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Outlook & Investment Strategy 2019

Table of Content

- Outlook & Investment Strategy 2019
  - Introduction -> slide 3
  - Global Macro Economics -> slide 4
  - USD Rates -> slide 5
  - USD Credit -> slide 6
  - Foreign Exchange: The Majors -> slide 7
  - Foreign Exchange: The Turkish Lira -> slide 8
  - Commodities -> slide 9
  - Equities -> slide 10-11
  - Our Preferences for 2019 on one slide -> slide 12

Outlook & Investment Strategy 2019

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Introduction

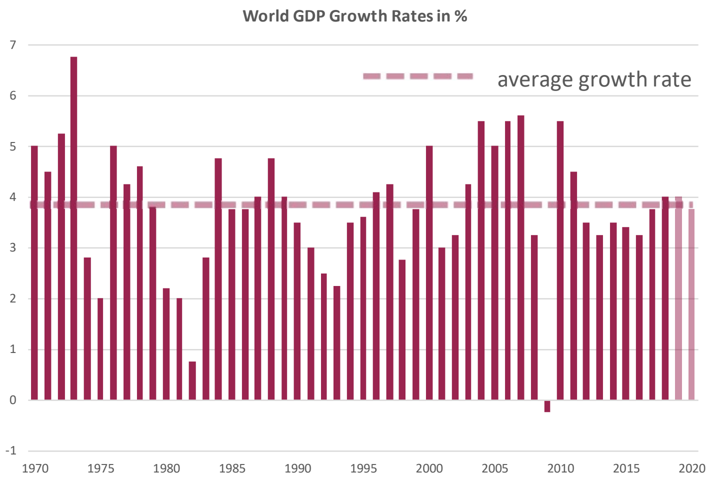
- We are of the opinion that the importance of yearly economic & strategy outlooks should not be overestimated. Investment management is a continuous process and not something which should be done exclusively at any given due date of the calendar. Therefore, depending on the ongoing developments in world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

- Since we don’t engage in any economic research activities ourselves, we do not publish our own economic forecast nor price targets for individual assets/securities.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.

- That all said, please find thereafter a summary of our thoughts and expectations for 2019 as well as a summary of our investment strategy for 2019

Global Macro Economics



GDP Growth Rates *)	2017	2018	2019
Global GDP Growth	**3,7%**	**3,7%**	**3,7%**
US GDP Growth	2,2%	3%	2,9%
China GDP Growth	6,8%	6,6%	6,4%

Press headlines might **suggest the global economy is on the verge of a collapse**: a major trade war between the US and China, Brexit, Italy's conflict with the EU, renewed sanctions on Iran and many more. The data however, draw a different story. **According** to the **International Monetary Fund's** latest assessment published back in October 2018, the **World Economy is set to grow by a healthy 3,7%** in 2018 (which would match the growth rate of 2017). For **2019**, the **IMF's forecast is again 3,7%.** So all well? For a better understanding, we shall look at the biggest growth contributors in detail. Over the recent years, US and China accounted for > 50% of global GDP-growth**) **For 2019, the two largest economies are set to experience decelerating growth dynamics** *(see table on the left)*. The retreat does not look alarming at first glance but it should be noted that during Q2/Q3 18 for instance, the US saw much higher growth dynamic at 4,2% and 3,5% annualised. China's expected +6,4% growth for 2019 would mark the smallest growth figure since 1989. Furthermore, it should be noted that **US tariffs** which cover more than half of Chinese export to the US and **China's efforts to deleverage** its indebted public- and private sector pose **headwinds to this outlook**. Last but not least, **global GDP growth will be less synchronised in 2019**. According to the IMF, a smaller share of countries is expected to experience an acceleration for 2019 which reflects diverging cyclical positions.

