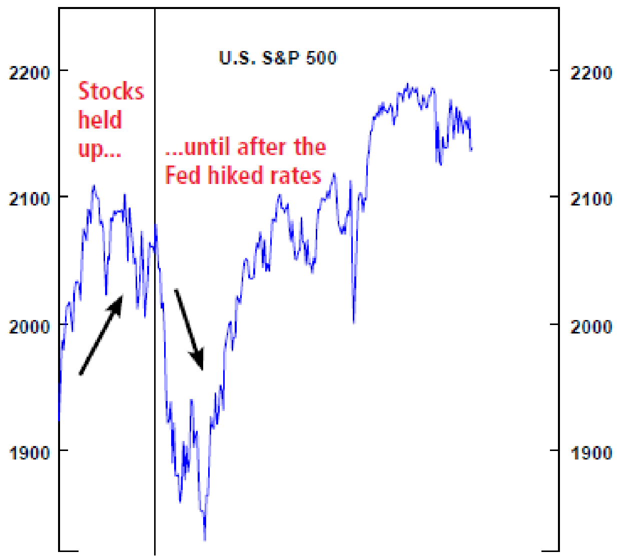

# Quarterly Investment Letter

**Q4/2016**

## Getting answers soon...

The first 10 months of the year have been very much aligned to our base case scenario of slowing growth globally with only Europe showing slightly better than anticipated numbers. The markets have gone through a couple of corrections only to quickly re coup these losses, the latest one being the market rebound post the Brexit vote (see chart 1). Since then, markets have been relatively uneventful as the earnings' season met expectations while there were no big news or events affecting the markets which even showed some level of complacency.

**Chart 1: US equties remain fragile ahead of FED decision**




Source: BCA

**Most of the attention was focused on the US presidential debate and on the timing of the FED's next rate increase**. We stick to our view that the FED will increase rates by 0.25% in December based on recent solid economic data points.

In our last Macro Outlook, we mentioned that equities were richly valued, especially in the US and that consequently, we would expect Emerging Market equities to outperform the US. That is what we witnessed with the S&P500 being up 1.3% while the MSCI Emerging

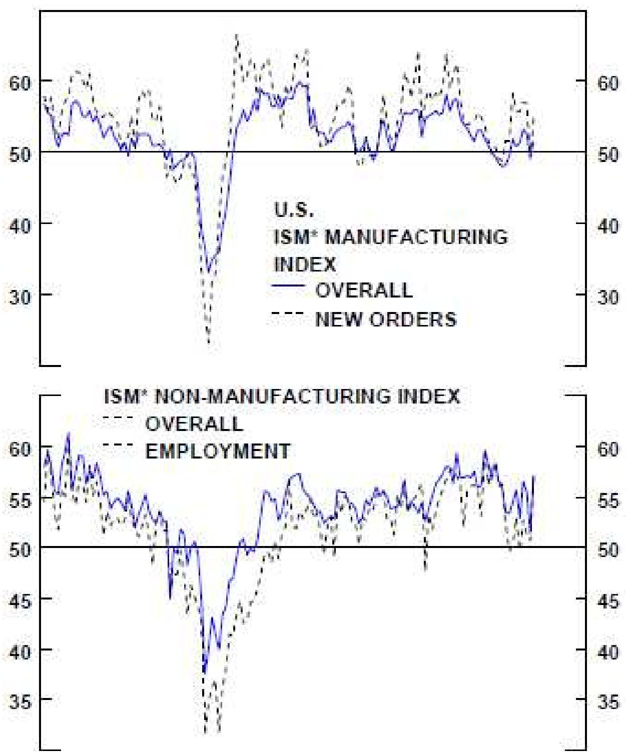
## Summary Points

- **Markets showed high levels of complacency** brushing aside the negative Brexit vote consequences as all risky assets quickly recouped their losses.
- **Global growth has softened** but shows signs of stabilization. **US elections dominate market sentiment in the short term** and we expect the FED to raise rates in December.
- **Equity markets have rebounded in July** but have stabilized and consolidated since early August ahead of the US elections waiting for uncertainty to dissipate.
- **Emerging Market equities and bonds** have offered the strongest performances as these have caught investors' attention lately. We are still positive but careful around US elections and the expected FED rate increase.
- **US High Yield bonds and US/European Loans** have been the strongest asset classes in the fixed income space and we believe they still offer great value going forward.
- While we are still **cautiously positive on risky assets**, we anticipate that the US elections and the expected December FED interest rate hike could provide catalysts for increased volatility in the coming months.
- **Private Loan investments are offering very attractive yields** and we allocate more capital to this illiquid asset class for investors, who are willing to lock up capital for 3-7 years.

