NAHMANI GRUNDER
WEALTH MANAGEMENT & MULTI-FAMILY OFFICE

MARKET INSIGHTS

A QUARTERLY REVIEW AND PERSPECTIVES ON FINANCIAL MARKETS

18 May 2018

Dear Investor,

After the risk-on, low volatility regime that dictated an extremely friendly backdrop for financial markets in 2017, the start to 2018 has been rather eventful as expected. 2017 was aided by easy comparisons and the unusual combination of better than expected economic growth with mysteriously tame inflation. The datapoints in 2018 so far have been consistent with our thesis that this year will involve exactly the opposite. The soft patch in the global economy in Q1, and especially in Europe, gives more credence that global growth will most probably peak in 2018. Economic growth rate for G4 plus China looks set to decelerate into 2019, in our view. At the same time, inflationary pressures in the US have been on the rise with wage inflation clearly picking up in Q1. **Moving within the late stages of the current business cycle, there is no doubt that the growth / inflation mix has already worsened in 2018 while monetary policy uncertainty remains elevated and concerns around FED tightening rise.** Moreover, President Trump seems to have returned to his unconstructive pre-election rhetoric, with the global trade rift possibly being a pre-cursor to increasing global tensions and thus a potential headwind for the global economy. All of this has **meant that volatility returned with a vengeance in Q1** and remains elevated so far in Q2, with rather disappointing returns across most asset classes. The era of low volatility and outsized returns should be over.

2018 started on a tear with markets off to continue from where they had left 2017, leading to an intermediate peak for equities on 26 January. Following the sell-off in late January/early February and the subsequent VIX peak on 5 February, equity markets have since been sideways in a trading range amidst this higher volatility backdrop. Overall broad cross-asset performance appears to have been consistent with rising US inflation and FED tightening concerns. For Q1 2018 as a whole, MSCI World lost -1.7% in USD terms after having been up as much as +6.9% by 26 January. Fixed income markets have been even more difficult with developed market sovereign bond yields increasing during the quarter and credit spreads widening marginally too. The 10-year Treasury yield popped up by 33bps to 2.74% by the end of Q1, only to breach the 3.0% for the first time in 4 years by the end of April. The 10-year US real rates also moved out of the 0-4 – 0.6% range they had been since early 2017 to end the quarter at 0.69% with a further move to 0.80% by early May. Unfortunately, this increase in long-term US real rates has taken place, primarily due to worries around a twin deficit in the US and Trump's negative rhetoric around trade. And, not due to better growth expectations. We see 1.0% as the clear line in the sand, and any further increase in long-term US real rates be-

yond that level would start to challenge our still constructive view on global equities for 2018, which we continue to base on strong corporate earnings fundamentals. For Q1 as a whole, commodity prices were also mostly down led by industrial metals, with Oil (+7.5%) and Gold (+1.7%) being positive outliers. The USD weakness which started in early 2017 persisted during Q1 with the EURUSD peaking at 1.25 by mid-February and ending the quarter with a depreciation of 2.7%. But the swift reversal of USD against all major currencies since early April has meant that EURUSD is now back to December 2017 levels, and has by early May moved back into the 1.10 – 1.20 range we expect it to trade at for the remainder of 2018.

As discussed in our previous letter, we think we are now in the early stages of exiting the 2017 paradise of "accelerating global growth without inflation". Since early February 2018, the tone of the global macro debate has changed, and global growth data suggest Q1 registered a slowdown phase. A slowdown phase, where growth is strong but slowing, has occurred in the past with 13 such episodes over the past 22 years. The latest batch of global current activity indicators (CAI) have decelerated in 60% of the economies since their recent growth rate peaks of January. The Goldman Sachs Global Current Activity Indicator (CAI) has decelerated to a preliminary 4.6% in April, down from 5.5% at the end of 2017. The slowdown has been most notable in Europe, with the economy recording its slowest growth in 18 months for Q1, and the manufacturing PMI for April coming in at 56.2, a sharp fall from 60 at the start of 2018. While economic growth may have passed its peak in the Eurozone and the UK, we still expect an improvement in global data as of Q2 especially due to the US economy, as the benefits of the tax cuts start to materialize through higher disposable income. Meanwhile, EM growth also remains robust, with China's Q1 GDP release exceeding expectations (leading us to nudge up our 2018 forecast to 6.6%) and firm growth numbers in both Brazil and India. The Goldman Sachs "60/40" rule, which combines the latest real GDP and CAI signals, still suggest that underlying global growth is running a tad above 4.0%, consistent with our forecast of 4.1% for 2018 and also above the 3.8% achieved in 2017. So, **despite some weakness in the first quarter and concerns about protectionism, global economic growth is likely to hold up well this year albeit with a shift of emphasis to the US.** On the other hand, we also think that the sequential acceleration will be over, with 2018 marking peak global GDP growth. Rising trade restrictions remain a downside risk to this view, but the threat to global growth looks modest unless an all-out trade war erupt, which surely is not our base case currently. We still want to believe that Trump's trade spat with China, which escalated in March, is being done as negotiating tactics to get China to reduce intellectual property violations and reduce its trade surplus with the US by opening up its domestic market more.