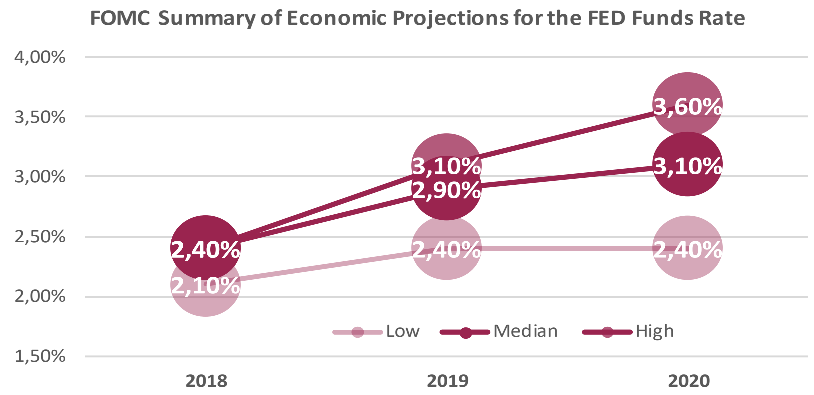
Gigant's view on the global economy in 2019:

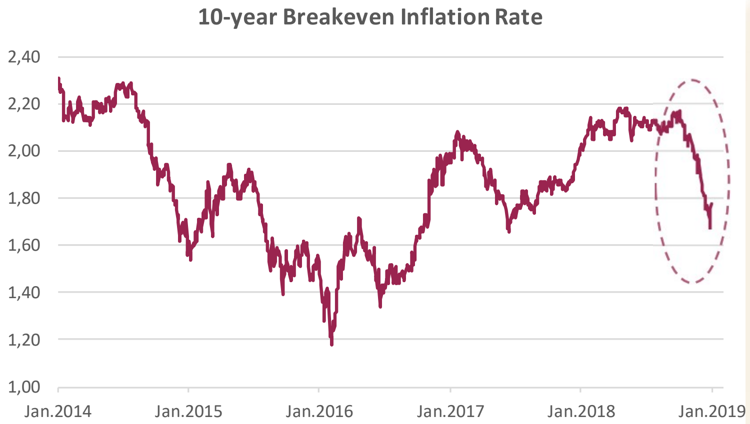
Global growth is not as **bad** as news headlines might imply. During Q4 18, markets have finally noticed there won't be a quick fix to the ongoing Chinese/US trade conflict which still represents THE major risk for 2019. Anyhow, **we believe most of the receding growth rates are now priced in**. While the **US economy may face a further cooling off**, leading indicators point to a slight pick up in areas such as Europe and Emerging Markets. Those areas have already seen slower growth for more than 12 months and the level of their asset prices is less demanding.

*) estimated numbers by The International Monetary Fund (IMF); **) Focus Economics

USD Rates

The market expectation for USD rate hikes implied by FED Fund Futures have cooled off meaningfully during Q4 18. At the end of 2018, **market expectation** was for **no rate cut at all** which strongly contradicting the four rate hikes totalling 100bps we witnessed during 2018. The **FED itself is more hawkish** with 2 forecasted rate hikes (although that number was trimmed down from initial 3 at the last FED meeting in Mid December 2018).





The longer end of the yield curve instead is not directly controlled by the FED but rather impacted by longer term growth and inflation expectations. Despite short term inflationary pressure due to wage growth**, longer term inflation expectations are well anchored** thanks to aging demographics, low productivity, a lack of capital investments and rising debt levels. During Q4 2018, the expected inflation rate has already dropped meaningfully.

Gigant's view on USD-rates in 2019:

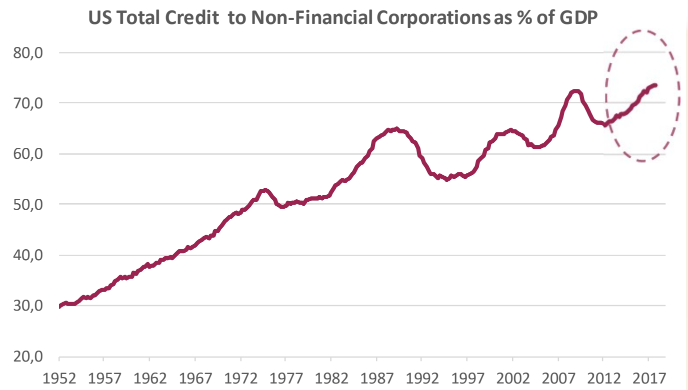
There is a clear risk **in our eyes the market is underestimating the FED's willingness to raise (short term) rates**. We are of the opinion that in particular future wage growth is likely pressuring the FED to maintain its ongoing tightening path. Accordingly, we still see **risks for rates to the upside although by a much lesser extent than in 2018**. The longer end of the yield curve is likely to rise at a much more muted pace which would result in an even flatter **yield curve** (which is likely to fully **invert in 2019 in our eyes**). Accordingly, investors are not adequately compensated for holding longer term debt. The European Central Bank is scheduled to first rise its rate in Summer 2019, a move which has been well telegraphed to markets since quite a while and which is unlikely to have a meaningful impact in our eyes.

