Investment Policy

January 2019 - 1. Quarter

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Press date: February 2019

MARKET SUMMARY

The year 2018 ended in the wake of the worst December in decades. The difficulty of investing in a zero or negative *risk-free* environment undoubtedly played an important role: over the course of the year, many investors were drawn towards *asset classes* that were riskier than what is tolerated on average. The two stock market shocks (February and October) have inevitably left a permanent scar on portfolios, a situation that worsened with the panic triggered at the end of December, largely due to a less accommodating Fed than expected and at the mercy of trade skirmishes between the USA and China.

This 2019 has begun with the same uncertainties as last year, with the economy appearing to lack the synchronised growth that had kicked off 2018. Europe and the emerging markets are lagging behind, while the growth rate in the United States remains positive but at more moderate levels than those observed in 2018, mainly due to lack of tax cut stimulus.

Undoubtedly, some of the geopolitical uncertainties that affected 2018 (*mid-term* elections in the USA and the tariff war with China) seem to have faded; however, others show up on the horizon, such as the European parliament elections and the difficulties in the process of the *Brexit* agreements.

Ultimately, European investors will likely face the same dilemma that characterised the last year: accepting risk and facing highly volatile returns, or rejecting it and accepting zero- or, even worse, negative returns.

In the area of risk assets, there is no doubt that the return offered by the emerging credit and equity markets appears to be more attractive than just a few months ago. Only personal risk appetite and investment horizon can decide the right portfolio mix for each investor.

Summary of the 2018 global scenario

The year 2018 began with strong, synchronised global growth and ended in the wake of a generalised panic over the arrival of an imminent but, in our opinion, unlikely recession.
The beginning of the year was supported by a strong Chinese economy, which prompted authorities to speed up the reform programme and, in particular, to make a substantial cut to *shadow banking*. However, the consequence was an unwanted monetary tightening.
In the US, Trump's fiscal stimulus led the Fed to adopt a more restrictive monetary policy than expected, thereby contributing to appreciation of the dollar and causing stress on the emerging markets.
Over the course of the year, the Trump administration began to use increasingly less conciliatory tones towards China, leading to the application of tariffs on over 300 billion dollars of Chinese goods. China's response to US protectionism was quick, with a combination of devaluation of the yuan, household subsidies and tariffs in response to those imposed by the American economy. Following the G20 in November, the US and China agreed to a three-month suspension of duties, initiating negotiations to rebalance bilateral trade.
The key issues in our area were the Italian government and *Brexit*. The former, having to yield to the demands of Brussels, adopted a more balanced and conservative attitude, while the latter issue is still far from being resolved. Added to this is the discontent shown by some of the French electorate towards Macron's policies, which have resulted in the violent and subversive demonstrations by the so-called "yellow vests".

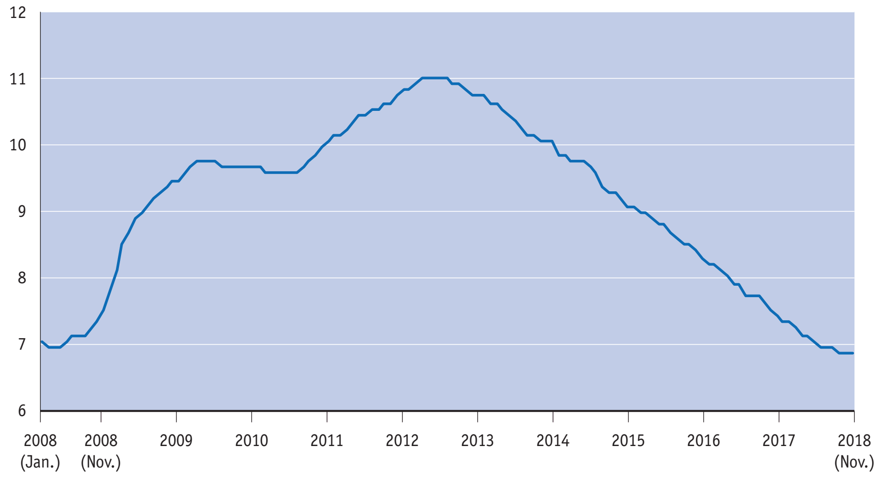
Macro data are currently solid, leading to optimism for the 2019 outlook

