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HOTTINGER

GROUP

Family Office of the Year 2017
City of London Wealth Management Awards

GLOBAL INSIGHT

Overview

- Our **feature article** takes a look at the economic and political highlights of 2017, and discusses the risks and opportunities they present for this year.
- 2017 was an eventful year, which saw the chaotic first year of the Trump Administration, a political revolution in France amid broader instability in Europe, far-reaching economic reforms in India, and a momentous National Congress in China.
- We see the major risks for 2018 in the geopolitical space. The prospect of conflict on the Korean Peninsula and direct skirmishes between Iran and Saudi Arabia is a very real tail risk.
- In our **Macro View**, we report on the continued success of the global economy and question where and when all-important inflation will appear.
- Low inflation supports conditions of high liquidity and low yields, creating the space for firms to invest and generate earnings that justify their high valuations. Higher inflation would cause investors to question the duration of the recovery and whether future earnings will justify these valuations.
- In the **Investment Outlook**, we think that abundant liquidity has driven asset prices higher to the point where signs of excess are becoming evident.
- The current year could see recent tailwinds start to turn into headwinds as Quantitative Easing progressively shifts to Quantitative Tightening and inflationary pressures build.
- However, these concerns are just on the radar at present and going into the first three months of the year we continue to favour equities and real estate over fixed income.

Oil picked up strongly in H2 2017 as the global capital cycle strengthened

Inside this issue

Economic Highlights

- World trade expanded by 3.6% in 2017.
- Inflation remains below 3% in most developed markets.
- US growth reaches 3.0% in Q4 2017.
- China contributes 33% of global growth last year.

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Based upon information available up to and including 15th January 2018

Key Issues in Charts

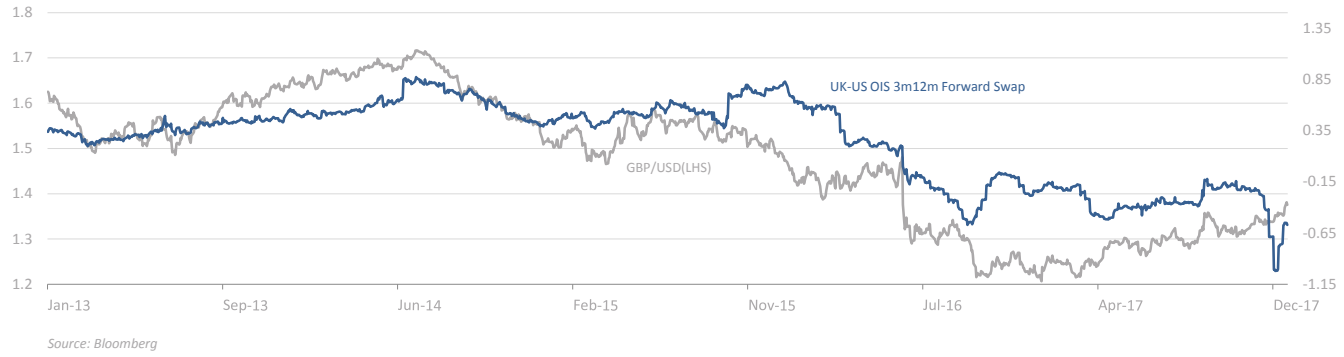
Spread: European High Yield Credit vs US 10-year Treasuries

- During most of Q4 2017, European High Yield Credit has delivered the same returns as 10-year US Treasuries.
- This is largely the result of €100bn of ECB purchases of European corporate bonds, pushing investors out of European investment grade credit.
- The spread of BB-rated European HY over German bunds has often fallen below 200 basis points, below the level considered adequate to provide investors an 'illiquidity premium'.

FTSE 100 in 2017

- Up until December, it was looking like a relatively flat year for the FTSE 100, with the pound steadily regaining strength over the dollar.
- In December the index rallied on the back of strong performance in the oil and commodities, a sector which is heavily weighted in the index.
- The FTSE ended the year at a record high.

3m12m OIS Forward Swap Spreads (UK-US) vs GBP/USD



- Relative interest rate expectations are historically a strong predictor for GBP/USD.
- A prolonged period of uncertainty after the Brexit vote in 2016 caused the series to decouple during H2 2016 and most of 2017, but the relationship is reasserting itself.
- If the Bank of England raises rates in line with the Federal Reserve, the GBP/USD rate can be maintained at around 1.35 and could push higher. But if Brexit fears keep the Bank of England from raising rates, the pound could suffer.

