INVESTMENT OUTLOOK

MARCH 2018

MACRO-ECONOMICS

Developed and Emerging Markets

Strong indications of inflation, in tandem with a shift higher in US Treasury yields, triggered increased nervousness amongst investors around the world during the first two weeks in February. This led to a technical correction in US Equity markets, before rebounding towards the end of February. The rapid pace at which bond yields rose and the subsequent moves in equity prices forced a higher level of volatility, which has been labeled as healthy adjustment to an atypical tranquil risk environment that has befallen financial markets as of late. Investor complacency has been replaced with a more differentiated (and more cautious) interpretation of what “risk” assets are.

To that end, the incoming Fed’s Chairman, Jerome Powell, calmed investor nerves by giving reassurance that he would “support continued economic growth, a healthy job market, and price stability”. His resolve will be tested as early as next month, when it will be his turn to host his first meeting as Chairman of the Federal Reserve. Apart from that, economies around the world actually are moving in sync and no recession signs have been spotted yet on the horizon. Yes, interest rates will rise over the coming years, and yes, financial markets will answer with increased volatility because they will need to adjust to this normalized environment. But at same time it is also true, that the state of the global economy is healthy and corporate earnings are rising, and this will help counterbalance some of the negativity which has lately crept into the market.

Currencies

No rest is given to the beleaguered US Dollar. The $-Index fell further against its major peers intra-month, mirroring expectations that other central banks will eventually catch up with the Federal Reserve’s rate tightening cycle. Following the passage of the biggest US tax reduction package in a generation, and attempts by the current administration to push an enormous infrastructure and defense spending program through Congress, will lead to a significant deterioration of the country’s fiscal position, and thus further fuel the Dollar weakness.

Energy and other commodities

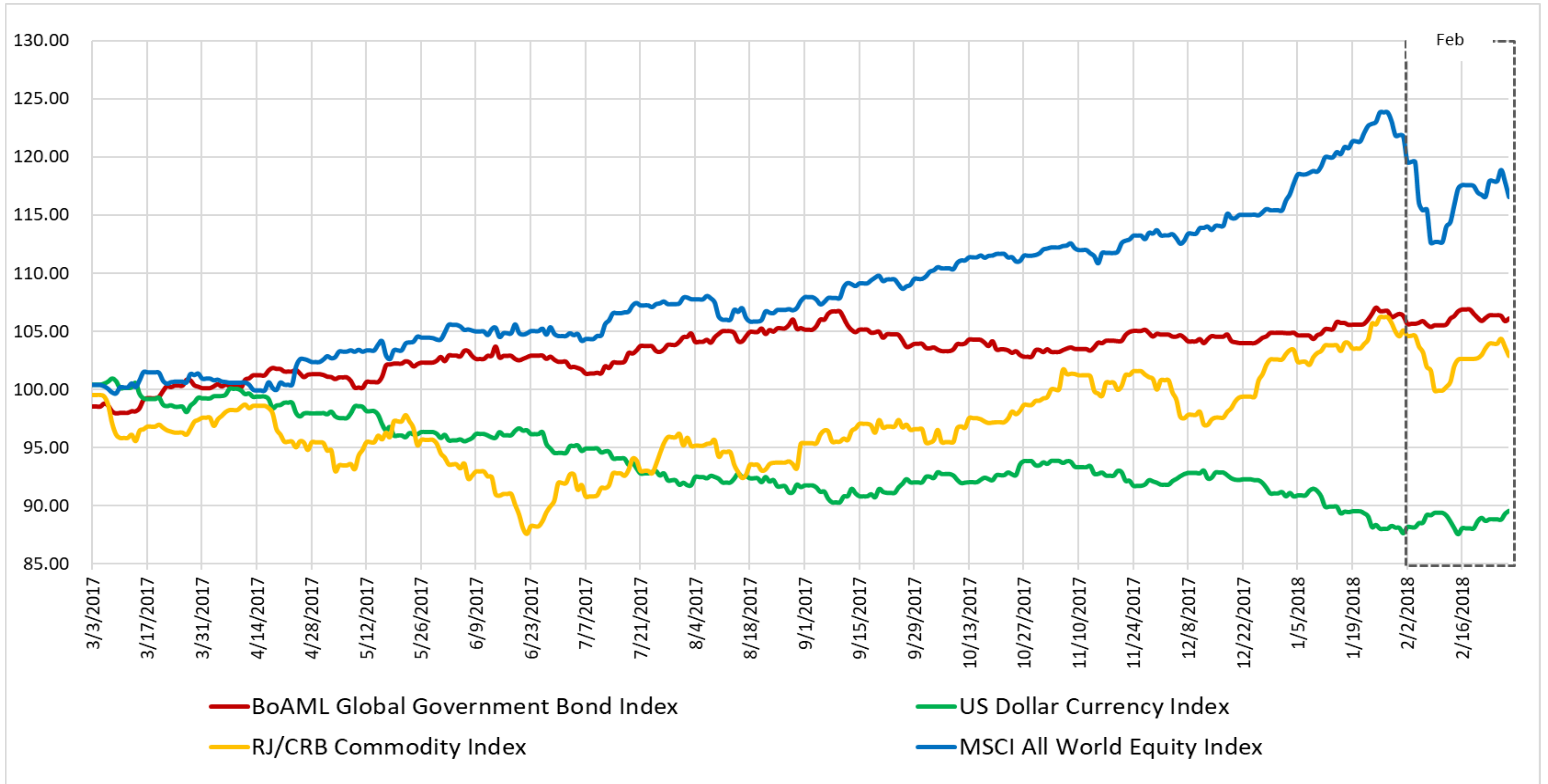
Crude Oil maintained its strong rebound in pricing for the year, supported by the OPEC-led efforts in order to reduce supply. This was underlined by comments out of Saudi Arabia who as an OPEC member will only look to relax production cuts in 2019. Commodities on a wider-scale suffered slightly on a US Dollar rebound towards the end of the month, agriculture being the positive outperformer.

