2017

INVESTMENT THEMES

BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world

2017:

FISCAL STIMULI, INFLATION, RISING INTEREST RATES, TIGHTER US MONETARY POLICY AND THEMATIC INVESTMENTS

2016 was driven by greater flexibility in monetary support, with a gradually improving global economy, punctuated by political shocks and some surprising reactions from financial markets.

In 2017, we expect a continued economic recovery, rising inflation, a less accommodative monetary policy and more fiscal stimuli.

We have selected 10 investment themes, which along with our global strategy, could be a trump card in this changing world.

There are some attractive solutions for investors seeking stable income or wishing to hedge against rising interest rates, but also for those willing to capitalize on more dynamic products or new developments.

2017 INVESTMENT THEMES

Looking back at 2016 and looking ahead to 2017

2016 got off to a difficult start. Disappointing economic developments in China that hurt commodities as well as a subdued expansion in the United States led to rising doubts and volatile financial markets. Increased monetary support subsequently restored calm and put the global economy on a growth trajectory. Overall, 2016 was a smooth year in economic terms. China managed to stabilize its economy and the United States was able to offset the weak start to the year. Europe made gradual economic progress but faced a number of political concerns (Brexit and Italy). For the most part, inflation and the long-awaited economic recovery in Japan did not materialize.

The United States leads the way

In 2016, we had a déjà vu feeling about the interest-rate policy in the United States. As in 2015, the US Federal Reserve (Fed) was expected to raise interest rates, perhaps more than once. In the end, there was one interest-rate rise at the end of the year.

After a weak start, US stock markets recovered nicely in 2016, culminating with a sprint in the last quarter (the "Trump rally"). Despite higher valuations, record after record was broken. The US dollar also rallied strongly at year-end. Even though US interest rates were at their lowest in 2016, a turning point was reached. We assume that there will be two interest-rate hikes in 2017 due to the robust job market, healthy economic growth and inflationary developments. As the financial markets are prepared for this, we do not expect any shockwaves. However, due to rising interest rates, it would be less advisable to invest completely in the bond component.

We are at the end of a 35-year bull bond market cycle. Investing selectively in bonds and seeking protection against inflation is recommended. Gold could be one solution.

One uncertainty for 2017 is the attitude of the new President-elect, Donald Trump. He has opted for a less radical approach since his election victory and is profiling himself as the president of all Americans. His ambitious reflation policy, entailing higher public expenditure in infrastructure and tax cuts, is intended to spur economic growth and push up operating profits. Cyclical sectors could capitalize on this environment. He also has the ambition of bringing the foreign production of American companies back home. It remains to be seen how President Trump will deal with his foreign trading partners.

Signs of recovery in Europe

Europe had a difficult 2016 overall, but there are signs of recovery. The clouds hanging over the economy dispersed last year and inflation started to rise. Some of the credit for this must go to European Central Bank (ECB) President, Mario Draghi. 'Super Mario' ensured the expansion and extension of the bond-buying programme, reduced the deposit interest rates and reactivated the TLTROs (targeted long-term refinancing operations). More investments by European governments and companies will be needed alongside monetary support in 2017. Conviction about this is steadily starting to grow. Optimising the Juncker Plan is already a step in the right direction.

Political issues and the emergence of populist parties in a number of EU Member States cannot be resolved quickly. Major events in 2016 included Brexit and the Italian rejection of the proposed constitutional reform.

The surprising choice made by the British to go their separate way and leave the Eurozone led to a temporary dip in European stock markets. However, after a brief setback, the financial markets recovered quickly. Nonetheless, as the plans are put into practice, Brexit will have an economic impact on the United Kingdom with a ripple effect in the rest of Europe. A number of political events, including elections in the Netherlands, France and Germany, could also stir things up in 2017.

European stock markets clearly suffered from the political headaches of 2016. Notwithstanding their attractive valuation, the improved operating results after leaner years, a weaker euro that lent support and continued accommodating monetary policies, stock market performances were challenging. However, we have renewed confidence in European equities for 2017. Company operating profits could be stronger while negative factors for banks and the energy sector should start to fade. The European market is a cyclical market that should be able to benefit from the changing economic landscape, partly because of exports to emerging countries. Dividend yields remain very attractive. Contrary to expectations, corporate and government bonds performed well. With the prospect of modestly higher interest rates in Europe, bonds will have a far harder time in 2017.

Japan's inventive central bank

Japan is, and remains, a special case. For decades, the land of the rising sun has been contending with a stubborn lack of inflation and economic expansion, prompted by structural problems, such as an ageing population and a decreasing savings ratio. Despite massive monetary intervention, little has changed in this regard. In order to implement and be able to maintain more efficient monetary policy, the Bank of Japan has been implementing a new strategy for a number of months. It wants to keep the 10-year interest rate at around zero by adapting the purchasing volume to this rate.

In contrast to 2015, Japanese equities performed poorly in 2016. Nonetheless, after a bad start, they recouped most of their losses. Much of this can be explained by the strong rise in the yen, which was once again considered as a 'safe-haven' currency in troubled times. A rebound in the US dollar after the American presidential elections reversed this trend.

Profits of Japanese companies generating sales abroad will revive if the yen continues to weaken. Japanese equities, which are cyclical for the most part, appreciated attractively compared with other equity markets.

Emerging countries remain promising

Doubts over the sustainability of the Chinese economy and its impact on commodities, combined with an escalating political issue in Brazil meant a challenging start to 2016. Due to a raft of monetary and fiscal interventions, Beijing managed to keep the Chinese economy growing at the desired pace in the following quarters of the year. Managing debt and increasing productivity in companies were huge challenges. Commodities started the same trend towards recovery while oil staged a second comeback following the OPEC (Organization of the Petroleum Exporting Countries) agreement.

Both bonds and equities in growth markets generally delivered a series of good performances. However, the end of the year proved somewhat more challenging following Trump's election victory, with the prospect of a protectionist approach and a stronger dollar.

2017
INVESTMENT THEMES

Countries, such as India and Indonesia—where a new political wind has been blowing for some time coupled with strong economic growth—offer opportunities for investors, while China still enjoys constant value. Emerging countries focus strongly on technological developments and innovation. There are many attractive themes and equities available that are in keeping with our new investment themes.

The consensus on global warming is growing worldwide. Many companies are investing massively to reduce environmental pollutants - a theme we are keen to bring to the fore and which offers many investment opportunities.

OUR 2017 INVESTMENT THEMES AT A GLANCE

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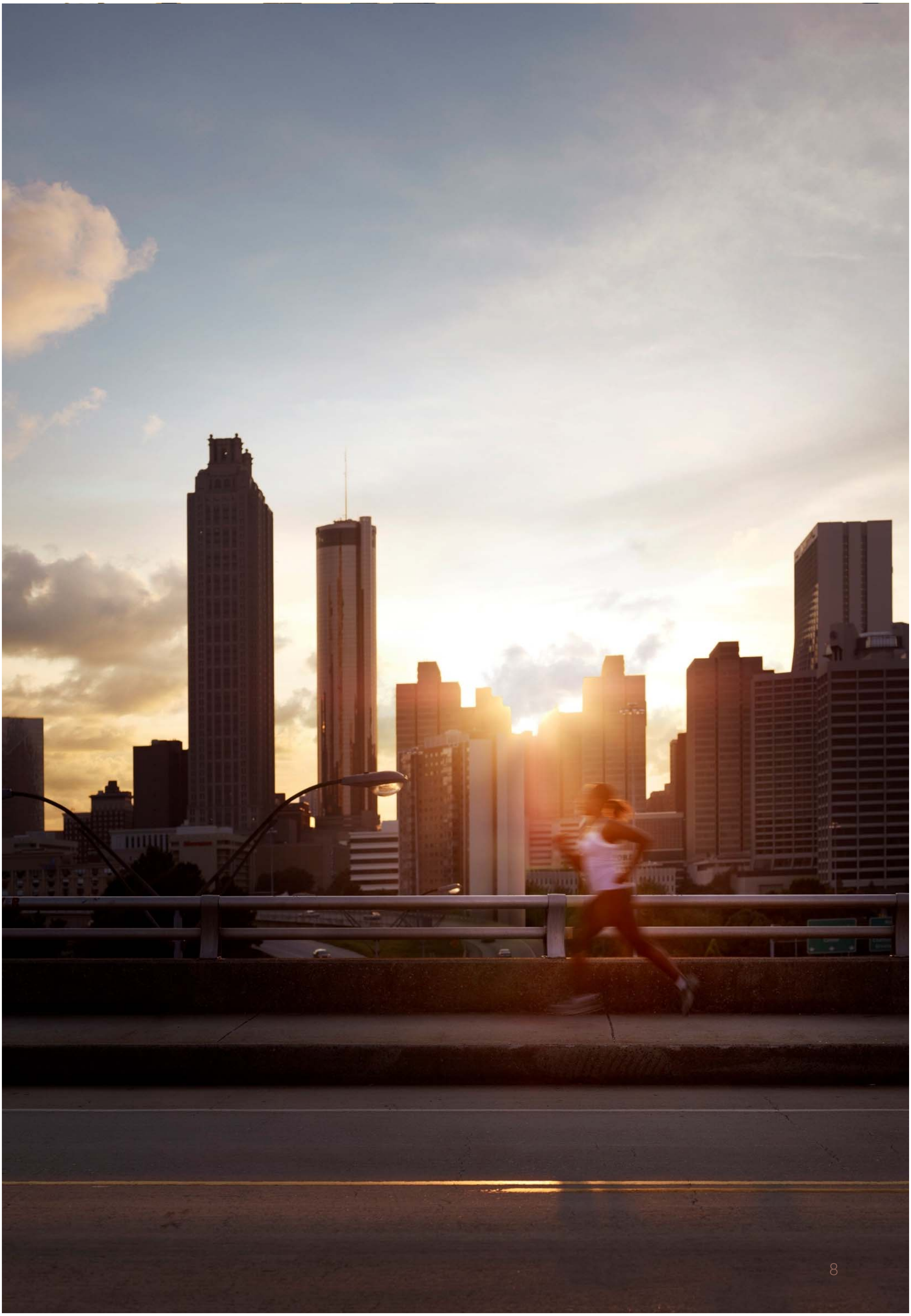
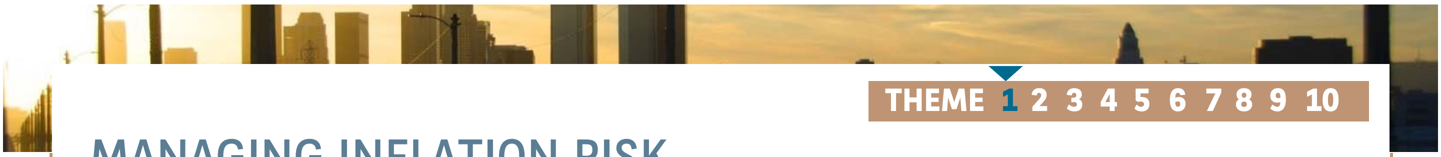




