Q1 2018 INVESTMENT OUTLOOK: OPTIMISM, COMPLACENCY OR FROTH

Global markets had a solid performance in Q4 following an upward revision in global, synchronized economic growth. Expectation for stronger growth was due to stronger corporate earnings in the US, a tax cut and reform, benign inflation signs, extremely low volatility in global risk assets, Fed gradual and slow albeit constant rate hike, European activity and inflation read better than expected, Japanese corporate earnings stronger after weaker yen and continued stimulus, China's service market reforms and deleveraging efforts avoiding slowdown in activity, supporting therefore most of the industrial commodity space, healthier structural reforms in most Emerging Market countries supported in part by a weaker USD, and ongoing extreme policy accommodation by major global central banks.

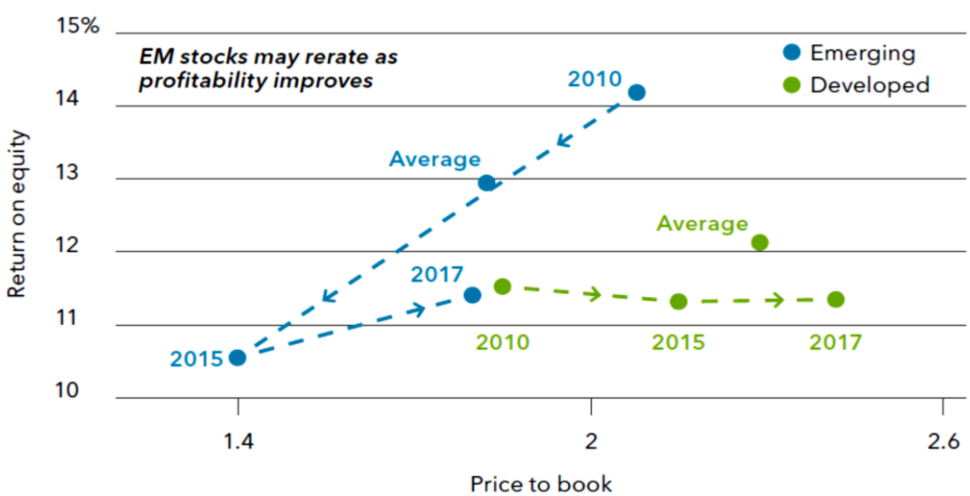
Equities

We still favor financials and technology, consumer discretionary and industrials. The US tax overhaul, the Fed's gradual but patient rate hikes and strong growth oversees are positive catalysts for continued low volatility in the next quarter. We are also overweight in European and Japanese stocks, especially in financial, consumer discretionary and industrial sectors, given European better than expected recovery in activity and Japanese resistant consumer spending.

Momentum strategies in earnings and dividend growth have still room to advance, however at a slower pace as investors get more skittish on future bullishness. Value strategies on the other hand, become increasingly attractive as some sectors (e.g. energy, telecommunications) and regions (e.g. Asia ex China, Brazil, Russia) play catch up and start benefiting of accommodative central banks, cyclical recovery, structural reforms and lower currency volatility. Investors should evaluated more cautiously any leveraged, high dividend or short volatility strategies and be more selective in the timing, horizon and idiosyncratic risks. We recommend shorter tactical horizons of not more than 90 days for these types of moves.

Emerging trends

EM vs. DM return on equity and price-to-book ratio, 2010–2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters and IMF, November 2017. Notes: The chart shows return on equity and price-to-book ratios for EMs and DMs. EM is represented by the MSCI Emerging Markets Index and DM by the MSCI World Index. The averages are based on the period 2000–2017.

Source: Blackrock Investment Institute

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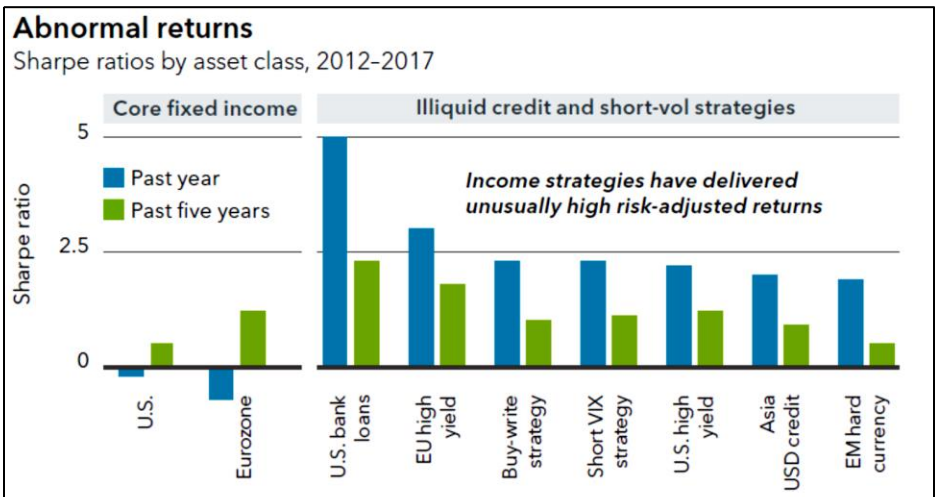
Rates and Credit