Markets rose 8.5% since June to the end of October. Emerging Markets benefitted also from recovering commodity prices, which is particularly the case for the energy sector.

We were positively surprised by how well European stocks in general fared in this post-Brexit vote rally (+2.8%) given that we had expected capital to be diverted to other markets given the growing uncertainty surrounding the Brexit negotiations. UK markets did very well (+6.9%) mainly on the back of a significantly cheaper currency helping many exporters and boosting tourism. Although the UK has been able to avoid an immediate recession, the country is still bracing for the aftershock, with expected volatility and difficult times, as firms and politics evaluate how to concretely react and negotiate Brexit.

**Chart 2: US ISM data recovered strongly last month**

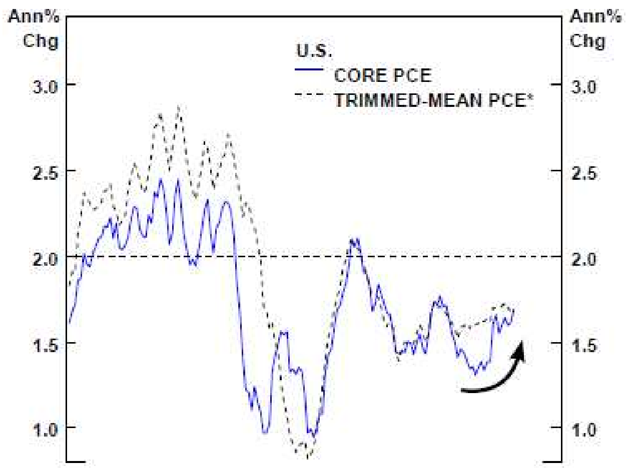



Source: BCA

A **moderately growing global economy is supportive for credits** and consequently, High Yield bonds have continued to do very well. Emerging Market bonds (in both local and hard currencies) have also outperformed most other developed market investment grade bonds by a significant margin, confirming our view that investors are increasingly looking to re-allocate to Emerging Markets in general, after having already been under-weighted in the region for a few years.

With **interest rates already being negative** for many **developed countries** at the end of the second quarter and pushed even lower by the post-Brexit fears, Government bonds had almost no chance to generate positive returns. We are witnessing these bond prices to look fragile and vulnerable, something that came already into effect in October. Should the FED interest rate cycle move as widely anticipated, the vulnerability of rate sensitive bonds will further increase. Bearing in mind the turning US core inflation numbers (see chart 3) in combination with good ISM data (see chart 2) and a strong employment market, a move higher in US rates is almost inevitable.

**Chart 3: US Core inflation turning the corner**




Source: BCA / FED

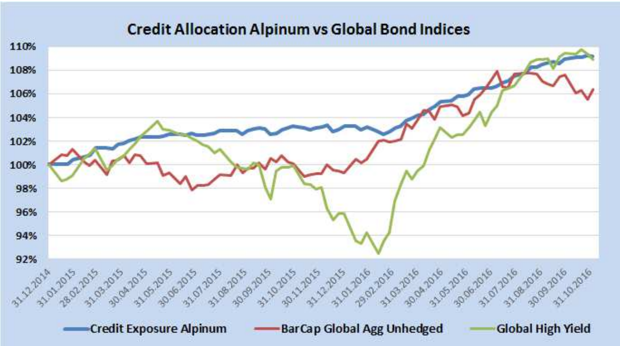
**Our macro view has not meaningfully changed since the beginning of the year and our July update proved to still be relevant.** For sure, we are concerned that a Trump win could cause heightened volatility in the currency, bond and equity markets of Emerging Markets given his proposed economic policies. Trump has also been very vocal that he would change Janet Yellen at the head of the FED as he feels rates need to normalize much faster. On the contrary, a Clinton win would certainly be comforting for (Latin) Emerging Markets investors as the FED would be likely to stay the course of very gradual normalization, not affecting too much the USD which is so important to the stability of these Emerging Markets countries. A Trump win could also give support to already richly valued US equities as the significant intended corporate tax rate cut would increase earnings. Given the uncertain outcome of the vote we are hesitant to deploy much capital in Emerging Market equities and bonds ahead of the election.

