6/ Mapping the markets

In our last letter, we were expecting inflation expectations to rise followed by new highs for this cycle on benchmark bond yields (our projections were towards 2.8 % on the US 10Y by March). These dynamics in our view would temporarily steepen yield curves, increase the US to Europe interest rate differential, and start to bring some support for the Dollar to turn up. Yet, inflationary pressures had reached a crucial tipping point and the speed of the rise in long term interest rates started to accelerate, correlations went astray, and the Dollar got hammered while interest rates continued to rise. As this negative feed-back loop progressed and equity markets continued up into uncharted territory, fear finally took hold, volatility started to creep up, then early February finally exploded, taking its toll on Equity indices, which plunged almost 10 % in 2 days. This inflation scare, the subsequent volatility spike and their dire consequences are now labeled Volmageddon.

As we write, Equity markets are still trying to stabilize. From an overnight low on the Futures on Monday morning, which was 12 % below their late January highs, the S&P500 has bounced back, plus 5 % over the last 3 days. It is now pretty much flat for the year, trying to hold on to this rebound. Other equity markets are slowly getting there too. Looking at our Daily oscillators, an intermediate low is approaching. It may help put a floor on equity market and bring support to the rebound. Gold and Yen, traditionally two defensive assets, had resisted well during the panic, but failed to make new highs. They have now reversed their respective trends and started to move in the opposite direction, a trend, which according to our projections, could gain momentum over the next few weeks until early March.

Looking out to the next few weeks, we expect that short term inflationary pressures should consolidate. The negative feed-back loop is probably pausing and indeed, the Dollar has started to rebound against European and Commodity currencies. Our analysis suggests that this reversal may also be the trigger point for a more sustained consolidation on commodities, possibly until the end of Q1. This could create a more friendly environment for equities, in developed markets at least. On the other hand, Emerging markets could start to underperform.

If we are correct, by the end of Q1, developed markets will have potentially recuperated their recent losses, and Emerging markets and Commodities will probably be oversold, on a relative basis at least. Volmageddon may become a more distant memory. That said, we believe it is an essential warning! Indeed, our graphs are pointing to the possibility of a new commodity acceleration in Q2, i.e. a potential late cycle commodity blow-off, and we now all have some clues as to how it could end.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	The S&P500 is trying to hold and consolidate its bounce. We expect it to succeed and resume up towards recent highs. Yet, the outcome is still quite uncertain for now.	The S&P500 should top out between late Q1 and late Q2. Above 2'900, the upside potential is exhausted on all frequencies
	Europe EuroStoxx50	If Europe can hold and bounce, and the US Dollar rebounds, Europe should outperform. Yet, the outcome is still quite uncertain for now.	During Q2, the EuroStoxx 50 may tag along other markets (the Dollar could retest down again) until it tops out towards mid year.
	EMs MSCIEM USD	Global Emerging Markets have probably topped out for Q1 and may correct down until late February / March	Late Q1 and into Q2, Global Emerging markets could accelerate up one last time to circa 5% above recent highs
Treasuries	US10Y Bond prices	US Treasuries may bounce short term, yet the downtrend is still in place and US 10Y yields could reach 3% during Q1	US Treasuries bottom out during Q2, yet before that US10Y could reach the mid 3s%. The move then reverses down in H2 2018.
	Germany 10Y Bund prices	Bunds may bounce short term, yet may consolidate down a further 2 to 3% during Q1.	The Bund could remain under pressure until mid/end Q2 2018 (towards circa 151), this Dip should be bought as the Bund should perform strongly during H2 2018

Legend: Strong Underweight | Underweight | Neutral | Overweight | Strong Overweight

Main Equities

World markets
p 35

Following their early February sell-off, equity markets are still trying to stabilize. We believe that inflationary pressures could moderate over the next few weeks and that the environment may become more friendly for equities. That said, these must hold their current levels over the next few days. If they failed to do so, the risk towards the next support levels is circa 5 to 10%.

