Investment Views

2nd quarter 2017

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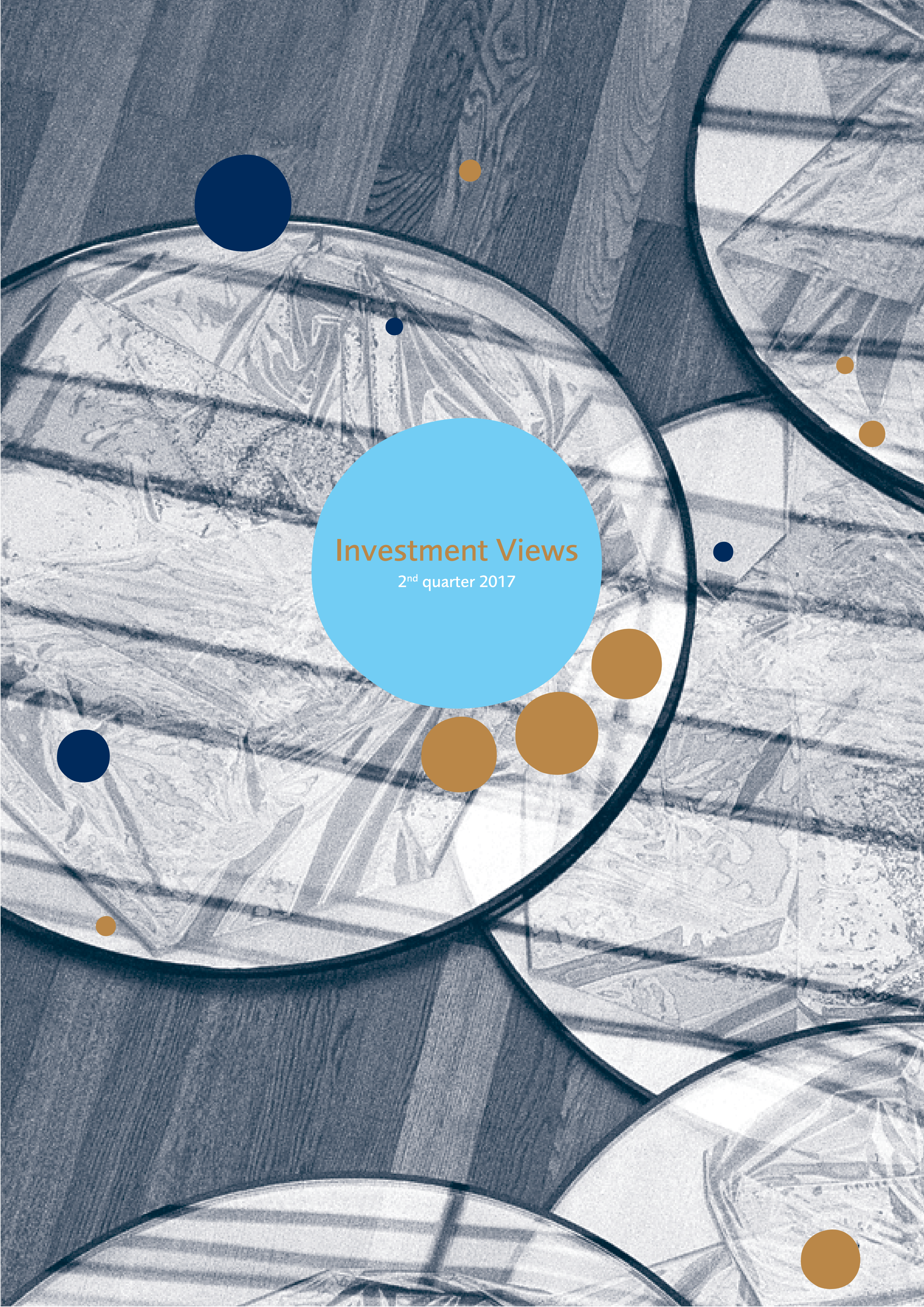

Investment Views

2nd quarter 2017

Foreword

A lesson for Trump?

Dear Reader

Financial market professionals know how the game works. When a company publishes its results, it wants them to look as good as possible. That means being able to boast higher sales and earnings that analysts expected. Corporate managers and their investor relations departments therefore try to ensure that market expectations are realistic but on the low side. They mostly achieve this. On average around three-quarters of US firms publish results that beat analysts' forecasts.

The new US president spurns this game. Donald Trump plays by his own rules. He makes no attempt to keep expectations low so that he can subsequently outdo them. On the contrary, he loudly proclaims his intentions and fans expectations with grandiose announcements, as if he were still on the campaign trail. He boasts that he will be the "greatest jobs producer that God ever created" and characterises his tax plan as "phenomenal".

Big advances on the US equity market suggest that investors have bought into this rhetoric, at least to some extent. After a brief period of hesitation, the market is now betting on economic stimulus and ignoring the dangers of import taxes and other protectionist policies that could lead to trade wars and currency conflicts.

After over two months in the White House, however, Donald Trump is having to face up to the realities of office. The going will not be easy. He has to reconcile Congress to his proposals and navigate a course through America's system of checks and balances.

Given the arduous political journey ahead, Donald Trump might come to regret not having taken a leaf out of the investor relations playbook by preparing the ground for positive surprises.

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 21.03.2017	February 2017	April 2017
EUR vs. USD	1.080	↘	↘
EUR vs. CHF	1.075	↘	↘
USD vs. CHF	0.995	→	→
GBP vs. CHF	1.236	→	→
USD vs. JPY	112.69	↗	↗
AUD vs. USD	0.772	→	→
USD vs. SGD	1.399	↗	↗
USD vs. RUB	57.102	→	→
Key interest rates			
Switzerland	–0.75%	→	→
Europe (EMU)	0.00%	→	→
USA	1.00%	↗	↗

Bond yields (pages 14–17)		
Investment grade government bonds		
Switzerland	→	→
Europe	→	→
USA	→	→
Investment grade corporate bonds		
Switzerland	→	→
Europe	→	→
USA	→	→

Bonds: total return (pages 14–17)		
High yield bonds	February 2017	April 2017
High yield	↘	↘
Emerging market bonds		
Hard currency bonds	→	→
Local currency bonds	→	→

Equities (pages 18–21)		
Switzerland	→	→
Europe	→	→
North America	→	→
Pacific	→	→
Emerging markets	→	→

Alternative investments (pages 22–25)		
Commodities	→	→
Crude oil	→	→
Gold	→	→
Real estate shares	→	→
Private equity	→	→
Convertible bonds	→	→
Hedge funds	→	→

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1. Focus

Top issue of the month | Bernd Hartmann

Bank regulation – taking the bull by the horns

Ten years ago the first signs of the looming financial market crisis hit the headlines. Events rapidly multiplied until the world was embroiled in the worst economic crash in recent history. The debacle prompted an unprecedented spate of regulation in the banking sector. Donald Trump now says he wants to unpick the new rules. What are we to make of this? Will the stability of the financial system be jeopardised? Or has bank regulation simply gone too far?

First too little ...

Although the roots of the financial crisis lay in the USA, the first alarm bell was sounded in Britain on 7 February 2007, when HSBC announced a multi-billion write-off on US real estate securities. The financial world did not initially know what to make of this, but it was not long before the ghastly truth dawned. What had initially seemed to be a problem affecting just one bank quickly erupted into a generalised crisis in the US real estate sector and the banking industry, eventually leading to the worst global economic crisis since the Great Depression of the 1930s. In 2009 the financial market crunch morphed seamlessly into the European debt crisis.

Faced with this debacle, politicians decided that everything had to be done to stabilise the fragile financial system. Much of the blame was placed on the deregulation of the banking industry that had taken place in the 1990s. The upshot has been a plethora of rules and regulations designed to control the banks and improve protection for consumers and investors. Measures were coordinated internationally under the aegis of the newly created G20 (G7 plus major developed and developing countries). The European Union set up a commission of experts, whose recommendations led to a new architecture for financial market supervision. Numerous new laws and directives were made subject to oversight by pan-European supervisory agencies. In America the centrepiece of the new regulatory system is the Dodd-Frank Act, which was designed to curb Wall Street excesses. Its most widely known provision is the Volcker Rule, named after former Fed Chair Paul Volker, which prohibits proprietary trading by banks. The Dodd-Frank Act is an extremely comprehensive and complex piece of legislation running to 849 pages. Seven years after it was passed it has still not been fully implemented.

... and now too much?

Now, almost exactly ten years after the first harbingers of the financial crisis, Donald Trump has issued an executive order directing a review of the current regulatory framework. The Dodd-Frank Act, introduced under President Obama, is a bugbear for Trump and Treasury Secretary Steven Mnuchin (previously a Wall Street banker). The aims of Trump and his advisors are still unclear. We do not yet know how far deregulation will go. Trump believes that the Dodd-Frank Act puts a brake on bank lending, which plays a crucial role in the real economy. Inadequate lending cripples investment and undermines economic growth. There is now heated discussion about the impact of tighter regulation on the banks' loan books. What degree of negative impact is justifiable for the sake of a more stable financial system? This is the conundrum that Secretary Mnuchin has to solve.

Many observers see the review as an attack on the stability of the financial system and a threat to global cooperation. In place of international arrangements, they say, individual countries will loosen their rules in order to gain a competitive edge for their own banks. However, at the G20 summit in March, Mnuchin committed himself to abide by the Basel III accord, whose rules on capital adequacy and liquidity are regarded as the lynchpin of international bank regulation.

