Market & Strategy Update Q2 2018

April 13, 2018 - Adrian Kirigin

PROBUS GROUP

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Executive Summary

While trade war rhetoric and rising geopolitical tensions have contributed to eroding investors' exuberance of early 2018, the abrupt rise in yields was the main cause for the dramatic rise in volatility and global selloff on equity markets. While the recent risk off environment has allowed long yields to retrace part of their move, the distortions in the bond market are still significant and the combination of inflation and rising supply suggest that the rise in yields is at its early innings. This new environment of tightening central banks will end up slowing global growth in its tracks but indicators do not suggest that a material slowdown is imminent. Risks abound nonetheless and investors should adopt a more dynamic approach focused on risk management.

The US economy has shown remarkable resilience in Q1, supported by rising investments and optimism around tax reform and infrastructure spending. Such fiscal profligacy is ill-timed given the stage of the business cycle and tightness of the labor market. While it is likely to support growth in the short term, it will also raise inflation in the process and push the Fed into more aggressive tightening. High corporate profit revisions and record buyback announcement could hold this expensive market but the Fed put is likely much lower than what investors believe now that Powell is in charge. Investors would be well advised to underweight this market.

The European economy has lost some momentum in Q1, disappointing the high expectations of early 2018, but remains on a solid footing. At this stage, it seems unlikely that the ECB will reverse course on its tapering stance but it could delay it, especially if activity does not rebound in Q2. The EUR has remained firm so far but record funding costs could lead speculators to cover their positions if the ECB shows signs of hesitation. Long yields will continue to be under rising pressure, which will keep a higher level of volatility on the equity market. European equities are attractively priced following the recent pullback and given the likely profit pick up, should be able to overcome key overhead resistance in coming months.

The BoJ has brushed off the recent loss of economic momentum as likely temporary in nature and surprised markets by suggesting that an exit to its current monetary policy could be discussed in the coming months. While adjustments to its yield curve control policy can be expected, changes should remain minor and policy very accommodative given the slowly improving inflation picture. Both businesses and consumer remain confident in the economy and the equity market, as the cheapest in the developed world, is likely to perform well in 2018.

Executive Summary

Asian markets will be the hub of global growth for decades to come, with a record increase of the middle class and soaring consumption. While a short term dollar rebound and slowing growth in China could lead to some downward pressure, valuations remain attractive and fundamentals sounder than for their developed market peers. Investors should tilt their portfolios toward emerging markets.

With emperor Xi firmly holding the reigns, China continues to deleverage and rebalance the economy. While the latter has held up well so far, signs are emerging that a slowdown could occur in coming months, as tightening monetary policy takes its toll. Divergences are starting to appear between Shanghai and Hong Kong indices, suggesting that the equity market could be at risk in the short term.

India is on the right track following the tough reforms implemented by Narendra Modi. While the long term picture remains compelling, the rising commodity complex could force the central bank into tightening. With earnings growth picking up and the market correcting, valuations have come down to more attractive levels.

Cold water has been poured on the Russian investment case following the sanctions imposed on some businessmen and their companies. While the actual economic impact is likely to be limited and the reaction on financial markets appears to be excessive, especially given the commodity rising environment and the central banks ability to intervene, we opt not to increase our already sizable exposure at this stage.

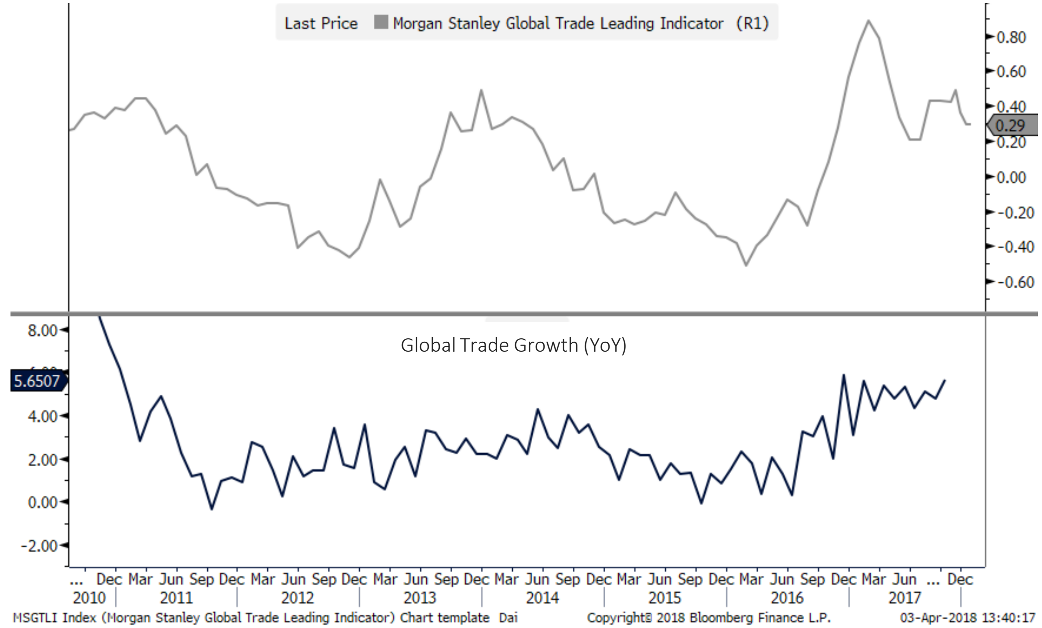
Bonds have likely further to fall given robust growth, rising inflation and increased supply due to fiscal profligacy and reduced CB purchases. The current extreme bearish positioning suggests however that the next leg up in yields might not occur in the short term. In the US, investors should focus on floaters and short term UST. European debt should still be avoided while certain emerging market debts in local currency offer the attractive combination of cheap valuations and high real rates.

Commodities are cheap vs. financial assets and investors should look to increase exposure to this asset class, as EM-led demand will increase dramatically over the next decade. With inventories drawn down and demand outpacing supply, oil is likely to remain around current levels, although record positioning could lead to a temporary pullback. Investors should use any pullback to add exposure to Gold, silver and their miners.

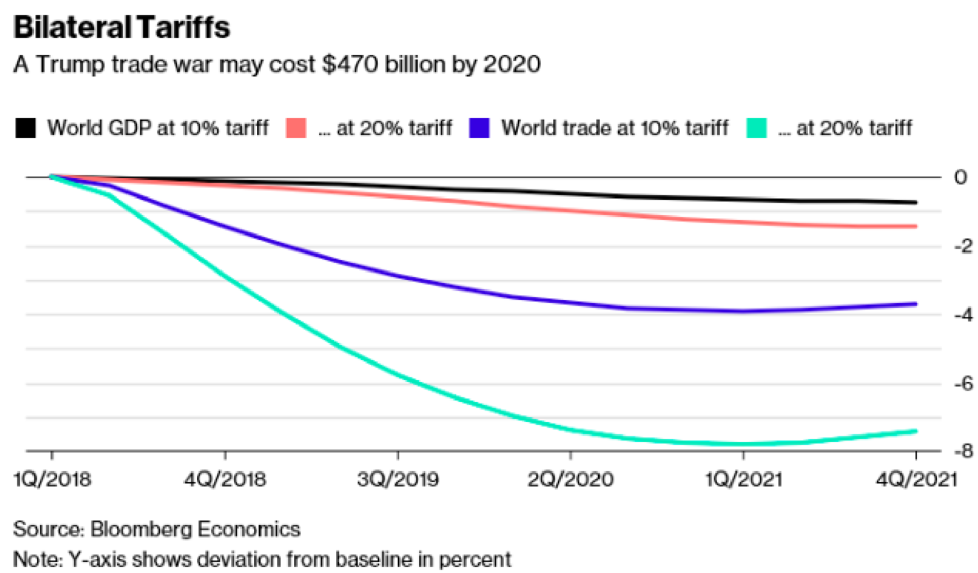
Developed Markets

Global – trade growth resilient but watch trade war rhetoric!

Leading indicators, while turning down slightly, do not suggest that a material slowdown in global trade is likely, as economic momentum remains resilient. The second half of 2018 should however be monitored for a more material slowdown.

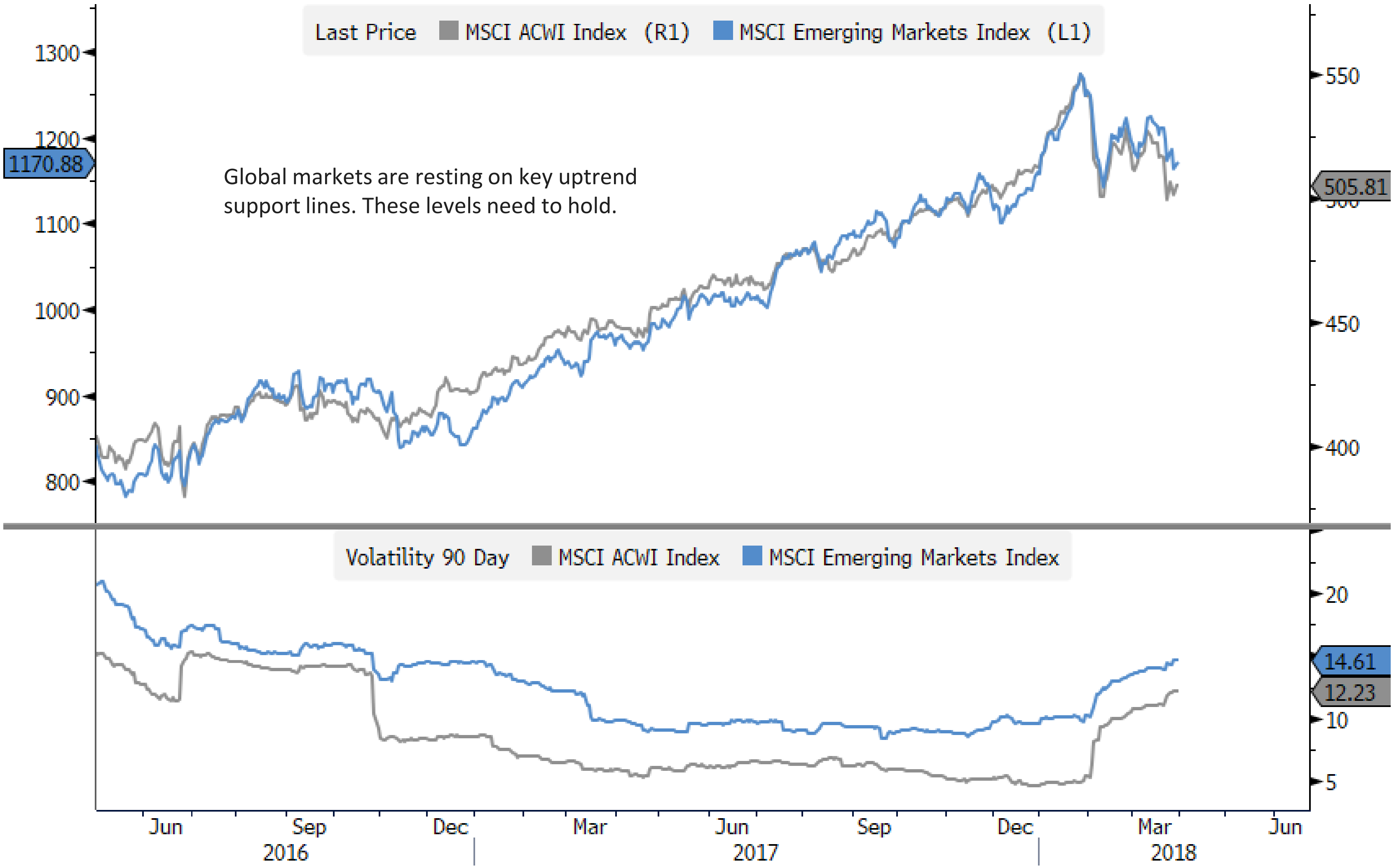


The recent pick up in trade war rhetoric is worrying and could have dramatic consequences on world GDP. At this stage, the US is playing a dangerous game but it is most likely merely a negotiation tactic that should lead to a deal at some point in the coming months.



Global – as expected, volatility is back!

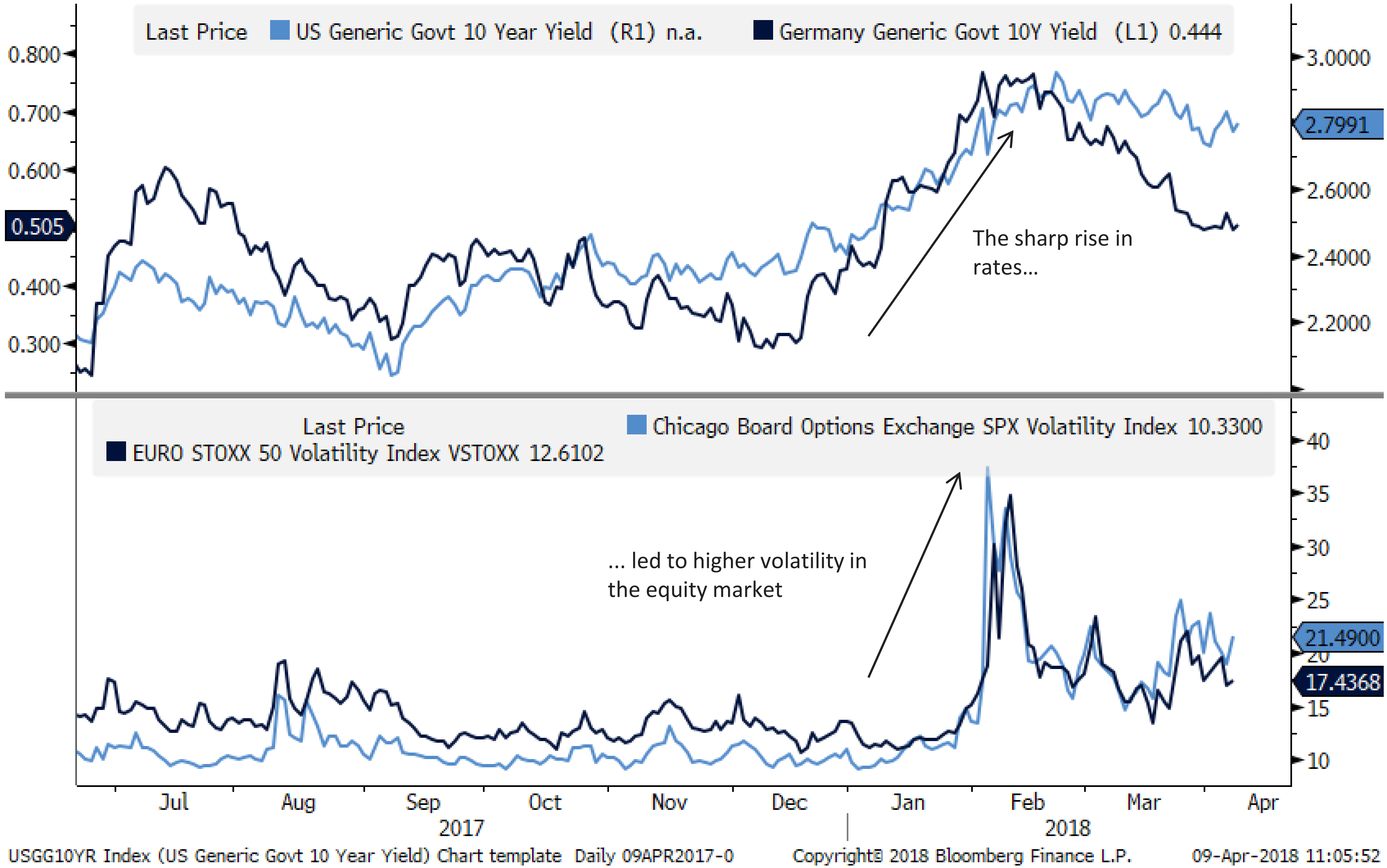
After one of the calmest years on record, 2018 has seen a return of volatility. While the rising risk of a trade war has contributed to the recent turmoil, the initial reaction of the market was caused by rapidly rising yields.



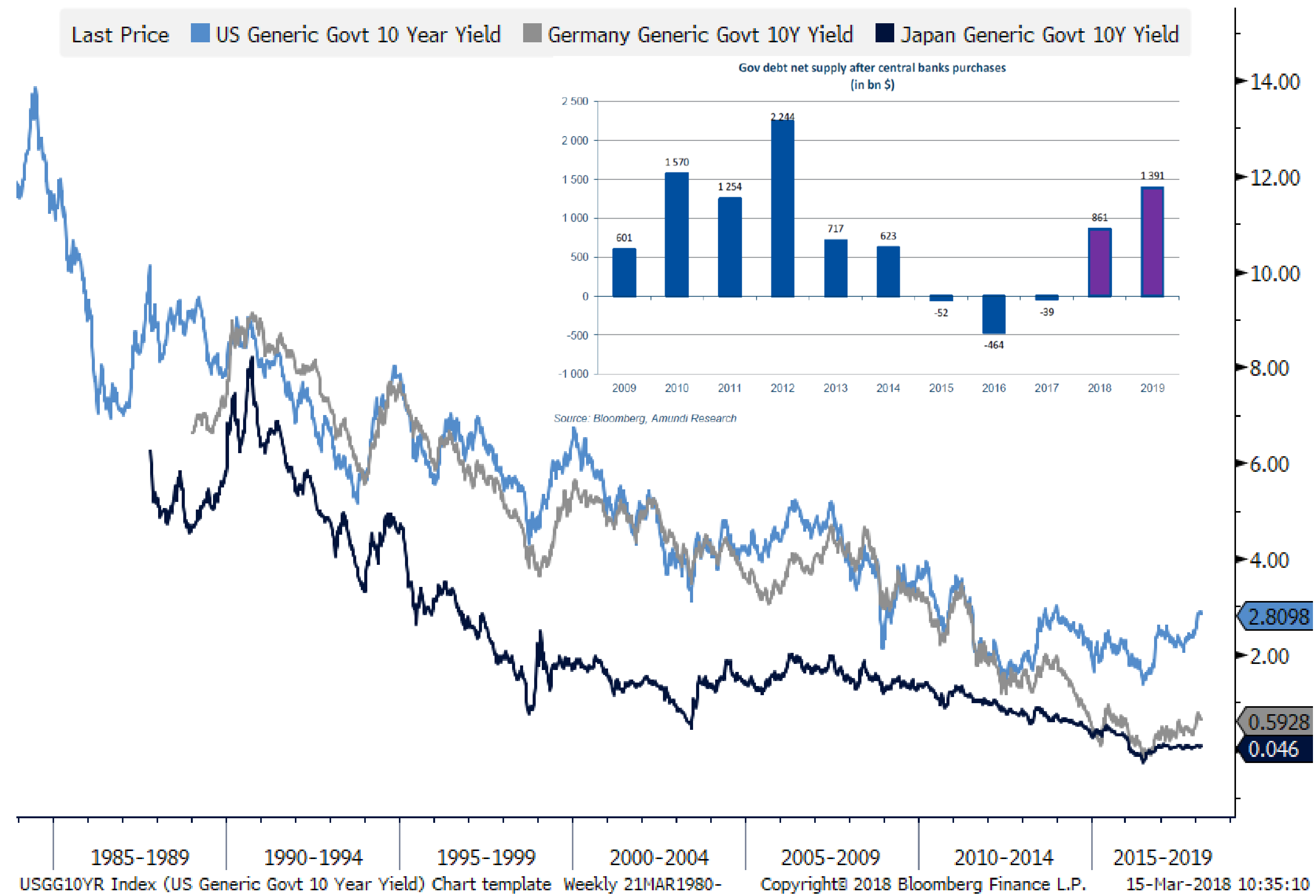
MXWD Index (MSCI ACWI Index) Chart template Daily 03APR2013-02APR2018 Copyright© 2018 Bloomberg Finance L.P. 02-Apr-2018 12:44:31

Global – rising yields have been the trigger for higher volatility

While long yields have slightly retraced in this phase of market turmoil, it is likely that they will trend higher in 2018, sustaining a higher overall level of volatility in financial markets.



Global – the rise in yields remains marginal



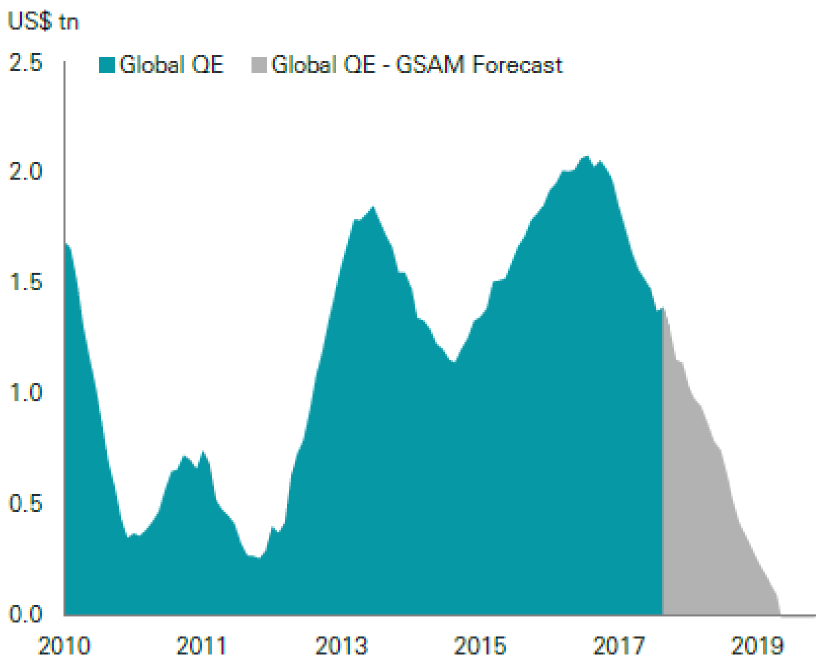
Global – central banks will keep tightening their policy

Central bank actions have contributed significantly to maintaining interest rates at current levels. Considering the improvement in economic growth, monetary policies are being adjusted; the quantity of bonds purchased by the various central banks will keep declining (see previous slide). This has the effect of pushing interest rates up and bond prices down while increasing volatility in the equity market. In this scenario, a lasting positive correlation between bonds and equities cannot be excluded, which would hurt traditional balanced portfolios.

The Fed has company, with more central banks gearing up to raise rates globally.

Quantitative Easing (QE): Past the Peak

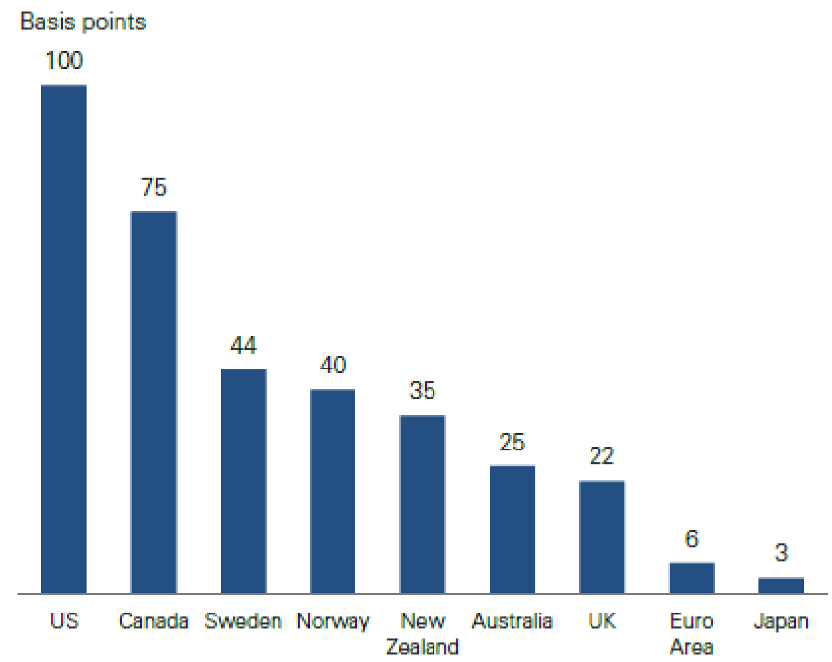
Central Bank Asset Purchases – Rolling 12 Month Change



Source: GSAM, Macrobond. GSAM forecasts as of December 2017.

Global Rates: Moving Higher

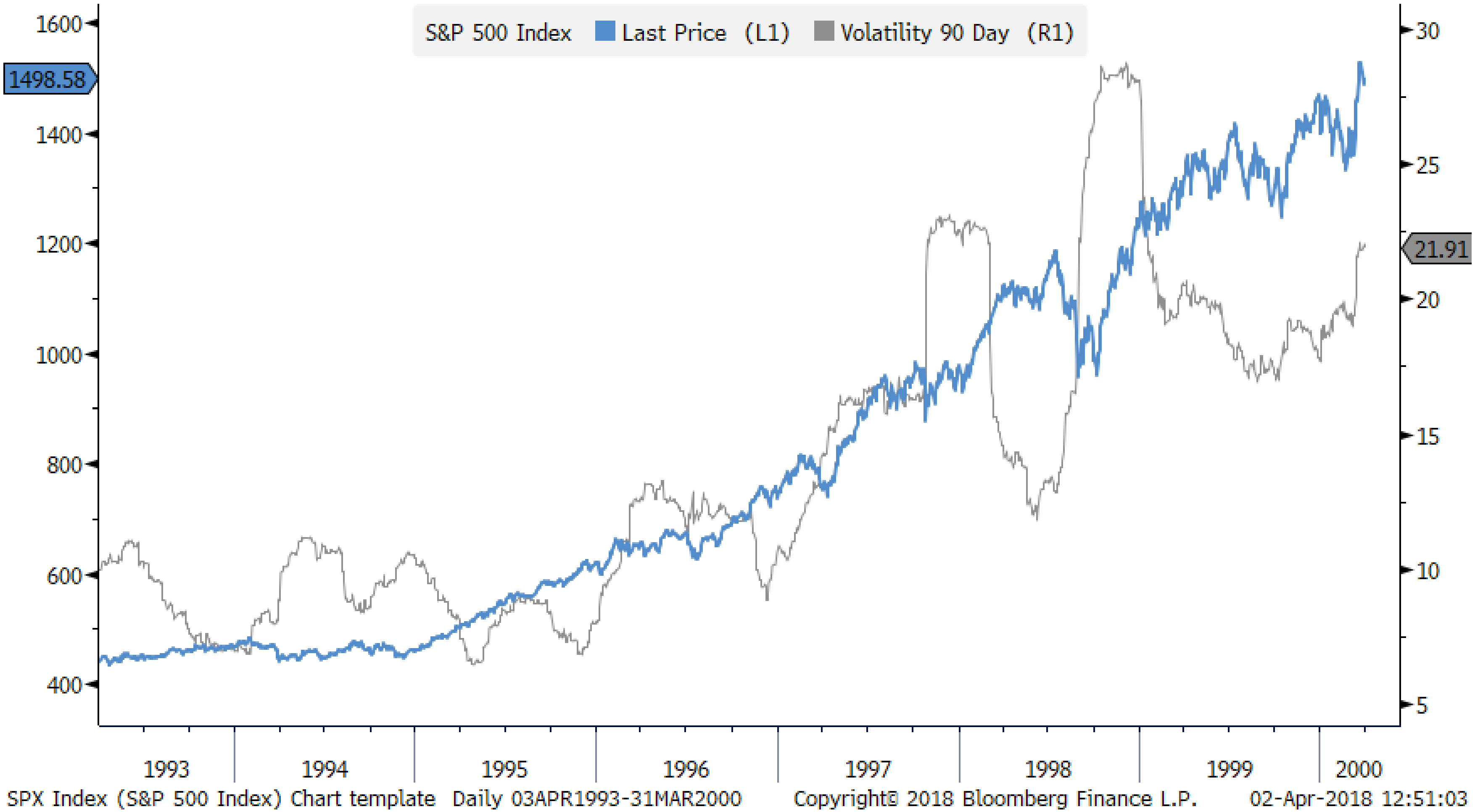
GSAM Forecasts for Change in Policy Rate – 2018



Source: GSAM. As of February 5, 2018. US Federal Reserve (Fed).

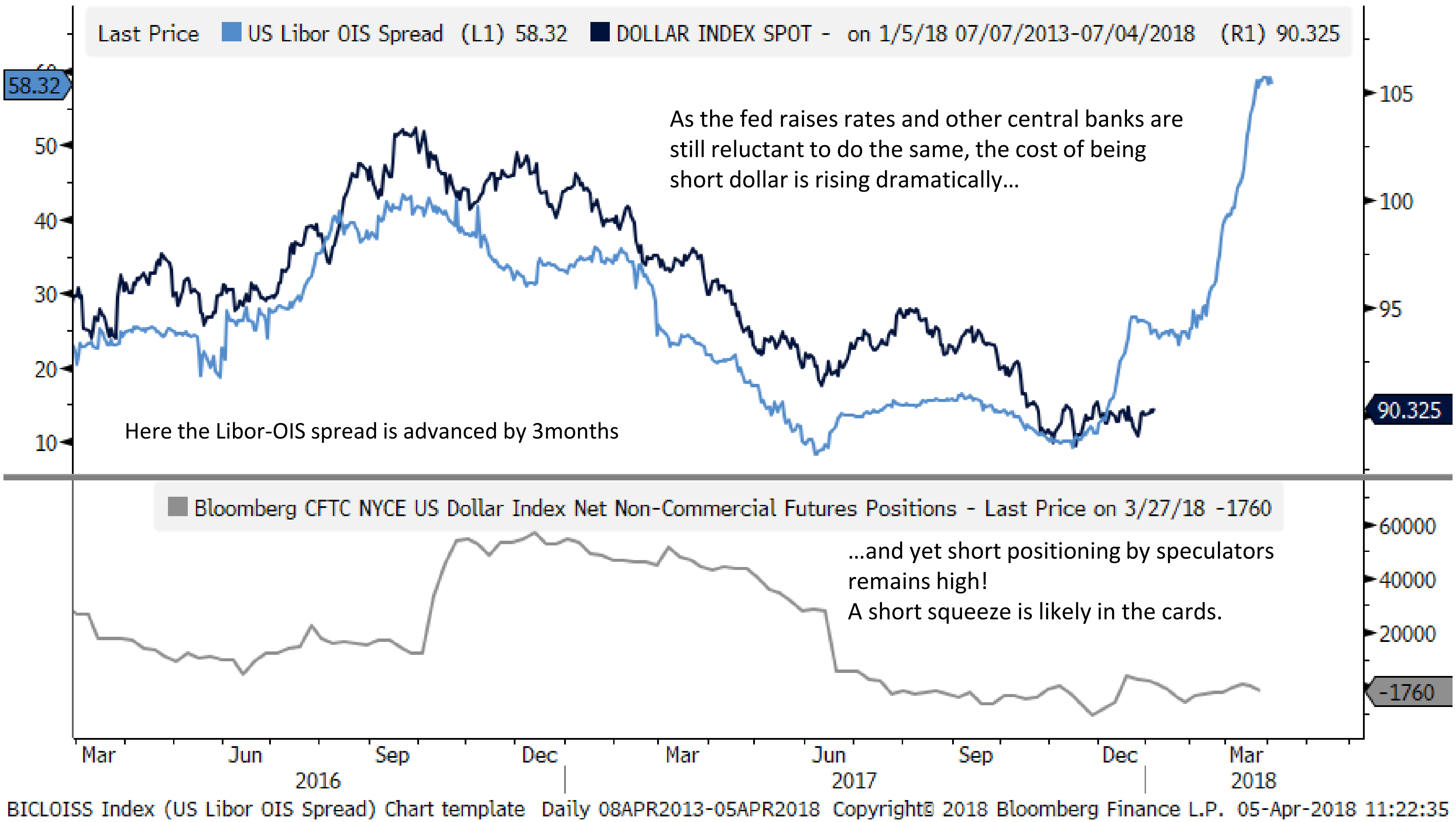
Global – higher volatility does not necessarily mean a bear market

It is not uncommon for the last stages of a bull market to be accompanied by rising volatility, as was the case in the second half of the 1990s, when the US market rose (blue line) at the same time as realised volatility (grey). Such an environment, being associated with higher risks given valuations, should be approached with a more dynamic strategy and a steady focus on risk and hedging.



