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SWISS CONSULTING

Outlook & Investment Strategy 2018

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Introduction

- As regular readers might know, we at Gigant Swiss Consulting don't engage in any primary research on both, macro- and micro-economic levels. In this field, we as a boutique asset manger, may not compete against much bigger banks or research. Instead, we focus intensively on desk research and thanks to our independence, we are able to brows for the very best out of a vast array of externally produced primary research.

- Since we don't engage in any economic research activities ourselves, we do not publish our own economic forecast nor price targets for individual assets/securities. Instead, we compare consensus forecasts vs current market prices out of which one can draw valuable conclusions.

- Our investment strategy is free from any unwanted or hidden bias. Because we are independent, we do not need to sell a given set of products, unlike many much larger players in the area of investment management. Instead we can exclusively focus on our clients true needs and always put performance at the forefront of our investment decisions.

- Last but not least, we are of the opinion that the importance of yearly economic & strategy outlooks should not be overestimated. Investment management is a continuous process and not something which should be done exclusively at any given due date of the calendar. Therefore, depending on the ongoing developments in world financial markets, its half-life may be very short.

- That all said, please find thereafter a summary of our thoughts and expectations for 2018 as well as a summary of our investment strategy for 2018

- For the sake of simplicity and readability of the outlook section, an overview about the sources of quotes can be found here:

Barclays Global Outlook 2018: Rationale exuberance; published on16th of Nov
Bank of America Merrill Lynch Global Research 2018 Year Ahead Outlook; published 5th of December
Citi Global Economic Outlook and Strategy; published 27th of Nov & *Citi Private Bank Outlook 2018: Accelerating global growth: profits and pitfalls*; date of publication unknown
Deutsche Bank Capital Markets Outlook 20189: deceptive calm coming to an end?; published on 22nd of Nov
Goldman Sachs Global Economic Analyst: As Good As It *Gets*; published on 15th of Nov
Morgan Stanley 2018 US Credit Outlook: When the Levee Breaks; date of publication unknown
UBS Wealth Management House View: Year Ahead 2018; date of publication unknown & *UBS Investment Bank Top 5 Themes and 19 trades for 2018*; date of publication unknown

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Global Macro Economics: further improving

Forecast for end of 2018:	Global GDP Growth	US 10yr Yield	EURUSD
current	**3,6% *)**	**2,37%**	**1,1800**
Citigroup	**3,8%**	**2,7&**	**1,24**
Deutsche Bank	3,8%	n/a	1,20
UBS	3,8%	2,5%	1,25
Bank of America	3,8%	2,75%	1,10
Barclays	4%	2,5%	1,24
Goldman Sachs	4%	3%	1,20
average	**3,86%**	**2,7%**	**1,205**
Average Delta to 2017	***+0,26%***	***+0.33%***	***+0.025***

- Barclays: *"The **synchronized global recovery looks to extend into 2018-19.** We forecast growth to reach 4% for the first time since the 2010-11 post-recession rebound, **supported by improving investment and trade and with strong cyclical momentum in the euro area**. "*
- Citigroup: *"Our global economic outlook for 2018 is largely characterized by a **continuation of recent developments – higher growth, steady inflation** and rising advanced economy (AE) policy rates. "*
- UBS: *„In the past, recessions were traditionally triggered by one of the following factors: an oil price shock, too tight monetary policy, shrinking government expenditures and /or a a financial- or credit-crisis. None of these factors seem to occur into 2018"*
- BofA: *"(…) we issued a bullish macro outlook for 2018, calling for **robust global economic growth and a steady U.S. expansion** (…)"*

Gigant's view on the global economy:

The macro economic outlook for 2018 is spectacular in a sense that experts expect among the highest growth figures since 2010. That said, there is plenty of evidence that **on a global basis, the current growth dynamics we saw in H2 2017 is likely to continue into 2018.** While some economists point to the fact that the **current cycle in the US & China** was relatively **mature**, it's worth noticing that **growth dynamics in EU, Japan & EM are further improving**. Therefore, a **continued global growth** story in 2018 is likely to be **much better balanced** (which is a good sign).

