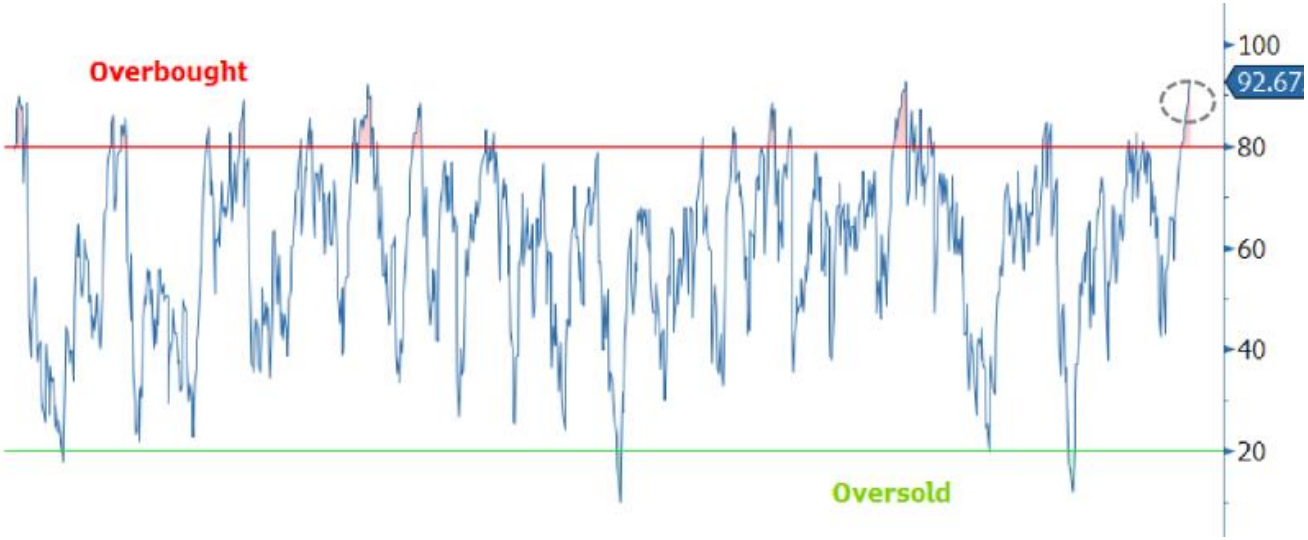
HERON
ASSET MANAGEMENT

Market Update

Chief Investment Officer



With Monthly RSIs at the third highest reading in 90 years, Institutional Investors holding their highest gross leverage in 12 years, Individual Investors the most bullish in 10 years, it looks like we are getting ready for a correction. This can be a bullish signal in the intermediate term (3-6 months) but is generally a negative signal over the near term

Main points

- Macro data / Earning season
- Inflation / Yields
- ECB / FED
- Trades of the week
- Executive summary: **market ready for short term correction?**
- Investment ideas

9th of January 2018

As we have seen towards the end of 2017, **Q3 Earning Season** and **Tax Reform** were the positive catalysts needed for the market to rally into the year-end. We have now started the year with some positive impressive performances.

The first week of 2018 resembled how markets finished 2017, while it felt like US equities led with both the Dow and Nasdaq at all-time highs, also saw international markets join the festivities with both Japan equities and the Hang Seng exceeding highs reached in 2007. To a similar vein, volatility remains low, inflation expectations and yields continue to rise, cyclicals continue to outperform and global economic data continues on its resilient path as seen by the Econ Surprise Index hovering near its highest level since 2012.

We expected US Tax legislation to be the most significant upside catalyst for equities given the market has been underpricing the probability of passage (in August people were pricing in near zero probability of tax cuts). The size of this catalyst should remain a significant driver of equities and rotation within and across sectors and styles and we believe that fundamentals remain very supportive, as the US tax cuts are starting to be implemented and given the continued upturn in global growth, as seen in consistently strong PMI and CESI prints.

We continue to have very strong global macro data. US ISM expanded for a 16th month, increasing +1.5pts to 59.7, as new orders now over 60 for 7th straight month, the highest expansion level in 14 years. China, India and Japan PMIs data were all in expansion territory.
Economic activity in the euro-area accelerated to the fastest pace in almost 7 years as services surged while factories benefited from booming domestic demand and near-record growth in export orders. A composite Purchasing Managers' Index for manufacturing and services rose to 58.1 in December from 57.5 a month earlier.

The US MNI Chicago Business Barometer, which economists consider a proxy of manufacturing in the area, unexpectedly jumped in December to 67.6, the strongest since March 2011. The gauge was boosted by the strongest reading of production in 34 years and the highest new orders index (an indicator of demand) in 3 1/2 years.

In just six months the US economic surprise index has moved from -80 to +80, a speed and severity of turnaround only seen previously in Q1'12 and Q2'09 (chart). Among the good macro newsflow, the NAHB housebuilding index has risen to its highest level since 1999.

Germany's unemployment rate fell to a record low as the number of people out of work slid for a sixth month, signalling that Europe's largest economy is continuing to boom despite a slight softening in business confidence.

The US tax reform took shape faster than expected, pushing the full-year estimates to 2.7% for 2018 and 2.1% for 2019. Overall, the market is now factoring in a fiscal boost of about 0.5pp for this year's GDP growth rate in the US.

The benefits of this reform are however quite debatable as Goldman expected the tax cuts to boost growth by 0.3% in 2018 and 2019, but "After that, the size of the tax cut flattens off and starts to decline somewhat, so we don't estimate any additional uplift to GDP in 2020".

Investors still lack visibility into the impact of specific provisions at the company level and how corporate behaviour will respond to the new tax code and the incremental cash flows it creates.

Wharton Business School issued a report finding the tax cuts would add 1.5trn$ to the national debt over 10 years even with assumptions favourable to economic growth. The Tax Policy Centre says that in 2027, when the individual tax cuts have expired, more than 60% of the benefits of the reform would accrue to the top 1% of earners. Whilst this would increase inequality of income.

In addition, Reuters said the U.S. tax bill included a tax break for exporters that appears to contravene WTO rules and is likely to spark a major trade dispute with Europe according to legal experts.

Bloomberg said that President Trump aims to release his infrastructure proposal before the January 30th State of the Union address. Economists question 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).

On Friday is going to kick-off the Q4 reporting season in US and as for Q3 it will be very important for understanding the market for the next few weeks.

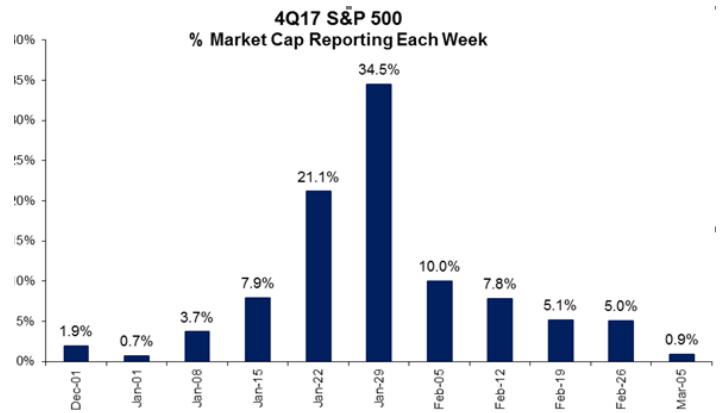
2017 was the best year for global earnings since 2010, with consensus expecting MSCI World EPS to grow by 14%. In contrast, with the negative revisions seen in each of the last few years, global EPS momentum was positive throughout 2017. Global weekly EPS revisions (the ratio of analyst upgrades to downgrades) were outright positive the whole of the year in '17, a rare feat.
2018 could be a second year in a row where earnings will not see downgrades. **Earnings are set to continue growing**.
The bounce in the oil price should help drive PPIs higher again, which is typically closely linked to earnings dynamics. We are finally starting to see some uplift in 2018 consensus earnings projections for S&P500, as benefits of the US tax reform bill are getting priced in.
Global PMIs are at cycle highs and might not increase materially from here. However, unless they fall off significantly, they would still be consistent with EPS revisions staying in positive territory.

The S&P 500 is therefore expected to deliver another positive YoY quarterly EPS growth. Historical trend does indicate that companies are more likely to beat consensus than miss (historically 67% of SPX companies beat earnings) thus earnings growth could surprise to the upside, but it should be noted that this time **earnings estimates have not been revised down** coming into this earnings

season nearly as much as recent quarters, which may indicate that the bar is higher for beats this time around. The next few weeks will 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.

