BBGI GROUP Global Investments

Investment Strategy

January 2020

"THERE IS A BEAUTY THAT REMAINS WITH US AFTER WE'VE STOPPED LOOKING."

CORY RICHARDS,
PHOTOGRAPHER AND EXPLORER, WEARS THE VACHERON CONSTANTIN OVERSEAS.

VACHERON CONSTANTIN
GENÈVE

ONE OF
NOT MANY.

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Graph sources: Bloomberg/BBGI Group

INTRODUCTION

Letter to Investors - Investment Climate

- The consensus scenario adopts a more positive macroeconomic outlook
- Status quo on key rates but significant injections of liquidity
- Beware extreme equity valuations
- Emergence of serious new geopolitical risks
- 2020 will not be able to repeat the feats of 2019

After five to six months of horizontal consolidation of equity markets, 2019 eventually ended with very substantial growth in risky assets in the last quarter, which essentially occurred in the last two months of the year driven by the massive injections of liquidity undertaken by the US Federal Reserve. We believe this factor played a key role in the increased sense of optimism and confidence observed in financial markets, even though the first phase of a global trade agreement between China and the US, which was meant to reduce the main source of uncertainty of 2019, had still not been ratified. After cutting its key rates three times by -0.25% in H2, the US central bank thus decided to reinject, over a mere few weeks, more than 400 billion in liquidity and to thus expand its balance sheet by 11% in record time. Indeed, the bank had needed twelve long months and five times more time to reduce its balance sheet by as much between September 2018 and September 2019. This exceptional level of activity might have raised questions and worried rational investors regarding the reasons that may have pushed the central bank to such hasty action in relation with the difficulties observed in the repo market, but that was not the case. International equities thus increased an average by +8% (Swiss equities +5%), while international (+ 3.3%) and Swiss (+5.7%) real estate both progressed significantly, and commodities (+8.3%) posted one of the highest increases. International (+0.5%) and Swiss (-1.7%) bonds ended on a weaker note in this context.

Over the year as a whole, we thus observed a quasi generalised and quite rare increase in most asset classes that make up the traditional investment universe, from international (+6.84%) and Swiss (+3.05%) bonds to international (+27.67%) and Swiss (+30.59%) equities, along with international (+22.5%) and Swiss (+20.67%) real estate and commodities (+17.63%) in particular. This increase is all the more remarkable given that, over the year, US corporate earnings dropped by approximately -5%, suggesting that the almost +30% increase in the S&P 500 index was exclusively due to the expansion of multiples, which indeed rose from 14x to 19x earnings over the course of the year. Already relatively expensive in Q3 2019, equities seem even more highly valued in this context following the +8% increase of the S&P 500 in Q4. Other valuation measures confirm this analysis and are a real source of concern for rational investors at the start of this new year and new decade. We are now seeing that valuations in terms of price-to-sales and enterprise-value-to-EBITDA have reached historically high levels, similar to those reached in 1999 before the beginning of the bear market that started in 2000, which saw equity prices drop by -50%, These considerations provide essential perspective in terms of evaluating risks and opportunities in the markets at the outset of this new year.

On the macroeconomic level, manufacturing PMI indices and, more broadly, the outlook for the industrial sector, which were other significant sources of concern in 2019, have stabilised and even improved in some countries, including the US and China, in particular by moving back into the growth zone during that period. The upswing of long-term interest rates that was also observed is in line with a gradual adjustment of the economic scenario, which is slowly moving away from a recession scenario to become somewhat normalised. Let us recall that the Fed expects a real growth rate of +2% for US GDP in 2020. Our outlook for the Eurozone and Japan is closer to +1%, while Switzerland's economy may well be on track to grow by +1.5%.

On the currencies front, the franc appreciated in the last few weeks of the year to finish on small yoy increases against the dollar (+1.43%), the Australian dollar (+1.88%), the yuan (2.59%) and the euro (+3.7%), while it depreciated by -0.5% against the yen and -2.85% against the Canadian dollar.

On the political level, 2020 is likely to begin with better visibility and more encouraging prospects. A truce between China and the US is likely to ensue after the signature of the first phase of negotiations in January. Indeed, it is undoubtedly essential for Donald Trump to be able to display a victory in his commercial power struggle with Beijing during the upcoming election campaign. In this respect, let us note that the Democratic nomination may also be a significant risk factor for markets in the event that Senator Elizabeth Warren were appointed with a political programme not favourable to financial assets. The risk nevertheless seems weak at this time according to the polls, which show Joe Biden to be the best candidate to beat Donald Trump in November. We believe that, on the political front, 2020 is likely to enjoy a smoother start. Nevertheless, the latest geopolitical developments in the Middle East, which arose at the beginning of the year, should not be underestimated. The increase in tensions between the US and Iran is brutal and very real following the assassination of General Qasem Soleimani, considered the number 2 of the regime. Iran's reaction is difficult to predict, but the sudden surge in tensions in the region has already impacted oil and gold prices. We reckon these price increases will continue in the next few months, in a probably still more uncertain context, which will likely help silver to perform well. With regards to risky assets, and equities in particular, extreme valuation levels, at times close to those we have seen in the past, especially in 1999, before periods of significant price corrections, suggest a certain degree of caution at the start of 2020.

Alain Freymond
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Graph sources: Bloomberg/BBGI Group

BIG PICTURE

Key Convictions

- US economy will remain robust
- Liquidity factor will lose importance
- International prospects are underestimated
- Continuing gradual adjustment of long-term rates
- Return of volatility in equity markets

US economy will remain robust

The US economy remained relatively robust in 2019, posting one of the best performances among developed economies with a growth rate of close to +2%. The recession predictions that had emerged in Q4 2018 turned out to be completely unfounded, as we had mentioned in our previous analyses. Nevertheless, these alarmist predictions continuously impacted the stock market to the extent of pushing the Federal Reserve to start carrying out an accommodative policy once again in July, which is likely to reinforce a still robust underlying growth.

The decline in rates across the whole yield curve, as well as the liquidity injections in Q4 2019 will have a positive impact on US economic momentum in 2020, especially since the upcoming signature of a trade agreement between China and the US, which will likely herald the beginning of a proper truce during the US election campaign, will probably also reduce the uncertainty that weighed on the prospects of the global industrial sector. The US economy will likely remain robust in 2020 thanks as well to buoyant domestic consumption and an upswing in investment.

Liquidity factor will lose importance

Following the last three rate cuts of -0.25% each in particular as well as the USD 400 billion injections over a few weeks in the US, the return of liquidity may be considered significant in H2 2019. Nevertheless, during that period, the US economy surprised observers rather favourably as shown by the sharp increase in Citigroup's economic surprise index and did not really seem to require this level of support by the central bank. If, as we think, the US economy continues on its relatively robust trend at the start of 2020, the Federal Reserve may consider that these interventions were not essential and that they may have already generated the conditions required to strengthen the already existing trend.

The abundance of liquidity certainly drove increases in financial markets, but financial conditions in the US also improved for all economic agents. Hence, it is likely that the Fed will not tweak its interest rates during an election year, even if economic conditions improve. It may nevertheless limit its quantitative easing again for a while by stabilising its balance sheet at the current level. Consequently, no more potential support should be expected from this factor for financial markets in 2020.

International prospects are underestimated

We feel that global economic growth prospects have been underestimated by the consensus forecast at the beginning of 2020, due in particular to the inertia of economic forecasts that are too heavily influenced by leading indicators such as the manufacturing PMI. The uncertainty triggered by risks of a total trade war between China and the US was a major factor leading to downwards revisions in recent economic forecasts.

In 2020 this factor will likely lose some of its influence and will gradually be revised upwards with tangible improvements in the industrial cycle, which is already improving in some countries.

The global economic scenario is thus likely to be gradually revised upwards unless the emergence in the beginning of the year of new geopolitical risks in the Middle East leads to a crisis with negative consequences for the oil market.

Continuing gradual adjustment of long-term rates

August 2019 crystallised all the fears and uncertainty relating to economic growth in a blind panic that spread to all interest rate markets, although the drop in yields in most countries seemed unrelated to the real potential economic risks for most markets concerned.

The central authorities' responses in various developed and emerging countries varied, although in most cases, they reassured investors concerned with possible risks of a dip in economic activity. These actions will develop even more positive effects on the economies concerned in 2020, starting with the US. A likely improvement in economic conditions and growth prospects will likely support the continuation of the change in expectations which has been ongoing since September 2019. Thus, the gradual adjustment of long-term rates that started in Q4 2019 will likely continue in 2020, as economic statistics confirm the improved economic situation.

Ten-year dollar rates dropped from 3% in September 2018 to less than 1.5% in August 2019 in anticipation of a recession or a steep decline in growth. A +2% growth rate in 2020 might thus push the US Treasury's long-term rates to between 2% and 2.5%.

Graph sources: Bloomberg/BBGI Group

Return of volatility in equity markets

The performance of equity markets in 2019 was particularly welcome and impressive, with the US market once again featuring among the best performers in developed markets. First of all, the S&P 500's +28.88% 12-month performance in dollars is exceptional if we compare it with yearly results over the last 20 years. Indeed, it is the second best performance in the period just behind the +29.6% increase in 2013.

In comparison with an average yearly performance of approximately +6% over 20 years and +10.4% over 30 years, results for 2019 are also extraordinary, capping the eleventh year of a bull market that began in the spring of 2009 and is now the longest rise in stock prices in the last decades.

However, placing the 2019 rise into perspective relative to more recent developments in stock market indices, we notice that the S&P 500 index remained until October 2019 in a phase of consolidation that had started in January 2018, without being able to significantly exceed the intermediary highs achieved in January 2018, September 2018, May 2019, July 2019 and September 2019 of close to 3000 points.

Hence, between September 2018 and September 2019, the S&P 500's performance actually turned out to be close to zero. Indeed, the increase in the nine first months of 2019 simply helped offset and erase the volatility and temporary correction of close to -20% that had impacted financial markets in Q4 2018. Consequently, the impressive growth rate in 2019 does not appear as exceptional anymore. The +8.5% growth rate in Q4 2019 may appear to be a new rise in indices after a 21-month long period of consolidation, noting admittedly high volatility at the end of 2018.

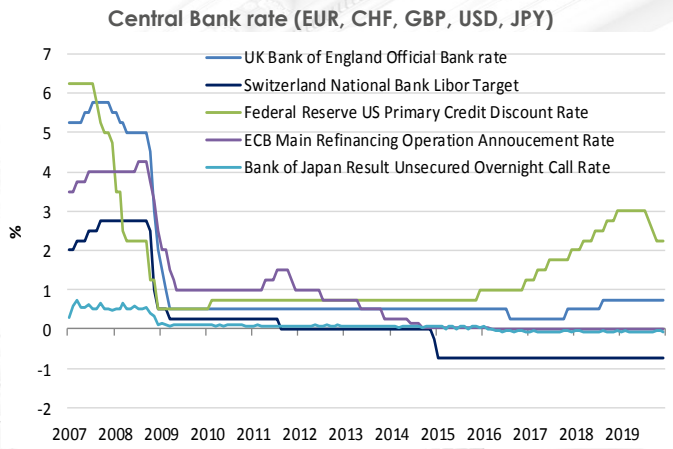
Let us mention, however, that this latest rise clearly seems due once again to the liquidity factor rather than an upward trend in corporate earnings that is likely the healthiest factor in the long term in terms of justifying an increase in share prices. Indeed, the massive liquidity injection that the Federal Reserve undertook during this period, corresponding to more than USD 400 billion, i.e. more than 10% of the central bank's balance sheet, is no stranger to investors' increased confidence. Nevertheless, US corporate earnings are likely to be down approximately -5% in 2019, and the earnings growth outlook for 2020 is unlikely to be strong in a context of weaker economic growth and pressure on margins.

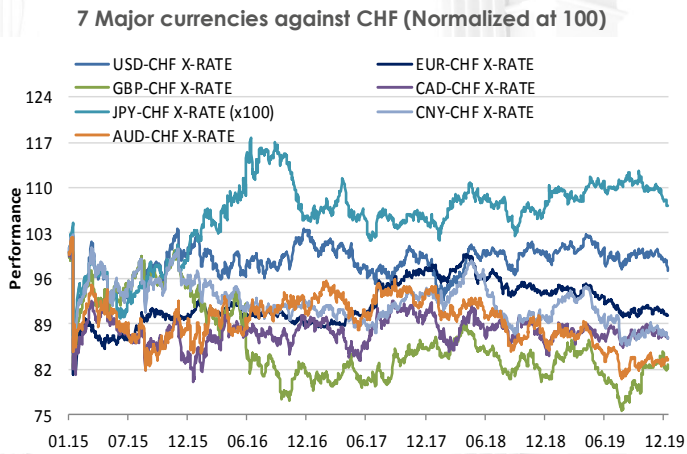
Let us also mention that the increase in 2019 was driven by a limited number of stocks and that, consequently, participation in the rise of the markets was not broad-based.

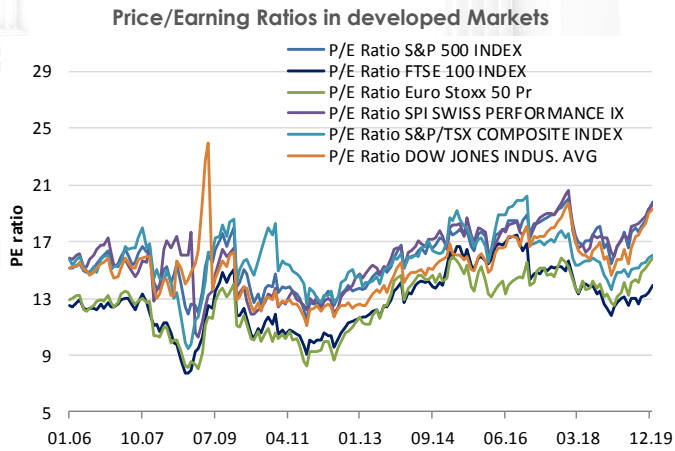
In this specific context, the valuations of equity markets and of the US market in particular tightened in 2019. The rise in prices was due to the increase in the P/E ratio, which climbed from 14x to 19x earnings in the context of falling earnings. Other valuation measures confirm this analysis and are true sources of concern for rational investors at the start of the new year and the new decade.

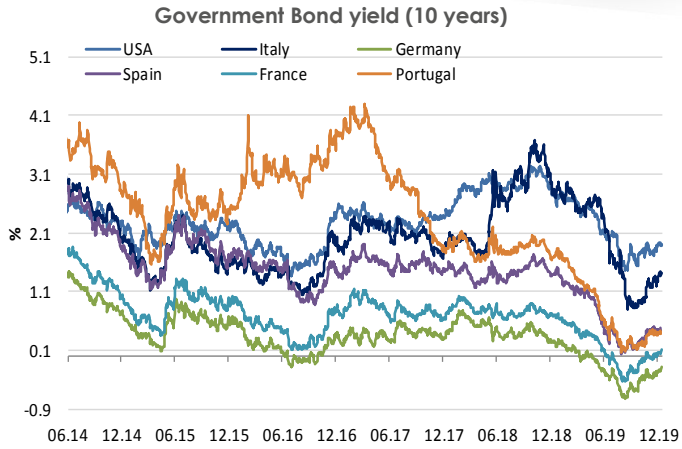
We are now seeing that valuations in terms of price-to-sales or enterprise-value-to-EBITDA have reached historically high levels similar to those reached in 1999 before the beginning of the bear market that started in 2000, which saw equity prices drop by -50%. These considerations provide essential perspective in terms of evaluating risks and opportunities in the markets at the outset of this new year.

We believe equity markets are more vulnerable than ever to a reduction or interruption of quantitative easing, a gradual increase in long-term interest rates or disappointments in terms of earnings growth in 2020. A return of volatility seems likely after the exceptional share price increase in 2019.









Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Global Outlook

- US GDP growth of +2% expected in 2020
- Technical recession avoided in 2019- an uncertain future
- Japanese GDP almost stands at zero
- Spending will remain the main growth driver in Switzerland

US GDP growth of +2% expected in 2020

We mentioned it several times in 2019, the key rate cuts, the Fed's liquidity injections and the only slight rise in long-term rates have served as extremely positive economic drivers that will have even more impact in 2020. For several quarters, financing costs for all economic agents, individuals, SMEs, multinationals, public entities and governments have thus been more attractive, which will likely support both consumption and investment in an ultimately much more favourable economic context than expected by the consensus forecast in 2019. Beyond the decline of nominal rates, real rates will likely also indirectly contribute to the economy, thus strengthening economic growth and the real estate market especially in the next few months. Real interest rates, usually positive, became negative in the US following the drop in long-term rates (10 years) from 3% to 1.5% (August 2019).

They remain negative at the start of 2020 despite the upswing in ten-year yields to 1.9% and an inflation rate excluding food and energy of 2.3% (overall inflation at 2.1%), both slightly above the Fed's objective. Excessive and unfounded pessimism in 2019 thus led to adjustments in nominal and real interest rates that will help boost the economy in the next few quarters. The expected signature on 15 January of part 1 of the trade agreement between China and the US will undoubtedly mark the beginnings of a welcome truce with regard to this complicated issue that marked 2019. It is indeed very likely that Donald Trump will be satisfied with this first success, which is probably sufficient to enable him to position himself as the defender of the interests of the American people against the economic threat of China, and to make the most of it during the presidential campaign.

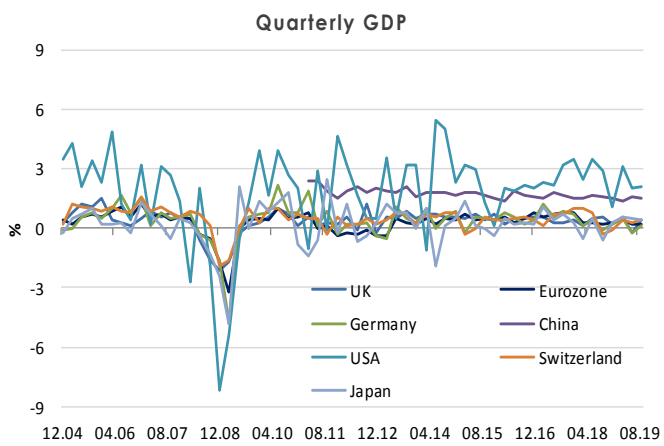
Fears of a recession fuelled or triggered by a possible trade war between China and the US have thus been discarded, although they remain a possible factor of a resurgence of risks in 2020. However, we believe that this factor will take a back seat because of the interests and objectives of the presidential campaign.

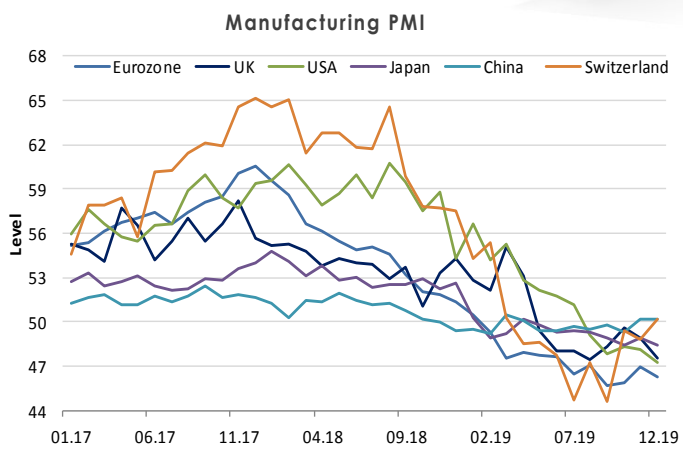
The employment market is showing increasing signs of vigour, while the economy has posted its longest period of expansion. Jobs are being created at a sustained pace of around 180,000 to 200,000 new jobs per month, i.e. almost twice the growth rate of workers entering the market. In this context, the unemployment rate is likely to drop further to below 3.3% in 2020. Wage pressures have increased (hourly wage increase of +3.1% in November), and with rising disposable income, consumption is likely to remain buoyant, pushing price indices up.

Germany is standing strong, but Eurozone prospects are only scraping above +1.0% for 2020

The German manufacturing index reached a new low in September at 41.7 before jumping back up in October and November (44.1). The manufacturing purchasing managers' barometer thus fell lower than it was during the downturn of the summer of 2012. Despite this recovery, confidence is still far from heralding a recovery in production after a two-year-long decline. For the time being, fears that other economic sectors would be contaminated have fortunately been only moderately confirmed. The services PMI fell in H2 2019 from 55.8 (June) to 51.7 (November), although it remains within a historically positive fluctuation range that supports the segment's growth prospects. In the construction sector, the rebound in the last three months signals more favourable prospects with an increase from 46 to 52 points between August and November.

Germany's industrial production is still stuck in a downward spiral, contracting by another -1.7% in October, and -5.3% yoy. The impact of Germany's downturn on the Eurozone's industrial production is serious, but overall, Europe's industrial production is holding up, posting slightly positive growth of +0.1% in October. But the large majority of national composite PMI leading indicators remain encouraging and stand well above the growth threshold of 50. The Eurozone's composite PMI recovered slightly in November, climbing from 50.3 to 50.6 as a result of improving sentiment in both the manufacturing sector and services.





Graph sources: Bloomberg/BBGI Group

Nevertheless, despite a 0.3-point increase to 46.9, the manufacturing PMI is still far from its theoretical growth threshold and is still a significant cause for concern for Europe's industrial sector. The services PMI jumped up 0.4 to 51.9 in November. While this figure in itself is synonymous with growth, it should be noted that it is still among the lowest since 2014. The Eurozone economy in Q3 may tentatively be climbing out of a period of weakness that has lasted several quarters, as recently published statistics point to GDP growth of +0.2% (+1.2% yoy) in the Eurozone in Q3. Economic activity seems slightly better than predicted by the consensus forecast, which expected growth of only +1.1%. Most importantly, the fact that this recovery is clearly visible in most economic sectors is relatively encouraging for prospects in 2020.

Technical recession avoided in 2019- an uncertain future awaits in 2020

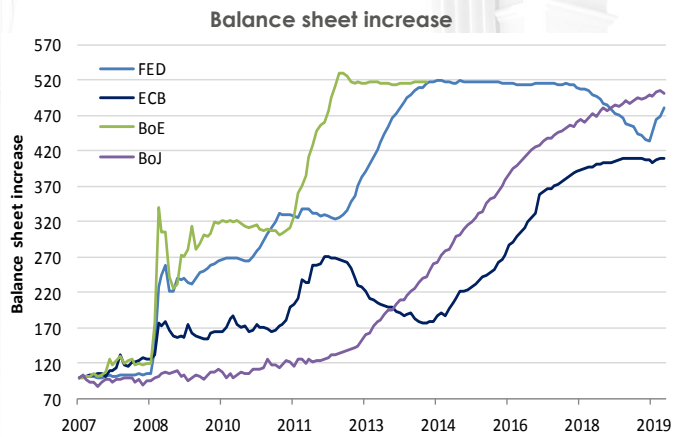
UK monthly GDP growth was nil in October and –0.3% yoy on a quarterly basis. This deterioration in economic conditions follows on the heels of the publication of Q3 GDP growth figures pointing to an improvement in the UK economy. GDP growth of +0.3% in Q3 came after a -0.2% contraction in Q2, once again avoiding a technical recession. However, the overall picture is far from reassuring. On an annual basis, GDP growth slid further, landing at +1.0%, significantly lower than the +1.8% growth posted in March. Consumption and government spending were up +0.4% and +0.3%, respectively, while investment stagnated and exports surged by +5.2%, after falling by -6.6% in the previous quarter. Fundamentals published more recently continue to point to a less dynamic fourth quarter in the UK. The upswings in industrial output (-0.3% to +0.1%) and manufacturing output (-0.4% to +0.2%) in October were significant, but this temporary increase in activity must be confirmed over the next few months.

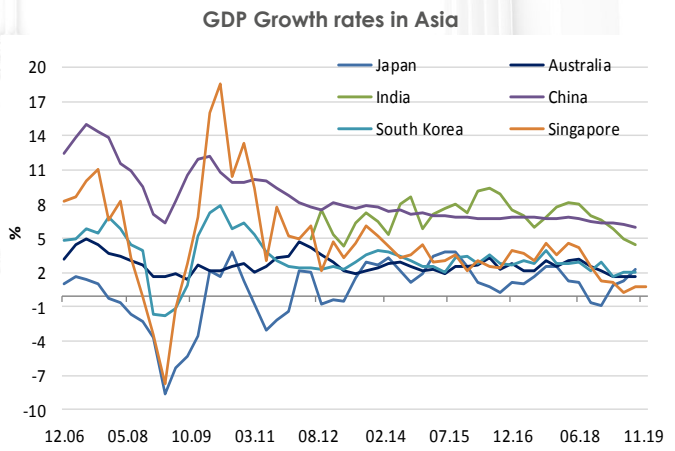
The construction sector on the other hand is once again in turmoil. Indeed, it slid by -0.2% in October for a yoy drop of -2.1%, disappointing results indicating a sharp deterioration of the situation since the month of September, when it was still up +0.5% yoy. Following Boris Johnson's win and the Conservative camp's now absolute majority, the growth outlook may improve. A decrease in uncertainty could boost investment, although in the absence of real clarity regarding the implications of the any potential withdrawal strategy, these positive reactions will likely remain constrained.

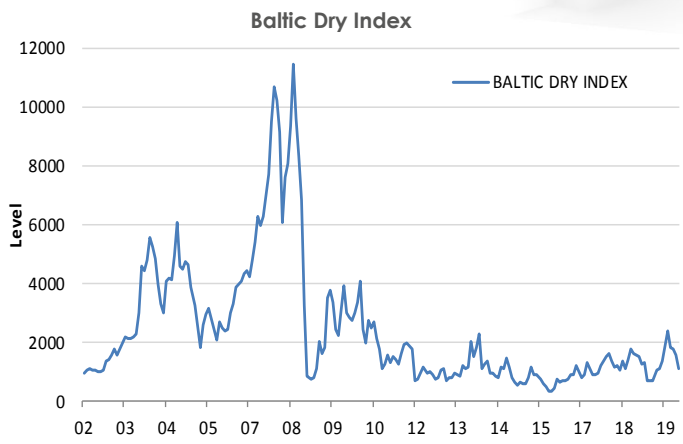
Japanese GDP almost stands at zero, a recovery will require an export recovery

GDP growth slowed sharply in Japan in Q3 due to a further drop in exports. The quarterly growth rate of +0.1% is well below the growth rate in Q2 (+0.3%), which was already lower than growth in Q1 (+0.5%). Economic growth yoy has fallen to +0.2%, a sharp decline compared to yoy growth of +1.3% (revised to +1.8%) at the end of June. The Japanese economy is increasingly impacted by its falling exports and by the trade tensions that continue to put pressure on global demand for manufactured products. Capital expenditure continued to rise (+0.9%), while public spending (+0.8%) slowed compared to the previous quarter. Consumption held up fairly well over the quarter, rising by +0.4% just before the introduction of new taxes at the beginning of the fourth quarter, just a little below the +0.6% increase expected. However, there is still the risk that private demand will slow following this introduction, impacting economic growth in Q4.

By historical comparison, excess consumption demand in Q3, immediately preceding the introduction of the tax, was well below that seen in 2014, which had then led to a very sharp slowdown in economic activity in the following months. To mitigate the potential impact of the tax on growth, Prime Minister Shinzo Abe will likely announce a fiscal package aimed at stimulating the economy. The scope of these stimulus measures will be a determining factor for the Japanese economy over the next few months. A range of figures have been cited for this economic stimulus programme going from 3 to 6 trillion yen (28 to 55 billion dollars).







Graph sources: Bloomberg/BBGI Group

An economic upturn is unlikely to materialise in 2020 without a more significant contribution from the export sector. We thus have slightly more favourable expectations for Japanese exports in Q1, which could grow more rapidly than imports. As Japanese exports were impacted by flagging global demand and a slowdown in the manufacturing sector, any significant trend reversal will require conditions in these areas to improve as well as at least relative weakness of the yen.

The nominal interest rate spread, which typically penalises the yen, has in fact be countered by trends in real interest rates, which for now are impeding any depreciation of the yen likely to boost exports. Consumer confidence improved significantly for the second month in a row in November after declining for 20 long months. The increase is substantial and constitutes a positive factor indicating that the VAT increase will not necessarily penalise private consumption. Japanese growth prospects for 2020 should remain below +1.0% unless there is a clearer boost to international demand.

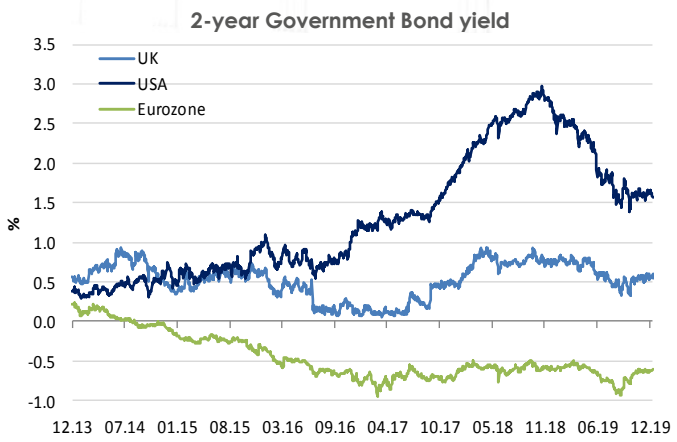
Public and private spending drive growth in Switzerland

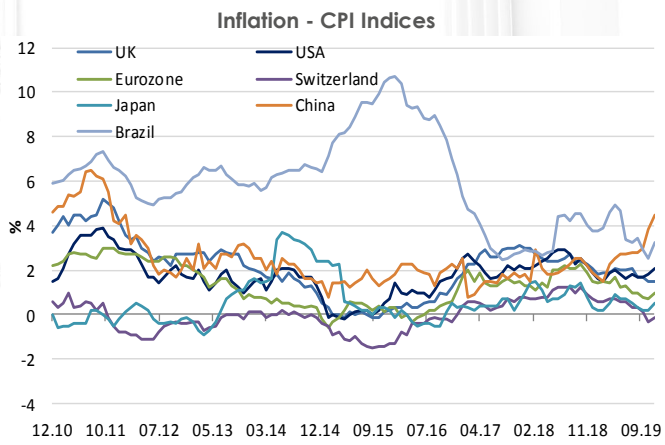
The State Secretariat for Economic Affairs (SECO) has published our country's growth figures for Q3 of this year, which highlight unexpectedly stronger growth. Indeed, the +0.4% quarterly growth rate surprised forecasters, who expected a limited increase of +0.2%. This result actually corresponds to the high side of estimates, which ranged from -0.1% to +0.4%. In unadjusted annual comparison, Switzerland's GDP rose by +1.1%, significantly more than the average consensus forecast of +0.8%. Nevertheless, our economy's performance is rather satisfactory in this context, even if risks of a more abrupt slowdown in the next few months still remain.

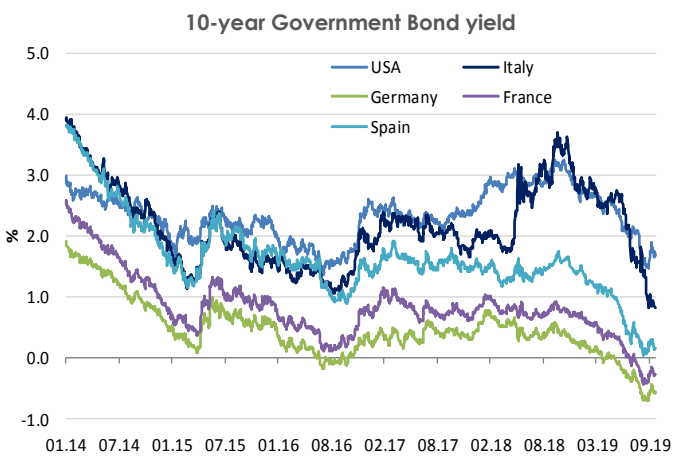
This +0.4% increase in real GDP in Q3 is rather welcome given the particularly bleak context that impacted financial markets over the summer. Fears of a recession and the collapse in interest rates following growing uncertainty about prospects for economic growth turned out to be particularly excessive given our economy's actual results.

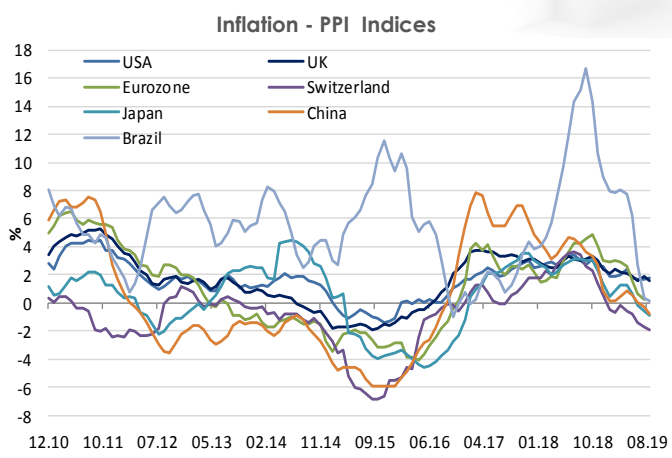
Switzerland's nominal GDP in Q3 thus increased from CHF 174.5 billion to 175.04 billion. Year-on-year, Switzerland's GDP thus passed the historic threshold of CHF 700 billion Swiss francs for the first time. Switzerland's economy benefitted from somewhat improving trends in Europe and a +0.3% growth rate in the EU in Q3, which was slightly better than in the previous quarter (+0.2%).

The situation in Germany obviously influenced economic developments in Switzerland and did not have a significant positive impact this quarter. The lessening of tensions between the US and China helped reduce the uncertainty that weighed on Germany's economy and its industrial sector, but this was not enough to have a real impact on the latter. The economic situation in Germany remains weak (+0.1%), but the country avoided recession after a negative Q2. In this context, economic growth in Switzerland will likely be close to +1.1% for 2019 and +1.5% for 2020.









Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

United States

- Election year could prove turbulent for investors
- Growth in 2020 : favourable situation in interest rate markets
- Trade conflict should abate
- US yield curve returns to "normal"
- Further liquidity injections in 2020
- Leading indicators more optimistic

Election year could prove turbulent for investors

In terms of the economy, 2019 was characterised by continued uncertainty relating to trade relations between China and the US. This risk factor has often been described as the main driver behind the widespread collapse of global manufacturing activity, leading to possible risks of contagion to other economic sectors and growing concerns regarding global economic growth. Nevertheless, the US economy proved resilient until the end of the year, and the growth figures soon to be published for Q4 will confirm that real GDP growth exceeded +2.2% in 2019. Recession risks, which had been regularly mentioned since September 2018, did not materialise and will likely fade further still in 2020 for various reasons, including reduced trade tensions primarily.

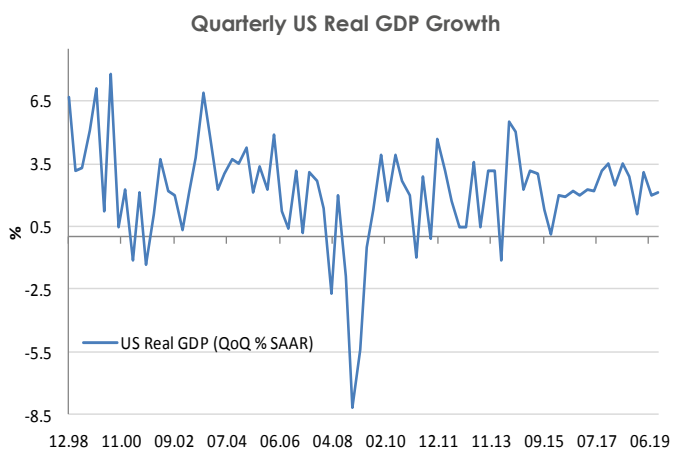
Indeed, in a few days, the first phase of a trade agreement between China and the US is likely to be signed, a first step towards a more comprehensive deal subject to future negotiations. Nevertheless, in the present context of the US presidential election, this first phase is crucial for the US president and his administration, who will be able to claim they are the only ones to have faced down China. They will undoubtedly seek to make the most of this argument and will not risk any further clashes, at least until November. The main factor of uncertainty in 2019, which impacted economic prospects and financial markets, is thus unlikely to be a major risk factor in 2020.

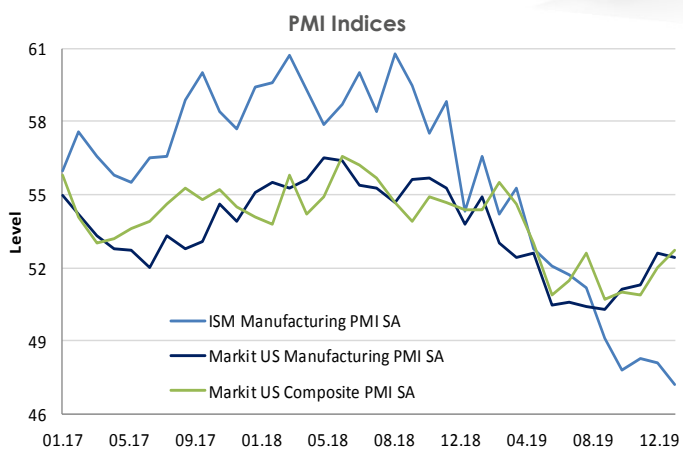
In economic terms, the situation still seems satisfactory at the start of the year in the US, and the main underlying trends will likely continue in 2020, with a GDP growth outlook of +2% for 2020. However, this election year could prove turbulent for investors and risky for financial markets. The presidential campaign will only start in Q2 after the Democratic presidential nomination, but risks of a left turn in US politics may start to be factored in before then. In 2020, clashes between the Democrats' and the Republicans' political programmes may well be more polarised than in the previous elections.

Within the Democratic party, the temptation to choose a candidate who is more favourable to the underprivileged and middle classes may well grow and focus on Senator Elizabeth Warren rather than a more "centrist" candidate such as Senator Joe Biden. Nevertheless, the latter is still the most likely to succeed against Donald Trump according to the latest polls in January 2020. If Biden is nominated by the Democratic Party, the race for the White House is unlikely to be a major factor of uncertainty for financial markets. However, if Elizabeth Warren is nominated, risks of a major political change of course will have a direct impact on financial markets, and 2020 is likely to be much more volatile with the surprise nomination of Elizabeth Warren.

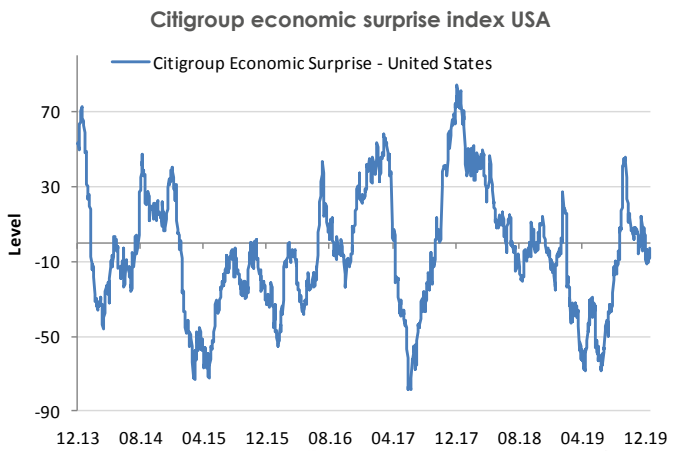
Growth in 2020 driven by the favourable situation in interest rate markets

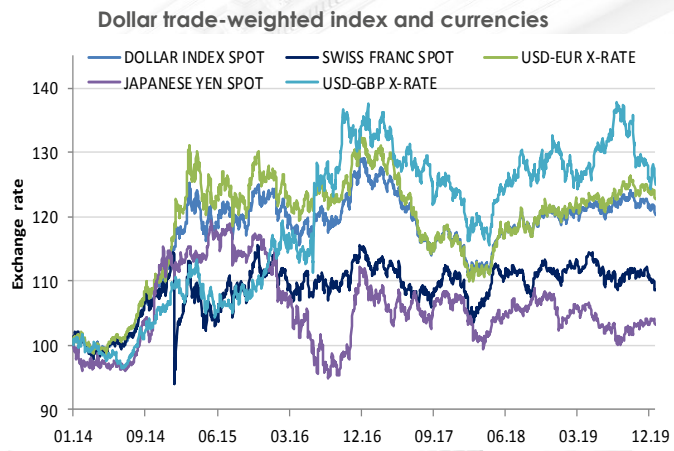
We mentioned it several times in 2019: the key rate cuts, the Fed's liquidity injections and the only slight rise in long-term rates have served as extremely positive economic drivers that will have even more impact in 2020. For several quarters, financing costs for all economic agents, individuals, SMEs, multinationals, public entities and governments have thus been more attractive, which will likely support both consumption and investment in an ultimately much more favourable economic context than expected by the consensus forecast in 2019. Beyond the decline of nominal rates, real rates will likely also indirectly contribute to the economy, thus strengthening economic growth and the real estate market especially in the next few months. Real interest rates, usually positive, became negative in the US following the drop in long-term rates (10 years) from 3% to 1.5% (August 2019). They remain negative at the start of 2020 despite the upswing in ten-year yields to 1.9% and an inflation rate excluding food and energy of 2.3% (overall inflation at 2.1%), both slightly above the Fed's objective. Excessive and unfounded pessimism in 2019 thus led to adjustments in nominal and real interest rates that will help boost the economy in the next few quarters.





Graph sources: Bloomberg/BBGI Group





Trade conflict should abate

The expected signature on 15 January of part 1 of the trade agreement between China and the US will undoubtedly mark the beginnings of a welcome truce with regard to this complicated issue that marked 2019. It is indeed very likely that Donald Trump will be satisfied with this first success, which is probably sufficient to enable him to position himself as the defender of the interests of the American people against the economic threat of China, and to make the most of it during the presidential campaign. Fears of a recession fuelled or triggered by a possible trade war between China and the US have thus been discarded, although they remain a possible factor of a resurgence of risks in 2020. However, we believe that this factor will take a back seat because of the interests and objectives of the presidential campaign.

