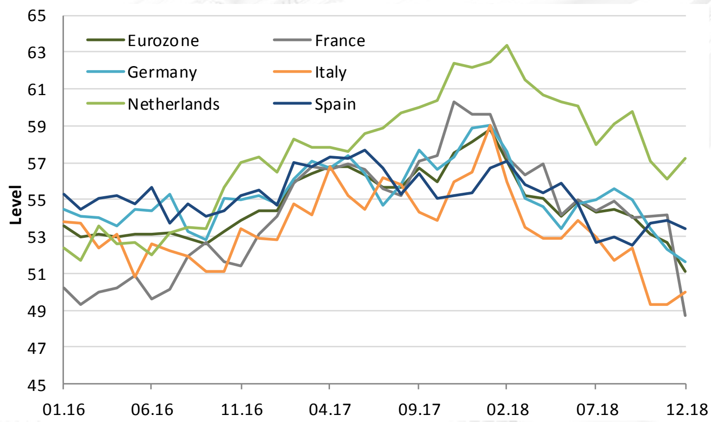


Graph sources: Bloomberg/BBGI Group

ECB Balance Sheet



Composite PMI



The situation is not bright for the second largest European economy, which has lost some momentum with the yellow vest crisis. France's composite PMI index fell below the growth threshold to 48.7 in December. Overall, growth forecasts for the Eurozone are increasingly uncertain in this context both for Q4 and for the beginning of 2019.

However, momentum in the job market is fortunately increasing steadily. The unemployment rate (7.9%) in Eurozone countries dropped for the first time below 8%, thus returning to its year-end 2008 level, a 50% decrease in unemployment compared with the 12% high reached in 2013. It is drawing nearer to the EU's 6.7% unemployment rate, thus constituting one of the positive factors pointing to a possible upswing of GDP.

Confidence gives way to concern

Similarly to the PMI indices, various measures of household and business confidence also continue to point south. The European Commission Economic Sentiment indicator has declined for 12 consecutive months. Households and businesses seem increasingly concerned with regard to the trade dispute between the economic superpowers. Various factors impacting confidence in Europe include the fall in exports and the risks related to a hard Brexit coupled with other political uncertainties, such as the Italian crisis. The business climate indicator declined in the five largest economies, with a more significant decline seen in Spain.

Euro surprisingly stable

The Eurozone's challenging economic environment stands in rather sharp contrast to that prevailing in the US. Fears of a recession have been raised in both cases, but the Eurozone is decidedly more at risk, as the US economy continues to grow without encountering any real obstacle.

However, the euro surprisingly was not negatively impacted over the past several months by this factor, which should have penalised it. The interest rate spread between the euro and the US dollar and diverging economic performances did not cause any significant movement. The current exchange rate of 1.15 USD to the euro likely already incorporates a good number of euro area risk factors.

The current stabilisation could then give way to a stronger euro in 2019 if growth prospects normalise. Accordingly, the long-term interest rate spread could decrease and benefit the single currency.

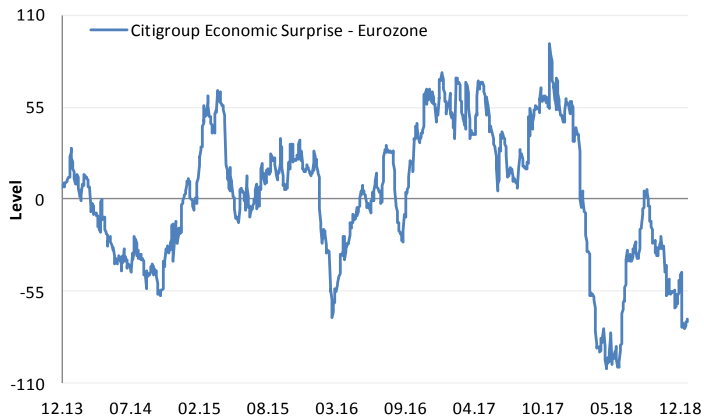
ECB already in electoral mode?

ECB president Mario Draghi's term will end in May, just after the European elections and before the central bank committee meeting on 6 June 2019. As his tenure comes to an end in just a few months, Draghi was likely hoping to leave the economy in better shape than what we just described. Indeed, just a few months ago he could still legitimately hope that European growth would accelerate, allowing him to leave the ECB with the belief that he had fulfilled his mission.

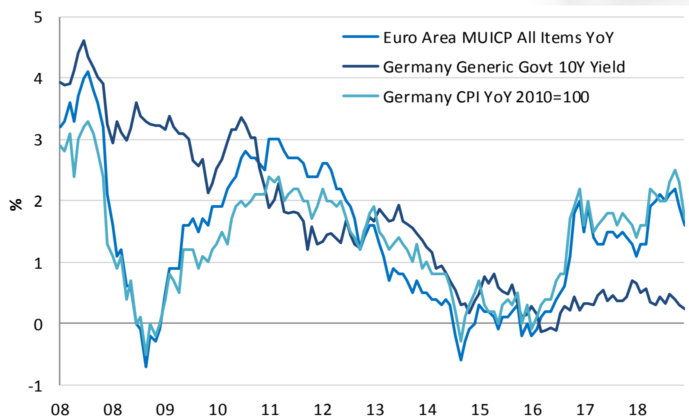
However, this was of course assuming that the pressure exerted by the US president with regard to tariffs and the strain caused by Brexit would not cause as much uncertainty as they have, to the point of imperilling the results achieved over the past eight years by shattering the economic momentum that seemed to be accelerating in the Eurozone.

The imminence of Draghi's departure is perhaps not without influencing the ECB's assessment of the economic situation. Indeed, the bank's continued optimism, in spite of a slew of worrying data, leads us to believe that the bank does not wish to call its policies into question.

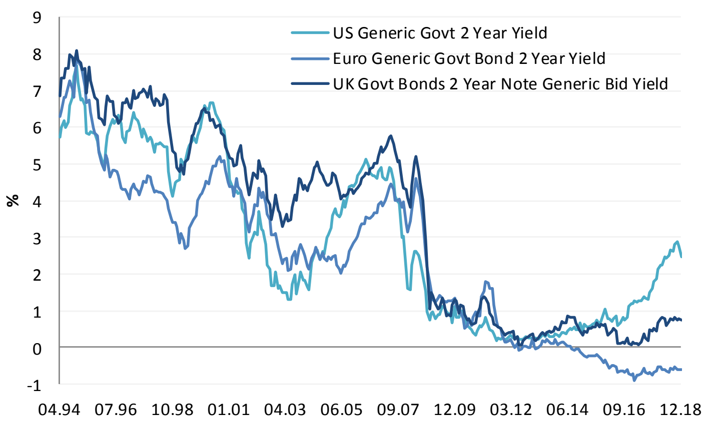
Citigroup Economic Surprise Index - Eurozone

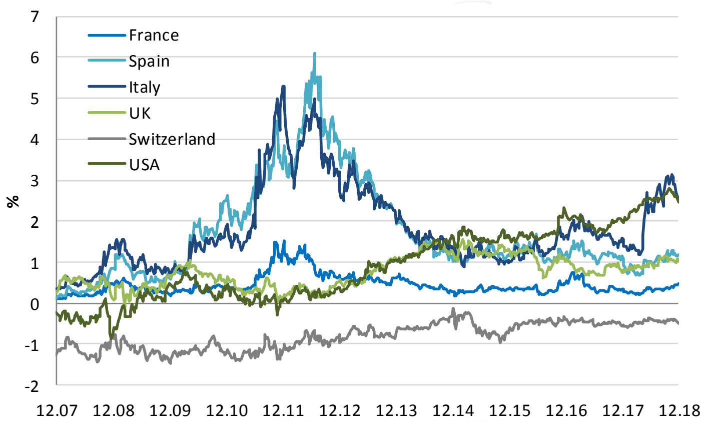


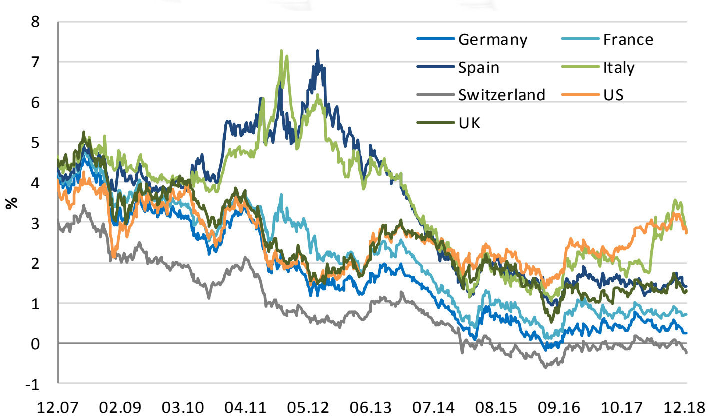
10 year Government Bond yield - CPI



Graph sources: Bloomberg/BBGI Group







In any event, current economic data will not alter at least one of the elements of current stated monetary policy. Indeed, already there was no question of a rate hike in Q1, but in the current environment, it seems unlikely that a hike would be announced before Q4 2019.

Nevertheless, the ECB did revise downward its forecast for European GDP growth to +1.9% for 2018 and in particular to +1.7% for 2019. The bank is thus increasingly taking into account the risks of a decline in foreign demand. It also kept its rates steady at -0.4% on deposits (banks' excess reserves) and 0.25% on its marginal lending facility. With regard to liquidity injections via government debt repurchasing, even though the programme ends in January 2019, this does not mean that the ECB will be completely passive. For a prolonged period, the bank will continue to reinvest maturing government debt in order to maintain as long as necessary favourable liquidity conditions and a high level of monetary support.

The ECB will look for several more quarters of accelerating growth and improvement in the job market to take action with regard to policy rates. Inflation will have to be resilient for the bank to feel comfortable changing its position without risking having a negative impact on economic and financial conditions. Moreover, the bank will likely wait for the euro to weaken and inflation to pick up before raising rates.

Outlook for euro fixed income markets in 2019

The economic slowdown in the EU unsurprisingly reduced upward pressure on long-term euro rates. The risks of an adjustment or of a rate shock across the entire yield curve thus are now significantly lower. Inflation is trending down, due in particular to the drop in energy prices, and is not currently a threat requiring a quick adjustment in rates.

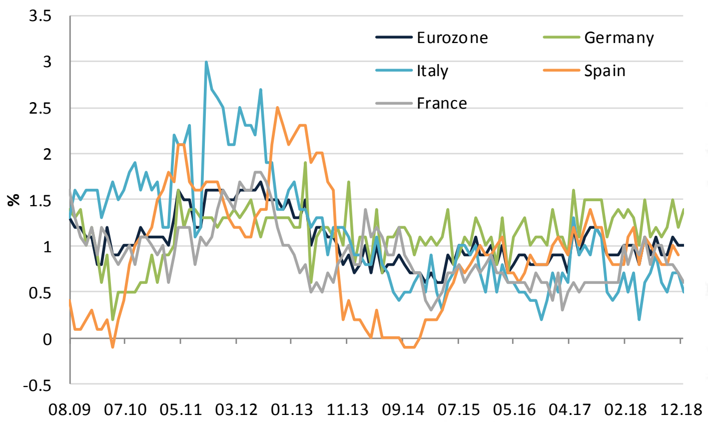
President Draghi still seems convinced that the job market will show increasing signs of upward pressure on wages, which will ultimately lead to an increase in underlying inflation over the next few months. Indeed, the trend is positive, as the unemployment rate dropped below 8% for the first time in ten years. Inflation was only 1.9% in November, or 1% excluding food and energy. We believe that these short-term trends are somewhat counter to the ECB's assessment. They also affect the estimation of long-term rates' normal levels, which is tied to the assessment of inflationary trends, the growth rate, and the ECB's quantitative policy.

The risk of an increase in long-term rates is somewhat deferred for now given the economic slowdown, but it is possible that demand for government securities will be significantly impacted by the termination of the ECB's purchasing programme, causing volatility to increase in euro fixed income markets. Recall that ECB purchases had absorbed almost the entirety of net new sovereign bond issuance in the euro area in 2018.

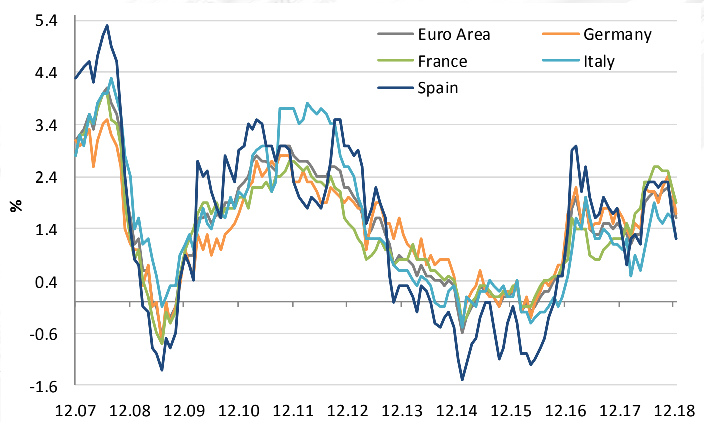
Assuming Germany does not go into recession, the yield on the 10-year German Bund will likely be closer to the 0.55% level reached in October.

Graph sources: Bloomberg/BBGI Group

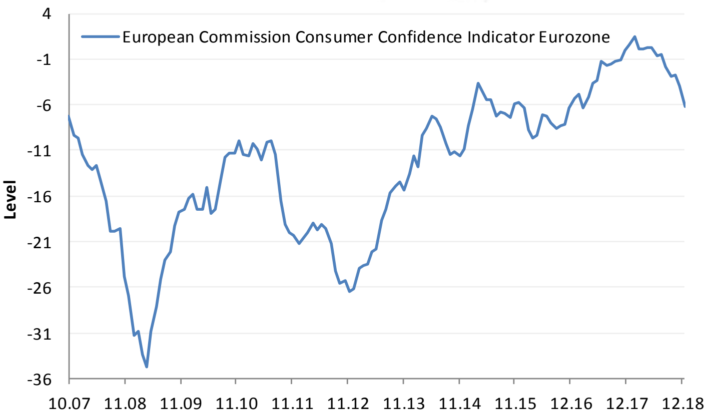
Eurostat CPI - Core Inflation (Eurozone, YoY)



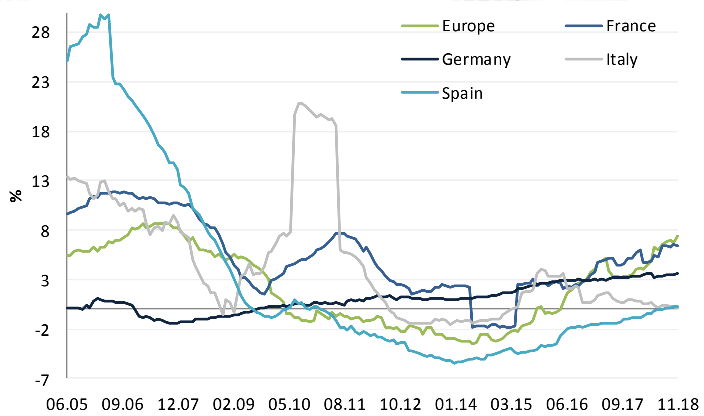
Eurostat CPI - all items (Eurozone, YoY)



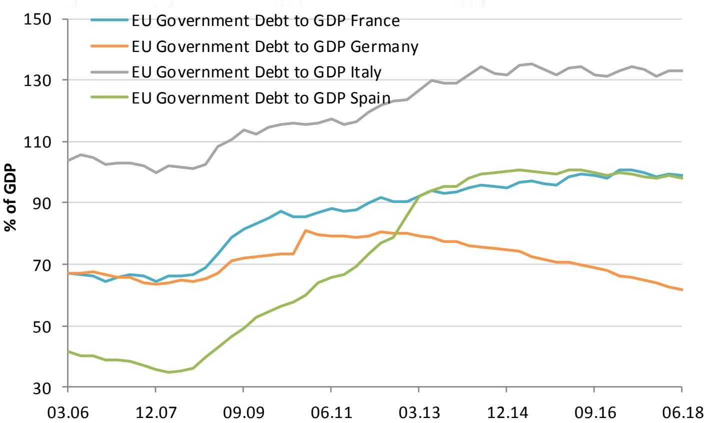
Consumer Confidence - Eurozone



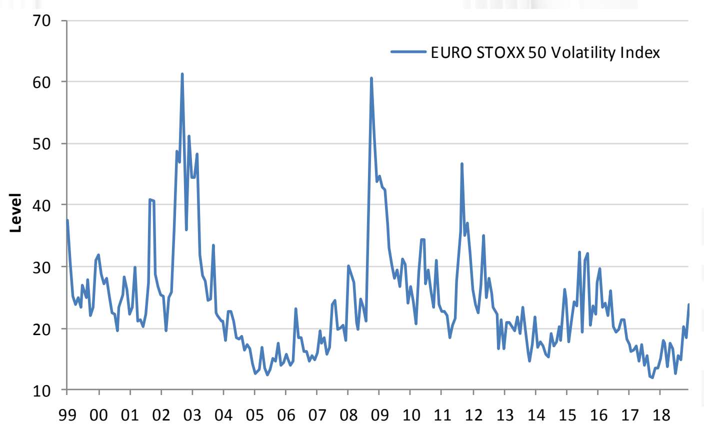
Loans to households (Eurozone - YoY)



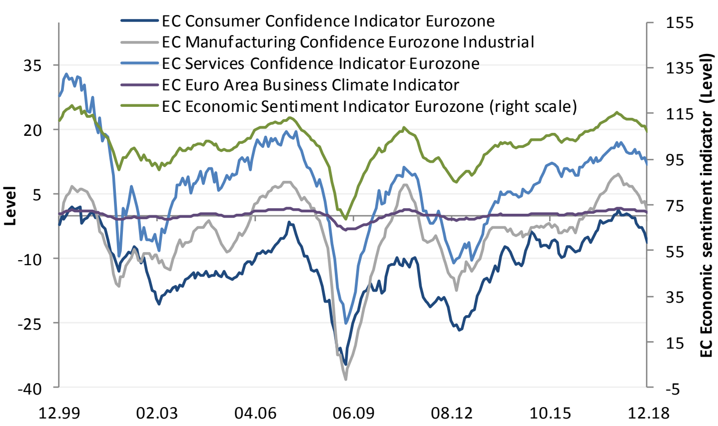
EU Government Debt



Euro Stoxx 50 Volatility Index



Economic Confidence Index



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

United Kingdom

- Theresa May will play her last card in January
- New referendum to break the deadlock
- Brexit still weighing on the pound
- Worrisome threats to GDP
- BOE still in wait-and-see mode

Theresa May will play her last card in January

The British prime minister, Theresa May, returned from Brussels with an agreement in her suitcase, whose ratification by Parliament she was rather smugly hoping to obtain. In this sense, she once again underestimated the risk that her strategy would fail vis-à-vis British MPs, before ultimately grasping the risk of a wholesale rejection and postponing at the last minute the vote planned for 11 December. After this political defeat, she was then barely confirmed as PM after a vote of confidence organised by her party, which puts her in far from an excellent position to carry out her policies and negotiations with the EU. She remains doomed to try again and again to find a solution to the Brexit conundrum with her European partners, who have made clear their lack of interest in renegotiating the agreement. Over the next few weeks, Theresa May will continue to seek to obtain assurances with regard to the issue of the physical border between Ireland and the British province of Northern Ireland in final attempts at conciliation, seemingly increasingly in vain. Indeed, the European Council is weary of the negotiation process, which is constantly bumping up against dissention among various factions in the Conservative Party in the UK, undermining the Brexit process.

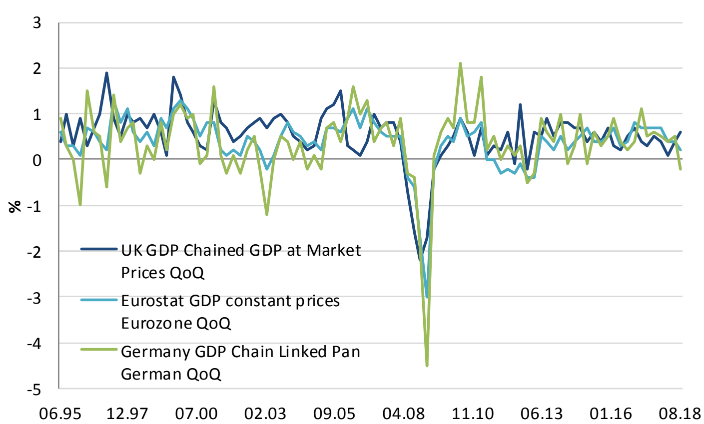
Time may be up for Theresa May, who cannot bring herself to resign and who is certainly not being pushed in this direction, possibly due to the lack of enthusiasm demonstrated by those who could or should take up the challenge in her stead. Indeed, no one is hastening to replace her and take on the responsibility of managing this unique crisis with possibly dramatic consequences for the UK. Even those who fanned the flames of populism and fuelled resentment against the EU are not keen to take up the torch. Theresa May might well continue until the end to refuse to put forward the only alternative to a defeat that seems more and more likely in March, that is, a new referendum.

In reality, Theresa May no longer has any counterparty with whom to renegotiate her "agreement" and will certainly not be able to count on a "miracle" before facing MPs between 14 and 20 January 2019, when she will play her last card, following which Parliament will likely reject the proposed agreement. Uncertainty is thus at an all-time high as 2018 comes to a close. Over two years after Brexit garnered 52% of votes in June 2016, the government is still not ready to obtain the approval of Parliament to implement the people's decree. The January vote will occur only a few weeks before the deadline, and the risks of a "no deal" have never been as high. While the worst case scenario is certainly not a given, the prime minister does not have a plan B that could save the UK from what would likely be a brutal shock if this scenario were to come to pass.

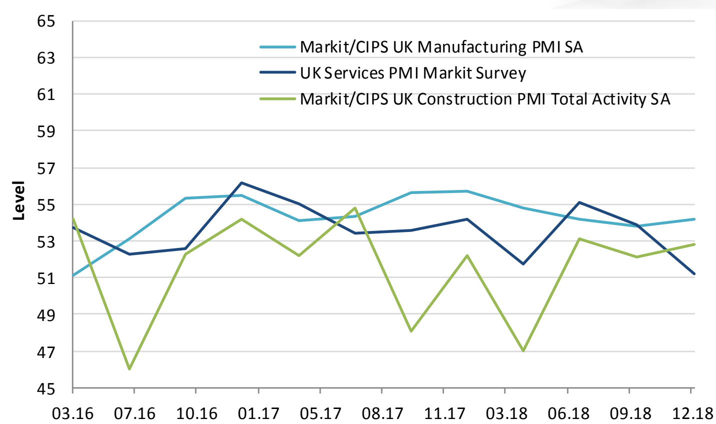
Why not consider a plan B?

The prime minister considers herself responsible for carrying out the will of the people and will likely never deviate from her trajectory. She was appointed prime minister to implement Brexit and will likely reject any initiative or proposal that would deviate from her mission. We had already brought up, several months ago, the notion of a second referendum to break the deadlock in which the Brexit vote had placed the UK, and this is now increasingly frequently mentioned as the plan B the country needs to counter a conclusive defeat of the strategy doggedly pursued by Theresa May. Just recently the latter flatly rejected any notion of organising a new referendum, whatever its source. Indeed, she seems convinced that this solution would go against her commitment to the British people – a failing and a betrayal that could call into question, irreparably in her view, the integrity of political life in the future. She seems ever more certain that a new referendum would be even more divisive, just as the country needs more unity.

Quarterly GDP Growth - UK

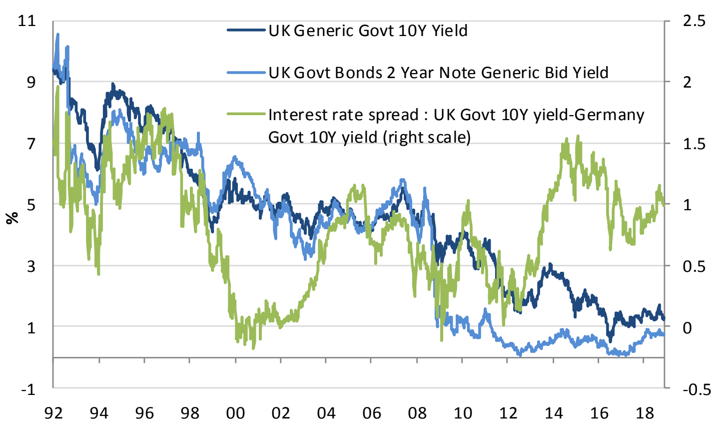


Manufacturing, Services and Construction PMI - UK

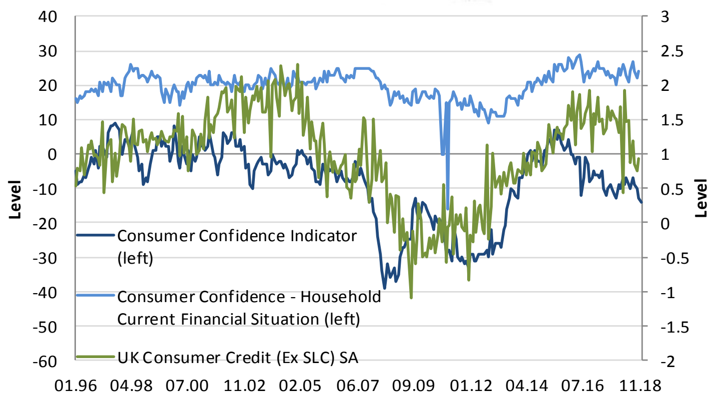


Graph sources: Bloomberg/BBGI Group

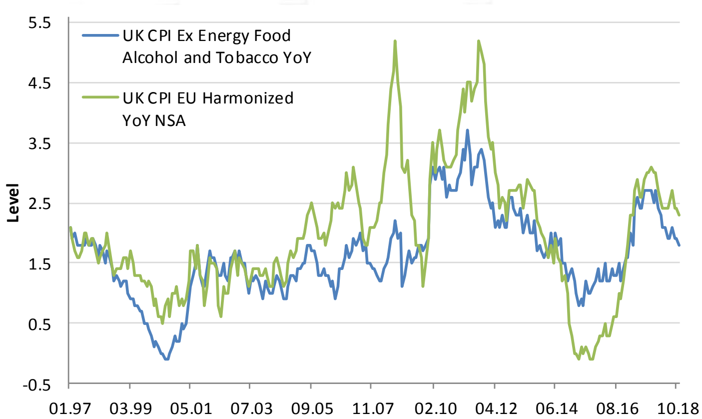
UK Government Bonds - 10 year and 2 year yield



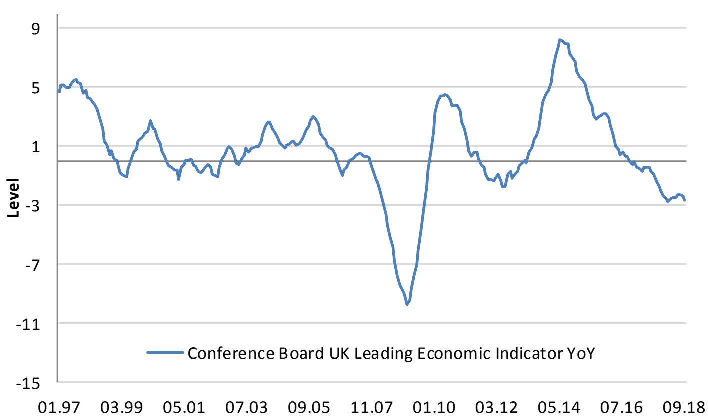
Consumer Confidence



Inflation CPI



UK Leading Economic Indicator



Graph sources: Bloomberg/BBGI Group

It is surprising that she does not realise that Brexit is precisely what has most divided the country. Doomed to pursue a single path, she will not explore the only possible alternative before a defeat in January spells the end of her project.

Absent a swift reaction, the struggle will continue, and the UK will be faced with two possible outcomes: an unsatisfactory project likely to be rejected and a brutal withdrawal from the EU without an agreement and with even more dramatic consequences. The prime minister seems to have deliberately decided to stall in order to force Parliament to accept a last-minute agreement to avoid a leap in the dark.

New referendum to break the deadlock

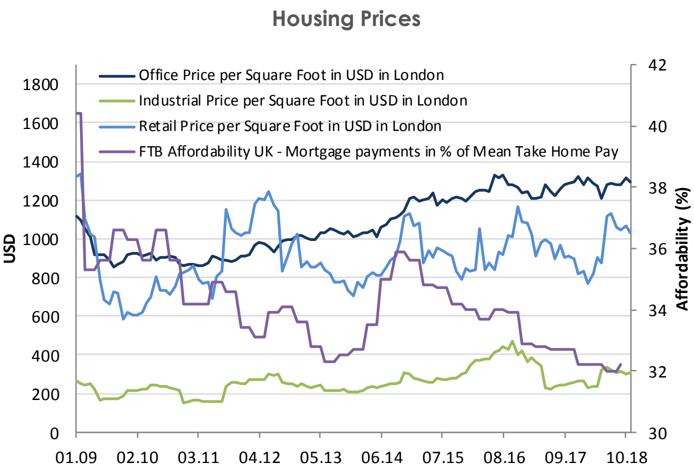
Theresa May is more than ever opposed to organising a new referendum, although the latter is increasingly clearly the only viable alternative. With regard to Labour, former prime minister Tony Blair chimed in to criticize the prime minister's irresponsible strategy, which he claims forces MPs to accept an agreement that they consider bad, leaving only a "no deal" as an alternative. However, the clock is ticking, and if the deal fails as expected, a referendum will become the only realistic solution to avoid in extremis an abrupt break from the EU with no safety net. Polls are showing that close to 48% of British voters want a new referendum against 34% who do not. The British would vote differently today given the uncertainty that has been weighing on the future of the country and its economic prospects for over two years. While 700,000 people gathered in London to demonstrate their support for a new referendum, no fewer than 53 MPs also support this idea.

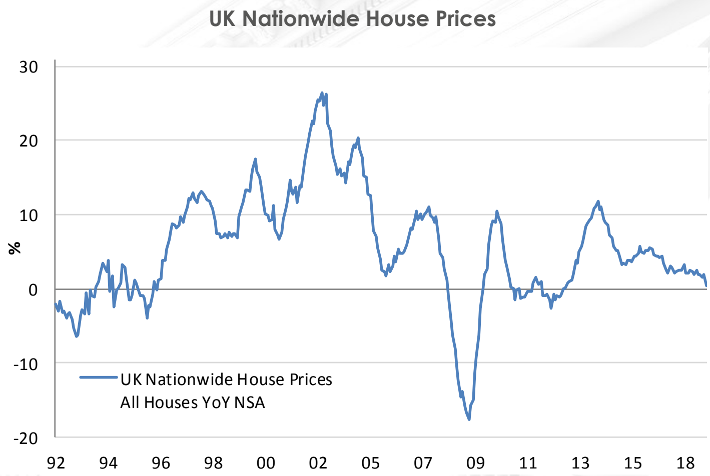
"What the people have done only the people can undo" – perhaps a useful maxim to justify a complete reversal in attitude, which could well offer a simple solution to the conundrum British politicians have been puzzling over for months without finding an acceptable solution.

