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GLOBAL MARKETS OUTLOOK 2018

January 2018

2017: A low vol, high return year

Looking back to early 2017, investors started the year with cautious optimism, assuming moderate growth and limited inflation would support markets. Yet, 2017 turned out to be a stellar year for most major asset classes.

On the equity front, a stable and synchronized recovery marked with repeatedly positive economic surprises and strong corporate earnings has helped most global markets to the rally. The MSCI World index gaining ~20%. US market indices ended the year above 20%, as the Tech sector outperformed and all sectors except Energy and Staples ended the year in the green. European, Japanese and other Asian markets produced double-digit growth as well. Emerging markets largely outperformed DM as they benefitted from record low-volatility in economic data, improving corporate margins on the back of China capacity shut-ins, and a dovish Fed tightening policy, together with a softer US dollar.

This exceptional year was underpinned by record-low volatility. Contrarian positioning was very costly in terms of performance. Drawdowns in US equity prices didn’t exceed 3% and left little room for “buy the dip” strategies.

On the bond level, credit spreads tightened dramatically across the Investment grade and high yield spaces, in both EM and DM. Portugal was the largest winner in Europe as the country regained its Investment grade status. USD short duration bonds were the weak spot as a sell-off in the front end of the curve pushed 2-year US rates higher while 10-, and 30-rates were roughly flat.

Commodities staged a rally as well, with EV-related metals (lithium, cobalt) rallying. “Doctor Copper” reached a 3-year high end December, amidst a rise in industrial metal prices driven by a moderation in the oversupply situation in China. As for oil prices, they were supported by coordinated OPEC supply cuts and a recovery in demand. Gold trended higher, driven by bouts of geopolitical tensions and supported by a weakening US dollar. Indeed, the most notable loser in 2017 was the greenback, as US political risks failed to abate and the improved growth momentum outside the US reduced its relative appeal.

Last but not least, 2017 saw the emergence of a new type of asset: cryptocurrencies. They build on a new technology called blockchain – public, digitized, and decentralized ledgers for transactions. Prices quickly entered into bubble territory by increasing more than tenfold, exceeding the $700 billion a market capitalization, and catching the attention of Media and the financial sphere. Wall Street jumped in to have a piece of the pie, and introduced future on Bitcoin in the CME and the CBOE in December.

Are we there yet?

In contrast to 2017, the start of 2018 has seen investors embrace risk assets with relative fervor. Indeed, the range-bound long-term yields, the acceleration of the recovery outside the US, and the stability of the Chinese economy have supported markets and sentiment across 2017 and lifted forecasts for this year.

From this standpoint, we believe 2018 should be another positive year for equity markets as increasingly synchronized global growth momentum supports earnings. In the US, as November mid-term elections loom large, we expect President Trump, ever conscious of the nexus between wealth and political success, to pursue a narrative designed to support markets.

