HERON
ASSET MANAGEMENT

Market Update

Chief Investment Officer

US 5Y yields have broken a downtrend that was lasting since 1988 and for the 1st time in 30 years we are testing the important resistance of 200 monthly moving average.

Main points

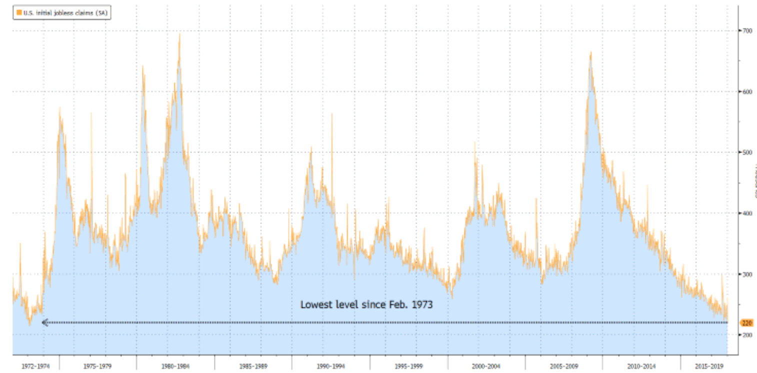
- Macro data / Earnings season
- Inflation / Yields
- ECB / FED
- Trades to be monitored
- Executive summary: **market ready for short term correction?**
- Investment ideas

1st of February 2018

Consistently **good Macro Data**, **Q3 Earnings Season** and **Tax Reform** were the positive catalysts helping the market to have a sustained rally into the end of 2017 and beginning of New Year.

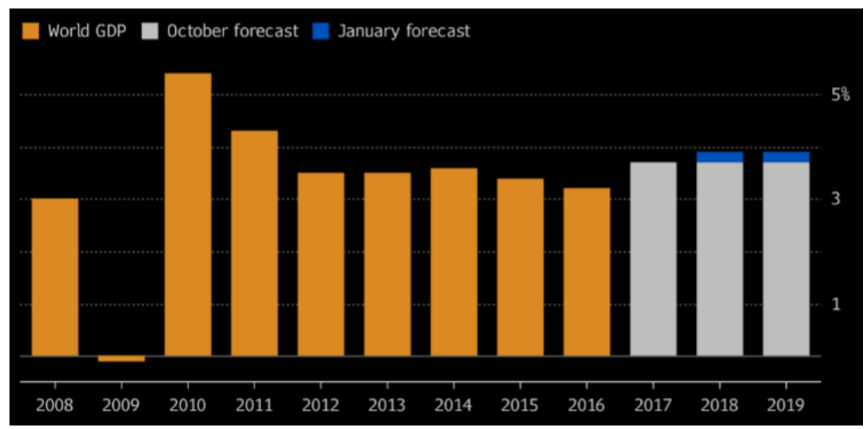
2018 has started at an even stronger pace helped by **Macro Data** and we are about to discover if **Q4 Earnings Season** will be as good as it is expected.

US Industrial Production hasn't been as strong as it is in almost a century, a strong run at factories, improvement in mining and a colder-weather boost to utilities lifted December's industrial output index 0.9% to 107.46, the highest in records back to 1919.



US filings for unemployment benefits fell to the lowest level in almost 45 years in a sign the job market will tighten further in 2018 (chart).

The International Monetary Fund said that global growth would accelerate to the fastest pace in 7 years as US tax cuts spur businesses to invest. The fund raised its forecast for world expansion to 3.9% this year and next, up 0.2% both years from its projection in October. That would be the fastest rate since 2011, when the world was bouncing back from the financial crisis (2nd chart).



PMIs remain stellar across the Eurozone. With the preliminary January composite hitting fresh highs (at 58.6), and particular strength across German manufacturing (61.2) and French services (59.3). This level of activity suggests a 3.5% current pace of Euro area GDP growth which contrasts with ECB and IMF 2018 forecasts at just 2.0%.

Euro area economic sentiment (EUESEMU) is at a 17-years high. With all sectors rising into December, across manufacturing (+1pt), construction (+1.2pts), services (+2pts) and retail (+2pts).

Risk appetite hasn't looked this euphoric since the tech-bubble. Goldman Sachs's US Financial Conditions Index, a cross-asset gauge of market health, signals the most accommodative investing environment since April 2000, spurred by the tumbling dollar and the relentless bull run in stocks and corporate bonds.

At almost 6% the pace of gains in US stocks in January is strong. FANG (Facebook, Apple, Netflix, Google) is up 21% YTD and we walked into ~$34bn of M&A (DPS/Keurig, KS/WRK & Ablynx/SNY) taking the Ytd US total notional of pending and proposed M&A to $196bn

When you are building on combined market cap that already exceeds $30 trillion, the result is wealth creation of unprecedented scope. Approaching $2 trillion, the amount of value added to equities in January is poised to exceed any month on record.

MSCI World had the strongest start for more than 25 years, US bonds selling off as market wakes up to fact that repatriation (& tax payment linked to it) could put selling pressure on bonds.
In Asia we had the 2nd-best performing January in the last 10 years, and the third-best performing since 1999.

<ins>Logically, even the **positioning is extreme**</ins>, as the <ins>Buy-side has added a record amount in S&P futures during the month</ins>. During the first 3 weeks of the year the Buy-side has added more than 50.4bn$ on S&P futures, equivalent to 11% of total open interest, a 2% standard deviation event.
<ins>Retailers are in "all in" mood</ins>. TD Ameritrade's CEO Hockey noted that cash allocations as a percentage of total client assets are at record-lows (no cash = all invested). At SCHW, cash as a percentage of client assets is also at historic low of ~10.8% (compares to ~12.5% a year ago… and at the market bottom in March of 2009 after the 2008 Crash, it stood at 23.4%).
Asia-focused hedge fund positioning as an aggregate, PB net exposure has reached 65%, worth being cautious about, as this is ~ 10% above the 2015 peak.
<ins>**Collectively, this paints the picture of a market that is already *very long*.**</ins>

As expected, Trump's **Tax Reform** plan would spur companies that have been stockpiling cash overseas (to avoid paying taxes) to bring the money home. The lower tax rate could be seen as "deemed repatriation" rates, which means that companies would owe the tax regardless of whether they actually repatriate the income.

The repatriated money could be used on share buybacks, dividends, acquisitions and capital spending. Tech companies would be the biggest beneficiaries: Apple, Microsoft and Cisco Systems alone have a total of $427 billion stored overseas. The 50 top overseas cash holders in the S&P 500 have parked $925 billion of their cash and marketable securities outside the U.S., an increase of $118 billion since their filings one year ago.

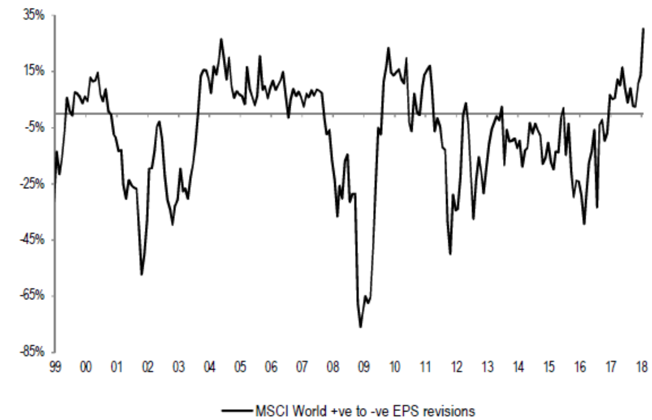
With the announcement of Apple, we have seen the beginning of this shift. The pie charts on the side shows clearly which the companies that held the most overseas.

<ins>**Earnings season** has already started and is entering into the busy period now. Unsurprisingly, so far Q4 earnings season is off to a good start with a very high beat rate across most sectors</ins>.

<ins>In US, with the passage of tax reform, there has been a rush to adjust forecasts</ins>. Since December 15th, S&P 500 NTM EPS has risen by over 5%. Stocks have moved in unison and taken on an almost parabolic surge higher.

We remain bullish on 2018 earnings and expect further upgrades to consensus estimates. At present, global EPS revisions are running at the highest and most positive pace in over 20 years.

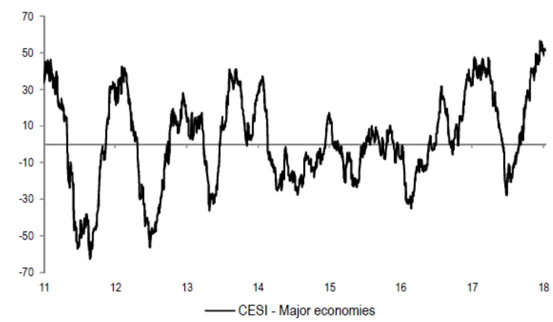
The 1st chart on the side shows the positive to negative EPS revisions on MSCI World. The combination of positive operating leverage, rising pricing power and lower US tax rate is going to drive upgrades to EPS estimates in ’18, for the second year in a row. MSCI World EPS revisions are above zero since Q4 ’16, and currently at their best levels in 14 years.



