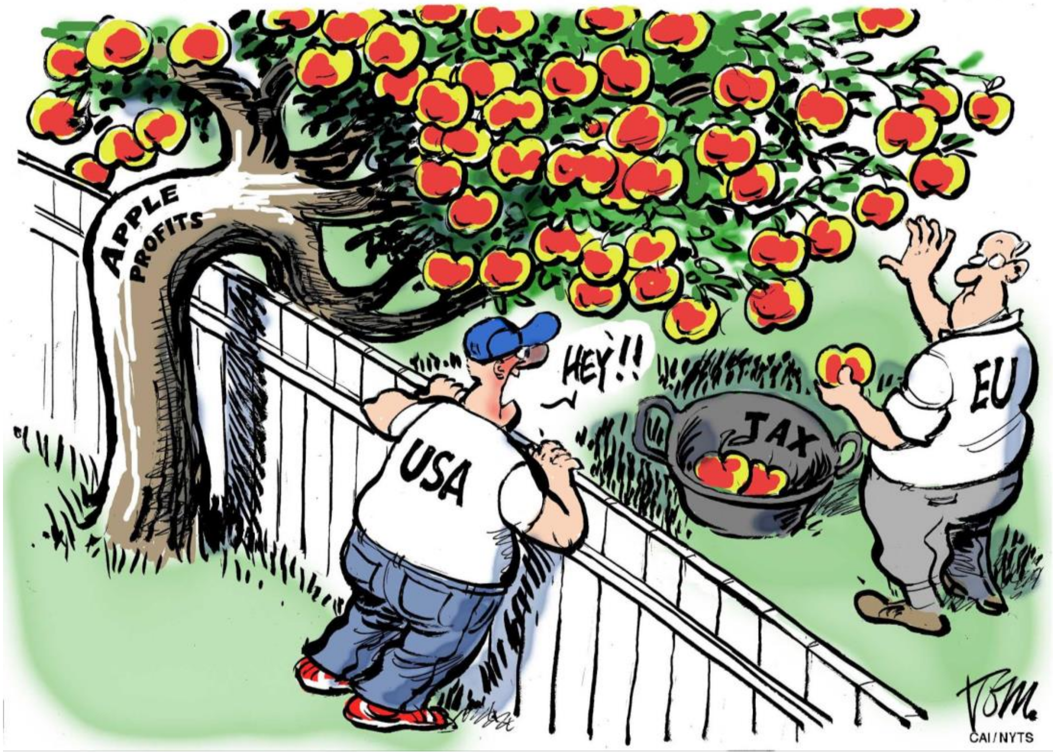
DECALIA

INVESTMENT INSIGHTS

MONTHLY ISSUE #21

October 1st, 2016



NEW CHALLENGES FOR GOVERNMENTS

EDITORIAL VIEW — Page 2

- The case against Apple shows how mega-corporations are avoiding EU taxation
- States will be increasingly challenged by the power of large global firms
- Mega-firms may also face a fiscal backlash if this turns into a political issue

GLOBAL STRATEGY & MARKET REVIEW — Page 3-5

- Investor complacency is more of a concern than recessionary risk
- EU economic momentum is still catching up with the US
- FX & Rates: USD down to Neutral due to a less hawkish Fed

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- Eurozone real estate: positive spillover from the Brexit

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- Keep defensive tactical bias ahead of key events, buying downside protection
- Stay neutral on global equities, favoring Switzerland and specific themes
- Favor investment grade corporate bonds while keeping moderate duration

Editorial View

New challenges for governments

- Recent Apple case shows how mega-corporations are avoiding EU taxation
- States will be increasingly challenged by the power of large global firms
- Mega-firms may also face a fiscal backlash if this turns into a political issue

Media coverage of Apple tends to focus on its latest cool products. But recent reports paint a less sympathetic picture of the Cupertino firm, detailing its efforts to minimize taxes on its EU operations through "undue allocation of profits to its head office". The real issue, however, is not whether you like Apple or whether you believe

