4th quarter 2017

Investment Views

VP BANK

Contents

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.

	Rate as of 19.09.2017	Aug. 2017	Oct. 2017	
Money market and currencies (pages 6–9)				
Currencies				
EUR vs.USD	1.199	↘	↘	
EUR vs.CHF	1.155	↘	↘	
USD vs.CHF	0.964	→	→	
GBP vs.USD	1.351	↘	↘	
USD vs.JPY	111.61	↗	↗	
AUD vs.USD	0.800	→	→	
USD vs.SGD	1.349	↗	↗	
USD vs.RUB	58.138	→	→	
Key interest rates				
Switzerland	-0.75%	→	→	
Europe (EMU)	0.00%	→	→	
USA	1.25%	↗	↗	
Bond yields (pages 10–13)				
Investment grade government bonds				
Switzerland		↗	↗	
Europe		↗	→	New
USA		↗	↗	
Investment grade corporate bonds				
Switzerland		↗	→	New
Europe		↗	→	New
USA		↗	↗	
Bonds: total return (pages 10–13)				
High yield bonds				
High yield		↘	↘	
Emerging market bonds				
Hard currency bonds		→	→	
Local currency bonds		→	→	
Equities (pages 14–17)				
Switzerland		→	→	
Europe		→	→	
North America		→	→	
Pacific		→	→	
Emerging markets		↗	→	New
Alternative investments (pages 18–21)				
Commodities		→	→	
Crude oil		→	→	
Gold		→	↗	New
Real estate shares		→	→	
Private equity		→	→	
Convertible bonds		→	→	
Hedge funds		→	→	

// Evolution or disruption? //

Bernd Hartmann
Head of Group Investment Research

Dear Reader

Continuous change is a feature of modern life. VP Bank's publications are no exception. In the context of our company's rebranding, we have decided to give Investment Views a new look. But the tried and tested basic structure will be retained. Alongside articles on the outlook for the various asset classes, we will continue to highlight major topical themes.

This edition's "Top issue of the month" focusses on one of today's hottest topics. The car industry is attracting widespread debate and controversy. The industry's reputation has been tarnished by the self-inflicted "dieselgate" emissions scandal. The discovery that, under real driving conditions, traditional diesel engines cannot comply with legal emissions limits has not only cast a shadow over diesel technology as such but has put all established car makers on probation. With the advent of electric cars, it might seem that the future belongs to insurgent new manufacturers.

So does the automobile industry face a period of severe disruption? Does the technological leap from combustion engines to electric motors mark the death knell of today's big-name car makers? In "Top issue of the month" we explain that a rapid switch to e-mobility, though desirable, is not realistic. During the period of transition, the imperative of reducing emissions as quickly as possible will require pragmatic solutions. Germany's much maligned top producers are well equipped to meet this challenge. As with the transition from horse-drawn carriages to motor cars, the switch from combustion engines to electric motors may go down in the history books as a revolutionary break. For most car makers, however, the technological change will be an evolutionary process.

1. FOCUS

German car makers wired for change

THE AUTOMOBILE INDUSTRY IS UNDERGOING A RADICAL TRANSFORMATION. THE "DIESELGATE" SCANDAL HAS SPARKED HEATED DEBATE. BUT THE INDUSTRY IS WELL-PREPARED FOR TOMORROW'S ELECTRIFYING CHALLENGES.

The frictions caused by the transformation process in the automobile industry were clearly evident at the IAA International Motor Show in Frankfurt. This is Europe's top motor show alongside Geneva, but Tesla decided to stay away. Tesla does not see itself as a traditional car maker – an attitude that speaks volumes about the modern world of individual mobility.

Mainstream manufacturers exhibited large and efficient vehicles using hi-tech combustion engines. While the diesel scandal continues to reverberate, its impact on sales of combustion-driven automobiles remains superficial. Demand for cars using combustion technology is still robust, and it will be seven to ten years before electric cars become technologically mature enough to establish a mass market.

The success of electric mobility (e-mobility is now the buzzword) depends on the following crucial factors:

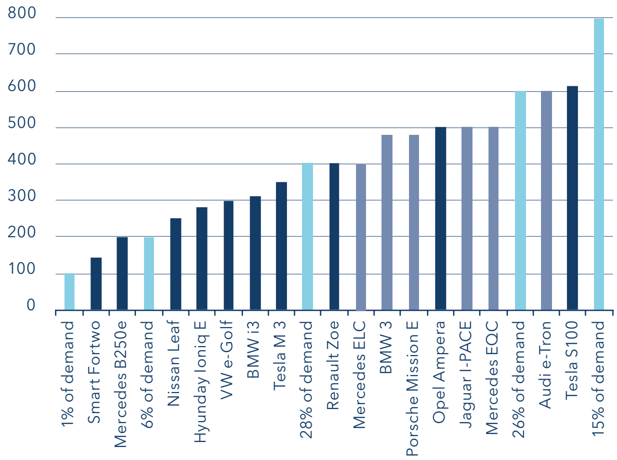
- Adequate travel range on a single battery charge
- Affordable purchase price
- Developed infrastructure for battery charging when travelling or parked.

Range: "Take me where I want to go"

Range is a vital factor in the switch to electric vehicles. Statistics show that the average daily driving distance in Europe varies between 28 kilometres (Austria) and 44 kilometres (Sweden). For buyers, however, range anxiety is a still key factor. It tends to set in at around 300 kilometres. Latest surveys indicate that 54% of potential buyers regard a range of between 400 and 600 kilometres as a crucial requirement.

The following table shows that some available models already match mobility requirements in urban areas. The models marked in grey will be on the market in 2018 or 2019.

Electric cars and range demand (in kilometres)



The laws of physics, engineering constraints and driving speed all have a bearing on travel range. The biggest factors are weather conditions and driving behaviour. The simulation of Opel's new Ampera model provided on the maker's website shows that, at medium speed, a fall in the outside temperature from a comfortable plus 20 degrees centigrade to a wintry minus 10 reduces the car's range by almost 17% from 527 km to 439 km. If the heating is switched on, the effective range comes down to 256 km, a loss of over 51%. Other weather factors can also erode the car's range, with headwinds and rain perhaps knocking off an additional 25%. Added to this is the fact that batteries become less efficient over time, losing 1–5% of their capacity per year. Tesla tackles this problem by providing additional built-in battery capacity to which the driver has access only in special circumstances. This came in useful in September, when Florida was hit by hurricane Irma and Tesla issued a software update that provided clients with enhanced range by freeing up reserve capacity.

