Monthly
House Views

Skies yet to clear

After a soft patch in Q1, global growth is picking up, although the pace is slower than last year. Regional divergence will be more marked, as US tax cuts have provided additional stimulus whereas the eurozone has experienced some capacity constraints. Growth however should continue to outpace its potential. Brexit uncertainties are capping both business investment and consumer spending in the UK. In emerging countries, China remains a substantial contributor to global activity.

Headline inflation pressure continues to build, given tightening labour markets and rising energy prices. These are most visible in the US, although recent price data in Germany did surprise on the upside. In the UK, sterling strength in recent quarters has alleviated imported price pressure and inflation has eased lower. Although inflation rates in emerging countries have converged with the advanced world and stand at multi-decade lows, this masks wide disparity between countries.

Although consensus expectations are for two more US rate hikes this year, a third remains a distinct possibility given the inflationary potential of pro-cyclical tax cuts. Recent political turmoil in Italy seems likely to foster continued uncertainty, which could delay the ECB's plans to wind down asset purchases. The Bank of England has taken advantage of the slide in inflation towards its target to put plans for hikes on hold. And recent declines in Japanese inflation suggest continued patience from the Bank of Japan.

Our overall neutral stance on risk reflects opposing forces. Moderating but still robust growth is a strong support for corporate credit quality and earnings. On the other hand, talk of trade wars, Italy's eurosceptic coalition, tightening dollar financial conditions and the turmoil buffeting Argentina and Turkey all suggest caution. In this context, we propose adding to uncorrelated sources of returns, such as hedge funds, to enhance portfolio diversification.

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

EQUITIES | BONDS | ALTERN.

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:

Least preferred | Neutral | Most preferred | Upgrades in green, downgrades in red

EQUITIES

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

BONDS

EUR	Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
Duration*		Short		

USD	Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
Duration*		Short		

GBP	Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
Duration*		Short		

CURRENCIES

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

ALTERNATIVES

Hedge funds	
Gold	
Oil	

Source: SG Private Banking, 08/06/2018, * Duration: short = 3 to 5 years, medium = 5 to 7 years, long = 7 to 10 years. HY = High Yield bonds (higher return but greater risks), Inv. Grade = Investment Grade bonds (higher quality but lower return)

In other words

EQUITIES*	United States	The tax reform will encourage share buybacks this year. The resulting boost will lead to stronger profit growth but Fed rate hikes will remain gradual. The oil and IT sectors will be supported by higher prices and receding fears of tighter regulations respectively. We upgrade US equities to neutral, tactically.
	Europe	Slower corporate earnings growth and political risks (Brexit, Italy) could worry investors and limit upside potential.
	Eurozone	Despite slower profit growth, we stay neutral as recent euro weakness should see upward earnings revisions while corporate fundamentals remain sound as indicated by improved margins and return-on-equity and decreased leverage over the past decade.
	UK	Given our expectations for a fading energy price rally, further economic weakness and persistent Brexit uncertainty in coming months, we stay cautious on UK equities.
	Switzerland	High valuations and slower earnings growth should weigh on this market but its bias towards high-quality defensive stocks means we remain neutral.
	Japan	Although political risks have receded in Japan, softer global trade growth and trade tensions will act as headwinds. Downgrades to earnings forecasts in recent months encourage us to shift to neutral.
	Emerging	Despite slower but still high earnings growth, improved profitability and higher oil prices that benefit commodity producers, headwinds remain plentiful (Fed rate hikes and rising global yields, trade tensions, and a stronger dollar), warranting a neutral stance.
BONDS*	Sovereigns	Further Fed hikes and cuts in its reinvestment programme put US long-term yields under upward pressure.
	Duration**	We continue to favour short maturities which are less sensitive to rising inflation and rates.
	Inflation-linked	Tighter labour markets should encourage higher wages, and we expect long-term inflation expectations to rise.
	Investment Grade	We still prefer US Investment Grade to High Yield given the latter's weaker balance sheets and lower protection from covenants.
	High Yield	Balance sheets are relatively solid in EUR High Yield, but Italy has proved a headwind for credit markets.
	Emerging debt (in € and $)	Rising US yields, a stronger dollar and higher oil prices are bad news for this segment although there are still pockets of opportunity.
CURRENCIES	EUR/USD	Political headwinds from Italy and rising US rates have pushed the dollar close to its highs for this cycle.
	GBP/USD	We are neutral on sterling given economic weakness and poor Brexit visibility.
	EUR/GBP	The eurozone's good macro fundamentals and faster growth should push it higher versus sterling.
	USD/JPY	Higher hedging costs and foreign capital repatriations may underpin the yen and we remain neutral.
	EUR/CHF	As eurozone concerns about Italy ease, safe-haven CHF buying should fade, pushing it lower again.
	Emerging	Emerging currencies are feeling the pain of a stronger dollar, higher US rates and oil-driven price pressure.
ALTERNAT.	Hedge funds	The current uncertain environment underlines the attraction sources of independent returns, such as Hedge Funds, which bring portfolio diversification benefits.
	Gold	Rising US rates pushing the dollar higher represent a strong headwind for gold. However, it retains safe-haven status which helps mitigate drawdowns and reduce volatility within portfolios.
	Oil	The US withdrawal from the Iran nuclear deal, strong demand and lower stocks have lifted oil prices towards $80 per barrel.