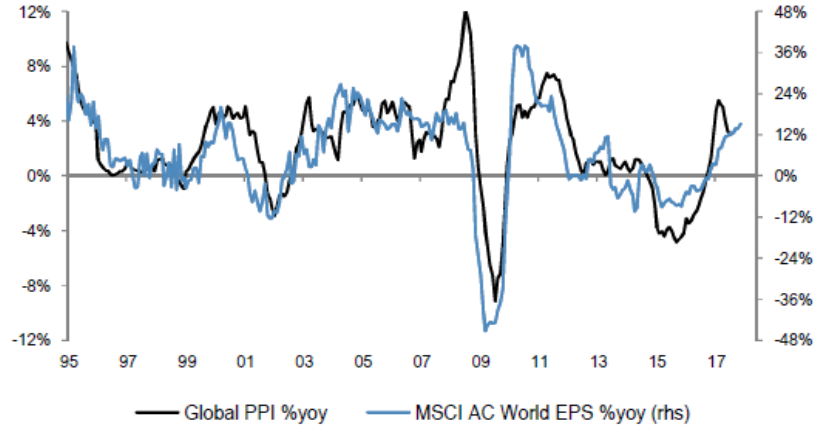
In US, the Q4 is expected to see +11.8% YoY EPS growth, which is higher than the previous two quarters of earnings growth (bottom chart on previous page). Sector wise, Energy is projected to see +130% Y/Y EPS growth in Q4, continuing the triple-digit-growth trend, largely a base effect.

In terms of timing, 23% of Financials will be releasing numbers over next days, including JP Morgan and Wells Fargo. By the end of the month of January, 52% of the S&P 500 will have reported earnings. The biggest week for 4Q earnings season is the week of January 29 when 34.5% of the S&P market cap is projected to report. By January expiry, 16% of SPX and 7% of QQQ will have reported earnings, and by February expiry, 87% of SPX and QQQ will have reported (see histogram).



In Europe for the first time since 2010, earnings drove returns rather than valuation expansion; the P/E was roughly unchanged through the year. EM and Eurozone earnings have fallen sharply over the last few years, but they are starting to rebound. There could be much more to go as both have a depressed base.

The current level of Eurozone PMIs is also consistent with double digit EPS growth, in the range of 10-15%. We also expect inflation to rise next year, as it typically lags activity and commodities, and this should help pricing. The chart shows the high correlation between Global PPI and MSCI World EPS.



Current consensus estimates are looking for marginally lower EPS growth in '18 compared to '17 in most regions. Only the US is expected to deliver higher earnings growth.

In Europe, the hurdle rate is actually near the bottom of the historical range, at +9.5% currently.

In the US, 11.8% is close to the levels seen over the last few years, but below the historical average of 13%. In other words, consensus doesn't appear to be overly optimistic about earnings for '18 (see table).

	2017e	2018e	2019e
World	12.8%	9.7%	9.4%
EM	22.4%	12.7%	11.1%
US	10.4%	11.8%	10.3%
UK	20.7%	6.4%	6.9%
Eurozone	9.8%	9.5%	9.2%
Japan	20.9%	4.7%	8.3%

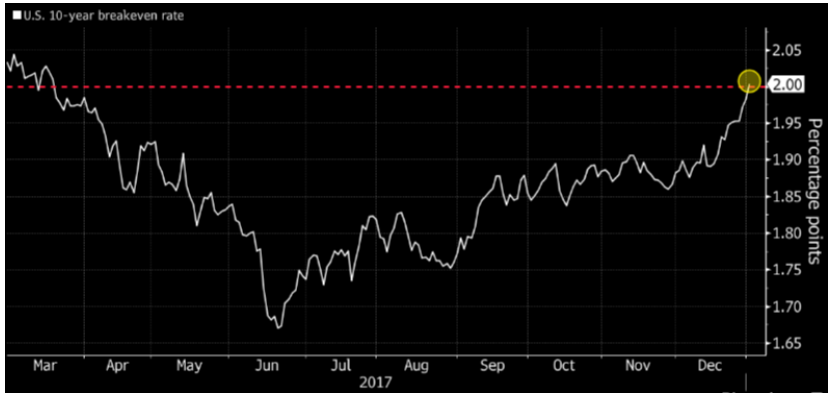
The relative quarterly results delivery between European and US corporates was clearly impacted by FX this year. More companies beat sales estimates in Europe than in the US in Q1, but this was the opposite in Q2 and Q3.

Let's analyse some new data about **Inflation** as prints remain subdued, but the pressures are building and bond yields are likely to be higher from here.

The continued run of good economic newsflow was also corroborated by a further move higher in commodity prices through December with Oil up 4%, Copper up 6% and Iron Ore up 7%. Copper is now 30% higher than this time last year and Brent Oil is up 50% in just six months. Even the CRB RIND index, which is often less volatile, has bounced sharply back towards its highs.

The S&P GSCI Index of commodity prices rallied the past four months (chart), pushing the gauge above its 30-year average once the impact of U.S. consumer-price inflation is stripped out. Given the historical importance of raw material costs to broader price measures, a persistent uptick in real commodity prices could help resolve the inflation dilemma that has been plaguing central bankers.

The yield spread between 10-year U.S. Treasuries and similar-maturity Treasury Inflation Protected Securities climbed above 2%, the first time since March that it's exceeded the Federal Reserve's target level for inflation (2nd chart)

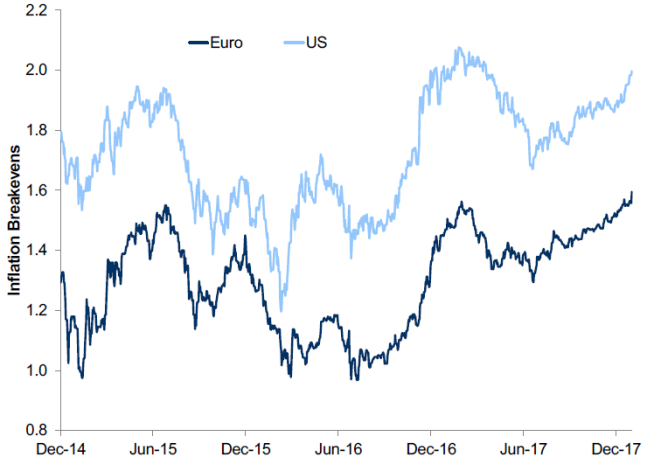


The inflation breakeven chart (3rd on the bottom) clearly shows what is the current trend both in US and Europe as they have been rising to a three-year high.

The big gap between PMIs and bond yields is still there. As we showed already through last update, there is a considerable gap between economical data and yields.

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.

Japanese workers will see a 1% increase in their total earnings next year, the most since 1997, as rising profits and the tightest labour market in decades add upward pressure on pay.



We are not yet detecting signs of excess demand causing a sharp rise in inflation pressures that could push inflation beyond central bank targets but we **expect core inflation to rise materially from the spring onwards.** Bond yields appear to be undershooting the improvement in economic activity, suggesting they should bounce.

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.

Bond yields failed to move higher in 2017, but there are strong reasons why this might ultimately happen in 2018. The modest back-up in 10Y yields we have seen masks some larger, more pronounced moves elsewhere, e.g. both 2Y and 5Y US bond yields have risen 60bps since September and are up to their highest levels since 2008 and 2011 respectively and US 5Y is attempting to break out the 30Y downtrend (chart).

The strengthening U.S. economy has stoked demand for high-grade corporate bonds, dropping the spread on investment-grade debt up to 93 basis points, a level last seen before the financial crisis.

The 2nd chart shows how US High-grade spreads tighten to 93bps from 122bps in January.

After a strong run of positive macro data, Citigroup's US economic surprise index has risen to the highest level since January '14, while Bloomberg's ESI appears even stronger at the highest level since March '11.
Historically there has been a fairly close relationship between the level of US ESIs and the 3M change in the slope of the US yield curve. Despite the surge in ESIs, the yield curve has instead continued to flatten.

We expect the Fed to be pleased that financial conditions are finally tightening, so the yield curve continues flattening on the view that the Fed will continue hiking rates and we should see a complete flatness of the curve in the 3rd quarter of next year with the Fed's target rate range at 2.00-2.25%.

