Investment Views

1st quarter 2017

VP BANK

Contents

Investment Views

1st quarter 2017

Foreword

Deceptive numbers

Dear Reader

At the end of the year we always ask the same question: How will the past year go down in the history books? In the world of finance we tend to answer this question by examining the indices for the various asset classes.

Looking at 2016 as a whole, no particular index stands out. Many market segments have hardly moved at all compared to last year. On the basis of the year-end figures alone, one could conclude that 2016 has been an unspectacular and tedious year.

But these annual numbers do not tell the whole story. We need to look at the monthly breakdown. Economic worries sent equity prices into a tailspin at the start of the year, resulting in the worst correction in recent years. Fortunately, the gloom turned out to be exaggerated. The markets emerged with renewed strength, and most indices recouped their losses. Their enormous resilience was subsequently put to the test several times in the course of the year.

The markets now look forward to 2017 in a relaxed and confident mood. In our view, however, this upbeat judgment cannot be applied to every market segment. In the following pages we examine the prospects and risks of the various asset classes in 2017. Our main conclusions are summarised in "Top issue of the month".

Despite the short-termism that increasingly characterises the financial markets' behaviour, it is vital to keep an eye on the big picture. With this in mind, we have decided that Investment Views should now become a quarterly publication with a stronger focus on overriding medium-term developments. At the same time, we will make greater use of state-of-the-art electronic publication channels to keep you up to date on current events and opportunities. Your client adviser will be pleased to explain the range of information and analysis that we provide.

We wish you an enjoyable and successful New Year.

Bernd Hartmann
Head of Group Investment Research

Current market assessment

The tables below summarise VP Bank's trend assessments for all asset classes in our investment universe. The arrows reflect the forecasts of our investment strategists for the coming three to six months.

Money market and currencies (pages 10–13)

Currencies	Rate as of 20.12.2016	November 2016	January 2017	
EUR vs. USD	1.036	↘	↘	
EUR vs. CHF	1.069	→	↘	New
USD vs. CHF	1.032	↗	→	New
GBP vs. CHF	1.272	→	→	
USD vs. JPY	118.10	↗	↗	
AUD vs. USD	0.723	→	→	
USD vs. SGD	1.447	↗	↗	
USD vs. RUB	61.684	→	→	
Key interest rates				
Switzerland	–0.75%	→	→	
Europe (EMU)	0.00%	→	→	
USA	0.75%	↗	↗	

Bond yields (pages 14–17)

Investment grade government bonds			
Switzerland	→	→	
Europe	→	→	
USA	↗	→	New
Investment grade corporate bonds			
Switzerland	→	→	
Europe	→	→	
USA	↗	→	New

Bonds: total return (pages 14–17)

High yield bonds	November 2016	January 2017	
High yield	→	↘	New
Emerging market bonds			
Hard currency bonds	↗	→	New
Local currency bonds	→	→	

Equities (pages 18–21)

Switzerland	→	→	
Europe	→	→	
North America	→	→	
Pacific	→	→	
Emerging markets	↗	→	New

Alternative investments (pages 22–25)

Commodities	→	→	
Crude oil	→	→	
Gold	↗	→	New
Real estate shares	→	→	
Private equity	→	→	
Convertible bonds	→	→	
Hedge funds	→	→	

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1. Focus

Top issue of the month | Bernd Hartmann

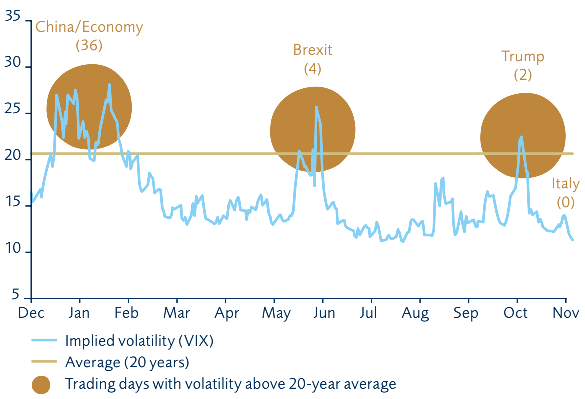
Outlook for 2017: selectivity pays

2016 ended on an upbeat note in the financial markets after an extremely eventful and sometimes turbulent year. Political surprises in the UK (Brexit) and the USA (election of Donald Trump) were a major feature. Even more surprising was the markets' increasingly relaxed reaction to these events. Financial markets usually favour continuity and predictability and greet novelty and uncertainty with a frown. Now, however, the markets are no longer dwelling on the negatives, as they did during the US election campaign, but are focussing on the opportunities and impetus that the policies of the incoming president might generate.

Watching the fear gauge

Particularly interesting in this context is the behaviour of the CBOE Volatility Index (VIX), often referred to as the "fear gauge". At the start of 2016, when economic worries emanating from China sent markets into a tailspin, the VIX jumped above its long-term average and stayed there for 36 trading days in succession. Following the Brexit decision, this happened for only four trading days. In November, when Trump emerged as the victor in the presidential election – again against market expectations – the volatility blip lasted only two trading days. And in December, after the Italians delivered a resounding no in the constitutional referendum, the fear gauge did not even flicker.

VIX fear gauge: trading days with above-average volatility



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This refusal to be rattled created the basis for the markets' subsequent recovery from the correction at the start of the year. But what was helpful in 2016 could now become a handicap. We know from experience that the fear gauge always tends to return to its long-term average. Thus a period of acute uncertainty is more likely to be followed by a calmer phase than by increased jitters. Conversely, when investors become too relaxed they are vulnerable to negative surprises. The mere non-fulfilment of expectations can then plunge the markets into turbulence. The present relaxed mood could therefore turn out to be deceptive. Periods of heightened volatility in the form of at least temporary corrections are now again on the cards.

Bond markets running out of oxygen

Another factor that is liable to generate increased volatility is the credit cycle, which is now at an advanced stage. Here, too, the situation is characterised by contradictions. Corporate debt in the USA is steadily growing. In itself, this is not necessarily undesirable. The problem is that companies are not using this borrowed money primarily to fund investment in new capacity. Debt is increasingly being used to finance shareholder-friendly actions (dividends or share buybacks). As spending on these giveaways now exceeds operational earnings, there is clearly an increased financial risk. The fact that heightened latent risks have not led to wider credit spreads is presumably due to the yield famine and the expansionary bias of monetary policy. As a result, investments in the credit markets now involve higher risks combined with lower (instead of a higher) returns. We therefore advise caution vis-à-vis the credit markets, especially with regard to low quality borrowers, and recommend focussing on more attractive types of asset. You can find more on this subject in the Bonds section.

Movement in the credit markets

After years of trending in just one direction, bond yields have experienced a major spasm in recent months. Some market observers were quick to proclaim (yet again) that the great yield turnaround had arrived. We, too, have been arguing for some time that inflation expectations (a key component of bond yields) were too low. The recent yield backup was driven by a reassessment of the inflation outlook and, in our opinion, is therefore justified and durable. Even so, we are dubious about the likelihood of a further steep increase in yields.
We believe it is more likely that yields will consolidate near their present level before embarking on a moderate further rise in the course of the year. The countervailing forces are still too strong to permit a genuine yield breakout. Major obstacles include the savings glut, demographic developments and continuing heavy demand for safe fixed income securities in response to new regulations for banks (Basel III) and insurance companies (Solvency II).

New vigour in the equity markets

The bull market in equities is at an advanced stage compared with earlier cycles. In the history of the US stock market there has been only one longer period of rising share prices and two periods with bigger advances. Even so, we believe that the market still has upside potential. But for this to be realised, corporate earnings need to return to a growth trajectory. Until recently this was the markets' Achilles heel. Global corporate earnings posted a gain of just 1% in 2016. Adjusted for inflation, that actually represents a slight decline.
Now, however, thanks to improved conditions in various sectors, we regard a return to earnings growth in the mid to high single digit range as feasible. On the other hand, we do not share the optimism of bottom-up equity analysts who are still predicting double-digit earnings growth.

Within the equity allocation we believe that selectivity is now increasingly important – especially in view of the advanced stage of the market cycle. In our view, a better risk/return ratio can be achieved by a systematic selection of sectors and themes rather than by a broad index-based exposure. In the Equities article on page 20 we explain which opportunities we regard as most attractive at present.

Conclusion

The credit cycle and the bull market in equities are both well advanced. Risks in the corporate bond sector have increased and are no longer being adequately covered by risk premiums in the lower rating categories. The situation in the equity markets, on the other hand, has improved, with better earnings growth providing share prices with broader support. At this stage of a prolonged bull market, we regard such support as necessary. But the fact remains that potential returns are limited by elevated valuation ratios. To achieve an attractive risk/reward profile in this environment, we recommend a selective approach

Economic outlook | Dr Thomas Gitzel

Shock? What shock?

Highlights

- The financial markets have so far responded to 2016's electoral decisions with remarkable aplomb.
- The true consequences of Brexit, Donald Trump's election and the Italian referendum will not become visible until 2017.
- Political risks will continue to stalk the world stage in the coming year.

So what was all the fuss about? The financial markets have displayed amazing composure in the face of recent political upsets. The Brexit decision, the election of Donald Trump and the no vote in Italy's constitutional referendum have inflicted no serious damage on the markets. But all three events have one thing in common: their consequences will not be fully felt until next year.

Europe: more political tests ahead

2017 will be another decisive year for the European Union. At present the British vote to leave the EU is merely aspirational. Prime Minister Theresa May has still not set the ball rolling by triggering Article 50. But that will soon change. The UK government has announced a deadline of March 2017 for officially notifying Brussels of its intention to withdraw. Negotiations will then kick off, concentrating minds on the practical economic consequences. Woolly theory will become vivid reality on both sides of the Channel.
March is also the date for parliamentary elections in the Netherlands. Polls suggest that Geert Wilders and his right-wing populist Party for Freedom will get the largest chunk of the votes. Wilders wants a Nexit plebiscite (Netherlands exit) on the model of the Brexit referendum. Under the Dutch constitution, a referendum is not binding on the legislature, but if the vote goes against the EU it would deliver a devastating political signal.
The most important European political event in 2017 will be the French presidential election in late April. The polls indicate a second round run-off between the right-wing populist Marine Le Pen and the conservative François Fillon on 7 May, when Le Pen is expected to be beaten.
Germany faces federal elections in the autumn, with the right-wing populist Alternative for Germany (AfD) party set to emerge as the third strongest force in parliament. Even so, AfD participation in the government can probably be ruled out. France and Germany are the two central pillars of the EU. If one of them started to give way under the political strain, the EU would be in serious danger of collapse.