	As of Dec 29 2017	2017 Perf %	YTD Perf %
Equities			
MSCI WORLD	2,103.45	20.11	4.59
S&P 500 INDEX	2,673.61	19.42	4.82
NASDAQ COMPOSITE INDEX	6,903.39	28.24	5.72
Euro Stoxx 50 Pr	3,503.96	6.49	3.24
FTSE 100 INDEX	7,687.77	7.63	0.22
NIKKEI 225	22,764.94	19.10	4.39
MSCI EM	1,158.45	34.35	5.54
HANG SENG CHINA ENT INDX	11,709.30	24.64	11.83
MSCI EM EASTERN EUROPE	165.59	12.85	9.09
MSCI EM LATIN AMERICA	2,828.15	20.83	7.86
MSCI AC FAR EAST	155.99	30.48	5.86
Fixed Income			
US Generic Govt 2 Year Yield	1.88	58.46	8.95
US Generic Govt 10 Year Yield	2.41	-1.59	8.31
Germany Generic Govt 10Y Yield	0.43	105.29	37.24
Liquid Investment Grade	282.46	7.29	-0.72
Liquid High Yield	269.13	6.32	0.68
Citi EuroBIG Index	231.16	0.53	-0.11
Pan-Euro HY Unh Eur	381.40	6.24	0.61
EM USD Aggregate	1,096.07	8.17	0.13
Currencies			
DOLLAR INDEX SPOT	92.12	-9.87	-1.51
EUR-USD X-RATE	1.20	14.15	1.72
USD-CHF X-RATE	0.97	-4.39	1.24
GBP-USD X-RATE	1.35	9.51	2.41
AUD-USD X-RATE	0.78	8.34	2.19
USD-TRY X-RATE	3.80	7.80	-0.04
USD-BRL X-RATE	3.31	1.76	2.80
Commodities			
BBG Commodity	88.17	0.75	0.70
Oil (Brent)	66.87	17.69	3.63
Gold Spot $/Oz	1,302.80	13.53	1.97
Silver Spot $/Oz	16.94	6.34	0.78
Platinum Spot $/Oz	928.25	2.78	7.63
Generic 1st 'TIO' Future	71.28	-10.62	7.00
LME ALUMINUM 3MO ($)	2,268.00	33.96	-3.35
LME COPPER 3MO ($)	7,247.00	30.92	-2.94
Generic 1st 'NG' Future	2.95	-20.70	9.01

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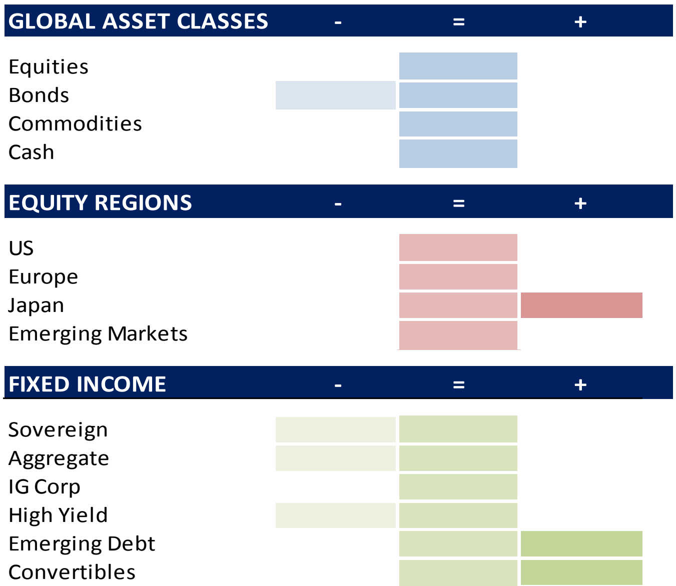
Investment Strategy and Asset Class Review

- **In 2018, we expect another year of synchronized global growth.**
- **Macroeconomic conditions should be supportive for risk assets, yet main risk is inflation overshoot.**
- **In equities, cyclical stocks are poised to outperform. We favor Japan for its relatively attractive valuations, but other regions ae expected to catch up with the US as well.**
- **In fixed Income, we are very selective and prefer to stay short duration. Focus on active and targeted strategies for bond investments.**
- **The unloved US dollar would benefit from any inflation surprise but remains at mercy of US politics. The EUR remains sensitive to Chinese demand and under-priced political risks in Europe. We like exposure to JPY as an undervalued safe haven.**
- **This year will be volatile for industrial metals and oil as China steers its economy into a soft landing. Gold financial demand is set to continue but investors looking for a cheap hedge will be wary of purchasing at high prices.**



The above table is meant as a reference.

FOMO (Fear Of Missing Out) is ruling and risk-reward standards are weakening, creating the potential for investors to underestimate threats.