Main Regional picks
p 36, 44

On a relative basis, Europe still seems oversold and Japan could still deliver strong potential. We continue to favour these markets over the US and Emerging Markets in Q1. The Dollar, which has probably started to rebound, should also help these market outperform in their local currencies, at least over the next few weeks

Emerging markets
p 26- 31

Emerging Markets have resisted better than developed ones during the sell-off. Yet the tide has probably started turn. A USD rebound and a consolidation on Commodities over the next couple of months should lead Emerging markets to underperform. Late Q1 and into Q2, they should then start to accelerate up again towards mid year, when we would expect a secular top.

Volatility

Volmageddon has hit and volatility registered a record volatility spike. VIX is now retracing down, yet may take time to stabilize. It should settle at higher levels than before the crisis, given that a higher interest rates environment is ultimately more risky for equities.

Government Bonds

US & European Benchmarks
p 37

US 10 year yields should continue to progress, yet the pace of this progression may moderate during Q1. That said, they could still reach 3 % over the next couple of months, and probably more during Q2. In Europe, the Bund is correcting lower, some 2 to 4 % more until mid year. It may stabilize a bit over the next few weeks.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	If Equities manage to stabilize, they will outperform bonds. We favour a positive outcome, yet the risk/reward is rather on the bond side given their lower volatility	If Equities manage to stabilize, they will outperform bonds. We favour a positive outcome, yet the risk/reward is rather on the bond side given their lower volatility
	Europe	If Equities manage to stabilize, they will outperform bonds. We favour a positive outcome, yet the risk/reward is rather on the bond side given their lower volatility	If Equities manage to stabilize, they will outperform bonds. We favour a positive outcome, yet the risk/reward is rather on the bond side given their lower volatility
Duration		Yield Curve spreads in the US and Europe should continue to progress during Q1, yet at a slower pace	The steepening bounce gradually dies out during Q2, yield curves then flatten again until end 2018.
Credit		High Yield, Corporate, EM and Sovereign Credit Spreads may retrace some during Q1, but the lows for the cycle were probably made last year	Between late Q1 and mid Q2 , Credit Spread start to move up towards end 2018/2019
TIPs/Treasuries		TIPs continue to progress vs Treasuries until end February/March yet at a slower pace	TIPs continue to progress vs Treasuries until mid year, then inflation expectations worldwide will start to fall as risk assets top out
Oil		Oil consolidate down into the low 60s (Brent) until late Q1	A last push higher during Q2 2018 will probably materialise. From mid year, Oil should start to reverse down
Industrial metals		Industrial Metals continue to consolidate at high levels until late Q1.	Industrials Metals may extend up from late Q1 to mid year. Copper reaches above 8'000 USD/ton on the LME
Gold		Gold retraces back down into late February/ March, retesting lows towards 1´250 USD/oz and possibly below.	From late Q1, Gold gradually starts to move up again. It may reach 1'5 00 USD/oz by year-end. Accumulate!

Legend: Strong Underweight | Underweight | Neutral | Overweight | Strong Overweight

Equity to Bond Ratios

US Markets

If equities manage to stabilize the ratio will probably make new highs in H1 2018, yet by mid year, we would expect the ratio to roll-over more permanently as risk assets start to correct. Short term, the risk/reward is probably in favour of bonds. Indeed, the possibility of a further strong sell-off in equities, although unlikely in our view, outweighs the impact of further declines in Bonds.

Eurozone Markets

Similarly in Europe, we expect the ratio to retest up until mid year. Yet, shorter term the higher risk on equities outweighs the probably of further declines in Bonds.

Fixed Income Dynamics

Duration (10Y - 3Y)

Yield Curves have started to bounce. We expect them to continue to do so, until late Q1 in the US and possibly towards mid year in Europe. Following that they should retrace down during H2 2018 and make new lows towards year-end. Real bearish steepening will then start.

Credit

While long term interest rates continue to rise, we expect Investment Grade Corporate debt to continue to outperform Treasuries, possibly until mid year. At the end of the spectrum, High Yield is looking weaker. It sold off quite aggressively with equities over the last few days, and could now make a weak comeback over the next couple of months. In general, however, we believe Credit has probably already topped-out for this cycle, on the highs made last Summer. High Yield remains one of the weakest link in these last months of the reflation trade.

