

OPPORTUNITIES AND THREATS IN 2018



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SUMMARY

Looking ahead in 2018, we consider the impact of inflation and geopolitics to investments, examine the valuation level of assets and assess the risk of the market, in order to establish the key factors that could impact returns for this year.

2017 was on one hand an uneventful year, with equity and bond markets maintaining their upward trend. On the other hand, there were several macro and market events that could have derailed the near-decades long bull market, such as the ever-challenging Brexit negotiations, presidential elections in France, political uncertainty in Germany, unrest in Spain's Catalonia region, rates hikes in the U.S. and of course North Korea.

How will markets fare in 2018 and what does the global economy have in store for investors? Positive growth, accommodative financial conditions and supportive sentiment point again towards a second year of synchronized above trend global growth next year, while inflation will remain a focus point as it will shape monetary policy normalisation speed and magnitude going forward. The members of SYZ Asset Management Investment Strategy Group take a look at key important factors that could impact investor returns in the New Year, by focusing on Macroeconomics, Asset Valuations and Risks.



MACROECONOMIC ANALYSIS

While there are many factors that could impact the global economy from a macro-perspective, we believe that inflation and geopolitics are the greatest threats to risk assets in 2018.

1. **Inflation** has remained stubbornly low in the last decade, despite exceptionally accommodative monetary policies. In large part, this is due to structural factors such as demographic changes, globalisation or technological innovations. Moreover, the legacy of the Financial Crisis on growth has persisted and began to dissipate only recently in Europe.

In the current, more favourable economic backdrop, central banks are now hinting toward normalizing their policies, with the Fed leading the way. Given the support risk assets have derived from those accommodative policies in the past years, markets will be highly sensitive to any news that could encourage central banks to move faster than expected. Therefore, even just modestly higher inflation could spark sudden repricing of equity and credit markets. Investors should be wary of this risk and protect their portfolios accordingly.
2. **Geopolitics** is the other area of concern. By mid-2018, the terms of any Brexit agreement (or lack of) will be clear. Should the ultimate divorce be a messy one, this would certainly be risk-off for the UK and could have broader regional implications. The Italian elections also loom on the calendar of risk-events in 2018. At this point, the election could really go in any number of directions. This degree of uncertainty – one of the world's most indebted economy – may not bode well for risky assets. Finally, any conflict on the Korean Peninsula or in the Middle East would most

certainly be a negative event. Our base case is that none of these situations is likely, but the lack of clear visibility and greater-than-limited chance of a miscalculation should be factors in investors' asset allocation decisions.



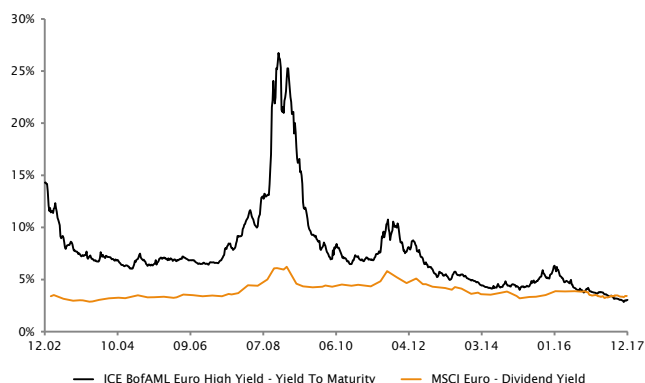
ASSET VALUATIONS

Asset valuations is another area investors need to be mindful of in 2018 and beyond. What makes valuations so dangerous is the fact that as long as the macroeconomic environment is good, investors don't pay too much attention to them. Yet, even where there are only mild changes to the overall market backdrop, investors may all of a sudden start paying a lot of attention to valuations and the fact that almost everything is expensive.

Looking at bond markets, everyone knows that western government yields are low. But it is not the government bond segment where the majority of frothiness in valuations transpires, it is corporate credit. After years of loose monetary policy and investor's desperate hunt for income, high yield markets and in particular European High yield has become the single most expensive asset class in the world.

Here in the chart we see that the yield of European high yield bonds shown in black is below the dividend yield on the MSCI Euro shown in orange. In an environment where inflationary pressures are mounting and question marks over the ECB's monetary stance are increasing, European high yield bonds at these valuation levels are vulnerable.

European High Yield vs. European Equity Dividend yield

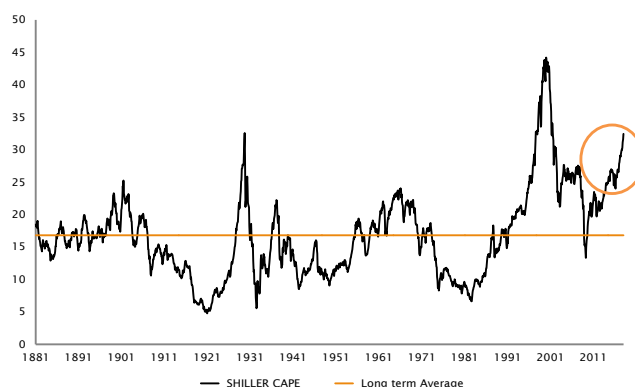


Source: Factset
Data as at: December 2017

In investor's minds equities are at the moment the asset class of choice. And indeed while bonds are expensive, equities are in comparison closer to fair value. This is obviously a relative argument, but when looking at equity valuations in absolute terms the picture looks very different.

Taking the S&P 500 as an example, Robert J Shiller a Yale professor and Nobel laureate has created a time series called the Cyclically Adjusted Price Earnings ratio (CAPE). The aim of this CAPE measure is to provide an objective framework to compare equity valuations over the long term. This measure is currently at a level above 32 compared to a long-term average just under 17. The only other times when this measure was that high was in 1929 shortly before the stock market crash and in 1999 during the dot-com Bubble.