Tense times therefore lie ahead in Europe, especially with Italy's new government still far from secure. Given the political pitfalls, economic euphoria about the eurozone would be out of place. Next year's GDP growth rate is likely to weaken from 1.6% to 1.3%.

USA: early days for President-elect Trump

The financial markets have awarded Donald Trump an array of medals for actions not yet performed. Equity investors are looking forward to a government spending bonanza, while the fixed income markets are expecting resurgent inflation. So far this is nothing but wishful thinking. Trump's policies still have to be tested. We, too, expect US public expenditure to rise, but whether the financial markets' high expectations will be fulfilled remains moot. Potential for disappointments certainly exists.

Conclusion

Economic euphoria about the coming 365 days is inappropriate. True, US growth will probably be somewhat higher than in 2016, and the oil-exporting emerging nations are climbing out of their trough. But Europe is navigating through a political minefield. As for monetary policy, the leading central banks will be unable to steer a strongly restrictive course, even if inflation moves somewhat higher. The Fed will stick to its policy of cautious interest rate increases, but rates will still be historically low by the end of the year. Meanwhile the European Central Bank will have no choice but to carry on protecting the eurozone with expansionary monetary measures.

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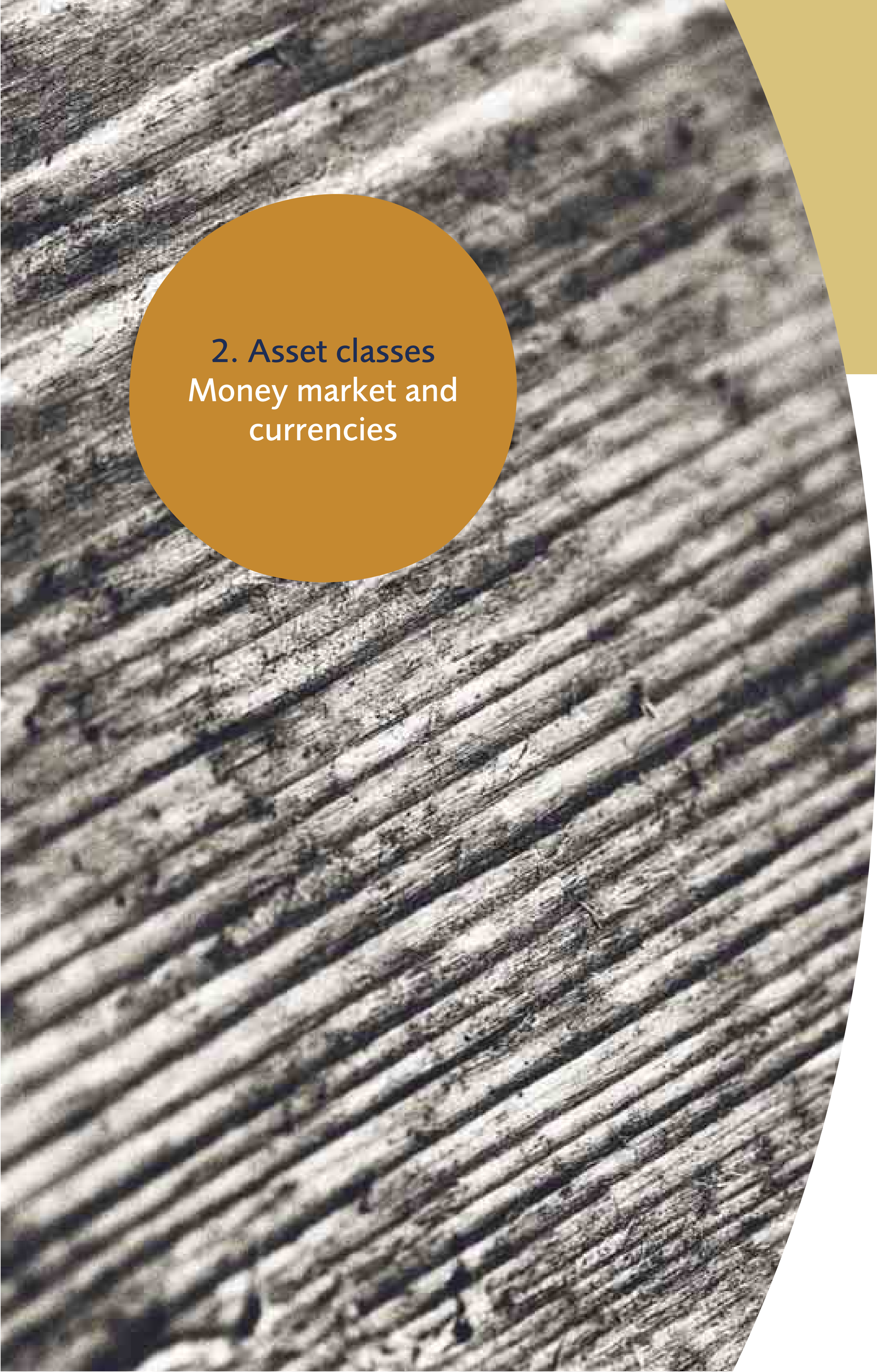
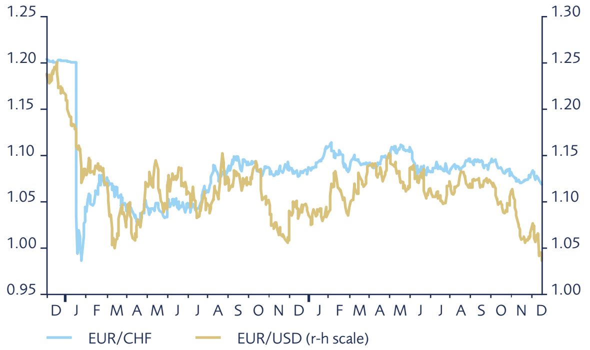


2. Asset classes Money market and currencies

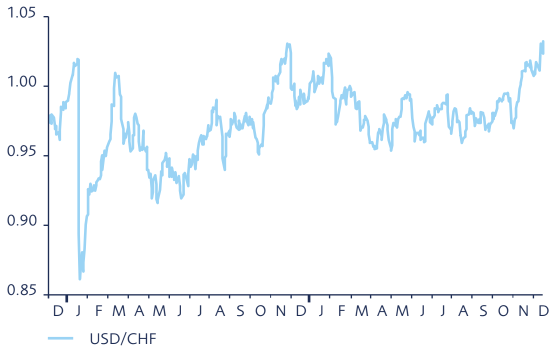
Money market and currencies

Market overview

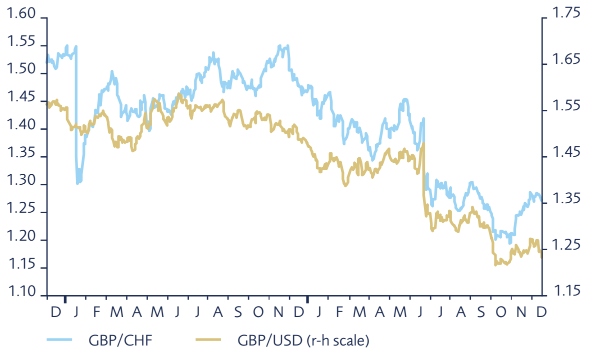
EUR/CHF and EUR/USD: exchange rates since December 2014



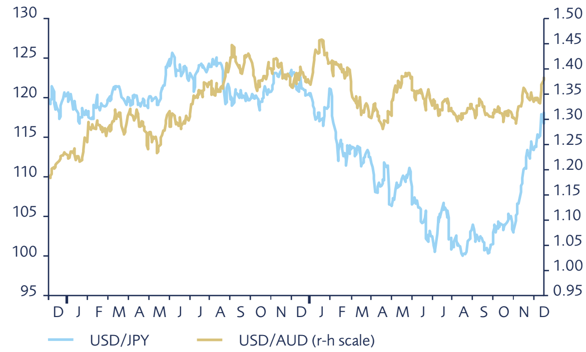
USD/CHF: exchange rate since December 2014



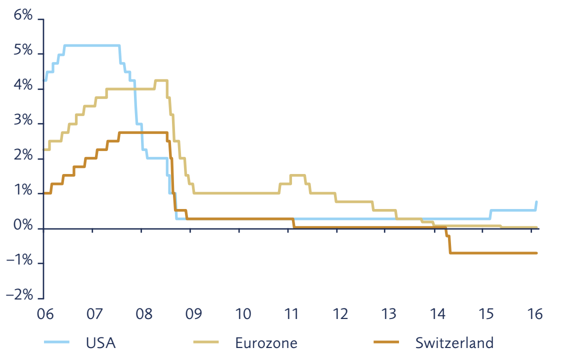
GBP/CHF and GBP/USD: exchange rates since December 2014



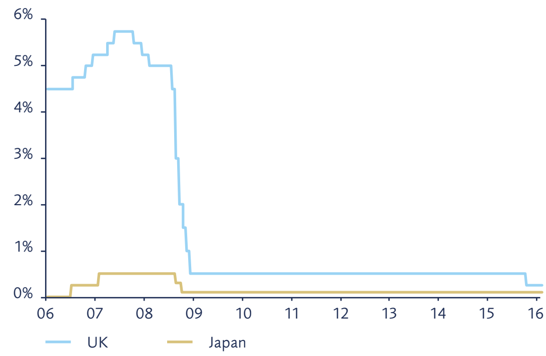
USD/JPY and USD/AUD: exchange rates since December 2014



Key interest rates in Switzerland, eurozone, USA: since January 2006



Key interest rates in UK and Japan: since January 2006



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Money market and currencies | Dr Thomas Gitzel

Market outlook

Groundhog Fed

When trying to assess the likely actions of the US Federal Reserve, markets and analysts seem to be stuck in a "Groundhog Day" time loop. The protagonist of that famous Hollywood movie finds himself reliving the same day again and again. Similarly, investors are now asking daily: How many times will the Fed raise interest rates? And again and again there is no unanimity about the answer. Market expectations as reflected in Fed Funds futures prices imply two interest rate hikes in the period January to December 2017. Economists surveyed by Bloomberg also came up with an average forecast of two 25-basis-point hikes in 2017, but this overall number covered a broad spread of forecasts, ranging from no action at all to four increases. Fed officials also publish a regular assessment, indicating three hikes on average. The upshot is that investors get no clear answer from the experts or the markets about the likely course of official US interest rates. We therefore prefer to look at more predictable factors as a basis for gauging the Fed's likely actions.

Inflation will continue to climb in the months ahead. This prognostication does not require a crystal ball. Higher oil prices alone are enough to make it a racing certainty that inflation will accelerate. US inflation will head towards 3% in the first quarter of 2017, well above the Fed's 2% target. At the same time, leading indicators now suggest a somewhat higher rate of GDP growth in the coming two quarters. Added to that, various data point to an increase in wage levels. This is a factor that the monetary guardians in Washington always keep a close eye on. In a nutshell: higher inflation, rising wages and solid economic growth mean that the Fed will virtually be forced to tighten. From this perspective, we regard three interest rate hikes in 2017 as realistic.

