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Investment Strategy
Private Clients

1/4

January 2018 · 1st quarter

Macro insights

Can we enjoy the "best of all worlds" again in 2018?

p.03

At a glance

- It took a decade but the crisis is now behind us: the global economy has found a "normal" footing, inflation is starting to come back into the picture – although far from posing a risk – and central banks are able to gradually remove exceptionally supportive policies.
- The US is on track for its second longest post-World War II expansion, even if growth should prove somewhat softer in 2018, given reduced slack.
- Europe outperformed expectations in 2017 as economic and political risks abated. All signs suggest the strong recovery will continue in 2018.
- The Bank of Japan remains the most accommodative central bank, despite some supply limits having been reached and inflation picking up on wage growth and an undervalued currency.
- Accelerating growth in most of the emerging markets complex should offset a likely modest Chinese deceleration next year.
- Our view of the world warrants continued pro-growth investment positioning, even though we expect more modest returns going forward as the cycle matures.

Also featured

OPEC acting as the oil market stabiliser

Quarterly publication of Lombard Odier Investment Solutions - Strategy

Important information

Please see important information at the end of this document.

Data as of 11 December 2017

Global outlook for 2018: the cycle extends

After a year of strong economic and financial market performance, with volatility printing historical lows and asset valuations looking increasingly rich, investors are naturally questioning the sustainability of current trends. Are we nearing the end of the cycle? Our answer would be – not yet.

Forecasting a breakdown scenario for 2018 requires expecting either that an exogenous shock hits the global economy or that an endogenous negative feedback loop takes hold. While clearly always possible, the former is unpredictable by nature, and unlikely in our view. It would certainly be complicated to base an asset allocation on such a premise.

As for the endogenous threat, it has to do with the very functioning of economic cycles. In a recovery, there eventually comes a point when the engine overheats. This can show up in price pressures that develop to the point of becoming counterproductive for economic actors, or investment spending that well exceeds true economic needs. Policymakers typically then press hard on the brakes – causing the engine to stall. Expansion turns into recession.

Absent signs of excesses on the inflation and investment fronts, we thus conclude that 2018 is more likely to be a year of economic continuity. Growth should remain above-trend, and broadly in line with 2017. While the business cycle does show signs of maturing in the US (at eight years old) and Japan, in Europe and emerging markets it is much younger, and, we believe, has further to run (see chart I, page 04).

Crucially, financial conditions remain supportive. Even though 2018 is likely to mark a turning point in monetary policy, central banks are proceeding cautiously in their removal of ultra-loose monetary policies. Combined with macro momentum, this still ample liquidity bodes well for corporate profits over the next quarters. European earnings, in particular, have room to catch-up with the US and previous cycle highs.

That said, continuity does not mean more of the same. The cycle is moving forward, progressively reducing the slack in the global economy. So, although 2018 nominal growth should be stable relative to 2017, a trade-off between its real and inflation components is to be expected (see chart II, page 04).

If inflation does indeed creep-up during the coming quarters, financial market volatility should make a comeback and developed market government bonds – an asset class that we have long strongly underweighted – come under further pressure. Our most recent move in the fixed income space has been to shift part of our allocation away from credit and towards convertible bonds and hard currency-denominated emerging market bonds, where we see better value and more upside potential.

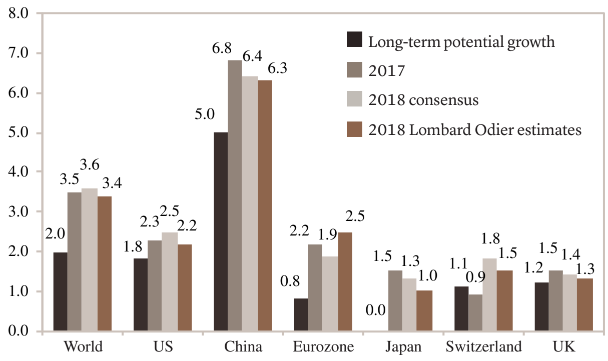
We stand firm on our equity overweight, in view of the solid corporate profit outlook. But regional preferences are likely to matter in 2018. Valuation considerations, as well as their earlier stage in the recovery, make us favour the European and emerging markets over the US.

Commodities are benefitting from their best demand backdrop in over a decade. Although this might fade somewhat in the new year, we like the potential diversification effect of this asset class – warranting a continued overweight.

Note: Unless otherwise stated, all data mentioned in this publication is based on the following sources: Datastream, Bloomberg, Lombard Odier calculation.

I. 2018 potential, consensus and expected GDP* growth

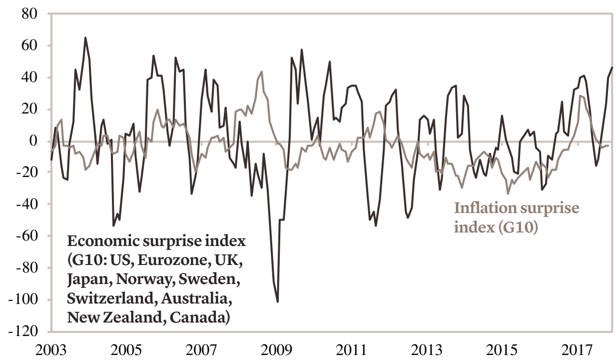
Bloomberg consensus and Lombard Odier estimates and forecasts



* Gross Domestic Product
Sources: Datastream, Bloomberg, Lombard Odier calculation