The most obvious risk factor to full-filling the “death in euphoria” for markets would be that the positive growth, easy fiscal and monetary policy mix that is increasingly fueling investor optimism starts to feed inflationary trends, just as investors have finally given up on ever seeing a sustained pick-up in prices and wages. Stronger than anticipated inflation would undermine the support low interest rates have provided to risk asset valuations. With labor markets tightening globally, positive trends in commodity markets, Asian export prices picking-up, and factory orders relative to inventory balances narrowing, we think it is already prudent to limit interest rate risk in fixed income portfolios and maintain a core allocation to gold relative to our current positive exposition to equity risk. In an extreme case, a rise in interest rates could be more pernicious than justified by the fundamentals alone, given the risk that short volatility strategies, that have gained increasingly wide distribution in yield deprived world, may be forced to be unwind.

Other key risks ahead relate to the Geopolitical, monetary policy and growth environment. So far geopolitical tensions have had limited lasting impact despite increasing challenges to end the era of US Hegemony. This year, we have to navigate elections in Russia/Italy/Venezuela/Mexico/Brazil/US, and Brexit negotiations. From the perspective of Central Bank policy, markets currently discount limited disruption from the start of ECB tapering or changes to the composition of the US Federal Reserve board that see both the Chair and several board member changes potentially challenging the traditionally dovish doctrine that leaves markets currently discounting 2 hikes in the year ahead versus the 3 estimated by the FOMC (dot plot). In terms of the rosy growth outlook the clearest threat could emerge from a sharper contraction than anticipated due to on-going tightening in monetary and credit policy in China and in turn de-railing broader risk appetite.

EQUITIES

Equities finished the year on strong terms. Tax reform in the US and the prospect of an infrastructure deal ahead have fueled a rally in industrials and commodities. Corporate Nirvana is gaining traction as the US presidency now houses one of the most pro-business presidents in history.
In 2018, earnings growth should be the main driver for equity prices. So far, US markets have exhibited strength and may be positioned for higher prices. Outside the US, most of the markets could be poised for a much awaited catch up, based on relatively lower valuation.
On a geographic level, we have a slight preference for Japan for its attractive valuation, strong balance sheets, good technicals, positive earnings growth, and strong thematics. Emerging markets also offer attractive prospects as both technology and commodities march on an upwards path. Europe which remains exposed to Brexit ripples should eventually find its way to higher prices.

The US recovery has principally been driven by consumers. However, as the savings rate has dropped to ~2.9%, it is now time for corporations to take the reins on economic growth by increasing wages and capex. The tax plan should fuel corporate spending via the decrease in tax rates to 21% from 35%, and full expensing of newly purchased capital goods. **Energy** names are nicely positioned to increase their bottom-line as they have a high effective tax rate. On the other hand, **Industrials** and Tech (**software**, **IT services**) should profit from the spending spree as companies will seize the tax windfall to boost their productivity via investments. On another note, cash repatriation should boost M&A deals and capital return to shareholders from **Big Pharma** and large **Biotech** names. **Financials** have significantly rallied in 2017 but continue to benefit from tailwinds: higher rates, strong economy, and possible deregulation. **Big tech** remain in the top 10 sales and earnings growth of US companies, hence it is hard to leave the FAAMGs on the sidelines. Main risk is increased regulatory scrutiny – and possible actions/sanctions – given the increased amount of data and social impact these companies have been accumulating.

In Europe, as the Old Continent is in the mid-stage of its economic cycle, we favor **cyclical** sectors and **domestically-focused** companies that are immune to variations of the euro currency. We remain cautious in the UK as Brexit negotiations are yet to draft the future UK- EU Bloc relationship.

Globally, we like the prospects for **Small & Mid** cap stocks. Also, we prefer to be selective in bond-proxy sectors and favor self-help and turn around stories (alpha). We like exposure to **Artificial intelligence** and **Robotics** as a longer-term theme.

FIXED INCOME

Amid a low volatility environment, with political risk losing its power to shock and central banks remaining relatively accommodative, most Fixed Income markets enjoyed a positive tone during 2017, leading to another positive year for credit markets.