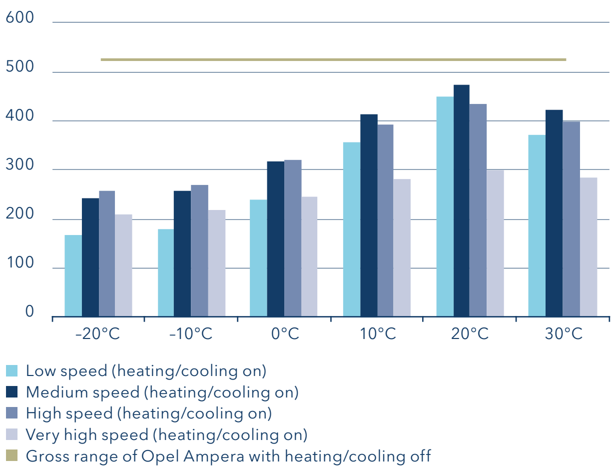
Bottleneck: costs and infrastructure

Increased battery capacity enhances the driver's mobility but pushes up the car's price. Over the last seven years the production costs of batteries have fallen by more than 50% to currently about USD 200 per kilowatt hour.

Tesla says that its present battery costs are below USD 190 per kilowatt hour. In a direct comparison with combustion engines, battery production costs would have to fall below USD 50 per kilowatt hour to produce the same price for buyers. For example, the showroom price of a new VW e-Golf now starts at EUR 34,900, which is over 45% more than the price of a comparable diesel model while involving reduced mobility and achieving hardly any significant overall improvement in the environmental footprint.

By 2025 many car makers will be able to offer competitive electric cars that meet customers' needs regarding mobility and convenience. But will it be possible to provide adequate battery charging coverage by then? As regards highway charging stations and car owners with their own garage, the answer is yes. In public parking areas, however, coverage will be very difficult, especially in the urban setting. Local authorities will face major challenges and high costs. Rapid charging requires a high voltage. Drivers who live in urban rented apartments and have no fixed parking place will find it extremely difficult to charge their cars cheaply overnight.

Opel Ampera: range factors



Conclusion: evolution not revolution

In all probability, the widely feared "cliff edge" in the transition to e-mobility will be avoided. Manufacturers are making rapid progress towards meeting the challenges that e-mobility poses. However, the rapidity with which electric cars catch on will depend above all on the development of an adequate local infrastructure. At the same time, mainstream car makers will gradually adapt their models to e-mobility as well as to modern mobility concepts such as car sharing.

Hybrid cars – i.e. cars that combine an electric motor with a combustion engine – will initially take pride of place. These models provide maximum range flexibility and can already cope with 90% of all typical daily driving distances using their electric motors. In this context investors' attention will focus on traditional manufacturers, for it is they who are leading this market.

A look at the new models appearing in the showrooms makes it very clear that leading German makers like Opel, Volkswagen, Mercedes-Benz and BMW have exciting new products to offer. In Germany, each hybrid or electric car is subsidised to the tune of EUR 3,000–4,000 (half paid by the government and half by the manufacturers). In view of the current heated debate about a possible ban on diesel vehicles in German towns and given the age of vehicles on German roads, Germany's prime manufacturers can now expect a gentle boost in activity.

VP Bank has produced a detailed analysis of the opportunities and risks for investors during the transition to e-mobility. Your personal advisor will be pleased to discuss these issues with you.

Trick or treat on the financial markets?

AS THE NIGHTS GET LONGER AND THE DAYS SHORTER, WE KNOW THAT AUTUMN IS UPON US. CHILDREN START LOOKING FORWARD TO THE FUN AND GAMES OF HALLOWEEN, WHEN THEY WILL GO FROM HOUSE TO HOUSE IN SEARCH OF TREATS AND THREATENING TRICKS IF THEIR DEMANDS ARE NOT MET. BUT WHAT ABOUT THE FINANCIAL MARKETS? WILL THEY BE TRICKING US OR TREATING US THIS AUTUMN?

The policies of the world's central banks certainly have the potential to play tricks on us. But there is also a real possibility that we will be treated to a period of continued calm and stability.

Disappointing news from the USA ...

The summer brought not only balmy temperatures but also encouraging developments on the financial markets. Now, however, the weather is getting more challenging. Hurricane damage in Texas and Florida has enabled Donald Trump to obtain a short-term suspension of the US debt ceiling, but the debt issue has not been settled and will be fiercely debated in the coming months. Political scandals and staffing convulsions in the White House have undermined international investors' confidence in the USA. The dollar's current weakness is partly due to the perceived political risks in Washington. Added to that, central banks are on the verge of refocussing their monetary policies. The European Central Bank is expected to implement a step-by-step wind-down of its monthly asset purchases next year, as we explain in the "Money market and currencies" section on pages 14 and 15. In the USA, meanwhile, the Fed will take another step away from its ultra-expansionary course by partially halting the reinvestment of maturing securities so as to bring its balance sheet back to the pre-crisis level.

Highlights

- Central banks on both sides of the Atlantic are set to push ahead with a gentle tightening of monetary policy.
- Does this mean we are heading for a turbulent autumn?
- Caution is called for, but we believe that the financial markets will avoid major shocks.

... will not last

This combination of political imponderables and monetary tightening undeniably creates a risk of major shocks. In our view, however, that should be regarded as the worst case scenario. The central banks are not shooting from the hip and have already primed the financial markets to expect imminent changes. The prospect of a gentle tightening of the monetary reins by the ECB has caused a substantial appreciation of the euro. Thus the financial markets have already started to price in the new climate.

The biggest potential for surprises lies on the US side. The reduction of the Fed's balance sheet could have a substantial impact on government bond markets during the months ahead. Moreover, current grim assessments of the US political situation mean that any small successes achieved by the Trump administration, for example a minor reform of corporate taxation, would catch the markets on the wrong foot. Similarly, market expectations of further Fed interest rate hikes are very subdued at present. If the Fed does deliver a further upward push on rates, the greenback will start flexing its muscles again.

Conclusion

Do the financial markets have treats or tricks in store? We regard treats as more likely. The change in the monetary weather has already been priced in. The potential for surprises is greatest on the US side. Even small successes by the Trump administration could lift the clouds of pessimism and put wind in the dollar's sails.