A taboo that needs to be broken?

As so often, Donald Trump has dared to raise a subject that had previously been taboo (at least since the financial crisis). The new rules may have enhanced the stability of the financial system, but after years of stringent regulation it is only right to take a critical look at their impact. Reviewing the effectiveness and appropriateness of

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existing measures is normal practice in the business world, so why not in this case too? Legislators need to ask whether the rules are genuinely conducive to the stability of the financial system and whether the current supervisory mechanisms are still fit for purpose. A critical analysis will not necessarily lead to deregulation. On the contrary, it may lead to gaps being plugged. In any case, regulation is not an end in itself. It must serve society and the economy. Superfluous rules that do more harm than good should be ditched or at least revised.

Finding the right level of regulation is far from easy. Too much regulation puts a drag on the free market economy and results in unnecessary costs. Too little exposes the world to crises that can inflict huge damage on the real economy. A balance has to be sought.

Alongside the enhancement of financial market stability, regulation also serves to protect consumers and investors. Here too the appropriateness of current measures needs to be critically examined. For example, the rules on transparency and due diligence generate enormous costs and necessitate time-consuming dialogue between customers and the banks. Many banks therefore economise by slimming down the range of services they offer. While high net worth individuals and institutional clients still have access to a full range of products, small clients are provided with little or nothing in the way of investment solutions. But complex solutions that require detailed explanation are often the most lucrative for the client. While regulation certainly protects many investors from inappropriate products, it can therefore lead indirectly to a widening of the gulf between the super-rich and the less well-off.

Dangers of going it alone

In tackling the financial crisis the international community rightly put the emphasis on cooperation. Only in this way was it possible to make the global financial system more resistant to crisis. A relapse into unilateral action would be fraught with danger. Instead of going it alone, the United States should therefore try to convince its international partners of the need for a review. Europe must play an active role here. Positions are probably not as divergent as is often claimed. After all, Donald Trump would not want to see distressed banks being bailed out again with public money. If that is to be avoided, high-quality regulation is a must. Europe and Asia also have another reason for wanting an international discussion: they know that unilateral deregulation by the USA would distort international competition. US banks, enjoying a laxer regulatory framework, would be at an advantage compared with their foreign rivals.

Conclusion

Although Donald Trump's announcement has been widely lambasted and we do not yet know exactly what his thinking is, a critical review of existing regulations is basically welcome. Despite the obvious difficulties, discussion on these matters needs to be globally coordinated, because the system itself is a global edifice. But red lines have to be drawn. Deregulatory measures that ignore financial market stability might seem attractive for an individual country, but they can damage the system as a whole.

Economic outlook | Dr Thomas Gitzel

Dawn of a new political era

Highlights

- Donald Trump is set to initiate new economic legislation in the USA.
- France appears to be heading for a paradigm shift in its political landscape.
- Thus the world is facing fundamental changes, with likely reverberations on the financial markets.

As winter gives way to spring, the political weather is also heating up. Donald Trump will soon have to flesh out his legislative agenda, replacing vague utterances with concrete action. In Europe attention is focussed on France's presidential election. The front-runners are Emmanuel Macron and Marine Le Pen, two non-establishment candidates. This unprecedented situation marks a paradigm shift in French politics.

Guessing Donald Trump's economic policy

So far the only thing that is certain about Donald Trump's economic policy is that nothing is certain at all. In recent weeks the new US president has had to come to terms with the harsh realities of day-to-day government. New laws have to take account of the debt ceiling, budget discipline and free trade. Tax cuts are therefore unlikely to be implemented rapidly. The core points of the administration's fiscal strategy are being vehemently debated behind the scenes. Relief for tax payers will therefore come later than originally hoped. At the same time, government sources have been toning down Trump's aggressive protectionist rhetoric. The charge that the Chinese are the "grand champions" of currency manipulation has not been repeated. There has also been an effort to defuse fears that America is about to unleash a trade war. Trump has certainly not abandoned his "America first" creed, but he is proceeding with greater caution than expected. This puts a big question mark over the mooted "border adjustment tax" (BAT), which would tax imports while exempting exported goods. Thus the USA will experience months of heated political debate, which could cause uncertainty on the financial markets.

France heading for the ballot box

Ahead of France's presidential election the representatives of the established political parties are languishing in the polls. Surveys currently indicate a neck-and-neck race in the first ballot between the right-wing populist Marine Le Pen and the independent Emmanuel Macron, who is then expected to emerge victorious in the second ballot on 7 May. France is entering a new political era. As Macron will not be beholden to established political alliances, there is genuine hope of reform. Macron wants to apply the labour market formula that has already proved so successful in Spain. Instead of nationwide battles between employers and unions, wage negotiations would be carried out at industry level, or even better at factory level. Labour market deregulation would be flanked by liberal social reforms. In this way Macron might at last be able to reconcile the strike-happy French to a new direction in economic policy.

Fundamental changes ahead

It is hardly an over-dramatisation to say that events in the coming months will have a fundamental impact for years to come. A revamped economic policy in the USA and a paradigm shift in French politics will have repercussions on the financial markets. In the long term a strengthened French economy would be a positive signal for European equity markets, but the short-term outlook for Europe is one of uncertainty. That could benefit the US dollar. At the same time, an ongoing flight of capital into Switzerland will maintain the upward pressure on the Swiss franc against the euro.

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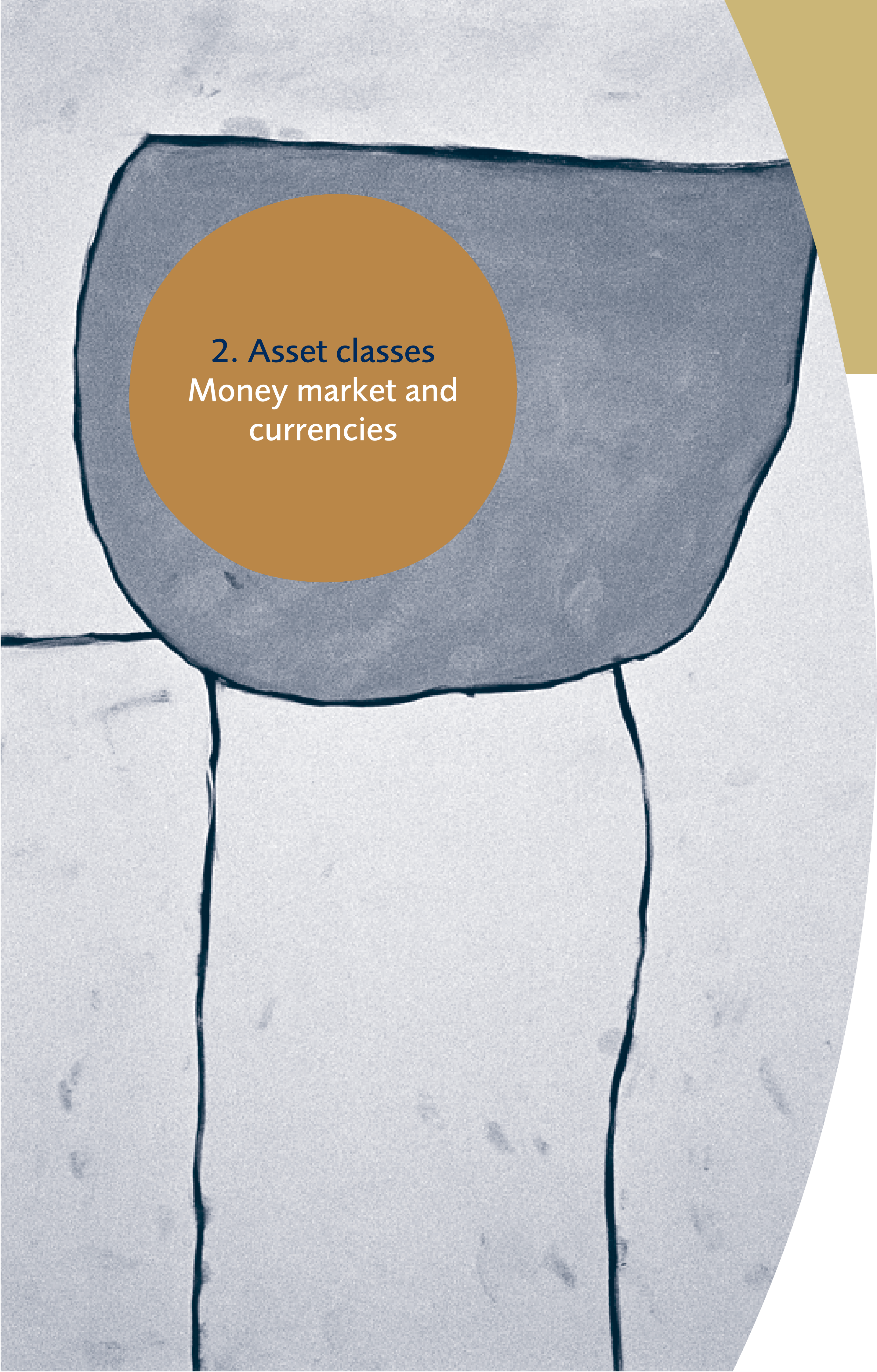
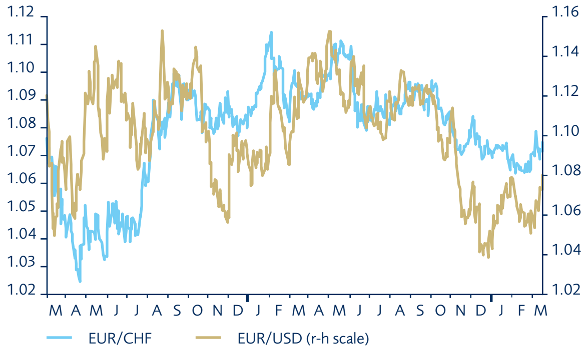


