BANQUE
ERIC STURDZA

WHERE WILL IT BE POSSIBLE TO MAKE MONEY IN 2018?

THE PROBABLE
THE POSSIBLE
THE HYPOTHETICAL
THE RISKS

"Every certainty is a lie", Henri Poincaré

Bruno Desgardins

15 January 2018

- 2017 performances (measured in CHF) were exceptional: the Nikkei posted +18%, the Euro Stoxx 50 +16%, both the S&P and the SMI +14%, Gold +8% and the Commodity index +15%. The forecasts of major institutions, the OECD and World Bank, forecast 3.6% global growth in 2018, in line with the figures for 2017.

- This optimism is supported by strong job creation (totalling 8 million in the OECD in 2017), an upturn in global trade, and positive business and consumer sentiment worldwide. Although the growth cycle has extended beyond nine years in the United States, according to the IMF real GDP there is only 15% higher than its pre-crisis level in 2007. And, in Europe and Japan, it is only 6 and 5 percentage points higher respectively. So there is no over-heating.

- Despite these reflections, on the threshold of 2018, many questions arise, the replies to which will determine the guidelines for investment policy:

    - First, the situation of the leading world economy, the United States. Is there a risk of overheating due to implementation of a tax reform? Is there a risk of recession after more than 100 months of growth? Is it possible to imagine a non-inflationary continuation of the growth cycle? More specifically, is there possibly a bubble in technology stocks?

    - Next, China: Should we worry about a slowdown in a Chinese economy grappling with extensive overcapacity in industry, and the excessive debt of businesses and numerous provinces? Or should we on the contrary, applaud the very fast development of new technologies and automation?

    - Likewise, Europe, with three themes: the sustainability of the recovery, the institutional reforms that can be expected, and the impact of Brexit.

    - In Japan, there is speculation concerning on the one hand, the effects of a policy of quantitative easing on an unrivalled scale. While also, the chances of success of the policy pursued by Shinzo Abe to encourage companies to raise wages and reduce their cash piles.

    - These aspects should provide an answer to the trend in commodity prices, especially regarding Oil, and the trend for inflation and thus interest rates.

    - Another aspect to consider is the "hypothetical", i.e. what could be the result of the elections in Brazil, in Mexico and elsewhere?

    - Lastly, we will have to consider possible geopolitical risks (Iran, North Korea), which, in stock market history, often prove decisive.

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

- To answer the question of the title page, we have a guide, the words of Henri Poincaré, quoted in the title and set out in his book entitled "Scholars and Writers", and four factors: the probable, i.e. regions or sectors to be over-weighted; the possible, i.e. neutral weightings; the hypothetical, which may represent investment opportunities; and the risks, which will require underweighting.

I. **The probable** :

1. ***Japan***: ***"The sun is now my companion on the highway of life", Mishima***.

- The Japanese market posted a strong performance in 2017, but the bull trend is not exhausted. Liquidity injections by the Japanese central bank since 2012 are unmatched worldwide, and have capped the 10-year interest rate at 0% even though the country is the most heavily indebted of the OECD, at 2.3x GDP. Economic growth is expected to reach 1.3%. To the sceptics, we can point out that, calculated on a per capita basis or better still, per person employed, this growth is in fact higher than that of the United States or the European countries. Remember that the population is declining, with 941,000 births in 2017 for 1.3 million deaths.

- The outlook remains positive: public debt, at 2.3x GDP, has been stabilized by Abe at 2012 levels. Industrial production has risen 3.7% year-on-year. Exports in volume terms have risen 18% year-on-year, as businesses profit from the lagged effects of the depreciation of the yen. The unemployment rate is 2.7%, the lowest level in the past 22 years. The number of employees has risen 1.7% year-on-year. Wage hikes are small but nevertheless higher than inflation growth, which has boosted consumption, up 1.7% year on year. In short, it can be observed that all growth components are positive. The inflation target of 2% seems unattainable in the near term. The Japanese central bank will be the last to stop QE. At the same time, businesses, with a cash pile exceeding $3,000 billion, are starting to show a concern for return on equity. At Abe's instigation, they will probably be incentivised to increase wages in order to benefit from tax cuts which would stimulate household consumption.

2. ***Europe and the Euro***: ***"Nothing is possible without people, nothing is lasting without institutions", Jean Monnet***.

