Outlook for 2018: Stronger for Longer

Although we predicted a positive year for risk assets in 2017, we had anticipated more conservative returns and increased levels of volatility. Low interest rates, a weak U.S. dollar and strong earnings have each played a key role in propelling markets to historic highs. The synchronized global growth story and improved fundamentals across regions have created a ripe environment for this bull market to continue into 2018.

For the first half of 2018, we expect a positive performance for risk assets amid a backdrop of continuing growth in the U.S., synchronized global growth and rational exuberance. However, we consider the outlook for the second half of 2018 to look more complicated, as we expect the growth rate to decelerate as markets reach their peak.

Still, we believe the factors that could prompt a downturn are not in place yet and that it is still too soon to de-risk portfolios. The end of a bull-run is where a lot of money can be made, and bull markets do not die simply because of old age. Although our fundamental analysis shows a healthy global environment, we do believe that technical factors could contribute to a short-lived, yet meaningful correction in markets. Volatility levels remain at record lows, with investors shrugging off political risk and holding strong cash positions to deploy during market dips.

We are cautiously bullish for 2018, but we recommend investors to remain vigilant given that we are in the late stage of this economic cycle, central banks are beginning to tighten, and equity valuations continue to expand. At BigSur, we are constantly monitoring recession triggers, their probabilities and impact potential, as well as indicators that could signal irrational exuberance in markets.

At this time of the year, we engage in the task of compiling the next year's views of major banks and independent researchers. This exercise serves not only as a tool to gauge the Street's sentiment for the coming year, but also as a starting point to form our own outlook. The table below summarizes the 2018 views of the major research providers.

	BCA *	MRB*	BAML	Citibank	Credit Suisse	Deutsche Bank	Goldman Sachs	JPM	Morgan Stanley	UBS
Cash	Green	Green	Red	Yellow	Green	Green	Green	Green	Green	Green
Government Bonds	Red	Red	Red	Red	Red	Red	Red	Red	Green	Red
Credit	Red	Red	Red	Red	Red	Red	Red	Red	Red	Yellow
Equities	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
USD/EUR	Green	Yellow	Green	Red	Red	Red	Yellow	Red	Red	Red
Commodities	Green	Red	Yellow	Yellow	Yellow	Green	Yellow	Red	Green	Yellow

* Independent Research

There is consensus that Equities will outperform Fixed Income next year, a view supported by the themes of global synchronized growth and rising interest rates – two topics highly addressed in research reports. Analysts predict a strong performance in Equities amid the backdrop of strong, growing corporate earnings. Although there will be opportunities in Fixed Income, the fact that there will be a global environment of rising rates has led analysts to be Underweight in Government Bonds. Analysts are also Underweight in Global High Yield Credit given that spreads are very tight.

The Thinking Man's Approach

December 2017 | Series #55

Ignacio Pakciarz | CEO
Eduardo Sensel | Analyst
Salvador Juncadella | Analyst

- Markets reached historic highs in 2017 due to low interest rates, weak USD, low rates and strong earnings
- We expect a positive 1H 2018 due to continuing growth in the U.S. and synchronicity in global growth
- The outlook for 2H 2018 looks more complicated. We expect the growth rate to decelerate as markets reach their peak
- We are cautiously bullish for 2018. Although we consider this market has room to grow, we recommend investors to remain vigilant given that we are in the late stage of the economic cycle, central banks are tightening, and valuations are high
- Equities: O/W Industrials and Financials; EM & Europe over U.S.
- Fixed Income: EM credit over U.S. and European HY
- Alternatives: O/W private equity, private debt and real estate.
- Commodities: bearish on gold and metals, bullish on oil

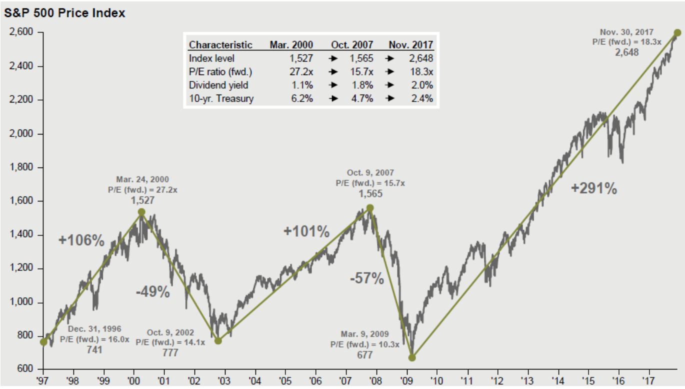
For more on how we are positioning our portfolios, please contact your investment advisor or email: ideas@bigsurpartners.com

Cash is an asset class that most analysts believe will benefit from major central banks' tightening policies, although some analysts voiced their opinion regarding the unattractive returns for the asset class. The outlook for FOREX tilts towards the underperformance of the USD, as analysts are predicting a weakening USD against the Euro. In Commodities, analysts' opinions are more mixed – which is normal given the complexity of predicting prices.

