HOVING & PARTNERS

WEALTH MANAGEMENT

QUARTERLY INVESTMENT VIEW

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SUMMARY

We would like to start with a famous quote from physicist Sir Isaac Newton after he lost the equivalent of $2.7 million in today's inflation adjusted dollars in the South Seas stock bubble in the 1720s:

"I can calculate the motion of heavenly bodies, but not the madness of people!"

That is kind of how we feel, with the short-term direction of the various markets. We have taken a cautious stance towards the equity markets since the beginning of September, following our indicators.

In fact, until the end of September markets had not done much, while since the beginning of October markets reversed to the upside and now appear to be involved in what could be called a "melt up."

Since the lows of February 2016, High Yield bond yields collapsed from 10% to 5% in the US and from 6% to a record low 2% in Europe. The S&P500 soared from 1800 to 2550, as did the Nasdaq from 4300 to 6600, the China H-shares from 7500 to 11500, and the oil price, doubling from $25 to $50.

This optimism in the last 18 months has increased the global stock market capitalization with an epic $18.5tn, which is a bigger number than the GDP of the US. Drivers have been a strong earnings recovery, no consensus of a "Goldilocks" economic scenario (above trend growth, below trend inflation) and no fear of Central banks (the G4 central banks have bought since February 2016 over $3tn of financial assets).

Today, corrections have proved limited The main US equity index S&P 500, for example, is currently going 333 calendar days without a higher than 3% dip on a closing basis, the record being 370 days ending in 1928.

So, should we now throw in the towel on calls for a correction, and join the buy the market herd? Not quite, instead, our thesis has shifted that this correction will be more likely towards the end of Q1 2018 when G4 Central Bank liquidity will peak. The most obvious catalyst to hurt today's consensus and to cause a big correction is a spike in wage and inflation data, bringing back "fear of the Fed". In our view higher bond yields and higher bond market volatility are necessary to trigger a major correction in equity and credit markets.

We have now entered the fourth quarter period which has historically been kind to investors. Tactically it still makes sense to lock in some profits, perhaps hedge against any near-term downside. We can only say that stocks continue to rise despite all figures showing signs of "over-bought-ness" that one might wish to conjure up. We may sound like a broken record, noting stock valuations look high; that leverage is high, that the Fear & Greed Index is at its highest levels in the past decade . . . but it does not matters; stocks just continue to advance.

The current bull market persists and one seems to have no choice but to remain long on equities on balance. However, we feel moderate optimism seems more justified.

ASSET ALLOCATION – Q4, 2017

We recommend global and balanced portfolios to continue to be overweight in equities, in the Euro area, emerging markets and Japan. U.S. Credits score the best "quality" yields. Alternative strategies should help diversifying portfolios with non-correlated strategies.

Higher interest rates and political risk are **Investment risks,** justifying a relatively large cash position in balanced portfolios.

In the coming months, we expect **European shares** to outperform all other asset classes. They are generally under-owned, less generously priced that most U.S. equities and are building up momentum. Growth in Europe is robust, the integration of the Euro area should continue. We like financials, small caps and technology.

We also continue to be overweight **emerging equity markets** with emphasis on India and China. Oil exporting nations like Russia, Brazil and Mexico should profit from higher Oil prices. Emerging markets are the bright spot amidst improving fundamentals.

We are currently underinvested in the **S&P 500 equity group**, except for a few large capitalized Technology stocks based on their high free cash-flows (Alphabet and Microsoft) which are superior to the S&P 500.

In **Japan** there are signs of a tightening labor market. Business conditions and consumer confidence are improving. Japanese equities are attractive.

Emerging market fixed income is attractive with average yields at 6 percent. EM local currency bonds backed by Oil exports are attractive. We generally prefer equities over High yield corporate bonds.

We increased our exposure to **Alternative Investment Strategies.** Ideally, these investment strategies are non-correlated, to most stock and bond indices. Alternative Investment strategies include among others Private Equity, Infrastructure, Long/Short Equity managers, Macro Hedge Funds, Event driven Hedge Funds.

CURRENCY STRATEGIES

The **EUR** has become expensive against most currencies. The USD/EUR weakness was not anticipated beginning 2017. On the contrary, it was thought that U.S. economic growth would be higher following President Trump's election, supporting the USD.

It's the EUR with the stronger economic growth prospects going into 2018 that should remain on top. We recommend **hedging the USD** against the EUR. We also recommend diversifying into currency positions outside the EUR/USD block.

We anticipate the SEK, SGD, Japanese Yen and generally EM currencies to outperform the USD and/or the EUR.

Fundamentally, the **GBP** should remain a weak currency (negative current account & budget deficits).

Oil related currencies (NOK) should continue to do well in the current up-cycle of Oil prices.

ALLOCATION OF ASSETS Q4 2017

CASH	10%
U.S. CREDITS	10%
EM BONDS	10%
EUROPEAN EQUITIES	25%
U.S. EQUITIES	5%
JAPANESE EQUITIES	5%
EM EQUITIES	15%
ALTERNATIVE STRATEGIES	20%

BASE CASE SCENARIO

The global recovery is continuing and at a faster pace to finish the year with gains in every region in the world for the first time in a decade. The IMF lifted its growth forecasts for practically all advanced economies but the U.K. and Spain, and boosted the outlook for the global economy to 3.6% this year and 3.7% for 2018.

