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IMT GROUP

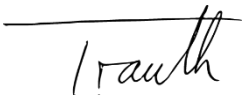
INVESTMENT OUTLOOK 01.2017

20 January 2017

Traditionally, we devote the January issue to presenting ten predictions for the new year. In addition, we review last year's forecasts. As always, we have been right in some cases and wrong in others. We believe that such a review is a healthy exercise as we strive to learn from a critical examination of our own writing and thinking of a year ago.

In 2016, we were faced with numerous challenges and surprises: the strong recovery of commodities, the Brexit, and the Trump election to name just a few. One prediction we are very confident about is that 2017 will bring new surprises.

We look forward to a challenging 2017 and hope you stay with us throughout the year. We are very grateful for your loyalty as well as your feedback and comments.



Thomas Trauth
CEO – IMT Asset Management AG

LAST YEAR'S PREDICTIONS

Our predictions for 2016

As always, we will first take some time to review last year's predictions and see how they have matched up against the actual outcomes. For the details, we refer to our Investment Outlook 01.2016.

1. Growth

We correctly forecasted the gradual increases in growth. US growth, according to the latest estimates, is likely to stay slightly below our 2% expectations, Eurozone growth estimates are at 1.6% vs our expectations of 1.7%, and Japanese growth exactly equals our forecast of 1%.

2. Inflation

As expected, we observed a mild pickup of inflation rates and a correction of ultra-low inflation expectations. Inflation expectations rose more meaningfully especially after the US elections.

3. Central Banks

We expected the Fed to hike two to three times in 2016. However, the Fed decided to hike only once, in December.

We were right to state that the ECB would keep its policy stance. Rates remained unchanged, while the QE program was somewhat extended during the year.

As expected, the Bank of Japan (BoJ) decided on additional monetary policy measures. For example, the BoJ introduced a direct targeting of 10Y government bond yields. The BoJ succeeded in stopping the appreciation of the JPY, which changed course in Q4 and weakened significantly.

4. Rates

We were spot-on with our forecast for US 10-year treasury yields, which for most of December 2016 traded within the forecasted 2.5-2.6% range. But while we predicted higher European rates, these fell further, even down to -0.2% in July, ending the year at 0.2%, which was about 0.18%-points lower than at the end of 2015.

5. Credits

In contrast to our predictions, credit spreads tightened and credits in general performed positively. The riskier part of the bond universe, like high-yield and emerging markets, even performed very strongly.

6. Equities

We were right in our prediction that equities would yield single-digit returns. However, in contrast to our expectations, Europe and Japan underperformed clearly. We rightly foresaw opportunities in the commodities space, the sector which clearly outperformed last year.

7. Emerging markets

Emerging markets were quite volatile in 2016, so our cautious stance at the beginning of that year was right. During the course of the year emerging market assets recovered noticeably and EM equities yielded a healthy 8.6%, despite a setback after the US election.

8. Commodities

While we anticipated an upturn in commodity prices, we started the year with a cautious stance and expectations that the recovery would come later and would be more gradual. We were, however, surprised by the steepness of the rally after February, which was led by industrial metals, energy, and also gold.

9. Alternatives

We looked for some diversification in the portfolio and added absolute return strategies. While we still believe that this helps to improve risk-return, the broad hedge fund index gained only 2.5% in 2016 and fell somewhat short of our expectations.

10. Currencies

As far as currencies are concerned, we were right that the USD would somewhat strengthen vis-à-vis EUR and JPY, which it did, by 3.2% and 2.7% respectively.

We expected that the CHF would weaken against the EUR, which it did in the first half of the year. However, after Brexit, the CHF strengthened again and gained about 1.5% vis-à-vis the EUR if you compare end of December values.

OUTLOOK 2017 – TEN PREDICTIONS

1. Growth

In 2016 most growth indicators clearly improved. Taken together with expectations of a strong fiscal stimulus in the US and a more business-friendly US policy – if we exclude public shaming of individual companies and protectionism – this leads to a brighter growth outlook. We expect the US to grow by 2.0%, the Eurozone and Japan by about 1.5%, and China by about 6.5% in 2017.

2. Inflation

Inflation rose somewhat in 2016, albeit from very low levels. As we slowly leave a deflationary environment we are not excessively concerned about any possibility of massive inflation overshoot. However, since interest rates are still at historically low levels, additional fiscal stimulus, rising commodity prices, and tightening US labor markets will most likely lead to higher US inflation. The inflation outlook in Europe, however, is very different. A weaker EUR and rising commodity prices will help inflation rates to grind only a little higher. We expect US inflation to rise towards 2.5% and European inflation towards 1.7% in 2017.