INVESTMENT MANAGER
Quantum Global Investment Management AG · Bahnhofstrasse 2 · 6300 Zug · Switzerland
Phone +41 41 560 29 00 · Fax +41 41 710 63 00 · investment.im@quantumglobalgroup.com · www.quantumglobalgroup.com

MACRO-ECONOMICS AND CURRENCIES

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

Commodities vs. Equities, Government Bonds and US Dollar



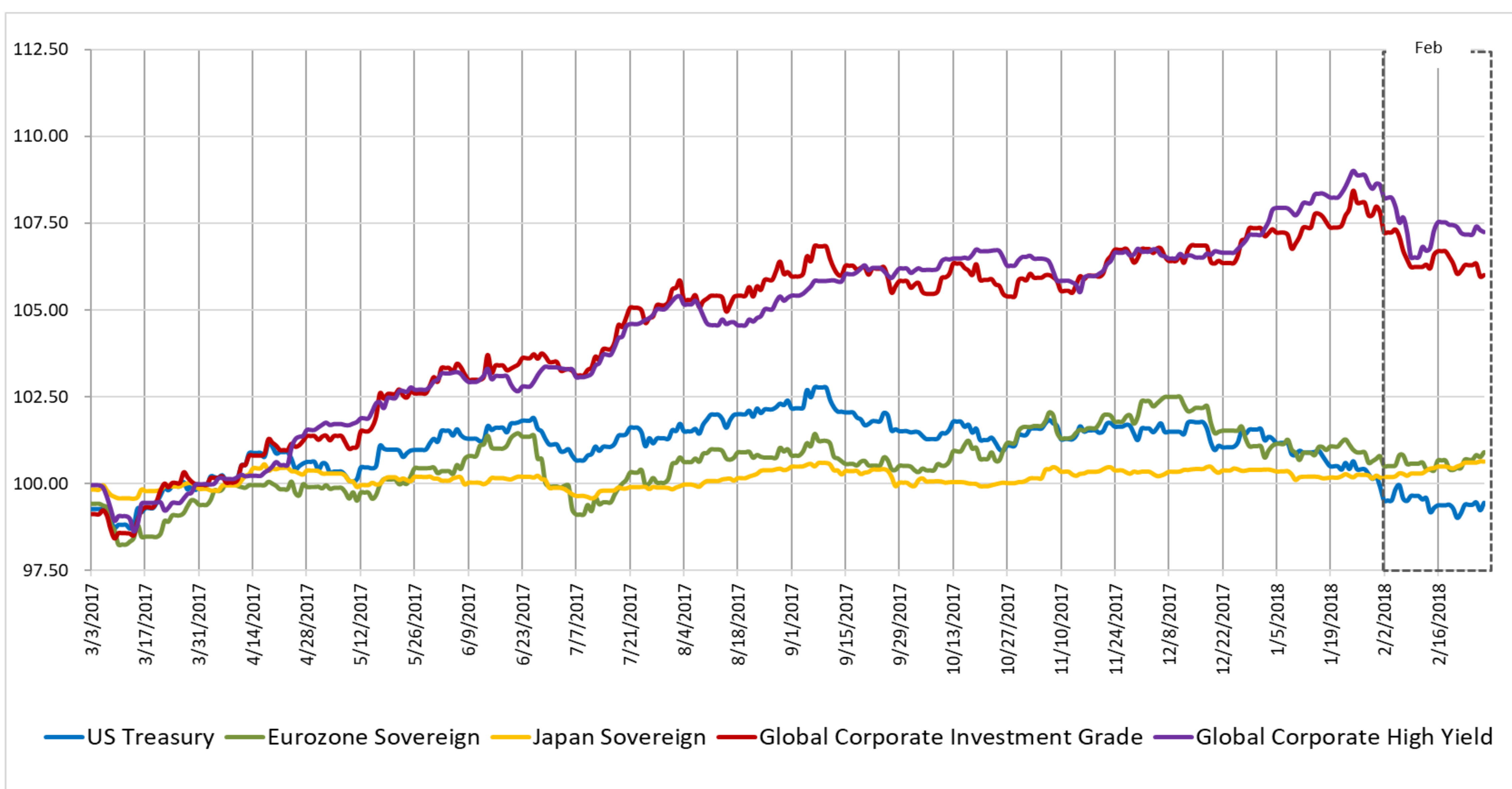
Source:	Bloomberg Finance L.P.	
Graph:	Quantum Global Investment Management (1-year rolling, daily, indexed)	
Indices:	Commodities:	RJ/CRB Commodity Index Total Return Price Index. The base currency is USD.
	Equities:	MSCI All Country World Index includes both developed and emerging world markets. The 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

February was a mixed month for the Fixed Income asset class as yields soared higher and credit spreads widened on global inflation indicators, driven very much out of the US. Investors moved assets away from the risk spectrum earlier in the month and as a result, higher yielding subsectors experienced losses. Towards the end of the month, however, these moves were muted. Volatility gauges backed off the highs and investors saw this an an opportunity to re-enter at more advantageous levels. Data continues to indicate global expansion in the first quarter remains strong. Despite recent communication from the US Federal Reserve, by the outgoing Chair Yellen, for now financial conditions remain highly accommodative and their loosest since late 1994. This is supportive for risk assets but early February was indicative of how quickly sentiment can change. Complacency is currently fighting caution in the markets as investors struggle to see a catalyst for a sharp decline in assets. Bond investors should care more on the rapid pace of monetary policy tightening and higher rates. Corporates should benefit from the tax cuts, which will hopefully be enough to prevent highly leveraged companies from defaulting in times of higher rates.
In Europe, the ECB kept rates and monthly assets purchases at the same levels and pace. Inflation gauges continue to increase in-line with the gradual uptrend witnessed for almost a year. Some participants believe this could trigger the current stimulus plan to be revisited/reduced which is inturn supporting higher yields and a stronger Euro. Japanese inflation woes continues to challenge policy makers and adds distance to the Bank of Japan and other developed countries making progress. Wage growth is not obvious in the near term and positive inflationary suprises are unlikely. The anticipation of a greater recovery in Japan is yet to be witnessed and therefore the Central Bank will continue with asset support.
Emerging markets have shown resilience in their outperformance during the month. Investors require a level of yield and carry, believing fundamentals to be more attractive and have further to achieve than developed markets. The current landscape of moderate US Dollar, improving global growth have helped underpin assets from within the regional classification.