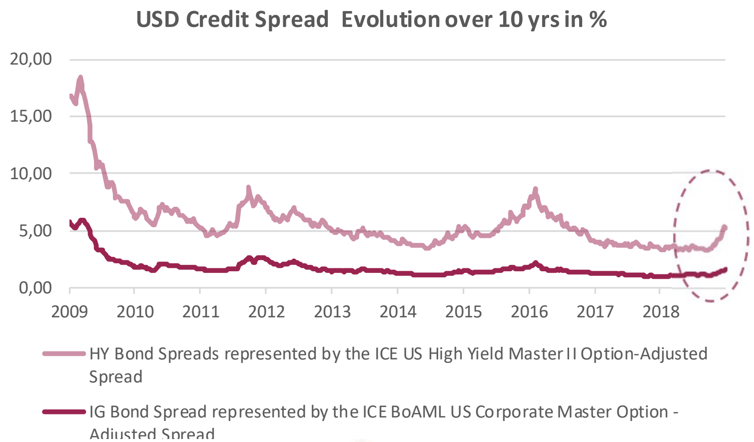
Source: St.Louis FRED

Credit

Relative to their own historic average, **credits spreads** (i.e. the extra yield borrowers have to pay over treasury bonds) **are still extremely low**. While they have risen rather quickly during Q4 18 *(see chart on the right),* investors should aske themselves whether they are truly willing to provide borrowers their money for just a proverbial handful of bps more, in particular after **corporate leverage has risen for years.** According to the Bank of International Settlements, debt held by non-financial US companies is at 73% of GDP- the highest reading on record *(see chart on the left).*

Additionally, the **outstanding debt is of poorer quality** nowadays. According to Morgan Stanley, BBB-rated bonds outstanding exceed by 50% the size of the entire investment-grade market at the peak of the last credit boom in 2007. While its unlikely that default rates will rise substantially nor that credit conditions will deteriorate significantly, **H2 2018 is an excellent reminder that total returns of credit investments can actually be negative once spreads start to widen**.





Gigant's view on Credit in 2019:

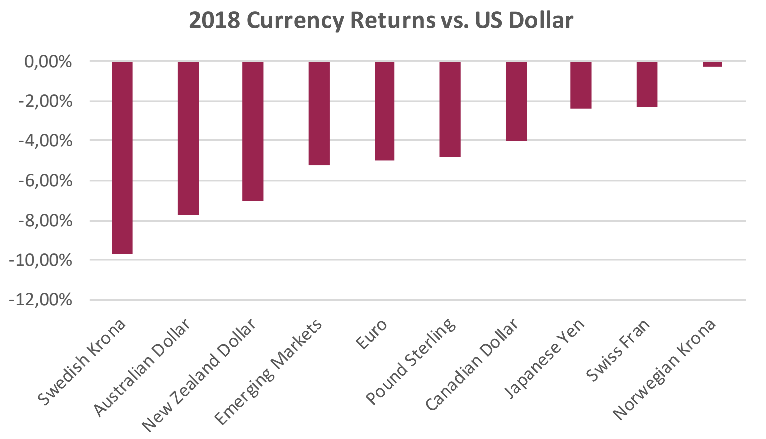
Rising credit spreads are one of our highest convictions for 2019. Late Q4 2018 was a harbinger of how damaging rising credit spreads may be for bond investors. Therefore, even at current spread levels which are still low by historic standards, we see **risk-free (US) government bonds as viable alternative**. Within Credit investments, the **selection should be tilted towards above average credit quality**. On the back of improving fundamentals and after the 2018 sell-off, we consider **Emerging Market debt** (in hard currency) as **relatively attractive**. Anyhow, be selective in terms of credit quality and stay diversified from a regional aspects.

