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Weekly Investment Focus

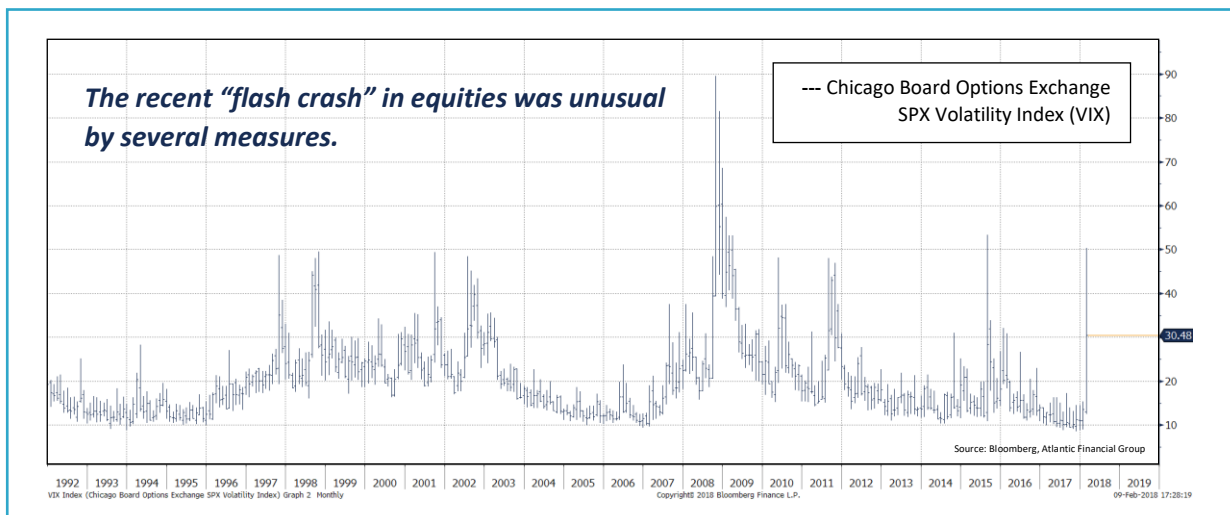
February 12, 2018

Headlines

- Equity markets are falling on inflationary fears
- We disagree with this analysis because inflationary pressures are structurally weak
- The increase in volatility is worrying, skyrocketing to a level observed only few times in the history
- We favour a bear trap scenario and remain constructive, but we remain on alert mode
- China enters the lunar year of the dog, not the gloomy bear: economic lights are green and orange, not red

Chart of the Week

“Volatility is making a comeback”



Market Comments

“After goldilocks, markets have entered a new regime”

Stock markets peaked on January 26th. Between January 27th and February 1st, they began to fall but the real decline has been taking place since February 2nd. In six sessions, the S&P500 lost 10.25%. Several questions or untruths make the headlines in financial newspapers. **We are coming back on these topics in order to provide clear advices.**



▪ Why are markets falling?

The main explanation does not deserve a long speech because it is simple: **they are highly valued**. As proof of this, Shiller's PER has recently reached 33x long-term earnings (see chart 2), it is at an all-time high, with the exception of the internet bubble period. **Sentiment and volatility indicators also reached extreme points**: highs for the former (see chart 3), lows for the latter (see chart of the week).