## Model Portfolio Positioning

Our Absolute Return model portfolio was **positioned to take advantage of the Emerging Market bond rally as well as the global High Yield bonds and loans**, which continued their strong performance. As soon as it became clear that investors brushed aside the Brexit vote impact in early July, we decided to deploy the relatively high cash levels we held after the referendum. We felt that the risk-reward of the High Yield bonds, Loans and Emerging Market bonds as well as mortgage-backed loans were offering our investors the best opportunities to deploy the extra capital ahead of the US election and the anticipated December FED rate hike.

Our structural overweight positions in corporate loans as well as short term High Yield bonds have paid off nicely over the last quarter despite the fact that corporate loan default rates rose to 2.4% and marking the highest level in 5.5 years. Please see in chart 4 the development of our total credit book since the end of 2014 until October 2016.

**Chart 4: Alpinum Credit Exposure vs Global Bond Indices**

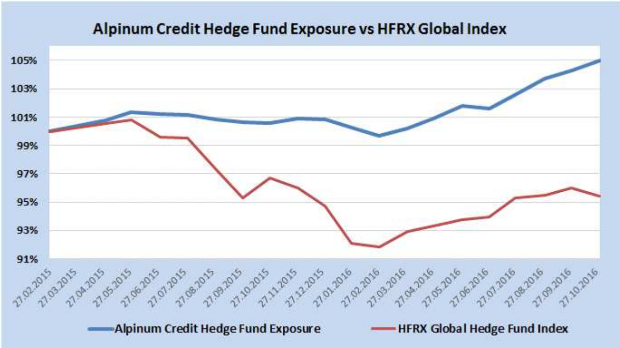



Source: Bloomberg / BoAML / Alpinum Investment Management

Our hedge fund strategies, which experienced a relatively challenging time at the beginning of the year, have been able to start delivering interesting risk-adjusted performance. **Equity Long-Short managers** generated positive returns, but still had **to cope with difficult market dynamics**. On the contrary, the Credit Long-Short managers have been benefitting from their fundamental research and tactical trading during relatively calm and positive market conditions.

We are particularly encouraged to see how the **credit hedge funds have been recently unlocking value**.

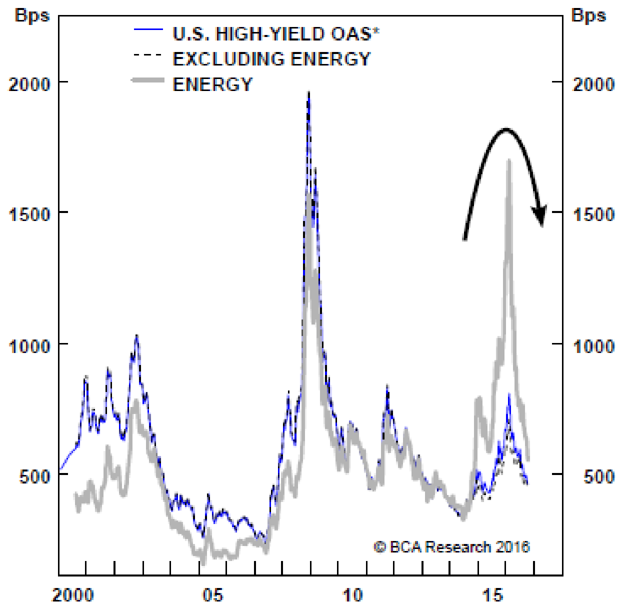
**Chart 5: Credit centric HF allocation vs HFRX Global Index**




Source: Bloomberg / HFRX / Alpinum Investment Management

After a stressful start for credit in general at the beginning of the year, the credit hedge funds needed some time for their asset class to normalize and their investments to finally benefit. Chart 5 above shows the performance of our credit centric Hedge Fund allocation over the last 1.5 years.

