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Investment Policy

April 2018 - 2. Quarter

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After a very strong start in January, the markets clashed with inflationary fears that caused a sharp and rapid adjustment in prices in early February, giving way to termination of the excessive number of "short volatility" strategies that had accumulated and which in 2017 brought the VIX index to historic lows.

After an initial recovery, the markets suffered several setbacks that impacted their upward trend. The Cambridge Analytica scandal that hit Facebook and the presidential tweets regarding Amazon triggered the second round of price decreases, this time affecting the technology sector as well, which until then had enjoyed a leading market position.

Renewed geopolitical tensions in the Middle East and the threat of introduction of US trade duties, particularly on Chinese imports, contributed to keeping volatility high and increasing market uncertainties. We believe this climate will continue to impact the recovery of the equity market growth trend for some time.

On the interest rates front, this climate of uncertainty mainly impacted spreads, which have generally widened as far as credit and emerging markets are concerned.

The flattening trend continues on the interest rate curves, while real interest rates - especially in Europe - remain inexplicably negative, despite a generalised increase in confidence with regard to recovery of the current economic cycle.

In general, 2018 is proving to be a more difficult year to interpret, in terms of both rates and equity market direction. We expect the trend of economic growth and earnings forecast to continue, hoping that this will be able to support risk assets.

The driving sectors on the equity front will continue to be technology, biotechnology and small and medium capitalisations.

In the technology sector, the industrial revolution brought about by the dissemination of robotics and artificial intelligence is expected to continue, but - with some exceptions - has not yet resulted in bubbles with regard to company valuations.

Biotechnologies represent the new frontier of the pharmaceuticals sector, which has seen the end of growth possibilities linked to pure biochemistry and is increasingly aiming at genetics.

Lastly, small and medium capitalisations are expected to draw the most benefit from the widespread economic growth trend underway.

Context

Looking at the current situation from a political standpoint, the European scenario is characterised by a certain level of stability, with establishment of the fourth Merkel government and expectations of an enlarged government in Italy as well, after an electoral outcome with no clear winner. Political observers are therefore focusing on the trade war between the USA and China, implemented through application of duties on certain categories of imported goods. The desire to intervene on commercial trade, already expressed by President Trump, has become a reality and was immediately followed by a similar provision by the Chinese government. The consequences of fears of a slowdown in the global economy due to these events (in addition to problems linked to technology stocks) have appeared on the government bond market, with yields approaching minimum levels for the year, as well as on the stock markets, with a sharp adjustment to the highs recorded in January. However, we highlight the contingent nature of these events, which are not currently indicating a more significant geopolitical crisis.

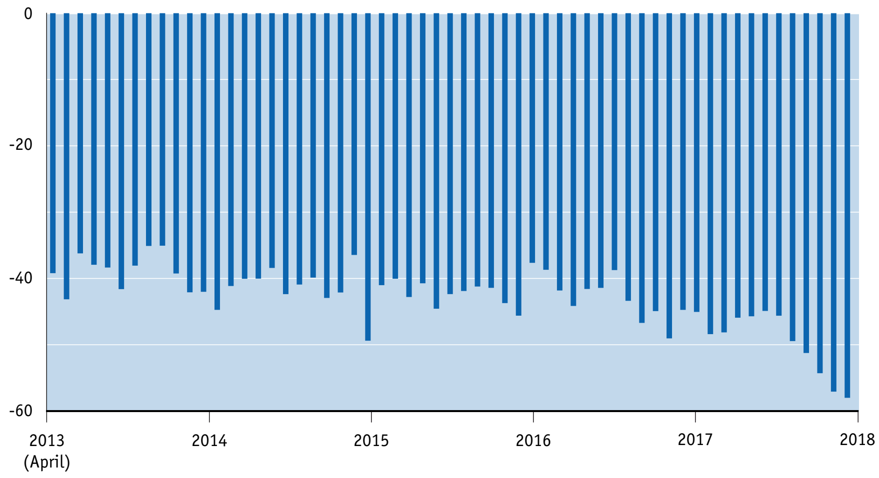
Macroeconomic indicators in positive territory

The overall macroeconomic scenario is headed in a positive direction. Specifically, the PMI indices continue to remain in positive territory, with renewed convergence of the US and European indicators. The indices that measure macroeconomic surprises are slowly receding, after reaching very high levels. The indices measuring financial conditions remain at accommodating levels, although down from their highs. The leading indicators continue to show signs of recovery, after a stagnant phase. The Atlanta Fed's snap indicator, measuring GDP growth, is at 3%, while unemployment in the United States is at record lows.