2. Asset classes
Money market and currencies

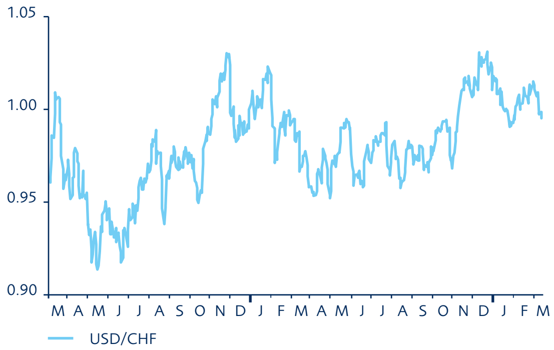
Money market and currencies

Market overview

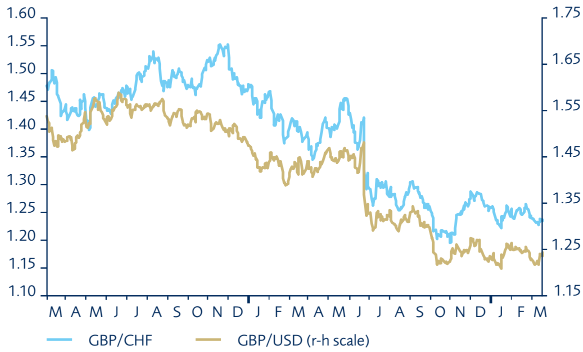
EUR/CHF and EUR/USD: **exchange rates since March 2015**



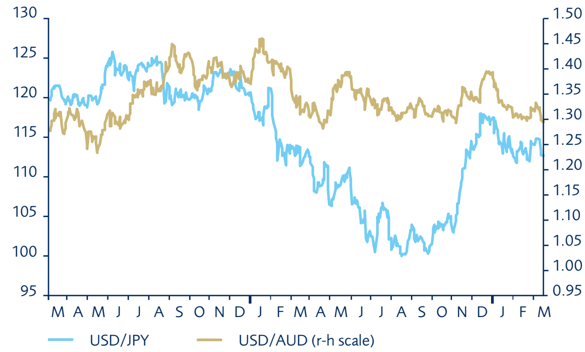
USD/CHF: **exchange rate since March 2015**



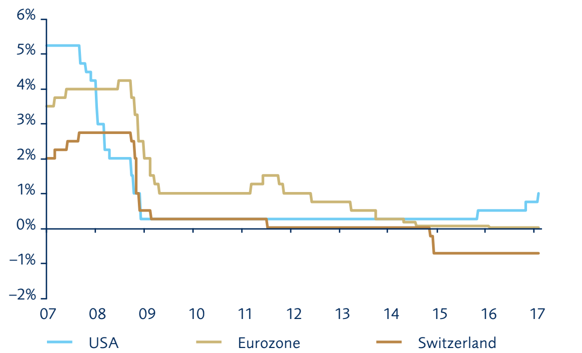
GBP/CHF and GBP/USD: **exchange rates since March 2015**



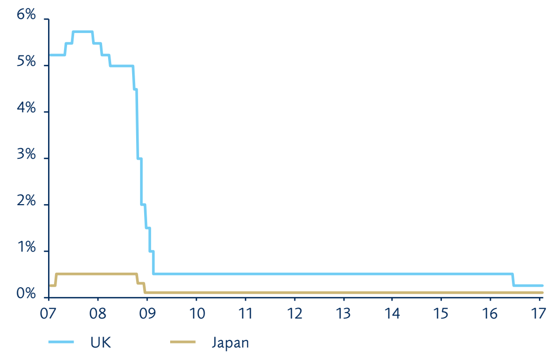
USD/JPY and USD/AUD: **exchange rates since March 2015**



Key interest rates in Switzerland, eurozone, USA: **since January 2007**



Key interest rates in UK and Japan: **since January 2007**



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Money market and currencies | Dr Thomas Gitzel

Market outlook

Fed still playing safe

At the start of the year the Fed was still shilly-shallying about further interest rate hikes, but in March it suddenly changed its tune and raised the fed funds rate by 25 basis points. Accelerating inflation and overwhelmingly good economic data left ultra-cautious Fed Chair Janet Yellen little choice. But the financial markets' response to the Fed's earlier-than-expected action was decidedly cool. The US dollar retreated against other major currencies, and long-term US bond yields failed to move higher. The fact of the matter is that the currency markets are less interested in the timing of a particular hike than in the likely frequency of hikes in the future. In this respect there has been no fundamental change either within the Fed or on the money markets. Hence the markets' muted reaction:

- Fed Chair Janet Yellen has repeatedly stated that an interest rate hike should not be misinterpreted as a pointer to a faster pace of monetary tightening in the future.
- The futures market for short-term dollars is still signalling only one further interest rate hike this year.

We, on the other hand, still regard two further hikes in 2017 as the likeliest scenario. But it should not be assumed that further action by the Fed will come automatically – witness what happened (or rather failed to happen) after Janet Yellen's previous rate increases. A number of hurdles have to be overcome in the coming weeks.

Temporary dip in sentiment ahead

Available data suggest that US economic growth slowed in the first quarter of 2017. Real consumer spending in January showed an unexpectedly sharp drop compared with December. Automobile sales have also declined after handsome growth rates at the end of 2016. The Federal Reserve Bank of Atlanta's "GDPNow" model calculates a real-term GDP growth rate on the basis of available monthly data. The first quarter "nowcast" issued at the start of February was 0.8%, but this has since been clipped to 0.2%. Buoyant sentiment in the US manufacturing sector can be expected to lose its shine in the coming months. Rising wages, sharply higher factory gate prices, a strong dollar and higher interest rates are making life difficult for many American firms. It should also be noted that US inflation has peaked for the time being and can be expected to edge down in the coming months. In a nutshell: the situation confronting the Fed will become more challenging during the spring and summer. That could tempt the cautious Fed to postpone further rate increases.

Two further hikes are feasible

Despite the expected weakening of activity in the coming months, the basically positive trend of the US economy remains intact. The situation will be helped by Donald Trump's planned corporate tax cuts and promised infrastructure projects. It should also be noted that inflation, though having peaked for the time being, is still relatively high at 2.3% when volatile energy and food prices are bracketed out. No substantial change is in prospect here. America's 4.7% jobless rate is tantamount to full employment. If wage pressures continue to intensify during the coming quarters, core inflation will stay at elevated levels. That alone gives the Fed good reason to implement further interest rate hikes.

USD outlook

Although the expected moderate economic slowdown and possible zigzagging by the Fed do not favour a stronger dollar, other factors could push the greenback higher:

- Donald Trump's team is now putting together its economic programme. Trump has promised to unveil a "phenomenal" tax plan in the coming weeks. Officials have also compiled a list of 50 priority infrastructure projects. The ten largest would involve a capital outlay of USD 137 billion and are to be fast-tracked.

Highlights

- US economic growth will be far from spectacular, despite good leading indicators.
- In fact, America's economic prospects are likely to deteriorate slightly in the months ahead.
- Further US interest rate hikes will therefore not come automatically.

- The main focus will be on building a high speed rail network and renewing the nation's highways. Resurgent economic optimism inspired by these measures could lead to renewed dollar strength.
- The approaching presidential election in France is making investors jittery. If National Front leader Marine Le Pen becomes the next French President, that would have thunderous consequences not only in France but also beyond. Le Pen wants to take France out of the EU, which would probably spell the beginning of the end for the European project. Polls indicate that Le Pen will come top in the first ballot on 23 April but will fail to achieve an absolute majority. That will lead to a run-off between the two leading candidates on 7 May, with Le Pen then expected to lose. However, the EU referendum in Britain and the US presidential election have shown just how wrong opinion polls can be. Until 7 May the forex markets will therefore not be betting on a higher euro.

Thus a number of weighty factors point towards a further strengthening of the US dollar in the coming weeks. Even so, the possibility cannot be ruled out that the dollar's present consolidation phase against the euro will continue for a while.

Conclusion

Despite some good economic numbers, America's GDP appears to have grown by only 0.2% in the first quarter. That is hardly a tempestuous rate. Moreover, major leading indicators may slacken in the months ahead. Further interest rate hikes will not happen automatically. Given the relatively high core rate of inflation, however, we expect two further hikes this year. The US dollar should also be helped by political uncertainties in the eurozone, enabling it to appreciate moderately against the euro. Against the Swiss franc we forecast a continued sideways movement.