**Chart 6: US High Yield spreads have tightened**



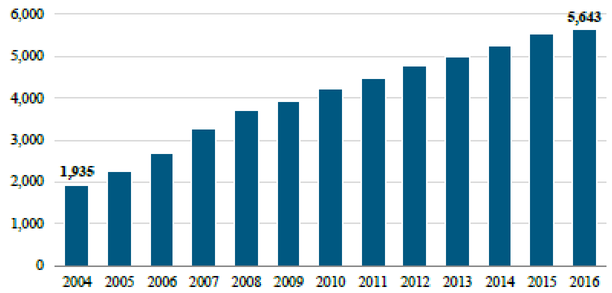

Source: BCA / Barclays

As described before, High Yield bonds have generated very strong performance since March this year and as a consequence, credit spreads have tightened a lot (see chart 6) and a more cautious stance to this asset class is generally warranted. We continue to hold on to our strategic holdings in **short term high yield bonds and corporate loans, which are cherry picked and offer only very limited default risk, but still offer in combination a yield of around 5% p.a.**

## Private debt – A growing asset class

In a world of historical low interest rates it is generally hard to identify attractive yield opportunities without taking undue risks. Even when we anticipate that the FED will start to normalize its interest rate policy and lift the yield curve, the income generation from "safe" bonds such as high quality investment grade or US Treasury bonds will remain meagre. The situation gets even worse when we turn to European or Japanese bonds, earning in many instances negative yields. In this environment private debt looks like a "yield island" offering an average yield of 7-8% p.a. for senior secured loans of well backed small and medium sized companies ("SME's"; described as middle market). **We have invested in this illiquid asset class since many years for clients who are willing to lock up capital (typically for 3-7 years) and give even more weight to this asset class going forward.**

**Chart 7: Middle market companies owned by PE firms**




Source: S&P / Angelo Gordon

The above chart is an example to demonstrate the rapidly **growing number of small and medium sized companies tapping the private market** for their borrowing needs. Non-bank lenders are increasingly an alternative to the traditional bank lending as the regulatory burden for commercial banks has steadily increased since the financial crisis. Banks need to reduce their balance sheets because of the regulatory environment. As a consequence, it is in many instances not efficient for them to hold exposure to small- and midsized companies. Alternative lenders step in to provide the lending and offer interested investors to participate in this asset class via closed end fund structures.

Privately structured deals have led in the past to high absolute and relative returns. Not only are the private lenders able to ask for a higher yield compensation, but they are also able to negotiate for "upfront fees" (as a compensation for the underwriting work) and call protection what leads to a **target return for senior loans of 7-8% p.a.**

The additional loan spread between SME's and large corporate loans from 2010 to 2015 were 155 bps higher as it is demonstrated in the chart below.

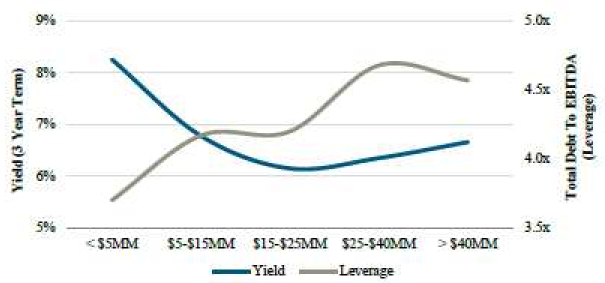
**Chart 8: Average yield for middle market loans**


Source: S&P Capital IQ LCD / Angelo Gordon

Historical analysis shows that experienced private debt lenders **suffer lower default- & loss rates as compared to the "public" market**. On average, directly originated middle market senior secured debt typically offers not only a higher yield, but has on average also a lower debt/EBITDA leverage profile than large syndicated corporate loans.

Chart 9 well illustrates the fact that smaller credits have more conservative capital structures in place. More equity within the capital structure leads not only to lower leverage ratios of smaller companies versus its larger counterparts, but also to higher recovery rates in case of default.

**Chart 9: Middle market loans are more conservative**




Source: Thomson Reuters / Angelo Gordon

We have already been successfully investing in illiquid credit for many years and have also exposure in direct lending funds. The asset class is growing rapidly and accounts today for **more than 2'000 funds** with an aggregate value of more than USD 140 bn. Besides experience and superior selection skills of the management team, **portfolio diversification** is an absolute necessity in running a successful long term private loan portfolio. A **diligent underwriting process** with **strong covenants** in the documentation and an effective loan **monitoring process are other key success factors**.