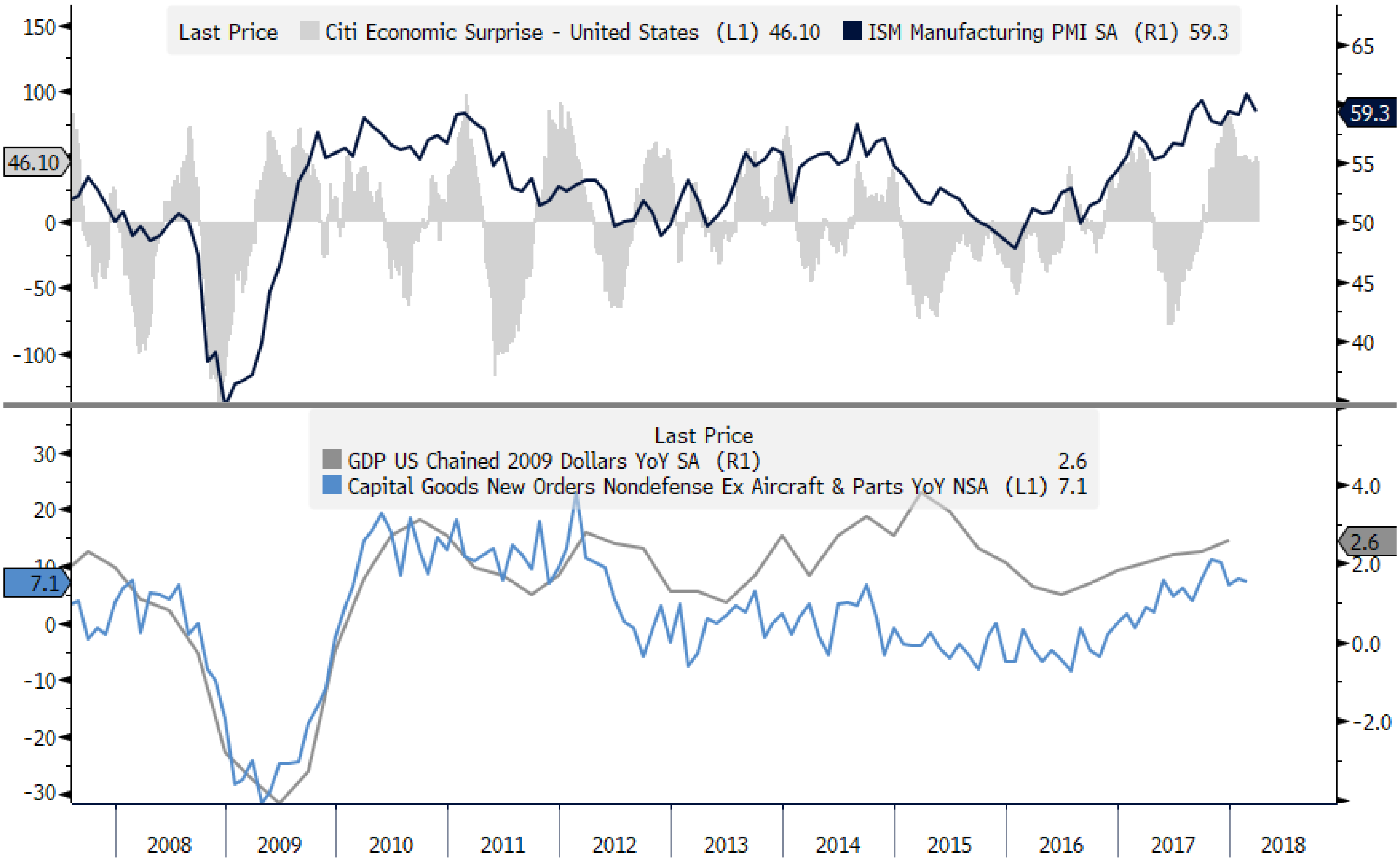
The USD is likely to rebound given the liquidity drain

Signs of stress in the dollar funding market have appeared. With the debt ceiling raised, the treasury was able to issue bills again, draining USD liquidity (as they sell bills for cash). At the same time, US companies are repatriating their cash, reducing the amount of dollars available on the offshore market. This has led to a spike of the spread between the Libor and the OIS rate over the last 3 months. The Libor/OIS spread has been a reliable 3 month leading indicator of movements in the dollar, suggesting that the latter could rebound.



US – economic data has remained resilient in the US

US economic data has remained surprisingly resilient, continuously beating expectations so far in 2018, contrary to other developed markets. There remains no sign of an impending recession, with GDP growth and capital goods new orders (i.e. Capex) is on the rise.

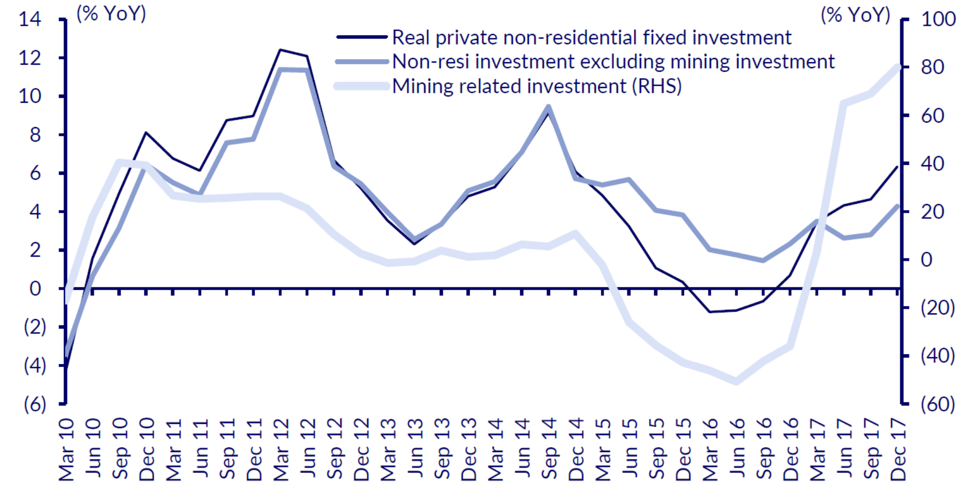


CESIUSD Index (Citi Economic Surprise - United States) Chart template Daily 30A Copyright© 2018 Bloomberg Finance L.P. 03-Apr-2018 14:52:04

US – broad based pick up in investments and rising leading indicators

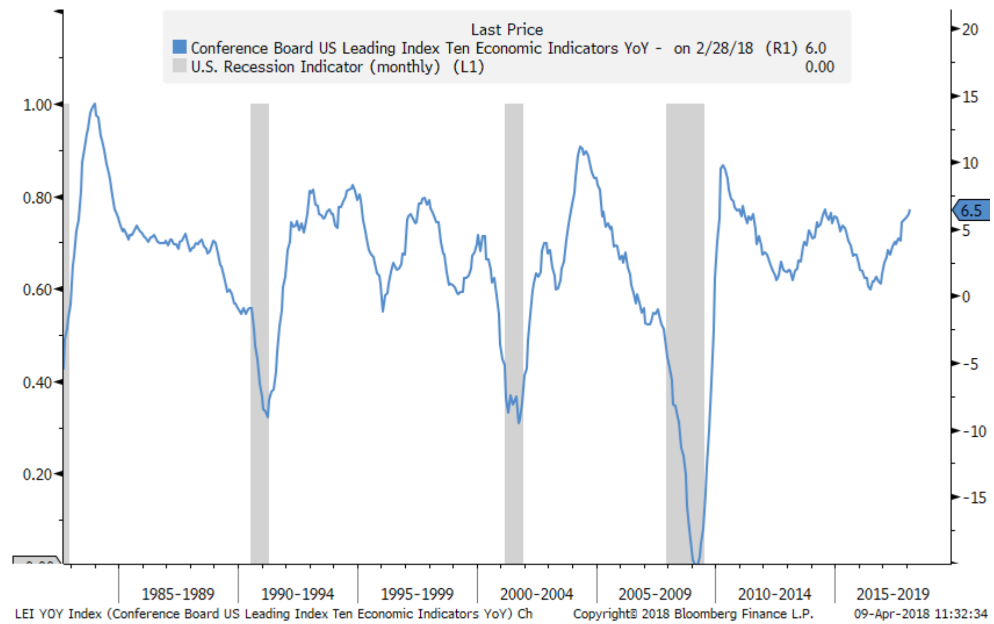
Contrary to early 2017, when investment in the US was mining-related following the pick up in commodity prices, the last 6 months have seen a broad-based increase in investments, boding well for growth…

US real private non-residential investment excluding mining investment



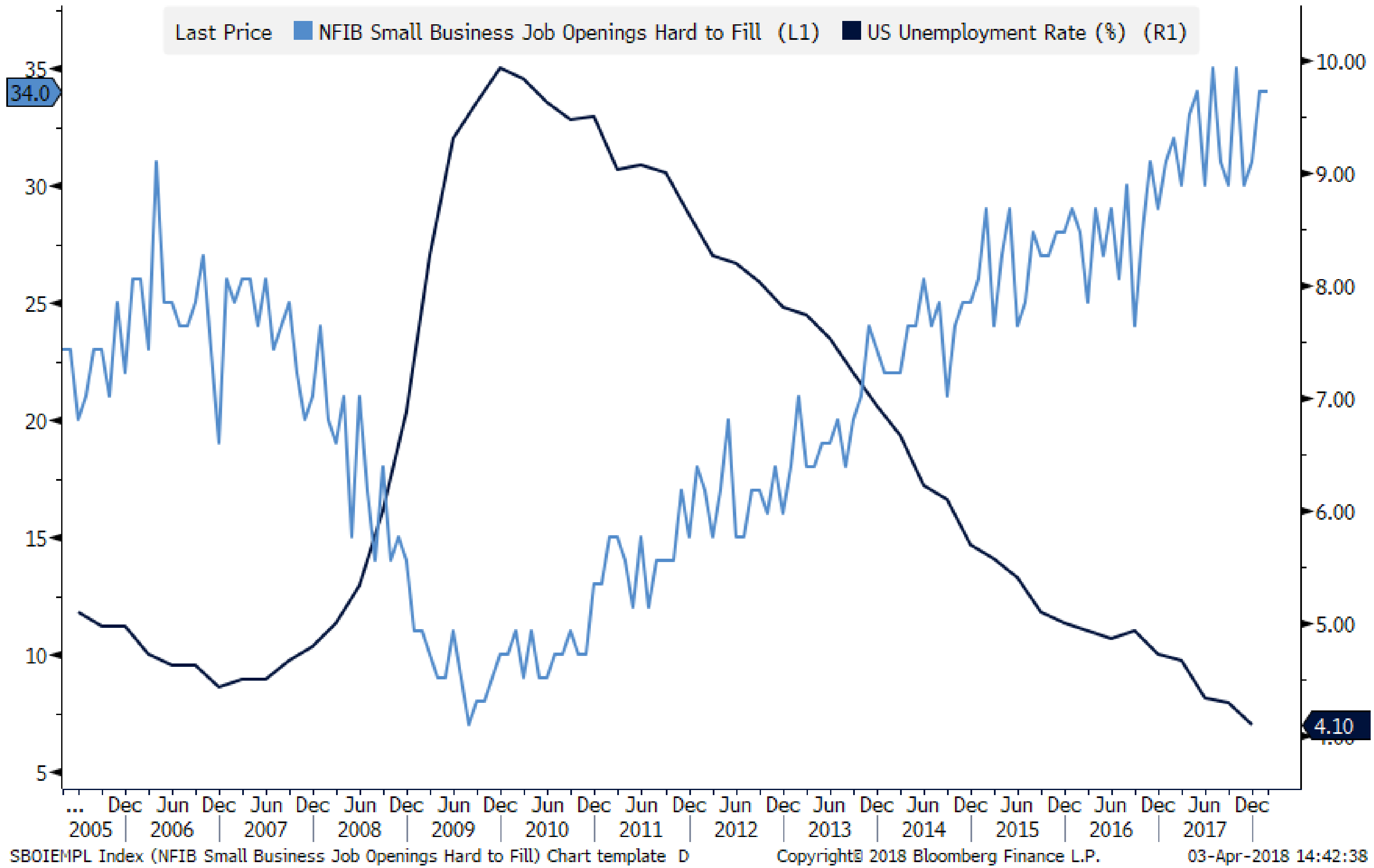
Note: Mining investment includes investment in mining exploration structures, shafts, and wells, and investment in mining and oilfield machinery. Source: CLSA, Bureau of Economic Analysis

The main US leading indicator still shows no signs of a recession in the short term.



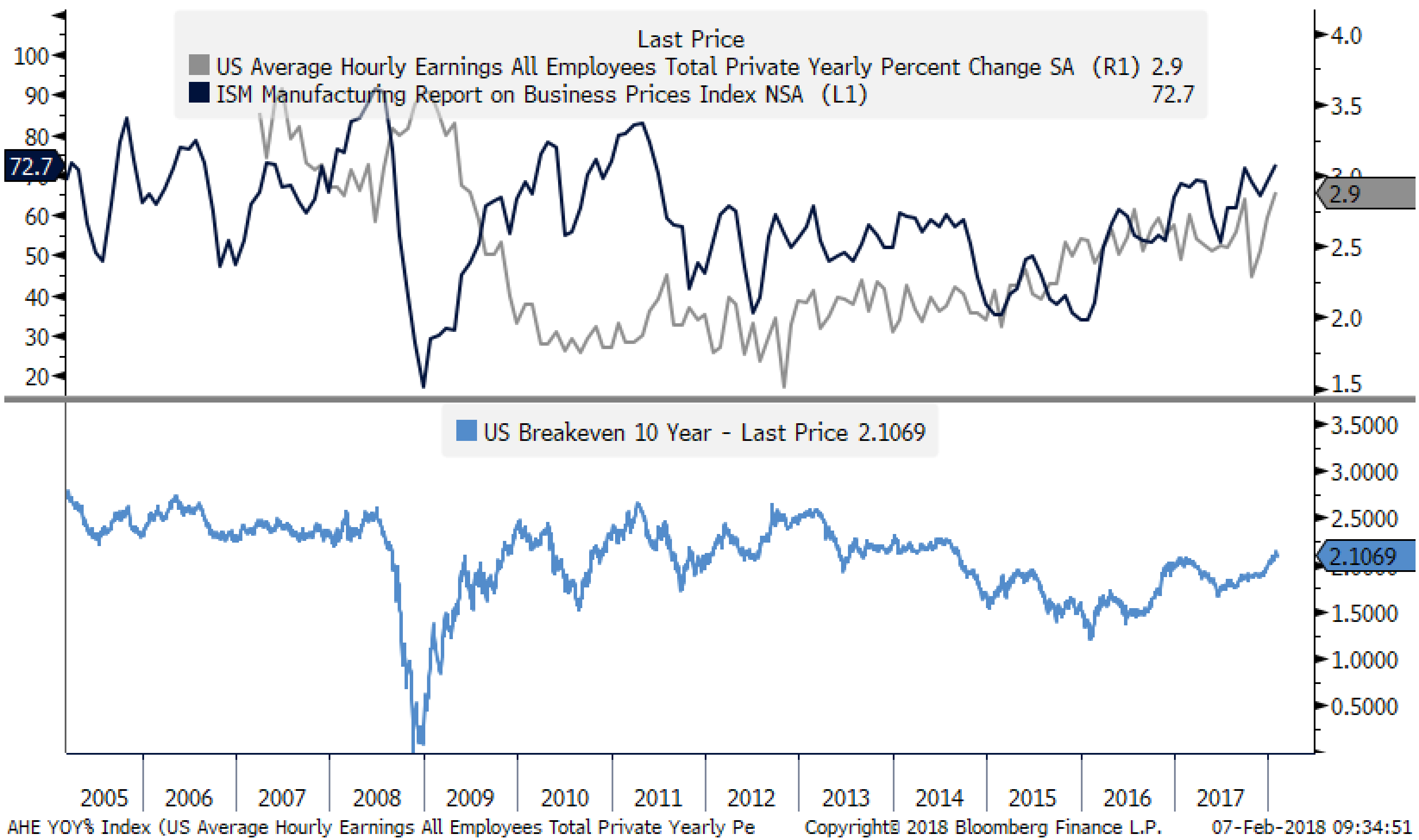
US – the labor market is tight

With the unemployment rate at 4.1% and the number of open jobs reportedly hard to fill far higher than in 2006, the US market is relatively tight. As many corporations are currently relating, there is upward pressure on wages and inputs (see next slide).



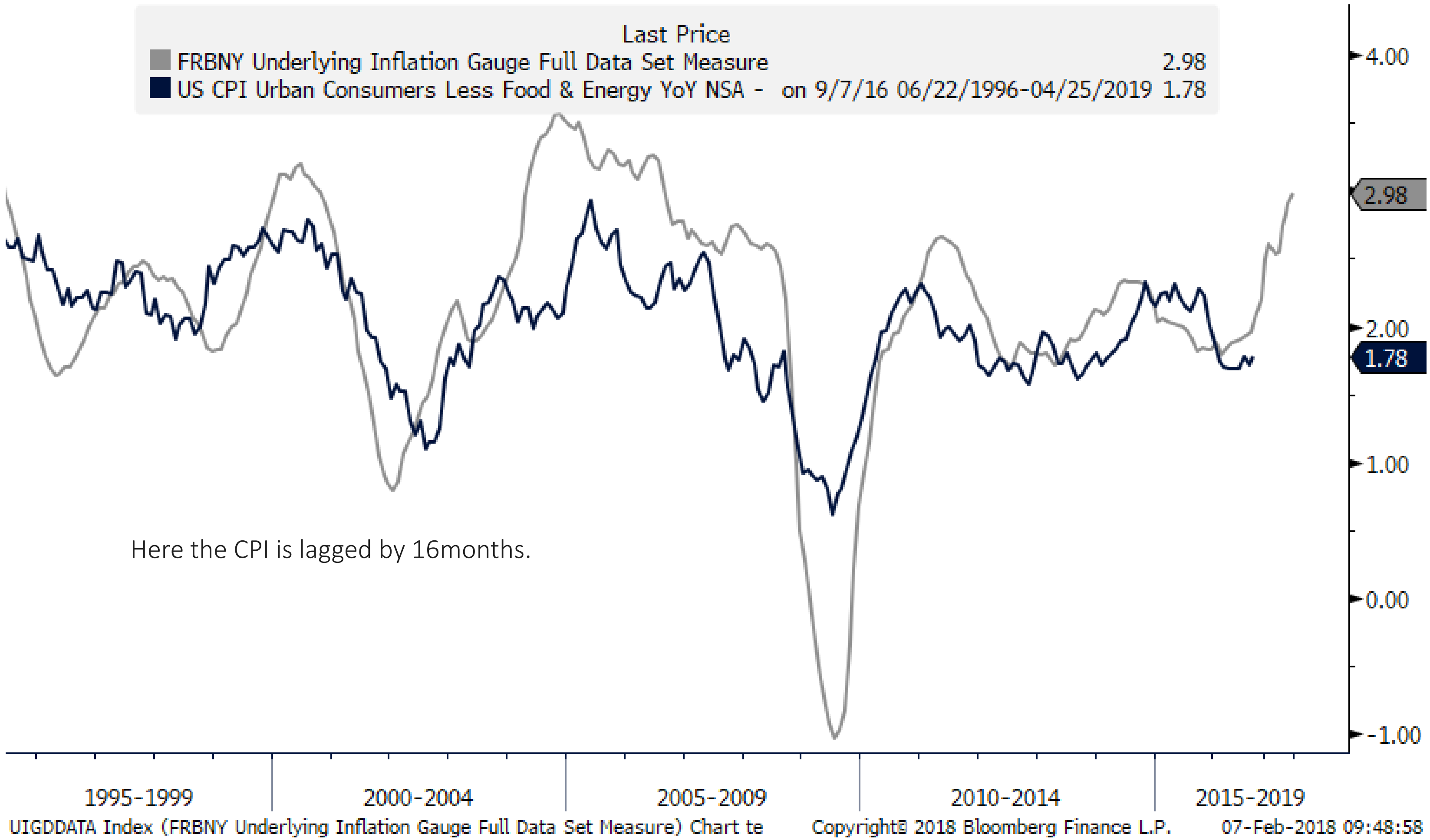
US – inflationary pressures keep building

US wage growth has picked up to its strongest since the GFC and ISM prices paid to its highest since 2011, suggesting that inflationary pressures are building, as expected. Inflation expectations have finally picked up and are at their highest since 2014. They remain however too low when considering the Underlying Inflation Gauge (next slide). The below dynamic is before even factoring in the inflationary consequences of tariffs…



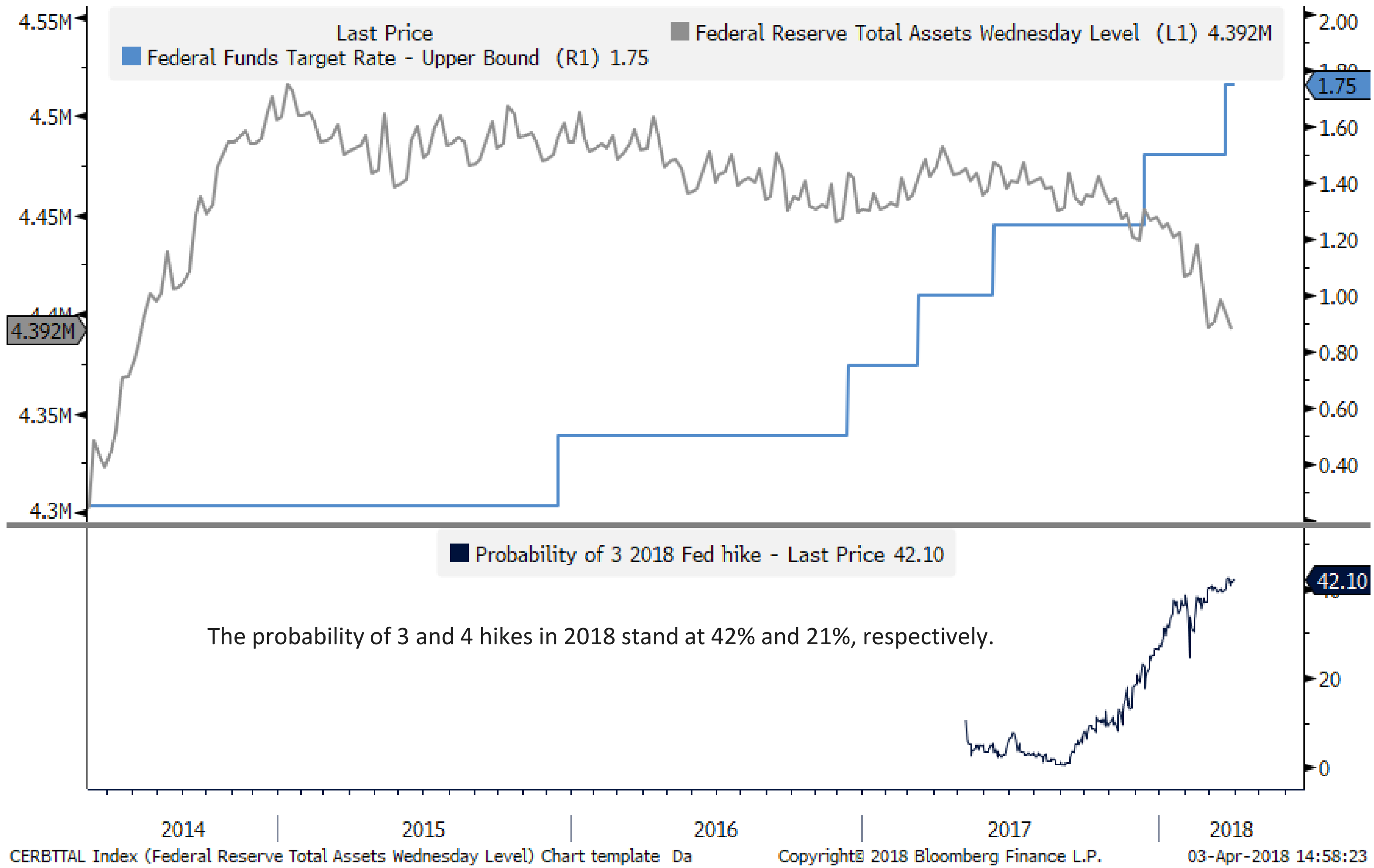
US – inflation is indeed likely to trend higher

Signs of a potential inflation uptick are accumulating, capacity utilisation and PPI numbers are rising, wages picking up and growth robust. The Underlying Inflation Gauge (UIG – below in grey) has shown a significant 16-month lead on core CPI. According to this measure, inflation will keep rising in 2018. Given current inflation expectations of around 2.1%, the markets could be in for further surprises.



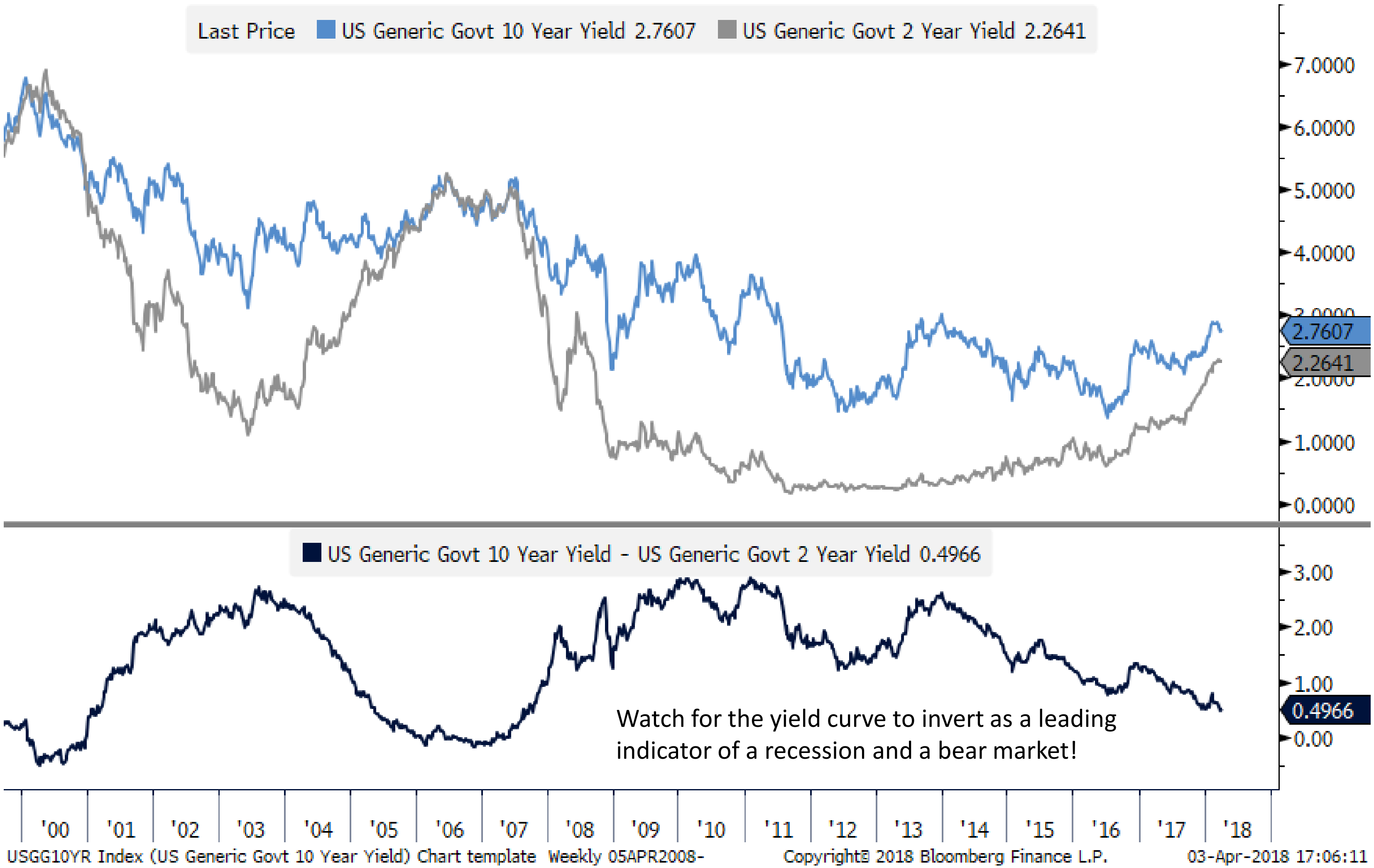
US – Fed to continue shrinking balance sheet and raising rates

The new chairman of the Fed has shown a refreshing disregard for the academic models that his predecessor have mistakenly followed. Mr. Powell is likely to be pragmatic and react to actual data rather than where models suggest data should be. Given the current environment, barring a deeper selloff in the market, the Fed is likely to continue raising rates and shrinking its balance sheet.



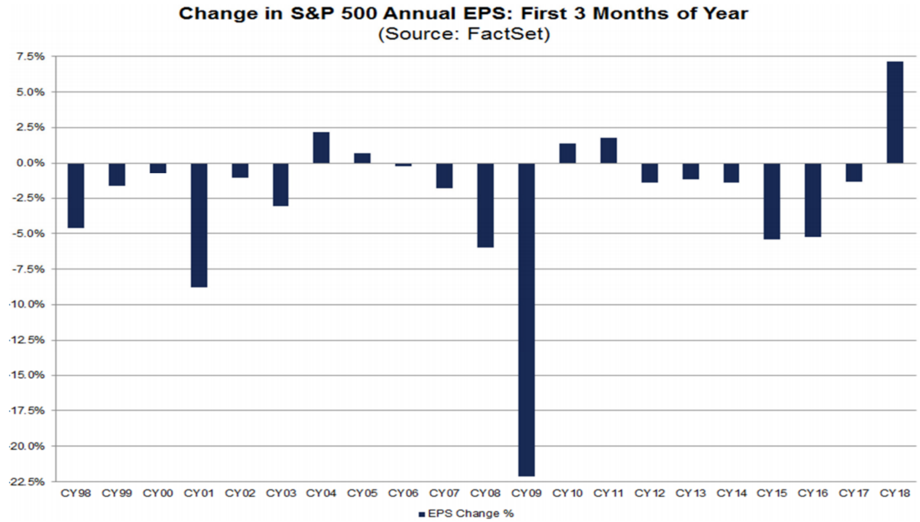
US – the bond market still thinks that the Fed is making a mistake

The continued flattening of the yield curve (dark blue) is surprising and suggests that the market does not believe in a sustained pick up in inflation and that the Fed's tightening will slow down the economy.



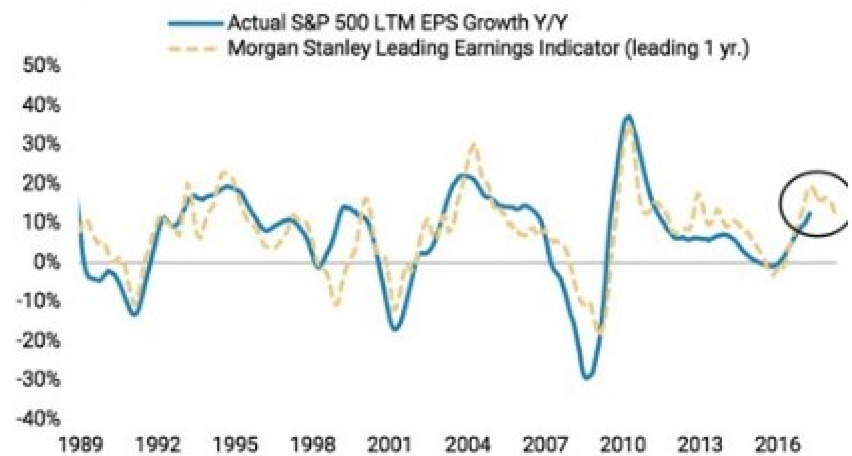
US – record earnings revisions could lead to disappointments

The first quarter of 2018 marked the largest increase in the bottom-up EPS estimate over the first month of a quarter since FactSet began tracking the quarterly bottom-up EPS estimate in Q2 2002. Excessive optimism? Not necessarily…but these expectations will be hard to beat, which, added to the post-earnings buyback blackout period, could lead to significant volatility.



Morgan Stanley's leading earnings indicator suggest that earnings growth will slow down in the second half of 2018…

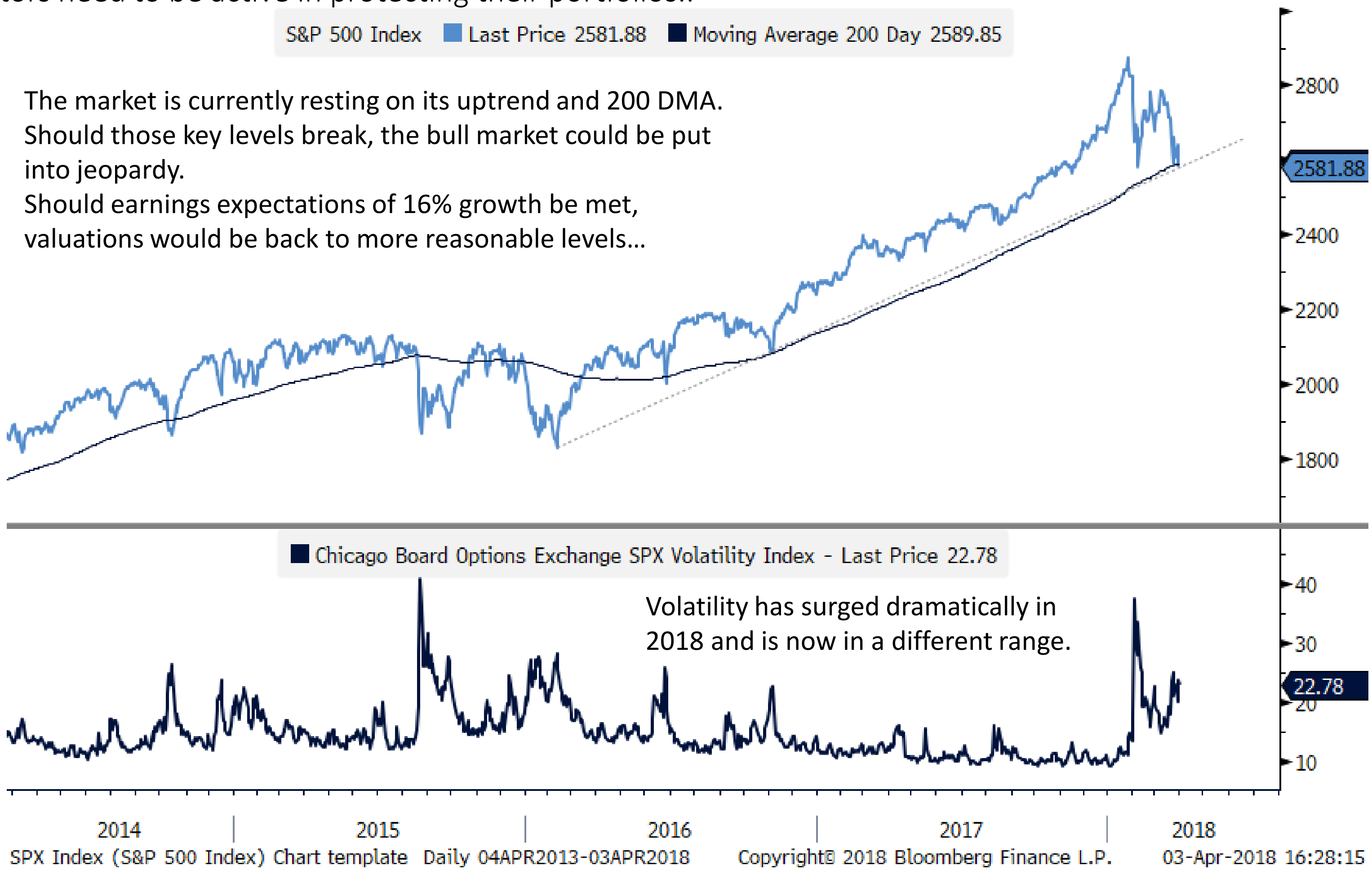
Exhibit 2: Leading Earnings Indicator Does Not Roll Over Until 2Q/3Q



Source: Morgan Stanley Research as of March 31, 2018.