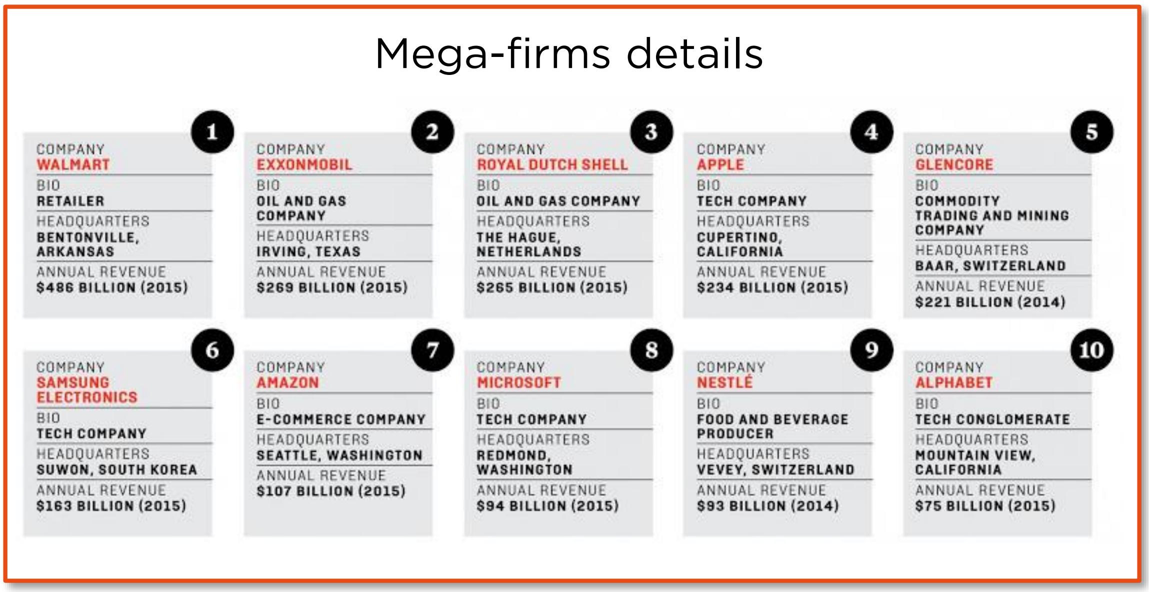
- The European Commission's position that "an effective tax rate of about 0.05% on overall annual profits of around US$ 22 billion in 2011" amounts to a form of illegal, competition-skewing aid from the Irish government, or
- Apple's claim that it paid taxes of "$400m to Ireland… based on the statutory rate of 12.5%".

Rather, this tussle is an early sign of the unprecedented challenge posed to governments by the rise of mega-firms, some of which have revenues as large as some countries' GDP. The power of global companies, especially the American ones dominating the digital world, a space that fundamentally questions the concept of local sovereignty, could become a critical issue for the EU and its member states.

In a clear sign of escalation, Apple CEO Tim Cook wrote to European customers warning them that the EU commission was striking "a devastating blow to the sovereignty of EU member states". This was followed by 185 US CEOs urging the EU to reverse its tax decision on Apple. Meanwhile, the EU competition enforcement body is also accusing Starbucks, Google, and Amazon of benefiting from anti-competitive tax schemes. The argument is likely to take a more political turn before long.

Funnily enough, a common trait of most of these firms is the way they loudly proclaim their ethical values and cool, friendly attitude. No question that paying one's taxes is painful, particularly in Europe, which has a long history of rapacious tax collectors and profligate royalty. However, public opinion in Europe is likely to view tax avoidance by foreign firms as neither ethical nor cool, especially in the wake of possible bailouts of "too big to fail" domestic firms (e.g. Deutsche Bank). The European Commission and governments could retaliate against global firms, and we worry about the potential impact on their image and bottom line. Holding large amounts of cash always attracts tax collectors…

Chart of the Month



Global Strategy

ECONOMICS & ASSET ALLOCATION

It is always very quiet before a storm

- "Goldilocks" scenario still in place but risks and mixed signals are building up
- EU economic momentum is still catching up with the US
- Investor complacency is more of a concern than recessionary risk

Global markets are never boring, but they can be wearying for anyone hoping for less erratic patterns. A few weeks ago, stock markets rallied strongly after Brexit, before pulling back early this month when central banks (ECB, BOJ, and Fed) announced no change in their accommodative policies. To explain these seemingly absurd patterns, some may quote the old adage "buy the rumor, sell the news". We see things somewhat differently: investors, carried away by their enthusiasm, have been buying after any news over the summer. A lot of high expectations have now been priced in, making markets vulnerable to disappointments.

