INVESTMENT OUTLOOK

JANUARY 2018

MACRO-ECONOMICS

Developed and Emerging Markets

Global economic growth has accelerated at a solid pace. The risk of deflation has almost disappeared, inflation remained depressed and kept major central banks in accommodative mode. As a consequence, bond yield levels stayed low, which in turn fueled higher equity valuations. Now, that was the easy reporting part.

Christmas seemed to have started early this year, with Uncle Sam presenting a tax gift to corporate America and wealthy individuals as the U.S. Senate and a day later, the House of Representative, passed the much advertised Tax Bill on Dec 19th. In the end, the policy makers delivered on what is Trump's first major legislative victory during his presidency. However, the tax headline news failed to inspire financial markets, closing lower in the aftermath. The realization that a $ 1.5 trillion tax gift translates into a $ 1 trillion increase of the (already stretched) nation's debt over the next decade and the fact that corporations and the wealthy (top 1% earners) profit most from lower taxes, muted investors' response somewhat. As many of the provisions in the bill have expiration dates before 2025, Congress will have to decide on each one of them whether to extend or not. Also, buried in the 430-pages of the bill, it has dawned on the less-well-off taxpayers and environmentalists that the reach of the bill extends beyond taxes. Namely, the Bill opens the Arctic National Wildlife Refuge in Alaska to oil and gas drilling and eliminates the requirement for people to have health coverage (or pay a penalty…- thus basically removing a core component of the Affordable Care Act). So, the biggest tax overhaul in 30 years will occupy lawmakers' minds for years to come. Who would have thought? cynics might add.

Elsewhere, the Federal Open Market Committee (FOMC) decided to raise rates by an expected 25 basis-points. It projects the labor market to remain strong with a lower unemployment rate of 3.9%, and a stronger GDP growth in part due to the (now passed) Tax Bill. Core inflation forecasts were left unchanged but three more rate rises were flagged for 2018. In what was Chair Yellen's last press conference, she offered positive remarks on a range of topics. Regarding the state of the economy she stated, "I feel good about the economic outlook…" and "…risks are balanced…". Asked to comment on the level of stock prices, she specified that "…the fact that those valuations are high, doesn't mean that they are necessarily overvalued". On broader financial stability risk, she concluded that no indicators she monitors "are flashing red or possibly even orange". Bond investors and economist were equally relieved to hear her remarks on the yield curve as she noted that "the yield curve is likely to be flatter than it's been in the past". This is important as it indicates that the Fed isn't as concerned about an inverted yield curve and could carry on hiking even if longer maturity yields stay low. On the much discussed Tax Bill topic, the FOMC members identified "changes in tax policy as a factor supporting modestly stronger economic outlook", although many noted "much uncertainty remains about the macro-economic effects of the specific measures". Chair Yellen added a more critical assessment insofar as she thinks that the economic uplift from tax cuts "it's not a gigantic increase in growth" and could be modestly short term.

The almost uneventful press conference hosted by the European Central Bank (ECB) offered a stark contrast to the closely monitored FOMC meeting and the U.S. Congress vote on the Tax Bill . The ECB left rates unchanged and its President Draghi noted that the "recovery is at a much earlier stage in Europe (compared to the US)". More importantly however, the ECB raised growth forecasts and stated that inflation will average below the 2% target.

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MACRO-ECONOMICS AND CURRENCIES

