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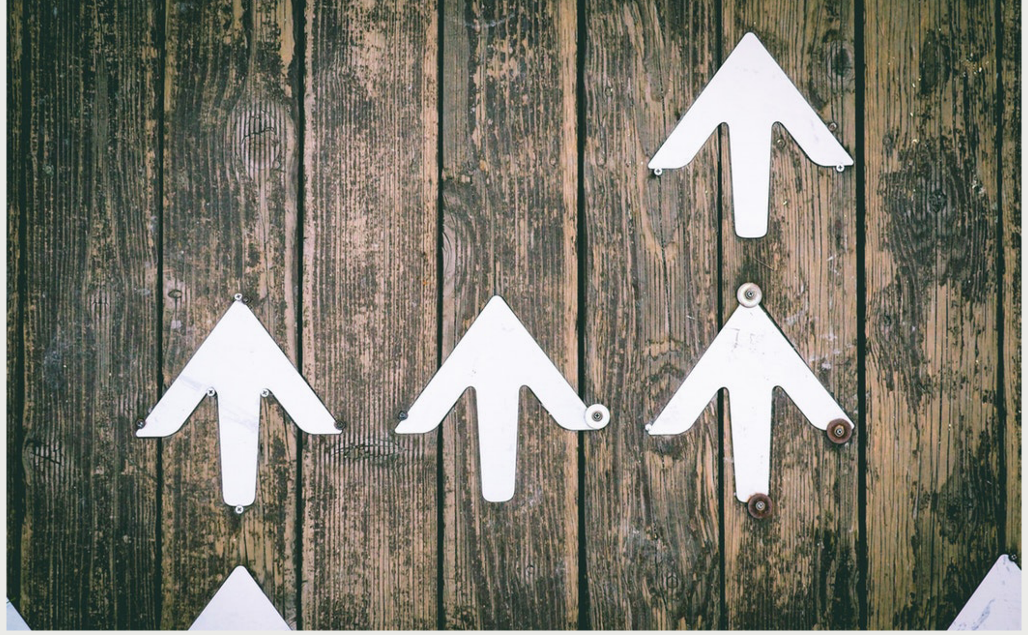
Luminor financial markets update

January 2018



Year 2017 in review – in a pace of a healthy uptrend

The year 2017 provided global investors with many reasons to worry: rising interest rates and diminishing monetary stimulus, equity valuations and the length of the current uptrend, tensions in the Middle East and North Korea, and elections in Europe. Such worries are nothing extraordinary though and are actually needed for the market to be in a healthy uptrend. Otherwise, if there's nothing to worry about, then everybody would already be fully invested and there would be a state of euphoria, which would actually mean that the uptrend is over.

Highlights:

- World equities in 2017 returned 3 times more than the average annual gain of the last 30 years
- Euro appreciation against the dollar, by 13.8%, was a significant headwind for euro-based investors, significantly reducing the gains
- Most bonds provided very low or negative return in EUR due to adverse foreign exchange movements
- Crypto currencies gained much attention due to astonishing returns, but bear significant risks and are impossible to fundamentally value
- Stocks are expected to rise in 2018 but volatility may increase
- World equities experience a drawdown of 7.1% on average each year, but in 73% of years the return is positive
- Bonds will mostly provide diversification benefits, as 2018 are likely to be low
- Potential risks in 2018: inflation, investor sentiment, disasters or conflicts

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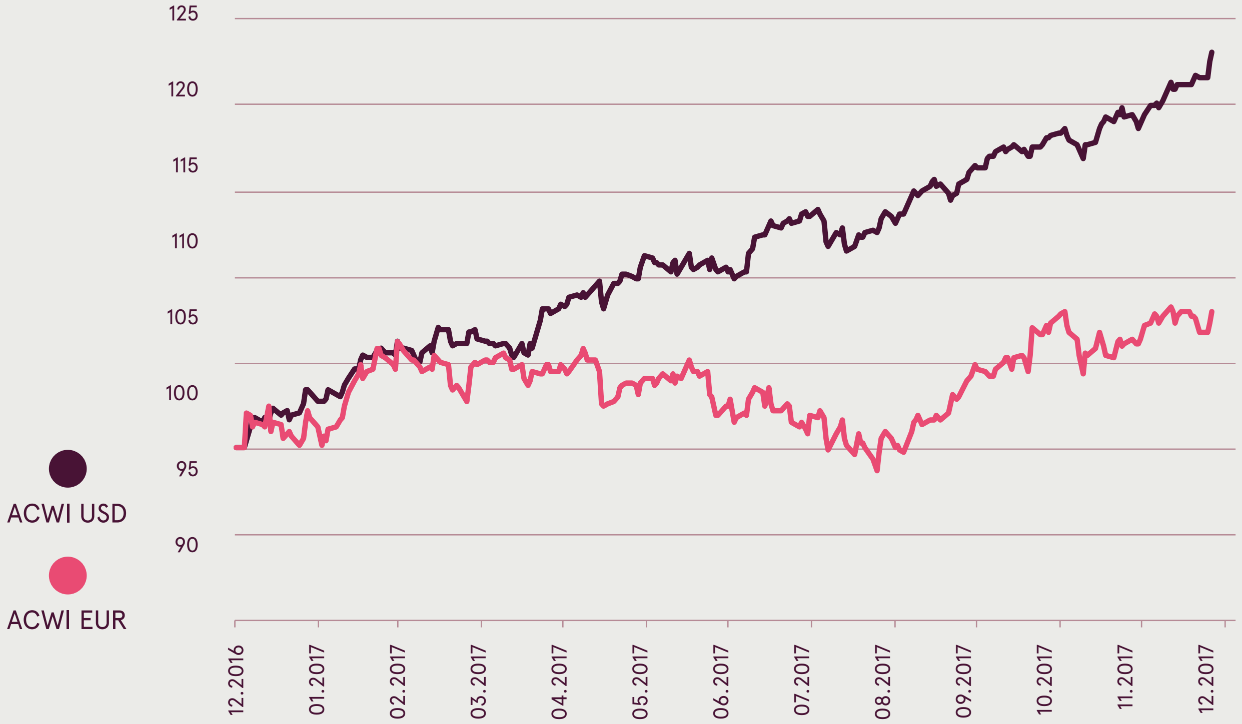
Global equities continue to grow

