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Market Outlook – January 2018

Market Outlook

Strengthening US Economic Data

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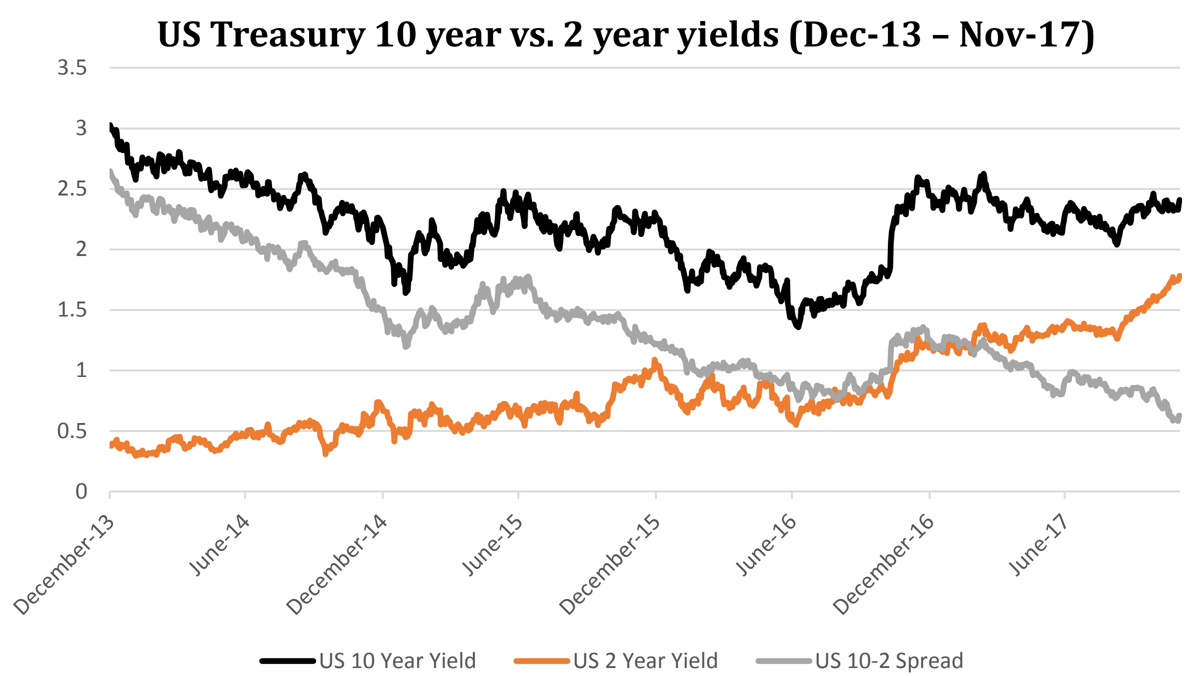
US economic data has been very strong over the last two months. Demand data including retail sales, production data including ISM Non-Manufacturing, employment and housing have all been above the 1-year average. We think this sets the stage for the Fed to continue tightening monetary policy with 3 hikes over the next year.

Recent US Growth Data			
Demand	**Current**	**1-Year Average**	**Current vs. 1-Year Average**
Retail Sales Change YoY	4.60	4.26	Stronger
Total Vehicle Sales	17.40	17.19	Stronger
Consumer Confidence	129.50	119.74	Stronger
Bloomberg Consumer Comfort	52.30	49.61	Stronger
Production			
Industrial Production	106.15	104.53	Stronger
Durable Goods Orders YoY	3.20	4.03	Weaker
ISM Manufacturing	58.20	57.14	Stronger
ISM Non-Manufacturing Index	57.40	57.02	Stronger
Employment			
Nonfarm Payrolls	261.0	167.0	Stronger
Unemployment Rate	4.1	4.5	Stronger
Underemployment Rate	7.9	8.8	Stronger
Unit Labor Costs YoY	-0.7	-0.5	Weaker
Housing			
Housing Starts	1290.0	1201.0	Stronger
New Home Sales	685.0	604.4	Stronger
Pending Home Sales	3.5	0.0	Stronger
Home Prices	6.2	5.7	Stronger
Government and External			
Budget Balance	-3.40	-3.18	Weaker
Total Debt ($TN)	20.59	20.02	Weaker
Current Account Balance	5.60	4.78	Stronger
Exports YoY	-2.39	-2.37	Weaker
Inflation			
Consumer Price Index	2.00	2.08	Weaker
PCE Price Index	1.60	1.67	Weaker

Source: Bloomberg and Infinity Q Research

Flattening US Treasury Yield Curve

The US yield curve has flattened to the tightest 10-year/2-year spread since 2007. The spread was at 2.65% in January 2014 and has tightened to 60 bps. Given our expectation of the Fed hiking 3 times over the next year, the QE unwind will need to be executed aggressively to insure the yield curve does not flatten further or even become inverted.