Eight highlights from 2017 and what they mean for 2018

While 2017 was a very good year for markets and global economic activity, it has also been a year of geopolitical events that set the scene for 2018. Here, we review the ten most significant events and trends across the world from 2017 and discuss what they might mean for global markets this year.

1. US tax reform finally gets passed

In the last fading weeks of 2017, US President Donald Trump made arguably his first legislative achievement. Congress passed a significant reform to federal taxes. The changes will have sizeable effects for business, but they will be short-lived. Under the plan, according to analysis from the University of Pennsylvania, the average effective corporate tax rate will fall from 21% in 2017 to 9% this year, before rising again to 19% by 2027.

"The average effective corporate tax rate will fall from 21% in 2017 to 9% this year, before rising again to 19% by 2027."

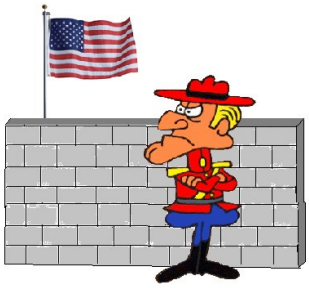
Sectors that are capital intensive – such as manufacturing and mining – benefit the most from the changes. However, limits on interest deduction will reduce the benefit received by firms that are highly leveraged. The hope is that the changes will encourage companies to increase capital expenditures that generate more sustainable rises in output, employment and profitability.

The risk, given that corporate cash balances are already high and interest rates low, is that firms simply use the tax break to return cash to investors and increase debt on their balance sheets. New limits on tax-deductibility of interest may , however, discourage this. In any case, the reform's passing is likely to push US equities higher early this year.

… but the Trump administration struggles with its broader agenda

"Trump's promise to reshape the parameters of global trade along protectionist lines so far remains unfulfilled."

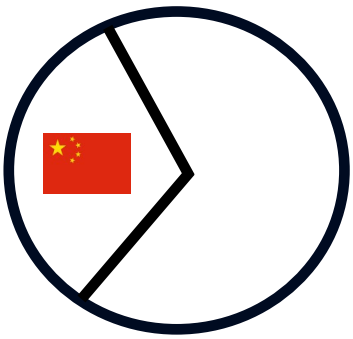
For some this will be a source of relief. Trump's promise to reshape the parameters of global trade along protectionist lines so far remains unfulfilled, but a close eye should be kept on the NAFTA renegotiation talks and US interference with the WTO. Trump has also struggled to meaningfully reform healthcare and immigration, and in a speech in December he more or less reaffirmed America's commitment to NATO and the rules-based international order. Trump's pledge to rebuild American infrastructure is likely to hit the buffers as the effects of the tax cuts cause the fiscal deficit next year to balloon.



The US President will remain a source of instability this year but with the global economy in good health, the risk of a protectionist turn is a somewhat lower.

2. Brexit softens

Last year was eventful in British politics too. Brexit remains an issue that divides many within the country, leading Prime Minister Theresa May in April to call an election to settle doubts over the decision. The result was the election of a Par-



*According to the World Bank, China will account for **a third** of global growth between 2017 and 2019.*

liament that is opposed to a so-called 'Hard Brexit' and that prefers close regulatory alignment with the European Union.

… and fundamental difficulties remain over the Irish border

However, leading members of the Leave campaign, Boris Johnson and Michael Gove, prefer a more complete divorce, taking Britain out of the Single Market, Customs Union, ending free movement and removing the influence of the European Court of Justice. This creates a tension that will re-emerge in the second phase of talks regarding the Irish border. Maintaining the integrity of the United Kingdom and the essential Good Friday Agreement may frustrate Gove and Johnson's plans.

3. China is now the world economy's biggest driver

China is expected to deliver another year of growth at or above the government's target rate of 6.5%. Chinese economic statistics are not always reliable, but it is hard to refute the idea that the world's largest economy (measured on a purchasing-power basis) continues to act as its largest engine. World Bank projections for 2017-19 suggest that China will account for over a third of global growth. By comparison, the US will contribute 18% and the EU just 8%, the same as India.

