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HBZ Investment Quarterly

Good momentum, greater uncertainty

Q1 2017

Table of contents

Table of contents

Editorial

Dear Reader,

The hot topics of the past twelve months have undoubtedly been the UK's referendum vote to leave the EU and the election of Donald Trump to the US presidency, two of the greatest political upsets of recent years. These twin events will continue to make their presence felt on the financial markets as their consequences crystallize out during 2017. Investors have generally taken a positive view so far, particularly in anticipation of political change in the US.

Economic fundamentals have remained encouraging for financial markets in the run-up to the new year, with activity in many economies finding more traction in the second half of 2016, creating welcome positive momentum. We take heart from the robustness of leading indicators and maintain a constructive investment outlook.

Global uncertainty has undeniably increased as the world learns to deal with two untested leaders and a host of complicating factors, but greater uncertainty, and thus increased market volatility, is not unusual at an advanced stage of a business cycle – and it does not necessarily imply negative returns. It simply indicates a larger dispersion of possible outcomes, in itself a strong argument for maintaining a well-diversified portfolio. In light of these fundamentals, and notwithstanding the rich valuations prevalent on some markets, we remain positive about stocks, as outlined in this issue's Special Topic.

We greatly appreciate the attention and interest of our readership and hope you will continue to enjoy our short quarterly publications.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Strong momentum entering 2017

Global economic momentum accelerated noticeably as the upturn in the manufacturing cycle finally made itself felt, while higher US interest rates and the strong USD have yet to have any material impact on global growth. US policy remains the principal source of both upside and downside risk.

Table 1: Real GDP growth (y/y in %)

	2016E	2017F	2018F	Short-term trend
United States	1.6	2.2	2.3	→
Eurozone	1.6	1.4	1.5	→
Germany	1.8	1.4	1.5	→
United Kingdom	2.0	1.2	1.3	↘
Japan	0.9	1.0	0.8	→
China	6.7	6.4	6.1	↘
India	7.5	6.9	7.6	→
Russia	-0.5	1.1	1.5	↗
Brazil	-3.5	0.8	2.2	→

Table 2: Consumer price inflation (y/y in %)

	2016E	2017F	2018F	Short-term trend
United States	1.3	2.3	2.4	↗
Eurozone	0.2	1.3	1.5	↗
Germany	0.4	1.6	1.7	↗
United Kingdom	0.6	2.4	2.5	↗
Japan	-0.2	0.6	1.0	→
China	2.0	2.2	2.2	→
India	4.9	4.8	5.0	→
Russia	7.1	5.0	4.4	↗
Brazil	8.8	5.1	4.7	↗

Source: Bloomberg, IMF, HBZ

Key points

- New US administration likely to enact tax cuts and reduce regulation
- Global growth set to push higher
- US trade policy major risk to constructive outlook

The US enters uncharted territory

In choosing Donald Trump as their 45th president, the American electorate has opted for change over experience and – given the euphoric market reaction to his surprise victory – US economic agents are clearly expecting the new administration to implement many of the bold pledges made during the campaign. While there is ample scope for disappointment here, some of the proposals, including large corporate tax cuts, reduced regulation and increased public spending, have every chance of becoming actual policy and US growth, which is already forecast to accelerate beyond 2016 levels, is likely to receive a further boost from such measures. Combined with the robust momentum apparent from the most recent data, this should also help to extend the current growth cycle by several quarters. The Federal Reserve, which despite significant improvements in the labor market and rising inflation managed only one interest rate increase in 2016, could be forced into further tightening beyond the two hikes implied by December's FOMC projections. The principal risk remains the potential for foreign trade disruption: while Canada and Mexico have already demonstrated their willingness to revisit the NAFTA treaty, China appears less amenable to such talks. An outright trade war, though unlikely, cannot be excluded.

Moderate uptick in global growth anticipated

The new US president's more protectionist rhetoric notwithstanding, growth in the rest of the world is likely to pick up from the modest pace attained in 2016. As unemployment continues to recede and increased public spending is likely in a year of multiple national elections, growth in Europe may surprise to the upside. Monetary policy will remain supportive in the eurozone and the UK alike, although the era of unconventional policy measures is drawing to a close. Among the emerging markets, both China and India will once again achieve fairly robust rates of expansion (with the oft-cited risks emanating from China indisputable but remaining manageable), and Brazil and Russia are set to emerge from recession. The rebound in crude prices during 2016 will help stabilize activity in many oil-producing countries without compromising the outlook for the large importing nations, for the moment at least, as the new geopolitics of oil limits the upside to crude.

