EUROPEAN
PRIVATE BANKERS

2018 GLOBAL INVESTMENT OUTLOOK

EUROPE
NEW PERSPECTIVES FOR AN OLD CONTINENT

THE KNOWN & UNKNOWN
Assessing risks to global markets and economic growth

ENTER THE DRAGON
The unstoppable rise of Asian tech

WHAT GOES DOWN MUST COME UP
Inflation is likely to accelerate in the new year

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200
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50
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WELCOME.

The Group Asset Allocation Committee of KBL European Private Bankers is pleased to share with you our views on the 2018 global investment outlook.

As you will read in the following pages, we believe that, despite an array of political challenges, Europe's economic fundamentals are increasingly strong and its growth outlook positive. At the same time, there are plenty of risks to the long boom in global markets and the sustained expansion of the world economy. We examine the factors most likely to keep investors up at night in 2018.

Meanwhile, fast-growing and highly profitable Asian tech firms are presenting serious challenges to the dominance of Western household names. We ask whether the future will belong to the likes of Amazon or Alibaba.

▲ The outlook for Europe and the global economy is positive

We then turn to inflation – or, more precisely, the lack of it – and look at the structural forces that have so far prevented liftoff. As we anticipate rising inflation expectations in 2018, we review appropriate investment strategies in such an environment.

Turning to key asset classes, equity markets and corporate profitability increased in sync in 2017, and we expect this trend to continue in 2018. While some are concerned about investor complacency, we see many good reasons why the equity boom will continue.

Looking at fixed income, we note that central bank asset

purchasing will effectively come to an end in 2018. Long-term bond yields could subsequently rise in Europe, though that is less likely in the US. Indeed, we argue that the end of monetary easing, which creates a risk of more turbulent financial markets, should lead to greater consideration of alternative strategies – especially via investor-friendly funds.

Commodity prices continue to climb, slowly but steadily, and we expect them to rise further in 2018. Nevertheless, we anticipate that both oil and gold will remain stable. Concluding with currencies, the US dollar is likely to continue its slide versus the euro, while the yen and Swiss franc should remain weak. Sterling's fortunes, unsurprisingly, will hinge upon Brexit negotiations.

While we are confident about our overall asset allocation strategy, we recognize that no one can perfectly predict the future, particularly over the course of a full year. That is why we provide such forecasts on an ongoing basis, updating our recommendations in line with changing times.

For further information in this regard, please do not hesitate to contact one of our private bankers in any of the 50 European cities where the KBL *epb* group is present.

Wishing you all the best in 2018,

Frank Vranken

George Raven

Don Smith

Robert Greil

NEW PERSPECTIVES FOR AN OLD CONTINENT

THE EUROZONE BY NUMBERS

Think back to a year ago. Following the election of Donald Trump, Europe was braced for a similar populist backlash. And while growth was modestly positive in 2016, there remained widespread fears that the economy could slow over the subsequent 12 months.

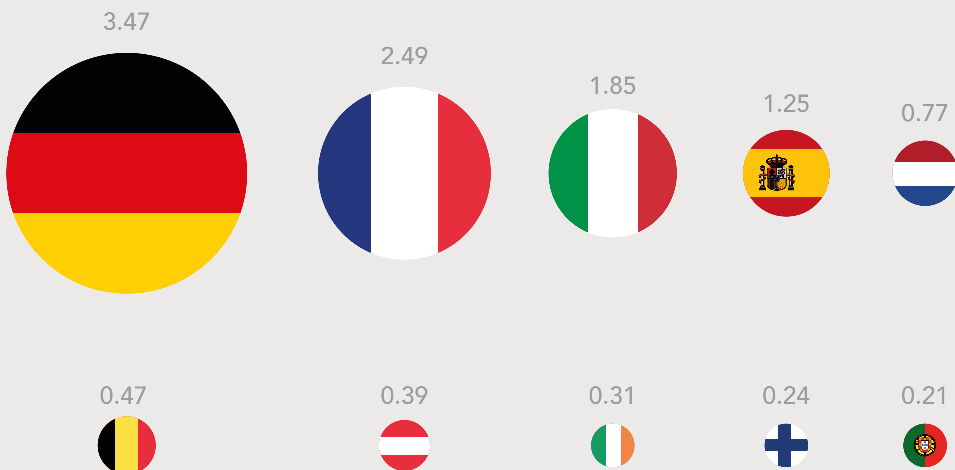
Fast forward to the present. The economic outlook for Europe is now brighter than it has been in a decade – despite political uncertainty in Germany, worrying upcoming Italian elections and the potential Brexit fallout.

Eurozone GDP growth continues to accelerate, investor and corporate confidence is solid, business activity is rising at a rapid clip and companies are hiring at a 17-year high. Importantly, the eurozone unemployment rate has been falling steadily since mid-2013.

Barring unexpected shocks, the eurozone is poised for a period of sustained growth, supported by a host of domestic reform movements, including in France, Italy and elsewhere.

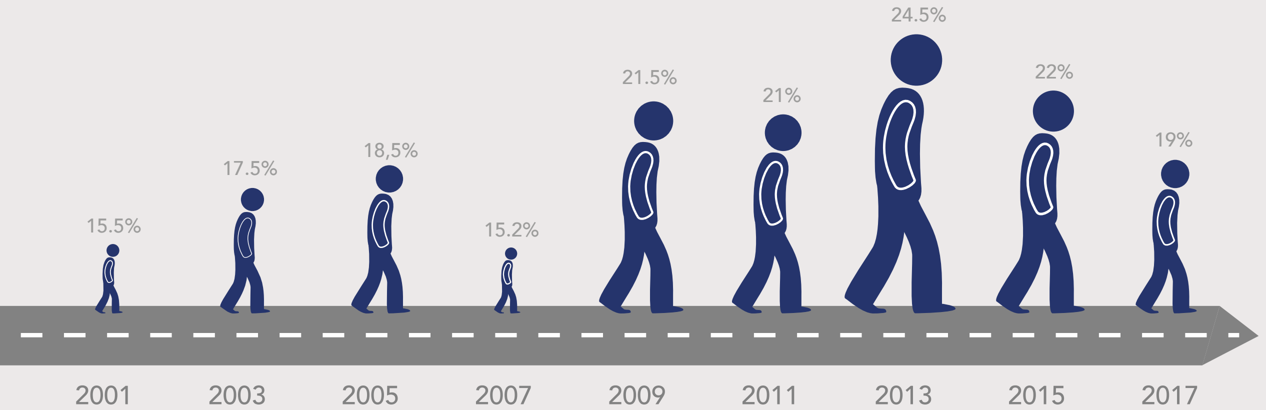
THE WEALTH OF NATIONS

Largest eurozone economies by GDP (2016), in USD trn



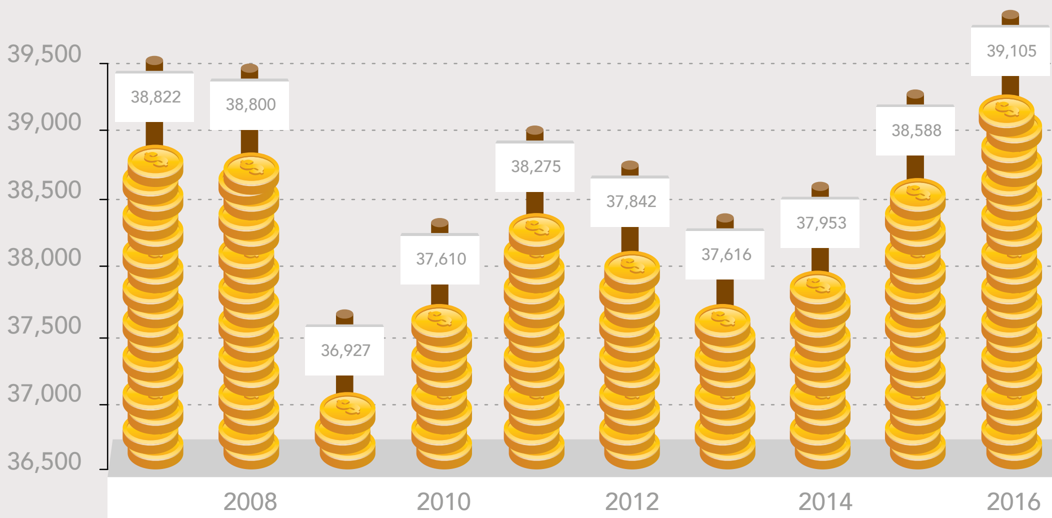
Source: OECD

YOUNG & RESTLESS
Eurozone youth unemployment



Source: Eurostat

RICHER THAN EVER
Eurozone per capita GDP (in USD)



Source: World Bank

NEW PERSPECTIVES FOR AN OLD CONTINENT

From the core to the periphery, despite an array of political challenges, Europe's economic fundamentals are increasingly strong and its growth outlook positive

The skies over the eurozone brightened significantly in 2017 as the single currency area moved into the vanguard of global economic growth. This improvement is certainly timely, as the continent faces a host of looming political challenges.