There remain concerns over China's credit markets and the levels of indebtedness within State-Owned Enterprises and Local Governments, but the authorities took steps in H2 2017 to slow down credit growth and consolidate debt. Time will tell whether slowing monetary growth in China will feed through into the global inventory cycle as it did in 2010-12.

4. A good year for the European economy

2017 was the year that recovery truly returned to Europe. France saw a surge in growth in H2 2017. Spain saw 3%+ growth for the second year in a row. Even Italy, whose economy has barely grown since 2001, saw GDP rise by close to 2%. This underpinned the strong performance of European assets.

"Time will tell whether slowing monetary growth in China will feed through into the global inventory cycle as it did in 2010-12."

… but there was little progress on political reforms

Fears that 2017 would be a year of disintegration in which populism swept the continent faded with the election of political upstart Emmanuel Macron. He, along with Italy and Spain, wants a Eurozone budget and finance minister with power to levy taxes, fund investment and raise debt. There may not be a better time to push forward the European project for those who wish to do so, but the worry is that the chance is being squandered as national policy concerns and inter-state tensions come to the fore.

5. Germany looks less strong and stable

While Germany's export-manufacturing powerhouse continues to go from strength to strength, cracks have emerged within the country's cosy centrist politics. In the election last September, just over 50% of the electorate opted for the country's two governing centrist parties, Angela Merkel's CDU/CSU and Martin Schultz's SPD, down from 67% in 2012. Chancellor Merkel's decision to admit over 1m refugees alienated her party's right-wing and much of Eastern Germany, while her junior coalition partners of the SPD failed to differentiate themselves and lost votes to the left. The free-market, eurosceptic FDP picked up votes from those who are unwilling to share the financial burden with poorer EU states. All this means that building a new coalition government has been extremely challenging. At the time of writing, a new "*Große Koalition*" between the CDU/CSU and the SPD was in the early stages of agreement, with reforms to Europe top of the governing agenda.

A draft text calls for "renewal and new dawn" in Europe and proposes reforms that would harmonise taxation and social security, establish deeper institutions for foreign policy and defence, and — most importantly — move to create a Eurozone budget controlled centrally. This has to be the right ambition but the challenge will be bringing all states along, particularly other creditor nations, such as the Netherlands and Austria; and those in Eastern Europe that increasingly reject the values of the EU.

5. Divisions grow between Western and Eastern Europe and within Spain

In Eastern Europe, both Hungary and Poland have moved in more authoritarian directions. In Poland, the ruling PiS party has passed 13 laws limiting the independence of the judiciary. The EU, in response, invoked Article 7 of the Lisbon Treaty that could suspend Poland's membership privileges. Similar measures could be presented to Hungary as Victor Orban's government continues to clamp down on free speech. With the far-right Freedom Party (FPÖ) in government in Austria alongside Sebastian Kurz's centre-right party ÖVP, there are fears that Europe's eastern states might form an opposition group to the EU itself.

In Western Europe, the integrity of the Spanish state is under threat. Catalonia's unofficial referendum, which notionally produced a Yes vote for independence, represents only the latest chapter in a pitched battle between Spain (Madrid) and Catalonia (Barcelona). In December, the region returned a parliament narrowly in favour of secession, setting the stage for further skirmishes this year.

The EU, however, finds itself in a bind on this issue because it is a body that is formally a club of nation states but also an entity that recognises the concept

"In Poland, the ruling PiS party has passed 13 laws limiting the independence of the judiciary."

"Opinion polls in Italy have consistently put five Eurosceptic parties at around 50% ."

Wanted: ***12 million jobs***

"The basic reality for India is that the country needs to create 10-12 million jobs per year just to keep up with its population growth."

of an 'EU citizen'. By clearly coming down on either side on this issue, the union would have to sacrifice one of these qualities. This matters because political uncertainty may undermine Spain's healthy economy, particularly if it is not clear whether an independent Catalonia could remain seamlessly in the EU.