On the economic front, our Goldilocks scenario (moderate growth and low inflation) is still in place. But consensus is taking this for granted, while we see risks building up. For instance, short-term US surveys are already showing possible GDP weakness in Q4, while production figures still indicate a solid pace of activity for Q3. In Europe, we observe the opposite pattern. Consensus revised prospects down right after Brexit, but actual figures have been quite resilient. This convergence will likely also affect monetary policies, with a cautious Fed and a more confident ECB. If these trends persist, currencies should quickly adjust, leading to renewed volatility. On a positive note though, shipping trends suggest that EM regions have managed their downturn without any severe crisis as the FED paused its tightening, thus easing global liquidity stress.

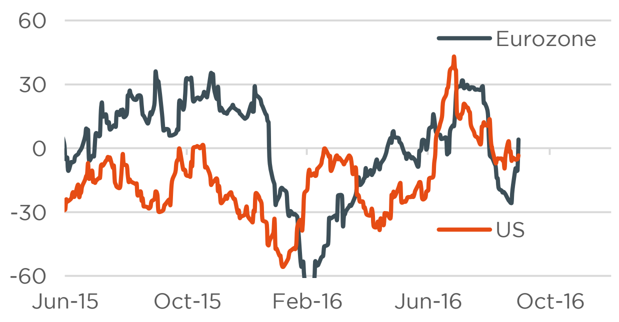
In short, global activity is still above average during this second half, but is already sending mixed signals for next year. At this stage, we do not see any signs of recession, but the risks are increasing, along with other specific disruptive events, as mentioned in previous months:

- Political risks: US elections in November and Italian referendum in December
- Economic risks: Full implications of the Brexit
- Financial risks: Italian banking sector issues mirrored in Germany, with Deutsche Bank under severe pressure to recapitalize.

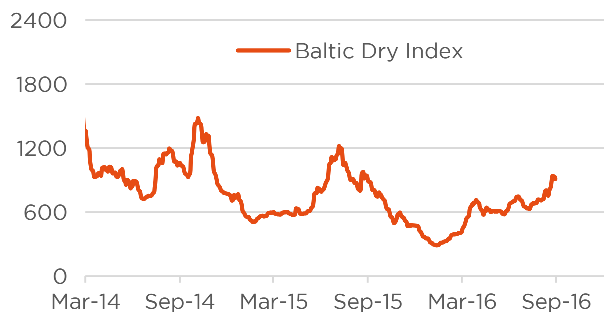
Uncertainty surrounding the US elections will dominate headlines going forward. Markets are predicting a Clinton victory (65%/35%), but polls are showing a tighter race (51%/49%). Market probabilities have a better track record than polls in predicting election outcomes, but they missed the Brexit. Nonetheless, we still expect a Clinton win, which should bring relief to stock markets.

Overall, we adopt a slightly more defensive bias ahead of key events later this year, buying some equity protection and taking advantage of current cheap volatility. As such, we made only few changes to our core allocation, which remains close to neutral and focused on key strategies: i) Quality stocks offering large regional diversification and exposure to structural trends, and ii) Corporate bonds with moderate duration and credit risk.

Economic surprise



Shipping index



Markets review

EQUITY MARKETS

Living with complacency

- Neutral on stocks as fundamentals are fine but markets are too complacent
- Focus on structural themes and quality global companies
- Take the opportunity of low volatility to hedge portfolios

Global equity markets have sent conflicting signals in 2016 with, on the one hand, modest, single-digit returns from the MSCI World Index, and on the other, strong performance across the most unloved cyclical themes, namely commodities and EM, which underperformed significantly in 2014 and 2015.