*) Source: International Monetary Fund as of October 2017

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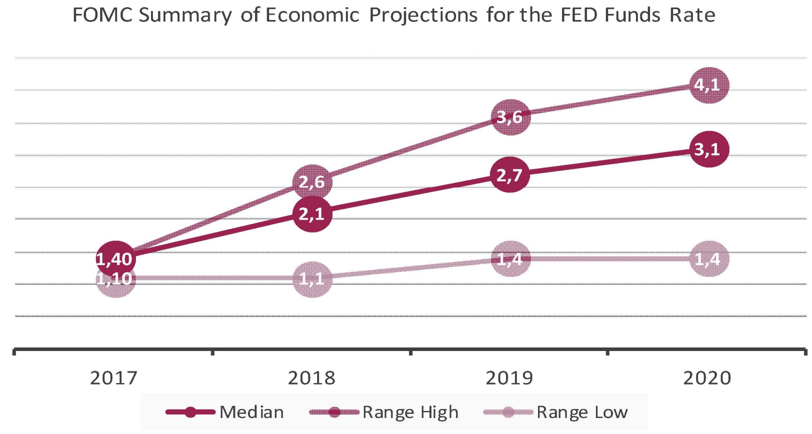
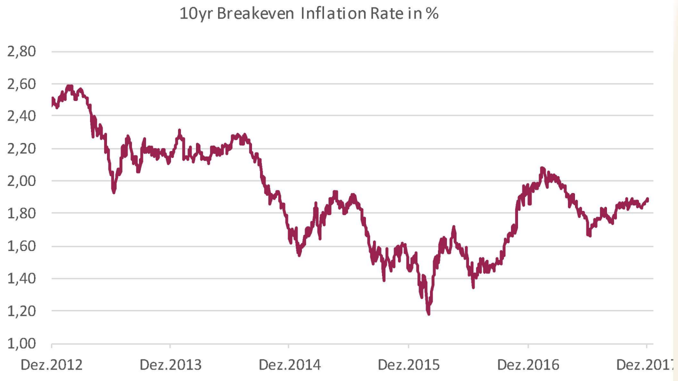
USD rates: rising slowly but steadily

- The probabilities derived from FED Fund Futures imply the **market is expecting the FED to raise** its FED FUND target rate **between 2-3 times during 2018**, whereas the so-called FED Dot-Plot suggest another 3 hikes for the coming year. 3 hikes, the same amount as in 2017, would imply a FED Fund target rate of 2,0-2.25%



Source: Federal Reserve Bank of St.Louis



Source: Federal Reserve Bank of St.Louis

- **The longer end of the yield curve**, whose level can not be set by the Central Bank, **is expected to rise by a much lesser extend** when looking at the forecasts poste on the previous page. **Structurally low inflation** expectations and depressed so-called term premiums are cited as **major reason** for the rather muted rise.

Gigant's view on USD rates in 2018:

The main message from consensus expectations is: **rising rates for 2018, albeit at a relatively muted pace**. Simply speaking, rising yields imply lower bond prices which makes **bonds a structurally un-attractive investment** going into 2018. After all, short term rates rising at a faster pace than rates at the longer end **implies** an even **flatter yield curve**. Now, flattening curves are not unusual during tightening cycles nor does it warn of a recession yet. So where's the problem then? Well, **the FED** is somewhat **limited in moving the short end of the curve** above the longer end of the yield curve. By doing so, it would risk an overheating which at a later stage would push the economy into recession.

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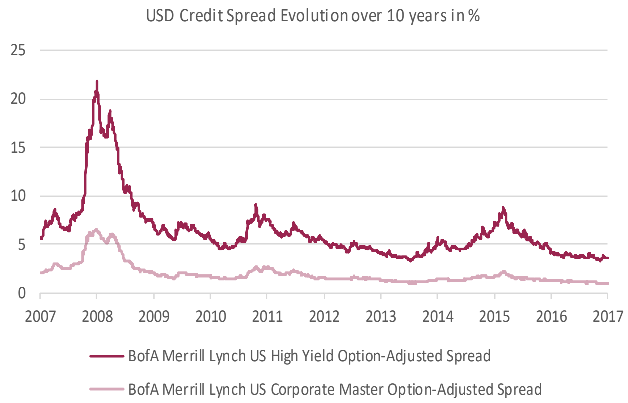
Credit: relatively unattractive- watch out!

