December 31, 2016

Dear Client

We are pleased to enclose your end-of-year portfolio statement, accompanied with a brief commentary on the key events of the year 2016 and the expectations for the upcoming year 2017.

Economic and financial summary of the year 2016

Investor's nerves were strongly tested from the beginning of the year. Rarely a year starts with such poor financial market performance.

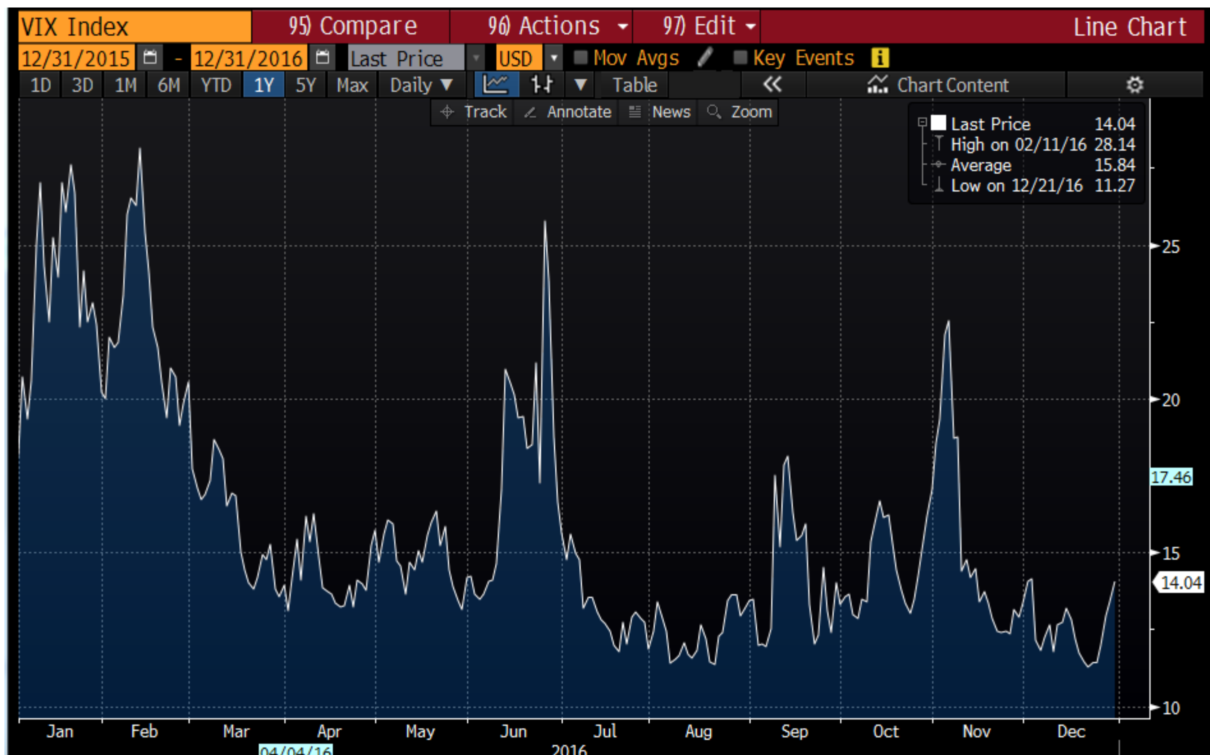
Early 2016, markets were facing the possibility of a hard landing in China (forcing even its' stock exchange to suspend the trading), plummeting oil prices, economic weakness in the US, and fragile solvency in the European banking sector. Yet as the months went by, the global economy was able to overcome many of these challenges and maintain a "modest but stable" momentum, helped by supportive monetary policies from central banks around the world.

Later in the year, economic fears were succeeded by political shocks. At the end of June, the UK's Brexit referendum was a reminder of the important challenges facing many European countries: loss of purchasing power, tense social climate, mistrust of the government, skepticism about the globalization, fear related to immigration and inflation of financial assets. These themes were also at the heart of the debate in more recent presidential elections, spurring Donald Trump's victory in the USA. Both events where two of the biggest shocks in modern political history, demonstrating that today, risks are easier to be found than returns...

There were definitely key lessons "learned" or "recalled" in 2016:

- A "base case forecast" is not a "done deal": The past year has been one of disgrace for many forecasts, surveys or polls institutes. Donald Trump was able to secure the Republican nomination and then win the US elections, while the UK electorate decided to leave the EU.
- Panic is not helpful: 2016 was a year of shocks but also a year of rewards for investors who were able to remain calm amid uncertainty.
- Do not bet against Central banks: Central banks showed that they have still "muscle" to act, steer the markets and surprise.