Capital market players might object that Janet Yellen and her colleagues at the Fed have pursued an ultra-cautious policy over the past year, so why should we expect them to change their spots now? It is true that the Fed has tended to pursue a very circumspect approach. But average inflation in 2016 was well below the Fed's 2% target, while wage growth remained below expectations until the autumn. Nor should we forget that GDP growth in the USA was very weak in the first and second quarters. By these criteria, the interest rate hike in December 2015 looks like a mistake. Now, however, conditions are at last ripe for a moderate lifting of interest rates, so the Fed can plausibly be expected to move into rate-hiking mode. The Fed usually follows an initial hike with several more, without prolonged pauses between them. In the tightening period from 2004 to 2006, the then Fed Chair Alan Greenspan repeatedly raised rates from one FOMC meeting to the next.

Implications for the EUR/USD exchange rate

Meanwhile the European Central Bank is still on an expansionary tack. Thus 2017 will again see an extreme monetary divergence between the two sides of the Atlantic. The eurozone/USA interest rate gap on the futures market, which is a good indicator of future forex prices, now points to a EUR/USD rate close to parity. Added to that, Europe faces a number of important elections in 2017, which could further undermine confidence in the euro. We therefore expect to see the dollar strengthening against the euro in the coming months to a level in the region of parity.

EUR/CHF: persistent appreciation pressure

The Swiss franc has come under increased appreciation pressure in recent weeks. For a long time the Swiss National Bank had been defending a rate of CHF 1.08 per EUR, but it is now tolerating rates below that level. The rate has recently moved towards 1.07 or even lower. Weekly figures on commercial banks' sight deposits at the SNB, which are an indicator of the SNB's market interventions, rose only minimally between the start of September and mid-November. Evidence of increased market interventions has been seen only recently. So it looks as if Switzerland's monetary guardians are no longer prepared to intervene at any price. The SNB is in a dilemma. On the one hand, ongoing interventions and the resultant growth of excess liquidity are

Highlights

- The Fed will launch further interest rate hikes in 2017. Central bank policy on the two sides of the Atlantic will therefore be extremely divergent.
- This will tend to cause the US dollar to appreciate further.
- The Swiss franc is encountering increased appreciation pressure. The SNB is holding fire and tolerating a somewhat stronger franc.

harmful to the Swiss banking industry. On the other, the SNB does not want Swiss manufacturers to suffer too much loss of competitiveness through an over-strong franc. In recent months, however, Switzerland's macroeconomic situation has improved. Swiss companies seem to be coming to terms with the high exchange rate, while the price-depressing effects of the franc's appreciation and lower oil prices are fading. Even if the franc were to hit CHF 1.06 per euro and oil prices stayed at their present level, Switzerland's inflation rate would climb back into positive territory in the first half of 2017. As the economic drag effect of the franc's appreciation recedes, the SNB might envisage allowing a somewhat stronger franc in the coming weeks. The present behaviour of the EUR/CHF rate suggests that the SNB is defending a level of 1.07. If appreciation pressure on the Swiss currency stays high in the run-up to the Dutch parliamentary elections and the presidential election in France, a euro rate below CHF 1.07 cannot be ruled out.

Conclusion

Political events and central bank actions will continue to call the tune on the foreign exchange markets in 2017. The euro may well lose further ground against the US dollar. At the same time the Swiss franc will stay strong, with the SNB probably having to tolerate a somewhat higher level against the euro.

Key interest rates	January 2017
Switzerland	→
Europe (EMU)	→
USA	↗

Upside/downside ranges indicated by our 3–6 month interest rate forecasts:
↑ > +50 basis points ↗ +25 basis points → No change
↘ –25 basis points ↓ < –50 basis points

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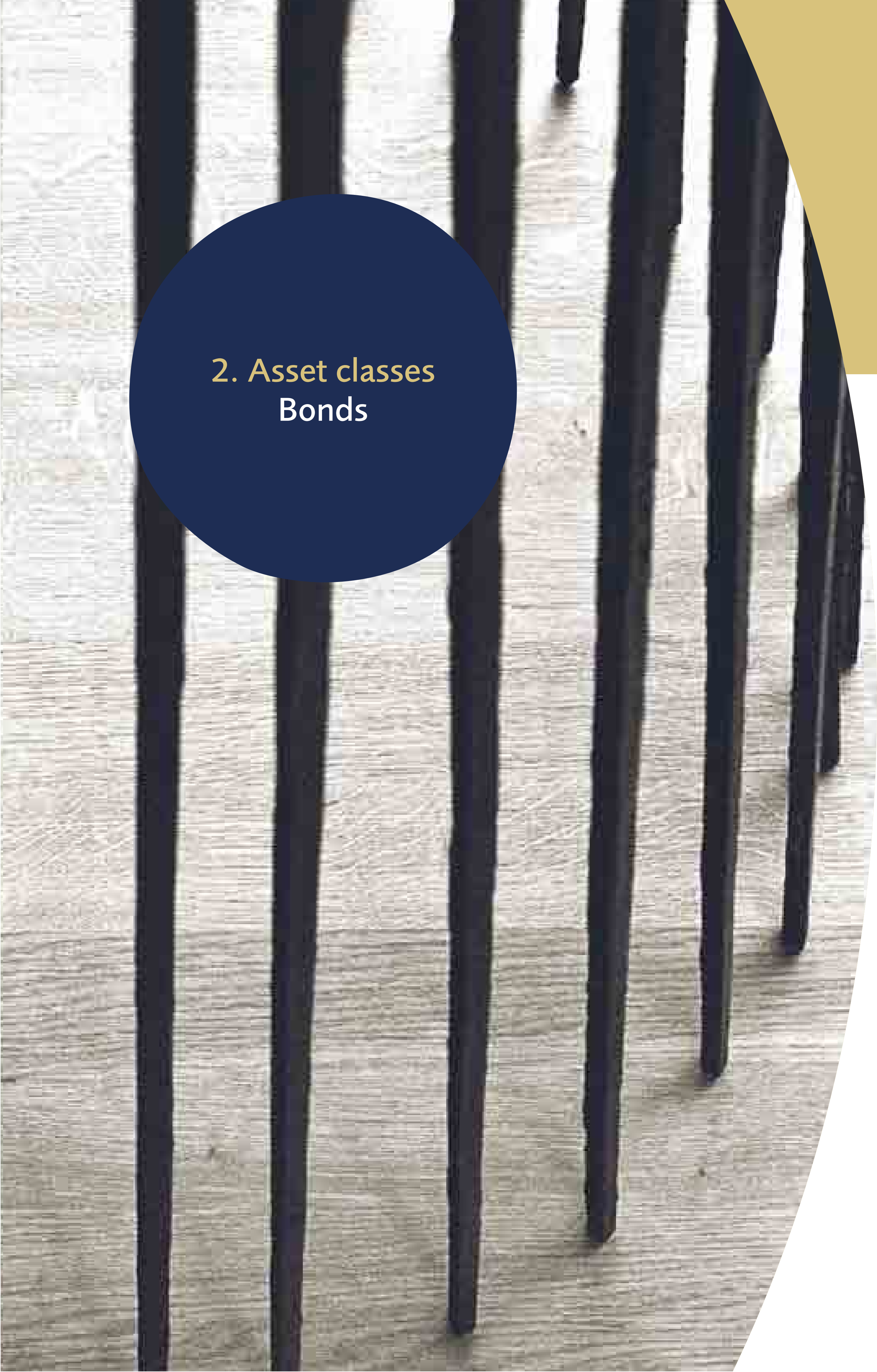


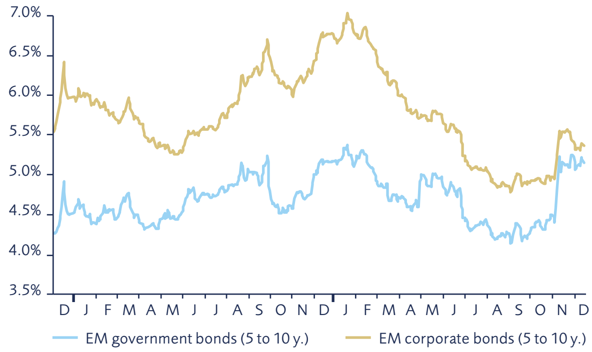
2. Asset classes
Bonds

Bonds

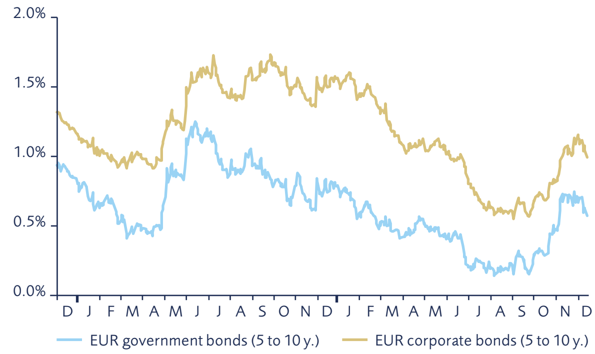
Bond yields – overview

Switzerland: yields since December 2014

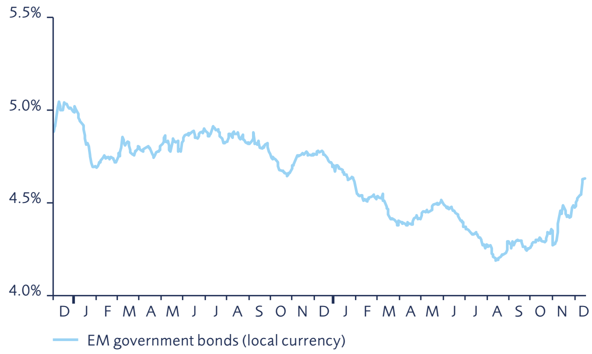
Emerging markets (hard currency): yields since December 2014



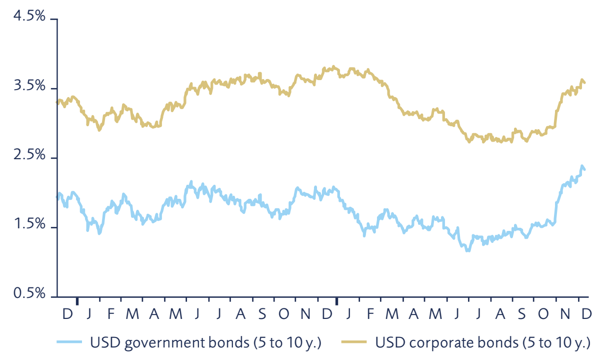
Europe: yields since December 2014



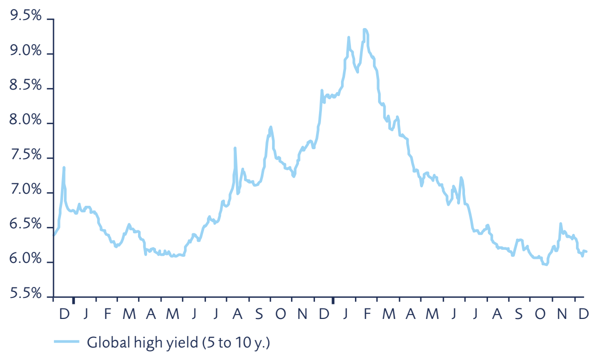
Emerging markets (local currency): yields since December 2014



USA: yields since December 2014



High yield: yields since December 2014



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Bonds | Dr Thomas Gitzel, Bernhard Allgäuer

Market outlook

Long-term yields have continued to climb. The scale of the movement is remarkable, both in absolute terms and historically. Some market participants are claiming that this marks a long-term change of trend.

