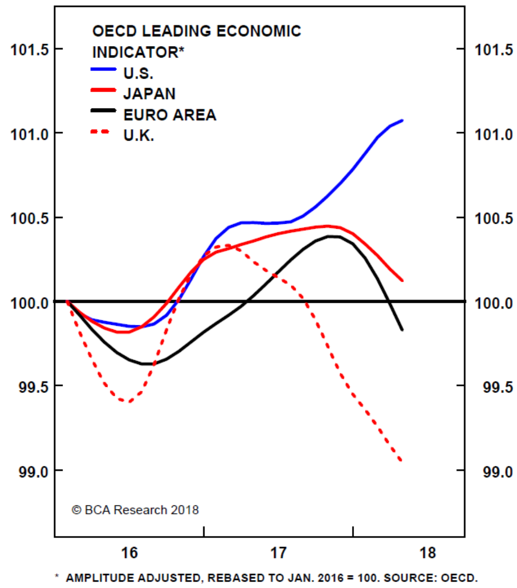

# Quarterly Investment Letter – Q3

**Q3/2018**

## Diverging growth paths

After a strong start to the year, markets have suffered from a hangover and have been having a hard time adjusting to some changing dynamics. Disappointing growth numbers in some key developed countries, combined with fears of imminent inflation, oil prices making steadily new highs, U.S. interest rates increasing and the yield curve flattening, led the USD to appreciate again quickly after a year of significant depreciation and caused investors to question the ability of Emerging Markets to absorb these headwinds. Key economic barometers (see chart 1) have already discounted a slower growth path outside of the U.S.

**Chart 1: U.S. is outshining its peers**




Source: BCA Research

As if that was not enough for these more vulnerable Emerging Markets, the U.S. Government went all-out threatening China, Europe and Canada/Mexico with newly imposed trade tariffs. These tariffs and the planned retaliation from trading partners could not be viewed as anything positive for global growth. However, the U.S. would still be the relative winner so Trump went ahead, doing what he has promised to do

## Summary Points

- We do not expect a recession in the U.S. and in Europe for the next 6 to 9 months. U.S. tax cuts and increased government spending will keep the U.S. economy relatively strong.
- Chinese growth is softening but the PBoC is carefully standing ready to ease conditions to prevent any escalating contraction.
- The trade tensions are steadily evolving into a trade war as political and personal egos are causing global growth collateral damages.
- The growing divergence (growth and monetary policies) between the U.S. and the rest of the world might cause some structural malaises, which will ripple through the markets.
- The USD has now appreciated again and will continue to benefit from tailwind factors, but most of the appreciation seems already discounted.
- Emerging Markets have to digest the increasing cost of a stronger USD and higher USD interest rates and trade tariffs, before resuming at a later stage their growth.
- Although many forces will prove challenging for Emerging Market assets, they have already discounted a large part of these expectations and offer longer-term investors interesting entry levels.
- In fixed income, the recent credit spread widening in specific markets offers some interesting entry points, such as in USD denominated Asian corporate bonds with good quality.
- We largely avoid duration exposure as inflationary tendencies are creeping up across the globe.
- Private debt markets, such as direct lending or secured lending remains in the sweet spot, but diversification and a thorough manager selection is a must.

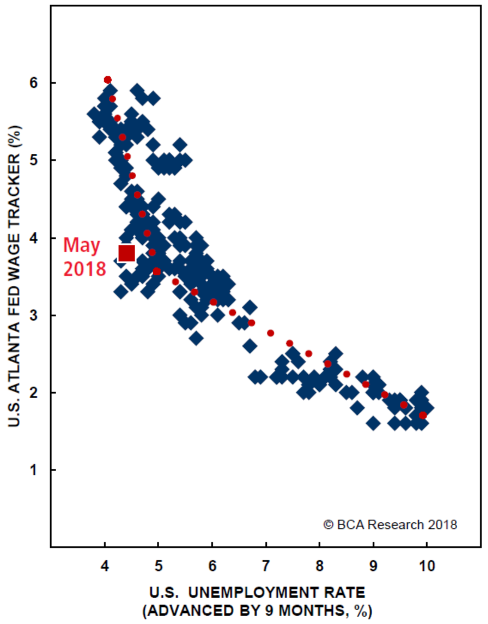
for months. The markets were not prepared, as most investors thought that Trump was simply using his forceful negotiating tactics to receive some concessions; however, no one accepted this hardline approach. The U.S., not to lose the credibility of their threats, went ahead, imposing ever-escalating tariffs.

At a time when the U.S. economy is running at full steam, with robust growth, which will be further benefitting from the increased government spending and tax cuts, risks that the economy could overheat are becoming real. The rest of the world's growth is moderating and Emerging Markets are coming under pressure, while many Central Banks are either tightening or preparing to phase-out their accommodative stance. The implications of such divergences and lag with FED policies could prove challenging for investors to properly assess the impact on asset allocation and opportunities.

## United States

Wage growth was so far stubbornly low compared to the level of unemployment. However, the CPI index clearly does not show the widespread wage growth currently creeping everywhere across the country.

