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MARKET INSIGHTS

A QUARTERLY REVIEW AND PERSPECTIVES ON FINANCIAL MARKETS

14 February 2018

Dear Investor,

The juicy cocktail of strengthening global economic growth, tame inflation readings, still accommodative monetary policies, and strong corporate earnings all helped 2017 to become a remarkable year for financial markets. The successful passage of US tax reform during Q4 also added an additional new layer to this positive constellation in the form of fiscal stimulus. In an environment of accelerating global GDP growth to 3.8% and abundant excess liquidity, the clear surprise of 2017 was that inflationary pressures remained subdued across advanced economies. For example, going into 2017, the FED was originally expecting core Personal Consumption Expenditure (PCE) inflation to end the year at 1.9%. It finished the year at 1.5%. **This backdrop resulted in a beautiful "Goldilocks" regime in which most asset classes delivered robust returns with equities and bonds rallying jointly during the entire year with low volatility and minimal drawdowns.** Global equities closed 2017 at all-time highs, with MSCI World delivering a return of +20.1% driven by healthy low-teens earnings growth but also some further multiple re-rating. With inflation under check and real rates remaining well-anchored, global bonds also powered ahead with corporate credit spreads narrowing further both in the US and Europe. The Barclays Global Aggregate Bond index rose by +7.4% for the year. Precious metals but also most industrial metal (such as Copper, Nickel, Zinc) prices also rose during 2017, with Crude Oil prices also rallying to close the year at multi-year high levels.

Since early 2017, our thesis has been that **we are in a reflationary sweet spot for financial markets that should last until the end of 2018:** First of all, underlying **global economic growth has strengthened since mid-2016,** coming in the form of the first synchronized global economic growth phase since 2007. Real-time measures of economic activity, such as the Goldman Sachs Current Activity Indicator (CAI), highlight that global real GDP is rising at a robust pace. The CAI is a collection of high frequency weekly and monthly data from 30 economies, and is currently increasing by +5% year-on-year, implying that further upward revisions to current global GDP forecasts are possible. Moreover, global financial conditions eased significantly in 2017, thanks mainly to higher equity prices and narrower credit spreads. Easier financial conditions tend to benefit growth with a 6-to-9 month lag. To put this into context, the Goldman Sachs Financial Conditions Index (FCI) is at end-1999 levels, a multi-year low in terms of how easy financial conditions have become, reinforcing the growth momentum. Fiscal policy should also remain stimulative, following the enactment of significant tax cuts in the US. The fiscal thrust moved into positive territory in advanced economies

in 2016-2017 and this should remain the case in 2018. We believe tax cuts could add about +0.3 percentage points to US growth in 2018. All of this bodes well for 2018. We expect global real GDP growth to accelerate from 3.8% in 2017 to 4.1% in 2018. At the same time, this might also be as good as it gets, as the sequential acceleration should be over.

Second, this acceleration in global growth has occurred against **mysteriously tame inflation,** which has allowed most central banks to keep short-term interest rates at exceptionally low levels. We find slack is the best indicator of inflation over the medium term. And, we are clearly in the latter stages in the global economic cycle, with capacity constraints finally coming through. Thus, the current global growth spurt is further reducing slack in many developed economies. Wage growth should accelerate as the labor market continues to tighten. This should put upward pressure on service inflation. Tax cuts should have a greater impact on demand than supply, putting even greater pressure on an already tight labor market. Goods inflation should also recover due to the lagged effects of a weaker dollar and the bleed-through of higher energy prices into several components of CPI. **We expect core PCE inflation in the US to move towards the FED's 2.0% target by the end of 2018,** versus 1.5% at the end of 2017. However, as long as inflation is rising in response to strong growth and finds itself in below-target levels, this is still a positive backdrop for financial markets, and especially for equities, as we experienced during 2017 and January 2018.