Currencies

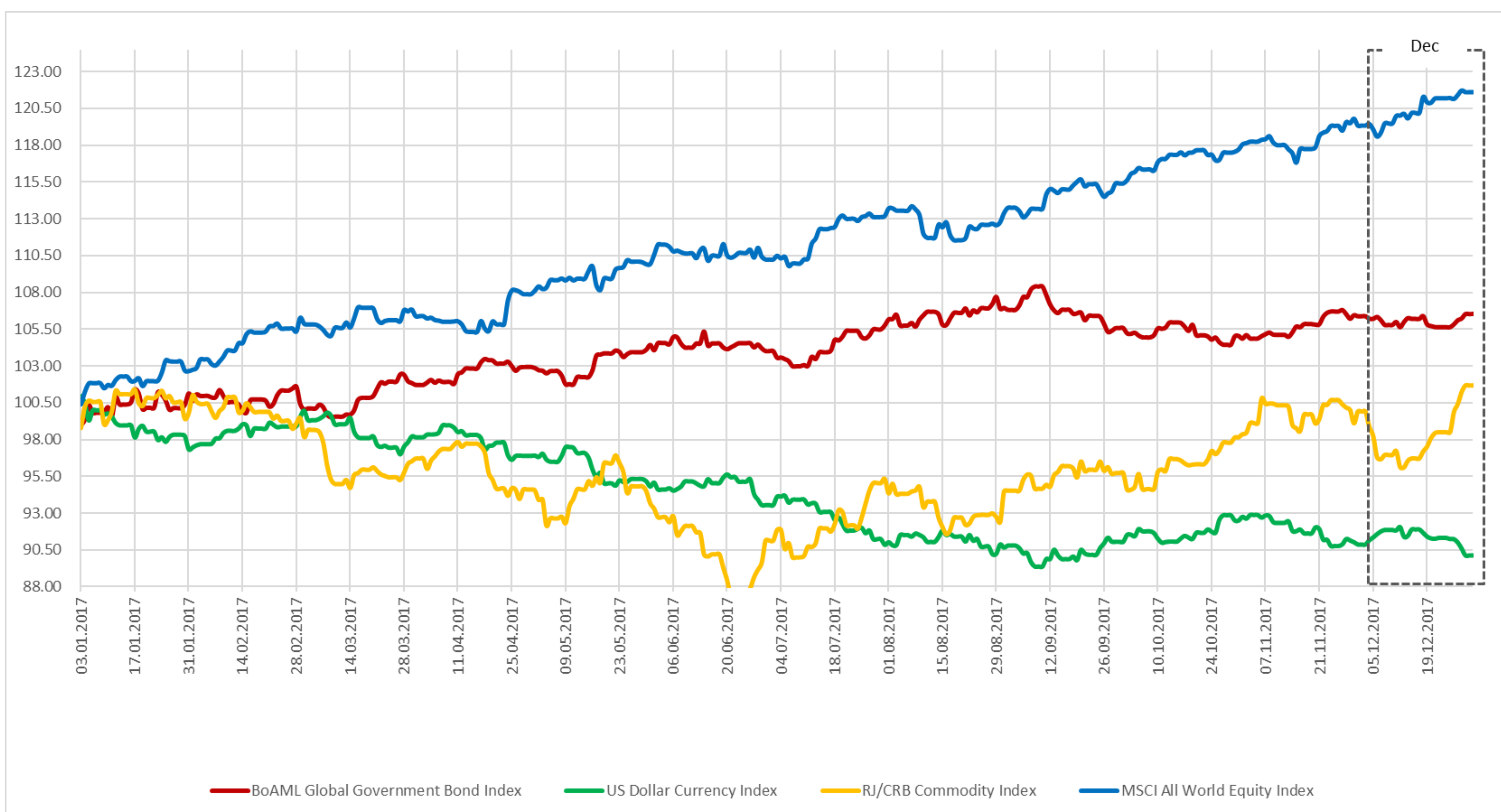
The U.S. Dollar regained some of the lost ground as the Japanese Yen slipped against most major peers. The beginning of the month saw a soft Euro, which changed direction following the comments offered at the ECB press conference.

Energy and other commodities

Traditional safe-haven assets were slightly weaker, and Gold remained slightly below previous months' levels. Brent Oil established new highs around $66 (or $60 for WTI) as supply was successfully stabilized by OPEC members.

Illustration (Section "Macro-Economics and Currencies"):

Commodities vs. Equities, Government Bonds and US Dollar



Source:	Bloomberg Finance L.P.	
Graph:	Quantum Global Investment Management (1-year rolling, daily, indexed)	
Indices:	Commodities:	RJ/CRB Commodity Index Total Return Price Index. The base currency is USD.
	Equities:	MSCI All Country World Index includes both developed and emerging world markets. The base currency is USD.
	Govt. Bonds:	The Bank of America Merrill Lynch Global Government Index tracks the performance of investment grade sovereign debt in local currency. The base currency is USD.
	USD:	U.S. Dollar Index indicates the general international value of the USD by averaging the exchange rates between the USD and major world currencies.