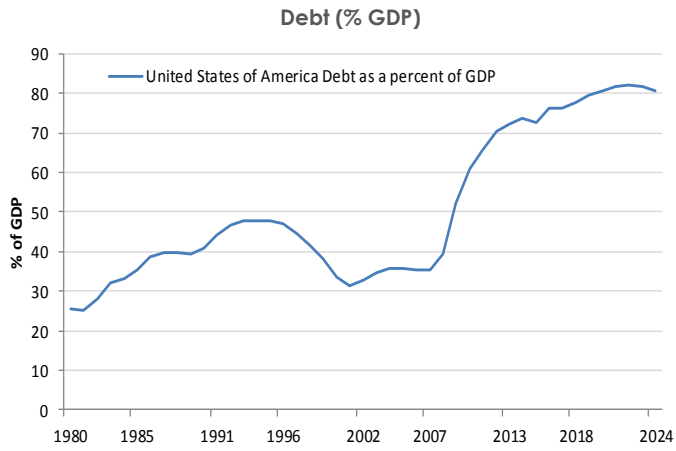
US yield curve returns to "normal"

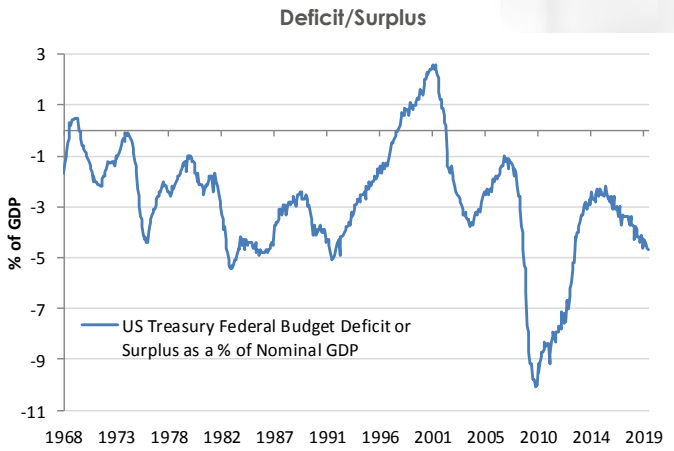
We mentioned various yield curve inversion processes in previous weekly analyses, recalling that the yield curve inversion in the winter of 2018-2019, which was seen as a sign of an upcoming recession, had no basis in any traditional theoretical framework and had actually been triggered by a drop in long-term rates rather than an excessive and inappropriate tightening of monetary policy, which has indeed often driven the economy into recession in the past. In these cases, the yield curve inversion resulted from a rise in short-term rates (the Fed's key rates) corresponding to the implementation of restrictive monetary policies meant to limit excessive inflation and slow down the economic cycle. Monetary policy thus led to a rebound in short-term rates, which then exceeded long-term rates to fend off inflation. A "classical" yield curve inversion thus follows the same logic, often exceeding theobjective of slowing the economy and ultimately triggering a recession, usually short-lived.

The Fed's change in monetary policy, by lowering short-term rates by 0.75% in H2, modified the yield curve by lowering its short end. Reduced recession risks coupled with relatively robust economic statistics for the US economy have enabled long-term rates to tighten once again and to rise by approximately 40 basis points. Henceforth, the yield curve is once again "normal", although relatively flat since both the three-month and ten-year rates lie at 1.9%. In 2020, although tensions on the labour market are likely to have an impact on business margins and prices, inflationary pressures will probably intensify somewhat and exceed the Fed's objective. In this context, ten-year long-term rates will likely continue readjusting to economic conditions that are more robust than predicted by the consensus forecast in 2020 and rise beyond 2.5%.

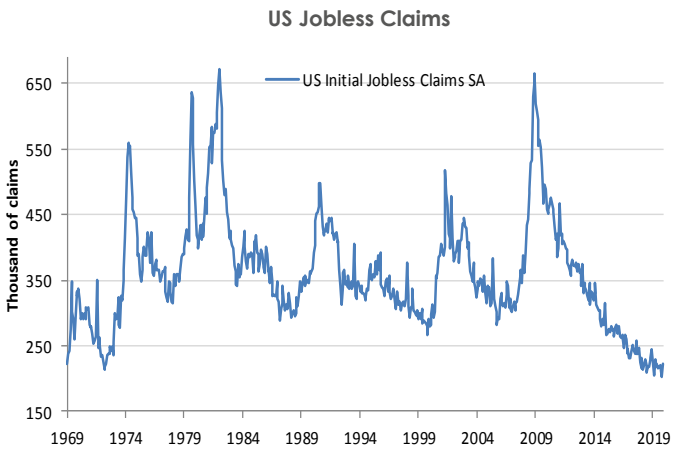
Further liquidity injections in 2020

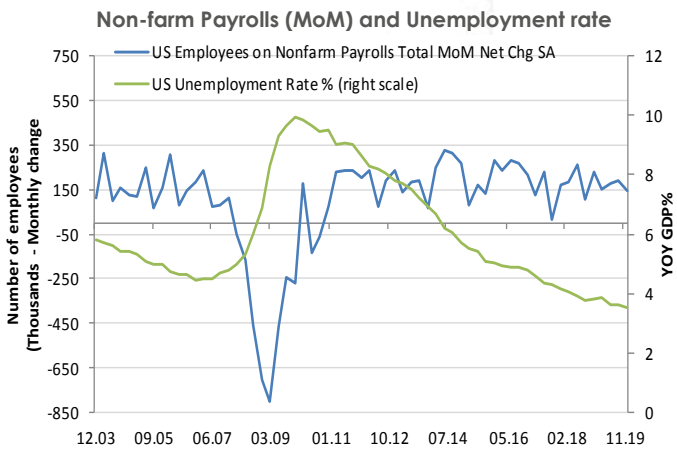
Since July, the Fed's monetary policy is once again accommodative. The central bank lowered its key rates by -0.25% three times in H2 starting in July, while boosting its asset purchase programme starting in September. Over just a few weeks, the Fed's balance sheet surged by +11% from USD 3,759 billion in September to 4,165 billion in December, implying a liquidity injection of 406 billion in less than four months. By comparison, the Fed had needed close to twelve months to reduce its balance sheet by as much between September 2018 andSeptember 2019. Thus, the Bank decided to act, to counter the expectations of an economic slowdown, or even a recession, that had been widespread over the past year despite the consistently solid quarterly results posted by the US economy. The New York Fed's 12-month forward recession probability index has since dropped from 37% to only 24% currently. In 2020, the Fed will likely maintain its low key rates policy, keeping it unchanged in the next few months, especially if an economic recovery is confirmed. Nevertheless, it seems to be aiming to maintain its liquidity injection policy by repurchasing assets at asustained pace.

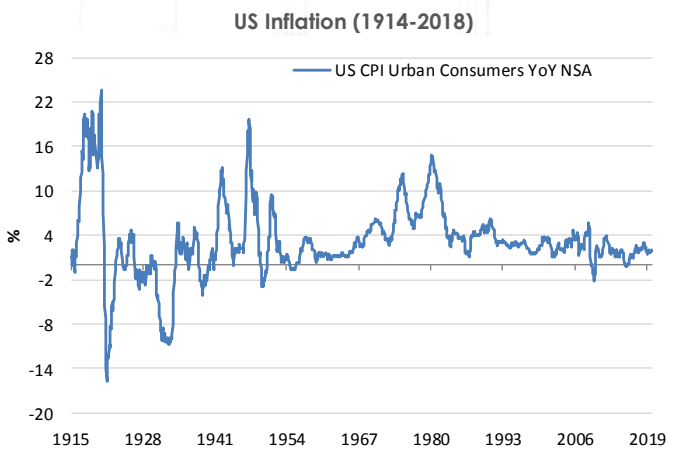


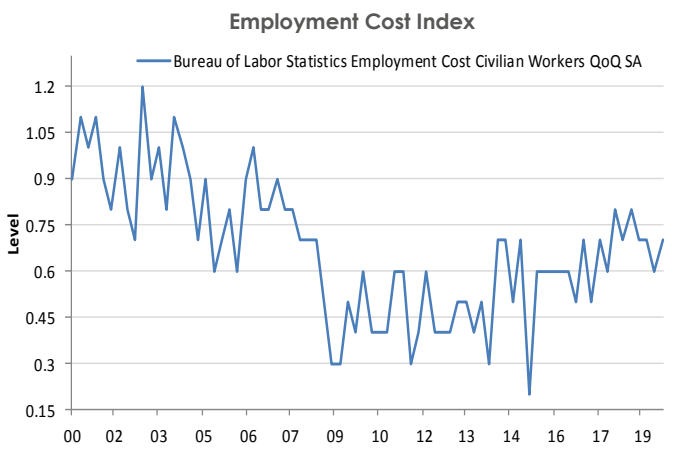


Graph sources: Bloomberg/BBGI Group









Graph sources: Bloomberg/BBGI Group

Leading indicators more optimistic

The manufacturing PMI index published for the month of December is down slightly from 52.5 in November to 52.4, thus confirming the upward trend in sentiment observed in the industrial sector since September. The recovery is now clear, attesting to the ongoing change in purchasing managers' outlook, which has been more optimistic in the last four months. Unfortunately, the ISM (Institute for Supply Management) manufacturing index did not confirm this result, dropping further from 48.1 to 47.2 in December, i.e. its lowest level since 2009.

Nevertheless, industrial production also rebounded by +1.1% in November, thus offsetting the weakness of the previous month. The services PMI index also strengthened in December, rising by 0.6 points to 52.2, a result that remains at the lower end of its range over the last few years but which enables the composite index to post a better result in December too. Recovery in the manufacturing sector many not be significant yet but signs of bottoming out are more apparent.

On the consumer side, confidence remains high even though it weakened very slightly in December from 126.8 to 126.5 (Conference Board Index). In parallel, Bloomberg's consumer comfort index is at a five-month high, confirming the University of Michigan's strong figures showing household sentiment at 99.3, close to its 10-year high. The drop in key rates, an unemployment level at a 50-year low, increasing household income and an agreement about to be signed between China and the US have certainly all been factors driving high levels of household confidence, which will likely persist at the start of 2020.

Full employment drives consumption

The employment market is showing increasing signs of vigour, while the economy has posted its longest period of expansion. Jobs are being created at a sustained pace of around 180,000 to 200,000 new jobs per month, i.e. almost twice the growth rate of workers entering the market. In this context, the unemployment rate is likely to drop further to below 3.3% in 2020. Wage pressures have increased (hourly wage increase of +3.1% in November), and with rising disposable income, consumption is likely to remain buoyant, pushing price indices up. A slowdown in the economic cycle in 2020 remains the favoured scenario, although the economy may well surprise on the upside thanks to robust domestic demand.

Equity markets threatened by high valuations and growing geopolitical risks

The last quarter of 2019 saw a sharp recovery in US equities, which reached new heights in a phase of acceleration essentially driven by the inflow of liquidity injected by the US Federal Reserve and the momentum observed on several tech stocks. The +8.5% rise of the S&P500 over the quarter, including +2.86% over the single month of December, brings 2019's performance to +28.9%, i.e. the second best performance since 1998. The rise is surprising if you consider that, in 2019, US corporate earnings dropped by an estimated -5%. Thus, the rise of US equities is essentially due to PE ratio expansion resulting from the Fed's rate cuts and sustained liquidity injections at the end of the year.

Growth of the PE ratio from 14x to 19x in 2019 in this context is not really rational and should thus be concerning, even though it is true that in other PE expansion phases in the past, this ratio exceeded 20x for the S&P500 index before being followed by a correction of prices. We are sticking to our analysis that, at the start of 2020, the emotional factor will irrationally drive equity prices to extreme heights, which usually heralds significant a stock market correction.

For the moment, the prevailing economic scenario in rate markets is still that of a slowdown in growth. We nevertheless believe it is likely that an increase in ten-year rates will be associated with better economic statistics in the next few months.

Rise in equities mainly due to PE expansion

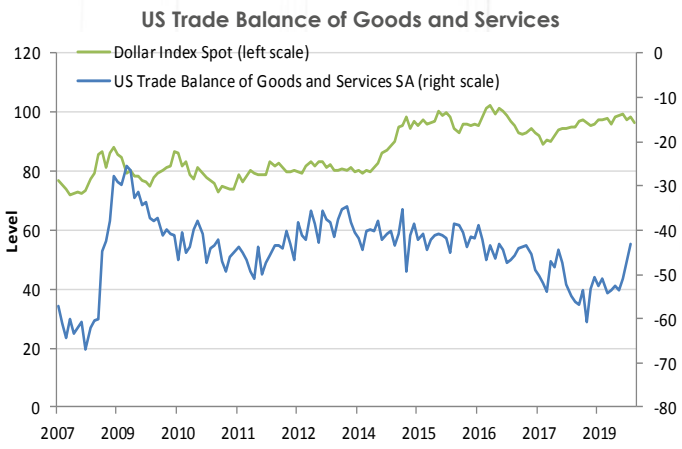
The return of equity indices to highs for the year places the asset class back into a high-risk zone and increases the probability of a price correction. If the slowdown turns out to be real, valuation levels for equities will not withstand the likelihood of profits collapsing. If conversely, the economy remains stable, the rebound in interest rates that will likely materialise will indeed have a negative effect on multipliers.

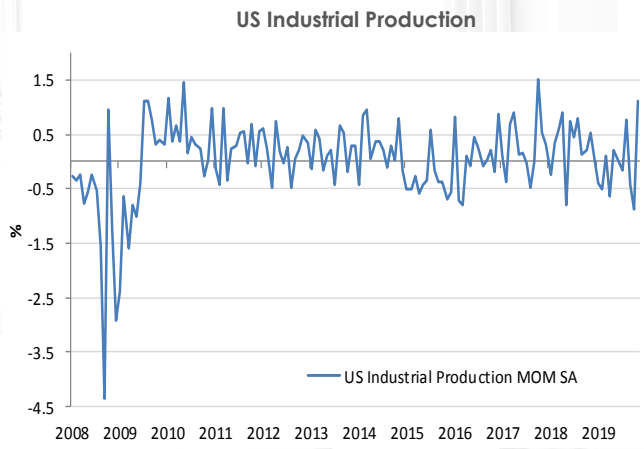
The rise in PEs associated with the drop in long rates in the last few months will be replaced by a unavoidable contraction that will accompany the rebound in rates. The impeachment proceedings against Trump that have finally been activated by the Democrats are very unlikely to succeed. It is unlikely to add much uncertainty and to be a major destabilising factor for financial markets.

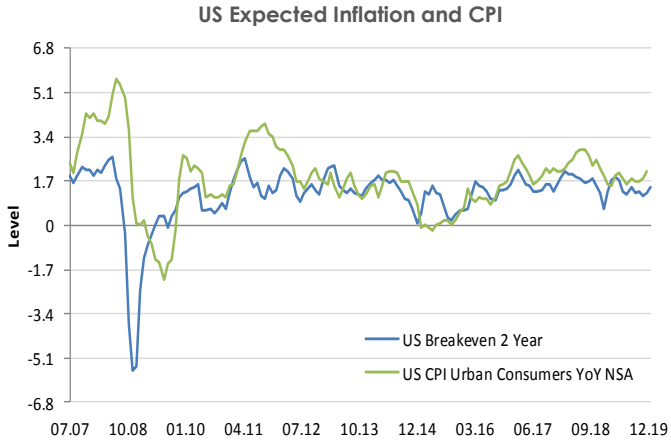
Reduced exposure to equities seems appropriate in this context, which seems unlikely to trigger a new wave of appreciation of prices beyond 3,000 points on the S&P500 index. The Fear&Greed index is now at a rarely-reached level of 96/100, while indices have diverged by more than two standard deviations from their trend, which is also a sign of a high probability of the trend being interrupted.

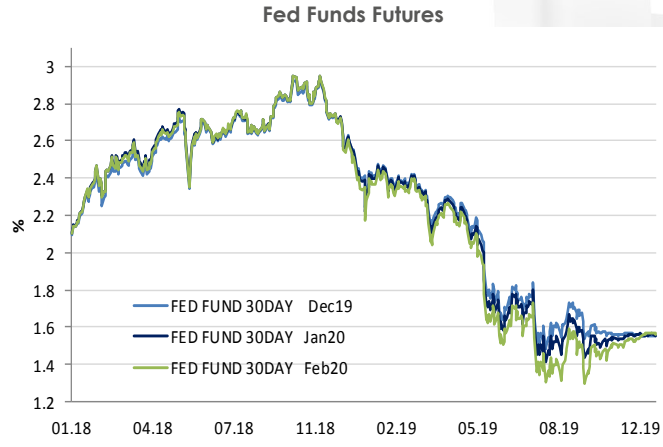
The last time the equity market reached current valuation levels of 2.4x sales (price to sales) was before the "dot.com" crash at the turn of the century. Other measures such as enterprise value/EBITDA are also at their peak, suggesting that the current situation is a decoupling that could be historically devastating in the medium term.

Nevertheless, growth may still be bolstered by the continued action of the Fed, although the geopolitical risks that emerged brutally at the start of 2020 in the Middle East may well degenerate quickly into a new crisis with negative effects on oil prices and investors' mindset, which may trigger an adjustment of expectations and a significant market correction.



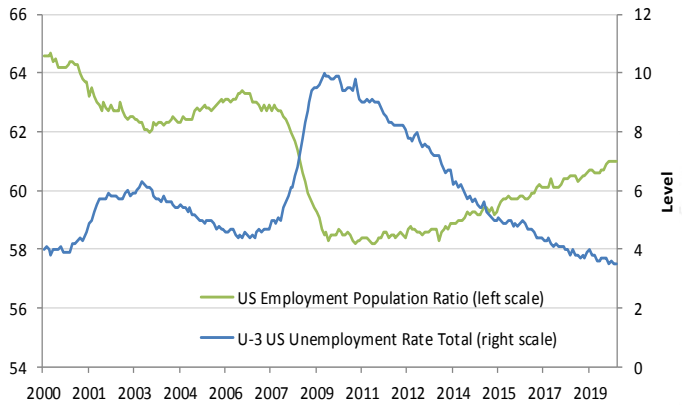




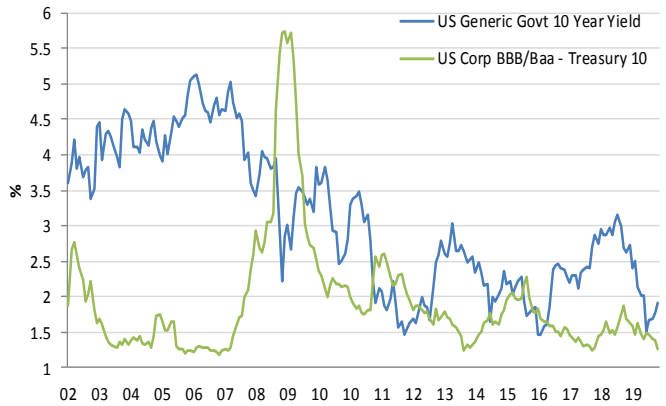


Graph sources: Bloomberg/BBGI Group

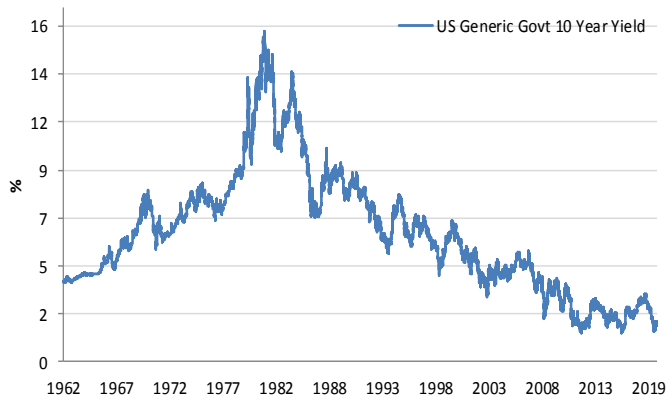
US Unemployment rate and Employment Population Ratio



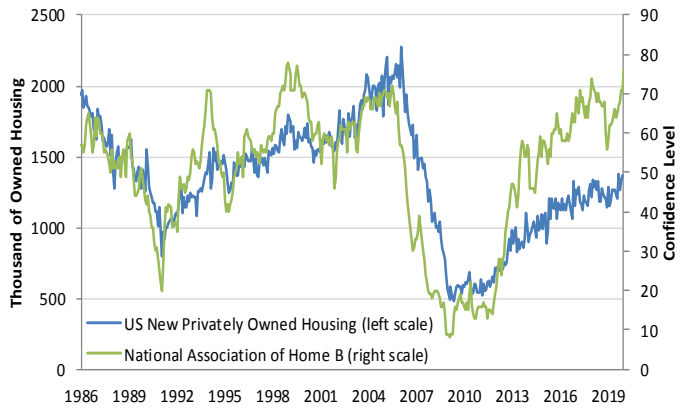
Yield spread Us Treasury - BBB 10 year



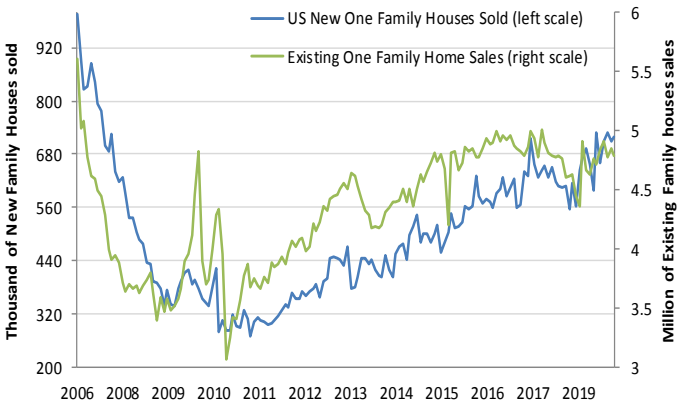
US Government Bonds 10 year yield



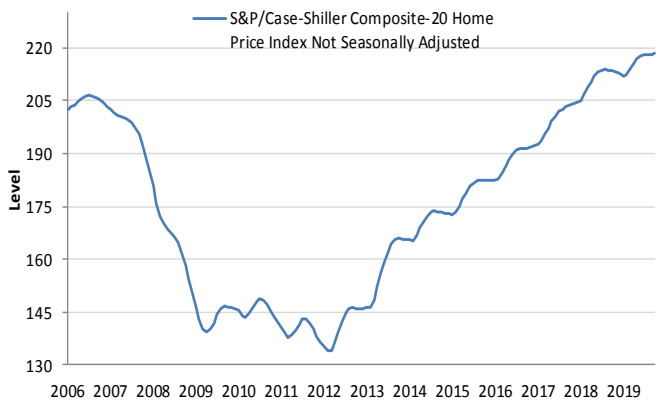
US New Privately Owned Housing and NAHB USA



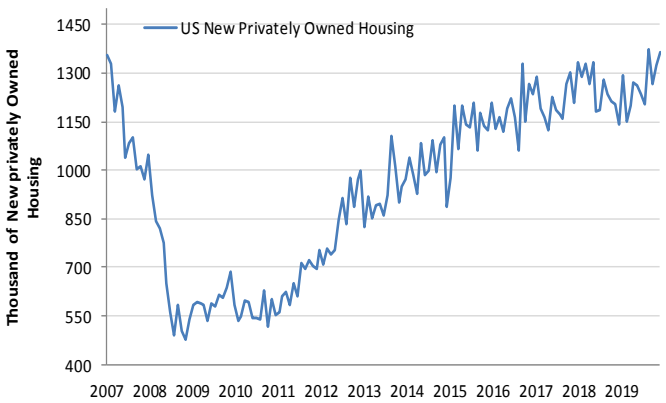
Sale of US New and Existing Family Houses



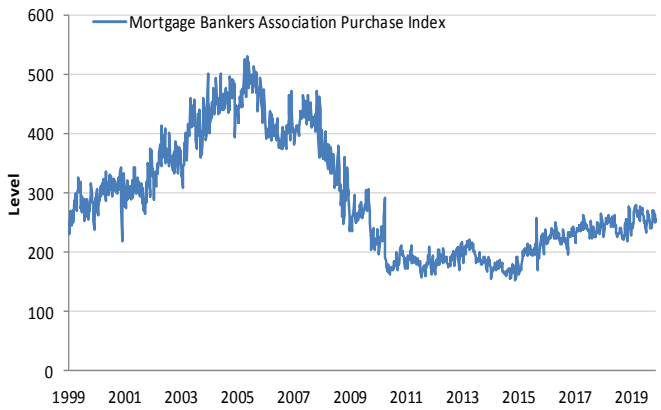
Real Estate Prices - S&P Case-Shiller Index



Housing Starts



New Mortgage Applications - MBA



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Switzerland

- Growth rate of +0.4% for Switzerland's GDP in Q3
- Sky clearing a little for leading indicators
- Quiet end to the year for the Swiss franc
- The Swiss National Bank (SNB) to stay on course

Growth rate of +0.4% for Switzerland's GDP in Q3 a favourable surprise for forecasters

The State Secretariat for Economic Affairs (SECO) has published our country's growth figures for Q3 of this year, which highlight unexpectedly stronger growth. Indeed, the +0.4% quarterly growth rate surprised forecasters, who expected a limited increase of +0.2%. This result actually corresponds to the high side of estimates, which ranged from -0.1% to +0.4%. In unadjusted annual comparison, Switzerland's GDP rose by +1.1%, significantly more than the average consensus forecast of +0.8%.

Nevertheless, our economy's performance is rather satisfactory in this context, even if risks of a more abrupt slowdown in the next few months still remain. This +0.4% increase in real GDP in Q3 is rather welcome given the particularly bleak context that impacted financial markets over the summer. Fears of a recession and the collapse in interest rates following growing uncertainty about prospects for economic growth turned out to be particularly excessive given our economy's actual results. Switzerland's nominal GDP in Q3 thus increased from CHF 174.5 billion to 175.04 billion.

Year-on-year, Switzerland's GDP thus passed the historic threshold of CHF 700 billion Swiss francs for the first time. Switzerland's economy benefitted from somewhat improving trends in Europe and a +0.3% growth rate in the EU in Q3, which was slightly better than in the previous quarter (+0.2%). The situation in Germany obviously influenced economic developments in Switzerland and did not have a significant positive impact this quarter. The lessening of tensions between the US and China helped reduce the uncertainty that weighed on Germany's economy and its industrial sector, but this was not enough to have a real impact on the latter. The economic situation in Germany remains weak (+0.1%), but the country avoided recession after a negative Q2. In this context, economic growth in Switzerland will likely be close to +1.1% for 2019 and +1.5% for 2020.

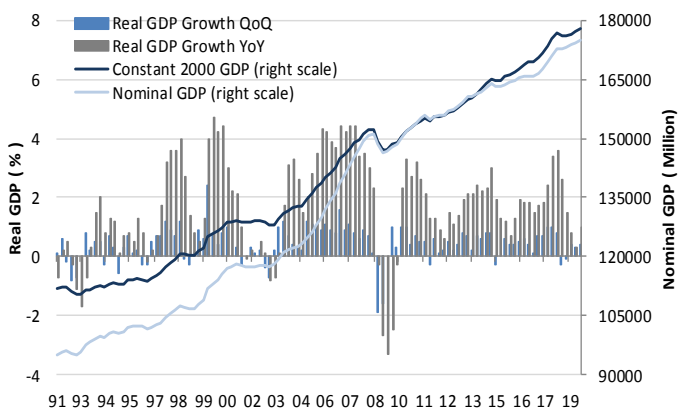
Growth still driven by private and government consumption

In the last quarters, consumption has established itself as an essential long-term driver for our economy. Nevertheless, its contribution was slightly less significant this quarter. Indeed, domestic demand posted a +0.2% increase in private consumption, slightly lower than in theprevious quarter (+0.3%), thus proving a little more subdued. Contrariwise, in comparison with the previous quarter, government consumption recovered strongly, returning to the +0.5% rate it had previously achieved in Q1 after a slump in Q2 (+0.1%). Overall, domestic demand thus drove GDP growth throughout the quarter.

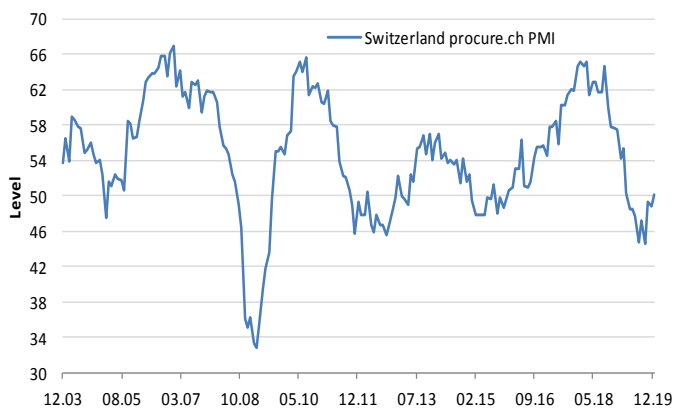
Capital goods investments on the other hand were particularly robust with a +0.7% upswing that almost completely offset the -1% drop in the previous quarter. In the building sector, the trend remains weak, as evidenced by the +0.2% increase in investments and the +0.1% in added value in the sector. The Swiss manufacturing sector is doing rather well in these circumstances and has surprisingly not really been affected as much as feared by the drop in global demand and the rise of the Swiss franc. Our country's industry has done well, unlike other European countries', contributing positively to GDP growth. The manufacturing sector grew further still at a steady pace of +1.2%, similarly to Q2 (+1.3%). Most of all though, it is the strength of the chemical and pharmaceutical industry, whose added value and exports increased significantly, that supported this positive trend.

Industrial segments such as machinery and metals declined in a difficult international context for manufacturing. The energy sector posted its strongest growth rate ever, benefitting from favourable meteorological conditions that resulted in a +8.2% rise and a sharp increase in energy exports. Merchandise exports rose by +0.7%, a little less than imports however, which rose by +1.1%. In services, exports grew by +1.1%, while imports increased by +0.9%. Switzerland's economy is gradually strengthening in an international context that is still relatively complicated in Q3.

Nominal GDP - Nominal and Real GDP Growth rate



Swiss Purchasing Manager Index (PMI)



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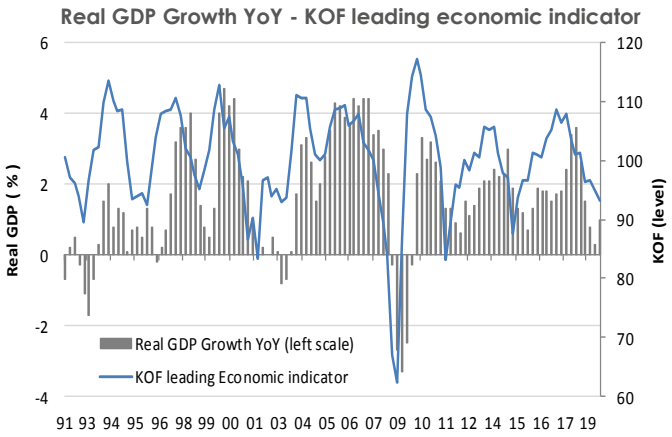
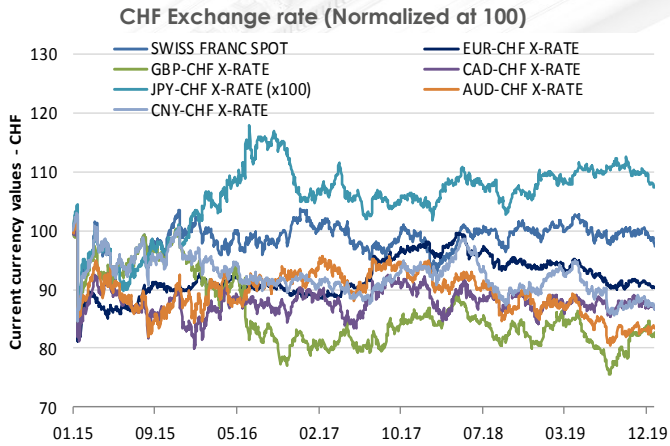




Sky clearing a little for leading indicators

The manufacturing PMI finally rebounded strongly in October to 49.4, nearing the threshold of 50, after dropping to its lowest point (44.6) in September, i.e. its worst result in close to ten years. Yet, the indicator's downward trend and its fall below the theoretical growth threshold of 50 was not followed by a breakdown in real industrial production. For more than a year now, Switzerland's manufacturing PMI has been signalling a drop in production, which still has not materialised and which, on the contrary, seems to have strengthened in September.

The +6.3% increase in Q3 might thus trigger a change in purchasing managers' perceptions and in the trend for this PMI. The KOF economic barometer also rebounded from 93.07 in September to 94.66 in October, without actually clearly pointing to any trend reversal. However, business conditions deteriorated in October in most sectors. Only the financial sector seems to be heading for a recovery.

Retail sales posted a +0.9% increase in September after a -1% drop in August, but consumer confidence still appears weak in an uncertain international context. The CS indicator on expected economic conditions increased significantly in November, climbing from -30.5 to -3.9, which represents its best result since July 2018. It follows a similar trend observed in the Eurozone and the US over the same period which shows a sharp improvement of confidence in terms of economic prospects for 2020.

Consumer confidence figures published by the State Secretariat for Economic Affairs for Q4 remain uncertain (-10.4) and fell a little further in comparison with the previous quarter (-8). Let us also mention that the decline in leading indicators, which has now been going on for close to two years, still has not been followed by a marked weakening of Switzerland's GDP. The economy is even holding up a little better in Q4 than predicted by leading indicators' negative forecasts with a +0.4% increase. Although they have not clearly turned positive, leading indicators have stabilised and show a few more optimistic signs of future recovery.

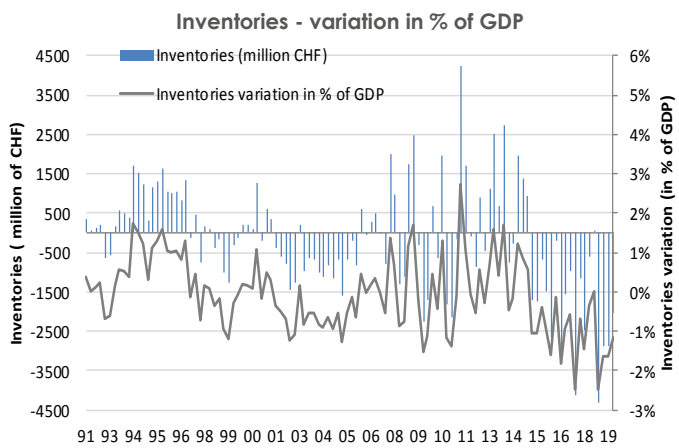
Quiet end to the year for the Swiss franc

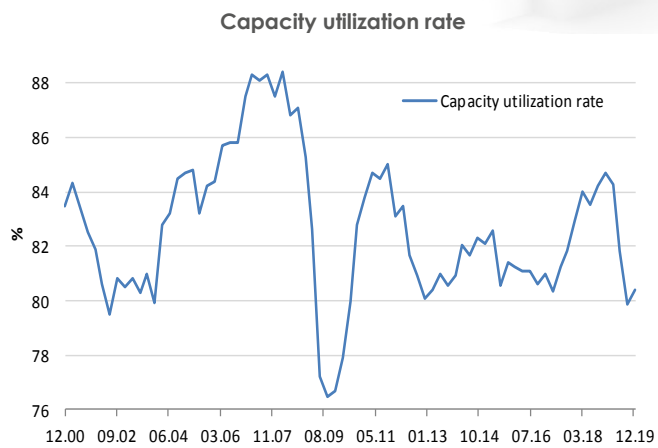
Following the Swiss franc's appreciation of approximately 2% against various currencies (EUR +2.05%, USD +2.2%, CNY +2.06%) in Q3, our currency stabilised during the quarter. The uncertainty which has affected financial markets in 2018 and 2019, essentially focused on risks of a recession relating to the absence of any clear progress on the trade issues between the US and China, has faded somewhat. Nevertheless, it has remained present enough to maintain strong international demand for safe bets, especially in Q3 when fears of a recession once again became more insistent.

However, Q4 will likely see a sharper reduction in recession prospects and an improvement in confidence for 2020. Demand for Swiss francs will likely go down, thereby helping our currency stabilise at the end of the year.

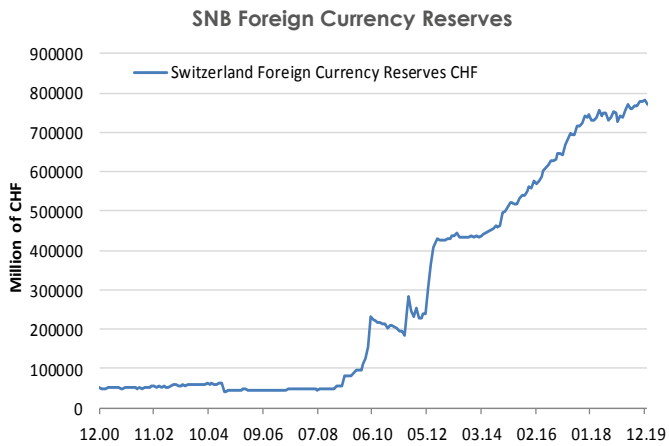
Nevertheless, in the longer term, we maintain our analysis and vision of a further weakening of the Swiss franc against the major currencies and against the euro in particular.

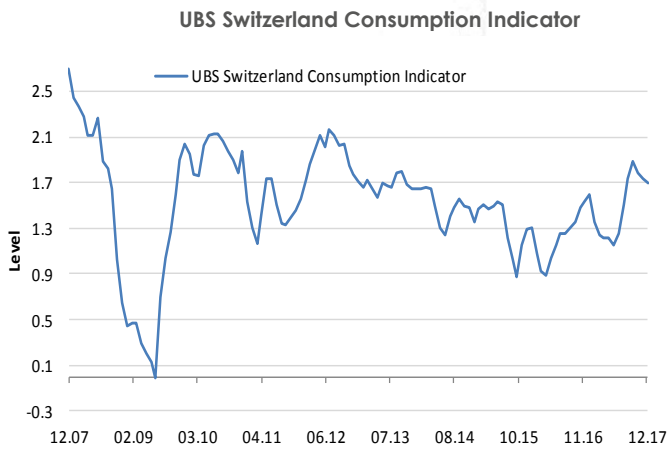
Let us mention that in terms of purchasing power parity (PPP), the Swiss franc may well be significantly overvalued in early 2020. A rise to 1.20 against the euro, which would represent a +10% increase, would help correct this excessive valuation and reduce pressure on our exports. According to the OECD, PPPs indeed suggest that the Swiss franc is overvalued in comparison with its "theoretical" value of 1.19 against the US dollar, 1.63 against the euro and 109 against the yen. According to the Big Mac PPP indicator, the franc's overvaluation is also particularly significant given its "theoretical" values of 1.18 against the US dollar, 1.56 against the euro and 109.6 against the yen.

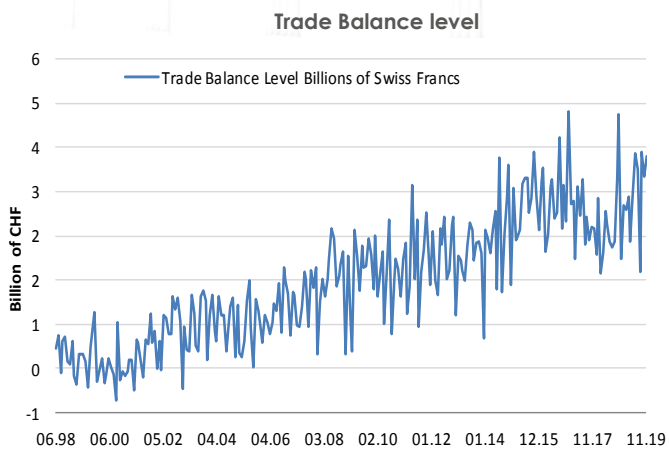


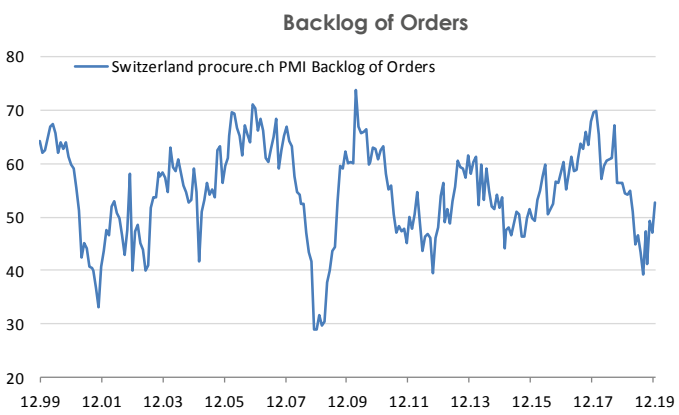


Graph sources: Bloomberg/BBGI Group









Graph sources: Bloomberg/BBGI Group

The Swiss National Bank (SNB) to stay on course

The SNB has once again recently announced that it had sufficient leeway to lower its key rates further still if necessary. The bank is thus clearly and unsurprisingly staying the course of its monetary policy which aims to curb the appreciation of the franc against the euro. Recent developments in US key and long-term rates have certainly reduced the yield spread which the SNB relied upon in its strategy to depreciate the franc and may have disrupted its policy.

However, let us highlight that the 75 basis point compression of the yield spread on long-term rates has had no real significant impact on the exchange rate and has not triggered any reaction from the SNB. The rise of the franc has indeed proven to be relatively moderate, as we mentioned in the previous paragraph, such that the SNB did not have to act during this period of adjustment of US monetary policy. Let us also mention that in the Eurozone, the drop in key rates is still very limited (-0.1%), meaning that no reaction from our national bank is required.

However, we believe that the next few months will likely be characterised by a new episode of widening yield spreads on long-term rates in particular, which will likely reinforce the dollar's appeal and drive the exchange rate above parity. The issue is different with regards to the euro, especially since the yield spread between rates in euros and in Swiss francs are not that significant and as the trend in the last few months does not augur the same type of development.

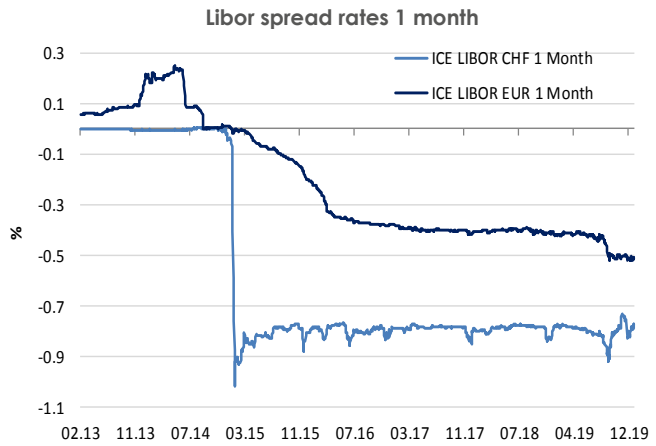
The yield spread which the SNB had hoped to create and maintain on three-month rates to weaken the franc has come increasingly under attack because of the ECB's rate cut. It has thus gone from -0.99% in January 2015 to -0.28% in late November 2019. Despite a PPP favourable to an appreciation of the euro, for such an appreciation to happen, a serious and lasting European economic recovery will have to occur or at the very least be anticipated with enough credibility Nevertheless, in the medium term, we believe that probabilities of a moderate weakening of the franc are increasing.