6. The Italian wildcard

Italy will go to the polls in April to choose their next national government. Opinion polls throughout 2017 have consistently put five Eurosceptic parties at around 50% (Five Star Movement, Lega Nord, Us with Italy, Italian Left and Brothers of Italy). The fifth return of Berlusconi, who heads up the pro-EU Forza Italia group, adds further unpredictability to the mix. Recent changes to Italy's electoral system make it harder for a single party to gain a majority of seats, meaning a hung parliament is likely. If a government does form it is more likely to be one from the centre-right, involving a mix of pro-EU and anti-EU parties, but we cannot discount the possibility of an upset, a eurosceptic "5 Star – Lega" coalition. In any case, Italy is another country that is likely to turn in a more nationalist direction this year, and this could upset reforms to the European project.

7. Modi's India faced teething problems

Narendra Modi was elected India's Prime Minister in 2014 on large part based on his record as Governor of the province of Gujarat. His time in that post saw huge transformations of the region's economy, which is now one of the strongest in the country. Modi promised he would deliver the same for all of India, and he has certainly been bold. Introducing a Goods and Services Tax, removing high-value paper currency from circulation, and consolidating public banks have incurred high costs on business. GDP growth decelerated from 9.2% in January 2016 to just 5% in July 2017.

… but his reforms are starting to bear fruit

The last set of figures shows that growth has ticked up again to 6.3% as Modi's reforms bed-in. Growth should continue to accelerate in 2018. The basic reality for India is that the country needs to create 10-12 million jobs per year just to keep up with its population growth. Economic returns should follow; Modi's re-election in 2019 depends on it.

"This year we see the major risks to markets stemming from geopolitics."

8. Renewables installations and EV purchases reach new records

According to Bloomberg New Energy Finance, about 150GW of solar and wind power generating capacity was installed worldwide in 2017. This would be more than enough to meet the electricity demands of the UK twice over. Each year the performance for renewables in terms of costs and supply exceeds expectations, and we expect further improvement this year.

… but global CO2 emissions rise for the first time in 4 years

For the first time in four years, global CO2 emissions rose (by 2% in 2017). The rapid development of India and other emerging markets will demand more from conventional sources of energy. The challenge for investors and policy-makers in the coming years is to help emerging markets develop with cleaner technologies, not just to relieve stress on the environment, but also to reduce pollution-related deaths and improve energy security.

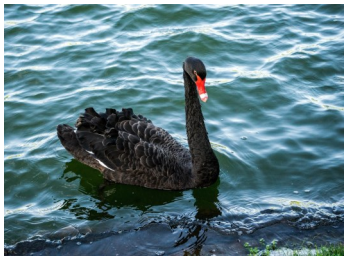
"Global CO2 emissions rose by 2% in 2017".

Major risks ahead

This year we see the major risks to markets stemming from geopolitics. Instability in the Middle East is rising and outright conflict between major states can no longer be ruled out. In this situation, we believe an oil price shock is more likely than last year. Oil is still the lifeblood of the global economy, so any sizeable price shock would have significant knock-on effects on international supply chains and asset markets.

The spectre of US-led protectionism remains, and could be triggered by sanctions placed by the Trump administration on North Korea's trade partners, the largest of whom being China. However, both the EU and China reaffirmed their commitment to rules-based trade in 2017, and we think this will strengthen as benign economic conditions continue.

In markets, a global recession will require a significant shock, an event that at this stage looks unlikely. We are concerned about the levels of debt in certain countries and sectors, but so too are global central banks, which are reining in excessive credit. It should be said however that central banks continue to operate in exceptional circumstances and are engaging in the unprecedented activity of "Quantitative Tightening", so we remain prepared for the tail risk of significant market events.



"We remain prepared for the tail risk of significant market events."

Macro View

+3.6% GDP (exp. 2017)
+3.6% International Trade (exp. 2017)

Sources: IMF, WTO

The start of 2018 sees most parts of the world continuing to enjoy a strong period of economic expansion, low inflation and falling unemployment. Both developed and developing markets are in good health on the back of low global interest rates and accommodative monetary policy. World GDP and trade grew by 3.6% in 2017, almost three times faster than the previous year.

While each of the key world regions finds itself at different stages in their cycle, inflation remains mostly subdued. This is important because low inflation supports conditions of high liquidity and low yields, creating the space for firms to invest and generate earnings that justify their high valuations. The strong performance of oil and commodities in Q4 2017 attests to a capital goods cycle that is strengthening. With unemployment at low levels in many jurisdictions, capital expenditure is more likely to feed through into higher productivity.