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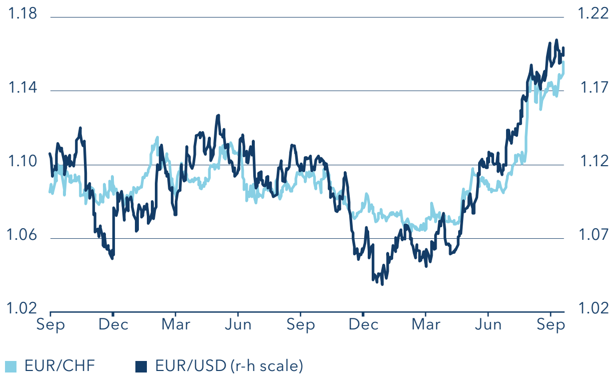
2. ASSET CLASSES

Money market and currencies

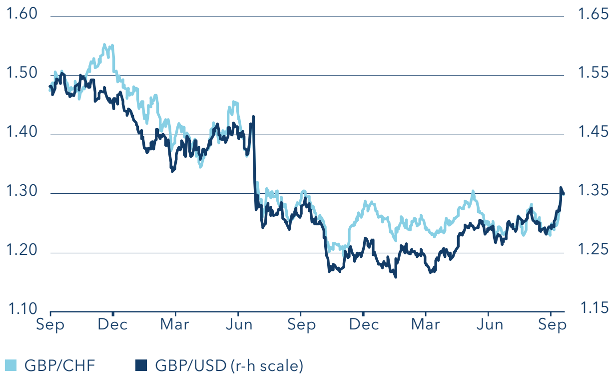
Market overview

EUR/CHF and EUR/USD: exchange rates since September 2015

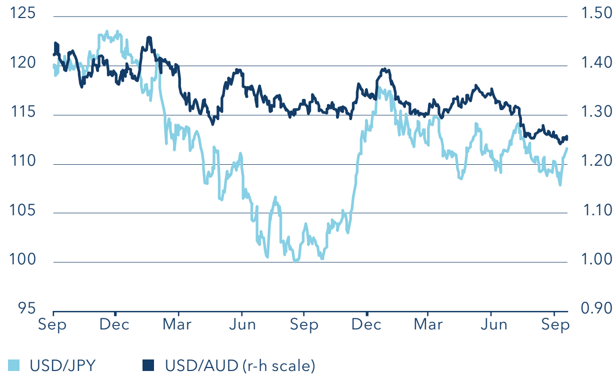


USD/CHF: exchange rate since September 2015

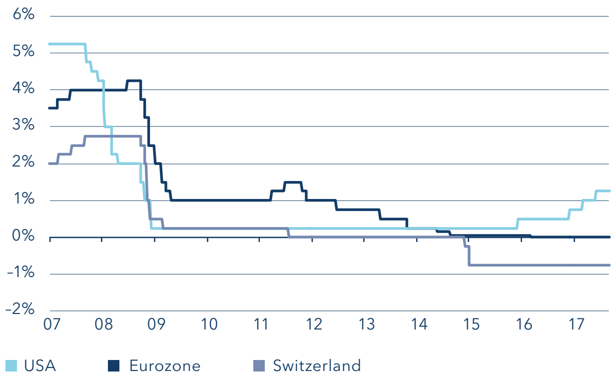
GBP/CHF and GBP/USD: exchange rates since September 2015



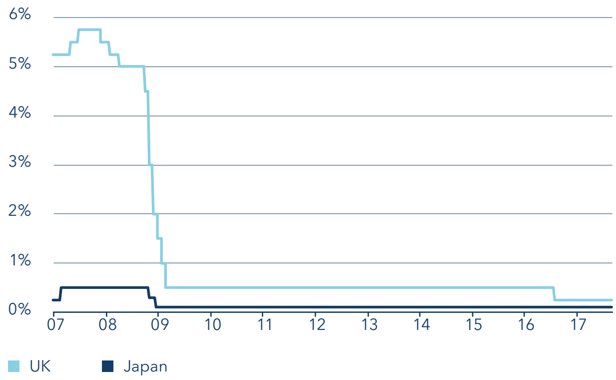
USD/JPY and USD/AUD: exchange rates since September 2015



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



Key interest rates in UK and Japan: since January 2007



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Mario Draghi steers the markets

IN PAST YEARS THE FINANCIAL MARKETS WERE DRIVEN MAINLY BY THE US FED, BUT NOW THE EUROPEAN CENTRAL BANK HAS ITS HAND ON THE TILLER. UPBEAT STATEMENTS BY ECB CHIEF MARIO DRAGHI HAVE CHANGED THE MARKETS' MOOD.

The financial markets are confident that the ECB will soon embark on a tightening of monetary policy. This has resulted in a substantial strengthening of the euro. The eurozone's monetary supremo, Mario Draghi, has been making optimistic noises, and these have fuelled speculation about an exit from the ECB's ultra-loose monetary policy and the possibility of interest rate hikes. The change of tone first became apparent in Draghi's speech to the ECB conference in the Portuguese city of Sintra at the end of June, when he declared that all the signs pointed to a stronger and broader economic recovery in the eurozone, which would enable the ECB to cast its gaze beyond the current period of sub-par inflation. His statement gave a major boost to the euro, which appreciated on a broad front.

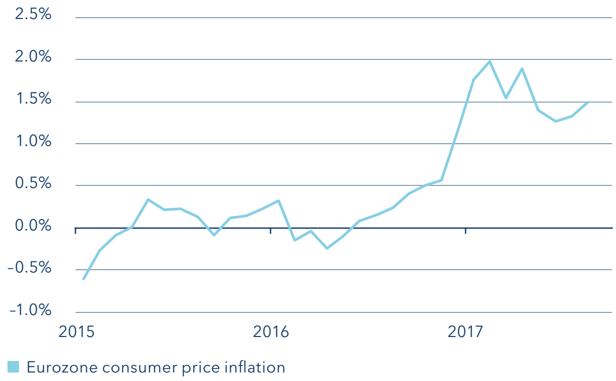
But the markets' reaction seems to have given Europe's central bankers cold feet. The euro's net trade-weighted appreciation since the start of the year now amounts to 7%. A strong currency not only handicaps exporters but makes it more difficult to achieve higher inflation, which is a prime objective of the ECB. A rising euro makes imports less expensive (oil imports are already cheap in any case), and this counteracts the effects of monetary looseness. The ECB is therefore now backpedalling, stating that it is prepared, if necessary, to prolong or even expand its asset purchases. But the financial markets regard this verbal retreat as a passing phase.

Monetary goals not achieved

Although Frankfurt has started to hedge its bets, the ECB's language remains generally more upbeat than at the start of the year. This suggests that it will still begin to scale back the monthly volume of asset purchases (currently EUR 60 billion) next year. The problem is that the ECB thereby lays itself open to the charge of inconsistency. When the asset buying programme was launched at the start of 2015, the ECB said it would persevere with the programme until inflation neared 2%. That target is still way out of sight. There is no sign of consumer prices rising significantly in the near future. So why is the ECB changing course?