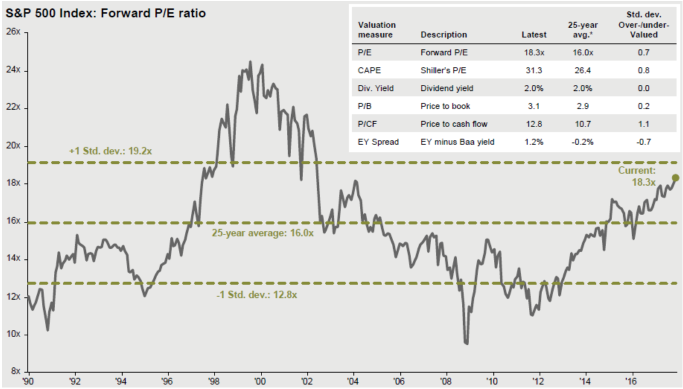
BigSur Views

Equities

Equity performance for 2017 has been nothing short of impressive - outsized returns with nearly non-existent volatility. The S&P 500 has returned over 290% since bottoming in March of 2009. The Dow Jones, since the election of President Trump, has soared from hovering around 18,500 to over 24,500.



J.P. Morgan



This growth has driven valuations towards expensive levels, with the S&P 500 currently trading at ~18.3x forward EPS. Considering that we are in the ninth year of this long economic cycle and bull market, it is not surprising that some investors are beginning to worry about rising valuations and irrational exuberance present across financial markets.

Rational Exuberance

Our view at BigSur is that although valuations seem high on an absolute basis, there continues to be room for equities to run further, albeit at a slower pace. Our rationale is three-fold:

1. From a relative perspective, U.S. valuations are not overpriced – particularly if we consider return expectations and earnings yield. Government bond yields are low, and the spreads for IG and HY bonds are tight by historical standards. Today, S&P 500 earnings yield is 4.4% – almost twice the 10-yer Treasury yield of 2.36%.
2. Valuation multiples seem high, but from a historical perspective are fair – current levels do not fall beyond one standard deviation from the 25-year average.
3. We believe investors are behaving rationally given that valuations are fundamentally supported by earnings growth expectations. Currently, the conversation is mostly about how much growth will the economy and corporates enjoy, rather than just how much the market will rise. There is still cash on the sidelines, and retail investors have yet to participate in this bull market.

Continuing Growth in the U.S.

In the U.S., we are seeing the initial phase of a real economic cycle being pushed forward by increased capital spending. Confidence indicators show that animal spirits are high, and tax reform will increase companies' free cash flow. This leads us to believe that companies will be more willing to increase long-term investments in order to add capacity. Our research partner Strategas[1] Research Partners ("Strategas") believes that tax reform alone could provide 0.5 to 1% of economic stimulus next year.

Now that U.S. tax reform has been passed, our belief is that equities will disproportionately benefit from tax reform not only because of increased corporate investment, but also due to share buybacks and dividend increases. We think we can conservatively expect over 10% growth for equities the next year. We think there could be even further upside – especially for companies with high tax rates and significant cash overseas.

We are particularly Overweight in two sectors: Financials and Industrials. Financials are poised to outperform due to deregulation and rising interest rates. Industrials have reached new highs, and their continued market leadership will be a recurring theme during 2018 – especially considering the prospects of rising corporate investments. According to Strategas, both sectors are approaching a 60% weight in the S&P 500 High Beta Index, which tracks 100 companies with the highest sensitivity to market movements.

Synchronicity in Global Growth

Although our U.S. outlook is positive, we are recommending our clients to a make a geographic shift in their portfolios in order to take advantage of the synchronized, global economic expansion. Global PMI surveys are growing at a faster rate, signaling there is a global gain in momentum. Surveys in the Eurozone, the U.K. and the U.S. showed comprehensive growth – an important sign given that they account for 45% of global manufacturing. Asian surveys also indicate continued expansion. China's PMI reading is indicative of a soft landing, which is significant considering this country's importance in the global growth picture. The macro backdrop of low inflation, easy money and healthy profits has proved positive, reason why we expect robust GDP and EPS growth at least for the first half of next year.

