

2016 MIDYEAR INVESTMENT PERSPECTIVES

TREADING CAREFULLY

Despite low interest rates and increased volatility, we see a range of investment opportunities. Given the many potential risks that lie ahead, however, investors should tread carefully

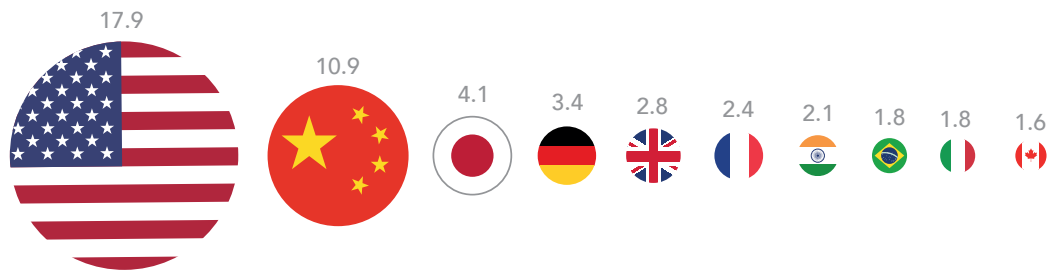
AMSTERDAM
BRUSSELS
LONDON
LUXEMBOURG
MADRID
MONACO
MUNICH
PARIS



THE WORLD'S TOP 10 ECONOMIES BY NUMBERS

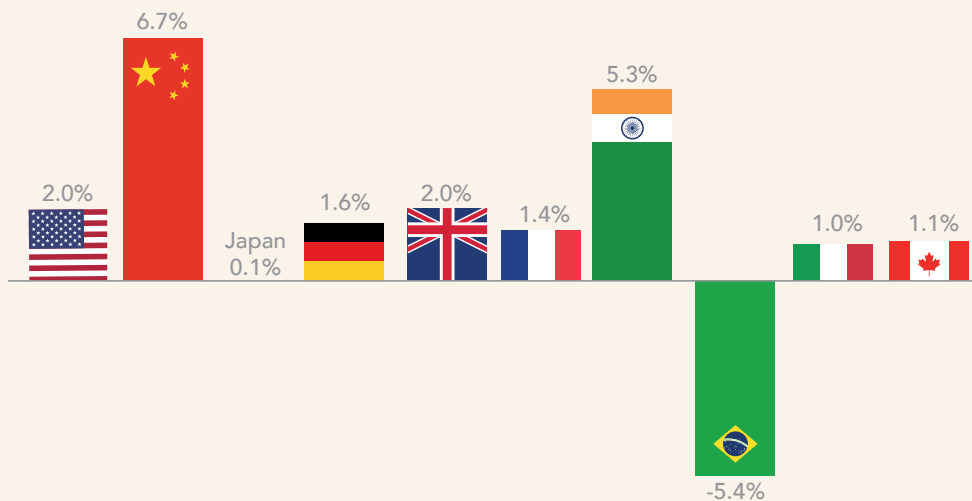
GROSS DOMESTIC PRODUCT

2015 nominal, in USD trn



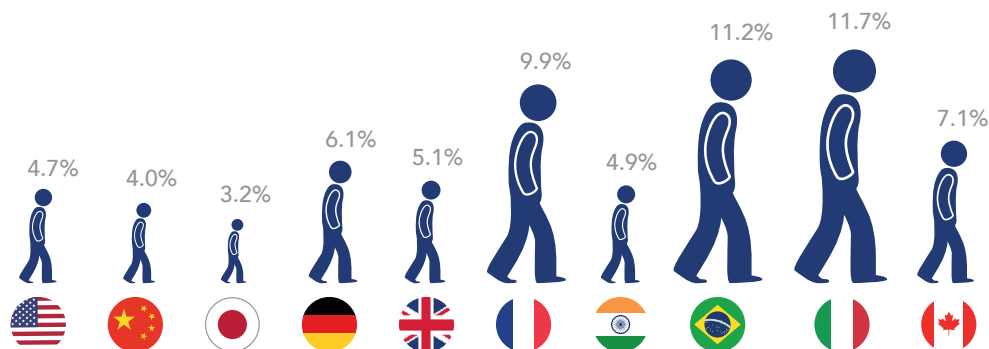
GDP GROWTH RATE

Q1 2016 YoY



UNEMPLOYMENT RATE

April/May 2016, as percentage of labor force



Sources: Bloomberg, Eurostat, IMF

SLOW AND STEADY

Despite popular fears of impending doom, triggered by events such as the Brexit vote, the global economic outlook remains modestly positive.



