

MARKET OUTLOOK

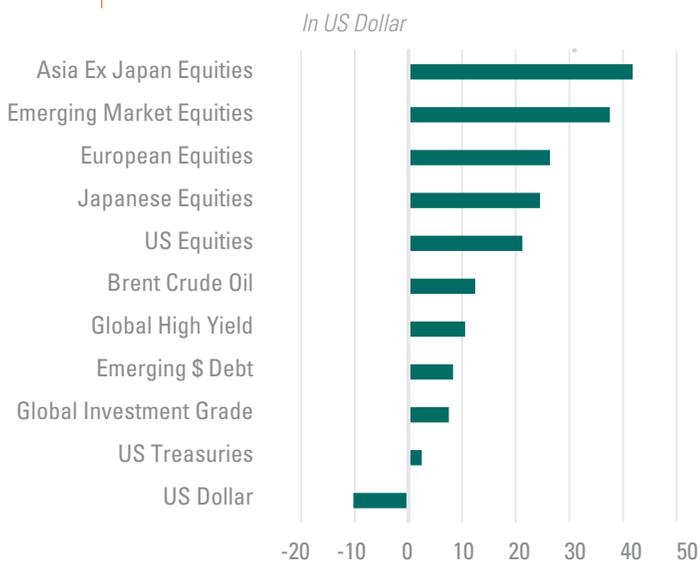
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Q1 2018: Goldilocks Need Not Fear the Bear in 2018... But Her Respite Will Be More Fitful

2017 IN REVIEW

2017 was nearly perfect for risk assets. Buoyant global growth, political stability in Europe, strong earnings momentum, a weak US dollar and steady policymakers' hands in China fueled risk assets to extraordinary levels. Most asset classes performed well, with many delivering double-digit returns (see [CHART 1](#)). Because the US dollar depreciated by over 10% during the year, non-US investments were especially attractive for US investors.

CHART 1 | 2017 Asset Class Returns
1 %



Source: MSCI

The events many worried about in early 2017 – including the election of a far-right government in France and aggressive US trade policy – didn't materialize. The MSCI ACWI closed at record highs 61 times, and the 30-day realized volatility of the S&P 500 Index hit its lowest level since the early 1960s. Global equities were also boosted by falling inflation and basically flat long-term bond yields, even as the economy improved, while cryptocurrencies posted huge returns. Finally, 2017 was also

a year of extraordinary divergences. In the U.S., the top performing sector, technology (up 38%), outperformed the worst-performing sectors, energy and telecom (down around 5%), by more than 43 percentage points. For emerging markets equities, the divergence was even more stark. Four Chinese technology stocks – Alibaba, Baidu, JD.com and Tencent – outperformed the MSCI Emerging Markets index by 59%, 5%, 25%, and 75% respectively and collectively accounted for 19% of index's performance. For a report card on the performance of our 2017 calls, please see [TABLE 1](#) on [PAGES 8-11](#).

For the seasoned investor, 2017's extraordinary equity returns should give rise to concerns that positive economic news and earnings have already been discounted and therefore are ripe for mean reversion. In the U.S., for example, the economic surprise index rose to a six year high during the last week of 2017 and global indices rose by 40%. According to CFRA, in years with above average new highs and below average volatility, the S&P rose the following year only 55% of the time, with an average gain of 3.1%. Conversely, in years where the dispersion between the best and worst performing sectors was high (such as 2017), the S&P 500 was up only 57% of the time in following year, with an average gain of 1.9%. Therefore, it would be reasonable to ask what additional positive economic or earnings surprises await us in 2018 that have not already been discounted? Relatedly, what risks are being underappreciated as the market plumbs new heights? On [PAGE 4](#) of this report, we discuss four such risks that, in our opinion, bear close monitoring.

2018: A TRANSITION YEAR

As we turn the page to 2018, there are few obvious clouds on the horizon for the world economy. Business surveys suggest positive sentiment and Purchasing Managers' Indices as well as earnings momentum continue to improve. Global equities will continue to be buoyed by three critical economic locomotives – the U.S., the European Area and China – none of which face an imminent meltdown in 2018. Underpinned by this synchronized global upturn, top-line earnings growth should be able to withstand less accommodative policies by the Fed and ECB. Despite tighter labor markets and above trend growth, our base case is a modest rise in inflation, particularly outside of the U.S., anchored by the deflationary effects of technological innovation and globalized competition which limits the pass through to wages. Therefore, a key risk in the U.S. could be an upside surprise in inflation.

Nonetheless, we expect 2018 to be a transition year. Stretched valuations and extremely low volatility imply that risk assets are vulnerable to the consensus macro view that central banks will not be able to reach their inflation targets, even in the long term. We expect equity markets to begin discounting the next US recession sometime in early 2019, but markets will be vulnerable in 2018 to a bond bear phase and escalating uncertainty regarding the economic outlook. Therefore, as suggested in the title of this research note, the Goldilocks markets will once again gain respite from the bear, but her rest will be somewhat more fitful in 2018.

In the U.S., tax cuts will give business outlays and overall GDP growth a modest lift in 2018. The new legislation will cut individual taxes by about \$680 billion over ten years, trim small business taxes by just under \$400 billion, and reduce corporate taxes by roughly the same amount (including the offsetting tax on currently untaxed foreign profits). The direct effect of the tax cuts will likely boost US real GDP growth in 2018 by 0.2 to 0.3 percentage points and boost after corporate tax profits by 3-5%. However, much depends on the ability of the tax changes and immediate capital expensing to further lift animal spirits in the business sector and bring forward investment spending. Any infrastructure program would also augment the fiscal stimulus.