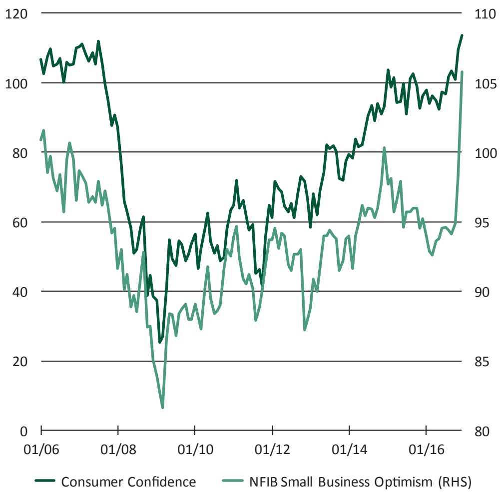
Investment strategy: Still in 'risk-on' territory

Global fundamentals remain promising for risk assets, with interest rates having to rise substantially before there is any change in this outlook. Earnings are set to prove a major test for equities, while the unexpected political twists of 2016 have increased overall levels of uncertainty.

Better fundamentals, greater uncertainty

Macro fundamentals are looking robust as the year begins. There have been substantial rises in global interest rates since the lows of early July 2016, although not to any extent that might end the accommodative rate environment; yields on 10-year US Treasuries would need to rise well above 3% for this to occur. Economic activity has maintained impressive momentum and could well improve further depending on the measures adopted by the new US administration. Lower tax rates will certainly lift earnings and banks have made further progress in shoring up their capital. Valuations have entered rich territory in many sectors, although the risk of a major sell-off is limited as long as earnings continue to meet expectations. Sound fundamentals also bode well for credit as default rates are unlikely to increase any time soon. Counter-intuitively, despite these improved fundamentals, uncertainty has increased, mainly due to the fickle temperament of the new US president; while Trump unquestionably has a businessman's mindset and an overwhelming desire to succeed, he will also enjoy a high degree of latitude in deciding matters of foreign policy and trade, where rash choices have the potential to wreak havoc. In addition, France, Germany and (possibly) Italy are set to hold general elections within the next nine months, and widespread popular discontent suggests that anti-establishment parties may do well at the polls. This could fundamentally complicate the European political context.

Chart 1: Carried away? Rising measures of US confidence



Source: Bloomberg, HBZ

Current positioning

Our portfolios reflect our constructive medium-term outlook and we have increased our equity exposure to benefit from the improved prospects of financials in particular. This said, we will continue to underweight US government debt and maintain our strategic all-weather hedge in the form of managed futures.

What to watch

Over the coming three months, we will concentrate our analysis on the measures adopted by the new US administration; the Q4 2016 earnings season, which has just started, will be a further focus for us. Any shortfall at the aggregate level could change our view on equities. We will also be tracking European politics (eurozone and UK in particular) very closely.

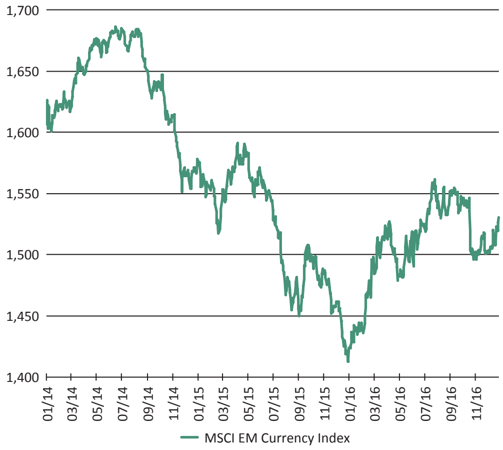
Key points

- Fundamental backdrop remains risk-friendly
- Politics as main source of uncertainty
- Earnings as major test for equities

Fixed income: Expect lower returns

While anticipating low returns in investment-grade bonds, we see the greatest potential in US high-yield, selected local currency government bonds and US mortgage-backed securities. Floating-rate instruments will add value to a portfolio against a backdrop of rising interest rates.