**Chart 2: Wage inflation will accelerate**

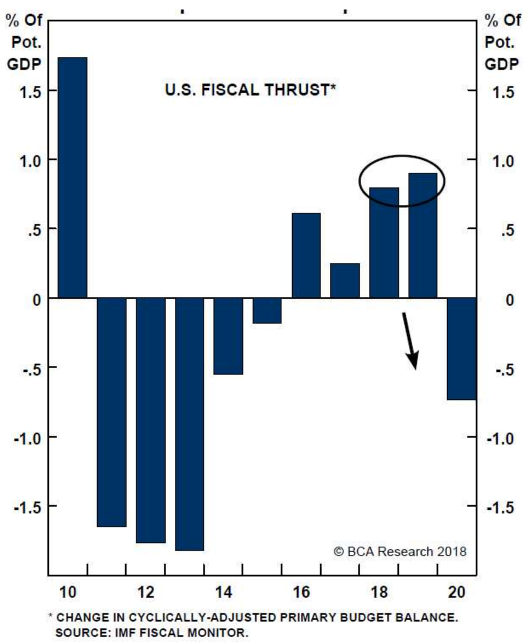



Source: BCA Research

**The pressure on rapidly rising wage growth is building in the background** and a faster rate of appreciation should be soon expected (see chart 2 showing the relationship between unemployment levels and wage inflation).

The FED is clearly aware and communicates that it will tighten steadily to prevent any excessive inflation. Increasing trade wars/tariffs are also inflationary in nature and could add to compounding forces already surprising investors, within the next 6 to 12 months. However, markets are currently not seeing it this way, with the consensus expecting the FED to raise rates by only +0.9% until the end of 2020. This is in sharp contrast to the FED forward indication and to some well-respected independent economists (we are also of the opinion that the market consensus is too conservative). The FED might need to change its "tone" and start to be more "pro-active" in its forward guidance.

**Chart 3: U.S. fiscal impulse set to drop in 2020**




Source: BCA Research

The markets will have a harder time to adjust to higher U.S. interest rates and higher inflation (in the coming quarters), especially when disruptive trade tariffs will soften the currently very robust corporate earnings growth (especially in the U.S.) and cause global trade disruptions. At the same time, the Mueller investigation, that has been very under-the-radar in the last months, could add to the uncertainty, at a time when investors and the markets are trying to adapt to a series of structural changes. When asset valuations are very high on both credit and equity assets, the probability of a disappointment to occur is increasing quickly and any external event like tariffs, higher USD or political uncertainty could be derailing investors' sentiment. It currently **feels like the mar-**

**kets have been too complacent in the face of major structural forces reshaping the world's economy.**

For the first time in a decade, the **FED is trying to slowdown GDP growth** to prevent the economy from overheating. This at a time when unemployment has never been as low in decades and while the fiscal stimulus will be adding significant tail wind to an already above-capacity economy until its effect will fade in 2020 (see chart 3 for scope of stimulus).

However, the FED does not want to be too aggressive as the market's reaction could be quick and violent, taking care by itself of "cooling down" the economy, by increasing the cost of capital very quickly. **As a reminder to be cautious, financial corrections historically happen mostly between August and November** and the coming months will be filled with potentially challenging catalysts, ranging from the trade war impacting earnings of U.S. multi-national firms, to mid-term elections results. If markets become more volatile, it may provide selectively interesting buying opportunities, although it has to always be borne in mind that structurally (for the coming few years), portfolios of very risk-adverse investors should be currently tilted to the cautious side.

## Emerging Markets

Emerging Markets were hit this year by a combination of factors. The rapidly strengthening USD (see graph to the right), higher USD rates (both leading to a higher cost of debt servicing by Emerging Market countries), global trade tensions/war, higher oil prices and somehow less accommodative global monetary policies all converged to create some significant short–term challenges to many Emerging Market countries.

While the 2016/2017 Emerging Markets rebound was solid and from very depressed levels, a period of consolidation and adjustment was needed before the rally could resume. Given the momentum on some of these factors, **more short-term pain cannot be ignored** before risky assets reach levels where the risk-reward will again be attractive enough for investors to "look beyond" the issues and challenges. **The important factor relates to the Emerging Markets' ability to withstand the current pressure**, while preventing triggering a credit crunch and further liquidity outflows from international investors. This implies proper policy responses (rate hikes in some cases to protect the currencies from falling too quickly, too fast, while not strangling the economic recovery) from most of the Central Banks, to prevent such potential panic.

International investors buy Emerging Markets because they grow faster than Developed Markets, and a faster growth typically translates into higher sales/earnings and asset valuations. On the credit side, Emerging Market countries have considerably less debt than most Developed Market countries, sound budgets, historically low inflation (especially in Asian countries) and nominal interest rates, providing investors attractive sovereign and corporate debt risk/reward characteristics. This is especially the case versus Developed Market countries plagued with massive debt/deficit/demographic issues. However, **stress periods as the current one can self-feed and cause sharp losses for investors ignoring the inherent liquidity risk** of these markets.

**Chart 4: US Dollar Index**

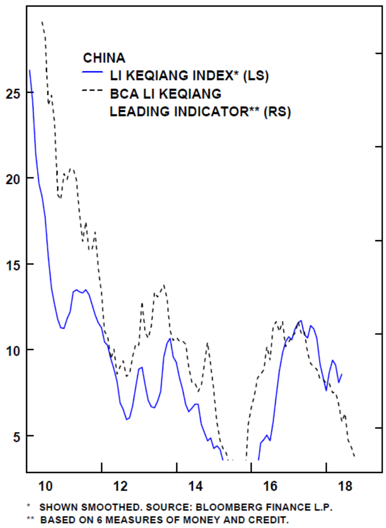

Source: TradingEconomics

Risky assets in Emerging Markets have been under pressure since February and were already subject to lots of outflows by international investors. The clearly diverging monetary and fiscal policies of the FED/U.S. versus most other countries have scared investors. **Historically, every time the FED has tightened monetary conditions, Emerging Market assets have suffered.** Although we do not see imminent global recession risks within the next 6 to 9 months, it is clear that global growth outside the U.S. will be steadily slowing down before rebounding.