The EU is struggling to manage the social issues generated by the migration crisis, while simultaneously defending itself from the fallout related to the UK's looming exit from the Union. Catalonia's tussle with independence has created further unease.

Importantly, however, the strength of economic resurgence across the continent has served to mitigate many of the risks that investors have become accustomed to managing in relation to euro assets.

Broad concerns about the inability of the economy to gain traction in response to the European Central Bank's extremely accommodative monetary policy stance are being eroded by the sheer strength of the upturn in activity. Through much of the

past year, activity data has consistently surprised to the upside, not just in the core but in the periphery as well. Importantly, the eurozone unemployment rate has been on an unrelenting downward trajectory since mid-2013.

Today, indicators firmly support a continuation of this trend. Investor, consumer and business confidence has surged. Companies are generating high levels of free cash flow, and the outlook for fixed investment spending is very positive.

Surveys point to a sharp increase in planned corporate investment spending in 2018, especially in Germany and France – with the latter partly related to the reform policies of the Macron government. And the role of corporate investment as a swing factor in the eurozone growth dynamic means that a resurgence here typically carries a much broader positive message about the outlook for GDP across the eurozone. Not least, investment spending raises productivity and wages, and can prolong the business cycle upswing.

THE BUOYANT GLOBAL ECONOMY IS SUPPORTING EUROZONE GROWTH, INCLUDING THROUGH EXPORT DEMAND

It's important to keep in mind the contribution that the strength of the global economy is making to eurozone growth, including directly through export demand. The eurozone's high exposure to such demand means that the ongoing buoyancy of the global economy should continue to lend support.

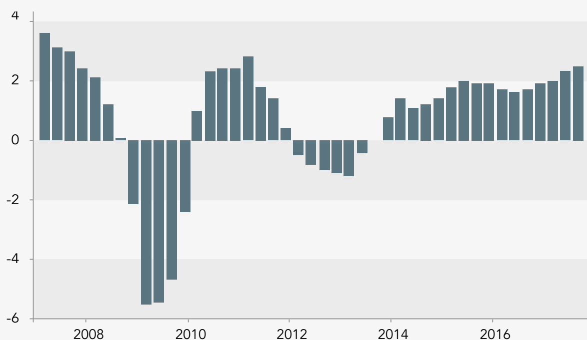
Despite all of these positive factors, there remain clear risks to sustained eurozone expansion.

In addition to German Chancellor Angela Merkel's November failure to form a coalition government – threatening the stability of the eurozone's largest economy – the outcome of upcoming Italian general elections could prove crucial.

Despite being the third-largest country in the eurozone, Italy has struggled with its common-currency membership, leading to a reportedly high level of domestic disaffection with the euro. In stark contrast to the performance of the other major eurozone economies, Italian per capita GDP is barely higher than when the euro was created some 18 years ago – and was left behind in the wake of the global financial crisis, stalling at a time when other major eurozone countries regained ground.

Today, however, the Italian economy has joined the rest of the eurozone as part of a broad economic upswing, dampening negative sentiment towards the euro. Consequently, the markets now appear much less concerned

ON THE RIGHT TRACK
EU GDP growth, quarter on quarter (%)



Source: Eurostat

about the risks in relation to this election, which will take place no later than May 2018.

To the extent that the root of Italy's economic troubles lies in its damaged banking sector, there are signs that we might be at a turning point. Actions in support of the Italian banking sector picked up in 2017: recapitalizations have increased, the stock of non-performing loans has fallen and failing banks are being shut down. This process still has a long way to go, but it should reinforce upward momentum in the economy.

The experience of Spain offers hope in this regard.

Four years ago, Spain's relative per capita GDP position was similar to that of Italy. But the bursting of its real estate bubble forced the country to radically reform its banking sector. Those changes created the foundation for a revitalized economy, catapulting Spain back into the eurozone mainstream and leaving Italy in the dust.

If not the pace of improvement (for it will take time to gather momentum), the direction of travel in relation to ▶

▲ Upcoming Italian elections could test the country's relationship with the euro

the resolution of the Italian banking crisis could likewise serve to improve sentiment towards the eurozone in the coming years.

Despite representing a clear and present danger to the eurozone economy, Brexit also seems to be helping to reduce political risk, acting as a catalyst for closer political integration. Member countries are pulling together in common cause to protect the Union from the economic and political challenge that Brexit represents.

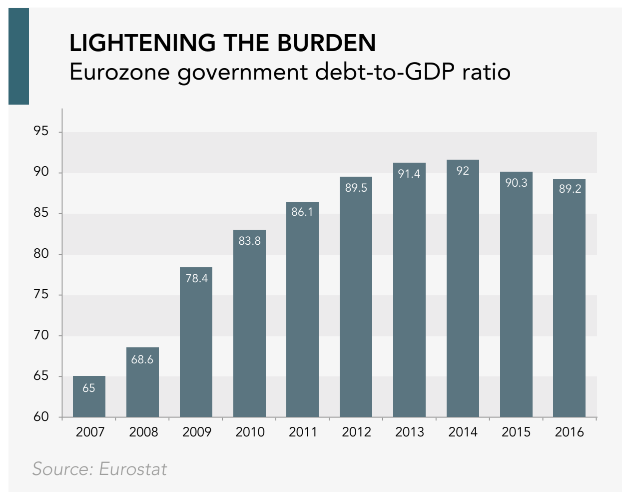
Meanwhile, investors should not fear that the ECB will step in to moderate the current recovery. Far from it.

As a whole, the eurozone remains far behind the US in the cyclical upswing following the Great Recession and has much further to travel before the ECB needs to consider policy tightening. Unemployment represents one measure of such relative growth capacity in the eurozone – having moved below 9% in the second half of 2017, it still remains well above pre-crisis levels. By comparison, US unemployment has fallen to some 4%, close to multi-decade lows.

> DESPITE REPRESENTING A THREAT TO THE EUROZONE ECONOMY, BREXIT ALSO SEEMS TO BE HELPING TO REDUCE POLITICAL RISK

Barring unexpected shocks, the eurozone looks well placed to move into a period of sustainably stronger economic growth. In aggregate and notwithstanding the challenges ongoing unification presents, Europe benefits from a balance and robustness that offer significant support to growth momentum.

In particular, government deficits have been contained and debt as a percentage of



LIGHTENING THE BURDEN
Eurozone government debt-to-GDP ratio

Source: Eurostat

▲ Unrest and uncertainty will continue in Catalonia in 2018

GDP has been falling. Moreover, the economy boasts a current account surplus. These factors should help buttress investment confidence against the internal political storms that are part and parcel of the process of unifying countries in a continent as old and culturally diverse as Europe.

The dispute over Catalan independence represents one of these storms, but there will be more. Investors must accept them as an inevitable fact of life.

Additional friction in the eurozone will be generated by the ongoing process of reform. The election of President Macron in France, in particular, has highlighted increased support for reform across the eurozone, and this has already begun to manifest itself in revisions to French labor market law.

Reform momentum is not strong everywhere, but it is moving in the right direction.

This year will be a challenging but important one for the eurozone. As the ongoing process of reform gains traction – in France, Italy and elsewhere – and as the economy continues to strengthen, stability should return to the region and, with it, investor trust. ■

THE KNOWN & UNKNOWN

There are plenty of risk factors that could threaten the long boom in global markets. What's most likely to keep investors up at night in 2018?

Optimism has become the new normal in the world's financial markets. Central banks may have embarked on tightening monetary policy after years of easing, but for now cheap money continues to drive asset prices higher in a global environment that, unusually, combines rising growth with low inflation. This "Goldilocks" scenario – not too hot, not too cold – won't last forever.

Risk asset valuation levels above long-term averages are a warning sign, although they don't usually trigger market corrections. The two major crashes this century stemmed from the bursting of the dotcom bubble in 2000 and the subprime crisis/Lehman collapse in 2008, both of which were followed by sustained economic downturns. Is a repeat on the way?

Despite pervasive market optimism as a result of the long boom and signs that the US is in the late stages of the bull market cycle, euphoria – the most urgent psychological indicator of

a looming crash – is by no means flashing red.

Investors seem comfortable with their gains and reluctant to take significant money off the table. Last year, this meant extremely low market volatility, with one of the longest periods in history without a 5% daily drop on the S&P 500. But confidence could dissipate quickly in the event of unexpected trouble – and there are plenty of factors that could spoil the party.

