DECALIA

INVESTMENT INSIGHTS

MONTHLY ISSUE #17

July 1st, 2016

THE BLOND FACTOR

Editorial View

The blond factor

- UK elections show populists have a supportive electorate in large countries
- Polls and experts have consistently underestimated unorthodox candidates
- Currency diversification is key to mitigating these political risks

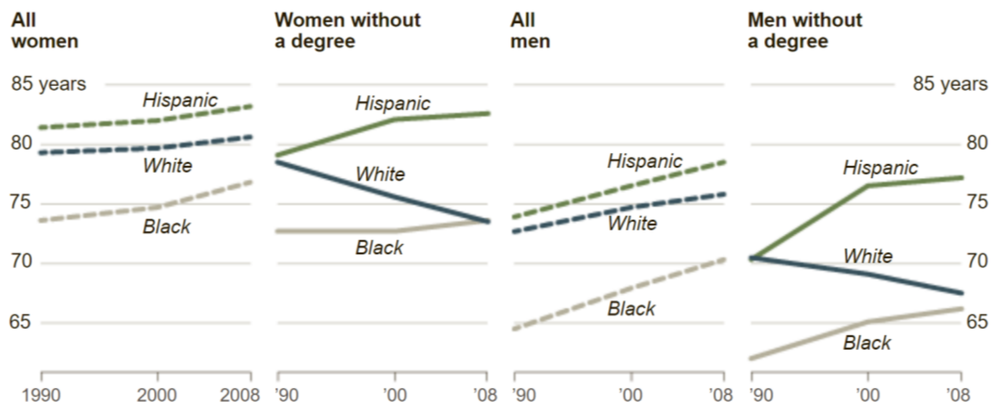
There is far more to Boris Johnson and Donald Trump than their bouffant blonde hairstyles. This article's attention-grabbing title is meant as a warning: don't underestimate the colorful political figures currently gaining traction around the world. They are buoyed by a powerful wave of deep frustration with globalization among the working and middle classes in the Western world.

The UK's recent vote to leave the EU was not just about Europe, but was motivated also by ordinary people's reaction to an increasingly globalized world. Breaking down the UK vote by education, social class, age, and location shows that the poorer, older, and more distant from the center (i.e. rural) you are, the more likely you were to vote against remaining in the EU, regardless of the candidates' rhetoric. Those were the factors influencing voters' cost/benefit analysis with regard to globalization. Many find the opportunity to work abroad not particularly attractive, nor are they swayed by the advantage of cheap foreign goods. Conversely, they care about their communities, and worry about the effect of multiculturalism on them. The Brexit surprised both markets and experts. They tried to rationalize the vote as an EU issue, when in fact it shows that rising income concentration has enabled popular resentment of globalization to rise up to the urban middle class. In the US in particular, the spike in mortality rates among older, poorly educated whites, both men and women, suggests they have lost hope, resulting in self-destructive behaviors. This trend should serve as a warning for countries whose presidential elections depend on such decisive swing voters, namely the US and France. The possibility that Donald Trump will become the next US president cannot be ruled out, nor should one discount the appeal of a blonde populist in France next year.

We don't encourage investors to bet on such binary events: predicting election outcomes or the immediate consequences of the Brexit involves too much randomness. As long-term investors, we prefer to focus on mitigating the political risks contaminating many advanced economies. For us, this means focusing on country and currency diversification. In the 1970s already, Switzerland and the franc were the ultimate refuge; they may end up playing this role again sooner than later.

Chart of the Month

The life expectancy of whites without a high school degree has fallen in recent years. Among the least educated Americans, white women have lost 5 years of life expectancy since 1990, and white men have lost 3 years.



Global Strategy

ECONOMICS & ASSET ALLOCATION

Re-building after Brexit

- Euro-skeptics' surprise victory wreaks havoc on markets
- The acceleration of global activity was gently moving from the US to Europe
- Brexit is a game-changer that could slow down the Eurozone economy

The Brexit vote outcome, on June 24th, was a shock to many investors who had stuffed their portfolios with risky assets only a few days earlier. Minutes after the result was announced, the GBP dropped to a 30-year low against the USD, and European stocks fell 10% on an intraday low. Investors may be overreacting, given than nothing material has happened yet. Conversely, it could be argued that markets are all about expectations, and that the real impact will undoubtedly be negative.

