DECALIA

INVESTMENT INSIGHTS

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BANKS vs. FINTECH

Editorial View

Banks vs. FinTech: who dares, wins!

- It has been a tough decade for banks, especially in Europe
- Small, agile start-ups are challenging a mature industry
- We believe selective FinTech stocks should emerge as relative winners

It has been a rough few years for banks. First, the credit crisis destroyed years of profits. Next, the sovereign debt crisis led to liquidity issues. Finally, regulators forced banks to increase capital, including their equity base. Seven lean years and a couple of major scandals later, banks were likely hoping to be rewarded with seven years of plenty. Instead, they now watch helplessly as myriads of small, aggressive start-ups harness new technologies to claim a piece of the financial services pie!

This "FinTech" trend takes advantage of three disruptions: first, smart devices enable easy access to service platforms that are relatively cheap to build; second, regulated activities (credit, payments) are opening up; and third, the incumbents' economic model is vulnerable. Indeed, universal banks have developed cross-subsidies within their services, a model that appears increasingly outdated. New FinTech players are slashing prices in the most profitable business lines and leaving the loss-leaders (checking accounts, etc.) to the banks. Nevertheless, banks have not lost the game yet, as they still control millions of clients!

We see two possible scenarios, which guide our investments in financial services, especially in connection to our millennials theme:

- **Pharma/biotech scenario:** Large incumbents became integrators by acquiring successful biotechs. Major Pharmas thus gained from no longer managing risky, expensive R&D, while the prospect of a nice payoff was an incentive for biotech entrepreneurs.
- **Telecom scenario:** Some innovative mobile players managed to become majors themselves without being acquired. Prices and margins fell, and large, non-flexible incumbents suffered.

Client acquisition costs will thus likely define the future face of the banking industry. However, regardless of which scenario unfolds, we believe that Fintech stocks should be relative winners, whether as valuable strategic takeover targets or as successful, cost-efficient industry consolidators. In that perspective, we favor disruptive bank business models, such as Fineco Bank and Virgin Money, but also innovative leaders in the fast-growing e-payment space.

Chart of the Month

Global Strategy

ECONOMICS & ASSET ALLOCATION

The light at the end of the tunnel

- Global activity is still fragile but gradually improving
- The USD is the key adjustment variable balancing growth across the globe
- We expect less divergence in performance between equity markets

Markets are finally putting a disappointing first quarter behind them. The current mixed earnings season is not pushing markets downward as the news had already been anticipated. Moreover, economic reports are in line with global GDP expansion hovering around the 1.8% mark on an annual basis. Prospects are fortunately brighter looking ahead, as activity in most areas is returning to the pace needed to deliver GDP growth closer to 3.0%. The US is on the path to more stable corporate activity and higher business investment, Chinese trade is on the mend, and Europe is staying the course to a slow but gradual recovery.

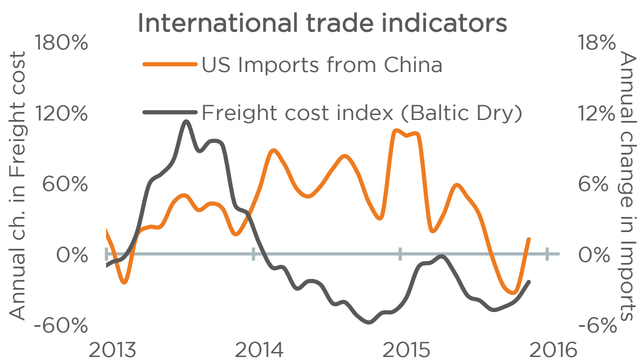
Leading indicators, such as the ISM (US) and European PMIs, are in line with such expectations. However, we are not out of the woods yet; central banks have acknowledged this fragile equilibrium and should avoid unexpected tightening which might lead to a contractionary shock.

The consequence of flexible, data-dependent monetary policies is volatility in the major currencies. The USD has been one of the key market factors for the past 18 months, and is likely to remain so in the near future. The rapid appreciation of the currency in 2015, ahead of probable rate increases, suffocated the US corporate sector, while EM bled from massive capital outflows.

