The year of the doves

With all major central banks now having turned dovish, we can expect the continuation of ultra low global interest rates in 2019. This is a relief for markets, which have already rallied in response. The greater concern is whether global growth can make a comeback.
ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT ESTIMATES (E) (AT 1ST APRIL 2019)*

<table>
<thead>
<tr>
<th>EQUITIES INDEXES</th>
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<th>DEC 2019 E</th>
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<td>European HY</td>
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<td>EM Corporates (USD)**</td>
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<thead>
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<tr>
<td>EUR/CHF</td>
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<td>GBP/USD</td>
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<th>DEC 2019 E</th>
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<td>US</td>
<td>3.1%</td>
<td>2.9%</td>
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<td>Euro area</td>
<td>1.2%</td>
<td>1.8%</td>
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<td>UK</td>
<td>1.3%</td>
<td>1.4%</td>
<td>1.4%</td>
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<tr>
<td>Switzerland</td>
<td>1.4%</td>
<td>2.5%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Japan</td>
<td>1.3%</td>
<td>0.8%</td>
<td>0.6%</td>
</tr>
<tr>
<td>China</td>
<td>6.8%</td>
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</tr>
<tr>
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<th>DEC 2019 E</th>
</tr>
</thead>
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<td>US (core PCE)</td>
<td>1.9%</td>
<td>1.9%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Euro area (headline HICP)</td>
<td>1.5%</td>
<td>1.7%</td>
<td>1.3%</td>
</tr>
<tr>
<td>UK (headline CPI)</td>
<td>1.8%</td>
<td>2.5%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Switzerland (headline CPI)</td>
<td>0.6%</td>
<td>1.0%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Japan (core CPI)</td>
<td>0.9%</td>
<td>0.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td>China (headline CPI)</td>
<td>1.8%</td>
<td>2.1%</td>
<td>2.0%</td>
</tr>
<tr>
<td>World (headline HICP)</td>
<td>4.0%</td>
<td>3.5%</td>
<td>3.5%</td>
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</table>

*Past performances or forecasts are not per se a reliable indicator of future performance.

Source: Pictet WM - AA&MR, Bloomberg, Factset, Eikon, AA&MR
PERSPECTIVES  
APRIL / MAY 2019  

INVESTMENT STRATEGY  

IT’S ‘SHOW ME THE MONEY’ TIME

Since the start of 2019 a series of discrepancies have dominated the macro and market environments. While macro data and indicators are cause for caution, markets across the board have shown signs of exuberance, with US equities posting one of their strongest starts to a year in history.

The current macro picture is concerning. The Italian and German economies are flirting with recession while the Chinese economy, the world’s second largest, is slowing noticeably. At the same time a look beneath the surface reveals that, after stripping out the negative impact of slowing trade, domestic demand remains robust in many places. This has been demonstrated by the rebound in the euro area’s (domestically oriented) services PMI, while its (export-oriented) manufacturing PMI continues to fall. At the same time the US consumer’s real disposable income is growing at a healthy 3% in the absence of inflation, which should boost consumer spending at a time when trade is falling. This gives us confidence that the global economy can bounce back in the second half of the year once the dust causing all the current uncertainty – from US-China trade to Brexit – has settled and the underlying fundamentals are given room to shine through once more.

Meanwhile, markets have essentially recovered all of December’s losses, rallying on hope rather than concrete assurances. Valuations are looking rich, as the return of the “Powell put” nudged those investors who feared the Fed would kill the cycle with continued interest-rate hikes back into equities. At the same time, bond and equity markets are telling a different story, with both recovering in step in 2019, while the yield curve has not recovered at all, meaning that investors continue to anticipate a recession. And even though the Fed’s policy U-turn has lifted markets, it creates a dilemma for the central bank. If it raises rates again, it could ultimately trigger a recession; and if it does not, the economy is at risk of eventually overheating, given that financial conditions have already improved. The European Central Bank, for its part, has made its own dovish turn, but with a different reaction from investors, who retreated from equity markets on fears of a slowing euro-area economy.

We see volatility in markets ahead until various resolutions have been reached, including around trade, Brexit, Venezuela and European parliamentary elections. In the meantime we will be taking profits in portfolios as opportunities present themselves. Beyond that, for markets to continue to rally, we will need economic activity to bottom out and earnings revisions to stabilise in the second half of the year. However, we remain cautiously optimistic that, given underlying fundamentals, the global economy can turn around in the next half of 2019, particularly if world trade is not held hostage and Chinese government stimulus is effective in preventing a severe slowdown in China’s economy.

For markets to continue to rally, we will need economic activity to bottom out and earnings revisions to stabilise in the second half of the year.”
In a nutshell

A US-China trade deal could directly impact business sentiment

Trade war worries were very much at the fore in earnings transcripts last year. Occurrences of the words “tariff”, “trade war” and “protectionism” were high, despite mentions having dropped in Q4 from the previous two quarters. This underscores our view that a US-China trade truce is pivotal to the future prospects of the global economy.

Historically, stocks have rebounded when the ratio between three-month and one-month volatility on the S&P 500 has fallen to 0.8, which coincides with signs of investor capitulation. On each of the past five occasions the ratio has reached 0.8, there has been a rebound in equities (although sometimes followed by renewed small dips). Past rebounds in the three-month/one-month ratio from 0.8 to 1.24 tend to be followed by a sharp recovery in equity prices.