We expect a strong Q4 results season given:

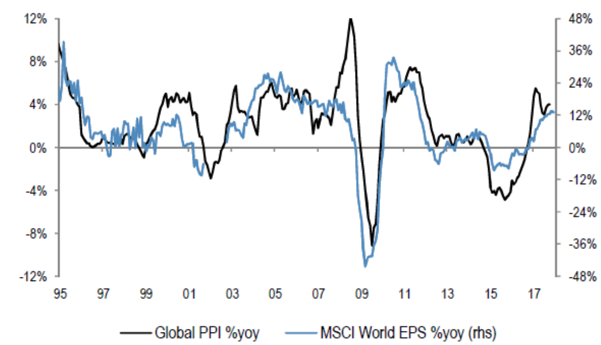
- Record strength in analyst survey. A majority of sector analysts expect earnings to come in ahead of expectations.
- Global economy is in rude health. Both global and domestic data have continued to surprise to the upside, with the European economic surprise index enjoying the longest ever run in positive territory and global data having bounced from the early Summer lull. This, combined with much smaller FX headwinds than in Q3 suggest a strong environment for earnings.
- Expectations look achievable. Consensus is looking for 9% yoy EPS growth in the US, 10% in Europe and 5% in Japan. Ex-Energy, EPS growth estimates are lower, in the 6-7% range. Yet again, estimates have come down during Q4, despite the pickup in activity and the higher commodity prices.

Global CESI (Citigroup Economic Surprise Index) is strongly positive correlated to earning and currently at its best levels in more than 6 years (2nd chart).



Commodity prices rallied strongly last quarter, which we see as another positive development for earnings.
The positive relationship between commodity prices and top-line growth works in US and in Europe.
Global PPI, which is a good proxy for corporate pricing, inflected higher over the last few quarters, providing a significant boost to earnings. This should play out favourably again in Q4.
The 3rd chart shows the relative performance of Global PPI vs MSXCI World EPS growth.

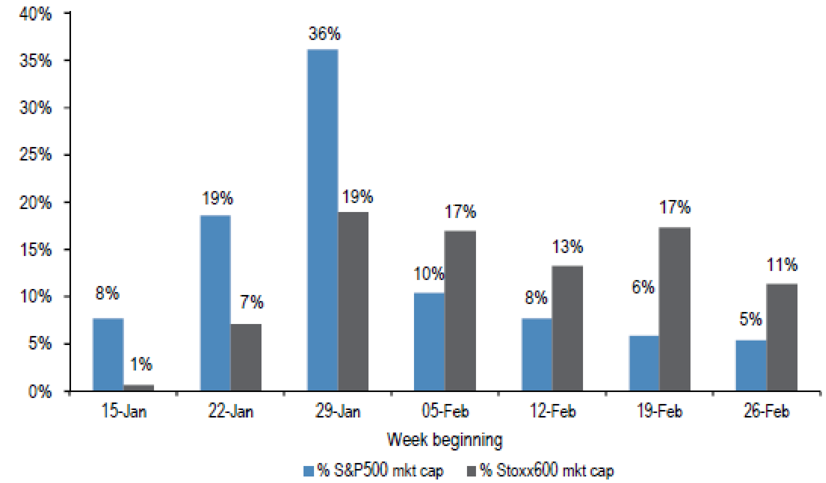
The Q4 reporting season will be very important for understanding the market for the next few weeks as we think that the bigger risk to P/Es is if EPS momentum falters; P/Es and EPS growth show a consistently strong link.



The next few weeks will also provide investors a chance to hear from management teams for the first time since the tax reform has been signed into law, the market will look for further guidance on how companies are thinking about corporate tax cut net benefit expectations, repatriated cash use, capex spending, buyback plans, hiring plans, etc.

In US so far 79% of the index has come in above expectations on EPS and 12% below expectations, which is a better beat rate than the historical average of 67%. On the revenue front, 75% of companies surprised positively, while 24% came in below consensus expectations. This is notably better than the historical beat rate of 55%.

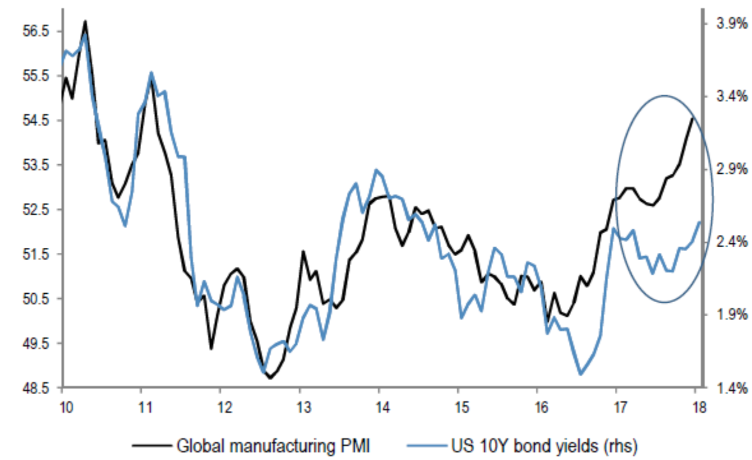
The Q4 earning calendar for US and Europe is shown on the histogram, in US by February expiry, 87% of SPX and QQQ will have reported while in Europe the biggest chunk of numbers is along the month of February.



Let's analyse some new data about **Inflation** as prints remain subdued, BUT the pressures are building and bond yields have risen as we rightly predicted over the last few updates.

The continued run of good economic newsflow was also corroborated by a further move higher in commodity prices through January, with Oil up 7%. Copper is now 30% higher YoY and Brent Oil is up 50% in just six months. Even the CRB RIND index, which is often less volatile, has broken the highs of last year and is not far away from the highs made in 2014.

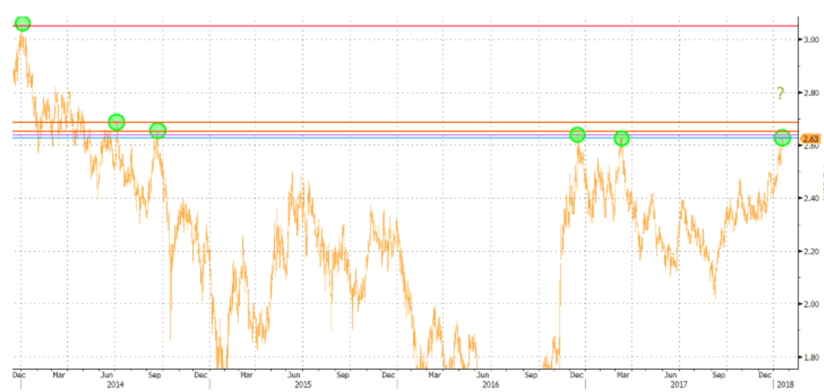
Industrial surveys in US and Europe indicate that both input and output prices are rising at the strongest pace since the beginning of the decade.



We continue to think that both headline and core inflation will likely trend higher from end-Q1. We believe that investors underappreciate this key shift. Given low market expectations, inflation will probably surprise to the upside even if it was to rise less than our out-of-consensus call envisages. Strong and above-potential growth is such that the output gap should turn positive this year and the unemployment rate fall below NAIRU. On top of this, wage and pipeline price pressures are starting to emerge and the rise in oil prices is more than offsetting FX strength.

We believe that bond yields are just catching up with the resilient activity dataflows. We have highlighted many times that a significant gap opened up between the two in'17 and it should finally start to close. The last time global PMI was at the current levels (in February '11) US bond yields were at 3.6%, 100bp above the current rate (2nd chart).

Yields are now finally starting to reflect the picture amid concern about faster inflation and a government deleveraging campaign. Investors should not expect any relief this year as tougher financial regulations and tighter monetary policy reduces the lure of bonds.



For sure bond markets had a bad start to the year. This year's $1.1tr imbalance in the bond demand/supply picture as a result of the Fed's balance sheet shrinkage and ECB/BoJ tapering provides a good reason to expect a bear market in bonds.

In US, the benchmark 10-year Treasury yield closed yesterday at 2.70% attempting the breach of the highest level since 2014. Should it continue to climb, traders will "enter a sort of No-Man's land where there is very little technical support" until 3%.

In the middle of December **<u>we mentioned that technicals were pointing to a potential turning point in US real rates</u>** (so called “flag or triangle”), **<u>we have now clearly broken this important level and what is more important is that we have broken several multi-year downtrends</u>**

<u>The chart on the US 5Y it is pretty amazing as we have broken a downtrend that was lasting since 1988 and for the 1st time in 30 years we are testing the important resistance of 200 monthly moving average</u> (arrow on the 1st chart).

While in Europe, <u>the German 5-year yield broke above 0% for the first time since December 2015</u> after a member of the European Governing Council said there is no further reason to continue with quantitative easing.

China added to bond investors’ jitters as senior government officials in Beijing have recommended slowing or halting purchases of US Treasuries. The world’s second-biggest economy holds about 19% of all foreign-held debt, the latest available Treasury data show.

