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HBZ Investment Quarterly

The best of all possible worlds?

Q3 2017

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Editorial

Dear Reader,

Global economic conditions are currently better than they have been at virtually any time in recent years: every major developed economy and many of the key emerging markets continue to deliver healthy growth rates, the much-feared populist surge in Europe has failed to materialize, and even the central banks have generally adopted a more upbeat stance (the eyes of the US Fed are now clearly set on policy normalization). Moreover, US corporate earnings growth has rebounded to levels last seen in 2011.

It would of course be foolish to pretend that we live in the best of all possible worlds, however; many – if not all – asset classes are richly priced and the return outlook for bonds in particular is hardly mouthwatering. We nonetheless expect a certain degree of stability to prevail on financial markets over the coming months and are thus maintaining a risk-friendly investment strategy. Having said this, we would not exclude the possibility of taking some chips off the table at one point.

The greatest risk to the current fair-weather scenario is a major growth disappointment or even a downturn. Our Special Topic takes a look at some of the early indicators for recession risks but concludes that there is no immediate cause for alarm.

As ever, we hope that our publication will prove food for thought and we look forward to receiving your comments and questions.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Broad-based global expansion

The global economy continues to perform well. Growth has picked up in the eurozone in particular, while inflation pressures remain contained. This context should allow other central banks, in the slipstream of the US Fed, to start normalizing monetary policy without stalling activity.

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

	2016	2017F	2018F	Short-term trend
United States	1.6	2.2	2.3	↗
Eurozone	1.7	1.7	1.6	→
Germany	1.9	1.7	1.6	→
United Kingdom	2.0	1.7	1.3	↘
Japan	1.0	1.3	1.0	→
China	6.7	6.6	6.3	→
India	7.5	7.1	7.5	→
Russia	-0.5	1.2	1.6	↗
Brazil	-3.5	0.7	2.2	↗

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

	2016	2017F	2018F	Short-term trend
United States	1.3	2.3	2.3	→
Eurozone	0.2	1.6	1.5	→
Germany	0.5	1.7	1.7	→
United Kingdom	0.7	2.7	2.6	↗
Japan	-0.1	0.6	0.8	↗
China	2.0	2.0	2.2	→
India	4.9	4.5	4.5	→
Russia	7.1	4.3	4.2	↘
Brazil	8.8	4.2	4.5	↘

Source: Bloomberg, IMF, HBZ

Key points

- Fed normalization on track
- Eurozone growth accelerates as political risk recedes
- Global trade lifts EM outlook

Fed stays the course

President Trump has little to show for his first five months in office – and, given the numerous political distractions he faces, this situation is unlikely to change any time soon. These preoccupations are not expected to damage the US economy, however, which is currently in no need of further stimulus. Meanwhile, the Fed is determined to proceed with policy normalization. After the rate hike at the June FOMC, attention will shift towards shrinking the balance sheet; the Fed has already published details on the mechanics of this process as well as an indicative timetable. Implementation will of course be contingent on external factors, not least the perennial risk of a debt-ceiling drama when the inevitable increase comes up for approval in the fall.

Eurozone recovery enters new phase

Growth in the eurozone is now the second-highest among G10 economies (with only Canada growing at a faster rate in Q1 2017), and leading indicators suggest that the end to this promising run is not yet in sight. The much-criticized ECB has played a considerable part in bringing this about, but the recovery now appears sufficiently self-sustaining that some reduction in stimulus may be warranted by 2018. Politics have proved another positive factor, with both the Netherlands and France resisting the temptations of populism in their recent national polls, and Germany will most likely offer a similar display of pragmatism in September. In the meantime, the UK has been thrown into disarray by Prime Minister May's ill-judged calling of a snap election; while the nitty-gritty of Brexit remains as complex as ever, a 'hard' version does now appear less likely.

Trade rebound benefits EM

The rebound in global trade is providing additional momentum in the emerging world. As the Trump administration has – for the moment at least – refrained from implementing its aggressive rhetoric on trade, this positive trend is expected to continue into H2 on the back of resilient global demand, although soft commodity prices and political machinations – witness Qatar's row with Saudi Arabia and its allies – are two factors that may yet undermine an otherwise robust outlook. Asian economies are set to maintain their growth leadership while Brazil and Russia will once again contribute positively following their respective recessions.