Source: Bank of International Settlements; Morgan Stanley; ICE Benchmarks Administration Limited (IBA); St.Louis FRED

Foreign Exchange: The Majors

Forecast *)	EURUSD
End of 2018	*1,1487*
Barclays	1,12
Citigroup	1,13
Deutsche Bank	1,14
Bank of America	1,15
Goldman Sachs	1,20
Average	*1,1616*
Delta for 2019	*+1,13%*

History suggest that foreign exchange forecasts have rather poor predictive power which is why they should be considered with more than just a grain of salt. That said, when looing at the expectations for the all-important EURUSD-rate from major players in FX markets on can draw the following conclusion: **after a** very **strong year for the US Dollar**, there is **hardly anybody giving credit to continued dollar strength**. That shouldn't be all to surprising since the **USD** is rather **expensive from a fundamental perspective**. Furthermore, **longer term interest rate differentials** between the US and Europe **are at its widest level** since the Euro was introduced and while this levels make sense for now (thanks to differences in inflation and growth dynamics), it is unlikely they stay as wide indefinitely. Therefore, while the **potential for further USD-strength is limited**, a renaissance of the EUR is also way too early as long as economic data do not improve. In the G4 area, **GBP** while extremely cheap from a fundamental perspective **continues to suffers from the Brexit-overhang**. During times of increased uncertainty, the JPY should held up relatively well.



Gigant's view on Foreign Exchange in 2019:

Despite the fact that future appreciation potential for the USD should be limited, **we (still) see no need for USD-denominated portfolios to get broad FX-exposure** (from a pure FX-perspective). First and foremost, the **USD is unlikely to weaken substantially** during times of slowing global growth & increased (short term) inflationary pressure. Furthermore, the **yield carry still strongly speaks for USD-investments** (*see page 5 for details*). If really at a later stage during 2019, EM & Europe should show signs of a catch-up, this would help the EUR to outperform. For now, less cyclical save havens such as USD, JPY and CHF remain currencies of choice.

Source: Bloomberg; FIS Market Map; *) as per December 2018

Foreign Exchange: The Turkish Lira

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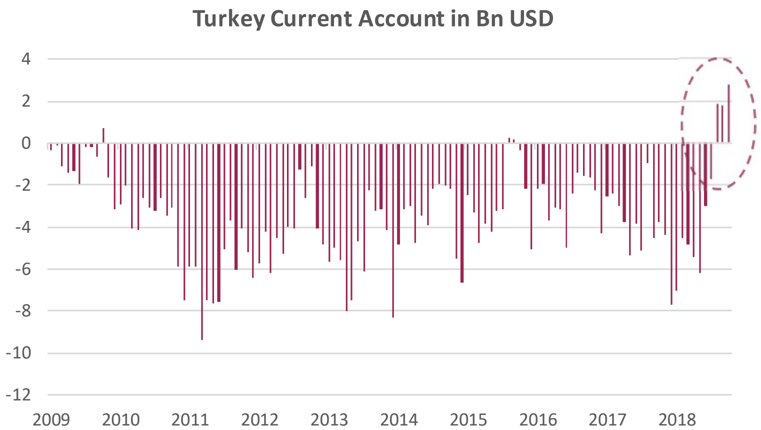
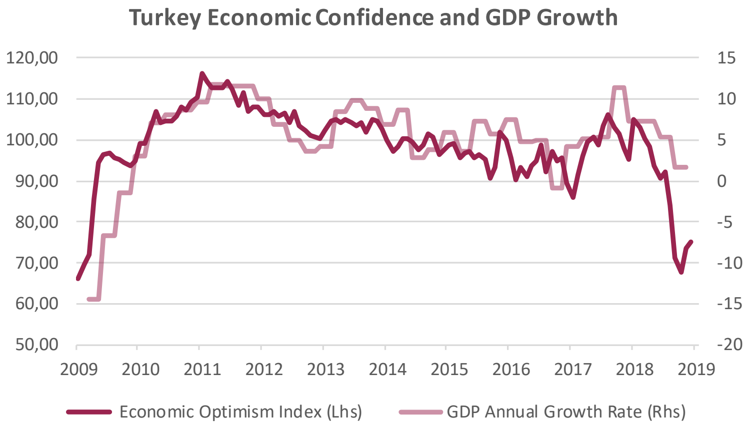




