HOVING
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WEALTH MANAGEMENT

QUARTERLY INVESTMENT VIEW

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Summary

It has been very easy to be negative this year given the constant bombardment of bad news. But important economic indicators in the U.S. and the relative strength of the U.S. and Asian stock markets are telling us that pessimism is not going to pay off. Even in Europe and despite the immigration and political turmoil, there are indications that the economies of the union are slowly getting back on their feet.

Protective assets posted stellar returns over the first half of 2016 as a whole, with Gold returning 24.4% and 30-year U.S. and German bonds returning 16.3% and 29.6%, respectively.

Protective and U.S. focused strategies are very crowded, making them expensive by historic measures.

In comparison, stock markets globally are not doing much for the year, with the exception of Brazil which is up by 60% in US$ (+56% in EUR).

The rally in the stock markets over the past few weeks - after the Brexit accident – has continued and broadened; the S&P500 index is making all-time highs, volatility has been falling and bonds and other safe haven strategies have started to sell-off. Cyclical stocks such as mining and steel manufacturers have outperformed defensive stocks.

Monetary stimulus by central banks globally, with the exception of the U.S. Fed which has stopped QE, has never been higher since 2009. The marginal impact of these monetary measures has become less significant, however. The opposition to negative interest rates is also growing.

Monetary policies are expected to be gradually replaced by **fiscal stimulus**. This would imply a slow return to higher bond yields. A dramatic sell-off of fixed income assets and other safe haven assets can be expected at some time in the near future.

By re-introducing fiscal stimulus, the classic Keynesian measure, governments would focus less on debt reduction or austerity, but more on growth. Infrastructure projects and generally the construction sector would benefit from this shift.

Although equities are generally expensive and earnings growth has been poor, we cannot ignore the fact that the most watched equity index in the world, the **S&P500**, has broken out to the upside of a two-year consolidation. Meanwhile many emerging markets are showing similar trends and so are a number of small capitalization stocks. This technical picture suggests an upside for the S&P500 index of 10-15% from current levels in the next twelve months.

Such an outcome is supported by some excellent economic data in the U.S. as recent strong employment numbers showed. It is worth monitoring however slowing consumer income growth, declining U.S. productivity and tightening lending standards at banks.

But the U.S. stock markets have mostly been driven by money leaving a disappointing Europe and very low

borrowing costs. Fundamentally, the U.S. stock market is expensive considering low head line sales and earnings growth of most U.S. companies. The U.S. labor market is practically at full capacity, even the participation rate has been growing. There are some signs of wage pressures returning. And will the Fed act regarding interest rates this year?

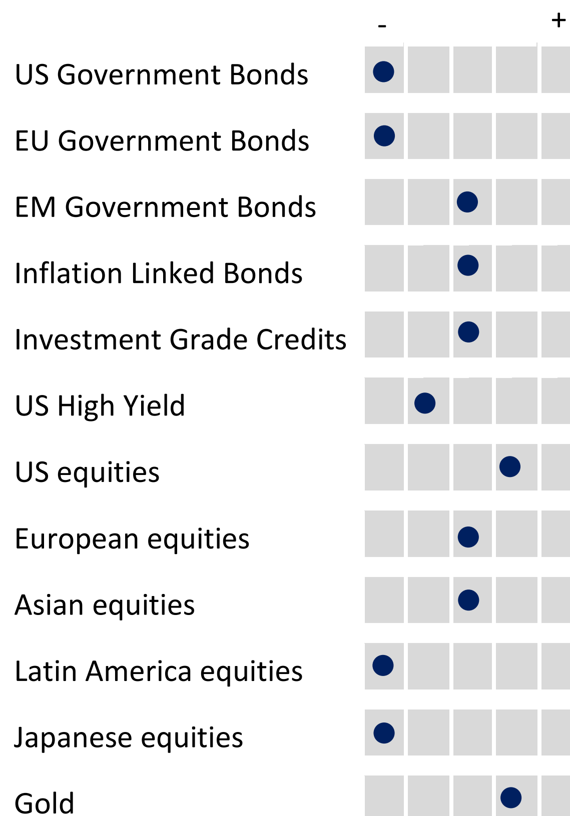
The 2nd half this year will see the outcome of three interesting and **important events**:

1) In November we will know who will lead the Western world as President of the United States.
2) By the end of the year we will know if the Fed sees sufficient reasons for raising rates. After a long spell, this first step should hopefully lead to normalization of Central bank's monetary policies.
3) We may know the outcome of the Brexit talks between Britain and the union leadership. The union leadership should drop its hawkish stand avoiding further damage to Europe.