G7 government bonds yields in have moved higher in the last quarter, reflecting strong global growth momentum and a pick-up in activity that supports risk assets. We expect this trend to continue at least through mid-2018. Long term investors (i.e. pension funds, insurance companies etc) continue to be thirsty for yield and any further selling pressure in the long end of the curve will meet a pretty large demand. Persistent weak wage pressure in the US and the rest of the developed world, mainly driven by cyclical factors such as the shifts to sectors and industries with continued idle factory capacity, lower global yields, shifting demographics that favor higher bond purchases as well as more structural and deeper changes in the quantity and nature of the workforce as a result of the alarming rate of technological change, dampens any temporary selling pressure in the market. Furthermore, we do see the market pricing in more Fed gradual but determined tightening in the shorter end. Therefore we don't see an extreme move in steepening of the USD curve in the next few months. Nonetheless, there are some troubling issues facing the treasury markets in the near future that places greater skepticism and uncertainty on investors, so they should be warned ahead of any temporary bouts of volatility. Higher market implied inflation expectations in recent months, lower demand of Treasury debt from China and Japan, higher expected consumer spending due to the tax cut reform, higher projected government deficits in the coming years, higher trade restrictions with higher impact in import prices in the US and US assets due to a weaker US dollar are some of the issues that can materialize in higher long term yields.



Past performance is no guarantee of future results. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Bloomberg, November 2017. Notes: The Sharpe ratio is the average weekly excess return divided by the volatility of returns. Indexes used: Bloomberg Barclays U.S. Aggregate, Bloomberg Barclays Euro Aggregate, S&P/LSTA Leveraged Loan, Bloomberg Barclays Pan-European High Yield, CBOE S&P 500 BuyWrite, S&P 500 VIX Short-Term Excess Return MCAP, Bloomberg Barclays U.S. Corporate High Yield, J.P. Morgan JACI Diversified (Spread Return), J.P. Morgan EMBI Global Diversified (Spread Return).

Source: Blackrock Investment Institute

As such, we recommend shortening the duration of bond portfolios and going up the credit and liquidity curve to absorb any issuer deterioration and minimize the impact in performance, especially in the high yield space. We are underweight US municipals, mainly because of the new tax reform and higher state and municipal deficits, as well as US high yields as valuations continue to be high and liquidity a concern on any spike in volatility. Likewise in European sovereign and corporates, where the ECB recent signals of reduction in stimulus can pull core Eurozone and corporate yields up but compress peripheral governments spreads. Extreme negative yields have increase the attractiveness of US dollar currency-hedged EUR denominated credits (i.e. long USD/short EUR cross currency hedges being deep in the money).

We are overweight in EM debt as weaker dollar, global growth inflation targeting and market reforms are all positive for further downward pressure in yields, but the sector especially in the sovereign sector is richly valued. For those investors feeling comfortable with Argentine sovereign credit and convertibility risks, we recommend a short term synthetic play in argentine central bank issued bills hedged in USD, allowing you to monetize a 5% annual return on one month (i.e. rollover and carry of a long position of a 30-day ARS dominated LEBAC hedged with a 30-day USD/ARS future position, minus applicable commissions and capital gains tax on the futures leg).

FX and Commodities

We are still bearish on the USD for the next few months as global geopolitical risks subside and central bank divergence narrow as global growth solidifies in the Eurozone, Japan, China and other major EMs. EURUSD is also well supported by lower political turmoil in peripheral economies at least for the coming months and we see its resistance at 1.25 as it might be a drag to the nascent recovery in the area. We are also attentive and recommend moving cautiously as Italy, Spain, Portugal and Greece could cause further disruption to the establishment in coming elections and other reform attempts, as well as Brexit negotiations taking a harder tone and causing instability in other regions of the EU.

Although there are major risks to the downside in the GBPUSD stemming from a hard Brexit negotiation in the coming months, we believe the Bank of England is well position and has given strong signals it is ready to act and pump more liquidity in the market in order to keep inflation in check and, at the same time, benefiting from a weaker pound tailwind.

As the BOJ is committed to anchoring the longer part of the curve, with the hope of keeping real yields positive but still injecting a massive amount of stimulus to its economy, we still see USDJPY range bound between 114 and 109.

