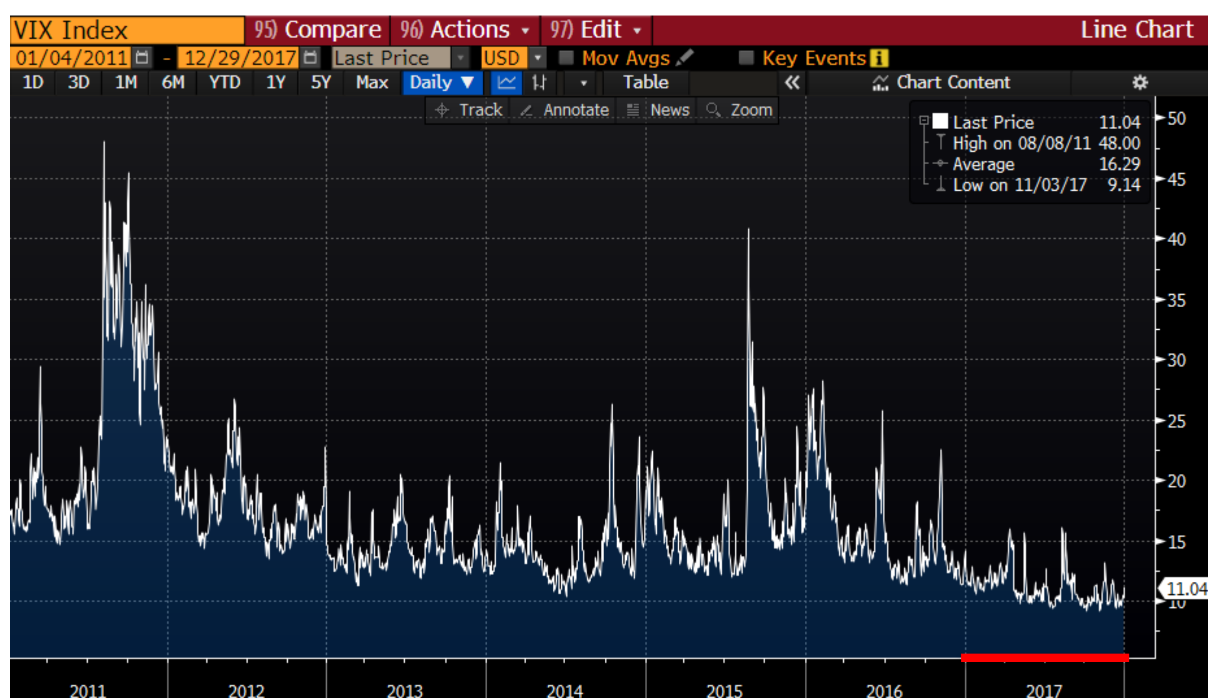
January, 2018

Dear Client

We are pleased to enclose your end-of-year portfolio statement, accompanied with a brief commentary on the key events of the year 2017 and our expectations for the year 2018.

## Economic and financial summary of the year 2017

The year 2017 was full of contrasts: On one side there was a rise of uncertainty due to the rising of geopolitical tensions in Middle East and North Asia, difficult BREXIT negotiations and US unilateralism. On the other side, the global synchronized growth (in US, EU, China, Japan, Russia and Brazil) brought stability, granting to the markets the lowest volatility levels in equity markets since decades.




*VIX = SPX Volatility Index*

*Source: Bloomberg*

Some of the key events of the year:

