January 12, 2015

Asset Allocation: Top 10 Investment Themes for 2015

Global liquidity and euro zone deflation risks hold back the interest rate hike. There are good growth prospects for equities, commodities and real estate markets.

2015 Investment Strategy

- Consumers will benefit from oil price drop
- Economic growth outlook for 2015 exceeds +3.5%
- QE in Europe and Japan will support global liquidity growth
- Short-term rates will remain low even in the U.S.
- Risks of deflation in the euro zone suggest an ECB's broad and immediate QE programme
- Rate increase on long-term rates restrained to the United States and United Kingdom in the 2nd semester
- Europe benefits from the ECB measures, fall of the euro, oil and recovery of the credit cycle
- Expected oil price rebound, but inflation risks are deferred to 2016
- Return of consumer/investors confidence
- Increasing asset reallocation from bonds into other real assets
- Risk-taking will pay-off in 2015

Our 10 tactical allocation themes

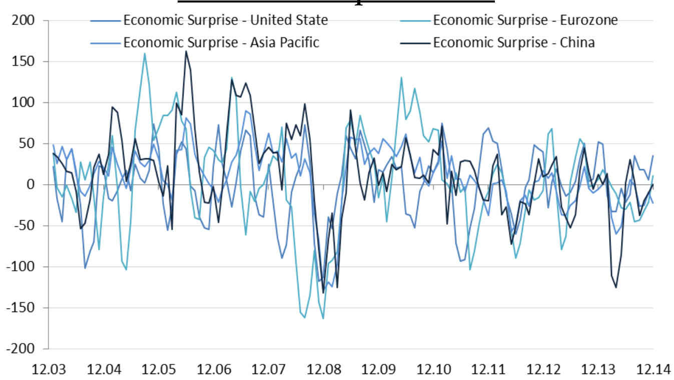
1. Underweight bonds
2. Overweight equities
3. Overweight commodities
4. Overweight real estate
5. Bonds: favor corporate bonds, reduce durations
6. Equities – by region: U.S. and Japan underweight, Europe, China and emerging markets overweight
7. Equities – by sector: energy sector and cyclical stocks overweight
8. Equities – by theme: alternative energy & infrastructure
9. Commodities: oil and precious metals overweight
10. Currencies: possible rebound in the euro, yen and commodity-linked currencies

Global growth is expected to accelerate by +3.5% in 2015 and further strengthen the risks of interest rate hikes

The past year ended with an acceleration of U.S. economic growth at an annual rate of +5.0 percent, this representing the largest increase since 2003. In January 2014, we had been expecting such economic strengthening in the United States to occur, but it mainly took place in the second half of the year. The U.S. economy is now capable of showing positive momentum without the help of the 5-year cycle of accommodating monetary policies and various QE programmes. The end of QE3 in October 2014 also coincided with the acceleration in GDP growth. As the U.S. is reinstated as the locomotive of global growth, it could well exceed its stride thanks to falling crude oil prices, which should extend the QE effect, ultimately acting as a boost for consumption and GDP growth.

The 1st quarter acceleration in global growth could already be the first major surprise of early 2015.

Economic Surprise Index



Sources: Bloomberg, Citigroup, BBGI Group SA

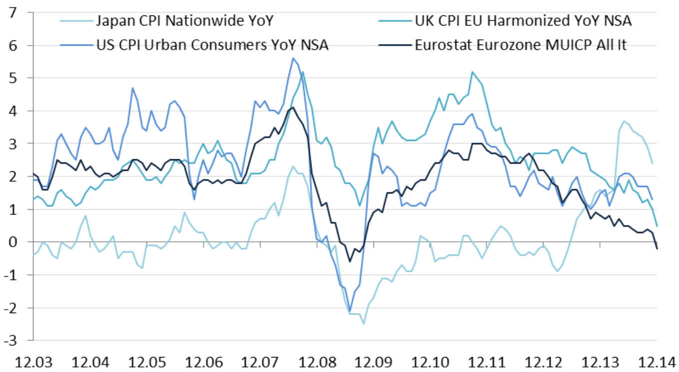
On the macroeconomic side, U.S. economic data rather positively surprised investors beginning 2nd quarter 2014.