December 2017 was the 106th month of the current uptrend in global equities since the low in 2009. Nevertheless, 2017 was excellent proof that the age of the bull market doesn't mean anything and uptrends don't end just because of their length. The All Country World Index, an average of all major world stocks, gained 21.6% last year, measured in USD. That is three times better than the Index average gain of 7.2% during the last 30 years.

One of the main highlights in global equities was the turnaround and comeback of Emerging markets after 6 years of mediocre performance. Emerging market equities as a whole gained 34.4% last year, also significantly surpassing the 30-year average return of 13.3%. And Emerging Asia equities really shined, returning over 40% for the year.

Euro appreciation was a big drag on returns for the euro based investor, as the EUR gained 13.8% percent against the USD in 2017, which nobody expected at the beginning of the year.



Currency impact on global equity returns

Emerging market bonds show the best performance

Local currency emerging market bonds were the best performing fixed income asset class, with a 14% return measured in USD. USD denominated emerging market bonds and high yield corporate bonds also provided meaningful return of around 10% in USD. For euro based investors, however, currency appreciation erased all those gains. Due to low yields at the start of the year, all investment grade bonds were loss making for euro investors this year.

In terms of longer term government bond yields movements were opposite in the EU and US. The US 10-year yield actually declined slightly from 2.45% to 2.41%. The German 10-year yield, on the contrary, doubled in 2017 from 0.21% to 0.43%. Such opposing moves are explained by the fact that the US economy is at a later stage of the cycle and the Fed policy tightening went much further than in the EU.

Crypto currencies – tempting, but with an unknown end

Crypto currencies were one of the most discussed topics, both among investment professionals and the general public. Of course the astonishing gains are sparking public interest as people are hearing stories of getting rich quickly. The best performing crypto currency in 2017 was Ripple, with a mind-blowing gain of 36,018%. The most widely known Bitcoin and Ethereum also rose remarkably, 1,318% and 9,162% respectively.

Although such gains look attractive and tempting to participate, investors should be very careful with this asset class. First it is important to bear in mind that most of the currently added new currency tokens will disappear and only a handful of the largest and most used ones will remain. Secondly, although it is hard to clearly define if, for example, Bitcoin is in a bubble, as it is really impossible to fundamentally value it, we clearly see that sentiment and positioning did go to the extremes. Most Bitcoin investors are currently very bullish and trade is pretty overcrowded. As a result, the potential for violent correction is very high. Finally, any person willing to invest in crypto currencies should be willing and able to tolerate violent swings, as historically Bitcoin had a 30% downward correction every quarter and even 80% corrections are also quite common.

As a result, we would not advise committing any meaningful part of your financial assets to crypto currencies. However, if you do decide to allocate your money there, use a very small portion of your financial assets, do your homework to understand what you are buying to avoid scams and be prepared for very wide swings with an unknown end result.