Key interest rates	April 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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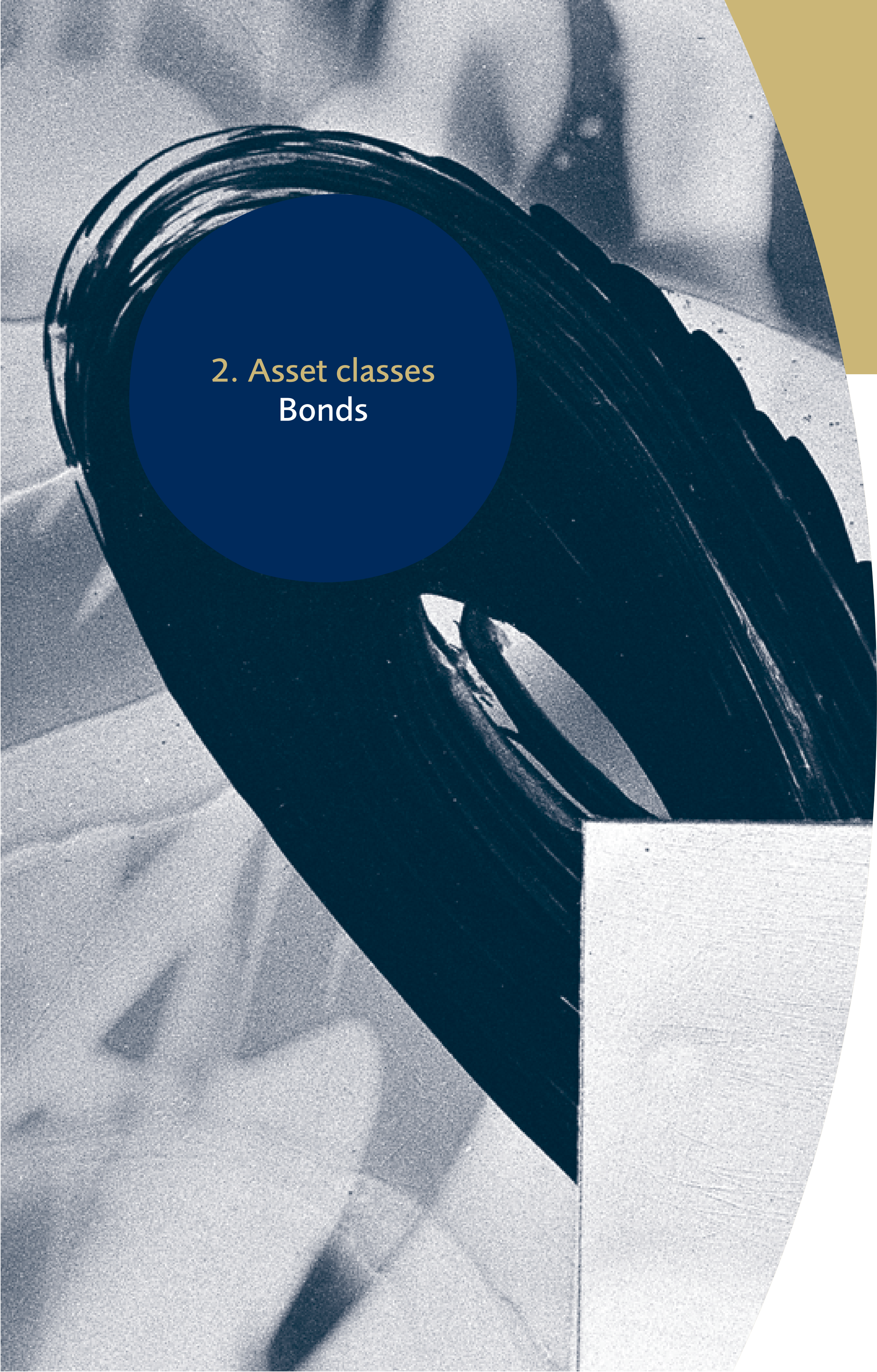
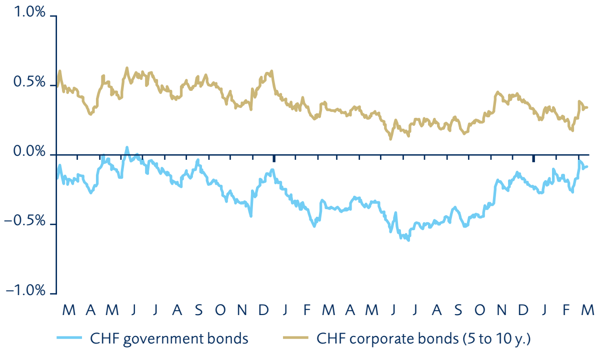


2. Asset classes
Bonds

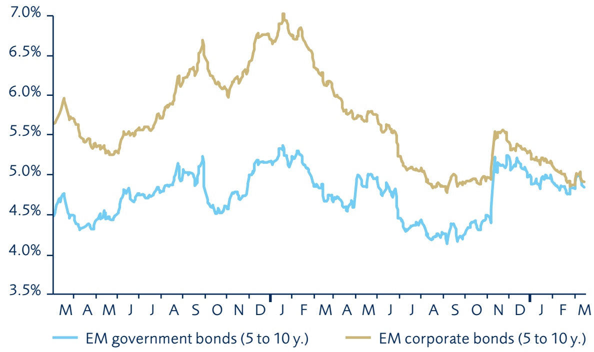
Bonds

Bond yields – overview

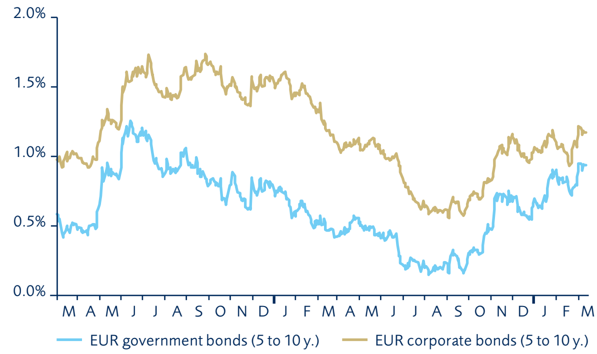
Switzerland: yields since March 2015



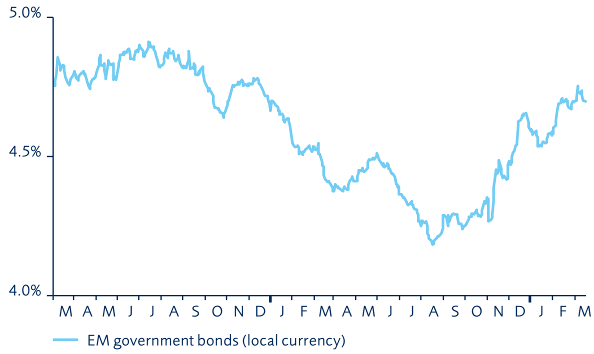
Emerging markets (hard currency): yields since March 2015



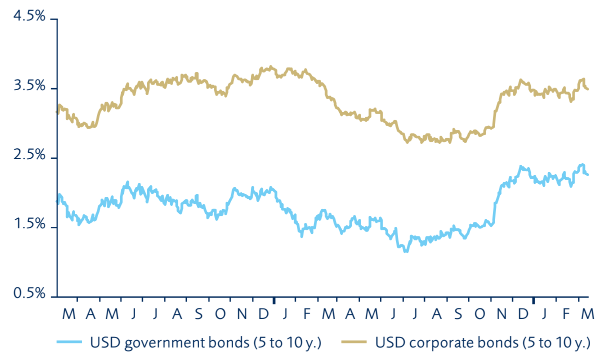
Europe: yields since March 2015



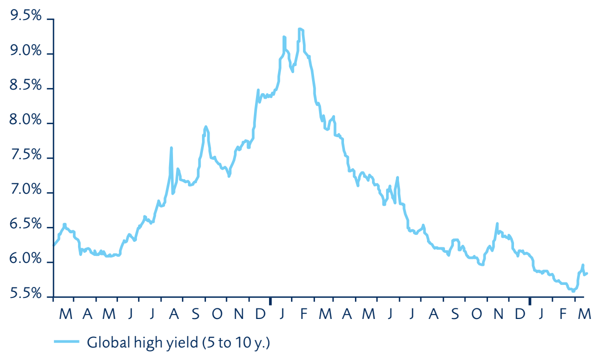
Emerging markets (local currency): yields since March 2015



USA: yields since March 2015



High yield: yields since March 2015



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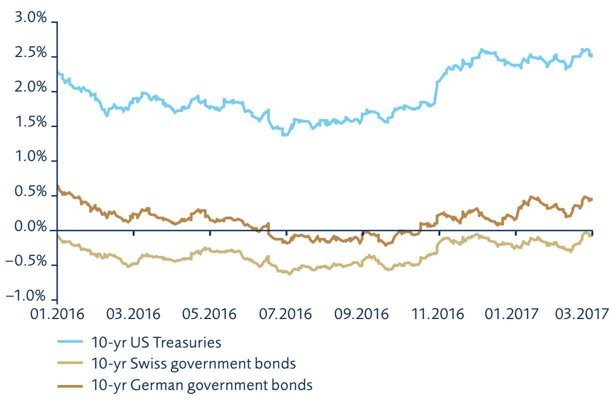
Bonds | Dr Thomas Gitzel, Bernhard Allgäuer

Market outlook

Yield backup on both sides of the Atlantic

The government bond sector has seen a change of trend in recent months. After a long period of sparkling performance, bond prices have been in retreat. The corollary of this has been rising yields. The yield on 10-year Swiss government bonds, which had notoriously been languishing in negative territory for a year and a half, briefly edged above zero again. In the eurozone, meanwhile, the yield on 10-year Bunds touched 0.5%. The main driver behind these movements, as so often, was the US market. Donald Trump's election was followed by a backup of yields on US Treasuries, and this movement was echoed in Europe. The tax cuts and infrastructure projects promised by the new president inspired hopes of a boost to US growth, paving the way for interest rate hikes by the Fed. Rising inflation generated by higher oil prices has also been a factor in pushing up long-term yields.