Part of British civil society has already taken a position on the issue and wishes to organise another referendum. A vast majority of British firms fear the consequences of a withdrawal from the EU. Other figures from across the political spectrum, such as the Labour mayor of London, Sadiq Khan, John Major (Conservative) and Vince Cable, leader of the Liberal Democrats, are all convinced that Brexit is not inevitable and could be stopped. Within the Labour Party, Jeremy Corbyn is now open to another referendum, in this sense following an overwhelming majority of the members of his party favourable to this proposal and who would vote in favour of staying in the EU. With regard to the majority party, Conservative Europhiles are making their voice heard and venturing to suggest the notion of a new vote on Brexit. Even the finance minister, Philip Hammond, seems to be admitting that remaining in the EU would be preferable to withdrawing. Labour's new position could well enable a composite majority to yield a different result and break the deadlock. However, we will likely have to wait until the end of January and the rejection of Theresa May's agreement for all conditions for a new referendum to be met. It may then perhaps not be easy to organise it before the 29 March deadline, but let us wager that to solve this problem via a new popular vote the EU will be willing to grant an extension. Speaking openly of a plan B amounts almost automatically to killing plan A, but the European Commission is no longer hiding its concern and is preparing member States for this contingency.

Brexit still weighing on the pound

For over two years the pound has been hostage to the complex political situation that has been generating uncertainty with regard to the UK's economic outlook. We still believe the pound has entered a stabilisation phase against most major currencies following its historic fall in the wake of the June 2016 vote pending better visibility on the political front. A "no deal" scenario in three months would certainly be the most dramatic for the British currency, which would likely not withstand the hit and could fall another -10% to -25% (worst case scenario according to the BOE).





In the manufacturing sector, production is following the same trend, posting an annualised growth rate of +1.1% in July, a sharp drop from its March 2018 rate of +2.5%. This trend was not showing any sign of reversing or any indication of a potential surprise upswing in September akin to that of industrial production. This expectation is back in full force, as shown by the recent -4% correction of the pound against the euro and the dollar. However, increasing willingness of the British over the next few weeks to organise a new referendum could help prop up the pound somewhat. Nevertheless, we are not anticipating the trend to be favourable over the next three months, unless plan B clearly becomes the solution to ending the crisis.

Worrisome threats to GDP

On the economic front, the numbers should convince MPs to accept the agreement negotiated by Theresa May, which would be less dramatic than a "no deal". A report presented to the government in November noted that withdrawing without an agreement would exact a cost of 9.3% of British GDP over 15 years, or approximately twice the 3.9% estimate attached to the prime minister's project. The BOE also noted that GDP could be short 7.8% to 10.5% by 2024 compared to what it would have been without Brexit, evoking an increase of the unemployment rate to 7.5%, an upturn of inflation to 6.5% and a dramatic -30% fall of real estate prices. Even if negotiations were successful, the BOE is anticipating an impact of -1.2% to -3.8% over five years. As the British wait for the crisis to be resolved, they are likely less than comforted by these figures. Unsurprisingly, uncertainty is on the rise and eating into the confidence levels of various economic agents. While Q3 GDP was up +0.6% or +1.5% yoy, figures for the past months suggest an increasingly clear loss of momentum as the year draws to a close. The three-month growth rate at the end of October was only +0.4% due to a much weaker month of October (+0.1%). The somewhat better performance of the service sector (+0.2%) helped avoid economic stagnation, as most majors sectors were showing declining activity.

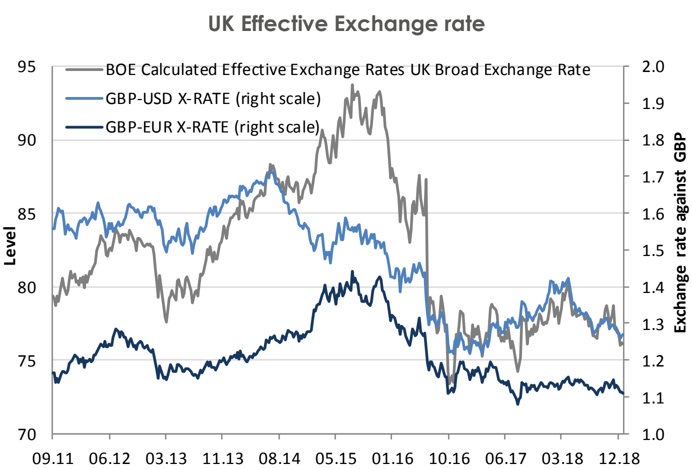
The manufacturing sector contracted by -0.9% in October (-1% yoy), slightly more than industrial production, which was down -0.6% (-0.8% yoy). In spite of a weak pound, exports (+0.8%) did not grow sufficiently to make a positive contribution, while the trade balance (-11.9 billion pounds) deteriorated following a revision of the initial figures, due to the rising cost of imports (+3.5%). The services balance (8.6 billion) helped decrease the overall trade deficit to 3.3 billion pounds.

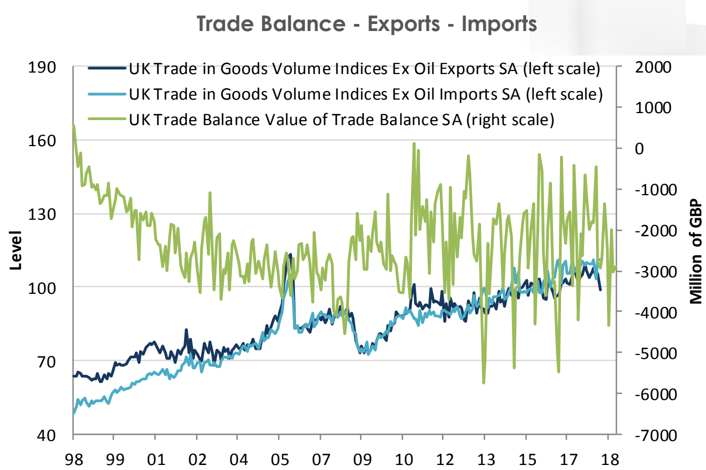
PMI indices nearing the growth threshold

Just a few months from the deadline for the UK, the British economy remains plagued by uncertainty. The slowdown is increasingly significant and is likely to worsen, if leading indicators are to be believed. The services PMI dropped from 56 in December 2016 to 50.4 in November, close to the growth threshold, its lowest level since June 2016, pointing to growing concern as the deadline nears. The manufacturing PMI ticked up slightly to 50.7, helping the composite index remain above the 50-point threshold. GDP growth in Q4 could be limited to +0.1%. The UK economy's growth prospects thus diminished further, confirming that an upswing at the end of the year or in Q1 2019 seems unlikely.

BOE still in wait-and-see mode

After the 0.25% rate hike in August, we expected the BOE's monetary policy to remain stable at least until the end of the year. The BOE will likely be reassured by the recent decrease in the inflation rate, which is trending back down toward its 2% target. The CPI index fell to 2.4% in November, while core inflation (ex food and energy) dropped to 1.9%. The BOE's reference rate (0.75%) will remain unchanged at least until closure is reached with regard to Brexit in March 2019. Members of the MPC still seem confident that the issue will be resolved favourably and expect possible positive surprises with regard to growth, justifying their predictions of further rate hikes in 2019.





Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Japan

- Unexpected growth shock in Q3
- Exports pick up in Q4
- Trade balance turned negative
- Leading indicators weighed down by uncertainty
- Outlook still mediocre for Japanese bonds

Unexpected growth shock in Q3; Japanese GDP dropped by -0.6%, or -2.5% yoy

Given the significant instability of Japan's economic performance, several months ago already we questioned the sustainability of the country's remarkable growth rate of +0.7% in Q2 (+3% annualised), the fastest growth rate posted since 2016. We predicted that GDP growth was unlikely to maintain this pace, in particular in the context of intensifying risks of trade tensions and a decrease of economic activity in Asia. Nevertheless, the growth shock caused surprise when the revision of growth figures, first published in November, showed that GDP had contracted by -0.6%, i.e. more than expected. In fact, it was the sharpest contraction since 2014. Unfortunately, these results confirmed the instability of Japan's economic performance over the past quarters.

Q3 results thus almost completely wiped out the exceptional performance generated in Q2, leaving little opportunity for the situation to reverse significantly for 2018 in Q4.

The Japanese economy thus contracted more sharply, essentially due to a steep drop in corporate spending. Natural disasters that hit Japan also played a role in this phenomenon and can in fact explain the contraction, which was the strongest of the decade.

The impact of natural disasters on GDP was indeed significant. However, with regard to corporate capital expenditure (-2.8%), it should be noted that the contraction followed a particularly solid quarter (+3.1%). Nevertheless, this element somewhat calls into question the positive perception of an improvement in business confidence, even though leading indicators are still not very optimistic.

Exports, a key component of Japanese GDP, were also affected by these extraordinary events. The -1.3% contraction in September thus diverged from the positive monthly results posted since December 2016. The +8.9% jump in October hinted at a welcome rally in Q4 for this segment. Private consumption was also weaker, declining by -0.2%. However, it was mostly the slump in non-residential private investment expenditure(-2.8%) that weighed on the revised figures.

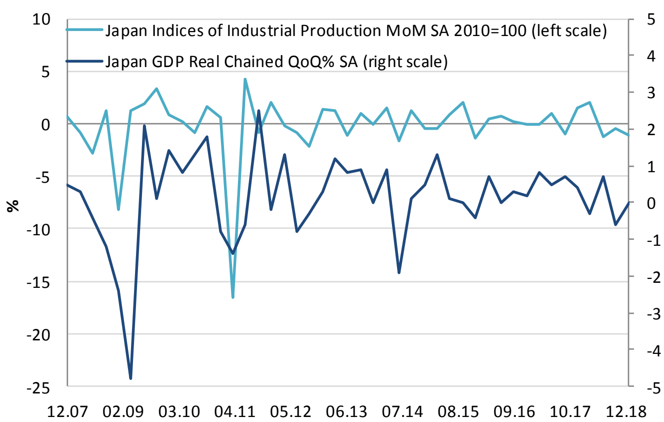
Q4 results will likely not paint such an indecisive picture of the Japanese economy as did performance in Q3. The risks of a trade war continue to constitute the main threat to Japanese growth, in particular given that the yen is likely to continue to stabilise over the next few months. Indeed, the monetary factor remains one of the key elements with regard to generating more positive growth.

Exports pick up in Q4

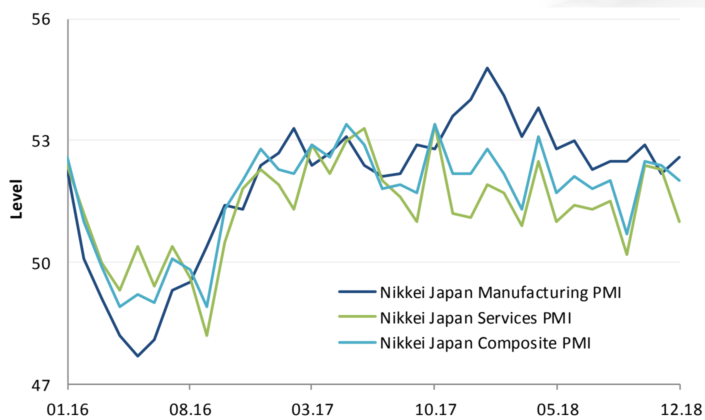
September was a particularly difficult month for the Japanese economy, which was impacted by several natural disasters with significant direct and indirect effects on several sectors. Japanese exports, which had been negatively impacted (-1.3%) in September by typhoons and earthquakes, rebounded very significantly in October (+8.2% yoy).

These results are especially important given the dependence of the Japanese economy on the export sector; Japanese growth is indeed particularly influenced by the health of the country's export sector. The upswing in the latter thus suggests a more positive last quarter in terms of GDP growth. The semi-conductor, electronic component, and vehicle sectors contributed to this upswing, thus boosting confidence in the on-going improvement in these sectors.

GDP and Industrial Production

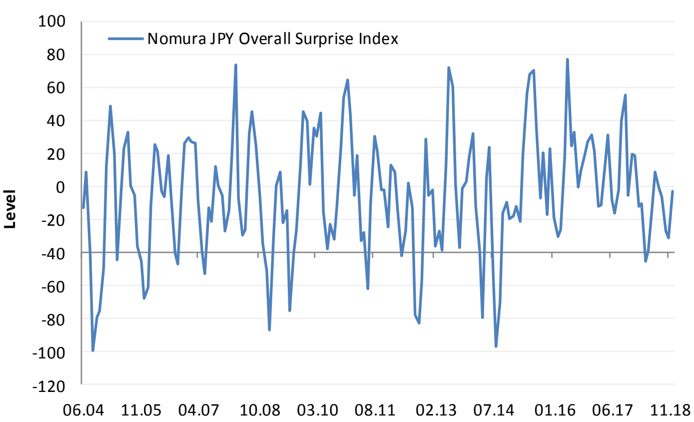


Composite, manufacturing and Services PMI - Japan

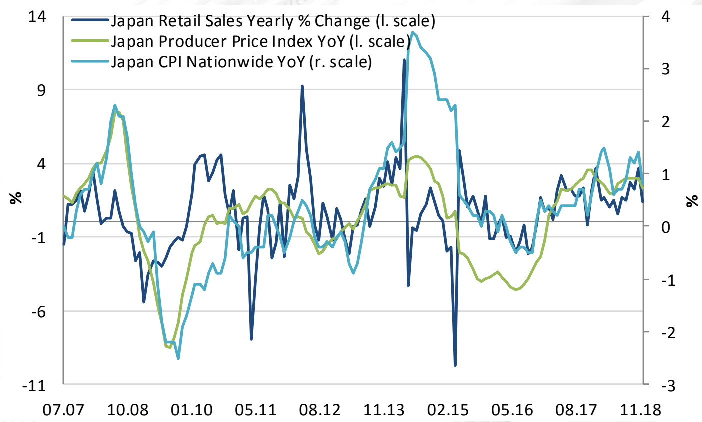


Graph sources: Bloomberg/BBGI Group

Economic Surprise Index



Inflation (CPI and PPI) and retail sales



Trade balance turned negative

Foreign trade results indicated a further deterioration of Japan's trade balance. While it was positive in 2016 and 2017, it turned negative in the past several months, posting a -302 billion yen deficit in October, after having achieved a surplus of +453 billion yen in April 2018. The +19.9% increase in imports, the largest increase since 2014, accounts for how a substantial surplus turned into a significant deficit. Energy costs were the most crucial factor, with a +33.7% increase in crude and LNG prices.

By region, Japan still has a surplus of 550 billion yen with the US, partially compensated by a deficit of over 400 billion yen with China and a negative balance of approximately 70 billion with Europe.

Increase in wages not sufficient to boost consumption

Wages increased by +1.5% yoy in October, which in real terms (-0.1%) is still insufficient to boost consumption. The +2.8% increase in August was short-lived. The -0.3% decrease in October followed on the heels of a -1.6% decrease in household spending in September.

Japanese consumers thus remain particularly cautious, in spite of a still very low unemployment rate (2.4%), wage growth, and an increase in corporate earnings. Consumer confidence has been steadily decreasing since the beginning of the year (44.6) and still did not seem to stabilize in November (42.9). More will likely be needed for a clearer and more lasting trend to take hold.

However, overall retail sales increased by a promising +1.2% in October, or +5.8% yoy. Vehicle sales dropped slightly in November but were still up +8.3% yoy. Nevertheless, more substantial improvement in the job market and more significant transmission of corporate earnings growth into wage increases are needed to boost household confidence and consumption levels in Japan.

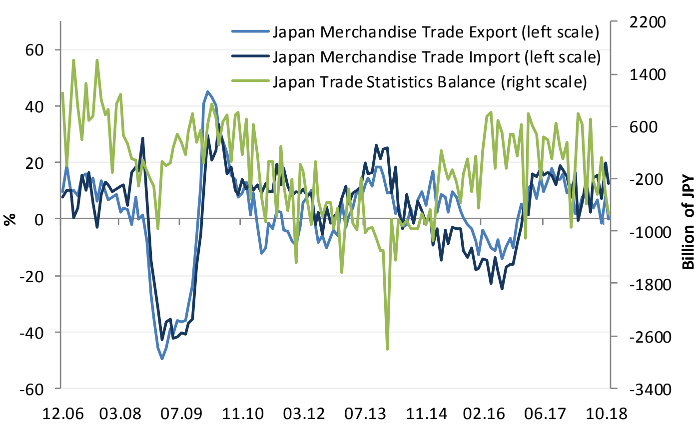
Leading indicators weighed down by uncertainty

Uncertainty continues to weigh on leading indicators as 2018 comes to a close. Business leaders sentiment is still not significantly improving in Japan, as in most countries. The wrestling match initiated by the US president remains the key factor of uncertainty in Japan as well, in spite of the truce negotiated on 30 November. The stabilisation of the yen after a correction of approximately -10%, although favourable to large Japanese export companies, does not seem sufficient to allay the concerns of purchasing managers, who still prefer to remain cautious given the persisting risks of a major trade war. The Japanese economy, which was booming in Q2, suddenly and unexpectedly contracted (-2.5% yoy), thus confirming the hesitancy seen in surveys. The PMI indices have been stabilising for several months but are still not showing clear signs of an upturn following the steady decline seen in the first half of the year. In November, the manufacturing PMI improved slightly (52.2) over October (51.8); even so, it did not point to any upturn in the industrial sector over the next few months. When industrial production came in at +2.9% for October it was thus a positive surprise, possibly offering clearer signs of an upturn in activity following a gloomy Q3. The composite index remained at 52.4, still close to its 2017 lows, bolstered by the more positive trend in the services PMI, which posted a heartening increase in October and stabilised at 52.3 in November.

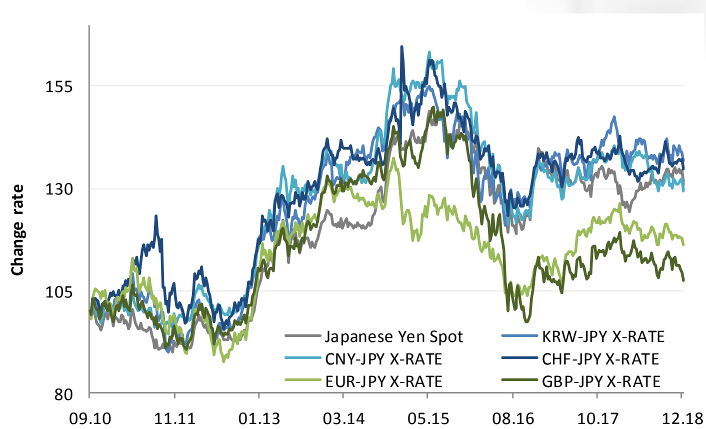
Outlook still mediocre for Japanese bonds

Q2 saw a welcome increase in price indices. Indeed, they slackened only over the period in which the yen was appreciating. Inflation (CPI) rose above 1%, establishing itself at 1.4% in October. An upswing in prices was conditioned upon on a depreciation of the yen, but inflation is still far from the BOJ's target (2%), and production prices are not displaying sufficient momentum to establish a more robust trend overall. However, the current context is clearly not favourable to the bond market, which still fails to offer attractive prospects to foreign investors.

Trade Balance (Billion of yen)



Exchange rate (Normalized at 100)



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

China

- Government policies will support growth
- Leading PMI indicators still a mixed bag
- A trade deal could be reached before 1st March
- Is the yuan once again a strong currency?

Government policies will support growth

The Chinese economy should finish 2018 with growth of +6.4%, but with rather worrying results at the end of the year. Uncertainty is affecting the manufacturing sector and could have a greater impact on the performance of Chinese industry at the start of the year. The services sector and consumer spending are not suffering in the same way, but Chinese authorities are taking risks of a slowdown seriously. The Chinese government and authorities seem determined to counter the country's economic slowdown, which is linked to ongoing trade tensions with the United States.

The PBoC has promised that its monetary policy will adapt to economic conditions, and that it will guarantee reasonably plentiful liquidity, with the aim of reassuring markets. As such, in the first few days of 2019, it reduced its RRR (reserve requirement ratio) by 1%. It has hung onto considerable room for manoeuvre due to the clear slump in price indices. The CPI slid from 2.2% to 1.9%, and the PPI dropped from 2.7% to 0.9% year on year in December.

The finance minister announced tax cuts for small businesses, particularly in the manufacturing sector. To the same end, government spending will be increased through new infrastructure and construction projects. Furthermore, the National Development and Reform Commission has announced measures to reduce bureaucracy and energy consumption, and has also promised to open up more development sectors to foreign investment.

The government seems to be implementing a support package which it values at nearly 300 billion dollars in total (around +1.2% of GDP), including 190 billion dollars' worth of tax cuts. This should foster good growth for the 1st quarter 2019 and fight any current risks of an economic slowdown. With these measures, the government is clearly hoping to put the brakes on the economic slowdown.

Credit growth also improved at the end of the year. This will help the government in its aim of stimulating the purchase of vehicles and consumer goods- Chinese vehicle sales have dipped for the first time in 28 years. Equally, local governments will be allowed to issue more special new bonds in 2019 than in 2018 in order to finance local infrastructure development projects.

Leading PMI indicators still a mixed bag

Leading indicators were still rather optimistic in September, but they have given quite some ground since. At the end of the year, they were pointing to a significant slowdown in manufacturing activity. The Caixin PMI manufacturing index headed below 50 (49.7) in December, suggesting that the period of growth had come to an end. The index has sunk back to levels seen in the 2nd quarter 2017 and confirms CNBS' official PMI figures. Given the tense trade negotiations with the United States, it is only to be expected that the Chinese manufacturing sector should be suffering. On the flipside, the services index (53.9) is showing better conditions, with a slight rise. This means that the global index rose from 51.9 to 52.2 overall.

The services segment accounts for more than half of Chinese GDP; as such, its end of year growth suggests that the Chinese economy is repositioning towards consumer spending and domestic sectors. The support measures announced by the government should put the brakes on the Chinese economic slowdown at the start of the year. The uncertainty which is currently prevailing in China and throughout the world, particularly in the industrial sector, due to the trade war being waged by Donald Trump, is affecting the sector's performance. Nonetheless, should the negotiations soon conclude successfully, this uncertainty could evaporate, and the current trend could be reversed.

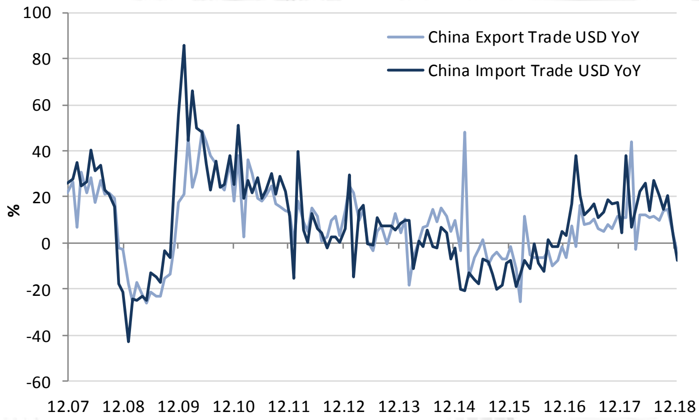
YoY GDP Growth

PMI and Industrial Production

Graph sources: Bloomberg/BBGI Group

Real Estate, Infrastructure and Industrial Investments (YoY)

Exports and Imports (YoY)



Exports fall, but the trade surplus increases

Chinese exports to the United States clearly shrunk in December (-4.4%) as a reaction to the US president's decision to tax Chinese imports more heavily. In parallel, Chinese foreign trade with the United States hit a new record at 323 billion dollars in 2018, thanks to a considerable drop in imports (-7.6%). With negotiations underway, the recent fall in exports drives home the need for a trade agreement with the United States, despite the trade surplus leaping +17% over 2018. Although the negotiations are encouraging, prospects for 2019 are nonetheless concerning due to the pace of the slowdown in global demand.

A trade deal could be reached before 1st March

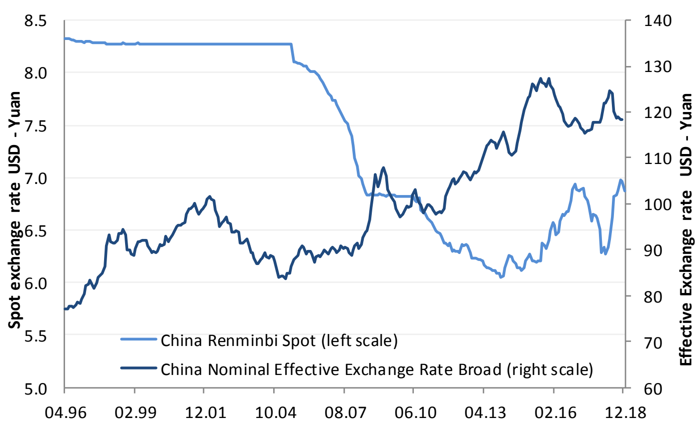
The truce in the trade war between the United States and China agreed upon on 30th November 2018 should foster an environment in which a resolution to the conflict is more likely within the seemingly reasonable 3-month deadline. Financial markets, however, were not reassured by this announcement in December, and instead rather panicked in light of the lack of specific, immediate results, causing an irrational fall in prices across most financial assets. Nevertheless, since then, the messages sent on either side have been rather positive, and have given to understand that the parties sincerely want to find a lasting solution. In just a few weeks, the domestic situations, both in China and in the United States, have presented more important, specific reasons to find a solution. For example, in China, the fall in exports was a major indicator that uncertainty was starting to seriously affect foreign demand, to the point that it was having an impact on the manufacturing sector as a whole. In the United States, the fall on equity markets also revealed that risks of a slowdown in the global economy would also affect the American economy and American businesses, as the CEO of Apple had suggested when he announced a fall in profits due to the slowdown in Chinese consumer spending.

As such, we believe that negotiators must be more motivated than ever to achieve a pragmatic agreement enabling the two countries to move beyond this impasse and make a win-win deal out of what today seems like a power struggle from which neither side will emerge victorious. Negotiators are aware that time is at their backs, and that the negative trend that is currently taking over because of uncertainty must be halted at all costs. We therefore think that an agreement will be found before the 1st March 2019 deadline. This will improve intellectual property protection and rights in China and broaden access to the Chinese market for American businesses.

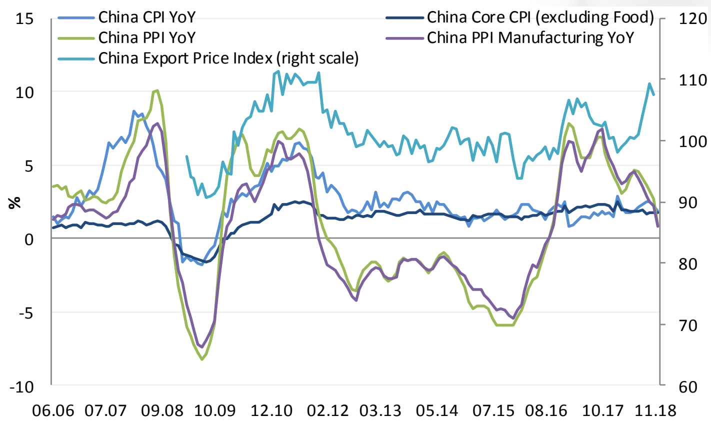
Is the yuan once again a strong currency?

Of course, the yuan suffered in the power struggle between the United States and China in 2018. At the start of 2019, it could be propped up by the new support measures announced by the PBoC and by the favourable developments in the ongoing negotiations. Changes in the political context between the two superpowers will of course be the main factor to influence future fluctuations in the Chinese exchange rate. The yuan appreciated +10% against the US dollar (from 7.3 to 6.25 yuan to the dollar) between December 2016 and March 2018, before correcting by the same amount due to the tensions of the past few quarters. The yuan/USD exchange rate could once again head back to an average rate of 6.7 over the coming months if the ongoing negotiations are successful.

Effective Exchange rate and USD/Yuan



Inflation CPI - Core CPI



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

United Arab Emirates

- UAE Economic Highlights
- Mixed Fortunes for UAE Equity Markets
- ADX second best performing index in the GCC
- DFM worst performing index in the GCC
- What lies ahead for the UAE Economy in 2019?

UAE Economic Highlights

Economic activity in the UAE appears to have taken a hit in the last quarter of 2018 due to the significant drop in oil prices in the period. Nevertheless, on a more encouraging note, growth in the non-oil sector remained steady in Q4 as reflected by the latest PMI data figures suggesting that non-oil GDP growth in 2018 should come up broadly in line with preceding year.

According the latest estimates by the World Bank, the UAE GDP grew at 2.0% in 2018 up from 0.8% in the previous year. The service sector which accounts for 40% of the GDP remains the biggest contributor, almost at par with oil and natural gas exploitation which create 38% of the country's wealth.

The UAE GDP is expected to grow at 3% in 2019, supported by an expansionary fiscal stance, higher government spending and from increasing investment ahead of the Expo 2020.

Inflation in 2018 was recorded at 3.73%, higher than the historical average of approx. 2% due to the implementation of VAT in early 2018. We anticipate the inflation to return to its long-term average of approx. 2% per annum over the coming two years.

Mixed fortunes for UAE Equity markets

GCC equity markets outperformed global peers with a yearly return of 12% in 2018 as compared to 0.7% returns in 2017. Overall performance was mainly driven by Qatar, Abu Dhabi, Saudi Arabia and Kuwait. In line with other GCC Indices, the UAE stock markets witnessed significant volatility during 2018 with Brent down 20% led by oversupply concerns and trade wars between the world's largest economies.

October saw Brent prices reaching a 4 year high level before nosediving on concerns about a risk of oversupply during the final two months of the year pushing back prices to sub-USD 50/b before a marginal recovery by year end.

ADX second best performing index in the GCC

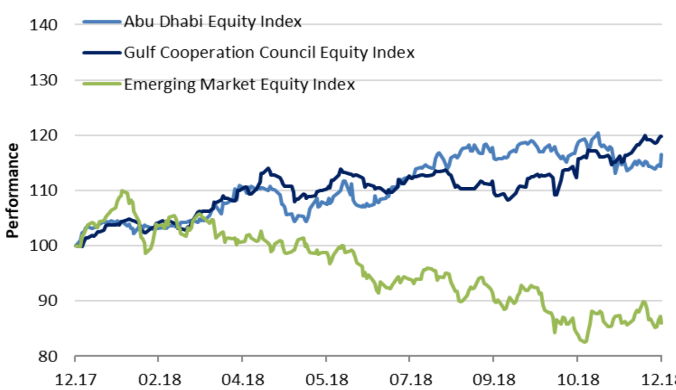
Despite a challenging economic year for the UAE, the Abu Dhabi Securities Exchange (ADX index) finished the year as the second best performing index in the GCC after declining in 2017. The index ended 2018 up +11.7% with banking being the best performing sector (up 26.8%) followed by the energy sector which despite the volatility in oil prices contributed positively to the index - ending the year up +16%.

On the decliners side, Real Estate was the worst performing index, as it declined by 28.3% y-o-y, driven by the same drivers witnesses across the GCC due to political tensions, lagging demand and increased supply. Trading activity was markedly down from AED 46.2 Bn in 2017 to AED 36.8 Bn in 2018.

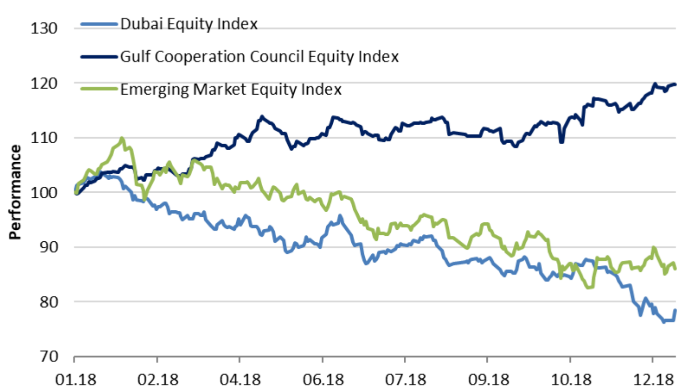
DFM worst performing index in the GCC

The Dubai Financial Market (DFM Index) on the other hand continued its declining trend from 2017 and lost more ground in 2018, ending the year as the worst performing index in the GCC. The DFM index crashed by 24.9% in 2018 as all sectors closed in the red. The Consumer Staple index was the worst performing index, plunging a staggering 61.7% followed by Real Estate and construction sectors which declined by 38.9% y-o-y. The drop in DFM index was mainly driven by the ever declining consumer sentiment due the introduction of the VAT in early 2018 and subdued job market. Trading activity on the exchange was also markedly down for the year as compared to 2017, both in terms of value traded and volumes traded. Value traded on DFM nosedived by 48% y-o-y from AED 114 Bn to AED 59.3 Bn in 2018.

