Monthly Market Update

Monthly focus on the financial markets

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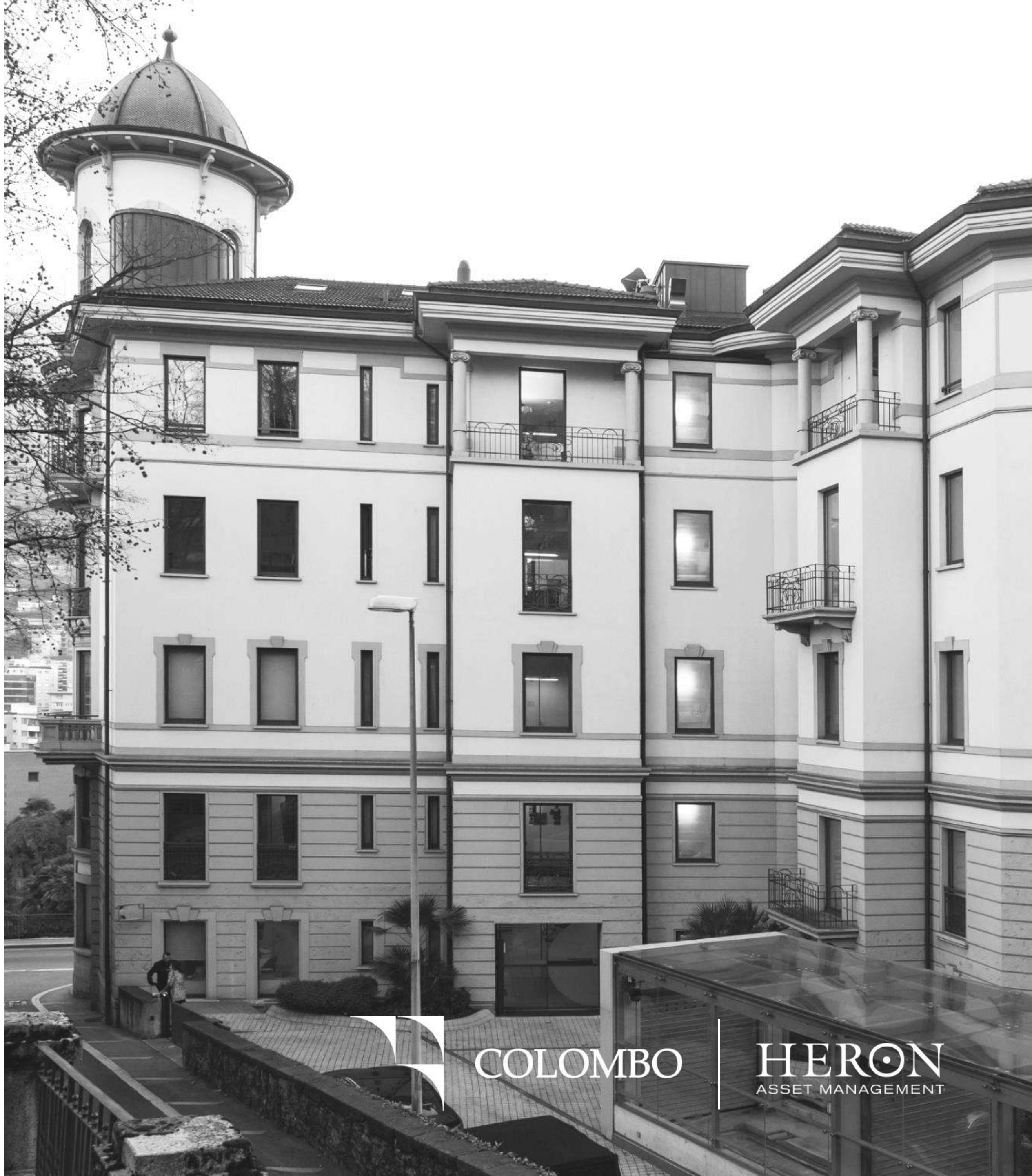


Market Analysis

The longest bull market in history ended last year with a very quick 3-month correction. The S&P had its worst December performance since 1931 and, the fact we couldn't have a bounce during a statistically very benign month of December, clearly shows that we are approaching a special moment in market history, the beginning of a bear market.

Poor volumes and the particular time of the year for the month of December were particularly disorientating for the investors. December last year saw the poorest performance for US equities since the Great Depression.

S&P Historical December monthly returns

We have witnessed a very difficult year with the worst US performance in a decade (US stocks lost nearly 6trn$ from the top), China down 25%, Nikkei -12% and Dax -18%. **2018 has been the worst year since 1901 if we consider how many asset classes have generated a negative performance in $ terms**. 89% of the world different asset classes have closed negatively vs 84% in 1920. Volatility has been very high, on the S&P we saw the most +/-2% spot moves since 2008.

This is in stark contrast to 2017 as it has been the best year ever in terms of number of asset classes closing positively with only 1% in negative territory (Philippines Bonds).

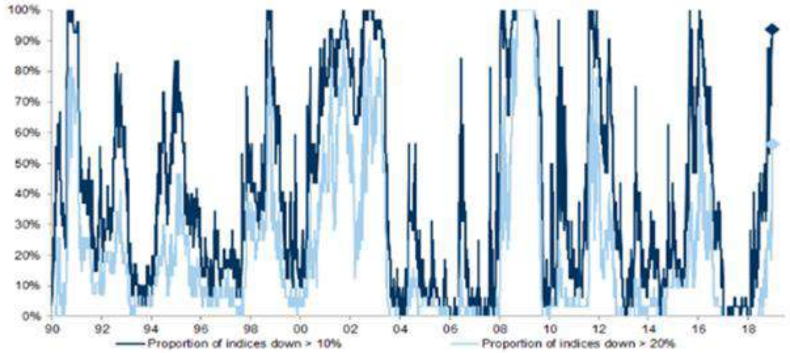
On average in the last 117 years, only 29% of asset classes had a negative performance at the end of the year.

After a very poor December, more than half of global equity markets were in a bear market (down more than 20%) and almost all were in a correction (down more than 10% but less than 20%).

This is what we already called the "beginning of a bear market", there is not enough demand to support sustained rallies because there has been too much profit/loss destruction and the volatility of people's portfolios is too high.

Proportion of global equity indices in a correction of bear market

Proportion of indices down +10% (dark line)
Proportion of indices down +20% (light line)



Market Analysis

We have been cautious since the beginning of the last year suggesting to buy volatility (which actually touched historical lows in January) but it was certainly difficult to predict such a dramatic end of the year.

During 2018, the global macro backdrop has worsened materially and risk premia across assets had to reprice this. Exactly one year ago, investors started with a bullish tone despite the difficult valuations owing to the longest bull market in balanced equity/bond portfolios in a century. This rally was in part due to structurally lower macro volatility since the 1990s, but in 2017 the 'Goldilocks' backdrop specifically, drove a carry-friendly low vol regime. The elevated valuations pointed to lower returns across assets and more drawdown risk in the event of growth or inflation shocks, with bonds unlikely to buffer equity drawdowns and equities likely to suffer from rate shocks.

The deleveraging has been massive and quick, no wonder about who was behind this selling pressure as we have been flagging in recent months the vulnerabilities from Equity Long/Short hedge funds and multi asset funds such as Risk Parity and Balanced mutual funds.

Over the past six weeks we had the largest single weekly equity mutual fund outflow on record with more than 100bn$ in December.

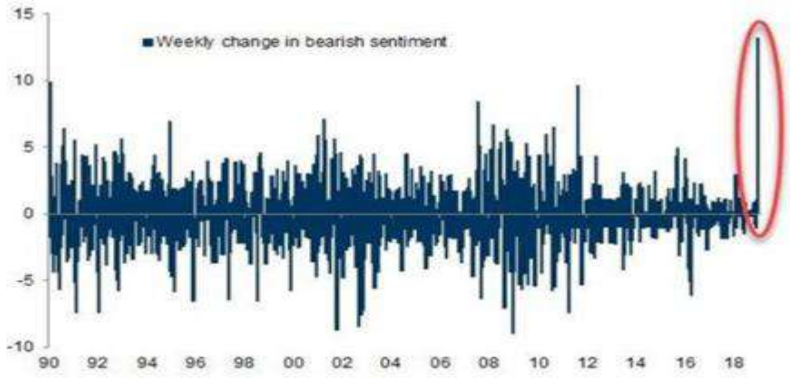
Importantly, the funding has dried up for the first time since the last recession with US Junk bond issuance falling to zero in December.

Investors have withdrawn nearly 13bn$ from US leveraged loan funds during the past 6 weeks, the CLO (Collateralized Loan market) has traded very little in December similarly to the beginning of the last recession.

Over the last 2 weeks of December, Money Market funds attracted a whopping 81bn$. We have rarely seen such a high level of cash raised in such a short time-frame.

At the end of the last month, the increase in bearish sentiment as measured by the Investors Intelligence survey during the last week of 2018 was the largest pick-up on record by a wide margin.

Weekly change in bearish sentiment (blue line)

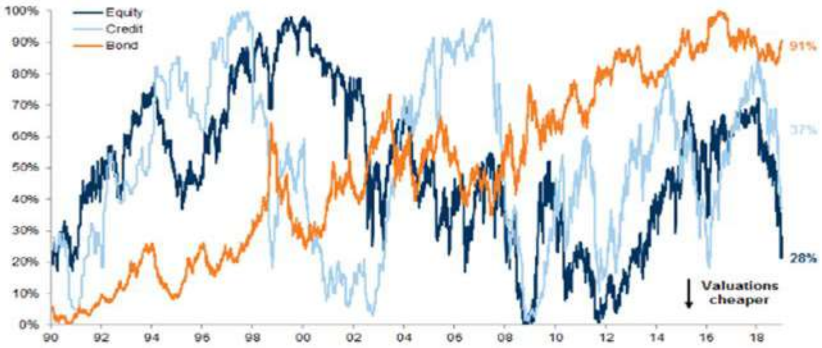


Valuations for risky assets have declined materially and are below the 1990s average. Equity valuations have de-rated due to a combination of price declines and still positive earnings growth. Credit spreads have widened across regions and the quality spectrum. US HY credit spreads have risen more than 200bp in the past three months. Only global bond valuations remain high, in particular after the recent rally.