Source: Heckyl

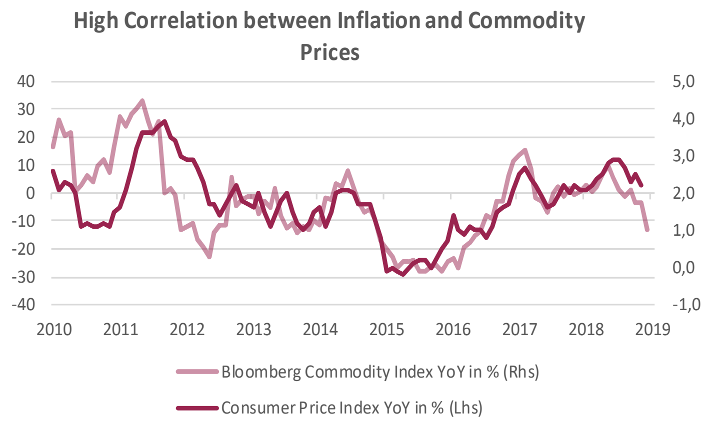
For years, the **current account deficit was Turkey's major economic problem** *(we wrote about this extensively in the past, for in Turkey: Economic Situation & Outlook from Sept 2018).* One of the ultimate impacts of the currency crisis of Q3 18 was that exports got a strong boost from the extremely low Lira while imports went back dramatically (money flows from Tourism also helped) **resulting in the countries first current account surplus in more than 30 years**. Arguably, an **inflation rate** north of 20% is still **extremely high**, both in an international context but also for Turkey's own history. It will takes months until the inflation rate will normalize again (the waterfall drop in oil prices will help). Furthermore, **GDP** even **shrank during Q3** and will **likely have dropped further during Q4** (see chart). Anyhow, the "root of al evil" has been moved away for now by market forces without help from the IMF or any other party. Going forward, a too quick recovery of the Turkish Lira or a premature rate cut by the CBRT would darken the outlook again. For now, the Lira's outlook is as good as it has rarely been over the last 24 months.

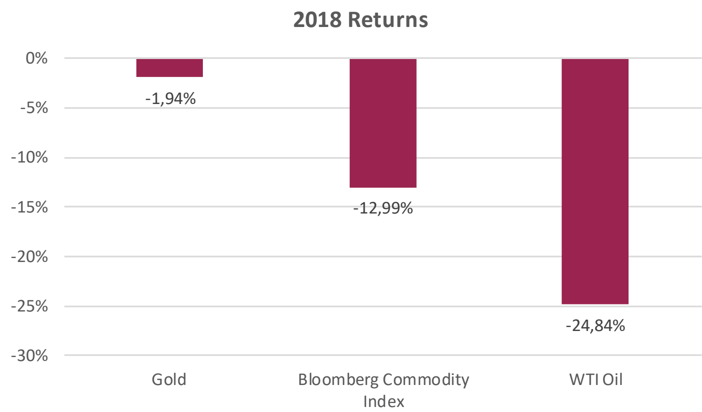
Gigant's view on the Turkish Lira for 2018:

An important overhang for the Turkish Lira, namely Turkeys current account deficit **has been removed** (for now). While this will **support the ongoing recovery rally** out of oversold territory for the months to come, some headwinds remain. Even if headline inflation might recede from record high level, it is sill structurally high. And last but not least, there remains a **risk the CBRT, in an attempt trying to please politics, will cut rates too early.** For now, we don't mind holding Turkish assets and earning the yield carry but bear in **mind this is not the beginning of a new bull trend.**