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**OCCURRENCES OF TRADE WAR-RELATED WORDS ELEVATED IN COMPANY REPORTING**

Source: PWM CIO Office, Bloomberg, February 2019

**CORRELATION BETWEEN SHORT-TERM VOLATILITY RATIOS AND EQUITY PERFORMANCE**

Source: Pictet - WM CIO Office, Bloomberg, 21 January 2019
Markets in early 2019 have been helped by the dovish turn in the Fed’s stance. Along with its promise to be “patient” on further rate hikes, the Fed has sent signals that it will soon end its balance-sheet reduction, thus helping ease concerns about tightening financial conditions.

With growth flagging and a certain lack of visibility on the trade and political fronts, central banks, like the Fed, have had little room to pursue policy ‘normalisation’. Slowing growth means the European Central Bank recently signalled a delay in its plans to tighten rates later this year, while the People’s Bank of China has been providing significant policy stimulus in response to a growth slowdown.

Although their deep-seated strategic rivalry will not go away soon, a certain rapprochement on trade matters between the US and China will increase visibility and could well give a further fillip to markets. So, too, could a stabilisation in earnings expectations (something that is possible, given the recent turnaround in the fortunes of energy companies). Confirmation that, despite slowing growth, recession is not imminent could likewise encourage risk taking. Indeed, we expect the present downturn in Europe and China to trough in the coming months. We might even see some fiscal stimulus in Europe, however limited.

Alongside our measured optimism, it may be legitimate to ask whether the Fed’s dovish turn marks a new chapter in central bank policymaking. We are late in the economic cycle, yet interest rates remain low, meaning central banks will have to become even more imaginative to tackle the next downturn. This, we believe, could mean the abandonment of inflation targeting along with stricter attention to financial market conditions and liquidity, especially given the high levels of leverage that have built up in parts of the economy, not to mention the large public debt burdens in much of the industrialised world.

With large or rising debt burdens a force for disinflation, the risk is that central banks’ 2% inflation target becomes ever more elusive. In spite of hefty doses of quantitative easing, they have still not met that target, with the Bank of Japan furthest behind. It may well be that central banks abandon their forlorn hopes on this front. They may concentrate instead on not upsetting markets, which could reduce liquidity for the most debt-laden corporates and countries via a tightening in financial conditions. In short, liquidity flows need to be maintained and the cost of credit has to be kept below nominal economic growth (about 4% in the US, 3% in Europe), something that will restrict central banks’ margin of manoeuvre in setting base rates.

All in all, we remain relatively upbeat about economic prospects, and we now expect that central banks, faced with the need to keep debt-laden markets and economies afloat, will keep the monetary spigots open in the months ahead, helping justify an expansion in earnings multiples even as earnings growth declines from last year’s high levels. We thus remain cautiously optimistic about equities.

“We are late in the economic cycle, yet interest rates remain low, meaning central banks will have to become even more imaginative to tackle the next downturn.”

CHRISTOPHE DONAY
Chief Strategist, Head of Asset Allocation & Macroeconomic Research
Pictet Wealth Management
The US Federal Reserve’s (Fed) dovish pivot has aided a recovery in market sentiment, while creating some easing space for other central banks around the world. Most central banks are currently grappling with their own idiosyncratic constraints however, with limited room for manoeuvre in most cases. As a result, the burden will fall on governments more than ever to adopt fiscal policy responses that mitigate the economic effects of the global slowdown currently underway.

The Fed triggered big market swings with its dovish shift at the turn of the year. Is this the return of the ‘Fed Put’, or should investors be concerned about the state of the economy?

When the Fed announced it was removing its rate-tightening bias and emphasising “patience”, Fed Chairman Powell described the dovish turn as just “common sense risk management”. While there is little doubt that the slowdown in global growth has played an important role in the Fed’s decision, market volatility served as the catalyst (hence the ‘Powell Put’ concept). Whether or not the Fed’s U-turn reflects a more significant change in its reaction function, it has probably put an implicit floor on asset prices.

As a result, monetary and financial conditions are likely to fluctuate within a range. With lower bond yields, tighter credit spreads and higher equity valuations, the Fed can afford to strike a more neutral tone. If monetary and financial conditions were to tighten again, the Fed is likely to respond with increased dovishness. There is an element of circularity that does concern us, when bad news can be good news for markets, but that may be the price to pay for policy normalisation over time.

What are the implications for other central banks around the world?

Initially you would expect other central banks to follow the Fed and turn more dovish as well, delaying monetary policy tightening if not cutting rates outright. We have seen many examples of this already (See chart 1), especially in emerging markets (EM), where lower US rates and the prospects of a weaker USD should alleviate the pressure facing some central banks of late.

However, the Fed’s pivot presents a double-edged sword, and a mixed bag for some countries. First, the outlook for monetary policy is more complicated, with other important drivers still playing a role (including trade disputes) and offering limited room to manoeuvre in most cases. In Europe, the Bank of England (BoE) and European Central Bank (ECB) are facing idiosyncratic constraints. At the same time, the Bank of Japan (BoJ) is being forced to taper its asset purchases when bond yields are declining, due to its ‘yield curve control’ policy framework.

More importantly, global manufacturing and trade data have deteriorated sharply over recent months but we expect a rebound in business confidence and growth over the course of this year, including in China and Europe. And while inflationary pressures remain subdued in most countries, wage growth has been rising further and an inflation surprise cannot be ruled out later this year. In other words, we could be back at square one in no time, with the Fed contemplating rate hikes again.

What is the outlook for global central bank liquidity this year?

The outlook for global liquidity boils down to the Fed. First, the Fed is the
only major central bank whose balance sheet is shrinking at the moment, by about USD 400bn, or close to 10% from the 2017 peak (see chart 2). True, other central banks, including the ECB (via LTRO extension and QE reinvestments), the BoJ (via asset purchases, albeit at a slower pace) and the People’s Bank of China (largely via liquidity provision) are expected to contribute to increasing global liquidity this year. But in the end ‘Quantitative Tightening’ (QT) is all about the Fed. If the autopilot QT stops in H2 2019 as expected, then it should provide some further relief to risk assets, all else remaining equal. In the meantime, the US Treasury is likely to draw on the Treasury General Account with the Fed, thereby increasing the balances of depository institutions and resulting in a temporary increase in excess liquidity, which would more than offset the Fed’s balance sheet run-off.