Chart 2 – US Cyclically Adjusted PE Ratio

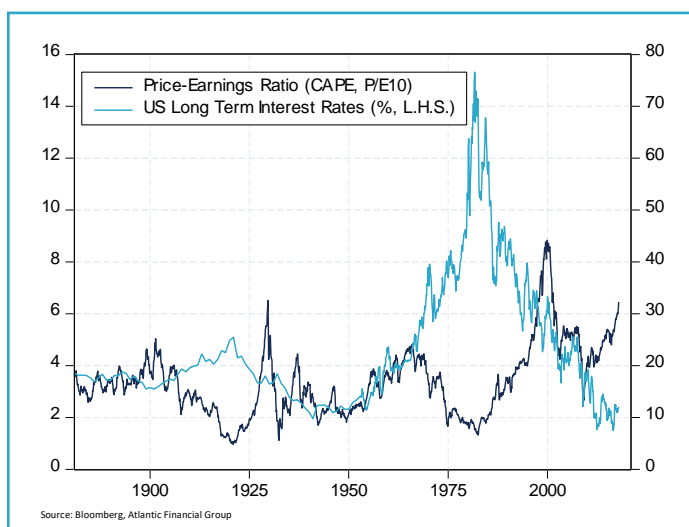
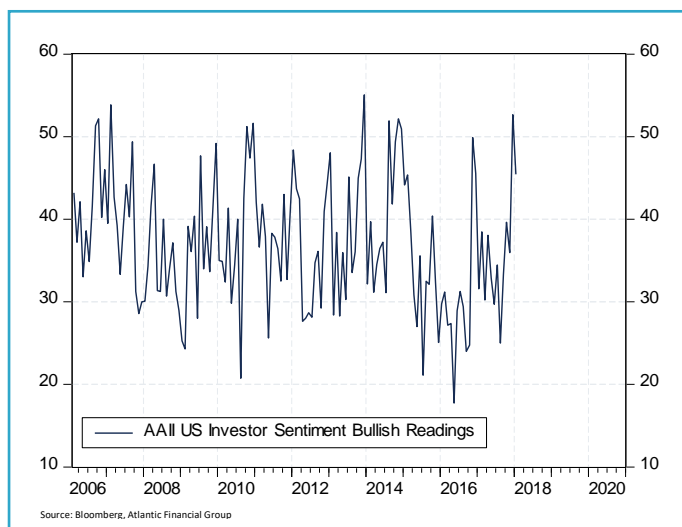


Chart 3 – US Equity Bullish Sentiment Indicator



▪ Are markets falling because of inflationary fears?

Some investors are trying to justify this decline in the equity markets because of a stronger-than-expected inflation, particularly in the United States, which would encourage central banks to tighten aggressively their monetary policies. This rise in interest rates would slack down economic growth and profits of listed companies, causing a bear market. **We disagree with this analysis.**

First, inflationary pressures are structurally weak. Undoubtedly, the global economy is at the top of the cycle and wages are beginning to rise in the United States (see chart 4) and prices of raw materials have risen last year. But these cyclical trends are not able to create an inflationary spiral. Weak productivity gains in the United States (see chart 5), weak job creation in Europe and costs control in emerging countries prevent any inflationary spiral from developing over the next few years.

Second, central banks continue to have very accommodative monetary policies. Most of them still print money (ECB, BoJ, SNB) and the others have a very low real interest rate policy (Fed, BoE).

Thirdly, this low-rate environment supports economic growth through cheap financing costs for businesses and households. Leading indicators are at an all-time high and point to robust economic growth this year. The cyclical slowdown is unexpected by the consensus, but it will take place at the beginning of next year.

Fourth, corporate profits have been rising sharply and **should continue to grow by about 10% this year**, largely supported by global demand.

All in all, it is not correct to explain the recent fall in the markets by using the inflation argument.



Chart 4 – US Wages & Leading Indicator

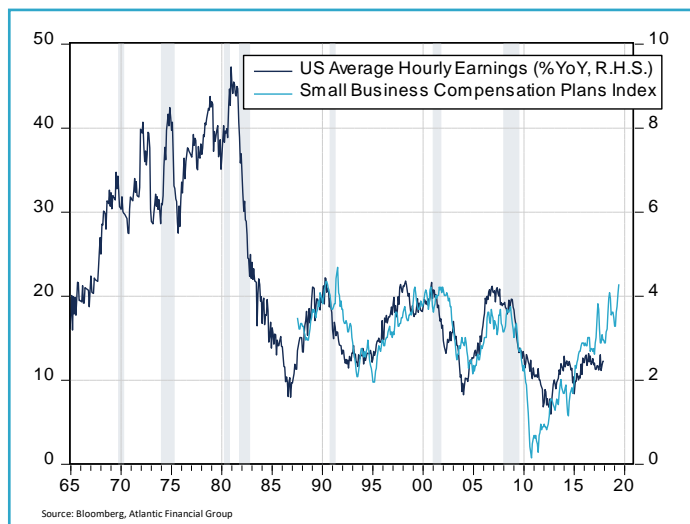
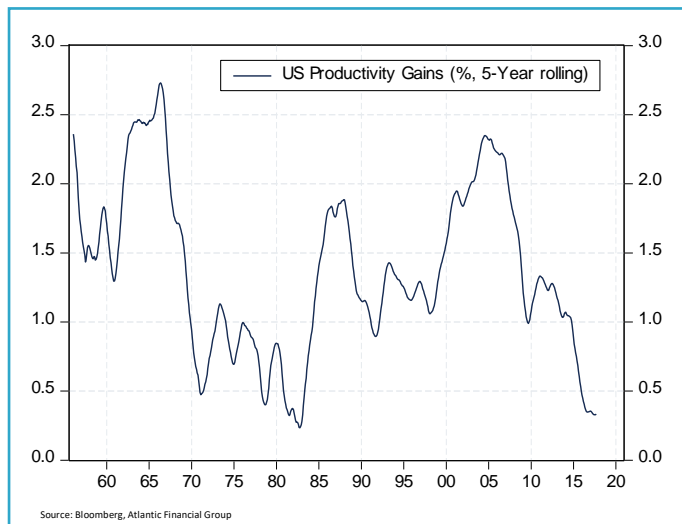