## China

The Chinese economy is finally showing signs of slowing down post its 2015/16 massive stimulus, as illustrated by the leading economic indicator represented by the Li Keqiang index in Chart 5. The different anti-corruption initiatives, the pollution/energy-related reforms, some targeted tightening to manage the credit bubble coupled with current trade tensions with the US and increasing commodity prices have all contributed to the current economic slowdown over the last few months. Although the official **GDP growth numbers will most likely be close to the 6.5% Government target, the "reality" is probably closer to the 6% or so**, maybe even temporarily lower.

**Chart 5: Chinese growth is slowing anew**




Source: BCA Research

If that slowdown persists and the Chinese Government fears that it would weigh on long-term structural reform goals, we expect another round of financial stimulus to avoid any hard landing. We are confident that the PBoC is able to continue to maneuver carefully as it did so far over the last years. Regarding the Sino-American trade tensions, China has effectively not as many obvious ways to answer to Trump's tariffs but in the end to use a carefully engineered depreciation of the currency as it was already the case recently (see graph 6) to counter-balance the increased tariffs.

We are monitoring the trade tensions/war negotiations, during which saving face is more important than potential damages the economy could suffer. China may have more to lose than the US, but saving face is culturally critical. President Trump might consolidate his core voters, but the financial consequences could be painful and indirectly affecting everyone.

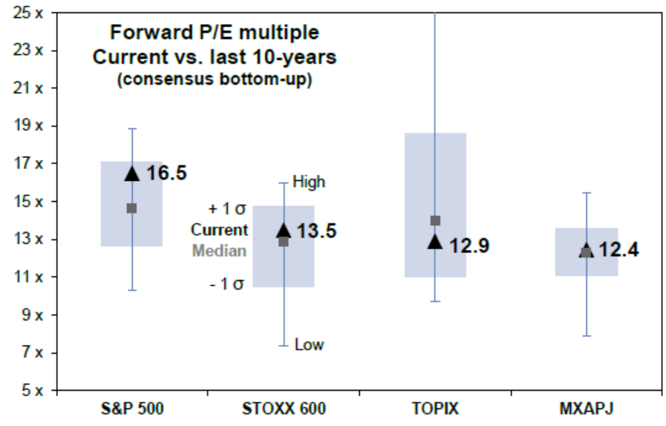
**Chart 6: Chinese Yuan**


Source: TradingEconomics

## Europe

The UK's evolving stance towards a potential softer-Brexit could lead to an unexpected rebound in business sentiment and capital expenditure, which could stimulate a sagging GDP growth, hit by uncertain Brexit negotiations and the spectre of a hard-Brexit. **ECB tapering its asset purchase programme from 30bn to 15bn EUR a month until it will be stopped at the end of the year. Rates are to be anchored at 0% until at least after summer 2019.** Germany is caught between potential new U.S. tariffs imposed on many of their exports (like cars and steel) and a moderating global (ex-US) GDP growth. Germa-ny's GDP growth is clearly being negatively impacted and we will see its GDP growth cool down towards the 2% (from 2.9%).

**Chart 7: Equity Valuations**



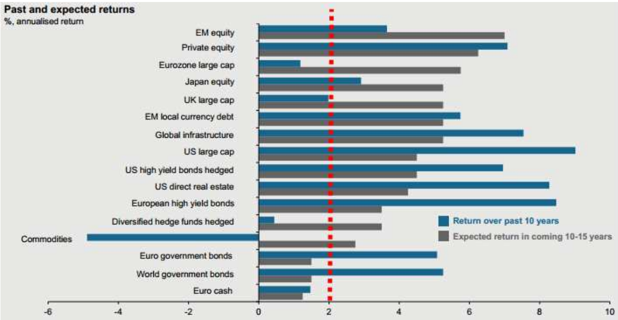

Source: Goldman Sachs

Italy is also a drag on Europe's growth with its high debt burden and a devaluation of the currency would certainly be helpful. A weaker EUR would also help European's large multi-national companies to generate better earnings. Europe still has a lot of slack in its economy and is earlier in its economic cycle than the U.S., but constant political issues plague the region and slows its recovery. The banking sector has still not really restructured itself post 2008/2011 crisis and unfortunately creates a drag on the recovery. The valuations of equities (see graph 7) are relatively interesting (bonds much less so), but Europe seems often to find itself at the mercy of other actors, in this case, Emerging Markets and U.S. growth and trade policies, as opposed to controlling more directly its destiny. **We therefore struggle to get too attracted to the cheaper asset valuations, as there are so many unknowns in Europe.** We prefer to focus on markets offering better long-term visibility. In some structural ways, Europe seems to remind us of Japan 20 years ago.

# Investment Focus

On a historical perspective, most asset classes are relatively highly valued given the strong performance they had experienced over the last few years. As a consequence, the return outlook is less favorable as chart 8 does well illustrate.

**Chart 8: Return outlook is capped for most markets**




Source: JPM / Alpinum IM

## Equities

Like always, every good thing eventually comes to an end at one point. The global equity markets have been pulled up mainly by 8 technology firms **(FAANG-BAT** as the now famous acronyms for Facebook, Apple, Amazon, Netflix, Google-Alphabet, Baidu, Alibaba and Tencent). **Without their fantastic contribution, most equity indices would have had significantly lower performance** as they accounted for a significant proportion of the overall performance. Trading at relatively lofty valuations, these stocks are very sensitive to the global consumer demands and hence, very exposed and levered to any slow-down in sales. Whereby in 2000, the tech firms were mostly trading on hope-valuations, these firms actually generate significant cash flow growth, but with very high expectations for the future.