| Absolute Return Mandates | Comments |
|---|---|
| **Equities** | |
| ▪ Keeping Equities at a conservative allocation with more exposure to Emerging Markets/Asian equities.<br><br>▪ Given that valuations in the US are quite stretched but that investors are still viewing the US as the strongest economy in the world, there is always potential for some moderate upside, especially post-election.<br><br>▪ Wait after the US elections to increase further exposure to Emerging Market equities with a preference for Asia (ex-Japan). | ▪ US Equities are still quite expensive from a historical perspective and corporate margins are pressured by rising wages. The general upside of the markets seems quite limited with the lack of global growth.<br><br>▪ European Equities are trading cheaper compared to US Equities but after Brexit, this discount is clearly justified and there will be headwinds during the Brexit negotiations.<br><br>▪ Emerging Markets Equities have finally started to catch-up on their Developed Market counterparts a few months ago and we expect that trend to continue, although with increased volatility along the way. |
| **Credit / Fixed Income** | |
| ▪ Stay away from Developed Markets' Government bonds.<br><br>▪ Overweight US High Yield Bonds, US Loans, European Loans and Emerging Market debt in both US dollars and local currencies.<br><br>▪ Overweight positions in structured credit (mainly European CLO's and US RMBS).<br><br>▪ We favor Private Corporate Loan funds investing into European and US mid-size firms. | ▪ Yields on quality bonds are negative in most Developed Markets around the world (ex-US where they are historically at their lowest points), providing very poor prospects of return for many years to come.<br><br>▪ The materially brighter outlook for many Emerging Market countries benefitting from low US and global yields, moderate global growth, a stabilization of Chinese economy, ample global liquidity and a stabilizing USD are all positive signs for High Yield bond/loans investing in this asset class.<br><br>▪ Private loans carry a significant illiquidity premium in the order of 3% per year. |
| **Alternatives** | |
| ▪ The funds are now harvesting great opportunities in the credit space, including the US middle market. Systematic strategies are for us still not interesting. | ▪ Systematic strategies are affected by the constant intervention of Central Banks which are affecting the historical relationships that such strategies are exploiting. |
| **Real Assets** | |
| ▪ Gold is expected to still be in a trading range between 1250 and 1400 for the coming months. | ▪ For gold to be fundamentally supported, we would need to see the global expectations on inflation turn positive and only the US seems to show very mild inflation at the moment. |

| Long Only Mandates | Comments |
|---|---|
| **Equities** | |
| ▪ Keeping Equities at a slightly conservative allocation with the aim of buying Emerging Markets/Asian equities once positive momentum would be confirmed.<br><br>▪ Given that valuations in the US are quite stretched but that investors are still viewing the US as the strongest economy in the world, there is always potential for some moderate upside, especially post-election.<br><br>▪ Wait after the US elections to increase further exposure to Emerging Market equities with a preference for Asia (ex-Japan). | ▪ US Equities are still quite expensive from a historical perspective and corporate margins are pressured by rising wages. The general upside of the markets seems quite limited with a lack of global growth.<br><br>▪ European Equities are trading cheaper compared to US Equities but after Brexit, this discount is clearly justified and there will be headwinds during the Brexit negotiations.<br><br>▪ Emerging Markets Equities have finally started to catch-up on their Developed Market counterparts a few months ago and we expect that trend to continue, although with increased volatility along the way. |
| **Credit / Fixed Income** | |
| ▪ Stay away from Developed Markets' Government bonds.<br><br>▪ Only consider investing into "BBB/BBB-" Investment Grade corporate bonds in USD taking some medium-term maturity.<br><br>▪ Mortgage-Back Securities in the US are offering attractive yields over any Government and corporate bonds for a similar risk level.<br><br>▪ Over-weight US High Yield Bonds, US Loans, European Loans and Emerging Market debt in both US dollars and local currencies.<br><br>▪ We favor Private Corporate Loan funds investing into European and US mid-size firms. | ▪ Yields on quality bonds are negative in most Developed Markets around the world (ex-US where they are historically at their lowest points), providing very poor prospects of return for many years to come.<br><br>▪ Mortgage-backed securities, some of which have an implicit Government backing, offer a "complexity" premium that can get investors about 2 to 3% more yield for the same duration. These are not the same complex structures which caused the financial crisis of 2008.<br><br>▪ The materially brighter outlook for many Emerging Market countries benefitting from low US and global yields, moderate global growth, a stabilization of Chinese economy, ample global liquidity and a stabilizing USD are all positive signs for High Yield bond/loans investing in this asset class.<br><br>▪ Private loans carry a significant illiquidity premium in the order of 3% per year. |
| **Commodities / Forex** | |
| ▪ Gold is expected to still be in a trading range between 1250 and 1400 for the coming months.<br><br>▪ Oil should now consolidate slightly higher given that the OPEC/Russia have been recently able to agree to some output reductions. | ▪ For gold to be fundamentally supported, we would need to see the global expectations on inflation turn positive and only the US seems to show very mild inflation at the moment.<br><br>▪ The oil price will be capped on the upside around 55/60 USD levels since many shale producers would re-start production above these levels. |