II. Inflation and economic surprise indexes

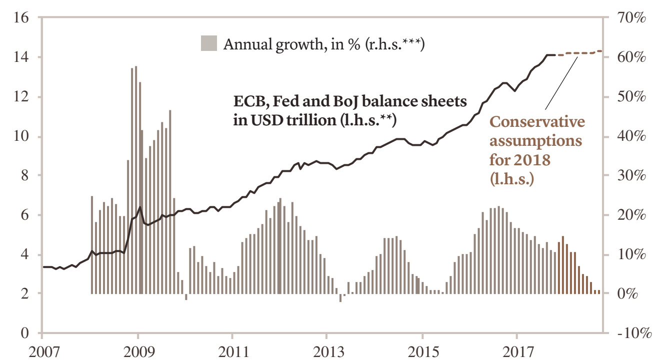
Citigroup diffusion indexes for the G10



Sources: Datastream, Bloomberg, Lombard Odier calculation

III. ECB, Fed and BoJ balance sheets

In USD trillion (left) and yoy%* (right)



* year on year, ** left hand scale, *** right hand scale
Sources: Datastream, Bloomberg, Lombard Odier calculation

On the currency front, in line with our expectations, US dollar strength is stalling. Going forward, we expect the euro to head higher against the greenback, and both the Swiss franc and the pound sterling to remain weak versus the single currency.
Our still constructive economic outlook for 2018 does not mean that we are not aware of the risks. On our watch list will be inflation data, financial markets' reaction to monetary tightening (see chart III), and Chinese economic and debt developments. Also, after dissipating during the course of 2017, protectionist and political threats could re-emerge – notably around the Italian or US midterm elections.

Samy Chaar, Chief Economist

Please see important information at the end of this document.

United States
More signs of a maturing cycle

In a nutshell

- The US is on track for its second longest post-World War II expansion, even if growth should prove somewhat softer in 2018, given reduced slack.
- While probably not as tame as most are currently predicting, inflation should not pick up to the point of forcing the Federal Reserve to accelerate its hiking process – and threaten the economic cycle.
- We foresee two further rate hikes in 2018, alongside balance sheet shrinkage of some USD 350 billion, making for relatively neutral financial conditions.

Our scenario for the US going into 2018 sees GDP (Gross Domestic Product) growth slow slightly to 2.2% – see chart IV – (versus a consensus of 2.5%) and inflation pick up somewhat – developments that would be quite natural for an economy entering its ninth year of expansion.

Private consumption is likely to decelerate in a context of slowing job creation and muted wage growth. Investment, on the other hand, has room to expand: capacity is looking increasingly constrained and in need of a boost. Trade can also be expected to contribute positively to growth, thanks to the lagged effect of a weaker dollar. Finally, the public sector's contribution to growth should remain slightly negative, as federal government spending is projected to remain stable while some consolidation is likely at the state and local levels.

On the inflation front, the October CPI (Consumer Price Inflation) report, which saw the core price index firm for the first time this year, might prove a turning point. While most economists expect inflation to remain tame in the near term, we would point out that the trend in US inflation has historically lagged GDP growth by several quarters. As such, "disappointing" inflation during most of 2017 could be partly explained by the weak economic growth experienced towards the end of 2015 and into early 2016. We thus see further upside for inflation as 2018 unfolds, although not to the point of an overheating that would force the Federal Reserve (Fed) to accelerate its hiking process.

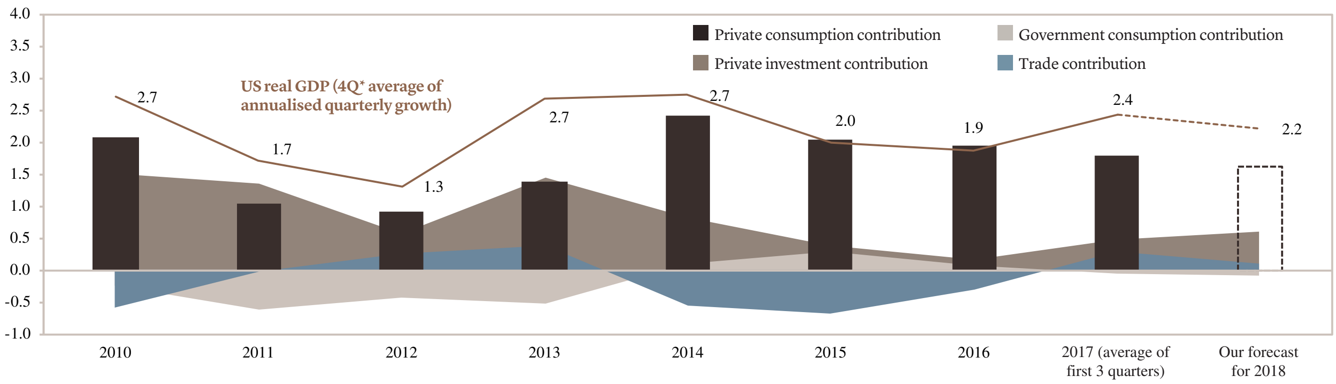
Strong macro data, as well as the minutes from the last Fed meeting, have confirmed expectations that a December rate hike remains the most likely outcome, taking the Fed funds rate to 1.50%. Our own assumption continues to be for two further hikes in 2018, alongside the ongoing balance sheet shrinkage that should amount to some USD 350 billion. After having eased considerably during 2017 (thanks to strong performance by risky assets and a softer US dollar), financial conditions thus look set to remain broadly neutral during the coming quarters. That said, we will certainly be keeping a close watch for any signs of them tipping into more restrictive territory – as this is the most typical way an expansion ends.

On the political front, the mid-term Congressional elections will be a risk event worth monitoring. While November 2018 is still distant, the possibility that the Republican party sustains a defeat that could cost it its Senate or House majority could change the political landscape for the 2nd half of Trump's presidency.

