Investment Policy

April 2019 - 2. Quarter

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Press date: April 2019

From panic at the end of 2018 to euphoria at the beginning of 2019? Not exactly. Although the share indices (with some rare exceptions) have returned to the levels of the end of September, it is difficult to be totally positive. Most investors have profited from the increase to lighten share exposure, and the climate is generally cautious for the remainder of 2019. Causing major concerns is the current economic slowdown, especially in Europe, where using taxation to support the economy is proving more difficult.

On the other hand, on the Asian front, things seem to be improving especially in China: already during the last quarter of 2018, the country launched both monetary and fiscal stimulus packages which have turned out to be effective. For now, the domestic Chinese stock market is the best in 2019, with an increase of more than 30%. As far as talks concerning duties are concerned, from both sides of the Pacific optimism is increasing and important steps forward have been taken. However, no final agreement has yet been reached.

Also, as far as Brexit is concerned, an agreement has yet to be reached between Great Britain and Europe, and the original deadline of the end of March has, for now, been extended until after the European elections.

In spite of these still unresolved problems, the recovery of risk asset prices continues at the beginning of the second quarter, and economic indicators also seem to show signs of stabilisation. In this sense, with central banks in stand-by mode and the absence of pressure on 10-year rates, for now it looks as if recovery can go ahead undisturbed.

Still no solution to the Brexit matter

The Brexit saga has kept the market with bated breath for the whole of the first quarter of 2019 and after the last deadline expired (29 March) no solution was found. At this point a no deal seems to be inevitable in spite of the repeated attempts to ward off this eventuality by the exponents in favour of Remain and a soft Brexit. Among the counterproposals to the deal negotiated by May and the no-deal scenario, the customs union and a second referendum are those who obtained a higher consensus in parliament (although without reaching a majority). Therefore, the political *impasse* forces Theresa May to seek a true dialogue with the Labour party, supporters of a customs union hated by the hard Brexiteers. After the failure to respect the leaving date fixed by the European Union for 12 April, postponement until after the date of the European elections could force the British to take part. This scenario, which could lead to a review of the balance of power within parliament, would make it possible to explore options which the current parliamentary structure would never have been able to approve. If the United Kingdom should actually take part in the European elections one wonders if, as suggested by the leave exponents, Great Britain would use its presence within the EU as a negotiating weapon.

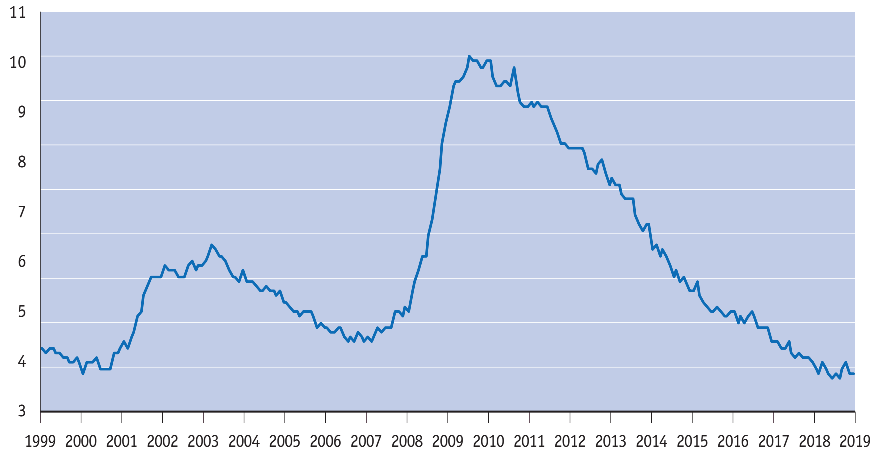
Trade tensions between USA and China have weakened but have not yet been resolved

The trade war between the United States and China has continued to fill the headlines of various newspapers, although after several meetings the climate now seems to have calmed down. Reaching an agreement which satisfies the American requirements is seen with optimism. However, some analysts emphasise that this agreement could disappoint expectations. Greater purchasing of US goods, a veritable opening up of the Chinese market for American businesses, and the ceasing of the forced transfer of intellectual property are the targets of US diplomacy, which, however, would also like to be able to control the implementation of a possible agreement, reserving the unilateral right to impose sanctions. The Chinese however do not seem willing to allow it, having been able to observe the actions of the USA after the agreement on the new NAFTA. In light of recent developments, it seems clear that tensions deriving from Huawei's 5G infrastructures were more an instrument than a cause of the dispute.

