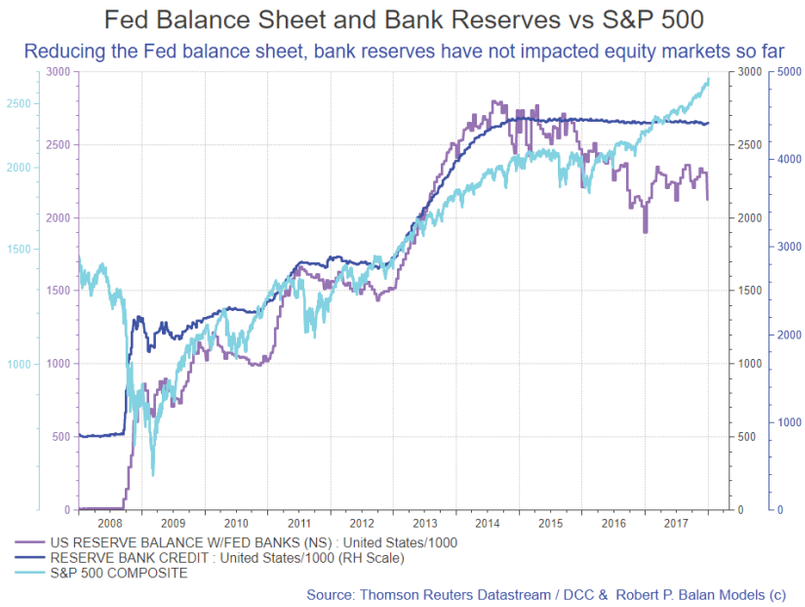
43 / These hurdles should not stop investors from engaging the equity markets this year

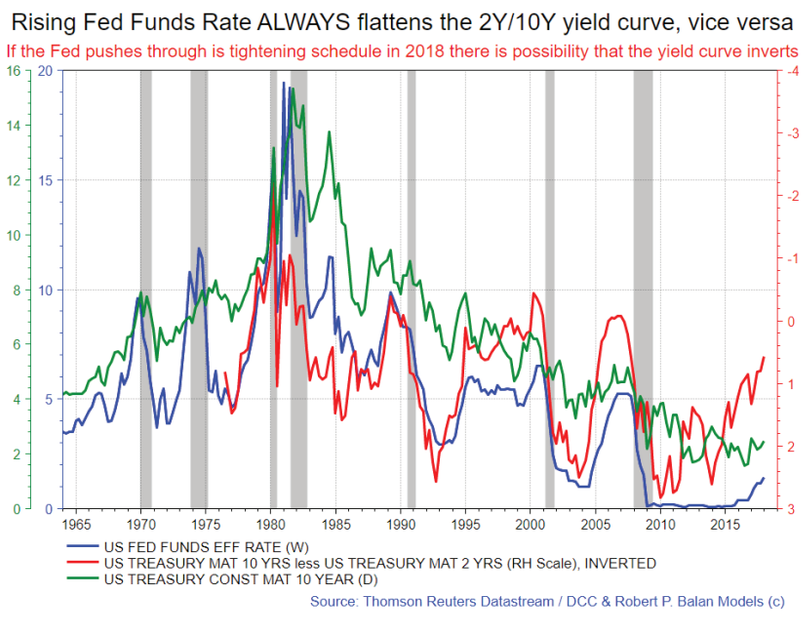
Forecasting «macro regimes» is difficult enough but predicting how the equity asset class and styles would behave in that regime is even more difficult. With the business cycle transitioning into its late stage, the task is set to become more difficult in 2018. Replicating last year's equity performance won' t be an easy task. Goldman Sachs in a report said that realized volatility for the S&P 500 was 6.7% last year, the second lowest on record. **2017 was also the only year on record in which the S&P 500 delivered a positive total return in every month of the year. A 20% return with very little downside is as good as it can get**. This of course leaves us wondering if there is any chance investors will be equally lucky in 2018.