Market Analysis

Valuations across assets have started to decline sharply in 2018 in particular for risky assets.

Equity valuation (dark blue line) vs. Credit valuation (light blue) vs. Bond (orange)

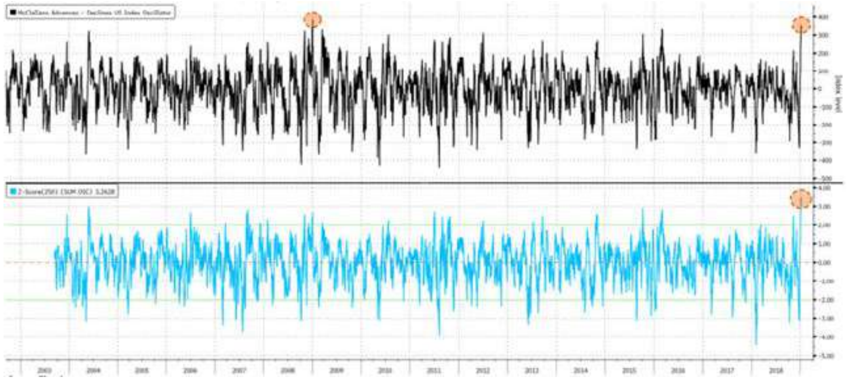


We are therefore not surprised to have seen the rally we got since the close of the 24th of December as positioning and sentiment has changed too quickly and reached an extreme.

Cyclicals and the most battered stocks have outperformed (mainly for short covering) the Defensive names in a 4x standard deviation move.

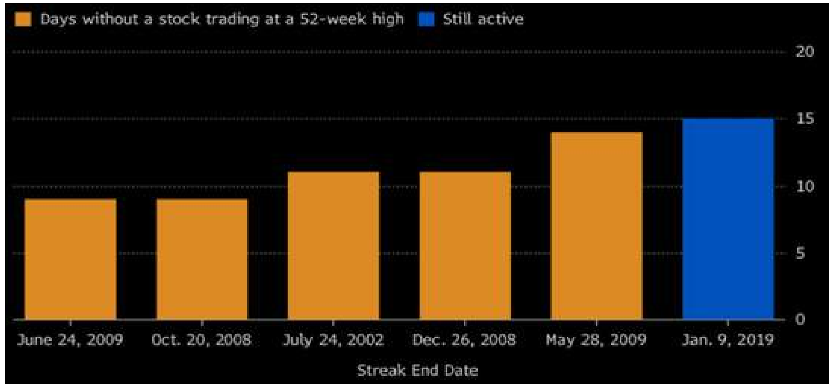
The S&P has bounced more than 10% in 3 weeks, Eurostoxx +5%, Nikkei +6%, China +4.5% and, typical to Bear market rallies, we have gone from extremely oversold to overbought. The McClellan Oscillator, a measure of the market breadth, hit a level not seen since the depth of the financial crisis for the US market, more than 3 standard deviations away from its mean.

McClennan advances – declines US index oscillator (black line)
US Z scores (light blue line)



It is however also important to see the single standout in order to illustrate how deep, widespread and painful the end of 2018 was for US equity investors, no stock in the index has yet reached a new 52-week high in 18 trading days, the longest stretch on record.

Days without a stock trading at a 52-week high (orange)



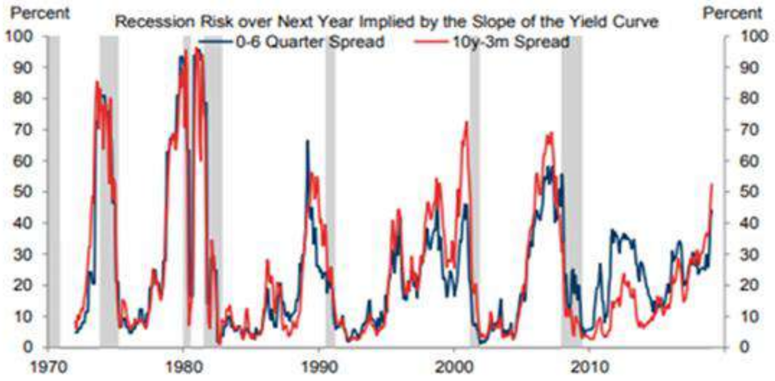
Market Analysis

<u>Investors have become more concerned about a possible recession in recent months, as financial conditions have tightened and growth has slowed.</u>

If we use statistical models introduced by Fed researchers to translate two market measure, the slope of the yield curve and credit spreads, into a market-implied recession probability. <u>Both measures now indicate sharply higher recession risk than a few months ago and combining the two suggests that the market sees a roughly 50% chance of recession over the next year</u>.

Slope of the Yield curve now points to a sharply higher recession risk within a year.

0-6 Quarter spread (blue line) vs. 10y-3m spread (red line)



Looking at different asset classes, a 55% chance of a US recession is reflected in today's level of US HG corporate credit spread. Similarly, the recent 70bps fall in 5-year US Treasury yields from their early November peak points to two thirds chance of US recession on our assessment.

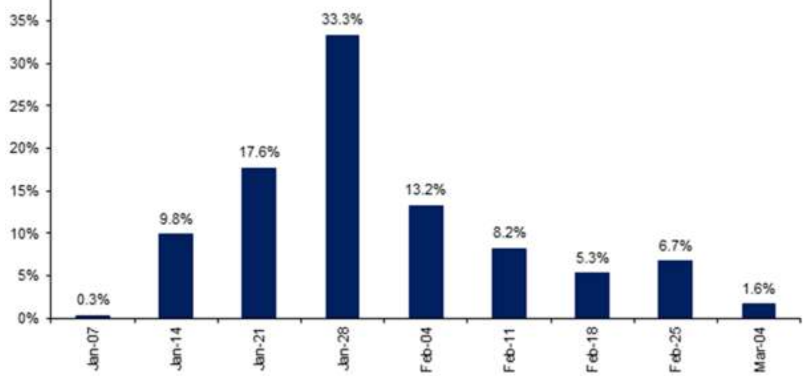
The performance of industrial metals over the past months suggests that commodity markets price in around a 56% chance of a typical US recession, in line with US HG, UST and US equity markets.

Therefore, considering the signals given by the different asset classes we have a 50/55% chance of a US recession within a year compared to just 5% only few months ago.

Q4 Earning Season

This week has started the US Q4 reporting season and Europe will follow over the next days. The biggest concentration of US numbers is on the week starting the 28th of January.

Q418 S&P500
% Market Cap Reporting Each Week



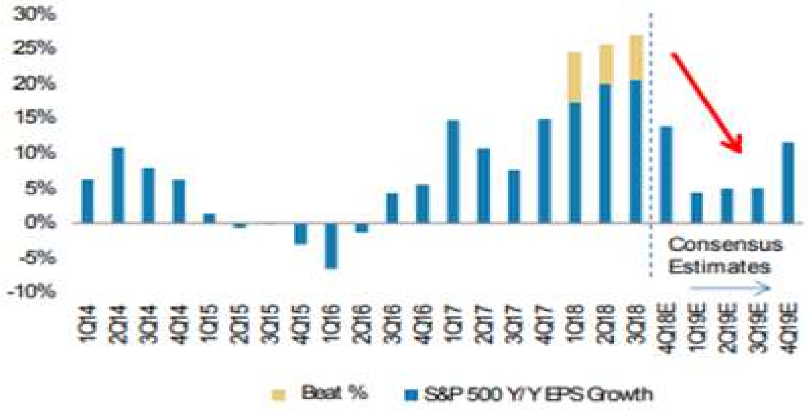
Market Analysis

Ahead of this earning season, negative forward signaling risks appear heightened, especially following recent cuts / negative outlook from several companies (Apple, Fedex, Micron, Medtronic, Macys..). There may be more cuts ahead, and it's possible that beats are not so prevalent this season.

US 4Q EPS is projected to grow +13%, the lowest YoY growth rate in 4 quarters. Revenue growth is just 4%, which would be the lowest growth rate in two years if unchanged by the end of the reporting season.

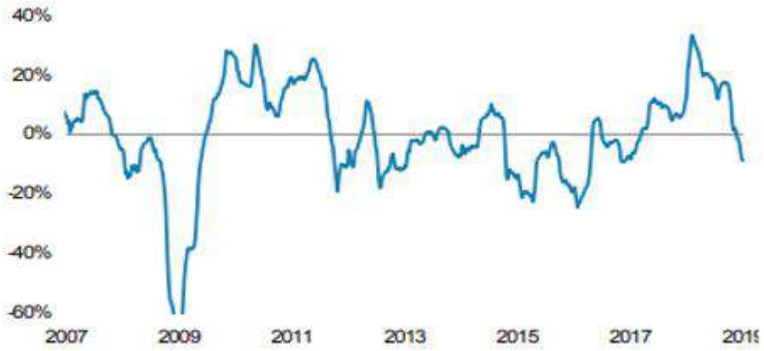
S&P YoY EPS growth is peaking.

S&P500 YoY EPS Growth (blue line) vs. EPS Beat (yellow)



S&P earning revisions breadth has plummeted.

S&P500 Earning Revisions Breadth



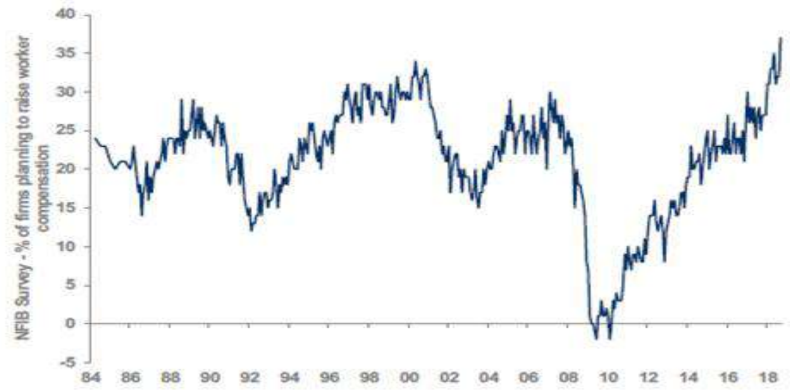
What will be important is the guidance and we suspect that it might not be easy for companies to have a clear idea of the future business with the current geopolitical environment. At the end of Q3, 33 out of 103 companies have provided positive guidance for 4Q18 with Negative to Positive ratio being 2.12x, slightly higher (more negative) than what was observed in earlier quarters of 2018. We might get even a higher number this quarter.