Source: SG Private Banking, 08/06/2018, 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

Italian political crisis unlikely to derail eurozone growth

- Political uncertainty will weigh on Italian growth.
- Many fear fiscal slippage but not all reforms will materialise.
- Italy's sovereign rating could be downgraded
- Yield spreads versus Germany – very volatile in Italy, less so elsewhere.

- After months of negotiations, the 5 Star Movement and Liga eventually agreed in late May to form a coalition government led by Giuseppe Conte. While this should help avoid new elections in the short term, the risk cannot be ruled out yet given the two parties disagree on most points, except Euroscepticism.

Marginal impact on eurozone growth

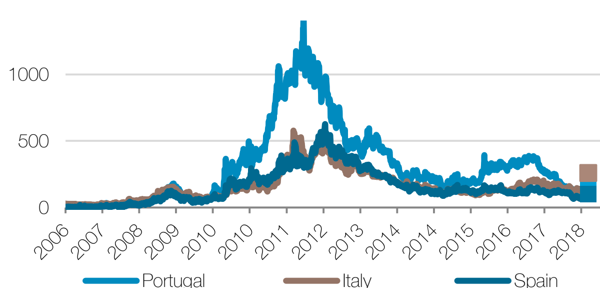
- While Italian political jitters could weigh on sentiment, we expect limited impact on the eurozone. Societe Generale Corporate and Investment Banking still forecasts 2018 GDP growth of 1.6% in Italy and 2.4% for the eurozone. Also, Italy's contribution to eurozone growth does not exceed 0.2pp per year. Lastly, speaking ahead of the June monetary policy committee, ECB chief economic Peter Praet said the robust growth of the eurozone and growing wage pressures reinforce the central bank's confidence that inflation will gradually return to its goal.

Not all reforms will go ahead

- Corriere della Sera estimated that all campaign promises could cost over €100bn, widening the public deficit by 5.5% of GDP. Markets fear this budget slippage but we do not believe all pledged reforms will materialise – Italy is severely constrained by the eurozone's second highest debt/GDP ratio (behind Greece) at 132%.