Chart 5 – US Productivity



▪ Why the increase in volatility is worrying?

The recent equity market sell-off was rather unusual. **Even if it was not associated with any exogenous systemic risk, implied volatility index (VIX) was multiplied by five** (see chart of the week). Started from a very low level (for most of 2017 it remained between 10 and 12), the fear gauge has finally touched an intraday high of 50.3.

Investors' hedging of equities exploded, causing the volatility skew to **skyrocket to a level observed only few times in the history**. Such extreme moves cannot be exclusively due to long-only and passive investors. The usual suspects are to be found in the following quantitative-driven strategies: volatility targeting, commodity trading advisors (CTA), trend-following, high-frequency and risk-parity funds. These quantitative strategies collectively have had a massive direct impact on implied volatility and on equities due to their initial high equity allocation.

As part of smart-beta strategies popular even among retail investors, shorting implied volatility was a profitable trade as long as spot implied volatility was drifting lower and term structures were in contango (steep upward sloping). The rise in popularity of such strategies explains to some extent why volatility was stubbornly low over 2017. These strategies were made available to retail investors through Exchange-Traded Notes (ETNs), the most famous one being the *Velocity Shares VIX Short Volatility Hedged ETN (XIVH US)*, which rose by 119% over 2017 and early 2018, but lost 90% of its value in just two trading days (5-6 February, see chart 6), when the implied volatility term structure abruptly reversed.

▪ Is it just a stock market correction or the start of a bear market?

Undoubtedly, the answer to this question is the most difficult to formulate. From a macroeconomic point of view, **a bear market (-20% or less) only occurs when a recession is looming**. Although we are largely more pessimistic than the economists' consensus for growth dynamics in 2019, **we do not envisage such a scenario**. And from a microeconomic point of view, companies are in good shape and their profits are rising. **The answer to the question will only come from the buying or selling behaviour of investors**. Since the subprime crisis in 2008 and to avoid a crisis like in the 1930s, central bankers have been playing the sorcerer's apprentice by injecting huge amounts of cash into the economy. It worked from an economic point of view but some of this money has not really reached its goal and has been "stuck" in

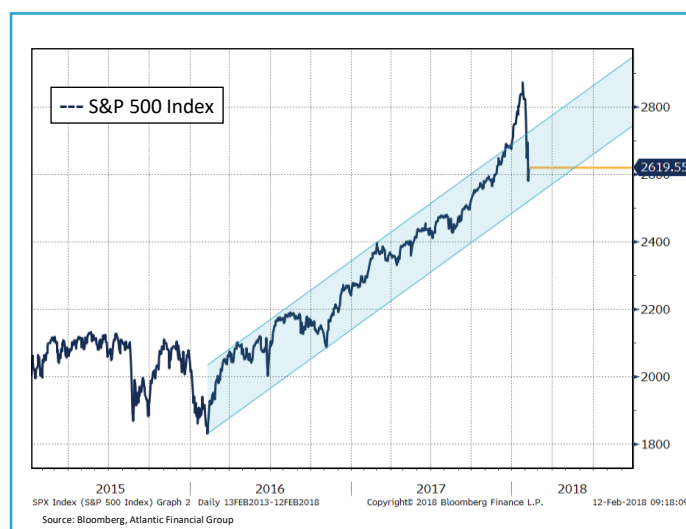


the financial markets, whether they are real estate, bonds or stock markets. This environment of abundant liquidity has encouraged the appreciation of these assets and generated an extreme climate of confidence. If this climate persists, this correction will only be temporary, taking the markets to new highs. On the other hand, if concerns reappear, valuations should deflate, leading to a bear market.

