BANQUE
ERIC STURDZA

INVESTMENT STRATEGY

"Remember to always be daring", Gabriele d'Annunzio

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Tactical allocation

		USD Account	*EUR Account*	*CHF Account*
Equities	United States Europe United Kingdom Japan China Other emerging	Neutral Overweight Neutral - Neutral Underweight	Neutral Overweight Neutral - Neutral Underweight	Neutral Overweight Neutral - Neutral Underweight
Bonds		Underweight	Underweight	Underweight
Currencies	Dollar Euro Swiss franc Pound sterling Yen Yuan Australian dollar	- hedged long hedged hedged hedged hedged	long - long hedged hedged hedged hedged	long hedged - hedged hedged hedged hedged
Commodities	Gold Oil Copper Coal	Sell 1200/Buy 1050 $45-65/barrel Neutral Neutral	Sell 1200/Buy 1050 $45-65/barrel Neutral Neutral	Sell 1200/Buy 1050 $45-65/barrel Neutral Neutral

- The magnitude of the increase in the markets since the lows of March 2009, the start of a turnaround in bond markets after over thirty years of a very positive cycle, the upturn in commodity prices in 2016 without necessarily any relation to final demand, and the sharp currency fluctuations seen in 2016 are causing many investors to hesitate.
- However alternatives to equities are increasingly scarce. Investors no longer consider real estate or art, and less and less consider private equity funds as reassuring havens for their investments.
- Since central banks have recognized the limits in their capacity for intervention, and have therefore gradually discontinued negative interest rates, since the start of a rise in long-term interest rates which has boosted equity markets, and since the upward revision of growth prospects, the main question for the coming months is the potential for reflation. In this environment, we consider equities and funds specializing in companies capable of regular earnings growth offer visibility. These growth stocks, which performed poorly in 2016, should offer reassurance in this uncertain environment, and it is here that the words of ***Gabriele d'Annunzio*** take on a new meaning.
- We will analyse consecutively the different stock markets, currencies, interest rates, the oil market, and other major commodities.

Stock markets: ***"Nothing is ever certain for man, neither his strength, nor his weakness, nor his heart… and when he thinks he is embracing his happiness, he crushes it," Aragon***.

- Stock markets have been very resilient: reviewing 2016, with its combination of economic disappointments regarding growth, and political risks due to the surge in populism nearly everywhere in the world, the resilience of financial markets may sometimes seem surprising. The lack of alternatives is a key cause, and volatility one of the consequences. We could add stock market gains to the list in Aragon's verse.
- In early 2017, markets will probably continue to be boosted by a slight acceleration of economic growth, an increase in discretionary consumption, a continuation of quantitative easing in Europe and Japan and further share buybacks.

- ***United States: neutral***.

  Once again, the US market has outperformed the other major stock markets, and there was extensive sector rotation, but valuations have become higher each year since 2012, as there has been no overall growth in earnings. What will be the situation in 2017? The forward PER is now 17x, a high level which raises questions concerning the market's drivers.

  Neither the Fed (which will raise interest rates), nor the US dollar (which will probably continue to strengthen), nor changes in the debt burden (which is worsening), nor net debt/EBIT ratios (which have exceeded the previous highs reached in the year 2000), nor the possible protectionist measures mentioned during the election campaign will support the market.

  We can be sceptical regarding two other reasons often mentioned for buying: companies' cash piles and share buybacks. Admittedly, companies' cash holdings at end-2015 were at a high of $1,700 billion, according to Moody's, but corporate debt increased by $850 billion year-on-year, to $6,600 billion. Admittedly, share buybacks, at $500 billion each year, equivalent to 15% of the market capitalization since 2009, are a factor of support in the short term, but they are negative for the manufacturing outlook because they consume part of the cash flow and they push up debt ratios.

  Despite these various aspects, the market will probably be supported by four factors: a change in tax policy, increased budget spending, consumption boosted by an acceleration of wage growth, and a populist surge which has a "reflationary" aspect. We may add that no recession is foreseeable until 2018 and that, including financial stocks, cyclicals and energy-related stocks, earnings growth could be close to 15% this year.

- ***Europe: overweight***.