It bears recalling that even the collapse of Lehman did not trigger an immediate financial meltdown. The following week, markets ended almost flat. We are not betting on such a dire scenario, but we are aware that the full consequences of the election will not be visible overnight, especially with the nomination of a new PM now scheduled for September. One possible scenario, repeatedly mentioned in the press, is that a series of similar votes elsewhere will cause the EU to collapse. We see this as far-fetched; the 300-year old British union is at greater risk of breakup at this point, as staunchly "remain" Scotland reconsiders its membership in the UK following its own rejected referendum on independence in 2014.

Brexit by voting area

Global economic data are improving, especially in Europe, with France showing notable improvement in sentiment. Therefore, investment strategies now boil down to a choice between politics or economics.

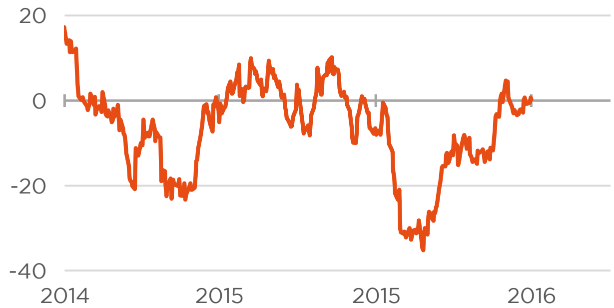
Economic trends are more persistent and usually prevail. We therefore remain constructive on financial markets, especially as the UK economy could surprise on the upside after the strong depreciation of its currency. We have also learned that Europe has a poor record of containing political issues. If not properly addressed by EU leaders, such a negative shock on Eurozone business confidence could derail recovery by year-end. This is not our central scenario, but we have to acknowledge that downside risks have now increased. Consequently, we intend to scale back our exposure to risky European assets mostly in favor of the US over the coming weeks.

Equities: Neutral; our tilt toward quality and defensive stocks translates into a slight bias towards Switzerland and the US.

Bonds: We find European quality credit attractive, while remaining neutral on EM debt. We also increase duration in our fixed income positions as a matter of risk management, to profit from any possible flight to quality.

Currencies: We favor the USD and CHF to diversify against European risks, in addition to our structural position in gold.

Global economic surprise balance



Markets review

EQUITY MARKETS

Beyond Brexit: risks and opportunities

- Neutral on stocks with a more cautious mid-term stance
- Continue to favor specific growth in stronger regions
- Regionally, still prefer Switzerland to EMU and UK
- More defensive sector positioning warranted

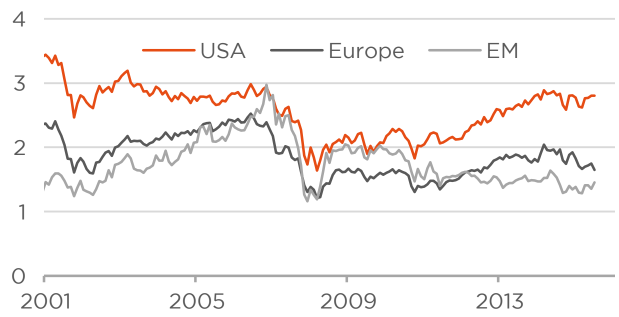
The outlook for global equities has deteriorated somewhat after the victory of the pro-Brexit camp. Investors, already faced with expensive valuations, financial crisis in China, and slowing productivity in developed countries, must now cope with a major political crisis at the heart of Europe. In such an environment, markets clearly need tangible growth rather than additional stimulus from central banks. Hence, strong fundamentals are a priority for sound investing. In this respect, we believe that investors should gain exposure to improving profit momentum in the US as both lower growth expectations and a recent bottoming in net revisions ratios are supportive.