<u>We still believe that any rise in bond yields from multi-year lows will be a positive for equities</u>, driving asset allocation shift and broadening of the market leadership. The common wisdom is that higher yields mean lower P/E multiples, but we disagree. It is typically lower earnings that would mean lower multiples, such as at the turn of ‘15.
<u>We continue to reiterate that Equities remain substantially cheaper than bonds. The yield gap between the two is near historical highs, which should provide some cushion to equities in the case of an increase of yields.</u>

<u>It is also important to consider that Central banks tightening is still in early stages</u>, <u>with US real policy rates outright negative. None of the last 8 downturns started with real rates lower than 2%. Classic end of cycle indicators are not flashing warnings signs yet. The yield curve is flattening, but it is unlikely to get inverted until at least 2H ‘18. Crucially,</u> **<u>stocks never peaked before the yield curve inverted</u>**.

<u>Trading-wise, we will now expect a consolidation in Yields as we might get a bit lower than current levels again before we brake higher.</u>

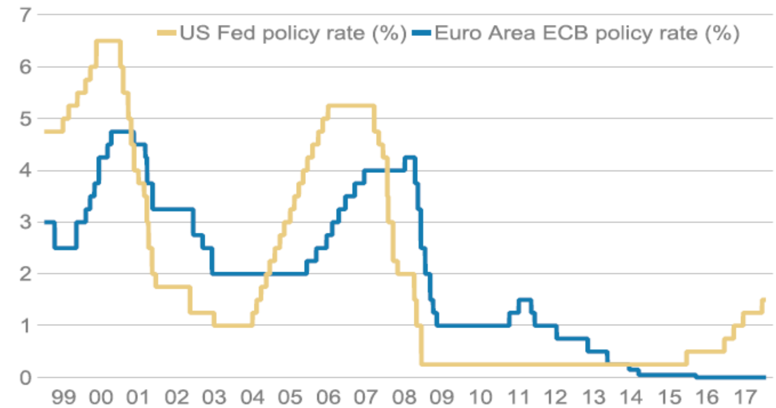
The **<u>FED</u>** <u>last night kept rates unchanged as expected but forecast inflation to increase before stabilising</u>. <u>It expected "further gradual" rate increases to be needed</u> (the previous description omitted the word “further”), which some economists said opened the door to 4 rates hikes this year rather than 3 it had previously indicated.

The market is now pricing a March rate hike as certain and an increasing probability of a further hike in August. Yellen was still the Chair of this latest meeting and <u>Powell will be be sworn in as Fed Chair on the 5th of February</u> and his first major speech will be his testimony to Congress in mid-February.

At the latest **<u>ECB meeting</u>** <u>Draghi offered a more balanced view on the European economic picture which triggered a spike in the euro and yields</u>, he suggested more confidence in the inflation picture and has not pulled back on the bullish growth outlook on the region, which he said 'continues to surprise to the upside. He did state that he puts a low risk of a rate hike later this year but there was a lot of pressure on the late 2019 euribor contracts that have rallied.

Importantly, there was no push back against the EUR strength beyond standard language and no convincing explanation of the strength. We think that possibly the EurUsd at 1.25 is not the pain threshold for the ECB to find sufficient agreement in adding any strength to their wording. With the currency at the highest level since 2014, Draghi basically used the same words used when the currency was at 1.20: "monitoring Eur volatility", "FX important but not a target". It is likely that Draghi is saving stronger words for a higher level of the currency.

The Market now expects changes in the forward guidance in March and June, to prepare the markets for the end of QE from October. We see the first 15bp depo rate hike to -0.25% in March 2019, with a signal towards the end of this year.



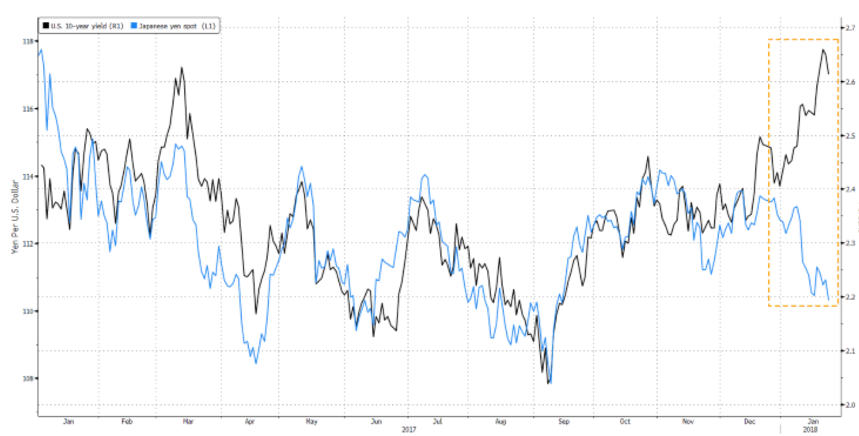
However, earlier this week some ECB officials were said to assume Quantitative Easing would end in a short taper, about three months rather than a sudden halt. The news was slightly dovish and slightly different from market expectations…

The monetary policy divergence between the FED and ECB is evident (chart) even if the **ECB** purchases of bonds started to scale down from EUR60bn a month to EUR30bn a month from the beginning of the year. The reduction of EUR30bn a month annualises at 3.04% of M3 money supply. With money supply only growing at 5% y/y in November, roughly where it has been since 2015, without the private sector stepping up, all other things being equal monetary growth would slow to just under 2%.

Combined with the Fed's quantitative tightening, which will total USD420bn this year, and the ECB's quantitative tightening of EUR270bn until September and possibly more thereafter, well over USD1trn of liquidity is going to be removed from the global economy this year, all other things being equal.

The **Bank of Japan** recently said that they will continue to support Japan economy with monetary easing. Kuroda tends to always sound bullish on the efficacy of BoJ policy but also emphasizing that BoJ easiness will continue so not a new tone, but a slow and broad shift is taking place even if this in particularly is not a shift. Curve steepens in Q3 with an increase in the target. So not in itself news but consistent with the longer running trend we're seeing here where things are looking good so that should enable the BoJ to start steepening the curve, assuming this continues.

Interestingly, the yen has stopped tracking US bond yields (chart) just when a weaker currency might have offered a boost to the corporate earnings needed to feed domestic wage and investment gains. Despite the recent jump in Treasury yields, which can increase the attractiveness of US assets, it is the yen, not the dollar that has strengthened. Japan's currency has risen over a percent against the dollar so far this year and pushed higher even last week, when the BOJ left policy unchanged while noting an improvement in inflation expectations.

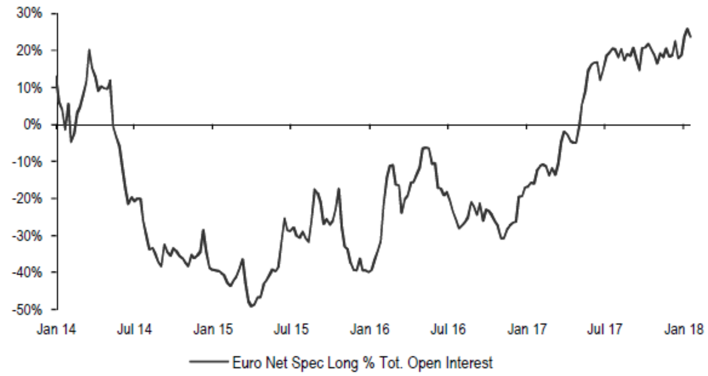


Trades to be monitored

<u>The Eur/Usd</u> has bounced 3.5% since the beginning of the year breaking the highs made last September to levels seen only in 2014.

As we flagged before, <u>the long positioning on EUR/USD was very consensual</u> and it's not a coincidence that most Macro/CTA funds are having good performance Ytd (which are also long Oil). The average CTA fund is up 8% Ytd having the 2nd best January since 2000.

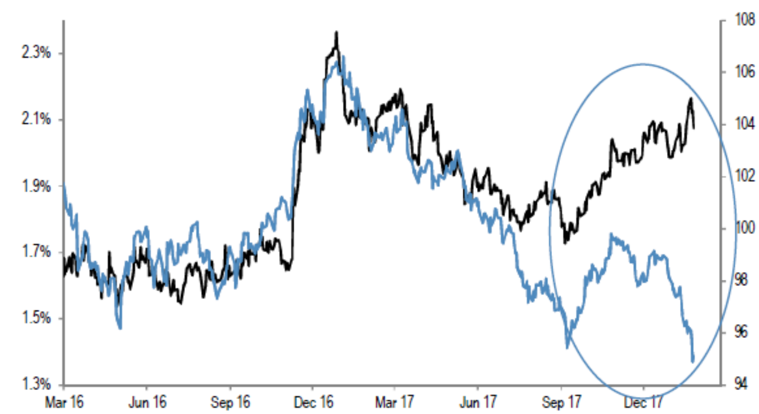
The net long speculative positions are the highest in 4 years (before ECB started QE) and it is estimated to be at 20bn€ vs 12bn€ through December (1st chart).
<u>The move of the € seems very stretched now, we would try playing a contrarian trade long USD. The Eur/Usd has rallied for 7 weeks in a row, the sequence of weekly rallies last extended to 8 weeks only in 2004.</u>



As we have seen above, <u>US activity is continuing to pick up</u>. CESI (Citigroup Economic Surprise Index), which turned deeply negative in April, is now strongly positive and <u>appears to be overlooked by USD so far, but might change soon (2nd chart).</u>

The 3rd chart shows instead the US 10Y bond yield minus German Yield on the black line and the USD Index on the blues. Once again it seems that the depreciation of the $ at current levels is unsustainable.