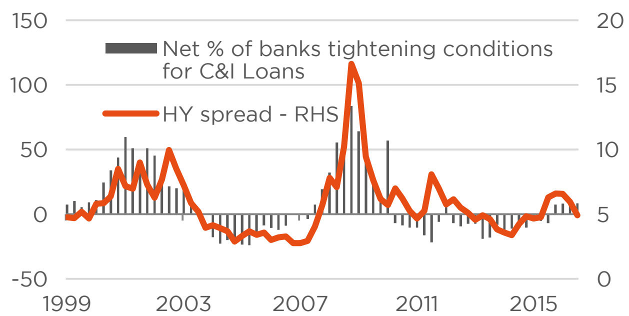
At the root of this situation lies the Fed's decision to opt for a very gradual monetary normalization in order to limit the adverse impact of higher US rates on the global economy. In doing so, the Fed took the risk of leaving US internal financing imbalances to spiral out of control.

The debt of non-financial US sectors has also become a matter of concern, as evidenced by the median net-debt-to-Ebitda ratio for companies in the S&P 500, which is at its highest level in more than 15 years. The Senior Loan Officer Survey reveals that for the first time since 2007 credit conditions for commercial and industrial lenders have deteriorated four quarters in a row. The current cycle is unique in that leverage is not rising through a strong expansion of physical investment, but rather through an increase in M&A deals, dividends, and share buybacks. Higher leverage does not mean immediate risk of market reversal but it does imply that when fundamentals begin to deteriorate at some point, the recessive effect will be magnified by low-quality balance sheets.

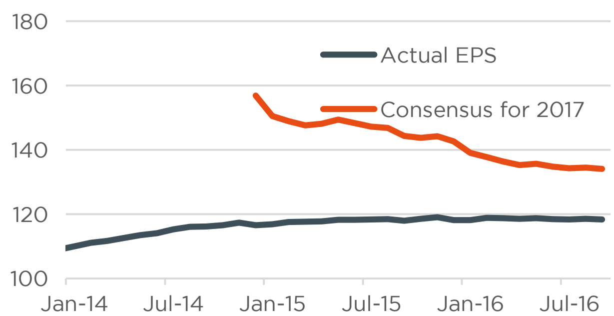
Market expectations have not factored in these risks. Even though consensus EPS expectations for Q3 have recently turned negative, which if realized will mark six consecutive quarters of YoY declines, estimates for 2017 remain ambitious, implying double-digit growth for S&P 500 EPS. In particular, we note that both margins and sales are expected to grow significantly, which seems rather unrealistic in a context of wage recovery as the latter may well help boost top-line growth but dent margins.

Faced with the risk of renewed earnings disappointment, investors should keep a quality bias in their equity allocation through global companies exposed to structural themes that benefit from new ways of producing and consuming: digitalization, millennials, and silver age. Overall, we believe that keeping a broad geographical exposure is wiser today than taking specific regional bets that are likely to come with significant risk management challenges, such as the US elections and the European banking sector crisis. In this respect, we remain selective in Europe, favoring Switzerland over the UK and the periphery, while keeping a neutral stance on the US. Japan remains an Underweight but we could start seeing some contrarian value emerging after the sharp underperformance this year. Finally, investors can also exploit market complacency by taking advantage of low volatility to hedge at a reduced cost.

Credit conditions



S&P 500 EPS forecasts vs. actual



Market review

CURRENCIES & COMMODITIES

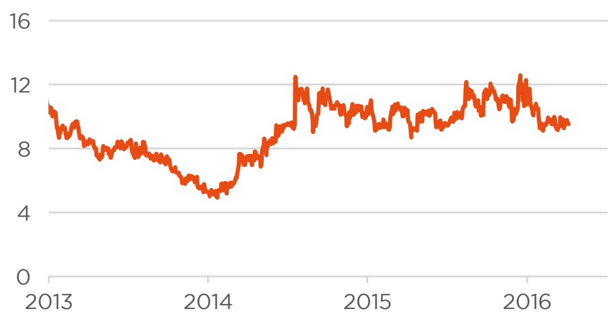
Not a great year for the dollar

- USD disappointed throughout the year and could continue to do so
- Currency volatility is representative of market tensions

The USD was this year's major disappointment: though widely expected to appreciate, it declined 5% against the EUR and 15% against the JPY. In that regard, it is noteworthy that the JPY continued to strengthen against the USD even after the latest BOJ policy announcement. Investors seem far from convinced of the likelihood of a rate hike. Indeed, the Federal Reserve's idle policy has been the determining factor behind the greenback's failure to appreciate. Hence, we move our USD view to Neutral.

