Investment Policy

October 2017 - 4. Quarter

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Press date: November 2017

After an underwhelming start of the year, macroeconomic indicators showed a significant acceleration in growth rates in the third quarter. Growth in the Eurozone have reached around 2.3%, among the highest levels of the last few years. Signs of recovery and upward revision have also been observed in Italy, the country which - among the European economies - has until now particularly struggled to grow.
While the economic scenario has been rife with positive signs, the political and diplomatic one has been plagued by a series of events that in a weaker economic scenario would have had heavy repercussions on the financial markets.
The geopolitical tensions in North Korea, with a number of missile launches over the northern part of Japan, had only a limited and temporary impact on the financial markets. The same goes for the latest rejection of the health reforms by the US Parliament.

We continue to believe that the low volatility and limited market adjustments are due to positioning that is still very cautious on equities, with investors taking advantage of buying opportunities at any shifts in trend. Moreover, good price support continues to be provided by corporate earnings and their constant revisions by analysts, which are particularly optimistic this year.

Tightening of the valuation spread between US and European equities, along with the growing profit trend especially in the Eurozone, may justify a contraction in the performance gap between the 2 markets at year-end. The US market will always be at a premium, thanks to equities reflecting the so-called disruption trends (such as Amazon, Tesla, etc.), lacking in Europe, as well as to the discount that inevitably weighs on Euro-based assets until the process of integration of community policies is completed.

Synchronised growth at global level and weakness of the dollar have fuelled a sharp rally (approximately +30%) of the emerging equity markets, which is the best asset class of the year.

The strong Euro is undoubtedly behind the renewed interest in European assets, together with the significant easing of fears on dismantling of the currency. In addition to this, expectations of a change in the QE policy by the ECB continue to grow; on the other hand, the Fed seems to have completed a large part of its work in terms of rate normalisation.

Unless there are surprises, no electoral events are planned for the last quarter of the year, with all eyes already turned towards 2018, with renewal of the head of the Fed (an event that may present significant obstacles) and elections in Italy.

Context

The political uncertainty in the last quarter has kept the strong economic data in check. The North Korean crisis has been the most pressing issue, with the Pyongyang government threatening global security several times through its launch of experimental, intercontinental range missiles. The domestic policy events in both the USA and Europe have been problematic as well. On the one hand, after an additional halt to its proposed repeal of Obamacare, the Trump administration has momentarily set the much-hailed health reform aside, focusing all of its energy on the tax issue. On the other, Merkel was once again elected as Premier in Germany. However, forming a stable government will be a more difficult task this time around, compared to her prior mandates. In fact, the social democrats under Schulz have stated a preference in this electoral round to sit amongst the opposition rather than alongside the CDU, forcing the latter to form new alliances with the liberals and green party. The big news, however, is the first-time entry in the Bundestag by the AfD party, the far-right, anti-European group that has become the third leading political party in the country. In other words, not a landslide or stress-relieving victory for Merkel and the pro-Europeans, who during the very early days of October found themselves dealing with the Catalonia issue, new hornet's nest in the heart of Europe.

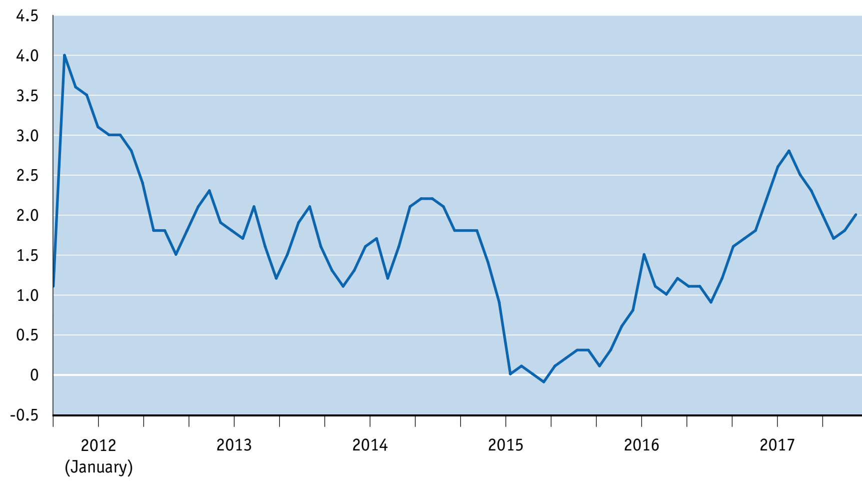
Moderate risks for the economy

Considering how bad news is now absorbed and digested at an unprecedented speed, our investment committee asked itself what traps investors have not yet taken into account, and we believe there are two risks in particular: inflation and a chinese hard landing.
The lack of inflation does not in itself present a threat to growth and it could actually increase the longevity of the cycle: there is still no rebound in terms of employment supply, but the growth in productivity, higher than potential growth, may gradually generate inflation.
Despite the risks arising from the significant amount of accumulated debt, we do not currently envisage immediate danger for the chinese economy and, within our portfolio strategy, the emerging markets in general are a predominant allocation choice, followed by the Eurozone.