  Overall, the market should be firm, because the growth momentum is positive, credit volumes are increasing by 4% year-on-year, employment and consumption have improved, and the market's performance and valuation remains below that of the US market. Also, at least throughout 2017, the ECB will continue its policy of liquidity injections and the depreciation of the euro will boost corporate earnings. These expected to grow by more than 10% this year. The elections in France and then in Germany are unlikely to cause markets to falter.

  - Still positive on mid-caps: since their debt ratio is lower than that of large caps in the Eurozone, upward pressure on interest rates is unlikely to cause an underperformance by small caps.
  - Which countries do we prefer? We prefer the main markets (France and Germany) compared with the peripherals (Italy and Spain), because the latter have profited greatly from the reduction in sovereign spreads and the fall in corporate bond yields. Non-financial companies of southern European countries have high debt ratios and are therefore more exposed to a rise in interest rates than the French and German markets.
  - Which sectors should be avoided or preferred in a context of rising long-term interest rates? Prospects of upward pressure on long-term interest rates lead us to avoid heavily indebted companies, i.e. telecommunications stocks and environment-related stocks (utilities). Symmetrically, we prefer companies generating free cash flow, especially companies with a high EBIT relative to their interest and bank charges. The positive consumption trend will benefit stocks in that sector.
  - What about the banking and insurance sector? Since 2007 the European banking sector has lost 75% of its stock market value, and most banks are trading at less than the value of their shareholders' equity. There are various reasons for this: non-provisioned non-performing loans, estimated at 11% of Italy's GDP, 8% of Spain's GDP and 7% of Portugal's GDP, the digital revolution which requires a reorganization of networks, and negative interest rates. But the credit recovery is benefiting the banks, and the steepening of the yield curve is positive for banks and insurance companies. In Italy, nationalization of Monte dei Paschi Bank, and the conversion of subordinated debt into equity or a deconsolidation of the non-performing loans of certain banks should improve the banking sector's risk profile. In Germany, we are more cautious. Deutsche Bank's fine due to its US litigation will not eliminate the need for the bank to make other provisions for miscellaneous litigation, and it is burdened with a portfolio of €42,000 billion in derivative products, equivalent to 14x Germany's GDP.

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- What about high-dividend stocks? We are selective regarding companies paying high dividends, very much sought-after by investors in pursuit of yields, but often chosen without watching out for the sustainability of the dividends, the vulnerability of the company's share price and the cyclicality of earnings, and overlooking the fact that such companies often have low growth.

The United Kingdom:

From a stock market viewpoint, some sectors will continue to be penalized by Brexit, the depreciation of the pound and an expected slowdown in economic growth. Examples being financials, property stocks and retailers. Conversely, companies dependent on foreign markets, such as Vodafone, Kingfisher and Bodycote, will benefit from the depreciation of the pound sterling.

- ***Japan***: ***hold***.

  The market is supported by two factors: purchases by the Bank of Japan (1.2% of the market capitalization each year), and share buybacks by companies, which were insignificant for a long time but which now amount to 3% of GDP. We could add that households have more than half of their assets in cash and only 8% in equities, but that is not new. What still has to be done is to win the confidence of foreign investors disappointed by the authorities' inability to meet their targets of 2% inflation, a pickup in growth and a weakening of the yen.

- ***Emerging countries***: ***underweight except for a neutral position on China***.

  Given the political situation, one could be surprised by the resilience of some markets, such as the Turkish, South African and Brazilian markets, and the Russian market, at a peak despite the economic sanctions. We recommend staying away from Turkey and South Africa.

  Until Donald Trump's position regarding protectionism is clarified, it is wise to stay away from emerging countries, especially those which, like Mexico, have based their development model on promoting the export of manufactured goods.

  This caution is especially important since, as stressed by the International Monetary Fund, between 2004 and 2014, the debt of non-financial companies in emerging countries increased from $4,000 billion to $18,000 billion, and the proportion of that debt in foreign currencies has also increased over the years.

  What about Asian markets? Some commentators are surprised that this region, which generates 50% to 65% of global growth and one-third of global GDP, accounts for only 15% of the global market capitalization. But past experience, e.g. the period of strong post-World War II economic expansion in Europe, shows that there is no parallel between high economic growth and rising stock markets. Quite the contrary, during periods of expansion, capital is used for investment, and there are numerous initial public offerings and capital increases which can cause congestion at times. So let us draw no hasty conclusions from the fact that the market capitalization to GDP ratio in China is 30%, while it exceeds 100% in the United States.