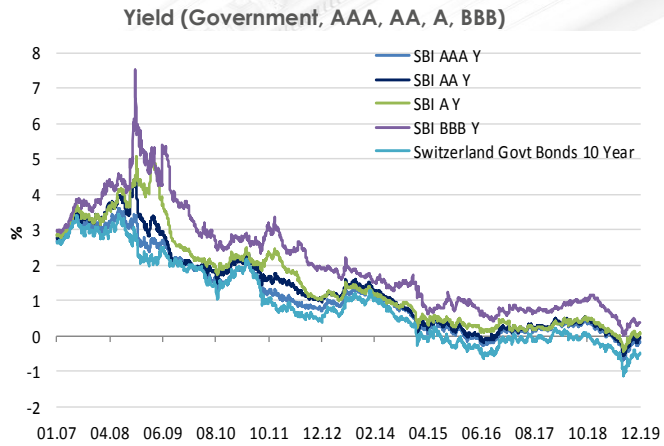
Slow rebound of long-term rates

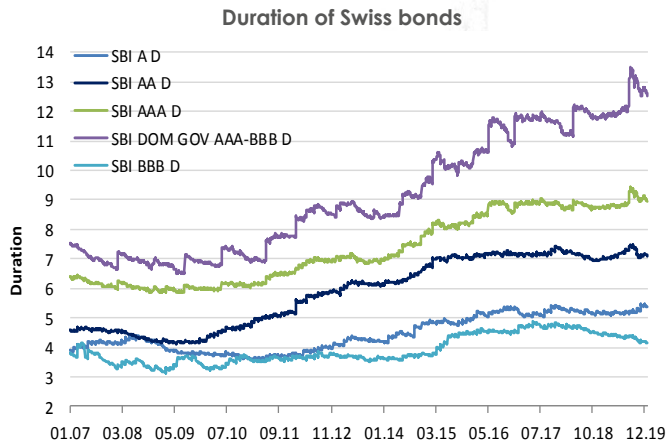
In September, we mentioned the irrational character of the collapse in ten-year yields from -0.5% to -1.12% in August, announcing a likely strong rebound as soon as risks of a recession are finally assessed rationally. The last few months of 2019 have thus been marked by a gradual increase of long-term rates from -1.12% to -0.4% in early November, which is likely to continue in the next few quarters. Prospects for bond markets in Swiss francs are negative in this environment, although the latest statistics published point to a possible return of deflationary risks in Switzerland. The CPI index for October shows a -0.2% drop in inflation for the month and -0.3% for the year. The real yield thus went from -0.85% to -0.75% in October.

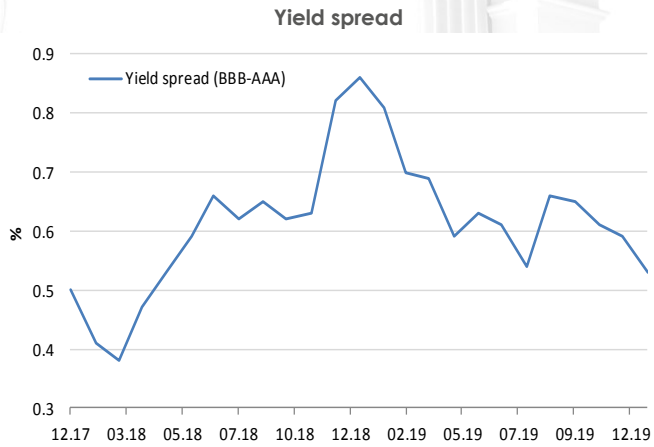
Equity markets benefit from the absence of alternatives

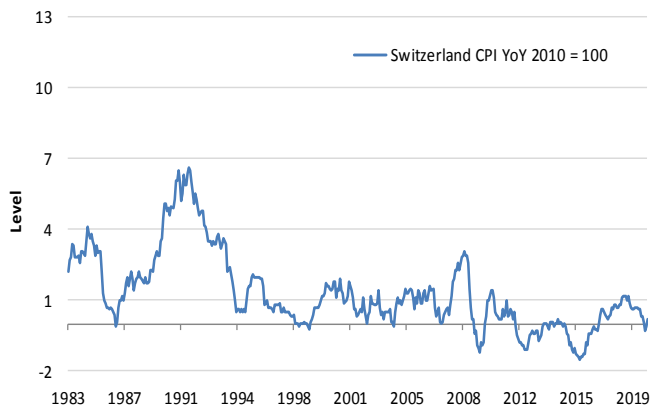
Consensus earnings growth estimates are above +10% for 2020, which we believe is a little high in a clearly weaker global economic growth context. A weak Swiss franc would be a favourable factor, however. The price/earnings ratio of the Swiss market is rather generous in this context, and at 18x expected earnings for 2020, these valuation levels lie between 15% and 20% above the historical average. In the absence of any investment alternative, the dividend yield may still be a driving factor for equities. Nevertheless, we recommend a more defensive strategy due especially to the high valuation levels.

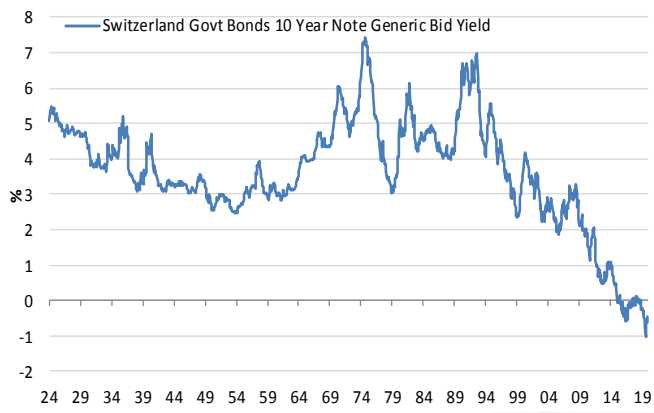


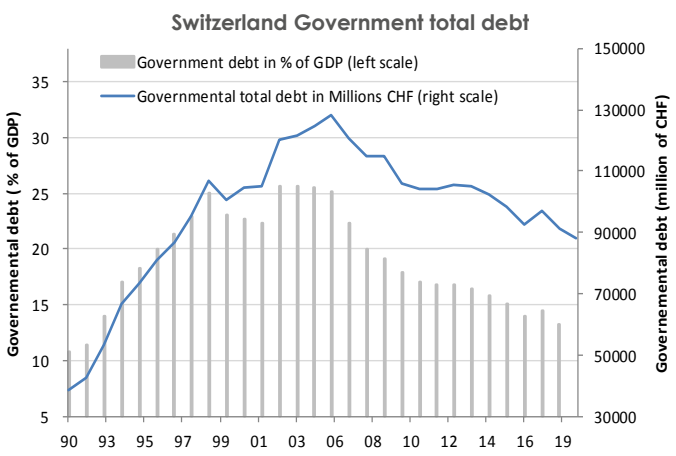


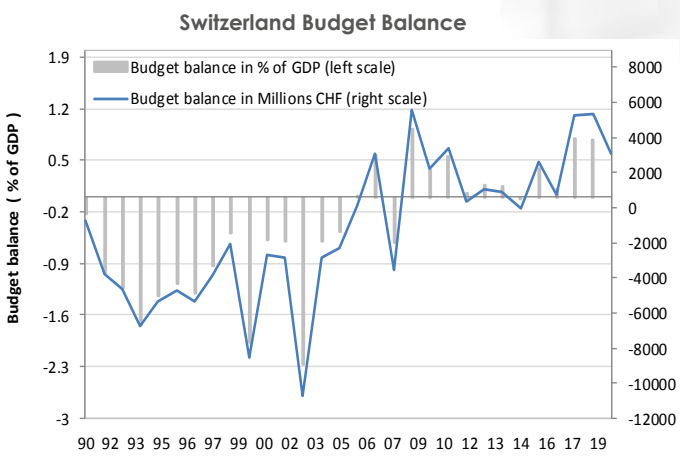












Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Eurozone

- Q3 slightly better than expected in the Eurozone
- Leading indicators leave room for doubt
- Germany holds up despite the collapse of its industrial sector
- Consumer confidence not benefitting from reduced trade tensions
- No new rate cuts by the ECB

Q3 slightly better than expected in the Eurozone

The Eurozone economy in Q3 may tentatively be climbing out of a period of weakness that has lasted several quarters, as recently published statistics point to GDP growth of +0.2% (+1.2% yoy) in the Eurozone in Q3. Economic activity seems slightly better than predicted by the consensus forecast, which expected growth of only +1.1%. Most importantly, the fact that this recovery is clearly visible in most economic sectors is relatively encouraging for prospects in 2020.

Nevertheless, the near-stagnation of GDP in Germany (+0.1%) after a -0.2% revision of its growth rate in Q2, continues to drive economic growth in the Eurozone downwards with no clear indication of any future reversal in trend. In Q3, only Germany, Italy and Austria posted growth rates (+0.1%) below the average (+0.2%), while every other country in the Eurozone and the EU posted results in excess of +0.2%. The highest quarterly growth rates were recorded in Poland (+1.3%), Hungary (+1.1%) and Estonia (+1%).

Germany has once again this year fended off the threat of a technical recession but is still suffering from the overall slowdown of the global manufacturing sector. Factory orders dropped by -0.4% in October and -5.5% yoy. The industrial complex in Germany is still plagued by uncertainty relating to trade issues, and the risks of a recession are thus logically much more real.

However, uncertainty relating to developments in global trade has decreased in the last few months, which will likely help sentiment, investment and consumption improve in the coming months. Quarterly GDP growth in the Eurozone has thus stabilised.

Growth in Q3 driven by consumption, government spending and exports

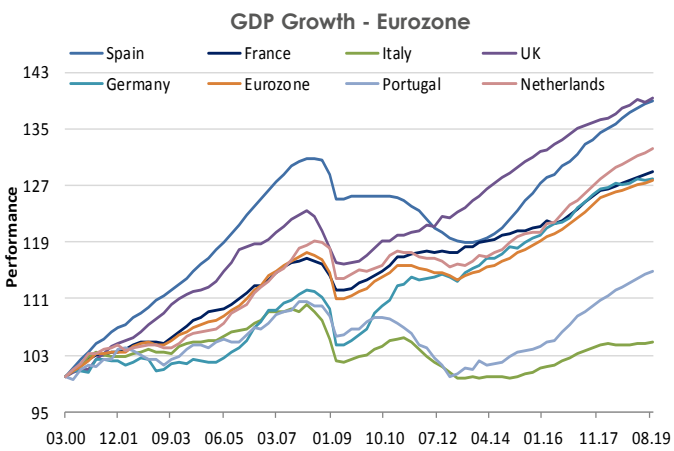
Private consumption (+0.5%), exports (+0.4%), government spending (+0.4%) and investments (+0.3%) have been driving European growth. In an environment that remains uncertain, these results contrast favourably with the ongoing difficulties in the manufacturing sector. These positive factors seem more resilient, inspiring a reasonable sense of optimism regarding the European economy's ability to avoid a sharper downturn in the coming months. Europe's economy will likely grow significantly more slowly in 2019 (+1.1%) than in 2018 (+1.9%), while risks of a recession are estimated at less than 20% for 2020.

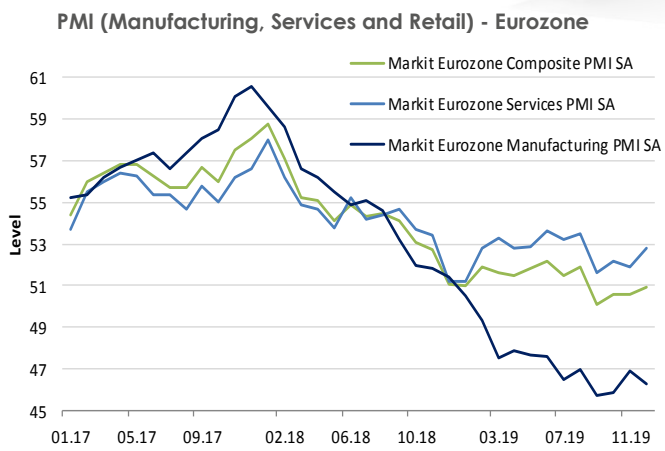
Leading indicators leave room for doubt

The large majority of national composite PMI leading indicators remain encouraging and stand well above the growth threshold of 50. The Eurozone's composite PMI recovered slightly in November, climbing from 50.3 to 50.6 as a result of improving sentiment in both the manufacturing sector and services. Nevertheless, despite a 0.3-point increase to 46.9, the manufacturing PMI is still far from its theoretical growth threshold and is still a significant cause for concern for Europe's industrial sector. The services PMI jumped up 0.4 to 51.9 in November. While this figure in itself is synonymous with growth, it should be noted that it is still among the lowest since 2014.

Germany holds up despite the collapse of its industrial sector

The German manufacturing index reached a new low in September at 41.7 before jumping back up in October and November (44.1). The manufacturing purchasing managers' barometer thus fell lower than it was during the downturn of the summer of 2012. Despite this recovery, confidence is still far from heralding a recovery in production after a two-year-long decline. For the time being, fears that other economic sectors would be contaminated have fortunately been only moderately confirmed.





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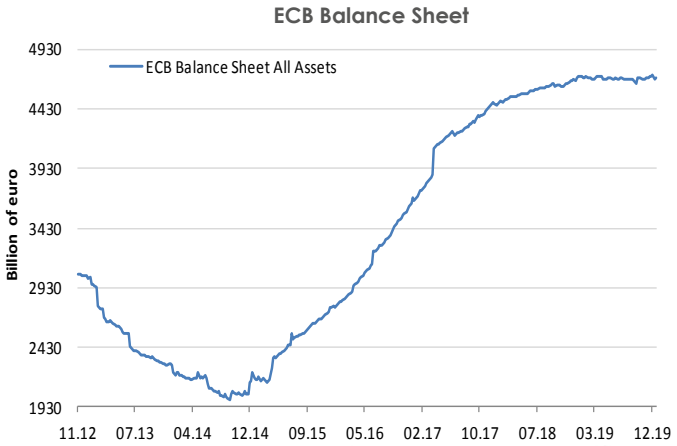
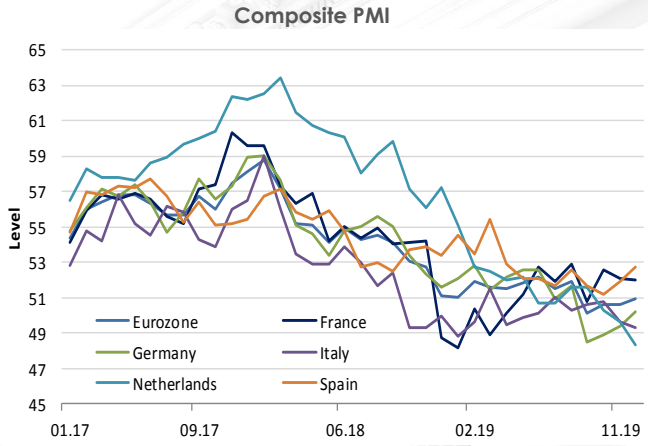




The services PMI fell in H2 2019 from 55.8 (June) to 51.7 (November), although it remains within a historically positive fluctuation range that supports the segment's growth prospects. In the construction sector, the rebound in the last three months signals more favourable prospects with an increase from 46 to 52 points between August and November. Germany's industrial production is still stuck in a downward spiral, contracting by another -1.7% in October, and -5.3% yoy. The impact of Germany's downturn on the Eurozone's industrial production is serious, but overall, Europe's industrial production is holding up, posting slightly positive growth of +0.1% in October.

Consumer confidence not benefitting from reduced trade tensions

The employment market has stabilised, and the unemployment rate in Eurozone countries remains unchanged at 7.5%, the level that prevailed at the end of 2008, which corresponds to a decline in unemployment of 35% in comparison with the 12% high reached in 2013. The European Commission's indicator, which measures the degree of economic confidence, has stabilised, although it does not point to brighter prospects.

The consumer confidence indicator regarding economic expectations in Germany looks a little more dynamic, posting its strongest monthly growth in nine years. However, the indicator that measures the general climate of consumption for December is less volatile and increased marginally from 9.6 to 9.7 in November. On the other hand, expectations with regards to the business cycle rebounded more sharply with a 15.5-point increase of the indicator. Confidence indices for Germany thus indicate a clear trend reversal. The reduced trade tensions and the decrease in rates in the US, in addition to political developments relating to Brexit, have certainly had a favourable impact on households' optimism.

No new rate cuts by the ECB

After its latest -0.1% rate cut in October, the European Central Bank us unlikely to make any new cuts in the coming months if economic conditions do not show any clear signs of deteriorating.

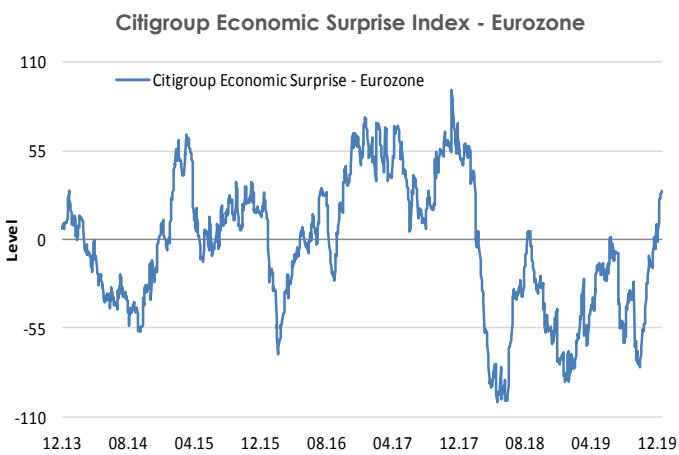
A short time ago, the consensus still expected a new rate cut in June 2020, but the most probable scenario points to a status quo until 2022 before any new hike. Despite persistent risks of a slowdown in the Eurozone due to the difficult economic situation in Germany, current monetary policy is deemed sufficient to overcome these risks. Nevertheless, the latest inflation figures in November (-0.3%) have rekindled risks of a deflation.

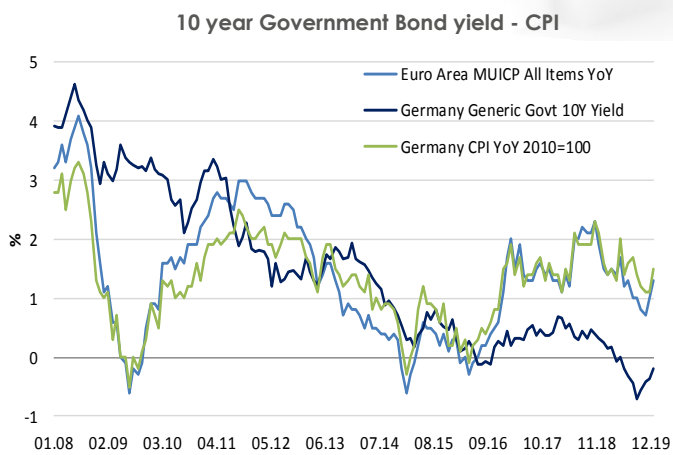
The new president of the ECB, Christine Lagarde will hold her first press conference on 12 December, which will likely follow the same line. She will undoubtedly address the issue of long-term strategic guidelines and possibly the idea of integrating issues relating to climate change in the ECB's global analysis. More specifically, expected economic projections might be a little more optimistic, without straying too far from the forecasts already presented. In terms of the asset purchase and quantitative easing programme, Christine Lagarde's comments regarding the stimulus measures that were carried out in the first month will be key.

Possible strengthening of the euro

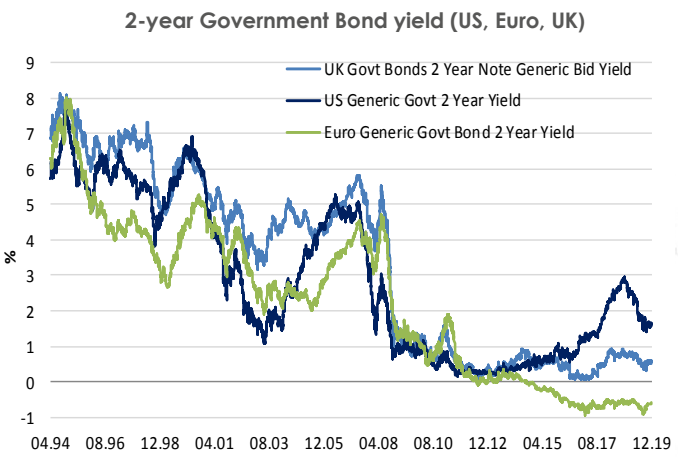
The deterioration of economic conditions in the Eurozone, mainly due to the specific situation of Germany's manufacturing sector, did not trigger any specific distrust of the euro by investors in H1. The growing general uncertainty in July and August then triggered a short period of weakness, which ultimately stabilised with a euro/dollar exchange rate above 1.10.

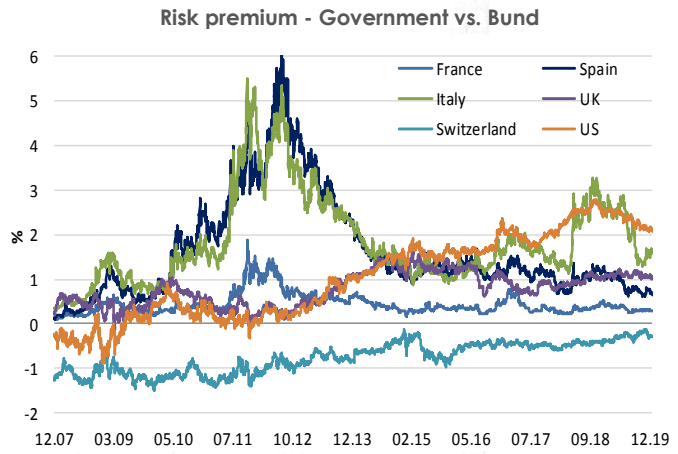
The yield spread remains quite clearly in favour of the dollar both in the short and the longer term. Nevertheless, we now believe that the euro's current level factors in most of the negative expectations with regards to the risks to Germany's economy. The support measures announced by the ECB will likely breathe some life back into the euro unless Trump decides to ramp up the pressure on Germany's trade. A normalisation of growth prospects will likely encourage investors to return to the European currency at its current levels, driving an increase in euro/USD and euro/CHF rates to 1.14.

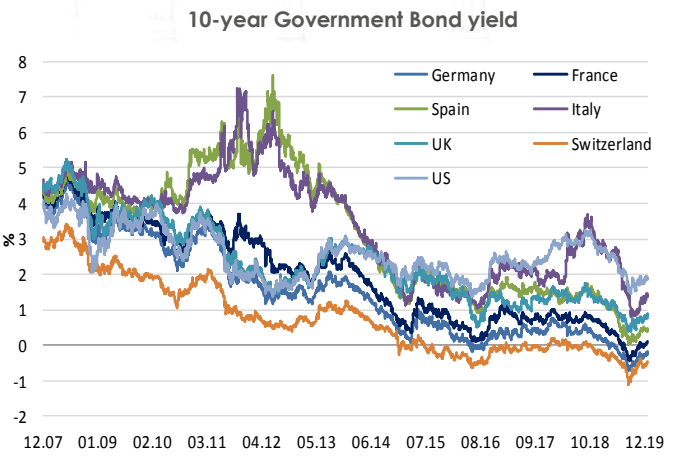


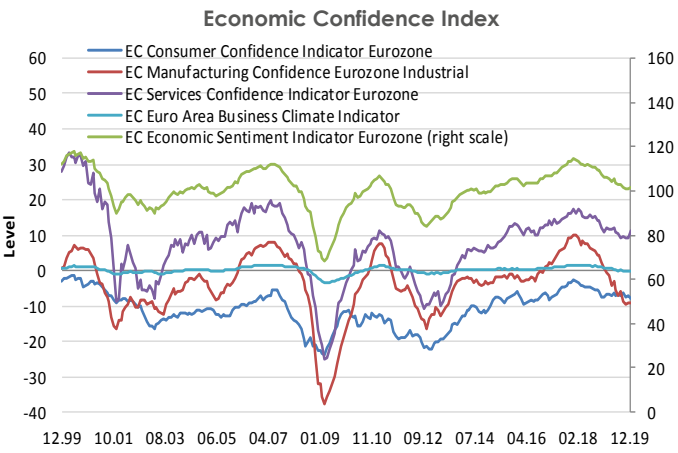


Graph sources: Bloomberg/BBGI Group









Graph sources: Bloomberg/BBGI Group

Real yields slightly less negative but still conducive to investment

Inflation slipped into negative territory in November with a -0.3% drop over the month. Over one year, the CPI index rebounded from +0.7% to +1.0%, while inflation excluding food and energy barely reached +1.3%. In terms of producer prices, the data in October is barely positive over a month (+0.1%), but the falling PPI has now dropped -1.9% over twelve months. Producer price indices have decelerated sharply since their high (+4.9%) in October 2018 and are now in the red since August 2019.

With falling inflation and an approximately 40-basis-point upswing in long-term rates in the last quarter, real yields have actually increased significantly in the Eurozone. Real yields on long maturities have gone from -1.3% at the end of August to -0.6% today. This correction of real euro yields is unlikely to have any major impact on the financing cost of investments, consumer credit and mortgage financing. Negative real yields, even reduced, will still foster in 2020 a recovery of demand, and investments over the next few quarters.

Sharp rise in long-term rates

For more than three months, a partial, yet rather significant change in investors' expectations regarding economic prospects and the appropriate relative level of interest rates has been occurring. A few months ago, falling euro rates were still justified by real risks of recession for Germany. In the last few months, the relative decline in uncertainty has enabled a progressive increase in yields, which has almost cancelled out the exaggeration observed in August.

The inversion of the euro yield curve during the summer thus normalised somewhat in the autumn with a rise in 10-year rates from -0.71% in August to -0.3% in November. Euro capital markets have begun integrating the falling risks of recession, but they are not ready yet to gamble on a clear economic upturn and higher inflation, which will undoubtedly be essential for any rise in yields back into positive territory.

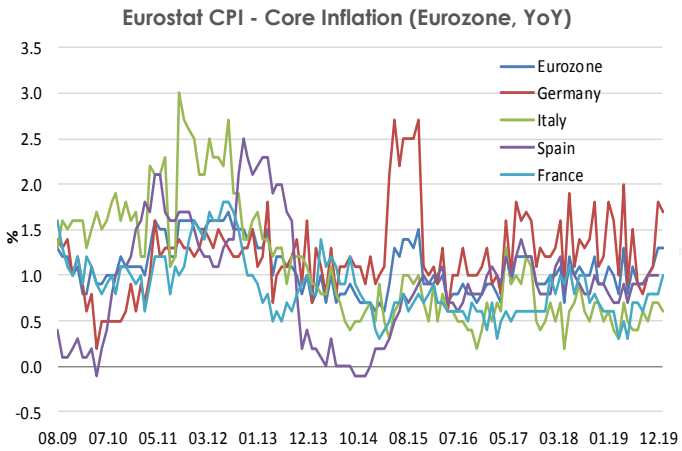
European equities still more attractive than US stocks

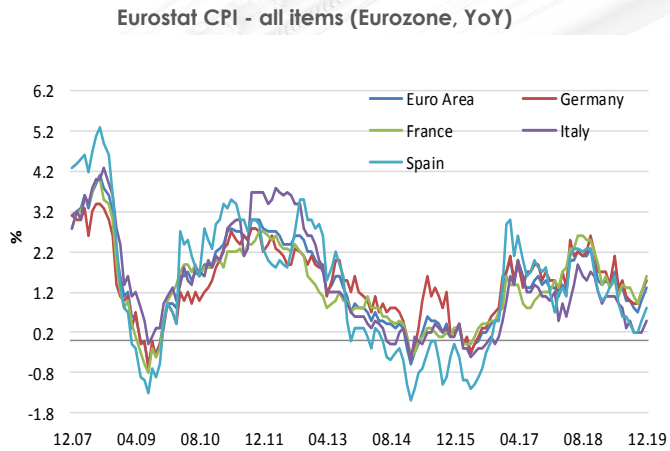
The performance of European equities (+19.5%) remains below that of the US market (+26.7%) since the beginning of the year. However, the outperformance of US stocks seems linked essentially to corporate share buy-backs. When corrected for this effect, the performance of European equities is actually similar. At year-end, the valuation of European equities remains attractive.

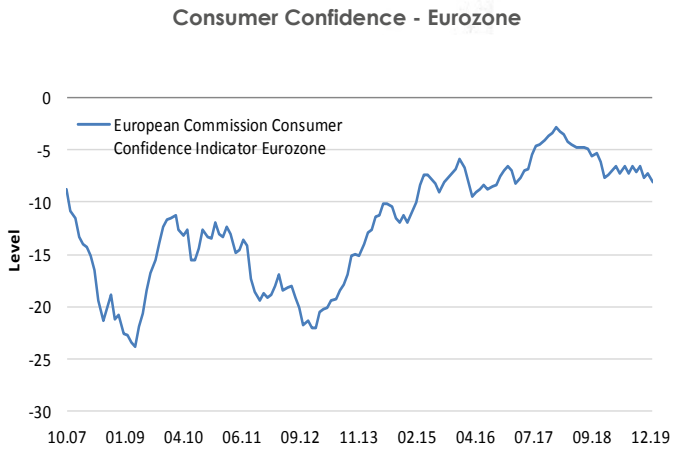
With a valuation of 15.9x expected 2020 earnings, they are at an almost -20% discount to US equities, with 2020 PE levels of 19.2x. Since 15 August, date of the trend reversal in the rate and equity markets, both markets have performed almost identically in terms of local or any other currency. The persistently low rates in the Eurozone will likely lead to investors taking a renewed interest in European equities as well as to an expansionary phase for PEs.

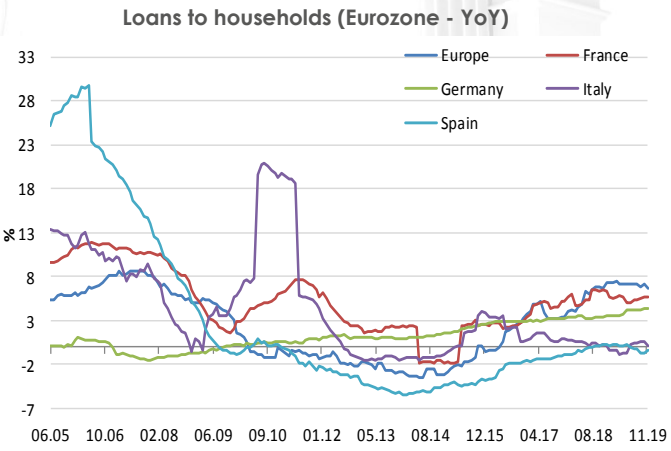
Beyond the more attractive valuation levels, European companies also offer a clearly superior yield compared with US companies. Their 3.3% yield is thus 80% higher than the yield of S&P500 stocks on average (1.85%). This valuation gap may be explained by the perception that European stocks are more sensitive to external shocks such as the slowdown in China and in emerging countries.

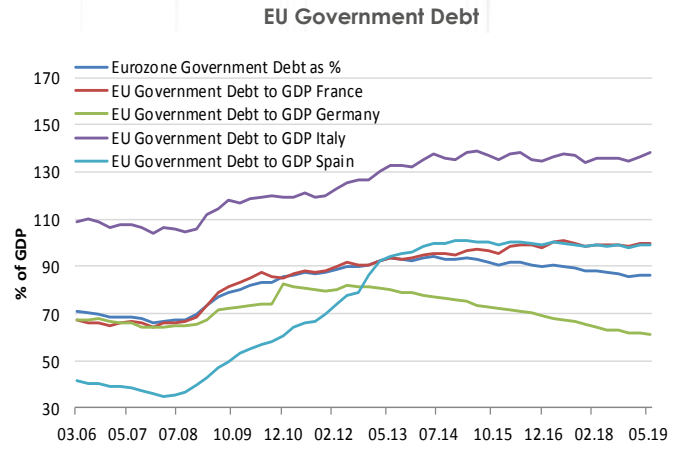
For now, investors may thus be more convinced by the capacity of US rather than European companies to withstand such shocks. Consequently, European equities will likely depend on better economic conditions to outperform.

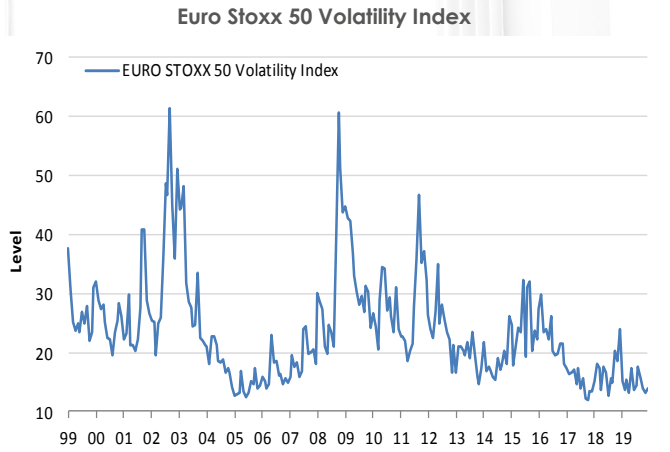












Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

United Kingdom

- British voters done with political foot-dragging on Brexit
- BOE prepared to cut rates
- Household confidence improves
- Real estate at a standstill
- Capital markets remain unattractive

British voters done with political foot-dragging on Brexit

Parliamentary election results finally reshaped the playing field, with the Conservatives winning a very clear majority. Hard not to see this as the prime minister's victory, who will now have complete freedom to undertake the domestic reforms he had promised and implement Brexit expeditiously.

British voters were clearly swayed by his "Get Brexit done" slogan, as they were ultimately exasperated by and keen to put an end to foot-dragging amongst the political classes. Given his parliamentary majority, he should have no difficulty getting his Brexit agreement passed by the Chamber of Commons before 31 January. Brexit will thus definitely happen, although its precise outline still has to be determined in negotiations with the European Union in 2020. However, Boris Johnson may now be less dependent on the party's hardliners thanks to his wide majority and to his 160-seat lead on Labour. Hard to say what strategy will win out at this stage, but recent trends in the pound's exchange rate suggest that business circles are seeing an increasing likelihood that a softer Brexit will prevail.

Although a technical recession was avoided in Q3, GDP is down already in October

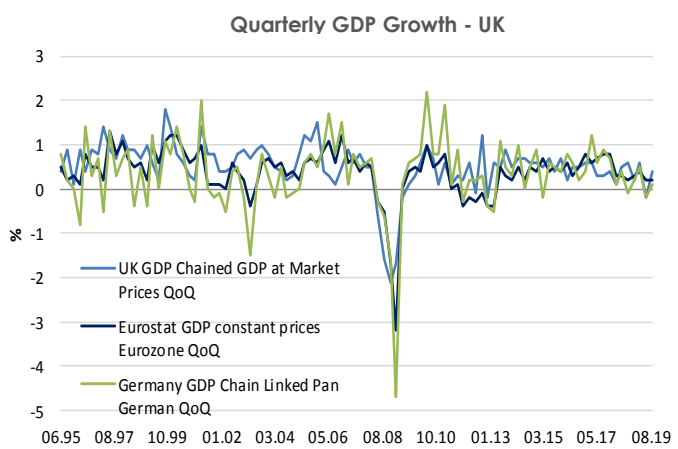
UK monthly GDP growth was nil in October and 0% yoy on a quarterly basis. This deterioration in economic conditions follows on the heels of the publication of Q3 GDP growth figures pointing to an improvement in the UK economy. GDP growth of +0.3% in Q3 came after a -0.2% contraction in Q2, once again avoiding a technical recession. However, the overall picture is far from reassuring. On an annual basis, GDP growth slid further, landing at +1.0%, significantly lower than the +1.8% growth posted in March. Consumption and government spending were up +0.4% and +0.3%, respectively, while investment stagnated and exports surged by +5.2%, after falling by -6.6% in the previous quarter. Fundamentals published more recently continue to point to a less dynamic fourth quarter in the UK.

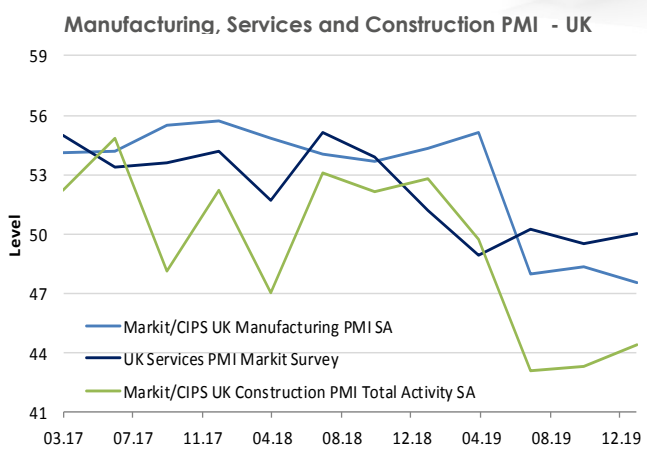
The upswings in industrial output (-0.3% to +0.1%) and manufacturing output (-0.4% to +0.2%) in October were significant, but this temporary increase in activity must be confirmed over the next few months. The construction sector on the other hand is once again in turmoil. Indeed, it slid by -0.2% in October for a yoy drop of -2.1%, disappointing results indicating a sharp deterioration of the situation since the month of September, when it was still up +0.5% yoy.

Following Boris Johnson's win and the Conservative camp's now absolute majority, the growth outlook may improve. A decrease in uncertainty could boost investment, although in the absence of real clarity regarding the implications of the any potential withdrawal strategy, these positive reactions will likely remain constrained.

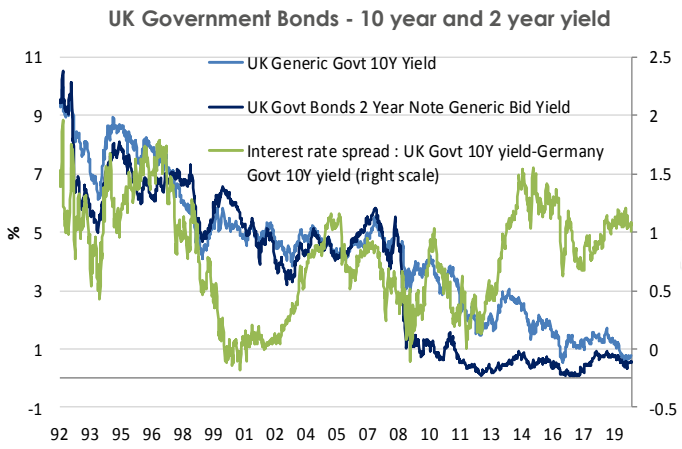
BOE prepared to cut rates

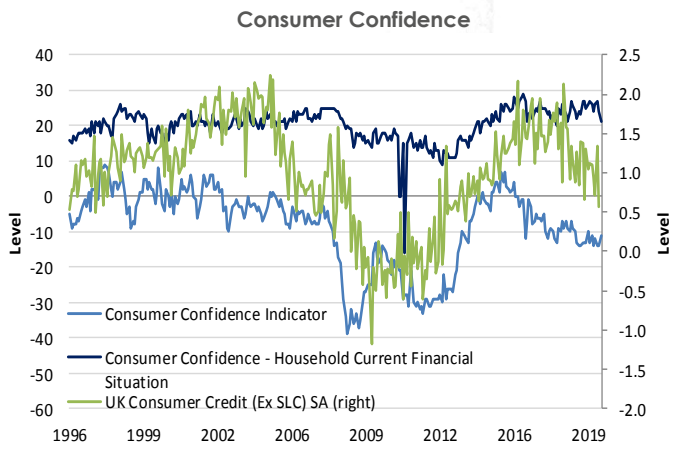
Given the UK economy's current weakness, the Bank of England will remain especially cautious and attentive to any threat of slippage. It is thus highly unlikely that it will change its accommodative monetary policy. However, the Bank could be tempted to cut short-term policy rates to counter the ever more present risks of recession. The significant rise of the pound along with cooling inflation will likely provide the BOE with a little more leeway. The British central bank will doubtless wait to see what kind of Brexit deal is ultimately sought by the prime minister. Whatever the agreement reached with the EU, the short-term risks remain significant. Thus, the BOE will likely be inclined to bolster the economy by cutting rates early in 2020.

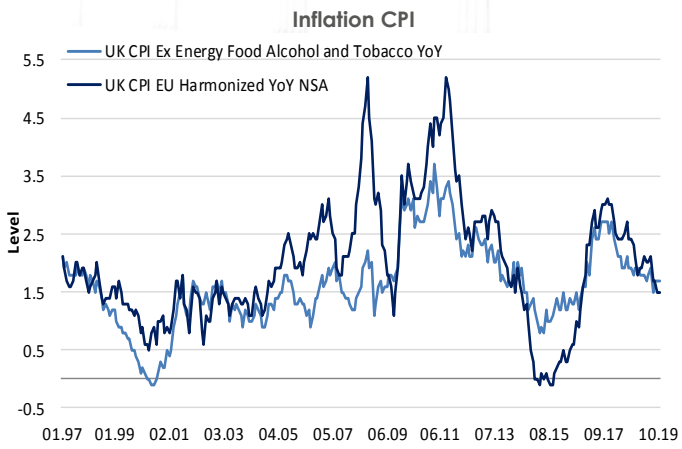


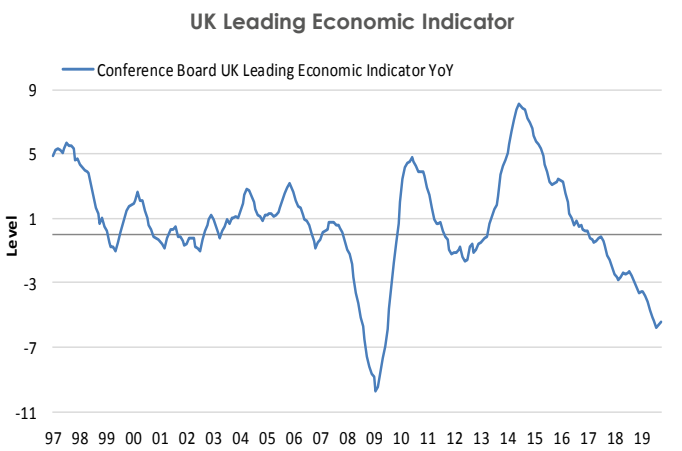


Graph sources: Bloomberg/BBGI Group









Graph sources: Bloomberg/BBGI Group

Parliamentary election results likely to boost leading indicators

The parliamentary elections on 12 December resulted in a clear victory for the Conservatives and Prime Minister Boris Johnson, who can henceforth count on broad popular support. British voters clearly had had enough of political foot-dragging and finally decided to get Brexit done whatever the cost. The people thus expressed a clear preference for clarity of vision, which will likely have a non-negligible impact on the mindset of both leaders and citizens. Political uncertainty has thus been dispelled without however solving the concrete issues that will result from the implementation of Brexit; nevertheless, the degree of uncertainty has decreased substantially.

The UK can now more calmly contemplate its uncertain future, which will likely translate into somewhat stronger confidence indicators and more optimistic PMI indices. The latest manufacturing PMI indices had already rebounded from their August low of 47.4 to 48.9 in November. The political crisis that was exacerbating popular discontent and fuelling uncertainty through August is now in the process of being resolved. We expect that the manufacturing PMI indicator could rapidly climb back above the threshold of 50 in the next few months, pointing to improved prospects for the UK's industrial sector.

A trade agreement between China and the US will also have a positive impact on UK industry. Furthermore, as the services PMI also dropped significantly through November, it will likely benefit even more substantially from the expected improvement in sentiment and climb back above the growth threshold at the beginning of 2020.

Household confidence improves

British consumers, justifiably anxious after a summer full of uncertainty and given the endless political crisis surrounding Brexit, will likely be slightly more optimistic as 2020 rolls around. Consumer confidence, which had reached a six-year low at the beginning of 2019, remained weak through November prior to the parliamentary elections. Although the job market remained solid, this absence of confidence was essentially due to the uncertainty tied to Brexit, with consumers remaining in wait-and-see mode.