Another interesting point to be discovered is given by cost pressures which is not just limited to US wages. Labor cost growth is now at or above 2% in Germany, France and Italy. In addition to wages/labor costs, companies are also facing higher costs from rising input prices, transport costs and raw materials prices too, and a number of company earning releases/trading statements in the last few weeks are increasingly citing these as important headwinds for their future margins/earnings outlook.

Market Analysis

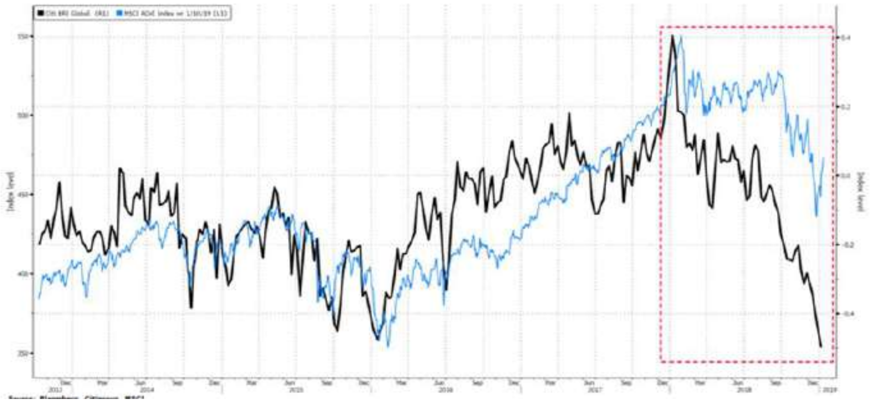
According to the NFIB survey, the percentage of small firms in the US planning to raise worker compensation is at a record high.

NFIB survey - % of firms planning to raise worker compensation



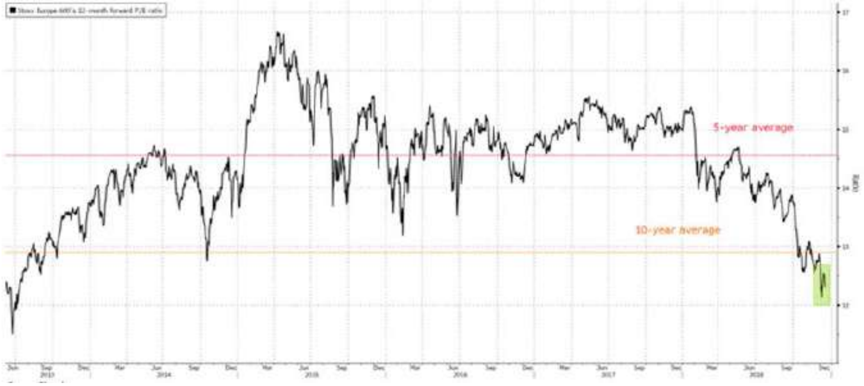
With the recent market correction, analysts have been steadily cutting their estimates and you can see over this chart the entity of this move.

Citigroup Earning Revision (black line) vs MSCI World



The bulls will now tell you that European shares are cheap: the forward one-year price-earnings ratio has plunged to near the lowest since 2013.

Eurostoxx 600 12-month forward P/E



Executive Summary

We have been calling for some market volatility since the month of October and the US started to unfold on Growth / Tech sectors as we were anticipating.

We entered the year with a non-consensus cautious view and worries over the potential Yields rally and hawkish Fed. Now, the market has drastically changed opinion and is forecasting a potential US recession before the end of the year.

This has been one of the most painful periods for global equity investors in many years, not only because of the size of the correction but also because of the significant impact it had on a wide range of investor portfolios.

All this damage occurred when interest rates in Europe and Japan are still negative and the Fed is only trying to reverse QE and lifting 2% Fed funds. The Quantitative Tightening has barely begun and markets have already shown how vulnerable they are.

Central Banks are not the only problem but it is clear how the global bubble was inflated by QE.

The combination of rate hikes and balance sheet reductions from the Federal Reserve in 2018 sucked up global U.S. dollar liquidity and put emerging markets under immense pressure in 2018. Emerging market equities were 20-30% lower from February through October, then the S&P played catch-up to the downside. This, combined with tariffs from the White House, has placed global manufacturing in a significant slowdown that has begun to circle back into the United States.

FED balance sheet (black line) vs S&P500 (orange)

The driver to market movement is not valuations but rather the degree of the system's liquidity condition.

Valuations generally don't matter much when liquidity is injected and expanding price- earning ratios don't end bull markets but when markets perceive a drying up in liquidity or central bankers pivot, as in late 2018, markets suffer.

In Q4 2017 the combined asset purchases of the Fed, European Central Bank (ECB) and Bank of Japan (BOJ) were $100 billion per month. The total dropped to zero in late 2018 and this quarter will turn negative, to withdrawals of roughly $20 billion per month.

Executive Summary

Although the macro backdrop for 2019 looks very challenging, a reasonable degree of bad news is now in the price and valuations are looking more attractive and investor sentiment decidedly bearish. The repositioning seen since the end of September is something we have seen only in great crisis/depressions and it has no equals over the last few years both in terms of speed and number of negative asset classes.

We believe that 2019 is going to be a potential better year vs 2018 as the risk-reward on Equities is easier but we will still need to face high volatility where market timing is going to be the only winning tool.

We would therefore selectively choose Equities as the best asset class with Bonds potentially less as a good hedge, especially outside the US and to have Gold as a considerable part of the portfolio.

We prefer strong versus weak balance sheets and focus on quality.

Let's now analyze the current positive and negative factors for the market:

POSITIVE FACTORS (6): *unlike last year, equities are pricing in slower economic growth and Earning Per Share concerns.*

- Market could still surprise on the upside as **positioning** is very light compared to the beginning of last year. The case for a Q1 performance chase is still here. This is especially true for Europe where investor positioning on Eurostoxx futures is the most negative since the European crisis in 2012 and we have already seen some deleveraging as more than 50bn$ have left the continent and the difference vs. other geographical areas is striking.

Market positioning : US, WE, Japan, Global and Emerging markets

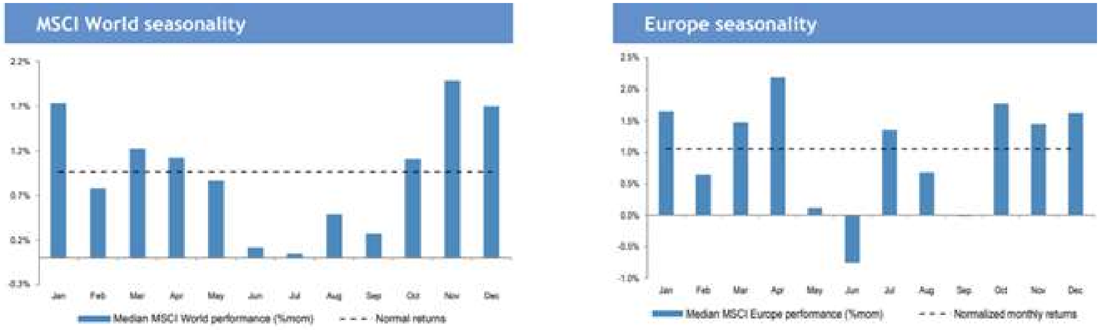
Open interest in US equity futures has been stagnant, indicating that the market's rally has been driven by short covering rather than fresh bullish positions.

Total outstanding open interest in four largest US Equity futures ($ Bln USD)

Executive Summary

- **Seasonality**: January tended to be strong both in US and Europe.

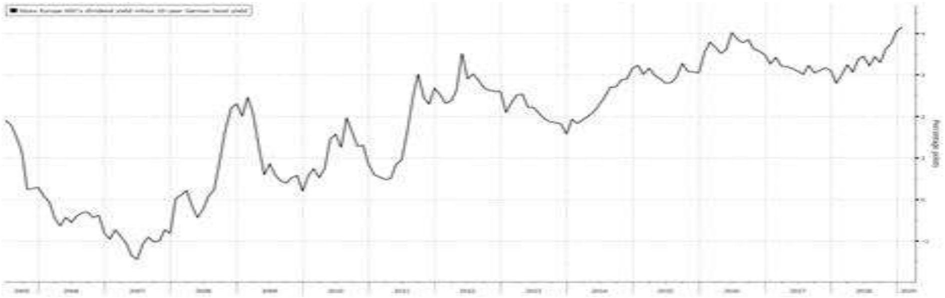
Median MSCI World performance vs. Median MSCI Europe performance



- **Q1 earning season** could eventually surprise on the upside in terms of numbers given the sudden repositioning of the consensus. We would however pay more attention at the future guidance.

- **Equity valuations** start to look compelling now and the gap between Europe's dividend yield and Government bond yields is at 4.1%, the highest on record.

Stoxx Europe 600's dividend yield minus 10-year German bund yield (black line)



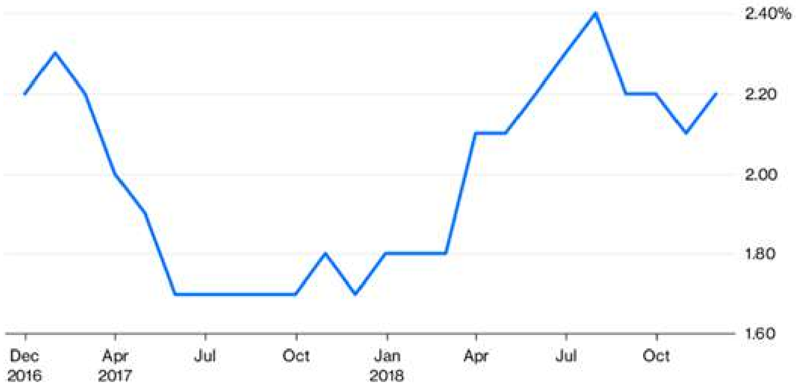
As a result of the market turbulence we've seen throughout Q4 2018, fundamental valuations of European equities have reduced further and Europe continues to look cheap relative to global regions. For example:

- The 12-month price to earning ratio has reached 11.9X (last lower in mid-2013).
- The 12-month forward dividend yield on MSCI Europe of 4.4% represents a 6-year high.
- The Shiller Price/Earnings for MSCI Europe is below the long run median for the first time in 2 years.