Commodities

History suggest that **towards the end of an economic cycle, commodities tend to do well** as overall demand stays high while inventories are relatively low. UBS notes that in the six months prior to the last three US recessions, well diversified commodity indices outperformed global equities by +15% on average. Bank of America for instance calculates that key commodity inventories are siting at or below 5 year averages. Anyhow, **we are only mildly positive on the overall asset class since the macro downside risks are imminent** (escalation of US/Chinese trade conflict; continued monetary tightening; deteriorating credit cycle). Instead, we would **expect a relatively large dispersion of returns between individual commodities**. **Gold** for instance is set to **shine thanks to rising** (short term) **inflation** and a relatively stable US Dollar and its ability to act as a hedge against macro risks. In crude oil, the worst is most probably behind us. **US sanctions over Iran and OPEC cuts will put a floor to crude oil prices** but we don't think this will be enough to trigger a renewed bull market. After all, if there is one thing we learned from the wild swings in oil markets over the last 2 years than it is that it's future return are difficult as hardly any other asset to predict. **Base metals** on the other hand are set to be **negatively impacted be the deteriorating industrial activities in China**.





Gigant's view on Commodities in 2019:

We **continue to be positive on gold** thanks to the above described factors. From a portfolio point of view, **increased volatility** in risk assets even more **calls for some sort of stable hedge element**. Selling downside risk is our strategy of choice for crude oil (something we already started during Q4 2018). **Hands** should be put **off base metals in 2019**. In our eyes, there is **no need for (non-interest) bearing investments in commodity indices** during times cash is a viable investment alternative again.

Source: UBS; Bank of America; Bloomberg; Heckyl

Equities

Forecast for end of 2019:	S&P500	Earnings per Share	PE-Ratio
End of 2018	**2507**	**162,11 *)**	**15,5x**
Morgan Stanley	2750	171 USD	16,1X
Bank of America	2900	170 USD	17,1x
Goldman Sachs	3000	173 USD	17,3x
Citigroup	3100	172,5 USD	17,1x
HSBC	3150	179 USD	18,6x
UBS	3200	175 USD	17,3x
Deutsche Bank	3250	175 USD	18,3x
Credit Suisse	3350	174 USD	19,3x
average	**3087,5**	**173,68 USD**	**17,8x**
Avg. Delta to 2018	***+23%***	***+7.1%***	***+2,3x***

As we have highlighted on *page 4,* we are not overly pessimistic when it comes to global growth in 2019. From that background, **the expected earnings per share growth** of **+7.1%** for the aggregated S&P500-index **does not look all too unrealistic**, even when considering that US GDP-growth is set to slow and consensus forecast have a tendency of being too bullish. Where we struggle to follow the market consensus is the earnings multiple. **At the current late stage of the economic cycle** with discount rates poised to stay or rise, **we don't see a reason why there should be a multiple expansion as expected by market consensus** which would again drive valuation beyond their multi-year average level. While not base case, there is a not to-underestimate risk in our eyes that the FED's ongoing tightening path (*see page 5 for details)* will terminate the current business cycle.

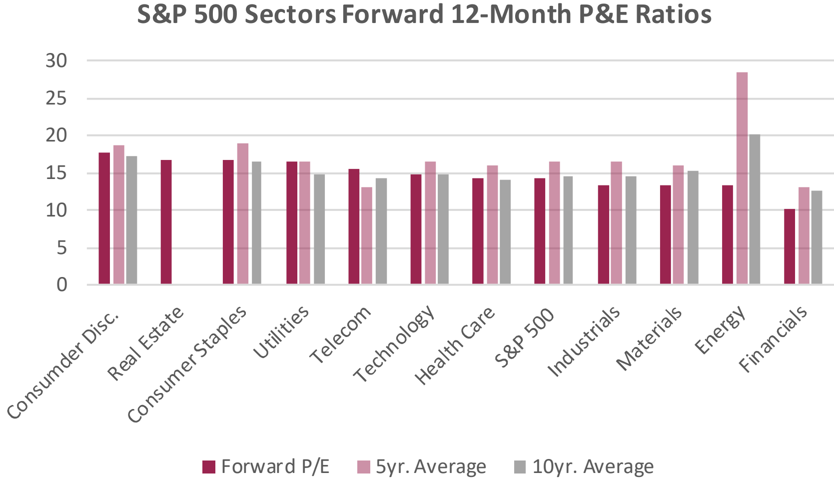
Gigant's view on Equities in 2019:

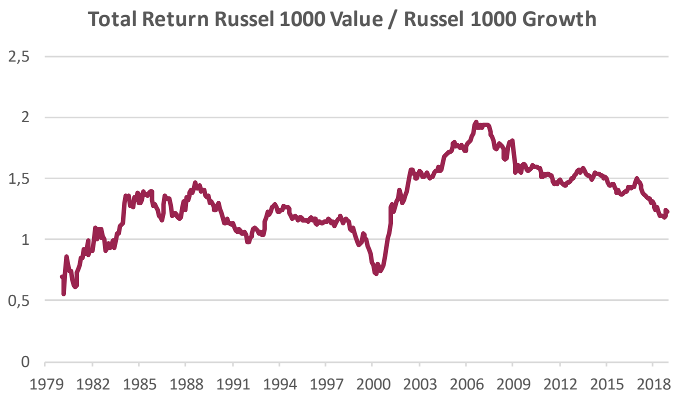
While bulls claim that the **current valuation** of the US-stock market is the cheapest in the last 24 months, we feel it **is about fair** for the current state of the economic cycle and much **more in line with longer term averages** than it was for most parts of the last 2 years. In that sense, **we neither see equity market valuation as a reason for a recovery nor a collapse**. If valuation is any guide than for Europe or Emerging Markets, where its absolute level is far less demanding and the drop from recent peaks much more pronounced. Anyhow, before turning bullish on either of those markets, we would want to see improvements in their fundamental growth dynamics. Overall, **we suspect selling pressure from Q4 18 is set to continue later in Q1 19 but likely to result in attractive buying levels later during the year**. In our eyes, the US yield curve will judge about the fate of the stock market in 2019. We would see an avoidance of a yield curve inversion as a positive catalyst.

*) Source: FIS Market Map as of 21th of December; Bloomberg, FIS Market Map

Equities: Sectors & Styles

In the US, **rising interest rates and relative labour scarcity will pressure margins**. One of the consequences will be that (excessive) share buybacks, a constant growth engine for equity markets over the last years will get back to more normal level. Stable to rising interest rates will make **growth-stocks less attractive** and the lower market momentum will remove money from trend-following momentum strategies (which again were chasing growth-style stocks for most of the last years).





As a consequence, **the spurt in tech shares is most probably over.** “Value” & “Quality” is likely to outperform “Growth” thus reversing parts of their extensive underperformance over the last years. **Less cyclically geared sectors such as Pharma, consumer defensives or utilities seem like the better choice**. From a geographical viewpoint, the times of relentless US equity market outperformance are most probably coming to an end later in 2019.

Gigant’s view on Equity Sectors in 2019:

We **plan to add EM and European equities** whose valuation is far less demanding in order to better diversify portfolios internationally. A **focus on “quality” companies with higher profitability, lower financial leverage and sound earnings visibility** should be self-explaining at this late stage of the economic cycle. Once energy prices have found a bottom (so far, the haven’t), the energy sector could gather our interest. Despite the very cheap valuation to its own history, it seems too early to get overly positive on financials. We have maintained a **preference for “value” and less cyclically exposed stocks** for most of H2 2018 and we continue to hold this positioning when going into 2019.

Source: FactSet; FTSE Russel

Our Preferences for 2019 on one slide

Asset Class	We Like	We Don't Like
Equities	*Area*: **Diversification among US, EU & EM** *Sectors*: **Pharma, Consumer Defensives, Utilites** *Style:* **Value**	*Area*: **China** *Sectors:* **Telecom, Energy** *Style:* **High growth *without* quality**
Bonds	*Duration:* ~~**Floating Rate Notes**~~, **Medium term duration** up to **7** years *Area:* **US; *selected* Emerging Markets (i.e.via Gigant High Income Emerging Market Bond Strategy)** *Credit:* **low grade IG**	*Duration*: **Ultra long duration** beyond **10** years Area: **China** *Credit:* **EU & US High Yield**
FX & Commo-dities	*FX Majors:* **USD, JPY** *Commodities:* **Gold**	*FX Majors:* **GBP, ~~AUD~~** *FX Minors:* ~~**TRY**~~**, NOK** *Commodities:* **Base Metals**
Alternatives	*Alternatives:* **Gigant Option Based Equity Growth Strategy; strategies with uncorrelated payoffs to equity & bond market direction**	

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