Over the year, the hunt for yield has depressed global credit yields back to 2016 levels (chart 1) while spreads (chart 1) hovered around 2014 levels. The low yield level might incentivize yield-hungry investors to further increase their risk appetite, but low spread across the quality spectrum could as well create negative downside risk down the line, especially in the riskier assets where idiosyncratic risk across many issuers and sectors remain elevated.

Chart 1: Global Credit Yields and Global Spreads

Interest Rates - 2018 is starting much like the beginning of 2017 where the "dots" foresaw three hikes and the Fed did manage to meet expectations. For 2018, the latest dots are also looking for another three hikes with about two priced in. Given our macro view on the emergence of inflation, we would like to be prepared in case the Fed decides to hike every quarter during 2018. Moreover, regardless if the Fed hikes three, four or more times next year, balance sheet reduction and tax deductibility poses the question as to how credit markets will interact.
Front-end rates reached their highest level in more than nine years, prompted by expectations the Fed would tighten and short-term government borrowing would grow from possible federal tax cuts. Markets are sending mixed signals with equities hitting all-time highs whereas short-term rates are moving higher and the curve is bear flattening. However, risks of recession are still minimal given the level of global synchronized economic growth, improving fiscal policies and more stable commodity prices.

Chart 2: US 2Y, 5Y & 10Y Yields

Even if default rates are still expected to trend lower in 2018, initial spread levels could prove to be challenging as, on average, balance-sheet leverage has risen steadily and cash flow generation is now slowing relative to earnings.

Credit - Credit spreads are at their tightest levels since November 2007 for EM hard debt with EM High Yield valuations appearing relatively even more expensive vs. EM investment grade. These spreads will probably not compensate for potential bouts of volatility during a heavy election cycle in emerging countries this year.

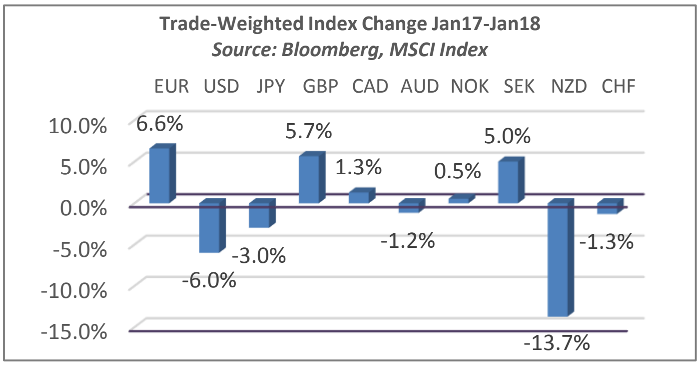
In the US, tax changes should act as an economic stimulus, because the reduction in corporate and other business taxes will increase both the funds and the incentive to invest. However, the impact on leveraged companies is more intricate. In fact, it could negatively affect some highly leveraged borrowers due to the limitation on interest deductibility.

Commodity-linked issuers with adequate liquidity and hedging strategies could benefit from potential stability in commodity prices in 2018. We would therefore favor selective positioning in Investment Grade (or near Investment Grade) EM issuers. In Developed Markets, we still see pocket of value on specific asset classes, namely Subordinated Financials with improving credit profile and Corporate hybrids, especially on seasoned issues benefiting from better covenants, higher step-ups and shorter duration than within new issues. Higher volatility could also benefit convertible bonds during 2018.
With increased volatility, and the potential for further dispersions among issuers and sectors, **2018 could very well be the year for fixed income relative-value investing** instead of long beta passive (index following) strategies. Entering 2018, we will therefore focus on active and targeted strategies for bond investment, while maintaining a high level of diversification, closely monitor market volatility and fund flows.