Global economic growth will start to decelerate as of 2019, even under the positive scenario that current trade disagreements come to an amicable solution. The exact trajectory of this growth slowdown and thus also the outlook for financial markets should depend on the inflation outlook and the monetary tightening response by central banks and the FED more specifically. From where we stand, monetary policy is now much more delicate and will continue to make 2018 much more difficult to navigate than 2017. What is also clear is that above potential economic growth, incremental fiscal expansion from US tax cuts and easy financial conditions with **increasing inflation readings will put the FED and financial markets on a collision course over the next 12 months!** One can easily infer this by comparing the Fed's dot chart which suggests 5 further 25bps rate hikes until the end of 2019, compared to the rates markets discounting only 3 to 4. In reality, we think the number could end up being as high as 6 further rate increases. And, it is also evident that this gap in expectations is centered around 2019, with risks surely tilted to the upside in terms of the rates outlook.

Inflationary pressures are still not pronounced enough for now to force central banks to act more decisively and spoil the economic upturn, but this should change quite quickly in the US. Euro area price pressures remain subdued, with core inflation actually even weakening in April to 0.7%, from 1.0% in March. A number of factors have likely weighed on price pressures, including immigration and labor market reforms. But at least, some of this weakness seems to reflect continued labor market slack. Our forecast continues to be that the first rate hike by the ECB will not materialize before mid-2019. On the other hand, **US inflation numbers have firmed notably during the last months.** Wage growth appears to be picking up after surprising on the downside in 2017, with growth in average hourly earnings and median weekly wages accelerating in the first quarter. Our updated wage tracker stands at 2.5% for Q1, up from 2.25% in Q4. The very low unemployment rate, continued strong job growth and endless reports of short supply of qualified labor point to a sustained pick-up in wage growth, probably topping 3% by year-end. Moreover, the composition of the March CPI report was firm and the year-on-year core PCE inflation came in at +1.9% for March (versus +1.6% for February). **We think we will breach FED's core inflation target of 2.0% sometime during late 2018,** at which point the FED will be prompted to raise rates even more aggressively than expected. In this regard, Fed officials have recently indicated that a 0.25 percentage point inflation overshoot is acceptable, but their tolerance probably doesn't extend too far beyond that number; in fact, we feel confident that sustained inflation above 2.5% would be viewed as a serious problem. To limit the risk of such an outcome, we think the FED will be keen to see the US unemployment rate, which is at a 17-year low level of 3.9%, stabilize no later than 2019. By Goldman Sachs' estimates, this requires a growth slowdown of about 1.0 percentage point against a backdrop of increasing fiscal stimulus via tax cuts. The obvious way to bring this about is via a tightening of financial conditions, which in turn requires a substantially larger FED funds rate increase than currently priced.

The FED's challenge in hiking cycles is to bring about a policy tightening that is sufficient to slow growth to a sustainable pace and keep inflation under check but not so large that it tips the economy into recession. However, **major tightening cycles frequently end in a recession** because monetary policy is a very blunt tool which however functions with a time lag. Inflation is also a highly lagging indicator. It typically does not peak, well after a recession has begun. In this regard, the NBER Cycle Dating Committee estimates that the current economic expansion is going on for nine years. If it makes it to July 2019, it will be the longest in history. Considering that records began in 1854 encompassing 33 business cycle, that will be an impressive achievement. Moreover, US fiscal policy with the new tax cuts will become much more stimulative as of Q2 2018. According to the IMF, US fiscal impulse will reach 0.8% of GDP in 2018 and 1.3% of GDP in 2019, versus earlier projections of -0.4% and -0.3% respectively. All this fiscal stimulus is thus arriving when the economy least needs it and inflationary pressures are already on the rise beyond FED's official target. The current tightening cycle should be seen in that context.

