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WEALTH MANAGEMENT

QUARTERLY INVESTMENT VIEW

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SUMMARY 2017

It was a good year for global equities and last year's greatest 'risks' were (a) to be underinvested in stocks and (b) to have misjudged the potential strength of the EUR.

The U.S. dollar (-15%), The Swiss Franc (-10%) and the Japanese Yen (-10%) all lost value against the EUR which was unexpected. Currency diversification can sometimes cause losses, defeating its purpose.

To the surprise of many investors, the U.S. stock market indexes surged to records with the S&P 500 returning 22% in 2017. Technology and Internet Retail contributed more than 40% to this performance.

Expressed in EUR however, the return of the S&P 500 was only 6.9%. In comparison, the STOXX 600, Europe's main index, was up by 11.3% in 2017. Emerging markets were the top performers with the MSCI EM index returning just over 17% in EUR.

For a EUR based balanced and diversified portfolio with benchmark cash (5%), EUR bonds (35%), global equities (45%), private equity (5%) and real estate (10%) should have returned approximately 3.9% in EUR in 2017.

IS THE BULL MARKET STILL INTACT?

Will the bull market in equities continue? Until something occurs, damaging positive investor sentiment, the U.S. stock market may not meaningfully derail in the near term. European stocks are still very much supported by their central bank in 2018.

The Global economy is moving forward and its recovery is synchronised. U.S. and European companies are expected to show double digit earnings growth in 2018. U.S companies will get a boost from lower corporate taxes and higher consumer confidence.

The "overvaluation" argument to sell stock holdings has often failed to support long term performance. Bear markets have very rarely been induced by overvaluation.

Corrections and even sharp ones (15-20%) are not necessarily the beginning of a long term bear market.

In the summer of 2018, most central banks, the Fed, the ECB, the BoE and even the BoJ, have indicated that they want to start normalizing their balance sheets with **quantitative tightening** (QT) ending or lessening their stimulus programs initiated many years ago. The amount of money involved impacting world liquidity is huge. This may significantly change yield curves and stock valuation models.

At the moment, the Bull market still seems to have some steam left to run its course. Also secular growth themes such as artificial intelligence, biotech, e-commerce and e-gaming remain attractive. However, investors should be very prudent when central banks decide to become "silent" killers of liquidity and force interest rates higher.

Stock markets, especially the U.S. markets, may correct in the 1st half of 2018 should QT and higher bond yields become a burden to U.S. companies. This impact should be less severe in case growth rates of U.S. company earnings surprise on the upside.

The more prudent investor would be wise to build up cash reserves and re-balance aggressive equity holdings. Longer term, we remain optimistic that equity holdings remain the investment of choice.

Our base case Scenario for the Global Economy

✓ We are optimistic that the global economy will continue to recover. We are entering a phase of expansion that could accelerate because all major economies are firing their cylinders simultaneously.

✓ Labour markets are becoming tighter. U.S. has full employment similar to Germany and the Netherlands. The rest of Europe is still weak. Japan's labour market has become tight and salary growth has followed.

✓ Inflation is coming back somewhat, but not yet too worrying to derail the growth momentum.

✓ The price of Oil has boomed to over $60/barrel. Global economic growth supports this or an even higher level.

✓ The Fed has announced three more rate hikes since December 2017 which would bring fed funds to a range of 2.00-2.25%. The Fed is afraid to be behind the curve as the U.S. labour market is very tight. Short term bond yields in the US have climbed from 0.2% in 2013 to 2% currently, while the long end so far has remained around 2.5%. In Europe, 2 year German Bunds still trade at -0.6% whilst 10 year Bunds trade at 0.45%, probably an unsustainable situation.

✓ The ECB monetary policy is announced to become more restrictive in 2018 (ECB reducing its bond buying program from €60bn to €30bn/month) but still much less restrictive than the Fed. German 10Y Bund yields are expected to rise following less demand from the ECB. Peripheral bonds will become much less attractive without ECB support.

✓ The U.S. Tax Plan should contribute to the bottom line of mostly domestically oriented sectors like retail, telecom and utilities. The return of offshore hoarded money by U.S. corporations (like Apple, Google and Facebook) could potentially be paid-out to investors as super dividends.

✓ Consensus average earnings growth of S&P 500 Index companies is about 11 per cent in 2018. This is similar to the consensus for 2017. Earnings quality is consistent with limited recessionary risks.

✓ U.S. Energy related stocks have by far the highest 2018 consensus earnings growth forecast (+38%), followed by Materials (+18%), Financials (+16%) and Technology (+12%).

"Must-Watch" Issues

In Q1 2018, top issues include: (1) Whether President Trump will cause significant deterioration in US-China trade and /or global trade relations; (2) How China will deleverage without sacrificing too much growth and how this will affect the exponential increase in household consumption; (3) The effect of a USD appreciation and/or slowing China on EM, particularly Latin America (commodities); (4) Signs of a UK snap election bringing Left Wing Socialist Corbyn to power; (5) The vast array of geopolitical and social risks – all interlocked and most potent in EM (Korea).