    - People and institutions: a regained confidence of the former and the necessary consolidation of the latter; the consumer recovery, and plans for a new start for Europe. These are the two reasons for our overweight European exposure in our portfolios. Economic growth exceeded US growth in 2017, at 2.4%, and will probably be identical in 2018 with a pickup in investment and credit, an unemployment rate at 8.7%, far from the 12.1% reached at the peak of the crisis, and a manufacturing confidence index at its highest level in twenty years.

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

- The growth outlook remains positive, especially for the German-French tandem which accounts for half of the Eurozone's GDP.

For France, recovery and reform, for Germany robust macroeconomic indicators, 2.3% growth well above the average of 1.1% per year observed since 1999, strong exports, worth €1,180 billion in 2017, almost twice the GDP of Switzerland, a large trade surplus of €226 billion, and further debt reduction.

For both, the hope of being able to combine their efforts to revive the process of European integration in agreement with their main partners.

For France, a cyclical upturn boosted by an upturn in building permits, (+30% year-on-year), and growth in corporate credit volumes (+5.7%). Manufacturing companies' margins at their highest level since the early 2000s, partly thanks to a reduction in payroll taxes.

For Germany, the benefits of the Schröder reforms, an unemployment rate at an all-time low of 3.6% according to Eurostat, a record number of people employed (44.3 million, or 5 million more than when Schröder stepped down), wage growth of 2.5% for core inflation of only 1.4%, and hence better retail sales and 2.3% GDP growth in 2017.

For France, the benefit of renewed confidence due to the labour-market reform which introduces flexibility and allows multi-national firms to lay off employees referring solely to the situation of their French subsidiary. Likewise, the tax reform which introduces a flat tax of 30% on investment income eliminates the wealth tax on personal property and introduces a staggered reduction in corporation tax to 25% in 2022.

For Germany, a further reduction in the public debt to 67% of GDP thanks to a budget surplus estimated at €30 billion in 2017, or 0.9% of GDP, and for businesses and households an economic situation conducive to increased public investment in infrastructure and private investment in production capacity, because capacity utilization rates are very high.

The performance of these two economies should not mask either the persistence of sustained growth in Eastern Europe, or the recovery in southern European countries. The unemployment rate has fallen from 17% to 8.8% in Portugal, from 27% to 17% in Spain and from 27% to 20% in Greece.

- After growth, the second reason for continued overweighting of Europe is again monetary policy, still surprisingly stimulating given the robustness of growth. This year, at a rate of €30 billion per month, QE will amount to €270 billion, and the official interest rate remains negative at -0.40%. To assess the success of this policy, remember that 10-year Portuguese debt is currently far less expensive than 10-year American debt: 1.78% compared with 2.53%!

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

- Lastly, the third reason for confidence is the expectation of a fresh start to the process of European integration, now perceived as a necessity in response to Chinese competition, the erosion of American protection, the challenge of new technologies, as well as migration pressures. An expectation dependent on the formation of a German coalition government which ought to be conducive to European consolidation. An expectation tied to the Italian elections in March. At the same time, we note with satisfaction that anti-euro parties are toning down or even discontinuing this theme. We are thinking in particular of the National Front in France and the Five Star movement in Italy. We could add the ousting, in Poland, of two openly anti-European ministers. The fields for European consolidation remain those that we described in detail in our previous report: discontinuation of the rule of unanimity in many areas, transformation of the ESM into a European Monetary Fund (funded by the ECB if necessary and no longer exclusively by national budgets), a change in competition policy in favour of a common front against China, creation of a European "bad bank" and reinforcement of the banking union, and progress towards a Social Europe with a minimum wage and a minimum level of social protection.

- For all these reasons, the European market continues to be over-weighted, especially since its valuation is lower than that of the US market, and corporate profits are still 25% below their 2007 peak whereas in the United States they are around 40% higher.

3. ***Oil and commodities***:

- The balance between supply and demand: while demand is boosted by the global economic growth environment, supply is more difficult to assess. First there are new discoveries, only 7 billion barrels of oil equivalent in 2017 to be compared with 8bn in 2016, 15bn in 2015 and 30bn in 2012. Following the fall in oil prices from $110 to $25 per barrel, oil companies reduced their exploration budgets by 60%. The consequences are being felt today, because the replacement rate fell to 10% in 2017! The supply is also the result of an agreement between OPEC and Russia to extend a production cut of 1.8m bpd and put pressure on prices. This recovery in prices serves the interests of Saudi Arabia, keen to optimize the value of Aramco before its initial public offering, and also serves the interests of Russia which, in an election year, needs additional tax revenues to respond to social demands. In the United States, shale oil production could increase by around 800,000 bpd. To this we can add the equivalent amount coming from new fields in Brazil and Canada.