ADX Index (2018) vs Emerging MSCI and MSC GCC



DFM Index (2018) vs Emerging MSCI and MSC GCC



Graph sources: Bloomberg/BBGI Group/UAE Central Bank

Bold reforms to retain talent and promote investment and tourism

The recent volatility in oil prices and stock markets in the UAE underscored once again the need for government to continue on the path of reforms in order to diversify its economy and encourage strong, stable and more inclusive growth. The United Arab Emirates government announced in 2018 a number of bold initiatives to stimulate the economy to increase demand by relaxing regulations.

One of the most ambitious reforms undertaken by the UAE government has been the relaxation to the visa regulations in order to better position the country to attract both foreign investments and human capital to further deepen economic diversification.

As highlighted in our previous publications, the UAE cabinet approved a new 10-year visa for investors, entrepreneurs, executives, as well as specialists working in fields of medicine, science and research in a bet to attract and retain highly qualified professionals in the country.

The UAE federal government also announced a new 5-year retiree visa targeting individuals aged over 55 years with AED 2 million real estate investment ownership or AED 1 million in savings or at least AED 20,000 monthly income to encourage the country's expatriate population to remain longer and to invest a bigger portion of their savings in the UAE, hence contribute more towards the GDP growth.

Finally, the latest measure taking on the visa front was the recent announcement by the government to grant 48-hour visas for transit visitors from almost all nationalities, free of cost. This is expected to positively impact the retain and hospitality sectors in the country considering the increasing number of passengers transiting via Dubai and Abu Dhabi Airports.

Increased government expenditure to bolster economic growth

Last year we witnessed the launch of "Ghadan 21", a USD 13.5 billion economic stimulus package by the Abu Dhabi government aimed at boosting the Abu Dhabi economy over the next three years and promoting the ease of doing business in the emirate. The plan is articulated around 10 economic initiatives to stimulate investment and create jobs while helping the emirate diversify its enconomy further away from its dependence on oil exports.

The Dubai Government on its part is pushing ahead with final phase of the construction of the Expo 2020 and related projects at an estimated cost of USD 6.9 billion. The cost of the expo being linked to a combination of the upgrades to transport infrastructure and real estate construction. Expo 2020 is expected to attract 25 million visitors from across the globe to Dubai and create some 280,000 jobs for the Emirate. Therefore, the real benefits of the Expo should finally be felt in strategic sectors for Dubai such as real estate, construction, retail and hospitality.

What lies ahead for the UAE Economy in 2019

The economic momentum in the UAE was subdued in 2018 mainly due to lower oil prices and regional geopolitical headwinds in the period.

Nevertheless, growth in the non-oil sector proved resilient, which suggests annual non-oil GDP growth in 2018 broadly matched the preceding year. However, as mentioned earlier, the stock market in Dubai posted its worst annual performance since 2008 with a 25% fall, owing to oversupply and falling prices in the critical real-estate market. In contrast, the Abu Dhabi stock index performed robustly.

Looking at 2019, Dubai unveiled its annual budget on 1 January, which was broadly stable from 2018's record expenditures, with a continued focus on infrastructure investment to prepare for Expo 2020. This spending will supplement the largest budget in history which was recently enacted at the federal level.

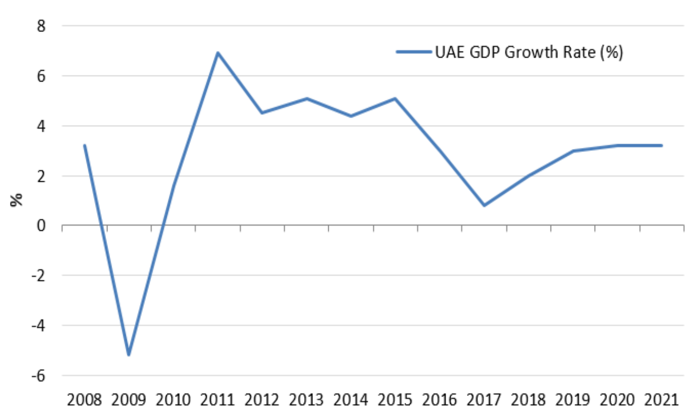
Dubai tourism also confirmed that the Emirate is on track to achieve its target of 20 million visitors by 2020. Dubai is today a world-leading leisure and entertainment destination with number of tourists booming from 8 million in 2010 to an estimated 16.16 million in 2018, placing the Emirate city as one of the fastest growing global destinations. Based on the latest study by Euromonitor International, Dubai ranked 7th amongst the top 10 global destinations and should overtake Singapore as the 4th most visited city in the world by 2020.

Despite uncertain prospects in the oil market, the UAE economy appears ready for liftoff this year, propelled by multiple tailwinds. First thanks to the to strong fiscal stimulus and bold reforms on residency both at the federal and emirate level, Second reason for cautious optimism lies in the Expo 2020-related infrastructure push, which should support construction and tourism activity.

The country should also benefit from a surge in FDI inflows thanks to its recent landmark investment reform and business-friendly laws enacted in the second half of 2018 designed to ease the cost of doing business. As most governments across the Middle East attempt to diversify away from natural resources and build resilient economies, let's not forget that the UAE remains at the forefront of this economic diversification with a leadership that has always embraced new challenges to better position the country both at the regional and global levels.

Nevertheless, a global growth slowdown, which could continue to weigh on oil prices, ongoing trade wars, and increased financial volatility could somewhat cloud this rosy outlook.

UAE GDP Growth Rate (%)



Graph sources: Bloomberg/BBGI Group/Asteco UAE Real Estate Report Q3 2018

Top 10 Global Destinations in 2018

Rank	City	Country	2018 arrivals	2018 change
1	Hong Kong	Hong Kong, China	29,827.20	+7%
2	Bangkok	Thailand	23,688.80	+5.5%
3	London	U.K.	20,715.90	+4.5%
4	Singapore	Singapore	18,551.20	+5.3%
5	Macau	Macau	18,931.40	+9.3%
6	Paris	France	16,863.50	+6.5%
7	Dubai	U.A.E.	16,658.50	+5.5%
8	New York City	U.S.	13,500.00	+3.1%
9	Kuala Lumpur	Malaysia	13,434.30	+4.6%
10	Shenzhen	China	12,437.30	+3%

Source : UAE Central Bank,

MACROECONOMIC SCENARIO

Emerging Markets

- The fall in crude prices over the quarter weighed on price indices
- Slight decrease in GDP growth expectations

Economic situation by country

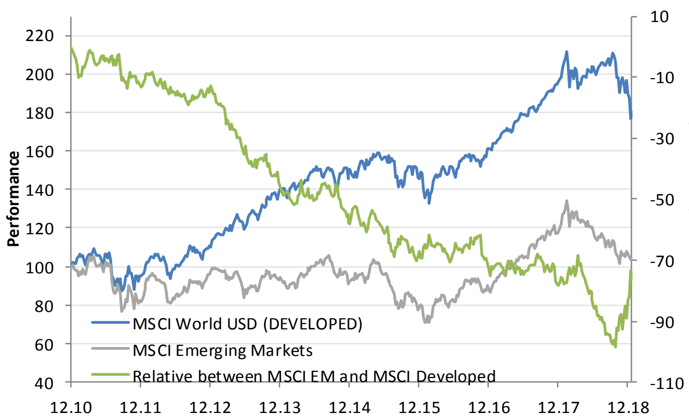
Brazil – Recent data regarding economic activity continue to point to a gradual upturn in Brazil's economy. The global outlook, however, remains challenging for emerging economies. The main risks arise from growing risk aversion in global financial markets, the normalisation of interest rates in some developed countries, as well as uncertainty regarding world trade. According to the central bank's Focus survey, inflationary expectations for 2018, 2019 and 2020 are of 3.7%, 4.1% and 4.0%, respectively, and 3.75% for 2021. The central bank's monetary committee (Copom) notes that the risks surrounding its baseline scenario are many and varied. A significant downturn of the global economy could lead to a lower inflation rate than expected. In addition, frustration with regard to the continuation of reforms and to necessary adjustments to ensure the health of the economy may affect risk premiums and thus widen the inflation forecast range over the time horizon relevant to the conduct of monetary policy. Based on its baseline scenario, the balance of risks, and available data, the Copom unanimously decided to maintain the Selic rate at 6.50%. The Copom deemed this decision to be in line with its baseline scenario with regard to inflationary expectations and the associated balance of risks and is consistent with the convergence of inflation targeted by current monetary policy.

The Copom continued to emphasise that a continuation of reforms and necessary adjustments to the Brazilian economy are crucial to maintaining a low level of inflation in the medium to long term, to reducing the structural interest rate, as well as to ensuring a sustainable economic recovery. The Copom reiterated that current economic conditions call for a monetary policy that can stimulate the economy via interest rates below the structural level. Based on the Copom's assessment, the evolution of its baseline scenario and the balance of risks call for maintaining the Selic rate at its current level for now. Nevertheless, the Copom continues to monitor economic activity in Brazil as well as inflation projections.

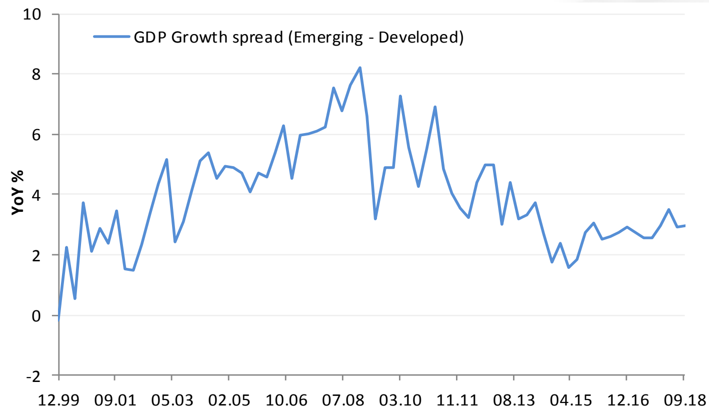
Russia – On 14 December 2018, the board of directors of the Central Bank of Russia decided to raise its key rate by 0.25 bps to 7.75% per annum. The decision is proactive and aims to limit the risks of inflation, which remain high, in particular in the short term. Uncertainty remains with regard to future external conditions and to the reaction of prices and inflationary expectations to the upcoming increase in the VAT. The rate hike will help prevent inflation from staying anchored at a level substantially above the bank's target rate. According to the central bank's forecasts, the consumer price growth rate will likely be between 3.9% and 4.2% by the end of 2018. The increase in the VAT and the depreciation of the rouble over the year will likely then result in a temporary acceleration of annual inflation, which should reach a high during H1 2019 before sliding back down to 5-5.5% by the end of 2019. Thereafter, it should decrease further to around 4% in 2020, once the impact of the rouble's depreciation and the increase in the VAT subsides.

The rate hike is thus proactive and will help to limit the risks of inflation staying put at a level well in excess of the Bank of Russia's target rate. These forecasts factor in the bank's decision, scheduled to take effect on 15 January 2019, to resume regular purchases of foreign currencies on the domestic market, in accordance with the budget rule. The central bank is not precluding further rate hikes should inflation, economic momentum, risks related to external conditions or the reaction of financial markets deviate from respective projections. Russian economic growth decelerated slightly, staying close to its objective. In Q3 2018, annual GDP growth fell to 1.5%, consistent with the Bank of Russia's forecast, mainly due to the high base effect in agriculture. Industrial output continued to grow in October, while growth in consumer demand slowed down compared to previous months, due to slower non-food sales. As for investment activity, it continued to rise in Q3. In this context, the Bank of Russia kept its annual GDP growth forecast unchanged at 1.5-2% for 2018.

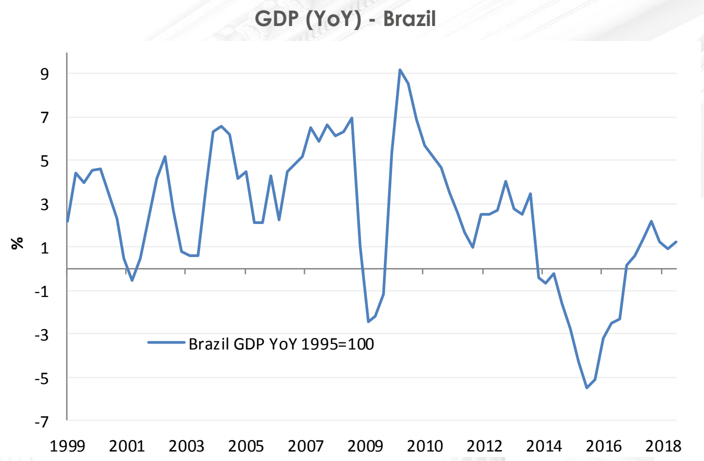
Emerging and Developed Markets - Performance



GDP Growth spread



Graph sources: Bloomberg/BBGI Group

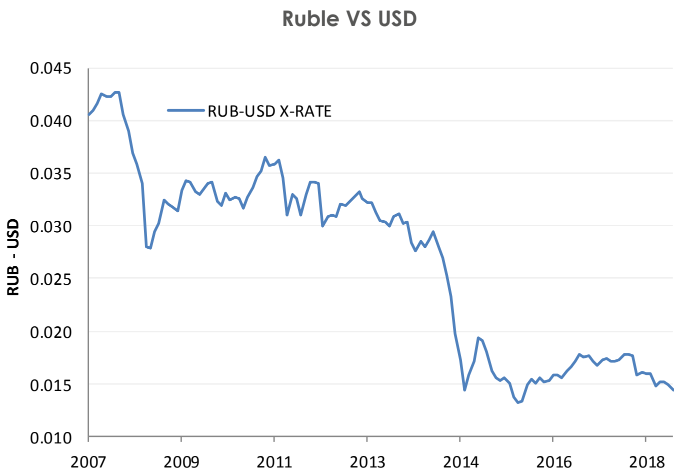


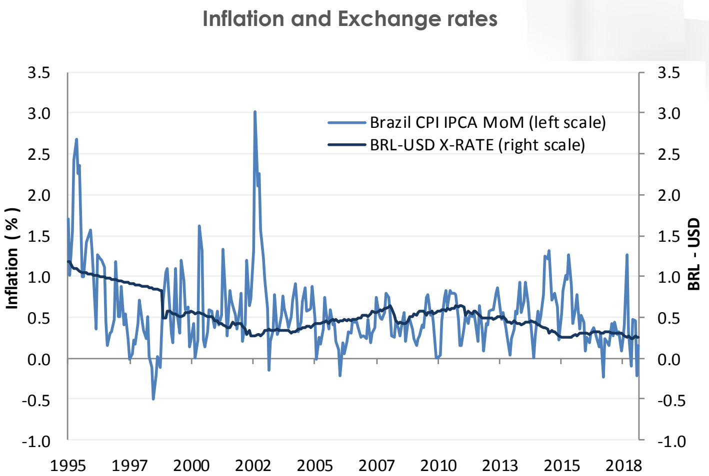
The Bank if Russia's view on the medium-term growth prospects of the domestic economy remains practically unchanged. Due to the budget rule, the decrease in the average annual oil price from 63 to 55 dollars per barrel in the 2019 baseline scenario will have little influence on macroeconomic fundamentals. In 2019, the upcoming VAT increase may have a slight constraining effect on business activity, particularly at the beginning of the year. The newly attracted funds will be used to boost government spending, including spending on investments, as early as 2019. As a result, according to the Bank of Russia forecast, GDP growth in 2019 will range between 1.2% and 1.7%, while the following years might see higher growth rates as the planned structural measures are implemented.

India – Since the last monetary policy meeting, several important developments affected the inflation outlook. First, in spite of a significant reduction in inflation projections in October already, mainly due to a moderation in food inflation, new data continued to come in lower than expected, with the food group even slipping into deflation. Second, in contrast to the food group, there was a broad-based increase in inflation in non-food groups. Third, crude oil prices have declined sharply since the last meeting. However, selling prices, as reported by firms polled in the Reserve Bank of India's latest IOS, are expected to edge up further in Q4 on the back of increased demand. Taking all these factors into account and assuming a normal monsoon in 2019, inflation is projected at 2.7-3.2% by the end of 2018 and at 3.8-4.2% in H1 2019. Financial market volatility, slowing global demand and rising trade tensions pose negative risks to exports. However, on the upside, the decline in crude oil prices is expected to boost India's growth prospects by improving corporate earnings and raising private consumption thanks to higher disposable incomes. Furthermore, investment activity has accelerated significantly, and leading indicators suggest that this situation is likely to persist.

Thus, the central bank is forecasting GDP growth of 7.4% for 2018 and 7.5% for H1 2019. In this context, the monetary policy committee (MPC) decided to keep the repo rate steady and maintain its stance of calibrated tightening. The MPC also reiterated its commitment to achieving its medium-term inflation objective of 4% on a durable basis.

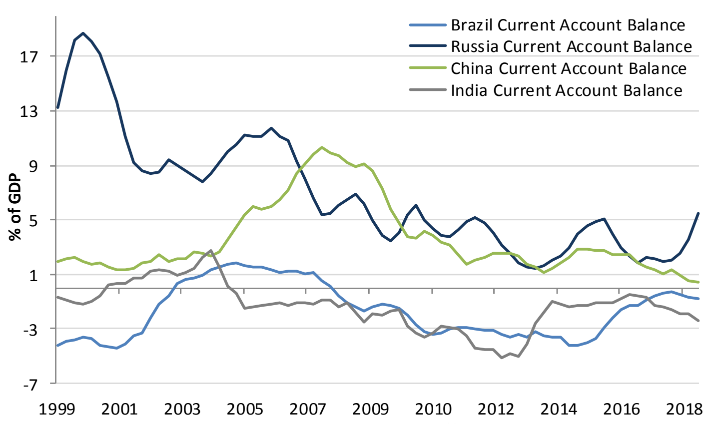
South Africa – Inflation projections improved significantly since the previous monetary policy committee (MPC) meeting. While remaining within the inflation target range throughout the forecast period, the South African Reserve Bank's (SARB) model projects an increase in inflation, albeit slightly lower than the September projection. Inflation is now expected to average 4.7% in 2018 (down from 4.8%), before increasing to 5.5% in 2019 and stabilizing at 5.4% in 2020, thus deviating from the mid-point of the target range. The MPC continues to deem that risks to the long-term inflation outlook have risen slightly. These risks include tighter global financial conditions, a weaker exchange rate, higher wage growth, oil prices and rising electricity and water tariffs. The domestic growth outlook remains challenging. Recent data on economic performance in key sectors suggest a more moderate recovery in growth in Q3 than expected in September. Thus, the SARB now forecasts growth in 2018 to average 0.6% (down from 0.7% in September), while the forecast for 2019 and 2020 is unchanged at 1.9% and 2.0% respectively. The MPC estimates risks to the growth forecast to be somewhat on the downside. The Committee remains of the view that current challenges facing the economy are primarily structural in nature and cannot be solved by monetary policy alone. Prudent macroeconomic policies are essential to ensuring that growth is sustainable and that the economy is more resilient to shocks. These should be complemented by implementation of credible structural policy initiatives with a clear impact on the cost structure of the economy, output and employment. Given available data, the MPC decided to increase the key rate by 25 basis points to 6.75%, continuing to reflect a monetary policy it terms accommodative.



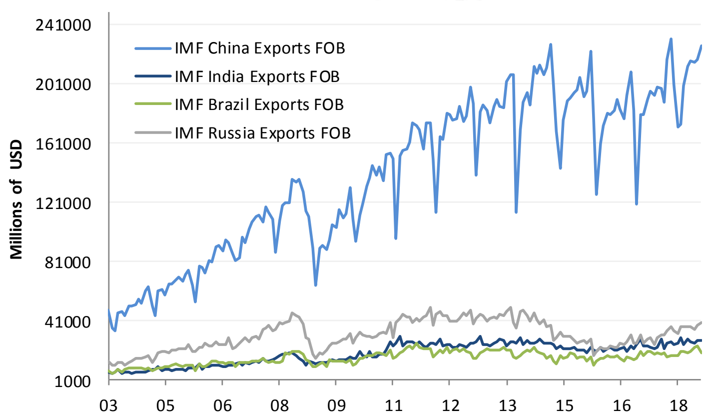


Graph sources: Bloomberg/BBGI Group

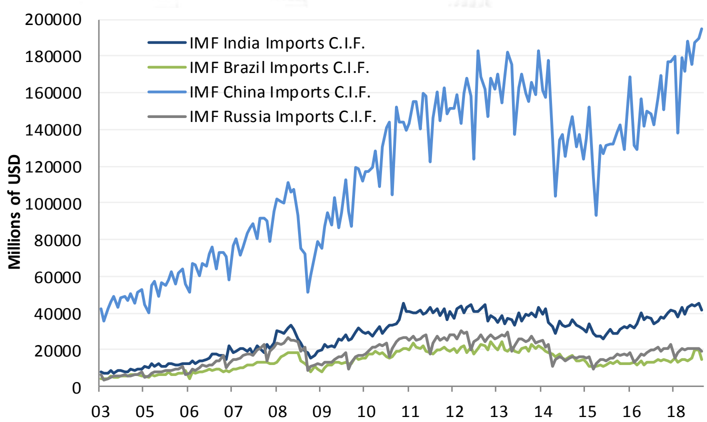
Current Account Balance



BRIC Exports



BRIC Imports



Colombia – In November, inflation fell to 3.27%. Medium-term inflationary expectations have changed very little and remain above 3.0%. Beyond the one-year horizon, analysts' expectations are slightly higher at around 3.4%. In Q3, domestic demand turned out stronger than expected, driven mainly by investments in construction. The economic activity indicators for Q4 suggested that output growth would be slightly higher than in Q3. Thus, central bank analysts maintained their economic growth forecast for 2018 at 2.6%, noting that the country's productive capacity continues to be underutilized. In this context, given its assessment of economic conditions and the balance of risks, the central bank deemed it appropriate to maintain the benchmark interest rate at 4.25%

Indonesia – On 20 December, Bank Indonesia kept its key rate unchanged at 6% following the previous month's hike. Policy-makers stated that the decision to pause monetary tightening is consistent with efforts to reduce the current account deficit to a more healthy level of around 2.5% of GDP in 2019, while maintaining the attractiveness of the domestic financial market for foreign investors and with due consideration to rising global interest rate in the next few months.

Mexico – As widely expected, at its December 2018 meeting the Bank of Mexico raised its key rate by 25 basis points to its highest level in the past 10 years (8.25%). The bank stated that it was necessary to take measures to restore investor confidence, given that volatility in global markets is high and uncertainty with regard to domestic politics still has not diminished. As for the annual inflation rate, it fell to 4.72% in November 2018 from 4.90% the preceding month but remains above the target range.

Taiwan – The Central Bank of Taiwan kept its key rate steady at 1.375%, which is unchanged since June 2016, as it is concerned with regard to a slowdown in economic growth and financial market volatility resulting from the trade dispute between the US and China along with a tightening of global financial conditions. The central bank lowered its growth forecast for 2019 from 2.48% to 2.33%.

Turkey – The Central Bank of the Republic of Turkey kept its key rate unchanged at 24% on 13 December, after inflation declined more than expected in November. The bank also stated that monetary policy would stay tight until the inflation outlook improved significantly.

Romania, Czech Republic, Poland, Hungary – The National Bank of Romania kept its key rate steady at 2.5%, in line with market expectations. In November, the annual inflation rate fell to 3.4%, its lowest level in 11 months and within the bank's 1.5-3.5% target range.

The Czech National Bank, as anticipated, kept its key rate unchanged at 1.75% on 20 December 2018. The annual inflation rate fell from 2.2% in October to 2% in November, in line with the central bank's objective and its lowest level since April.

The National Bank of Poland kept its key rate at a historically low level (1.5%), in line with market expectations. In November, the annual inflation rate fell to 1.3%, its lowest level since March.

The Central Bank of Hungary kept its key rate steady at 0.9% on 18 December 2018. The bank is thus maintaining a stable monetary policy following a decline in inflation, whose annual rate fell from 3.8% in October, close to the highs reached six years ago, to its lowest level in the past five months (3.1%) in November.

Graph sources: Bloomberg/BBGI Group


A STAR ALLIANCE MEMBER

PROSPECTS AND STRATEGIES

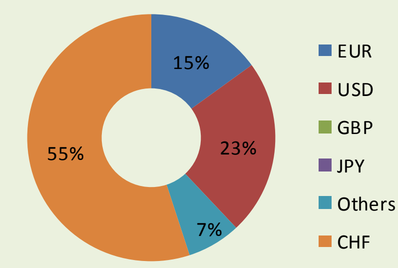
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Currencies

- Swiss franc is heading for further weak spells
- Euro is surprisingly stable
- Limited prospects for the US dollar
- Is the yuan a strong currency again?

Currency allocation - CHF portfolio



Tactical Allocation

- Underweight CHF
- Favor USD and AUD
- Overweight EUR
- Avoid JPY

LIQUIDITY/ CURRENCY	Expected Return 3months	1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
EUR vs CHF	↗	↗							
USD vs CHF	↗	→							
GBP vs CHF	↘	↘							
JPY vs CHF	↘	↘							
EUR vs USD	↗	↗							
USD vs JPY	↗	↗							
GBP vs USD	↘	↘							

Swiss franc is heading for further weak spells

After the significant appreciation of the European currency to 1.20 in April, we were expecting a phase of consolidation of the exchange rate, which occurred amidst an uncertain political context in the Eurozone. The Swiss economy, which appeared stronger several months ago, fell into line with the Eurozone's.

The economic growth differential, which at the time clearly favoured the Swiss franc, is no longer significant. Any future phase of weakness of the franc will depend on the relative economic performance of and on the interest rate spread between the franc and the euro. We continue to expect that the SNB will not raise rates as fast as the ECB. In the meantime, the exchange rate will likely stabilise between 1.12 and 1.17 against the euro.

Swiss economic performance was negative throughout the 3rd quarter 2018, and rather considerably affected by the clear slump in activity in Germany. The growth differential had worked in Switzerland's favour in the previous quarter but then swung in favour of Europe and the Eurozone. There should be no great change in this new trend at the end of the year.

Growth is weaker in Switzerland, but is still nonetheless essential in order for the Eurozone to achieve significantly better growth than is currently being achieved in order for the franc to start to weaken again. The interest rate differential between the franc and the euro has not changed a great deal and we still do not believe that the SNB will raise its key rates until the ECB does. The current situation seems to have pushed this prospect back, at least until the last quarter 2019.

In the meantime, the exchange rate should stabilise between a lower bound of 1.12 and an upper bound of 1.17 against the euro. The Swiss franc should also weaken against the US dollar and head back above one-to-one in the coming months.

Euro is surprisingly stable

The Eurozone's challenging economic environment stands in rather sharp contrast to that prevailing in the US. Fears of a recession have been raised in both cases, but the Eurozone is decidedly more at risk, as the US economy continues to grow without encountering any real obstacle.

However, the euro surprisingly was not negatively impacted over the past several months by this factor, which should have penalised it. The interest rate spread between the euro and the US dollar and diverging economic performances did not cause any significant movement. The current exchange rate of 1.15 USD to the euro likely already incorporates a good number of euro area risk factors.

The current stabilisation could then give way to a stronger euro in 2019 if growth prospects normalise. Accordingly, the long-term interest rate spread could decrease and benefit the single currency.

Limited prospects for the US dollar

The US dollar is still enjoying attractive yield differentials with most currencies, but this situation could change over the coming months. As far as 2019 is shaping up, yield differentials will likely be undermined by upward rates forecasts for the Eurozone and in other developed and emerging economies. The US dollar has benefited from the American cycle being a step ahead of other regions. Reforms and tax cuts should now have less of an impact, which should lead to a slowdown or normalisation of US economic growth rates. If global growth recovers in 2019 the US dollar will probably become less attractive comparatively speaking.

We are maintaining an upward forecast for the US dollar in the short term. The currency may head upwards of one-to-one against the Swiss franc. That said, the US dollar should gradually become less attractive as compared to the euro, the yuan, and other emerging currencies as the economic climate improves.

Graph sources: Bloomberg/BBGI Group

The yen is necessarily weaker

We are not changing our forecasts for the yen; the downward forecasts are here to stay for 2019. For several quarters, we have been pointing out that the yen needed to be weak in order to kick-start activity in Japan. This weakness should breathe a breath of fresh air into the Japanese economy, enabling it to get back to a more sustained growth rate. We also predicted that ten percent depreciation of the yen against the US dollar, which would take the exchange rate to 105 in March and 115 in the second half the year, would be enough to help out the eagerly anticipated recovery. In our analysis in March, we pointed out that the strength of the yen was due in part to its use as a safe-haven currency in an uncertain context, and announced that the exchange rate would probably return to 110-115 once volatility on financial markets had receded. Monetary policy is still aiming to weaken the yen, but the means available remain limited.

We remain of the opinion that investors will probably drop the yen because of the wholly unfavourable interest rate environment and rate differentials which should continue to punish the currency. US monetary policy normalisation and prospects of a rise in long rates in the United States should have a much greater impact on the value of the yen in 2019. After having hit our 115 target, the yen should stabilise, and then weaken again.

The pound is still feeling the pressure of Brexit

For over two years the pound has been hostage to the complex political situation that has been generating uncertainty with regard to the UK's economic outlook. We still believe the pound has entered a stabilisation phase against most major currencies following its historic fall in the wake of the June 2016 vote pending better visibility on the political front.

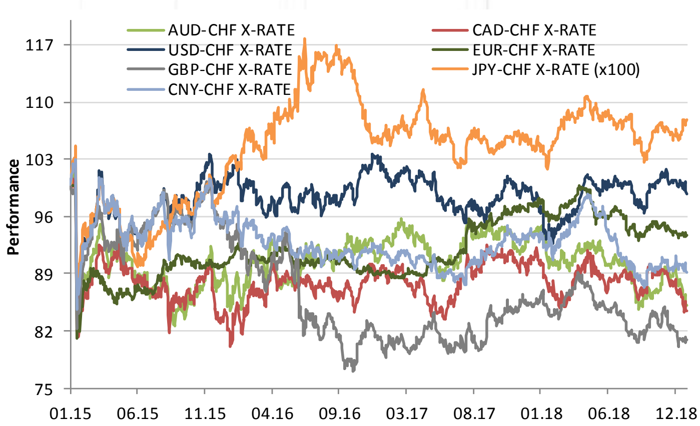
A "no deal" scenario in three months would certainly be the most dramatic for the British currency, which would likely not withstand the hit and could fall another -10% to -25% (worst case scenario according to the BOE). Previously, the pound had benefited from the negotiation period in 2017 and at the start of 2018; it helped it stabilise and appreciate +19% against the US dollar (+15% against the Swiss franc and +7.5% against the euro) before it then yielded two thirds of the ground it had gained at the end of the year. The British pound is naturally still in limbo, waiting to see how the political crisis in the United Kingdom plays out.