On our latest update we mentioned that technicals were pointing to a potential turning point in US real rates (so called "flag or triangle"), **we have now broken this important level leading the way to 2.5-2.6%** (chart).

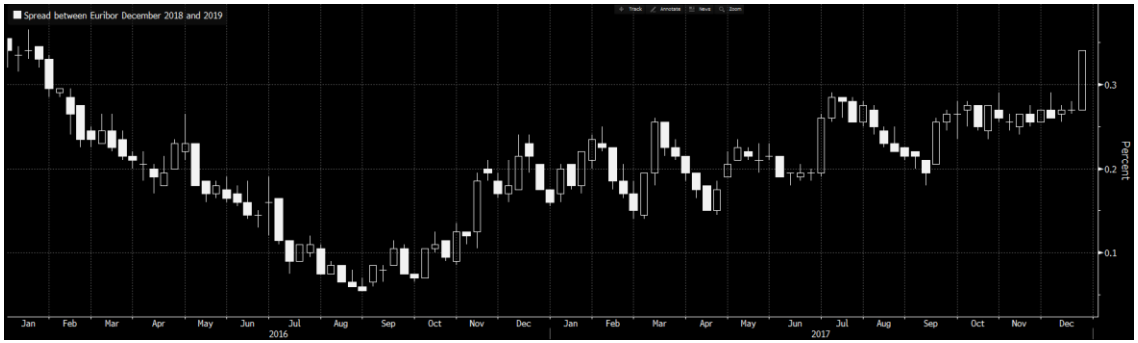
We believe that any rise in bond yields will be a positive for equities, driving asset allocation shift and broadening of the market leadership. The common wisdom is that higher yields mean lower P/E multiples, but we disagree. It is typically lower earnings that would mean lower multiples, such as at the turn of '15.

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.

It is also important to consider that Central banks tightening is still in early stages, 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, **stocks never peaked before the yield curve inverts**.

The minutes from the December **FOMC** meeting were consistent with a meaningful improvement in the growth outlook but provided little new information about monetary policy. The Committee's views on core inflation appeared little changed. The market is still pricing a March hike at 75%.

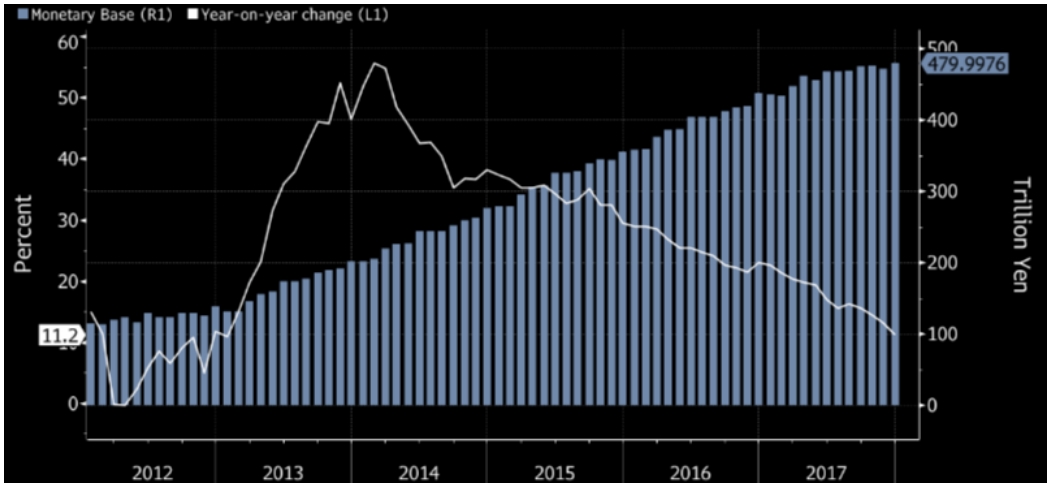
The **ECB** purchases of bonds started to scale down from EUR60bn a month to EUR30bn a month from the beginning of the year. The reduction of EUR30bn a month annualises at 3.04% of M3 money supply. With money supply only growing at 5% y/y in November, roughly where it has been since 2015, without the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



The chart shows the spread between Euriobr Dec 2018 and 2019 with some signs of "life"..

Combined with the Fed's quantitative tightening, which will total USD420bn this year, and the ECB's quantitative tightening of EUR270bn through 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 pace of the **Bank of Japan's** quantitative easing is also slowing down further, with money supply in December rising by the least in percentage terms versus a year earlier since January 2013. The deceleration is likely to continue in the near future since the BOJ shifted its policy toward yield-curve control, as long as the desired yield curve is being maintained, the amount of asset purchases itself isn't being pursued so much.
The 2nd chart on the side shows the pace of decoration of purchases by the BOJ and Monetary Base.

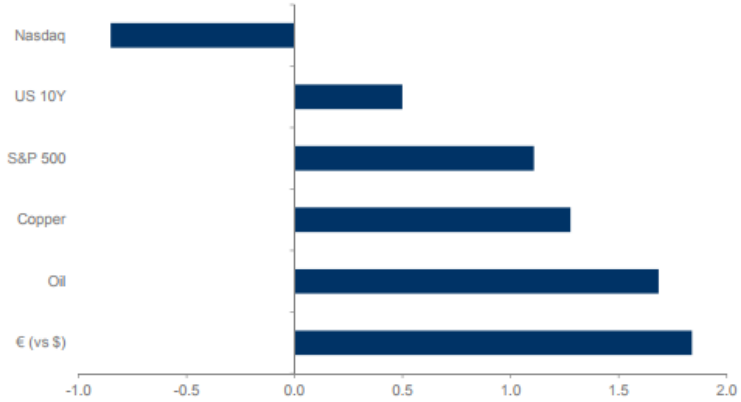


Basically, the Global monetary base which has been growing from 2009 thanks to QE will gradually start to tighten from Q318 and the level of sea where assets are floating will start to retract and volatility will grow.

Trades of the week

The Eur/Usd has bounced 2.4% since the middle of December attempting a new break of 1.2090 which was the high made last September but has since dropped 1.3% showing once again that that level is a strong resistance for the moment.

As we flagged before, the long EUR/USD was very consensual and we argued on September last year that it would have turned down. Now the long speculative position on $ futures have gone dropped substantially and the € long is the most consensual position on the market (via futures) as the table on the side is showing.

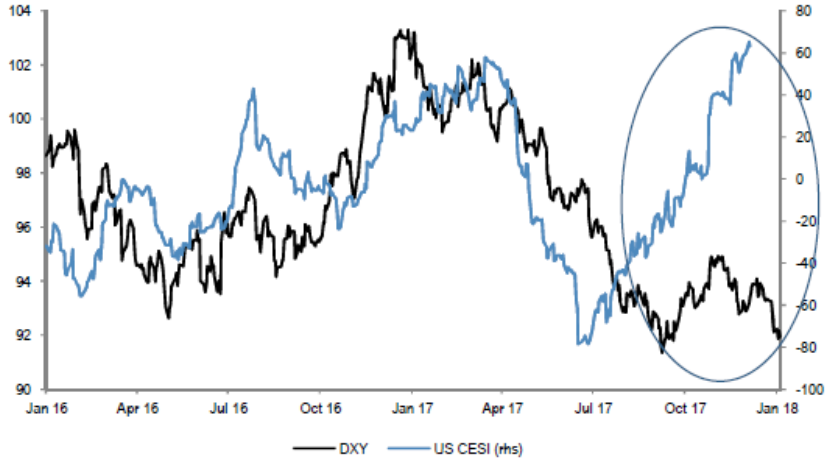


Positioning on long EUR has now turned outright long for the first time in 3 years.

The last week of the year was the biggest week of buying for Leveraged Funds since June 16, 2015. Leveraged Funds bought 34k contracts ($5.1 billion notional), driven by adding new longs.

The buy-side (Leveraged Funds and Asset Managers, collectively) are now the most net long Euro Currency futures (in numbers of contracts, though, not as a % of total open interest) that they have ever been!

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



Current market expectation of only 3 Fed hikes being priced in over the next 3 years as too conservative.

With the move we have described on Yields, the correlation between the US 5Y and Dollar Index (DXY) is broken and in the last 6 months we have seen a gap that was difficult to spot in the past (2nd chart). We now expect this gap to close and we cannot be too bearish on the USD short term.

Under the technical point of view we are getting some very interesting reversing signals on the EURUSD and DXY monthly charts, please let us know if you want to discuss this in details.