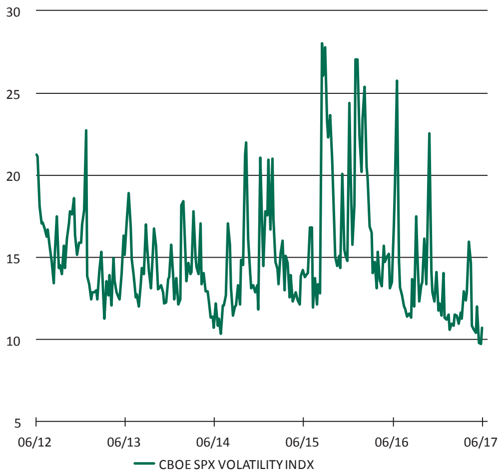
Investment strategy: Volatility reversal?

Volatility has been very low for a considerable time and fears of a reversal are growing. While economic fundamentals would tend to argue against an abrupt and sustained sell-off, anticipated changes in Fed policy could usher in a period of higher volatility.

A storm brewing?

Extremely low levels of volatility are weighing on many investors' minds. If we assume that volatility, like many other financial variables, is mean-reverting, then we must expect the currently benign market environment to come to an end at some stage. Predicting the precise timing of such a change is notoriously difficult, and is only compounded by the challenge of determining whether such a reversal signals the beginning of a new down cycle or is just an overdue – but passing – correction. Investors will soon be put to the test, however, when the Fed begins the process of reducing the size of its balance sheet. Central bank deleveraging in general will have major ramifications for all asset classes. Given the current backdrop of solid global fundamentals, we are not expecting a material or persistent downturn at this stage, but we would still be surprised if volatility failed to move away from current low levels. The potential consequences for fixed-income and low-rated credit in particular are our greatest concern: while the risk of a US recession remains low, tight spreads – almost three quarters of a standard deviation below the long-term mean – no longer provide a comfortable cushion against a sell-off. Viewed from this perspective, investment-grade credit and emerging sovereigns are looking more attractive, but are vulnerable to any sharp yield increases due to their longer duration.

Chart 1: S&P volatility near record lows (% p.a.)



Source: Bloomberg, HBZ

Current positioning

Over the past quarter, we have shifted some of our US equity exposure to Europe in order to take advantage of the better growth backdrop in the eurozone in particular. We have left our overweight in credit unchanged, but a reduction in our high-yield allocation is under consideration.

What to watch

While we have grown tired of the Trump comedy, the dysfunction at the heart of the world's only superpower is impossible to ignore and our attention will thus remain focused on US policy and its potential for surprise. In Europe, we will be tracking French reform efforts and watching out for indications of a decision on early elections in Italy; on the macro front, we will be closely monitoring leading and coincident data to gauge the longevity of the expansion; we consider an unexpected contraction to be one of the biggest risks to financial markets.

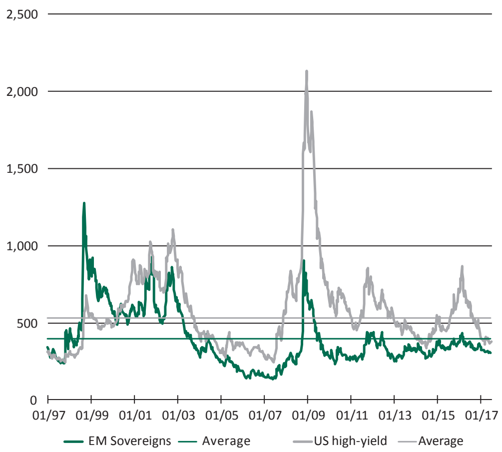
Key points

- Fed could end low global volatility
- High-yield at risk in event of reversion to mean
- European politics set to remain in flux

Fixed income: A low-return environment

Most fixed-income sectors have performed very well over the past few months, although we anticipate only modest returns in the foreseeable future. We see the greatest potential in financials, global high-yield and selected emerging-market bonds, in both hard and local currency.

