

INVESTMENT **INSIGHTS**

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Editorial View

The hunt for... yield!

- Interest rates hit new historical lows after three decades of decline
- Excess savings searching for safety explain this unprecedented trend
- The search for yield from safe assets will affect all asset classes

The year 1981 is remembered for several events that profoundly changed the world. Their impact was immediate in some cases, while in others it took several decades for the full effect to be felt. In Europe, the handling of the Polish crisis revealed that the Soviet Union was starting to lose control of its fragile empire. In the US, it was not yet clear that President Ronald Reagan, who took office in January, would massively change US policies. In particular, no one could have predicted that the all-time high reached by 10-year US Treasury yields in September 1981 would mark the beginning of an unabated 35-year decline. That trend is one of the most significant financial events since the end of Bretton-Woods in 1971. Today, sovereign bond yields are negative in Switzerland, Japan, and Germany, while a 10-year US government bond barely yields 1.5%, the lowest level on record for a reserve currency in the last 300 years.

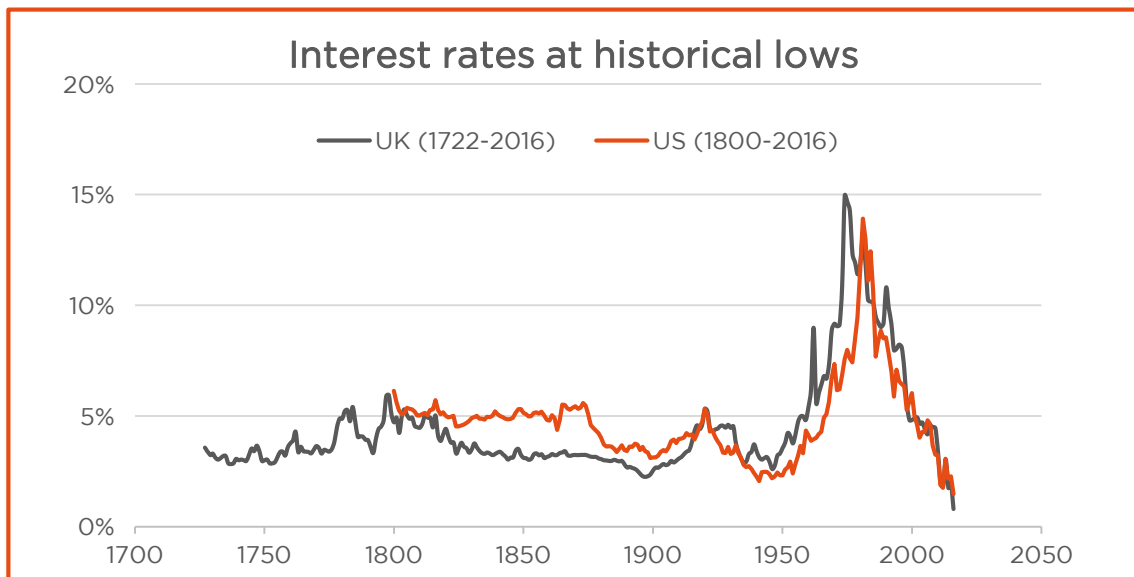
Common belief is that the decline has been caused by central bank (CB) actions. Easy money policies in the OECD have favored low rates in major currencies, while CBs in emerging markets have built up reserves by heavily purchasing bonds, pushing rates even lower.

Yet, these factors do not fully explain the trend's persistence over three decades. First, monetary policies were loosened in the OECD only after 2001 and following the 2008 crisis. Second, EM CBs adopted reserve accumulation as a strategy only after the Asian crisis of 1998.

A more likely driver of declining yields on safe bonds is demographics. World population aging has accelerated since the 1980s, impelling investors to favor safety over performance in order to secure their financial future. As senior cohorts accumulate wealth, they move more of their financial resources into safe assets providing steady income. Hence, what looks like a "hunt for yield", is in fact a "hunt for safety". As long as the asset is perceived to offer some protection, price has little influence.