Shiller Cyclically Adjusted Price Earnings ratio



Source: Robert J. Shiller, "Irrational Exuberance" Princeton University Press 2000, 2005, 2015, updated (<http://www.econ.yale.edu/~shiller/data.htm>)
Data as at: November 2017

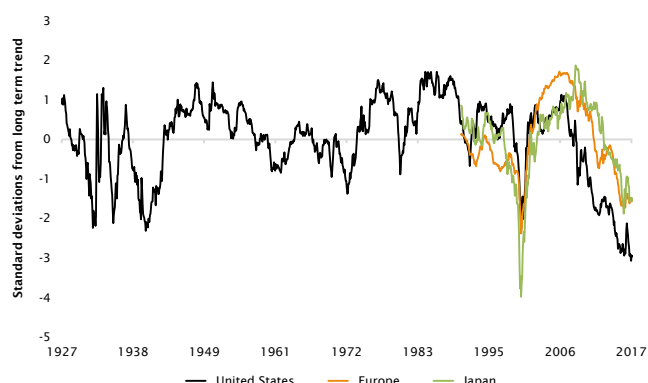
While it is true that valuations can stay elevated and even stretched for a long time, the important point here is that if sentiment towards equities turns negative, valuations will clearly not provide a cushion to soften the impact. That said, within equity markets there is significant dispersion of style and sector preferences. While a few areas are in vogue, other areas are completely neglected by investors.

A very good example of this is the relative dispersion of value versus growth stocks. In order to illustrate the long term history of value versus growth factors we use the famous Fama-French HML factor, which shows the relative performance of stocks with high book to market ratios versus low book to market ratios, i.e. value versus growth. The chart below shows the deviation of value versus growth stocks relative to their historic trend.

The U.S., shown in black, has a data history going back to the 1920s. What we can see is that today the value growth dispersion relative to trend amounts to 3 standard deviations. To put this in perspective, this is a one-in-370-year event and we are in the middle of it. The value-growth dispersion for Europe in orange and Japan in green is less extreme but also still there.

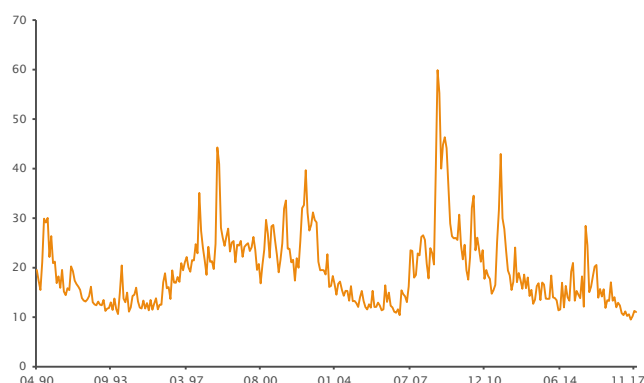
One has to bear in mind that the stark outperformance of growth over value coincided with a time period of very loose monetary policy, where access to credit to support further growth was cheap.

Fama French: Value versus Growth differential



Sources: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html,
SYZ Asset Management
Data as at: October 2017

Volatility Index



Source: Bloomberg
Data as at: 29 December 2017

Going forward, the path of monetary policy looks clearly different, which could trigger shifts in investor preferences. Given the extremes that we face, the risks of sudden style or sector rotations in different segments of the market, not only growth and value, is very high.



RISK ASSESSMENT

From a purely quant perspective and risk standpoint, markets seem to be behaving too well despite, in many cases, very stretched valuations, which indicates very little buffer and places to hide in the event of market dislocations.

A casual look at the VIX Index (top right), which reached an all time low, would give investors the false impression that there are no storm clouds or virtually any clouds on the horizon. Like if risks would have been suppressed from financial markets

A key milestone for investors in 2018 is to reconcile the inherent underlying risks to financial markets against the fact that market indicators appear to show they have disappeared.

Our base case is that we expect there will be at least one healthy market 'correction' in 2018. The concern would be to what extent such a market correction spreads. Leverage in the market will become clear as will the degree of confidence in the bull market. A risk-centred approach would be well warranted at this stage in the cycle. Markets may indeed continue to move higher, but the asymmetry is turning increasingly unfavourable at each new market high.

CONCLUSION

2018...ONE MONTH AT A TIME

Plans are nothing. Planning is everything. And so we have quite clear views of what could positively or negatively impact market returns in 2018. Much like last year or 2016, our longer views as well as our tactical positioning will be shaped by our in-depth monitoring of the economic backdrop, the valuations assessment of a large range of asset classes and a close attention to the various form of risks (intrinsic, across assets or within a balanced portfolio). With so many key events and outcomes still unclear at this stage, one cannot take a high conviction/or any directional view without an exposure to risk.

As a result, our approach will continue to find the best risk-adjusted positioning as well as instruments or creative ideas exhibiting favourable asymmetry - where our potential upside is far more attractive than any potential losses.

There are very likely to be interesting entry-points in the year to come, with some of the currently more expensive assets experiencing an overdue correction. In this way, 2018 may be somewhat different than 2017. As usual, we will be looking to deploy capital not following the market, but by identifying mispriced assets.

In this sense, whether inflation does spike, credit spreads widen, technology companies experience a re-pricing or any other unknown macro or market risks appear, our positioning will be one that allow for a close look at the dislocation and potentially find value that can be realised. This is what investing is all about and what we have been doing for the last 20 years and will do again in 2018 and beyond.