Australian dollar on the up

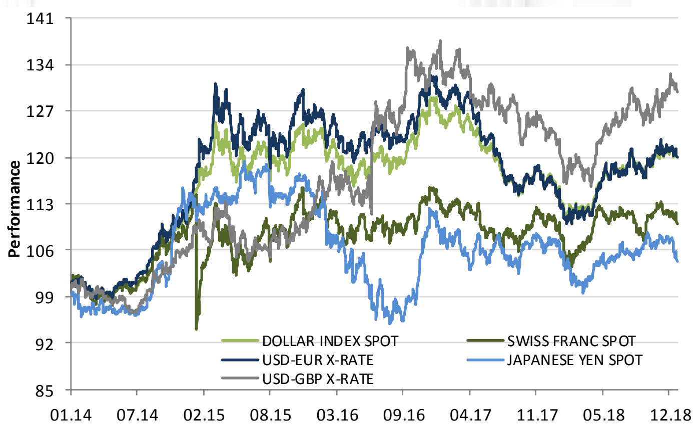
In 2019, changes in the Australian dollar will still be closely linked to growth prospects for the Chinese economy and future commodity trading between the two countries. In 2018, the Australian dollar was severely affected by the prospect of a considerable slowdown affecting both China and the yuan, with which the Australian dollar is strongly correlated. The outcome of the negotiations between the US and China will therefore be critical for the Australian economy and the Australian dollar. Investors are currently particularly negatively positioned on this currency, suggesting a strong tactical recovery should a trade deal surface before March.

The PBoC's latest decision to reduce its RRR by 1% may not be enough to spark renewed interest in the Australian dollar, but it is already helping to improve sentiment. The Australian dollar has remained stable against the US dollar since the start of September, consolidating between upper and lower bounds of 0.74 and 0.7. The Australian dollar would benefit from a trade deal being announced and could recover to its three-year average of 0.76.

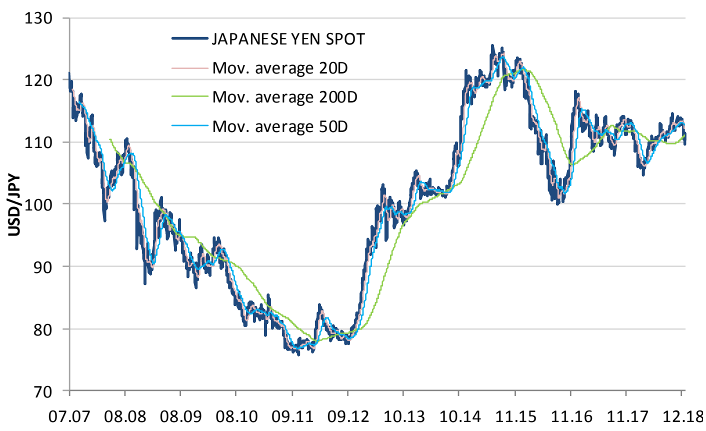
7 currencies against CHF (Normalized at 100)



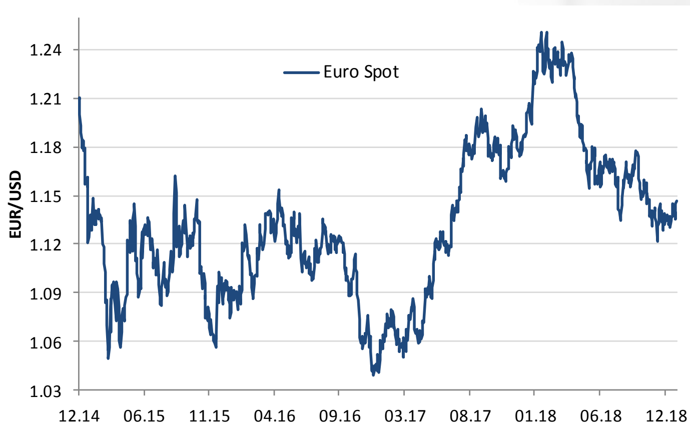
Dollar Trade-weighted index & cross rates (Normalized at 100)



JPY/USD



EUR/USD



Graph sources: Bloomberg/BBGI Group

Is the yuan a strong currency again?

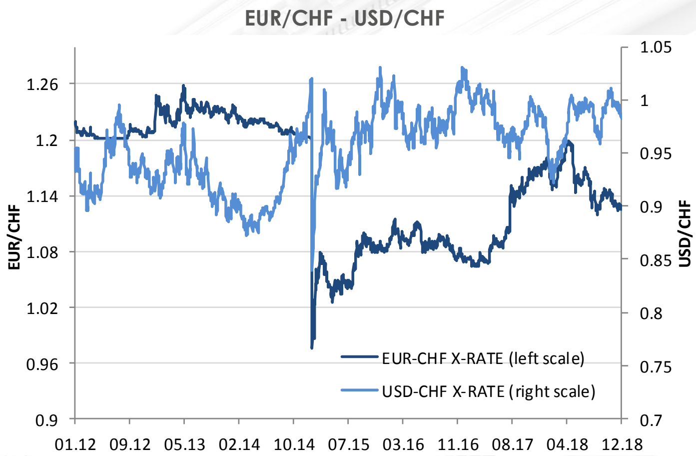
The yuan naturally came off badly in the power struggle between the US and Chinese authorities in 2018. At the start of 2019, it could be propped up by new support measures announced by the PBoC, and by a favourable outcome to the ongoing negotiations. The 1% drop in RRR (reserve requirement ratio) announced at the start of 2019, following four reductions in 2018, could be increased further if there is a pronounced slowdown in growth. A decrease in obligatory deductions and taxes on small- and medium-sized businesses is also considered a good sign for growth.

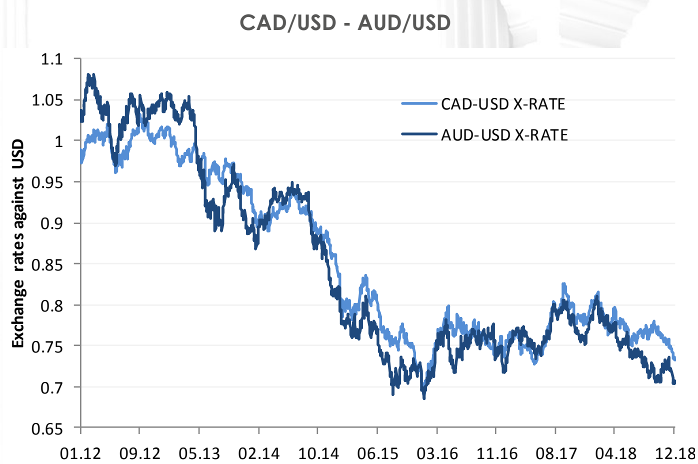
The way in which the political situation between the two superpowers develops will obviously be key in influencing future fluctuations in the yuan's exchange rate. The yuan had appreciated about +10% against the US dollar (from 7.3 to 6.25 yuan to the dollar) between December 2016 and March 2018, before correcting by the same amount in the tense atmosphere of the last few quarters. The yuan/USD exchange rate could change again and head back to 6.7 over the coming months if the ongoing negotiations are successful.

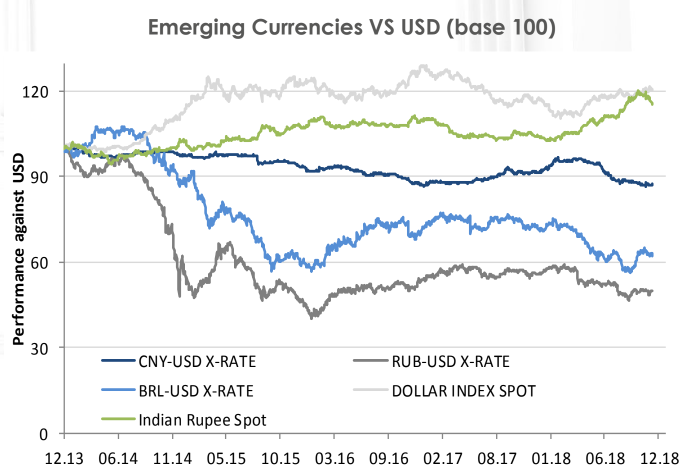
CURRENCIES

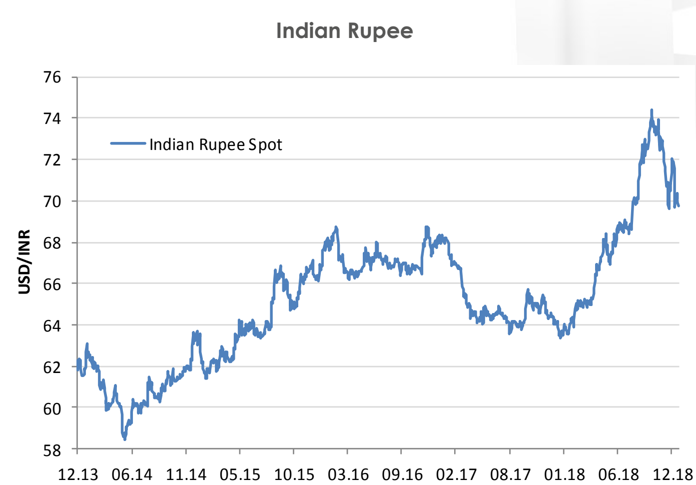
31.12.2018

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
AGAINST DOLLAR						
EUR-USD X-RATE	1.1	0.5	1.3	-0.7	-1.6	-4.5
CHF-USD X-RATE	1.0	0.5	1.7	0.2	1.2	-0.7
GBP-USD X-RATE	1.3	0.4	0.0	-1.7	-3.6	-5.6
JPY-USD X-RATE	0.0	0.8	3.5	3.7	0.8	2.8
CAD-USD X-RATE	0.7	-0.3	-2.5	-6.0	-3.6	-7.8
AUD-USD X-RATE	0.7	0.0	-3.5	-1.9	-4.6	-9.7
RUB-USD X-RATE	0.0	-0.8	-3.1	-5.3	-8.5	-16.7
CNY-USD X-RATE	0.1	0.3	1.2	-0.1	-3.6	-5.3
INR-USD X-RATE	0.0	0.5	0.2	5.3	-1.1	-8.3
BRL-USD X-RATE	0.3	0.6	-0.4	1.5	0.8	-14.7
AGAINST SWISS FRANC						
USD-CHF X-RATE	1.0	-0.4	-1.6	-0.2	-1.1	0.8
EUR-CHF X-RATE	1.1	0.0	-0.5	-0.9	-2.7	-3.8
GBP-CHF X-RATE	1.3	0.0	-1.6	-1.9	-4.7	-4.9
JPY-CHF X-RATE (x100)	0.9	0.3	1.8	3.5	-0.3	3.6
CAD-CHF X-RATE	0.7	-0.7	-4.0	-6.1	-4.6	-7.2
AUD-CHF X-RATE	0.7	-0.1	-4.7	-1.8	-5.3	-8.8
RUB-CHF X-RATE	0.0	-1.2	-4.8	-5.5	-9.6	-16.0
CNY-CHF X-RATE	0.1	-0.2	-0.6	-0.3	-4.7	-4.7
INR-CHF X-RATE	0.0	0.0	-1.4	5.2	-2.1	-7.8
BRL-CHF X-RATE	0.3	0.0	-1.9	1.2	-0.4	-13.9







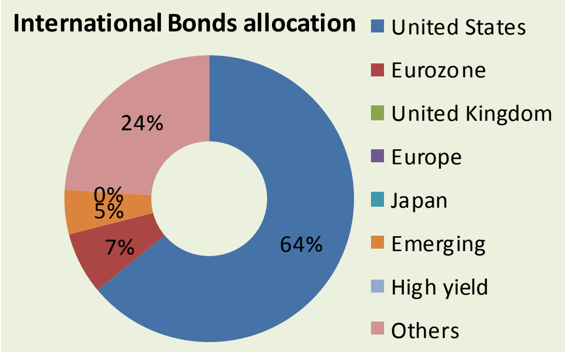


Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

International Bonds

- No yield curve inversion in the US
- Temporary reprieve for euro fixed income markets
- Negative outlook for GBP bonds
- US market still our first pick following the recent downswing in interest rates



Tactical Allocation

- Reduce exposure to Eurozone
- Overweight US bonds
- Diversify risks through an exposure to CAD and AUD
- Sell high yield bonds

BONDS (Areas/currency)	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Switzerland	↘	↘↘							
United States	↘	↘							
Eurozone	↘	↘↘							
UK	↘	↘							
Europe	↘	↘↘							
Japan	↘	↘							
Emerging	↘	↘							
Other (AUD, CAD, NOK...)	→	→							

No yield curve inversion in the US

In December, in a matter of days, fears of a yield curve inversion spread like wildfire, contributing to a large extent to the abrupt plunge in equity markets and downswing in interest rates seen not only in the US but in most other countries. This much hyped yield curve inversion likely originated in a situation observed in the US Treasury bond market on 4 December and in the days following. For the first time, the yield on 3-year US Treasury bonds was higher than that on 5-year maturities. This was enough to start fanning the notion that investors were obtaining higher returns on short-term than on long-term US government debt and that this indicated that the yield curve was inverting as a whole.

However, only a brief analysis was needed to show that these risks were completely exaggerated and there was no threat of a yield curve inversion in the immediate future. The yield curve was simply flattening in response to two distinct forces with differing effects on short and long maturities. The first of these two forces was generated by the Fed, while the second was instead the result of investor expectations with regard to the outlook on growth and inflation. Thus, the central bank's efforts to normalise its monetary policy via regular rate hikes impacted the short end of the yield curve, making it rise in stages, in particular with regard to maturities between 1 and 12 months.

With regard to longer maturities, the shift occurred in the other direction given diminishing inflationary pressures and rising uncertainty with regard to economic growth in 2019 over the past few weeks. Thus, the yield curve was shifting upward on the short end while it was shifting down on the long end. This phenomenon led to yields on various maturities shifting closer together but did not modify the "normality" of the curve. In other words, long-term yields remain higher than short-term yields, but the slope of the curve naturally tended to flatten. For all that, was it necessary to draw the conclusion that a flattening yield curve would necessarily and rapidly be followed by an inversion, as many investors seemed to have assumed at the beginning of December? It is also surprising to note how this shortcut with regard to risk analysis and assessment affected so many participants and investors, likely in too much of a hurry to react rather than verify the accuracy of the prediction.

Note as well that the current economic situation, as well as the outlook for 2019, does not seem to be indicating an acceleration of economic momentum that would lead to excessive inflationary pressure. The US economy is unlikely to accelerate given the current environment, and inflation is naturally slowing down as crude prices fall, sliding from 2.5% to 2.2% in November, closer to the Fed's target. In the current context, the decline in inflation is a crucial factor in predicting the Fed's future monetary policy. Thus, our analysis favours a scenario wherein the Fed changes its stance in the near future, underlining the increased vigilance of all members of the FOMC with regard to the risks of a potential unwanted inversion of the yield curve.

BOND INDICES (local currency)

31.12.2018 — Total Return Performance

	Name	Last price	Curr.	7 d%	1 m %	3 m %	6 m %	YTD %
SWISS BONDS	SBI AAA-BBB	136.5	CHF	0.1	0.9	1.2	0.5	0.1
UE BONDS	Barclays EuroAgg	249.7	EUR	0.1	0.6	1.0	0.0	0.4
UE BONDS - SHORT DURATION	ISHARES EURO GOV BND 1-3	144.0	EUR	0.0	0.2	0.7	0.1	-0.3
US BONDS	JPM U.S. Aggregate Bond Index	632.1	USD	0.3	1.9	1.6	1.6	-0.1
US BONDS - SHORT DURATION	BGF-USD ST DURATN BOND-USDA1	8.4	USD	0.4	0.4	0.4	0.8	0.7
EMERGING BONDS	JPMorgan Emerging Markets Bond	523.3	USD	0.0	1.4	-1.4	0.5	-5.2
INTERNATIONAL BONDS (DIVERSIFIED) - USD	JPM Global Aggregate Bond Index	564.1	USD	0.4	2.1	1.6	0.5	-1.0
INTERNATIONAL BONDS (DIVERSIFIED) - EUR	JPM Global Aggregate Bond Index	648.0	EUR	0.2	1.1	2.7	2.3	4.0
INTERNATIONAL BONDS (DIVERSIFIED) - CHF	Barclays Global Agg Corporate	141.3	CHF	-0.2	-0.1	-0.6	-1.2	-2.4
CONVERTIBLE BONDS (UE)	Exane Europe Convertible Bond	7353.2	EUR	0.1	-2.1	-5.8	-4.7	-4.9
HIGH YIELD BONDS	Markit iBxx Gbl Dev Lq HY USD	139.2	USD	0.5	-1.2	-4.5	-2.4	-3.7
HIGH YIELD BONDS - SHORT DURATION	AB SHORT DURATION HI YD-AT	14.2	USD	0.4	-1.2	-2.5	-0.8	-1.1

1) Short & Medium-term (1-5 years)
2) Emerging Bonds (Corporate)
3) Emerging Bonds - Eastern Europe

Graph sources: Bloomberg/BBGI Group

The Fed chair already hinted at such a change in policy, mentioning that the current policy rate levels were now just below the level he considers neutral given the current economic context. The Fed will thus likely remain particularly careful not to risk slowing down the economy by raising rates inappropriately. We believe the Fed will adopt a cautious policy over the next few quarters, leaving its rates unchanged as long as stronger growth does not cause inflation to accelerate. In addition, falling energy prices are currently acting as a brake on inflation. However, we anticipate that a positive economic outlook should quickly reverse the downward trend in fuel prices. First, inflationary risks appear moderate, but expected inflation will likely increase gradually, driven in particular – as long anticipated – by wage increases (+3.2% in December), which should intensify in 2019.

With regard to long-term rates, the correction from 3.2% to 2.6% seen in November and December appears to be petering out. It is unlikely that it will further benefit from the reinvestment of liquidity generated by the sell-off and from the fears of recession. Long-term rates will likely gradually increase back to 3%. The downward trend in yields in the dollar bond market over the past few weeks will thus likely be followed by an upswing. That said, by international comparison, current yields all along the government and corporate yield curves offer attractive relative investment opportunities. Yields on government debt currently provide an excellent opportunity to diversity within the fixed income universe. Indeed, current yields continue to provide better protection to investments in dollars against a potential rise in interest rates than to investments in other currencies, in particular in the Eurozone. The US market will thus likely rather quickly attract the renewed interest of investors looking for quality yields in a safe currency and benefit from a likely risk transfer and inflow of funds from the European market.

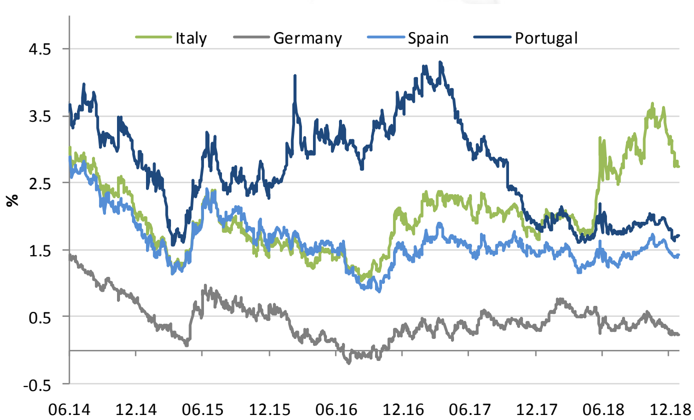
With regard to default risk, in this context we recommend rapidly reducing exposure to the US high yield segment, as it presents significant risks of imbalance and price correction as risk premiums readjust. Indeed, the increase in yields on investment grade issuance will likely attract funds that up until now were invested in that riskier segment. Consequently, the current risk premium, which is presently at a 10-year low and close to the level it had reached just before the 2007-2008 financial crisis, could undergo a significant and abrupt adjustment.

Temporary reprieve for euro fixed income markets

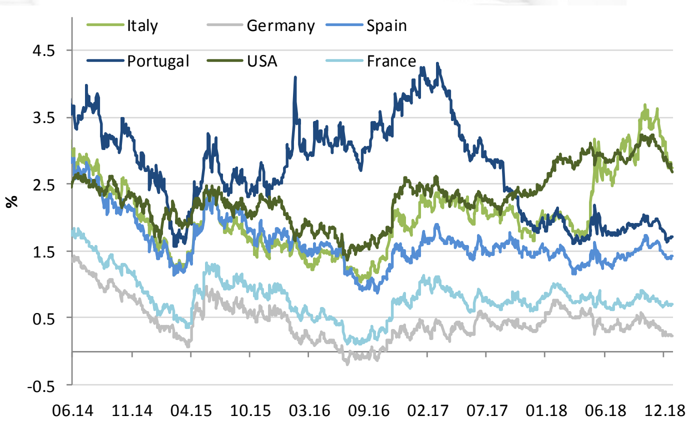
The economic slowdown in the EU unsurprisingly reduced upward pressure on long-term euro rates. The risks of an adjustment or of a rate shock across the entire yield curve thus are now significantly lower. Inflation is trending down, due in particular to the drop in energy prices, and is not currently a threat requiring a quick adjustment in rates. President Draghi still seems convinced that the job market will show increasing signs of upward pressure on wages, which will ultimately lead to an increase in underlying inflation over the next few months. Indeed, the trend is positive, as the unemployment rate dropped below 8% for the first time in ten years. Inflation was only 1.9% in November, or 1% excluding food and energy. We believe that these short-term trends are somewhat counter to the ECB's assessment. They also affect the estimation of long-term rates' normal levels, which is tied to the assessment of inflationary trends, the growth rate, and the ECB's quantitative policy.

The risk of an increase in long-term rates is somewhat deferred for now given the economic slowdown, but it is possible that demand for government securities will be significantly impacted by the termination of the ECB's purchasing programme, causing volatility to increase in euro fixed income markets. Recall that ECB purchases had absorbed almost the entirety of net new sovereign bond issuance in the euro area in 2018. Assuming Germany does not go into recession, the yield on the 10-year German Bund will likely be closer to the 0.55% level reached in October.

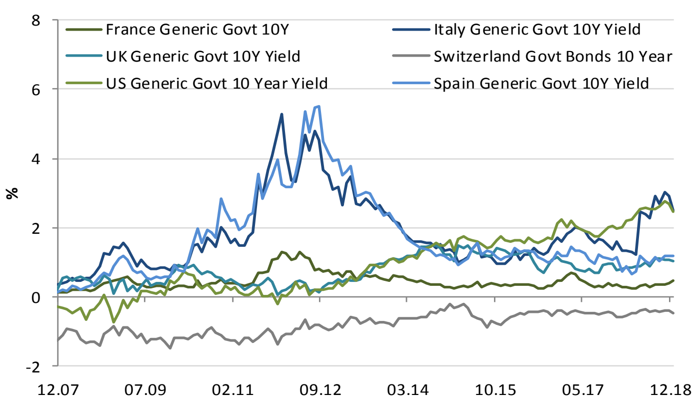
European Bonds (10 year yield)



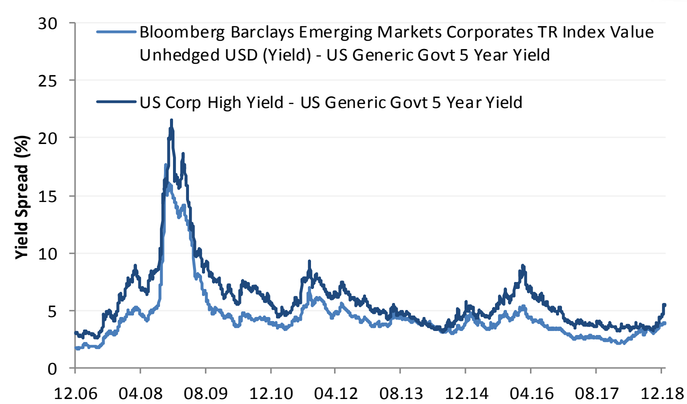
10 year yield



Risk premium over Bund



Risk premium over Treasury



Graph sources: Bloomberg/BBGI Group

Negative outlook for GBP bonds

The latest inflation figures now seem set to stabilise close to the BOE's target rate. In the UK's current context, short-term rates will remain stable, but long-term rates could still follow the downward trend seen in international bond markets in the past several weeks. Indeed, the overall global environment is also affected by the uncertainty regarding the tariffs issue and the risk of a yield curve inversion in the US. UK government bond yields participated in this trend, sliding back approximately 25 basis points on most maturities. However, we estimate that, from the point of view of foreign investors, the yields seen on the pound-denominated bond market do not compensate for the risks resulting from a possible breakdown of negotiations and a "no deal" withdrawal from the EU. The currency risk is high and is obviously not offset by a 10-year yield of barely 1.5%. The British bond market is thus currently not offering attractive prospects.

Japanese bonds still unattractive

Q2 saw a welcome increase in price indices. Indeed, they slackened only over the period in which the yen was appreciating. Inflation (CPI) rose above 1%, establishing itself at 1.4% in October. An upswing in prices was conditioned upon on a depreciation of the yen, but inflation is still far from the BOJ's target (2%), and production prices are not displaying sufficient momentum to establish a more robust trend overall. However, the current context is clearly not favourable to the bond market, which still fails to offer attractive prospects to foreign investors.

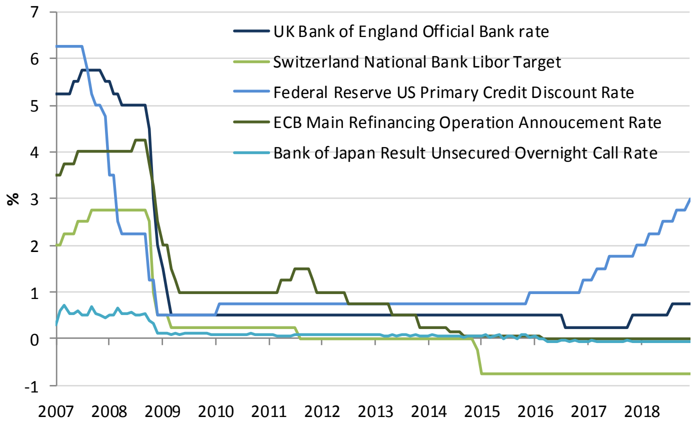
US market still our first pick following the recent downswing in interest rates

Following the overall easing of rates in Q4, during which time the rates markets generated capital gains regardless of their specific economic circumstances, most markets will likely see some tightening in 2019. In the US, long-term rates will likely rise back up above 3% if, as expected, the US economy avoids a recession and maintains a growth rate of close to +2.5%.

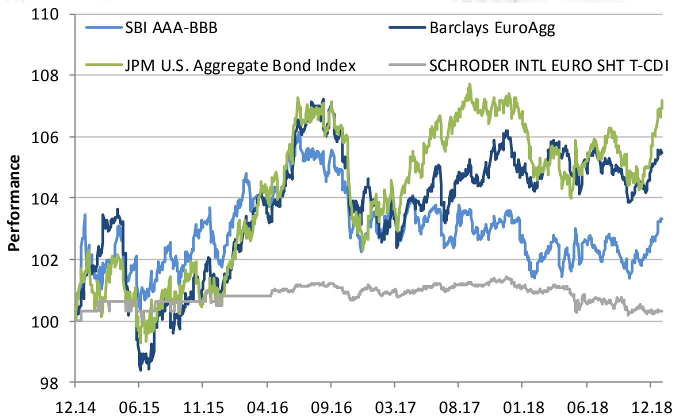
In the euro area, the ECB's European government bond purchasing programme kept long-term rates low in 2018. However, when the bank withdraws from the market on 1 January 2019, imbalances between supply and demand are likely to arise. European states' funding needs will have to contend with reduced investment demand. Yields may have to undergo an adjustment shock to rebalance this market.

Thus, we believe that US government bonds currently offer better opportunities for diversification in the fixed income investment universe. With regard to default risk, we recommend reducing exposure to the high yield segment, as it presents significant risks of imbalance and price correction as risk premiums readjust.

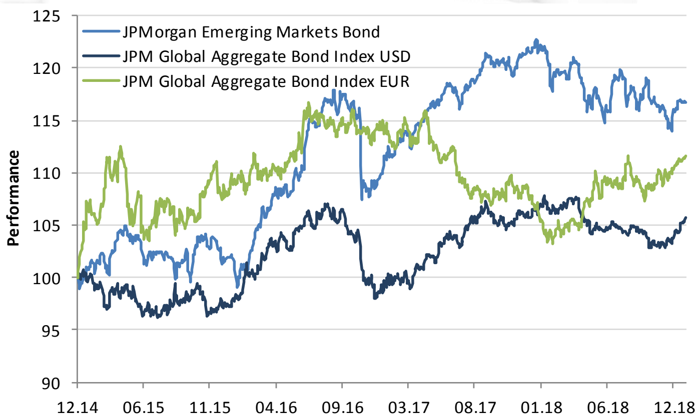
Central Bank rates (EUR, CHF, GBP, USD, JPY)



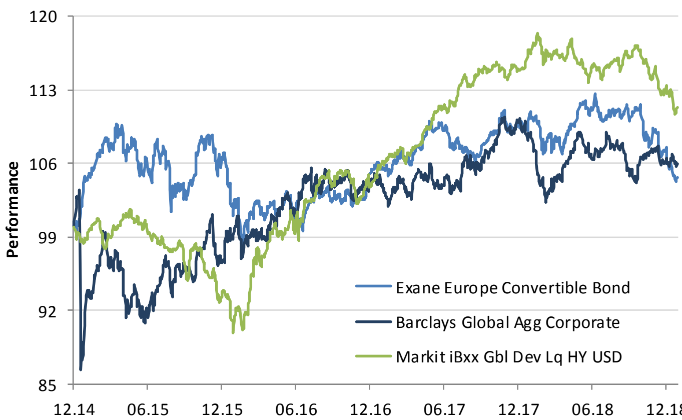
YTD Performance of Bond Indices 1- 5 years (Normalized at 100)



Emerging Bonds - Performance (Normalized at 100)



Eastern Europe Bonds - Performance (Normalized at 100)



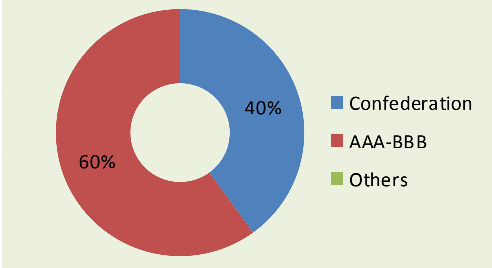
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Swiss Bonds

- The yield curve remains 'normal' in Switzerland
- Termination of the ECB's bond purchasing programme
- Swiss government bond yields at 0.2%
- Real yields even more negative

Swiss Bonds allocation



BONDS Type of Debtor	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Governement	↘	↘							
Corporate (IG)	↘	↘							
Others	↘	↘							

Tactical Allocation

- Underweight Swiss Government Bonds
- Overweight the "IG" segment
- Prioritise short durations on all segments

The yield curve remains 'normal' in Switzerland

The normalisation of long-term interest rates in Switzerland started in summer 2016, but this initial adjustment phase rapidly stabilised at 0% with regard to 10-year Swiss government bond yields. The surprise slowdown of growth in the Eurozone and in Switzerland as well as the stabilisation of inflation in the latter at around 1% somewhat slowed the gradual upward trend in long-term rates. To everyone's surprise, Switzerland's real GDP unexpectedly contracted by -0.2% in Q3, bringing GDP growth to +2.4% yoy. This slump occurred following excellent results in Q2 (+0.7%) and is surprising in terms of its relative magnitude, as economists' consensus anticipated growth of +0.4% over the quarter and +2.9% yoy. These developments are synchronous with the sharp slowdown in Europe and in Germany in particular. The normalisation process will have to wait for economic results to improve in both Switzerland and the euro area. The yield curve naturally flattened somewhat over the past few weeks given the overall downswing in long-term rates internationally. However, it should steepen once again in 2019 following an upswing in long-term yields and assuming the SNB's monetary policy remains unchanged. We expect the upward trend in Swiss long-term rates to strengthen somewhat in 2019 if economic momentum picks up in Europe and internationally.