On **Gold**, we have rightly called the reversal point in the support area at 1250$ explaining over last update the potential effect of a short squeeze.

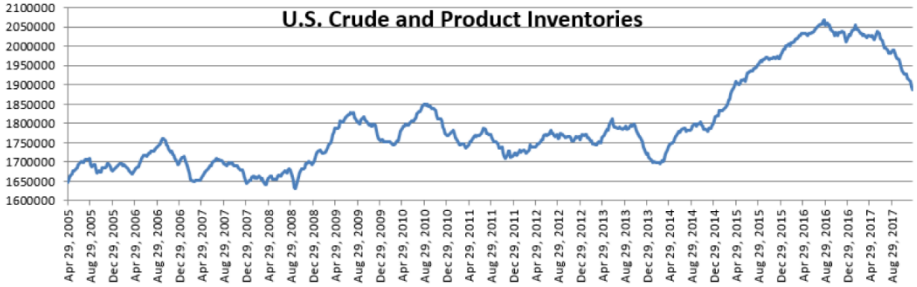
Once again, positioning has been helpful along the chart for calling these reversals.

In the middle of December Managed Money added a 3.3 standard deviation amount of shorts in Gold futures ($2.9 billion notional) and a 6.8 standard-deviation amount of shorts in Silver futures ($1.8 billion notional). The situation now is dramatically changed as Managed Money are small net long after being covering all the shorts.

We are currently trading at 1315 and would prefer to take some profit even if it could potentially continue to outperform if market would correct short term.

Crude oil is up 2.5% Ytd and up 50% from the lows made last June. 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. CTA funds are now all long Crude and they will comfortable keep these positions having had a positive return of more than 20%.

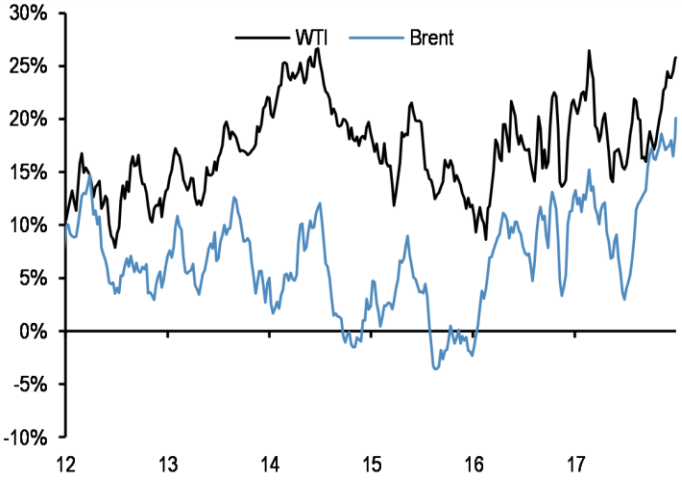
The American Petroleum Institute (API) published data suggesting that US crude oil inventories fell another 4.2 mln barrels last week, to which oil prices responded positively. Also, new data showed that Brazil oil production fell both m/m and y/y in November, whilst this is meant to be one of the growth drivers. Data from earlier this week showed a slowdown in exports from Iran, flat production from Russia in December and record product demand from Asia. Hence, incoming data points have remained encouraging.



The 6-month annualised decline of inventories of 14% was the biggest such decline since the 6 months to March 2003, and prior to that, the 6 months to April 2000 and the chart shows the magnitude of the move.

Unsurprisingly, energy rose to 6.41% of world GDP, the highest since December 2014.

However, similarly to what happened recently on the EurUsd and Gold, positioning on Crude/Brent is now extreme and has reached a new 5-years highs on Crude and 6-years high on Brent.



While we think the potential 'pain' in Crude is considerably skewed to the downside, it could take an extended move for these longs to liquidate.

The second chart shows the net speulative positions divided by open interest. CFTC futures positions for WTI and Brent are net long minus short for the Non-Commercial category

Under the **Geopolitcal point of view** the next important theme 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).

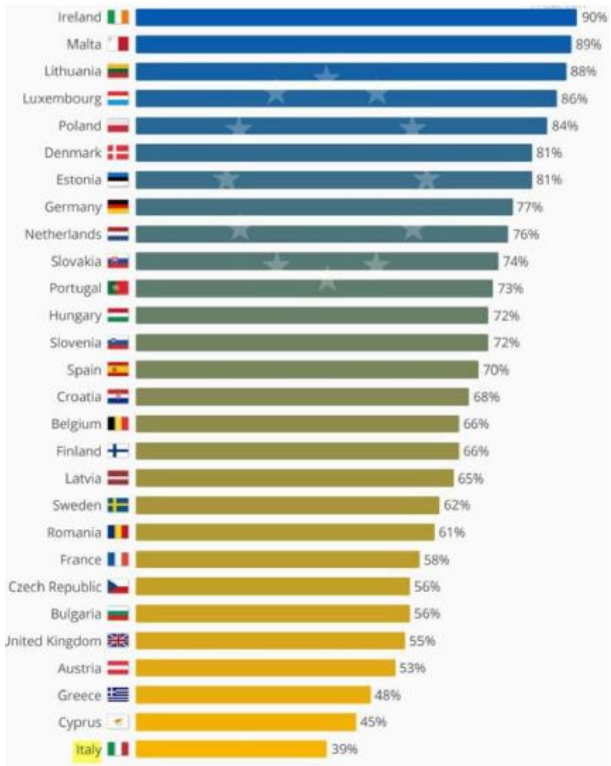
The latest polls shows that the center-right coalition is set to gain plurality as a whole, even though Five Stars could be the single most voted party. The table on the left is the average of the most recent polls.

	%
Five Stars	**27.7**
Centre-right	**36.9**
Forza Italia	16.0
Lega	**13.7**
Brothers of Italy	4.9
Other centre-right	**2.3**
Centre-Left	**27.4**
PD	**24.2**
Other centre-left	3.2
Left	**6.9**

However there is still some degree of risk as it is actually impossible to find another EU member country where the public opinion is more negative on EU than it is in Italy. Nowadays, even the Greeks rate the EU move favorably than the Italians do (table on the right).

Another important event to be followed is about the **NAFTA negotiations.**

Headlines are going to pick-up due to a a formal full round of NAFTA talks set to kick off January 23-28 in Montreal, upcoming tariff hearings and trade decision deadlines, and debates around trade and tariffs continue to unfold within the Trump administration.



The risk of the US pulling out of NAFTA has not dissipated. Senator Grassley said it's become clear after recent meetings with top administration officials that President Trump isn't ready to abandon his brinkmanship over a possible withdrawal from NAFTA. Moreover, with tax reform done, the emboldened President may no longer need to appeal to more moderate lawmakers who are in favor of keeping NAFTA.

Spain is already up 4% Ytd and is starting to catch up the other European markets after the sell-off on the **Catalonian issues.**

As we know, separatist parties won 70 out of 135 seats on a record 83% turnout. Rajoy's People's Party lost 8 of its 11 seats.

Rajoy had said he would rescind direct rule regardless of the election result, but could re-impose it if a new government again pursued secession and we are still waiting to hear some news from that front.

We continue to envisage that Catalonia will remain part of Spain, and high frequency data tell us that Spain's growth momentum is still strong. We remain positive on the Spanish economy and some are also saying that the country's economic fundamentals probably justify a rating upgrade to re-include the sovereign in the A bucket.

In **Germany, CDU and SPD parties** traded insults about migration and tax cuts amid mounting questions about whether they can agree to renew the "grand coalition". A growing number of politicians say Merkel might have to rule with a minority government or face new elections.