Second, the Fed matters because conventional easing in the form of rate cuts can presumably not begin before the balance sheet stops shrinking. Therefore, stopping QT would probably reinforce market expectations for rate cuts in an economic downturn.

Either way, rising central bank liquidity, even at a slower pace this year and next, should benefit risk assets in general, and EM in particular, against the backdrop of lower US rates and the prospects of a weaker USD. Within the EM space, we favour local currency bonds. Although developed markets (DM) should benefit as well, a tug of war of fundamentals is at play, including slowing economic activity and earnings growth, hence our broadly neutral stance on DM equities at present.

The ECB was the next in line to raise rates this year. What should we expect now?

Europe finds itself in a weak spot once again. Independently to the ongoing Brexit uncertainty and other political risks, the economic momentum in the euro area has slowed dramatically since 2017, with GDP now below most estimates of the region’s potential. Domestic fundamentals remain strong, with falling unemployment supporting rising wage growth, but underlying inflation pressures are rising at a frustratingly slow pace. All in all, the situation still looks very fragile and Europe may be only one shock away from another recession.

What is worrying about this situation is that if a recession were to threaten the European economy, it would be challenging for the ECB to respond, given the political and technical constraints it faces, while national governments and European institutions have few readily available stimulus levers. To be sure, we do expect the ECB to keep a very dovish stance, with only very gradual rate rises over the foreseeable future. We have also long expected some sort of extension to the long-term refinancing operations (LTRO) to support bank lending, possibly alongside other credit-easing measures. Ideally, the ECB would also introduce new measures aimed at mitigating the adverse effects of negative rates, if not hike the deposit rate back to zero as soon as possible.

However, if a protracted slowdown calls for a more radical policy response, then our concern would be that it will end up being ‘too little, too late’. This will sound like a broken record to ECB officials, but the burden should fall on governments for structural reforms and a more efficient (fiscal) policy-mix to boost economic growth closer to the so-called escape velocity levels it only briefly touched in 2017.
2019 surprises

2018 had no shortage of surprises that impacted markets and this year will doubtless hold one or two in store for us as well. While not part of any of our scenarios, our CIO office leaders examine possible surprises in 2019 and how they could impact markets.

1. A second Brexit referendum results in a No Brexit and the UK stays in the EU.

At the time of writing, it remains anyone’s guess as to how the Brexit saga will conclude. However far from likely, a second referendum that results in Brexit being cancelled is a possibility, and one whose odds ticked up following Prime Minister May’s announcement that she would put rejection of a no-deal and extension of the Article 50 deadline to a House of Commons vote in the same week as the opposition Labour party formally backed a second referendum. If the British populace were to U-turn on their 2016 decision, we could expect the pound to rally, possibly returning to its pre-referendum levels (the day before the June 2016 vote, sterling fetched around USD1.48; today it is closer to USD1.31). Inflation would come down with EU trade agreements keeping a lid on rising import costs and gilt yields would possibly move lower. The UK economy would resume strength and domestically-oriented UK equities would rally. Conversely, internationally-oriented UK equities could suffer from a strong pound. The Bank of England’s direction on interest rates would depend on inflation, keeping them low if inflation were to remain muted. The euro would strengthen.

2. A demand-driven inflation spike leads to a second Fed U-turn, resulting in a US recession.

Despite steadily rising wages, US inflation has so far remained low, giving the Fed breathing space from its rate hiking cycle. However, should inflation return, the US central bank would be forced to resume its programme of interest rate rises to prevent the economy from overheating. The US yield curve would steepen and long-term rates would rise well above 3.5%. Equity markets would suffer a serious correction and high-yield spreads would widen as markets turned risk-off. The USD would weaken.

3. Extreme weather triggered by climate change leads to extreme food shortages and soft commodity prices surge.

The 10 worst climate-driven disasters of 2018 alone chalked up a bill of USD85 billion, according to a report by UK charity Christian Aid. We can safely expect that 2018 will not prove the exception that breaks the rule in this case. With many of the world’s soft commodity (coffee, cocoa, sugar, cotton, etc.) producers in the low-latitude regions particularly vulnerable to climate change, should weather-related disaster strike, we could see soft commodity prices soar. This would send interest rates up across the board. All yield curves would steepen, especially in the US and Europe. Within equity markets, consumer companies would suffer as their margins are hit. Rising prices would be negative for consumption more generally as consumers’ disposable incomes are hit at the same time. Meanwhile, soft commodity exporters, which are predominately emerging markets, could stand to benefit from the price surges.

4. Earnings growth for US equities enters negative territory. EM performance decouples from the US.

US equities, at around 16x 2019 earnings, already look expensive. If earnings growth were to enter negative
A war on waste erupts after South-east Asia closes its ports to others' waste, leading to waste crises around the world.

To address its air pollution, China abruptly shut its doors to imports of recycled material for processing at the end of 2017, after previously receiving over half of all global plastic waste exports. Because most countries produce more waste than their recycling capacity can handle, much of it ends up being exported to countries like China, previously, and now increasingly those in South-east Asia, like Malaysia, Thailand and Vietnam. If they were to follow suit, however, the West could quickly face an overwhelming accumulation of waste, resulting in higher tensions — both domestic and international. This would lead to a rally in such safe-haven assets as the US dollar and gold, while emerging markets would suffer. A stronger USD would be negative for global trade, suppressing global growth. The result would have a potential positive impact on long-term US government bonds and gold, given their status as the safest assets on earth.