# Asset Class Conviction Levels for Absolute Return Mandates

The below conviction table reflects the investment team's conviction level of the absolute expected return outlook of an asset class/strategy in relation to "cash".

| Equities | Valuations | Corporate Profitability | Index Momentum | Underweight | | Conviction Level over 6 Months Neutral | | Overweight |
|---|---|---|---|---|---|---|---|---|
| North America | Rich | Stable | Neutral | ☐ | ☑ | ☐ | ☐ | ☐ |
| Europe | Rich | Stable | Neutral | ☐ | ☑ | ☐ | ☐ | ☐ |
| China | Cheap | Stable | Positive | ☐ | ☐ | ☑ | ← ☐ | ☐ |
| Japan | Rich | Stable | Neutral | ☐ | ☑ | ☐ | ☐ | ☐ |
| Asia - Emerging Markets | Cheap | Stable | Positive | ☐ | ☐ | ☑ | ☐ | ☐ |
| Others - Emerging Markets | Fair | Worsening | Positive | ☐ | ☐ | ☑ | ☐ | ☐ |

| Fixed Income | Central Banks Policy | Credit Spreads | Expected Default Rates | Underweight | | Conviction Level over 6 Months Neutral | | Overweight |
|---|---|---|---|---|---|---|---|---|
| US - Treasury Bonds | Tightening | - | - | ☐ | ☑ | ☐ | ☐ | ☐ |
| Euro - Government Bonds | Stimulating | - | - | ☑ | ☐ | ☐ | ☐ | ☐ |
| US - Investment Grade Bonds | Tightening | Fair | Rising | ☐ | ☑ | ← ☐ | ☐ | ☐ |
| Europe - Investment Grade Bonds | Stimulating | Rich | Stable | ☐ | ☑ | ← ☐ | ☐ | ☐ |
| Emerging Market Local Currency | Neutral | Cheap | Rising | ☐ | ☐ | ☐ | ☑ | ☐ |
| Emerging Market Hard Currency | Neutral | Fair | Rising | ☐ | ☐ | ☑ | ☐ | ☐ |
| US High Yield / Loans | Tightening | Fair | Rising | ☐ | ☐ | ☐ | ☑ | ☐ |
| European High Yield / Loans | Stimulating | Fair | Stable | ☐ | ☐ | ☐ → | ☑ | ☐ |

| Commodities | Cost of Production | Market Sentiment | Price Momentum | Underweight | | Conviction Level over 6 Months Neutral | | Overweight |
|---|---|---|---|---|---|---|---|---|
| Gold | Neutral | Positive | Negative | ☐ | ☐ | ☑ | ☐ | ☐ |

| Hedge Fund: Strategies | HF Strategy Momentum | Equity Index Momentum | Sector Dispersion | Underweight | | Conviction Level over 6 Months Neutral | | Overweight |
|---|---|---|---|---|---|---|---|---|
| Equity Long-Short | Positive | Neutral | Positive | ☐ | ☐ | ☐ | ☑ | ☐ |
| Credit Long-Short | Positive | Neutral | - | ☐ | ☐ | ☐ | ☑ | ☐ |
| Event-Driven - Corporate Actions | Positive | - | - | ☐ | ☑ | ☐ | ☐ | ☐ |
| Global Macro | Negative | - | - | ☐ | ☑ | ☐ | ☐ | ☐ |

| Hedge Fund: Regional Focus | Sector Dispersion | Equity Index Momentum | Corporate Activity Level | Underweight | | Conviction Level over 6 Months Neutral | | Overweight |
|---|---|---|---|---|---|---|---|---|
| Hedge Fund: North America | Positive | Neutral | Positive | ☐ | ☐ | ☑ | ☐ | ☐ |
| Hedge Fund: Europe | Positive | Negative | Positive | ☐ | ☐ | ☑ | ☐ | ☐ |
| Hedge Fund: China / Japan | Positive | Negative | - | ☐ | ☐ | ☐ | ☑ | ☐ |
| Hedge Fund: Emerging-Markets | Neutral | Neutral | - | ☐ | ☐ → | ☑ | ☐ | ☐ |

