DECALIA

INVESTMENT INSIGHTS

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HURRICANE SEASON CRUISING

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- The transition away from a Goldilocks macro scenario is now stirring up troubled waters
- Staying the course in this new volatility regime warrants more active portfolio management

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- Transition mode engaged – Economy, earnings, central banks and geopolitics in the spotlight
- Higher volatility is here to stay – Caution warranted but unchanged global macro scenario
- Market fundamentals remain healthy – Dare to be contrarian and don't capitulate!

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- Equities – Selectively constructive as the current period of transition still deserves a note of caution
- Fixed Income – Cautious stance; the risk-reward remains unattractive, especially in EU Credit
- Alternatives – Continue to favor uncorrelated strategies & Private Equity in the current environment

Editorial View

Hurricane Season Cruising

- Navigating global financial markets requires more than a compass, a map, and a sextant
- The transition away from a *Goldilocks* macro scenario is now stirring up troubled waters
- Staying the course in this new volatility regime warrants more active portfolio management

Investors ahoy! The auspicious skies of early 2018 have clouded up with the hurricane season now in full swing, making for much choppier financial waters. Strong macroeconomic tailwinds have faded, as the Federal Reserve steams ahead with its interest rate hikes and balance sheet normalisation. Tighter US monetary policy means lesser money available on a global scale, even if other major central banks have (so far) stayed put. Emerging economies have borne the brunt of the pain to date, particularly those with the largest current account imbalances and greatest dependence on US dollar financing. Argentina and Turkey are of course prime examples, with currencies that have depreciated massively this year against the greenback, igniting domestic inflationary pressures. But leading indicators have also heeled in many other parts of the world, suggesting a slowdown in global macroeconomic momentum as we sail towards 2019. Not to mention that the stimulus afforded to US economic growth and company earnings by the Trump tax breaks is set to wane.

Political storms are also brewing. The trade dispute between – chiefly – the US and China is escalating, rousing fears that it could turn into a full-fledged hurricane. Despite several rounds of negotiation, and the well-documented economic costs of protectionism, neither party has so far showed any willingness to bear away. Europe meanwhile is having to deal simultaneously with rogue waves coming from the north-west, as the Brexit deadline fast approaches, and from the south, where the 2.4% budget deficit put forward by the new Italian coalition government well exceeds prior pledges and will only add to the country's already colossal debt pile.

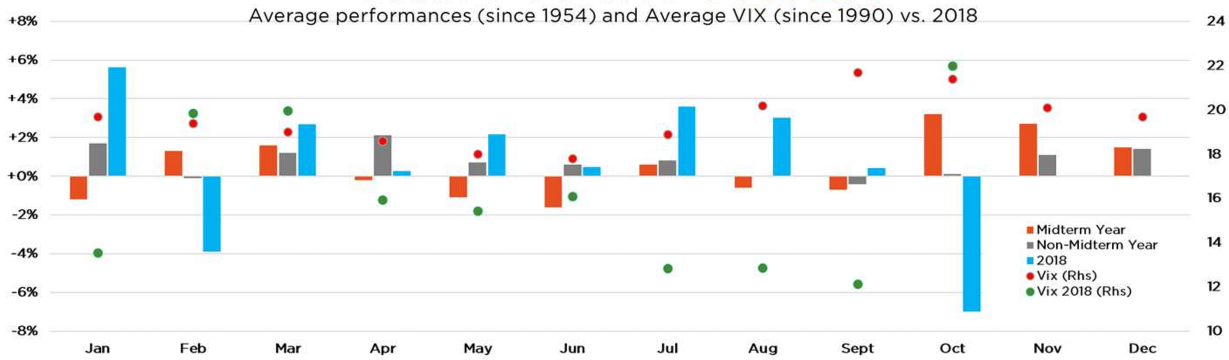
And then of course there is the electoral agenda. The forthcoming US midterm elections will see all 435 seats in the House of Representatives be up for grabs, alongside one third of the 100 Senate seats – not to mention a number of State governorships and local positions. The Democrats stand a chance of regaining control of the House, which would mean a divided US Congress and perhaps less leeway for President Trump to manoeuvre the US ship as he alone sees fit. Six months later, it will be up to European Union voters to elect their members of Parliament. This will provide an important indication of the level of public support for the European construction.

In the end, this all adds up to a new regime of market volatility. After several years of unusually low levels, the VIX index – the oldest and most commonly used measure of market volatility, constructed using the prices of multiple options on the S&P 500 – spiked to near 40 last February. It has recently started to move up again, heralding the risk of another volatility vortex.