MANAGING INFLATION RISK WITH FINANCIAL ASSETS

Over the past decade, inflation has been driven down by falling commodity prices, low capacity utilization and high unemployment rates. The rebound in commodity prices and improving job markets will help push inflation higher in most developed countries, especially in the US and the UK. Eurozone inflation will rise, and there are upside risks in the medium term. Long-term inflation expectations have already been raised.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR	x		

We have raised our inflation forecasts for the coming years based on a number of key factors.

The first source of inflation is the recent rise in commodity prices, particularly energy and industrial metals. Indeed, oil prices have risen from a $30 low to around $50 in recent weeks. Following the latest decision from OPEC (Organization of the Petroleum Exporting Countries) to cut production, we have raised our target range for end-2017 to $50-60. Industrial metals (copper, aluminium, zinc and iron ore) also witnessed a sharp rebound last year after a long period of falling prices.

The second key factor is Mr Trump's election victory and the raft of policy measures expected over the coming months. Regarding economic growth, we expect a large infrastructure stimulus programme and selected tax cuts. This should push economic growth higher, mainly in the United States, but also in Europe and the UK. This will generate a further improvement in the employment market and should lead to an acceleration in wage growth and higher inflation. Given that some job markets are already facing tight conditions, the effects should be much more noticeable in the United States and the UK than in the Eurozone.

OUR RECOMMENDATIONS

Geographical zones

The biggest upside potential is in the US and the UK. Long-term upside risks in the Eurozone have intensified

Risk profile

This is a rather defensive investment with the main aim being to compensate investors for inflation in order to keep real returns positive even in the event of major inflation surprises

Investment horizon

3-5 years

Asset classes:

Inflation-indexed bonds (with active interest risk management) and structured products (inflation derivatives), Newcits

MANAGING INFLATION RISK WITH FINANCIAL ASSETS

A more specific factor relates to the US and the likelihood that the new President could use barriers to trade and introduce tariffs on some imported goods. This would increase production costs for US companies and drive up the price of consumer goods. Whether companies pass on the increase in costs to final consumers will depend on pricing power and the extent of competition they are facing. A stronger dollar could limit these effects. We have not factored these into our inflation forecasts but there is a risk of higher inflation.

How to hedge against inflation

Investors who want to hedge against higher inflation - i.e. secure the purchasing power of their assets - have several options. Structured products (using inflation derivatives), Newcits funds and inflation-indexed bond funds (with active interest risk management) are the main examples.

Newcits funds allow fund managers to benefit from rising and falling asset prices, depending on the strategy. In this context, we favour so-called macro-economic strategies which can benefit from market trends in several asset classes such as commodities, currencies, interest rates, etc.

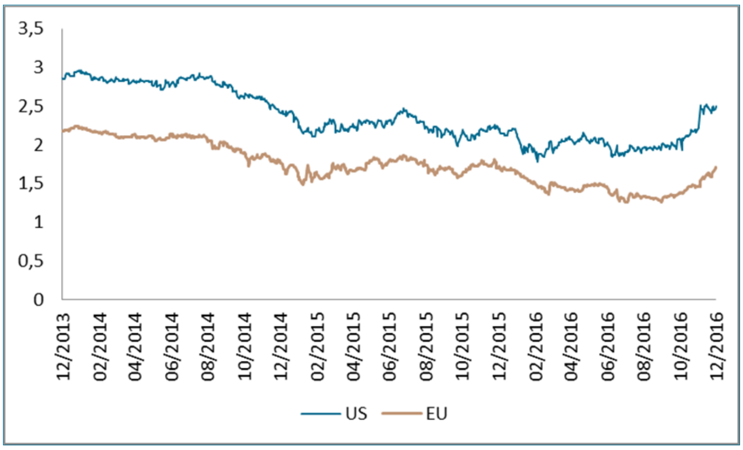
Inflation-indexed bond funds pay a fixed coupon that excludes inflation, and realized inflation is added after the period. This allows investors to hedge against inflation risk as the coupon payment is based on inflation at the end of the period. There is however an interest rate risk as the value of the bond falls when real rates (excluding inflation) rise. Fund managers can manage this risk by using derivatives.

Inflation risks are highest for the United States and the United Kingdom. Medium-term inflation risks for the Eurozone should not be underestimated.

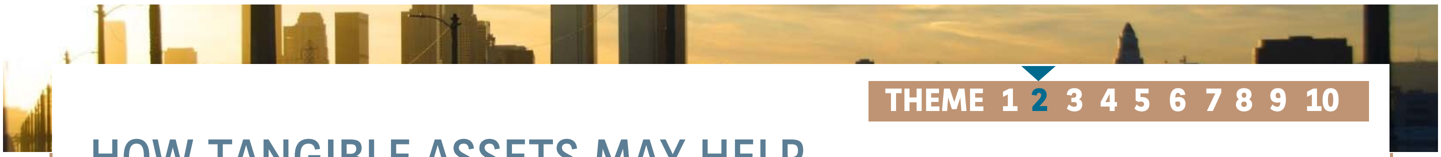
Risks to our base case

The main risk at this stage is a sharp fall-back in commodity prices or disappointments regarding US fiscal policy plans. This would reverse the dynamics of the past few months and reduce inflation expectations again. This would negatively affect the investment solutions mentioned above. An actively managed fund should limit such risk.

Long-term inflation expectations *(based on inflation derivatives)*



Source: Thomson Reuters Datastream, 06/12/2016



HOW TANGIBLE ASSETS MAY HELP TO MANAGE INFLATION RISK

Having a direct exposure to real assets is a smart way to maintain attractive long-term returns, enhance portfolio inflation protection, and reduce downside risk. Real assets include precious metals, direct real estate, agricultural properties and forests.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR			X

Inflation expectations surged globally after Donald Trump's election victory, on the back of higher growth and deficits in anticipation of a forthcoming fiscal package. Tax cuts and larger public spending on infrastructure and defense in a context of nearly full employment (the unemployment rate was 4.6% in November) could boost wages and inflation. The decision from OPEC (Organization of the Petroleum Exporting Countries) to reduce output by 1.2 million barrels per day over the next six months with an additional cut of 558,000 bpd by Russia and other non-OPEC producers is fuelling inflation fears.

Gold

Gold prices have recently suffered from rising bond yields and the strong dollar. Nevertheless, we keep a positive stance on gold and stick to our expected trading range of $1200-1500/oz.

- Real rates matter for gold. Gold could rally if inflation or inflationary expectations accelerate, which would lead to real rates staying relatively low or even turning negative.

- Gold is one of the few diversifiers left in this highly-correlated world. Gold should play a safe-haven role in the event of geopolitical shocks or a sharp market correction.

OUR RECOMMENDATIONS

Gold

- Gold bullion
- ETFs invested in physical gold
- ETFs or funds invested in gold mines

Agricultural properties, vineyards, forests

- Expert advice should be sought because quality and price may vary significantly
- In excess of €1 million

HOW TANGIBLE ASSETS MAY HELP TO MANAGE INFLATION RISK

- The world's gold mine supply fell in the first three quarters of 2016. Today, there are relatively few new projects and expansions expected to come on stream in the near-term.
- Since the pullback of the gold price, physical demand has begun to recover. Higher gold prices in the first half of 2016 dampened demand for gold jewellery.
- Central banks in emerging countries (e.g. Russia) should continue to increase their holdings.
- In China, new financial products, such as gold ETFs (exchange-traded funds), also started to register inflows which might grow significantly over time.

Direct real estate

Direct real estate (i.e. bricks and mortar) offers a strong protection against inflation. The rationale behind this is that rents are indexed to inflation in many countries. As a consequence, property values are projected to edge up as well, albeit with a time lag, depending on the country.