Chart 2: Very tight credit spreads (spread over US Treasuries in basis points)



Source: BoAML, HBZ

The relative appeal of global high-yield

Credit spreads have continued to tighten and are currently well below their long-term average; when it comes to investment-grade bonds, there is only limited scope for further spread tightening. Total returns will be driven by the expected moderate rise in US Treasury yields, although this may consume most of the carry and roll gains. The greatest upside in this asset class lies in subordinated financials, which have performed well over recent months and whose valuations are backed by stronger credit metrics. Valuations of high-yield bonds are also stretched, but a backdrop of good corporate fundamentals and low expected default rates means such bonds nonetheless remain relatively attractive, with their higher coupon and lower duration allowing them to better absorb rising interest rates. Potential negative risks may lurk in upside surprises emanating from inflation or lower oil prices. We prefer global high-yield to loans, which are typically arranged by banks for non-investment-grade companies and pay a floating rate based on Libor plus a spread. Since we do not expect Libor to rise substantially over the coming months, any return on loans will be modest.

Turkey: Short-dated, sovereign USD paper attractive

Emerging market sovereign bonds in hard currencies have performed extraordinarily well this year, and the overall outlook for EM remains favorable, with the ongoing hunt for yield buoying this asset class despite weaker commodity prices and potentially tighter global monetary conditions. Valuations are expensive, however, and we do not anticipate further spread tightening. Selectivity is thus the order of the day and investors should refrain from buying low-rated sovereigns purely to boost their returns. We see potential in short-dated Turkish sovereign or quasi-sovereign paper, for example, but in many other cases, fundamentals are not sound enough to justify the risk.

Finding opportunities in local currencies

Local rates should continue to benefit from accommodative EM central bank policies, although their easing cycles may prove shallower than expected, given Fed policy normalization. We prefer high-yielding issuers such as Columbia or Indonesia. However, these assets require a high risk appetite and investors should make use of a fund solution to ensure proper diversification.

Key points

- Only moderate rise in US Treasury yields expected
- Not yet time to sell global high-yield
- Selectivity advisable with EM bonds

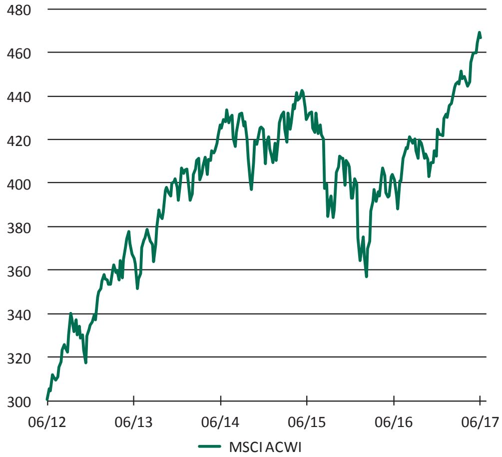
Equities: Earnings are back

Global equity markets have experienced another bull market rally in the last few months, interrupted only by a sudden sell-off in IT stocks. As the economic environment continues to remain favorable, we anticipate a positive trend through 2017.

Robust Q1 reporting season

Investor sentiment has been buoyed by a robust earnings trend in the US, with companies delivering 14% y/y profit growth in Q1 2017. Corporate profits have thus confirmed the revival of economic activity suggested by leading indicators and macro data. Every sector except telecoms has posted improved earnings, with technology, materials and financial stocks increasing their profits the most. Sustained earnings growth is required to keep multiple expansion in check. Having risen over 10% in developed markets and more than 20% in emerging markets, total year-to-date equity return has exceeded the annual average and there are still no imminent threats on the horizon. Political fears, especially in Europe and the US, have been largely allayed, with no abrupt policy changes forthcoming, although the sell-off in tech stocks (which had already delivered returns of 20% in 2017) took investors by surprise. In our view, this correction was principally motivated by profit-taking and worries about IT valuations. Telecoms and energy stocks in particular continue to lag; no turnaround is likely in the case of the latter until crude prices recover or productivity gains lift the sector's overall profitability.