G4 FX

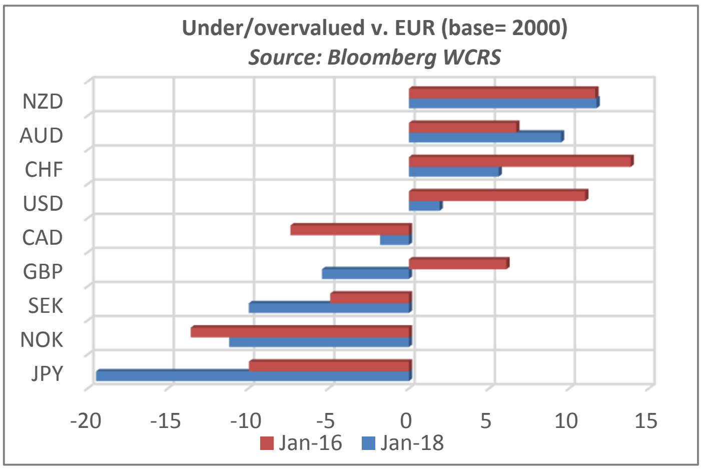
The combination of (1) lower political risks in Europe, (2) continued accommodative monetary policies, (3) stable and solid Chinese growth, (4) sustained pickup in global capital expenditure, as well as (5) low realized inflation, has helped real growth expectations for this year move in tandem into higher gear as of 4Q17. In this setting, countries with positive growth momentum and low political risk have benefitted (EUR, SEK, GBP, CAD, NOK), while safe haven currencies with still easy financial conditions (CHF, JPY) continue to suffer.
Investors have remained persistently negative on the US Dollar (-6.6% TWI) into 2018 as perceived political risks fail to abate (Russia investigation, government shutdown deadlines, Democrats' rising resistance to Trump's policies). What's more, the tax plan in its final form is seen as benefiting corporations without necessarily resulting in significant economic growth, thereby adding to the selling pressure on the greenback.

In 2018, we posit that US inflation is bound to surprise higher due to base effects (wireless deflation impact dropping out, higher commodity prices, and lower US Dollar), as well as higher wages and healthcare costs (up to 50% rise in premiums). Markets are currently pricing 2 rate hikes in 2018 and a 70% chance of a rate hike in 2019-2020. We think that an inflation surprise would lead markets to review their forecasts higher, which in turn could support the US Dollar.
A surprise in inflation could also hurt the global risk-on setting, and would prompt a USD rally as asset managers reverse their short USD (Short UST) – Long Foreign asset trade.



Looking at the **EUR**, the options market is currently pricing little political risk, with risk reversals the most in favor of EUR calls since 2009. What's more, CFTC data shows net long positioning for all types of speculative investors at their highest levels on the record. While we do believe that the economic recovery is still taking place, we prefer to wait for reversals in the EUR to purchase the single currency.

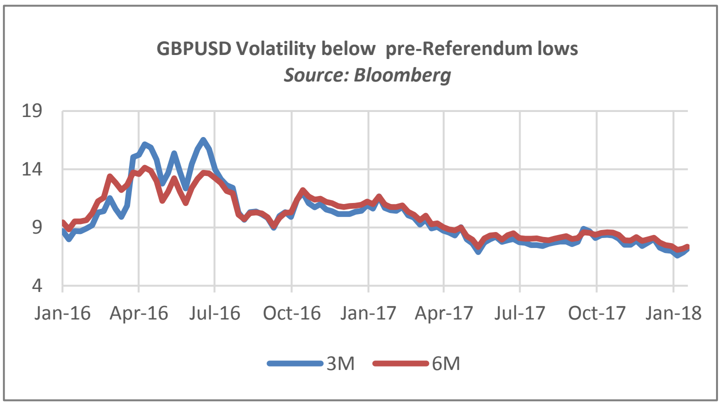
Such occasions would arise ahead of the March 4 Italian elections, as well as a possible repeat of German elections as Merkel struggles to form a government with former coalition partner SPD. What's more, a potential economic weakening in China, the EU's second largest trading partner, would definitely impact the EUR negatively.



