Quarterly Investment Letter

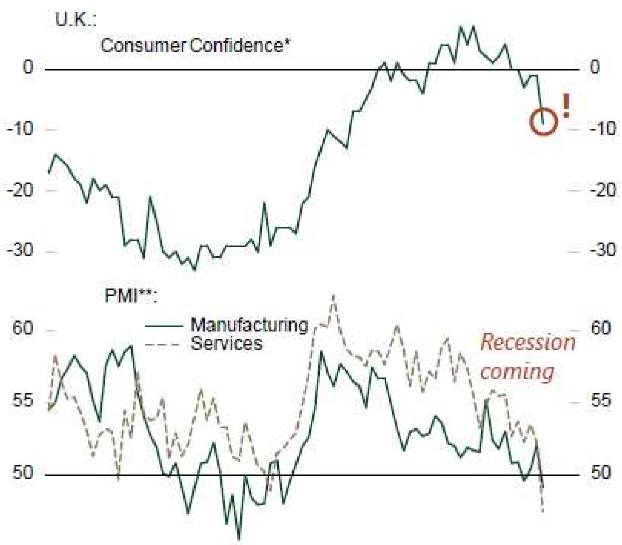
Q3/2016

"Search for Yield" got a new boost after Brexit...

The investment world was **shocked by the Brexit** vote. Everyone in the UK seems to have been surprised, even the promoters of Brexit themselves. Now everyone will have to live with the consequences of the **uncertainties for months and years to come**. Brexit was not our base scenario but we had prepared our portfolios for such a potential outcome.

Just as the global growth picture seemed to have stabilized in the last couple of months and the visibility of investment opportunities was increasing, especially in Europe, **Brexit came to cloud this view** once again. The risk of unforeseen events derailing the relatively low and somehow fragile global growth (especially in Europe) and taking down risky assets with it, has increased, although we think that the major regions will **avoid slumping into recession**. Aside from a **potential UK recession** in the coming months, backstopped to some degree by the plunging currency helping exporting companies and also by the Bank of England's proposed stimulus plan, the **biggest risk lies with the increasing probability of a Euro implosion** later down the road.

Chart 1: UK economy slows down



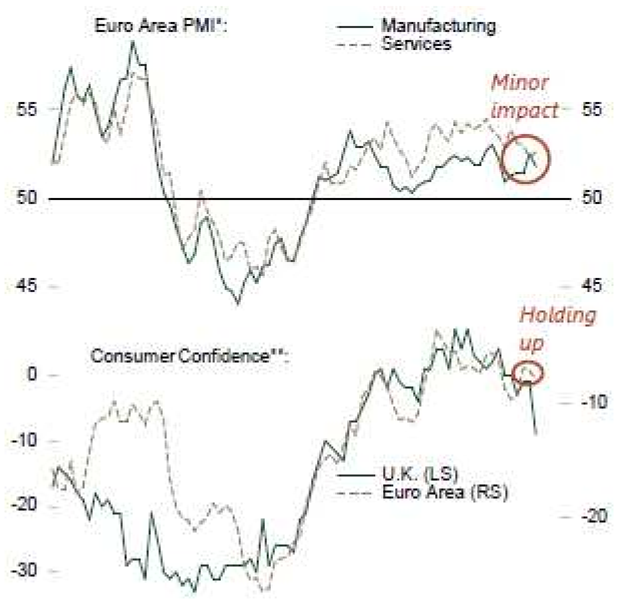
Source: MRB

Summary Points

- Global growth will only be moderately affected by Brexit. In Europe where there will be months of uncertainty affecting business and consumer sentiment, we expect a larger impact.
- Interest rate levels of government bonds have reached all-time low levels including negative nominal yields in countries like France, Italy or Spain. Many investors have not yet realized that this will have a major influence on future return generation.
- The US FED should delay any interest rate hike to either December or next year (if the Brexit impact is contained) to prevent derailing the global economy and not to be perceived as politically biased in the US election race.
- Tight US election polls would add to market volatility as a Trump government would be negative for Emerging Markets in particular.
- Emerging Markets led by China are slowly turning the corner and offering better value, especially as the USD stabilizes and does not resume its acceleration path.
- A continued cautious approach to investing is warranted given the macro uncertainties. Volatility will persist but some positive performance should ensue.
- Equities are not very attractive on a risk-reward basis but still can offer the best nominal expected performance. We prefer Emerging Markets valuations over the US while Europe will face headwinds.
- A prolonged low growth economic cycle is supportive for high yield bonds and loans in US and in Europe. Default rates will slightly increase, however, they are mainly concentrated on the commodity sector.
- Emerging Markets Bonds in both local and hard currencies are still displaying interesting value.