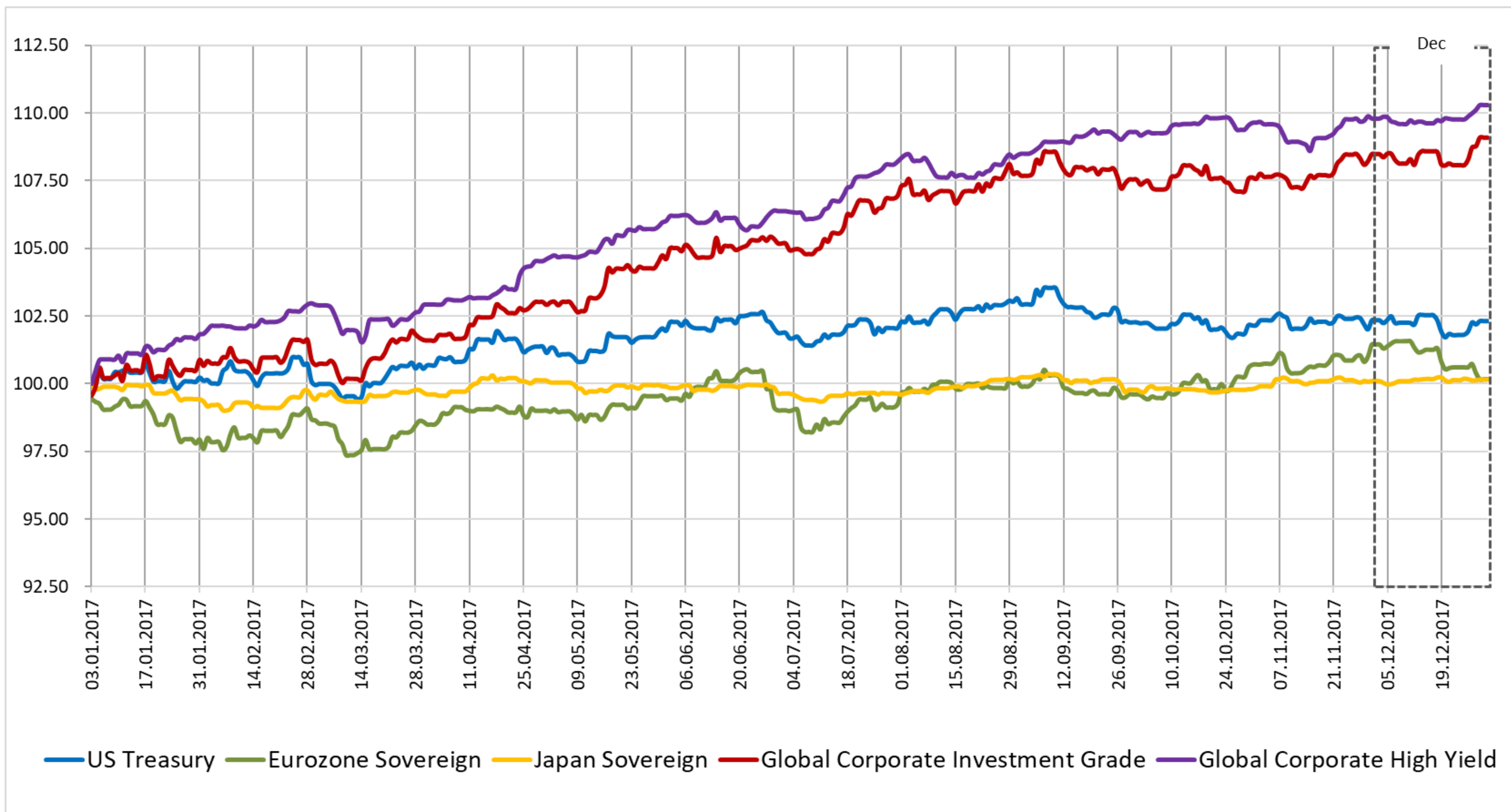
FIXED INCOME

Global Bond Markets

Major government yields (G7) moved higher in 2017, supported by improving global fundamentals. The US treasury yields trended higher, in particular the short and medium-term part of the curve. The 2 year treasury rate increased by more than 60bps to around 1.9%, driven by three FED rate hikes. Throughout the year, credit markets benefited from spread tightening across Investment grade and high yield bonds. The bond index, Bank of America /Merrill Lynch 1-5 year US broad market non-sovereign, had an absolute return close to +2%. The sub-asset class high yield posted a stronger return, with the representative index of Bank of America /Merrill Lynch 1-5 year BB US high yield returning over 4%. Emerging market bonds outperformed developed markets this year. Our fixed income allocation benefited from having a bias to both high yield bonds and issuers from emerging markets.

As largely expected, the FOMC increased the US interest rate by 25bps in December and continues to see a gradual tightening of its monetary policy. Three rate hikes are now featured in the dot plot for 2018. Throughout the month, US economic data came in quite strong confirming that growth is picking up without inflationary pressure. The third and final revision for Q3 GDP showed also the strong economic momentum. Before the Christmas holiday, US government yields moved higher and the treasury curve steepened. The main reason for the sell-off was the final passing of the US tax bill by the Senate and the House. President Trump is expected to sign into law on 3th of January. On the credit markets spreads tightened further, reaching the lowest level this year.