Chart 3: MSCI World AC USD on the rise (index)



Source: Bloomberg, HBZ

Sector rotation ahead?

The performance of equities since Trump's election raises questions and concerns about possible shifts in the markets. Will the list of winners, whether sectoral or regional, be shaken up some time this year? The US equity market now sports a price-to-earnings ratio of over 20; this is high but not yet excessive. Sales-based, top-line earnings metrics also confirm that US stocks are substantially more expensive than their European or Japanese peers. With solid growth in these regions, a catch-up seems likely over the next couple of quarters. With no clear obstacles in sight, emerging markets are also set to extend their winning streak. The once-feared trade wars have failed to materialize and positive global demand is continuing to shore up export growth. Economic tailwinds should favor cyclical sectors although some volatility is to be expected along the way. As a general rule, valuations will be more of a concern to investors, and this is likely to make them more sensitive to fundamentals and more cautious in their stock selection.

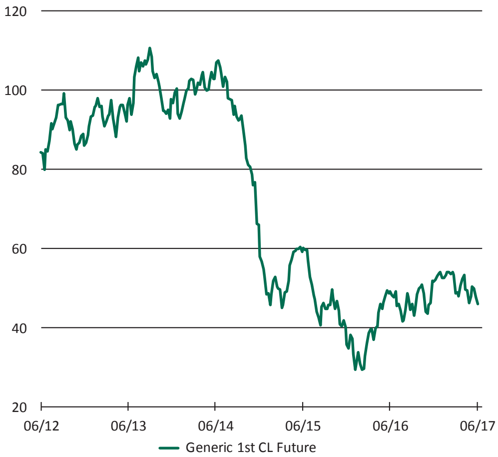
Key points

- Positive earnings trends support equities
- Sell-off in IT stocks mainly driven by profit-taking
- Outperformance anticipated for stocks with lower valuations

Commodities and FX: Cautiously risk-on

Despite solid global demand, commodity prices came under renewed pressure in Q2, driven largely by the energy complex. By contrast, FX markets have calmed down and have shifted to a risk-on mode following supportive European election outcomes.

Chart 4: Oil plummets again (WTI USD/bbl)



Source: Bloomberg, HBZ

Oil rally stalled

The effects of OPEC's production cuts tailed off quickly, with oil even falling back into a bear market in June as increased supply from Libya and Nigeria offset cuts by other OPEC countries. American drillers also added rigs as their productivity continued to improve. Consequently, energy prices have dropped almost 10% over the last three months, with just such supply concerns proving the principal cause of bearish investor sentiment in the energy sector. This trend creates further disinflationary effects in a global economy with no meaningful inflation risks. Gold, meanwhile, has been trading sideways on the back of a positive economic outlook and the Fed's commitment to gradual rate normalization. The appeal of the yellow metal has waned further as fears of inflation have receded. The big exception in the commodities space was once again palladium (used by the automotive industry for catalytic convertors); hedge funds have increased their bullish bets to a three-year high. Despite signs of weakening car sales, palladium remains 2017's best-performing commodity.

(Mostly) friendly skies for currencies

The dollar index (DXY) has reflected the ongoing weakness of the greenback over the last three months as the slower pace adopted for Fed interest rate hikes put a damper on the currency. On the flip side, emerging-market currencies made a strong showing on the list of appreciating crosses. Earlier concerns that rising US rates might trigger an exodus have been largely dispelled and the carry trade has continued, with the MXN in particular rebounding strongly due to its high carry and low inflation risk (and in the absence of threatened US trade restrictions). The unexpected outcome of the UK election has interrupted the recovery of the GBP. Uncertainty surrounding the contours and consequences of Brexit remains high, and investors should expect sustained higher volatility for the currency, which remains historically cheap. On the negative side, political turmoil in Brazil has marked out the BRL as a big loser against the USD, and this may also represent a threat to the region as the downside risk has not been fully priced. A failure to pass essential pension reforms would be detrimental to both Brazil's public finances and the country's growth outlook.