A surprise economic slowdown is the most obvious danger for markets, along with a surge in interest rates and/or inflation. In Europe, such scenarios could lead to a resurgence of debt problems left unresolved since the sovereign debt crisis. Possible triggers could include the rejection of market-friendly parties in Italy's general election, a further rise in populism or Catalonia-style separatism, or major new refugee streams into Europe.

Following the late November failure of German ▶

RISKS TO EMERGING MARKETS INCLUDE A STRENGTHENING US DOLLAR AND DEFICITS RUN BY COUNTRIES SUCH AS VENEZUELA AND ARGENTINA

Chancellor Angela Merkel to form a coalition government, the stability of the eurozone's largest economy has emerged as an additional potential risk factor. Depending upon the outcome of discussions, a host of major European projects may be stalled.

While one or more of these events are possible in 2018, Europe is not a major area of concern.

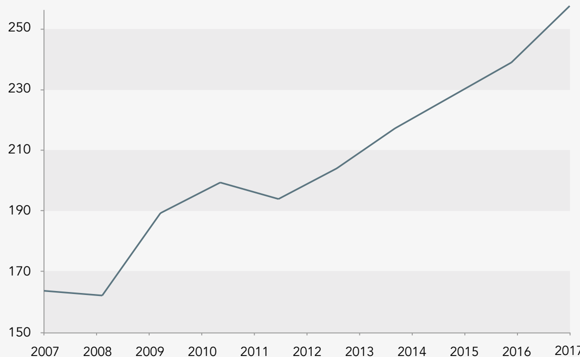
China's imbalances continue to threaten an unexpected hard landing. While Beijing has the deep pockets to finance counter-measures, People's Bank of China Governor Zhou Xiaochuan has cited the warning of late US economist Hyman Minsky that a long market rally could end in a sudden downturn caused by turbulence in some markets leading to contagion in others – as in 2007-08, when the US subprime crisis precipitated a global slump.

Zhou points to excessive levels of corporate and household debt – which is also an issue in Western countries, driven by ultra-low interest rates, but not on the same scale as in China. Other risks to emerging markets include the strengthening of the US dollar and the large deficits run by countries such as Venezuela and Argentina.

While the US president did not dent the markets in his first full year in office, Donald Trump has the potential to do so in future. One issue is whether the Republican party can defend its majority in both houses of Congress in

UNDER WATER

Chinese total debt as a percentage of GDP



Source: FactSet

next November's mid-term elections.

Trump's "America first" policy could damage global trade, his harsh tone toward North Korea and other perceived enemies might provoke conflict and further alienate allies, while failed tax reform would certainly upset the markets.

Further geopolitical risk factors, albeit hard to predict, include Russian policy and political tension in the Gulf. A worsening of the standoff between Saudi Arabia and Iran and their allies could push oil and gas prices substantially higher very quickly. Volatility in commodity prices or US dollar exchange rates always has the potential to tip countries, or entire regions, into recession.

Some analysts believe the normalization of central bank monetary policies will prompt a market correction around mid-2018. So far, the European Central Bank and the US Federal Reserve have managed expectations, but the looming reduction of their massive balance sheets will weigh on economies and markets far beyond 2018.

While the ECB seems unlikely to raise interest rates this year, markets are not convinced that the Fed will stick with its plan for a handful of rate hikes in 2018. Should annual US wage growth surge past 3% – which is possible if Trump's tax strategy is enacted and demand for workers surges in a labor market almost at full employment – inflation could take off faster than investors expect.

Central banks have prepared the ground for such developments with their quantitative easing programs, but the markets don't yet buy it. And with interest rates still extremely low by historical standards, central banks have little ammunition left to head off a possible recession.

Rising inflation could, in fact, trigger the scenario that global fund managers and others fear most: a bond market ▶

▲ Trump's "America first" policy could damage global trade flows in 2018

> IN A WORLD EMBRACING DIGITAL TRANSFORMATION AT AN EVER-FASTER RATE, THE NEXT BLACK SWAN MAY BE LURKING IN CYBERSPACE

crash. In 1994, surprisingly strong US wage growth led to major corrections in both equity and bond markets. In the past, yields of 10-year Treasury bills above 6% have led to economic slowdown. In the shorter term, even yields exceeding 3% could be critical.

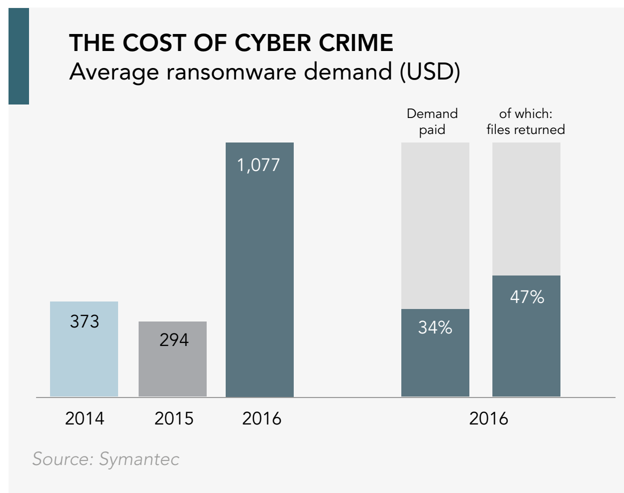
Rising bond yield levels and bad economic news also could prompt investors to rush out of what are currently extremely thinly traded corporate and emerging-market bonds. The lack of liquidity could lead to significant expansion of spreads from today's extremely low levels, which reflect investors' increasingly desperate search for even mildly positive yield.

With equity market valuations more justified by strong earnings trends and stellar global economic perspectives than they were in 2000, the biggest risk appears to lie in a bond market currently characterized by minuscule coupons and extremely long maturities.

While bond markets are at the top of the list of risk factors, history could be a poor guide to the cause of the next downturn.

In a world embracing digital transformation at an ever-faster rate, the most obvious black swan may be lurking in cyberspace. It's one thing to launch social media campaigns to influence US elections or UK referendums, but quite another to hack a central bank or globally important stock exchange.

As well, it's not hard to imagine a scenario in which coordinated cyberattacks on leading tech companies



A crackdown on bitcoin could negatively impact the broader economy

not only profoundly damage such businesses but also the wider economy. Even just a crackdown on bitcoin could have a negative economic impact, given the soaring value of the cryptocurrency. Another possibility is an event completely out of left field, such as 9/11.

That's the real worry: what then-US Defense Secretary Donald Rumsfeld called the "unknown unknowns," the things that we do not know that we do not know.

Setting aside such black swans, it's good to see that there is currently little sign of irrational exuberance and that investors still seem focused on risk, which is healthy. Indeed, while risks always abound, there's currently no indication that any truly game-changing market event is likely to become reality in 2018.

So our advice for the next 12 months is to be prudent, but not pessimistic, and to bear in mind that corrections are a market inevitability.

Remember, too, that a year ago the biggest concern for investors was upcoming elections in Europe, which turned out to support markets. And don't forget that risk is intimately bound together with opportunity. ■

ENTER THE DRAGON

THE UNSTOPPABLE RISE OF ASIAN TECH

Investors everywhere should take note of the seemingly unstoppable rise of Asian technology firms, especially those based in China. The world's most-populous nation is now the global leader in a wide range of tech segments, including alternative energy and electric-vehicle sales .

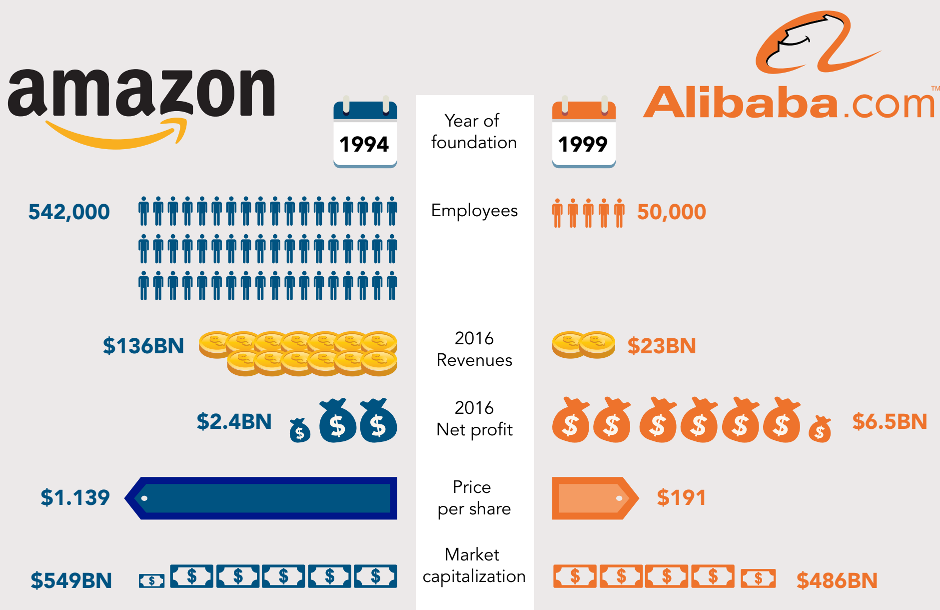
From Mumbai to Seoul, Asian technology companies are investing heavily in R&D – and increasingly reaping the rewards. The rapid growth of such firms is also having a marked impact on regional stock markets, where traditionally dominant players in sectors like energy, materials and resources are increasingly being replaced by tech firms.