This climate of geopolitical uncertainty has not yet resulted in negative repercussions on the macro data. Unemployment in the US is expected to reach record lows, while it is steadily declining in the Eurozone. Global growth is still in positive territory, although a physiological decline has been recorded compared to last year.
The year 2018 will also be remembered as a record year for corporate profits of US companies. Based on these data, in regard to the prospects for the new year, we believe the risk of an economic recession to be rather low, particularly in view of such unemployment levels. In our opinion, market stabilisation will be reached by returning to economic and corporate fundamentals which, as mentioned, are still good, although down from the record levels. Moreover, a reduction of the divergence in monetary policy trends of the central banks inside and outside the US should help stabilise and reduce the large bond yield spreads around the world, which impact the allocation of investments and have created heavy distortions on the markets (also outside of the bond context).

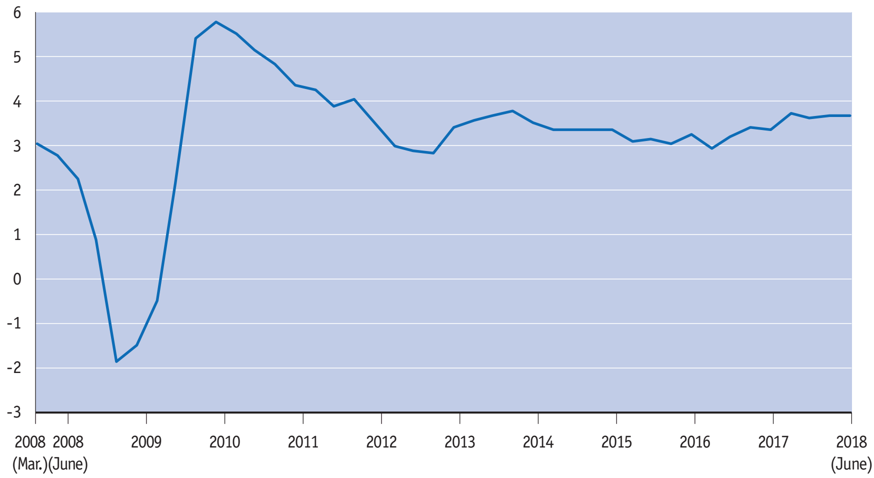
Latest developments on negotiations for the Brexit plan

At the time of writing, May suffered a heavy defeat in the parliamentary vote of 15 January: a defeat that should not, however, lead to a *Hard Brexit*, but rather to further negotiations with the EU or to an extension of the deadline (post March 2019). New elections or even a new referendum, albeit with a low probability, cannot be ruled out.
In essence, the indications on Plan B of the government subsequent to the parliamentary vote will be crucial for a more precise view on Brexit.

EU unemployment (%)



Global real growth rate (%)



Neutral on the EUR-USD exchange rate

The US *Federal Reserve* has implemented a sharp reversal in monetary policy over the past month. While forecasts up to last October indicated two rate increases for 2019, the market is currently discounting a 'no increase' scenario, with even a 30% chance of a cut at the end of 2019. When the stock market reached new highs at the beginning of October and everyone began revising their targets upwards, Powell stated that interest rates would still have plenty of room to increase. The stock markets took this statement very badly and a correction trend was triggered in the wake of the belief that the Fed was making one of the biggest monetary policy mistakes of recent decades, particularly during a global economic slowdown phase. In response, Powell changed his tune by cancelling the rate increase envisaged for March and allowing *Quantitative tightening* to be suspended if necessary, without actually eliminating it. In fact, the Powell call, namely the ceiling above market, is as strong as the Powell put, namely the safety net below market. In practice, should the stock exchange resume a bullish trend, we believe the Fed will be ready for new rate hikes.
Therefore, we remain positive on the dollar and consider this slowdown phase to be temporary. However, we know that in a ranging market, timing and entry levels can make a big difference. Consequently, at current levels, we suggest no exposure to the dollar. Our decision to be neutral at the current levels is best explained by looking at the side graph, which compares the EUR-USD rate trend to the yield differential between 10-year US and German bonds. As the chart shows, the narrowing of the US-German spread was not reflected in the exchange rate.