However, we think that moderate inflation should come through this year, but to different degrees in different places. Producer prices rose ahead of consumer prices across the G7 and in China last year. With firms needing to generate earnings, we expect these cost pressures to be passed through the system, although any material rise in productivity would dampen price pressures.

The UK muddles through

The United Kingdom grew by an annualised rate of 1.5% in 2017. While this was significantly higher than consensus forecasts at the end of 2016, it is still a slowdown at a time when growth in the rest of the world accelerated. Nevertheless, surveys of purchasing managers show that the UK can sustain a similar level of performance in 2017, absent any Brexit-related policy shock.

Inflation remained high in the last quarter of 2017, with RPI at 4.0% and Core CPI at 2.7%. With weekly earnings growing at a slower rate (2.5% in November), consumer incomes have been squeezed. Price pressure should ease this quarter, supported by the strong performance of sterling in Q4 2017. However, the prospect of positive real wage growth in H1 2018 looks unlikely as inflation is likely to stay relatively high by developed market standards

"Producer prices rose ahead of consumer prices across the G7 and in China last year."

The pound strengthened by 10% against the dollar in Q4 2017, reflecting a 25bp rate hike from the Bank of England, but weakened slightly against the euro. The weak dollar, driven by repatriation of US-based funds to the booming euro area, explains these results more than receding uncertainties over Brexit, and the pound may not hold its current value against either the dollar or the euro this year if either the Fed or the ECB becomes relatively more hawkish than the Bank of England (see chart on p.2).

But the generally weak pound since 2016 has provided benefits to UK financial stability. According to the Bank of England, the cumulative current account deficit in the UK has been £480bn. But this hasn't been funded in the traditional way – by fresh inflows of capital from foreign investors. Instead, almost all of this can be accounted for by UK entities cashing in some of their overseas investments.

In fact, the recent current account deficit is fully explained by UK entities' cashing in just the recent gains in their overseas portfolios. Sterling gains in these portfolios result largely from currency depreciation as well as increases in the underlying value of equities and bonds. The upshot is that the expansion of private sector credit is more sustainable than previously thought. Yet UK households are still rather indebted, with most of the burden borne by low-income households. Domestic risks therefore remain in the light of squeezed real incomes and lower UK welfare spending.

Even though the UK economic cycle is relatively old, the Bank is limited in the action it can take to normalise policy due to political uncertainty and the strong reliance of pockets of the low-paid on credit.

Some late-cycle fiscal expansion may help alleviate some of the UK's near-term problems and weaken demand for private sector credit.

Inflation continues to elude the US Federal Reserve

The US continued robust economic performance in Q4 2017, heading into the new year with growth above 3% and unemployment below its long run average. Inflation remains the great puzzle. While the US economy expanded handsomely last year, Core PCE inflation *fell* from about 2% at the start of the year to as low as 1.3% in September. The Federal Reserve believes that this weakness is transitory as the effects of a price war in the telecoms industry and discounts in the car industries fade; and indeed Core PCE picked up in Q4 2017.

Further, to a large extent it is wage growth that drives consumer price inflation. It is worth restating that the US participation rate remains 400 basis points below its pre-crisis level. So despite the low formal rate of unemployment at 4.1%, firms may not be feeling pressure to raise wages if they can induce discouraged workers to return to the workforce.

However, as many of the job losses since the Great Recession were structural, it is reasonable to say that US labour markets are tight. If we say too that transitory factors in the telecoms and automobiles industries have passed, and that other factors such as the growth of low-cost e-retail, the rise of flexible working and the effects of offshoring are insignificant, then inflation should come through this year. And if this is the case, and we add the pressures on consumer prices from rising producer costs, we should see the Fed continue to raise rates in line with its intentions (~75-100bps by December) and shrink its balance sheet. With annualized inflation now at 1.8% (December 2017), markets have priced in a March rate hike with probability 80%.

The rise to dominance of competitive, low cost e-retailing services such as Amazon may be putting downward pressure on consumer prices.