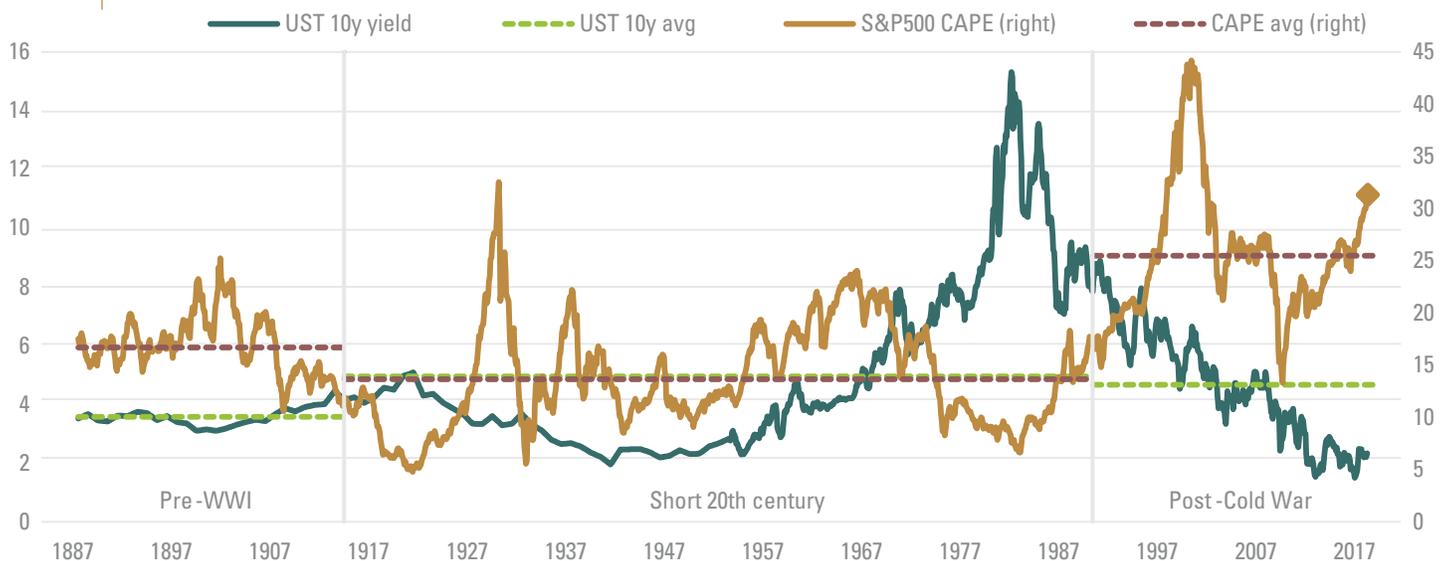
While we recognize that US equities are due for a correction, we doubt that they will plummet into bear market territory in 2018, even if the FOMC implements its interest rate hike projections, because the economic backdrop in the U.S. and elsewhere should remain healthy. Although equity valuations are not cheap by historical standards, they are still attractively valued compared to bonds. Shiller's cyclically adjusted p/e ratio, for example, is currently more than 31, well above the post-cold-war average of 25.5. However, 10-year US Treasury yields are also

well below their 4.7% average (see CHART 2 below). Moreover, growth in the US economy has tended to slow only gradually in response to higher rates. The party in the stock market has often only ended when it has become clear that the economy is about to stop growing altogether. This is the key reason why we project that the S&P 500 will only slide into bear territory in 2019.

Regionally, the Euro Area and Japanese economies registered the biggest upside surprises relative to IMF and consensus forecast. Moreover, in the Eurozone, growth has become increasingly broad-based both in terms of geography (even Italy is on the rebound) and in sector composition. Heretofore, the recovery was primarily led by export-oriented sectors but leadership is increasingly moving towards domestically oriented sectors such as financials, construction and consumer services. This is one of the reasons why continued strength in the Euro should not disrupt growth. Japan's strong Q3 GDP performance marked the longest expansion it has experienced this century. Moderate increases in wages and inflation suggest that Japan continues to climb out of its deflationary slumber. However, inflation will remain sufficiently subdued to prevent the BOJ from significantly altering its dovish monetary stance. **Equities in the euro-zone and Japan will again outperform US equities next year. Profits in both regions are less likely to be squeezed by rising wages than in the U.S.**

Global emerging markets have been turbocharged by both external and internal forces. The initial spark was Chinese reflationary policies which began in late 2015 and continued into 2016, followed by a growth uptick in the U.S. and European Area as well as a weak US dollar in 2017. However, EM equities have also been supported by improving earnings momentum, rebounding export growth, and strengthening balance

CHART 2 Rational Exuberance %

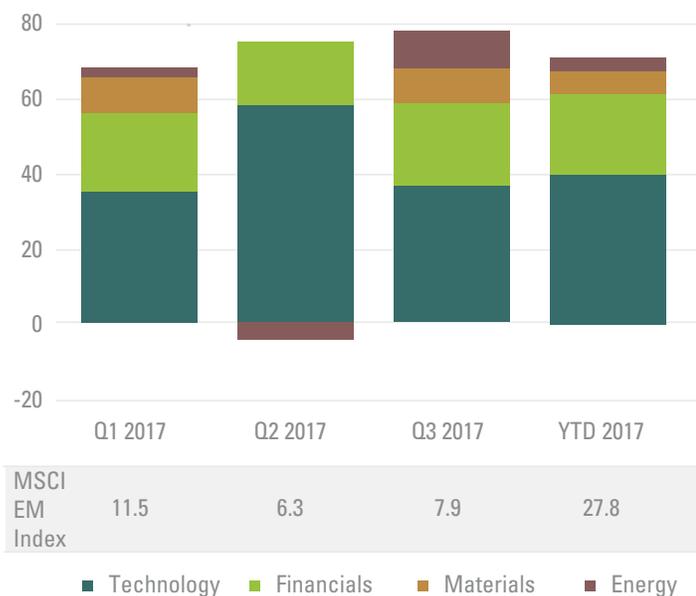


Source: Shiller, TS Lombard

sheets. With their higher risk premiums, EM companies have disproportionately benefited from yield-seeking in a low-rate world. Accordingly, through September 30, 2017, EM attracted \$65 billion in total inflows after approximately \$155 billion in outflows from early 2013 to mid-2016.

Encouragingly, the rally in EM equities appears to be broadening from one largely confined to Chinese, Taiwanese, and Korean technology companies in the second quarter to greater market interest in energy and materials companies as a result of improving economic data out of both Russia and Brazil as well as stabilizing oil prices. During Q4, earnings growth improved for most EM sectors, which should support rising Emerging Markets equity valuations (see CHART 3).