Government Bonds vs. Corporate Investment Grade and Corporate High Yield



Source:	Bloomberg Finance L.P.	
Graph:	Quantum Global Investment Management (1-year rolling, daily, indexed)	
Indices:	US Treasury:	The US Treasury Bond Index includes fixed rate coupon U.S. Treasuries with maturities greater than 12 months. The base currency is USD
	Eurozone Sovereign:	The Eurozone Sovereign Bond Index includes fixed-rate local currency securities issued by Eurozone countries. The base currency is EUR
	Japan Sovereign:	The Japan Sovereign Bond Index includes fixed-rate JPY securities issued by Japan. The base currency is JPY.
	IG Corp:	The Global Investment Grade Corporate Bond Index includes investment grade, fixed rate securities issued in major domestic and Euro-bond markets. The base currency is USD
	HY Corp:	The Global High Yield Corporate Bond Index includes non-investment grade, fixed-rate, taxable securities issued by global corporates. The base currency is USD.

EQUITIES

Global Equity Markets

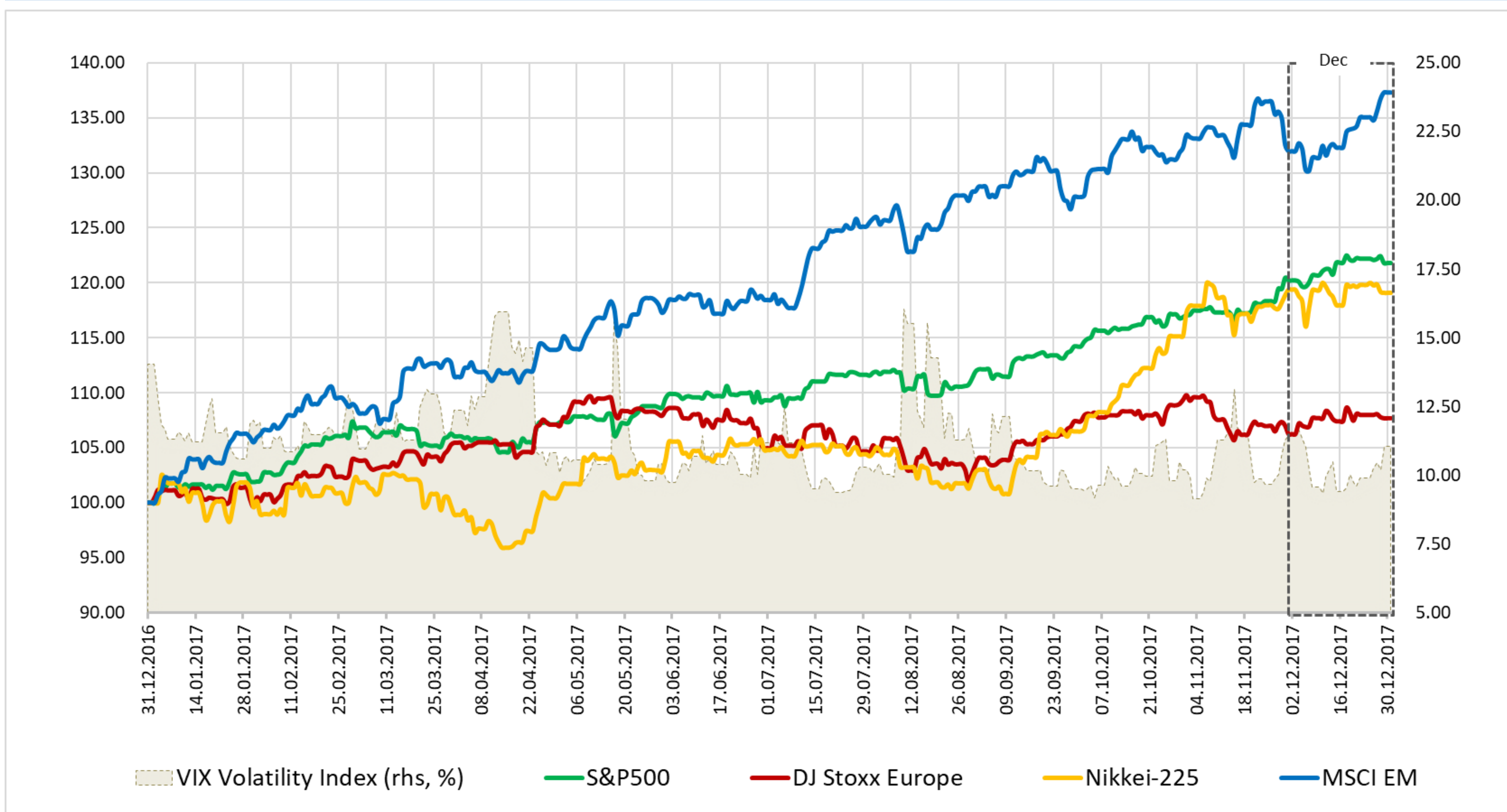
Reviewing the year, economic growth has become more synchronized, earnings have enjoyed a strong upturn and, together with low bond yield levels, supported the rise in equity prices across the globe.