At the moment, expectations have been adjusted, forecasts are more optimistic and it may be more difficult, from now onwards, to record positive surprises which are generally favorable to financial markets. If the lowest point was reached in June 2011, surprise indicators are currently more optimistic. Things are quite different if we look at the euro zone economy, whose expectations have rather deteriorated over the last six months and the ratio of positive surprises has only recently bounced back from its previous extreme pessimistic levels. So if the 1st quarter of 2015 will benefit from the fall in oil prices and low long-term interest rates, the momentum should be more favorable to the EU.

The acceleration of global growth in 2015 is expected to boost expectations of normalization of monetary policies and rising interest rates.

Three key challenges remain and could have significant potential impact on the financial markets. The first is a question of **timing**. If consensus believes that a change will take place in the U.S. sometime in mid-2015, we believe that the **rise in long-term interest rates** could take more time because of the decline in inflationary risks induced by the drop in oil prices and the euro zone deflationary risk environment.

Inflation (CPI YOY)



Sources: Bloomberg, BBGI Group SA

Under this scenario, another uncertainty concerns the **evolution of the correlation** between the various global bond markets. Europe should soon benefit from an already hinted QE, which should inject approximately €1000 billion liquidity. It is very difficult to picture a more favorable context for further rate cuts and the convergence of national euro zone yields, however, but interest rates are already extremely low and they no longer have a great potential. Still, we believe that a **correlation could still exist mainly due to the relative attractiveness of high yield U.S. government rates compared to European sovereign bonds. U.S. government debt could consequently be preferred because of its better rating and higher yield.**

Thus in theory, the growth differential which is favorable in the United States and the United Kingdom should trigger some kind of normalization in short-term interest rates and long-term interest rates are likely to trend higher before intervening on a European scale. We will probably be the spectators of a smooth normalization policy in short-term rates, in a context of very low inflation until the 3rd quarter 2015. This could also be followed by a potential flattening of the yield curve.

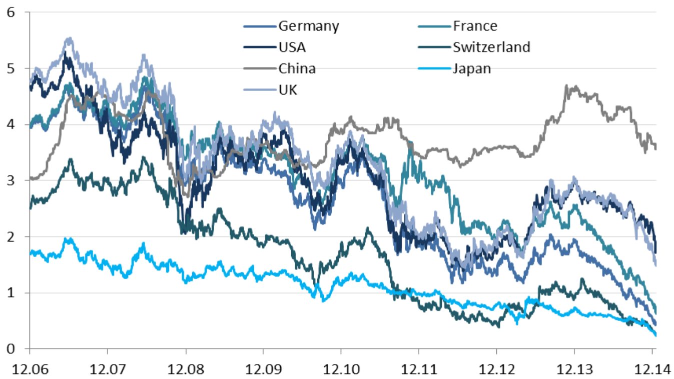
The increase in growth prospects strengthens the risks of a rate hike, but the European deflation and the yield differential might certainly encourage deferring the rate hike process.

The rotations process of financial assets out of bonds and into equities will intensify by 2015.

Fixed-income markets: favor corporate bonds and reduce durations

Consensus was already expecting a rate hike by 2014 with the improving global economic outlook; however, it remains negative in 2015 **considering bonds as a risky asset class.** The historically low long-term interest rates no longer offer much prospect of capital gain and if yields are still acceptable in several specific segments, it is usually insufficient to offset the risk of capital loss generated by the prospect of rising interest rates. European bonds will benefit from a positive environment supported by the QE programme hinted by the ECB, core-periphery countries spread will contract, but U.S. Treasury bonds could still seduce with their higher yield and higher ratings compared to euro government bonds.

Long-term Interest Rates



Sources: Bloomberg, BBGI Group SA

Therefore we recommend a more **diversified and balanced fixed-income allocation** in 2015. The currency component should still be a major contributor in terms of the overall performance of the segment. The rotations within the fixed-income market should further grow in favor of **corporate bonds** due to an improvement to their balance sheets. In all cases, we prefer **shorter durations**.