An equity market correction at the current stage could be rather caused by the high consensus earnings estimates (pls see chart 10), which appear to be priced at perfection.

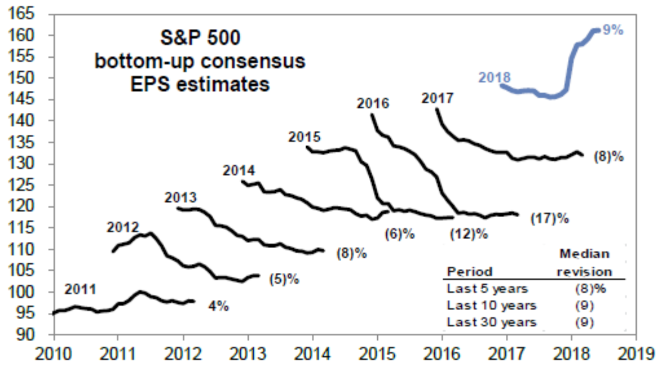
**Chart 9:**

| | Aggregate index | | Median stock | |
|---|---|---|---|---|
| **S&P 500 valuation metric** | **Current** | **Historical %ile** | **Current** | **Historical %ile** |
| US market cap / GDP | 182 % | **99 %** | NA | **NA** |
| EV / Sales | 2.3 x | **95** | 2.8 x | **97 %** |
| Cyclically adjusted P/E (CAPE) | 27.2 x | **89** | NA | **NA** |
| Cash flow yield (CFO) | 7.1 % | **87** | 6.8 % | **98** |
| Price / Book | 3.3 x | **87** | 3.3 x | **98** |
| EV / EBITDA | 11.6 x | **86** | 11.8 x | **96** |
| Forward P/E | 16.5 x | **81** | 16.7 x | **80** |
| Free cash flow yield | 4.2 % | **47** | 3.9 % | **60** |
| S&P 500 yield gap | 322 bp | **35** | NA | **NA** |
| **Median metric** | | **86 %** | | **96 %** |

Source: Goldman Sachs

The 2018 (and also 2019) sales and earnings growth expectations are so strong compared to the last years that only **a small disappointment could materially impact overall valuations.** As highlighted in the first graph above, based on a various number of valuation metrics, U.S. equities appear to be trading at historical record levels, making them more vulnerable than ever. The macroeconomic situation is clearly supportive of equities, but their current risk-reward is significantly less attractive, even after the latest pullbacks, mainly in Emerging Markets as U.S. firms starting to disappoint, would cause global sentiment contagion in cheaper markets like Europe and Asia. If the markets are avoiding any corrections, their valuation levels would point to an expected return over the next 12 months of about 5% to 8% from current levels, but with a clear risk of seeing a -10% to -15% relatively easily along the way.

**Chart 10: Consensus EPS estimates typically cut by 9%**




Source: Goldman Sachs

## Fixed Income and Credit

While credit spreads for Investment Grade corporate bonds have increased since the beginning of the year, they are still relatively low within a historical context.

Whenever we combine that risk premium to the increasing risk-free rate (mainly for USD bonds), we realize that **the required yield is now significantly higher** and, given the FED is expected to continue to increase interest rates in the coming quarters, this is expected to continue. This translates effectively into a loss of value for current bondholders, exacerbated by **the prospect of inflation that is lurking in the background, denting even more the real return for bond investors.**

Chart 11: Investment Grade Bond Indices

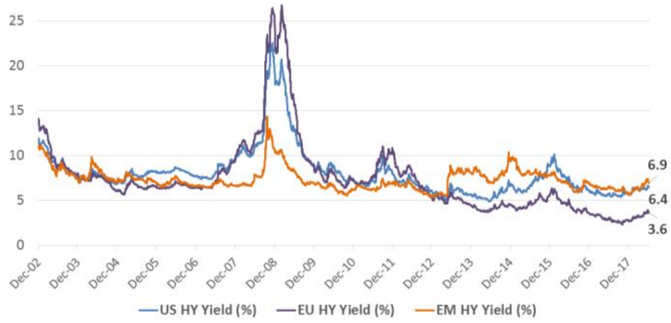

Source: Bloomberg, Marcuard Heritage

We were already for some time very negative on the risk-reward of investment grade bonds (and Government bonds) and the last months have finally provided evidence of the type of pain investors can suffer from perceived "safe" assets (at least on a "marked-to-market" basis). Given our macro scenarios, we still do not find much value in this asset class, although selectively, **for longer-term investors, the recent correction can offer pockets of opportunities**, especially in the BBB area of structured finance (MBS/ABS) and preferred securities.

On the **high yield front, our macro scenario for the U.S. and Europe are supportive for the asset class in general.** However, given the historically richly priced spread, we are turning more cautious as these bonds are becoming increasingly vulnerable to any market disappointment. Since it is relatively easy to eliminate the duration risk linked to the continued interest rate increases in the U.S. (and eventually in Europe) by buying loans instead of bonds, we have been overweighting this asset class. Even if there will be some increasing late cycle pressures on this asset class, the currently high nominal yield provided to investors is at least providing over a 12 months horizon some sort of decent cushion to weather momentary disruptions along the way. However, any widespread panic and significant outflows from the high yield sector could easily affect disproportionately the prices of these bonds/loans by 5% to 10% (if not more if there is a severe credit crunch, although this is clearly not our base case scenario for the next 6 to 9 months).