Euro's external value

Eurozone inflation



As we have repeatedly emphasised in the past, the main constraint on the ECB is the self-imposed rule that purchases must not exceed 33% per issuer. The ECB explained this limit by saying it wished to ensure that the markets continued to function in an orderly fashion and that market-driven pricing should not be compromised. It also wanted to avoid the risk of becoming the principal creditor of governments in the eurozone, which would raise the spectre of monetary policy being used to finance public deficits. The ECB has been anxious to counter charges that its asset purchase programme exceeds its monetary mandate.

Rules forcing the ECB's hand

Given the existing regulatory constraints, we expect the ECB to announce this autumn that its monthly asset purchases will be gradually scaled back from the start of 2018 onwards. In mid-August Germany's Federal Constitutional Court stated that the Public Sector Purchase Programme (PSPP) could be an infringement of the ECB's mandate and referred the matter to the European Court of Justice. This referral to Europe's supreme court will intensify the pressure on the ECB to stick to its self-imposed rules. The ECB will not of course openly allude to the 33% limit but will justify its actions by citing the need to ensure healthy economic growth, claiming that the asset purchase wind-down is justified by the economic fundamentals. However, the ECB will proceed with extreme circumspection. In the first half-year its monthly purchases might be cut from EUR 60 billion to EUR 40 billion. Such a EUR 20 billion reduction would significantly postpone the moment when purchases hit the 33% limit and thereby provide greatly enhanced flexibility. If necessary – i.e. if inflation disappoints – the ECB could then maintain the EUR 40 billion purchase volume in the second half of the year as well.

Highlights

- The European Central Bank will gradually scale back its asset purchase programme.
- The ECB's declared objectives have not, however, been achieved.
- The wind-down will therefore be managed circumspectly and will not fundamentally change the low interest rate environment.

Conclusion

The financial markets are currently keeping a weather eye on the ECB, which is expected to start winding down its monthly asset purchases next year. But this slight easing of monetary policy does not mean that the ECB has achieved its goals. The motive lies in the need to comply with regulatory constraints. Mario Draghi will therefore proceed very cautiously. There will be no fundamental change in the general low interest rate environment.

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

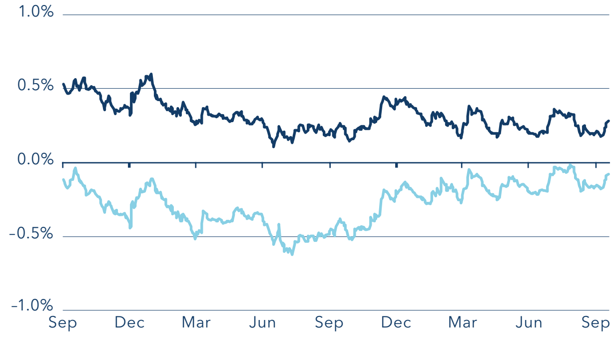
Upside/downside ranges indicated by our 3–6 month interest rate forecasts:
↑ > +50 basis points ↗ +25 basis points
↘ –25 basis points ↓ < –50 basis points → No change

2. ASSET CLASSES

Bonds

Bond yields – overview

Switzerland: yields since September 2015



CHF government bonds ■ CHF corporate bonds (5 to 10 yr)

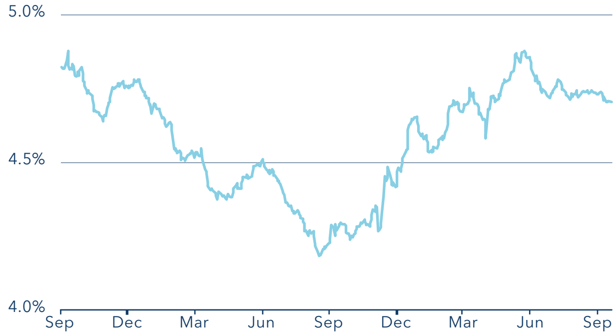
Emerging markets (hard currency): yields since September 2015

EM government bonds (5 to 10 yr) ■ EM corporate bonds (5 to 10 yr)

Europe: yields since September 2015

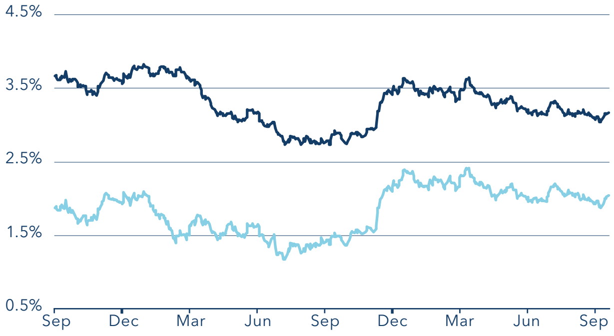
EUR government bonds (5 to 10 yr) ■ EUR corporate bonds (5 to 10 yr)

Emerging markets (local currency): yields since September 2015



EM government bonds (local currency)

USA: yields since September 2015



USD government bonds (5 to 10 yr) ■ USD corporate bonds (5 to 10 yr)

High yield: yields since September 2015

Global high yield (5 to 10 yr)

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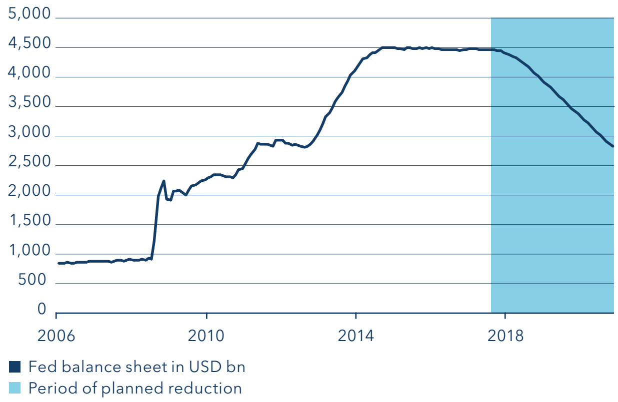
The Fed gets serious

US TREASURIES WERE IN HEAVY DEMAND DURING THE SUMMER. LOWER-THAN-EXPECTED INFLATION, POLITICAL CHAOS IN THE WHITE HOUSE AND THE DEVASTATING HURRICANES IN THE GULF OF MEXICO CAUSED INVESTORS TO TAKE REFUGE IN SAFE ASSETS.

Reducing the Fed's balance sheet



High demand pushed the yield on 10-year US Treasuries to its lowest level of the year. However, the markets largely overlooked the fact that the Fed was gearing up for a major adjustment, namely a shrinking of its elephantine balance sheet. Between 2012 and 2014 the Fed bought USD 1.6 trillion worth of securities, with the result that its balance sheet swelled to almost USD 4.5 trillion. With the US economy now performing solidly, the enormous volume of securities holdings has become a growing embarrassment. Starting in October, the Fed will therefore begin to shrink its balance sheet by cutting the reinvestment of maturing securities and interest income by around USD 10 billion a month. It is expected that this amount will be increased every three months by a USD 10 billion increment until it reaches USD 50 billion monthly. If this plan is adhered to, the Fed will have reduced its securities portfolio to its 2012 level within just over two years.