The impact of the Fed on stock markets should be muted as basically an interest raise is good news for the economy. And the level of interest is still extremely low.

One famous investment manager once said you must "manage money for the environment that you are in, not the one you wish you were in". Consequently, **we are raising our equity levels back to neutral benefitting from secular growth themes and we hedge this by increasing exposure to precious metals and Cash in USD.**

2. Asset Allocation



1. Invest in sectors and companies benefitting from strong secular trends such as digital payment processing, e-commerce, connectivity, cost saving software solutions and security;
2. Invest in high quality companies in Germany, Switzerland and the U.S. with growing dividends;
3. Invest in selected emerging economies such as India, currently having the highest potential for growth;
4. The energy sector is starting to look attractive with oil supply growth slowing and demand stabilizing, we favor a global energy tracker;
5. US longer dated investment grade Credits should give capital protection, in case the Fed hikes interest rates to counter potential inflation;

6. With the exception of Inflation linked Treasury Bonds, US Treasuries are to be avoided in the shorter dated maturities;
7. European government bonds are to be avoided. Spreads between peripheral bonds and Bunds may move up if and when Greece returns to the agenda;
8. The global high yield index approaches all-time highs, we take some profit as it will be vulnerable in periods of risk-off;
9. Physical Gold and gold miners should give capital protection against negative interest rates and currency devaluations.

3. Political and economic risks

The failed coup to topple an elected government in **Turkey**, a NATO ally, shows the great political instability of a country that still officially seeks membership of the union. But President Recep Erdogan's pursuit of the army leadership does not bode well for Turkey's own security and also threatens Turkey's role as a bulwark against the chaos of its Middle Eastern neighbors.

Brexit has increased uncertainty in Europe. The growth outlook in Europe most likely should not derail but it will be undermined. This is a UK and a European crisis not a global one, but it could turn into a major one if the survival of the euro as a single currency is put in doubt.

Brexit shows that further **fragmentation** of Europe is no longer theory. Fragmentation would also impact the euro (see "Stiglitz" on page 4). The Netherlands and France vote for new governments in 2017. Italy and Austria will be the next test grounds (2016) and the US Presidential elections in November this year also pose concern with Donald Trump drawing on anti-establishment sentiments. Germany a solid supporter of the union also votes for a new government in 2017. Frau Angela Merkel Federal Chancellor since 2005 has decided to present herself for a fourth term.

The **UK economy** will be hurt by Brexit as capital expenditure decisions will be delayed or scrapped. UK growth could take a hit of 1.2%. **European growth** prospects have been cut from 1.8% to 1.5%. Much will depend on the outcome of negotiations. The **current account of the UK** has been in deficit for the last fifteen years reaching a deficit of 6.9% of domestic GDP in the 1st Q 2016. The deficit explains the fundamental weakness of the Pound Sterling.

Growth of the US economy will hardly be affected by Brexit and is expected to hold up, also because the demographics are better.

The results of the **EBA stress tests** of 53 European banks and financial institutions were published on 29 July 2016. The EBA tests are designed to measure the banking system's resilience to "adverse economic shocks". The results single out the usual suspects (Italian banks). However, Ireland's banks found themselves in the line of fire again and German banks accounted for 4 of the 10 deemed to be the worst affected.

The stress test did show the global financial improvement of European banks. The core equity tier 1 ratio stood at 13.2 per cent on average at the end of 2015, up from 11.1 per cent at the end of 2013. A European Banking Union would greatly enhance this sense of security. Nevertheless, since the stress test was published, European banking stocks suffered strong declines lead by persistent concerns about negative interest rates and the outlook for Italy's troubled lenders.

Long term, one of the **biggest risks to our financial system** is the huge amount of global sovereign debt and the large share

that Central banks have taken holding this debt, Japan being the worst offender to date (BoJ holds two thirds of the outstanding government debt), but the UK will soon join. Since 2008, public and private debt has increased by more than $60tn to more than $200tn which is equivalent to about 300% of global gross domestic product. **Debt is growing faster than economic growth.** If we assume average interest rates at 2%, the global economy needs to grow at nominally 6% to be able to cover the interest charges. Today this is not the case. QE did not stimulate enough demand, growth and inflation; it has very much increased debt levels.