Emerging regions have been beneficiaries of this status quo. Even with a rate hike in December, the USD would remain cheap to borrow, and fears about renewed financial stress in EM are now behind us. Besides, oil is back above USD40/bbl, providing some relief to oil exporters. We still believe EM currencies provide significant carry at an attractive valuation. Such exposure would be an instant winner if US activity weakens, further delaying a rate hike. In Europe, faster economic activity is reducing policy divergence between the Fed and the ECB, thus favoring the EUR. Nevertheless, the restructuring of banks in Germany (DB) and in Italy will require government money, forcing the ECB to monetize further. This should delay any EUR appreciation and thus lead to a range-bound EUR-USD in the near term. In the meantime, gold would be able to appreciate, like the JPY, which could dip below the 100 mark.

FX Volatility



FIXED INCOME

Little left in bond markets

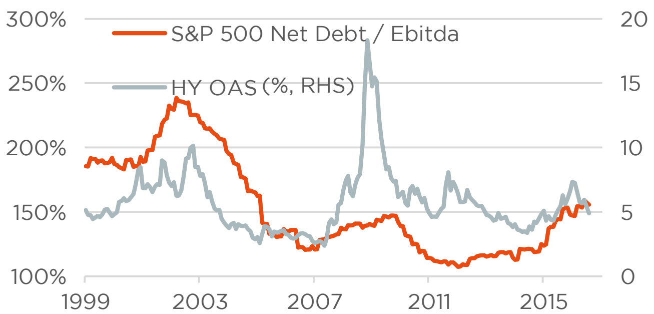
- Major countries provide negative yields on bonds
- Quality credit is still attractive
- Neutral on high yield

OECD government bond yields have stabilized but remain at low levels. As such, the US 10-year Treasury with yields at 1.60% does not promise great long-term returns while German and Swiss bonds offer even less. In this context, only European investment-grade bonds seem to capture acceptable yield with reasonable credit risk, given that fundamentals are improving in the region and leverage remains low.

We maintain moderate duration levels since, regardless of how low long-term interest rates currently are, we anticipate only limited rate hikes by the Federal Reserve and none by the ECB in the foreseeable future. Hence, should Janet Yellen and her colleagues decide to raise rates in December, we do not expect them to keep a steady pace thereafter.

We are still cautious about high-yield bonds, whose renewed spread contraction does not fit with increasing corporate leverage. Firms have taken advantage of easy financing conditions to issue debt and buy back their stocks in order to increase ROE, but debt holders are now exposed to higher risk. We are not worried at the firm level with the exception of the energy exploration industry, but we are conscious that a higher level of national debt could increase systemic risk. Such a critical point has not yet been reached, but at current spread levels, we feel that risk is not rewarded to become positive, as opposed to EM bonds which are cheap after being avoided by most investors.