Chart 6 – Short Volatility Strategy



Chart 7 – US Equity Market Trend (S&P 500)



The momentum is critical (see chart 7), and we maintain our alert mode and are ready to change our mind if market conditions do not improve rapidly. **Those levels are the last hope for equity markets to maintain their upward trend and to do not transmit additional stress to investors (and robots).**

▪ What are our main conclusions?

An “excess cleaning” was needed. Bear in mind that the safe-haven assets like physical gold (see chart8), US Treasury or Japanese yen (see chart 9) do not seem to react quickly which means that there is no panic and fear amongst the investors. In consequences, **we favour a bear trap scenario and remain constructive on the equities as the fundamentals remain strong.** As volatility is a means-reverting process, a spike in volatility is usually a good buying opportunity. Yet investors should bear in mind that adjustments in volatility take time to unfold and are asymmetrical: volatility can skyrocket quite suddenly and decrease only gradually. We believe we have entered just such a market regime.

The primary goal of our management is to preserve our clients' capital. In that way, the best strategy is to remain diversified. It is this optimization of investments that provides the best risk/return relationship in the medium term. We expected this type of corrections to happen later in the year. Direct equity exposure was reduced within our ‘Opportunistic Equity strategy’ before the correction. In the course of last week, we deployed the capital back into the strategy (fully invested) benefiting from the important market correction. On Friday we decided to hedge half of the exposure on the back of downward market acceleration. This protection will be reassessed through-out the coming days. In contrast, there are many ways to raise the ‘fundamental’ positions held in the portfolios, to benefit from a rebound in the coming days.

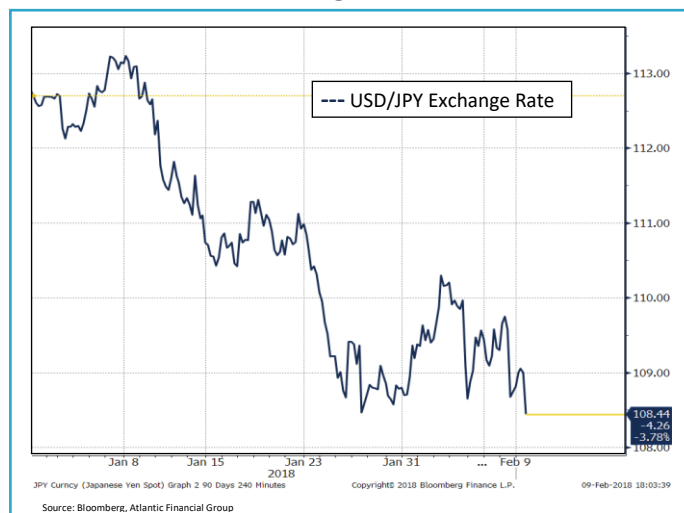


We remain on alert mode as most of positions are or were trading at alert levels (supports, broken trends) and we will apply a disciplined approach in case we need to cut positions if conditions continue to deteriorate.

Chart 8 – Gold Price Index



Chart 9 – USD/JPY Exchange Rate



Economic Analysis

“China”

China represents a quarter of global growth, as much as the United States and Europe together. It is therefore crucial to analyse scrupulously the health of its economy. If China were to slow down sharply, the world positive dynamic would be at risk. The country faces significant and structural challenges in the coming years. The sharp increase in indebtedness is a cause for concern, although most of this debt is held domestically. Debt was downgraded from AA- to A+ by S&P in September. Some other topics need to be addressed: overproduction in the steel industry, disorderly real estate development and shadow banking. In 2017, China’s economy posts its first full-year pickup since 2010 on global tailwind. **This year and according to the main leading indices, growth would stabilise at 6.5%** (see chart 10).