Bill Papadakis, Macro Strategist

IV. US real GDP growth and underlying contributors since 2010

Annual data and Lombard Odier expectations



* quarter / Sources: Datastream, Bloomberg, Lombard Odier calculation

Europe
Set to maintain its current momentum

In a nutshell

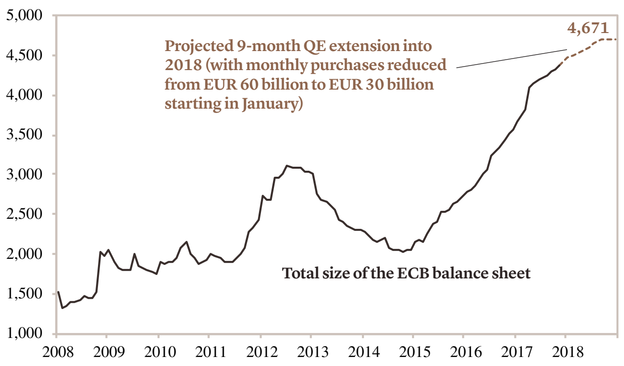
- Europe outperformed expectations in 2017 as economic and political risks abated. All signs suggest the strong recovery will continue in 2018.
- The European Central Bank has extended its commitment to support the recovery through extraordinary measures, but the day of normalizing monetary policy is getting closer.
- Politically, the landscape is much less worrisome than a year ago, notwithstanding Italian elections, government formation negotiations in Germany, and the issue of Catalonia.

Europe significantly outperformed expectations over the course of 2017 – both economically and politically – and we believe that this trend is likely to remain in place next year.
Like most macroeconomic data released during the past months, the 3rd quarter GDP report exceeded expectations, showing an annualized growth rate of 2.6% as of the latest revision. With most forward-looking indicators pointing to unabated strength, and still considerable slack in the economy, we look for Eurozone growth to again be meaningfully above 2% in 2018. Our above-consensus forecast is driven by a number of factors, including continued labour market improvements, solid corporate profitability dynamics, an increasingly firm investment outlook, a healthier global economy, and significant policy support for the recovery.
The fact that the European Central Bank (ECB) has committed to pursuing quantitative easing (QE) until September and keeping the deposit rate negative until after the end of its asset purchases will provide continued support to the economy. This is in stark contrast to what usually happens in periods of growth acceleration, which tends to push monetary policy into tightening mode. The renewed ECB commitment has ensured extraordinary policy support for most of next year, but we note that the debate about the timing is intensifying in the Governing Council, and late 2018 is likely to be a turning point (see charts V and VI).
Finally, while there is obviously some latent political risk, it is nothing like the heavy agenda that Europe was facing at the start of 2017. Euroscepticism failed to score any significant victories – if anything, Brexit appears to have actually increased the support for Europe. We see limited risks from next year's elections in Italy. We think Catalonia is likely to remain a fairly contained issue. And looking at Germany, after ups and downs in coalition talks, it has recently started to look increasingly likely that Merkel will manage to form another grand coalition thanks to a softening of the Social Democratic Party's position.

Bill Papadakis, Macro Strategist

V. Announced path for the ECB balance sheet

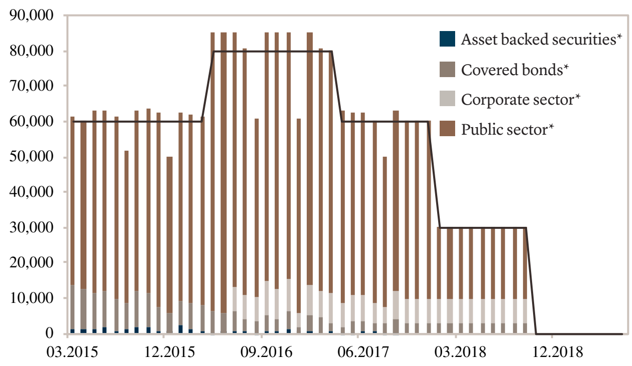
Stock of ECB assets (in EUR billion)



Sources: Datastream, Bloomberg, Lombard Odier calculation

VI. No rate hike until 2019

Amount of monthly ECB purchases (in EUR million)



* Purchase programme

Sources: Datastream, Bloomberg, Lombard Odier calculation

Japan
Soul food now has a higher price tag, even in Japan

In a nutshell

- Many Japanese domestic businesses are facing tricky margin dynamics as wages finally begin to take a higher share of the economy, courtesy of the tight labour market.
- The Bank of Japan's "symmetric targeting" framework should avoid overreaction to nascent inflation, particularly since the Abe cabinet will get to appoint future monetary leadership.
- Whether or not the country's politics – driven by old age pensioners depending on fixed income – can tolerate genuine symmetric inflation targeting remains a key question for 2018 and beyond.

The famous yakitori ("chicken skewer") shops near Shinjuku station in Tokyo are perhaps the right place to get clues about Japan's 2018 outlook. This jostle of 60 small restaurants has been the source of culinary solace to embattled salarymen during the worst of Japan's deflationary decades. While the charming grit and grime of the shops harkening back to the heyday of the Showa period (1945-1989) is probably a good enough draw for some patrons, we also think that the extreme stability of menu prices helped the shops' resilience. As Japan heads into the sixth year of Abenomics, however, this pricing formula is beginning to change, creating an unfamiliar challenge for these scrappy establishments.

The challenge mainly comes from the dearth of workers. With the Japanese labour market at its tightest in decades (see chart VII), most of these shops now rely heavily on migrant workers from developing Asian countries. Still, they are under pressure to raise prices – perhaps conspicuously already next year – not just for yakitori but also for beer, major manufacturers having just decided to adjust pricing for the first time in a decade.

Japan's stubbornly low prices have long been the staple of the investment community, and consumer price indices do so far support that narrative. But an expanding economy with a limited pool of young workers will eventually face price pressures, even if not along the linear relationship envisioned by the "Phillips curve[1]".