A neutral position on China can be explained by the persistence of measures to stimulate credit, ensuring growth in the short term but giving reason for concern in the medium term.

Currencies: long positions on the Swiss franc and US dollar, hedged on the pound, yen, euro and yuan.

- A positive trade balance means that a country lends to the world, and vice versa. As such logically, the US deficit should justify a depreciation of the US dollar, and the Chinese, European and Japanese surpluses should justify an appreciation in each of these currencies. The trend was in fact the opposite in 2016, because markets anticipated a possible acceleration of growth and inflation in the United States and hence sharper interest-rate hikes.
- ***Euro/US dollar***: ***further appreciation of the US dollar reaching parity***.

  In the United States, the combination of a more restrictive monetary policy, a probably more expansionary fiscal policy and an improved PMI production index points to further appreciation of the US dollar. This is especially true where monetary policies elsewhere still favour quantitative easing. The euro peaked in October 2009, after nine years of very strong appreciation.

  In the long-term, the US dollar is a weak currency, but it has periods of appreciation: +40% in nominal terms between 2011 and end-2015, +40% between 1995 and 2002, and +65% between 1979 and 1985. To those who contrast Europe’s current-account surplus (3.5% of GDP) with the US deficit of 2.5% of GDP, and believe in a revaluation of the euro, it should be noted that this surplus is mostly due to Germany (7.5% of GDP), and accessorily the Netherlands. In recent years, the PIIGS have at best reduced their current-account deficits which, admittedly, reached 10% of GDP in 2008. What will be decisive in 2017 is the number of US interest-rate hikes decided on by the Fed.

  Fluctuations in the US dollar can have major consequences for the situation of many companies and many emerging countries, because dollar-denominated debt outside the United States is estimated at $10,000 billion - sometimes, it is true, guaranteed by revenues in dollars.

- ***Yen***: ***hedge maintained against the US dollar***.

  The stated ambition is to weaken the yen, and, given the liquidity injected, the result so far is disappointing. The yen's recent decline merely reflects an appreciation of the US dollar against all currencies, and it could continue to 125.

  Fundamentally, we question whether a weak yen can generate extra growth in a country which has offshored many factories, which imports 60% of its food reuqirements, and which holds foreign assets representing 60% of GDP.

  Currency devaluation, which is often sought by governments, adversely affects importers and consumers. It is supposed to be favourable to exporters, generally manufacturers, but the impact is often disappointing because, as a consequence of globalization, the imported content of exports has greatly increased. It is also ineffective when there is no price elasticity. The recent example of Japan is topical because, despite a 40% decline in the yen, exports have scarcely changed. The same will almost certainly be true in the United Kingdom. The pound sterling will fall further, but exports will not benefit from this, because manufacturing industry, as a percentage of GDP, is small (less than 11%).

- ***Swiss franc***: ***continued strength***.

  To understand the strength of the Swiss franc, compare Switzerland's GDP growth with that of the major developed countries. Since 2007, Switzerland has ranked first for cumulative growth, and has managed to avoid a recession. Around 11% GDP growth, that's better than the United States (10%), and better still compared with the UK and Germany. To corroborate this positive view, we should also note the trade surplus, at an all-time peak in the first eight months of 2016, the current-account surplus of CHF 73 billion in 2015, an expected budget surplus this year (CHF 2.2 billion) and the SNB's balance sheet of CHF 720 billion. These figures demonstrate the adaptability of the Swiss economy and its companies. The trend is confirmed by the low unemployment rate of 3.2%. In this regard we agree more with the Peterson Institute, that sees the Swiss franc as undervalued by around 7%, than with UBS, who anticipate (and have anticipated for a long time now!) a sharp fall in the value of the Swiss currency.

- ***Pound sterling: hedge maintained***.

  The result of the Brexit vote caused the pound to fall by around 18%. Since then it has stabilized. The activation of Article 50 by the end of March 2017 will almost certainly cause a further fall in the pound.