GLOBAL GAINS

Emerging markets are the biggest winners this year, followed by Europe and Japan.

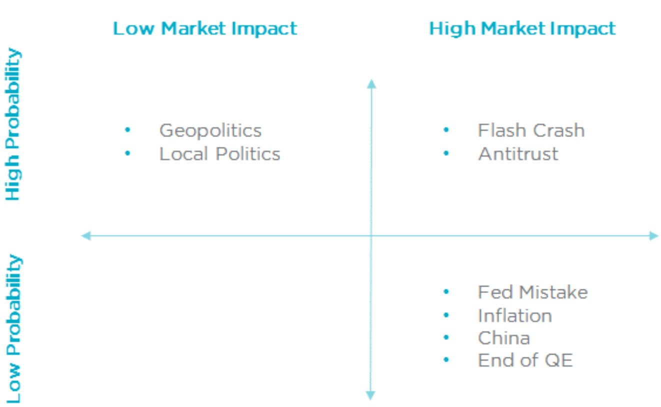
Index	Total Return*
S&P 500	19.7%
STOXX Europe 600	23.4
Nikkei	22.6
Shanghai	13.7
Emerging Markets**	30.6

*Through 12/6; U.S. dollar denominated
**Represented by MSCI Emerging Markets Index
Source: Bloomberg

We expect Europe and Emerging Markets to outperform given their improving fundamentals and more conservative valuations. Considering that these regions are in earlier stages of their economic cycles relative to the U.S., we expect margins and earnings to have more room for growth.

We expect the growth rate to start deaccelerating by 2H 2018. Usually, bullish macro conditions translate to lower asset returns. Equity markets will start discounting this deceleration, producing greater earnings estimate dispersion and lower equity multiples. Combined with the effects of narrower leadership and valuations potentially reaching their peak, we expect markets to run at a more conservative pace and with higher volatility during 2H 2018.

Throughout 2017, volatility remained at historical lows. As we expect a more complicated and volatile 2H 2018, it is important to evaluate the market risks we can encounter. We want to highlight three risks from our matrix:



[1] Strategas Research Partners: https://www.strategasrp.com

- Flash crash: investors should be wary of the possibility that a short-lived but aggressive correction can be triggered by an unpredictable event that could lead computer-driven strategies to trigger a continuous market selloff. The rise of momentum and passive strategies has caused the replacement of human market makers by algorithms, which can recognize quicker changes in the market and react accordingly. Risk parity, volatility targeting, leveraged ETFs and trend-following CTAs are all strategies that could cause severe liquidity disruptions

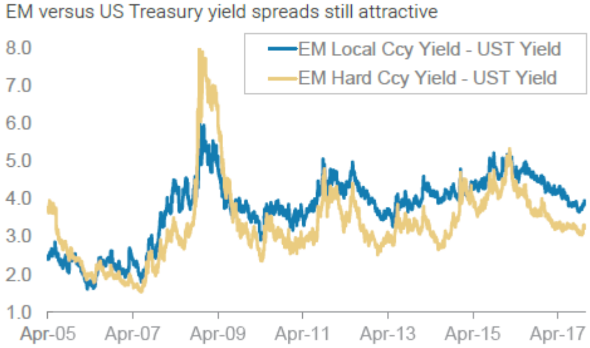
- Antitrust: Trump's populist nature represents a political risk to large tech companies. This is especially true for the FANGs of this world since their continued growth poses a monopolistic threat. Although FANGs' correlation to the overall market has been fading, a regulatory action against any tech giant could have a high market impact. Antitrust concerns have increased lately, and at least one of the four tech giants will see a $10 billion-plus fine, most likely coming out from Europe. Due to regulatory risk, we are Underweight in technology stocks.

- Geopolitics: we considered geopolitics to be a low market-impact factor during 2017, as investors shrugged-off any kind of geopolitical noise. However, this factor now demands special attention. Geopolitical events have now become understated, and they could give investors a not-so-pretty surprise in 2018. BCA mentions some Black Swan events that could surprise the market: a more protectionist U.S. as a "lame duck" Trump seeks relevance abroad, increased tensions with North Korea and Iran, increased political risk in U.K. and Italy while markets are overly complacent, renewed political risk in Latin America (Specifically in Mexico and Brazil). We also consider that NAFTA's gridlocked talks represent another important risk entering into 2018.