3. Central Banks

We expected the Fed to hike twice in 2017. The reflationary policy of president Trump and the low unemployment rate — full employment was almost reached — are likely to put the Fed under pressure to increase rates. However, we expect that the majority of monetary tightening will come via a stronger USD, which limits the Fed's ability to raise rates by too much.

The ECB announced it would start reducing its asset purchase program, starting in April 2017. This will be a gradual process but we still remember well the taper tantrum of 2013, when Fed president Bernanke's announcement triggered a major sell-off of bonds.

The Bank of Japan, however, appears very committed to extending its easing program until inflation moves up noticeably. It may even let inflation overshoot.

4. Rates

Rising inflation, more Fed hikes, and the ECB reducing its asset purchase program lead us to expect that bond yields will rise in 2017. Since central banks are unlikely to become very aggressive, inflation is unlikely to rise by too much, and investors' sentiment is very likely to remain cautious, we do not expect a dramatic bond sell-off in 2017. We prefer inflation-linkers since they provide some protection against rising inflation expectations.

5. Credits

We expect credits to do well in general. While high-grade credit is most likely to suffer from rising rates, we see positive return potential for high-yield bonds. We have scaled back our high-yield exposure, though, based on more challenging valuations and, at least in the US, a rise in corporate balance sheet leverage.

6. Equities

We remain constructive on equities in general, based on the brightened growth outlook, further monetary and additional fiscal stimulus, which will be coupled with a better outlook for earnings. However, relatively high valuation will limit the return potential, which will remain in the single-digits. At the start of the year we favor the US, Japan and emerging markets over Europe. Rising US yields, and a stronger USD are major downside risks for US equity. Various elections in Europe and anti-EU forces are major downside risks for European equities. As the Trump administration is likely to change global geopolitics, this may also create uncertainties.

7. Emerging markets

The outlook for emerging markets is not clear-cut for us. Negative for emerging markets are a strong USD, rising US yields, as well as Trump's protectionist rhetoric. Positive is the recovery of commodities, and more global growth. China is likely to maintain stimulus spending in the run-up to the Communist Party Congress in autumn, but may reduce it thereafter.

Overall, we are cautiously positive for emerging markets equities in 2017. Emerging market bonds will benefit after net issuance in 2016 and starting easing cycles in many countries.

8. Commodities

The oil market recovered in 2016 from a very depressed status. The market is, however, still faced with large overcapacity. Oil prices have been supported recently by OPEC's announced intention to cut production. The question that remains is how credible this is. Still we expect oil prices to stay stable in 2017 and gradually move higher in the course of the year.

Somewhat rising Chinese demand and stronger US infrastructure spend has initiated a strong rally of industrial metals. We think the market may have run ahead of fundamentals and we would not be surprised by a technical correction. In general, we think that the multi-year bear market for industrials may be over and expect a mildly positive year.

Gold was very volatile last year. We remain skeptical about the outlook for Gold in an environment with rising real and nominal yields. Gold may, however, serve as a hedge in a very uncertain world. We expect the Gold price to end the year between 1,000 and 1,200 USD/oz.

9. Alternatives

In a world with low return expectations for bonds and equities, we still like the diversification effects from alternative non-directional investment strategies. For investors who can accept lower liquidity, private equity can provide additional attractive risk-return.

10. Currencies

We see further upside for the USD, as rate differentials may increase further in 2017. The EUR could come under pressure as major European elections approach. We expect a weaker JPY due to aggressive Bank of Japan easing, a weaker CNY due to Trump's trade rhetoric and rising yields, and a weaker GBP due to a high likelihood of a hard Brexit.

Major risks to watch in 2017

US policy

Potential risks are related to a protectionist, "beggar-thy-neighbor" policy by the new Trump administration. This could disrupt trade and established business value chains, dampening growth, and driving inflation up. It remains to be seen to what extend the US president will finally implement his policy intentions.

European populism

Populism and nationalism are on the rise globally. In Europe this threatens the stability of the European Union. In 2017, major elections take place on 15 March in the Netherlands, on 23 April in France, and probably on 24 September in Germany. If anti-European parties were to gain support, this could trigger further referendums in 2018 as well as greater concern about the sustainability of the European Union. As a result, we need to prepare for a prolonged negative impact on European equity markets.