- **Central Banks (positive view):** still accommodative, with US real policy rates near zero.

Core inflation shows little signs of accelerating in recent months. Just over a month ago the market was pointing to a quarter-point hike in 2019, but it's now factoring in a more than 50% chance of a reduction this year. That's in stark contrast to the median projection of two increases projected by Fed officials last month. On top of that, traders are now fully pricing in a cut by April 2020.

US Consumer price Index ex food and energy



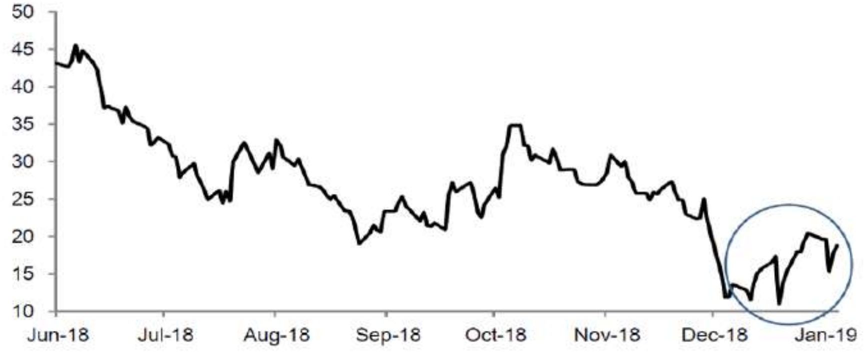
Executive Summary

In his latest statement Powell reinforced likelihood of pausing interest rate hike after assessing signals about potential downside risks from financial markets and China Macro data. In terms of monetary policy, Powell emphasized that policy is not on a "preset path" and the Fed is prepared to adjust policy flexibly.

The yield curve has flattened, but crucially, stocks have never peaked before the yield curve inverted. One typically doesn't see a slowdown without HY credit spreads widening materially.

Encouragingly, the US Yield curve might have stopped flattening and as Fed seems to have paused, the chance of "policy mistake" reduces.

US 10-2 year Yield Curve in bps (black line)



- **Buyback activity** is expected to increase significantly going forward after the blackout period given by the Q4 reporting season. Just a note on Apple as it is a striking example of what has happened. Apple has reduced the existing number of shares by 25% from 2012. In 2018, thanks to the Tax Reform, they have spent 100bn$ for the buyback with a current mark to market loss of 8bn$. Given the magnitude of cash generated, they could continue to spend 20bn$ on buyback per quarter… not bad considering that it was the biggest company in the World by market cap until 3 month ago (now it's the 4th).

NEGATIVE FACTORS (13): *unfortunately, still largely outpacing the positive factors.*

- We see limited risk that global economic momentum will re-accelerate here, as the year-on-year comparisons get tougher in the coming months and increased **uncertainty around trade and tariffs will continue to weigh on activity going forward.**

  Rising US trade policy uncertainty has already weighed on global equity fund flows this year as shown on chart.

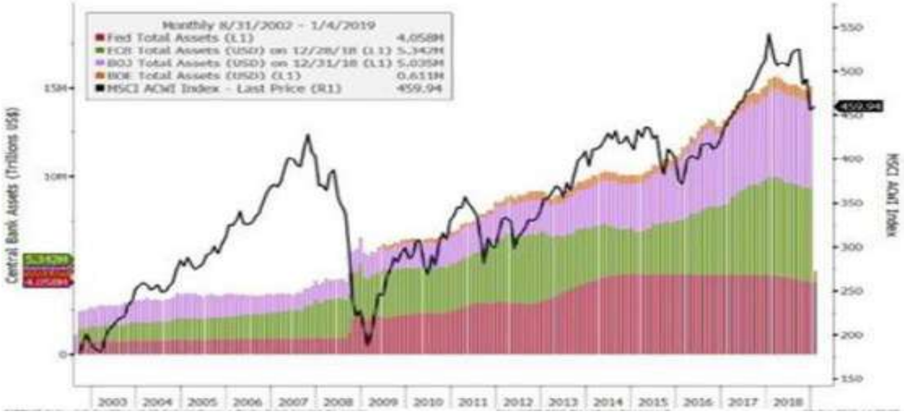
  US cycle is 10 years old, Current expansion has reached 112 months.

Cumulative 3M Equity Fund Flows Globally ($Bn) (dark blue)
US Trade Policy Uncertainty Index Inverted (light blue)

- **Central Banks (negative view):** Global monetary policy is set to (gradually) tighten further as the Fed continues to lift rates (at a reduced pace) and the ECB is at the end of its bond purchase program. Tighter financial conditions in general increase the pressure on the 'weaker links in the chain' and the chance that we see higher volatility. Credit spreads should slowly widen, unhelpful for equity valuations.

Executive Summary

FED, ECB, BOJ, BOE Central Bank balance sheets vs. MSCI World (black line)



- **<u>Margin pressures</u>** <u>are beginning to build</u>, which is perhaps not surprising given that input cost inflation (PPI) has been above CPI for much of the last two years. With labor cost gradually rising and tariffs offering up the potential for higher input costs and supply chain disruption ahead, <u>profitability concerns look set to become more of a focus for investors in the coming months</u>. Input prices are rising more rapidly than output prices (chart), negotiated wages are now rising sharply even in Europe. <u>Margin environment is less favorable now.</u>

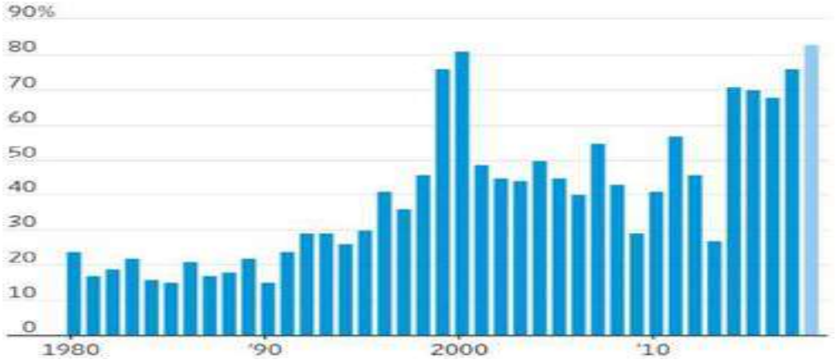
Input prices (dark line) vs. Output prices (light line)

- **<u>US estimated Quarterly S&P Earning Growth</u>** <u>set to decelerate to its long-term average of 6% in 2019</u>. Guidance of Q1 numbers is likely to be very conservative with a likely disappointment for the street.

- **<u>IPOs / Secondary/ Placing</u>**: The percentage of US listed IPOs that lost money in the last 12 months is marking a new record high (83%) exceeding the top reached in the dot bubble, the highest proportion since 1980 when record started. During the first three quarters of 2018, $50 billion in IPO money has been raised by more than 180 companies. This puts this year on track to be the busiest year for IPOs since 2014.

  Over the last couple of months a great number of IPOs has been called off and the performance of IPOs and Placings has been dreadful. <u>Not a great sign as it seems that the market cannot absorb any further paper.</u>

% negative IPOs after 12 months



Executive Summary

- **Cash Repatriation**: the repatriation flow slowed considerably in Q2 to 105bn$, less than half of the Q1 amount. Given that 330bn$ of repatriation took place already in H1 this assessment implies a significant slowing of the flow in the second part of the year. The Q3 reporting season revealed further slowing in the pace of cash holdings reduction by US companies.

  The boost that US repatriation provided to US equity and bond market via share buybacks and corporate bond redemptions is likely to slow considerably now as just 5% of the repatriated cash has been used for Capex.

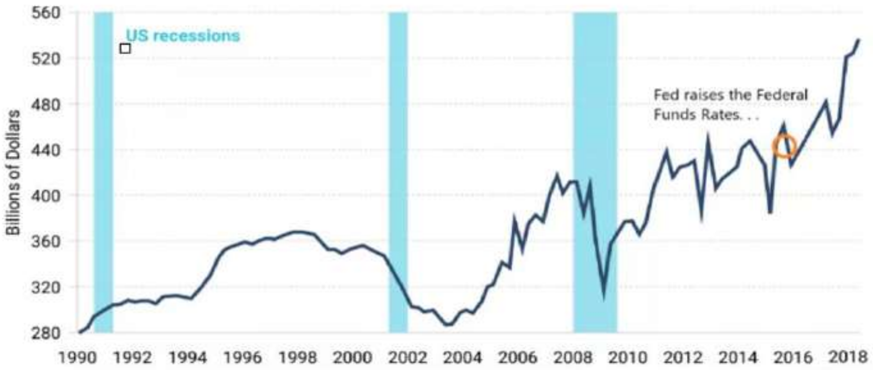
- In US the **relative appeal** of stocks is waning compared to fixed income. Yields on 10-year Treasures are around 2.7% while US equities are estimated to yield just above 2% in 12 months despite the sharp correction.

SP500 estimated 12-month div. Yield (light) vs. US generic 10-year yield (black)
US generic 10-year yield – SP500 Index (pink)

- **US government's borrowing** has increased to amounts that it hasn't since the 2008 recession. The US budget deficit is just shy of $900 billion which means a 40% increase since last year.

  Ignoring private consumer debt (which is greatly affected by rising rates), the US National Debt recently hit $21.3 trillion and the interest payments due on all this debt is at a record high. You can see on the chart that since the Federal Reserve began raising rates in December 2015, the cost of interest payments on the national debt has soared hitting an all-time high of 538bn$ per year!