Source: Bloomberg and Infinity Q Research

Political uncertainty increased following the collapse of a coalition in Germany. There is a growing risk of new elections if a coalition cannot be formed. The timing for these elections would most likely be in April or May 2018 placing them in the same period as the Italian elections. Spain's election in December 2017 may still create lasting uncertainty as a joint coalition will be challenging. The outcomes in German, Italy and Spain will have a significant impact on financial conditions in 2018. A negative scenario in these countries could reduce Eurozone GDP by as much as 1.5% in 2018 while a sanguine outcome could increase GDP by as much as 1%.

Exhibit 27: Italian polls point to no outright winner

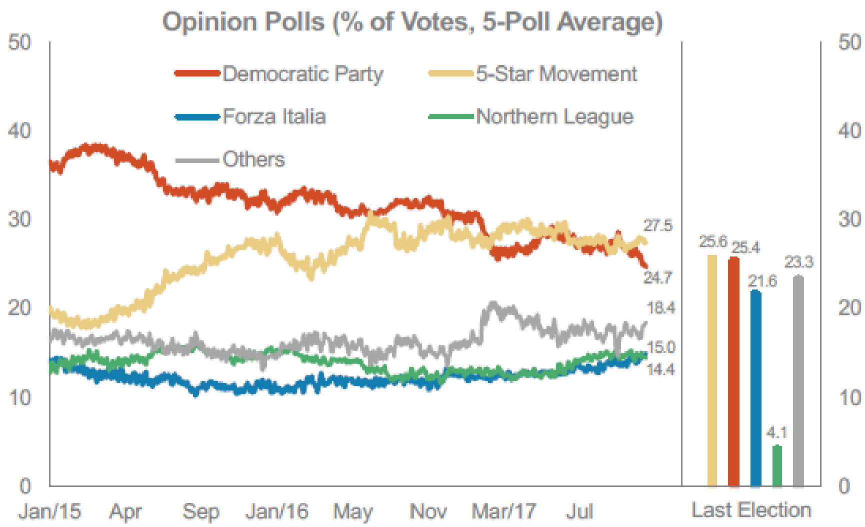
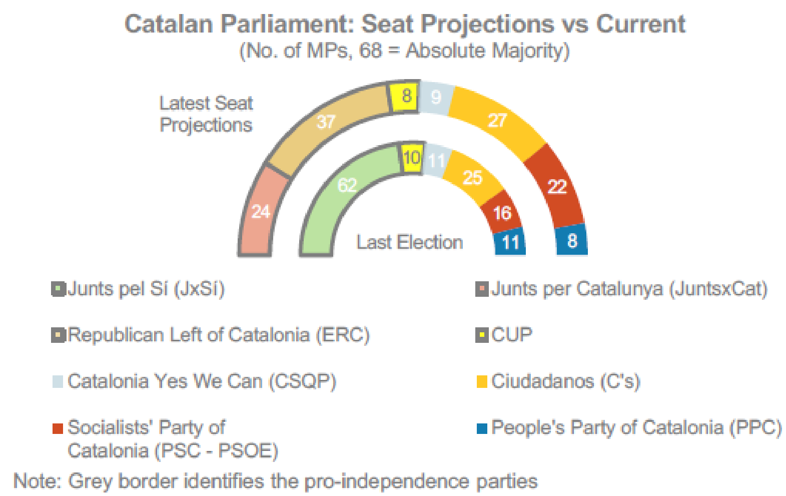