Rising inflation expectations

The powerful yield backup was fuelled by Donald Trump's victory in the US presidential election. The markets believe that the new occupant of the White House will fling open the federal coffers and propel the US economy onto a stronger growth trajectory. Economic momentum would then push up inflation and force the Fed to speed up the process of monetary tightening. At present, however, one can only speculate about how strong the fiscal stimulus will be. It is therefore not yet certain whether or to what extent the actions of the Trump administration will actually have an inflationary impact. One thing is for sure, though. Even in the absence of extra government expenditure, inflation is set to accelerate. The price-dampening impact of the previous oil price collapse is now fading, and that alone will ensure that inflation rises. Additional price-driving effects cannot be identified at present. As for the growth outlook, our calculations indicate that GDP will grow somewhat faster in the coming year, but the expected 2.3% rate of expansion can hardly be characterised as dynamic. Against this background, an "overshooting" of inflation is improbable.

Don't forget the underlying factors

The necessary ingredients for a long-term change of trend on the bond markets are still absent. That remains the case when underlying factors are taken into account. The secular decline in long-term bond yields since the 1980s has gone hand in hand with an increased savings ratio. According to the IMF, global savings as a percentage of world GDP amounted to just under 21% at the start of the 1980s. That figure has now risen to 26%. As there has been only a relatively small net change in capital spending over this period, the world is now faced with a savings glut, i.e. the amount saved is higher than the amount going into capital expenditure. The need to find a safe home for these surplus savings pushes up the price of secure government bonds and consequently depresses yields. Given that 2017 will bring little change in this situation, there is no reason to suppose that long-term yields will head for significantly higher terrain. Even so, if the Fed stays in rate-hiking mode as we expect, a somewhat higher yield level could be on the agenda in the course of 2017 – not only in the USA but also in the eurozone and Switzerland.

Corporate bonds: past their peak

Bond yields in the developed economies have now been on a downward trend for around 35 years. The movement was accelerated by the financial crisis and the subsequent monetary expansion engineered by the central banks. Investors have reacted to the yield famine by choosing longer maturities and exposing themselves to increased credit risk in order to achieve useful returns. This strategy has paid off in recent years, but we now advise against it. High yield (so-called "junk") bonds are especially vulnerable in the present situation. The relative lack of liquidity in this sector is a significant problem. If everyone heads for the exit at once, the door is too narrow to let them through.

No alternative to higher risk?

TINA – "There is no alternative" – was the watchword of UK Prime Minister Margaret Thatcher. For bond investors who want to achieve accustomed returns there has been no alternative in recent years to accepting a higher level of risk. Increased risk exposure in the bond market means either investing in longer maturities (duration) or incurring increased credit risk (default risk).

Variant 1: longer duration

"Risk-free" yields on government bonds have been lower than the fundamentals would justify for a long time now. In response, investors have been opting for ever longer maturities. By stretching duration, however, they magnify

Highlights

- There are strong signs of a further limited rise in US bond yields.
- The underlying long-term trend still argues against a fundamental turnaround on the credit markets, but interest rate hikes by the Fed should push yields moderately higher.
- The credit cycle is at an advanced stage. Additional exposure to credit risk will no longer generate enhanced performance at present.

the interest rate risk, as the following example illustrates. On 25 October 2016 Austria issued a 70-year bond with a 1.5% coupon. Two days later, yields rose by 0.14%, resulting in a 5% fall in the bond's value. If yields climb by 1% by the end of 2017, the capital loss on this bond will amount to 33%. More and more government borrowers have recently switched to issuing ultra-long maturities. As even a slight rise in yields is enough to swallow up several years' worth of coupons, we urgently advise against stretching duration.

Variant 2: higher credit risk

In the past we have therefore preferred increased exposure to credit risk. The lower a borrower's credit quality, the more sensitively the bonds react to the business cycle. An economic upturn enhances the probability that the bond will be repaid and also increases the chance of a rating upgrade. Around 80% of the high yield market is located in the USA, so the high yield sector benefits commensurately from America's economic buoyancy. The current expansion in the USA has now lasted 89 months, making it the third longest expansion since World War II. Although a downturn is not in sight, the default tally for 2016 had reached 148 by December, compared with 113 for the whole of 2015. The default rate has risen to 4.3%, its highest level since 2009, and Standard & Poor's expects it to climb to 5.6% in 2017. Meanwhile, the credit spread that is supposed to compensate for this risk has narrowed from 8.5% in February to 4.8% now, while the recovery rate in the event of default has sunk to an all-time low of 23%. Given this increased risk, credit spreads are clearly too narrow.

Problematic liquidity of high yields bonds

A further problem concerns the liquidity of high yield bonds in periods of stress. Retail products (investment funds and ETFs) have enabled private investors to invest in very low quality bonds on a diversified basis. The volume of the six largest ETFs has rocketed by USD 25 billion since 2011. But this huge increase amplifies the liquidity risk in the event that many investors decide to sell at the same time. In late October the market experienced withdrawals of USD 1.1 billion in a single day, the largest one-day exit ever. If selling pressure were to become prolonged, liquidity would quickly dry up. ETFs would then have to sell at big mark-downs or block withdrawals. When that happens, it is usually too late to get out of the market.

Conclusion

At this advanced stage of the credit cycle we regard it as counterproductive for bond investors to expose themselves to even greater risk. Additional credit risk will no longer lead to enhanced performance. We see better risk/reward ratios elsewhere: in money market investments, inflation-protected securities (TIPS), insurance-linked securities (ILS) and emerging market bonds denominated in hard currencies.

Benchmark	January 2017	% YTD[1]
Gov. bonds Switzerland[2]	→	1.17%
Gov. bonds Europe (EUR)[2]	→	3.09%
Gov. bonds USA[2]	→	0.41%
Inv. grade corp. bonds Switzerland[2]	→	1.11%
Inv. grade corp. bonds Europe (EUR)[2]	→	4.37%
Inv. grade corp. bonds USA[2]	→	5.23%
High yield bonds[3]	↘	14.58%
Emerging market bonds (hard currency)[3]	→	9.24%
Emerging market bonds (local currency)[3]	→	9.87%

[1] As of 20.12.2016
[2] Yield
[3] Total return

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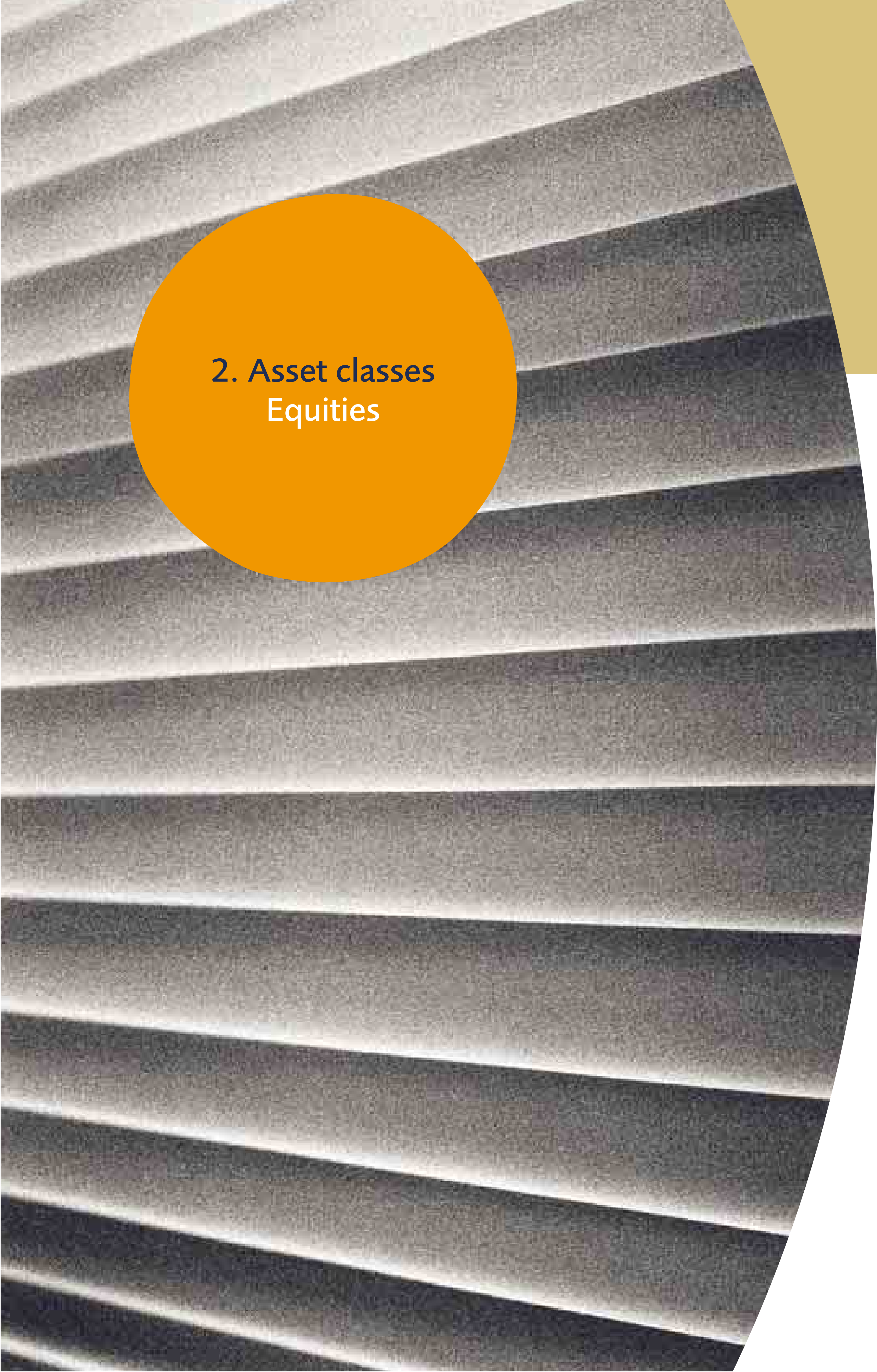
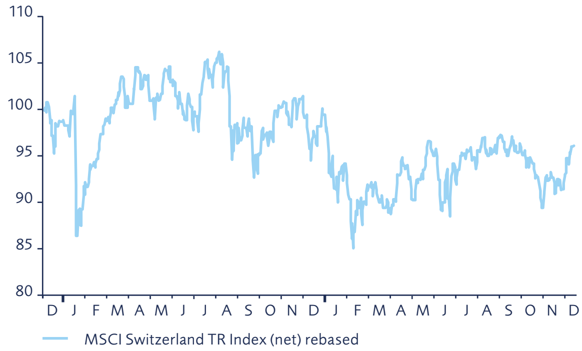


