

Investment Strategy

Private Banking

3/4

July 2017 · 3rd quarter

Macro insights

Mid-year review: so far so good

p.03

At a glance

- Most of the risks – notably political – outlined for 2017 have now abated, prolonging the “soft goldilocks” environment as we enter the 2nd half of the year.
- The recovery of the US economy proceeds apace, with no signs of overheating: we expect the Federal Reserve to soon transition from rate hikes to balance sheet management.
- In Europe, the economic recovery is broadening, with improving external demand adding to already robust domestic activity: a game-changing inflexion point in monetary policy lies ahead.
- Japan’s cyclical conditions remains solid, with growing domestic consumption and investment – and even incipient signs of wage inflation in some segments of the labour market.
- Asian economic and trade conditions are looking good, with China progressively replacing the US as the dominant force in the region.
- A continued risk-on stance is warranted in portfolios, generally favouring regions where the economic cycle is less advanced (emerging markets and Europe) and gearing up for a strengthening of the euro.

Also featured

European mergers and
acquisitions (M&A):
back in action?

Mid-year review: so far so good



Halfway into the year, let us pause to reflect on the global economic and financial situation. The good news is that many of the risks outlined in our 2017 outlook have abated, buttressing our view that a worldwide recession is not on the horizon. Rather, our favourite economic indicators point to continued and relatively broad-based expansion. But we must also acknowledge that a number of these indicators have begun to level off, suggesting some maturing of the cyclical upturn – at just the time when central banks are shifting away from crisis-management mode.

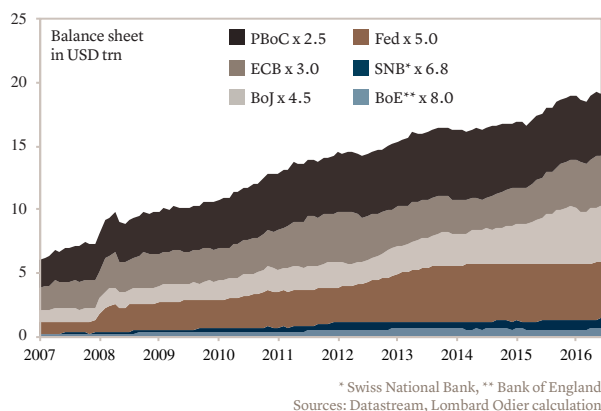
A slow but steady global growth environment, with limited inflationary pressures, has enabled central banks to maintain very accommodative liquidity conditions for a number of years (see chart I, page 04). As the recovery endures and broadens – extending now even to the Eurozone and Japan – central banks are beginning to take or at least consider tightening measures. Albeit still positive, growth in global liquidity, defined as the combined balance sheets of the Federal Reserve (Fed), European Central Bank (ECB), Bank of Japan (BoJ) and People's Bank of China (PBoC), thus looks set to slow down next year (see chart II, page 04). This is not to say that credit to the real economy will slump. After all, central bank liquidity injections were aimed first and foremost at preserving the financial system – not promoting growth and employment. The US is a case in point: while Fed money was the main driver of aggregate monetary growth between 2009 and 2014, there has since been a shift to commercial bank money, which in turn enabled liquidity to migrate from the financial to the industrial sector (see chart III, page 04). The recent drop in US commercial and industrial loans did admittedly come as a surprise, particularly in light of strong business confidence, but it could be partly attributable to energy companies having regained access to the bond market, hence needing to rely less on bank loans than during the oil price slump. In the Eurozone and Japan, credit trends have been steady to stronger, with surveys of bank lending confirming the improvement. There too, with a lag of few years relative to the US, commercial banks are taking over from the

central bank in driving money growth (see also chart III, page 04). Credit-ridden China is the relative exception to this brighter lending picture. Loan growth has been easing for over a year now, held back by a number of government measures: higher short-term rates, restrictions on shadow lending and housing curbs (impacting mortgage lending). But given policymakers' intent to maintain ambitious growth targets, we do not believe that fears of a collapse in Chinese credit are warranted. How about evidence that more expansionist fiscal policies will also help offset the shift in central banks' stance? While most advanced economies should indeed see modest fiscal easing over the next two years, the detailed picture on this front too is mixed, with fiscal paths set to vary substantially by country. Little incremental fiscal tightening is to be expected in the Eurozone. The UK should slow its pace of fiscal consolidation, as Brexit starts to bite into economic growth. In the US, we expect Congress to eventually lower corporate taxes, although the size of the cuts will fall short of what the President has suggested. Driving the compromise will be the fact that both Congress and the Trump administration need a political success ahead of the mid-term elections. Ironically, fiscal stimulus is coming to the US just as the economy has reached full employment. Finally, China is making a structural transition to large budget deficits. Policymakers' desire to rein in credit growth will only add to the impetus to find new sources of aggregate demand. All told, the "soft goldilocks" environment that has propelled financial markets ever higher remains very much in place. Neither

