Q4 2017 INVESTMENT OUTLOOK: INVESTORS IN AUTOPILOT MODE

For the most part of the third quarter, global markets seem to have relied on autopilot mode to drive pass through records without resetting expectations. After a more volatile second quarter were geopolitical risks could derail a fragile but sustainable growth momentum across the developed world and China, markets have seemed to consolidate their trend.

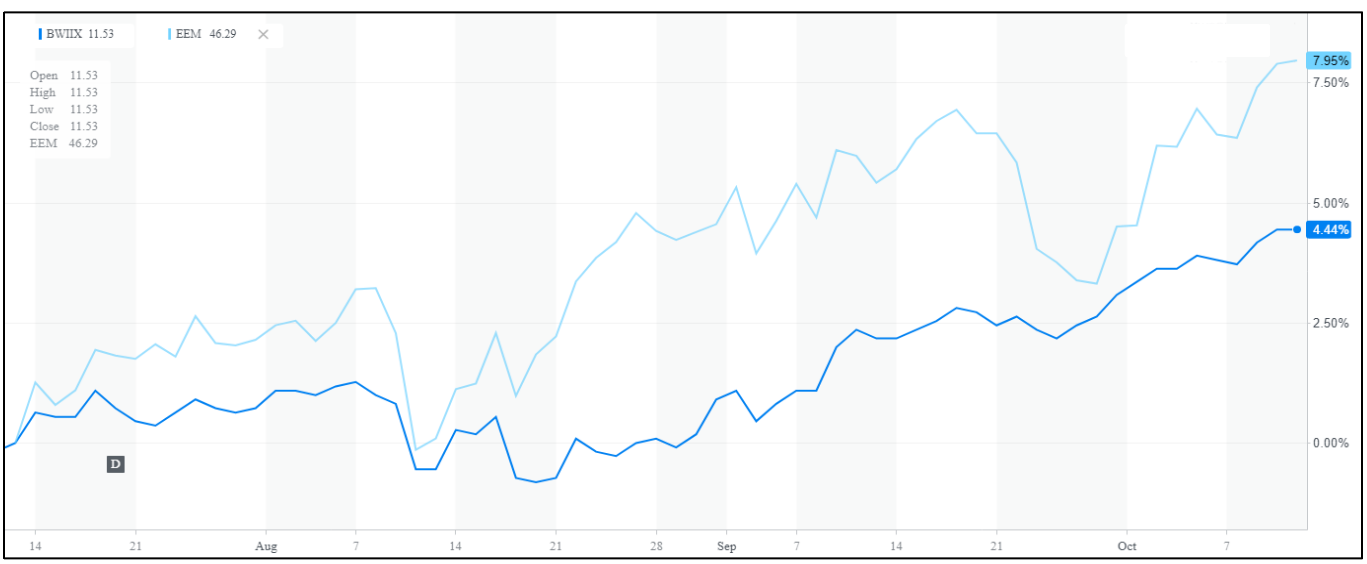
The consolidated bullish trend has created a low volatility environment, with the VIX index reaching record low levels which is slowly sinking in investors' mind and creating a support thesis for a well thought out, momentum-driven trend (typical of a consolidated bullish cycle), rather than a complacent sentiment. Complementing the prior argument is lower volatility in economic data experienced in the last quarter, with the market and macro environment being among their least volatile in the past 50 years.[1]

Given a stronger monetary policy divergence between major central banks (mainly the Fed, ECB, CBJ and China's PBOC) due to growth and inflation expectations, dispersion and relative value opportunities should be explored. Nonetheless, real GDP growth, especially in Emerging Markets, supported by a low yield environment and subdued inflation, provide a healthy back drop for us to be overweight equities.

However, brewing geopolitical risks coupled with policy missteps and miscommunications and China's preference for reform policies over short term growth can ignite volatility bouts, which in our view should be treated as temporary and taken advantage of.