Politics in the EU will need to react quickly, strongly and with a level of coordinated efforts probably never seen until today. Politics need to convince the markets that the Euro project will adapt and react to the growing concerns of other countries, which might be tempted to leave as well. If again the politics get caught-up in endless discussions leading nowhere, investors will find great opportunities speculating against the region; something that could deal a devastating blow to the economy and be fatal to the Euro.

Chart 2: EUROZONE with minor impact so far

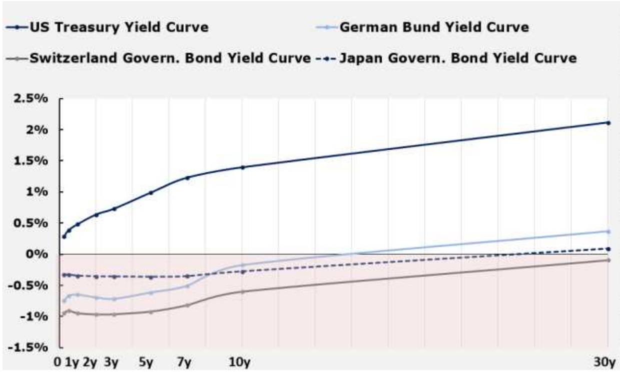


Source: MRB

Outside of Europe, the **United States is still in a good shape** with a slowly growing self-sustaining economy having a very small direct economic exposure to the UK while China's growth fears are waning. The risks and volatility are expected to remain higher in the coming months, probably until after the US elections. **Investing will feel uncomfortable and challenging** but through the fog, **we are still finding interesting opportunities**.

Looking back to the first half of the year, the violent equity and commodity correction experienced in the first 6 weeks of the year and the current post-Brexit market stress have offered a **lot of challenges and volatility** providing mixed returns for the various asset classes so far on a YTD-basis. However, long term government bond investments were an exception as they provided throughout the year high returns. Consequently, bond yields have reached **all-time low levels** as investors placed more money in these "safe-haven" investments at times of increased volatility and low inflation. But these are bad news for the future return generation as many countries offer now negative yields. For example, short term government bond yields of countries like France, Italy or Spain trade now also at negative yields.

Chart 3: Government bond yields at all-time low levels



Source: Bloomberg / Marcuard Heritage / Alpinum Investment Management

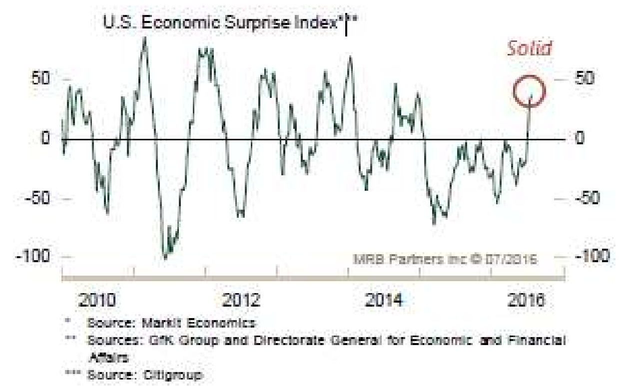
The world's growth prospects were stabilizing after a difficult 2015 when world growth worries, especially fuelled by Chinese fears of an economic growth's "hard-landing", plagued the markets and capped risky asset returns. Unfortunately, just as investors could witness positive and encouraging signs of a "soft-landing" in China, better than anticipated Eurozone growth and still robust US economy, the surprising **Brexit result** changed the picture. **Uncertainty about the path of the world's growth** will now be a reality for the coming months, probably until the US elections will be over.

The issue with Brexit is not much about the overall direct world growth impact, as the UK's main trading partners are located mainly in Europe and represent only a very tiny fraction of the US economy. It has to do with **businesses, consumers and investors' sentiment potentially turning negative** enough to drag in its path the real global economies.