Rate Differentials

Rate differentials are still moving in favour of the US (vs Europe, Japan or the UK) probably until mid year.

Tips
p 20, 40

TIPs should follow Gold and the whole fixed income space lower until March at least, considering the rising interest rates environment we expect. That said, inflation expectations are rising and the inflation break-even ratios (TIPs vs Treasuries) should continue higher until mid year. As Commodities consolidate some, it may also retrace a bit towards end Q1.

Commodities

Oil
p 19, 20

Oil has reached the targets we have been projecting since early 2016 for Q1 2018. Our daily graphs now seem to have made an intermediate top. We expect Brent to retrace in the low 60s over the next 3 to 6 weeks, yet believe that from late Q1, Oil may re-accelerate up again, probably towards mid year. Price targets for this move are anywhere from 75 to 100 USD/barrel.

Industrial metals
p 21

Similarly, following their strong rally in H2 2017, Industrial metals have probably made an intermediate top. They could consolidate at high levels over the couple of months. From late Q1, we expect them to resume up towards mid year and potentially accelerate in a typical late cycle Commodity blow-off. Our targets for Copper for example are above 8’000 USD/t on the LME.

Gold & PMs
p 21, 22, 38, 39, 40

If interests rates continue up and the US Dollar rebounds (which could happen over the next few weeks), we expect Gold and Precious Metals to sell-off once more (for Gold possibly back to below 1’250 USD/oz until March). We will then be positive for Gold for the rest of the year, and it could possibly reach 1’500 USD/oz by year end.

Agriculture
p 23

Agricultural Commodities as a whole are still lingering lower, possibly until mid year. They may bounce in Q1 as other Commodities retrace.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD consolidates at high levels, possibly towards 1.20-1.19	From late Q1 into Q2, EUR/USD attempts to move to new highs (1.25 – 1.28). It then weakens substantially during H2 2018
	GBP	GBP/USD moves back down to the 1.37 – 1.35 range during February, perhaps March	Late Q1 into Q2, GBP/USD moves up once more and may make new highs towards 1.44 – 1.45. It then weakens substantially during H2 2018
	JPY	USD/JPY moves up towards end February / early March with prices targets towards 114- 119	USD/JPY could extend into late Q2 above 119 and even possibly challenge previous 2015 highs above 125, even 130
	CHF	USD/CHF rebounds towards late February / March and possibly the 0.96 – 0.98 range	USD/CHF may then retrace some or all of these gains and build a base during Q2, before it moves up again from midyear
EUR vs	GBP	EUR/GBP weakens until late February / March, as the Dollar correction may be slightly stronger on the EUR than on GBP	Late Q1 and during Q2, asset rotation shifts to Growth and then Defensive assets, which should benefit EUR/GBP
	JPY	During Q1 EUR/JPY should continue up towards 140	Following some consolidation in late Q1 / early Q2, EUR/JPY extends towards 150 and even 160 by mid year.
	CHF	EUR/CHF may consolidate at high levels until mid/late February.	From late February, EUR/CHF re-accelerates up into mid/late Q2, when it could top out in the mid 1.20s
GBP vs	JPY	During Q1 GBP/JPY extends up another 5% towards 159/160	GBP/JPY continues up during late Q1 / Q2, possibly towards 165/166.
	CHF	During Q1 GBP/CHF extends up another 3 to 5% towards 1.35 - 1.39	GBP/CHF continues up during late Q1 / Q2 and extends above 1.40

Legend: Strong Underweight | Underweight | Neutral | Overweight | Strong Overweight

US Dollar
p 37, 38, 52

Since the start of the recent Equity sell-off a few days ago, the Dollar has started to bounce vs most currencies. Going forward, we believe this move can continue mostly on the back of a consolidation in Commodities and a temporary loss of momentum in inflationary concerns. Following that, it should retrace these gains during Q2, and possibly make new lows as Commodities start to accelerate up again. Its downside risk is probably towards 86 on DXY. Finally, the Dollar should regain strength in H2 2018 as risk assets start to correct from mid year / the Summer, possibly into 2019.