2. Asset classes
Equities

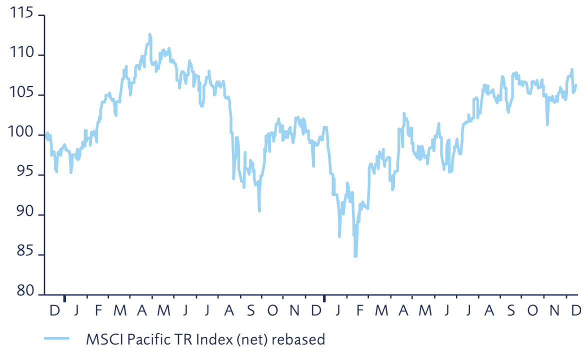
Equities

Equity indices – overview

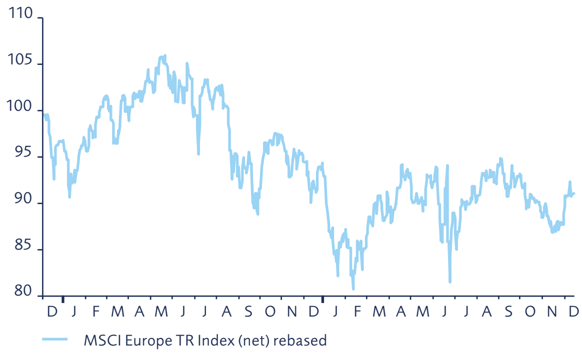
Switzerland: market movement since December 2014 (indexed)



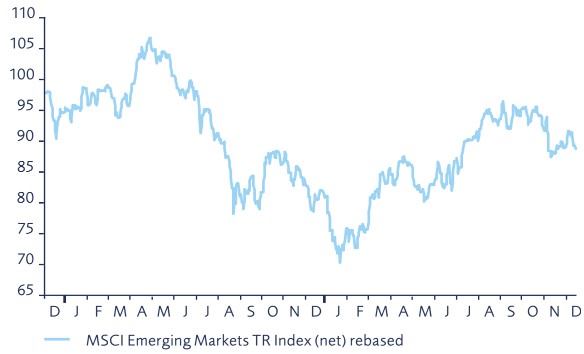
Pacific: market movement since December 2014 (indexed)



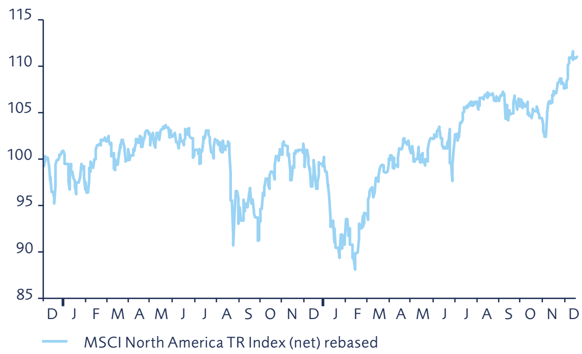
Europe: market movement since December 2014 (indexed)



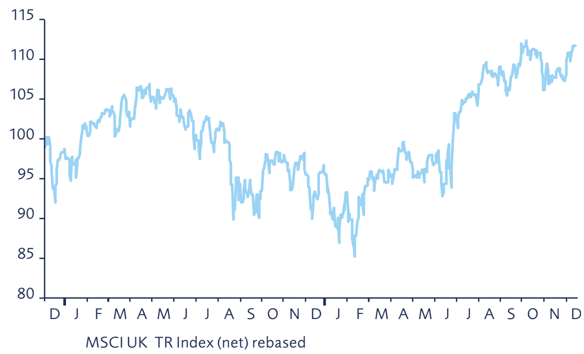
Emerging markets: market movement since December 2014 (indexed)



North America: market movement since December 2014 (indexed)



United Kingdom: market movement since December 2014 (indexed)



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Equities | Rolf Kuster

Market outlook

2017 – better prospects than a year ago

For many investors early 2016 was a nightmare. Economic worries emanating from China precipitated a headlong retreat on global equity markets. Even the defensive Swiss market lost 18% of its value in the first six weeks. But the fears turned out to be exaggerated, and the markets subsequently picked themselves up.

The present situation is very different. Global leading indicators point to an improved business outlook in manufacturing and services. Equity markets have greeted this cyclical improvement with enthusiasm. Share price advances in the last two months have been especially strong in the USA – clear evidence that the markets are already anticipating actions by the incoming president. Equity investors are enthused by the prospect of fiscal stimulus and tax cuts.

The precise contours of Donald Trump's programme will be a crucially important factor in 2017. We have to wait and see what concrete measures the new president will (or can) implement. Trump is already making a more thoughtful and statesmanlike impression than he did in the heat of the election campaign.

Although the incoming administration has revealed little about its plans, investors can look forward to a further improvement in the economic situation over the medium term. GDP growth in the USA remains moderate, but important leading indicators and purchasing managers' indices have shown a steady improvement in recent months. The unemployment rate has fallen to its lowest level in almost ten years, and fears of a deflation spiral – a recurring worry in previous years – appear to have been banished for the time being. The majority of economists are now forecasting higher inflation, and the market for inflation-linked bonds confirms this. These prospects are supportive for the equity markets. Economic momentum leads to expanding sales, while accelerating inflation prompts investors to rotate their investments away from bonds (deflation hedge) and into equities (inflation hedge).

In the medium term, however, investors' overriding concern is earnings growth. Earnings per share edged up by just 1% in 2016 (MSCI World), and this feeble rate of increase was widely regarded as the Achilles heel of an already expensive market. But a positive change of trend is emerging for fiscal 2017. Analysts are currently forecasting earnings growth of 12%. This figure seems rather ambitious even on the basis of an optimistic scenario and will probably be revised downwards in the coming weeks. Ultimately we expect EPS growth for 2017 as a whole to settle in the single digit range (5% to 7 %).

Earnings growth is an aggregate of individual sectors. In 2016 the overall rate of increase was dragged down by the energy, commodities and financial sectors. Thanks to the rising trend of commodity prices and gently climbing interest rates, the earnings contributions of these sectors will move from negative to positive in 2017.

Improved economic momentum and the positive earnings outlook should not blind us to the latent risks. Global equity valuations are now well above the long-term average, indicating that the equity market cycle is at an advanced stage. At the same time, burgeoning inflation pressure means that further Fed interest rate hikes are in the pipeline, while political risks are aggravated by imminent elections in Europe and possible moves to restrict free trade. The markets are currently focussing on the opportunities rather than the risks. Volatility and sentiment indicators are behaving as if there were no uncertainty at all. This is likely to change in 2017. Phases of heightened volatility are to be expected.

Selective approach – sectors, styles and regions

As a basic rule, investors should become more selective in their choice of investment opportunities as the business and equity market cycles reach a more advanced stage. The need for selectivity has now been made even more acute by the election of Donald Trump.

Highlights

- Higher corporate earnings will exert a stronger influence again in 2017.
- Instead of playing the whole market, investors should go one level lower and increasingly focus on selected sectors or investment styles.
- Our favourites in the USA include the financial sector, while in Europe we prefer the eurozone to the UK and Switzerland.

US equity allocations need to focus on shares of companies that make the bulk of their sales within the United States. These are less vulnerable to the threat of a stronger dollar and stand to benefit from planned economic stimulus and infrastructure programmes. Against the background of rising interest rates, however, investors should steer clear of businesses with a high debt ratio, e.g. companies in the utilities and telecommunications sectors.
Financials, especially banks, are classic beneficiaries of rising interest rates. Higher rates mean wider margins and bigger commissions, which should ultimately lead to a recovery of earnings. After a long period of neglect and low valuation, the US financial sector is now enjoying more positive investor sentiment, resulting in new inflows of investment capital.
In the European equity market, by contrast, we can offer no general recipe. The differences among individual countries and regions are simply too large. Equity markets in the eurozone are still benefitting from monetary expansion, comparatively low valuations and positive earnings momentum, whereas the UK market is threatened by the Damocles sword of Brexit. The rally of export-oriented UK large caps in reaction to the pound's depreciation has petered out since the pound stabilised, while the news flow will become more negative as Brexit negotiations get under way. The concrete impact of the negotiations will emerge only later in the year. Thus risk considerations suggest caution.
Caution is also appropriate with regard to Switzerland. Valuation levels in the Swiss market have been comparatively high for some time (partly reflecting the market's sector makeup), and earnings growth has been weak. Moreover, some international investors will tend to be wary about taking a Swiss exposure. The small and open Swiss economy is especially vulnerable to growing disenchantment with globalisation and the possibility of trade restrictions. The strong franc is a further disincentive.

Even so, we see opportunities in Switzerland. For investors with a Swiss focus, mid caps provide an interesting alternative to their large cap rivals. Mid cap firms tend to do comparatively well at a late stage of the cycle. Moreover, they usually have a smaller international orientation and are less exposed to tactical reallocations via ETFs and futures.