This wave of **negativity could also be exacerbated by investors' increased focus on the dysfunctionalities of the Euro's politics and needed reforms**, leaving ample room for renewed negative concerns about the banking sector, the Greek situation, the growing anti-Euro sentiment, or the faith in the Euro. All of these would simply add a lot of uncertainty and asset prices volatility along the way, preventing major economies from benefitting from a more conducive market environment necessary to sustain and grow the currently rich valuations on most investment asset classes. **Our base case scenario is that these fears will have an impact, especially in Europe** (up to -0.5% impact on GDP) with some collateral consequences around the world. But the relative robustness of the global growth, although very low by historical standards, helped by the coordinated actions of the different Central Banks keeping accommodative measures/stances, will allow **global economies to avoid a recession.**

The **US economy has shown resilience over the first 6 months of the year** when markets were spiralling downwards and energy prices were collapsing and putting a lot of stress on already pressured energy and commodity sectors, responsible for the majority of the large private investments in the country.

Chart 4: US economy shows resilience



Source: Markit Economics, MRB, Citigroup

The unemployment rate has continued to decline and wage growth has started to increase in some areas and industries, further supporting the view that the US is in good shape and could sustain more interest rate hikes (although very moderately) if we only would look at the country itself in isolation. The problem is that although the US has been more decoupled (less reliant) from the global markets in recent years, its **growth being still relatively low around 2%** for the last 12 months, its **economy is still quite vulnerable** to any significant changes in business and investment sentiment across other regions of the world.

The FED would be tempted to raise rates, but this could affect more significantly other countries and the **feedback loop could come back to hurt the US economy** quickly. Therefore, given the recent Brexit and the uncertain impacts it will have in the coming months, we do not believe that the FED will dare raising rates in the coming months and would most likely not want to do so before the US presidential election is over not to be perceived as having interfered in the election. **We believe that the best case scenario would be a single rate hike in December** if the economy shows moderate re-acceleration in the coming months.

We believe that Brexit will have a limited direct negative impact on US GDP and are still forecasting a 12-month GDP growth between 1.25% and 1.75%. Given that the FED interest rate hikes expectations are now much lower post-Brexit, this should **stabilize the USD versus most other currencies**.

China has been the main center of focus last year when its economy was decelerating relatively quickly only to now stabilize at around 6.5% GDP growth level for 2016. Recent months have shown that the **Chinese politics have so far been successful to implement market reforms,** which have the consequence of limiting the GDP growth while stimulating the economy via various infrastructure projects, accommodative monetary policies and a modest devaluation of its currency. Given that China is the only large single growth contributor to the world's economy, we are pleased to see that it has now fallen out of the market's focus. Although, it is clear that the country still has many issues to address like the amount of credit, the non-performing loans within the banking sector and its rich real estate market.

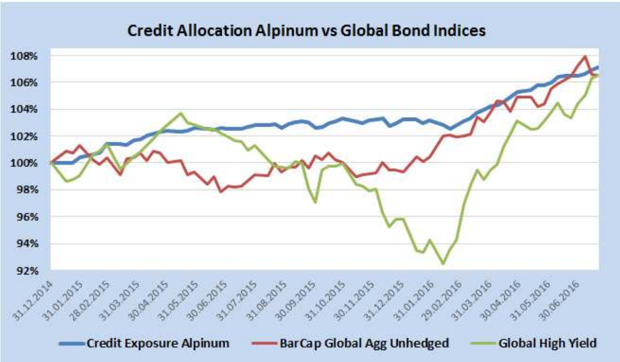
Japan has seen the **Abenomics plan recently falter** and unpopular decisions such as raising the VAT rate had to be postponed as the economy has faltered and is now flirting with recession again. The **Yen had been strong in June on safe-haven demand**, but growth is receding and deflation has made a comeback. We are therefore not very optimistic for any investment in Japan for the coming months as we do not see imminent fundamental changes to the situation. There are always pockets of opportunities but one has to be very selective and currency hedged.

The **Emerging Market countries have been able to stabilize** as a whole over the last months following a rebound in the commodity and energy prices and the soft landing of the Chinese economy. There are nowadays many differences between Emerging Market countries. However, in aggregate, these countries show better fundamentals and growth prospects as compared to Europe and the US even if the EMs' fiscal situation has deteriorated over the last years, their financial situation is still quite enviable versus most developed countries. Valuations in some of these countries (especially in Asia) have been under significant pressure and **we see more potential opportunities and upside** for investors at acceptable levels of risk nowadays than in the last few years, although any significant growth slowdown in Europe and in the US would directly have an impact on all Emerging Markets.

Model Portfolio Positioning

Our **Absolute Return Model Portfolios have been able to weather the storm relatively well in Q2 and generating positive returns for the quarter** despite the heightened volatility after the Brexit vote. Based on risk-/return assumptions we had held on to our overweight position in credit versus straight equity exposure as the latter would absorb a very large portion of our risk budget given the large return swings this asset class experiences. Our credit allocation provided very solid returns with little volatility, what is well illustrated in the chart below.