Sharp reversal in Italian spreads

10-year yield spreads with Germany (basis points)



Source: Bloomberg, 30/05/2018

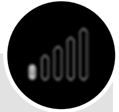
Italy sovereign rating at risk

- After a spike at 330 basis points (bp) in May, the spread between Italian and German 10-year government bonds is back at 250bp, its highest level since 2013. This wide spread reflects market participants' expectation of a downgrade from all three major rating agencies. Italy is rated Baa2 negative (Moody's), BBB stable (S&P) and BBB stable (Fitch). Fitch will be next to review its assessment on 31 August. However, early action cannot be ruled out, especially from Moody's which recently put the rating under review. A one-notch downgrade would leave Italy only one cut away from High Yield status. In that context, spreads are unlikely to return to their year lows.
- The European Central Bank (ECB) will continue buying Italian debt as part of its quantitative easing scheme as long as the country is still rated "investment grade" by at least one of the four agencies recognized by the central bank (Moody's, Standard & Poor's, Fitch and DBRS). At end May, the ECB held 17% of Italy's debt (€345bn).

Yield spreads versus Germany – very volatile in Italy, less so elsewhere.

- The spread between 10-year Italian and German government bond yields is set to remain very volatile and sensitive to market chatter – for instance, when ECB chief economist Peter Praet sounded a hawkish note in early June. The current spread now stands well above the equivalent spreads for Spain (100bp) and Portugal (150bp).
- Bottom line. The Italian political crisis is unlikely to derail eurozone growth, as fundamentals remain solid. Spikes in volatility could offer tactical entry points for short-dated Italian bonds, but the other peripheral issuers look much less risky.

Fixed Income



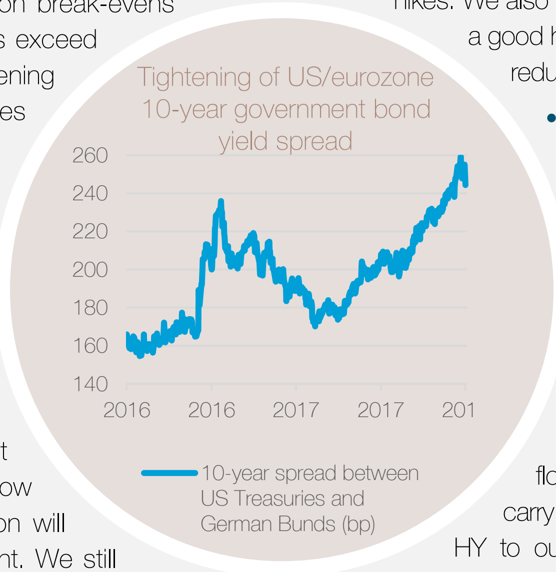
The risk remains higher rates

- US yields level off but uptrend should resume.
- Italian political crisis to put a lid on core EUR bond yields.
- Good fundamentals will cap corporate spread widening.
- We still prefer short maturities and floating-rate notes.

Rates

"US yields to pause, for now"

- United States. Although external factors may prompt the US Federal Reserve to pause after hiking in June, wage pressure from low unemployment is most likely to lead to two or three further rate hikes before year-end. However, the Fed will refrain from moving too aggressively as any inversion of the yield curve – the gap between 2- and 10-year yields – would be seen as early warning of downturn. Our scenario is a flat curve but we expect no inversion. Inflation break-evens could rise further if price pressures exceed expectations. This curve flattening suggests keeping bond maturities short.
- Eurozone. Political turmoil in Italy triggered a flight to safety on bond markets but nothing comparable to the debt crisis of 2011-12 as contagion was limited. Persistent uncertainty will stop spreads from returning to their early 2018 lows. We expect the German Bund yield to remain low for long as the slow rise in inflation will encourage the ECB to stay prudent. We still expect the ECB to remove QE by end 2018.