Emerging Markets have already suffered significant market corrections on some equity and fixed income markets. The significant headwinds facing both local and hard currency bonds caused by generalized outflows, higher risk premiums and a higher USD has created some opportunities for investors able to stomach more short-term pain.

Chart 12: High Yield Bond Indices




Source: Bloomberg, Marcuard Heritage

**We currently favor Asian corporate (BBB/BB) USD bonds as they offer more than 5% yield** and compare advantageously to Global High Yield bonds with lower risk and relatively short maturities. The risk profile is clearly closer to Investment Grade bonds but with yields now closer to High Yield bonds. Local currency bonds currently bear still a lot of risk as our view on the USD is tilted to a slight strengthening of the USD, which would further pressure the local currency bonds for USD investors.

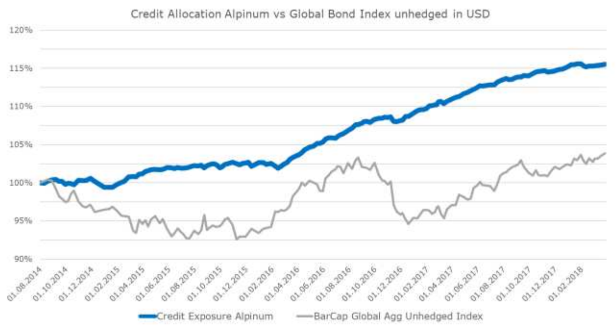
Chart 13: Asian Cross-Over Index versus IG / HY Bond Indices


Source: Bloomberg, Marcuard Heritage

While we currently refrain from "traditional" high yield bond allocations, we like our selected high quality short dated high yield bond exposure that provides us currently a yield of around 5% p.a. with very minimal default risk. In chart 14 we illustrate the performance of our credit-centric fixed income portfolio since mid-

2014. During this period we were able to weather a few storms with very limited drawdowns as compared to any major fixed income index. On the one hand, we achieved this lower risk profile via our very distinctive bond selection and on the other hand thanks to the very broad diversified portfolio across styles, managers, strategies as well as the inclusion of alternative long only income streams. Moreover, we employ a thorough drawdown management and act opportunistically.

**Chart 14: Credit long-only Exposure vs Global Bond Index**



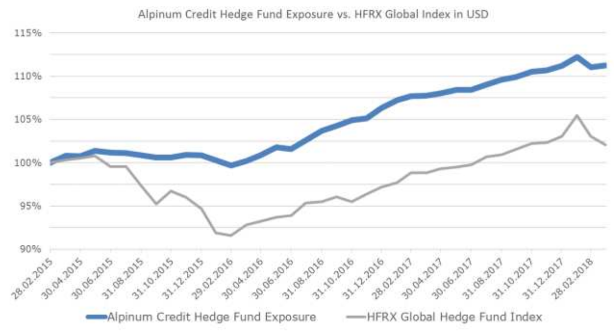

Source: Bloomberg, Alpnum

## Alternative Investments

As described before most traditional asset classes trade at relatively high valuation levels, while interest rates are creeping higher. In this environment, non-traditional strategies including hedge funds offer an attractive investment alternative. We consider **hedge funds as an important building bloc to construct portfolios with lower drawdown risks,** while optimising the risk-/return potential at the same time. At the current junction of the (late) market cycle, when equities tend to outperform fixed income assets it seems to be an opportune time to cut duration- and/or credit-sensitive assets in favour of less beta-driven strategies such as hedge funds. This will not only lead to a lower drawdown risk should markets start to correct (negative event), but it should also be beneficiary in a momentum gaining macro environment (positive event) when interest rates start to increase and putting stress on duration-sensitive assets.

We typically form our hedge fund portfolios with low market correlation and low drawdown profiles. Please see chart 15 the performance of our credit centric hedge fund allocation vs the HFRX Global index for illustration purposes.

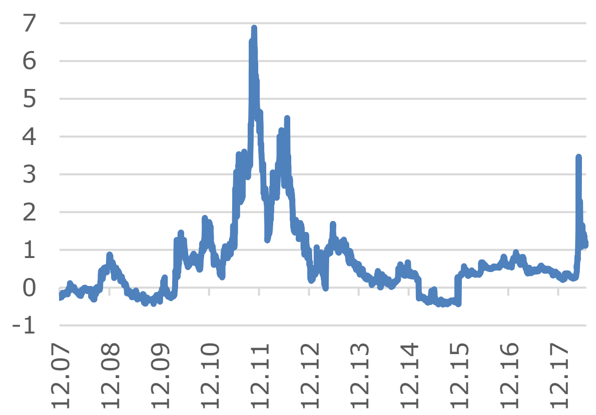
**Chart 15: Credit centric HF exposure vs HFRX Global Index**




Source: Bloomberg / Alpinum IM

In addition, in a late cycle environment, market moves tend to be more drastic for good or bad as it is well exemplified by the sharp move of the Italian interest rates (see chart 16) we have experienced in May. Increasing volatility and higher dispersion offer additional relative value opportunities for hedge funds.