Even though valuations continue to grind higher, they are in line with healthy global corporate earnings growth rate, US and international rebound of industrial production, consumption demand and low inflation expectations. We see a persistent anemic wage growth and slack in the US labor markets caused by a combination of structural shifts in relative prices within industries and sectors of the economy, which are causing a net drag in overall productivity. In the case of the US, the above combined with an aging population, and a widening savings/retirement gap generates a net grind in aggregate spending, which translates into lower low-growth, sluggish structural inflation and a lower for longer yield environment.

Nevertheless, the Fed's continued signals of rate normalization in a low inflation backdrop, bodes for a continuation in the flattening yield curve.



Source: Yahoo.com

[1] According to Blackrock Inc.

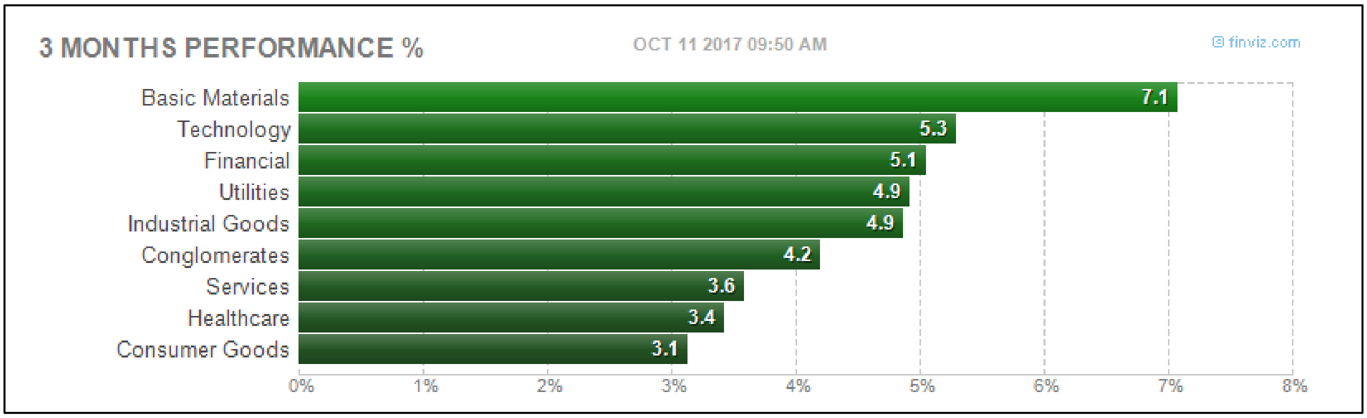
October 27, 2017

Equities

We remain positive in the asset class over all in almost all sectors for the rest of the calendar year, given the strength of global economic growth and contained geopolitical risks (for now). Continuous corporate earnings per share growth and higher analyst expectation even on the back of some policy risks and some asset bubble skepticism within some sectors are fueling a momentum-driven bullish sentiment hard to revert in the short term. Having said this however, we prefer European and Japanese equities in our developed international allocation, given cheaper valuations and improving economic indicators with tepid (if existent) inflation pressures for the year and into 2018. We are even more overweigh in EM large cap stocks, as economic reforms, improving cash flows, still reasonable valuations and monetary policy divergence in the developed markets provide a benign stage for improvement. Moreover, the relative stability of growth in China, clipping 6.9% in the last quarter, bodes well for commodity exporting EM regions.

