FIS GROUP

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MARKET OUTLOOK

Q4 2017

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Q3 Recap

Growth accelerated in Q3, with inflation quiescent in most countries; perpetuating the "Goldilocks" conditions that have generally favored risk assets since early 2009. Global equity markets continued their gallop in Q3, with the MSCI ACWI and the S&P 500 reaching all-time highs. Among developed markets, the MSCI Eurozone index outperformed the MSCI ACWI by 28 bps; Japan trailed by 44 bps whilst Emerging Markets (EM) bested the global benchmark by roughly 300bps. With the US dollar having fallen 8% year to date, a significant portion of the relative performance advantage for international equity markets came through currency gains. (See TABLE 1).

TABLE 1 | Major Markets – 2017 YTD Performance
In Local and USD Terms

Ticker	Short Name	PX Last	Local Currency	USD
SPX	S&P 500 Index	2,549.33	13.87	13.87
HSI	Hang Seng Index	28,458.04	29.35	28.49
DAX	DAX Index	12,955.94	12.85	25.44
SHSZ300	CSI 300 Index	3,836.50	15.90	21.23
SXXP	STXE 600 Euro Pr	389.47	7.76	19.79
NKY	Nikkei 225	20,690.71	8.25	12.02
UKX	FTSE 100 Index	7,522.87	5.32	11.38
NDLEEGF	ISCI Daily TRNet Emer	569.65	26.32	-
MXEF	MSCI EM	1,103.12	-	27.93
		Average	14.95	18.89

Source: TPP Analytics

Among sectors, IT, energy and materials outperformed the global equity index whilst consumer staples and health care underperformed in all three major regions. Financials outperformed in the U.S. and the Eurozone, but trailed in Japan and EM. Industrials also outperformed in the Eurozone and Japan but lagged in the U.S. and EM. Consumer discretionary, utilities and telecom services trailed the broad market and were a mixed bag across the three major regions.

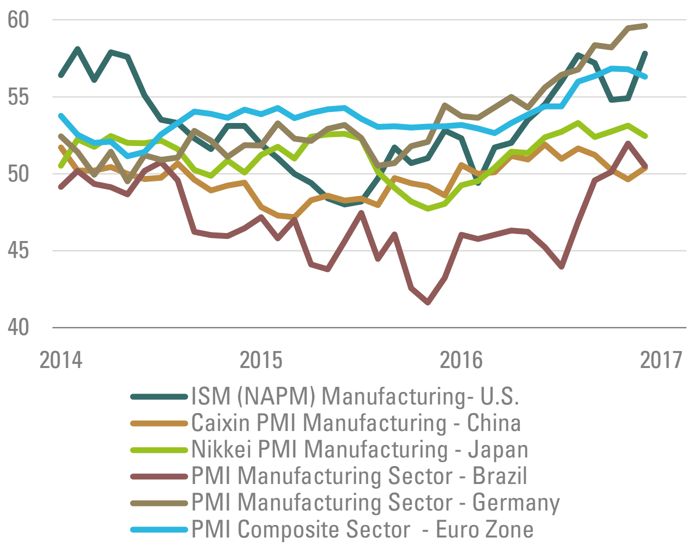
In the U.S., growth rebounded sharply after a seasonally weak Q1. First-half GDP growth came in at 2.2% (above trend, which is estimated at 1.8%), and the manufacturing ISM reached 57.7 in September. The two big hurricanes will probably knock around 0.5 points off Q3 growth but the lesson from previous disasters is that this will be more than made up over the following three quarters. Rebounding capex, and consumption aided by a probable acceleration in wages, should keep GDP growth strong. With Q2 GDP growth 2.3% YoY and the manufacturing PMI at 57.4, **Europe's** growth surpassed the U.S., reflecting its greater degree of cyclicality, with the German IFO growth index plumbing new heights and manufacturing wages growing by 2.9% YoY.