**Chart 16: Interest rate spread between Italy/Germany 2 yrs**

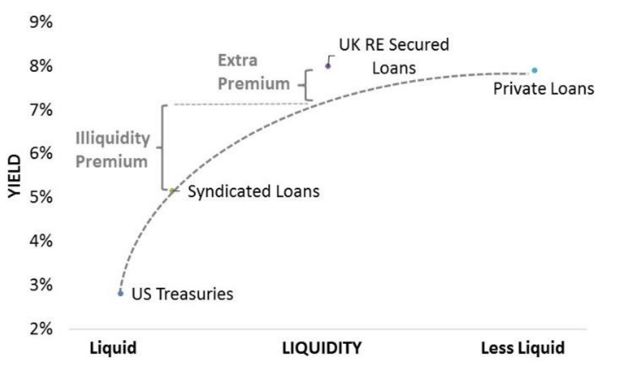



Source: Bloomberg / Alpinum IM

Moreover, for investors with a longer term investment horizon **we recommend diversified portfolios of direct loans, with which investors are able to harvest a complexity and illiquidity premium and generate returns of 7-8% p.a. in USD**. In this context, we have set up a dedicated investment solution in "Secured Lending" that is currently in the sweet spot as it optimally combines the desire for a high return expectation with a very limited risk of losing capital.

Our preferred investment solution in Secured Lending is currently focused on **short term residential mortgage backed lending**. We believe this strategy to be the preferred one within the secured lending market as it 1) generates a high income of ~8% p.a. in USD, 2) is backed by very strong collateral (homes with loan-to-value <65%) with extremely low historical loss rates, and 3) the maturity of the loans are short in nature at only 6-18 months. Hence, we can offer this strategy to investors in a relatively liquid format, while **avoiding any potential liquidity mismatch between assets and liabilities**.

Chart 17: Earning an Illiquidity and extra premium




Source: Alpinum IM

Chart 17 illustrates the **unique risk-/return profile** of the strategy. An investor can structurally achieve an additional return, which we describe as illiquidity plus extra premium due to limited market capacity. We gain access to this asset class via a "clean", closed-end fund structure with no asset-liability mismatch.

## Conclusion

The world is shifting gears, with the U.S. decoupling its economic strength and monetary/fiscal policies from the majority of the other Developed Markets' countries in the next few quarters. China is on a path of structural reforms to ensure a sustainable long-term growth, which is causing shorter-term headwinds to its economic growth, while Europe and Japan are whipsawed by politics, demographic challenges and trade tariffs consequences originating mainly from an escalating U.S. protectionism and Sino-American trade tensions. Investors have been only modestly reacting to the significant changes and forces happening globally and with elevated asset prices. **It is therefore a risk that investors' sentiment could shift abruptly towards a more negative one.** Such a trigger might come from disappointing sales/earnings from some of the market's bellwether stocks in the coming months.

As we do not expect any imminent recession (globally), and since we do not see elevated U.S. consumer leverage and real estate prices, we would not foresee that the next recession, if it were to come within the next 2 to 3 years, would be very severe. However, **traded financial assets might react disproportionately to any economic slow-down (or recession) or change of sentiment.**

For cautious investors, this is not a time to try to over-extend risky exposures, while for more risky investors, with a longer time horizon, the current market dislocations, especially within Emerging Markets (mainly credit and to a lesser degree equities), may provide some attractive opportunities. Volatility will most likely persist and even increase in the coming quarters, providing investors some more evidence that the markets will finally catch-up with the changing fundamentals.

| Absolute Return Strategies | Comments |
| --- | --- |
| **Equities** | |
| ▪ US equities incorporate advanced valuations compared to other regions, but earnings growth and tax cut perspectives should still lead markets slightly higher. However, given the current seasonality, we take an overall neutral stance towards equities. Should markets correct, we tend to buy opportunistically and would favour markets that had corrected the most (i.e. EM/Asia).<br><br>▪ Moreover, commodities tend to be a "late cycle" beneficiary when inflation trends higher. Therefore, we keep our exposure in U.S. energy-related MLPs, which benefit also from a high cash flow yield giving support to the investment case. | ▪ Equities trade with relatively high valuations, especially in the U.S. However, U.S. cyclical growth leads to strong earnings increases and still gives support to the current equity P/E multiples. In that respect, equity performance is linked to further earnings growth, as we don't expect multiples to expand.<br><br>▪ European equities still have some valuation gap versus the U.S. and corporations are supported by accelerating top line growth and increasing profit margins. Nevertheless, we hold a neutral stance for European equities and hold currently an underweight in emerging markets, but are willing to close the gap during market weakness. |
| **Credit / Fixed Income** | |
| ▪ Avoid Government bonds unless yields on Treasury 10-year reach close to 3% levels. Buy some U.S. Investment Grade bonds if yields increase and credit spreads are generally slightly wider.<br><br>▪ Focus the allocation mainly to U.S./European loans. European High Yield bonds are rich. Favour U.S. short-term maturities and add longer-term bonds on weakness only. Within IG, we prefer Asian bonds at higher spreads relative to the U.S./Europe.<br><br>▪ Emerging Market bonds offer pockets of opportunities after the recent sell-off. Be very selective in local currency bonds and favour Asia over rest of EM in hard currency bonds.<br><br>▪ Lower-ranked bonds of financials (i.e. preferred securities) offer relative value as banks are recapitalizing and the expected fiscal and de-regulation policies are positive factors. | ▪ U.S. interest rates should continue to trend higher, whereas we expect the short end to increase more meaningfully in the short term.<br><br>▪ Pro-growth policies in the U.S. continue to support high yield bonds/loans, as these companies will be able to grow their revenues, while default rates remain low. Loans offer better value vs High Yield Bonds. European credit markets still enjoy strong tailwind by low rates and the ECB's bond buying programme. However, it is going to fade in Q4 2018.<br><br>▪ Due to negative fund flows, we currently avoid to a large extent Emerging Market bonds in local currency, although, we believe selective markets are currently attractively priced.<br><br>▪ Consider harvesting the illiquidity premium from corporate and personal direct loans. |
| **Alternatives** | |
| ▪ Credit Long-Short strategies identify plenty of relative value trades, both long and short. Fixed-Income arbitrage offers more opportunities, as interest rates move as Central Banks are normalizing their policies. Equity Long-Short should benefit from the increasing performance dispersion and the continued support of their long-book helped by continued positive equity markets. | ▪ With the FED normalizing rates, Fixed-Income Arbitrage and Credit Long-Short managers will experience increasing price dispersion between different interest rates securities. This leads to more relative value opportunities and short opportunities in credit.<br><br>▪ Global macro managers should find more opportunities with the diverging global monetary and fiscal policies between countries. |
| **Real Assets** | |
| ▪ Gold will be caught between a slightly higher USD and rising U.S. interest rates and the increasing inflation rate. We expect the trading range between \$1200 and \$1350 to persist. | ▪ Should inflation continue accelerating in the coming quarters, we expect the gold price and other industrial commodities to go up. However, this will be a rocky path against higher U.S. rates/USD. |

