Investment Policy

July 2018 - 3. Quarter

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Press date: July 2018

While the eyes of investors were focused on the tariff conflicts across the ocean, the Italian government was formed in the last quarter, with the unprecedented Lega-5 Stelle coalition highlighting the fragility of European cohesion, struggling to go beyond a merely monetary union. Investor scepticism on the economic policies of the new government is once again fuelled by the Btp-Bund spread. However, the key developments of the economic policies are expected by autumn, when the financial budget will have to be approved.

Meanwhile, the ECB has taken more time, moving the end of QE to year-end but reducing its amount - from 30 billion to 15 billion per month -, and simultaneously further postponing guidance on the first interest rate hike towards the end of 2019.

Growth estimates for 2018 remain positive but slightly less optimistic compared to a few months ago, with a downward revision for Europe and for the emerging countries. Inflation is back in the game and approaching 2% in Europe, further exacerbating the already low level of real rates, which are firmly in negative territory within the Old Continent.

Across the pond, the United States is proceeding with a rebalancing of its trade deficit, through the introduction of tariffs on imports from China and Europe and threatening further duties if its major trade partners are not collaborative in rebalancing the 'trade balances'. The consequences of these measures are rather limited at the moment, although if this trade war climate continues, it could jeopardise the current economic growth trend.

The equity markets remain within the trading range established at the beginning of February. The continued flow of rumours on the political and commercial front are hindering a true resumption of the upward trend, even if earnings growth in the USA and valuations in Europe point to a more constructive market.

However, it should be noted that this year the 'damage' to portfolio performance is predominantly the result of the bond component, within which - paradoxically – the investments considered less attractive because lacking yield (such as European government bonds) were the ones that suffered the least since the beginning of the year. In fact, losses mainly stem from the emerging and European peripheral bond components.

Today, in a world desperately seeking bond yields, only some of the hard-currency emerging bonds - at a 9-year high in terms of yields - represent a real opportunity to be considered.

Context

Just over one year since Macron's election, which seemed to have opened up a new era for the Eurozone, European political risk has dramatically returned to the forefront. The political uncertainty created during the process to form the new Italian government generated significant pressure on government bonds of peripheral European countries and sustained the safe-haven securities, particularly the Bund. At the global level, attention remains focused on the trade policies of the Trump administration, notably the USA-China negotiations which have not yet provided clear results. Among the assets considered at risk, equities showed greater stability with respect to both the investment grade and high yield credit segment, while outflows from the emerging markets continue.

We cannot ignore a certain amount of concern on the re-emergence of the Europe risk, which had been considered eliminated. This uncertainty is triggered by a European macroeconomic scenario in which growth momentum is slowing and which coincides with a phase of normalisation of monetary stimuli, albeit slow, started with tapering and the approaching end of QE announced for December.

Possible scenarios under which the European political crisis might develop

Among the alternatives to take into consideration in resolving the European political crisis, an initial 'optimistic' approach envisages a joint commitment in accelerating the political and social cohesion process, which is showing a sharp delay compared to the monetary cohesion already achieved. However, the fact that continuation of the crisis has resulted in a nationalist and anti-European sentiment within the various nations is the main obstacle to such a scenario, with German leadership seemingly weakened by the elections and struggling to support Macron's desire for reform.

Consequently, we cannot exclude a second scenario that would instead involve a change of heart by certain countries as to their permanence in the EU.

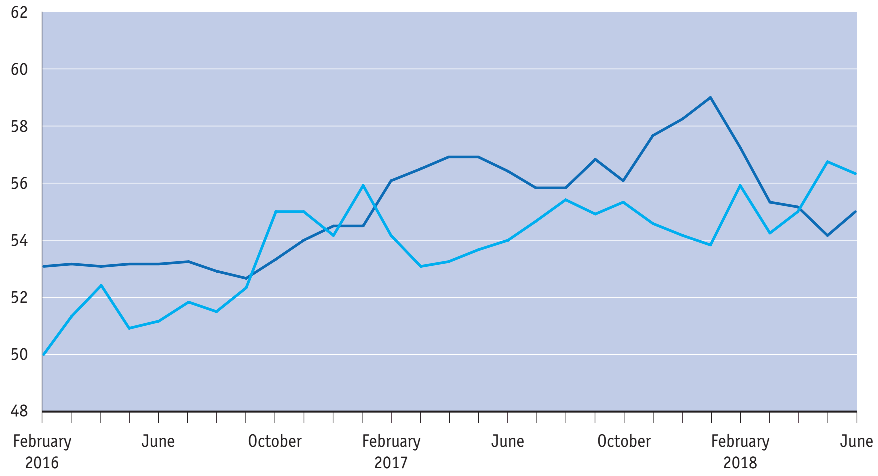
Lastly, a third scenario (perhaps less painful and more likely from a political standpoint, despite its risks and limits) would be to continue the ECB's Japanese-style accommodating policy for many more years. Of course, a combination of the aforementioned options is possible as well.