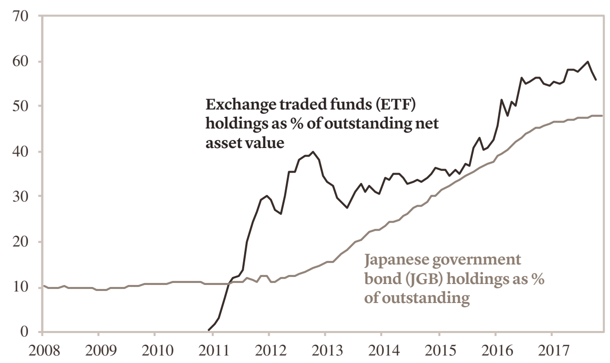
The good news is that the extension of Abe's mandate reduces the risk of over-reaction to nascent inflation, since Kuroda should be re-appointed at the helm of the Bank of Japan (BoJ) or a like-minded dove replace him. Note that Etsuro Honda, a widely rumoured successor and current Japanese ambassador to Switzerland, has actually criticized Kuroda for not doing more to meet the 2% inflation target.

The key question, however, is whether the BoJ, which already owns nearly 60% of the country's exchanged traded funds and half of its outstanding government bonds (see chart VIII), can muster enough political capital to tolerate domestic inflation above 1.0-1.5% once ordinary salarymen start feeling some squeeze in areas of usual spending, such as a relaxing dinner in Shinjuku's Memory Lane. The squeeze will be even greater for pensioners on a fixed income (some 32% of the population already). Will Japan manage to overcome this fundamental political constraint and show other countries how deflation is beaten? We are willing to give the country some benefit of the doubt, but believe that it is still premature to make this the central thesis for 2018.

Homin Lee, Macro Strategist - Asia

[1] Relationship between the rate of inflation and the unemployment rate.

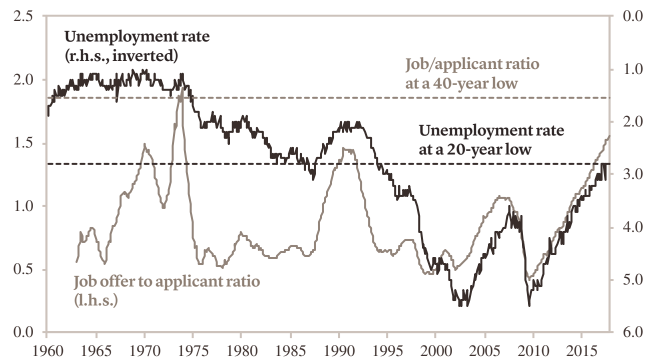
VII. Bank of Japan ETF and JGB Holdings



Sources: Japan Investment Trust Association (ETF outstanding), CEIC data, Lombard Odier Asia calculation

VIII. Japanese labour market

Job offer to applicant ratio and unemployment rate



Sources: CEIC data, Lombard Odier Asia calculation

Emerging Markets
Non-China emerging growth set to accelerate in 2018

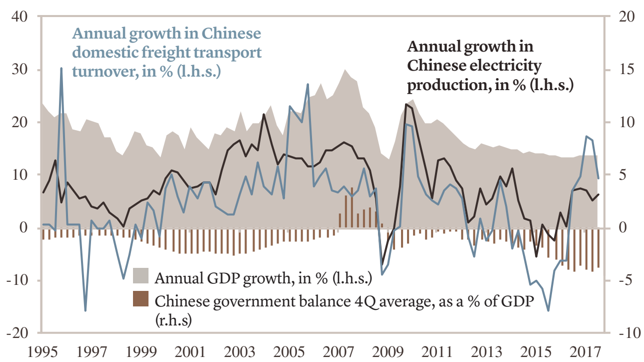
In a nutshell

- Chinese economic growth is decelerating but should remain above 6% in 2018 – with ample monetary and fiscal leeway for policymakers to intervene if headwinds really pick up.
- Accelerating growth in the non-China emerging complex should keep the emerging contribution to world growth stable next year.
- The countries that stand out from a macroeconomic viewpoint are (most of) emerging Asia, Russia, Peru and Chile. At the other end of the spectrum, Turkey and South Africa present the most worrisome situations.

Looking at a number of metrics beyond (not always helpful) GDP data, the Chinese economy appears to have decelerated recently (see chart IX) – but should be able to sustain low 6% growth in 2018. From a structural standpoint, successfully managing the production-to-consumption transition, recognizing the need for cuts in overcapacity, less inequality and stronger social nets, and addressing environmental issues will be the main challenges. Externally, China's strategy of openness, epitomized by the "One Belt, One Road" blueprint, is in direct contrast to Trump's protectionist stance and puts the country on track to rival the US as an economic powerhouse.
While under no pressure to hike rates (see chart X), given stable and low inflation, the People's Bank of China should keep a slightly hawkish bias in order to curb shadow banking sector risks. On the fiscal front, authorities may well take advantage of the satisfactory economic performance to withdraw some of the stimulus dating back to times of acute hard landing fears. That said, should headwinds arise, policymakers will have both monetary and fiscal leeway to uphold the economy. Longer-term, the main risk for China lies in the exponential rise and high level of total credit to the non-financial sector, now close to 260% of GDP.
Elsewhere in the emerging complex, the "easiest" part of the recovery may be over, with most of the inflation drop – thus central bank easing – probably behind. Still, we are confident that non-China emerging growth can accelerate in 2018, offsetting the modest Chinese slowdown. Many imbalances have been corrected over the past years, and vulnerabilities to external shocks have greatly decreased.
Our macroeconomic preference goes to most of emerging Asia, along with Russia in emerging Europe, and Peru and Chile in Latin America. Conversely, we remain extremely cautious on Turkey and South Africa, where political risks compound weak fundamentals. Colombia could look progressively better if it manages to reduce its twin deficits, in the wake of recent peace accords and higher oil prices. Benign NAFTA (North American Free Trade Agreement) renegotiations would likely lead us to upgrade our view on Mexico, while reform of the pension system would make us more decisively positive on Brazil. In Argentina, the turnaround is clearly unfolding – we just need more evidence of structural reforms actually taking effect before sounding the all-clear. In emerging Europe, Poland and Hungary are doing well, but overheating risks loom, potentially triggering tightening cycles.