As the commodities outlook has improved and stabilized, we are still recommending long carries in the NZD and the AUD versus CHF and the EUR.

Interest rates Jan 2018

Carry Pair	Direction	Yield %	↓ ↑
NZDCHF	Long	1.56%	
EURNZD	Short	1.21%	↑
AUDCHF	Long	1.15%	
NZDJPY	Long	1.05%	↑
USDCHF	Long	0.99%	↑
EURAUD	Short	0.83%	
EURUSD	Short	0.79%	↑
AUDJPY	Long	0.65%	
GBPNZD	Short	0.65%	
CADCHF	Long	0.62%	
USDJPY	Long	0.46%	↑
GBPCHF	Long	0.37%	
EURCAD	Short	0.35%	
NZDCAD	Long	0.34%	
GBPAUD	Short	0.33%	

Source: Forexop.com

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There are no major risks for the Chinese Yuan as the CBoC strongly maintains its grip on its fixing range. Although major EM currencies are experiencing stronger support and lower volatility due to global growth lifting all boats in the regions, higher commodity prices and inflation, major structural reforms being pressed into their economic models and society in general can pose serious temporary risks. We suggest being issuer selective, shortening duration and favor the more liquid local currency papers.

Crude oil is being pulled by a higher global demand, stronger and more committed production cuts by OPEC and major oil exporting countries, weaker US dollar across the board and lower inventory buildup and major US shell producers focusing on distributing profits, deleveraging and rebuilding the balance sheets.

Notwithstanding the above, we believe producers in the US will eventually start maximizing their profits by ramping up their production function in the margin and open up their rigs, putting pressure again to these markets.

Copper and other major industrial metals continue to be well supported as there still overcapacity to satisfy demand growth. We maintain our underweight and neutral in the major agricultural commodities due to better than expected weather on average and overproduction.

We are long term bullish on major traded crypto currencies, as governments, regulators and central banks will eventually give way to the decentralized, deflationary and reserve currency nature of the peer-to-peer protocol once they get around their scaling challenge. In the short term however, we keep a neutral recommendation and suggest trading it range bounded, as the Bitcoin futures markets have put a lid on the irrational valuation levels.

Energy	**Price**	**Q1/18**	**Q2/18**	**Q3/18**	**Q4/18**
Crude Oil	63.66	60.538	56.8438	53.3753	50.1195
Brent	69.2386	65.9891	62.3727	58.9517	55.7263
Natural gas	3.2398	2.7716	2.5205	2.2922	2.0843
Gasoline	1.8804	1.6902	1.5389	1.4012	1.2758
Heating oil	2.0624	1.9745	1.8667	1.7648	1.6683
Metals	**Price**	**Q1/18**	**Q2/18**	**Q3/18**	**Q4/18**
Gold	1,334.25	1,291.52	1,259.74	1,228.76	1,198.57
Silver	17.015	16.296	15.614	14.9627	14.3368
Platinum	993.74	941.86	904.8	869.11	834.89
Palladium	1,097.80	1,020.18	964.5	911.84	861.99
Agricultural	**Price**	**Q1/18**	**Q2/18**	**Q3/18**	**Q4/18**
Soybeans	982.4163	908.0262	873.084	839.4639	807.1659
Wheat	426.1152	405.9688	379.8011	355.2824	332.3694
Cotton	83.41	77.67	73	68.61	64.48
Rice	12.153	10.9501	10.3904	9.8596	9.3553
Corn	352.6764	333.3442	317.4156	302.2222	287.799
Industrial	**Price**	**Q1/18**	**Q2/18**	**Q3/18**	**Q4/18**
Copper	3.1805	3.0611	2.9162	2.7784	2.647
Steel	3,913.00	3,884.27	3,436.93	3,040.95	2,690.63
Iron Ore	75	71.46	65.05	59.21	53.91
Aluminum	2,220.00	2,099.74	2,020.53	1,944.38	1,871.07
Zinc	3,416.50	3,153.52	2,981.05	2,817.92	2,663.80
Nickel	12,678.50	11,701.44	10,830.40	10,025.11	9,279.23
Coal	105.82	99.44	94.45	89.72	85.23
Index	**Price**	**Q1/18**	**Q2/18**	**Q3/18**	**Q4/18**
Baltic Dry	1,129.00	1,249.89	1,143.62	1,046.49	957.43
LME Index	3,382.50	3,220.32	3,100.93	2,985.88	2,875.18
CRB Index	198.78	193.67	188.6	183.65	178.83
S&P GSCI	2,607.20	2,503.96	2,418.67	2,335.98	2,256.39

Source: Trending Economics

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