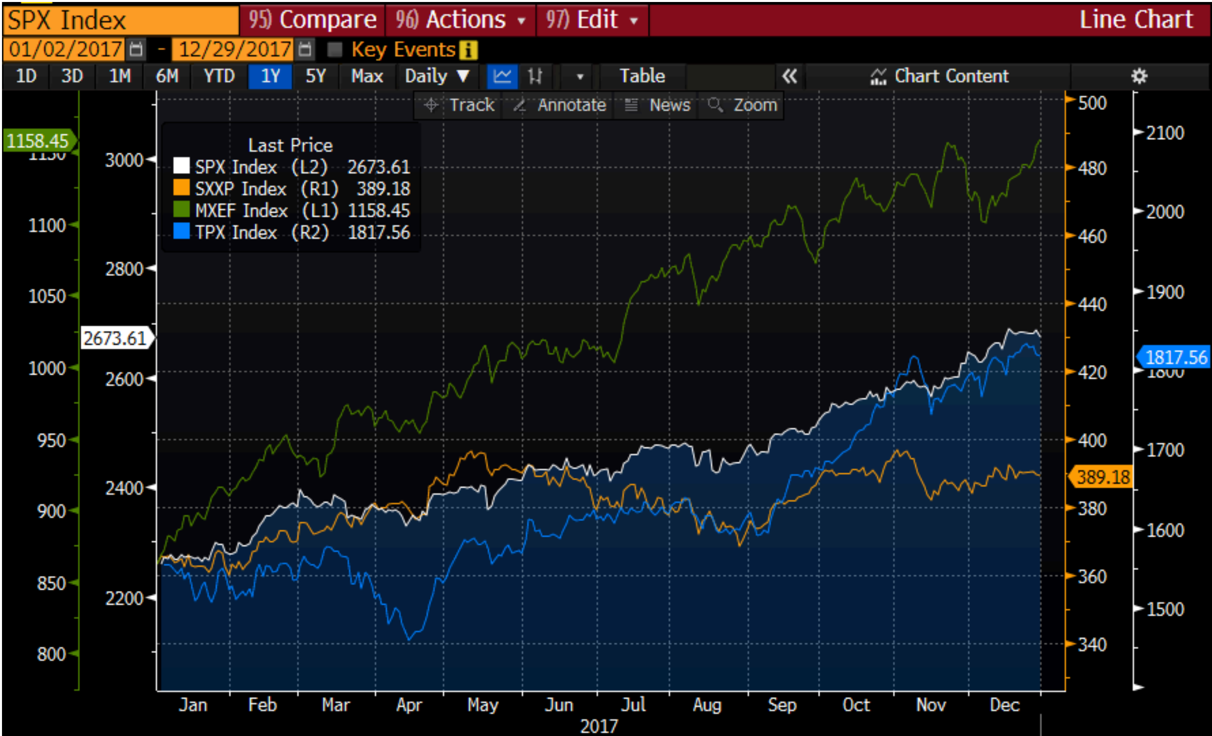
- Inauguration of Donald Trump as the 45th US president
- UK triggers Article 50 to exit the European Union ("BREXIT")
- Emanuel Macron wins the majority of votes in the first round of the French elections
- Global cyber-attack (WannaCry) infects several hundred thousand computers worldwide
- The diesel-gate emerges, triggering a crisis in Germany's automotive sector
- The 19th Chinese Communist Party Congress consolidates Xi Jimping's political power
- The EU Central Bank announces details how to "tapper" its asset purchases starting 2018
- Jerome Powell is nominated by as next US Federal Reserve (FED) chair

The global economic performance in 2017 was one of the best since 2011. Growth accelerated in the US, the Eurozone, China, Russia and Brazil, pushing the global GDP up to 3.8% (vs. 3.6% in 2016). This level of synchronicity was only the sixth time in the past 3 decades.

# A look at the main asset classes in 2017

## Equity markets

All core equity markets performed very well during the year, delivering in all cases double-digit returns (USA = +22%, Europe = +11%, Japan = +22%, Emerging Markets = +38%)[1]. This was driven by a combined effect of rising corporate earnings and higher valuation multiples.