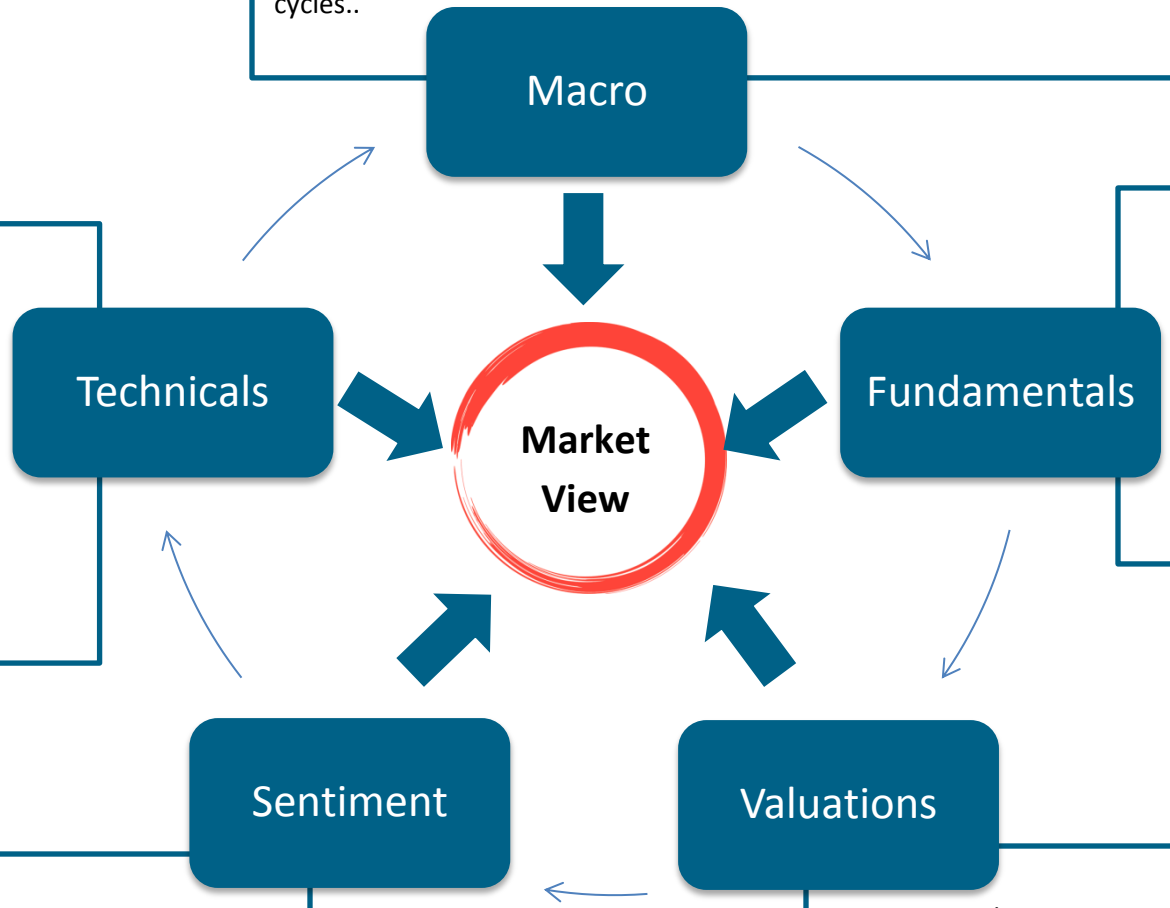
Free-market CDU party members and immigration hardliners said a coalition with the SPD would be too high a price for Merkel remaining chancellor. They are pressing instead for a minority government, fully aware of the greater uncertainty that would mean.

YouGov survey commissioned by Germany's DPA agency showed 47% of respondents wanted Merkel to step aside before 2021, when her 4th term would end, up from 36% in a poll taken in October.

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..



SLIGHTLY POSITIVE: GDP push top line higher with earnings growing.
Q4 season has just started, will be interesting if consensus will be beaten again as estimates are looking for marginally lower EPS growth in '18 compared to '17 in most regions.

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.

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

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.

The MSCI World has closed positively in December for the 14th consecutive month and is now up 2.5% Ytd, an historical record and the S&P 500 has seen a maximum drawdown of just 2.8% in 2017 (the second smallest drawdown in history with only 1995 seeing a smaller pullback).

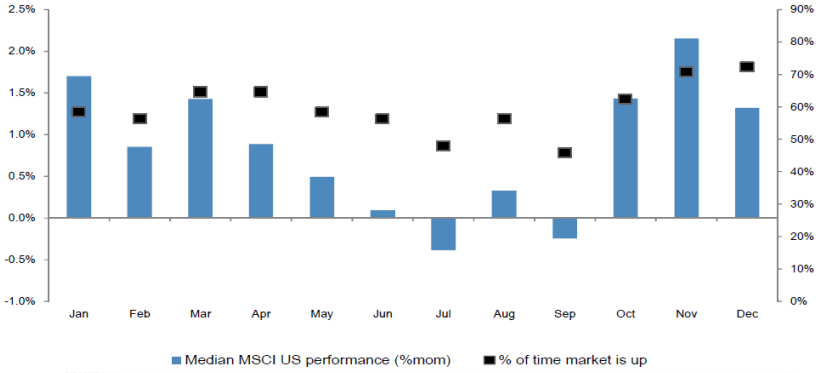
The start of the market has been ballistic with new record highs in US and Asian stocks with their best week in the last 6 months!

In contrast to what we have seen for most of last year, cash volumes have been very high in these first days of the year, **it is a proper capitulation/ melt up. While we are still keen to participate to the upside of the market** (positive factors described in the first pages of this note), **we would now be using any additional strength to reduce the weight and buy cheap volatility to protect the portfolios and to use the potential sell-off as a buying opportunity for the next leg up especially in Europe.**

The big picture for stocks remains an accommodative one. On the one hand, there is a positive operating leverage and the earnings tailwind. On the other hand, real policy rates are close to record lows, providing a favourable discount rate for equities.

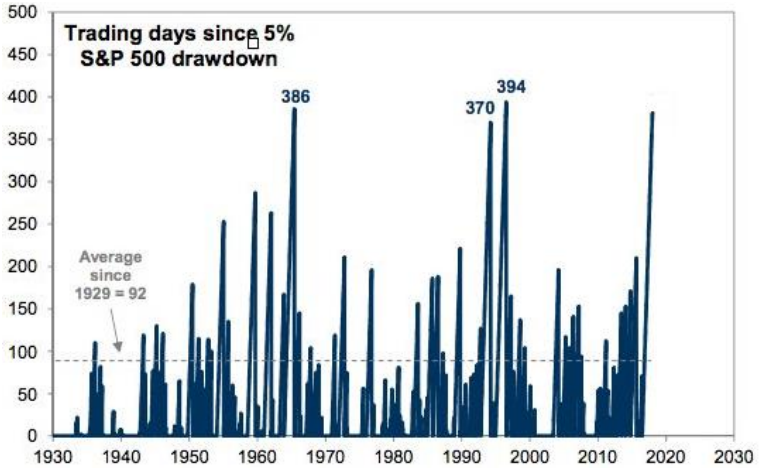
Equities are a "real asset class", which benefits from reflation, as it has nominal earnings and nominal top line. The last 20-year correlation between bond and equity prices was inverse. If yields were to rebound for the right reasons as we think, this should boost equities at least in the first set-up.

Another positive factor to be kept in mind is the seasonality of the beginning of the year, the 1st chart on the side shows the performance of the MSCI US.



But, the S&P has gone 392 days without a 5% pullback, putting it just over one week away from the longest streak on record, dating back to 1929 (2nd chart).

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.

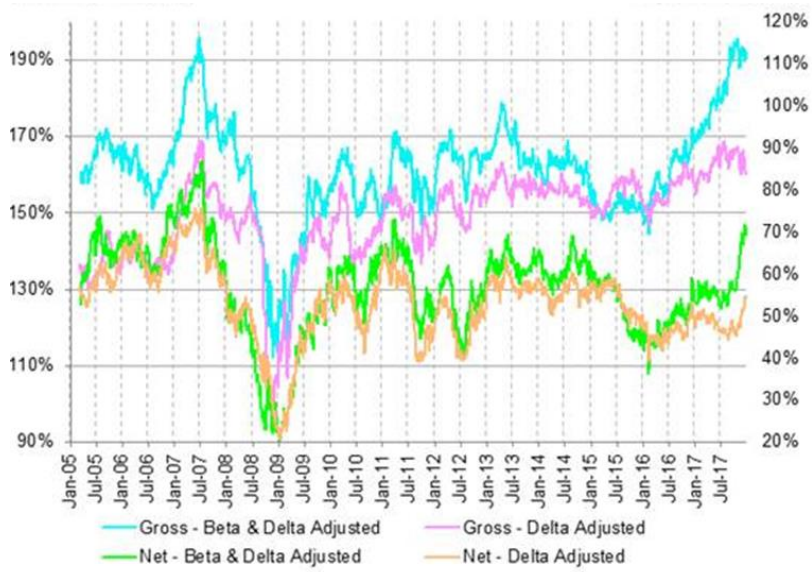


There are growing signs that the now-persistent trend of rising share prices and stronger economic data is prompting something of a "capitulation in caution" with US investor optimism rising sharply. For example:

- 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;
- CBOE put/call ratio is still at extreme lows;

- The RSI on S&P is currently at 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. In the past, when the RSI has peaked above 80 an average correction of -3.5% has followed one month later. The corrections have ranged from -0.8% to -7.7%;
- The S&P is also trading on the line of the second standard deviation where most of the time it generates an inversion-signal.