A case in point is Alibaba, founded just a few years after Amazon. As you will note below, a comparison between these e-commerce giants is illuminating. While Alibaba is dwarfed by Amazon when it comes to staff and revenues, the Chinese firm's operating margins are much higher, so its profits are of a different order of magnitude.

Alibaba is just one example of a fast-growing and highly profitable Asian tech firm that is rewriting the rules and seeking to conquer the global digital economy.

WEST MEETS EAST

*Amazon vs. Alibaba

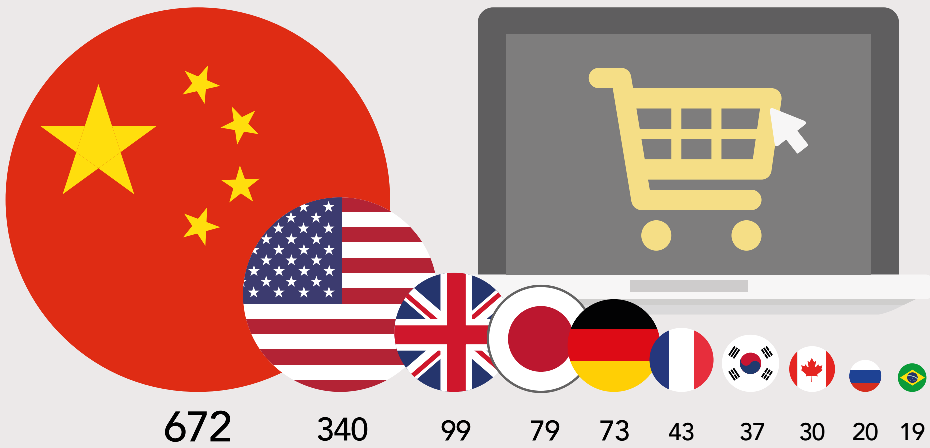


*All figures as of November 22, 2017

Source: Alibaba Group, Amazon, Nasdaq, Statista

SERIOUS SHOPPING

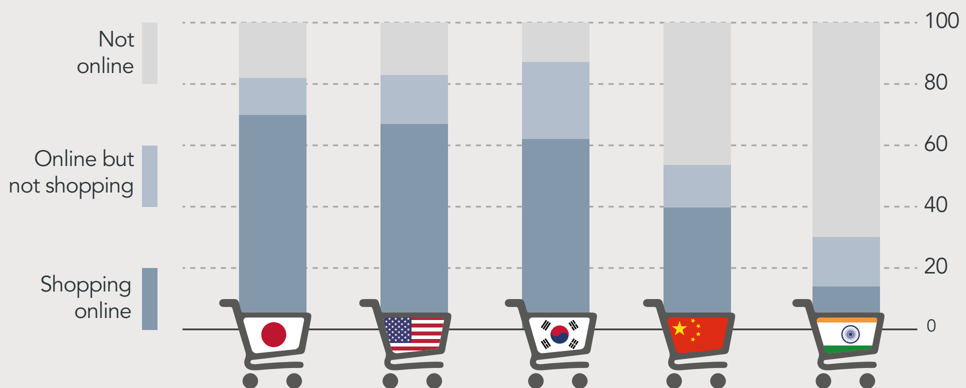
World's 10 largest e-commerce markets by annual sales (2016), in USD bn



Source: Statista

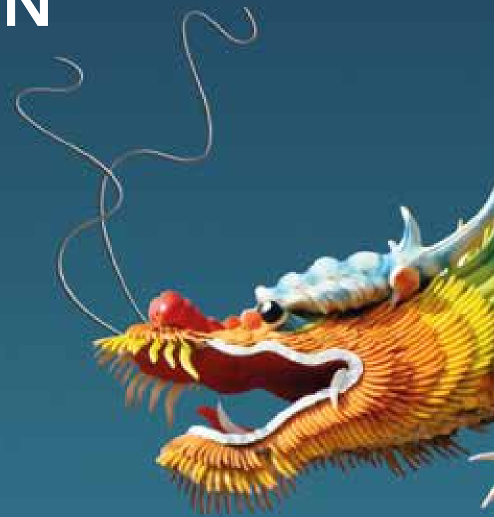
MIND THE GAP

Internet usage (2016), percentage of population



Source: eMarketer

ENTER THE DRAGON



Fast-growing and highly profitable Asian tech firms present serious challenges to the dominance of Western household names. Will the future belong to the likes of Amazon or Alibaba?

Today, roughly one in 10 retail transactions worldwide takes place online, up from 7.4% in 2015 and expected to reach 15.5% by 2021. Over the same period, the value of such transactions is anticipated to rise from $1.5 trillion to nearly $5 trillion.

That growth is coming, first and foremost, from China – where online spending now outstrips the US and UK combined. China has also emerged as the global leader in electronic payments and sits atop the so-called "sharing economy" of peer-to-peer transactions. China plays host to around a third of all "unicorns," startups valued at $1 billion or more.

Despite increasing investor awareness of Chinese e-commerce giants like Alibaba, a basic assumption prevails that Asian tech companies remain minor-league compared with US behemoths like Amazon and Google. But the speed with which Asian firms are catching up will soon make them impossible to ignore.

On the whole, US tech

giants still come out on top for R&D spending. Huawei's R&D budget is now greater than that of Apple, Oracle or Facebook, however, though still lags Intel, Microsoft, Google and Amazon. By contrast, South Korea is the global leader in terms of R&D outlay as a proportion of GDP, with Samsung its standard-bearer.

Nor is it all about the well-entrenched global players from China and South Korea.

India, for example, is far ahead in the field of financial technology.

Consider Mumbai's HDFC Bank, a fintech pace-setter in mobile banking that offers a broad range of internet-based services to its clients. Alongside traditional banking services, including robo-advisory, HDFC offers a web store that enables clients to shop for any kind of item at home, at work or anywhere in between, with all payments handled via the bank's electronic platform.

Asian gains in the digital economy shouldn't distract

> BY 2020, HALF OF THE MIDDLE CLASS GLOBALLY WILL BE IN EMERGING MARKETS, RISING TO TWO-THIRDS BY 2030

us from other fields of technological advancement.

China leads the way in alternative energy, too, including both solar and wind energy generation.

At the end of 2016, the country accounted for 26% of worldwide installed solar energy capacity and 31% of wind power. And it far outpaces other countries for sales of electric vehicles: in 2016, BYD Auto was the world's top electric car manufacturer, with 102,000 units sold, compared to 76,000 for Tesla.

There are demographic factors involved here, of course: China is already the world's most-populous nation, while India will have four times as many inhabitants as the US by 2030. Much more important than overall population growth, however, is the expansion of the emerging-market middle class.

It's forecast that, by 2020, half of the middle class globally will be in emerging markets, rising to two-thirds by 2030. Putting this in perspective, it took 10 years for the emerging-market middle-class population to increase by 1 billion, but it could take just six years to add the next billion.

The middle class in Asia is different from that in the West in important ways: its members are much younger and even more tech-savvy. Professionals in Asian cities are glued to their smartphones, night and day, and use payment systems like Alibaba's Alipay or Tencent's Wechat to bypass banks altogether.

Mobile services are more than just a convenience for this segment of the population: in remote regions of China or India,

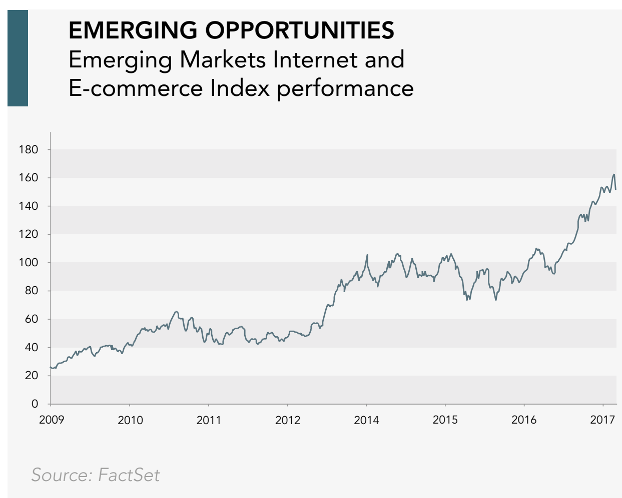
▲ Asia's middle class is young, mobile and extremely tech-savvy

the nearest bank branch could be many kilometers away, so mobile applications make much more sense than a credit card that has to be collected. Throughout emerging markets, many have grown up and gone about their business naturally and entirely with mobile services.