Even before the UK's fateful Brexit vote, the outlook for the world economy appeared to many to be increasingly unfavorable.

Consider the International Monetary Fund's 2016 global growth forecast, which was reduced in January from 3.6% to 3.4% and then in April to 3.2% – only slightly above last year's 3.1% expansion rate.

We recognize a wide range of risk factors in the second half of the year, but nevertheless also believe that global GDP will expand by roughly 3% in 2016.

Let's start by examining the health of the world's largest economy. After a disappointing first quarter, when GDP expanded by just over 1%, the US economy gained traction in the second quarter, with growth likely to reach nearly 3%.

Private consumption is the predominant driver, reflecting the lowest level of US unemployment since 2008 and the fewest jobless claims since 1970.

Consequently, US wages are now edging up – which will continue to support positive consumer sentiment and higher private spending in the second half of this year.

Today, however, US investments are dominated by savings, and productivity growth remains low, as it does globally. This is reflected by sentiment that is weaker in the manufacturing sector than it is in services – a trend that is again mirrored worldwide.

Nevertheless, positive order trends and strong lending growth support

Likewise, European Central Bank policy will continue to be influenced by the post-Brexit fallout. Prolonged political uncertainty will weigh most heavily on the UK economy but will also impact the eurozone outlook, where, following a solid first half and even after the Brexit vote, 1.5% annual GDP growth looks realistic.

“ WE RECOGNIZE A WIDE RANGE OF RISK FACTORS, BUT BELIEVE THAT GLOBAL GDP WILL EXPAND BY ROUGHLY 3% IN 2016 ”

our view of a good second half for the US, likely leading to the seventh consecutive year of growth at or above 2%.

At the same time, US inflation pressure will continue to build – as it could elsewhere, including in China, where producer price inflation is expected to recover. Indeed, inflation could be the trigger for the next Federal Reserve interest rate hike, most likely in December.

As the Fed also factors uncertainty into its decision-making process, the state of the presidential election campaign may sway sentiment – especially if Donald Trump appears to have a solid shot at the White House.

Uncertainty regarding the outcome of Italy's upcoming constitutional reform referendum and bad bank plan – as well as next year's parliamentary elections in France, Germany and the Netherlands – will also remain top of mind for economic policymakers.

Meanwhile, Japanese growth will remain sluggish. Emerging-market commodity exporters will experience a slight, price-driven recovery. And a Chinese hard landing, though unlikely and not our core scenario, cannot be ruled out.

For the world economy, these are by no means the best of times – but the slow and steady pace of global expansion will continue. ■

RULE BRITANNIA!

Just how badly will the Brexit vote impact the UK's already slowing economy?



The most comprehensive assessment of the impact of a “leave” vote on the UK economy was carried out earlier this year – before a single ballot had been cast.

According to that analysis by the Treasury department, domestic growth will be reduced by a total of 6.2% by 2030. That works out as roughly 0.5% lower annual GDP growth.

The short-term impact, however, is assumed to be even greater.

The Treasury estimated that in a shock scenario – involving a surge in uncertainty – Brexit would “push the UK into recession and lead to a sharp rise in unemployment.”

This Treasury projection was towards the more pessimistic end of the range of investment bank forecasts, which estimate a short-term negative GDP growth impact of between 1-2%. Given the current annual domestic growth rate of around 2%, these forecasts suggest a not insignificant risk of recession next year.

The truth, however, is that no one knows how the British economy will fare outside the EU – not even the Treasury. But it is fair to say that the consequences are much more likely to be negative than positive, certainly in the short term.

Economic activity revolves around decisions on spending, and current uncertainty undoubtedly restrains such activity.

On top of this, 13% of UK GDP is dependent on trade with Europe; the prospect of losing access to the single market is a very direct threat.