For investors looking to benefit from the improving EUR fundamentals, a better fundamental risk-reward will be purchasing EUR versus AUD, NZD, CAD and CHF.

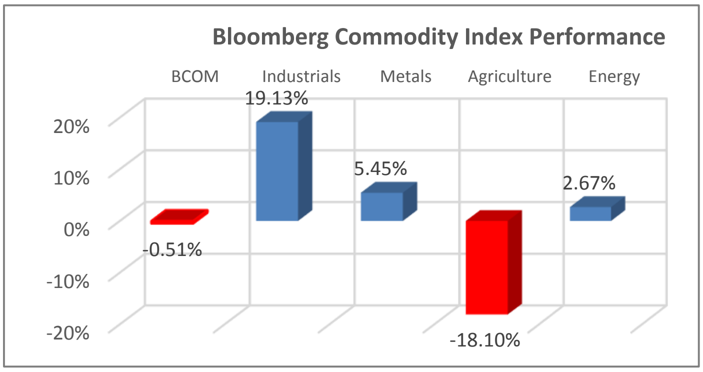
Looking at regional and global safe havens such as **CHF**, **SEK** and **JPY**, we reckon the non-negligible chance of monetary policy misstep in developed economies as inflation materializes, as well as the potential for a more rocky landing in China given the very high levels of indebtedness. Therefore, we like buying JPY versus a basket of EUR, AUD, NZD, and GBP.

As to **GBP**, we believe that a soft Brexit is currently being reasonably priced in against the USD if one considers the most recent 4Q18 targets by major banks which fall in the 1.20-1.57 range (spot ref = 1.38). The market is not discounting potential hiccups in future negotiations even as hard-Brexiters are becoming more vocal and we are far from concrete agreements with the EU. The fact that economic data is not faltering is also helping GBP sustain its recent gains. While we aren't buyers at current levels, for investors looking to profit from a potential GBP upside on a soft Brexit scenario, we like buying GBPUSD calls as the volatility remains quite appealing.



Commodities

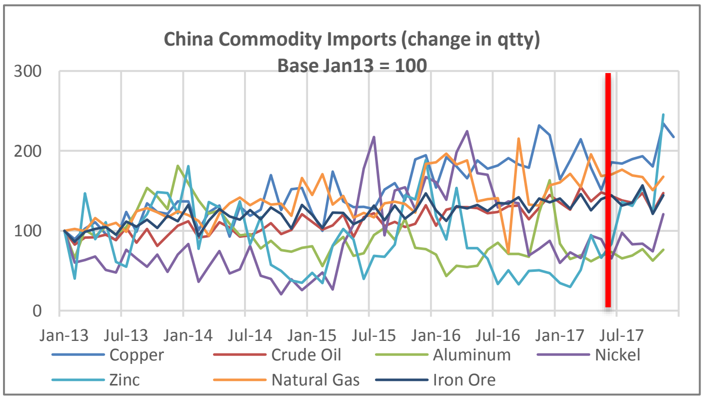
While one would be under the impression that commodities had a stellar run in 2017, the Bloomberg Commodity index (BCOM Index), an index based on futures commodity contracts, registered a 0.52% decline YoY. Agricultural (-18%) and Energy (+2.67%) were the laggards, while industrial (+20%) and precious metals (+5.54%) had a decent run. The discrepancy between futures and spot return is linked to negative roll yield that affected holders of commodities futures for which the curve is in contango.



As of 2H17, the decision by the Chinese government to consolidate SOEs in order to improve profitability and to shut down mining capacity to control pollution levels, have resulted in an accelerated demand for commodity imports by the world's largest consumer.

The graph below shows the change in demand (base =100) since January 2013. Zinc, copper and nickel imports accelerated strongly in 2017 in spite of the higher prices, while aluminum, iron ore, crude oil and natural gas imports remain within recent ranges.