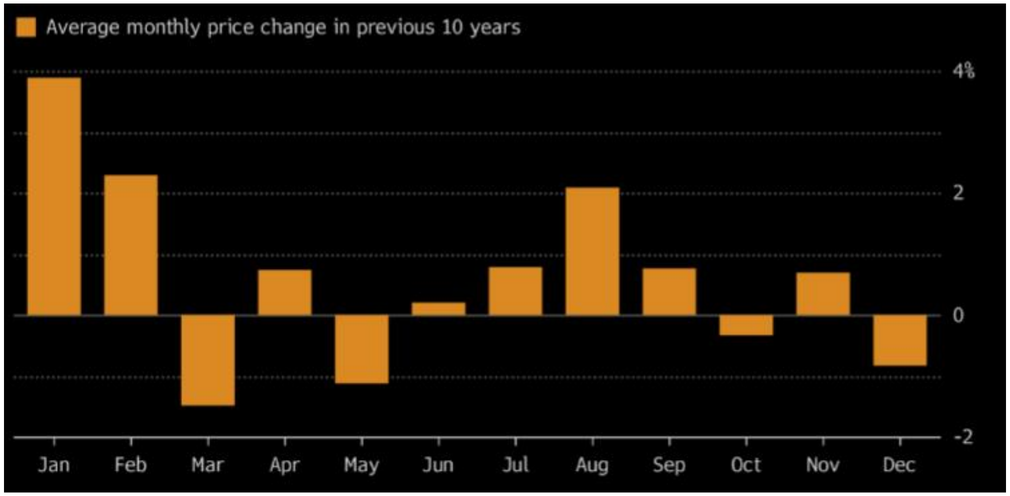
<u>Under the technical point of view we are getting some very interesting reversing signals on the EURUSD and DXY monthly charts</u>, please check below the Monthly chart of the EURUSD (resistance of downtrend started in 2008, negative divergence RSI and many other indicators), please let us know if you want to go more in deep on this analysis.



<u>We think a major driver of USD weakness has come from events and flows from outside of the US</u>. Most recently, oil prices rising 50% from their June low have pushed up inflation expectations in the Eurozone and Japan. Markets seeing the ECB and the BoJ no longer looking to ease financial conditions further has pushed the EUR and the JPY higher vs the USD. Additionally the PBoC has been fixing China's currency stronger, now sitting at the highest-level vs the USD since August 2015 when the CNY was devalued.

On a separate note, Japan's currency may be ready to gain momentum after moving within a 10 yen range against the greenback for the past 12 months. A break above 114.73 would end the triangle pattern and set stage for next near-term target of 118.66.

On **<u>Gold</u>**, as you know <u>we have rightly called the reversal point in the support area at 1250$ explaining over last updates the potential effect of a short squeeze. Once again, positioning has been helpful along the chart for calling these reversals.</u>



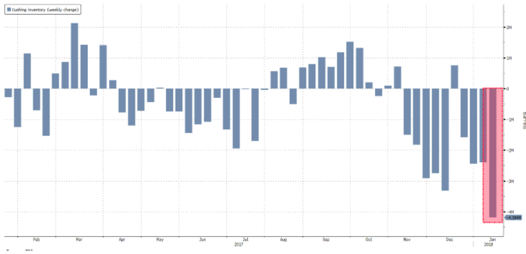
<u>In the middle of December, Managed Money added a 3.3 standard deviation amount of shorts in Gold futures</u> ($2.9 billion notional) and a 6.8 standard-deviation amount of shorts in Silver futures ($1.8 billion notional).

<u>The situation now is dramatically changed as Managed Money are again net long after being covering all shorts and since the beginning of the year</u> there were very high inflows with the best run since mid-2011. Since mid-December, Managed Money have bought nearly 20bn$ of Gold futures and even if the positioning is not reaching yet an extreme we are getting closer and closer.

January is traditionally the best month for Gold (as the chart shows).

<u>We would take some profits as we believe that the main upside on Gold from this level could only be given by the weakness of the equity market.</u>

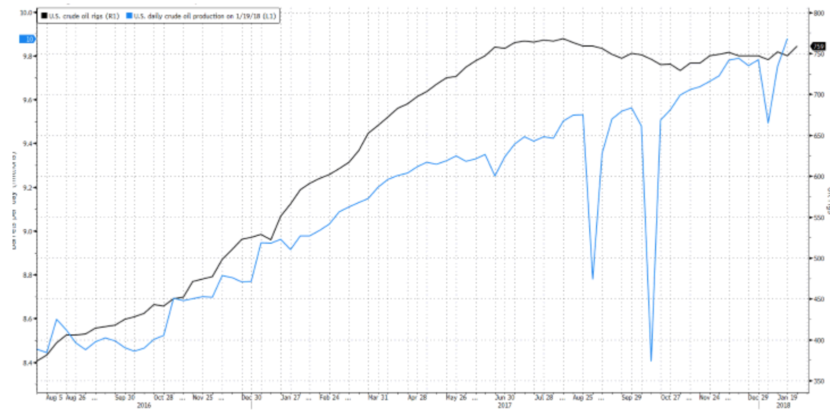
<u>Crude</u> <u>oil is up 7.5% Ytd and +50% from the lows made last June</u>. As you might remember we mentioned that in terms of positioning, all macro-funds and CTAs were short Crude and a break of 51.30$ level would have radically changed the positions of these funds, which are considered to be the biggest movers. <u>CTA funds are now all long Crude and they will comfortable keep these positions having had a positive return of more than 20%.</u>



<u>OPEC and Non-OPEC compliance fell to 112% in December</u> from 125% in November, with the biggest dips in compliance coming from OPEC. Saudi output increased by 90kbd m/m to a total of 9.98mbd, while Angola and Algeria both increased output by an additional 30kbd to 1.04mbd and 1.66mbd respectively.

Even if compliance has decreased, 112% it is still a pretty good level and it is fair to say that both OPEC and Non-OPEC have done a decent job in maintaining discipline.

At the same time, <u>US crude oil inventories in Cushing, Oklahoma, fell 4.18 million barrels last week, the biggest drop since 2004</u> (histogram).



The 3rd important effect is given by US oil production, which is nearing an all-time high as rising West Texas Intermediate crude prices make explorers eager to drill more. Rigs targeting oil in the U.S. surged by 12 to 759 last week. The blue line on the chart shows the daily crude production while the white line represent the number of US crude oil rigs.

The 4th aspect is given by the speculation as interestingly, world oil consumption is ~98 mb/d, but the barrels that leave the country in which they are produced (the internationally traded market) is just ~43 mb/d. At the same time, oil futures trading in Brent and WTI alone adds up to ~2,000 mb/d. In short, the 'paper' oil market is roughly 50x larger than the physical market. Financial in- and outflows can drive the market away from long-run marginal cost for some time.

The underlying dynamics below the Oil price are therefore quite complex. The Iran Oil Minister has recently said that “members of OPEC are not keen on increased Brent crude prices above $60 a barrel because of shale oil".

We are reaching some important technical and political resistance levels and positioning seems also too stretched. Since 2006, there have only been 3 other weeks when Managed Money have added more new longs in WTI futures that the Ytd period. Managed Money’s net long position is now the biggest it’s been (in numbers of contracts).
We now think that the potential ‘pain’ in Crude is considerably skewed to the downside but it could take an extended move for these longs to liquidate.

We should therefore start to see some consolidation around current prices and would start to take some profits (crude price has reached the important resistance of the 200 monthly moving average).

If we look at the commodities in general we need to analyse the **BCOM index** (Bloomberg Commodity Index) which is breaking out to a 3-year highs and we have seen 119bln$ of Commodity Open Interest initiated Ytd an all-time high for this time of year. Previous record for a like number of days in January (since 1996) was $69 Bil in 2013.
The majority of open interest change were on Crude (18% of total open interest from the beginning of the year) and Gold (30% of total interest built since the beginning of the year).

Under the **Geopolitcal point of view** the next important theme in Europe is the **Italian Election** which has been set for the 4rd of March.

The most likely scenario by far is a large grand coalition that should be reassuring to financial markets. Such a large grand coalition could emerge either as a result of parliamentary negotiations around a purely political government (if the centrist parties perform well) or as a result of the intervention of the President of the Republic in favour of something akin to a national unity government (in which case the government may well include technocratic or super parties figures).