U.S. equities have enjoyed a banner year, with the S&P500 rising above 20% in total return terms. Other regions fared similar or even better albeit only in U.S. Dollar terms. The broad European stock index, for instance rose only by an average of 8% in local currency, whereas a $-Investor would have earned closer to 23% in Europe. The developed Asian region including Japan, and represented by the MSCI Asia Pacific Index, returned an even more impressive 29%, which was only topped by the Emerging Market region's total return performance in the area of 35%.

Just looking at December, and in the wake of the U.S. Tax debate discussions and the passing of the Bill, U.S. stocks delivered another positive month. A weaker Euro negatively influenced European stocks which disappointed recently both in absolute and relative terms respectively. Developed Asian markets however joined their U.S. counterparts in contributing positively to global stock returns in December.

Also in December, cyclical sectors such as Consumer Discretionary, Materials, Energy, Financials and IT outperformed their defensive peers like Consumer Staples, Telecommunication and Health Care by quite a wide margin, once more highlighting the fact that a pro-growth bias in portfolio construction has been warranted so far.

MAJOR EQUITY INDICES & VOLATILITY



Source:	Bloomberg Finance L.P.	
Graph:	Quantum Global Investment Management (1-year rolling, daily, indexed)	
Indices:	S6P 500:	The Standard & Poor's 500 Index includes 500 U.S stocks representing all major industries. The base currency is USD
	Stoxx Europe:	The STOXX Europe 600 Index includes 600 stocks across 18 countries of the European region. The bas currency is EUR.
	Nikkei-225:	The Nikkei-225 Index includes 225 top-rated Japanese companies. The base currency is JPY.
	MSCI EM:	The MSCI Daily Total Return Net Emerging Market index captures the large and mid cap representation with 832 stocks across 23 Emerging Markets countries. The base currency is USD
	VIX Index:	The Chicago Board Options Exchange Volatility Index reflects a market estimate of future volatility and includes an average of the implied volatilities for a wide range of option strikes. The base currency is USD.

OUTLOOK

Market Implication

We expect that global economic expansion will continue in 2018, but the acceleration in growth relative to the past year is likely to moderate. We believe that profit margins, earnings growth, inflation and monetary policy will provide less of a support. The road ahead might not be as smooth as it has been in the past year, and thus we forecast lower returns at the cost of higher volatility.

Asset Allocation

Some near-run caution is warranted in risk asset markets, especially given prospects for higher bond yields. The outlook remains mildly positive for the global stock/bond ratio as we continue to expect stocks to outperform bonds in the year ahead.

Fixed Income:

The FED's tightening policy should continue in 2018 with further rate hikes, leading to higher yields at the short end of the US treasury curve. Major government yields should trend higher, supported by improving global fundamentals and less accommodating central banks policy . We keep a short duration in the fixed income portfolio. The global macro environment remains supportive for credit markets, contributing to keep credit spreads stable over the medium term. Within fixed income we still favor a bias to US high yield bonds and government related issuers from Emerging Markets.

Equities:

Cyclical economic conditions will support further upside in equities. Increased volatility might warrant a more defensive portfolio construction. However, we have to account for the still positive macro condition and maintain for the moment a moderately pro-growth positioning. Financials might outperform more significantly as bond yields climb, whereas Healthcare stocks appear to be a cheap hedge against market volatility thus counterbalancing cyclical exposures in IT and some selected industrials stocks.

Currencies:

Underlying fundamentals still favor a modest but narrow U.S. Dollar appreciation. Although the growth gap with the rest of the world has now largely closed (driven by a stronger Euro area expansion), interest rate differentials should still provide support over the next few months.

Commodities:

The recent oil price appreciation was mostly supply constraint driven and raises the risk that supply might increase again as non-OPEC producers such as U.S. shale companies raise their output quotas to capitalize on the higher prices.

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