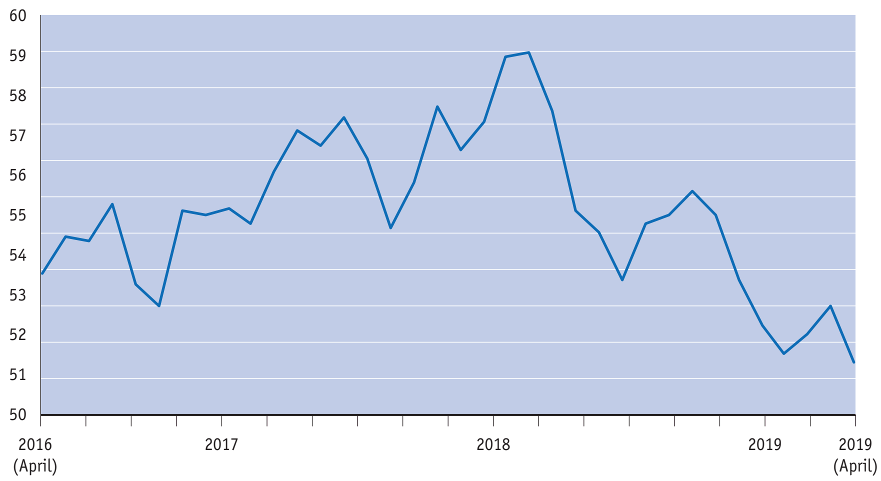
Macro figures emphasise a growing global economy although at a falling rate

Global macro-economic prospects remain rather disappointing and confirm the slowdown anticipated by the markets in the last quarter of 2018. The position of the United States however is more solid than that of Europe. Unemployment is at all-time lows. Growth is positive although slowing down as the impulse from the tax cuts of the Trump administration in 2018 is running out. Some of the figures which confirm the slowdown are without a doubt the February ISM and the lack of growth in wages in spite of low unemployment. The old continent is experiencing a very low overall growth, proven by disappointing PMI figures, attributable to the German manufacturing sector (more specifically the automotive industry) and the technical recession in Italy. On the other hand, the feared effects of the protest movement on the French economy do not seem to be significant. Uncertainty on the future of Brexit, the trade wars of Trump, the approaching European elections and the growth of the Chinese economy all contribute to limiting optimism for the future.

US Unemployment Rate (%)



German PMI



In the short term we remain short euro

The euro-dollar exchange rate has reached the low end of the 1.12 – 1.16 range. Our vision remains negative on the euro, also because the macro-economic figures of the last quarter partially disappointed market expectations. In particular, both inflation and sentiment data recorded a fall. The direct consequence was a shift in the stance adopted by the European Central Bank which postponed the normalisation phase of the monetary policy until next year (we recall that at the start of the year the market was discounting the first increase in interest rates for next September) and announced a new plan for the injection of liquidity into the "TLTRO" banking system. We believe that until we see a decisive economic recovery in Europe it is expedient to adopt a "short" position on the euro. If a series of positive figures should be recorded (as many analysts expect), in particular on inflation, we will reassess our short Eur-USD position.
On the American front, the following aspects support our positive view on the dollar: its G10 currency status with the highest yield and market expectations regarding the next moves of the Federal Reserve. In fact, not only do investors no longer expect an increase in rates for the current year but they even think there is a 75% possibility of a 0.25% reduction in the cost of money for January 2020. Therefore, we believe that a dovish policy by the FED is already in current evaluations and a surprise would be in favour of a more restrictive monetary policy. Remember that the American monetary authorities had interrupted the rate-hike cycle mainly because of the collapse of the stock market at the end of 2018. Now that stock indices are returning to maximum levels, we do not exclude the possibility that the FED may reverse its decision.