Japan has been buoyed by the external sector (with exports rising 18% YOY and industrial production 5%), but has thus far still been plagued by weak household spending and core inflation. Despite potential uncertainty with the impending election later this month, we expect a continuation of earnings-supportive Abenomics (monetary accommodation as well plus structural market reforms). Finally, **China's** PMI has oscillated around 50 all year, as the authorities tried to stabilize growth ahead of October's Party Congress. But money supply and credit growth have been slowing all year, and this is now showing through in downside surprises in fixed asset investment and retail sales data. Especially if the congress moves towards structural reform and short-term pain, growth may slow further.

Going forward, we expect growth to remain strong for the balance of 2017 and much of 2018. Accordingly, the Citi Economic Surprise Indices (see CHART 1 on the next page), show strong upward surprises in all major markets except for China, which since early this year has been undergoing a notable deceleration of money and credit growth.

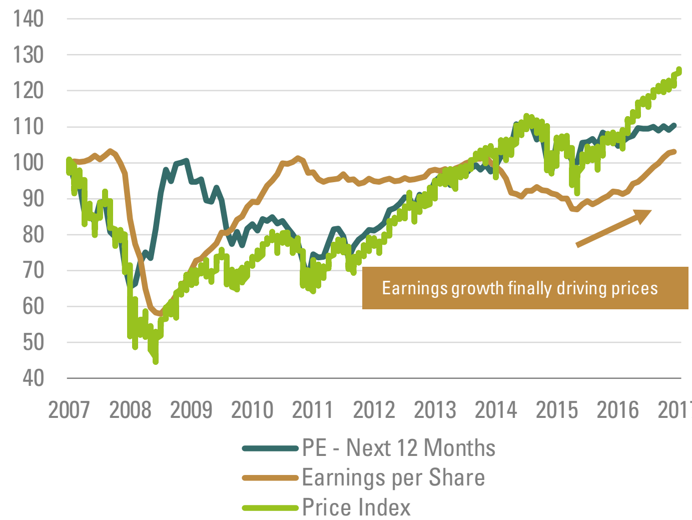
On the earnings front, Q3 2017 was the second quarter in a row in which the price appreciation in global equities was driven by earnings growth, as opposed to expansion in the forward price-to-earnings ratio (which contracted by 2% compared to Q2). Additionally, earnings upgrades continue to outpace downgrades. Even emerging markets earnings, that have been in steady decline since 2011, have turned a corner. (See CHARTS 2-4).

CHART 1 | Global Economic Activity Full Steam While China Lands Softly
Manufacturing PMI, As of June 30, 2017



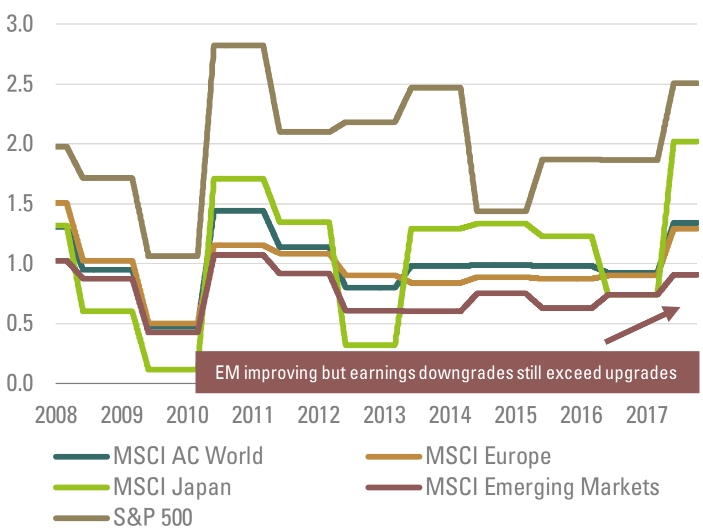
Source: FIS Group Professional Estimates and Factset

CHART 2 | Earnings Growth Overtaking P/E Expansion as Global Stock Price Driver
MSCI AC World, All Series Rebased to 100, As of October 6, 2017



Source: FIS Group Professional Estimates and Factset

CHART 3 | Global Earnings Recovering
Net Earnings Revision Ratio, MOV 1Q
As of October 6, 2017



Source: FIS Group Professional Estimates and Factset

CHART 4 | Relative EM Earnings Continues to Strengthen
MSCI EM (Emerging Markets)– Earnings Per Share Relative to World Index, As of October 6, 2017

Source: FIS Group Professional Estimates and Factset

Although we expect less flattering base-effects going forward (as we move pass the late 2015/early 2016 slump in earnings), top-line growth underpinned by a self-sustaining global upturn through at least mid-2018 should allow global equities to withstand less accommodative policies by the Fed and ECB. Moreover, although equity valuations are not cheap by historical standards, they are still attractively valued compared to bonds, especially after the recent safe-haven buying drove global bond yields to very depressed levels.