Nagging doubts

Given the sluggish rate of inflation, however, widespread doubts have arisen about whether the Fed will really be able to implement a further tightening of policy. These doubts exist not only in the financial markets but even within the Fed itself. Members of the Federal Open Market Committee (FOMC) have warned against repeating the mistakes that were made during the Great Depression of the 1930s.

After the Wall Street Crash in 1929 the US economy was plunged into recession, but the period 1933 to 1937 saw a remarkable recovery. It was then that the Fed decided to apply the monetary thumbscrews. But its precipitous action choked off the recovery and resulted in one of the deepest recessions in US history. Today's situation is far from identical, but the memory of that disastrous miscalculation is still very much alive in the Fed. Thus a further interest rate hike in December no longer looks as likely as it did a few months ago. But the door to a 25 basis point hike in the fed funds target rate is not yet fully shut. In their published forecasts, Fed officials are sticking to their expectation of a tightening by year-end. In any case, there is general agreement within the Fed that the reduction of the balance sheet should go ahead as planned. If that happens, long-term bond yields in the USA and continental Europe should show a moderate rise.

Companies exploiting low borrowing costs

Highlights

- The Fed is taking an historic step in October by starting to scale back the reinvestment of its securities holdings.
- This raises the prospect of at least moderately rising bond yields at the long end.
- Companies with weak credit ratings are exploiting the low interest rate environment to raise cheap finance.
- But spreads on high yields bonds do not adequately compensate investors for the risks involved.

COMPANIES ARE EXPLOITING THE LOW INTEREST RATE ENVIRONMENT TO RAISE CHEAP FINANCE. BUT ROCK BOTTOM BORROWING COSTS COULD CAUSE PROBLEMS NOT ONLY FOR INVESTORS BUT ALSO FOR THE COMPANIES THEMSELVES.

Three of the markets' favourites in the technology sector, Amazon, Netflix and Tesla, have recently launched jumbo bond offerings. Amazon is reinventing grocery retailing, Netflix is revolutionising the world of TV, and Tesla aims to supersede the internal combustion engine.

Such revolutionary endeavours are usually financed by venture capital or fresh equity. While Amazon is on a solid financial footing, Netflix and Tesla are speculative investments that carry a correspondingly high risk of default. Hedge funds are nevertheless buying these bonds because they can hedge their exposures by shorting the company's equities. If the company's performance deteriorates, they can simply increase these short equity positions. In the event of bankruptcy, they will make a profit on the shorted shares and possibly also benefit from higher creditor protection on the bonds. This tactic means that share prices could be negatively affected by a new bond offering. In any case, such bonds are unattractive for ordinary investors. If the projects come to fruition and supersede competitors' business models, the investor will still receive only a paltry coupon, whereas equities would offer a much higher reward.

Caution regarding high yield bonds

High yield bonds are generally too expensive at present and do not provide adequate compensation for the risks. The overall default rate in this sector during the last twelve months has been 3.5%, rising to an alarming 18.6% in the energy sector. Credit spreads, which are supposed to cover this risk, now average only 3.7%. If a borrower goes bust, bond holders recover only 23% of the nominal value of their investment on average. Thus present spreads are out of kilter with the risks involved. Global economic performance looks solid at present, but the next recession can be expected to lead to double-digit default rates in the high yield sector.

Even disregarding another recession, competitive pressures repeatedly lead to defaults and downgradings. Air Berlin is just the latest example. There are big worries now about the retail sector, which is coming under mounting pressure from online trading. Branch closures are rife in the USA, where eighteen retail companies have gone to the wall since the start of the year. If Amazon's new "Go" concept is successful, further defaults and downgradings in the retail sector are likely. But the new partnership agreement between Google and Walmart shows that the field will not be left to Amazon without a fight. In any event, consumers stand to gain.

Benchmark	October 2017	% YTD[1]
Gov. bonds Switzerland[2]	→	–1.19%
Gov. bonds Europe (EUR)[2]	→	–0.39%
Gov. bonds USA[2]	→	2.62%
Inv. grade corp. bonds Switzerland[2]	→	0.24%
Inv. grade corp. bonds Europe (EUR)[2]	→	1.19%
Inv. grade corp. bonds USA[2]	→	5.13%
High yield bonds[3]	→	5.84%
Emerging market bonds (hard currency)[3]	→	9.17%
Emerging market bonds (local currency)[3]	→	16.70%

[1] As of 19.09.2017
[2] Yield
[3] Total return

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2. ASSET CLASSES

Equities

Equity indices – overview

Switzerland: market movement since September 2015 (indexed)

MSCI Switzerland TR Index (net) indexed

Pacific: market movement since September 2015

MSCI Pacific TR Index (net) indexed

Europe: market movement since September 2015 (indexed)

MSCI Europe TR Index (net) indexed

Emerging markets: market movement since September 2015 (indexed)

MSCI Emerging Markets TR Index (net) indexed

North America: market movement since September 2015 (indexed)

MSCI North America TR Index (net) indexed

United Kingdom: market movement since September 2015 (indexed)

MSCI UK TR Index (net) indexed

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Global growth defying the bears

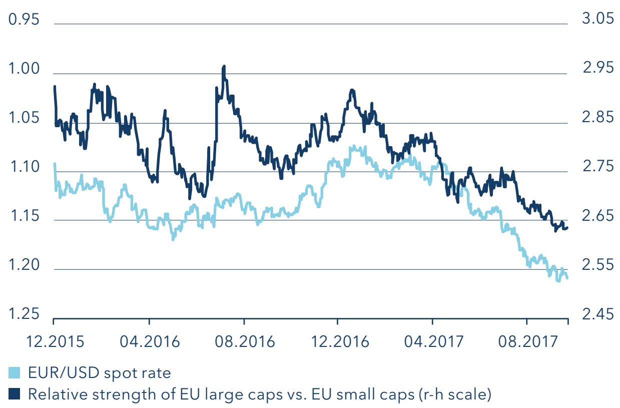
THIS SUMMER'S RETURNS ON EQUITY INVESTMENTS IN THE DEVELOPED WORLD – USA, EUROPE AND JAPAN – WERE MEAGRE TO NEGATIVE. UNCERTAINTY ABOUT CENTRAL BANK POLICY IN THE USA AND EUROPE HAS BEEN IMPACTING ON THE CURRENCY MARKETS, BUT WORLD ECONOMIC GROWTH REMAINS ON COURSE.