Despite the significant turbulence (see the chart below, depicting the S&P 500's volatility or "fear" index), the final verdict on the past year has been less negative than expected. The worst-case economic scenario (global economic downturn) did not take place, thanks to sufficiently solid economic fundamentals and supportive central banks.



VIX = SPX Volatility Index

Source: Bloomberg

A look at the main asset classes in 2016

Equity markets

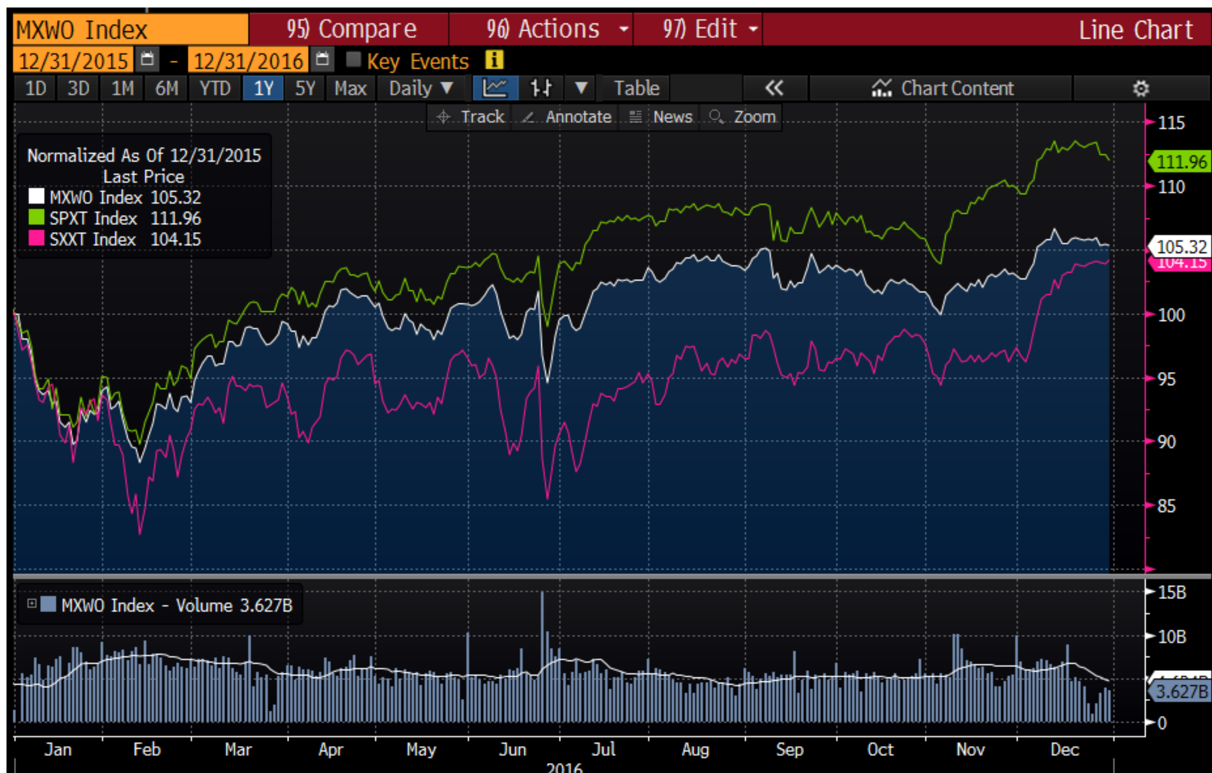
On 7 January, the Shanghai composite index experienced its shortest trading day in history, by closing -7% just 30 minutes after the opening, after triggering multiple times the newly implemented "circuit breakers".

In February, the European financial stocks became under selling pressure, due to a general uncertainty over the health of the leading European banks and Italian bank's non-performing loans.

Although the markets took weeks to recover from each of these market corrections, by end of May, all the exacerbation of beginning of the year seem to have been forgotten.

A new market shock occurred in June, with the decision of the UK electorate to leave the EU, triggering a strong equity market correction (especially in the UK and Europe), but as in previous corrections of the year, it happened to be short-lived.

Towards the end of the year, the global stock-markets unexpectedly rallied(!), in the wake of Donald Trump's election victory as the 45th POTUS.