Still positive on the Swedish krona and Norwegian krone

We confirm our positive *outlook* on the Swedish krona and Norwegian krone. In our opinion, macro-economic conditions in Sweden are favourable for a normalisation of monetary policy, as even the latest inflation figure positively surprised market and central bank expectations. Only the global context could drive monetary authorities to slow down (we recall that *RiksBank* is linked to the ECB and in the past month the market has begun to discount the European Central Bank's *dovish* stance).
The economy appears to be healthy in Norway as well, and even inflation continues to remain above the central bank's target. We believe that the Norwegian monetary authorities will aim to normalise monetary policy during the new year, creating a divergence with Europe and Switzerland (and thus fuelling appreciation of the NOK against the CHF and EUR). Finally, we must not forget that one of the main drivers of the currency, namely oil, corrected by over 20% in the last month of last year. The consequent partial correction of the Norwegian currency (which devalued by about 3%) is expected to recover shortly.

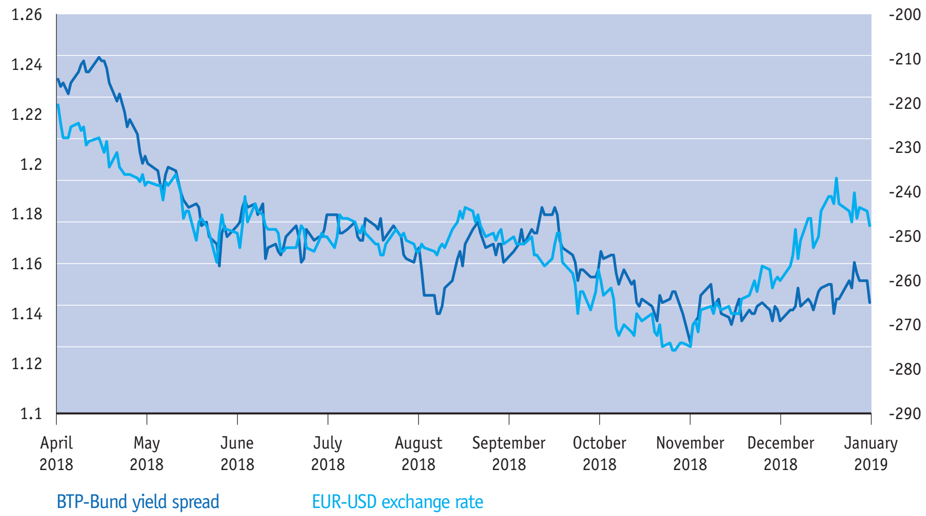
Continued relative strength of the Swiss Franc

The Swiss franc closed the year on an upward trend at the end of 2018. Switzerland's data on employment and growth remain excellent, but low inflation leaves room for a wait-and-see policy by the Swiss National Bank towards normalisation of the European Central Bank's policies.
The Swiss franc retains its role as a safe haven asset, also in response to the issues related to Brexit and to the strength of the pro-Europe parties in the upcoming European elections in the spring.

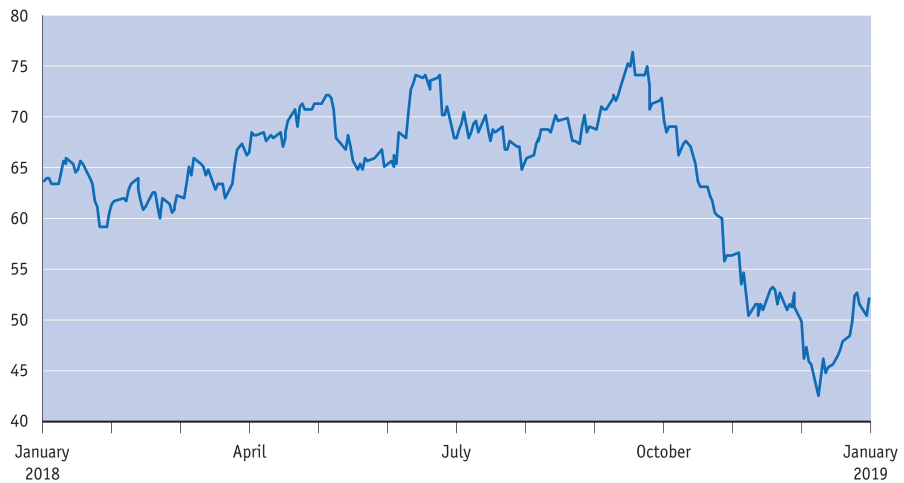
Prudent approach to emerging market currencies