The latest Purchasing Managers’ Index (PMI) confirms our forecast. It suggests that output growth held steady at the start of 2018 but hint at slightly weaker demand. After rebounding from 50.8 to 51.5 in December, the Caixin manufacturing PMI remained unchanged last month (see chart 11). In contrast, the official manufacturing PMI edged down slightly, from 51.6 to 51.3. We tend to put more weight on the Caixin index since it has historically done a better job of capturing cyclical trends in economic activity. On balance then, the survey data suggest that growth momentum was broadly steady last month. We suspect that factories have ramped up production in order to clear backlogs caused by anti-pollution restrictions that are now being eased and not entirely due to resilient underlying demand. Indeed, while the output component of the Caixin PMI rose last month, both surveys point to a decline in new orders. **Looking ahead, we expect demand to soften further over the course of this year.**



Chart 10 – Chinese GDP vs Leading Index

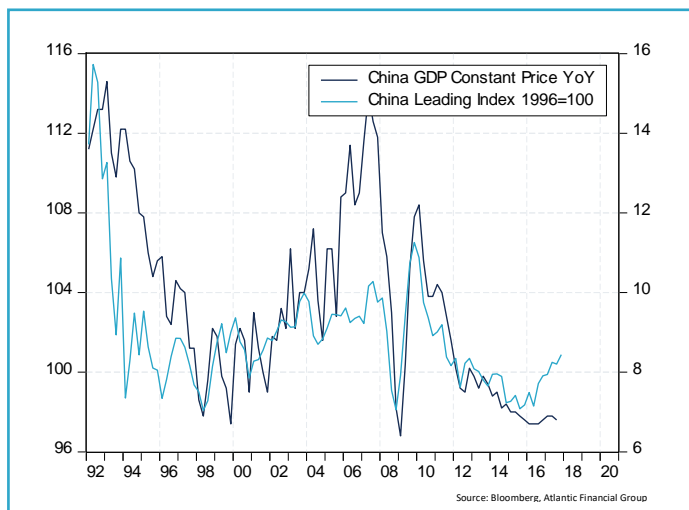


Chart 11 – Chinese Activity Indicators



Retail sales growth has edged down recently (see chart 12), hitting the lowest rate in more than a decade in December. One key driver has been a slowdown in car sales. Hopefully, the official gauge of consumer confidence has soared since early 2016, reaching the highest in over twenty years and the latest People's Bank of China (PBOC) surveys suggest that the share of depositors saying they would rather spend than invest or save remains close to the highest since 2009.

Chart 12 – Chinese Private Consumption

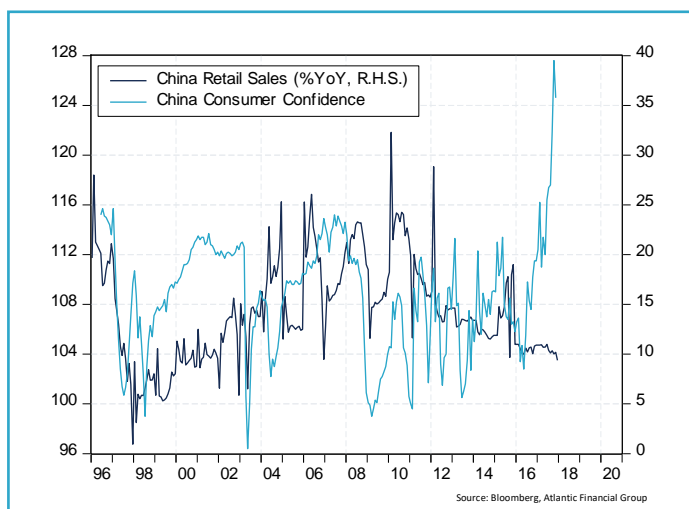
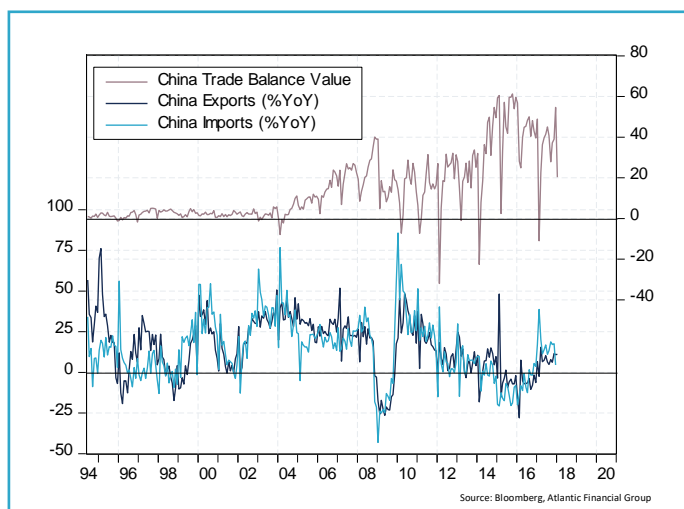


Chart 13 – Chinese Trade Balance



Recent concerns came from slowing trade dynamics (see chart 13). Export growth slowed slightly further last month in renminbi terms. But growth in imports slumped. The geographical breakdown shows that outbound shipments to the US, EU and ASEAN economies declined, outweighing a rise in exports to other regions. In terms of products, the latest fall was driven by a fall in outbound shipments of mechanical and electrical products. On a bilateral basis, China's trade surplus with the US has risen over the past year while its surplus with the EU has been broadly stable. The country's trade surplus with the rest of the world though has narrowed sharply since the start of 2017 as commodity prices have rebounded.