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Fundamentally, we are reminded of the chronic weakness of this currency, which was worth CHF 12 in 1973 and now trades at CHF 1.22! The UK economy will not benefit from currency devaluation because its industry is closely integrated into the Eurozone for components, and represents only 11% of GDP. The UK has a chronic trade deficit, among the highest in the OECD area, and its economic prospects are increasingly gloomy. Convincing evidence of this is provided by the significant revisions, downward for growth and upward for the budget deficit, recently made by the Chancellor of the Exchequer. To that we can add the figures released by the Chancellor in November, a reminder that hourly productivity in the UK is 25% lower than in Germany and 20% lower than in France and Italy. So there are several factors pointing to a further weakening of the pound.

- ***Yuan***: ***further depreciation***:

  The yuan continues its creeping depreciation (by 10% since May 2015) due to capital outflows, a decline in foreign exchange reserves, from $4,000 billion at the peak to $3,166 billion, and a loss of export competitiveness, illustrated by a 5.6% year-on-year decline in exports.

  The contraction in foreign exchange reserves is not necessarily worrying because the country still has one-third of global foreign exchange reserves and because it reflects an unprecedented effort by Chinese firms to make acquisitions beyond their borders (€155 billion in 2016). There is even less reason to be alarmed because the trade balance still posts the biggest surplus in the world, $600 billion in 2015.

  However, free convertibility remains a distant prospect. The authorities seem to fear that there would be massive outflows of households' capital, but they are struggling to reconcile a fixed exchange rate regime and freedom of capital movement.

  Finally, we may add that one-quarter of China's foreign trade is now denominated in yuan, i.e. 2.5% of payments worldwide. The currency has been included in the SDR (Special Drawing Rights) in the International Monetary System, with a 10.9% weighting compared with 41% for the dollar, 31% for the euro, 8.3% for the yen and 8% for the pound sterling.

  Given the prospect of further depreciation of the yuan, we will keep an eye on the currencies of emerging countries which often move downward in step with the yuan.

- ***Australian dollar: a slight strengthening***.

  The policy rate was cut by 0.25% to 1.5% in August, because the inflation rate is low, at 1.7%, wage growth is moderate and job creations are modest. The currency reached a low of 0.68 against the USD in January, and since then it has risen slightly to 0.72 due to the first signs of a recovery in commodity prices.

Interest rates: ***"In financial matters, whatever is pleasant is unhealthy, and whatever is healthy is unpleasant", Churchill*** in 1926.

$16,000 billion worth of financial assets have been acquired by central banks since 2009, and after seven years of liquidity injection, it is time to take stock:
What is pleasant, to adopt Churchill's phrase, is the fact that long-term interest rates are two or three percentage points lower than they should be in light of the worsening public debt situation. It is pleasant that governments have been able to extend the maturity of their debts and improve their solvency ratios.
What is unhealthy is the fact that the primary cause of the decline in budget deficits is often the reduction in the cost of debt. Having absolutely no incentive to be disciplined, governments are taking advantage of the low rates to allow their debt to spiral. What is unhealthy is asset price inflation, disconnected from earnings growth, inflation favourable to the owners of capital and therefore increasing inequalities.
It is unpleasant to have to conclude that the liquidity injections have succeeded in limiting the duration of recessions but have hardly stimulated credit, hardly revived growth, and hardly made it possible, so far, to bring the inflation rate up to 2%. What is even worse is that they have encouraged the substitution of capital for labour, and therefore sacrificed employment. They have allowed unprofitable companies to survive and have therefore maintained overcapacity, with deflationary pressure on prices in many sectors.
The results are mixed, but central banks have nevertheless offset the shortcomings of government policies, even though they have no miracle recipe for stimulating growth.

- ***What prospects***?
    - A slight rise in inflation outside the United States: in the United States recently, core inflation, excluding energy, was 2.2%, exceeding the 2% target, wage growth was 2.9%, rental inflation was accelerating and inflation in services – accounting for almost two-thirds of the consumer shopping basket - was 2.9%. Elsewhere, inflation remains below the 2% targets, at 0.9% in Europe for core inflation (and 1.1% for headline inflation in December) and -0.5% in Japan.