With bond yields dropping like a stone and set to remain low for longer, this hunt is likely to continue spreading to other asset classes, including corporate debt, high yield, EM debt, and, ultimately, equities. However, as perceived risk stays at the core of security selection, both safer bonds and defensive high-dividend equities should appreciate more than riskier ones.

Chart of the Month



Global Strategy

ECONOMICS & ASSET ALLOCATION

Staying the course

- Solid macro backdrop prevailed after initial Brexit turmoil in markets
- Central banks are accommodative but lagging behind markets
- Political risk could return as a primary market driver, especially in Europe

Last month, we summarized the main short-term investment decision as a simple choice between politics and economics. The Brexit clearly revived the risk of the EU breaking up, which is bearish for markets, but the global macro backdrop keeps improving, which is bullish. After a few days of post-Brexit trauma, markets recovered, and economics clearly prevailed.

Theresa May took office earlier than anticipated, but, as expected, Britain did not rush to act on EU issues, nor has it applied for exit yet. Hence, as both initial fears and speculation gradually dissipated, investors were prompt to refocus on steady fundamentals in the short term. In the US, stock markets even reached a new all-time high in the certainty that the Federal Reserve would not raise rates soon after the Brexit vote despite continued positive domestic economic surprises.

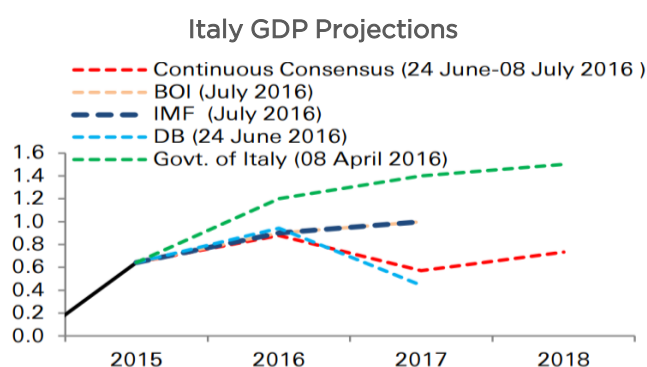
Overall, monetary authorities around the world have lost the initiative and remain data-dependent, with an accommodative bias. The Brexit, for instance, came as a surprise to central bankers ; they unanimously opted to ease, if possible, to prevent any risk of financial crisis. Their unwillingness to tighten was anticipated by markets, which are now weighing the likelihood of further easing measures, such as “helicopter money” in Japan. Though central banks are unlikely to resort to such drastic measures in the short term, they may well do so in the years to come, as they gradually run out of conventional stimulus options.

Given this monetary backdrop, as suggested in the editorial, our tactical stance reflects a further search for yield within quality securities across all asset classes. In the longer term, a sizeable position in gold is still warranted to hedge any possible “helicopter money” fallout.”