In this phase of market uncertainty, we recommend rationalising investments and maintaining a concentration on few sectors. Consequently, we believe it is more prudent to reduce exposure to *emerging currencies*.
In particular, we believe that, rather than holding them structurally, emerging currencies should be approached more tactically in the coming months. We therefore suggest avoiding investment and possibly resuming under stressed conditions, should we find value.
According to a more macro-based argument, the drop in the US 10-year yields could favour emerging currencies. However, the reasons for this decline need to be assessed. If, as it would appear, the reduction in US yields is the result of a more *dovish* FED, due to fears of a slowdown or, worse, recession, this would be far from favourable to the emerging sector. Moreover, the weakness of *equity* and a generally not very positive market environment do not favour the *asset class*.

BTP-Bund yield spread vs. EUR-USD exchange rate



WTI crude oil price (USD)



The bond scenario in 2018

With regard to government bonds in general, the Global Aggregate Index closed in negative territory by more than one percentage point in 2018, as the historic inverse relationship between bonds and equities failed to materialise last year. European, Swiss and Japanese government rates remained at zero in nominal terms and negative net of inflation. The US interest rate curve was still flat but interesting on the short-term side. However, hedging against exchange rate risk made the yield negative for those dealing in EUR or CHF.
The credit market underwent strong *spread* widening at year-end, partly due to fears of an economic slowdown and partly to forced sales of funds affected by heavy *redemptions*. In a context of low liquidity, these flows had a significant impact, bringing the *spreads* back to levels unseen since the beginning of 2016.

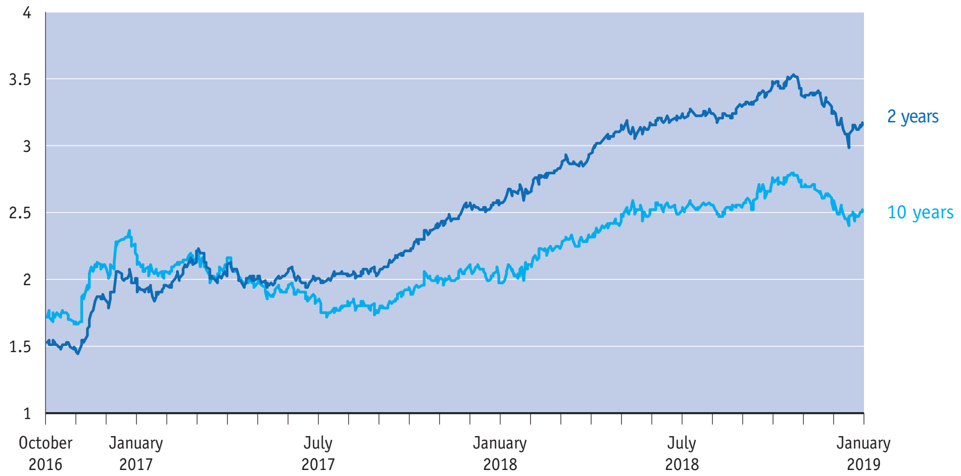
Outlook for the new year

In general, the market situation appears to be heading towards at least a temporary solution to the problems that impacted the last 2 months. The BTP-Bund *spread* fell significantly from 3.26% to 2.83%. The rhetoric has also softened, and we continue to believe that the German election results represent an important *turning point*. US-China relations seem to have eased post G-20 as well, at least in the short term.
The Brexit question mark obviously remains, along with other elements of disturbance, but we believe that we can soon go back to reflecting on numbers and fundamentals. The 10-year yield on the *US Treasury* bond, after the *spike* of over 3.25% at the beginning of October that triggered the *risk-off*, is now below 3%; the Fed has also changed its tone, suggesting that the future trajectory of rates is less steep than expected.
On the European front, weak growth figures fuel concerns on the exit from the ECB's stimuli. It will be essential to hope for a fiscal support manoeuvre, without which this stagnation can only continue, also since the spread between the US and Euro curves remains close to historic highs for both the 10 and 2-year segments, although it recovered significantly during the last quarter