CHART 3 | The EM Bull Market Broadened in Q3
Total Return Contribution by Sector (%), As of September 30, 2017



The MSCI Emerging Markets Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.
Source: MSCI

In **China**, a newly emboldened President Xi will further centralize economic policies by emphasizing deleveraging in the financial sector; enforcing a more intense anti-corruption campaign focused on the shadow-banking sector; reducing the regional government control over economic policy; and improving the quality and environmental sustainability of Chinese growth at the expense of its capital intensity and pace. As Xi and the top-decision-making Politburo officially stated on December 9, the coming year will be a “crucial year” for advancing the most difficult aspects of the agenda. *Therefore, we expect Chinese government policy to become a headwind, after having been a tailwind in 2016-17.*

We believe that Emerging Markets will continue to outperform

in 2018, but will be challenged over time by China’s changing growth strategy, which will gradually remove a powerful tailwind for EM economies that most directly benefit from its historical capital-intensive growth emphasis. On the positive side, the earnings rebound for many EMs are lagging the cyclical upswing more broadly and is still supported by mostly accommodative central bank policies. At 15.7 times trailing earnings and 12.6 times forward earnings, EM equities offer increasing earnings growth, better (and rising) returns on equity, and slightly higher dividend yields compared to developed markets. Across emerging markets, companies have made inroads in reducing capex over the past two years and free cash flow margins have risen substantially. Despite these fundamental improvements, emerging markets equities continue to trade at a 25% discount to developed markets on a forward basis, suggesting that the runway for the asset class remains decent.

Among the various EM regions, despite short term growth challenges emanating from China’s economic rebalancing, we still expect Chinese equities, particularly H-shares, to outperform the EM benchmark, assuming the economy does not spiral out of control and cause a global rout. President Xi’s goal of “leaping forward” to become a global “new economy” leader in 10 years will result in heavy state sponsored subsidies and protections in renewable energy, biotech, robotics, artificial intelligence and big data. On a sectoral basis, China’s health care, tech, and consumer staples sectors (and arguably energy) all outperformed China’s other sectors in the wake of the party congress, as one would expect of a reinvigorated reform agenda. These sectors should continue to outperform. In our inaugural “Foresights” for 2018, we explore the sustainability of the Chinese tech stock rally.

LATE CYCLE AND CAPEX EXPOSED SECTORS WILL OUTPERFORM

As is typical for late in the global market cycle, performance will be driven primarily by earnings as opposed to multiple expansion. **With synchronized global growth ensuing for the first time since the GFC, we expect performance leadership from cyclical sectors as well those who primarily benefit from increased business capex.** For the Q1 2017 Outlook, we posited that **industrials** and **defense** stocks in particular would be buoyed by both their exposure to capex and rising global geopolitical risks. Defense stocks rose by 39% in 2017 and therefore are somewhat expensive. However, this sector remains a high conviction sector for us and we believe that it would be worth buying after a generalized pullback. Another high conviction sector is **financials**, which should benefit from improving economic activity and credit conditions globally and rising interest rates and regulatory rollbacks in the U.S. In Europe and particularly in Germany and Spain, we expect domestically oriented sectors such as construction to outperform. More broadly, **technology** (whose industries that are exposed to the business capex cycle) is another high conviction sector. However, this sector warrants some discrimination after its stratospheric performance in 2017.

As we begin the year, semiconductor stocks appear to provide the best value. Finally, **energy** is our fourth high conviction sector. Like industrials and technology, our positive view on this sector is a continuation of our 2017 view, which was based on an expected rebalancing of energy supply/dynamics. While the energy markets did rebalance in 2017 (oil prices rose from 53.75 per bbl. at the beginning of 2017 to 60.35 per bbl. at its close), energy ETFs decoupled and lagged oil prices. Going forward, we expect this discrepancy to close. Moreover, the Trump Administration’s increasingly bellicose stance towards Iran and unfettered support for Saudi adventurism in our view adds a geopolitical risk premium to oil prices which is not fully appreciated. The last two years have been remarkably benign regarding unplanned oil production outages. Iran, Libya, and Nigeria all returned production to near-full potential, adding over 1.5 million b/d of supply back to the world markets. This supply increase is unlikely to repeat itself in 2018, particularly as geopolitical risks remain elevated in Iraq, Libya, Nigeria, and Venezuela.

On **PAGES 12-14**, please find a summary of our regional and sector positions (**TABLE 2**).

Potential risks to an otherwise rosy scenario for global equities in 2018 include:

1. Aggressive fed rate hikes
2. A “melt-up” in the US dollar
3. Mean reversion of the market’s extraordinarily low volatility
4. Market relevant geopolitical red herrings

Below, we discuss our perspective on all four.

1. AGGRESSIVE FED RATE HIKES

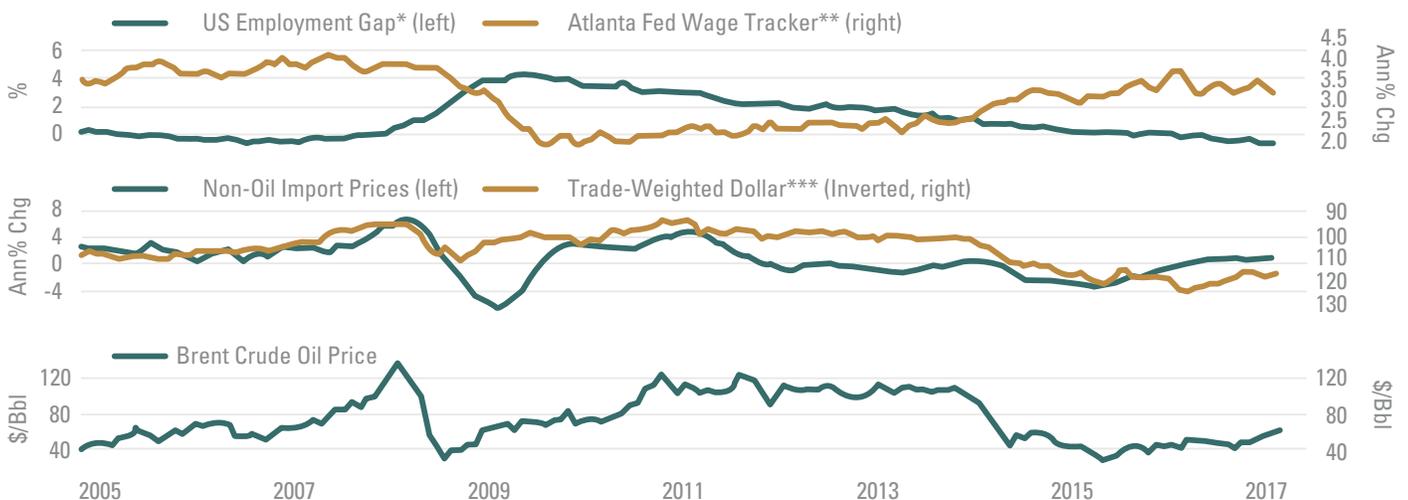
Ever since the 2013 taper tantrum, the markets and the Fed have been locked in a game of chicken in which the market has con-

sistently (and thus far correctly) ignored the Fed’s projections. This game has continued into 2018. The FOMC is projecting three rate hikes in 2018; but financial markets have only priced in one rate hike.