Second quarter earnings reports are the next big milestone, and will be closely monitored in July and August. The novelty is that after several years of flat growth, 2016 sales are expected to grow faster (+1.9%) than 2016 EPS (+1.5%). Sales growth is a critical issue because a low top line is a key symptom of deflationary pressure. As margins are topping, we are approaching the stage where future market appreciation will almost entirely depend on top line growth. The key issue of this reporting season will thus be to what extent the top line will indeed recover and/or be reflected in management guidance. Having said that, in the short term, the impact of Brexit will likely continue to dominate market dynamics. The big losers are of course the European markets.

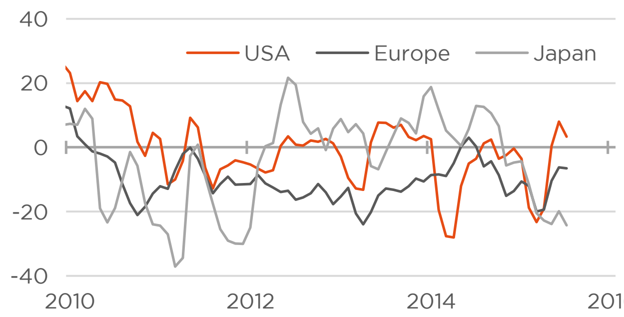
The Brexit only adds to an already long list of structural weaknesses that are likely to contribute to maintaining Europe at a significant discount. Hence, the institutional crisis and subsequent adjustment of the EUR/GBP should weigh strongly on the euro area but lead to a mixed outcome for UK equities as domestic uncertainties are offset by currency benefits for exporters. Interestingly, despite latest positive news flow (withdrawal of Boris Johnson, announcements of the BOE & ECB), sectors perceived as most exposed to Brexit risks (e.g. Banks and Autos) have struggled to rebound so far, suggesting that some impacts may be here to last.

Overall, we remain selective in Equities as the current lack of clarity regarding the implications of the Brexit vote warrants a higher risk premium. In this respect, sentiment will remain a key market driver in the coming months. Regionally, we continue to prefer core defensive markets such as Switzerland and the US while becoming more cautious on Europe and keeping a constructive but Neutral stance on EM. Sector-wise, we have turned less pro-cyclical recently, still favoring Healthcare and Technology, but upgrading Telecom, Utilities and Staples by one notch while downgrading Industrials and Consumer Discretionary to Neutral. We stick to our cautious stance on Financials for now but acknowledge increasingly depressed valuation multiples.

Price to Book



Earnings Revisions



Market review

CURRENCIES & COMMODITIES

In the eye of the storm

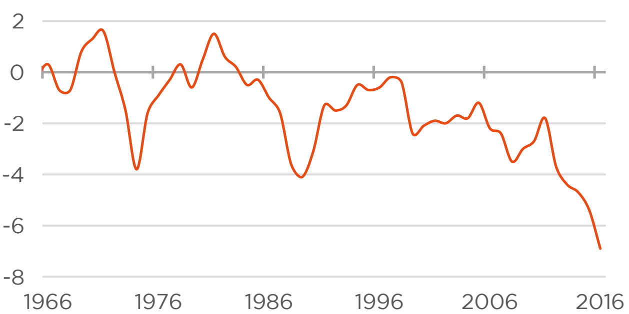
- GBP has collapsed after Brexit
- Currency war is reignited
- Federal Reserve delayed tightening
- CHF remains a unique diversifier

Currencies have been in the eye of the Brexit storm. On Friday, June 24th, the GBP fell to its lowest level since 1985 against the USD in a matter of minutes. UK voters' decision to leave the EU can be compared to the 1992 GBP exit from the European Monetary System, which was followed by a recession in continental Europe. As a result, the EUR also fell.

In hindsight, the weakening of the GBP was just an accident waiting to happen, and there is little chance of rapid recovery. The UK current account deficit stands at a record level of 7% of GDP, an unsustainable path that shows no sign of reversal, making it unlikely that the GBP will go back above 1.40 anytime soon. This new episode of competitive devaluations will put pressure on the CHF, the ultimate safe-haven currency. The SNB immediately intervened to slow the currency's appreciation, buying itself time to build some cheap protective strategies.