Undoubtedly, the UK economy appears vulnerable. If Britain had been part of the euro, however, the consequences of an exit decision would have been far more dire. Sterling dropped sharply in the wake of the vote and, if sustained, should provide significant support to the economy.

There is also scope for policy response from both the government and the Bank of England if the economy appears to be going off

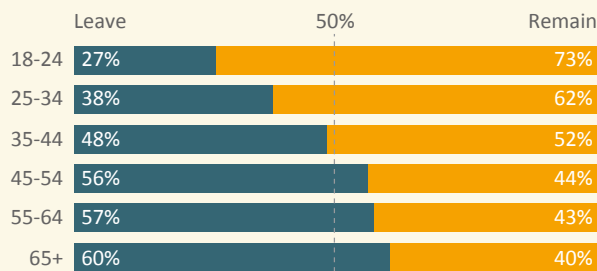
the rails. The higher-level policy objectives of fiscal restraint, debt reduction and keeping a tight lid on inflationary pressure may well have to take a back seat for a period.

This would mean the Bank of England scaling back its anti-inflation rhetoric, with a rate cut now seeming appropriate.

Although the Chancellor of the Exchequer recently said that tax increases and spending cuts will be necessary, today’s extraordinary circumstances still offer scope for the government to loosen the austerity straightjacket.

The pre-referendum threat of a tax-raising emergency budget looks hugely out of step with the near-term economic risks now presented by the UK’s impending exit from the European Union. ■

A DEMOGRAPHIC DIVIDE Brexit voters, by age bracket



Source: Lord Ashcroft Polls

MAKING AMERICA GREAT AGAIN?

Following the Brexit surprise, could American voters provide an even greater shock by electing Donald Trump? If so, what would his presidency mean for the global growth outlook?



As the outcome of the Brexit referendum reminds us, the well-prepared investor must plan for a range of scenarios, considering the possible consequences of even seemingly unlikely outcomes – such as the election of Donald Trump.

Predicting the economic impact of a potential Trump presidency is extremely difficult, particularly as his policy positions change by the day. There also remain questions about whether any of those positions would actually be implemented by Congress.

Nevertheless, key elements of Trump's economic platform include massive tax cuts (resulting in an estimated \$9.5 trillion reduction in revenues over 10 years) and increased military spending, with no cuts to Medicare or Social Security.

He has also proposed the deportation (voluntary or forced) of close to 11 million undocumented immigrants, and high tariffs on goods from China and the imported products of any US company that has moved jobs offshore.

Assuming all these measures were implemented, the immediate effect would be stimulative: the domestic economy would receive a

boost from increased government spending and higher wages from employers competing to replace lower-cost immigrant labor.

However, that positive impact wouldn't last long as punitive tariffs and increased labor costs would be passed on to consumers in the form of higher prices. Retaliatory tariffs could also be expected, which would hurt corporate profitability and likely depress hiring.

In the slightly longer term, the US would witness rising inflation due to increased costs, higher wages and increased government borrowing to fund an additional annual shortfall of \$1 trillion. This, in turn, would lead the Federal Reserve to raise interest rates to combat inflation, leading to a drop in employment and, potentially, domestic recession.

Analysis by Moody Analytics suggests the following specific outcomes for the United States:

- Unemployment would increase from 5.5% to 7% (representing a loss of 3.4 million jobs)
- Inflation would rise from 1% to 4.2% (leading the Fed to hike interest rates)

- National debt would grow from about 75% of GDP to more than 130%
- 10-year Treasury rates would increase from 2.4% to 6.7%

Trump's defenders dismiss such analysis and insist upon the stimulative effects of cutting taxes. But history shows that tax cuts are no panacea.

It seems quite probable that President Trump would unilaterally rescind many important trade treaties. Indeed, it is not hard to imagine the New York real estate developer slapping tariffs or other retaliatory measures on any country that annoyed him.

The possibility of a global trade war therefore cannot be dismissed, with higher costs to consumers worldwide and multiple countries falling into recession.

Ultimately, it's anyone's guess how the most unusual major-party presidential candidate in US history would actually conduct policy.

But there is no doubt that the economic platform he has espoused so far would be highly negative for the United States and the world. ■

THE UNCERTAINTY PRINCIPLE

In an investment environment characterized by increased volatility, low returns and a world of risk, the only certainty is uncertainty.