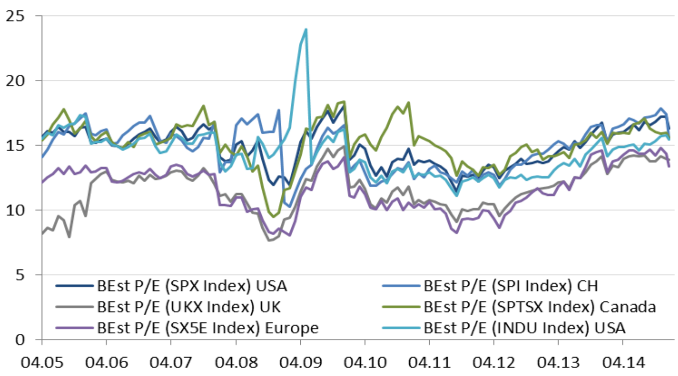
Equities - by region: U.S. and Japan underweight, Europe, China and emerging markets overweight

The equity markets should still be favored in a context of low interest rates and strengthening growth prospects of profits and corporate margins.

Without being extremely high, valuation levels are, however, no longer as attractive as in 2014, particularly in the United States, Canada and Switzerland. The price/earnings ratio (P/E) in equity markets increased significantly between 2011 and 2014. They are now back to pre-crisis levels.

The P/E expansion process which supported the rise in equity indices and accompanied the interest rate decline phase should end in 2015 with the normalization of interest rates.

Market Valuation (P/E)



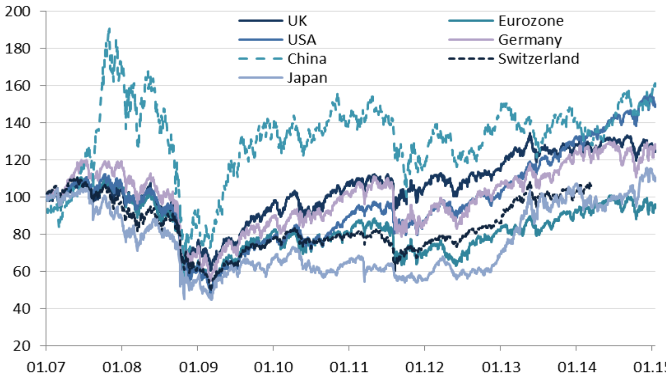
Sources: Bloomberg, BBGI Group SA

In the **United States**, the economy will remain sound. Its competitiveness increased with the decline in the U.S. dollar and the development of cheap and local energy resources (gas and shale oil). The U.S. budget deficit fell from -10% to -3% of GDP in recent years, and job creation, in a context of very low inflation and low interest rates, supports consumption.

U.S. stocks should remain attractive, but at 17x earnings (P/B 2.7x) they now appear to be correctly valued, even if U.S. corporate earnings are expected to grow by +8.5% in 2015. Six years after the outbreak of the financial crisis, price/earnings ratio (P/E) of the S&P 500 is the highest of the G7 countries (e.g. Japan). The **Swiss market** is still benefiting from low interest rates, but the strength of the Swiss franc against the euro is still a threat to our exports, while the rise of the U.S. dollar in 2014 has certainly contributed to the excellent results recorded in our trade balance.

With a price/earnings ratio (P/E) of 18x (P/B 2.29x), our market has clearly benefited thanks to its defensive approach, outperforming by +20% European equities since the beginning of the bull market.

Equity Market



Sources: Bloomberg, BBGI Group SA

If earnings growth in the United States and Switzerland will probably be the main driver of rising markets, in **Europe** and the **emerging markets**, the increase will be largely supported by a greater growth potential for margins and higher profits as well as attractive valuations supporting a probable P/E expansion.