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

I. Major central banks' balance sheets

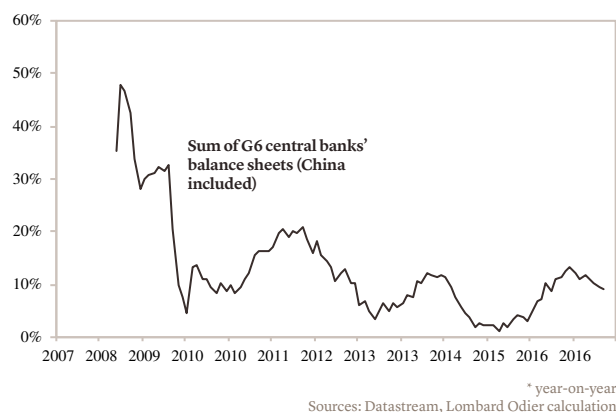
In USD trillion (trn)



an inflationary drift nor a recession seem likely scenarios for the near future, warranting a continued risk-taking stance in portfolios. Elevated equity valuations are, however, a cause for concern, particularly in the US. We prefer to focus on regions where the economic cycle is less advanced, hence liable to boast greater earnings stamina. Emerging markets and the Eurozone thus remain our favoured regions – the latter also standing to benefit from dissipated political risks and a near climax in Fed-ECB monetary policy divergence, which should strengthen the prospects for the single currency.

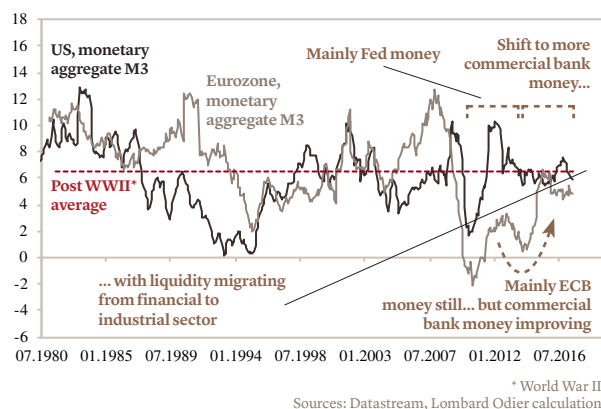
II. Combined G6 central bank balance sheet

In % yoy*



III. Monetary aggregate M3 in the US and the Eurozone

In % yoy



United States

Neither inflation, nor recession

In a nutshell

- The multi-year recovery of the US economy proceeds apace, with no signs of overheating.
- The lack of inflationary pressures should limit the Fed's leeway to raise rates much further, paving the way for balance sheet management.
- Recession signals are also absent for now, pushing that risk out at least 12 to 18 months.

Although macro data has been choppy of late, the US economy remains on a positive track with no obvious signs of overheating. Most metrics that could suggest such a development (i.e. consumer and producer price indices, commodity markets, US dollar, wage growth, bank loans) still remain well below long-term norms. In particular, there has been no upturn in inflation during the last few months (see chart IV).

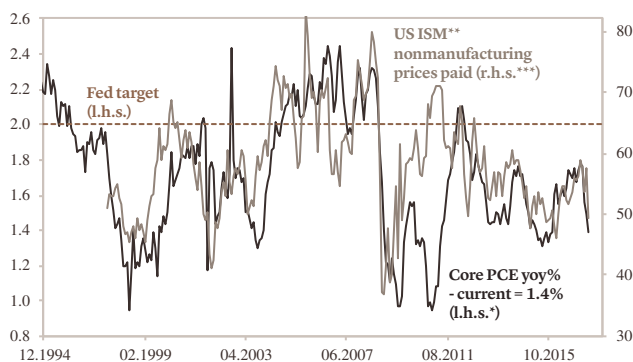
A number of reasons can be found to explain why the improvement in employment has not led to faster wage growth, and consequently price inflation. The US labour market is perhaps not as tight as generally believed. Demographic changes over the past decade, notably the retirement of baby boomers, may be reducing the pressure on wages. Since NAIRU (the non-accelerating inflation rate of unemployment) is but an estimate, it could be understating the slack in the labour market. And low productivity growth (see chart V), technological change, globalisation, part-time employment and diminished worker bargaining power also all contribute to a flattening of the Philips curve.