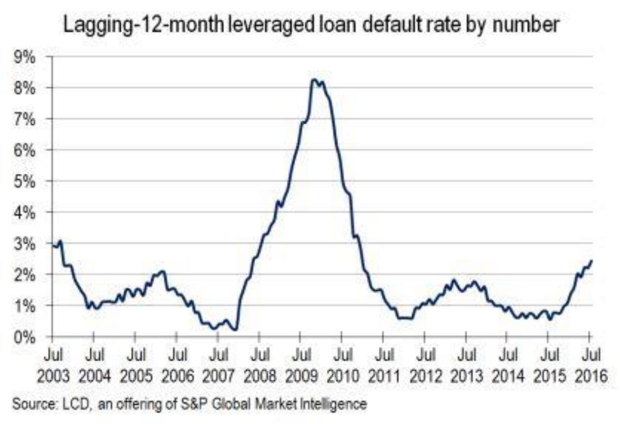
Chart 5: Alpinum Credit Exposure vs Global Bond Indices



Source: Bloomberg / BoAML / Alpinum Investment Management

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 2.44% and marking the highest level in 5.5 year.

Chart 6: Loan Defaults at highest level in 5.5 years



Source: LCD

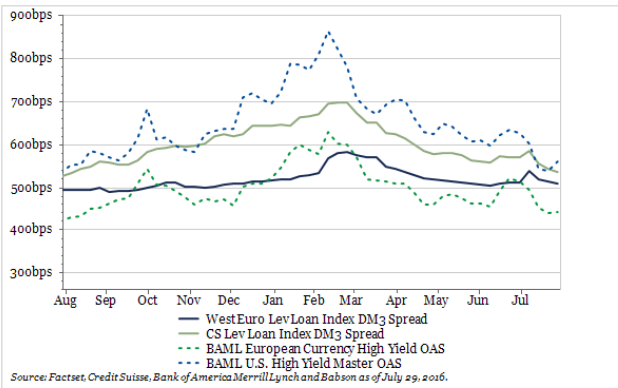
Our allocations in corporate loans are very selective and have a focus on "boring" businesses with low cyclicality and good visibility. As a consequence, our portfolios have not been directly affected by the increasing default rate. Moreover, as the table in chart 7 does well illustrate, the corporate defaults were mostly concentrated on the commodity sectors, in which we hold close to zero exposure.

Chart 7: Defaults mainly concentrated in commodity sectors

Source: LCD

Coming back on the macro discussion and the inherent outlook the question to be answered is where does the mixed global macro picture leave us as investors and what would be the best way to navigate these tumultuous markets? The answer lies in greater **portfolio diversification, lowered return expectations** and in concentrating our investments into the ones that offer the best risk-reward, avoiding the ones that may have more upside potential but at the cost of significantly more risks. **The lack of market and economic visibility post-Brexit calls for being prudent** and a close monitoring of sentiment, market and economic indicators in order to evaluate if any market correction should be considered as an opportunity to increase risk in equities or credit.

Chart 8: Sub-investment grade offers attractive spreads



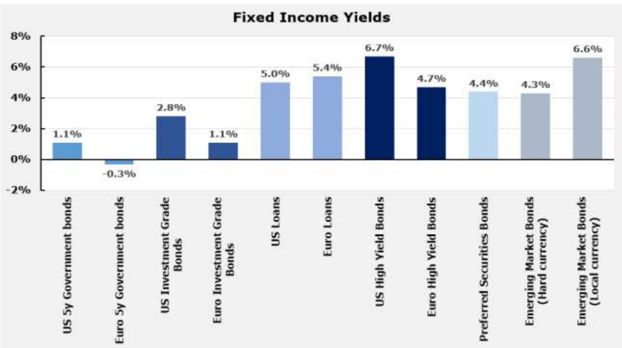
Source: Factset / Credit Suisse / BoAML / Babson Capital Management

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.** as chart 8 on the former page does well illustrate.

Expectations of still relatively low global GDP growth combined with rising US wages and commodity/energy prices puts pressure on profit margins of US companies. In this context, US but also global **equities are quite expensive with Emerging Markets** (especially Asia) **representing the cheapest valuations** with the most probability to offer acceptable returns if the global economy does not slow too much. European equities are cheaper than US equities but with the uncertainties in Europe, a certain valuation gap seems certainly to be justified. A market correction could offer an opportunity to increase our allocation to equities as the risk-reward remains not very appealing at current valuation levels. In order to better protect our portfolios from sharp drawdowns we have a preference to use equity long-short managers. This is especially true for the US market, where valuations are stretched. Same for Asia where institutional competition for investment ideas is significantly lower and allows managers to generate better (alpha) returns.