The IMF no longer expects President's Trump's proposed tax cuts to happen; impacting its growth forecast for the U.S. economy. Some economists predict a recession is looming on the horizon in the U.S. Nevertheless, the U.S. is still growing above trend.

Optimism is picking up causing increased spending by businesses and consumers. We seem to be in a **synchronized "Goldilocks" environment** which is likely to fuel more global growth the basis for companies to grow earnings.

Wage inflation, the largest component of inflation, has been dormant but it is not dead. There must be factors that explain this phenomenon. Either workers are replaced by workers abroad (globalization) or they are being replaced by progress in technology (more and faster with fewer hands), or the business has become obsolete (M&A), or more workers do not have fixed jobs any more. The deflationary forces have to work through the system before inflation comes back in a significant way. This may take years, or the deflationary forces disappear much more quickly than anticipated because of higher economic growth. We are in the latter camp.

In August 2017, Sweden, a relatively open economy, recorded inflation of over the 2 % target for the first time in six years. The UK is now also facing inflation of above 2 %. This shows that the tides can change quickly.

INVESTMENT RISKS

Complacency has never been higher. **Volatility** of stock and bond prices has never been lower. Investors believe that the current behavior of markets will continue for a while as there is still plenty of easy money and inflationary pressures are absent. However, stock markets can change course very suddenly and fast. The U.S. stock market is a prime candidate for a correction. It seems to be priced to perfection.

The other major risk is a **policy mistake** by the Fed. If the Fed tightens money too fast on top of an already slowing economy, this could lead the U.S. economy into a recession next year.

The **debt ceiling** issues (8 December 2017) of the U.S. will cause a lot of debate, but in the end of the day, the printing press will probably continue. This is another expression of complacency: the huge debt problems that are not being addressed.

Geopolitical risks which overshadowed stock markets in Q3 seem to have stabilized and although we do not believe in further escalation between the U.S. and North Korean governments leading to war, any negative development should influence the financial markets.

The negative outcome of the **Catalan independence vote** (although the vote was declared illegal by the Spanish High Court) represents a very high risk to Spain's political stability. Prime Minister Mariano Rajoy takes a tough stance to the independence movement. Spanish police are ready to arrest Catalan President Carles Puigdemont immediately if he declares independence in the regional parliament. Are we at the birth of a revolution? Neither Spain nor the European Union needs this headache. The country's economic performance is "best in class" among the EU members this year. Brussels is reluctant to interfere, but what can they do?

China has been instrumental for the global economy returning to health this year. It should regain the fastest growing nation status in 2017 (+6.8 percent), while India is expected to top the growth charts in 2018. There is no doubt that the PBoC played a central role with QE stimulus. At the end of 2017 the Central Bank's assets are estimated to represent >40 percent of China's GDP!

The sharp increase of **China's debt levels** are overshadowing China's outlook. Xi Jinping, as

General Secretary of the Communist Party of China, and President of the People's Republic of China, has been the architect of China's remarkable progress, but also at the cost of enormous debts.

Credit growth in China has averaged 20 percent on an annual basis over the last seven to eight years, outstripping the pace of GDP.

The IMF warned that for China to achieve its 2022 GDP target, the cost of this will push the Credit/GDP ratio to 300% of GDP

Excessive credit growth has almost always led to crises in other countries according to the IMF.

We should also mention that **China** may enter a phase of much lower growth (currently 6.5 percent) as stimulus wanes and credit risks rise (China has a high debt problem). Such a slow-down, although we do not expect it to happen, would break the economic growth path of the rest of the world.

CENTRAL BANK POLICIES

We expect Central Banks, lead by the Fed, to continue pulling back liquidities (tightening) from the Financial markets in one form or another (tapering, higher Fed funds).

*According to the **Taylor rule**, the Fed should raise rates when inflation is high or when employment exceeds full employment levels, which is the case today (Prof. John Brian Taylor has been mentioned as a possible candidate to succeed Janet Yellen).*

We anticipate the U.S. Fed to hike **Fed fund rates** in December this year by 0.25%, bringing Fed funds to 1.00 %. Next year, a further number of rate hikes by the Fed can be expected.

In **Europe**, the ECB has continued its liquidity programs (QE) and low interest rate policies (negative interest rates) during 2017. For next year, we expect the ECB to introduce important changes diminishing or even ending "easy money" policies. There is no need for this anymore. The euro area's economic machine has shifted gear.

The **BoJ** may be the only Central Bank continuing easy money policies next year.

BOND INTEREST RATES

The simultaneous and faster global growth needs liquidity. Without this liquidity higher bond yields are beckoning, giving investors alternatives to dividend yielding stocks (so called bond proxies). This scenario is becoming more likely to take place in 2018.

We expect **USD yields** to move up next year to levels above 3 percent for 10Y Treasury yields.

Global yields as well as euro area yields may be pulled higher as a result.

Should the U.S. economic cycle weaken later next year, we may see yields reversing their up-trend. This may also depend on the strength/weakness of the USD at that time.

Higher yields are not necessarily bad for stock markets, especially when these are the result of higher growth expectations.

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