Benchmark	January 2017	% YTD[1]
Switzerland	→	–3.36%
Europe	→	–1.94%
North America	→	12.63%
Pacific (incl. Japan)	→	5.19%
Emerging markets	→	9.47%

Upside/downside ranges indicated by our 3–6 month absolute performance assessments
↑ > +5% ↗ +2% to +5% → –2% to +2%
↘ –5% to –2% ↓ < –5%

[1] As of 20.12.2016

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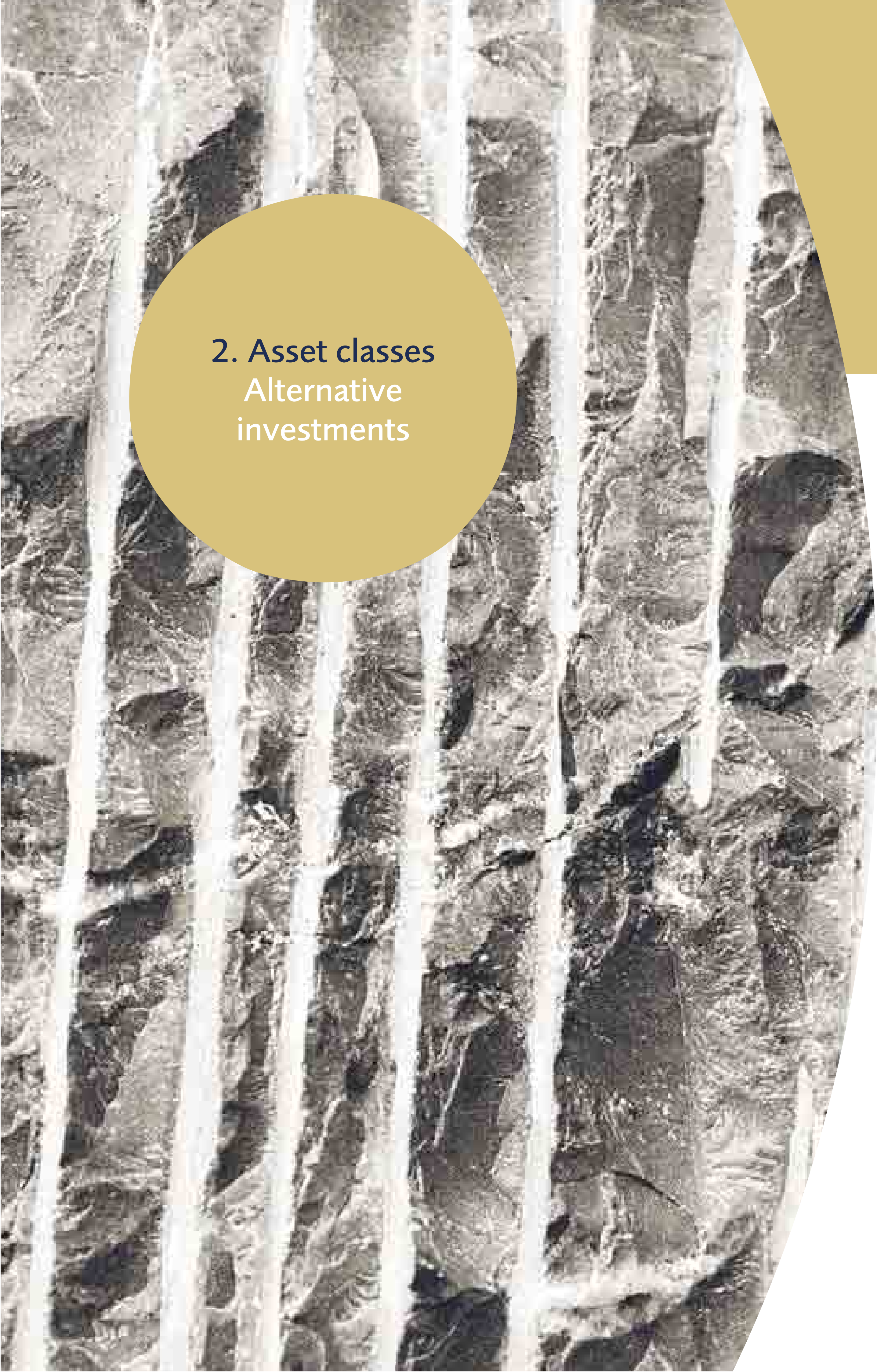
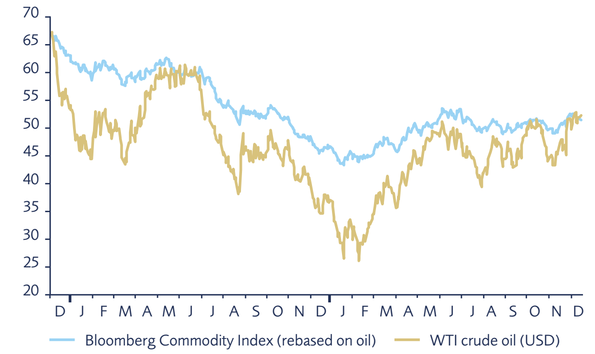
2. Asset classes
Alternative investments



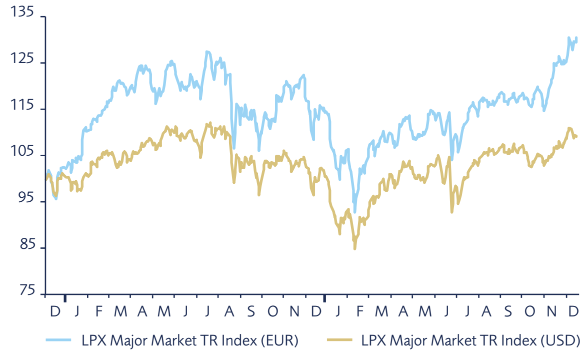
Alternative investments

Alternative investments – overview

Commodities: performance since December 2014

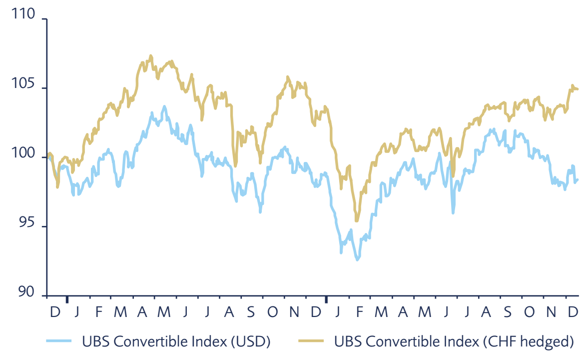


Private equity: performance since December 2014 (indexed)

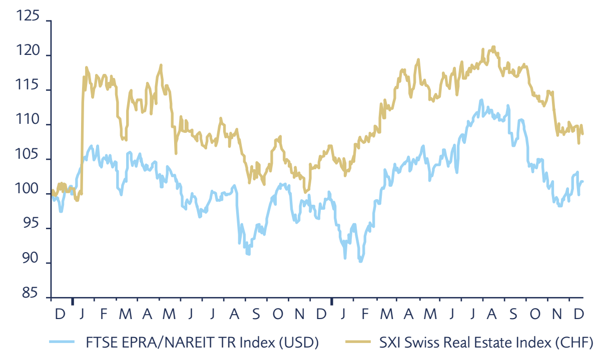


Precious metals: performance since December 2014

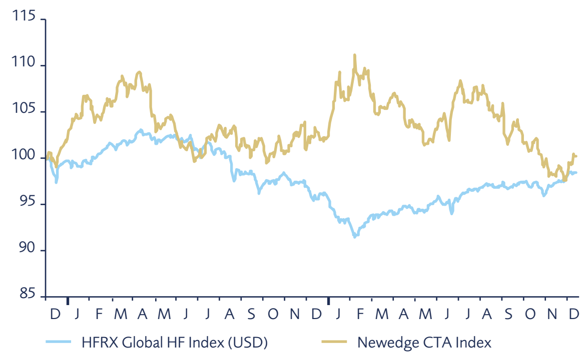
Convertible bonds: performance since December 2014 (indexed)



Real estate: performance since December 2014 (indexed)



Hedge funds: performance since December 2014 (indexed)



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Alternative investments | Rolf Kuster

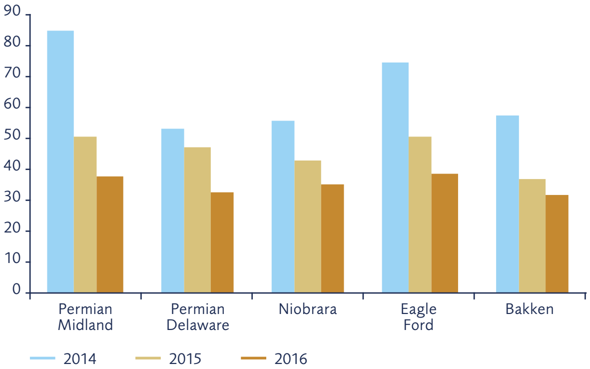
Market outlook

After five lean years, 2016 finally delivered a positive performance for commodity investors. As we go to press the Bloomberg Commodity Index is up by around 12% since the start of 2016. But the favourites have changed repeatedly during the year. At the start of the year, investors were focussing primarily on crude oil. Later we saw a resurgence of interest in gold following the Brexit decision. Finally the baton passed to industrial metals, notably copper. Donald Trump's promise to unleash an infrastructure blitz and revitalise the economy by means of a public spending bonanza sent the copper price rocketing by 18.9% in November.

Energy: shale oil comeback

The price of crude oil is currently being driven primarily by the supply side. Demand is relatively stable and predictable and therefore has only a subordinate effect. Speculation about the supply outlook is a much more potent price factor. OPEC is now doing its utmost to win back control of the market. It is noticeable, however, that announced production cuts and intensified collaboration with Russia (the world's biggest oil producer) have had only a short-term upward impact on oil prices. This price inertia is attributable to US shale oil, as has been the case for some time now. Attempts by the traditional oil exporting countries to "starve out" their new competitors in the USA have so far failed. True, US shale oil production and overall investment in the US energy sector have declined since the start of the year. But global crude oil supply has hardly fallen at all, thanks to higher output in Iran. Added to that, America's shale oil producers are gradually coming to terms with the lower price level. Rystad Energy forecasts that investment in the shale oil sector will start to climb again in 2017, and effective output of shale oil has been on the increase again since September. The production cost of a barrel of crude oil from the Bakken formation (the lowest-cost source of shale oil) has come down from USD 58 in 2014 to around USD 32 in 2016.

Shale oil production costs (USD per barrel)



The average cost of producing a barrel of crude oil has fallen by around 22% since 2013, and this trend is likely to continue under a US president who is favourably disposed to the shale oil industry.

We expect no significant upward pressure on the oil price in 2017. Price potential is limited by the steady decline in the cost of shale oil production. A reintroduction of OPEC production quotas would have no more than a short-term impact on the price level and would further diminish Saudi Arabia's share of the market.

Precious metals: useful diversifier

Precious metals, especially gold, have an aura of security about them. They are seen as a safe haven, a last-ditch means of payment in the event of catastrophe and a sound store of value in times of heightened inflation. Against a background of imminently rising inflation, heightened political and economic uncertainties and official measures to curtail the volume of cash in circulation, gold has quite a lot going for it. But rising interest rates and a stronger dollar will rule out a steep upward movement on the gold market in 2017. We remain cautiously optimistic in view of the uncertainties that 2017 will bring, but we recommend gold primarily as a supplementary portfolio diversifier for the purpose of risk reduction.