Fixed Income

We believe that Fixed Income will underperform next year due to a global environment of rising rates. Earning an attractive risk-adjusted carry in fixed income markets has become challenging, and our view is that it will only get more difficult going forward. For example, the market for government bonds is worth $100 trillion, of which $11 trillion have negative nominal yields and +$50 trillion have negative real yields. For these reasons, we are Underweight in Government Bonds.

Exhibit 35:
EM versus US Treasury yield spreads still attractive



Source: Datastream, Bloomberg, Morgan Stanley Research

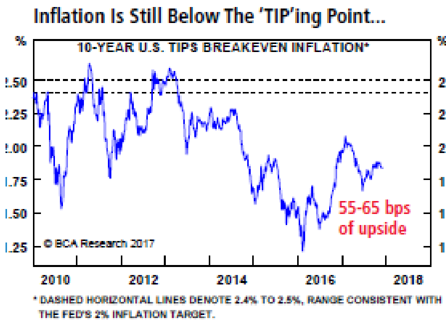
We are also Underweight in Global Corporate Credit. We are neutral to slightly bearish on U.S. and European HY given that spreads are extremely tight. Our Overweight for Fixed Income has shifted to Emerging Market debt where, although modest in comparison with previous years, returns will continue exceeding those of other fixed income markets. EM has shown resilience, valuations are attractive on a relative basis, and the region is expected to benefit from improving global macro conditions. EM companies have changed dramatically over the years. Today, they are more growth-oriented, less volatile, and less sensitive to commodities prices. Credit quality in EM is improving significantly, and country return dispersion is more likely to be driven by political factors rather than diverging economic factors. As we have extensively written about in the past, for a well-diversified investor, political noise is often overstated and will not materially impact a portfolio. Yet, at the local level politics can have a greater impact, particularly in election countries. In Latin America, Brazil, Mexico and Colombia will each vote for a new leader in

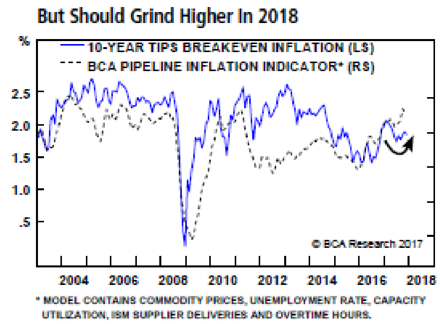
2018, and there is the potential for presidential elections in Venezuela. We see value in certain credits like Argentina, where idiosyncratic risks –such as political transition– are low.

Moving over to the United States, the U.S. Treasury yield curve has been flattening for the majority of 2017. After Trump's election, long-term yields rose as investors placed high hopes on pro-growth policies. Over 2017, those market expectations started to wane amid the slow materialization of policy changes and surprisingly weak inflation readings. We believe that the yield curve will completely flatten by the end of 2018, with a recession likely occurring 9 to 12 months later. Historically, the market usually begins to discount this 6 months before. Therefore, if a recession is to come in Q3 or Q4 of 2019, then the market should discount this as early as Q4 2018.

J.P. Morgan

The recurrence of inflation is another factor that could increase the risk of a recession. Inflation has not reached the Fed's 2% target, but on a backdrop of economic expansion, it is reasonable to expect that it will accelerate. The Fed could commit a mistake when reacting to inflation by rushing to hike rates. Although such mistake could be catastrophic as it would push the economy to a recession, it is also possible that consequences would be minor given that financial conditions are not tight. We believe TIPS are a cheap way to hedge against inflation. Currently, the TIPS market is not pricing in the possibility that inflation –and therefore rates– picks ups faster than expected.



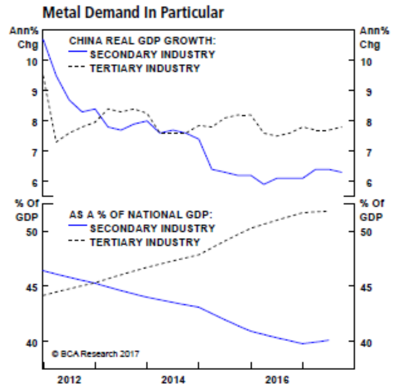


Commodities

Our outlook for Commodities is mixed, but we expect to see more upside than downside for the year.

We are particularly positive on oil amid a backdrop of strong demand growth and disciplined supply, driven by improving manufacturing PMIs and world trade growth. Additionally, the oil market is expected to move from deficit in 2017 to balance in 2018, and OPEC will likely extend production cuts for at least

Morgan Stanley



the first half of the year. Historically, energy is a classic late-cycle performer, and some believe the time for its outperformance has finally arrived.