- As we showed on the previous slide, the absolute level of rates seems to be somewhat "under control" but **after years of extremely low rates, there were arguably some excesses in the credit markets** According to Morgan Stanley, credit markets have grown by 116% in this cycle and low BBB-quality issuance was 44% of total investment grade supply in 2017, the highest on their record. That said, it is widely accepted that **financial conditions will tighten in 2018**, not only because of rising rates but mainly due to the FEDs balance sheet reduction. Therefore, the big question to ask in 2018 is: **can credit markets comply with rising rates AND tighter financial conditions?**

- Barclays: "*Growth in the credit market has been focused on investment grade, specifically BBBs. This presents risks, if demand slows or fundamentals deteriorate (…). However,* ***we do not expect these risks to become a reality in 2018****".*
- Societe General: "*We expect next year to be a transition year, when the* ***ultra-low yield environment finally starts to lose its grips****"*
- Morgan Stanley: "*In our view, credit investors underestimated the tailwind from QE in this bull market. Similarly, they may now be* ***underestimating the headwind from reverse QE.*** *And while the global central banks will still be adding liquidity next year, even they will be doing so at a slower pace (…)"*



Source: Federal Reserve Bank of St.Louis

Gigant's view on Credit in 2018:

Unlike in rates, there seems to be much less of a consensus of where the journey in credit markets 2018 will go. We are of the opinion that **as long as economic growth remains strong, all looks well**. **However, as soon as growth rates start to slow down, the high level of leverage is likely to push credit spreads** wider (than the market might currently forecast). This must not necessarily be the case in 2018. However, the **risk-reward ratio for an investment in credit is not overly attractive since there is virtually no room for tighter spreads any more**, the big performance driver for credit investments over the last years. Accordingly, we tend to avoid the riskiest rating buckets in US High Yield markets whereas Emerging Markets, whose credit cycle is not yet that advanced as that in the USD seems less of concern to us (with the exception of China).

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Foreign Exchange: no outlier expected

Will there be consequences from rising USD-rates for foreign exchange markets? While there is traditionally a very large dispersion between individual FX forecasts, its worth highlighting that (all considered) forecast for the all-important EURUSD-exchange rate are in a relatively narrow range *(see slide 4 for details).*

The USD-bears:

- Citigroup: *"Our FX macro strategy team expects the US dollar index to weaken ~5% by end-2018* ***on the build-up of external debt and a top-out in the cycle*** *"*
- UBS: *„we are factoring in a modest depreciation oft the "greenback" in 2018. While the* ***tax reform might bring some short term support****, the* ***longer term deficit*** *of both,* ***the trade balance*** *as well as budget* ***will weight*** *on the currency".*
- Barclays: *"Our medium-term views remain* ***driven by the re-synchronization of cyclical prospects****, warranting resumption of the USD downtrend beyond Q1 18 as* ***US tax policy announcement risks dissipate.*** *The EUR, Scandies, and the JPY are likely outperformers. "*

The USD-bulls:

- Deutsche Bank: *"We assume that this trend could reverse in the first half of 2018 and that the US dollar could strengthen against the euro again. The* ***main reason*** *for this* ***is the monetary policy of the Fed****. Nevertheless, the euro might already make good the lost ground in the second half of 2018: as soon as the ECB will probably terminate its bond purchase programe towards the end of the year (…)*
- BofA: *"The U.S. dollar is expected to rally in the first quarter,* ***supported by rising U.S. interest rates*** *and* ***potential repatriation flow*** *occurring as a result of* ***tax reform****"*

Gigant's view on Foreign Exchange in 2018:

Due to its rather poor predictive power, Foreign exchange forecasts should always be considered with more than just a grain of salt. What we take away for 2018 is that **any substantial, large moves in favour or against any of the G3 currencies seems unlikely** to us. For the sake of having some sort of tendency at hand: the EUR might be helped by a better economic developments in the Euro-area whereas further GBP appreciation seems notoriously limited due to looming BREXIT risks. We at Gigant believe that interest rate differentials seem to offer the best guide for further FX-evolution: therefore, **higher USD-rates** (which are set to rise faster than its G3-peers in Europe and Japan) **should be USD-supportive**. What **investors with USD-denominated accounts should take note of is the fact that the other G3-currencies do not offer impressive investment opportunities** as A) USD-rates are most attractive for investors and B) any appreciation potential of peers seems limited. Furthermore, **absence of** (substantial) **USD-weakness traditionally bodes well for Emerging Market asset**s.

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Equities: earnings expectations are not unusually high….

Forecast for end of 2018:	S&P500	Earnings per Share	PE-Ratio
current	**2685 *)**	**131,73 **)**	**20,38x**
HSCB	2650	142 USD	18,7x
Citigroup	2675	141 USD	19x
Morgan Stanley	2750	145,9 USD	18,8x
Bank of America	2800	139 USD	20,1x
Deutsche Bank	2850	140 USD	20,4x
Goldman Sachs	2850	150 USD	19x
UBS	2900	141 USD	20x
average	**2782**	**145,5**	**19,4x**
Avg. Delta to 2017	***+97 / +3.6%***	***+10,7%***	***-0.98x***

As we showed previously, the consensus expectation is for further growth in both, the global as well as the US economy. At this stage, we can already draw two important conclusions:

1) Judging from mid December 2017, and on the back of the initially described macro economic outlook, **it seems as if the average +10% YoY earnings growth expectations for 2018 is reasonable** (see graph on page 9). In the past years, we witnessed equally high expectations combined with much less favorable economic conditions.