US HY spreads & corporate leverage

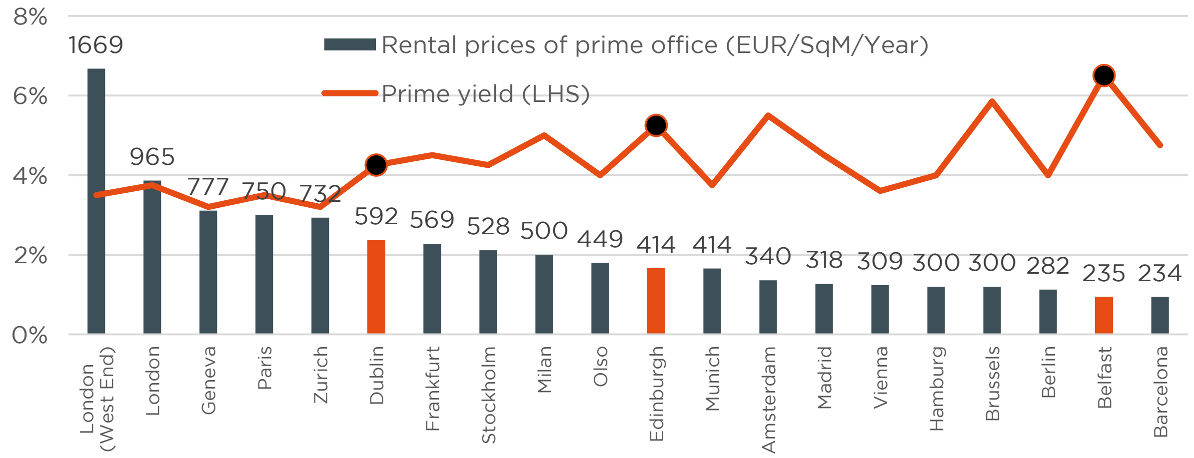


Investment Focus

EUROZONE REAL ESTATE: POSITIVE SPILLOVER FROM THE BREXIT

- Listed real estate has been a top performer in the Eurozone and globally
- Fundamental drivers are consistent with our “quest for yield” theme
- Brexit adds to attractiveness of real estate in English-speaking cities

European prime office properties



Nine months into the year, some trends are quite clear: Gold is up, long-term yields are lower around the OECD, stocks are slightly positive, with a clear underperformance of the Eurozone, and Real Estate (RE) is the best performing sector, both globally and in the Eurozone, with a 11.8% and 7.6% appreciation respectively.

The inclusion by MSCI of this industry into a major sector recently provided a positive technical support, mainly by forcing asset managers to increase their holdings in RE to avoid tracking error risks. Nevertheless, RE outperformance was already prevalent before this decision as we see a strong fundamental rationale for an appreciation, especially in Europe:

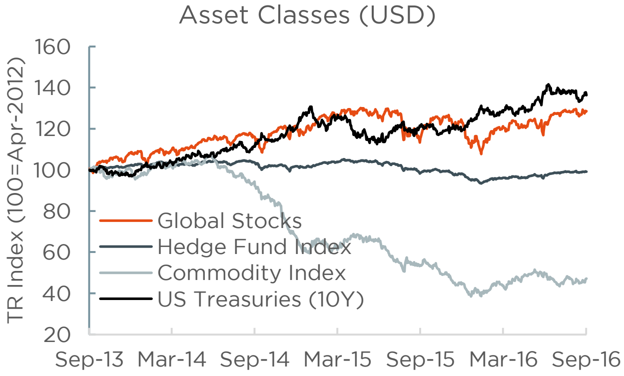
- Yields are historically low across safe and non-cyclical assets in CHF, USD and EUR. This makes global real estate a natural haven for yield-seeking investors. This is clearly within our “quest for yield” theme.
- Financing conditions are very favorable for high profitability. Thanks to ECB policy, rates are low and liquidity is abundant, enabling commercial banks to provide leverage to solid RE firms with physical assets as collateral.
- The Eurozone is recovering, albeit slowly. Growth has persisted for the past 12 quarters, and is expected to remain steady. This is supportive for commercial RE, in particular.

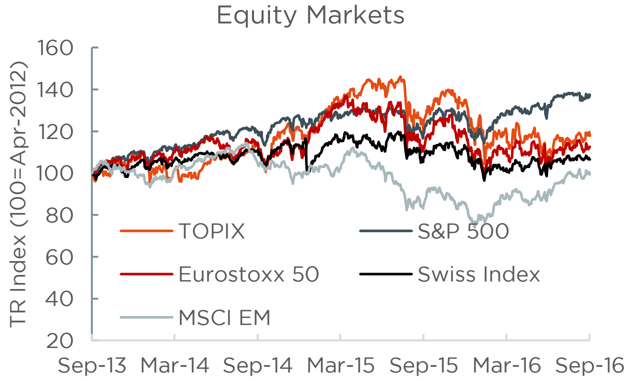
Brexit should bring an unexpected tailwind to the real estate theme. The potential loss of London’s passport to export financial services to the continent may indeed provide new investment opportunities, boosting the attractiveness of other major business centers. Hence, Frankfurt, Paris, Brussels and Luxembourg are already eyeing possible transfers of financial sector HQs. We doubt that the exodus will be massive though some operations will surely move out of Britain. The most positive impact will likely be experienced by English-speaking cities within the UE, such as Dublin. Belfast and Edinburgh could also emerge as potential winners should Northern Ireland and Scotland decide to secede from the UK and remain in the EU.