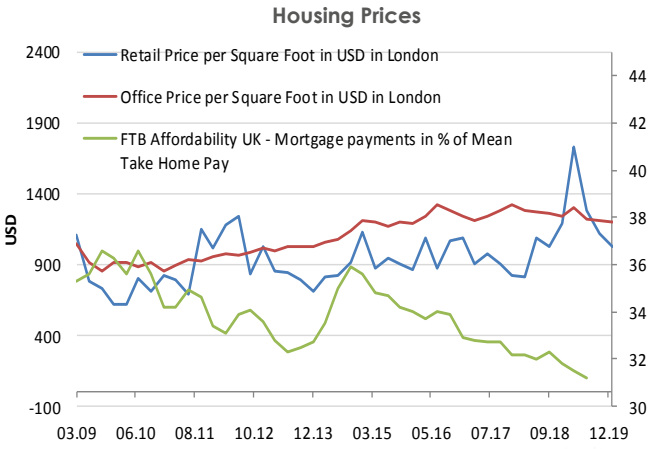
The election results have now offered better visibility regarding Brexit, and whatever the final outcome, this will have a positive impact on household confidence over the next several weeks. The latest yoy wage growth figures (+3.6%) remain strong, although they slackened very slightly, and are still at a 10-year high. The jobless rate stabilised at 3.8% in September, still at the bottom of the cycle, but job creation dropped into negative territory over the past two months, with -58,000 fewer jobs in September.

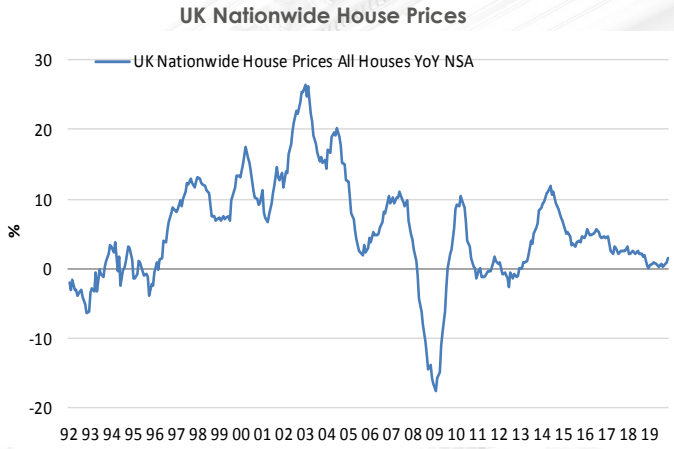
Wage growth, which had reached +3.8% yoy in July, declined slightly to +3.6% in September, although it remains much higher than inflation (+1.5%, or +1.7% ex food and energy), which means that purchasing power increased by close to 2% in 2019. This situation should persist over the next few quarters, in particular due to the appreciation of the pound, which will likely keep twelve-month forward inflation growth under the currently expected 3.1%.

Real estate at a standstill

The construction PMI remained in the contraction zone at 45.3 in November. Various measures of real estate price trends continue to point to declining prices and general stagnation. The Nationwide Building Society's price index confirms that real estate prices are stagnating, with price growth of barely +0.8% yoy.

Monthly figures were somewhat volatile in 2019, but while the real estate market has remained resilient so far in the face of Brexit-related uncertainty, buyers' enthusiasm has waned. In the medium term, the imbalance in the real estate market should continue to bolster demand and prices, in particular if borrowing costs going forward remain as low as they are today and if job market conditions stay robust. Wage growth has stabilised, and mortgage rates are still at record lows. Mortgage loan approvals fell for the third consecutive month to 64,600.





Capital markets remain unattractive

While long-term rates dropped from 1.6% in September 2018 to only 0.4% at the end of August 2019, the last decline in long-term rates in the UK over the summer was followed by a rapid upswing to above 0.8%. The global context improved somewhat over the period, but economic risks remain high in the UK, still in search of a political solution to the Brexit issue. The uncertainty resulting from the absence of a Brexit deal and the risks of a real collapse in economic activity in the event of a no deal had first pushed long-term rates below the lows reached just after the 2016 vote. The parliamentary election results will likely strengthen the trend seen in the past three months, pushing pound yields above 1%. However, pound capital markets are still unattractive, as yields are significantly lower than those in US, Australian, and Canadian dollar markets.

Political risks have subsided considerably, but while there is now a higher likelihood of seeing an orderly Brexit take form, Boris Johnson still has to determine its final shape. The risks to the UK economy are still high at the beginning of 2020 following zero growth in Q4 of last year. We may have to remain patient in terms of seeing any significant economic upturn in the UK. However, if the job market remains strong and wage growth continues to be higher than inflation thus boosting purchasing power, consumption, services, and industry may surprise on the upside in 2020.

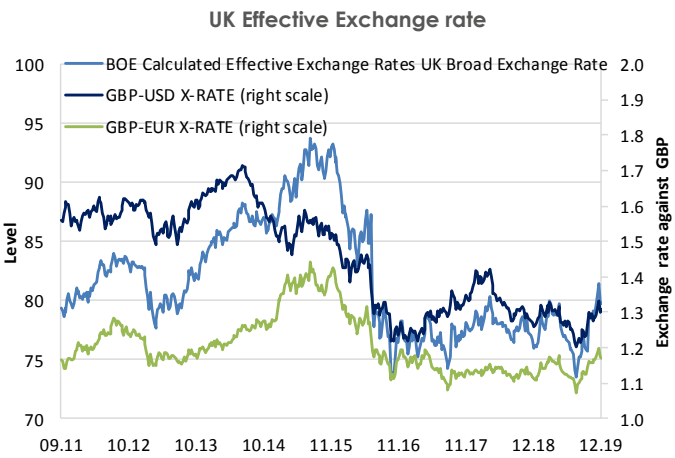
A negotiated withdrawal of the UK is now more probable, and the risks of recession will then likely be adjusted downwards, with a gradual increase in long-term rates and stabilisation of the pound as likely corollaries. The risks of holding pound-denominated bonds seem sufficiently high in this context to avoid overly aggressive positioning in this market. Given the uncertain context, we recommend that international investors avoid any exposure to capital markets in pounds and take positions in other bond segments.

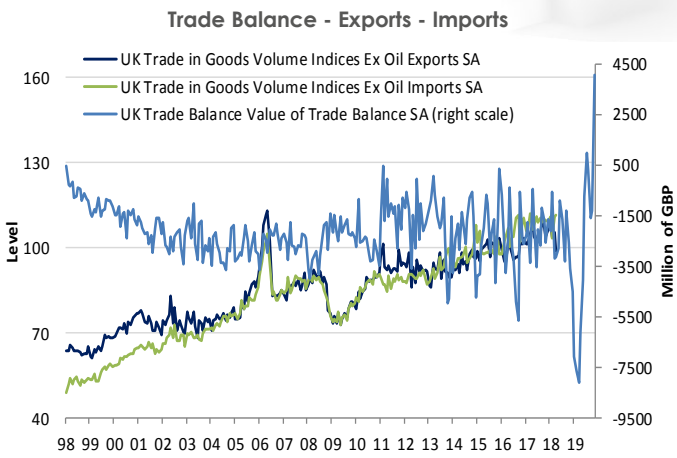
Brexit more favourable to the pound than expected?

As we mentioned previously, the pound will be affected for a long time by the political situation in the UK and by the shape Brexit ultimately takes. The British currency had lost -20% against the US dollar in the wake of the June 2016 vote, falling from 1.50 to 1.20. In 2019, the pound regained more than +10%, climbing to 1.35 in anticipation of a clear political result following the December elections and more visibility regarding future relations between the UK and the EU. As we predicted, the pound stabilised above 1.24 and appreciated towards 1.30-1.35 in anticipation of a Conservative victory. Consequently, we are not predicting any significant further increase of the pound in Q1 2020.

Persisting uncertainty with regard to equities and real estate

The political and stock market environment now seems less uncertain. However, the equity market's risk/expected return ratio does not seem much more attractive in relative terms than the bond market's. We continue to recommend caution with regard to UK equities, in spite of reasonable valuations and attractive dividend yields. As for securitised real estate, the risks of a further deterioration in market conditions seem significant enough to recommend waiting. Recall that the BOE noted that real estate prices could fall by up to 25% if the negative scenario of a no deal came to pass.





Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

Japan

- GDP growth in Japan ground to a halt in Q3 (+0.1%)
- Exports fell further
- Consumption slows in spite of improving household confidence
- BOJ's flexibility is much reduced

GDP growth in Japan ground to a halt in Q3 (+0.1%)

GDP growth slowed sharply in Japan in Q3 due to a further drop in exports. The quarterly growth rate of +0.1% is well below the growth rate in Q2 (+0.3%), which was already lower than growth in Q1 (+0.5%). Economic growth yoy has fallen to +0.2%, a sharp decline compared to yoy growth of +1.3% (revised to +1.8%) at the end of June. The Japanese economy is increasingly impacted by its falling exports and by the trade tensions that continue to put pressure on global demand for manufactured products. These results are well below the consensus forecast, which had predicted yoy growth of +0.9%. The Japanese economy was also affected by tensions with South Korea and by weather events including Typhoon Hagibis, factors that will likely no longer be present in Q4.

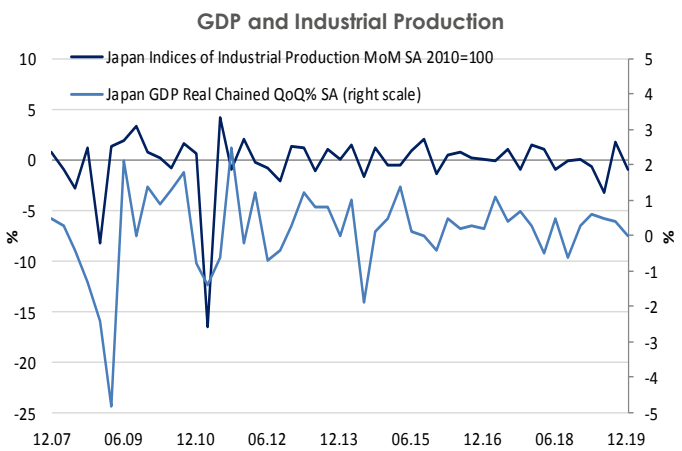
Capital expenditure continued to rise (+0.9%), while public spending (+0.8%) slowed compared to the previous quarter. Private consumption, capital expenditure, construction, and public spending contributed positively, while falling inventories and the contraction in net exports, and in particular service exports, as Korean tourists shunned Japan, contributed negatively. Consumption held up fairly well over the quarter, rising by +0.4% just before the introduction of new taxes at the beginning of the fourth quarter, just a little below the +0.6% increase expected. However, there is still the risk that private demand will slow following this introduction, impacting economic growth in Q4.

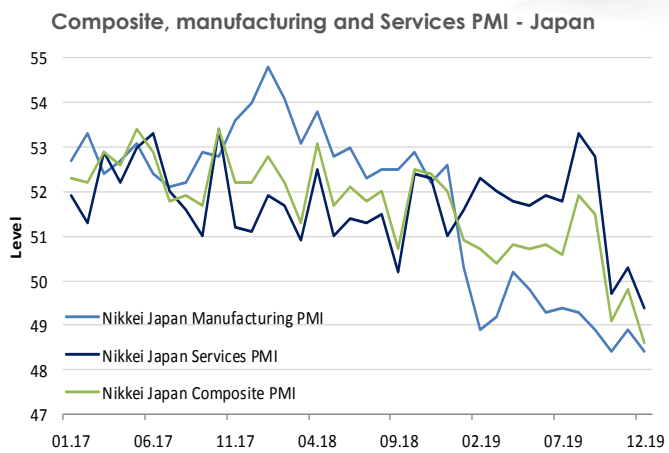
By historical comparison, excess consumption demand in Q3, immediately preceding the introduction of the tax, was well below that seen in 2014, which had then led to a very sharp slowdown in economic activity in the following months. To mitigate the potential impact of the tax on growth, Prime Minister Shinzo Abe will likely announce a fiscal package aimed at stimulating the economy. The scope of these stimulus measures will be a determining factor for the Japanese economy over the next few months. A range of figures have been cited for this economic stimulus programme going from 3 to 6 trillion yen (28 to 55 billion dollars).

Exports fell further, but the trade balance is once again showing a surplus

Japanese exports fell further in November, actually posting their sharpest drop (-9.2%) in three years. The open crisis with South Korea had a significant impact on the economy due to the boycott of Japanese goods as well as the collapse of Korean tourism to Japan. This factor is likely temporary, but it contributed to exports' 11th consecutive drop, highlighting the sector's struggles in the uncertain trade environment prevailing in the past several quarters. Exports to the US (-11.4%) as well as to China (-10.3%) also declined significantly. The auto and steel sectors were particularly impacted by weaker foreign demand. In spite of the announcements suggesting that China and the US are about to reach an agreement, uncertainty persists, putting a damper on orders.

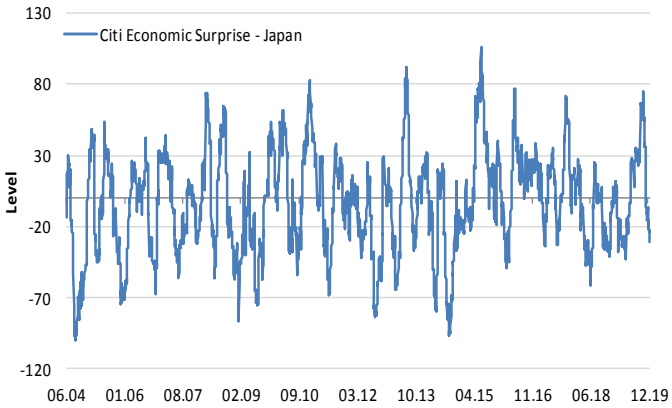
The fall in exports will no doubt be taken into account by the Japanese government as it draws up its stimulus plan, which is unlikely to reach the higher end of the expected range, however. These developments imply that, in the short term, the Japanese economy is somewhat more dependent on consumption than previously. Historically, Japan has run a trade surplus over the past decade, notwithstanding a deficit between 2011 and 2015. Although the trade balance was negative for several months, it turned positive once again in October with a surplus of 17.3 billion yen stemming from the -14.8% fall in imports. The situation is unlikely to change significantly in Q4, and we expect the trade balance to remain close to equilibrium. An economic upturn is unlikely to materialise in 2020 without a more significant contribution from the export sector. We thus have slightly more favourable expectations for Japanese exports in Q1, which could grow more rapidly than imports. As Japanese exports were impacted by flagging global demand and a slowdown in the manufacturing sector, any significant trend reversal will require conditions in these areas to improve as well as at least relative weakness of the yen. The nominal interest rate spread, which typically penalises the yen, has in fact be countered by trends in real interest rates, which for now are impeding any depreciation of the yen likely to boost exports.



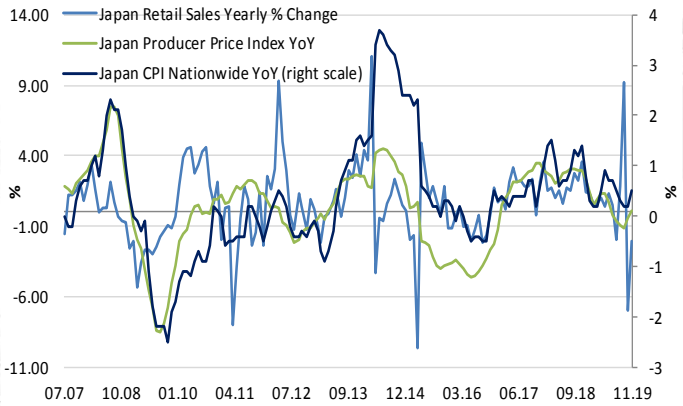


Graph sources: Bloomberg/BBGI Group

Economic Surprise Index



Inflation (CPI and PPI) and retail sales



Parliamentarians in Japan's upper house approved the trade agreement with Washington on 4 December. The agreement would ideally take effect as soon as 1 January 2020. The agreement covers imports and exports of agricultural products as well as e-commerce and other online activities. This development reduces the level of uncertainty that was weighing on relations between Japan and the US until now.

Industrial output dipped again at year-end after showing some signs of improving

The Japanese manufacturing sector continues to be broadly influenced by the external factors mentioned above, and there are few signs that the trend will reverse any time soon. The small upswings in industrial output in July (+1.3%) and September (+1.7%) were erased by the -4.2% fall in November, among the steepest in the past five years. These results seem especially worrisome at this stage in the cycle, even though external factors were exacerbated by the tax increase and the super typhoon, two non-recurring temporary factors that depressed industrial output.

Consumption slows in spite of improving household confidence

Consumer confidence improved significantly for the second month in a row in November after declining for 20 long months. The increase is substantial and constitutes a positive factor indicating that the VAT increase will not necessarily penalise private consumption. The challenges in the manufacturing sector have had only a very limited impact so far on the unemployment rate, which nevertheless jumped from 2.2% to 2.4% in October. The job market remains tight, but the job-openings-to-applicant ratio (1.57) will likely decline further due to decreased demand in the manufacturing sector. Given the more challenging environment, businesses are turning somewhat more to part-time positions in the short term. While real household consumption slackened from +0.6% to +0.4% in Q3, more recent statistics indicate a significant drop in household spending in October. Auto sales plummeted by -26.4% yoy in October before bouncing back somewhat in November (-14.6%).

Department store sales benefited from an increase in demand (+20.7%) prior to the introduction of new taxes but fell sharply in October (-19%). The central bank continues to hope that the job market's particular situation will boost wages, consumption, and inflation, but these effects are still struggling to materialise.

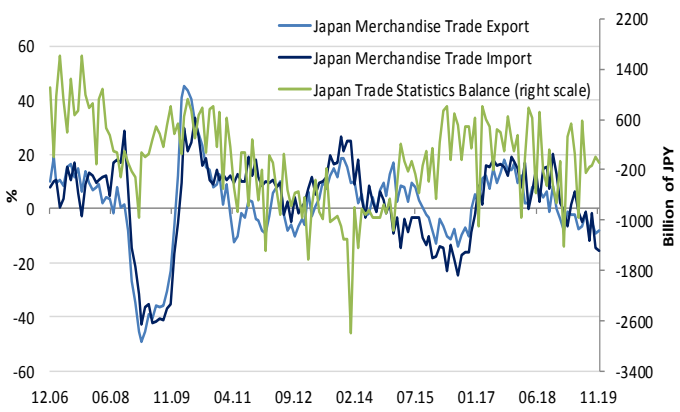
BOJ's flexibility is much reduced

The Bank of Japan kept its monetary policy unchanged at its meeting on 31 October and is unlikely to announce any major change at its last meeting of the year on 19 December. The governor of the central bank recently pointed out that the BOJ's ultra-accommodative monetary policy was aimed at boosting inflation and not at financing government spending, commenting just as the government is preparing to announce additional economic stimulus measures to counter the threat of an economic slowdown.

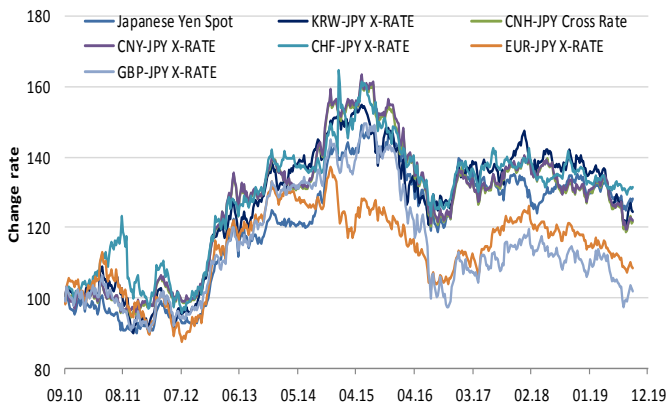
The warning is unlikely to have a significant effect on politicians, who will likely not hesitate to take measures that could further increase government debt and the debt ratio, which is already among the highest across industrialised nations. Governor Kuroda will likely not hesitate to cut rates again should price indices lose momentum. The monetary policy committee takes deflationary risks seriously, but patience still seems to be winning out. The latest CPI figures show that inflation has stabilised at 0.2%, which can be considered as relatively far from the BOJ's target.

The BOJ is probably wondering if the appreciation of the yen and the struggling manufacturing sector are sufficient reasons to justify a rate cut in December or if sitting tight for a few weeks will leave enough time for a more positive outlook to finally take shape. Kuroda could look at the stabilisation of manufacturing leading indicators over the past several months already as a positive sign and anticipate that the Japanese economy overall will likely benefit from the improvement in global conditions that will undoubtedly materialise following the rate cuts in the US and Europe. Indeed, the BOJ is under a lot of pressure to act, in particular in terms of weakening the yen, but we do not believe that a rate cut would be the appropriate trigger in that regard.

Trade Balance (Billion of yen)



Exchange rate (Normalized at 100)



Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

China

- China's economy regains confidence
- Leading indicators herald economic upturn
- PBOC begins the year with a 50 basis points cut in the RRR
- Excellent prospects for Chinese equities

China's economy regains confidence

The improvement in China's economic situation appears to have strengthened further still in December. With regards to industrial production, leading indicators are in a phase of expansion, especially Korean exports of intermediate products or finished products, which are generally positively correlated with those of China. This positive change seems to be quite generalised across surveys regarding the business outlook, external demand, household consumption and market sentiment.

The trade agreement that has been negotiated has already had a positive impact on demand and production. China's economic growth is likely to rebound in Q1 2020 already thanks to improved sentiment, reduced uncertainty, credit growth, the decline of the required reserve ratio for the banking sector and an upswing in public investments. Industrial corporate profits surged by +5.4% at the end of the year, fuelled by stronger domestic demand.

After three months of declining profits, down by -9.9% yoy in October, this rebound is very much welcome though it will have to be confirmed in the next few months. That being said, GDP growth is still likely to fall below +6% in 2020, but we are pleased to see that the rebound in industrial production in November from 4.7% to 6.2% yoy reverses the trend of the summer with its best result since June.

This recovery is mainly due to the private sector, since the SOE segment has actually continued to decline. As regards consumption, retail sales also picked up with yoy growth of +8% against a +7.6% estimate. Phase 1 of the trade agreement has clearly brought new impetus to China's economy, which nevertheless does not preclude new weaknesses. The Chinese government will likely maintain its fiscal and monetary economic support policy.

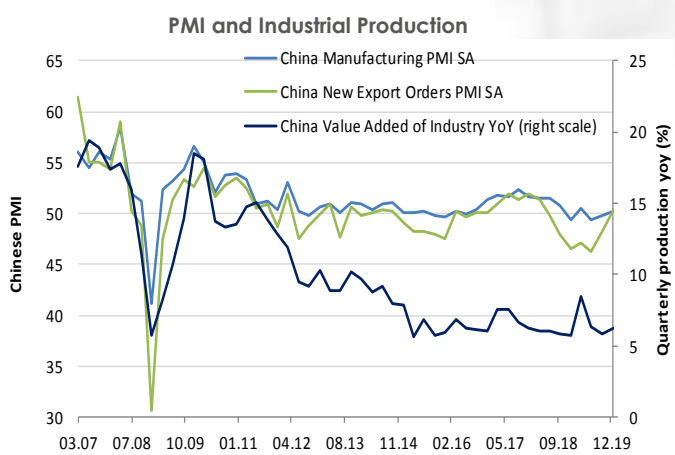
Leading indicators herald economic upturn

The Caixin China manufacturing PMI ended the year in a phase of expansion for the fifth consecutive month. The weakness in Q2 and the risks of a new collapse in economic activity seem to have been clearly averted thanks to the increase from 48.3 in January to 51.5 in December. It should be noted that, while the absolute figure for this leading indicator is not far from the expansion/contraction point of 50, the 51.8 level in November 2019 was actually the highest in the last five years.

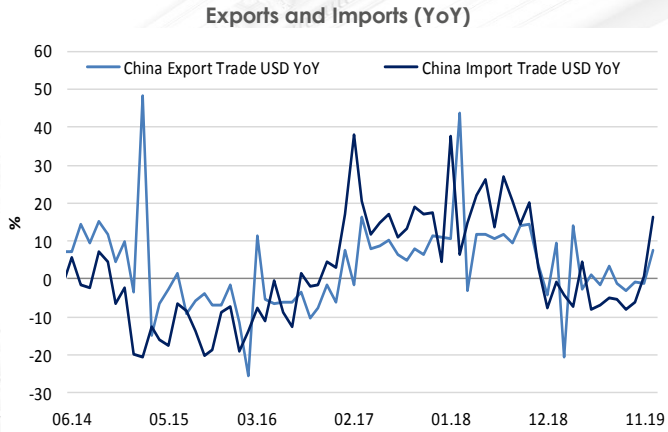
Phase 1 of the agreement with the US will have no tangible impact on China's economic momentum, but the signature of the agreement is nevertheless likely to have an impact on purchasing managers' sentiment. The export sector is likely to see some improvement in its prospects, and industrial production is also likely to come out strengthened. The Chinese government will continue its stimulus efforts, and a truce during the US election period may have a positive influence on the sentiment of consumers and manufacturers. The improvement in manufacturing PMIs is likely to strengthen in this context.

Increase in CPI due to spike in pork prices

Inflation in December (2.9%) came close to the 3% target set by the PBOC and is now stabilising, while the growth rate of the index excluding food and energy remained limited to 1.4%. The specific situation of the food segment due to the spike in pork prices explains 2.3% of the rise in the general consumer price index. As regards producer price indices, prices have declined by -0.3%, but as China's economy is on the upswing, this trend is likely to be reversed in 2020, driven by increases in commodity prices.



Graph sources: Bloomberg/BBGI Group



PBOC begins the year with a 50 basis points cut in the RRR

The PBOC began the year with a 50-basis-point cut in its required reserve ratio (RRR) for banks. This decision occurred a little before Chinese New Year with the aim of increasing the liquidity available in the banking sector. It has thus freed up RMB 800 billion, i.e. close to USD 115 billion, in cash to finance the country's economic activity, and more specifically, the growth of small companies at the local level.

This is the eighth cut in the RRR since 2018. It is likely to further improve economic actors' confidence and support the economy, which seems to have been in a phase of recovery for some time now. The cut in the RRR to 12.5% (17% at the start of 2018) means the it has now been reduced by 4.5% over two years. It nevertheless remains relatively high in international comparison.

China's central bank is likely to maintain its accommodative monetary policy in the next few months, even if it might gradually reduce the magnitude of its actions. The 1-year loan prime rate, which is currently at 4.3%, may still be cut by another 30 basis points, while the RRR may still be cut by 50 to 100 basis points in 2020.

Trade agreement reverses yuan's downwards trend

Since the phase 1 agreement was announced in the negotiations between China and the US, which have been ongoing for close to two years, the exchange rate has once again fallen below 7 yuan to the dollar. The yuan thus appreciated by +3.7% in three months. After this preliminary agreement, which is scheduled to be signed by both parties on 15 January 2020, we are likely to see tensions diminish between the two countries.

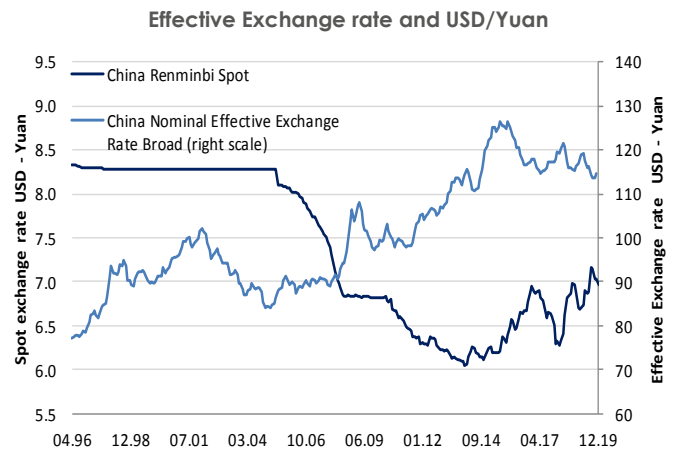
In this election year in the US, President Trump is unlikely to launch new negotiations in the near future, opting for a relative truce in his power struggle with China's president. Reduced political tensions in the next few months are thus likely to favour an adjustment of the economic outlook and stronger growth expectations.

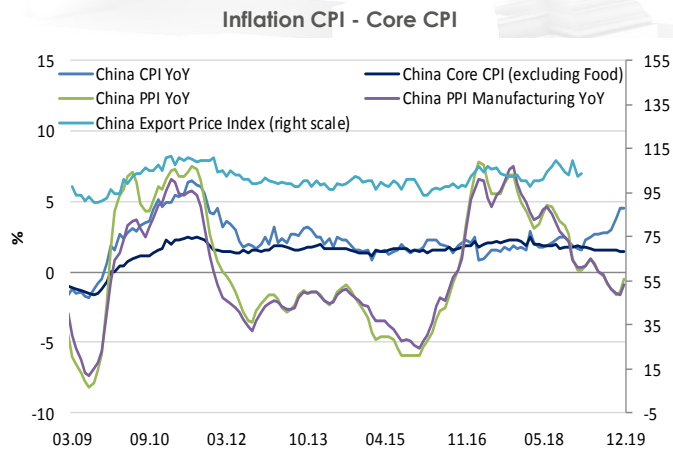
In this context of appeasement, the yuan's gradual devaluation against the dollar, which began in April 2018, may well have already reached its inflection point in September 2019. After suffering a devaluation of approximately -15% over 20 months, the current appreciation is undoubtedly only the beginning of a more lasting upwards trend for the yuan in 2020.

Excellent prospects for Chinese equities

If a truce between China and the US is established as expected in 2020, Chinese equities may well post excellent absolute and relative results this year. In this context of economic recovery and diminished uncertainty, Chinese equities may well grow by +20% to +30%. With a valuation of close to 12x 2020 earnings, Chinese equities are significantly cheaper than most other international equities and offer valuation growth potential that goes hand in hand with a likely upturn in the cycle of corporate earnings growth.

A number of foreign investors are already positioning themselves to take part in this possible revaluation as mentioned by the Chinese central bank in its publication regarding the record figure of USD 254 billion in foreign investment in September 2019.





Graph sources: Bloomberg/BBGI Group

MACROECONOMIC SCENARIO

United Arab Emirates

- UAE Economy to grow at a faster pace in 2020
- Sustaining growth post 2020
- Dubai set to become the second most-visited global city
- Dubai Real Estate transactions hit 11 Years high in 2019
- UAE unveils first multi-entry five-year tourist visas

UAE Economy to grow at a faster pace in 2020

Economic activity in the UAE is projected to grow at a faster pace in 2020, despite regional geopolitical tensions, driven by business optimism, stronger fiscal stimulus and higher government and private sector spending in projects related to Expo 2020.

In fact, in its latest economic forecasts, following its Article IV Consultation with UAE authorities, the International Monetary Fund (IMF) revised growth forecast for the UAE to significantly pick up in 2020. The IMF expects the UAE GDP to grow by 2.5 per cent this year from a relatively modest growth of slightly above 1 per cent in 2019.

Economic activity in the UAE is recovering and is likely to pick up more momentum, hopefully with easing political tensions, and helped by Expo 2020 and government fiscal stimulus. The UAE government continues its reform agenda to sustain growth momentum over the medium term while further diversifying its economy away from oil. As result, following a challenging period, the UAE economy is expected to recover strongly in 2020. Non-oil growth, according to the IMF, could exceed 1 percent in 2019 and pick up to around 3 per cent in 2020, the fastest since 2016 with overall GDP to register 2.5 percent growth rate.

Sustaining growth post Expo 2020

Sustaining robust non-oil growth after expo 2020 remains a key priority for the UAE government in a context where demand for global oil demand is expected to slow in the face of technological advances as well as increasing global awareness to climate change.

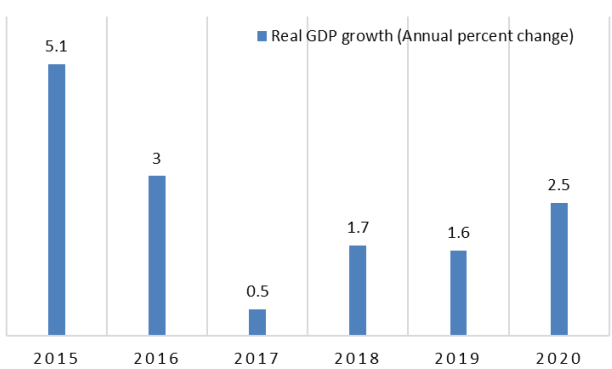
To address the medium term challenges, the UAE authorities discussed two key policy priorities consisting in promoting the growth in the non-oil private sector, including small and medium enterprises (SMEs), and strengthening fiscal frameworks to ensure both sufficient saving derived from oil wealth for future generations and smoothing of short-term fluctuations.

In line with these policies, the UAE has already taken a number of important steps which include the adoption of the new foreign direct investment (FDI) law allowing 100 per cent foreign ownership in strategic economic sectors, and reducing or eliminating fees and penalties. Going forward, the UAE government is also expected to implement a comprehensive national SME development strategy with important steps to be taken to lower start-up costs; implementation of the new insolvency framework; and promotion of greater financial inclusion.

For Dubai, a key challenge will be to convert the enthusiasm generated by Expo into longer-term gains. The investment in the Exo site will continue to have a positive contribution as it is expected to convert into a mixed-used development anchored by the Dubai Exhibition Center. It is anticipated that the venue will continue to host major events and attract yearly an estimated 1.1m foreign visitors to the global city. On the other hand, one can also expect new visitors who attend Expo to become regular visitors to Dubai. The Emirate city is in fact best placed to serve as a central hub location on intercontinental transit routes between Europe, Asia and Africa. In addition, the recent Dubai International Visitors Survey highlighted once again the very high satisfaction results from international visitors which supports the city's attractiveness when compared to peer global cities.

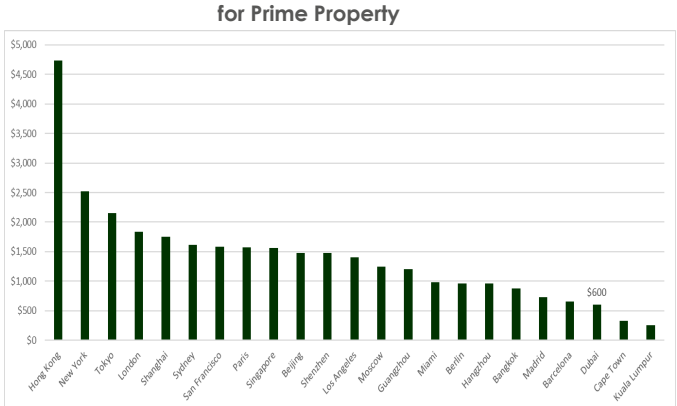
Dubai's economic model has always been geared towards converting tourists into investors, particularly in real estate. Since most Expo visitors are expected to be relatively affluent and in turn, potential investors, it is very likely that these potential investors will take advantage of the current very competitive pricing of the property in Dubai to secure long-term investments and further contribute to Dubai's economy. In fact Dubai real estate market according to many international studies is ranked as most "fairly valued" property market among other global cities. Dubai with an average price per sq ft of USD 600 and a prime rental yield of 4.6% offers very competitive rental yields when compared to other global cities, not to mention the strong potential for capital appreciation over the medium term.

GDP Growth in UAE and projected 2020



Graph sources: Bloomberg/BBGI Group /FMI

Dubai name World's Third Most Affordable Global City for Prime Property



Source: Savills World Cities Prime Residential

Dubai set to become the second most-visited global city

The Expo 2020 in Dubai, which is expected to open on 20th of October 2020 and run for nearly six months, will showcase on a global stage the city's economic development and potential. The event is also expected to contribute to ongoing efforts to attract foreign direct investments (FDI) to the emirate city helping it further diversify its economy. The recent political tensions in the GCC have once again become the main risk topic in the news and to some extend for the right reasons. The Expo 2020 would therefore constitutes a unique opportunity for Dubai and the region to present a different side to key audiences globally.

The Expo 2020 in Dubai will be the first time that the Middle East region has hosted a World Expo, a major global event taking place every 5 years aiming to showcasing national cultures and human progress since 1851. Ongoing preparations are expected to ramp up this year with increased government spending on infrastructure for the Expo site coupled with private sector investments to expand accommodation and entertainment capacity.

The event is therefore expected to provide a welcome boost to Dubai and UAE economies through increased number of visitors and related spending. Dubai hosted 15.9 million tourists in 2018, placing it firmly as the fourth most-visited city globally according to Mastercard's Destination Cities Index. In its 2020 Outlook for the Middle East region, PwC forecasts that the surge of visitors for World Expo should result in it advancing Dubai further in the global raking of most visited global cities. Dubai is therefore expected to become the second most-visited city during 2020-2021, reaching 23 million visitors in 2020.

The study is based on official forecasts for about 11m additional tourists to visit the Expo, which PwC assumes to be distributed evenly across the six months of the event, and underlying growth trends for the reminder of each year. It is even anticipated that if the numbers exceed expectations, or if tourism growth is slower in Bangkok, which is currently the most-visited, then Dubai might even move into first place.

Dubai Real Estate transactions hit 11 Years high in 2019

Property sales transactions in Dubai hit a 11-year high in 2019, recording a growth of 20 per cent compared to previous year, as new government policies boosted the sector, according to Property Finder.

Total real estate transactions in Dubai reached 41,988 last year according to new data from the real estate listing portal found, which compares favorably to the 11'662 property sales transactions registered the emirate city in 2008, at the height of the global financial crisis.

Off-plan property sales accounted for 56 percent of the overall sales levels with a total number of 23'643 transactions in 2019. The imbalance between off-plan sales and secondary market can be mainly explained by the incentives offered by developers such as the waiving of service charges, a range of post-handover payment plans, discounts on registration charges and guaranteed rental returns. Going forward, looking into 2020, we expect the secondary market to take over off-plan sales as new off-plan launches in Dubai were considerably down from previous years level.

According to the data compiled by Property Finders, the top five areas with the highest overall property sales transactions in 2019 were Business Bay with 3'146 transactions, Downtown Burj Khalifa with 2'816, Dubai Creek Harbour with 2'492, Dubai Hills Estate with 2'373 and Dubai South with 2'045 deals.

For off-plan sales, the top 5 performing areas in Dubai were Dubai Creek Harbour (2'423 transactions), Downtown (2'088), Dubai Hills Estate (1'949), Dubai South (1'942) and Business Bay (1'811).

On the secondary market, areas that witnessed the most sales were International City (1'342), Business Bay (1'335), Dubai Marina (1'280), Jumeirah Village Circle (1'108) and Jumeirah Lakes Towers (851).

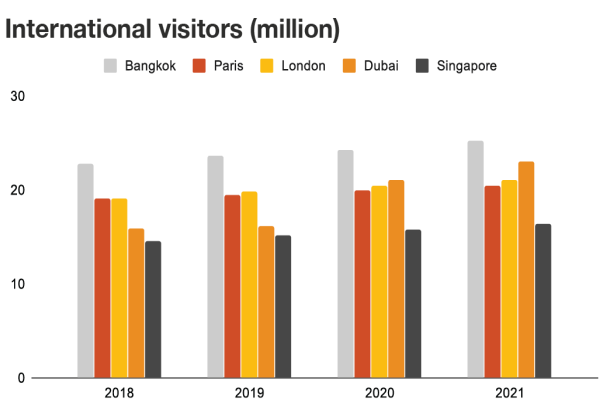
Going into 2020, as Dubai is gearing up to host World Expo, one can expect to see increasing transaction levels which in turn could bring more stability to Dubai's real estate market and pave the way for a healthy growth in terms of capital values.

UAE unveils first multi-entry five-year tourist visas

The first major measure announced in 2020 by His Highness Sheikh Mohammed Bin Rashid, Prime Minister and Ruler of Dubai, was the updated visa scheme that would allow tourists multiple entries into the UAE over five years. At present, tourists can visit the UAE with a multiple entry visa for up to a maximum of 90 days from the date of entry.

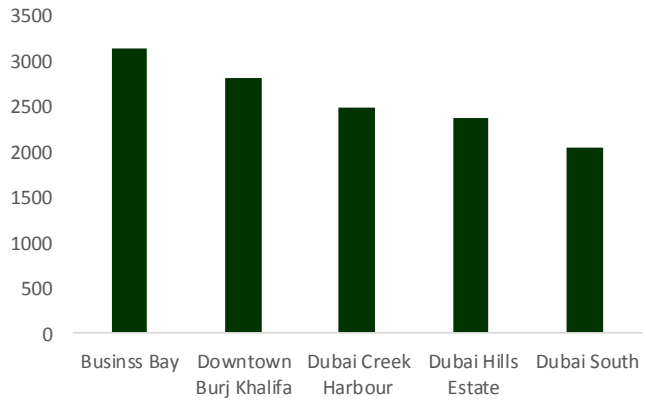
According to the UAE cabinet, the new multi-entry five-year tourist visa will be introduced within the first four months of 2020, aiming at establishing the UAE as a major global tourism destination and is part of the wider plans to prepare the country for the next 50 years of development. The UAE receives more than 21 million tourists every year with more than 200 nationalities living in the country. The updated multi-entry five-year visa will without doubt provide another major boost to total number of visitors to the country by widening the list of nationalities that can access the multi-entry visa scheme.

Dubai set to become the second most visited global city



Graph sources: Bloomberg/BBGI Group /Mastercard, Dubai Tourism, PwC forecasts

Top 5 five performing areas in Dubai by Sales in 2019



Source: Dubai Land Department, Property Finder, BearBull Global Investments Group

MACROECONOMIC SCENARIO

Emerging Markets

- Emerging equities close Q4 up more than +10% (+11.74%)
- Emerging markets offer more upside potential in 2020 than developed countries

Economic situation by country

Brazil— With regards to global prospects, the implementation of monetary stimulus measures in the larger economies, in the context of an economic slowdown and below-target inflation, has helped create a relatively favourable environment for emerging economies. Brazilian economic data since Q2 show that the economic recovery process has accelerated in comparison with Q1 2019 and will continue to do so at a gradual rate.

The Copom reckons that the various measures of underlying inflation are at a comfortable level. The latest Focus survey shows inflation expectations for 2019, 2020, 2021 and 2022 at 3.8 %, 3.6 %, 3.75 % and 3.5%, respectively.

The Copom has noted the progress made in the process of reforms and adjustments required for Brazil's economy and has emphasised that it is essential to persevere in this process to allow the decrease in structural interest rates to consolidate and to foster a sustainable economic recovery.

The Copom believes that the current phase in the economic cycle requires caution in the conduct of monetary policy, emphasising that the latter's next steps will continue to depend on developments in economic activity, on the balance of risks as well as on inflation projections and expectations. The Copom unanimously decided to cut the Selic rate to 4.50%, which is likely to help inflation converge towards its target.