When we look at the fixed income asset class, the first thing that strikes us post-Brexit, was the shock downwards on the Developed Markets' government yield curves on safe-haven buying.

Chart 9: Fixed Income yields in comparison



Source: Marcuard Heritage / Alpinum Investment Management

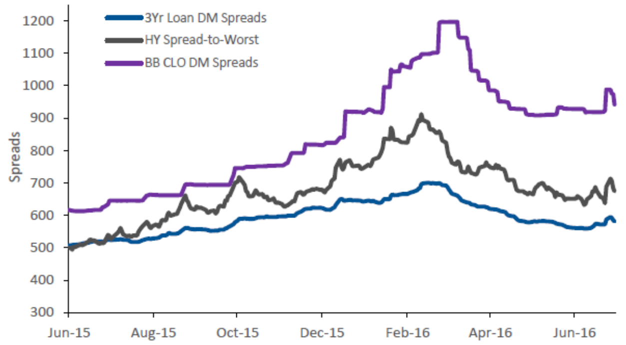
This was also justified by investors now anticipating a prolonged period of subdued inflation around the world (positive for bond prices). For some countries like Switzerland, the **yields on a government bond are negative** up to 50 years and for many others it is up to 15 years. That means that investors are expected to pay for the safety of government bonds as negative yields on cash accounts are forcing investors to make some difficult investment choices.

The low yield environment is pushing most investors, including ourselves, to look into more risky opportunities such as **corporate high yield/loan bonds or emerging market bonds** where, given our macro scenario, we feel the risk is **currently worth the reward**. As shown in chart 9, it is nowadays impossible to make any decent returns on government bonds of developed countries. Only below investment grade or emerging market bonds are offering interesting yields above 4% (gross of fees).

We still find **value in structured credit and specifically in US mortgage-backed securities** offering on average an investment-grade rating but given the bad emotions still linked to the 2008 financial crisis, there seems to be a premium yield that investors can easily collect even if these instruments are nowhere near similar to the ones that caused the US housing crisis.

After the sell-off in January/February of this year, corporate loans and high yield bonds experienced a steep rally, which took only a brief breather after the Brexit vote, but resumed its acceleration path in July. As the chart below well demonstrates, the CLO market has not moved in parallel and offers today an attractive valuation gap.

Chart 10: Comparison of BB Loan, BB CLO & High Yield bonds



Source: LCD, J.P. Morgan; CS, HCM

We also find some **value in European preferred securities and selective financial securities**. These are typically low-ranked bonds of investment grade companies which can be converted into equities (like a convertible bond) but this time at the request of the firm (often large financial institutions) if it requires more capital to comply with regulations.

Absolute Return Mandates	Comments
Equities	
▪ While keeping equities at a slightly conservative allocation with the aim of buying Emerging Markets/Asian equities once positive momentum would be confirmed. ▪ 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 upside surprises on the revenue and earnings side. ▪ Wait for an opportune time to invest or increase exposure to Emerging Market equities with a preference for Asia (ex-Japan). Marginal improvement in market sentiment and corporate sales & earning expectations should be watched closely as a trigger point. ▪ The preferred region to extract extra return from equity hedge funds is at the moment Asia.	▪ 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 limited with the lack of global growth. ▪ European equities are trading cheaper to US equities but after Brexit, this discount is clearly justified and there will be headwinds for most companies. ▪ Emerging markets equities have generally been under severe price pressure since many years now but significantly cheaper valuations should eventually provide the basis for an attractive upside potential.
Credit / Fixed Income	
▪ We avoid Developed Markets' Government bonds. ▪ Over-weight US High Yield bonds, US loans: over-weight slightly European High Yield bonds and Emerging Market debt in both US dollars and local currencies. ▪ Structured credit in general and European CLO's in particular offer attractive spread levels. ▪ We favour private loan funds investing into European and US mid-sized firms.	▪ Corporate High Yield bonds/loans are the only fixed income opportunities providing enough nominal yield at an acceptable risk level (in addition to Emerging Market bonds). ▪ 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 returns for many years to come. ▪ The materially brighter prospect for many Emerging Market countries benefitting from low US and global yields, decent global growth, a stabilization of Chinese economy, ample global liquidity and a stabilizing USD are all positive signs for bond investing in this asset class. ▪ Private loans carry a significant illiquidity premium in the order of 2% to 4% per year.
Alternatives	
▪ The funds are currently finding interesting investment opportunities into mainly the credit space where some price dislocations occurred in the market turmoil of the last months. 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 could be partly used as a trading instrument between 1300 and 1400 USD for more active investors. ▪ Real Estate still offers interesting value and a hedge against future unexpected inflation.	▪ For Gold to be fundamentally supported, we would need to see the global expectations on inflation turn positive.