Despite a global manufacture-driven expansion, we do not expect a great rise in demand for metals given China's transition towards a consumption-based economy. Economic growth is becoming less commodity-intensive, which could dilute the impact of stronger growth on long-term commodity demand.

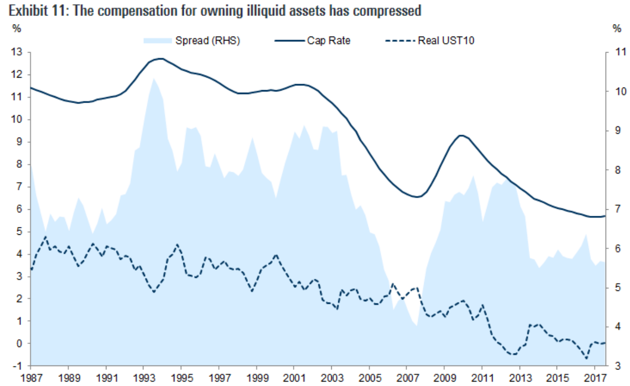
Gold and Bitcoin

Gold price is driven by three key indicators: the USD, interest rates and the S&P 500 equity risk premium. We are bearish on the precious metal given that for next year we expect the USD to strengthen during the first half of the year, interest rates to increase throughout 2018, and the S&P 500 to continue rallying. Although we expect volatility to pick up next year, we believe there are better volatility-hedging products. We believe volatility is the cheapest security, and SPY put spreads would provide protection against a correction.

During 2017, Bitcoin has experienced incomparable and incomprehensible price movements. We consider that Bitcoin is a venture-like investment, and therefore advise our clients to have none to minimal exposure. At BigSur, we are waiting for the market to further mature – as we do not know yet if Bitcoin classifies as a currency play or storage of value. Valuation expert and NYU Stern Professor Aswath Damodaran explains that cryptocurrencies like Bitcoin have succeeded in attracting investors and public attention, but they have yet to prove themselves as a currency. He explains a currency require three essential characteristics: be a divisible unit of account, work as a transaction medium, and serve as a storage of value. Bitcoin has yet to prove it possesses these last two qualities. Nonetheless, we believe Bitcoin has intrinsic value due to blockchain technology. In terms of asset allocation, we cannot foresee yet what role Bitcoin (or other cryptocurrencies) will play in our portfolio. We will continue to analyze cryptocurrencies' valuations and purpose, as well as how institutional investors begin to approach them.

Alternative Investments

Exhibit 11: The compensation for owning illiquid assets has compressed



Source: Bloomberg, Goldman Sachs Global Investment Research

We continue to be Overweight income-producing strategies across private debt and real estate, as well as niche pockets of value in the private equity space. We recommend clients to allocate about 25% of their portfolios to top-tier private investments, which provide diversification and upside for portfolios while simultaneously lowering the correlation to public market movements.