The rapid growth of tech companies is having a spillover effect on Asian stock markets, where such firms are becoming the heavyweights, pushing out traditionally dominant players in sectors like energy, materials and resources.

IT is now the biggest sector in the MSCI EM index, representing 26% of its total market capitalization, with the financial and consumer discretionary sectors not far behind. Technology firms now make up 36% of the MSCI China index, compared with just 1% in 2007.

When it comes to technology investment, Nasdaq is clearly no longer the only game in town.



EMERGING OPPORTUNITIES
Emerging Markets Internet and E-commerce Index performance

Source: FactSet

Yet the best of this Asian growth story is still to come – and comparing Amazon with Alibaba offers some insights. While Amazon's sales are five times larger than Alibaba's, and its market cap about 12% bigger, the quality of growth is very different. Alibaba's operating margins are much higher, so its profits are of a different order of magnitude.

While both groups profit substantially from cloud computing businesses that offer electronic storage to companies, the real difference lies in their web shops. Alibaba is a virtual sales point for purchasing goods and services, offering a platform for bricks-and-mortar businesses. Unlike Amazon, Alibaba doesn't bother with the hassle of operating logistics and maintaining inventory – two activities that significantly eat into Amazon's profitability.

TECHNOLOGY FIRMS NOW MAKE UP 36% OF THE MSCI CHINA INDEX, COMPARED TO JUST 1% A DECADE AGO

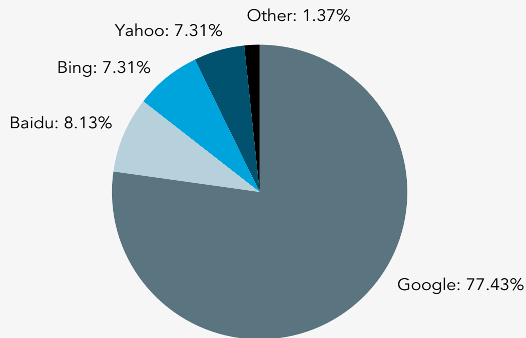
Alibaba is a good example of how fast-growing tech firms in Asia are generally at least as profitable as their US counterparts, and often more so. Between December 2016-August 2017, a weighted sample of Asian tech stocks comprising JD.com, Alibaba, Tencent and TSMC posted an average return of 71%, compared with 37% for the so-called FANG quartet (Facebook, Amazon, Netflix and Google/Alphabet) in the US.

Another difference between the US and Asia is the role of government. In the US, political support is growing for the dismantling of the digital giants that dominate the economy, which could lead to more assertive antitrust enforcement. A perception moving into the mainstream holds that since these companies have become so central to everyday life, they should be regulated as public utilities.

Dominant they certainly are. In the US, 50% of e-commerce goes through Amazon, while 77% of mobile social traffic happens via Facebook, and Google accounts for 81% of search engine activity. Market analysts increasingly describe them as vertically integrated platforms that close off market entry to potential competitors.

Equally contentious are issues such as job destruction – US President Donald Trump has targeted job losses linked to Amazon in his Twitter tirades – and tax avoidance. European competition authorities have ordered Ireland and Luxembourg to recover large

GOOGLEOPOLY
Global search engine market share (April 2017)



Source: Net Market Share

Beijing is more concerned with online content than monopolistic tech practices

amounts of tax that they say Amazon and Apple illegitimately avoided through over-generous tax rulings.

And underlying these questions is disquiet about privacy issues and the use of individuals' personal data.

By contrast, in Asia and especially in China, government priorities are focused much more on monitoring and restricting digital data content than the size and market reach of tech giants.

Companies such as Tencent and Alibaba routinely praise and endorse Chinese culture and the country's national leadership. During the 19th Communist Party Congress, Tencent launched a mobile game enabling users to applaud President Xi Jinping's speech; that game was played more than 400 million times.

Across many emerging markets, technology is having a rapid and, no pun intended, game-changing impact. Such private-sector growth is leading to structural change in economies and societies. Investors need to take notice. ■

WHAT GOES DOWN MUST COME UP

Loose monetary policies may have lifted economies worldwide, but they've failed to boost inflation. Where has it gone, and when will it come back?

The world's main central banks have been carrying out extremely aggressive monetary policies for nearly a decade, lowering official short-term interest rates to zero or below, while also printing money, likewise pushing government bond yields to historic lows, often in negative territory. Such policies sought not only to stimulate the economy but also to lift inflation to nearly 2%, the official target of most central banks but one that so far remains out of reach.

Where has inflation gone, and what's holding it back?

The answer may be the economic system itself, or perhaps central bank policies. There are also strong structural deflationary forces, notably demographic, as well as shorter-term deflationary shocks, although the latter appear to be fading.

Meanwhile, cyclical forces boosting inflation seem to be gaining ground. Inflation may therefore start rising faster than most investors currently expect in countries such as the US and Germany, where

unemployment rates are very low, possibly leading to more rapid interest rate rises, in particular in the US. Higher inflation in 2018 is far from assured, but we should be on the lookout for surprises.

The most natural deflationary force in the world may be capitalism itself, which focuses on producing goods ever more efficiently. On the other hand, the fiat currency system prevalent since the 1970s, without a link to gold, tends to be inherently highly inflationary because most governments can't resist overspending. Counterbalancing that, companies and consumers have accumulated substantial debt, which is highly deflationary to service. Overall, our current economic system seems to be inherently deflationary.

Excessive money printing is not in itself enough to create inflation, which requires either strong demand or a supply shock. Indeed, the oldest economic law states that for prices to rise, demand should exceed supply.

In recent history, serious supply shocks have mostly been due to war, which has ▶

> THE MOST NATURAL DEFLATIONARY FORCE IN THE WORLD MAY BE CAPITALISM ITSELF, WHICH FOCUSES ON PRODUCING GOODS EVER MORE EFFICIENTLY

always been accompanied by massive inflation. In its absence, Western economies and Japan seem to suffer from weak demand as the huge baby-boom generation ages. Simply put, it's the young who buy stuff, not empty-nesters.

Other recent major deflationary shocks include China joining the world economy, resulting in large-scale offshoring and lower prices, while the deleveraging of private and public sectors in the US and Europe has sapped demand since the financial crisis. However, these deflationary shocks are fading, with producer prices in China now rising strongly, and deleveraging in the US and Europe mostly over.

Richard Cantillon (1680-1734), an Irishman who lived mainly in France, argued in his book *Essai sur la nature du commerce en général* that those closest to a source of new money benefit most, while those further away suffer.

Cantillon pointed to the silver from Latin America plundered by Spain. Prices of goods bought by the Spanish court rose spectacularly, but most of the population, which had nothing to sell to the court, failed to benefit and subsequently saw food prices rise.

Similarly, those closest to central banks have benefited from their extravagant provision of liquidity: too-big-to-fail banks and clients to whom they provide leverage, such as hedge funds and real estate developers.

Banks and hedge funds buy bonds and stocks, possibly at inflated prices; bonuses and performance fees then create demand and boost inflation, at least for

▲ While unemployment keeps dropping, wages remain stuck

certain rare goods. But the purchasing power of most of the population still lags behind.

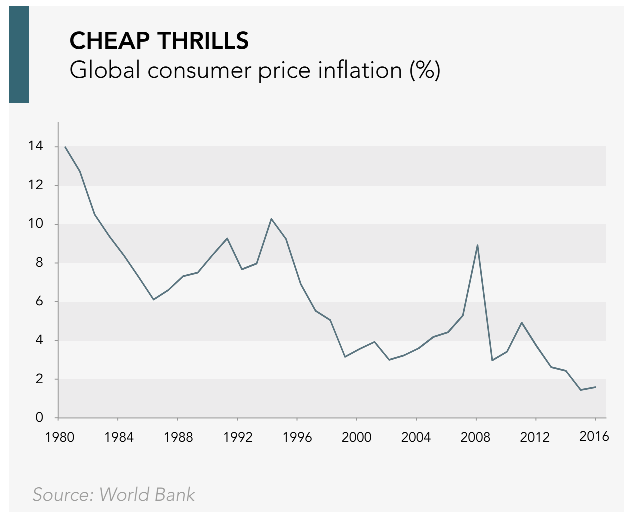
Cantillon therefore seems correct in arguing that new liquidity initially boosts inflation for a limited range of goods and investments, and spreads only slowly to the rest of the economy.