It remains to be seen whether incoming chair Jerome Powell will continue Chair Yellen’s dovish and cautious approach. For the Trump Administration, continued dovishness by the FOMC along the lines of the market’s expectations would be the most politically expedient. This would prolong the current Goldilocks environment and prompt a melt-up in risk assets along the lines of 1999 in 2018.

Ultimately, the path taken by the Fed to increase interest rates will follow the trend in inflation expectations. To date, the Fed, like its counterparts in Europe and Japan, has made little progress in returning inflation to target since the FOMC started its tightening cycle. In November, the annual core CPI inflation rate fell to 1.7% from 2.3% in January 2017, with most of the drop coming from shelter, medical care and wireless services. As discussed previously, inflation has been plagued by structural headwinds emanating from both globalization as well as technological disruption. However, it is possible that the market may be underappreciating the risk of inflation surprising to the upside. For one, economic slack is disappearing at the global level. The OECD as a group will be operating above potential in 2018 for the first time since the Great Recession. Secondly, oil prices have further upside potential. Higher energy prices will add to headline inflation and boost inflation expectations in the U.S. and the other major economies. Thirdly, focusing on the U.S., the lagged effects of dollar weakness as well as the Trump Administration’s fiscal expansionism in an economy which is close to or at full employment (see **CHART 4**) would also be expected to boost prices. As a result, we believe that conditions may be in place for at least 3 rate hikes in 2018.

CHART 4 | Inflationary Pressures Are Turning



* Unemployment Rate Minus Nairu, Source: CBO ** Source: Federal Reserve Bank of Atlanta ***Source: JP Morgan Chase & Co.

2. A “MELT-UP” IN THE US DOLLAR

In 2017, the US dollar depreciated by 10.5%. This was a major source of pain for our portfolios as we were positioned for a rising US dollar. The weak dollar also supported EM risk assets and commodities. US dollar weakness in 2017 resulted primarily from a combination of factors. The first is that investors were massively bullish and long the dollar at the end of 2016, making the market vulnerable to disappointments. And disappointment did come with US inflation weakening and accelerating in the Euro Area. Additionally, there were positive political surprises in Europe, especially the presidential victory of Emmanuel Macron in France. In the U.S., the government’s failure to repeal Obamacare forced investors to lower expectations about fiscal stimulus. As a result, while investors were able to price in an earlier first hike by the ECB, they cut down the number of rate hikes they anticipated out of the Fed over the next 24 months. In terms of the current environment, positioning could not be more different because investors are aggressively shorting the dollar. (See **CHART 5**). The hurdle for the dollar to deliver positive surprises is thus much lower than a year ago. Moreover, the successful passage of the tax cut bill will help restore the Trump reflation trade which boosted the dollar early in 2017. This is why as it became evident that the tax cut bill would succeed the dollar began to show some renewed strength.

CHART 5 | Too Much Pessimism On The Dollar



*Source: Bloomberg/NYMEX

**Source: CFTC

A rising US dollar would provide a less hospitable environment for emerging markets and will remove a currency-based tailwind for US multinationals that may mute the earnings supportive tax reduction on foreign assets. We believe EM currencies as well the Yen are most vulnerable relative to the greenback. The European Area’s positive trade balance coupled with the Euro’s still reasonable valuation on a purchasing power parity basis renders that currency less vulnerable to depreciation against the US dollar.

3. MEAN REVERSION OF THE MARKET’S EXTRAORDINARILY LOW VOLATILITY

Implied volatility is a mean-reverting series which can remain at depressed levels for extended periods, especially when global growth is robust and synchronized. The danger for the current market is complacency, based largely on widespread assumptions that despite globalized cyclical growth, central banks will proceed slowly in tightening interest rates and that we are close to peak rates. This assumption is in turn anchored by the belief that technological advancement in robotics and AI as well as new economy companies such as Amazon have structurally constrained inflation in advanced economies even in a full employment economy. Consequently, consensus assumptions for prolonged Goldilocks macroeconomic conditions have given rise to a “Teflon” market which has shrugged off both policy and political uncertainty. Moreover, with declining volatility, trading models encourage more risk taking, such that lower volatility enters a self-reinforcing feedback loop. Should Fed tightening exceed expectations, towards the end of 2018 or early 2019, the current extraordinarily low level of volatility could therefore quickly change from a virtuous to vicious self-reinforcing feedback loop.

TABLE 3 on **PAGES 6-7** evaluates the relationship between changes in the VIX and the return of various assets. The “VIX Beta” column shows the ratio of the percent decline in the S&P 500 to the change in the VIX. The average beta over the 15 episodes suggests that stocks fall by almost a half of a percent for every one percent increase in the VIX.

In light of currently lofty stock valuations, it is interesting to note that the equity market reaction to a given jump in the VIX does not appear to intensify when stocks are expensive heading into the shock. Today, the VIX would have to rise by about 7.5% to reach the median value, implying that the S&P 500 would correct by roughly 3.5%. Investment- and speculative-grade corporate bonds would underperform Treasuries by 22 and 46 basis points, respectively, in this scenario. The implication is that a shock that simply returns the VIX to “normal” would not be devastating for risk assets. The shock would have to be worse.

4. MARKET RELEVANT GEOPOLITICAL RED HERRINGS

2017 began with a mountain of geopolitical concerns which either turned out to be red herrings or were overcome by positive market fundamentals. Consequently, we have a nagging concern that market participants enter 2018 somewhat anesthetized to lurking geopolitical risks that could become market relevant.

First, the most likely red herring in terms of market relevance (as opposed to political or constitutional relevance) is the Russia collusion/obstruction of justice investigations being conducted by Congress and Special Counsel Robert Mueller. While the Mueller investigation could catalyze drawdowns in equity markets throughout the year, we believe that strong market fundamentals will present a buying opportunity should that occur. Moreover, even if the Democratic Party were to take

control of the House of Representatives in 2018, impeachment proceedings are not likely to begin in 2019 and would require ratification by the two-thirds of the Senate, a decidedly uphill climb.

Similarly, last quarter, we suggested (and still believe) that the market was correct to treat North Korea related tensions as a red herring. We stated that it would 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.