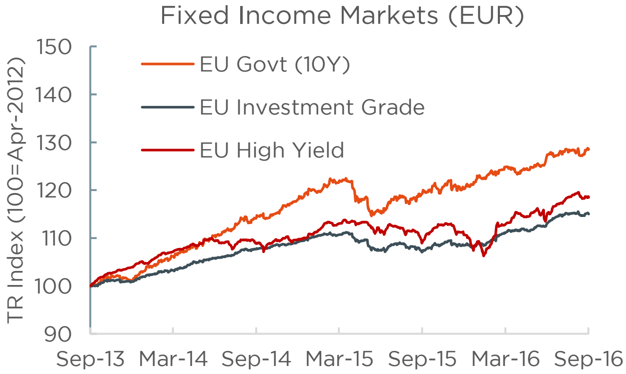
In practice, investing in real estate, especially in specific cities, is not fast and easy as listed stocks are very diversified, often pricey, and exposed to major urban areas such as London. Hence, investors need to look for specific deals and spend great effort on property details.

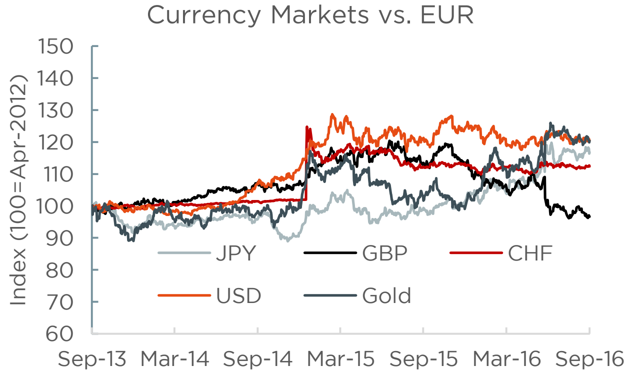
For instance, attractive opportunities are arising in Ireland from the combination of housing supply/demand imbalances, a lack of financing, and recovering prices. The convergence of these economic forces has created unique RE investment opportunities in the country. We are currently looking at investing in this theme through a new dedicated vehicle focusing on the Irish property market.