Much will be made of the subsequent effect of this on US yield curves, which will continue to flatten, but this should not be taken as an indication of recession. Curves have flattened since 2014, and much of this is due to bull-flattening global QE that has held down long-term rates. The Bank of Japan's ongoing commitment to hold 10-yr bonds at 0% until inflation picks up could lead to further spill-overs into US Treasuries.

The US business cycle is more advanced, yet we continue to look for benign signs of maturity – a pick-up in inflation along with faster productivity growth – or more worrying indicators, such as any increase in debt distress.

"Europe enjoyed a strong H2 2017 with growth above 2.0% in almost all major EU member states."

Booming Europe risks repeating same mistakes

Europe enjoyed a strong H2 2017 with growth above 2.0% in almost all major EU member states and close to 3.0% in many. Inflation is low and – importantly – balanced – across the euro area, keeping real effective exchange rates between countries relatively stable and supporting a benign environment for trade and profit generation. The ECB has committed to only tapering in 2018, so we are not expecting any rate rises until next year, but the minutes for the most recent meeting of the Governing Council noted that price pressures are building up in the Eurozone faster than expected and that the body is open to changing its monetary stance early this year.

We are concerned with the emerging credit relationships between EU states. One of the consequences of the ECB's Asset Purchase Programme was to create channels for Germany's sizeable current account surpluses to be funnelled into Southern European countries – either indirectly through the Target2 payment system or by encouraging investors to buy peripheral debt and rebalance away from negatively yielding Bunds. Excessive intra-eurozone credit flows drove the competitive imbalances that underpinned the 2010-12 euro crisis, so the re-emergence of similar patterns is a reasonable cause for concern.

Is China now the world's most important economy?

The conventional view about the global economy is that the United States is the 'consumer of last resort'. If the US is doing well, the effects tend to spill over through import demand into other markets. The sheer size of its economy, combined with its large consumption sector, and control of the world's reserve currency means that the country runs large current account deficits.

But has China been more instrumental to the 'synchronised global growth' story? In 2017, China accounted for 12% of global imports compared to 18% in the United States, but it is in other areas that the Middle Kingdom has been more influential. The country contributed about one-third of all global growth in 2016 and 2017, and over 70% of its GDP is made in its manufacturing sector. Chinese final demand therefore has a significant influence on capex spending in developed economies, commodity exports from other emerging economies and the inventory cycle that lubricates global supply chains. How China therefore handles its programme of liquidity controls and deleveraging will have consequences for all of us.

Control of the world's reserve currency means that the US runs large current account deficits and thus has been seen as the world's 'consumer of last resort'.

Keeping an eye out for the Black Swans

Finally, a word of caution. Global debt stands at 330% of world GDP, up from 225% in 2008. We have lived through an extraordinary period of easy liquidity, feeding extremely low asset market volatility. This creates an environment for malinvestment . We think there are two major sources for this – US companies that have either loaded on high-yield debt or levered their balance sheets by buying back stock; and Chinese state-owned enterprises that have misallocated large amounts of government-backed capital. While there is reason to be encouraged by the recent performance of the global economy, there can be no room for complacency.

Investment Outlook

Investment markets ended the year in ebullient fashion buoyed by synchronised global growth, easy monetary policy and positive company earnings reports. It is fair to say that we have been through such periods before, but the difference this time has been the lack of inflationary pressures. Against this backdrop, equities appreciated by more than 20% during 2017. Meanwhile, global fixed income markets, as measured by the Bloomberg Barclays Global Aggregate, returned c. 7%.

"The S&P 500 and the Nikkei 255 indices gained c.20% ... and the tech-rich Asian markets gained c.40%."

Growth stocks dominated equity market performance, especially in the technology sector where some US and Asian large-cap names revalued considerably. By contrast, value stocks were relative underperformers. By region, the FTSE 100 ended the year at a record high, buoyed by a recovery in commodity prices; the S&P 500 and the Nikkei 255 indices gained c.20%; European equities outperformed their US peers (excluding the technology sector); and the tech-rich Asian markets gained c.40%.

In fixed income markets, the strengthening global economy stoked demand for high-grade corporate debt. The spread over US Treasuries as measured by the Bloomberg Barclays US Aggregate Average narrowed to 93 basis points from 122 basis points at the start of the year and marked the lowest differential since 2007. Further down the credit scale, European high yield traded in line with US Treasuries for the first time ever. However, it was emerging market currency bonds that were the best performers in fixed income while government bonds lagged.