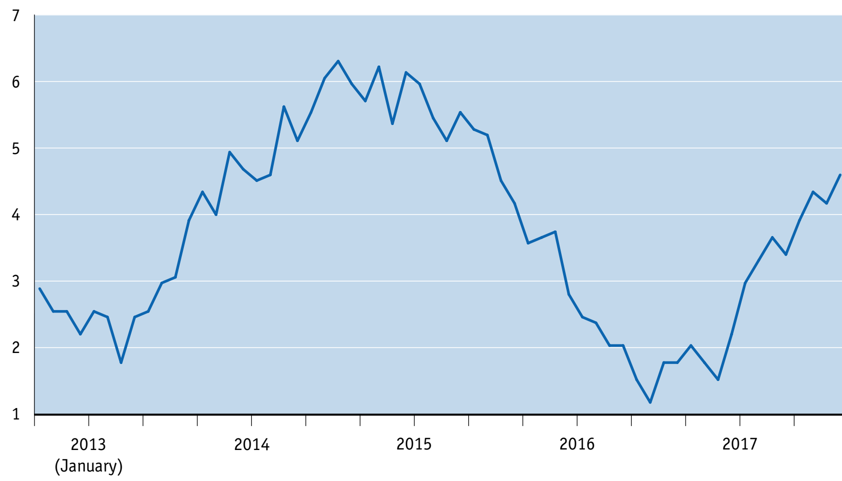
Favourable macroeconomic scenario in terms of the key indicators

The PMI indices continue to remain positive, with renewed acceleration in the USA.
The indices that measure macroeconomic surprises are showing signs of recovery in the USA as well, following the sharp slowdown in the prior month; similarly, after a stagnant phase, the leading indicators appear to be bouncing back.
The GDP figure has accelerated compared to the beginning of 2017 and is now in line with the fast indicator of the Atlanta Fed, at growth levels around 3%.

Inflation rate in the US



US Leading Indicators Index



Wait-and-see attitude on the EUR-USD exchange rate

The EUR-USD cross has signed steady appreciation during this year, with highs over 1.20, due to both political and economic reasons.
On the European political front, stability in France and the victory by Angela Merkel in Germany (although with less extention than expected) dissolved fears on Europe, shifting the attention towards the upcoming Italian elections in spring 2018. Moreover, on the macroeconomic front, satisfactory data on the European economy indicates that the ECB is ready for normalisation of interest rates, after a long expansive period. The only uncertainty regards the rate of slowdown in the current monetary policies, due to the inflation level which, although rising and far from the deflationary fears of the past, is still subdued. It will be possible to evaluate the details of the exit from quantitative easing in the upcoming meetings of the ECB.
With regard to the dollar, the US economy is clearly growing at significant rates and without generating major inflationary pressures. However, there are still a number of challenges to be met that could impact decisions on interest rates: these include the appointment of the future FED's chair after the good Yellen mandate, future rate hikes and the impact of future tax policy slowly being outlined by Trump.
We therefore await all of these upcoming developments, which may significantly impact the currency pair.

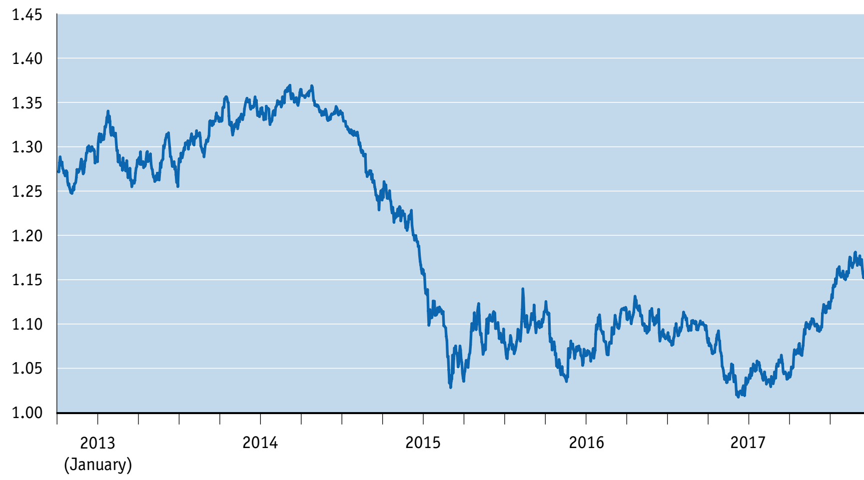
Switzerland and Japan: for the long run expansive monetary policies