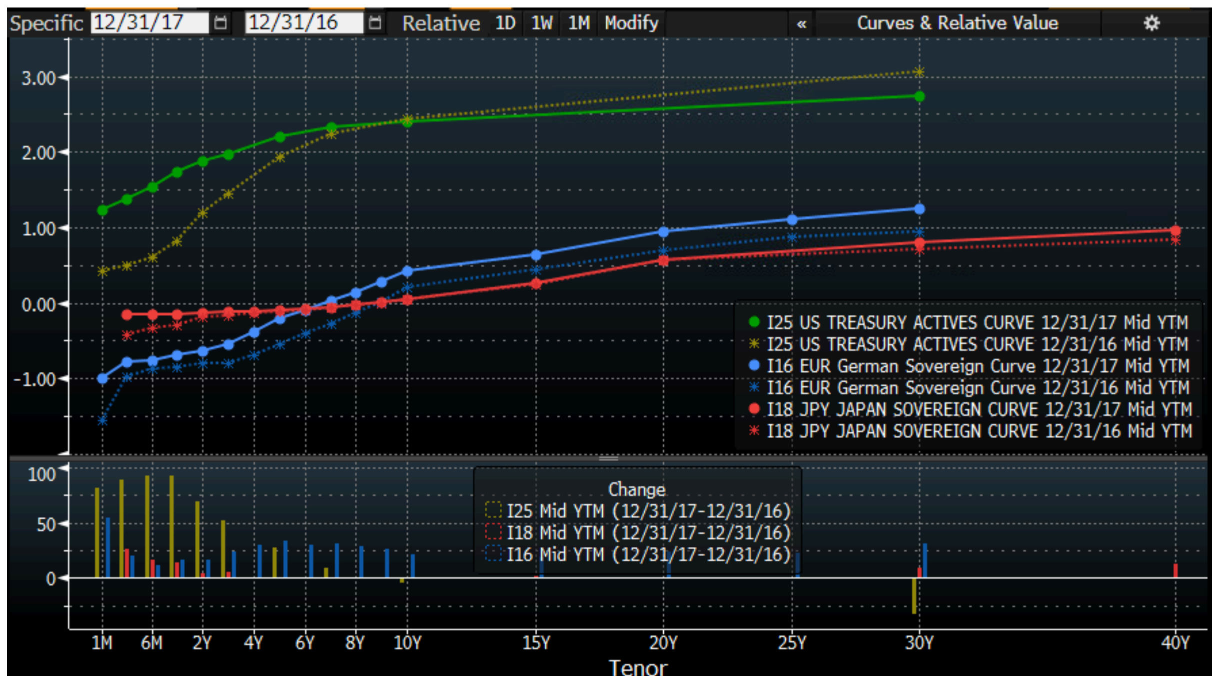



*SPX (S&P 500 Index), SXXP (STOXX EU 600 Index), TPX (TOPIX Index), MXEF (MSCI Emerg. Mkt. Index)*
*Source: Bloomberg*

## Bond markets

Benchmark (risk-free) interest rates had a noteworthy increase only in the USA and only in the short-term segment of the curve, inflicting limited damage to well positioned sovereign investors.

[1] Measured in local currency (for emerging markets measured in USD), including dividends.