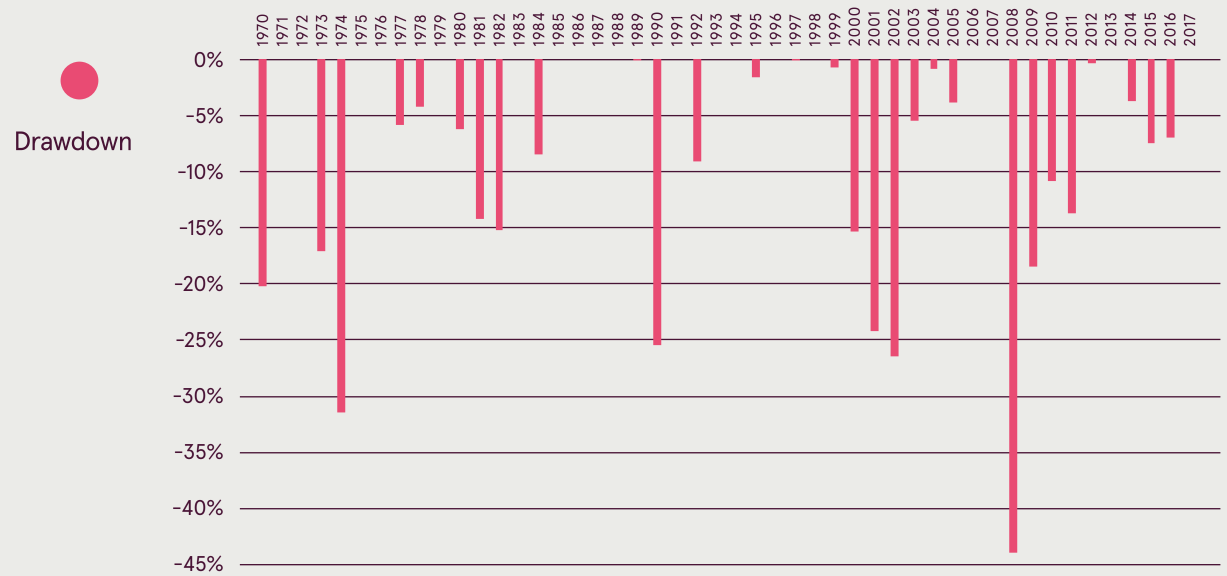
2018 Outlook

Stocks are expected to rise but not in a straight line

Looking forward, everything seems to be lined up for the continuation of the global equity rally. Economic momentum is robust and broad-based, while global trade is also growing. Global monetary policy is still very accommodative and although gradual tightening is expected, JP Morgan reports that stocks perform well historically in the early tightening cycles.

From the valuation perspective global stocks as a whole are fairly valued, as the All Country World Index, excluding US, forward-looking P/E ratio is slightly below the 20-year average – 14.3 vs 14.5. The US equity valuation can be considered moderately expensive, but far from extreme. At the same time Emerging markets are a bit below long-term fair value. As a result, valuation should not be a drag to future equity returns. Moreover, next year's global corporate earnings are expected to be very strong and thus only from increased earnings global equities could rise to 10% without any change in valuation.

What investors should remember however, is that last year was quite extraordinary in terms of very low volatility. Actually, corrections within the year are very common for stocks, even during



Intra-year drawdowns of World Equity Index uptrends. For example, during the last 48 years, the World Equity Index experienced a drawdown of 7.1% on average each year. However, of all those 48 years, 73% ended with yearly gains for the index. This means that equities have an upward bias and the odds for stocks rising in any year are almost 3 times greater than for them to fall. The extraordinarily low volatility does not signal an imminent market crash or downtrend. The probability of a usual correction does increase, of course, however a low volatility period can last for 2–3 years, as was the case during similar periods in the 1990s and 2000s. Furthermore, historically volatility has started to rise well before the market top as in 1999 and 2007, so we would get an indication of potential trouble ahead.

Finally, the significant price increase in 2017 shouldn't scare investors. Historically, since 1970, after a 20% or higher price increase the World Equity index rose the next year an average of 12% and the next year's return was actually positive in 8 of the 9 cases.

Bonds will mostly provide diversification benefits

In the fixed income space, fairly low current yields, narrow credit spreads and tightening monetary policy all mean that prospective bond returns will be fairly mediocre. However, bonds should still be included in portfolios for diversification benefits and to protect against unexpected outcomes.

We do not advise to hunt for yield by moving into riskier bonds, as at the current stage of the credit cycle on size of the credit spreads the additional risk and is not worth it.

Potential risks in 2018: inflation, investor sentiment, disasters or conflicts

For now, global financial markets have enjoyed a so-called goldilocks situation of robust economic growth with benign inflation. However, some experts are worried that we may witness a spike in inflation due to interest rates being too low for too long. An unexpected spike in inflation is bad for both equities and bonds, as earnings would not be able to rise fast enough, while interest rates would increase in response. However, we believe that central banks have good control over inflation and no such spike should materialize next year.

Investor sentiment has steadily improved into the end of the year with growing prices. According to the latest data by the American Association of Individual Investors, 52.65% of investors now expect equities to rise. Although that level is far from extreme, a continued increase in the number of bullish investors may become a bad sign for global stocks. However, such an indicator has fairly short-term influence and would just signal a potential short-term correction.

With geopolitical tensions being quite high in certain regions, there is always a possibility that a conflict may be ignited. However, as history has shown, besides short-term dips there is usually no lasting negative effect on the market. The same is also the case with natural disasters – the most impacted is the region that bears the economic consequences, but the general financial market is usually not affected in the longer-term.

Sources: JP Morgan, Reuters, Bloomberg, The Fat Pitch, MSCI.