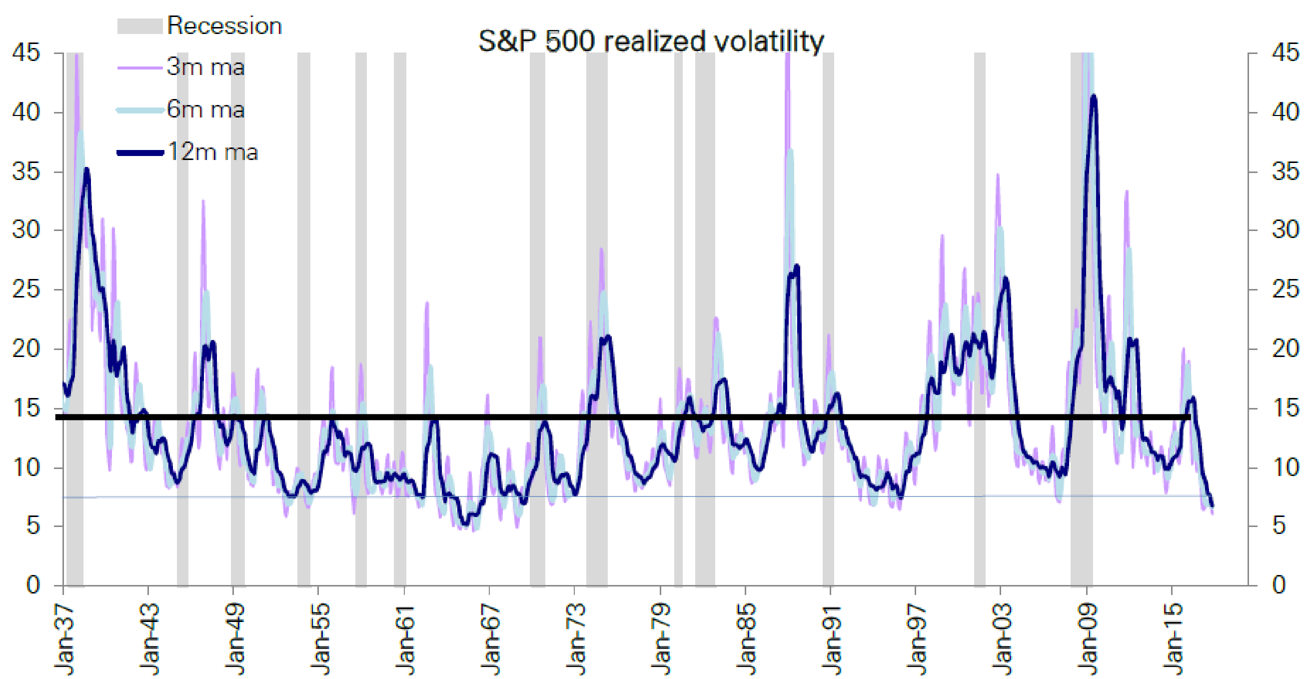
Exhibit 28: Catalan election remains highly uncertain



Source: Morgan Stanley Research

SPX realized volatility is at 50 year low

SPX realized volatility has declined to a 50 year low. The strength and stability of US economic data has been a strong driving force for this decline in addition to extremely accommodative central banks. It is an extremely rare event to find such strong economic data this late in the cycle combined with accommodative monetary policy. These forces have caused the volatility of economic data and earnings data to substantially decline. In addition, the correlation between stocks has declined substantially in 2017.



Source: Deutsche Bank Research

Index Correlation at all time Low

S&P 500 1-month realized volatility has averaged 7.05% in 2017 and currently stands at 6.55% (as of 12/29/2017). The main driver of this decline is the sharp decline in SPX realized correlation. SPX 6-month realized correlation averaged 43% in 2016 and currently stands at 12.5%. As a result, an increase in correlation will amplify the impact of a stress event, which creates additional negative convexity in investor portfolios. The current environment makes most investors have a large **short correlation** position imbedded in their portfolios.

SPX 6M Realized Correlation (12/31/11 – 11/30/2017)