Governors of the Japanese and Swiss central banks continue to send calming signals to the markets. Until inflation exceeds 2% on a stable basis, Japan will continue to adopt an accommodating monetary stance. In Switzerland, despite the recent depreciation of the Franc, the SNB still considers the currency to be relatively strong although not as overvalued as in the past; even in this case, low inflation should allow expansive monetary policies to be maintained.
These themes, beside the current 'risk-on phase', should lead to further weakening of the two safe-haven currencies.

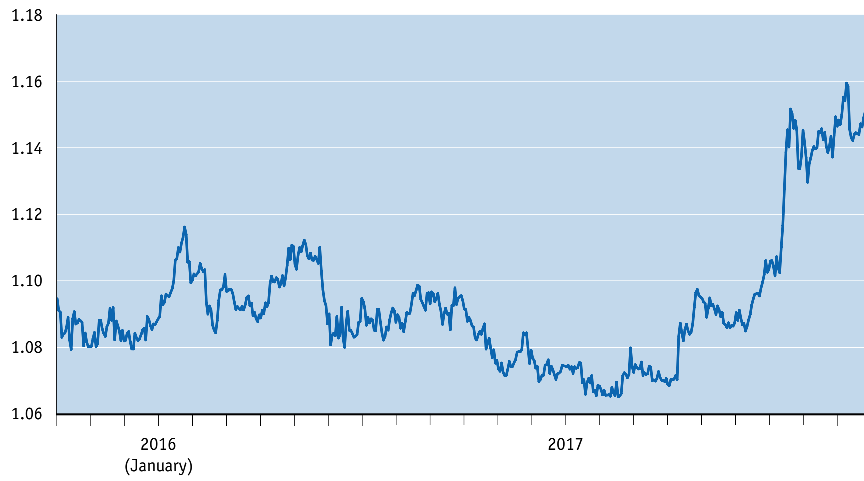
We remain bullish on emerging market currencies

The recent market adjustment does not indicate, in our opinion, the end of the bull market in emerging markets. In fact, we expect a further increase in fixed income and in the emerging forex for various reasons: the high real yields significantly offset the reduction in the inflation rate; fundamentals are improving, with increased growth, trade and investments; valuations are still attractive; positioning on the asset class, despite significant capital inflows, is not over.
In detail, we are positive on the Mexican peso, Turkish lira and South African rand, while we prefer to refrain from investing in Brazil and in Asian currencies (with the only exception of Indian rupee).

Euro-USD exchange rate



Euro-CHF exchange rate



Context

On the rates front, the market has been more volatile compared to the prior quarter: the ten-year US rate initially touched lows for the year at 2.04 and then rose sharply back to where it began the quarter, namely at 2.3. A similar trend has been seen on the Bund, which from 0.6 dropped to 0.3 and then rose back to 0.4. Credit spreads, on the other hand, remained at decidedly compressed levels, also favoured by excellent corporate results.

Flattening of the US rates curve appears to be at the end

The Fed has started to reduce its balance sheet at a rate that will vary between 10 and 50 billion USD a month. For the moment, the impact of this decision on the market has been low, but it will certainly be a good idea to monitor the effect of such an increase in supply of US government bonds in the upcoming months. The US curve has been very flat in the last quarter, a sign that inflationary forecasts have found it difficult to move up, despite the positive outlook by the Fed. Nevertheless, the flattening in recent months now appears to have ceased, with a moderate recovery in steepening.