Termination of the ECB's bond purchasing programme has indirect impact

The planned termination of the ECB's bond purchases could generate a few unpleasant surprises with regard to sovereign bond yields and cause long-term rates to tighten, even in the absence of above-average GDP growth in the Eurozone.

The SNB's monetary policy is the main factor keeping long-term rates stable for now via the pressure exerted by key rates on the short end of the yield curve. This factor will likely remain stable in 2019. The second major factor is the ECB's monetary policy, which is inhibiting the rise of euro yields via similar means (negative key rates) and especially via its government bond purchase programme. The termination of this programme could result in an adjustment of European yields as well as adjustments in Switzerland.

Swiss government bond yields at 0.2%

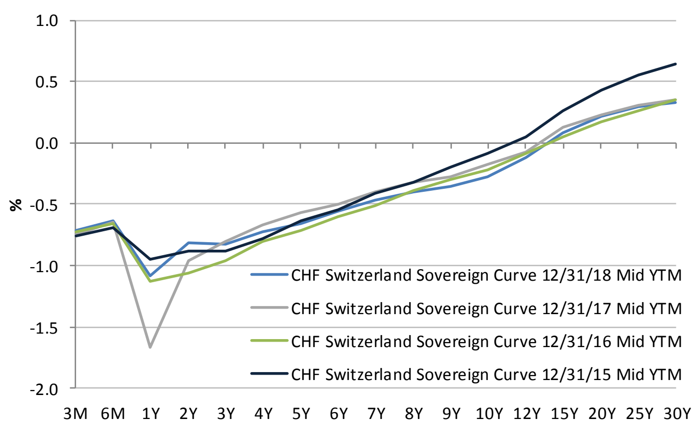
Barring a more pronounced global slowdown and a recession in Europe, long-term rates will likely undergo further adjustments, which should again push 10-year Swiss government yields from -0.25% to +0.20%.

Real yields even more negative

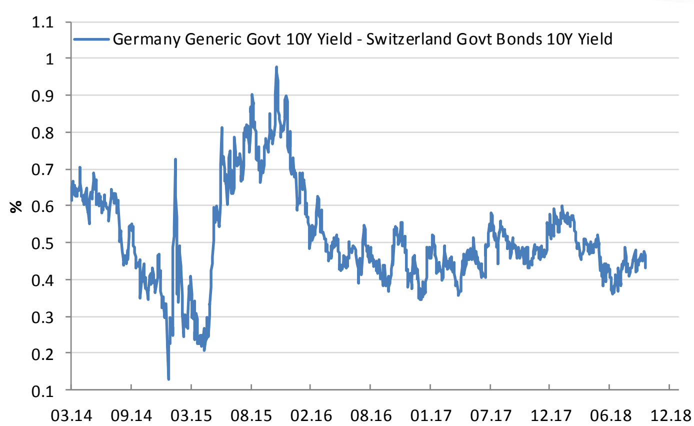
As logically expected, real yields remain solidly negative at around -1% due to an inflation rate of 0.7% and nominal yields of -0.25%. This situation is unusual, as real interest rates should be positive, but it will not rectify itself in 2019.

With regards to investment strategy, we are overweight high grade issuers and short maturities given the international context, which will likely demand higher risk premiums for non-government issuance.

Switzerland Sovereign Yield Curve

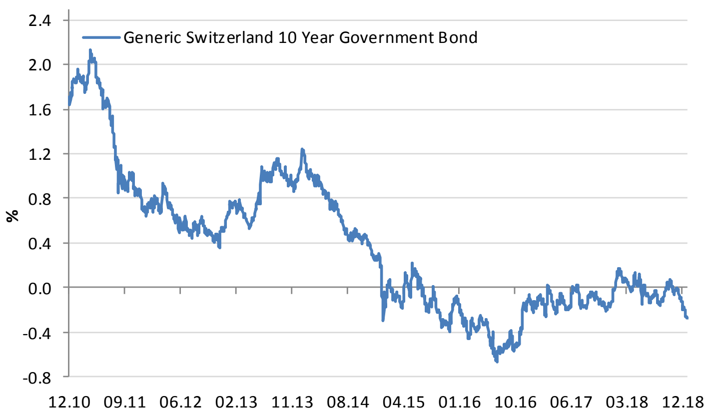


Long rates Yield Spread (German Bund - Swiss Confederation)

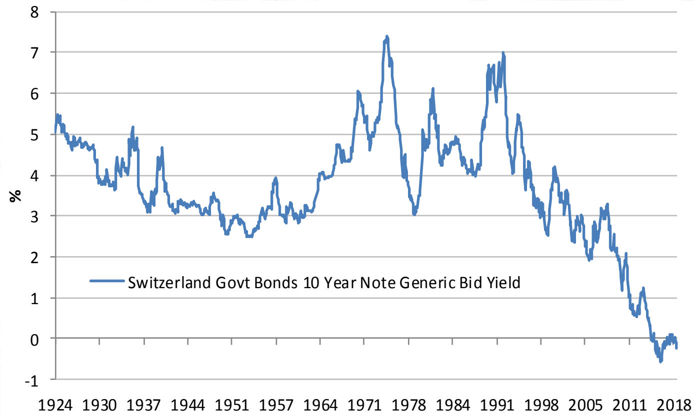


Graph sources: Bloomberg/BBGI Group

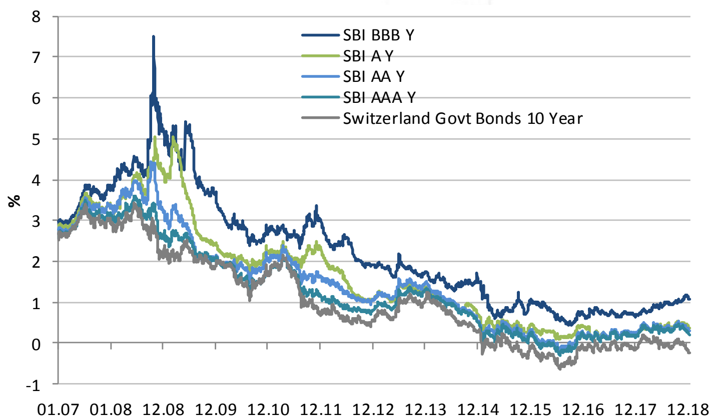
Switzerland Government Bond yield (10 year)



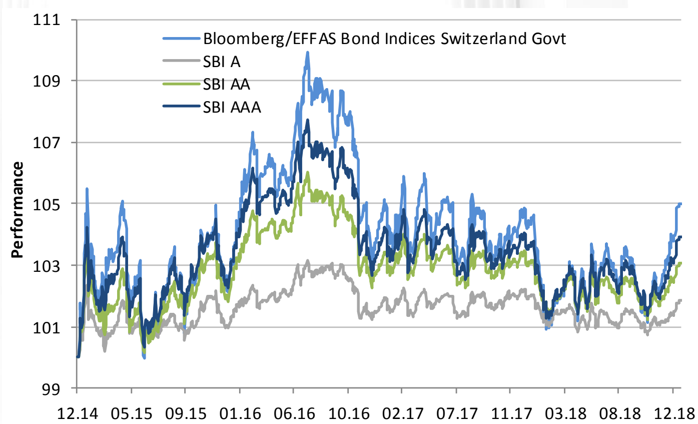
Switzerland Government Bond yield (10 year) since 1924



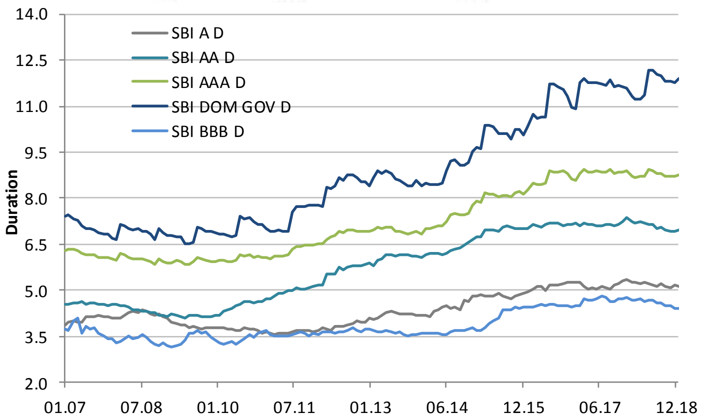
Yield by debtor type



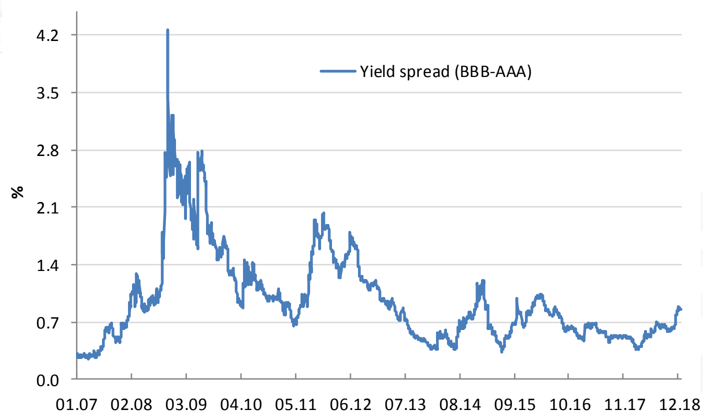
Performance of Swiss Bonds (Normalized at 100)



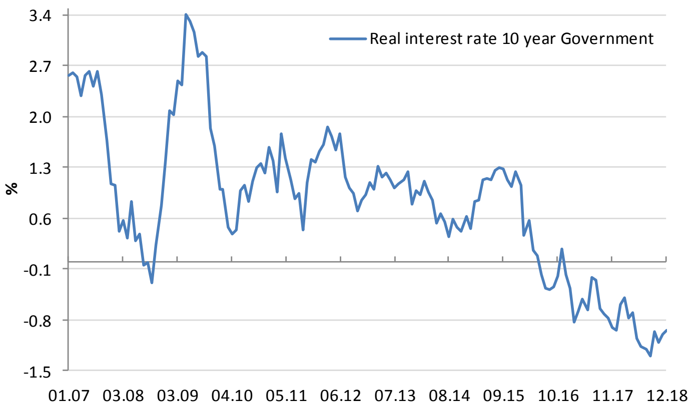
Duration of Bond Indices



Yield spread



Real Interest Rates



Graph sources: Bloomberg/BBGI Group

SWISS BOND INDICES (CHF)

31.12.2018 Total Return Performance

	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
Bloomberg Barclays Series-E Switzerland Govt All > 1 Yr Bond Index	263.0	CHF	0.1	1.7	2.8	1.3	0.6
SBI A-BBB	135.7	CHF	0.1	0.5	0.3	0.2	-0.3
SBI AA-BBB	134.5	CHF	0.1	0.6	0.7	0.3	-0.2
SBI AAA-AA	136.3	CHF	0.1	1.0	1.5	0.6	0.2
SBI BBB	146.9	CHF	0.1	0.5	-0.1	0.0	-0.6
SBI AAA-BBB	136.5	CHF	0.1	0.9	1.2	0.5	0.1
SBI DOM GOV AAA-BBB 1-3P	68.8	CHF	-0.1	-0.2	-0.5	-1.2	-2.9
SBI DOM GOV AAA-BBB 3-7P	87.9	CHF	0.0	0.3	0.5	-0.6	-1.8
SBI DOM GOV AAA-BBB 7+ P	128.1	CHF	0.1	2.3	3.5	1.1	-0.7

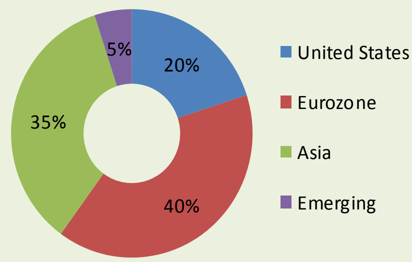
PROSPECTS AND STRATEGIES

International Real Estate

- The slump in securitised real estate is a golden opportunity
- Real estate prices continue to trend upward
- Economic fundamentals remain favourable
- No threat of interest rate increases
- Asian securitised real estate proves resilient in December

REAL ESTATE Areas	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Switzerland	↗	↗							
United States	↗	↗							
Eurozone	↗	↗↗							
United Kingdom	↘	↘							
Asia	↗	↗↗							
Emergents	↗	↗↗							
Liquidity									

International Real Estate allocation



Tactical Allocation

- Overweight Europe and Asia
- Cash 0%

The slump in securitised real estate is a golden opportunity

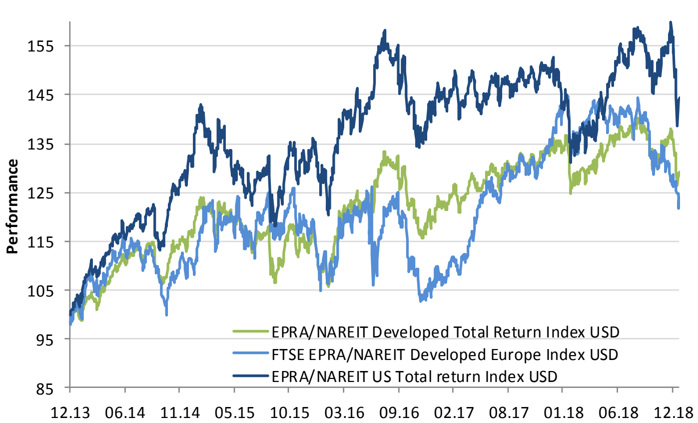
Securitised real estate investments were not spared the effects of the irrational behaviour of stock markets at the end of 2018, which saw steep price corrections in all regions. Globally, listed real estate fell -5.04% in dollars in December and -6.37% over the year. The collapse in prices over the past few weeks was thus particularly severe for this asset class, which suffered a massive impact over a short period of time, pushing annual results deep into the red. Panic was certainly a key factor in the behaviour of investors who sold off their investments at the cost of significant price drops.

The US market was the first affected by these waves of profit-taking and fell -8.23% in December, closing the year down -3.43%, wiping out over half the gains achieved over the first eleven months of the year. December was also challenging for the European market (-6.56% in euros), which closed the year down 7.82%. The corrections in the British (-3.53%), Asian (-0.48%) and emerging (-1.48%) real estate markets were less severe, as some of these markets had already been hit hard during the year, such as the British market, down 13.03% in pounds. Over the full year, the Asian market thus posted the best performance, sliding back a mere -1.92%.

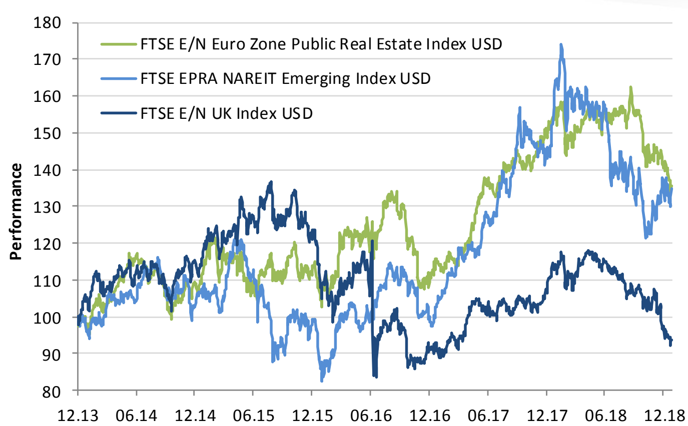
Overall, the abrupt change in economic expectations at the end of the year does not seem rational. We are not anticipating a global recession in 2019, or even a recession in the US or in Asia for that matter. Thus, the precipitous fall of securitised real estate in all regions in December appears to have resulted more from a temporary market effect than from a real and rational change in outlook. The valuation of real estate investments did not seem excessive before these price corrections. Assuming a moderate slowdown of the global economy in 2019 and a likely trade agreement between China and the US in Q1, we view the dip in the real estate securities market as a clear investment opportunity.

In most regions, trends in direct real estate prices continue to be positive, reflecting completely different dynamics from those affecting securitised real estate. In the growth scenario mentioned above, we do not expect a decrease in physical demand that could cause a significant drop in real estate prices in the US, Asia, or Europe. Our real estate strategy has been overweight Asia in particular. We maintain this position, while noting that buying on the current weakness in securitised real estate prices in the US and Europe would be perfectly appropriate.

EPRA Nareit - USA, Europe, Global (USD)



EPRA Nareit - Eurozone, United Kingdom, Emerging (USD)



Graph sources: Bloomberg/BBGI Group

Real estate prices continue to trend upward

The trend in real estate prices in the US remains unchanged as the year comes to a close. The deceleration of yoy price growth (+5.7%) is due to a slowdown in the monthly increase in prices in the past few months. Indeed, prices have been slowing down for seven consecutive months, suggesting a decline in buyers' interest given rising mortgage rates and high prices.

However, demand will likely remain solid due to an increasingly robust job market and a high level of confidence. Economic momentum in the US is not in doubt and will drive continued progression in prices albeit at a much slower rate. The market is thus showing signs of fatigue, although it will continue to benefit from somewhat low inventory. In this context, exposure to the US real estate sector obviously remains warranted though with a smaller allocation.

In the UK, Brexit continues to weigh on investor sentiment and on real estate prices, which decreased further in London in November (-0.7%). For the country as a whole, price growth decreased yoy but is still +2.8%, which is the slowest growth rate since August 2013. Brexit continues to cast a shadow over the British market, which still does not offer any repositioning opportunity. We recommend staying away from this market for now, as the Bank of England is suggesting that real estate prices may plunge 25% based on a pessimistic no-deal Brexit scenario. In China, new housing prices in the 70 largest cities grew a further +0.77% in December, indicating that monthly price growth has continued to decelerate since September. Yoy monthly growth remains uninterrupted, however, suggesting a stabilisation of the real estate market consistent with the government's stated objectives. The goal of developing real restate while avoiding speculation may be relaxed in 2019 to counteract the risks of a slowdown, in particular by easing purchase and sale restrictions in certain cities. With regard to financing, banks have lowered mortgage costs.

Economic fundamentals remain favourable

The fears of a recession are irrational and largely attributable to the abnormal stock market environment at the end of the year. Even though trade tensions may generate risks of a short-term slowdown, we believe it is highly likely that an agreement will be reached before the 1st March that will curtail this major source of uncertainty. Our scenario anticipates a moderate slowdown that will not have the same effect as a recession on the construction and real estate sectors. Consequently, we expect that the global economy will continue to expand and will be favourable to real estate markets.

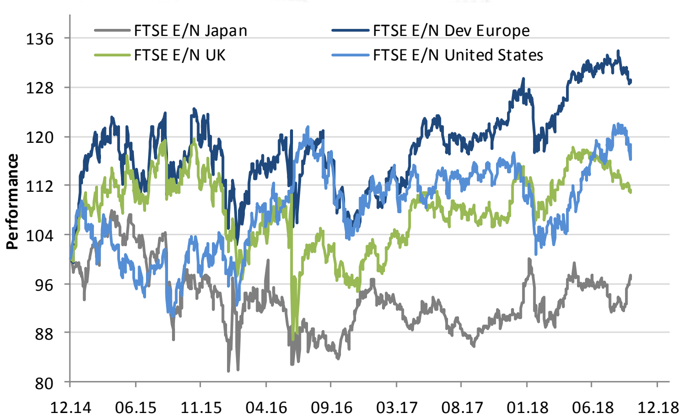
No threat of interest rate increases

The latest developments in fixed income markets have lowered the risks of tightening in 2019, both on the short and the long end of the yield curve in the US. The likelihood that interest rates will rise significantly in the Eurozone, Japan or Asia is also low. The fear of rising interest rates is often cited as one of the main risks with regard to real estate asset valuation, and rightly so. But in the current context, this factor is unlikely to have a negative effect on real estate prices.

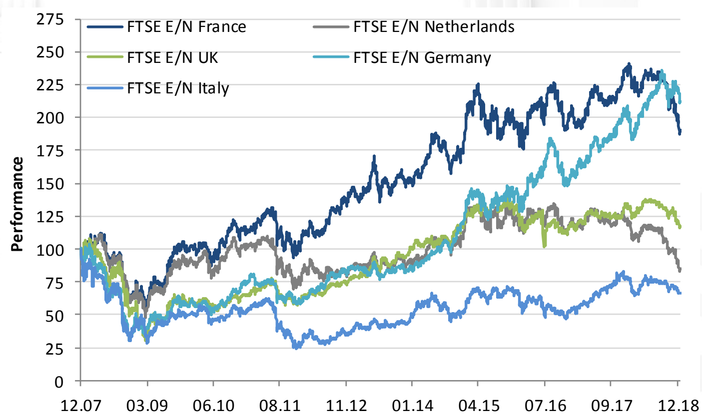
Real interest rates still favourable to real estate markets

Real estate markets typically perform better when real interest rates are low and growth trends are on par with or exceed their historical average. Excessive fears of a slowdown affected expectations at the end of the year, but the global economy will likely turn out to be more resilient in 2019, maintaining GDP growth of close to 3.5%. In this context, we continue to anticipate that the environment will remain favourable to moderate growth in rents and in real estate prices in general. With regard to real interest rates, the decline in inflation in most developed countries as measured for instance by consumer price indices was accompanied by even more substantial declines in long-term yields.

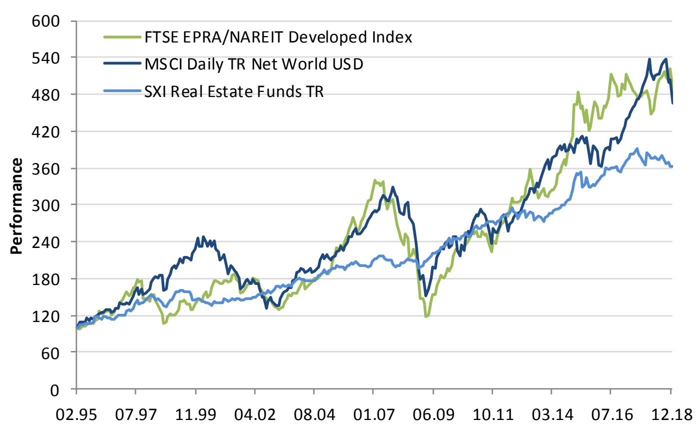
Real estate markets (local currency)



European real estate markets (local currency)



Long-term Performance : international real estate, swiss real estate and international equities (local currency)



Graph sources: Bloomberg/BBGI Group

INTERNATIONAL REAL ESTATE INDICES (local currency)

31.12.2018

				Total Return Performance				
N° ISIN	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
GLOBAL	FTSE EPRA/NAREIT Glb TR	2538.4	USD	2.1	-4.9	-3.5	-5.4	-5.5
DEVELOPED	EPRA/NAREIT Dev TR USD	4748.6	USD	2.0	-5.4	-4.2	-5.8	-4.7
DEVELOPED EUROPE	FTSE E/N Dev Europe	1993.9	EUR	-1.0	-4.9	-7.8	-10.3	-7.8
EUROZONE	FTSE E/N Euro Zone	2362.8	EUR	-1.5	-6.6	-8.7	-11.2	-7.8
USA	FTSE E/N United States	2707.6	USD	4.1	-8.2	-4.8	-5.3	-3.4
DEVELOPED ASIA	FTSE E/N Dev Asia	1514.3	EUR	-0.1	-1.3	1.8	0.3	3.5

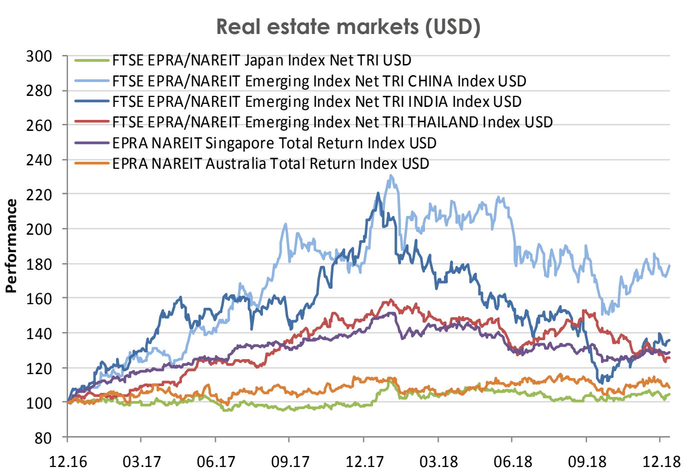
In the US, inflation slid from +2.2% to +1.9% in December, while 10-year Treasury yields fell from 3.1% to 2.6%. Similarly in the euro area, inflation slid from 2% to 1.9% in December, and the 10-year German Bund rate dropped from 0.55% to 0.35%. Barring a real recession, inflation will likely be bolstered in 2019 by increasingly robust job markets, hourly wage increases, and rising commodities and energy prices. Current real yields are negative not only in dollars and euros but in other developed countries as well, such as Japan. In emerging markets, this factor will be less favourable due to positive real yields. This is the case in China in particular, where inflation (1.9%) is lower than the yield on government bonds (3%).

Asian securitised real estate proves resilient in December

Securitised real estate in Asia remained especially resilient in Q4, in particular given the widespread panic that broke out in December. In dollars the three main real estate markets posted performances ranging between +3.2% for the Chinese market (+3.3% in yuan) and -3.2% for the Australian market (-0.59% in Australian dollars). Japan was up +0.6% in dollars and down -2.8% in yen. Asian real estate markets thus reacted only marginally compared to the dramatic plunge seen in some segments in the US and Europe. These markets' resilience is encouraging.

Asian real estate ultimately withstood the threats and pressure exerted by the US president rather well, unlike Asian and emerging equity markets. The sector posted excellent Q4 results in relative terms, sharply limiting its losses compared to those posted by the US and European real estate markets in particular. Fears of a trade war with significant effects on respective regional economies and on Asia remained strong at the beginning of the year. However, a calmer economic environment will be even more beneficial to Asian real estate, which can count on resilient domestic and investment demand. The Chinese market could see an increase in the relocation activity of certain industries to Vietnam in particular, as has been happening for several years already. But most other segments will likely not be significantly impacted. The Chinese government has taken measures to ease the restrictions on the real estate market and on foreign investors in the hopes of offsetting the potential negative effects of the relocations outside China and boosting domestic demand. The appetite of Chinese investors for local real estate remains high in China, Southeast Asia, and Australia.

Asian securitised real estate will likely benefit from a change in the assessment of regional risks over the next few months, which will boost demand and prices. The fall in the price of Chinese real estate securities already seems to be reversing since October, posting growth of close to +15% over a few weeks. Asian real estate remains overweight in our allocation grid.



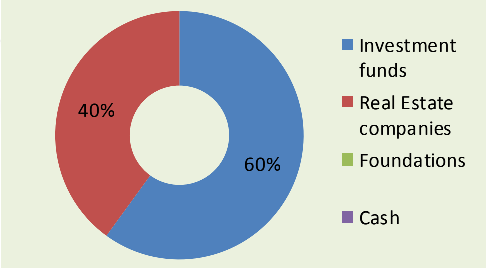
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Swiss Real Estate

- A year's respite for securitised real estate
- Attractive yields and sharp adjustment in premiums
- Interest rates' limited impact

Swiss Real Estate allocation



REAL ESTATE Switzerland	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Investment funds	↗	↗							
Real Estate companies	↗↗	↗↗							
Foundations	→	→							
Cash									

Tactical Allocation

- Underweight investment funds
- Overweight listed real estate companies

A year's respite for securitised real estate

Swiss securitised real estate made out rather well from a relative perspective in 2018, mainly due to its remarkable resilience in the face of surging uncertainty in Q4. Indeed, while risky assets plunged dramatically, Swiss real estate companies declined by only -2.03% and real estate investment funds slid back barely -0.99%. The behaviour of Swiss securitised real estate in this period of high volatility was thus particularly beneficial and strongly contributed to effective risk management in diversified strategies. Over the full year, real estate funds (-5.32%) posted a larger decrease than real estate companies (-1.99%). Over the next few months, we continue to recommend a higher exposure to real estate companies while maintaining a significant exposure to investment funds.

Attractive yields and sharp adjustment in premiums

Real estate companies are trading at around 16x current earnings, but the valuation of 20.6x expected 2019 earnings seems high by historical comparison absent higher earnings growth. However, they have a significant comparative advantage in terms of yield, as real estate companies' average yield still exceeds 4%, producing an excess yield of close to 1% compared with the average yield of investment funds, which stabilised at 3%. In both cases, yield levels are attractive given Swiss franc interest rates, which remain close to zero. Average fund premiums have steadily contracted since the highs of around 30% reached in 2017 and are currently at around 15%. The average premium is thus once again close to its 30-year average, which is a positive support factor for the market.

Real estate company premiums, on the other hand, are currently still relatively high (18%) by historical comparison, but they are on par with investment funds' premiums.

Interest rates' limited impact

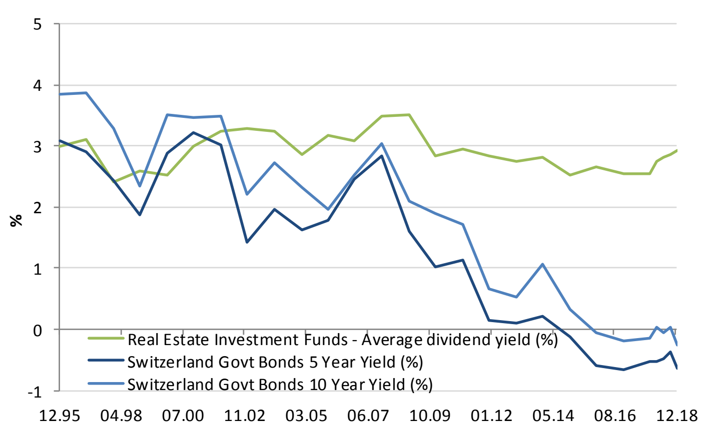
For the past two years, 10-year Swiss government bond yields have fluctuated between -0.2% and +0.2%. This low level of volatility of long-term interest rates has little influence on the valuation of securitised real estate. However, when adjustments occur such as in January 2018 (increase from -0.2% to +0.2%) or over the past quarter (decrease from +0.1% to -0.25%), expectations that trends will shift certainly impact the price of both real estate funds and real estate companies. We continue to believe that the current yield offered by securitised real estate is particularly attractive, presenting a comfortable risk premium allowing one to envisage a moderate increase in interest rates without trepidation.