- Copper is a metal worth considering. Possible further strikes in big mines will add to the pressure on prices generated by Chinese demand and the shortfall in supply which can be explained by under-investment in capacity in recent years. From $70 billion in 2012, the amount of investment in mines fell to $25 billion in 2016. The price rose 40% in 2017 to $7,240 per tonne and is still far from its peak of $10,000 at a time when some analysts fear a shortfall in supply during 2019. The

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

growing number of electric cars offers a new application, because they require 40 to 60 kilograms of copper versus slightly more than 20 kilograms for a normal car. 800,000 electric cars were sold in 2016, and 14 million could be sold in 2020, of which 5 million in China, where large subsidies of up to $15,000 per vehicle are paid. This reasoning concerning copper could also apply to nickel, lithium and cobalt.

II. **The possible**:

1. ***A further moderate rise in the US market***:

Although the doomsayers are alarmed to see the spread between 10-year interest rates and 2-year rates reduced to less than 0.5 percentage point, a level as low as in 2007 before the crisis, we do not perceive this risk. The concern shared by many results from the Fed's stated intention of trimming its balance sheet, currently at $4,500 billion, by $320 billion in 2018. The fear of some other investors is that this exceptionally long growth cycle will end with the start of a recession.

We do not share these concerns, because the economy is faced with neither a real estate bubble (prices in the twenty largest cities have increased by only 6.4% year-on-year), nor excessive household debt (75% of GDP) given that the cost of debt servicing is at its lowest level in over thirty years. Not a corporate debt bubble, nor manufacturing overcapacity. Neither student loans, at more than $1,300 billion, nor automotive loans despite a default rate at its highest level since 2008. Not corporate inventories, currently low, nor orders backlogs, currently high, are likely to break the growth dynamic. The tax reform, by reducing income tax, will stimulate demand and increase the budget deficit by $100 billion per year, but it is not yet sure that it will have an impact on investment.

The reduction in household taxes, by slightly more than 3 percentage points (more than the 2 percentage points enacted under the Bush presidency in 2002/2003 but less than the 4.5 percentage points granted by Reagan between 1986 and 1988) and the corporate tax cut to 21% are expected to generate extra growth estimated at 1% per year in 2018 and 2019. In this context, our exposure to the US market is clearly not over-weighted, however kept at its current level. Admittedly, since March 2009, the S&P 500 Index has risen from 666 to 2759 (i.e. it has been multiplied by 3.8x when GDP, since that date, has grown by only one third), but let's not panic, because two-thirds of the 19% average annual rise since 2009 can be explained by increased earnings or dividend distributions. Only one-third is due to a rise in P/E ratios, which is by no means shocking given the level of interest rates. Some pessimists will point out that the market's rise has been largely driven by technology stocks, but in 2017 the S&P 500, without those stocks, rose 17%, only four percentage points less than with those stocks. There is still potential for technology stocks but we recommend giving priority to cash-rich companies over

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

companies which do not yet generate cash. From a monetary perspective, the euro-dollar exchange rate is currently still in a range between 1.215 and 1.16.

2. ***A slight slowdown of growth in China***:

Despite several decades of strong economic expansion and real GDP growth of 120% since 2007, China still has between 300 and 400 million people living on less than $2 per day, mainly in rural areas. According to the World Bank, per capita GDP represents only 15% of America's per capita GDP. China seems to be finding an initial growth driver in the digital economy. R&D spending has been increased to 2% of GDP, the country is developing its expertise in aeronautics, investing heavily in automation, now registering more patents than the United States, profiting from a vast domestic market fairly closed to foreign competition, and it is endeavouring to buy technology firms in Germany and the United States. A second driver is apparently the essential transition to an environmentally-friendly economy. Before investing on the Chinese stock market, investors used to a market economy are always ill-at-ease, because it seems that the country is going back on the deregulation of private enterprises, largely guiding decision-making from a government level, neglecting short-term returns on investment, accepting the losses and spiralling debts of state-owned enterprises, and putting off the deregulation of capital movements and hence the international development of the Yuan. We therefore leave our exposure to the Chinese market unchanged.