US – a healthy pullback or the end of the bull market?

Economic activity and corporate profits have improved in the US. As we have previously argued, this robust dynamic is the greatest threat to risk assets, especially if inflation ticks up, as it increases the odds of tightening and pushes yields higher. The market has finally noticed, dropping around 10%. While the correction does not yet suggest an end to the bull market, the latter is likely in its last innings and, with volatility back on the table, investors need to be active in protecting their portfolios..



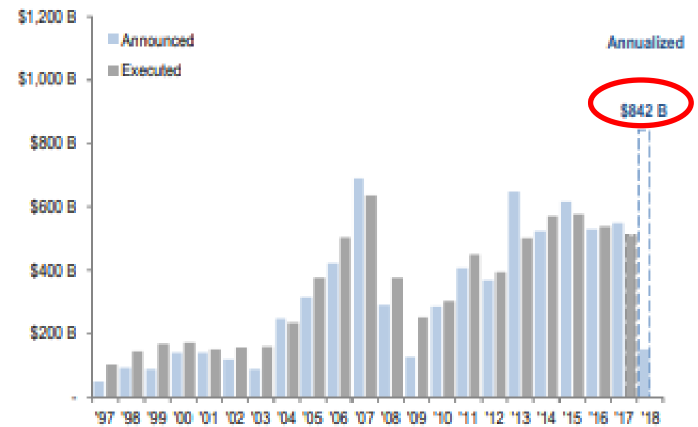
US – the importance of buybacks in 2018

The importance of buybacks in this bull market cannot be understated; corporations have been the largest equity buyers since 2009. Artemis Capital estimates that buybacks accounted for 40% of EPS growth since 2009! While rising debt levels and interest rates usually lead to slowing buybacks, Trump's tax break for the repatriation of foreign profits has led to the largest announcement of corporate buybacks in history, currently reaching USD 842bn.

Although observers will note on the below chart that companies historically buy the most shares at the worst time, such huge buybacks could support the market in 2018.

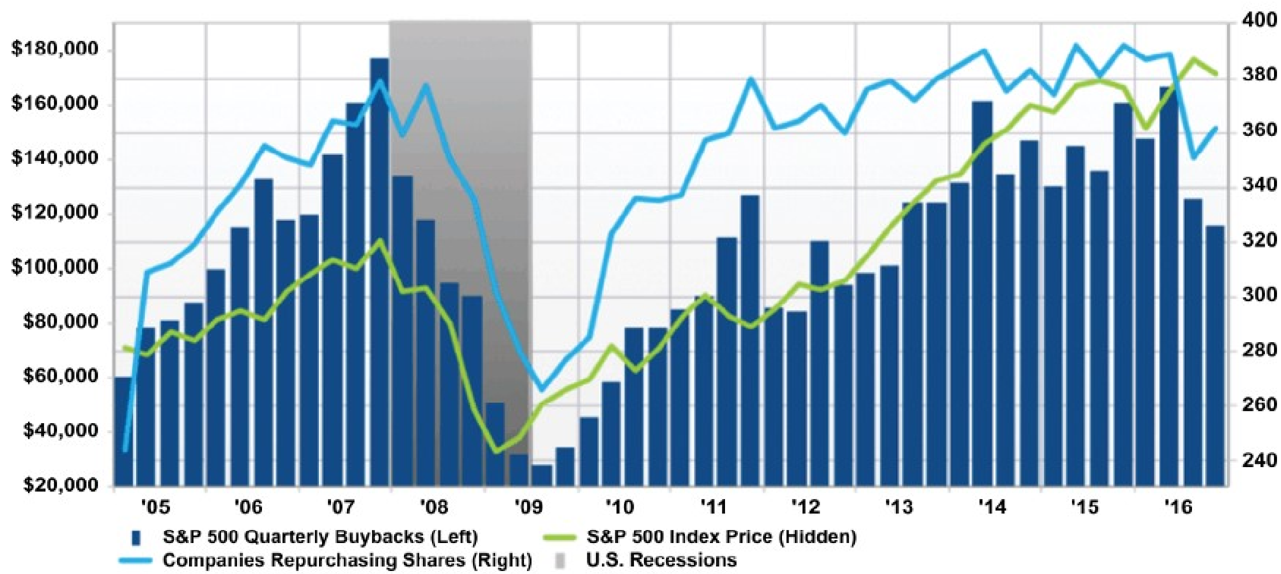
Figure 8: Announced vs. Realized Buybacks

S&P 500 Companies



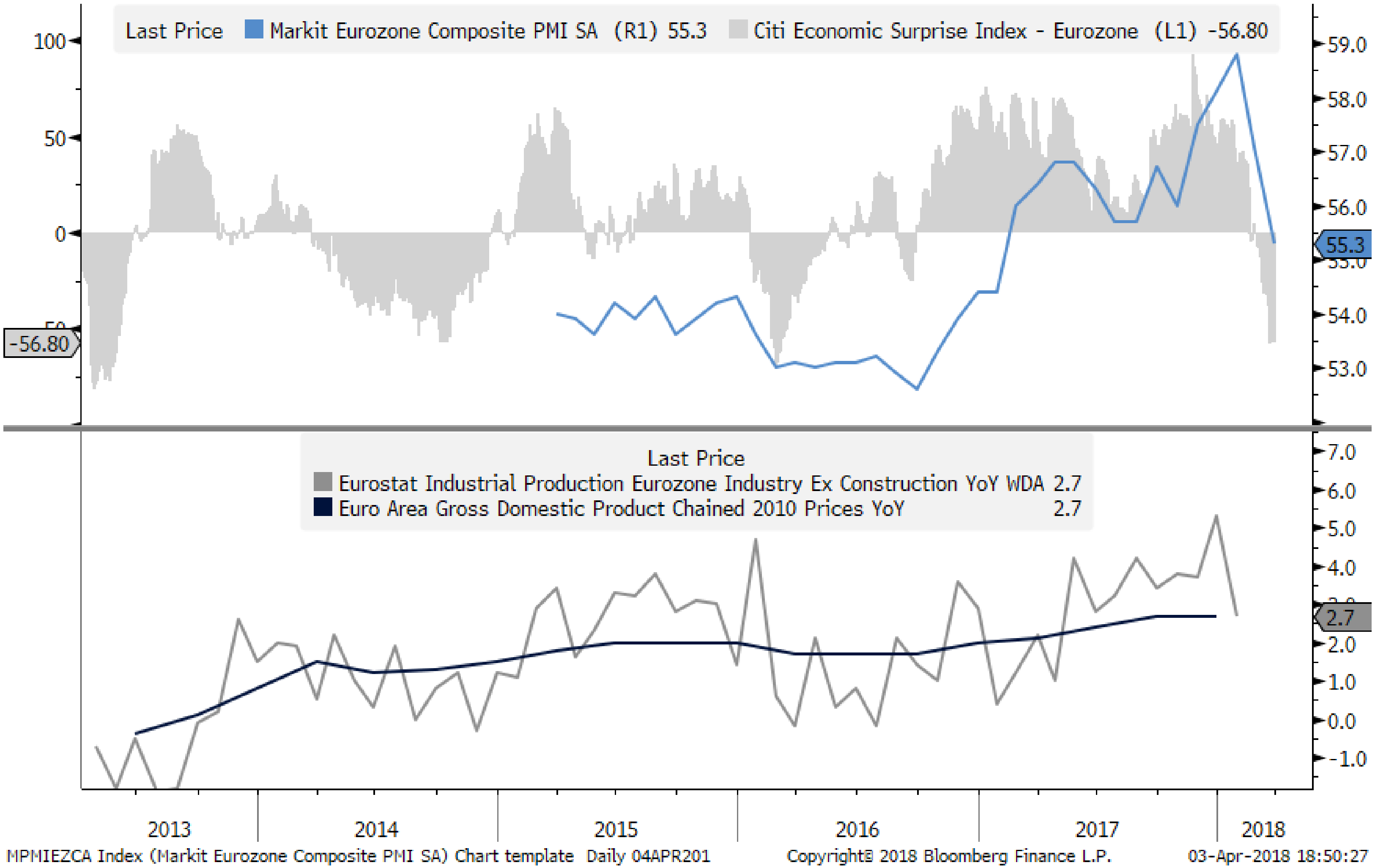
Source: J.P. Morgan US Equity Strategy and Quantitative Research, Bloomberg

Quarterly Share Repurchases ($M) and Number of Companies Repurchasing Shares



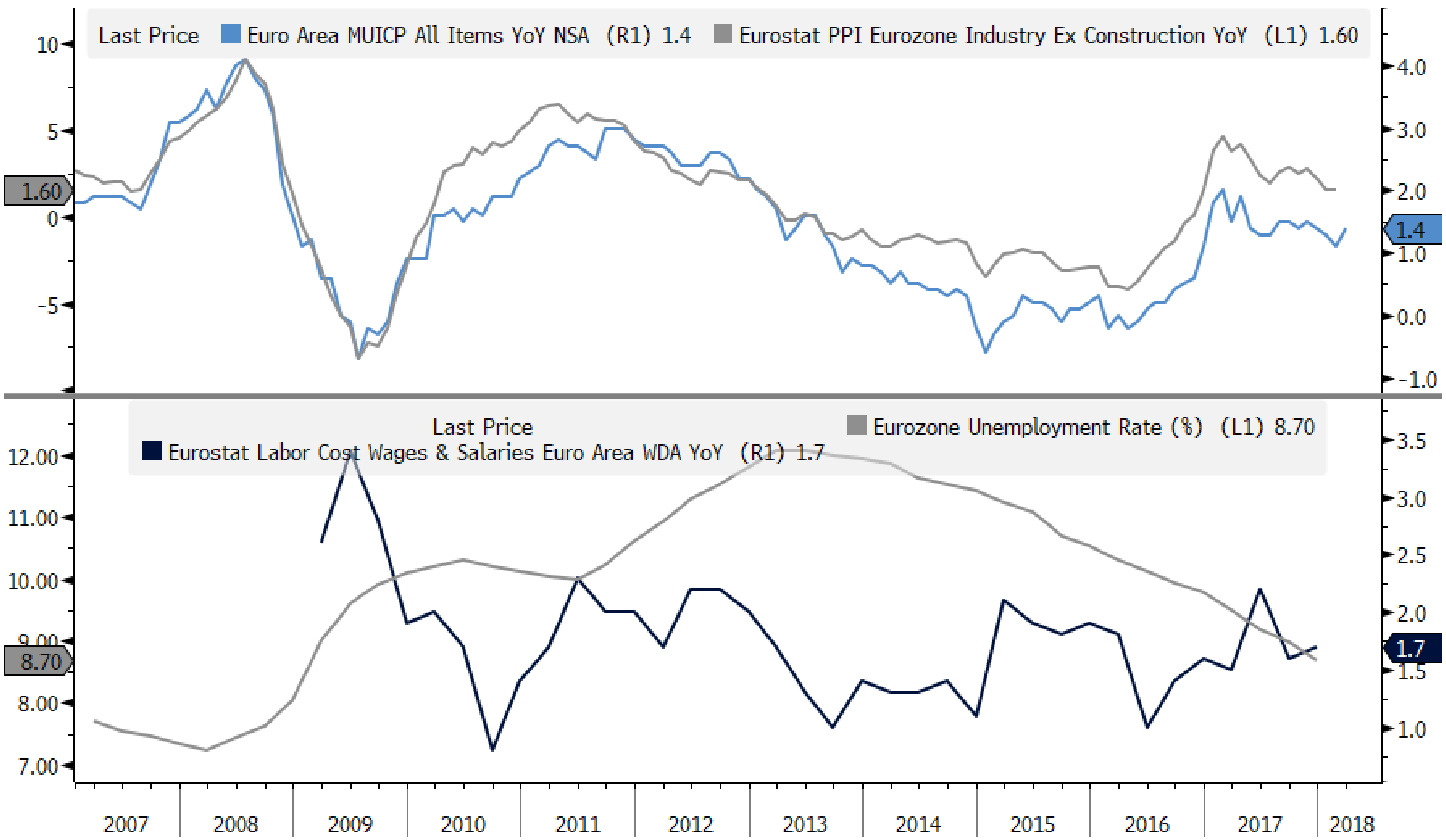
EU – high expectations increase chances of disappointment

Eurozone economic data has mostly disappointed what were high expectations in early 2018. While PMIs have come down with industrial production, likely followed by a slight downtick in GDP growth, the overall situation remains resilient.



EU – will the ECB turn away from tapering?

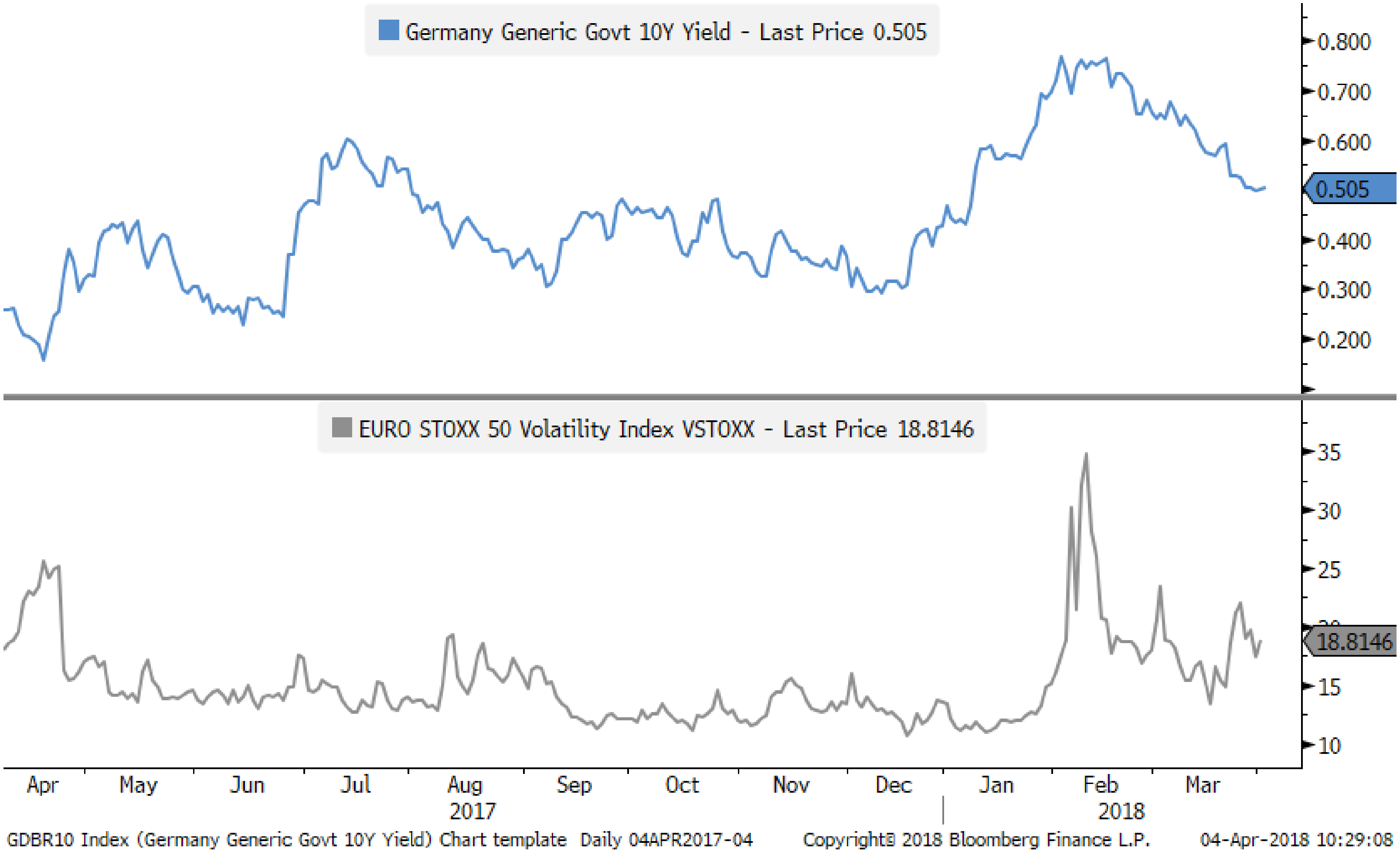
Inflation may have come down over the last year but the disinflationary trend seems behind us, with both CPI and PPI at levels unseen in years. With unemployment at its lowest level since the crisis, wage growth could pick up in 2018 given the resilient economic activity. At this stage, the ECB is unlikely to reverse its policy normalisation stance and should continue to wind down its bond purchases.



ECCPEMUY Index (Euro Area MUICP All Items YoY NSA) Chart template Daily 31JAN20 Copyright© 2018 Bloomberg Finance L.P. 09-Apr-2018 12:44:31

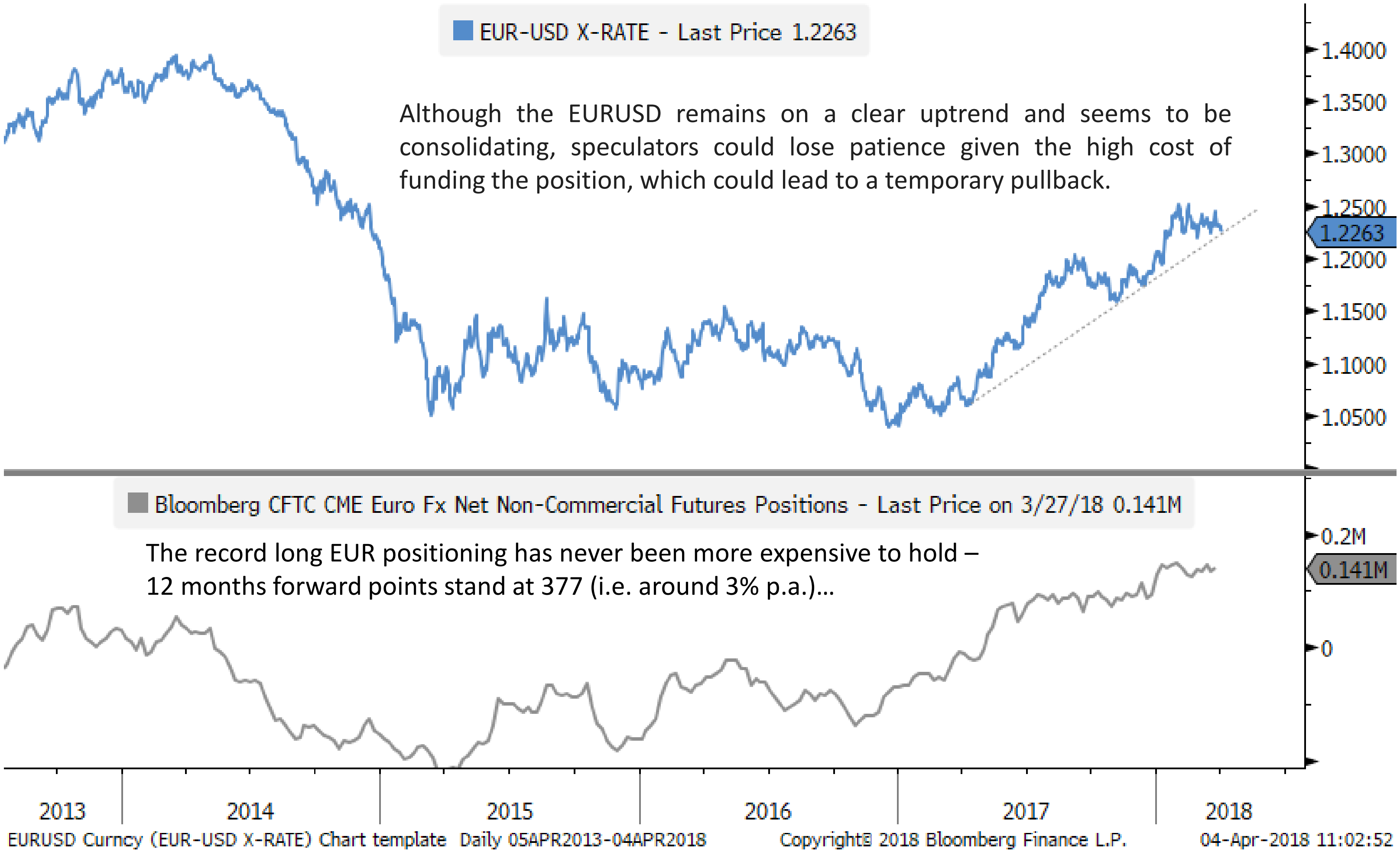
EU – the bond market will remain under pressure

Even if the ECB slowly normalises monetary policy, yields will keep rising, as the distortions in the bond market are huge, with real rates still largely negative. As we have seen in 2018 with German 10Y yields doubling in the span of 2-3 months, these abrupt adjustments will trigger bouts of volatility in the equity market, providing opportunities to buy certain yield substitutes such as REITs, which still offer significant yield premia.



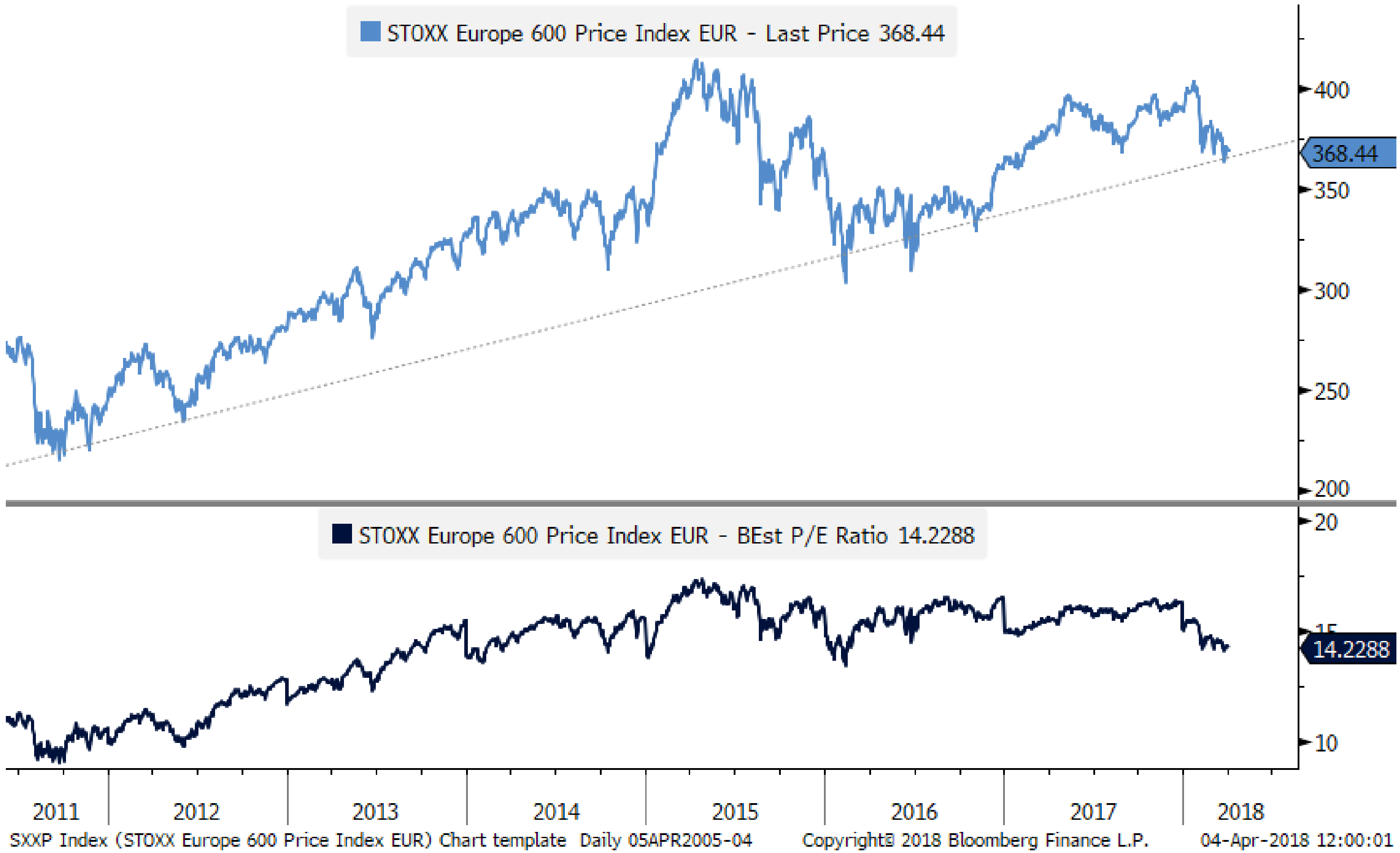
EU – it has never been more expensive to be long EURUSD

Even though long yields should continue to rise in 2018, the ECB will keep its target rate around or below zero while the Fed raises its own. This implies that the cost of funding a long EURUSD position will keep rising from the already record 377 forward points p.a. Given the EUR's lack of progress in 2018 and recent loss of economic momentum, speculators could start to unwind their position and lead to a pullback, possibly toward 1.19.



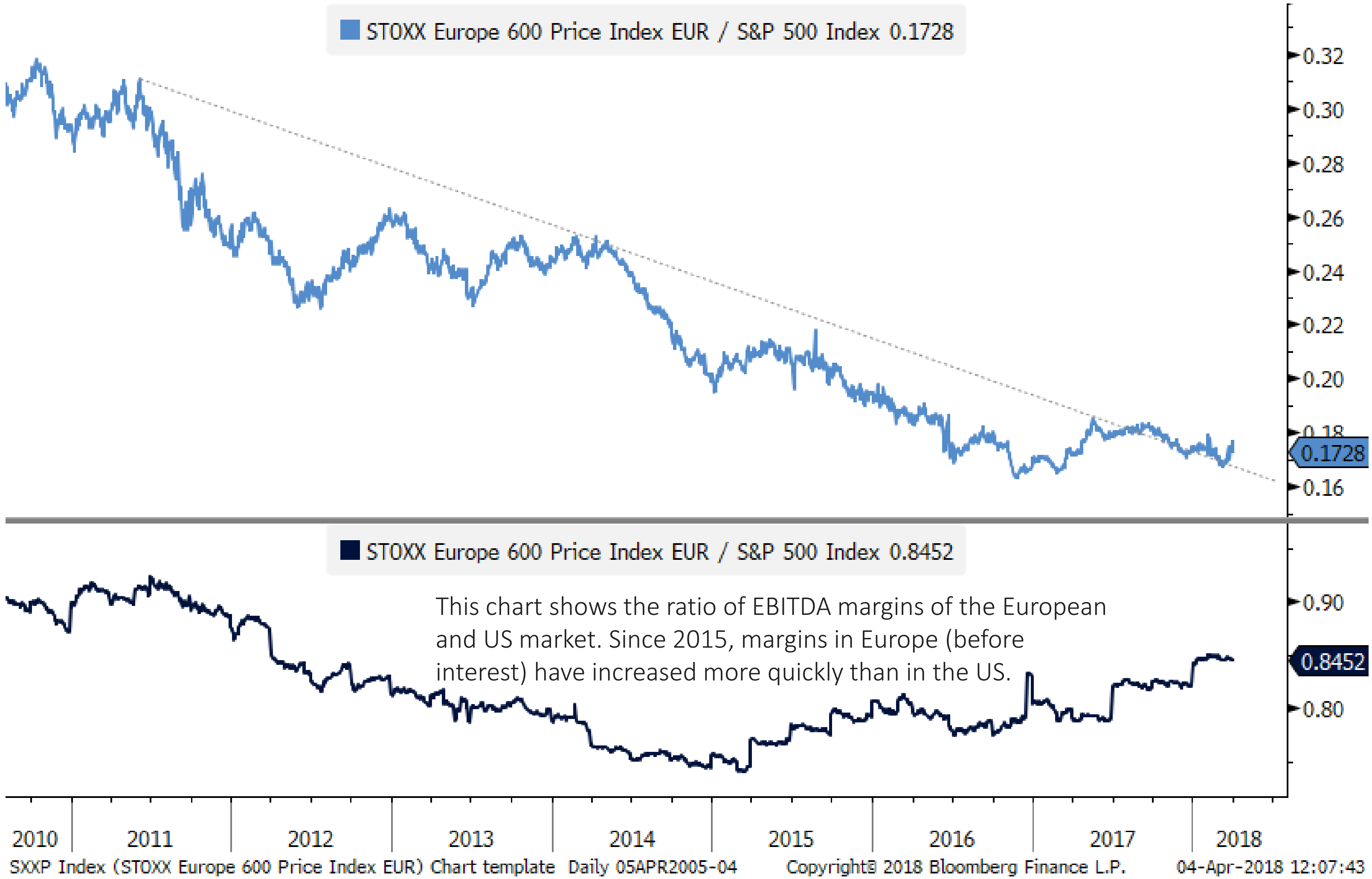
EU – markets stall at major resistance

The Stoxx Europe 600 failed to break out above key resistance around 400 and has pulled back roughly 10% from the highs. A strong EUR, abruptly rising yields and increasing trade war rhetoric have weighed on the market. However, the EU economy remains fairly resilient and corporate margins are on the rise. EPS are expected to grow by 13% in 2018, which would bring PE multiples to 14.2 in 2018. The index should hold its key long term uptrend, providing a reasonable entry point.



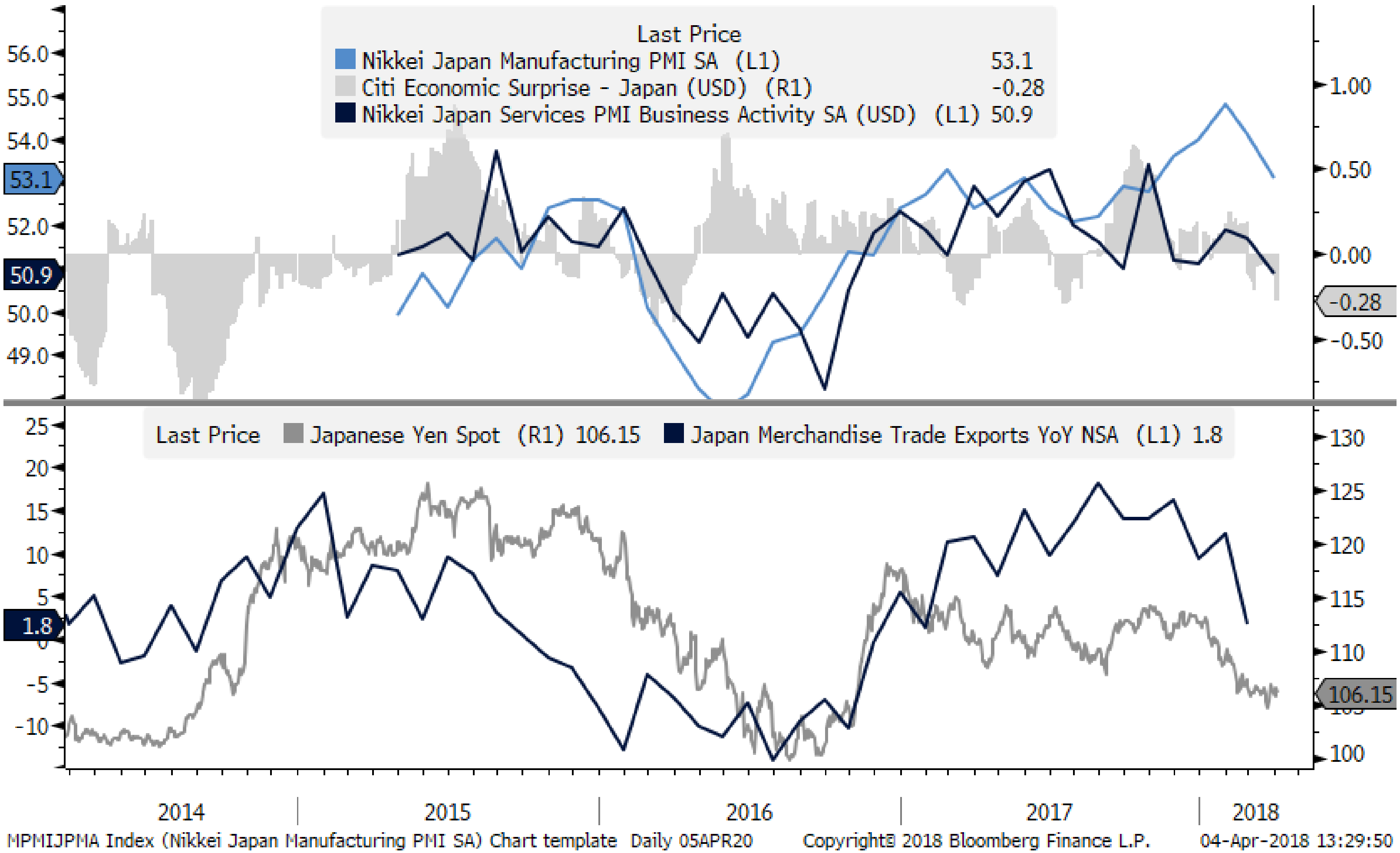
EU – will EU underperformance continue in 2018?