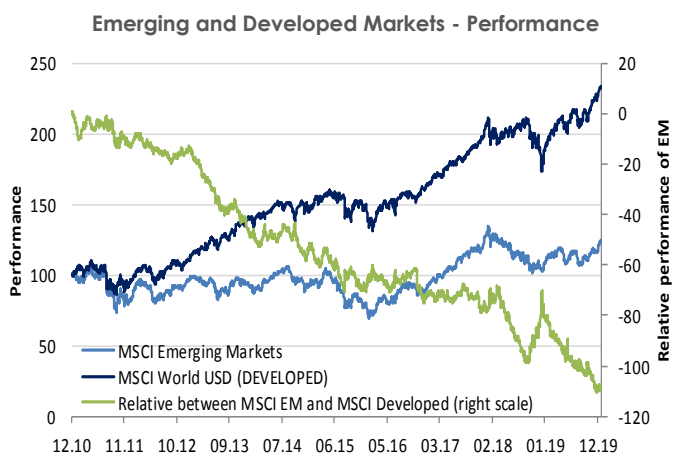
Russia— The annual growth rate of consumer prices returned to 3.5% in November (against 3.8% in October) and is likely to drop to 3.4% in December according to estimates. According to the Bank of Russia's estimates, the inflation indicators that reflect the most lasting price movements are just below 4%. The Bank of Russia expects that inflation will settle between 2.9% and 3.2% at the end of 2019. In November, deflationary factors continued to exert significant influence on inflation. Among others, the annual growth rate of food and non-food product prices continued to drop. One-off factors such as a good harvest and increased supply in various segments of the food market have helped maintain slow growth rates for food product prices. The appreciation of the rouble since the beginning of the year coupled with lower inflation rates among Russia's trade partners have limited the growth of import prices.

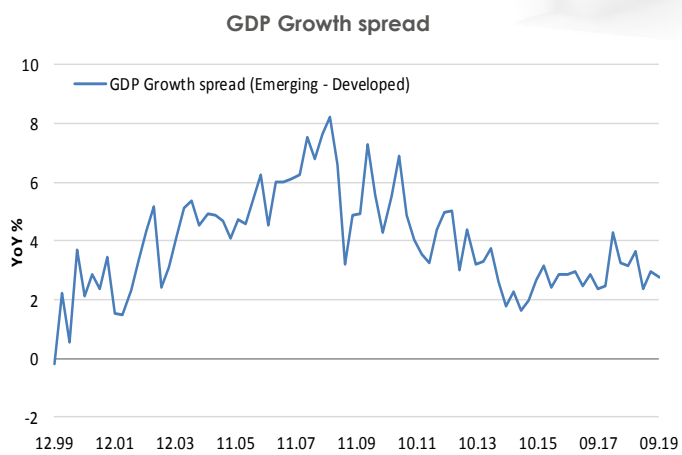
Nevertheless, the acceleration in inflation in November in the services sector, where prices are determined by the market, may point to an upswing in consumer demand. In accordance with the Bank of Russia's forecasts and given the orientation of monetary policy, annual inflation is likely to fall between 3.5% and 4.0% in 2020 and remain close to 4% subsequently.

In 2019, GDP growth may end up close to the upper limit of the Bank of Russia's forecasts at 1.3%, due in particular to higher than expected growth in Q3. Domestic demand improved somewhat during Q3 and Q4. In October, the annual growth rate of retail sales increased, while industrial production continued its year-on-year rise. Nevertheless, leading indicators show that the business climate in the industrial sector, which applies mainly to export orders, remains weak.

Economic activity continues to be hampered by weaker external demand for Russian exports in the context of a global economic slowdown. The Bank of Russia left its GDP growth forecast unchanged for 2020-2022. GDP growth will increase gradually from 0.8%-1.3% in 2019 to 2%-3% in 2022. This will be possible if the measures taken by the government to overcome structural constraints, including the implementation of national projects, are carried out. Nevertheless, the expected slowdown in global economic growth over the forecast period will continue to exert an unfavourable effect on Russia's economic growth.

On 13 December 2019, the Board of the Bank of Russia decided to cut its key rate by 25 basis points to 6.25% and is likely to evaluate the necessity of a further rate cut during H1 2020.





Graph sources: Bloomberg/BBGI Group

India— In the next few months, the inflation outlook will be influenced by several factors. First, the increase in vegetable prices is likely to continue, although the last kharif crops of the season as well as the measures taken by the government to increase supply through imports is likely to help ease vegetable prices by the beginning of February 2020. Second, rising pressure on the prices of other food products such as milk, dry vegetables and sugar is likely to persist, which will impact the trajectory of food inflation.

Third, domestic demand has slowed down, leading to a cooling off of inflation excluding food and energy. Finally, crude oil prices may have a considerable impact if geopolitical tensions end up affecting supply. In this context, the inflation forecast as measured by the consumer price index was revised upwards to between 4.7% and 5.1% for Q4 2019 and between 3.8% and 4% for Q1 2020.

GDP growth for H2 2019 ended up far lower than expected. Various indicators suggest that domestic and external demand conditions remained weak. On a positive note, however, the easing of monetary policy since February 2019 and the measures taken by the government in the last few months are likely to help stimulate domestic demand further. Given these elements, GDP growth for the end of 2019 has been revised downwards, from 6.1 % in October to 5.0%.

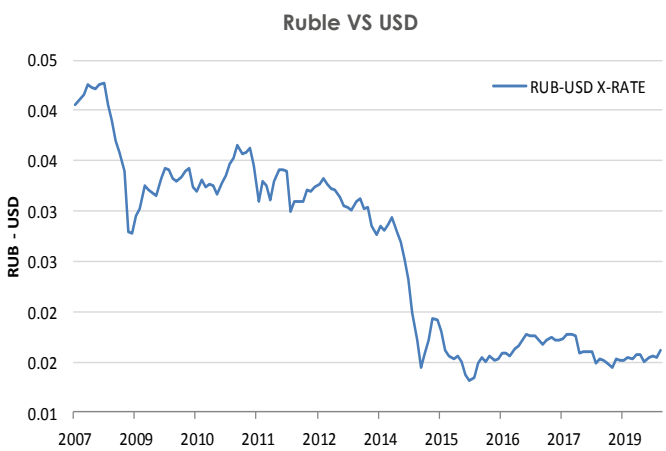
The Reserve Bank believes that it still has some leeway with regards to its current monetary policy if necessary. Nevertheless, given the changing growth and inflation dynamics, the Monetary Policy Committee opted for a pause at this stage. Consequently, the Committee decided to maintain the key repo rate unchanged at 5.15% and to continue with an accommodative orientation for as long as required in order to restore growth while ensuring that inflation remains within target.

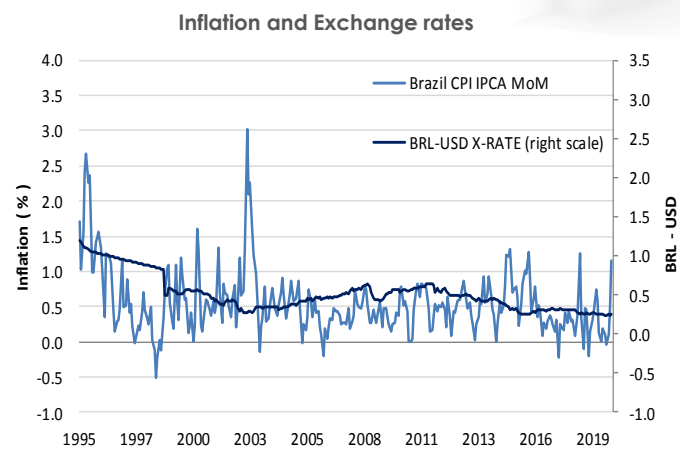
South Africa— Since the meeting of the Monetary Policy Committee in September, global economic indicators as well as global inflation have remained weak. The central banks of advanced economies have boosted their accommodative monetary policy, thus helping ease financing conditions on a global scale, although new measures seem quite unlikely. Risks relating to intensified trade tensions and geopolitical developments remain.

Although GDP growth rebounded to 3.1% in Q2, the long-term weakness of most sectors remains of great concern. Based on recent short-term economic indicators for the mining and manufacturing sectors, GDP in Q3 is likely to be weak. Public-sector investment has decreased, and export growth remains weak, while government and household consumption continue to rise, albeit modestly. The GDP growth forecast for 2019 has been revised downwards to 0.5% against 0.6% previously, while forecasts for 2020 and 2021 have been reduced to 1.4% (against 1.5%) and 1.7% (against 1.8%), respectively, due to slower than expected growth in Q3 and Q4, both domestically and globally.

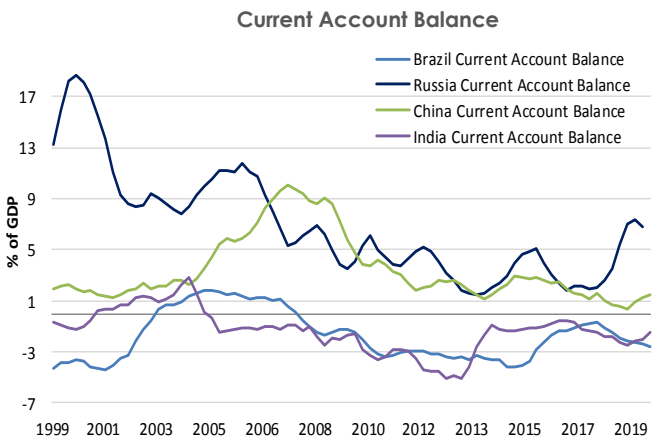
The medium-term inflation outlook has remained largely unchanged since September. The inflation forecast generated by the South African Reserve Bank's model is unchanged in comparison with September, standing at 4.2% for 2019, 5,1% for 2020 and 4.7% for 2021.

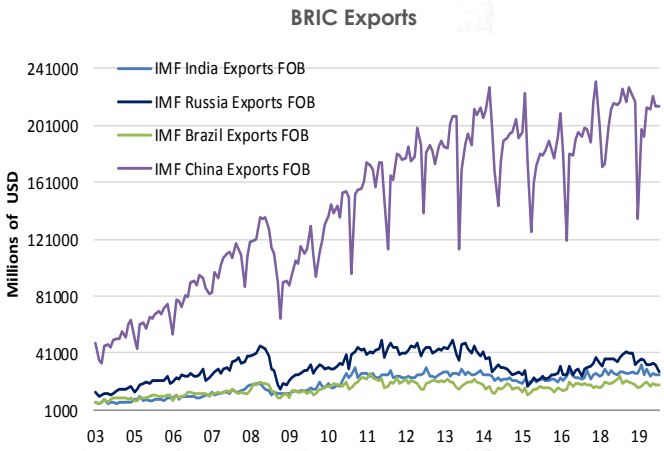
In this context, the MPC decided to maintain its repo rate unchanged at 6.5%, despite two members hoping for a 25 basis point reduction.

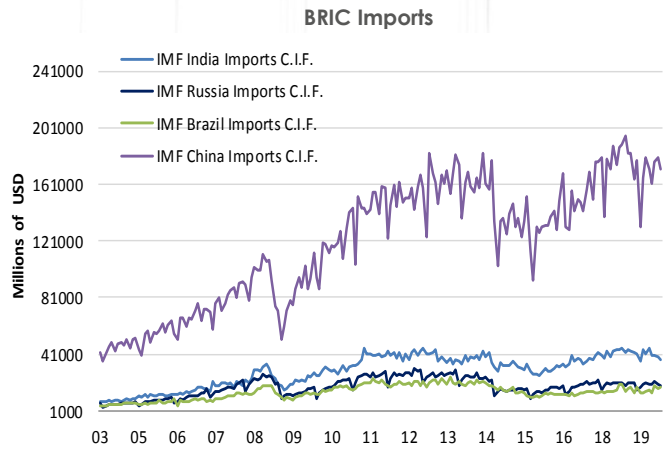




Graph sources: Bloomberg/BBGI Group







Colombia— In November, annual inflation decreased slightly to 3.84%, although it remains close to 4%. The supply shocks that significantly affected inflation are likely to start fading such that inflation will resume its convergence towards its target in the first few months of 2020, as reflected in the market's expectations.

Despite new information on economic activity, the Bank of the Republic's technical staff has maintained its economic growth forecast for 2019 at 3.2%. In this context, after evaluating the economic situation and the balance of risks, the Bank unanimously decided to maintain its benchmark interest rate unchanged at 4.25%.

Mexico— The Bank of Mexico reduced its interbank interest rate by 25 basis points to 7.25% for the 4th consecutive meeting, wherein it has repeatedly highlighted the appreciation of the peso. The annual inflation rate clearly dropped, lying at 2.9% in November, even though it still stood at 4.83% in December 2018. Mexico's economy stagnated in Q3 2019 (+0%), below a preliminary estimate of +0.1% and following a -0.1% contraction in the previous period.

Indonesia— Bank Indonesia left its 7-day benchmark repo rate at 5% during its meeting in December, in accordance with efforts undertaken to anchor the rate of inflation close to +3% and support GDP growth (+3.06% in Q3).

Taiwan— The Central Bank of Taiwan maintained its key rate at 1.375% on 19 December 2019. Policy-makers upped their economic growth forecasts for 2020 from 2.34% to 2.57% in a context of improving national export prospects. In November, annual inflation stood at 0.6%, against 0.4% in the previous month.

Turkey— During its meeting in December, the Central Bank of Turkey reduced its key rate by 200 additional basis points to 12%, exceeding the 150 basis point cut expected by the market. It follows on from a 250 basis point cut in October, although inflation forecasts decreased across the board and economic activity continues to pick up. GDP thus increased by +0.40% in Q3 2019.

Romania, Czech Republic, Poland, Hungary— The National Bank of Romania kept its benchmark interest rate stable at 2.5% on 6 November, after annual inflation (3.4%) dropped back within the central bank's target range of 1.5%-3.5% for the first time in nine months. Romania's GDP increased by +0.60% in Q3 2019.

The Czech National Bank maintained its repo benchmark rate unchanged at 2% during its meeting in December, despite a rebound of inflation to its highest level in seven years (3.2%), while the persistent weakness of manufacturing output is concerning. Czech GDP increased by +0.4% on a quarter-on-quarter basis, against a +0.6% increase in the previous quarter and a preliminary estimate of +0.3%.

The Polish National Bank maintained its benchmark rate at 1.5% during its last meeting in 2019, although inflation reached 3.4% in December, its highest level since October 2012, above the central bank's medium-term target of 2.5%. In Q3 2019, Poland's GDP increased by +1.30% in comparison with the previous quarter.

The Hungarian National Bank maintained its benchmark rate unchanged at 0.9% on 17 December 2019, after annual inflation reached 3.4% in November, exceeding the medium-term target of 3% and GDP's quarterly growth of +1.10%.

Graph sources: Bloomberg/BBGI Group

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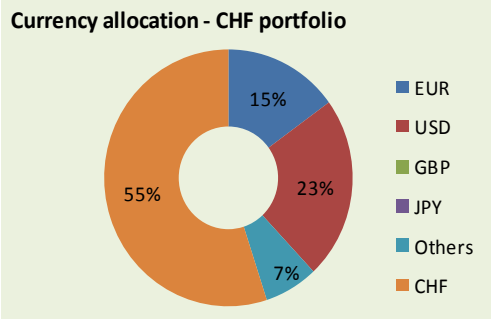
PROSPECTS AND STRATEGIES

Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Currencies

- Further weakness of the Swiss franc likely
- Rise of the pound coming to an end
- Patience! Yen likely to depreciate in 2020
- Trade agreement reverses the yuan's downward trend



Tactical Allocation

- Underweight CHF
- Favor USD, AUD and CAD
- Overweight EUR
- Avoid JPY and GBP

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

Further weakness of the Swiss franc likely

After the franc's +2% appreciation against the US dollar and the euro in Q3, the Swiss franc/euro exchange rate remained stable in the final months of the year, while the franc/dollar exchange rate was once again more variable. The +3% increase against the US dollar echoes the +3.7% increase against the yen. The uncertainties that marked financial markets in 2018 and 2019, essentially focused on recession risks relating to the absence of any tangible progress on the trade issue between the US and China, have faded a little with the promise of a phase 1 agreement in negotiations in January 2020.

They have remained present enough, however, to maintain strong international demand for safe investments, from which the Swiss franc has benefitted. The Federal Reserve's massive quantitative easing in the US in Q4 certainly weighed on the dollar in the short term, but the ongoing normalisation of growth prospects as well as the improvement in confidence regarding 2020 are likely to help reduce safe-haven demand. Demand for Swiss francs is thus likely to contract and help stabilise our currency. Nevertheless, in the longer term, we maintain our analysis and vision of a further weakening of the Swiss franc against the major currencies and against the euro in particular.

Let us mention that in terms of purchasing power parity (PPP), the Swiss franc may well be significantly overvalued in early 2020. A rise to 1.20 against the euro, which would represent a +10% increase, would help correct this excessive valuation and reduce pressure on our exports. According to the OECD, PPPs indeed suggest that the Swiss franc is overvalued in comparison with its "theoretical" value of 1.19 against the US dollar, 1.63 against the euro and 109 against the yen. According to the Big Mac PPP indicator, the franc's overvaluation is also particularly significant given its "theoretical" values of 1.18 against the US dollar, 1.56 against the euro and 109.6 against the yen.

The SNB has once again recently announced that it had sufficient leeway to lower its key rates further still if necessary. The bank is thus clearly and unsurprisingly staying the course of its monetary policy which aims to curb the appreciation of the franc against the euro. Recent developments in US key and long-term rates have certainly reduced the yield spread which the SNB relied upon in its strategy to depreciate the franc and may have disrupted its policy.

However, let us highlight that the 75 basis point compression of the yield spread on long-term rates has had no real significant impact on the exchange rate and has not triggered any reaction from the SNB. The rise of the franc has indeed proven to be relatively moderate, as we mentioned in the previous paragraph, such that the SNB did not have to act during this period of adjustment of US monetary policy. Let us also mention that in the Eurozone, the drop in key rates is still very limited (-0.1%), meaning that no reaction from our national bank is required.

However, we believe that the next few months will likely be characterised by a new episode of widening yield spreads on long-term rates in particular, which will likely reinforce the dollar's appeal and drive the exchange rate above parity. The issue is different with regards to the euro, especially since the yield spread between rates in euros and in Swiss francs are not that significant and as the trend in the last few months does not augur the same type of development.

The yield spread which the SNB had hoped to create and maintain on three-month rates to weaken the franc has come increasingly under attack because of the ECB's rate cut. It has thus gone from -0.99% in January 2015 to -0.28% in late November 2019. Despite a PPP favourable to an appreciation of the euro, for such an appreciation to happen, a serious and lasting European economic recovery will have to occur or at the very least be anticipated with enough credibility Nevertheless, in the medium term, we believe that probabilities of a moderate weakening of the franc are increasing.

Graph sources: Bloomberg/BBGI Group

Rise of the pound coming to an end

As we mentioned previously, the pound will be affected for a long time by the political situation in the UK and by the shape Brexit ultimately takes. The British currency had lost -20% against the US dollar in the wake of the June 2016 vote, falling from 1.50 to 1.20. In 2019, the pound regained more than +10%, climbing to 1.35 in anticipation of a clear political result following the December elections and more visibility regarding future relations between the UK and the EU. As we predicted, the pound stabilised above 1.24 and appreciated towards 1.30 -1.35 in anticipation of a Conservative victory. Consequently, we are not predicting any significant further increase of the pound in Q1 2020.

Patience! Yen likely to depreciate in 2020

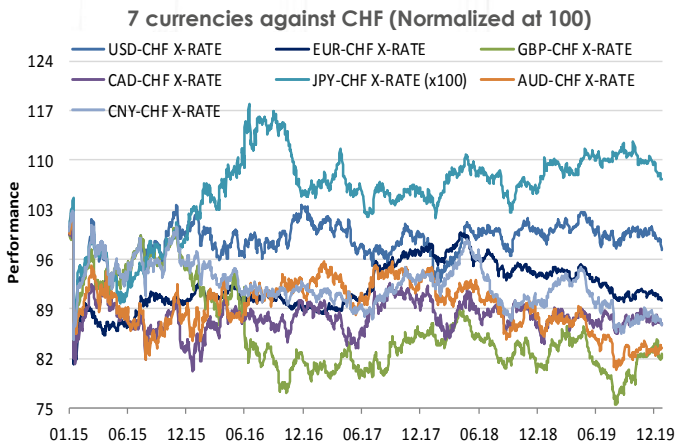
Negative nominal interest rates (-0.1%) in yen remain unattractive overall by global comparison, and more specifically compared with US dollar rates still close to 1.5%. This nominal rate differential could seem favourable to the dollar, but due to lower inflation (+0.2%) in Japan combined with higher inflation (+1.8%) in the US, real yields are in fact similar (-0.3%). This real yield differential is thus likely one of the main factors explaining movements in the yen/US dollar exchange rate over the past few months.

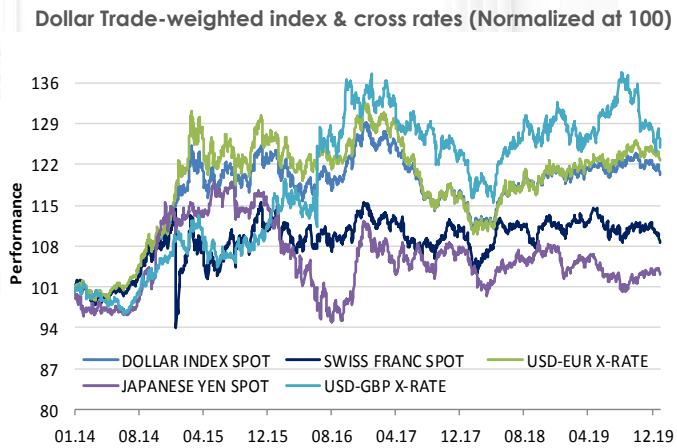
The BOJ would obviously prefer real yen yields to be lower, but in that regard the only factor likely to have an impact would be an upswing in price indices, as a large cut in policy rates does not seem to be a serious option. Thus, the BOJ's only choice is to opt for patience, waiting for external factors such as an upturn in inflation or in long-term rates in the US to take shape, changing valuation parameters such that the yen may depreciate. We are not changing our outlook for the yen, which remains fundamentally bearish for 2020. A weak yen remains a necessary condition in terms of boosting economic activity and inflation in Japan. The stability of the yen against the US dollar since the beginning of the year will likely be followed by a decline of the yen.

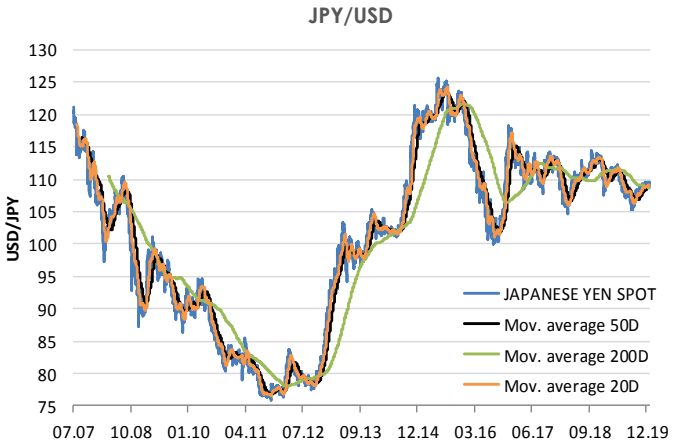
Trade agreement reverses the yuan's downwards trend

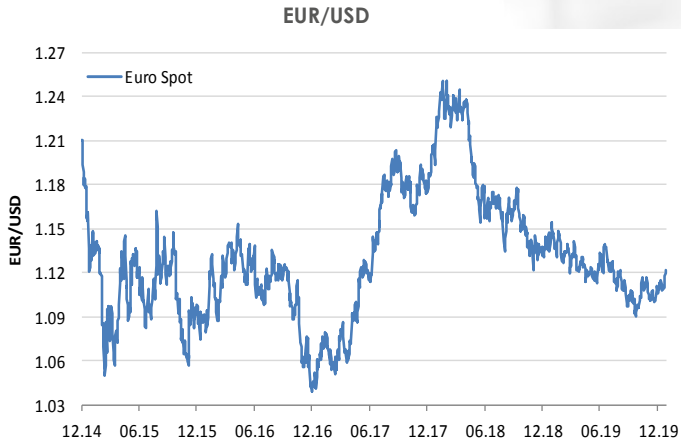
Since the phase 1 agreement was announced in the negotiations between China and the US, which have been ongoing for close to two years, the exchange rate has once again fallen below 7 yuan to the dollar. The yuan thus appreciated by +3.7% in three months. After this preliminary agreement, which is scheduled to be signed by both parties on 15 January 2020, we are likely to see tensions diminish between the two countries. In this election year in the US, President Trump is unlikely to launch new negotiations in the near future, opting for a relative truce in his power struggle with China's president.

Reduced political tensions in the next few months are thus likely to favour an adjustment of the economic outlook and stronger growth expectations. In this context of appeasement, the yuan's gradual devaluation against the dollar, which began in April 2018, may well have already reached its inflection point in September 2019. After suffering a devaluation of approximately -15% over 20 months, the current appreciation is undoubtedly only the beginning of a more lasting upwards trend for the yuan in 2020.







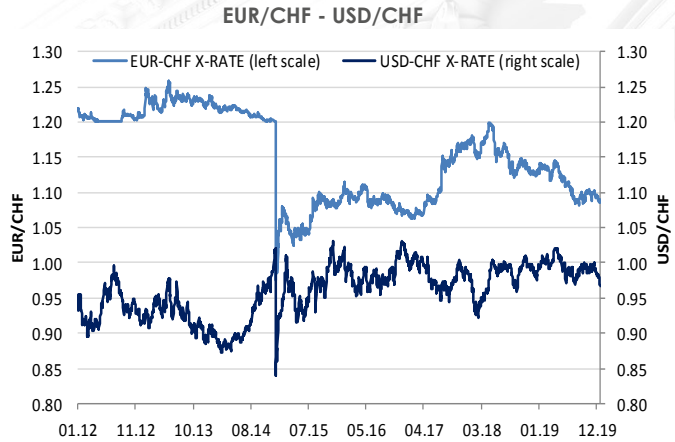


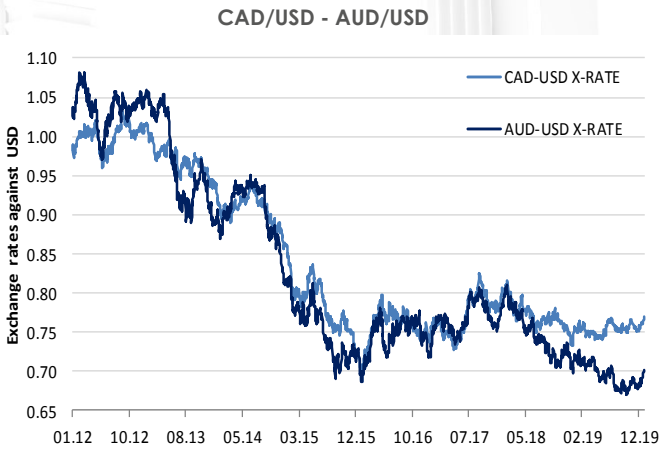
Graph sources: Bloomberg/BBGI Group

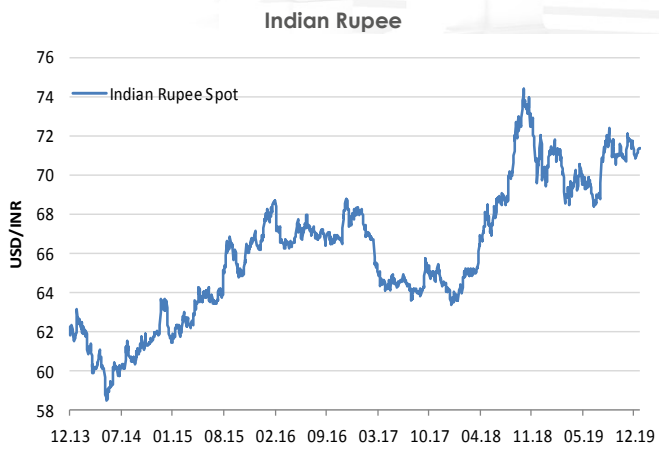
CURRENCIES

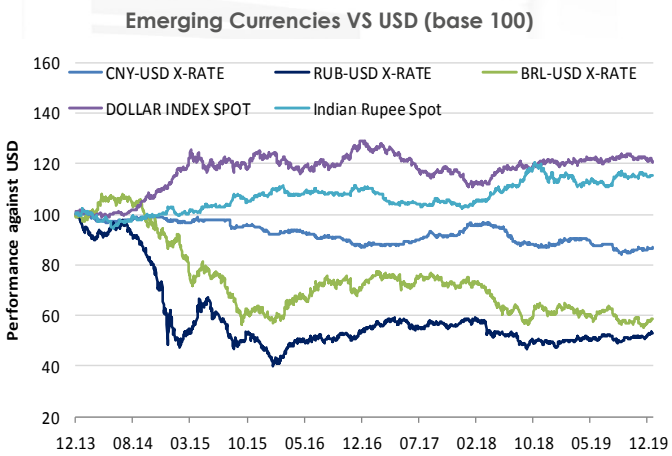
31.12.2019

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
AGAINST DOLLAR						
EUR-USD X-RATE	1.1	1.1	1.8	2.9	-1.4	-2.2
CHF-USD X-RATE	1.0	1.3	3.3	3.1	0.9	1.4
GBP-USD X-RATE	1.3	2.4	2.6	7.9	4.4	3.9
JPY-USD X-RATE	0.0	0.7	0.8	-0.5	-0.7	0.9
CAD-USD X-RATE	0.8	1.4	2.2	1.9	0.8	5.0
AUD-USD X-RATE	0.7	1.4	3.8	4.0	0.0	-0.4
RUB-USD X-RATE	0.0	0.2	4.2	4.5	2.0	11.6
CNY-USD X-RATE	0.1	0.6	1.0	2.7	-1.4	-1.2
INR-USD X-RATE	0.0	0.1	0.7	-0.8	-3.2	-2.3
BRL-USD X-RATE	0.2	1.6	5.4	3.5	-4.2	-3.4
AGAINST SWISS FRANC						
USD-CHF X-RATE	1.0	-1.4	-3.4	-3.1	-1.0	-1.6
EUR-CHF X-RATE	1.1	-0.1	-1.5	-0.2	-2.2	-3.5
GBP-CHF X-RATE	1.3	1.1	-0.8	4.6	3.5	2.4
JPY-CHF X-RATE (x100)	0.9	-0.6	-2.5	-3.5	-1.6	-0.6
CAD-CHF X-RATE	0.7	0.0	-1.1	-1.2	-0.1	3.4
AUD-CHF X-RATE	0.7	-0.1	0.2	0.6	-1.1	-2.4
RUB-CHF X-RATE	0.0	-1.1	0.5	1.4	1.1	9.9
CNY-CHF X-RATE	0.1	-0.7	-2.3	-0.4	-2.3	-2.6
INR-CHF X-RATE	0.0	-1.4	-2.2	-3.5	-4.2	-3.5
BRL-CHF X-RATE	0.2	0.4	2.1	0.4	-5.1	-4.7









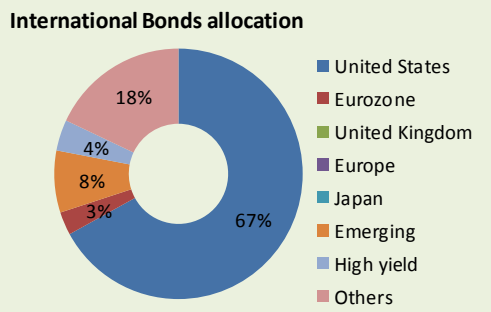
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

International Bonds

- US yield curve returns to "normal"
- Gradual rise in Eurozone long rates
- Prioritise emerging bonds over high yield
- Regional and monetary allocation should favour the US dollar

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



Tactical Allocation

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

US yield curve returns to "normal"

We mentioned various yield curve inversion processes in previous weekly analyses, recalling that the yield curve inversion in the winter of 2018-2019, which was seen as a sign of an upcoming recession, had no basis in any traditional theoretical framework and had actually been triggered by a drop in long-term rates rather than an excessive and inappropriate tightening of monetary policy, which has indeed often driven the economy into recession in the past. In these cases, the yield curve inversion resulted from a rise in short-term rates (the Fed's key rates) corresponding to the implementation of restrictive monetary policies meant to limit excessive inflation and slow down the economic cycle. Monetary policy thus led to a rebound in short-term rates, which then exceeded long-term rates to fend off inflation.

A "classical" yield curve inversion thus follows the same logic, often exceeding the objective of slowing the economy and ultimately triggering a recession, usually short-lived. The Fed's change in monetary policy, by lowering short-term rates by 0.75% in H2, modified the yield curve by lowering its short end. Reduced recession risks coupled with relatively robust economic statistics for the US economy have enabled long-term rates to tighten once again and to rise by approximately 40 basis points. Henceforth, the yield curve is once again "normal", although relatively flat since both the three-month and ten-year rates lie at 1.9%. In 2020, although tensions on the labour market are likely to have an impact on business margins and prices, inflationary pressures will probably intensify somewhat and exceed the Fed's objective.

Fed liquidity injections could slow long rate growth

Since July, the Fed's monetary policy is once again accommodative. The central bank lowered its key rates by -0.25% three times in H2 starting in July, while boosting its asset purchase programme starting in September. Over just a few weeks, the Fed's balance sheet surged by +11% from USD 3,759 billion in September to 4,165 billion in December, implying a liquidity injection of 406 billion in less than four months.

By comparison, the Fed had needed close to twelve months to reduce its balance sheet by as much between September 2018 and September 2019. Thus, the Bank decided to act, to counter the expectations of an economic slowdown, or even a recession, that had been widespread over the past year despite the consistently solid quarterly results posted by the US economy.

The New York Fed's 12-month forward recession probability index has since dropped from 37% to only 24% currently. In 2020, the Fed will likely maintain its low key rates policy, keeping it unchanged in the next few months, especially if an economic recovery is confirmed. Nevertheless, it seems to be aiming to maintain its liquidity injection policy by repurchasing assets at a sustained pace. Following the huge liquidity injections over the past few months, the Fed might ease off over the coming weeks. They could then intervene again to slow the gradual rise in long rates.

In this context, ten-year long-term rates will likely continue readjusting to economic conditions that are more robust than predicted by the consensus forecast in 2020. The prospect of +2% US GDP growth, as well as slightly higher inflation than the Federal Reserve's targets, should push for an adjustment of ten-year Treasury rates to 2.5%.

BOND INDICES (local currency)

30.09.2019

	Name	Last price	Curr.	Total Return Performance 7 d%	1 m %	3 m %	6 m %	YTD %
SWISS BONDS	SBI AAA-BBB	143.2	CHF	-0.3	-1.7	1.4	3.3	4.9
UE BONDS	Barclays EuroAgg	270.7	EUR	0.0	-0.5	2.4	6.1	8.4
UE BONDS - SHORT DURATION	ISHARES EURO GOV BND 1-3	144.9	EUR	0.0	-0.1	0.2	0.5	0.6
US BONDS	JPM U.S. Aggregate Bond Index	688.9	USD	0.2	-0.6	2.2	6.2	9.0
US BONDS - SHORT DURATION	BGF-USD ST DURATN BOND-USDA1	8.5	USD	0.3	-0.1	0.7	2.1	3.9
EMERGING BONDS	JPMorgan Emerging Markets Bond	595.0	USD	-0.7	-0.6	0.9	5.8	13.7
INTERNATIONAL BONDS (DIVERSIFIED) - USD	JPM Global Aggregate Bond Index	604.1	USD	-0.2	-1.0	1.2	5.1	7.1
INTERNATIONAL BONDS (DIVERSIFIED) - EUR	JPM Global Aggregate Bond Index	727.6	EUR	0.6	0.0	4.8	8.2	12.3
INTERNATIONAL BONDS (DIVERSIFIED) - CHF	Barclays Global Agg Corporate	156.6	CHF	0.6	0.0	2.2	5.5	10.8
CONVERTIBLE BONDS (UE)	Exane Europe Convertible Bond	8070.3	EUR	0.3	0.2	1.6	2.7	9.8
HIGH YIELD BONDS	Markit iBxx Gbl Dev Lq HY USD	150.6	USD	-0.7	-0.3	-0.4	1.7	8.2
HIGH YIELD BONDS - SHORT DURATION	AB SHORT DURATION HI YD-AT	14.8	USD	-0.5	0.0	0.5	2.5	8.0

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

Graph sources: Bloomberg/BBGI Group

Gradual rise in Eurozone long rates

For more than three months, a partial, yet rather significant change in investors' expectations regarding economic prospects and the appropriate relative level of interest rates has been occurring. A few months ago, falling euro rates were still justified by real risks of recession for Germany. In the last few months, the relative decline in uncertainty has enabled a progressive increase in yields, which has almost cancelled out the exaggeration observed in August. The inversion of the euro yield curve during the summer thus normalised somewhat in the autumn with a rise in 10-year rates from -0.71% in August to -0.3% in November.

Euro capital markets have begun integrating the falling risks of recession, but they are not ready yet to gamble on a clear economic upturn and higher inflation, which will undoubtedly be essential for any rise in yields back into positive territory.

In this respect, inflation slipped into negative territory in November with a -0.3% drop over the month. Over one year, the CPI index rebounded from +0.7% to +1.0%, while inflation excluding food and energy barely reached +1.3%. In terms of producer prices, the data in October is barely positive over a month (+0.1%), but the falling PPI has now dropped -1.9% over twelve months. Producer price indices have decelerated sharply since their high (+4.9%) in October 2018 and are now in the red since August 2019.

With falling inflation and an approximately 40-basis-point upswing in long-term rates in the last quarter, real yields have actually increased significantly in the Eurozone. Real yields on long maturities have gone from -1.3% at the end of August to -0.6% today. This correction of real euro yields is unlikely to have any major impact on the financing cost of investments, consumer credit and mortgage financing. Negative real yields, even reduced, will still foster in 2020 a recovery of demand, and investments over the next few quarters.

In this context, we believe that long rates in Euros should gradually recover to the levels seen in the first half of 2019, and thus move back into the black over the coming months. They will likely stabilise at those levels and wait for better economic signals, especially in Germany.

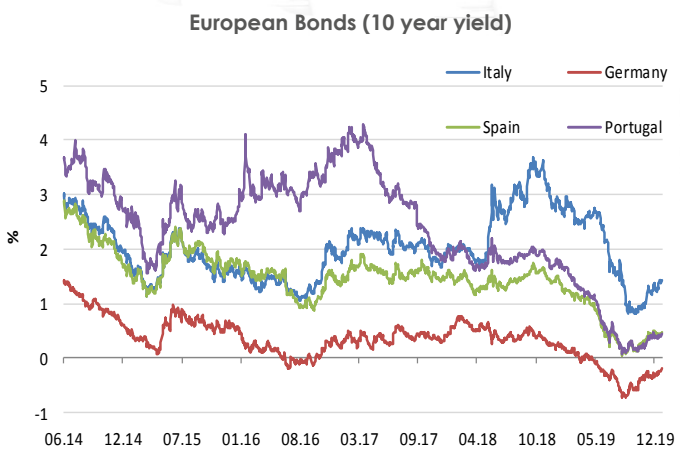
Capital markets in GBP still retain little appeal

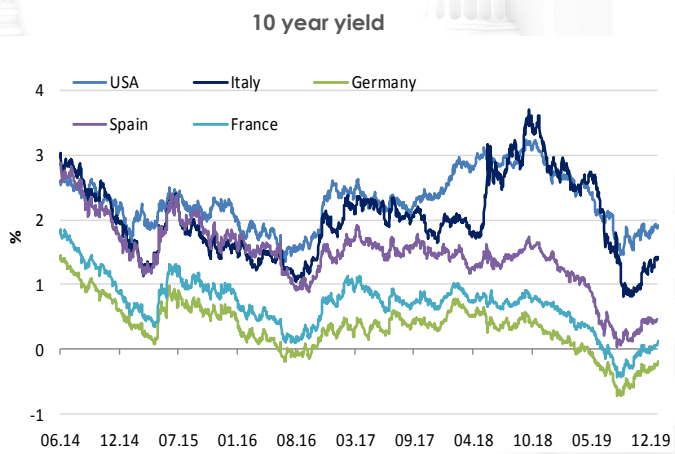
While long-term rates dropped from 1.6% in September 2018 to only 0.4% at the end of August 2019, the last decline in long-term rates in the UK over the summer was followed by a rapid upswing to above 0.8%. The global context improved somewhat over the period, but economic risks remain high in the UK, still in search of a political solution to the Brexit issue.

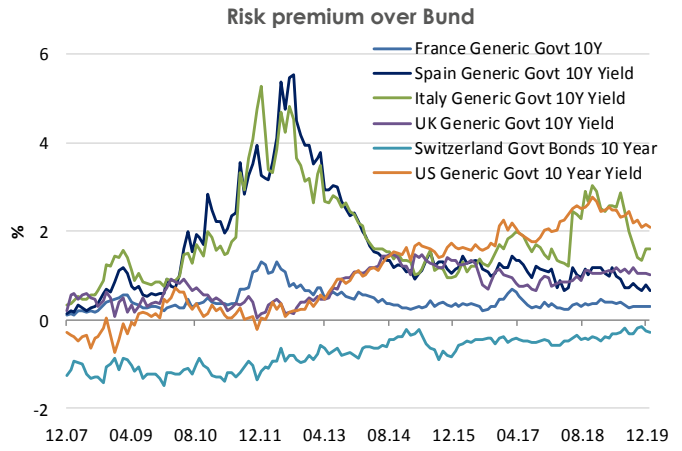
The uncertainty resulting from the absence of a Brexit deal and the risks of a real collapse in economic activity in the event of a no deal had first pushed long-term rates below the lows reached just after the 2016 vote. The parliamentary election results will likely strengthen the trend seen in the past three months, pushing pound yields above 1%. However, pound capital markets are still unattractive, as yields are significantly lower than those in US, Australian, and Canadian dollar markets.

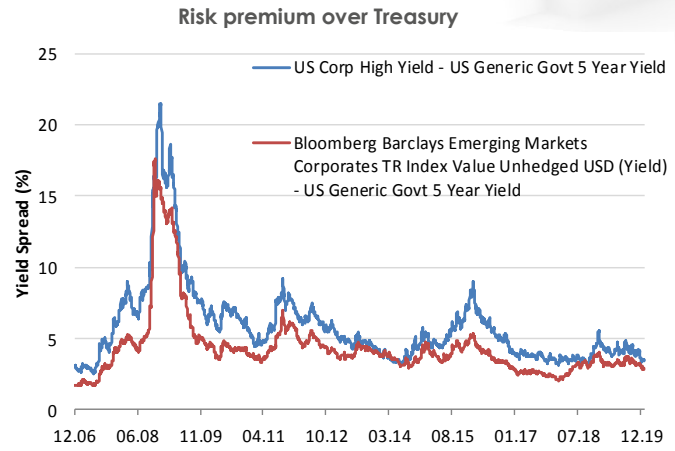
Political risks have subsided considerably, but while there is now a higher likelihood of seeing an orderly Brexit take form, Boris Johnson still has to determine its final shape. The risks to the UK economy are still high at the beginning of 2020 following zero growth in Q4 of last year. We may have to remain patient in terms of seeing any significant economic upturn in the UK. However, if the job market remains strong and wage growth continues to be higher than inflation thus boosting purchasing power, consumption, services, and industry may surprise on the upside in 2020.