We might find out that the set-up for 2018 looks to be more challenging than initially perceived. Valuations globally, especially in the US, have expanded meaningfully while margins in the US are at all-time highs as positioning on a Gross and net basis remains elevated (see chart).



For the medium-term view we will need to monitor closely the continuation of the positive earnings trend coupled with the perceived outlook for inflation, **sovereign yields and corporate spending will dictate the breadth and direction of markets from here on out**.

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**. In Q4, the positive newsflow from Tax Reform and Seasonality for Year End have helped the market despite many difficulties. 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 for 2018 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. **Earnings** are likely to show further robust improvement. With 2% Eurozone real GDP growth projection, 10% EPS growth looks reasonable. This might make '18 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 firs 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.

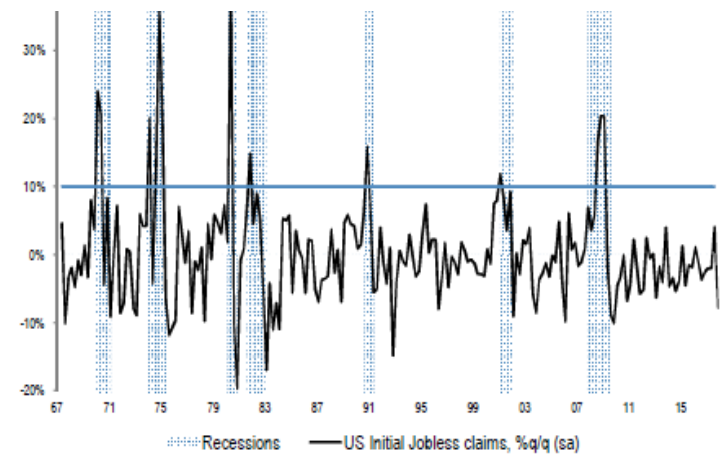
We also know that the inverted yield curve was a good predictor of slowdowns. Looking at the last seven US recessions, the US yield curve would invert ahead of every single one but crucially equities did not tend to peak before the signal was reached, before the curve inverts, they peaked only afterwards.

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.

Start of Expansion	End of Expansion	# Months
Nov 45	Nov 48	36
Nov 49	Jul 53	44
Jun 54	Aug 57	38
May 58	Apr 60	23
Mar 61	Dec 69	105
Dec 70	Nov 73	35
Apr 75	Dec 79	56
Aug 80	Jun 81	10
Dec 82	Jun 90	90
Apr 91	Feb 01	118
Dec 01	Nov 07	71
Jul 09	*Current*	*102*
Average		**61**
Max		**118**
Min		**10**

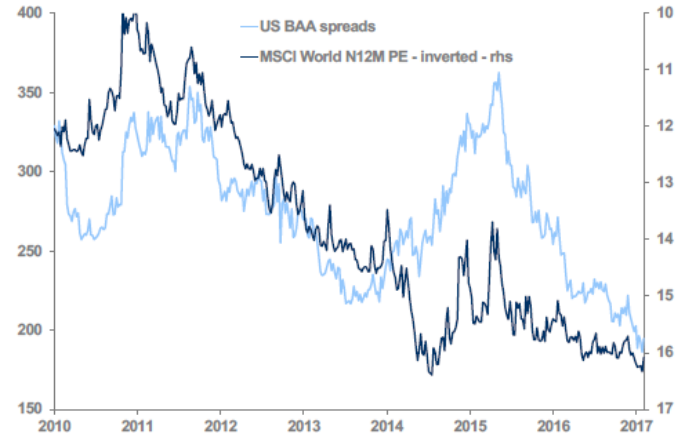
Negatives:

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.
As the table shows we have currently reached 102 months of expansion. The S&P 500 Index's price-sales ratio, which surpassed 2.2 last week and neared 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. According to the chart on the side, 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.

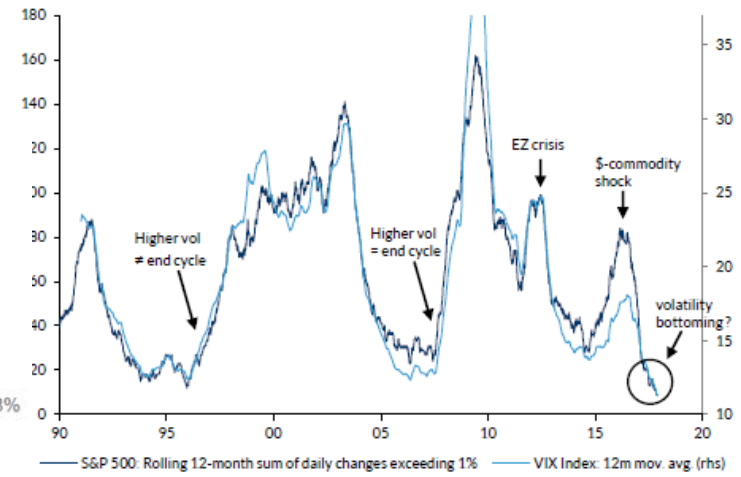
3) **Credit spreads set to widen**. A combination of tighter monetary policy, record spread valuations and high leverage (especially on US corporate balance sheets) looks set to weigh on credit markets going forward. We forecast spread widening in all regions next year with the biggest move projected in the US. As shown in the second 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 next year. Again, this is likely to put downward pressure on equity valuations.

We think that volatility is bottoming out (chart), market risk has tumbled while global equities have kept on hitting fresh peaks. On top of this, sliding currency volatility has sent a Bank of America Merrill Lynch gauge of future price swings across asset classes to its lowest level since September 2014.

The S&P realised volatility is near all-time lows! (closest chart).



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.

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

Why do we like Europe?

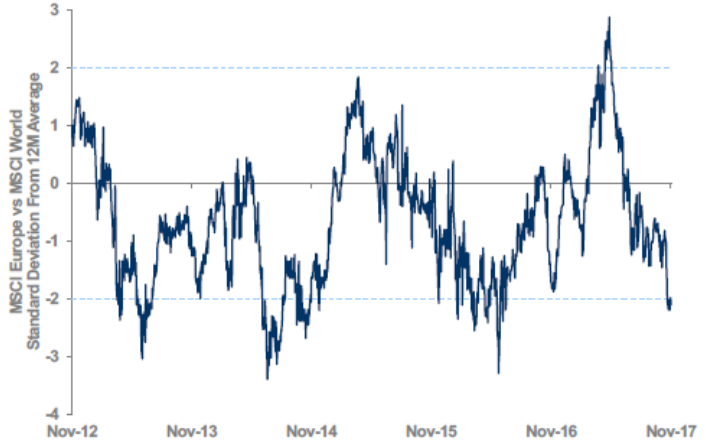
1) **Attractive macro outlook.** All Brokers have upgraded GDP forecasts for the Euro Area again and see 2018 as a second year of >2% growth followed by 1.9% in 2019. Despite strong above-trend growth, the ECB looks set to maintain an extremely easy monetary policy setting, while fiscal policy may also 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.

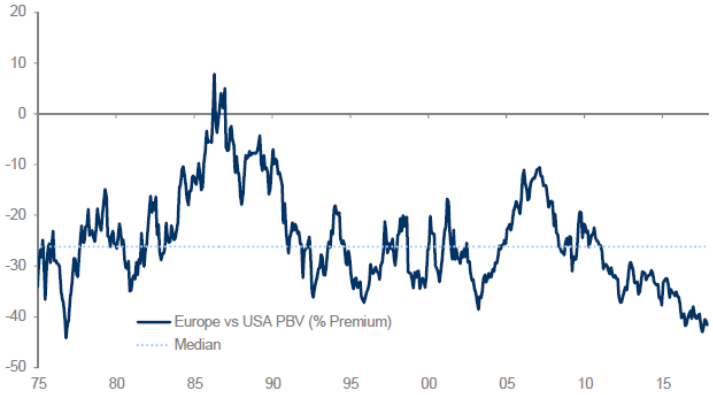
Eurozone valuations are attractive, both in absolute and in relative terms. The region has seen inflows in 2017, but this has not translated into higher multiples. Eurozone P/E has barely moved over the last two years, contrasting with the re-rating seen in all the other regions.