2) Despite continued economic growth expectation, the **consensus expectation** is **for a rise** in the S&P by +3,6% (as of now) which is **substantially lower than the return achieved** so far **in 2017.**

That all said, the **big questions for investors going into 2018 will be whether the current valuation multiples already price in the expected growth** or not?

*) Source: FIS Market Map as of 18th of December; **) Source: FactSet as of 14th of December

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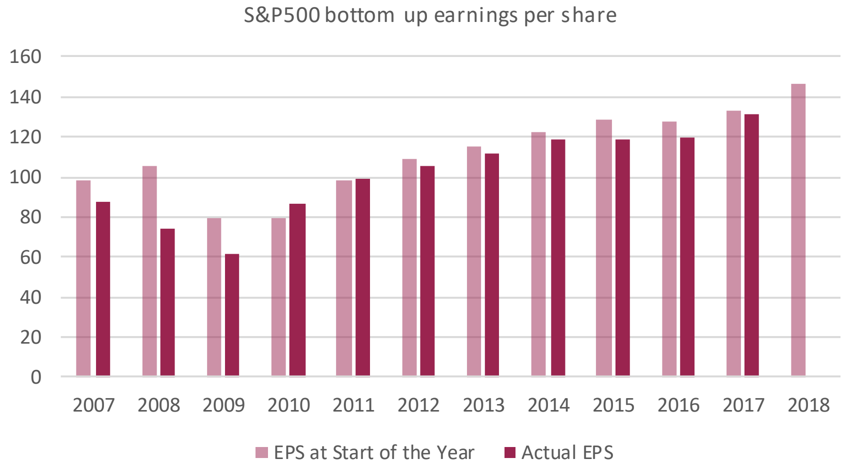
Equities: …but valuations!

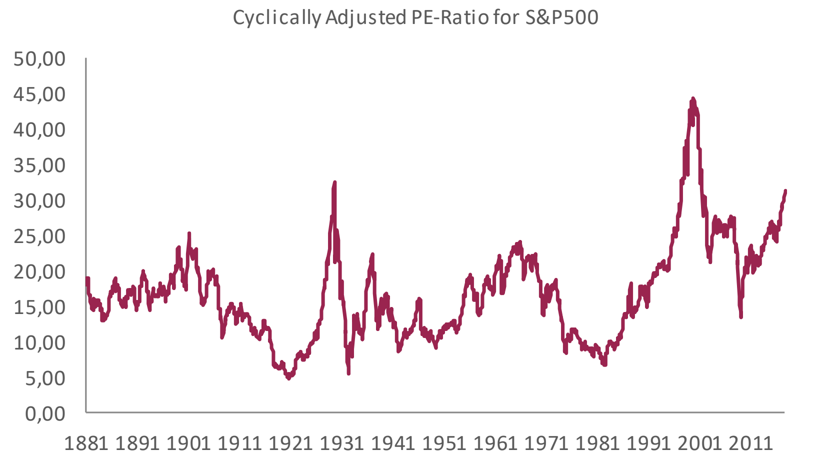
And this is what the research providers say about equity valuation:

- Societe General: *"Since Trump's election, the US equity market has risen 24%, but only half of this came from earnings growth. The other half has been driven by P/E expansion. **According to our calculations, the US Equity market is already pricing in potential tax reform**. The rise in bond yields and FED repricing should be headwinds against further US equity rerating."*
- Morgan Stanley: *"(…) the year is beginning with booming confidence, as hopes for tax cuts rise, thus **the bar to positively surprises is high wile "goldilocks" is firmly in the price across most risk assets**"*
- UBS: *«Although many are concerned about the rise in P/Es, we have shown that **high P/Es** amid lower growth are a rational reflection of the low risk-free rate regime, **not a source for concern**."*
- Barclays: *"Concerns about an elevated multiples in the US are not new (…). **Earnings growth is strong** and (…) consensus earnings revisions have held up well. Overall, we think **fundamentals still support equities and pro-cyclical positioning**"*

At least, there seems to be some sort of **consensus that markets are relatively expensive** today (see also lower chart on the right) While there is no unity about whether high valuations should be a source of concern, experts seem to agree that the **equity return potential for 2018 is lower** than the performance we witnessed in 2017.