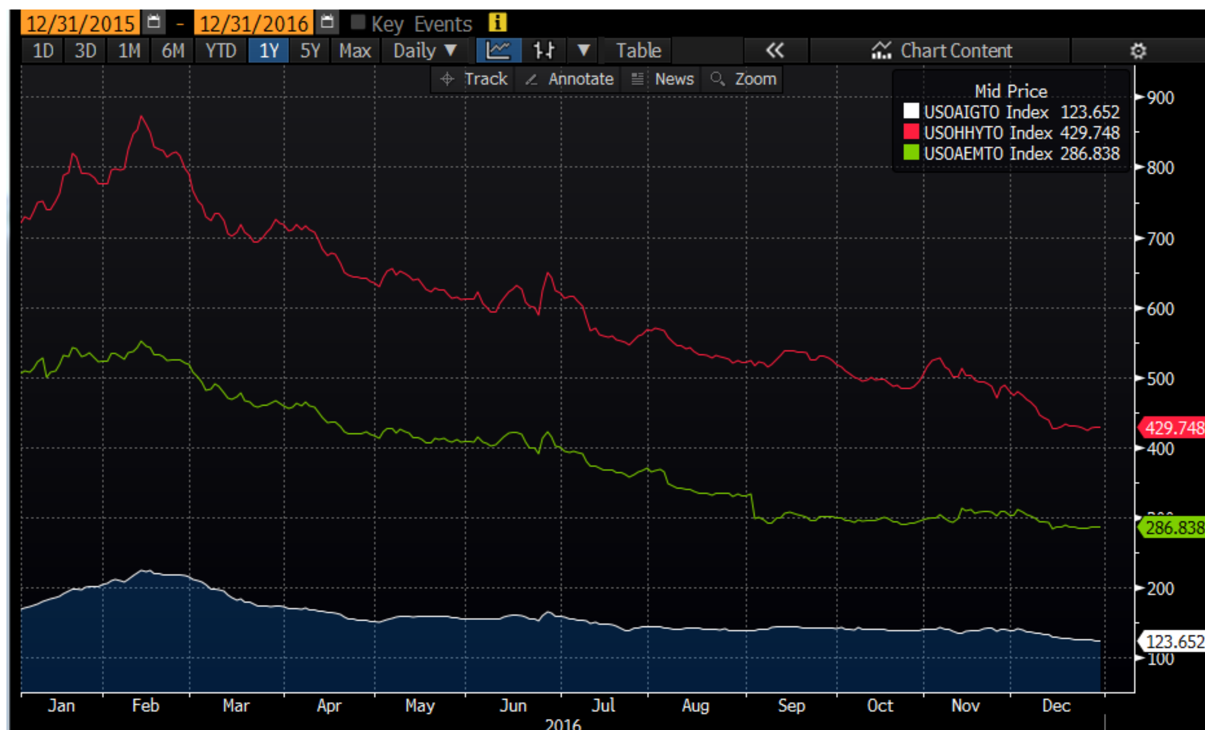
MXWO = MSCI World Index (in USD); SPXT = S&P 500 (in USD); SXXT = Stoxx Europe 600 (in EUR)
Source: Bloomberg

Looking ahead to 2017, global equities are trading in line with their long-term average valuations, and although they are not cheap in absolute terms, they are attractively valued relative to bonds. Return is expected to come mostly from earning growth across regions and selective sectors (e.g. IT, healthcare and financial services) and not from further multiple expansion as in previous years.

Bond markets

The FED left during most of the year the benchmark interest rate unchanged, making just in December the second rate increase in 8 years, while the ECB and the BoJ continued with their negative yield policies. This “particular” situation pushed the yields of multiple bonds sectors to exceptionally low levels, causing ~40% of the global bond market to finish the year with negative yields.

This “particular” situation lead investors to embark on a “search for yield” by taking larger credit exposure, via lower investment grade, emerging market and high-yield bonds, causing a continuous compression of the spreads and price increase also in these segments (see picture below).



USOAIGTO = Inv. Grade OAS, USOAEMTO = Emerging Market OAS; USOHHYTO = High Yield OAS
Source: Bloomberg