Source: Bloomberg

Short SPX Vol with no hedges

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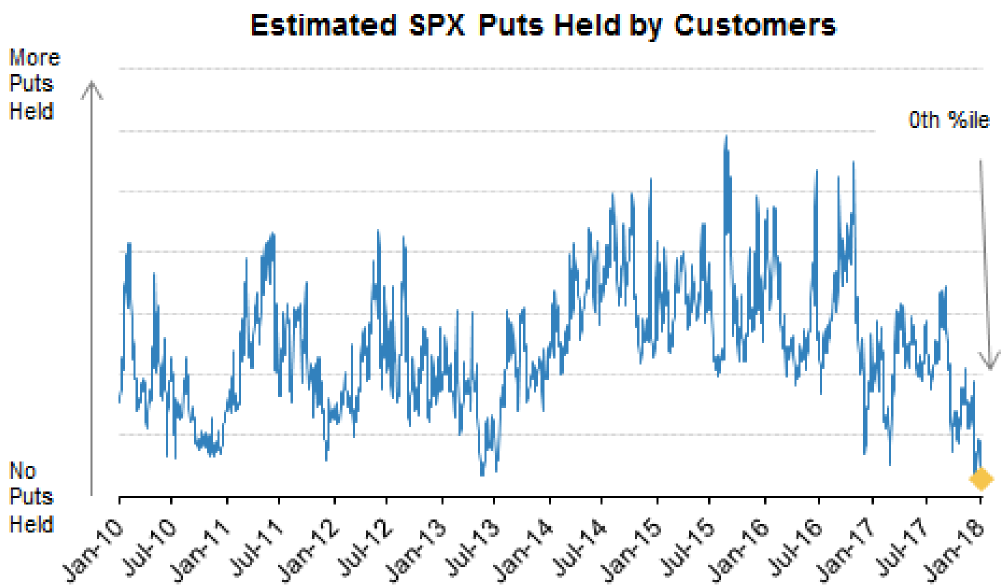
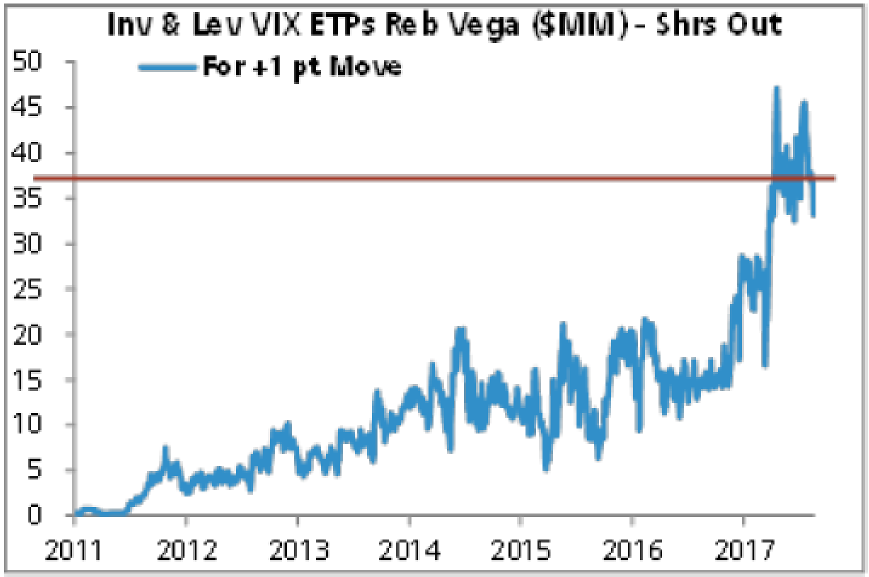
SPX Net Customer Put OI (Jan-10 – Jan-18)



Source: Morgan Stanley QDS

VIX ETP Vega to buy per pt (Jan-11 – Jan-18)



- The strong performance in SPX Volatility Risk Premium has caused investors to have minimal exposure to SPX puts while also reaching an all-time high of short VIX Futures exposure.
- If equities decline and volatility spikes, we expect there to be a sharp reaction as investors hedge after the event.