In summary, **our base case scenario remains that rising price pressures in the US will prompt to raise rates more aggressively than the market prices in, leading to a growth slowdown by early 2019 and possibly a US recession** (which would take the whole global economy down with it; decoupling is a myth!) **sometime by H2 2019/2020 period.** Obviously, this is just an educated guess, since many factors including the exact trajectory of FED's policy tightening, a sharp appreciation in the dollar and a variety of political shocks, could impact the timing of the recession. In this regard, we are keeping a close eye on the **US yield curve, which has inverted in the lead-up to every recession over the past 50 years.** The curve flattening which started in early 2017 has

continued so far in 2018, with the 2-year/30-year spread (2s30s spread) at around 62bps currently, versus 85bps at the end of 2017 and 186bps at the end of 2016. In a speech on 14 May, FED Governor also suggested that we might get an inverted yield curve by early 2019.

Our Investment outlook for 2018: Global Equities still the place to be, although with much higher volatility than in 2017

Given the base case presented above, 2018 remains a year of key inflections to the rate of growth, inflation and policy accommodation. We see continued, above-trend global economic growth for the remainder of 2018 with a likely recession in the US by H2 2019 induced by aggressive FED tightening in reaction to increasing inflation beyond its 2% target. There seems to be too much comfort in the lack of recession risk, and not enough concern that markets often peak when conditions are good. This means that navigating financial markets will only get trickier from here. As it is the case for an inverted yield curve which typically is a good leading indicator, bear markets are normally associated with recessions, and **equity markets typically discount recessions 6 – 12 months ahead of time on average.** And, credit typically also start to underperform before equities do. So, despite still reasonable levels of global growth, **the chance that 2018 sees a cyclical peak for stocks, rates and corporate bond prices is thus high,** and we may have to scale back risk in our portfolios into 2019. At the same time, we believe we still have a window of opportunity over the next 6 months whereby it should still pay off to be positioned in Global equities and to a lesser extent in US investment grade (IG) corporate credit. This strategy should continue to generate modest but positive returns for the remainder of 2018, as long as we are right about the probability of a US recession in the near-term being very low. Finally, we don't think what follows this equity market peak in 2018 will be anything like the drawdowns of 2000 or 2008 but rather a shallower, choppier decline.

A summary of our main views would be:

1. Total returns in 2018 will be much more modest compared to 2017 returns. At the same time, as we go through this regime shift away from the 2017 "Goldilocks" set-up, we also forecast the **higher volatility environment to persist for the foreseeable future** which will require investors to be much more flexible in their approach to net positioning, in our view. S&P 500 realized volatility is nearing 20% so far in 2018, versus 6.7% for 2017 (the second quietest year on record).

2. **We have a tactically positive view on Global equities but also think they should experience a cyclical top during H2 2018.** Above-trend global growth, double digit EPS growth, strong corporate dynamics and still relatively easy financial conditions are significant anchor points for equities. That said, over the past 3 months, it certainly feels like the best days of this long cycle are behind us, at the very least on the basis of risk-adjusted returns. As global equity markets (driven by S&P 500) are going through a fairly clear topping process, the first phase of this topping process was actually already put in place when equity valuations peaked in December 2017. P/E multiples for the S&P 500 probably peaked the day before the US Senate passed the tax bill. This still leaves us with forward earnings estimates which are still likely to rise from here, at least for the next few quarters. In other words, **we believe we can still re-test the high set on 26 January and potentially make new highs for the S&P 500 around 2,900 – 2,950 while staying below the December peak forward (rolling next 4 quarters) P/E of 18.5x.** As global economic data and earnings momentum over the next 2 quarters remain strong, even if the rate of change is topping, that should be enough to help the equity market grind higher within the valuation band of 16.5x – 17.5x. In this regard, S&P

500 earnings for Q1 were stronger than expected, and achieved year-on-year growth of +18% even excluding the one-time tax benefits. **Global equities should thus generate high-single digit type of total returns until the end of 2018** from current levels driven by earnings growth. We have a preference on developed market equities also given our positive USD bias. The combination of higher US rates, a stronger dollar and weaker Chinese growth will continue to weigh on EM equities over the coming months. There is $ 17 trillion of USD denominated debt held outside the US, most of it in emerging markets. Eventually global equity prices could potentially start to experience downward pressure into 2019 as the market starts to contemplate a peak in the rate of change for earnings growth being behind us.

3 We see a **cycle peak 10-year nominal Treasury yield of 3.50%, which we should reach during H2 2018/early 2019,** compared to 3.05% as of 15 May. This means global government bond yields will continue to trend higher over the next 6 - 9 months, but will begin moving lower by mid-2019 marking a cyclical peak for US long-term nominal rates as recession risks mount. **Corporate credit spreads should also form a bottom during 2018, with major spread widening to take place in 2019.** With higher US inflation readings and credit spreads at multi-year lows, it is difficult to create a scenario under which global bonds generate any meaningful positive returns during the remainder of 2018, even after their rather negative start to the year. Within fixed income, we clearly prefer US investment grade (IG) corporate credit and Treasuries over their European and EM counterparts. We continue to be negative on European credit which has been completely manipulated by ECB buying since January 2015.