Of greater concern, is the risk of increased foreign policy adventurism as well as a ratcheting up of protectionist trade policy by the Trump Administration both to distract from domestic political troubles and feed red meat to the President’s base. It is in this context that we are keenly monitoring the recent ratcheting up of tensions with Iran. The Trump Administration’s

increasing bellicosity towards Iran and their open support for Saudi adventurism risks further igniting regional tensions, particularly if Tehran feels encircled and decides to retaliate against any re-imposition of economic sanctions by Washington. Not only could Tehran retaliate by ratcheting up the insurgency in Yemen, deepening the political conflict in Lebanon, or supporting Shia dissenters in either Bahrain or even Saudi’s own eastern provinces, if pressed it could even go back to its favorite tactic from 2011: threatening to close the Straits of Hormuz. Another critical issue to consider is how the rest of the world would respond to the re-imposition of sanctions against Iran. Under IFCA, the Trump Administration would be able to sanction any bank, shipping, or energy company that does business with the country, including companies belonging to European and Asian allies. A move by the U.S. to re-open the front against Iran, with no evidence that Tehran has failed to uphold the nuclear deal itself, would throw US alliances into further flux. The implications of such a decision could therefore go beyond merely increasing the geopolitical risk premium. Saudi assets are not yet widely held by global investors, but Emirati stocks are. Abu Dhabi has thus far been supportive of the new aggressive Saudi policies in the region, and the market is largely leveraged to real estate assets which are in turn highly dependent on the stability and neutrality of Dubai as a regional entrepot. A deterioration, or perceived deterioration in that neutral status could put significant pressures on local equities.

TABLE 3 | Relationship Between Asset Returns and Changes in the VIX

| Episodes | # Of Weeks | Change In VIX | Forward PIE* | Change In S&P 500 (%) | S&P 500 Beta** | Investment Grade Corporate Bonds*** Excess Returns (%) | High-Yield Corporate Bonds*** Excess Returns (%) | Treasury Master*** Return (%) | Change In Gold Price (%) |
|-----------------------------|------------|---------------|--------------|-----------------------|----------------|--|--|-------------------------------|--------------------------|
| Aug 12 to Nov 25, 1994 | 16 | 6.4 | 12.2 | -1.9 | -0.29 | 0.0 | 1.5 | -0.7 | 0.2 |
| Dec 24, 1993 to Apr 1, 1994 | 15 | 11.0 | 13.6 | -4.6 | -0.42 | 0.3 | 1.1 | -3.5 | 0.7 |
| Mar 24 to Jun 9, 2006 | 12 | 6.9 | 13.8 | -3.9 | -0.56 | -0.1 | 0.6 | -0.4 | 10.6 |
| Jul 17 to Oct 9, 1992 | 14 | 7.9 | 14.2 | -3.1 | -0.39 | -0.7 | 1.5 | 6.0 | 0.7 |
| Feb 16 to Mar 2, 2007 | 2 | 8.6 | 14.4 | -4.7 | -0.55 | -0.3 | -1.3 | 1.2 | -2.0 |

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| Episodes | # Of Weeks | Change In VIX | Forward PIE* | Change In S&P 500 (%) | S&P 500 Beta** | Investment Grade Corporate Bonds*** Excess Returns (%) | High-Yield Corporate Bonds*** Excess Returns (%) | Treasury Master* *** Return (%) | Change In Gold Price (%) |
|------------------------|------------|---------------|--------------|-----------------------|----------------|--|--|---------------------------------|--------------------------|
| Nov 15 to Dec 13, 2013 | 5 | 3.6 | 14.7 | -1.3 | -0.36 | 0.8 | 1.2 | -0.4 | -4.3 |
| Jan 10 to Jan 31, 2014 | 4 | 6.3 | 14.9 | -3.2 | -0.52 | -0.3 | -0.6 | 0.8 | 0.5 |
| Feb 18 to Apr 15, 2005 | 9 | 6.6 | 14.9 | -4.9 | -0.75 | -1.6 | -3.5 | 0.5 | -0.6 |
| Jul 4 to Aug 1, 2014 | 5 | 6.7 | 15.2 | -3.0 | -0.45 | -0.2 | -2.4 | 0.8 | -2.1 |
| Sep 19 to Oct 17, 2014 | 5 | 9.9 | 15.4 | -6.2 | -0.62 | -0.8 | -2.7 | 2.1 | 1.2 |
| Jul 17 to Aug 21, 2015 | 6 | 16.1 | 15.6 | -7.3 | -0.46 | -1.2 | -3.7 | 1.7 | 2.1 |
| Dec 4 to Dec 12, 2014 | 2 | 9.3 | 15.8 | -3.5 | -0.38 | -0.5 | -2.8 | 1.0 | 1.9 |
| Sep 23 to Nov 4, 2016 | 7 | 10.2 | 16.1 | -3.7 | -0.36 | 0.3 | 0.2 | -0.8 | -2.7 |
| May 27 to Jun 24, 2016 | 5 | 12.6 | 16.2 | -2.9 | -0.23 | -0.5 | -0.4 | 1.8 | 8.2 |
| Aug 19 to Sep 9, 2016 | 4 | 6.2 | 16.6 | -2.6 | -0.42 | 0.0 | 0.6 | -0.5 | -1.2 |
| Average | 7.4 | 8.54 | 14.91 | -3.79 | -0.45 | -0.32 | -0.71 | 0.63 | 0.88 |

* Forward PIE at the Beginning of the Episode ** Sensitivity to Change in VIX Volatility Index

*** Relative to a Duration-Matched Position in Treasury Securities. Source: Bloomberg Barclays Indices **** Source: Bloomberg Barclays Indices

TABLE 1 | Q1 2017 Scorecard

| Risk / Environment | What was said... | Results |
|--------------------------------|--|---|
| Global Equity Risk Environment | Sentiment rally ripe for short term (2 months or less) consolidation; but beta risks will be supported by positive earnings momentum and fiscal expansion over the next 12 to 24 months. Our systemic risk indicator entered into risk neutral in mid-December and has stayed there in 2017. The deterioration is mostly due to currency inputs, particularly the US dollar. However, both components of the Equity market sentiment indicator remain in risk-on territory, underscoring that the sentiment driven Q4 rally that is already discounting improving growth and supportive policy in 2017 could face near term consolidation vulnerability. | Correct. Global Markets (MSCI ACWI Index) rose by 24.6% in 2017. |
| US Dollar | Overweight through currency hedged equity positions although net speculative positions suggest that this is a crowded trade and thus ripe for short term consolidation. The US Dollar strengthened as we expected in the second half of the year, finishing the year up 3.6%. The next 12 months are likely to see stronger US economic growth and higher inflation, which will support higher long term interest rates, and allow the Fed to hike two to three times in 2017. All would be supportive of an already stretched US dollar. Dollar strength will however continue to be capped by a negative feedback loop with respect to its dampening effect on inflation. | Missed the mark, the US dollar declined by 10.5% as the Trump reflation trade was undermined mid-year by dysfunction in Washington and both Europe and Japan outperformed consensus growth estimates. |