Some consideration : the cost of borrowings should be capped prior to any inflation. Otherwise inflation may result in a higher cost of finance. This would partly offset an increase in higher revenues.

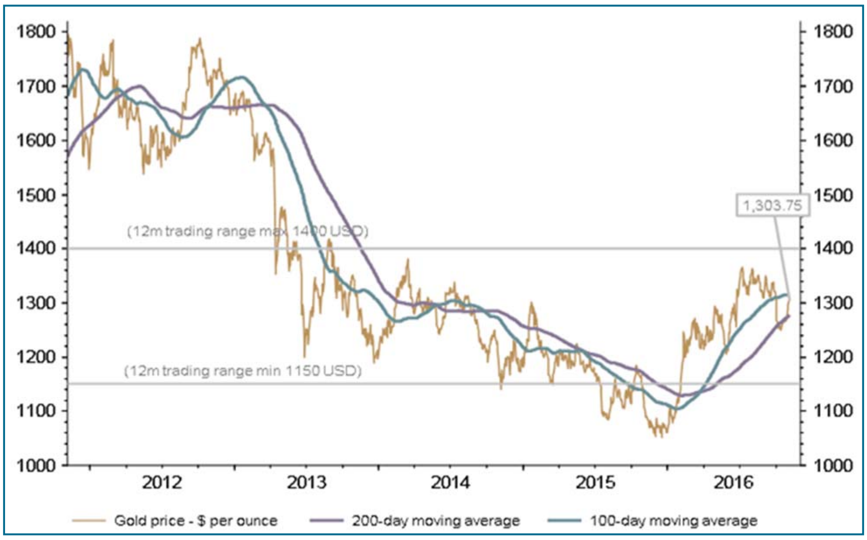
Agricultural properties and forests

Agricultural properties represent a good alternative for investors willing to diversify their portfolio. They are not correlated to the financial markets and provide revenues which are usually indexed, while offering a long-term capital appreciation.

BNP Paribas Wealth Management has a dedicated department, Agrifrance, which offers clients advice (on buying and selling) and facilitates transactions in agricultural properties, vineyards, forests and country estates.

- Agricultural properties: most land (74%) on the market is leased, demand is resilient, gross yields vary between 2% and 4%, and the French market is attractive compared with neighbouring countries.

Gold



Source: Thomson Reuters Datastream

HOW TANGIBLE ASSETS MAY HELP TO MANAGE INFLATION RISK

- Vineyards: with the exception of the most renowned locations which have become quite expensive, prices have increased moderately in recent years. Therefore, it is still possible to find reasonable yields (leased vineyards) and potential for capital appreciation.

- Forests: volatility of timber prices has no impact on forest prices and demand exceeds supply.

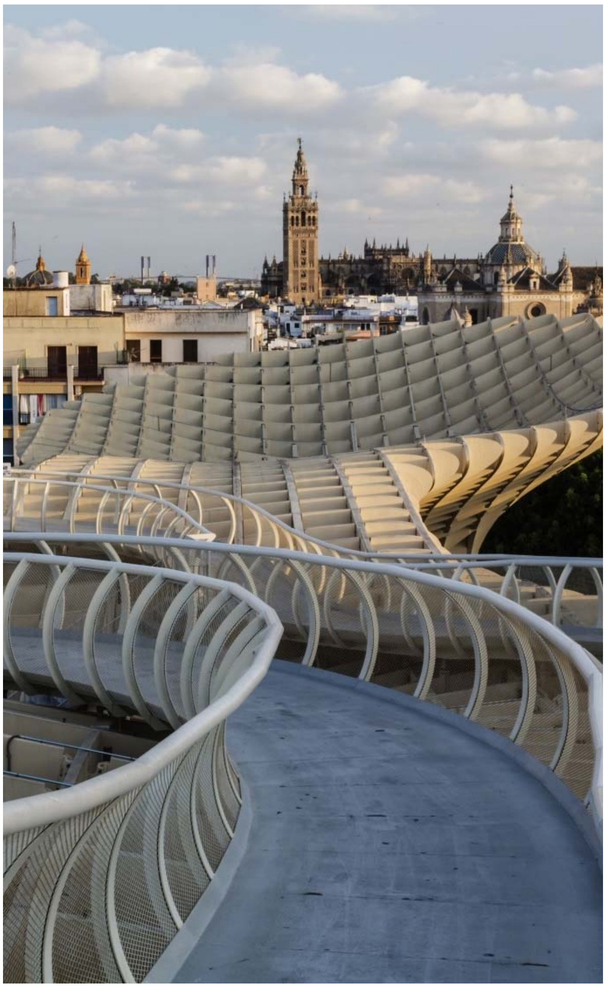
Risks to our base case

Gold

Downside risks have increased since the US election as markets have shifted their focus to the prospect of an expansionary fiscal policy which would push up real yields. So there is a risk that bond yields will increase more than the forecasts in our base case scenario, leading to attractive real rates which could be detrimental for gold.

Agricultural properties, vineyards and forests

Investments in agricultural land and forests are by nature long term and may be considered as illiquid. Quality and price vary considerably according to location, topography, accessibility as well as economic and technical yields, etc.



MANAGING INTEREST RATE RISK

Until recently, interest rates and bond yields had been falling continuously since the financial crisis. With an expected rise in inflation and increasing economic growth, central banks should normalize their monetary policies. Some (e.g. the Fed) might even raise their policy rates. Bond yields are set to continue their upward trend. Traditional bond investors are at risk as the rise in yields will push down the value of existing bonds. We offer a number of solutions to benefit from rising interest rates and bond yields.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR		X	

US

Mr Trump is set to be an inflationary president. Indeed, his policy which is mostly based on a large fiscal package, more protectionism and tax cuts, will push up expected inflation and yields via increased deficits. Inflation expectations and yields have already priced in this anticipated effect. US yields jumped by about 40bp in the few days post-election (from 1.80%) while inflation expectations gained about 30bp (from 2.15%).

> We believe the rise is not over as inflation will continue to grind higher in the US via energy prices, a tighter labour market and some potentially difficult discussions on trade agreements.

We think the Fed will respond by becoming more aggressive. We expect two interest rate hikes in 2017, followed by three in 2018, suggesting a Fed fund rate of 2.00% towards the end of 2018. This is slightly lower than the Fed forecast (2.125%) according to the Fed's median dot plot, now that the projections have been revised higher in the December FOMC meeting. The terminal rate might reach around 2.5% in 2019.

OUR RECOMMENDATIONS

Geographical zones

- For short-term interest rates, the US offers the most upside.
- For bond yields, we see upside in the US, Eurozone and the UK.

Risk profile

This is a rather balanced profile especially for solutions that include risks on corporate issuers.

Horizon

3-5 years

Asset class

- For the US: Floating Rate Notes, leveraged loans, short duration High Yield, Credit Linked Notes (indexed to short-term rates) and selected Newcits.
- For the Eurozone and the UK: Credit Linked Notes (indexed to long rates), and selected Newcits.

MANAGING INTEREST RATE RISK

We have adjusted our yield projections to take into account the new economic environment and a hawkish Fed. Our 12-month forecasts are 2.75% for the 10-year yield and 1.70% for the 2-year yield.

Traditional bond investors are at risk as the rise in yields is pushing down the value of existing bonds. We offer a number of solutions to benefit from rising interest rates and bond yields in the US. We recommend buying Floating Rate Notes (FRN), leveraged loans, short duration High Yield, Credit Linked Notes (CLN) indexed to short-term rates and Newcits.

- FRN are instruments that provide protection against rising interest rates. They usually pay a quarterly coupon based on the US 3-month Libor (0.99% currently) + spread. Hence, interest payments on FRNs rise when short-term rates go up. The spread depends on the issuer's credit rating.

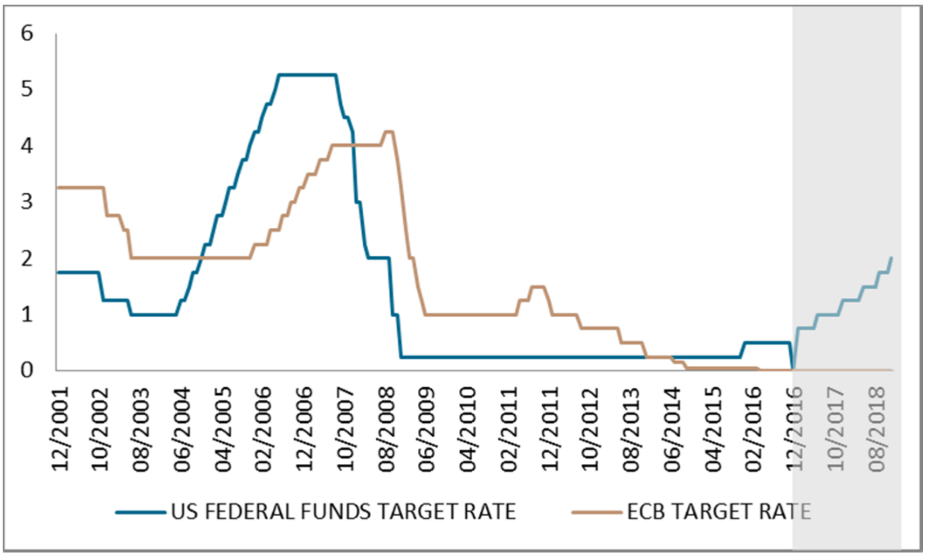
- Leveraged loans are senior secured corporate loans to high yield companies. They also pay floating coupons, generally indexed to short-term rates. However, leveraged loans are often more senior compared with High Yield bonds.