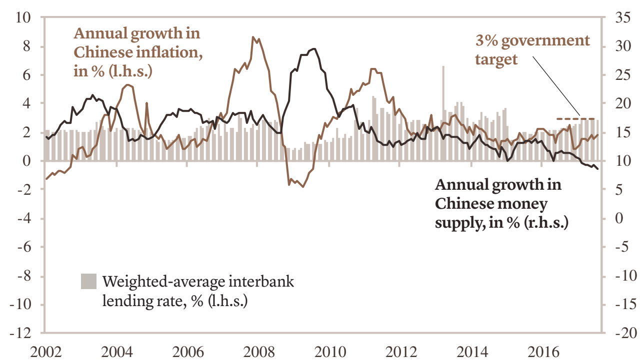
Stéphanie de Torquat, Macro Strategist

IX. Chinese activity to moderate from high levels
Fiscal support will not collapse suddenly



Sources: Datastream, Bloomberg, Lombard Odier calculation

X. Tighter policy containing Chinese inflation
Providing room for manoeuver if necessary



Sources: Datastream, Bloomberg, Lombard Odier calculation

Asset Allocation
2017 momentum to continue, but...

In a nutshell

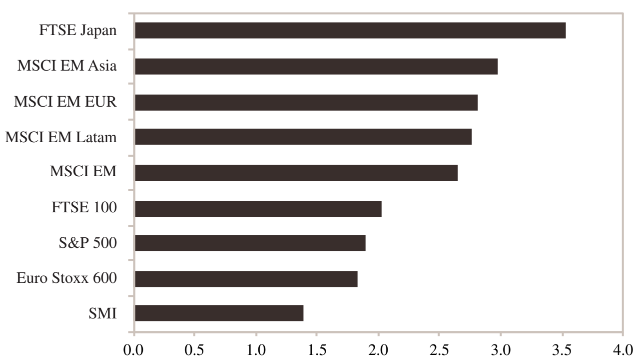
- Our view of the world warrants continued pro-growth investment positioning, even though we expect more modest returns going forward as the cycle matures.
- Global trade escaping the post-crisis gloom provides strong support, yet it will come alongside a normalisation of inflation and monetary policies, two regime changes that are likely to fuel investor concerns and, in turn, market volatility – meaning that tactical moves and agility will be paramount.
- We continue to favour cyclical assets, notably European and emerging equities, while being more cautious on US assets where we see little room for valuation expansion.

The broad-based acceleration in global manufacturing activity has buoyed risky assets since the last edition of this quarterly letter. A large majority of equity markets are set to end the year with positive – often double-digit – performance. As such, markets are heading into 2018 with strong momentum, but also with demanding valuations, in what could be a more challenging environment. Indeed, as pointed out in our macroeconomic outlook, the extension of this cycle is likely to lead to some (long-awaited) inflationary pressures. Also, the normalisation of the Fed balance sheet, a historical first that will gain traction in coming months, will gradually withdraw a major market participant from the US bond market. Even if we expect these pressures to remain under control, we cannot exclude some episodes of volatility as investors question the implications of such momentous changes in the market environment.

We expect the positive trend in global trade to extend into 2018 and further underpin cyclical assets and sectors (see chart XI). Within equities, emerging market earnings should be strong beneficiaries of this trend, especially the Asian IT (information technology) sector which accounts for an increasing share of global indices (see Box A, page 12). Other emerging exposure, financials notably, should also be supported by the ongoing domestic recoveries in those economies. European markets will continue to enjoy a very supportive domestic-driven recovery. The consensus still seems somewhat conservative, underestimating economic momentum and thus earnings growth (see chart XII). Our 2018 European GDP forecast is consistent with double-digit EPS (earnings per share) growth (versus the 9% consensus), which should trigger positive surprises in coming quarters for both small- and large-caps. We thus continue to overweight European equities, especially relative to US markets with our currency outlook suggesting less negative feedback from the euro. The US economic recovery is already very mature, making for less impressive, albeit still positive, earnings dynamics and little room for operating margin expansion. The same holds for the Japanese economy, where we thus maintain a neutral stance – recognizing, however, that the ongoing recovery in global trade might support further positive earnings revisions going forward.

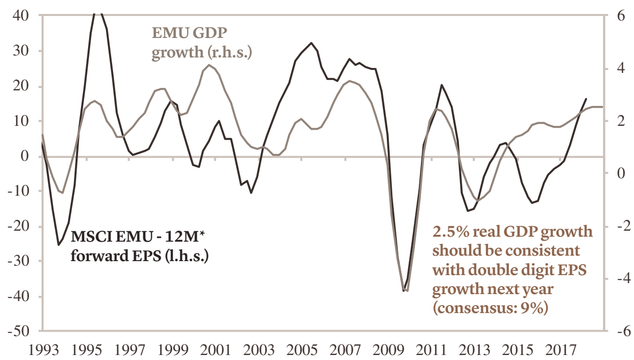
We are aware that our outlook on equities and ensuing regional positioning is dependent on US tax reform. We expect 2018 returns for US large-caps to range from 5% to 13% according to the extent and timing of implementation. The tax cuts should support earnings

XI. Equity markets' sensitivity to global trade
Impact on earnings growth* of a 1% increase in global trade



* estimates since 2000
Sources: Datastream, Lombard Odier calculation

XII. European earnings to beat consensus expectations
EMU earnings per share and GDP annual growth (in %)



* month
Sources: Datastream, Bloomberg, Lombard Odier calculation

growth but valuations are likely to deflate once the one-off effect has been priced in. The chief impact should come at the sector level, with the most domestic sectors seeing the greatest benefit and health care, IT and materials being only very marginally affected. In terms of style, small-caps have exhibited high sensitivity to this theme since President Trump's election (see chart XIII), as they are the companies that actually pay the statutory tax rate – larger capitalisations tend to achieve lower effective tax rates.