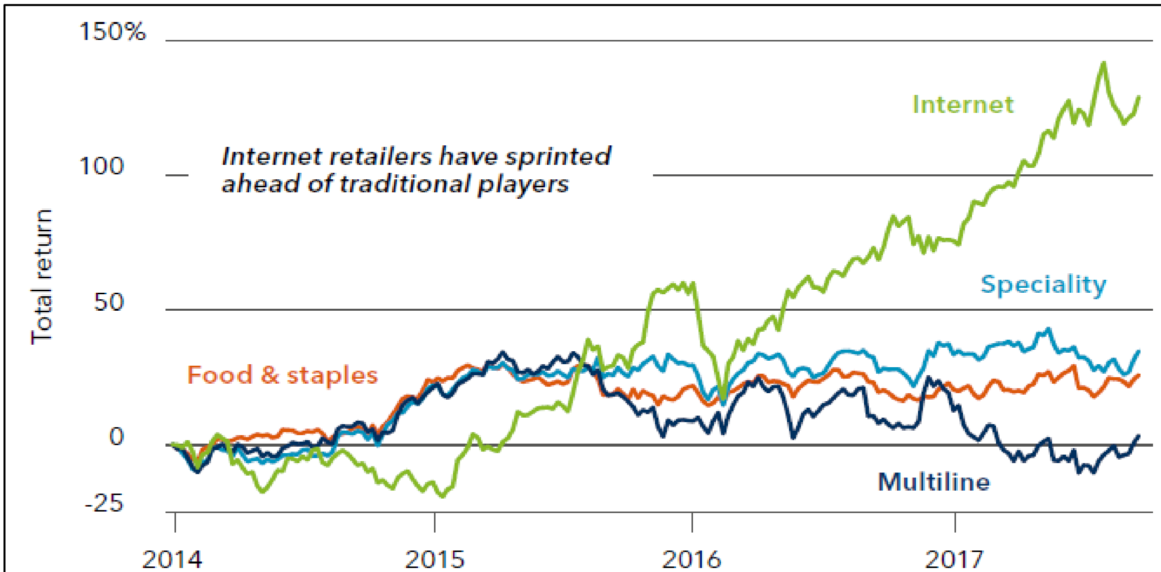
Source: BlackRock Investment Institute

All sectors performed well during the last quarter given a stronger economic growth, lower macro data volatility, subdued inflation and controlled geopolitical risks. Basic materials experienced a strong rally mainly due to the revival of reflationary policy talks and tax reforms benefiting mainly materials and industrial sectors in the US. Financials also got a tailwind from the above macro trends as well as a more hawkish Fed. Healthcare and consumer discretionary were lagers but they still bucked the trend.



Source: Finviz.com

We expect the momentum trend to keep steaming ahead, at the expense of stretching valuations higher but still justified by heathy bottom line growth mainly by improvements in operating margins. Nonetheless we are slightly reallocating away from cyclical growth oriented sectors to more value-attractive larger internationally exposed cap names to capture oversees growth. One powerful shift is becoming more evident in the consumer discretionary sector, as online retailers have gained significant ground against traditional brick and mortar competitors and are now shifting the operating business model across the entire sector.



Sources: BlackRock Investment Institute, with data from Standard and Poor's, September 2017.
Notes: The lines show the total return for S&P 1500 retail subsectors from January 2014. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

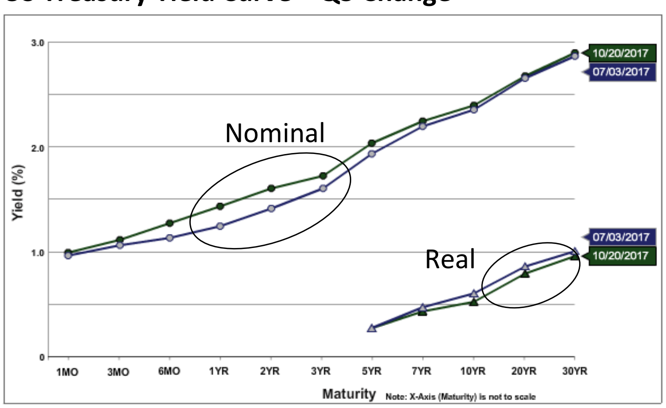
Source: BlackRock Investment Institute

Finally it is worth to mention that most investors in broad equity indices are over exposed in two or three style factors and underdiversified in others.[2] Therefore one should consider, for example, underweighting a broad market cap weighted equity index and increase other less represented factors, such as minimum volatility, dividend growth or sector neutral quality.