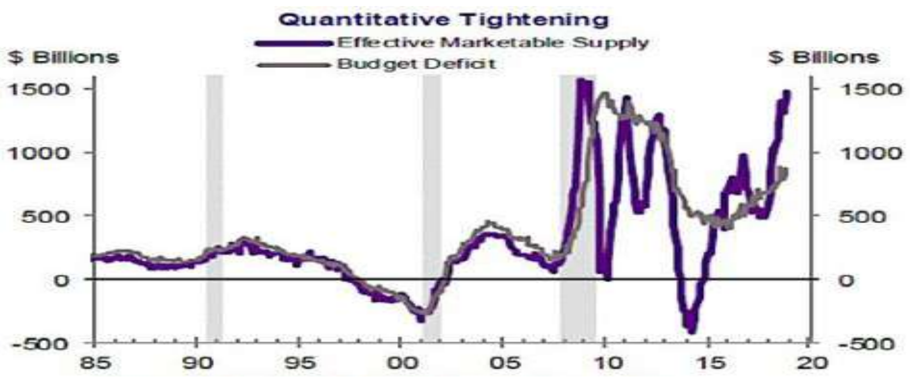
Federal government current expenditures: Interest payments



Executive Summary

<u>The ratio between the US budget deficit (grey on chart) and the Treasury issuance (purple) poses substantial risks as they are going to issue 1.3trn$ this year and the unbalance has never been that great!</u>

Quantitative Tightening
Effective marketable supply (purple) vs. Budget deficit (grey)



Remember that US is taking in less tax revenue because of Trump's tax cuts and the Treasury will have to borrow new debt just to pay off maturing old debt and interest. Short term interest costs will continue to rise over the near-term because of 3 reasons: higher inflation, Fed tightening, and the increased amount of debt needed by the Treasury.

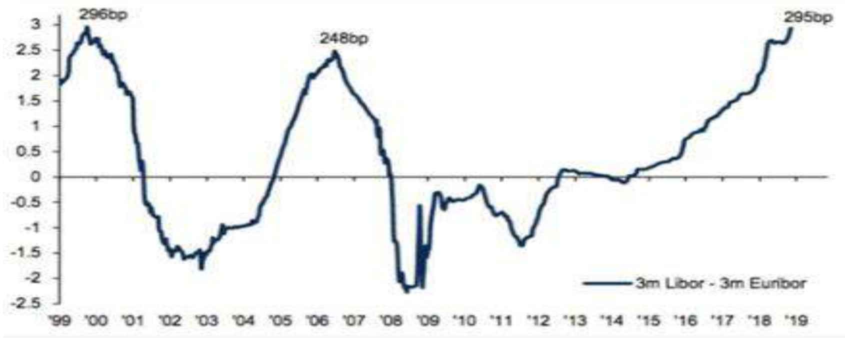
- **<u>Junk Bonds</u>**<u>:</u> They crashed really hard just before the financial crisis of 2008, and they started to fall again in October. <u>A full-blown junk bond panic would definitely be a very clear sign that a major market crash is imminent</u>. **We are in the terminal phase of the biggest debt bubble in human history. In fact, <u>total indebtedness in the United States has increased by more than 2 trillion dollars over the past 12 months</u>**…

All of this debt has fueled a short-term bubble of relative "prosperity" but meanwhile all of our long-term problems just continue to get worse.

<u>Deutsche Bank has calculated that since US QE began, 14trn$ in monetary and fiscal spending has created about 13mln jobs, that's a cost of 1mln$ per job created!</u>

- **<u>Abnormal Libor-Euribor spread</u>**: London Interbank Offered Rate known as Libor is spiking to new highs. <u>Libor reflects what banks charge to borrow dollars from each other</u> and is used as a benchmark for trillions of dollars' worth of loans. <u>The increase is seen as a further indicator of tightening financial conditions showing that corporate costs are experiencing a much further increase in interest rates than Fed funds</u>.

3m Libor – 3m Euribor (black line)

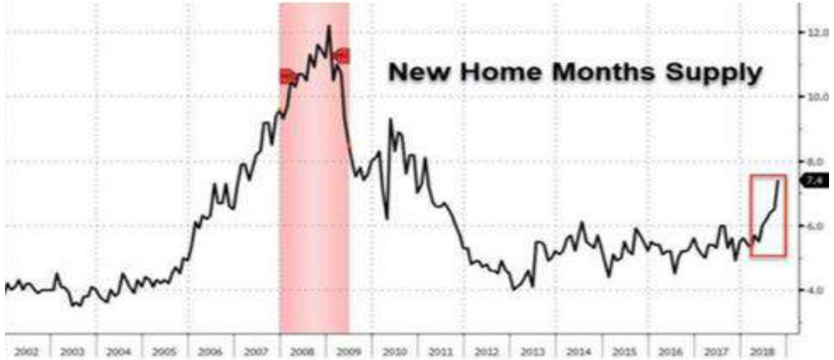


Executive Summary

- **<u>Declining US House Prices</u>**: US Housing data are continuing to surprise on the negative side.

  The University of Michigan Home-buying conditions are currently the worst since Lehman… and supply is soaring.

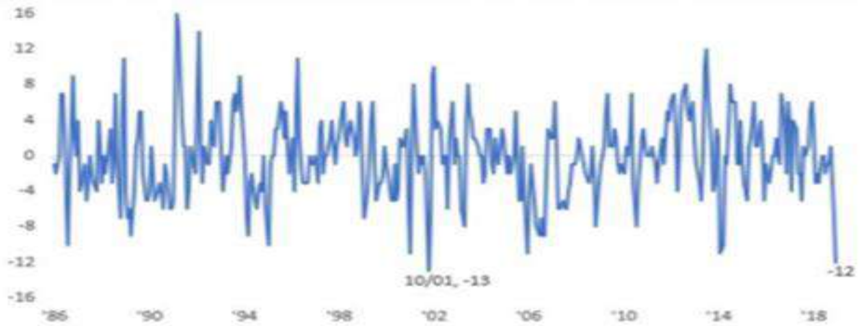
New Home months supply Index



UMich Home-buying conditions Index

The only homebuilder sentiment 2-month rate of change dropped faster than the last two months reaching the level only seen after the 11th of September 2001!

US Homebuilder sentiment Index



- <u>**Market liquidity** continues to drop and we have seen in December how can this affect markets when there is the need to sell.</u>

  Looking at some statistics helps to understand the entity of this factor. Current average of US S&P futures is 66% below the 2018 average and 85% below the average since December 2015. US 10Y futures are trading 31% below 2018 average. WTI crude futures are trading 25% below the 2018 average and 48% below the average since March 2016.

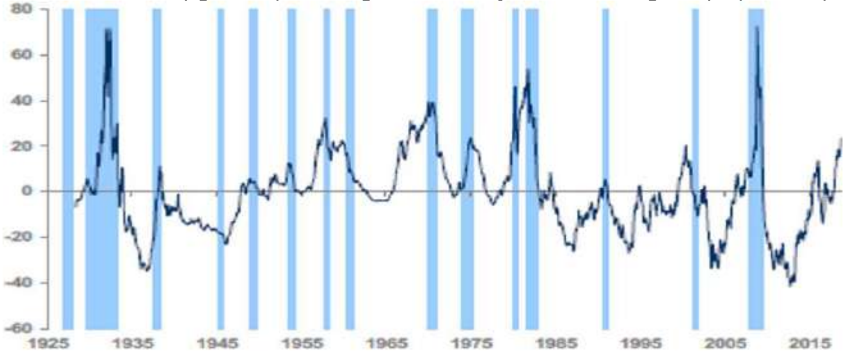
- <u>According to the recent data in the US, stocks now make up an increasing portion of **household wealth** and has overtaken real estate for the first time</u>. Furthermore, not surprising, growth in household wealth has been highly uneven for the last 10 years. Bottom income earnings have recovered a lot less relative to the top 10% of earners.

Executive Summary

The most worrying points to monitor short-term are possibly the Credit Spreads and US corporate debt.

Even before we see any further widening in credit spreads, corporates are already facing a very hefty increase in their cost of capital. The chart shows that the increase in US corporate bond yields relative to their trailing 5-year average is at its highest level since the early 1980s (if we exclude late 2008, when default rates were spiking).

US recession (light area) % change in US BBB yields vs. 5Y avg. In bps (blue line)

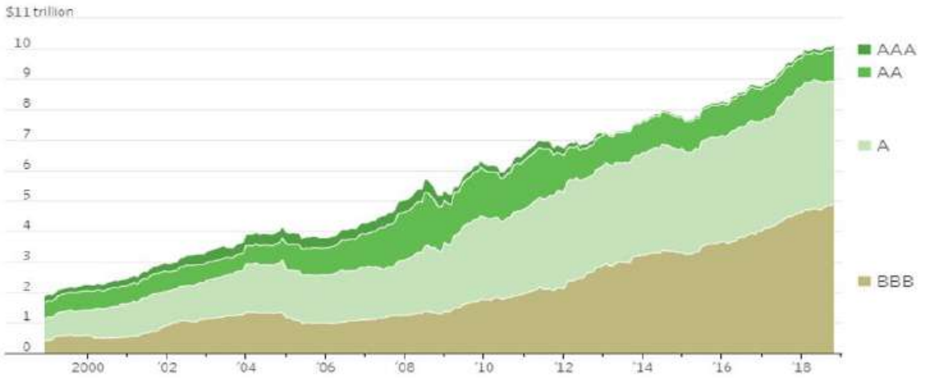


As we have seen above, the cost of debt (Libor) relative to corporate earnings is on the rise and is at the highest level since 2008.

US nonfinancial corporate debt is at its all-time high and average credit ratings of IG debt have fallen sharply. Corporates have shown little inclination to reduce debt despite strong earnings (+25% yoy in Q3), whilst an estimated USD5.6trn debt matures by 2023.

Over the last few years, yields on bonds with triple-B credit ratings (the lowest score, still considered investment-grade), have risen faster than those on safer debt.

Face value by bonds by rating



The Q4 pace of downgrades from A into BBB territory is the largest since the late 2015 wave of commodity related fallen angels.