The US imposes auto tariffs on European exports and the EU launches a coordinated fiscal stimulus to avoid a recession. The euro appreciates above USD1.30.

Given that the US threat to impose tariffs on European autos is live at the time of writing, this ‘surprise’ may not turn out to be so surprising. Initially European growth would fall, especially in Germany. Assuming European governments would launch a coordinated fiscal stimulus programme in response, a mounting fiscal deficit would lead to higher European sovereign yields. The euro would appreciate but, in this case, large European exporters may correct as well as the more domestically-oriented companies that are often their subsidiaries. This would have a marginally positive impact on gold because of the weaker US dollar and political tensions between the US and the EU would rise further. Italy’s deficit would be a growing cause of concern.

Maduro administration ends peacefully and Venezuela’s oil market reopens. Oil falls below USD50 per barrel.

Today, 50 countries officially recognise Juan Guaido, Venezuela’s opposition leader, following the 2018 elections that are widely considered a sham. If Maduro were to step down peacefully, Venezuela’s oil market would reopen with the removal of US sanctions, driving oil prices lower. If oil prices were to fall below USD50 per barrel, energy companies would be hit as would the US economy, which is a major oil producer. This would lead to lower investment in US oil-related industries. We could expect high-yield spreads to rise, especially in the US, where energy makes up around 17% of the US market. This would be positive for oil importers, notably emerging markets like China and India.

10 OF THE MOST EXPENSIVE CLIMATE CHANGE-DRIVEN WEATHER EVENTS OF 2018

<table>
<thead>
<tr>
<th>Event</th>
<th>Estimated cost (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US - Hurricanes Florence &amp; Michael</td>
<td>$17 billion (Florence) $15 billion (Michael)</td>
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<tr>
<td>California, US – fires</td>
<td>$7.5-10 billion (Camp Fire) $1.5-3 billion (Woolsey Fire)</td>
</tr>
<tr>
<td>Europe – drought</td>
<td>$7.5 billion</td>
</tr>
<tr>
<td>Japan – floods</td>
<td>$7 billion (June-July floods) $2.3-$5.5 (Typhoon Jebi)</td>
</tr>
<tr>
<td>Argentina – drought</td>
<td>$6 billion</td>
</tr>
<tr>
<td>China – floods</td>
<td>$3.9 billion (July floods) $5.4 billion (Tropical Storm Rumbia floods)</td>
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<tr>
<td>Australia – drought</td>
<td>$5.8-9 billion</td>
</tr>
<tr>
<td>Kerala, India – floods</td>
<td>$3.7 billion</td>
</tr>
<tr>
<td>Cape Town, South Africa – drought</td>
<td>$1.2 billion</td>
</tr>
<tr>
<td>Philippines &amp; China - Typhoon Mangkhut</td>
<td>$1.2 billion</td>
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</table>

Source: Pictet WM, Christian Aid UK charity, Counting The Cost: A Year of Climate Breakdown, December 2018
REGIONAL FOCUS

European parliament elections 2019 – the next key challenge for Europe

The 2019 European Parliament (EP) elections will be the next key political event in Europe, with the composition of the EP setting the tone for Europe’s political future. The elections will start on 23 May and end on 26 May, with the exact dates and times fixed by each member state. The European Union (EU) Parliament is elected for five years and after the UK decided to exit the EU, the EP voted to decrease the number of members of the European parliament (MEPs) from 751 to 705. The number of seats now needed to get an absolute majority is 353. That could change, however, if the UK extends its stay in the EU by three months or more.

Turnout in EU elections has historically been low, far lower than most national elections. It has been on a downward trend since 1979, dropping from 62% to 42% over the last four decades (see chart) even though voting is compulsory in a handful of countries, including Belgium, Greece and Luxembourg. One of the crucial questions surrounding the EP elections is whether this downward trend will continue or can be broken.

Role and powers of the European Parliament

The EP is a major player in the EU’s decision-making triangle of institutions, which also includes the Commission and Council of Ministers. The Treaty of Lisbon which came in force in late 2009, brought new law-making powers to the EP and put it on an equal footing with the Council in deciding what the EU does and how money is spent. The EP also elects the head of the Commission. Nevertheless, the EP alone cannot bring forward a piece of legislation and trigger the decision-making process. The EU Commission is the only EU institution that has the right of initiative. Thus, the EP can (re)act only once the EU Commission has tabled a legislative proposal. This implies that even with a significant presence of EU-sceptical parties, the EP could not, for example, change the fiscal framework of the EU Treaty. However, if the EP achieves a majority among its members, it can request from the Commission the right to submit a proposal on a matter it considers of importance for the EU in order to implement its treaties.

What are the polls telling us?

Predicting how the EP will look like is hard. The EP is unique in that its members (MEPs) organise themselves into pan-European groups roughly along ideological lines. Many national parties have refused to make EU Parliament arrangements ahead of the elections. Nevertheless, several conclusions can be drawn from recent polls. First, the mainstream centre-left and centre-right will probably lose their joint control of the legislature. Anti-establishment and nationalist parties are expected to make further gains, but not reach a majority. While an increase in EU-sceptical MEPs could somewhat impair the smooth functioning of the EP, it remains to be seen whether they could manage to forge a single, coherent group. Even if they share a scepticism towards Europe, the individuals vary significantly in their focus, agenda and ideology. In the short term, we expect the EU parliamentary election results to have a limited impact, but in the long term, if more countries were to see populist parties accessing power, the impact will be much more worrying for Europe.