Now is thus no longer the time to be cruising at full speed, with all sails hoisted. Rather, active portfolio management is warranted, drawing on an experienced investment crew and first-rate navigating tools. Ballasting portfolios is key, such that they are solid enough to stay the course in more volatile waters. Also, constant watch of the risk horizon is now required, so as to steer away from the worst of the storms. Last but not least, as good skippers, remaining on the lookout for sunny patches in otherwise cloudier skies is vital. These may be market segments that still boast favourable underlying currents, or battered assets offering bottom-fishing opportunities.

Hence, as the 2018 regatta comes to a close, navigating financial waters has become more of a challenge, but investment opportunities can and will arise for those investors willing to embrace the new volatility regime in an active manner.

Chart of the Month



Global Strategy

The Party Ain't Over 'Til It's Over…

- Transition mode engaged – Economy, earnings, central banks and geopolitics in the spotlight
- Higher volatility is here to stay – Caution warranted but unchanged global macro scenario
- Market fundamentals remain healthy – Dare to be contrarian and don't capitulate!

Trick or Treat? Buy or Sell? Halloween has come and gone but global financial markets still seem to be choking on the (artificial) sweets they were spoon-fed until recently. Let's face it, the jig is up, celebrations are coming to an end, and hangovers looming for most partygoers. Some fun time does still lie ahead for the braves though – that is, until the lights go off and daylight brings investors back to the harsh reality.

Staying up for this *after* party is, however, not for the faint of heart, with volatility spikes accompanying yet another surge in interest rates and equity market pullback. We nonetheless stick to our constructive global macro scenario, keeping our asset allocation broadly unchanged as we navigate this widely anticipated "transition period". Higher volatility is here to stay, fostered by the latest mixed economic and corporate trends, ongoing global monetary policy normalization, and renewed geopolitical risks (e.g. Saudi Arabia). More than ever, investors need to keep faith and fasten their seatbelts for what promises to be another bumpy year-end.

Despite signs of resilience as of late, global economic growth is now slowing, with the decoupling between the US and the rest of the world still a matter of concern. Meanwhile, inflation is picking up : core levels are now dangerously close to central bank targets. Finally, global interest rates should continue to trend up, driven by the US Federal Reserve's ongoing monetary tightening. That being said, we still see market fundamentals as healthy overall and thus recommend taking advantage of this shakier environment to sell volatility and selectively add to beaten-up high-conviction equity ideas boasting superior visibility.

In this context, we keep our neutral stance on Equities unchanged, having trimmed our allocation in recent months. While not inclined to cut exposure further at these levels, we do not advocate increasing it either, as the latest cyclical trends and geopolitical events warrant a dose of caution. Offsetting these decelerating earnings and mixed geopolitics are healthier equity valuations, resilient economic growth, and favorable investor positioning. As such, the markets' recent vulnerability to higher volatility did not come as a big surprise to us and supports our more balanced approach in terms of sectors (defensives), size (large-caps), and style (value).

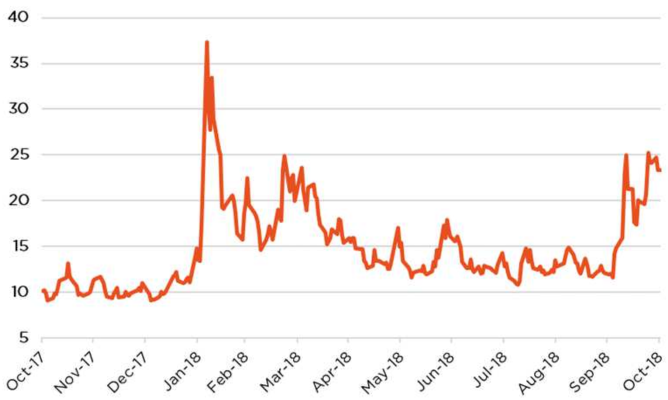
We remain underweight Fixed Income and downgrade the investment grade segment by a notch, as spreads remain unattractive in our view. Still, we keep our 10-year US Treasury position as a hedge against political turmoil.

As regards currencies, we continue to believe that the USD should benefit from the higher rate differential, stronger US economic momentum, Federal Reserve tightening, and investor positioning in the short run. Medium-term, however, relative valuation and fundamentals (current account, budget deficit, debt to GDP), alongside the shift in European Central Bank stance, should support the euro.

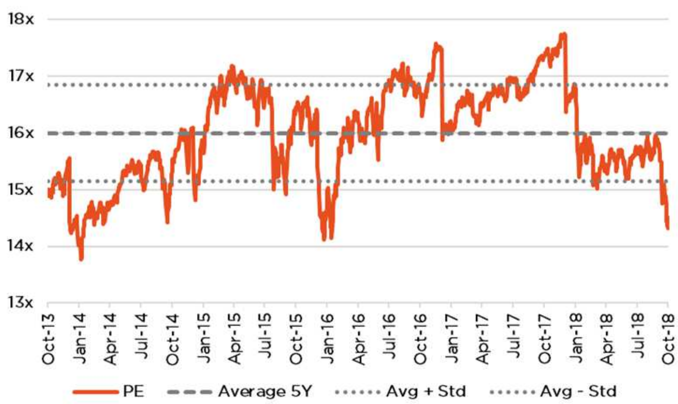
In Commodities, we keep our gold allocation unchanged as a safe haven and geopolitical hedge. Moreover, we stay constructive on oil fundamentals, amid Middle East tensions.