There are no guarantees, but the start to the year is auspicious. **2018 seems to be starting where 2017 ended -- a synchronized global recovery with low inflation is taking place, and US financial market conditions remain benign**. True, US equity valuations became even more elevated during the first week of the year, but we cannot extrapolate that performance over the next few quarters. There are high hurdles for continued equity markets appreciation over the next 12 months, not least is the monetary tightening regimen that the Fed has published, and the systematic reduction of its balance sheet over time.

The Federal Reserve stated in several post-FOMC meeting statements that they will continue to reduce the size of its securities portfolio systematically over time. The Fed has been reducing the size of its securities portfolio -- From the Fed´s H.4.1 statistical data base, we see that since September 27, 2017, the Federal Reserve has reduced the size of its securities portfolio by $22.8 billion. During this time, however, reserve balances at Federal Reserve banks, a proxy for excess reserves, have remained roughly constant – and in fact, actually increasing by a modest $15.9 billion. **The Federal Reserve has overseen the reduction in its securities portfolio without undue disturbances. And apparently, investors liked that, as no ill effects has been seen from this limited example of Quantitative Tightening (QT). Put simply, the feared market disruptions emanating from the Fed's systematic QT did not materialize, and, indeed, it may not materialize at all** *(see 1st graph above)*.

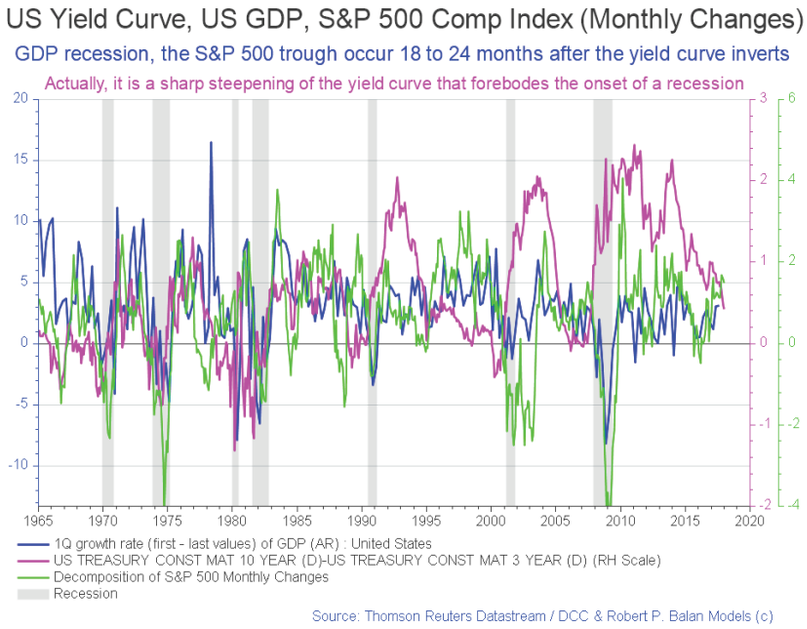


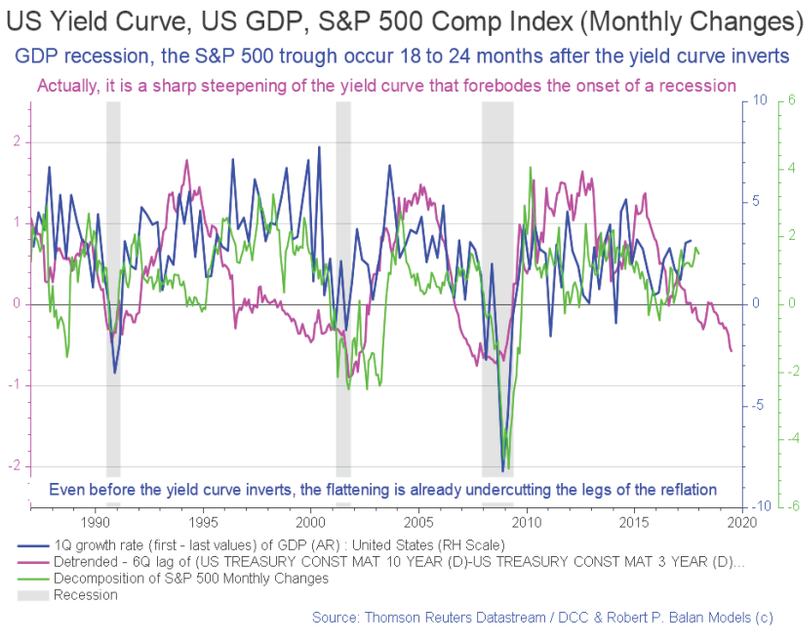
The other buzz words which investor cite for their wariness of the market is the flattening and eventual inversion of the yield curve. There's a reason for being cautious -- each of the past seven recessions has been preceded by an inverted yield curve. With the curve—the spread between the two-year and 10-year Treasuries—flattening of late, there's growing nervousness about an inverted yield curve this year, and a recession not long thereafter. The spread has dropped to about 51 basis points from 120 basis points 12 months ago. While nowhere near the inversion level, the sharp declines in the slope of the curve over the past few weeks does invite some vigilance *(see graph below)*.



The spread is flattening as the Federal Reserve pushes up short-term rates, which it controls through the Fed Funds Rate. The faster the Fed pushes up the policy rates, the flatter the yield curve becomes. Reason: the primary movement is happening at the short end of the curve. At the same time, 10-year Treasury yields—which are set by the market and respond to inflationary threats—have remained stable over the past 12 months, at about 2.41%. The Fed is expected to raise the Fed Funds Rate by 0.75 percentage point to 2% to 2.25% by year-end 2018, and some even expect a 1 percentage point increase. That translates into two-year Treasury yield at about 1.89%. Therefore, if the current 10-year yield doesn't move much, then a flat or even inverted yield curve is almost inevitable in 2018.