Third, it is hard to imagine that we could have had a more stimulative monetary environment than the one which existed in recent years. Central Banks have been in panic mode since the 2007 – 2009 financial crisis, with a period of negative real rates in the advanced economies coupled with an extraordinary expansion of central bank balance sheets to never before seen levels. They flushed the system with an unprecedented wall of liquidity through their money printing programs, bringing the cumulative size of their balance sheets to a whopping $ 15.5 trillion by the end of September 2017, or 20% global GDP. That translates into **a massive liquidity injection of $ 11.5 trillion globally over the last 9 years.** This wall of liquidity in the system has not only kept long-term sovereign rates at historic low levels, but also further compressed corporate credit spreads and boosted valuation multiples in equity markets. Our base case was that the current easy monetary policy regimes by central banks would be reversed gradually, but our conviction around this thesis is certainly much lower for 2018 than it was in 2017, especially given the emerging signs of inflation creeping up in the system.

What is new is that we think we are in the early stages of exiting the 2017 paradise of "growth without inflation". **Accordingly, we think the key now for financial markets in 2018 is the inflation outlook and the monetary tightening response by central banks** and whether it comes in the form of more than what markets price in. From where we stand, monetary policy is now much more delicate and will make 2018 more difficult to navigate than 2017. What is also clear is that above potential economic growth, incremental fiscal expansion from US tax cuts and super easy financial conditions **with improving inflation readings will increasingly put central banks and financial markets on a collision course during 2018!** In this regard, the FED's preferred wage measure Employment Cost Index (ECI) compensation grew by +2.5% on average in 2017, accelerating from the +2.2% gain in 2016. 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. In that regard, the monthly US employment report published on 2 February showed average hourly earnings increased by +2.9% year-on-year in January, much higher than expectations of +2.6%.

It is evident that any overall inflationary surge beyond the 2% target will push the FED to become more aggressive with its policy tightening. Major tightening cycles frequently end in a recession because monetary policy is a very blunt tool which however functions with a time lag. The FED is at the leading edge of pursuing policy normalization by hiking interest rates and reducing the size of its $ 4.5 trillion balance sheet. The pace of this regime shift, and whether it is gradual or more aggressive, will now depend the course of inflationary readings with increasing upward pressure as we move into the second half (H2) of 2018. We think financial conditions will start to tighten in the US during 2018. At the same time, we also think a US recession in 2019 triggered by too aggressive FED tightening is within the realm of possibility, which would surely impact all financial markets globally.

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

We are now more convinced that the "Goldilocks" environment with prices trickling up in almost all asset classes on exceptionally low volatility has run its course and that the delicate balance of abundant liquidity, improving economic growth with tame inflation will change during 2018. **This should mean more volatility, a more difficult backdrop for bond markets but a still ongoing upward trajectory for global equities despite the swift correction in early February which more than wiped out the initial gains of January.** At the current juncture of the market in early February, **this also means continued preference for equities over bonds during 2018.**

Given our inflation views, we expect the FED to hike interest rates by 3 - 4 times during the year, and the ECB and SNB to follow during H1 2019. We also see long-term rates to be under upwards pressure in most major markets during 2018. Accordingly, we believe equities continue to offer better return prospects, also versus corporate credit as spreads have narrowed to historically low levels. While equities are far from any historical measure of cheap, we don't think current 2018 valuation multiples have much downside for now especially in the context of current 10-year US real rates of 0.75%. At the same time, factors that have typically accompanied a peak in equity markets are also not in place. Yield curves remain upward-sloping and, most importantly, core inflation still remains much more subdued than we have tended to see before previous peaks in the equity market. The risks of rising inflation pushing interest rates up sufficiently to derail the global growth recovery seem remote for 2018. However, the overall framework does get more complicated as we move into H2 2018. Beyond a steady rise in US inflation dynamics and the prospect of a peak in global economic growth, central banks are slowly getting out of the QE bond buying policies, with the FED already slowly shrinking its $ 4.5 trillion balance sheet since October 2017. Peak QE is behind us and the inflection in the dynamics of global liquidity towards the end of 2018 should not be dismissed.