China

The fact that Trump's rhetoric has been very critical regarding China could disrupt the strong trade links between the two countries. A strong USD and rising yields are weakening the CNY. The Bank of China has spent about USD 1 trn for currency market interventions to stabilize the CNY.

Furthermore, the ongoing territorial dispute concerning the South Chinese sea could heat up. In addition, the upcoming 19th Communist Party Congress in autumn, with far-reaching changes in the leadership of the party, could potentially lead to heightened uncertainties.

Middle East and global Terrorism

It remains to be seen how a US administration, which on the one hand puts out a harder rhetoric against Islam but on the other hand wants to reduce its international military engagements, will impact developments in the middle east. In addition, the balance of power between the US and Russia does have a strong impact on the region. For us, it is completely open how the relationship between Trump and Putin will develop and how this will impact the various forces in the middle east.

Valuations

Equities and credits are richly valued. While the still ultra-low rates and an improving growth are likely to support risky assets, the market may start to become concerned about stretched valuations.

Conclusions for asset allocators

In general, and despite the above-mentioned risks we expect risky assets to perform well in 2017. Central banks – despite first Fed rate hikes – remain very accommodative and growth dynamics not only stabilized but in fact improved last year. This should provide the prerequisites for a lasting equity bull market and good performances of other risky assets. However, expected returns need to be adjusted downwards as valuations have become more challenging.

The above-mentioned risks will lead to phases of uncertainty and market corrections. It will be important to anticipate those and potentially to profit from lower entry levels.

To summarize, we start the year with a balanced risk exposure, i.e., a slight tilt towards risky assets. We continue to underweight government bonds and have increased our strategic exposure to inflation-linked bonds. We have also reduced our strategic overweight in European equities and increased our weighting for US equities. We continue to see some upside for the USD and remain especially cautious with regard to the GBP. Elections in Q1 and Q2 in Europe could weaken the EUR. Bank of Japan's easy monetary policy will, in our view, lead to weaker JPY and a good performance of the Japanese equity market.

ECONOMICS

In 2016 growth indicators improved across the board. Also, inflation started to increase somewhat. However, this was largely attributable to cost-push effects from rising commodity prices. The US economy continued to create jobs and wage inflation seems to be grinding higher. As a result, we can be a bit more optimistic that growth will become more sustainable.