The Swiss franc remains strong, with some doubts for the second half of the year

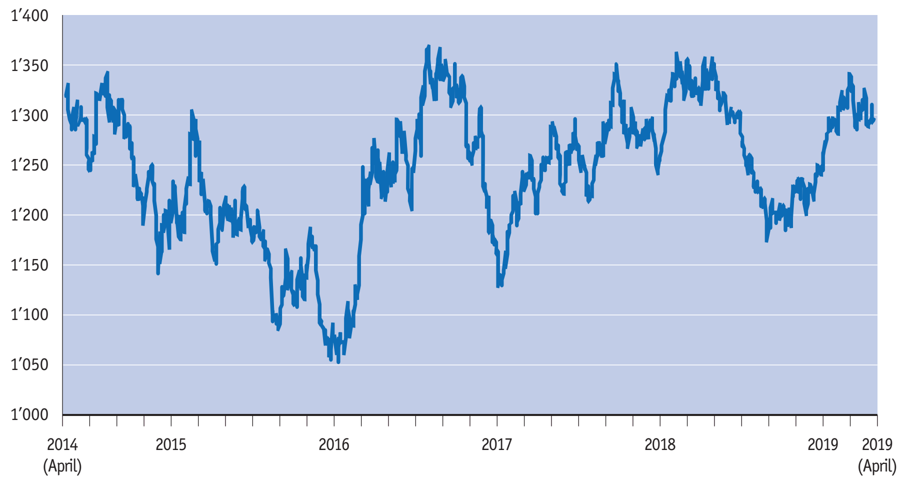
The Swiss economy remains solid and continues to grow, notwithstanding a strong franc. The Swiss National Bank excludes any increase in rates, at least until a normalisation of the ECB policies, which for now does not seem to be on the horizon. The strength of the franc remains based on its function as a safe haven asset in periods of uncertainty. However, negative figures in Europe could now have reached a turning point: in the months to come, more solid or positive figures, combined with a soft Brexit, a limited success of sovereigntists at the European elections, and Chinese tax incentives, could stabilise – if not even strengthen– the euro against the franc.

Gold may represent a performing safe haven possibility in the second quarter

Gold can, without a doubt, be considered another safe haven asset. The price of gold has had a good performance in the first quarter of 2019, in spite of a bullish stock market. All the more reason, therefore, why any equity correction in the next quarter could support a bullish trend.
Gold is also interesting considering the scarcity of safe haven assets not encumbered with negative yields, in a context full of uncertainties, including the trade war between USA and China, Brexit and the imminent European elections.

EUR-CHF Exchange Rate

Gold Price Index (XAU)



Central banks abandon normalisation of rates

The first months of 2019 did not offer any comfort to those hoping for a prompt re-acceleration of the global economy: figures in fact have continued to surprise in a negative way both in emerging countries and in the advanced economies. The perception of a worsening has been exacerbated by the inversion in the US yield curve, in the past a good leading indicator of recession. However, in the current situation, the curve could be excessively distorted by the intervention of the central banks to offer reliable indications.
Economic policies will remain in support of the cycle, as testified by the message of "patience" introduced in January and strengthened at the meeting of the FOMC in March, in which the end of rate-hike cycle in 2019 was announced, to which a halt to quantitative tightening will be added as of September. The ECB also reduced its growth forecasts and announced new long-term refinancing operations (TLTRO) in replacement of those expiring in the years to come, extending the forward guidance on rates at least until December. The factor that triggered the downward pressure on curves can therefore be identified in the turn of the central banks, mainly due to the slowdown in global growth and limited inflation pressures. The periphery should therefore benefit from it, in virtue of an ongoing search for yield.
Such a scenario could force the ECB to reconsider normalisation of negative deposits as the next step, in order to reduce the collateral effects on bank profitability and make the transmission of monetary policy more effective. In this case, a flattening of government curves could be likely, but for the moment the ECB does not seem to be willing to move in that direction. However, the decision to index-link the new TLTRO to the refinancing rate as opposed to the rate on deposits leaves the door open for an attempt at normalisation.