China's bilateral trade surplus with the US rose in 2017 to a record high of US\$275bn according to Chinese data. President Trump stressed his "disappointment" with this imbalance in a call with President Xi and introduced new tariffs on washing machines and solar panels that targeted China. The tariffs in themselves are not a major departure from the status quo – the two countries have had many spats over trade of specific products in the past – but they underline that the relatively soft line that D. Trump has taken on China since taking office may not last through 2018.

Chart 14 – Yuan Exchange Rates

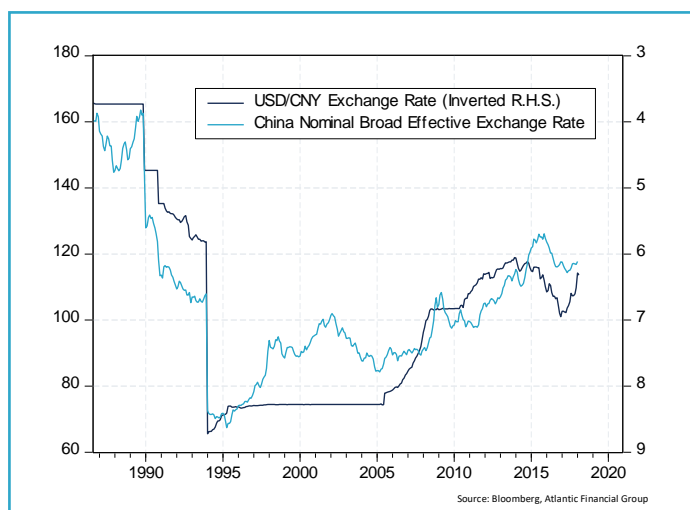
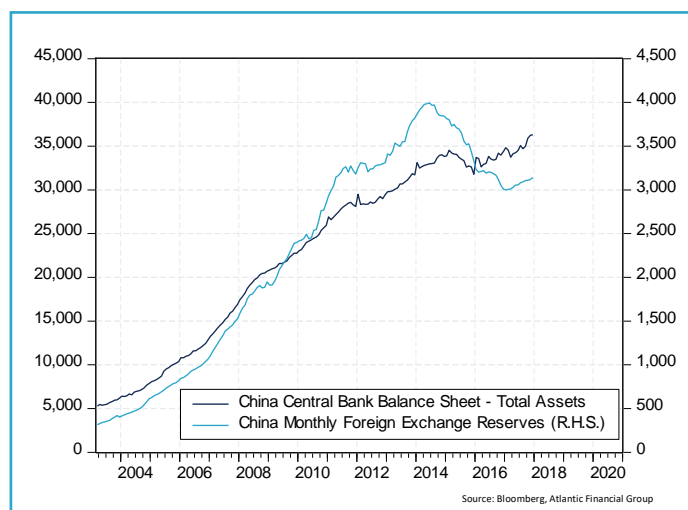


Chart 15 – PBOC Balance Sheet & Forex Reserves



The renminbi has now reversed all of its losses against the dollar since the day of the botched exchange rate reform in August 2015 (see chart 14). China's foreign exchange reserves data (see chart 15) suggest that the People's Bank has not been directly intervening to limit the renminbi's recent gains against the dollar. That partly reflects the fact that the renminbi has strengthened much less against other currencies than against the dollar. But it also suggests that **policymakers are more relaxed about market-driven exchange rate moves than in the past.**

China enters the lunar year of the dog, not the gloomy bear. The challenges to maintain growth momentum are not trivial, but for the time being the lights are green and orange, not red.