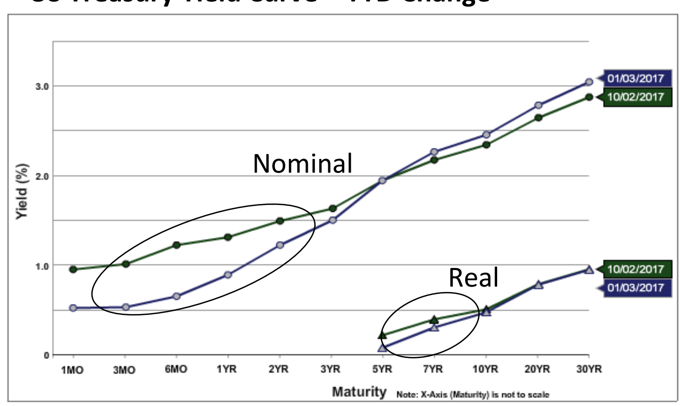
Rates

Until midyear, nominal yields were mainly driven by lower inflation expectations. However the 3Q driver of lower yields were lower real yields mainly on global geopolitical events and a less hawkish tone by the Fed and optimism on fiscal stimulus. Only by early September nominal yields began their ascent mainly due to explicit US tax reform proposals and the Fed's firmer talk on lifting fed funds rate and balance sheet reduction measures. The ECB is slowly starting to convey a more hawkish tone, given by the evidence of tepid realized inflation and early green shoots of stronger, more sustainable economic growth in the Eurozone and we could see euro yields creep higher for the first two quarters of 2018 given current economic data projections. Nonetheless, it can cause severe market volatility given the relatively shallow sovereign and corporate debt market into which is exercising its quantitative easing. In addition, the BOJ is forecast to continue its expansive monetary stimulus for the remaining of the year and into 2018 further providing downside pressure in global yields. Having said this, US tax reform and Fed action can lead nominal yields higher for the last quarter of 2017, however dollar portfolios should position for further curve flattening as the elusive inflation will apparently not deter the Fed to keep ramping up its forward guidance.

US Treasury Yield Curve – Q3 Change

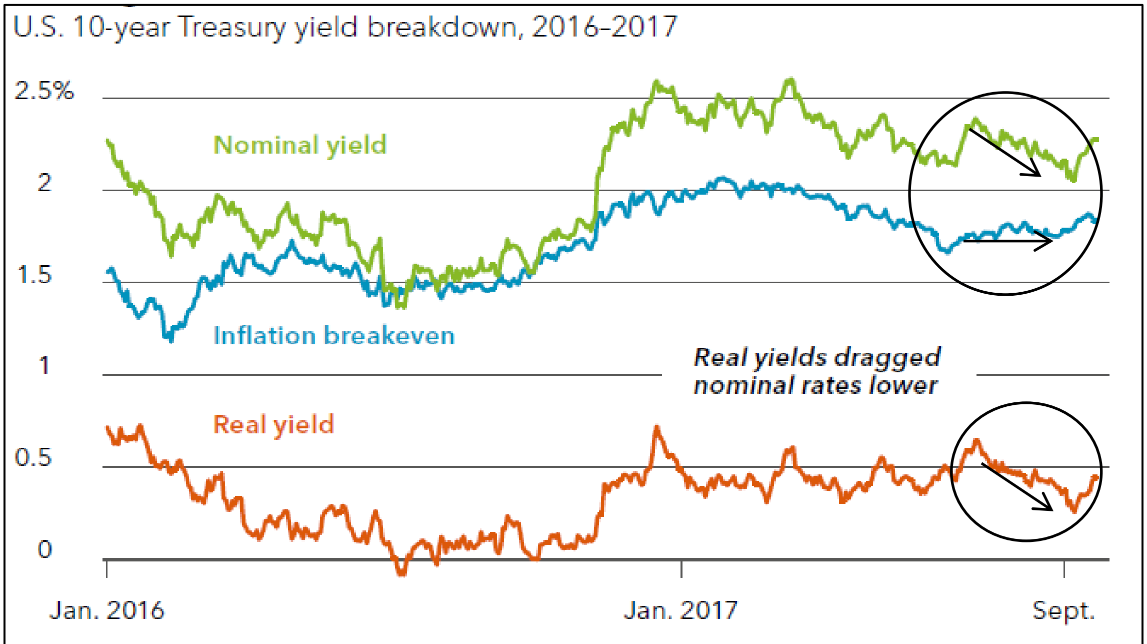


US Treasury Yield Curve – YTD Change



Source: Department of Treasury

[2] According to the BlackRock Factor-Based Strategies Group, most market-cap-weighted equity indexes are heavily slanted toward just a handful of style factors, dominated by momentum and value.