As expected, Europe's equity markets have continued to consolidate. At the same time, advances on the US and Japanese markets have slowed, while emerging markets have continued to boom. Alongside Asia, Latin America also showed renewed momentum from June onwards, enabling the emerging markets as a whole to outperform the global average. Their performance was underpinned by strong domestic activity based on vigorous private consumption (in line with our forecasts) as well as by intensive infrastructure investment. So what is the outlook until year-end?

Relative earnings growth driving equity returns

The MSCI World has put on over 8% during the last six months. The only regions to outperform the aggregate were emerging Asia and China. The UK was the only developed country to record a negative performance (just shy of minus one percent). Earnings expectations have been an important driving force. Forecasts for the current business year are still confident, but attention is now focussing on 2018. While expectations of rising corporate earnings in Switzerland and the emerging markets continue to strengthen, forecasts in Europe have been trimmed by 1.5% to 8.4%. This is due mainly to the strong euro, which exposes European goods and services to tougher competition on world markets. Big companies are hardest hit in this respect, whereas European small and mid caps continue to do very well, again scaling new all-time highs in September.

EUR/USD exchange rate and large cap performance



But it would be wrong to heap all the blame on currency movements. Currencies usually follow economic realities. So we need to look at the factors that are driving global growth.

Global productivity improvement

The world economy is slowly but surely extricating itself from the aftermath of the financial crisis and assuming a new and distinctive character. The crucial paradigm is productivity improvement. Angela Merkel repeatedly talks of "Industry 4.0", referring to the fourth industrial revolution in which information and communications technology will be fused with industrial production. The corresponding English buzzword is "digitalisation". These days, automation increasingly involves the use of advanced information technology and digitalised value creation. That is why, since 2008, growth stocks have been outperforming value stocks. Productivity growth in earlier periods was achieved mainly through mechanical improvements. That is no longer the case. Hence the vigorous performance of the technology sector and European small and mid caps. Asia, too, is riding high on the technological revolution and is being helped by the resurgent economic interaction between the USA and Europe.

Thus the present world economic picture is characterised by productivity improvement driven by new technologies. All G20 regions will post positive GDP growth this year, and this is expected to continue in 2018.

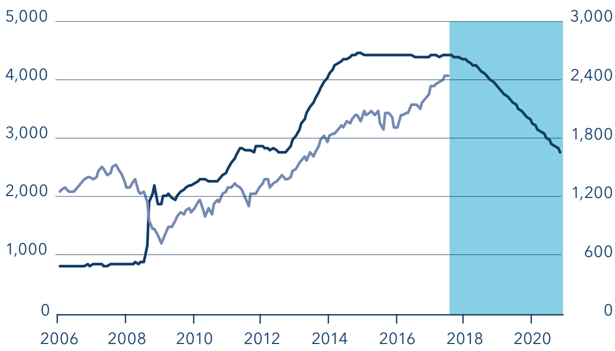
Highlights

- Synchronous global growth continues to provide a solid environment for equity investments.
- The following investment themes reflect key economic trends:
  - automation based on increased use of robotics
  - global infrastructure investments
  - transformation in China.
- Financials, notably banks, are attractively valued and should offer solid dividends.
- Special factors in the automobile industry could develop into a cyclical trend.

Central banks aiming for normalisation

These positive trends are encouraging the Fed to achieve a normalisation of monetary policy. Care will be taken, of course, not to cause undue disruption on the capital markets. The markets are well aware of the manipulative power of central bank policy. The huge expansion of central bank balance sheets resulted in a major decline of interest rates and credit risks, with positive effects on the equity markets via ultra-low borrowing costs.

Fed balance sheet and US equity market performance



The Fed has already presented a timetable for shrinking its balance sheet (see the blue area in the above chart). Will this put the equity markets on a downward trajectory? We think not. The equity markets can deliver solid returns against the backdrop of robust economic growth, with rising borrowing costs being offset by expected higher productivity.

Disorderly monetary action, however, would pose a danger. Resultant elevated credit and interest rate risks could lead to equity market corrections. Such worries are especially prevalent in Europe. The strength of the euro against the dollar is partly due to speculation that the ECB might tighten policy earlier than expected. ECB chief Mario Draghi is well aware of this problem.

Conclusion

The current economic situation is supportive of the equity markets. The switch to tighter monetary policies need not spell the end of the bull run. It will, however, be a testing time for the markets. After the latest gains we advise investors against assuming aggressive exposures. Our neutral positioning will enable us to take advantage of any setbacks.

Synchronous global growth has a positive impact on household incomes and hence on consumer spending. This enhances companies' pricing power. At the same time, increased production volumes support the prices of industrial raw materials. Our investment themes are geared to these developments. We are focussing on infrastructure spending, continuing consumer strength in China and productivity improvement based on automation. In this environment, the technology sector remains an important component of a balanced equity allocation.

With central bank policies on the verge of adjustment and interest rates already stabilising, the financial sector is returning to health. Banks are still attractively valued and offer solid dividend yields. We see special prospects in the automobile sector, which is heavily influenced by regulatory changes and now offers exciting investment opportunities. You can read more about this in "Top issue of the month" on pages 3 and 4.

MSCI benchmark	October 2017	% YTD[1]
Switzerland	→	13.27%
Europe	→	22.11%
North America	→	13.07%
Pacific (incl. Japan)	→	14.80%
Emerging markets	→	31.41%

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 19.09.2017; net return in local currency incl. dividends

2. ASSET CLASSES

Alternative investments

Alternative investments – overview

Commodities: performance since September 2015

■ Bloomberg Commodity Index (rebased on oil) ■ WTI crude oil (USD)

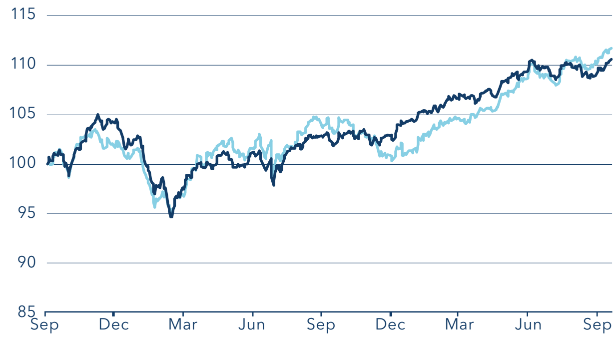
Private equity: performance since September 2015 (indexed)

■ LPX 50 TR Index (EUR) ■ LPX 50 TR Index (USD)

Precious metals: performance since September 2015

■ Gold (USD) ■ Silver (rebased on gold)

Convertible bonds: performance since September 2015 (indexed)



■ UBS Convertible Index (USD) ■ UBS Convertible Index (CHF hedged)

Real estate: performance since September 2015 (indexed)

■ S&P Global Property TR Index (USD) ■ SXI Swiss Real Estate Index (CHF)

Hedge funds: performance since September 2015 (indexed)

■ HFRX Global HF Index (USD) ■ Newedge CTA Index

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Precious metals – return of the Golden Age?

