Monthly
House Views

Hurdle Race

Household and business confidence indicators suggest that the global economy will continue to expand in coming quarters. The tax cuts implemented by the White House will provide further stimulus to the US economy, raising concerns about possible overheating. In the euro zone and Japan, the outlook for robust growth and sluggish inflation is unchanged. The UK continues to benefit from global demand which helps mitigate the impact of the domestic slowdown. And emerging economies should continue to enjoy the global pick-up in growth.

As suggested in our January House Views, households and investors have begun to expect price rises. In the US, 10-year "breakeven" inflation expectations (calculated from bond yields) have increased from 1.85% on average in Q4 to 2.1% at present. Recent strong employment figures in the US included a sharp rise in wage growth – which had dipped last autumn – suggesting that upward pressure on prices will persist. Although the current wage round in Germany also sees rising earnings for workers, the overall picture for the euro zone remains one of slow inflation.

The shift in inflation expectations over the past four months has moved investor forecasts for US monetary policy closer to the central bank's own projections, i.e. three hikes in 2018. Although this remains our base case, if the economy shows any signs of tax-cut-fuelled overheating more tightening might be on the cards. For the ECB on the other hand, we expect the asset purchase programme to be fully wound down – by end 2018 – before key rates will be increased. Japan faces little meaningful inflationary pressure and is likely to continue its stimulus measures.

As global growth accelerates, equity investors are increasingly fearful of inflation and rate hikes, causing volatility spikes. However, we would suggest keeping calm as macro fundamentals and corporate earnings still paint a favourable backdrop for risky assets.

More details inside...

2 to 3 – Our views summarized

4 to 7 – The longer read

In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document.

Our views summarized

Here, we present our VaMoS investment approach, combining economic, valuation, momentum and sentiment signals that help us fine-tune our views on asset classes for the coming period. The signals below reflect the latest conclusions of our Global Investment Committee. Here's how to read them:

EQUITIES		VA			MO		S	
		Valuation	Fundam.	Macro.	Momentum	Technicals	Sentiment	Risk
United States								
Eurozone								
UK								
Switzerland								
Japan								
Emerging								

BONDS – EUR	Global	VA	MO	S
Govies				
Linkers				
Inv. Grade				
HY				
*Duration**	Short			

BONDS – USD	Global	VA	MO	S
Govies				
Linkers				
Inv. Grade				
HY				
*Duration**	Short			

BONDS – GBP	Global	VA	MO	S
Govies				
Linkers				
Inv. Grade				
HY				
*Duration**	Short			

CURRENCIES	
EUR/USD	
GBP/USD	
USD/JPY	
EUR/CHF	
USD/CNY	
Emerging vs USD	

ALTERNATIVES	
Hedge funds	
Gold	
Oil	

Source: SG Private Banking, 12 February 2018, * Duration: short = 3-5yr, medium = 5-7yr, long = 7-10yr; HY = High Yield