Fig. 1: PMIs

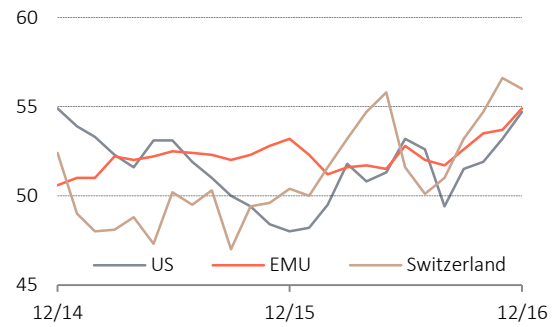


Fig. 2: PMIs

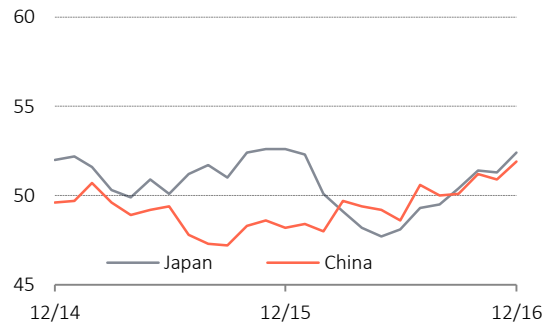


Fig 3: Consumer price inflation, in % YoY

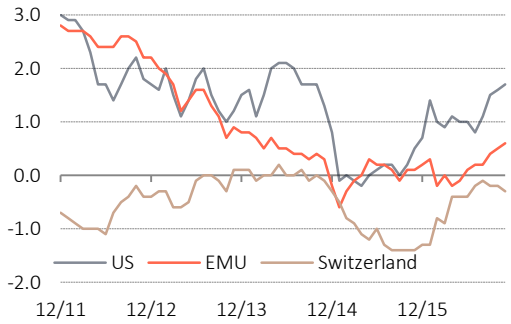


Fig. 4: Consumer price inflation, in % YoY

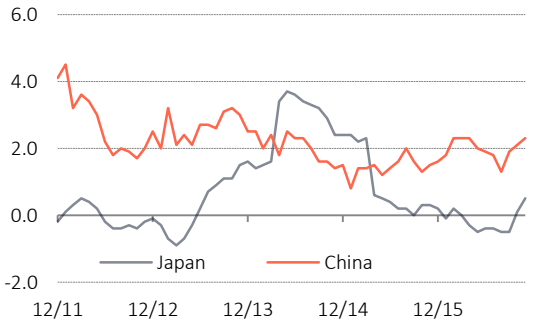


Fig 5: Unemployment rates, in %

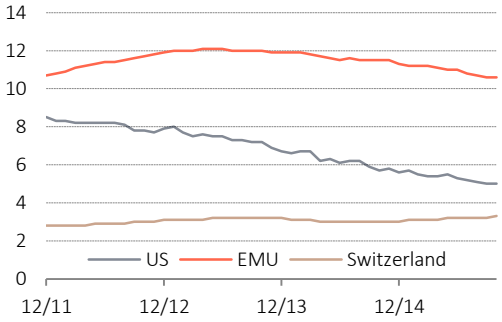
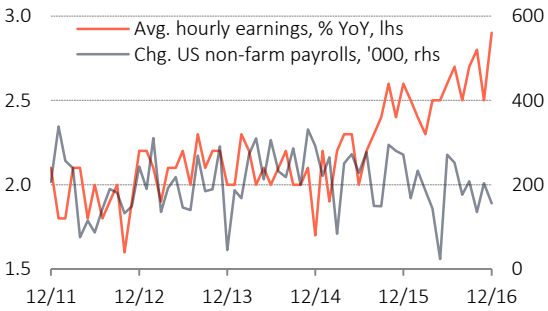


Fig 6: US labor market



FIXED INCOME

While most of 2016 yields declined further, we observed a significant correction in Q4. This was driven primarily by US yields and the expectations of a more aggressive reflationary policy by president-elect Donald Trump. This can be seen by the significant correction of break-even inflation rates (Fig. 9). Credit spreads tightened in 2016, which translated into healthy returns from high-yield and emerging-market bonds.

Fig.7: 2Y government bond yields

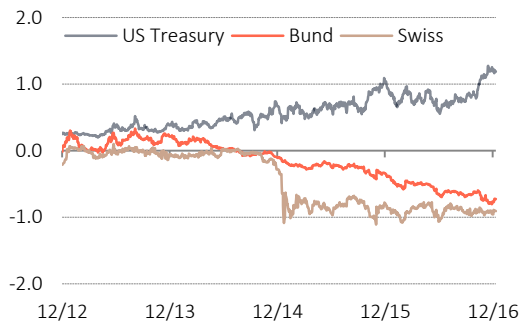


Fig. 8: 10Y government bond yields

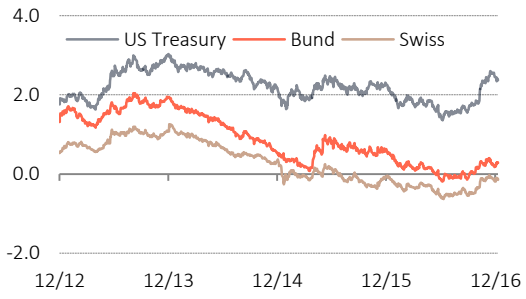


Fig 9: 10Y break-even inflation

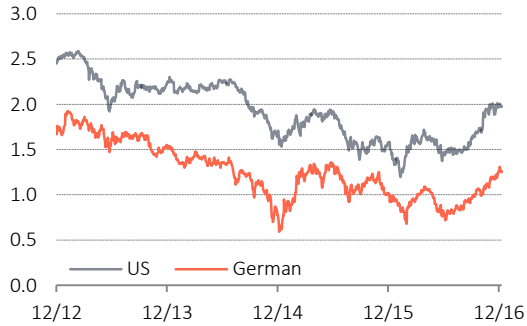


Fig. 10: Credit spreads, 5Y credit default swaps

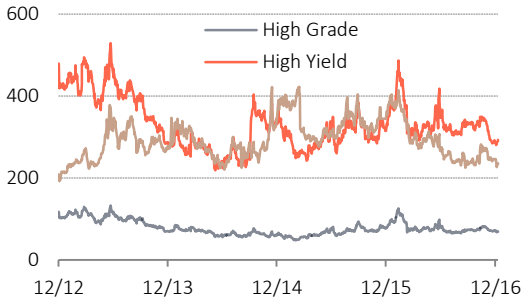


Fig 11: Money market spreads (3M-2Y)