European markets are underperforming US markets again (in USD), showing greater sensitivity to a risk off environment, despite having more accommodative monetary policy. Interestingly, EBITDA margins have progressed at a quicker pace for European market since 2015, when the ECB eased monetary policy.



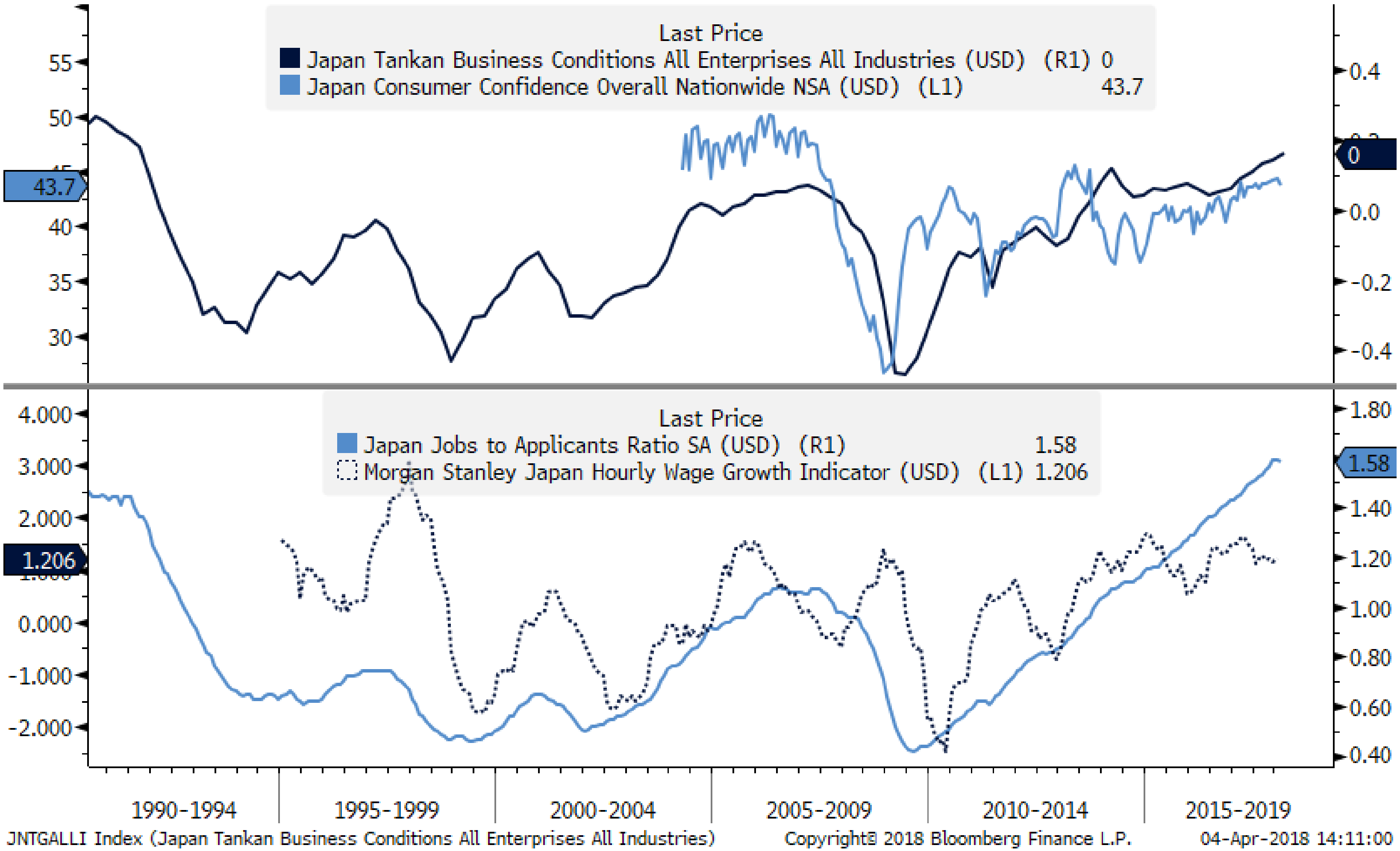
Japan – economic activity slows down in 2018

Economic data have mostly disappointed in 2018, with services and manufacturing activity slowing down but remaining in expansion territory. Export growth has also declined, weighed down by an appreciating yen, which was pushed higher by a risk off environment and comments by the BoJ that policy normalisation could be on the table. With speculative positioning currently long the JPY, it’s rise may not have much further to go.



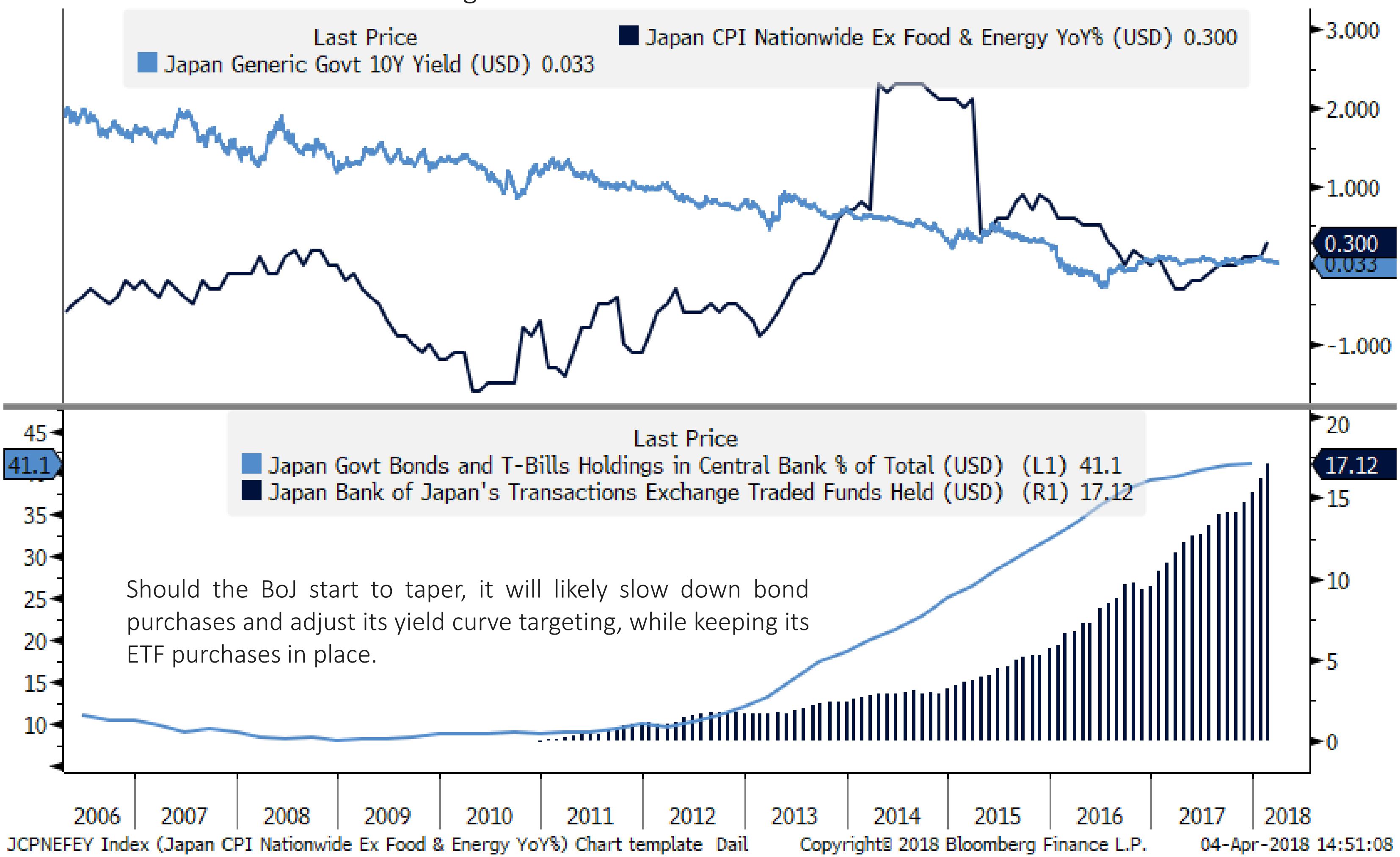
Japan – the situation remains favorable

Business conditions are the best they have been in decades according to Japanese corporations and consumer confidence remains elevated and on the rise. The labor market is tight, with the unemployment rate at 2.7% and roughly 1.6 job opening per applicant. Wage growth remains a bit tepid but headed in the right direction, potentially helped in 2018 by new tax incentives for corporations to increases wages by 3%.



Japan – significant change in BOJ policy unlikely

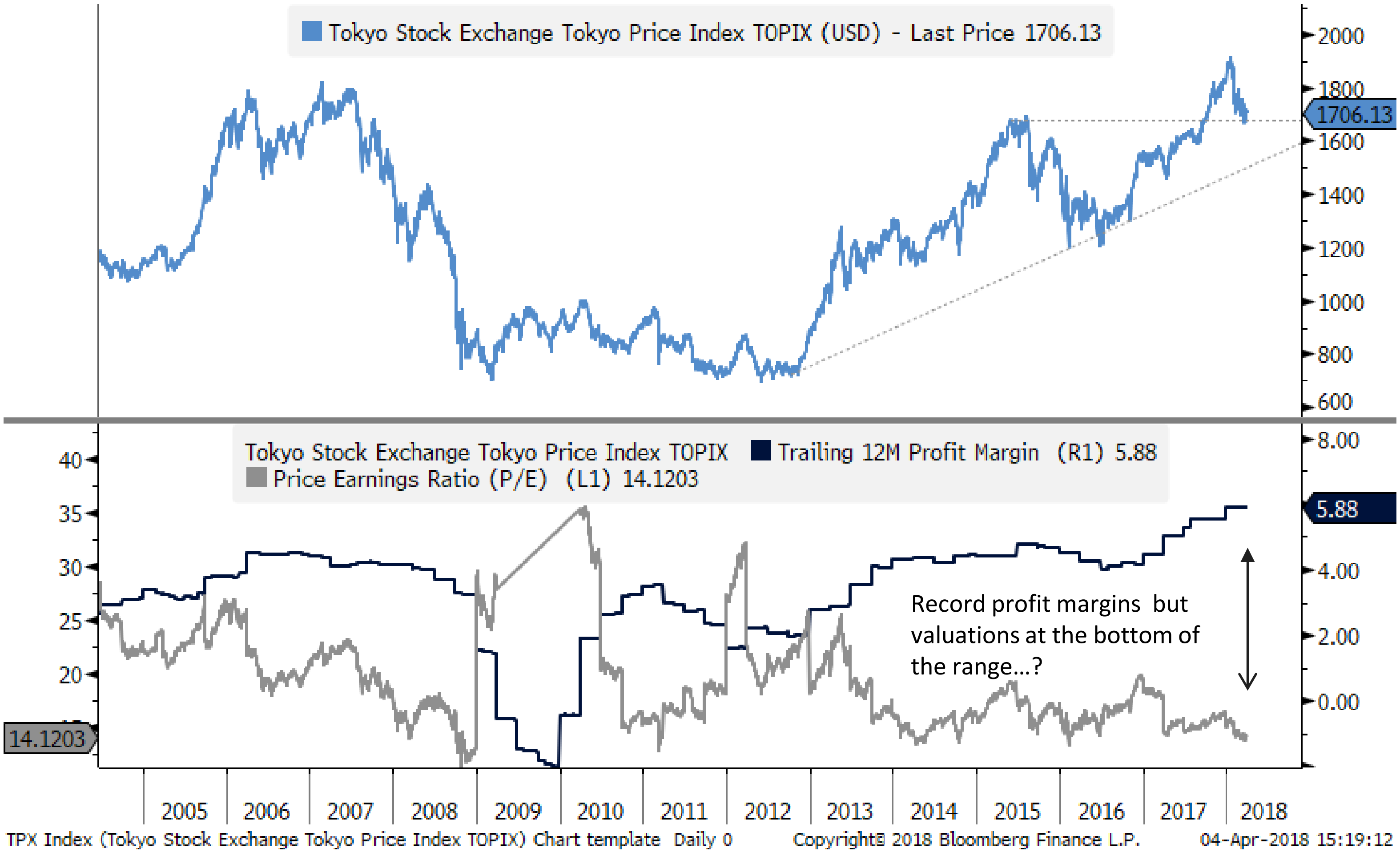
The BoJ's Kuroda mentioned that discussion of normalisation of monetary policy could commence in fiscal 2019, suggesting that the inflation target may not be strict anymore. While inflation is rising, it remains far from 2%. Even if normalisation begins, which could be delayed by the yen's recent appreciation, the BoJ's policy will remain accommodative for a long time.



Should the BoJ start to taper, it will likely slow down bond purchases and adjust its yield curve targeting, while keeping its ETF purchases in place.

Japan – retracement from key resistance likely temporary

The TOPIX has followed global markets lower, retracing around 10% from its recent highs. While the correction may not be over and a retest of the uptrend around 1600 could be in the cards, the TOPIX only trades at 15x 2017 earnings, vs. 16.4x for the Stoxx 600 and 21.6x for the S&P500. This relatively cheap valuation comes at a surprise given that profit margins are at their highest on record (see bottom chart). Japan remains our favorite developed market for 2018 but the uptrend since 2011 should hold for us to keep this view intact.

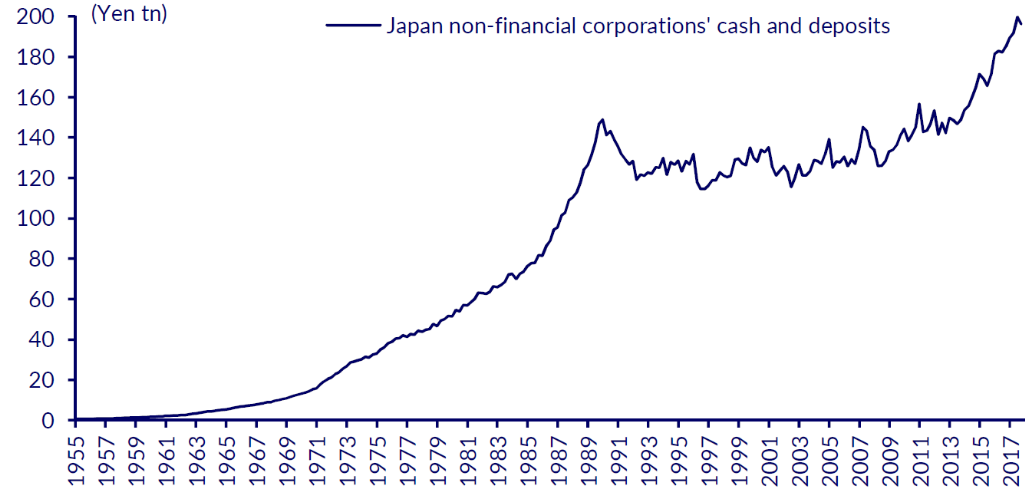


Japan – cash piles likely to be used for buybacks and wage increases

Japanese corporations have been hoarding cash for decades at the expense of shareholders. With the change in corporate governance incited by the government, distributions to shareholders in the form of buybacks and dividends will keep rising.

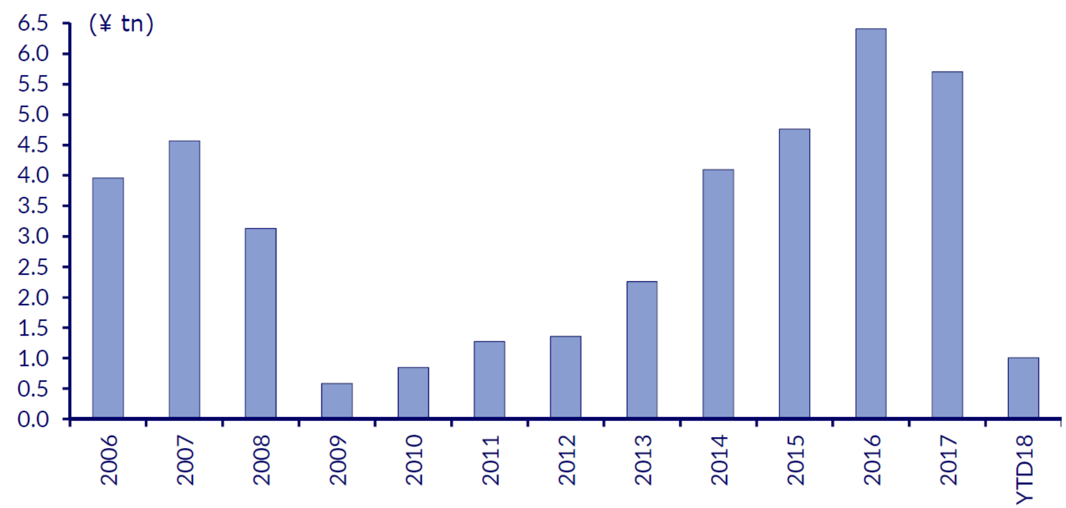
As of end of February, JPY 1tn of buybacks had been announced, a 6% rise vs. 2017.

Japan non-financial corporations' cash and deposits



Source: Ministry of Finance - Financial Statements Statistics of Corporations

Topix share buyback announcements



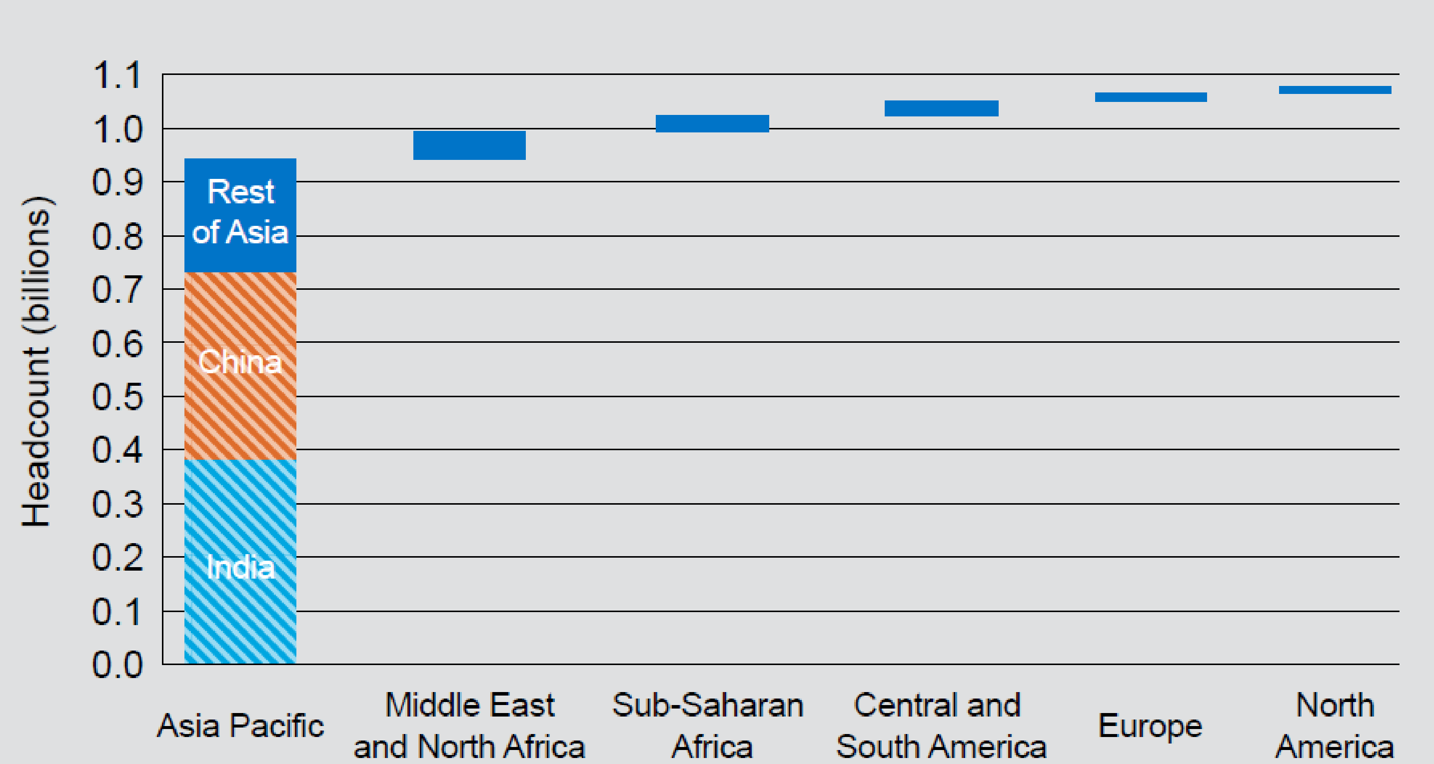
Note: Data up to 28 February 2018. Source: CLSA, Bloomberg

Emerging Markets

The expansion of the global middle class

According to a study published by Brookings Institute, we are experiencing the largest historical increase in the global middle class. 140m individuals join the middle class each year and this figure will increase to 170m in the next 5 years. By 2022, the middle class will probably consume USD 10 trillion more than in 2016. By 2030, the global middle class will consume USD 29tn more than in 2016. Asia will be the largest contributor to the middle class as shown in the table below.

Figure 7. Regional contribution to next middle class billion, 2015-2022



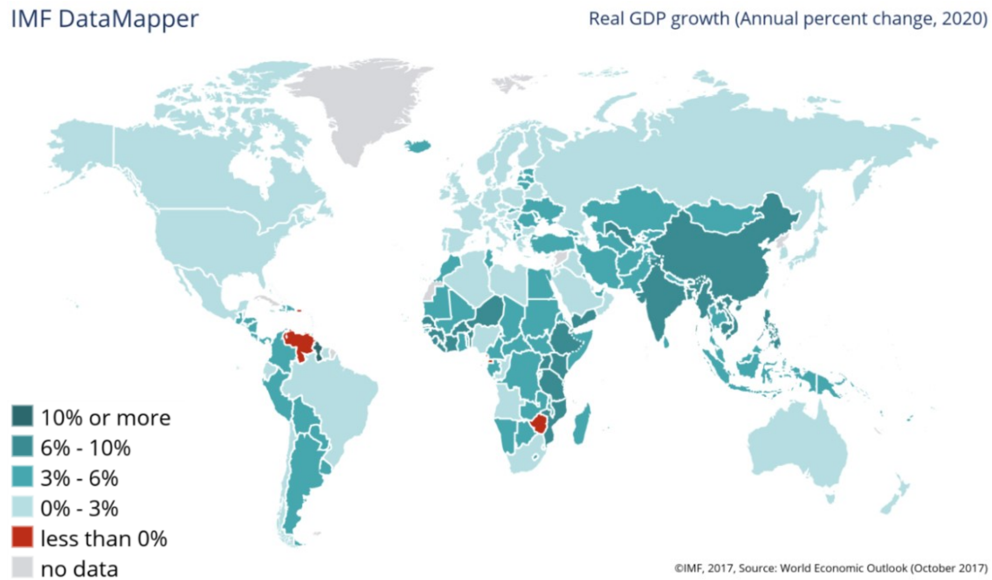
Source: Author's calculations

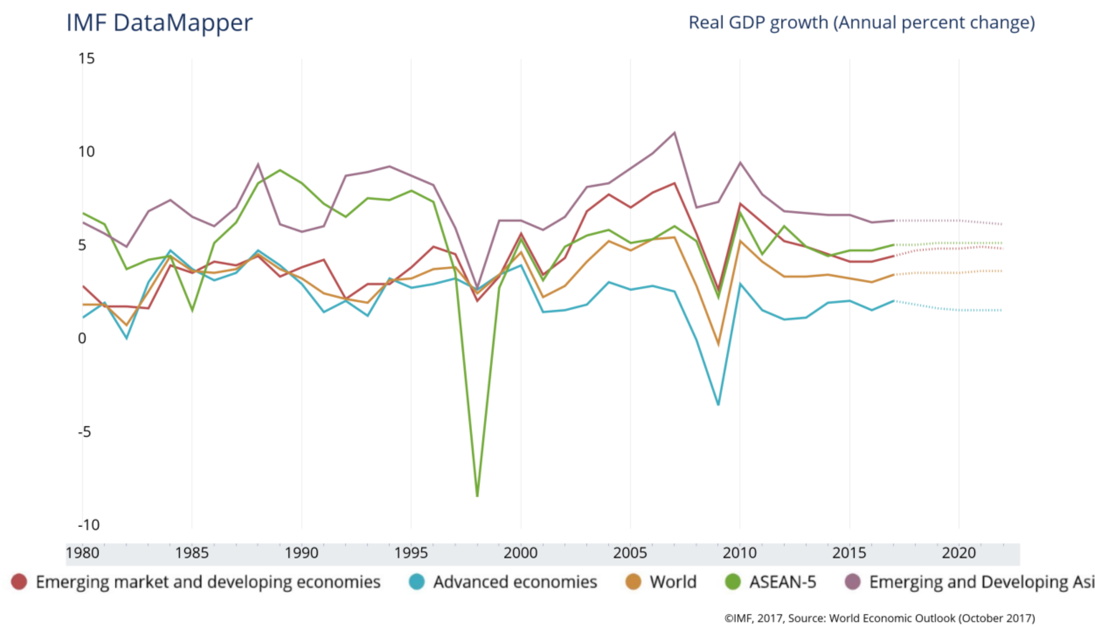
Emerging markets are the focus of future growth

The entire emerging complex is home to future growth ...

... and Asia stands out as having the most potential ...

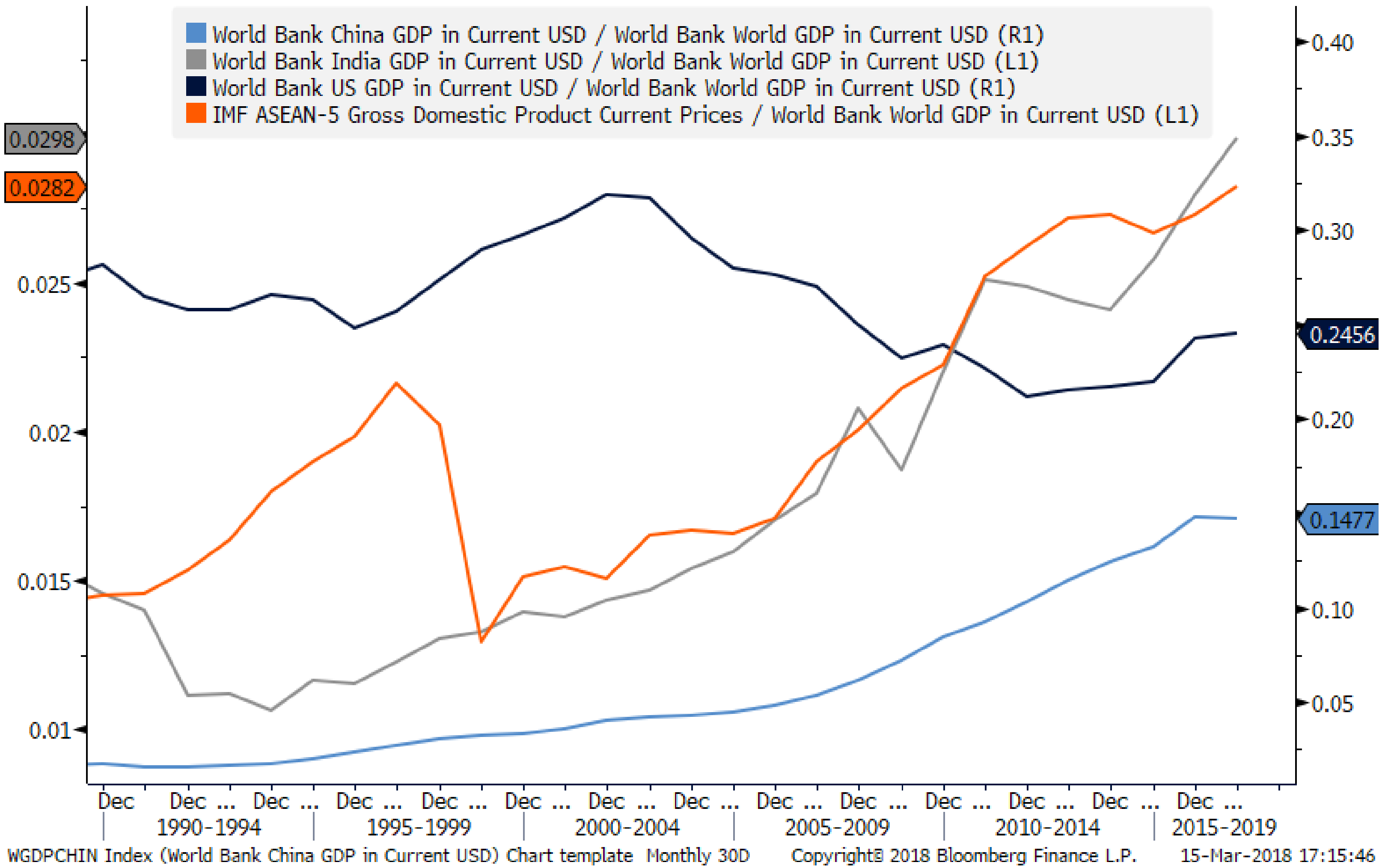
... in a catch up phase after two centuries in which its potential was initially contained by colonisation and the cold war.





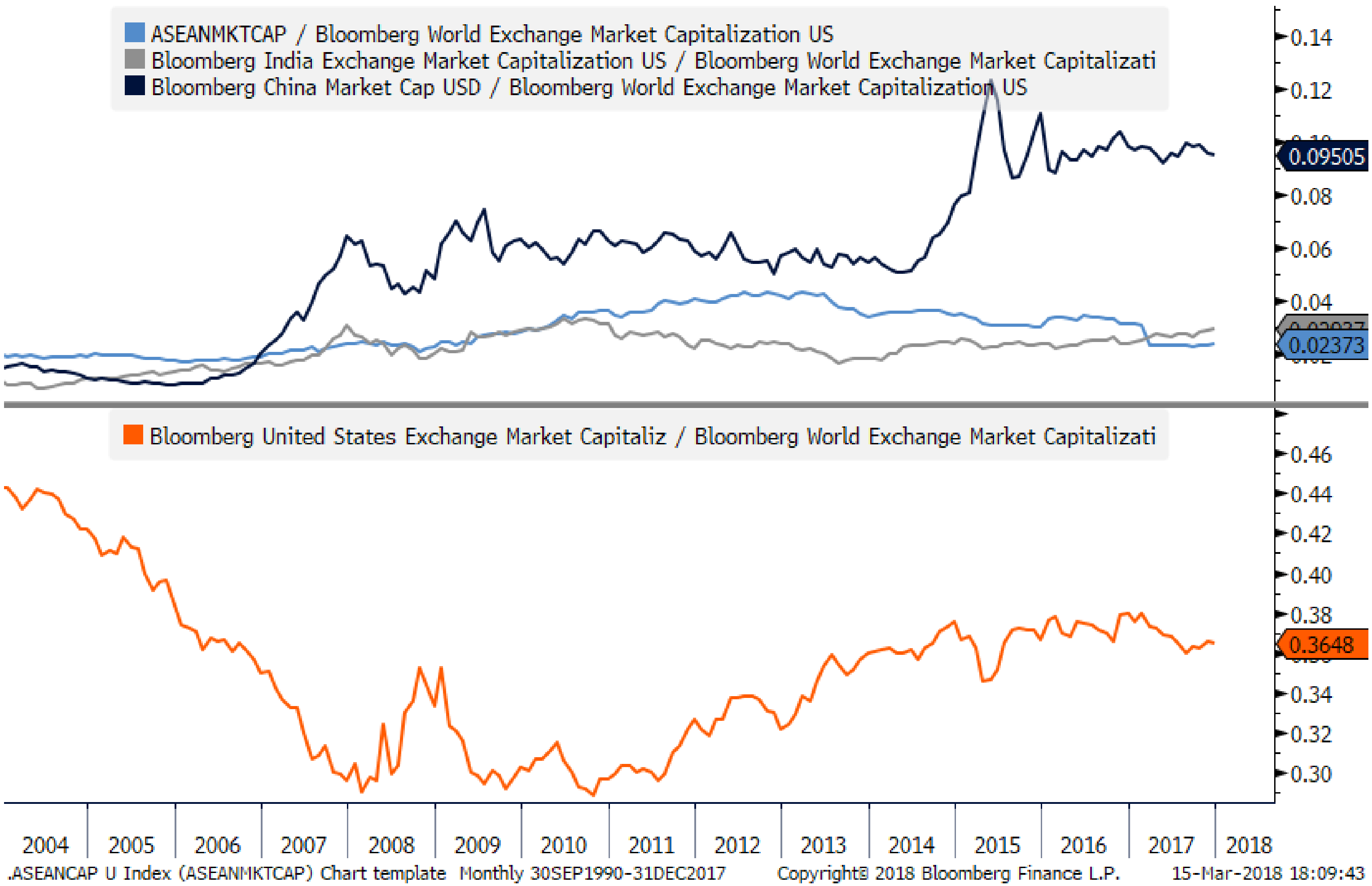
Asian markets – hub of future growth

The graph below illustrates the GDP of some countries as a percentage of world GDP. It is clear that Asia, represented here by China (14.77%), India (2.98%) and ASEAN (2.82%), represents a growing proportion of global GD, while the US's share is in a downtrend.