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. ▪ 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 upside surprises on the revenue and earnings side while European equities will face headwinds from Brexit. ▪ Wait for an opportune time to invest or increase exposure to Emerging Market equities with a preference for Asia (ex-Japan). Marginal improvement in market sentiment and corporate sales & earning expectations should be watched closely as a trigger point.	▪ 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. ▪ European equities are trading cheaper to US equities but after Brexit, this discount is clearly justified and there will be headwinds for most companies. ▪ Emerging Markets equities have generally been under severe price pressure since many years now but significantly cheaper valuations should eventually provide the basis for an attractive upside potential.
Credit / Fixed Income	
▪ We avoid Developed Markets' government bonds. ▪ Only consider investing into "BBB/BBB-"investment grade corporate bonds in USD taking some medium-term maturity. ▪ Mortgage-back securities in the US are offering attractive yields over any government. Structured credit in general and European CLO's in particular offer attractive spread levels. ▪ Over-weight US High Yield bonds, US loans: over-weight slightly European High Yield bonds and Emerging Market debt in both US dollars and local currencies. ▪ We favour private debt 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 returns for many years to come. ▪ 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 structured which caused the financial crisis of 2008. ▪ While less liquid on the trading side, European CLO's offer at current valuations very attractive yields (6-9%), while default rates remain low in a historical perspective. ▪ The materially brighter prospect for many Emerging Market countries benefitting from low US and global yields, decent global growth, a stabilization of Chinese economy, ample global liquidity and a stabilizing USD are all positive signs for bond investing in this asset class. ▪ Private loans carry a significant illiquidity premium in the order of 2% to 4% per year.
Commodities / Forex	
▪ Gold could be partly used as a trading instrument between 1300 and 1400 USD for more active investors. ▪ Oil should consolidate in the next few months between 40 to 50 USD.	▪ For Gold to be fundamentally supported, we would need to see the global expectations on inflation turn positive. ▪ The production of many shale oil producers (mainly in the US) would start again if oil price trades above 50 USD. This would lead to higher supply and lower prices in the end.

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	Negative	☐	☑ ←	☐	☐	☐
China	Cheap	Stable	Neutral	☐	☐	☐	☑	☐
Japan	Rich	Worsening	Negative	☐	☑ ←	☐	☐	☐
Asia - Emerging Markets	Cheap	Stable	Neutral	☐	☐	☑	☐	☐
Others - Emerging Markets	Fair	Worsening	Neutral	☐	☐ →	☑	☐	☐

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	Positive	☐	☐ →	☑	☐	☐

Hedge Fund: Strategies	HF Strategy Momentum	Equity Index Momentum	Sector Dispersion	Underweight	←	Conviction Level over 6 Months Neutral	→	Overweight
Equity Long-Short	Neutral	Neutral	Positive	☐	☐	☐ →	☑	☐
Credit Long-Short	Neutral	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	Conviction Level over 6 Months: Underweight		Neutral		Overweight
North America	Rich	Stable	Neutral	☐	☐	☑	☐	☐
Europe	Rich	Stable	Negative	☐	☐	☑ ←	☐	☐
China	Cheap	Stable	Neutral	☐	☐	☐	☑	☐
Japan	Rich	Worsening	Negative	☐	☑ ←	☐	☐	☐
Asia - Emerging Markets	Cheap	Stable	Neutral	☐	☐	☐	→ ☑	☐
Others - Emerging Markets	Fair	Worsening	Neutral	☐	☐	☑	☐	☐

Fixed Income	Central Banks Policy	Credit Spreads	Inflation	Conviction Level over 6 Months: Underweight		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	Fair	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	Conviction Level over 6 Months: Underweight		Neutral		Overweight
Gold	Neutral	Positive	Positive	☐	☐	→ ☑	☐	☐
Oil	Neutral	Positive	Positive	☐	☐	☑ ←	☐	☐

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