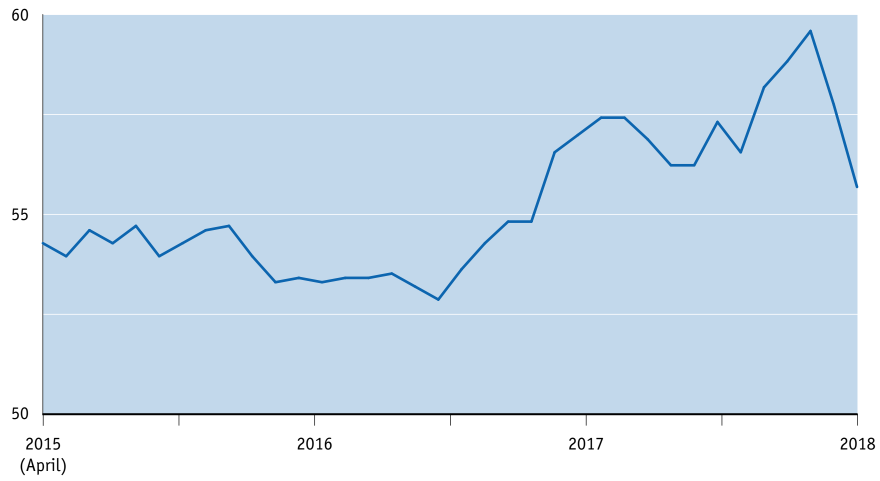
Rising inflation in the USA suggests further rate hikes, while it remains limited in the Eurozone and in Japan

With regard to central banks' monetary policies, keeping inflation under control is guaranteeing a gradual rise in rates in America, while in Europe the ECB has not clearly outlined the exit from QE. Moreover, as envisaged, the constant divergence between the monetary policy of the Federal Reserve and that of the central banks of the leading industrialised countries was accompanied by a significant difference between current and expected inflation. At the end of the first quarter, inflation of consumer prices in the Eurozone recorded a moderate annual increase of 1.40%, but according to the ECB inflation in the Eurozone will remain steady at around 1.50% until the end of the year. In Japan, expected inflation shows a slight increase, driven by growth in salaries and in the price of land and imported goods, but as in Europe, the price increase will likely be gradual. Conversely, in March, the US CPI recorded an annual inflation rate of 2.40%.

US trade balance deficit (bln USD)



Eurozone Composite PMI



Moderately optimistic on the relative strength of the Euro

In our view, the more likely EUR/USD scenario is for the exchange rate to remain in a 1.20-1.25 trading range. The recent weakness of the Euro is mainly linked to end-of-quarter macroeconomic data, which were below expectations. However, we believe this decline is normal, following a series of very strong months.
One aspect that the market currently seems to be ignoring is the appointment of the new Governor of the European Central Bank. Mario Draghi's mandate ends next year, but the announcement of his successor should be made shortly. The appointment of German Jens Weidmann should be favourable, in terms of relative strength, for the single currency.

Continued weakness on the Swiss Franc

Swiss inflation continues to under-perform the rest of Europe, forcing the Swiss National Bank to remain accommodating and intervene in the forex market in the event of sudden spikes. We believe that the persisting weakness of the Swiss Franc will lead Swiss investors to reduce hedges on foreign currency assets. For example, the Swiss pension funds have increased the portion of their investments in foreign currencies.
We are still rather negative on the CHF for the second quarter as well and recommend maintaining the current exposures on the currency, with a target of 1.20 for the EUR-CHF exchange rate.