Highlights

- 2017 looks set to be a mixed year for commodities. A major rally in commodity prices is unlikely.
- In our view, industrial metals offer the best upside potential.

Agricultural commodities: high stocks and good harvests

A key driver of agricultural commodity prices is the weather. Droughts and phenomena like El Niño play a crucial role and are difficult to predict. However, barring unexpected weather events, there is little to be said for investments in agriculturals at present. Global stocks of wheat, corn and soybeans are comparatively high, harvests are good, and input costs (e.g. fertilizer) are relatively low thanks to depressed crude oil prices. Greatly improved productivity means that rising demand does not necessarily lead to higher prices. We remain cautious about agricultural commodities and expect no significant change in 2017.

Industrial metals: driven by Trump and China

The fundamentals do not offer much indication of a further rise in industrial metal prices at present. According to the World Bureau of Metal Statistics, demand is growing only weakly. Chinese demand for industrial metals has been flagging for several years. China is still by far the most important user of industrial metals, accounting for around 50% of global consumption. Low demand has resulted in a general supply glut. Production capacity is being scaled down, but inventories are still full. Even so, positive impetus from the demand side is possible. New infrastructure investment in China, coupled with Donald Trump's promised economic stimulus programme, should generate additional buying. The market reacted with an upward lurch in November, though this was triggered mainly by speculators. Effective demand for copper still needs to catch up with high expectations. On balance, we remain cautiously optimistic about industrial metals and expect slightly higher prices in the course of 2017.

2017: mixed year for commodities

Although commodity prices still appear generally low, we are wary about making positive predictions. The outlook is handicapped by higher interest rates, a stronger dollar and generally abundant supply. Accelerating inflation, political risks and promised economic stimulus programmes could boost demand for gold and industrial metals, but excess supply of crude oil and agricultural commodities looks set to persist. It should also be noted that roll costs erode the potential gains on many commodities.

Benchmark	January 2017	% YTD[1]
Commodities	→	10.30%
Gold	→	18.53%
Crude oil	→	6.46%
Commercial real estate	→	2.69%
Private equity	→	13.53%
Convertible bonds	→	−0.21%
Hedge funds	→	2.48%

Upside/downside ranges indicated by our 3–6 month absolute performance assessments:
↑ > +5% ↗ +2% to +5% → −2% to +2%
↘ −5% to −2% ↓ < −5%

[1] As of 20.12.2016

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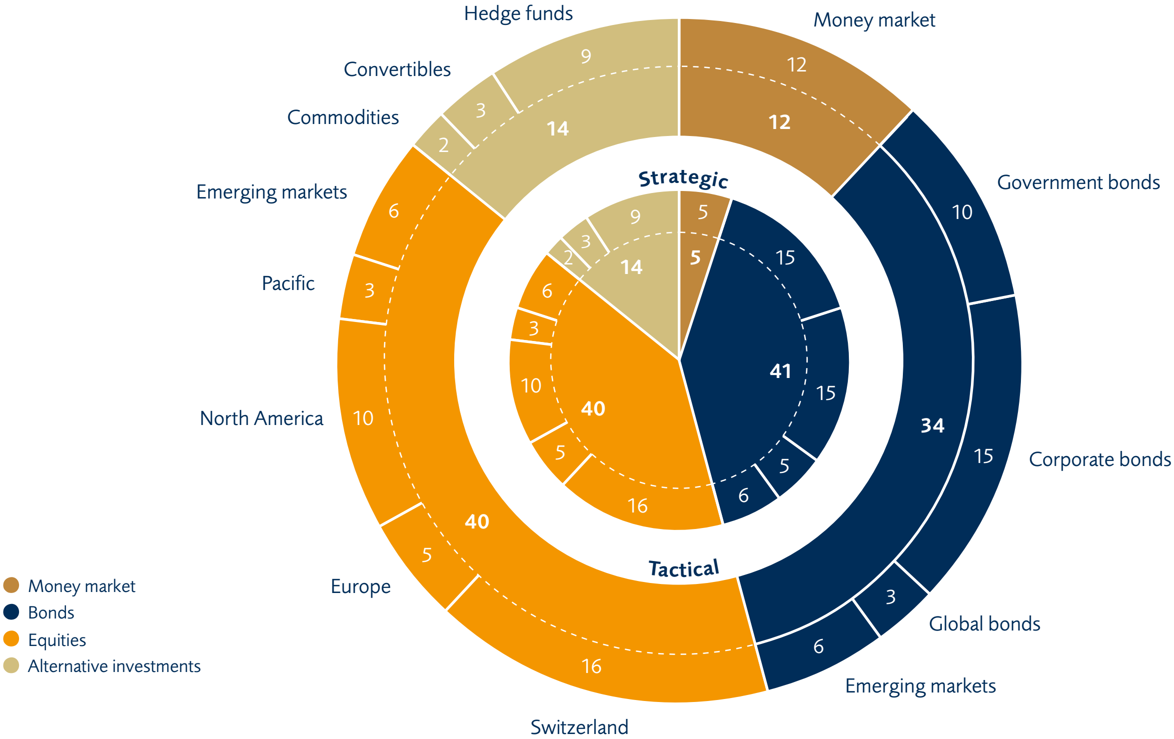
3. Investment management

Investment management | Aurelia Schmitt, Christoph Boner

Investment management portfolios

Strategic and tactical allocation – balanced portfolio based in CHF (% weightings)



VP Bank Strategy Funds

Product name	Curr.	ISIN	NAV date	NAV	Payout	Currency hedged	YTD perf. %
VP Bank Strategy Fund Conservative (CHF)	CHF	LI0017957502	13.12.2016	1,036.52	no	yes	−0.25%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	13.12.2016	1,388.05	no	yes	1.99%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	13.12.2016	1,313.66	no	yes	1.94%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	13.12.2016	1,514.15	no	yes	0.16%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	13.12.2016	959.83	no	yes	1.93%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	13.12.2016	1,451.27	no	yes	3.34%

For detailed information on our investment management mandates, please contact your personal advisor.

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Investment management

Current investment tactics

Equity markets continue to recover. The programme of the incoming US administration includes changes in fiscal policy, financial regulation and foreign trade policy. This has pushed up inflation expectations, resulting in immediate capital losses on the US bond market. The markets appear to believe that Donald Trump is serious about boosting economic growth. In Europe the negative fallout from the Italian referendum was short-lived. The markets' composure was helped by the announcement that the European Central Bank's asset purchase programme will be prolonged beyond March 2017.

The biggest surprise for most market participants in recent weeks has been the sharp rise in long-term bond yields. We have profited in relative terms from our underweight position in government securities. The yield backup is likely to continue in 2017, though with reduced momentum. We believe that the chief feature of equity market behaviour in 2017 will be a rotation among regions and sectors. Since the end of the financial crisis the markets have been in a cycle characterised by a preference for growth stocks. With economic activity improving and inflation expectations on the rise, we might now see investor preferences shifting towards value stocks. Within the eurozone, the Euro Stoxx 50 has a fairly high proportion of such stocks and valuations are relatively low.

At year-end we are keeping bonds underweighted and equities neutral.

Bonds

Global economic indicators are now improving, while inflation expectations continue to rise. Bond yields have climbed accordingly. We are sticking to our positioning and keeping duration below benchmark in all reference currencies. Our allocation in the major fixed income categories remains unchanged, with government and global bonds being kept underweight. We regard inflation protected securities as attractive.

Equities

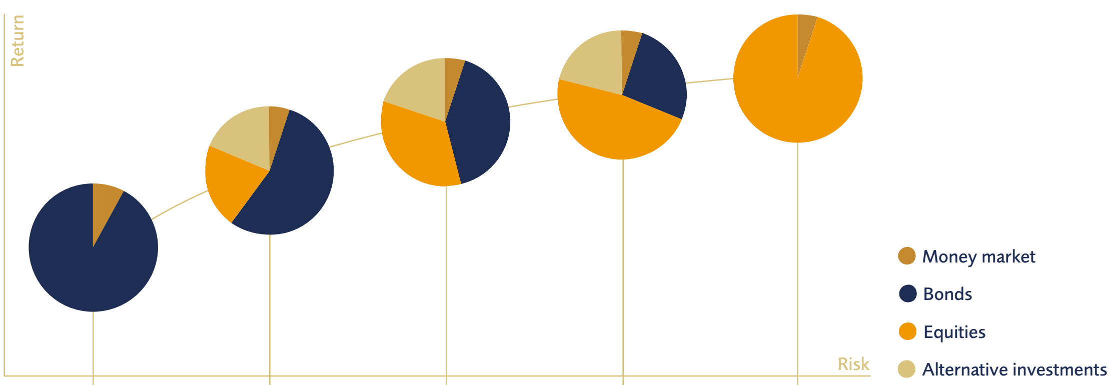
We expect a slightly higher rate of earnings growth in the USA, with positive impetus from fiscal measures. We have increased our weighting in US shares to neutral and corrected our overweight position in the emerging markets. We believe that the relatively high valuation level of the US equity market is justified by higher earnings growth. Valuations in Europe and the emerging markets are cheaper, but emerging markets could be adversely affected by a change in US trade policy. The constitutional referendum in Italy has had only a limited impact on the equity markets, but the political risks in Europe remain high in 2017.

Alternative investments and currencies

We hold positions in alternative investments, notably commodities, convertible bonds and hedge funds, as a useful portfolio component providing risk diversification. These categories are weighted at neutral. We have an open USD position in our EUR-based portfolios. Otherwise currencies of the major developed countries remain hedged.