TURNOUT IN EUROPEAN ELECTIONS SINCE 1979

<table>
<thead>
<tr>
<th>Year</th>
<th>% of eligible voters</th>
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<tr>
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</tr>
<tr>
<td>1984</td>
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E=Estimate
ASSET CLASS FOCUS

The time for Asia credit is now

In January, Asia hard-currency (USD) credit had one of its best starts in recent years, as credit spreads tightened fast and furiously. Undeterred by China’s weaker data and the unresolved US trade negotiations, Investor sentiment continued to improve on the back of China’s unwavering support of the economy and the US Fed’s pause in rate hikes. Given the attractive valuation and broadly supportive macro picture, now looks like a good time to invest in Asia credit.

Not only is now the time for emerging market (EM) debt, but the conditions for Asia credit look particularly promising. The positive environment for Asia credit is supported by stabilising regional growth rates, manageable inflation, accommodative central bank policy and low default rates. While the asset class has rallied, yields remain comfortably above historical averages. The US Federal Reserve’s recent dovish guidance, together with the People’s Bank of China’s (PBoC) current policies, directly supports Asia USD credit. In terms of the Chinese economy, a PBoC liquidity injection and various tax cuts are likely to help offset weaker Q4 GDP growth numbers. Furthermore, in January, the PBoC broadened its bill swap programme to include the additional tier-1 (AT1) perpetual hybrid instruments (also known as CoCo bonds) of commercial banks as part of the collateral pool. This action demonstrates the Chinese government’s support for the healthy functioning of capital markets and its attention to liquidity, which is essential for banks’ regulatory capital instruments. We believe such Chinese government action will benefit the broader Asia credit space.

The evolution of Asia USD credit

The Asia USD credit universe has grown significantly over the last decade, offering investors an enhanced breadth and scale of available investment opportunities. In terms of the JP Morgan Asia Credit Index (JACI), which represents the investable Asia credit universe, the market value today is around USD 900bn, with an average rating of BBB+ (see diagram). In off-setting the potential impact of USD volatility, Asian central banks have made considerable adjustments to their economic framework over the years, including both monetary and fiscal policy. This has resulted in a higher quality universe by way of higher sovereign ratings and lower volatility compared to other global EM regions. The lower volatility is partly attributed to the mix of clientele; Asian investors now account for the majority of primary credit bond holders in 2018 compared to less than half in 2011. Despite the negative return in 2018, Asia credit (as reflected by the JACI) has never suffered back-to-back years of losses and, given the strong start to the year, this trend looks likely to continue.

From a carry perspective, Asia investment grade (IG) credit has consistently offered a pickup of 75bps over its US and European IG counterparts (See chart 1). There is rarely ever a good time to chase yield, especially given the uncertainties around the trade discussions between the US and China, which will be a key driver of sentiment and risk in the region.

We expect credit fundamentals to remain satisfactory and have already seen a modest reduction in the Asia high yield (HY) debt multiple (debt/EBITDA) over the past two years. With credit spreads currently at wider levels, Asia HY valuation, in terms of
spread-per-unit of leverage, appears even more compelling. A theme we are currently focused on is around capitalising on the cheap valuations and attractive yields, which offer a meaningful pickup over both US and Europe HY. Within this space, Chinese real estate issues are especially interesting, as we expect Chinese home prices to stabilise on the back of the PBoC’s accommodative policies. The opportunities presented by both investment grade and HY Asian bonds are likely to see ongoing interest from investors looking for carry from spread pick up over developed markets and potential capital appreciation. For fixed income investors seeking reasonable returns without excessive risk or exposure to emerging market currency volatility, US dollar-denominated Asia credit currently presents a compelling opportunity.

POCKETS OF VALUE IN ASIA CREDIT

INDIA
Sovereign Rating (M/S) Baa2 / BBB-
*Market Cap and Percentage of JACI $52bn
*Avg Bonds Yield 6.0%
Avg Bonds Rating (M/S) Baa1 / BB+

CHINA
Sovereign Rating (M/S) A1 / A+
*Market Cap and Percentage of JACI $455bn
*Avg Bonds Yield 6.7%
Avg Bonds Rating (M/S) Baa1 / BBB

SINGAPORE
Sovereign Rating (M/S) Aaa / AAA
*Market Cap and Percentage of JACI $25bn
*Avg Bonds Yield 4.6%
Avg Bonds Rating (M/S) A1 / A+

THAILAND
Sovereign Rating (M/S) Baa1 / BBB+
*Market Cap and Percentage of JACI $13bn
*Avg Bonds Yield 4.2%
Avg Bonds Rating (M/S) Baa1 / BBB

MALAYSIA
Sovereign Rating (M/S) A3 / A-
*Market Cap and Percentage of JACI $23bn
*Avg Bonds Yield 4.1%
Avg Bonds Rating (M/S) A3 / BBB+

HONG KONG
Sovereign Rating (M/S) Aa2 / AA+
*Market Cap and Percentage of JACI $73bn
*Avg Bonds Yield 4.8%
Avg Bonds Rating (M/S) Baa1 / A-

PHILIPPINES
Sovereign Rating (M/S) Baa2 / BBB
*Market Cap and Percentage of JACI $97bn
*Avg Bonds Yield 6.7%
Avg Bonds Rating (M/S) Baa1 / BB+

INDONESIA
Sovereign Rating (M/S) Baa2 / BBB
*Market Cap and Percentage of JACI $97bn
*Avg Bonds Yield 6.7%
Avg Bonds Rating (M/S) Baa1 / BB+

OTHERS (CAMBODIA, PAKISTAN, MONGOLIA, SRI LANKA...)
Sovereign Rating (M/S) n.a.
*Market Cap and Percentage of JACI $33bn
*Avg Bonds Yield 6.7%
Avg Bonds Rating (M/S) B2 / B+

Source: Pictet WM – Asset Management, Morgan, December 2018
An examination of the US provides a pretty good flavour of what lies in store for global oil markets. Company fourth-quarter earnings and 2019 guidance suggest rather strong US oil growth resilience, led by the Permian basin, which hosts two-thirds of all US oil drilling rigs.