While the robust economic conditions will certainly allow the Fed to pursue its policy tightening, the absence of overheating signs should serve to limit its actions. In our view, the peak of the rate hiking cycle is not far away – with balance sheet management to take over from that point.

Conversely, what about the risk of a recession in the US? None of the macroeconomic and market measures that we monitor are sending such a signal for now, with service activity particularly solid. Some concern has been expressed about the flattening of the yield curve during the last few quarters. We would counter that, historically, recessions were preceded by an inversion – not just a flattening – of the yield curve. The extraordinary monetary policies of the past eight years may have affected the yield curve's signalling ability but, until proven otherwise, it is only inversion that counts. The US economy thus appears at the very least 12 to 18 months away from recession.

IV. US core PCE (Personal Consumption Expenditures) versus leading price indicator

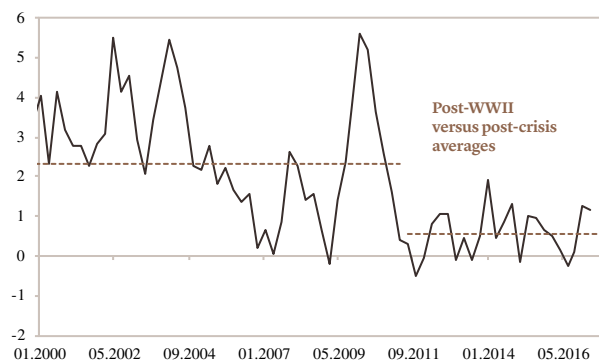
In % yoy and level



* left hand scale, ** Institute for Supply Management, *** right hand scale
Sources: Datastream, Lombard Odier calculation

V. US worker output per hour (business sector, all persons)

In % yoy



Sources: Datastream, Lombard Odier calculation

Europe

Euroscepticism losing ground

In a nutshell

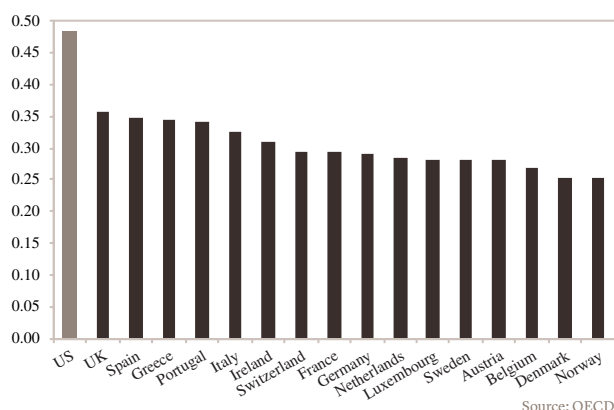
- Euroscepticism is on the wane, after a series of populist party defeats in recent elections. Nevertheless, the situation in Italy and the popularity of Five Star Movement bear close monitoring.
- The European economic recovery is broadening, with improving external demand adding to already robust domestic activity.
- Progressive (rather than sharp) ECB policy normalisation is likely going forward.

The obstacles to an economic return-to-normal are being gradually removed in Europe, most notably the threat of political disruption. Tempering the appeal of anti-establishment parties have been the electoral systems (proportional or two-round voting) but also the social welfare states – however onerous, inefficient and clearly in need of reform. Indeed, unlike the US and the UK, continental European countries have redistributed some of the proceeds from globalisation (see chart VI). As such, their voters have not proved angry enough to demand a dramatic rethinking of their societies, and in particular to abandon support for European institutions. Following the French elections, some anti-establishment factions are dropping Euroscepticism in order to remain “competitive”. The best examples of this trend are Spain’s Podemos and Greece’s SYRIZA, which have evolved over a short period of time into mainstream left-wing parties. In Italy, the Five Star Movement bears close watching over the next months. There is evidence that it is currently riven by internal conflict over how far to take its

Eurosceptic stance. And several moves by party leadership – including attempting to exit the legislative alliance with the UK Independence Party at the European Parliament level – appear designed to pursue a more centrist approach. The problem, however, is that the median Italian voter shows little commitment to European integration. This makes Italy the key risk for the European construction going forward, with elections planned for May 2018. Politics aside, the European growth recovery is spreading. A revival of external demand is occurring in a context of more robust domestic demand than at any time since 2007. And, like in the US, labour market improvements have so far not fuelled overly strong wage growth (see chart VII) – implying that a sharp normalisation of monetary policy is not warranted. From the ECB’s perspective, the Eurozone economy is effectively four years behind US trends. So, just as the Fed did in 2013, the ECB is likely to simply respond to the improvement in economic conditions recorded over the last three years by progressively adjusting its policy.