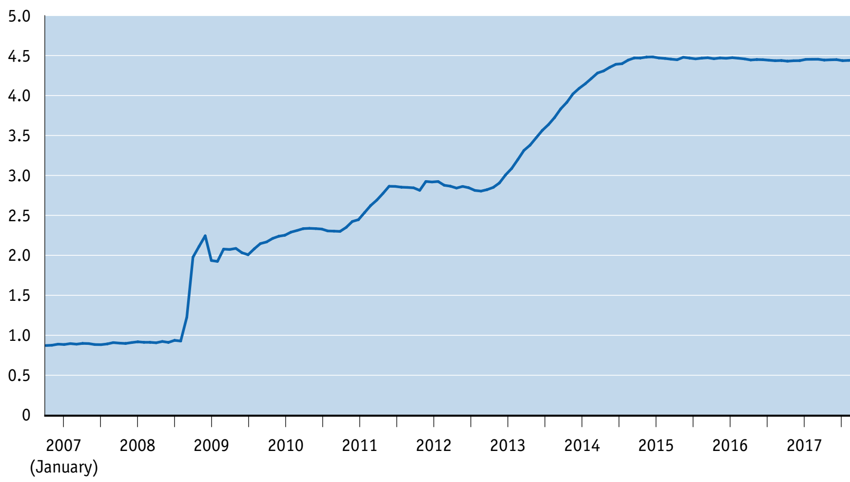
Bund yields constantly under pressure

The ECB continues to maintain a highly cautious approach, and it has postponed any decision on quantitative easing to the next meeting. We believe tapering will be inevitable, regarding the good European macroeconomic fundamentals and the scarcity of bonds to purchase in many countries of the Eurozone. Bund yields are currently very depressed, in our view, and we expect a repositioning towards 1% in the upcoming months, despite the highly accommodating rhetoric by the central bank. The spread between the USD and EUR curves is stable at around 2 basispoints (both on the 2-year curve as well as on the 10-year curve).
Lastly, we expect the spreads of peripheral European countries to remain under control, despite the approach of the Italian electoral deadline, which could put the BTP under pressure.

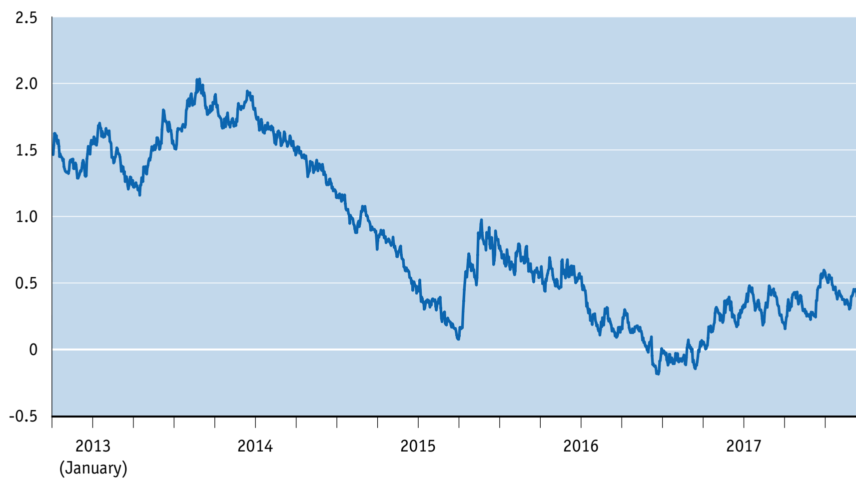
HY spread remains at historically low levels

Generally speaking, the fundamentals are solid on many High Yield bonds, but the valuations are very high, providing an unattractive risk/return ratio. As for some emerging market and European financial securities with still attractive yields, we recommend implementing carry trade strategies, eventually offset by high exposure to short-term securities and liquidity. On the other hand, investment grade European bonds with duration of several years and highly compressed yields should be avoided, as they are subject to both credit and duration risk, without offering adequate remuneration.

Fed balance sheet size (millions)



Curve of the Bund Yields



Context

All of the main stock indices have shown positive performance in the third quarter: the S&P 500, the Stoxx 600 and the MSCI Emerging market closed up 4.48%, 2.75% and 8.01%, respectively.
Essentially, new timid highs constantly showed up in the USA, while Europe has fully recovered the post-Macron drawdown and is headed towards new annual highs. In particular, we have seen a sharp acceleration in the FTSE MIB, best index of the third quarter, with a performance of 10.82%. The EMs remain the best asset class of the year, driven by purchase flows and by a weaker USD than expected.
Despite positive returns and extremely low volatility for the equity asset class, it has not been a calm quarter on the geopolitical front; nevertheless, we believe that the political risks concerning North Korea and the US Congress will ultimately vanish, enabling the assets to optimise on the growth momentum.