Government Bonds vs. Corporate Investment Grade and Corporate High Yield



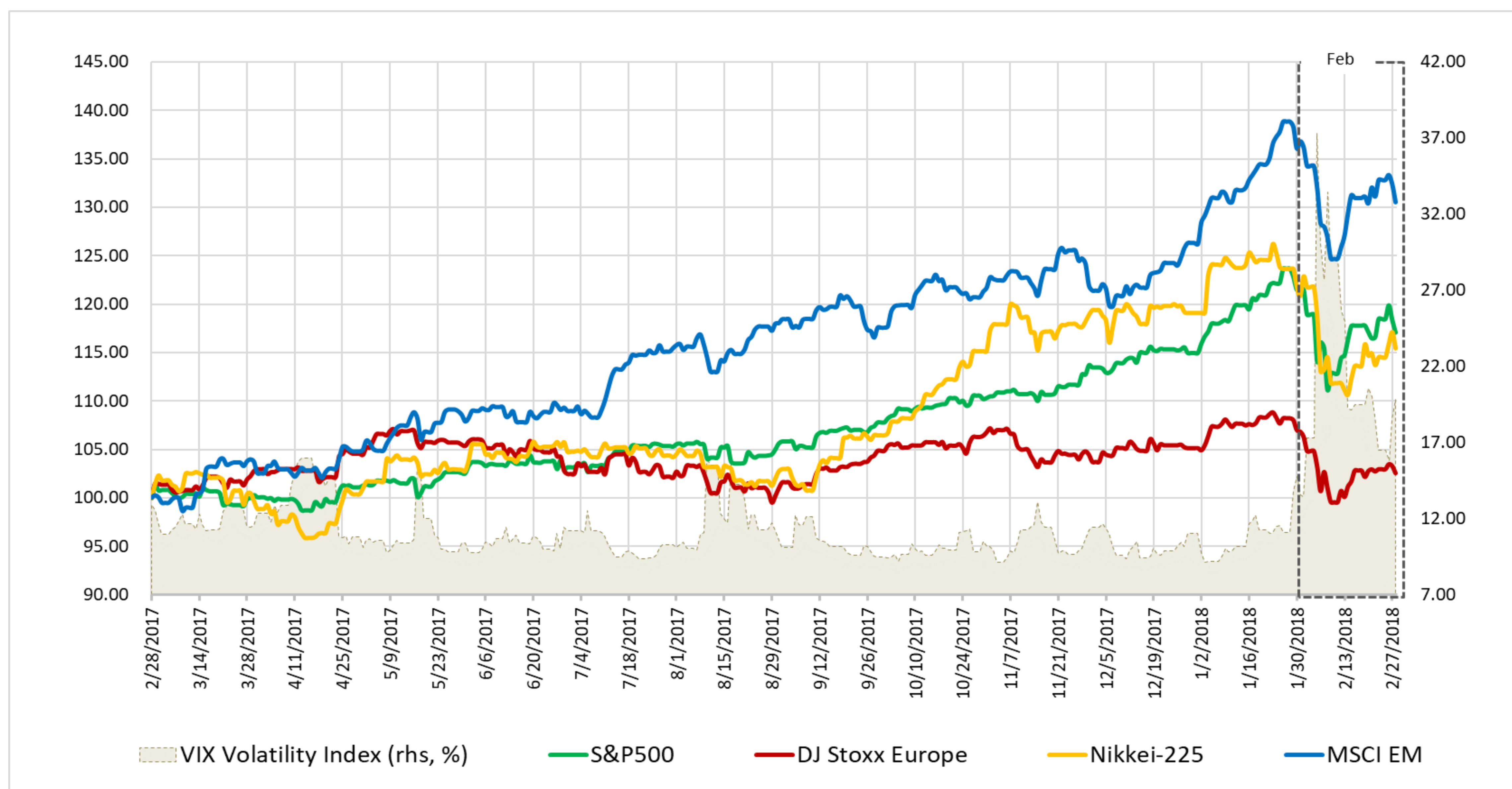
Source:	Bloomberg Finance L.P.	
Graph:	Quantum Global Investment Management (1-year rolling, daily, indexed)	
Indices:	US Treasury:	The US Treasury Bond Index includes fixed rate coupon U.S. Treasuries with maturities greater than 12 months. The base currency is USD
	Eurozone Sovereign:	The Eurozone 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