RECENT MONTHS HAVE BEEN AN ENCOURAGING TIME FOR GOLD INVESTORS. THE PRICE OF GOLD IN US DOLLARS HAS CLIMBED BY OVER 12% SINCE THE START OF THE YEAR. BUT APPEARANCES ARE DECEPTIVE. MOST OF THE INCREASE HAS BEEN DUE TO DOLLAR WEAKNESS.

Investors based in euros, for example, saw the value of their gold holdings rise by only about 2%. But why does the gold price have such a strong inverse correlation with the US dollar? Would it make sense for gold investors to hedge their positions against currency movements, using one of the many hedging products now available?

The textbook explanation for the negative relation between the gold price and the greenback is the fact that gold mines sell their output in US dollars but incur most their costs in other currencies, e.g. South African rand or Australian dollars. If the US dollar climbs against these input currencies, the USD price can be lowered without shrinking the mine's profit margin. This makes gold a sort of natural hedge. An additional currency hedge would therefore make little sense.

Gold price in various currencies (indexed)

The same phenomenon can be seen in all commodity markets, but the effect is especially clear in the case of gold, which often functions as an alternative currency.

What drives the gold price?

It is difficult to attach a value to gold. In common with other commodities, gold does not provide an income in the form of interest or dividends. In contrast to crude oil or wheat, however, gold is never really consumed. Once mined, it exists for ever. Many people regard gold as a reliable store of value. Unlike paper currencies, it is thought to provide a hedge against inflation, at least over the medium term. But even this feature is not rock-solid. Ultimately the gold price is simply a function of supply and demand. Total supply amounts to around 4,500 tonnes a year at present, of which about 30% comes from recycling. The recycling component acts as a natural price stabiliser. When the price of gold is high, as it was in 2010–2012 for example, there is a pecuniary incentive to melt down jewellery and gold scrap. More expensive forms of recycling, e.g. of gold in computers, can also become economic if the price is high enough. While mine output is relatively sluggish and takes time to affect the price trend, supply from recycling acts as a natural regulator.

The demand side is much more dynamic. Unlike silver and platinum, almost half of purchased gold goes into jewellery. In 2012 China overtook India as the world's biggest jewellery market. China's jewellery makers take around 630 tonnes of gold a year. Global jewellery demand has been falling slightly since 2014, mainly due to reduced buying in the Middle East, where purchasing power has been hit by the oil price collapse.

The chief price-determining factor in the short and medium term is investment demand. Gold ETFs and physical bars and coins are bought for speculative purposes and as a hedge against political risks or inflation. However, gold seems to have lost some of its popularity as a safe haven. Donald Trump's election victory and the Brexit vote in the UK led to no substantial increase in the gold holdings of physically backed ETFs. Total holdings in this sector are still about 20% lower than at the peak of the European debt crisis in late 2012.

Are gold mine shares an alternative?

In order to gain a long-term exposure to gold while simultaneously profiting from rising equity markets, many investors have opted to buy gold mining shares instead of directly investing in the metal. To assess the relative attractiveness of gold and gold mining shares one needs to look at specific valuation metrics and the relationship between mining companies and the gold price. In terms of valuation ratios, gold mining shares are not particularly expensive at present but nor are they being traded at a discount. Bloomberg reports that all-in production costs per fine ounce of gold in the first quarter of 2017 were USD 917. Other important metrics for the gold industry, such as geological deposits in comparison with the mining company's market value, also suggest that mining shares are close to fair value.

Gold investors should be aware, however, that mining shares mostly carry a significantly higher risk. "Junior miners", i.e. relatively small exploration companies that concentrate on opening up new deposits, can be especially risky. They react extremely sensitively to changes in the underlying gold price, and their market liquidity can quickly become problematic. The recent troubles of the VanEck Vectors Junior Gold Miners ETF are a case in point. Together with its big brother, VanEck Vectors Gold Miners ETF, this fund's precipitous growth pushed its stake in relatively small cap mining companies to almost 20%, which meant it was in danger of falling foul of regulatory thresholds. When VanEck sought to solve the problem by adjusting its reference index, the announcement triggered a sell-off that hit junior miners very hard. This example highlights the fact that ETFs and index funds in niche markets carry risks that are hard to gauge. Equity investors who seek an exposure to a rising gold market are therefore well-advised to concentrate on shares of selected individual mining companies.

Highlights

- Currency hedging of gold investments makes little sense and can even exacerbate the overall risk.
- In the short and medium term, demand for gold ETFs and speculative futures is the driving force behind the gold price.
- The gold market situation has become somewhat more encouraging. Higher inflation expectations and geopolitical risks are providing support.

Conclusion: further price gains expected

After a long period of relative weakness there are now convincing arguments in gold's favour. The expected acceleration of inflation in the eurozone and fears of heightened market volatility driven by geopolitical risks have led to a reassessment of the market. ETF holdings and speculative futures are showing a change of trend, at least in the short term. Nevertheless, although we believe the gold price has medium-term upside potential, we advise investors to adopt a long-term approach and avoid speculative buying. Given the negative correlation with the US dollar, preference should be given to non-currency-hedged investments.

Benchmark	October 2017	% YTD[1]
Commodities	→	-2.04%
Gold	→	-11.92%
Crude oil	↗	13.55%
Commercial real estate	→	8.01%
Private equity	→	8.50%
Convertible bonds	→	9.99%
Hedge funds	→	4.14%