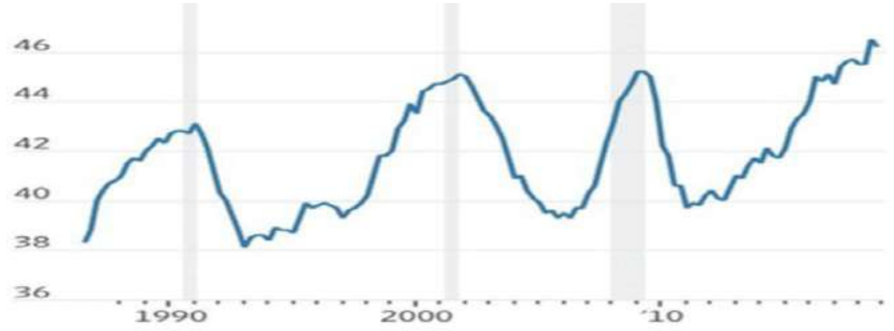
Morgan Stanley has recently calculated that 31% of all US BBB bonds have a debit that the is 4-times higher than their equity level and if we would only look at the financial leverage, 55% of these corporates would have been already downgraded to junk.

Markets could therefore soon face a “tsunami of junk rated debt” as about half of 5trln$ market for investment-grade bonds now resides in the lowest tier of ratings prone to a downgrade to junk.

Executive Summary

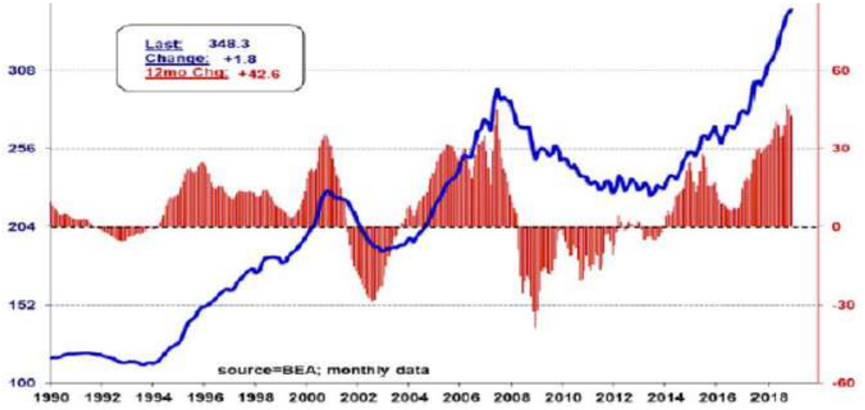
The ratio of US corporate debt to GDP is on new all-time highs as shown on the chart.

Corporate Debt/GDP ratio (blue line) US previous recession (grey area)



US personal interest payments have soared to a new all-time high exposing even more the consumers to a recession.

Personal Interest Payments (Non-Mortgage) $Bln SAAR



Last week Fitch has warned of a possible cut to US AAA rating. The effect of a potential downgrade would generate a tremendous selling pressure.

The credit bear market in the US, which began in early 2018 due to weaker flows and tighter liquidity conditions, will continue in 2019 given decelerating US growth, restrictive Fed policy and weaker corporate EPS growth.

Even European credit markets are likely to see further spread widening in 2019 as growth moderates and ECB QE ends. BBB ratings represents more than 50% of IG volumes in Europe and the largest 25 BBB names account for 26% of IG Index.

The European market has nearly locked up over the last month with many loan-deals scrapped. The junk bond market, whether in loans or bonds, has traded very little with fund managers refusing to fund buyouts and investors shunning high-yield bond sales as rising interest rates and market volatility weigh on sentiment.

In US we had in December the first month since November 2008 where not a single high-yield bond priced on the market.

Investors have withdrawn nearly 13bn$ from US leveraged loan funds during the past 6 weeks, the CLO (Collateralized Loan market) has traded very little in December.

Oil price has been an additional unwelcome negative factor as it is clearly a component of the High Yield widening.

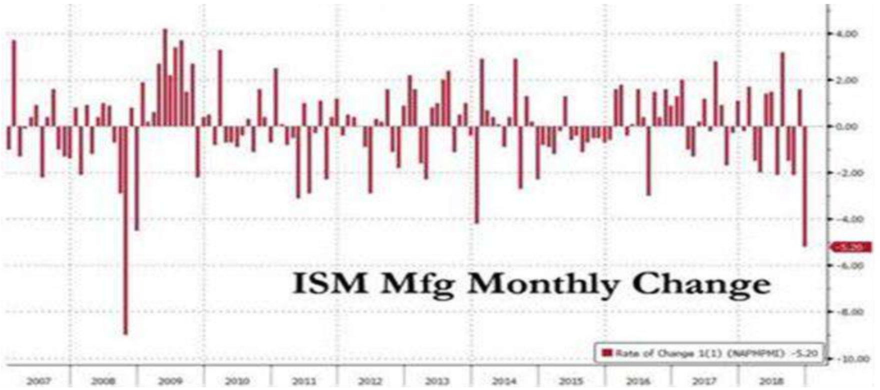
We would therefore recommend to have a close look at Credit markets also as a proxy for Equites risk-premia (Credit didn't have a single uptick despite the equity bounce we had at the end of November) **and we would start 2019 with a switch into better-rated credits.**

Macro

United States

- Growth is gradually slowing. Q4 GDP is currently tracking 2.2/2.6% range down from 3.5/4% range seen in the summer and Q3.
- December CPI in line with forecast, -0.1% MoM. Core PCE inflation at 1.9% YoY and unlikely to rise significantly for at least the next several months. This implies a pause in the rate hike process until conditions have settled down.
- The December ISM manufacturing index showed its largest one-month decline, -5%, since 2008. Whilst business surveys are not direct inputs into GDP, this deterioration has contributed to the view that recession risk has increased. However, we have to considerations: a) the ISM index fell from an elevated level and its current level is still consistent with above trend growth b) manufacturing surveys are more sensitive to moves in equities, oil prices and foreign growth.

ISM Index monthly change

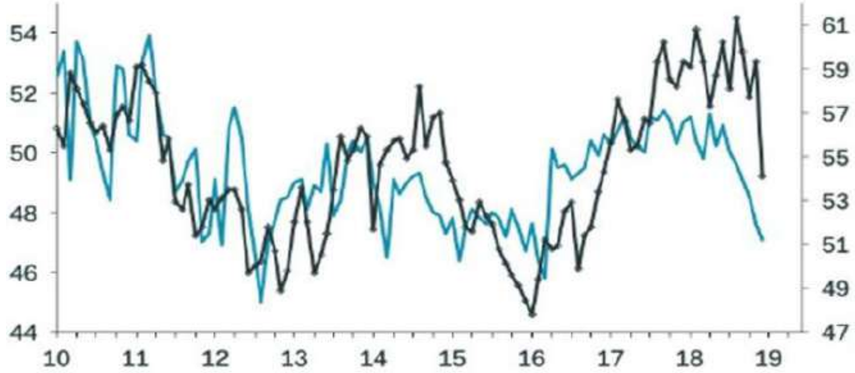


- The ISM factory index decline has been exceeded just twice this century, both times during recessions: in the financial crisis a decade ago and following the Sept. 11, 2001, terror attack.

ISM Index monthly change

- PMI China (importation component) in green and US ISM Manufacturing (black), the correlation is striking, the trade war has a high cost on the US Manufacturing

PMI China (green) vs. US ISM manufacturing (black)

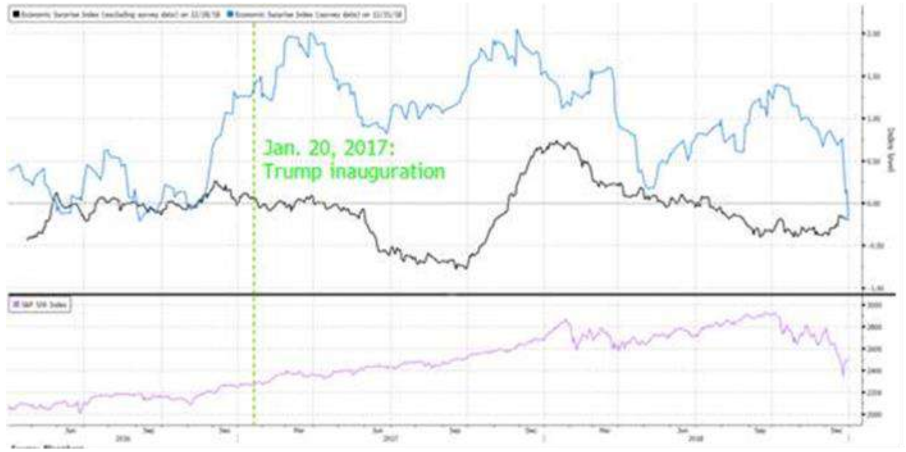


Macro

- The December job growth beat was the largest of the cycle, up 312k exceeding expectation by 128k. Since job growth tends to lag output by 2-3 months, we then expect a slowdown this quarter following the deceleration in business surveys.

- Major types of U.S. economic data, "hard" nationwide reports and "soft" smaller-scale surveys, are simultaneously missing expectations for the first time during Trump's presidency, suggesting momentum that once spurred economic growth is transforming into pessimism.

Economic Surprise Index (excl. survey data) on 12/28/18 (black line)
Economic Surprise Index (incl. survey data) on 12/31/18 (blue line)
S&P500 Index (purple line)



Europe

- <u>Growth is gradually slowing</u>. Further weakness with flash EU PMI dropping another 1.4% to 51.3, the lowest level in five years. Germany GDP growth is expected to decelerate from 1.9% in 2019 to trend rates of around 1.2% by 2022. German industrial production down by 1.9% MoM in November against expectations of a slight increase, extending a run of disappointing data.

German Industrial production index

- The Italian Economy decreased 0.1% in 3Q, on the verge of recession as companies see demand plunging, manufacturing contracting and export demand falling. In December, Industrial production decreased by 1.6% against expectations of -0.3%. So far, all data are pointing to another quarter of negative growth.

Macro

- On the flash estimate, Euro area annual core HICP inflation was +0.97% in December, averaging +1% in 2018, unchanged from 2017. Euro area annual headline HICP inflation fell to +1.58% in December after +1.95% in November. Country-level flash estimates showed German, French, Spanish inflation falling in December.