      Despite the stir aroused by the publication of the German inflation figure, despite the effect of the fall in the Eurozone's currency against the dollar and the effect of the doubling of the oil price in one year, inflation will remain low. Services, which are an essential part of developed economies, face stiffer competition, an "Uberization" of the economy, and in future they will face competition from automation. Examples such as taxis, the hotel industry, travel agencies and in many other sectors. Inflation is also being curbed by the stagnation of wages, the persistence of disguised unemployment in many countries, competition from self-employed entrepreneurs, mini-jobs in Germany paid €400 per month, the Renzi Act in Italy and the measures adopted in Spain and recently in France, which increase flexibility in the labour market. We may add the reduction in economic sensitivity to fluctuations in commodity prices and, finally, the decline of potential growth in recent years. These are all barriers to inflation.

Nonetheless we fear a resurgence of inflation if protectionist measures were to become widespread, and if measures were taken to counter competition from low-wage countries and to hinder offshoring.

- A gradual removal of negative interest rates: at present, official interest rates are negative by 0.75% in Switzerland, 0.65% in Denmark, 0.4% in the Eurozone, 0.35% in Sweden and 0.1% in Japan.

  If these negative interest rates were adopted, it was because of the prevalent deflationary risks, which are no longer perceptible. In those countries which have chosen to adopt negative interest rates, the stock market has declined or has been only slightly positive. This is true of Switzerland, Japan and European markets. Conversely, the best stock market performances have been observed in emerging countries which have the highest interest rates, such as Brazil and Russia.

  Negative interest rates can only be temporary, because their knock-on effects are very harmful for wealth, as a negative interest rate is equivalent to a tax. While wealth erosion was for a long time due to inflation, it is now the result of negative interest rates. And yet, German criticisms complaining of the ruin of savers are excessive, because the German economy is boosted by a low euro.

  It is also harmful for pension fund management. Negative interest rates add to the problem of pension management, already rendered acute by longer life expectancy, population ageing, slowdown in structural growth and, more recently, the decline in salaried work. Future generations will have to bear the public debt, face difficulties in finding jobs, and cope with a reduction in pensions.

  Harmful also for investment and consumption: by introducing negative interest rates the central bank thought it would discourage saving and stimulate consumption. The opposite occurred, because a negative interest rate instils worry about the future, and households prefer to save more rather than less for their retirement. The negative interest rates were supposed to stimulate credit, but in practice, because of the Basel III regulations, the banks are subject to other constraints.

- Ongoing liquidity injections in Japan, Europe and the United Kingdom, at a rate of $2,000 billion per year, will curb a rise in interest rates which would be very harmful to indebted economic agents, both governments and companies.
- A stabilization of public debt ratios: thanks to the fall in interest rates and the budget surplus, the public debt ratio has declined in Germany (from 81% to 71%), in the Netherlands (from 68% in 2014 to 65%), very slightly in France in 2016 and, outside the Eurozone, in Denmark and Sweden. Elsewhere, in most countries, a stabilization of government debt ratios is expected. To reduce the public debt, we can see only three options: restrictive fiscal policies (but there are few advocates of this approach at present), an economic growth rate that is higher than the level of interest rates (several countries enjoy such a situation) or a partial default, but this is no longer a risk in the short term.
- Ongoing increase in corporate debt ratios: in the United States, companies have taken advantage of low interest rates to optimize their balance sheets. Their debt has increased significantly, and hence, according to S&P, whereas in 1998 there were 100 firms in the S&P500 enjoying an AAA rating, now only two remain, Microsoft and Johnson & Johnson. In Europe and Japan, there has not been the same use of borrowing, as banks, struggling with the Basel regulations, have less leeway for lending. With the restoration of confidence and ongoing purchases of corporate bonds by the ECB, that could yet change.
- Further widening of yield spreads between the United States and Europe: the differential between the German 10-year yield and the US 10-year yield is almost at a peak since 2011 (at 2.10%). It will probably increase further in the first part of the year because the monetary policies of the Fed and the ECB will continue to take diverging paths.

- ***What will be the Fed's policy? At least three interest-rate hikes***.

In the United States, the federal debt has doubled since 2007, to 75% of GDP (public debt of 105% including federal entities), but the cost of debt (1.2% of GDP) is at its lowest level since 1968. The Fed is the biggest holder of US Treasury bills, $2,460 billion worth out of a total of $13,400 billion, a figure to be compared with the amounts held by the Japanese and Chinese, $1,130 billion and $1,120 billion respectively. If the Fed has kept $4,000 billion on its balance sheet, it is because the economic indicators are contrasting.