A negotiated withdrawal of the UK is now more probable, and the risks of recession will then likely be adjusted downwards, with a gradual increase in long-term rates and stabilisation of the pound as likely corollaries. The risks of holding pound-denominated bonds seem sufficiently high in this context to avoid overly aggressive positioning in this market. Given the uncertain context, we recommend that international investors avoid any exposure to capital markets in pounds and take positions in other bond segments.









Graph sources: Bloomberg/BBGI Group

Still no yield for Japanese government bonds

Ten-year yields for Japanese government bonds posted a considerable rise, which pushed them back into positive ground at the end of the year. Interest rates rose from -0.3% at the end of August to 0% on 31st December. The Japanese economy is still being held back by weak international demand as well as its exports, whereas inflationary risks are low with a year-on-year CPI index of +0.9% in December.

Long rates should stabilise above zero after the adjustments over the past few months. The current context is not favourable to the bond market, which still fails to offer attractive prospects to foreign investors in terms of yields, while the risk of incurring capital and FX losses over the long run is significant.

Prioritise emerging bonds over high yield

High yield bonds and emerging bonds have benefited from renewed investor confidence and liquidity injections, leading them to post good performances in December after a nearly six-month period of stabilisation. However, we are concerned by the drop in yield on high yield bonds, which once again reduced the risk premia for this type of investment as compared to investment grade bonds.

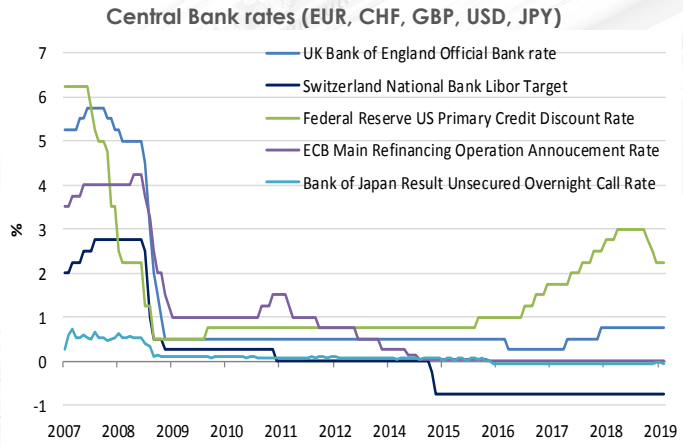
There is no doubt that the negative yields on this type of investment continue to push investors to seek positive yield from more risky alternatives at the cost of a fall in their investment's risk premium. Despite this, the yield pick-up process is continuing and could last until government yields become more attractive or default ratios rise considerably. In the current phase of gradual, moderate readjustment of global growth prospects for 2020, we are prioritising quality emerging market debt in local currencies and in US dollars over high yield bonds.

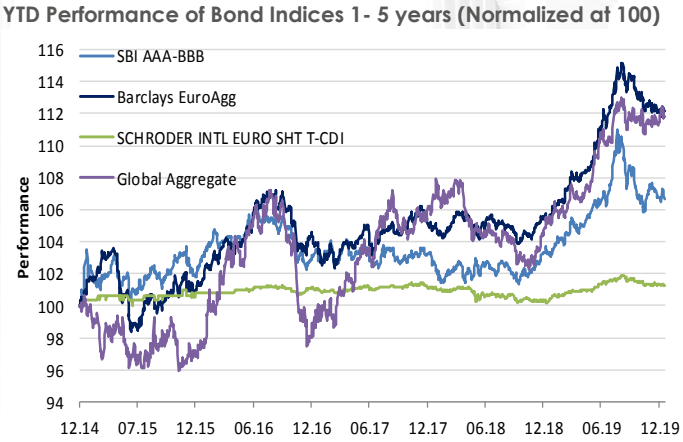
Regional and monetary allocation should favour the US dollar

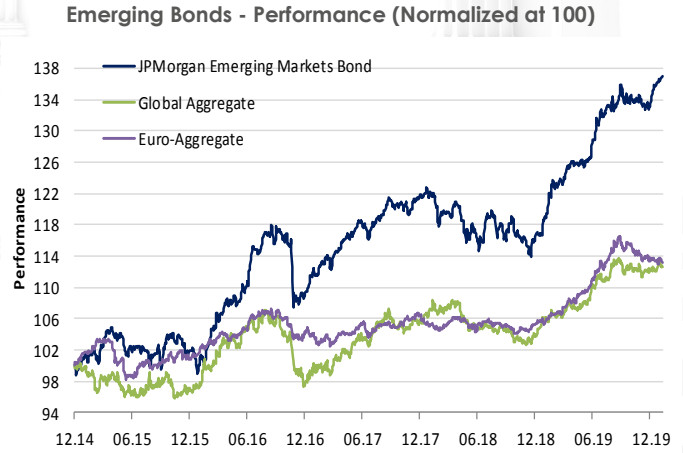
The fall in bond yields over the first nine months was widespread, despite often varying economic situations. Fears of a global economic slowdown propped up this high correlation between various rate markets in 2019. In 2020, this correlation could shrink significantly, with evaluations of national economic prospects gradually becoming more rational again.

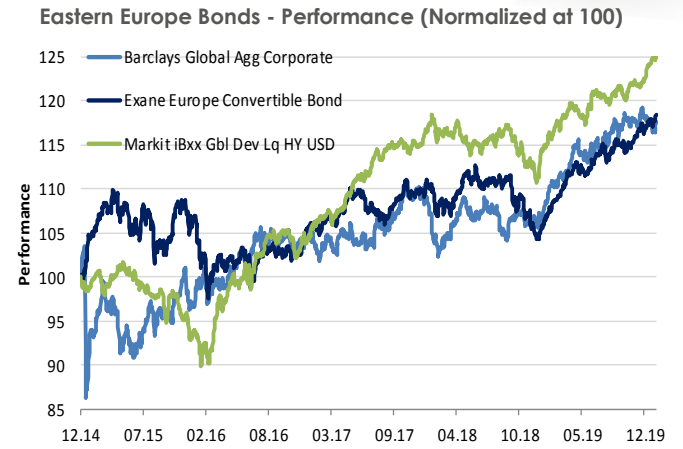
Government yields in Euro, Swiss francs, and yen are negative or close to zero according to the issuing governments and offer little to investors. In developed markets, the drop in yield in Canadian and Australian dollars seems excessive compared to the economies and prospects of these two countries.

After having recommended prioritising exposure to these markets, and having benefited from capital gains, we now believe that the risk of an upward adjustment to long rates is higher than in the United States. The yields now on offer are significantly lower (1.38% and 1.2% respectively) than yields in US dollars (1.8%); we recommend shifting bond allocation in Canadian and Australian dollars towards short-term debt in US dollars given the current flat rate curve.







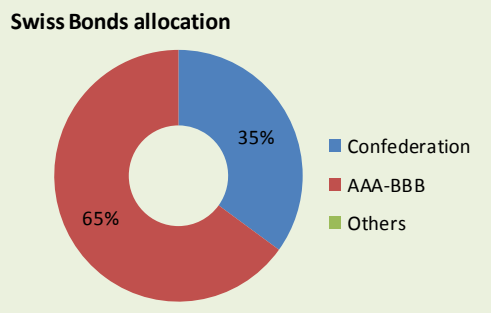


Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Swiss Bonds

- Swiss long-term rates fall into unknown territory
- No key rate cut following the ECB's decision
- Only a recession can justify current ten-year yields
- Negative real yields favourable to growth in Switzerland



Tactical Allocation

- Underweight Swiss Government Bonds
- Overweight the "IG" segment
- Short durations

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

Slow rebound of long-term rates in Switzerland

In September, we mentioned the irrational character of the collapse in ten-year yields from -0.5% to -1.12% of the Confederation in August, announcing a likely strong rebound as soon as risks of a recession are finally assessed rationally. The last few months of 2019 have thus been marked by a gradual increase of long-term rates from -1.12% to -0.4% in early November, which is likely to continue in the next few quarters.

Prospects for bond markets in Swiss francs are negative in this environment, although the latest statistics published point to a possible return of deflationary risks in Switzerland. The CPI index for October shows a -0.2% drop in inflation for the month and -0.3% for the year. The real yield thus went from -0.85% to -0.75% in October.

We believe risks of a recession or an economic slump in our country are relatively slim and certainly not sufficient in and of themselves to justify the current persistently negative yields. Moreover, the CPI index's return to zero yoy in December is also not enough to prevent deflationary risks from returning. Nevertheless, Switzerland's economic prospects are positive with expected GDP growth of +1.5% in 2020, which is obviously not reflected in the current levels of long-term rates.

The SNB's monetary policy, maintaining a negative rate of -0.75%, is thus still a primary factor impacting long-term rates in our country. Even so, in this context, the negative performance of bond indices (-1.74%) in the last quarter reduced the positive overall result of +3.05% achieved by the asset class for the whole year. Prospects for 2020 are negative for Swiss investment grade bonds.

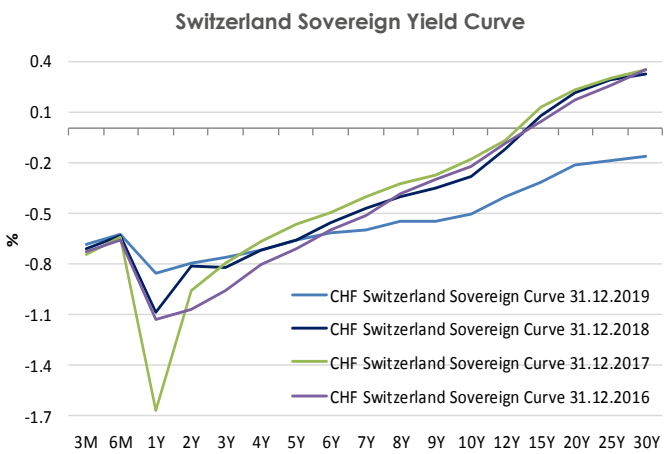
Real yields remain negative in Switzerland

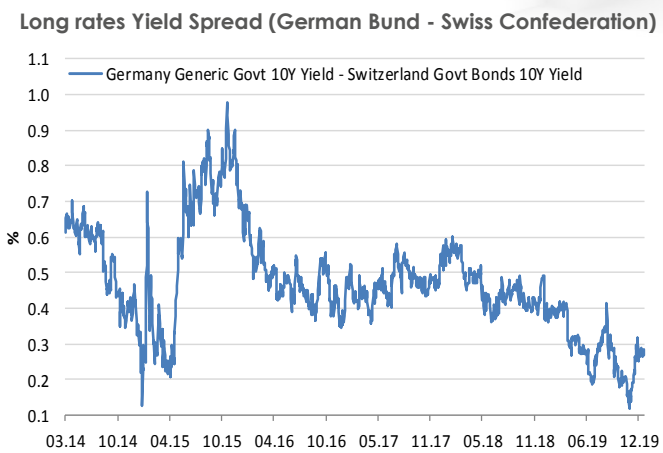
The rebound in the Confederation's ten-year nominal yields from -1.12% at its lowest in the summer to -0.47% at the start of 2020 and price indices' fall to zero in December yoy have significantly affected real yields in Swiss francs. The long-term real yield has thus climbed back up from -1.62% in September to -0.47%.

The real one-year yield, calculated based on borrowing costs using a 12-month LIBOR rate of -0.49%, is thus very similar. Negative real yields support economic growth, in particular by boosting consumption and investment. A prolonged period of negative real rates typically heralds an economic recovery. Real rates remain negative although to a lesser extent than in the previous quarter, but they are still a factor supporting economic momentum in our country.

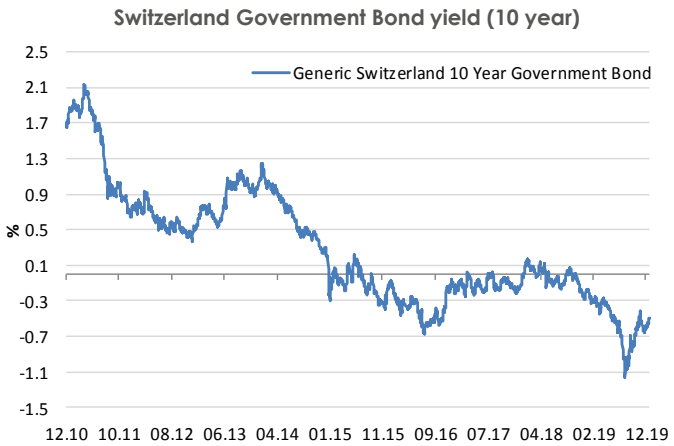
A period of weakness for the Swiss franc would favour a sharper adjustment of yields

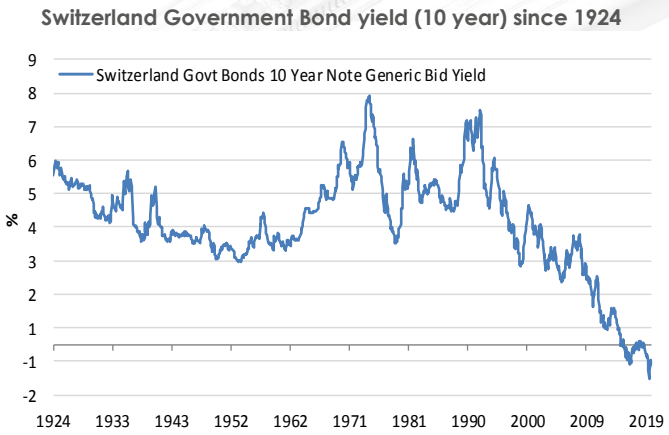
Despite PPP (purchasing power parity) levels that would support a depreciation of the franc, being able to observe or at least credibly anticipate a serious and lasting economic recovery in Europe will be essential for such a trend to take hold. Nevertheless, in the medium term, we believe that there are increasing probabilities of a moderate weakening of the franc, and we will have to count on these developments for long-term Swiss interest rates to turn positive again.

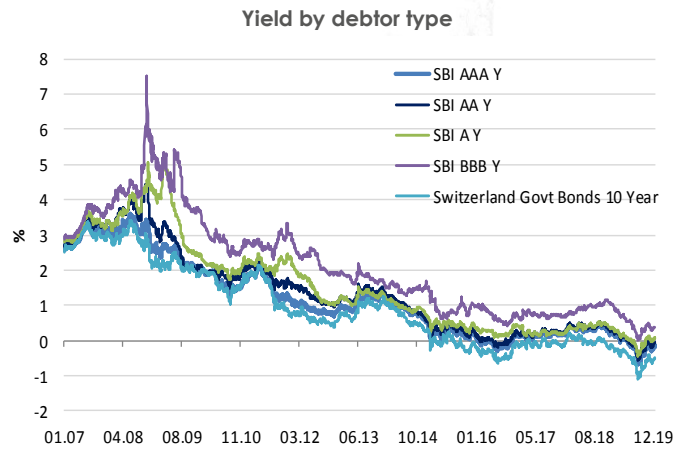


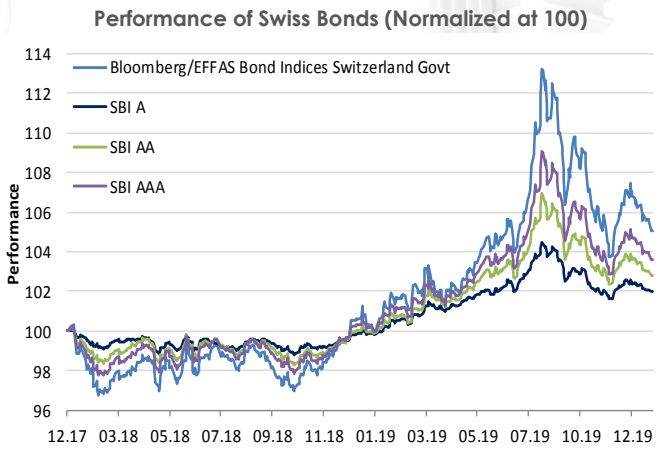


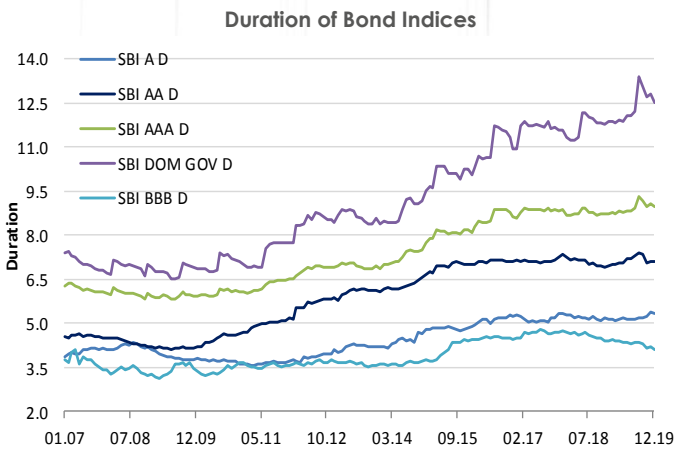
Graph sources: Bloomberg/BBGI Group

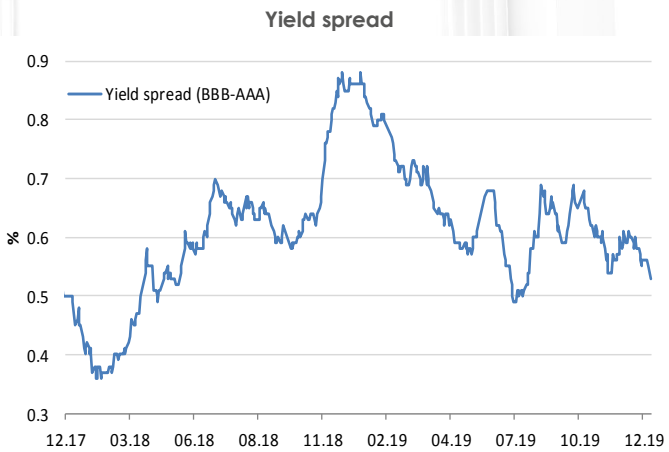


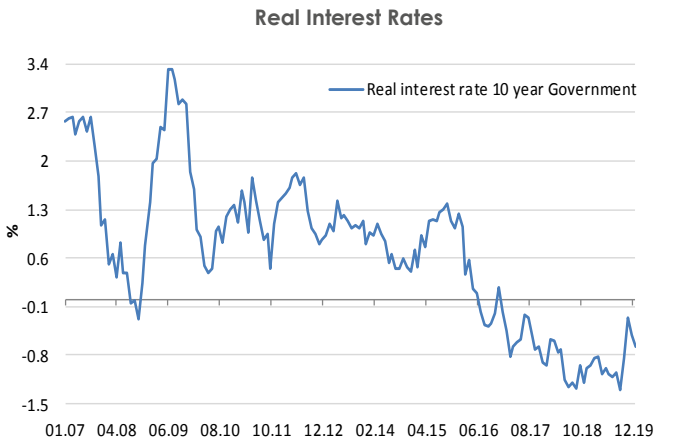












SWISS BOND INDICES (CHF)

31.12.2019

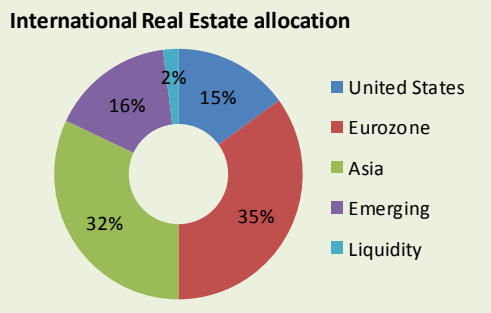
	Last price	Curr.	Total Return Performance 7 d %	1 m %	3 m %	6 m %	YTD %
Bloomberg Barclays Series-E Switzerland Govt All > 1 Yr Bond Index	274.6	CHF	-0.5	-1.9	-3.3	0.3	5.1
SBI A-BBB	139.7	CHF	-0.1	-0.4	-0.6	0.1	2.6
SBI AA-BBB	138.3	CHF	-0.2	-0.7	-1.2	-0.2	2.6
SBI AAA-AA	140.5	CHF	-0.3	-1.2	-2.1	-0.2	3.3
SBI BBB	152.6	CHF	0.0	-0.3	-0.2	0.6	3.3
SBI AAA-BBB	140.7	CHF	-0.3	-1.0	-1.7	-0.2	3.1
SBI DOM GOV AAA-BBB 1-3P	66.8	CHF	0.0	-0.4	-1.0	-1.7	-5.7
SBI DOM GOV AAA-BBB 3-7P	85.8	CHF	-0.2	-0.8	-1.8	-2.2	-4.1
SBI DOM GOV AAA-BBB 7+ P	135.1	CHF	-0.7	-2.6	-4.7	0.3	4.8

Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

International Real Estate

- International securitised real estate performed well in 2019
- Liquidity still having a positive impact on securitised real estate
- The liquidity factor will become less important in 2020
- Funds will continue to flow from bonds into real estate investments
- Overweight Asia and emerging markets in regional allocation



Tactical Allocation

- Overweight Europe, Asia and Emerging
- Partial profit-taking
- Increase liquidity

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 securitised real estate performed well in 2019

Investments in international securitised real estate continued to perform well in Q4, rising by a further +3.3%. Over the full year 2019, the EPRA/Nareit global real estate index thus increased by +22.5%. However, this decidedly positive result is not exceptional by historical comparison.

Indeed, since the index was launched in 2008, international real estate posted more impressive results on three occasions: in 2009 (+35.68%), 2012 (+25.67%) and 2014 (+27.42%). As an asset class, international real estate has in fact displayed relatively short market cycles since 2008. So ultimately, the sector's overall rise has been made up of a succession of very good years almost always followed by price corrections in the following year.

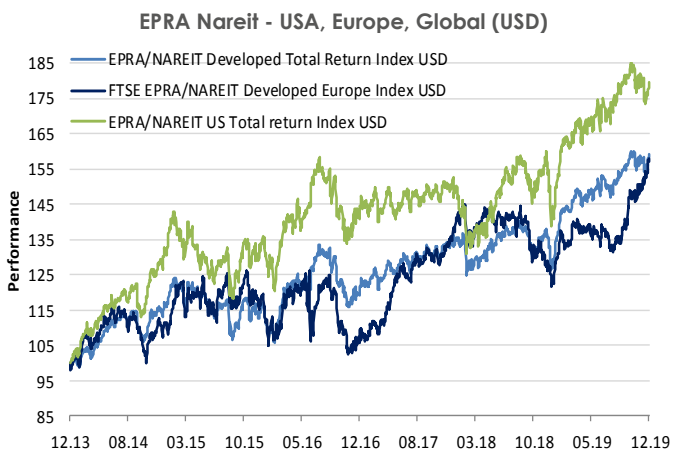
Volatility is thus an important factor to take into account, as it determines the pace of growth for this asset class. Over the year as a whole, note that most of the rise took place in Q1 (+14.73). Over the next two quarters, average monthly growth of +1.5% pointed towards more of a stabilisation phase, before the upswing mentioned above at the end of the year, likely driven by the massive liquidity injections with which the US Fed gratified the markets at the end of the year.

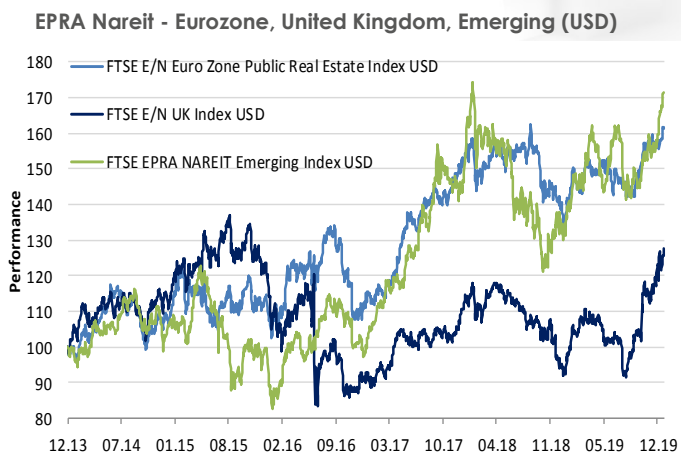
Exceptional quarter for the UK and emerging markets

There were some regional surprises, with UK real estate posting the best performance of the year. Up by +30.6%, the EPRA Nareit UK index well exceeded the average global performance of +22.5%. These excellent results were essentially due to an extraordinary streak in the last quarter, allowing the UK to pull ahead.

Indeed, as polls were increasingly showing Boris Johnson in the lead in the December elections, increasing the likelihood of a quick Brexit in 2020, the significant uncertainties that were keeping investors from the UK real estate market abated. The last quarter was thus fantastic for UK securitised real estate, which posted its strongest upswing (+11.65%) since September 2009.

In Q4 as well, Asia benefited from the improvement in the political situation involving China and the US. The signature of an agreement regarding the first phase of trade negotiations, announced for January 2020, at least partly diminished the uncertainty penalising investments in the region and thus improved perceptions regarding opportunities in emerging markets and Asia. The region's otherwise solid fundamentals had been overlooked due to the trade risks, which had kept investors away for a time, but in the last quarter it was possible to evaluate risks and opportunities more objectively.





Graph sources: Bloomberg/BBGI Group

In terms of results by region, the +14.3% increase in emerging real estate at the end of the year is thus the best performance of the period. With this exceptional reversal of fortune in Q4, this segment thus posted excellent annual results of +29.82%, just slightly below the UK. Asian markets that were still lagging at the end of the year will likely also benefit from a return of investors to these more dynamic markets in 2020.

US real estate was thus the only one to book a loss in Q4 (-0.94%), although its performance in the preceding months was strong enough to deliver a very respectable annual increase of +24.35%.

Liquidity had a positive impact on securitised real estate

Since 2018, financial markets have been threatened by a global economic slowdown, which was to stem in part from the difficulties encountered by the global manufacturing sector. The risks of a total trade war between China and the US were the main factor boosting these uncertainties and driving downwards revisions in the economic growth outlook. Nevertheless, in this more uncertain economic context, real estate shares posted double-digit growth often similar to, but occasionally well in excess of, the performance of equity markets. Emerging real estate thus significantly outperformed emerging equities, as did UK real estate.

The return of liquidity in the second half of the year was a positive factor for listed real estate investments, which were not really affected by the risks of declines in rental income, which should logically have been considered in relation to the global economic slowdown scenario.

The renewed growth in global liquidity was thus a factor supporting securitised real estate, which benefited both from the rate cuts that occurred in a large number of countries as well as from the further liquidity injections and asset purchases carried out by the main central banks.

The liquidity factor will become less important in 2020

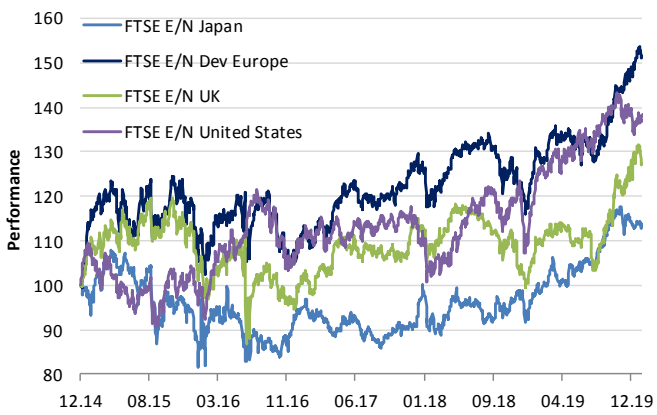
In 2020, the liquidity factor will likely become less important in the US, Europe, and Japan in particular. Rate cuts will likely taper down following expected improvements in economic performance, and key rates will thus likely stabilise in these regions. In the US the Fed may decide to rapidly reduce its liquidity injections after having no doubt been especially active in the last quarter, expanding its balance sheet by 400 billion dollars over only a few weeks.

Financial markets will thus not benefit from the status quo in those countries. Elsewhere, in China and Asia in particular and in emerging markets more generally, central banks may continue to boost liquidity and maintain it for a longer time, which would constitute an additional supporting factor.

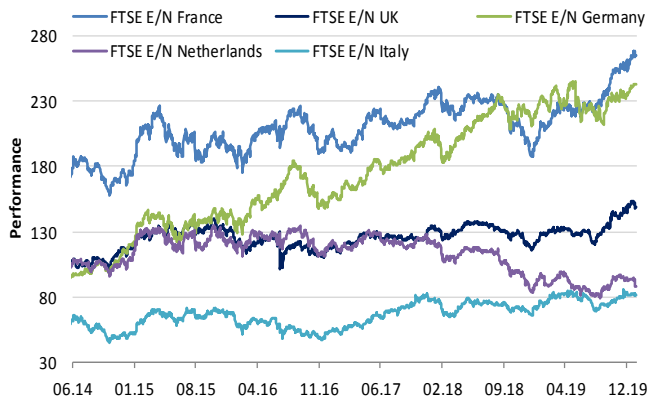
Funds will continue to flow from bonds into real estate investments

Following a rather remarkable year in 2019 for most asset classes, we believe that economic conditions in 2020 will benefit securitised real estate even further. The yields on real estate assets often continue to be more attractive than those on traditional investment grade bond investments or even high yield bonds.

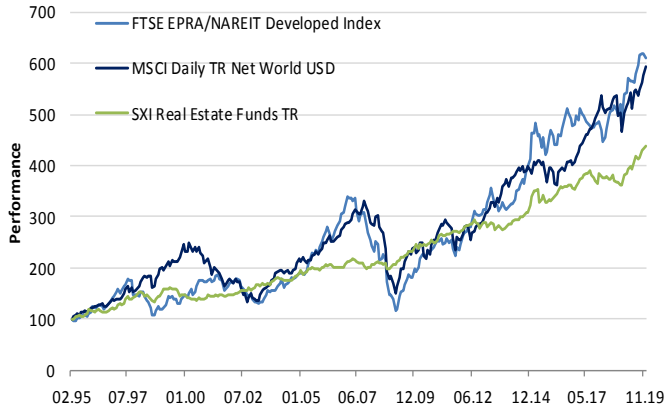
Real estate markets (local currency)



European real estate markets (local currency)



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



INTERNATIONAL REAL ESTATE INDICES (local currency)

31.12.2019 — Total Return Performance

N° ISIN	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
GLOBAL	FTSE EPRA/NAREIT Glb TR	3137.0	USD	1.8	1.7	3.5	7.1	23.6
DEVELOPED	EPRA/NAREIT Dev TR USD	5843.7	USD	1.7	0.6	2.0	6.9	23.1
DEVELOPED EUROPE	FTSE E/N Dev Europe	2485.9	EUR	0.9	3.0	9.0	18.6	29.4
EUROZONE	FTSE E/N Euro Zone	2740.7	EUR	0.5	0.8	5.0	12.9	21.6
USA	FTSE E/N United States	3236.4	USD	1.9	-1.0	-0.9	6.6	24.3
DEVELOPED ASIA	FTSE E/N Dev Asia	1742.3	EUR	0.0	-0.5	-1.0	2.9	19.2

Graph sources: Bloomberg/BBGI Group

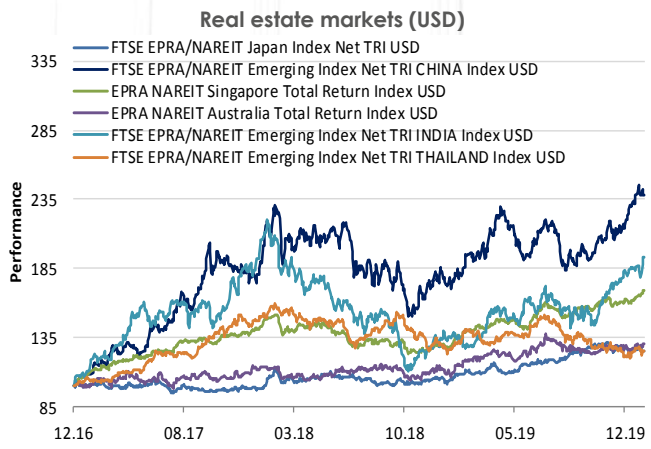
Rate cuts and lower long-term rates pushed yield curves and overall financing terms down yet further in 2019. Consumption and investment can now count on even better conditions than in 2017. In particular, real estate investment is benefitting from exceptionally low borrowing costs. Consequently, the economic outlook for 2020 will benefit from this situation, which will eventually cause long-term rates to rise.

With regards to asset allocation, it may well be the very last moment to reduce exposure to fixed income investments before being subject to the capital losses inevitably resulting from any increase in yield. In this context, over the next few quarters, we expect that allocation transfers from bonds to real estate investments will likely continue. This trend could drive further increases in securitised real estate prices far greater than any related increase in direct real estate prices.

Overweight Asia and emerging markets in regional allocation

2020 will likely remain favourable to international real estate investments, even though the liquidity factor will likely become less important, in effect limiting the potential for capital gains. We maintain a positive outlook on the asset class and our generally favourable recommendation with regards to real estate.

In terms of regional allocations, the US market is perhaps the most likely to lack support in 2020. Asian and emerging markets still seem to have stronger momentum and rental income growth. In 2020, these two regions are likely to benefit most from the current adjustment in the economic outlook and from the truce likely to ensue in the tariff talks between China and the US. We recommend overweighting emerging markets and Asia and underweighting the US and the UK.

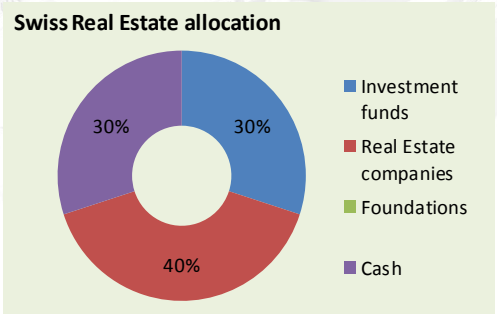


Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Swiss Real Estate

- Record performances for securitised real estate
- Securitised real estate valuations reach new heights
- No resisting the appeal of an attractive alternative return



Tactical Allocation

- Reduce investment funds
- Reduce listed real estate companies
- Profit-taking and 30% liquidity

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

Record performances for securitised real estate

Securitised real estate in Switzerland ended the quarter on a positive note once again, crowning a truly exceptional year on a historical level. The SXI Swiss Real Estate Funds index's quarterly performance (+5.7%) drove the year's overall results higher still to +20.67%, i.e. the best performance since 1997 (+22.51%), and the second best since the creation of the index. Listed real estate companies recorded an even more exceptional increase in 2019, meaning last year was by far the best in the rankings of yearly results. Indeed, real estate shares' +40.16% increase as measured by the SXI Swiss Real Estate Shares index exceeds by far all annual results posted since the creation of this index in 2005, and in particular the previous best historical yearly performance of +26.07% in 2010.

Securitised real estate valuations reach new heights

A few weeks ago, we mentioned the rising valuation levels of Swiss investment funds and real estate companies by recalling that they had now reached levels of risk that gave pause. Rising premiums are a risk indicator that must be seriously considered in analysing risks and opportunities for this asset class. At the start of this year, traditional measures of risk assessment for Swiss securitised real estate have reached extreme historical levels.

The average premium for Swiss investment funds now lies at 34.9%, i.e. the highest level in the last 30 years. As for listed real estate companies, the increase in the last few weeks has driven the average premium to 37.5%, i.e. a quite extreme level in historical comparison. These extreme valuation levels are now meaningful signs of excessive enthusiasm for this asset class, whose rationality may be questioned.

No resisting the appeal of an attractive alternative yield

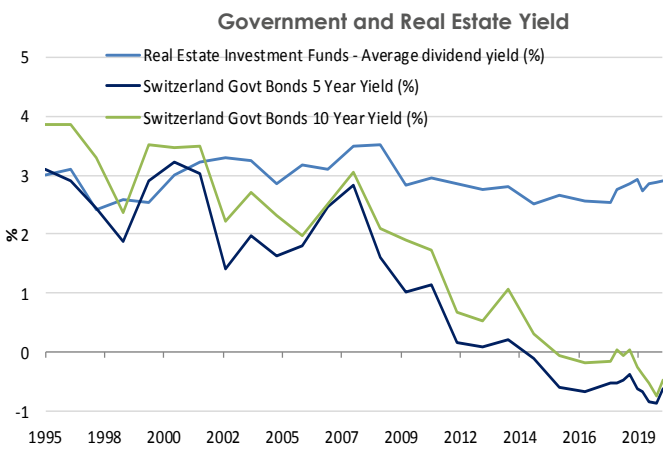
The expected yield for these two market segments is nevertheless still high. We believe the average expected yield in 2020 will lie at 2.91% for investment funds and 3.49% for real estate companies. This factor is certainly enough for investors early on in the year to put depreciation risks into perspective and still justifies the reallocation of assets in favour of securitised real estate investments at the expense of non-remunerative bonds.

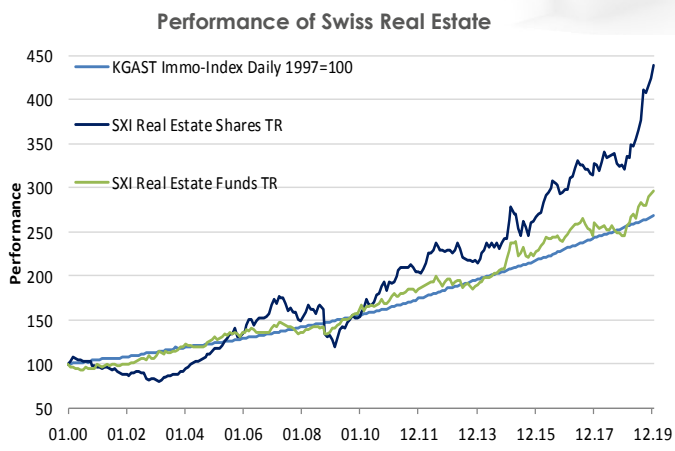
The drop in bond yields to ridiculous levels in August had reinforced the need for an alternative and undoubtedly further drove the transfer process from bond to real estate risk. Funds are thus flowing in the same direction, as direct and securitised real estate indeed still make up the primary alternative source of returns outside of bonds.

SWISS REAL ESTATE

31.12.2019 — Total Return Performance

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
SXI Real Estate Funds TR	436.3	-1.4	1.1	5.7	6.8	20.7
SXI Real Estate Idx TR	3273.7	0.3	3.6	7.9	20.3	37.0
KGAST Immo-Index	300.6				3.1	5.2





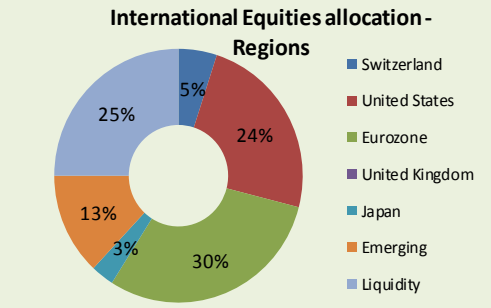
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

International Equities - Regions

- Volatility returns to equity markets in 2020
- European equities still more attractive than US stocks
- US equities under threat from high valuations and growing geopolitical risks
- Emerging markets likely to outperform in 2020

EQUITIES REGIONS	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Switzerland	↘	→							
United States	↘	→							
Eurozone	↘	→							
United Kingdom	↘	→							
Japan	↘	→							
Emerging	↘	→							
Liquidity									



Tactical Allocation

- Overweight Europe and emergent
- Underweight United Kingdom and Japan
- Neutral United States
- Temporary profit-taking

Volatility returns to equity markets in 2020

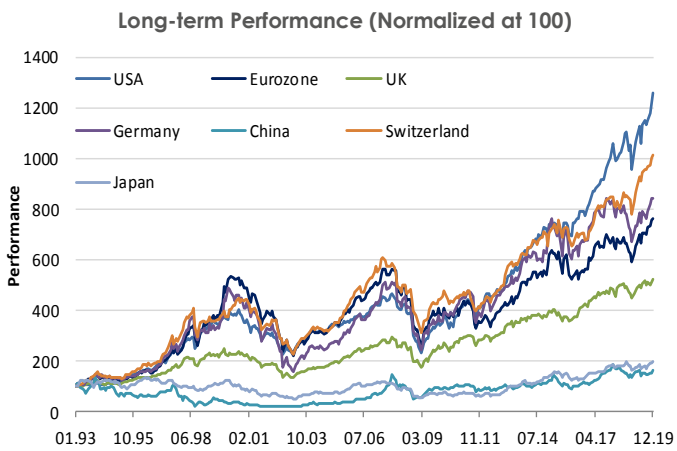
Equity markets' performance for 2019 was particularly gratifying and impressive, with the US market once again amongst the top performers in developed markets. The +28.88% performance in US dollars of the S&P500 over twelve months is exceptional when compared to the raft of yearly performances posted over the last twenty years. Indeed, it is the second-best performance over the period, just lagging behind 2013's +29.6%. Compared to the average annual performance of around +6% over the last twenty years, and +10.4% over the last thirty, 2019 falls outside normal parameters. It topped off an eleventh consecutive bull market year, starting in 2009.

This is now the longest upward phase on stock markets of the past decades. If we put 2019's growth into context with the most recent developments on stock market indices, we can see that until October 2019 the S&P500 index remained in a consolidation phase. This had started in January 2018, with the index unable to push past the intermediate peaks seen in January 2018, September 2018, May 2019, July 2019 and September 2019 at close to 3,000 points by any significant amount. As such, S&P500 performance between September 2018 and September 2019 was in fact close to zero.

The growth over the first nine months of 2019 effectively served to compensate for and cancel out the volatility and nearly -20% temporary correction which had affected financial markets in the 4th quarter 2018. Once that is taken into account, 2019's stellar growth does not look quite so exceptional. The +8.5% rise in the 4th quarter 2019 might look like a new push forward on indices, after a twenty-one-month period of consolidation, admittedly with high volatility at the end of 2018.

However, it should be noted that this push forward very much seems due to liquidity rather than a positive development in company profits, which would be the healthiest driver of price growth in the long term.

Indeed, the US Federal Reserve has injected huge amounts of liquidities over the period, corresponding to more than 400 billion US dollars, or more than 10% of the central bank's balance sheet. These injections are not entirely unrelated to investors' renewed confidence. Nonetheless, 2019 should draw to a close with US company profits having shrunk around -5%.



Graph sources: Bloomberg/BBGI Group

Growth prospects for 2020 should not be high given the current context of weaker economic growth and pressure on margins. In this specific context, equity market valuation levels, particularly for the US, tightened in 2019. The price rise can be explained by the growth in the price/earnings ratio, which grew from 14x to 19x earnings in a context of shrinking profits. Other valuation yardsticks confirm this observation and are real sources of concern for rational investors as we start a new year and a new decade. Today, we can see that price to sales and enterprise value to EBITDA valuations stand at historically high levels, similar to those seen in 1999 before the start of the bear market in 2000, during which equity prices halved.

This information gives a much-needed dose of perspective as we weigh up market opportunities and risks at the start of 2020. We believe that equity markets are more vulnerable than ever to a dip or interruption in liquidity injections, a gradual increase in long term interest rates, or disappointments with regard to profit growth in 2020. It seems likely we will see further volatility following the exceptional price growth in 2019.