Government bond yields



Sideways trend ahead

Although major leading indicators in the USA have recently improved, the hard facts are not encouraging. Available numbers point to a meagre growth rate in the first quarter of 2017. Moreover, our analysis suggests that leading indicators will retreat from their current elevated levels in the coming months. Wage growth, higher producer prices, dollar strength and higher interest rates are making life difficult for many American firms. Meanwhile, the Trump administration is having to face up to political realities. New laws will have to take account of the debt ceiling, budgetary discipline and the dictates of free trade. America will therefore have to wait a bit longer for possible tax cuts and infrastructure projects. A Trump boost for the economy will therefore probably not materialise until 2018.

Inflation, moreover, has already peaked for the time being. The inflationary impact of the oil price recovery is petering out. US inflation is set to decelerate in the coming months from almost 3% recently towards 2% in the second half of the year. A further substantial backup of yields is therefore unlikely in the immediate future. That applies not only to US Treasuries but also to government bonds in Germany and Switzerland. The time is not yet ripe for a yield breakout. Weaker leading indicators and decelerating inflation will militate against higher yields for a while. However, US core inflation will still be relatively high, and we therefore expect the Fed to implement two further rate hikes this year. Bond yields are unlikely to climb until the futures markets discard their current doubts about a higher interest rate outlook.

Highlights

- Bond yields have risen significantly in recent months.
- A consolidation is now on the cards for the coming weeks.
- The boom in mergers and acquisitions has a negative impact on corporate and high yield bonds

Corporate bond market impaired by M&A

The availability of cheap finance in a low interest rate environment and corporate profitability has fuelled a boom in mergers and acquisitions in recent years. While takeovers push up the price of the target company's shares, corporate bond holders usually come off worse. Downpricing frequently affects not only the buyer's bonds but also those of the seller. Sometimes even the mere rumour of a merger is enough to cause credit spreads to widen. As long as interest rates stay very low, the M&A trend can be expected to continue. Corporate and high yield bonds remain unattractive not only therefore.

Booming mergers and acquisitions

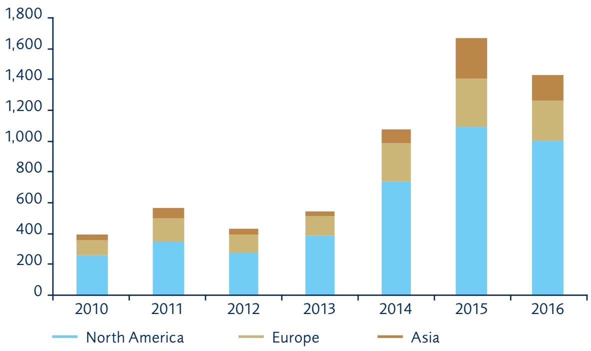
With financing costs at rock bottom, barely a day passes without a new corporate acquisition hitting the headlines. The number of transactions is constantly rising, and so is their size. Bayer's acquisition of Monsanto, now awaiting regulatory approval, carries a price tag of USD 66 billion. M&A deals priced at more than USD 5 billion reached a worldwide volume of approximately USD 1,400 billion last year.

A merger or acquisition usually results in a higher debt ratio for the new company. This releveraging leads to increased risk, thereby heightening the likelihood of borrower default. Impaired credit-worthiness increases the danger of rating downgrades and shifts in credit spreads, while the trend towards megadeals produces significant risks on the supply side.

Conclusion

The M&A binge is likely to continue in 2017. The resultant widening of spreads can quickly demolish the positive "carry", i.e. the extra yield for years. Compensation for credit risks hasn't been adequate for a while. Thus the M&A boom is a further argument against risk exposure on the corporate bond markets.

M&A volume in USD bn (deals above USD 5 bn)



Benchmark	April 2017	% YTD[1]
Gov. bonds Switzerland[2]	→	–1.36%
Gov. bonds Europe (EUR)[2]	→	–2.42%
Gov. bonds USA[2]	→	0.17%
Inv. grade corp. bonds Switzerland[2]	→	–0.11%
Inv. grade corp. bonds Europe (EUR)[2]	→	–0.34%
Inv. grade corp. bonds USA[2]	→	0.57%
High yield bonds[3]	↘	1.42%
Emerging market bonds (hard currency)[3]	→	3.43%
Emerging market bonds (local currency)[3]	→	7.87%

[1] As of 21.03.2017
[2] Yield
[3] Total return

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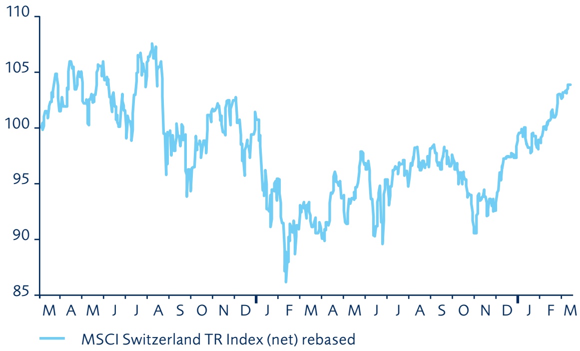
2. Asset classes
Equities

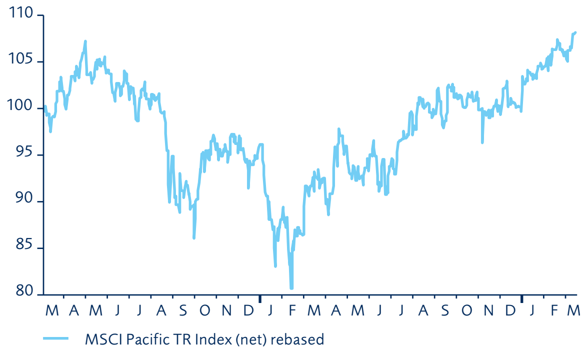
Equities

Equity indices – overview

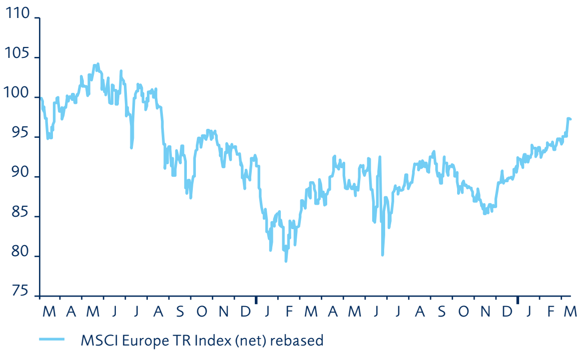
Switzerland: market movement since March 2015 (indexed)



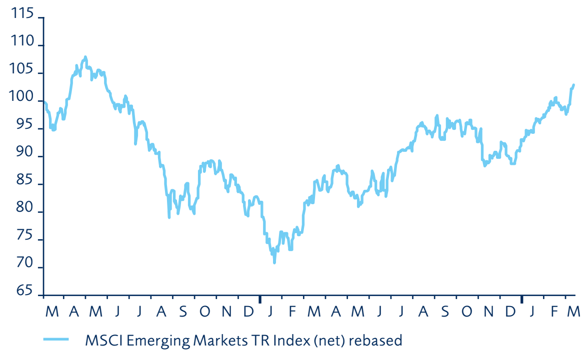
Pacific: market movement since March 2015 (indexed)



Europe: market movement since March 2015 (indexed)



Emerging markets: market movement since March 2015 (indexed)



North America: market movement since March 2015 (indexed)

United Kingdom: market movement since March 2015 (indexed)

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Equities | Rolf Kuster

Market outlook

Recent years have been a good time for "Russia bears". Sanctions and the oil price collapse caused serious damage to the Russian economy. But the mood is now brightening. New data indicate that Russia's longest recession in 20 years came to an end in the fourth quarter of 2016. This creates opportunities for the attractively valued Russian equity market.

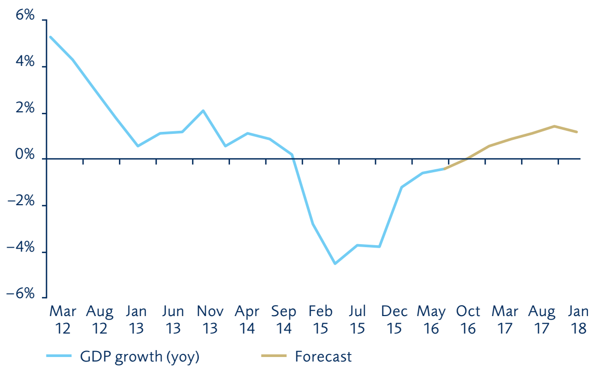
Red Square blues

The economic misery suffered by many Russians in recent years was caused principally by the dramatic collapse of world oil prices. The Russian economy is heavily dependent on exports, which account for around 30% of GDP, with oil making up almost a quarter of foreign sales. Plunging oil prices not only hit exports but also caused a drastic decline in tax revenue, while consumers were bludgeoned by imported inflation due to the weak rouble. The result: two years of recession, inflation above 15% and a budget deficit that caused the financing base for future public expenditure to shrink by 80% in the space of two years. The pain was compounded by the imposition of sanctions by Western governments in response to Russia's annexation of the Crimea. Economic weakness and geopolitical uncertainties meant that the Russian equity market was long regarded by many international investors as a no-go zone.