Credit

"Divergence between US and eurozone spreads"

- United States. Corporate spreads have moved sideways in reaction to a bright economic outlook and strong profit growth with stable default rates. Despite this supportive environment, we still prefer investment-grade (IG) bonds to high yield (HY), which is more sensitive to risk aversion and more correlated to equities. HY has suffered outflows as carry on IG has become more appealing. We still favour short maturities given the prospect for Fed rate hikes. We also like floating-rate notes as they offer a good hedge against rising rates and help reduce portfolio duration.
- Eurozone. Eurozone credit is now less attractive because of rising yields, political crisis in Italy and softer economic momentum. However, the market is also supported by solid balance sheets, ongoing recovery and ECB asset purchases. We still favour corporate hybrids, and selected floating-rate notes offering higher carry. For the year ahead, we expect HY to outperform IG as credit conditions ease further.
- Emerging debt. Rising US yields, a stronger dollar and higher oil prices are bad news for this segment. Outflows have been recorded as the carry on US debt has improved. With some emerging central banks in tightening mode, funding is turning less easy – a negative for the asset class. Pockets of opportunities still exist but we would stay prudent for now.

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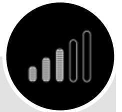
Equities



Fundamentals still positive overall despite political turmoil

- Heightened volatility to stay in coming months due to Fed policy normalization and lingering political and geopolitical risks.
- However, the macroeconomic environment remains positive. Momentum in global manufacturing and trade growth has faded in recent months but the global economy will continue to expand at a solid pace in coming quarters as the softening observed in the first quarter should prove temporary. Monetary policy normalization is still at its early stage, led by the US Federal Reserve.
- Against this background, corporate profits will grow at a slower but still double-digit rate this year while equity market valuation is less a concern.

Stay neutral on global equities

Revived political worries in the eurozone

Expect weaker profit growth in Japan

- USA. The one-off tax-cut boost to profit forecasts is now behind us and dollar strength may exert pressure on earnings, leading to downward revisions in the short term. Moreover, rising wages may start to weigh on margins in coming quarters while rising rates will penalize companies which have increased leverage over past years. However, the tax reform will stimulate economic activity throughout the year, leading to strong earnings growth and buybacks, which remain key supports for US equities. Also, the Fed will continue to hike rates only gradually. In the short term, higher oil prices will support the energy sector and fears of tighter regulations in the US tech industry have receded. Finally, price momentum is positive. All in all, we upgrade US equities to neutral, tactically.
- Eurozone. Despite a weak start to the year, the economic context looks solid with GDP growth above potential and monetary policy still easy as core inflation remains tame. European companies have seen their margins and profitability grow while leverage is down since the financial crisis. However, corporate profit growth is expected to slow from 13% last year to 7% in 2018 and Italian politics will remain a concern in coming months, a negative for the banking sector. In the short term, recent euro weakness should ease pressure on multinationals and lead to earnings forecast upgrades, giving this cyclically-tilted equity market a temporary boost. All in all, we stay neutral.

- UK. UK equities have recovered sharply since end-March as higher oil prices benefited energy-related sectors (25% of the FTSE 100 index) while recent sterling weakness provided a fillip to the many companies generating revenues abroad. However, we remain cautious – coming months should see sterling headwinds (see page 7), lower oil prices, economic weakness and lingering Brexit concerns.
- Switzerland. High valuations and slower profit growth should weigh on this market but its bias towards high-quality defensive stocks means we remain neutral.
- Japan. In the long run, equities should again benefit from structural tailwinds, very loose monetary policy and attractive valuations. In the shorter run, while political risks have faded in Japan, trade tensions and weaker growth have led to cuts in earnings-per-share forecasts and we have chosen to reduce our overweight.
- Emerging markets. Growing protectionism, higher global rates and a stronger dollar have weighed on emerging markets in past months. Export-dependent countries which suffer current account deficits (e.g. Brazil and Turkey) are once again vulnerable, causing currency weakness and driving their central banks to hike rates. However, a resilient Chinese economy, higher oil prices, double-digit earnings growth (+15% IBES consensus forecast for the MSCI EM this year after 22% last year) and attractive valuations encourage us to stay neutral.