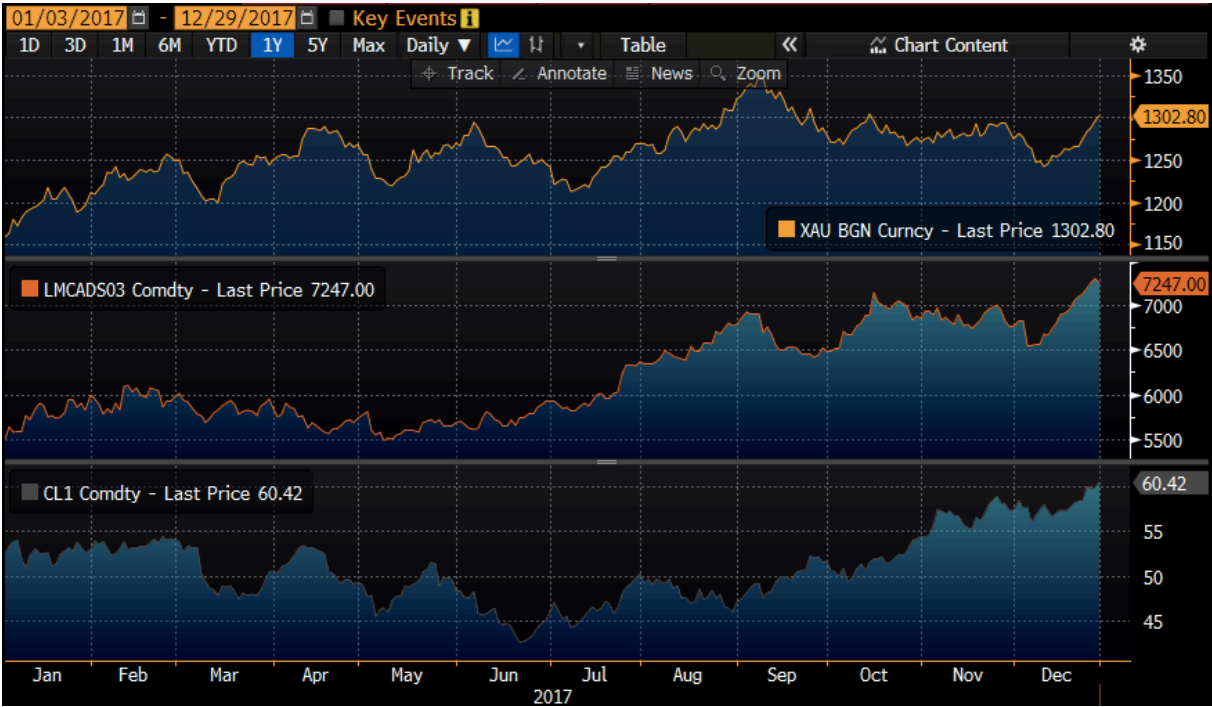

*Benchmark rates: GREEN (USA); BLUE (Germany); RED (Japan)*
*Source: Bloomberg*

The slightly increase of the USD benchmark rate was more than compensated by declining spreads in the USD investment grade, USD high-yield, and USD denominated emerging market bond sub-asset classes, allowing USD investors with credit risk exposure to yield above average returns during 2017 (attractive carry combined with capital gains and limited credit defaults). EUR and CHF investors had less luck in their home currency credit markets.

*Spreads: BLUE = USD Investment Grade; WHITE = USD Emerg. Mrkt.; ORANGE = USD high-yield*
*Source: Bloomberg*

## Commodities

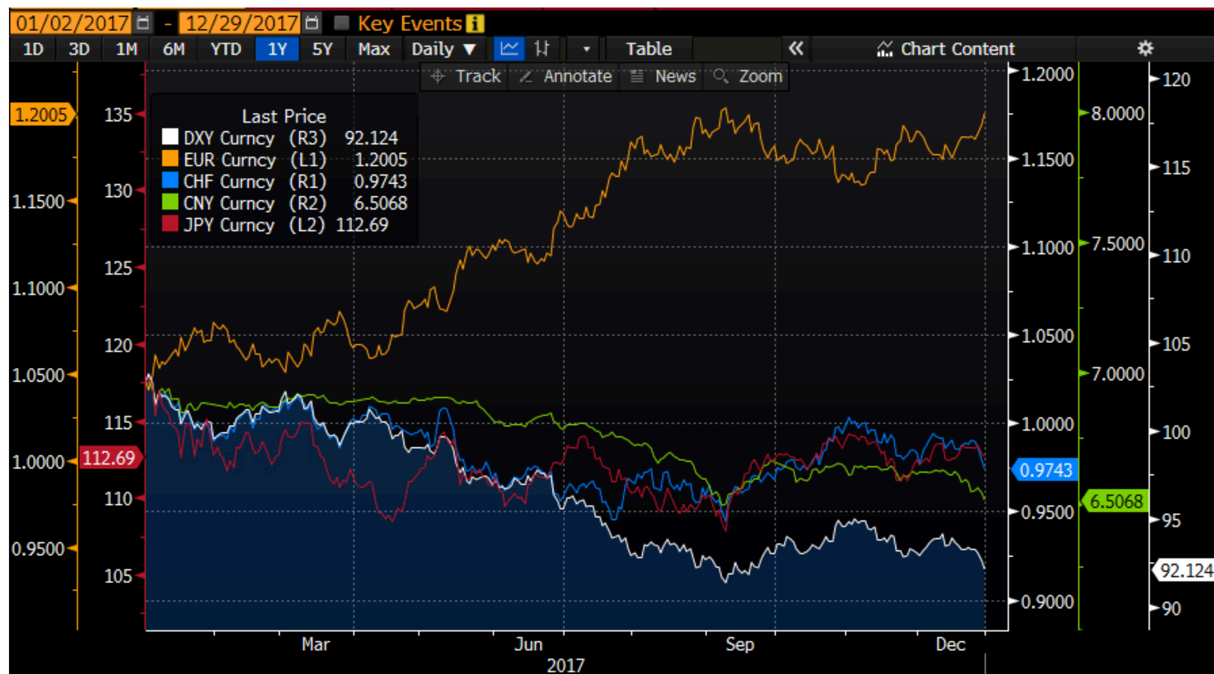
Key commodities (oil, precious metals -> gold, industrial metals -> copper) finished the year with a positive stance. The gold price benefited from a robust jewelry demand (specially from China and India) and the rally of industrial metals (e.g. copper) was driven by the robust economic growth. After the volatile 2015-2016 years, the oil market continued to rebalance (less supply, stronger demand), allowing the oil prices to move higher, reaching USD 60 per barrel.