III. **The hypothetical**:

1. ***A positive outcome of certain elections***? Russia? Brazil? Mexico? Since the end of the 1990s, emerging countries are less vulnerable because they have accumulated substantial foreign exchange reserves and can more easily repay their debts.

- In ***Russia***, the elections are in March, and Vladimir Putin will probably win. Following a recession in 2015 and 2016, growth was positive again in 2017. The possible interest in this market is, in light of our opinion on oil, its dependence on oil and gas which still account for half of the state's revenues.

- In ***Brazil***, following a period of recession, growth was 0.7% in 2017 and could reach 1.8% in 2018. The elections are in October. Until then, there is little hope of having an essential pension reform enacted, but if the opposition manages to win against the PP, then one could bet on an increase in this market.

- In ***Mexico***, Trump's threats to build a wall and dismantle NAFTA have not yet materialised, and so its currency strengthened in 2017. As we know, the $60 billion US trade deficit with Mexico is the cause of all the procrastination. As we know, Mexican exports to the United States represent one-

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

third of Mexican GDP whereas US exports to Mexico are equivalent to only 2% of American GDP. As we know, many investments in Mexico are dependent on a hypothetical US decision, and this is adversely affecting growth and employment. One is tempted to wager that nothing major will happen, and this should boost the Mexican stock market, but we are talking about a bet!

- ***Argentina*** is yet another gamble. A wager on the success of the country's free-market President Macri. GDP declined by 2.3% in 2016 and is now growing by about 3%. The official inflation figure has been reduced sharply, the government is combating tax evasion and undeclared work which is the fate of 40% of workers. They are not hesitating to prosecute the circle of those close to the Kirchners in power between 2003 and 2015, and are tackling the budget deficit. Better still, they have removed capital controls. The stock market there rose sharply in 2017, Macri has consolidated his position in recent elections, and the country, renowned for its seven debt defaults in the past century, has been able to borrow on a 100-year term.

2. ***An abandonment of Brexit***?

It is too soon to say so, and nothing is likely to happen until completion of the negotiations in 2019. But as the fated date approaches, three years after a tight vote, it is possible to imagine a vote on the final terms of the process. Before then, the economy will have further deteriorated, and this could reverse the result at the ballot box. Expected growth in 2018 has fallen to 1.2%, following a mediocre 1.5% in 2017. There is increasing stress on the labour market, with an increase in those leaving the UK up from 28,000 to 123,000 between June 2016 and June 2017, and a reduction in the number of arrivals from the European Union from 280,000 to 230,000.

3. ***A rise in the price of gold***:

The price of gold rose 13% last year, boosted mainly by the depreciation of the US dollar, and accessorily by a sharp increase in Indian demand (+65% year on year, at 855 tonnes). This was its best performance since 2010. In the very near future, a rise in long-term interest rates will be a negative factor for gold. Further on, gold could become attractive if signs of a slowdown and/or inflation were to appear. If we were to buy gold, we would do so with a strategy of selling out-of-the-money Call options.

IV The risks: ***"I confess to you that it is very harsh to lose everything just when you should be considering yourself fortunate", Andromeda in Corneille.***

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

Historically, and regardless of the possibility of a recession (which we rule out for the time being) a downturn in stock markets is often triggered by a rise in long-term interest rates due to restrictive monetary policies and/or inflation, or by geopolitical events. It is therefore important to analyse these two risks.

1. ***Inflation and spiralling long-term interest rates***?

- Undoubtedly, due to the effects of the rise in commodity prices, headline inflation will be higher in the coming months, but this phenomenon will be temporary and with hardly any consequences for core inflation, which was 0.9% in the Eurozone in December, and 0.2% in Japan. Completely in line with our conclusions of recent years, inflation is not a threat as long as the global economy remains impervious to the sirens of protectionism. Wage growth, which would be a key indicator of an upturn in inflation, is low despite a situation of full employment which prevails in the United States, Japan, Germany, the United Kingdom and China. This can be blamed on the loss of influence of the trade unions, the decline of salaried work, the rapid growth of fixed-term or part-time contracts, competition from digital technology in numerous sectors, and globalization. However, in the United States 2018 will be a test year. If wages do not increase despite pressure on the production system and an unemployment rate which will slip below 4%, this really means that inflation is no threat.