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Currencies

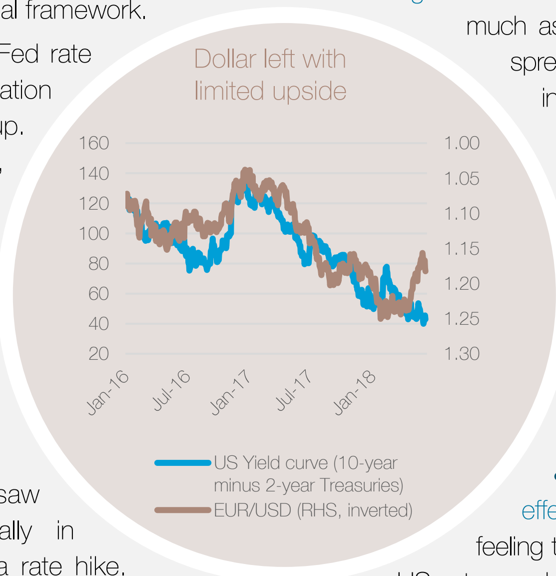
Dollar close to its highs

- Dollar bounce won't last.
- Revived political risks will be a drag on the euro in the short term.
- Sterling is set to remain cheap
- Emerging currencies with solid fundamentals should remain resilient.

Euro under near-term pressure

Politics is back in the driving seat

- Euro – Political headwinds. The Italian crisis and softer growth have sent the euro down and there is little hope for a bounce in the short term given this environment will encourage the European Central Bank to continue asset purchases through to year-end. We expect the single currency to recover in the longer term and target 1.23 in six months. However, much will depend on the growth outlook and the ability of eurozone members to go ahead with reforming the institutional framework.
- Dollar – cyclical revival. Stronger Fed rate hike expectations in light of inflation have helped US yields creep up. Although growth looks buoyant, we forecast limited price pressure and do not think long-term yields will move much higher. This will keep the yield gap in check and put a lid on the recent dollar rally. The greenback is left with limited upside and structural factors are negative overall.
- Sterling – headwinds. Early 2018 saw the pound continue 2017's rally in anticipation of a soft Brexit and a rate hike. Sterling dropped below 1.35 when both projections were dashed. First, GDP growth was almost non-existent in Q1 at 0.1% and recent surveys are not encouraging despite some pick-up in manufacturing activity. Second, after signalling a hike, the Bank of England finally backtracked. Against this backdrop, we cut our forecasts for GBP/USD and have turned neutral, especially given greenback strength.



Risk appetite drives flows

Weak emerging currencies at risk

- Swiss franc – back south. Revived risk aversion has driven investors back towards safe-haven currencies. As concerns ease, the franc will head south. The 1.20 mark will be hard to break given its previous importance for central bank policy but if it gives in as we expect, the currency will fall more easily. Our target remains 1.22 in six months.
- Yen – tug of war. The Italian crisis did not benefit the yen much as risk aversion in Europe failed to spread. Weaker growth in Q1 and low inflation call for the Bank of Japan to maintain an easy policy, a negative for the yen. However, bouts of risk aversion could provide short-lived support. Higher hedging costs and foreign capital repatriations may also underpin the yen. Against this backdrop, we keep our 6-month target at 110.
- Emerging currencies – domino effects. Emerging currencies are feeling the pain of a stronger dollar, higher US rates and oil-driven price pressure. Several central banks have hiked rates to curb inflation and outflows. Once again, Turkey, Brazil and South Africa are in trouble and raising rates too fast could choke growth, making things worse. Not all emerging currencies are struggling – those to favour should be based on economic fundamentals in a context of tougher dollar funding. Commodity exporters running large current account surpluses are more likely to outperform their peers. We remain neutral overall versus the dollar.