As long as inflation is rising in response to strong growth and still finds itself below target levels (as it does currently), both US and global equities should still generate positive returns from current levels, especially after the 10% pullback in the S&P 500 in early February. Historically, inverted yield curves have traditionally been a good predictor of recessions. The US yield curve is still positively sloped with the 2-year/30-year spread at 100bps in early February. Overall, we think that while quite low in the near-term, the probability of a US recession in 2019 is rather high, especially if the FED tightens too aggressively in reaction to a possible inflationary surge beyond its 2% target. **Equity markets typically discount recessions 6 – 12 months ahead on average, implying more caution will be needed also for Global Equities as of H2 2018.** In this regard, in addition to US inflation readings, we will also be watching the US yield curve closely for clues as to any peak in Global equity prices.

A summary of our main views would be:

Overall, following the swift correction in Global equities in early February, we are again pro-risk in our asset allocation, with an overweight on equities, neutral on credit and commodities including Gold, and clearly underweight on government bonds for 2018, albeit with the readiness to scale back risk during H2 2018:

1. Total returns in 2018 will not come anywhere close to 2017 returns, even for global equities. At the same time, as we go through this regime shift away from the "Goldilocks" set-up, we also foresee a resurgence in volatility which will require investors to be much more flexible in their approach to net positioning, in our view.

2. Global equities should generate low-teens type of total returns until the end of 2018 from current levels, with a preference on developed market equities also given our positive USD bias. However, returns should be concentrated into the first half of 2018. For the S&P 500, our year-end target remains 2,850 on an implied P/E multiple of 18.5x, versus 20.2x at the end of 2017. Accordingly, the recent healthy correction in early February, which also rectified the extended positioning and sentiment levels during January, should be used as a buying opportunity.

3. With higher 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 2018. Within fixed income, we clearly prefer corporate credit over sovereign bonds.

4. Gold prices do well in situations where real rates are falling and the USD is weakening. That's not the environment we find ourselves into 2018, in our view. With Gold prices around $ 1,330 per ounce, we think the upside case is getting weaker for now, until a potential stagflationary period after 2020. We expect flattish USD returns from Gold during 2018, with prices around $ 1,300 per ounce.

5. We keep our bullish USD stance, and believe the weakness seen against EUR will be capped to the EUR USD rate of 1.25 and there will a likely normalization back to what we think is a new trading range of 1.10 – 1.20 during 2018. The period of surprising depreciation against all major currencies which dominated 2017 should be over now, especially as real interest rate differentials continue to widen to the benefit of USD.

Equities: Earnings growth driven upside offset by slight multiple de-rating; prefer Technology, Health care and Financials

We expect corporate earnings fundamentals to continue to be healthy, with the recovery that began in mid-2016 to be sustained at least in the next 12 months. Global earnings per share (EPS) should expand by around +10% for MSCI World and +12% for MSCI EM in 2018. US earnings growth should outperform due to the tax cuts which became effective in Q4 2017, with **S&P 500 EPS forecasted to increase by 16% year-on-year to $ 154 in 2018,** following an already healthy increase of 10% in 2017. This is backed up by the strong Q4 earnings season, where quarterly reports are surely coming in stronger than in Europe. That means **S&P 500 P/E 18e declined from 18.5x to 16.8x in the last 10 days.** With positioning much cleaner and valuations having dropped by two full P/E points, we believe the **early February correction now presents good opportunities** to lift some S&P futures hedges and add to some of other favorite bottom-up stock ideas.

We focus our overall equities analysis on the US market, as we believe that the notion of European and Emerging markets (EM) equities decoupling from the US in a downside scenario is nothing more than a myth. US equities do drive global valuations. In that regard, while US equities corrected by around 10% in the current correction around early February, MSCI EM also declined by 8.6% between 26 January to 8 February time frame. Valuation on equities, while still high compared to long-term history, are now back to the lower range of the last few years. **S&P 500 P/E multiples increased from 18.7x at the end of 2016 to an estimated 20.2x by the end of 2017.** The 2-year P/E multiple range has been 18x to 20x, which is surely above historical average valuation of 15-16x. The way to justify this multiple re-rating has been through low real rates and the abundant liquidity in the system. With both of these factors being reversed as we move along the year, it is possible that valuation multiples will contract from the levels at the end of 2017. At the same, with the correction having reduced current P/E 18e multiples to below 17.0x, we now again see upside potential in US as well as Global equities. **Using a fair-value implying multiple at the low-end of the 2-year range of 18-20x, we come up with a year-end 2018 target of 2,850 for the S&P 500. This implies an upside potential of 10% from current levels,** excluding a dividend yield of 2% on top, driven by EPS growth, as opposed to any further P/E multiple expansion. As one looks beyond the next 6 - 12 months, the skies also begin to darken for global equities. As stated earlier, the stock market usually sniffs out recessions before they happen, but the lead time is quite variable and generally around 6 -12 months between peak of S&P 500 and the official start of a US recession.