Key points

- Energy prices plummet once again
- Palladium is most notable positive surprise on commodities front
- FX markets remain in risk-on mode

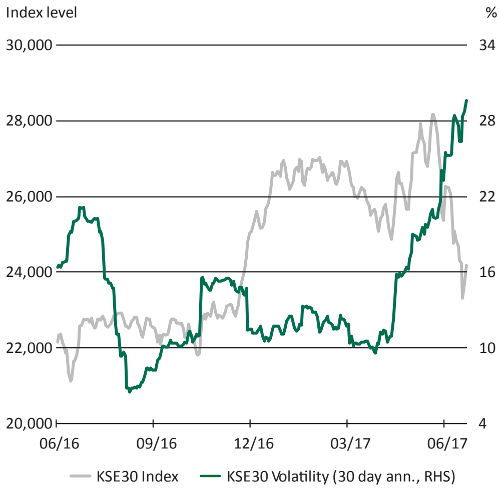
Key markets: Unwelcome surprises

Pakistan's inclusion in the MSCI Emerging Market Index and the UK's snap election were both expected to be positive, uncertainty-reducing events; things have turned out rather differently, however. Meanwhile, the UAE remains entangled in Saudi Arabia's spat with Qatar.

Pakistan: No gain from EM status

The much-vaunted re-admission of Pakistani stocks to the MSCI Emerging Market Index has failed to ignite the local equity market – indeed, return to EM status has led to increased volatility and ultimately a widespread sell-off. Global investors have yet to allocate a meaningful place to Pakistan in their portfolios and an index weight of only 0.14% suggests there is no immediate pressure on them to do so. The new budget, which increased and extended the capital gains tax and raised other sector-specific taxes and levies, may also have contributed to negative investor sentiment, and an ongoing investigation into the prime minister's business dealings is a further cloud hanging over the market. This said, fundamentals have remained robust, with C-PEC investments lifting overall activity, but the key risk remains an unduly strong currency that is punishing exports and aggravating external imbalances. Although the incumbent government appears unwilling to make the necessary adjustments, such a step is highly likely under the interim government to be appointed ahead of the 2018 election.

Chart 5: Pakistan's MSCI EM inclusion: higher volatility, lower index level



Source: Bloomberg, HBZ

UAE: Collateral damage

The dispute between Saudi Arabia and Qatar has highlighted the latent political risks within the GCC even as fundamentals have continued to improve. Most analysts expect a peaceful resolution to the situation, although the UAE economy will face some collateral damage in the form of higher borrowing costs and lower trade and investment. The latest fall in the oil price will only compound the situation.

UK: And now for the hard part

The already dauntingly complex task of orchestrating an orderly exit from the EU has become even harder after the Conservative party lost its overall majority in a snap election in June. Since the new incarnation of parliament is unlikely to approve a hard Brexit (i.e. leaving the EU without any follow-on arrangement in place), the final outcome of the process could be less damaging than initially expected, however. The Bank of England nonetheless now finds itself in an uncomfortable position, with inflation rising and economic activity slowing; in such a context, uncertainty will remain high and the GBP will continue to act as a shock absorber.

Key points

- No benefit yet from Pakistan's graduation to MSCI EM status
- GCC dispute with Qatar to affect UAE economy
- GBP to function as shock absorber for heightened economic and political uncertainty in UK

Special topic: The end of the cycle?

When equities take a dive, investors routinely start predicting the next recession – only to see stocks rebound and fears of recession dissipate. Bond markets have a better record of predicting recessions, but central bank buying has distorted their signaling power.

Chart 6: Yield curve signals no imminent recession risk for the US (10 year/3 month)

Source: Bloomberg, HBZ

Key points

- Equity markets poor predictors of recessions
- Inverted yield curve is strong signal, but central banks have distorted bond markets
- US recession likely within three years

Equities and recessions

Equity investors are fickle, so it should come as no surprise that bear markets (defined as a 20% decline over a period of more than one month) tend to be more frequent than recessions; equally not every recession leads to a bear market. In other words, the stock market – for a range of reasons that are beyond the scope of this short piece – remains a poor predictor of future economic conditions. The bursting of the tech bubble in 2000 illustrates this point well: confidence imploded as investors realized that they had paid ludicrous prices for often inane and untested business models – but the US recession that ensued was mild by any standard and one of the shortest on record.