Returns on Financial Assets

Total return performance by asset class

Markets Performances (local currencies)	Last Price	1-Week (%)	1-Month (%)	Year-to-Date (%)	Last Year (%)
Equities					
World (MSCI)	501	-5.7%	-5.0%	-2.2%	24.6%
USA (S&P 500)	2 620	-5.1%	-4.7%	-1.8%	21.8%
EMU (DJ EuroStoxx)	376	-5.1%	-7.4%	-3.9%	13.4%
UK (FTSE 100)	7 185	-4.7%	-8.2%	-7.7%	12.0%
Switz. (SMI)	8 844	-5.8%	-9.7%	-7.5%	17.9%
Japan (TOPIX)	1 732	-7.1%	-8.3%	-4.7%	22.2%
Emerg. (MSCI)	1 143	-7.1%	-5.1%	-1.3%	37.7%
Bonds (FTSE)					
USA (7-10 Yr)	2.89%	0.1%	-2.0%	-2.9%	2.9%
EMU (7-10 Yr)	1.00%	0.0%	-1.1%	-1.2%	1.2%
Germany (7-10 Yr)	0.78%	0.1%	-1.1%	-1.4%	-1.4%
UK (7-10 Yr)	1.62%	-0.2%	-2.1%	-2.9%	1.8%
Switz. (7-10 Yr)	0.20%	0.0%	-1.9%	-1.9%	n.a.
Japan (5-10 Yr)	0.07%	0.1%	-0.1%	-0.2%	0.2%
Emerg. (5-10 Yr)	5.43%	-1.7%	-2.8%	-2.8%	9.3%
USA (IG Corp.)	3.59%	-0.8%	-1.9%	-2.3%	6.4%
EMU (IG Corp.)	0.87%	-0.2%	-0.4%	-0.6%	2.4%
Emerg. (IG Corp.)	4.86%	-0.8%	-1.3%	-1.1%	8.0%
USA (HY Corp.)	6.36%	-1.2%	-2.0%	-1.3%	7.5%
EMU (HY Corp.)	3.19%	-0.5%	-0.8%	-0.5%	6.9%
Emerg. (HY Corp.)	6.37%	-1.5%	-2.2%	-1.8%	9.5%
USA (Convertibles)	50	-3.7%	-3.9%	-1.2%	5.7%
EMU (Convertibles)	7 560	-1.6%	-3.6%	-2.2%	3.5%
Listed Real Estate					
World (MSCI)	197	-5.2%	-6.8%	-7.0%	15.6%
USA (MSCI)	196	-4.1%	-6.6%	-8.9%	10.9%
EMU (MSCI)	217	-4.9%	-11.1%	-9.7%	15.6%
UK (FTSE)	7 217	0.2%	1.0%	1.0%	6.9%
Switz. (DBRB)	3 891	-1.5%	-5.1%	-4.5%	7.9%
Japan (MSCI)	255	-7.9%	-8.2%	-4.0%	3.7%
Emerg. (MSCI)	128	-10.9%	-12.0%	-5.3%	49.7%
Hedge Funds (Crédit Suisse)					
Hedge Funds Indus.	596	n.a.	0.9%	n.a.	7.1%
Distressed	830	n.a.	1.5%	n.a.	7.3%
Event Driven	647	n.a.	1.5%	n.a.	6.3%
Fixed Income	336	n.a.	0.9%	n.a.	6.5%
Global Macro	936	n.a.	1.0%	n.a.	2.1%
Long/Short	742	n.a.	0.8%	n.a.	13.4%
CTA's	305	n.a.	1.6%	n.a.	3.3%
Market Neutral	278	n.a.	2.4%	n.a.	8.5%
Multi-Strategy	581	n.a.	-0.5%	n.a.	6.8%
Commodities					
Commo (CRB)	416	-2.9%	-1.5%	-1.1%	0.0%
Gold (Troy Ounce)	1 321	-1.4%	-1.2%	1.4%	13.0%
Oil (Brent, Barrel)	63.81	-8.3%	-10.1%	-6.6%	20.6%
Currencies					
USD (Dollar Index)	90.15	0.7%	-0.9%	-2.1%	-9.9%
EUR	1.2277	-0.7%	0.6%	2.3%	14.1%
GBP	1.3864	-0.7%	1.0%	2.6%	9.5%
CHF	0.9378	-0.7%	3.1%	3.9%	-2.1%
JPY	108.69	0.4%	2.2%	3.7%	2.8%
EM (Emerging Index)	1 705	-0.8%	1.1%	1.6%	11.4%

Source : Bloomberg, AFG

Performance (Negative \ Positive)

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