| Regions / Countries | What was said... | Results |
|---------------------|---|--|
| United States | Tactically underweight;/Neutral over the next 6 to 12 months. Structurally, US equities' more defensive posture underperforms when global growth strengthens. Additionally, after correctly predicting the Q4 rally, our tactical models appear to be pointing to some consolidation in Q1 2017. Countervailing crosswinds include earnings improvements, fiscal policy support for select sectors and improving but still benign inflation growth on the positive side. On the negative side, a near term risk of consolidation after the Q4 rally, less generous valuations, a pickup in wage growth and a strengthening dollar could cap earnings improvement. | Correct. Despite strong performance in Q4, US equities underperformed non US developed markets by 5.9% and Emerging Markets by 15.9%. |
| United Kingdom | Neutral but currency hedge. Hard Brexit makes GBP depreciation more probably but the globally focused FTSE 100 index could benefit from a pickup in global growth momentum. | Correct on market, wrong on currency. The MSCI UK market outperformed the US by 47 Bps, but the currency hedge would have led to 10.1% underperformance. |
| EU (Core) | Short term consolidation but outperformance over the next 6 to 12 months. We are taking some profits to our core strategic overweight to Euro core. This reflects considerable risk of near term consolidation, is consistent with our tactical forecast as well as heightened political risk. Last quarter, we were overweight (Germany and Spain) but hedged the currency exposure. We continue to believe that the combination of attractive valuations, relative operating leverage to global growth along with positive earnings revision momentum warrant at least a neutral/slight strategic overweight. Upcoming elections in Germany and France present a risk to this view, which we will continue to monitor. In deference to our models, we will reduce our weight to neutral. | Correct. The European region outperformed the US by 4.33%. |
| EU (Periphery) | Short term consolidation but outperformance over the next 6 to 12 months. After correctly forecasting outperformance for Spain in Q4, our tactical models are forecasting a reversal in Q1 2017. In deference to the model, we will reduce our weight to neutral in relative to Spanish equities. | Correct. The European region outperformed the US by 4.33%. |

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● Correct ● Mostly Correct ● Partially Correct ● Incorrect

| Regions / Countries | What was said... | Results |
|--------------------------------|---|--|
| Japan | Short term consolidation but outperformance over the next 6 to 12 months. After correctly forecasting a performance rebound in Q3, our tactical models forecast another negative reversal, albeit with low conviction. Our primary concern is that the BoJ's QE policy of containing the 10 year JGB yields without more substantial fiscal support will not deter ongoing deflation. Corporate earnings are already suffering under the weight of the yen's appreciation this year. We will continue to monitor policy developments during the quarter to upgrade to at least neutral. Key signals would be more aggressive fiscal expansion as well as outright debt monetization (which we believe to be highly likely). | Correct. Japanese equities outperformed the US by 2.49%. |
| Australia | Neutral. Expect short term consolidation, hence a tactical underweight. Australia represents a leveraged China's policy reflation play and should remain well bid at least for the first half of the year. | Mostly correct. Australia underperformed the US by 1.74%. |
| Canada | Expect short term consolidation, hence a tactical underweight. However, ongoing rebalancing of supply/demand conditions in oil prices over the next year will support Canadian equities. Our tactical models forecast outperformance, albeit with low conviction. | Correct. Canada underperformed the US by 5%. |
| Emerging Markets (Pacific Rim) | Expect short term consolidation/ underweight to Chinese, Korean and Taiwanese equities. However, over the next 6 to 12 months, we believe that an overweight to North Asian equities on a currency hedged basis will outperform the EM benchmark. We are past the peak impact of China's reflation policy initiated in the second half of 2015. Indeed Chinese policy makers have begun to marginally tighten liquidity/credit conditions to battle China's growing credit bubble. However with the 5 year Communist party congress scheduled in the fall, as signs of job weakness reemerge, fiscal stimulus will be back on as Beijing does not want to risk labor strife or any other threat to social stability. This will support Chinese and China exposed equities in Taiwan, Korea and Japan but result in further Yuan weakness of around 5%, despite Beijing's attempt to moderate by expending more of its FX reserves. | Mostly correct. EM Asia outperformed the broader EM index by 5.51% (China and Korea outperformed, Taiwan underperformed). |
| Emerging Markets (South Asia) | Tactically underweight; Strategic overweight in the context on an EM portfolio. India's demonetization efforts remain a short term policy risk as it has already been shown to erode consumption growth. This is why we have reduced our exposure to Indian small caps. However, its current and fiscal health render it less vulnerable to Fed normalization. We expect a rebound in Indian assets towards year-end as recent rate cuts and economic recovery drive sentiment ahead. | Correct. After underperforming significantly in the 2nd and 3rd quarter, India outperformed the EM index by 4.32% in the 4th quarter to finish the year outperforming by 1%. |
| Emerging Markets (Europe) | Outperform. Russia will continue to rebound on the back of improved prospects for oil price stabilization, moderating inflation and a declining geopolitical premium as a result of Trump's election. Additionally, both the Polish and Czech economies are showing signs of strength with currencies which we expect to strengthen relative to the Euro. | Mostly incorrect. Wrong on Russia, correct on the rest of EM Europe. Russia underperformed by 31.6%, while the rest of EM Europe outperformed by 12.8%. |
| Emerging Markets (Africa) | South Africa presents a tactical outperformance opportunity. Our tactical models are forecasting a rebound in globally focused and commodity intensive South Africa. However, for US dollar based investors, we strongly suggest a currency hedged position. | Incorrect. South Africa underperformed the EM index by 91 Bps for the year. |
| Emerging Markets (LatAm) | Underweight Brazil; Neutral to overweight in Colombia and Argentina. Brazilian equities benefitted from positive market sentiment in response to the impeachment of Dilma Rousseff and more benign dollar liquidity in 2016. With Brazilian equities now trading at least one standard deviation above their 7.5 year range, they remain vulnerable to deteriorating dollar liquidity as the Fed continues to tighten in 2017. Our tactical models confirm this concern with a moderate conviction underperform forecast. That said, we remain sanguine towards other LaTAM markets such as Argentina and Colombia. | Mostly correct. Brazil underperformed the EM benchmark by 13.2%, Argentina outperformed by 19.1%. However Colombia underperformed by 22.3% . |