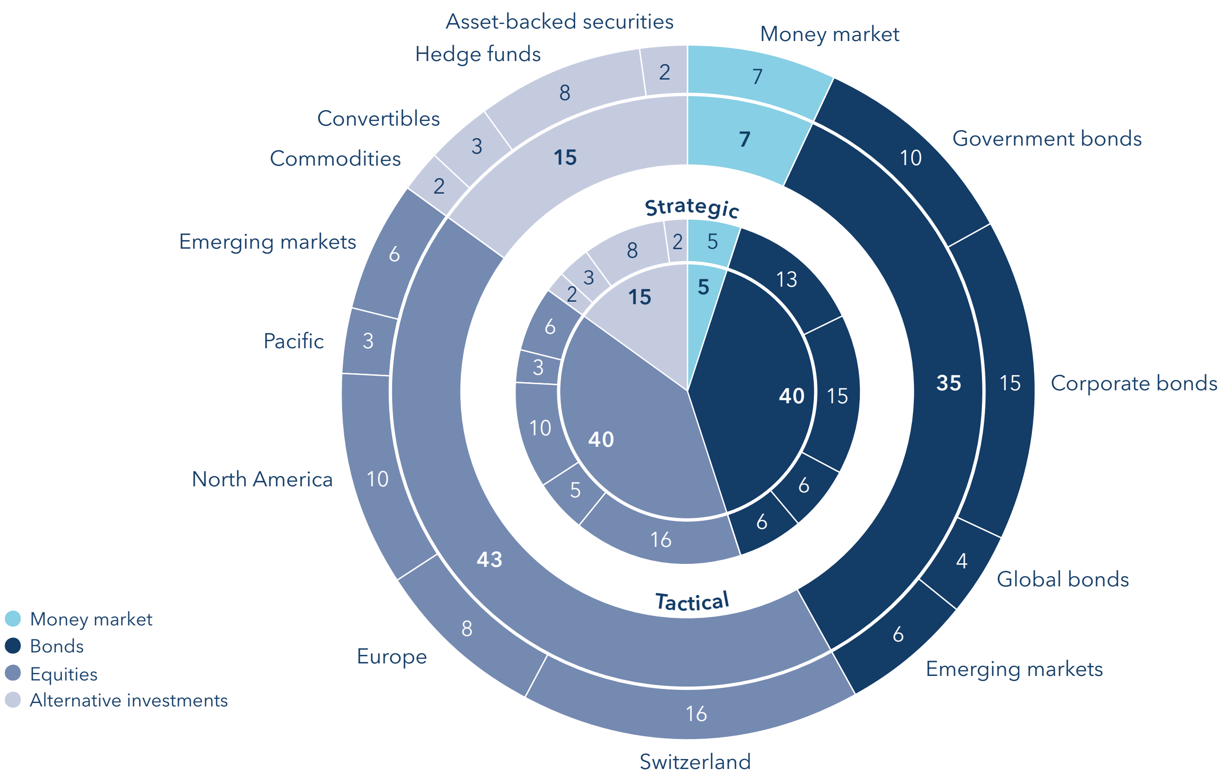
Upside/downside ranges indicated by our 3-6 month absolute performance assessments:
↑ > +5% ↗ +2% to +5% → -2% to +2% ↘ -5% to -2% ↓ < -5%

[1] As of 19.09.2017

3. INVESTMENT MANAGEMENT

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	19.09.2017	1,071.75	no	yes	3.19%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	19.09.2017	1,420.98	no	yes	2.06%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	19.09.2017	1,374.22	no	yes	4.76%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	19.09.2017	1,597.99	no	yes	5.41%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	19.09.2017	997.74	no	yes	3.68%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	19.09.2017	1,548.29	no	yes	6.89%

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

Current investment tactics

Current investment tactics

Geopolitical risks and comments by the European Central Bank suggesting a possible exit from its ultra-loose monetary policy have had only a short-lived negative impact on the equity markets. The main factor underpinning the markets' positive performance is the robust condition of the world economy. Equity markets in the eurozone have been more subdued than elsewhere, handicapped by the appreciating euro. Eurozone bond yields have risen since the start of this year, and the yield gap between Europe and America has contracted in recent weeks. The US dollar has been hit by the Fed's dithering about further interest rate hikes. In our view, however, the situation of the US economy is unchanged.

We believe that current economic weakness in the USA is only temporary. Capital spending, in particular, should gather momentum in the coming quarters – partly due to the need to repair the colossal damage caused by hurricanes Irma and Harvey. This will give further support to the labour market. Moreover, recent statements by the US administration indicate that tax reform is still on the table. All this suggests that the current dip in US growth could soon be consigned to the past. Equity markets are therefore still on solid ground. European shares, especially, will benefit from a stronger US economy.

Yields in the US bond market have fallen since the start of the year, and the US yield curve has consequently flattened. We do not expect the flattening to go any further at present. The outlook for US economic growth is still robust.

Bonds

The yield picture has recently been split in two: falling yields in the USA – rising yields in Europe. The duration of our bond positions remains below benchmark in all reference currencies. Overall we are still underweight in investment grade bonds. Our position in emerging market bonds is neutral. This asset class offers an attractive risk premium and has been supported by the decline in US yields. We continue to hold a position in inflation-linked bonds.

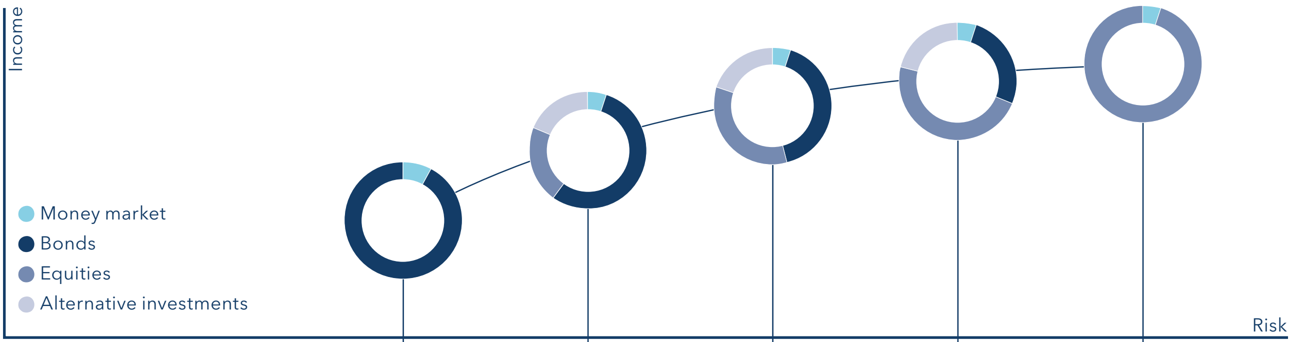
Equities

The pick-up in economic activity is reflected in a sharp rise in corporate earnings expectations, as evidenced by business surveys and analysts' more optimistic forecasts. Eurozone equities are also supported by relatively favourable valuation levels compared with the US market. Eurozone markets still have catch-up potential vis-à-vis the USA. Additional support comes from high dividend yields relative to bonds. The emerging markets likewise stand to reap the benefits of ongoing earnings growth.

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.

Our solutions



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

Investment solutions	Fixed-income	Conservative	Balanced	Growth	Equity
Strategy Fund from 1 unit		●	●		
Fund Mandate from CHF 250,000	●	●	●	●	●
Classic Mandate from CHF 1 million	●	●	●	●	●
Special and Sustainability Mandate from CHF 2 million	●	●	●	●	●
Enhanced Mandate from CHF 5 million		●	●	●	

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4. APPENDIX

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