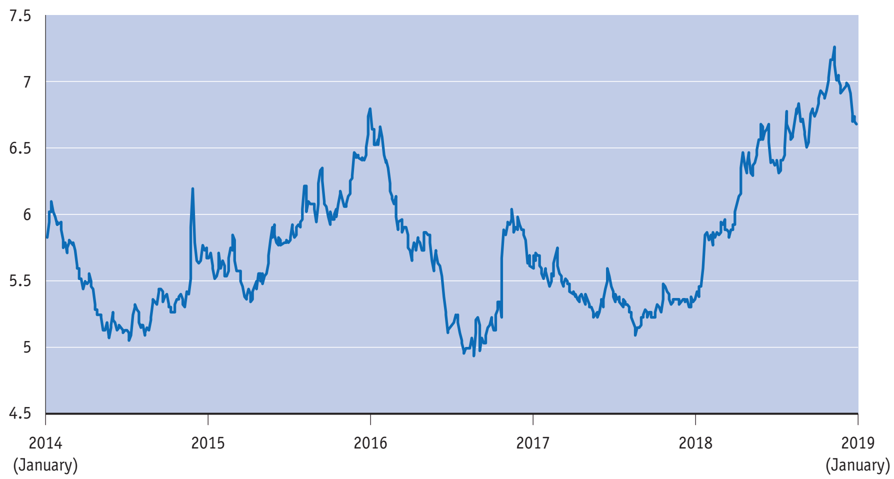
Improved outlook for emerging markets bonds while high yield segment remains at risk

Stabilisation of US-China relations and the renewed calm in US rates should also allow for a rebound in emerging assets, with the emerging bond spread slowly decreasing from the highs reached in November, at the highest levels ever reached since the economic crisis. Even financials, particularly impacted by the year-end sales, now appear to offer an excellent risk/return ratio (obviously always careful to avoid the most problematic names).
On the *high-yield* segment, however, we call for extreme caution: after many years of low rates that prompted many companies to increase leverage, a context of rising rates and economic slowdown could lead to an increase in *default rates*, especially in the United States.

USA vs Eurozone spread on the 2- and 10-year curve



Emerging Bonds Yield Index



Global equity markets trend in 2018

Performance of the financial markets in 2018 was extremely "disorderly". In a nutshell, sudden trend shifts on the stock markets, loss of correlations that traditionally balanced portfolios and specific crises that expanded to also impact the general trend essentially characterised the markets in the past year.
All of the major global stock indices closed with a "negative sign". Indeed, the *MSCI World* recorded a negative performance of over 10 points, and things were not much better at the regional and sector levels either. In particular, after an enthusiastic first part of the year, small- and mid-caps suffered strong sales pressures. A case in point is the *Swiss Performance Index* (SPI), which was still positive at the beginning of October but closed the year down by around 10 points. The emerging markets suffered from the FED's *quantitative tightening*, ending the year on negative ground (over -15% for equities and approximately -5% for bonds). From April onwards, geopolitical events completely overshadowed the strong macroeconomic data and corporate fundamentals. Since May, with the formation of the Italian government, the European stock market began its correction, underperforming the other markets and closing the year with a negative performance of about 15 points (the BTP-Bund *spread* simultaneously widened to nearly 350 basis points).

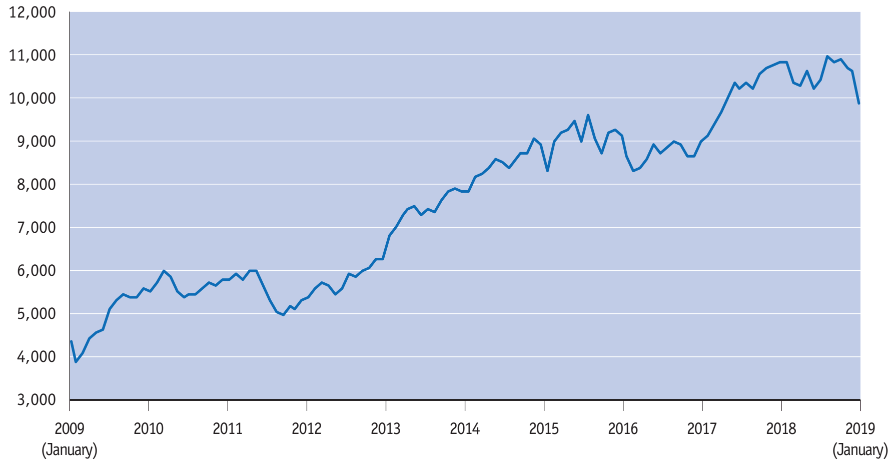
Equity market valuations and earnings revisions in the new year