Russia bears could turn bullish

However, there have been growing signs in recent weeks and months that the worst could now be over. Tax revenues indicate a welcome rise in domestic output. The positive mood is underscored by leading indicators, e.g. the purchasing managers index (PMI), which are clearly in the expansion zone. Most analysts reckon that Russian GDP growth in the fourth quarter of 2016 edged above zero.

Russian GDP



Source: Bloomberg

The Russian government's budget is slated to stay in deficit for the next two to three years. However, the official forecast of a USD 40 oil price for the next couple of years looks pessimistic, so there is a good chance that the Russian state, with its low level of debt, will be able to achieve a budget surplus before 2019. The inflation picture is also encouraging. Galloping CPI inflation had been a serious problem, but the annual rate in January was down to 5%, only slightly above the 4% target for 2017. This provides the central bank with leeway for monetary easing.
Despite these signs that the Russian economy is on the mend, big questions remain concerning the future political relationship between Russia and the West. Donald Trump is widely expected to pursue a basically friendlier policy towards Russia than his predecessor, but anti-Russian feeling is still strong among his colleagues in the Republican Party. The rumpus surrounding the resignation of national security advisor Michael Flynn has not been helpful in this respect. Little can be said with certainty in the present volatile environment, but the chances of a relaxation of sanctions are now undoubtedly greater than they were under Obama.

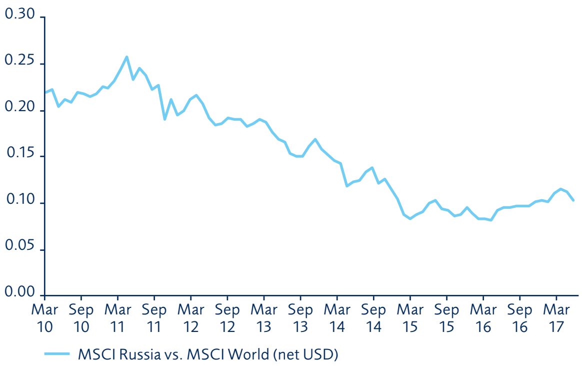
Highlights

- The Russian economy is on the mend. The fourth quarter of 2016 appears to have marked the end of two years of recession.
- Russia's equity market is also benefitting from comparatively stable oil prices, a low valuation level and rising earnings expectations.
- The new US administration is likely to be friendlier towards the Kremlin than President Obama was.

Are Russian equities attractive?

Historically the Russian equity market has often been among the cheapest in the world. But investors should not be dazzled by apparently low price/earnings ratios. The low valuation level is partly attributable to the market's one-sided composition (energy, commodities, finance) and also reflects the political risk.

Russian equity market: relative performance (in USD)



Sources: Bloomberg, VP Bank

At its present level the Russian equity market can no longer be regarded as substantially undervalued relative to its historical levels despite a slight discount compared with other emerging markets. The present incentive for investors is not low valuations but rather the positive outlook. The clouds over the Russian economy are lifting. The negative effects of the previous collapse of crude oil prices are petering out, and a renewed oil price crash is unlikely despite the recent weakening. The political situation is admittedly still fragile, but the new occupant of the White House does not appear to be essentially unfriendly towards Putin.

These improved conditions are reflected in gradually rising expectations. Analysts have been ramping up their forecasts for Russian corporate earnings for some time now. The I/B/E/S data service currently puts Russian earnings growth for 2017 at around 10%. Flows of assets by reputable investment funds show that emerging market managers in particular are starting to build up an overweight position in Russian shares – a trend that is underscored by numerous investment banks, which are recommending an increased focus on the Russian market.

Benchmark	April 2017	% YTD[1]
Switzerland	→	6.78%
Europe	→	6.91%
North America	→	6.25%
Pacific (incl. Japan)	→	8.04%
Emerging markets	→	12.97%

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 21.03.2017

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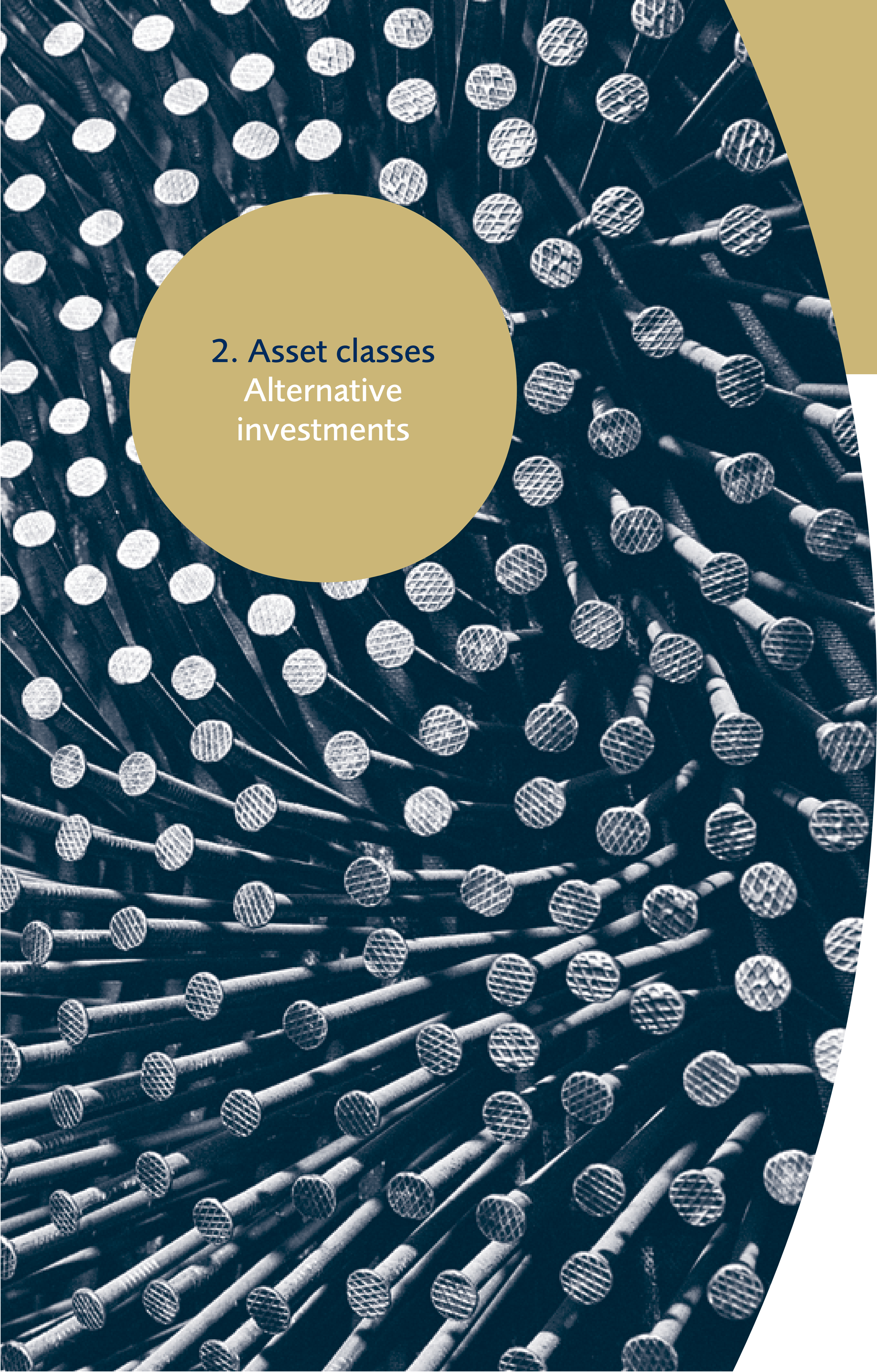
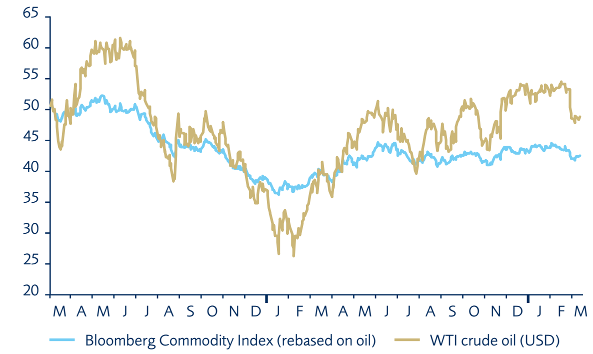