SOCIETE GENERALE Private Banking

In other words

Asset class	Segment	View
EQUITIES*	*United States*	*Given inflation and rate hikes will cap already extended valuations, the key driver for US equity return this year will be robust profit growth. We keep a small underweight due to excessive valuations and the Fed policy normalisation.*
	Europe	*Profits will remain supported by the global economic recovery but will rise at a slower pace than in 2017. Political uncertainty (Brexit, Italian elections) and weaker asset purchases from the ECB may cause investor concern.*
	Eurozone	*A stronger euro will weigh on exporters' profits. However, the broad-based recovery in domestic demand and solid global growth will drive earnings higher. We maintain a slight overweight.*
	UK	*Slower EPS growth, lacklustre economic activity and Brexit talks remain key concerns. Stay cautious.*
	Switzerland	*A weak franc, strong business sentiment and the robust global economic recovery will benefit Swiss multinationals.*
	Japan	*Stronger domestic demand, more robust global trade, slow exit from deflation and attractive valuation all compound to support Japanese equities.*
	Emerging	*Valuations are attractive but the economic context will be a little less supportive in 2018.*
BONDS*	*Sovereigns*	*As growth shows no sign of abating, markets have turned wary of inflation, driving yields higher. However, potential for higher yields will depend on inflation developments.*
	*Duration***	*The bounce in US yields makes longer maturities slightly more attractive.*
	Inflation-linked	*Signs of inflation pressure reinforce our positive stance on inflation-linked bonds.*
	Investment Grade	*Investment Grade markets have weathered the recent bout of volatility rather well as demand remains high despite heavy issuance year-to-date. In the US, we retain a slight preference for Investment Grade bonds over High Yield.*
	High Yield	*In the US, wider high yield spreads could offer attractive entry points. In the eurozone, we still prefer high yield to investment grade bonds.*
	Emerging debt (in € and $)	*Selectivity is still key and we would advise keeping a close eye on US inflation – faster Fed hikes than expected could reduce the segment's appeal.*
CURRENCIES	*EUR/USD*	*After a broad-based bounce, we still expect the dollar to lose ground versus the euro as it remains rather expensive. However, higher inflation in the US than in Europe is a downside risk for EUR/USD.*
	GBP/USD	*Risks are now to the downside – we forecast slower growth in the short and medium term and Brexit uncertainty remains high. We expect a modest drop versus the dollar.*
	EUR/GBP	*We expect the pound to experience a sharper fall against the single currency.*
	USD/JPY	*The economy is slowly exiting deflation but the Bank of Japan will stay ultra-accommodative this year with inflation still below the 2% target. Bouts of market volatility may cause yen spikes.*
	EUR/CHF	*We would expect the franc to correct lower as soon as volatility abates. It is also sharply overvalued which augurs renewed weakness in coming months.*
	Emerging	*Valuations look fair to cheap, providing support – we remain constructive on emerging currencies.*
ALTERNAT.	*Hedge funds*	*A recent rise in volatility, lower correlations and rising dispersion suggest better market dynamics for Long/Short Equity and Event Driven managers.*
	Gold	*Rising inflation expectations and a rise in US interest rates this year are negatives for bullion. However, growing market volatility should underline gold's safe haven status.*
	Oil	*The positive effects of the output cuts decided by OPEC and Russia have been offset by growing output of shale oil in the USA, leaving supply in excess of demand.*

Source: SG Private Banking, 9 February 2017, EM = Emerging markets, hard currency = dollar & euro, *Relative views expressed in local currencies, ** Duration: short = 3-5yr, medium = 5-7yr, long = 7-10y

Economic focus

Dollar – More weakness ahead?

- After a rally from 2014 to early 2017, the dollar index has lost significant ground, erasing half its gains.
- However, the dollar recently bounced as participants started to fear more aggressive monetary tightening in the US following strong inflation data.
- We expect the dollar to lose further ground versus the euro in 2018 although an inflation-induced repricing of Fed rate hike expectations could provide a temporary boost.

- Last year saw mixed currency trends. While the dollar fell 10% after a 30% rally from mid-2013 to late 2016, the euro recovered around 15%, correcting more than half the losses recorded since 2014, and sterling rose gradually, approaching pre-Brexit levels. Meanwhile, emerging currencies regained ground versus the dollar thanks to the global recovery, higher commodity prices and stronger exports.
- Although the US Federal Reserve (Fed) is more advanced in normalizing its monetary policy, with a first rate hike in December 2015 and a reduction of its balance sheet since October 2017, we expect the dollar to stay under pressure for structural reasons.

What explains the dollar rally these last few years?

1. *Robust growth.* The United States have recovered stronger and faster than the other developed countries, helping the dollar pick up. Expectations for higher inflation in light of the shrinking economic slack in the US have been disappointed, curbing US rates and flattening the yield curve.
2. *Monetary policy divergence.* Since the European Central Bank (ECB) embarked on quantitative easing in March 2015, markets have priced in policy divergence between the ECB and the Fed, causing euro weakness and dollar strength.
3. *The performance of US assets.* US firms have benefited from robust growth, driving flows into equities. Also during cycle upturn, the dollar tends to outperform the other developed market currencies.

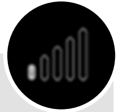
Why do we expect further dollar weakness?