SWISS REAL ESTATE

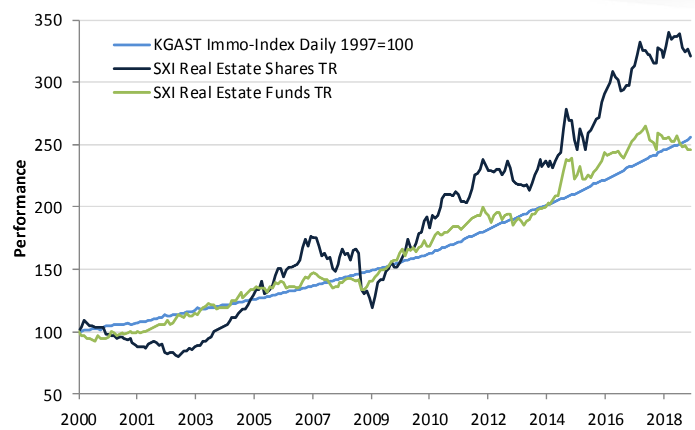
31.12.2018	Total Return Performance					
Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
SXI Real Estate Funds TR	361.5	0.8	0.1	-1.3	-2.8	-5.3
SXI Real Estate Idx TR	2389.8	-0.5	-1.7	-1.9	-4.2	-2.1
KGAST Immo-Index*	285.8				2.8	4.9

* subject to one-month lag

Government and Real Estate Yield



Performance of Swiss Real Estate

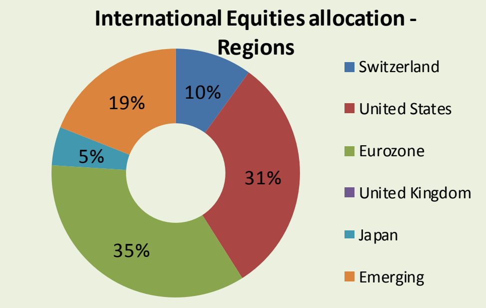


Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

International Equities - Regions

- An irrational market shock of exceptional magnitude
- Attractive valuation levels in all markets
- European equities offer new opportunities
- Nikkei to benefit from an increase in global demand
- Significant potential for Asian emerging markets



EQUITIES REGIONS	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Switzerland	↗	↗↗							
United States	↗	↗							
Eurozone	↗	↗↗							
United Kingdom	↗	↗							
Europe	↗	↗							
Japan	↗	↗							
Emergents	↗↗	↗↗							

Tactical Allocation

- Overweight Europe
- Overweight emerging markets
- Underweight United Kingdom and Japan
- Neutral United States

An irrational market shock of exceptional magnitude

Three months ago we noted that risks were multiplying and uncertainty was growing, while at the same time equity indices in the US seemed indifferent to the increasingly uncertain economic outlook and to often excessive valuations, in particular in the tech sector. A six-month rally, which had started in Q2 2018, thus came to an end in Q4, with a significant increase in volatility in most equity markets. The correction, initially triggered by an increase in long-term interest rates above 3% and growing concerns with regard to US corporate earnings trends, was short-lived and was quickly followed by a general upswing in prices based on hopes of a resolution of the Sino-American conflict.

However, following the announcement on 30 November of a 90-day truce to allow American and Chinese negotiators to find common ground regarding trade relations between the two countries, an ‘inversion’ of the yield curve led to fears of a recession in the US and caused financial markets to nose-dive abruptly and indiscriminately. Just before the end of the year, this wave of panic rapidly swelled into a tsunami. Share price corrections were widespread and exceptionally steep. By mid-December, investor sentiment, as measured by the American Association of Individual Investors, attested to this sharp change in risk perception. The indicator was then nearing its lowest level of optimism in the past twenty years at approximately 20% bullish.

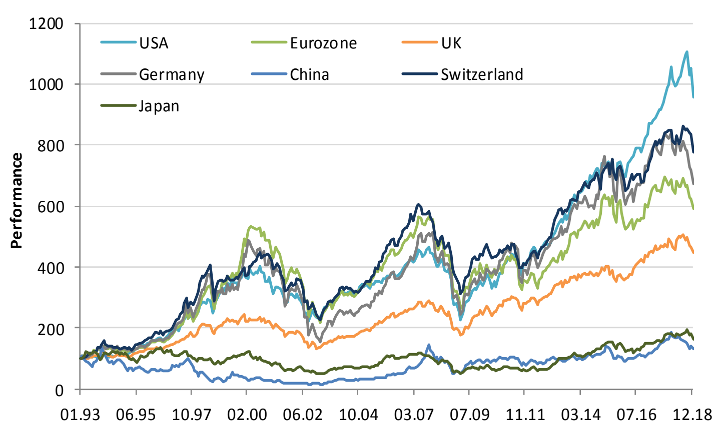
However, we believe a recession in the US to be highly unlikely, based in particular on the assumption that the most likely scenario is that China and the US will reach an agreement.

Hence, if the growth outlook ultimately starts to look more positive in Q4 and at the beginning of the year, it is not unreasonable to anticipate that the uncertainty that turned into a wave of panic could cause a further adjustment, this time in a positive direction with regard to risky assets.

Attractive valuation levels in all markets

In this context, the fall in US share prices unsurprisingly and significantly reduced the valuation levels of S&P500 stocks. At around 14x 2019 expected earnings and -13% lower than the high reached on 20 September, valuation levels are attractive. Tech stocks also experienced a significant sell-off and price drops (-23%), with valuation levels falling accordingly (19.2x) at constant earnings. Small cap indices suffered massive sell-offs and even steeper price drops, such as the Russell 2000 (20.5x) in the US (-27%), the MSCI Small Cap Europe (-23%), and the MSCI Small Cap Switzerland (-34%). In terms of risk assessment, the magnitude and swiftness of the price corrections had a greater impact on the valuation, quantitative, technical, and sentiment-related risk factors in our valuation models.

Long-term Performance (Normalized at 100)



Chinese Equities - A and B (Normalized at 100)

Graph sources: Bloomberg/BBGI Group

The adjustment in scores put almost all markets on par, indicating a clear improvement in the risk/return ratio. The Swiss market's current PE ratio of 13.9x 2019 expected earnings is slightly higher than the Eurozone's (11.9x) but is below the Nikkei 225's (14.7x) and the S&P500's.

These valuation levels seem attractive in an economic environment that corresponds to a growth scenario in which we assume no recession. However, keep in mind that analysts have not yet significantly reduced their earnings expectations for 2019. Barring a pronounced slowdown of economic growth in 2019, we believe the outlook for equities to be favourable, in particular with respect to small and mid caps, which were especially impacted by the recent rise in volatility, as well as real estate investments and commodities.

After the Q4 shock European equities offer new opportunities

European equity markets were strongly impacted by the deterioration in economic statistics in various countries in the euro area, even though the approximately -15% decrease in the share price of the largest European stocks between September and December 2018 was no more dramatic than that of US stocks, which fell more recently and more steeply. In spite of diverging price and value corrections amongst geographic regions, the valuation of European equities remains persistently lower than that of US equities, without it leading to any obvious arbitraging or share price revaluation. Still today the overall PE ratio of the European market (11.9x 2019 earnings) remains very attractive. Compared with the US's PE ratio (15.1x 2019 earnings), the valuation gap remains at around 25%, which is a relatively significant risk premium, as we noted at the end of September.

European stocks maintain a valuation and yield (3.6% vs. 1.9%) advantage, while the earnings outlook for 2019 is converging with that of US stocks. European equities should see investors flow back in, although the macroeconomic environment is currently uncertain and the news flow rather bleak.

However, the uncertainty related to the protectionist threat coming from the US will likely subside gradually once an agreement is reached amongst the parties.

The drop in prices and valuation levels provides new investment opportunities in Europe. European equities will likely benefit from an easing of international tensions and from investor arbitrage generated by European shares' risk premium.

Maintain caution with Brexit just a few weeks off

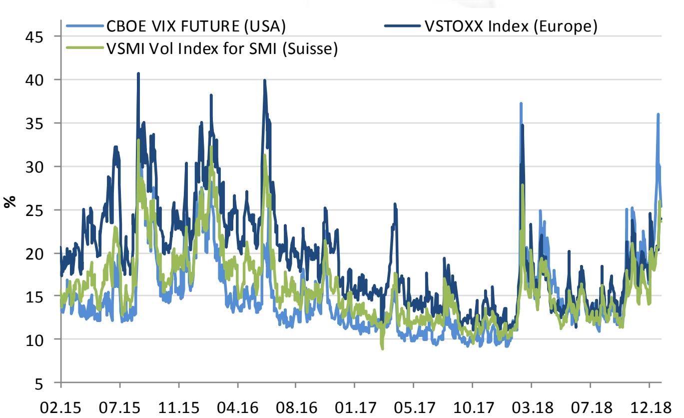
Given the continuing uncertainty surrounding Brexit, the equity market's expected risk/return ratio remains unattractive. While the pound seems to be withstanding this uncertainty, we continue to recommend caution with regard to British equities, in spite of reasonable valuations and attractive dividend yields

Nikkei to benefit from an increase in global demand

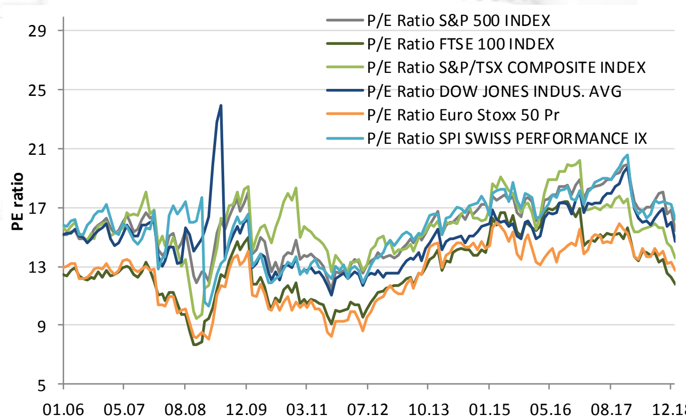
The drop in Japanese share prices associated with the confidence shock that affected global markets in December was not very different from that seen in the US. Furthermore, the -22% overall correction in Japan over a quarter only seems rational if we assume a lasting slowdown of the Japanese economy following a drop in Chinese demand impacting Japanese economic momentum. A normalisation of Sino-American relations with regard to the tariffs issue should strongly benefit Japanese stocks. The Japanese economy's reliance on the export sector was indeed a source of concern with regard to GDP growth and corporate results.

A brighter outlook for the semi-conductor, electric components and auto sectors will likely drive an upswing of the Nikkei index at the beginning of 2019. The latest Tankan survey pointed to a slight improvement in sentiment among large manufacturers at the end of the year. Businesses' average exchange rate forecast was of 109.4 yens to the dollar at the end of the year, or almost the same as the actual year-end exchange rate (109.7).

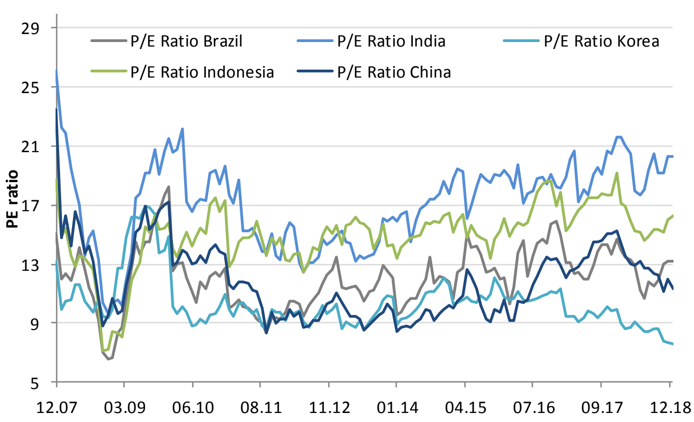
Volatility (USA, Europe, Switzerland)



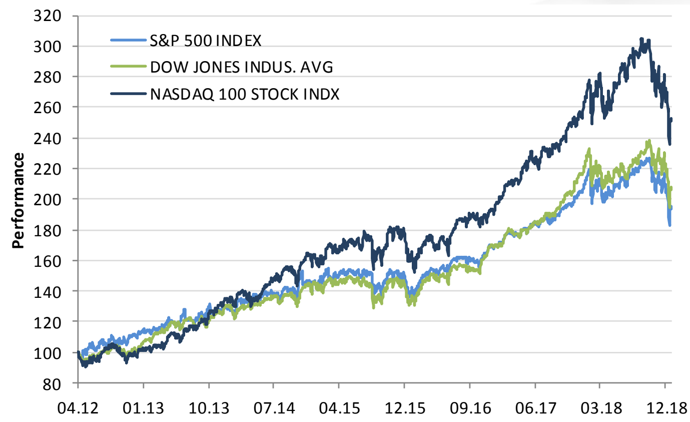
Price/Earnings Developed markets



Price/Earnings Emerging markets



US Equities (Normalized at 100)



Graph sources: Bloomberg/BBGI Group

The yen benefited temporarily as Japanese investors bought back into the currency, but we believe fundamentals are not strong enough to warrant an appreciation of the yen at the beginning of 2019.

A weaker yen along with a brighter outlook for exports will likely lead to upward revisions of Japanese corporate earnings. The +17.9% increase in yoy profits announced at the end of June eroded away to a mere +2.2% as of the end of September. An acceleration in Japanese corporate earnings growth is thus only possible if the risks of a trade war can be eliminated. With that in mind, the decline in equity valuations to 14.5x earnings offers an attractive repositioning opportunity.

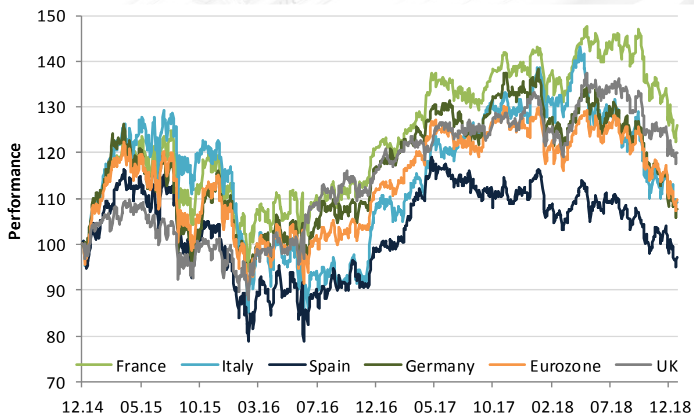
Significant potential for Asian emerging markets

Chinese markets were the first to take into account the risks resulting from the deterioration of trade relations between China and the US since January. The investor sell-off was particularly intense in Q2, although in the absence of any positive news with regards to the tariffs issue, uncertainty grew and share prices continued to drop in Q3. Emerging markets had already mostly factored in the risks of a slowdown such that they did not suffer the same impact as the US markets in Q4. The -2.8% drop in December and -7.6% over the quarter were thus not as severe as those posted by US indices such as the S&P500 (-9% and -13.5%).

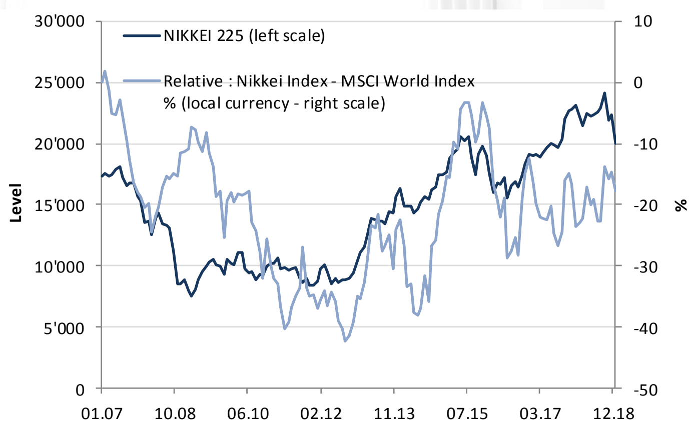
However, not all emerging markets were affected in the same way by these uncertainties. Among the five largest components of the MSCI Emerging Markets index – China (30.4%), South Korea (13.8%), Taiwan (11.4%), India (9.4%) and Brazil (7.5%) – only China had started correcting back in January, with shares eventually down -25%.

The other two Asian emerging markets were only recently impacted by investors' growing concerns. South Korea thus dropped -14% in Q4 (-17% over the year), and Taiwan slid into negative territory (-12%) after having been positive over the first nine months of the year (-8.6% over the year). While the Indian market experienced some volatility in September and October, its performance over the year was positive (+5.8%). Brazil benefited from the change in leadership, also closing the year up +15%. Among the major emerging markets, Asian markets definitely have the most potential for gains in the event of an agreement between China and the US.

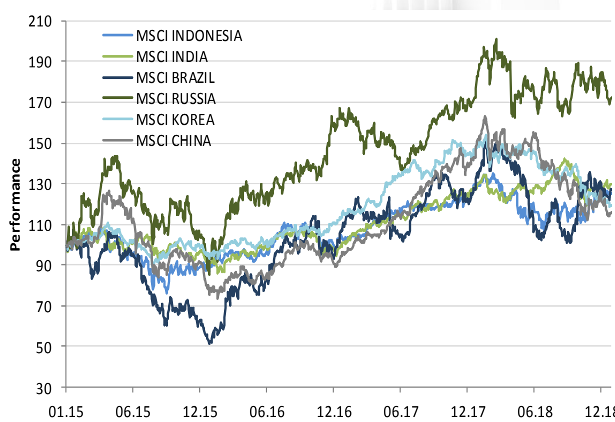
Performance of Stock markets (Normalized at 100)



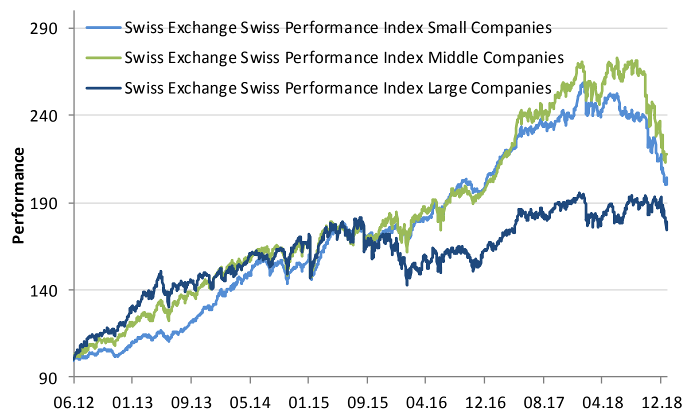
Japanese Equities VS MSCI World



Emerging Markets (Normalized at 100)



Swiss Equities (large - middle - small caps/Normalized at 100)



EQUITIES - BY REGION (local currency)

31.12.2018 — Total Return Performance

	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
SWITZERLAND	SPI Swiss Performance Index	9443.1	CHF	0.2	-6.7	-9.1	-5.2	-8.6
SWITZERLAND SMALL-MID CAPS	SPI Extra Total Return	2903.8	CHF	1.2	-6.7	-18.2	-17.2	-17.2
EUROPE	STXE 600 € Pr	394.6	EUR	0.8	-5.4	-11.2	-10.4	-10.3
EUROPE SMALL-MID CAPS	MSCI Europe Small Cap Net TR E	352.7	EUR	1.5	-6.4	-16.4	-16.8	-15.9
UK	FTSE All-Share Index	3595.9	GBP	0.8	-3.7	-9.8	-10.3	-9.5
USA	S&P 500 Index	2506.9	USD	6.7	-9.0	-13.8	-6.7	-4.4
USA SMALL-MID CAPS	RUSSELL 2500	537.2	USD	6.6	-11.0	-17.1	-15.2	-10.0
JAPAN	NIKKEI 225	20014.8	JPY	-0.6	-10.3	-17.4	-7.0	-10.4
JAPAN SMALL-MID CAPS	Russell/Nomura Mid-Small Cap I	777.9	JPY	1.2	-10.4	-17.3	-11.6	-16.9
ASIA EX-JAPAN	MSCI AC Asia Pac Ex Japan	477.1	USD	1.5	-2.9	-7.2	-8.8	-13.7
ASIA EX-JAPAN SMALL-MID CAPS	MSCI AC Asia Pacific Ex Japan Small Cap	872.3	USD	1.3	-3.2	-8.8	-13.0	-19.9
EMERGING	MSCI EM	910.4	USD	1.4	-2.8	-6.3	-7.4	-14.5
INTERNATIONAL EQUITIES -DIVERSIFIED USD	MSCI Daily TR Net World	4693.2	USD	4.5	-7.6	-13.4	-8.8	-8.7

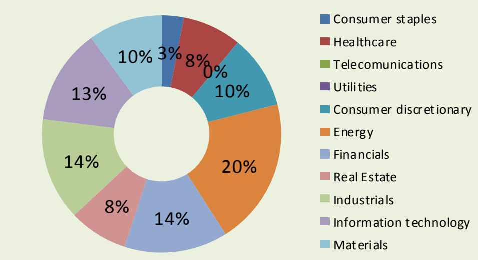
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

International Equities - Sectors

- Overweight cyclical sectors (financials, industrials, energy)
- Reinvest in tech stocks
- Overweight consumer discretionary
- Small caps expected to outperform

International Equities allocation - sectors



Tactical Allocation

- Overweight digital stocks and technology
- Overweight energy, materials, consumer discretionary and financials

EQUITIES Sectors	Expected Return 3months	1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Consumer staples	↗	↗							
Healthcare	→	↗							
Telecommunications	→	→							
Utilities	→	→							
Consumer discretionary	→	→							
Energy	↗	↗							
Financials	↗	↗							
Real Estate	→	↗							
Industrials	↗	↗							
Information technology	↗	↗							
Materials	↗	↗							

EQUITIES - BY SECTOR

31.12.2018 — Total Return Performance

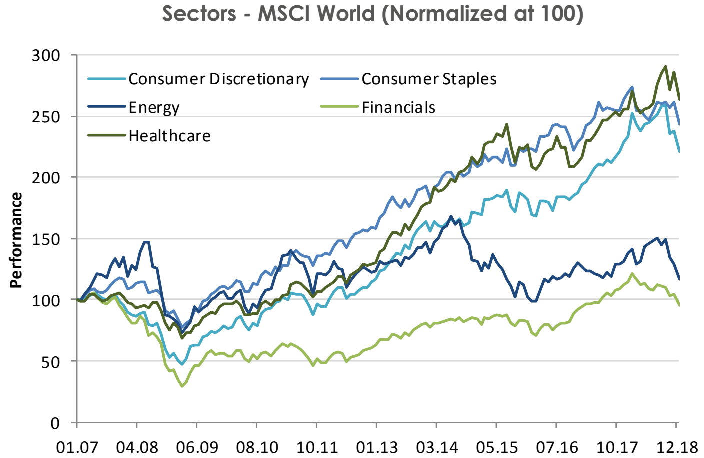
N° ISIN	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
CONSUMER DISCRETIONARY	MSCI WORLD/CONS DIS	200.9	USD	5.3	-6.9	-13.7	-9.8	-5.1
CONSUMER STAPLES	MSCI WORLD/CON STPL	208.3	USD	2.3	-6.7	-6.7	-4.2	-9.5
ENERGY	MSCI WORLD/ENERGY	206.3	USD	4.6	-9.6	-22.4	-20.3	-15.1
FINANCIALS	MSCI WORLD/FINANCE	105.4	USD	4.3	-9.1	-13.2	-10.9	-16.4
HEALTHCARE	MSCI WORLD/HLTH CARE	222.5	USD	5.1	-8.0	-9.6	0.7	3.0
INDUSTRIALS	MSCI WORLD/INDUSTRL	196.5	USD	4.3	-8.4	-16.4	-10.3	-14.1
MATERIALS	MSCI WORLD/MATERIAL	208.5	USD	3.3	-4.0	-14.5	-12.7	-16.6
REAL ESTATE	MSCI WORLD/REAL ESTATE	192.1	USD	2.2	-5.2	-3.1	-5.2	-5.6
TECHNOLOGY	MSCI WORLD/INF TECH	145.5	USD	6.9	-8.0	-17.8	-10.4	-2.3
TELECOMMUNICATION	MSCI WORLD/TEL SVC	71.1	USD	4.7	-6.9	-6.4	-2.8	-9.1
UTILITIES	MSCI WORLD/UTILITY	113.8	USD	1.6	-2.2	0.2	0.5	3.1

In our previous strategy review in September 2018 we mentioned the concentration of risks in the US and the increasing likelihood of share price corrections that might shortly affect very large market caps such as Amazon and Apple.

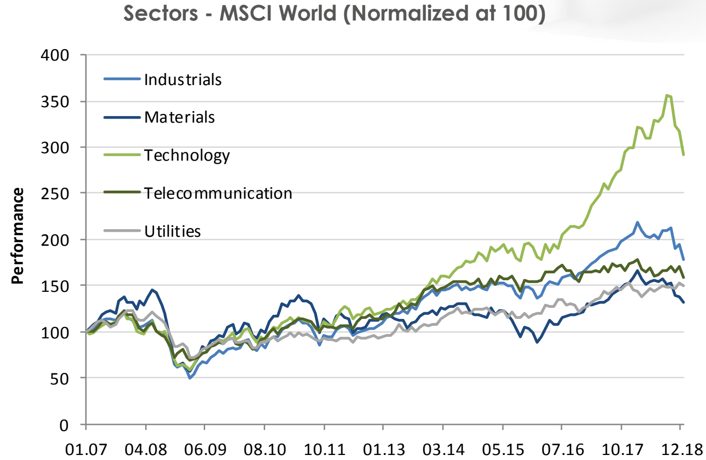
We recommended significantly underweighting tech stocks in general and GAFA stocks in particular, pending more reasonable valuation levels. Last quarter's market shock seems to have sufficiently impacted various stocks – and certain tech stocks in particular – for us to modify our international sector allocation in favour of this segment. We are also increasing the weighting of more cyclical sectors, which suffered more markedly from the excessive fears of a generalised collapse of international economic activity.

Cyclical sectors will likely perform better than defensive stocks in Q1 2019.The tech sector, underweight until now, is once again over weight following the -22% drop of the Nasdaq and the improvement in the valuation levels of individual stocks. The -39% correction of Apple's stock, for example, stands in contrast to that of Microsoft (-18%) in Q4. The former was down -7% yoy, while the latter was up +18%. Apple's PE ratio dropped to 12.6x, or about half of Microsoft's (22.9x). Beyond sector allocation, it will probably be more crucial in 2019 to take a more selective approach to stock picking. We recommend overweighting cyclical sectors, which were especially impacted by the excessive fears of an economic slowdown, such as financials, industrials, consumer discretionary, and energy. Small and mid caps should also be overweight.

Sectors - MSCI World (Normalized at 100)



Sectors - MSCI World (Normalized at 100)

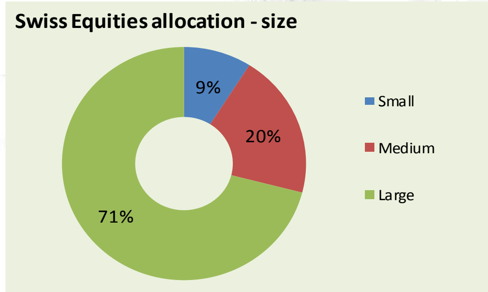


Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Swiss Equities

- Irrational drop in Swiss stock market in December
- Swiss small caps unfairly penalised
- New opportunities in Swiss equities in 2019



Tactical Allocation

- Favor stocks sensitive to exchange rates and to European economic dynamics
- Increase exposure to « blue chips »

EQUITIES capitalization	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Small	↗↗	↗							
Medium	↗↗	↗↗							
Large	↗	↗							

Irrational drop in Swiss stock market in December

2018 closed on an outbreak of panic and extreme volatility in financial markets, which unfortunately did not spare the Swiss market. While December is typically positive, this time investors were not able to count on the traditional year-end rally, as the month closed on negative performances overall in a particularly irrational context. The Swiss equity market (SPI) was still slightly positive as of 30 September (+0.5%), but the panic which affected Switzerland as well in December (-9%) reversed the market's year-to-date gains (-8.5%). After stock prices fell in Q1, we had noted that Swiss equities offered long-term investors the opportunity to stake a position, while not ruling out that volatility could persist for some time. Following this observation, the market rose approximately +10%, before uncertainty resumed in October and the December shock erased previous gains. The excessive drop in Swiss markets and share prices in December means that Swiss equities once again provide opportunities for long-term gains. The Swiss market's current PE ratio valuation of 14x 2019 expected earnings is well below the average PE ratio of the past few quarters and is thus attractive in a 'normal' economic growth context.

Barring a pronounced slowdown of global growth in 2019, we believe that the outlook for Swiss equities is favourable, in particular with regard to small and mid-caps, which have been particularly impacted by the recent rise in volatility. In the next few months, the stock market's behaviour in December will thus certainly seem to have been particularly irrational, in particular with regard to the Swiss market.

Swiss small caps unfairly penalised

Macroeconomic factors revived uncertainty in Switzerland along two main axes in Q4: first, due to the economic slowdown in our country, along with the sharp slump in Germany and the euro area; second, the risks of an abrupt downturn in global trade and a fall in foreign demand heightened uncertainty with regard to the performance of Swiss companies in 2019. Following the rise in Swiss equity prices in Q3, we mentioned the increased risk of a temporary consolidation in the Swiss market that would likely coincide with the expected correction in the US stock market, but the plunge that did occur was excessive. The collapse in the share prices of small (-20.1%), mid (-16.1%) and large caps (-6.3%) in Q4 brings the performance gap between small and large caps over the full year to -19%, a level rarely seen before. The gap between mid and large caps is only -3.3%. While the performance of small and mid caps had been especially positive over the past five years, the past few weeks nevertheless wiped out half of small caps' outperformance.

New opportunities in Swiss equities in 2019

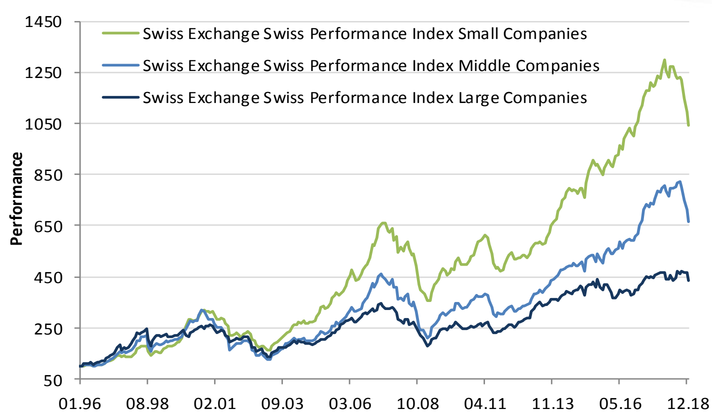
Market performance did not recover at the end of the year as we had hoped, in particular when talks between American and Chinese negotiators had suggested a potential solution to the conflict before the end of March 2019, which should logically have decreased uncertainty and risk levels. However, in driving down the price and valuation levels of many stocks, the market panic created new investment opportunities for the coming year, which should be positive for Swiss equities, unless of course the recession scenario ends up materialising.

SWISS EQUITIES - Capitalization

31.12.2018 — Total Return Performance

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
SPI SWISS PERFORMANCE IX	9830.1	0.2	-6.7	-9.1	-5.2	-8.6
SPI SMALL COMPANIES INDX	22940.9	1.1	-4.9	-14.5	-15.2	-17.1
SPI MIDDLE COMPANIES IDX	13855.8	1.3	-6.5	-17.1	-16.0	-16.3
SPI LARGE COMPANIES INDX	9336.6	-0.1	-6.8	-7.1	-2.4	-6.5

Swiss Equities Performance

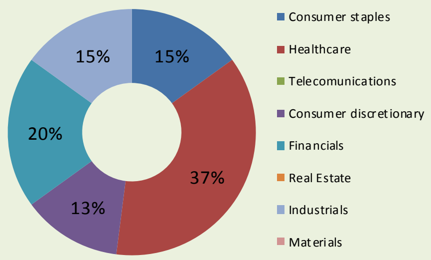


Graph sources: Bloomberg/BBGI Group

Swiss Equities - Sectors

SWISS EQUITIES Sectors	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Consumer staples	↗	↗			■				
Healthcare	↗	↗			■				
Telecommunications	↗	↗				■			
Consumer discretionary	↗	↗					■		
Financials	↗	↗					■		
Real Estate	↗	↗				■			
Industrials	↗	↗					■		
Materials	↗	↗			■				

Swiss Equities allocation - sectors



Tactical Allocation

- Decrease health care sector
- Decrease consumer staples sector
- Increase consumer discretionary sector

Fewer blue chips and more medium caps

The comparatively decent performance of the three major Swiss blue chip stocks over the past three months has more to do with their relatively defensive character – much sought after in an anxiety-ridden market environment – than with genuinely higher earnings growth prospects. Indeed, in the panicked financial market context of December, Novartis, Roche and Nestlé were, as logically to be expected, popular with investors focusing their equity investments on these stocks to the detriment of most others and in particular of small and mid caps. However, the excessive attention paid to the risks of a collapse in growth should abate fairly rapidly at the beginning of 2019. We believe that the potential for capital appreciation is currently much more significant in the small and mid cap segment and recommend increasing exposure to these stocks. The major blue chips will thus likely underperform over the next few months.