Practically all central bankers are Keynesians who believe that lowering interest rates to zero or below will stoke inflation through the "euthanasia of the rentier," as Keynes put it. Low rates should make rentiers stop saving and start spending, invigorating demand and inflation.

However, the Austrian school of economists, led by Joseph Schumpeter, argues that artificially lowering rates involves meddling with the price of money, which always ends badly.

Low interest rates allow "zombie" companies (and sometimes even states) to survive; the system cannot cleanse itself through "creative destruction," causing overcapacity and deflation. Rather than euthanizing rentiers, the Austrians believe that low rates simply induce people to save even more: low returns require a larger nest egg.

If that's correct, low rates may be the cause of deflation, not the solution to it. More than 25 years of Keynesian policy in Japan has not created inflation, although that has not prompted central bankers to question their core beliefs.



Source: World Bank

Low-rate policies therefore seem here to stay.

At the same time, the so-called "Phillips curve" shows that as unemployment drops, wages rise, generally meaning higher inflation. With unemployment in the US already close to a cyclical low of around 4%, why are wages and inflation not rising faster?

This may be less paradoxical than it seems, as the Phillips curve is not a straight line: wage increases only really accelerate when

unemployment becomes very low, as in the US and Germany today.

Wages have also been held back by the baby-boom generation, which is not receiving large salary increases due to advancing age. When the boomers retire, they are replaced by younger workers on lower salaries, although actual wage increases for various age groups are higher than the average suggests.

Finally, the participation rate of the US working population has been recovering in recent years. As the non-registered unemployed re-enter the labor market, they hold down wages. Therefore, wage increases correlate much more closely with the larger group of non-employed than with the smaller group of unemployed. As the number of non-employed declines, wage increases are likely to accelerate in the US, keeping the Federal Reserve on a tightening course.

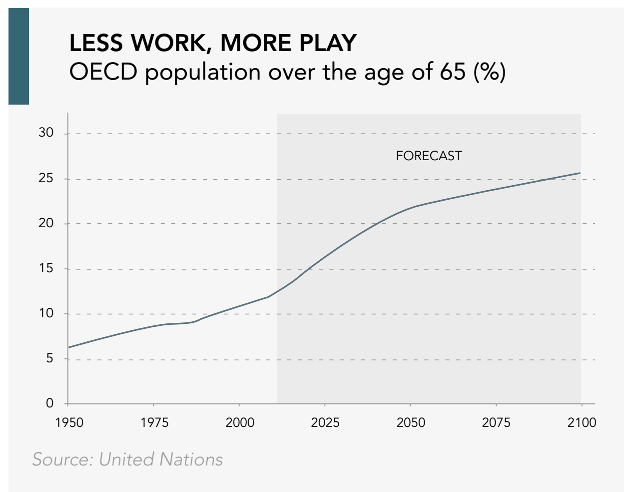
> WE EXPECT A CYCLICAL REBOUND IN US INFLATION IN 2018 DESPITE STRUCTURAL DEFLATIONARY FORCES

Other factors should boost US inflation in 2018. The weakness of the dollar should lead to higher import prices. Meanwhile, consumer confidence is high, the housing market continues to recover and companies are slowly increasing investment.

Overall, we expect a cyclical rebound in US inflation despite structural deflationary forces, taking into account that inflation always lags economic growth by about 18 months.

If inflation expectations rise in 2018, as we anticipate, the Fed will likely continue raising short-term rates, perhaps faster than

LESS WORK, MORE PLAY
OECD population over the age of 65 (%)



Source: United Nations

▲ Printing money and lowering interest rates have failed to boost inflation

expected. Rising short rates are usually accompanied by higher bond yields, but the global savings glut, primarily caused by excessive saving in Germany and China, should keep a lid on yields until the mid-2020s – when retiring baby boomers will have used up enough of their savings to end the glut.

Corporate debt should see a limited impact, with risk spreads likely to remain thin in a strong economy. Overall, bond market returns are unlikely to impress investors.

Equity market returns will largely depend on how fast US inflation expectations rise. Aggressive Fed tightening could stall or reverse the bull market. If short rates approach or exceed long rates, banks will struggle to make money and will not appear as attractive an investment.

Other more cyclical sectors could benefit from the strong economy, but repeated Fed rate hikes could make investors nervous. We again expect higher returns from equities than bonds, but risks may increase as the year progresses. And if the Fed is slow to react to signs of rising inflation and real interest rates drop, gold could be a beneficiary. ■

EQUITIES

Last year, the surge in equity markets and corporate profitability came as a surprise to many. While risks exist, there seems to be no obvious reason why 2018 should not see more of the same

Equity markets and corporate profitability increased in sync in 2017, and we expect this trend to continue in 2018. While some analysts are concerned about complacency among investors, there are many good reasons why the equity boom has further to run.

Economic growth is buoyant in all major parts of the world, helping push corporate earnings higher in a way not seen since before the global financial crisis.

In Europe, the ECB's asset purchasing program has succeeded, despite the expectations of many, in stabilizing once-troubled economies and improving overall fundamentals. On the other side of the Atlantic, the often erratic behavior of US President Donald Trump has not damaged the economy nor frightened Wall Street, and hopes remain high for the administration's tax reform plan.

Across the Pacific, Japanese equity markets have been lifted by the Bank of Japan's ongoing monetary expansion, a weaker yen and a

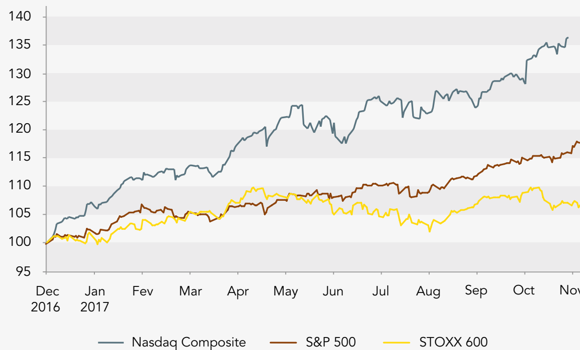
renewed electoral mandate for the policy's architect, Prime Minister Shinzo Abe. And emerging markets are thriving, too, thanks to rising global demand, stability in China and rebounding commodity prices.

True, market bears insist valuations are too high to be sustainable and that earnings growth could fail to materialize. Countering that view, bulls point to ongoing growth in market share by highly valued technology companies, attractive risk premiums, and an upbeat mood among households and boardrooms.

In this "Goldilocks" environment of subdued inflation and buoyant growth, we see no evidence that market optimism is overblown. Investors are focusing on critical factors such as earnings, which underpin surging tech stocks today in a way they did not during the late 1990s dotcom boom-and-bust cycle.

Fundamentals remain exceptionally strong: Companies around the world are sitting on huge piles of cash and – apart from Chinese state-

MANY HAPPY RETURNS
Nasdaq Composite, S&P 500 and STOXX 600 indices, rebased to 100



Source: FactSet

owned companies – possess solid balance sheets, rather than relying on nearly free borrowing. Capital investment is increasing in the US, Europe and Japan, suggesting the next major step in the bull market may be deployment of capital surpluses to invest and make acquisitions – including, in the US, a surge in share buybacks financed by the repatriation of overseas funds.

Despite last year's stock market growth, equity investors still have plenty of cash on the sidelines awaiting good opportunities. For now at least, there are few good alternatives for high returns.

At the start of 2017, investors were worried about a series of elections looming in major countries, lackluster growth and weakening earnings prospects. Instead, the year brought greater political stability, a sharp upturn in growth and a brightening earnings outlook that pushed several eurozone equity markets to record highs – despite concerns about a messy Brexit, populism and separatism.

Earnings prospects remain impressive amid accelerating profitability and monetary support from the ECB's bond purchases, benefiting in particular cyclical stocks, from banks to industrials.

Wall Street continues to outshine other markets in terms of absolute and historical valuation levels, and a successful tax reform package could lift the annualized rate of growth close to 3%. Equity markets are increasingly dominated by tech behemoths like the so-called FANG quartet (Facebook, Amazon, Netflix and Google/Alphabet). The sector now makes up nearly a quarter of the S&P 500's market capitalization, a share that seems set to increase.