1. *Tighter growth gaps.* Although US growth will remain strong thanks to the tax boost, the growth gap with the eurozone will narrow. Key emerging economies are exiting recession and activity in China has surprised on the upside.
2. *A shift in political risks.* Political risks have shifted from the eurozone to the United States. The defeat of populist parties in several European elections in H1 2017 revived hopes for institutional reform in the eurozone, helping the euro recover. Conversely, the United States have been regularly faced with political gridlocks such as the recent government shutdown.
3. *Monetary policy expectations.* While the yield gap between 10-year US and German sovereign bonds peaked at 235 basis points in December 2016, the differential between US and eurozone short rates has only narrowed somewhat. The focus is now more on monetary policy guidance in the eurozone.
4. *The dollar is overvalued.* A year ago, the dollar hit a cyclical high and started to correct lower. We believe there is more to come as it remains expensive.

Bottom line

- We expect the dollar to lose further ground versus the euro in 2018 although an inflation-induced repricing of Fed rate hike expectations could provide a temporary boost.

Fixed Income



Inflation concerns drive rates up

- As growth shows no sign of abating, markets have turned wary of inflation, driving yields higher.
- The bounce in US yields makes longer maturities slightly more attractive as upside inflation risks are moderate.
- Inflation-linked securities still provide good diversification.
- Despite the equity sell-off, credit spreads have only widened modestly thanks to strong demand.

Rates

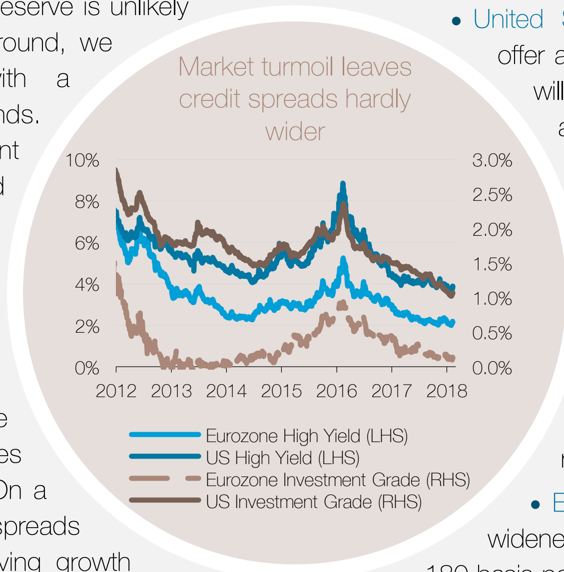
Potential for higher yields will depend on inflation developments

- United States. Stronger-than-expected wage growth triggered a sharp rise in bond yields to four-year highs and an equity sell-off. Perceptions of inflation risk have soared in the US, given the tax boost to growth, an ever tighter labour market and the dollar slide. However, actual inflation has yet to spike and long-term inflation breakevens have only risen modestly, moving back to early 2017 levels. Given that the rise in inflation should remain gradual, the US Federal Reserve is unlikely to overreact. Against this background, we remain on the defensive with a preference for inflation-linked bonds. Investors could also use the recent surge in US yields to raise bond duration to benchmark level as part of a tactical move.
- Eurozone. Despite the equity sell-off, bond markets have seen little safe-haven buying. Indeed, we expect yields to increase further, especially in core countries where they still look rather low. On a more positive note, peripheral spreads have narrowed further on improving growth prospects and expectations for rating upgrades. We expect higher long-dated yields in core countries and still favour the periphery. We also prefer linkers to fixed-coupon bonds.
- United Kingdom. Gilt yields should rise further in the wake of the US and eurozone. However, now that inflation pressures are easing, the upside will be limited.

Credit

Credit markets still in a sweet spot

- High-quality corporate bonds have proved resilient to the equity sell-off. High Yield bonds (HY) suffer more in turbulent times because of their higher correlation to equity markets. And indeed, Investment Grade (IG) credit spreads have only widened marginally compared to HY.
- Overall, IG credit markets have weathered the recent bout of volatility rather well as demand remains high despite heavy issuance year-to-date.
- United States. Wider HY spreads could offer attractive entry points. However, we will wait for dust to settle before adding to positions, and retain a preference for US IG bonds.
- Eurozone. The credit market will benefit from strong growth, cheap financing and the pivot in ECB purchases towards corporate bonds. Although we still prefer HY to IG bonds in euros, hybrid bonds offer the best risk-adjusted return.
- Emerging debt. Spreads have widened modestly from their all-time low at 180 basis points. However, synchronised global growth, better macro fundamentals and a softer dollar remain supportive. Selectivity is still key and we would advise keeping a close eye on US inflation – faster Fed hikes than expected could reduce the segment's appeal.