What does the yield curve tell us?

The bond market seems to be a better predictor. Every US recession since 1960 has been preceded by an inversion of the yield curve, meaning that longer-term yields (typically those on 10-year notes) fell below short-term yields (typically those on 3-month T-bills). The yield curve remains distinctly upward sloping, although this slope is less pronounced than it was a year ago, but further flattening is possible; however, this will depend largely on the actions of the US Fed in H2 and is unlikely to occur in the short term. Historically, credit markets have also had some predictive power. At first sight, the current low levels of spreads suggest no immediate cause for concern, although central bank asset-buying has distorted fixed-income markets to such an extent that the informational value of credit spreads is now limited at best.

There will be a recession – eventually

The financial markets are not currently signaling any material risk of recession over the next twelve months at least, but with the US economy experiencing one of its longest expansionary phases in recent history – 96 months, compared with an average post-1945 peak-to-peak cycle of some 68 months – a downturn within the next three years is highly likely. Based on historical prices, most (if not all) asset classes look expensive; if the risk of recession starts to rise, or investor sentiment turns bearish due to an external shock or some economic event (e.g. the Fed's planned balance sheet adjustment), they are all in for a correction. It will make sense to reduce risk exposure in due course, but we have not reached that point just yet.

Market data summary

As of 26 June 2017

Equity indices	Last	-3M %	YTD %	-3YR %
MSCI World USD	5'381.8	5.0	11.1	17.5
S&P 500	2'438.3	4.0	8.9	24.6
EuroStoxx 50	3'574.1	3.8	8.6	10.5
FTSE 100	7'471.3	1.8	4.6	10.9
SMI	9'132.3	6.0	11.1	6.9
Nikkei	20'153.4	4.6	5.4	31.6
MSCI EM USD	449.4	5.0	18.3	3.6
Sensex 30	31'138.2	5.8	16.9	24.2
KSE 100	46'332.3	-5.5	-3.1	59.8
Hang Seng	25'871.9	6.2	17.6	11.5
Russia RTS	997.9	-11.3	-13.4	-27.6
Brazil Bovespa	61'087.1	-4.3	1.4	14.2

Bond indices	Last	-3M %	YTD %	-3YR %
Citi US gov	1'477.79	1.9	2.5	7.2
CIti US HY	2'148.15	3.6	4.6	12.7
CIti US Corp	966.37	2.7	4.1	12.0
Citi Euro gov	231.37	2.3	0.4	11.2
CIti Euro Corp	236.08	1.3	1.0	8.6
CIti EM Sov	806.08	2.6	6.8	15.6
DB EM Local USD	160.82	2.3	10.3	-8.0

Currencies	Last	-3M %	YTD %	-3YR %
DXY	97.43	-2.4	-5.3	20.9
EUR/USD	1.12	3.9	7.3	-17.3
USD/CHF	0.97	2.2	5.6	-7.7
GBP/USD	1.27	1.7	3.5	-25.0
USD/JPY	111.86	-1.1	4.5	-9.4
AUD/USD	0.76	-0.3	5.3	-19.5
USD/CAD	1.32	1.3	1.8	-19.2
USD/ZAR	12.86	-1.9	5.8	-18.5
USD/INR	64.52	0.8	5.3	-6.9
USD/PKR	104.86	0.0	-0.4	-5.8
Gold oz	1'244.73	-0.4	8.4	-5.1

Interest rates	3M interbank %	10YR government %
USD	1.29	2.13
EUR	-0.33	0.23
GBP	0.30	1.00
CHF	-0.73	-0.17
JPY	0.00	0.05
AUD	2.96	2.37
CAD	1.17	1.45
ZAR	7.33	8.51

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