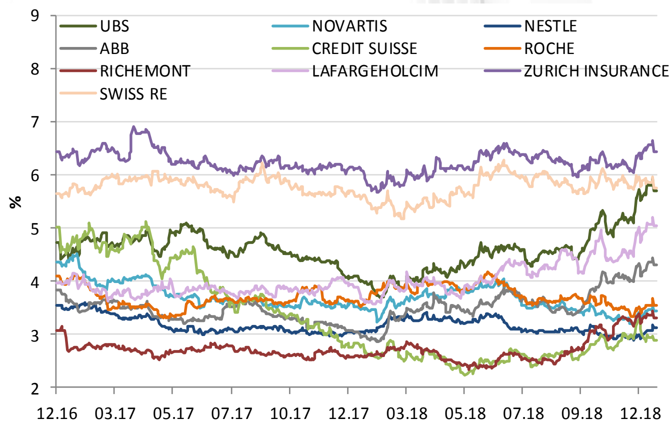
Exchange rate factor slightly positive in 2019

The exchange rates that most strongly determine the economic performance of Swiss companies remained remarkably stable in Q4. Indeed, the dollar remained steady, and the euro slid back only -1% against the franc. The impact of exchange rates on 2018 earnings will thus remain unchanged. A slight appreciation of the euro and the dollar in 2019 will likely have a positive impact on results in Swiss francs.

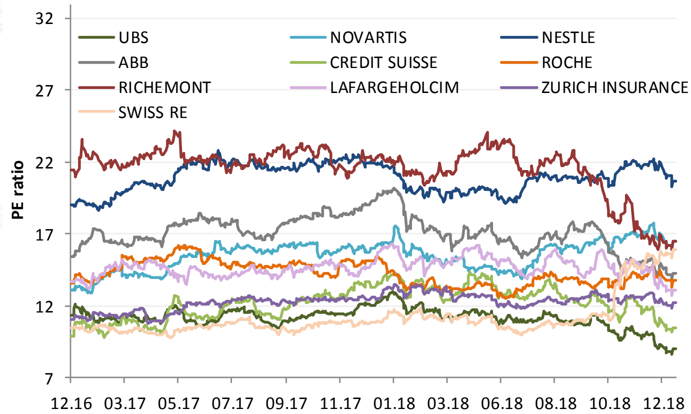
Dividend yield remains attractive

The dividend yield for the SPI index is currently 3.2%, which is rather high by historical comparison and definitely a positive factor.

Dividend Yield



PE ratio

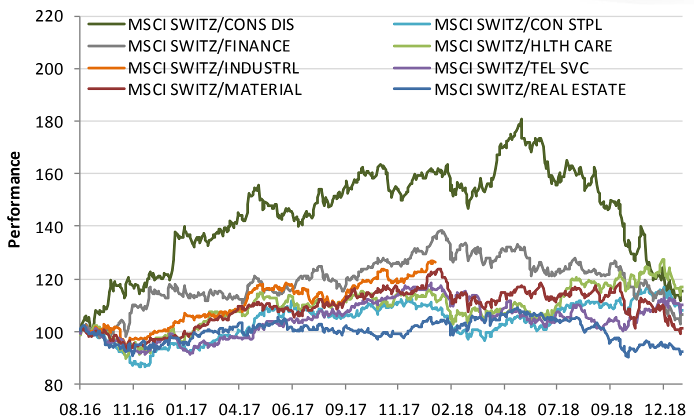


SWISS EQUITIES - BY SECTOR

31.12.2018 — Total Return Performance

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
MSCI SWITZ/CONS DIS	248.8	1.3	-3.7	-21.6	-26.5	-27.3
MSCI SWITZ/CON STPL	263.8	-1.8	-6.5	-3.4	0.2	-1.9
MSCI SWITZ/FINANCE	49.4	1.2	-6.9	-13.6	-12.6	-18.0
MSCI SWITZ/HLTH CARE	145.0	0.4	-7.5	-3.0	6.6	3.3
MSCI SWITZ/INDUSTRL	153.6	0.6	-5.9	-16.6	-12.6	-20.7
MSCI SWITZ/MATERIAL	252.1	0.4	-6.6	-14.0	-9.1	-13.2
MSCI SWITZ/REAL ESTATE	926.0	-0.7	-3.5	-4.1	-11.6	-11.0
MSCI SWITZ/TEL SVC	88.8	-0.7	-2.0	7.2	3.3	-5.0

Performance



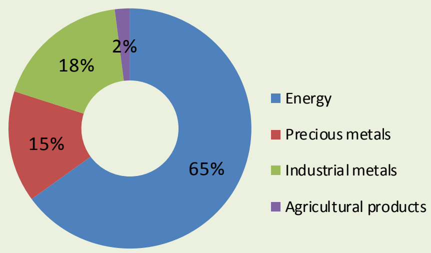
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Commodities

- Expectations of a recession are dragging down commodities
- Crude oil is seriously under-valued
- Industrial metals will benefit from a trade deal
- Increased investment demand for gold and silver

Commodities allocation



COMMODITIES	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Energy	→	↗							
Precious metals	↗	↗↗							
Industrial metals	↗	↗↗							
Agricultural products	→	↗							

Tactical Allocation

- Large energy exposure
- Overweight precious metals
- Overweight industrial metals
- Include agricultural products

Irrational expectations of a recession are dragging down commodities

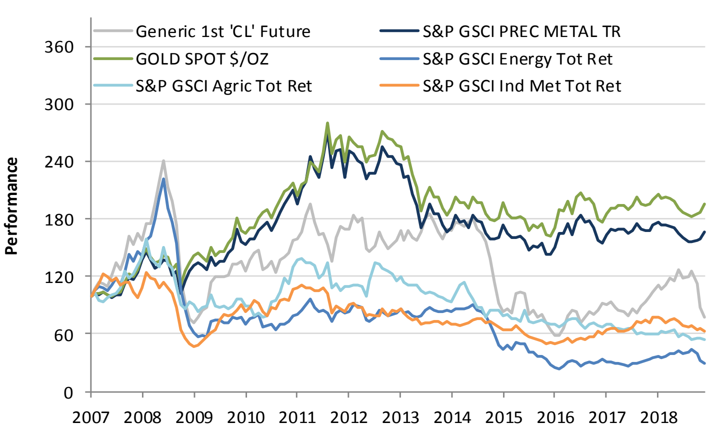
In October 2018, we saw a quick about-turn in economic growth forecasts and the threat of recession. For several important commodities, including crude oil (-32.7%), this marked a turnaround in their stock market trend, at least in the short term. The general drop across all assets, excluding rate markets, did not of course spare commodities. The energy sector was the first to be affected by swift corrections of between -27.9% and -36.2%. Industrial metals also suffered under fears of a collapse in Chinese imports, particularly nickel (-15.1%) and aluminium (-9.6%). Similarly, copper and zinc fell around -4% apiece. Precious metals were the big winners of this stock market panic- gold leapt +7.3% and silver rose +5.4%. In the end, agricultural products were hardly affected by this new investment climate and only lost a few percentage points, with the exception of sugar, which posted the best performance of the quarter (+7.9%). The recovery of the US dollar in the 4th quarter probably also had an impact on commodity prices. The shock in the 3rd quarter was so severe that it entirely wiped out (-22.9%) indices' excellent performance (+11.8%) in the first nine months of the year. As is to be expected, commodities had out-performed equity markets while economic activity was improving. They were on their way to posting a third consecutive year of rises, but in the end posted a -13.8% drop due to the threat of recession. We have not ruled out the risk of a slowdown in 2019 in our forecasts, but it seems unlikely and a far cry from the picture that fears of a slowdown are painting. These fears emerged in the 4th quarter, predicting both a recession in the United States in 2019 and a collapse in demand in China, but we believe them to be ill-founded.

On the contrary, most commodity sectors should enjoy positive fundamentals, despite an economic slowdown. It should not be forgotten that in the coming quarters global supply will still be straitjacketed by the fall in capex over the past few years, whereas if there is no major global economic shock, demand should grow. We believe that imbalances will emerge and prop up prices in the industrial metals sector, too. Chinese growth, even if it does slow, will still undoubtedly remain between +6% and +6.5%, which should continue to help global demand to increase, particularly if global GDP growth remains high.

Crude oil is seriously under-valued

Crude oil posted its greatest quarterly price drop (-38%) since the last quarter 2014 (-41.5%) in the 4th quarter 2018. This was the largest drop in prices in the last twenty years apart from the collapse (-55.7%) in the wake of the 2008 financial crisis. Current prices have clearly incorporated what we consider to be excessively negative global economic growth prospects for 2019. As such, unless there is a real recession in the United States in 2019, or a collapse in Chinese and global demand, crude oil prices are undoubtedly under-valued. Despite the backdrop of pessimism at the end of the year, we do not believe that these extreme global economic predictions are rational. Equally, the behaviour of crude oil prices at the very end of the year instead seems to be suggesting that a floor at below US$45 per barrel has been hit. After a period of stabilisation at above US$50 at the beginning of the year, investors should take more account of oil market fundamentals.

Commodities



Graph sources: Bloomberg/BBGI Group

COMMODITIES (USD)

31.12.2018 — Total Return Performance

N° ISIN	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
	MSCI Daily TR Net World USD	5412.12	USD	4.54	-7.60	-13.40	-8.80	-8.71
GLOBAL	S&P GSCI Tot Return Indx	2203.5	USD	2.0	-7.8	-24.8	-20.9	-13.8
WTI CRUDE	Generic 1st 'CL' Future	45.4	USD	6.8	-10.8	-39.6	-38.8	-24.8
BRENT OIL	Generic 1st 'CO' Future	53.8	USD	6.6	-8.4	-36.6	-31.2	-19.5
NATURAL GAS	Generic 1st 'NG' Future	2.9	USD	-15.2	-36.3	-7.1	2.4	-0.4
OR	GOLD SPOT $/OZ	1282.5	USD	1.0	4.9	6.6	2.2	-1.6
ARGENT	Silver Spot $/Oz	15.5	USD	4.9	9.1	5.5	-3.7	-8.5
AGRICULTURE	S&P GSCI Agric Indx Spot	283.9	USD	-1.2	-2.3	-0.4	1.8	0.6
INDUSTRIAL METALS	S&P GSCI Ind Metal Spot	319.3	USD	-0.8	-4.1	-8.8	-11.4	-19.0

We believe it entirely likely that prices could head back up to US$70 per barrel over the coming months. We are expecting a combination of various fundamental and technical factors to support a robust upward trend on crude oil. Energy market fundamentals are actually rather positive, particularly for crude oil, in our scenario of a mere global economic slowdown in 2019. Indeed, we expect OPEC to continue to take action to reduce the production levels of its member states and for US oil production to fall. Together, these would lead to a drop in global crude oil supply. In fact, OPEC has already decided to reduce production by -1.2 mbd for the first six months of 2019, completely reversing the OPEC and Russian increase in production in the second half of 2018. Saudi Arabia decreased production from 11.07 mbd to 10.65 mbd in December, and will operate more extensive cuts in January 2019, bringing it down towards 10.1 mbd. As regards US supply, prices dropping below US$ 50 is certainly already starting to affect the profitability and production levels of producers in the Permian Basin. The pressure on Iran is limiting its export capacity to around 1 mbd, with no potential for upward movement.

On the demand side, the forecasts of a recession in the United States or a major slowdown in global growth, which we believe to be irrational, have been affecting demand and therefore crude oil prices. However, we believe that these fears are overblown and remain convinced that any global growth slowdown would not exceed +3.5% in 2019 without an out-and-out trade war between China and the United States. Our scenario favours a solution to the conflict in the long-term, avoiding a head-on clash. This type of environment is rather positive for the crude oil market. It should find a middle ground between a slight 1 mbd increase in supply and a 1.2 mb d increase in global demand. The crude oil market will therefore be slightly imbalanced in 2019. This should prove sufficient to ensure that crude oil prices head north of US$70 per barrel.

Industrial metals will benefit from a trade deal

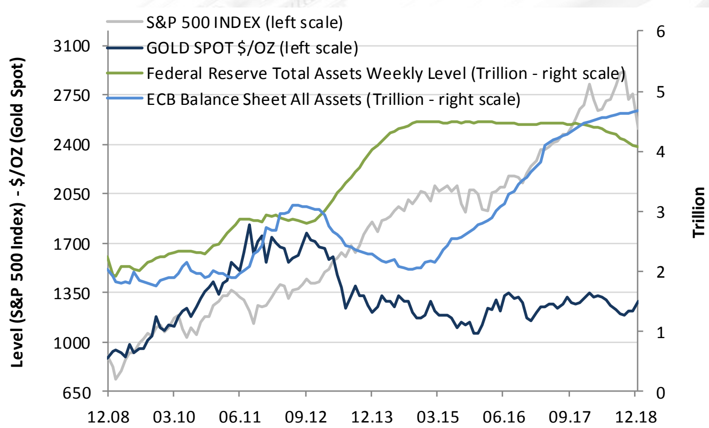
Industrial metals suffered for the same reasons as crude oil in 2018, but should benefit from traders seeing reason on economic prospects in 2019. Global growth and Chinese demand for industrial metals will not have the expected negative impact. Consequently, a slowdown in global growth will not derail the fundamental trend on industrial metals. The fall in capex will further restrict any increase in supply for a few years, though Chinese demand should remain a key component of physical markets. China has announced a stimulation package, including infrastructure, construction and, more broadly, economic sectors which will prop up demand for copper and other industrial metals. There should be a deficit in the copper market in 2019 and falling inventories. However, copper will not be alone in this, and it should encourage a significant price rise after the irrational corrections of 2018- as soon as an agreement is in place ending the crisis between China and the United States.

Increased investment demand for gold and silver

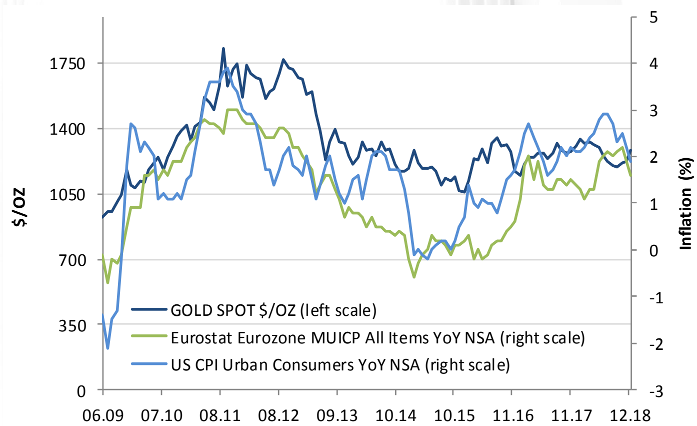
In our latest strategy from October 2018, we revealed that a positive development in investment demand would certainly trigger a new upward trend on gold and silver. We predicted that this would happen at the end of the year after a four-month drop. The particularly uncertain context of the 4th quarter did prop up a +7.4% increase in investment demand for ETFs investing in physical gold. Demand rose from 67 to around 72 million ounces of gold. The amount of physical gold held in ETFs recovered to levels seen in May 2018, while gold prices increased by +7.5%, heading towards the US$1300 per ounce threshold. It now appears that any interest rate rise or weakening of the US dollar in 2019 will be modest.

From a technical point of view, gold and silver are now on the up and benefiting from several favourable technical factors. Precious metals will also benefit from a gradual rise in inflationary forecasts in 2019 and a broadening of investment demand as investors hunt out defensive assets. In the medium term, gold prices should head up above the US$1300 threshold, and then above the US$1350 zone of resistance, before soaring above US$1400. Silver prices should also recover to US$17 per ounce.

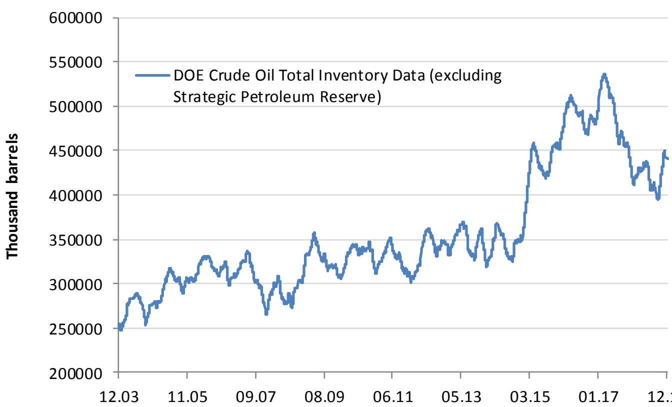
Gold and Global liquidity



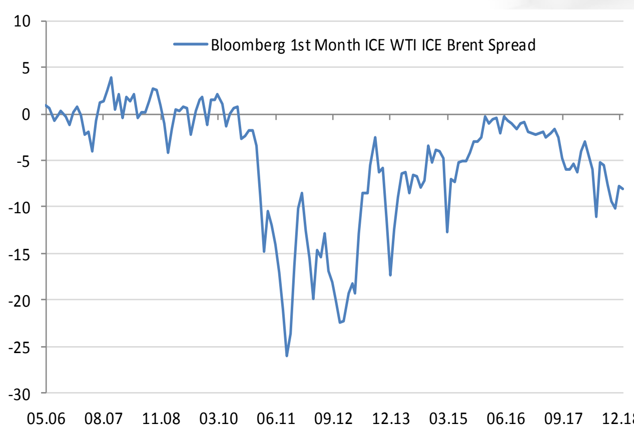
Gold and Inflation



Crude Oil Inventory (USA)



WTI - Brent Price Spread



Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Hedge Funds

- Hedge funds correct less than equities

Hedge funds correct less than equities

Alternative investment strategies were not exempt from the generalised slump seen in most asset classes in Q4. Nevertheless, hedge funds managed to limit their decline between the months of September and December. Thus, the global alternative investment index fell -5.46% over the quarter for a FY2018 performance of -6.72%, while international equities posted quarterly and annual losses of -13.42% and -8.71%, respectively.

As for the different asset management styles, none managed to close the quarter in the black. However, the macto/CTA and relative value arbitrage strategies limited their decline over the quarter to only -2.30% and -3.64%, respectively, with the latter flirting with zero performance year-to-date (-1.17%). The equity hedge (-8.09%) and event driven (-6.60%) strategies posted more pronounced corrections.

Private Equity

- Private equity indices plummet

The highly uncertain environment in Q4 proved to be rather disadvantageous for private equity (-17.87%), which posted its most significant drop since Q3 2011, cancelling out a cumulative performance of close to +10% over the first nine months of the year and closing at -9.58%.

At a regional level, in spite of a pronounced correction of -17.98%, the US closed out the year down -5.93%, well ahead of the main equity markets of developed countries.

Europe (-15.15%) and the UK (-11.32%) were also negative over the quarter and posted annual results of -12.27% and -9.28%, respectively, in line with the performance of their respective equity markets.

HEDGE FUND INDICES (USD)

31.12.2018 — Total Return Performance

	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
GLOBAL	HFRX Global Hedge Fund Index	1189.9	USD	1.1	-1.9	-5.5	-6.1	-6.7
EQUITY HEDGE	HFRX Equity Hedge Index	1151.1	USD	2.2	-4.2	-8.1	-9.9	-9.4
EVENT DRIVEN	HFRX Event Driven Index	1471.3	USD	1.7	-1.2	-6.6	-7.9	-11.7
MACRO/CTA	HFRX Macro/CTA Index	1126.1	USD	0.0	0.8	-2.3	-1.7	-3.2
RELATIVE VALUE ARBITRAGE	HFRX Relative Value Arbitrage	1171.0	USD	0.2	-2.0	-3.6	-3.3	-1.2
LATIN AMERICA*	HFRX Latin America Index	2058.1	USD	-	-1.3	1.6	-0.6	-7.7
ASIA COMPOSITE*	HFRX Asia Composite Hedge Fund Index	2169.6	USD	-	-3.5	-7.9	-11.1	-13.3
NORTHERN EUROPE*	HFRX Northern Europe Index	1983.5	USD	-	-1.0	-2.9	-2.0	-0.9
ASIA EX-JAPAN*	HFRX Asia ex-Japan Index	2289.6	USD	-	-3.0	-9.5	-15.7	-18.7
MULTI-REGION	HFRX Multi-Region Index	1284.8	USD	1.4	-2.1	-5.6	-6.4	-5.9

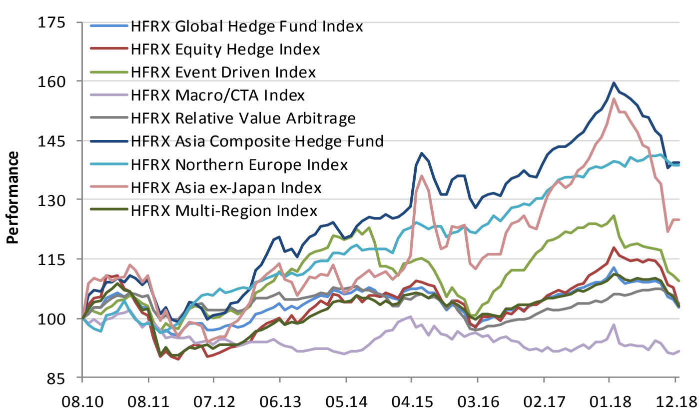
* Subject to one-month lag

PRIVATE EQUITY INDICES (EUR)

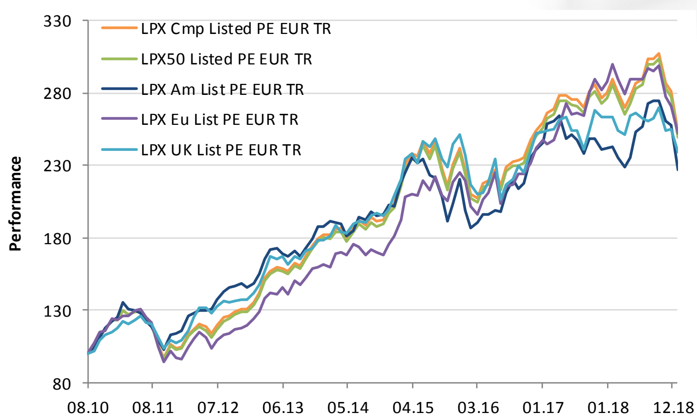
31.12.2018 — Total Return Performance

	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
COMPOSITE	LPX Cmp Listed PE EUR TR	210.7	EUR	2.0	-9.8	-17.9	-14.3	-9.6
MAJOR COMPANIES	LPX50 Listed PE EUR TR	1974.3	EUR	2.1	-10.1	-18.3	-14.7	-9.7
USA	LPX Am List PE EUR TR	302.2	EUR	2.9	-12.0	-18.0	-14.3	-5.9
EUROPE	LPX Eu List PE EUR TR	806.7	EUR	0.4	-7.0	-15.1	-12.9	-12.3
UK	LPX UK List PE EUR TR	267.3	EUR	-1.5	-6.2	-11.3	-9.1	-9.3

Hedge funds

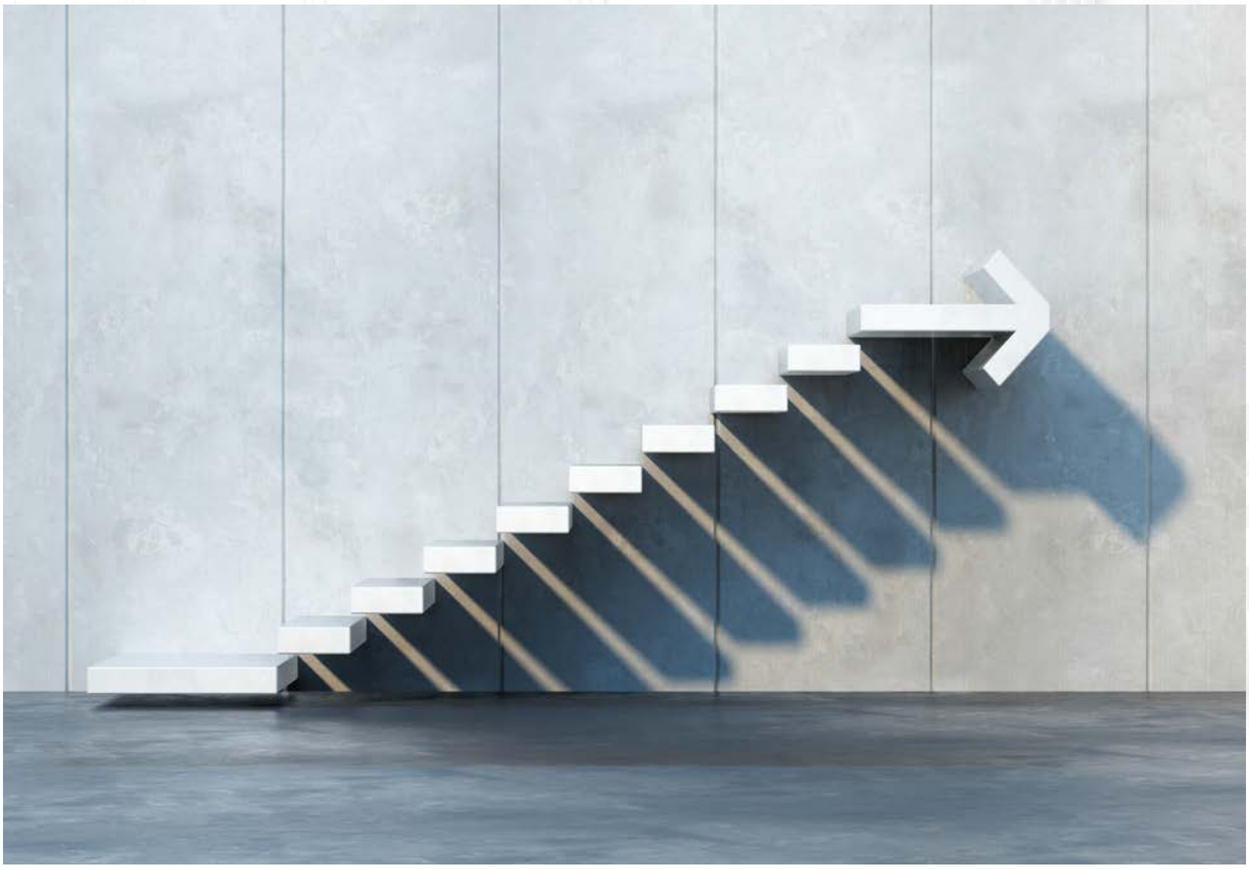


Private Equity



Graph sources: Bloomberg/BBGI Group

GLOBAL STRATEGY & ASSET ALLOCATION



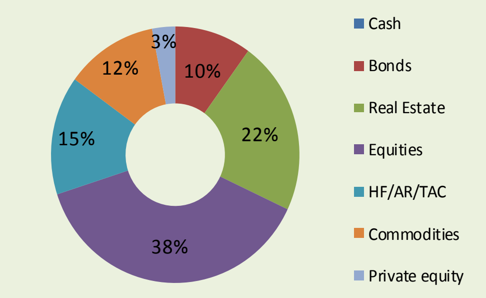
Graph sources: Bloomberg/BBGI Group

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - CHF

- Prioritise bonds in USD
- Real estate yield is still competitive
- Reinvest in equities during weakness
- Commodities out-perform

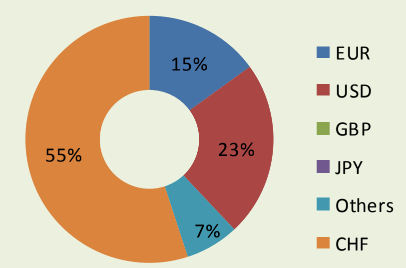
Asset allocation - CHF portfolio



Tactical Allocation

- Overweight equities again
- Overweight real estate, commo, currencies
- Underweight bonds

Currency allocation - CHF portfolio



ASSETS	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Cash	↘	↘							
Bonds	↘	↘							
Real Estate	↗	↗							
Equities	↗	↗							
Hedge funds	↗	↗							
Commodities	↗	↗							
Private equity	↗	↗							

Asset allocation

The core of our investment strategy is made up of traditional liquid assets (liquidities, bonds, equities and real estate), complemented by other diversified, tradable assets (commodities, hedge funds, private equities).

Bonds

In the United States, the interest rate curve is still offering up relatively good opportunities in the fixed-income investment segment when compared to bond markets in euro, yen, Swiss francs and sterling. Long rates will probably bounce back on most markets in 2019, thanks to the tensions on various jobs markets which may affect inflation. We believe that yields in USD are attractive enough to rule out high yield investments, the risk premium of which are now too low to justify high allocation. Before any slowdown in global growth, we should first see a modest rise in inflation, which will go hand in hand with a rise in bond yields. We are prioritising a cautious bond strategy and reduced overall exposure, favouring investments in US dollars and short maturities.

Equities

As we had announced in September, we did see fresh volatility in the 4th quarter. We now believe that forecasts of an economic slowdown, or even a recession in 2019, are overblown, but they certainly offer new investment opportunities, with valuation levels that are now attractive. We recommend shoring up positions that take advantage of this short-lived weakness and overweighting European and international equities for as long as profit growth is in line with forecasts. Greater diversification into small- and medium-sized businesses would seem sensible.

Commodities

Crude oil prices were affected by the extremely rapid, powerful rise of the prospect of recession at the end of the year. We believe that the fall in crude oil prices was temporary, but it was certainly also exceptional and went hand in hand with lesser decreases in industrial metal prices, also due to the prospect of recession. However, we believe that there is only a very slim chance of the "disaster" scenario playing out. Investors will likely start to see reason again at the start of the year, significantly benefiting most commodities and sparking a significant trend reversal, particularly on energy prices. Precious metals should also benefit from fears linked to trade tensions between the United States and China dissipating.

Real estate

Real estate is still the main alternative to rate markets. Yields are attractive and the risk of a price correction sparked by a rate rise still seems low given the often negative real-terms yields. Our strategy prioritises Swiss real estate; internationally, we favour European and Asian real estate.

Currencies

The quarter has seen no significant movement on exchange rates; the US dollar has started to stabilise, whereas there is almost no change on the euro. The Swiss franc should weaken with the expected improvement in the stock market climate in the 1st quarter 2019.