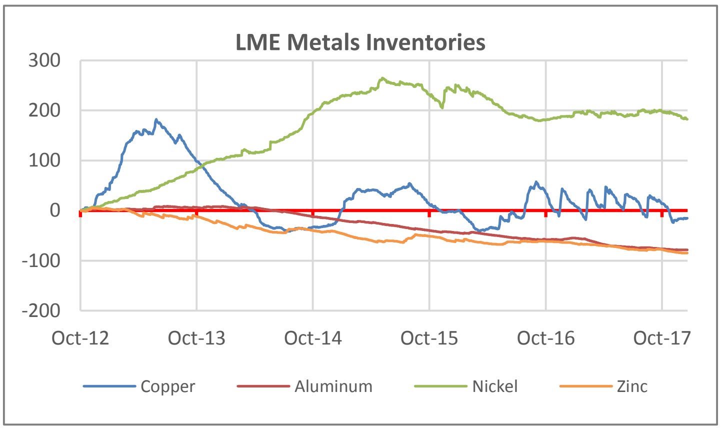
NB: Natural gas/LNG imports are set to boom in the future as China turns towards cleaner energy.



Chinese commodity demand is expected to remain solid barring renewed FX outflows and domestic equity market volatility. However, as winter passes by mid-March, if prices remain at present levels or higher, Chinese miners might move to restart previously idled production of **steel** (negative for **iron ore**) and **aluminum**. We would take profit on assets exposed to iron ore and aluminum ahead of March. We would only re-enter if prices drop by 10% or more (re-entry px = 60-65$/tn for iron ore and 1,830-2,000$/tn for aluminum) .

As for **copper**, last year's unplanned production declines in the world's two larges mines, Escondida and Grasberg, continue to weigh on supply. What's more, Chinese demand is expected to remain strong given the planned and ongoing urbanization and infrastructure spending. For investors already owning copper-linked assets, we would look to take profit before March (seasonality), and would reenter gradually as copper moves to the 6,200$/t level by 2Q-3Q.

For **zinc**, one can expect that producers have hedged their future production at exceptionally high prices, which justifies more supply coming online. However, with supply elasticity to a rise in prices being low, we need to wait for a 1-2 year delay to see significant production changes. Looking at inventories, zinc remains our favorite base metal as supply-demand dynamics are expected to remain favorable (buy on dips). However, given that current prices strongly incentivize future production, we remain on the lookout for capacity increase announcements.



Looking at **nickel,** while prices remain near their pre-GFC levels, inventories have continued booming thereby rendering any potential price increase unsustainable.

We continue to like **gold** in any type of portfolio in as much as 5-10% of the total investable wealth but at an average purchase cost of 1,200-1,250$/Oz. With the financial demand growth for gold accounting for all of the price growth in 2017 on the back of gold being one of the few financial assets that were cheap and under-owned, current prices do not incentivize further purchase of gold as a "cheap" hedge to risky portfolios. What's more, given gold's lower appeal as a substitute to negatively yielding currencies (JPY and EUR), the precious metal will be volatile and toppish from here. Barring sustained risk aversion, gold should be capped and could return to the 1,240$/oz area. Our trading range for this year is 1,200-1,390$/oz. As to other precious metals, we think the **palladium** move was outdone, especially versus **platinum**. **Silver** is likely to underperform gold unless the latter sustainably breaks the 1,400$/Oz area.

Last but not least, we think that given anecdotal evidence of higher **oil** production in the US as well as a buildup in oil product inventories and improved efficiency per well in high-breakeven oil plays (offshore & oil sands), we prefer to take profit on most of our oil-linked positions after this earnings seasons, while still maintaining a 30% portion of intended investments in oil-related assets. The goal of holding 30% is to be exposed to any upside caused by a potential sharp decline in Venezuelan production or a rise in unplanned production shut-ins. Further down the line, and should Chinese demand remain strong at current prices, we will be willing to add to our position, even at higher prices than today.