Investment management

Our solutions



Features	Fixed income	Conservative	Balanced	Growth	Equities
Equity allocation	0%	10–30%	20–50%	30–70%	80–100%
Investment horizon	3 years	5 years	7 years	10 years	15 years
Liquidity requirement	●●●●●	●●●●○	●●●○○	●●○○○	●○○○○
Expected return	●○○○○	●●○○○	●●●○○	●●●●○	●●●●●

Investment solutions	Fixed income	Conservative	Balanced	Growth	Equities	
Strategy fund		●	●			1 unit
Fund mandate	●	●	●	●	●	from CHF 250,000 or equivalent
Classic mandate	●	●	●	●	●	from CHF 1 mn or equivalent
Special mandate	●	●	●	●	●	from CHF 2 mn or equivalent
Portfolio management enhanced mandate		●	●	●		from CHF 5 mn or equivalent

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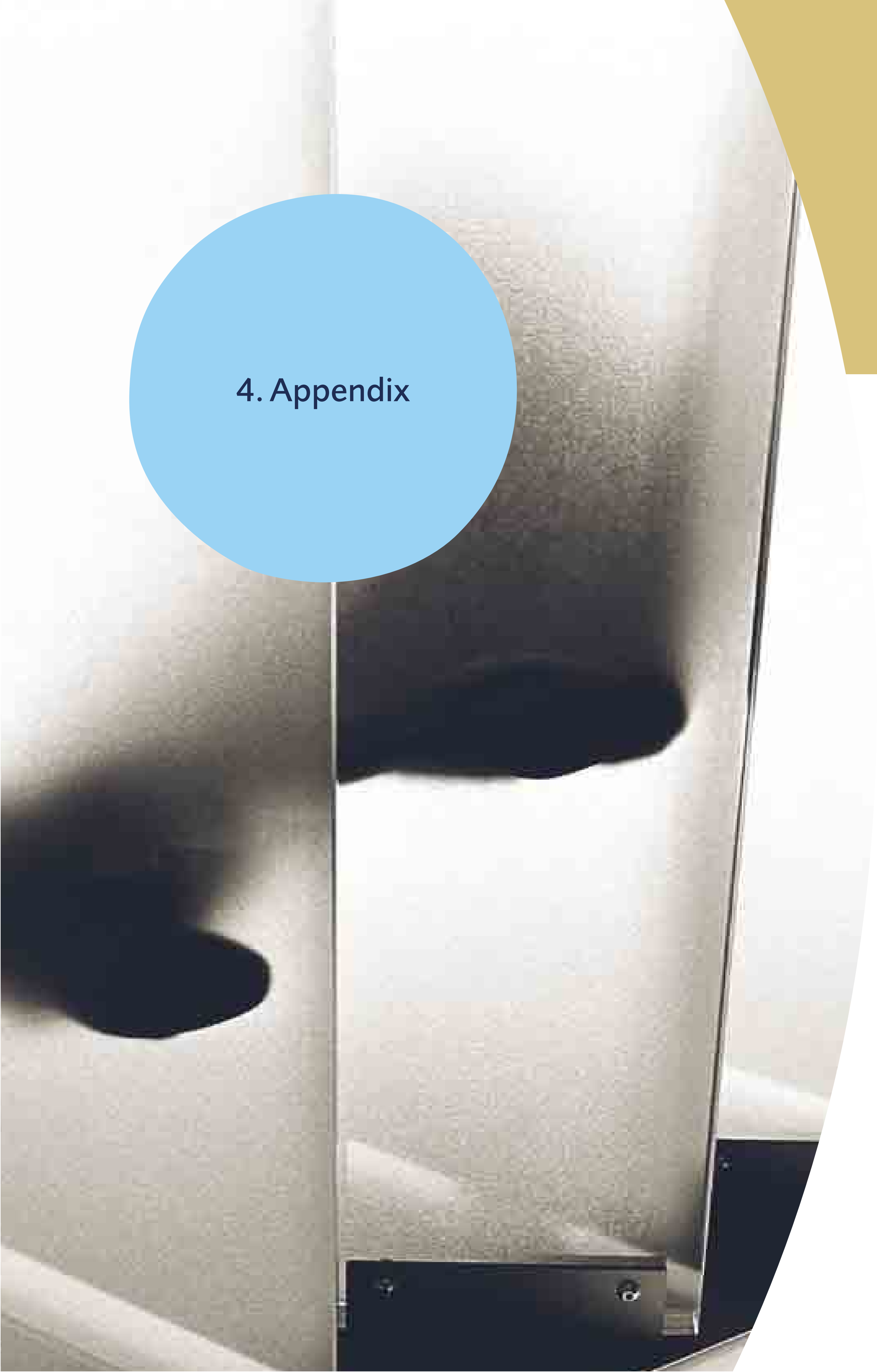
4. Appendix



Glossary

Allocation

Strategic Long-term division of an investment portfolio into various asset classes (money markets, bonds, equities, alternative investments) on the basis of a defined investment strategy. The strategic allocation is reviewed twice a year and adjusted if appropriate.

Tactical Modification of the strategic allocation by short-term variations. The tactical allocation is the portfolio mix implemented at any given time with the aim of achieving an above-average return.

Benchmark A standard, e.g. a market index or index-based portfolio, against which the performance of a portfolio is measured.

Bond fund Investment fund investing chiefly in bonds of the currency stated in the fund's name.

Commodity fund Investment fund investing chiefly in tradable commodities and commodity-linked financial instruments.

Conversion premium Percentage difference between the price of a share acquired by converting a convertible bond and the price of the same share bought directly on the stock market.

Conversion price The price at which a convertible bond can be converted into shares or participation certificates. The conversion price is fixed when the convertible bond is issued.

Convertible bond fund Investment fund investing chiefly in convertible bonds.

Currency hedging Technique whereby the value of an investment or debt denominated in a foreign currency is protected against exchange rate movements. Investors and borrowers achieve this by taking positions in the currency futures market. Hedging excludes the risk of exchange losses but also rules out the possibility of exchange gains.

Dividend yield A measure of the profitability of an equity investment, calculated by comparing a company's dividend with its current share price. This figure can be used to make yield comparisons with other types of capital market investment.

Duration A weighted average of the maturity of all income streams (principal repayment and interest payments) from a bond or bond portfolio. In the case of coupon payments the duration is shorter than the period to maturity. In the case of zero coupon bonds duration and maturity are identical.

Equity fund Investment fund investing chiefly in equities of the country or region stated in the fund's name.

Euribor (Euro Interbank Offered Rate) Interest rate at which first-class banks borrow from each other at short term on the euro interbank market.

Exchange traded commodity (ETC) A secured debt instrument with an unlimited term whose value is coupled to the value of one or more commodities.

Exchange traded fund (ETF) Investment fund whose composition mirrors that of an index and which can be traded at any time without an issue commission.

Exchange traded notes (ETNs) are debt securities. Although distinct from investment funds, they have similar characteristics. Like an ETF, they are traded on an exchange and usually linked to the return on a benchmark index. Special types of ETN are exchange traded certificates and exchange traded commodities.

Fiduciary deposit A money market transaction in which a bank places a deposit with a foreign bank on a client's behalf. The deposit has a fixed term, fixed amount and fixed interest rate, or it may take the form of call money with a 48-hour period of notice. Fiduciary deposits can be made in various currencies. The deposit is in the name of the client's bank but for the account and at the risk of the client.

Fixed-term deposit Money deposited by a client with a bank for a fixed term and at a predetermined interest rate. Fixed-term deposits are subject to a minimum deposit amount (frequently CHF 100,000) with terms ranging from one to twelve months.

Fund of funds Investment fund that invests exclusively in other investment funds.

Hedge fund Investment fund in which the manager can employ various alternative investment techniques such as leverage, short-selling and derivatives.

Investment grade Credit ratings of BBB to AAA, indicating that the securities are of satisfactory to very good quality.

ISIN International Securities Identification Number.

LIBOR (London Interbank Offered Rate) Interest rate at which first-class banks borrow from each other at short term on the interbank market in London.

Lombard loan Loan granted against a collateral pledge of securities, bank balances, precious metals or claims under life insurance policies. Lombard loans can be granted for private or commercial use and can take the form of a fixed loan or overdraft.

Medium-term note Debt security issued on tap by Swiss and Liechtenstein banks with a maturity of two to eight years.

Money market fund Investment fund that invests only in assets with a very short remaining life to maturity or with a very short duration.

NAV (net asset value) Value of a unit of an investment fund, calculated by taking the market value of the fund on a specified date, deducting the fund's liabilities and dividing the result by the number of units outstanding.

Open end An open end certificate is a certificate that has an unlimited life. The holder can remain invested as long as he likes.

Price information / indicative prices The prices stated in this publication are closing prices on the date indicated. They are net prices, i.e. excluding purchasing costs. The price of an asset when bought on the stock exchange or other market will usually differ from the price stated in this publication because of changes in supply and demand. Current prices are available from your advisor at VP Bank.

Private equity fund Investment fund investing chiefly in equity securities that are not (yet) listed on an exchange. The liquidity of such funds can be very limited.

Real estate fund Investment fund that invests on a diversified basis in land and buildings and sometimes also in equity or debt securities of real estate companies.

Strategy funds A family of strategic investment funds distinguished by different risk categories. The portfolio mix of each fund is based on the corresponding asset allocation of VP Bank.

Third party fund Investment fund issued on behalf of and managed by a third party.

Volatility The range of fluctuation of an interest rate or asset price (stock, bond, commodity, investment fund unit, etc.) within a given period. It is a mathematical expression (annualised standard deviation) of the overall risk on an investment. For example, to find the standard deviation for changes in the price of an investment fund, one takes the average price of the fund over a given period and then calculates how far the price has deviated from that average during that period. The greater the range of fluctuation, the more volatile and therefore more risky the fund is. Risk can also be expressed as maximum loss.

Yield The effective interest rate on a bond, as calculated by the ISMA (International Securities Market Association) method. This internationally recognised method is the most commonly used basis for yield calculations. It permits precise adjustments for fractional periods and multiple coupon payments within a year.

YTD perf. % Year-to-date performance in per cent, i.e. performance from the start of the current year to the present date.

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- statistics in the public domain.

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The same remarks apply to performance forecasts. The performance shown does not take account of any commissions and costs charged when
subscribing to and redeeming units in investment funds. Such commissions and costs have a detrimental effect on performance. Any investment mentioned in this document may involve the following risks (the list of these risks should not be regarded as exhaustive): issuer (creditworthiness) risk, market risk, credit risk, liquidity risk, interest rate risk, currency risk, economic risk and political risk. Investments in emerging markets are speculative and particularly strongly exposed to such risks.

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Core methods used in financial analysis: VP Bank has adopted the following core methods in its financial analysis:

- The stock selection list is based on a global, quantitative screening model. This classifies stocks according to factors that deliver the highest performance levels over the long term.
- In each currency sector, bond selection considers only bonds without special clauses (bullet bonds). These tend to be Eurobonds with investment grade ratings and no special risk premiums. Attention is also paid to the marketability factor before allocations are divided into the sovereign and corporate segments.
- ETF selection is based on quantitative scoring and a qualitative analysis.
- Investment funds are selected according to the "best in class" method. Our multi-tiered analytical process includes both quantitative and qualitative elements.

Investment horizon: Recommendations are based on well-diversified portfolios. The recommended investment horizons for balanced portfolios are five to ten years, and for equity portfolios generally more than ten years.

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4. are a market maker in the issuer's financial instruments;
5. have within the past twelve months concluded an agreement relating to the provision of investment banking services with issuers subjected to financial analysis (with regard to themselves or their financial instruments) or received a service or an undertaking to provide a service under such an agreement;
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