Asset Allocation - Balanced

Cash	5%
Corporates	10%
E.M. Bonds	15%
U.S. equities	6%
European equities	14%
U.K. equities	5%
Japanese equities	5%
E.M. equities	20%
Alternatives	20%

Sector Recommendations

- Maintain exposure to Commodity & Energy stocks;
- Maintain exposure to emerging market equities, especially to India where growth has been re-established;
- Focus on U.S. companies benefitting from the Republican Party's Tax Plan; the Oil & Gas sector and Financials.
- In the Euro area, increase exposure to Financials, Materials, Industrials, and Staples;
- Focus in Europe on small caps rather than large caps;
- Focus on value stocks as they should outperform growth stocks;
- Remain invested in secular growth themes such as biotech, artificial intelligence, digital payments, e-gaming and e-commerce.

Quantitative Tightening and its Potential Consequences

Between 2009 and 2014, the US Fed created $3.5 trillion during three phases of QE. It used that money to buy $3.5 trillion dollars' worth of financial assets, a pretty large amount of money. When quantitative tightening commences, the Fed will start tapering these financial assets, allowing its balance sheet to gradually shrink. The program will continue until June 2021 contracting the balance sheet by approx. $2 trillion, it is estimated by Nomura.

We expect the Fed will have three basic objectives:

- Keeping bond yields from moving higher
- Do not crash the stock market
- Do not crash the economy

The Fed stands to retire $300bn in FY 2018 and $600bn in FY 2019. For reference, $600bn is equivalent to the federal budget deficit in 2016. Collectively, retiring $2 trillion equates to a massive new supply of bonds that need to be bought, but at what price or at what yield?

The equivalent outcome for the equity market, effectively an increase in risk premium, would manifest itself in a falling P/E multiple. In a very richly priced US stock market, in practice this means:

- On a risk adjusted basis, future returns may disappoint, just at a point where past returns have been very impressive.
- Stocks are vulnerable to negative shifts in fundamentals or bearish swings in sentiment.
- Investors have bought every stock market dip into the recovery. Will that remain the correct response going forward as liquidity is withdrawn?
- QE has caused a collapse in volatility; QT may cause the opposite.

Governments and households are all more leveraged today than when the world fell to bits a decade ago. We have to assume that if interest rates move higher as a result of QT; private sector credit growth will slow, compounded by a negative wealth effect if asset prices move lower as well.

QT is a most dangerous exercise. **If QE pushed interest rates lower and asset prices higher, why would the opposite not unfold under QT?**

Brexit

Britain and the EU are on the brink of sealing a Brexit divorce. A good deal on Trade, the key hurdle is economic necessity for both parties.

We expect common sense to prevail and expect a decent performance of the Footsie in 2018 as a result. We recommend initiating exposure to the British stock market in 2018.

The GBP may strengthen with reduced perceived risks.

U.S. Tax Bill

Donald Trump has claimed a big victory on tax reform when he signed it on 22 December 2017. This reform is the first major change to the U.S. tax system in decades.

Mainly domestic corporations are the beneficiaries of the Tax Cuts and Jobs Act. The top individual tax rate will drop to 37 percent. The most important question is the economic effect on growth and investment of cutting the headline corporate tax rate from 35 per cent to 21 per cent.

It is certain that the cut will increase the deficit by a large amount – at least $1tn – over a decade. The idea that the cut would pay for itself has modest support in theory and none in history. It is certain that that the cut will produce some economic growth like an injection of cash.

Will the growth be worth the costs? The battle lines on this issue are drawn. However the tax breaks come at a moment when corporate coffers are near an all-time high and many companies are flush with cash. Despite this, fixed asset investments are near all-time lows. Will companies rather spend the tax windfall on buy-backs?

OPEC – Production Cuts

Since agreeing production cuts with Russia last year, OPEC has succeeded in boosting the oil price by 30 per cent to back above $60/barrel. The Saudis and Russia steer a deal to extend curbs on oil production to the end of 2018 (curb of 1.8m barrels). By agreeing an extension, Saudi Arabia and Russia show a serious commitment to keep pushing down inventories while propping up the price of oil. Oil inventories are declining for the first time in three years. With some confidence, memories of the worst crude crash in decades are receding. The U.S. shale industry has been rejuvenated and many service providers, such as Halliburton and Schlumberger are making a strong come-back.

Conclusion

At the moment, the Bull market still seems to have some steam left to run its course. However, investors should be very prudent when central banks decide to become “silent” killers of liquidity.

We believe the withdrawal of liquidity (QT) by the Fed is so huge that it should negatively impact bond yields in USD. The ECB continues to have the dilemma of the huge economic Gap between Germany and the Peripheral economies. Despite this problem, we see Bund yields moving up as a result of USD yields moving higher and the ECB reducing QE.

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The more prudent investors would be wise to build up more cash reserves and re-balance aggressive equity holdings. Longer term, we remain optimistic that equity holdings remain the investment of choice.

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