The Japanese Yen maintains its risk-balancing role in the Forex portfolio

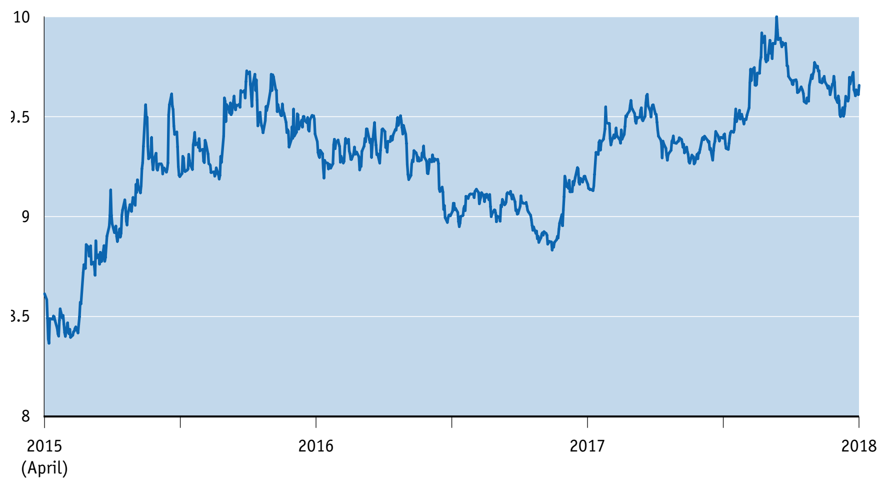
We believe the Japanese currency could go back to appreciating not only in risk-off conditions, due to its historic role as a safe haven currency, but also upon the country's exit from the expansive monetary phase. The inflation target has been reached and the overall macro-economic scenario is good. In this respect, exposure to the JPY could have a major role in balancing the total risk of a currency portfolio in the upcoming months.

Bullish on Scandinavian currencies

The Swedish Krona is the worst performer among the G10 currencies in the last month of the first quarter. This under-performance began with weak inflation and the ensuing rhetoric of the central bank which maintained its expansive phase. The CTA funds, currently extremely short on SEK, contributed to extending this trend. We believe the currency offers value at its current levels and we recommend awaiting the right trigger that can stimulate a trend inversion to open long positions on the currency.
Unlike the Swedish Krona, the Norwegian Krone demonstrated excellent resistance in the final weeks of the quarter and, from a fundamental point of view, remains interesting. However, the fact that the market is already discounting the interest rate hike of September-October leads us to favour consolidation of a large part of our investment in NOK. Only after a possible retracement, due to the closure of long positions, will it be possible to once again seize the opportunity of investing in the currency.

EUR-USD exchange rate

EUR-NOK exchange rate



Context

Both the US and European curves resumed a flattening trend at the end of the quarter: in Europe, yields on the long ends returned to levels difficult to comprehend in terms of fundamentals, and, in the USA, they are well-anchored as well, despite the Fed's intention to regularly continue the cycle of gradual increases planned for the next two years.
The uncertain outcome of the Italian elections, on the other hand, did not have any significant repercussions on the markets and did not affect the compression trend of the European peripheral spreads, led by Spain and Portugal.
The spreads on government bonds, both investment grade and high yield, widened consistently with the risk aversion triggered on the equity market. In absolute terms, spreads remain rather limited and do not make the overall corporate segment particularly attractive. We therefore recommend maintaining a selective approach, seeking the individual opportunities that periodically appear on the credit market.