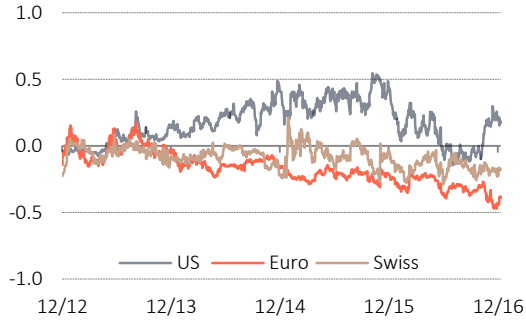
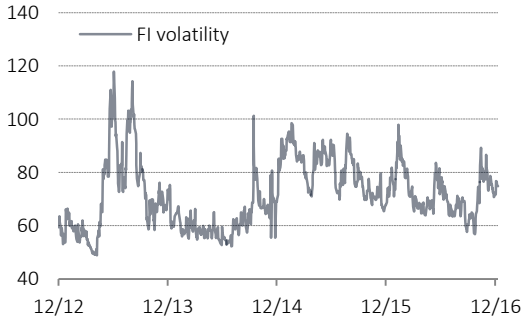


Fig 12: Merrill Lynch volatility index



EQUITIES

Overall, equity markets performed well in 2016, led by US and emerging markets equities. European and Japanese equities clearly underperformed. The markets started with a significant sell-off in January and February, followed by a recovery, which was interrupted in June around the Brexit vote and in Q3 during the run-up to the US elections. 2016 was also a year of wild sector rotations, starting with a strong performance of energy and materials, followed by a strong rotation into financials and more cyclicals.