<table>
<tr><th>Long Only Strategies</th><th>Comments</th></tr>
<tr><td>Equities</td><td></td></tr>
<tr><td>▪ US equities incorporate advanced valuations compared to other regions, but earnings growth and tax cut perspectives should still lead markets slightly higher. However, given the current seasonality, we take an overall neutral stance towards equities. Should markets correct, we tend to buy opportunistically and would favour markets that had corrected the most (i.e. EM/Asia).<br><br>▪ Moreover, commodities tend to be a "late cycle" beneficiary when inflation trends higher. Therefore, we keep our exposure in U.S. energy-related MLPs, which benefit also from a high cash flow yield giving support to the investment case.</td><td>▪ Equities trade with relatively high valuations, especially in the U.S. However, U.S. cyclical growth leads to strong earnings increases and still gives support to the current equity P/E multiples. In that respect, equity performance is linked to further earnings growth, as we don't expect multiples to expand.<br><br>▪ European equities still have some valuation gap versus the U.S. and corporations are supported by accelerating top line growth and increasing profit margins. Nevertheless, we hold a neutral stance for European equities and have currently an underweight in emerging markets, but are willing to close the gap during market weakness.</td></tr>
<tr><td>Credit / Fixed Income</td><td></td></tr>
<tr><td>▪ Avoid Government bonds unless yields on Treasury 10-year reach close to 3% levels. Buy some U.S. Investment Grade bonds if yields increase and credit spreads are generally slightly wider.<br><br>▪ Focus the allocation mainly to US/European loans. European High Yield bonds are rich. Favour U.S. short-term maturities and add longer-term bonds on weakness only. Within IG, we prefer Asian bonds at higher spreads relative to the U.S./Europe.<br><br>▪ Emerging Market bonds offer pockets of opportunities after the recent sell-off. Be very selective in local currency bonds and favour Asia over rest of EM in hard currency bonds.<br><br>▪ Lower-ranked bonds of financials (i.e. preferred securities) offer relative value as banks are re-capitalizing and the expected fiscal and de-regulation policies are positive factors.</td><td>▪ U.S. interest rates should continue to trend higher, whereas we expect the short end to increase more meaningfully in the short term.<br><br>▪ Pro-growth policies in the U.S. continue to support high yield bonds/loans, as these companies will be able to grow their revenues, while default rates remain low. Loans offer better value vs High Yield Bonds. European credit markets still enjoy strong tailwind by low rates and the ECB's bond buying programme. However, it is going to fade in Q4 2018.<br><br>▪ Due to negative fund flows, we currently avoid to a large extent Emerging Market bonds in local currency, although, we believe selective markets are currently attractively priced.<br><br>▪ Consider harvesting the illiquidity premium from corporate and personal direct loans.</td></tr>
<tr><td>Commodities / Forex</td><td></td></tr>
<tr><td>▪ Gold will be caught between a slightly higher USD and rising U.S. interest rates and the increasing inflation rate. We expect the trading range between $1200 and $1350 to persist.<br><br>▪ Given the continued global growth and our view that inflation expectations will slowly emerge, oil (Brent) tends to trade slightly higher although a temporary period of consolidation is now to be expected.</td><td>▪ Should inflation continue accelerating in the coming quarters, we expect the gold price and other industrial commodities to trend upwards. However, this will be a rocky path against higher U.S. rates/USD.<br><br>▪ While OPEC+Russia have decided to start lifting their production as the glut of oil has finally been absorbed, the overall increase is relatively small, as some members have had production problems. In addition, the U.S. producers (including shale ones) are expected to fill the production gap, lifting lately the WTI price versus the Brent.</td></tr>
</table>

# Asset Class Conviction Levels for Absolute Return Strategies

The below conviction table reflects the investment team's view of the absolute expected return of an asset class/strategy in relation to "cash".