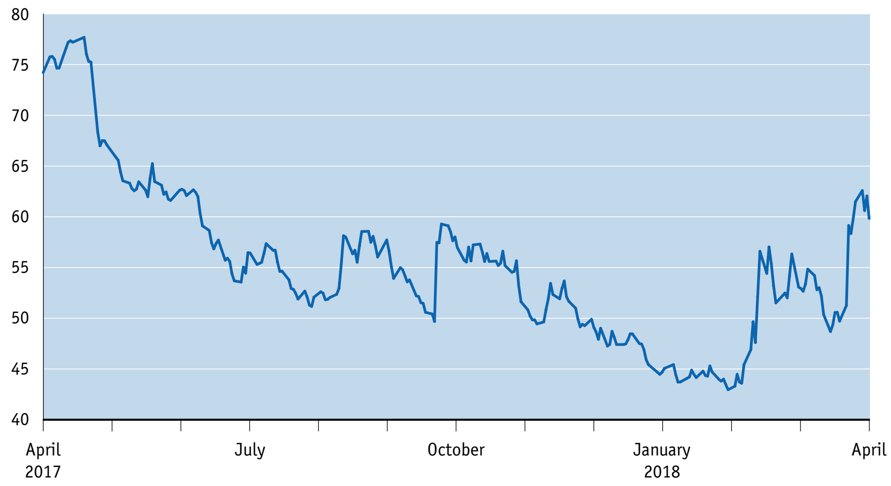
Avoid high durations on the European markets

We continue to believe that yields in Europe are excessively low and unsustainable, although we are aware that the ECB will continue to offer price support. The Bund yields made a surprising return to the levels recorded at the beginning of the year, but we consider this due to technical factors rather than real changes in the fundamentals.
We are convinced that we will see a normalisation of yields in the upcoming months, albeit slow and discontinuous. In this respect, we recommend avoiding exposure to EUR and GBP high duration bonds.

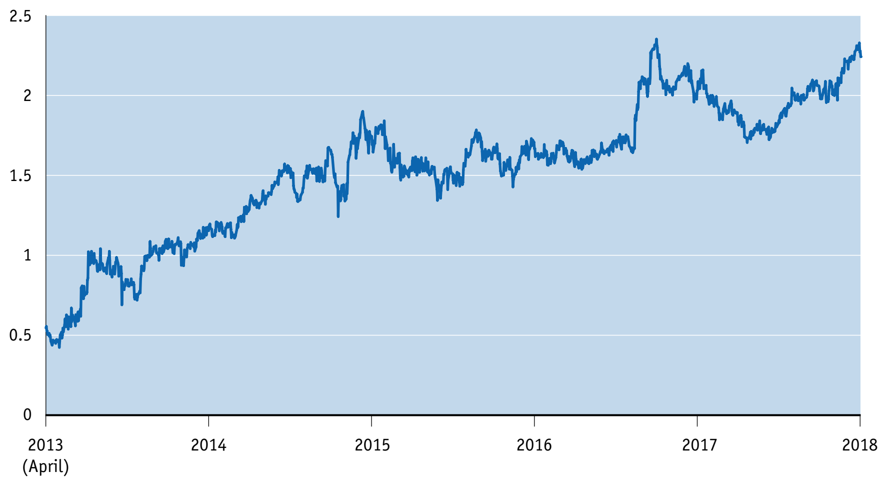
Widening spread between the US and German curves

In relative terms, particular attention should be paid to the spread between US and German rates. The yield differential between the two ten-year rates reached period highs of around 230 basis points. We consider these levels to be excessively high, as performance of the two economies is not very different. We also think expectations of an increase by the Fed are too high: should it really raise rates as envisaged (3 times this year plus 3 next year), the restrictive effect on the economy would be massive. The 3% rate over ten years should therefore provide strong resistance.
Lastly, we recommend betting on flattening of the Italian curve, as we are convinced that this would provide a positive contribution under all market conditions: indeed, the Italian curve is among the steepest at the global level.