Prospects look less buoyant when it comes to the fixed income space, where our baseline scenario suggests little to no returns, while the normalisation of inflation and monetary policies could be a source of volatility. That said, structural forces such as lower potential growth and the appeal of US Treasuries to international yield-seeking investors are likely to prevent a sharp rise in interest rates. Also, while we foresee two further rate hikes, the Fed's own guidance for a very long-term Fed funds rate of 2.75% should cap potential market moves at the long-end of the curve. As such, the US yield curve is likely to flatten further next year. In Europe, more steepening is instead to be expected, as long-term yields have appeared extremely disconnected from fundamentals ever since the start of QE (see chart XIV). Indeed, the current economic environment would be consistent with real rates 100 bp (basis points) higher. We think that the overvaluation of European core yields should reverse once the ECB starts preparing markets for interest rate normalisation.

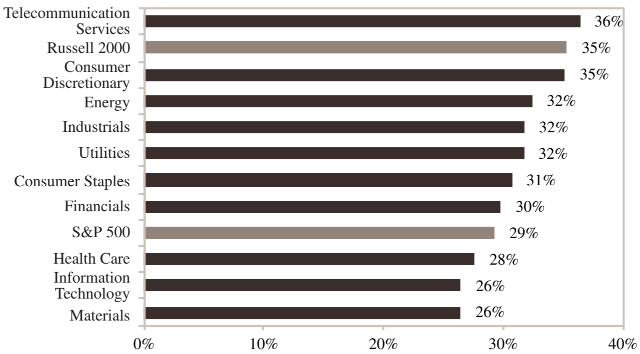
We continue to prefer credit over sovereign bonds as benign financial conditions support corporates and prevent a surge in defaults. That said, the attractiveness of the asset class has deteriorated with future expected returns looking subdued (there is limited spread compression potential from current levels in both the investment grade and high yield segments). In addition, indices duration is historically high (at 5.4 currently in Europe versus 3.8 in 2012), increasing the vulnerability of the asset class should our risk scenario of volatile interest rates materialise. We see greater value in the emerging bond market, and took the recent market consolidation as an opportunity to strengthen our exposure (see chart XV, page 11). Stable growth and subdued inflation will allow emerging central banks to maintain an accommodative stance. With the US dollar foreseen as stable during coming quarters, investors should make a rapid comeback, as emerging bonds constitute one of the last pockets of returns in fixed income markets. We thus maintain our overweight in local currency-denominated emerging debt while having recently initiated an overweight stance in the hard currency segment, which now offers a better outlook than investment grade bonds in our baseline scenario.

We also recently adapted our portfolio positioning in favour of convertible bonds. Whereas corporate bonds present limited upside, convertible bonds bring exposure to equity bull markets. Another attractive feature is the increase in the option value in the event of higher volatility, not to mention the lower duration of the bond.

All told, with interest rates likely to trend higher at least in Europe, the core issue from a portfolio construction standpoint is the declining hedging capacity of government bonds. Over the last two decades, high quality government bonds were defined and widely used as a diversifier within a traditional multi-asset portfolio, thanks to their strong negative correlation to equity markets. This is no longer the case, especially in Europe where the danger is much greater with the coupon on 10-year German bonds providing almost no cushion (50 bp). In our view, commodities constitute one of the asset classes that should offer the best diversification and hedging capacities in 2018. Performances are likely to be driven by supply developments (OPEC – Organization of Petroleum Exporting Countries – and US shale producers in the oil market – see Box B, page 13 – and capex cuts in base metals), implying a lower correlation with equities than in the past, while the downside should be limited by the favourable demand backdrop. We thus maintain our commodity overweight despite expected returns having been reduced by the impressive price action witnessed last quarter. The

XIII. The effect of the tax cuts should vary by sector

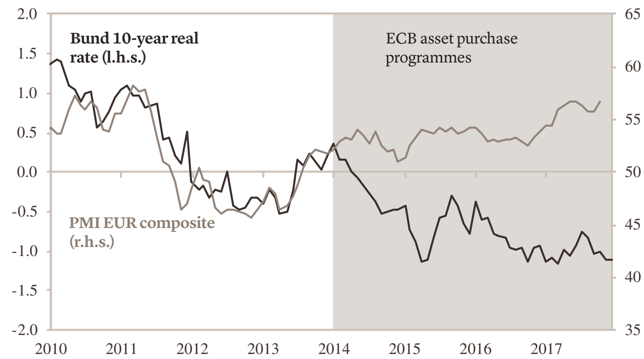
5-year average effective tax rate*



* Lombard Odier calculations for S&P 500 companies with positive pre-tax income
Sources: Bloomberg, Lombard Odier calculation