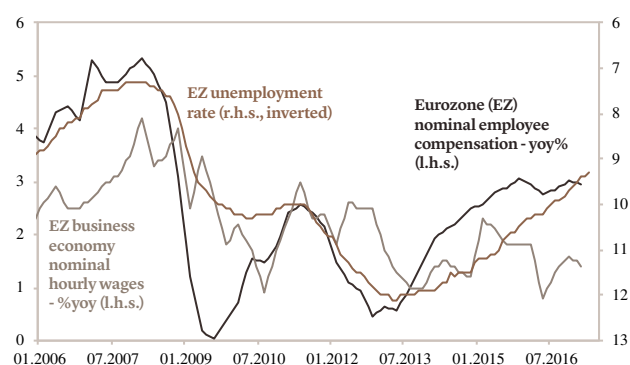
VI. Income distribution

Gini coefficient



VII. Eurozone wage growth versus employment

In % yoy and %



Japan

As good as it gets

In a nutshell

- Japan's cyclical conditions remains solid, with growing domestic consumption and investment – and even incipient signs of wage inflation in some segments of the labour market.
- The monetary policy framework unfortunately ties the economic outlook largely to external factors such as crude oil prices, US fiscal policy and geopolitics.
- The recent Tokyo assembly election results will drive doubts about Prime Minister Abe's political longevity, heralding a return of factional competition and leadership uncertainty.

Despite the apparent mediocrity that pervades Japanese headline data, current cyclical conditions can only be described as the best possible outcome. Unemployment is near a 20-year low, with the ratio of vacancies to applicants at its highest since the 1970s. For the first time since 2005 the country has also registered five straight quarters of positive growth. Better still, various consumer indicators have almost erased the negative consumption tax shock of 2014 and there are signs of incipient wage inflation, notably for part-timers (chart VIII).

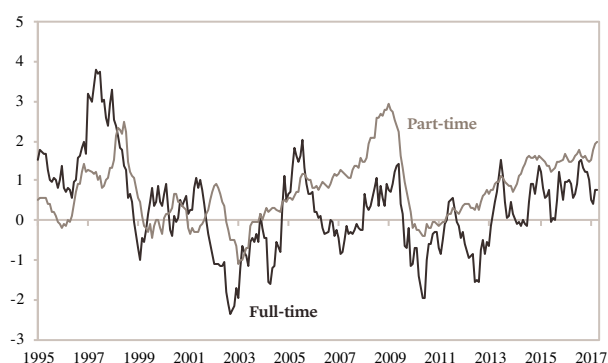
The question is the sustainability of this supposedly demand-driven, zero output gap environment. For an inflexible economy like Japan, it can be argued that room for policy error is reduced. The lack of workers constrains the country's upside growth potential. It is difficult to imagine that the sexagenarians accounting for an increasing portion of the new labour supply (chart IX) can achieve dramatic improvement in work hours or productivity. Businesses are

enjoying higher profits and better financing conditions but, as we have often written, they have shown a bias to invest in their overseas productive capacities rather than onshore. The onus of extending the business cycle thus rests still on the shoulders of policymakers. Unfortunately, the BoJ appears no longer to have a clear solution. Its yield curve targeting framework, adopted as a means to avoid public blame on negative rates and market confusion on quantitative guidance, actually increases external dependence. It can turbo charge the economy when outside developments threaten the vague 10-year yield target from below (the implied infinite government bond purchases fuel expectations of much higher nominal GDP (Gross Domestic Product) growth and a weaker yen). And the opposite holds when factors such as crude oil prices, US fiscal policy or geopolitics put downward pressure on global yields.

To make matters worse, recent political events have considerably reduced the prospects for supply-side solutions. Concerns about Abe's political longevity, which we discussed last quarter, are becoming the main story. The media's exaggerated reaction to the ruling Liberal Democrat Party's heavy losses in the Tokyo assembly election suggests that the Japanese elite are increasingly tired of Abe's unique dominance and eager to return to the old days of factional intrigue.