Eurozone Corporate Investment grade spread



US vs. Germany 10-year Yield spread



Context

We have come out of a particularly turbulent quarter, with the S&P 500 in the USA recording the worst performance since January 2016. Things were not much better on the European and Asian fronts: at the end of the quarter, the indices were down by 11.5% and 15.5%, respectively, compared to the highs of January. Rather than a one-off shift of a few days, it was the third adjustment since the beginning of the year, which we approached gradually starting from March 13th, when Trump announced the dismissal and subsequent replacement of Secretary of State Tillerson with Mike Pompeo, more intransigent in matters of foreign policy. This was followed by an escalation of "provocations" in terms of international trade, beginning with the proposal to impose US import duties on steel and aluminium (from which Argentina, Australia, Brazil, South Korea and the EU were later exempted), and then specifically targeting China, with the announcement of tariffs on over USD 60 billion of goods imported from China by the USA each year. The Chinese reaction was much more subdued than expected: it "counter-attacked" with tariffs on only USD 3 billion worth of goods produced in the USA (well below the over 60 billion they send to the United States), and Mnuchin declared himself optimistic that a trade agreement could be reached.
Specific factors such as the Cambridge Analytica scandal that rocked Facebook also impacted the market. Adjustment of the stock market price gave way to a more generalised adjustment of tech equities, particularly in the internet sector.

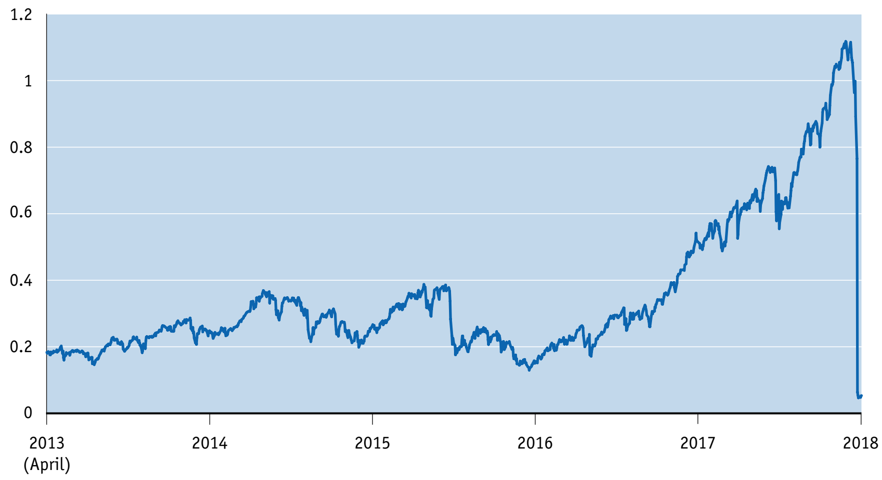
Sharp increase in volatility

Consolidation of the stock markets was accompanied by a significant increase in volatility which, in turn, as a sort of vicious circle, caused even more substantial adjustments.
The sudden shift had been anticipated by the foreign exchange market (with safe haven currencies such as the CHF and JPY particularly strong on the days leading up to the adjustment) and was likely caused by a new hike in long-term rates in the USA and in Europe, with ten-year rates at 2.8% in the US and 0.75% in the Eurozone.
As we do not believe the macroeconomic bases are in place for the beginning of a bear market phase (since monetary policies remain expansive and the fundamentals support an acceleration of economic growth), we consider this adjustment to be more likely due to excess leverage caused by the low volatility that had in turn resulted in extreme positions with regard to ETF and risk parity and volatility controlled funds. In this respect, the spike in volatility can almost be considered "healthy", having cleared the market of excesses in short volatility strategies. A case in point is the performance of the Credit Suisse ETF shown in the chart, which was liquidated after a sharp decline in the first quarter 2018.
It is likely that the technical damage caused by this phase of volatility and violent adjustment will lead to a ranging market period, possibly lasting a few months.