Finally, uncorrelated hedge fund strategies (market neutral, arbitrage) and private equity remain our preferred plays in Alternatives.

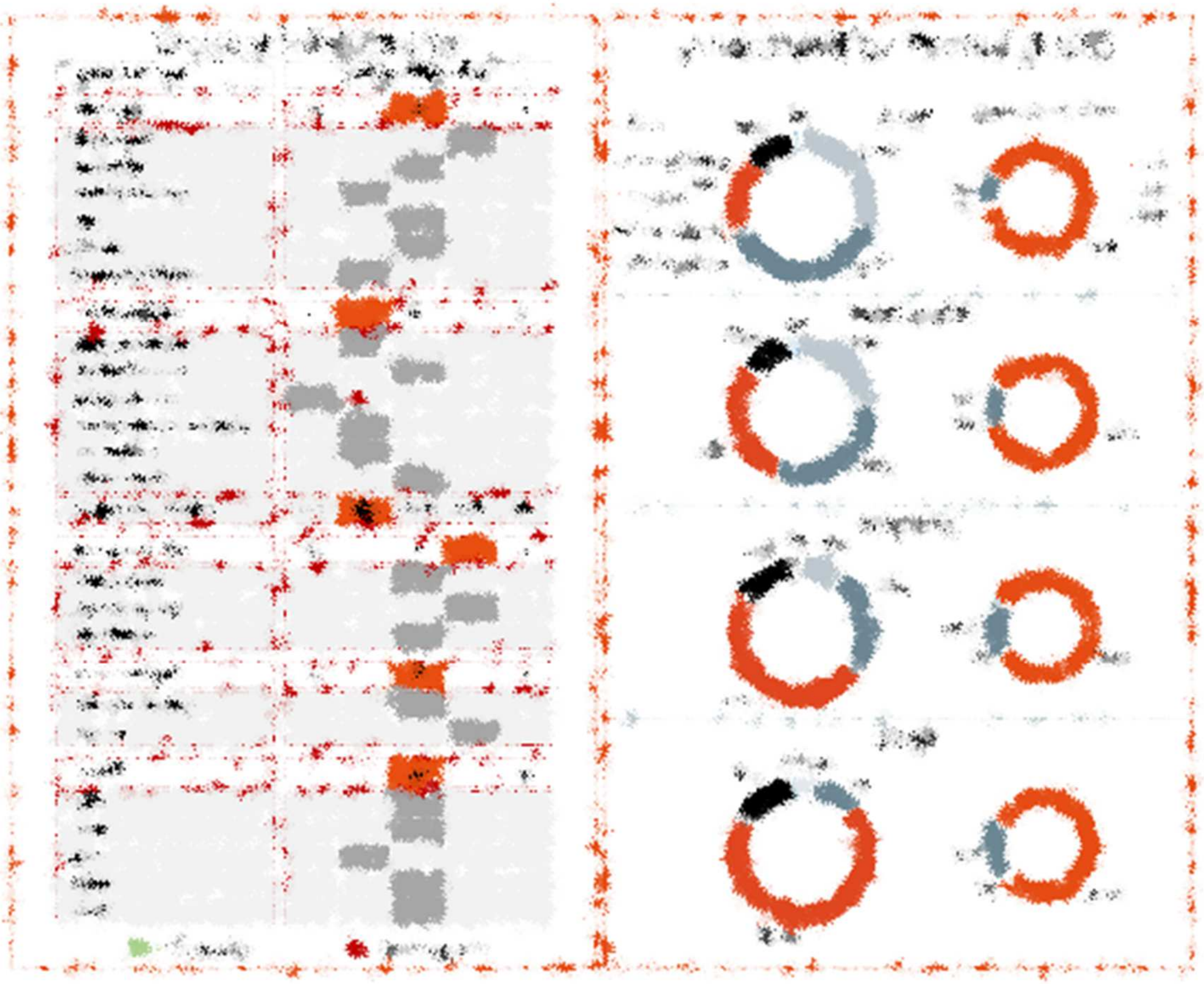
Equity Volatility CBOE VIX



MSCI World AC 12M Fwd P/E



Asset Allocation



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- Fixed Income: Cautious stance; the risk-reward remains unattractive, especially in EU Credit
- Alternatives: Continue to favor uncorrelated strategies & Private Equity in the current environment

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: Thomson Reuters, Bloomberg and State Street.

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