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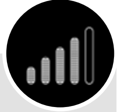
Equities



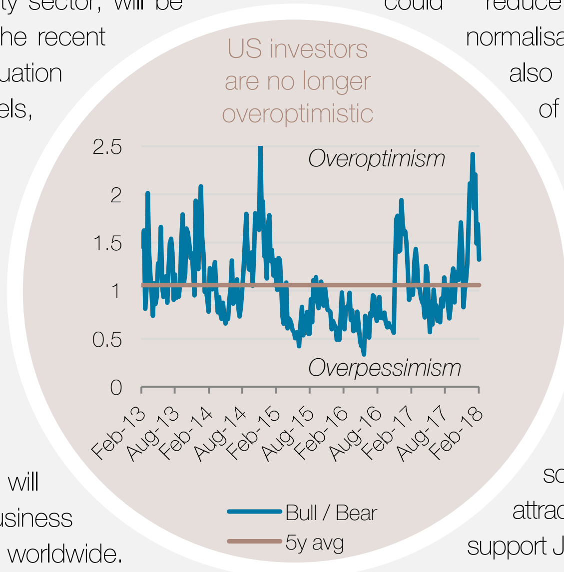
Keep cool

- After a long and steady rise in recent quarters, global equities were overbought and investor sentiment overly optimistic, setting the scene for a sell-off.
- Growing inflation expectations, gradual monetary tightening and rising government bond yields should limit expected performance.
- Global equity returns will be supported by synchronised global economic expansion and robust corporate profit growth in coming months.
- Financials should be the main beneficiaries of rising global rates.

Favour those regions which benefit most from global economic expansion

Eurozone to benefit from strong global economic expansion

- Eurozone. Although a stronger euro is bad news for exporters, the broad-based domestic recovery and solid global growth bode well for earnings in coming months. Profitability is improving slowly but sales growth remains strong and margins should expand further as wage pressure is muted. All in all, earnings-per-share (EPS) are likely to grow nearly 10% this year and should be the main driver of equity return as rising yields will limit valuation upside. Financials, the largest equity sector, will be the main beneficiaries. Moreover, the recent sell-off has brought eurozone valuation back to more attractive levels, especially versus the United States.
- UK. The UK market will continue to lag developed peers as we expect slower EPS growth in the UK than elsewhere this year. In addition, lacklustre economic growth and Brexit uncertainties remain serious concerns, encouraging us to handle UK equities with caution.
- Switzerland. Swiss multinationals will enjoy a weak franc, strong business confidence and economic strength worldwide. High exposure to defensive sectors may limit the upside.



US equities: strong profit growth will be mitigated by rising inflation and higher rates

- United States. US equities will be mainly supported by strong profit growth in coming months. Although the reporting season is not over, earnings growth appears to have been very strong in Q4. More importantly, companies are delivering positive guidance for this year. Tax reform, a weaker dollar and robust economic growth have triggered an upgrade in consensus forecasts to double-digit growth this year. However, rising wages could reduce margins. Monetary policy normalisation and rising Treasury yields will also increase volatility, capping upside of this very expensive market.
- Japan. Japanese firms should continue to benefit from robust domestic demand and stronger global trade. The economy is slowly exiting deflation but the Bank of Japan will stay ultra-accommodative this year with inflation still below the 2% target. Corporate governance reforms, sound company fundamentals and attractive valuation metrics will also support Japanese equities.
- Emerging markets. The economic environment will be a little less supportive this year with a mild slowdown in China, rate hikes in the US and a rise in global yields in reaction to higher inflation expectations. However, strong global trade, high exposure to technological innovation, rising oil prices, a weak dollar and attractive valuations will support emerging markets. We keep a neutral stance.