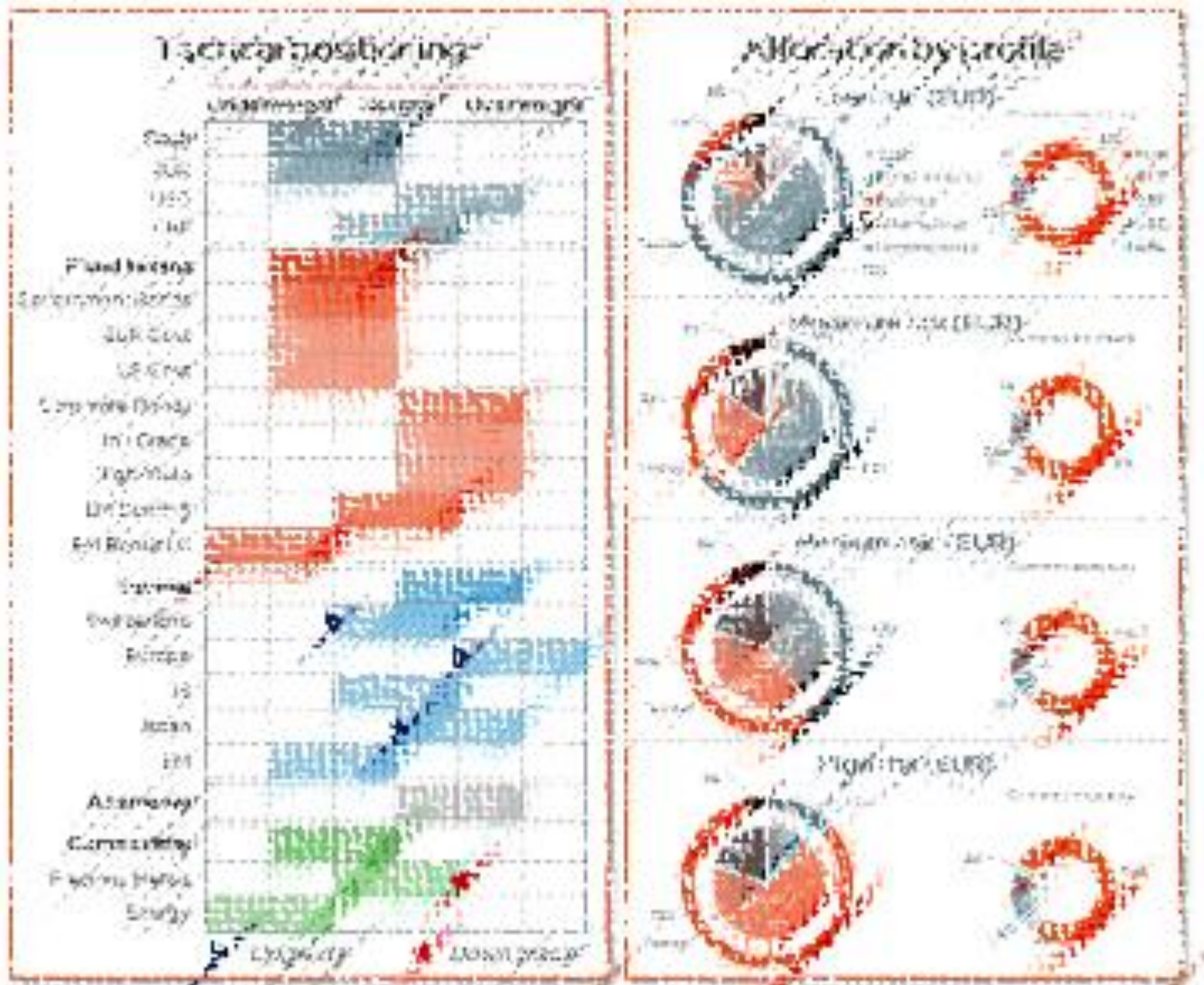
Though July was broadly positive for markets, it would be foolish to assume that all risks have now disappeared. Italy could well haunt us in the months ahead, both on the political and financial fronts:

- A rejection of the referendum on Senate reform could bring down the Renzi government, discouraging further initiatives.
- Banks bail-in has not yet been decided. Investors are still waiting for a comprehensive systemic solution to the problem of high NPLs, in a country that still heavily relies on banks for financing.

Our asset allocation still focuses on the big picture, which is showing accelerating growth, while managing for local risks. For the past 18 months, markets have been switching directions about every quarter. In these conditions, it is better to avoid stop-and-go in tactical bets. Hence, while we remain constructive overall, our well-diversified neutral exposure to equities reflects some note of caution ahead of further key event risks in the near term.



Asset Allocation



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- Still Neutral on Equities with a defensive bias
- Maintain tactical overweight on Gold

Contacts

DECALIA Asset Management SA

31, rue du Rhône
Case postale 3182
CH - 1204 Genève

Tél. +41 22 989 89 89
Fax +41 22 310 44 27
info@decaliagroup.com

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External sources include: Nintendo, Decalia, Bloomberg, Federal Reserve of Saint-Louis, ISM Institute, Eurostat, J. Friggit, Standard & Poors, Deutsche Bank, IMF, World Bank
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