XIV. European core rates are disconnected from fundamentals

10-year Germany real rates (%) and EUR PMI*

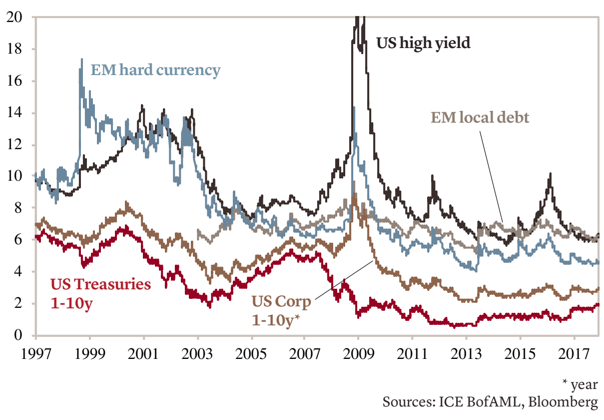


* Purchasing Managers' Index
Sources: Bloomberg, Lombard Odier calculation

potential diversification effect of the asset class looks interesting, particularly in a period of rising geopolitical risk (energy and precious metals) and potentially higher inflation (energy and base metals).
Finally, major currencies might play a less important role next year in a context of monetary policy re-synchronisation, at least when it comes to the Fed and the ECB. With the nomination of Jerome Powell at the helm of the Fed virtually ensuring continuity in US monetary policy, we see no big catalyst likely to question US dollar stability in the short-term. Medium-term, our outlook remains unchanged: we still expect the euro to head higher against the US dollar (our 1.25 medium term target is maintained) on improved growth prospects for the Eurozone. We do not see the Bank of England hike as the start of a monetary tightening cycle given the challenging real economy situation, although recent progress in the Brexit negotiation process might alleviate near-term pressure on the pound. In the absence of inflationary signs, a change in the Swiss National Bank (SNB) stance appears unlikely during the next few months, keeping the franc weak against the euro. The downside appears limited though, as the SNB might take the opportunity of a weaker currency to sell some of the foreign reserves accumulated over the past years. Finally, the yen should remain under pressure as the BoJ is one of the last remaining accommodative central banks. That said, we are starting to see some asymmetry in this positioning. With the present pick-up of economic activity and expectations of higher inflation, this very accommodative stance might gradually be questioned over the course of the year, a prospect that is not priced in by market participants (see chart XVI).

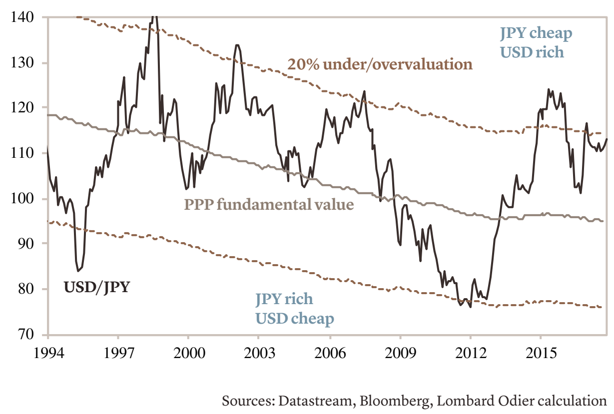
Sophie Chardon, Cross-Asset Strategist
Grégory Lenoir, Head of Asset Allocation

XV. Emerging debt looks attractive in relative terms
Yield-to-maturity, dividend yield, %



* year
Sources: ICE BofAML, Bloomberg

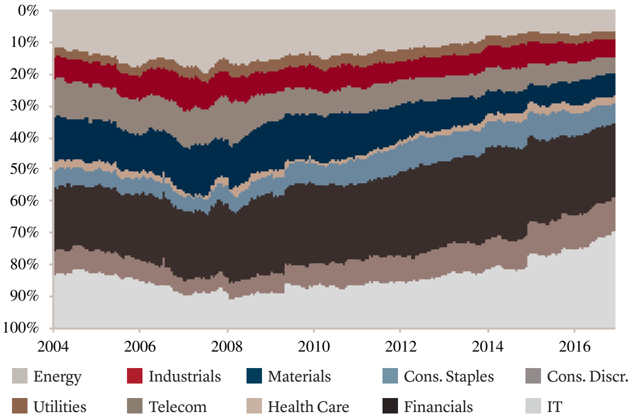
XVI. The BoJ is the last central bank in easing mode, leading to an undervalued currency
Purchasing power parity (PPP)



Sources: Datastream, Bloomberg, Lombard Odier calculation

XVII. Dramatic change in EM equity index composition: more IT, less energy and materials

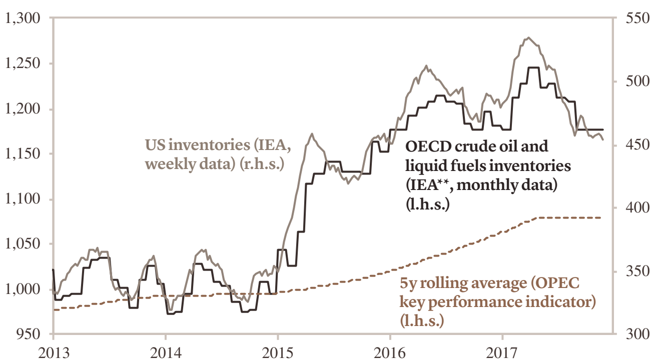
MSCI Emerging Industry Breakdown (%)



Sources: Datastream, Bloomberg, Lombard Odier calculation

XVIII. OPEC inventory draw target

OECD and US crude oil and liquid fuels inventories (in MB/D*)



* million barrels per day, ** International Energy Agency
Sources: Bloomberg

A. Breaking down the emerging equity index

We initiated an overweight position in emerging market equities in July 2016. Since then, the region has posted a strong outperformance, gaining more than 30% in absolute terms. By many measures long emerging exposure now appears consensual, and valuations have become more demanding. The recent break in the MSCI Emerging Markets index's momentum (the benchmark for an equity investment) suggests that the re-rating is well advanced. Going forward, earnings growth should be the main driver of performance.