In hindsight, the weakening of the GBP was just an accident waiting to happen, and there is little chance of rapid recovery. The UK current account deficit stands at a record level of 7% of GDP, an unsustainable path that shows no sign of reversal, making it unlikely that the GBP will go back above 1.40 anytime soon. This new episode of competitive devaluations will put pressure on the CHF, the ultimate safe-haven currency. The SNB immediately intervened to slow the currency's appreciation.

UK Current account (%GDP)



FIXED INCOME

Bond yields in the "N-zone"

- Major countries provide negative yields on their bonds
- Quality credit is still attractive
- Neutral on High Yield

Freefall in OECD government bond yields is simply unstoppable. Even ahead of the Brexit referendum, German 10-year Bund dropped below zero to join Switzerland and Japan in the "Negative-Zone". After the vote, it is now France that is flirting with the zero bound. In the years to come, if the trend persists the US and UK would be the next potential candidates to enter the "N-Zone".

We consider long term rates to be abnormally low, but we are not expecting any short-term reversal. Indeed, there are structural buyers of safe government bonds that are insensitive to prices, such as central banks and pension funds. These inflows should persist given monetary challenges and demographic trends. Besides, we see that during deflation scares, bonds provide valuable diversification for equity portfolio. With that in mind, we still target a neutral duration.

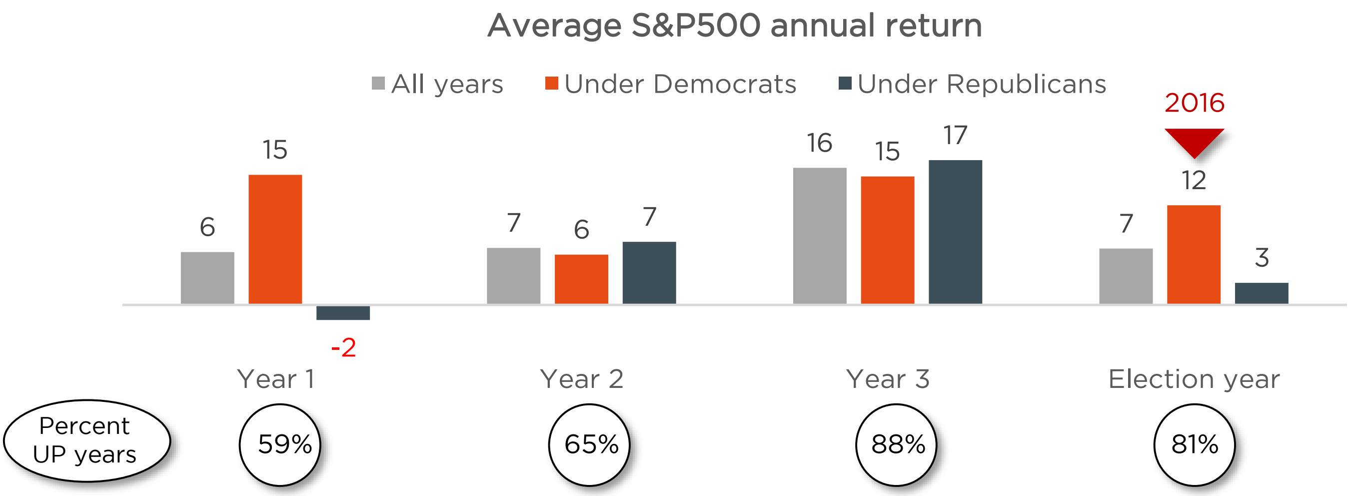
Following market turmoil, we see tactical opportunities in investment grade bonds, both in Europe and North America. On average, bonds of quality firms will converge back to government yields. On the High Yield segment, we are still very selective. In addition to economic uncertainty, European banks may start tightening their credit conditions. This would hurt weaker European firms looking to refinance. On the other side of the pond, a rebound in oil prices has brought some relief to US bonds in the energy sector after being challenged for months.