The latest polls shows that the center-right coalition is set to gain plurality as a whole (36.7% vs 37.2% one week ago), even though Five Stars (27.8%) could be the single most voted party. The table on the left is the average of the most recent polls.

In US Trump has failed to release his **infrastructure proposal** before the end of January and Economists are questioning whether Congress would be able to pass a spending plan now that it has approved the tax measure that is expected to add 1trn$ plus to the budget.

With the tax reform out of the way, the legislative branch in the US will likely start to focus on the **mid-term elections.** A slimmer Senate majority and mid-term election campaign should limit the likelihood of major fiscal policy changes (independent of whether they would come via infrastructure spending or entitlement reductions). Hence, the US policy focus might shift to areas where the president has more discretion (trade and regulation).

NAFTA negotiations have continued in Montreal this week and debates around trade and tariffs continue to unfold within the Trump administration. The Mexican peso has started to weaken again amid reports that Canadian officials see rising odds that the US will quit the North American Free Trade Agreement.

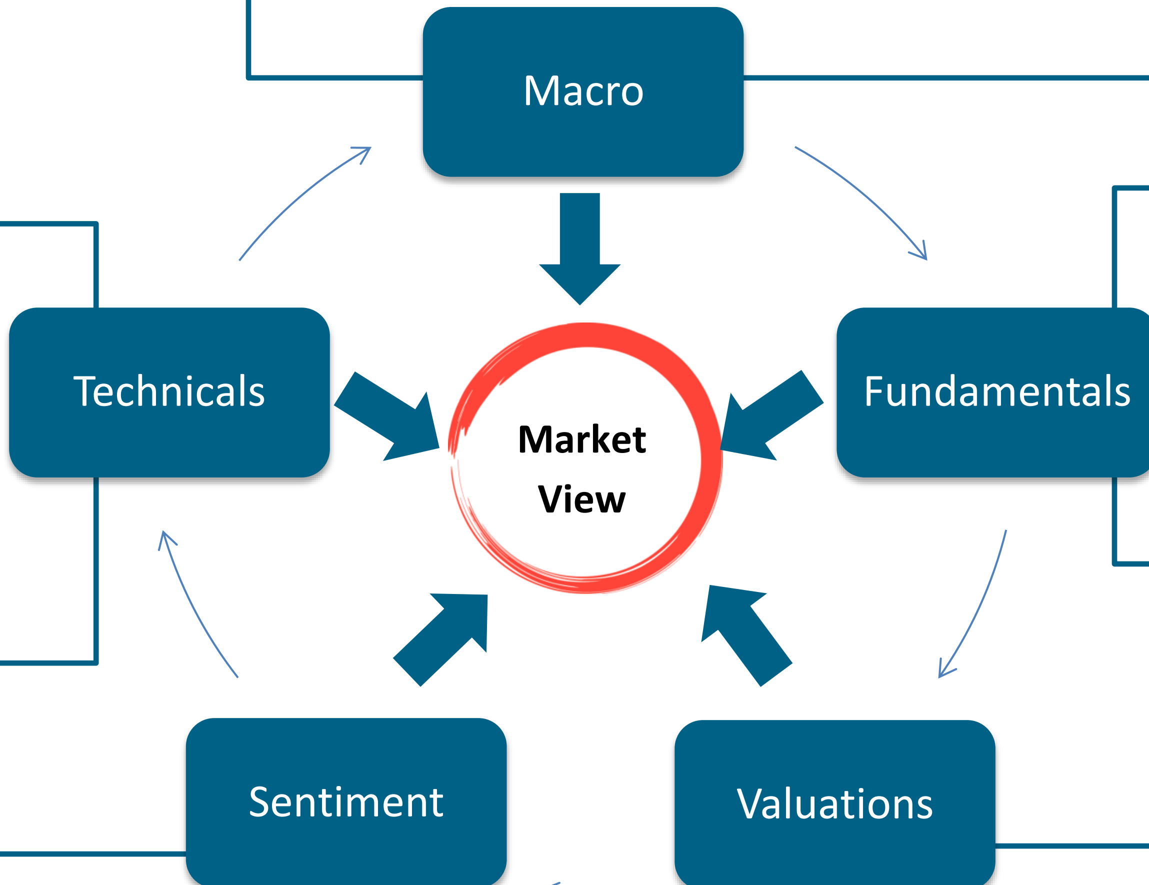
In **Germany**, Merkel's negotiations on forming a new coalition government have run into renewed trouble over migration. Marathon talks over the issue lasted nine hours and went on into the early hours of Monday morning, eventually ending shortly before 2am without the parties reaching agreement.

Merkel's Christian Democrats (CDU) and the Social Democrats (SPD) are working against the clock to hammer out a coalition agreement before a self-imposed deadline of Sunday night. Migration is the issue that refuses to go away for Merkel, even after she gave up her "open-door" refugee policy and agreed to a limit on the number of asylum-seekers allowed into Germany. The parties are also divided over the issue of healthcare as the SPD wants to end private health insurance, and is pushing for reforms to prevent access to more expensive treatment, a policy vehemently opposed by Merkel's party.

We doubt there is popular support in Germany to move forward quickly with grand plans to deepen fiscal integration and governance within the Euro area (such as those proposed by French President Emmanuel Macron). However the market seems to think that Germany will continue to play its necessary role underwriting the Euro project that can fly beneath the radar of sceptical German voters.

Executive summary and conclusions

BUY: Global Economy could remain in expansion mode for the whole 2018. Data continue to be good even if we have reached a difficult hurdle. Inflation is finally starting to pick up globally.
Cycle indicators remain in expansion across all regions, supporting an equity-heavy and HY-light portfolio. But risks of a 'signal switch' over the next 12 months are starting to appear elevated when looking at what typically derails cycles..



SHORT-TERM NEGATIVE: Positioning is still extreme and exhuberance is eccesive. Seasonality and "beginning of the year dynamics" are however powerful and helping the markets to be sustained also helped by lack of selling pressure.

Q4 reporting season to be monitored: GDP pushes top line higher with earnings growing.
Q4 season has just started, will be interesting if consensus will be beaten again.

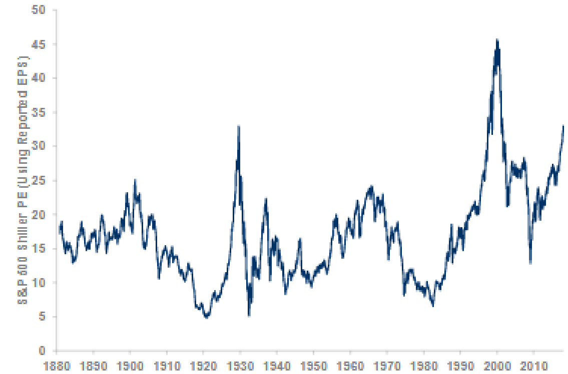
SELL: extremely high complacency, very low levels of cash...

NEUTRAL: valuations are stretched. US equities in particular are looking "challenged". Everybody is talking about "synchronized global economic vigour". Cyclicals are stretched. MSCI Europe trades at 15.0x forward P/E, S&P at 18.5x. Europe looks to be a better spot in relative terms.

The MSCI World has closed positively in January for the 15th consecutive month, an historical record (strongest start of the year in more than 25 years) and the Dow is having the longest stretch without a 5% drop in 120 years.

The start of the year has been impressive and despite the many positive factors we have analysed, there is the feeling that the market is in a "melt-up" or "fear of missing out" phase.

We are in the second largest rally ever for the US market but also in the 2nd greatest expansion. We have witnessed the 2nd best beginning of the year for the US market since 1987 but we are also in the longest period without a 5% correction on the S&P and we are witnessing the worst start ever for the Bond markets. We are also at record high levels of overbought (RSI above 89) and we have seen similar levels only 3 times in history.



Today's S&P shares some similarities with 1929 & 2000. In the last week the relative total return of US stocks versus US bonds has breached 2000's prior peak and the S&P's Shiller PE has moved up to 33, which is comparable to the peak reading seen in 1929. Although US equity valuations are still some way below their own 2000 peak this should provide limited comfort to investors (1st chart).

Total return from US stocks over US bonds has been 10% in 3m. Investor sentiment continues to rise with recent 60% reading on the AAII 'bulls' index (the highest since 2003) the latest evidence of animal spirits. This optimism is putting upward pressure on both equity prices and bond yields such that the total return on US stocks has exceeded that on US bonds by 10% in just three months. Further, this latest move has finally lifted the relative total return of US stocks versus bonds above the prior peak seen in 2000 (2nd chart).

The S&P has more than tripled since the '09 lows and the cycle-adjusted P/E is currently at 32x, 93% above the long-term average. Historically, from these P/E levels, real capital returns have tended to be minimal over the next ten years.

Fund flows started the year on a very strong tone. A massive $50bn or 1.5% of total AUM has been poured into Equity ETFs alone in 4 weeks. This flow is 50% higher than the same period of last year and last year was already a rather strong year for equity fund buying with an estimated $541bn injected into equity mutual funds and ETFs.