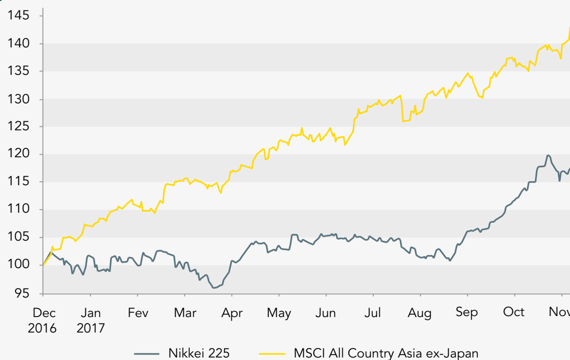
Last autumn's stellar Tokyo Stock Exchange performance reinstated Japan as a market powerhouse. The combination of still-low valuations, improving economic growth driven both by domestic demand and exports, and ongoing monetary easing by the Bank of Japan makes it currently the most attractive of the four main regions for equities.

IN A "GOLDILOCKS" ENVIRONMENT OF SUBDUED INFLATION AND BUOYANT GROWTH, WE SEE NO EVIDENCE THAT MARKET OPTIMISM IS OVERBLOWN

Following Prime Minister Abe's new electoral mandate in October, the continuation of his pro-growth, anti-deflation strategy seems assured for now. With the yen kept low, some corporate cash piles are likely to be channeled into M&A activity, further boosting the market.

Emerging markets, including China, are also benefiting from increasing demand in the developed world and at home. China's pockets seem to have been deep enough to ward off the much-feared "hard landing," while political stability has been underlined by the 19th Communist Party Congress.

THE RISE OF ASIA
Nikkei 225 & MSCI All Country Asia ex-Japan indices, rebased to 100



Source: FactSet

Commodity exporters should continue to benefit as resource prices, from base metals to energy, continue to recover. Like Brazil, many emerging-market countries are taking steps to reduce domestic and international debt levels, while India's infrastructure plans demonstrate an increased focus on pro-growth policies.

Can such stability last? Volatility indices were at historical lows for much of 2017, and drawdowns were limited and brief as investors seized buying opportunities. But sectors, styles, themes and stock-picking are becoming more important to extract alpha in a low-volatility environment. At the end of September, technology companies were outperforming energy stocks by more than 22%.

Moving forward, we continue to prefer cyclical sectors over defensive ones, and favor value and small-caps stocks, especially in Europe, as well as technology on a longer-term basis, with capital expenditure set to be a top theme in 2018. ■

FIXED INCOME

In 2018, central bank asset purchasing will effectively come to an end. Long-term bond yields could subsequently rise in Europe, though that is less likely in the US

Fixed-income investors face another challenging year. The "easy money" policies implemented in the wake of the global financial crisis are ending, as the world's major central banks begin to cut back or even reverse easing measures.

Such moves will result in their net asset purchases dropping to zero by the end of 2018, potentially triggering greater volatility in nervous financial markets, as well as higher interest rates and increasing spreads between different categories of bonds.

The European Central Bank will halve its monthly bond-buying, to €30 billion, starting in January, and plans to end purchases altogether in September – unless the continent's economy unexpectedly deteriorates. The ECB will reinvest the proceeds from maturing bonds in its portfolio, softening the impact of reduced purchasing.

ECB President Mario Draghi insists that loose monetary policy will remain necessary for some time – even though the eurozone economy is now growing strongly – because inflation remains stuck well below the central bank's target of close to 2%.

> EXPECT EUROPEAN YIELD CURVES TO STEEPEN OVER THE YEAR, WITH LONGER-TERM BOND YIELDS RISING FASTER THAN SHORT-TERM ONES

Draghi expects interest rates to remain low even after bond purchases end, virtually ruling out a rate hike in 2018. However, indicators point to a very strong eurozone recovery, which could push up inflation expectations. We therefore expect European yield curves to steepen over the year, with longer-term bond yields rising faster than short-term ones.

In October 2017, the US Federal Reserve began

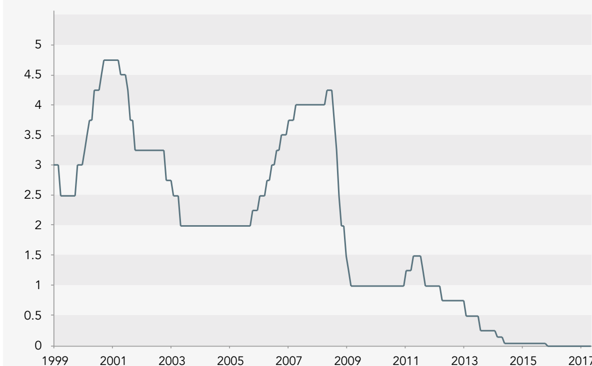
reducing its stockpile of bond assets by $10 billion a month, gradually increasing sales each quarter until they reach $50 billion a month. The Fed is also indicating that it intends to hike rates at least three times in 2018.

That prospect is driving up short-term interest rates, though longer-term rates seem unlikely to rise much as long as US inflation remains subdued. So we expect short- and long-term US bond yields to converge toward the end of the year – and short-term rates could even go higher.

In Japan, asset purchases are set to decline. Because the Bank of Japan already holds more than 40% of all government bonds, smaller purchases will be sufficient to keep interest rates low.

By late 2018, the end of net asset purchases and higher interest rates will likely make riskier bonds less attractive and widen the yield gap to safer investment-grade debt. This could badly hurt bond prices. That's why our advice is to stay short and safe to survive the great unwinding. ■

SUBZERO
ECB refinancing rate



Source: FactSet

COMMODITIES

Commodity prices continue to climb, slowly but steadily, and should improve further in 2018. Over the same period, both oil and gold are expected to remain stable

After hitting bottom in early 2016, commodity prices continued their slow, steady climb in 2017. The outlook should improve further in 2018 thanks to strong, synchronized global growth and a more supportive supply-demand equation. However, not all commodities are equal.

Oil is the key commodity and prices finally seem to be rebounding, with Brent settling slightly above $60 per barrel in late 2017. At a time when global demand continues to increase, OPEC and Russia are demonstrating greater supply-side discipline, which was required to counter rising US shale output. As OPEC has increased its outlook for shale production, quotas may remain in place longer than originally anticipated.

It's worth noting that, as oil prices slid over the past few years, OPEC countries have been underinvesting in future capacity. As current wells run dry, new ones will nevertheless need to be found and activated to overcome this looming shortfall. That explains why some expect the oil market to fall into deficit in 2018 or early 2019.

AS OIL PRICES SLID OVER THE PAST FEW YEARS, OPEC COUNTRIES HAVE BEEN UNDERINVESTING IN FUTURE CAPACITY

The markets are increasingly reflecting this fact, paying a higher price for oil delivered today or in the near future than for deliveries scheduled at a later date – which is a typical sign of a tight market. With Saudi Arabia's budget-neutral price sitting at $80 p/b, we believe the kingdom will seek to impose production quotas for longer. Hence, we remain confident that oil prices will remain stable or slightly higher in 2018.

Energy prices are a major

cost factor for other commodities. Together with better growth, and thus demand, we also feel more confident about base-metal prices.

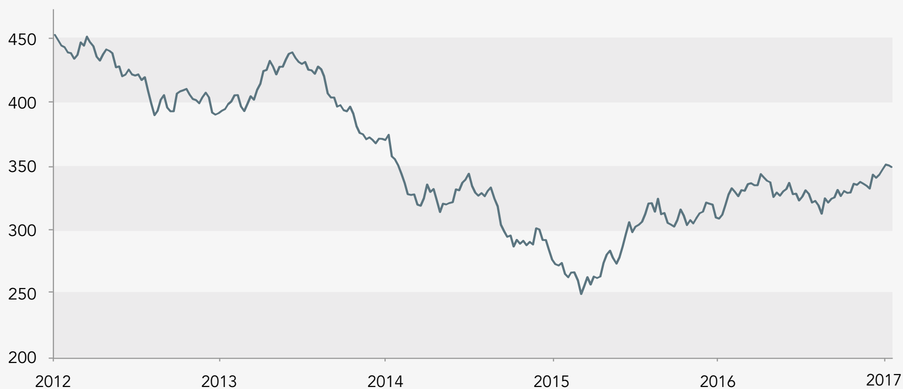
Here, China is key. The Beijing government continues to seek to steer the country towards a services and consumer-led economy and to destock domestic heavy industry of metals. That said, the "One Belt, One Road" project will require massive infrastructure development.

Gold is a distinct asset class. It is perceived as a separate currency and a safe haven. But as gold pays no dividend or coupon, its performance depends solely on price returns – and is therefore highly sensitive to the movement of the US dollar and US interest rates.

If higher nominal interest rates, through Federal Reserve rate hikes, compensate for higher inflation, gold will face tough times. But if inflation spirals out of control, then gold will perform well.