| Equities | Underweight | ← | Conviction Level over 6 Months<br>Neutral | → | Overweight |
|---|---|---|---|---|---|
| North America | ☐ | ☐ | ☑ | ☐ | ☐ |
| Europe | ☐ | ☐ | ☑ ← | ☐ | ☐ |
| China | ☐ | ☐ | ☑ ← | ☐ | ☐ |
| Japan | ☐ | ☐ | ☑ | ☐ | ☐ |
| Asia - Emerging Markets | ☐ | ☐ | ☑ ← | ☐ | ☐ |
| Others - Emerging Markets | ☐ | ☐ | ☑ ← | ☐ | ☐ |

| Fixed Income | Underweight | ← | Conviction Level over 6 Months<br>Neutral | → | Overweight |
|---|---|---|---|---|---|
| US - Treasury Bonds | ☑ | ☐ | ☐ | ☐ | ☐ |
| Euro - Government Bonds | ☑ | ☐ | ☐ | ☐ | ☐ |
| US - Investment Grade Bonds | ☑ | ☐ | ☐ | ☐ | ☐ |
| Europe - Investment Grade Bonds | ☑ | ☐ | ☐ | ☐ | ☐ |
| Emerging Market Local Currency | ☐ | ☐ | ☑ ← | ☐ | ☐ |
| Emerging Market Hard Currency | ☐ | ☐ → | ☑ | ☐ | ☐ |
| US High Yield / Loans | ☐ | ☐ | ☐ | ☑ | ☐ |
| European High Yield | ☐ | ☑ ← | ☐ ← | ☐ | ☐ |
| European Loans | ☐ | ☐ | ☐ | ☑ | ☐ |

| Commodities | Underweight | ← | Conviction Level over 6 Months<br>Neutral | → | Overweight |
|---|---|---|---|---|---|
| Gold | ☐ | ☐ | ☑ | ☐ | ☐ |

| Hedge Fund: Strategies | Underweight | ← | Conviction Level over 6 Months<br>Neutral | → | Overweight |
|---|---|---|---|---|---|
| Equity Long-Short | ☐ | ☐ | ☑ | ☐ | ☐ |
| Credit Long-Short | ☐ | ☐ | ☑ | ☐ | ☐ |
| Event-Driven - Corporate Actions | ☐ | ☐ | ☑ | ☐ | ☐ |
| Global Macro | ☐ | ☐ | ☑ | ☐ | ☐ |

| Hedge Fund: Regional Focus | Underweight | ← | Conviction Level over 6 Months<br>Neutral | → | Overweight |
|---|---|---|---|---|---|
| Hedge Fund: North America | ☐ | ☐ | ☑ | ☐ | ☐ |
| Hedge Fund: Europe | ☐ | ☐ | ☐ | ☑ | ☐ |
| Hedge Fund: China / Japan | ☐ | ☐ | ☑ | ☐ | ☐ |
| Hedge Fund: Emerging-Markets | ☐ | ☐ | ☑ | ☐ | ☐ |

# Asset Class Conviction Levels for Long Only Strategies

The below conviction table reflects the investment team's view of the relative expected return of an asset class in relation to traditional well-recognized benchmarks such as BarCap Global aggregates (bonds) and MSCI World (equities).

| Equities | Underweight | | Conviction Level over 6 Months<br>Neutral | | Overweight |
|---|---|---|---|---|---|
| North America | ☐ | ☐ | ☑ | ☐ | ☐ |
| Europe | ☐ | ☐ | ☑ | ☐ | ☐ |
| China | ☐ | ☐ | ☑ | ☐ | ☐ |
| Japan | ☐ | ☐ | ☑ | ☐ | ☐ |
| Asia - Emerging Markets | ☐ | ☐ | ☑ | ☐ | ☐ |
| Others - Emerging Markets | ☐ | ☐ | ☑ | ☐ | ☐ |

| Fixed Income | Underweight | | Conviction Level over 6 Months<br>Neutral | | Overweight |
|---|---|---|---|---|---|
| US - Treasury Bonds | ☑ | ☐ | ☐ | ☐ | ☐ |
| Euro - Government Bonds | ☑ | ☐ | ☐ | ☐ | ☐ |
| US - Investment Grade Bonds | ☐ | ☑ | ☐ | ☐ | ☐ |
| Europe - Investment Grade Bonds | ☑ | ☐ | ☐ | ☐ | ☐ |
| US High Yield | ☐ | ☐ | ☑ | ☐ | ☐ |
| US Short Term High Yield | ☐ | ☐ | ☐ | ☑ | ☐ |
| US Loans | ☐ | ☐ | ☐ | ☐ | ☑ |
| US Municipal Bonds | ☐ | ☑ | ☐ | ☐ | ☐ |
| European High Yield | ☐ | ☑ | ☐ | ☐ | ☐ |
| European Short Term High Yield | ☐ | ☑ | ☐ | ☐ | ☐ |
| European Loans | ☐ | ☐ | ☐ | ☑ | ☐ |
| US/EUR Preferred Securities | ☐ | ☐ | ☐ | ☑ | ☐ |
| US/EUR Asset Backed Securities | ☐ | ☐ | ☐ | ☑ | ☐ |
| Emerging Market Local Currency | ☐ | ☐ | ☑ | ☐ | ☐ |
| Emerging Market Hard Currency | ☐ | ☐ | ☑ | ☐ | ☐ |
| Emerging Market High Yield | ☐ | ☐ | ☑ | ☐ | ☐ |

| Commodities | Underweight | | Conviction Level over 6 Months<br>Neutral | | Overweight |
|---|---|---|---|---|---|
| Gold | ☐ | ☐ | ☑ | ☐ | ☐ |
| Oil (Brent) | ☐ | ☐ | ☑ | ☐ | ☐ |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