As such, we have dug further into the index breakdown to highlight the underlying drivers of past performance. First, we found that regional and sector weights have changed dramatically since 2014, when commodity markets collapsed. Asia has always accounted for over 60% of emerging markets' capitalisation. But this bias has been amplified – to 75% presently – by the sharp fall in commodity share prices, at the expense of both Latin American and Eastern European capitalisations. From a sector perspective, the obvious implication is that the index is now extremely biased towards IT and financials, with the consumer discretionary sector also growing in weight. Conversely, the energy and materials sectors are now less represented. All told, then, emerging equity indices have experienced a profound shift towards the Asian IT sector (semiconductors in Taiwan and Korea, internet in China) (see chart XVII).

One consequence is that their future performance should be less influenced by the very volatile commodity markets and more correlated with the US stock market and the global business cycle.

A second consequence, as regards the 2018 outlook more specifically, is that both engines should be at work: 1) secular IT growth is here to stay – although the pace may slow down compared to the impressive earnings-driven price action of 2017; 2) improved global trade and stabilized commodity markets should support ex-IT earnings.

B. OPEC acting as the oil market stabiliser (see chart XVIII, page 12)

OPEC and non-OPEC participants (Russia) met on 30 November 2017 and agreed to extend their production cuts through year-end 2018, with the goal of normalising inventories. The group made clear that it wants to act as a market stabiliser, limiting oil price downside in the short- to medium-term and generating a favourable backdrop for a return of foreign capital towards the conventional oil sector.

In many respects, a parallel can be drawn with modern central bank communication strategies. Given the relatively stretched market positioning ahead of the meeting, how the decision would be communicated was crucial – and successfully managed. Recent interviews indicated that while a broad agreement to extend the cuts was in the making, Russia had yet to endorse Saudi Arabia's proposal for a nine-month extension. They could have waited until March to make a decision, but the 14-member OPEC and its outside allies, accounting for close to 50% of the global oil supply, preferred to show a strong commitment, rolling over their production cuts until the end of 2018 – an attitude that resembles the "forward guidance" used by central bankers to anchor market expectations. With the situation in the oil market evolving fast, in particular as regards the potential US shale response to this healthier price environment, the next meeting scheduled for June 2018 will offer oil producers an opportunity to reassess the need for these cuts – a kind of "data-dependency" typical of central bank speeches. The cherry on the cake came from Nigeria and Libya: previously exempted from the deal, they agreed to limit their production to its 2017 level. And it is precisely the growth in those two countries' production that fuelled oil price volatility earlier this year. Finally, interestingly, OPEC president Al-Falih declined to talk about any exit strategy during the press conference, focusing instead on the efforts required to achieve the inventory draw target of over 150 million barrels – just like Mario Draghi kept the ECB's asset purchase program open-ended when announcing its tapering.

We see this meeting as the confirmation that oil diplomacy and economic rationale prevail despite recent geopolitical tensions. Saudi Arabia, Russia, UAE and Kuwait are the biggest contributors to the production cuts and they need to ensure oil price stability. The Kingdom of Saudi Arabia has both huge financing needs and the Aramco IPO scheduled for 2018, while the Russian economy remains very dependent on oil prices.

We believe that OPEC is bound to remain in a market-management mode for the foreseeable future, which is good news as we enter a period of seasonally weaker prices.

Short-term, while the technical and fundamental factors underpinning the oil market will most likely remain supportive, the upside seems limited from these levels. Inventory draws, strong product demand and backwardation are all positive. In our view, the current price environment can persist so long as US producers remain unable to significantly up their investments (notably because of shareholders requiring free cash flow generation). Indeed, if WTI (West Texas Intermediate) futures manage to stay above USD 55 per barrel, there is still a risk that these producers could deploy some of the increased cash flow to accelerate drilling and completion activity, eventually fuelling greater market volatility.

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

AMSTERDAM
Lombard Odier (Europe) S.A. · Netherlands Branch[2]
Herengracht 466 · 1017 CA Amsterdam · Nederland
amsterdam@lombardodier.com
Credit institution supervised in the Netherlands by De Nederlandsche Bank (DNB) and Autoriteit Financiële Markten (AFM).

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

GIBRALTAR
Lombard Odier & Cie (Gibraltar) Limited
Suite 921 Europort · P.O. Box 407 · Gibraltar
gibraltar@lombardodier.com
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LONDON
Lombard Odier (Europe) S.A.[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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Lombard Odier Asset Management (Europe) Limited
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
luxembourg@lombardodier.com
Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.
Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
luxembourg@lombardodier.com

MADRID
Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).
Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Management Company supervised by the Comisión Nacional del Mercado de Valores (CNMV).

MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
Credit institution supervised in Italy by the Commissione Nazionale per le Società e la Borsa (CONSOB) and la Banca d'Italia.

MOSCOW
Bank Lombard Odier & Co Ltd · Representative Office Moscow
82 Sadovnicheskaya Street · 115 035 Moscow · Russian Federation · moscow@lombardodier.com
Under the supervisory authority of the Central Bank of the Russian Federation.

PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France.
RCS PARIS B 803 905 157 · paris@lombardodier.com
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BERMUDA
Lombard Odier Trust (Bermuda) Limited
3rd Floor, Victoria Place · 31 Victoria Street · Hamilton HM 10 · Bermuda · bermuda@lombardodier.com
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DUBAI
Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

HONG KONG
Lombard Odier (Hong Kong) Limited
3901, Two Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
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ISRAEL
Israel Representative Office · Bank Lombard Odier & Co Ltd
Museum Tower, 7th floor · 4 Berkowitz Street · Tel Aviv 6423806 · Israel · telaviv@lombardodier.com
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MONTREAL
Lombard Odier & Cie (Canada), Limited Partnership
1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) · Canada H3A 3R7
montreal@lombardodier.com
Regulated by the Autorité des Marchés Financiers du Québec.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
nassau@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA
Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Superintendencia de Bancos de Panamá.
Lombard Odier (Panama) Inc.
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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SINGAPORE
Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan
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