Euro
p 38, 52

Following its break-out and subsequent rally to above 1.25 in January, the EUR/USD topped out just before the equity market sell-off and has been correcting down since. We expect this consolidation to continue during February, possibly down to the 1.20 – 1.19 range, or the top of its consolidation range between September and December last year. Thereafter, during Q2, it could resume its uptrend and attempt to make new highs in the 1.25 – 1.28 range. Longer term, we believe that the uptrend on EUR/USD since late 2016 is only a correction, which should die out during H1 2018 / mid year, before it resumes down quite aggressively in H2 2018. Vs GBP, EUR may correct down a bit during Q1 and then gradually move up again during Q2, and even towards year-end as GBP could be particularly vulnerable in a market downturn. Vs JPY and CHF, EUR could consolidate at high levels until late February/March and then accelerate to new highs towards mid Q2 and possibly the Summer vs JPY. As the risk asset correction takes holds from mid year, JPY and CHF should regain some of their defensive profile. EUR/JPY and EUR/CHF will then correct back down towards 2019.

Yen
p 37, 52, 53

The Yen remains the ultimate defensive currency, and although we just saw a strong Dollar sell-off, followed by a strong equity market sell-off, it hasn't made new lows vs USD. We interpret this as a sign of upcoming weakness for the Yen vs most currencies. USD/JPY should start to move down during Q1 if as we believe equity markets stabilize. This downtrend should then accelerate up in Q2 as the Commodity Bull market reaches its final stages and accelerates up. Towards midyear, our targets for USD/JPY are at 130 and for EUR/JPY at 150. The Yen could then bottom out between mid year and the Summer as markets and risk assets top-out, and recoup all of its losses, and perhaps, more until mid/end 2019.

Sterling

In the Dollar rebound we are expecting in Q1, Cable could consolidate towards the 1.37 – 1.35 range, yet during Q2 it could then make new highs towards 1.44- 1.45. Following that, we expect it to weaken vs most currencies during H2 2018 as we believe the UK to be particularly vulnerable in an important market downturn such as the one we are expecting.

Oil & Commodities currencies
p 31, 53

Commodity currencies have seen a strong rally vs the US Dollar since December (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB and ZAR). Over the last few days, they have started to reverse and we would expect them to retrace most of this performance and perhaps slightly more until early March. Following that, Commodity currencies seem well positioned until mid year (which may confirm a scenario, where Commodities accelerate up), before they roll-over and underperform aggressively into 2019. Vs EUR, the articulations we anticipate are similar yet with slightly less volatility (they are positively correlated for now).

Asian currencies
p31, 53

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) could consolidate against USD and EUR over the next couple of months and then resume up towards mid year and possibly the Summer. In the downturn that follows (late 2018 into 2019), they will correct down vs the USD and the Yen, and should gain further strength vs European currencies as they seem more defensive than them for now.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500			**The current environment of rising interest rates is beneficial to Financials. We are neutral on other pro cyclical sectors and still negative on Defensive profiles**					**We expect Commodity related themes to re-accelerate up from end Q2 into mid year, Financials should continue to be strong**				
Sectors	ETF symbol	Benchmark-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	26%										
Financials	XLF	15%										
HealthCare	XLV	14%										
Discretionary	XLY	12%										
Industrials	XLI	10%										
Staples	XLP	8%										
Energy	XLE	6%										

European Sectors - Europe Stoxx 600			Next 2 months: The current environment of rising interest rates is beneficial to Financials. We are neutral on other pro cyclical sectors and still negative on Defensive profiles.					3 to 6 months ahead: We expect Commodity related themes to re-accelerate up from end Q2 into mid year, Financials should continue to be strong.				
Sectors	Index symbol	Benchmark-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Banks	SX7P	13%										
Industrials	SXNP	12%										
HealthCare	SXDP	11%										
Pers. & HH Goods	SXQP	9%										
Food & Beverage	SX3P	7%										
Insurance	SXIP	6%										
Energy	SXEP	6%										

Main Sectors Allocation

p 46- 49

Over the next couple of months, even if inflationary pressures do moderate some with the consolidation we expect on Commodities, rates should continue to rise, perhaps at a slower pace. Long duration equities (Technology) and Defensive sectors should continue to be under pressure. Financials still seem to be the strongest sector in this environment. Commodity related sectors are now neutral and could even underperform during this period.