Macro indicators still positive

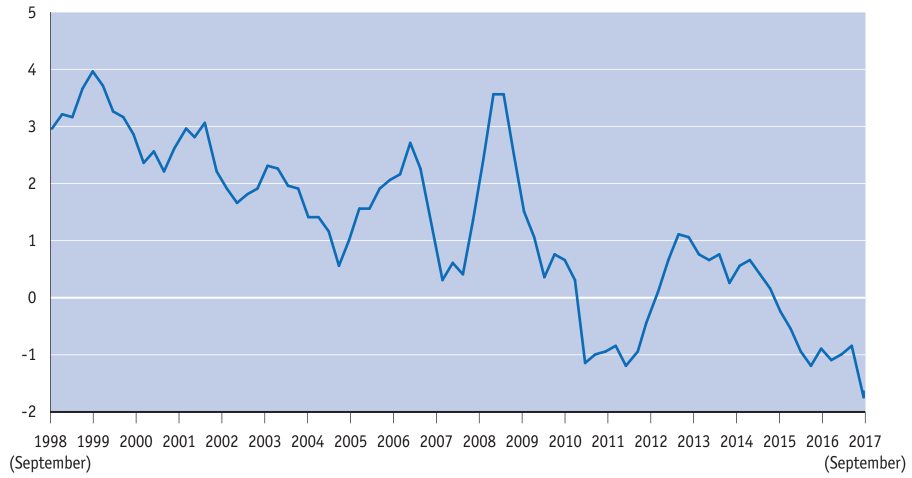
The PMI indices are still positive in the USA, with signs of recovery in the Eurozone. The same holds true for the indices that measure macroeconomic surprises and for those that measure financial conditions: the latter remain at accommodating levels, although they are retracing from their highs and showing signs of weakness only in the Eurozone. The leading indicators continue to show signs of recovery after a stagnant phase, together with the GDP growth rate, expected to rise to around 4% (record for the last few years).

The true problem lies in the clamour of news triggering uncertainty on the political and commercial front and hindering stabilisation of the financial market.

Eurozone PMI vs. US PMI



European real rates (%)



Keep a neutral/bearish approach to the EUR/USD cross rate

The EUR-USD exchange rate decreased by more than 5% in the last quarter. The factors that had supported said cross rate throughout 2017 bringing it from 1.05 to 1.25 fell through for various reasons.
In terms of monetary policy, the ECB has set the first rate hike in summer 2019, at the earliest, thus widening the EURO and USD yield spread even more. Such issue, which the market did not seem to take into much account only a few months ago, has now become the main driver for identifying the exchange rate trend.
The European macroeconomic indicators are down on last year, whereas the American ones keep on looking in good shape.
On the European political front, after Macron's victory, the risk of Europe's disintegration appeared to be over, but the newly elected Italian government and the crisis in the Spanish and German ones have raised the same issue. However, we assign almost zero probability to the European Union ending, even though rumours on the topic tend to weaken the Euro.
On the American political front, instead, if at the start of the year any appreciation of the USD was promptly stopped by a tweet by Trump, such political intent seems now over.
Several ECB representatives are expecting a weak EURO against the greenback over the next few months: the current 1.15 support area is important. If this level is not broken, we expect the exchange rate to remain within the 1.15-1.20 range. In light of the carry trade position (over 3% YoY) we recommend keeping a neutral approach at these levels and buying USD again only if the cross rate should go back to the 1.20 area.