Fig. 13: MSCI equity indices – major regions

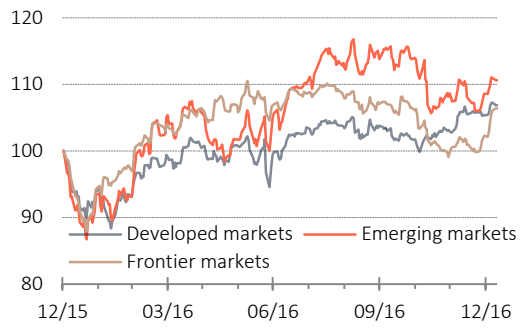


Fig.14: Equity indices – major developed markets

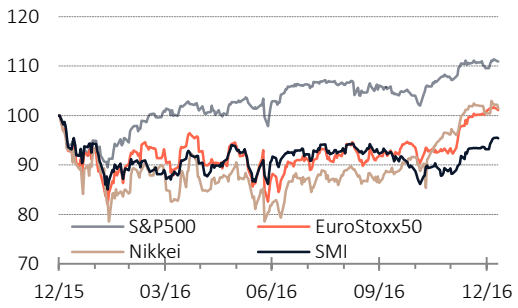


Fig 15: Equity indices – major emerging markets

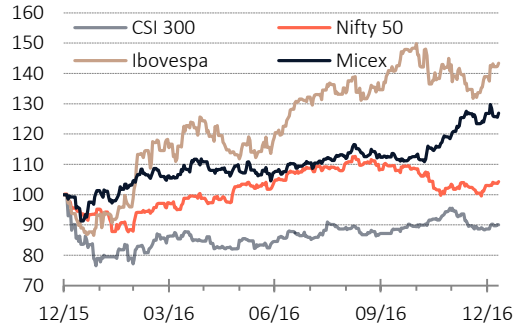


Fig. 16: Sector performance, MSCI Europe, 2016

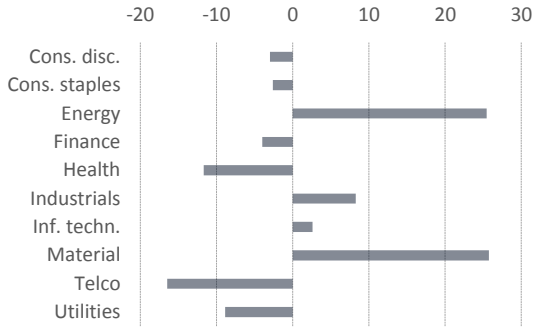


Fig 17: Price-earnings ratios

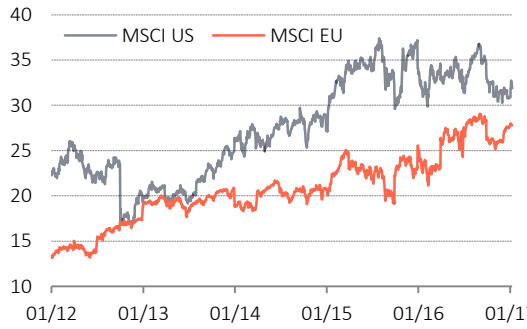
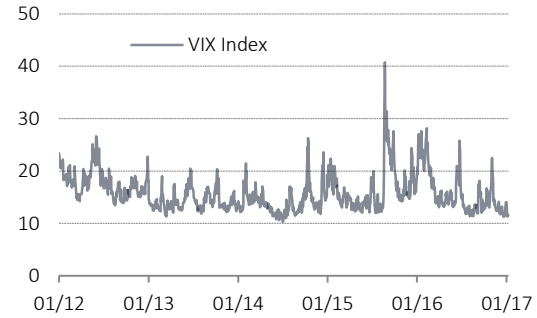


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

In 2016 commodities were able to recover significantly, led by industrial metals and energy prices. Gold performed strongly but gave back part of its gains in the fourth quarter. Also REITS have been very volatile but ended the year with a positive performance. Listed private equity performed very well in 2016.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

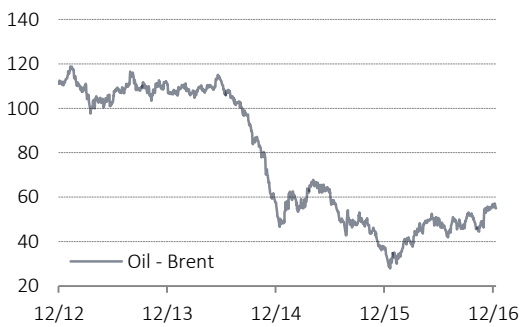


Fig 21: Bloomberg commodity indices

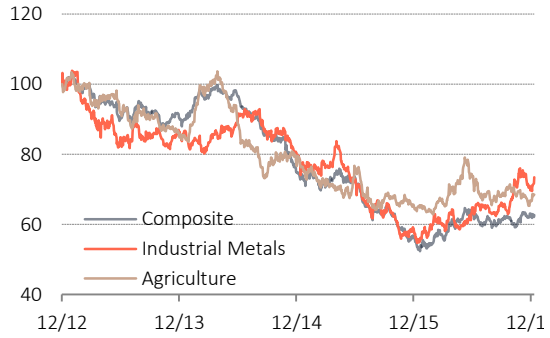


Fig. 22: HFRI hedge fund indices

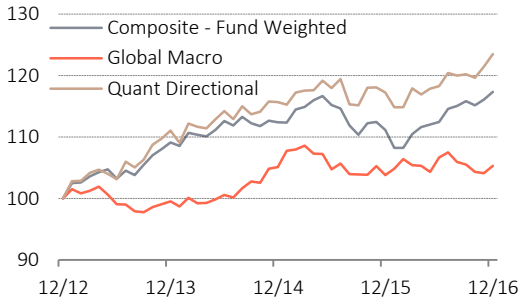


Fig 23: FTSE EPRA/NAREIT global index

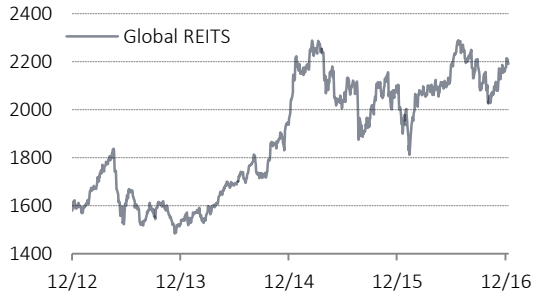
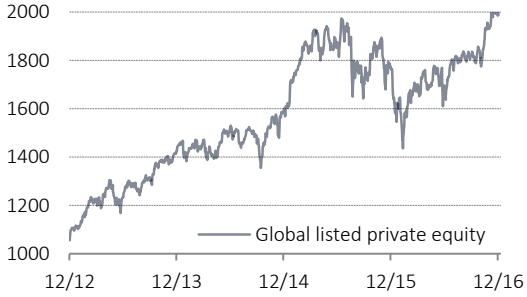


Fig 24: LPX global listed private equity



CURRENCIES

Brexit led to a weaker GBP, and the Trump election coupled with a Fed rate hike in December strengthened the USD. While a devaluation of the CNY was a concern in 2015 and in early 2016, the CNY clearly weakened in 2016 with little impact on other markets. The SNB was not able, despite negative money market rates and currency interventions, to weaken the CHF.