As we approach 2018, the following factors bear monitoring.

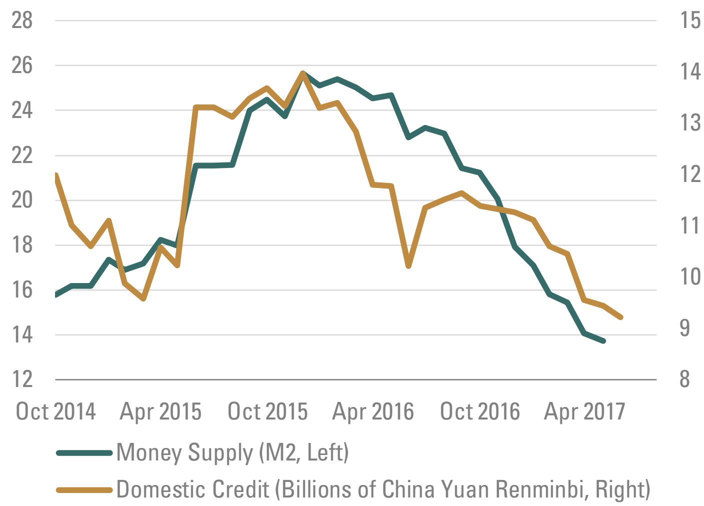
1. **The disconnect between the Fed and the market on the path of interest rates and inflation.** The US Federal Reserve continues to confirm that it will start shrinking its balance sheet soon. This should be dollar bullish. However, the key risk is whether inflation, which has been soft this year, will rebound and force the Fed to tighten monetary policy in line with its current projections. This would likely cause long-term rates to rise and the U.S. dollar to appreciate, which would hurt government bonds, commodities and some emerging markets. A potential preview of this risk occurred in the latter half of September when after months of pricing in flat-lining inflation, after a more stable core inflation report, the probability of a December Fed hike priced by the futures market moved from 25% to 75%.

   While our baseline expectation is that the Fed will raise rates in December as well as at least two more hikes next year, this expectation may be adulterated or enhanced by personnel changes at the Fed. With Chair Yellen's term due to expire next February and four other vacancies on the FOMC, personnel changes could significantly change the Fed's direction. For the Trump Administration, the most politically expedient course of action is a series of appointments that steer the Fed in a direction which is more tolerant of rising inflation. This would prolong the current Goldilocks environment and prompt a melt-up in risk assets along the lines of 1999. On the other hand, some of the names being circulated (such as Kevin Warsh and Jerome Powell) are likely to be more hawkish than current Chair Yellen. Either such appointment would again be dollar bullish.

2. **Fiscal policy uncertainty.** The Trump Administration's recently proposed tax legislation, if enacted, would represent a form of modest fiscal stimulus late in the economic cycle when the economy is at or very close to full employment. As currently proposed, the legislation would cut taxes by around $1.5 trillion with modest offsets of around $500 billion. A pro-cyclical fiscal stimulus should be bullish for U.S. small caps, companies that maintain significant assets overseas (because of the potential asset repatriation tax break) and bearish for 10 year Treasuries.

3. **Credit slowdown and structural reform in China.** Money supply growth in China continues to slow (See CHART 5). This slow-down could be exacerbated if a newly re-elected President Xi Jinping moves forward with structural reforms; even at the expense of a short-term growth slow-down. From a global perspective, a significant slowdown in Chinese money and credit growth should negatively affect demand for China exposed export sectors in Asia and Europe.