Sources: BlackRock Investment Institute, with data from Thomson Reuters, September 2017.
Notes: The nominal yield is based on the benchmark 10-year Treasury yield. The real yield is based on the 10-year benchmark inflation-linked Treasury. The inflation breakeven is calculated as the nominal yield minus the real yield.

Source: Blackrock Inc.

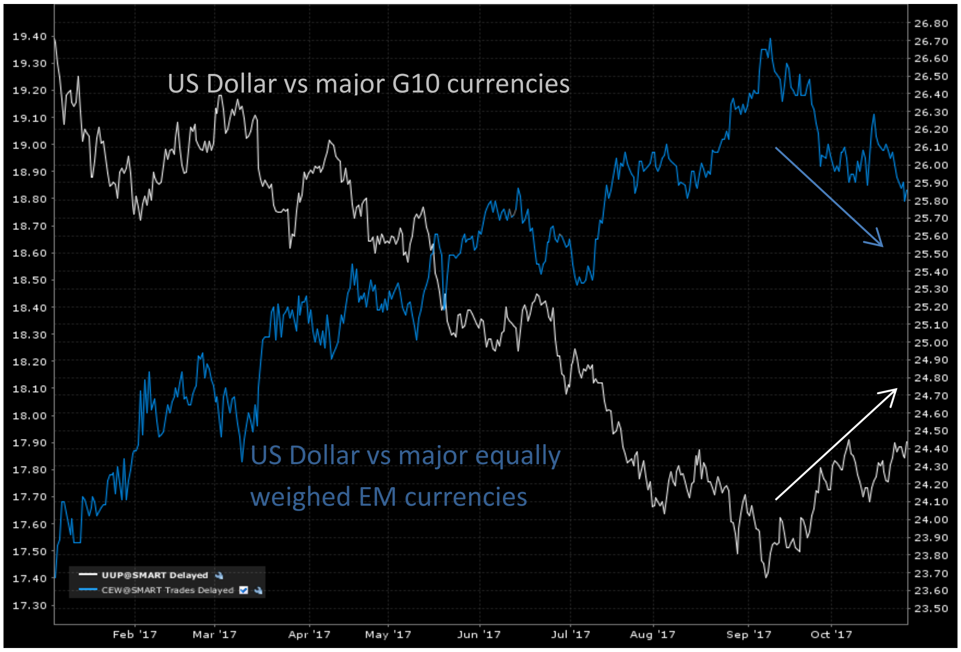
Credit

We are neutral in this space as spreads have tightened considerably and valuations may have become a bit stretched, having widened in the past few weeks and default rates appear to be limited given low macro data volatility. We would be selective on US high yield and step up the credit curve, as well as decrease exposure to European credit given current political events in the euro zone as well as the ECB tapering signals.
We are overweight on Emerging Market debt (sovereign and high credit corporate) as it should keep outperforming the developed market one on stronger growth posted in the quarter, leading to central bank rate cuts and tightening risk premiums. We've become even more bullish though on Local currency debt due to lower currency and inflation volatility that has provided further support to the asset class, outweighing the negative effects of a stronger dollar environment in the quarter. As we expect a continuation of this trend in search of a yield pickup, we feel confident enough to increase allocation of local currency debt to as high as 50% of EM debt on strong selective credits.