Will we see a widening of credit spreads if we enter a late cycle phase?

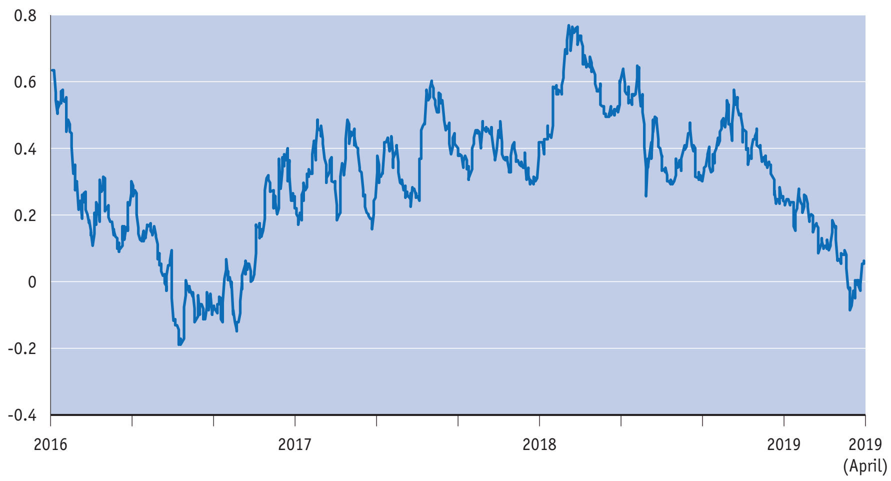
We believe there is a limited directional upside and we therefore prefer to avoid areas where the risk profile is asymmetrical in the short term (more risk of correction than profit opportunity).
In this wait and see phase, the corporate market remains attractive, but it is constantly necessary to monitor the risks which could worsen the current scenario (hard landing in China, chaotic Brexit, trade war).
So, we continue to be positive on the European credit market (with a lower debt than the US market) since it is the main beneficiary of the new TLTRO announced by the ECB. Moreover, we expect that the search for return will continue in a regime of negative rates, considering the still positive outlook of default rates. You just have to think that in March more than 9.3 trillion dollars in debt in global bonds had negative returns. In particular we believe there is value in both banking and insurance subordinated financial corporate bonds.
Although the momentum of the emerging market has recently deteriorated, the dovishness of the main world Central Banks can still play in favour of the emerging debt. We remain constructive on the emerging debt in hard currency due to its attractive carry, although the spread squeeze is limited.

What position to take for the second quarter

Finally, although the dovishness of central banks is an element to be taken into consideration, we believe it is preferable to maintain a low duration, since we must take into account the extreme evaluations of rates and their effects in the long term. Interesting yields can be found on emerging markets such as Romania, Oman and Mexico. In Europe we favour a convergence positioning between Spanish and French rates.
In corporate bonds we see value on European subordinated financial bonds as well as on some hard currency emerging market bonds.

Spread on European Financials subordinated debt (bp)

German 10-year yield curve (Bund)



Stock markets' trend in the first quarter

We last spoke at the end of the last quarter of 2018 which, to use a euphemism, could be defined at the very least as catastrophe. Without a doubt, share valuations were negatively affected by the Brexit matter, fear of a global recession and the feeling that the Fed's restrictive policies could damage the economy. As a result of this scenario, we therefore saw an almost unprecedented compression of multiples. As if by magic, however, all it took were the words of Powell at the beginning of 2019 to dissipate fears on the markets: the Fed in fact decided to suspend or at least to postpone any increase of rates in 2019. At the same time, the economic figures published by the major economies showed signs of a slowdown but not serious enough to predict a recession.
So, only Brexit remains out of the three fears mentioned above, which on its own, until now, has appeared to be incapable of influencing the market on a global scale and has, on the contrary, perhaps further accelerated the process which has resulted in a preference for risk assets in USD rather than those in the EUR zone. So, no more fears, and, consequently even multiples are growing, recovering the fall of the last quarter. The result of these elements is that in the quarter a positive performance was recorded in stock markets sufficient to recover the drawdown of 2018 in all geographical sectors: S&P500 +13.07%, EuroStoxx600 +12.27% and MSCI EM +9.56% (to be emphasised CSI, the China A-Shares, +28.62%). This increase is to be attributed more to flows and to the so-called FOMO, the fear of missing out on an opportunity offered by a rising market, rather than to fundamental data. We will have to wait and see if corporate profits will be able to give a further boost to the rally at the beginning of the year or even completely overturn the expectations of this 2019.