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Portfolio Update

Global markets remain fragile

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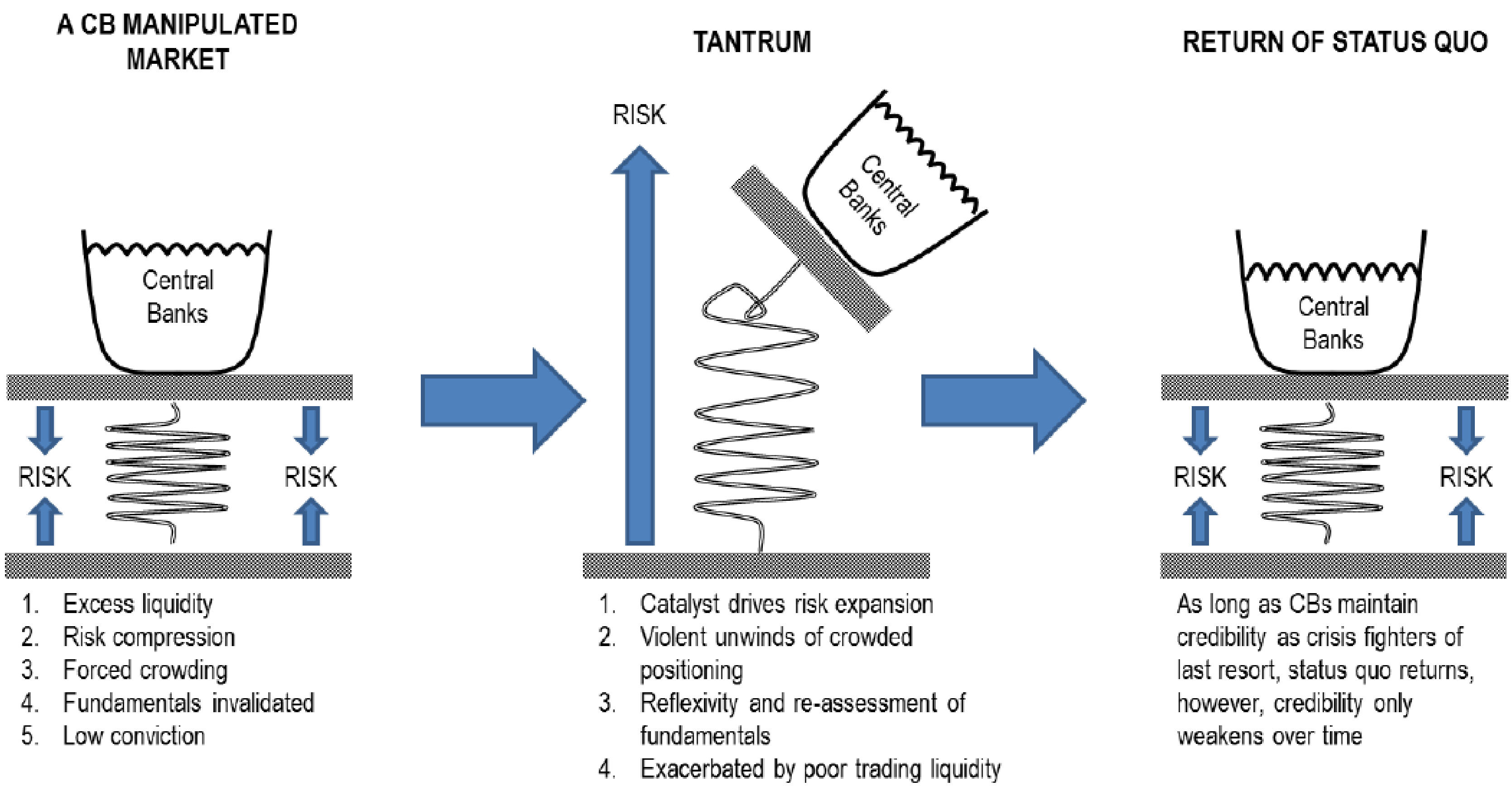
We expect the market environment to remain fragile with short-term bouts of risk aversion followed by compressed risk. We are in the midst of a prolonged period of risk compression, and expect the “tantrum” to be particularly pronounced.



Source: BofA Merrill Lynch Global Research

Positive carry and long convexity

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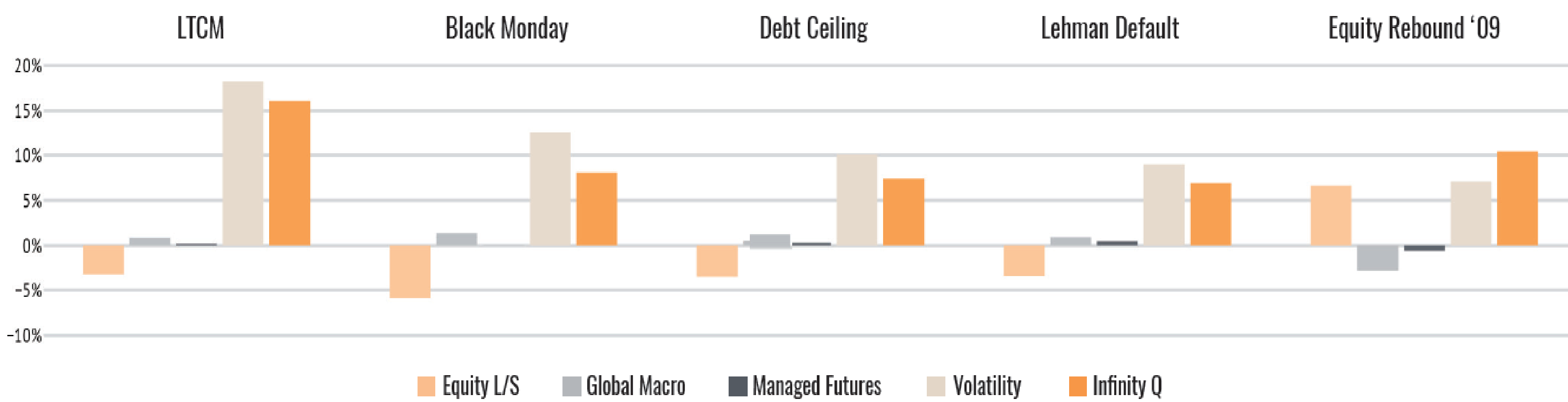
We are positioned to have flat carry in our portfolio, but have also increased our long convexity exposure. We expect the environment of market fragility to persist and anticipate the one year period of low volatility with no market shocks is nearing an end.



Source: Infinity Q Research