Stock indices appreciate but valuation multiples do not expand

In the last quarter of the year important signs of recovery in profit growth in the USA and Europe have been observed. Corporate results are solid, and we do not see signs of an inversion in this trend, at least not in the short term.
We also take into consideration the fact that the recent market upward trend has not coincided with an expansion of multiples. The current P/E in the USA is around 21.5 and the expected annual figure is 19.2. Indeed, in Europe, the recent good performance of profits of the Eurostoxx index has been accompanied by a contraction of multiples to 18.4; even those estimated for the end of 2017 have dipped to around 15.

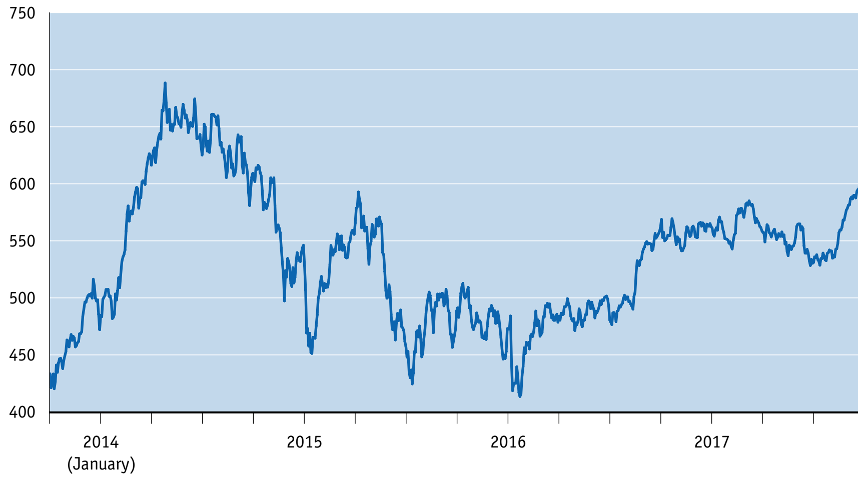
Implications for asset allocation

With regard to sectors, the best performance during the quarter has been signed by equities linked to natural resources (given the recovery in oil, gold and copper prices), automotive and parts manufacturers and technological stocks, which continue their now unstoppable rally. Conversely, reinsurance stocks were heavy (due to hurricanes Harvey and Irma), along with those of retailers, with persistent weakness threatened by the phenomenon of online sales and increasingly narrow margins.

For the last quarter of the year, at the geographical level, we maintain overweight positions on the emerging markets, sustained by accommodating monetary policies and a weak dollar. Simultaneously, among the developed markets, we prefer to assign an overweight position to Europe rather than America, for more attractive valuations in the old continent. More specifically, expecting the rates curve to steepen significantly, as we suggested last quarter, we maintain our recommendation in favour of European industrial and financial equities.

The S&P500 index

The european automotive sector index (Stoxx600 Auto)



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.

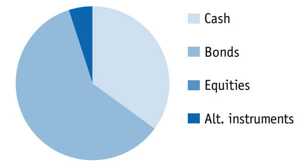
In our opinion, the implementation of systematic strategies allows for portfolio risk reduction and profit achievement whilst protecting invested capital, even in difficult markets. Due to their cold and mechanical approach, these strategies sharply mitigate the emotional component that drives and influences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

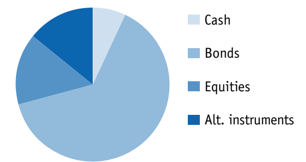
Cash	35
Bonds	60
Equities*	–
Alternative instruments	5
	100



Asset classes

Income Plus

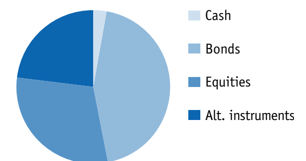
Cash	7
Bonds	64
Equities*	15
Alternative instruments	14
	100



Asset classes

Dynamic

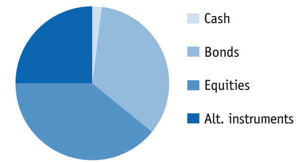
Cash	3
Bonds	44
Equities*	30
Alternative instruments	23
	100



Asset classes

Balanced

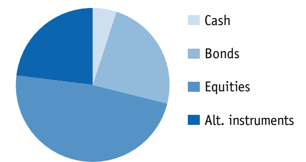
Cash	2
Bonds	34
Equities*	39
Alternative instruments	25
	100



Asset classes

Growth

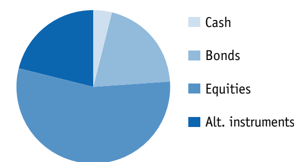
Cash	5
Bonds	24
Equities*	48
Alternative instruments	23
	100



Asset classes

Equity

Cash	4
Bonds	20
Equities*	55
Alternative instruments	21
	100



Asset classes

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

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