Foreign Exchange

The US dollar has been pushed higher lately by the US tax reform chatter as well as Fed hawkish rhetoric. That was not the case at the beginning of Q3 when EM currencies were being supported by a lack of fiscal and monetary guidance from the US and the stronger than previously forecast global growth, especially from China. We see the trend reversing and giving the USD a push, especially versus EM currencies, putting pressure to some EM central banks to hike rates depressing local currency debt but being countered by better export terms and sustained global growth. We see EURUSD staying well supported at the 1.15-1.20 till the end of the year and

USDJPY pushing towards the 111-120 range on the back of fresh post-election support for massive monetary stimulus from the BOJ and rising USD rates. Latest macro data in UK has come in favor of raising rates from the BOE but slow moving Brexit negotiations can dampen any pound rally, so a range of 1.30-1.35 is appropriate for the GBPUSD. G10 commodity currencies are expected to outperform their G10 peers on the premise of increased demand from US and Europe and some EM regions.



Source: Interactive Brokers LLC

Interest rates Oct 2017

Carry Pair	Direction	Yield %	↓ ↑
NZDCHF	Long	1.63%	↑
AUDCHF	Long	1.40%	↑
EURNZD	Short	1.38%	↑
NZDJPY	Long	1.24%	
EURAUD	Short	1.09%	
GBPNZD	Short	1.08%	↑
AUDJPY	Long	1.02%	↑
USDCHF	Long	0.73%	↑
GBPAUD	Short	0.71%	
CADCHF	Long	0.67%	↑
EURUSD	Short	0.59%	↑
NZDCAD	Long	0.52%	
EURCAD	Short	0.38%	↑
USDJPY	Long	0.34%	
AUDCAD	Long	0.31%	

Source: Foxpro.com

October 27, 2017

Commodities

Gold has been under pressure due mainly to the strengthening US dollar in the last few weeks. Although we don't see major corrections we do see it under significant resistance to the upside partly due to the lack of mayor geopolitical risks and Fed signals.
Energy markets have been more muted lately, although we have been experiencing a sustained rally in WTI evidencing a slow enactment of production cuts from OPEC countries as well as a more muted adjustment from US shale producers. We do see it reversing to mean and trading in the 45-55 range in last quarter of 2017. Reiterating Q3 outlook's comments, the lack of real commitment from OPEC members to cut production due to their growing external imbalances still pose an large obstacle at every effort by the oil exporting group to support a long term recovery, making us become neutral to bearish on the sector for the foreseeable future.
Natural gas inventories have had the same run given a mild winter in the northern hemisphere. Large infrastructure and trade developments such as Iran, Qatar and US gulf region in LNG production and trade routes are further pressuring the sector. We are still bearish to neutral.
Copper has been the great over performer this past quarter as EM economies have picked up the pace and together with stronger Chinese growth have pushed demand over and above any expectations, especially on the backdrop of US fiscal policy uncertainty.
We are still neutral on soft commodities as now stronger demand from China, might be neutralized by larger supply given despite unfavorable weather affecting some crops on global regions especially in the US.

Commodities Forecast 2017-2018 (as of October 24, 2017)

	Price		Day	Q4/17	Q1/18	Q2/18	Q3/18
Crude Oil	53.5583	▲ 0.80	1.52%	45.6	41.8	38	34.2
Brent	59.8650	▲ 0.70	1.18%	51.9	48	44.1	40.2
Natural gas	2.7971	▼ 0.10	-3.36%	2.6	2.3	2	1.7
Gasoline	1.7578	▲ 0.00	0.23%	1.42	1.27	1.12	0.97
Heating oil	1.8628	▲ 0.02	1.05%	1.64	1.53	1.42	1.3
Gold	1,270.41	▲ 3.42	0.27%	1230	1190	1160	1120
Silver	16.7144	▲ 0.01	0.04%	15.5	14.7	13.9	13.1
Soybeans	971.1914	▲ 0.75	0.08%	927	886	845	805
Wheat	426.8516	▼ 4.25	-0.98%	411	381	350	320
Cotton	68.19	▼ 1.12	-1.62%	64.8	60.8	56.7	52.7
Live Cattle	113.9473	▼ 0.15	-0.13%	104	97.6	91.2	85
Copper	3.0761	▼ 0.10	-3.05%	2.6	2.8	2.7	2.7
Aluminum	2,190.00	▲ 4.00	0.18%	2090	2010	1940	1860

Source: Trading Economics

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