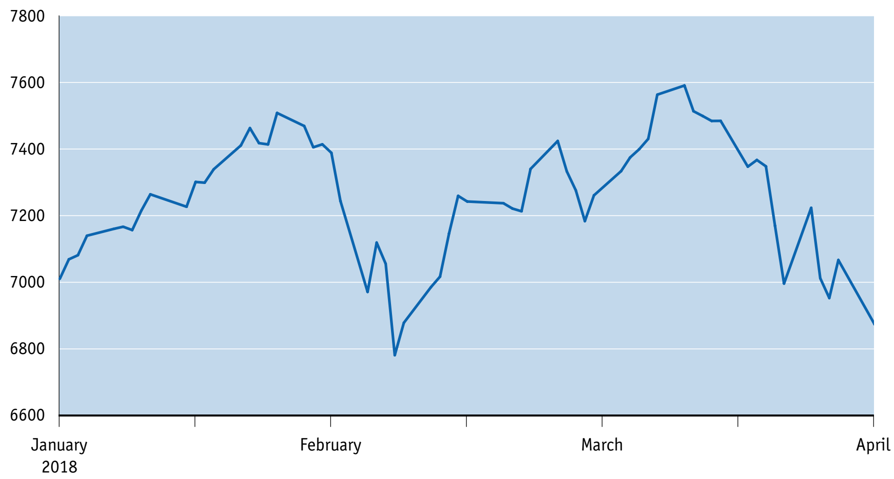
Profits and valuations of the equity markets in the United States and Europe

The epicentre of what can now be considered the third bearish leg of the first quarter is the US tech sector, which is now paying for the excess valuations at which these companies were priced.
Apart from tech, we do not believe there are any bubbles underway in terms of valuation. In fact, there are major signs of recovery in profit growth in the USA and Europe and, if the earnings forecasts prove to be correct, at the end of 2018, the 1-year forward PE on the S&P 500 should be at around 15X, with the European one even lower (about 14X).
In relative terms, it is Europe which is over-performing after several years. The reason for this is the composition of the index, less tech-weighted than the US. In Europe, the FTSE MIB is proving to be one of the strongest indices, a sign that market participants do not appear to be worried about the political situation in Italy.

Credit Suisse Inverse VIX Etf



Nasdaq Composite Index



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.

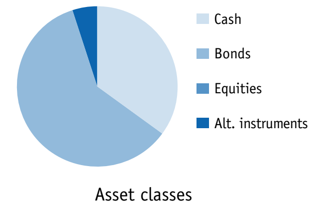
In our opinion, the implementation of systematic strategies allows for portfolio risk reduction and profit achievement whilst protecting invested capital, even in difficult markets. Due to their cold and mechanical approach, these strategies sharply mitigate the emotional component that drives and influences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

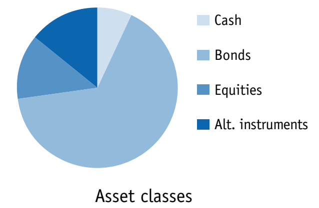
Cash	35
Bonds	60
Equities*	–
Alternative instruments	5
	100



Asset classes

Income Plus

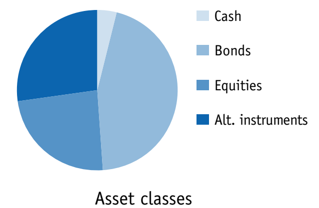
Cash	7
Bonds	66
Equities*	13
Alternative instruments	14
	100



Asset classes

Dynamic

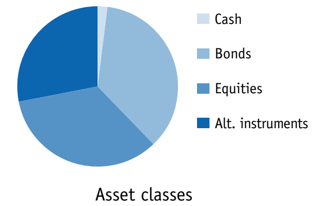
Cash	4
Bonds	45
Equities*	24
Alternative instruments	27
	100



Asset classes

Balanced

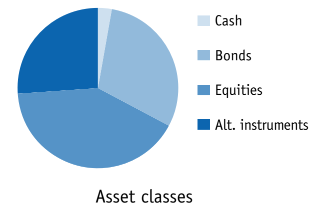
Cash	2
Bonds	36
Equities*	34
Alternative instruments	28
	100



Asset classes

Growth

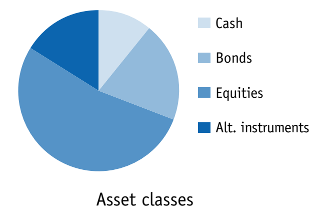
Cash	3
Bonds	30
Equities*	41
Alternative instruments	26
	100



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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