German 10-year yield

Investment Focus

EDUCATIONAL SERIES: INVESTING THROUGH THE PRESIDENTIAL CYCLE

- November election will revive the so-called presidential cycle for investing
- Historical record show that winning party would make a difference in 2017
- Contrary to popular beliefs, elections are not relevant for sector strategies



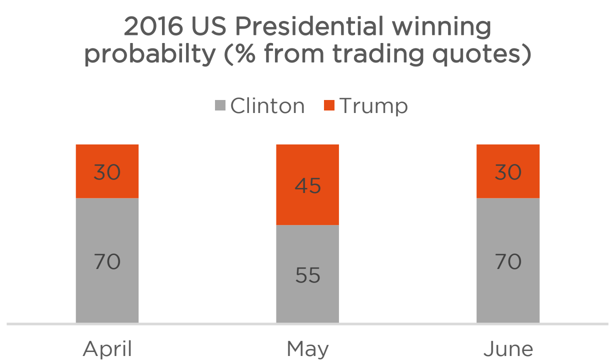
This month we have been heavily focusing on politics, but it still comes second to our main priority: investing. Here are some reflections about how to deal with the upcoming US presidential elections.

In the foreword on this monthly issue, we mentioned political risks following UK Brexit vote and the upcoming US presidential elections, but there are also opportunities, especially for investments. Indeed, trading US election cycle has been a popular theme for years, and many equity analysts are often referring to the presidential cycle, a repetitive 4-year pattern on stock market. We try here to present a clear and simple strategy to profit from it.

Historical data since 1945 suggest that stock market returns vary widely between the four years of a presidency.

The first year is usually below average, especially when Republicans lead the White House. In that case, the average S&P500 return is a negative two-percent. Then, the odds improve somewhat for a positive mid-term year, with more than 60% of occurrences, followed by a third year clearly providing the best market performances with double digit average returns, regardless of the incumbent party. Finally, the last year of the cycle, also called election year, provides a valuable signal for 2016.

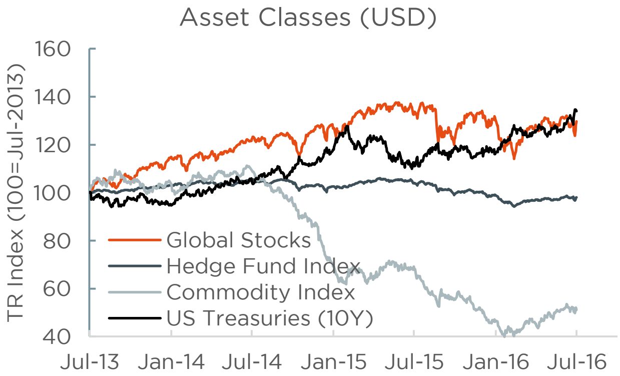
Indeed, 81% of such years are positive with Democratic presidents usually ending their mandate on a high note showing an average 12% performance for US stocks. Overall, these historical averages seem to be more than pure randomness, given the spread and consistency of over/underperformance. Hence, assuming a continuation of such trends, not only should we conclude that 2016 will likely see a better second half than the first, but also that the US market should record lower stock returns in 2017, especially if Trump is elected. However, as for the Brexit vote, we do not believe such a victory is currently priced in by the markets.