Chart 2: Low valuation of emerging-market currencies



Source: Bloomberg, HBZ

Key points

- US rates to trend higher
- US high-yield bonds to remain attractive
- Opportunities in BRL and RUB government bonds

Opportunities still to be found in credit

Credit remains attractive, although we are not expecting a repeat of last year's excellent performance; the US economy is now more than seven years into its recovery and interest rates are positioned to rise still further, although rates are set to remain low in other developed markets. At the same time, spreads for investment-grade bonds are unlikely to tighten any further and their return potential is limited. Subordinated financials, which offer an attractive risk-return profile, remain our preferred choice within this segment. The outlook for high-yield bonds, especially in the US, is brighter, however; corporate default rates should continue to fall over the coming year and the 12-month trailing default rate has already dipped. In addition, high-yield bonds traditionally perform well during times of moderate interest rate rises.

Good entry point into select local EM debt

Most hard currency emerging market sovereigns are still offering attractive yields, and we recommend bonds of short duration. While we are endorsing Russian and Brazilian quasi-sovereign paper, we would be cautious about Turkey. We see some real opportunities in the local currency sovereign markets, particularly in Russian RUB and Brazilian BRL bonds, where we expect local yields to fall and the currencies to stabilize. We recommend bonds with a maximum maturity of around three years, but be warned: These bonds exhibit high volatility and are suitable only for investors with a high risk tolerance.

US mortgage-backed securities and floaters

US mortgage-backed securities (MBS) make up another interesting segment as the US housing market is bound to continue its recovery, and the quality of these bonds has greatly improved since the financial crisis. Since higher interest rates are on the cards, it would also be advisable to retain some instruments of low duration in any portfolio, with floaters representing one possibility; the palette of products available is currently limited, but rising rates should increase issuance. Bank loans – which are priced on a floating-rate basis and earn Libor plus a spread – are another possibility. Typically arranged by banks for non-investment-grade companies, these offer returns comparable with those of high-yield bonds, but are secured and thus hold a more senior position within the capital structure.

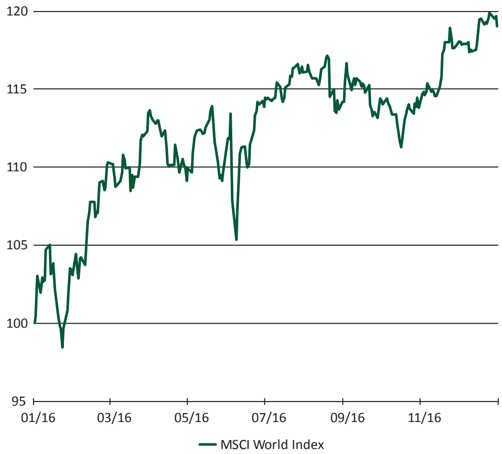
Equities: Sector rotation

With an economic environment that remains benign and both fiscal and monetary policies still accommodative, equity markets look set to deliver decent returns in 2017. Investors will nonetheless have no choice but to accept the volatility arising from high valuations and the complex political backdrop.

The million-dollar earnings question

The major question facing investors is whether corporations will be able to accelerate earnings growth in 2017 – given that around 40% of their revenue comes from overseas, the strong dollar alone will crimp S&P 500 companies' earnings. While yet to enter genuinely dangerous territory, valuations have also increased. Investors will demand justification for the multi-year highs in equity prices at some point and the breadth of equity indices may narrow, much as it did in 2015, leaving only a small group of winners.

Chart 3: 'Trump rally' extends bull market



Source: Bloomberg, HBZ

US lead to continue

US stocks are likely to continue their dominance, as there is little hard data to suggest any sustained outperformance on the part of eurozone stocks. European earnings are still languishing at close to prior-cycle lows even as US earnings approach record highs. US corporations have enjoyed a notable differential in corporate earnings and profitability for years; amongst other things, they have been more active in repurchasing shares compared to their European peers and, by reducing the share count, have greatly boosted the earnings per share they report. Emerging markets, the other important region for equity investors, enjoyed a good run in 2016 but have been losing some of their appeal in Trump's new investment world. While economic trends have improved, it remains to be seen whether such momentum can translate these better fundamentals into higher earnings and share prices. Emerging market equities have once again turned more into trading assets than investments, not least due to the increase in FX volatility.