On a sector basis, we certainly like Financial Services. We see **US Banks** as major beneficiaries of higher Treasury yields, a steeper yield curve and lower US taxes. **Eurozone Banks** will also benefit from steeper yield curves, faster credit growth and ongoing declines in NPLs. Moreover, with the finalization of Basel III regulations at the end of 2017, we see the prospects of higher payout ratios for many Eurozone Banks which still pay out 50% of earnings only. For example, BNP Paribas paid out 50% of its earnings in 2017 amounting to EUR 3.02 of dividends per share. This results in a dividend yield of 4.8%. However, at the same time, BNP Paribas had a CET1 ratio of 11.8% at the end of 2017, implying that its capital position was already at where it should be from a regulatory point of view by 2020. In other words, the bank should easily be able to increase its payout ratio towards 80% from 50% today. On that higher payout ratio, its dividend yield would be a whopping 8.0%! Beyond Financial Services, we would also highlight our long-term favorites, namely **Technology** and **Health care** which carry structural growth, high barriers to entry and high and sustainable free cash flow (FCF) margins on rather cheap valuation.

Lastly, while Global equities were having their best start to a year in the past 30 years during January 2018, some investors had started to compare the current phase to the formation process of past bubbles. They asked whether there would be a final blow-off/melt-up phase in this very long bull market. When looking at all great past bubbles, we see that prices alone are by no means a sufficient sign of an impending bubble break. Indicators of extreme euphoria seem the strongest indicator and were much more important than price alone. This can be signified by the true psychological event of momentum increasing to a frenzy, or an acceleration of price. According to GMO, the average time of the final bubble phase of the great equity bubbles has been just under 3.5 years, with the average upcycle of real acceleration in just 21 months and an average price gain of 60% in that short period. If we apply that rule of thumb to the S&P 500 and assume that inflation would still under control for the time being, that would imply an S&P 500 level of around 3,400 – 3,700 over the next 9 – 12 months. So, that would still imply further sensational gains, both in speed and extent, albeit from a decreasing number of index constituents. This is not our base case, but is surely something to keep on the back of our minds.

Bonds: Treasuries yields have further upside; US and EM credit if it need be

The 35-year bond bull market is over, with nominal rates having now bottomed. We have made both the secular low in inflation and the secular low in bond yields relative to inflation. FED has started the wind-down of its $ 4.5 trillion balance sheet in October 2017. The ECB has also started tapering its EUR 60 billion per month in purchases as of January 2018 over a period of 12 months. This clearly means that we are slowly moving to a new post-QE world where liquidity will rather be taken out of the financial system. Between the prospect of rising inflation expectations, more government spending, less demand for Treasuries from the slow reversal of QE by the FED, and a US economy that is rolling forward on a healthy path, none of these 4 factors was consistent with the 10-year Treasury yield at 2.40% at the end of 2017. Hence, **we are not surprised to see yields moving up to 2.85% as we speak. Above-trend GDP growth and rising inflation are likely to push up long-term bond yields even higher in most economies over the next 2 quarters.** At the same time, without any sustainable acceleration in US real economic growth to 2.5 – 3.0%, we also conclude that it will be difficult for long-end Treasury yields to move meaningfully above 3.5%, especially if neutral real rate in the US economy is currently close to zero. In this regard, we see steeper yield curves both in the US and the EU, but also think the yield curve in the euro-area should steepen more than in the US, since the ECB has pledged not to raise rates until well after its QE program is complete. In terms of corporate credit, spreads have now fallen back to their post-recession lows after widening in the wake of the global manufacturing recession, and we think **spread compression should also be over now.** This creates a backdrop in which it will be virtually impossible to generate any meaningful real returns (inflation adjusted) in global bond markets in 2018, compared to +7.4% in nominal returns for the BarCap Global Aggregate index in 2017 (on less than 2% inflation).