*Commodity prices: YELOW (Gold, in USD); ORANGE (Copper, in USD); GRAY (Oil, in USD))*
*Source: Bloomberg*

## Foreign exchange markets

The USD depreciated in 2017 as the monetary tightening of the FED was delayed in response to softer-than-expected US inflation, while the EUR appreciated on expectations that the ECB would soon stop its asset purchase program. The Swiss franc (CHF) depreciated against a stronger EUR, compensating partially its overvaluation. The Bank of Japan maintained its loose monetary policy during the year, leaving the JPY at a stable level vs. most of its trading partners (except the EUR).




*Currencies: WHITE (USD Index); ORANGE (EURUSD); BLUE (CHFUSD); GREEN (CNYUSD); RED (JPYUSD)*
*Source: Bloomberg*

## Market outlook for the year 2018

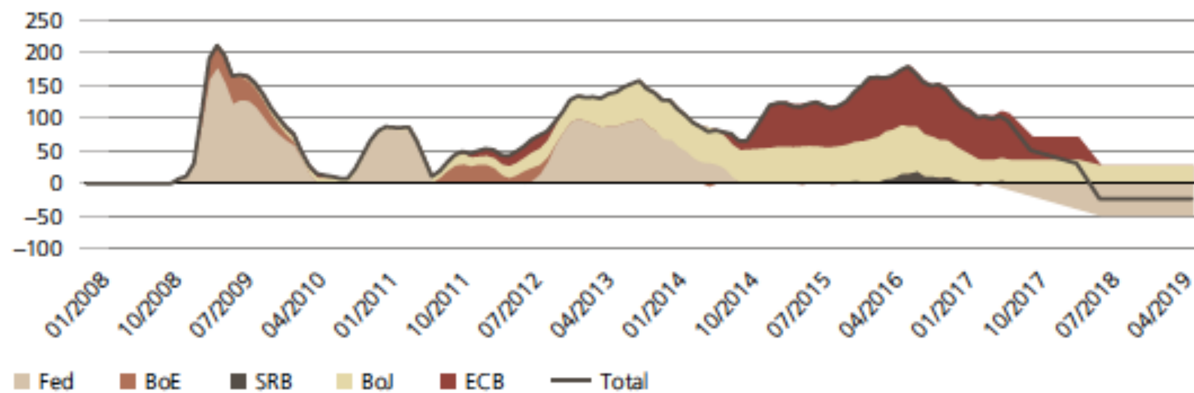
We forecast little change in the positive economic backdrop for 2018:

- The US economy shall remain solid, supported by a moderate FED policy, an expansive fiscal policy, tax cuts, strong domestic consumption and a full employed workforce.
- A stronger EUR and the BREXIT uncertainty are likely to weigh on Europe's economy, whose growth is expected to slow down, but still denoting a positive growth.
- We expect the Swiss economy to slightly accelerate in 2018, with a supportive SNB (no rate hikes expected) and a slightly weaker CHF vs. the EUR and USD.
- We expect China to maintain it's policy direction, balancing reform and growth ("One Belt One Road" initiative).
- The remaining emerging markets are also expected to grow, but will (together with China) have to counterbalance the potential strengthening of the USD, the US initiated "trade-war" and local political challenges (e.g. Brazil).

With the apparent peak of central bank stimulus across the world, we expect the "great normalization" of interest rates to have significant impact on the financial markets' equilibrium: higher opportunity costs, positive [real] returns, disappearance the "equity puts". All those effects will come into the asset value equation. At the same time, governments that walk this path will have to find new [private sector] buyers for their net new debt issuance. With that, increase market volatility is almost granted, across all asset classes, when compared to what we saw in 2017.