Key points

- Strong USD will impact S&P earnings
- US outperformance to continue
- Cyclical sectors have the edge

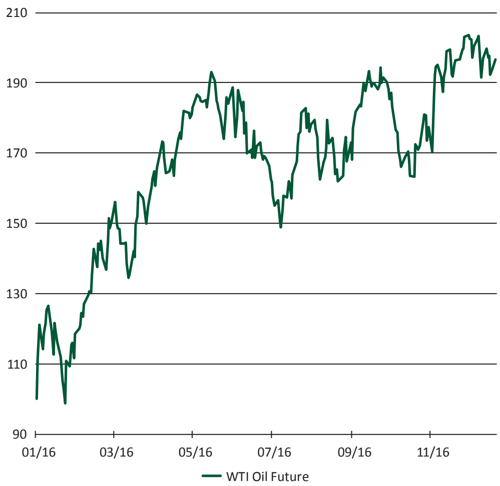
Sector trends

Two sectors, energy and materials, dominated the equities market in 2016, while the healthcare and consumer sectors lagged. Pronounced sector trends are likely to continue into 2017, with anticipated beneficiaries of Trump's victory to include the likes of consumer discretionary, defense and industrials, energy, financials, healthcare and materials. It will nevertheless take time for current legislation to be overturned and new policies to translate into real earnings. As a final point, high-dividend sectors such as utilities, telecoms and consumer staples are expected to suffer if interest rates rise.

Commodities and FX: Politics take center-stage

With long-neglected commodities making a roaring comeback and currencies acting as shock absorbers for economic disruption, commodities and currencies were once again a constant source of surprise in 2016, and this is unlikely to change in 2017.

Chart 4: Oil prices gradually rising



Source: Bloomberg, HBZ

Commodities: Oil in the ascendant

Energy prices rallied in the past three months on the back of cutbacks in OPEC and Russian production. While these announcements initially lifted the price of oil, OPEC production cut agreements have a rather patchy record and we anticipate only modest rises in crude prices over the coming months. Gold and other precious metals receded deep into negative territory over the same period, with 2016 in fact proving a twelve-month rollercoaster for gold; it began the year with the biggest first-half rally in decades before falling away sharply as focus shifted from the political uncertainty generated by the Brexit referendum to US monetary policy. Since Trump's US election win, holdings in ETFs have been shrinking continuously and gold and silver have lost about 15%. Base metals, on the other hand, have benefited in anticipation of the more expansionary policy expected from the Trump administration. The current 'risk-on' environment will push commodities higher, although precious metals may also see their prospects improve over the course of the year in the event of renewed skepticism about US growth and other global uncertainties.

Currencies: Shock absorbers again

The USD has been shored up principally by a hike in the Fed's interest rate and anticipation of a more expansionary fiscal policy under the Trump administration. As a result, the trade-weighted USD index broke out of a trading range that had persisted for almost two years as the greenback appreciated against most crosses. As interest rate and growth differentials were expected to widen, the EUR and other G10 currencies in turn felt the pinch, and we would not be surprised to see further downside pressure on major currencies. The tax cuts and aggressive protectionist policies proposed by the new administration may boost the USD above current levels, potentially affecting the currencies of the US's main trading partners. In such a scenario, the largest exporters' currencies, including the CNY, KRW and MXN, could weaken still further. The decline of other currencies – most notably the Turkish lira, which depreciated by some 20% during 2016 – was generally a result of domestic circumstances. Given Turkey's economic deterioration, political instability and the government's cheap lira policy, the TRY's underperformance is expected to persist.

Key points

- USD will remain strong
- Crude price with limited upside
- Protectionist US policy a risk for exporters' currencies

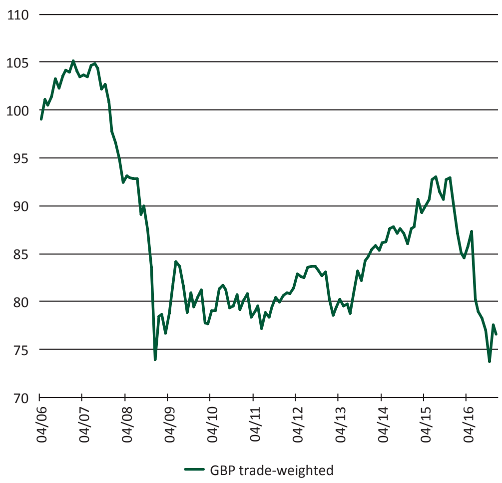
Key markets: Change of status

This year will bring important changes in two of our key markets: Pakistan is set to regain EM status from MSCI and the UK will take its first steps towards leaving the EU. Elsewhere, the UAE can look forward to gradual recovery of economic growth.