Factors in favour of an interest-rate hike are the prospect of growth stimulus measures which could be adopted by the Trump administration, confidence indicators, job creations, low unemployment rate, signs of an acceleration in wage growth, perceptible especially for those who change jobs (+4% year-on-year according to the Atlanta Fed), business innovation, property price inflation in the commercial sector (which is worrying some members of the Fed such as Rosengreen), and service price inflation, at 3.1%.

Against this backdrop, the obstacles to interest-rate hikes, such as margin erosion, rising default rates and weak growth in investment, seem feeble.

Finally, remembering that, on average, in each recession since the start of the 1980s, interest rates have been cut by five percentage points, the Fed is far from being able to face the next recession calmly and must therefore do everything to increase interest rates without killing growth.

- ***What will be the European Central Bank's policy*? *A gradual removal of negative interest rates in 2017*.**

The total balance sheet of the ECB in mid-2016 was €3,240 billion, equivalent to 30% of Eurozone GDP, compared with 95% in Switzerland, 85% in Japan, 20% in the United Kingdom and about 25% in the United States.

In 2017, the ECB will inject €780 billion, slightly less than the 2016 figure of €960 billion, and has agreed to raise the cap on its purchases above 30% of the debt stock. To boost economic growth, each month it acquires about €5 to €10 billion in corporate bonds with at least a BBB-rating, compared with the stock of corporate debt which stands at €660 billion. This figure is larger than the issuance by non-financial companies, and such purchases could lead to valuation differentials with US corporate bonds.

There are four reasons to expect the ECB to maintain its policy of liquidity injection, which will continue to provide an incentive for domestic investors to buy Treasuries.

Firstly, it has not yet reached the 2% inflation target.

Secondly, it aims to restore the flow of savings between Eurozone countries, because at present it cannot be said that there are any genuinely European banks. In Greece before the crisis, 25% of the banking system was owned by foreign banks, compared with zero at present.

It must also overcome contradictions between its policy and Basel III, between its desire to make lending conditions easier and the capital constraints affecting banks, which account for the fact that they keep around €700 billion in liquid assets at the central bank. The credit lever remains important for the ECB, because European companies still obtain 75% of their financing by means of borrowing, versus 25% in the United States. The LTRO is an effective tool, because banks which borrow from the ECB benefit from a negative interest rate and lend at a premium.

Finally, the ECB must watch out for the banks' solvency, i.e. changes in the capital adequacy ratio. Since the start of the crisis, banks have doubled their capital; recently, they successfully passed stress tests which evaluate their level of capital but which, it should be noted, do not evaluate liquidity, i.e. the capability of a bank to meet cash obligations. The European banking union is being established, but the European guarantee fund will be only €55 billion in 2023 and, to take just the French as an example, the deposit guarantee fund is only €2 billion compared with €1,500 billion in deposits.

To conclude regarding interest rates worldwide, remember what we have stressed several times: the traditionally defensive nature of fixed-income investments is undermined by the volatility of interest rates and the prospect of a rise in interest rates. To take an extreme example, a 1% rise in the yield of a thirty-year bond would cause a 35% variation in the price of a zero-coupon bond. So the watchword is caution, with a preference for equities. From a slightly longer-term perspective, central banks will endeavour to stay on the dividing line between excessively lax monetary policies which would ultimately arouse mistrust regarding the currency, and excessively restrictive monetary policies which would cause a rise in interest rates and risks of default. It may be feared that if economic growth remains weak and not very inflationary, several countries will have to restructure their debt.

- ***What will be the Bank of Japan's policy*? *Continuing liquidity injections at the same rate*.**

  The consequences of Japan's extreme monetary policy are an official interest rate of -0.10%, which can hardly be reduced because banks hold over half of their assets in cash, a 10-year yield capped at 0, which guarantees the cost of capital, a central-bank balance sheet which has reached a record of 85% of GDP, a portfolio of government bonds which represents more than one-third of Japanese debt and will represent 50% in 2018, and annual bond purchases which are equivalent to 16% of GDP and which absorb all the new debt. Not to mention that the Bank of Japan has become the biggest buyer in the equity market!