# Asset Class Conviction Levels for Long Only Mandates

The below conviction table reflects the investment team's view of the relative expected return of an asset class in relation to traditional well-recognized benchmarks such as BarCap Global aggregates (bonds) and MSCI World (equities).

| Equities | Valuations | Corporate Profitability | Index Momentum | Underweight | Conviction Level over 6 Months ← | Neutral | → | Overweight |
|---|---|---|---|---|---|---|---|---|
| North America | Rich | Stable | Neutral | ☐ | ☐ | ☑ | ☐ | ☐ |
| Europe | Rich | Stable | Neutral | ☐ | ☐ | ☑ | ☐ | ☐ |
| China | Cheap | Stable | Positive | ☐ | ☐ | ☐ | ☑ | ☐ |
| Japan | Rich | Worsening | Neutral | ☐ | ☑ | ☐ | ☐ | ☐ |
| Asia - Emerging Markets | Cheap | Stable | Positive | ☐ | ☐ | ☐ | ☑ | ☐ |
| Others - Emerging Markets | Fair | Stable | Positive | ☐ | ☐ | ☑ | ☐ | ☐ |

| Fixed Income | Central Banks Policy | Credit Spreads | Inflation | Underweight | Conviction Level over 6 Months ← | Neutral | → | Overweight |
|---|---|---|---|---|---|---|---|---|
| US - Treasury Bonds | Tightening | - | Stable | ☐ | ☑ | ☐ | ☐ | ☐ |
| Euro - Government Bonds | Stimulating | - | Stable | ☑ | ☐ | ☐ | ☐ | ☐ |
| US - Investment Grade Bonds | Tightening | Fair | Stable | ☐ | ☐ | ☑ ← | ☐ | ☐ |
| Europe - Investment Grade Bonds | Stimulating | Rich | Stable | ☐ | ☑ ← | ☐ | ☐ | ☐ |
| US High Yield | Tightening | Fair | Stable | ☐ | ☐ | ☐ | ☑ ← | ☐ |
| US Short Term High Yield | Tightening | Fair | Stable | ☐ | ☐ | ☐ | ☑ ← | ☐ |
| US Loans | Tightening | Fair | Stable | ☐ | ☐ | ☐ | ☐ | ☑ |
| US Municipal Bonds | Tightening | Cheap | Stable | ☐ | ☐ | ☑ | ☐ | ☐ |
| European High Yield | Stimulating | Rich | Stable | ☐ | ☐ | ☑ | ☐ | ☐ |
| European Short Term High Yield | Stimulating | Rich | Stable | ☐ | ☐ | ☑ | ☐ | ☐ |
| European Loans | Stimulating | Fair | Stable | ☐ | ☐ | ☐ | ☐ → | ☑ |
| US/EUR Preferred Securities | Stimulating | Fair | Stable | ☐ | ☐ | ☐ | ☐ | ☑ |
| US/EUR Asset Backed Securities | Tightening | Cheap | Stable | ☐ | ☐ | ☐ | ☑ | ☐ |
| Emerging Market Local Currency | Neutral | Cheap | Mixed | ☐ | ☐ | ☐ | ☑ | ☐ |
| Emerging Market Hard Currency | Neutral | Fair | Mixed | ☐ | ☐ | ☐ | ☑ | ☐ |
| Emerging Market High Yield | Neutral | Fair | Mixed | ☐ | ☐ | ☑ | ☐ | ☐ |

| Commodities | Cost of Production | Market Sentiment | Price Momentum | Underweight | Conviction Level over 6 Months ← | Neutral | → | Overweight |
|---|---|---|---|---|---|---|---|---|
| Gold | Neutral | Positive | Negative | ☐ | ☐ | ☑ | ☐ | ☐ |
| Oil | Positive | Positive | Positive | ☐ | ☐ | ☐ → | ☑ | ☐ |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