Market performances - Q4 2018

		Q4 2018 local	Q4 2018 CHF	YTD local	YTD CHF
Exchange rates					
USD/CHF		0.0%		0.8%	
EUR/CHF		-1.3%		-3.8%	
GBP/CHF		-2.1%		-4.9%	
JPY/CHF		3.8%		3.6%	
Equity markets					
World	MSCI World USD	-13.4%	-13.4%	-8.7%	-8.0%
Europe	DJ Stoxx 600	-11.6%	-12.7%	-10.8%	-14.2%
Eurozone	DJ Eurostoxx 50	-11.7%	-12.8%	-14.3%	-17.6%
	MSCI Europe S.C.	-16.7%	-17.8%	-17.7%	-20.8%
Germany	Dax 30	-13.8%	-14.9%	-18.3%	-21.4%
France	Cac 40	-13.9%	-15.0%	-11.0%	-14.4%
United Kingdom	FTSE 100	-10.4%	-12.3%	-12.5%	-16.8%
Switzerland	SPI	-9.0%	-9.0%	-8.6%	-8.6%
	SMI	-7.2%	-7.2%	-10.2%	-10.2%
	MSCI Swiss S.C.	-20.6%	-20.6%	-27.8%	-27.8%
North America	SP500	-14.0%	-13.9%	-6.2%	-5.5%
	Nasdaq	-17.5%	-17.5%	-3.9%	-3.1%
	Tse 300	-10.9%	-15.6%	-11.6%	-18.0%
	SP600 Small C.	-20.4%	-20.4%	-9.8%	-9.0%
Japan	Nikkei 225	-17.0%	-13.9%	-12.1%	-8.9%
Emerging	MSCI EMF USD	-7.8%	-7.8%	-16.6%	-16.0%

		Q4 2018 local	Q4 2018 CHF	YTD local	YTD CHF
Interest rates (3 months)		*(level)*			
CHF		-0.71%			
EUR		-0.36%			
USD		2.81%			
JPY		-0.07%			
Bonds markets					
World	Citi Gr Global Govt.USD	1.8%	1.8%	-0.8%	0.0%
Europe	Euro Ser-E Gov > 1	1.5%	0.2%	1.0%	-2.9%
United Kingdom	UK Ser-E Gov > 1	2.1%	0.0%	0.5%	-4.4%
Switzerland	SBI Général AAA-BBB	1.4%	1.4%	0.1%	0.1%
	SBI Govt.	3.0%	3.0%	0.7%	0.7%
USA	US Ser-E Gov > 1	2.6%	2.6%	0.9%	1.7%
Japan	Japan Ser-E Gov > 1	1.4%	5.2%	1.0%	4.6%
Emerging	J.P. Morgan EMBI Global	-1.2%	-1.2%	-4.6%	-3.8%
Miscellaneaous					
	LPP 25 Index	-1.8%	-1.8%	-2.2%	-2.2%
	LPP 40 Index	-3.6%	-3.6%	-3.4%	-3.4%
	LPP 60 Index	-6.1%	-6.1%	-5.0%	-5.0%
Real Estate CH	DB RB Swiss Real Est Fd	-0.4%	-0.4%	-4.0%	-4.0%
Hedge Funds	Hedge Fund Research USD	-3.9%	-3.9%	-5.4%	-4.6%
Commodities	GS Commodity USD	-22.9%	-22.9%	-13.8%	-13.1%

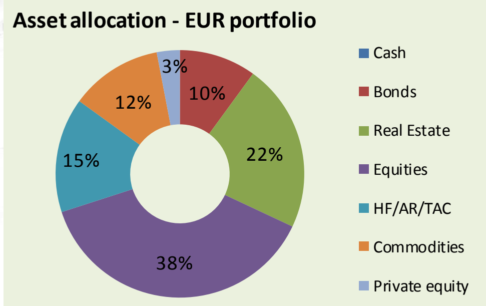
Graph sources: Bloomberg/BBGI Group

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - EUR

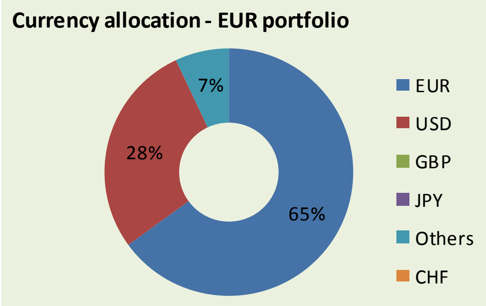
- Reduce risk in the Eurozone
- Real estate yield is still competitive
- Reinvest in equities during weakness
- Commodities out-perform

ASSETS	Expected Return 3months	Expected Return 1year	ALLOCATION (EUR Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Cash	→	→							
Bonds	↘	↘							
Real Estate	↗	↗							
Equities	↗	↗							
Hedge funds	↗	↗							
Commodities	↗	↗							
Private equity	↗	↗							



Tactical Allocation

- Overweight equities again
- Overweight real estate and commodities
- Underweight bonds and decrease USD



Asset allocation

The core of our investment strategy is made up of traditional liquid assets (liquidities, bonds, equities and real estate), complemented by other diversified, tradable assets (commodities, hedge funds, private equities).

Bonds

In the United States, the interest rate curve is still offering up relatively good opportunities in the fixed-income investment segment when compared to bond markets in euro, yen, Swiss francs and sterling. Long rates will probably bounce back on most markets in 2019, thanks to the tensions on various jobs markets which may affect inflation. We believe that yields in USD are attractive enough to rule out high yield investments, the risk premium of which are now too low to justify high allocation. Before any slowdown in global growth, we should first see a modest rise in inflation, which will go hand in hand with a rise in bond yields. We are prioritising a cautious bond strategy and reduced overall exposure, favouring investments in US dollars and short maturities.

Equities

As we had announced in September, we did see fresh volatility in the 4th quarter. We now believe that forecasts of an economic slowdown, or even a recession in 2019, are overblown, but they certainly offer new investment opportunities, with valuation levels that are now attractive. We recommend shoring up positions that take advantage of this short-lived weakness and overweighting Swiss and international equities for as long as profit growth is in line with forecasts. Greater diversification into small- and medium-sized businesses would seem sensible.

Commodities

Crude oil prices were affected by the extremely rapid, powerful rise of the prospect of recession at the end of the year. We believe that the fall in crude oil prices was temporary, but it was certainly also exceptional and went hand in hand with lesser decreases in industrial metal prices, also due to the prospect of recession. However, we believe that there is only a very slim chance of the "disaster" scenario playing out. Investors will likely start to see reason again at the start of the year, significantly benefiting most commodities and sparking a significant trend reversal, particularly on energy prices. Precious metals should also benefit from fears linked to trade tensions between the United States and China dissipating.

Real estate

Real estate is still the main alternative to rate markets. Yields are attractive and the risk of a price correction sparked by a rate rise still seems low given the often negative real-terms yields. Our strategy prioritises European real estate; internationally, we favour Asian real estate.

Currencies

The quarter has seen no significant movement on exchange rates; the euro has started to stabilise against the us dollar, which has been going on for almost six months. An improvement in the stock market climate and better economic prospects could favor the euro.

Market performances - Q4 2018

		Q4 2018 local	Q4 2018 EUR	YTD local	YTD EUR
Exchange rates					
USD/EUR		1.2%		4.7%	
CHF/EUR		1.1%		3.8%	
GBP/EUR		-0.9%		-1.2%	
JPY/EUR		4.9%		7.5%	
Equity markets					
World	MSCI World USD	-13.4%	-12.4%	-8.7%	-4.4%
Europe	DJ Stoxx 600	-11.6%	-11.6%	-10.8%	-10.8%
Eurozone	DJ Eurostoxx 50	-11.7%	-11.7%	-14.3%	-14.3%
	MSCI Europe S.C.	-16.7%	-16.7%	-17.7%	-17.7%
Germany	Dax 30	-13.8%	-13.8%	-18.3%	-18.3%
France	Cac 40	-13.9%	-13.9%	-11.0%	-11.0%
United Kingdom	FTSE 100	-10.4%	-11.3%	-12.5%	-13.6%
Switzerland	SPI	-9.0%	-8.0%	-8.6%	-5.1%
	SMI	-7.2%	-6.2%	-10.2%	-6.7%
	MSCI Swiss S.C.	-20.6%	-19.6%	-27.8%	-24.4%
North America	SP500	-14.0%	-12.9%	-6.2%	-1.8%
	Nasdaq	-17.5%	-16.5%	-3.9%	0.6%
	Tse 300	-10.9%	-14.6%	-11.6%	-14.7%
	SP600 Small C.	-20.4%	-19.5%	-9.8%	-5.5%
Japan	Nikkei 225	-17.0%	-13.0%	-12.1%	-5.4%
Emerging	MSCI EMF USD	-7.8%	-6.7%	-16.6%	-12.7%

		Q4 2018 local	Q4 2018 EUR	YTD local	YTD EUR
Interest rates (3 months)		*(level)*			
CHF		-0.71%			
EUR		-0.36%			
USD		2.81%			
JPY		-0.07%			
Bonds markets					
World	Citi Gr Global Govt.USD	1.8%	2.9%	-0.8%	2.9%
Europe	Euro Ser-E Gov > 1	1.5%	1.5%	1.0%	1.0%
United Kingdom	UK Ser-E Gov > 1	2.1%	1.2%	0.5%	-0.7%
Switzerland	SBI Général AAA-BBB	1.4%	2.5%	0.1%	3.9%
	SBI Govt.	3.0%	4.2%	0.7%	4.5%
USA	US Ser-E Gov > 1	2.6%	3.8%	0.9%	5.6%
Japan	Japan Ser-E Gov > 1	1.4%	6.3%	1.0%	8.6%
Emerging	J.P. Morgan EMBI Global	-1.2%	0.0%	-4.6%	-0.1%
Miscellaneaous					
	LPP 25 Index	-1.8%	2.0%	-2.2%	1.5%
	LPP 40 Index	-3.6%	0.0%	-3.4%	0.3%
	LPP 60 Index	-6.1%	-2.6%	-5.0%	-1.4%
Real Estate CH	DB RB Swiss Real Est Fd	-0.4%	-0.4%	-4.0%	-0.4%
Hedge Funds	Hedge Fund Research USD	-3.9%	-2.8%	-5.4%	-0.9%
Commodities	GS Commodity USD	-22.9%	-22.0%	-13.8%	-9.8%

Graph sources: Bloomberg/BBGI Group

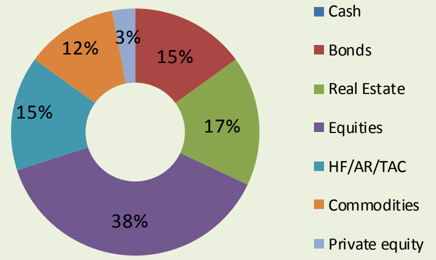
GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - USD

- Attractive returns in the United States
- Real estate yields remain attractive
- Reinvest in equities during weakness
- Commodities outperformance

ASSETS	Expected Return		ALLOCATION (USD Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Cash	→	→							
Bonds	→	→							
Real Estate	↗	↗							
Equities	↗	↗							
Hedge funds	↗	↗							
Commodities	↗	↗							
Private equity	↗	↗							

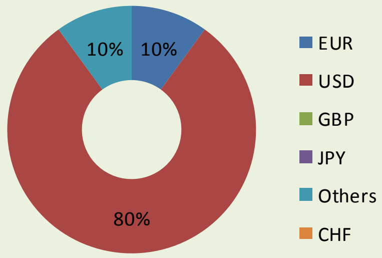
Asset allocation - USD portfolio



Tactical Allocation

- Overweight equities again
- Overweight real estate and commodities
- Avoid High Yield

Currency allocation - USD portfolio



Asset allocation

The core of our investment strategy is made up of traditional liquid assets (liquidities, bonds, equities and real estate), complemented by other diversified, tradable assets (commodities, hedge funds, private equities).

Bonds

In the United States, the interest rate curve is still offering up relatively good opportunities in the fixed-income investment segment when compared to bond markets in euro, yen, Swiss francs and sterling. Long rates will probably bounce back on most markets in 2019, thanks to the tensions on various jobs markets which may affect inflation. We believe that yields in USD are attractive enough to rule out high yield investments, the risk premium of which are now too low to justify high allocation. Before any slowdown in global growth, we should first see a modest rise in inflation, which will go hand in hand with a rise in bond yields. We are prioritising a cautious bond strategy and reduced overall exposure, favouring investments in US dollars and short maturities.

Equities

As we had announced in September, we did see fresh volatility in the 4th quarter. We now believe that forecasts of an economic slowdown, or even a recession in 2019, are overblown, but they certainly offer new investment opportunities, with valuation levels that are now attractive. We recommend shoring up positions that take advantage of this short-lived weakness and overweighting Swiss and international equities for as long as profit growth is in line with forecasts. Greater diversification into small- and medium-sized businesses would seem sensible.

Commodities

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Real estate

Real estate is still the main alternative to rate markets. Yields are attractive and the risk of a price correction sparked by a rate rise still seems low given the often negative real-terms yields. Our strategy focuses on US domestic real estate as well as broad international diversification in Europe and Asia.

Currencies

The quarter has seen no significant movement on exchange rates; the dollar remains preferred but should lose momentum if an improvement in the stock market and better economic prospects could finally be imposed in the first quarter of 2019.

Market performances - Q4 2018

		Q4 2018 local	Q4 2018 USD	YTD local	YTD USD
Exchange rates					
CHF/USD		0.0%		-0.7%	
EUR/USD		-1.2%		-4.5%	
GBP/USD		-2.1%		-5.6%	
JPY/USD		3.7%		2.8%	
Equity markets					
World	MSCI World USD	-13.4%	-13.4%	-8.7%	-8.7%
Europe	DJ Stoxx 600	-11.6%	-12.6%	-10.8%	-14.8%
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	Tse 300	-10.9%	-15.7%	-11.6%	-18.6%
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Japan	Nikkei 225	-17.0%	-13.9%	-12.1%	-9.6%
Emerging	MSCI EMF USD	-7.8%	-7.8%	-16.6%	-16.6%

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EUR		-0.36%			
USD		2.81%			
JPY		-0.07%			
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Europe	Euro Ser-E Gov > 1	1.5%	0.3%	1.0%	-3.5%
United Kingdom	UK Ser-E Gov > 1	2.1%	0.0%	0.5%	-5.1%
Switzerland	SBI Général AAA-BBB	1.4%	1.4%	0.1%	-0.7%
	SBI Govt.	3.0%	3.1%	0.7%	0.0%
USA	US Ser-E Gov > 1	2.6%	2.6%	0.9%	0.9%
Japan	Japan Ser-E Gov > 1	1.4%	5.1%	1.0%	3.8%
Emerging	J.P. Morgan EMBI Global	-1.2%	-1.2%	-4.6%	-4.6%
Miscellaneaous					
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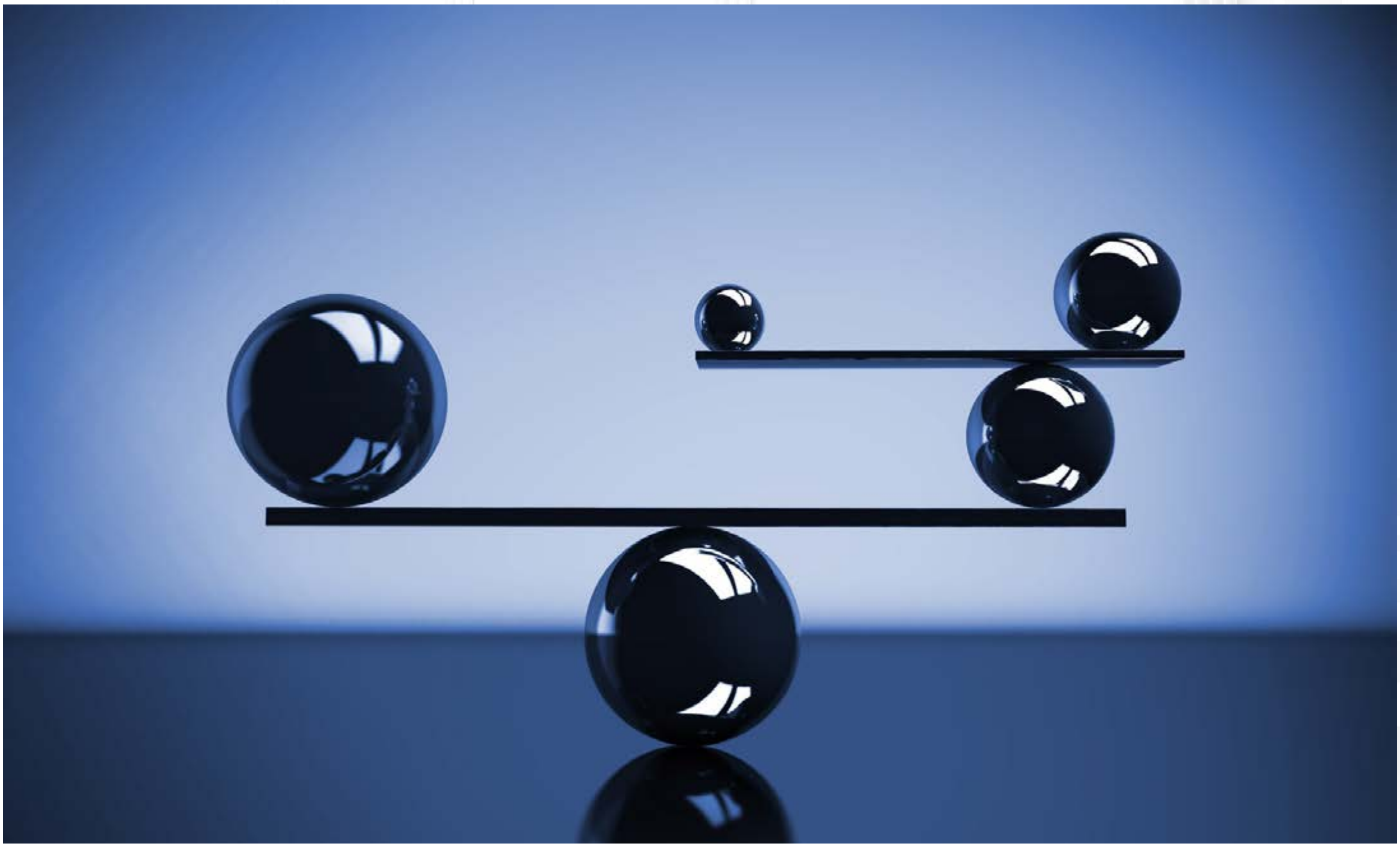
	LPP 60 Index	-6.1%	-6.8%	-5.0%	-5.7%
Real Estate CH	DB RB Swiss Real Est Fd	-0.4%	-0.4%	-4.0%	-4.7%
Hedge Funds	Hedge Fund Research USI	-3.9%	-3.9%	-5.4%	-5.4%
Commodities	GS Commodity USD	-22.9%	-22.9%	-13.8%	-13.8%

Graph sources: Bloomberg/BBGI Group

INVESTMENT THEME
FOCUS



Graph sources: Bloomberg/BBGI Group

INVESTMENT THEME

Fears of a yield curve inversion in the US are unfounded

- Markets spooked in December by the risk of a yield curve inversion
- What yield curve inversion are we talking about exactly?
- Yield curve flattening rather than inverting?
- Is the inversion of the 2- to 10-year yield curve a good indicator?
- Don't fear the yield curve!

Markets spooked in December by the risk of a yield curve inversion

Following the announcement on 30 November of a 90-day truce to allow American and Chinese negotiators to find common ground regarding trade relations between the two countries, a reversal of the yield curve abruptly revived fears in the financial markets.

While the beginnings of a solution was finally emerging with regards to the main risk factor in the global economy thanks to a resumption of talks – already considered promising – between the two economic partners, a new risk factor suddenly arose, eclipsing the positive prospects of a possible resolution of the dispute.

Within mere days the fear of a yield curve inversion spread like wildfire, contributing significantly to the steep drop in the US equity market of close to -8% in a mere 4 days.

This new source of concern affected not only the US market but also most financial markets and asset classes in a rare wave of panic during the period preceding the year-end holidays.

The month of December, which statistically has been positive overall over the past several decades with a higher than 80% probability of a rise, thus started out deep in the red, with many investors remaining on the cautious side.

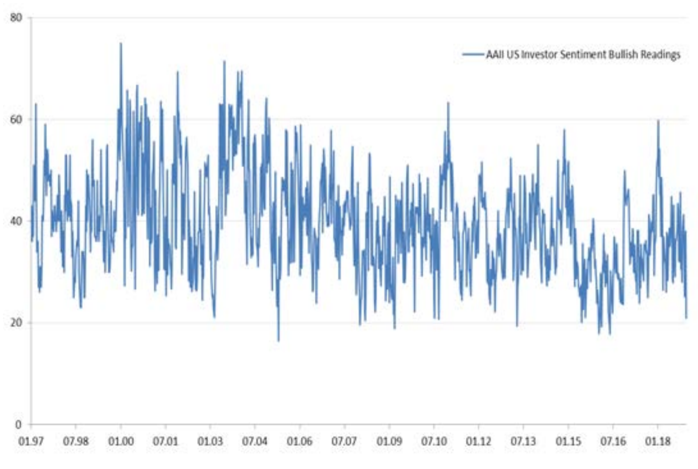
Without taking the time to look into the actuality of the yield curve situation or even to think about the fundamental principles or conditions that could influence or lead to a potential yield curve inversion in the US, investors seized on the theme, noting and underscoring, sometimes with the utmost gravity, the predictive nature of this phenomenon signalling a recession.

A few weeks away from year's end, it was likely all too much for those who were already fearing an abrupt slowdown in 2019 resulting from the negative impact of the introduction of tariffs by the US and China.

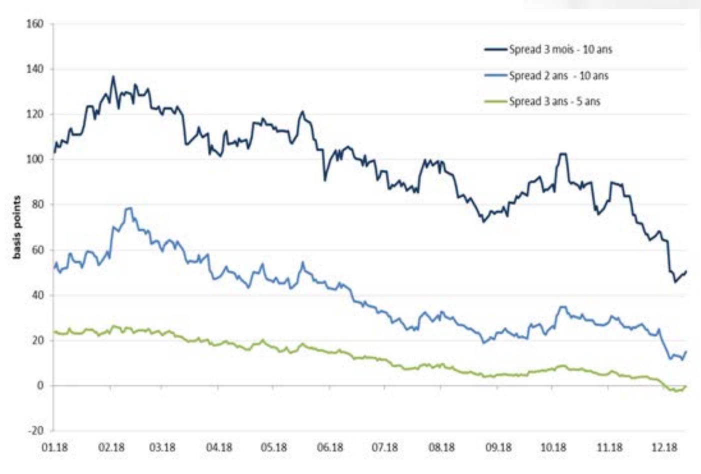
As of mid-December, the investor sentiment, as measured by the American Association of Individual Investors, attested to this sharp change in risk perception, nearing its lowest level of optimism in the past twenty years at approximately 20% bullish.

Note that these levels of wariness have typically been followed within months by a normalisation of investor sentiment along with a rally in financial markets.

American Association of Individual Investors investor sentiment bullish readings 1997-2017



3y-5y, 2y-10y, 3m-10y yield spreads in 2018



Graph sources: Bloomberg/BBGI Group

What yield curve inversion are we talking about exactly?

This much hyped yield curve inversion likely originated in a situation observed in the US Treasury bond market on 4 December and in the days following. For the first time, the yield on 3-year US Treasury bonds was higher than that on 5-year maturities. This was enough to start fanning the notion that investors were obtaining higher returns on short-term than on long-term US government debt and that this indicated that the yield curve was inverting as a whole.

At time of writing this phenomenon had been occurring for only a week, so its magnitude must be determined before drawing any conclusions or making any pre- dictions. Indeed, the yield spread between 3- and 5-year US Treasury bonds had been positive for around nine days, with the largest spread amounting to barely 2 basis points or 0.02% during that time. This spread corresponds to the rate spread between the 3- and 5-year maturities, that is as of this date 2.85% on the 3-year and 2.83% on the 5-year.

Upon rational analysis of the situation, it must be noted that we are still a far cry from a real yield curve inversion.

It would thus be much more appropriate to talk about a flattening of the yield curve with regard to these relative yield levels. Moreover, the phenomenon did not occur with regard to any other segment of the yield curve and remains a unique occurrence at this stage.

We are thus far from proclaiming an inversion harbinger of future recessions, as had been the case since the Second World War, when the spread between 2- and 10-year yields increased significantly in favour of short-term rates.

At this point in the analysis, it seems totally premature, not to say completely inconsistent, to suggest that there might be a generalized risk of recession based only on the observation of a positive yield spread of barely 0.02% on a very limited portion of the yield curve.

Yield curve flattening rather than inverting?

Since the last intervention of the US Federal Reserve, the yield curve indeed flattened under the influence of two distinct forces acting in different ways on short and long maturities. The first of these two forces was generated by the Fed, while the second was instead the result of investor expectations with regard to the outlook on growth and inflation. Thus, the central bank's efforts to normalise its monetary policy via regular rate hikes impacted the short end of the yield curve, making it rise in stages, in particular with regard to maturities between 1 and 12 months. We thus saw a logical tightening of rates of around 0.25% when the central bank raised its rates correspondingly such as in September or in December for example.

With regard to longer maturities, the shift occurred in the other direction given diminishing inflationary pressures and rising uncertainty with regard to economic growth in 2019 over the past few weeks. Thus, the yield curve was shifting upward on the short end while it was shifting down on the long end. This phenomenon led to yields on various maturities shifting closer together but did not modify the "normality" of the curve.

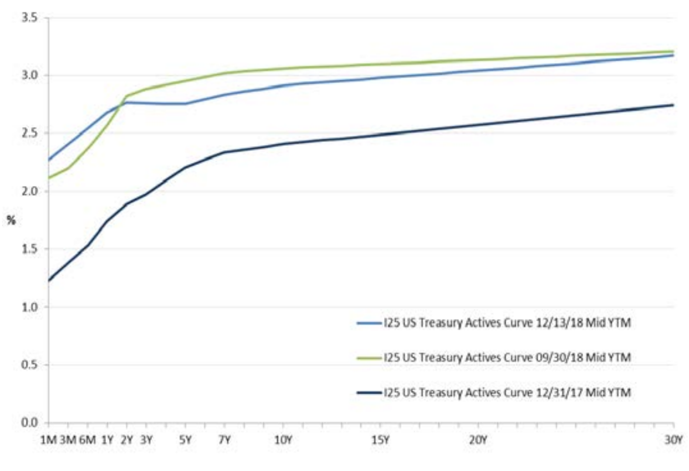
In other words, long-term yields remain higher than short-term yields, but the slope of the curve naturally tended to flatten.

For all that, was it necessary to draw the conclusion that a flattening yield curve would necessarily and rapidly be followed by an inversion, as many investors seemed to have assumed at the beginning of December? It is also surprising to note how this shortcut with regard to risk analysis and assessment affected so many participants and investors, likely in too much of a hurry to react rather than verify the accuracy of the prediction.

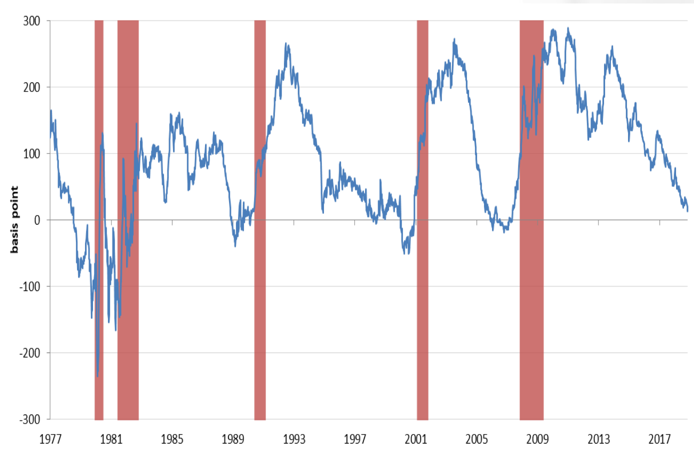
Is the inversion of the 2- to 10-year yield curve a good indicator?

It should be noted that an inversion of the yield curve between these two maturities was indeed followed by a recession in the US several times throughout the past. In particular in 1980, 1981-82, 1990-91, 2000-01 and 2008-09, this phenomenon signalled an economic recession with, however, a varying amount of lag, from several quarters to several years.

US Treasury yield curve (December 2017, September and December 2018)



Yield spread between 2- and 10-year Treasuries and US recessions since 1977



Graph sources: Bloomberg/BBGI Group/SSF

Once more, we must underline that in no way does the recent phenomenon correspond to a significant inversion in the yield curve at this stage, in our view constituting merely a likely temporary convergence of short- and long-term yields.

Moreover, a yield curve inversion is not, in itself, a crisis-triggering factor, but rather a result of economic conditions and monetary policies that may generate a recession in the future.

Thus, it is generally in the context of strong economic growth accompanied by significant inflationary pressures that increases in policy rates initiated by the central bank, and in short-term rates more generally, lead to an overly severe tightening of monetary conditions, which prevents a soft landing of the economy and causes an unwanted recession.

Simply looking at trends in the spread between 2- and 10-year yields between 1977 and 2018, we can see that US recessions were indeed preceded by a yield curve inversion, although the recessions occurred sometimes only years later and after other factors finally led to that outcome.

The 2008-2009 recession, for instance, happened three years after the yield curve started to invert; thus, it will obviously be crucial to watch how the current yield spread evolves to assess the actual risks threatening US growth and on what time horizon they may have an effect.

What of the current situation?

In this regard, it may be interesting to look at the measure published by the New York Fed, which continually assesses the risks of recession, to put into perspective investors' negative expectations that emerged over the past few days. The figure below suggests that the risk of a recession within 12 months is of only 15%.

By historical comparison, that level of risk cannot be considered as sufficiently high and significant to justify an abrupt change in outlook and consequently in risk perception. However, while in several cases a recession did occur within several quarters to several years, this indicator was not relevant in two cases in the past decades – in the nineties and in the three years preceding the 2008-2009 recession.

Note as well that the current economic situation, as well as the outlook for 2019, does not seem to be indicating an acceleration of economic momentum that would lead to excessive inflationary pressure.

The US economy is unlikely to accelerate given the current environment, and inflation is naturally slowing down as crude prices fall, sliding from 2.5% to 2.2% in November, closer to the Fed's target. In the current context, the decline in inflation is a crucial factor in predicting the Fed's future monetary policy.

As the economy is likely to slow down in 2019 and inflation remains under control, in spite of a very low unemployment rate, conditions thus do not seem to justify a continuation of US monetary policy normalisation.

Don't fear the yield curve!

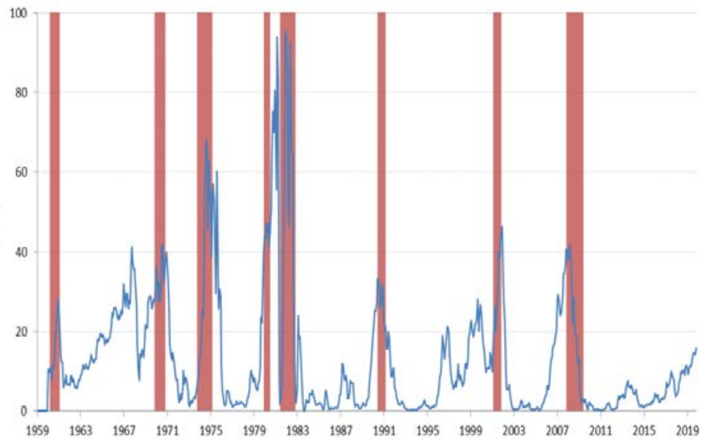
Thus, our analysis favours a scenario wherein the Fed changes its stance in the near future, underlining the increased vigilance of all members of the FOMC with regard to the risks of a potential unwanted inversion of the yield curve.

The Fed chair already hinted at such a change in policy, mentioning that the current policy rate levels were now just below the level he considers neutral given the current economic context.

The Fed will thus likely remain particularly careful not to risk slowing down the economy by raising rates inappropriately.

We believe the Fed will adopt a cautious policy over the next few quarters, leaving its rates unchanged as long as stronger growth does not cause inflation to accelerate.

Probability of a recession within 12 months calculated by the New York Fed



Graph sources: Bloomberg/BBGI Group

Graph sources: Bloomberg/BBGI Group

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