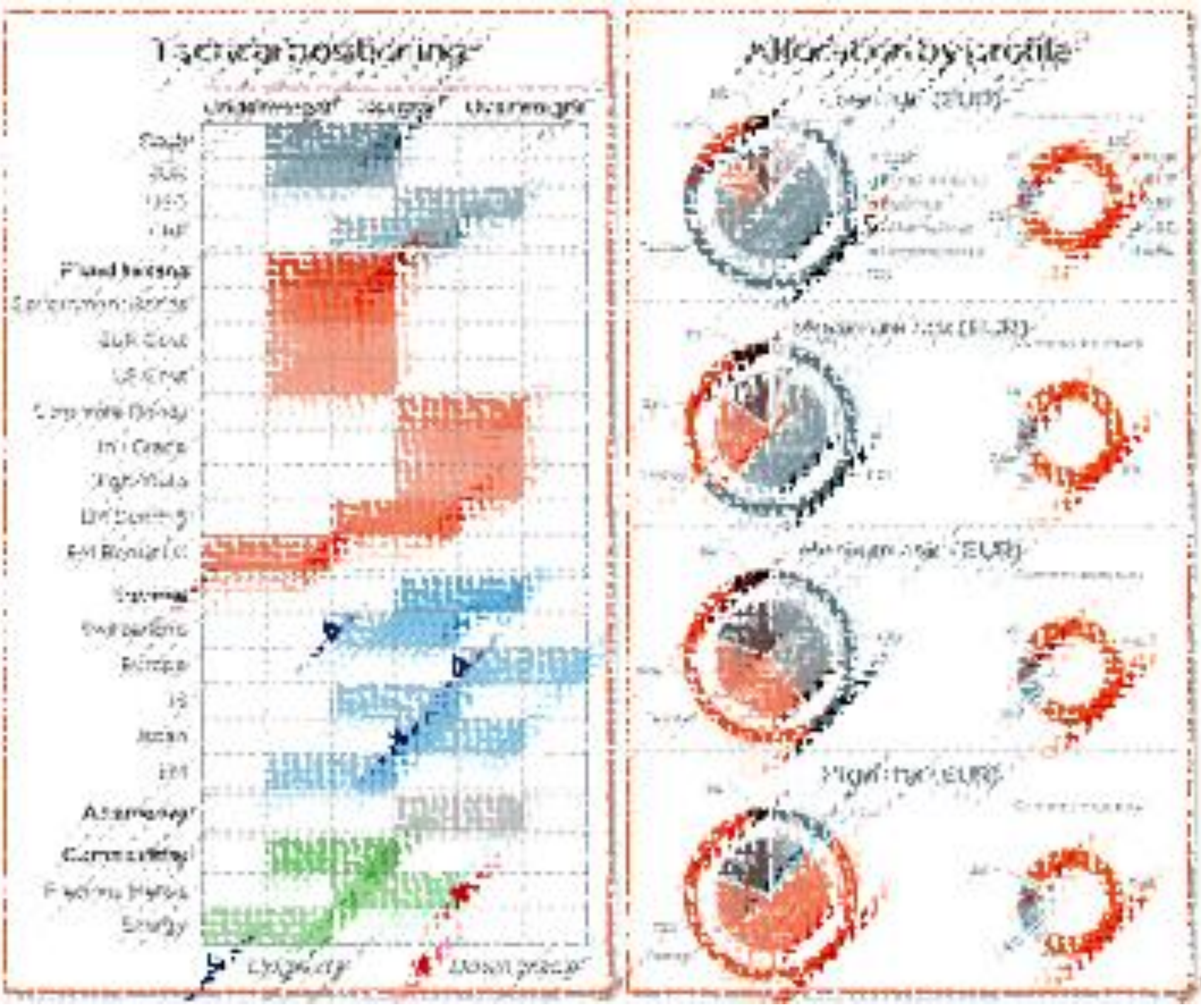
Now, thanks to a less hawkish Fed, the greenback has halted its upward trend and a pullback has offered relief to both regions. It seems probable that the USD will appreciate at a moderate pace, since the Federal Reserve will only raise rates after evidence of steady growth, due to the current fragile equilibrium between activity, financial flows, and monetary policy. As a result, after witnessing massive divergence in stock market performance between regions, we now expect some convergence again, with the exception of Japan, whose currency is again caught in a deflationary spiral.

This recovery scenario, accompanied by lower dispersion, translates well into our current neutral asset allocation.

- Equities: While we remain largely sector-agnostic at this stage, we have nevertheless rebalanced some of our Japan exposure into Emerging markets. We keep a strong focus on specific themes such as high quality, yield, and intergenerational opportunities.
- Bonds: We continue to favor mid-term investment-grade corporate bonds and remain selective in the high yield space.
- Maintain strategic positions on gold as a key diversifier in the current low (negative) interest environment; moreover, should global activity relapse, a more dovish Fed is likely to support gold prices.



Asset Allocation



- Rebalancing toward a more neutral stance
- Lowering Japan equities and becoming more constructive on Emerging Markets
- We started taking profits on earlier protective put options

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External sources include: Shutterstock, Goldman Sachs, Decalia, Federal Reserve Board, FRED, Bloomberg, ISM Institute, IFO Institute, JP Morgan
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