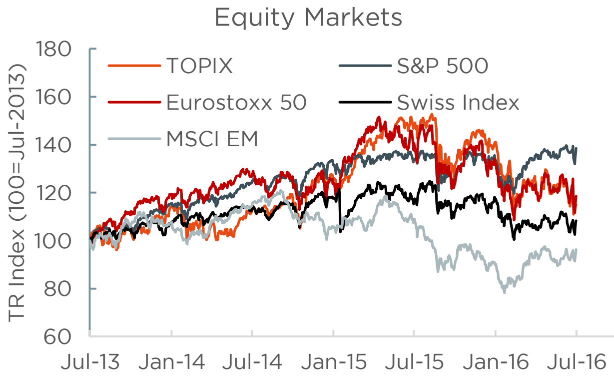


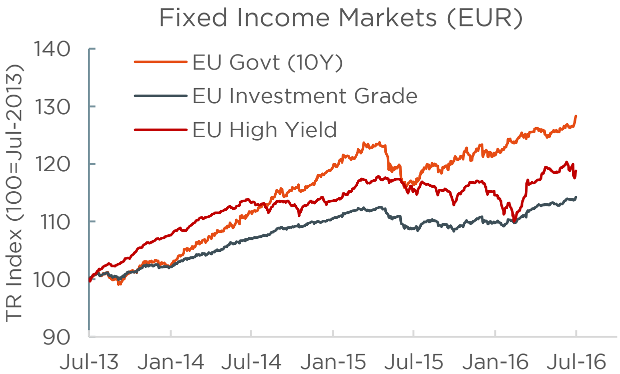
Please contact your sales representative for our previous **Educational series** that include:

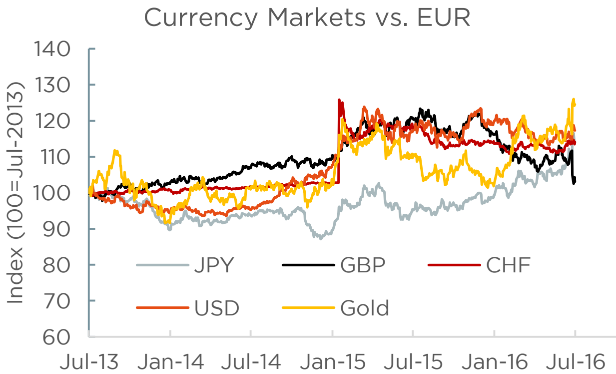
- Gold investing (2016Q1)
- Investing in rising rates (2015 July)
- Seasonal investing (2015 June)