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 the drag on European earnings from FX should now be behind us.

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) **Technically Europe is oversold**. The relative performance of the MSCI Europe vs MSCI World is striking, we have now reached the 2nd standard deviation (1st chart at the top).
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 2nd chart shows the appealing Europe vs US Price to Book value.
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.

6) **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%.

The table shows the performance of Eurostoxx after a year when the index shows a positive gain and underperforms the S&P500 by more than 5% (since 1990)

PRIOR YEAR	JANUARY AFTER	Q1 AFTER	1 YEAR AFTER*
2016	-1.82%	6.39%	8.21%
2014	6.87%	17.90%	4.85%
2013	-2.80%	1.96%	1.13%
2003	3.24%	1.36%	7.31%
1995	6.92%	7.00%	23.38%
1991	4.90%	6.41%	3.77%
Up / Down	4 up / 2 down	6 up / 0 down	6 up / 0 down
Avg. % Return	2.89%	6.84%	8.11%

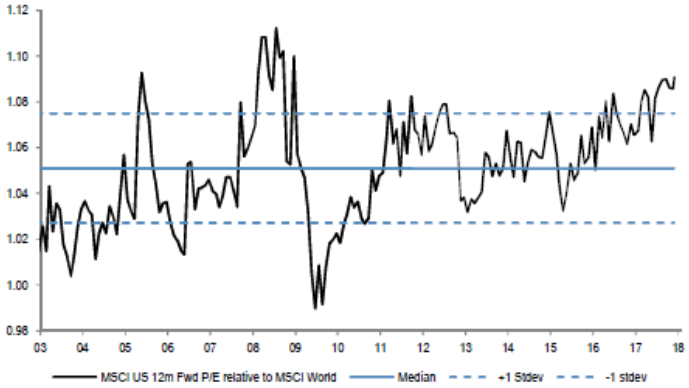
Why are we more negative US?

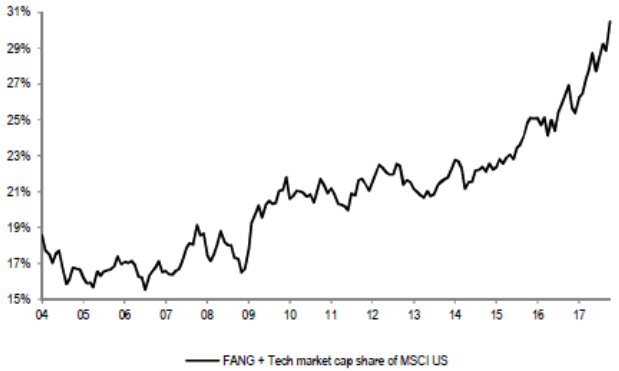
2017 has been one of the best years for equity investors in recent memory. Not only have absolute returns been high, but every sector has participated with the exception of Energy and Telecom Services which represent less than 10% of the index. If that wasn't enough, the largest drawdown this year for 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 and the chart on the right shows the combined market cap of FANG (Facebook, Apple, Netflix, Google) + Tech into MSCI US (2nd chart).



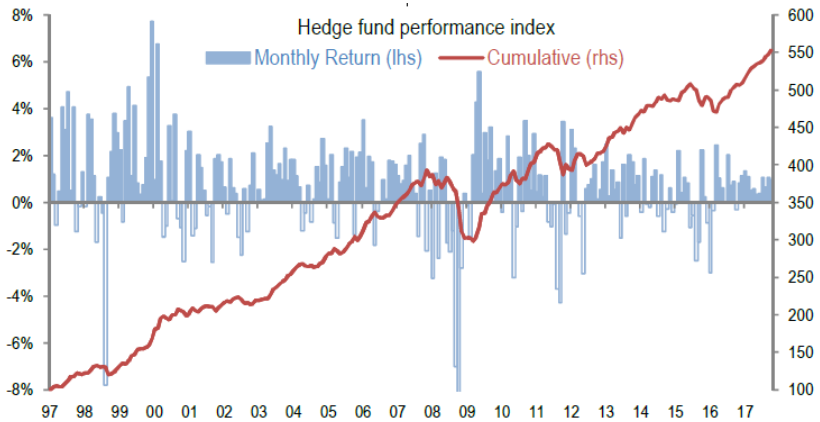


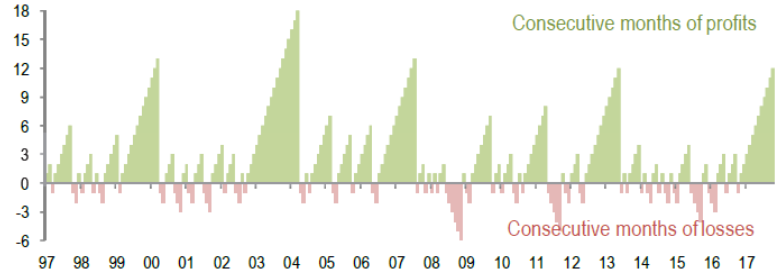
The relative weight of the Tech growth category within the US equity space has become so considerable that leading large cap market indices are dominated by its behaviour. Without strength in large cap growth the leading indices of US equity cannot go far.

Earnings dispersion is currently at a 40 year low, it doesn't take a complex algorithm to understand there is a much higher probability this rises rather than falls in 2018, particularly if there is decelerating growth, rising interest rate and credit volatility, higher oil prices and tightening financial conditions generally.

There could be some profit taking this year as Hedge Fund had the best run in 4 years in terms of returns. The chart shows on the top the monthly hedge fund returns reported by BarclayHedge while at the bottom we have the number of consecutive months of profits and losses.

In addition to that, the US Investors which have bought after the Trump elections (8th of November 2016) can now sell and be taxed as long term capital gain because they have held their positions for more than 12 months.



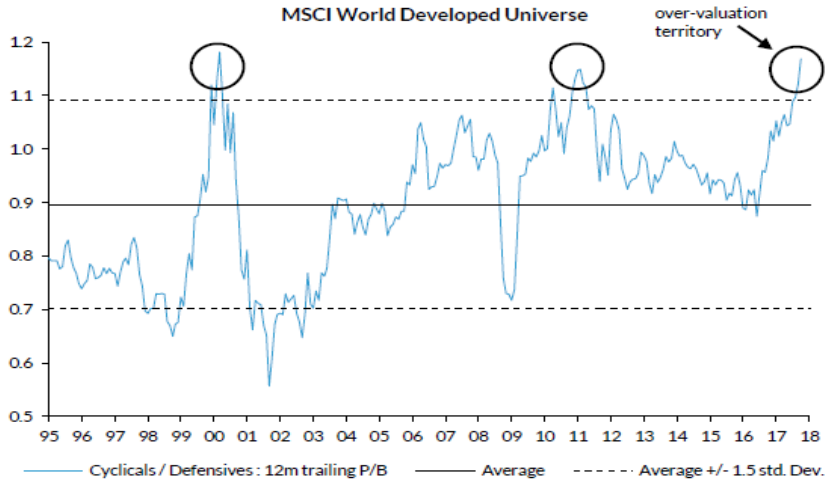


On last update we said that there was an high probability of continuing the bullish trend until Christmas, at least under the statistical point of view and this has also continued in the first days of 2018…. **We reiterate the 3 things we believe investors can do to equip portfolios for whatever 2018 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).