VIII. Growth in hourly total cash earnings, by contract type

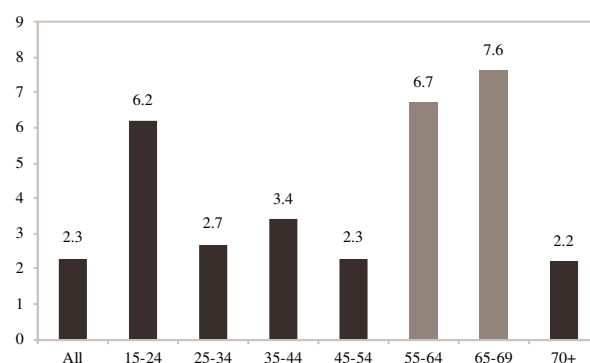
In % yoy



Source: CEIC

IX. Change in labour force participation since Abe's second term began (Dec 2012-May 2017)

In %



Sources: CEIC, Lombard Odier Asia

Emerging Markets

China spreading its influence

In a nutshell

- Asian economic and trade conditions are looking good, with China progressively replacing the US as the dominant force in the region.
- Reduced dependence on the US market makes Asian exporters less vulnerable to any protectionist measures that could be taken by the Trump administration.
- Downside risks to the Russian economy have subsided, but the same cannot be said about Brazilian politics.

Asean and South Asia demographic trends, attractive labour cost differentials vis-a-vis North Asia and the growing number of middle-income households make us upbeat on the region. Asian trade patterns have changed dramatically since the 1990s, with the US no longer the dominant force (see chart X). Intra-regional trade has been lifted by buoyant domestic demand and Chinese economic stability. Their now reduced dependence on the US market makes Asian exporters less vulnerable to any adverse trade protectionist policies that the Trump administration might implement.

Just as the post-war Marshall Plan was arguably a way to drive US dollar dominance, China's bilateral help and arms-length financing of partner emerging countries via the key "One Belt, One Road" initiative (more specifically the Asian Infrastructure Investment Bank and Silk Road Fund) could be a means to further internationalise its currency. Achieving something akin to the Marshall plan will be a huge task for China, but the window of

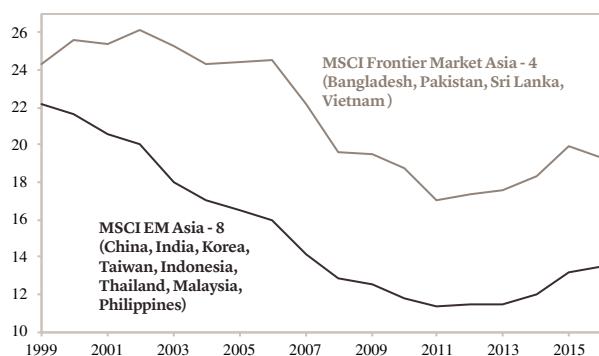
opportunity does exist, at least for Eurasian countries that have been plagued by lack of funding and interest.

Outside of Asia, Russia has regained considerable credibility with respect to its monetary and fiscal policies, which should lessen the country's vulnerability to foreign outflows. The current account has remained in surplus, the budget deficit is in check and the central bank introduced a freely floating currency in late 2014. But although the economy seems to have seen the worst of the downturn, it does remain vulnerable. Despite efforts to diversify its income sources, Russia still relies mainly on energy goods for its economic prosperity, as evidenced by the persistently strong correlation between oil prices and the Russian real GDP (Gross Domestic Product) (see chart XI).

As for Brazil, while the economic turnaround has been impressive on many counts, the path out of political quagmire is far from clear or easy. Brazil's political issues are deep and unlikely to be solved by an interim government of questionable legitimacy.