Corporate earnings forecast to fall during 2019

As usual at the beginning of the year, at the dawning of 2019 analysts' expectations concerning corporate earnings were rather high, with an estimated growth of 8% in the United States and 3% in Europe. As time goes by, as by now is normal, estimates have been revised downwards: 5% for the USA and around 0% for Europe. Moreover, we find ourselves in a mature phase of the economic cycle and businesses are forced to reduce prices to keep sales volumes unchanged, to the detriment, inevitably, of margins. An example of this is the drastic reduction made by Apple on the price of *iPhones* in China to stimulate their demand. So, we are therefore justified in asking ourselves whether the earnings downward revision trend has come to an end or, after corporate results, we could have further negative surprises.

Excellent performance for the Swiss stock market

The Swiss stock market has undergone an appreciation of 14.37% during the first quarter of 2019, notwithstanding a very strong Swiss franc. One of the reasons for this increase is the preference of investors for equity rather than bonds, also considering the nil -if not even negative- bonds yields in advanced economies and the end of tensions between USA and China. However, the slowdown in the global economy to which Swiss companies are exposed remains a risk for the Swiss market. This is true in spite of the fact that Swiss companies are currently less exposed towards the Eurozone, as their 55% quota of exports in 1995 decreased to 44% in 2018. The Swiss National Bank, which fears this slowdown and a resulting appreciation of the Franc, is ready to act with easing transactions and further reduce rates if necessary. Last but not least is the fear of the SNB concerning a possible bubble in house prices.

China A-Shares Index (SHSZ 300)

Swiss Market Index (SMI)

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.

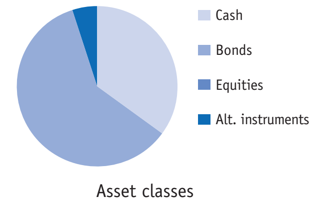
In our opinion, the implementation of systematic strategies allows for portfolio risk reduction and profit achievement whilst protecting invested capital, even in difficult markets. Due to their cold and mechanical approach, these strategies sharply mitigate the emotional component that drives and influences 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

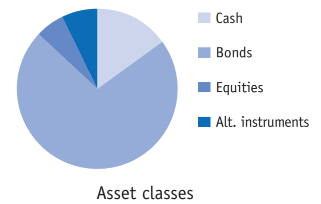
Cash	35
Bonds	60
Equities*	–
Alternative instruments	5
	100



Asset classes

Income Plus

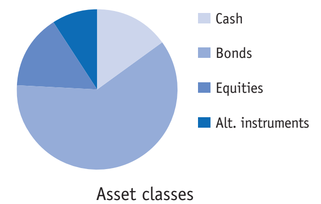
Cash	15
Bonds	72
Equities*	6
Alternative instruments	7
	100



Asset classes

Dynamic

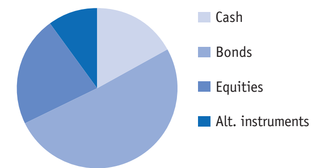
Cash	15
Bonds	61
Equities*	15
Alternative instruments	9
	100



Asset classes

Balanced

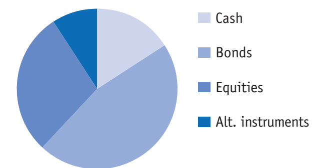
Cash	17
Bonds	51
Equities*	22
Alternative instruments	10
	100



Asset classes

Growth

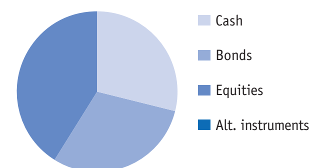
Cash	16
Bonds	46
Equities*	29
Alternative instruments	9
	100



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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