CHART 5 | Chinese Money and Credit Still Tumbling
Annual % Change, As of September 29, 2017



Source: FIS Group Professional Estimates and Factset

Geopolitical risks emanating from North Korea. Despite the constant chest-pounding and saber-rattling from the leaders of both North Korea and the U.S., investors appear to have become relatively desensitized to geopolitical risks emanating from North Korea. We do not believe that the market is wrong in this assessment. In this regard, it is encouraging that both of North Korea's allies, China and Russia have turned up the pressure; which is starting to impinge on critical fuel supplies there. It would now require a major provocation (i.e. a direct attack on the U.S. or its allies), for tensions to escalate from current levels, reflecting a level of recklessness by Pyongyang which is difficult to fathom. However, while we believe that a full-out war is unlikely, a ratcheting of tensions and minor military skirmishes are quite likely before Pyongyang returns to the negotiating table. The most relevant market threat is to South Korean equities, which traditionally experience a pullback when tensions escalate. Thus far, each such pullback has given rise to a buying opportunity. With currently positive fundamentals (fiscal and monetary policy support, that market's exposure to the global trade cycle, as well as corporate governance reform), we would agree with such action.

Our Q4 2017 Strategy is delineated in the TABLE 2 on PAGES 4-6.

TABLE 2 | Global Country and Sector Positioning

Risk / Environment	-		N		+	
Global Equity Risk Environment				Strategic		**Risk On.** 2017 is on pace to be the first year since 2007 in which all countries in the MSCI ACWI are experiencing growth at the same time. The soon to begin Fed tapering has been long signaled and priced into risk assets. The BOJ and ECB are expected to continue to buy bonds into at least 2018 (albeit at a slower pace for the ECB come 2018), leaving monetary policy in an accommodative stance. With US markets in overvalued territory, and implied volatility at all-time lows, any shock to the status quo could be sharp, but the trend is for asset appreciation for the short to intermediate term.
U.S. Dollar				Strategic		**Slight Overweight Relative to the Yen** through currency hedged equity positions. We have a neutral view on the dollar relative to the Euro due to the personnel uncertainty surrounding the FOMC. We remain bearish on the Yen relative to the USD due to continued strong accommodation by the BOJ in light of still low inflation and domestic spending.
Market Type (Developed at Left/Emerging at Right)			Tactical	Strategic		**Strategic Overweight to Emerging Markets, with Neutral tactical positioning.** A declining generalized EM growth dividend from productivity improvements will require greater selection among EMs. Although the earnings performance of EM has improved and EM markets are trading at a discount to the developed world, they are trading near historical averages and could see devaluation should Fed policy accelerate or China further retrenches credit growth.

Region / Countries	-		N		+	
United States		Strategic	Tactical			**Tactically Neutral with Strategic Underweight.** Strong earnings and low inflation have kept US markets strong, despite high valuations. We prefer other developed markets due to lower valuations, potential for margin expansion, and more potential to benefit from improving capital structures. However, we are tactically neutral because of tax legislation, which if enacted could provide a strong positive catalyst for certain U.S. equities and prolong the current "sugar high."
United Kingdom			Strategic			**Neutral.** Large UK companies generate 70% of their revenue abroad, which has been supported by the decline in the Pound. Muddied political waters makes the ultimate timing and cost of Brexit unknown, and we expect continued supportive policies from the Bank of England in the interim. This will continue to undermine the pound.
EU				Strategic		**Strategic Overweight.** Europe continued its strong growth, with earnings up 14% in the 2nd quarter. In addition, GDP was revised upward to 2.3% and economic sentiment is the highest since 2007, without rising inflation. We are focused on small cap companies with sectors and countries exposed to construction and capital spending within the EU.
Japan				Strategic		**Strategic Overweight.** Falling Yen and strong global growth has been a boon for internationally exposed Japanese stocks. GDP growth has been strong, but has yet to flow through to retail sales and wages. We maintain an overweight to higher quality small cap stocks and financials, which we think will continue to benefit from the BOJ's effort to steepen the yield curve. Corporate governance codes are increasingly taking hold, benefiting equity investors through shareholder friendly practices.
Emerging Markets (Asia)			Strategic	Tactical		**Tactical Overweight on the Region, with Overweight to South Korea, Taiwan and Pakistan.** Structural changes in the Pakistani market and continued corporate governance improvements in South Korea project to strong outperformance as valuation multiples normalize. Our Taiwan overweight is tied to our belief that the semiconductor cycle has not yet peaked. We have a neutral view on Chinese and Indian equities, but are focused on the higher growth sectors.