The flattening of the yield curve toward inversion has not only had a consistent long-term track record of predicting the onset of economic recessions, it has also done well in providing a leading signal of an impending bull market peak and subsequent bear market decline *(see 1st graph on this page)*. **While the premise is generally true, the devil is in the details. A US GDP recession, and the S&P 500 trough occur 18 to 24 months (even 32 months thereafter) after the yield curve first inverts. Investors will have plenty of time to curb their bullish sentiments** (*see 1st graph on this page)*. The message -- the yield curve inversion and the bottom of the market do not happen simultaneously. In fact, some of the strongest gains in the SPX happened after the yield curve inverted (e.g., Sept 1988 - Sept 1999). No need to panic when (if) the yield curve inverts. If at all, be glad when you see a yield curve inversion -- you know a market top is just a matter of time, and you can use other tools to determine the top of the bull market.





There is actually a procedure to see the impact of the yield curve on the stock market and GDP without waiting for an inversion of the curve. Supposing we do a simple extrapolation work after a simple regression procedure, using the same yield curve, GDP and stock market data we used in the 1st chart of this page. The next step is to move forward the yield curve by 6 quarters, the average time lag between the trough of a yield curve inversion and the GDP trough following recession. The results are illustrated in the 2nd graph of this page. So you can have all the trappings of growth, even as the flattening yield curve is already cutting down the legs of the recovery. If the yield curve is to sharply steepen today (an indication of a likely onset of a recession), it simply means that the middle of the recession will be sometime in May 2019.

The message that we are trying to get across is that Quantitative Tightening being conducted by the Fed, and that the dynamics of flattening of the yield curve or even an inversion of the yield curve are so well known that they should not be feared. In fact, these developments often provide opportunities with very quantifiable risks, just because their mechanics are so well-known. **These macro hurdles are not insurmountable, and these factors should not stop investors from participating in a blow-off last stage of the business cycle later in the first part of the year.**