Markets prefer good news to bad, as the immediate reaction to the Brexit vote showed, but there is nothing they hate more than uncertainty.

In the second half of this year, the world faces a great deal of such ambivalence – about, for example, the longer-term consequences of the UK referendum, the outcome of US elections, oil-price and inflation trends, and the potential ongoing devaluation of the Chinese yuan.

Consequently, moving forward, public-sector investment may stall, private-sector firms will continue to hoard cash, and consumers will remain focused on saving or paying down debt. All of this could negatively impact the global macroeconomic outlook (slightly), corporate profitability (somewhat) and investor sentiment (potentially significantly).

In this environment, characterized by high levels of volatility and low returns, we believe that it's important to focus on portfolio diversification, likely including frequent short-term adjustments.

While it's currently difficult to find any value in fixed income – with some 40% of government bonds now trading at negative yields – bond markets could normalize, at least somewhat, if inflationary pressure increases.

We have a preference for bonds offering better potential returns but also more risk, including corporates, US high-yield and peripheral government bonds, emerging-market debt and, given the inflation outlook, US inflation-linked bonds. Furthermore, absolute return strategies could provide value, as the use of derivatives could dampen risks and benefit from rising yields.

Overall, we remain underweight on fixed income.

When it comes to equities and more risky assets, we take a neutral stance. Although current equity valuations are not particularly attractive, they are not excessive. Equity risk premiums are slightly above historical norms, but should be lower as bond yields remain low or negative and as there are few attractive alternatives.

While this may prove supportive of equities, the potential upside

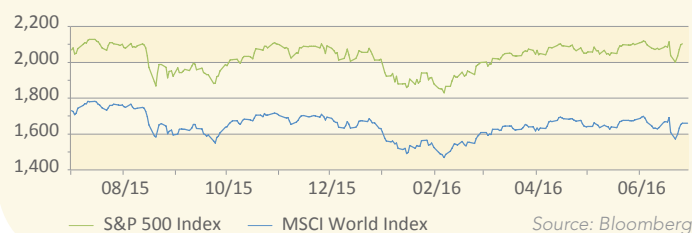
appears limited – especially given current market uncertainty.

In 2017, we expect improved profit growth and earning estimates due to higher commodity prices, causing a turnaround for companies in the energy and materials sector. In parallel, as inflation and wages start to rise, spending and corporate pricing power could improve.

For now, we see promise in real estate – excluding in Europe, due to the Brexit impact. Globally, vacancy rates are low, the finalization of new construction is limited, and both rents and asset values are rising. Gold also holds appeal – not only as a safe haven but also as a hedge against currency devaluations and negative interest rate policies.

Finally, we also favor absolute return equity strategies, where being short on overvalued equities and long on attractive ones could provide additional returns. ■

MARKET MOVEMENT
S&P 500 and MSCI World indices



HANG ON FOR A WILD RIDE

Global stock markets will continue fluctuating for the rest of the year, and regional divergences will likely remain significant.



As expected, global equity markets experienced high volatility levels in the first half of the year.

The MSCI World Index was down double digits by mid-February, hitting its lowest level since 2013, then clawed back to slightly positive territory before turning marginally negative after the surprising outcome of the Brexit referendum.

There were also significant regional divergences. Although the S&P 500 recorded a small rise, for example, Europe's Stoxx 600 posted a significant decline.

Japanese stock markets likewise took a hit, while most emerging markets (notably excluding China) rose slightly, benefiting from the recent recovery in commodity prices. Latin American, Russian and some Asian stock markets are expected to continue to be supported by this trend.

Equity markets in the first half-year suffered due to sharply falling 2016 earnings estimates. This dip was heavily influenced by significant uncertainty on various fronts, ranging from the European refugee crisis to Brexit-related fears both before and after the June 23rd referendum.

As a result, estimates for earnings per share plummeted for both European and US companies, dropping from +7% in January to virtually zero in June.

That said, the US market should benefit from factors like oil prices averaging \$45 per barrel, leading to an expected increase in S&P 500 margins by 40 basis points in the second half of the year. On the other hand, rising US wages and exports, suffering from the strong dollar, will weigh on earnings trends.

We believe that analyst consensus estimates of double-digit earnings growth for both the US and Europe

European equities over their slightly underweighted US counterparts.

Considering currently expansive central bank policies and the desperate search for yield, we believe in a neutral equity weighting. Indeed, we expect stock markets to continue fluctuating for the rest of the year, with particular downside risk if populist parties prove ascendant.

Major uncertainty has been triggered by the Brexit vote, further stoked by the US Federal Reserve's expected rate path, the European Central Bank's handling of its quantitative easing program and

“ANALYST CONSENSUS ESTIMATES OF DOUBLE-DIGIT EARNINGS GROWTH FOR EUROPE AND THE US LOOK OVERLY OPTIMISTIC”

look overly optimistic, as US margins will face additional pressure and Brexit could negatively impact current European growth trends.

Meanwhile, valuation metrics deliver a mixed picture.

Although price-to-earnings ratios are approaching historic averages, price-to-book levels look more attractive, particularly in Europe – one reason for favoring neutral-weighted

the unpredictable outcome of US elections.

Given that there is so much global uncertainty, we expect continued market volatility, fueled to a degree by cash sitting in investor accounts, now standing at the highest level among global fund managers since 2001. Some of this money will flow in and out of investments based on risk, and that will only make the ride wilder. ■

WHY BIGGER ISN'T ALWAYS BETTER

Over the long term, small and mid-cap stocks have clearly demonstrated their potential to deliver superior returns. What explains this historical outperformance?



When it comes to investing, bigger isn't always better. Indeed, over the long term, except during periods of economic downturn, small and mid-cap (SMID) stocks consistently outperform large caps.

Consider that, from December 31, 2000-June 30, 2016, the MSCI Europe Small Cap Index generated a total return of 216%. Over the same period, the MSCI Europe Index generated a total return of just 125%.

What explains this historical outperformance?

First, the very essence of small and mid caps: given the size of such firms, they are able to react quickly to market trends.

Typically founded by one person or a small group of like-minded individuals with an idea for a new product or service, SMIDs are also inherently focused on innovation – and profit from that dynamic, entrepreneurial spirit.

Given that such firms often find accessing capital very difficult, founders are typically primary investors, with their own money on the line and, accordingly, uniquely high levels of management commitment.

As such companies cannot seek to compete in market segments dominated by giants that benefit from economies of scale, SMIDs tend to focus on a niche, where structural opportunities support sustainable growth.

As SMIDs start from a lower base than large caps, they can grow faster. And with leaner and more flexible cost structures – supported by efficient decision-making – SMIDs can typically better manage earnings.

In percentage terms, SMIDs reinvest more than large caps in future growth, partly because



SMIDs ARE INHERENTLY FOCUSED ON INNOVATION AND PROFIT FROM THAT DYNAMIC, ENTREPRENEURIAL SPIRIT



dividend distribution is normally limited. They also tend to have low debt-to-equity ratios, reflecting typically conservative borrowing strategies.

The lack of significant analyst coverage of SMIDs can make it difficult to attract external investment, and also creates plenty of market inefficiency. Given that investment banks are actively

reducing their coverage of SMIDs, such inefficiency will only increase.

It is therefore safe to assume that the share price of many of the more than 1,000 European SMIDs does not reflect fair value. And therein lies a mostly untapped opportunity.

Against the current backdrop of modest economic recovery, we expect SMIDs to continue to outperform, further supported by an interest rate environment that has reduced the cost of borrowing and accelerated M&A trends – making SMIDs especially attractive takeover targets.

There are, of course, risks associated with investing in companies with limited track records and minimal analyst coverage. Market volatility and macroeconomic uncertainty further cloud this picture.

However, over the long term, small and mid-cap stocks have clearly demonstrated their potential to deliver superior returns – proving that bigger isn't always better. ■

SLIP SLIDING AWAY

At a time when yields continue to slide lower, short-duration bonds are among the most attractive in the fixed-income universe. Meanwhile, gold looks like an especially appealing safe-haven investment.

There appears to be no end in sight for the slide in global bond yields – with practically all Swiss bonds, most Japanese government bonds and 70% of German government bonds yielding negative rates.

Here’s why: a double whammy of low-to-no inflation coupled with quantitative easing by the European Central Bank and Bank of Japan, which are focused on maintaining low interest rates to stimulate the extension of credit to businesses and consumers.

The result is classic oversupply: mountains of bonds now sitting on the balance sheets of central banks, which continue to print cash to fund those purchases.

With all that fresh money, there is no guarantee that inflation will remain at its current low rates, even if markets have priced in a lower inflation outlook going forward.

But that may come back to bite them as the price of oil and other commodities has been trending higher. Notably, since hitting bottom in January, the price of Brent crude has nearly doubled.

Even if current prices remain unchanged, the energy component

of the basket of prices that determines the inflation rate will start turning north from August onwards – as the so-called “base effect” kicks in.

Consequently, if Brent stays above \$45 per barrel, the headline inflation rate will rise to 2.3% in the US and 1.1% in the eurozone. Those are significant increases from today’s levels, and we haven’t even factored in the same base effect applied to agricultural commodities.

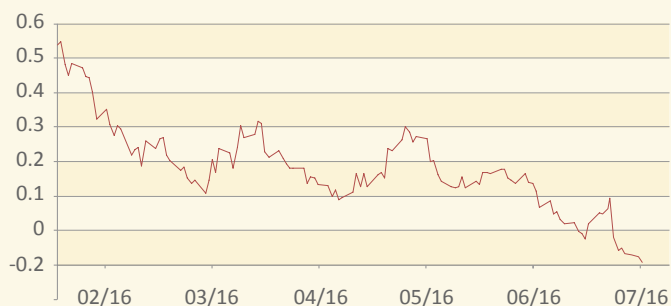
While there’s no guarantee that commodity prices will remain at these levels, or increase, bullish fixed-income investors should nevertheless recognize such cautionary signs.

For the above reasons, we continue to prefer short-duration bonds, which are less sensitive to interest-rate fluctuations. Indeed, even if short-term rates (which are determined by central bank monetary policy) stay low, longer-dated interest rates could climb, steepening the yield curve.

At the same, given low real rates and geopolitical jitters, investors are increasingly turning to gold as a safe haven and as part of a broader diversification strategy.

Nevertheless, by historical standards, the yellow metal is currently underweight in average portfolios – despite a steady price rise since the start of the year. ■

NEGATIVE TERRITORY
10-year German government bond yields



Source: Bloomberg



THE FAMILY BUSINESS PREMIUM

Family-owned businesses generate, on average, higher returns than their peers – making this niche a potentially attractive long-term investment opportunity.

What do Walmart, BMW and Maersk have in common – besides being among the world's largest companies? Each is also a family business, with a significant percentage of shares owned by, respectively, the Walton, Quandt and Moller families.

Unlike these three multinationals, however, most family businesses – whether defined by equity ownership, board representation or senior management authority – are small companies, rather than big ones.

Indeed, despite the fact that the vast majority of companies start life as a family business, those that grow don't tend to stay that way.

Globally, fewer than 30% of family-owned businesses survive to the third generation as family-run concerns. Looking at the S&P 500, we see that less than one-third of such firms are currently controlled by a founding family.

Worldwide, the significant majority of family-owned companies are, of course, unlisted. Among those that are listed, unsurprisingly, nearly all are small and mid caps.

For investors interested in targeting family businesses, this

poses a double challenge. First, family-owned businesses are not homogeneous, and there is no listed index of them. Second, analyst coverage of the broader small and mid-cap segment is patchy, at best.

Nevertheless, there are a range of compelling reasons to look long and hard at the opportunity listed family businesses represent.

Family-owned businesses, generally speaking, benefit from

The fact that the majority of listed family-owned companies are small and mid caps provides a second competitive advantage: as history shows, small and mid-cap stocks consistently outperform large caps over the long term.

Family-owned European small and mid caps currently hold special appeal. That's partly because their geographic exposure tends to be more local than international, with greater exposure to the relatively stable

“ FEWER THAN 30% OF FAMILY-OWNED BUSINESSES SURVIVE TO THE THIRD GENERATION AS FAMILY-RUN CONCERNS ”

especially keen market insight, an unusually deep commitment to success and a particularly stable long-term vision.

There is also growing evidence that family businesses take a more disciplined approach to capital allocation, have stricter standards of corporate governance and, ultimately, generate higher and more stable returns.

All of these factors support the so-called “family business premium.”

European market than to more volatile emerging markets.

Because the appeal of such firms is based on their underlying quality, they should rather be seen as potential buy-and-hold investment opportunities. Indeed, such long-term perspective is only fitting for family-owned concerns.

After all, family businesses typically focus less on the current quarter than the next quarter-century, when the succeeding generation will come of age. ■

THE ECONOMICS OF EXCHANGE RATES

Despite sharply divergent monetary policies on either side of the Atlantic, the current EUR/USD cross rate should remain relatively stable. A look at the economic factors influencing both currencies.



Over the past 16 months, the EUR/USD cross rate has remained in a narrow range between 1.05-1.15. What lies ahead for the common currency vs. the greenback?

The answer starts with basic economics.

Today, the United States is running a current account deficit of 2.7%, while the eurozone's surplus continues to widen, now standing in excess of 3%.

For the US to achieve parity in its balance of payments, it must look to areas like the eurozone to invest some of their surplus liquidity into US bonds and other securities, or goods and services. While such a trend could arise, it greatly depends upon the level of additional interest rate payments dollar-denominated securities can provide.

With US Federal Reserve monetary policy tightening and the European Central Bank (ECB) still loosening, via quantitative easing, investors can generate higher returns from dollar-denominated assets – thus supporting a stronger dollar, at least in theory.

However, a strong dollar also makes US exports more expensive, contributing to deflationary

pressure and further deepening the country's current account deficit – all things the Fed is eager to avoid.

Meanwhile, on the other side of the Atlantic, inflation remains nearly flat, despite the ECB continuing to target a rate just under 2%. Given such deflationary pressure, rate hikes are clearly not on Frankfurt's agenda.

Instead, the ECB will continue to roll the monetary printing presses and inject vast amounts of liquidity into financial markets, tamping down the common currency and enhancing the competitiveness of euro-denominated exports.

So does this mean that we should expect the dollar to strengthen against the euro?

Europe's huge current account

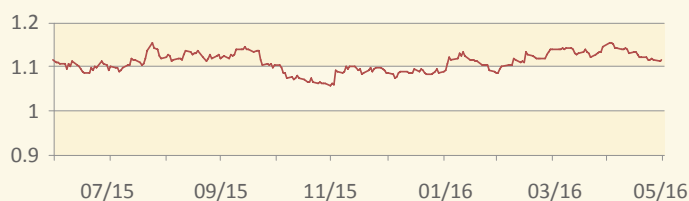
surplus will – all other things being equal – lead the EUR/USD cross rate higher. However, the ECB is not particularly keen for that to happen as a stronger currency implies monetary tightening.

At the same time, guessing when and by how much the Fed will next raise rates has become an international pastime. We expect not more than one additional rate hike this year; consequently, we do not expect the dollar to suffer vs. the euro.

While the underlying factors impacting both currencies are complex, we ultimately believe that – absent any major structural surprises – the EUR/USD cross rate will remain between 1-1.15 this year.