While the rig count has been declining over the last few weeks, consensus expectations for 2019 US volume growth are being revised upward. Drilling efficiencies continue to increase, enabling companies to do more with less. However, the anatomy of the US rig count comprises a large fragmentation of operators with diverging strategies.

Private E&P (Exploration & Production) companies make up 46% of the total rig count. Visibility on their spending aspirations remains fairly limited, but typically private E&Ps tend to act in a pro-cyclical manner, shedding rigs when oil prices are falling. Since peaking at 536 rigs in November, their activity dropped by 62 units (12%) in response to the 40% collapse in oil prices. Should the oil price continue to strengthen from here, this trend will reverse, with private E&Ps adding rigs once again, eventually translating into additional oil volumes.

The US-listed E&Ps also represent a pretty large chunk of the US land rig count, making up about 42% of drilling activity. These companies provide a good picture of their plans; they all share a common strategy centred around capital discipline and free cash flow generation. Capex plans remain based on a USD 50-55/bbl WTI oil price. Should average oil prices move higher, any additional cash generated is going to be redepolyed towards shareholders’ returns. This bodes well for the oil macro picture; overall volumes growth expectations came down for the group post-earnings season, as investment plans become more measured.

The remaining US land drilling comes from the oil majors that have been adding rigs in the Permian despite the sharp fall in oil prices. The trend is unlikely to reverse over the short to medium term. The majors think from a global portfolio standpoint and are driven by very different objectives to the US E&Ps, with US onshore becoming a strategic priority.

Pressures facing the industry
At this stage, the risk that the discipline of the US E&P industry is offset by the frenetic behaviour of the majors is considerable, while private E&Ps are adding an additional layer of pro-cyclical volatility. Crude oil volumes are likely to grow again significantly in 2019, putting pressure on the rest of the oil-producing nations once again.

Given the surprises and volatility that drove oil prices between a high of USD 85.8 and a low of USD 53.1 per barrel (pb) in 2018, forecasting what this year holds for oil markets is no easy exercise. Oil prices increased steadily from USD 45.5 in June 2017 to their USD 85.8 peak in October 2018. What followed was a deterioration in market sentiment and rising anxieties around global economic momentum due to the ongoing trade dispute. This in turn triggered concern about a potential oil glut, driving a rapid fall in the oil price. In the space of a few weeks, the price of Brent collapsed by USD 33, erasing all gains made in 2018.

Several factors have prompted the 20% oil price rebound since 27 December 2018: 1/ hopes of a trade agreement between the US and China, 2/ OPEC+ production cuts, 3/ US sanctions on Venezuela and 4/ diminished concerns
about an imminent global recession. What we are now forced to confront is the prospect of continued oil price volatility and the possibility of 2019 being a repeat of 2018.

In terms of global demand, as the acute fears of a global recession that marked the end of 2018 have in part faded, progress in the US and China negotiations has also favoured a more positive mood. A 1.4 million barrels per day (mbd) rise in global demand – a level near that of 2018 – seems probable for 2019.

Regarding OPEC+ cuts, the latest data show variable compliance. While the other OPEC members have kept close to the target for output cuts, Saudi Arabia has actually cut production by even more than was agreed, producing 10.1mbd in February, below its target of 10.3mbd. Furthermore, the kingdom has since announced that it will reduce production even further, to 9.8mbd in March. However, Russia continues to drag its feet. In February, it produced 11.34mbd, only 85,000 barrels fewer than its reference output and 145,000 barrels above the agreed target production levels. However, Russian authorities continue to confirm that they will stick to their pledge in the months ahead. Meanwhile, higher oil prices have already triggered a reaction from President Trump, leaving Saudi Arabia to tread a fine line between striving for higher oil prices to heal its finances and avoiding the Trump administration’s wrath. However, the Saudis seem determined to pursue their current strategy of aggressive output cuts to create a rapid rebalancing of the oil market before US shale producers can respond.

In Venezuela, the latest political turmoil has already taken a heavy toll on oil production. Its oil output has been more than halved, from 2.5mbd at end-2015 to 1.1mbd today. New US sanctions on Venezuelan oil exports following the contested re-election of Nicolas Maduro risks further reducing the major global supplier’s ailing production.

The US oil industry has shown continued dynamism, despite Permian basin pipelines facing capacity issues. The US liquids trade balance moved to a net export position for the second time in 75 years. With crude oil exports reaching 2mbd, the US has become a major global producer, and North America, including the US, Canada and Mexico, is becoming a sort of new Middle East. This is clearly a disruptive development for OPEC. Permian basin pipeline expansion will de-bottleneck US shale supplies, releasing them into global export markets sometime between H2 2019-2020. However, the different actions taken by Permian basin operators will ultimately determine the path of shale oil supply in the second half of the year.

While Saudi Arabia’s strategy is already bearing fruit in terms of an oil price rebound in the short term, in the longer term, it is unworkable given it implies significant market share losses in favour of the US, particularly after the Permian basin is de-bottlenecked. As a result, the profile of oil price dynamics in 2019 is being progressively clarified. We have a window in H1 2019 for Brent prices landing in a USD60–USD70 range, bolstered by decent oil demand, relaxed world recession worries, OPEC+ cuts and waning geopolitical risks. In the second half of the year, however, the oil price context appears less supportive as the oil balance risks shift again towards surplus due to increased US export capacity along with the risk that OPEC+ cuts are not extended. These structural changes in the oil industry risk flooding the market once more and weighing on oil prices. As a result, we may see prices reach the USD 50s range again by the end of 2020. In conclusion, volatility is likely to prove to be an intrinsic element of the oil market this year as it was in 2018.