It is therefore not a coincidence that we have started to see a pick-up in volatility and some market correction towards the end of the month. We will analyse below more in detail the most important market factors to monitor but given that complacency is very high, the market is in a state of euphoria, Gross Leverage has increased to 168% and cash is at multi-year lows.. it cannot be a surprise to see some weakness.

Investors have been selling volatility and basically betting that tomorrow will be as calm as today. We estimate that there are over 2 trillion $ in these kind of short volatility strategies. Putting this number into a context, you have 20 trillion $ in central bank balance sheets. Then you have 8 trillions worth of negative yielding bonds and 5 to 6 trillion non-investment grade bonds that trade at a yield of close to 2% and then you have the 2 trillion in short volatility strategies. These strategies are just the top of the pyramid of what could be a big issue for the market.

We mentioned over the last updates that we were still keen to participate to the upside of the market and would have used any additional strength to reduce the weight and buy cheap volatility to protect portfolios. We would now suggest starting this process with more urgency as we might have a correction along the month of February.

The divergences in global equities and market breadth continues to deteriorate in all market segments. Against the new index highs, we have fewer stocks making new highs, fewer stocks trading above their 20-day moving average (trading momentum indicator) and also the number of stocks trading above their 200-day moving average, which indicates that also from an investment standpoint we see more and more stocks rolling over.

There are growing signs that the now-persistent trend of rising share prices and stronger economic data is prompting something of a "capitulation in caution" with US investor optimism rising sharply. For example:

- the AAII 'bulls minus bears' score has moved above 30 for the first time in three years;
- Investors' Intelligence 'US Advisors' net bullishness index' is now up to an all-time high;
- Sell-side Prime Brokerage Content data suggests that US hedge funds net leverage rose sharply in Q417 and in January 2018;
- CBOE put/call ratio is still at extreme lows;
- The RSI on S&P has reached last week the second highest level it has reached since 1928, a whopping 93. With the RSI, a reading above 70 is typically considered overbought territory. We chose 80 as a higher barrier; the index has remained above 80 since the end of May
- The S&P is also trading on the line of the second standard deviation where most of the time it generates an inversion-signal.

Our suggestion is that **avoiding a nasty drawdown at the beginning of 2018 could make all the difference in the performance to starting what is likely to be a much more difficult year to trade than 2017**. 2018 is likely to prove a trickier year for equities despite a good macro backdrop. A combination of overbought momentum and a polarised market makes crowded trades look increasingly precarious.

The following are the potential positive and negative catalysts and will be followed through the course of the year.

Positives:

1) **Growth** momentum might have peaked, but activity is still likely to remain above trend. 2018 might be the second year in a row without EPS disappointments. Global weekly EPS revisions (the ratio of analyst upgrades to downgrades) were outright positive the whole of the year. **We will soon find out if Earnings are going to act again as a positive catalyst for the market.**

2) **Central banks** tightening is still in early stages, with US real policy rates outright negative at present. None of the last 8 downturns started with real rates below 2%. Any inflation pickup would act to reduce real rates further. Yield curve is unlikely to invert until at least until 2H, and crucially, stocks never peaked before the yield curve would be outright inverted.
The liquidity withdrawal will be gradual and that Fed will remain very sensitive to the conditions within risky assets at least in the first stage. It seems highly unlikely that the Fed will persevere with hikes in the case equity markets deliver a meaningful correction.

The latest market expectation is that the 2year-10year curve is likely to flatten much further from here, in essence ending largely flat by year-end. The curve flattening is nothing unusual while the Fed is tightening. In the last six episodes, the yield curve was flattening every single time that the Fed was tightening. We also know that the inverted yield curve was a good predictor of slowdowns. Looking at the last seven US recessions, the US yield curve would invert ahead of every single one but crucially equities did not tend to peak before the signal was reached, before the curve inverts, they peaked only afterwards.

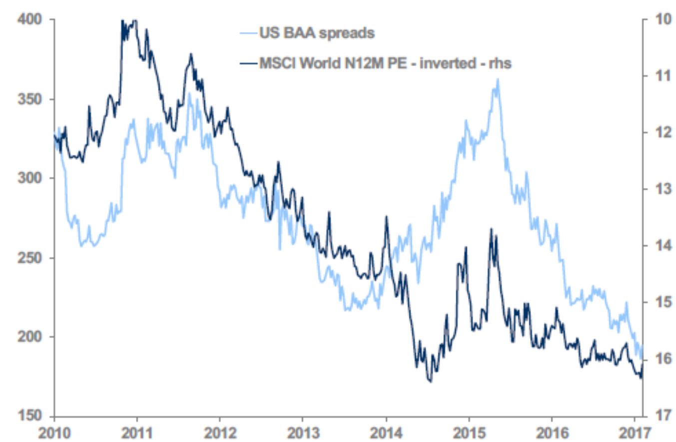
3) **Equity multiples** do not look cheap in absolute terms, but relative to both bonds and to credit, we find equities continue to offer a valuation gap. Compared to equities, which show a small P/E premium to historical, bond yields are significantly below their averages, trading close to the 30-year lows. Relative to credit too, equities keep trading favourably. The gap between the dividend yields on stock vs the high-grade yield that these stocks borrow at is as much as 230bp, on average in Eurozone.

Negatives:

1) **US Cycle is 9 years old**. The longevity of the current US upcycle is a concern, as it is approaching the longest on record since WW2.
We have currently reached 103 months of expansion. The S&P 500 Index's price-sales ratio, which surpassed 2.2 is approaching a bull-market peak of 2.25 dating from March 2000. Other gauges in a similar position are the 10-year Treasury note's yield, wage and price inflation, unemployment, oil prices and the dollar.
Another reliable indicator of US recession risk is given by the jobless claims. If **weekly claims** move up by 10% or more qoq, the bearish signal would be reached. Every single time that claims moved up by this or greater amount, we had a recession, and we did not have any false signals.

2) **Pace of global monetary policy tightening to pick up**. Although central banks are likely to continue moving slowly and carefully in 2018, we should nevertheless see a pick-up in the pace of monetary tightening. The market expects 3 to 4 Fed rate hikes over the next 12m, while 2H18 is also likely to see the conclusion of the ECB's tapering program and the first increase in the BOJ's long-term interest rate target.

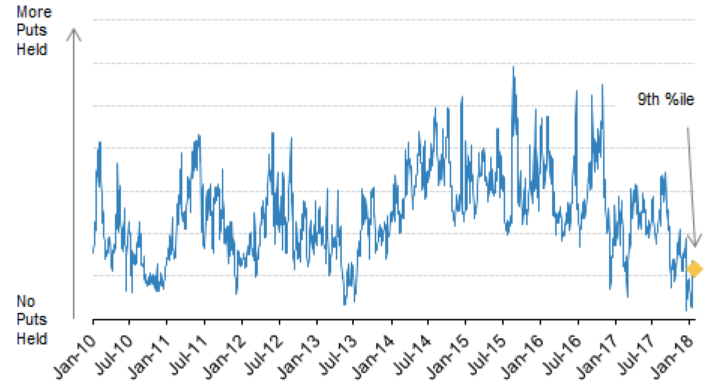
3) **Credit spreads set to widen**. A combination of tighter monetary policy, record spread valuations and high leverage (especially on US corporate balance sheets) looks set to weigh on credit markets going forward. We forecast spread widening in all regions with the biggest move projected in the US. As shown in the chart, there has been a tight link between credit spreads and the PE ratio for global equities. Equity valuations have been negatively correlated to credit spreads in this cycle, the chart shows the correlation between US BAA spreads and the inverted curve of MSCI World 12Months Price/Earnings. It should be also added that High Yield spreads are in complacent territory and is not compensating one much for holding risk. If the spreads start to widen, equities will not ignore that.



4) **Higher volatility**. A backdrop of less liquidity provision from central banks, higher interest rates, a peak out of economic, and earnings growth momentum is likely to lead to more volatility in asset classes this year. Again, this is likely to put downward pressure on equity valuations.
We think that volatility has already bottomed out, market risk has tumbled while global equities have kept on hitting fresh peaks.

There are about $60bn explicit short volatility strategies and these are only the tip of the iceberg as the biggest dangers lie underneath the surface. We estimates that there are $2tn of implicit short vol strategies involving risk parity, VAR control, CTA funds are at the mercy of a flip in correlation between bonds and stocks to positive which historically is not unusual.

Volatility is not simply an external measure of the market but rather an implicit factor that could disrupt risk markets.



This week we have seen volatility squeezing higher as equity markets move lower, and given current positioning the trend towards higher volatility likely continues. **Both investors and dealers will need to buy volatility if the market sells off, making a still flat SPX skew underpriced.**
The current situation is quite rare as **most investors do not own puts and are under protected (**meaning they need to buy options or sell stock as markets fall, see chart with estimated put held by the market) but there has been enough concentrated OTM (out of the money) put buying by a few investors than means dealers are short downside puts and downside volatility and need to buy volatility as markets fall.