- Short duration High Yield is unsecured corporate debt (below BBB-). It is usually considered as more risky than leveraged loans. A shorter duration than the benchmark reduces the negative impact of rising yields.

- CLNs indexed to short-term rates help investors to benefit from a more aggressive Fed tightening cycle while offering a premium as it is based on a credit portfolio.

- Newcits offer a fund manager the possibility of going long and short. In this context, we favour macro-economic strategies which can be based on a large number of asset classes (Commodities, Currencies, Interest Rates, etc.).

Fed vs. ECB forecasts



Source: Thomson Reuters Datastream, November 2016

Eurozone and UK

In the Eurozone and the UK, yields and inflation expectations also surged due to a spill-over effect after the US election. German 10-year Bunds and 10-year Gilts rose about 20bp, Eurozone and UK inflation expectations gained about 13bp a few days after Trump's victory. Eurozone expected inflation reached 1.70%, a YTD high. However, this level is still too low to trigger a monetary policy shift. We believe that the ECB will keep its policy rate unchanged in 2017 and that it will continue to taper the asset purchase programme because deflation risk has diminished. As a consequence, we think that German yields still have upward potential. Our 10-year Bund target is 0.75% in 12 months.

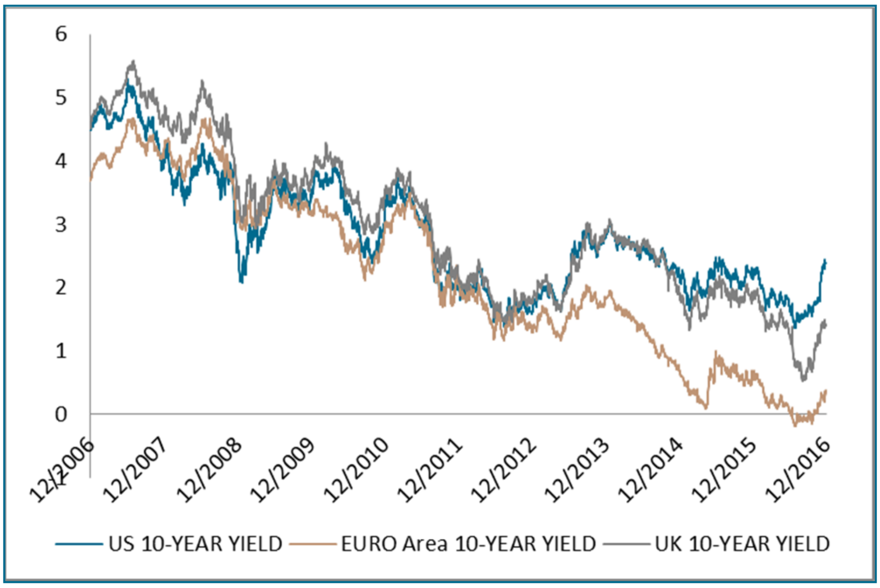
Turning to the UK, we think that the BoE will leave its policy rate and its asset purchase programme unchanged for the foreseeable future. Our 12-month target on the 10-year Gilt is 1.90%, or an upside of around 50bp from current levels.

Consequently, we see more upside at the long-end of the German and UK yield curves. We favour products like Credit Linked Notes (CLNs) indexed to long rates, and Newcits to benefit from the long-end of the yield curve (see section on the US for more details on these investment solutions).

Risks to our base case

The above strategies should pay off in a reflation scenario, assuming that the Trump administration delivers. If this is not the case, yields might fall back in a global risk-off sentiment. Products with floating coupons might pay very low coupons. There would be an opportunity cost relative to fixed-income bonds. Investment solutions with credit risk exposure could suffer from downward revisions to growth. Even if we cannot exclude such scenarios, risks remain low.

10-year yields – US, Euro area, UK



Source: Thomson Reuters Datastream, 06/12/2016

RIDE THE REFLATION TRADE

Last summer, market sentiment shifted from deflation fears to reflation hopes. Investors were more confident about the ability of governments to stimulate growth via fiscal policy. We recommend playing this reflation trade in mature stock markets. Cyclicals, Value stocks and Financials are expected to be the main beneficiaries.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR		X	
1 YEAR			
> 1 YEAR			

From deflation to reflation

Over the last few years, investors have feared deflation in developed economies. In a context of low economic growth and low inflation, the global economy has relied on highly-stimulative monetary policies. Central banks of the main developed economies have implemented unconventional measures. The dominant effect has been a sharp decline in bond yields. In a context of low economic growth, the impact has been huge on stock markets, triggering a massive search for yield with a stable, solid growth. Among the best opportunities to achieve regular income, investors have found stocks that offer safe and growing dividends; they have also favoured quality and defensive stocks.

Last summer, the market sentiment shifted to reflation hopes. Investors were more confident about the ability and willingness of governments to stimulate growth via fiscal policy, and consequently, their fears of deflation and stagnation faded. In this environment, cyclicals began to take the lead. Their outperformance accelerated with the election of Donald Trump and his promise of tax cuts and higher infrastructure spending.

OUR RECOMMENDATIONS

Asset classes

- Prefer equity markets.
- Developed equities will be the main beneficiaries.
- We favour Cyclicals, Value stocks, and Financials in developed markets

Horizon

- Play this theme as long as the reflation trade remains in place

RIDE THE REFLATION TRADE

In a reflation scenario, inflation pressure re-emerges because the output gap closes and wage inflation rises. Public authorities can help to reflate the global economy, by taking measures to curb the effects of deflation by an intended acceleration of economic activity. Reflationary policies may include tax cuts and public stimulus.

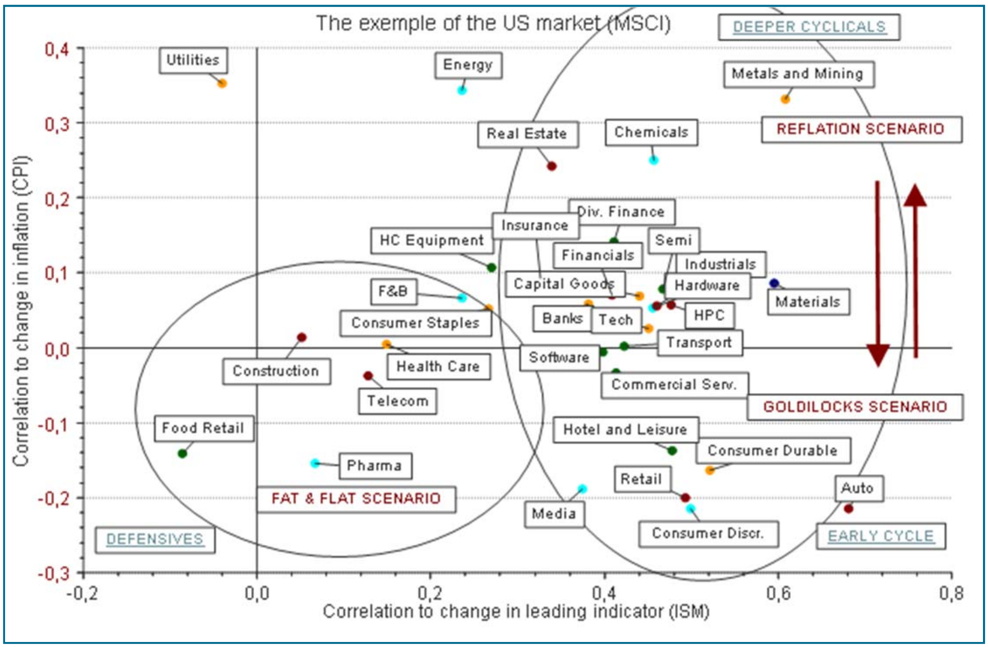
There are two consequences for the macro-economic environment:

1. A shift from monetary to fiscal policy means higher interest rates and a re-pricing of a steeper yield curve in our scenario;
2. The move towards an expansion of fiscal policy will imply incremental growth in the US and other developed economies. We have raised our growth forecasts. The global economy should expand by more than 3% in 2017 before accelerating in 2018. We also expect inflation to pick up in the US and globally in 2017 while the USD will continue to rally.

Play the reflation trade via Cyclicals, Value stocks and Banks

These macro-economic changes will have a major impact on equity strategies. Waning fears about global growth suggest a change in leadership in equity markets, which are feeding appetite for investment themes such as Value stocks, Cyclicals and Banks. Over the last few years, these have been the biggest laggers in a world of scarce growth and low interest rates. The expected acceleration in earnings growth should lead to these investment themes outperforming again. The return to the reflation trade is also supported by relatively attractive valuations. Banks, Cyclicals and Value stocks are trading at low valuation levels while fixed income assets and bond-proxies stocks – the main alternative in investors' minds – look relatively expensive. Banks will be the main beneficiaries of a reflation policy. If interest rates rise and yield curves steepen, pressure on banks will be alleviated. Cyclicals stocks will benefit from higher growth.