Asian markets – hub of future growth

The chart below compares the market capitalization of different countries as a percentage of global market capitalization. We find that the US market capitalization (36%) seems disproportionate compared to the weight of the American economy (24%), while those of Asian economies remain conservative.

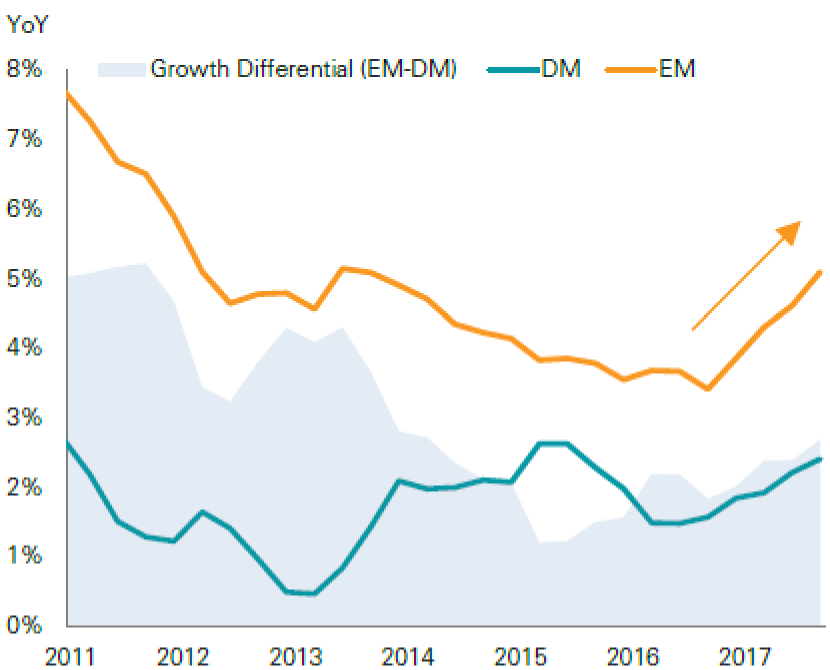


Emerging markets – higher growth and historical valuation discount

The dynamic highlighted on the previous pages suggests that the growth potential is clearly on the side of Asian economies for decades to come, making these markets essential to any long-term investment portfolio. In addition, the level of indebtedness of these economies is significantly lower than in developed markets. In the current environment of relatively high equity market valuations, investors need to expose themselves to the fastest growing economies / markets. In addition, emerging markets are currently cheap relative to developed markets. Should a dollar rebound lead to weakness in the coming months, investors should take the opportunity to increase their allocation.

EM Growth: Built for Speed

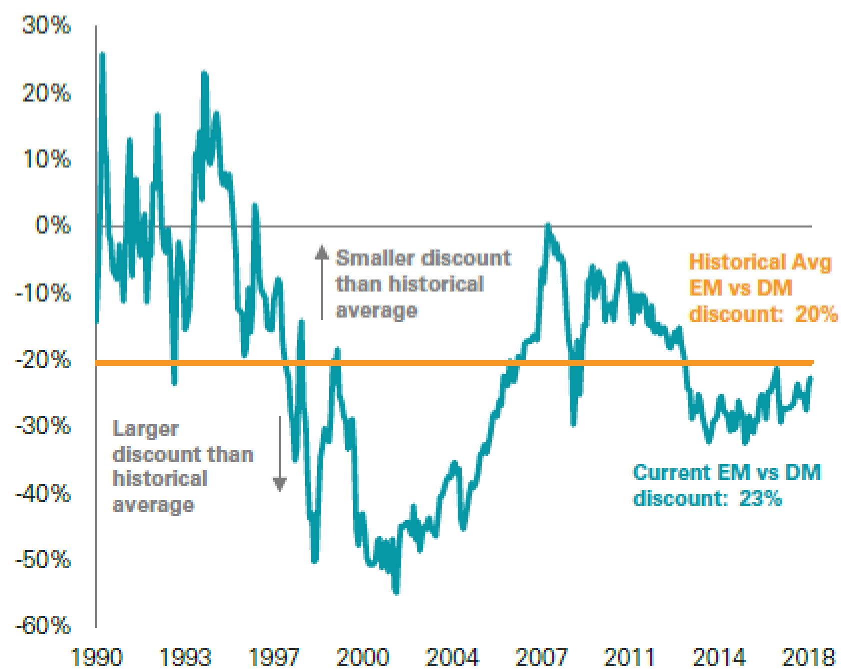
EM vs DM GDP Growth



Source: Macrobond. EM and DM Growth based on GSAM. As of Q4 2017.

Valuations: EM Cheap Relative to DM

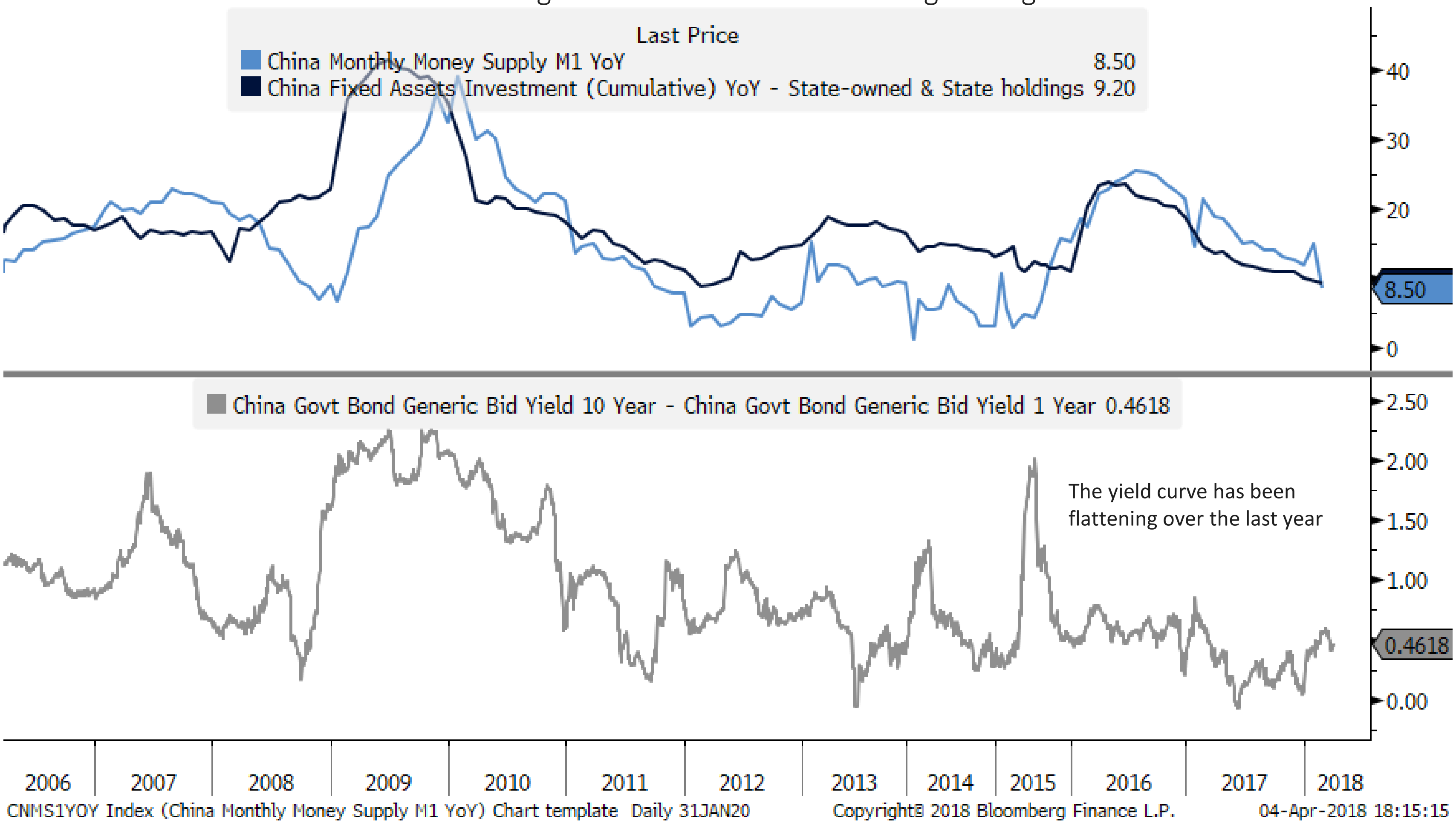
EM vs DM 12m Forward P/E Premium/Discount



Source: IBES via Datastream. As of February 28, 2018.

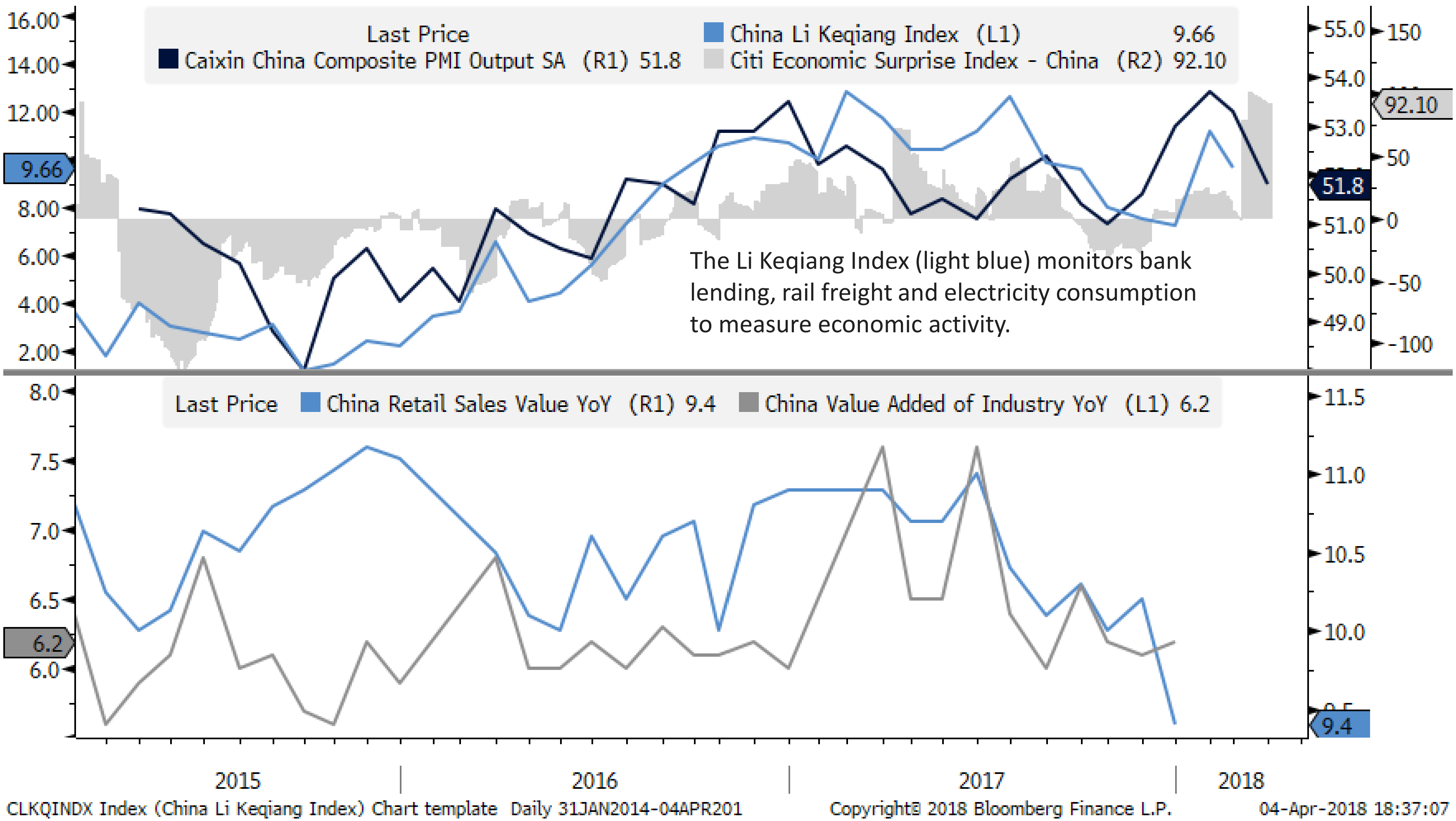
China – more stability with Xi for the long term

The removal of term limits suggests that Xi Jinping will remain in power beyond his second term, ensuring political stability and the continuation of his policies, which notably include supply side reforms and the One Belt One Road. While these are positive developments, the short term is less bright, as China's intention to tackle imbalances in 2018 has been made clear by a number of officials in recent speeches. M1 growth and fixed asset investments confirm that the government is serious about tightening in the short term.



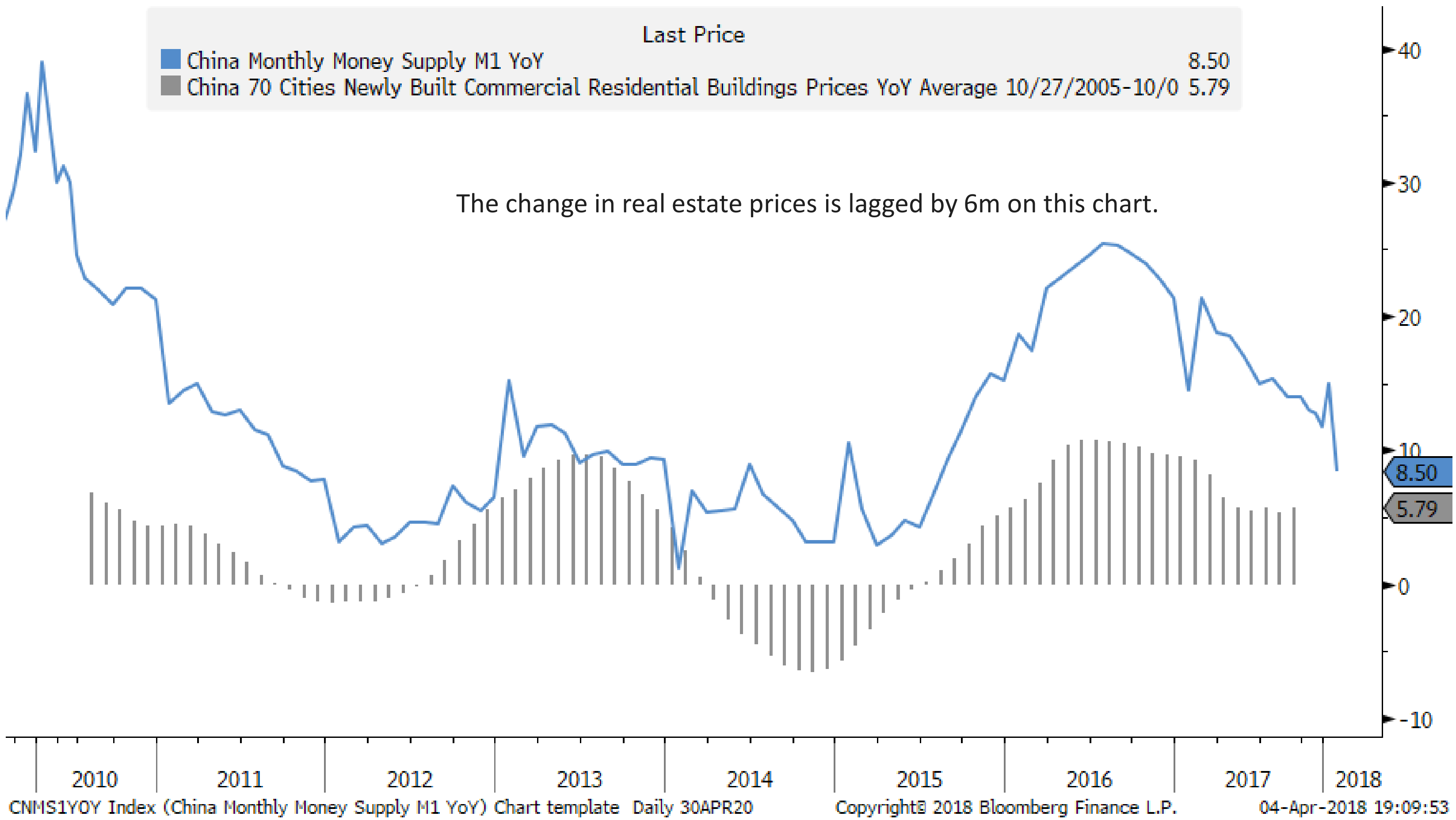
China – surprising resilience in 2018 unlikely to be maintained

Economic data in China has surprised positively during Q1, with the composite PMI and Li Keqiang index bouncing. However, as the latest PMI in March suggests, that bounce was likely temporary; given the government's focus on deleveraging, it is likely that economic activity slows down in the coming months.



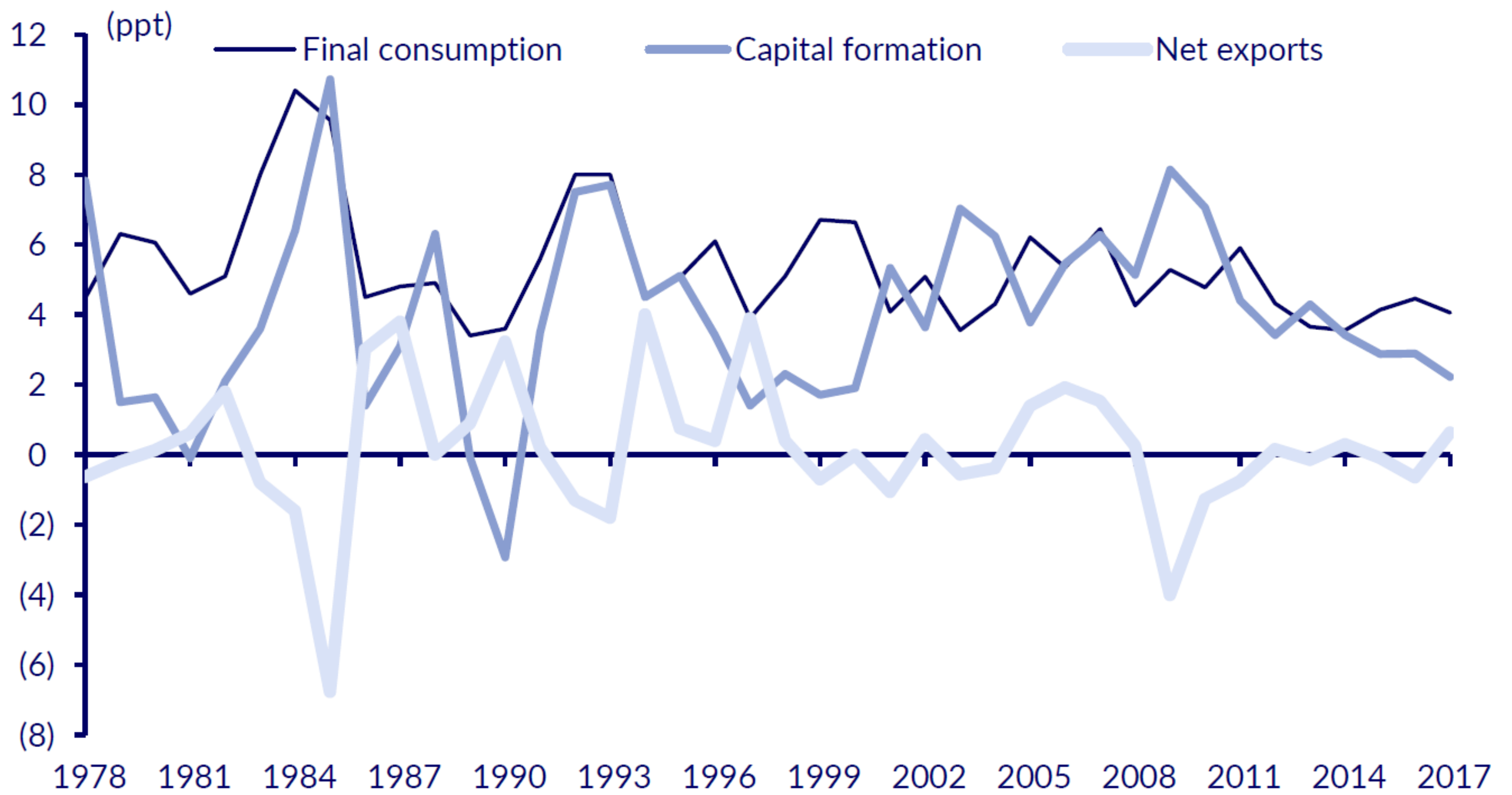
China – the property market could foretell a broader slowdown

The price change for newly built buildings in China has been coming down over recent months, as a result of the financial crackdown orchestrated by the government (e.g. tighter lending standards). M1 growth has a 6m lead on real estate price changes, suggesting prices will come down further, which could put pressure on households.



China – consumption is the largest contributor to GDP growth

As can be seen on the below chart, consumption has been the main contributor to Chinese growth since 2014, as the government has successfully rebalanced the economy away from investment and exports. This also means that a slowdown in the housing market, which would affect the Chinese household, could have a sizable impact on growth.



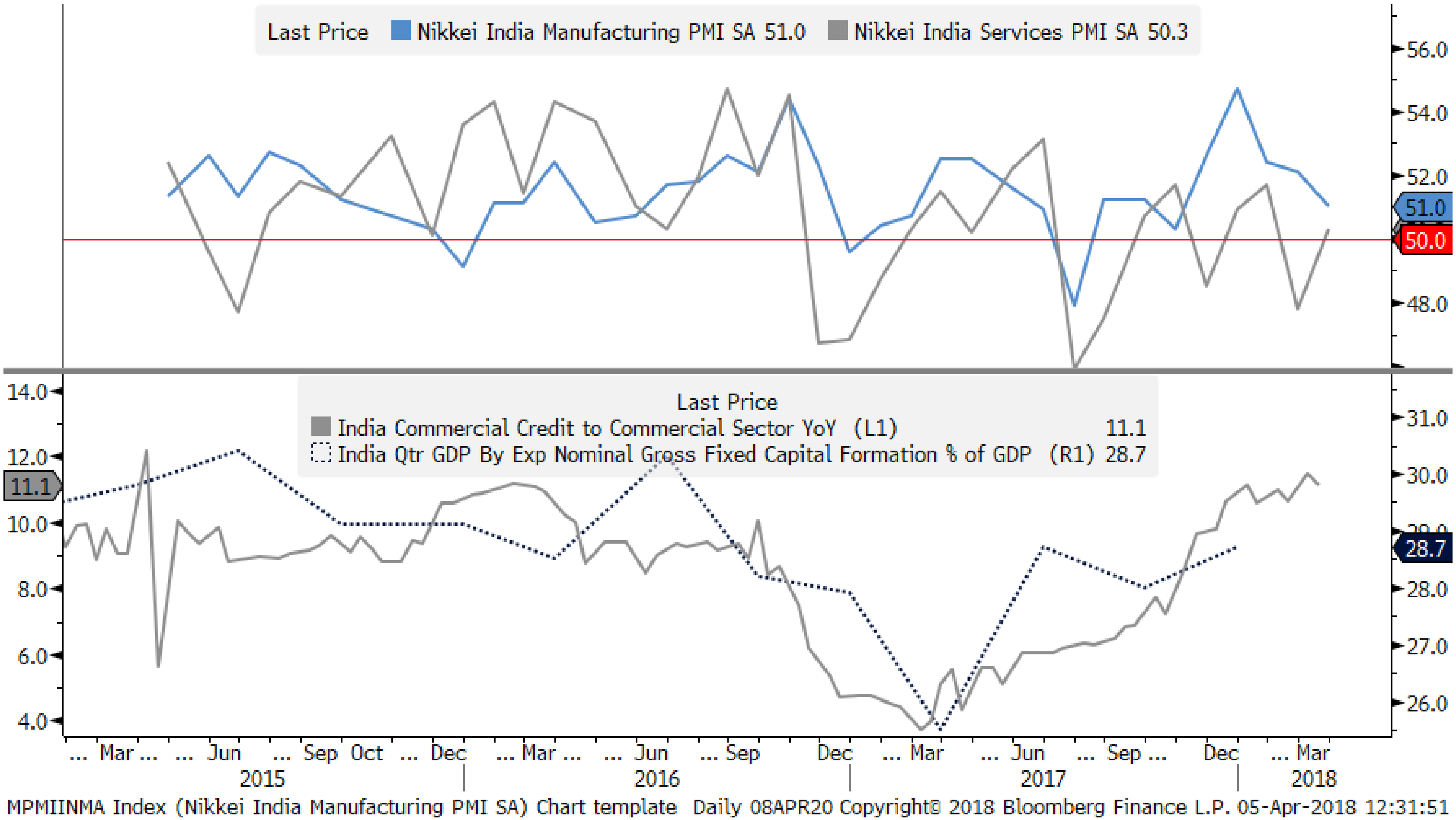
Source: CEIC Data, National Bureau of Statistics

China – signs of weakness emerging on the equity market

The Chinese equity market was not immune to the exuberance of investors in early 2018, especially as economic data came in stronger than some feared. The recent selloff has created a divergence between Chinese equities trading in Hong Kong and in Shanghai, with the latter index having broken its uptrend. Given that economic momentum is likely to slow down, the warning sign given by the Shanghai index should be heeded and investors should not increase exposure at this stage.

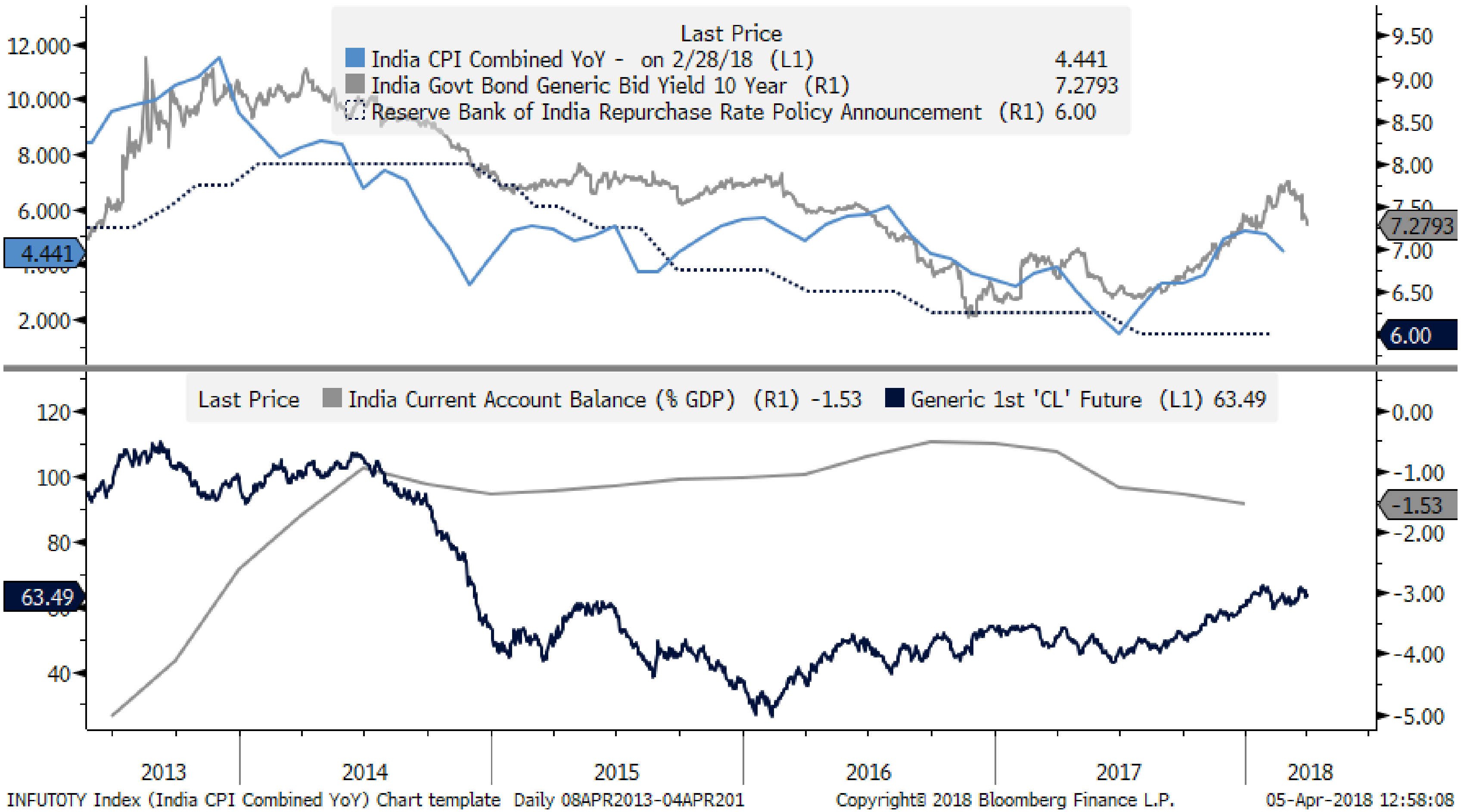
India – weakening economic momentum

Although the USD 2bn Punjab National Bank fraud case was a reminder that Mr. Modi's intention to tackle corruption may be more arduous than anticipated, credit growth has clearly picked up following the demonetisation and the bank recap plan. This is starting to stimulate the long awaited investment cycle and is a strong positive for the economy. However, the situation in India has somewhat weakened over recent months, with PMIs flirting with the 50 mark, likely due to rising yields and commodity prices.



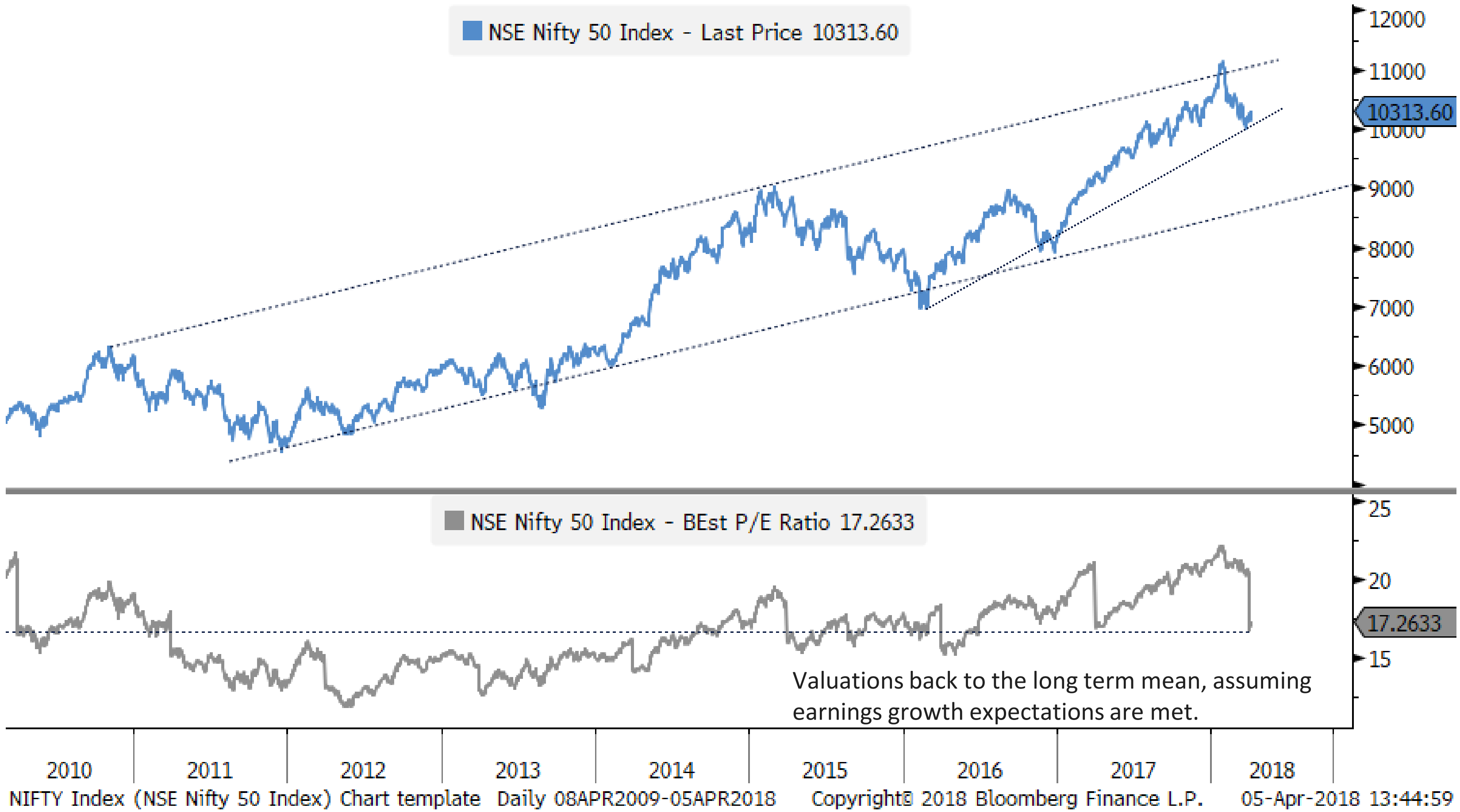
India – commodity prices increase odds of tightening

Due to its reliance on imported commoditie, inflation is on the rise in India, which, added to populist policies due to coming elections (e.g. the National Health Protection Scheme), has pushed long yields higher. Although the central bank has decided to keep rates at current levels, it could be forced to tighten in coming months, as the current account deficit widens and pressures the currency. This dynamic could become a headwind for India in the short term, but would still be outweighed by the strong structural fundamentals of the country.