Bet on a weaker Swiss franc

Tensions connected to the Italian political situation have brought interest back into safe-haven currencies, in particular the Swiss franc. During the last quarter, the Swiss currency appreciated again, especially against the EURO. We suggest taking advantage of this trend to build up short/bearish positions on the CHF, with the expectation that the exchange rate will go back to the 1.20 area. As a matter of fact, we believe that, in ordinary market conditions, foreign investors would not be really stimulated to invest in Swiss Francs, as bond yields offer extremely negative returns, if not the lowest at the global level.

Swedish krona has good potential, Norwegian krone is on *stand-by*

As for the Swedish krona, we think current valuations are already discounting both the imminent rate hike and oil prices. This is the reason why we prefer maintaining a more neutral approach in the third quarter, yet without ruling out the idea of buying the Norwegian krone on possible dips again in the future.
On the other hand, after having reduced exposure to the Swedish krona in recent months, we now feel confident to suggest gradually building the position back up again. The currency has in fact depreciated by over 3% towards the end of the third quarter, offering an attractive opportunity to open positions. The main reasons behind this trend are the following three. To start with, from a monetary standpoint, Sweden is linked to the ECB's choices and, after Mario Draghi stated that rates in Europe would not rise before summer 2019, we believe that the Swedish monetary authorities could make a step back too and postpone the normalisation phase (the market is currently discounting the first rate rise expected in November 2018). Secondly, the nationalist right wing party has gained ground, reaching 20% in surveys and undermining historic parties' consensus. Elections will be held in autumn and conservative parties seem to want to form a large coalition just to exclude this Eurosceptic party. Finally, the current general market risk off sentiment cannot be disregarded.

EUR/USD exchange rate

EUR/CHF exchange rate

Context

It is a very complicated year for the bond market. At the global level, the *Global Aggregate* index has dropped approximately 2% and performance has been negative across all components (duration, emerging bonds, credit).
Besides, in Europe the recent *flight to quality* has adversely impacted macro strategies which were essentially in favour of short duration on the Bund and spread narrowing in Europe.
Emerging bond spreads are still attractive at these levels and convertible bonds – being naturally sensitive to equities – continue to be the focus for several investment managers operating in the segment. In this respect we do not rule out that the bond sector may be achieving a better performance in the second half of the year, after the recent shock that has caught many investment managers off guard.

Avoid long duration on the European markets

On the monetary front, the FED has confirmed its gradual tightening policy, whereas in Europe the end of QE is expected only towards the end of 2018, with further reduction in asset purchases to €15 a month from October to December (although a greater cut was expected). By contrast, the forward guidance is for leaving rates unchanged until after summer 2019 (autumn 2019 at the earliest).
Mr Draghi's office should expire in October 2019 and we deem it unlikely for him to leave it at the same time as the first rate hike.
The market reacted very strongly to this guidance, generating a downshifting trend on all European curves and causing some weakness to the Euro.
It should also be noted that the renewed bond strength and the outlook for low rates for some time to come are weighing on banks.
Ultimately, a Japanese-style long-lasting low rate scenario appears to be taking shape in Europe as well. Perhaps we will have to resign ourselves to negative real returns in the awareness that ECB will not be able to be as imaginative as the BOJ, if needed.

Widening spread between the US and German curves

The US curve flattening trend has been continuing for several months now. Short-term rates are led by the FED's gradual rate rise policy, but the long end of the curve still seems anchored below the 3% level, due to low inflationary expectations and concerns over economic growth and trade policies.

The widening of credit spreads that occurred in the first semester was across the board: it brought market valuations to more reasonable levels from the lows recorded at the end of January. In general, credit remains vulnerable to deterioration in the global economic outlook. However, we can start showing more interest in certain bonds, specifically the emerging segment, which, to date, seems to have been excessively hit compared to fundamentals.