Within fixed income, we favour corporate credit over sovereign bonds, with a clear preference of US and EM credit, while being negative European credit which has been completely manipulated by ECB buying since January 2015.

Currencies: Ongoing positive stance on USD, despite the flow/sentiment driven depreciation in 2017

Global economic growth revisions were more favorable outside the US in the first nine months of 2017, which probably helps explain why the dollar came under downward pressure during 2017. More recently, US growth estimates have begun to drift higher. We expect data to continue to favor the US; financial conditions have eased a lot more in the US than in the rest of the world. Fiscal policy is also set to loosen relatively more in the US. On the other hand, euro area growth is likely to tick lower next year from its current stellar 2+% pace, as the impact of the strong euro begins to bite.

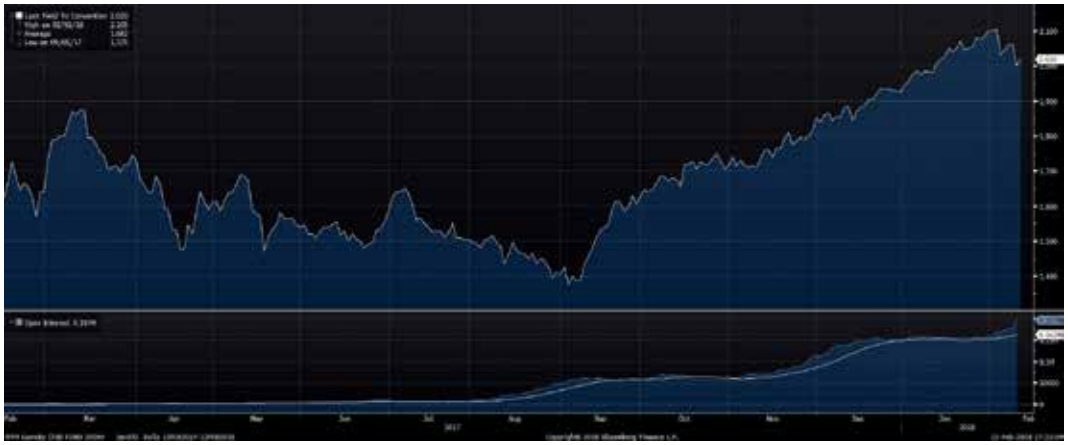
We remain positive on the **US Dollar.** We were clearly surprised with its 14% depreciation against EUR but also its weakening versus all other major currencies. Relatively stronger US growth and relative tightening of US policy versus the rest of world should be USD-bullish, and thus, despite the sentiment/flow driven move down in 2017, **we think the dollar should appreciate back to its new trading range of 1.10 – 1.20 versus EUR during 2018,** from 1.2260 today.

It is not the absolute level of real interest rate spreads that matters for FX rates, but how spreads evolve relative to market expectations. In this regard, FED will deliver more tightening over the next 12 months than the market is expecting while the ECB will deliver less, in our view. Forward markets are still pricing in a 30% chance of a rate hike by the ECB by the end of 2018, whereas we take

Mr. Draghi by his word that any rate changes will only come well past the end of its QE program. This would be potential rate changes by ECB only as of mid-2019. At the same time, **the Fed Funds Futures now imply that markets price in 65bps of hikes, or slightly more than 2 interest rate increases over the next 12 months until January 2019. In contrast, we believe it will rather be 3 to 4 further hikes over this period** due to our macro framework explained above.

We are neutral on CHF for now, but we are also ready to reassess this view during the second half of 2018 with a potentially more positive bias.

Table: Fed Funds Futures, January 2019 contract implies a 2.02% rate by early 2019 (from 1.375% 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 IG/HY Corp EM Corp TIPS	US Treasury Bonds 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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