CONTINUES ON NEXT PAGE

● Strategic (6-12 months+) ● Tactical (3 months) ● Variance for Non-U.S. Portfolios

Region / Countries	-		N		+	
Emerging Markets (Europe)			Strategic	Tactical		**Neutral with tactical Overweight to Russia.** Russia has potential to rebound on the back of improved prospects for oil price stabilization, moderating inflation and improving governance. Polish and Czech economies are showing signs of strength with currencies which we expect to strengthen relative to the Euro.
Emerging Markets (LatAm)			Strategic	Tactical		**Neutral with tactical overweight to Brazil and Colombia;** Brazilian stocks have rallied despite another round of corruption charges, suggesting that the bad news is priced in. We remain cautious on the larger ETF driven flows, but believe smaller stocks will benefit from broadening local pension demand for equities. Colombia represents a very cheap market with the potential to benefit from falling rates and market reforms.

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary		Strategic		Variance		**Strategic Overweight in Europe and Japan.** This sector tends to underperform at the beginning of interest rate tightening cycle which appears to be at least a year away in Europe and Japan. We are underweight the sector within the US, due to the timing of the interest rate cycle.
Consumer Staples		Strategic				**Strategic Underweight;** Defensive sectors tend to underperform at this point in the cycle of all major markets. We reduced an underweight within European staples due to sensitivity to the rising Euro.
Energy			Strategic			**Neutral.** We expect that oil prices will continue their modest rise as inventories continue to dwindle amid strong global demand.
Financials				Strategic		**Strategic Overweight in the U.S., Europe and Japan.** We continue to believe in the positive correlation to a steepening yield curve and financial performance, focusing our investment in extremely cheap Japanese and European financials.
Health Care			Strategic			**Neutral.** Our tactical models have turned Neutral. Valuations are compelling, but the tightening cycle and policy risk are too much to overcome.
Industrials				Strategic		**Strategic Overweight to Europe and US.** This sector should benefit from an acceleration in growth and/or inflation with a free option on any infrastructure related fiscal expansion, which continues to look unlikely. We have maintained our overweight to European defense companies, and added to smaller companies exposed to EU capital spending.
Information Technology				Strategic		**Strategic Overweight.** We expect the sector to benefit from strengthening global growth and tame inflation, while we remain at this point in the tightening cycle, we expect our exposure to persist.
Materials				Strategic		**Strategic Overweight.** There is some risk to waning Chinese demands, but this sector typically outperforms early in the interest rate tightening cycle.
Telecommunications		Strategic				**Strategic Underweight.** Higher yield defensive sectors are overvalued and tend to underperform at this point in the cycle of all major markets.
Utilities		Strategic				**Strategic Underweight.** Higher yield defensive sectors are overvalued and tend to underperform at this point in the cycle of all major markets.

CONTINUES ON NEXT PAGE

● Strategic (6-12 months+) ● Tactical (3 months) ● Variance for Non-U.S. Portfolios

Sector / Style / Capitalization	-		N		+	
Style (Value at Left / Growth at Right)			●	●		**Bias to Growth in US and Europe, Quality in Japan.** Moderate growth and low inflation represent an ideal backdrop for growth stocks in the US and Europe. We are mindful of the risks to this bias from either an upside surprise in inflation or relative valuation as growth stocks are currently trading one standard deviation above their 15-year average. We still believe in the structural repricing of quality in Japan as companies adopt structural corporate reforms. We are beginning to see the early stages of shareholder friendly corporate activism in smaller Japanese companies.
Capitalization (Small at Left / Large at Right)		●		●		**Strategic Overweight to Large Cap US, Small Cap Europe, Japan, Brazil and India.** Smaller US stocks are extremely expensive and increasingly dependent on tax reform / infrastructure spending bills being passed. European small cap stocks are directly exposed to pent up capital spending demand within Europe. Other positions are taken to maximize exposure to structural reform stories within domestic markets.

● Strategic (6-12 months+) ● Tactical (3 months) ● Variance for Non-U.S. Portfolios

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