Sources: SGPB, Datastream, 08/02/2018, US AAII Sentiment survey, % of bullish to % of bearish answers. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

Currencies

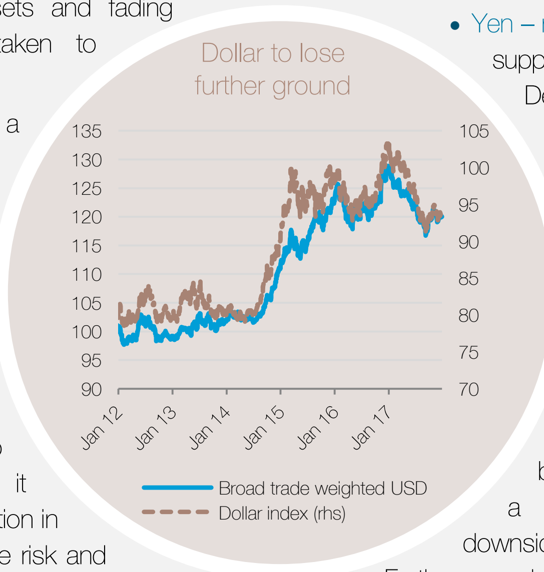
Dollar – just a dead-cat bounce

- Dollar to be supported by revived price pressure in the US – but don't get carried away.
- After a bout of weakness, the euro should recover in the medium term.
- Slow growth and political uncertainty will keep sterling southbound.
- Solid growth prospects and rising commodity prices should hedge emerging currencies against dollar strength.

Dollar recovery

"The euro has eased from 3-year highs"

- Euro – taking a pause. Good economic surprises and hopes for a change in tack from the ECB drove EUR/USD to a three-year high above 1.25 in early February. Then, with price pressures building in the US, investors started to buy the Fed's rate hike scenario, helping the dollar take the upper hand. While we expect further upside for the dollar in coming weeks, we believe the euro will strengthen thereafter thanks to a growth-related shift in ECB guidance, stronger foreign demand for euro-denominated assets and fading political risks as initiatives are taken to strengthen the institutional framework.
- Dollar – a dead-cat bounce. After a steady decline in 2017, the dollar has recovered thanks to strong macro readings, tax reform and revived Fed rate hike expectations. There is little doubt the Fed will continue to normalize policy, leaving the focus on the ECB and Bank of Japan (BoJ). After this broad-based bounce, we still expect the dollar to lose ground versus the euro as it remains rather expensive. Higher inflation in the US than in Europe is a downside risk and the exchange rate should adjust accordingly.
- Sterling – heading lower. In 2017, sterling was supported by a softer dollar and economic resilience. By early 2018, the pound had recovered the ground lost after 2016's Brexit vote. Risks are now to the downside – we forecast slower growth in the short and medium term and Brexit uncertainty remains high. We expect a modest drop versus the dollar but a sharper fall against the single currency.



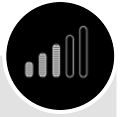
Risk aversion benefits safe havens

"Emerging currencies should benefit from high yields and dollar weakness"

- Swiss franc – edging lower. The franc shot higher in the wake of the recent market rout. As a safe haven, the Swiss franc remains highly sensitive to shifts in risk appetite. However, we would expect it to correct lower as soon as volatility abates. Furthermore, it is sharply overvalued which augurs renewed weakness in coming months. The central bank should maintain an aggressive monetary policy stance, paving the way for a weaker franc.
- Yen – range-bound. The yen has also been supported by recent market turmoil. Despite higher inflation, the Bank of Japan (BoJ) should maintain an easy policy and continue its asset purchases. Capital outflows from domestic institutional investors are also a drag on the yen. However, bouts of volatility may cause yen spikes.
- Emerging currencies – Carry on. Emerging currencies have been weakened by risk aversion and a stronger dollar. We see limited downside risks as carry is still attractive. Furthermore, improving fundamentals and prudent economic policies will make currencies less sensitive to rising US rates. The upturn in global growth is also a positive as it implies higher commodity prices and accelerating exports. Overall, valuations look fair to cheap, providing additional support – we remain constructive on emerging currencies.