Central banks will be withdrawing liquidity by end-2018

Monthly net securities purchases by the world's major central banks, in USDbn

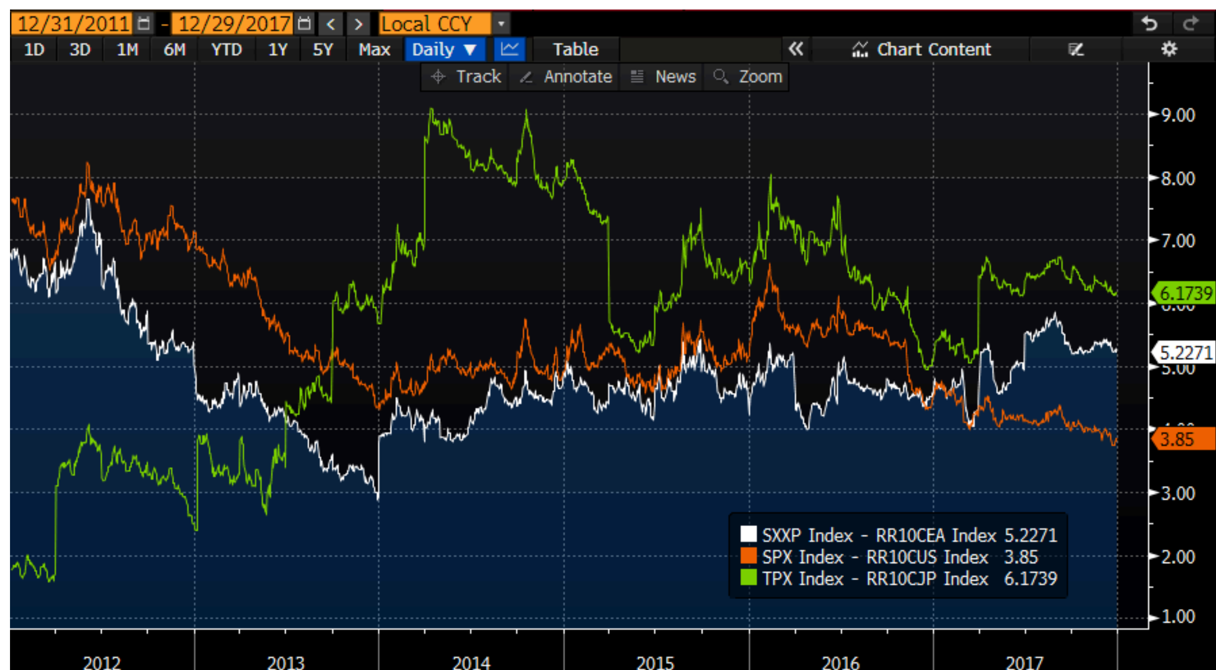



*Source: UBS, Haver Analytics*

There is little evidence today of an impending recession, typically caused by a combination of: oil price shocks, too-tight monetary policies, government spending contraction or financial/credit crisis. None of them are likely to materialize next year. The economic expansion has run for long time in some economies (e.g. in the USA), but we do not see why a boom should finish due to its age.

Our base scenario for 2018 is for a positive global equity market, amid solid economic growth, albeit with more conservative returns and higher volatility.

Global equities are trading currently at a 18x price-to-earning ratio, in line with their long-term average (18.3x). The equity risk premiums[2] of most relevant equities markets still look attractive (especially in Europe, Japan and Emerging markets).

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[2] Defined as the forward looking equity earning-yield minus the 10-year sovereign yield.

The sectors we like are:

- Financials (especially in the USA): Higher interest rates and growing economy (higher loan demand, good credit quality).
- Technology: Secular growth (online advertising, cyber security, cloud) and healthy enterprise IT spending.
- Energy: Sustainable increase of oil prices and attractive dividend yields.
- Health Care: Strong pricing power, positive demographic trends and less exposure to trade escalation.

For fixed income we expect a challenging year due to rising benchmark rates, compressed spreads and stable/rising inflation. We expect an upward shift of the yield curve in the US (higher/flatter) as monetary policy tightens. Investment grade corporate bonds in developed markets continue to be, as in 2017 fairly unattractive, due to their limited pick-up vs. sovereign alternatives. We see also limited value/upside potential in high yield bonds due to compressed spreads both in the USA and Europe. Emerging markets bond valuations are less unfavorable, but still not very attractive, especially in countries with significant political risks and or weak macroeconomics (e.g. Brazil, Turkey, Argentina).

Entering 2018, we expect the USD to outperform other developed markets currencies (EUR, JPY, CHF), amid the increasing interest rate differential, growing global trade tension, political uncertainty in the EU (Brexit, Spain, Italy) and the resurgence of real expected returns of USD sovereign bonds.

Finally, we expect commodities to trail only slightly higher in 2018. The oil supply is expected to increase after the recent price increase (OPEC, US) and the demand growth is expected to weaken, as the economic cycle matures. Monetary tightening (rising interest rates), moderate inflation and a strong global growth are challenging parameters for the gold price.

As in previous years, we will continue to monitor the global economy and financial markets closely for any sign of change and react accordingly.

We wish you a happy holiday season and a good start of 2018!

Your Triaxis Team.