Pakistan: A solid case for growth

With low interest rates, moderate oil prices, robust rates of investment (thanks to CPEC) and political stability, prospects for Pakistan's economy have rarely been better, and under such circumstances, growth is expected to accelerate in 2017, perhaps even topping 5%. There are of course a number of potential stumbling blocks – including the political situation in a pre-election year, relations with the US under the new administration and, more generally, global economic conditions – but as long as the State Bank remains firmly in pro-growth mode, the economy should be able to withstand most temporary shocks. The stock market has already priced in much of the good news with its stellar performance in 2016 (the KSE100 was up 46%), but a combination of reasonable valuations, a strong earnings outlook and the imminent upgrade to MSCI Emerging Market status, which should increase interest from foreign investors, still justifies expectations of healthy returns.

Chart 5: UK: More downside for GBP?



Source: Bloomberg, HBZ

UAE: Slow recovery underway

The latest PMI survey has confirmed that activity in the Emirates stabilized at the end of the year. Growth in 2017 is expected to accelerate from the low levels recorded last year, not least due to increased spending on Expo 2020. Higher oil prices have reduced fiscal pressure, removing one headwind to growth, but further diversification of the economy remains essential. In the meantime, higher USD interest rates will continue to weigh upon real estate in particular, which has always been a key sector of the economy.

UK: Exiting the single market

Prime Minister May has announced that the UK is to seek a totally new relationship with the EU and as a result will leave the single market altogether. While the UK economy has coped surprisingly well with the decision to leave the EU so far, only time will tell whether it will deal equally well with the reality of Brexit. The Bank of England has adopted a neutral policy stance and is expected to look beyond any short-term increases in inflation, keeping rates unchanged. Investors will continue to use the GBP to express their views about the UK economy, and the risk is for more downside. This may prove a boon for UK-based international companies.

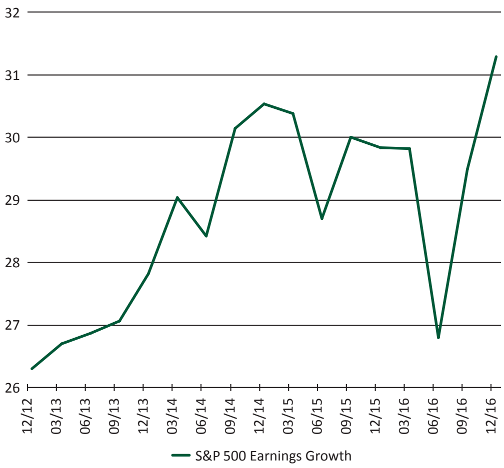
Key points

- Another year of solid growth ahead for Pakistan
- Gradual recovery of UAE economy
- UK to leave single market

Special topic: Prospects for equities in 2017

A positive outlook informed by improved global economic growth, lower US tax rates under the new Trump administration and a healthy flow of central bank liquidity could give equities a boost in 2017, but investors should be mindful that the next 'up leg' will not be without its challenges.

Chart 6: US earnings are recovering (USD per share)



Source: Bloomberg, HBZ

Support for earnings growth

Equities have rallied in recent weeks, although consensus bottom-up earnings forecasts have remained unchanged since Trump's election win. US investors are expected to focus less on the actual Q4 results and more on management insight into business trends, which in turn will drive 2017 earnings revisions and prices: corporate taxes, a destination-based border tax, fiscal spending and changes in regulation. Current market projections anticipate double-digit earnings growth as negative base effects ease off during the first two quarters of 2017. Despite high valuations, US equities remain attractive and the current 'sweet spot' should also benefit other regions. Most analysts foresee an increase in core inflation, principally due to higher energy prices. While we are not expecting much more Fed tightening over and above what has already been priced in, a little inflationary pressure is generally positive for earnings, as it allows companies to raise prices.

Breaking trends?