In other asset classes, European real estate fared well, gold gained 13% but traded in the narrowest range in a decade, and crude oil posted double-digit gains as demand surprised on the upside and OPEC compliance remained resolute.

From a bond investor's perspective, the flattening of the US yield curve driven by the rise in short-term rates has been the major talking point. The spread between two and ten-year Treasuries has fallen to a 10-year low and is threatening to turn negative. This is a concern as an inverted yield curve has been a harbinger of every recession going back to the 1960s. With the US Federal Reserve (Fed) seeking to remove liquidity, albeit gradually, there remains upward pressure on short-term rates. However, there is good reason to believe an economic contraction may not be imminent and, in fact, the US yield curve could steepen during 2018. Longer-dated yields are heavily influenced by growth and inflation expectations and there is evidence that both could be heading higher. Yet, there remain some long-term factors at play which may contain any rise in longer-dated yields; namely ageing populations, high levels of debt and technological advancements.

"Crude oil posted double-digit gains as demand surprised on the upside."

In a similar vein to the Fed, the European Central Bank is taking a measured approach to removing stimulus by reducing the volume of asset purchases,

The ECB and the Bank of Japan will continue to buy bonds this year.

despite having lifted growth projections considerably. German yields moved higher by about 25 basis points across the curve through 2017 and we would expect this trend to continue. Meanwhile, the Bank of Japan has reaffirmed its ultra-loose monetary policy despite an improving economic backdrop. In the UK, the Bank of England tightened monetary policy by 25 basis points in November 2017 and has become more hawkish, but structural reasons including disappointing productivity growth should keep a lid on yields at the long-end. Short-dated gilts will remain dependent on political events with any positive news relating to Brexit likely to cause the yield curve to flatten.

In global credit markets, the ECB will continue to purchase corporate bonds this year while on the supply side some of the largest serial borrowers may require less funding following the US tax reforms. The backdrop in the short-term remains favourable as debt affordability is good, interest coverage ratios are high and the economy remains buoyant. The counter-argument is that the premium for lending to companies is at a record low and the removal of central bank liquidity could have major repercussions. Whilst bond yields may remain at low levels in the short-term, we have reduced our allocation to credit and currently favour strategic bonds funds, which are able to benefit from rising yields. We are also cautious on the high-yield sector, which peaked in mid-October, as we believe it offers limited upside potential from here and favour inflation-linked bonds as there is a bias for higher real rates during the next 12 months.

"The backdrop in the short-term remains favourable as debt affordability is good, interest coverage ratios are high and the economy remains buoyant."

Despite a strong 2017, we believe global stock markets should make further progress in the current year. Equities have never peaked before the yield curve inverted and typically have performed well while the Fed has tightened. Further, in the event equities were to roll-over, we believe central banks would take a step back from raising rates. That said, global equity market valuations have rerated and valuations stand at a premium to the long-term average. US equities are a case in point. At 18.5x forward earnings, they are the most expensive in 14 years. However, part of the revaluation is structural with a greater exposure to the more richly valued technology sector, which currently accounts for 30% of the market value compared to 15% ten years ago. Part could also be due to investors discounting the benefits from the fiscal bill agreed shortly before Christmas.

For 2018, the challenge could be that if growth slows, earnings could fall shy of the high expectations currently priced-in. At the same time, if growth accelerates, bond yields could rise to levels where investors would — once again — look to earn their income from their bond portfolios at the expense of their equity portfolios. Given the normalisation path for Fed funds of four rate increases this year, the US 10-year Treasury could conceivably rise towards 2.75% and start to test this relationship. Yet, for the time being central bank policy is far from being restrictive with real US interest rates outright negative at present. Therefore, we are sanguine about US equities going into the first quarter.

The UK equity market remains impaired by the lack of clarity over Brexit. Economic activity indicators have softened and GDP growth is relatively anaemic. On the face of it, this is not a favourable backdrop for UK stocks. But on a positive note, further monetary tightening appears less likely than elsewhere and inflation is likely to moderate as the one-off effects of sterling's weakness fade. Fundamentally, UK equities are less richly valued than their international counterparts as global asset allocators have been generally underweight the UK. The currency weakness has benefited those companies with international earnings and has potentially made UK companies more attractive takeover targets. On balance, the outlook for UK stocks remains constructive although a totally disorderly Brexit could test investors' resolve.