X. Asian exports to the US

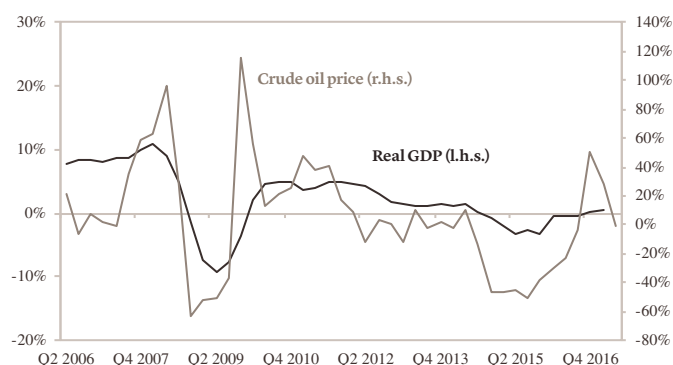
In % of total trade



Sources: Bloomberg, Lombard Odier Asia calculation

XI. Russian GDP growth versus the oil price

In % yoy



Sources: Datastream, Lombard Odier calculation

Asset Allocation

Towards an inflexion point in ECB policy

In a nutshell

- The “goldilocks” economic environment of improving growth and stable inflation leads us to maintain our risk-on investment stance.
- Now that political concerns have abated, investor focus is shifting back to fundamentals. The particularly improved picture in the Eurozone warrants continued preference for European equities.
- The corollary is that an inflexion point in ECB non-conventional monetary measures lies ahead, quite probably the main game changer of coming quarters: we have thus begun to position portfolios for euro appreciation.
- The impact of a tighter ECB stance on European bond markets will need to be closely monitored: higher core yields, wider spreads?
- Oil seems the only potential disruptive factor in this ultra-low volatility world. At this point, we reaffirm our range-bound scenario.

Is reflation over for good? With US inflation prints having trended down since their February peak, investors are questioning the sustainability of the manufacturing recovery and the so-called “reflationary trade”. Many reasons can be put forward to explain a temporary pull-back: fading base effects on inflation, a tightening of Chinese monetary conditions, the delay in President Trump’s fiscal plan and oil price weakness. But more structural issues that hint to the demise of the Phillip’s curve (low unemployment no longer translates into higher wages because of negative demographics, lesser worker bargaining power, global deleveraging...) continue to feed investor doubts as regards the inflation outlook.

This “goldilocks” economic environment of improving growth and contained inflation has translated into a very favourable mood across financial markets, with most asset classes up over the last quarter. Growing concerns about the outlook for oil prices have, however, recently awakened market volatility from historical lows. For now, given that medium-term oil fundamentals have not deteriorated markedly, we hold to our baseline scenario of prices evolving between USD 45 and 60 per barrel. That said, as the stabilisation of oil prices was a prerequisite for our global scenario and positioning – especially influencing our emerging markets (EM) exposure – we will continue to monitor developments in Libyan and Nigerian production, alongside US shale investment prospects (see box A, page 10).

Oil risk aside, we think that investor focus is now shifting to central bank activity, with the Fed and ECB policies likely to gradually

converge. Eurozone core government bond markets have reached excessively stretched valuations in view of the strengthening economic backdrop. Although a tapering of ECB purchases will affect the sovereign bond universe uniformly, we think that investors’ search for yield will more easily lead them to purchase peripheral bonds than ultra-low yielding core bonds. As such, we maintain our preference for peripherals over core sovereign bonds. With respect to the US Treasury market, we see no reason for the Fed to hike rates more than once more this year. None of the inflation fundamentals (such as the output or unemployment gap, inflation expectations or bank lending dynamics) are pointing to overheating conditions. Headline inflation should even decelerate during the next few months as positive base effects wane. In the credit space, financial conditions should stay benign, supporting corporates and preventing a surge in corporate defaults. We expect relative spread stability in both in Europe and the US, with a preference nonetheless for US credit which offers a better balance of risk from an all-in yield point of view, mainly as we expect less support from ECB purchase programmes going forward. We believe that the high yield (HY) segment should also benefit from the improved growth outlook, warranting spread stability. It is true that the oil price correction has recently caused spreads to widen in the energy sector but, so far, there has been no contagion to the rest of the HY segment. That said, combined with the tightening of financial conditions in the US, the effect of the gradual reduction in ECB corporate bond purchases does warrant close monitoring and selectivity going forward.

In the currency space, with the climax of the monetary divergence between the Fed and the ECB possibly already behind, we can expect the euro to rebound towards the 1.20 level against the greenback over the next 12 to 18 months (see chart XII, page 10). As such, we began to hedge some of our dollar exposure in EUR and CHF portfolios last month. Given the close watch kept by the Swiss National Bank on the ECB, we see it likely to adjust its negative rate policy shortly after the ECB does, so as to maintain the exchange rate broadly within the same range. Despite a slightly more hawkish stance from the Bank of England, the British pound will remain under pressure with domestic activity, notably consumption, clearly in a depressed state. Finally, the Bank of Japan being the last central bank to persist in its accommodative stance, the Japanese yen will continue to suffer.