Sector rotation and business cycle

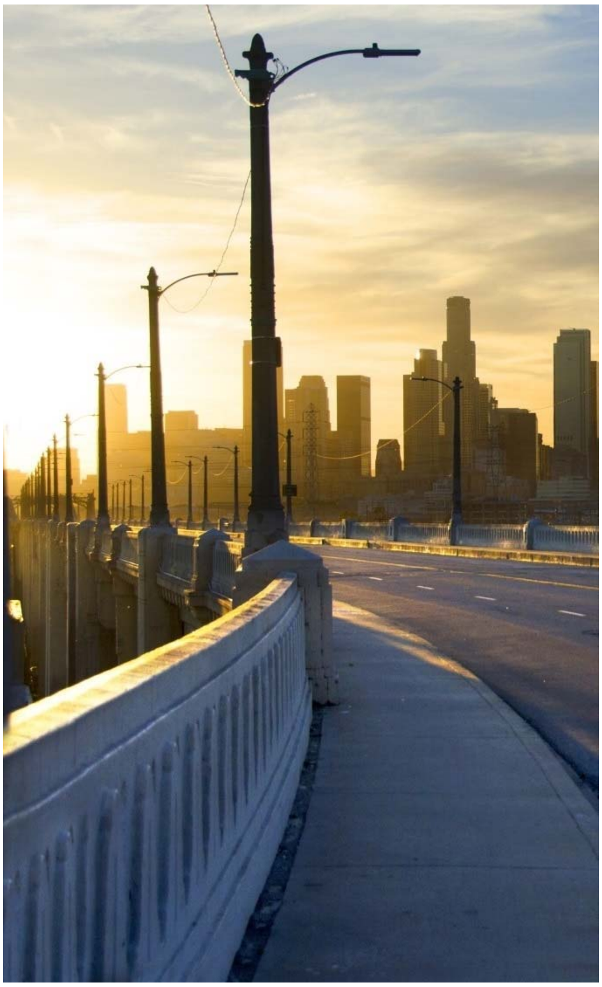


Source: Thomson Reuters Datastream

RIDE THE REFLATION TRADE

We expect domestic cyclicals exposed to US growth to outperform large-cap exporters. Specific themes such as infrastructure can also be played.

> We favour developed markets essentially. The US will be the main region with a reflation policy, but Europe and Japan will benefit from spill-over effects as they are pro-cyclical markets.

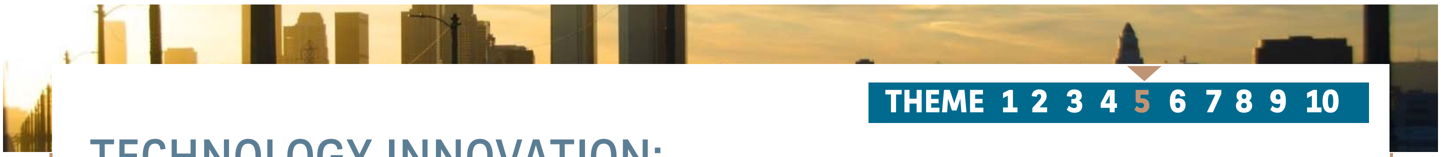


Risks to our base case

In the event of disappointment over fiscal impetus, the macro-economic scenario could shift from reflation hopes to stagnation. A rise in inflation without a corresponding rise in growth expectations would be negative and would support a move to more defensive investment themes.

Another risk is the pace (and extent) of the bond yield rise. A strong rise in yields could undermine growth expectations and equity valuations. In this case, it would start to raise concerns about growth too.

Unexpected political events in developed economies still have the potential to impact the ongoing reflation rotation. In 2017, several key elections will be held in Europe (the Netherlands, France, and Germany).



TECHNOLOGY INNOVATION: THE KEY TO CORPORATE SUCCESS

In today's world of intense competition, the declining working age population, global anaemic demand and appetite for re-industrialization, technology innovation is the key to corporate success. The "survival of the fittest" requires businesses to embrace digital transformation (industry 4.0, robotics and cybersecurity).

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR		X	

Industry 4.0 is now on

Over the last few years, companies have been reluctant to invest, because of surplus capacity and anaemic final demand. However, the situation is improving. Going forward, firms will look first to defend or improve their competitiveness, particularly in the face of declining working age populations and deteriorating productivity. Furthermore, they will harness any opportunity to reduce costs. In addition, there is increasing appetite for re-industrialization in developed countries, allowing companies to be closer to consumers and to tailor products to their needs. The best option to achieve these targets is to use technology innovation, but above all, undergo a digital transformation.

There is a lot of talk about "industry 4.0", which refers to the fourth revolution. After mechanization, with the steam engine, electrification and automation, now comes digitalization. Connected concepts apply to smart factories, smart grids, smart logistics, smart machines and smart products. According to PwC, an audit firm, "Industry 4.0 combines advanced connectivity and advanced automation, cloud computing, sensors and 3D-printing, connected capability, computer-powered processes, intelligent algorithms and 'Internet of Things' services." All these factors help to deliver revenue growth, cost control, efficiency gains and customer satisfaction.

OUR RECOMMENDATIONS

Geographical zone

This is a global theme. Many global companies fit into this theme.

Risk

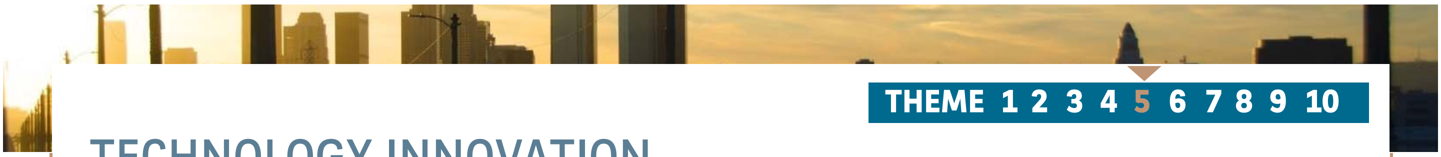
However, in view of constant innovations, today's winners might be tomorrow's losers. Hence, investing in specific companies requires close monitoring and an acceptance of above-average risk.

Asset class

Leaders in this theme are often not large capitalization stocks, so it is advisable to invest in this theme through funds or a basket of stocks.

Horizon

This is mainly a long-term theme, playing structural and unavoidable shifts in the corporate world. Investments in it imply a holding commitment of at least several years.



TECHNOLOGY INNOVATION, THE KEY TO CORPORATE SUCCESS?

Robots are taking over

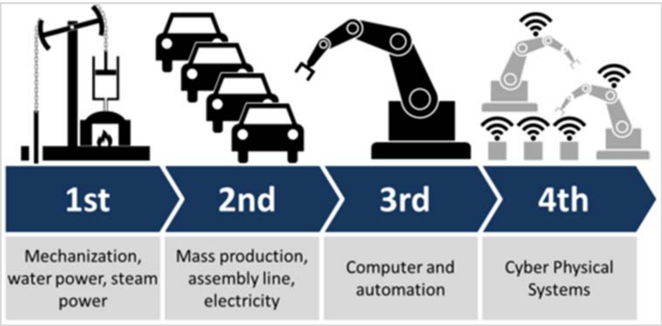
The "robotics revolution" is another term used to describe the huge transformation in manufacturing. Boston Consulting Group, a consultancy firm, expects advanced robotics to grow by 10% annually over the next decade, thanks to a drop of more than 20% in the price of hardware and enabling software over the next decade. These trends mean that robotics will become affordable for small companies. Productivity will benefit the most from robots (or "co-bots", as collaborative robots are called). And needless to say, labour costs will also benefit enormously.

Since 2008, there have been more connected objects than human beings! Cisco Systems, a specialized IT group, forecasts that there will be more than 50 billion connected objects by 2020, mostly serving industrial applications but also health and finance apps. The "Internet of Things" is clearly a booming trend.

Artificial intelligence is another field where demand is huge. For the time being, large companies are taking the lead in exploring technology, such as machine learning, chatbots (software to simulate human conversations), virtual assistants, natural language and face recognition. However, as solutions mature and costs fall, artificial intelligence will attract small and medium-sized firms too.

Given that connectivity is becoming widespread, security issues are becoming very complex and difficult to tackle, hence, the exploding demand for cybersecurity.

Industry 4.0

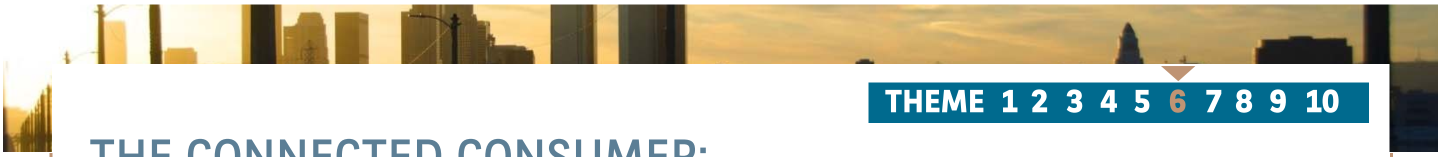

1st
Mechanization, water power, steam power
2nd
Mass production, assembly line, electricity
3rd
Computer and automation
4th
Cyber Physical Systems

Source: http://www.allaboutlean.com/

Risks to our base case

This theme is essentially a long-term core investment. It plays heavy structural trends. As these industries are still young and innovations are constantly taking place, today's winners might not be tomorrow's winners. A close monitoring of this theme and of the underlying trends is necessary.

Although this is a long-term recommendation, we believe that the next few quarters should be profitable for investors who take up this theme, based on our positive macro-economic outlook for 2017. Should the macro-economic climate deteriorate, companies will slow down their digital transformation. In this scenario, stock prices would suffer and long-term promises would take longer to materialize.