Performances





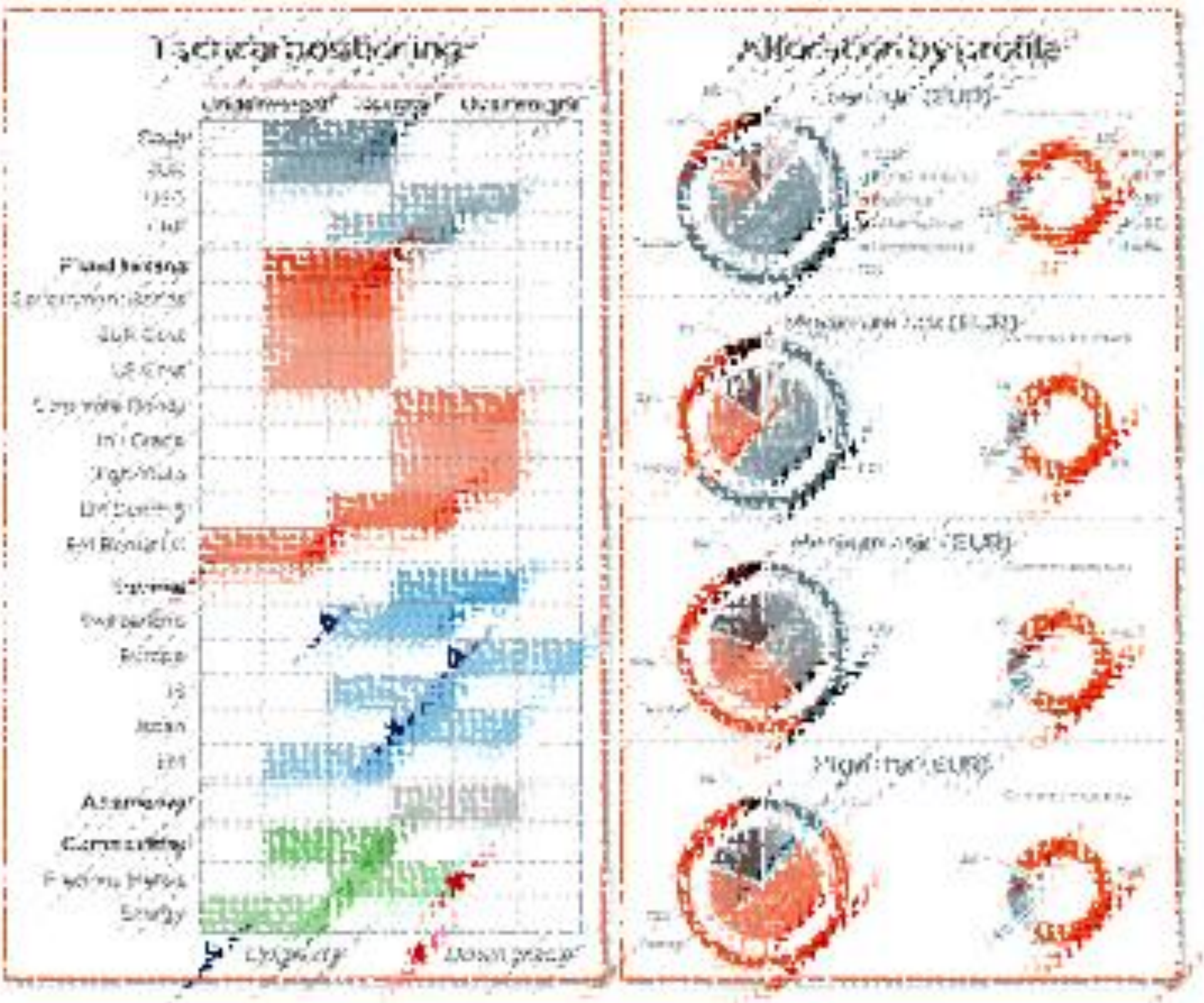




As of 30.6.2016	Asset	Current level	1-m change (%)	3-m chg. (%)	YTD chg. (%)	12-m chg. (%)
MSCI World	Equity (USD)	1 653	-1,3	0,0	-0,6	-4,7
EuroStoxx50	Equity (EUR)	2 865	-6,5	-5,9	-12,3	-16,3
S&P500	Equity (USD)	2 099	0,1	1,7	2,7	1,7
Topix	Equity (JPY)	1 246	-9,7	-8,1	-19,5	-23,6
SPI	Equity (CHF)	513	-2,6	1,8	-7,7	-6,0
MSCI EM	Equity (USD)	834	3,3	0,0	5,0	-14,2
EURUSD	Currency	1,1110	-0,2	-2,2	2,3	-0,3
EURCHF	Currency	1,0823	-2,2	-0,9	-0,5	3,9
USDCHF	Currency	0,9742	-2,0	1,3	-2,7	4,2
GBPUSD	Currency	1,3368	-8,2	-7,5	-9,3	-15,0
JPYUSD	Currency	102,59	-7,5	-8,8	-14,7	-16,2
EURBRL	Currency	3,5592	-11,2	-13,0	-17,2	2,8
As of 30.6.2016	**Asset**	**Current level**	**1-m chg. (bps)**	**3-m chg. (bps)**	**YTD chg. (bps)**	**12-m chg. (bps)**
10-Year GER	Bond (EUR)	-0,19%	-34	-35	-83	-96
10-Year US	Bond (USD)	1,47%	-38	-36	-83	-89
EU Inv. grade	Bond (EUR)	0,91%	-11	-17	-50	-52
US Inv. Grade	Bond (USD)	2,89%	-25	-38	-78	-48
EU High yield	Bond (EUR)	4,08%	24	-24	-55	1
US High yield	Bond (USD)	7,47%	-6	-98	-139	61

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



- Still Neutral on Equities – reduce European equities
- Increase duration on government bonds
- Tactical overweight on gold reiterated

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

External sources include: New York Times, Getty images, YouGov, JPMorgan, Decalia, Bloomberg, ISM Institute, IFO Institute, World Bank, BOE, Iowa Electronic Markets, Factset
Finished drafting on July, 1st 2016