![Chart 1: Oil has rebounded sharply since December’s lows](source: Pictet WM - AA&MR, Thomson Reuters, March 2019)

![Chart 2: Global oil supply – where it is coming from](source: Pictet WM - AA&MR, US Energy Information Administration, Thomson Reuters, March 2019)
Data has become businesses’ most precious resource.

Investment professionals across the industry have begun to understand the utility of alternative data and that it is forever changing the investment landscape. But what exactly is it? Alternative data (Alt Data) is information gathered from non-traditional information sources. By analysing it, is possible to gain insight beyond what traditional data sources are capable of providing. Alt Data sources are typically non-financial information that can be used to better assess the future price performance of invested assets. Alt Data is found in a company’s internal data, physical technological installations or, most commonly, via web-scraping tools, an automated method of extracting data from websites. The web-scraped data itself takes many forms, including product pricing, search trends, insights from expert networks and web traffic data of all kinds. Around 2014, a group of largely sophisticated hedge funds started operating in this new data-rich investment world, aggressively seeking information advantages. Since then, many start-ups have jumped into this business, attempting to monetise this extensive availability of data.

Why Alt Data? We found four reasons.

The first factor driving the need for Alt Data is related to the growth of data availability over the last ten years, thanks to advancements in technology. Roughly 800 datasets across more than 20 categories relevant to the buy-side are available today. The five most popular data types are: social/sentiment, private company, credit card, supply chain and Web. Examples include satellite imagery used to count the number of cars in shopping centre car parks as a metric for retail sales activity; geospatial analysis for identifying the geographical proximity of competitors; and pricing data analysis for insight on everything from bundle pricing to financial rates monitoring.

The second is the pursuit of buy-side firms to ride the “low latency” world of delivering non-traditional data in order to make faster and better investment decisions, enabling them to capitalise on opportunities early and mitigate potential risks. Using Alt Data, investors can monitor how a business is doing on a weekly or even daily basis (rather than waiting for the monthly or quarterly company updates), giving them an incredible edge over other investors. For example, by employing “quantitative overlays”, such as leveraging credit-card swipe payment information, fundamental analysts can now monitor sales data against earnings estimates and forecast potential share price impact well in advance.

The third reason is based on ROI (return on investment). Alt Data is expensive and failure is often due to spending too much money and time on the wrong data firms. But if you are wise enough in selecting the right vendors, you can get a very good edge and performance ROI from your data spend.

And finally there is the so called “fear of missing out”: buy-side firms do not want to be left out of this party and are keen to glean insight on what is happening around the business. All types of investors are now embracing the use of more data and those who fail to join this revolution are likely to underperform and be left behind.

Implementing Alt Data is not only about benefits.

While firms recognise the alpha generation potential of these new datasets, they face challenges like data connectivity, data cleaning, varying quality and ease-of-use. Some of the top challenges when leveraging Alt Data are lack of workflow integration, short histories, collection systems that are prone to change, information integrity and reliability as well as data protection policies. Sufficient regulatory protection for individuals remains elusive at this stage. And some of the data types being procured by hedge funds are not anonymous with respect to personal information. The GDPR (General Data Protection Regulation) in the EU, for example, has recently been adopted to strengthen and
standardise the protection (anonymity) of its citizens’ personal data. The main driver behind this regulation lies in the problematic nature of the complex information management, which results in the difficult governance of Big Data. Data must now be handled appropriately, certified and compliant with local laws, in respect of both privacy and security management. Despite these challenges, we still think there can be substantial benefits to using alternative data. Very recently, some of the leading sources of reference in pricing data and major investment firms have started offering clients a single access point with multiple, market leading alternative data providers, for finding and receiving reliable data, that eliminates costly and lengthy procurement processes. This speeds up time to value, enabling easy and efficient integration to existing systems or databases with quant investors who need only select their preferred programming languages (mainly Python). With this access point, professional investors can browse and examine quality metadata online, trial sample datasets prior to acquisition and immediately put them to use within their organisation.

**How quants will start using alternative data practically**

According to recent studies and surveys, on average over 80% of funds use or are expected to use alternative data. We believe that 2019 will mark the beginning of a more mature phase of this business that will probably last between five to seven more years, and where the early majority of quants will start incorporating alternative data in their businesses. We think the hottest category of alternative data that we will emerge in the coming years could be consumer transaction data, where the buy side gets the most return on investment. The most prominent emergence will probably be the increase in demand for employment data. The first significant challenge for quants dealing with Alt Data is backtesting - having a mechanism to evaluate the effectiveness of a trading strategy by running it against historical data. Today, backtesting on Alt Data is very difficult, simply because we do not yet have good and sufficiently broad historical data.

This also creates an urgent need for advanced analytics skills and capabilities to process this vast amount of data. As a result, data teams are growing everywhere: the number of Alt Data full-time employees on the buy side - mainly data scientists and analysts - has grown ~450% in last five years.

To fully reap the benefits of this new investment world of abundant data, machine learning will play a central role in identifying patterns and correlations, managing risk and transforming this knowledge into actions that allow buy-side firms to gain a competitive advantage. TensorFlow and Scikit-learn in Python are the prevailing big data analytics used in asset management today. Nearly all major industry players are now filling their quant teams with physicists and data scientists, providing them with access to the data and turning them loose, expecting them to come up with something brilliant. We do not agree with this kind of approach: quants will certainly fail if they do not use a more “conservative approach” that keeps all decisions and management in the hands of experienced finance professionals. Discerning valuable information from noise requires extensive real financial experience – not maths and statistics alone.