Many market commentators foresee trends breaking in 2017, at national, sector and style level alike. Most obviously, companies with a US focus will derive the greatest benefit from new fiscal spending, lower taxes and a brightening economic outlook, and it will come as no surprise that mid- and small-cap stocks are likely to be better positioned to capitalize on these developments than globally operating large-cap stocks; surveys have shown that business sentiment among small enterprises has already soared. Faster earnings growth and enhanced investor demand during the currently benign conditions will also be of greater benefit to cyclical than to defensive stocks. Equity investors will clearly have some risks to contend with, nonetheless: While deterioration of earnings is unlikely to set in on a broad scale, the Fed could hit the brakes harder than expected. This would undoubtedly have negative effects on global equity markets – and not just on yield-driven defensive stocks. FX moves represent a further source of substantial risk. EM crosses – and others besides – could suffer extended declines and G10 exchange rates are certainly not out of the woods, as has been demonstrated by recent movements. Investors would do well to bear currency swings in mind when constructing their portfolios.

Key points

- Focus on US tax reforms, fiscal spending and deregulation
- We favor US-based, cyclical, small- and mid-cap stocks
- Risks: rising interest rates, FX volatility, disappointing earnings

Market data summary

As of 25 January 2017

Equity indices	Last	-3M %	YTD %	-3YR %
MSCI World USD	4'954.9	5.6	2.3	17.4
S&P 500	2'280.1	6.4	1.8	27.4
EuroStoxx 50	3'319.7	7.5	0.9	9.6
FTSE 100	7'170.2	2.2	0.4	7.6
SMI	8'336.8	5.1	1.4	1.6
Nikkei	19'057.5	9.7	-0.3	23.8
MSCI EM USD	400.3	-0.7	5.4	2.9
Sensex 30	27'708.1	-1.4	4.1	31.1
KSE 100	49'756.8	22.1	4.1	84.3
Hang Seng	23'049.1	-2.2	4.8	2.7
Russia RTS	1'155.3	15.3	0.3	-15.3
Brazil Bovespa	65'840.1	3.1	9.3	37.8

Bond indices	Last	-3M %	YTD %	-3YR %
Citi US gov	1'443.29	-2.8	0.1	5.8
CIti US HY	2'057.28	-2.6	0.2	11.9
CIti US Corp	937.23	1.6	1.0	13.6
Citi Euro gov	227.80	-3.0	-1.1	14.6
CIti Euro Corp	232.62	-1.6	-0.5	10.8
CIti EM Sov	766.70	-2.8	1.6	20.5
DB EM Local USD	150.25	-3.7	3.0	-6.2

Currencies	Last	-3M %	YTD %	-3YR %
DXY	100.35	1.3	-2.1	24.3
EUR/USD	1.07	-1.3	2.2	-21.4
USD/CHF	1.00	-0.4	2.1	-10.4
GBP/USD	1.25	3.2	2.0	-23.7
USD/JPY	113.79	-8.2	3.1	-9.9
AUD/USD	0.76	-1.2	4.8	-13.0
USD/CAD	1.32	1.7	2.4	-15.5
USD/ZAR	13.38	3.7	3.6	-16.4
USD/INR	68.15	-1.8	-0.2	-7.9
USD/PKR	104.82	0.0	-0.4	0.6
Gold oz	1'208.82	-5.3	4.6	-5.1

Interest rates	3M interbank %	10YR government %
USD	1.03	2.47
EUR	0.06	0.43
GBP	0.36	1.41
CHF	-0.73	-0.06
JPY	-0.01	0.07
AUD	2.96	2.73
CAD	1.17	1.77
ZAR	7.37	8.71

For your notes

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Authors

- Dr. David Wartenweiler, Chief Investment Officer (d.wartenweiler@habibbank.com)
- Angelika Stückler, Senior Portfolio Manager, Equities (a.stueckler@habibbank.com)
- Stefan Wüthrich, Senior Portfolio Manager, Fixed Income (s.wuethrich@habibbank.com)

Contact for Switzerland

- Nasir Ahmad (n.ahmad@habibbank.com)

Contact for UK

- Miguel Sanchez (m.sanchez@habibbank.com)

Contact for UAE

- Kamran Ahmed Suhrwardy, Private Banking (k.suhrwardy@habibbank.com)

Layout

- Pascale Manga, Communication Support (p.manga@habibbank.com)

Printing

- Theiler Werbefabrik GmbH, Rütenenstrasse 6, CH-8102 Oberengstringen (werbefabrik@bluewin.ch, www.werbefabrik.ch)

Editing

- MOTIF Executive Communications, Kämbelgasse 4, CH-8001 Zurich (www.motif.ch)

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Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

Habib Bank AG Zurich
Private Banking
Weinbergstrasse 59
P.O. Box 225
CH-8042 Zurich
Tel: +41 44 269 45 00
Fax: +41 44 269 45 18