THE CONNECTED CONSUMER: A HUGE OPPORTUNITY

Today, consumers increasingly enjoy life in digital mode. They spend more and more time connected, at home, at work and while on the move. They shop progressively online, live in smart homes, drive connected cars, make mobile payments, have recourse to telemedicine, and so on. These trends provide huge investment opportunities.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR			X

A booming sector

Today our everyday life is increasingly digital: we spend an increasing amount of time on devices to consume digital content. Babies born after 1980 are called "digital natives" or "millennials". People surf the Internet, watch TV online, shop online, listen to music on MP3 players, read books on eReaders, store data on the Cloud, pay with smartphones when shopping in-store, drive connected cars, etc. Growth in all these areas reminds us of the words of the science fiction author William Gibson: *"the future has arrived. It's just not evenly distributed yet".* Indeed, more and more people are joining the world of the connected consumer and taming it. They are connected at home, at work or on the move, anywhere, anytime.

A survey conducted by the consultancy firm, A.T. Kearney, revealed four main motivations for connectivity, which meet basic, universal needs: interpersonal connection, self-expression, exploration and convenience. Exploration is the most mentioned motivation; it allows people to quench their thirst for knowledge.

OUR RECOMMENDATIONS

Geographical zone

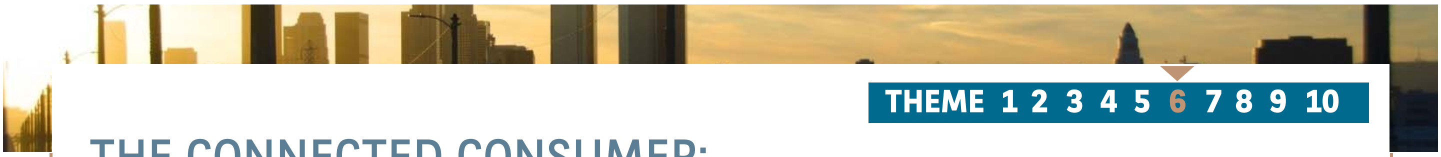
This is a global equity market theme, with no country or regional preferences.

Horizon

It capitalizes on secular trends and is therefore a long-term investment.

Asset classes

- Many large capitalization stocks fit into this theme.
- That said, it mostly has small-to-medium capitalization stocks and their focus makes them high-risk investments.
- The best approach for investors who do not want to take too much risk is to invest in a diversified pool of stocks, most appropriately through funds.



THE CONNECTED CONSUMER: A HUGE OPPORTUNITY

The investor perspective

From an investor perspective, the connected consumer theme can be played in various ways, from looking for economic participants in hardware, such as consumer electronics (smartphones, tablets, computers, eBook readers, etc.), 4G networks or OLED equipment suppliers. This also goes for those active in IT services, e-commerce (online sales are growing rapidly and already represent 7% of the world's total retail sales), smart homes, telemedicine, mobile payments, connected cars, etc.

The connected home market is a huge opportunity. According to a report by the business website Business Insider, it will represent roughly 27% of the broader "Internet of Things" market in 2019. This market covers thermostats, detectors, sensors, cameras, etc. And security systems are considered as necessities!

The 2016 PwC Total Retail Survey highlights several impressive trends. Online shoppers who buy every day represented 7.1% of the total in 2016 versus just 2.9% in 2012. Over the Thanksgiving weekend in the US in 2015 (24-29 November), roughly 103 million people bought online, accounting for 29% of total sales, up from 12% the year before. The frequency of purchases via mobile and smart phones rocketed from 30% in 2012 to 54% in 2015.

Connected cars are another huge opportunity. In-car technology includes infotainment systems using smartphones, Bluetooth, voice commands and hands-free controls, to traffic/safety/collision warning systems, automobile diagnostics, navigation tools, offering recommended departure times, updates on bad weather and an estimated time of arrival.

Demographics play an important role in the attractiveness of this theme. "Millennials" or "digital natives" - represent the largest generation in history (2.3bn).

They are overtaking the baby boomers in terms of spending and can be described as a "smart consumer" generation, using technology to compare prices, research products or benefit from loyalty/reward programmes. Their consumption behaviour is oriented towards healthy living and experiences, favouring areas such as fast fashion, athletic apparel, digital fitness, organic food, online travel services and airport operators.

Risks to our base case

This theme is all about secular trends and it is thus meant as a long-term investment. However, it is not immune from stock market gyrations. During downturns, this theme could suffer from larger corrections than average as a vast proportion of stocks are small-to-medium-sized companies.

Because technological innovation can be very disruptive, investing in specific companies requires close monitoring as the rapid pace of modernity could lead to large losses.

Many stocks that reflect this investment theme are trading at high levels. Hence, investors should pay a lot of attention to bottom-up analysis and purchase prices.

CHINDIA – EXTREMELY COMPLEMENTARY MARKETS

Growth is accelerating in India, driven by infrastructure spending and manufacturing. Meanwhile in China, growth is stabilizing in rebalancing mode, driven by services and consumption. India is a growth story; China a value story. Both are the least exposed in Asia to US protectionism. Adding all these parts makes for an attractively balanced investment theme.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR			X

Extremely complementary

Growth is accelerating in India and stabilizing in China. The working age population is expanding in India and, since 2014 has been contracting in China. Growth in India is expected to be driven by infrastructure spending and manufacturing; in China, consumption and services should become the growth engines. India is a growth style investment, whereas China is a value-style investment. An advantage of pooling India and China together is that India has little exposure to China's economy, with exports accounting for just 0.5% of GDP (Gross Domestic Product) and just 1% of value-added exports. Both countries have the lowest level in Asia of value added exported for US final demand, as a percentage of GDP (apart from Indonesia); this is an advantage in view of the huge uncertainties over US protectionism going forward.

India: on a journey towards middle-income class status

India is the fastest-growing economy in the world, and it will be a major driver of global growth for several years. This potential comes from 1.4%e per annum growth in the working age population between 2015 and 2025 - the fastest among the 10 biggest economies - and the anticipated strong improvement in productivity. Today, India's productivity per hour represents 42% of China's.

OUR RECOMMENDATIONS

Asset classes

This theme is an investment in equity markets

Geographical zone

- It is exposed to countries in the emerging world that have strong secular trends and are relatively insulated from US protectionism and vagaries in the global economy
- Moreover, this theme provides a diversification in portfolios which are primarily invested in developed stock markets

Horizon

This investment best suits a multi-year horizon.

Risks

Main risks concern the execution of policies. With regards to currencies, India's rupee is expected to remain relatively stable whilst the Chinese yuan has further downside, albeit relatively limited in our view.

CHINDIA – EXTREMELY COMPLEMENTARY MARKETS

India has a lot of catch-up potential: its GDP per head is just 11% that of the US, versus 25% for China; the manufacturing share of GDP is 17.5% compared with 39% in China.

To capture this catch-up potential, reforms are proceeding at a good pace (accelerated infrastructure investment, introduction of a goods and services tax, consolidation and recapitalization of the banking sector, greater openness to foreign direct investment, etc.). As a result, India posted the strongest gain in the World Economic Forum competitiveness index in 2016-2017 and increased 16 places to rank 39th out of 138 countries. The strongest progression was in "goods market efficiency" whilst labour market efficiency also made an outsized progression. The recent decision to scrap large denomination banknotes will ultimately help India's public finances, by reducing the size of the informal economy and boosting tax collection.

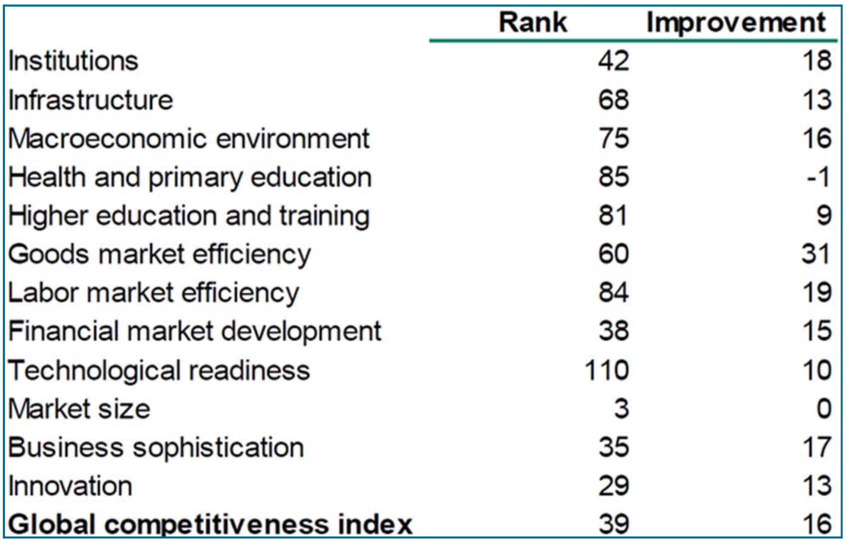
Another attraction of India is its relative insulation from trends in the world economy. This is always a good factor in the construction of portfolios as it offers a decorrelation.

China: a shift in growth model

Fiscal support is allowing China's economy to grow by at least 6%. All measures will be taken to support this trend as in 2017 there will be a rejuvenation of the political elite. Eventually, consumption and services will take over investment and exports as the main growth drivers, after a decade of China benefiting from an undervalued currency and WTO (World Trade Organization) membership.