As political risks abate one after the other, fundamentals are back to centre stage in equity markets. The decent macroeconomic picture and strong earnings season continue to support risk-taking, as evidenced by US indices reaching new highs and volatility at ultra-low levels. As expected, Emmanuel Macron’s win in France drove investors to reassess their European equity underweight:

A. What is the downside risk to our oil price scenario?

Following a series of negative news, oil prices are evolving at the lower end of our anticipated USD 45-60 per barrel range. More information would, however, be required for us to change our outlook.

Indeed, fundamentals remain well-oriented, with the oil market in deficit since the start of the year (after almost three years of oversupply). This is mainly the result of the OPEC¹ agreement, which targets prices just below US shale companies' marginal costs so as to restrain their investments and future production. The firm commitment of all OPEC members to respect their quotas keeps us optimistic. While recent data points do show increasing production in Nigeria and Libya, these two OPEC members were initially exempted from the deal. Should these trends persist, we would expect OPEC to take measures to ensure the efficiency of its agreement.

Another market concern relates to US production. After several months of declining inventories, some mixed figures in the US fuelled market volatility of late. The period of oil prices above USD 55 per barrel witnessed earlier this year stimulated more investments than expected. Conversely, though, the currently depressed market environment should lead to cuts in capital expenditure in months to come.

Given the currently very bearish market sentiment, a downward trend in US inventory data and/or OPEC action to address Nigerian and Libyan production would be supportive to the oil price. Seasonality should help on the inventory front (driving season in the US and power burn in the Gulf countries), while we expect OPEC to effectively do "whatever it takes" to ensure the efficiency of its agreement.

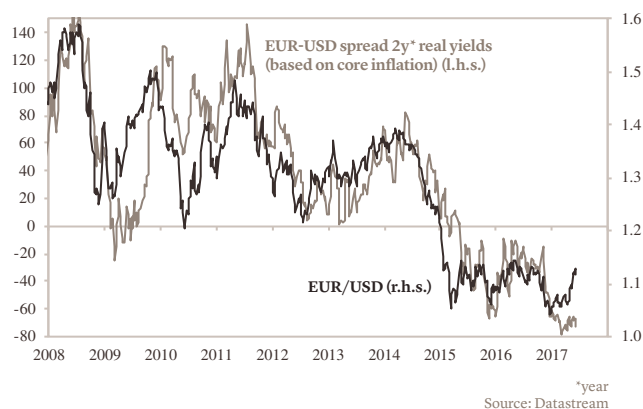
European equity funds are seeing considerable inflows. And while stock market valuations are clearly rich, this situation can persist so long as the earnings dynamics are supportive and interest rates stay contained by historical standards. This is particularly the case in Europe, where economic growth and, in turn, company earnings expectations continue to be revised up (see chart XIII). Bottom-up factors, such as mergers and acquisitions (M&A) activity, are likely to fuel another leg of the rally (see box B, page 11). Admittedly, the currency appreciation that should go with improved European macroeconomic momentum might eventually dampen some companies' earnings prospects. We thus advise a portfolio positioning that favours domestic themes (banks, small caps) as well as industrial sectors exposed to emerging markets (themselves in recovery and currency appreciation mode).

Finally, we maintain our strategic overweight of emerging markets given low valuations levels, improved earnings dynamics and the early stage of their economic recovery cycle. We also continue to favour emerging market local currency debt. Beyond the attractive carry, we feel comfortable with the long-term prospects for currencies that have depreciated heavily against the US dollar during the last few years. And, interestingly, while commodity volatility must obviously be monitored, it has so far had limited impact on emerging markets.

¹ Organization of Petroleum Exporting Countries.