European equities still more attractive than US stocks

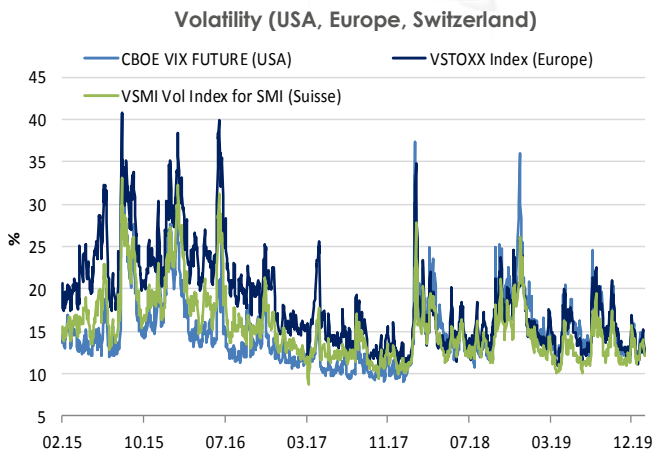
The performance of European equities (+19.5%) remains below that of the US market (+26.7%) since the beginning of the year. However, the outperformance of US stocks seems linked essentially to corporate share buy-backs. When corrected for this effect, the performance of European equities is actually similar. At year-end, the valuation of European equities remains attractive. With a valuation of 15.9x expected 2020 earnings, they are at an almost -20% discount to US equities, with 2020 PE levels of 19.2x. Since 15 August, date of the trend reversal in the rate and equity markets, both markets have performed almost identically in terms of local or any other currency. The persistently low rates in the Eurozone will likely lead to investors taking a renewed interest in European equities as well as to an expansionary phase for PEs. Beyond the more attractive valuation levels, European companies also offer a clearly superior yield compared with US companies. Their 3.3% yield is thus 80% higher than the yield of S&P500 stocks on average (1.85%). This valuation gap may be explained by the perception that European stocks are more sensitive to external shocks such as the slowdown in China and in emerging countries.

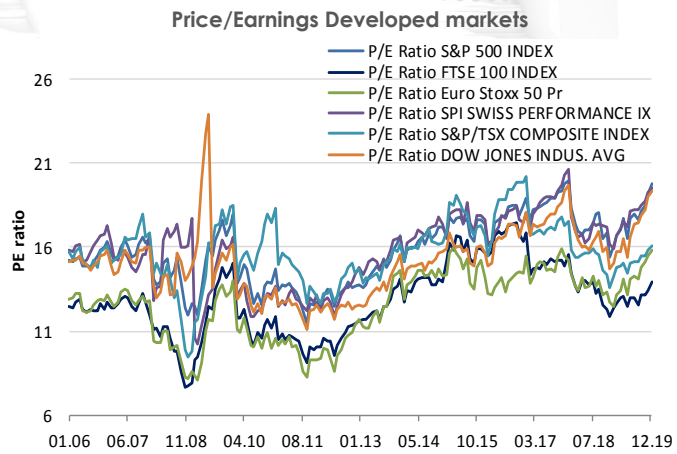
For now, investors may thus be more convinced by the capacity of US rather than European companies to withstand such shocks. Consequently, European equities will likely depend on better economic conditions to outperform.

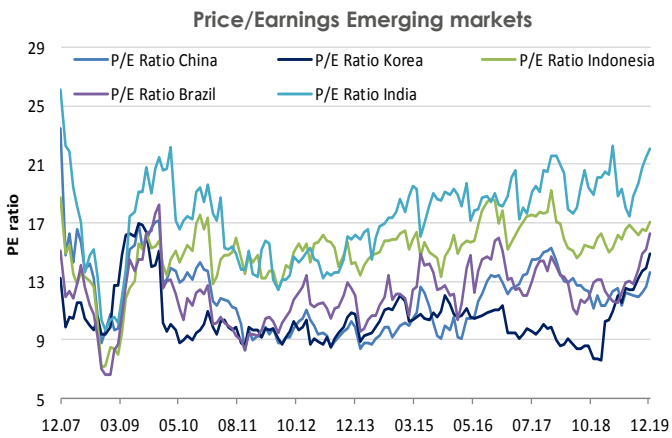
US equities under threat from high valuations and growing geopolitical risks

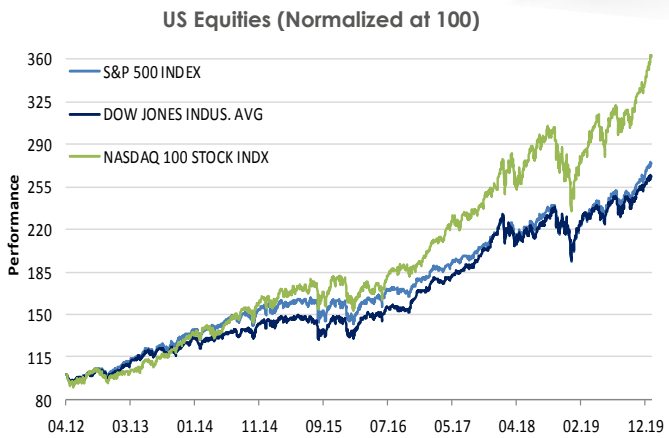
The last quarter of 2019 saw a sharp recovery in US equities, which reached new heights in a phase of acceleration essentially driven by the inflow of liquidity injected by the US Federal Reserve and the momentum observed on several tech stocks. The +8.5% rise of the S&P500 over the quarter, including +2.86% over the single month of December, brings 2019's performance to +28.9%, i.e. the second best performance since 1998. The rise is surprising if you consider that, in 2019, US corporate earnings dropped by an estimated -5%. Thus, the rise of US equities is essentially due to PE ratio expansion resulting from the Fed's rate cuts and sustained liquidity injections at the end of the year. Growth of the PE ratio from 14x to 19x in 2019 in this context is not really rational and should thus be concerning, even though it is true that in other PE expansion phases in the past, this ratio exceeded 20x for the S&P500 index before being followed by a correction of prices. We are sticking to our analysis that, at the start of 2020, the emotional factor will irrationally drive equity prices to extreme heights, which usually heralds significant a stock market correction.

The Fear&Greed index is now at a rarely-reached level of 96/100, while indices have diverged by more than two standard deviations from their trend, which is also a sign of a high probability of the trend being interrupted. The last time the equity market reached current valuation levels of 2.4x sales (price to sales) was before the "dot.com" crash at the turn of the century. Other measures such as enterprise value/EBITDA are also at their peak, suggesting that the current situation is a decoupling that could be historically devastating in the medium term. Nevertheless, growth may still be bolstered by the continued action of the Fed, although the geopolitical risks that emerged brutally at the start of 2020 in the Middle East may well degenerate quickly into a new crisis with negative effects on oil prices and investors' mindset, which may trigger an adjustment of expectations and a significant market correction.









Graph sources: Bloomberg/BBGI Group

Earnings of Nikkei companies fell for the third quarter in a row

A weaker yen, lower trade tensions, and an improved economic outlook bolstered by the latest decreases in long and short rates in the US would be favourable to an upswing of the Nikkei. With this in mind, we maintain a neutral strategy on Japanese equities.

Economic activity and the results of Japanese firms remain strongly affected by the feud with South Korea and the trade tensions between China and the US. The fall in exports is obviously having an impact on the results of listed companies, whose earnings dropped by -5.3% yoy, while sales fell for the first time in three years (-2.6%).

Avoid British equities

The political and stock market environment now seems less uncertain. However, the equity market's
risk/expected return ratio does not seem much more attractive in relative terms than the bond market's. We continue to recommend caution with regard to UK equities, in spite of reasonable valuations and attractive dividend yields.

Emerging markets likely to outperform in 2020

Concerns of an economic slowdown in 2019 dealt emerging markets a harder blow than others, but now the adjustment to global growth prospects for 2020 favours emerging markets more than developed markets. The IMF is predicting an increase in pace in emerging markets, such that their average growth should double that of developed countries.

Emerging countries' central banks have been more proactive with their policies to shore up the economy and should undoubtedly take a similar stance at the start of 2020. Generally speaking, there is more room for manoeuvre in emerging countries, and we are seeing an improvement in monetary, fiscal, and economic conditions, as well as structural reforms that are starting to bear fruit. In 2020, emerging markets will benefit from further economic support measures, just as the improvement in the global cycle will start to have a positive impact on emerging economies.

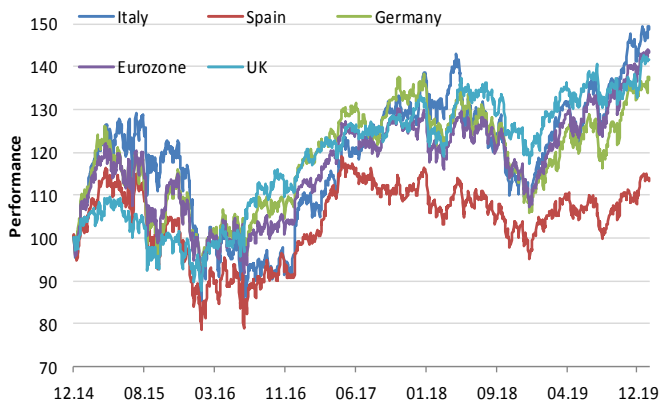
In 2019, emerging indices underperformed industrialised countries' indices by around -10%; 2020 should enable some markets, such as Vietnam, China, and India, to outperform. It is recommended to overweight exposure to emerging markets.

EQUITIES - BY REGION (local currency)

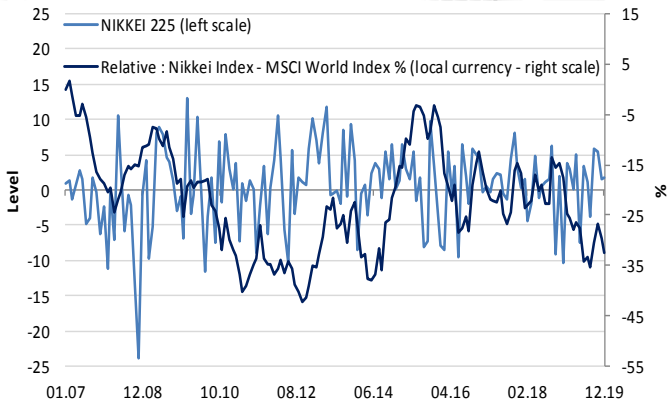
31.12.2019				Total Return Performance				
	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
SWITZERLAND	SPI Swiss Performance Index	12837.5	CHF	-0.9	1.3	4.9	7.2	30.6
SWITZERLAND SMALL-MID CAPS	SPI Extra Total Return	4640.9	CHF	-0.3	1.9	7.6	8.7	30.4
EUROPE	STXE 600 € Pr	415.8	EUR	-0.7	2.1	6.2	9.0	27.7
EUROPE SMALL-MID CAPS	MSCI Europe Small Cap Net TR E	465.7	EUR	0.0	4.2	11.7	13.6	31.4
UK	FTSE All-Share Index	4196.5	GBP	-1.0	3.3	4.2	5.5	19.1
USA	S&P 500 Index	3230.8	USD	0.3	3.0	9.1	10.9	31.5
USA SMALL-MID CAPS	RUSSELL 2500	675.2	USD	-0.2	2.1	8.5	7.1	27.7
JAPAN	NIKKEI 225	23656.6	JPY	-0.6	1.7	8.9	12.3	20.7
JAPAN SMALL-MID CAPS	Russell/Nomura Mid-Small Cap I	897.4	JPY	-0.4	1.2	8.9	12.5	15.4
ASIA EX-JAPAN	MSCI AC Asia Pac Ex Japan	552.7	USD	0.5	5.7	10.5	6.3	19.6
ASIA EX-JAPAN SMALL-MID CAPS	MSCI AC Asia Pacific Ex Japan Small Cap	939.5	USD	1.7	3.9	6.2	0.7	7.7
EMERGING	MSCI EM	1114.7	USD	0.6	7.3	11.7	7.1	18.6
INTERNATIONAL EQUITIES -DIVERSIFIED USD	MSCI Daily TR Net World	6909.7	USD	0.3	3.0	8.6	9.1	27.7

Graph sources: Bloomberg/BBGI Group

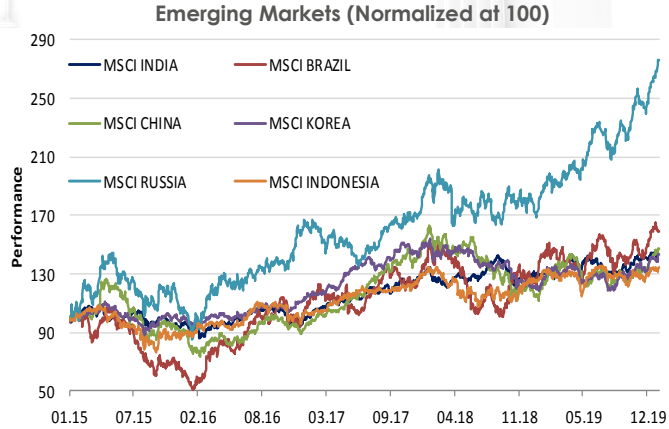
Performance of Stock markets (Normalized at 100)



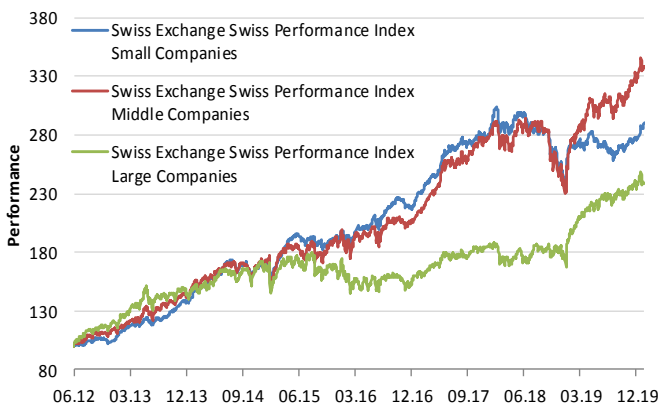
Japanese Equities VS MSCI World



Emerging Markets (Normalized at 100)



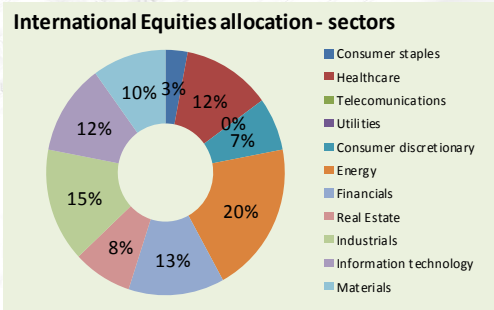
Swiss Equities (large - middle - small caps/Normalized at 100)



PROSPECTS AND STRATEGIES

International Equities - Sectors

- Shore up defensive position
- Health, energy, industry and materials overweighted
- Technology sector underweighted
- Prioritise value stocks



Tactical Allocation

- Underweight digital stocks and technology
- Overweight energy, materials, industrials and financials

EQUITIES Sectors	Expected Return 3months	Expected Return 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

31.12.2019

	Name	Last price	Curr.	Total Return Performance 7 d %	1 m %	3 m %	6 m %	YTD %
CONSUMER DISCRETIONARY	MSCI WORLD/CONS DIS	278.3	USD	0.6	3.0	6.9	7.3	27.2
CONSUMER STAPLES	MSCI WORLD/CON STPL	251.1	USD	0.1	2.2	2.7	7.0	23.6
ENERGY	MSCI WORLD/ENERGY	196.9	USD	0.1	5.4	5.2	-0.6	12.6
FINANCIALS	MSCI WORLD/FINANCE	125.7	USD	0.5	3.1	8.9	9.4	26.5
HEALTHCARE	MSCI WORLD/HLTH CARE	279.1	USD	-0.2	3.4	13.8	12.5	23.9
INDUSTRIALS	MSCI WORLD/INDUSTRL	276.4	USD	-0.1	1.0	7.5	6.9	28.5
MATERIALS	MSCI WORLD/MATERIAL	272.2	USD	0.7	4.1	8.7	5.3	24.0
REAL ESTATE	MSCI WORLD/REAL ESTATE	231.4	USD	1.5	1.3	1.4	5.9	23.9
TECHNOLOGY	MSCI WORLD/INF TECH	310.9	USD	0.5	4.2	14.1	16.8	48.1
TELECOMMUNICATION	MSCI WORLD/TEL SVC	77.5	USD	0.0	2.0	8.0	9.6	27.9
UTILITIES	MSCI WORLD/UTILITY	150.2	USD	0.8	4.0	2.2	9.1	23.8

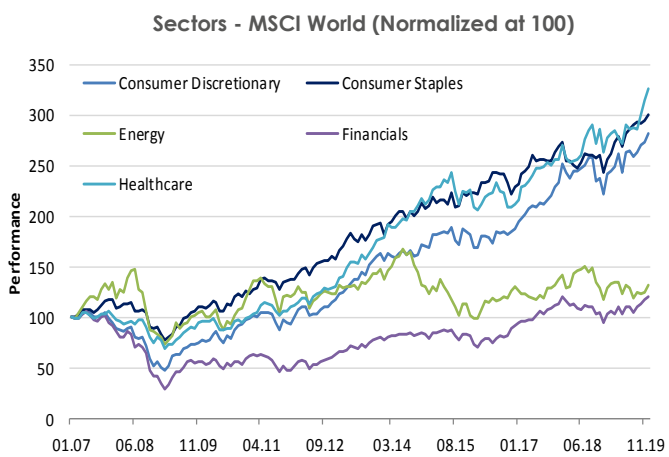
The last quarter produced results that varied greatly across sectors and showed greater performance dispersion between these market segments than in previous quarters. Although all international sectors posted positive performances, the gap between the best (13.7%) and the least good (0.6%) result nonetheless stands at nearly 14%. As such, seven sectors have posted performances lower than that of the MSCI World Index, with only four beating it.

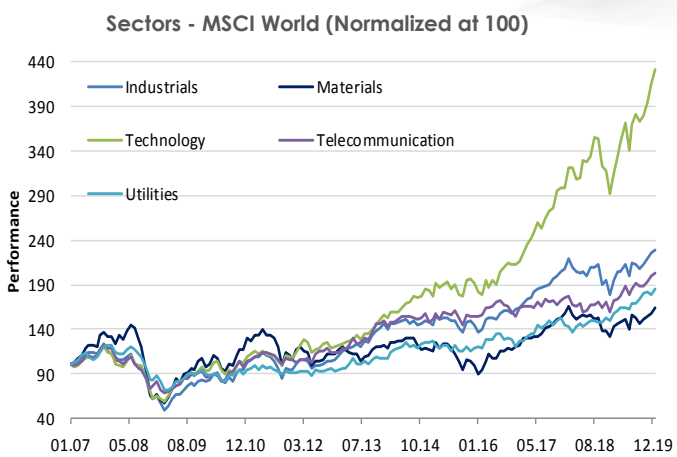
Our international sectoral position prioritised, among others, health, materials and financial sectors over the last few months. They posted +13.4%, +8.4% and +8.3% respectively, to be outdone only by the technology segment, which grew +13.7%. These four were the only sectors to post higher performances than the MSCI World Index (+8.2%). By overweighting three of the four top performers of the quarter, our sectoral allocation proved particularly judicious and took advantage of the bounce back on the stock market at the end of the year.

The defensive sectors which were prioritised in the short term to reduce overall risk for equity portfolios worked as we had hoped. At the start of this year, we would recommend adopting a strategy aiming at even more defensive sectoral distribution, given the current uncertainty.

In this vein, we are adjusting our sectoral allocation; we are once again overweighting health, energy and materials, as well as financial and industrial stocks. The technology sector remains underweighted.

The energy sector has attractive valuation levels and enticing profit growth prospects. As such, it should benefit from a less pessimistic outlook for global growth and a more positive trend for crude oil prices. This change in outlook will also have a positive impact on the demand for materials.





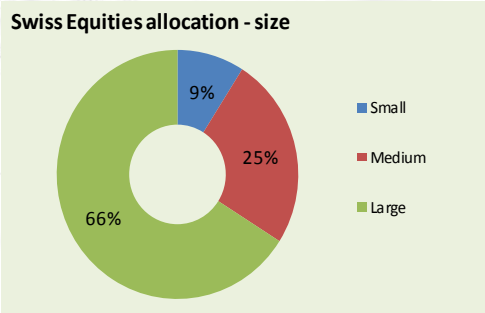
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Swiss Equities

- Historically strong performance and valuations
- Defensive nature may still be attractive to international investors
- Absence of alternative does not justify overweighting the sector

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



Tactical Allocation

- Overweight mid-sized capitalizations
- Decrease exposure to « ultra blue chips »

Historically strong performance and valuations

In 2019, Swiss equities almost kept pace with US equities (+31.48%), increasing by +30.59% in local currencies. Expressed in Swiss francs, however, this performance places the SPI index ahead of the S&P 500 in annual rankings. This outperformance was mainly achieved at the start of the year since Swiss stocks performed less strongly in the last quarter, losing close to 4% on a relative basis at the end of the year.

The Swiss market benefitted from improvements in the stock market climate without suffering the negative effects of the rising franc during the period, a factor that is usually negative for earnings prospects. Swiss equities' performance in 2019 is absolutely exceptional on a historical level. Indeed, only 2015 was better (+35.6%) in the last 20 years. The excellent behaviour of Swiss stocks quickly erased the negative results of Q4 2018, continuing on a positive trend in Q2 before stabilising during the summer and benefitting further from the absence of alternatives for investors at the end of the year.

At the start of this new year, the Swiss market's PE of 25x is one of the highest among developed markets. It exceeds by 25% the valuation of European stocks, which are nevertheless trading at 20.3x, slightly less than the S&P 500's 21.6x. For 2020, these ratios drop to 16.8x for Switzerland, 14.5x for Europe and 18.6x for the US. Based on this, the Swiss market is trading at a discount to the US market and at a premium to European markets.

Consensus earnings growth estimates are above +10% for 2020, which we believe is a little high in a clearly weaker global economic growth context. A weak Swiss franc would be a favourable factor, however. The price/earnings ratio of the Swiss market is rather generous in this context, and at 16.8x expected earnings for 2020, these valuation levels lie between 15% and 20% above the historical average. In the absence of any investment alternative, the dividend yield may still be a driving factor for equities. Nevertheless, we recommend a more defensive strategy due especially to the high valuation levels.

Defensive nature of the Swiss market may still be attractive to international investors

Despite high valuations, the Swiss market continues to benefit from certain advantages that might well enable it to remain among the best performers in developed markets in 2020. Indeed, in the current economic and political context, Swiss equities have preserved a few essential advantages.

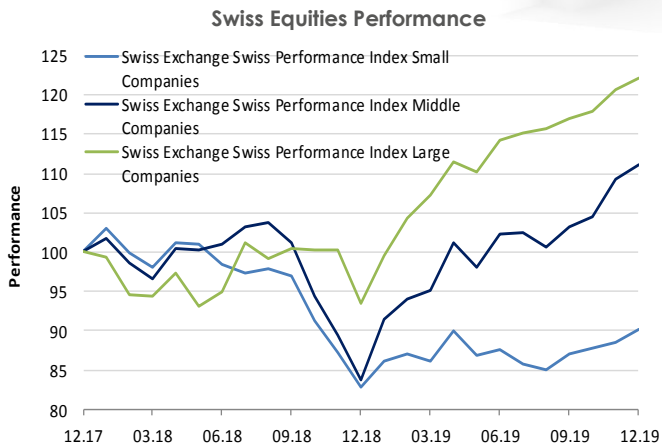
The Swiss market is usually perceived as a defensive market, especially due to the weight of its three main blue chips, Novartis, Roche and Nestlé. The pharmaceutical and food sectors are classic defensive segments that may still appeal in 2020 to investors and strategists looking for positions in solid defensive stocks. A selection process seeking high-quality, defensive blue chips offering attractive dividend yields in a traditionally strong currency is unlikely to overlook the Swiss market.

The current context of low rates and weak growth will continue to lead investors in 2020 to seek alternatives to bonds by increasing risk taking and equity allocations. However, they will have to be more selective and attentive to the stocks in their equity portfolios. In that sense, a more significant equity allocation should logically include more defensive securities. The Swiss market offers a significant number of stocks whose capacity to generate cash flow is high by international standards. Swiss companies are well managed, enjoy a stable political environment and are often leaders in their respective fields, and these very characteristics, as well as the visibility of their earnings growth, are likely to make them attractive to international investors.

Finally, the Swiss market's current dividend yield of close to 3% exceeds the dividend yield of the S&P 500 (1.8%) and the Nikkei (1.9%) and is similar to the dividend yield of the Euro Stoxx 50 (3.2%). It is thus a factor favouring an overweight exposure to Swiss equities in a globally diversified equity allocation.

SWISS EQUITIES - Capitalization

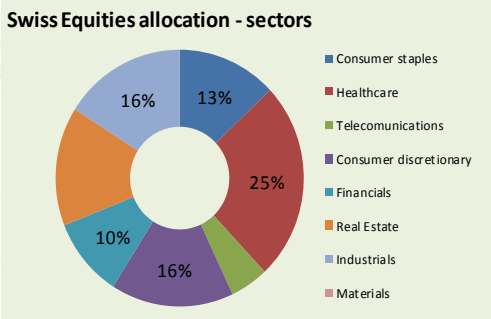
31.12.2019		Total Return Performance				
Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
SPI SWISS PERFORMANCE IX	12837.5	-0.9	1.3	4.9	7.2	30.6
SPI SMALL COMPANIES INDX	24984.8	0.2	1.9	3.7	2.9	8.9
SPI MIDDLE COMPANIES IDX	18384.4	-0.4	1.5	7.6	8.6	32.7
SPI LARGE COMPANIES INDX	12207.3	-1.1	1.2	4.4	7.0	30.7



Graph sources: Bloomberg/BBGI Group

Swiss Equities - Sectors

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



Tactical Allocation

- Underweight consumer staples and Healthcare sectors in favour of cyclical stocks
- Overweight consumer discretionary sector

Limited growth prospects for prices in 2020

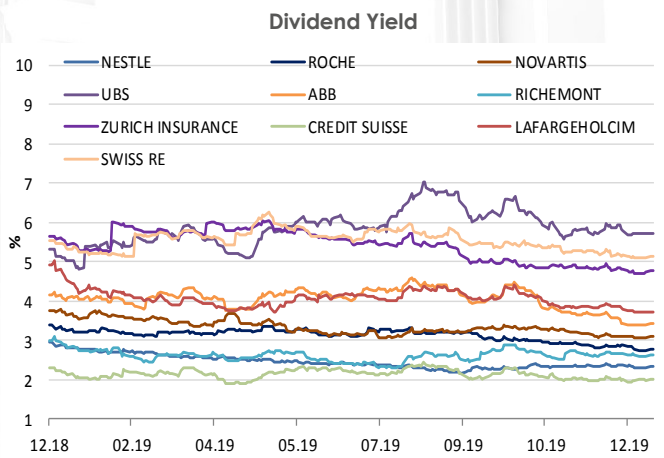
As the year kicks off, SMI stocks seem to have a more reduced margin for growth after their rise in December. In the last few weeks, only four stocks among the SMI's 20 have seen their 12-month average target price adjusted upward. Gradual revisions of earnings prospects in 2020 have thus not significantly modified price growth targets. Overall, the price growth target for the SMI's 20 stocks is below +4% for the three main blue chips and below +1.5% for the other stocks taken as a whole.

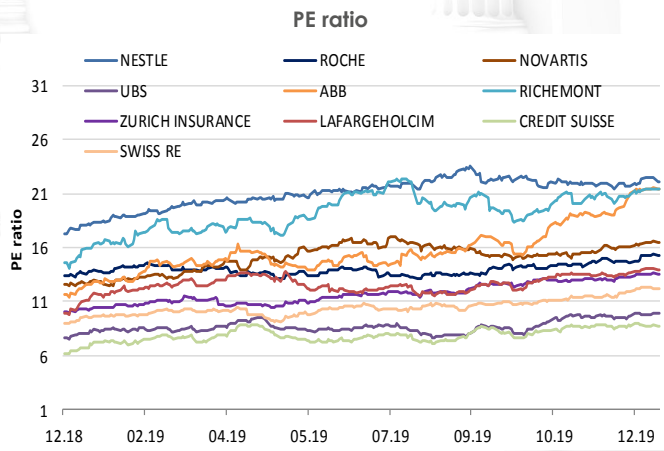
In other words, the SMI index currently already seems to have reached its 12-month average price target considering earnings growth expectations in 2020. Among the four stocks that held out attention in our previous Investment Strategy, Sika posted the best performance of the SMI with a +24.55% quarterly rise. Lafarge also achieved satisfactory results (+9.3%), posting the fifth best performance and clearly outperforming the SMI index (+5.3%).

We recommend limiting exposure to the Sika stock, which has reached our valuation target. Expected price growth for Lafarge, Swatch and Richemont is still above that of the market. These three stocks offer attractive prospects and remain our preferred choice. The bottom-up approach also favours two stocks from the banking sector with expected price growth of approximately +10%.

Dividend yield remains a selection factor

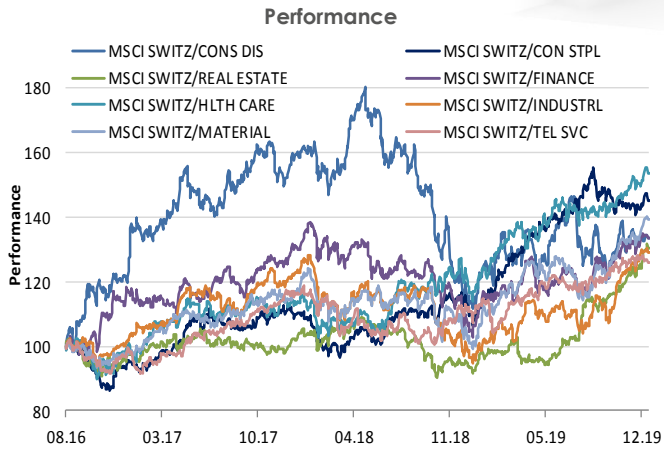
Dividend yields for the SMI (2.9%) and SPI (2.7%) remain high and attractive in the current context of persistently low rates. Quality high-yield stocks will still be sought after by investors in 2020. Among Switzerland's three ultra blue chips, Novartis' yield (3.1%) remains significant and superior to that of Roche (2.75%) and Nestlé (2.37%). The financial sector continues to offer the best yields in the market, often in excess of 4%. This factor will remain significant in the stock selection process.





SWISS EQUITIES - BY SECTOR

31.12.2019		Total Return Performance				
Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
MSCI SWITZ/CONS DIS	280.9	-0.7	-0.9	4.3	-3.9	15.9
MSCI SWITZ/CON STPL	345.1	-1.6	0.9	-2.8	3.9	34.1
MSCI SWITZ/FINANCE	60.5	-0.7	1.1	6.1	10.4	25.7
MSCI SWITZ/HLTH CARE	184.9	-0.9	0.8	6.3	7.7	31.2
MSCI SWITZ/INDUSTRL	197.0	-0.6	2.8	13.8	14.6	32.7
MSCI SWITZ/MATERIAL	341.7	-0.6	3.8	12.5	10.1	37.3
MSCI SWITZ/REAL ESTATE	1302.5	0.2	6.0	14.6	31.3	40.7
MSCI SWITZ/TEL SVC	96.9	-0.7	-1.0	4.1	4.6	14.3



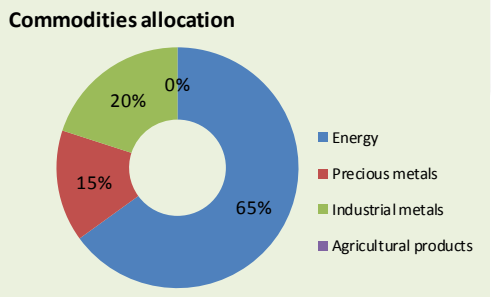
Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Commodities

- Prospects still positive in 2020
- New increases in Brent crude and WTI oil prices to $70
- Rising gold prices and outperformance of silver
- Industrial metals to perk up soon

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



Tactical Allocation

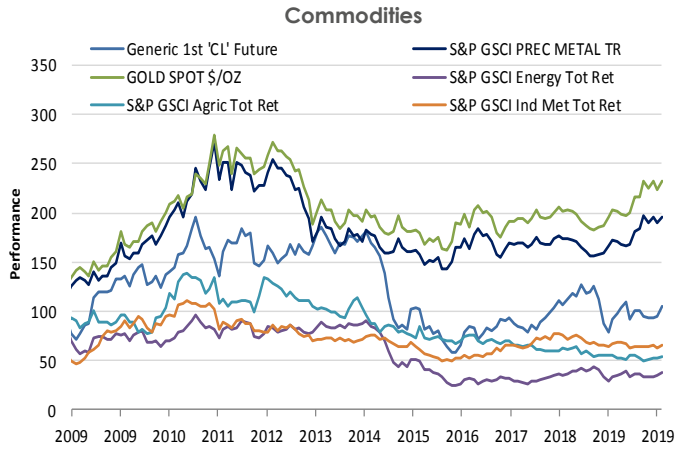
- Overweight energy, precious and industrial metals
- Underweight agricultural products

+17.6% increase in commodities thanks to energy and precious metals

Commodities did very well in 2019 as indicated by the +17.63% increase in the S&P Goldman Sachs Commodity index. This excellent result happened in a financial context that over the year was all-too-often affected by risks of recession or at least of a global economic slump. The consensus forecast, rather pessimistic in terms of economic growth, turned out to be substantially incorrect in 2019, since global growth, albeit slightly weaker, remained rather resilient and relatively robust. In this context, the increase in commodities will appear as a surprise for some, even though it is true that part of the increase took place in the last quarter (+8.31%), when prospects of an agreement between China and the US somewhat diminished uncertainty and economic risks.

In our previous Investment Strategy, we mentioned that this type of development in the China-US crisis would have a positive impact on commodities and on oil prices in particular. Indeed, this segment of the commodity market benefitted the most from the reduced tension between the two economic partners, posting a +29.69% yoy increase (+11.53% in the last quarter). Precious metals also benefitted at the end of the year (+3.49%) from the inflow of liquidity into the market following the US Fed's fairly massive injections, pushing the precious metals segment up by +17.62%.

In 2019, commodities thus posted a strong performance, slightly weaker than that of real estate but still very much welcome given the late cycle context and forecasted recession. A fairly wide spread of results can be seen among the various components of the global indices. While energy and precious metals posted excellent performances, industrial metals (+2.59%) and agricultural products (-0.34%) remained largely excluded from the general enthusiasm for this asset class.



Graph sources: Bloomberg/BBGI Group

Prospects still positive for 2020

Commodities have not yet benefitted enough from the change in the global economic outlook and scenario, although the signature of phase 1 in the agreement between China and the US at the beginning of the year is likely to mark a new stage in the negotiations initiated by the US president. In this election year, we now believe that Donald Trump will likely be satisfied with this agreement for a while and will avoid opening new negotiations that might compromise the favourable situation in both economic and political terms. A truce for a few quarters will help reduce uncertainty and find a little more serenity in the assessment of growth prospects. These remain weak after the latest waves of revisions by economists, but we reckon on the contrary that positive surprises will likely accompany upwards revisions in expectations over the next few months.

China's economy in particular in likely to see its manufacturing sector strengthen progressively and its industry recover in the next few months. Commodities will then benefit from a more positive news flow for industrial metals and the energy segment. As for precious metals, the recent increase in gold prices to above $1,600/ounce (target mentioned in our previous Investment Strategy) was quick and boosted by a resurgence of geopolitical risks at the start of the year. Nevertheless, precious metals are also likely to benefit from a better economy, silver in particular, which will undoubtedly outperform gold prices in 2020 during the next growth phase. Energy prices have been penalised by expectations of falling demand, but we believe on the contrary that demand will remain strong in 2020. WTI oil prices are likely to consolidate temporarily above the $60/barrel target mentioned in our previous Investment Strategy before progressing once again and nearing $70-75.

COMMODITIES (USD)

31.12.2019				Total Return Performance				
	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
	MSCI Daily TR Net World USD	6909.66	USD	0.31	3.00	8.56	9.14	27.67
GLOBAL	S&P GSCI Tot Return Indx	2591.9	USD	0.1	7.0	8.3	3.8	17.6
WTI CRUDE	Generic 1st 'CL' Future	61.1	USD	-0.1	10.7	12.9	4.4	34.5
BRENT OIL	Generic 1st 'CO' Future	66.0	USD	-1.8	5.7	8.6	-0.8	22.7
NATURAL GAS	Generic 1st 'NG' Future	2.2	USD	0.8	-4.0	-6.1	-5.2	-25.5
OR	GOLD SPOT $/OZ	1517.3	USD	1.2	3.6	3.0	7.6	18.3
ARGENT	Silver Spot $/Oz	17.9	USD	0.3	4.8	5.0	16.6	15.2
AGRICULTURE	S&P GSCI Agric Indx Spot	301.9	USD	1.4	4.6	7.5	1.2	6.3
INDUSTRIAL METALS	S&P GSCI Ind Metal Spot	324.2	USD	-0.7	3.1	1.4	1.2	1.5

New increases in Brent crude and WTI oil prices to 70$

At the start of the year, the oil market is still relatively unaffected by the likely emergence, in our minds, of a more positive global economic growth scenario, in particular in emerging markets. Expectations of demand growth of approximately 1 mbd for 2020 had been reduced in the context of a likely economic slowdown and have not changed.

In terms of demand and supply equilibrium, the oil market is likely to stabilise once again in 2020 with demand corresponding to actual production capacity. However, account must be taken of OPEC's recent decision to reduce its production by 500k bpd, which could lead to a supply deficit during the year of several hundred thousand barrels per day. In 2020, oil prices will be affected by three main variables, including shale oil production in the US, compliance with OPEC's production cuts, and the resurgence of geopolitical tensions. In the last few days, the geopolitical situation in the Middle East has become more tense between Iran and the US, and we should not overlook the risks of it escalating or spinning out of control.

On a political level, higher probabilities of an event occurring that might raise real concern and have a tangible impact on oil prices and supply must be factored in. Iran might try to disrupt Iraq's oil production in the next few weeks and destabilise the market over the longer term. Iraq is unlikely to have the same response capacity as Saudi Arabia when the latter was attacked by Iran a few weeks ago. Given this incapacity, the impact of such an action on crude oil prices would certainly be more powerful and long-lasting.

We believe traders are not currently really taking these risks into consideration. With regards to shale oil production, the trend remains positive, but we have doubts regarding the sector's capacity to sustain its production growth. Overall, we believe that oil prices may reach $70-75 for WTI with a stable premium of $5 for WTI over Brent.

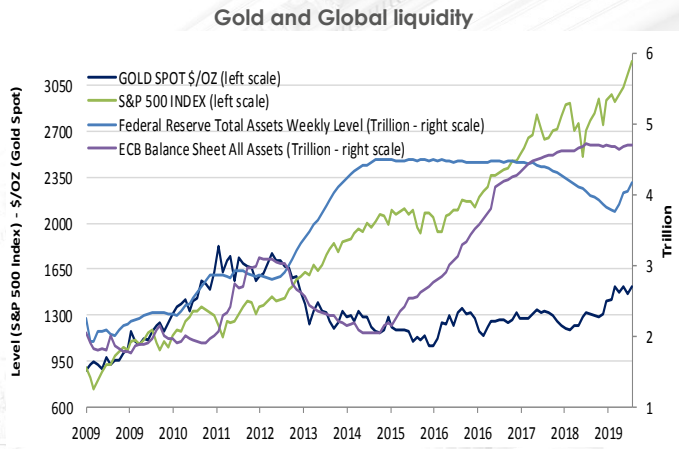
Rising gold prices and outperformance of silver

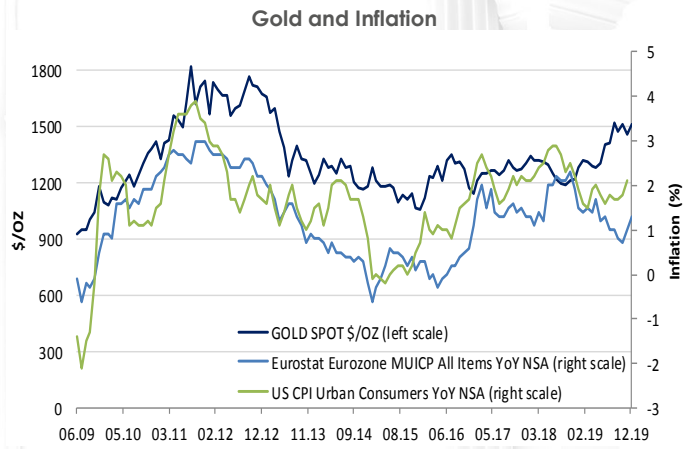
Following the fairly impressive increase in gold prices between June and August, gold logically entered a phase of consolidation at around $1,500 an ounce. The massive quantitative easing in the following months did not trigger any reaction in precious metals until an acceleration in prices took hold at the end of the year, then further exacerbated by the crisis in the Middle East. Investment demand for physical gold measured by the total amount of gold held by ETFs has remained stable, however, oscillating only marginally between 81 and 82 million ounces in the last quarter.

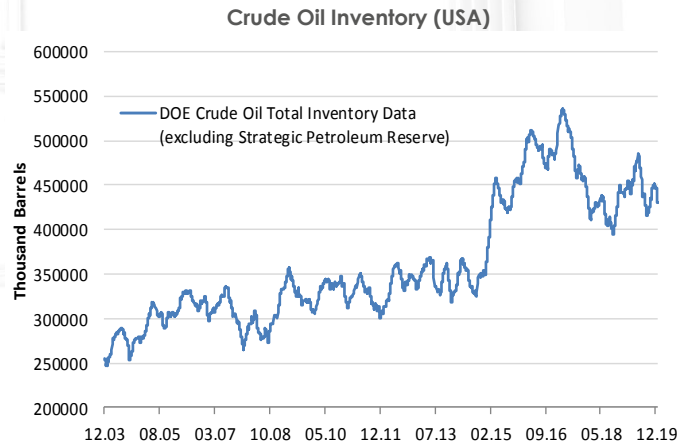
The above-mentioned crisis had no impact on this vector in January. In 2020, we believe that gold prices will likely be supported by a recovery in investment demand triggered by a desire to hedge against the risks of an increase in volatility in financial markets after a clearly exceptional 2019. Silver prices came close to our intermediate target of $20 in September and have been consolidating since. They will undoubtedly require better economic statistics to exceed this level during the year.