  Overall, the Bank of Japan injects the equivalent of €660 billion each year. Each year it purchases JPY 80,000 billion worth of government bonds, JPY 3,200 billion worth of corporate bonds and JPY 6,000 billion worth of equities, or 1.2% of the market capitalization.

  Despite all these measures, the core inflation rate remains negative, at -0.5%, and the yen rose 3% in 2016 against the US dollar whereas the euro lost 3%. The only reason for satisfaction is the recent inflection of monetary policy, the decision to target a 10-year yield of 0% which is positive for the banking sector.

  To conclude, Japan seems unable to wean itself off quantitative easing and, at best, will eliminate the official negative interest rate.

Oil:

- ***What outlook for oil prices? Brent between $45 and $65 per barrel***.

- Low prices have shaken up the industry, the oil production companies have reduced their operating costs, increased pressure on their suppliers and obtained reductions of up to 60% in daily hiring prices. The Douglas-Westwood consulting firm estimates a fall in exploration-production costs on projects confirmed between 2012 and 2016 at 40% on average, and Wood Mackenzie estimates that 70% of oil projects are now competitive with an oil price of less than $60 per barrel.
- <u>The agreement between producer countries</u>:

  Prices have been able to recover because the various protagonists shared the same dependence on oil revenues and suffered a sharp deterioration in their public finances, so it was in their interest to establish a formal agreement.

  The agreement between OPEC member countries provided for a reduction of 1.2 mbpd in the member countries' production, thus removing 1.5% from global supply, and several non-OPEC countries, notably Russia, also agreed to reduce their production.
- <u>Impact on the price of crude oil in 2017</u>?

  The price rise will be limited by growing production in the United States, which de facto acquires the status of swing producer. US production peaked at 9.7 mbpd in 2015, but in 2016 crude oil production did not exceed 8.7 mbpd. However, the number of wells in production, which declined by 75% between 2014 and May 2016, has started to increase, because shale production is now conceivable with prices close to $45 per barrel.

  The rise in prices will also be limited by an increasingly weak increase in demand, due to sluggish global economic growth, increased energy savings and a real boom in alternative energies.

  We therefore adopt a price scenario of $45 to $65 per barrel for 2017.
- <u>2018 and beyond</u>:

  After 2018, prices will probably rise further, because overcapacity will decrease. Spending on exploration has dried up in recent years and, according to the International Energy Agency, unused production capacity has been reduced from around 2 mbpd at end-2015 to 0.2 mbpd at end-2016.

  Due to the fall in oil prices, global discoveries, at 12 billion barrels, are at their lowest since 1952, far from the 47 billion barrels found in 2010 (according to the IHS consultancy).

- ***Oil companies on the stock exchange:***
  At the current price of $55 per barrel, it is still possible to take an interest in integrated companies, the big majors, and if crude prices fell to around $45 again, then pure production companies could be purchased. The idea is that the current price range of $45-65 per barrel could be followed, in 2018, by a second round of price increases, due to the fact that far fewer new fields will be brought into production because companies have slashed their exploration-production budgets.

Other commodities and metals: caution

In 2016, there was a substantial upturn in the prices of various commodities, admittedly after years of decline. Bolstered by major efforts to reduce production costs, boosted by cuts in capacity, driven by cuts in exploration budgets and favoured by the Trump administration's programme, these price rises often remain vulnerable, because global growth will probably increase only moderately. The only metal on which we are positive is gold.

- ***Gold:***
  Gold benefitted greatly from the implementation of quantitative easing policies from 2009, and hence from the fall in interest rates to very low levels. Symmetrically, gold fell, in the second half of 2016, with the prospect of a rise in US interest rates. Gold remains volatile and we therefore advise reducing positions at $1200/ounce and buying if the price falls to $1050/ounce.
- ***Coal*:**
  Global coal reserves are concentrated, with 26% in the United States, 17% in Russia, 13% in China, 9% in Australia and 7% in India, and coal maintains a stable position in the global energy balance, at around 28%.
  The key player is China, with 44% of production, 50% of global consumption and 16% of global imports. According to the Platts Agency, in 2001 a tonne of thermal coal traded at $140, and in early January 2017 at $110, after bottoming at $47 in January 2016. Recently, China has stated its determination to reduce its capacity by 300 million tonnes each year until 2020, when production is expected to reach 3,900 million tonnes and consumption 4,100 million tonnes. But it is still too soon to believe in a lasting stabilization. India is looking to increase its production and thereby reduce its imports, and Platts estimates at between 1,200 and 9,000 the number of mines which will probably have to be shut down in the coming years to restore the

market's balance. In the Shanxi, however, which accounts for one-quarter of China's production, the provincial government is renewing loans to companies.