To **cure the sovereign debt problem**, the only real alternative is debt forgiveness or debt cancellation. The Central bank cancels the sovereign debt it has acquired, thus reducing not only the sovereign debt outstanding but also the annual interest bill. This is a metaphor for the government borrowing from the Central bank and never paying back (perpetual bonds). In this concept, private and institutional sovereign bond holders should be protected against debt cancellation.

4. Can the euro be saved?

Joseph E. Stiglitz, the eminent economist and Nobel laureate, describes in his new book “The Euro; How a Common Currency Threatens the Future of Europe”, that the euro was a tragic mistake, a currency without the necessary political integration and fundamentally flawed. He blames the euro for Europe’s economic trauma. A lot of people pushing for the euro were not economists but politicians.

For the euro to work, the general belief was that the countries had to converge (convergence criteria). One of the most important criteria was to keep their deficits and debts relative to GDP down (austerity). After the financial crisis, the leaders of the union applied more austerity. The austerity amplified the structural deficiencies and the result was that the member states diverged.

In the best-case scenario the euro is reformed in time, otherwise it is better to scrap it as a waste of time. **Reforms** should include:

- A banking union with deposit insurance
- The introduction of euro bonds
- An ECB with two mandates: inflation and full employment
- Eliminate the 3 per cent deficit limits

The muddling through cannot continue. The likelihood that another country will hold a referendum, and an exit will occur, is high.

5. The Fed, when will it act?

The Fed has been sending mixed signals this year. It forecasted raising rates at least twice in 2016, before withdrawing and announcing no changes. Under the leadership of Janet Yellen, the Chairwoman, the Fed takes external factors more into account than Ben Bernanke, her predecessor. Last year it was China’s economic downturn and this year it is the unknown consequences of Brexit.

At one stage, the U.S. economy will enter a recessionary period (we are now 7 years into expansion) and at that moment, the Fed must have tools to fight a potential down-cycle. If interest rates remain at current (too) low levels, one of the most effective tools would not be around.

In the U.S., improved housing prices and low unemployment have caused **a boom in consumer loan demand** (through credit

cards and bank overdrafts). New consumer loans reached $54bn in 2015. While credit cards are unsecured, American banks are attracted by hefty returns (average interest on debit balances of 12-14 per cent). Bank margins (median of 3.45 per cent) remain under pressure and the lending binge has helped improving U.S. bank revenues. Car loans have also boomed with average loans topping $30'000 but the debt taking much longer to pay off (average six years). Delinquency levels of sub-prime loans, the fastest growing part of the market, are growing.

Now that the U.S. economy seems close to the **peak in the cycle**, the soaring lending numbers may cause stress in a downturn. A house built on falling cards; déjà vu?

We believe the Fed will probably act and raise rates in December this year.

The Investment Committee

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Market Returns

Equity	Q1 2016	Q2 2016
MSCI AC World Daily TR Net	-1.5%	1.2%
MSCI North America NR	1.3%	2.5%
MSCI EUROPE NR	-7.1%	-0.2%
NIKKEI Net Return	-11.4%	-6.9%
MSCI EM NR	5.7%	0.7%
SHANGHAI SE COMPOSITE	-15.1%	-2.5%
Bonds		
US Treasury	3.2%	2.1%
Eurozone Sov	3.3%	1.9%
Germany Sov	3.8%	2.3%
USD EM Sov	5.8%	4.9%
Loc EM Sov	4.6%	-0.5%
USD HY Corp	3.7%	5.7%
EUR HY Corp	1.9%	1.5%
Commodities		
ROGERS COMMODITY INDEX	-0.3%	13.0%
GOLD SPOT $/OZ	16.1%	7.3%
Currencies		
USD - EUR X-RATE	-4.6%	2.5%
CHF - EUR X-RATE	-0.5%	1.0%
GBP - EUR X-RATE	-7.0%	-5.0%
JPY - EUR X-RATE	1.9%	11.8%
NOK - EUR X-RATE	2.0%	1.2%
AUD - EUR X-RATE	0.3%	-0.3%

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