2. Asset classes
Alternative investments

Alternative investments

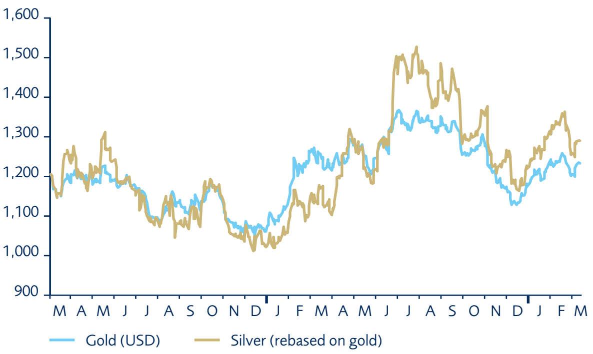
Alternative investments – overview

Commodities: performance since March 2015

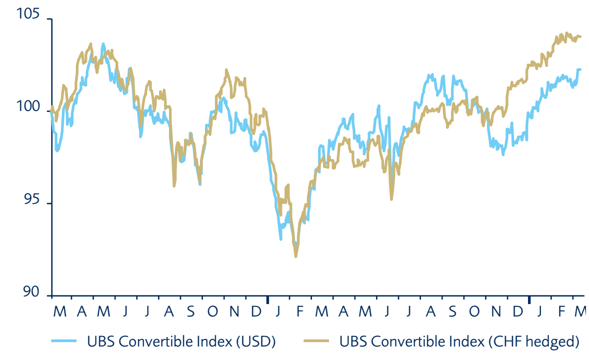


Private equity: performance since March 2015 (indexed)

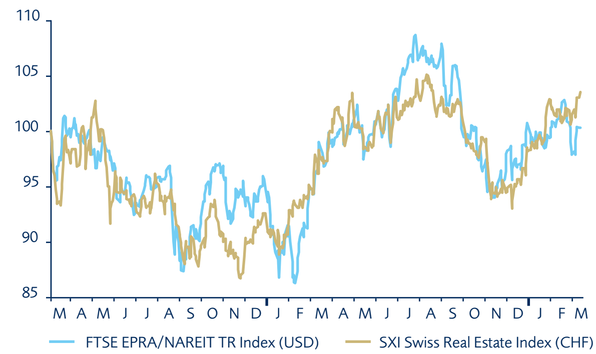
Precious metals: performance since March 2015



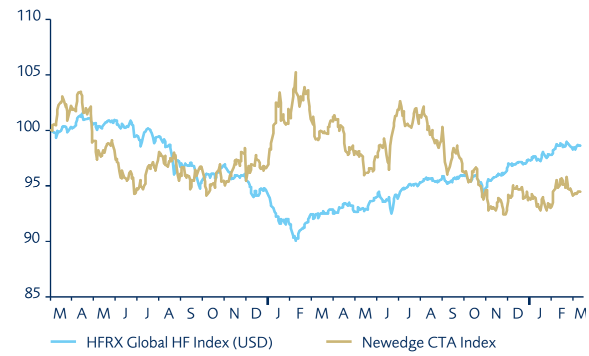
Convertible bonds: performance since March 2015 (indexed)



Real estate: performance since March 2015 (indexed)



Hedge funds: performance since March 2015 (indexed)



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Alternative investments | Rolf Kuster

Market outlook

2017 has begun rather quietly on the commodity markets. The broad Bloomberg Commodity Index lost around 3% of its value in the first three months. Most of this slight fall was due to the energy component, with weaker oil prices playing a key role. Precious metals like gold have profited from the weaker US dollar and an upward trend in inflation, while industrial metals have been driven higher by the economic stimulus programmes promised by President Trump. Commodity investors should proceed rather cautiously at present. The crude oil market is asymmetrically exposed to a risk of further price falls, while high industrial metal prices already appear to contain an element of growth euphoria that could lead to disappointments in the medium term.

US shale oil – return of the giant

After a strong showing in 2016, the crude oil price has performed disappointingly so far this year. The reason – as so often – is on the supply side. The initial signs were good. In late November OPEC decided to cut production by 1.2 million barrels a day at the start of this year. A further 11 non-OPEC countries, including world leader Russia, also committed themselves to big cuts in output. The aim was to bring down inventories and put the market back on an even keel.

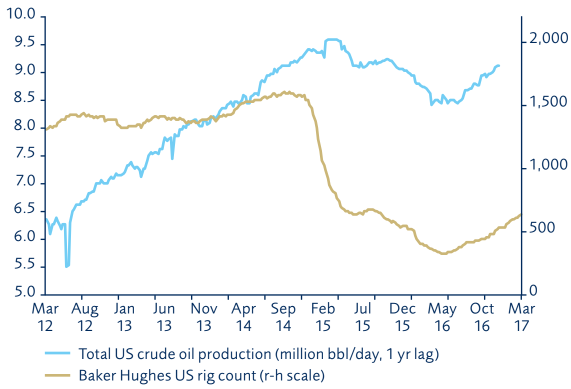
These were the first productions cuts in over eight years and took the markets by surprise. Until then the strategy had been to keep the oil price low in order to drive upstart US competition out of the market. The fact that Russia and OPEC reached agreement and are generally sticking to the announced production cutbacks highlights how desperate these producers are for oil prices to rise. In many oil-exporting countries a higher oil price is essential if government budgets are to be balanced.

The US shale oil industry was plunged into crisis by the plummeting oil price in 2014 and 2015. As production became uneconomical, output slumped. But a slight rise in the crude price in mid-2016 was enough to re-energise investment and production.

Supply boosted by productivity and investment

The US shale oil industry has emerged from the crisis with renewed strength. Total US oil output is still below its mid-2015 peak, but the sector has recovered strongly over the past year. America's energy sector is now investing enthusiastically in future growth. This is reflected in employment figures and in the number of active horizontal rigs, which has more than doubled since its low point in June 2016. The driving force behind this upturn is productivity.

US crude oil production



Source: Baker Hughes

Production from shale oil wells has an extremely rapid decline rate, i.e. after a few months of operation the well is producing only a fraction of its initial output. Even so, the production profile has greatly improved. According to the US Department of Energy, in 2013 an average shale well achieved a maximum output of around 100 barrels a day in its first month of operation, but by 2015 this figure had climbed to over 230 barrels a day. Total productivity roughly tripled between 2012 and 2015. New extraction techniques that improve output are pushing down the marginal costs per barrel of crude oil.

Highlights

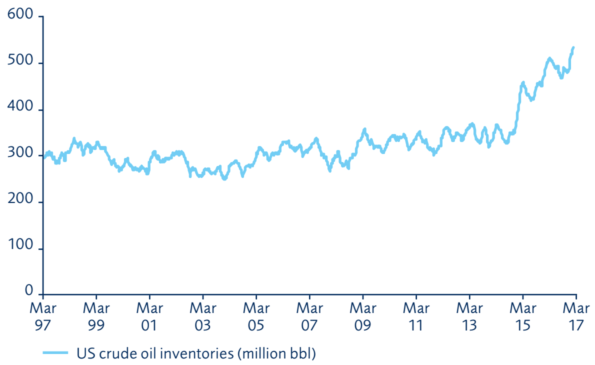
- The US shale oil industry has recovered from its crisis.
- New investment and major productivity gains have given a boost to supply, causing inventories to grow again.
- The risks in the oil market have shifted, but we are sticking to our sideways forecast at present.

This means that the US shale oil industry can operate profitably at lower prices – a fact that traditional oil producers find hard to stomach.

Speculators still betting on higher oil prices

The rapid resurgence of the US shale oil industry and its impressive productivity improvements have surprised even experienced analysts.

US oil inventories



Source: US Department of Energy

Following OPEC's production cuts, most analysts thought that brimming oil inventories would gradually be depleted, resulting in a more evenly balanced market. Data provided by the US Commodities Futures Trading Commission showed that most market participants were betting on rising oil prices. In the event, however, US inventories climbed again, causing disappointment and increased selling pressure. Some traders were forced to cover their long positions, exacerbating the temporary sell-off.

Outlook

Risks in the oil market have shifted. The main danger now is that the price could weaken again. But the basic picture is still the same. The price of crude oil is being driven principally by supply, with the upper price limit being defined by the marginal costs of US shale producers. If these fall, the price of crude oil will have to adapt.
But we regard a dramatic price collapse (as seen at the start of 2016) as improbable. Marginal costs in the shale sector are too high and global demand too stable for that to happen, especially in view of upcoming economic stimulus programmes. Moreover, OPEC is sticking to its new quotas and thereby signalling that it would be prepared to make further production cuts if necessary.