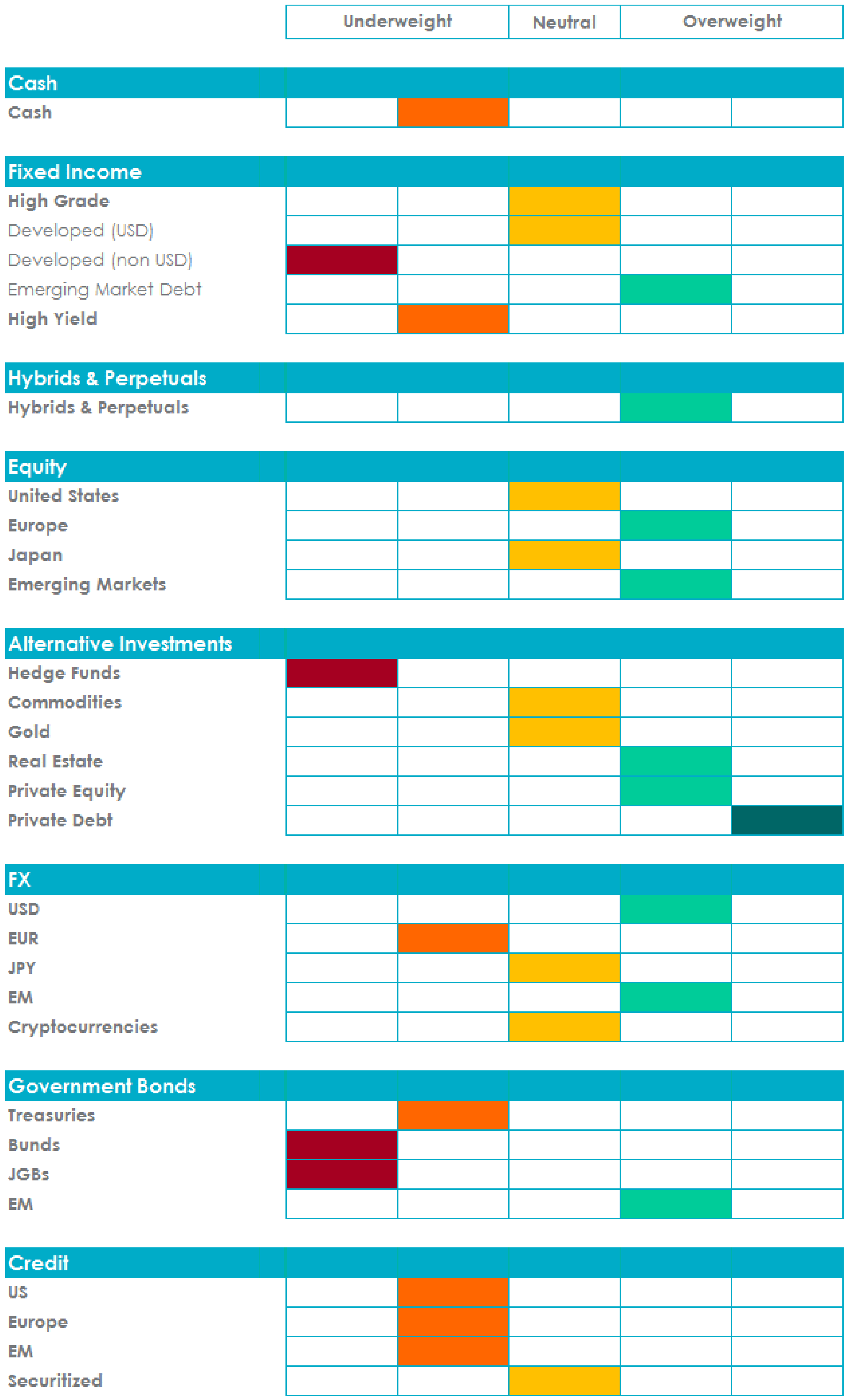
Instead of seeking levered exposure to low-spread assets, the search for yield has driven investors to earn incremental yield by leaning harder into liquidity premium – "anything without a CUSIP". The compensation for owning illiquid assets has consequently compressed, which can be seen in the differential rate of return between Commercial Real Estate and real Treasury yields.

The silver lining to this shift is that investors appear to have deployed far less leverage than in the last cycle. Long duration, illiquid assets are owned today primarily by long-horizon investors with long-term funding, and in many cases, such funds are sitting on cash. So, in the event of a sufficiently large market drop, there is reason to believe there is money on the sidelines that could step in to seize on opportunities and cushion a sell-off.

One risk we do see inherent to private investments is the level of fundraising taking place – particularly in private equity and venture capital. These funds are sitting on record levels of dry powder, which in turn has helped drive up private valuations to record highs. There are hundreds of billions of dollars that need to be deployed on behalf of investors, making it easy for startups to raise money - and much more than they need. Today there are over 200 unicorns, or companies valued at over $1 billion. Many believe a large percentage of these are significantly overvalued and pose the threat for a "private market bubble". The perfect example of extremes in terms of fundraising and valuations can be seen with two major players: SoftBank's Vision Fund and Uber. This year, SoftBank launched their $100 billion Vision Fund - the largest tech fund ever and also the largest corporate venture fund ever. Additionally, Uber, the unicorn with the highest valuation, recently stated it was selling a portion of its shares at a 30% haircut to its previous fundraising round.

For these reasons, we place a large importance on only investing with very disciplined managers that are conservative on entry multiples and valuations, and that can create value for investors. We like hands-on managers that are heavily involved in their portfolio companies, and those that have experienced multiple market cycles and come out on top. Lastly, as per usual, we remain Underweight in hedge funds since we believe managers cannot generate enough alpha in the long-term to justify their high fees.

BigSur Partners - Strategic Asset Views



Note: The strategic asset views represent BigSur's overall asset weighting by general asset class, which may be impacted by individual investor characteristics, portfolio weighting, time horizon, etc. – which should be assessed and individually analyzed accordingly.

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