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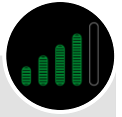
Alternatives



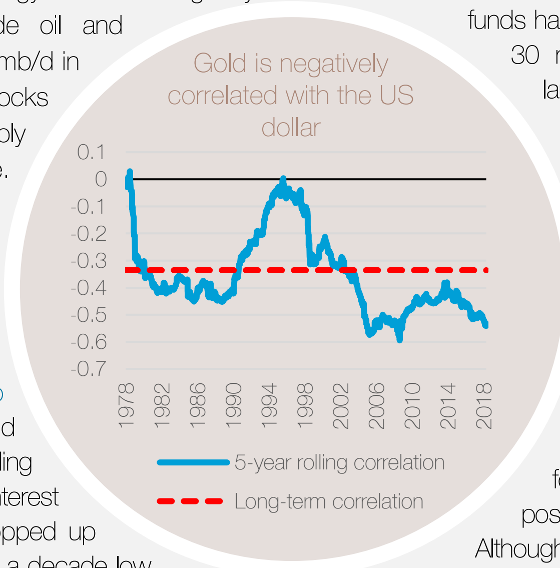
Time to trim the cuts

- With OPEC and Russia talking about increasing output and strong output growth in the US, we expect oil prices to ease lower.
- Turbulence in Europe has cut correlations favouring Long/Short Equity, while the spate of restructurings offers new opportunities in Special Situations.
- Robust growth means slim pickings in Distressed Debt, while CTAs have adapted well to this year's switches in market regime and diversified their themes.

Commodities

US oil imports are at 60-year lows

- Crude oil. Oil prices broke the $80 mark in May – a first since November 2014 – prompting the International Energy Agency (IEA) to cut its global demand growth forecast for 2018 to 1.4 million barrels/day (mb/d). Meanwhile, non-OPEC output was robust in April – mostly thanks to the US – offsetting weakness in Venezuela and Africa. The US withdrawal from the Iran nuclear deal may add to pressure in the short term. The US is increasingly self-sufficient thanks to shale oil and the US Energy Information Agency sees total net imports of crude oil and petroleum at a 60-year low of 1.5 mb/d in 2019. Output cuts drove OECD stocks to a 3-year low in March and supply is now below its 5-year average. However, OPEC and non-OPEC countries led by Russia said they were considering lowering their supply caps by 1 mb/d to avoid overheating.
- Gold – higher US rates set to weigh. For the first time this year, gold broke below its $1,300-1,360 trading range in mid-April as rising real interest rates and stronger US growth propped up the dollar. In Q1, global demand hit a decade low as weaker investment in bars and ETFs was only partly offset by stronger appetite from central banks (+42% YoY). The correlation between the dollar's effective exchange rate and gold is historically high at -0.55 year-to-date and the stronger the greenback, the weaker the demand as dollar-denominated gold becomes less affordable in non-USD regions. Market turmoil remains a tailwind for gold. However, we remain mildly bearish given the pressure from dollar strength and higher interest rates.



Hedge funds

With no sign of a pick-up in defaults, opportunities for Distressed Debt are unlikely to improve

- Equity Long/Short. While May was a difficult month for active equity managers, such as Equity Long/Short funds, the outlook now looks more promising. In particular, European markets, where intra-stock correlations are lower than elsewhere and volatility has been driven higher by Italian political risk, offer new opportunities. In this context, Variable Bias funds – which adjust exposures as market conditions evolve – look attractive.
- Event Driven. The opportunity set for Special Situations funds has continued to improve, with around 30 new plans for capital restructuring launched since February, often by mid-sized tech and industrial players. In Merger Arbitrage on the other hand, there are a number of jumbo deals, many China-linked which has widened spreads and improved return potential, given trade-war fears.
- Credit/Distressed Debt. Recent volatility in credit markets has yet to widen spreads enough for arbitrageurs to build new positions, which will limit return potential. Although balance sheet quality has worsened in the US and covenant-light bonds have proliferated, defaults remain rare and Distressed Debt specialists will continue to struggle to deploy capital.
- Global Macro/CTAs. We still highlight the diversification benefits of CTAs which have identified an eclectic assortment of new trends to play, in areas such as energy, rates and forex. The less systematic managers in Global Macro have struggled to adapt to the rapid switches in environment and have scaled back exposures as a result. In addition, they tend to be clustered in the same themes.

Sources: Datastream, 01/06/2018. 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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CA150/JUN/2018