Performances





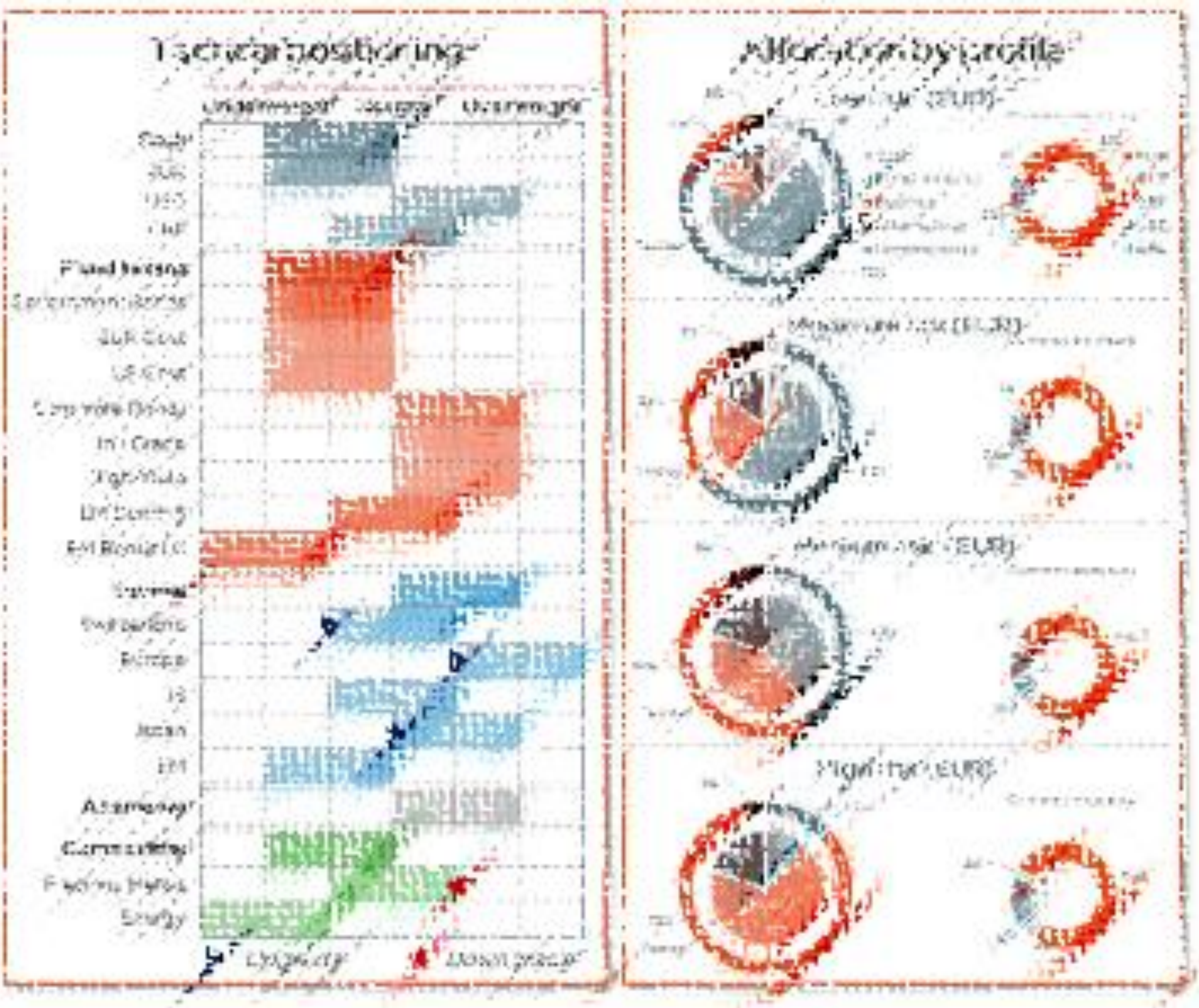




As of 30.9.2016	Asset	Current level	1-m change (%)	3-m chg. (%)	YTD chg. (%)	12-m chg. (%)
MSCI World	Equity (USD)	1 726	0.4	5.6	3.8	9.1
EuroStoxx50	Equity (EUR)	3 002	-0.7	6.0	-8.1	-3.2
S&P500	Equity (USD)	2 168	-0.1	4.7	6.1	12.9
Topix	Equity (JPY)	1 323	-0.5	6.0	-14.5	-6.3
SPI	Equity (CHF)	525	-0.4	2.9	-5.5	-1.0
MSCI EM	Equity (USD)	903	1.1	9.9	13.8	14.1
EURUSD	Currency	1.1238	0.9	1.2	3.5	0.7
EURCHF	Currency	1.0894	-0.4	0.1	0.2	-0.1
USDCHF	Currency	0.9694	-1.3	-1.1	-3.2	-0.8
GBPUSD	Currency	1.2990	-0.8	-4.0	-11.9	-14.2
JPYUSD	Currency	101.27	-2.1	-1.3	-15.8	-15.4
EURBRL	Currency	3.6511	1.4	1.6	-15.0	-17.9
As of 30.9.2016	**Asset**	**Current level**	**1-m chg. (bps)**	**3-m chg. (bps)**	**YTD chg. (bps)**	**12-m chg. (bps)**
10-Year GER	Bond (EUR)	-0.12%	-5	1	-75	-70
10-Year US	Bond (USD)	1.60%	1	8	-70	-44
EU Inv. grade	Bond (EUR)	0.66%	3	-28	-75	-92
US Inv. Grade	Bond (USD)	2.85%	5	-5	-83	-57
EU High yield	Bond (EUR)	3.56%	21	-57	-108	-125
US High yield	Bond (USD)	6.57%	-11	-97	-229	-162

Glossary *- TR: Total Return (i.e. Price change plus coupon or dividend), Govt: Government, 10Y: 10 years, GER: Germany, bps: basis points (1/100th of a percent), chg.: Change*

Asset Allocation



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External sources include: New York Times Syndicate, Wikipedia, Deutsche Bank, Eurostat, Colliers International, Bloomberg, Citibank, Statistica, Apple, European Commission.

Finished drafting on October, 1st 2016