Market performances

Equities	Last	2W	YTD
MSCI World Index USD	2'158.0	2.6%	2.6%
MSCI All Country World EUR	189.2	3.1%	3.1%
MSCI All Country World Local	603.8	2.7%	2.7%
North America			
Dow Jones Industrials	25'383.5	2.7%	2.7%
S&P 500	2'752.6	3.0%	3.0%
Nasdaq 100	6'687.0	4.5%	4.5%
Russell 2000	1'560.2	1.6%	1.6%
S&P/TSX Composite	16'326.2	0.7%	0.7%
Europe			
Euro Stoxx 50	3'622.2	3.4%	3.4%
FTSE 100	7'727.1	0.5%	0.5%
CAC 40	5'519.9	3.9%	3.9%
DAX	13'388.6	3.6%	3.6%
IBEX 35	10'422.8	3.8%	3.8%
FTSE MIB	22'985.4	5.2%	5.2%
SMI	9'593.9	2.3%	2.3%
Asia - Pacific			
MSCI AC Asia Pacific	179.9	3.5%	3.5%
Nikkei 225	23'850.0	4.8%	4.8%
Hang Seng	31'011.4	3.7%	3.7%
S&P ASX 200	6'135.8	1.2%	1.2%
KOSPI	2'510.2	1.7%	1.7%
Taiwan TAIEX	10'914.9	2.6%	2.6%
Emerging Markets			
MSCI Emerging Markets	1'206.9	4.2%	4.2%
Brazil Bovespa	79'052.1	3.5%	3.5%
Russian MICEX	2'225.4	5.5%	5.5%
BSE India Sensex	34'443.2	1.1%	1.1%
Shanghai Composite	3'413.9	3.2%	3.2%
Mexican Bolsa	49'788.5	0.9%	0.9%

Equity Sectors	2W	YTD
Stoxx Europe 600 Sectors		
Banks	2.7%	2.7%
Basic Resources	4.2%	4.2%
Auto & parts	7.7%	7.7%
Oil & Gas	4.1%	4.1%
Health Care	2.4%	2.4%
Telecomm.	2.6%	2.6%
Insurance	2.4%	2.4%
Food & Beverage	0.7%	0.7%
Industrial	4.0%	4.0%
Utilities	1.2%	1.2%
Personal & Household Goods	0.8%	0.8%
Chemicals	3.9%	3.9%
IT	3.7%	3.7%
Construction & Materials	4.3%	4.3%
Travel & Leisure	0.6%	0.6%
S&P 500 Sectors		
Financials	2.5%	2.5%
Energy	4.4%	4.4%
Health Care	3.9%	3.9%
Consumer Staples	0.5%	0.5%
Consumer Discretionary	3.4%	3.4%
Utilities	-2.3%	-2.3%
IT	4.5%	4.5%
Industrials	3.8%	3.8%
Materials	4.6%	4.6%
Telecomm.	-1.8%	-1.8%

Bonds	2W	YTD	Yield
US govies			
BBG US Gov 1-3 Yr	-0.1%	-0.1%	1.97%
BBG US Gov 3-5 Yr	-0.2%	-0.2%	2.19%
BBG US Gov 7-10 Yr	-0.5%	-0.5%	2.45%
EU govies			
BBG EU Gov 1-3 Yr	0.0%	0.0%	-0.40%
BBG EU Gov 3-5 Yr	0.1%	0.1%	-0.01%
BBG EU Gov 7-10 Yr	0.2%	0.2%	0.83%
BBG EU Gov 10+ Yr	0.3%	0.3%	1.65%
BBG GER Gov 3-5 Yr	0.0%	0.0%	-0.34%
BBG ITA Gov 3-5 Yr	0.3%	0.3%	0.45%
Yield to maturity	2W (bp)	YTD (bp)	
US Gov. 2 Yr Yield	8	8	1.96%
US Gov. 5 Yr Yield	11	11	2.32%
US Gov. 10 Yr Yield	13	13	2.53%
US Gov. 30 Yr Yield	14	14	2.88%
German Gov. 2 Yr Yield	2	2	-0.61%
German Gov. 5 Yr Yield	0	0	-0.20%
German Gov. 10 Yr Yield	4	4	0.46%
German Gov. 30 Yr Yield	5	5	1.32%
Swiss Gov. 2 Yr Yield	11	11	-0.79%
Swiss Gov. 5 Yr Yield	7	7	-0.45%
Swiss Gov. 10 Yr Yield	8	8	-0.07%
Swiss Gov. 30 Yr Yield	3	3	0.42%
Bond index TR	2W	YTD	
BBG USD IG Corp Bond 1-5 yrs (dur 2.80)	-0.1%	-0.1%	
BBG USD HY Corp Bond 1-5 yrs (dur 2.59)	0.5%	0.5%	
BBG EUR IG Corp Bond 1-5 yrs (dur 3.03)	0.1%	0.1%	
BBG EUR HY Corp Bond 1-5 yrs (dur 2.97)	0.5%	0.5%	
BBG USD EM Bond (dur 6.42)	0.3%	0.3%	
BBG EM Local Ccy Sovereign (dur 6.57)	0.4%	0.4%	

Alternative investments	Last	2W	YTD
Hedge fund index			
HFRX Global Hedge Fund	1'290.9	1.2%	1.2%
HFRX Equity Hedge	1'288.6	1.4%	1.4%
HFRX Equity Market Neutral	1'006.4	0.2%	0.2%
HFRX Event Driven	1'688.2	1.3%	1.3%
HFRX Global Macro	1'184.1	1.7%	1.7%
HFRX Systematic CTA	1'623.4	2.3%	2.3%
Commodities			
BBG Commodity TR	179.0	-0.5%	-0.5%
Gold spot	1'311.4	0.6%	0.6%
Silver spot	17.0	0.2%	0.2%
Copper 3m	7'125.0	-1.7%	-1.7%
Aluminum 3m	2'175.0	-4.1%	-4.1%
WTI Crude Oil	62.1	2.8%	2.8%
Platinum	968.3	4.1%	4.1%
Palladium	1'105.9	3.9%	3.9%
Forex			
EUR/USD	1.1926	-0.7%	-0.7%
EUR/CHF	1.1724	0.2%	0.2%
EUR/GBP	0.8824	-0.6%	-0.6%
EUR/CAD	1.4863	-1.5%	-1.5%
EUR/JPY	134.21	-0.8%	-0.8%
EUR/AUD	1.5245	-0.8%	-0.8%
EUR/NOK	9.6828	-1.6%	-1.6%
USD/CHF	0.9831	0.9%	0.9%
USD/GBP	0.7400	0.0%	0.0%
USD/JPY	112.54	-0.1%	-0.1%
USD/NOK	8.1193	-1.0%	-1.0%
CHF/GBP	0.7526	-0.9%	-0.9%
CHF/CAD	1.2676	-1.7%	-1.7%
CHF/JPY	114.48	-1.0%	-1.0%

Investment ideas

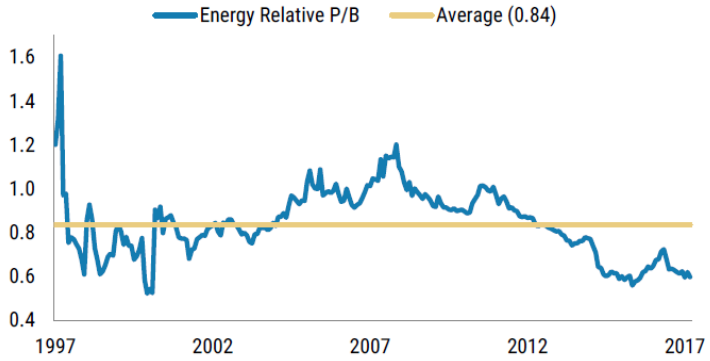
- **Long EU Banks, SX7E Index (+3.6% Ytd, they have been stable since the end of May underperforming the market).** Banks are still one of the few sectors to offer upside to both valuation and profitability going forward. Valuations are at the 10-year 'crisis' average and could re-rate by 10%+ given 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, such as the one that our economists forecast for '18, and P/B was 1.6x. This compares to 8.0% ROE and 0.9x P/B at present.

  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.

- **Long Energy Sector, SXEP Index (+4.4% Ytd and +5.7% from last update).** 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.
  If we were to see another month of net buying in January, this would be the first time we have seen three consecutive months of net energy buying since Q216.

- **Long EU Telecoms, SXKP Index (+2.75% 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.

  As we mentioned over the latest few updates, we also see the potential of M&A newsflow: NL mobile consolidation approaching Q1 18 (when Tele2 can sell trade spectrum), potential for Nordic deal (Kinnevik/ Com Hem) and VOD/ LBTY being discussed again.
  Today Altice has announced spinning off its US cable-TB business trying improving liquidity. There is obviously some short covering.
  Yesterday in Italy, Mr. Calend stated that in his opinion it would be good for Telecom Italia to separate the network from service… the newsflow on the sector is pretty active now.

  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.

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

- **Buy Put-spreads on US Indexes**: 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.**

  A Put spread on the S&P strikes 2700 (out 1.5%) / 2550 (out 7.0%) 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 24%.

- **Gold**: as explained above we would take profit at least on half position as the short term bounce has materialized.