On top of this important factor, we also need to consider that the **net position of VIX ETPs has become short over the past few weeks, for only the second time in their eight year history**. Though some may view this as excessive risk taking, we are less worried about this net number and more concerned about inverse and levered products' flows that would be generated by a rise in VIX futures. The potential for short and levered ETPs to start buying VIX futures quickly on a sudden vol spike (issuers would be driven to buy $110mm vega on a 3-point spike in VIX futures, for example) has grown, making short-dated VIX-based hedges timely. The 2nd chart shows the Vega outstanding ($mm per VIX futures point) of major VIX ETPs.

5) **A flat US yield curve**. Markets may react more cautiously to a flat curve in this cycle, given the very low level of policy rates and the potential signal from the curve that the next downturn could occur with very little scope for central banks to react by easing monetary policy. The yield curve is among the best market signals for a recession. Since the 1950s, there has not been a US recession without the yield curve inverting. Historically, the front end has driven the majority of the flattening during slowdowns, the US 10-year yield has been flat to slightly up, on average. But this time, most of the bear-flattening has been driven by US 10-year yields, which might distort the signal.
Also, Rising US HY credit spreads late cycle have also signalled rising recession risk historically, although there have been a few false signals (in 2015). Given the search for yield and lower liquidity in credit markets, the signal from credit for recession risk might be less reliable. However, as mentioned above, we think credit spreads would likely need to rise from here to signal concern more broadly for risky assets.

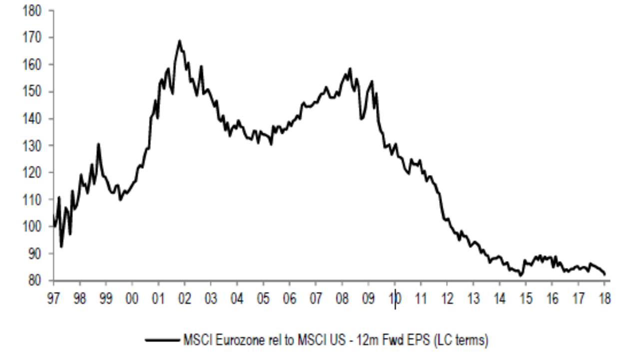
Another important factor that could potentially gain the attention in the next weeks is that at 2.7/2.8% the US 10Y yield is exceeding the dividend yield on the S&P which is roughly at 1.8%....

As you could perceive from the points above, the result is that if we have to choose the Asset Class where to be invested we prefer Equities and we are particularly positive on European equities.

Equities should be a natural inflation hedge as their earnings are strongly correlated to PPIs, they could benefit from improving pricing power, better top line growth and a reallocation of investor flows. Even if equity valuations are not cheap in absolute terms, b in the past 15 years, the correlation between P/E multiples and bond yields was positive rather than negative.

Why do we like Europe?

1) **Attractive macro outlook.** All Brokers have upgraded GDP forecasts for the Euro Area again and see 2018 as a second year of >2% growth followed by 1.9% in 2019. Despite strong above-trend growth, the ECB looks set to maintain an extremely easy monetary policy setting, while fiscal policy may also ease further at the margin.
The key drivers of the Eurozone domestic recovery appear to be well aligned. The unemployment rate has already moved below its long-term average and we should expect it to continue falling in '18 and be a positive for the consumers.
Eurozone valuations are attractive, both in absolute and in relative terms. The region has seen inflows in 2017, but this has not translated into higher multiples. Eurozone P/E has barely moved over the last two years, contrasting with the re-rating seen in all the other regions. The 1st chart shows the 12-month forwards EPS of MSCI Eurozone vs MSCI US.



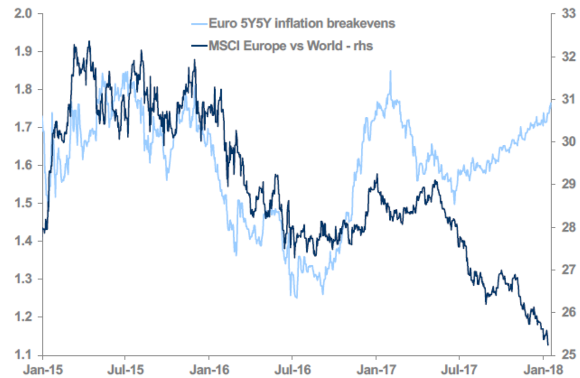
2) **Eur strength to moderate**. The relative performance of European equities has been highly negatively correlated to moves in Eur this year, so a potential Eur depreciation is helpful and the drag on European earnings from FX should now mostly be behind us. The profit warning we had on Infineon on Wednesday was due to the dollar weakness.

3) **European credit supported by ECB**. European credit markets should be less vulnerable to any wider global sell-off in credit markets, given continued purchases as part of the ECB's QE program. In addition, European companies are less levered than their US peers and Europe's relative equity valuation has badly lagged its relative credit valuation
Credit conditions appear favourable in Europe, with rising loan growth, easier Banks' lending standards and still subdued interest rates.

4) **No flattening in the Euro Area yield curve**. The region's relative performance has correlated positively with bond yields in this cycle. While the market is forecasting lower yields and a flatter curve for the US, market is expecting higher yields and a steeper curve across European bond markets.
In addition, the relative performance of Europe was typically strongly linked to the direction of bond yields, as the region is Value heavy. If higher yields materializes next year, Europe will likely be supported.

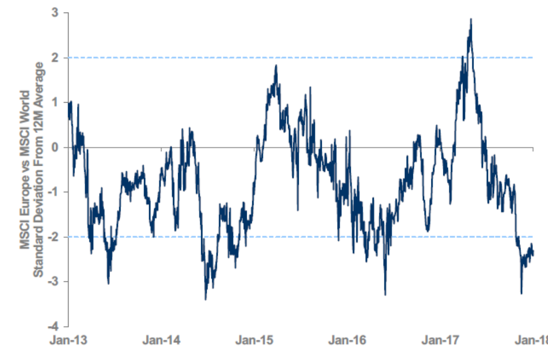
5) **Investor sentiment is more downbeat in Europe versus elsewhere** and there has been a reduction in hedge fund net exposure down to 18-months lows (2nd chart).

6) **Europe has lagged the rise in bond yields and inflation expectations**. Europe should be a relative beneficiary of 'reflation' (i.e. stronger nominal growth) and, in this context, its recent underperformance versus both bond yields and inflation expectations looks overdone. The 1st chart shows the relative performance of MSCI Europe vs World (black line) and Euro Inflation.



7) **Technically Europe is oversold**. The relative performance of the MSCI Europe vs MSCI World is striking, we have now reached the 2nd standard deviation (2nd chart).
After hitting "peak optimism" in May post the French election, Europe has underperformed the US consistently over the last 6 months as tech has helped the US hit new all-time highs whilst EUR strength and negative relative earnings revisions have weighed on Europe's relative performance.

The unemployment rate dropped to 8.7% in November from 8.8% the previous month, according to a report from Eurostat on Tuesday, this is the lowest level we had since early 2009.



With Europe now at 12 month relative performance lows , it looks set to outperform into 2018, led by banks and oils. Europe is on track to underperform for the eighth time in nine years, MSCI Europe is now close to its lowest ever relative levels versus MSCI AC World.
The strong rally in Tech YTD has been a big headwind for the relative performance of European equities, given that IT accounts for just 5% of MSCI Europe market cap, compared to 18% for MSCI ACWI and 25% for MSCI US.

Positioning. Over the past 3 months, Eurostoxx50 has underperformed SPX by ~8% (5.5% in USD terms). This has created a notable divergence in futures positioning (only this extreme 16 times since 2002), which is causing some to question the sustainability of this underperformance in the face of still very robust data in Europe.
The last **30-day build in net longs in E-mini S&P 500 vs. net shorts in EuroStoxx 50 futures now amounts to $57 billion notional (nearly 10% of total open interest).**
European equities have gained 6.5% in 2017, these returns lag in comparison to US equities (S&P 500, +19.4%)
Since 1990, the Eurostoxx has shown a positive return while underperforming the S&P 500 by > 5% in 6 other years (1991, 1995, 2003, 2013, 2014, 2016).
Following these years, the Eurostoxx has performed very well in the Q1 that follows with a 6 up / 0 down and a mean return of 6.84%

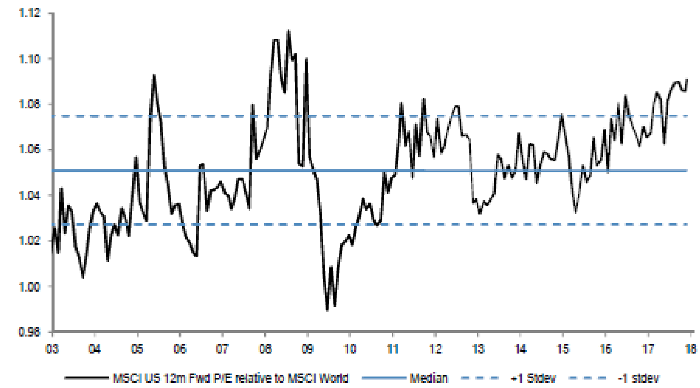
Why are we more negative US?