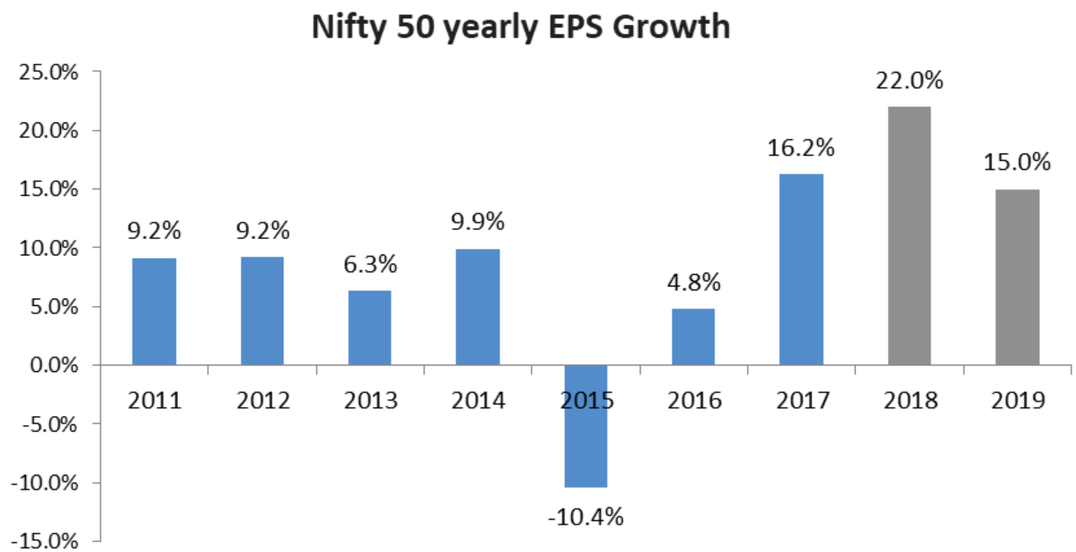


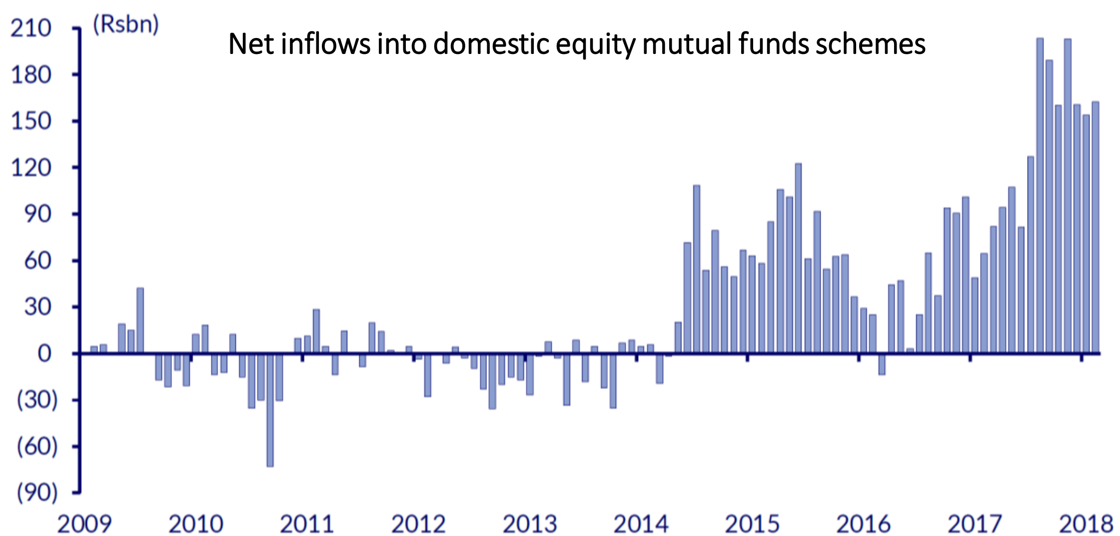
India – high expectations for earnings growth

Indian equities followed global markets lower, correcting by roughly 10% from all time highs. Some domestic factors did not contribute to improving sentiment, notably the PNB bank scandal, rising yields or the introduction of a long term capital gain tax. Yet, domestic flows into equity funds run unabated (next slide), earnings have grown more than 16% in 2017 and are expected to rise 22% and 15% in the coming 2 years. While disappointing earnings growth or a rate hike could lead to further weakness, the long term case for India remains one of the most attractive worldwide and the recent pullback offers an attractive entry point.



India – earnings growth and domestic flows

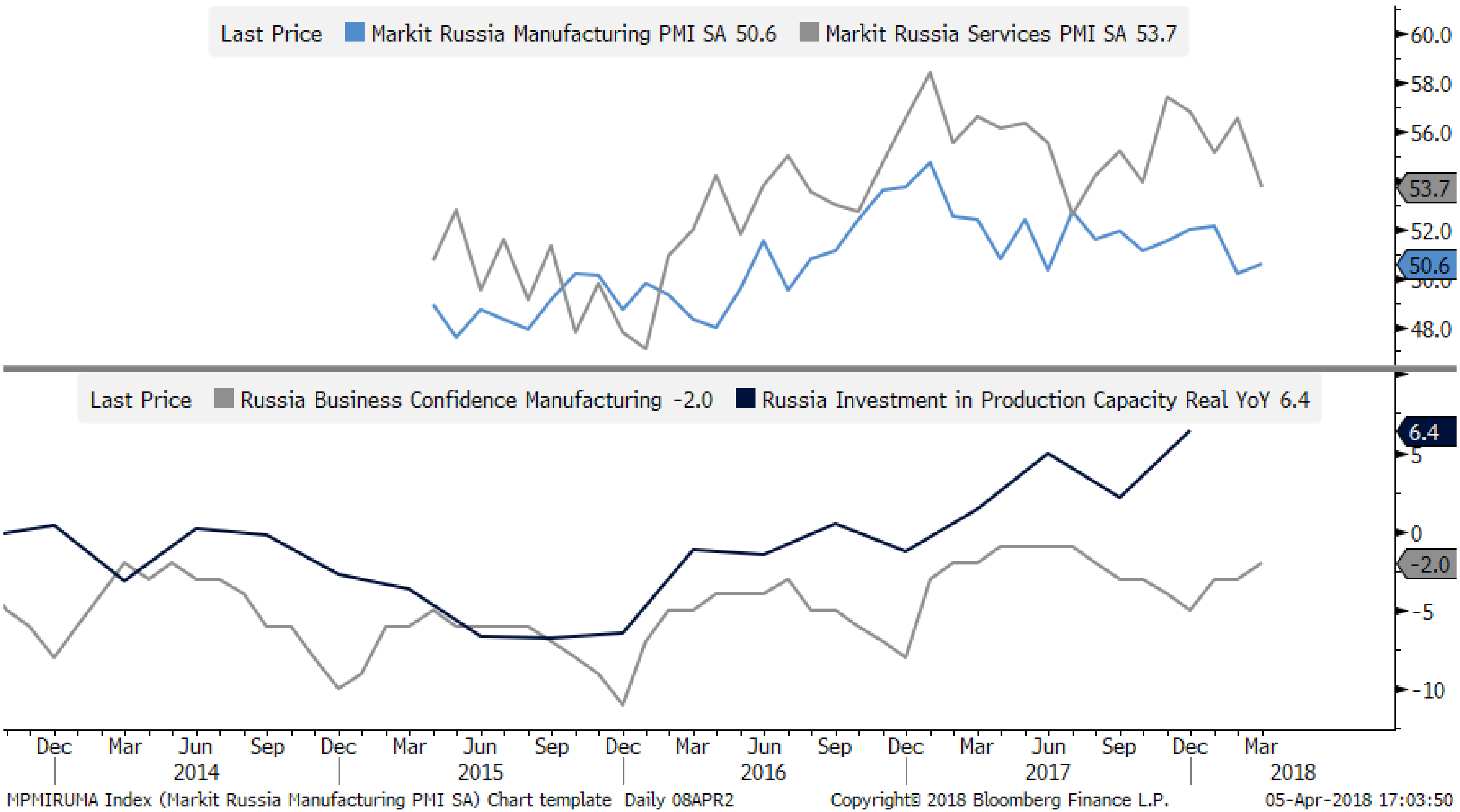




Note: Include equity funds and ELSS funds, but not balanced funds.
Source: Association of Mutual Funds in India (AMFI)

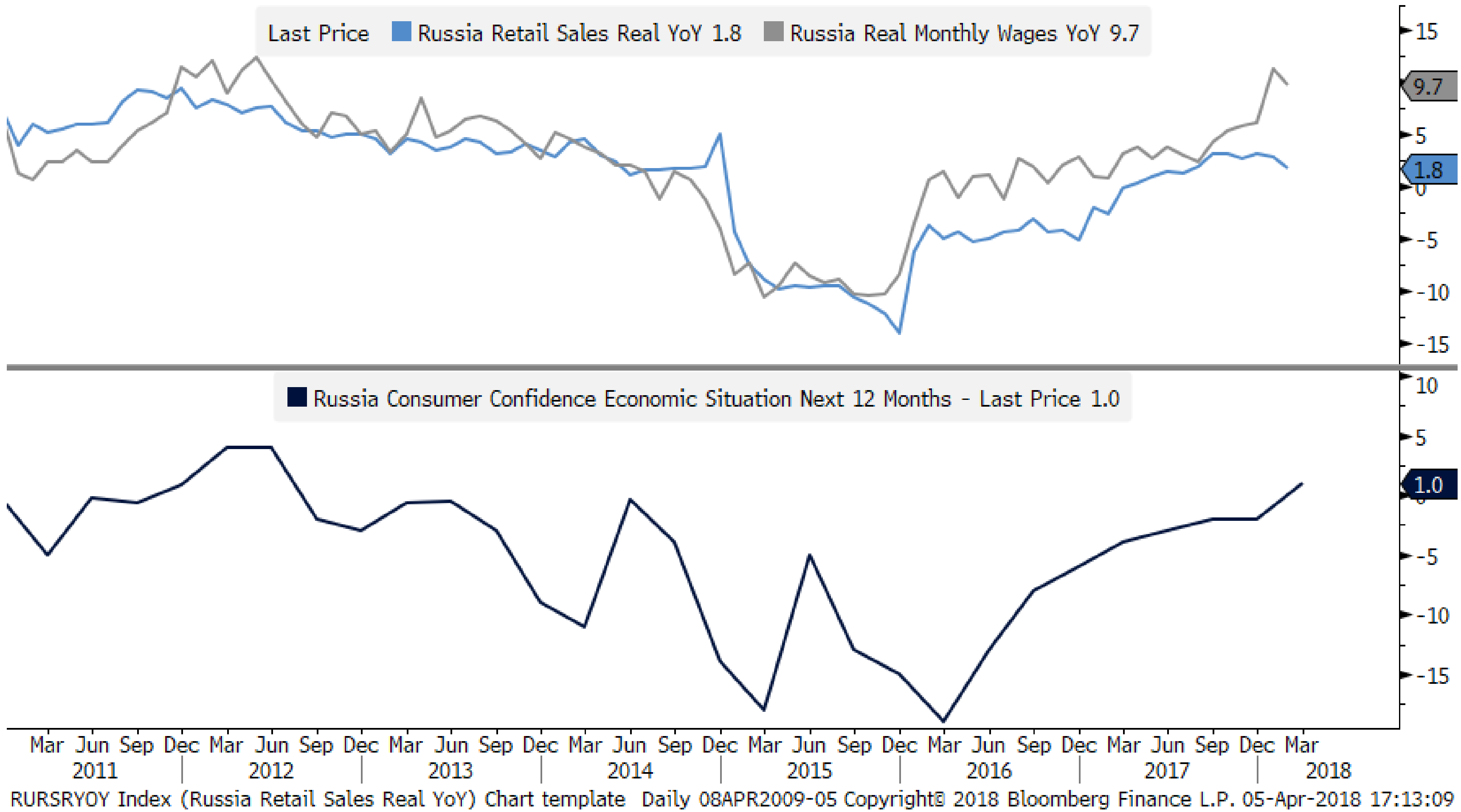
Russia – recent sanctions could threaten the encouraging backdrop

Despite a recent slowdown, with PMIs coming of their highs, Russian economic activity has been encouraging. However, Russia's alleged involvement in the Skripal case and a chemical attack in, which led to new sanctions on oligarchs and companies, might have poured some cold water on the investment case. While the new sanctions imposed are unlikely to have a significant direct impact on the economy, it could hurt business confidence and therefore investments into the country, which have been on the rise.



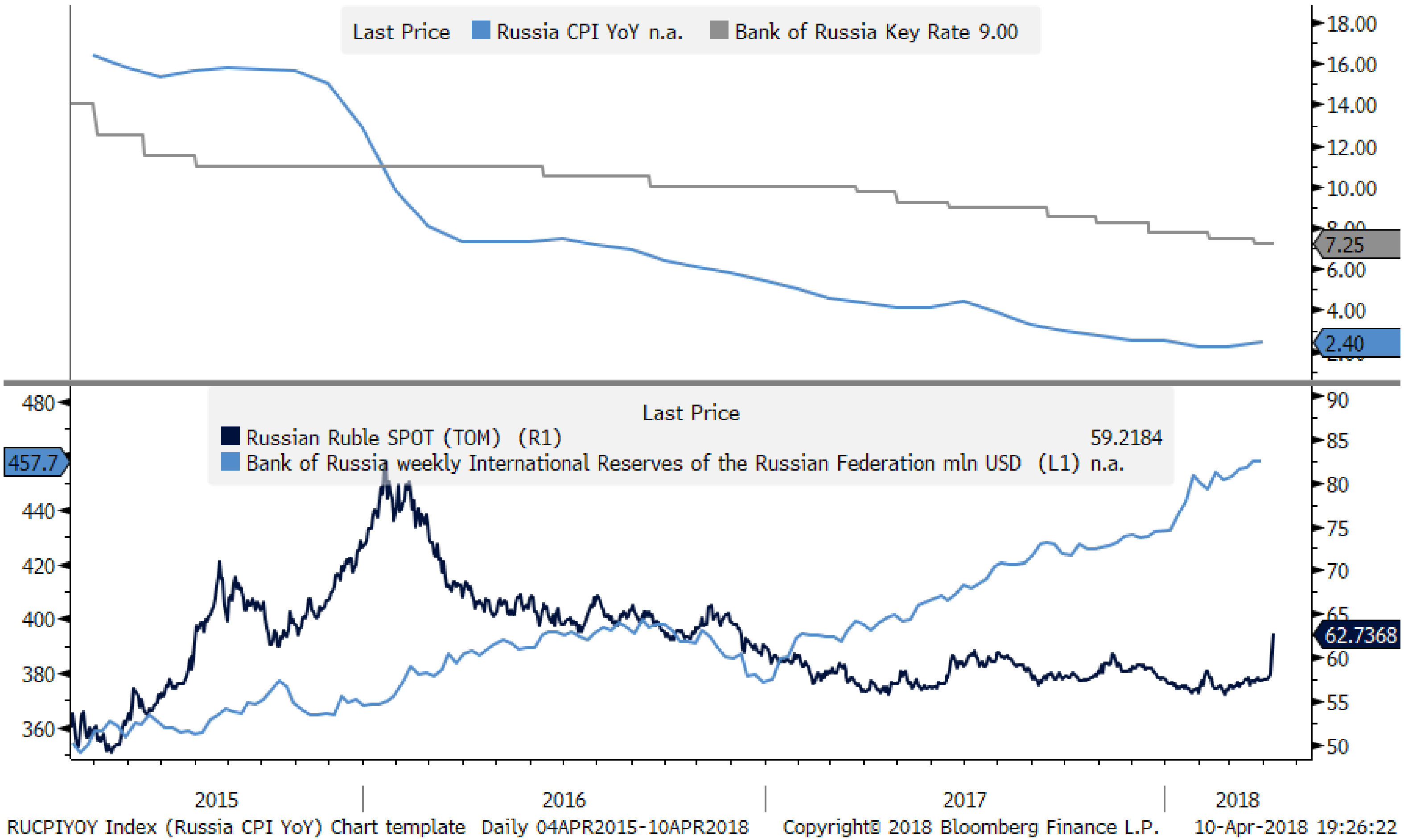
Russia – recent sanctions could threaten the encouraging backdrop

With rising real wages, consumer confidence has been improving, pushing retail sales higher. Recent development could threaten to reverse this positive dynamic through a weaker RUB and higher inflation. While economic numbers will have to be monitored, we do not expect a significant impact given the central banks ability to intervene and the positive backdrop on commodity markets.



Russia – recent RUB weakness likely to be met by central bank action

With consumer price inflation declining over the last 2 years and oil prices rising, the central bank has been steadily cutting its key rate without risking RUB depreciation. While the recent events have led to an abrupt and most likely exaggerated decline in the RUB, the central bank has ample means to intervene and stabilise the currency, which might not even be necessary past the current panic, given the level of real rates and the improving commodity market.



Russia – markets react violently to the new sanctions

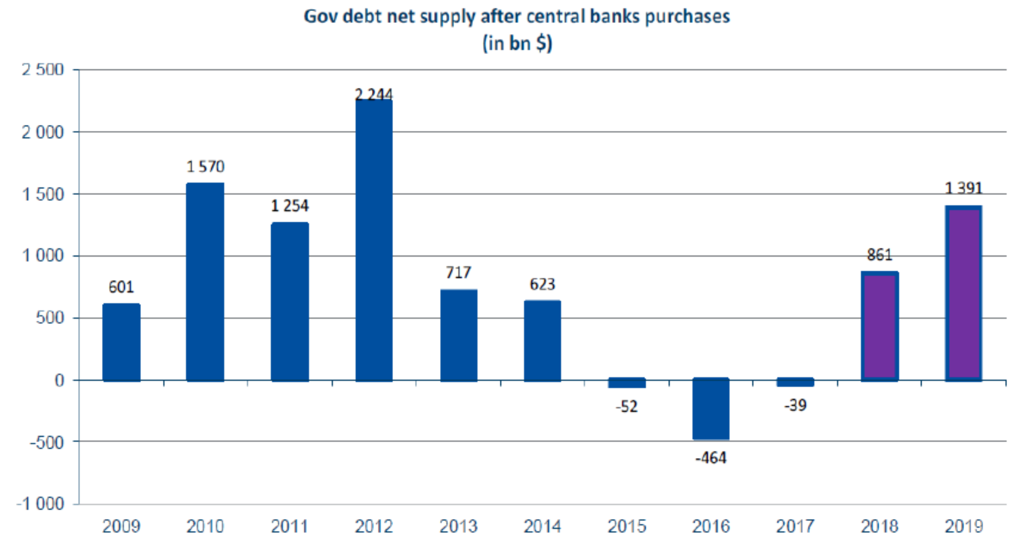
Whereas Russian equities had weathered the global market correction surprisingly well, the recent addition of sanctions on Russian companies has led to an abrupt pullback, testing key support. Russia now trades at a discount to its historical valuation vs. emerging markets, which seems reasonably cheap in an environment of rising commodity prices. Even though the easing stance of the central bank, the (so far) resilient economy, cheap currency and rising commodity prices should provide a floor to Russian assets, recent action is worrying; we opt not to add to our exposure and await further developments.

RTSI$ Index (Russian Trading System Cash Index) Chart template Daily 02APR2011- Copyright© 2018 Bloomberg Finance L.P. 10-Apr-2018 19:23:35

Fixed Income

Bond market distortions remain significant

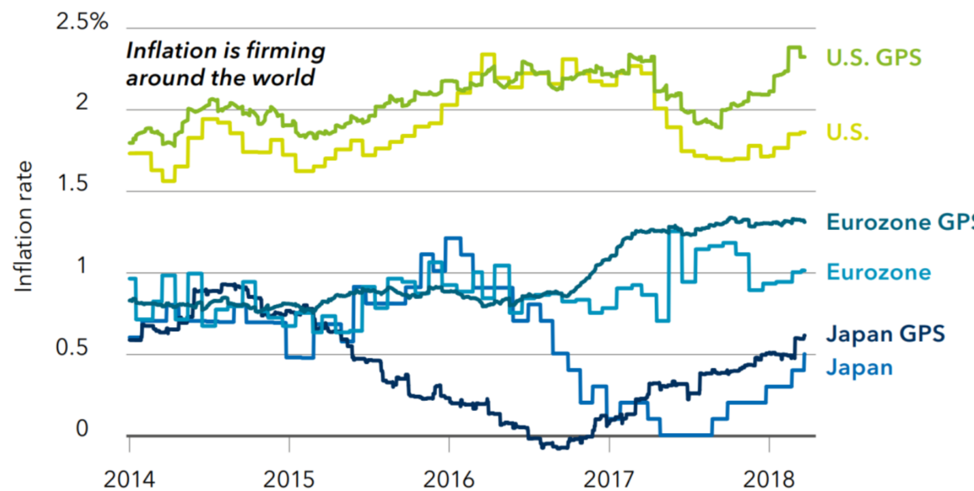
As government spending rises at the same time as central banks stop their bond purchase programs, the supply of government bonds will dramatically increase in coming years…



Source: Bloomberg, Amundi Research

…at a time when growth is resilient and inflation is picking up. This dynamic should continue to exert upward pressure on yields.

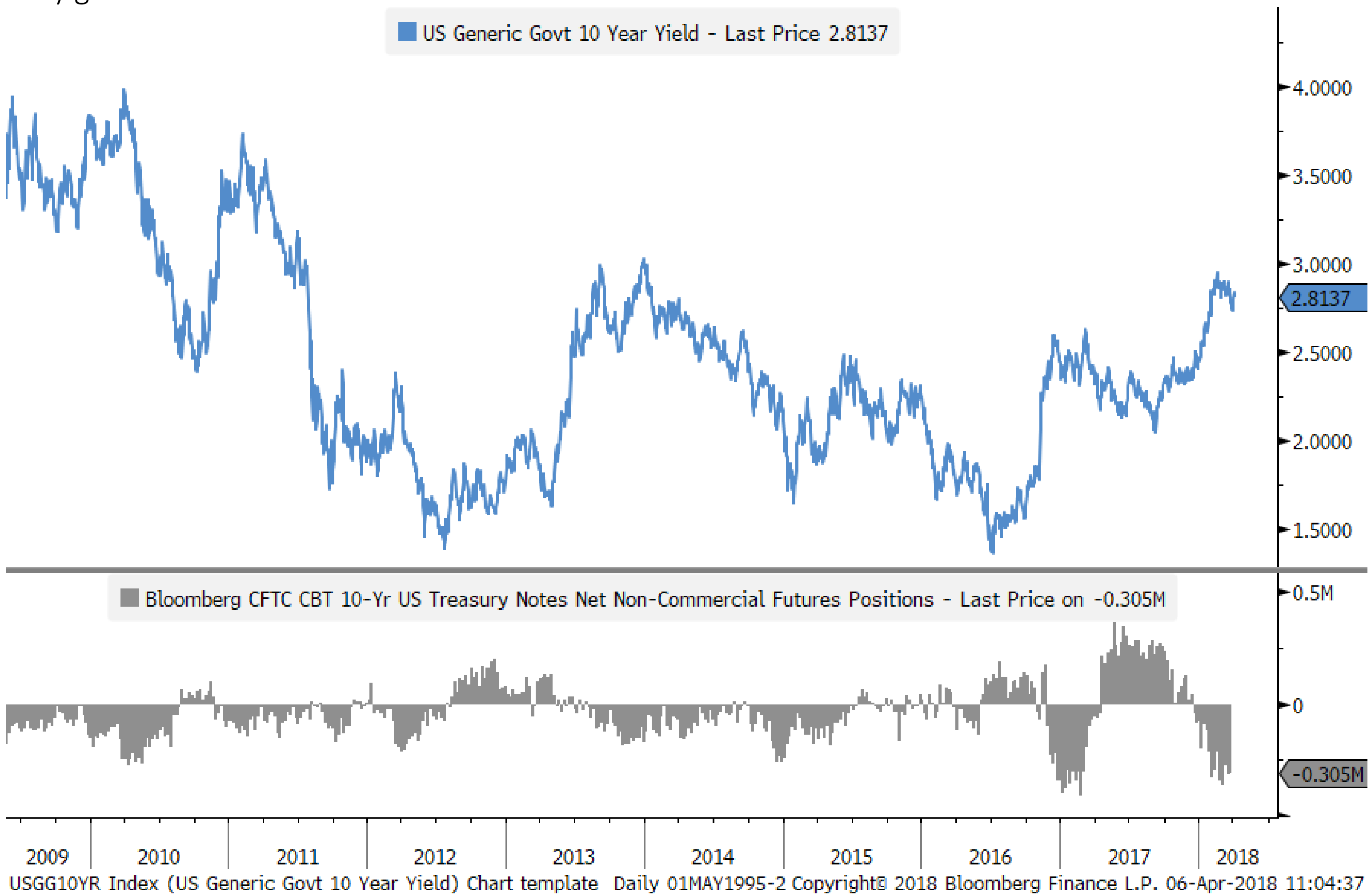
Core inflation: actual vs. BlackRock GPS-implied, 2014–2018



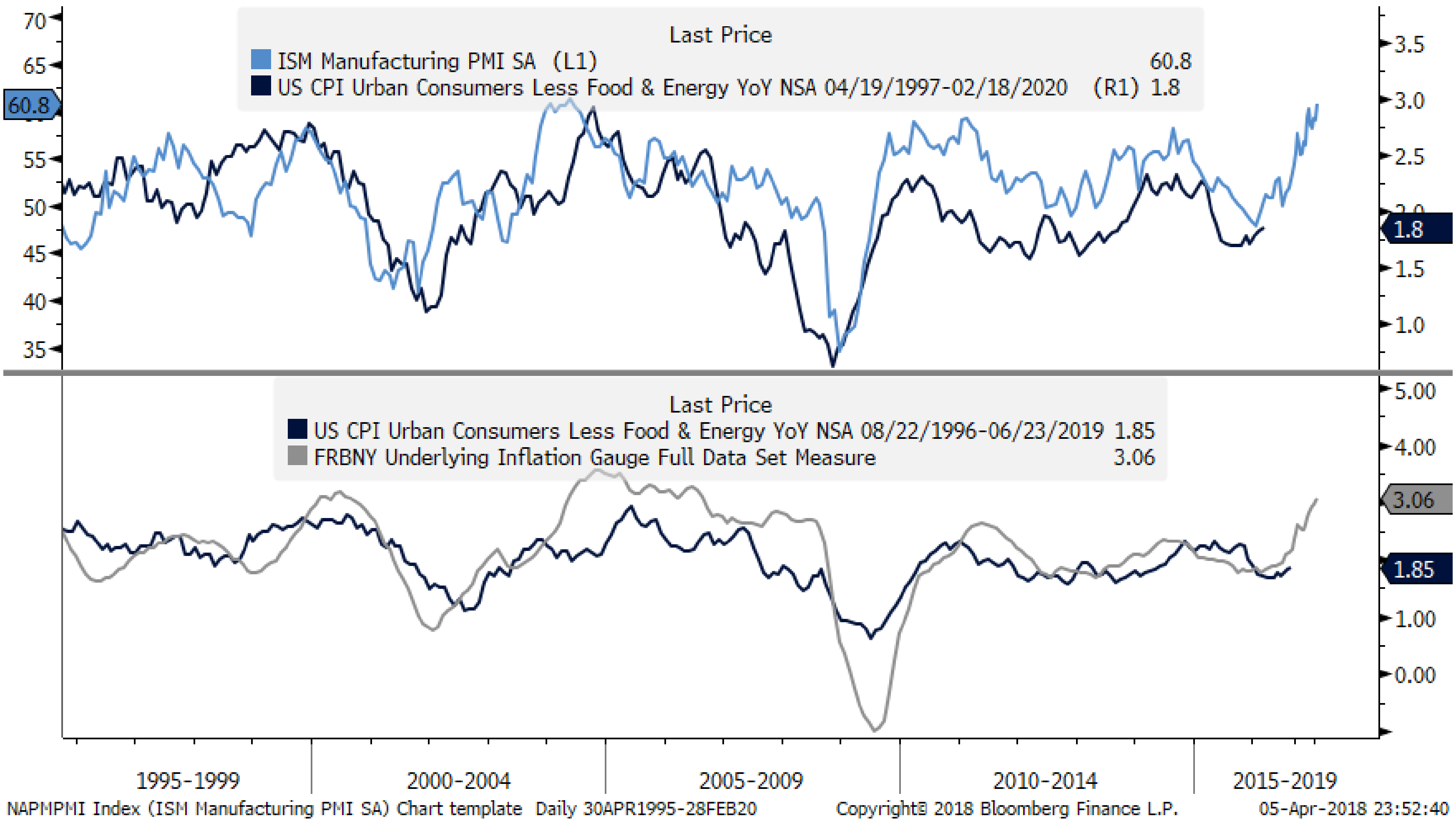
Sources: BlackRock Investment Institute, with data from Thomson Reuters, March 2018.

US bond market sell off and extreme bearish positioning

As expected, the US bond market sold off in 2018 on the back of late cycle fiscal profligacy, rising inflation and rising supply. The market is currently heavily positioned for a further rise in rates. While we believe the bond selloff has further to go, the current extreme bearish positioning suggests that a pullback could occur, especially given recent market weakness.



Late cycle fiscal stimulus in the form of infrastructure spending and tax reform should lead to higher inflation. The Underlying Inflation Gauge (below advanced by 16 months) and the ISM manufacturing PMI (advanced by 24 months) provide reliable leads on core CPI and suggests that inflation will shortly start to rise. The below numbers do not even take into consideration the potential impact of tariffs, which would be inflationary.

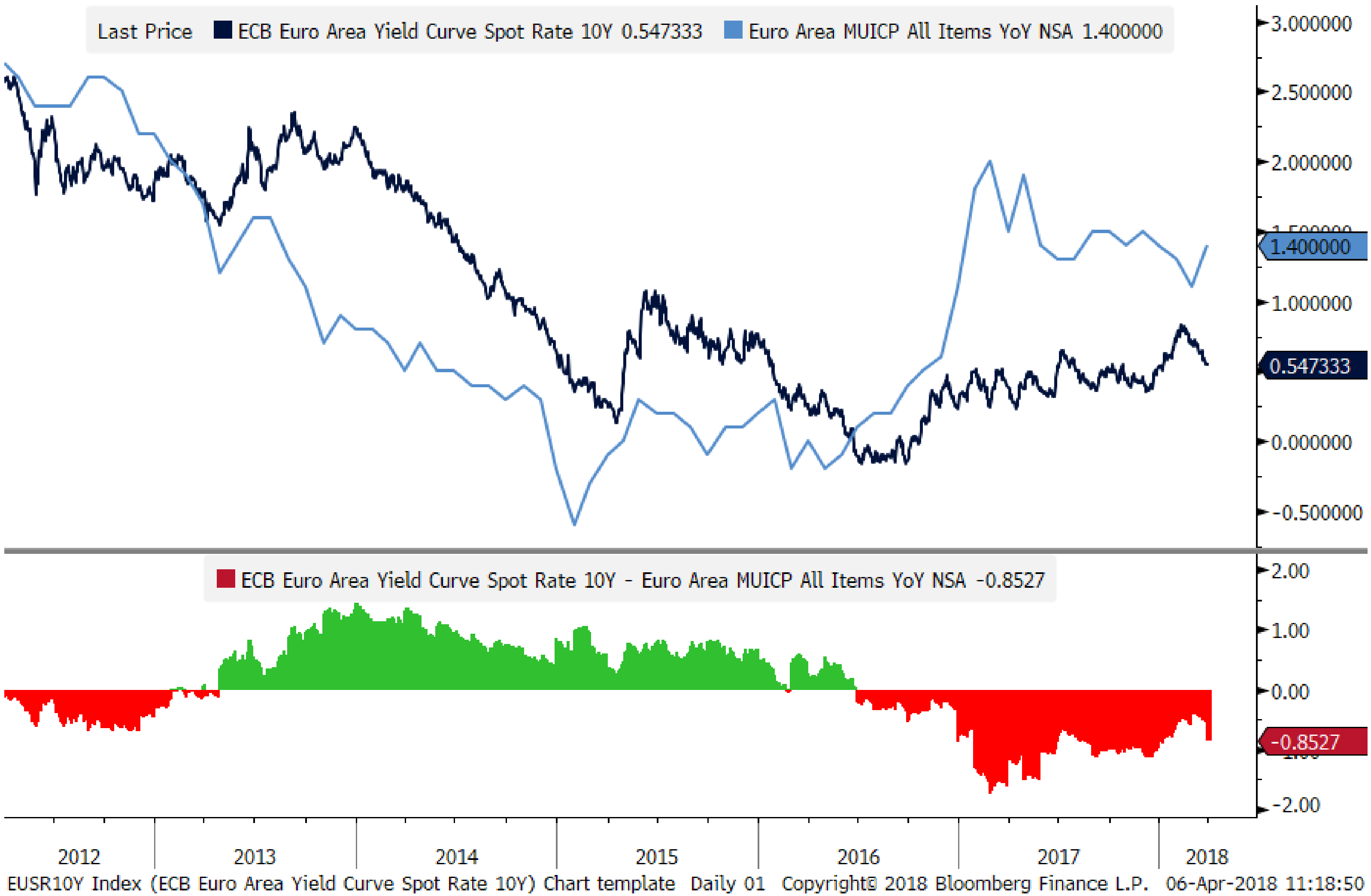


Focus on floating rate bonds and short term treasuries

Investors should start to look into building a sizable allocation to short term treasuries and keep buying floating rate bonds, which would yield between 2.5% and 3% currently. The main risk in the event of inflation is in the long end of the yield curve.