A number of issues remain unresolved in 2019: stability of the Italian government, *Brexit*, *trade wars*, possible global economic slowdown and, lastly, the restrictive stance of the FED.
Despite these, the correction in 2018 and the expansion in profits for 2019 have made the valuations of stock indices more attractive, creating good opportunities for the year just begun: in the US, the market's expected P/E was around 14.9x, while in the Eurozone it was around 11.9x. Corporate profit growth has stabilised in Europe and is expected to reach record highs in the US.
All of this should offer the possibility to gradually bring average portfolio investments to a higher percentage than that of end-2018. Of course, we cannot ignore the trend in the financial markets, which will have to find a certain balance beforehand.

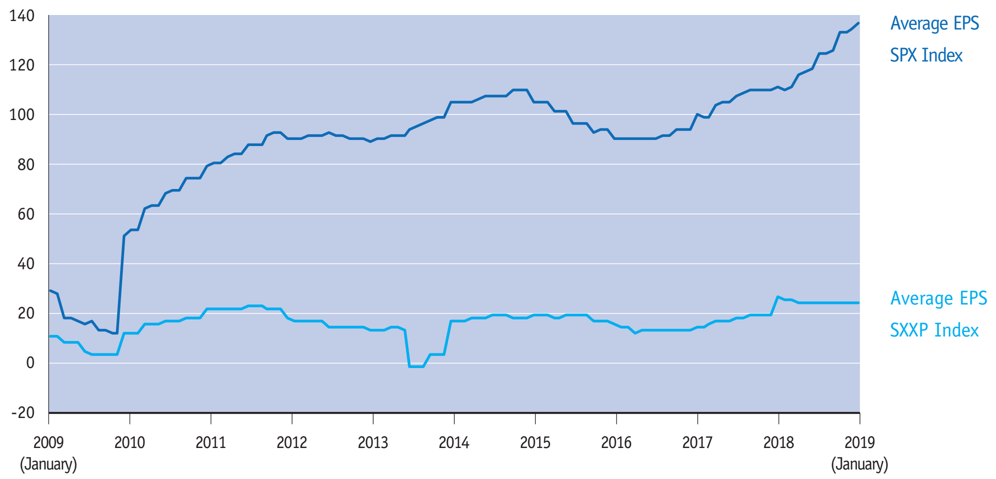
Changes for 2019 in the portfolio management concept

In the last quarter of 2018, extreme price movements were largely the result of exasperation, due to market algorithms, unrelated to fundamental logic, which disoriented many investors. In this context, the search for value in the composition of a portfolio is and will be achievable only by sustaining a volatility to which investors are not accustomed.
This is a situation we will all have to learn to live with - in all likelihood - even in the first part of the new year, through an understanding of the logic that will shift markets significantly in the short term, and through a process of communication that allows us to understand and accept a higher level of volatility than in the past as an inevitable requirement for portfolio growth, in a negative rate scenario.

Swiss Performance Index (SPI)



Historic EPS trend: USA vs. EU



Goals

In a world characterised by increasingly squeezed yields expected for traditional risk categories (shares and bonds) and by more and more frequent market shocks, the objective set by Banca del Sempione's asset management is to achieve a real growth in capital in the medium-long term. To achieve this result we use the most advanced and innovative techniques accompanied by the healthy values of a Swiss tradition and culture which within the area of asset management can rely on people with an excellent level of professionalism.