- The implementation of the tax reform against the backdrop of an economy at the top of the cycle with an historically low unemployment rate is creating pressure on long yields, which some will call a bursting of the bond bubble, and this could prove worrying, because it is liable to curb credit, and hence business. Remember that the bond market was bearish from 1940 to 1981 and bullish until 2016, and it would seem that another negative period has been initiated. Tempering this pessimism on bonds, we know that central banks are watching, because global debt represents 3.2 years of global GDP and a drastic surge in interest rates could bankrupt several states and numerous businesses. Of all the subjects discussed in this note, this is undoubtedly the most critical: for the G4 alone, central banks have since 2007 acquired around $8,000 billion of the $18,000 billion in new debt. On the global level, quantitative easing has exceeded $14,000 billion. Central banks have in this way managed to prevent a logical sharp rise in long-term interest rates at the cost of major distortions of yield curves and an impoverishment of pension funds, but how long will they be able to hold out?

2. ***Geopolitics***?

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

- ***Iran***? In this country of 80 million inhabitants, the revolt is among the young disadvantaged classes in small provincial cities affected by the reduction in health and education spending while the defence budget and the budget allocated to the religious authorities have increased, because Rohani does not dare to oppose them. Although the education level is high, the economy is incapable of meeting the 800,000 new job applications each year. In the wake of the nuclear agreement, Rohani was counting on $50 billion in foreign investment to stimulate the economy, but the country has only received $4 billion. 50% of revenues depend on oil. And 80% of the economy is still controlled by the public sector, and in particular by the Revolutionary Guards (Pasdaran) who pay hardly any tax. The private sector's growth is slow. In the short-term, even if Rohani has been weakened, we expect no major change because the middle and upper classes are not joining forces with this movement which lacks a leader.

- ***Saudi Arabia***? These are troubled times. The population is 30 million, including 10 million foreigners, and it will double within the next 25 years. 70% of the population are aged under 30, 25% are unemployed, and the oil industry, which accounts for over 80% of revenues, creates few jobs. So it is essential to diversify the economy, which requires the trust of foreign investors, because by itself, the country, faced with a large budget deficit of $50 billion, does not have the capacity to do so. This explains why the regime wants to create a 5% VAT, to raise petrol prices (by 120% in early 2018), and to float a fraction of Aramco on the stock exchange. This also explains the desire to bring about changes in society, and political efforts to reduce the power exercised by the religious authorities. On the international stage, we do not believe in a conflict with Iran, because the war in Yemen alone is very costly and the country is struggling to get out of it.

- ***North Korea***: In our opinion, the programme is too far advanced for a unilateral American intervention without the risk of retaliation against South Korea and Japan. Hence the desire for appeasement expressed by Seoul.

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse
T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

Conclusion: ***"The art of prophecy is very difficult, especially with respect to the future", Mark Twain.***

- This report has attempted to sketch an overview of the current situation and as well as to outline the trends for 2018, without losing sight of Mark Twain's call for modesty. After nine years of rising US markets, the concern for some investors is all the more understandable in that economic growth is low in light of stimulus measures, productivity gains are modest in light of the plethora of innovations, investment is moderate in light of the cash flow generated by companies, wage gains are minimal in light of the situation of practically full employment in most of the large countries, the stock market's rise has been sometimes staggering in certain segments of the digital economy in light of the low level of profits, inflation is insignificant in light of the quantity of liquidity injections, and long-term interest rates remain low in light of the accumulation of debt worldwide. In short, for many observers, global capitalism is buying growth (which is now moderate) at the cost of an unlimited debt burden and a retreating welfare state.

- Despite these pertinent structural reservations, it is clear from the various issues discussed in this report that the markets' rise has not ended. For many years, liquidity injections by central banks have represented an undeniable stimulus for the markets' rise. At present, the Fed's trimming of its balance sheet is unlikely to cause this trend to derail, because it is positively offset by an improved growth dynamic on a global level. While the markets' rise was for a long time stimulated artificially, it is now boosted by the real economy.

- The higher valuation of stock markets can be explained by increased savings as a result of population ageing in many regions of the world, as well as by falling interest rates.

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch