KBL EUROPEAN PRIVATE BANKERS

2017 MIDYEAR INVESTMENT PERSPECTIVES

BACK ON TRACK

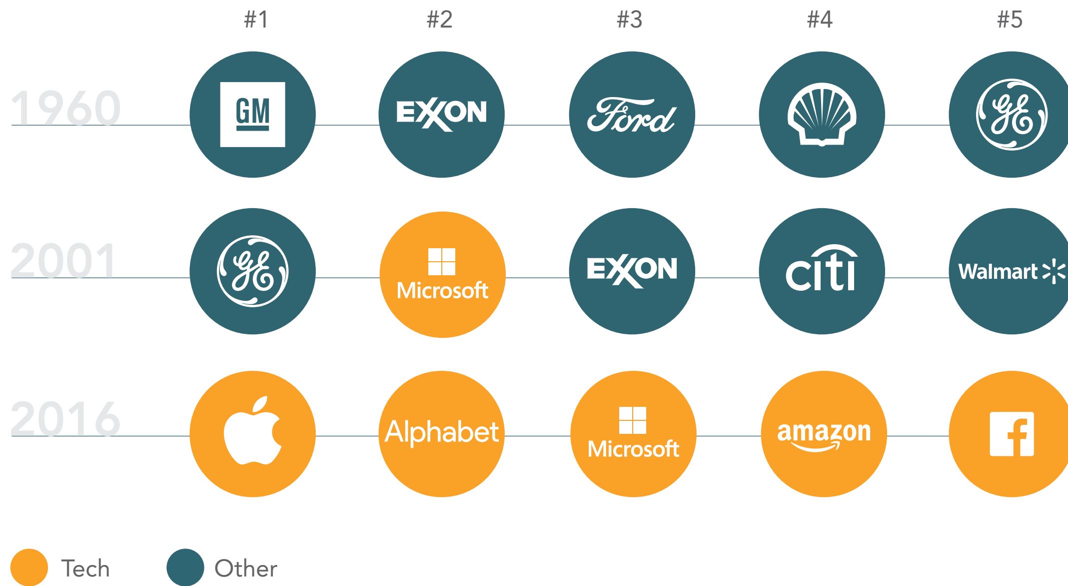
At a time when worldwide growth is accelerating, which trends are shaping the investment landscape?

AMSTERDAM
BRUSSELS
LONDON
LUXEMBOURG
MADRID
MONACO
MUNICH
PARIS

THE WORLD'S LARGEST COMPANIES BY NUMBERS

TECH TAKES OVER

World's largest listed companies, by market cap

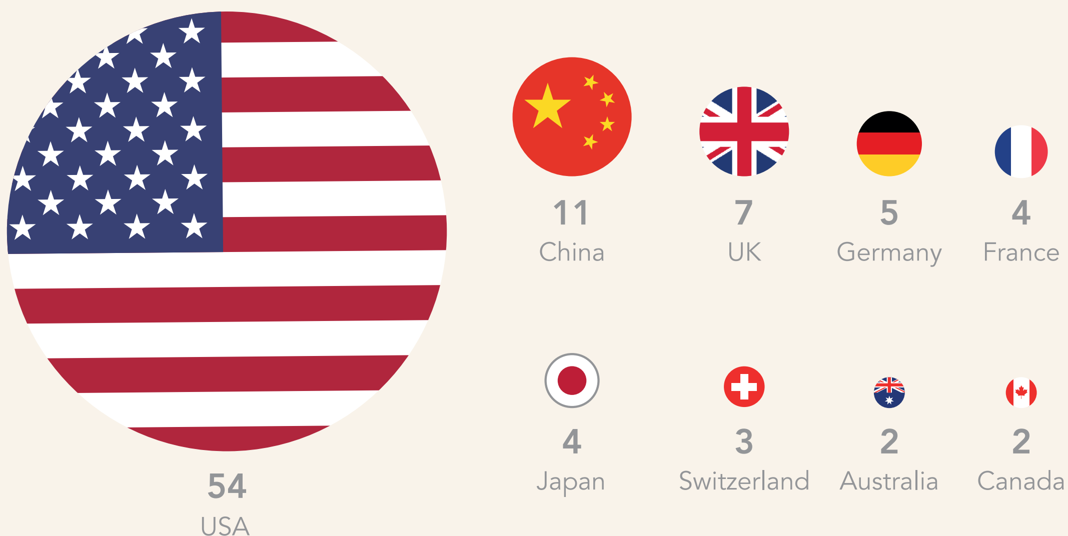


Tech Other

Sources: Relevant indices, Fortune magazine

BORN IN THE USA

World's top 100 listed companies, by country of domicile



Sources: PwC

ON THE UPSWING

The global economic outlook is increasingly positive, led by Europe and emerging markets. The US and UK, however, face headwinds

Consistently positive economic news since the summer of 2016 has resulted in a brighter global outlook. Today, both developed and emerging markets appear on course for a broad-based, though still modest, economic upswing.

In Europe, a synchronized recovery finally seems to be taking hold. In fact, the cyclical recovery that started in the second half of 2016 has only grown stronger since the start of this year – supported by a reduction in fiscal austerity and increased consumer spending as employment prospects look more secure.

Deflationary concerns have also taken a backseat, although core inflation in Europe remains too low. Investments, which have long been the missing piece in the European recovery puzzle, are finally picking up as domestic and international demand is rising and the overall profit picture improves.

Additionally, the fact that banks have managed to sufficiently restore their liquidity ratios – and are again able to make loans – has certainly helped.

All in all, Europe could be on its way to recording its best year since the crisis, with GDP expected to expand by at least 1.6%.

That said, structural problems in France and Italy remain key concerns that will need to be solved by those countries' respective (new) governments, without stoking social tensions or shaping a platform that could give further rise to populism.

On a similar note, Brexit negotiations are shaping into a messy affair that could hurt confidence in the UK, as well as growth prospects in Europe.

> SINCE THE START OF THIS YEAR, A SYNCHRONIZED RECOVERY FINALLY SEEMS TO BE TAKING HOLD IN EUROPE

The island's economy has so far held up better than expected since the referendum; the sharp drop in sterling has actually helped exports. However, the consequent inflationary shock due to the weakened pound has led to diminished purchasing power for UK consumers, resulting in lower consumption – an effect that may ultimately overshadow export gains.

Meanwhile, growth in emerging markets is also picking up, with the recovery in some commodity prices providing support to exporters. Brazil, for instance, following a long and deep recession, has once again experienced growth – although a scandal surrounding the president could deteriorate prospects.

At the same time, China remains focused on addressing debt levels and limiting credit growth without overly impacting the pace of broader economic expansion.

The big (and unexpected) negative this year has been in the US. President Trump has so far failed to fulfill his campaign promise of economic stimulus through tax cuts and infrastructure spending. Several months into the job, the US president does not seem to have established normal working relations with Congress.

Belief is now growing that Trump's economic measures will not only be watered down, but also kick in later than promised.

Given weaker-than-expected first quarter GDP figures (partially reflecting persistent issues with seasonal adjustments for the winter period), we have lowered our full-year growth forecast for the US from 2.4% to 2.1%. ■

WEATHERING THE STORM

Despite widespread fears, Brexit hasn't capsized the UK economy – at least not yet

Almost exactly a year after the UK voted to exit the European Union, we are little wiser as to the longer-term implications of this decision – both for the UK and Europe. One thing, however, is nevertheless clear.

Confounding the expectations of many economists – and, significantly, the UK Treasury itself – the sky has not fallen on the British economy, which expanded by 2% last year, down only slightly from 2015.

It was thought that a vote to leave the EU would unleash a surge in uncertainty and fear that would bring the UK economy to a grinding halt. But that has not happened, at least not yet.

Political stability, central bank action and currency depreciation – including sterling's biggest-ever one-day drop against the dollar, the day after the referendum – have all served to provide support. Despite widespread anticipation of foreign investor flight, foreign direct investment rose sharply last year. The UK real estate market, excluding prime London properties, has proved surprisingly resilient.

Of course, all this might not last. Brexit remains a major threat to the domestic economy, and surveys suggest there is a great deal of pessimism – both among the general population and the private sector – about the post-Brexit outlook. There is clearly a risk that this could snowball, leading to a significantly weaker growth dynamic for the UK.

Much depends, however, on the negotiations and decisions surrounding the Brexit process itself. The degree to which the UK and EU can agree a trade deal is of particular importance.

> "FOREIGN DIRECT INVESTMENT ROSE SHARPLY IN 2016, AND THE PROPERTY MARKET HAS PROVED SURPRISINGLY RESILIENT"

Failing that, the spotlight would turn to the policies the UK government implements to mitigate the economic damage caused by a move to WTO international trade rules, such as a more aggressive corporate tax regime and fast-track trade agreements with non-EU countries.

While Prime Minister Theresa May called the June 8 snap election hoping to provide the government with greater scope to protect the economy in the event of failed Brexit negotiations, the vote proved another twist for Britain's political future.

Rather than the predicted increase in the government's working majority, the vote instead ended with a hung Parliament – with May's Conservative party falling eight seats short. Nevertheless, the prime minister is set to stay in charge, forming a government with the support of the Democratic Unionist Party to assure a parliamentary majority.

Meanwhile, there appears to be no softening in the EU's stance. That said, the importance of politics to the outcome of negotiations might be overstated, and thus the scope for the UK to arrive at an agreement greater than widely perceived.

There is a sense that this view is also helping to provide some support for the pound, which is currently trading some 16% lower than in late 2015, when the referendum first appeared on the horizon.

It almost goes without saying that the shape of the UK's post-EU trading relationships is by far the most important factor influencing sterling. As a result, its movements on foreign exchange markets are perceived by many as a bellwether of expectations relating to a successful Brexit outcome for the UK. ■

BRIDGING THE INFRASTRUCTURE GAP

Infrastructure investment can provide significant long-term economic benefits. Such spending can also generate short-term political capital

Many of the world's railways, highways, airports, electrical grids and telecom towers are badly in need of an upgrade, wholesale replacement or new construction. But that's not the only reason why so many governments are now focused on infrastructure investment.

At least as importantly, such spending stimulates immediate growth through job creation, as well as longer-term growth thanks to increased productivity.

Infrastructure investment typically has a socioeconomic rate of return of around 20%, according to McKinsey, meaning that $1 of well-spent infrastructure investment can raise GDP by 20 cents in the long run.

Little surprise, then, that PwC predicts that annual global infrastructure spending will reach $9 trillion by 2025, more than double current levels.

Between 2000-2015, China led the way – investing over $8 trillion in infrastructure projects, more than North America ($6.9 trillion) or Europe ($5 trillion).

Since the start of its recent domestic slowdown, China has stepped up such spending to compensate for a decline in manufacturing investment.

Meanwhile, in the United States, Donald Trump has promised to inject $1 trillion into domestic infrastructure, while also continuing to ease key financial, energy and environmental regulations to help accelerate that effort.

Markets are likely to continue to focus attention on infrastructure-related companies with significant exposure to the US.

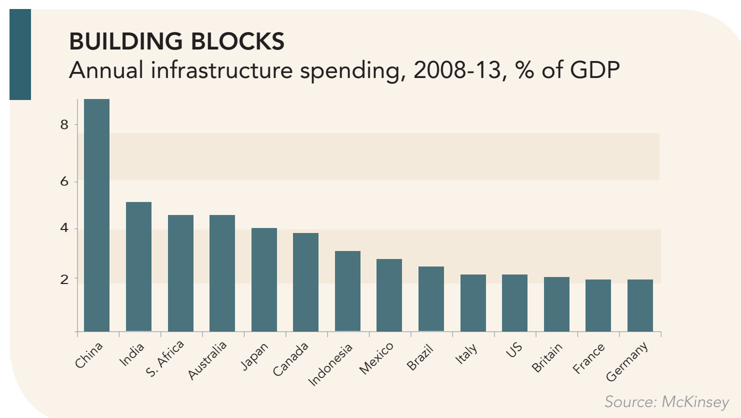
The sector is already outperforming in the US, as demonstrated by the MSCI Infrastructure indices, which measure the performance of owners and operators of infrastructure assets.

In 2016, the MSCI Global Infrastructure Index rose almost 9%, while the US index soared by nearly 22%. Over the same period, the European index declined by more than 9% – at a time when European investors bet heavily on undervalued sectors such as financials and energy.

Today, European construction is in the early stages of recovery, supported by rising home prices and high borrowing capacity. Moving forward, we can expect greater emphasis on infrastructure spending as a vehicle of job creation.

It's worth noting that European infrastructure is in generally good shape, at least compared to America's dilapidated bridges and potholed highways.

While the US may eventually invest heavily, the greatest infrastructure gap is in emerging markets – particularly in countries like India, South Africa, Indonesia and Mexico – where some 60% of all such investment will be required over the next 15 years and where the greatest long-term opportunity lies.



BUILDING BLOCKS
Annual infrastructure spending, 2008-13, % of GDP

LOOKING UP

Despite significant political risk and questions about future central bank policies, the global investment outlook remains favorable, especially for equities

From an investment perspective, the second half of the year is shaping up to be less straightforward than the first.

There are plenty of explanations for this shift. First, an improving global economic outlook has triggered increased uncertainty about whether central banks will keep their spigots open.

Unlike the US Federal Reserve, the European Central Bank and Bank of Japan are still buying bonds, and are not expected to raise rates in the near future as inflation remains below targets. Nevertheless, investors continue to fear a pivotal change to the so-called "liquidity supernova" and, as a result, tend to position ahead.

With equity markets fairly valued – and some even seen as expensive – continuous improvement in earnings growth will be necessary as a counterbalance, but occasional weaker quarterly results could cause problems.

Higher bond yields present another potential obstacle. Should the Fed hike rates beyond expectations, the bond curve could be affected. In that scenario, the Fed would be forced to gradually decrease its $4.5 trillion bond portfolio.

While political risk has declined in Europe, Asia is facing significant political tensions, especially as North Korea continues to rattle its sabers.

President Donald Trump is another source of global unpredictability. His April order to bomb a Syrian installation shows that US military action is always a possibility. Although very little of Trump's protectionist wish list has been achieved as of yet, the North American Free Trade Agreement remains at risk, as are US commercial relationships with a host of countries.

PROFIT AND SALES GROWTH ARE NOW ACCELERATING, INVESTMENT IS INCREASING AND HIGHER PRODUCTIVITY IS EXPECTED

On the brighter side, consider that many investors are simply waiting to find the right opportunities for their excess cash – with inflation likely off the table, investors are now focused on identifying potential real returns.

In today's favorable economic environment, it is important to look at the bigger picture: profit and sales growth are accelerating, investment is increasing and an upward turn in productivity is expected.

Meanwhile, most bonds have been yielding negative real returns as inflation has climbed above nominal interest rates.

As a result, the safest bond classes with the lowest yields might continue to underperform. We believe that the reduced number of eligible bond categories will lead investors to focus on equities and their still-handsome dividends.

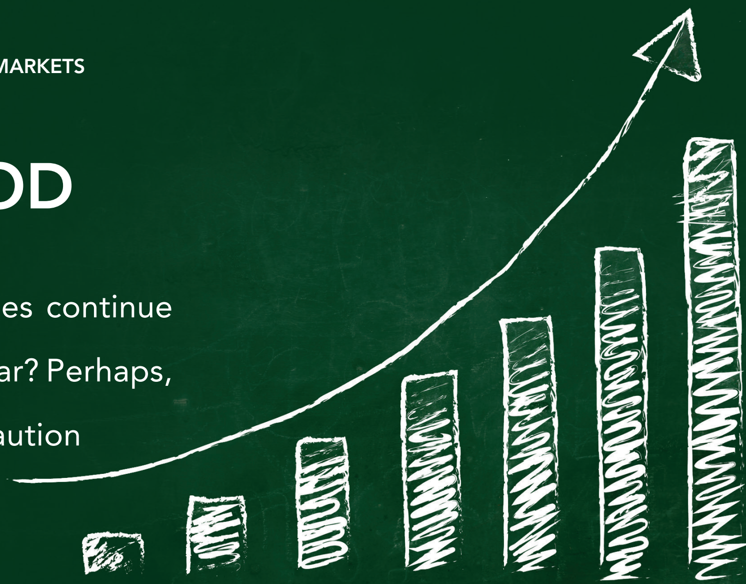
The risk-return relationship looks best in Japanese equities, followed by European and emerging-market shares – US markets seem overpriced.

For bonds, on the other hand, better to be safe than sorry. Higher-yielding corporates and emerging-market debt seem more promising. At the same time, the big turnaround from its recent trough has been encouraging for gold. We stick to our confident position on commodities for diversification purposes.

Finally, as the dollar looks more challenged despite the rising trend in US interest rates, it is advisable to reduce currency exposure, especially vis-à-vis the greenback. ■

SO FAR, SO GOOD

After a stellar first half, will equities continue their bull run over the rest of the year? Perhaps, but that outlook is tempered by caution



In mid-2016, doubts abounded about the outlook for global equity markets. So far this year, however, so good. Indeed, in the first half of 2017, a range of US and European indices hit all-time highs, as did the MSCI World Index.

Earlier concerns about political risk and earnings momentum turned out to be unfounded. In sharp contrast to recent years, analyst expectations were stable to higher in the first half, driven by an impressive run of economic data and strong earnings releases.

Will equities continue their bull run in the second half of the year? Perhaps, but prudence remains justified for two main reasons.

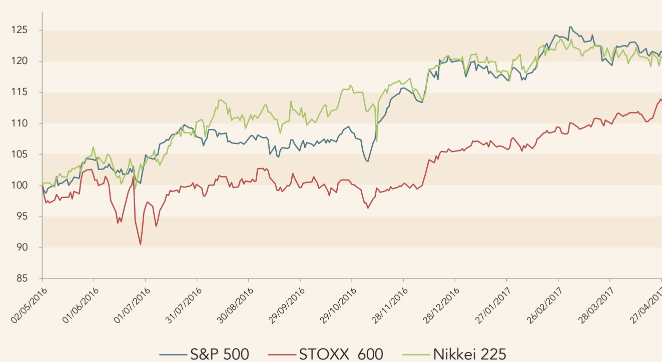
First, valuation levels appear to be quite stretched in the United States, although less so in Europe and especially in Japan and emerging markets, where earnings and valuations both look particularly attractive.

Second, we are moving ever closer to an environment where central banks will begin tightening. Rate hikes, European Central Bank tapering and US Federal Reserve balance-sheet shrinking lie ahead. That will result in tighter liquidity conditions across the globe.

From the current position of ultra-low volatility, either of these factors (in addition to political risk) could trigger at least a slight equity market correction.

Nevertheless, we remain cautiously positive on equities.

RUNNING OF THE BULLS
Key indices, rebased to 100



Source: FactSet

Investor cash searching for yield is still struggling to find convincing alternatives, while central banks stand ready to intervene in the event of a serious threat. That last fact alone provides powerful psychological support to the market, which could continue to benefit from positive economic trends and ongoing upward earnings revisions.

However, the more elevated valuations and index levels become, the more caution is justified. Moving forward, an incremental reduction in equity risk may be called for – helping reduce exposure to a possible correction without fully negating upside potential.

Given current market levels, European, Japanese and emerging-market equities hold the greatest appeal. Meanwhile, the outlook for US shares will hinge at least partly on President Trump's ability to deliver promised tax reform.

Cyclical stocks continue to remain preferable to defensive ones. Despite the ongoing long-term attractiveness of the tech sector, some profit-taking looks increasingly appropriate given high valuation levels. Finally, should markets remain on a solid path, banks, especially in Europe, could turn out to be one of the top-performing sectors. ■

THERE'S NO PLACE LIKE HOME

What do sports fans and stock-market investors have in common?

Both tend to be strongly biased in favor of their home market

Sports fans the world over (from Manchester to Munich to Mumbai) often form a profoundly intense attachment to their team. Very rarely, however, is that attachment founded upon rational deliberation, objective research or any kind of considered personal preference.

Instead, we simply root for the team based in the place we call home.

In fairness to sports fans, nearly all of our core beliefs are similarly arbitrary. That includes, at least partly, when it comes to investing.

Individuals worldwide tend to invest disproportionately in stocks listed in their native country, a phenomenon known as "home bias." Given the proven benefits of diversification and easy availability of global data flows, this makes little strategic sense.

Consider South Korea, which has a global index weight of less than 2%. Residents there nevertheless make 90% of their equity investments in the domestic market.

Even the United States, with a massive global index weight of 53%, is guilty of home bias – with American investor holdings in domestic equities standing at approximately 80%.

Such bias is found, to a greater or lesser degree, in every single market worldwide. The trend is particularly pronounced in emerging markets – where there are often structural barriers to overseas investment – and is least evident in Europe, especially since the introduction of the common currency and elimination of exchange-rate risk.

> THE LEVEL OF EUROPEAN HOME BIAS HAS STEADILY DECLINED SINCE THE INTRODUCTION OF THE COMMON CURRENCY

Between 1997-2004, the level of home bias in the eurozone declined by 9%. Over the same period, the level of regional bias (meaning total investment in eurozone shares) increased slightly.

Within Europe, the Dutch are by far the least exposed to home bias, with slightly more than 20% of equity investments allocated to the domestic market. That sounds pretty balanced – until you consider that the Netherlands represents less than 1% of total world market capitalization.

Like the Netherlands, other European nations, such as Austria, Belgium and Germany also at first appear relatively unbiased, with roughly 37%, 45% and 48% of their equity investments in domestic shares. Once again, though, this has to be put in context: Germany, the largest of the three markets, has a global index weight of barely 3%.

The home-bias trend is even more exaggerated in France, which also has a global index weight of just 3% and where residents nevertheless make fully 60% of their equity investments in the domestic market.

While each of these countries compares favorably to the international mean – which is skewed by emerging markets – the broader issue of home bias remains a puzzle that has left economists scratching their heads for decades.

It may pain practitioners of the dismal science to admit it, but, in the end, the value of geographic portfolio diversification is simply no match for the power of human psychology. ■

BACK TO NORMAL

Nearly a decade after the start of the global financial crisis, monetary policy on both sides of the Atlantic is finally approaching normalization

The improving macroeconomic environment is creating challenges for monetary policymakers.

With growth finally in a synchronized upswing and deflationary pressure receding, the question for central banks (widely seen as way behind the curve) is how to transition out of a highly supportive policy stance without roiling the markets.

In the US, the Federal Reserve managed market expectations by implementing an interest rate hike in March, following the December 2016 increase.

After years of ultra-loose policy – and with the US economy now at virtually full employment and President Trump planning further stimulus through tax cuts and infrastructure spending – Fed Chair Janet Yellen has clearly decided that now is the time to begin normalizing rates.

By acting sooner rather than later, according to the Fed's logic, it can avoid a series of quick rate hikes in future that could threaten the business cycle.

In the immediate wake of the unexpected March rate increase, 10-year yields shot back up to 2.6%. Since then, however, the market has had second thoughts about Trump's ability to deliver his stimulus plans, and rates again dropped lower.

Two further hikes are anticipated this year, as mounting tension in the labor market should lead to intensifying inflationary pressure. Long rates should end the year in the 2.75-3% range.

Debate about how to rein in the Fed's $4.5 trillion balance sheet should also commence in earnest in the second half of the year, possibly leading to even more tension on money markets in 2018 as liquidity is drained from the system. The US curve should flatten in the process.

The European Central Bank faces its share of challenges, too, as better growth figures and increasing headline inflation feed speculation that the ECB may taper its quantitative easing program ahead of the announced December 2017 deadline.

Some analysts have made the unlikely suggestion that the central bank could hike rates even before the bond-buying program concludes; hawkish ECB members then added to the confusion by publicly stating that an accelerated exit out of the program might not be such a bad idea. Mario Draghi has quashed those rumors, though, pointing to the eurozone's still very low core inflation rate.

QE WILL LIKELY BE TAPERED FROM 2018 ONWARDS, AND INTEREST RATE HIKES SHOULD REMAIN ON HOLD UNTIL THEN

We are in line with market opinion that QE will be tapered from 2018 onwards and that rates should remain on hold until then.

However, as the market starts to anticipate higher short-term rates, we expect long rates to come under upward pressure, with the curve steepening accordingly.

Credit markets – and especially high yield – continue to perform strongly in Europe as the ECB's corporate bond-buying program and the hunt for yield drive down spreads. However, as high-yield valuations become increasingly rich, we are exercising greater discretion in this segment. ■

THE DIVERSITY DIVIDEND

Conventional wisdom suggests that companies with more women in the boardroom deliver higher returns. The truth, however, is more complicated

In the waning months of 2016, senior French businesswomen were in unusually high demand.

Since the start of this year, at least 40% of board members at large French firms (including those with over 500 employees and annual revenues in excess of €50 million) must be female.

Legislating gender diversity is hardly controversial in Europe, where women today account for just under 25% of board members at the largest listed companies. By comparison, they hold roughly 19% of board seats at S&P 500 firms and fewer than 3% of seats at TOPIX-listed companies.

However, it's not clear that such quota systems – which also exist in Belgium, Iceland, Italy, Germany, the Netherlands and Spain, and will be introduced in 2018 in Portugal – have much trickle-down impact.

A recent review of the pioneer in this regard – Norway, whose 40% quota for female directors came into force in 2006 – found that "the reform had very little discernible impact on women in business beyond its direct effect on the newly appointed female board members."

There are also reasons to challenge the conventional wisdom that greater gender balance on a board level is linked to superior financial performance. Despite the publication of multiple studies that claim to demonstrate such a correlation, there is little evidence that having more women in the boardroom actually causes profitability to increase.

That distinction – between correlation and causation – is important.

Consider the correlation between sleeping with one's shoes on and waking up with a hangover. While the presence of shoes in bed may be statistically interesting, the Hush Puppies obviously aren't the cause of the headache.

In this case, too, there are additional variables that may inform why companies with diverse boards perform better – including that companies that do better tend to attract more diverse board members.

Indeed, a 2016 Peterson Institute study of some 22,000 firms in 91 countries found that "the impact of women's presence on the board is not statistically robust."

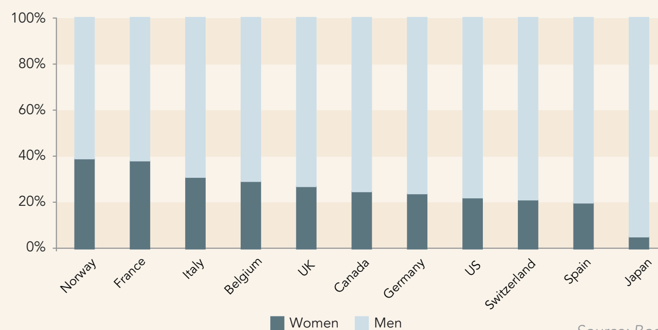
Meanwhile, there is an area in the organization where gender diversity seems to more clearly pay a dividend: senior management, where fewer than 25% of all roles worldwide are held by women.

Having a higher proportion of women at the C-suite level is strongly correlated to improved corporate performance, according to the Peterson Institute, which argues that "a more diverse leadership team tends to deliver better outcomes on average."

The same study found that female CEOs did not significantly underperform or overperform when compared with male chief executives.

In other words, having a robust pipeline of senior women – who are actively involved in day-to-day management – is more important to corporate profitability than such diversity in the boardroom or CEO's office.

OLD BOYS' CLUBS
Board representation, by gender



Source: BoardEx

WHEN SUPPLY MEETS DEMAND

Expect the euro to post gains against other major currencies over the second half of the year, while commodity prices will benefit from positive trends

Until recently, the outlook for the common currency appeared, at best, mixed. Following the first-round French vote and subsequent election of pro-EU President Emmanuel Macron, however, the euro now looks poised to gain against other major currencies, including the USD, GBP and JPY.

By April, the euro had already erased the dollar's 3% gain recorded in 2016. In the second half of this year, the greenback is likely to slide further – dragged down by President Donald Trump's support for a weak dollar to stimulate US manufacturing and limit imports, as well as the structural deterioration of the country's budget deficit and debt-to-GDP ratio.

Consequently, we expect the EUR/USD currency pair to fluctuate between 1.05-1.20 over the next six months.

Meanwhile, the yen has benefited from its safe-haven status during a period of heightened geopolitical tension. Moving forward, we expect the JPY to weaken due to the Bank of Japan's yield-targeting policy, keeping its 10-year government bond yield at zero. Stronger worldwide growth, beginning in the fourth quarter, should increase the country's current account surplus, however, and reduce the need for accommodative monetary policies.

Our six-month range for the JPY is 105-120 against the USD and 110-130 against the EUR.

As for sterling, the Bank of England should maintain its dovish policy stance in the wake of weaker industrial production and employment data, potentially balanced by rising inflation.

Improving manufacturing activity and increased state spending on infrastructure projects are favorable for the demand side of the equation, while producers appear more open to limiting output, including oil production. In that regard, we forecast that Brent prices will fluctuate between $40-60 per barrel until the end of this year.

> “THE GREENBACK IS LIKELY TO SLIDE FURTHER IN 2017, DRAGGED DOWN BY WEAK-DOLLAR POLICIES”

While the surprise decision to call a snap election on June 8 first pushed the currency higher, increased political uncertainty could weigh on the GBP, as could the long-term deterioration of the country's current account deficit.

Among commodity currencies, the Norwegian krone should benefit from the country's fundamentally sound economy, while others are likely to fluctuate, primarily in line with commodity prices. Emerging-market currencies appear more expensive at current levels and could suffer from the two additional US rate hikes we expect this year.

Turning to commodities, the outlook for global prices is positive, thanks to greater supply-demand equilibrium.

During the same period, industrial metal prices should be pushed higher by production cuts, following earlier reductions in capital expenditure.

Regarding China, we expect overcapacity to shrink as the world's most-populous country transitions from an export-driven economy to a market led by domestic consumption. Nevertheless, a major Chinese property market slowdown, along with a reduction in demand for construction materials and commodities, remains a risk factor.

Overall, global commodity prices should also be supported by increased investment flows, reflecting the associated diversification benefits in a balanced portfolio. ■

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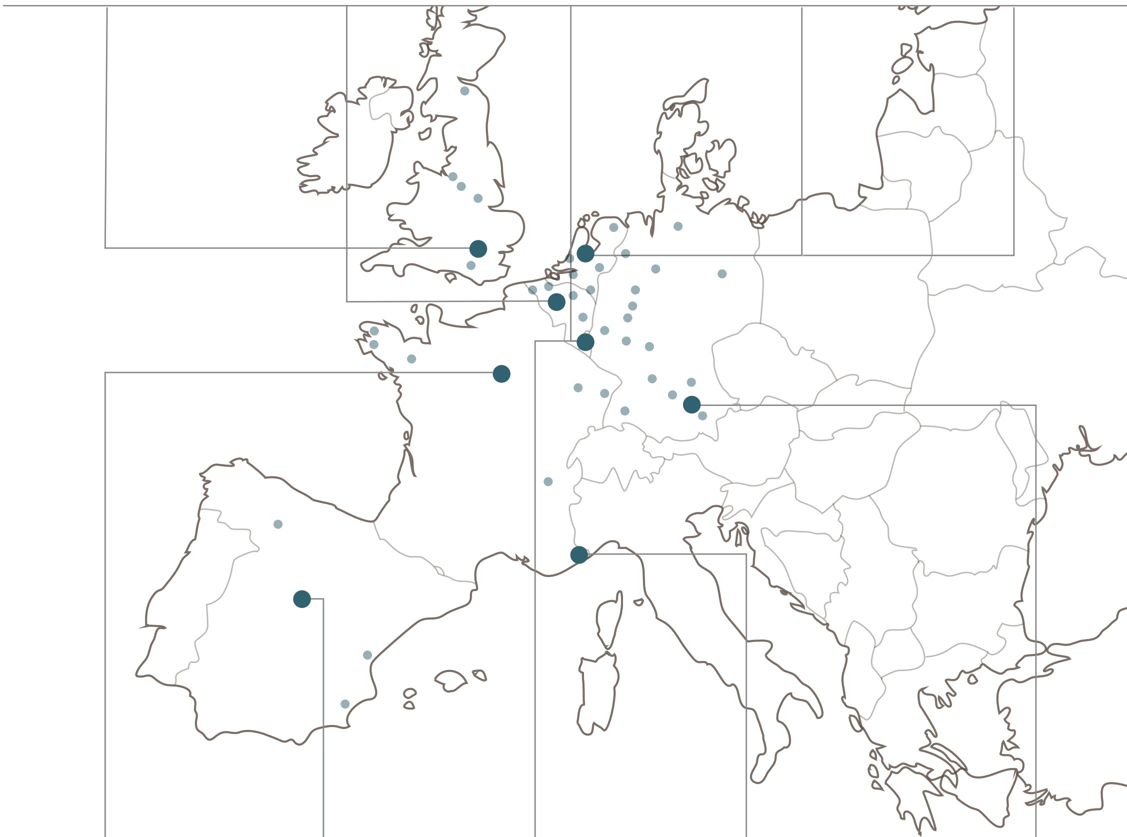

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