China

- Growth is gradually slowing; 2019 Real GDP growth is currently tracking 6.0%-6.3% range. Some soft Macro in December such as NBS and Caixin manufacturing PMI down to 49.4 and 49.7, respectively, the lowest since February 2016 and May 2017. In addition weak China December trade data with Exports -4.4% (vs. exp +2%) and Imports -7.6% (vs exp. +4.5%) due to trade war and global slowdown. China is not focusing on growth anymore but rather on unemployment as social stability is the main concern. There are large pockets of unemployment in the coastal eastern regions. Current measure in place: lower VAT for consumer goods, lower tax for SME companies, increasing infrastructure expenditures, and lowered the RRR (Required Rates Ratio) for banks in order to force them to lend more.

Geopolitics

Trade war: US officials expect China's top trade negotiator may visit Washington this month, signaling that higher-level discussions are likely to follow this week's talks with mid-level officials in Beijing, as both sides expressed optimism that progress had been made. Although we still have no conclusive outcome, we believe a trade truce would be a win-win situation considering the looming global slowdown.

US Politics: The current government shutdown is the longest in US history. A row with Democrats over funding the wall on the Mexican border has left the government partially shut down for 20 days, leaving some 800,000 federal employees unpaid. Although the wall construction is critical in Trump's campaign, we believe an agreement is likely to be found soon.

Brexit: Parliament continues to debate May's apparently doomed Brexit deal, with speculation mounting that exit day will be delayed beyond March 29. Foreign Secretary said on Friday he believes Parliament won't stand for no-deal Brexit. It's much more likely that politicians will try to stop the U.K. leaving without an agreement. MPs will vote on PM May's deal for the first time on the 15th of Jan. We expect the deal to fail in the first instance, but for a close variant of the deal to eventually pass. The risks around our central view have been shifting however. We now see the risks to our base case skewed towards a later, softer Brexit, or none at all.

Italy: the approved budget law for 2019 in December, allows the government to pursue a smaller fiscal expansion (2.04%) in 2019 than previously planned. Some important reforms such as the universal guaranteed income and the pension scheme have been cut versus earlier forecast, although their related law decrees have not been submitted to Parliament yet. However, as already discussed, we believe that a) government's growth forecasts are too optimistic b) the approved budget law for 2019 is unlikely to provide a strong boost in demand growth, rebound in consumer and business confidence c) the government deficit/GDP ratio is likely to be higher for the next years due to Macro environment, Central banks tightening, higher interest rate expenses, lower real GDP growth rate and government inability to sell asset (privatize) worth 1% GDP as planned d) strong political instability being the economic and social agenda of the two parties wide.

Forex

It seems the USD has lost some of its safe currency appeal due to an unexpected Fed's dovishness, slightly positive improvements on Trade-War and some concerns about the US debt. The CNY has continued to appreciate since the beginning of December and the EUR has attempted to break 1.15 for the first time in 3 months.

The **DXY Dollar Index** is down 1.7% since last update, net speculative positioning has started to decrease while the DXY index has gone back to the trading range we had since June last year.

Bloomberg Dollar Spot (black line) vs. US dollar net long-short positions (dotted)

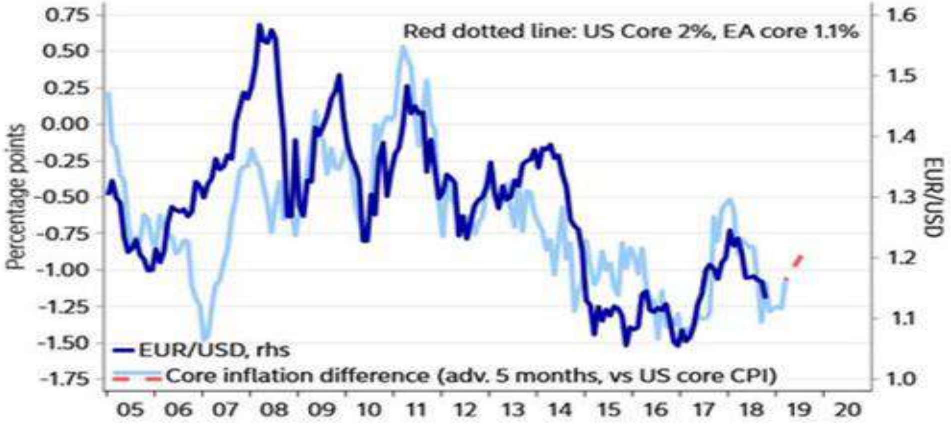
The optimism on USD is therefore slowly changing but as you can spot from the chart it is still a consensus long.

As said over the last two newsletters, we are calling for a very limited USD upside from here if not a proper downside.

Main factors for a weaker USD:

- US growth peaked in Q2 an annualized rate of 4.2% and is likely slowing down from here (sectors sensitive to funding costs, such as housing and autos, have all slowed). Weakening liquidity conditions, tightening, rates, weakening US data etc. Warning signals of a potential significant decline in the USD are flashing, with foreign investors no longer steering funds into long-term USD-denominated assets. It seems the trust of investing in US assets for the long-term strategy has declined.
- Short-term fiscal stimulus running out of steam.
- US corporate leverage.
- Relative inflation may soon start to support a higher EUR/USD exchange rate.

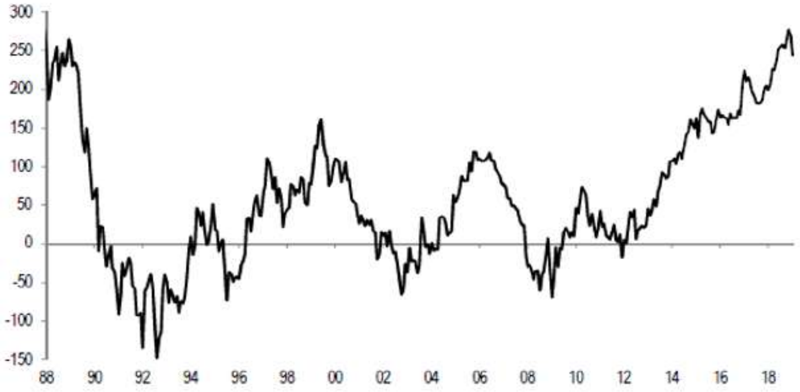
EUR/USD currency (blue line) vs. Core Inflation difference (blue light line)



Forex

- The Eurozone current account surplus has increased materially over the last few years, driven by Germany. This, coupled with the upcoming unwinding of QE by the ECB, will likely support a rising euro over time.

US and German 10-Year yield differential



- Global tensions caused by economic sanctions and trade conflicts triggered by Washington have forced targeted countries to take a fresh look at alternative payment systems currently dominated by the US dollar.

  This is especially true for China (trying to internationalize its own currency, the yuan, which was included in the IMF basket), India (6th largest economy, switching to ruble for payment to Russia and other currencies for main trading partners), Iran (finding alternative USD payments for oil exports) and Russia.

Commodities

The Blomberg commodity Index is 4.5% above our last update and still 13% below the highs made at the end of May.

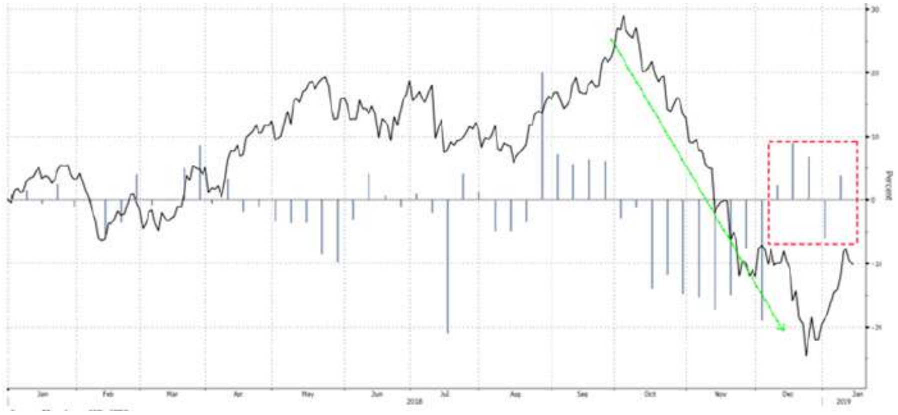
Oil prices have dropped a further 2% since last update and more than 32% from the highs made on the 3rd of October (WTI was down 43% from peak to the 24th of December). We have called the profit taking at the beginning of October and the last time we suggested to start getting back into the sector.

OPEC production fell by the most in almost two years in December impacted by drops in Iran (sanctions) and Libya (protests). Importantly they have decided on the 7th of December to cut oil production by a further 1.2mln bpd.

Oil was a consensual long position in October and after losing for 3 months in a row, Managed Money's net long position (as a % of open interest) across the hydrocarbon futures complex is now just 5% of total open interest!

Since the beginning of the year flows have been mixed as showed on chart.

WTI price Index (black line) vs. Managed Money's positioning (blue histogram)



Commodities

Gold has bounced 4% since last update (+9.5% from the lows at end of September) and after breaking 1250$ is approaching the 1300$ level. This was function of the risk-off mode on markets.

Over last update we suggested that a short squeeze was very likely and the Fed latest stance has also helped the bounce.

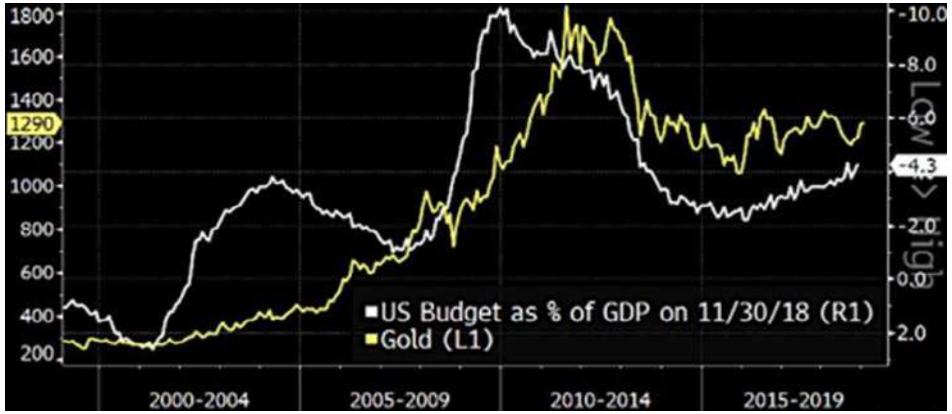
Positioning is still mainly short with Central Bank, Governments and consumer demand on the buyside.