Investment Philosophy

Our investment philosophy is based on five main principles:

- Composition of profits
- Drawdown reduction
- Discipline of the method, rather than "passivity" of the method
- Reduction of cognitive and emotional biases
- Limited presumption of market timing

Specifically, a reduction in drawdowns (i.e. negative fluctuations in asset values) combined with capitalisation of profits (defined by Einstein as the eighth wonder of the world), allows for triggering a snowball effect, through which profits are generated on profits, resulting in growth of invested capital over the medium-long term.

Portfolio Structure

		Maximum investment limits (%)					
Investment Profile	**Risk category**	**Cash**	**Investment Grade Bonds (>=BBB-)**	**Non Investment Grade Bonds (<BBB>)**	**Equities**	**Other Funds***	**Currency Diversification**
Income	Low	100	100	0	0	5	15
Income Plus	Medium-low	50	100	15	15	15	15
Dynamic	Medium	30	100	20	30	25	25
Balanced	Medium-high	30	80	20	50	25	25
Growth	High	30	50	20	75	30	25
Equity	Very high	30	50	20	100	30	25

* Non-directional funds, total return funds, funds of funds

The limitation of drawdowns via compounding of profits – defined by Einstein as the eighth wonder of the world – permits the accrual of profits on profits, triggering a snowball effect that results in growth of capital invested in the long term. The main innovation of this approach is in the way of limiting losses: in

the past, portfolio volatility was offset by investments in instruments considered to be free of risk, namely bonds. Today, the protection offered by such instruments is mostly limited, while in the medium/long-term, traditional investment in bonds could even increase portfolio risk, especially if we consider that over the recent period, stocks and bonds have increased in perfect harmony.

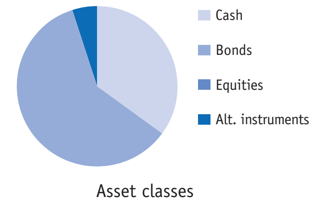
In our opinion, the implementation of systematic strategies allows for portfolio risk reduction and profit achievement whilst protecting invested capital, even in difficult markets. Due to their cold and mechanical approach, these strategies sharply mitigate the emotional component that drives and influences investment decisions and are based on the concept that it is preferable to participate in market trends rather than anticipate a shift or change in trend. On this basis, market prices are the best indicators of the current trend. As opposed to traditional ones, systematic strategies may also participate in market price downturns and, combined with a more traditional fundamental analysis approach, are able to offset sharp downward shifts such as those of 2008 or 2011.

In essence, common sense, systematic behaviour and discipline in making investments are the bases on which we build the portfolios of our clients.

Allocation by asset class

Income

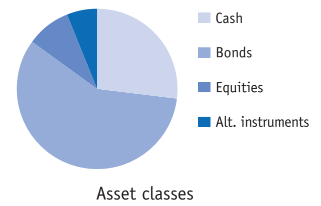
Cash	35
Bonds	60
Equities*	–
Alternative instruments	5
	100



Asset classes

Income Plus

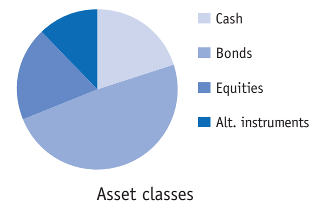
Cash	27
Bonds	58
Equities*	9
Alternative instruments	6
	100



Asset classes

Dynamic

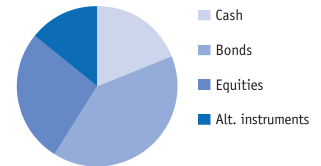
Cash	20
Bonds	49
Equities*	19
Alternative instruments	12
	100



Asset classes

Balanced

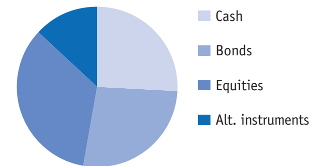
Cash	19
Bonds	40
Equities*	27
Alternative instruments	14
	100



Asset classes

Growth

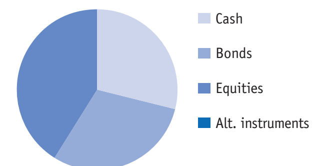
Cash	26
Bonds	27
Equities*	34
Alternative instruments	13
	100



Asset classes

Equity

Cash	29
Bonds	30
Equities*	41
Alternative instruments	–
	100



Asset classes

* Part of equity allocation is hedged with index options or futures

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