The **euro area** and **Germany** in particular, could clearly benefit even more in 2015 from world economic strengthening. The ECB's QE might also support the expansion of multiples in Europe. **The chances of earnings growth and margin improvement are higher and valuations also look more attractive** (13x P/E and 1.3 P/B). The economy of the **United Kingdom** has already surprised by its vigor in 2014 and at 13x earnings and 1.6x P/B, UK **equities also offer an attractive alternative to U.S. equities.**

In **China**, and in most emerging markets, the plunge in oil prices comes as good news. The growth potential in emerging countries has improved and is closer to +6% in 2015. Inflation will be better contained, which will also improve the chances of further interest rate cuts and more accommodating monetary policies. Chinese equities also have a higher potential for earnings growth and valuations remain historically attractive (P/B 1.7x and P/E 12.6x). Chinese equities deserve to be overweight, like those of some emerging markets which are benefiting from the global trade recovery and the oil price decline (Taiwan, South Korea, India, Thailand and Singapore). More generally, emerging markets should benefit from an arbitrage and repositioning out of the U.S. market and in favor of emerging markets.

Equities – by sector: alternative energy & infrastructure

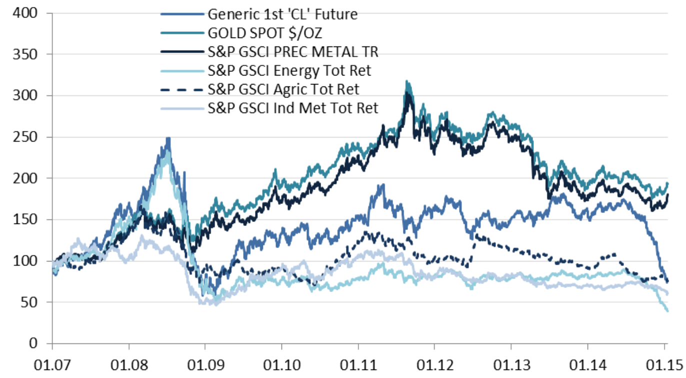
The oil price drop has seriously influenced the global energy sector and the alternative energy securities. These sectors will benefit from the gross rebound towards $60, then $80 in 2015, which will go hand in hand with a recovery in global growth (+3.5%) and an increase in demand. The recovery in the investment cycle (CAPEX), especially in the United States should benefit the cyclical and also the technology sector. Corporate wind and solar sectors were unfairly penalized by the collapse in the crude oil market. They are particularly undervalued and should quickly record double-digit growth in the upcoming months.

Commodities: oil and precious metals overweight

Two-thousand fourteen will not go down in history as one of the commodities years, despite an above average global economic growth. The -60% collapse in oil prices over the past seven months – which we mentioned in our last Weekly Analysis – is difficult to justify with market fundamentals. That said the current price fall could reverse the effect to a rapid drop-off in production. Oil fields and shale oil/gas production sites with higher production costs will soon face major difficulties. With an expected increase in demand by the IEA in 2015 and a more likely decrease in production in the United States rather than in Saudi Arabia, crude oil prices should quickly rebound. As for precious metals, abundant liquidity and a reversal of the parameters of supply and demand could finally support a new rise in both gold and silver.

Speculative sales have stopped, central banks will remain buyers, while jewelry demand remains strong and gold mine production has been slashed. Overall, many commodities are now trading close to their production costs.

Commodities prices



Sources: Bloomberg, BBGI Group SA

Currencies: possible rebound in the euro, yen and commodity-linked currencies

Fundamentals indicate favorable underlying factors to the U.S. dollar just when the ECB is on the verge of implementing a QE programme, which should negatively affect the common currency. But, the soar in the U.S. dollar was already substantial in 2014 and partly anticipated within the hinted ECB measures. A stabilization of the EUR/USD exchange rate between 1.16 and 1.25 will be necessary to ignite the expected effects on inflation and on the euro zone's competitiveness. A rise in commodities should also favor the return of investors on commodity-linked currencies such as the Canadian Dollar (CAD) and the Australian Dollar (AUD).

Conclusion

The overall liquidity in the banking system will remain abundant thanks to the euro zone and Japan's QE programmes. The spread of deflation risk in Europe seems to be keeping interest rates from elevated levels. Global growth forecasts for 2015 are favorable to equities, commodities and real estate. Risk-taking should once again pay-back in 2015.

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