Table 1: US High yield credit spreads 2013 – 2018 at multi-year lows

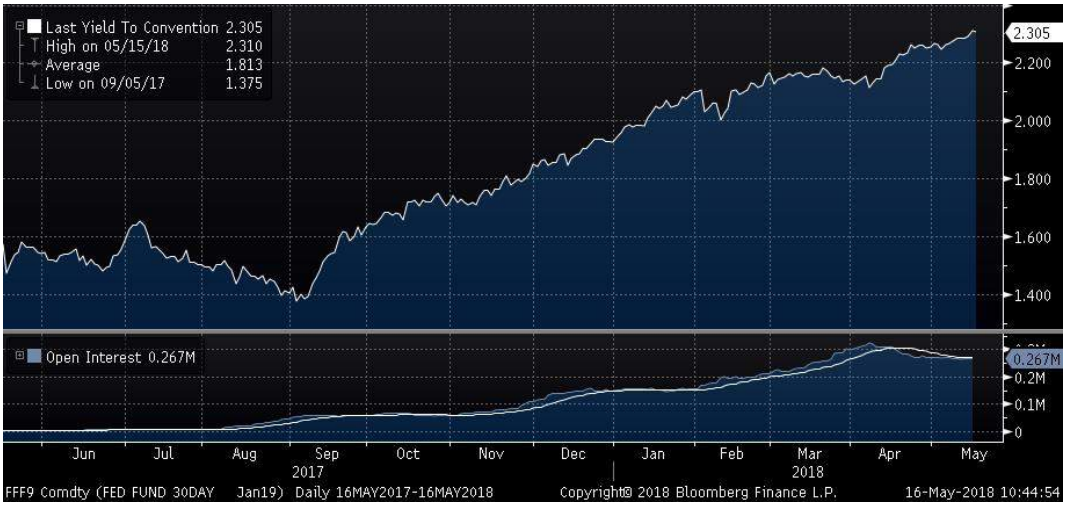
4 **Gold prices do well in situations where real rates are falling and the USD is weakening.** That's exactly the opposite environment we believe we find ourselves in 2018. With Gold prices around $ 1,300 per ounce, we think the upside case is getting weaker for now, until a potential stagflationary period after 2021. We expect flattish USD returns from Gold during 2018, with prices remaining around $ 1,300 per ounce.

5 We reached maximum bullishness on European economic growth prospects and net long EUR positioning during Q1 2018. The clear slowdown in Eurozone growth for Q1 has now clearly raised the odds that we may very well have already passed peak growth for the region. This has led to markets pushing forward any hope that ECB policy tightening would commence during 2018. We do not see ECB and SNB raising their short-term rates any time before H2 2019. As such, EURUSD came back to its mid-term trading range of 1.10 – 1.20 by early May, after peaking around 1.25 in mid-February. **We keep our bullish USD stance,** and believe the period of its surprising depreciation against all major currencies which dominated 2017 should be over now. This is because **real interest rate differentials will continue to widen to the benefit of USD,** as the FED firmly executes on its rate hike path. Lastly, a very positive USD story would be one based around an extended economic expansion, not cycle ending rate hikes, and hence we also think the upside case against EUR is capped to the lower-end of this 1.10 – 1.20 range.

Table 2: Specific FX cross rate expectations

	Directional view	Target range
EUR USD	↓	1.10 – 1.15
EUR CHF	=	1.15 – 1.20
USD CHF	↑	1.00 – 1.05

Table 3: Fed Funds Futures, Jan. 2019 contract implies a 2.30% rate by early 2019 (from 1.70% today)



Below, you can find our Asset Allocation Grid for a Global Balanced mandate:

Asset Classes	Positive	Neutral	Negative
Fixed Income & Cash –	Money market T-Bills	US Treasury Bonds US IG/HY Corp EM Corp TIPS	EU Sov. Bonds EU IG/HY Corp
Equities (sectoral view) +	Technology Healthcare Insurance US Banks EUR Banks	Consumer Staples Energy Metals & Mining Telecom	Industrials Consumer Discretionary Chemicals Utility
FX	USD	EUR GBP CHF JPY	CNY EM
Commodities =		Copper, Nickel Oil Precious metals	Iron ore, Coal

Please do not hesitate to call us, should you have any questions and/or feedback.

Kind regards,

Can Elbi
Chief Investment Officer

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