Fig. 25: EUR-USD exchange rate

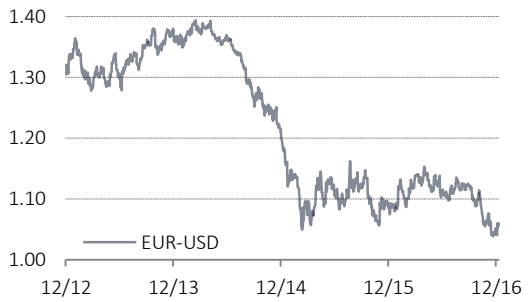


Fig. 26: GBP-USD exchange rate

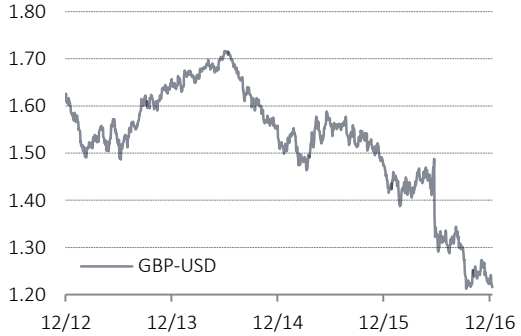


Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

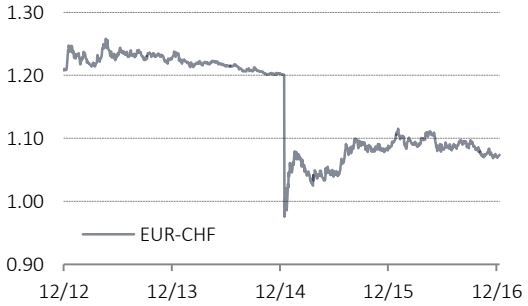
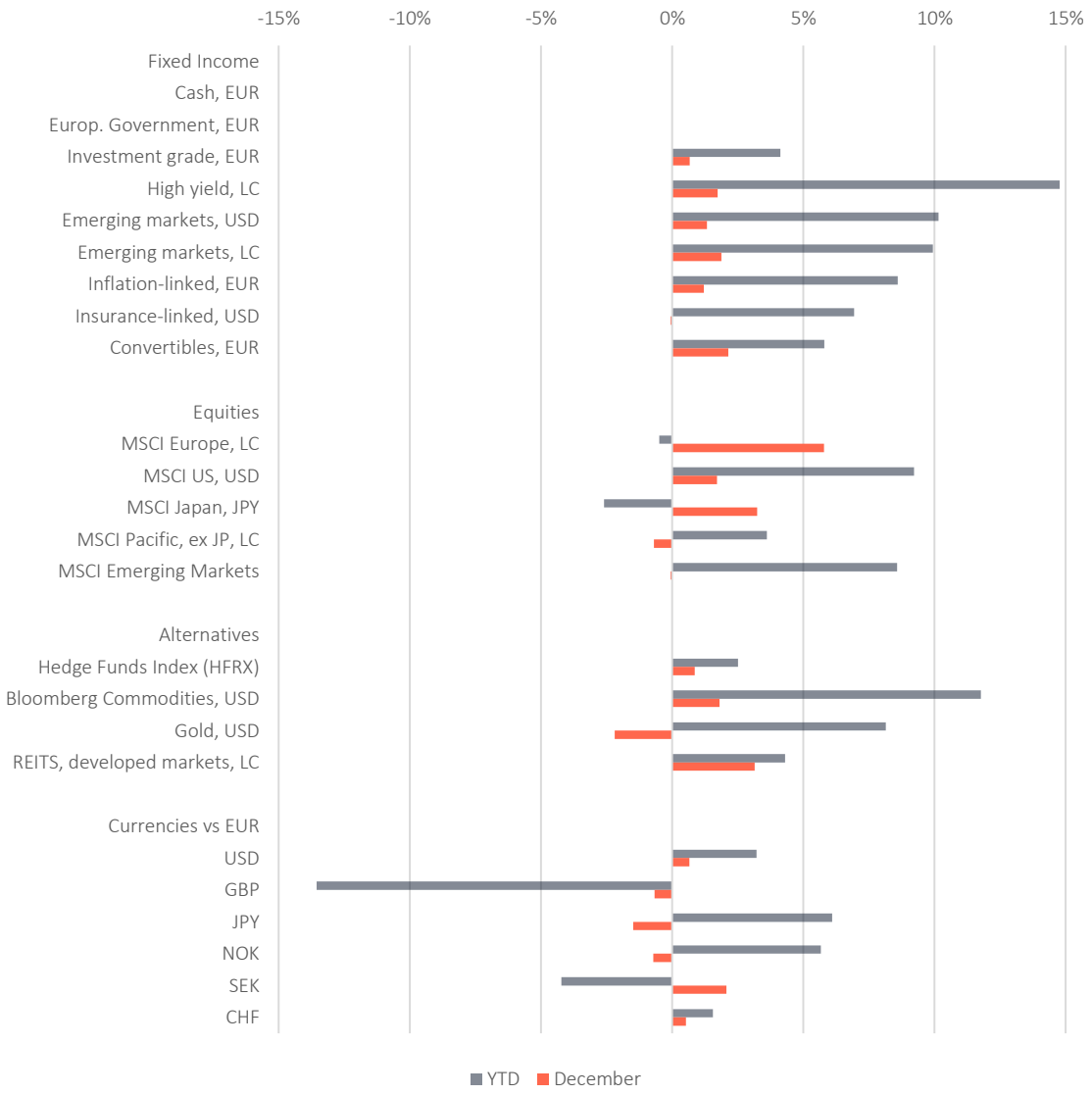


Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

2016 was a very volatile year. It started with a severe sell-off of risky assets and a flight to quality. Overall, however, the performance of a balanced portfolio was largely driven by good performances of risky assets. High-yield and commodities were strong outperformers, followed by US and emerging markets equities. EUR investors were also able to benefit from currency exposures to USD, JPY and NOK. Japanese equities and the GBP were the worst performers overall.

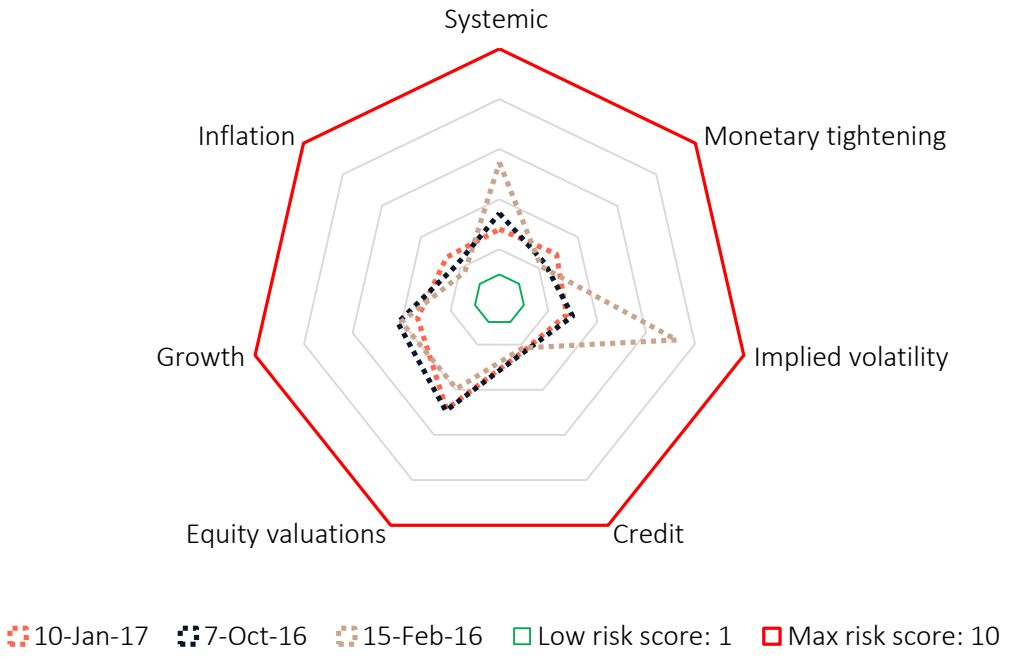
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy



RISK MONITOR

The risk monitor shows that our favorite market risk indicators remain at moderate levels. There is a slight uptick in inflation and monetary tightening risks. Equity valuation risks remain somewhat elevated. Systemic risks, i.e., the market perception regarding the health of the financial system, have been falling steeply since last year.

Fig. 32: IMT Risk Monitor



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