We estimate that $10 billion of new longs (equal to 8.5% of total open interest) has been established in Gold futures over the last 30 trading days. This 30-day build in net longs in Gold futures is the largest we've seen since February 2018.

Most of the rebound has come from short-covering, not adding longs.

Gold is also positive correlated to the US deficit, the chart shows the Gold move along with the US deficit ratio to GDP.

US Budget as % of GDP on 11/30/18 (white line) vs. Gold price (yellow line)



Gold is the only real money that has survived throughout history. Current economic, financial and geopolitical risk is unprecedented. **Physical gold is the ultimate insurance against these risks and should form the solid foundation of investors' wealth pyramid**.

We would therefore strongly suggest to keep and gradually increase the portfolios with some precious metals assets.

Current Investment Ideas

<u>Long Dax in relative terms</u>: Germany's stock market was one of the worst performers in 2018 being down 18.3% Ytd, underperforming the Eurostoxx 600 by more than 5%.

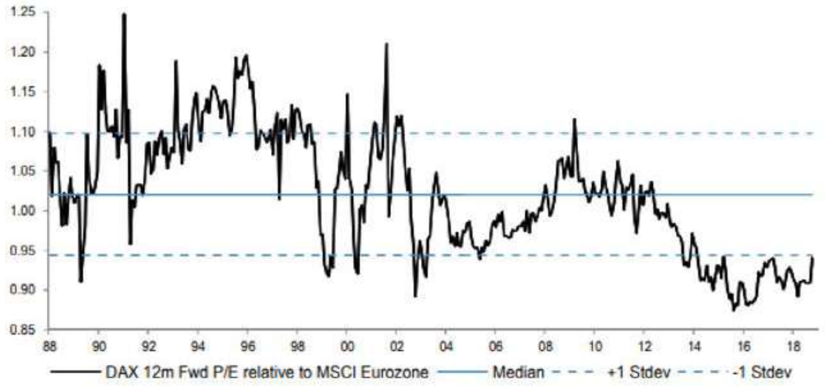
- <u>German companies have been hit by a combination of the following factors</u>:
- <u>Trade tensions:</u> DAX is the European index with the highest beta to world trade growth and ranks just after MSCI EM and the Topix.
- <u>EM slowdown:</u> German companies generate about 30% of their sales from EM and Asia-Pacific.
- <u>Regulation:</u> The European Auto sector has taken a big, but probably temporary, hit from changes in environmental rules. Since July, car registrations in the Euro area have fallen 25%, and the auto dependent German manufacturing PMI has dropped by nearly 5 points, underperforming its peers significantly.

While these factors are not going to change in the short-term, we believe that the market is discounting some degree of the above uncertainties as has fallen more than periphery did and could recover something in the short-term.

We had a negative November Industrial Production data last week but the broader dataflow remains consistent with a moderate growth in Germany. This year we will get a growth' boost from the fiscal policy and strong wage gains should continue to support household income.

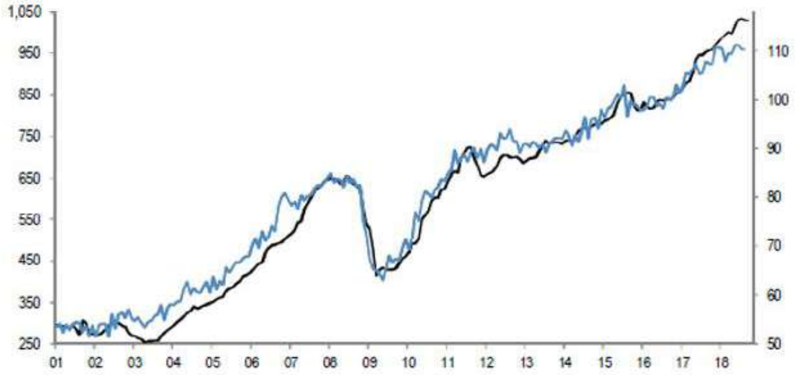
DAX has lagged, and it is getting attractive, especially as € lost 4.5% in 2018, DAX valuations are near the lows of the range…

DAX 12M Forward P/E relative to MSCI Eurozone



Interesting to see how 12-month Forward EPS is correlated to growing German exports.

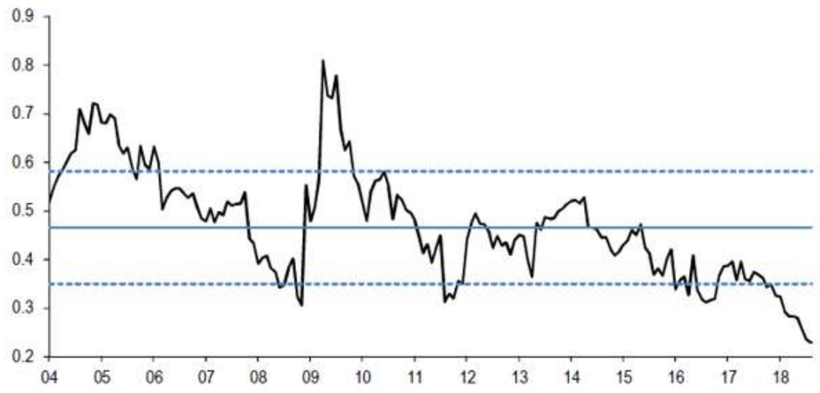
DAX 12m Forward EPS (black line) vs. German exports (light line)



Current Investment Ideas

The Auto sector is the most oversold in recent years in relative to Europe (EV/EBITDA).

Autos EV/EBITDA vs. relative to Europe (black line)



<u>Long Miners (SXPP Index)</u>: The European SXPP Miner Sector has sold off over the last 6 months, on trade concerns, global growth slowdown and disappointing China data.

Having risen 8% over the first six months of 2018, the SXPP has fallen materially and has closed 2018 down 16.3% dropping nearly 23% from the highs made in May when the street was consensually positive.

<u>The majority of this sell-off can be attributed to</u>:

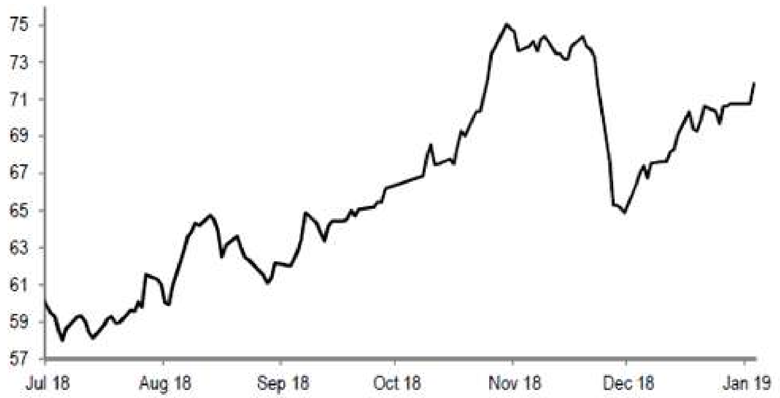
- trade tensions between the US and China.
- a weakening of the growth narrative, which has seen global growth decline.
- disappointing data from China, as policymakers have resisted a broad stimulus.

Recent commentary on trade tensions/Chinese growth / stimulus has been more positive.

Miners are likely to have EPS upgrades of 10% for ‘19 and 20% for ‘20, if underlying metal prices stay at current levels. Encouragingly, <u>metal prices such as iron ore have been moving up recently, and the inventories of a number of metals are near multiyear lows.</u>

Iron Ore pushing higher.

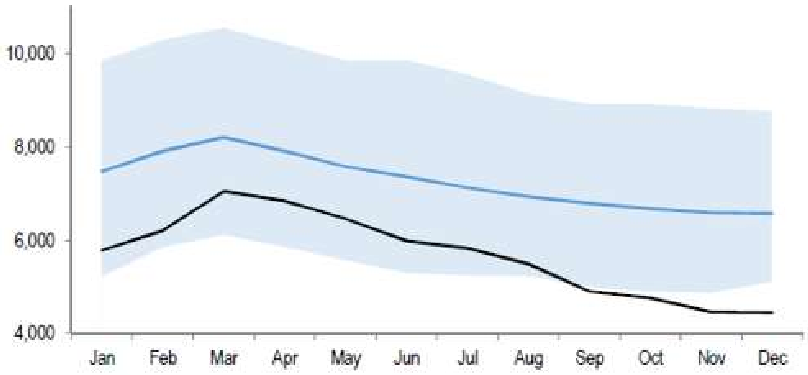
Iron Ore price ($)



Current Investment Ideas

Inventories of key metals are at multi-year lows.

5-year range (light area) vs. 5-year average (blue line) vs. 2018 Base metals inventory (black line)



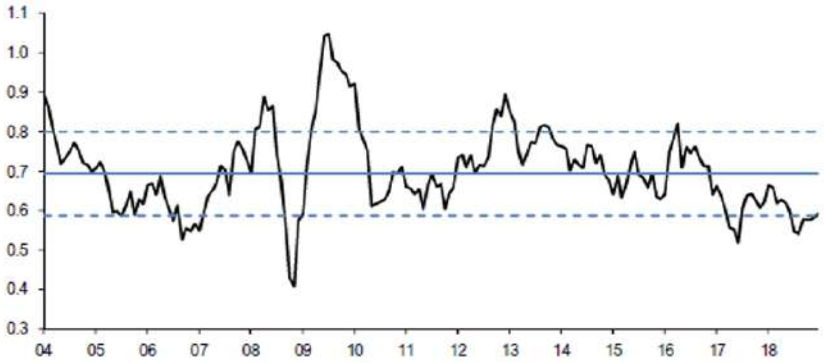
Miners are also a good hedge on rising inflation, with the second highest positive correlation to inflation forwards, at the sector level.

Miners are a play on China improving, easing trade concerns, USD peaking, are an inflation hedge and offer much stronger cash flow generation and balance sheets than before.

Chinese activity stabilization, lower inventories and potential for a rebound in commodity prices make the sector an attractive investment.

The sector is attractively valued as is trading outright cheap relative to the overall market on EV/EBITDA metric.

Metal & Mining EV/EBITDA relative to Europe (black line)



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