In the end, the more things change, the more they stay the same. ■

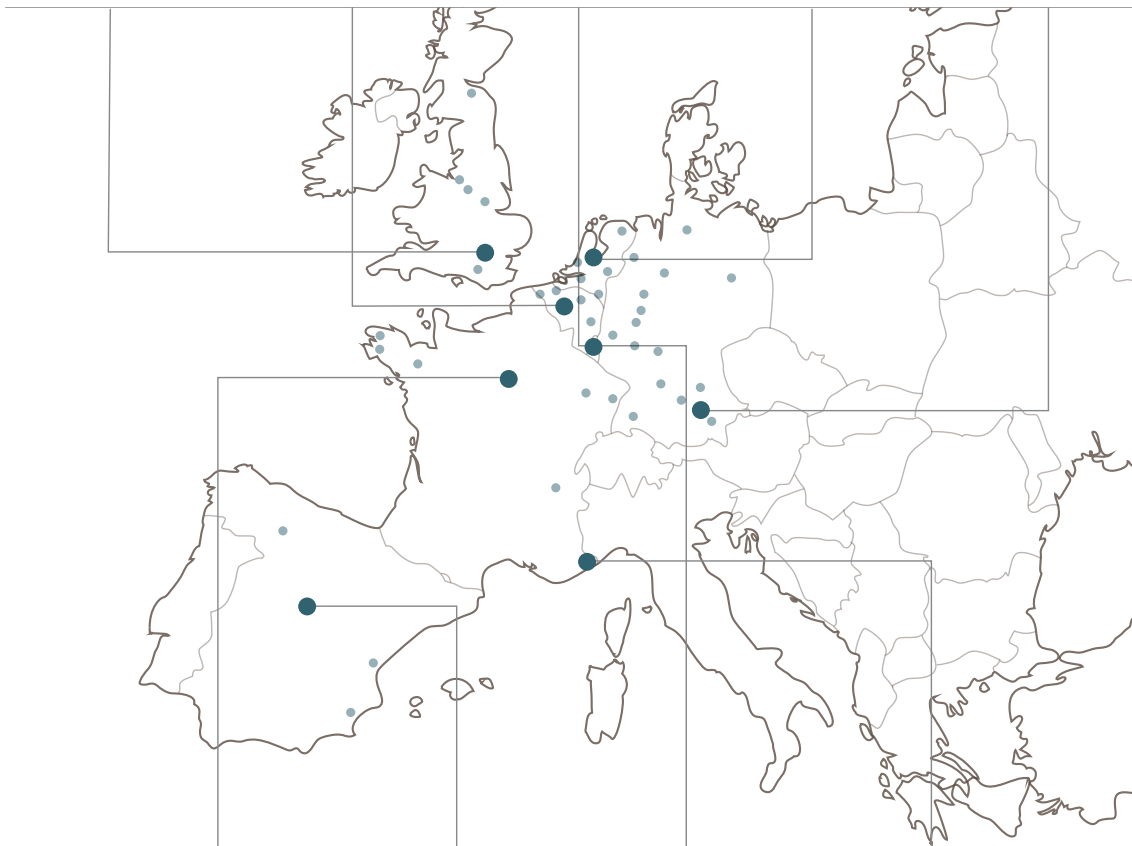
HOLDING STEADY EUR/USD cross rate



Source: Bloomberg

EUROPE'S ONLY NETWORK OF BOUTIQUE PRIVATE BANKS

<p>BROWN SHIPLEY</p> <p>Founders Court, Lothbury London EC2R 7HE United Kingdom www.brownshipley.com</p>	<p> Puilaetco Dewaay PRIVATE BANKERS</p> <p>Herrmann Debrouxlaan 46 B-1160 Brussels Belgium www.pldw.be</p>	<p> KBL EUROPEAN PRIVATE BANKERS</p> <p>43, boulevard Royal L-2955 Luxembourg Luxembourg www.kbl.lu</p>	<p> GILISSEN</p> <p>Keizersgracht 617 1017 DS Amsterdam The Netherlands www.gilissen.nl</p>	<p>MERCK FINCK & CO PRIVATBANKIERS</p> <p>Pacellistrasse 16 D-80333 Munich Germany www.merckfinck.de</p>
---	--	---	---	--



<p> KBL RICHELIEU</p> <p>22, boulevard Malesherbes F-75008 Paris France www.kblrichelieu.com</p>	<p> KBL ESPAÑA EUROPEAN PRIVATE BANKERS</p> <p>57, Calle Serrano E-28006 Madrid Spain www.kbl-bank.es</p>	<p> Puilaetco Dewaay PRIVATE BANKERS</p> <p>2, boulevard E. Servais L-2355 Luxembourg Luxembourg www.puilaetco.lu</p>	<p> KBL MONACO PRIVATE BANKERS</p> <p>8, avenue de Grande-Bretagne MC-98005 Monaco Monaco www.kblmonaco.com</p>
--	--	---	--

This document has been prepared by KBL European Private Bankers. The statements and views expressed in this document – based upon information from sources believed to be reliable – are those of KBL epb’s Group Asset Allocation Committee (GAAC) as of July 1, 2016, and are subject to change. This document is of a general nature and does not constitute legal, accounting, tax or investment advice. All investors should keep in mind that past performance is no indication of future performance, and that the value of investments may go up or down.

Copyright © KBL European Private Bankers 2016. All rights reserved.