Source: FactSet



Source: Professor Robert Shiller via University of Yale

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Equities: however, it's about the sentiment anyway!

Gigant View on on equity valuation:

In terms of high valuation as described on the previous page, **we don't consider the bull's argument orderly convincing.** Just because valuation were high for quite some time does not alter the probability for even higher valuation nor does it lower the probability for lower multiples. For long, the argument was that during times of ultra-low interest rates, higher P/E-multiples might be justified which makes perfect sense to us. However, **under the assumption that rates are on the rise going forward (albeit slowly), the reverse conclusion would imply PE should start normalize back to down to more reasonable levels** again…..

Gigant's Equity Sector Strategy for 2018:

Thanks to the relatively bright macro economic outlook described in the first section of our outlook, it seems intuitively logic that c**yclical sectors such as technology, finance, industrials and consumer cyclicals should be preferred** over less cyclical industry groups. Furthermore, sectors with high sensitivity to (rising) interest rates, such as **telecom and utilities are deemed to underperform**.

Gigant's Equity Strategy for 2018:

As we have been saying for quite some time during H2 2017, we believe the current uptrend which is mainly driven by improving sentiment is very strong. As we tried to show previously, we **don't believe it would be economically justified to see higher valuations**. However, this does not mean markets can actually go higher. **Rather than valuation, the rise in markets is fuelled by higher investor appetite, more aggressive risk tolerance and yes, exuberance (hence, by sentiment).** This allows to draw the following 2 conclusions:

1) whether it makes fundamentally sense or not, **it would be suicidal to fight this trend which is why we stay bullish for equities.**
2) **By knowing about the fragility of sentiment, we always keep one finger close to the selling-button** in case there is a deterioration in sentiment.

As a best guess scenario, **we forecast an equity market top during H1 2018 before we will se a more severe (intermediate) correction** (in the form of >10%) **in H2 2018**.

Gigant's Geograpic Equity Strategy for 2018:

In developed markets, we (continue) to **favour US & EU**. We remain **constructive for selected emerging market** assets, with the exception of China & Turkey

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Biggest risks for 2018

We know all to well that predictions sometimes have their limitations when it comes to find prosperous investments. For those who don't trust predictions at all, looking at potential threats might be a suitable, alternative strategy. Given the large amount of (consensus) opinions we were browsing through, the below factors seemed best qualified to spoil the party in 2018:

- **sudden rise in inflation**
- **ECB exiting QE at early stage**, accompanied by rising EUR-yields
- **Jump in equity market vola**tility because of any of the above
- And as with every yearly outlook: **politics**, from rising middle east tension to an escalation in the North Korea conflict and from elections in Italy to Russia, there is no shortage of mine fields in the area of politics

And last but not least:

- Inevitably, a 2018 investment strategy without a forecast for the price of bitcoin would not be complete. For the sake of having a view: In 2018, bitcoin might do both, trade above 50'000 USD (don't ask us by how much- we just don't know) and below 5'000 USD (in this very order)

- Speaking about gambling, our gut feeling is telling us that Germany is going to be the Football World Cup Champion in 2018 again. Our conviction for this call is higher than that for our bitcoin outlook.

- Historically, equity market returns for January have a relatively high volatility….so fasten your seatbelt

Our Preferences for 2018 on one slide

Asset Class	We Like	We Don't Like
Equities	*Area*: **EU, EM** *Sectors*: **Tech; Financials; Pharma; Consumer Cyclicals** *Style*: **Momentum *with* quality!**	*Area*: **China** *Sectors:* **Utilities, Telecom** *Style:* **Momentum *without* quality**
Bonds	*Duration:* **Floating Rate Notes**, **Medium term duration** up to **5** years *Area:* **selected Emerging Markets; US** *Credit:* **EM Credit; low grade IG** *Theme*: **US Senior Loans**	*Duration*: **Ultra long duration** beyond **10** years Area: **Developed Market Government Bonds** (ex US); **China** *Credit:* **High grade IG, EU High Yield**
FX & Commo-dities	*FX Majors:* **EUR** *FX Minors:* **BRL** *Commodities:* **Gold**	*FX Majors:* **GBP, AUD** *FX Minors:* **TRY, CNY** *Commodities:* **Base Metals, Agricultural**
Alternatives	*Alternatives:* **Gigant Option Based Equity Growth Strategy; strategies with uncorrelated payoffs to equity & bond market direction**	

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