Every equity market correction is different. During the current decade, risk-off phases have been triggered by bouts of economic weakness and concerns about future corporate earnings. The current correction, spike in volatility and subsequent rebound towards the end of February, however, has been driven by the U.S. bond market. It underscores that stability in the latter is a necessary first step before the next rally phase in equities takes hold. Equity markets will need to transition and adapt to a more “normalized” investment environment, where fundamental conviction, based on corporate earnings developments, higher interest rate and capital cost levels and increased volatility are once more back on the menu.

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.

INVESTMENT MANAGER
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OUTLOOK

Market Implication

Financial markets have begun their transit to normality, i.e. interest rates start to follow economic cycles, unemployment numbers will start to drop, participation rates and wages will start to rise, trade and consumption will remain strong, and we might even see some inflation (at some point in time). Risk assets' volatilities will adjust further and remain at elevated levels. The sooner investors return to a more pragmatic assessment of major topics, such as the state of the global economy, corporate cash flow and earnings growth, consumption and trade, and shield themselves against short-term market noise, the sooner they will focus again on fundamentals rather than algorithms.

Asset Allocation

Rising uncertainty about the pace of interest rate hikes point to a higher average volatility than in recent years. Some markets, such as the U.S., experience elevated valuation levels, which need to be diluted by rising corporate earnings and a stabilization of bond yields. Some Emerging Market countries are set to benefit from a weaker Dollar, whereas Europe still needs to transform its strong economic performance into a more tangible and sustainable corporate earnings growth.

Fixed Income:

Sovereign yields have risen sharply but in the short-term we have not witnessed US 10yr yields break, nor close above the psychological level of 3%. We expect to see short-term rates in the US rise and longer dated yields stabilize somewhat. The ECB is poised to revisit stimulus but could be held back by the strength of the Euro. Europe may also experience some volatility derived from the upcoming Italian elections. Global credit markets are supported for now. A slight widening of credit spreads and a back-up in yields have allowed investors an interesting re-entry level and observations made state that the fundamental backdrop has not changed dramatically. We continue to target value in the Emerging Markets region and remain cautious amongst low-rated issuers.

Equities:

Corporate earnings will continue to trend higher, but estimate variability is also poised to rise, which will add to upside for equity price volatility. While it is premature to declare the bull market in equities over, we expect prices to rebound beyond the near run. The road ahead will be considerably bumpier as macro fundamentals shift, with likely moderate returns and greater volatility.

Currencies:

The US Dollar has suffered this year as investors have bet against it, versus it's peers. It has recently gained ground as investors anticipate a fourth rate increase by the US Federal reserve at the year-end. Euro and Yen have shown to be favourable alternatives, Yen as a haven in the recent unstable risk environment and the Euro in light of regional strength and recovery. US political instability, fiscal and current account deficits do not point to a stronger US Dollar. The British Pound has benefitted from a weaker European rhetoric in regard to the Brexit process, however, volatility should resume once firm details surrounding the UK's agreed exit strategy is finally confirmed.

Commodities:

The broad commodity landscape is inversely correlated to US Dollar performance. As the lag in US Dollar appreciation continues, the opposite is true for this asset class. In tandem with supply cuts, Crude Oil has bennefitted. This is set to continue as the agreement to reduce output by OPEC members still stands. Should the Chinese economy continue to deliver in growth numbers, then metals should remain underpinned, albeit precious metals to hold support in uncertain and more volatile periods.

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