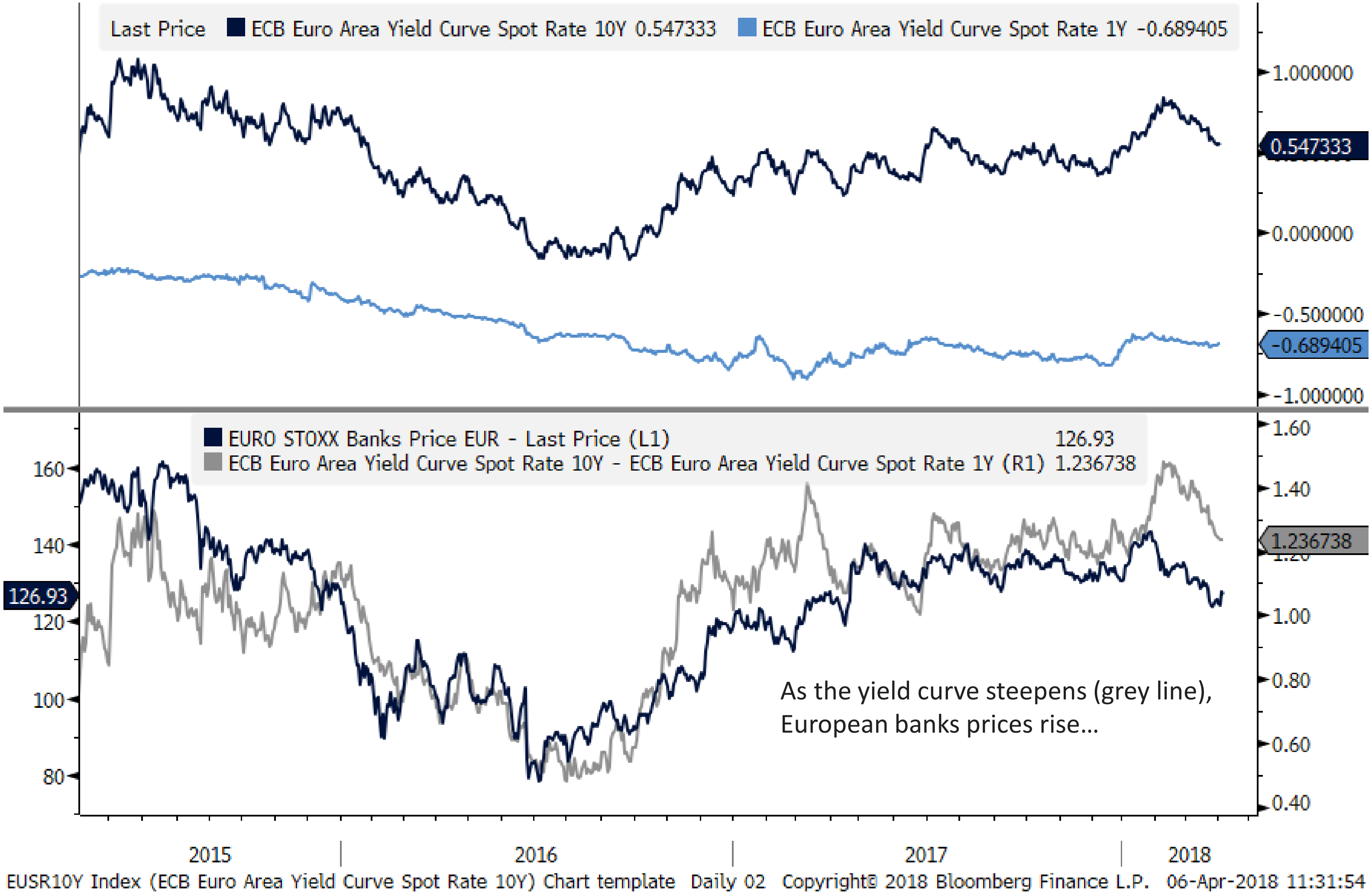
European bond market still extremely distorted and vulnerable

European sovereign yields have only started to readjust to higher inflation. With the latter at 1.4% and 10Y yields at 0.55%, real rates remain at absurdly negative levels. With the ECB scaling back, rates have much further to go. The long end of the curve is most at risk.



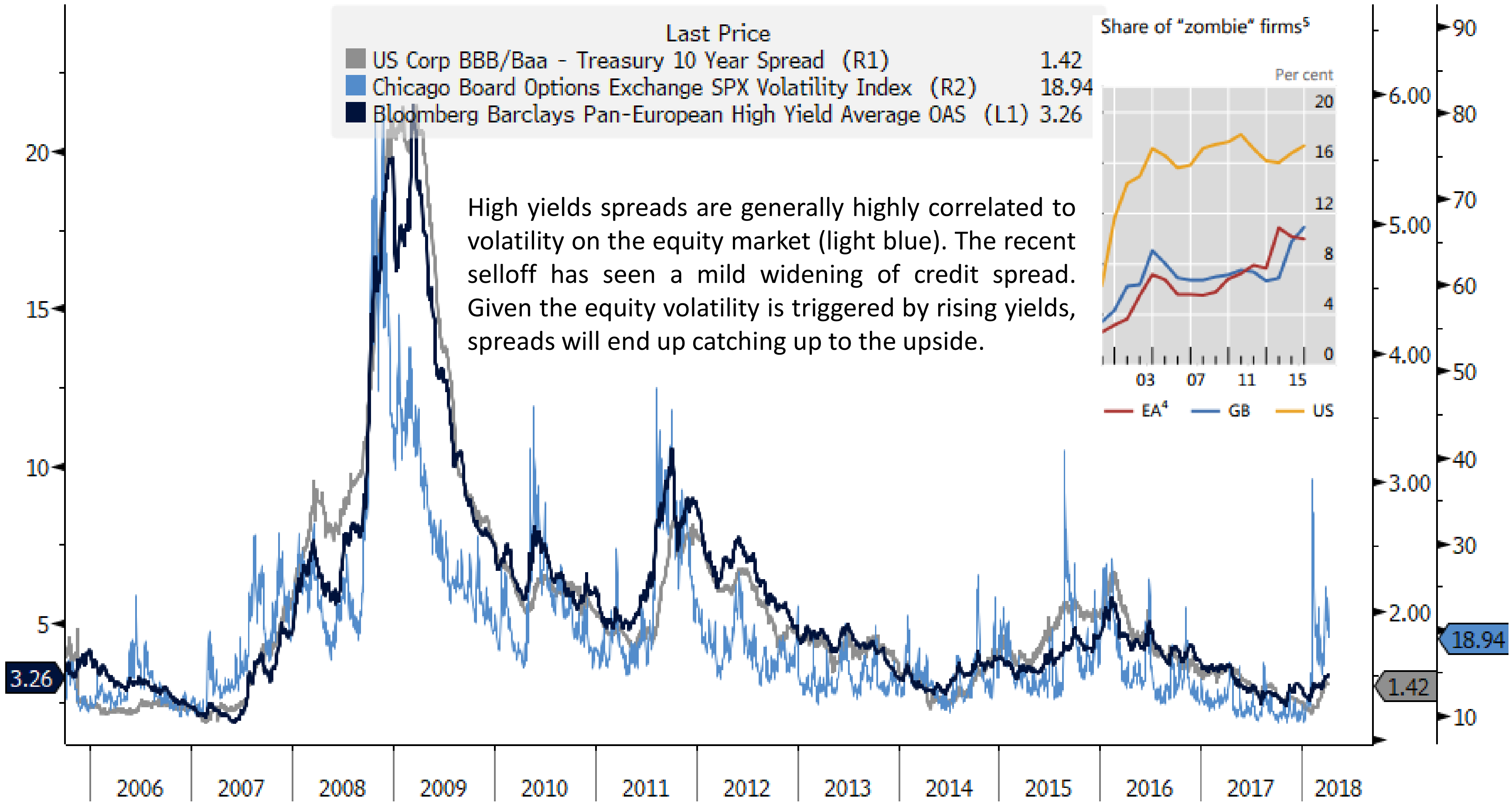
Steepening European yield curve will benefit financials

While the long end of the yield curve will readjust, the ECB will likely keep short term yields stuck to zero (or below) for a while, leading to a steepening yield curve. In this regard, the financial sector should benefit and could be used as a hedge against a further selloff in the bond market.



High yield spreads surprisingly well behaved in the recent selloff

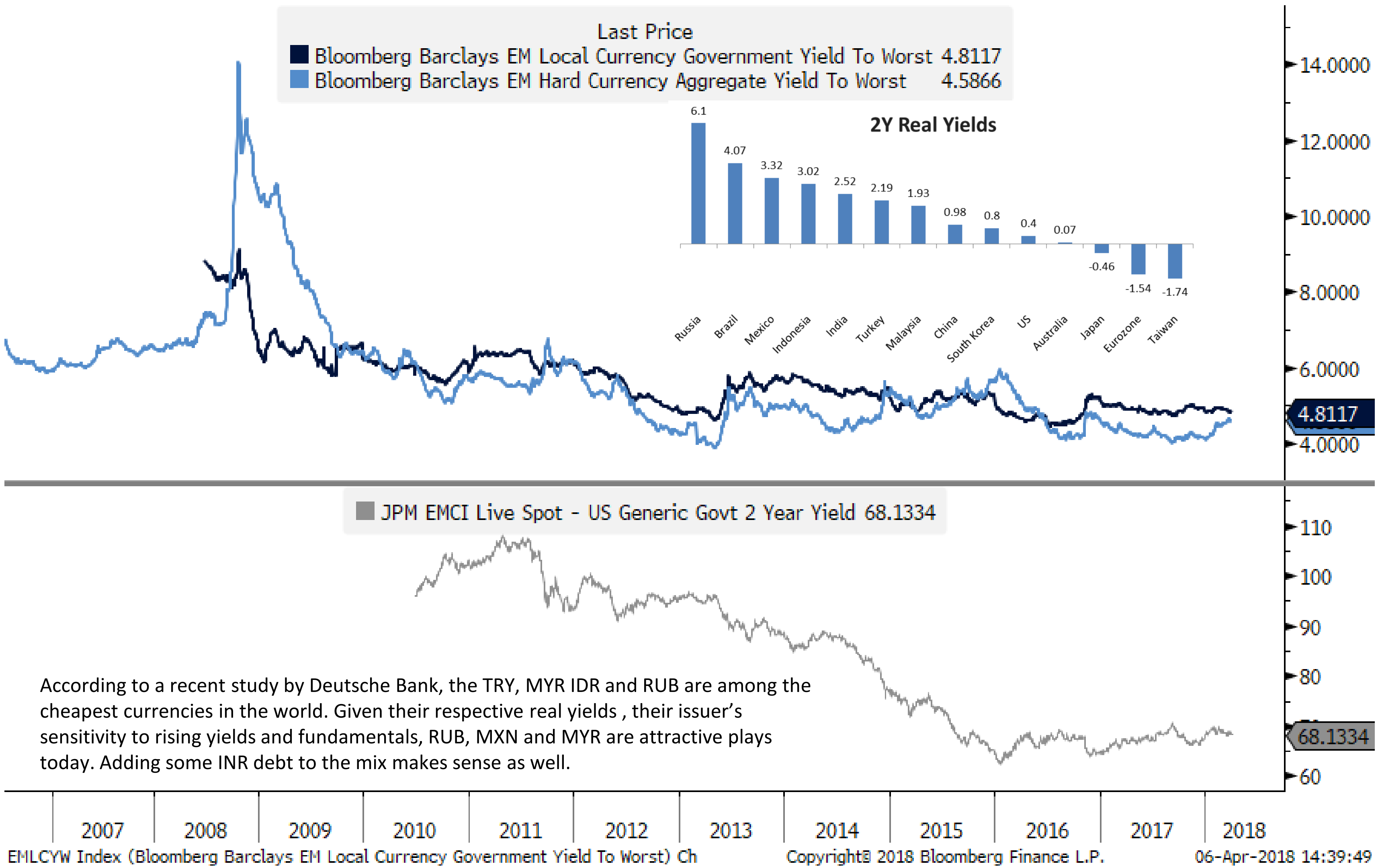
The recent bout of equity market volatility has not seen a significant widening of credit spreads. The credit cycle may not be at its end, given the resilience of global growth so far in 2018, but tightening central banks and the consequent rise of interest rates will inevitably increase default rates given the number of zombie firms, which will end up widening spreads. While a case can be made for holding investment grade corporate debt over government debt, junk bonds are not worth the risk, especially in Europe.



CSI BBB Index (US Corp BBB/Baa - Treasury 10 Year Spread) Chart template Daily Copyright© 2018 Bloomberg Finance L.P. 06-Apr-2018 16:46:29

Cheap currencies and high real yields favor EM debt in local currency

Despite historically low yields on the overall EM complex, some countries offer the combination of high real yields, cheap currencies and sound fundamentals, a much more compelling situation than DM debt.



According to a recent study by Deutsche Bank, the TRY, MYR IDR and RUB are among the cheapest currencies in the world. Given their respective real yields , their issuer's sensitivity to rising yields and fundamentals, RUB, MXN and MYR are attractive plays today. Adding some INR debt to the mix makes sense as well.

Commodities

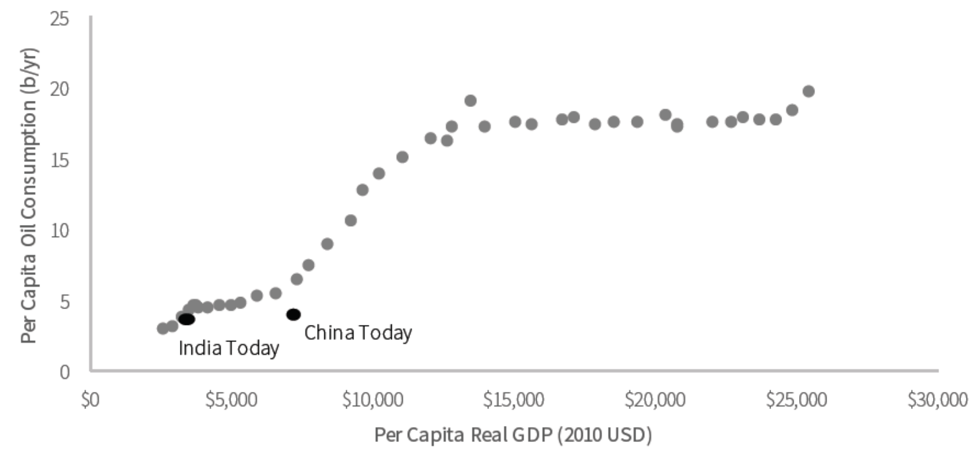
Rising middle class and commodity consumption

As mentioned on slide 36, we are living through the largest expansion of global middle class in history, largely in Asia Pacific.

As GDP per capital increases, commodity consumption rises accordingly. A comparison of the evolution of oil consumption per capital as GDP per capita increases suggests that China's and India's consumption will dramatically increase in the coming years. For example, with GDP per capita at USD 7'500, China's per capita oil consumption stands at 3.5 barrel/year, while India's consumption is below 1.5 barrels/year. South Korea's consumption per capita is over 20 barrels/day and its GDP per capita is USD 25'000.

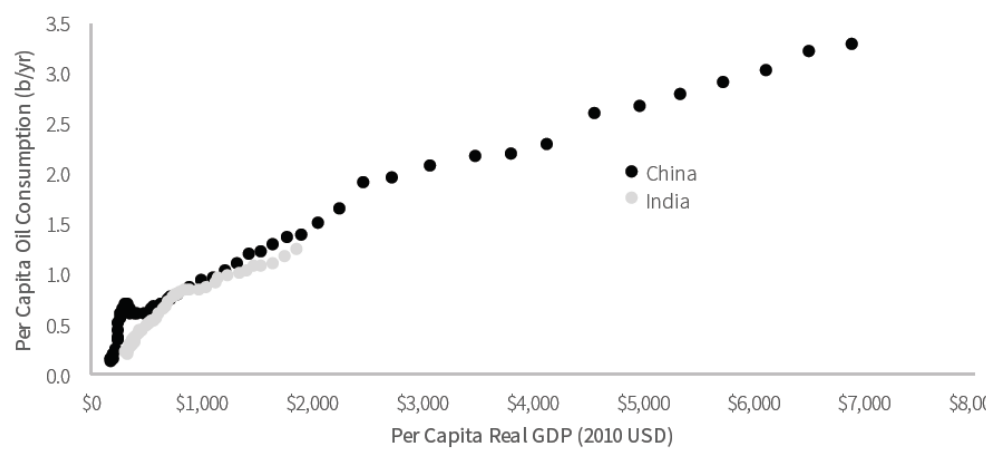
While those charts are focused on oil, one can assume that the consumption of other commodities will rise substantially as well.

CHART 2 South Korea Oil S-Curve



Source: BP Statistical Review, World Bank

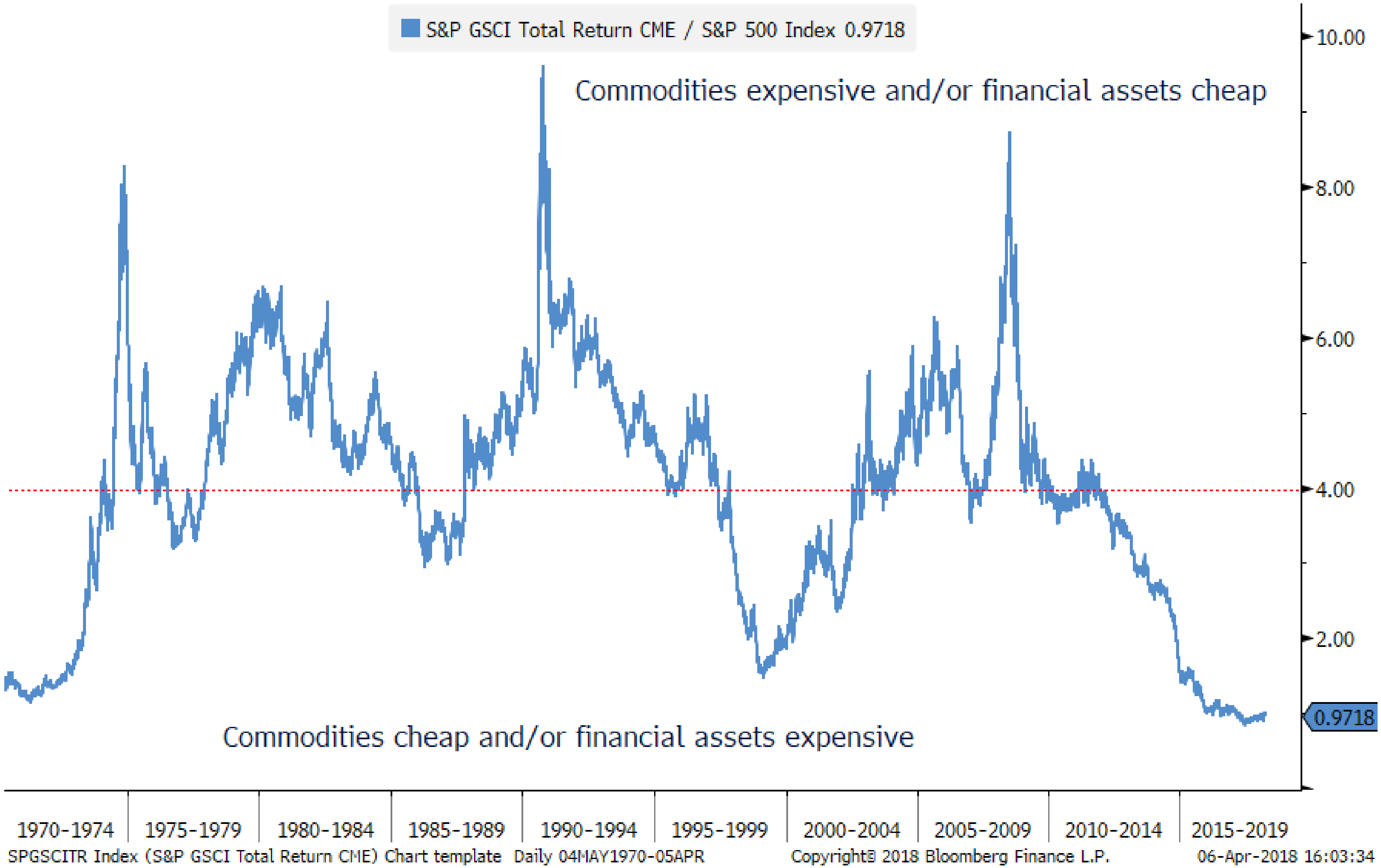
CHART 3 China and India S-Curve



Source: BP Statistical Review, World Bank

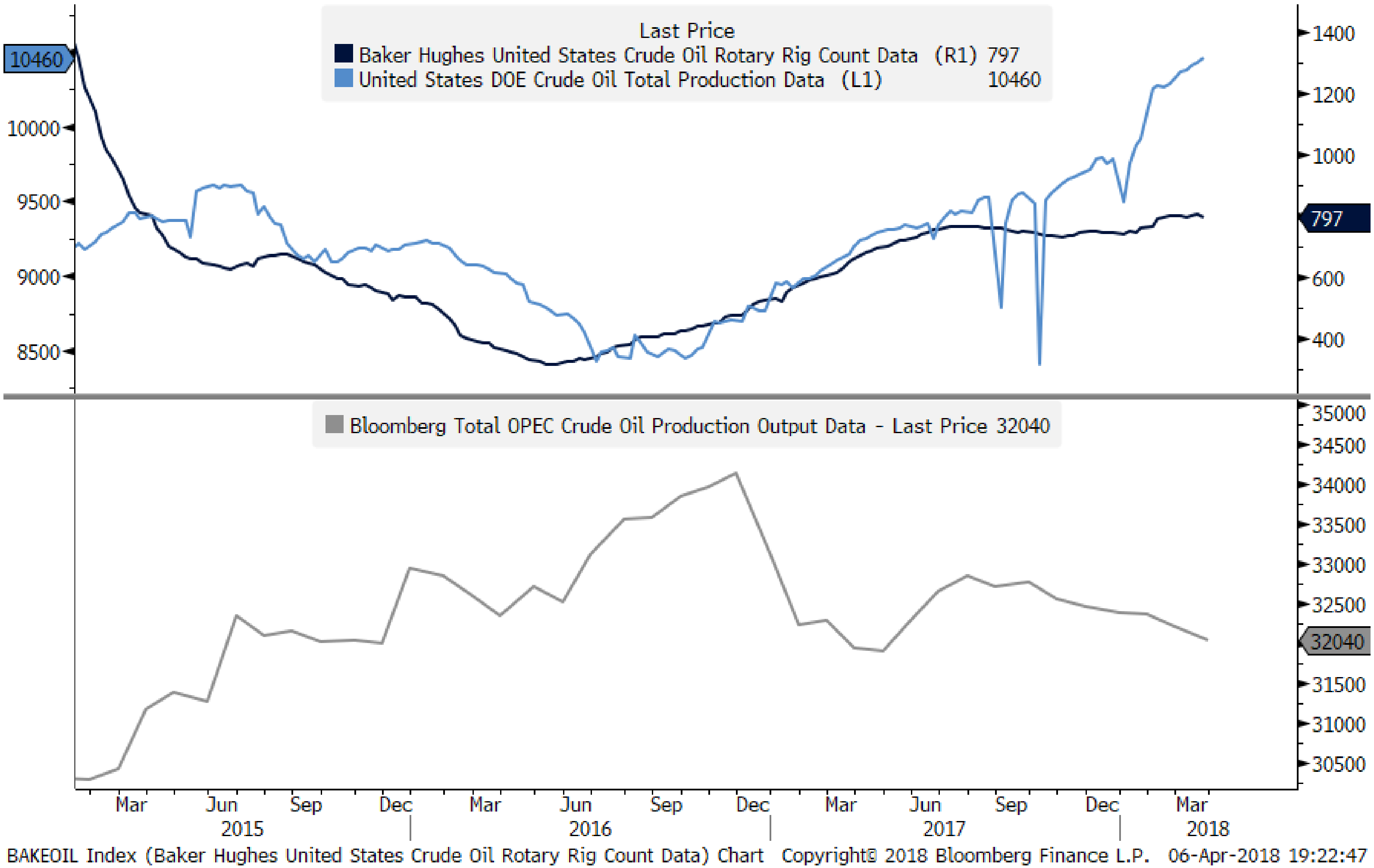
Commodities have not been this cheap vs. the S&P500 in decades

With financial assets on the rich side of valuations, inflation on the rise and commodity consumption likely to increase dramatically in the coming decade, investors should clear some room for this asset class in their portfolio. The time has never been more opportune.



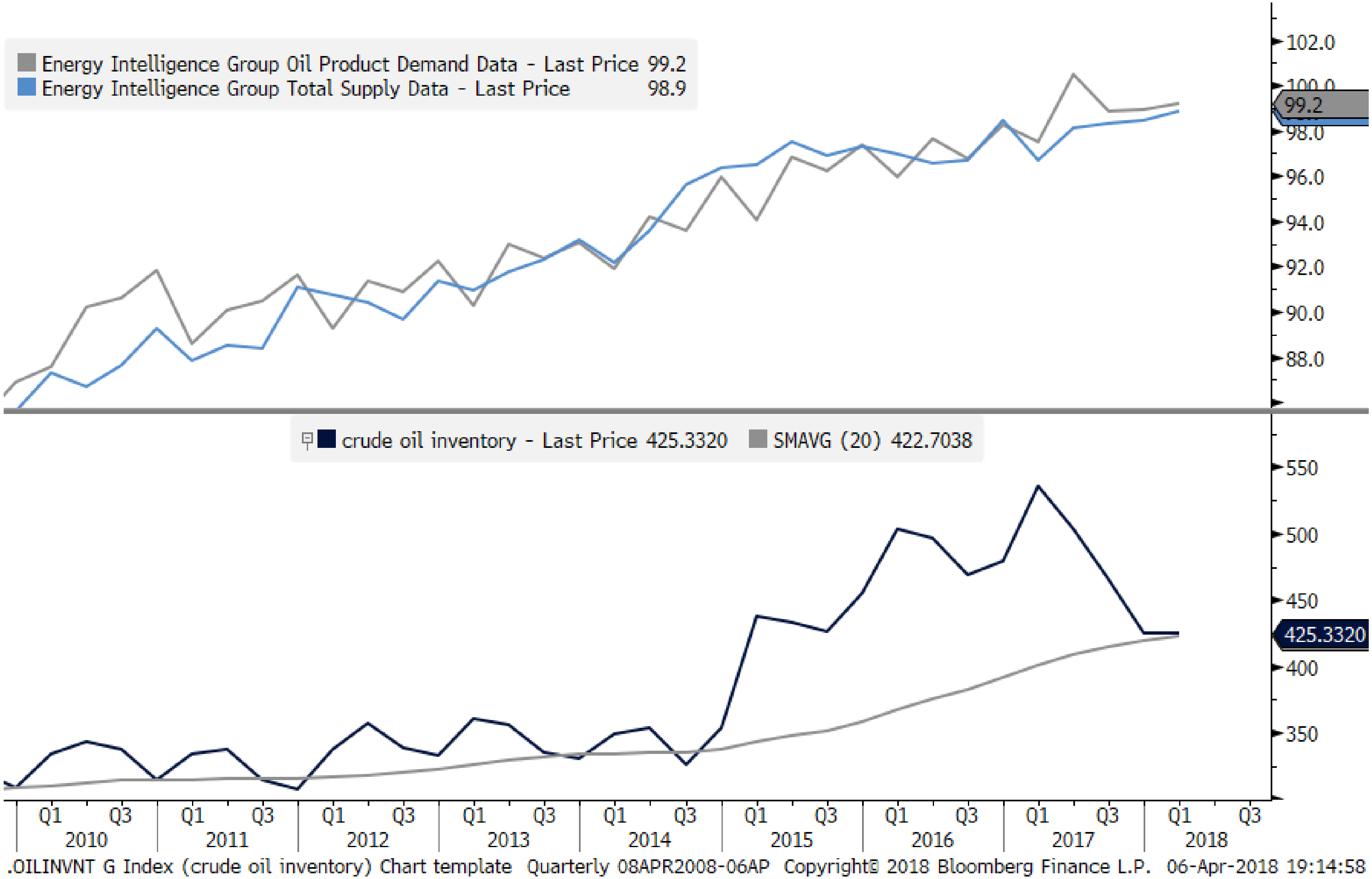
Oil – How long will OPEC make up for US production gains?

As US production rises, OPEC production decreases, keeping a balanced market and supporting prices. One wonders for how long Saudi Arabia will accept to lose market share, as US ramps up exports. The rig count is still rising in the US, albeit at a much slower pace (rigs in certain basins are stagnant). Saudi Arabia could be betting on an eventual slowdown of US production growth.



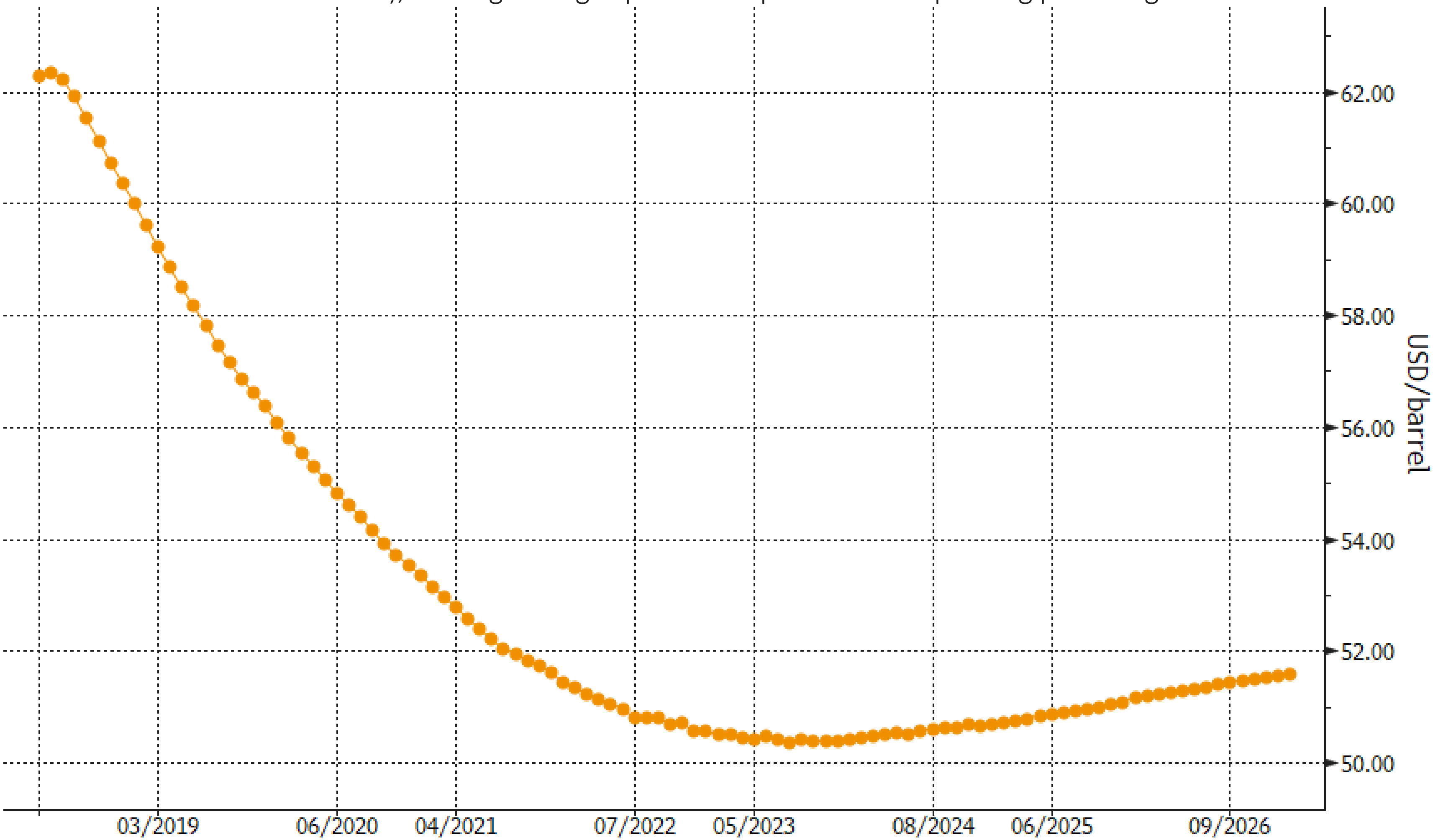
Inventories have come down as consumption has outpaced production

Since early 2017, oil demand has outpaced supply, which has allowed inventories to come back down to their 5 year average, a level that is consistent with oil price around USD 65.



The oil curve remains in backwardation, suggesting short term tightness

When the oil futures curve is in backwardation, contracts further out in time trade lower than the ones closer to the present day. This allows investors and traders to hold position in oil with a positive carry (as they roll from one contract to the next), leading to large speculative positions and pushing prices higher.