Bloomberg Barclays Global-Aggregate Total Return Index Value Hedged EUR

J.P. Morgan EMBI Global Spread

Tariff disputes between US and China create market instability

The recent market weakness has been caused by the Yuan depreciation which is reminiscent of what happened back in 2015. An initial normalisation of US rates was followed by a depreciation trend in the Chinese currency and weakness on the commodities front, which culminated in the January-February 2016 collapse.
Today the situation is different: commodities provide support to emerging markets, the rise in US ten-year rates and the USD revaluation have stabilised, whereas the Yuan depreciation has not reached the 2015 levels. We are still convinced that tariff disputes will settle after a necessary rebalancing, which Europe also needs, and will not end up in a bloody trade war.

Repercussions of automobile tariffs on Eurozone GDP

The automobile trade between the EU and the US accounts for about 10% of the overall business between the two areas. The United States is the largest importer of EU cars, both in terms of units (about 20% in 2017) and value (almost 30%). Analysts and rating agencies estimate that an increase in tariffs from 2.5% to 25% may determine almost a 0.3% GDP decrease in the Eurozone. The most affected country would be Germany, as its automotive industry accounts for about 7% of the national GDP.
Undoubtedly a 25% tariff on imported vehicles and components would be negative on all sectors of the automotive industry (carmakers, spare part suppliers, car dealers, transport companies, etc.). Should tariffs be imposed, auto makers would definitely have to either absorb costs in order to protect sales volumes or increase prices in order to pass tariff costs onto their customers thus damaging sales.

Our view on portfolio allocation for the next quarter

Undoubtedly European government bonds and cash are still safe-haven assets, mostly against volatility, but they are not certainly profitable investments. To escape from this non-performing return spiral and obtain pay-back, risks must be taken on equities. The important thing is to keep risk asset diversification as broad as possible.
Europe’s valuation discount compared to the US stems from the uncertainties weighing on the Old Continent and from the fact that the sectors driving the US stock markets, headed by technology, have been underweight on the European indexes. In fact, while Europe was once again being affected by the Italian events, the Nasdaq 100 reached new highs.
Based on what just said, we recommend keeping underweight positions in the European equity portion of the portfolio in favour of the American one.
Finally, we continue to find value in emerging stocks, at least until the economic scenario is characterised by global growth and strong commodities.

Nasdaq Composite Index

European Automotive Industry

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.

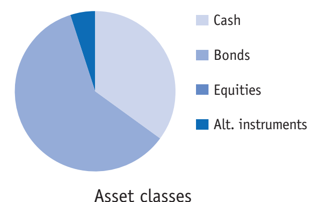
In our opinion, the implementation of systematic strategies allows for portfolio risk reduction and profit achievement whilst protecting invested capital, even in difficult markets. Due to their cold and mechanical approach, these strategies sharply mitigate the emotional component that drives and influences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

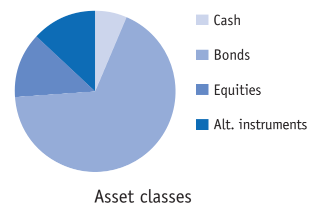
Income

Cash	35
Bonds	60
Equities*	–
Alternative instruments	5
	100



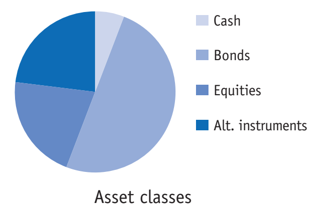
Income Plus

Cash	7
Bonds	66
Equities*	13
Alternative instruments	14
	100



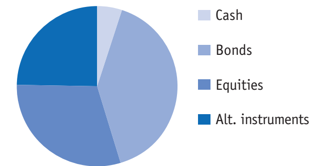
Dynamic

Cash	4
Bonds	45
Equities*	24
Alternative instruments	27
	100



Balanced

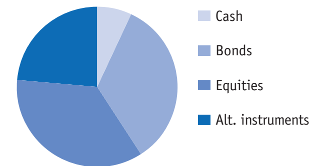
Cash	2
Bonds	36
Equities*	34
Alternative instruments	28
	100



Asset classes

Growth

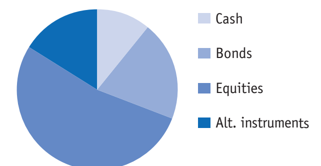
Cash	3
Bonds	30
Equities*	41
Alternative instruments	26
	100



Asset classes

Equity

Cash	11
Bonds	20
Equities*	53
Alternative instruments	16
	100



Asset classes

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

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