- ***Iron ore***:

  China accounts for more than 40% of global production, ahead of Australia 17%, Brazil 14% and India 8.5%. China still has very large stockpiles, and the recent stimulation of the Chinese economy will have only temporary effects. Accordingly, the 81% price rise in 2016 to $78/tonne remains vulnerable.

- ***Steel***:

  China accounts for 50% of global production of 1.67 billion tonnes. Its consumption has doubled in ten years to 740 million tonnes, but it exports large quantities, 112 million tonnes in 2015, a figure exceeding the production of the second-largest global player, Japan. After the steep fall in prices in 2015 (-30%), China announced a reduction in capacity by 100/150 million tonnes over five years, resulting in 500,000 job layoffs. This is still insufficient, however, especially since China is unwilling to cut its subsidies. A close watch will be needed on the measures that Donald Trump takes following his election, the taxes that the European Union could increase, and the impact of the trade barriers established by India and South Africa.

- ***Zinc***:

  Zinc is used in the galvanization of steel, and demand for the metal has been boosted by the pickup in steel consumption in China; the price has also been driven up by Glencore's decision to shut down significant production capacity.

- ***Copper*:**

  The main producers are Chile, which accounts for one-third of global production, Peru and the United States, 7% each, and Australia, Russia and Zambia, 4% each.

  There is still excess supply, production has increased by more than 5% year-on-year but the sector is benefiting mainly from economic stimulus in China, strong activity in China's real estate sector and, accessorily, from the prospect, mentioned by Donald Trump, of an infrastructure renovation programme in the United States.

  At the current price, caution is starting to become imperative, because we foresee a slowdown in real estate in China in mid-2017 and because mines temporarily shut down in the Democratic Republic of Congo and in Zambia could re-open.

- ***Basic resources companies on the stock exchange:***

  While the companies in the sector posted excellent performance in 2016, that is because the previous years had been dreadful and because the companies have undertaken major restructuring programmes. BHP posted a loss of $6.4 billion in the first half and reduced its dividend drastically, because it had to write down by $7 billion the $20 billion acquisition made in 2011 in the shale oil sector. Glencore also posted a net loss and has endeavoured to dispose of mining assets to reduce a net debt of $23 billion contracted at the time of the $30 billion acquisition of Xtrata in 2012 when it wanted to reduce its dependence on the trading business. This same Glencore has profited from the recovery in the zinc price since it decided, at end-2015, to reduce its production sharply.

Conclusion:
It is astonishing to see how fast financial markets changed their expectations at the time of Donald Trump's election. The ambient fear, in mid-2016, was deflation, while now the media speak of nothing but a pickup in inflation. Investors were expecting indefinitely accommodative monetary policy to avert a debt crisis, while they now expect three interest-rate hikes in the United States in 2017.

What to think? In 2017, economic growth will be undeniably stronger than in 2016 because the economic situation is better in Europe, China will do everything to maintain growth before the Party Congress in November, and because in the United States, fiscal stimulus and tax cuts will fuel additional growth.

Financial markets will benefit from this: initially, value stocks, stocks considered undervalued, consumer discretionaries, cyclicals, financials, especially insurance companies, and to some extent commodities, in line with the second half of 2016, then, fairly rapidly, growth stocks will again be preferred at the expense of "value". Our preferred market is Europe.

The securities and countries to be avoided will be the same as at the end of 2016, i.e. bonds, shares of heavily indebted companies that are sensitive to rising interest rates, utilities, telecommunications stocks, and emerging markets penalized by the appreciation of the US dollar and by Donald Trump's protectionist talk.

The stock market will have a good year, but at the end of the second half, fundamental questions regarding the spiralling growth of global debt, low productivity gains and the consequences of population ageing will resurge. And, if protectionism were to prevail, financial markets would fall.