Sources: SGPB, Bloomberg, 09/02/2018. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

Alternatives



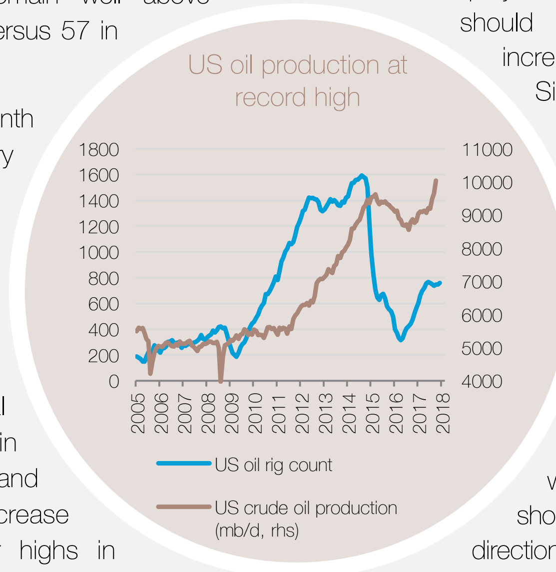
A Shift in Dynamics

- The US is emerging as the world's second-largest oil producer, which should cap upside for prices.
- Recent rises in volatility, lower correlations and rising dispersion suggest better market dynamics for Long/Short Equity and Event Driven managers.
- Despite turbulence in bond markets, spreads in Credit have yet to rise enough to provide new opportunities, while Global Macro/CTA managers may struggle with volatility spikes.

Commodities

"The oil price rally is over"

- Crude oil. The positive effects of the output cuts decided by OPEC and Russia have been offset by growing output of shale oil in the USA, leaving supply in excess of demand. According to the Energy Information Agency (EIA), the USA could overtake Saudi Arabia as the second world producer with average daily output of 10.3 million barrels per day this year and close in on Russia in 2019 with 10.9 mb/d. US oil exports reached an all-time high at 1.6 mb/d in Q4 2017 and world crude inventories remain well above average at 62 days of demand versus 57 in 2013.
- Gold. Bullion posted an 18-month high above $1,366 in late January despite a 7% decline in world demand in 2017 according to the World Gold Council. Investment demand was down 23%, mainly due to weaker inflows into ETFs. Bar and coin demand fell 1.9% and central banks bought 5% less gold than in 2016. On the other hand, demand for jewellery rose 4%, the first increase since 2013, driven by 17-year highs in demand in India thanks in part to the government's Q4 decision to exclude jewellery from anti-money laundering regulation. On the supply side, gold recycling normalized last year after a very strong 2016 while mining growth remained sluggish. All in all, total supply was down 4% versus 2016. Rising inflation expectations and US rate hikes this year are negatives for bullion. However, growing market volatility should underline gold's safe haven status.



Hedge funds

"Rising interest rates have historically been associated with stronger hedge fund performance"

- Equity Long/Short. Long/Short managers are required to post collateral against their shorts in the form of Treasury notes, meaning that they tend to register improving returns as interest rates rise. In addition, the improving dynamics we described in January (multi-year lows in correlations and rising stock dispersion) now come with higher volatility. Active managers should benefit in these conditions.
- Event Driven. Boosts to corporate profits from tax cuts and the deployment of repatriated foreign earnings should boost corporate activity, further increasing opportunities for Special Situations funds. Recent market volatility should increase the spreads between the share prices of acquirers and their prey on heightened uncertainty, helping enhance potential returns in Merger Arbitrage.
- Credit/Distressed Debt. As suggested last month, corporate credit spreads have begun to widen as equity volatility feeds worries in high yield – Credit investors should continue to avoid funds with high directional exposure to prices. In Distressed Debt, Fitch's forecast of a doubling of defaults in US high yield in 2018 suggests better opportunities ahead.
- Global Macro/CTAs. Recent whipsaw trading in equities may have proved challenging for all but the most agile CTAs. On the other hand, the reemergence of stronger trends in bonds should help diversify their portfolios. For Global Macro managers, the shift in fundamentals driven by reduced monetary policy support should improve their opportunity set in coming months, once the volatility spike is over.

Sources: SGPB, Bloomberg, 31/01/2018. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

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