2017 has been one of the best years for equity investors in recent memory. Not only have absolute returns been high, but every sector has participated with the exception of Energy and Telecom Services which represent less than 10% of the index. If that wasn't enough, the largest drawdown this year for the S&P 500 has only amounted to less than 3%, tying the smallest we have seen in 38 years!

While we are not calling for the end of the cyclical bull market yet, as we mentioned over last few updates, we think the odds of that happening during 2018 are higher than a typical year and much higher than it was during 2017.

US equities are currently trading on 18.5x 12m forward P/E, the highest in almost 14 years. In relative terms, US stocks have also strongly re-rated over the last few years, to be now more than one standard deviation expensive (1st chart on the side).
Beyond this, the US re-rating could be structural as the share of Internet and Tech stocks in the overall US equity market has grown materially, from 15% 10 years ago to 30% at present. FANG (Facebook, Apple, Netflix, Google) is up already 22% in 2018, how can continue to perform at this pace?

The relative weight of the Tech growth category within the US equity space has become so considerable that leading large cap market indices are dominated by its behaviour. Without strength in large cap growth the leading indices of US equity cannot go far.

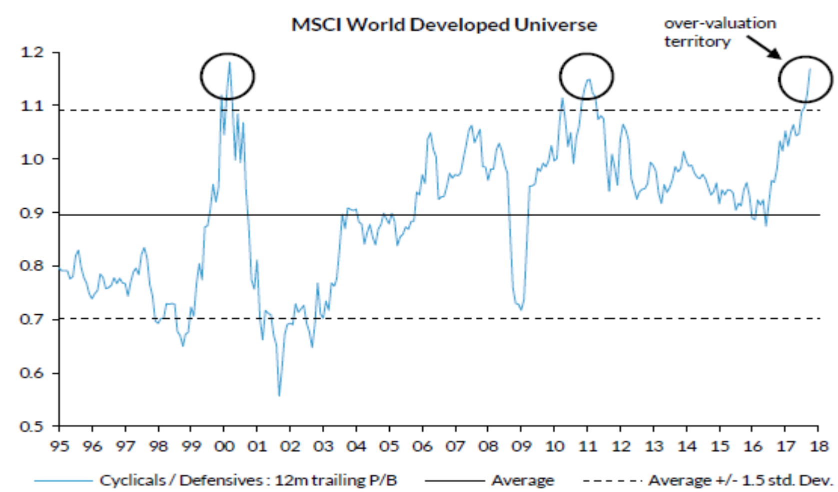


We reiterate the 3 things we believe investors can do to equip portfolios for whatever 2018 brings:

1) **Buy some portfolio insurance through derivatives** (Put-spread is still our favourite vehicle);

2) **Buy anything you can find with less cyclicality than the overall market and trading at discount**;

3) **Continue to invest in those regions with the best economic momentum. The cyclical growth universe within developed equity has entered the territory of relative over-valuation** (chart on the side).



Investment ideas

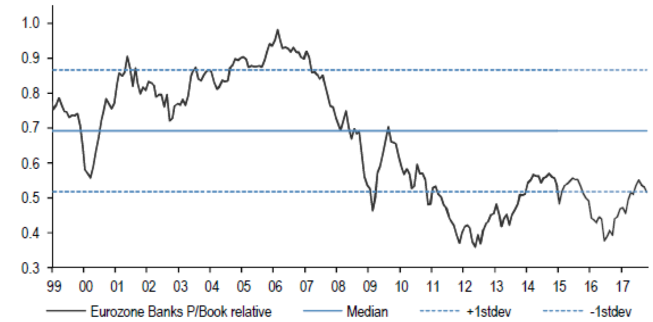
- **<u>Long EU Banks, SX7E Index</u> (+9.0% Ytd, they have been outperforming the market from the beginning of the year).** Banks are still one of the few sectors to offer upside to both valuation and profitability going forward. Valuations are at the 10-year ‘crisis’ average and could re-rate by 10%+ given lower risk profile and better growth. Consensus EPS forecasts for the next 2Y look too low.

  We see their earnings benefiting from a potential further increase in bond yields as ECB starts tapering in ‘18, from the ongoing recovery in credit growth and the fall in NPLs.

  The recovery in private loan growth is gathering pace across Eurozone, which is driving the rebound in Banks' profitability.

  Typically, Banks’ ROE averaged 9.7% in a 2-3% GDP growth environment for '18, and P/B was 1.6x. This compares to 8.5% ROE and 1.2x P/B at present.

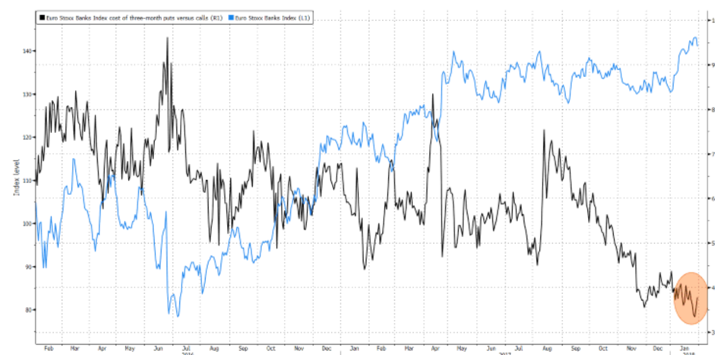
  <u>Banks have seen positive and stronger EPS revisions compared to the Eurozone market.</u> Likewise, Banks’ P/Book relative is still below the historical median. As balance sheet repair comes to an end and earnings grow sustainably again, we believe that the sector could re-rate (chart)



  We like the banks sector as a value cyclical over 'early stage cyclicals'. Historically, when PMIs are as good as it gets then many investors tend to take profits on growth cyclicals, but you still tend to see the overall index rally. In order to get above 3700 on SX5E you need financials (22% of index) to rally significantly and it makes sense to us that investors will move out of other sectors considering where the data points are and move into banks, particularly if yields start to rise in a significant way.

  <u>The sector has had a strong run in a short-time and is overbought like the rest of the market. Yields might also contract a bit before they will get higher. We would then start to take some profit with the idea of getting in back at lower prices.</u>

  Interestingly, investors are now optimistic about the trajectory of financial stocks and the cost of hedging against declines in the sector is hovering near the lowest level since at least 2015 (2nd chart), this is consistent with the idea of taking some profits.



- **<u>Long Energy Sector, SXEP Index</u> (+2.3% Ytd and +8.5% from our buy signal).** The energy sector has seen in Q3 more EPS upgrades since 2008 when oil was at 146$. The sector has actually seen the strongest rise in NTM earnings of any sector in the S&P. Oil demand growth outpacing supply is what drives the outperformance of Energy equities late in the cycle. Global oil demand looks to be growing above its historical trend rate now for the third year in a row and we note that in Q2, global oil demand increased more than 2 mmbd, nearly double the trend rate of the period 2004-14.

We expect European Big Oils to generate the strongest FCF in over a decade in 2018 allowing for full cash coverage of capex and dividends from Q4 2017. We think the sector is entering a positive cycle of earnings revision, with 16% median upside to 2018 consensus EPS, supported by the end of scrip dividends and the start of a buyback cycle.

Energy equities have lagged the upward move in the commodity, and the relative P/B of the sector still sits near 20-year trough levels. With the positive backdrop we outlined above, we suspect that this low relative valuation is untenable. The chart on the side shows the Energy P/B relative to the S&P 500.

In addition to the relatively valuation lows in the sector, investor positioning in Energy equities still looks exceptionally light.
<u>With the buying flows we have seen in January, it is the first time we have seen three consecutive months of net energy buying since Q216.</u>

- **<u>Long EU Telecoms, SXKP Index</u> (-0.8% Ytd)**: underperformance has been massive, valuations appear very attractive. Telecoms' profitability is improving as both top line and earnings are growing. Telecoms' Q3 results were encouraging and we now expect decent Q4 numbers. FCF could be bottoming out as capex growth is expected to soften. Pricing has diverged from the overall CPI in the past 12 months, resulting in a significant underperformance, but this should start to change.
  Without doubt, positioning is bearish into 2018 which is helpful at least and valuations low with a 5% sector dividend yield and 6x EBITDA multiple.

- **<u>US/ German rates</u>:** We continue to stay bearish the long end of the yield curve and recommend to shorten duration on strength.

- **<u>Buy Put-spreads on US Indexes</u>**: as explained above **we would take advantage of low volatility in order to spend few bps and protect the portfolios from a potential downturn of US equities.**

  <u>A Put spread on the S&P strikes 2775 (out 1.6%) / 2550 (out 6.0%) expiring on the 16th of March 2018 would only cost 0.6bps for ever 1% notional of the portfolio covered It is still very cheap as the volatility is at 11%. The current delta adjusted position would be 12%.</u>

- **<u>Gold</u>**: as explained above we would continue to take profit.