From end Q1, early Q2, Commodity related sectors should resume their uptrend, while Financials continue higher. Defensive sectors should continue to underperform until equity markets top out towards mid year.

Satellite sectors and Segments

Along with Industrials metals and Emerging markets, which we see consolidating during Q1 (before they accelerate up again in Q2), alternative Energy and related sectors, which have performed strongly in H2 2017 (solar, lithium) could also consolidate during Q1, before they re-accelerate up in Q2.

Countries allocation

Core Countries Weightings: All World Country Index Currency hedged			Next 2 months: European Markets may be starting to bounce vs World markets. Indeed, the USD may have started to reverse. Inversely, the US and EMs could underperform.					3 to 6 months ahead: As Commodities re-accelerate up, related geographies and Emerging Markets should outperform until mid year.				
Sectors	Index symbol	Benchmark-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
US	S&P 500	52%										
Canada	TSX	3%										
Europe	SXXP	21%										
-UK	FTSE	6%										
-France	CAC40	3%										
-Germany	DAX	3%										
-Switzerland	SMI	3%										
Japan	N225	8%										
China	MSCICN	3%										

Main Country allocation
p 26- 31 (EMs)- p 44, 45, 50, 51 (Europe)

The Dollar rebound may have started. Provided Equity markets can stabilize over the next few weeks, it should benefit European markets, and especially the EuroZone. We hence continue to Overweight the EuroZone and its Core markets (France and Germany) during Q1. Japan should also continue to outperform, although its strong performance in H2 2017 leaves less upside potential. In this environment, over the next couple of months, we are underweighting the US and Emerging markets (and hence China).

Going forward and looking into Q2, we expect a potential Commodity blow-off scenario until mid year and a Dollar that could retrace vs most currencies, except for the Yen. Hence, we would favour Commodity related geographies and Emerging markets, as well as Japan on the back of a weaker Yen.

Note: the country and regional allocations in the table above are considered hedged for currency risk, ie. the relative performances are anticipated in local currency.

Satellite Country allocations
p 26-31

In Emerging markets, Asian Growth countries may outperform other EMs during Q1, while China and Commodity related geographies should re-accelerate up in Q2. In Europe, we would favour France and Germany over the next couple of months. From late Q1 and into Q2, we would shift to more dynamic geographies such as Italy, Portugal, Austria or even Greece.

Core factors and Themes

Core Factor/Themes Weightings	Next 2 months					3 to 6 months ahead				
General Comment	**Over the next 2 months, we would favour Themes, which could benefit from a USD rebound and a steepening bounce in the Yield Curve.**					**From late Q1 and into Q2, pro-cyclical and Commodity related profiles are favoured, while defensive profiles remain weak**				
Themes	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Nasdaq 100 (vs S&P500)		■						■		
DJ Industrial (vs S&P500)			■					■		
Russell 2000 (vs S&P500)				■					■	
Wilshire REITs (vs S&P500)	■						■			
US Value (vs US Growth)				■				■		
Southern EuroZone (vs Stoxx EZ 600)			■						■	
EuroZone Small Cap (vs Stoxx EZ 600)		■						■		
Japanese Small Cap (vs N225)		■						■		
GDX - Goldmines	■							■		
XME - Diversified Mining			■						■	

Core factors and Themes
p 39 (Goldmines)

Over the next 2 months, we continue to underweight Growth (Nasdaq100) and Defensive (REITs) themes as well as Goldmines and Small Caps profiles outside of the US. Value and Small caps profiles in the US continue to be overweight given the rebound we still expect on the USD.