"If growth slows earnings could fall shy of the high expectations currently priced-in."

Flattening US yield curves might not mean recession this time

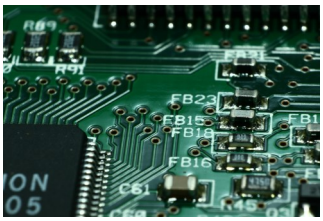
Source: *Bloomberg*

European equities start 2018 with several tailwinds including a positive economic backdrop, rising loan growth and improving company earnings. Meanwhile, eurozone valuations are attractive as multiples have barely moved over the past two years in contrast to the re-rating seen elsewhere. For example, the relative P/E of eurozone equities versus their US peers has widened to one standard deviation below its long-term average, which could narrow if the region's companies continue to grow earnings at a superior pace.

In France, the benign outcome of the presidential election has boosted private sector sentiment and should be a lasting driver for eurozone equities. German activity could slow after a strong 2017 but the consumer should remain buoyed by the rises in house prices, credit and wages. Elsewhere, political risks remain with uncertainty surrounding Catalonia's future and a General Election due in Italy in the early part of this year. However, any downside going forward may be limited; Spanish equities have already underperformed the rest of Europe in recent months despite resilient economic activity and in Italy it would appear a coalition of Eurosceptic parties is unlikely.

"If growth accelerates bond yields could rise to levels where investors would, once again, look to earn their income from their bond portfolios at the expense of their equity portfolio."

Japan is the only region where the central bank will continue to offer support.



In Asian equity markets, the technology sector has grown to 30% of market cap, having tripled since 2008.

This policy divergence from other regions could translate into a weaker yen, which would be a positive factor for the country's exporters. In addition, Japan has historically performed well in times of rising bond yields while fundamentally shareholders should benefit from ongoing corporate reforms. Arguably, much of the favourable outlook may already be priced into the Nikkei, which trades on a forward multiple of 17 times, but consensus earnings growth projections of 3% in 2018 would appear to be conservative.

Asian markets experienced an exceptionally strong 2017 as a result of the pick-up in international trade and the associated improvement in earnings. Going forward, an eye should be kept on activity in China where there is growing evidence of a softening trend in response to tighter monetary policy. In terms of sectors, technology has grown to 30% of market cap, having tripled since 2008. Whilst we remain positive on the technology sector over the long-term, we are cognisant that valuations have materially re-rated and could be susceptible to profit taking. From a broader perspective though, emerging markets are trading on a forward P/E multiple of 12x, which puts them on a 25% discount to developed markets.

In commodity markets gold may struggle as interest rates start to rise and if the dollar rebounds. However, any retracement towards US$1,250 could provide a buying opportunity, especially as we see increasing uncertainties beyond 2018. Meanwhile, oil demand continues to grow, OPEC output remains restrained and there is little supply growth elsewhere. A recent report by Boston Consulting Group suggests the decline in rates of existing fields have been much sharper than widely assumed. Consequently, prices may have to stay higher than before to balance supply and demand.

In summary, markets are currently in a sweet spot fuelled by a decade of extraordinary, coordinated monetary policies (there have been over 700 rate cuts since the fall of Lehman Brothers) and subdued inflation. The abundant liquidity has driven asset prices higher to the point where signs of excess are becoming evident. Janet Yellen, the outgoing Fed Chair, and the Bank of International Settlements have expressed concerns over the levels of debt that have been accumulated. The current year could see recent tailwinds start to turn into headwinds as Quantitative Easing progressively shifts to Quantitative Tightening and inflationary pressures build.

"Going into the first three months of the year we continue to favour equities and real estate over fixed income."

Movements in the US 10-year Treasury will be a key factor. If the yield goes though 2.75% and starts to challenge 3%, not only would the almost 40-year bond bull market come to an end, but the relationship between bonds and equities could change and result in investors looking to earn their income from their bond portfolios at the expense of equities. However, these concerns are just on the radar at present and going into the first three months of the year we continue to favour equities and real estate over fixed income.

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