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- Correct
- Mostly Correct
- Partially Correct
- Incorrect

| Sectors / Style / Capitalization | What was said... | Results |
|----------------------------------|---|---|
| Consumer Discretionary | Tactical overweight/strategic underweight in the U.S.; overweight in Europe and Japan. Our tactical models continue to forecast this sector's outperformance; which is somewhat surprising because this sector tends to underperform at the beginning of interest rate tightening cycles. That said, a healthy US consumer and a strong labor market should continue to provide solid support to the sector's earnings, but rising interest rates are a growing headwind. Provided inflation and interest rates remain low by historical standards., downside risks to relative earnings will be limited. | Partially correct. Discretionary stocks outperformed in the US by 1.1%, while underperforming in Europe and Japan by 1.4% and 2.4% respectively. |
| Consumer Staples | Tactical overweight/strategic underweight in the U.S.; overweight for 3 months. Our tactical models support an overweight with low conviction. This sector is on the pricey side but should benefit from a short term consolidation in energy prices. This is another sector which suffers in both a rising US dollar and inflation environment that typically accompanies Fed tightening. However, it could also provide some shelter if January sees another consolidation event. | Correct. Staples outperformed the broader market by 29 bps in the first quarter followed by a sharp underperformance of 8.2% for the rest of 2017. |
| Energy | Tactically underweight but neutral strategic weight. Oil prices late 2016 rise based on a combination of the recent OPEC agreement and a weak dollar has accelerated the balancing process and is now ripe for a pull back. Rising bond yields and range-bound oil prices implies relative headwinds for energy stocks. Our tactical models also predict some consolidation for this sector. | Correct. Energy stocks had a terrible 2017 experiencing negative returns and underperforming the broader market by over 20%. |
| Financials | Despite near term risks of consolidation; overweight strategically. Financial stocks are overbought and are at risk for near term consolidation. However, this sector is strategic overweight reflecting its positive correlation to a steepening yield curve and more robust growth early in the tightening cycle. The Financials sector had been out of favor for several years and currently trades at 1.35 time book value and 16.6 times trailing earnings, which is still relatively cheap compared to its historical averages of 1.78 times BV and 22.3 times earnings. Many financial companies should also benefit from promised regulator relief by the new administration and congress. Despite their recent bounce as a result of the ECB's and BoJ's attempts to offset profit impairment from negative rates, we are more comfortable expressing this overweight through US companies. | Correct. Financial stocks outperformed the broader market in the US, albeit by a modest 29 bps. |
| REITs | We are neutral on REITs in the U.S. for now; but they face the crosswinds of an improving wage backdrop and an accommodative but gradually increasing interest rates. We are highly bullish on REITs in Europe and Japan as a result of the extremely favorable policy backdrop. | Incorrect. REITs underperformed significantly in the US and Japan (-11.1% US, -24.6% Japan). European REITs underperformed by a modest 52 bps. |
| Health Care | Outperform. Our tactical models forecast moderate conviction outperformance. This sector has been a strategic overweight. Trump's election and the likely repeal of the ACA as well as the medical devices tax would be expected to boost this sector. | Correct. Despite multiple failures to repeal ACA, the sector outperformed the market in the US by 18 bps. |
| Industrials | Short term consolidation but neutral strategic position for US Industrials; overweight European and Japanese peers. This sector should benefit from accelerating growth and infrastructure related fiscal expansion. However expected dollar appreciation is a headwind for US companies relative to their European and Japanese peers which are especially geared towards Chinese infrastructure. | Correct. The US industrial sector was roughly in line with the market (-87 bps). Japanese industrials outperformed by 6.4% and European industrials outperformed by 5%. |
| Information Technology | Outperform. Technology stocks have served as a source of funds for the rotation into deep cyclicals post the election, yet the fundamentals for the sector are strengthening. Improving global semiconductor demand and positive indications from companies geared to hardware sales suggest that cyclical conditions for technology companies are brightening, which should drive relative earnings higher, thus enabling the sector to resume outperforming. | Correct. Technology stocks significantly led markets globally. US technology outpaced the market by 16.9%, with global technology following a similar pattern of performance. |

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● Correct ● Mostly Correct ● Partially Correct ● Incorrect

| Sectors / Style / Capitalization | What was said... | Results |
|---|---|---|
| Materials | Short term consolidation but neutral strategic overweight. Chinese reflation has supported this sector which typically outperforms early in the interest rate tightening cycle. Our tactical models forecast near-term consolidation | Correct. US material stocks underperformed in the first quarter by 21 bps, yet finished the year 1.9% ahead of the broader market. |
| Telecom | Tactical overweight/strategic underweight. Cheap and provides defensive haven. Could also be boosted by M&A activity. Our tactical models are forecasting outperformance with moderate conviction. | Incorrect. The tactical overweight was a mistake with the US sector underperforming significantly during the first quarter and underperforming by 23.2% for the year. |
| Utilities | Tactical overweight/strategic underweight. Our tactical models are forecasting a short term bounce from recent selling pressures. However, rising bond yields and range-bound oil prices implies relative headwinds for utility stocks. These dynamics are behind our strategic underweight. | Correct. Utilities outperformed the broader market by 33 Bps in the first quarter followed by a sharp underperformance of 9.8% for 2017 as a whole. |
| Style (Value at Left/Growth at Right) | Neutral - Focus on sector and industry exposures. Although rising bond yields should continue to support value outperformance on a 6-12 month horizon, the post-election run-up in U.S. bonds yields is extended; such that a near-term consolidation or pullback phase is overdue. A pause or pullback in the uptrend for bond yields could therefore spur a bout of profit-taking in value stocks. Our neutral style exposure reflects a much greater focus on sector exposures. For example, the value index is overweight in financial, utility and energy stocks, while being underweight in technology and consumer discretionary stocks. As discussed above, we are overweight Financials but underweight Utilities; while being overweight both medical devices in Health Care and software/semiconductors in Technology, traditionally Growth industries. | Correct. Our Sector positioning was more accurate than not in 2017. |
| Capitalization (Small at Left/Large at Right) | Ripe for short term pull back from overbought conditions; but reflationary policies and globalization will thereafter support small caps. Despite Q4's small cap outperformance, our models support a U.S. large cap overweight. Over the intermediate 6 to 12 month period, small caps will be boosted by reflationary policies and if protectionist policies and corporate tax cuts are implemented. Deteriorating credit impulses in Europe leads to a neutral cap position there; but less so in Japan and EM. Therefore our cap positions have become more nuanced. | Correct. US small-cap stocks underperformed large cap stocks by 7.3%. Japanese small caps outperformed large caps by 6.8%, while European small caps outperformed by 9.3%. EM small cap stocks underperformed large caps by 3.9%. |