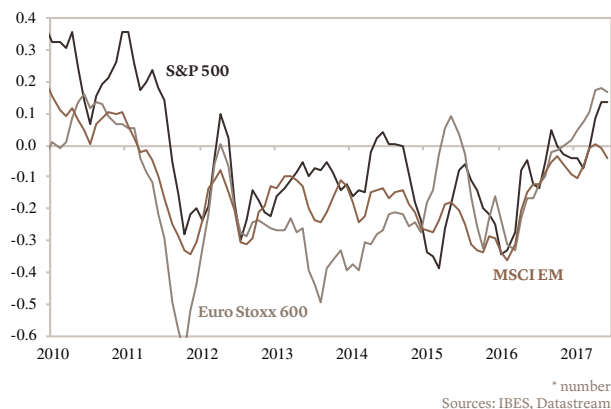
XII. ECB monetary policy to support further EUR appreciation

In basis points



XIII. Earnings expectations continue to improve in Europe

(nb* of upgrades - nb of downgrades)/total nb of revisions



B. European M&A: back in action?

After a fairly subdued 2015-2016 period, European M&A volumes have strengthened markedly year-to-date, bringing the thematic back to centre stage. In the first six months of this year, the value of M&A transactions rose 13% year-on-year in Europe, versus a 19% decline in the US (see chart XIV). And European targets represented 37% of global M&A, up from 33% for the same period last year.

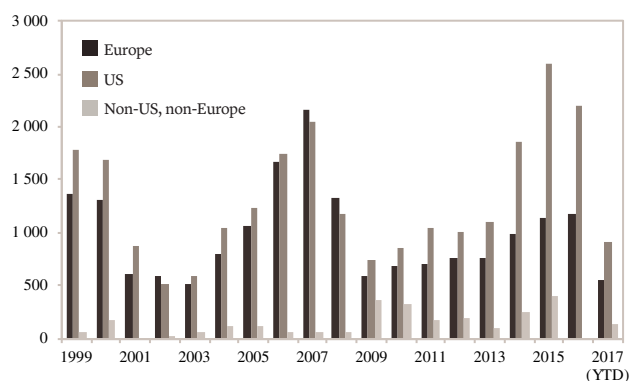
What are the reasons behind this M&A revival? For a start, financing conditions in Europe are very favourable with ample liquidity provided by the ECB, good credit impulse from commercial banks, a near 10-year low cost of debt for European corporates and cash-rich balance sheets. But while this is a necessary condition, it had already been in place for several quarters. Why then is M&A really picking up now? We see business confidence as the major element that had been missing on this side of the Atlantic. Despite fairly robust economic data and low market volatility, uncertainty surrounding the future of the single market certainly dampened management enthusiasm. Following Emmanuel Macron's election, optimism as regards deregulation and more generally a pro-business environment provide the perfect background to initiate major operations. Going forward, given that the US and Europe are at different stages of the credit cycle, there is some room for European M&A activity to catch up (see chart XV).

Market impacts are twofold. First, with investors nervous about valuations at the index level, M&A could serve as another catalyst for the equity rally, generating value while also increasing the stock-picking opportunity set. Second, from a cross-asset standpoint, M&A traditionally calls for a preference for equity markets over credit markets. Indeed, when operations are financed by debt issuance, the resulting impact on the balance sheet favours the shareholder over the bondholder. Corporate bonds of acquiring companies are likely to be more volatile as their creditworthiness deteriorates. Conversely, expectations of improved earnings on the back of synergies and expanded market share are likely to support inflows on the equity side.

Rising M&A activity thus offers another justification for maintaining our risk-on strategy, via an overweight of European equities, while keeping a prudent and selective stance on credit.

XIV. M&A transaction value

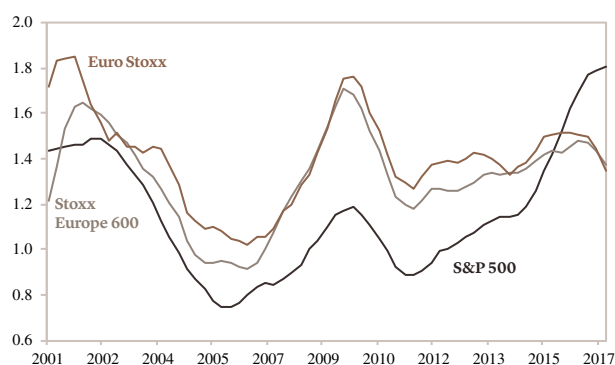
In USD billions



Sources: Bloomberg, Lombard Odier calculation

XV. US and Europe at different stages of the credit cycle

Net debt/EBITDA, median of index components



Source: Bloomberg

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The Bank is authorised and regulated in the UK by the Prudential Regulation Authority (PRA) and subject to limited regulation by the Financial Conduct Authority (FCA) and the PRA. Details of the extent of our authorisation and regulation by the PRA and regulation by the FCA are available from us on request. Registered in Luxembourg No. B169907.

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