Benchmark	April 2017	% YTD[1]
Commodities	→	–2.47%
Gold	→	–12.09%
Crude oil	→	6.93%
Commercial real estate	→	1.55%
Private equity	→	6.47%
Convertible bonds	→	3.46%
Hedge funds	→	1.68%

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 21.03.2017

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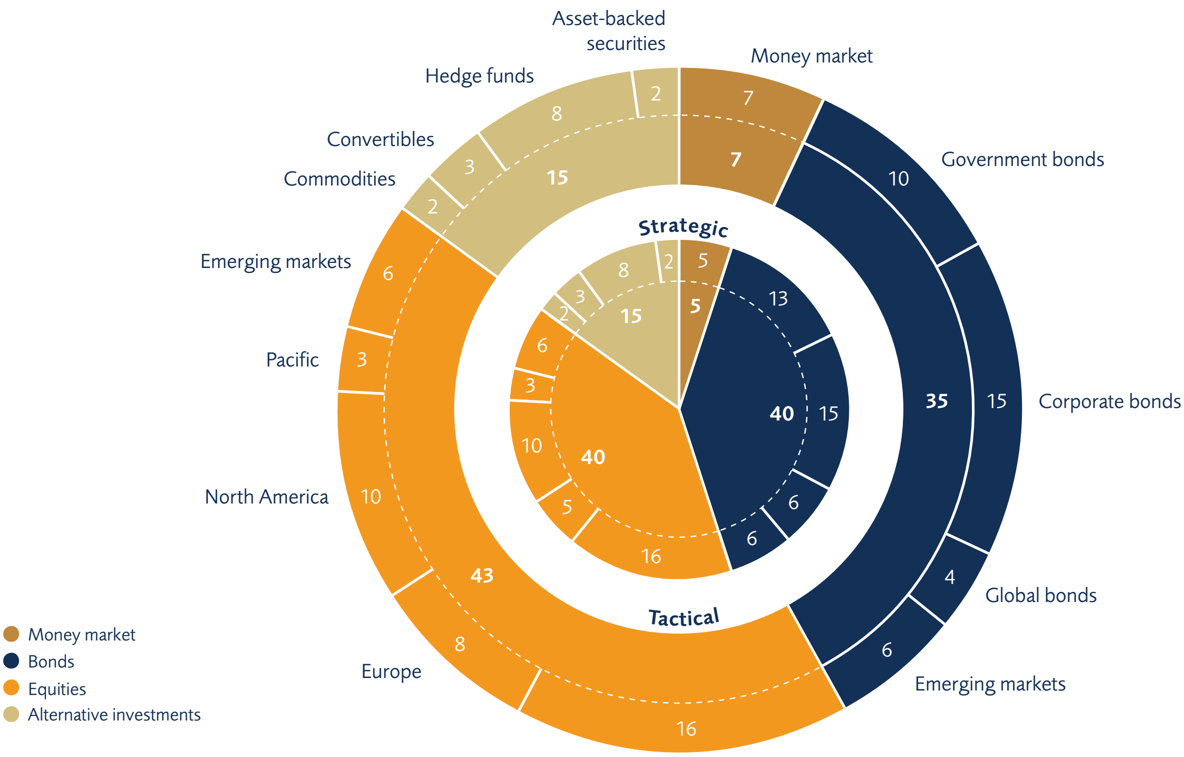
3. Investment management

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	21.03.2017	1,049.51	no	yes	1.05%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	21.03.2017	1,401.20	no	yes	0.63%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	21.03.2017	1,335.94	no	yes	1.84%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	21.03.2017	1,549.14	no	yes	2.19%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	21.03.2017	979.67	no	yes	1.80%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	21.03.2017	1,488.63	no	yes	2.77%

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

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Investment management

Current investment tactics

Despite upbeat data from the economy and the corporate sector, a continued upward trend on European equity markets will not be plain sailing. Most market participants still regard the political risks as high. Investors' caution is evidenced by the yield gap between French and German government bonds and by outflows from European equity index funds. A National Front victory in the French presidential election looks unlikely, but experience has shown how unreliable political forecasts can be. Investors in Europe will want to see greater political clarity before committing themselves more heavily.

The change of administration in the USA has unleashed a sharp rise in share prices. We believe that tax cuts and deregulation should generate faster economic growth. So far, however, the measures are still in the planning stage; concrete implementation is further down the road. After the steep climbs posted in recent weeks, there is short-term potential for disappointments in the US equity market. Long-term bond markets behaved bumpily in the first quarter. We expect yields to rise farther, though at a slower pace. In the USA much will depend on how successful the new administration is in stimulating corporate investment. If action is effective, it should mean higher wage growth and inflation.

Conclusion: We believe that European equity markets still offer catch-up potential, and we are therefore keeping our overall equity position overweight. We are taking profits on US equities and reducing our US position to neutral for the moment. Bonds remain underweight.

Bonds

Global economic indicators are currently showing an improvement – hence the recent rise in bond yields. We are maintaining our previous 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 are maintaining a position in inflation protected securities.

Equities

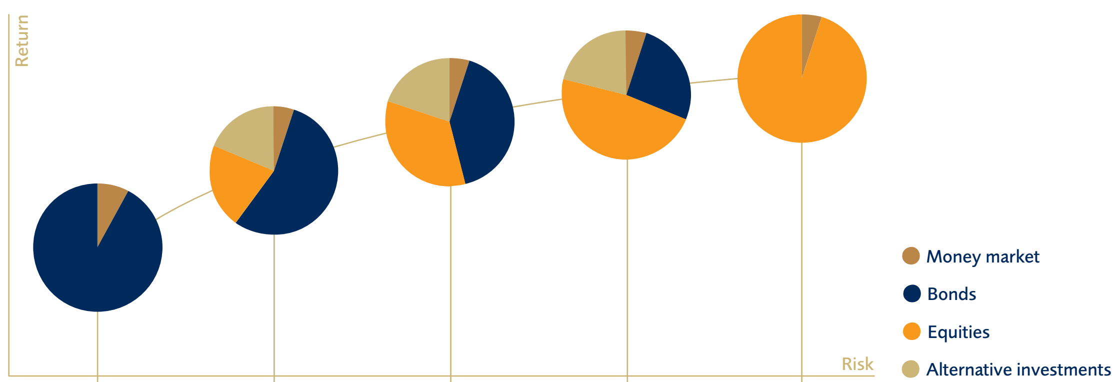
Economic growth in the eurozone has recently accelerated. Monetary action by the European Central Bank seems to be working. Credit growth in the eurozone has climbed to a positive rate of 2% after years in negative territory. Despite these upbeat factors, European shares are still attractively priced compared with the US market, and earnings growth is steeper in the eurozone (and in the emerging markets) than in America.

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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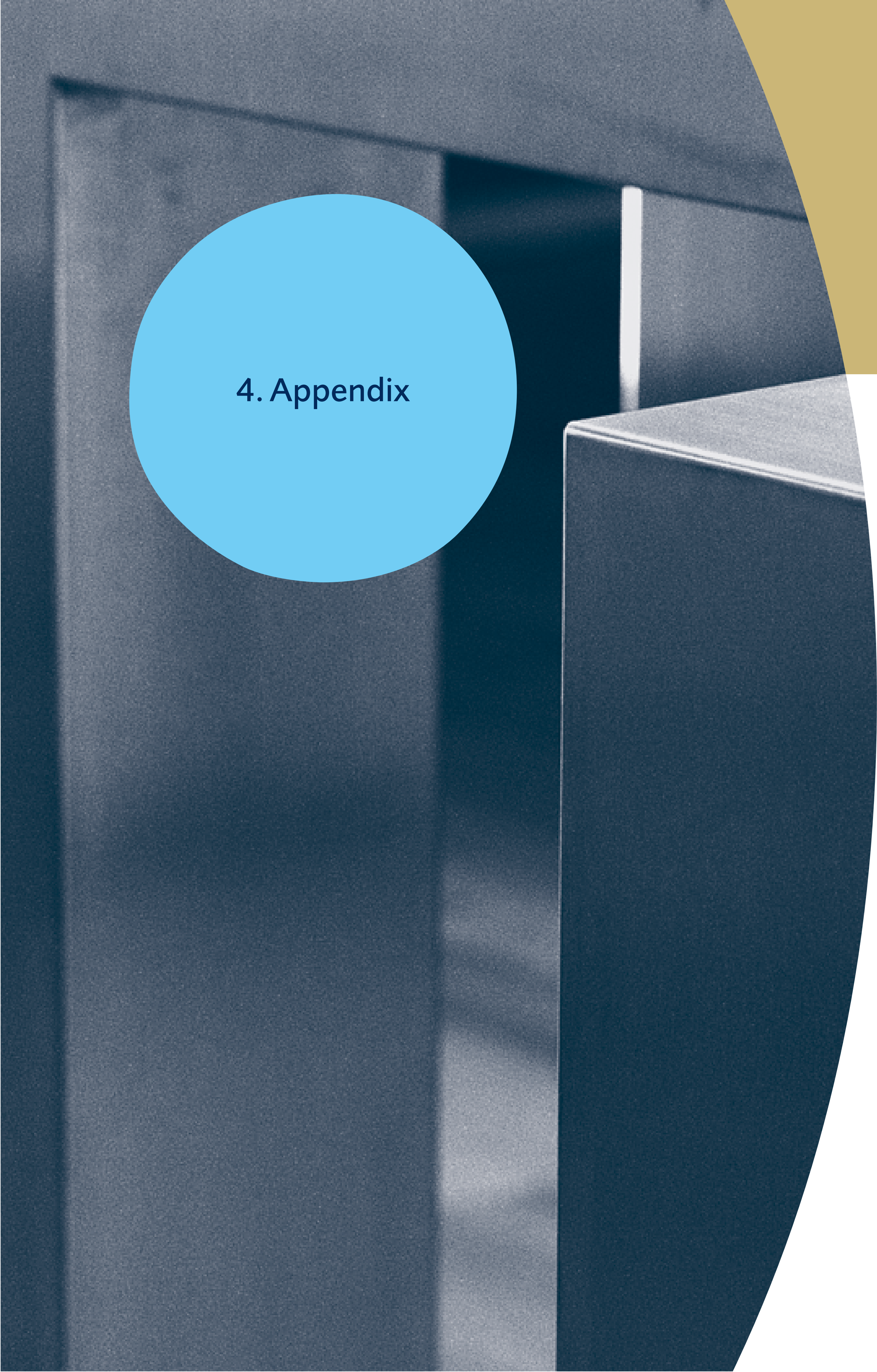

4. Appendix

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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- 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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3. have within the past twelve months been involved in managing a consortium that issued the issuer's financial instruments by way of public offering;
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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