Given its safe-haven status, the precious metal always of course responds favorably to dramatic market events, especially a crash. As that is not our expectation for 2018, we anticipate that gold will trade sideways, remaining within a tight range. ■

SLOW AND STEADY
Bloomberg Commodity Spot Index performance



Source: FactSet

NON-TRADITIONAL ASSET CLASSES

As central banks end monetary easing, thus risking more turbulent financial markets, alternative strategies merit consideration – especially via investor-friendly funds

Since the global financial crisis, years of central bank intervention have pushed government bond yields and credit spreads to historically low levels. Evidence now abounds that such ultra-loose monetary policies are finally coming to an end.

With economic growth taking off worldwide and interest rates poised to move higher, there's a greater risk of a simultaneous market selloff in both fixed income and equities.

Hence the growing appeal of alternative investments. Because they offer exposure to different sources of risk than shares and bonds, they have low correlation with traditional investments, thus increasing the diversification of a portfolio.

They also offer the prospect of better potential returns. After years of meager yields, even modestly positive performance looks appealing. We estimate that a diversified basket of absolute return strategies could deliver an annualized return between 2-4% higher than cash in the medium to long term – a level that would require a high degree of risk in the bond market.

FUNDS COVERED BY THE EUROPEAN UCITS FRAMEWORK OFFER INVESTORS GREATER PROTECTION AND INCREASED TRANSPARENCY

Before the financial crisis, offshore hedge funds were virtually the only route to access alternative strategies. Now, however, managers have replicated many strategies through funds covered by the European Union's UCITS regulatory framework, which offers investors greater protection and increased transparency.

Investors can now benefit from diversification and higher return opportunities much more easily – which is especially appealing at this point in the market cycle. ■

CURRENCIES

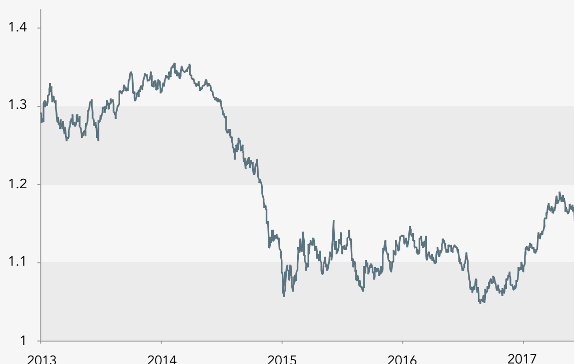
The US dollar is likely to continue its slide versus the euro, while the yen and Swiss franc should remain weak. Sterling's fortunes will hinge upon Brexit negotiations

2017 marked the end of the dollar's three-year run versus the euro. Down at one point last year nearly 15% versus the single currency, the greenback is likely to fall further over the next 12 months. That reflects the fact that the US suffers from both a fiscal and current account deficit, and that the economy appears to be approaching the end of the cycle.

In the very short term, however, US tax reform and the widening interest rate gap between the US and Europe – as the Federal Reserve hikes rates, while the ECB sits on its hands – could help the dollar temporarily make up some of the ground lost to the euro in 2017.

In Japan, the re-election of Prime Minister Shinzo Abe implies a continuation of "Abenomics," guaranteeing prolonged dovishness from the Bank of Japan, translating into sustained low rates and possibly a weaker yen. In the longer term, when the cycle strengthens further in Japan or if geopolitical jitters cause concern, the yen should appreciate.

MAKING EUROPE GREAT AGAIN
EUR/USD exchange rate



Source: FactSet

Meanwhile, sterling remains highly dependent on Brexit's final form. The Swiss franc will continue to be driven by Swiss National Bank policy focused on weakening the currency.

Finally, 2018 could be a mixed bag for emerging-market currencies. Those with strong fundamentals and investment inflows could do fine; others, like the Turkish lira and South African rand, could suffer from adverse domestic political dynamics. ■

EUROPEAN NETWORK

BROWN SHIPLEY

Founders Court, Lothbury
London EC2R 7HE
United Kingdom
www.brownshipley.com

PUILAETCO DEWAAY
PRIVATE BANKERS

Herrmann Debrouxlaan 46
B-1160 Brussels
Belgium
www.pldw.be

KBL EUROPEAN PRIVATE BANKERS

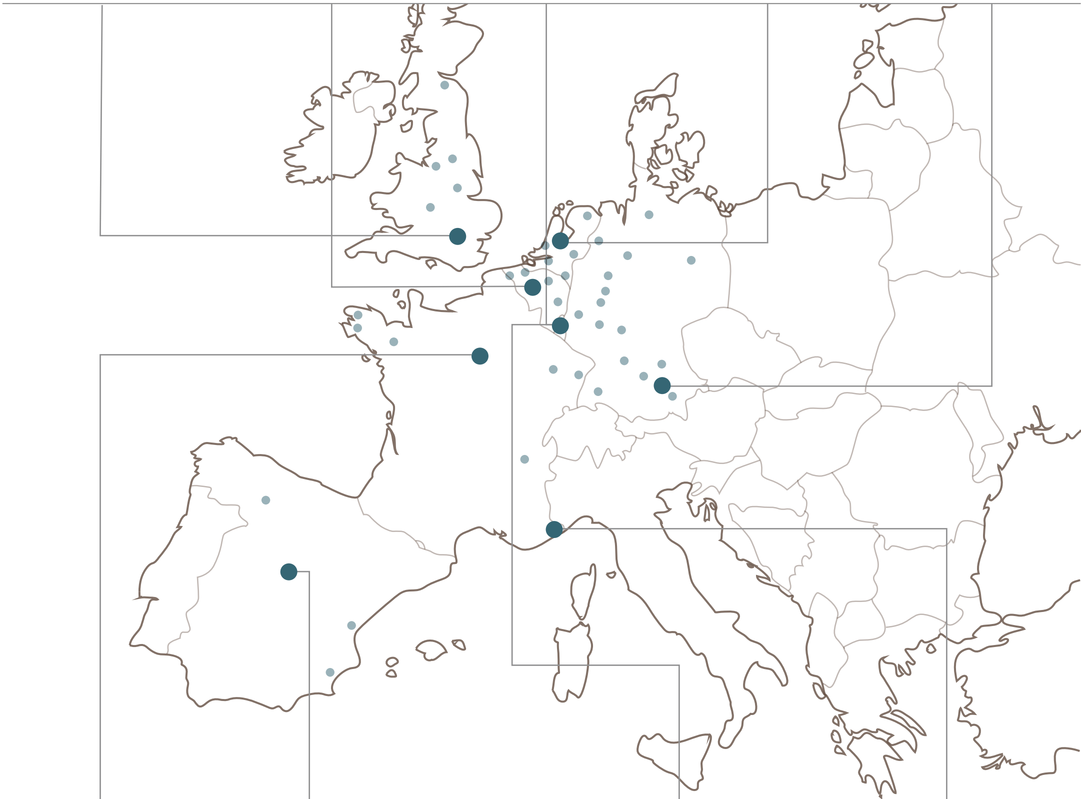
43, boulevard Royal
L-2955 Luxembourg
Luxembourg
www.kbl.lu

insinger gilissen

Herengracht 537
1017 BV Amsterdam
The Netherlands
www.insingergilissen.nl

MERCK FINCK
PRIVATBANKIERS

Pacellistrasse 16
D-80333 Munich
Germany
www.merckfinck.de



KBL RICHELIEU

22, boulevard Malesherbes
F-75008 Paris
France
www.kblrichelieu.com

KBL ESPAÑA
EUROPEAN PRIVATE BANKERS

57, Calle Serrano
E-28006 Madrid
Spain
www.kbl-bank.es

Puilaetco Dewaay
PRIVATE BANKERS

2, boulevard E. Servais
L-2355 Luxembourg
Luxembourg
www.puilaetco.lu

KBL MONACO PRIVATE BANKERS

8, avenue de Grande-Bretagne
MC-98005 Monaco
Monaco
www.kblmonaco.com

KBL *epb* HEADQUARTERS

HEAD OFFICE
43, boulevard Royal
L-2955 Luxembourg
T: (+352) 4797-1
www.kbl.lu

PRIVATE BANKING
Private Client Services
T: (+352) 4797-2099
info@kbl-bank.com

GLOBAL MARKETS
Treasury, Trading, Sales & Execution
T: (+352) 4797-2774
financial.institutions@kbl-bank.com

INSTITUTIONAL &
PROFESSIONAL SERVICES
Client Relationship
Management
T: (+352) 4797-2495

MEDIA RELATIONS
Group Corporate Communications
T: (+352) 4797-2658
nicholas.nesson@kbl-bank.com

CAREERS
Human Resources
T: (+352) 4797-3412
recruitment@kbl-bank.com

KBL EUROPEAN PRIVATE BANKERS

43, BOULEVARD ROYAL
L-2955 LUXEMBOURG
T: (+352) 4797-1
INFO@KBL-BANK.COM

WWW.KBL.LU