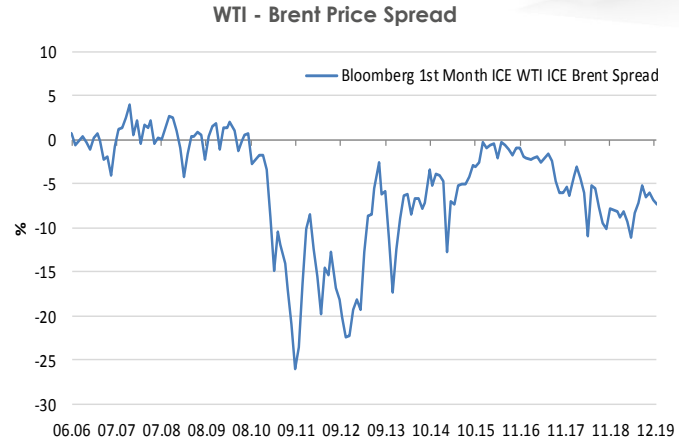
Industrial metals to perk up soon

Industrial metal prices have not yet really reacted to the improvement in the global economic scenario and in the Chinese manufacturing sector. Indeed, industrial metal indices are still very close to the levels reached in 2018 after the drop in prices triggered by the collapse of manufacturing PMI indices. Since this approximately -20% drop, the industrial metal segment has seemed totally inert and unresponsive to positive news. A price adjustment is likely in 2020.









Graph sources: Bloomberg/BBGI Group

PROSPECTS AND STRATEGIES

Hedge Funds

- Steepest rise of the decade

Steepest rise of the decade

Hedge funds continued to trend upwards in the fourth and last quarter of the year (+2.6%), thus completing a series of four positive quarters for an annual increase of +8.6%, the best performance in the last ten years. The different management styles closed the year in positive territory albeit with relatively heterogeneous results.

Indeed, while the macro/CTA (+4.8%) and relative value arbitrage (+6.6%) strategies posted lower gains than that of the overall index, the equity hedge and event-driven strategies posted results of +10.7% and +10.0%, respectively.

Private Equity

- Private equity rises by +45% in 2019

Private equity rises by +45% in 2019

Despite an already significant increase in the first nine months of the year (+36.2%), private equity rose further between September and December (+6.1%), posting results exceeding +40% for 2019 as a whole (+44.61%). Private equity is thus the best performer of all asset classes in 2019 and, much like hedge funds, posted its best performance since 2009.

From a geographical standpoint, the UK (+9.7%) came ahead of the US (+5.8%) and Europe (+5.0%) over the quarter, while over the full year, the US (+48.1%) performed better than Europe (+32.6%) and the UK (+31.4%).

HEDGE FUND INDICES (USD)

31.12.2019

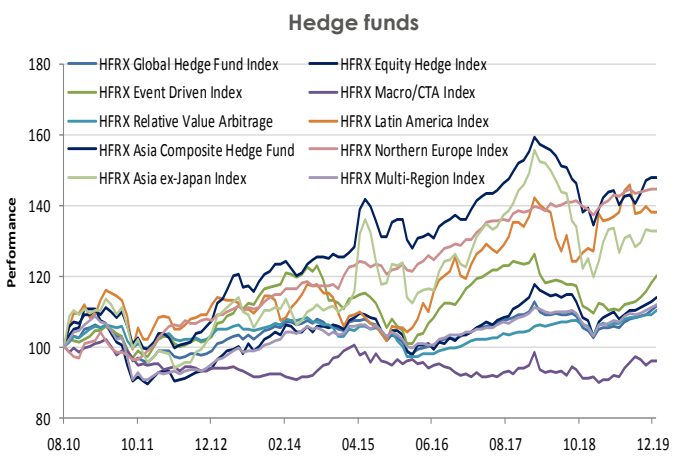
	Name	Last price	Curr.	Total Return Performance 7 d %	1 m %	3 m %	6 m %	YTD %
GLOBAL	HFRX Global Hedge Fund Index	1292.4	USD	0.1	1.2	2.6	4.2	8.6
EQUITY HEDGE	HFRX Equity Hedge Index	1274.4	USD	0.1	1.2	2.6	4.5	10.7
EVENT DRIVEN	HFRX Event Driven Index	1617.8	USD	0.3	2.0	5.4	7.3	10.0
MACRO/CTA	HFRX Macro/CTA Index	1180.6	USD	-0.2	0.3	-0.2	2.2	4.8
RELATIVE VALUE ARBITRAGE	HFRX Relative Value Arbitrage	1247.7	USD	0.3	1.0	1.6	2.3	6.6
LATIN AMERICA*	HFRX Latin America Index	2359.9	USD	-	4.7	4.9	0.3	13.9
ASIA COMPOSITE*	HFRX Asia Composite Hedge Fund Index	2458.4	USD	-	3.1	6.3	6.9	13.4
NORTHERN EUROPE*	HFRX Northern Europe Index	2113.3	USD	-	1.2	1.8	1.7	6.6
ASIA EX-JAPAN*	HFRX Asia ex-Japan Index	2594.7	USD	-	3.6	6.1	5.1	14.9
MULTI-REGION	HFRX Multi-Region Index	1395.5	USD	0.1	1.0	2.3	3.1	8.6

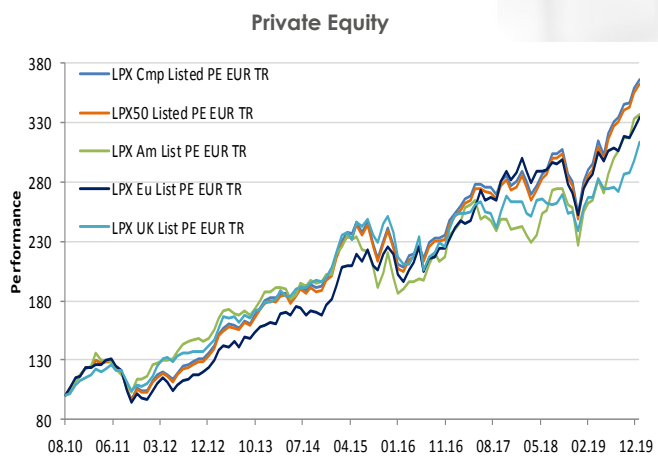
* Subject to one-month lag

PRIVATE EQUITY INDICES (EUR)

31.12.2019

	Name	Last price	Curr.	Total Return Performance 7 d %	1 m %	3 m %	6 m %	YTD %
COMPOSITE	LPX Cmp Listed PE EUR TR	304.6	EUR	-0.2	1.9	6.1	14.3	44.6
MAJOR COMPANIES	LPX50 Listed PE EUR TR	2870.7	EUR	-0.2	1.9	6.2	14.5	45.4
USA	LPX Am List PE EUR TR	447.6	EUR	-1.0	0.8	5.8	17.5	48.1
EUROPE	LPX Eu List PE EUR TR	1070.0	EUR	0.5	3.1	5.0	9.1	32.6
UK	LPX UK List PE EUR TR	351.3	EUR	1.2	5.4	9.7	14.3	31.4





Graph sources: Bloomberg/BBGI Group

GLOBAL STRATEGY & ASSET ALLOCATION

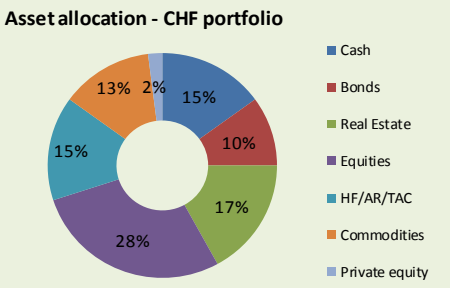
Graph sources: Bloomberg/BBGI Group

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - CHF

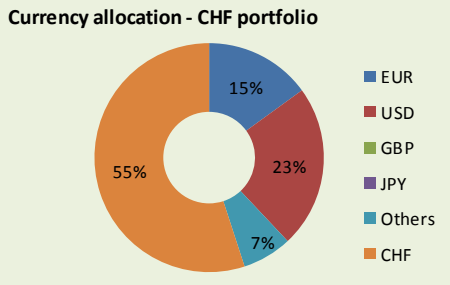
- Overweight USD bonds and short maturities
- Real estate yields remain attractive
- Reduce equity allocations
- Overweight commodities

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



Tactical Allocation

- More conservative strategy
- Underweight equities and favor liquidity (CHF, USD and EUR)



Asset allocation

Our investment strategy focuses on traditional liquid assets (cash, bonds, equities and real estate), supplemented with other diversified and tradable assets (commodities, hedge funds, private equity).

Bonds

Rate markets undoubtedly reached an inflection point during the crisis in the summer of 2019 and suffered a few upwards adjustments in long-term rates. After a long-feared recession had still not materialised some 15 months later, better economic prospects will inevitably have a negative impact on long-term rates. We believe long-term rates will gradually adjust to a more ordinary reality, in which the risks of recession are receding. Yield curves are expected to normalise.

The context that will prevail in 2020 will leave little room for capital gains. Nominal yields in US, Canadian and Australian dollars as well as in pounds remain weakly positive. We are overweight these markets within the developed market segment. Emerging bonds are still relatively attractive compared to high-yield bonds. We recommend a cautious bond strategy and reduced global exposure favouring US dollar investments and short maturities.

Equities

Equity markets performed exceptionally well in 2019, which is unlikely to reoccur in 2020. Valuation levels are now high in historical comparison due to the disparity between stock performance and real corporate earnings growth. Equity markets appear weakened by these extreme valuations similar to those in 1999, which preceded the drop in stock prices in the following years. The continuous rise in prices is too dependent on changes in global liquidity and monetary injections. We recommend reduced exposure to equities pending better opportunities.

Commodities

At the start of 2020, the signature of phase 1 of the trade agreement between China and the US is likely to be followed by a truce that should lead to better economic prospects. An upturn in growth will be favourable to oil and industrial materials, which will benefit from this trend. We believe an increase in gold and silver positions is appropriate in the context of higher volatility risks that could materialise in equity markets.

Real estate

Real estate still remains the main alternative to rate markets. The returns are attractive, and the risks of price corrections induced by a rate increase seem weak in our view, in a context of real yields that are often negative. Our strategy favours Swiss real estate, and at the international level, Europe and Asia. However, in the short term, the rise in premiums may limit global performance to direct yields only.

Currencies

Changes in monetary policies are unlikely to radically affect interest rate differentials to the extent that rates are likely to follow a similar path as in the US. Nevertheless, the US dollar remains the favourite currency both because of this differential against the Swiss franc and due to the higher likelihood of an economic upturn. The franc is also likely to begin a phase of weakness against the euro.

Market performances - Q4 2019

Exchange rates	Q4 2019 local	Q4 2019 CHF	YTD local	YTD CHF
USD/CHF	-3.1%		-1.6%	
EUR/CHF	-0.2%		-3.5%	
GBP/CHF	4.6%		2.4%	
JPY/CHF	-3.5%		-0.6%	

Interest rates (3 months)	(level)
CHF	-0.69%
EUR	-0.41%
USD	1.91%
JPY	-0.05%

Equity markets		Q4 2019 local	Q4 2019 CHF	YTD local	YTD CHF
World	MSCI World USD	8.6%	5.2%	27.7%	25.7%
Europe	DJ Stoxx 600	6.1%	5.9%	26.8%	22.3%
Eurozone	DJ Eurostoxx 50	4.9%	4.7%	24.8%	20.4%
	MSCI Europe S.C.	11.4%	11.2%	28.4%	23.8%
Germany	Dax 30	6.6%	6.4%	25.5%	21.0%
France	Cac 40	5.3%	5.1%	26.4%	21.9%
United Kingdom	FTSE 100	1.8%	6.5%	12.1%	14.8%
Switzerland	SPI	4.9%	4.9%	30.6%	30.6%
	SMI	5.3%	5.3%	26.0%	26.0%
	MSCI Swiss S.C.	11.9%	11.9%	28.5%	28.5%
North America	SP500	8.5%	5.2%	28.9%	26.8%
	Nasdaq	12.2%	8.7%	35.2%	33.1%
	Tse 300	2.4%	1.2%	19.1%	23.2%
	SP600 Small C.	7.8%	4.4%	20.9%	19.0%
Japan	Nikkei 225	8.7%	4.9%	18.2%	17.5%
Emerging	MSCI EMF USD	11.4%	7.9%	15.4%	13.6%

Bonds markets		Q4 2019 local	Q4 2019 CHF	YTD local	YTD CHF
World	Citi Gr Global Govt USD	-0.4%	-3.5%	5.9%	4.2%
Europe	Euro Ser-E Gov > 1	-3.0%	-3.1%	6.8%	3.0%
United Kingdom	UK Ser-E Gov > 1	-4.2%	0.2%	7.1%	9.8%
Switzerland	SBI Général AAA-BBB	-1.7%	-1.7%	3.0%	3.0%
	SBI Govt	-3.3%	-3.3%	4.5%	4.5%
USA	US Ser-E Gov > 1	-0.8%	-3.9%	6.9%	5.2%
Japan	Japan Ser-E Gov > 1	-1.2%	-4.7%	1.7%	1.1%
Emerging	J.P. Morgan EMBI Global	2.1%	-1.1%	14.4%	12.6%

Miscellaneaous		Q4 2019 local	Q4 2019 CHF	YTD local	YTD CHF
	LPP 25 Index	0.0%	0.0%	8.8%	8.8%
	LPP 40 Index	1.1%	1.1%	12.4%	12.4%
	LPP 60 Index	2.5%	2.5%	17.0%	17.0%
Real Estate CH	DB RB Swiss Real Est Fd	5.2%	5.2%	22.0%	22.0%
Hedge Funds	Hedge Fund Research USD	1.9%	-1.3%	5.3%	3.7%
Commodities	GS Commodity USD	8.3%	4.9%	17.6%	15.8%

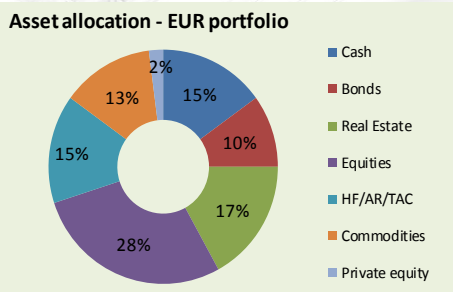
Graph sources: Bloomberg/BBGI Group

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - EUR

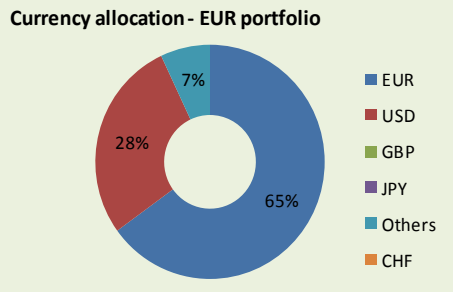
- Overweight USD bonds and short maturities
- Real estate yields remain attractive
- Reduce equity allocations
- Overweight commodities

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

- More conservative strategy
- Underweight equities and favor liquidity (USD and EUR)



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The context that will prevail in 2020 will leave little room for capital gains. Nominal yields in US, Canadian and Australian dollars as well as in pounds remain weakly positive. We are overweight these markets within the developed market segment. Emerging bonds are still relatively attractive compared to high-yield bonds. We recommend a cautious bond strategy and reduced global exposure favouring US dollar investments and short maturities.

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Equity markets performed exceptionally well in 2019, which is unlikely to reoccur in 2020. Valuation levels are now high in historical comparison due to the disparity between stock performance and real corporate earnings growth. Equity markets appear weakened by these extreme valuations similar to those in 1999, which preceded the drop in stock prices in the following years. The continuous rise in prices is too dependent on changes in global liquidity and monetary injections. We recommend reduced exposure to equities pending better opportunities.

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Real estate still remains the main alternative to rate markets. The returns are attractive, and the risks of price corrections induced by a rate increase seem weak in our view, in a context of real yields that are often negative. Our strategy favours Swiss real estate, and at the international level, Europe and Asia. However, in the short term, the rise in premiums may limit global performance to direct yields only.

Currencies

Changes in monetary policies are unlikely to radically affect interest rate differentials to the extent that rates are likely to follow a similar path as in the US. However, the US dollar remains the favoured currency due both to its generally positive differential against other currencies and to stronger economic momentum. Diversification outside the euro is justified by the absence of yield on the European currency.

Market performances - Q4 2019

Exchange rates	Q4 2019 local	Q4 2019 EUR	YTD local	YTD EUR
USD/EUR	-2.8%		2.3%	
CHF/EUR	0.2%		3.9%	
GBP/EUR	4.9%		6.3%	
JPY/EUR	-3.3%		3.2%	

Interest rates (3 months)	(level)
CHF	-0.69%
EUR	-0.41%
USD	1.91%
JPY	-0.05%

Equity markets		Q4 2019 local	Q4 2019 EUR	YTD local	YTD EUR
World	MSCI World USD	8.6%	5.5%	27.7%	30.6%
Europe	DJ Stoxx 600	6.1%	6.1%	26.8%	26.8%
Eurozone	DJ Eurostoxx 50	4.9%	4.9%	24.8%	24.8%
	MSCI Europe S.C.	11.4%	11.4%	28.4%	28.4%
Germany	Dax 30	6.6%	6.6%	25.5%	25.5%
France	Cac 40	5.3%	5.3%	26.4%	26.4%
United Kingdom	FTSE 100	1.8%	6.8%	12.1%	19.2%
Switzerland	SPI	4.9%	5.2%	30.6%	35.6%
	SMI	5.3%	5.6%	26.0%	30.8%
	MSCI Swiss S.C.	11.9%	8.8%	28.5%	31.4%
North America	SP500	8.5%	5.5%	28.9%	31.8%
	Nasdaq	12.2%	9.0%	35.2%	38.3%
	Tse 300	2.4%	1.5%	19.1%	27.9%
	SP600 Small C.	7.8%	4.7%	20.9%	23.6%
Japan	Nikkei 225	8.7%	5.1%	18.2%	22.0%
Emerging	MSCI EMF USD	11.4%	8.2%	15.4%	18.0%

Bonds markets		Q4 2019 local	Q4 2019 EUR	YTD local	YTD EUR
World	Citi Gr Global Govt.USD	-0.4%	-0.1%	5.9%	10.0%
Europe	Euro Ser-E Gov > 1	-3.0%	-3.0%	6.8%	6.8%
United Kingdom	UK Ser-E Gov > 1	-4.2%	0.5%	7.1%	13.9%
Switzerland	SBI Général AAA-BBB	-1.7%	-1.5%	3.0%	7.0%
	SBI Govt.	-3.3%	-3.1%	4.5%	8.5%
USA	US Ser-E Gov > 1	-0.8%	-3.6%	6.9%	9.3%
Japan	Japan Ser-E Gov > 1	-1.2%	-4.5%	1.7%	5.0%
Emerging	J.P. Morgan EMBI Global	2.1%	-0.8%	14.4%	17.0%

Miscellaneaous		Q4 2019 local	Q4 2019 EUR	YTD local	YTD EUR
	LPP 25 Index	0.0%	3.8%	8.8%	13.0%
	LPP 40 Index	1.1%	5.0%	12.4%	16.7%
	LPP 60 Index	2.5%	6.5%	17.0%	21.6%
Real Estate CH	DB RB Swiss Real Est Fd	5.2%	5.2%	22.0%	26.7%
Hedge Funds	Hedge Fund Research USD	1.9%	-1.0%	5.3%	7.7%
Commodities	GS Commodity USD	8.3%	5.3%	17.6%	20.3%

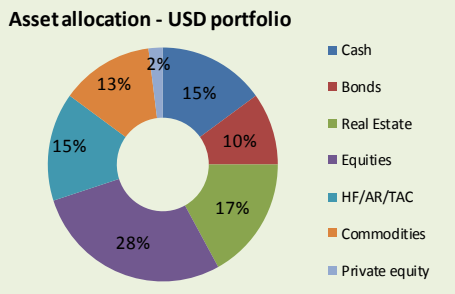
Graph sources: Bloomberg/BBGI Group

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - USD

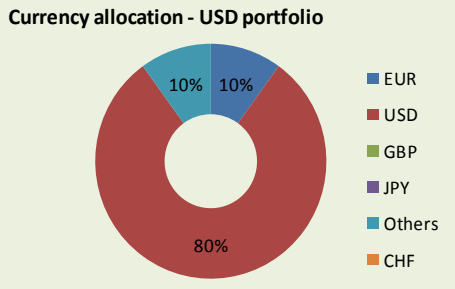
- Overweight USD bonds and short maturities
- Real estate yields remain attractive
- Reduce equity allocations
- Overweight commodities

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



Tactical Allocation

- Profit-taking on « risky » assets
- Underweight equities and bonds in favor of liquidity (USD)



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The context that will prevail in 2020 will leave little room for capital gains. Nominal yields in US, Canadian and Australian dollars as well as in pounds remain weakly positive. We are overweight these markets within the developed market segment. Emerging bonds are still relatively attractive compared to high-yield bonds. We recommend a cautious bond strategy and reduced global exposure favouring US dollar investments and short maturities.

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Equity markets performed exceptionally well in 2019, which is unlikely to reoccur in 2020. Valuation levels are now high in historical comparison due to the disparity between stock performance and real corporate earnings growth. Equity markets appear weakened by these extreme valuations similar to those in 1999, which preceded the drop in stock prices in the following years. The continuous rise in prices is too dependent on changes in global liquidity and monetary injections. We recommend reduced exposure to equities pending better opportunities.

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Currencies

Changes in monetary policies are unlikely to radically affect interest rate differentials to the extent that rates are likely to follow a similar path as in the US. However, the US dollar remains the favoured currency due both to its generally positive differential against other currencies and to stronger economic momentum. Diversification outside the dollar offers few prospects of yield and monetary gains.

Market performances - Q4 2019

Exchange rates	Q4 2019 local	Q4 2019 USD	YTD local	YTD USD
CHF/USD	3.1%		1.4%	
EUR/USD	2.9%		-2.2%	
GBP/USD	7.9%		3.9%	
JPY/USD	-0.5%		0.9%	

Interest rates (3 months)	(level)
CHF	-0.69%
EUR	-0.41%
USD	1.91%
JPY	-0.05%

Equity markets		Q4 2019 local	Q4 2019 USD	YTD local	YTD USD
World	MSCI World USD	8.6%	8.6%	27.7%	27.7%
Europe	DJ Stoxx 600	6.1%	9.2%	26.8%	24.0%
Eurozone	DJ Eurostoxx 50	4.9%	7.9%	24.8%	22.0%
	MSCI Europe S.C.	11.4%	14.6%	28.4%	25.5%
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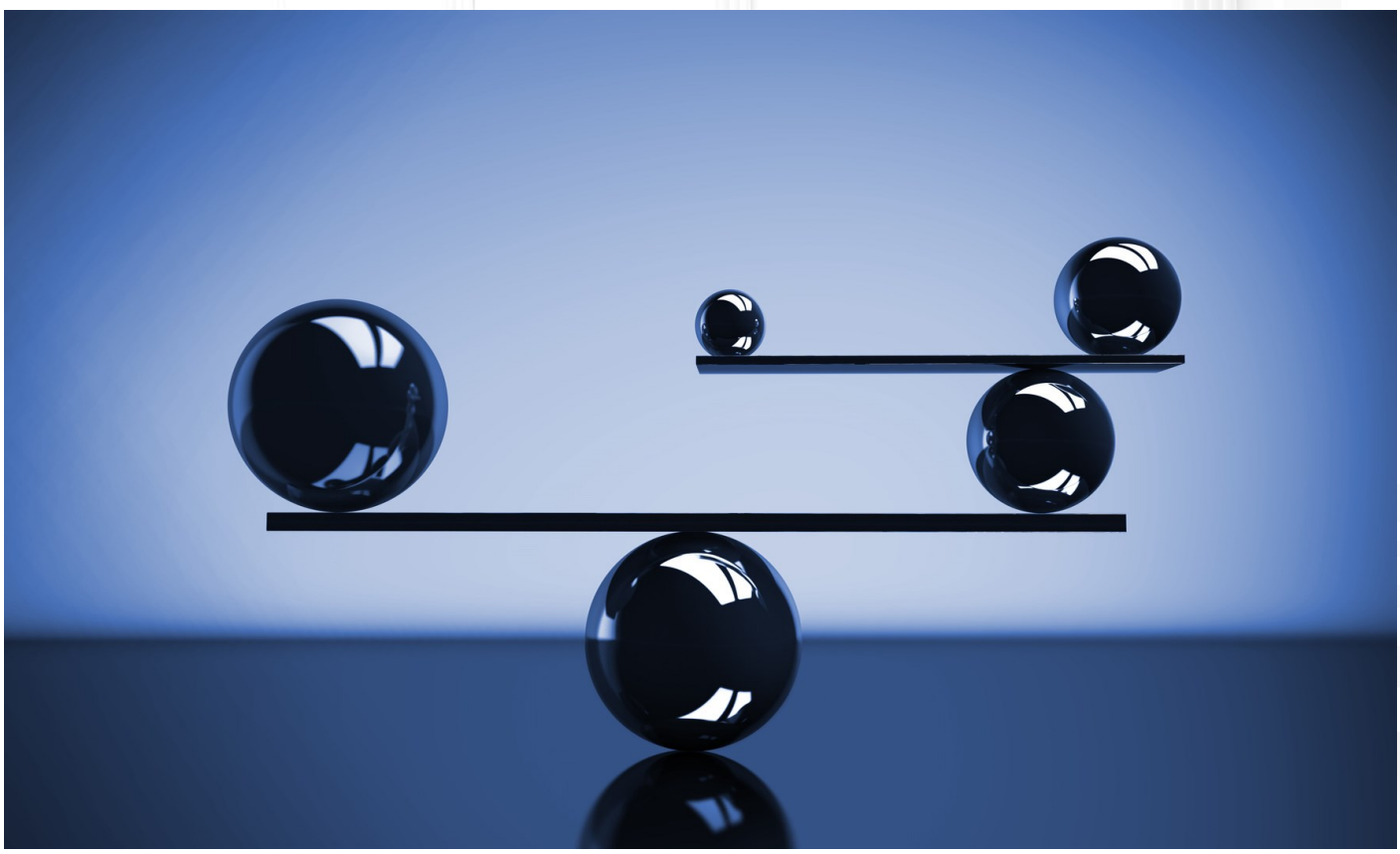
Switzerland	SPI	4.9%	8.2%	30.6%	32.5%
	SMI	5.3%	8.6%	26.0%	27.8%
	MSCI Swiss S.C.	11.9%	11.9%	28.5%	28.5%
North America	SP500	8.5%	8.5%	28.9%	28.9%
	Nasdaq	12.2%	12.2%	35.2%	35.2%
	Tse 300	2.4%	4.4%	19.1%	25.1%
	SP600 Small C.	7.8%	7.8%	20.9%	20.9%
Japan	Nikkei 225	8.7%	8.2%	18.2%	19.3%
Emerging	MSCI EMF USD	11.4%	11.4%	15.4%	15.4%

Bonds markets		Q4 2019 local	Q4 2019 USD	YTD local	YTD USD
World	Citi Gr Global Govt USD	-0.4%	2.8%	5.9%	7.4%
Europe	Euro Ser-E Gov > 1	-3.0%	-0.2%	6.8%	4.4%
United Kingdom	UK Ser-E Gov > 1	-4.2%	3.4%	7.1%	11.4%
Switzerland	SBI Général AAA-BBB	-1.7%	1.3%	3.0%	4.5%
	SBI Govt	-3.3%	-0.3%	4.5%	6.0%
USA	US Ser-E Gov > 1	-0.8%	-0.8%	6.9%	6.9%
Japan	Japan Ser-E Gov > 1	-1.2%	-1.8%	1.7%	2.6%
Emerging	J.P. Morgan EMBI Global	2.1%	2.1%	14.4%	14.4%

Miscellaneaous		Q4 2019 local	Q4 2019 USD	YTD local	YTD USD
	LPP 25 Index	0.0%	1.4%	8.8%	10.4%
	LPP 40 Index	1.1%	2.5%	12.4%	14.0%
	LPP 60 Index	2.5%	4.0%	17.0%	18.7%
Real Estate CH	DB RB Swiss Real Est Fd	5.2%	5.2%	22.0%	23.8%
Hedge Funds	Hedge Fund Research USI	1.9%	1.9%	5.3%	5.3%
Commodities	GS Commodity USD	8.3%	8.3%	17.6%	17.6%

Graph sources: Bloomberg/BBGI Group

INVESTMENT THEME FOCUS



Graph sources: Bloomberg/BBGI Group

INVESTMENT THEME

Financial market outlook and liquidity cycle in 2020

- 400 billion in cash injections in Q4
- Expansion or status quo in 2020?
- High earnings expectations
- Extreme equity valuations
- More risks than opportunities

Massive and questionable cash injections in Q4

At the start of 2020, it once again looks like most investors minded the old saying "Don't fight the Fed" in Q4 2019! Clearly, one had to brave the already high risk and valuation levels of financial assets at the end of Q3 to benefit from the positive effects on financial markets of the significant activity undertaken by the Federal Reserve at the end of the year with its massive cash injections.

In the last few months, the Fed has indeed relaunched its monetary activity by boosting the size of its balance sheet by more than USD 400 billion in a few weeks,i.e. more than 10% the total size of its balance sheet in record time, from 3.75 (end of August 2019) to 4.17 trillion dollars on 1 January 2020.

The debate consisting in determining whether or not this is a relaunch of QE (quantitative easing) is ultimately of limited interest, since the fact that the Fed has not massively bought Treasury bonds (formal definition of QE) but rather Treasury bills is only a technical matter.

In fact, the central bank has indeed injected an exceptional quantity of cash into the financial system, which at this point in the cycle should actually come as a surprise and raise questions among rational investors.

Indeed, the question arises of why the Fed deemed it necessary, or even essential, to inject such quantities of cash at the end of 2019, when its three -0.25% key rate cuts had certainly been sufficient to support an ultimately not-so-weakening economic situation in Q3 and Q4, with the real need for more QE thus not clearly justified. When these purchase operations began three months ago, one of the reasons invoked had been to ensure liquidity during the tax payment period, especially in mid-October, but these operations then continued until the beginning of 2020.

Moreover, in historical comparison, these 2019 purchases have no equivalent in previous years,enough to wonder about the soundness of the argument.

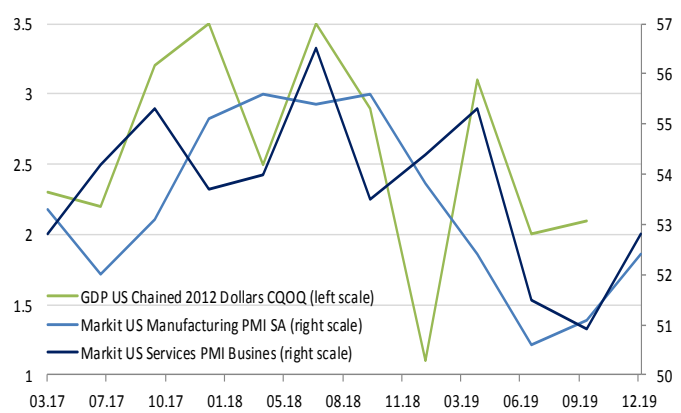
The question thus remains about the real justification of these activities, which actually helped reinitiate a new phase of appreciation in the price of equities and risky assets at the end of the year, while equity valuations were already flirting with historical extremes.

Might there be an issue in the market that the Fed has identified, pushing it to intervene in a state of near panic by providing liquidity that may have already been missing in the financial sector?

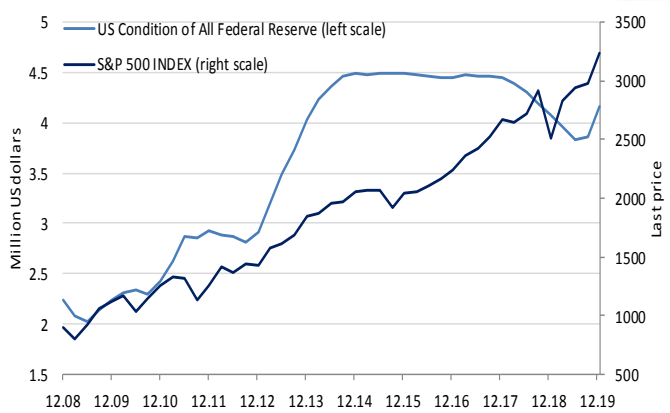
The repo market redistributes and provides liquidity essential for the fluidity of the financial system and the smooth flow of short-term trades between financial institutions, banks, insurance companies, etc. The central bank may have aimed to prevent this system, which represents close to a trillion dollars per day, from spinning out or seizing up.

More than ten years on, we still remember the impact in 2008 of how banks instantaneously mistrusted one another, which contributed to the rise of interbank rates and the financial crisis in 2008. Could the end of 2019 have been affected by a similar episode?

Evolution of US GDP and PMI indicators



Total FED's balance sheet / S&P500 index



Graph sources: Bloomberg/BBGI Group

Dangerous interdependency between markets and monetary policy

Has the Fed become the hostage of financial markets and vice-versa?

Be that as it may, financial markets have once again welcomed with enthusiasm the monetary injections at the end of 2019, as they actually have every time the economic cycle has been boosted by accommodative monetary policies. There is a very clear correlation between the Fed's actions and movements in equity markets since 2009. Hence, if the Fed has partly become hostage to financial markets, the latter have also become dependent on the Fed's injections.

The current relationship is thus a dependency that works both ways with the growing risks that this entails. The rise in markets depends on the cash injections, which also indirectly aim to create and boost a positive wealth effect to bolster consumption. This interdependency has not been denied by the Fed's former Chair Ben Bernanke, who acknowledged the explicit link when he mentioned that QE was meant to increase the price of financial assets to create a wealth effect favourable to consumption.

The central bank is now faced with a quasi-obligation to maintain an accommodative policy at the risk, if it did not, of once again brutally waking up investors who have become dependent over time. The Fed does not wish to expose itself to such a situation, now that it has experienced the risks of markets slumping, in the event that its normalisation policy were to be perceived as too aggressive, as was the case in Q4 2019.

It has now become a complex issue, of which the Fed is more aware, which is likely to prevent the bank from speeding up any future normalisation attempts. As we have mentioned several times, the Fed will prefer to delay any rate hikes as inflation rises, which will underlie its activity in 2020, an election year, moreover, during which the central bank is generally fairly inactive. The Federal Reserve may thus have hoped to act more massively before 2020 in order to avoid having to act at a later stage during the campaign.

Can the Fed prevent the speculative bubble it has created from bursting?

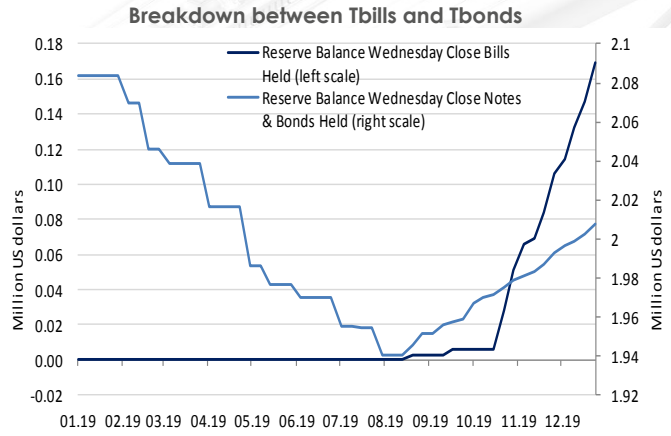
In an early 2020 context characterised by a weak probability of business fundamentals and earnings prospects improving in comparison with current expectations, the share price increases in the last few weeks are thus exclusively attributable to the rate cuts and monetary policy and have resulted directly in the further expansion of PEs and other market valuation measures.

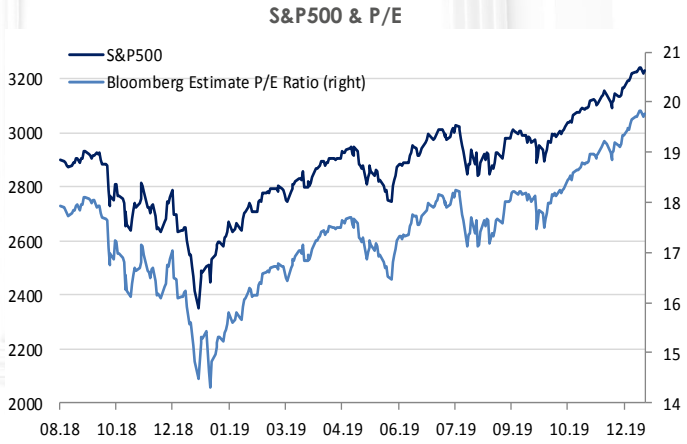
Hence, the Fed is contributing to the expansion of valuations, or in other words an overvaluation of financial assets, with no real possibility of dampening or limiting this effect. It is thus possible that the Federal Reserve may be realising that it is trapped in an impossible situation in which any normalisation attempt may cause a fall greater than that observed in Q4 2018 and where lack of action may encourage investors to take even more risks and drive market valuation levels higher still.

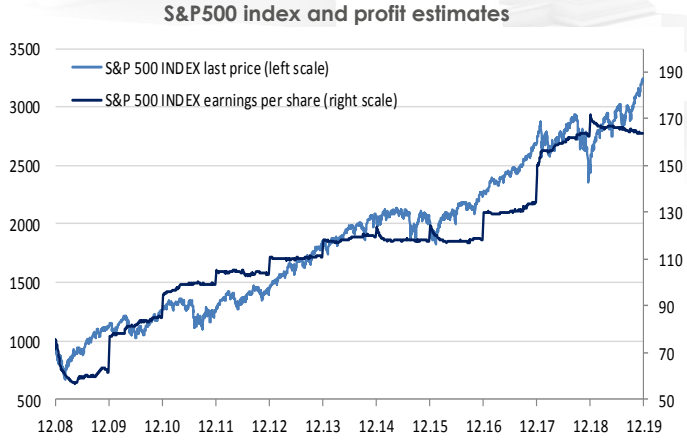
The longer this spiral lasts, the more likely it will end with the speculative bubble bursting, bubble which has expanded exponentially in the last few months. The growth rate of equity markets in the US is indeed in an acceleration phase characteristic of the end of a financial cycle.

After phases of consolidation and hesitation on already high valuation levels in the summer, the almost +10% increase over two months rests on nothing but the liquidity factor and is thus not supported by fundamental factors.

Hence, it is becoming difficult, if not impossible for the Fed to climb out of this situation without causing the crash that it is seeking to prevent by all means. By slowing its quantitative easing, it risks provoking further undesired market volatility. Yet, it will not be able to continue on this path indefinitely, especially if growth occurs in the first few months and quarters of 2020.







Graph sources: Bloomberg/BBGI Group

Are there any rational investors left in 2020?

The +10% increase in equities at the end of the year also seems to reflect a total capitulation of rational investors, the saying "Never fight the Fed" having undoubtedly pushed investors' enthusiasm for risky assets to the extreme, seeing as many likely found it unbearable to miss an opportunity to generate gains in a low-rate environment, as the Fed once again seems ready to offer a free "put", encouraging maximum risk-taking.

Private investors are largely invested and optimistic, traders' net long futures positions on most US indices are reaching new heights, the flow of funds into equity funds is once again high and complacency is once again present. Are there any rational investors left or have we all dropped our guard, no longer wanting to consider risks and focusing exclusively on opportunities?

One way of assessing the degree of euphoria of private investors is by looking at the CNN Fear and Greed Index, which has been very close to its maximum of 100 for a few weeks now. It had reached a high level of greed before the drop in equities in February 2018 and again in September.

However, other more serious measures, fundamental and rational ratios, underline the particularity of the current situation in financial markets and the extreme levels of risk that have now been reached.

Equity valuations are indeed at their highest historical levels according to various measures, which should come as a wake-up call for all rational investors who do not want to see the fate of their investments depend on the Fed's continued quantitative easing only.

As evidence of the extreme irrationality of the current situation, in comparison with the ratios that prevailed 20 years ago, right before the Internet bubble burst, the current valuation of the S&P 500 as measured by the enterprise value to EBITDA ratio has exceeded that which preceded the crash in 2000-2002.

The same goes for the sales to EBITDA ratio. Let us remember that the Fed had then also indirectly driven financial asset valuations upwards by injecting close to 100 billion dollars into the financial system to ward off the unknown potential risks relating to the Y2K issue.

In September 1999 the Fed's balance sheet only stood at USD 567 billion and had only increased by +17% to 668 billion. Liquidity inflated the speculative bubble, which quickly reached record height in the next quarter in 2000 before bursting in a three-year-long bear market that wiped out the previous two years of growth and close to -50% in market capitalisation.

After this peak of monetary creation, the Federal Reserve tried to normalise or sterilise its action by reducing its balance sheet from USD 668 billion back to 579 billion, creating the context that brought about the drop in equities.

What is there to fear in the short term if markets depend on liquidity?

The rise in equity markets has thus been closely linked with movements in interest rates and ultra-accommodative monetary policies. It is estimated that approximately 90% of the increase in prices in 2019 boils down to this factor.

If you consider that high equity valuations in a low rate context can still be acceptable, as supported by some models, then the risks are focused on further shifts in interest rates and central bank liquidity.

Nevertheless, it appears clear that the exceptional growth in bond markets, and more specifically in investments peripheral to investment grade debt cannot continue indefinitely.

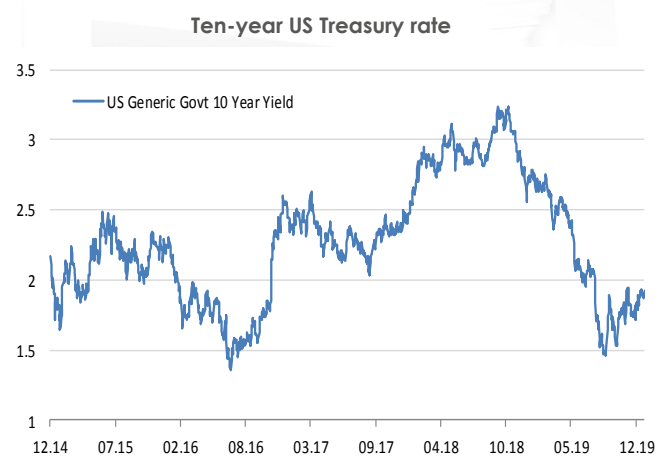
Monetary injections in Q4 2019 may also, as was the case in 2000 following the massive action in 1999, be followed by a year of stabilisation of the Fed's balance sheet, especially if 2020 holds its promises on an economic level, which is likely to be the case after monetary policies returned to the front of the stage since the summer of 2019.

US GDP growth may well close in on +2.2% this year if no external shock undermines current trends, in which case recession risks would likely be completely averted, and expectations regarding appropriate interest rate levels might then return to normal in 2020. The yield curve is also likely to normalise thanks to an upward movement on all maturities, aside from the short end.

Hence, if interest rates gradually climb back up in the US from 1.8% to 2.5% for example on ten-year Treasury bonds, the impact on equity markets would likely come as a clear surprise with potential negative effects. However, if this were to happen less gradually and more quickly, the effects would then be more brutal.

Should the increase in liquidity from central banks be reduced, a significant correction in equity markets, of a magnitude not seen in a long time, may be feared in the short term. Should we already see a sign of this trend in the reduction from USD 4,173 to 4,149 billion of the Fed's balance sheet in the first week of 2020?

Be that as it may, the Federal Reserve may also remain positively biased and continue injecting liquidity in the next few months at a significantly lower pace, although sufficient to enable risky assets to continue rising. It is also possible that the +10% earnings growth expectations for 2020 finally materialise, supporting the markets' extreme levels.



Graph sources: Bloomberg/BBGI Group

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