● Correct
 ● Mostly Correct
 ● Partially Correct
 ● Incorrect

TABLE 2 | Global Country and Sector Positioning

| Risk / Environment | - | | N | | + | |
|--|---|---|---|--|---|--|
| Global Equity Risk Environment | | | | | ● | Risk on. Despite elevated valuations, there are few obvious clouds on the horizon for the world economy. Monetary policy is beginning to normalize but is still accommodative, global growth is strong and beginning to broaden in formerly troublesome markets. 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. |
| US Dollar | | | | | ● | Slight overweight relative to the Yen through currency hedged equity positions. We have a low conviction positive view on the dollar relative to major currencies. We think the Federal Reserve is likely to 'surprise' the market by following their plan of 2 rate increases in 2018. The ECB is unlikely to surprise on the side of tightening given the slack left in some European economies and relative youth of the recovery. We have maintained a position relative to the Yen due to need of continued strong accommodation by the BOJ in light of still low inflation and domestic spending. |
| Market Type (Developed at Left/Emerging at Right) | | | ● | | ● | Strategic overweight to emerging markets, with neutral tactical positioning. EM stocks continue to benefit from improving earnings momentum, rebounding export growth and strengthening balance sheets. At 15.5 times trailing earnings and more attractive ROEs, EM stocks still trade at a 25% discounts to developed markets on a forward basis; suggesting more runway for outperformance. We have maintained our neutral tactical positioning due to risks from potential Dollar strength or Fed policy surprise. Chinese reforms also have potential to derail some GDP growth should it lead to a growth shock. |
| Region / Countries | - | | N | | + | |
| United States | | ● | | | | Strategic underweight. Strong earnings, tax reform 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. |
| United Kingdom | | | ● | | | Neutral. Brexit negotiations and Sterling weakness continue to weigh on sentiment. Large UK companies generate 70% of their revenue abroad, which has been supported by the decline in the Pound. However much of this revenue is made up of Dollar sensitive EM demand. |
| EU | | | | | ● | Strategic overweight. European growth has expanded to the point of being self-reinforcing and important structural issues have been addressed in the banking system. The ECB will remain accommodative throughout 2018 supporting reasonably priced risk assets. |
| Japan | | | | | ● | Strategic overweight. Abe's government has been given the electoral support to continue their inflationary policy measures. Japanese earnings have experienced double digit growth for 4 consecutive quarters for the first time since the financial crisis. A weak Yen and strong global growth has been a boon for internationally exposed Japanese stocks. 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. |

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

| Region / Countries | - | N | + | |
|---------------------------|---|---|---|---|
| Emerging Markets (Asia) | | ● | ● | Strategic and tactical overweight to the region. High China tech valuations lead us to express this view through positions in South Korea, Taiwan and Pakistan. Structural changes in Pakistan 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 positive view on Chinese equities, but are cautious due to high valuations of the tech sector and unknown response to economic reforms. |
| Emerging Markets (Europe) | | ● | ● | 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 (Africa) | | ● | ● | Neutral with tactical overweight to Nigeria. South African stocks have moved past the cloud of outgoing ANC Leader Jacob Zuma, suggesting that the bad news is priced in. While we are no longer outright bearish on market sentiment, we do not yet see much cause for a re-rating of the market or a spark to a new earnings cycle. In Nigeria, we continue to see recovery from the previous FX regime debacle and the slump in global oil prices and an equity market that is simply too cheap for even its own mediocre fundamentals. |
| Emerging Markets (LatAm) | | ● | ● | Neutral with tactical overweight to Brazil, Chile and Colombia. We have maintained our overweight to smaller Brazilian stocks which 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. The Chilean market is very cheap and should be poised to take advantage of dual tailwinds of loose monetary conditions and a slowly improving economy. |

| Sector / Style / Capitalization | - | N | + | |
|---------------------------------|---|---|---|--|
| Consumer Discretionary | | ● | ● | Strategic overweight in Europe and Japan, neutral in the U.S. The sector is supported by broadening recovery in Europe and continued accommodative monetary conditions by the ECB and BOJ. We are underweight the sector within the U.S., due to the timing of the interest rate cycle. |
| Consumer Staples | ● | | | Strategic underweight. Defensive sectors tend to underperform at this point in the cycle of all major markets. We have reduced the underweight within the U.S. due to rising risk associated with high valuations. |
| Energy | | | ● | Strategic overweight. The sector is fairly valued and we see little downside risk to oil prices. Oil market supply/demand fundamentals are tightening with strengthening demand and continued declines in crude oil inventory. |
| Financials | | | ● | 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. Fair valuations and regulatory reforms should provide a tailwind in the U.S. and Europe. |
| Health Care | | ● | ● | Neutral. Compelling relative valuations in the U.S. are not enough to overcome the tightening cycle and policy risks. We have a tactical overweight to Chinese health care stocks to exploit favorable valuations and structural reforms. |
| Industrials | | | ● | Strategic overweight to Europe and U.S. This sector should benefit from an acceleration in growth and/or inflation with a free option on any infrastructure related fiscal expansion, which is unknown. We have maintained our overweight to European defense companies, and added to smaller companies exposed to EU capital spending. |

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

| Sector / Style / Capitalization | - | N | + | |
|--|---|---|---|---|
| Information Technology | | | ● | 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 overweight. There is some risk to waning Chinese demands, but this sector typically outperforms when the cyclical recovery has gathered steam. |
| Telecommunications | ● | | | Strategic underweight. High yielding defensive sectors are overvalued and tend to underperform at this point in the cycle of all major markets. |
| Utilities | ● | | | Strategic underweight. High yielding defensive sectors are overvalued and tend to underperform at this point in the cycle of all major markets. |
| Style (Value at Left / Growth at Right) | | ● | ● | Neutral in the U.S., slight growth bias in Europe, quality in Japan. Moderate growth and low inflation represent an ideal backdrop for growth stocks in Europe. We have shifted to neutral in the U.S., given the projections of rate increases and the relative valuation of growth stocks', which are currently trading one standard deviation above the 15-year average. We still believe in the structural repricing of quality in Japan as companies adopt the 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 U.S., small cap Europe, Japan, Brazil and India. Smaller US stocks are extremely expensive and have priced in tax reform. 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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