Leading indicators are sending positive growth signals, which should help translate into better earnings growth figures. Another sign that the situation is improving is that the PPI (Producer Price Index), which had been in deflation territory since early 2012, finally turned positive in 3Q16.

India's impressive jump in global competitiveness



	Rank	Improvement
Institutions	42	18
Infrastructure	68	13
Macroeconomic environment	75	16
Health and primary education	85	-1
Higher education and training	81	9
Goods market efficiency	60	31
Labor market efficiency	84	19
Financial market development	38	15
Technological readiness	110	10
Market size	3	0
Business sophistication	35	17
Innovation	29	13
Global competitiveness index	39	16

Source: World Economic Forum; BNP Paribas

CHINDIA – EXTREMELY COMPLEMENTARY MARKETS

Given that valuations are low by historical comparison, China's stock market is well positioned to deliver attractive returns in 2017.

In 2015, the service sectors reached 50% of contribution to GDP, and this share will continue to grow as the rebalancing of growth within the economy gathers pace.

The existing and former China indexes track mostly the old economy. The new drivers of China economy - consumption and services - are under-represented in the former indexes. New indexes are now available to play this shift in the growth model theme.

Risks to our base case

The Modi administration is taking courageous measures to *"make India a global manufacturing hub"*, according to the words of the prime minister, and to modernize the economy. This means that there are high risks of encountering hurdles, but the rewards are also high. Another hurdle is valuation, at least when compared with other emerging markets or the rest of the world, because it is undeniably high. However, it is justified by a substantially above-average ROE and Indian stocks are trading close to their long-term average

We have reservations about China, mainly that the resolution of the debt issue is continuously being postponed and reforms are progressing at a snail's pace, jeopardizing medium-term growth opportunities.

It is important to highlight that authorities have the means to resolve structural issues. The main question is the timing of related decisions. Clearly, the authorities want to ensure that the renewal of the political elite in the second half of 2017 goes ahead as smoothly as possible. We note that bolder reform steps are normally taken in the second 5-year term of the government.

PLAY THE SECULAR TREND ON STOCK MARKETS

Reflation is on track and has supported a major sector rotation into cyclicals over the past few months. For investors taking a longer-term view or convinced of current cyclical drivers, we suggest playing companies which benefit from a secular trend in their activities. They will offer solid growth potential in the medium term. We recommend two sectors: Technology and Health Care.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR		X	

A shift in momentum on stock markets

Since last summer, stock markets have clearly benefited from the signs of a shift from monetary stimulus to a more fiscal policy. Investors have progressively embraced the view that the next key policy tool will be fiscal support via tax cuts and higher infrastructure spending. Investors, who in previous years were centered on the downside risks of a deflationary environment, have moved to reflation themes in the past few months.

Some investors may not fully believe in this reflation trade as a long-term investment theme. There are still many uncertainties about implementation of the reflation policies. In the event of disappointment over fiscal impetus, the macro-economic scenario could shift from reflation hopes to stagnation. A rise in inflation without a corresponding rise in growth expectations would be negative and would support a move to more cautious investment themes.

A prudent view about longer-term growth prospects will favour companies offering a solid and visible earnings outlook in our view. For investors taking a long-term view, we recommend playing sectors with secular growth.

OUR RECOMMENDATIONS

Asset class:

- Equities
- Select attractive opportunities in equities with a robust growth potential
- Play secular growth through growth sectors such as Technology and Health Care

Horizon

For investors with a more defensive stance or with a long-term view.

Geographical zones

Invest in all regions, both developed and emerging markets

PLAY THE SECULAR TREND ON STOCK MARKETS

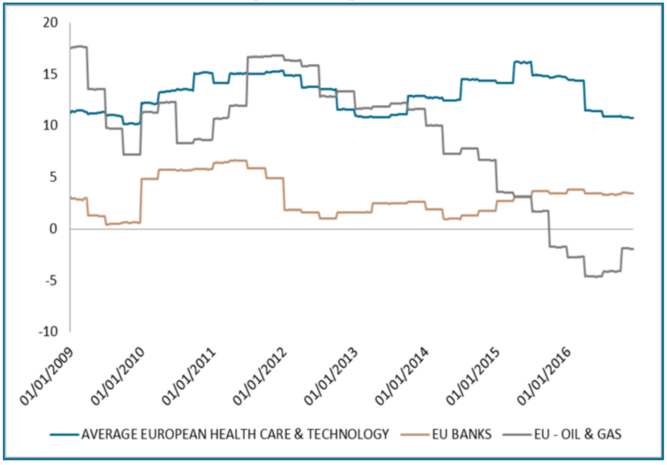
Adopt a long-term stance through robust activities

By definition, a "secular sector" benefits from a positive earnings growth trend over the long term. It is likely to profit from global changes in demographic and consumption trends and is consequently less sensitive to cyclical drivers. Although the reflation trade will continue in 2017, the secular trend is expected to remain intact. Any market correction in these sectors will thus offer buying opportunities.

For the time being, we identify two sectors with a solid long-term growth : Technology and Health Care. Both sectors show consistent demand for products or services, regardless of the economy. Their resilient profitability (see chart below) underlines their decisive advantage in comparison to sectors such as Banks and Energy, which have suffered from major structural changes over the last few years.

Health Care regroups both the Pharma and the HealthCare Equipment industries. Ageing population and medical innovation are supportive for these sectors as demand is expected to remain strong over a long period.

Return on Equity (Europe)



Source: Thomson Reuters Datastream

The pipeline of new products is strong in oncology and Alzheimer disease for example. In addition, Health Care companies benefit from solid balance sheets and often pay high dividends. As the pharma industry has performed badly during the last few months, valuations have become relatively attractive. Current share price levels thus offer an attractive entry point for investors with a long-term perspective.

Technology is another sector benefitting from secular growth. We live in a fast-paced world in which consumption habits and the way people communicate are changing. Industry segments, such as Cloud computing, e-commerce, big data, Internet of things, mobile payments, and offshore models, are likely to benefit from increasing demand for innovation and connectivity.

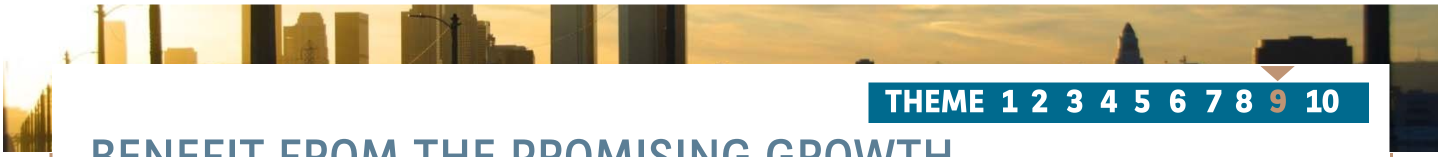
Note: this list is not exhaustive as other sectors can be played if secular growth potential is identified in specific activities such as infrastructure.

Risks to our view

From a relative perspective, the largest risk is the continuation of the reflation trade beyond the short-term horizon. In that case, the pro-cyclical sector rotation is set to continue and secular stocks may continue to underperform Cyclicals.

Another risk is the growing concerns over global trade. The rise of populism around the world may fuel an increase in protectionism in major countries. This might affect companies which are sensitive to the global economy.

A tighter regulatory framework is also a risk to the Health Care sector, even if Trump's election victory makes this unlikely, at least in the United States.



BENEFIT FROM THE PROMISING GROWTH IN RESPONSIBLE INVESTMENTS

SRI (Sustainable and Responsible Investment) aims to combine financial performance with a social and/or environmental impact. A full range of SRI solutions are available to clients to suit their investment profile. There are numerous investment possibilities: Energy: renewable energy; energy management, distribution and efficiency; Water: infrastructure and treatment; Waste: management, equipment; Pollution control; and Smart cities. SRI funds perform in line with (or better than) traditional funds in the long term.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			
1 YEAR			
> 1 YEAR		X	

SRI themes supported by a tighter regulatory environment

SRI is an investment discipline that takes into account Environmental, Social and corporate Governance (ESG) criteria to generate long-term competitive financial returns while having a positive societal impact.

Economic regulation, Capex and population growth, rising living standards, infrastructure deficits, finite natural resources and pollution are powerful drivers. More and more sectors are participating in the SRI story.

SRI themes are increasingly supported by the regulatory environment. Therefore, the climate change conferences “COP21” in Paris (December 2015) and “COP22” in Marrakech (November 2016) were important milestones for cementing the agreement to limit average global warming in 2100 to 2°C above pre-industrial levels. This will be a strong growth driver in the long term.