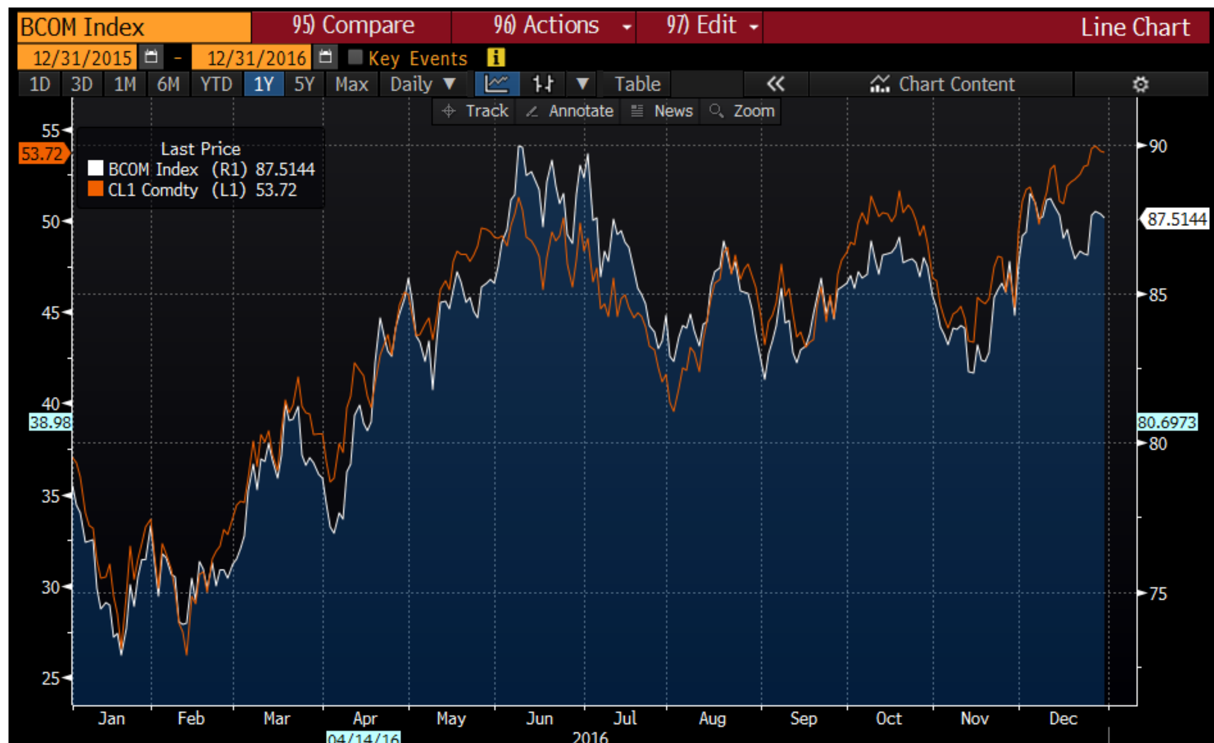
We expect for 2017 a very gradual upward shift of the benchmark yield curve in the US, and stable yield curves in Europe and Japan. Investor should therefore be cautious of long-maturity USD bonds, since the move in yields could wipe out several years of income.

Emerging market bonds, high-yield bonds and senior loans still offer moderately attractive yields and the latter offer additionally a “floating rate” feature, making them less vulnerable to US interest rate rises.

Commodities

The year 2016 started with a record decline of the oil price, down to USD 26 per barrel, triggering a slow and painful structural rebalancing process (that may last for years). Towards mid of the year, a tangible oversupply response from important producers was noticeable (mainly from US producers) and the oil price recovered substantially (up to ~USD 54/bbl).

In parallel, positive economic data from China and USA triggered the recovery of industrial metals (e.g. iron, aluminum, copper).



BCOM = CTRB Bloomberg Commodity Index; CL1 = Generic 1st Crude Oil (WTI)

Source: Bloomberg

Over the long term, commodities are likely to deliver positive but unattractive returns on a risk-adjusted basis, so only tactical commodity opportunities should be pursued as they emerge.

Foreign exchange markets

2016 was characterized by large ForEx moves, triggered mostly by political uncertainty (e.g. Brexit -> GBP, Trump's election -> MXN), and leading to a relative overvaluation of safe-haven currencies such as the USD and CHF (see picture below).

Looking forward, currency moves will continue been driven by the monetary policy regimes chosen by the main Central banks. We expect a stronger performance from the Euro, as the ECB is expected to scale back its easing program. The GBP shall continue to be vulnerable to the Brexit negotiations, but it should trade stronger once clarity emerges.

Emerging currencies are expected to strengthen against the USD moderately in 2017, as the block continues with its economic recovery, driven by improving commodity prices.

BBDXY = Bloomberg US Dollar Index

Source: Bloomberg

Market outlook for the year 2017

Our base scenario for 2017 is for the global economic growth to continue, with a slight improvement in momentum compared to 2016, thanks to an expected US fiscal stimulus, a degree of recovery in Europe, and continued solid growth in emerging markets (especially in China).

The market performance will surely also be influenced by the answer of the following two questions:

- Faced with a lack of growth and inflation, will central banks choose to stop their loose monetary policies (to avoid distorting the local bond markets even more), to maintain them, or go even further (e.g. buying equities)?
- Faced with rising overseas competition, will the electorate stick to the status quo / the globalization path or turn to protectionism?

The negative yields on many sovereign bonds will continue to penalize more defensive strategies, favoring risk-taking strategies based on equities and less liquid instruments. We will nevertheless continue implementing well diversified portfolios with a systematic allocation approach.

We will continue to monitor the markets closely for any sign of deterioration of the global economy to be able to react accordingly.