The goal then, is not to replace finance professionals with mathematicians, but to evaluate an experienced investor’s hypothesis and test it with machines to realise superior, explainable and more actionable information. Intelligently mining this data is critical to avoid getting lost in machine-made interpretations. As we said last year, it is not mans versus machine, but experienced finance professional with machine.

To conclude, we believe the big data revolution will usher in a new era of investing that will ultimately benefit markets by lowering day-to-day volatility, producing fewer surprises and empowering investor confidence, enhancing market stability. Big data holds incredible promise to facilitate so many investment decisions. Companies capable of extracting value from their data will enjoy a competitive advantage – as long as they ensure they distinguish what is of value from what is not.

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1 Source: Element-22

**BUY SIDE ALT DATA SPENDING ON TRACK TO MULTIPLY**

Source: Pictet WM - CIO Office, AlternativeData.org, February 2019
Demystifying Responsible Investing

Many investors are keen on the idea of Responsible Investing but at a loss when it comes to making sense of the various options available, not to mention the vocabulary typically used to discuss them. While the arena is rapidly evolving, the investment options can be broadly classified into a handful of often complementary approaches.

There is no one way to invest responsibly, but rather, several approaches to consider, which can be standalone or combined in application, on a spectrum from avoiding certain investments to investing to make a desired impact, be it social, economic or governance.

Values
Norms-based screening
This approach aims to exclude companies that have negative externalities as identified by international norms. These norms are often defined by supranational organisations like the United Nations or the International Labour Organization and cover such issues as controversial weapons and child labour.

Values-based screening
This approach screens out and excludes those companies whose practices are not aligned with certain values. Common exclusions include businesses that profit from tobacco, gambling, alcohol, weapons and fossil fuels.

Selection
Best-in-class
This approach aims to identify and select those companies that rank the highest in terms of environmental, social and governance (ESG) considerations within their sectors. It also aims to indirectly encourage firms to enforce ESG criteria in their corporate culture.

ESG integration
In addition to traditional financial analysis, this approach integrates ESG factor analysis into the consideration process when identifying a company to invest in. It is a natural extension of investment analysis in that it identifies potential areas of business risk, particularly over the long term. Companies with strong and transparent governance are more likely to avoid regulatory fines and expensive lawsuits, while good environmental practice can prevent accidents and non-compliance with new and changing environmental regulation. A company’s social standards, like employee health and safety and community relations, can be used to assess its reputational risk. This approach to analysis and selection can go hand in hand with engagement.

Impact
Engagement & proxy voting
At a minimum, engagement can entail the commitment to actively exercise voting rights with the objective of influencing a company’s governance or strategy (e.g. at the annual general meeting). Large investors can go a step further than proxy voting in taking active ownership by using their influence to engage directly with company management on the adherence to certain standards (e.g. environmental, social, accounting) or changing business practices (e.g. around diversity, wage equality), etc. As an example, the world’s largest coal exporter recently vowed to cap coal production in the face of pressure to take action on climate change from its large investors.

As individuals, we each have distinct goals, as shaped by our values and beliefs, which may evolve throughout life’s journey. However, as investors, we may struggle to reflect these values and beliefs in our portfolios. While there is no one solution that matches the diversity of the investor community, there is a common framework that can be adapted to meet each individual’s investment goals.

We take a long-term approach to investing that starts by understanding and defining the investor’s wealth values and goals, which are often intergenerational. At our disposal is a responsible investing (RI) framework that selects from a number of different approaches. The entire RI space is growing rapidly, increasingly able to provide something for everyone, regardless of objectives or financial constraints. The key is in understanding what is available in order to identify the best approach and mix for your own portfolio.

This context also allows us to re-examine the role and meaning of fiduciary duty. Is it purely to look after financial returns? Or does true fiduciary obligation demand a more holistic responsibility – one that considers and drives results beyond the financial, taking into account the social and environmental impact of our investments as well. Perhaps the current use of the word “investment” has become too narrow – overemphasising the financial and overlooking its broader meaning, which includes result expectations beyond the financial.

Karina Genevey
Head of Investment Solutions
Pictet Wealth Management
Sustainable thematic
Environmental and social-themed investment offers investors seeking to confront global challenges a way to align their capital with those objectives. This often involves targeting emerging sectors that will support a sustainable future and reap long-term financial gains. These strategies tend to invest in companies that are highly innovative and span all sectors, from those developing ‘green’ building and construction techniques to those that will support tomorrow’s energy needs without contributing to global warming. Such themes could include the transition to a cleaner energy mix, water and food sustainability, artificial intelligence and smart technology, etc.

Impact investing
Most commonly found in microfinance, private equity or green bonds, investments in this category have the dual objective of generating both measurable financial returns and positive social or environmental impact. By directing capital to projects like affordable housing or microfinance, investors can participate more directly in causes they identify with and believe in. A McKinsey study showed that impact investments have already touched the lives of between 60-80mn people in India alone, the equivalent to the entire population of France¹. Impact investing is the smallest, but fastest-growing area of RI.

Responsible investing tends to be synonymous with investing for a better future, regardless of which approach is taken. We believe it is important that each investor considers which version of the world he or she wishes to underwrite in taking investment decisions. As a forward-looking organisation, Pictet considers RI as a natural approach to investing in a way that will take care of those who follow in our footsteps while creating a legacy that has both financial and social value.


“The current use of the word ‘investment’ has become too narrow – overemphasising the financial and overlooking its broader meaning, which includes result expectations beyond the financial.”
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