OUR RECOMMENDATIONS

Geographical zone

- Worldwide

Risk profile

- High

Horizon

- 5 years

Asset class

- Global equities through funds or single lines

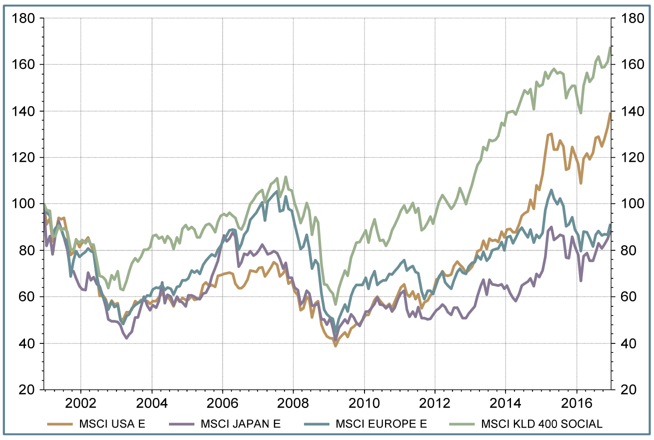
BENEFIT FROM THE PROMISING GROWTH IN RESPONSIBLE INVESTMENTS

The main targets

- Reduce greenhouse gas emissions by 40% by 2030
- Increase renewable electricity to 20% by 2030
- Cut carbon emissions by 26-28% by 2025 and increase renewable electricity to 28% by 2030
- Cut energy consumption by 20% and raise renewable electricity to 22-24%
- Increase non-fossil energy sources to 40% and cut emissions by 33-35% by 2030

Companies that have adopted adequate ESG practices are usually efficient and have solid business fundamentals. They are able to create value-added products and services. They tend to outperform in the long term. Sustainability trends are not yet fully appreciated by stock markets.

MSCI indices evolution (in EUR)



Source: Thomson Reuters Datastream

The most popular SRI themes

Energy: Global energy consumption has more than tripled over the last 50 years and will increase by a further 37% by 2040. Therefore it is necessary to invest in:

- *Renewable Energies:* Wind (wind turbine & gearbox manufactures); Solar: demand for solar is expected to rise because the price of solar modules in $ per watt produced is declining; Renewable Power Producers
- *Energy Management and Distribution:* smart grid suppliers, Lithium – Ion batteries: strong demand from electric vehicles and energy storage systems
- *Energy Efficiency:* Buildings with efficient lighting, isolation, windows, power management and home automation.
- *Substitute fuels*, such as propane, natural gas, electricity and hydrogen

Water: Of the Earth's water, only 3% is fresh. Of this amount, 7.5% is usable. Water used for agriculture and urban consumption is set to triple, and to double in industry. Without water there is no economic growth. Governments worldwide increasingly recognize the importance of useable water. Companies offering solutions in this area should grow tremendously in sectors such as:

- *Water infrastructure:* pumps, pipes, irrigation valves and smart applications
- *Water treatment:* chemical treatment, filtration, monitoring and water reuse

Waste: The steady increase in general waste is supporting growth of companies operating in waste management, hazardous waste management, waste technology equipment, recycling and value-added waste processing, etc.

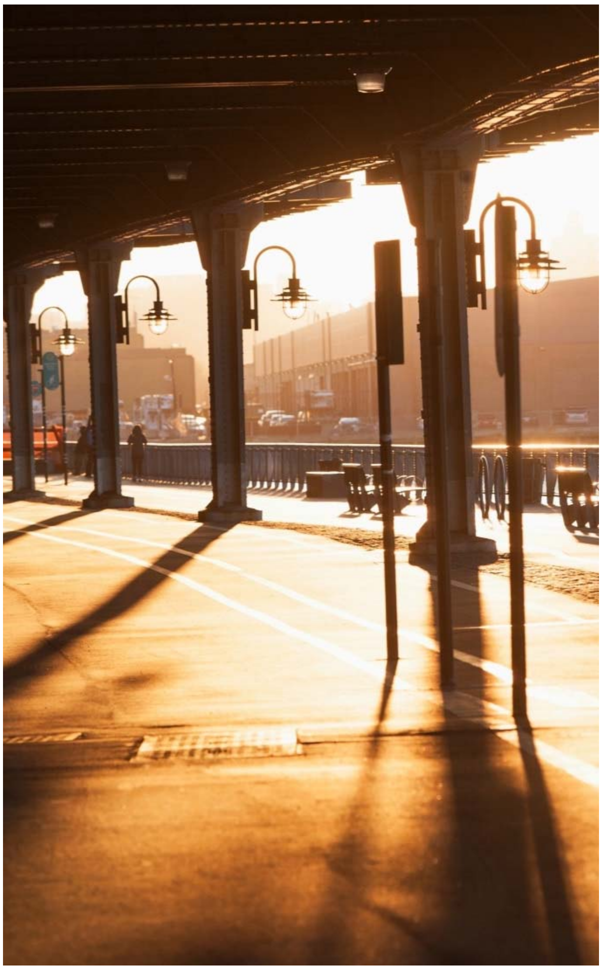
BENEFIT FROM THE PROMISING GROWTH IN RESPONSIBLE INVESTMENTS

Pollution control:

Pollution prevention and sustainability efforts must be accelerated. Fixing pollution problems is essential for efficient economically-viable manufacturing, providing services and addressing many environmental problems.

Smart cities:

Climate change has been a significant factor in the push for smart cities, in the hope that enhancing our highly-populated urban areas will decrease environmental risks such as gas emissions and waste production, while increasing efficiency in natural resource management (water and energy distribution).



Risks to our base case

- Unforeseeable changes to policies in favour of the energy transition
- Investors with doubts about this long-term investment
- A significant deterioration in equity market sentiment, with investors turning from stocks to less risky assets
- A strong decline in the oil price may have a negative impact on investments in environment solutions and renewable energies.

WHY FAVOUR COMPANIES WITH HIGH OPERATING LEVERAGE?

In the context of an improving economic backdrop, companies with high operating leverage are expected to benefit from higher profitability. For these companies, rising sales will imply higher profit margins and thus higher earnings. We recommend a stock selection based on this quantitative criterion.

RISK	LOW	AVERAGE	HIGH
< 1 YEAR			X
1 YEAR			
> 1 YEAR			

A bottom-up approach

Unlike our other investment themes, this one is based on a bottom-up approach and relies on the selection of stocks using an explicit quantitative criterion: operating leverage. This financial concept is crucial for companies' profitability. Operating leverage measures the change in operating profit as a function of the change in sales. It is high when a company shows a large change in operating profit for every euro of change in sales. Inversely, it is low when changes in sales do not impact largely operating profits.

The cost structure of a company is decisive in the operating leverage effect. A company with high fixed costs benefits from high operating leverage. If sales accelerate, its fixed costs weigh less on its operating margin which should rise more than for a company with variable costs (see graph). On the other hand, when sales shrink, a high operating leverage may drag on a company's profits.

A more favourable economic background

Over the past few years, US and European companies have not enjoyed growing revenues owing to low economic growth and low inflation.

OUR RECOMMENDATIONS

- We play this theme on equity markets.
- Developed equities will be the main beneficiaries.
- This theme is based on a bottom-up approach (stock selection).
- We invest in companies with a high operating leverage and a BUY or HOLD rating by BNP Paribas Wealth Management.
- Play this theme for as long as the reflation trade is in place.

WHY FAVOUR COMPANIES WITH HIGH OPERATING LEVERAGE?

Their sales growth has even contracted in recent quarters. 2017 should offer the opportunity to deviate from this unfavourable trend as reflationary effects are expected to be supportive in developed economies.

Against this macro-economic backdrop, companies should benefit from rising demand while revenues should rebound from their current lows. Companies with a high operating leverage could take advantage of this improving macro-economic environment.

Stocks with a high operating leverage can be identified in any sector or industry, but some of them have a high structural operating leverage. Fixed costs are high in the Industrials, Telecoms equipment, Materials, Utilities and Energy sectors.

We recommend selecting stocks, essentially in developed markets.

So far, profits have been weak, particularly in Europe. The rise in the European equity markets from 2009 lows has been almost entirely driven by valuation expansion, not by an earnings improvement.

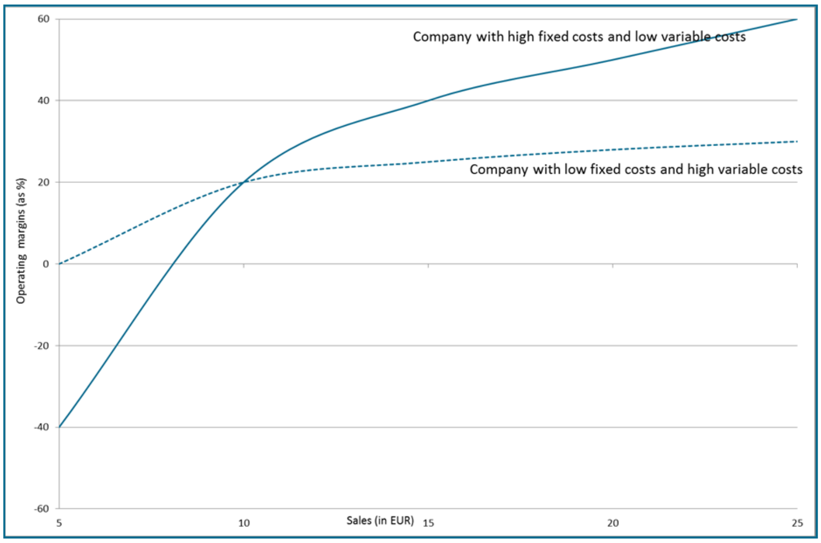
Profit margins are historically low. In this context, industries with a high operating leverage benefit from any improvement in sales in Europe.

We favour stocks with a BUY or HOLD rating by BNP Paribas Wealth Management.

Risks to our base case

The absence of a sales momentum in developed economies may negatively affect this theme. Any reversal in trend in our macro-economic scenario for 2017 would be unfavourable. Another deflationary spiral or recession scenario should be particularly negative for high operating leverage companies.

Impact of a company's cost structure on profit margins: Spread between a company with high fixed costs and another with high variable costs



Source: Thomson Reuters Datastream

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BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world