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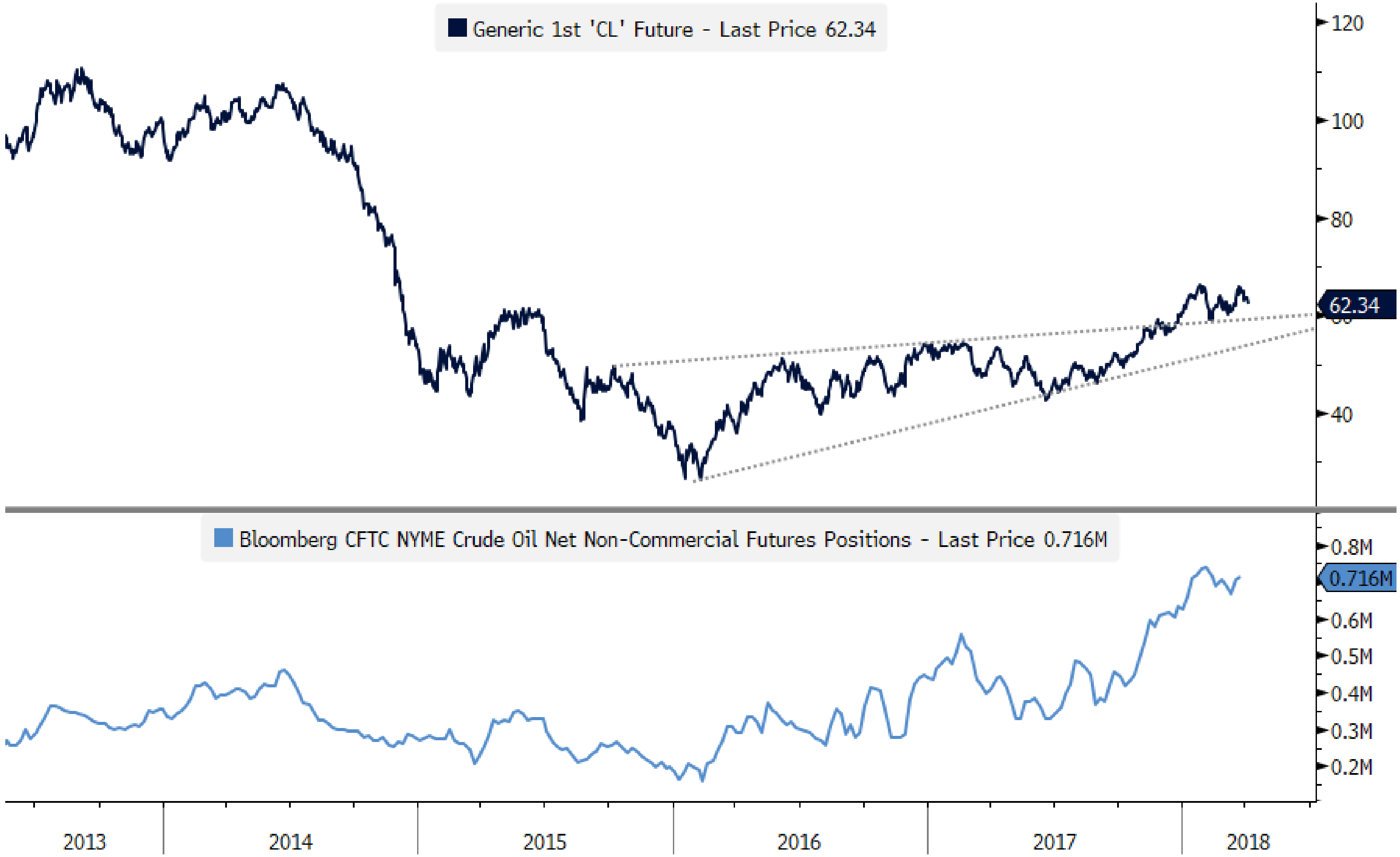
Solid technical and fundamental picture threatened in the short term

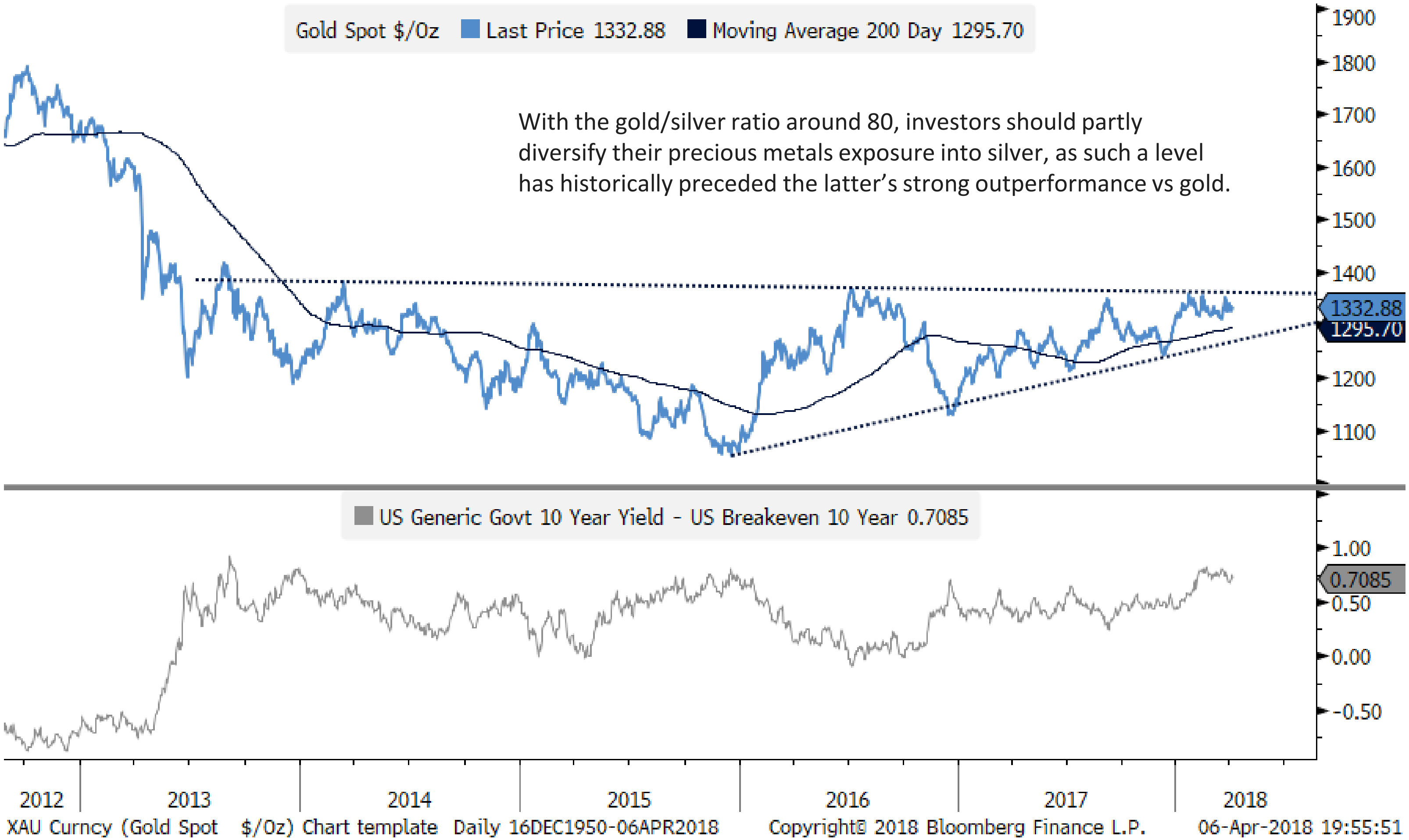
Oil is currently vulnerable to a short term pullback, as speculators have never held a long positioning of this size and prices have likely been pushed higher by rising geopolitical tensions as well. Thus, the slightest disappointment could lead to some profit taking. However, the technical and fundamental pictures are long term positive and oil stocks remain attractive investments at current levels, as they have lagged the market.



CL1 Comdty (Generic 1st 'CL' Future) Chart template Daily 07APR2013-06APR2018 Copyright© 2018 Bloomberg Finance L.P. 06-Apr-2018 19:40:39

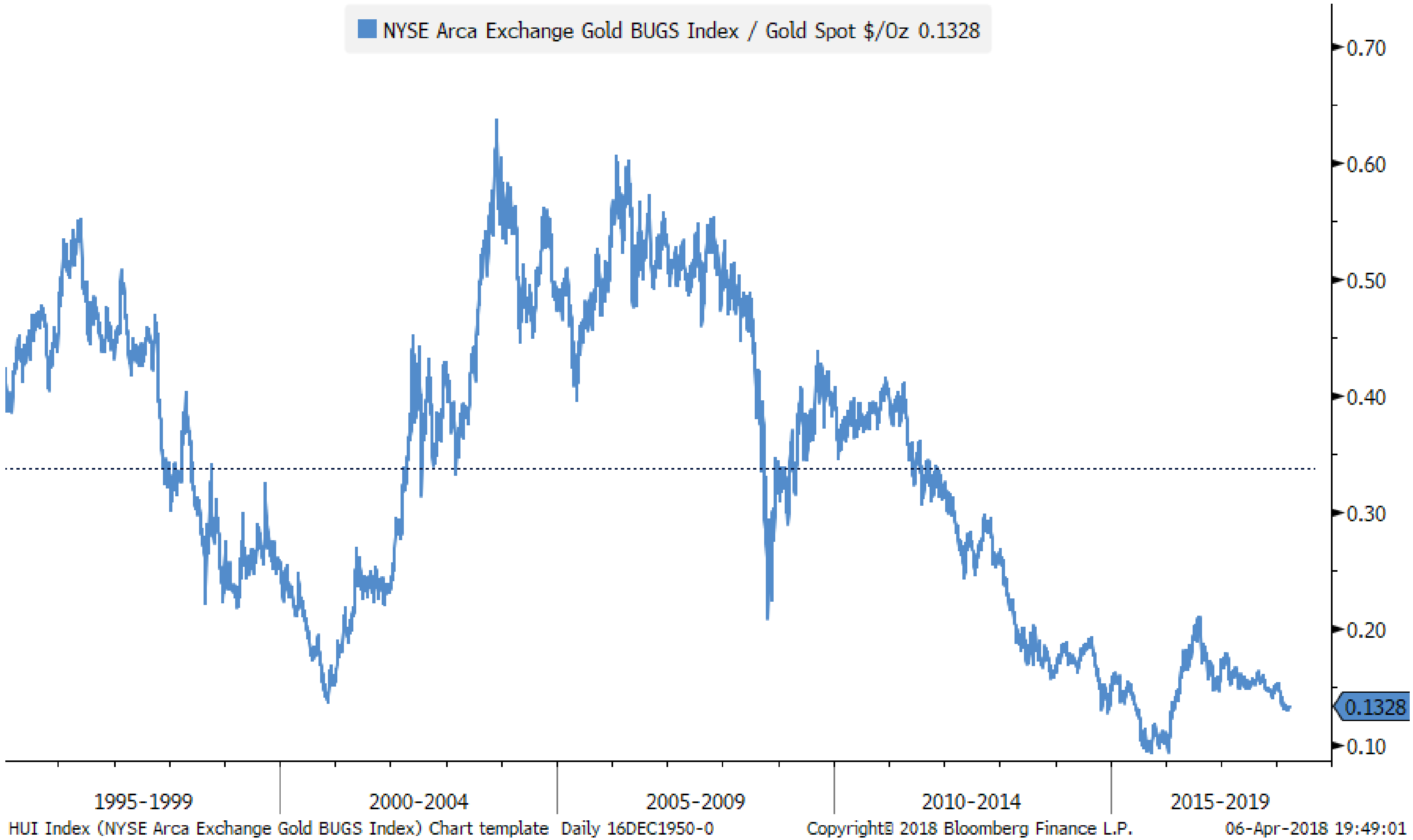
Gold's next leg up likely to occur in 2018

Considering the risks currently present on both equity and bond markets, every portfolio should have a healthy allocation to gold. With governments unlikely to allow real rates to rise durably given the level of indebtedness, investors should take advantage of any pullback toward 1250-1275 to increase exposure to gold. A close above 1380 would suggest the beginning of the next leg up for gold.



Precious metals miners - extremely cheap

Gold and silver mining stocks remain one of the most despised segments of the market. However, with the price of raw materials rising, the fundamentals have improved noticeably; trading at the lowest price to cash flow of the last 30 years. These miners offer one of the most compelling opportunities in the current environment.

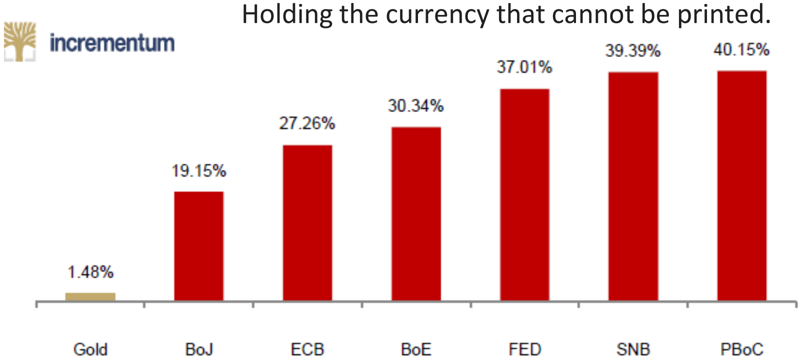


Gold – still the best hedge against systemic risk

Since this graphic was made in mid 2017, the global level has increased to over USD 230 trillion.

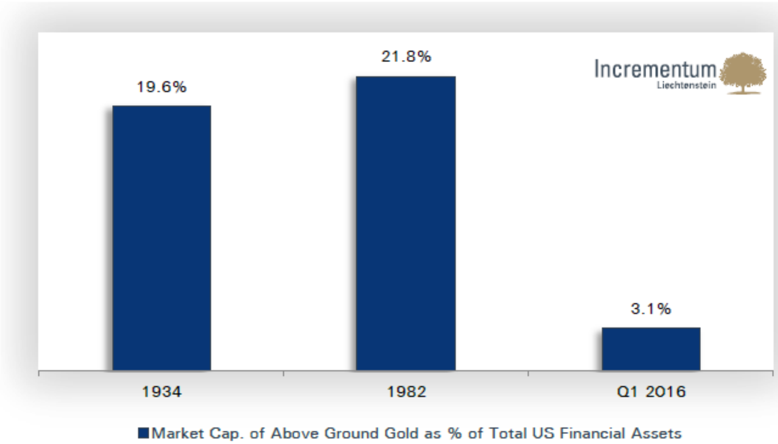
Annualised rate of change of central bank balance sheets vs. annual change of gold reserves (2003-2017)

Holding the currency that cannot be printed.



Source: FRED, SNB, BOE, PBPC, Incrementum AG

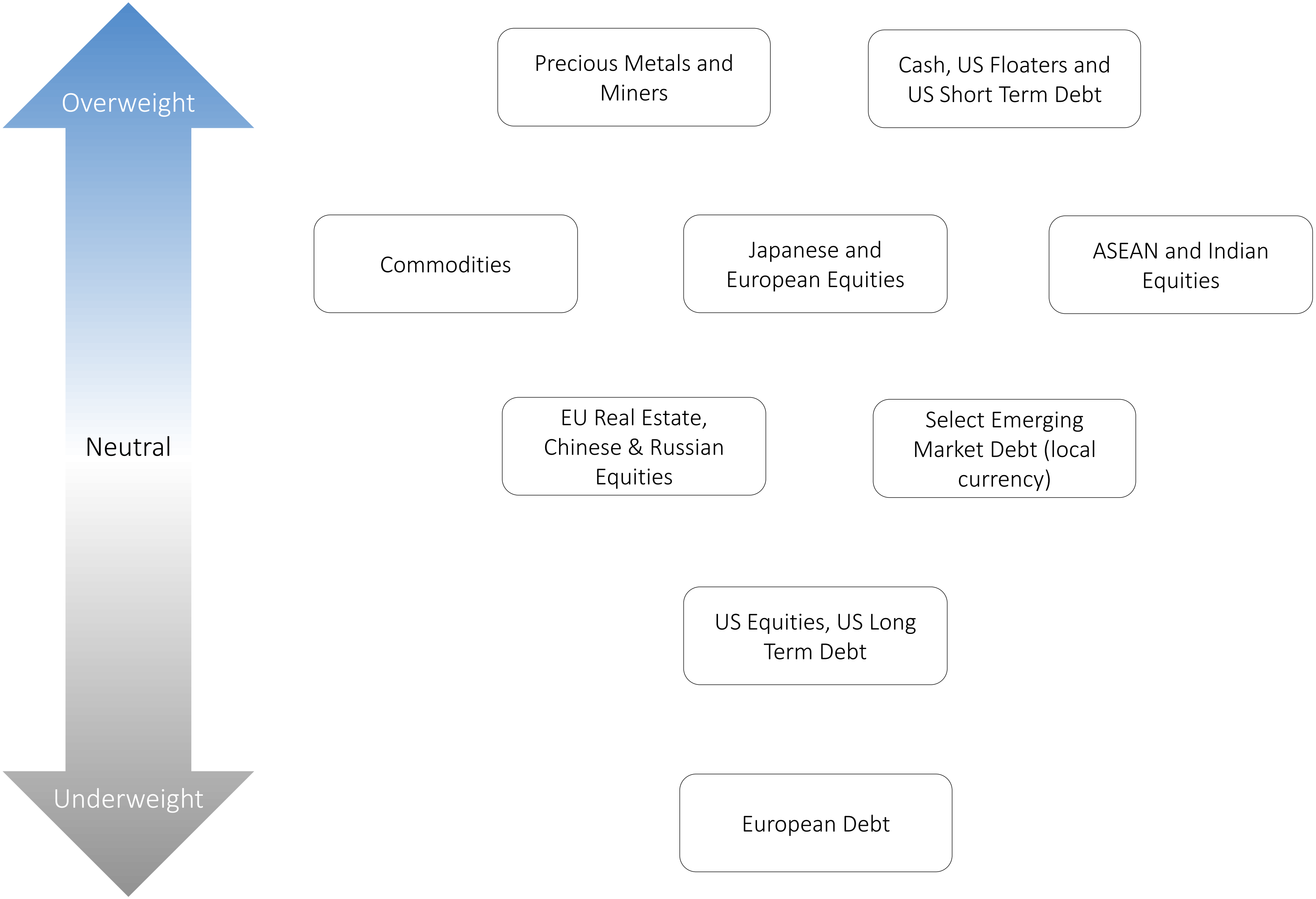
Market capitalization of the global stock of gold in % of US financial assets



Source: Tocqueville Asset Management, Incrementum AG

Our views at a glance

Key takeaways



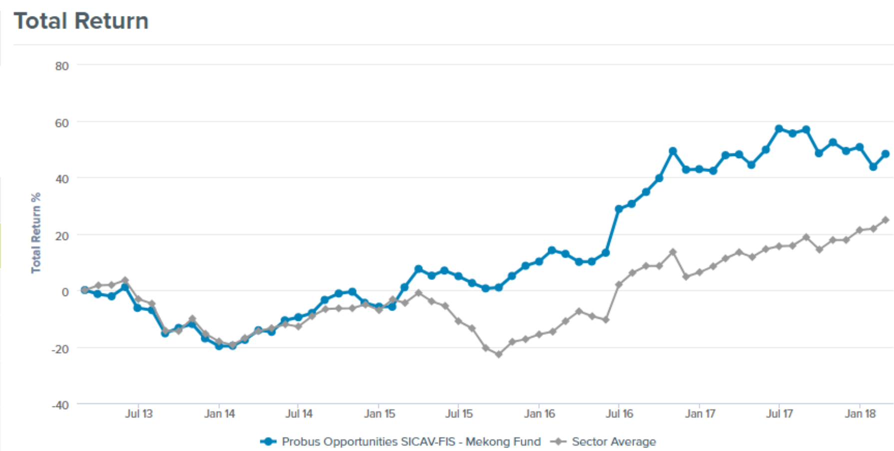
Appendix

ASEAN – Probus Mekong Fund

ASEAN over : 5 years ▾ 28/02/2013 - 28/02/2018

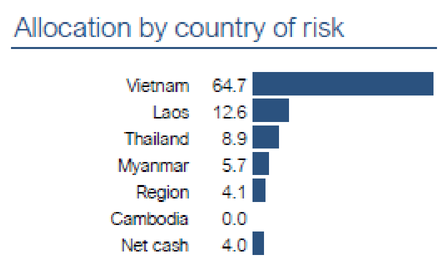
Rank 1/10	Rank 3/10	Rank 2/10
Total Return	Standard Deviation	Max Drawdown

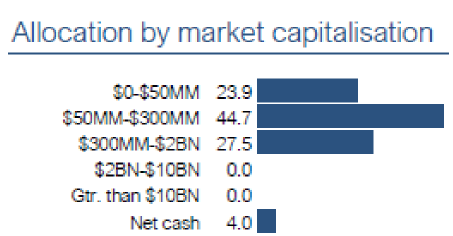
	Fund Name	Currency	Return
1	Probus Opportunities SICAV-FIS - Mekong Fund	GBP	48.2%
2	Waverton South East Asian Fund R USD Cap	GBP	37.6%
3	JPM ASEAN Equity A Acc USD	GBP	35.4%
4	Milltrust ASEAN A Acc USD	GBP	34.3%
5	Baring ASEAN Frontiers A USD Inc	GBP	32.5%

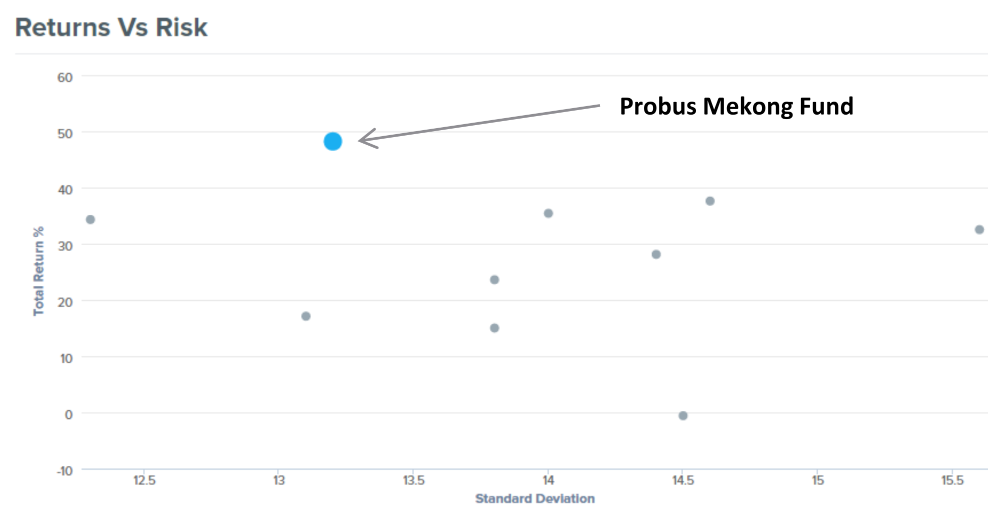


The above data can be found on Citywire .

The Probus Mekong Fund is down 6.6% in 2018. Its compounded annual return over the last 5 years stands at 4.6%, significantly above the 2.7% p.a. delivered by the FTSE ASEAN TR.



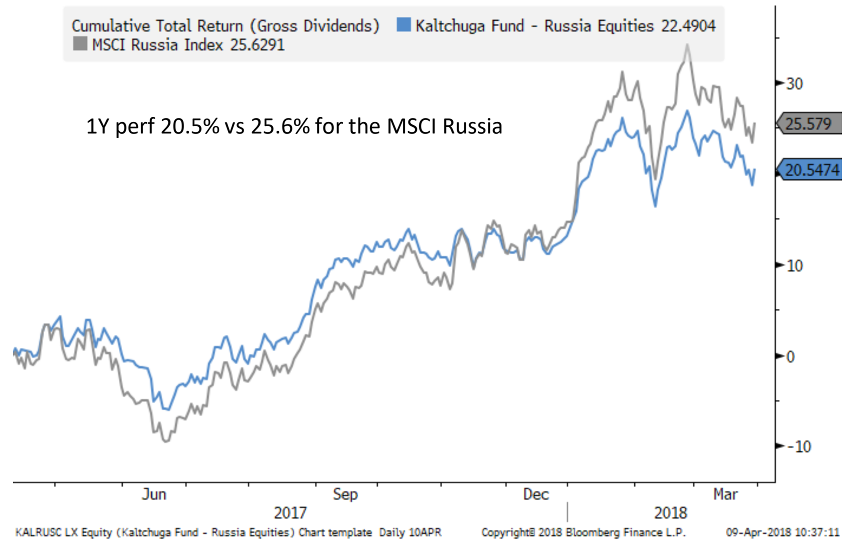




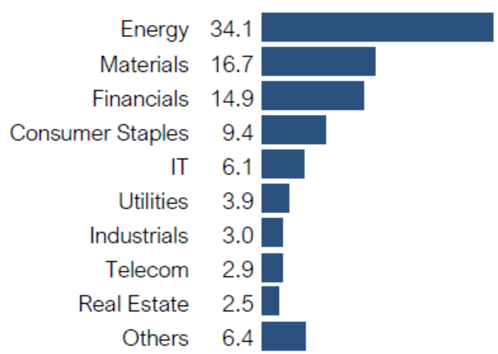
Kaltchuga Russia Equity

INVESTMENT OBJECTIVES (data as at 28.02.2018)

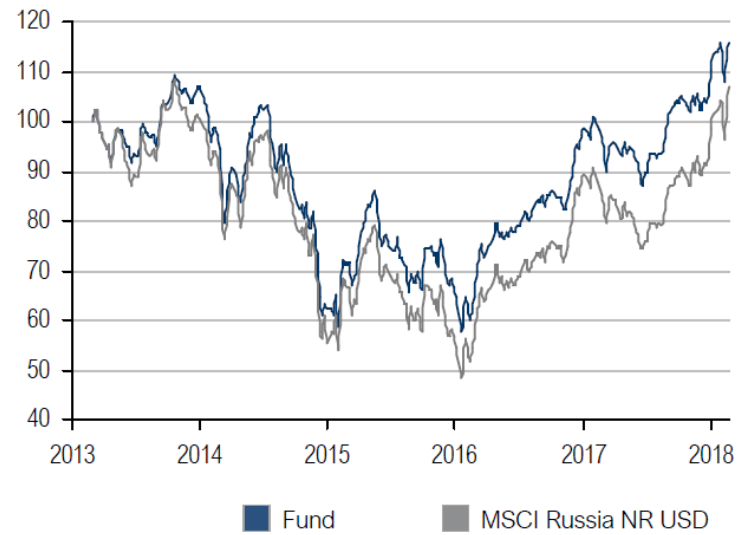
The Fund's objective is to outperform the MSCI Russia and achieve medium to long-term capital appreciation from long-only investments in liquid Russian equities, mainly Blue Chips. The Fund's strategy combines top-down analysis, together with a bottom-up stock-picking approach and doesn't use leverage or derivatives.



Sectorial allocation (%)



Cumulative performance



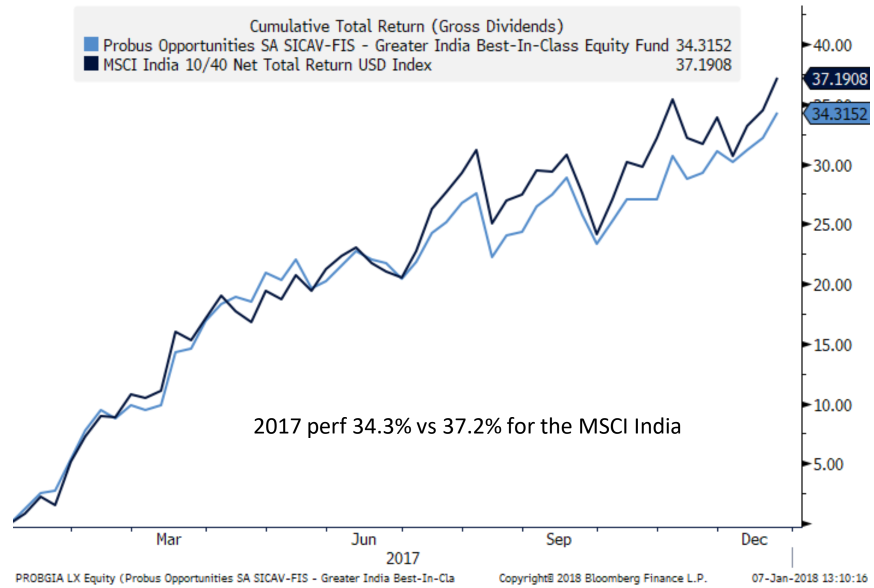
Top 10 holdings (%)

Sberbank	9.7	X5 Retail Group	3.5
Gazprom	9.6	Yandex	3.5
Lukoil	9.1	Magnitogorsk	3.3
Novatek	5.6	Tatneft	3.3
Surgutneftegas	3.5	MMC Norilsk Nickel	3.3
Top 5 positions	37.4	Top 10 positions (%)	54.2

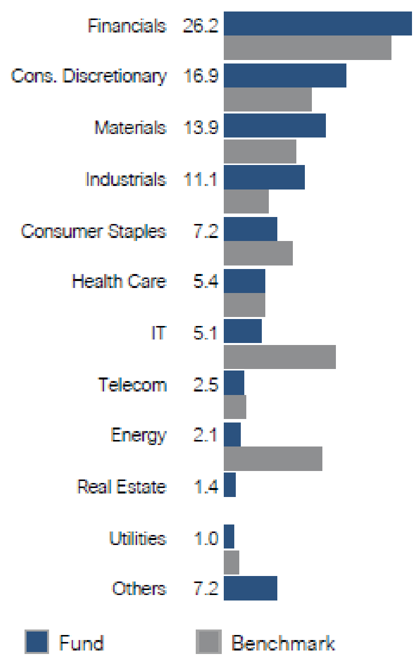
Probus Opportunities Greater India

INVESTMENT OBJECTIVES (data as at 28.02.2018)

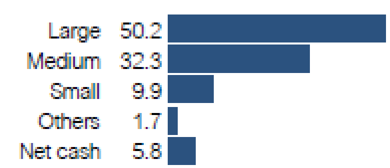
The Greater India Best-in-Class Equity Fund invests in a portfolio of collective investment undertakings mainly exposed into securities of issuers which have their registered office in, are listed in, or carry out the majority of their economic activities in the Greater India region. It's objective is to leverage on local managers' expertise to achieve long-term growth while seeking market opportunities. The fund is benchmarked to the MSCI India 10/40, and will allocate its assets between core and satellite funds in the region.



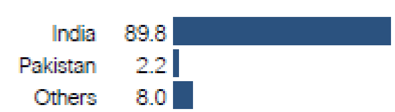
Sectorial allocation (%)



Market cap breakdown (%)



Geographical allocation (%)

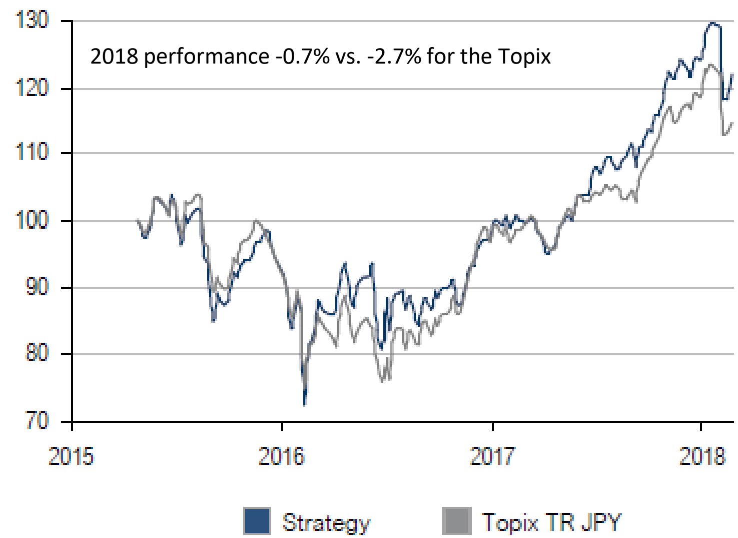


Saisei Japan Opportunities Fund

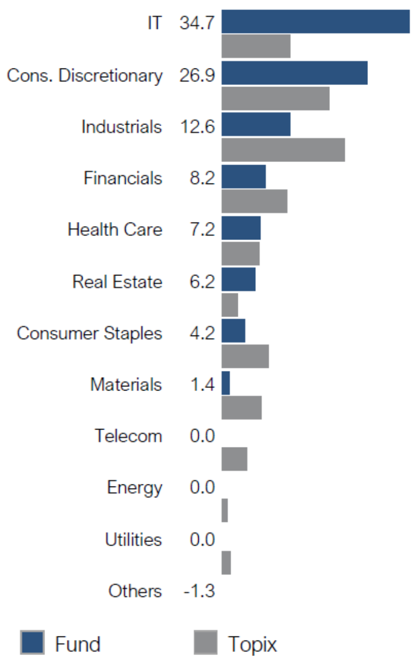
INVESTMENT OBJECTIVES (data as at 28.02.2018)

The IGNI SAISEI JAPAN OPPORTUNITIES Fund is a long-only open-end fund incorporated in Luxembourg. Its objective is to carry out long-term investments, and to generate capital gains. The Fund seeks returns on an absolute basis in Japanese equities listed exclusively in Japan. The approach is both thematic and bottom-up, with high conviction selection and no more than 35 names in the portfolio. It is benchmark and sector agnostic. The Fund offers great flexibility among market caps in which it has no limits, though it tries to keep a certain balance to capture market directions.

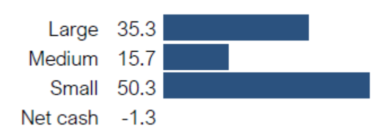
Cumulative performance



Sectorial allocation (%)



Market cap breakdown (%)



Top 10 holdings (%)

Alps Electric Co Ltd	5.6	Investors Cloud	3.7
Sony	5.5	United Arrows	3.7
Sumitomo Mitsui Financ	5.3	V Technology	3.4
Murata Manufacturing	5.2	Konica Minolta	3.3
Gurunavi Inc	4.6	ABC-Mart	3.0
Top 5 positions	26.2	Top 10 positions (%)	43.3

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